HIGHLIGHTS from Chapter 4:
Fiscal Challenges in Small States: Weathering Storms, Rebuilding Resilience

Key Points

- *Fiscal positions have deteriorated markedly in emerging market and developing economy (EMDE) small states over the past decade. Forty percent of the 35 EMDE small states are at high risk of or already experiencing debt distress, roughly twice the share for other EMDEs.*
- *Natural disasters and global recessions weaken small states' fiscal and debt positions, even more than in other EMDEs. Since the pandemic, debt has been driven up by fiscal deficits, as well as significant economic contractions, and slow recoveries.*
- *A variety of reforms are needed to rebuild buffers and strengthen fiscal resilience. Notably, rules-based fiscal frameworks can be implemented more widely to better manage volatility, complemented by policies to increase reliance on efficient taxes and repurpose already high spending. Support from the international community is critical to bolstering resilience against climate-change-related natural disasters in these economies.*

Small states' fiscal vulnerabilities. Small states face significant fiscal challenges arising from common vulnerabilities. Many of them are tropical islands, and highly exposed to costly natural disasters, particularly storms and other weather-related events that have become more frequent with climate change (figure 1.A). Additionally, their high economic openness and narrow export bases expose them to adverse external developments, notably global recessions. As a result, natural disasters and global recessions weaken small states' fiscal and debt positions, even more than in other EMDEs. These challenges are further exacerbated by highly volatile revenues and large spending needs, including to invest in climate-change-resilience.

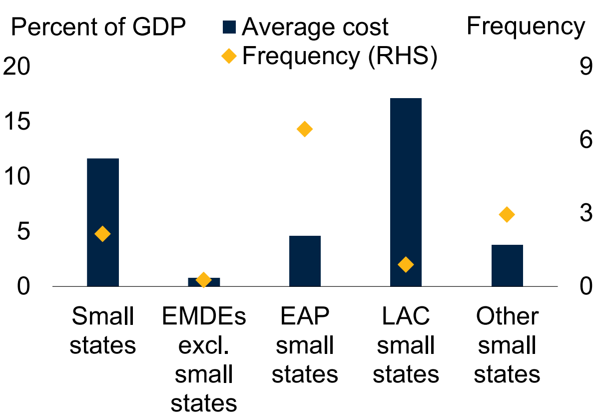
Small states' fiscal positions have deteriorated over the past decade. Between 2011 and 2023, average government debt in small states increased by about 11 percentage points of GDP, with the average debt-to-GDP ratio standing at 61 percent in 2023, higher than in other EMDEs. Prior to the pandemic, rising debt levels in small states partly reflected persistent primary fiscal deficits. Since the pandemic, debt levels have been driven up by larger deficits, as well as significant economic contractions, and slow recoveries. In 2020-23, primary fiscal balances were weaker than their pre-pandemic average in three-quarters of small states (figure 1.B). Forty percent of the 35 EMDE small states are at high risk of or already experiencing debt distress (figure 1.C).

Comprehensive fiscal reforms are necessary. The experience of the pandemic highlights small states' vulnerabilities to large shocks and their related fiscal challenges. Small states' fiscal frameworks should, therefore, be even more resilient than those of other EMDEs. A well-designed, flexible, but enforceable rules-based fiscal framework with ample buffers can provide a better response to external shocks and manage volatility (figure 1.D). These can be complemented by reforms to make better use of already high spending, and enhance revenue mobilization, particularly through greater reliance on efficient taxes. The international community has important roles to play in supporting small states in all these areas, particularly in bolstering resilience against larger and more frequent climate-change-related natural disasters.

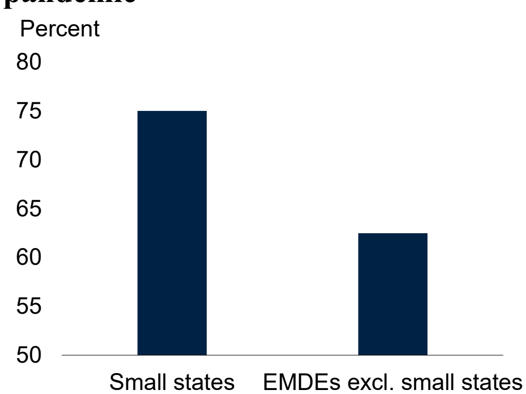
Figure 1. Fiscal Challenges in Small States: Weather Storms, Rebuilding Resilience

The COVID-19 pandemic, the global shocks that followed, and costly natural disasters have worsened budgetary and debt positions in small states, intensifying their already substantial fiscal challenges. Since the pandemic about three-quarters of small states have had primary balances weaker than the pre-pandemic average. Forty percent of small states are at high risk of debt distress or already in it, roughly twice the share for other EMDEs. To improve their fiscal sustainability and resilience to future shocks, notably from large climate-change-related natural disasters, small states need to strike a balance between maintaining adequate fiscal buffers and increasing investments in climate-change-resilient infrastructure and other priority areas. Comprehensive reforms are essential, including expanding well-designed, and flexible but enforceable rules based fiscal frameworks.

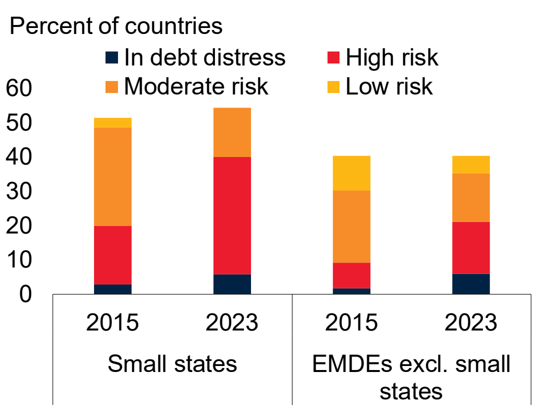
A. Average cost and frequency of natural disasters



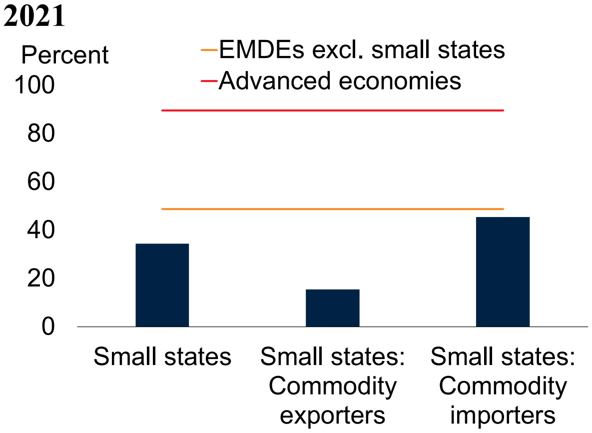
B. Shares of EMDEs with weaker primary balances in 2020-23 than before the pandemic



C. Risk of debt distress



D. Share of economies with fiscal rules, 2021



Sources: Davoodi et al. (2022); EM-DAT (database); WEO (database); World Bank.
Notes: EMDEs = emerging market and developing economies; EAP = East Asia and Pacific; LAC = Latin America and the Caribbean.
A. Frequency is the average number of natural disasters per year, adjusted by land mass. Unit of frequency is the number of natural disasters per year per one hundred thousand square kilometers. Average cost of natural disasters per year as percent of

GDP for 24 small states and 93 other EMDEs. EAP small states include 8 economies, LAC small states include 11 economies, and other small states include 5 economies. Natural disasters include droughts, storms, floods, extreme temperatures, earthquakes, volcanic activity, and wildfires. Sample period from 2000-22.
B. Bars show the percent of countries with weaker primary balances as a share of GDP in 2020-23 than the average for the period 2015-19. Sample includes 32 small states and 110 other EMDEs.
C. Shares of small states and other EMDEs in overall debt distress or at risk of debt distress, based on the published Joint World Bank-IMF Debt Sustainability Framework for Low Income Countries (LIC-DSF) as of March 30, 2024.
D. Percent of economies that have fiscal rules as of 2021.