

How losing access to concessional finance affects Small Island Developing States (SIDS)

Evert-jan Quak

Institute of Development Studies

16 July 2019

Question

How does losing access to concessional finance affect state effectiveness, human development and fragility of SIDS, in comparison to other middle-income countries?

Contents

1. Summary
2. Framing of SIDS and the graduation process
3. Key characteristics for SIDS' economic development
4. What does graduation mean for SIDS?
5. Evidence on the impacts of graduation
6. References

The K4D helpdesk service provides brief summaries of current research, evidence, and lessons learned. Helpdesk reports are not rigorous or systematic reviews; they are intended to provide an introduction to the most important evidence related to a research question. They draw on a rapid desk-based review of published literature and consultation with subject specialists.

Helpdesk reports are commissioned by the UK Department for International Development and other Government departments, but the views and opinions expressed do not necessarily reflect those of DFID, the UK Government, K4D or any other contributing organisation. For further information, please contact helpdesk@k4d.info.

1. Summary

This rapid review synthesises the literature from academic, policy, and knowledge institution sources on how losing concessional finance could affect Small Island Developing States (SIDS) in their economic development. Graduation to higher income levels results in restrictions for access to concessional finance and development assistance:

- SIDS that graduate to high-income status face several challenges in the loss of Official Development Assistance's (ODA) associated financial and non-financial support.
- When SIDS move from Lower Middle-Income Country (LMIC) to Upper Middle-Income Country (UMIC) status, they have to become less dependent on ODA for governmental expenditures and infrastructural investments, by increasing other funds and private sector investments.
- SIDS that have been for a longer period middle-income economies have no access to concessional finance from multilateral organisations, while many bilateral development agencies are reducing concessional finance (even if SIDS have some access to concessional finance, it shifts away from grants).
- There are all kinds of preferential trade measures for LDCs that will not apply for middle-income countries without LDC status.

Because most SIDS are middle-income countries, this means that, for the most part, they are not eligible to receive concessional resources from the multilateral financial institutions and preferential trade arrangements, although there may be some temporary exceptions based on vulnerability and smallness. **It can be concluded from the literature that graduation does pose challenges for SIDS, although very different per country, and that it is not clear that graduation processes are well handled by both domestic governments and development agencies.** This poses a threat for SIDS, in particular because they are extreme vulnerable for economic and natural shocks (e.g. price/demand changes and climate change) due to their geographical remoteness and small size, often resulting in high public debts.

This rapid review illustrates with various examples that there are better-placed SIDS and worse placed SIDS, in terms of ability to adapt to changes that are the result of graduation. **Overall, it appears that SIDS graduate through a combination of limited diversification towards services, especially tourism, and investment in human capital.** The literature also shows clearly that there is little reason to expect that SIDS graduates see a direct positive effect on crucial things like private capital flows such as foreign direct investment (FDI), remittances and portfolio investment. In particular, LDCs that graduate to LMIC status, like Cabo Verde, show high dependency on ODA.

Since the great majority of SIDS run structural current account deficits and are heavily reliant on external finance to support their capital accumulation, the implications of graduation for external financing are potentially critical. Disruptions to access to concessional financing may result in balance-of-payments problems, which could jeopardise the continuation of the development process that led to graduation. After graduation, Cabo Verde and Maldives have seen their expenses as percentage of GDP increased, like other SIDS as Mauritius and Seychelles.

Not surprisingly, many UMIC SIDS seem to be stuck with high total debt payments due to their vulnerabilities to natural disasters in particular, reducing their ability to maximise

economic growth and invest in further economic development. Countries that are eligible for non-concessional finance only are precisely those countries in which debt problems have been more pronounced, e.g. Antigua and Barbuda, Belize, Jamaica, the Seychelles and St. Kitts and Nevis. Graduates from LDC status Cabo Verde and Samoa have moved from “moderate” debt risks to “high” debt risk by the International Monetary Fund. Rising debt vulnerabilities in SIDS are related to fast global financial integration, open trade, lack of economies of scale, in particular combined with the exposure to natural disasters. Research indeed shows that debt to GDP ratios increase in SIDS following storms and floods and that the changes in debt ratios are statistically significant.

It is less clear from the literature and available data how graduation impacts on human development. **Unemployment, youth unemployment, income inequality and poverty are all common features in SIDS, however, there is no evidence that losing access to concessional finance and ODA is a major driver of this.** In general, SIDS have shown consistent improvements in the human development index, although slowing down. However, on very specific topics graduation could have significant consequences for human development. For example, Cabo Verde’s ODA to education has fallen dramatically after graduation, resulting in a reduction in government spending on education. Overall, for all ODA recipient SIDS, **investments in education are not meeting the need to produce the skilled workforce necessary to diversify their economies, increase productivity, employment and wages.**

Most important determinants for further progress include market size, resource and/or skill endowments, infrastructure, labour costs, tax and regulatory frameworks, and trade and investment agreements, which all need human capital and good governance to succeed. For example, good macroeconomic performance and a reliable financial sector tend to increase the likelihood that remittances are sent through official channels and are mobilised into diaspora investment. Therefore, **SIDS need to access (technical) assistance from the international community in addressing economic and environmental vulnerabilities and associated catastrophic risks in combination with capacity development to access new funds and attract private sector investments (and improve forward and backward linkages with domestic businesses).** The literature shows that many SIDS struggle to get access to these funds (e.g. Other Official Funds – OOF), such as Cabo Verde, while others succeed, such as the Maldives.

Some lessons can be learned for development agencies to support a smooth graduation process for SIDS. The literature mentions the following:

- A key issue is to integrate sustainable development criteria beyond income (e.g. vulnerability).
- Transition support is needed and, particularly needs to be coordinated between agencies while providing support to renegotiate key economic policy agreements (e.g. preferential trade schemes, non-concessional finance and eligibility for ODA).
- Key sectors such as infrastructure must be strengthened to attract the private sector and to ensure a return on investment to repay growing debt.
- Debt is one of the main issues for SIDS after graduation, which means new and innovative ways should be found for debt restructuring and access new funds, like bonds in the Blue Economy or climate finance.

- Development partners can support national priorities in leveraging the vast array of resources in areas such as renewable energy that can spur additional investment opportunities and shift energy production, particularly solar and wind energy.

Most of the literature used in this rapid review comes from multilateral organisations within the UN, World Bank Group and OECD. Overall, **there is limited literature available on the real impacts of graduated SIDS from LDC status to higher income categories.** Most literature has a focus on the general SIDS characteristics and their overall challenges for development, without explicitly mentioning graduation. The literature on graduated SIDS mainly mentions access to substitutional finance resources after losing out of concessional finance and ODA. Of that literature, the majority focusses on the recently graduated SIDS from LDC status (Cabo Verde, the Maldives and Samoa). Income graduation between LMIC to UMIC and to high-income countries is not mentioned frequently in the literature. **It seems that there is a gap in the literature, in particular for academic research, to find evidence on the impacts of income graduation on state effectiveness, fragility and human development.**

2. Framing of SIDS and the graduation process

Small Island Developing States (SIDS) are a distinct group of developing countries facing specific social, economic and environmental vulnerabilities. **Fifty-eight countries and territories are presently classified as SIDS** by the United Nations Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States (UN-OHRLLS), of which 38 are UN members.¹ Of this total, 35 SIDS are currently eligible for official development assistance (ODA) (OECD, 2018).²

The majority of SIDS are middle-income countries, ranging from Lower Middle-Income Countries (LMICs) to Upper Middle-Income Countries (UMICs) (see Table 1). Recently, **SIDS have been the main contributor for graduation from the status of Least Developed Countries (LDCs).** So far, only five countries (among them three SIDS) have graduated from LDC status: Botswana (1994), Cape Verde (2007), Maldives (2011), Samoa (2014) and Equatorial Guinea (2017). In the next five years another 16 countries are expected to graduate beyond LDC status, among them six SIDS: Kiribati, Sao Tome and Principe, Solomon Islands, Timor-Leste, Tuvalu, and Vanuatu (UNCTAD, 2016). This means that all but three SIDS (Comoros, Guinea-Bissau and Haiti) are expected to gain a non-LDC status by 2024.

¹ **SIDS UN Members:** 38 countries – Antigua and Barbuda, Bahamas, Bahrain, Barbados, Belize, Cape Verde, Comoros, Cuba, Dominica, Dominican Republic, Fiji, Grenada, Guinea-Bissau, Guyana, Haiti, Jamaica, Kiribati, Maldives, Marshall Islands, Federated States of Micronesia, Mauritius, Nauru, Palau, Papua New Guinea, Samoa, São Tomé and Príncipe, Singapore, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Seychelles, Solomon Islands, Suriname, Timor-Leste, Tonga, Trinidad and Tobago, Tuvalu, and Vanuatu. **SIDS non-UN Members:** 20 countries - American Samoa, Anguilla, Aruba, Bermuda, British Virgin Islands, Cayman Islands, Commonwealth of Northern Marianas, Cook Islands, Curacao, French Polynesia, Guadeloupe, Guam, Martinique, Montserrat, New Caledonia, Niue, Puerto Rico, Sint Maarten, Turks and Caicos Islands, and US Virgin Islands. Retrieved from UN OHRLLS website <http://unohrlls.org/about-sids/country-profiles/>

² Most SIDS are part of the Alliance of Small Island States (AOSIS), an intergovernmental organisation of low-lying coastal and small island countries. Established in 1990, the main purpose of the alliance is to consolidate the voices of SIDS to address global warming.

Table 1. Classification of SIDS according to the World Bank, based on Gross National Income (GNI) per capita³

Low-Income < US\$1,025	Lower Middle-Income US\$1,026-US\$3,995	Upper Middle-Income US\$3,996-US\$12,375	High-Income > US\$12,376
<i>Guinea-Bissau</i>	Cabo Verde	American Samoa	Antigua and Barbuda
<i>Haiti</i>	<i>Comoros</i>	Belize	Aruba
	<i>Kiribati*</i>	Cuba	Bahamas
	Federated States of Micronesia	Dominica	Bahrain
	Papua New Guinea	Dominican Republic	Barbados
	<i>Sao Tome and Principe*</i>	Fiji	Bermuda
	<i>Solomon Islands*</i>	Grenada	British Virgin Islands
	<i>Timor-Leste*</i>	Guyana	Cayman Islands
	<i>Vanuatu*</i>	Jamaica	Curacao
		Maldives	French Polynesia
		Marshall Islands	Guam
		Mauritius	Puerto Rico
		Nauru	Seychelles
		Samoa	Singapore
		St. Lucia	Sint Maarten
		St. Vincent and the Grenadines	St. Kitts and Nevis
		Suriname	Trinidad and Tobago
		Tonga	Turks and Caicos Islands
		<i>Tuvalu*</i>	Virgin Islands

Italic = SIDS with current LDC status

* SIDS expected to gain non-LDC status by 2014

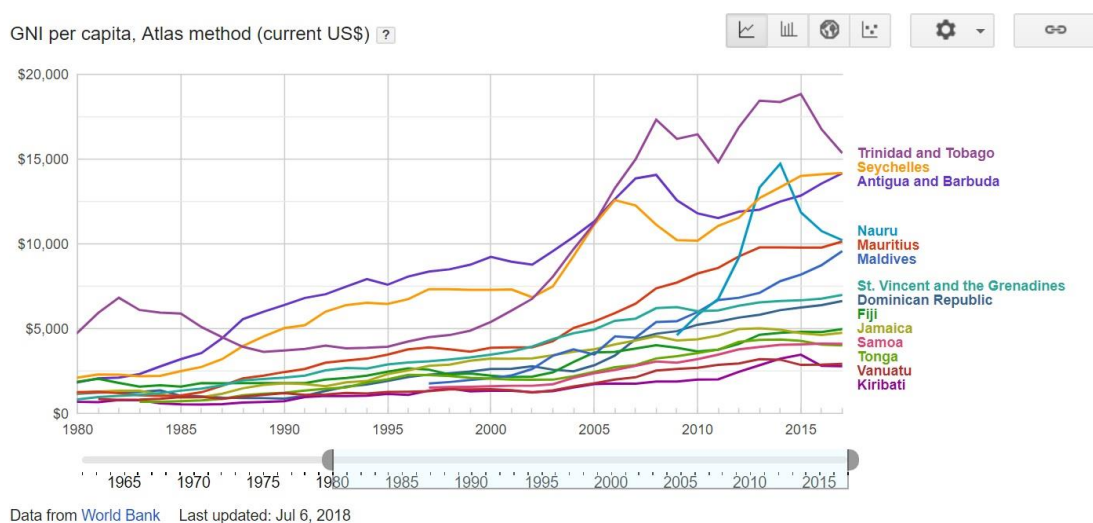
The LDC status does not only apply for low-income economies, as Table 1 shows. For example, Comoros is according to the World Bank a LMIC with LDC status, and Tuvalu is currently an UMIC with LDC status, but on the list to graduate. **The forthcoming six SIDS LDC graduates will do so mainly because of their country income status, as they are not making**

³ Retrieved from World Bank website <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups>. The UN-OHRLLS makes use of slightly different list of SIDS categories as mentioned in Tierney (2018).

substantial progress on the reduction of economic vulnerabilities.⁴ This raises concerns regarding sustaining their development momentum as well as advancing on the broader 2030 Agenda and the Sustainable Development Goals (SDGs).

Most of the SIDS have seen a rise in income per capita graduating on their income status from lower middle-income economies to upper-middle income economies in the 1990s and 2000s. Where some countries like Cabo Verde, Kiribati, Federated States of Micronesia, and Vanuatu have been LMIC SIDS for decades; others, like Sao Tome and Principe, Comoros and Solomon Islands have recently graduated out of the low-income economy status of the World Bank - with Comoros hanging on to the lowest threshold. As Figure 1 shows, some UMIC SIDS are flattening at the lowest income threshold around US\$4,000, like Tonga, Samoa, Jamaica and Fiji (other examples are Tuvalu and Marshall Islands). SIDS that have managed to continue their income improvements are the Maldives, Mauritius, Dominican Republic and St. Vincent and the Grenadines (other examples are Cuba, Dominica, Grenada and St. Lucia). The Seychelles became a high-income economy according to the World Bank, in 2015. Other countries, such as Trinidad and Tobago, and Antigua and Barbuda reached this status earlier in the 2000s. However, between 1990 and 2017, **there have been several cases, mainly SIDS, of countries returning briefly to middle-income classification from high-income status** (e.g. Antigua and Barbuda, Aruba, Barbados, Guam), while others (e.g. American Samoa in the late 1980s and Nauru in 2015) briefly had high-income status, but degraded to UMICs (OECD, 2017).⁵

Figure 1. Gross National Income (GNI) per capita (current US\$) using World Bank Atlas method for selected SIDS (1980-2017)



Source: World Bank World Development Indicators, available through Google Public Data⁶

⁴ Information retrieved from OECD blog post series Development in Transition <https://oecd-development-matters.org/2018/06/11/the-transition-from-least-developed-country-status/>

⁵ OECD (2017, p.7) stated that countries that reverse from high-income economies are mainly small islands states, or have economies dominated by petroleum (e.g. Bahrain, Equatorial Guinea, Saudi Arabia, Venezuela) or were where significant external shocks were amplified by domestic weaknesses (Latvia, Malta, Hungary, Korea, Russian Federation).

⁶ Author's figure based on World Bank data retrieved from Google Public Data https://www.google.com/publicdata/explore?ds=d5bncppjof8f9_

Graduation from LDC status to non-LDC status is a long process based on GNI per capita, human assets and economic vulnerability to shocks. The last two use indices that measure structural weakness, namely the human assets index (HAI) and the economic vulnerability index (EVI). The thresholds of these criteria are set, and periodically reviewed by the Committee for Development Policy, a subsidiary of the United Nations Economic and Social Council. To qualify for graduation, a LDC must have reached threshold levels for graduation for at least two of the three criteria, or its GNI per capita must be at least twice the graduation threshold (the 'income only' graduation rule) (Ancharaz, 2019). Of the six expected SIDS graduates by 2024, only Timor-Leste is expected to graduate by 'income only', while the other five are passing through their GNI per capita and HAI status. In the past, only the Maldives met all three criteria, including an index of economic diversification to withstand economic shocks (Ancharaz, 2019). However, **it appears that SIDS graduate through a combination of limited diversification towards services, especially tourism, and investment in human capital** (UNCTAD, 2016).

Outside the LDC status, countries are mainly measured on their GNI per capita in their progress to high-income status. However, **several institutions like bilateral donors and the International Monetary Fund (IMF), take factors other than high per capita income into account when classifying countries**. For example, in Trinidad and Tobago at the time of transition to high income (US\$11,905), under-5 mortality rates were at the levels of Armenia, with a GNI per capita of US\$1,990 (OECD, 2017). Hence, according to the United Nations, some high-income countries may also be developing countries.

3. Key characteristics for SIDS' economic development

SIDS face many challenges in their quest to achieve sustainable economic development. First, SIDS have **small internal markets**, which precludes economies of scale and, along with a narrow resource base, forces undue specialisation and openness to trade, exposing SIDS to external shocks and accentuating their inherent vulnerability. Lack of economies of scale results in higher costs and a lower volume of public services; a generally uncompetitive private sector, characterised by monopolistic firms, high production costs and a lack of product diversification; and high transport costs, which raise the cost of imports and reduce the export competitiveness of remote and geographically isolated SIDS (IMF, 2013). The OECD (2018) shows that SIDS are on average the most vulnerable among developing countries by using the economic vulnerability index. Upper middle-income SIDS are 73% more vulnerable than other upper middle-income countries, due to their open economies and low diversification levels.

Not surprisingly, SIDS have suffered more from the financial crisis in 2008 than most other developing countries, witnessing plummeting GDP growth rates (Hurley, 2015). Over the last decade most SIDS, mainly in the Caribbean,⁷ have had **slow economic growth** or no economic growth at all (e.g. American Samoa, Aruba, Bermuda, Cuba, Curacao, Jamaica, St. Lucia). Others have regained some low-medium growth rates between 2% and 4% (annual GDP growth) in recent years (e.g. Antigua and Barbuda, Cayman Islands, Turks and Caicos Islands, and Vanuatu). Others see high variable GDP growth levels (high growth rates followed with negative growth rates): examples are Kiribati, Marshall Islands, Federated States of Micronesia, Samoa and Tuvalu. Very few SIDS have persistent medium level GDP growth over 4%, but best scorers

⁷ The annual GDP performance in the Caribbean has averaged only 0.8% since 2010 (ECLAC & OECD, 2018)

are Grenada, Dominican Republic, Fiji, Maldives, Nauru, Sao Tome and Principe, and Seychelles.⁸

While the causes of persistent slow growth in most SIDS require further investigation, the IMF (2013) points to the brain drain-induced decline in productivity and generally weak competitiveness. The result of slow economic growth (or high variable growth rates) and the inherent constraints to the development of the private sector (lack of economies of scale) mean that **few employment opportunities** exist. SIDS often exceed 10% unemployment rates, in particular in the Caribbean SIDS, with St. Lucia and St. Vincent and the Grenadines having the highest unemployment rate of approximately 20%, in 2018.⁹ These problems are particularly severe among young people, with youth unemployment rates exceeding 20% in many SIDS (e.g. Marshall Islands, Curacao, Dominica, and French Polynesia).¹⁰ High poverty levels still exist in many SIDS where **income inequality** is amongst the highest in the world: GINI coefficients are 40 or above, even in high-income SIDS, like Cayman Islands, Bermuda and Barbados.¹¹

Although SIDS, by and large, understand that services are the way to go, **poor information technology (IT) connectivity**, especially on islands far off the path of major submarine fibre optic cables, impedes the development of IT-enabled services and also affects other service sectors, such as education and health (Ancharaz, 2019; Bourne, 2015). **Smallness also makes it difficult to train people in a wide range of areas, resulting in a shortage of staff in critical sectors.** A consequence of lack of human resource development, along with low financial capacity, is that SIDS have poor representation at the level of international organisations, which has negative effects on their advocacy efforts (Ancharaz, 2019). Khor et al. (2016) therefore highlights that due to severe shortage of expertise and implementation capacity in SIDS, reform should be carefully prioritised to address the most serious and binding constraints affecting each individual country (efforts that have the greatest impact on the countries), instead of attempting to implement all facets of “international best practice” standards in a comprehensive single stage.

It is well known that SIDS have a **high exposure and vulnerability to natural hazards** and that these have imposed tremendous costs in terms of loss of human lives, productive assets, physical infrastructure, output supply and product demand especially in agriculture and tourism. While the monetary value of damage from natural disasters is much larger in advanced economies due to the accumulation of valuable assets, at 17% SIDS have the largest losses as a percentage of national output (OECD, 2018). The development challenges posed by natural hazards are compounded by climate change, which has increased the frequency and force of hurricanes, caused sea level rise which threatens coastal infrastructure, beaches which are integral to tourism, housing settlements and fresh water supplies, and marine life and coastal fisheries (Bourne, 2015).

The IMF (2013) has identified three elements of volatility common to SIDS: volatility of growth, external sector volatility and fiscal volatility. Although smallness per se is not associated with

⁸ Information retrieved from World Bank website, based on national accounts data and OECD national account data: https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2017&name_desc=false&start=2005

⁹ Information retrieved from World Bank website, based on ILO statistics: <https://data.worldbank.org/indicator/SL.UEM.TOTL.ZS>

¹⁰ Information retrieved from World Bank website, based on ILO statistics: <https://data.worldbank.org/indicator/SL.UEM.1524.NE.ZS>

¹¹ Information retrieved from World Bank Open Data website <https://data.worldbank.org/>

higher growth volatility, there is evidence that the recent slowdown of growth in SIDS has coincided with **greater output volatility**, which arises from variability in terms of trade, external demand and ODA (Ancharaz, 2019). Foreign direct investment (FDI) and other private finance flows are highly volatile and on average contribute little to SIDS' external sources of financing: only 12% in 2012-15 (for the 35 ODA-eligible SIDS) compared to 35% in other ODA-eligible developing countries (OECD, 2018). Owing to large diasporas, remittances represent the largest flow of external finance for SIDS: 54% in 2012-15, compared to 27% in other developing countries (OECD, 2018). This reflects the lack of creditworthiness of many SIDS to raise funds in capital markets and, in other cases, especially in the Caribbean, the recent deterioration in international capital market and debt sustainability ratings (ECLAC & OECD, 2018).

Small states have experienced **greater current account and fiscal volatility** compared to larger countries with similar income levels (IMF, 2013). Higher costs, low tax revenues and high fiscal volatility have resulted in debt issues: on average, the debt over GNI of SIDS (57%) is significantly higher than for other developing countries (47%) (OECD, 2018). UNCTAD (2018) mentioned that public finances have continued to be stifled by heavy debt servicing costs, which accounted for 16% of SIDS government revenue in 2010, and more than doubled to 40% in 2015, particularly for Caribbean SIDS.¹² "SIDS tend to have small and erratic domestic revenues, which combined with high costs for providing public services and the fiscal impacts of natural disasters, often result in limited fiscal space for development investments," states the OECD (2018, Chapter 2) report.

Box 1. Alternative sources of finance for development during graduation process

Sustainable Development Strategic Plans and how they seek to finance investments needed to achieve the SDGs, should mobilise resources to substitute for ODA in middle-income SIDS. Morris et al. (2019) mentioned the following, in particular based on the case of Cabo Verde's graduation from LDC:

- **Climate finance:** Green Climate Fund (Green Climate Fund - GCF) and the Global Fund for Environment (Global Environment Fund - GEF), other innovative facilities such as Blue Bonds, Debt Swaps/ capacity building to access these instruments,
- **Development finance:** South-South and triangular co-operation,
- **Domestic Resources Maximisation:** Tax revenue through enlargement of the tax base, the reduction of informality, the modernisation of administrative machinery,
- **Blended finance:** PPPs for example through trade boards and the Chambers for Trade and Tourism for investment promotion,
- **Remittances:** Remittances for investment rather than consumption (through mutual funds, tax incentives for financial savings, facilitation of access to housing).

In particular, the climate finance should be an important resource. Today there are large number of international public and private funds in operation and this number looks set to rise further in the future. Examples include the Adaptation Fund (AF), the Climate Investment Funds (CIF), and the Green Climate Fund (GCF), as well as new financial mechanisms such as performance-based payments for reducing emissions from deforestation,

¹² ECLAC & OECD (2018, p.18): "The Caribbean countries are amongst the world's most indebted. In 2015, 4 of the 25 most highly indebted countries in the world (measured by gross general government debt levels relative to GDP) were in the Caribbean: Antigua and Barbuda, Barbados, Grenada and Jamaica. It is estimated that 10 Caribbean countries now have debt-to-GDP ratios that exceed the accepted sustainability threshold of 60%. At the end of 2015, the overall debt burden amounted to US\$ 52 billion, which on average represents 70% of the sub-region's GDP. As a result, the Caribbean sub-region's total debt service payments represented, on average, over 20% of total government revenue in 2015. Despite the high debt burden, the sub-region's total debt to the rest of the world is relatively insignificant and its resolution would pose no systemic risks for global financial stability."

degradation, and forest conservation (e.g. REDD+). Several of these funds are capitalised from innovative sources of finance such as a levy on fuel exports or a 2% levy on the proceeds of certified emission reduction issuances under the Clean Development Mechanism which are allocated to the Adaptation Fund (Hurley, 2015).

Often however, many of these new climate and environmental funds and programmes are under-capitalised. Rather than reflecting the need to manage exponentially increasing resources, the development of new financing instruments appears as a sub-optimal response to an unresolved financing gap. In addition, an unintended consequence of the proliferation in funds for environmental protection and climate change is a dramatic increase in complexity. Requirements, processes and reporting differ markedly among the new funds and instruments (Hurley, 2018).

Other funds can come from Aid for Trade and technical assistance recognised in bilateral trade agreements, like the CARICOM (Caribbean countries) signed with the European Union.

4. What does graduation mean for SIDS?

Financial and non-financial transition support is vital for sustainable economic development, in particular for SIDS. **Countries that graduate to high-income status face the loss of ODA-associated financial and non-financial support.** The Development Assistance Committee's (DAC) list of ODA recipients, designed for statistical purposes, includes all middle-income and low-income countries. Every three years the list is updated, eliminating countries that have been above the high-income threshold for three consecutive years (Fantom & Serajuddin, 2016).

The US government also uses the World Bank's classification in setting trade policy. For example, the US Trade Act of 1974 provides that the President will remove "high income" countries as classified by the World Bank from the list of countries benefiting from the US Generalised System of Preferences (GSP) schemes that grant preferential duties access (Fantom & Serajuddin, 2016). However, **a sharp fall in concessional financing or cessation of such financing that occurs when a country transitions from ODA-eligibility, risks slowing the development momentum in the country.** This, in turn, can raise the likelihood of a transition reversal (OECD, 2017).

Most UMIC SIDS face a so-called middle-income trap. This refers to the long-lasting slowdown in growth that many countries endure when they approach middle levels of per capita income. Arriving at UMIC status usually requires new engines of economic growth based on capital- and skill-intensive manufacturing capabilities and service industries, which need extensive investment in infrastructure and human capital, which are very costly for SIDS (OECD, 2017). **To escape the middle-income trap, indicators for the capacity of the state to raise and spend resources to foster the development process and to transform national income into positive development outcomes are of particular interest.** This is also a key discriminating variable that the OECD Development Centre uses to determine whether countries that escaped the middle-income trap in the past have progressed on other variables like rule of law, the dependency ratio, quality of education, the polity measure of democracy, gross capital formation, credit market development and export diversification (OECD, 2017).

Another change occurs **when SIDS move from LMIC to UMIC status, in particular becoming less dependent on ODA for governmental expenditures and infrastructural investments, by increasing other funds and private sector investments.** In moving from low- to middle-income status, the International Development Assistance (IDA) eligibility threshold of the World Bank is the most significant marker. At GNI of US\$1,215 (Atlas method) in 2015, this threshold reflects the operational availability of concessional finance from the World Bank (graduated

countries see their finance extended at market terms), and guides the determination of access to concessional finance from a number of other multilateral financial institutions (the Asian Development Fund, the African Development Bank, the Asian Development Bank and the IMF) (OECD, 2017).¹³ It is also important to mention that **non-LDCs could lose their UN travel benefits to attend international meetings, which could mean SIDS graduates have reduced advocacy ability and visibility on the international stage** (Hurley, 2015). The OECD also uses the World Bank income classification for its arrangement on Officially Supported Export Credits: the lower middle-income threshold is the cut-off line between countries that are eligible for tied aid credits and those that are not (Fantom & Serajuddin, 2016).

Furthermore, **there are all kinds of preferential trade measures for LDCs that will not apply for middle-income countries without LDC status** (e.g. the EU's Everything but Arms free trade agreement and the Global System of Trade Preferences). Estimates from UNCTAD (2016) show that Vanuatu will particularly suffer from leaving preferential trade measures that comes with its LDC status, as the agricultural sector in particular will suffer from this change. By the end of the transition period, graduating countries have lost access to all LDC-specific Special and Differential Trade provisions under WTO rules and WTO-compliant regional trade agreements, as well as those afforded by their trading partners, retaining access only to the typically less generous provisions available to other developing countries (Ancharaz, 2019; Soobramanien & Gosset, 2015).¹⁴

Because most SIDS are middle-income countries, this means that, for the most part, they are not eligible to receive concessional resources from the multilateral financial institutions. However, the World Bank operates 'a small island exception' that permits a few SIDS to borrow concessional finance from IDA despite higher income per capita levels (World Bank, 2017). Those SIDS with fewer than 1.5 million people, significant vulnerability due to size and geography, and very limited credit-worthiness and other financing options retain access (Hurley, 2015).¹⁵ Most, however, are considered 'blend' countries, i.e. they can borrow simultaneously from both IDA and the Bank's non-concessional loan facility, at the International Bank for Reconstruction and Development (IBRD). Blend countries include the following SIDS: Cabo Verde, Dominica, Fiji, Grenada, Papua New Guinea, St Lucia, St Vincent and the Grenadines and Timor-Leste.¹⁶

All others borrow on commercial terms from the multilateral lenders through IBRD. **Some bilateral donors also use income per capita to steer aid allocation decisions, although this does vary between donors.** Furthermore, multilateral financial institutions, such as the World Bank and the IMF, do not have specific graduation support programmes or mechanisms for the

¹³ Tierney (2018) gives a very detailed overview per SIDS what exact access to finance (concessional or non-concessional) and what climate fund and other private funds they can tap based on the different criteria, exceptions and income categories for SIDS.

¹⁴ This could be the reason why SIDS were among the first to sign economic partnership agreements (EPAs) with the EU, which offer them the privilege of exporting duty-free and quota-free to the EU, although reciprocal.

¹⁵ According to the World Bank website the following SIDS are eligible for IDA: Comoros, Guinea-Bissau, Guyana, Haiti, Kiribati, Maldives, Marshall Islands, Federated States of Micronesia, Samoa, Sao Tome and Principe, Solomon Islands, Tonga, Tuvalu, and Vanuatu <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups>

¹⁶ Information retrieved from World Bank website <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups>

LDCs. No established institutional mechanism exists for the phasing out of SIDS LDC country-specific benefits (Hurley, 2015). As a result, entities may not always be able to support a country's smooth transition process. Overall, **the continuous engagement after graduation is mainly determined based on mutually agreed country programme frameworks.**¹⁷

Many governments have called for more favourable access to concessional resources for SIDS and to include a measure of vulnerability in multilaterals' assessments as to which countries should be eligible for concessional finance (see some statements of government in Box 2). Ancharaz (2019, p.4) states: "[B]ecause the international community will be withdrawing the very support measures that contributed – in part, at least – to the SIDS' development while they were LDCs, it has a moral obligation to ensure that graduates do not become a victim of their success."

Box 2. Reactions from SIDS governments on graduation¹⁸

The Maldives' representative reported during a 2012 UN meeting that there had been a lack of progress in the area of development assistance and access to concessional finance, explaining that pledges made at a donor conference had gone largely unfulfilled. He noted that graduation did not bring increased FDI except for the tourism industry, leaving his country's structural vulnerabilities as a small island unchanged. He recalled the crucial role played by the Maldives' lobbying and advocacy efforts in obtaining the granting of favourable new trade measures and waivers, such as the TRIPS extension until 2013 granted in the aftermath of the 2004 Tsunami, which was later applied to all LDCs. The Maldives' promotion of its SVE status articulated during the Trade Policy Review (TPR) resulted in the extension of the Everything but Arms (EBA) trade agreement with the EU.

At the same UN meeting, **the Solomon Islands'** representative underscored the need for predictability, outlining that many SIDS LDC country programmes were unrelated to the Barbados Programme of Action (BPoA), and stressed the need for better coordination of UN system activities on the ground. He stressed that many LDC country programmes were not related some special SIDS development action programmes: their focus was on institutions, gender, etc. but not on the productive sector, with limited resources to focus on a few game-changing issues, e.g. agriculture or energy. He also stressed the need for better coordination of the UN system's activities on the ground.

Prime Minister Browne of **Antigua and Barbuda** questioned during a UN meeting in 2018 the validity of modalities used to assess development levels. He said his small, vulnerable country was disqualified from access to concessional loans and grants due to "skewed constructs of what represents development". People in middle-income countries were being punished for their adherence to human and political rights and the openness of their economies to foreign investment, he said. Small groups of expatriates received most of the profits from those investments, while arbitrary rules imposed by a handful of rich countries made economic diversification difficult. Fair trade, access to finance, anti-competition rules and debt burden should be among the factors used to measure development as opposed to simply using per capita income, he said, warning that middle-income countries will witness economic decline and social dislocation if the way they are assessed does not change.

President Michel of the **Seychelles** highlighted in 2017, when his country received the high-income economy status, the importance of looking at development beyond the reductive practice of simply measuring GNI per capita. He reiterated the importance of addressing the specific concerns of SIDS and in particular the need to

¹⁷ Information retrieved from OECD blog post series Development in Transition <https://oecd-development-matters.org/2018/06/11/the-transition-from-least-developed-country-status/>

¹⁸ Sources used: Statements on Maldives and Solomon Islands were retrieved from the UNOHRLLS website <http://www.unohrlls.org/UserFiles/File/LDC%20Documents/AHWG%20on%20smooth%20transition/SUMMARY%20RECORD%20AHWG%2026%20March.pdf>. The statement on Antigua and Barbuda was retrieved from the UN website <https://www.un.org/press/en/2018/ga12098.doc.htm>. The statement on the Seychelles was retrieved from the website of the Department of Foreign Affairs of the Republic of the Seychelles http://www.mfa.gov.sc/static.php?content_id=18&news_id=1071

couple all measures of development in the context of countries' vulnerability such as through a vulnerability index. He stressed that 'high income status' should not be a means to exclude countries like Seychelles and other SIDS from legitimate development tools that allow them to adapt and build resilience against both the vagaries of the global economy and climate change.

5. Evidence on the impacts of graduation

Next to the key characteristics and constraints of SIDS for economic development as afore mentioned, graduation itself and its changes in access to concessional finance, development assistance and preferential trade may have impacts on SIDS. **There is no abundance in literature with a focus on the actual impacts of graduation** than some evaluation reports from the UN-OHRLLS (which are more procedural than profound research on developmental impacts). Most literature focusses on the challenges of SIDS in general and their needs to access new kind of funding, like climate funding or bonds. However, very recently there seems to be some interests to study more profoundly the impacts of graduation as some studies from the OECD (e.g. Morris et al., 2019) and the Commonwealth Secretariat (e.g. Ancharaz, 2018) show.

Debt and vulnerability

It is important to note that several of the **countries which are IBRD eligible only (i.e. eligible for non-concessional finance only) are precisely those countries in which debt problems have been more pronounced, e.g. Antigua and Barbuda, Belize, Jamaica, the Seychelles and St. Kitts and Nevis** (Hurley, 2015). Morris et al. (2019) show that for Cabo Verde (access to blend finance), external debt increased substantially after LDC graduation in 2007. Debt reached 129% of GDP and 134% GNI in 2018. Private debt on commercial terms is the fastest growing source of external debt, increasing seven-fold since LDC graduation. Morris et al. (2019) further show that external multilateral debt provided on non-concessional terms represents the second fastest growing source. During the same time period Cabo Verde suffered from extreme weather conditions, extreme rainfall, hurricanes and drought, and volcanic activity, with damage costing over US\$40 million since 2012 (Morris et al., 2019). The other graduate Samoa (still eligible for IDA under exception rules) has also seen increased debt pressure (IMF, 2018). The recovery efforts and reconstruction required after the 2009 tsunami and 2012 Cyclone Evan were largely financed by borrowing, pushing total public debt close to 58% of GDP in 2014/15. Samoa's debt is still largely concessional and long-term; however, according to the IMF (2018), the debt restructuring is highly vulnerable to external shocks, such as natural disasters.

SIDS have on average higher debt levels than other developing countries (King & Tennant, 2014). This is not only the case for low-income and LMIC SIDS, as Barbados, Bahamas, Antigua and Barbuda, St. Lucia, Jamaica and Grenada, have above 35% total debt service payments compared with total government revenues (data from 2013) (Bourne, 2015). **In 2017, the IMF (2017) classified 20 of the 35 ODA eligible SIDS as "moderate" risk, "high" risk and "in debt distress"**. Grenada is the only SIDS in debt distress, but since 2016, three SIDS – Cabo Verde, Haiti and Samoa – have moved from a moderate to a high-risk level of debt distress (Cabo Verde and Samoa are graduates from LDC status) joining eight other SIDS. Of the high-income SIDS that are non-eligible for ODA, Barbados, Antigua and Barbuda, and Aruba in

particular have high debt–GDP (economic growth) ratios of 157%, 87% and 87% respectively in 2017.¹⁹

Debt-to-GNI ratios (for 2015) are particularly high in UMICs (as well as Cabo Verde as LMIC and the afore mentioned high-income SIDS) that are outside the Pacific region: e.g. Mauritius (128%), Jamaica (103%), Cabo Verde (98%), Belize (82%), Grenada (73%), Dominica (63%). Samoa (60%) has the highest ratio for the Pacific SIDS. Five SIDS – Comoros, Haiti, Guinea Bissau, Guyana, and Sao Tome and Principe – benefitted from the HIPC Initiative, which contributed to bring down their debt from an average of 196% of GNI in 2000 to 35% in 2015 (OECD, 2018). **Debt-to-GNI ratios for the remaining SIDS are on the rise, having reached 62% in 2015, up from 44% in 2000. This is higher than other developing countries with on average approximately 50% debt-to-GNI ratio** (OECD, 2018). Average debt service-to-exports ratio also worsened substantially from 8.6% in 2008 to 19.2% in 2017, while the ratio of external debt to exports rose from 67.4% to 163.8% of GDP (UNCTAD, 2018).

This debt burden for SIDS increases their vulnerability to economic shocks and natural disasters. **UNCTAD (2018; 2017) shows that rising debt vulnerabilities in SIDS are related to fast global financial integration, open trade, lack of economies of scale, in particular combined with the exposure to natural disasters** (see also King & Tennant, 2014). The long-term environmental challenges faced by these countries are compounded by high levels of external economic vulnerability and public debt, which create a vicious cycle. In particular, countries in the Caribbean recurrently use public debt to absorb the impact of external shocks and natural disasters (UNCTAD, 2017). In turn, higher levels of public debt constrain capacity to effectively address vulnerabilities. As a result, each new wave of shocks and disasters simultaneously amplifies vulnerabilities and weakens domestic response capacity.

Research results by Mitchell et al. (2018) suggest that **debt to GDP ratios indeed increase in SIDS following storms and floods and that the changes in debt ratios are statistically significant**. They conclude that floods lead to faster debt accumulation than storms, and that debt increases less in non-SIDS, mainly because of their stronger macro-economic fundamentals. Aid relief is found to play a significant mitigating role in SIDS. However, aid increases following an exogenous expansion in the primary surplus, but this trend reverses fairly quickly (Mitchell et al., 2018).

Due to their relative remoteness and size, many SIDS have a relatively narrow resource base to drive their industrial development. A few key industries including fisheries, tourism and agriculture help in contributing a significant share to national GDP. The adverse impact of climate change makes SIDS already open and exposed economies therefore even more vulnerable (UN-OHRLLS, 2017). Some literature have measured the costs. Acevedo (2014) finds negative effects from both storms and floods in Caribbean countries. Loayza et al. (2009) find that although small disasters may have a positive effect in the short term (owing to reconstruction boosting growth, for example), the short-term effect of large disasters on growth is always negative. Some international organisations have also estimated the cost of natural disasters and climate change in terms of reduced economic growth. **According to the World Bank (2014),**

¹⁹ Information retrieved from Photius website, based on data from the CIA World Factbook 2019
https://photius.com/rankings/2019/economy/public_debt_2019_0.html

natural disasters in the Pacific SIDS cause damage, every year on average, of nearly 2% of GDP (about US\$248 million).

For climate change, the Asia Development Bank (ADB) estimates economic costs for the Pacific islands of 2.2 to 3.5% of GDP annually, which could rise to as high as 12.7% by the end of the century (ADB, 2013). The ADB also estimates that preparing for the effects of climate change may cost between 1.5 and 2.5% of GDP a year. Cabezon et al. (2016) estimated the impact of natural disasters on long-term growth for the Pacific SIDS (Fiji, Papua New Guinea, Samoa, Tonga, Vanuatu). They concluded that for damage and losses equal to 1% of GDP, growth in these countries falls on average by 0.3 percentage point over 10 years. Therefore they conclude that **the long-term impact of natural disasters on GDP growth is substantial**. After a disaster, with damage and losses equal to 60% of GDP, growth falls by 18 percentage points, resulting in a 10-year growth loss of 16% on a cumulative basis (Cabezon et al., 2016).

To link this with graduation, it can be concluded that recent graduates Cabo Verde and Samoa are increasingly indebted now at a “high risk” status, while many UMIC SIDS seem to be stuck with high total debt payments due to their vulnerabilities to natural disasters in particular, reducing their ability to maximise economic growth and invest in further economic development. For low-income SIDS, LDC status already takes into account climate vulnerability and recent exceptions to IDA access have significantly increased concessional finance flows. For this group, the challenge is now to mobilise these resources and tailor programmes to address the specific needs between and within each country (Tierney, 2018). This will require coordinated technical assistance from a range of regional and international agencies to supplement and build national capacities and deliver transformational change across all sectors of the economy.²⁰ For middle-income SIDS the financing outlook is less clear. Eligibility for concessional finance for this group of SIDS is closely associated with conventional concept of national income level.

SIDS need to access assistance from the international community in addressing economic and environmental vulnerabilities and associated catastrophic risks.²¹ For example, the most important initiative in this regard is the Green Climate Fund, established in 2010 as part of the financial mechanism of the United Nations Framework Convention on Climate Change. The Green Climate Fund is expected to mobilise US\$100 billion a year by 2020 to be invested worldwide in climate change mitigation and adaptation projects (UNCTAD, 2017). However, the main concern is that resource allocation is based on the same approach currently used for the allocation of ODA and concessional lending, making most SIDS ineligible to access the fund (UNCTAD, 2017). **Another concern is that graduated countries, like Cabo Verde, have lost access to the National Adaptation Programmes of Action (NAPA), which helped**

²⁰ Some examples show that climate change funding is available. For example, Samoa gained access to the UNFCCC LDC Fund after graduation due to some rules of exception for vulnerable SIDS. A climate change adaptation and disaster risk reduction project (\$12 million grant) was approved under LDC Fund in October 2014. A flood management project was approved under the Green Climate Fund in December 2016.

²¹ According to World Bank (2018) these existing financing includes the Adaptation Fund (including Direct Access), GCF, GEF, Least Developed Countries Fund (LDCF), Special Climate Change Fund (SCCF), Climate Investment Funds (CIFs including the Pilot Partnership for Climate Resilience), MDBs (including IDA with its focus on small states), GFDRR, and bilateral donors. In addition, funds available after a disaster include IDA's CRW, IMF Standard Window, IMF Poverty Reduction and Growth Trust Fund, IMF Catastrophe Containment and Relief Fund, insurance facilities such as Pacific Catastrophe Risk Assessment and Finance Initiative (PCRAFI) being converted into a Facility, Caribbean equivalent (CCRIF), and Africa Risk Capacity Insurance Facility. For low emissions—renewable energy, energy efficiency, forests—CIFs (SREP, FIP, DGM); GEF, MDBs (IDA, IBRD equivalent), GCF, and bilateral donors.

to strengthen climate change adaptation strategies and access to financing (Morris et al., 2019). Without NAPA support, many sources of climate financing such as the Green Climate Fund require technical capacity and expertise that are challenging for SIDS with small administrations. SIDS also face challenges in identifying the risks and impacts of natural disasters and, consequently, in securing resources in their national budgets. High implementation charges further reduce the benefits received by SIDS through intermediary agencies. Due to these constraints, Cabo Verde has not yet accessed the Green Climate Fund financing (Morris et al. 2019).

UNTCAD (2018, p.8) states: “While the international community has to an extent recognized the need to pay specific attention to the plight of small island developing States facing recurrent debt and financial distress in the wake of their environmental vulnerability, a more encompassing multilateral approach to address systematic underinvestment in climate change adaptation in the long term – and an inappropriate reliance on domestic resource mobilization and short-term insurance mechanisms – will be required.”

Economic and human development

Economic and human development in SIDS varies very much per country and per region. Before 1990, the Human Development Index increased steadily for SIDS as a whole, but improvements slowed in the 1990s and 2000s, and have further slowed since the financial crisis in 2008 (Hurley, 2015). **A more detailed look at several countries that have in some way been involved in graduation processes in recent decades (Cabo Verde, Maldives, Mauritius, Seychelles, Samoa, Antigua and Barbuda, and Jamaica), shows that no conclusions can be made from existing literature on clear trends with regard to what graduation means for economic and human development.** There are too many variables, such as size, existence of natural resources, access to global tourism markets, political stability and good governance; this rapid review could find no literature that compared all of them with the graduation process.

By looking to what sectors ODA flows, no clear pathway is visible. As total ODA may reduce after graduation, it seems that **there is a shift away from social infrastructure like education and health care towards climate change resilience, the productive sectors and economic infrastructure.**²² A focus on private sector development ODA is mainly the case in countries such as the Seychelles, the Maldives, Samoa²³ and Jamaica (including multi sector ODA).²⁴ Also, it is clear for Cabo Verde (LMIC SIDS) that since graduation in 2007 it has witnessed a

²² Authors own observation based on data from OECD website on ODA: <http://www.oecd.org/dac/financing-sustainable-development/development-finance-data/aid-at-a-glance.htm> and also mentioned in the 2015 OECD flyer Small island developing states (SIDS): financing the 2030 Agenda for Sustainable Development, which can be retrieved from https://www.oecd.org/dac/environment-development/SIDS_flyer_COP.pdf

²³ Samoa continues to be supported by its development partners through investments in particular the infrastructure sector particularly in the transport sector. New activities include the construction of an upgraded airport terminal building including runway, taxiway and apron and equipment; the construction of more resilient road networks and bridges rehabilitation in addition to recently completed roads built as part of the Cyclone Evan Recovery programme. Increases in households' access to water supplies were achieved with almost 90% of the total coverage areas having access to treated water supplies and basic sanitation services. Conservation of water catchment areas has progressed with increased community commitment to implement approved watershed management plans. There is a growing number of renewable energy projects approved to be undertaken under the auspices of Government with development partners cooperation as well as investments by the private sector through Power Purchasing Agreements. The number of renewable energy technologies used has increased with multiple solar panel plants in place and extension of hydro electric plants expected to begin operations in 2017-2019.

²⁴ Information retrieved from OECD website <http://www.oecd.org/dac/financing-sustainable-development/development-finance-data/aid-at-a-glance.htm>

significant reduction of ODA to support education (-30%). ODA in health care remains low compared to other SIDS. The share of Cabo Verdean government spending in support of health and education has declined (-1.5% in education and -0.4% in health over the 2012-16 period) (Morris et al., 2019). In parallel, Cabo Verde receives significant increasing bilateral support for water supply and sanitation and renewable energy (Morris et al., 2019). **Overall, for all ODA recipient SIDS, investments in education are not meeting the need to produce the skilled workforce necessary to diversify their economies, increase productivity, employment and wages.** However, in some UMIC SIDS, such as Mauritius, ODA is mainly focussing on education (another example is Suriname). Furthermore, humanitarian aid is an important contributor to recover from natural disasters, even for a high-income country like Antigua and Barbuda, which had zero ODA in 2016, but received ODA in 2017 after Hurricane Irma.²⁵

As ODA will reduce, SIDS have to find other ways to access crucial funding. One solution is to successfully leverage Other Official Funds (OOF) to strengthen private sector engagement, (e.g. upgrading tourism value chains and sustainable fisheries). **However, OOF does not fill the gaps in social sectors as ODA is reduced. Some SIDS struggle, to access OOF** (e.g. Cabo Verde), while others succeed (e.g. the Maldives, Jamaica and Mauritius – other examples are Suriname and Dominican Republic). In particular, capacity to increase access to these funds is necessary for countries in transition (Morris et al., 2019).

On the other hand, private sector actors can invest in crucial parts of the domestic economy. For SIDS these private sector actors are located overseas, and increasingly coming from South-South relations (e.g. China and India) (UNCTAD, 2014). However, FDI net inflows vary very much per SIDS. **The Maldives is doing well in attracting FDI after graduation and is now in the top five recipient SIDS.** Investments are mainly going to tourism and construction, making the country's economy heavily dependent on tourism and highly vulnerable to shocks, as indicated by the persistently high level of its economic vulnerability index (EVI). However, **flows of FDI into Cabo Verde have decreased considerably since their peak in 2008**, although FDI inflows to Cabo Verde represent a higher relative share of external financing compared to other SIDS. In 2018, inflows totalled US\$100 million, a slight decrease compared to 2017 (US\$111 million).²⁶ The tourism sector is the largest recipient of FDI in Cabo Verde. Samoa's FDI is also mainly in tourism and fluctuates significantly. Overall, considering all SIDS, it can be concluded that **the most attractive SIDS for FDI are those rich in mineral resources (Trinidad and Tobago, Jamaica, Papua New Guinea); those that offer fiscal advantages to foreign capital (Bahamas, Barbados, Seychelles); and those that have a relatively bigger market size (Mauritius, Jamaica), while the combination of remoteness, small population, low income, and lack of natural resources is a deterrent to FDI** (UNCTAD, 2014).

Employment statistics show that the Maldives has seen a clear continual increase in unemployment and youth unemployment since graduation, with total unemployment rate in 2018 at 6.2% and youth unemployment at 14%. This is part of a long-term trend since the late 1990s.²⁷

²⁵ Information retrieved from OECD website <http://www.oecd.org/dac/financing-sustainable-development/development-finance-data/aid-at-a-glance.htm>

²⁶ Information retrieved from the World Bank Open Data website <https://data.worldbank.org/>

²⁷ Idem

The private sector jobs are heavily dependent on tourism and highly vulnerable to shocks. The Maldives also has an important fishery industry, but while it survived the loss of trade preferences in the European Union market and Japan by diversifying to other export destinations, this has certainly contributed to the sector's declining importance, notably in the case of the tuna industry (UN, 2018).²⁸ Samoa has an unemployment rate of around 8.5%, which is stable since its graduation in 2014, however, it is still significantly higher than before 2012 when Samoa had around 5.5% unemployment.²⁹ Cabo Verde has a high unemployment rate of 12%; after graduation this went up quickly (although at the same time as the financial crisis) and reached its highest point of nearly 17% in 2012 after which it has fallen again. Jamaica has a high unemployment rate, like most Caribbean SIDS, but it has shown a consistent fall in the unemployment rate to 8% in 2018.³⁰ Mauritius has a stable unemployment rate of around 7% and Seychelles around 4%.³¹ Youth unemployment remains high, in particular in Samoa, Jamaica, Cabo Verde, Mauritius, Antigua and Barbuda. In the latter country, which is a high-income country (with a history of degradation) unemployment rates are the highest recorded as 14% in 2015 census. Youth unemployment was even recorded at 50%.³²

Overall, it can be concluded that unemployment and the creation of new employment opportunities represent a key challenge for many governments, which have traditionally acted as the 'employer of last resort'. This, in turn, has led to bloated and costly public administrations (as well as helped to exacerbate public debt burdens). The social safety net is not well-developed in many countries and the high unit cost of social service provision means that their sustainability is constantly challenged. The result is that **SIDS have high income inequality rates.** For example, in Cabo Verde, the country's GINI coefficient has increased to 51 in 2013 from 45 in 2007 and poverty reduction across the islands is uneven (Morris et al., 2019). Samoa graduated in 2014, since when income growth has reduced. The UN (2017) Committee for Development Policy monitoring report shows that there is no sign of progress or regress in the income or HAI indicators. No statistics on GINI coefficient after 2014 could be found for Samoa. On the other hand, the Maldives is slowly reducing income inequality as measured in GINI from just above 40 before graduation to just below 40 in 2013.³³ Seychelles witnessed an increase in GINI in 2015 at a level of nearly 47, while it is measured stable for Mauritius at 35. **It does not seem that any clear message comes out from the graduation process in SIDS on employment and inequality, but pockets of poor and vulnerable communities persist due to low-income levels, insecurity and exposure to natural disasters and climate change.** FDI is not always targeting the best employment opportunities

²⁸ However, and in addition, Maldives is diversifying its export markets and incentivising environmentally sustainable fishing value chains. Through the use of ecolabels or Marine Stewardship Council (MSC) certification, the country has created a price premium for local fishermen and the possibility for consumers to make more informed choices.

²⁹ In particular, for Samoa graduation in 2014 did not yet change a lot for the economy. Samoa continues to enjoy duty-free quota-free treatment under the Everything But Arms initiative for a period of three years; and a similar transition period has been negotiated, at least for some key products, with other trading partners. Samoa also continues to enjoy access to concessional borrowing from multilateral financial institutions, and to receive technical assistance and financial support to attend United Nations meetings.

³⁰ Information retrieved from the World Bank Open Data website <https://data.worldbank.org/>

³¹ Idem

³² Information retrieved from <https://antiguaobserver.com/report-places-abs-youth-unemployment-rate-at-50-per-cent/>

³³ Information retrieved from the World Bank Open Data website <https://data.worldbank.org/>

and poor linkages (forward and backward) with local productive sectors exist, nor between job demand and supply (e.g. there seems to be a tendency of rent-seeking) (UNCTAD, 2014). In that sense, related to (youth) unemployment, inequality and poverty (but also related to drug routes), in particular for the Caribbean, crime has become one of the main challenges threatening economies and livelihoods.³⁴

Evidence on the impacts of graduation on state effectiveness

There is evidence that economies that have successfully transitioned from ODA eligibility since 1985 (including SIDS) have exhibited a number of key policy characteristics, notably strong rule of law, quality education and capabilities to mobilise domestic resources (tax revenue) (UNCTAD, 2016). This means that state effectiveness and good governance are both important drivers to succeed. In particular for LMIC SIDS that already have relatively high domestic resources (e.g. 20% tax-to-GDP ratio in Cabo Verde), fiscal space is limited, putting pressure on domestic expenditure to ensure debt sustainability and finance the SDG gaps (Morris et al., 2019). As a result, many LMIC SIDS' governments remain highly dependent on ODA, while they need to improve capacity to access other forms of external finance, like OOF and climate finance, while also mobilising domestic resources. **Support must be targeted to help countries identify, model, and implement the tax policies needed to increase expenditure, particularly in key social sectors (e.g. health and education).** In order to reduce aid dependency, OECD DAC members must provide investments that secure long-term sustainable development. Understanding how to better target domestic resource mobilisation and public financial management will be essential to balance country ownership and long-term strategic interests that will benefit them in the graduation process.

Domestic public financing is challenging for many SIDS. On the one hand, the provision of public goods tends to be more expensive on a per capita basis compared to countries with larger (and more concentrated) populations. Tax revenues as a percent of GDP would probably have to be even higher in SIDS than in many other countries because the marginal cost of public good provision is higher (Hurley, 2015). On the other hand, increasing trade liberalisation leads to eroding tax bases for many SIDS that are highly dependent on trade taxation for generating tax revenue. Some SIDS have managed to broaden the personal income tax base, but many rely significantly on indirect taxation, especially value added and sales taxes which can be regressive (Hurley, 2015). Widespread tax exemptions meanwhile help translate into low collection levels in many countries. Efforts to control tax avoidance and evasion (and other illicit flows) have also, in many cases, been weak (Hurley, 2015).

Domestic revenues can be volatile in SIDS given the relatively narrow productive bases concentrated in sectors that are exposed to external fluctuations. SIDS that rely on natural resource rents or tourism as their primary export sectors are especially prone to fluctuating domestic and tax revenues. In Timor-Leste, for example, tax revenues accounted for 103% of GDP in 2010, rising to 133% in 2012 before falling to 40% in 2015 (OECD, 2018).

Tax revenues as percentage of GDP shows that over the years most SIDS graduates' governments increased revenues compared to their GDP. Only Cabo Verde witnessed a

³⁴ The Caribbean are well known for its position between South America's production of drugs and the markets in North America and Europe. Recently, some reported an increase of Pacific islands in drug routes. Information retrieved from <https://www.theguardian.com/world/2019/jun/24/the-new-drug-highway-pacific-islands-at-centre-of-cocaine-trafficking-boom>

decrease after graduation, but has improved this ratio since 2014.³⁵ Taxes from income, profits and capital gains as a percentage of total tax revenues have been particularly going downwards in Jamaica (to 28% in 2017), while in the long-term in Seychelles, Mauritius and Samoa have an upward trend up to 29%, 20% and 19% respectively.³⁶ The Maldives in particular has reported an increase since graduation from 3% to 20%, while Cabo Verde has a relatively stable revenue from income, profits and capital gains. The opposite is true for taxes on international trade as a percentage of total tax revenues. Jamaica has increased these taxes (around 35%), while Seychelles and Mauritius decreased this as percentage of total tax revenues over the long run (under 5%).³⁷ Samoa and Cabo Verde stabilised their percentage on 9% and 13% respectively, while the Maldives saw a sharp decrease after graduation from 27% to 14%.³⁸

Besides limited domestic revenue generation, the high unit costs of services have a significant effect on public finances, leading to larger public sector expenditures than in other developing countries. This is especially true in Pacific SIDS, where small populations are often scattered across a multitude of islands, compared to developing countries of a similar income level (Horscroft, 2014). Government expenses accounted for 29% of GDP in SIDS, compared to 22% in other developing countries in 2014 (OECD, 2018). For Maldives Cabo Verde, Jamaica, Samoa and Jamaica, this is between 23% in Samoa and 33% in Seychelles.³⁹ **After graduation Cabo Verde and Maldives have seen their expenses as percentage of GDP increased, like other SIDS as Mauritius and Seychelles.**

Compared to other developing countries, a larger share of public expenditure is also current expenditure and not capital investment. The importance of public sector employment meanwhile implies that states have high expenditures not only in terms of public service provision, but also in terms of their wage bill varying between 35-40% of total government expenses in countries like Maldives, Cabo Verde, Jamaica, Samoa and Jamaica.⁴⁰ Furthermore, **SIDS' domestic savings rates are much lower than other developing nations. SIDS' average savings rate is half that of upper middle-income countries (11% versus 22% in 2014) despite many SIDS being classified as middle-income countries.** This means a smaller pool of domestic resources on which to draw to fund investment and development (Hurley, 2015).

In summary, Horscroft (2014) concludes for the Pacific islands that **the extent to which the relatively large public sectors in these countries are 'crowding out' private sector activity seems likely to be quite limited** and that the flip-side of this situation must also be taken into account. That is, there is also an extent to which the public sectors in most Pacific islands are 'crowding in' private sector activity. It is certainly true that the private sectors are quite small, but Horscroft (2014) suggests that this is probably not primarily because the public sectors are large, but that the private sectors are small due to smallness and remoteness from major markets. It is

³⁵ Information retrieved from the World Bank Open Data website <https://data.worldbank.org/>

³⁶ Idem

³⁷ Idem

³⁸ Idem

³⁹ Idem

⁴⁰ Idem

this – rather than the large size of their public sectors – that is likely to be the key constraint on the range of feasible private sector activity.

Box 3. Recommendations for a shift in development aid for SIDS graduates

What can development agencies do to support SIDS through the graduation process? The World Bank (2017) mentions seven priority areas:

- **Inclusion of Vulnerability as a Criterion for Concessional Financing:** This priority action area explores how best to address the specific vulnerabilities and the unique financial and institutional capacity challenges that small states face.
- **Predictability of Affordable Financing:** IDA 18 has significantly enhanced IDA support to small states; however, many small states continue to face the central financing challenge of enhancing the predictability of resources and securing a reliable flow of funds to close their financing gap.
- **Debt Sustainability:** To address debt challenges, small states focus on debt relief opportunities and innovative instruments to work with partners to address debt sustainability, increase domestic resource mobilisation, and crowd in private sector investment.
- **Access to New and Existing Climate Financing:** To develop instruments that will increase small states' access to climate finance, and to develop a dedicated platform with the Green Climate Fund and the Global Environment Facility to more effectively discuss issues around financing and donor fragmentation.
- **Capacity Building and Technical Assistance:** Donor fragmentation in small states hinders the effective use of financing for achieving development outcomes. In light of the significant increase in IDA resources and anticipated increase in engagement, this action area highlights options to address small states' chronically limited absorptive capacity and institutional constraints that hinder their ability to manage donor resources.
- **Diversification of Small States' Economies:** Where multiple asset types and economic options provide resilience, lack of such economic diversity leaves small states dependent on the economic and political situations of neighboring transit countries, as well as vulnerable to economic and climate shocks.
- **Access to Financial Markets:** Many large financial entities are effectively cutting ties between banks in small states and global finance. A decline in correspondent banking relationships is having damaging results at the individual and community levels, particularly by affecting remittance.

The OECD calls for “transition finance” to finance sustainable development for SIDS that go through graduation processes. OECD main policy recommendations are:⁴¹

- **Better anticipation and preparation of substitutions** – using ODA and non-concessional flows (Other Official Flows – OOF) to support a sustainable transition finance path;
- **Better support to countries in transition through adequate capacity building** (e.g. debt management support), investment in enablers (e.g. domestic resource mobilisation, trade and investment promotion) and in channels (e.g. financial system, business environment);
- **Better mitigation of the effects of ODA phasing-out and resilience building**, as well as definition of new forms of co-operation less funding-focused.

ECLAC and OECD (2018) recommended:

A mechanism of swapping debt for climate change adaptation measures which may be a useful tool in building a viable solution for their heavy indebtedness. In exchange for a given extent of debt forgiveness or cancellation, the debtor country allocates funds to environmental conservation projects. These projects may deal with such areas as natural resource management, investment in renewable energy technologies and climate adaptation, building resilience, education and training, and the designation and management of protected areas.

⁴¹ Information retrieved from the OECD 2019 flyer on transition finance <https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/Transition-Finance-Main-Findings-2019.pdf>

OECD (2018) highlights three priority areas for SIDS finance for development, which are important in successfully graduating to higher income levels:

- **Enhancing access, modalities and partnerships for concessional finance:** To help SIDS manage external resources more effectively and tap into a larger array of resources, development partners will need to invest in more systematic and long-term approaches for strengthening national capacities and releasing absorptive capacity constraints. The revival of budget support in some SIDS, especially in the Pacific, is welcome and could be further expanded to other SIDS where the use of budget support is currently limited. Attention should be paid to the new 'conditionalities' attached to budget support, to ensure that SIDS governments preserve ownership.
- **Using concessional finance innovatively to leverage additional resources for sustainable development:** Development partners can support the adoption of adequate policy and regulatory frameworks as well as provide support to increase the economic and financial viability of income-generating activities. Official finance can be used more catalytically to de-risk investments or structure returns in a way to mobilise finance from the private sector through new and emerging blended finance arrangements. Development partners can support the design and implementation of innovative financial instruments, such as green and blue bonds - including by backing them through blending arrangements - to help mobilise financing from private investors.
- **Channelling concessional resources to priority areas:** Development partners can help SIDS explore new development paradigms and approaches to break dependence from fossil fuels, build climate resilience, and grasp the opportunities of the blue economy for sustainable development. Development partners need to encourage a transition to low-carbon economies, including by helping SIDS address barriers to investments for renewable energy, such as high initial costs. This would in turn significantly reduce the import bill for SIDS, with positive impacts on the fiscal space available for sustainable development investments.

6. References

- Acevedo, S. (2014). *Debt, Growth and Natural Disasters*. IMF Working Paper 14/125, International Monetary Fund: Washington D.C.
<https://www.imf.org/external/pubs/ft/wp/2014/wp14125.pdf>
- ADB (2013). *The Economics of Climate Change in the Pacific*. Asian Development Bank: Manila.
<https://www.adb.org/publications/economics-climate-change-pacific>
- Ancharaz, V. (2019). *Graduating from LDC Status: A Focus on Small Island Developing States (SIDS)*. International Trade Working Paper 2019/04, Commonwealth Secretariat: London.
https://www.thecommonwealth-ilibrary.org/commonwealth/trade/graduating-from-ldc-status_b2df5803-en
- Bourne, C. (2015). *Financing for Development Challenges in Caribbean SIDS: A Case for Review of Eligibility Criteria for Access to Concessional Financing*. United Nations Development Programme: Trinidad and Tobago.
https://www.undp.org/content/dam/rblac/docs/Research%20and%20Publications/Poverty%20Reduction/UNDP_RBLAC_Financing_for_Development_ReportCaribbean.pdf
- Cabezon, E., Hunter, L., Tumbarello, P., Washimi, K., Wu, Y. (2016). Strengthening Macro-Fiscal Resilience to Natural Disasters and Climate Change in the Small States of the Pacific. In: Khor, H., Kronenberg, R., Tumbarello, P. (eds.), *Resilience and Growth in the Small States of the Pacific*, International Monetary Fund: Washington D.C. (p.71-94)
<http://dx.doi.org/10.5089/9781513507521.071>
- ECLAC & OECD (2018). *Emerging Challenges and Shifting Paradigms: New Perspectives on International Cooperation for Development*. United Nations Economic Commission for Latin America and the Caribbean (ECLAC), Development Centre of the Organisation for Economic Cooperation and Development (OECD): Santiago.
https://repositorio.cepal.org/bitstream/handle/11362/44002/1/S1800619_en.pdf
- Fantom, N., Serajuddin, U. (2016). *The World Bank's Classification of Countries by Income*. Policy Research Working Paper 7528.
<http://documents.worldbank.org/curated/en/408581467988942234/The-World-Banks-classification-of-countries-by-income>
- Horscroft, V. (2014). *Public Sectors in the Pacific Islands: Are They 'Too Big' and Do They 'Crowd Out' the Private Sector?* World Bank Policy Research Working Paper 7102, World Bank: Washington D.C.
<http://documents.worldbank.org/curated/en/986481468098052675/pdf/WPS7102.pdf>
- Hurley, G. (2015). *Financing for Development and Small Island Developing States: A Snapshot and Ways Forward*. UNDP and UN-OHRLLS discussion paper.
[https://sustainabledevelopment.un.org/content/documents/2181\(UNDP%20%20OHRLLS%202015\)%20Financing%20for%20development%20and%20SIDS%20A%20snapshot%20and%20ways%20forward.pdf](https://sustainabledevelopment.un.org/content/documents/2181(UNDP%20%20OHRLLS%202015)%20Financing%20for%20development%20and%20SIDS%20A%20snapshot%20and%20ways%20forward.pdf)
- IMF (2018). *Samoa. Staff Report for the 2018 Article IV Consultation – Debt Sustainability Analysis*. International Monetary Fund: Washington D.C.
<https://www.imf.org/external/pubs/ft/dsa/pdf/2018/dsacr18145.pdf>

- IMF (2017). *List of Low Income Countries' Debt Sustainability Analysis for Poverty Reduction and Growth Trust-Eligible Countries*. International Monetary Fund: Washington D.C., <https://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf>
- IMF (2013). *Macroeconomic Issues in Small States and Implications for Fund Management*. International Monetary Fund. <https://www.imf.org/external/np/pp/eng/2013/022013.pdf>
- Khor, H., Kronenberg, R., Tumbarello, P. (2016). *Resilience and Growth in the Small States of the Pacific*. International Monetary Fund: Washington D.C. <http://dx.doi.org/10.5089/9781513507521.071>
- King, D., Tennant, D.F. (2014). *Debt and Development in Small Island Developing States*. Palgrave Macmillan, New York. <https://doi.org/10.1057/9781137392787>
- Loayza, N., Olaberria, E., Rigolini, J., Christiaensen, L. (2009). *Natural Disasters and Growth: Going Beyond the Averages*. Policy Research Working Paper 4980, World Bank: Washington D.C. <https://elibrary.worldbank.org/doi/abs/10.1596/1813-9450-4980>
- Mitchell, T., Zaman, S., Raja, C. (2018). *A Panel VARX Analysis of Debt and Natural Disasters in SIDS*. Economics Technical Working Paper 2018/02, The Commonwealth. http://thecommonwealth.org/sites/default/files/inline/ETWP_2018-02.pdf
- Morris, R., Cattaneo, O., Poensgen, K. (2019). *Transition Finance in Least Developed Countries and Small Island Developing States: Cabo Verde Country Pilot*. Organisation for Economic Cooperation and Development: Paris. <https://doi.org/10.1787/1affcac6-en>
- OECD (2018). *Making Development Co-operation work for Small Island Developing States*. Organisation for Economic Co-operation and Development: Paris. <https://www.oecd.org/publications/making-development-co-operation-work-for-small-island-developing-states-9789264287648-en.htm>
- OECD (2017). *Next Steps for Development in Transition: A Background Paper*. Presented during the 18 May 2017 meeting in Brussels, Belgium, co-hosted by The Directorate-General for International Cooperation and Development of the European Commission, the OECD Development Centre and the Economic Commission for Latin America & the Caribbean. http://www.oecd.org/dev/BackgroundPaper_DiT.pdf
- Soobramanien, T. Y., Gosset, L. (2015). Small States in the Multilateral Trading System: An Overview. In Soobramanien, T. Y. and Gosset, L. (eds.), *Small States and the Multilateral Trading System: Overcoming Barriers to Participation*. Commonwealth Secretariat: London. <https://sscoe.thecommonwealth.org/wp-content/uploads/2018/11/SmallStatesintheMultilateralTradingSystem.pdf>
- Tierney, P. (2018). *Climate and Post-Shock Concessional Finance in SIDS. Contributing to resilience of Small Island Developing States*. UN-OHRLLS. http://unohrlls.org/custom-content/uploads/2018/11/SIDS_Report_Climate-and-Post-Shock-Concessional-Finance.pdf
- UN (2018). *Maldives. Monitoring of Graduated and Graduating Countries from the Least Development Country Category*. Committee for Development Policy, 20th Plenary Session, New York. <https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/CDP-PL-2018-3c.pdf>

- UN (2017). *Samoa. Monitoring of Graduated and Graduating Countries from the Least Development Country Category*. Committee for Development Policy, 19th Plenary session, New York. <https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/CDP-PL-2017-5c.pdf>
- UNCTAD (2018). *Financing for development: Debt and debt sustainability and interrelated systemic issues*. Trade and Development Board Intergovernmental Group of Experts on Financing for Development, Second session Geneva, 7–9 November 2018. https://unctad.org/meetings/en/SessionalDocuments/tdb_efd2d2_en.pdf
- UNCTAD (2017). *Environmental Vulnerability and Debt Sustainability in the Caribbean: Do we have enough tools to address catastrophic risk?* United Nations Conference on Trade and Development Policy brief no. 62. https://unctad.org/en/PublicationsLibrary/presspb2017d11_en.pdf
- UNCTAD (2016). *The Least Developed Country Report 2016: The Path to Graduation and Beyond*. United Nations Conference on Trade and Development: New York and Geneva. https://unctad.org/en/PublicationsLibrary/lcdc2016_en.pdf
- UNCTAD (2014). *FDI in Small Island Developing States: Its Limitations and Potential*. Global Investment Trends Monitor, Special Edition No. 17. https://unctad.org/en/PublicationsLibrary/webdiaeia2014d6_en.pdf
- UN-OHRLLS (2017). *Small Island Developing States in Numbers: Updated Climate Change Edition 2017*. http://unohrlls.org/custom-content/uploads/2017/09/SIDS-In-Numbers_Updated-Climate-Change-Edition-2017.pdf
- World Bank (2017). *Small States: A Roadmap for World Bank Group Engagement*. World Bank Group: Washington, D.C. <http://pubdocs.worldbank.org/en/982421496935264348/Small-States-Roadmap.pdf#zoom=70>
- World Bank (2014). *Helping Small Island States Cope with the Aftermath of Natural Disasters*. Treasury Case Study, World Bank: Washington D.C. <http://documents.worldbank.org/curated/en/806491468128093045/Helping-small-island-states-cope-in-the-aftermath-of-natural-disasters>

Suggested citation

Quak, E. (2019). *How losing concessional finance affects Small Island Developing States (SIDS)*. K4D Helpdesk Report No 626. Brighton, UK: Institute of Development Studies.

About this report

This report is based on five days of desk-based research. The K4D research helpdesk provides rapid syntheses of a selection of recent relevant literature and international expert thinking in response to specific questions relating to international development. For any enquiries, contact helpdesk@k4d.info.

K4D services are provided by a consortium of leading organisations working in international development, led by the Institute of Development Studies (IDS), with Education Development Trust, Itad, University of Leeds Nuffield Centre for International Health and Development, Liverpool School of Tropical Medicine (LSTM), University of Birmingham International Development Department (IDD) and the University of Manchester Humanitarian and Conflict Response Institute (HCRI).

This report was prepared for the UK Government's Department for International Development (DFID) and its partners in support of pro-poor programmes. It is licensed for non-commercial purposes only. K4D cannot be held responsible for errors or any consequences arising from the use of information contained in this report. Any views and opinions expressed do not necessarily reflect those of DFID, K4D or any other contributing organisation. © DFID - Crown copyright 2019.

