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Island countries: Lessons of
the past decade and
opportunities ahead.

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Note: This paper was prepared as the *Keynote Paper on Economic Growth* for the *2006 Forum Economic Ministers Meeting* that was held in Honiara on July 4, 2006. I am grateful to the Secretary General of the *Pacific Island Forum* and his officials for the privilege of preparing and presenting this paper. Views expressed here are those of the author alone and thus should not be attributed to the *Forum* or its officials.

Economic growth in Forum Island Countries: Lessons of the past decade and challenges and opportunities ahead.

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Abstract

This paper makes three principal claims with respect to the economic performance of 14 Forum Island Countries (FICs) over the decade to 2005. First, the FICs (as a group) have performed below their potential. Second, it is the poor policy-choices rather than the handicaps of smallness and isolation that have been responsible for this poor performance. Third, past experimentation with growth strategies offers several lessons for future policy choices to accelerate the rate of growth of income. Amongst the recommendations are: improving demand for better governance by allowing the public freer access to government information; integrating regional communications through open-skies and open-ports policies for the region; and, regional under-writing of security, both within and across the borders of member states.

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1. Introduction

1. The leaders of the Pacific Forum have articulated a vision ('the vision' henceforth) for the region as one of:

“peace, harmony, security, and economic prosperity, so that all of its people can lead free and worthwhile lives” whilst the region is respected for “the quality of its governance, the sustainable management of its resources, the full observance of democratic values, and for its defence and promotion of human rights.” *Pacific Island Forum Leaders Vision: Auckland Declaration, 2004*

2. The Economic Ministers endorsed this vision, recognizing that: “sustainable development predicated on economic growth” is crucial to the realisation of this vision (FEMM Action Plan, 2004). How urgent is the growth imperative? What success, if any, has the Forum Economic Ministers Meetings (FEMMs) had in its first decade of existence in raising growth?¹ What lessons, if any, are there from the past for future policy choices? These are formidable and long-standing challenges; here I attempt to sketch out some of the answers to these questions.

3. On the first question, there is a strong consensus within the leadership and the technocrats responsible for economic management that sustained growth in income (that is, prosperity) is essential for the realisation of the vision of lasting ‘peace and harmony’. There is, moreover, an agreement amongst policymakers that the private sector will be the source of faster growth in all of the Forum Island Countries (FICs henceforth) and that the role of the public sector would largely be confined to providing the preconditions, principally in the form of regulations, for growth of private enterprise. Furthermore, the necessary preconditions for raising investment will be the outcome of deliberate interventions on the part of economic managers. FEMM could have a pivotal role in this endeavour.

4. Why the focus on growth? The development community has reached a consensus on poverty reduction as the primary goal for development. The Ministers reaffirmed this commitment in 2003 by noting that poverty reduction “should be the backdrop to all the issues discussed during Forum Economic Ministers Meetings” (FEMM Action Plan, 2003; paragraph 5). Substantial reductions in poverty have been achieved in countries that have experienced sustained and thus sustainable rates of growth of income for extended periods of time. China and India demonstrate that rapid and sustained growth of income leads to significant reductions in poverty while sub-Saharan Africa shows that growth declines lead to increased poverty (Commonwealth of Australia, 2006; Chen and Ravallion, 2004). There is considerable evidence of rising poverty in a number of the FICs; reversing this necessitates increases in the rate of growth of income and thus the growth imperative.

5. This paper presents the following four key messages. First, poor governance has been the primary reason for the poor economic performance of the FICs. Furthermore, past attempts at improving governance failed because it, in the main, addressed improving supply of rather than the demand for better governance. Second, FEMM and the Forum leaders, collectively, can work together to provide regional

¹ While Forum Leaders have been meeting annually since 1971, FEMM started in 1997 with its first meeting held in Cairns on 11 July.

public goods, including security and good governance. Third, economic growth can be promoted through increasing mobility: that is, facilitating mobility of people to jobs, jobs to people, and, idle-resources into productive use. Policy has a role in the above through improving access to credit, basic education, primary healthcare, and transportation and communications services. Finally, the isolated communities within the FICs can boost their opportunities for growth by integrating more deeply with the national, regional, and global economies. Some lessons on what to do and those to avoid are drawn from past experimentation with policies targeted at raising growth.

6. In drawing lessons from the past, a number of pleasant and the ‘not-so-pleasant’ country experiences have been highlighted. The list is far from complete. The aim of this exercise has been to draw policy lessons on what to do and those to avoid. Any omissions and overt criticisms of economic management in any particular country are unintended and unfortunate.

7. The rest of the paper is organised as follows. Section 2 provides a succinct survey of the poor growth record of the FICs and presents the case for raising rates of economic growth. Section 3 discusses lessons from growth strategies used in the past, both within the FICs and abroad. Section 4 highlights the challenges and opportunities for growth for the FICs over the next decade. Conclusions and sum-up bring the paper to a close.

2. The growth record and the growth imperative

Economic performance

8. There is considerable heterogeneity in economic performance across the individual FICs. Table 1 provides data on land area, total population, average per capita income, aid receipts on a per capita basis, and life expectancy for three groups of nations: the FICs; Australia and New Zealand (ANZ henceforth); and, three island economies, namely, Maldives, Malta, and Mauritius (the 3Ms henceforth). As shown in the table, there is far greater diversity on all the above-listed indicators within the FICs than across the three country groupings². Drawing generalisations for the FICs as a group, therefore, is problematic.

9. In terms of per-capita income, the most widely used measure of economic wellbeing, Cook Islands ranks the highest with a purchasing-power-parity (PPP)-adjusted (per capita) income, as of 2004, of US\$6,092. Solomon Islands and Tuvalu rank particularly low on this measure. In terms of levels of per capita GDP, the FICs as a group have per capita incomes well below those of ANZ. With the exception of Papua New Guinea, which has a land mass and population that is greater than that of New Zealand, the above comparison could be unfair given the considerable differences in size and endowments between ANZ on the one hand and the FICs on the other.

10. Benchmarking performance of individual FICs is extremely difficult. Here three island economies, those of, Malta, Maldives, and Mauritius, are used as the preferred

² Data for several indicators for the FICs are either unavailable or of poor quality. Data from the one consistent source, namely, the World Development Indicators (WDI) has been used wherever possible. The *World Fact Book* has been used to fill data gaps left by WDI. Assuming that the errors are consistent over time for a given country, at a minimum these figures reflect broad, within-country trends. However, cross-country comparisons are far more problematic.

benchmarks and for the following reasons. First, the three are small island economies that have done exceptionally well in terms of economic growth and poverty reduction despite their handicaps of size and isolation. Second, there are strong parallels between Mauritius and Fiji, and Maldives and Marshall Islands; these are elaborated upon later in the text. Third, Malta is chosen because it is an island nation scarce in natural resources; limestone is its main natural resource. Malta imports nearly 80 percent of its food needs, draws some half of its drinking water from desalination plants, and is dependent on imports of fossil fuel for its energy needs. It has however been successful in using its people as the main resource for development. Growth in manufacturing and tourism on the back of private sector investments has enabled this small isolated island economy to reach high income status. The FICs, and particularly those without abundant natural resources, can use Malta for comparative purposes.

11. FIC economies on the whole have performed poorly relative to their potential. Two pairs of country comparisons are used to support this claim. Mauritius and Fiji have a number of similarities including their common colonial heritage, close to identical structure of production, and parallel dependence on access to preferential markets for their sugar and garment exports. Both are island economies isolated from their major markets, both have a heavy dependence on tourism, and both face the prospects of loss of significant export revenues as world trade for sugar and garments is liberalised. Mauritius gained its independence in 1968 and Fiji did the same two years later, and from the same colonial power; thus the two have very similar institutions. Fiji, however, has the advantage of having a land area that is some nine times larger and a population that is some 32 percent smaller than that of Mauritius. Population density in Fiji, consequently, is nearly one-fifth the corresponding figure for Mauritius. Fiji also had a 19 percent head start in terms of per capita GDP in 1980. If Fiji and Mauritius were two horses at the gates on the tracks in 1980, most punters would have placed their money on Fiji's success over the subsequent two decades. This, with the benefit of hindsight, would have been a mistake. By 2004, Mauritius had a per capita GDP nearly double that of Fiji (see Figure 1). As discussed later, the quality of governance seems to be the key difference between the two.³

12. Like Fiji and Mauritius, Maldives and Marshall Islands (the latter being the 4th 'M' but with the difference of being a FIC and with a lot poorer economic record) have many similarities; both being atoll states heavily dependent on tourism and located some distance away from their major tourist markets. Marshall Islands, however, has the advantage of being in a *Compact of Free Association* with the United States of America. Compact Funds and associated grants account for more than two-thirds of total government revenues. The Compact also allows for unfettered access to the Marshallese to the US labour market.⁴ Despite these advantages, per capita income in Marshall Islands as of 2004 was less than one-half that of Maldives.

³ But this then begs the question of the reason for the poorer governance in Fiji. My own research on the deep determinants of growth uses the Fiji and Mauritius comparison extensively. Land tenure arrangements seem to be one reason for the weaker governance in Fiji compared to that of Mauritius (Chand, 1996).

⁴ The FICs as a group receive high levels of aid on a per capita basis (see data in Table 1).

13. Generalisations drawn from cross country comparisons are fraught with problems but the pair wise comparisons made above are indicative of the poor performance of the FICs vis-à-vis their potential. Comparing Nauru in 1970 to now reveals a similar conclusion. Furthermore, Nauru and Tuvalu, two similarly sized economies have had very different experiences in managing their savings. While Tuvalu and Kiribati have been successful in growing their Trust Funds, Nauru has nearly depleted the same. Governance is the critical difference; FICs rich in natural resources have had a tendency towards poorer governance.

Some of the factors impinging on past economic performance

14. Disasters have led to growth collapses. Some of the FICs have been badly affected by disasters, some natural, others man-made.⁵ These disasters in the form of cyclones, coups, civil strife, droughts, earthquakes, and tsunamis have had a devastating impact on their economies. Comparing coups and cyclones in Fiji, I have come to the conclusion that the former has been far more devastating; coups, much like civil strife, create distrust between communities and thus taxes entrepreneurial activity, the effects of which lingers for decades. The decade long conflict in Bougainville and the 4-year conflict in the Solomon Islands reaffirm these conclusions. Policy has a pivotal role in averting conflicts and in building resilience to natural disasters. A number of the FICs, however, have failed to avert conflicts. Success with the above, therefore, is a major challenge in preventing economic collapse and spikes in poverty.⁶

15. Policies to raise the rate of growth in a regionally accommodative labour market have had some success within the FICs. Cook Islands and Samoa have witnessed recent surges in the rate of growth of their GDP following major economic reforms. Accesses to foreign labour markets in the absence of the policy shifts were insufficient to induce growth in per capita income. Table 2 shows that aggregate GDP between 1999 and 2004 in Cook Islands grew by an annual average rate of 5.71 percent while the corresponding figure for Samoa was 3.16 percent. Per capita GDP in Cook Islands and Samoa grew by 4.74 and 3.39 percent, respectively; the comparatively high rates of growth of per capita income in these two countries were due to a combination of access to foreign labour markets, thus the low rates of growth of their population, and policies conducive to growth. Kiribati, in contrast and without the same access to foreign country labour markets, experienced growth in aggregate GDP for the same period of 3.03 percent but with the population growing at 2.3 percent, per capita GDP grew by less than one percent per annum.⁷

16. Even the 'high performers' such as Cook Islands and Samoa have to improve on past performance if the vision of 'peace and prosperity' is to be realised by 2020. Figure 2 shows that a continuation of the current rates of growth of per capita gross

⁵ Tonga, for example, was struck by two earthquakes within a month; an earthquake measuring 7.8 on the Richter scale struck on 4 May 2006 followed by another measuring 6.7 on the Richter scale on 28 May 2006. Neither of these is reported to have caused major damage; this is in sharp contrast to the macroeconomic effects of a salary rise won by public servants in the aftermath of their seven-week-long strike of the previous year.

⁶ There is a large and growing literature showing the link between conflict and chronic poverty (Goodman, 2003)

⁷ Tuvalu appears to provide an even sharper contrast on this front, but with this data being drawn from the *World Fact Book* it is likely to be of lower quality than the World Bank data for Kiribati.

national income (GNI) will see Cook Islanders reach a per capita GNI of US\$14,000 by 2020; this would be equal to 60 percent of the current per capita GNI of New Zealand.⁸ Sustaining the past rate of growth for Samoa until 2020 will see its per capita GNI, at official exchange rates, reach US\$5,000 or equal to 22 percent of the 2004-GNI for New Zealand.⁹ The 2020 prospects for Nauru, Solomon Islands, and Vanuatu look particularly bad given that their per capita GNI has been slipping back at rates in excess of 2 percent per annum.¹⁰ Lasting peace for the FICs will require much greater prosperity.

Population and the Environment

17. Population growth in the FICs is high and likely to remain so for the foreseeable future. Fertility rates, defined as the number of children per women, within the FICs ranges from 2.5 for Palau to 5.3 for Solomon Islands (see table 3), thus the difference in the rates of growth of the domestic population is principally determined by the extent of out migration. The population growth momentum in the FIC-region is likely to continue given the largely young population. Table 3 shows that some 40 percent of the FIC-population (equal to 3.1 million of the 7.8 million total) was below 15 years of age as of 2004. Papua New Guinea alone accounted for some 2.3 million, or some 74 percent, of the total 0-14 year old population of the FIC-region.

18. A young population can be a resource for raising economic growth, but this necessitates equipping the workforce with skills in demand. While the case for up-skilling of the workforce pervades the FICs, particularly when compared to Malta, PNG provides the strongest case for greater investments in the above. Nearly half of the PNG-workforce is illiterate thus ill equipped to take advantage of the opportunities offered by globalisation. The loss from this handicap is potentially large since these workers remain trapped within the subsistence sector and often within their own localities. PNG has the resources to generate its own jobs; the large proportion of its population being young can, therefore, be an important resource for the growth of the economy. The situation for the resource-scarce Micronesian states is dissimilar, but the workers with the requisite skills have been able to find gainful employment both at home and abroad. The case of Kiribati is instructive in this regard since its strategy of training seamen and nurses is now providing dividends in terms of increased remittances.

19. The imperative of job growth within urban centres and access to basic services such as urban infrastructure, basic education, and primary healthcare will increase as rural/outer-island-to-urban migration continues. Most urban centres in the FICs, the capital cities in particular, have witnessed a steady inflow of migrants; urban swell,

⁸ Note that the GNI figures used in Figure 1 are different to those of the PPP-adjusted GDP figures reported in table 1. GNI takes into account net transfers, remittance flows particularly, and the conversions into US\$ is done at the official exchange rate. PPP-adjusted GNI figures are not available for several FICs.

⁹ New Zealand is used for comparisons given the easy access Cook Islanders and Samoans have to this country.

¹⁰ It is hard to imagine that per capita income will continue to shrink in Solomon Islands at the past rate of 5.69 percent per annum.

however, has still a long way to go in the more populous Melanesia given the relatively low levels of urbanisation in a number of these countries.¹¹

20. Problems of squatting and land disputes within the urban centres and its immediate periphery have increased over time; this trend is likely to continue with rising urbanisation. For the vast majority of urban settlers, the difference between being in or out of poverty is whether the family head is able to hold on to a regular income source. Those at the greatest risk of falling into poverty are the unskilled landless families who neither have the savings nor the fallback of subsistence living in urban settings. The traditional safety net, moreover, is eroding with an increasing number of youth raised within urban centres unable to go back to the villages or live off the land of their kin.¹²

21. Pressure on natural resources is uneven across the FICs but on the whole rising. Population densities within the FICs range from 8 persons per square kilometre in Niue to 619 on Nauru; these figures on the whole compare favourably to the 3Ms (see table 1). The country-aggregates, however, mask the large variations within the FICs and the problems with accessing land for housing and enterprise. Urban slums have mushroomed throughout the FICs, and over-crowding is a serious issue in a number of the urban centres. Jenrok, a crowded settlement on Majuro, which is home to some 200 households or some 2,000 individuals all housed on 6.5 hectares of land is a good case in point. Jenrok has a population density of 28,000 people per square kilometre and is experiencing serious social problems including drug abuse, crime, and youth suicides and a near collapse of the coastal environment (see ADB, 2005).

Sustainable resource use for sustained growth

22. Sustained growth necessitates sustainable management of the nation's resources. A call was made at the 2002 FEMM for mainstreaming of environmental issues into physical and economic planning. Reversing environmental degradation in some of the heavily populated areas remains a pressing concern in several FICs. Sustainable growth predicated on effective management of the environment is particularly difficult for the Micronesian states where the environment is particularly fragile. The high population growth rates of the past, accompanied by rising population densities, have placed a severe toll on some of the surrounding ecosystems. In a few cases, the extent of the environmental degradation has gone beyond the natural regenerative capacity¹³

23. Increases in infectious and life-style diseases across the FICs are eroding the human resource base that is critical for income growth. People incapacitated by these preventable ailments raise demand for health outlays whilst reducing the workforce, both directly as the sick withdraw from the workforce and indirectly by pulling out their carers with them. Nearly half of the population of Nauru has type-II diabetes. HIV/AIDS has already reached epidemic proportions in Papua New Guinea and is

¹¹ PNG, as an example, has less than 20 percent of its population residing in urban centres when the comparative figures for many African economies at a similar level of development is around 50 percent.

¹² Graffiti on the wall of a public convenience in Port Moresby aptly captures the plight of such individuals; it reads, "I live to rob and rob to live".

¹³ 'Subsistence affluence' for these folk is a distant memory. Many residents in the urban centres of the FICs risk starvation from interruption of international shipping services.

spreading across to the rest of the FICs. The disease affects every facet of life; the economic and social costs of a HIV epidemic could be far more catastrophic than any of the previous disasters encountered in the region.¹⁴

Governance and Growth

24. Poor governance remains an issue of serious concern.¹⁵ FEMM emphasised the centrality of ‘Governance and Accountability’ in providing the foundations for private enterprise and noted the drag poor governance in the form of “increasing corruption ... and poor fiscal management” has placed on the development within the region. The ‘Eight Principles of Accountability’ were created out of these concerns and the Ministers had resolved to increasing transparency in decision-making (FEMM Action Plan, 2002). Progress in terms of improved governance remains slow with the FICs continuing to lag behind other nations in terms of ‘Government Effectiveness’, ‘Rule of Law’, and ‘Control of Corruption’ (see Figures 3, 4 and 5).¹⁶

25. Policy and political instability continue to plague the region. Cross border spillovers from the occasional civil strife in member nations is of increasing concern. On the last mentioned, FEMM noted the damaging effects of the coups in Fiji and the ethnic tensions in Solomon Islands and discussed the impact of frequent natural disasters on their economies. The April 2006 riots of Honiara continue to portray the FIC region as one of high security risk.

26. In sum, many of the problems listed above have been known for a while; progress in terms of addressing some of these has been less than enviable however. The very first FEMM, for example, noted that:

“private sector development is central to ensuring sustained economic growth, and that governments should provide a policy environment to encourage this.”
(FEMM Action Plan, 1997; page 47).

Each FEMM since has reiterated the importance of growth; the central role of the private sector in job creation; the role of the public sector in providing the needed regulatory environment for private sector investment; and, a more recent emphasis on strengthening institutions for improved economic performance. Ministers have repeatedly acknowledged that low economic growth is the cause of many of their economic and social ills.

3. Policy lessons from past experimentation

27. The FICs have experimented with a wide range of policies targeted at raising growth. Here we draw on seven specific lessons from past experimentation with growth-enhancing strategies. The lessons include: (i) import substituting industrialisation has on the whole been a failure; (ii) state-led development has had

¹⁴ The experience of Botswana where some 40 percent of the population has been infected with HIV would be the worst nightmare for PNG. Interestingly, PNG had the first case of HIV about the same time as Botswana but did not experience a similar increase over time.

¹⁵ Notwithstanding the ongoing debate on the definition, governance here refers to the exercise of authority for public good. It includes the exercise of power, vested in the individual or organisation either by the traditions and/or legislation, and includes the processes via which citizens are given a voice in public decision-making. The country-level measures for good governance include political stability, government effectiveness, regulatory quality, the rule of law, control of corruption, and voice and accountability (see Nanda, 2006; and, Kaufmann, Kraay, and Mastruzzi, 2005).

¹⁶ Of the remaining three indicators, namely, that of Voice and Accountability, Political Stability, and Regulatory Quality, the FICs compare unfavourably with ANZ and two of the 3Ms.

very limited success; (iii) communally owned land can be accessed for private enterprise; (iv) public-private sector partnership have had some recent success; (v) regional trading arrangements have proved to be problematic; (vi) good economics can be good politics; and, (vii) superior economic management is required for resource abundance to lead to improved developmental outcomes.

28. Several FICs embarked on economic reforms to raise the rate of growth of income. The success in reform implementation and in raising the rate of growth of income is mixed, however.¹⁷ Vanuatu's *Comprehensive Reform Program* (CRP) was successful in restoring the health of the financial sector and in containing growing budget deficits. Samoa and Cook Islands achieved macroeconomic stability but were also able to make additional ground with microeconomic reforms. Samoa, for example, deregulated its financial sector, removed price subsidies on major crops, instituted tax and tariff reforms as part of trade liberalisation, and introduced new governance arrangements that are consistent with available best practice for their state owned enterprises. The dividends in terms of higher growth rates are being reaped.¹⁸

29. Import substituting industrialisation has been experimented with in several of the FICs. Many industries were developed through substantial tariff protection afforded to domestic manufacturing, including those given to downstream processing activities. Domestic consumers paid the price (the tax) for the establishment of these industries. The economic case for such support can be made only if the protection is temporary and leads to the establishment of a local industrial base; this justification is referred to as the 'infant-industry argument' for protection.

30. A rare example of the successful use of this strategy within the FICs is the case of biscuit manufacturing in Fiji. The industry was established in the period when tariffs on biscuits were extremely high. The effective rate of protection on bakery products in Fiji in 1991 was in excess of 600 percent. Two local manufacturers were subsequently successful in exporting their products without the need for continuing protection. This particular 'infant industry' matured. Fiji now exports biscuits not only to the other FICs but also to Australia and New Zealand. It is hard to know if the industry would have established itself without the initial protection, but the conclusions drawn above give the benefit of doubt in favour of the infant industry argument for protection. However, in the decade to 1991 Fiji provided similarly high levels of protection to meat products, flour milling and cereals, paper and printing, cement and concrete products, and scores of others, but none to date have matured into successful export industries (Chand, 1996).

31. Protection to create domestic industry can be a high-risk strategy. Assuming that the above-mentioned case of Fiji-biscuits was a successful use of infant industry protection, this rare success amongst scores of products that were protected would suggest that the probability of successful use of infant industry protection is small.

¹⁷ There generally is a long time lag between reforms and the rewards of these interventions thus it may be a bit too early to gauge the success of reforms within the FICs.

¹⁸ Concerns, however, have been expressed regarding the gradual loosening of public expenditure since 2000 that has been funded with domestic borrowings (Sialoa, 2005).

The successes with infant industry protection from the other FICs are rare.¹⁹ The case of a state owned and operated poultry farm on the outskirts of Port Moresby that was closed in 1999 can be used to illustrate the more common occurrence. The farm had been making losses since its inception. This was despite a duty of K2.40 per kilogram for imported poultry; thus, the PNG consumer was paying a price premium, at the prevailing exchange rate, nearly equal to the price of poultry in Australia. The consumer was slugged twice from the protection afforded to this industry; first in the form of a price premium paid on the imports and their local substitutes, and again through the taxes paid to government that were channelled via the budget to support the farm.

32. Cement, fabricated steel, and other similar building products have been protected in nearly every FIC on the grounds of inducing the development of a local industrial base. The higher price paid for these products than their landed-price at the ports makes local production using them as inputs internationally uncompetitive. Duty-drawback schemes have provided some relief, but only to exports and have in the process added another layer of complexity to the tax system. Protection of domestic industry has, on the whole, been damaging to export competitiveness, even though occasional exceptions, as in the case of Fiji biscuits, can be found.

33. Jobs created on the basis of trade preferences, including domestic protection, often last only until the preferences remain. Fiji made a marked shift from import-substituting industrialisation after the 1987 coups, which saw rapid growth of labour-intensive manufacturing, mainly garments, that was helped by preferential access given to the product in industrial country markets. These jobs are now disappearing as preferences are withdrawn.

34. Protection of domestic industry has on the whole hampered job creation. This is because the protected sector in the FICs, in general, have been capital intensive while the sectors discriminated against in the process have tended to be labour intensive. One FIC government, as an example, recently proposed to impose a tax on exports of cocoa beans, on the grounds that it will induce the setting up of a local processing plant. If such a policy is adopted, the farmers will receive a price lower, by the value of the tax, than the world market price for the product. This will lower the income of farmers and reward the owners and employees of the (capital intensive) processing plant. Jobs will be lost in the process since processing of cocoa beans is far more capital intensive than the growing of the crop.

35. The protection of capital-intensive industries such as cement and metal fabrication raises the costs of building and thus constitutes an income transfer from the masses to the owners and employees of the protected industry. Protection to inputs creates demand for protection of final goods that use the above as inputs, adding further layers of complication to the tax system. The political economy of protection makes it extremely difficult to withdraw such support once it is granted. Much like any public handout, those who are likely to lose from the withdrawal of assistance tend to be few and geographically concentrated and thus better organised

¹⁹ I cannot think of any other examples, other than Fiji biscuits, as cases of successful use of infant-industry protection in the FICs as a whole. This is a common finding from the broader development literature.

compared to the potential beneficiaries who tend to be dispersed and thus far less well organised and vocal.

Lesson 1: *Given the low probability of success in the use of the infant industry protection, the adverse impact it has on job creation and income distribution, and the difficulty of withdrawing support once offered, policymaker would be well advised to be cautious of using this strategy for growth.*

36. State-led development has, on the whole, been a failure. Several FIC governments after independence embarked upon the establishment of state run enterprises on the grounds that the private sector would not provide these services. National Airlines and state run utility companies were set up to fill this perceived void. These interventions at best promoted growth of private enterprise (this is the case of ‘crowding-in’) and at worst stultified private entrepreneurship. There is evidence of both. The colonial government pre-independence initiated the establishment of the oil-palm industry in Papua New Guinea. Under its land resettlement scheme, farmers from the more populous regions of the Highlands and the Sepiks were relocated to Bougainville and West New Britain to expand production of cocoa and oil palm. The private sector took a lead role in the establishment and growth of Oil Palm; with the private company establishing its plant and support services on alienated land (this being the ‘nucleus’) while encouraging supply of produce from the surrounding areas. The Fiji sugar industry was established on a very similar basis, where the mills were established on freehold land while sugarcane growing was out-sourced to the smallholder sector that, in the main, utilised communally owned land.

37. However, examples of the public sector stultifying growth of private enterprise are a lot more common. For example, the state has taken an active role in the provision of shipping services whereby the services have been heavily subsidised from the budget and/or private operators have been taxed when viewed as operating in competition with state-owned ships. The case of Solomon Islands is most illuminating on this count. The Provincial governments run their own ships and private operators were charged as much as SI\$5,000 for every landing on their ports. The Republic of Marshall Islands had a similar scheme until 2004 but then tendered out its unprofitable routes to a private operator only to restart operations once the private operator had begun operations. The cases of state-owned and operated airlines have shown a similar pattern. Governments have been reluctant to let go of airlines that have been profitable and protected the most profitable (dense) routes from competition, even at a cost to tourist arrivals into their countries. In the few cases of loss making airlines, these have been propped up with budgetary support until the fiscal burden became unbearable. The poor record of the state in running enterprises in competition with the private sector is not unique to the FICs; there are many examples from the developing world where state-run enterprises have come out second best when operating in competition with the private sector.

38. If it is certain that the private sector will not provide the needed services, governments could consider tendering out the provision of the services to the private sector. The PNG experience with its commodity boards for cocoa, coffee, and copra demonstrated that a competitive marketing structure is a better strategy than the use of parastatal monopolies for exports. These outcomes raise the question of privatisation;

that is, how can the FIC-governments withdraw from active participation in commerce. An in-depth coverage of this issue is beyond the purview of this paper but the successful privatisation of *Papua New Guinea Banking Corporation* (PNGBC), the *National Bank of Vanuatu* (NBV), and *Polynesian Blue* provide lessons for others.²⁰

Lesson 2: *A risk-averse policymaker would be well advised to steer clear of using state owned enterprises as a means to inducing growth of private enterprise.*

39. Access to land for large-scale commercial agriculture and for development of tourist facilities that require long-term security of access to the resource remains a vexed issue in most of the FICs. The 3Ms may have some lessons for the FICs on this issue given that they have been highly successful in attracting large foreign investments in the development of resorts and related tourist infrastructure. Mauritius, for example, is providing state land that was used for sugarcane farming for development of resorts. The Maldives government leases islands for development of tourism infrastructure by private investors on a competitive basis.²¹ Closer to home, the Denarau complex in Fiji provides another model where communally-owned land in combination with freehold and state-owned land have been used jointly by private multinationals to build resorts and accompanying facilities of the highest quality.²²

Lesson 3: *Improving access to land for large-scale private enterprise remains a vexed issue and one that needs to be addressed soon. There are models of success from Mauritius, Maldives, and Fiji that could be adapted to improve access to communally owned land for private enterprise.*

40. Access to competitively priced credit has been a longstanding problem in the FICs. State-owned Development Banks have had limited success in alleviating this constraint. The poor access to credit has been due to macroeconomic instability, the lack of collateral, the absence of creditor records, and the high costs of enforcing debt contracts; addressing these factors is likely to be far more productive in lowering the cost of credit than setting up government-owned banks. Recent experimentation with provision of rural banking services by a commercial bank in partnership with the State in Fiji and Solomon Islands is a model of greater promise for the rest of the region. The State, moreover, has a critical role in the provision of prudential supervision and in reducing the costs of enforcing debt contracts.

Lesson 4: *Extension of subsidised credit via state-owned development banks is unlikely to have the desired effects. The 2005 FEMM, in its endeavour to reduce costs of doing business, had agreed to: “addressing issues of collateral, access to credit and enforcement of contracts” (FEMM Action Plan, 2005, paragraph 7). The above together with encouragement to the private and informal sector in the provision of banking services to the rural sector holds greater promise.*

41. Attempts at increasing international trade through regional trading arrangements have had limited success. The confluence of canned beef, biscuits, and kava in

²⁰ An alternative would be build-own-operate-and-transfer (BOOT) schemes; this is considered in an out of session paper.

²¹ See <http://www.maldivesisle.com/tourismsector.htm>

²² See <http://www.denarau.com/>

Melanesia often meant a spontaneous party! This has changed dramatically over the recent past, however. There have been repeated threats of a trade war between Fiji, PNG, and Vanuatu. The *Melanesian Spearhead Group* (MSG) and the *Pacific Island Countries Trade Agreement* (PICTA) were envisaged as ‘stepping stones’ to freer regional and global trade (World Bank, 2002). Success on this front has been less than enviable.

42. Preferential access into industrial country markets, such as those for sugar from the ACP states into the EC and garments via the *South Pacific Regional Trade and Economic Cooperation Agreement* (SPARTECA) and the now expired *Multi-Fibre Agreement* (MFA), have had limited success in creating a domestic industry that is able to survive without the need for continued support. The continued erosion of the preferences, as assured under the commitments to liberalising global trade under the auspices of the WTO, and an impending FTA between China and Australia, will create further pressures for adjustment.

43. The newly proposed *Economic Partnership Agreements* (EPAs) by the EC provides an opportunity for MFN-based liberalisation around the principles set out in Article 34 of the *Cotonou Agreement*.²³ EPAs, importantly, have facilities for adjustment assistance towards most favoured nation (MFN)-based trade liberalisation. The initiative for further liberalisation of trade by FICs, therefore, could be undertaken unilaterally and on a MFN-basis without risking further regional trade conflicts. The Pacific Islands Forum Representative Office in Geneva that began operations in July 2004 could be drawn upon for technical assistance with WTO-compliant MFN-based trade liberalisation.

Lesson 5: *Given the risks of protectionism from regional trading arrangements, consideration could be given to greater use of the multilateral route to trade liberalisation. Furthermore, the multilateral path to trade liberalisation could be taken unilaterally and without compromising the existing commitments to regional trading agreements.*²⁴

44. Political instability and weakened governance have risen with economic decline. The experience of Indonesia during the Asian Financial Crisis of 1998 shows that holding on to political office becomes extremely difficult during an economic collapse while the decade-plus of *Human Rights Protection Party* in Samoa suggests that voters reward office-holders for superior economic performance.²⁵ Governments have lost office in periods of fiscal crisis in Nauru, Papua New Guinea, and Vanuatu. Political turmoil triggered by an economic crisis led to fragmentation of political parties in Nauru, PNG, and Vanuatu, that in turn led to an era of political instability. Governance has deteriorated with economic decline; governments most desperate for funds have often attracted ‘snake-oil’ merchants who in turn have contributed to

²³ The *Cotonou Agreement* replaced the *Lomé Convention*, and is valid for a period of 20 years, subject to revision every 5 years. The EC and the ACP States signed this Agreement in Cotonou, Benin on 23rd June 2000.

²⁴ The suggested path of multilateral liberalisation is consistent with the concept of ‘open regionalism’ as expounded under APEC commitments.

²⁵ The decade of *Liberal Government* in Australia is another case in point.

further deterioration in governance.²⁶ Holding on to power in the face of continuous economic decline has proved to be increasingly difficult in the region. In short, good economic management leading to a superior economic performance can reduce political instability and reward the incumbent government.

45. The feedback between economic decline and political instability can lead to a vicious circle and thus to a trap of continuing instability and poor economic performance. Reversing the feedback could have high rewards in terms of triggering a virtuous feedback from economic growth to political stability. Papua New Guinea seems to have been successful in reversing the negative feedback whereby economic decline led to increased political instability to one of economic growth with increased political (and policy) stability. The two factors responsible for this switch from a vicious to a virtuous feedback between political stability and economic performance were: first, the healthy movements in its terms of trade such that export earnings improved in the last electoral cycle; and, second, the passage of the *Organic Law on the Integrity of Political Parties and Candidates* (2000) and *Central Bank Act* of 2000. The first of the above was part of good fortune but the latter two were the product of deliberate policies targeted at reducing political (and policy) instability²⁷ and reducing political interference in the conduct of monetary policy.

Lesson 6: *The recent PNG experience provides policy lessons for reducing political and macroeconomic instability and demonstrates the rewards to office-holders of good macroeconomic management.*

46. Superior economic management is required for resource rents to be used for long-run growth in income. The post-independence experience of Nauru has lessons for others. Nauru was the second FIC (after Samoa which gained independence in January 1962) to have gained independence, in January 1968. It was then thought that the rich phosphate resources would provide the basis for long-term development of the nation but this, with the benefit of hindsight, was not the case. The resource abundance led to high wages, low participation in the workforce, and reduced incentives to invest in skill acquisition, while much of the resource rents were lost due to poor governance. Tuvalu, with a similarly sized population but without the resources that Nauru had, has successfully managed its trust fund and thus avoided the problems besetting Nauru.²⁸

47. Another of the negative consequences of resource abundance, referred to as the 'resource curse', arises from a heavy dependence on a few non-renewable resources that then leads to an appreciation of the real exchange rate, thus penalising the other export sectors of the economy. The discovery of large mining deposits has often led to wage inflation, particularly for those with formal training, and further narrowing of the production base. Large quantities of aid run similar risks.²⁹ Rents, and the

²⁶ Fly-by-night financiers supposedly with billions of dollars in hand and those with supernatural healing powers have frequented the FICs at their most desperate moments.

²⁷ This law was introduced to promote formation of political parties, induce their longevity, and stabilize executive governments (Reilly, 2002).

²⁸ Kiribati has also managed its Trust Fund well but this is a much larger economy than Nauru's.

²⁹ Palau, on per capita terms, is one of the largest recipients of aid and the FICs in general rank high compared to countries with similar levels of per capita GDP. The impact of aid on growth of the FICs remains to be ascertained, however.

competition for these, can have a deleterious impact on institutions of civil society. The conflict in Solomon Islands and that in Bougainville that led to the closure of their only (large) copper mine are examples where competition for rents led to disastrous outcomes including the destruction of social, physical, and environmental capital.

48. The issue here is not the presence of (resource) rents *per se* but the lack of the capacity to manage these rents for the benefit of the present and future generations.³⁰ The experience of PNG and Nauru with mining demonstrates the perils of a mining boom without the capacity to manage it for development. The resource rich FICs have failed to invest the income derived from liquidating their non-renewable resources into alternative forms of capital to the extent that in a number of cases mining has led to a depletion of the aggregate capital base of the economy. This has serious inter-generational consequences as the future generations no longer have access to the depleted resources or the income derived from the liquidation of these resources.³¹

49. The FICs, as a group, are rich in marine resources. The Pacific Ocean spans more than half the surface area of the planet, fisheries alone contributes some 11 percent of the FICs GDP, and tuna constitutes the only significant natural resource for several of the smallest FICs. The two major concerns with the management of the fisheries resources of the region are: (i) maximising returns from the given stock; and, (ii) the challenge of ensuring long-term sustainability of this resource. Sea bed mining has potential and it will raise issues of non-renewable resource extraction alluded to in the two preceding paragraphs.

Lesson 7: *Natural resource abundance should not be a handicap but its presence demands superior economic management for the ensuing income to be translated into superior developmental outcomes.*

4. The challenges and opportunities

50. This section highlights the challenges that need to be addressed and the opportunities that could be realised to raise the rate of growth of income. The challenges, if successfully addressed, offer the opportunities for growth. Country context, however, is important in the considerations that follow. The seven specific challenges/opportunities considered next include: (i) the creation of the conditions for job growth and thus exploitation of the benefits of using idle resources for growth of production; (ii) the use of technological improvements for raising agricultural productivity; (iii) the use of international labour mobility for growth; (iv) the improvements in personal security for growth of tourism; (v) freeing up of regional aviation and telecommunications markets to realise the benefit of greater economies of scale; (vi) improvements in governance via inducing greater demand for the same; and, (vii) the under-writing of security within member states in order to reduce sovereign risk for greater private investment and thus growth.

51. Many of the FICs have idle labour, land, and marine resources. Bringing them into production is as much a challenge as an opportunity for raising income in the

³⁰ Sala-I-Martin and Subramanian (2003) show that revenues from natural resources that lend themselves to easy appropriation have an adverse impact on the quality of a nation's institutions.

³¹ That is, policymakers have been negligent of the 'Hartwick rule'.

short to medium term. The challenge for policy is to create the conditions for increased private investment leading to job growth and increased utilisation of idle land and marine resources and on a sustainable basis. The vast tracts of under-utilised land in several Melanesian countries, the Guadalcanal plains for example, suggest that these conditions do not, as yet, exist. The owners of these resources, however, remain income-poor.

Challenge/Opportunity 1: *Create the conditions for job growth and productive use of idle resources. The commitment by FEMM to halve the costs of doing business by 2007 is encouraging in this regard. Monitoring of progress and any remedial action that may be necessary to achieve this target is crucial for success on this front.*

52. The vast majority of the FIC population live off their land and this includes the majority of the poor. Some 80 percent of the 5.5 million residents of PNG draw their livelihood from the rural sector. In terms of numbers, these individuals make up more than the rest of the FIC population. Agricultural productivity, therefore, would need to rise if the majority of the population is to witness an improvement in their wellbeing. There is little evidence of improvements in agricultural productivity, however (Reddy and Duncan, 2006). A more concerted effort at land reform and use of modern technology is likely to produce dividends in terms of increased productivity. Vanuatu and PNG, for example, have had considerable success in breeding high-yielding and disease resistant copra and oil palm, respectively. Oil Palm and Sugar industries in PNG and Fiji, respectively, have had some success in drawing on communally owned land for commercial agriculture. These models could be adapted/adopted elsewhere for other crops and countries.

Challenge/Opportunity 2: *Poverty reduction in the short to medium term warrants improvements in agricultural productivity. There is an opportunity to improve long-term and secure access to land, the dissemination of high-yielding crops that have been developed from within the region and abroad, and the use of modern technology to raise farm productivity.*

53. People represent the Pacific's best resource, and as such are potentially the most important source of growth for the future (see the case of Malta in paragraph 10). However, a scenario where all of the region's labour is productively employed at home within the short term may be unrealistic. Additional opportunities for employment, moreover, will not occur without sustained efforts at improving the investment climate within the individual economies and the region more broadly. It is clear that the private sector will be the source of job growth while the role of the public sector will be in creating the conditions, including providing the regulatory environment, for increased private sector investment. Private enterprise has noted that policy instability, poor contract enforcement, and the poor and deteriorating law and order situation in a number of the countries has impeded investments; these concerns will need to be addressed.

54. Those who will be entering the workforce over the next 15 years, that is, up to 2020, are already amongst us. Table 4 provides data on the prevailing size of the work-age population, the level of the total formal sector employment, and the rate of entry of new job seekers. The last right-hand column shows that, with the lone exception of Fiji, the workforce will grow at approximately 5 percent in nearly every

FIC for the foreseeable future. Assuming that labour-productivity increases one percentage point per year and that there is unimpeded access to capital from the global marketplace, the economies could grow at a rate of 6 percent per annum simply by absorbing those entering the workforce. Given that the rate of population growth is falling as fertility rates decline, the above demographic transition will lead to an increase in per capita income in the interim. The FICs are in an enviable position vis-à-vis Australia, New Zealand, and the rest of the industrialised world where this ‘demographic bonus’ is now in reverse.³²

55. The third column in table 4 (and the figures in parenthesis) shows that the formal sector is unlikely to absorb all those who enter the workforce. Formal sector employment in PNG, as one example, would have to expand by 85 percent if it were to absorb the 18,600 new job seekers each year. Such growth is unlikely given that the public sector accounts for a large proportion of formal sector employment and the fact that public sector downsizing is in place in nearly every FIC. Besides improving the domestic employment climate, FICs could over the short term consider exporting their excess labour.

56. Labour mobility is an issue of existing interest to the countries of the region. Ministers at the 2005 FEMM “supported the need for further examination of Pacific labour market issues at the regional level”, with one specific area of interest being “the promotion of labour mobility through the region and beyond”. Similarly, at their last meeting the Forum Leaders agreed to continue to consider the issue of labour mobility in the context of member countries’ immigration policies’ (36th *Pacific Islands Forum Communique*, 2005: PIFS(05) 12). The arguments around international labour mobility for sustainable livelihood differ across the individual FICs, however. The Micronesian states have very high population densities, a diminishing capacity of the environment to sustain this population at home on subsistence alone, and thus perhaps have the most persuasive and immediate case for out-migration. In other parts of the region other factors figure more prominently. International labour mobility, and this could very much be within the FICs or more broadly, could serve as an effective response to macroeconomic shocks. The mobility of workers from small regions, and particularly those at risk of facing frequent natural disasters, provides a means for employment diversification in the face of frequent adverse shocks. Furthermore, in those countries facing the most significant governance challenges, labour mobility could induce better governance by allowing people to ‘vote with their feet’.

57. Access to industrial country labour markets, even for the smallest and resource poor states, is likely to have the largest long run effects on poverty if the labour force is ‘tooled-up’ to take advantage of the opportunities abroad. The contrasting cases of Kiribati and Marshall Islands demonstrate some of the risks of unimpeded access to foreign labour markets. Kiribati does not have privileged access to industrial country labour markets, but trains a small workforce that has traditionally managed to get employment on foreign vessels. These workers have provided remittances to their families and the scheme has been relatively successful. The Marshallese workers have unfretted access into the US under their *Compact of Free Association* but

³² The ‘demographic bonus’ is the excess of the rate of increase of the workforce vis-à-vis the population.

poverty and high unemployment have persisted over the past decade. While the USA in this period has succeeded in keeping unemployment low and stable, the Marshall Islands has witnessed a persistent rise in its unemployment rate (ADB, 2005).

58. The majority of the Marshallese who have emigrated have not fared much better than their counterparts at home. Of the 2000 Marshallese living in Hawaii and surveyed in 2003, some 49 percent lived below the (Hawaiian) poverty line. Net remittances into Marshall Islands for the past decade have been negative (ADB, 2005). The reasons for this outcome, according to ADB (2005), include the lack of skills of migrant Marshallese. However, temporary migration of unskilled and semi-skilled workers will in the immediate to short term lower poverty since even migrants working in low wage jobs tend to save and remit some money home whilst developing skills and attitudes that enable them to be more productive workers on their return.

59. Sustained poverty reduction, therefore, requires mobility of workers up the wage ladder. Such mobility, however, takes time, as it requires appropriate training. Access to training facilities at home, therefore, is essential if workers are to be able to take advantage of opportunities both at home and abroad. The trainees and their families, moreover, must have the income (liquidity) and the incentives to release a potential worker for studies. Absent perfect capital markets, temporary labour mobility for those unable or unlikely to be trained provides the liquidity while long-term access on the basis of skills the incentives for the above-mentioned. That is, labour mobility, particularly where it is temporary, of unskilled and semi-skilled workers, could help to meet the current demand for jobs in the FICs whilst providing the incentives and the funds for investment into skill upgrading.

Challenge/Opportunity 3: Temporary access to the labour market in ANZ for school dropouts and those unlikely to go back to school such as those above 35 years of age will fill an immediate void for jobs in the FICs whilst providing the liquidity and the incentives for investment in skill acquisition within the more able population. The last necessitates availability of requisite training facilities, information, and portability of skills. This is consistent with the case made within the Pacific Plan for improved technical and vocational education and the standardisation of qualifications across the region.

60. Tourism provides the greatest prospects for job creation within several FICs. Their isolation from the major industrial centres has left the natural environment in a number of the Pacific Islands free of industrial pollutants.³³ Pacific Islanders, on the whole, are extremely hospitable people.³⁴ The growth of this sector has varied over time but there remains considerable potential for further expansion. Fiji, the most successful of the FICs, received some 110,000 tourists in 1970; by 2005, the number of arrivals had reached some half a million. The five-fold increase in tourist arrivals is impressive but Mauritius, a lot smaller nation with far fewer natural attractions, received some 700,000 tourists in 2005. Fiji and Mauritius are very similar in many respects including targeting the high-value end of the market, but Fiji has the advantages of a larger physical size, better geographic positioning in being close to

³³ Radioactive waste left after nuclear testing in the Northern Pacific is an exception, however.

³⁴ This includes the vast majority of Papua New Guineans.

ANZ and Asia, and a lot more natural attractions (see paragraph 11). Bali, another much smaller competitor of Fiji, received more than one million tourists annually until the tsunami of December 2004. Papua New Guinea, a much larger country with far more natural and historical attractions, attracted some 61,000 tourists in 2004.³⁵

61. The poor performance of the tourism sector in the FICs is attributed to a lack of personal security, health risks as those due to the prevalence of malaria, poor and high cost of travel, and the insecurity of property rights to land-based investments such as into hotels and resorts (Yala and Duncan, 2006). The above-mentioned issues except for personal security have been addressed above. The number of tourist arrivals into Fiji fell sharply in the aftermath of each of the three coups. Security is a strong factor in determining tourism flows. Being small and isolated from the rest of the world, the FICs have a comparative advantage in providing security and thus could use this fact to their competitive advantage.

62. Improving personal security has the potential to attract a lot more tourists, as well as generating major benefits for the local population. Port Moresby is notorious for its incidence of crime; while tourists who fall victim to crime get a lot of publicity, the majority of the victims of crime are locals. The donor community has a large appetite for expenditure on improvements in law and order. This is one area of considerable overlap in terms of expenditure priorities for donors as for FIC-governments and presents itself as a unique opportunity for improving law and order with the joint effort of recipient governments and donors. Such investments have the potential to improve the wellbeing of the local population whilst creating more favourable conditions for growth in tourist arrivals. Visitors, and particularly those with families, will pay a premium price for such security.

Challenge/Opportunity 4: The FICs can build on and market their more secure environment for growth of tourism.

63. Being geographically fragmented, trade and communications, both within and across FICs, are extremely difficult. That is, the challenges in terms of improving intra-nation trade are at least as great as that for international trade. While high transportation costs will continue to impose a competitive disadvantage on commodity exports, innovations in telecommunications technology, together with growth in service exports, are likely to reduce the economic disadvantage from physical isolation. Transportation and communication services are major inputs into several industries, and thus FIC-governments should encourage competitive supplies of these inputs.³⁶ Scale effects from amalgamation of regional markets for these services could bring about reductions in the costs of these provisions.

64. Several FIC governments have significant equity in their national airlines (flag carriers) and telecommunications companies. They consequently have protected their aviation and telecommunications sectors from foreign competition but to the detriment of the growth of the rest of the economy and towards creating a more fluid

³⁵ Data is the most recent available from the National Statistics Office, Port Moresby.

³⁶ A number of the FICs have been doing the very opposite; that is, taxing the supply of transportation and communication services (see Duncan, 2004).

(cohesive) society.³⁷ The high costs of transportation and communications services have impeded deeper integration within as much as across nation states. They have also hampered growth of industries that use transportation and communications intensively; tourism and outsourcing being the most obvious cases in point.

Opportunity 5: *The FICs have the opportunity to legislate for an open-skies policy for the region as a whole whilst opening up their local markets for these services. Carriers could then hub and spoke on commercial considerations alone.³⁸ The same could happen for shipping and telecommunications services.³⁹ It is quite feasible that in the process some destinations may not get serviced; the economic solution to this problem would be in the form of purchasing the desired services on social considerations through a competitive tender (see paragraph 38).*

65. **Poor governance, corruption** in particular, remains a serious issue in several FICs. The Vanuatu Chamber of Commerce in 2001 ranked policy instability and corruption as the major problems holding back private sector investment (Chand, 2002). A similar study in PNG found political instability, high rates of crime, and corruption as the major constraints to growth of private investments (Manning, 2005). Evidence on weak governance in the FICs is supported by data from two independent sources; namely, the US State Department and Kauffman and Kraay (2005).⁴⁰ While the subjectivity and the timeliness of this data make cross-country comparisons problematic, they still are indicative of the extent to which weak governance is an issue within the FICs. Table 5 shows that corruption, for the ten FICs for which data is available, remains high in comparison to ANZ and the 3Ms. The qualitative data here corroborates well with the quantitative estimates provided by the World Bank and reported in Figure 5. On the last, Samoa and Palau rank most favourably amongst the FICs but even they fall short of the benchmarks set by Mauritius and Malta.

66. The quality of governance in many instances has deteriorated whilst ‘institutional strengthening’ projects, often funded with donor resources, have been in place within the Police and the Offices of the Public Prosecutor, the Auditor General, and the Public Accounts Committee. Interestingly, most of the attempts at improving governance in the FICs have been through improving the supply of rather than the demand for better governance.⁴¹

Challenge/Opportunity 6: *Improving governance remains a difficult issue, but there is an opportunity to expand the demand for better governance. This could be done as a regional initiative whereby the public, including the media, is given legislated-access to public information, possibly modelled on similar legislation in ANZ or in*

³⁷ Communally-owned land has impeded greater mobility of individual families; this is an issue currently being researched on.

³⁸ Pacific Islands Air Services Agreement (PIASA) tries to do this but has to date had limited success.

³⁹ This is consistent with the *Digital Strategy* within the *Pacific Plan*.

⁴⁰ The US State Department provides assessment of the levels of corruption in government and the extent of transparency in public decision-making for 196 countries. The State Department notes that: “These reports describe the performance of 196 countries in putting into practice their international commitments on human rights. These basic rights, reflected in the UN Universal Declaration of Human Rights, have been embraced by people of every culture and color, every background” sourced from <http://www.state.gov/g/drl/rls/hrrpt/2005/61550.htm>

⁴¹ The limited support given to the establishment of the offices of Transparency International in a few of the FICs and support for the media are exceptions in this regard.

Mauritius. Additionally, journalists and whistle-blowers could be freed from the need to reveal the sources of their information whilst being subject to the normal defamation legislation.

67. Security breaches, including those highlighted above, now readily spill across national borders. The regional effects of the 1987 Fiji coups were confined to its national borders except for disruptions to trade to the surrounding nations that used Fiji as a shipping and aviation hub. The 2000 coup, however, was alleged to have led to a copycat coup in Solomon Islands. There is now concern over ex-Fiji Military Forces personnel being involved in the training of a rebel force in Bougainville. The recent standoff between the military and the Fiji Government suggests that power once usurped creates the preconditions for its repeat. Averting conflicts before they arise and containing them once they do is, therefore, a regional responsibility. Conflicts disrupt growth and raise poverty (Goodman, 2003); interventions to avert and contain conflicts, therefore, constitute a backstop against slippage into increased poverty.

68. Interventions to avert and/or contain conflicts when undertaken at a regional level raise several questions. When and how should the region respond to conflicts in its member countries? Under what conditions should the region, and the wider international community, intervene in an internal conflict without the invitation of the host government? The latter question did not arise in the cases of the Regional Assistance Missions to Solomon Islands and Nauru since the host governments instigated them, but such invitations are unlikely when the government is taken hostage, as was the case for two of the three coups in Fiji. How can the taxpayer be protected from internal threats such as those against coups from its own ‘disciplinary’ forces that are trained, equipped, and paid for by the citizenry? These are difficult questions but questions that have to be addressed if peace and stability is to prevail in the region. This brings us to the last and perhaps the most ambitious recommendation.

Opportunity 7: *Drawing on the Biketawa Declaration, the region as a collective body should examine further how it could support the security and integrity of each of its member states. The region could, as an example, consider underwriting the rule of law as spelled out in the member nation’s constitution. That is, the regional collectively could commit itself to re-establishing the rule of law as reflected in each nation’s constitution and its supporting legislation, when and if power is usurped in any member state. This sounds like an expensive commitment but one that may never need to be demonstrated. A credible commitment to restoring law and order in the event that it is usurped can on its own be enough to deter such an activity.*

5. Conclusions

69. In terms of economic performance, the FICs as a group have performed poorly compared to similarly endowed economies in the rest of the world. The small size and isolation of island economies from the major markets means special problems in respect of development, but these problems have been overcome by other small states such as the Maldives, Mauritius, and Malta (the 3Ms).

70. Policies can be used to ameliorate the handicaps of smallness and isolation. The handicap of small size, for example, could be minimised through deeper integration

with the global market place. The debilitating effects of isolation can be reduced by taking advantage of technological progress that is delivering lower costs of communications and transportation services.⁴² The exposure to volatile production and earnings can be reduced via use of appropriate financial instruments. In short, some of the adversities of smallness and isolation can be overcome by well-targeted policies.

71. The poor economic performance of the FICs can, on the whole, be attributed to poor policy choices. The inferior quality of governance distinguishes the poorly performing FICs from their better performing counterparts both within the region and abroad. The data in table 5 shows that Palau and Samoa, the better performing FICs, have the lowest level of corruption in government within this group. Within the FIC-group, neither of these two economies has the advantages of location or size. On international comparisons, the FICs as a group score poorly on this count (see Figure 5). Improving governance and security (the two being inter-related) is identified as the major challenge in raising growth in the FICs. Being able to overcome this challenge presents the opportunity to bring about poverty reduction within the region.

72. The claims in the preceding paragraph have to be qualified by the fact that there is no single recipe for raising growth of income in every FIC. The FICs are a diverse group of economies; each is at a different stage of development, and each with its own legacy of past policies. The experiments of the past offer many lessons on what to do and those to avoid; some degree of experimentation and fine-tuning would still be necessary as time progresses. Evidence-based policymaking, however, requires good data and this is lacking at the moment. The key message here is that the recipe for raising the rate of growth will differ across the individual FICs, but the ingredients for success are most likely to be similar.

73. Many of the policy ingredients for growth are readily identifiable given the outcomes of past experimentation. These include a stable macroeconomic environment, the presence of clear and enforceable property rights, access to good public infrastructure, the presence of an open trading regime, and an accommodating international trading environment. Furthermore, there is a clear sequence of interventions if the foundations of growth are to be built. Macroeconomic conditions in terms of fiscal sustainability, low and stable inflation, and internationally competitive interest rates have to be in place before the microeconomic foundations can be worked upon. The latter includes a competitive business environment, security of person and property, improved contract enforceability, and rewards for risk taking. The challenge for policy is to create these conditions.

74. Successful small states, the 3Ms in particular, demonstrate that the handicaps of size and isolation can be overcome. These countries have had considerable success in raising growth of income by ensuring good governance, macroeconomic stability, and security to returns from private investments. A few of the FICs have had some success in emulating some of the policies of the 3Ms and are reaping the benefits in terms of higher growths. The poorest performing FICs, in contrast, are still struggling with political and macroeconomic stability and thus experiencing low rates of private investment and job-growth. It would be unrealistic to expect these countries to be

⁴² This is commonly referred to as 'death of distance' in economic geography.

able to change their policy settings overnight, thus some breathing space in terms of having temporary overseas access to their jobless would be of considerable value.

75. The particular set of interventions, however, will depend on the economic and political circumstances of the individual country. Moreover, conditions are changing so all of the past lessons may not be relevant. In short, the message for growth strategies is that there is not 'a single strategy for all the FICs', but this does not imply that there is 'no growth strategy for any individual FIC'.

76. The key message of this paper is that only sustained growth in per capita income predicated on sustainable use of all of the nation's resources can bring about the realisation of the vision of lasting 'peace, harmony, and security' for the FIC region (see paragraph 1). Forum Economic Ministers endorsed this vision, noting the centrality of economic growth in the above (see paragraph 2). A number of policy-interventions at the regional level for FEMM have been identified. It would be opportune to debate their pragmatism, particularly at the level of FEMM.

77. The Forum has a role in providing regional public goods such as data collection, information dissemination, policy advice, and acting as an anchor against backsliding on instituted reforms. All of the above could be incorporated within the ambits of 'measures for good regional governance' within the *Pacific Plan* (re page 8). The region could also collectively underwrite security and law and order in the member states. This will lower sovereign risk and encourage private investments thus contributing to growth in income.

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Data Appendix

Table 1: Basic Indicators for Forum Island Countries (FICs); Australia and New Zealand (ANZ); and Maldives, Malta, and Mauritius (The 3Ms)

Country/Group	Land area (sq km)	Population (‘000) (2004)	Population density (people/km ²)	GDP per capita (PPP, 2004\$)	Aid per capita (2003 US\$)	Life expectancy at birth (2003)
FICs						
Cook Islands ^a						
Fiji	18270	848	46	6092	61	70
Kiribati	730	98	134		191	63
Marshall Islands	181	60	331	1600 ^e	991	70 ^e
Micronesia, Fed. Sts.	702	127	181	2000 ^f	923	69
Nauru ^a	21	13	619	5000 ^b	..	63
Niue ^a	260	2	8	3600 ^c	..	..
Palau	460	20	43		1295	
Papua New Guinea	452860	5625	12	2564	40	57
Samoa	2830	179	63	5694	186	70
Solomon Islands	27990	471	17	1773		70
Tonga	720	102	141	7236	270	71
Tuvalu ^a	26	11	423	1100 ^d	..	68
Vanuatu	12190	215	18	2893	154	69
ANZ						
Australia	7682300	20120	3	30116		80
New Zealand	267990	4061	15	22912		79
The 3Ms						
Maldives	300	300 ^g	998	3900 ^h	61	69
Malta	320	401	1253	18954	25	79
Mauritius	2030	1234	608	11943	20 ⁱ	72

Notes: The most recent data available has been used; .. indicates unavailability of data; ^a these countries are not members of the World Bank, thus their data has been sourced from *The World Fact Book*; data accessed online on 16 March, 2006; ^b per capita GDP for Nauru is for 2001; ^c data on per capita GDP for Niue is for 2000; ^d per capita GDP data for Tuvalu is for the year 2000; ^e data on per capita GDP (data for 2001) and life expectancy for Marshall Islands are taken from *The World Fact Book*; ^f data for per capita GDP for FSM is for the year 2002 and taken from *The World Fact Book*; ^h data for per capita GDP for Maldives is for 2002 and from *The World Fact Book*; and, ⁱ aid per capita data for Mauritius is for 2002.. Data from *The World Fact Book* is only used when this is not available from *The World Development Indicators*.
Source: Unless otherwise stated, the source for all data is *The World Development Indicators* online. Data accessed on 15 March 2006.

Table 2: Rates of growth in GDP and population

COUNTRY	Aggregate GDP growth rates		Population growth rate	Per capita GDP growth rate
	1994- 2004 (I)	1999- 2004 (II)	1999-2004 (III)	1999-2004 (IV)
Cook Is	..	5.71%	0.97%	4.74%
Fiji	2.86%	3.37%	1.41%	1.95%
Micronesia, Fed. Sts.	-0.05%	1.33%	0.12%	1.22%
Marshall Islands	-0.86%	1.28%	1.98%	-0.70%
Kiribati	4.84%	3.03%	2.30%	0.73%
Nauru		-0.05%	1.98%	-2.03%
Palau	3.35%	0.67%	1.65%	-0.98%
Papua New Guinea	1.03%	1.44%	2.40%	-0.96%
Solomon Islands	-0.04%	-2.75%	2.94%	-5.69%
Samoa	3.04%	3.16%	-0.24%	3.39%
Tonga	2.41%	2.78%	1.85%	0.92%
Tuvalu		4.16%	1.41%	2.75%
Vanuatu	1.39%	-0.37%	1.68%	-2.05%
TOTAL			2.15%	

Data source: As listed for table 1 above.

Table 3: Demographic indicators for Forum Island Countries (FICs); Australia and New Zealand (ANZ); and Maldives, Malta, and Mauritius (3Ms)

	Fertility rate (births per woman) Y2003	Population ages 0-14 (% of total) Y2003	Adult literacy rate ^b (% of total)	Urban population (% of total) Y2003
Cook Islands	..	..	..	..
Fiji	2.6	32	92.3	52
Kiribati	3.6	38		47
Marshall Islands	3.9 ^a	38 ^a		67
Micronesia, Fed. Sts.	3.4	36		29
Nauru	3.2 ^a	38 ^a		..
Niue	..	..		..
Palau	2.5 ^a	26		69
Papua New Guinea	4.3	41	57.3	13
Samoa	4.0	35	98.7	22
Solomon Islands	5.3	45	76.6	17
Tonga	3.4	34	98.9	34
Tuvalu	3.0 ^a	31 ^a		..
Vanuatu	4.3	41	74.0	23
ANZ				
Australia	1.8	20	..	92
New Zealand	1.9	22	..	86
3 Ms				
Malta	1.4	19	87.9	92
Maldives	4.0	39	97.2	29
Mauritius	2.0	25	84.3	43

Notes: ^a Data for Fertility rate, Life expectancy, and Population 0 to 14 years are for 2005, extracted from *The World Fact Book*, <http://www.cia.gov/cia/publications/factbook/geos/> accessed on 16 March 2006. Data is for 2003, the most recent year for which this information is available, and sourced from World Bank Development Indicators, unless otherwise stated; ^b data is 2003 and is from the 2005 *Human Development Index*, published by United Nations at http://hdr.undp.org/statistics/data/excel/hdr05_table_1.xls.

Table 4: Annual supply-demand imbalance for formal sector employment.

Country	Working age population (15-24yrs in 2004)	Total formal sector employment ^a	Fresh entrants into the workforce per year	Fresh entrants as a share of working age population (%)
	<i>No.</i> <i>(Year of data)</i>	<i>No.</i> <i>(% of work-age population)</i>	<i>No.</i> <i>(% of total formal sector employment)</i>	
Cook Islands	7,276 (2001)	5,900 (81)	341 (6)	4.7
Fiji	487,450 (2003)	120,000 (25)	18,600 (16)	3.8
FSM	61,786 (2003)	15,137 (25)	3,008 (20)	4.8
Kiribati	54,335 (2004)	7,900 ^a (15)	2,537 (32)	4.6
Marshall Islands	29,634 (2000)	10,300 (35)	1,604 (16)	5.4
PNG	3,320,217 (2002)	187,320 ^b (6)	159,618 (85)	4.8
Samoa	91,139 (2001)	57,100 (63)	5,298 (9)	5.8
Solomon Islands	239,362 (2002)	22,177 ^c (9)	13,320 (60)	5.6
Tonga	51,824 (2003)	34,600 (67)	2,415 (7)	4.7
Vanuatu	110,976 ^d (2004)	16,300 (51)	6,359 (39)	5.7

Work-age population is defined as those in the 15 to 64 year age cohort. Data for column 3 are calculated assuming a uniform distribution of the population of under-14s. Notes: ^a data is for 1996 the most recent data available from ADB, 2001; ^b formal sector employment in PNG includes only jobs in urban centres; ^c formal employment in (pre-crisis) Solomon Islands in 1996 was 34,200; and ^d formal sector jobs in Vanuatu includes those in large scale plantations. Data for Palau and Tuvalu are not available. Source for all data, with the exception noted above, is Booth *et al*, 2006.

Table 5: Perceptions regarding levels of Government-Corruption and Transparency

Country	Commentary from US Department of State	Laws giving access to government information to media and citizenry
Fiji	<p>“Corruption within government, including the civil service, was a problem. The media continued to raise numerous allegations of nonaccountability, bribery, abuse of office, fraud, misuse of public property, financial mismanagement, failure to complete statutory audits, and conflicts of interest regarding officials and ministries. In some ministries transparency was virtually nonexistent. The constitution gives the auditor general the right to audit all national and local government bodies. In its annual report to Parliament, the auditor general's office highlighted numerous instances of corrupt practices in government offices and ministries.”</p>	No
Kiribati	<p>“Nepotism, based on tribal, church, and family ties, is prevalent. The auditor general (AG) is responsible for oversight of government expenditures. However, in reality the AG lacked sufficient resources, and findings of misappropriations and unaccounted-for funds were generally ignored, or the investigations were inconclusive.”</p>	No
Marshall Islands	<p>“According to the general audit report of 2003, performed by an independent accounting firm, government corruption was a problem, including instances of misuse of public funds and irregularities in the collection of certain taxes. The attorney general's office is responsible for investigating cases of alleged corruption, but only a few cases have been prosecuted. In 2003 the auditor general and the finance minister were replaced and the Finance Ministry reorganized in an effort to increase accountability.”</p>	No
FSM	<p>“Government corruption was a problem, particularly in Chuuk State. Following the 2004 convictions of the then speaker of Congress, one other member of Congress, and two former members on charges relating to misuse of government funds, the Attorney General's Office investigated and indicted other Chuuk politicians for corrupt practices, although one indicted member of Congress retained his seat in the March</p>	No (Legislative hearings and deliberations open to the public, however)

	elections.”	
Nauru	<p>“During the year the government took corrective measures in government and in publicly owned corporations to combat corruption. Loose controls on the enormous revenues generated by phosphate mining led to mismanagement and misappropriation of vast sums of public funds. With the effective end of mining in recent years, within a decade the country went from great wealth to de facto bankruptcy. A search for new sources of income led to the creation of facilities to register offshore businesses and banks. This led in turn to the creation of thousands of shell banks and companies and to massive money laundering. In 2000 the country was placed on a list of noncooperative countries by the Organization for Economic Cooperation and Development (OECD) antimoney laundering taskforce and forced to close its offshore banking sector and revise its business incorporation program. In recognition of its corrective actions, in October the OECD removed the country from the list. The financial and regulatory crises, accompanied by continued corruption and severe national impoverishment, dominated national politics from the late 1990s. The 2004 elections were widely interpreted as a victory for reformists dedicated to addressing corruption and economic problems.”</p>	No
Palau	<p>“Government corruption was a problem, which the government took some steps to address. The special prosecutor has authority to investigate allegations of corrupt practices. In June the special prosecutor charged the governor of Ngiwal State with grand larceny, forgery, and other offenses for allegedly diverting at least \$25 thousand in state funds to his personal use and for other alleged misconduct. The case was still pending at year's end. In October 2004 an employee of the Koror State government was charged with cashing for his personal use \$30 thousand in checks intended for the state government. During the year the employee entered into a plea agreement with the Office of the Attorney General to serve two years in jail and pay a five thousand dollar fine.”</p>	Yes
PNG	<p>“Corruption at all levels of government was a serious problem, primarily because clan-related obligations continued to undermine allegiance to constituents or to the country as a whole. ... At year's end more than 50 government officials were under investigation by the ombudsman's office.”</p>	No

Samoa	“Government corruption was not widespread, although there were some instances of corrupt practices involving misuse of public funds. During 2004 and 2005, charges were brought against several current and former employees from the Ministry of Health and the Department of Customs for theft of government funds, and the chief executive officer of the Ministry of Health was suspended. At year's end the cases were pending.”	Yes except for privileged information.
Tonga	“There were reports of government corruption during the year. Officials working in the main port reportedly took bribes in exchange for not charging the full amount of port and duty tax. In addition the Privy Council promulgated certain policies that appeared to benefit unfairly businesses associated with members of the royal family.”	No
Tuvalu	“Laws against corruption are weak. There was a widespread public perception that the government lacked transparency and accountability, that public funds sometimes were mismanaged, and that government officials benefited unfairly from their positions.”	No
Vanuatu	“Government corruption was a problem. ... The law provides for the appointment of public servants on the basis of merit; however, in practice political interference at times has hampered the effective operation of the civil service. At year's end several officials from the Vanuatu Maritime Authority were awaiting trial on charges of criminal conspiracy for alleged mishandling of the awarding of licenses and contracts.”	No
Maldives	“There were anecdotal reports that the power of the president and his family directed many decisions, including economic activities and political reform. There was an anticorruption board that investigates allegations of corruption in the government. The board meets regularly and refers cases, usually concerning monetary fraud, to the AG's office.”	No
Malta	“There were no reports of government corruption during the year.”	Yes, but government has the discretion to refuse requests for information.
Mauritius	“The public perceived that corruption existed in the legislative and executive branches. The ICAC and the media were the primary outlets to report acts of corruption. The 2002 Prevention of Corruption Act regulated such complaints.”	Yes (The law provides for access to government

		information, and the government has generally complied with the requests.)
Australia	“There were no reports of government corruption during the year.”	Yes (FOI ^a).
New Zealand	“There were no reports of government corruption during the year.”	Yes ^b

Source: 2005 *Country Report on Human Right Practices*, US Department of State, Bureau of Democracy, Human Rights, and Labour (released online at <http://www.state.gov/g/drl/rls/hrrpt/2005/c17093.htm> on March 8, 2006). Notes: ^a The federal, state, and territorial governments have freedom of information (FOI) laws. These laws provide the public with access to government information, subject to an application and a processing fee; ^b the New Zealand law provides for public access to government information. This is legislated to be provided within 20 working days of a request and the information must be made available unless a good reason exists for not doing so. The requester must be provided with an estimate of any fees before the information is provided.

Figure 1: Per capita GDP in constant USD over time for Fiji and Mauritius

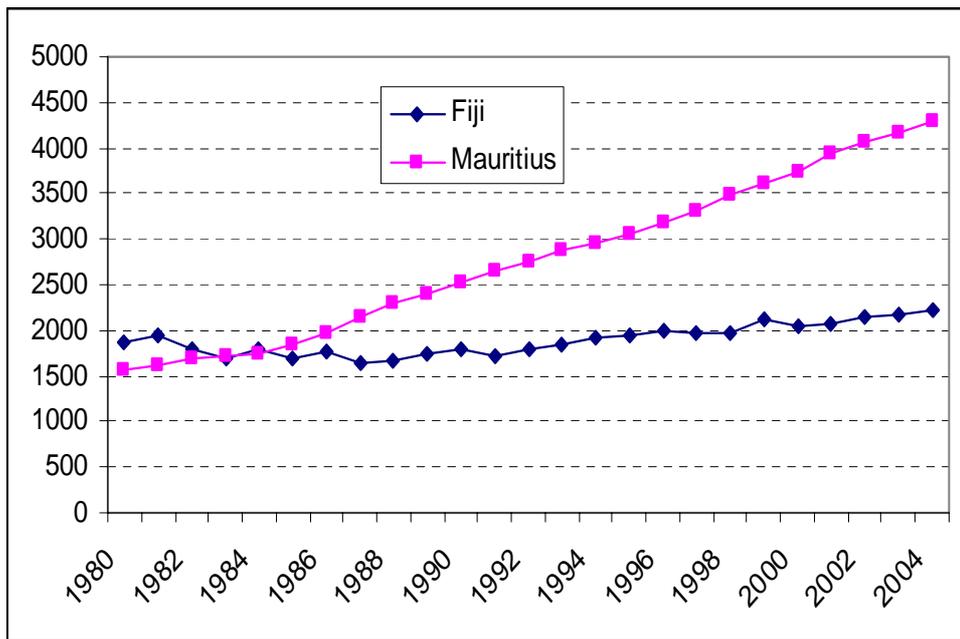


Figure 2: Per-capita GDP with current rates of growth continuing, 2004 and 2020.

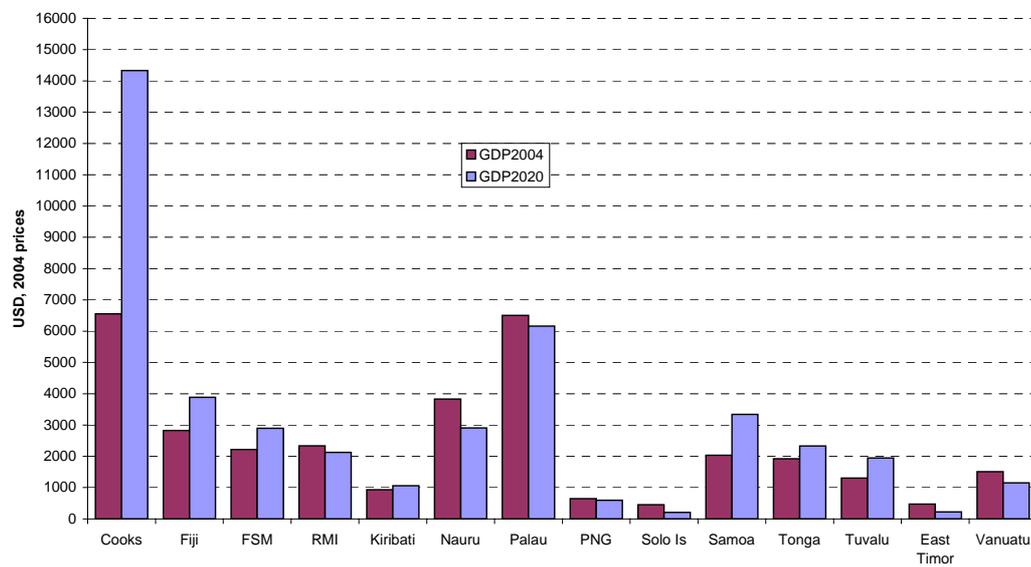
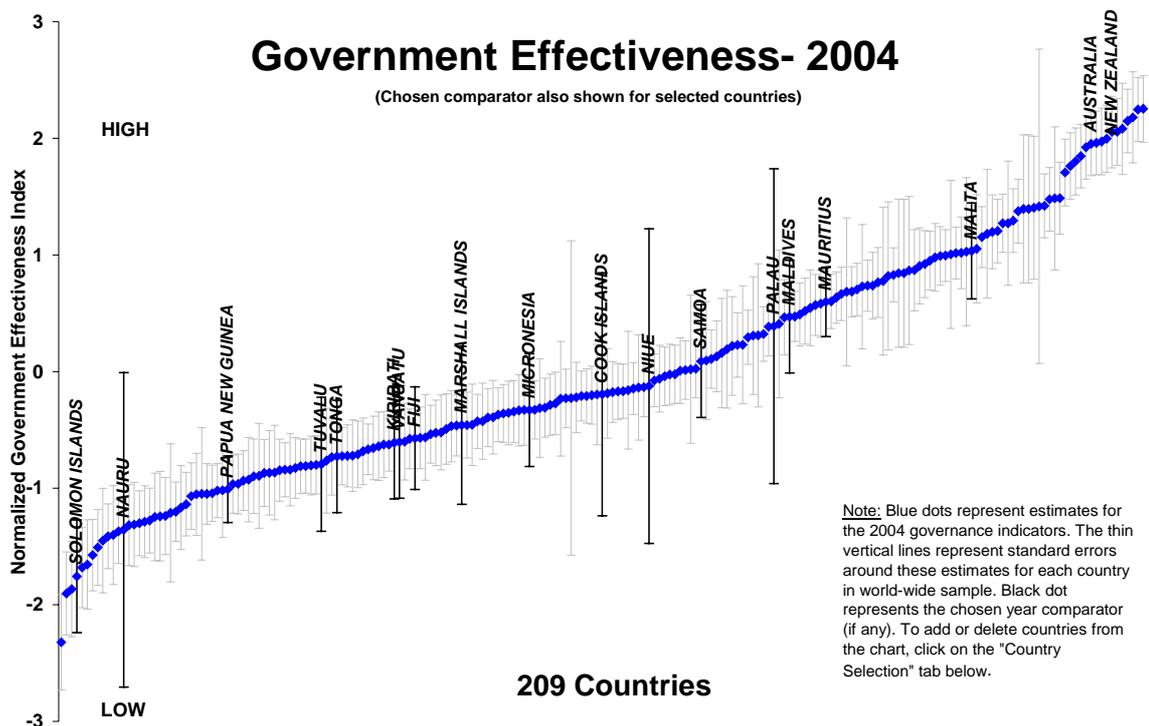


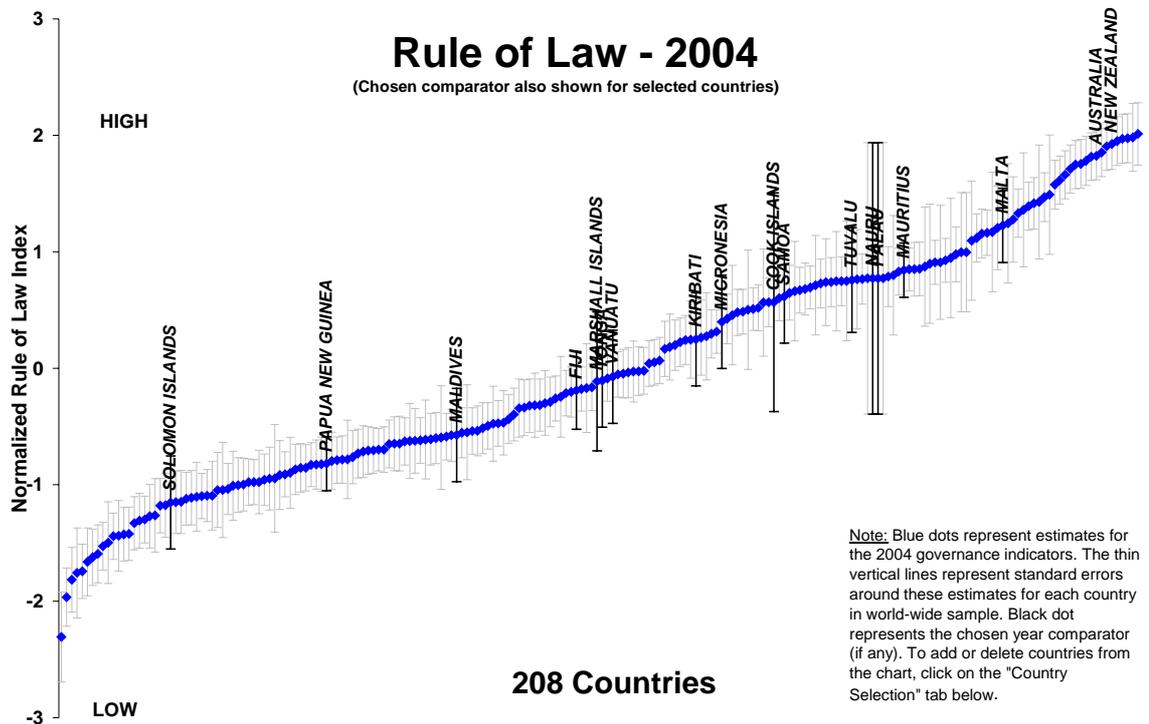
Figure 3:



Source: "Governance Matters IV: Governance Indicators for 1996-2004 " by Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, 2005.

Disclaimer: The governance indicators presented here reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators in no way reflect the official position of the World Bank, its Executive Directors, or the countries they represent. As discussed in detail in the accompanying papers, countries' relative positions on these indicators are subject to margins of error that are clearly indicated. Consequently, precise country rankings should not be inferred from this data.

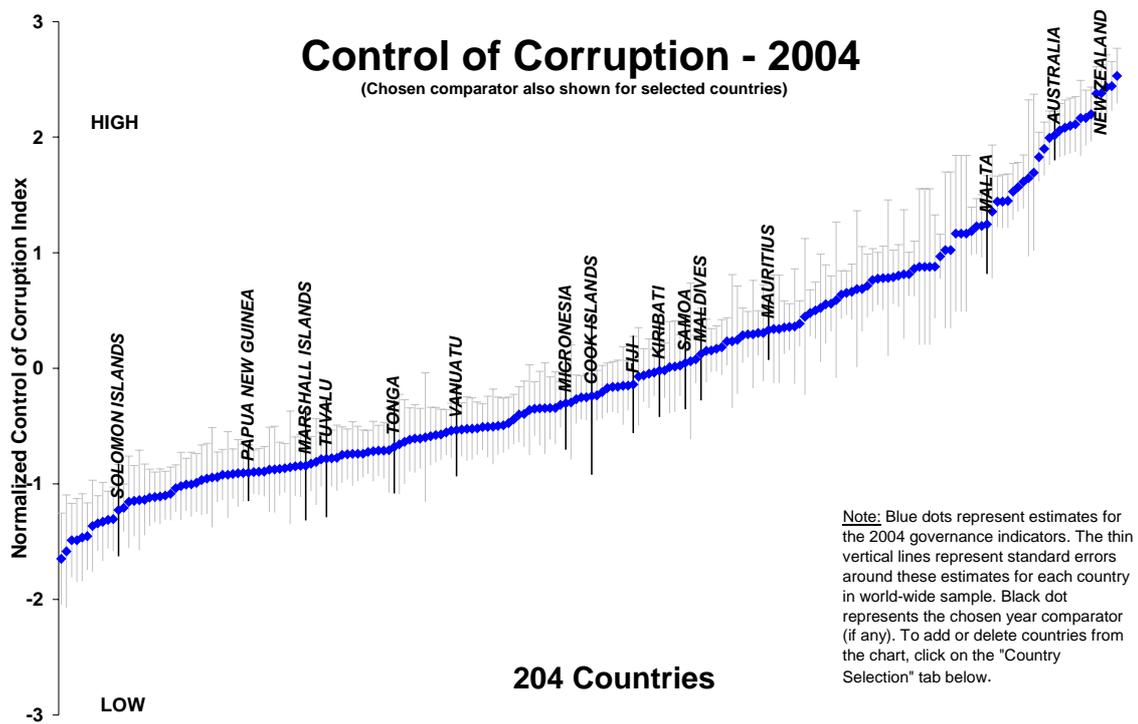
Figure 4:



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Figure 5:



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Table A1: Poverty levels within Pacific Developing Member Countries of the ADB

DMC	Population in Poverty (%) (National Poverty Line) ^a				Proportion of Population Below \$1 (PPP) a Day (%)	
	Total	Urban	Rural			
Cook Islands	...	...	...		...
Fiji Islands	25.5 ^g	27.6 ^g	22.4 ^g	(1990)	25.0	(1990)
Kiribati	51.0 ^h	...	...	(1996)	38.0	(1996)
Marshall Islands	...	...	...		20.0	(1999)
Micronesia, Fed. States of	27.9	...	...	(1998)	5.2	(1998)
Nauru	...	...	...		...
Palau	...	...	...		...
Papua New Guinea	37.5	16.1	41.3	(1996)	24.6	(1996)
Samoa	20.3 ^h	...	...	(2002)	5.5	(2002)
Solomon Islands	...	...	...		...
Tonga	22.7 ^h	...	...	(2001)	4.0	(2001)
Tuvalu	29.3 ^h	...	...	(1994)	17.2	(1994)
Vanuatu	...	...	...		26.0	(1998)

Source: Table 1. *Poverty, Inequality, and Human Development*, Asian Development Bank (ADB) - *Key Indicators 2005* (www.adb.org/statistics)