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Strengthening fiscal policies to ensure fiscal sustainability, efficient and dynamic financing for development, and better debt management in Liberia

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Abstract

This policy brief is drawn from a case-study on “Strengthening fiscal policies to ensure fiscal sustainability, efficient and dynamic financing for development, and better debt management in Liberia”. The results of the study are briefly presented and some policy recommendations discussed.

The study used annual data from 1990 to 2020 to estimate a vector error correction model (VECM) to determine the relationship between debt relief and selected variables in Liberia. The results show an improvement in the health system, expanding international trade, reducing the exchange rate against the USD and infant mortality could reduce total debt in the long term.

Background and objective

Fiscal policies are development instruments. They can be understood as a set of measures related to public spending and debt used to generate enough public savings to encourage national public investment. Liberia currently faces a rapid weakening of macroeconomic conditions: sources of fiscal revenue have fallen, causing the fiscal deficit to deteriorate to 2.77% of GDP in 2020, mainly caused by declining investment and import and export demand, which have been exacerbated by the COVID-19 pandemic, and increasing spending pressures to mitigate the socioeconomic and health effects of the pandemic.
According to the International Monetary Fund (IMF), Liberia's gross debt reached $ 1805 million in 2020. Since 2009, the level of debt has grown steadily to represent 59.5% of GDP in 2020 due to reduced demand for raw materials and a sharp fall in imports. Moreover, taxes on international trade and a protracted pandemic have led to an unprecedented slowdown in global and regional economic growth. The lack of fiscal space limits the ability of the Liberian government to respond with a comprehensive and efficient fiscal policy in times of crisis, therefore, the Government has been financed with external loans.
The health emergency created by the COVID-19 pandemic has caused a sharp contraction of the Liberian economy, mainly because of its dependence on the manufacturing and mining sectors. To better cope with the impact of COVID-19, Liberia benefited from the debt relief mechanism granted by the IMF to free resources to meet the exceptional payment balances generated by the pandemic.
Other concerns brought by the pandemic include increased social inequality, a lack of basic services and facing increasing other challenges. In addition, it must guarantee the quality of public spending and strengthen social cohesion to promote progressive fiscal reforms and reduce tensions in the internal intervention, which is an immense challenge because the Liberian government must guarantee food security and reduce economic disturbances caused by the pandemic.
The objective of the study is to estimate the effects of health, debt, fiscal and inequality related measures on economic growth, and total debt.

Promising macroeconomic conditions for debt reduction, fiscal sustainability: Key findings

This study used annual data from 1990 to the end of 2020 and the vector error correction modelling (VECM) technique to determine the relationship between debt relief and selected variables in Liberia. This study then tested the presence of Granger causality, indicating a long-term relationship between the variables.
The data used in this study was collected from the World Bank databases and the IMF, and cover the 1990-2020 period. The economic measures used include GDP, inflation, health expenditure, government expenditure, total debt, short-term debt, Gini coefficients and trade.

In addition, we consider measures from SDGs 3, 8 and 10, such as infant mortality rate (as health status), the proportion of people living below 50% of the median income, labor force participation and Country Policy and Institutional Assessments Fiscal Policy Rating (CPIAF). We used vector error correction model (VECM) to estimate the relationship between debt alleviation and selected variables in Liberia. The results show an improvement in the health system, expanding international trade, reducing the exchange rate against the USD and reducing infant mortality will reduce total debt in the long term.

The results confirm that increasing health expenditure leads to economic growth and less debt. In fact, health status has a positively effects on economic growth, thus reducing infant mortality rate leads to economic growth. In contrast, the results suggest that infant mortality decreases total debt in the long term. The results show as well that transparency in fiscal policy has a significant and positive impact on debt alleviation and economic growth.
Further, increased labor force participation reduces debt in the long run, and leads to increased economic growth, while trade, not only has a positive and significant effect on economic growth, but it negatively affects total debt as well, for, increased exportation helps reduce total debt. However, since Liberia's trade balance is negative, decreasing the moderate exchange rate leads to economic growth and decreased total debt. We recommend creating exporting policies to increase international trade. Moreover, income equality plays an important role in economic growth.

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Recommendations for Action: approaches for achieving better policy outcomes

Given the rising importance of Agenda 2030, this study could help policymakers and other regulators define impactful frameworks promoting transparency, sustainability, and income equality. More importantly, greater tax effort would likely be costly because it would reduce incentives for investment and production.

However, increasing tax efficiency would eventually positively affect growth, which is essential in creating fiscal space. In the end, several recommendations can be drawn from this analysis:

- Pay special attention to improving public health, especially reducing infant mortality and improving health in general, because health policies that reduce infant mortality will reduce debt and increase economic growth in the long run.

- Monitor policies that increase labor force participation, because debt reduction will lead to long-term economic growth. In addition, policies that increase labor force participation increase social inclusion and social well-being.

- Increase transparency in fiscal policies to reduce debt in the long run. Transparency in fiscal policy improves economic growth and helps reduce total debt.

- Increase trade, with an emphasis on exporting reduce debt and increase economic growth in the long run. Incentivizing export policies will be one solution for Liberia. In the same vein, moderately lower the exchange rate will help promote exports, decrease total debt in Liberia and promote economic growth.

- Decrease government expenditure will help decrease total debt, and promote economic growth.

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