Economic survey

Economic trends in the Pacific island countries

Satish Chand

The Pacific islands economies display considerable heterogeneity on all counts except for their poor economic performance. The few positives however, are overwhelmed by the fiscal stress experienced in Nauru, Papua New Guinea, Solomon Islands, and Vanuatu. Tourism, a sector with significant potential for the entire region, has been buffeted by massive external shocks. This paper surveys key issues that pervade the Pacific: namely, deteriorating budgets and rising debt levels; increasing dependence on foreign aid for funding of basic services; and rising unemployment and crime. The prognosis for a sharp turnaround in any of these areas is poor, and concerted efforts must be made to kick-start growth to secure employment prospects and incomes of Pacific islanders.

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The Pacific islands display considerable heterogeneity on all counts except for their poor economic performance. Over the recent past, Samoa has experienced faster GDP growth, but GDP growth above the population growth rate would have to persist for a decade at least to make a discernible impact on employment, poverty, and average life expectancy. Even this star performer of 2001, with GDP growth of 8 per cent, was only able to register growth of 1 per cent in 2002. Fiscal problems persist in nearly all of the Pacific island countries, but the severity of the problem in Nauru, Solomon Islands, and Papua New Guinea is such that it has compromised the ability of the state to deliver basic services, such as primary education, health care, and personal security.

The region has a reputation for its 'subsistence affluence', a term coined to reflect the minimal hours of work necessary to meet the dietary requirements of the family. While the average Pacific islander probably works fewer hours to feed her family than in other developing economies, diminishing access to traditional foods are leading to pockets of food-poverty in nearly all Pacific island countries. In several cases, lack of access to protein and thus a preponderance of starch in the diet has led to nutritional deficiencies. Children and mothers are most at risk of such deficiencies even when hunger is not an issue.

Data on the economic performance of Pacific island countries has traditionally been weak. This is partly a reflection of resource constraints and partly a reflection

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of the low value that political leaders place on the collection of such information. Capacity building in national statistics offices, often funded by donors, is being undertaken in several Pacific island countries; this will relieve the problem of resource constraints but leaders also need to be convinced of the value of using timely and accurate information in informing policy if this perennial problem is to be contained.

Given the data deficiencies, the data used in this paper are only indicative of broad trends. In terms of the macroeconomic aggregates, the worst performer has been the Solomon Islands with the economy contracting by a massive 25 per cent in 2001; debt levels are estimated to have exceeded GDP. Public services have contracted to the urban centres and are mostly funded by aid donors. In early 2003 the public service

Table 1 **Basic indicators for Pacific island countries**

	Land area (km^2)	Population 2000 ('000s)	Population density (persons/ km^2)	Annual growth 1970–2000 Population (per cent)	Annual growth 1970–2000 Real GNP per capita	GNP per capita 2000 ($ purchasing power parity[h])
Papua New Guinea	463,000	5,200	11	3.7	0.3[d]	2,180
Fiji	18,272	812	44	1.9	2.7[e]	4,480
Solomon Islands	28,530	447	16	3.9	–0.4[f]	1,710
French Polynesia	3,265	235	72	3.7	..	23,340
New Caledonia	19,103	213	11	3.2	..	21,820
Vanuatu	11,880	197	17	4.6	–0.3[g]	2,960
Samoa	2,935	170	58	0.6	0.8[g]	5,050
Federated States of Micronesia	702	118	6	3.3[a]	..	2,000
Tonga	699	100	143	0.5	2.6	1,660
Kiribati	690	91	132	2.8	–1.2	950
North Marianas	477	70	68	..	..	12,857
Marshall Islands	181	50	36	2.9[b]	..	1,600
Cook Islands	240	21	88	-[b]	..	5,000
Palau	458	20	23	..	..	9,000
Wallis and Futuna	274	20	14	..	..	2,000
Nauru	21	12	571	..	..	5,000
Tuvalu	26	11	423	1.6[c]	–1.4[f]	1,100
Niue	259	2	8	..	..	3,800
Tokelau	10	1	100	..	..	1,500
Pacific average				3.4	0.6	

[a] 1980–2000 [b] 1981–2000 [c] 1983–2000 [d] 1973–2000 [e] 1968–2000 [f] 1967–2000 [g] 1979–2000
[h] Purchasing power parity for the Pacific is not derived directly but from econometric estimates based on 'like' countries; it is only applicable to urban, not to subsistence rural areas.
.. Data not available or vary by more than 25 per cent among sources.
Source: Hughes, H., 2003. *Aid has failed in the Pacific*, Issue Analysis 33, The Centre for Independent Studies, Sydney:Table 2.

was without electricity as power supplies were cut due to non-payment of arrears, while the Treasury was closed for a week as the Accountant General and the Secretary had left due to pressure to make payments under duress.

Nature has also contributed to the troubles of Pacific island countries in the form of cyclones, earthquakes, floods and drought. But these natural calamities, against which the people have very little recourse, are the least of their worries (while often drawing the most international attention). Man-made disasters such as coups, violent conflicts, corruption and crime are the major distractions from productive activity. Moreover, policies such as price controls, excessive constraints on informal sector operations, and budgetary outlays far in excess of the revenue-raising capacities of the state have all weighed heavily on growth of production. In those countries where there is also high population growth, there is likely to be declining per capita GDP. A comparison of the adverse growth effects of coups and cyclones in Fiji demonstrates the much more debilitating impacts of man-made catastrophes (Chand 2000). Disturbingly, policymakers have had little success in averting the more damaging man-made disasters. Lack of discipline within the army and the police forces in Fiji, Papua New Guinea, Solomon Islands and Vanuatu has been a major source of political instability; some of their actions have been reported by international observers and non-government organisations as amounting to 'human rights' violations.

A state of emergency was declared on Guadalcanal in June 1999 as the Solomon Islands descended into a vicious civil war between opposing paramilitary forces, the Malaita Eagle Force (MEF) and the Isatabu Freedom Movement (IFM). On 5 June 2000, MEF militants, together with disaffected police officers, took the Prime Minister, Bart Ulufa'alu, hostage. A week later the Prime Minister resigned, renewing the spiral of political uncertainty and social chaos. The government of Prime Minister, Manasseh Sogavare, was then voted into power as a replacement. A peace deal brokered by Australia in October 2000 officially ended the ethnic conflict. It provided for the decommissioning of weapons and a general amnesty for former combatants. The war may be over but the violence and economic paralysis continues. A reconciliation ceremony involving exchange of gifts of shell money, a pig and baskets of food between the former supreme command of the MEF and members of the former Solomon Islands Alliance for Change (SIAC) took place in Honiara on 7 May 2003. It is too early to judge if this will bring lasting respite from the violence of the past so as to allow the economy to recover from the huge decline that it has experienced in the past four years.

Papua New Guinea, the largest and, in terms of resources, the richest economy in the region, continues to stagger from one crisis to another. Several commentators have predicted yet another year of severe fiscal problems with international financial institutions led by the World Bank putting a hold on the issue of new loans, noting that lack of funds is not the source of the problems. The World Bank's Director for Papua New Guinea and the Pacific, Mr Zhu Xian, is reported as stating that: 'Better management of resources and a government bureaucracy free of corruption is the tonic needed to drag it [Papua New Guinea] out of its parlous position' (Pacific Island News Agency, 13 March, 2003). It is widely acknowledged within government and in the donor community that corruption, tribal violence and crime—issues that fall squarely within the responsibility of the state—have been the major impediments to investment. Exploration activity for minerals is at an all-time low; and Papua New Guinea's mining revenues are falling rapidly as existing mines

approach closure. The impacts of a sharp contraction in mining activity on the budget, the exchange rate, and exports are already being felt in Port Moresby.

Depressing as the above stories are, for generations the ordinary village folk of the Pacific islands have learned to live with the devastating impact of natural disasters, and have repeatedly proved their resilience to such adversities. For example, not a single person was killed by cyclone Zoe that had wind-speeds approaching 200 miles per hour; this was in sharp contrast to the assessments made by outsiders while contact was being restored with the people on the island. Will these same people that have withstood the worst of natural disasters prove equally resilient to man-made catastrophes? Perhaps not, given the overwhelming evidence showing stagnant per capita income, rising unemployment and crime, and deteriorating access to basic services in several Pacific island countries.

Life expectancy in Cook Islands, Fiji, French Polynesia, New Caledonia, Samoa, Tonga, and Palua is around 70 years—high

Table 2 **Social indicators of development for the Pacific island countries**

	Life expectancy		Fertility rate (births/woman)		Infant mortality (per '000 live births)	Maternal mortality (per 100,000 live births)
	1970	2000	1970	2000	2000	1996–2000
Papua New Guinea	47	59	6.1	4.4	56	370
Fiji	64	69	4.1	2.8	18	..
Solomon Islands	40	..	7.0	5.4	22	..
French Polynesia	..	73	5.6	2.6	10	..
New Caledonia	61	73	4.3	2.6	7	..
Vanuatu	40	..	6.5	4.4	35	68
Samoa	61	69	6.7	4.3	21	30
Federated States of Micronesia	..	68	5.0[a]	3.7	26	274
Tonga	..	71	6.5	3.6	17	81
Kiribati	..	62	4.3[b]	3.9	52	56
North Marianas	..	..	..	..	..	..
Marshall Islands	..	65	..	..	..	..
Cook Islands	..	71	..	3.3	20	20
Palau	..	70	..	..	..	..
Wallis and Futuna	..	..	..	..	..	..
Nauru	..	59	..	4.6	25	..
Tuvalu	..	64	..	2.8	38	..
Niue	..	..	..	..	..	..
Tokelau	..	..	..	..	..	..
Australia	71	79	2.9	1.8	5	6

[a] 1987 [b] 1973

.. Data not available or varies by more than 5 per cent among sources. Estimates for medium sized populations necessarily fluctuate from year to year and for very small populations would be meaningless.

Source: Hughes, H., 2003. *Aid has failed in the Pacific*, Issue Analysis 33, The Centre for Independent Studies, Sydney:Table 3.

by developing country standards and particularly so relative to their per capita incomes (Table 2). Papua New Guinea, Solomon Islands and Nauru, with average life expectancy of less than 60 years are in sharp contrast to the previous group. Various hypotheses may be suggested to explain the difference in life expectancy between these two groups of countries. First, the high life expectancy group have higher literacy rates and, on average, better access to primary healthcare—these at least partly being the result of access to better resources, particularly in the French territories and those under the Compact of Free Association with the United States. Second, Cook Islands, Niue, Samoa, Tonga and, to a degree, Fiji (the Indian Fijian community in particular) have been able to gain access to labour markets in neighbouring industrial countries (Australia, Canada, New Zealand and the United States), strengthening incentives for investment in human capital (Duncan and Chand 2002). Third, the ability of the people to 'vote with their feet' in the high-emigration countries provides some market discipline on governance in the host nation.

The support provided by donors tends to be appropriated disproportionately by the urban élite (Hughes 2003); aid has thus rewarded rent-seeking behaviour, helped maintain an overvalued (real) exchange rate, and consequently biased production towards non-tradables and the urban sector. These consequences have led one prominent Australian academic to call for a suspension of all Australian aid as the first best policy, and for 'mutual obligation' (as the second best aid policy) as part of a pact to return to policies conducive to growth if the aid is to continue (Hughes 2003). This latter suggestion is not new; indeed the bilateral treaty between Australia and Papua New Guinea is in this very spirit. It may be too early to pass full judgement on the success of the treaty but early signs are not promising. There obviously is a need to rethink how good policies and resuscitation of growth may be fostered from outside. Past crises in Papua New Guinea and Vanuatu have been brought about due to imprudent fiscal policies, persistent deficits leading to high debts in particular. This source of macroeconomic instability is considered next.

Public sector finances

Macroeconomic stability in the Pacific island countries rests heavily on fiscal prudence. Given their smallness and with an open capital account (and often a fixed exchange rate), monetary policy has a minimal role in stabilisation. High interest rates, weakening currency and/or foreign reserves position, and rising inflation have been the direct consequence of budgetary outlays well beyond fiscal sustainability. Several Pacific governments are in serious fiscal strife as revenues continue to fall short of expenditures and the rolling over of public debt is proving increasingly difficult. Vanuatu has introduced a debit tax which starts at a US$0.10 levy on bank transactions of US$10. The tax is expected to raise approximately US$60,000 a year in revenue. The government argued that the tax was necessary to enable continued provision of basic public services, especially to the outer islands. Nauru and Solomon Islands are by far in the most perilous state in terms of state finances. Once one of the richest nations in the world—thanks to its rich phosphate resources that are near depletion and to offshore investment revenues—Nauru is now without sufficient funds to provide even the most basic public services. Life expectancy in this once extremely rich tiny island nation is low at 59 years, even lower than what the current purchasing power parity adjusted per capita GDP of $5,000 would suggest (see Table 1). There is a significant increase in lifestyle

diseases and health indicators have shown little, if any, improvement. The government of Guam is seeking a US$200 million loan to fund government operations: this amount is to be raised through the sale of government bonds. The PNG Treasurer is reported in the daily newspapers of 9 May 2003 to be short of cash, with all hopes resting on a K14 million (approximately US$35 million) loan from the Asian Development Bank and proceeds from the sale of public assets.

Persistent deficits over prolonged periods in several of the Pacific island countries have led to high levels of public debt. In a few cases public debt is approaching the level of GDP. In many cases debt finance has been used to fund recurrent outlays or investments with yields insufficient to cover interest costs of the loan: a recipe guaranteeing reductions in the net worth of the state and a certain path to financial collapse. Poorly performing state-owned enterprises have significantly added to the burden; in many cases debt guaranteed by the state to these state-owned enterprises may have to be honoured by the tax payer and as yet are not accounted for in the reported statistics.

In a separate paper, I have argued that the recent rapid accumulation of debt in Papua New Guinea is due to one, or a combination, of the following three factors (Chand 2002). First, the debt blow-out is due to a lack of understanding of the impact of persistent deficits on interest rates and the penalty high interest rates impose on growth of output that in turn has led to a deficit–debt spiral. Second, the deficit bias is due to a common pool problem where each individual Member of Parliament 'grabs' the maximum possible from taxpayer funds (that is, the 'common pool') for their narrow support base with a consequent 'blowing-out' of the deficit. Third, debts are purposefully maximised by incumbent governments to constrain future governments from 'wasteful' expenditure: this being a 'strategic argument for debt accumulation'. Running for elections in Papua New Guinea is an expensive affair with costs, often shared by the *wantoks* or kin of candidates, of anything between half a million to two million kina. Consequently, there is significant pressure on candidates, should they succeed, to recoup returns

Table 3 **Appropriation of resources by the public sector in Pacific island countries**

	Government expenditure (per cent of GDP)	Employment (per cent of total paid employees)	Debt financing (per cent of domestic credit)
Fiji	19.4	18.7	54
Federated States of Micronesia	89.8	69.2	
Kiribati	100.6	28.7	
Marshall Islands	98.1	46.4	
Palau	..	..	
Samoa	28.0	10.0	
Solomon Islands	53.1	32.5	
Tonga	43.4	41.0	
Vanuatu	39.4	33.3	58

Source: World Bank, 2002. *Pacific Islands Regional Economic Report*, World Bank, Washington, DC.

commensurate to these 'investments', inclusive of the risk premium. These demands on the successful candidate are seriously underestimated and constitute the rationale for the 'common pool' problem. This all compounds the problem for the leader who has to protect the public purse whilst holding together his support base; this is no mean task as the many failed leaders demonstrate. The above is not unique to Papua New Guinea but pervades to varying degrees throughout the Pacific island countries (the Polynesian states are least prone to this problem).

It is evident that the macroeconomic conditions prevailing in the majority of the Pacific island countries are not conducive to investment and growth of private enterprise. The high (real) interest rates, the volatile exchange rates as in Papua New Guinea, and high inflation can be linked to imprudent fiscal management. Insecure property rights, high crime in several of the Pacific island countries, and allegations of corruption amongst public officials all act as a drag on private sector growth. Each of the above problems signals failure in the provision of public goods. There has to be a clear understanding of the causes of these problems before remedial strategies can be devised. Each of the individual causes of persistent deficits suggested above has a specific remedy.

Sectoral outlook

It is clear from the deteriorating fiscal situation in several of the Pacific island countries that fiscal prudence will be a necessary, if not sufficient, condition for growth of output. The performance of public enterprises suggests that the impetus for economic growth has to come from the private sector. Several industries in the region are dependent on preferential access to industrialised country markets; further expansion of these sheltered/cushioned industries is at risk given the global push towards reductions in such preferences as part of liberalisation of world trade. The Fiji sugar sector is an obvious case in point. The price premium paid to sugar exported to the European Union under the Cotonou Agreement will be reviewed at the end by 2007 when it is anticipated that the premium will be slowly phased out. Continuing problems with renewal of land leases and falling milling efficiency as a result of the emigration of skilled and professional labour is already severely affecting sugar production in Fiji.

The performance of primary commodities such as cocoa, coffee, copra, oil palm and minerals hinges in large part on movements in international prices; an issue well beyond the purview of domestic policymakers. However, the general investor climate in terms of the competitiveness of domestic interest rates, the real exchange rate, and access to land and competitively priced transportation infrastructure can be influenced by policy. Long-term, secure access to land is proving to be a particularly difficult issue for several agricultural commodities, as well as for mining and the construction of transport and telecommunications infrastructure. Eviction of tenants from sugarcane farms in Fiji and oil palm plantations in West New Britain in Papua New Guinea is already adversely affecting production.

Papua New Guinea palm oil output has defied trends in other primary products by continuing to show solid growth. The first palm oil refinery in Kimbe, West New Britain commenced shipments to Europe in February 2003. To date, the industry has managed to overcome problems of transportation, access to competitively priced credit, and crime but is now facing fresh challenges in accessing communal land for expansion of the crop. The Oil Palm Industry Corporation (OPIC) imposes a levy to expand the road network

around the mills to facilitate smallholder participation around the nucleus estates. These estates were first established to ensure the minimal throughput for the mills. OPIC pays for materials used for road construction but as a rule does not pay compensation for land acquired for the road construction. Their rationale is simple. OPIC claims that a community demanding compensation for land used for the construction of their own road does not need the road enough and that there is always another community willing to offer their land for the proposed road without compensation.[1] Such a scheme not only saves costs but also ensures protection and maintenance of the asset. The millers provide credit to the farmer with proceeds from the crop used as collateral. This is a model worthy of detailed analysis with a view to replication in other crops and areas.[2]

Driven by a surge in demand from industrialised countries, kava was a promising growth industry with Fiji, Samoa, Tonga, and Vanuatu being the major beneficiaries. Investment in the industry was brought to an abrupt halt in late 2001 as restrictions were placed on sale of kava-based products in Europe and the United States. The ban followed preliminary research suggesting liver damage from consuming kava or kava-based products. The United Kingdom asked for a voluntary restraint on sales of kava-based products while Australia issued a health warning against consumption of kava extracts. The Pacific island countries have recourse via the WTO to see that the restrictions are based on objectively assessed evidence and in conformity with international food safety standards. The Sanitary and Phytosanitary (SPS) Agreement states that

> [i]n cases where relevant scientific evidence is insufficient, a member may provisionally adopt sanitary or phytosanitary measures on the basis of available pertinent information, including that from relevant international organisations or phytosanitary measures applied by other members. In such circumstances, Members shall seek to obtain the additional information necessary for a more objective assessment of risk and review the sanitary or phytosanitary measure accordingly within a reasonable period of time (Article 5, clause 7).

On this basis, the onus may rest with the countries that placed the ban to provide the necessary assessment of risk. Such a review is now long overdue given the lapse of time since the bans were put in place and the fact that it was based on a single study.

Tourism has held the hopes of most of the Pacific island countries: a well-justified hope given the beauty of the region and the hospitality of its people. The US terrorist attacks of 2001 and those on Bali in 2002, the Afghanistan and Iraq wars, and SARS (severe acute respiratory syndrome) as of April/May 2003 have seriously damaged prospects for a quick rebound in tourist flows to the region. Tourist arrivals to Tahiti in the first quarter of 2003 fell as tensions grew between North Korea and the United States. The 2000 coups in Fiji and Solomon Islands and the revolt by the mobile force in Vanuatu and the army in Papua New Guinea in 2002 have all adversely affected the regional tourism industry. Tourists, particularly those from the United States and Europe, often see the Pacific island countries as a single region and hence problems in any one Pacific island country are often associated with the entire region. Profit margins are being sacrificed with promotional fares to keep the number of arrivals up while long-term investments are being kept on hold. However, these are not healthy signals for the long-term growth of the industry. While on the one hand direct air links are being established between Port Moresby and Narita, Korean Airlines suspended its Saipan–Seoul flight in March

2003—a move that will seriously affect the Northern Marianas economy.

Labour-intensive manufacturing such as clothing in Fiji, wire harness in Samoa, and tuna canning in American Samoa, are heavily dependent on preferential trading arrangements for Pacific islands' exports into industrial country markets. These preferences, however, will erode as world trade is liberalised. The United States is not interested in negotiating a bilateral agreement with Fiji and has announced its intention to withdraw the current quota system for clothing exports from 2005 to comply with WTO rules. The transition to freer trade could be better managed by the Pacific island countries if their domestic markets, including those for capital, labour and other inputs, could be simultaneously liberalised. Political and macroeconomic stability will also assist in lowering the costs of doing business, thereby enhancing competitiveness of surviving domestic industries.

Aid to the region[3]

Official aid to some of the Pacific island economies, measured in terms of the aid to GDP ratio, is among the highest in the world (for example, recent figures are Federated States of Micronesia 36 per cent, Kiribati 47 per cent, Marshall Islands 38 per cent, Tonga 23 per cent and Samoa 28 per cent). These percentages are much higher than for most sub-Saharan African countries where the per capita GDP is much lower than in the Pacific. The comparatively large per capita aid levels may reflect the small populations in Pacific countries, as aid delivery is ultimately subject to economies of size. The motivations for aid include humanitarian, such as in the wake of natural disasters; strategic, including maintaining goodwill by current and former colonial powers; and commercial.

Alesina and Dollar (2000) show that the direction of foreign aid globally is dictated as much by political and strategic considerations as by the economic needs and policy performance of the recipients. They argue that past colonial and political alliances are major determinants of foreign aid. The Pacific island countries are no exception. The weighting towards strategic motivations for aid has been on the ebb since the end of the Cold War but increased global tensions in the recent past may see a resurgence of aid to secure long-term access to military bases within the Pacific Ocean.[4]

France has been by far the largest donor to the Pacific, followed by Australia, the United States, Japan, New Zealand and the European Union, in that order. France has historically given the bulk of its annual aid of US$750 million to its existing and former colonies. Half of the US$232 million annual Australian aid to the Pacific island countries goes to Papua New Guinea while the bulk of the US$161 million of annual US aid is destined for the former and current trust territories. Japan, New Zealand and the European Union have annual aid budgets of US$145 million, US$75 million, and US$45 million, respectively, devoted to the Pacific island countries (Hughes 2003).

The effectiveness of official development assistance to the Pacific island countries remains to be critically assessed, but preliminary assessments are less than promising. Duncan and Chand (2000) in the first of such assessments do not give a favourable prognosis. Their criterion for aid effectiveness is that the recipient is ultimately made free of the need for future aid, barring that given for humanitarian reasons; aid on this criterion has been ineffective. Hughes (2003) in a more recent study argues that aid has failed the Pacific, for the reason that aid has primarily benefited the élite through the successfulness of their rent-seeking activities—in conformity with the Bauer hypothesis (Bauer 1966).

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Research in the 1990s confirmed the following three stylised facts regarding the effectiveness of aid in development. First, that sustainable policy reform cannot be enforced through conditionality and that countries have to have 'ownership' of the reforms in order for them to be successful. Second, the basic institutional underpinnings of private sector activity, that is, secure, widely distributed, individual property rights to land, and security of contracts, must be in place in order to have rapid, sustainable economic growth. Third, good governance (effective, inclusive, corruption-free government) is a necessary condition for good economic growth.

In contrast to the long-held belief that the acquisition of capital was the key to development, globally aid is now much more concerned with improving governance, with the environmental sustainability of projects and economic growth more generally, effective policies, institution building and poverty alleviation. Most recently, there has been a realisation that while economic growth may be rapid, it need not necessarily be inclusive, in the sense that all in society experience improved living standards. Therefore, development agencies are now focused on how to make sure that the poorer segments of society contribute to and share in any economic growth. Aid delivery in the Pacific has followed these changes in development thinking, with an emphasis on education and health, on good policies, on environmental sustainability, and more recently on good governance, capacity building, 'ownership' of reforms and 'participation' in design and delivery of projects, and development of market-friendly institutions. The fungibility of money implies that funds provided as aid could and probably have been used to fund activities other than those for which they were intended. A donor agency always walks a tight rope in ensuring that funds provided are used as intended while not interfering with the domestic affairs of the recipient nation.

In some of the Pacific countries, aid delivery is largely managed within the context of a coordinated operation between the multilateral agencies and some bilateral donors. These 'structural adjustment programs' combine short-term stabilisation loans with long-term loans and grants assisting in capacity building, policy reform, public service reform, and infrastructure development. These programs have an implicit prioritisation and sequencing of measures: these are drawn from an understanding of the important ingredients for development. However, the understanding that drives the program's strategy may well reflect earlier ideas about development priorities, because of 'institutional lag' in keeping up with new ideas.

The strategic motivation for aid to the Pacific island countries is making a strong comeback following its decline in importance in the aftermath of the Cold War. The Pacific Solution, where Australia sent its refugees arriving by sea to Nauru and Manus in Papua New Guinea, signalled a new era in the use of Australian aid to secure short-term places for the detainees. Nauru, a cash-strapped nation, was pledged A$14 million in additional aid for holding around 600 Australian asylum seekers.[5] In 2002, China provided 'unconditional' budget support to Fiji of US$3.5 million but with an expression of interest in the commercial harvesting of Fiji's large mahogany plantations. Fiji's Prime Minister, who had secured the aid on his visit to China, also extended an invitation to China to the South Pacific Forum leaders' meeting in Fiji as an observer. Similarly, Taiwan has on several occasions extended budgetary support to cash-strapped island governments: the most recent instance was the provision of funds to Vanuatu to fund copra price support arrangements prior to the 2002 elections. The tensions on the Korean Peninsula leading to a build-up of US military hardware on Guam

has led the United States to commit to increased spending on such bases in the Pacific. Palau, with a population under 20,000, on gaining independence in 1994 signed a Compact of Free Association with the United States for funding for 15 years to help develop the economy.

Population growth and employment

Approximately 40 per cent of the population of the Pacific island countries is below 15 years of age, guaranteeing that the present population growth momentum will be sustained for a decade and half at least.[6] The entry of large numbers of workers into the workforce in a climate of low growth of employment opportunities and downwards wage rigidity will lead to a growing pool of underemployed and unemployed people. Wage inflexibility is due to labour market imperfections including minimum wage legislation and a high reservation wage due to the high levels of subsistence production. Wage inflexibility has to be removed and regulations restricting the operation of the informal sector relaxed if unemployment is to be contained. As an illustration, in Marshall Islands between 600 and 1,000 young people enter the job market each year while formal sector employment has remained static at 10,000 for the past ten years. This example is not an exception but a common phenomenon in the Pacific island countries. Those countries not seeing increased underemployment and unemployment are those where emigration to industrial countries is reasonably easy.

Employment in the importable sector, often the manufacturing sector, has been protected at the prevailing wage via high tariffs and rents from preferential trading agreements. State-owned enterprises provide much of the employment for the more highly skilled and educated. The exercise of market power by governments in raising employment and wages conditions can be counter-productive, given that these actions crowd-out private employment and raise expectations about the responsibilities of the state.[7] The prevailing weak fiscal position of the state implies that such a strategy cannot be sustained. The prices of services of both the government and state-owned sectors have been raised through protection of markets so as to minimise losses; these policies, however, raise the costs of doing business in several of the Pacific island countries.

Pacific island governments have embarked on various initiatives to increase employment opportunities. Fiji has been sending soldiers on peacekeeping missions to the Middle East since the early 1980s as a means of providing employment for the growing pool of school leavers. Kiribati, Tuvalu, and Vanuatu have actively supported—via providing training at home—employment of their nationals as seamen on foreign ships. Nauru and Vanuatu have sponsored onshore international financial centres via tax concessions in the hope of creating jobs but now have created strong lobby groups against withdrawal of such concessions. These initiatives have had minimal impact on the pool of unemployed, however, and are unlikely to be a sustainable source of employment opportunities.

Demand for jobs varies considerably between the Pacific island countries. Emigration of workers from Palau, Samoa, and Tonga has acted as an escape valve for qualified workers in search of better employment opportunities abroad. These same opportunities have induced investment in skills acquisition. The same forces are in play in Fiji where, to facilitate emigration, the Indian Fijian population is investing more in education than the indigenous population. On a cross-country basis, literacy rates in Palau, Samoa and Tonga, where emigration is relatively easy, are high

compared to the Solomon Islands and Vanuatu where emigration to high-income countries is low. While higher education facilitates emigration from the Pacific island countries to Australia and New Zealand, the availability of such an option (for whatever reason) provides the incentives for greater investment in education.

In the short to medium term, emigration can reduce the adverse effects of demand shocks. However, the sustained loss of skills through migration can reduce employment opportunities for the unskilled, given the complementarity between skilled and unskilled labor. To the extent that reforms necessary for growth in the Pacific island countries result in labour displacement from the protected sectors, temporary relief through access to jobs abroad may assist in the adjustment process. For example, Cook Islands was able to complete its reforms which involved severe cuts in the civil service, because many of the displaced workers were able to move to New Zealand. Access to such employment opportunities is all the more important in the absence of social security benefits at home and when those with formal sector employment are the source of such transfers at the level of the family and/or clan.

Policy implications

Restoring fiscal discipline has received the highest priority in every Pacific island faced with an impending crisis forcing the launch of a structural adjustment program. The motivations for running deficits until public debt reaches unsustainable levels may be rational while political instability continues and in the absence of institutions that constrain future governments from using up any savings made by the incumbent administration. Samoa has managed to maintain fiscal discipline and implement reforms recently; Vanuatu was able to balance the budget and hold public debt to healthy levels in the first decade following independence; and Fiji and Papua New Guinea were able to maintain fiscal health until the late 1980s. These episodes of fiscal responsibility were maintained during periods of political stability, the loss of which coincided with a loss of macroeconomic control in Vanuatu and Papua New Guinea. An in-depth analysis of macroeconomic crises with a view to the design of remedial actions to return to fiscal sustainability is long overdue in these countries.

The Pacific island countries have open capital accounts with a large proportion of their investment being funded from foreign savings, made up of official aid, foreign debt, and foreign direct investment. While foreign aid flows respond to political variables, Alesina and Dollar (2000) show that foreign direct investment is more sensitive to economic incentives, particularly 'good policies' and protection of property rights in the receiving countries. The bias of capital inflows in favour of aid (and, to a degree, debt) to Pacific island countries suggests that the incentives for foreign direct investment may be lacking. If the growth effects of foreign direct investment are considerably higher than from other forms of capital inflow, as Yano and Nugent (1999) suggest, then policymakers may want to improve incentives so as to accelerate growth.[8]

Providing employment opportunities for the growing labour force is likely to remain the largest economic and social challenge for the foreseeable future. The public sector cannot be relied on to perform this role. Foreign employment may provide respite for those with privileged access to industrial country markets, but the bulk of employment opportunities has to come from the private sector within these countries.

While there is ample evidence of Pacific island government failure in managing

development, these comprise many errors of commission as well as several of omission. Those of commission include government involvement in commerce via high-cost and often loss-making, state-owned enterprises that have drained resources away from funding of basic services. Examples include the creation of development banks, national airlines, government owned hotels (in Cook Islands and Nauru), and the many commodity-marketing boards. Each of these enterprises has added to the costs of inputs while being sheltered from competition through regulatory protection. Those failures of omission include the failure to fund basic services, including of law and order, education and health, and public infrastructure. Governments have often got the balance wrong, undertaking activities that the private sector would otherwise have picked up while failing to provide those public goods that are the primary responsibility of government; obviously these imbalances have to be corrected.

Conclusion

Pacific island countries are small, isolated from the major markets (which increases the costs of trade), and prone to natural disasters. The people of the Pacific island countries have adapted exceptionally well to these natural adversities. However, the Pacific island countries are not unique, as there are many other small nations that have proved just as resilient to adversity. The developmental record of most of the Pacific island countries has generally been poor in recent decades, whereas other small isolated island economies such as the Bahamas, Malta and Mauritius have demonstrated that the handicaps of size and isolation, while barriers to economic growth and development, are surmountable.

This survey has argued that the policy environment in the Pacific island countries has generally not been conducive to growth of production. Extensive regulatory controls on prices, exchange rates, the operation of the informal sector, etc., have impeded private investment. Government involvement in private commerce has crowded out private enterprise while drawing resources away from the provision of public services, which is so necessary for growth of private enterprise. Poor property rights to land, insecurity of debt contracts, unsustainable budget deficits, and political and policy instability have all raised the risk premium on investment, resulting in high-grading of investment opportunities.

Where there is high population growth in a climate of subdued economic activity, per capita income has either stagnated or been falling. Consequently, the pool of unemployed has been rising, with ramifications for social problems. Employment opportunities sufficient to absorb all those in search of work will develop only if the necessary reforms are undertaken to make the economies grow rapidly. Weak and family or clan-based social safety nets imply that reforms entailing major displacement of formal sector workforce are going to be politically difficult. Temporary access to labour markets in industrialised economies where there is the will to carry out the necessary reforms may be an option worth further consideration.[9] This may be attractive to bilateral donors if the alternative is to continue to provide aid at present or increasing levels. Such action would also be consistent with liberalisation of factor and product markets (amounting to deep integration) to enable the real sector to adjust to shocks whilst rewarding policymaking in the interest of the wider community.

Governance remains a serious problem in several of the Pacific island countries. If bilateral donors have a choice between

providing aid or promoting remittance flows via more fluid regional labour markets, at least at the margin the latter seems to be the more attractive option. The reasons for this are several, including the fact that remittances are private transfers with better accountability than aid; but most importantly, enabling people to 'vote with their feet' provides a market discipline on policymakers to act in the interest of the wider community. Ideally, circular and free migration between the metropolitan countries and the Pacific island countries will create pressures for better policymaking while bringing about all of the conventional benefits of freer trade.

Notes

1 Compensation for roads leading to a mine is a rational means of extracting mineral rents by communities distant from the mine, but such demands for industries with minimal rents constrain growth of production.

2 Cocoa and vanilla production, particularly in East Sepik, has shown rapid growth over the recent past but could benefit from the lessons from oil palm.

3 This section draws heavily from Duncan and Chand (2000).

4 In May 2003, the government of Marshall Islands and US State Department agreed to an amended Compact of Free Association worth US$3.1 billion. This includes funding for grants and a trust fund of more than US$800 million, and a pact for the extension of the use of the Kwajalein missile testing range through to 2066, valued at about US$2.3 billion.

5 This policy gave Australia a lot of adverse international publicity that may have actually helped its cause by averting greater flows of refugees.

6 For example, the rate of population growth in Solomon Islands is 3.9 per cent (see Table 1). By comparison the average for countries that are members of the Asian Development Bank is 1.3 per cent per annum.

7 Demekas and Kontolemis (1999) use evidence from Greece to show that higher levels of public sector remuneration and employment have a deleterious impact on aggregate labour market performance and that government employment is not an effective counter-cyclical instrument.

8 Yano and Nugent (1999) show for 44 aid-dependent economies over the 1970 to 1990 period that aid can reduce growth via its impact on the price of non-traded goods.

9 Under the amended Compact of Free Association with the United States, Marshall Islanders now have the right to enter the United States without visas or 'employment authorisation documents' to work and live there.

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Table A1 **Total and per capita aid flows to the Pacific since 1970**

	Total flows since 1970 (million US$, 1998)	Average annual aid flow per capita since 1970 (US$)
Papua New Guinea	15,592	104
Fiji	1,576	65
Solomon Islands	1,477	110
French Polynesia	8,533	1,210
New Caledonia	8,708	1,363
Vanuatu	1,285	217
Samoa	1086	213
Tonga	698	233
Kiribati	593	217
North Marianas	–2	-
Marshall Islands	362	232
Cook Islands	407	646
Palau	532	933
Wallis and Futuna	274	457
Federated States of Micronesia	630	178
Nauru	18	51
Tuvalu	214	647
Niue	182	3,558
Tokelau	91	3,026
Pacific islands (Trust Territories)	5,193	
Oceania (unallocated)	1,449	
Total	49,258	220

Source: Hughes, H., 2003. *Aid has failed in the Pacific*, Issue Analysis 33, The Centre for Independent Studies, Sydney.