I. INTRODUCTION

1. The coronavirus disease (COVID-19) pandemic is the most severe economic shock faced by the Pacific. As small island developing states (SIDS), the Pacific economies are highly vulnerable to shocks and fragility or near-fragility—since each country exhibits at least some aspect or dimension of fragility—exacerbates the pandemic’s economic and social impacts. Travel restrictions pushed the subregion into unprecedented economic contractions during 2020 and 2021, rolling back per capita income by several years and placing hard-won gains in poverty reduction at serious risk. With tourism constrained since the second quarter of 2020, the previous strong momentum in visitor arrivals in Pacific destinations has been lost. Weak tourism performance could linger over the medium term through supply-side constraints stemming from business closures, resulting in further challenges to recovery. Although some countries have seen rising remittance inflows as relatives overseas provide support to families back home, remittances from seasonal workers have declined, with prospects for near-term recovery contingent on the resumption of international travel. Delays in project construction caused by constraints on mobility of labor and capital equipment have impeded productivity gains from infrastructure upgrades.

2. Eroding fiscal space from a collapse in government revenues amid subdued economic activity, along with increased expenditure needs to finance COVID-19 response packages, has translated into rising debt burdens for at least some countries in the Pacific. Latest assessments by the Asian Development Bank (ADB) and the International Monetary Fund (IMF) indicate that 8 of the 14 ADB developing member countries (DMC) in the Pacific are at high risk of debt distress. These are the Federated States of Micronesia (FSM), Kiribati, Papua New Guinea (PNG), Republic of the Marshall Islands (RMI), Nauru, Samoa, Tonga, and Tuvalu. However, only PNG’s rating has deteriorated due to COVID-19 pressures—with the IMF downgrading its risk of debt distress rating for PNG from moderate to high in June 2020—to account for ongoing adverse impacts on the economy, fiscal accounts, and the trajectory of debt. Others have been rated at high risk of debt distress even before the pandemic, largely due to their structural constraints as small economies with limited debt-carrying capacities, which is further compounded by elevated cost structures reflecting extreme remoteness, as well as an acute vulnerability to external shocks, including from climate change and disasters.

3. Debt risks are particularly heightened in the Cook Islands, Fiji, and Palau, where public debt is projected to rise by more than the equivalent of 30% of gross domestic product (GDP), with ongoing disruptions to international tourism driving a vicious combination of sharp economic contractions and mounting financing needs (Figure). Another group of countries is seeing more moderate increases in public debt mostly reflecting economic declines (i.e., in Samoa, Tonga,

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1 The authors can be reached through: pardeconomicsteam@adb.org.

2 It is important to highlight here that while some Pacific economies face elevated risks to debt sustainability, none of them are technically in debt distress. The IMF’s “in debt distress” rating applies to countries that are already experiencing difficulties in servicing their debt. In general, high risk of debt distress ratings in the Pacific primarily reflect structural constraints and the effects of the pandemic, rather than unsustainable borrowing policies by governments.
and Vanuatu) along with some new borrowing (i.e., in PNG and Solomon Islands). For the remaining countries, sustained access to grant assistance amid relatively less severe economic contractions is allowing for steady declines in respective debt burdens. Nonetheless, debt risks remain high the FSM, Kiribati, Nauru, the RMI, and Tuvalu.

**Figure: Projected trends in public debt-to-GDP in the Pacific, 2019–2022**

COO = Cook Islands, e = estimate, FIJ = Fiji, FSM = Federated States of Micronesia, GDP = gross domestic product, KIR = Kiribati, NAU = Nauru, p = projection, PAL = Palau, PNG = Papua New Guinea, RMI = Republic of the Marshall Islands, SAM = Samoa, SOL = Solomon Islands, TON = Tonga, TUV = Tuvalu

Notes:
(i) Niue has no public debt;
(ii) The superscript * denotes a high risk of debt distress rating.
Source: Asian Development Bank estimates using data from national sources and the International Monetary Fund.

4. Rising debt burdens represent a critical risk to the eventual recovery phase from the COVID-19 crisis. Although economic recovery will allow Pacific DMCs to gradually regain some fiscal space, a substantial portion of this will then have to be allocated toward higher debt servicing requirements arising from substantial new borrowing necessitated by COVID-19 pressures. Compounded by additional risks potentially emerging from contingent liabilities, fiscal space may be constricted enough to mute potential stimulus from infrastructure projects, which has long been a key driver of near-term growth accelerations in the Pacific, while also precluding the re-accumulation of fiscal buffers for responding to possible future shocks.

5. This note gauges the extent of contingent liability risks in the Pacific, given the limited availability of data. It offers insights on the potential adverse implications that contingent liabilities may pose on the sustainability of the Pacific’s recovery from COVID-19, as well as on the longer-term prospects of completing the remaining development agenda. The note concludes with recommendations toward strengthening management of contingent liabilities and mitigating macro-fiscal risks.
II. SOURCES OF CONTINGENT LIABILITIES

6. A contingent liability is a payment obligation whose occurrence, timing, and amount depend on some uncertain future event or circumstance. In the context of the public sector, explicit contingent liabilities may include: (i) borrowing, lending and guarantees by state-owned enterprises (SOEs); (ii) obligations arising from public-private partnership contracts; (iii) unfunded pension liabilities from social security schemes; (iv) damage and loss to government-owned infrastructure after disasters; and (v) other legal claims against the national government. For Pacific governments, the bulk of contingent liabilities stem from (i), (iii), and (iv).

7. SOE borrowing and guarantees. With limited private sector development in most Pacific DMCs, SOE operations tend to permeate across various segments of the economy. In addition to their central roles in delivering essential infrastructure services—including power, water supply and sanitation, information and communications technology, as well as airports and seaports—SOEs in the Pacific also venture into commercial activities, for example in agriculture, banking, oil and gas, and tourism. Mandates to provide services at noncommercial or below full cost-recovery terms, on top of weak productivity due to managerial capacity constraints and low investment in human and physical capital, result in overall poor financial performance of Pacific SOEs. This, in turn, has translated into perennial needs for government assistance through direct transfers and/or debt guarantees, which add to contingent liabilities. Risks are exacerbated further during economic downturns, particularly during the ongoing COVID-19 pandemic, when SOEs providing utility, infrastructure, and financial services face heightened cashflow pressures due to reduced demand (Box 1). However, more sustained fiscal strain can emanate from SOEs whose operations are subsidized mostly as a form of indirect social assistance and are therefore lacking commercial principles that are critical for financial sustainability (Box 2).

Box 1: Fiji Airways and Fiji Development Bank in the time of COVID-19

The Government of Fiji had extended financial support to two of its state-owned enterprises as the COVID-19 pandemic wreaked havoc on the country’s tourism-dependent economy.

On 25 May 2020, the Parliament of Fiji approved the government’s plan to provide sovereign guarantees to Fiji Airways in the amount of up to F$455 million to cushion the airline’s ongoing liquidity pressures brought about by the pandemic. The global movement restrictions and border closures have effectively eliminated travel demand and, essentially, the airline’s primary source of revenue. The support, which is equal to about 4.6% of Fiji’s 2020 GDP, will last for a period of three years. This is expected to boost the airline’s cash reserves, payment deferrals, and new long-term debt financing.

A year after, on 26 May 2021, an additional government guarantee for F$170 million (1.8% of 2021 GDP) was extended to Fiji Development Bank. Given FDB’s mandate, among others, to take on noncommercially-viable economic development investments and low-income borrowers who are unable to access commercial sources of funds, the guarantee will enable government to continue supporting essential and resource-based sectors, such as agriculture, as well as assist Fijians, both in the formal and informal sectors. It is also expected to serve as a lifeline for businesses severely affected by pandemic. The financial

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support comes with a .075% fee on the cumulative utilized guarantee credit. Total guarantees to FDB were 3.5% of GDP as of July 2021 (IMF 2021).

Sources:

Box 2: Stuck in the Middle: Tobolar in the Marshall Islands

Tobolar Copra Processing Authority, the state-owned copra processing plant of the Republic of the Marshall Island (RMI), purchases copra at above-market prices but exports it at market prices. This has driven operating losses that averaged $3.8 million a year from FY2012 (ended 30 September 2012) to FY2020 and rose by 20.8% a year in the last 4 years of that period.

The government offsets Tobolar’s losses via subsidies, which were doubled from $1.7 million (0.9% of GDP) in FY2015 to $3.4 million (1.7% of GDP) in FY2016. This was supposed to be a temporary pre-holiday bonus, but Tobolar’s annual subsidy has generally risen since then to stand at $8.1 million (3.3% of GDP) in FY2020. During the period, its share of total subsidies—which themselves have also increased—soared from 16.5% in FY2015 to 57.4% in FY2020.

The significant increases in support reflect Tobolar’s increased role as a channel for social assistance; purchasing copra at above-market prices guarantees an income for farmers and encourages those based in the outer islands to stay in these areas instead of migrating to the country’s heavily congested urban centers. However, these also pose a major fiscal risk given tighter fiscal resources due to the pandemic and the looming expiration of the RMI’s Compact of Free Association with the United States.

The government reduced subsides to Tobolar in FY2021. However, adjusting payments to farmers will prove difficult given the high priority given to supporting incomes in the outer islands, and the political sensitivity accompanying this issue.

Sources:

8. **Unfunded pension liabilities.** Several superannuation or pension funds in the Pacific have built up substantial unfunded liabilities, with the growth in benefit payments outpacing contribution rates, thus leaving systems unbalanced over the long-term. A common driver of sudden or rapid accumulations in unfunded pension liabilities is ad hoc benefit adjustments, usually legislated mainly based on political considerations (Box 3). Substantial unfunded liabilities then lead to periodic needs for large injections from government to fund benefit payments that otherwise cannot be covered by the pension fund’s available assets.

9. **Disasters.** Country-level estimates by the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI, now known as the Pacific Catastrophe Risk Insurance Company or PCRIC) show that Pacific economies face average annual losses from earthquakes, tsunamis,
and cyclones ranging from 0.2% of GDP in Kiribati to 6.6% of GDP in Vanuatu.\(^5\) Average annual losses for the Pacific DMCs from earthquakes, tsunamis, and cyclones are almost $300 million, with PNG accounting for about $85 million and Fiji for $80 million. Governments may incur substantial contingent liabilities in the aftermath of major disasters, as infrastructure and other assets will need to be rehabilitated and restored (Box 4).

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**Box 3: Dual risks from Palau’s pension funds**

The social security framework in Palau comprises the Civil Service Pension Plan (CSPP) for public sector employees and the Social Security Administration (SSA) that covers the private sector workers. As of October 2020, the SSA’s unfunded liabilities amounted the equivalent of 170% of annual GDP. The buildup in unfunded liabilities ramped up in recent years with the legislation of supplementary benefits for members. In FY2017 (ended 30 September 2017), an additional $50 per month in benefits was legislated, supported by a government transfer of $2 million and an increase in the contribution rates of employers and employees from 6% to 7% of gross salaries. However, a further $50 per month was awarded to beneficiaries in FY2019, but with no compensating increase in rates, leaving the system imbalanced. The latest actuarial valuation projects that the SSA’s pension fund will be exhausted by 2041/2042 absent reforms.

Similarly, as of October 2020, the CSPP has large unfunded liabilities totaling the equivalent of 71% of GDP, but its pension fund is projected to collapse much sooner, by 2027/2028. Benefits have continued to outstrip contributions as much-needed reforms—chiefly the introduction of a defined contribution scheme to complement the current defined benefit plan—have remained stalled.

As a result of these dual pressures, Palau’s social security pension funds received transfers totaling the equivalent of 1.3% of GDP in FY2019. Needs for transfers are only projected to rise in the future while large substantial unfunded liabilities persist, emphasizing the urgent need for broad social security reform.


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**Box 4: Damage and losses from the 2022 volcanic eruption in Tonga**

On 20 December 2021, an underwater volcanic eruption was observed in the vicinity of the uninhabited islands of Hunga Tonga and Hunga Ha’apai around 65 kilometers north of the Tongan capital of Nuku’alofa. Another eruption occurred on 14 January 2022 followed by a massive eruption in the early morning of 15 January 2022, resulting in ashfall and tsunami alerts for Tonga and neighboring countries.

The latter event is considered as one of the largest eruptions in the last 30 years, generating up to 15-meter-high tsunami waves that ravaged the western coasts of Tongatapu, Ha’apai, and ‘Eua islands and shockwaves that were felt 800 kilometers away in Fiji. No additional eruptions have been reported but further volcanic activity still cannot be ruled out. Communication lines were cut due to damage to the undersea internet cable with only partial restoration of service and unreliable connectivity to date.

Limited communications have prevented a clear picture of the situation on the ground especially in the outer islands. There are reports of significant damage to infrastructure in the main island of Tongatapu and four people have been confirmed dead thus far. The government placed the entire country under a state of emergency on 19 January 2022.

While damage to agriculture has been less severe than initially expected, around 60-70% of households engaged in livestock raising have been badly affected. Around 84% of the population have been directly affected by the disaster though everyone has been impacted in one way or another. Initial assessment by the government and humanitarian partners indicate about 293 houses have been damaged or destroyed.

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and 2,390 people are still displaced as of 31 January 2022. Most humanitarian needs are being met by the government and international partners, but access to safe drinking water remains challenging due to the contamination of water sources by seawater and volcanic ash.

The eruption once again highlights the vulnerability of Small Island Developing States (SIDS) to natural hazards such as volcanic activity and tsunamis. In the case of Tonga, the great majority of human settlements and infrastructure are concentrated in low-lying coastal areas and there is limited higher ground for people to evacuate to during tsunamis. Water supplies dependent on rainwater harvesting and ground water were also susceptible to contamination from ashfall. The World Bank estimates the economic cost of the eruption, tsunami and ashfall at $90.4 million, equivalent to around 18.5% of Tonga's GDP. Most of the damage was accounted for by structures, followed by agriculture, infrastructure, and ash clean-up costs.

Sources:
United Nations Office for the Coordination of Humanitarian Affairs. 2022. Tonga: Volcanic Eruption and Tsunami - Jan 2022 | ReliefWeb

10. Based on these three broad categories, Table 1 below summarizes the latest available estimates of contingent liabilities faced by Pacific governments. Contingent liabilities stemming from SOE guarantees and pension funds are compiled using national budget documents and the IMF’s Article IV reports, which generally contain data on both public sector debt and publicly guaranteed borrowing. For contingent liabilities due to disasters, ADB estimates are based on average annual losses from disasters as calculated by PCRAFI, scaled to reflect the government’s share in these losses by using the public sector’s share in total consumption, from national accounts by expenditure data.

11. Contingent liabilities from SOEs are most substantial in Fiji, the FSM, Palau, and Vanuatu. Contingent liabilities in Fiji have mainly focused on three SOEs: Fiji Airways, Fiji Development Bank, and Fiji Sugar Corporation. The government’s progress in SOE reforms saw contingent liabilities improve in the last few years until FY2017 (ended 31 July 2017). However, an increase in contingent liabilities has been observed since then and the onset of the pandemic has exacerbated the situation, with the government extending guarantees to severely affected SOEs (see Box 1). This has translated to a surge in the country’s total contingent liabilities, rising 46% over the last three years.

12. In the FSM, contingent liabilities are derived from total outstanding guaranteed loans by the National Government to SOEs (i.e., "national component units"). In the latest FY2020 (ended 30 September 2020) Audit Report of National Government and Component Units, this is equivalent to the sum of long-term obligations under discretely presented component units. The bulk of these liabilities are accounted for by FSM Telecommunications Corporation, FSM Petroleum Corporation, and Vital Energy, Inc. mainly for capital expenditures such as Pohnpei’s submarine fiber optic cable.

13. Palau’s contingent liabilities from SOEs are mainly from long-term debt of the Palau Public Utilities Corporation (PPUC), a combined utility that provides electricity as well as water supply and sanitation services. PPUC is the country’s largest SOE, whose financial sustainability has historically been constrained by tariffs that are set below full-cost recovery as well as gaps in financial management and corporate governance. The National Development Bank of Palau has
also incurred some borrowings for capital funds. Overall, debt holdings of Palau’s SOEs are in the order of about 10% of annual GDP.

### Table 1: Estimated Contingent Liabilities in the Pacific, by source

<table>
<thead>
<tr>
<th>Pacific DMC</th>
<th>SOE guarantees</th>
<th>Pension funds</th>
<th>Disasters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cook Islands</td>
<td>5.6</td>
<td>...</td>
<td>0.6</td>
</tr>
<tr>
<td>Fiji</td>
<td>10.4</td>
<td>...</td>
<td>0.6</td>
</tr>
<tr>
<td>Kiribati</td>
<td>6.0</td>
<td>...</td>
<td>0.1</td>
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<tr>
<td>Marshall Islands, Rep. of</td>
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<td>0.7</td>
<td>0.9</td>
</tr>
<tr>
<td>Micronesia, Fed. States of</td>
<td>11.6</td>
<td>...</td>
<td>1.2</td>
</tr>
<tr>
<td>Nauru</td>
<td>0.0</td>
<td>...</td>
<td>0.0</td>
</tr>
<tr>
<td>Niue</td>
<td>0.0</td>
<td>...</td>
<td>1.8</td>
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<tr>
<td>Palau</td>
<td>10.9</td>
<td>1.3</td>
<td>0.5</td>
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<tr>
<td>Papua New Guinea</td>
<td>3.1</td>
<td>0.1</td>
<td>0.3</td>
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<tr>
<td>Samoa</td>
<td>8.3</td>
<td>...</td>
<td>0.4</td>
</tr>
<tr>
<td>Solomon Islands</td>
<td>0.0</td>
<td>...</td>
<td>0.9</td>
</tr>
<tr>
<td>Tonga</td>
<td>1.6</td>
<td>...</td>
<td>0.8</td>
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<tr>
<td>Tuvalu</td>
<td>1.8</td>
<td>...</td>
<td>0.3</td>
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<tr>
<td>Vanuatu</td>
<td>20.0</td>
<td>...</td>
<td>1.8</td>
</tr>
</tbody>
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... = data unavailable, DMC = developing member country, GDP = gross domestic product, SOE = state-owned enterprise.

Notes:

(i) For contingent liabilities from pension funds, figures only reflect the magnitude of recent annual transfers from national governments toward social security administrations.

(ii) Contingent liabilities from disasters are gauged based on average annual losses from disasters as estimated by the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI, now the Pacific Catastrophe Risk Insurance Company, or PCRIC), with government’s share in these losses proxied by the public sector’s share in total consumption in national accounts by expenditure data.

(iii) In March 2021, the Government of Nauru resolved previous contingent liabilities from the Bank of Nauru, the Nauru Phosphate Corporation, and the Nauru Phosphate Royalties Trust. Further, PCRAFI estimates Nauru’s expected losses from disasters at less than $2,000 annually, which is negligible in proportion to GDP.

(iv) Niue has no public debt nor any contingent liabilities from SOE operations.

(v) Solomon Islands has no explicit nor implicit contingent liabilities from SOE operations. The government plans to provide guarantee to Solomon Power’s loan for the Tina hydro project in 2022, equivalent to 0.6% of GDP.

(vi) After taking direct control over Air Vanuatu, the high figure for Vanuatu reflects the possibility of the national government assuming financial obligations for recent aircraft purchases.

Source: Asian Development Bank estimates using data from national sources, the International Monetary Fund, and the Pacific Catastrophe Risk Assessment and Financing Initiative.

14. In Vanuatu, the government took direct control of Air Vanuatu in March 2021 for restructuring to reduce its reliance on state subsidies. Air Vanuatu was in the process of buying four new aircrafts estimated at $185 million (20% of GDP). The restructuring process includes review of aircraft contract for possible cancellation. If the government assumes full obligation over the aircraft cost, public debt ceilings will be breached.

15. Nauru has a history of assuming financial obligations of SOEs that failed. Its domestic debt at around 21.8% of GDP at end-FY2021 (ended 30 June 2021) consisted mainly of obligations from Nauru Phosphate Corporation. Prior to that, arrears from the liquidation of Bank of Nauru pushed domestic debt at 43.7% of GDP in FY2018. External debt also dropped from
30.1% of GDP in FY2020 to 5.2% in FY2021 with the resolution of liability related to Yen-denominated bonds defaulted by the Nauru Phosphate Royalty Trust. A settlement agreement was reached in March 2021 which included payment of A$4 million for the defaulted bonds.

16. In Tonga, total government-guaranteed loans are estimated at $7.3 million in FY2021 (ended 30 June 2021) representing around 1.6% of GDP. This is composed of $6.3 million for project loans for the Roads Improvement Project from Tonga Development Bank and $1.0 million for Lulutai Airlines Insurance Premium.

<table>
<thead>
<tr>
<th>Table 2: Indicative Mapping of Guarantees to State-Owned Enterprises, by sector</th>
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<tr>
<td>Pacific DMC</td>
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<td>Nauru</td>
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<td>Niue</td>
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<td>Solomon Islands</td>
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<tr>
<td>Tuvalu</td>
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<td>Vanuatu</td>
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Note: Gray shaded cells indicate government guarantees to state-owned enterprises in the corresponding sector.

17. Unfunded pension fund liabilities have necessitated transfers in recent years from the national government of Palau, PNG, and the RMI. In Palau, unfunded liabilities from both the Civil Service Pension Plan and the Social Security Administration have required total transfers equivalent to 1.3% of GDP as of FY2019 (ended 30 September 2019). Similarly, in 2019, PNG’s Nambawan Super Fund received transfers amounting to 100.0 million kina or $29.5 million, equivalent to 0.1% of annual GDP. For the RMI, transfers to the Marshall Islands Social Security Administration have steadily declined from the equivalent of 1.7% of GDP in FY2017 (ended 30 September 2017) to 0.7% by FY2020, reflecting progress from the implementation of a reform package approved in 2016.

18. For other Pacific DMCs, updated actuarial valuations are likely needed to determine the extent to which the economic and social impacts of COVID-19 are possibly contributing to emerging risks from unfunded liabilities. For instance, a 2017 fund valuation showed the FSM Social Security Administration may be unable to meet future benefit obligations given huge unfunded liabilities even ahead of the pandemic, though no actual transfers have been made to plug funding gaps thus far.

19. Considering potential damage and losses from disasters, contingent liabilities are highest in the FSM, Niue, and Vanuatu. In the FSM, the country’s geography consisting of scattered, low-
lying islands makes it susceptible to disasters as well as the effects of climate change. Population centers are susceptible to tropical cyclones, floods, landslides, and earthquake-induced tsunamis. Its small population and economy inherently restrict the size of the private sector, making the country especially dependent on SOEs in providing key infrastructure and services.

20. Niue is expected to incur average annual damage and losses from disasters equivalent to about 5.8% of GDP, the second highest in the Pacific after Vanuatu, based on PCRAFI estimates. Risks mostly stem from tropical cyclones, along with possible moderate earthquakes and tsunamis. The most severe cyclone in Niue’s history, Tropical Cyclone Heta in 2004, caused widespread damage valued equivalent to a staggering 500% of annual GDP. Most recently, Cyclone Tino in January 2020 damaged Alofi wharf, leaving the country’s only maritime transportation hub temporarily out of commission and disrupting fishing and business activity.

21. Vanuatu was rated as the world’s most vulnerable country for disasters in the World Risk Report (2020). It is vulnerable to cyclones, and the damage is often substantial relative to national income, as well as volcanic eruptions and tsunamis. In 2015, Tropical Cyclone Pam caused damages equivalent to around 60% of GDP. In 2020, damages from Tropical Cyclone Harold were estimated at 54% of GDP.

III. RISING RISKS AMID SIGNIFICANT REMAINING FINANCING NEEDS

22. The magnitude of contingent liabilities across the Pacific—and its potential to expand further as the economic and social impacts of COVID-19 pandemic linger—is an emerging fiscal risk that becomes even more critical in the context of the subregion’s substantial financing needs to bridge infrastructure gaps while also building resilience to climate change and disasters. Most Pacific DMCs still need to considerably expand access to basic services and greater connectivity. The financing gap for basic infrastructure alone in the Pacific is estimated to exceed $2.8 billion per year—equivalent to 8.2% of GDP—up to 2030. Further, Pacific DMCs are disproportionately susceptible to climate change. Depending on global efforts to limit warming, the World Bank estimates suggest that Pacific economies will need between $350 million and $1 billion annually during 2020–2029 (and between $400 million and $1.1 billion annually by 2040) to adapt to climate change, undertake necessary costal protection, and climate-proof infrastructure. Needs are especially acute in atoll countries such as Kiribati, the RMI, and Tuvalu, and could reach 5%–10% of GDP annually.

23. If significant enough portions of contingent liabilities—particularly from SOE guarantees—are realized, governments’ scarce fiscal resources will need to be diverted away from essential spending on infrastructure and social services toward additional debt servicing and repayment. In the near-term, this has the potential to undermine the sustainability of economic recovery from the pandemic by disrupting paths toward fiscal consolidation. Over the longer-term, realized contingent liabilities may lead to cases of debt overhang, where heavy sovereign debt burdens translate to low episodes of low economic growth as large debt servicing requirements preclude both countercyclical fiscal policy as well as productive investments in human and physical capital. This can also slow the accumulation of sufficient fiscal buffers to allow for adequate responses to

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possible future shocks. Ultimately, realization of significant contingent liabilities can significantly delay the achievement of Sustainable Development Goals, to the detriment of the welfare of current and future generations.

IV. POLICY RECOMMENDATIONS

24. **Strengthening accounting and control of contingent liabilities.** A key initial step toward mitigating mounting fiscal risks is to address currently weak frameworks and limited capacities to monitor and control contingent liabilities. Strengthening the management of contingent liabilities arising from SOE operations will require a comprehensive review of relevant policies, including loan guarantees to SOEs and state or local governments, as well as on the issuance of indemnities through social security schemes. Further refining these policies, possibly through legislation, with the primary objective of limiting the national government’s exposure to major sources of contingent liabilities will help contain fiscal risks.

25. Building capacities for accurate and timely recording, monitoring, and reporting of any ongoing and new sources of contingent liabilities will likewise enhance transparency and enable governments to undertake appropriate mitigating measures should risks become elevated. Regular stocktaking assessments and risk analyses will also be critical to identify and address emerging issues early enough to avoid rapid accumulations in the fiscal burden posed by contingent liabilities. ADB’s ongoing Public Financial Management Project in the RMI is helping the government to strengthen control over contingent liabilities, initially through the development of a detailed policy paper on contingent liabilities that will help inform subsequent legislation.⁸

26. **SOE reforms.** For broad oversight and to facilitate the successful implementation of reforms, some Pacific DMCs have established dedicated SOE monitoring units focused on strengthening operational efficiency, financial management, and broader corporate governance frameworks of SOEs to help reduce fiscal risks arising from this sector. In the RMI, ADB’s ongoing project (footnote 8) also helped establish and operationalize an SOE Monitoring Unit within the Ministry of Finance. It is tasked with strengthening fiscal discipline and monitoring the performance of SOEs toward ensuring value-for-money for government’s support while reducing any exposure to contingent liabilities. Similar units are in place in Kiribati (within the Ministry of Finance and Economic Development), Nauru (the Public Enterprise Monitoring Unit within the Department of Finance), and Vanuatu (the Government Business Enterprise Monitoring Unit within the Ministry of Finance and Treasury). SOE monitoring and oversight are responsibilities of the Solicitor General in Fiji, the Minister for Public Enterprise and State Investments along with the National Executive Council in PNG, and the Minister for Public Enterprise in Samoa. In Palau, the government is also embarking on broader SOE reform, beginning with the adoption of performance monitoring standards and a pending SOE Governance bill that will, among others, enable the creation of a dedicated monitoring unit.

27. Progressively building the capacity of SOE monitoring and oversight bodies can help promote synergies from greater interlinkages across SOE reforms, ministries’ sector strategies, and the government’s broader development agenda for a more concerted approach to improving service delivery over the longer term. Further, complementing SOE reforms with the requisite

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⁸ ADB. *Marshall Islands: Public Financial Management Project (Second Additional Financing).*
sustained funding commitments—for example, with properly costed and targeted community service obligations (CSOs) in governments’ rolling medium-term fiscal strategies, as well as through adequate upgrading and maintenance provisions for critical infrastructure in national investment plans—can promote fiscally sustainable delivery of essential services, including by potentially expanding opportunities for further private sector participation.

28. Given the continuing need to deliver basic services across the Pacific DMCs’ widely dispersed populations, including those in remote outer island communities, proper identification and costing of legitimate CSOs will be central to any efforts to contain contingent liabilities arising from SOE operations. Comprehensive assessments of CSO costs will help identify, and eventually phase out, the portion of annual subsidies that effectively finance lingering SOE inefficiencies, which will help reduce the government’s obligations for transfers and exposure to contingent liabilities. Alternative mechanisms to provide social assistance, e.g., a formal system providing direct and targeted transfers, will help fulfill government objectives to protect vulnerable populations without sacrificing SOE efficiency gains.

29. More broadly, moving to full-cost tariff regimes with well-specified CSO frameworks, along with financial management and corporate governance reforms will reduce subsidy requirements and contingent liability risks from SOEs. The latter could involve professionalizing management of SOE boards, improving revenue collection and infrastructure, and promoting more timely and detailed record-keeping and financial reporting. ADB is supporting a suite of such reforms to help the PPUC to improve the reliability, affordability, and sustainability of its service delivery.\(^9\)

30. **Pension fund reform.** In view of additional pressures stemming from the COVID-19 crisis, updated actuarial valuations of the Pacific’s superannuation or social security pension funds are necessary to gauge current levels of unfunded liabilities and funded ratios, projected long-term trends of benefits and contributions, and other indicators of longer-term sustainability. As necessary, this will help inform the design of comprehensive reform packages to help restore social security schemes into long-term balance. Parametric, structural, or even systemic reforms should be considered to avoid large contingent liabilities arising from financially unsustainable pension schemes.

31. A key near-term step will be an unwinding of various temporary social assistance measures delivered actively and passively through pension funds—for example by national provident funds in Fiji, Kiribati, Solomon Islands, Tuvalu, and Vanuatu—one the economic and social impacts of COVID-19 sufficiently dissipate. Over the longer-term, reform packages may include, among others, adjustments to contribution rates, phased increases in the retirement age, and the introduction of a defined contribution plan to complement existing defined benefit systems. In particular, reforms to allow for inflation-indexed pension adjustments will help eliminate pressure for any future unfunded and politically-driven increases or additions to benefits that push social security schemes into imbalance and unsustainability and result in contingent liabilities for government. Technical assistance from ADB is currently supporting the conduct of updated actuarial valuations and subsequent design of reform packages for Palau’s two social security schemes.\(^{10}\)

\(^9\) ADB. Palau: Palau Public Utilities Corporation Reform Program (Subprogram 1).
\(^{10}\) ADB. Regional: Pacific Economic Management (Phase 3).
32. Another area for potentially boosting the long-term sustainability of pension funds concerns maximizing returns from their respective investment portfolios. Sustained increases in investment income will help meet annual benefit payment obligations but will also require a comprehensive review and refinement of relevant strategies and policies. On specific portfolio investment strategies, although there will likely be opportunities to raise returns during the eventual recovery phase as the global economy rebounds from the COVID-19 crisis, realizing these will depend on institutional capacities to judiciously pursue potential market gains subject to an acceptable level of risk. More flexible frameworks allowing investments in a wider range of asset classes can be useful, but decisions on limiting or expanding portfolio exposure to particular asset types will need to account for a similarly critical need to also manage volatilities in year-to-year returns toward increasing predictability in the share of payments that can be funded through investment income. At the macro level, easing any remaining constraints to capital flows will further allow more opportunities for potentially more profitable cross-border investments.

33. In 2021, the Palau Social Security Administration (along with the FSM Trust Fund) formally adopted an investment strategy that aligns with national climate goals, whereby pension fund investments are channeled toward global companies that either provide solutions to climate change or whose business models are oriented toward a low-carbon economy. Capacity development, including possible supplementation through outsourced fund management expertise, will be critical in managing this transition to a novel strategy that precludes investment in conventionally financially profitable but environmentally unfriendly assets, toward achieving the dual objectives of long-term portfolio appreciation while maintaining a consistent commitment to reducing carbon emissions.

34. **Quality infrastructure, climate change adaptation, and disaster resilience.** To bridge wide remaining gaps in access to basic infrastructure services in an economically efficient, socially inclusive, and environmentally sustainable and resilient manner, future investments in the Pacific can be guided by the Group of 20 (G20) Principles for Quality Infrastructure Investment. These principles are: (i) maximizing the positive impact of infrastructure to achieve sustainable growth and development, (ii) raising economic efficiency in view of life cycle costs, (iii) integrating environmental considerations into infrastructure investments, (iv) building resilience against disasters and other risks, (v) integrating social considerations into infrastructure investment, and (vi) strengthening infrastructure governance. In view of Pacific DMCS’ disproportionate susceptibility to climate change and heightened vulnerability to disasters, the G20 principles (iii) and (iv) are particularly important underpinnings in climate- and disaster-proofing of infrastructure to ensure quality investment. These will also help mitigate contingent liabilities arising from economic damage and losses from climate change and disasters.

35. During 2015–2019, ADB has helped five Pacific DMCs—the Cook Islands, Fiji, Kiribati, Nauru, and Tonga—mobilize $133 million in concessional financing from the Green Climate Fund to build climate-proof infrastructure, adapt water supply services to changed climatic conditions, and install new renewable energy generation capacity across the Pacific. Moving forward, ADB’s *Pacific Approach 2021–2025* prioritizes quality infrastructure and disaster risk reduction, among others, toward an overall goal of supporting a resilient Pacific.

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