Discussion Note: Pacific Futures*

DISCUSSION DRAFT: COMMENTS APPRECIATED

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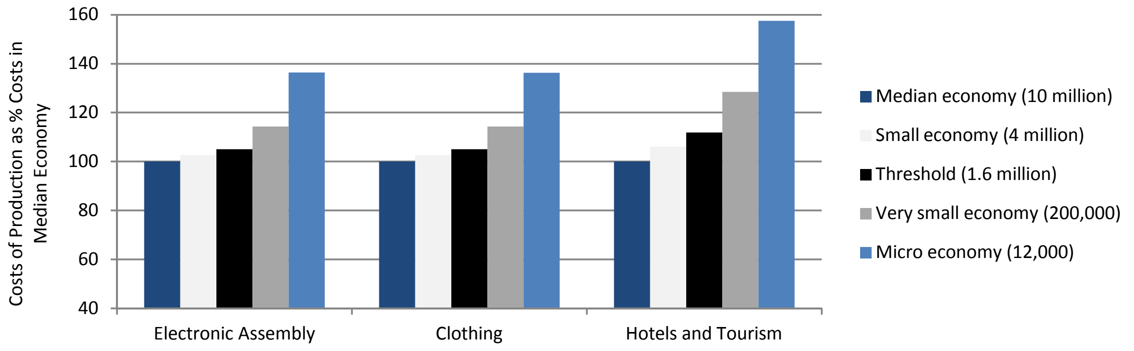
Executive Summary

- This note provides an economic geography perspective on economic policy issues for Pacific Island Countries, to inform ongoing discussions about the appropriate direction of reforms.
- Globally, growth in most countries has been accompanied by a move from agricultural production towards exporting manufactured goods and services or both.
- Geographical factors constrain the extent to which PICs are likely to be able to follow this path: the economic costs of smallness and distance undermine export competitiveness in production of commonly traded manufactured goods and services.
- PICs can mitigate some of the costs of smallness and distance by pursuing labor market integration, ensuring good telecommunications and transport policies, ensuring alignment and harmonization in regulatory regimes, and sharing the burden of certain public services across the region and with nearby large markets.
- But even these measures are unlikely to allow broad-based, export-led growth of the kind seen in most fast-growing economies.
- PICs and donors may therefore wish to consider also prioritizing 1) management and growth of natural resource industries (including tourism) which are less subject to geographical disadvantages, and 2) mainstreaming aid and maximizing the benefits of international assistance.
- International assistance both financial and sustained technical capacity, will need to play a key role in supporting shared regional institutions, delivering public services, and financing imports, over the medium to long-term. Delivery of aid, and approaches to evaluating its impact, could be altered to better reflect its likely long-term role in supporting social outcomes and the expansion of opportunities for Pacific Islanders working at home and internationally.

'Pacific Futures' provides a framework for considering recent performance and future prospects for economic development in Pacific Island countries. Despite improving social outcomes, slow rates of economic growth in Pacific Island Countries have remained a source of consternation to donors and governments. By emphasizing the importance of geographical factors in shaping economic outcomes, we hope to foster new debate regarding the appropriate path for economic policy reform in Pacific Island Countries. We do not present new research or detailed policy recommendations, but rather apply an economic geography framework to identify a coherent set of potential economic policy priorities for Pacific Island Countries. Given the diversity of the Pacific region, the applicability of this framework will vary across countries, and has been developed primarily with smaller Pacific Island Countries in mind. Many of the ideas for increased regional economic integration presented here have been heard before. But we hope to spark further progress towards implementing some of these ideas by showing how important economic geography is to the economic development prospects in the Pacific, and how important regional integration will be to achieving progress within these geographical constraints.

Small size and long distances to major markets have a determining impact on economic development in the Pacific. Small economies face special disadvantages. With limited domestic markets, it is difficult for the private sector to achieve economies of scale and specialization, and firms lack access to new knowledge and cheaper inputs available in larger markets. Typically, small economies have overcome obstacles of small size by trading extensively with larger economies, allowing access to larger markets, new ideas, and cheaper imports. Pacific Island Countries are small, but also distant to major markets. It is difficult for firms in Pacific Island Countries to overcome the costs of smallness by trading internationally, because the costs of accessing foreign markets (in terms of transport, communication, and compliance costs associated with operating across multiple jurisdictions) are high. Small economies also face disadvantages in the provision of public services and infrastructure, due to inability to realize economies of scale and the fixed costs of administration and service delivery having to be borne by a small number of taxpayers. Small countries, with small domestic labor markets, also tend to face more serious capacity constraints, further impeding the functioning of the public sector. Cumulative costs of smallness to various export industries are presented in Figure 1. When disadvantages of smallness and isolation are taken into account, research suggests that PICs have actually grown more quickly than might be expected.[1]

Figure 1: Costs of Production by Sector and Country Size
Source: Winters and Martin (2004)



This has important implications for economic development strategies in the Pacific, including for private sector development. Internationally, economic development strategies tend to emphasize providing the broad suite of institutions, public services, and infrastructure that support fluid factor markets, economic diversification, and the emergence of globally competitive export firms. This reflects the global experience of development, whereby countries have achieved growth through economic diversification and the movement from agricultural production to manufacturing and services. Such economic development strategies are unlikely to be effective in Pacific Island Countries for two key reasons. Firstly, due to the costs imposed on businesses by small size and distance from markets, business-enabling environment measures are unlikely to be enough to ensure global competitiveness in manufacturing and services. Secondly, implementing the full range of policy and regulatory reforms necessary to establish a globally competitive business enabling environment is likely to be beyond the reach of most Pacific Island Countries, given their small size, constrained fiscal resources, and inevitably limited capacity in certain areas. A key implication of this is that limited reform capacity should be tightly focused on reducing the disadvantages imposed by geography and on opportunities that are less impacted by geographical disadvantages.

Applying this framework suggests that the best prospects for economic development of Pacific Island Countries might lie in four areas:

First, pursuing integration to reduce the economic costs of distance. The best way to overcome disadvantages of smallness is through integration with larger economies, which provides access to larger markets, skills, ideas, cheaper imported products, and investment. Within the limits imposed by

[1] See Gibson, J. (2006) "Are the Pacific Island Economies Growth Failures?" Working Paper #3, Pasifika Interactions Project. http://ips.ac.nz/events/completed-activities/Pasifika%20project/Pasifika%20WP3.pdf

geography, greater progress could be achieved towards facilitating the flow of goods, services, finance, and ideas between Pacific Island Countries, and with nearby large markets. Key priorities in this area include:

a. **Increased labor market integration.** Progress could be achieved in removing barriers to increased flows of short and eventually, longer-term or permanent migrant workers to large markets. At the same time, removing unnecessary barriers to skilled individuals moving to and between Pacific Island Countries could provide benefits to the public and private sectors. Within Pacific Island Countries, progress is needed to ensure that investment in human capital continues to ensure that Pacific Island workers are healthy and well-educated, and can contribute strongly within nearby large economies as well as at home. Institutions with responsibility for negotiating international labor arrangements and supporting participation of workers in regional or global schemes also need to be strengthened in Pacific Island Countries.
b. **Better transport and communication links, with the private sector playing a key role.** Good transport and communication systems can mitigate the costs of distance and allow closer integration with nearby large markets. Improving the policy and regulatory settings in transport and communication infrastructure is therefore a key element of integration.
c. **Aligning and harmonizing regulatory frameworks and services.** Costs of distance also arise when different jurisdictions have different regulatory regimes or standards. To reduce these costs, regulatory rules and standards between PICs, and between PICs and nearby large markets, could be harmonized or aligned in certain areas. Options could include the adoption of aligned education criteria, customs and immigration rules and regulations, or even tax regulations which allow investment capital to move without changing jurisdictions.

Second, integration to reduce the costs of providing public services. Pooling the provision of services across small Pacific Island countries addresses problems of cost and capacity simultaneously. It allows various institutions or facilities to service a larger number of people, therefore reducing the fixed cost per person served. It also creates opportunities for the pooling of capacity, with specialists from various fields able to come together to achieve critical mass. Options underway or with potential for consideration include shared telecommunications and competition regulation, specialist financial management capacities (such as audit and tax assessment), and certain specialized health and education facilities. In some cases, more effective regional integration may arise from negotiating the expansion of larger-country institutions to cover PIC economies.

Third, maximizing gains from natural resource industries (including tourism). In the absence of vibrant manufacturing and export service sectors, Pacific Island Countries will continue to rely on natural resource industries – such as mining, fisheries, tourism, and logging – to a greater extent than countries with a broader range of export options. Due to the geographically fixed nature of natural resource wealth, investment can be attracted to natural resource industries despite higher costs in Pacific Island Countries. It is vital for both donors and Pacific Island Country governments to acknowledge the ongoing importance of these alternative sources of income, and prioritize reform capacity and effort towards maximizing these opportunities. Ensuring good outcomes from ongoing investment in natural resource industries is a major challenge. Countries across the world struggle to ensure that natural resource industries are well-governed, deliver economic benefits, and do not impose unacceptable social or environmental costs. Extensive policy and regulatory reform, and institutional strengthening is required to ensure good outcomes in Pacific Island countries, and international assistance will be required for much of this work. A key immediate priority is to progress regional cooperation to leverage maximum benefits from exploitation of Pacific fish stocks through the strengthening of regional fora.

Fourth, recognizing the long-term role of aid and maximizing the benefits from international assistance. Aid is likely to remain a key source of foreign exchange for many Pacific Island economies, and international technical capacity is likely to continue to be required to support various government functions over the long-term. International financing and capacity are likely to be required to provide sustainable support for the establishment and operations of shared regional institutions, improvements in telecommunications and transport links, and regulation of natural resource industries.

With international assistance continuing to play an integral role, it is important to consider how current aid engagements could be broadened and deepened to better reflect their medium- to long-term nature. Frequently discussed policy options for increasing the benefits of aid include:

- Increasing the use of country systems and budget-support modalities
- Increasing the role of the private sector in delivering aid-financed goods and services
- Recognizing the need for sustained capacity support, rather than short-term capacity building, in contexts where key capacity gaps are unlikely to be filled domestically over the medium-term.

A further challenge is to ensure that available climate change adaptation financing is readily accessible by Pacific Island Countries, and that available funds are used in ways that strengthen country systems and support the achievement of countries' overall development objectives.

There may also be scope for an explicit reconsideration of the objectives of aid in PICs and the benchmarks by which its success is measured. GDP growth has received high attention for assessing the impacts of aid. However, the combined effects of geography and size potentially limit the rates of growth that can be achieved by the PICs on a sustainable basis. Increased consumption of imports resulting from remittance flows to households has little impact on GDP figures but a large impact on welfare. Conversely, unsustainable and poorly regulated extraction of natural resource stocks can boost GDP while providing few benefits to citizens. Outcomes in health, education and employment, and the breadth of opportunities available to Pacific Island people – including those living outside of their home countries – may provide better indication as to the success of development efforts.

1. Introduction

- Since independence, Pacific Island Countries have achieved substantial progress in improving the standard of living of their citizens. Economic growth, however, has lagged other developing countries.
- This note applies an economic geography framework to explain historical growth performance in PICs and identify a coherent set of potential economic development priorities for Pacific Island Countries.
- Appropriate policies for economic development will vary across Pacific Island countries and will be depend on the views of leaders and citizens. This framework applies most directly to the smaller PICs.

Since independence Pacific Island Countries have achieved substantial progress in improving the standard of living of their citizens. Across the board, life expectancies have increased, infant mortality rates have declined, and the incidence of infectious disease has fallen (See Figures 2 and 3). Health and education coverage has expanded, along with improvements in the quality of services and infrastructure in many countries. The business environment in many countries has improved, especially through the liberalization of telecommunications and financial sectors. Progress, however, has been uneven, and many PICs remain off-track to achieve Millennium Development Goals.

For various reasons, including economic geography, Pacific economies have not sustained high rates of economic growth. Despite gains in social outcomes per capita income in Pacific Island countries has grown at substantially slower rates than in other countries at similar levels of income, and other countries in the East-Asia Pacific region. Figure 4 shows average per capita growth rates of selected Pacific Island countries against comparator groups during recent decades. Low growth rates among Pacific Island countries, and the apparently limited impact of foreign aid in increasing the rate of economic growth, have been of concern to governments and donors over recent decades.

This note applies an economic geography framework to identify a coherent set of potential economic policy priorities for Pacific Island Countries. This note does not present new research or policy ideas. Rather, it emphasizes the key importance of accelerated progress with a select range of policy reform agendas that are already underway, given geographical realities facing Pacific Island Countries. Two key themes underpin this discussion. Firstly, geographical realities are fundamental to historical growth performance and the likely nature of future economic development in Pacific Island Countries, and these realities need to be better reflected in policy. Secondly, integration and cooperation between Pacific Island Countries, and between Pacific Island Countries and larger regional economies, is vital to mitigate inherent geographical disadvantages.

Appropriate policies for economic development will vary across Pacific Island countries. There is no silver bullet for achieving economic development in Pacific Island Countries or any other region. This note is intended to summarize much that is already known about economic development in the Pacific Region and provide a conceptual framework for considering future policy options. It does not present significant new research. Nor does it present detailed policy recommendations. Countries of the Pacific region vary considerably in terms of the size of their populations and economies, resource endowments, and historical ties with larger countries in the region. The framework presented in this note has been primarily developed with the smaller Pacific Island Countries in mind, but appropriate policies will vary even between small countries. Development of specific policy options, which could reflect some of the ideas presented here, will require ongoing research, and consultation between Pacific people, their governments, and donors.

Figure 2: Improving Life Expectancy - Pacific Island Countries[2]

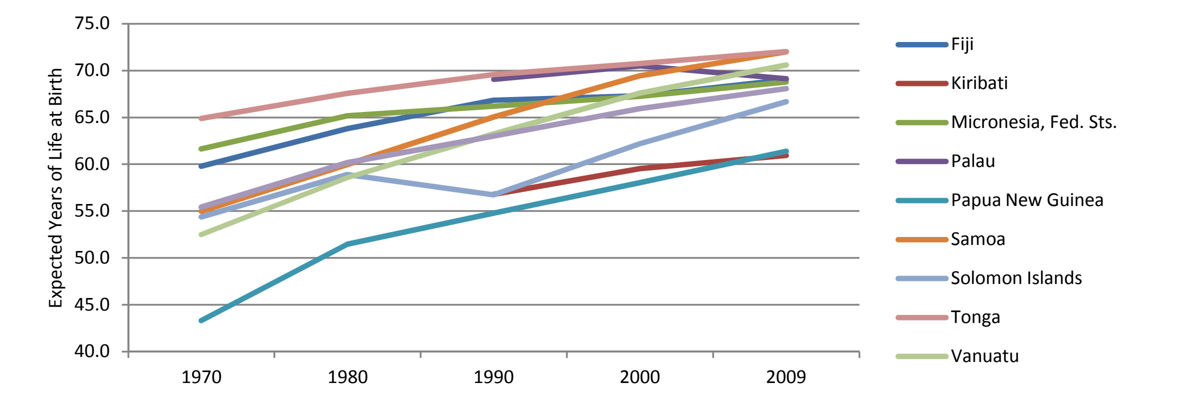


Figure 3: Declining Infant Mortality – Pacific Island Countries

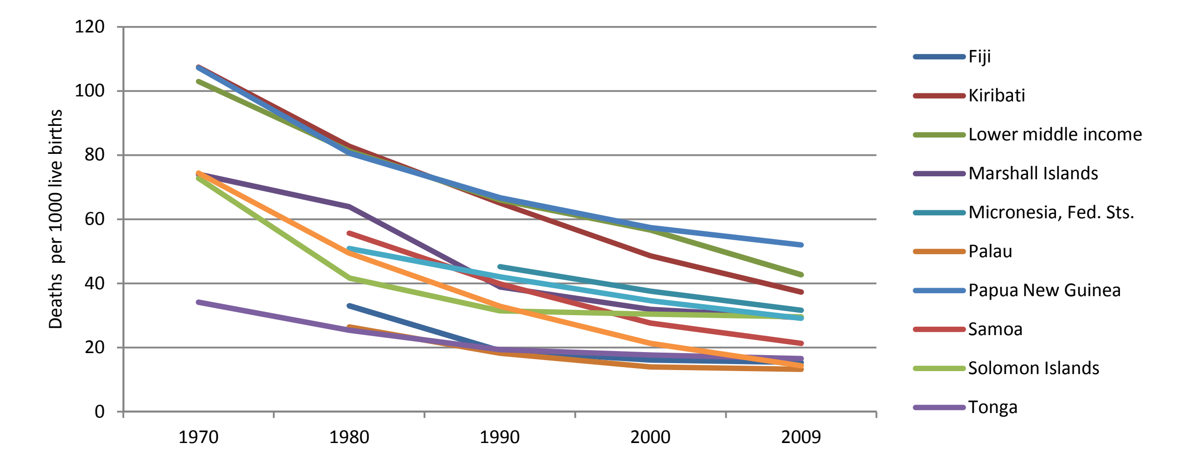
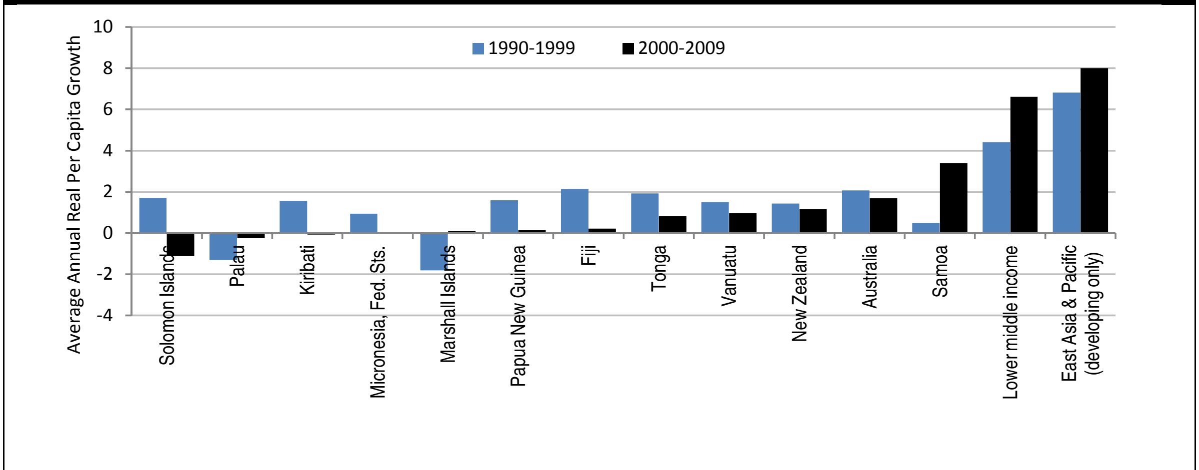


Figure 4: Per Capita GDP Growth in PICs and Comparators



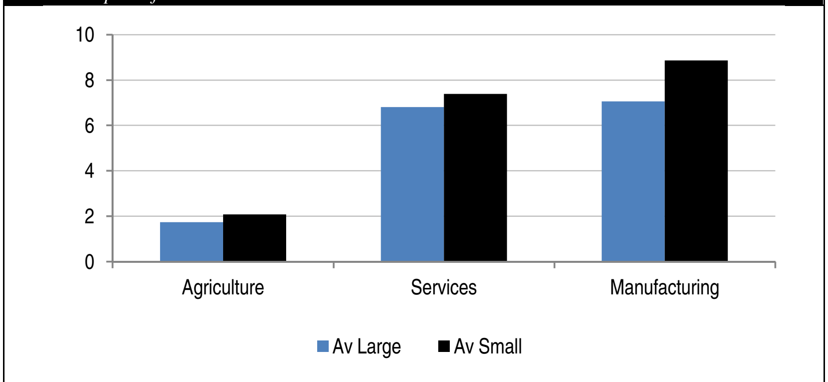
[2] Unless otherwise noted, all charts created using World Bank/IMF data

2. Pacific Island Countries will not follow the same Development Trajectory as most economies

- Internationally, economic growth has involved countries moving from agricultural production in rural areas to urban-based production of globally-traded manufactured goods or services or both.
- Geographical factors limit Pacific Island Countries' capacity to follow the path taken by rapidly growing states. Smallness, when combined with distance to large markets and dispersal of population, fundamentally constrains opportunities for the development of globally competitive manufacturing and service industries that has accompanied development in most countries.
- Because of these disadvantages Pacific Island economies export very little relative to other developing economies. PICs, however, have managed to achieve improvements in social outcomes and increased consumption by leveraging other advantages, including remittance flows from large populations living abroad, natural resource wealth, and large aid flows resulting from strong historical ties and key strategic location.

Internationally, manufacturing and services have driven economic growth. Growth involves transition from agricultural production to manufacturing and services. Figure 5 compares growth by sector of the 13 fastest growing economies examined as case studies in a recent Growth Commission report and growth by sector of those small economies that have achieved 3.5 percent annual rates of growth since 1970, 1980, and 1990. The same pattern of transition from agriculture to manufacturing and services holds across both large and small countries.

Figure 5: Growth by Sector in Rapidly Growing Small and Large Economies
Source: Report of the Growth Commission and World Bank data



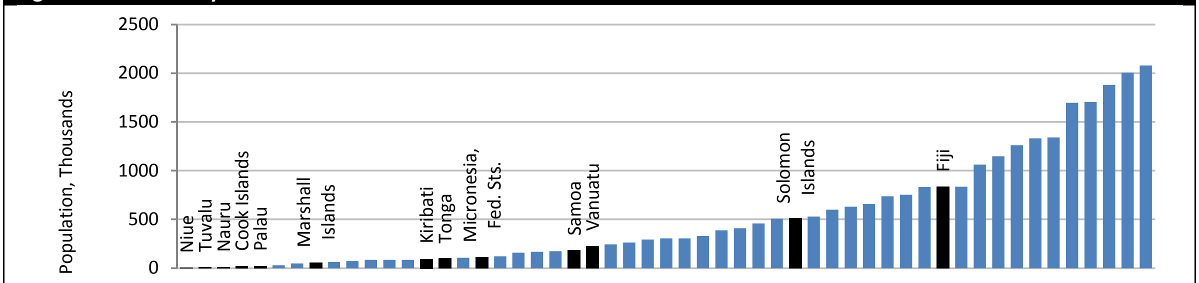
Geographical factors limit Pacific Island Countries' capacity to follow the path taken by rapidly growing states. Smallness does not, in itself, preclude economic growth. In this section we argue, however, that smallness when combined with distance to large markets, and dispersal of population fundamentally constrains opportunities for the development of globally competitive manufacturing and service industries that has accompanied development in most countries.[3] The current structure of Pacific Island economies reflects the need to focus on alternative pathways for economic development.

[3] Throughout this paper we make a crucial distinction between competitive manufacturing and service industries and those which involve the realization of rents within imperfectly competitive international markets. Pacific Island Countries are unlikely to be capable of achieving price competitiveness in general manufacturing and service industries (textiles, electronics, processed foods, financial services, call centers, etc.) due to inherent cost disadvantages. Prospects are therefore likely to be limited to "niche" markets and natural resource industries (i.e. specialty tourism, mining, fisheries) where price competition is not necessary and rents can be acquired despite the existence of cost disadvantages.

2.1. Pacific Island Countries' Options are Constrained by Size

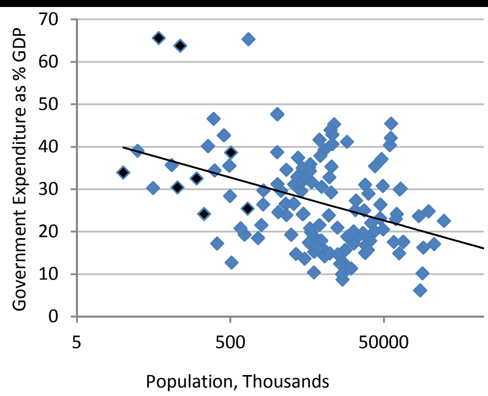
Smallness increases costs of production in the private sector. With the exception of Papua New Guinea, all Pacific Island Forum Countries are among the world's fifty smallest countries. Nine are among the world's smallest 25 countries. Smallness makes it hard for businesses to achieve economies of scale. Most forms of manufacturing and services are efficient when they occur at a large scale, but countries with small domestic markets can only achieve economies of scale if they export. Smallness also has other costs. In small countries, with relatively few domestic businesses, firms find it difficult to outsource upwards and downwards through the supply-chain. Firms also experience less exposure to positive knowledge externalities, as they are unable to observe the practices of other firms in the same industry, and lack access to a pool of workers with experience in different firms.

Figure 6: Countries by Size – Smallest Countries



Smallness also increases the costs of providing public services and infrastructure. A country's smallness increases the costs of providing many public services, due to the high fixed costs involved. A road, energy network, or government ministry that serves 200,000 people is likely to have a higher cost per user than one that serves 2 million people, because the associated fixed costs – costs of administration and certain capital costs – must be spread across a smaller number of people. Higher costs of providing services and infrastructure require higher taxes – which can slow growth – and mean that it is more difficult for governments in small countries to provide the public goods on which the private sector relies. The absence of economies of scale in government administration in Pacific Island economies are reflected in comparatively high levels of government expenditure as a proportion of GDP. The proportionately higher fixed costs of government administration mean that fewer human and financial resources are available for productive use elsewhere in the economy.

Figure 7: Size of Population and Government Expenditure as a Proportion of Output – All Countries



Smallness exacerbates capacity constraints in public administration. Even when the higher fixed costs of government can be met, small countries face additional problems because they have a limited pool of human resources to carry out administrative functions. Functioning of government can be impeded by a shortage of specialist skills in various areas of administration and service delivery (including financial management, policy development, engineering, macroeconomic management, health, etc.) with flow-on impacts to the quality of public services and prospects for private-sector growth.

2.2. Distance and Dispersal Present Further Obstacles

Internationally small countries have been able to overcome problems of scale arising from small domestic markets by trading internationally. External trade allows small countries to achieve economies of scale in production by accessing larger, foreign markets for their exports. Trade also allows small countries to import products at lower prices than at which they could be produced domestically, because they can be produced at a more efficient scale in other larger countries. As a result, small countries tend to trade more than larger countries and specialize in the export of only a small number of goods and services within which they can achieve efficient scale.

Prospects for employing this strategy are limited for Pacific Countries due to their distance from large markets. By any measure, Pacific Island countries are further away from centers of economic production and population than other small countries. The average population and GDP-weighted distances between three Pacific Island groups (Micronesia, Polynesia, and Melanesia) and 218 other countries are shown in the matrix below. The average Pacific Island is 11,456 km from any other randomly selected country weighted by rest-of-the world GDP, compared to 8,103 km for small countries in the Caribbean. Trade data provides further evidence of Pacific Island countries' long distance to markets. Figure 8 shows weighted-average size of major export markets for groups of small states, weighted by distance. The countries that Pacific Island countries trade with are typically smaller and more distant than the trade partners of other small states, especially Caribbean countries with easy access to the large US market.

Internal dispersal further exacerbates the problems of smallness for government and the private sector. Production and population are dispersed widely in Pacific Island Countries. As shown in Figure 9, urbanization is strongly related to economic output. Population density reduces the costs of supplying infrastructure and services, as well as facilitating the exchange of new technology and ideas. Several Pacific Island Countries are further disadvantaged because of their low population densities and low levels of urbanization, with already-small populations often spread thinly over large areas. In some countries, such as Solomon Islands, populations are also spread over many different islands, with inter-island transport costs imposing an additional and substantial cost burden on exporters and the provision of infrastructure and government services.

Table 1: Measures of Isolation - Small Country Groups
Source: Gibson (2006)

Country	2003 GDP-weighted distance (km)	GDP-weighted distance rank (2003)	Population-weighted distance rank (2003)
Micronesia	10,377	176	146
Polynesia	11,942	207	201
Melanesia	11,972	207	170
Pacific Islands (mean)	11,456	197	176
Caribbean (mean)	8,103	100	176

Figure 8: Distance-Weighted Size of Major Trade Partners

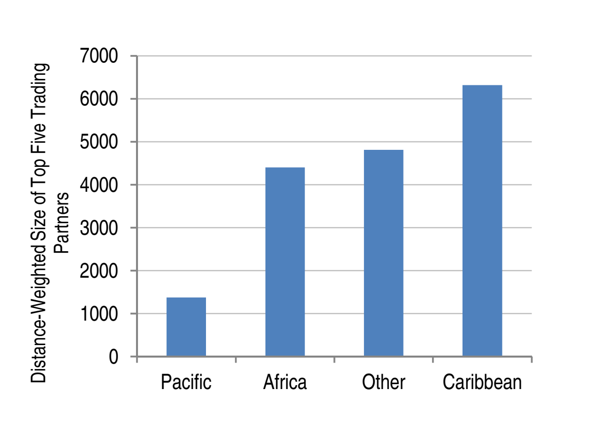
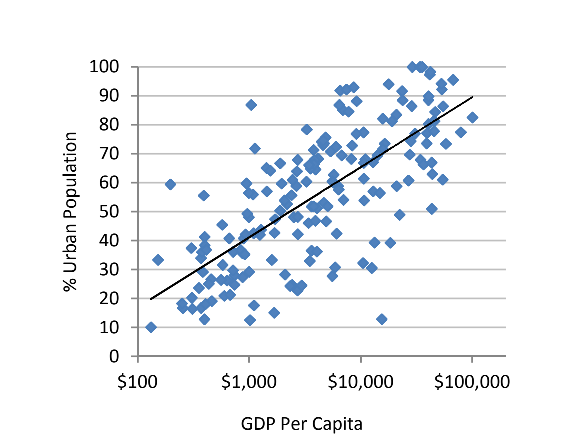


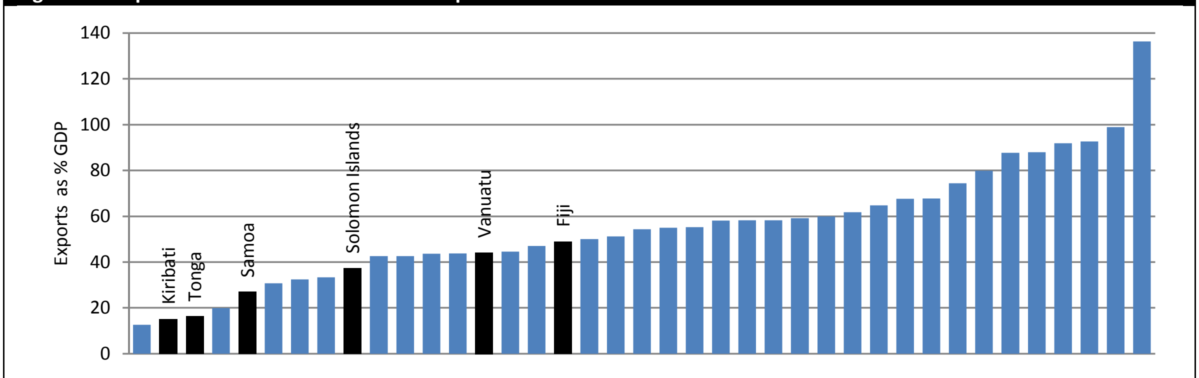
Figure 9: Urbanization and Output – All Countries



2.3. Impacts of Geography are Significant and Unlikely to Decline

The impacts of distance and dispersal are reflected in Pacific Island Countries' low level of exports relative to other small countries. Countries are only able to export manufactures and services if they can produce at prices that are competitive on international markets. Figure 10 shows exports of goods and services from Pacific Island Countries relative to other small countries. Comparatively low exports of goods and services from Pacific Island countries is consistent with empirical evidence suggesting small size, compounded by additional disadvantages of distance and dispersal, undermines international competitiveness, and imposes a possibly permanent cost wedge between world prices and the costs of production in Pacific Island Countries. Box 1 summarizes recent research quantifying the impacts of size and distance on the competitiveness of small countries.

Figure 10: Exports of Goods and Services as Proportion of GDP – Small Countries



The disadvantages of small size and distance are becoming increasingly apparent. Many Pacific Island Countries have recently had to deal with the erosion of post-colonial preferential trade access to large markets. These changes are unlikely to be reversed and have revealed a lack of competitiveness in key industries in certain countries. Reductions in transport and communication costs, arising from advances in technology and the erosion of regulatory barriers to trade, present further challenges. Because of these advances Pacific Island Countries are able to access cheaper imports and have far greater access to new ideas, while Pacific people are more able to travel to and interact with a wider range of foreign countries. But such advances do not necessarily improve prospects for manufacturing and service exporting. As transport and communication costs continue to decline the importance of production being located near consumption will be reduced. Production in Pacific Island economies will become even less competitive relative to production in major population centers if businesses in production centers are able to supply consumers in Pacific Island Countries at lower transport cost, and without facing disadvantages of small size. Overall, and other things being equal, the competitiveness of Pacific Island Countries in manufacturing and services is unlikely to increase solely as the result of continuing globalization.

Box 1: How significant are the costs of smallness and distance?

Recent quantitative research has investigated just how significant the costs arising from small scale and high transaction costs might be for countries like those of the Pacific. The following table shows 'income penalties'- potential reductions in income to labor and capital – arising in an economy of less than one million people as a result of diseconomies of scale, and higher costs of doing business. According to this analysis, capital would earn negative returns if it were invested in export manufacturing in nearly all of the Pacific Island economies. The italicized figures in the rows labeled capital and labor show the extent by which the returns to capital or labor would have to fall in order to be competitive. Even if wages were zero in a micro-economy, total costs would still exceed world prices. This is true not only for manufacturing but also for a service industry such as tourism.

COST INFLATION FACTORS AND INCOME PENALTIES

	Electronic assembly				Clothing				Hotels and Tourism			
	Micro	V. small	Thres.	Small	Micro	V. small	Thres.	Small	Micro	V. small	Thres.	Small
Cost inflation factor	36.4	14.3	5.0	2.7	36.3	14.3	5.1	2.7	57.5	28.5	11.9	6.2
Income penalty (% of median-country's income flow												
1. all domestic supplies	-38.8	-11.6	-3.0	-1.2	-40.1	-12.0	-3.1	-1.3	-36.2	-17.4	-7.1	-3.3
2. factors and services	-42.6	-13.3	-3.6	-1.5	-44.7	-14.0	-3.8	-1.6	-46.3	-22.3	-9.1	-4.3
3. value added	-88.0	-29.2	-8.6	-3.8	-86.0	-28.6	-8.4	-3.7	-71.9	-34.0	-13.7	-6.5
4. capital	*-245.1*	*-91.8*	*-30.9*	*-14.1*	*-263.9*	*-99.9*	*-34.0*	*-15.6*	*-202.1*	*-98.4*	*-40.5*	*-19.2*
5. labour	*-175.5*	*-62.5*	*-20.1*	*11.2*	*-161.0*	*-57.3*	*-18.4*	*-10.2*	*-116.5*	*-56.6*	*-23.4*	*-12.4*

Source: Winters and Martin (2004)

2.4. Pacific Island Economies Reflect the Realities of Economic Geography

Pacific Island Countries have historically leveraged particular economic opportunities to overcome geographical disadvantage. Once the extent of geographical obstacles to economic growth are taken into account, Pacific Island Countries have performed unexpectedly strongly in developing their economies and improving the standards of living of their populations.[4] Given the scarcity of the export prospects in manufacturing and services enjoyed by other countries, Pacific Island Countries have effectively financed higher imports and consumption for their populations through:

[4] See Gibson, J. (2006) "Are the Pacific Island Economies Growth Failures?" Working Paper #3, Pasifika Interactions Project. http://ips.ac.nz/events/completed-activities/Pasifika%20project/Pasifika%20WP3.pdf

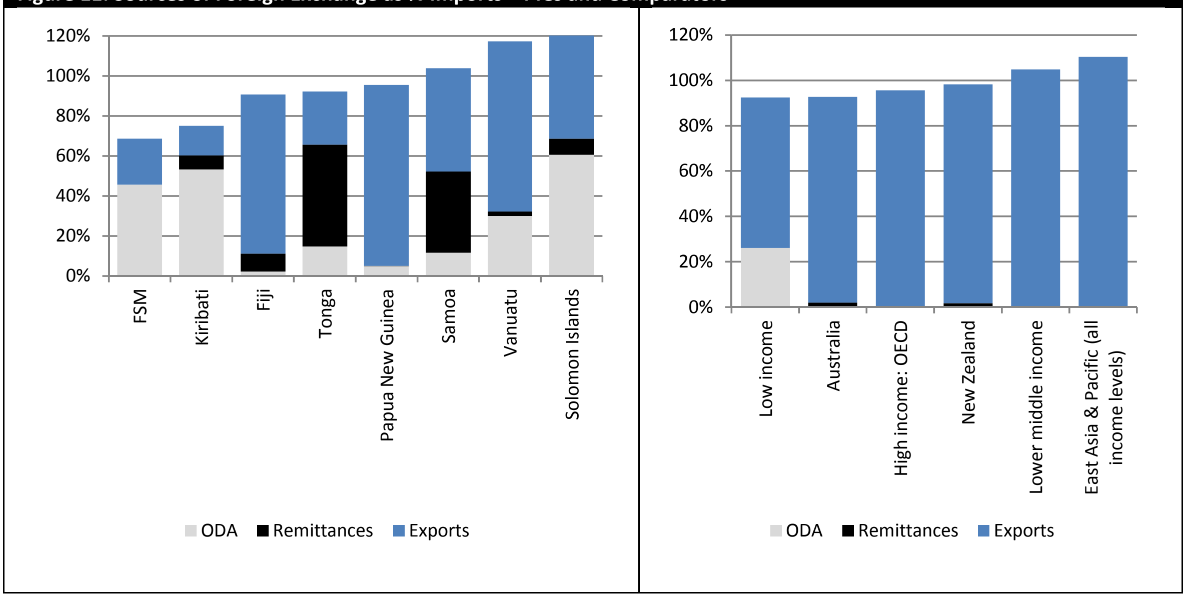
- **Natural resource wealth and niche opportunities.** Natural resource opportunities, including specialized tourism, attract investment to areas where resources and attractions are located rather than to where business costs are low. Low business costs are therefore not a prerequisite for attracting investment when an economic rent can be earned from the exploitation of natural resources (including unique scenery or high-quality spring-water) and the negative impacts of high costs of distance are less relevant. This is reflected in Pacific Island Countries' historically high reliance on fisheries, minerals, forestry, and tourism.

- **Remittances from their populations living abroad.** Several Pacific Island Countries have accessed sustained remittance flows from members of their populations working in nearby large markets. With a scarcity of local employment opportunities, Pacific Island workers have demonstrated flexibility in moving to where jobs are located. Some Pacific Island countries have already achieved substantial integration with larger nearby labor markets and remittance flows constitute a large proportion of foreign exchange income.

- **International development assistance.** Pacific Island countries have been successful in leveraging their historical ties, strategic locations, and close diplomatic relations with larger economies to access sustained and durable transfer of official development assistance. In several countries aid flows finance a large proportion of imports and international assistance plays key roles in various areas of government administration and service delivery.

These alternative sources of financing have been exceptionally significant in Pacific Island Countries, as illustrated in Figure 11.

Figure 11: Sources of Foreign Exchange as % Imports – PICs and Comparators



3. Pacific Island Countries' Best Prospects Lie in Economic Integration and Maximizing Existing Advantages

- With prospects for competitiveness in manufacturing and services limited, general business environment reforms are unlikely to be sufficient to support sustained improvements in living standards.
- PICs need development strategies that reflect geographical realities, and target limited reform capacities towards highest priorities.
- Rather than viewing export-led growth as the goal of reform, development efforts could instead focus on mitigating costs of geography, improving public services, and ensuring that PICs benefit as much as possible from areas where they have demonstrated strengths.
- Such strategies could focus on four areas:
  - **Reducing the economic costs of distance** through policy reforms aimed at facilitating the flow of people, goods, investment and ideas between PICs and with nearby large markets
  - **Reducing the costs of providing public services** by sharing certain functions across the region and with nearby large markets
  - **Maximizing the benefits of natural resource industries** through accessing international assistance to establish good regulatory and policy frameworks
  - **Mainstreaming aid and maximizing the benefits of external assistance** by moving towards more long-term, stable, and predictable aid flows and provision of technical assistance, and creating a larger role for the private sector in the delivery of aid-financed goods and services.

The above analysis suggests that a more focused approach to economic development strategy may be appropriate in Pacific Island Countries. Traditional approaches to economic reform typically emphasize the importance of establishing a sound business-enabling environment to facilitate economic diversification, and expansion into manufacturing and services. There is no doubt that Pacific Island Countries have much to gain from basic steps towards improving their regulatory and policy environments. Few countries have achieved sustained growth without certain basics in place, such as a relatively stable macroeconomic environment. But the above evidence suggests that across-the-board business enabling reforms may not, on their own, enable sustained growth, with geographical disadvantages leading to a scarcity of viable investment opportunities even under good policy settings.

A prioritized approach is needed. Reform strategies aimed at establishing well-functioning markets and similar business and regulatory environments to those existing in rich countries requires a level of financial resources and technical capacities that are often beyond what is achievable for less wealthy, capacity-constrained states. The track record of strategies involving wholesale reform of Pacific business environments are mixed, with many reforms typically left unimplemented, or achieving limited impact.

In this section, we argue that reform efforts must continue but might best be heavily prioritized towards achieving increased economic integration and maximizing existing opportunities. Such a strategy might involve: 1) actions to reduce the economic costs of distance, 2) actions to reduce the costs of providing public services, 3) actions to maximize the benefits of natural resource wealth, and 4) actions to mainstream aid and maximize the benefits of international assistance.

3.1. Integration to Reduce the Economic Costs of Distance

Geographical disadvantages can be minimized by good policies. The best way to overcome disadvantages of smallness is through integration with larger economies. Integration with other economies means access to larger markets, skills, ideas, cheaper imported products, and investment. As discussed above, Pacific Island Countries face many immutable geographical obstacles to integration. But in many situations, existing policy and regulatory settings in Pacific Island Countries avoidably exacerbate the already substantial geographical barriers to integration, including through imposing artificial barriers to trade and migration, providing poor transport and communication services or policy frameworks, and maintaining regulatory regimes in certain areas that are not harmonized with those of neighbors or large nearby countries. Within the limits imposed by geography, greater progress could be achieved towards facilitating the flow of goods, services, finance, and ideas between Pacific Island Countries, and with nearby large markets. Key priorities in this area include:

- **Increased labor market integration.** One of the most important artificial constraints to integration is restrictions on the mobility of workers. If opportunities for production in Pacific Island Countries are likely to remain constrained, a key priority is to ensure that Pacific Islanders can access employment opportunities in nearby large markets where production is concentrated. Evidence shows that such integration benefits both migrant workers and their families in sending countries. But progress in this regard is uneven, with workers in some Pacific Island Countries still having only very limited access to overseas employment opportunities. Progress could be achieved in removing barriers to increased flows of short and eventually, longer-term or permanent migrant workers to large markets. Removing barriers to migration into Pacific Island countries could also have beneficial impacts, providing new sources of skills and knowledge, and helping mitigate various capacity constraints in the public and private sectors. Such reforms could facilitate improvements in public services, private sector growth, and the creation of new employment opportunities. Within Pacific Island Countries, continued progress is needed to ensure that investment in human capital continues to ensure that Pacific Island workers are healthy and well-educated, and contribute strongly both locally and within nearby large economies. Institutions with responsibility for negotiating international labor arrangements and supporting participation of workers in regional or global schemes also need to be strengthened in Pacific Island Countries.

- **Better transport and communication links with the private sector playing a key role.** Integration with nearby markets requires easy movement of goods, people, knowledge, and ideas. Geographical factors mean that the economic costs of distance will inevitably be relatively high in many Pacific Island Countries. But at present, they are often higher than they need to be. Good transport and communication systems can mitigate the costs of distance and allow closer integration with nearby large markets. Improving the policy and regulatory settings in transport and communication infrastructure is therefore a key element of integration. The gains that can be achieved through good policy and regulatory settings in transport and telecommunications have been demonstrated repeatedly in Pacific Island Countries, especially through liberalization of air services and the spread of mobile telecommunication technologies driven by private participation and competition. Yet poorly-performing SOEs and a lack of competition continue to undermine telecommunications performance in some PICs. A key policy question is how to further spread and deepen the already substantial economic benefits achieved through improved telecommunication policies within the region.

- **Aligning and harmonizing regulatory frameworks and services.** Costs of distance also arise when transition between different jurisdictions have different regulatory regimes or standards (examples include different product standards, competition and business laws, tax regimes, investment requirements, immigration and emigration requirements, qualification frameworks, etc.). Firms and individuals have to understand and comply with two sets of rules when working across countries. This increases the costs of moving goods, services, people, and capital between jurisdictions, and therefore impedes closer economic integration. To reduce these costs, regulatory rules and standards between PICs and between PICs and nearby large markets could be harmonized or aligned in some areas. Greater alignment would make it easier for firms to operate across jurisdictions because the additional compliance costs would be minimized. Options could include the adoption of aligned education criteria, customs and immigration rules and regulations, or even tax regulations which allow investment capital to move without changing jurisdictions. But much work remains to be done in identifying areas where the gains from harmonization and alignment are greatest and where efforts could best be prioritized.

Box 2: Efficiency through harmonization in aviation safety and security

The Pacific Aviation Safety Office (PASO) provides a good example of regional initiatives that can reduce the economic costs of distance and make doing business easier in the Pacific.

Air transport operations are required to employ internationally recognized safety regulations and oversight practices. However, Pacific Island Countries face a severe lack of funds and skilled personnel and consequently have often failed to meet requirements. Non-compliance places safety and security at risk and potentially jeopardizes continued international services. PASO was established to allow the pooling of resources across the region to provide joint oversight for (i) aerodrome safety, (ii) flight operations, (iii) airworthiness of aircraft, and (iv) personnel licensing. The use of a body with shared oversight responsibilities reduces the costs to each country of maintaining its own aviation standards authority.

Over recent years, aviation safety and security regulatory requirements have increased significantly, with higher hurdles to achieving international accreditation under global standards. Regulatory and legislative frameworks across the region are inconsistent – both with global standards and with each other. Variations in the rules cause increased compliance costs for airlines and make efficient implementation of the PASO work plan more challenging.

To create a least-cost operating environment for airlines, PASO is now helping revise the legislation and regulations of member countries to create a common inspection regime and common compliance protocols. A harmonized operating environment will produce benefits to airlines, national civil aviation administrations, and travelers.

Box 3: Does everyone win from lower costs of distance?

Reductions in the costs of distance through erosion of regulatory, communications, and transport barriers will open up new opportunities for certain types of business activity. With lower costs of distance firms in Pacific Island Countries will be able to better access overseas markets, people, and ideas. Costs of production will decline, and new export opportunities may be identified. Reductions in the costs of distance will also substantially benefit Pacific Island consumers by allowing them to access a broader and cheaper range of goods and services. An economic distortion is being eliminated, which will unambiguously lead to an overall increase in welfare, once the benefits of consumers and producers in all countries are taken into account.

But some particular Pacific Island firms may lose. Reduced costs of distance also help foreign firms access Pacific Island Country markets. With costs of business often higher within Pacific Island countries, one consequence of increased economic integration may therefore include the closure of some Pacific Island businesses as they lose their markets to cheaper imports. Reductions in tariffs can also deprive governments of a vital source of income.

Given these potential costs of integration, it is vital that durable options are identified to replace any loss in revenue arising from reductions in tariffs before such changes are implemented. Measures could include tax reform to increase revenue from alternative domestic sources. But this may often not be possible and shortfalls in financing for public services arising from reductions in tariff revenues might need to be filled through increases in aid. Policy settings in Pacific Island Countries must also be in place to ensure that any job losses arising from increased economic integration can be offset by growth in other sectors – such as natural resource industries or private businesses that partner with government to deliver public services.

3.2. Integration to Reduce the Costs of Providing Public Services

Costs of smallness faced in the delivery of public services could be reduced through increased integration in provision of services. As discussed above, Pacific Island Countries face difficulties in individually providing full complement of functions expected to be performed by a state. In economic terms, the fixed costs of operating complete administrative bodies, specialist health and education facilities, law and justice services, monetary and financial systems, and competition and utility regulation, are unfeasibly high given that they must be borne by taxes from a private sector that has limited markets and few prospects for exporting. Further, delivering certain functions requires very specialized capacities and skills that are sometimes in short supply within Pacific Island Countries. Delivering all of these functions together often place an unrealistic work burden on Pacific Island Countries' inevitably limited pool of skilled and experienced public servants.

Integration is key to mitigating these problems. Pooling the provision of services across small Pacific Island countries addresses problems of cost and capacity simultaneously. It allows various institutions or facilities to service a larger number of people, therefore reducing the fixed cost per person served. It also creates opportunities for the pooling and concentration of regional capacity, with specialists from various fields able to come together to achieve critical mass in the delivery of certain functions and creating greater opportunities for Pacific Island Countries to make the best use of locally available skills or technical assistance provided by donors. A specialist regulatory authority that serves only a single country is likely to impose higher costs and have more limited access to necessary skills than a regulatory authority that serves multiple jurisdictions. If that regulatory function is shared with or provided with ongoing technical assistance from a nearby large country, capacity constraints can be avoided altogether.

There are options for cooperation between Pacific Island Countries. Many options exist for establishing regional providers of certain administrative and public services. Options underway or with potential for consideration include telecommunications and competition regulation, specialist financial management capacities (such as audit and tax assessment), and certain specialized health and education facilities and professionals. Lessons from experiences so far could usefully be shared and existing initiatives in particular areas accelerated and broadened.

Sharing specific functions with nearby large economies should also be considered. In some cases, a more comprehensive and efficient solution to inevitable regional capacity constraints might be to identify options for negotiating the expansion of the jurisdiction of larger-country institutions to cover PIC economies. There are many areas where this could be achieved (for example in specific areas of competition or financial regulation) without significantly undermining the policy autonomy of Pacific Island Countries. Identifying the particular options that are likely to have the greatest impact and prospects for success is a key challenge for Pacific Island Countries and donors.

3.3. Maximize gains from Natural Resource Industries

Integration is not a complete solution. In the above sections, we have argued that Pacific Island Countries can gain substantially from increased economic integration. Integration can reduce the economic costs of distance faced by businesses and help overcome capacity and cost constraints to the provision of high-quality public administration and services in very small countries. But integration does not provide a complete solution. Even if the ideas above are fully implemented, Pacific Island Countries will continue to face economic costs of distance and diseconomies of smallness that are not faced in competitor countries and regions. While these costs are likely to fundamentally constrain options for production in competitive global industries, niche opportunities will continue to arise in areas where Pacific Island countries have a particular advantage and do not have to compete on price. Examples of this include mining, tourism, and mineral water. It is important that the regulatory and policy setting support the private sector in making the most of the opportunities available.

Natural resources will play a key role. As discussed above, natural resource industries have historically played a vital role in Pacific Island economies, reflecting the fact that they are less subject than manufactures and services to the competitiveness constraints imposed by scale and distance. With a large share of global stocks of certain fish species, current strong commodity prices, and ongoing discoveries of new mineral wealth in the region, Pacific Island Countries will continue to attract the attention of investors. This does not, however, mean that sustainable economic gains from development of such industries should be taken for granted. Internationally, development of natural resource industries has frequently been associated with lower levels of economic growth, conflict, environmental degradation and poor social outcomes. Pacific Island Countries' have much historical experience with natural resource industries, including phosphate, fisheries, logging, and mining. This experience demonstrates all too well the importance of good policy and regulatory settings for ensuring that governments and citizens receive a fair share of the gains from such industries, and that associated revenue is used to finance high value and sustainable investments. Overall, extensive policy and regulatory reform, and institutional strengthening are required to ensure good outcomes in Pacific Island countries. A key immediate priority might be to progress regional cooperation to leverage maximum benefits from exploitation of Pacific fish stocks through the strengthening of regional fora.

Achieving progress in all of these areas is likely to require 'importing' certain specialized capacities on an ongoing basis – such as mining taxation, environmental policy, and broader public financial management – that may not be easily sourced in Pacific Island Countries. The provision of technical assistance from nearby large countries on an ongoing basis is therefore likely to be important for success.

Box 4: Opportunities in the fisheries sector

Fishing (not including processing and support industries) is estimated to contribute at least US$ 550 million the economies of Pacific Island countries annually. Coastal fishing (subsistence and commercial) accounts for half of this total, with locally based offshore fisheries making the next largest contribution. Fisheries access fees are a source of government finance in all Pacific Island countries, providing more than 10 per cent of revenue in four of them.

A quarter of the world catch of tuna now comes from the waters of Pacific Island countries, and Pacific Island Countries are now moving to take cooperative action to maximize benefits from this endowment. Pacific Island country Parties to the Nauru Agreement have recently established their own office as a means of furthering their common interests in regard to management of the tuna purse-seine fishery concentrated in their waters. These countries have already successfully used their powers of collective bargaining to extract greater concessions from distant water fishing nations operating in the region, and to impose on them more stringent conditions for fishery access. The recently-established Te Vaka Moana Agreement between several Polynesian countries has similar ambitions in regard to the southern longline fishery for tuna in their waters. The Melanesian Spearhead Group has established a Fisheries Technical Advisory Committee to identify opportunities for sub-regional collaboration in fisheries among Melanesian countries. Coupled with the long-standing cooperative efforts implemented through the Secretariat of the Pacific Community and the Forum Fisheries Agency, the countries of the region have a number of powerful tools at their disposal to address common problems in the fisheries arena when they work collectively to maximize their shared interests.

Box 5: The Benefits of Mobility under the Seasonal Workers Scheme

Recent research has confirmed the positive economic benefits of increased labor mobility in the Pacific. McKenzie and Gibson (2010) reviewed the development impacts of New Zealand's Recognized Seasonal Employer program on communities in Tonga and Vanuatu and found that the scheme had positive and substantial impacts.

Under the Recognized Seasonal Employer program, up to 5,000 seasonal workers are permitted to work in New Zealand for seven months per eleven month period to work in the horticulture and viticulture sectors. Preference is given to workers from Pacific Island Forum countries, and the majority of participants are currently from Vanuatu (3590 workers) and Tonga (1971 workers).

Using surveys, and comparing the experiences of households with and without members participating in the scheme, McKenzie and Gibson conclude that participation in the scheme allows:

- Increases in household income and expenditure
- Accumulation of household assets, such as washing machines, housing improvements, or savings in bank accounts
- Improvements in school attendance for children
- Greater sense of subjective wellbeing.

The review concludes that the Recognized Seasonal Workers program is "one of the most effective development interventions for which rigorous evaluations are available", and consider the scheme an example of "international best practice" which other countries should follow.

Source: McKenzie and Gibson (2010)

3.4. Fourthly, mainstreaming aid and maximizing the benefits of international assistance

Aid will continue to play a key role in many Pacific economies. Due to inherent capacity and fiscal constraints Pacific Island countries are unlikely to be able to achieve greater or deeper economic integration, growth in remittances, and well-regulated natural resource industries without external assistance. A collaborative approach, involving donor support and technical assistance is likely to be required for progress under each area. Even once key objectives under the areas discussed above have been achieved, it is reasonable to expect that a gap will remain between the tax revenues available to several Pacific Island Country governments and the costs of providing adequate services and public goods. At almost any conceivable scale, remittances and natural resource development will not completely and sustainably substitute for the absence of large and vibrant manufacturing and services sectors, in terms of income and revenue generation. Overall, international assistance of various kinds is likely to remain an enduring feature of Pacific Island economies for the foreseeable future. A key priority is to consider means by which current aid engagements could be broadened and altered to better reflect their medium- to long-term nature. Policy options for consideration include:

- **Providing sustainable donor financing and capacity support for regional public goods.** Many of the policy ideas discussed above require institutions that serve all countries in the region. Individual countries have limited incentives to meet the costs of provision because they will be able to benefit in any case. Further, individual countries face severe competing pressures on overstretched budgets and are often not in a position to provide the long-term, sustained financing required to make such institutions viable. The experience with regional institutions suggests that a key role for international assistance might be to provide necessary support for the establishment and operation of shared institutions, thereby avoiding political-economy and budgeting obstacles to sustainable financing that might otherwise be encountered.

- **When appropriate, increasing the use of country systems and budget-support modalities.** Donor project modalities tend to take a short-term focus, often involve unpredictable flows of resources, and assume impact and hence exit within relatively short-timeframes. In the Pacific, very substantial donor flows channeled through large numbers of projects compound problems of coordination and macro-fiscal management. Use of government systems and budget support modalities – by contrast – can increase predictability, reduce the compliance costs associated with large numbers of projects, and provide greater assurance that donor resources are aligned to and supporting governments' own policy goals. Moving towards greater use of government systems is consistent with principles specified in major international agreements such as the Paris Declaration and Cairns Compact. But moving in this direction will also require improvements in government fiduciary and public financial management systems, and joint accountability for ensuring that resources are directed to genuine priorities. Continued government efforts and donor support to improving quality and allocation of public expenditure within Pacific Island countries represents a vital complement to reform in this area.

- **Increasing the role of the private sector in delivering aid-financed goods and services.** A long-term role for aid and accelerated private-sector development are not mutually exclusive. Recent experience in some Pacific Island Countries has demonstrated the potential for the private sector to become more strongly involved in the delivery of public services and infrastructure. Private participation, when properly managed, can increase efficiency in delivery of services through the introduction of competition in areas previously dominated by government bodies. Opportunities for increased participation in delivering aid financed goods and services are broad, and range from increased participation of local firms in meeting donor procurement contracts to the outsourcing of certain kinds of government service delivery to contracted private companies.

- **Using sustained capacity support rather than short-term capacity building in some contexts.** With competition from the private sector, and an inevitably limited pool of specialists in most fields due to small population size, some kinds of capacity are unlikely to be able to be reliably and consistently sourced within Pacific Island Countries. Capacity building efforts to fill such gaps are frequently hampered by the frequent departure of key local staff and too-short project timeframes. As a consequence, progress achieved through some capacity building programs is often patchy and short-lived, and vital functions in various countries have remained unfulfilled for long periods. In this context, several countries have gained substantially from departing from traditional models of capacity building, and instead adopting sustained provision of ongoing technical assistance, especially in highly specialized areas with broad development impacts (for example, audit, taxation policy, or mining regulation). Technical assistance provided in such positions has not primarily played a capacity building role, but rather fulfilled a function for which no appropriate capacity could be locally sourced. Important gains could be made through a frank assessment of specific capacities and roles that are unlikely to be able to be filled locally over the medium-to-long term and the establishment of processes to see these roles efficiently and reliably undertaken through the provision of ongoing technical assistance from nearby large countries.

- **Ensuring climate change adaptation funds can be accessed and are well-utilized.** With hundreds of millions of dollars already committed, climate change adaptation financing flows to Pacific Island Countries are expected to grow rapidly over coming years. This presents a clear opportunity for

Pacific Island countries to meet the threats posed by rising sea-levels and other extreme weather events. But, to make the most of this opportunity, processes for accessing this financing need to be suitable to Pacific Island Country contexts and capacities. Modalities for delivering adaptation financing need to strengthen government systems and align with countries' own development priorities – rather than work outside government priorities and systems, and impose additional transaction costs on already overstretched government officials. Project-based modalities are unlikely to be optimal for managing funds of the quantity that are likely to become available. Cooperation between donors and Pacific Island Country governments is needed to ensure that these vital resources become accessible as quickly as possible, and are used in ways that have the greatest possible benefits.

Explicit reconsideration of the objectives of aid in PICs, and the benchmarks by which its success is measured, may also be useful. GDP growth has received high attention for assessing the impacts of aid. However, the combined effects of geography and size potentially limit the rates of growth that can be achieved by the PICs on a sustainable basis. Increased consumption of imports resulting from remittance flows to households has little impact on GDP figures but a large impact on welfare. Conversely, unsustainable and poorly regulated extraction of natural resource stocks can boost GDP while providing few benefits to citizens. Outcomes in health, education and employment, and the breadth of opportunities available to Pacific Island people – including those living outside of their home countries – may provide better indication as to the success of development efforts.

Box 6: Capacity Constraints and Public Financial Management in PICs

The World Bank has recently begun analytical work identifying patterns in Public Financial Management (PFM) performance across PICs. Using information from standardized assessments of PFM systems (PEFA Assessments) carried out in seven countries, we have so far found that:

- **There is significant variation in overall PEFA scores of small PICs.** Two countries achieve a higher overall average PEFA score than the world average, while another two are in the weakest 15 percent. Most small PICs (i.e. excluding Papua New Guinea) score less than the world and comparator country averages against "basic" PFM functions required to ensure fiscal discipline.
- **Capacity constraints seem to have a strong influence on performance.** Small PICs perform less strongly against PEFA indicators that require higher levels of capacity (especially procurement processes and internal audit), relative to both their own average scores and global averages. These capacity constraints impact throughout the PFM chain – impacting on the ability of small PICs to achieve good "basic" PFM systems and the maintenance of fiscal discipline, and also their ability to achieve more advanced PFM functions.
- **In the context of capacity shortages, prioritization of available capacity to address binding constraints is imperative when designing and implementing PFM reform programs in small PICs.** Existing regional good practice recommendations for prioritization of reforms towards "getting the basics right" need to be followed.
- **Ongoing capacity supplementation may be required.** With capacity constraints binding against achieving even "basic" PFM systems, and an inevitably limited pool of local specialists, ongoing international assistance may be necessary to support some areas of PFM performance in some countries.

Source: World Bank