

Trends and Challenges Facing the Public Finance Sector: Insights from the Least Developed Countries

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Abstract--- Sections of underdeveloped countries, which constitute the least developed countries (LDCs), have been characterized by a relatively weak economic growth outlook. This outcome offers a critical backdrop for the public finance challenges that continue to face the regions. According to Buttiglione, Lane, LDCs exhibit the lowest levels of socio-economic development indicator.

Keywords--- Volatility and the Declining, LDCs, Trends and Challenges, Developed Countries.

I. INTRODUCTION

SECTIONS of underdeveloped countries, which constitute the least developed countries (LDCs), have been characterized by a relatively weak economic growth outlook. This outcome offers a critical backdrop for the public finance challenges that continue to face the regions (Baffles, Ohnsorge and Stocker, 2015). According to Buttiglione, Lane, Reichlin and Reinhart (2014), LDCs exhibit the lowest levels of socio-economic development indicator. Some of the countries that fall in this category include Madagascar, Guinea, Equatorial Guinea, Liberia, Gambia, Lesotho, Ethiopia, Angola, Somalia and Uganda in Africa. Others include Afghanistan, Bangladesh, Yemen, Cambodia and Nepal in Asia, Haiti in the Caribbean zone and Kiribati, Tuvalu and the Solomon Islands in Australia and the Pacific (Carrère and de Melo, 2009). The aim of this study is to examine some of the challenges that continue to face the public finance sector of LDCs, gaining insights from a secondary research perspective.

II. CHALLENGES FACING THE PUBLIC FINANCE SECTOR IN LDCS

Exposure to External Debts

The vulnerability to shocks among LDCs has been aggravated by their high level of exposure to external debts. Since 2009, flows in the search-for-yield have been high. Similarly, bond-fund allocations from the developed regions to LDCs have nearly quadrupled, with equity-fund allocations expanding significantly (International Organization of Securities Commissions, 2014). One of the issues arising from this scenario is that the search-for-yield inflows exacerbate existing fragilities while introducing new

fragilities. The eventuality is that the affected zones face unsustainable financial feedback loops. In turn, the latter produces short-term growth but puts pressure on the LDC's currencies. The exposure to external debts has also interfered with local monetary policies and credit cycles, besides producing shadow-banking risks, distorting asset prices and prompting structural reforms about incentive provision (Rajan, 2013). External-debt sustainability has also been affected adversely by the exposure to external debts, attributed to the rapidly strengthening U.S. dollar, yet a majority of external debts continue to be denominated in foreign currencies (Turner, 2014).

The exposure has also led to the spillover of vulnerabilities in the LDCs' public finance sectors. The criticality of this outcome is that an increase in the interest rate implies that other markets may be affected, including funding costs and asset prices. Lastly, less developed financial frameworks such as the lack of surveillance and supervisory capacities, lack of strong institutions, prudential tools, technical experience, and shallow local financial markets compound the LDCs' fragility in public finance (Baffles, Ohnsorge and Stocker, 2015).

Increasing Oil-Price Volatility and the Declining Price

In LDCs, most of the economic activities are shaped by dynamism in the oil industry. The summer of 2014 saw oil prices drop to about \$50 a barrel (at the start of 2015), declining sharply from the previous price that had been set at \$100 a barrel (Buttiglione, Lane, Reichlin and Reinhart (2014). This adjustment led to a significant shift in wealth from the exporters to the importers of oil, extending to about \$750 billion per year. On one hand, the persistence in low oil prices prompts a boost in consumption and investment among the net importers. The outcome is also attributed to the process through which lower inflations offer policy spaces to

central banks – because of improvements in the income positions and balance sheets. However, a reversed case characterizes the part of oil exporters (Carrère and de Melo, 2009). Dilemma in the public finance sector of exporting groups arises from price volatility, as the force leads to a significant erosion of debt sustainability. Dilemma arises further from vulnerability differences in the LDCs’ strength of domestic markets and banks, overall public debt positions, types of exposure to foreign creditors, exchange-rate regimes and the nature of external accounts (Culpeper, 2010).

Global Rebalancing: Disrupted Growth Prospects and Global Financing Patterns

Before 2008, current-account imbalances were witnessed. The imbalances arose from investment dynamics and distortions in the global savings. The resultant implication was that the imbalances triggered financing patterns that were unsustainable on the cross-border levels (Di John, 2008). After the crisis, deficit countries such as LDCs have been exposed to demand compression. A long-term adversity saw the current-account imbalances contribute to a weakening growth outlook and performance, rising trade tensions and slowing global trade, rising unemployment, and a falling inflation (Rajan, 2013). As such, LDCs have experienced a disinflationary pressure. Additionally, the growth in global stock imbalances have led to high external financial vulnerabilities among the LDCs; weakening their currencies

while widening the surpluses.

High Global Debt Levels

A rise in the total debt among LDCs has led to debt-overhang effects. The latter pose adversities on various economic incentives and behaviors. The eventuality is that a feedback loop is produced, with debt-sustainability concerns creating deflationary pressures while undermining the nominal economic growth. Overall, high levels of the global debt have been challenging to the public finance sectors of LDCs because of the tensions that arise regarding debt sustainability (Turner, 2014).

Continuing Idiosyncratic and Geopolitical Risks

This attribute is particularly felt when conflict-stricken areas are relied upon by the LDCs. For instance, the Russian-Ukraine crisis and turmoil in the Middle East form crucial drivers responsible for geopolitical volatility. The eventuality is that the volatility causes regional spillovers while disrupting the global energy market. This effect trickles down to a majority of the highly-dependent LDCs in such a way that the affected countries’ public finance sectors are forced to adjust issues such as asset pricing; attributed to adversities that result from geopolitical conflicts in the oil-producing and distributing regions (Rajan, 2013). The following figure presents a summary of these outcomes.

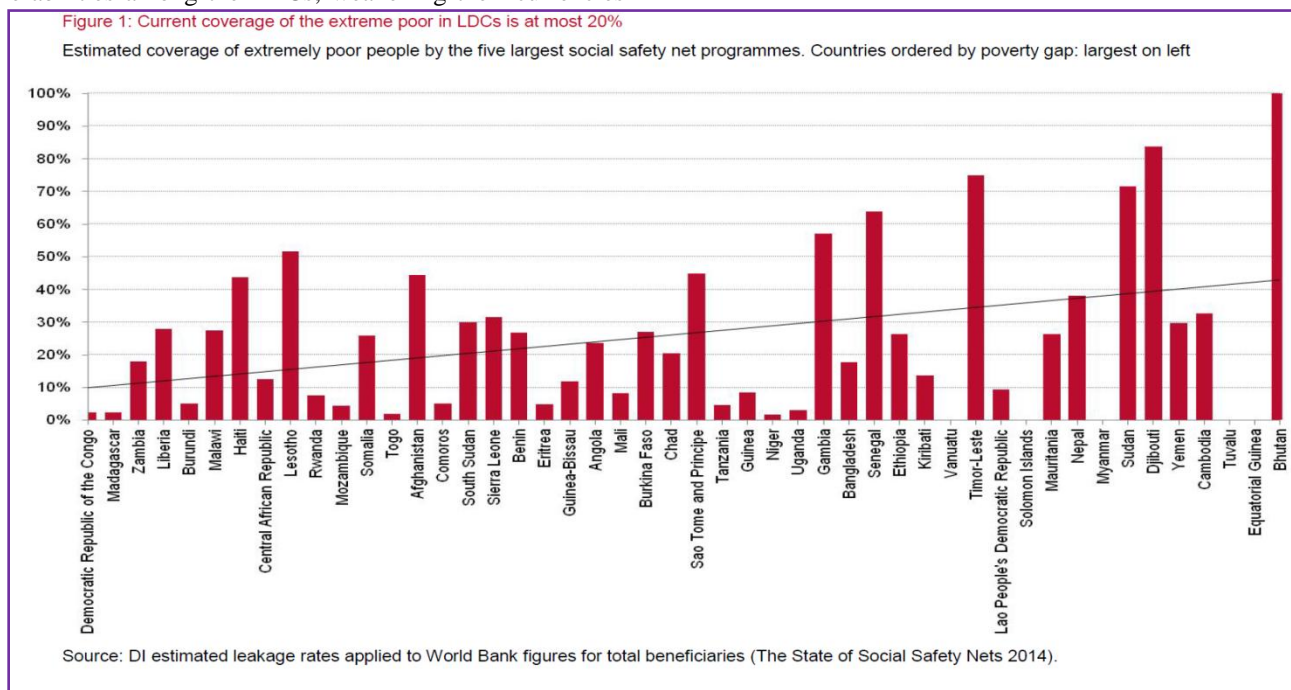


Figure 1 - A Reflection of Public Finance Dilemma in LDCs

III. GOVERNMENT INTERVENTIONS TO STREAMLINE THE PUBLIC FINANCE SECTOR OF LDCs

In LDCs, the public finance sector is depicted as that which faces numerous challenges in fostering structural transformation and sustainable growth. From the analysis in

the preceding section, this study advocates for a paradigm shift towards a more inclusive and new development path that relies on the promotion of production capacities. The State’s strengthened developmental role is identified as an ideal approach towards better outcome provision in the affected regions.

Promotion of Domestic Financial Resource Mobilization

There is a need to greatly mobilize domestic financial resources. This action is projected to reduce the LDCs' dependence on aid. Given that the official development assistance and the quantity of LDC programmable aid is high, it is critical for the countries' public finance sectors and other relevant authorities (such as the finance ministries) to establish real democratic foundations and build capacity by increasing revenue generation. Indeed, an improvement in tax and savings mobilization is likely to yield desirable outcomes.

It is also imperative to note that the concept of capacity-building towards the mobilization of taxes could be achieved by engaging international organizations and donor agencies in building effective and competent tax administrations. Whereas the organizations have offered capacity-building support and technical assistance, they can improve on this trend by offering equipment and training. However, the act of tax mobilization should be aligned to the prevailing level of development among the targeted populations.

The concept of tax and financial cooperation is also critical to the affected LDC public finance sectors. Through cooperation, the issue of illegal capital outflow is likely to be addressed. Indeed, greater tax and financial cooperation is likely to staunch capital flight while striving to minimize tax-related dilemma in the public finance operations. Similarly, financial deepening is likely to strengthen the public finance sector by allocating savings to the commercially viable initiatives. To achieve a more dynamic and active financial sector in the LDCs, international and donor agencies may establish credit reference bureaus. In turn, this step could facilitate transactions through the reduction of information asymmetry that lenders continue to face. Furthermore, there is a need for the majority of donor countries to offer business and credit advice to the small and medium sized enterprises (SMEs) in LDCs, leading to the maintenance of development financing institutions.

Innovation in Public Finance

According to Culpeper (2010), the next decade will see LDCs face extraordinary challenges, attributed to projections regarding inadequate financial resources. Therefore, situations where national aid budgets are not adjusted upwards attract innovative and new sources of financing. Some of the innovations that the public finance sector in LDCs could embrace towards stability include redistributions of special drawing rights (SDRs) and enhancements of country ownership of developmental strategies at the national level.

According to Baffles, Ohnsorge and Stocker (2015), situations where countries assume the ownership of developmental strategies constitute cornerstones of designing and implementation long-term solutions to the public finance dilemma. By enhancing country ownership of the strategies, LDCs are likely to portray a foundation from which aspirations and conditions in the local context might be aligned to the formulation and implementation process.

However, situations where LDCs require official debt relief and, continue to exhibit chronic aid dependence have led to the tension between the desire of international financial institutions (IFIs) and the promotion of country ownership. To curb this tension, inequalities between the parties could be addressed by increasing resource mobilization regarding domestic financial resources.

Another strategy through which country ownership could be fostered includes the examination of the meaning of country ownership through transitional, transactional and transformative leadership that translates national development plans into results-oriented initiatives. The effectiveness in public finance leadership among LDCs could also be achieved by taking the lead in aid coordination while aligning the operations to other development resources while embracing dialogue with donors to attract participations of the private sector and the civil society. Another approach involves reforming and reducing policy conditionality while strengthening the role of sub-regional and regional development banks. Additionally, there is a need to rebuild state capacities while strengthening and introducing aid management policies. In so doing, it is projected that a responsible public finance sector might be realized in the LDCs.

Innovation in Aid Utilization and Promotion of Productive Capacity Development

LDCs face a significant problem regarding the low proportion of aid that they allocate to the production sector and economic infrastructure (Buttiglione, Lane, Reichlin and Reinhart, 2014). This affirmation points to the criticality of investing in education, as well as the related social sectors. However, a lacking complementary investment has crippled the plan of reducing poverty. One of the strategies that could ameliorate this dilemma is that which might foster the catalytic utilization of donor aid for purposes of developing the finance sector. Carrère and de Melo (2009) documented that a commercially bankable atmosphere is lacking in most of the LDCs because of problems of weak infrastructure, poor business support services, and risk. Therefore, there is a need for the public finance groups to establish more creative plans for offering direct support to the economic development practice. Furthermore, public-private partnerships could be supported in a quest to embrace an investment in the LDCs' infrastructures. This recommendation is informed by the scale of the wanting infrastructural development. By involving the private sector to participate in streamlining the issues faced, it is projected that a desirable level of stability might be witnessed. Specific actions could entail providing several concrete proposals and mitigating risks for foreign investors; especially those that stall infrastructural development.

Compensatory Financing for Shocks and Debt Relief

The latter half of the 2000s saw a majority of LDCs experience financial, food and fuel crises (Di John, 2008). This trend indicates the need for the LDCs' anti-shock financing facilities. Whereas international funding institutions

responded to the global crisis after 2008 (through increased emergency financing), weaknesses continue to characterize the shock-financing architecture. Therefore, new compensating mechanisms should be driven by a sufficient speed of disbursement, examining proportionality between the amount disbursed and the needs of LDCs, addressing the concept of conditionality, embracing graft funding, and, measuring and monitoring shocks precisely.

Regarding the issue of debt relief, the year 2010 witnessed 14 LDCs remain at high risk of debt distress while others were at moderate-to-high risk. Therefore, persistence of debt overhangs in about half of LDCs suggests that extended eligibility could be achieved by fostering participation the multilateral creditors' participation. Lastly, there is a need to conduct reviews of the requirements about minimum concessionality among countries that are eligible to borrow. This aspect of flexibility is likely to reduce regulate the conditions for borrowing. The following section focuses on the analysis of data outcomes as depicted in graphical presentations. It is projected that the outcome will give insight into probable actions that public finance sectors could adopt towards better outcome provision.

IV. DATA ANALYSIS

The study utilizes a descriptive statistics approach while seeking to analyze data from secondary sources, constituting a content analysis technique. Research outcomes regarding the challenges facing public finance sectors of LDCs are summarized in figures as follows:

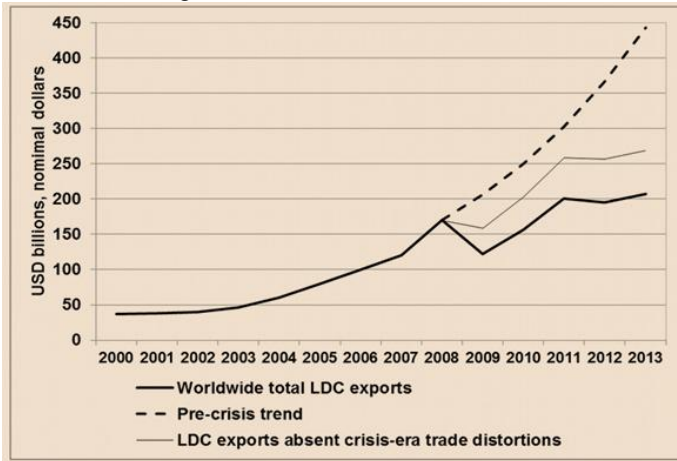


Figure 2 - Trade Distortions Reduced Total LDC Export Growth by 5.5% Per Annum

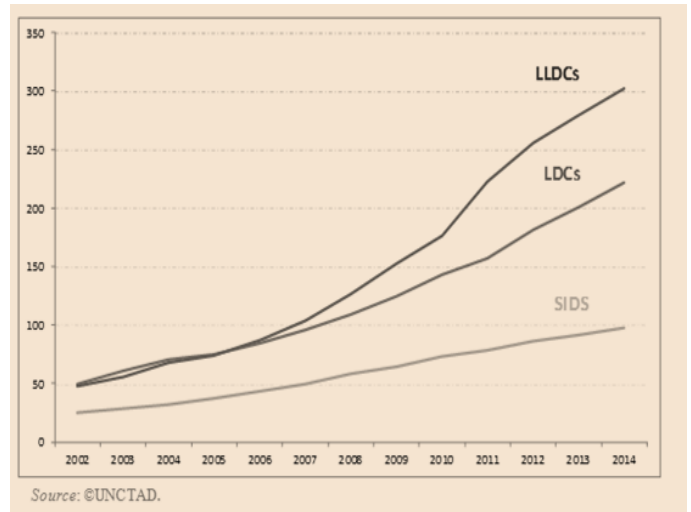
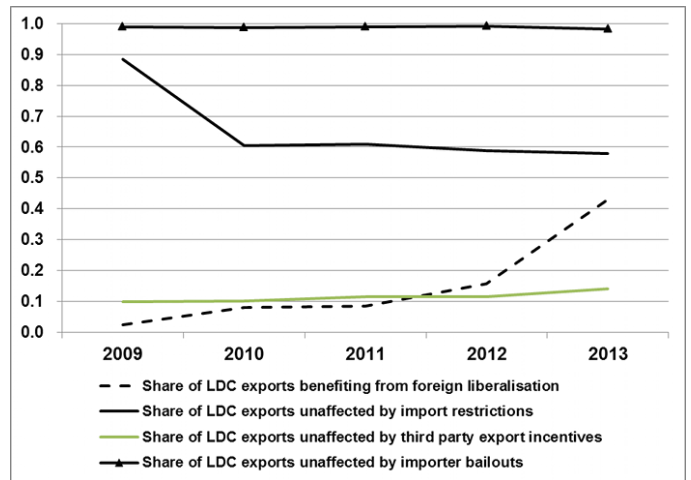
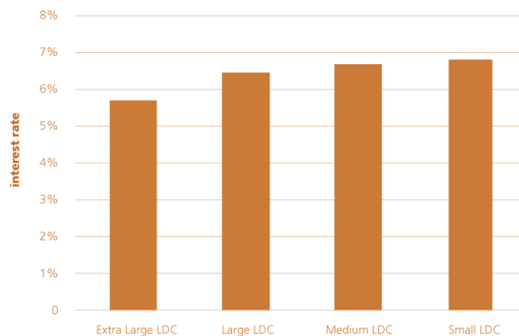
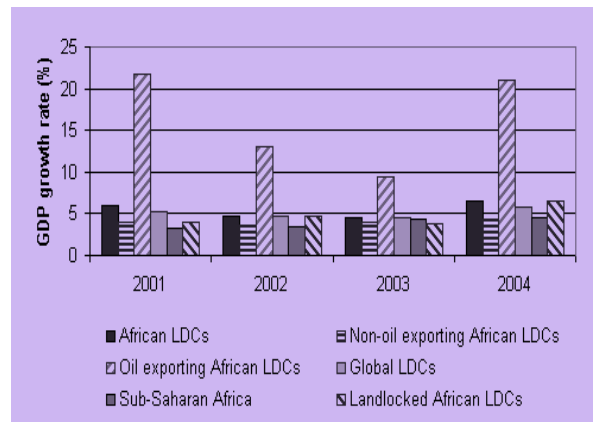
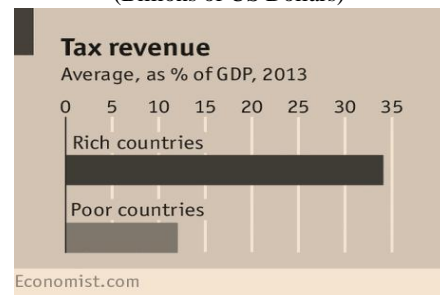


Figure 3 - FDI Inward Stock in LDCs, LLDCs and SIDS, 2002-2014 (Billions of US Dollars)



Applying a *t*-test on the data received from the final figure gives the results as follows:

- \bar{X} — mean of the sample
- n — size of the sample
- $\hat{\sigma}$ — standard deviation.
- $\hat{\sigma}/\sqrt{n}$ — *t*-test, based on the standard deviation.
- Mean=42/4=10.50

In this case, 42 represent the total number of LDC categories, multiplied by the number years rated while 4 represents the number of years in which the variables were tested.

$\hat{\sigma}/\sqrt{n}$ — *t*-test, which is based on the standard deviation

Standard Deviation formula:

$$\sigma = \sqrt{\frac{1}{N} \sum_{i=1}^N (x_i - \mu)^2}$$

X_i : Individual values for LDCs rated to be at high risk of debt distress

In debt distress: 14 LDCs

At high risk: 6 LDCs

At moderate risk: 5 LDCs

Standard deviation= $\sqrt{[1/42((14 - 10.5)^2 + (6 - 10.5)^2 + (5 - 10.5)^2 + (12.25 + 20.15 + 22.56 + 30.25))]}$

Standard deviation = $\sqrt{[1/42(12.25+20.15+22.56+30.25)]}$

Standard deviation = $\sqrt{(1/42*65.06)}$

Standard deviation = $\sqrt{1.5490} = 1.2446$

t-value = $\hat{\sigma}/\sqrt{n}$

t-value = $1.2446 \div \sqrt{42} = 1.2446 \div 6.4807 = 0.19$

Taking $P=0.01$, the difference between 0.19 and 0.01 is 0.18. This value, compared to the level of significance, rates at 94.74 percent. The implication is that inferences from the data obtained in the project are highly significant. This finding correlates to the existing literature in which LDCs are perceived to face significant challenges, with their public finance sectors on focus.

V. CONCLUSION AND RECOMMENDATIONS

In conclusion, this paper has examined some of the challenges facing public sectors in LDCs and the potential interventions that could be adopted to ameliorate the challenges. Findings indicate that the public finance sector in LDCs faces challenges such as Continuing idiosyncratic and geopolitical risks, high global debt levels, global rebalancing that disrupts growth prospects and global financing patterns, increasing oil-price volatility and the declining price, exposure to external debts, and extraordinary and prolonged monetary policies. To curb these challenges, some of the interventions that the study identifies include the compensatory financing for shocks and debt relief, innovation

in aid utilization and promotion of productive capacity development, innovation in public finance, and the promotion of domestic financial resource mobilization. In so doing, it is projected that both the short-term and long-term solutions towards an effective public finance system might be realized in LDCs.

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