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THE IMPACT OF DEBT SERVICE ON ECONOMIC GROWTH IN A SMALL ISLAND DEVELOPING STATE: A CASE STUDY OF ZANZIBAR

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Abstract: *This study examines the relationship between Zanzibar's debt service and economic growth (GDP per capita) from 1987 to 2022. Employing a Vector Error Correction Mechanism (VECM) with time series data, we analyze the long-run impact of debt service on growth. While our results show a positive correlation, it's not statistically significant. This suggests that effective debt management, fostering investor confidence and stability, can potentially stimulate growth. The study emphasizes the importance of balanced debt strategies and informed policymaking for Zanzibar's sustainable development. It highlights the complexities of debt-growth dynamics, underlining the need for fiscal discipline and prudent debt management for long-term prosperity. This research offers valuable insights for policymakers navigating debt and economic policy in island economies.*

Keywords: ***Debt service, Economic growth, SIDS***

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1. INTRODUCTION

The utilization of national debt as a fiscal tool to fund government spending plays a vital role in driving infrastructural development and stimulating economic growth. However, an excess of such debt can pose threats to economic stability and hinder growth. Theoretical frameworks like neoclassical growth theory and Keynesian theory suggest that external debt could positively impact the economy through increased investment and productivity. Yet, the potential misallocation of internal loans toward short-term needs rather than long-term projects poses a challenge [1].

Zanzibar's economic growth faces challenges due to inadequate revenue collection, leading to a fiscal deficit. The region relies on diverse internal revenue sources but explores external debts to bridge financial gaps. Zanzibar can independently secure domestic loans but requires Tanzanian government involvement for external loans. The process involves documentation submission to Tanzania; subsequent loan negotiations and agreements are managed by the Tanzanian government. Zanzibar can access external loans from various sources but is responsible for repaying domestic debts, while Tanzania oversees external debt repayment. Revenue-sharing mechanisms between Zanzibar and Tanzania allocate portions of Tanzanian revenue to Zanzibar, as outlined in [2].

In 2020, Zanzibar, like many developing nations amid the COVID-19 pandemic, faced reduced economic activities, leading to limited borrowing capacity and hindering economic growth. The absence of loans from developed countries exacerbated these challenges (as shown in the Figure 1). However, in 2021, Zanzibar obtained debt relief from developed nations, notably reducing interest payments from 122.8 billion to 116.4 billion [3]. This relief granted vital fiscal flexibility, enabling efforts to stimulate economic growth and foster sustainable development. The economic slowdown in 2020 hindered debt obligations and restricted new borrowing avenues, mirroring a global trend of reduced economic activities impacting borrowing capabilities. Subsequently, in 2022, Zanzibar received financial aid