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Impact of rich country policies on the Pacific Island Countries

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Abstract

The Pacific Island Countries (PICs), isolated from the rich and/or larger countries, are not immune to shocks from their distant neighbours. Rather, their smallness with a heavy dependence on trade, aid, migration, and tourism has exacerbated their exposure to such shocks. This paper draws on the experiences of 19 Pacific island states to argue that their poor developmental record is as much the result of their own failings as the result of factors well beyond their control. Rich countries, consequently, have a role in facilitating development in the PICs. Such facilitation requires a lot better understanding of the impact of rich country policies on development in distant island nations.

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Introduction

The nineteen Pacific Island Countries (PICs),[1] strewn across the 180 million square kilometres of the Pacific Ocean and home to some 8 million people, face enormous developmental challenges given their poor economic performance over the past three decades. In the smaller atolls, sea level rise is depleting fresh water supplies and cultivable land while pollution from mining, logging, and industries in the larger islands is eroding the capital base of the state. Rising global tensions, particularly on the Korean peninsula, has raised the strategic value of military bases in the Pacific. This has already seen increased 'aid' flows to the trust territories of the US and may be a precursor to similar flows to the other island states. While the bulk of the resource transfers from the rich countries to the PICs is motivated by concerns for development, it is not clear if such transfers have delivered on intent. The achievement record on the non-altruistic goals of 'aid' such as securing access to military bases, gaining support from another sovereign nation in multilateral voting contests, and enabling access to resources of the PICs are a lot better.

Rich and often larger distant nations have maintained a continued interest in the PIC region for well over a century. This interest has been driven partly by the colonial past, rich resource (often marine) endowments, and more recently by strategic (military) considerations. The sprawling Pacific Ocean has provided the testing grounds for military hardware, including the nuclear tests by the US during the Second World War and more recently by France. Recent tensions on the Korean peninsula that saw a build

[1] Countries here is used in a loose sense since of those listed, two are French territories, three are part of the US trust territory

up of US military hardware on Guam prompted the US to secure long-term access (that is, to 2066) to military bases in the Marshall Islands. Of the nineteen countries listed in table 1, fourteen are members of the United Nations and carry full voting rights; the non-members include Cook Islands (a New Zealand protectorate), French Polynesia and New Caledonia (French territories), North Marianas, Wallis & Futuna, Niue, and Tokelau. The PICs have used their voting power in multilateral organisations such as the United Nations to secure aid from the richer nations in search of such votes.

Aid flows to the region are high relative to countries with similar per-capita income while the developmental record over the past three decades has been poor. The high per-capita GDP in the French states and those under US compact of free association are due to the large transfers from the super powers (see tables 1 and A1).[2] Social indicators for development vary considerably between the 19 countries; for example, life expectancy ranges from a high of 73 years in the French territories to a low of 59 years in Papua New Guinea. Annual growth in per capita income since 1970 ranges from 2.7 percent for Fiji, implying a doubling in per-capita income every 26 years, to –1.4 percent for Tuvalu with an average for the PICs as a whole for which data is available of 0.6 percent, a rate at which per-capita income will double every 115 years. While a few of the PICs, namely Samoa and Cook Islands, have registered an acceleration in growth of output over the past half a decade, the majority appear to be increasingly reliant on external assistance for their sustenance. Given the above, it is debatable as to whether aid has helped (or hindered) development.

[2] The compact allows the US free access to the islands and its surrounding waters for military and strategic purposes in return for ‘aid’; the aid for the FSM has amounted to around 50 percent of GDP.

Fiscal problems persist in nearly all of the Pacific Island Countries (PICs), but the severity of the problem in Nauru, Solomon Islands, and Papua New Guinea is such that it has compromised the ability of the state to deliver basic services such as primary education, health care, and personal security. The region has had a reputation for having "subsistence affluence", a term coined at the Australian National University[3] to reflect the minimal hours of work necessary to meet the dietary requirements of the family. While the average Pacific Islander probably works a lot fewer hours to feed her family than in other developing countries, diminishing access to traditional foods and rising income disparities are leading to pockets of food-poverty appearing in nearly all PICs. In several cases, lack of access to protein and thus a preponderance of starch in the diet have led to nutritional deficiencies. Children and mothers have been most at risk of such deficiencies even when hunger is not an issue.

Data on the PICs' economic performance is weak. Given the data deficiencies, the data used in the paper has to be taken as only indicative of broad trends. In terms of the macroeconomic aggregates, the worst performer has been the Solomon Islands as the economy contracted by a massive 25 percent in 2001; debt levels are estimated to have exceeded GDP. Public services have contracted to the urban centres and even here aid donors fund the bulk of the basic services. In early 2003 the public service was without electricity as power supplies were cut due to non-payment of arrears. The Treasury was

[3] Professor Fisk has been credited with creating this term.

closed for a week as the Accountant General and the Secretary had left because of pressure to make payments under duress.

Nature has also contributed to the PICs' troubles in the form of cyclones, earthquakes, floods and drought. But these natural calamities against which the people have very little recourse are the least of their worries (while often drawing the most international attention). Man-made disasters such as coups, violent conflicts, corruption, and crime have acted as major distractions from productive activity. Moreover, policies such as price controls, excessive restraints on the operation of the informal sector, and budgetary outlays far in excess of the revenue raising capacities of the state have all weighed heavily on growth of production. Where the population growth is also high, per-capita GDP has declined. In a comparison of the adverse growth effects of coups and cyclones in Fiji, Chand (2000) demonstrated the much more debilitating impacts of man-made catastrophes. Disturbingly, policymakers have had little success in averting the more damaging man-made disasters. Lack of discipline within the army and the police (i.e., the 'disciplinary') forces in Fiji, PNG, Solomon Islands, and Vanuatu has been a major source of political instability: some of their actions have been reported by international observers and the NGO community as amounting to "human right" violations.

A state of emergency was declared on Guadalcanal in June 1999 as the Solomon Islands descended into a vicious civil war between opposing paramilitary forces, the Malaita Eagle Force (MEF) and the Isatabu Freedom Movement (IFM). On 5 June 2000, MEF militants together with disaffected police officers took the Prime Minister, Bart Ulufa'alu, hostage. A week later the Prime Minister resigned, renewing the spiral of political uncertainty and social chaos. The government of Prime Minister, Manasseh Sogavare, was then voted into power as a replacement. A peace deal brokered by Australia in October 2000 officially ended the conflict. It provided for the decommissioning of weapons and a general amnesty for former combatants. The war may be over but the violence and economic paralysis continues. The international community, other than the lone Australian effort to broker a peace deal, has left Solomon Islands in the cold and to deal with its own misery.[4] Taiwan province of the Republic of China in 2001 provided a US$17 million loan to Solomon Islands, $13 million of which was used for compensation payments to the MEF; rather than quell the violence, this exacerbated the problem as other groups contested even more vigorously for their share of the 'gift' (see Chand, 2002a). A reconciliation ceremony involving exchange of gifts of shell money, a pig and baskets of food between the former supreme command of the Malaita Eagle Force (MEF) and members of the former Solomon Islands Alliance for Change (SIAC) took place in Honiara on 7 May 2003.[5] It is too early to judge if this will bring lasting respite from the violence of the past so as to allow the economy to recover from the decline that it has experienced in the past four years. In the meantime, the majority of the 447,000 inhabitants have retracted to traditional ways of life in the village while being deprived access to basic services.

[4] A politician from Solomon Islands informed the author that requests for assistance to the UN to resolve the conflict were refused because 'too few people had died in the conflict'.

[5] The size of the compensation has to be 'right' in that too large a compensation can be as counterproductive as no compensation. The correct value can only be determined via competition and in the absence of outside resources.

Papua New Guinea, the largest and in terms of resources the richest economy in the region, continues to stagger from one crisis to another. Several commentators have predicted yet another year of severe fiscal problems with international financial institutions led by the World Bank putting a hold on the issue of new loans, noting that lack of funds is not the source of the problems. The World Bank's Director for PNG and the Pacific, Mr Zhu Xian, is reported as stating that: "Better management of resources and a government bureaucracy free of corruption is the tonic needed to drag it [PNG] out of its parlous position".[6] It is widely acknowledged within government and in the donor community that corruption, tribal violence, and crime, – issues that fall squarely within the responsibility of the state - have been the major impediments to investment.

Depressing as the above stories are, for generations the ordinary village folk of the Pacific Islands have learned to live with the devastating impact of natural disasters, and have repeatedly proved their resilience to such adversities. For example, not a single person was killed by cyclone Zoe that hit Solomon Islands in 2002 with wind-speeds of up to 200 miles per hour; this was in sharp contrast to the assessments made by outsiders while contact was being restored with the people on the island. Will these same people that have withstood the worst of natural disasters prove equally resilient to man-made catastrophes? Perhaps not, given the overwhelming evidence showing stagnant per-capita income, rising unemployment and crime, and deteriorating access to basic services in several of the PICs.

[6] News report by the Pacific Island News Agency (PINA) of March 13, 2003.

Data in Table 2 show life expectancy in Cook Islands, Fiji, French Polynesia, New Caledonia, Samoa, Tonga, and Palau of around 70 years; these are high levels by developing country standards and particularly so relative to their per-capita incomes. Papua New Guinea, Solomon Islands, and Nauru, with average life expectancy of less than 60 years are in sharp contrast to the former group. Various hypotheses may be suggested to explain the difference in life expectancy between these two groups of countries. First, the high life-expectancy group have higher literacy rates and, on average, better access to primary healthcare – these at least partly being the result of access to better resources, particularly by the French territories and those under the compact of free association with the USA. Second, Cook Islands, Niue, Samoa, Tonga and, to a degree, Fiji (the Indo-Fijian community in particular) have been able to gain access to labour markets in neighbouring industrial countries (Australia, Canada, New Zealand, and the USA), strengthening incentives for investment in human capital.[7] Third, the ability of the people to 'vote with their feet' in the high-emigration countries provides some market discipline on governance in the emigrating nation.

The support provided by donors tends to be appropriated disproportionately by the urban elite (Hughes, 2003); the economic rents associated with aid have helped to maintain an over-valued (real) exchange rate, rewarded rent-seeking behaviour, and consequently biased production towards non-tradeables and the urban sector. These consequences of aid has led to one call for suspension of all Australian aid to the PICs as the first best policy, and for 'mutual obligation' (as the second best policy) as part of a pact to return to

[7] Duncan and Chand (2002) make this observation.

policies conducive to growth if the aid is to continue (Hughes, 2003). This latter suggestion is not new; indeed the bilateral treaty between Australia and Papua New Guinea of 2000 is in this very spirit. It may be a too early to pass full judgement on the success of the treaty but early signs are not promising. There obviously is a need to rethink how good policies and resuscitation of growth may be fostered from outside.

Public sector finances

The donor community has readily provided support in the event of past fiscal crises. This generosity may have prevented severe adjustment costs but also stalled much needed reforms. Past crisis in PNG and Vanuatu have been brought about due to imprudent fiscal policies, persistent deficits leading to high debts in particular. Macroeconomic stability in the PICs demands fiscal prudence. Given their smallness and with an open capital account (and often a fixed exchange rate), monetary policy has a minimal role in stabilisation. High interest rates, weakening currency and/or foreign reserves position, and rising inflation have been the direct consequence of budgetary outlays well beyond fiscal sustainability. Several PIC governments are in serious fiscal strife as revenues continue to fall short of expenditures and the rolling over of public debt is proving increasingly difficult. Vanuatu introduced a debit tax in 2003: it starts at a ten-cent levy on bank transactions of US$10. The tax is expected to raise approximately US$ 60,000 a year in revenue. The government argued that the tax was necessary to enable continued provision of basic public services, especially to the outer islands.

Nauru and Solomon Islands are by far in the most perilous state in terms of state finances. Once one of the richest nations in the world — thanks to its rich phosphate resources that are near depletion — Nauru has wasted its income to such an extent that it is now without sufficient funds to provide even the most basic public services. Life expectancy of 59 years is low, even lower than what the current purchasing power parity adjusted per-capita GDP of $5000 would suggest. There is a significant increase in life-style diseases and health indicators have shown little if any improvement. The government of Guam is seeking a $US200 million loan to fund government operations: this amount is to be raised through sale of government bonds. The PNG Treasurer is reported in the daily newspapers of 9 May 2003 to be short of cash with all hopes resting on a K140m (approximately $US35 million) loan from the Asian Development Bank and proceeds from sale of public assets.

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

In many cases, donors and international financial agencies have supported public investments, including those that have lowered the net worth of the state. Policymakers within the PICs should take some responsibility for such waste, but part of the blame should also rest with the sponsors of such projects; the latter all the more important when conditionalities and aid are used to support preferred ‘investments’. As an example, in 2002 a donor part funded some 100 steel road bridges in Papua New Guinea; one of these had to be installed some two hours walk from the nearest road with little if any use at all except for villagers to walk on. It would be extremely difficult to argue that such a ‘white elephant’ has improved the net worth of the state and that sufficient due diligence was carried out by the financiers of this ‘investment’. Curiously enough, this project occurred in an election year with the investments having circumvented the government’s prioritisation process for public investment projects.

I have argued in a separate paper (Chand, 2002b) that the recent rapid accumulation of debt in PNG is due to one or a combination of the following three factors. First, the debt blow-out is due to a lack of understanding of the impact of persistent deficits on interest rates and the penalty high interest rates impose on growth of output that in turn has led to a deficit-debt spiral. Second, the deficit bias is due to a common pool problem where each individual Member of Parliament ‘grabs’ the maximum possible from taxpayer funds (i.e., the ‘common pool’) for their narrow support base with a consequent ‘blowing-out’ of the deficit. Third, debts are purposefully pushed to the maximum possible by incumbent governments to constrain future governments from ‘wasteful’ expenditure: this being a ‘strategic argument for debt accumulation’. Running for elections in PNG is an expensive affair with costs, often shared by the *wantoks*[8], of anything between half a million Kina to two million Kina. Consequently, there is significant pressure on the candidate, should he succeed, to recoup returns commensurate with such ‘investments’ inclusive of the risk premium. The demands on the successful candidate to provide such returns to the financiers are seriously underestimated by outsiders and constitute the rationale for the ‘common pool’ problem. The above compounds the problem for the leader who has to protect the public purse whilst holding together his support base; this is no mean task as the many failed leaders demonstrate. The above is not unique to PNG but pervades to varying degrees throughout the PICs.[9]

It is evident that the macroeconomic conditions prevailing in the majority of the PICs are not conducive to investment and growth of private enterprise. The high (real) interest rates, the volatile exchange rates as in PNG, and high inflation can be linked to imprudent fiscal management. Insecure property rights, high crime in several of the PICs, and allegations of corruption amongst public officials all act as a drag on private sector growth. Each of the above problems signals failure in the provision of public goods. There has to be a clear understanding of the causes of these problems before remedial strategies can be devised. As an example, each of the individual causes of persistent deficits suggested above has its specific remedy. Donors have to be cognisant of the impact of their actions on the economy of small island states; sometimes their assistance can be counterproductive. There is a void in understanding of such effects.

[8] Wantok in Pidgin English stands for ‘one talk’ and denotes people who speak the same language or belong to the one clan.
[9] The Polynesian states are least prone to this problem due to their hereditary system of leadership.

Trade as a source of growth

It is clear from the deteriorating fiscal situation in several of the PICs that fiscal prudence will be a necessary, albeit not sufficient, condition for growth of output. The performance of public enterprises suggests that the impetus for economic growth has to come from the private sector. Given the narrow endowment base, the PICs have to access global markets to trade their narrow range of produce for a diversified consumption basket that their citizenry desire. Their isolation from the major markets, implying high transportation costs, favours industries with commensurately high returns. Consequently, high-value products such as mining and tourism have faired better than industries with minimal rents. Several of the latter group of industries are dependent on preferential access to industrialised country markets; further expansion of these sheltered/cushioned industries is at risk given the global push towards reductions in such preferences as part of liberalisation of world trade. The Fiji sugar sector is an obvious case in point. The price premium paid to sugar exported to the EU under the Cotonou Agreement comes up for review at the end by 2007 when it is anticipated that the premium will be slowly phased out. Similarly, labour-intensive manufacturing such as clothing in Fiji, wire harness in Samoa, and tuna canning in American Samoa, are heavily dependent on preferential trading arrangements for PIC exports into industrial country markets. These preferences, however, will erode as world trade is liberalised. The U.S. is not interested in negotiating a bilateral agreement with Fiji and has announced its intention to withdraw the current quota system for clothing exports from 2005 to comply with World Trade Organization rules.

The performance of primary commodities such as cocoa, coffee, copra, oil palm and minerals hinges in large part on movements in international prices; an issue well beyond the purview of domestic policy makers. However, the general investor climate in terms of the competitiveness of domestic interest rates, the real exchange rate, and access to land and competitively priced transportation infrastructure can be influenced by policy. The abolition of commodity marketing boards, which have invariably proved to be a drain on the public purse, is long overdue such that market based instruments could be used to mitigate price volatilities. Long-term, secure access to land is proving to be a particularly difficult issue for several agricultural commodities, as well as for mining and the construction of transport and telecommunications infrastructure. Eviction of tenants from sugarcane farms in Fiji and oil palm plantations in West New Britain in PNG is already adversely affecting production.

There are, however, a few promising starts. PNG palm oil output has defied trends in other primary products by continuing to show solid growth. The first palm oil refinery in Kimbe, West New Britain (PNG) commenced shipments to Europe in February 2003. To date, the industry has managed to overcome problems of transportation, access to competitively priced credit, and crime but is now facing fresh challenges in accessing communal land for expansion of the crop. The Oil Palm Industry Corporation (OPIC) imposes a levy to expand the road network around the mills to facilitate smallholder participation around the nucleus estates. These estates were first established to ensure the minimal throughput for the mills. OPIC pays for materials used for road construction but does not pay compensation for land acquired for the road construction. Their rationale for such a stance is simple. OPIC claims that a community demanding compensation for land used for the construction of their own road does not need the road enough and that there is always another community willing to offer their land for the proposed road without compensation.[10] Such a scheme not only saves costs but also ensures protection and maintenance of the asset. The millers provide credit to the farmer with proceeds from the crop used as collateral. This is a model worthy of detailed analysis with a view to replication in other crops and areas.[11]

Driven by a surge in demand from industrialised countries, kava was a promising growth industry with Fiji, Samoa, Tonga, and Vanuatu being the major beneficiaries. Investment in the industry was brought to an abrupt halt in late 2001 as restrictions were placed on sale of kava-based products in Europe and the USA. The ban followed preliminary research suggesting liver damage from consuming kava or kava-based products. The UK asked for a voluntary restraint on sales of kava-based products while Australia issued a health warning against consumption of kava-extracts. The PICs have recourse via the WTO to see that the restrictions are based on objectively assessed evidence and in conformity with international food safety standards. Article 5, clause 7 of the Sanitary and Phytosanitary (SPS) Agreement states that:

> "In cases where relevant scientific evidence is insufficient, a member may provisionally adopt sanitary or phytosanitary measures on the basis of available pertinent information, including that from relevant international organisations or

[10] Compensation for roads leading to a mine is a rational means of extracting mineral rents by communities distant from the mine but such a demand for industries with minimal rents constrains growth of production.

[11] Cocoa and Vanilla production, particularly in East Sepik, has shown rapid growth over the recent past and could benefit from the lessons from oil palm.

> phytosanitary measures applied by other members. In such circumstances, Members shall seek to obtain the additional information necessary for a more objective assessment of risk and review the sanitary or phytosanitary measure accordingly within a reasonable period of time."

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

The tuna resources of the Western and Central Pacific (WCP) are the world's largest and most valuable fisheries of their type and are of significant economic importance to the PICs. Distant water fishing nations, namely Japan, Taiwan, and the USA fish these waters. The PICs to date have earned access fee of 3 percent of gross revenues from the catch; this compares with a range of 18 to 45 percent paid by the European Union to African countries as access fee to their fisheries. There is, however, an even more urgent issue of ensuring long-term sustainability of the resource as some of the species such as the big-eye are being over-exploited. The Multilateral High Level Convention (MHLC) on the Conservation and Management of Highly Migratory Fish Stocks in the Western and Central Pacific Ocean (MHLC 2000) was signed in 2000 by coastal and distant water fishing nations (except Japan) to induce cooperation between the stakeholders so as to conserve fish stocks. The proposed WCP Tuna Commission is due to be established by 2004 to realise the goals of the MHLC 2000 (see Chand, Grafton, and Petersen, 2003 for details on the above).

Tourism has held the hopes of most of the PICs: a well-justified hope given the natural beauty of the region and the hospitality of its people. The US-terrorist attacks of 2001 and those of Bali of 2002, the Afghanistan and Iraq wars, and SARS (severe acute respiratory syndrome) as of April/May 2003 have seriously damaged prospects for a quick rebound in tourist flows to the region. Tourist arrivals to Tahiti in the first quarter of 2003 fell as tensions grew between North Korea and the US. The 2000-coups in Fiji and Solomon Islands and the revolt by the mobile force in Vanuatu and the army in PNG in 2002 have all adversely affected the regional tourism industry. Tourists, particularly those from the US and Europe, often see the PICs as a single region and hence problems in any one PIC are often associated with the entire region. Profit margins are being sacrificed with promotional fares to keep the number of arrivals up while long-term investments are being kept on hold. Again, ripples from increased global tensions continue to buffet one of the growth sectors in the PICs.

The transition to freer trade could be better managed by the PICs if their domestic markets, including those for capital, labour, and other inputs, could be simultaneously liberalised. Political and macroeconomic stability will also assist in lowering the costs of doing business, thereby enhancing competitiveness of surviving domestic industries. Given their size, the costs of the PICs engaging in negotiated access to markets in the rich countries are high if not prohibitive. As such, rich countries could lower barriers to trade to small island states unilaterally.

Aid to the region

Official aid to some of the Pacific Island economies, measured in terms of the aid to GDP ratio, is among the highest in the world (e.g., recent figures are Federated States of Micronesia 36%, Kiribati 47%, Marshall Islands 38%, Tonga 23%, Samoa 28%). These percentages are much higher than for most Sub-Saharan African countries where the per capita GDP is much lower than in the Pacific. The comparatively large per capita aid levels may reflect the small populations in the Pacific countries, as aid delivery is ultimately subject to economies of size. The motivations for aid include: (i) humanitarian, such as in the wake of natural disasters; (ii) strategic, including maintaining goodwill by current and former colonial powers; and (iii) commercial. Alesina and Dollar (2000) show that the direction of foreign aid globally is dictated as much by political and strategic considerations as by the economic needs and policy performance of the recipients. They argue that past colonial and political alliances are major determinants of foreign aid. The PICs are no exception to this generalisation. The weighting towards strategic motivations for aid to the PICs has been on the ebb since the end of the Cold War but increased global tensions in the recent past may see a resurgence of aid to secure long-term access to military bases within the Pacific Ocean.[12]

France has been by far the largest donor to the Pacific, followed by Australia, the US, Japan, New Zealand, and the European Union in that order. France has historically given the bulk of its $US750 million of annual aid to its existing and former colonies. Half of

[12] In May 2003, the government of Marshall Islands and U.S. State Department agreed to an amended Compact of Free Association worth $US3.1 billion. This includes funding for grants and a trust fund of more than $800 million, and a pact for the extension of the use of the Kwajalein missile testing range through to 2066, valued at about $2.3 billion.

the $US232 million annual Australian aid to the PICs goes to PNG while the bulk of the $US161 million of annual US aid is destined for the former and current trust territories. Japan, New Zealand, and the European Union have annual aid-budgets of $US145million, $US75million, and $US45 million, respectively, devoted to the PICs.[13]

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

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

[13] The figures quoted here are drawn from those reported in Hughes(2003).

In contrast to the long-held belief that the acquisition of capital was the key to development, globally, aid is now much more concerned with "improving governance", with the "environmental sustainability" of projects and economic growth more generally, "effective policies", "institution building", and "poverty alleviation". Most recently, there has been a realisation that benefits from a surge in economic growth need not necessarily be inclusive, in the sense that all in society experience improved living standards.[14] Therefore, development agencies are now focused on how to make sure that the poorer segments of society contribute to and share in any economic growth. Aid delivery in the Pacific has followed these changes in development thinking, with an emphasis on education and health, on "good policies", on "environmental sustainability", and more recently on "good governance", "capacity building", "ownership" of reforms and "participation" in design and delivery of projects, and the development of "market-friendly" institutions. The fungiblity of money, however, implies that funds provided as aid can be used to fund activities other than those for which they were intended (Bauer, 1966). Donor agencies are more than ever walking a tight rope in ensuring that funds provided are used as intended while not 'interfering with the domestic affairs' of the recipient nation.

In some of the Pacific countries, aid delivery during an impending crisis is largely managed within the context of a coordinated operation between the multilateral agencies and some bilateral donors. These "structural adjustment programs" combine short-term stabilisation loans with long-term loans and grants assisting in capacity building, policy reform, public service reform, and infrastructure development. These programs have an implicit prioritisation and sequencing of measures: these are drawn from an understanding of the important ingredients for development. There is an urgent need to gauge the success of these reforms; preliminary evidence on reform success in Papua New Guinea and Vanuatu are less than favourable. Donors as much as domestic policymakers should share the blame for past failures and more importantly, draw lessons for future reforms.[15]

The strategic motivation for aid to the PICs is making a strong comeback following its decline in importance in the aftermath of the Cold War. The '*Pacific Solution*', where Australia sent its refugees arriving by sea to Nauru and Manus in Papua New Guinea, signalled a new era in the use of Australian aid to secure short-term places for the detainees. Nauru, a cash strapped nation, was pledged A$14 million in additional aid for holding around 600 Australian asylum seekers.[16] In 2002, China provided 'unconditional' budget support to Fiji of US$3.5 million but with an expression of interest in the commercial harvesting of Fiji's large mahogany plantations. Fiji's Prime Minister, who had secured the aid on his visit to China, also extended an invitation to China to the South Pacific Forum leaders' meeting in Fiji as an observer. Similarly, Taiwan has on several occasions extended budgetary support to cash-strapped island governments: the most recent instance was the provision of funds to Vanuatu to fund copra price support arrangements prior to the 2002-elections. The tensions on the Korean

[14] Should growth be rapid and sustained, then the benefits must over time pervade across society.
[15] The author is engaged in assessing the success of the structural adjustment program for Vanuatu initiated in 1997 and funded with an Asian Development Bank loan.

Peninsula leading to a build-up of US military hardware on Guam has led the US to commit to increased spending on such bases in the Pacific. Much of the above are payments for services purchased by rich countries but couched as 'aid'. Some transparency in such exchanges between the PICs and the rich countries could foster better decision-making and improve governance.

Migration

There is significant potential for gainful trade via deeper integration of labour markets of the PICs with neighbouring industrial countries. Approximately two-fifths of the population in the PICs is below 15 years of age, guaranteeing that the present population growth momentum will be sustained for a decade and half at least.[17] The entry of large numbers of workers into the workforce in a climate of low growth of employment opportunities and downwards wage rigidity will lead to a growing pool of under- and unemployed people. Wage inflexibility is due to labor market imperfections including minimum wage legislation (often imported from abroad) and a high reservation wage due to the high levels of subsistence production. Wage inflexibility has to be removed and regulations restricting the operation of the informal sector relaxed if unemployment is to be contained. As an illustration, in Marshall Islands between 600 and 1,000 young people enter the job market each year while formal sector employment has remained static at 10,000 for the past ten years. This example is not an exception but a common

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[16] This policy gave Australia a lot of adverse international publicity that may have actually helped its cause by averting greater flows of refugees due to the 'free publicity'.

[17] For example, the rate of population growth in Solomon Islands is 3.9 per cent (see Table 1). By comparison the average for countries that are members of the ADB is 1.3 percent per annum.

phenomenon in the PICs. Those countries not seeing increased under- and unemployment are those where emigration to industrial countries is reasonably easy.

Employment in the importable sector, often the manufacturing sector, has been protected at the prevailing wage via high tariffs and rents from preferential trading agreements. State owned enterprises (SOEs) provide much of the employment for the more highly skilled and educated. The exercise of market power by governments in raising employment and wage conditions can be counter-productive, given that these actions crowd-out private employment and raise expectations about the responsibilities of the state.[18] The prevailing weak fiscal position of the state implies that such a strategy cannot be sustained. The prices of services of both the government and SOE sectors have been raised through protection of markets so as to minimize losses; these policies, however, raise the costs of doing business in several of the PICs.

PIC governments have embarked upon various initiatives to increase employment opportunities. Fiji has been sending soldiers on peacekeeping missions to the Middle East since the early 1980s as a means of providing employment for the growing pool of school leavers.[19] Kiribati, Tuvalu, and Vanuatu have actively supported — via providing training at home — employment of their nationals as seamen on foreign ships. Nauru and Vanuatu have sponsored onshore international financial centers (IFCs) via tax concessions in the hope of creating jobs but now have created strong lobby groups

[18] Demekas and Kontolemis (1999) use evidence from Greece to show that levels of public sector remuneration and employment have a deleterious impact on aggregate labour market performance and that government employment is not an effective counter-cyclical instrument.
[19] All of the three coups in Fiji were manned by these international 'peace keepers'.

against withdrawal of such concessions. These initiatives, moreover, have had minimal impact on the pool of unemployed and are unlikely to be a sustainable source of employment opportunities.

Demand for jobs varies considerably between the PICs. Emigration of workers from Palau, Samoa, and Tonga has acted as an escape valve for qualified workers in search of better employment opportunities abroad. These same opportunities have induced investment in skills acquisition. The same forces are seen to be in play in Fiji where, to facilitate emigration, the Indo-Fijian population is investing more in education than the indigenous population—the difference being most apparent following the two coups of 1987.[20] On a cross-country basis, literacy rates in Palau, Samoa, and Tonga, where emigration is relatively easy, are high compared to the Solomon Islands and Vanuatu where emigration to high-income countries is low.[21]

In the short to medium term, emigration can reduce the adverse effects of demand shocks. However, the sustained loss of skills through migration can reduce employment opportunities for the unskilled, given the complementarity between skilled and unskilled labor. To the extent that reforms necessary for growth in the PICs result in labour displacement from the protected sectors, temporary relief through access to jobs abroad may assist in the adjustment process. As an example, Cook Islands was able to complete its reforms, which involved severe cuts in the civil service, because many of the displaced

[20] The economic factors underlying migration from the PICs have always been present but the recent surge in migration of Indo-Fijians can be attributed to 'push' factors.

workers were able to move to New Zealand. Access to such employment opportunities is all the more important in the absence of social security benefits at home and when those with formal sector employment are the source of such transfers at the level of the family and/or clan.

Some Policy Implications

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

[21] While higher education facilitates emigration from the PICs to Australia and New Zealand, the availability of such an option (for whatever reason) provides the incentives for greater investment in education.

The PICs have open capital accounts with a large proportion of their investment being funded from foreign savings, made up of official aid, foreign debt, and foreign direct investment (FDI). While foreign aid flows respond to political variables, Alesina and Dollar (2000) show that foreign direct investment is more sensitive to economic incentives, particularly "good policies" and protection of property rights in the receiving countries. The bias of capital inflows in favour of aid (and, to a degree, debt) to PICs suggests that the incentives for FDI may be lacking. If the growth effects of FDI are considerably higher than from other forms of capital inflow, as Yano and Nugent (1999) suggest, then policy makers may want to improve incentives for FDI so as to accelerate growth.[22]

Providing employment opportunities for the growing labour force is likely to remain the largest economic and social challenge for the foreseeable future. The public sector cannot be relied upon to perform this role; foreign employment may provide respite for those with privileged access to industrial country labour markets. Thus the employment opportunities have to come from within the countries. Short-term access to foreign labour markets may reduce the pains of labour-displacing reforms, but even without such mitigating circumstances the reforms will have to be undertaken.

There is ample evidence of PIC-government failure in managing development: these comprise many errors of commission as well as several of omission. Those of commission include government involvement in commerce via high-cost and often loss-

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

making, state owned enterprises (SOEs) that have drained resources away from funding of basic services. Examples include the creation of development banks, national airlines, government owned hotels (in Cook Islands and Nauru), and the many commodity-marketing boards. Each of these enterprises has added to the costs of inputs while being sheltered from competition through regulatory protection. Failures of omission include the failure to fund basic services, including law and order, education and health, and public infrastructure. Governments have often got the balance wrong, undertaking activities that the private sector would otherwise have picked up while failing to provide those public goods that are the primary responsibility of government.

Conclusion

PICs are small countries, isolated from the major markets, which increases the costs of trade, and are prone to natural disasters. They also have a benign climate, rich natural resources, and an English- and/or French-speaking population favourably disposed to visitors. The people of the PICs have adapted exceptionally well to the natural adversities, but are being increasingly troubled by the lack of opportunities for growth. The PICs are not unique, as there are many other small nations that have proved just as resilient to adversity whilst taking full advantage of their strengths to accelerate the pace of development. The developmental record of most of the PICs has generally been poor in recent decades, whereas, other small isolated island economies such as the Bahamas, Malta, and Mauritius have demonstrated that the handicaps of size and isolation are surmountable barriers to economic growth and development.

This paper has argued that the policy environment in the PICs has generally not been conducive to growth of production. Extensive regulatory controls on prices, exchange rates, the operation of the informal sector, etc., have impeded private investment and employment creation. This in turn has exacerbated social problems Government involvement in private commerce has crowded out private enterprise while drawing resources away from the provision of public services, which is so necessary for growth of private enterprise. Poor property rights to land, insecurity of debt contracts, unsustainable budget deficits, and political and policy instability have all raised the risk premium on investment, resulting in high grading of investment opportunities. The above are issues that the PICs themselves will have to address.

Where there is high population growth in a climate of subdued economic activity, per capita income has either stagnated or been falling. Consequently, the pool of unemployed has been rising, with ramifications for social problems. Employment opportunities sufficient to absorb all those in search of work will develop only if the necessary reforms are undertaken to make the economies grow rapidly. Weak and family/clan based social safety nets imply that reforms entailing major displacement of formal sector workforce are going to be politically difficult. Temporary access to labour markets in industrial countries where there is the will to carry out the necessary reforms may be an option worthy of further thought.[23] This may be attractive to the bilateral donors if the alternative is to continue to provide aid at present or increasing levels. Such action would also be consistent with liberalisation of factor and product markets

[23] Under the amended Compact of Free Association with the United States, Marshall Islanders now have the right to enter the U.S. without visas or "employment authorization documents" to work and live there.

(amounting to deep integration) to enable the real sector to adjust to shocks whilst rewarding policy-making in the interest of the wider community.

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

The PICs being isolated from the rest of the world has not shielded them from actions of rich countries; to the contrary, their size has made the PICs all the more vulnerable to sea level rise, trade, migration, and large aid flows. The rich countries, therefore, have a critical role to play in supporting the PICs improve the wellbeing of their people. This can be done via several means including the following four: (i) via deeper integration with the PICs, particularly through freeing up of labour mobility; (ii) through having a clearer understanding of the impact of their policies on growth of production in the PICs; (iii) by taking up the some of the responsibility for failed investments funded with aid and/or debt; and, (iv) by allowing greater transparency in payments made for services purchased from the PICs rather than classifying these as aid. The above is a beginning on the thinking required to ensure coherence between rich country policies with the developmental aspirations of small island nations in the Pacific.

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Table 1: Basic Indicators for Pacific Island Countries (PICs)

	Land area Km^2	Population '000s 2000	Density people/Km^2 2000	Annual growth % 1970-2000 Population	Annual growth % 1970-2000 Real GNP per capita	GNP per capita $ purchasing power parity [8] 2000
Papua New Guinea	463,000	5,200	11	3.7	0.3[4]	2,180
Fiji	18,272	812	44	1.9	2.7[5]	4,480
Solomon Islands	28,530	447	16	3.9	-0.4[6]	1,710
French Polynesia	3,265	235	72	3.7	(NA)	23,340
New Caledonia	19,103	213	11	3.2	(NA)	21,820
Vanuatu	11880	197	17	4.6	-0.3[7]	2,960
Samoa	2,935	170	58	0.6	0.8[7]	5,050
Micronesia Fed. States	702	118	6	3.3[1]	(NA)	2,000
Tonga	699	100	143	0.5	2.6	1,660
Kiribati	690	91	132	2.8	-1.2	950
North Marianas	477	70	68	(NA)	(NA)	12,857
Marshall Islands	181	50	36	2.9[2]	(NA)	1,600
Cook Islands	240	21	88	0.0[2]	(NA)	5,000
Palau	458	20	23	(NA)	(NA)	9,000
Wallis & Futuna	274	20	14	(NA)	(NA)	2,000
Nauru	21	12	571	NA)	(NA)	5,000
Tuvalu	26	11	423	1.6[3]	-1.4[6]	1,100
Niue	259	2	8	(NA)	(NA)	3,800
Tokelau	10	1	100	(NA)	(NA)	1,500
Pacific average				3.4	0.6	

Notes: (NA) data not available or vary by more than 25 per cent among sources.
[1] 1980-2000; [2] 1981-2000; [3] 1983-2000; [4] 1973-2000; [5] 1968-2000; [6] 1967-2000; [7] 1979-2000
[8] Purchasing power parity for the Pacific is not derived directly but from econometric estimates based on 'like' countries; it is only applicable to urban, not to subsistence rural areas. The high purchasing parity per capita incomes for French Polynesia and New Caledonia reflect the high salaries of the French 'metros' employed in the public service.
Source: Hughes, 2003; Table 2.

Table 2: Social indicators of development for the PICs

	Life expectancy 1970	Life expectancy 2000	Fertility rates births per woman 1970	Fertility rates births per woman 2000	Infant mortality per 1000 live births 2000	Maternal mortality per 100,000 live births 1996-2000
Papua New Guinea	47	59	6.1	4.4	56	370
Fiji	64	69	4.1	2.8	18	(NA)
Solomon Islands	40	(NA)	7.0	5.4	22	(NA)
French Polynesia	(NA)	73	5.6	2.6	10	(NA)
New Caledonia	61	73	4.3	2.6	7	(NA)
Vanuatu	40	(NA)	6.5	4.4	35	68
Samoa	61	69	6.7	4.3	21	30
Micronesia Fed.States	(NA)	68	5.0[1]	3.7	26	274
Tonga	(NA)	71	6.5	3.6	17	81
Kiribati	(NA)	62	4.3[2]	3.9	52	56
N. Marianas	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)
Marshall Islands	(NA)	65	(NA)	(NA)	(NA)	(NA)
Cook Islands	(NA)	71	(NA)	3.3	20	20
Palau	(NA)	70	(NA)	(NA)	(NA)	(NA)
Wallis & Futuna	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)
Nauru	(NA)	59	(NA)	4.6	25	(NA)
Tuvalu	(NA)	64	(NA)	2.8	38	(NA)
Niue	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)
Tokelau	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)
Australia	71	79	2.9	1.8	5	6

Notes: (NA) data not available or varies by more than 25 per cent among sources. Estimates for medium sized populations necessarily fluctuate from year to year and for very small populations would be meaningless.
[1] 1987; [2] 1973
Source: Hughes, 2003; Table 3.

Table 3: Appropriation of resources by the public sector in PICs

Country	Government expenditurea (% of GDP)	Employment (% of total paid employees)	Debt Financing (% of domestic credit)
Fiji	19.	19	54
FSM	90	69	
Kiribati	101	29	
Marshall Islands	98	46	
Palau	NA	NA	
Samoa	28	10	
Solomon Islands	53	33	
Tonga	43	41	
Vanuatu	39	33	58

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

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

	Total flows since 1970 US 1998 million dollars	Average annual aid flow per capita since 1970 US dollars
Papua New Guinea	15,592	104
Fiji	1,576	65
Solomon Islands	1,477	110
French Polynesia	8,533	1,210
New Caledonia	8,708	1,363
Vanuatu	1,285	217
Samoa	1086	213
Tonga	698	233
Kiribati	593	217
North Marianas	-2	0
Marshall Islands	362	232
Cook Islands	407	646
Palau	532	933
Wallis & Futuna	274	457
Micronesia Fed. States	630	178
Nauru	18	51
Tuvalu	214	647
Niue	182	3,558
Tokelau	91	3,026
Pacific Islands (trust Tr.)	5,193	
Oceania Unallocated	1,449	
Total	49,258	220

Source: Hughes, 2003; Table 5