Pacific 2020

BACKGROUND PAPER: FRAMEWORK FOR GROWTH

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Pacific 2020 Background Paper: Framework for Growth

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THE GROWTH RECORD: LEARNING FROM HISTORY

'IS THE REASON WE TALK SO MUCH ABOUT GROWTH THAT WE UNDERSTAND SO LITTLE ABOUT IT?'

Dani Rodrik, 2004[1]

What should the countries in the Pacific do to speed up economic growth and raise the level of material wellbeing for their citizens? To help answer this question, this section draws out the key lessons from the growth experience of developing countries over the past 25 years, and subsequent sections focus on the special issues facing small states.

There is a long history of economic thought devoted to exploring the determinants of growth in developing countries. Towards the middle of the 20th century, the emphasis was on planning models and import-substitution policies to promote growth. By the 1980s the importance of an outward orientation and the role of the market began to gain emphasis and policy advice centred on reforms to bring about fiscal discipline, trade liberalisation, privatisation and the deregulation of markets. This is commonly referred to as the Washington Consensus, put forth by Williamson in 1990.[2]

Over time, the need for second-generation reforms was stressed in response to the recognition that market-oriented policies may have, at best, only a limited growth impact if not accompanied by institutional transformation. This led to the importance of sound governance in the public and corporate sectors gaining more prominence. There was also concern that the Washington Consensus amounted to a trickle-down approach to poverty reduction, leading to more focus on the design of appropriate social safety nets and on broader definitions of poverty (extending beyond income poverty). This augmented 'list of virtues' continues to underpin the definition of a desirable growth framework even today.

With the benefit of hindsight, it is possible to compare the growth record of countries and regions in the world and broadly conclude that:

> Growth is consistent with some of the higher order economic principles that have inspired the policy consensus. A semblance of property rights, sound money, fiscal solvency, market-oriented incentives are all elements that are common to all successful growth strategies. Where they have been lacking, economic performance has been lacklustre at best.[3]

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1 D Rodrik, *Growth strategies*, Harvard University, 2004.

2 J Williamson, 'What Washington means by policy reform', in John Williamson (ed.), *Latin American adjustment: how much has happened?*, Institute for International Economics, Washington, DC, 1990.

3 Rodrik, 2004.

The real-world growth record also throws up some interesting stylised facts: interesting because they offer some suggestions as well as considerable leeway to practitioners on how to formulate a growth strategy from the rather overwhelming array of recommended reforms. Four main messages emerge.

The **first** message is that it can take quite little to get growth started. This is one of the encouraging aspects of the comparative evidence on economic growth and found to be true in the majority of cases where a growth acceleration was noted. While there are no 'silver bullets' to prescribe, small changes in policy can yield significant increases in economic activity. This suggests that countries need not get paralysed into inaction when faced with an extensive policy and institutional reform agenda. Growth spurts can be brought about by implementing a few policies in the right way. Of course, the difficulty lies in identifying these few policies to start with. Hopefully the next few messages offer some insights on that aspect.

The **second** message is that the policy reforms associated with growth transitions typically combine orthodox and unorthodox principles. The orthodox principles are of sound economic governance mentioned earlier – due respect for property rights, market-oriented incentives, sound financial policies, etc. Addressing the orthodox principles can be viewed as correcting government failures by removing barriers to macroeconomic stability, reducing distortions in taxation or wages, ensuring fiscal sustainability, and reducing policy uncertainty and risk. The experience from other parts of the world (see Box 1 for examples from Asia, Africa and Latin America) shows that these principles were often implemented via policy arrangements that are quite unconventional such as in China's two-track reform strategy, Mauritius's export processing zones and Chile's copper export strategy.

The unorthodox principles often belong to the realm of correcting market failures – where externalities and coordination failures (such as information asymmetry plaguing investor information) are mitigated with the appropriate policy interventions to 'crowd in' investment. However, caution in framing them is needed to prevent the intervention from exacerbating the market failure via additional distortions and the encouragement of rent-seeking behaviour. For every South Korea that managed to combine elements of unorthodoxy with the orthodox, there are numerous other countries where such attempts only made matters worse.

BOX 1 EXAMPLES OF UNCONVENTIONAL POLICY ARRANGEMENTS FOR IMPLEMENTING THE ORTHODOX PRINCIPLES OF SOUND GOVERNANCE

The authorities in **China** liberalised agriculture only at the margin while keeping the plan system intact. Farmers were allowed to sell surplus crops freely at a market-determined price only after they had fulfilled their obligations to the state under the state order system. This addressed the difficult question of how to provide microeconomic incentives to producers while insulating the central government from the fiscal consequences of liberalisation. This approach was critical in achieving political support, building momentum and minimising adverse social implications.[1]

The small African island of **Mauritius** followed an import substitution policy from the 1960s until well into the 1980s. Since the industrialist class that was protected by this policy was opposed to opening up, instead of liberalising its trade regime across the board it created export-processing zones. New profit opportunities were created at the margin while leaving old opportunities undisturbed.[2]

While **Chile** has displayed an almost textbook-like adherence to the standard checklist of market-oriented reforms, it has also departed from it sometimes by keeping the largest export industry, copper, under state ownership, by maintaining capital controls on financial flows through the 1990s, and by providing technical and marketing assistance to its fledgling agro industries.[3]

[1] Lawrence J Lau, Q Yingyi and R Gerard, 'Reform without losers: an interpretation of China's dual-track approach to transition', Journal of Political *Economy*, vol. 108, no. 1, 2000, pp. 120–43. [2] A Subramanian and D Roy, *Who can explain the Mauritian miracle: Meade, Romer, Sachs, or Rodrik?*, International Monetary Fund Working Paper, 2003. [3] D Rodrik, *Growth strategies,*, Harvard University, 2004.

The **third** message is that institutional arrangements do not necessarily travel well. The policy package needed to get growth started in one country is likely to be quite different in another – particularly the elements that are non-standard. Attempts to emulate successful policies elsewhere often fail, which means successful reforms are those that package sound economic principles around local capabilities, constraints and opportunities.

Since local circumstances vary, so do the reforms that work. So while the good news is that it need not take comprehensive reform to stimulate economic growth, the bad news is that it may be quite difficult to identify where the binding constraints or promising opportunities lie. A certain amount of policy experimentation may be required to discover what will work, as growth strategies need to be highly context-specific. 'This much more targeted approach … calls for more economic, institutional, and social analysis and rigor rather than a formulaic approach to policy making'.[4] Box 2 lays out an example of following a diagnostic approach to kick-start growth in an economy.

[4] World Bank, *Economic growth in the 1990s: learning from a decade of reform*, Washington, DC, 2005.

BOX 2 A DIAGNOSTIC APPROACH TO GROWTH STRATEGIES

Designing a growth strategy for an economy involves diagnosing its most significant binding constraints and focusing efforts on addressing those constraints.

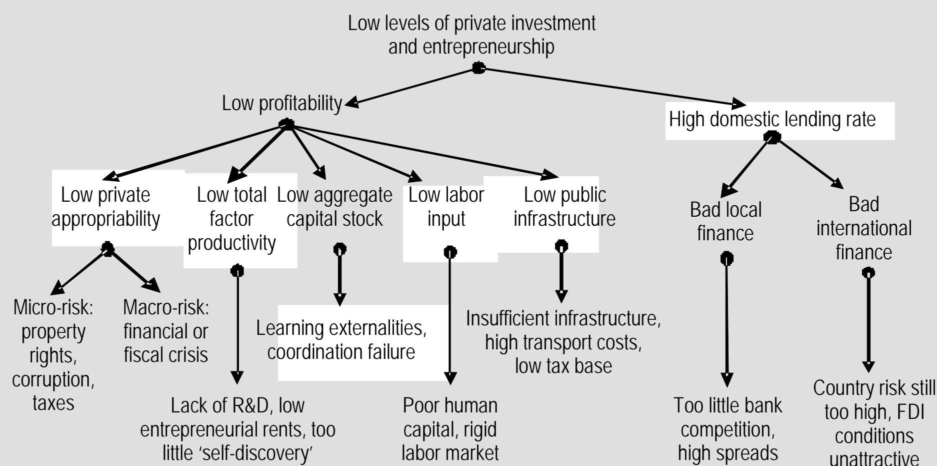
The first step to finding out the specific constraints to economic growth is identifying the symptoms. The figure below illustrates the possible explanations for low growth associated with low levels of investment and entrepreneurship. The most binding constraints can be traced by starting from the fundamental symptom.

For example, if investment is constrained by low social returns, perhaps it is because of poor human capital or inadequate infrastructure relative to comparable countries. If investment is inhibited by the high domestic cost of capital, perhaps the local banking environment is not competitive enough or perhaps perceived high country risk reduces foreign investors' willingness to lend. Or if investment is harmed by the low appropriability by private investors, perhaps investors are faced with institutional failures, high corruption, or macroeconomic instability.

The diagnostic approach offers a potentially useful way of identifying country-specific solutions by matching policy priorities with diagnostic signals. Its bottom-up nature enables countries to diagnose themselves. It is also sensitive to political and administrative constraints, and recognises the dynamic nature of binding constraints.

Rather than overwhelming developing countries with a menu of low context-specific wide-ranging reforms, it would be more productive to target areas where the returns are the highest – that is, by relaxing the biggest constraints. This may be relevant for all poor countries embarking on reform, but seems particularly so for small countries where implementation capacity constraints are most acute.

Diagnosing the problem of low levels of investment and entrepreneurship



Source: R Hausmann, D Rodrik and A Velasco, *Growth diagnostics*, Harvard University, October 2004.

The **fourth** message is that, once growth is launched, the key to sustaining it is giving attention to institutions that can maintain the productive dynamism and generate resilience to external shocks. In the long run, high-quality institutions are vital for convergence with the living standards of advanced countries. One could think of institutions as defining the prevailing rules of society, and high-quality institutions induce socially desirable behaviour on the part of economic agents. Such institutions can be informal or formal, with the relative importance of the latter increasing as the scope of market exchange broadens and deepens. But again, the institutional form need not be uniquely prescriptive. In fact, appropriate regulation, social insurance and even macroeconomic stability can be provided through diverse institutional arrangements.[5]

The appropriate institutional arrangements will emerge on the basis of the country's characteristics such as the social preferences of its agents and complementarities with other parts of the institutional landscape. The level of economic development and related capacities within the country, which are in turn greatly influenced by country size, age and geography, will shape the policy package and institutional design to support economic growth and ultimately the welfare of its citizens. The next section explores in depth the impact of country size and geography and offers an analytical and empirical basis for focusing on these dimensions in the Pacific region.

DO SMALL STATES HAVE BIG PROBLEMS?

The issues that small states face have not received steady and rigorous attention until recently. Some 20 years ago small states were considered to be bestowed with special advantages such as endowments of natural resources and small homogenous populations that allowed for political consensus to be reached easily and for adaptation to change to be more manageable.[6] Even the presence of higher risk premiums for private investment was not considered a problem, as it was compensated for by higher aid flows. Their openness to trade was also considered an asset that positioned them for higher growth. Overall the message was that the lessons from the growth experience of other developing countries could be easily applied to small states[7] and examples such as Hong Kong, Singapore, Luxembourg, Switzerland and Qatar were cited to support these views.[8]

With time and experience, our understanding of these issues has progressed, in the process overturning some of these views. We know now that greater openness to trade is also accompanied by greater volatility in small, undiversified economies that

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5 For example, communally held land is part of the traditional culture in the Pacific and poses an obstacle to attracting foreign private investment. While the privatisation of land may not be in accordance with social preferences in the region, a long lease system very well could be.

6 TN Srinivasan, *The costs and benefits of being a small, remote, island, landlocked, or ministate economy*, World Bank, Washington, DC, 1986.

7 W Easterly and A Kraay, 'Small states, small problems? Income, growth, and volatility in small states, *World Development*, vol. 28, no. 11, pp. 2013–27.

8 These countries are not the micro-states that characterise the Pacific or even small states more generally.

are price takers. Natural resources unfortunately can be more of a curse than a blessing and small populations may have a more difficult time avoiding capture by special interests since interest groups can be more prominent. We also recognise now that aid and private investment are not interchangeable and that aid may crowd out investment and possibly undermine the incentive framework (more on this in the next section).

Recent empirical evidence has added further credibility to the unique problems faced by small states by showing that there is a significant 'price' of smallness. This price manifests itself in the form of higher costs for transporting exports and imports, higher utility costs, and higher (30–40%) wages and rents.[9] Given the price-taker status of small countries in world markets, these cost premiums are hard to pass on to customers, which implies that the only way these economies can export at world prices is if some factor of production accepts lower returns than it would get in larger economies. Winters and Martins have calculated such 'income penalties' and found that capital would earn negative returns if it were invested in a micro-economy and had to bear the cost of local inefficiencies itself (see Table 1). Similarly, even if wages were zero in a micro-economy, total costs would still exceed world prices. This is true for manufacturing as well as a service industry such as tourism.

Why are the costs of smallness so substantial? Three possible factors are highlighted – market size, location and policies.

MARKET SIZE

Market size is defined as the scale of economic activity over which agents can contract. Usually national borders define the scope of this contractual space. The larger this space the greater the potential for reaping economies of scale and the greater the scope for specialisation. Reaping economies of scale and scope requires

TABLE 1 CENTRAL CASE 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: A Winters and P Martins, 'When comparative advantage is not enough: business costs in small remote economies', *World Trade Review*, vol. 3, no. 3, 2004, pp. 347–83.

[9] A Winters and P Martins, 'When comparative advantage is not enough: business costs in small remote economies', *World Trade Review*, vol. 3, no. 3, 2004, pp. 347–83.

specific investments in physical and human capital, as well as marketing channels, which are constrained when the scale of economic activity is small. This is true not only when producing and exporting goods, but also when providing government services – be they public utilities or general government administrative functions where indivisibilities in certain services can increase the overall size of the public sector.

Of course, the moot question is how much does market size matter if the country has open trade policies – which small countries do generally follow. It appears to matter quite a lot, as international fragmentation seems to affect trade and capital flows, and hence price equalisation. McCallum found that trade between Canadian provinces was 20 times larger than with an equidistant US state (despite the fact that the US–Canada border is perhaps the easiest to cross, given similarities in economic development as well as broad cultural characteristics).[10] Similar evidence from Engel and Rogers found that crossing a border is the economic equivalent of adding thousands of miles to the distance between cities.[11] Parsley and Wei estimate that crossing the US–Japan border adds 43 000 trillion miles to the process of price convergence between cities.[12]

These 'border effects' could also translate into a negative impact on output levels – and hence possibly growth rates to transition into higher income levels, as trade has significant effects on income. An increase in trade of 1 per cent raises income by 0.33 per cent over 20 years. As new small states emerge, so do new transaction costs, which seem to limit both foreign and domestic trade and hence income in the long run.

It is possible that the increased transaction costs or border effects could be compensated for by the positive impact of sovereignty, if the latter prompted independent nations to adopt policies that are superior to the ones otherwise imposed on them. The broad empirical evidence from Africa, the Caribbean and the Pacific, however, indicates that typically after independence countries do not experience acceleration in their growth rates. (See the appendix for graphs with pre-independence and post-independence growth rates for three Pacific countries, as well as post-independence records for others. Samoa and Kiribati are the only exceptions where growth has not trended downward since independence.) This suggests that the costs of sovereignty may not be trivial; furthermore, the evidence from the Caribbean suggests that the old independent states are the poorest while the dependants are the richest.[13]

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10 J McCallum, 'National borders matter: regional trade patterns in North America', *American Economic Review*, vol. 85, no. 3, 1995, pp. 615–23.

11 C Engel and J Rogers, 'How wide is the border?', *American Economic Review*, vol. 86, no. 5, 1996, pp. 1112–25.

12 D Parsley and S-J Wei, 'Explaining the border effect: the role of exchange rate variability, shipping costs and geography', *Journal of International Economics*, vol. 55, 2001, pp. 87–105.

13 R Hausmann, M Braun and L Pritchett, *The proliferation of sovereigns: are there lessons for integration?*, Harvard University, 2002.

LOCATION

In addition to size, distance from markets or the main centres of economic activity plays a role in inflating the cost disadvantages faced by small countries. Remoteness or isolation from trading partners as well as main economic hubs exacerbates the disadvantages of small market size that prevents specialisation. Most countries that are small, particularly in the Pacific region, are also remotely located.

In empirical studies, it therefore becomes hard to disentangle the size effect from the isolation effect. But Winters and Martins have put a distance variable into their regression equations for estimating costs. For sea freight costs as well as the cost of passenger travel, distance turns out to have a significant effect. Given the large percentage of imports in the consumption basket and the need to export products to larger and far away markets (particularly for the Pacific, where inter-island trade is negligible), the higher cost of sea freight poses a major disadvantage to Pacific islanders. The high cost of passenger travel to distant locations also limits the ability of small islands to sell tourism services to the rest of the world.

Another type of transaction cost faced by businesses in small states results from the disruption of services such as utilities or the lack of skilled workers. If disruptions and skill shortages are true of small countries in general, those small countries that are isolated by the ocean, as is the case in the Pacific, must be affected much more. That they are located in the ring of fire and highly vulnerable to natural disasters such as cyclones, virtually guarantees that the cost of disruptions is excessive.

POLICIES

With size and location presenting formidable obstacles to the competitiveness of economic activity in the Pacific, are policies appropriately designed to promote growth and the welfare of their citizens? While this is a difficult question to answer at a broad level, the available evidence does suggest there is considerable scope for improving policies and institutions. Summary indicators such as the Country Policy and Institutional Assessments developed by the World Bank rank developing countries across a variety of attributes that range from economic, structural and social policies to the quality of public sector management and institutions. While these assessments do not point to systematic shortcomings in the policy and institutional settings of small states as a group vis-à-vis all developing countries, the small states of the Pacific (that are members of the World Bank Group) tend to rank below the average for developing countries, though with considerable variation within the group. Moreover, assessments of sectoral policies specific to the issues of competitiveness confronting the Pacific islands also point to the scope for improvement. For example, a World Bank study that focused on the infrastructure challenges facing the Pacific revealed that infrastructure performance in the Pacific was worse than that predicted by their gross domestic product (GDP) as well as the

standards prevalent in comparator countries such as the Caribbean islands (although even the Caribbean is perhaps not a good comparator since size and remoteness are far more acute problems in the Pacific).[14] What is more telling is that within the Pacific region some countries with greater inherent challenges demonstrate better performance of certain infrastructure, suggesting that poor performance is due to poor institutional performance. For example, Vanuatu has a relatively dispersed population, a high degree of ethnic diversity amidst a moderately small population and dependence on aid, and yet is one of the most efficient providers of water and electricity in the region. Overall though, telephony prices in many Pacific countries are among the highest in the world, often due to non-contestable telecom markets, while in others they are artificially low due to heavy subsidies from government, which drain the public budget. The report concluded that better coordination, accountability and risk management can help improve the overall level of infrastructure performance in the Pacific.

To assess policies related to the private sector, a recently compiled database known as the Doing Business indicators database offers information on 131 countries on a number of attributes that might affect business entry and exit, access to credit, contract enforcement and rigidity of employment. Using this database it is possible to compare developed country regulations with those prevalent in developing countries as well as compare small countries with large ones. Again, while there is variation within these groups, including some very pleasant surprises, overall the findings seem to be that poor countries regulate more than others and small countries seem to do so more than their larger counterparts. The report[15] also points to the fact that the more the regulation, the more the scope for corruption and the greater the burden on businesses, resulting in lower productivity of all factors of production in the economy. While most countries that regulate more tend to do so in the interest of protecting the vulnerable, the evidence seems to show that the vulnerable are left out of the regulatory framework anyway (see Figure 1), so regulations seem to crowd out investment rather than perform a social protection role.

By benchmarking against the global best, the Doing Business indicators show that the Pacific island countries are heavily regulated in some areas (Figures 2, 3 and 4) and less in others (Table 2). The areas for reform include the time to start a business, the cost to enforce a contract, and credit information sharing. In particular, there are no credit registries or bureaus in the region except in Fiji (see Table 2). The regional credit bureaus of New Zealand and Fiji are best practice models, especially for small countries, as the cost of implementation is low and the benefits of information sharing are large.

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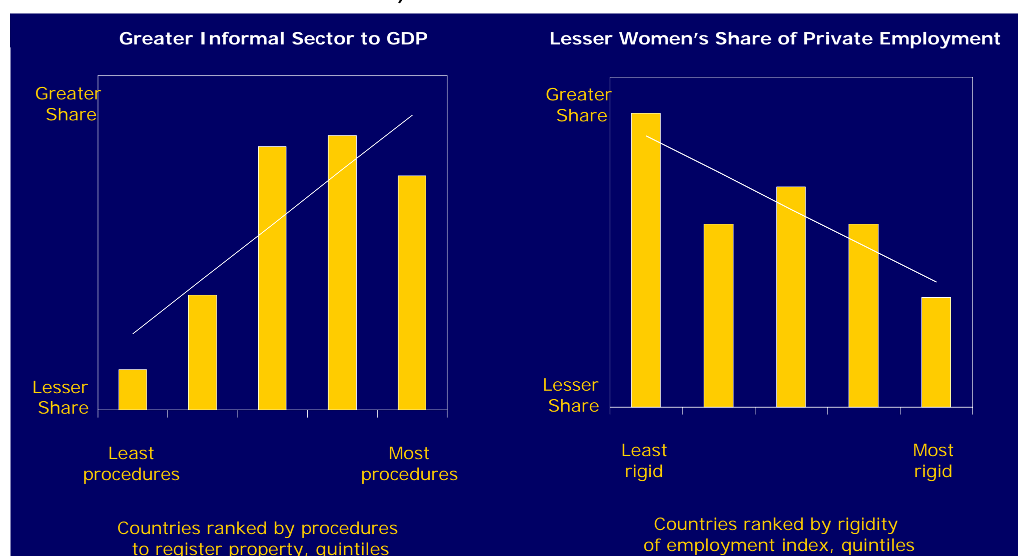
[14] World Bank, *Pacific infrastructure review*, prepared by Castalia Strategic Advisors for the World Bank, 2005.

[15] World Bank Group, *Doing business in 2005: removing obstacles to growth*, Washington, DC, 2005.

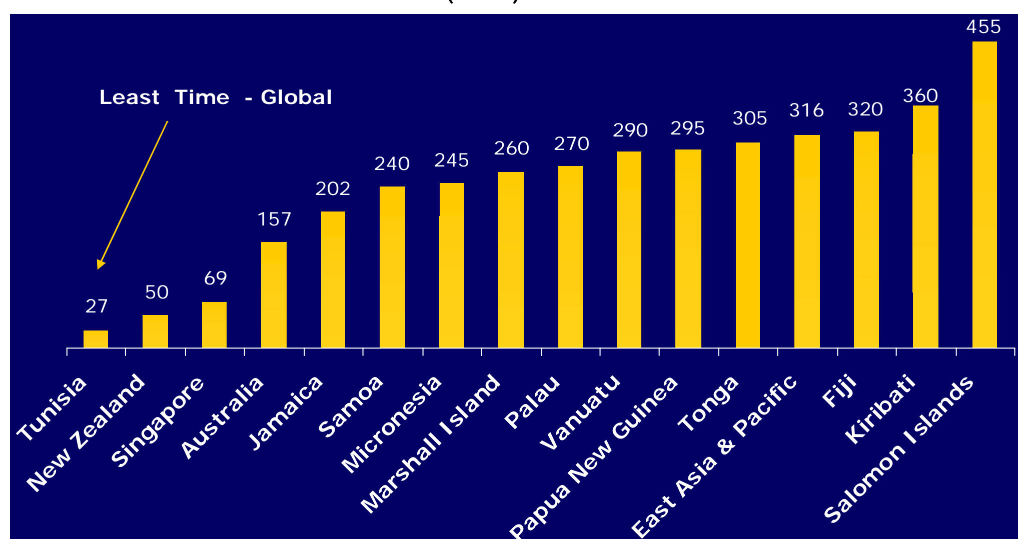
Reducing the steps in regulations concerning entry and exit of business, reducing the rigidity of employment and improving contract enforcement are all important policy messages that emerge from this database. Many of the changes required are fairly low cost to implement, even in small countries.

FIGURE 1 HEAVY REGULATIONS HURTS MOST THE VULNERABLE (WOMEN, YOUNG, LOW-SKILLED WORKERS) AND EXCLUDES THEM FROM DOING BUSINESS



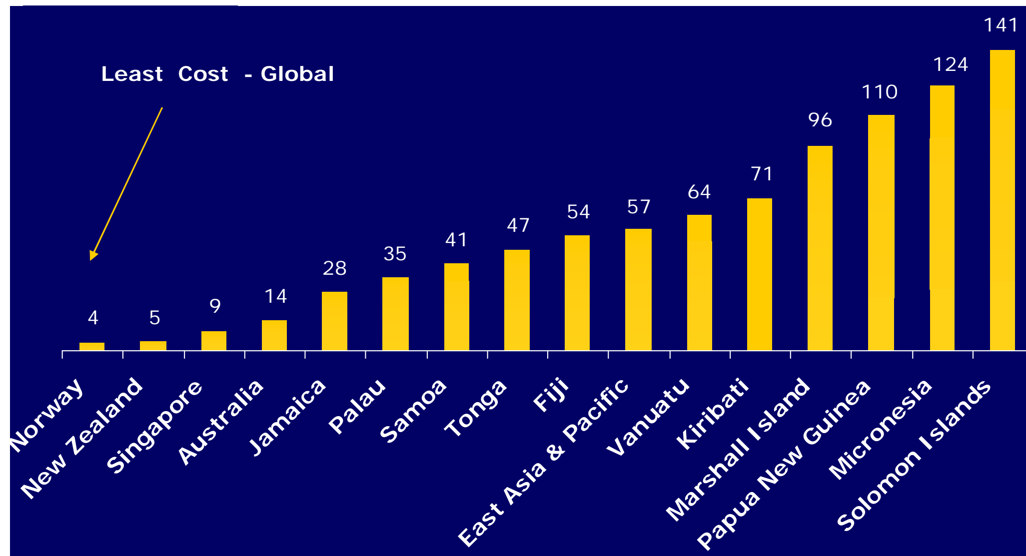
Source: World Bank Group, *Doing business in 2005 (Pacific islands): removing obstacles to growth*, Washington, DC, 2005.

FIGURE 2 TIME TO START A BUSINESS (DAYS)



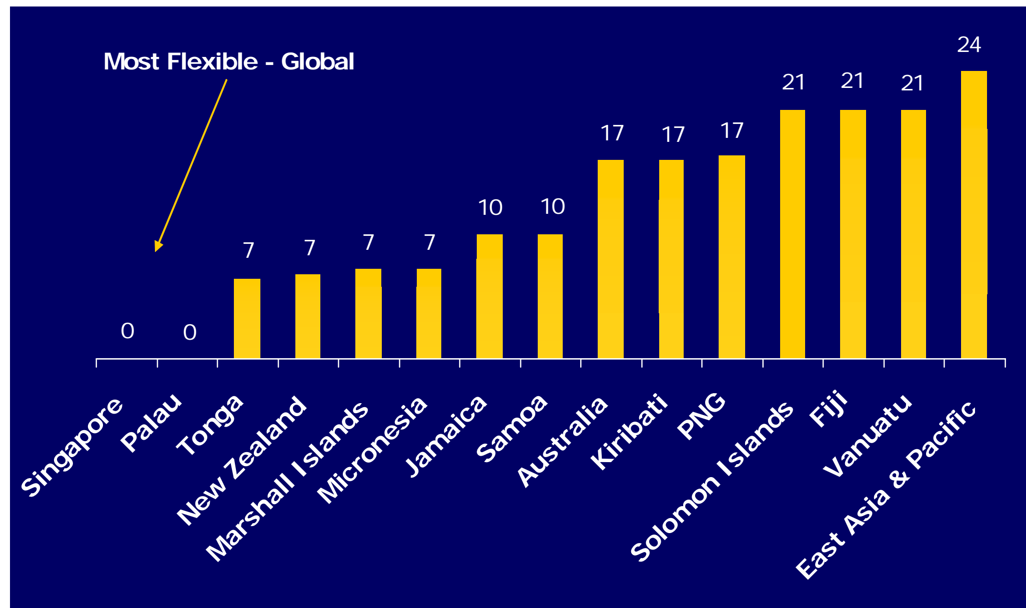
Source: World Bank Group, *Doing business in 2005 (Pacific islands): removing obstacles to growth*, Washington, DC, 2005.

FIGURE 3 COST TO ENFORCE A CONTRACT (% OF DEBT AMOUNT)



Source: World Bank Group, *Doing business in 2005 (Pacific islands): removing obstacles to growth*, Washington, DC, 2005.

FIGURE 4 RIGIDITY OF EMPLOYMENT LAW INDEX Pacific islands are among the least regulated in the world



Source: World Bank Group, *Doing business in 2005 (Pacific islands): removing obstacles to growth*, Washington, DC, 2005.

TABLE 2 CREDIT INFORMATION SHARING: PUBLIC AND PRIVATE REGISTRY COVERAGE

Country	Public Registry (borrowers /1000 adults)	Private Bureau (borrowers /1000 adults)
Portugal	637 (highest coverage)	79
United States	0	1000 (highest coverage)
East Asia & Pacific	33	67
New Zealand	0	978
Australia	0	954
Singapore	0	335
Fiji	0	212
Jamaica	0	0
Kiribati	0	0
Marshall Islands	0	0
Micronesia	0	0
Palau	0	0
Samoa	0	0
Solomon Islands	0	0
Tonga	0	0
Vanuatu	0	0

Source: World Bank Group, *Doing business in 2005 (Pacific islands): removing obstacles to growth*, Washington, DC, 2005.

SPECIAL SOLUTIONS TO SPECIAL PROBLEMS?

If small remote states face special problems, special attention needs to be paid to designing appropriate solutions to mitigate them – within these economies as well as by the international development community. There are a host of 'solutions' being proposed and being implemented in many small states. It is useful to bunch these solutions into three categories: policies that do more harm than good, good policies that require careful implementation, and some new ideas that are promising but raise sensitivities (Table 3).

TABLE 3 POLICY OPTIONS FACING PACIFIC ISLAND COUNTRIES

Policies that do more harm than good	Good policies	New ideas worth pursuing
Trade protection • tariffs • special preferences	Multilateral liberalisation	Pooling of government functions and infrastructure
Domestic subsidies, monopolies	Niche markets	Migration
South–south free trade areas	Sectoral policies in fishing, logging	Rethinking aid mechanisms

POLICIES THAT DO MORE HARM THAN GOOD

A leader in the first category is **trade protection**, usually justified on the grounds that since trading costs are high, domestic industry needs special protection. This only exacerbates the problem, as higher tariffs and taxes increase the cost of trading, reducing trade and output levels further below optimum levels for a small price-taking economic entity.

Related to this is the case often made for **subsidising business activity**. The earlier income penalties data point to worries about the overall feasibility of production activity in some micro-states rather than a distortion or market failure, which an intervention such as a subsidy can fix. From the theory of first best we know that domestic distortions should be addressed with domestic policy and that, if excess costs are non-distorting, a policy intervention is likely to make the country worse off. For example, small countries do not have a comparative advantage in energy-intensive manufacturing and, if power is expensive in small countries, subsidising such manufacturing to compensate for high power costs would be bad economics and would increase the use of relatively costly inputs and divert resources away from their optimal use in the economy.

Protecting monopoly interests to address the small scale of production, which is a natural constraint, only makes the problem worse as monopolists restrict production even more, resulting in further harm to the community.[16]

In a similar vein, **trade preferences** have been used to support small states' exports. Trade preferences explicitly recognise that some countries cannot compete at internationally competitive prices and are guaranteed a price higher than the world price to offset the higher costs entailed in producing or transporting exports to the market. While this arrangement has historically been very important (banana and tuna from the Caribbean to the European Union, and sugar from Fiji to the European Union, and clothing to the United States and Australia), other developing countries have challenged these special arrangements and the WTO regime makes them difficult to retain in the global trading system.

Trade integration among small countries is another commonly proposed solution to the problems raised by small market size and the related problems of scale and specialisation. However, when free trade agreements are formed between only small states, as is the case under the Pacific Islands Countries Trade Agreement (PICTA), the resulting trade policy is suboptimal and can promote welfare losses. This happens because the tariffs on the largest share of imports are unchanged because they come from outside the agreement and small countries usually do not satisfy each other's demands. This leaves the potential for welfare-enhancing trade creation unexplored, while trade diversion (from the efficient trading partner outside the free trade

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[16] Winters and Martins, 2004.

agreement to the inefficient trading partner within the agreement) continues, thus reducing welfare.[17]

GOOD POLICIES THAT COULD HELP SMALL ECONOMIES REDUCE THE DISADVANTAGES OF HIGH COSTS DUE TO SIZE AND REMOTENESS

The first of these is the converse of the selective and restricted free trade arrangements that small states often enter into. Expanding them to include all trading partners is beneficial because trade can then be pursued with the globally most efficient producer. This will result in lower prices and higher welfare.

Concentrating on finding niche markets for exports, rather than attempting to enter markets characterised by global price competition, is also good policy. For the vast majority of manufacturing and unfortunately even service industries, for which the small island states are at a disadvantage, finding a way to differentiate the product or service so highly as to allow them to charge well above market prices is the surest way to sustain economically productive onshore activities (examples being Fiji water and Maldives tourism).

Two important caveats are in order on this point. First, governments should not get into the business of identifying which niche markets should be developed, as the record of bureaucrats 'picking winners' is not very promising. Niche markets thrive when private agents pursue investment in a market-based activity on the basis of expected profits. Second, the role for governments in developing niche markets should be as a facilitator, such that infrastructure or regulatory constraints to the development of a niche market are reduced. This simply means that governments should not be distracted from their core mandate of instituting reforms that improve service delivery to the private sector.

Another viable strategy is to actively pursue the main sources of revenues such as those from fishing licences or timber. Several small island states are surrounded by plentiful marine resources. However, overfishing, poor negotiations in international arrangements and corruption prevent these revenues from being raised to their maximum potential or from being distributed equitably within the economy. Unsustainable logging also puts a finite limit on forest revenues and, as in fishing, powerful special interest groups prevent the establishment of a transparent framework for exploiting resources. Improving the returns from these activities is likely to yield large benefits to the citizens of small states. Hence, reforms in these sectors should be a matter of immediate priority in the Pacific.

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17 World Bank, 'Embarking on a global voyage: trade liberalization and complementary reforms in the Pacific', *Pacific Islands Regional Economic Report*, 2002.

NEW IDEAS WORTH PURSUING

The third group of policies requires serious reconsideration on the part of the Pacific community, bilateral donors and multilateral institutions. If we recognise that the problems of small states are systemic, any real long-term solution will have to take on at least three difficult issues requiring possibly bold responses that may make political leaders, as well as the citizens of this region, somewhat uneasy. These are increasing labour mobility, outsourcing government functions, and rethinking the nature of aid and the manner of its delivery.

The economic benefits of liberalising the movement of labour have been estimated to completely overshadow the potential gains to welfare to the world economy that would result from further liberalising the movement of goods. Whereas world incomes would increase by 2 per cent if progress in liberalising agriculture were achieved, global incomes would double if labour were fully mobile.[18] The World Bank's report *Global economic prospects 2006* estimates that, if labour mobility allowed the workforce in high-income countries to increase by 3 per cent by 2025, global real income could increase by 0.6 per cent, or US$356 billion.[19] Though this number represents less than 1 per cent of world GDP, it is three times larger than all official development assistance and far greater than the estimated gains from all proposed remaining trade liberalisation (US$104 billion).

This is significant, but also raises equally significant social and political concerns, which realistically place the multilateral liberalisation of labour movement beyond the realm of feasibility in our lifetimes given the global volume of potential migrants. However, the populations of small states, and micro-states in particular, are unlikely to pose immigration issues that would overwhelm recipient nations. And the majority of citizens of small states may not even want to migrate, which should be reassuring to those worried about depopulation of small states and their traditional cultures. Many might choose to work abroad but consume at home if legal arrangements were put in place that allowed it.

Recent evidence on the size of remittances and their positive impact on poverty and income distribution in recipient communities is quite persuasive. Remittances to the Pacific are quite substantial due to strong family and community ties, have served to reduce poverty and improve education and health outcomes, and functioned quite well as an instrument of social protection for vulnerable populations.[20] Also, remittances do not seem to bring about the same detrimental effects of overvalued

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[18] L Pritchett, *The future of migration: part one and two*, Yale Center for the Study of Globalization, 2003.

[19] World Bank, *Global economic prospects 2006: economic implications of remittances and migration*, Washington, DC, 2005.

[20] World Bank, *The economic case for promoting labor mobility in the Pacific region*, Washington, DC, forthcoming 2006.

exchange rates and reduced competitiveness of the traded sector as aid does, because they tend to move countercyclically with exchange rate trends.[21]

The labour mobility issue can also be placed within the context of the earlier recommendation of multilateral free trade arrangements in goods – which should be extended to services to expand the welfare gains, and to allow people to deliver these freely traded services. Coincidentally, because many large developed countries have aging populations and are in need of semiskilled or unskilled workers in labour-intensive industries, a labour exchange program within the region could provide a win–win outcome for all concerned.

Another issue for small states is the cost of providing public services to their citizens. A sensible approach to overcoming some of the costs of smallness is to pool capacity and resources, either among neighbouring small states if that translates into a viable service, or outsourcing some specialised functions to a larger provider in the region. Regional pooling to form institutions of higher education such as the University of the South Pacific is an example of the former. Outsourcing specialised functions, particularly those that have a large up-front fixed cost in terms of capital and expertise such as credit registries or regional aviation regulators (or other transportation institutions and perhaps even central banking institutions), would save small states the burden of setting up these institutions from scratch and outline a contractual agreement where services are provided and costed on a case-by-case basis.[22] 'After all, if integration (goods, services, fiscal) makes sense for Europe it certainly makes sense for small islands.'[23]

The rationale behind proposing these arrangements is ultimately to reduce the per unit costs of sovereignty or 'border costs' by promoting economic integration with the large economies in the region. Bertram empirically tests the hypothesis that the per capita GDP of small island economies and their growth over time are explained to a large extent by two variables: the political–economic linkages tying each island to a corresponding metropolitan patron in the core of the world system, and the level of GDP in the metropolitan patron economy.[24] A one dollar increase in the per capita GDP of the metropolitan patron economy increases per capita GDP of its linked economies by 44 cents.

The study also points out that, for a sample of 22 Pacific island economies, sovereign independent states had an average per capita GDP of only US$1229 compared with US$2187 for territories in free association with the United States or New Zealand (such as Cook Islands) and US$22 615 for territories that were politically integrated

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21 RG Rajan and A Subramanian, *What undermines aid's impact on growth?*, Working Paper, International Monetary Fund, 2005.

22 Outsourcing or pooling Central Bank capacity through a common currency has also been a subject of some debate and discussion in the Pacific.

23 R Hausmann, M Braun and L Pritchett, *The proliferation of sovereigns: are there lessons for integration?*, Harvard University, 2002.

24 G Bertram, 'On the convergence of small island economies with their metropolitan patrons', *World Development*, vol. 32, 2004, pp. 343–64.

with France or the United States (such as French Polynesia and Hawaii). The reasons for this wide variance probably reflect the issues of limited market size, economies of scale and specialisation that independence poses for small economies, coupled with the large fiscal transfers and provision of several government services where there is political integration with a larger economy. While political integration for the Pacific island countries is not a realistic proposition, the moot question is whether aspects of economic integration that are associated with political integration can be replicated in a way that alleviates some of the constraints that size imposes in order to deliver the positive income benefits to their citizens.

Aid flows into small states are quite large and the Pacific region receives some of the highest per capita aid figures in the world. This aid has several objectives: humanitarian, transitional, capacity building and budget support for recurrent as well as development expenditures. However, even in countries with good policies, there appears to be no robust relationship between aid and growth. This places into question the previously held view that aid would be effective if policy settings were appropriate, which means that governance and capacity issues alone do not explain the poor record of aid.

A recent paper points to various channels through which aid could undermine long-term growth – by weakening institutions as well as causing a deterioration in the country's competitiveness.[25] Aid can weaken institutions by creating a culture of dependence where aid recipients become lax in raising tax revenues. By expanding the government's resource envelope, aid can relax its need to explain its actions to the public, which ultimately dampens governance structures overall. Aid also undermines the competitiveness of the traded goods sector by strengthening the nominal exchange rate (under a flexible exchange rate regime) and pushes up the price of factors of production (under a fixed exchange rate regime). In either regime, the traded goods sector becomes less competitive. This is a concern, especially where the traded goods sectors could be labour intensive and provide employment in labour-surplus economies. By compromising the competitiveness of traded goods, not only are employment and growth trajectories affected, but also the potential for productivity improvements through exporting. Not least is the loss of a class of entrepreneurs that usually demand good government policy. Separately from its impact on the exchange rate, public sector projects financed by aid can attract scarce skilled labour away from the productive sectors of the economy to the detriment of long-term growth. These factors are not necessarily arguments to reduce the volume of aid, but they do raise the bar on the quality of government spending financed by aid. If such spending is highly effective, the productivity improvements generated by aid can offset the adverse effects from a fall in competitiveness.

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[25] Rajan and Subramanian, 2005.

For instance, it may be better to use the aid to compensate for these adverse effects by building up a supply of critical resources that will be needed to use aid effectively such as a larger body of skilled workers. Providing additional human resources to cover services and functions for which local skills are scarce is likely to be of particular value, more so if local people can be trained in the process. Pursuing economic growth entirely through traditional aid mechanisms may frustrate the donor community and continue the fallacy that aid can replace or even catalyse home-grown development by simply making the requisite attempts to institute monitoring mechanisms. In fact, from all accounts, it may delay it and hence new modes of delivery will have to be found.

> As the developed world has finally started gathering the political will to do something about the blight of poverty, it will be a shame to fritter this will through grand schemes that repeat the past, though only a little better. Instead it makes sense to adopt a more experimental approach … paying attention to delivery mechanism, incentives, and spillover effects, and allowing aid recipients to develop their own approaches while sharing experiences about what works.[26]

SUMMARY MESSAGES

The above discussion implies that there are a few important messages for all parties involved in articulating a vision and a strategy for improving the lives of Pacific islanders over the next 15 years.

For the Pacific island communities and policymakers, it is important to recognise that policy and institutional shortcomings can be significant and detrimental to sustaining economic growth. Given the natural disadvantages facing the Pacific island countries, and the intensification of global competition in goods, capital and skills, the premium on sound policy settings and well-functioning institutions may be particularly high. At the same time, given capacity constraints, the pay-off from identifying and acting on critical constraints to growth also appears to be high. Hence, a customised set of reforms that are context specific will need to be identified and pursued in order to fuel economic growth. In this context, addressing the binding constraints that impede sustainable revenue generation from sectors such as fishing, agriculture, forestry and mining should be a high priority. The Pacific island countries will need to make a concerted effort to adopt institutional arrangements that work well for small countries such as pooling regional capacity and resources where possible to reduce the already very high transactions costs facing these individual small entities. The countries would benefit greatly from committing to regional integration, which necessarily entails opening up their own markets to inflows of goods, services and labour from the region. In addition to the effort and ingenuity in policy design, a continuous process of self-assessment will need to be followed in order to implement

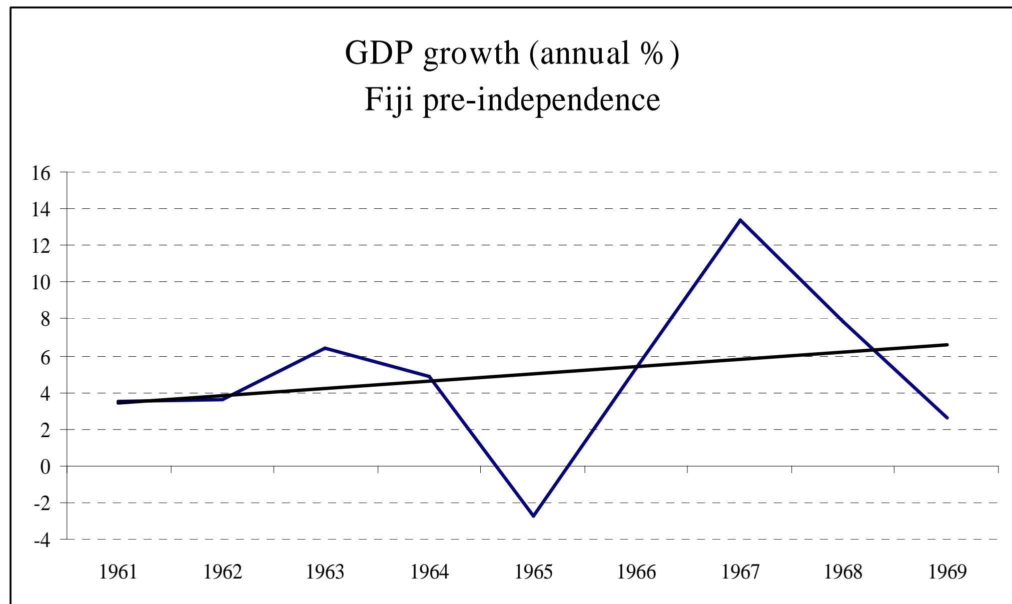
[26] Rajan and Subramanian, 2005.

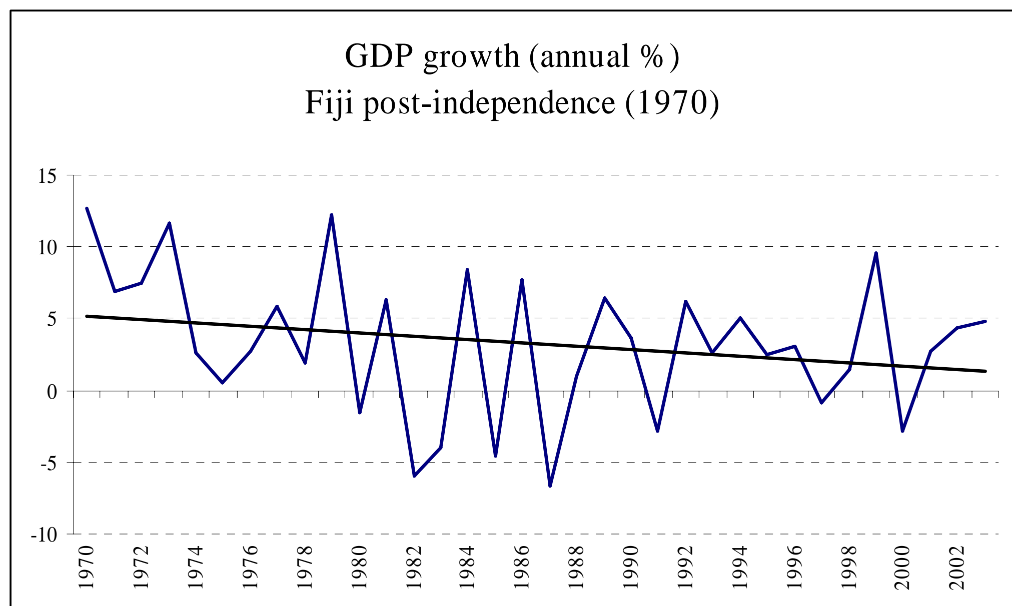
a successful reform agenda that stays relevant to the changing regional and global economic environment as well as local capabilities.

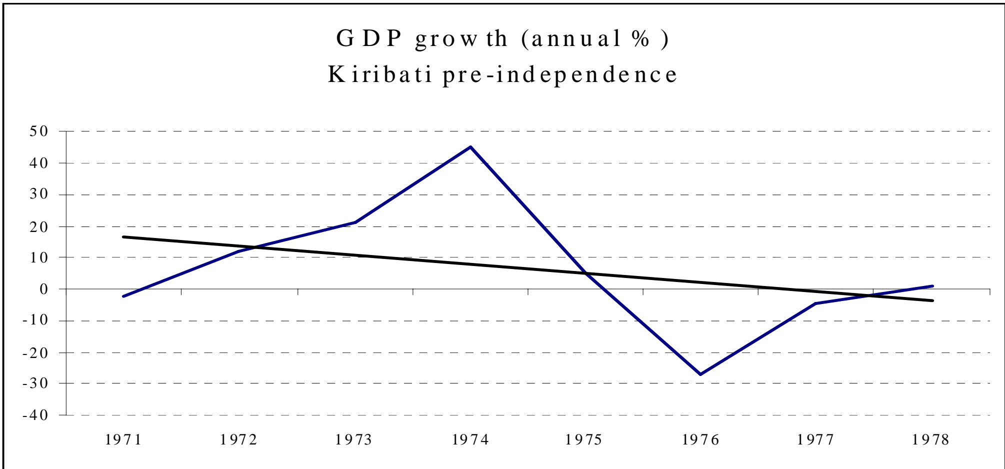
Donors that provide the bulk of the aid flows need to recognise that aid can have detrimental as well as positive effects on growth and welfare. Hence, there is a need to deepen the understanding of aid's impact on growth in order to decide whether and how a restructuring of aid flows may be warranted to enhance their net impact on long-term growth. As part of the process of rethinking aid delivery mechanisms, the effects of geography and size on transaction costs in the micro-states, and consequently the rather limited ability of aid to translate into improved competitiveness of some island states, need to be recognised. For neighbouring donors, the prospects of a fuller regional integration with the Pacific in terms of goods and services needs to be explored as a necessary and useful complement to aid. Integration may include allowing Pacific islanders to access their labour markets, particularly as shortages of skilled and unskilled workers continue to be the norm.

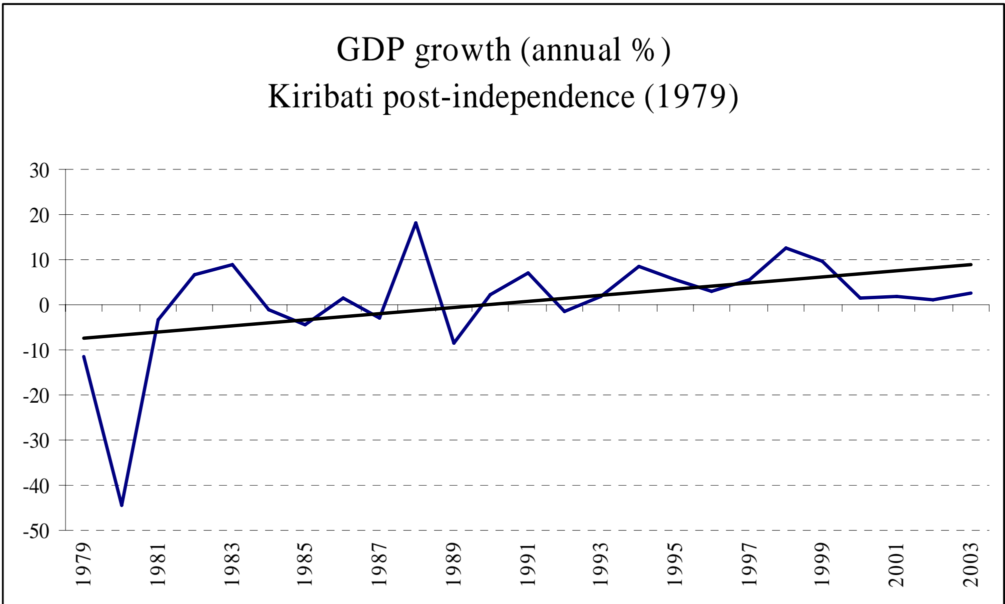
And for the multilateral development institutions engaged in the Pacific, whose financial transfers to the island countries are small compared with the bilateral donors, the message is to stay engaged by offering sound policy advice and objective technical analysis to shape and inform the debate – on igniting growth and elevating income, and on developing and deepening institutions. Global development institutions should focus on customising technical assistance for designing and implementing domestic policy reforms in the Pacific as well as facilitating global arrangements by working closely with the bilateral donors whose resources could be leveraged effectively in the Pacific. These institutions would do well to harvest lessons and relevant insights from other regional experiences in pooling public goods or providing infrastructure to alleviate the constraints in the Pacific imposed by geography – and in some cases their history.

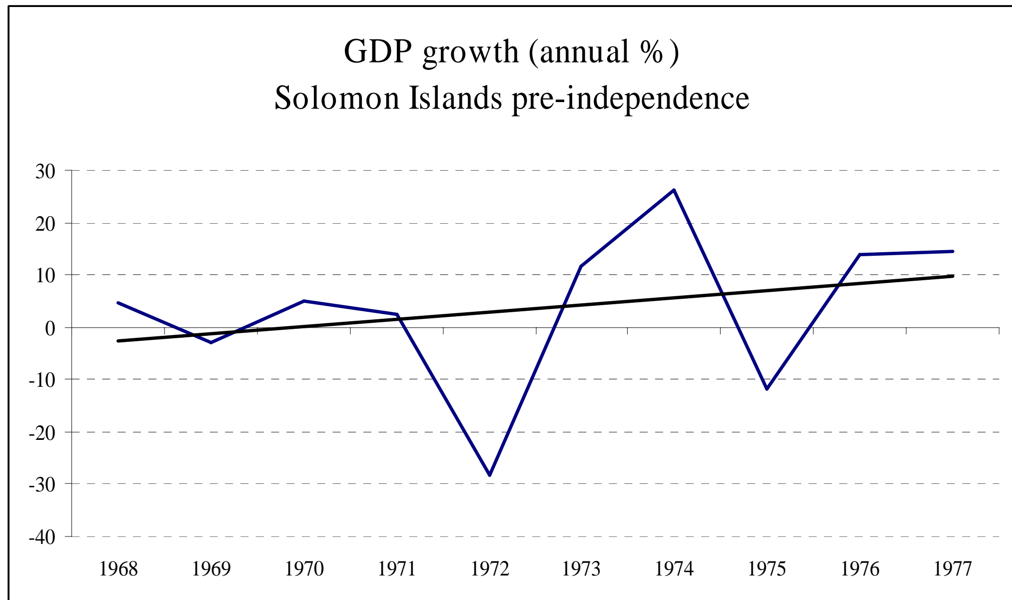
APPENDIX: PRE-INDEPENDENCE AND POST-INDEPENDENCE GROWTH IN PACIFIC COUNTRIES

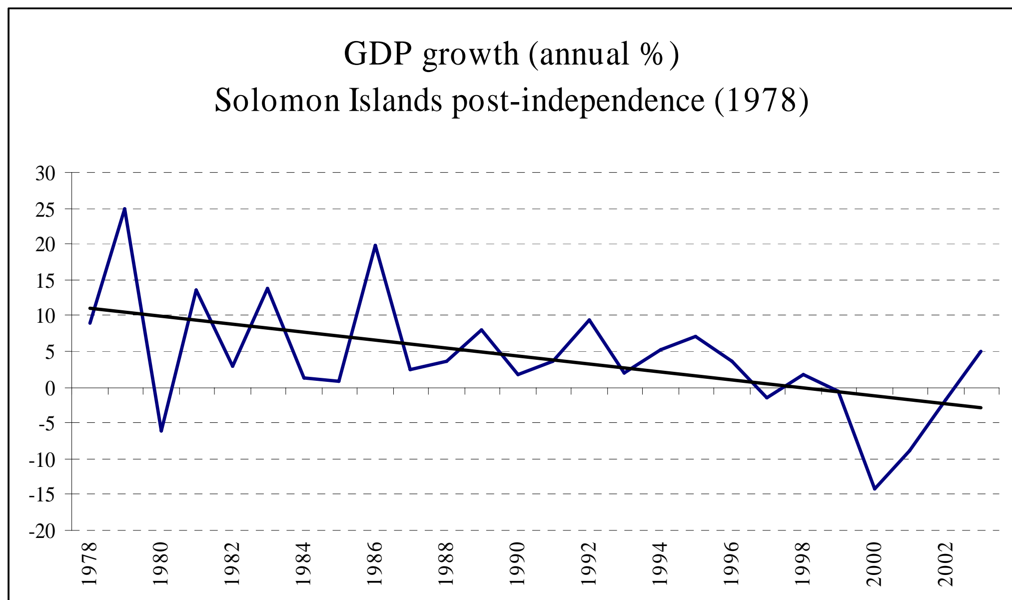


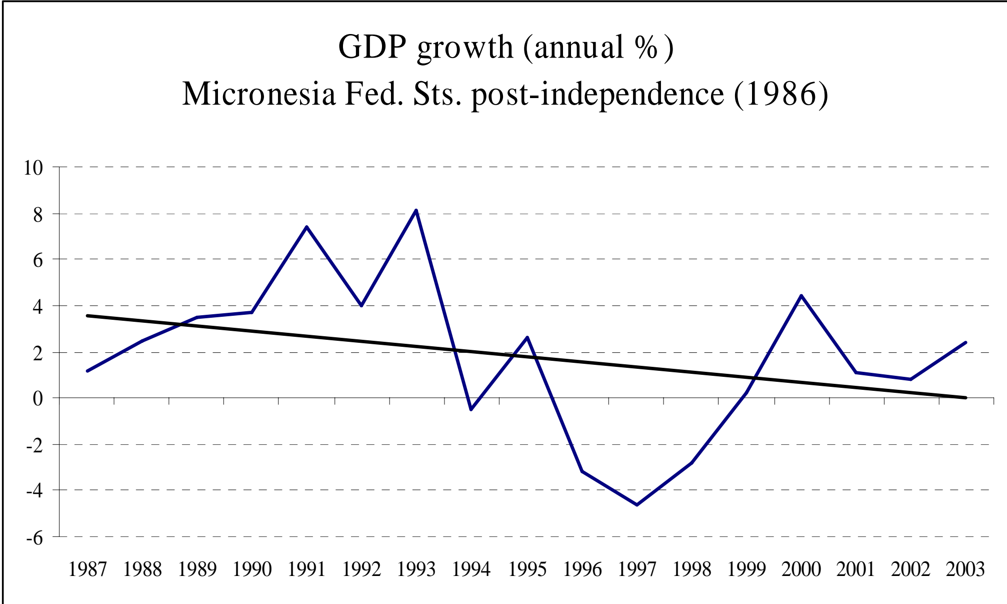


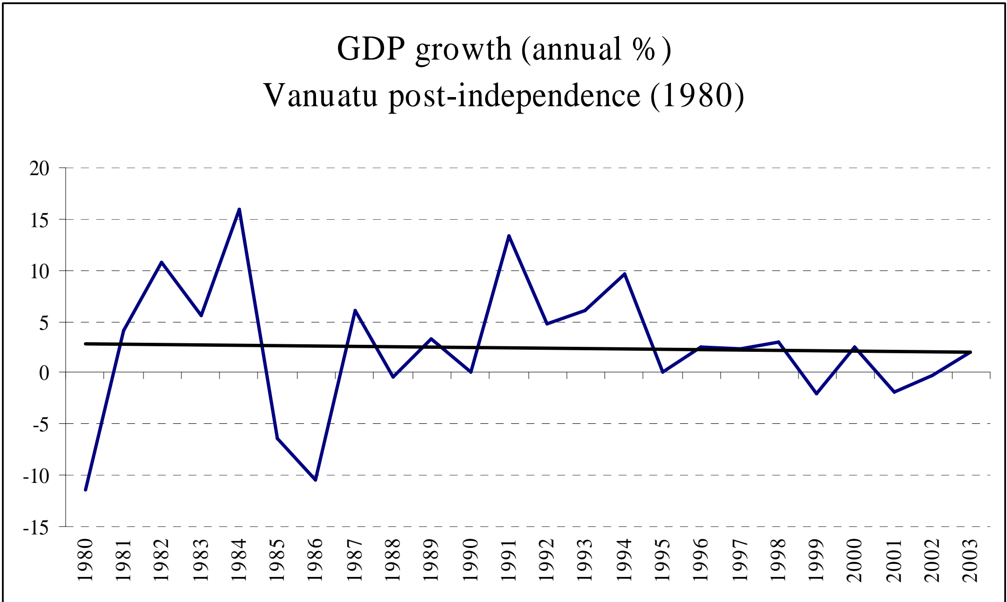

GDP growth (annual %)
Kiribati pre-independence
50
40
30
20
10
0
-10
-20
-30
-40
1971
1972
1973
1974
1975
1976
1977
1978

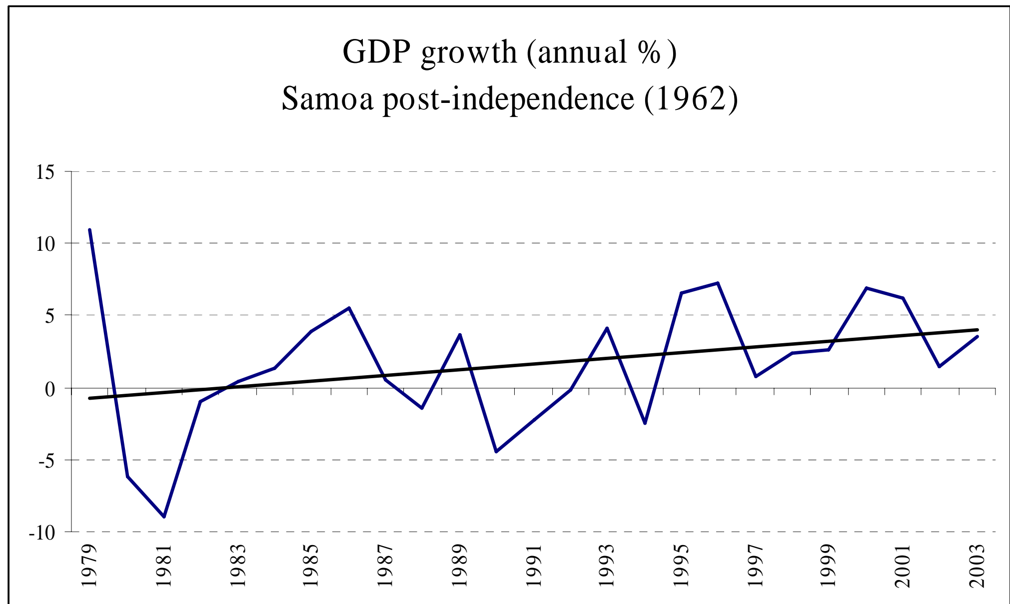

GDP growth (annual %)
Kiribati post-independence (1979)
30
20
10
0
-10
-20
-30
-40
-50
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003

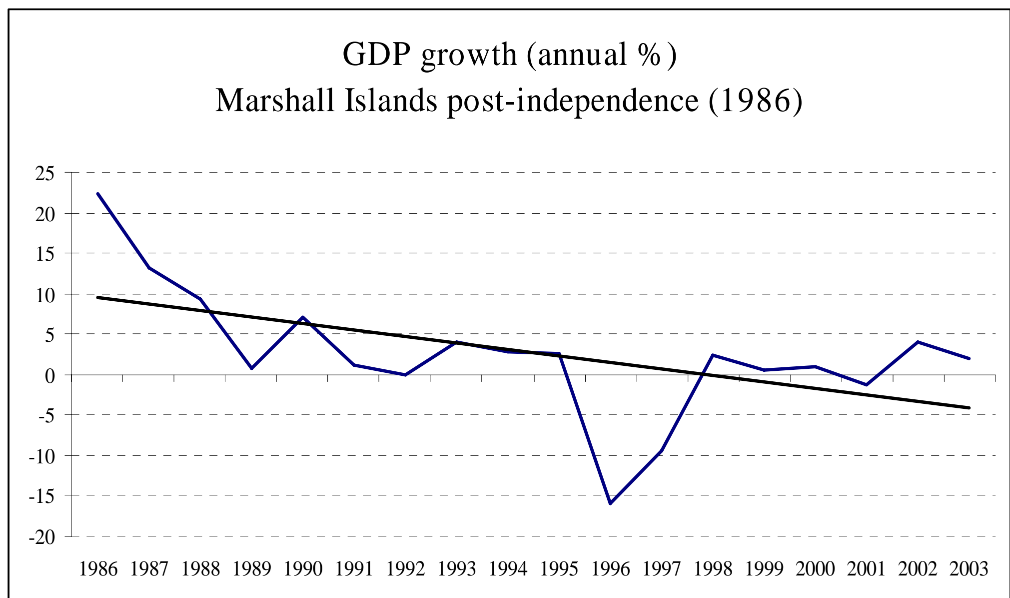

GDP growth (annual %)
Solomon Islands pre-independence
30
20
10
0
-10
-20
-30
-40
1968
1969
1970
1971
1972
1973
1974
1975
1976
1977

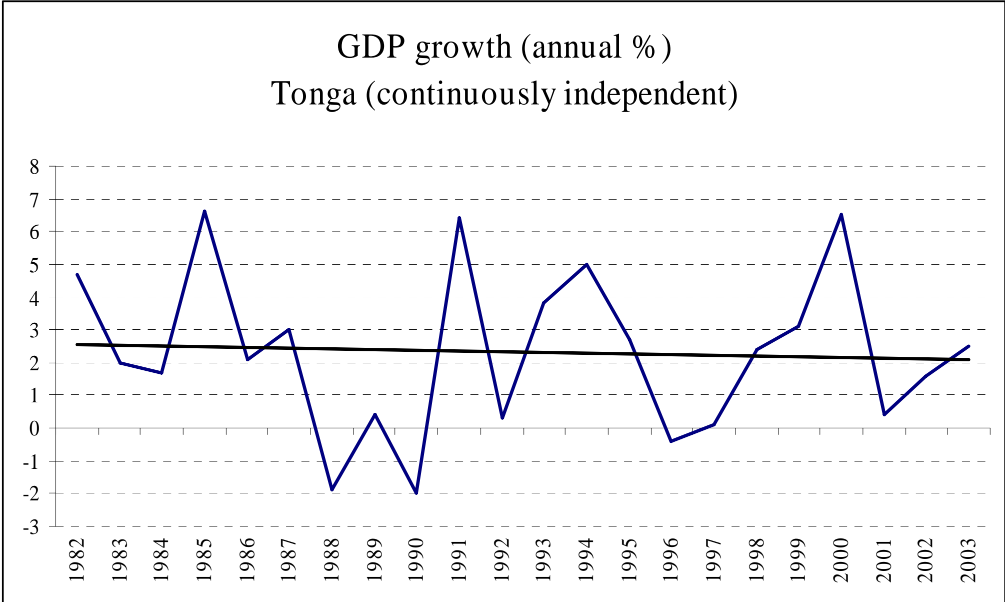

GDP growth (annual %)
Solomon Islands post-independence (1978)
30
25
20
15
10
5
0
-5
-10
-15
-20
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002


GDP growth (annual %)
Micronesia Fed. Sts. post-independence (1986)
10
8
6
4
2
0
-2
-4
-6
1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003


GDP growth (annual %)
Vanuatu post-independence (1980)
20
15
10
5
0
-5
-10
-15
1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003


GDP growth (annual %)
Samoa post-independence (1962)
15
10
5
0
-5
-10
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003


GDP growth (annual %)
Marshall Islands post-independence (1986)
25
20
15
10
5
0
-5
-10
-15
-20
1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003


GDP growth (annual %)
Tonga (continuously independent)
8
7
6
5
4
3
2
1
0
-1
-2
-3
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
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2002
2003