PACIFIC ISLAND COUNTRIES

ANALYTICAL REPORT FOR THE WHITE PAPER ON AUSTRALIA'S AID PROGRAM

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Executive summary

Australia has important humanitarian and strategic interests in the Pacific region. These are best protected by a prosperous region in which governments discharge their domestic and international obligations. These obligations include providing an environment conducive to investment (domestic and international), ensuring sound governance (including protection of property rights and the accountable collection and expenditure of revenues) and ensuring that prosperity is shared (particularly through providing equitable access to basic services).

The Pacific region's performance over the past decade has been weak. Social indicators suggest there is regression in health and poverty outcomes, that youth unemployment is rocketing and that the rapid urbanisation taking place has many unhealthy outcomes. Basically, the region is not on track to meet the Millennium Development Goals (MDGs). The root cause is a failure of the Pacific Island Countries (PICs) to grow at a rate that will lead to sustained increases in living standards for all. Substantial aid flows have mitigated the impact of this weak performance, but it appears they have done so at a cost.

PICs face a wide range of factors that make achieving robust and stable growth an uphill struggle. Their small size and remoteness mean that over the long term they must rely on niche market opportunities, rather than preferential market access for uneconomic activities. They are mostly newly independent countries still coming to terms with the notion that a scattered collection of tiny islands can constitute a discrete state. They are vulnerable to climatic and trade shocks. In a rapidly globalising world, they have major disadvantages. Yet for most PICs, these obstacles are surmountable, as other nation states facing similar challenges have demonstrated.

The key problem for PICs is they have not taken control of the factors that will determine their fate. Their political governance is weak. Policies are not credible. Political systems have in-built instability. Public sectors are mostly too large and inefficient, often due to support from aid inflows. There is minimal accountability and high levels of corruption. Economic governance is also fragile, with few of the institutions that are essential for creating robust social and public capital to support market-based activities. There are high barriers to trade and investment, high levels of monopoly practice, and a preponderance of inefficient state-owned enterprises dominating some of the most important markets in the region, including telecommunications and power. Poor and obfuscatory regulations, underdeveloped financial markets (particularly in relation to land) and ineffective infrastructure complete a sorry picture for potential investors.

If PICs are to reach the growth rates necessary to achieve shared prosperity and stability, significant changes are required. Sound, locally owned policies need to be developed, backed by strong, locally-designed institutions to support market-based activity. Most importantly, greater openness to external and internal trade, investment, and labour mobility is needed. However, PICs need to receive similar treatment from their trading partners.

Donors have a vital role to play. They have the technical knowledge to support important reforms, and the financial capital to provide transition costs in areas such as basic services. Yet their record in the region, by their own admission, is unsatisfactory.

Newly announced donor strategies rightly acknowledge the need to change, and recent announcements in the area of supporting private sector development suggest progress will be made. But there is no room for complacency. There are strong indications that significantly more aid will be spent in the region over the next decade, including by new donors such as China and Taiwan. This could make a crowded field even more congested, further diluting domestic pressures for change.

For Australia, perhaps the most important donor to the region, this requires changes on several fronts. Programs in the region must be more clearly focused and targeted on achieving high levels of growth and removing the constraints—including weak political governance—preventing poor people from benefiting. It means increased investment in human capital, particularly in education. It may also mean taking a lead role in public sector reform, reflecting Australia's own experience in this area.

Process must also change, including better alignment of program activities with national policies. Australia needs to work harder to become a genuine partner to the region. Heavy dependence on Australian technical assistance as the primary delivery option needs to be reconsidered. A much tighter focus on performance management and research is needed, because too little is known about what changes must be made and how to make them. Investing in better, independent statistics on development outcomes is required. More effort is needed on the process of donor coordination, both through strengthening domestic aid coordination capacities and through high-level relationships with new and traditional donors, such as Japan and China, whose presence in the region could frustrate attempts to encourage change. More structure will also have to be brought to the support of regional approaches. Finally, building on the early work in Pacific 2020, more resources must be dedicated to research on the region.

1. Why is the Pacific Islands region important for Australia?

This section looks at Australia's motivation for being engaged in the Pacific Islands region. It notes that because of strong historical and cultural links Australians care about the welfare of the islands. Such concern is demonstrated during appeals for assistance in the face of natural disasters. New pressures on the region, including from globalisation and, potentially, climate change, strengthen this concern. The section also notes that, in the wake of increased apprehension about international crime, terrorism and global pandemics, the region's stability is inextricably tied to that of Australia.

Historic and cultural links

In its 2003 White Paper, Department of Foreign Affairs and Trade (2003) notes that:

> History has tied Australia intimately to the nations and peoples of the South Pacific. Australia helped to shape some of the island states as they became independent—their economic bases, power-sharing arrangements between the centre and the provinces, and philosophy of governance. And in some cases we passed on our institutions and the ideas underpinning them—constitutions, parliaments, public services, legal systems, and security forces.

Strong sporting links, and a substantial diaspora from the islands living in Australia, further consolidate this relationship. Moreover, hundreds of thousands of Australians holiday in the region. Together, these forces create a strong public concern for the peoples of the Pacific.

Shared prosperity

These historical and cultural links also underpin a humanitarian concern. Strong support for disaster appeals is one manifestation. So is the Australian Government's substantial aid program (A$463 million). This humanitarian concern will probably grow as the extent of poverty—now thought to be around 20 per cent of the population—is more widely realised. Concern about the potential negative consequences of globalisation and climate change will likely strengthen the humanitarian dimension of the relationship.

Credibility

As other powers have withdrawn from the Pacific, Australia is increasingly expected by the international community to take a lead role in maintaining stability. The aid program makes no bones about this. The current Minister for Foreign Affairs states in the introduction to AusAID's regional aid strategy (2004) that there is '…a strengthened realisation that a porous and under-developed region is neither in the Pacific's or Australia's interest'. It follows that the performance of the region reflects upon Australia's implicit responsibility.

Commercial

Despite being a main exporter to the region, Australia's commercial reliance on the region is not substantial. Merchandise exports in 2004 were worth A$624 million, and imports were valued at A$319 million (ABS, 2005). These represent around 0.5 per cent of Australia's total exports and 0.25 per cent of its total imports. Services trade is insignificant, except to Fiji, which takes services exports of A$129 million and provides services worth A$417 million in return.

Stability

The stability of the Pacific region has always featured highly in Australian foreign policy. Prior to current concerns about terrorism, the region was a focus of cold-war politics. International concern about boat people, money laundering and drug running also influenced Australian policy. Today, international concern about regional stability focuses on a growing appreciation of the risks presented by what have become known as 'fragile states' (Box 1). These risks can impact negatively on the livelihoods of the populations of the fragile states themselves, and on neighbouring countries, including Australia. Such risks include: threats from criminal gangs using weak states as entrepots for entry to Australia, for example for smuggling narcotics and arms; trans-boundary implications from the failure to manage effectively the spread of diseases such as SARS and Avian Flu; and, more speculatively, the threats posed by hostile powers establishing a foothold in the region.

Box 1: Views on the fragility of the PICs

The recognition that there is a group of states that has proved largely unresponsive to donor-led reforms has inspired a growing body of research into how the outcomes can be improved. The range of definitions of unresponsiveness is large and complex. Nonetheless, the core definition is that the countries concerned have governments unable or unwilling to use resources to encourage growth and reduce poverty. Changing this is important for humanitarian reasons, to enable Pacific peoples to participate fully in economic activities and thereby lift their living standards considerably, and for reasons of political and economic stability.

Early in the evolution of research into state fragility, the countries initially highlighted included Afghanistan, the Sudan and Liberia. As awareness grew of the underlying issues that contributed to fragility, the list of countries grew. It now includes more than one-third of the PICs. In addition to Solomon Islands, which features on most lists, Tonga, Kiribati and Vanuatu have been identified by the World Bank as at risk, through appearing in the lowest two quintiles of their Country Political and Institutional Assessment rankings. Fiji is identified by Robert Rotberg, author of *Why States Fail*, as a weak state, because of its perceived inter-communal antagonisms. The non-appearance of Nauru in these definitions probably results from a lack of data rather than a perception that it is not at risk.

Outline of the report

This report is in six sections. Following this introduction, section two summarises the recent economic performance of the region. Section three explains what lies behind this performance. Section four considers the prospects for the region over the next decade, and posits what would be needed to attain strong, sustained five to seven per cent growth—the level required to raise living standards substantially. Section five asks how donors as a group can support such an ambitious growth target. Finally, section six considers Australia-specific opportunities to support this growth target.

2. Recent economic performance in the Pacific Island Countries

The thrust of this section is that:

- with few exceptions, per capita growth in the PICs has been negligible, even negative
- governments are getting into more debt, without much to show for it in terms of more productive economies
- social indicators suggest serious slippage, notably in the areas of poverty incidence and health standards
- there are significant disparities between rich and poor and between urban and rural areas (including outer islands) with respect to service delivery
- youth unemployment is high in many countries and likely to worsen
- rapid rural-urban migration, combined with poor job creation, is leading to significant problems in local government
- there are signs of increasing social problems in several countries related mainly to high youth unemployment, including youth suicide, crime, and disintegration of traditional support systems.

The economic performance of the PICs between the second half of the 1990s and the first half of the 2000s varied considerably from country to country (Table 1). Cook Islands, Fiji, Kiribati, Samoa, Tonga, and Tuvalu all had positive per capita GDP growth during this period, while Marshall Islands, the Federated States of Micronesia (FSM), Solomon Islands, and Vanuatu experienced negative per capita GDP growth, on average. Global cross-country research has shown that per capita income growth rates have to be above two per cent for poverty to be reduced (Dollar and Kraay 2001). If this result holds in the PICs, only Cook Islands (6.5 per cent) and Samoa (3.1 per cent) would have made inroads into poverty reduction over the past decade. In countries with per capita GDP growth below two per cent (Fiji and Tonga) and countries with negative per capita GDP growth rates (Marshall Islands, Solomon Islands and Vanuatu), poverty is likely to have worsened. The civil unrest in Solomon Islands and the coup in Fiji can be blamed for a substantial part of the poor economic performance of these countries. While aggregate income in several countries has been stagnant, inequality has risen. The Gini coefficient for Marshall Islands, for example, is amongst the highest in the world. The basic arithmetic of this implies that those at the bottom of the income ladder must have seen a sharp decline in their income.

How have the PICs done by comparison with other developing countries? Comparisons are in Table 1. The average 1995–2003 per capita GDP growth rates of the Low Income, Lower Middle Income, and Low and Middle Income countries are all higher than that of the PICs (0.7 per cent average for 1995–2004), which suggests PICs are not doing as well as many other developing countries. The small economies of the Caribbean are widely used as comparators for PICs. For the 12 Caribbean countries for which World Bank per capita GDP data are available, the average per capita GDP growth rate for the period 1970–2003 (not all countries have data covering the full period) was 2.8 per cent. For the ten PICs for which these data are available, the average per capita GDP growth rate was one per cent. For the period 1995–2003, the average for the Caribbean countries was 1.6 per cent, compared to the 0.7 per cent average for PICs for 1995–2004.

The economic performance of Cook Islands improved substantially following the comprehensive economic reform program begun in 1996, moving from a negative GDP growth rate in 1995 to a positive 5.8 per cent in 1998 and 13.9 per cent in 2000. Its performance since then has been less impressive, with GDP growth rates in the three to five per cent range. Cook Islands' population has declined at an annual rate of 3.4 per cent over the past ten-year period because of emigration, resulting in a very high rate of per capita GDP growth.

Samoa had two years of six to seven per cent GDP growth in 1995 and 1996 and another two years of growth at similar levels in 2000 and 2001. The economic reforms undertaken in the 1990s, such as tariff reductions, adoption of the Value Added Tax (VAT), liberalisation of the foreign investment environment, and public sector reform, appear to have played a role in the reasonably good performance over the past decade. Drought and the downturn in tuna harvests help explain the disappointing GDP growth of one to three per cent since 2001. However, there are signs of backsliding on reforms in the investment environment and in economic management.[1]

While per capita GDP growth in Kiribati has been reasonable, the Kiribati economy is primarily services (75 per cent). Moreover, public administration is the major part of the services sector and the only component of the economy that has grown (doubling over the past decade in current dollar terms). Thus the Kiribati economy is largely driven by aid, fishing licence fees, trust fund revenues, and remittances, with most of these funds supporting growth in the public service.

The economy of the Solomon Islands suffered a considerable decline during 1999 to 2002 as the result of civil unrest. The economy is recovering following the regional intervention that stabilised the security situation. However, at recent rates of GDP growth, it will take 20 years just to recover to the output levels before the civil unrest. Improvements in performance across all sectors of the economy are needed to generate the rapid growth needed to improve living standards rapidly and reduce the likelihood of future domestic conflict. A particular challenge will be how to replace the revenue from unsustainable logging, which accounts for half of the current five per cent GDP growth.

Vanuatu has experienced considerable political instability in recent years and averaged only one per cent GDP growth during 1995 to 2004, which translates into an annual per capita GDP decline of 1.6 per cent over the past decade. Seventy-five per cent of the Vanuatu economy is recorded as services—a large part of which is public administration. As elsewhere, macro-economic stability has been achieved relatively easily in Vanuatu. In 1998, when the Comprehensive Reform Program was introduced, the fiscal deficit was 10 per cent. In 2004, the government budget recorded a surplus of 1.1 per cent. However, achieving micro-economic reform has proven difficult. Moreover, the level of the exchange rate favours the small urban sector while penalising the export prospects of the majority living in rural areas.

Only 15 per cent of the economic output of the Marshall Islands is contributed by agriculture and manufacturing. Of the remaining 85 per cent of GDP, the public service and state-owned enterprises form the bulk. Hence, the economy is basically funded by the aid funds distributed under the Compact of Free Association with the United States.

[1] The International Finance Corporation's *Starting a Business* database says it takes on average 73 days to set up a business in Samoa, compared to the regional average of 51 days. The average time for Fiji is 45 days and Vanuatu 39 days.

Table 1: Key economic statistics of selected PICs and international comparators, 1995–2004

Country	GDP growth 1995-2004 (%)	Population growth 1995-2004 (%)	Inflation 2003	EEZ[a] (km^2) (thousands)	Estimated population (thousands)	Per capita GDP growth 1995-2004 (%)
Cook Islands	3.1	-3.4	2.4	1,830	18.4	6.5
Fiji	2.6	1.0	4.2	1,135	819.0	1.6
Kiribati	4.1	1.8	2.6	3,550	87.4	2.3
Marshall Islands	-2.0	2.6	1.2	…	56.6	-4.6
FSM	-0.5	0.1	-0.3		107.5	-0.6
Nauru	…	2.4	…	431	…	…
Samoa	4.1	1.0	0.1	96	177.7	3.1
Solomon Islands	-0.8	2.7	12.5	1,116	490.0	-3.5
Tonga	2.2	0.5	11.6	596	101.0	1.7
Tuvalu	3.3	1.3	3.3	857	10.9	2.0
Vanuatu	1.0	2.6	3.0	857	202.2	-1.6
Caribbean countries	1.6					
Low Income Countries	3.2					
Lower Middle Income Countries	3.6					
Low and Middle Income Countries	2.3					

Notes: a : EEZ - Exclusive Economic Zone, … Data not available.
The per capita GDP growth rates for the Caribbean, Low Income, Lower Middle Income, and Low and Middle Income countries are for the period 1995–2003.

Sources: ADB (2004) *Key Indicators 2004*; ADB (2005) *Asian Development Outlook 2005*; World Bank, Online Database.

2.1 Fiscal deficits and debt

The budget deficits of most PICs widened in the late 1990s and early 2000s and increased budget deficits have led to increased public debt burdens. Propping up loss-making, state-owned enterprises is a major reason for the increased budget deficits, as is the inability of governments to generate revenue increases sufficient to match the needs of fast-growing populations. In some cases fiscal deficits have been financed by external borrowings. For example, Tonga's external debt/GDP ratio increased from 42 per cent in 1998–99 to 53.5 per cent in 2002–03. In other cases there has been 'public capture' of national provident funds. For example, in Fiji, fiscal deficits have been primarily financed by borrowings from the Fiji National Provident Fund (of the F$2.5 billion of public debt in 2004, around 80 per cent was held by the fund). External debt in Fiji therefore remains at relatively low levels.

Fiji's net deficit stood at 0.6 per cent of GDP in 1999 but increased to 5.6 per cent of GDP in 2002. This increase resulted from the need to follow an expansionary fiscal policy to restore confidence and set the foundations for growth following the 2000 political crisis. Financing of the deficit led to a build up of debt, which stood at 37 per cent of GDP in 1999 but had increased to 47.7 per cent of GDP by 2002 and to 53.7 per cent in 2004.

External debt of Solomon Island increased almost four-fold during the period of civil unrest. Samoa's public debt rose significantly as the result of the losses made by Polynesian Airlines. However, in line with its other reforms of the public sector, Samoa reduced its debt/GDP ratio from 63 per cent in 1999–2000 to 47 per cent in 2003–04. Vanuatu's debt/GDP ratio has increased to 38 per cent as the result of the Vanuatu Provident Fund crisis and the financing of infrastructure.

2.2 Poverty in the Pacific

Analysis by the Asian Development Bank (ADB) of poverty in South Pacific countries, carried out over 2000 to 2003, concluded it is a significant problem in the Pacific. There are no time-series data available on poverty measures so it is not known how poverty has been affected by the poor economic growth of many PICs. Still, countries finding it difficult to maintain real per capita income levels, and which have increasing income inequality, are more likely than not experiencing increasing levels of poverty.

Poverty of a kind that means severe malnutrition and death, as seen in Africa and South Asia, is not present in the Pacific. However, poverty at a level that leads to difficulties in meeting basic needs in food, clothing and shelter, as well as severely limited access to education and health services, exists in urban and peri-urban areas, as well as in the more isolated and less fertile rural areas and in the outer islands. The ADB undertook substantial analysis of household income and expenditure surveys. While mostly dated, these showed significant levels of poverty below basic needs—ranging from 12 per cent of the population in Cook Islands to 40 per cent in Vanuatu and 50 per cent in Kiribati.

The ADB also undertook extensive surveys of the poor in eight of the Pacific states. These surveys revealed that the key concerns of poor people are insufficient job opportunities, unusable roads, deteriorating transport and other public services, and lack of safe drinking water. Not surprisingly, the poor want access to cash income-generating opportunities and to social services, especially primary education and health care. Pacific states with substantial proportions of their population living in dispersed, isolated communities present special challenges for development policy and development assistance.

The migration from Pacific countries to metropolitan countries can mean that costs of support for the poor are transferred to destination countries if migrants end up on welfare. For instance, a case could be made that New Zealand is contributing much more than is reflected in its aid budget in income support of Pacific Islanders.

2.3 Social indicators

A substantial challenge in reporting against social indicators is the paucity and weakness of data. Weaknesses include the lack of time-series data, incompatibility between national-level data, and the absence of intra-country information. Even where raw data has been collected, analytical resources are limited, so easy-to-use information is at a premium. A further concern is that, even when data exists, governments can be reluctant to release it when it suggests deterioration in standards.

In the face of these challenges, the South Pacific Community (SPC) and the United Nations Development Programme (UNDP) in late 2004 completed an analysis of the performance of the region against the MDGs. Whilst acknowledging the limitations in data quality and availability, the review revealed a mixed picture, with progress differing across the region. The report noted 'substantial progress' and indicated that the region was on track to meet some of the MDG targets. But it also recognised slow progress, particularly on health and poverty indicators. With health, the report warned of a reversal of gains.

MDGs for **gender** equality and the empowerment of women show the region still has progress to make to fully tap the economic potential of its women. Consistently, less than one-half of women are engaged in wage labour in the non-agricultural sector, with FSM and the Solomon Islands scoring particularly low. Only Fiji and Nauru have ten per cent or more of their seats in national parliament held by women. Solomon Islands, Tonga and Tuvalu have no women holding seats.

With respect to the **education** MDGs, FSM, Nauru, and Solomon Islands are some way from achieving universal primary enrolment. Also of concern are low levels of retention (grades 1 to 5) in Fiji, FSM and Samoa. New work by the World Bank has also thrown light on education outcomes. Studies undertaken in 2004 suggest that in English language tests for Year 4 students several countries had around 40 per cent of students at risk of failure, and even worse performance levels were reported at Year 6. The studies also suggest high levels of inequality in access to education services (the concerns expressed by the poor to the ADB). This is most pronounced at the secondary levels. In Vanuatu, for example, less than 20 per cent of children in the poorest fifth of the population attend secondary schools. Kiribati, Palau, FSM, Republic of the Marshall Islands (RMI), and Samoa have less than 50 per cent of poor children attending secondary schools. The goal of equal educational opportunity will likely not be reached.

With the MDGs on **health**, only Vanuatu is convincingly on track to achieve the target for under-five mortality (it has reduced the rate from 79 per 1,000 live births in 1989 to 33 in 1999). Life expectancy has improved across the region, with an average of 62 in Kiribati and up to 71 in Tonga, although the increasing incidence of so-called lifestyle illnesses could soon lead to declining life expectancy in some countries, such as Nauru. Fertility rates are also declining (although at a slower rate amongst poorer women). The impact of wealth on access to clean water is also revealed by the World Bank study. In Kiribati, at one extreme, only 30 per cent of the lowest quintile has access to safe water, compared to almost 100 per cent of wealthy families. Samoa, by contrast, has almost equal rates of access, as does Palau. Inequality is even more marked with access to improved sanitation—only in Palau and Samoa do more than one-half of the poorest households have access to improved sanitation, while poor families in Kiribati have almost zero access.

The number of reported **HIV** infections in PICs is low, at 956 (as at March 2005), with 278 deaths from AIDS reported as of June 2004. But the trend is upward and the reported data are almost certainly underestimates. The high prevalence of sexually transmitted infections, gender-based violence and other related risk factors increase vulnerability for HIV transmission. In addition to the usual vulnerable groups such as commercial sex workers, men who have sex with men, and young people, vulnerable groups include seafarers and uniformed services personnel (especially those participating in overseas peacekeeping missions). Moreover, with high youth unemployment and increasing drug use, the risks for further increases in infection are high.

The conclusion that Pacific states simply need to increase funding for these social sectors is not valid. Indeed, the World Bank report states that 'public spending on health and education are at par or above those for countries at the same level of development' and states are devoting more than a quarter of their public funds to health and education spending (World Bank, 2004). On a per capita basis, countries spend an average of US$79 on health services, and all countries except Vanuatu and Tonga report higher spending than the average for East Asia and the Pacific (US$48).

Much of this public funding is provided by donors. Fiji, FSM, RMI, Palau, Solomon Islands, Tonga, and Vanuatu spend more than half of their aid funds on social sectors. Simple analysis of the effectiveness of this aid suggests that donor funds do not have the significant impact on outcomes that might be expected (World Bank, 2004). This points to the detrimental impact the region's poor governance and policy environment has on outcomes. Indeed, where governance is poor, the impact of public spending on basic educational outcomes is almost zero.

2.4 Increasing urbanisation/squatter settlements

Rapid urban growth (up to five to six per cent per year) experienced in most PICs is the result of rural-urban migration. Reasons for this are not altogether clear but they do not appear to be related to positive factors such as rapid growth of employment in urban areas. The rapid urban-rural migration is more likely due to parents moving to urban areas seeking better education for their children because of the poor quality of education in rural areas, queuing for formal sector jobs, people being pushed out of communal areas because of low output productivity growth and high population growth, and young people seeking the bright lights of urban areas. With Fiji, the displacement of Indo-Fijian farmers after leases to sugar cane farms expired recently became a major contributor to the rural-urban migration and increased numbers of squatters.

In Polynesian and Micronesian countries, more than half the population will be living in the few urban areas within ten to 15 years. This migration is placing huge stress on local government resources, and especially on natural resources such as lagoons and freshwater lenses in the atoll island countries. The substantial growth of squatter settlements, particularly in Fiji, Marshall Islands, Solomon Islands, and Vanuatu, is posing major problems with access to land and supply of services. Local governments have to supply services such as garbage collection, water and sanitation to squatter settlements, which is raising questions about how best to integrate the settlements into local government structures. Should they, for example, have to pay for services and have representation in government?

Urbanisation *per se* is not necessarily bad since urban areas exist because of the benefits derived from scale and agglomeration. The key issue is that urban development should be managed well so services are delivered effectively. The dispersed nature of many of the PICs with small, isolated communities means delivery of services is very high cost. There can be benefits, therefore, to moving people to urban centres. However, if the isolated communities continue in an even less viable state, with increasing costs of service delivery due to even smaller and more elderly populations, the net outcome of the rural-urban migration could be negative.

2.5 Population dynamics

Projected population growth rates for PICs vary widely between countries. Cook Islands is expected to continue losing population over the next 25 years at an annual rate of one to two per cent through migration to New Zealand. Fiji, Nauru, Samoa, Tonga, and Tuvalu, which also have relatively easy emigration access to metropolitan countries, are projected to experience population growth of 0.5 to one per cent; while the populations of French Polynesia and New Caledonia are projected to grow at around 1.5 per cent. The PICs expected to have the most rapid population growth over the next 25 years are FSM, Kiribati, RMI, Solomon Islands, and Vanuatu, with projected growth rates of two to 2.5 per cent. This last group will obviously have to sustain high GDP growth to achieve substantial, widespread increases in living standards. They are also some of the countries that have had the greatest difficulty in achieving positive per capita income growth over the past decade.

All PICs have relatively high fertility rates and therefore have large cohorts of young people. In countries experiencing strong investment growth, a large supply of youthful labour can provide a demographic bonus, as experienced in East and South-East Asia. However, when investment is not growing strongly, the youth bulge can be a problem, including through contributing to political instability. Large numbers of young unemployed male youth in urban areas can be an ingredient for political instability by providing the manpower for those keen to foment civil unrest.

Through relatively easy emigration possibilities, young people from several PICs have for many years been able to find employment elsewhere; thus reducing the population growth and contributing substantially to the economy through remittances. In recent years, for various reasons—including the ageing of the populations in developed countries—the possibilities for short- to medium-term off shore employment and remittances have become more widely available to skilled and highly skilled labour in the PICs.[2] However, for the countries where populations are expected to grow most strongly, such opportunities are not so readily available. It will be in these countries that the problems of youth unemployment will be most worrisome.

[2] In Fiji, remittances earned by teachers, nurses, and military and security personnel have climbed rapidly in recent years. It is reported that close to 3,000 Fijians have been recruited into the British defence forces. Prior to 2001, net remittances were negative in Fiji. However, they amounted to 2.9 per cent of GDP in 2001 and 3.4 per cent of GDP in 2002, and are estimated at around F$300 million in 2004 (approximately equal to the export revenues earned by sugar) and projected to be F$500 million in 2005. While these overseas workers are primarily indigenous Fijians, the permanent migration of skilled and highly skilled Indo-Fijians continues unabated at around 5,000 per year.

While the employment of younger people overseas for substantial periods provides them with jobs not available at home because of the low levels of domestic investment, their absence can create problems. For example, the recent increase in the off shore movement of nurses and teachers has raised considerable concern about declines in the quality of medical and education services in PICs. The loss of younger people from isolated communities could also lead to a decline in traditional social security mechanisms.

In conclusion, it is clear governments are failing to meet the aspirations of their people. Unless governments can create conditions for much improved economic performance, aid and emigration opportunities are probably all that stand in the way of a more serious breakdown of state legitimacy and capacity in the region. However, there can be a serious moral hazard problem with aid in that aid itself can contribute to the incapacity of the state.

3. What are the reasons for poor economic performance by the Pacific Island Countries?

This section identifies the reasons PICs are falling behind other developing countries. It argues that the fundamental problem is an inadequate environment for private sector growth. This inadequacy is attributed to three types of weakness: particularly for the micro states, such as Nauru and Tuvalu, the binding constraint is the high costs of doing business, both natural and imposed; for the larger states, besides the natural disadvantages of remoteness and smallness, the problems can be found in weak governance and an investment climate hostile to private investment, both domestic and foreign. Some conclusions drawn are:

- the smallest, most isolated states may well face insurmountable obstacles to achieving sustainable growth and remain dependent upon aid
- PICs have an inherent difficulty in achieving good governance because of their small populations
- political instability and antipathy towards markets and private property rights makes economic liberalisation problematic
- regulatory barriers to informal sector activity obstruct the development of entrepreneurship
- problems giving rise to the PICs' poor economic performance and outcomes such as high youth unemployment favour the development of illegal activities and regional insecurities
- there is cause for some concern over the adverse impacts of aid on economic performance in PICs.

3.1 The importance of size

Are small island countries such as PICs condemned to slower economic growth than others because of their size and remoteness? Most research undertaken to date suggests not. The research results reported in Box 2 indicate that small island countries can, on average, grow as fast as larger countries. However, the geographic isolation of PICs increases the difficulty of achieving economic growth, and the combination of smallness and remoteness of the micro-states—which are usually not well represented in empirical research because of data limitations—may mean growth opportunities are severely limited.

Box 2: Do small countries grow more slowly?

Despite the seeming disadvantages of small countries, cross-country studies have not found a negative relationship between smallness and economic performance—whether economic performance is measured by income levels or economic growth rates (Milner and Westaway 1993, Armstrong *et al* 1998, and Easterly and Kraay 2001). Recent research undertaken for the Pacific Islands Forum Secretariat showed that from 1995 to 2003 PICs as a group grew more slowly than other groups of small island states, even allowing for the fact that three of them (Fiji, Papua New Guinea and Solomon Islands) suffered economically from civil unrest during this period (Sampson 2005). While their remoteness from major markets accounts in part for their slower growth, their smallness *per se* does not. Further, the recent erosion of trade preferences resulting from the trade liberalisation agreed to under the WTO Uruguay Round did not contribute to their slower growth.

However, research by Winters (2005) shows that the costs of isolation and small domestic markets can be so large that it may well be uneconomic for some very small states to trade—that is, they are naturally autarchic. This situation has obvious implications for their potential growth rate. But it does not mean they should protect domestic industries—quite the opposite in fact (Chand 2004).

3.2 The quality of governance

3.2.1 Political governance

There is widespread belief that governance problems lie at the heart of the difficulties PICs are experiencing in improving the welfare of their peoples. Research into governance is moving towards agreement that the quality of governance is the outcome of the appropriateness of political institutions and the incentives they provide for individual behaviour—and ultimately of government behaviour—or the extent to which the existing institutions are enforced.

Political science theories about the relationship between political institutions and governance quality point in two somewhat contradictory directions: (i) the risk of arbitrary behaviour associated with the concentration of power; and (ii) the virtue of flexibility and thus the ability to respond swiftly—a quality associated with more concentrated power sharing. The first direction leads to more decentralised political institutions. The second points to more concentration of power.

Thus, there appears to be a trade off between political credibility and flexibility in the structure of political institutions. Fragmentation of power has a positive impact on governance quality as it creates checks and balances, and hence exerts some control over discretionary behaviour. However, beyond a point, the benefits of dispersing power may be offset by governance problems associated with fragmentation. Because promises made by governments are often not self-enforcing, division of power can help a government keep its commitments credible through accountability mechanisms designed to limit the abuse of executive power, and provide a system of punishment for undesirable government intervention and reward for desirable interventions. Regular auditing of public accounts and more vigilance by national media are some mechanisms believed to improve transparency and accountability. However, in a concentrated political power system, these means are often absent or highly ineffective.

The small Pacific economies generally do not appear to have the balance right between credibility and flexibility. They function like highly authoritarian political systems in that mechanisms for ensuring good governance such as auditing and media freedom do not appear to work well. Due to the smallness of the populations and the resulting close relationships between those holding positions of authority, the normal checks and balances between political institutions are not very effective (what Harberger 1988 has called the tyranny of demography). Further, PIC governments generally do not see Non Government Organisations (NGOs) as partners but more as antagonists. In part, this is due to the activist policies of the NGOs but there must also be an element of competition between governments and NGOs over aid funds.

There is substantial pressure from various quarters in the Pacific to involve traditional authority structures more in government in order to improve governance. However, getting the balance right with respect to such fragmentation will not be easy. One possibility may be to give traditional authority more power and resources to govern at the local village level and thus to benefit from the checks and balances that operate at the local level, while trying to find ways to introduce more effective checks and balances at the national level. Having traditional authorities play a larger role at the national level, as is done in Fiji and has been suggested in Vanuatu and other PICs, may not be helpful. Traditional leaders have used the institutions of the introduced state to consolidate their own positions of power, sometimes at the expense of the traditional checks and balances in place to condition their behaviour. For example, chiefs in Fiji and the Marshall Islands have registered land in their own names and are collecting the bulk of rental income generated from the asset. Land rights, moreover, have been used to mobilise voters, thus allowing traditional chiefs to successfully contest national elections.

There is proliferation of political parties and lack of ideology/policy platforms in most PICs, often resulting in the formation of unstable coalition—and ultimately poorly-performing—governments. These outcomes may be related to the electoral and parliamentary systems adopted. Some electoral system engineering has taken place (in Fiji and New Caledonia) but the jury is still out on whether these changes have improved government performance. Constitutional and electoral system change is topical in the Pacific and warrants close attention for the possibilities that may arise to improve governance. There appears to be considerable room for research with respect to the lack of political parties/ideology; the relationships between parliamentary/electoral systems, political behaviour, and economic performance; the benefits and costs of incorporating traditional government into the adopted Western systems; and whether reform of political institutions would be beneficial.

In strictly constitutional terms, only two countries of the region (Solomon Islands and Fiji) have encountered unconstitutional government overthrow. But political instability, characterised by frequent change of government, is a hallmark of the region; for example, Nauru has seen 11 governments since 1996. Moreover, as Box 1 shows, several states in the region are now thought to present dimensions of fragility that are associated with instability.

To some degree, these states are going through the same kinds of constitutional debates that countries such as Australia and the United States went through years ago, with regions threatening to leave if they did not get their way. These disputes should be seen more in the way of the struggle towards the optimal contract between parties over the sharing of government and resources. However, it is important that there is resistance to the breaking up of countries and the formation of more high-cost, small states. Aid donors should not subsidise smallness, which is frequently taking place in the Pacific with donors meeting the costs of tiny states undertaking all the trappings of statehood. Some of these state activities, such as ensuring phytosanitary and transport standards, are essential but the costs may well be rising, especially as international standards are rising. Other state-related activities such as postings to international organisations are less essential but also costly.

Political instability, civil unrest, the prospects of continuing poor economic performance, high population growth, and increasing youth unemployment are of concern since they could lead to the development of international criminal activity and regional insecurity. Regional security concerns relate to more than political actions. They include the weakening of quarantine and health barriers and increases in criminal activity. Recent research has shown the importance of the neighbourhood effect of civil unrest and poor governance (Chauvet and Collier, undated). The civil unrest in Bougainville, Fiji and Solomon Islands appeared to have flow-on effects to other countries in the region. The mismanagement of fishing and logging resources has encouraged the entry of corrupt elements and there is the possibility of such criminal elements developing close relationships with governments. Once entrenched in this way, these elements are difficult to remove. Criminal elements undertake all kinds of illegal practices, such as gun running, people smuggling, drug trade, prostitution, and money laundering.

A basic issue to be faced is that those in power are benefiting from existing institutional arrangements (such as constitutions, electoral systems, parliamentary systems, administrative systems, and law and justice systems) or by seeing that they are not enforced. They are not, therefore, keen to see the situation change. This is the core of the political governance problem. The basic questions about political governance therefore relate to ways of improving institutions or, if the institutions are appropriate, to enforcing the rules these institutions provide.

One possibility for introducing institutional change is to design reforms, or packages of reforms, that benefit those holding political power as well as the public. Another possibility is to introduce 'smart' reforms that subtly create pressures for change in institutions or their enforcement. Withholding aid to try to force change is not a viable strategy for Australia as there are too many other potential donors willing to assist these small countries.

3.2.2 Economic governance

Following independence, the new governments in PICs took on many of the productive activities outside of agriculture, as well as utilities and major infrastructure such as ports. Manufacturing, largely in the nature of minimal processing activities, was widely supported through protection. With inevitable losses by public enterprises, because of their monopolistic and rent-seeking characteristics (over-manning, excessive salaries and inefficiency), as well as political interference, plus the indiscipline of public expenditure and corruption, fiscal deficits and growing public debts became widespread, with resulting fiscal crises. Also, increasing political instability, with governments formed of unstable coalitions, led to unstable policies and extreme difficulty in introducing micro-economic reforms.

The above factors contribute to the lack of investment, jobs and economic growth in PICs. However, behind these problems is a fundamental obstacle—the resistance to open markets from the vested interests that have developed. Many who have become well off have largely acquired their wealth due to governments creating monopoly positions through, for example, restricting trade and investment or from establishing privileged positions in parastatal organisations. Therefore, in the Pacific there are few 'champions' of open markets. Moreover, the belief in the pre-eminence of government appears to fit comfortably with some traditional communal systems under which Pacific peoples still live outside the urban areas.

The difficulties that development assistance agencies have in assisting PICs to liberalise their international trade and investment regimes, to privatise their state-owned enterprises, to create more favourable conditions for private investment, and to reduce the use of commodity price stabilisation schemes and agricultural and development banks stem from antipathy towards open markets. The antipathy towards open markets also explains the lack of interest in establishing secure property rights and ensuring impartial enforcement of contracts—the foundations of effective markets and private sector development.

It appears critical to create vested interests in open markets. Therefore, it is important to keep promoting ideas of free markets, property rights, impartial contract enforcement, non-discretionary behaviour of public servants, and adoption of mechanisms for improving governance (public education, codes of ethics/conduct, robust civil society and media, and regional pooling of resources providing oversight). Infrastructure support, physical and social, will help reduce costs and could be a 'driver' of free markets and secure property rights. There also needs to be research into ways of improving political governance. Most of this assistance is not high cost, but it is heavily dependent upon good research and analysis, and is likely to make only slow progress.

All PICs have some natural resources that can produce sustainable revenue streams and provide some basis for economic growth. The atoll island countries, such as Kiribati and Tuvalu, are most disadvantaged in this respect, having only sea-based resources such as tuna. The Melanesian countries are endowed with natural resources—arable land, forests, minerals, and their exclusive economic zones. However, with the exception of minerals, these resources are poorly managed and revenue streams prone to mismanagement and corruption. The contracts with mining companies have improved greatly over time. They now ensure a fairer share of the resource rents accruing to governments and landowners and take good account of environmental issues. However, the resource rents going to governments and landowners from mining projects are not well managed, with existing arrangements for distribution and investment of these funds highly susceptible to mismanagement and corruption. Rents induce rent-seeking, particularly in the presence of weak institutions. Customary ownership allows those in authority to extract rents under the guise of 'custom'. The contractual arrangements for the harvesting of logs and tuna, and the distribution and investment of revenue streams going to resource owners, leave a great deal to be desired.

Political instability has also presented significant obstacles to the micro-economic reforms that appear to be essential for robust economic growth and poverty reduction in the Pacific. The lack of political stability is mainly manifest in governments taking form through unstable coalitions. Globally, coalition governments have been less able than single-party governments to undertake reforms. Highly unstable coalition governments, as frequently occurs in the Pacific, find economic reform almost impossible; as the government can always be held to ransom by minority parties.

3.2.3 The investment climate

PICs face inherent difficulties in attracting investment and new jobs because of the high costs due to uncontrollable factors such as isolation from major markets, small domestic markets and frequent natural disasters. However, PIC governments have magnified these costs by restricting trade and investment and monopolies in telecommunications and other essential services. Where it has been possible, labour has migrated permanently, or taken up medium-term, off-shore employment. This phenomenon follows a global pattern of household risk diversification, which is income supplementing as well as providing protection against the high volatility of incomes due to factors such as natural disasters and commodity price fluctuations.

The conclusion that investment, especially private investment, is very low in PICs is inferred primarily from the low growth rates in formal employment, as data on public, private and foreign investment is very limited. Investment data are available only for Samoa, Tonga and Vanuatu. The investment/GDP ratio in Fiji is around 16 per cent, having risen from around ten per cent in 2001. Fiji's investment/GDP ratio was close to 30 per cent during 1979–81 but has fallen steadily since. It has been estimated by Rao (2004) that Fiji would need to achieve an investment rate of around 25 per cent to maintain a GDP growth rate of five per cent. Recently, only one-quarter of Fiji's investment has been private. Another one-quarter of investment is public investment in infrastructure. The remaining half has been invested in state-owned enterprises, many of which are performing poorly.

The investment/GDP ratios in Tonga and Vanuatu have recently been around 20 per cent. There are no data available to show the breakdown of investment into public and private investment in these countries. There are also no reliable statistics to show the extent of foreign investment in PICs. From observation in Fiji, it appears most foreign investment is going into the tourism industry. This is likely also the case in other countries with substantial foreign investment. Other foreign investment is most likely concentrated in local branches of international manufacturing industries, which are generally assisted through restrictions on imports. It is also likely that, similar to Fiji, a large share of public investment is supporting state-owned enterprises, rather than public infrastructure. There are no estimates of the extent of 'capital flight' from Pacific countries, which could indicate that domestic savers are confident in investing in their own economies.

Formal sector employment is also low in PICs and dominated by the public sector. Therefore, private sector employment conditions are generally linked to public service conditions. Public sector wages, often supported heavily with donor funds, such as in the US Compact countries, are considerably higher than private sector wages, which then has 'Dutch disease' effects. The absorption of some of the most qualified and enterprising Pacific Islanders in the large and inefficient public sectors and the emigration of skilled workers severely inhibits private sector development.

A basic institution of any society relates to property rights over land. In PICs, land, particularly land outside urban areas, is mostly held under customary ownership, to which there is strong cultural attachment. When population growth rates were very low, increasing land productivity was not important—especially in island countries with more fertile land. However, with increases in fertility rates and reductions in mortality (as a result primarily of clean water and sanitation), there is a need to increase land productivity. In the absence of some form of leasehold tenure to make land available to individual investors, customary ownership is most unlikely to be the basis for rapid increases in productivity and economic growth. Through the development of its leasehold system for customary land, Fiji was able to maintain a large sugar industry based on smallholder farmers and is sustaining a large and growing tourism industry.

Land held only under customary ownership cannot be used as security for borrowing from commercial banks. However, secure, long-term, land leases—backed by government—can be as acceptable as freehold and used as collateral for commercial credit. The absence of long-term commercial borrowings by customary landowners in PICs is due to their inability to use their land as security. Also, without individual title landowners are not able to exclude others from the benefits of any investments of time and effort that they put into the land. Therefore, landowners' ability and willingness to make long-term investments in land, the basis for productivity growth, is limited.

Changes to land tenure in PICs will have to come from within and are likely to take considerable time. However, successes with individualisation of land tenure, such as with tourism, will foster interest in tenure change for other activities. It is also likely that government provision of infrastructure such as roads (which opens up land to commercial opportunities) and trade liberalisation (which opens up opportunities for exploitation of international markets and prices), will create pressure for secure individual land tenure.

Subsistence and informal sectors form a large part of economic activities in PICs. Because of the absence or limited extent of government welfare services, informal and subsistence sectors provide an important safety net for those who cannot find work in the formal sector. The subsistence way of living forms part of the rich cultural heritage of Pacific Islanders. However, growth of the subsistence sector is not a long-term solution to poverty eradication and community development in the Pacific. The transition from the subsistence to the formal sector will, over the long term, improve living standards, build investor confidence, broaden the tax base and increase government capacity for providing social services, reinforce the social contact between citizens and the state, and improve access to business services.

Several institutional barriers to the shift from the informal to the formal sectors may be encountered in PICs. These commonly include inappropriate administrative and regulatory barriers, regressive fees that penalise small firms, corruption in issuing of business licenses, lack of key business services such as finance and infrastructure, and socio-cultural barriers to people moving from communal ownership to individual ownership. Informal sector activity should be encouraged as it provides an important learning environment for future entrepreneurs and investors.

3.3 Does aid contribute to poor performance?

The literature on links between aid and growth is substantial but inconclusive.[3] The core question—does aid encourage growth?—is fundamental to interpreting the poor results of PICs over the past decade. If, as some contend, aid damages the economies, this has far reaching implications for regional donors. Indeed, some (for example Hughes, 2003) use these negative results to conclude that aid to the region should be drastically cut.

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3 Amidst the claims and counter claims on whether there are robust links between aid and growth, Roodman (2004) concludes 'if there is one strong conclusion from this literature, it is that on average aid works well outside the tropics but not in them'.

On the face of it, with high levels of aid but low levels of per capita growth, the interpretation that aid has not helped generate growth seems plausible. Recent international research by Raghuram and Subramanian (2005) provides a useful framework for examining this relationship. According to their research, aid has had an adverse effect on labour-intensive and export sectors in the developing world, largely through its impact on the real exchange rate. They note that this effect may offset the undeniably positive short-term effects of many aid projects and programs. Their findings are supported by an earlier study by Feeny (2004) who was unable to find a positive relationship between rural growth (clearly, a labour intensive sector) and aid spending in Melanesia.[4] If these studies are correct, they have disturbing implications for long-term economic growth and income inequality. If sectors such as agriculture are placed at a disadvantage by aid spending, the majority of PICs will experience increasing inequality and, in all likelihood, increasing levels of instability.

On the other side of the argument, the majority of recent research indicates that aid and growth are positively correlated, particularly when aid is disaggregated according to its purpose (Clemens *et. al.* 2004). And, as noted, Feeny (2004) detects evidence of the growth impact of aid in Melanesia.

So, has aid been responsible for damaging economic prospects in the region? It would be foolhardy, given the liveliness and capriciousness of the debate, to come down on one side or the other. Moreover, definitive, high-quality evidence from the region has not been produced. Nevertheless, it seems fair to conclude that aid has not had the impact in the region that it should have had. What this points to is a need to pay much greater attention to the details of aid provision: where it can be used well; how much can be absorbed; how it should be delivered; and how it can be spent. It is not safe to assume that aid will always have a positive impact.

3.3.1 New entrants and established challenges

New donors are entering the region, including China, the Republic of China and, perhaps, India. Already, by indicating their intention to support maintenance of the Highlands Highway in PNG, the Chinese Government has signalled an approach to aid that could complicate attempts to encourage better financial management by recipients. Taiwan's support for the payment of compensation in the Solomon Islands provides another example of how aid can, in the wrong circumstances, add to a problem rather than solve it. India is making overtures in the sugar sector in Fiji that may yet be at odds with support offered by the ADB.

All donors will make mistakes. Provided that they learn from these mistakes, this may not be a problem. However, where the new entrants may create more significant difficulties is where they use aid solely to secure political support. Under these circumstances, new entrants could undermine the efforts of established donors like Australia and, quite possibly, set back prospects for sustainable development.

[4] Feeny did, however, detect evidence of an impact of aid on total growth—a finding which could perhaps be expected, particularly in states where aid is a high proportion of GDP.

4. Prospects for growth in the Pacific Island Countries and agendas for change

PICs have been encouraged to pursue economic growth by opening their economies to trade and investment, and reform of the public sector. Is this reform agenda appropriate for PICs, however? Some argue that Pacific peoples do not wish to develop in the same manner as other countries. Others argue that the disadvantages these small states suffer mean they cannot compete on world markets and therefore their economies cannot grow in the way economies in other countries can. Therefore, where it is able to do so, labour will have to find employment in other countries and remittances from overseas workers and donor aid will have to sustain these PICs.

What are the likely prospects for growth in PICs over the next decade or so? Is it possible for them to muddle through as they have been for the past decade or so? What is needed for considerably improved economic growth performance that would lead to substantial reductions in poverty and less likelihood of further civil unrest?

4.1 A muddling-on scenario

Given the continuation of aid and the existing emigration opportunities, most PICs should be able to muddle on, with likely continuation of the deterioration of services and increasing levels of poverty. With the ageing of developed countries, opportunities for off-shore employment for semi-skilled and skilled labour should increase. However, there will be continued growth of urban areas in PICs and, with the loss of younger people from rural areas, ageing of populations in rural areas. Thus, the safety net of the village will not be so robust and groups most likely to suffer will be elderly women and children experiencing deteriorating education and health services.

Countries at most risk under this scenario are those with projected population growth rates in the two to 2.5 per cent range: FSM, Kiribati, RMI, Solomon Islands, and Vanuatu. With their poor capacity to absorb waste, the atoll island countries, Kiribati and RMI, face alarming infectious disease burdens and poverty if populations in their major urban centres continue to grow at recent rates. The land-rich Melanesian countries, Solomon Islands and Vanuatu, will be at most risk from political instability and law and order problems due to large numbers of unemployed youth and rents offered by the natural resource sectors. Poor economic growth will exacerbate these problems because the institutions expected to maintain law and order will be starved of funds.

Under this scenario, it is highly likely that conditions in traditional rural areas will continue to deteriorate significantly. Rural fertility rates are high everywhere. Without substantial rural-urban migration, the rural population growth rates will be in the two to 2.5 per cent range. Under the existing form of customary ownership of land, productivity increases are likely to be much lower than this. Therefore, the capacity for rural areas to meet needs will decline.

4.2 A sustainable growth scenario

To move away from the present highly volatile situation of low average per capita income growth to a robust, sustainable economic growth path that will lift living standards on a widespread basis, PICs will have to increase private investment and productivity growth substantially, supported by effective physical and social public goods. Investment will have to be funded largely by domestic savings, although foreign investment can play a critical role by introducing new technology and skills, and providing access to global marketing networks. The levels of private and public investment needed to move to a sustainable, robust growth path are not clear, but from the limited evidence noted above, it appears a substantial increase is required.

The basic questions surrounding sustainable growth are: what do PICs have to do to encourage levels of savings and investment; and how can development assistance partners help in achieving these objectives? Specifically, what is required to overcome obstacles to higher growth?

Given their disadvantages in terms of scale of production and costs of transport, it appears that, with a few exceptions (such as coffee, cocoa, palm oil, and minerals) in some of the Melanesian countries, the PICs will always be uncompetitive in the production and export of standardised primary commodities. Competition in these commodities is largely through volume, standardised quality, and transport costs. Chand (2004) notes, industries established in PICs tend to '. . . be those requiring minimal economies of scale, such as small scale agriculture, boutique tourism, and assembly activity, such as clothing, and/or those with large rents, such as mining, forestry, and fishing'. Others receiving large rents from preferential prices and market access are sugar and tinned fish and import-substituting industries receiving protection from restrictions on imports.

To compete in world markets, PICs should concentrate on differentiated products with prices that more than cover high transactions costs. Tourism, which is location specific, is one such product. Other export products are Fiji Water, Pure Fiji cosmetics, black pearls, and squash.[5] The capacity for developing other differentiated products depends on freedom of entry of investment, entrepreneurship, ideas, and ease in establishing businesses.

As small, isolated countries, PICs' greatest need for economic growth is to be able to exploit economies of scale by pursuing opportunities for marketing differentiated products available from trade with the rest of the world. To do this they need to be open economies. In fact, they probably have a greater need to be open to trade and investment than any other group of countries. Unfortunately, they are reluctant to open up to trade and investment. As well as raising costs for consumers, the use of tariffs or quotas to restrict imports taxes exports—directly by raising costs of inputs used by exporters and indirectly by leading to exchange rates that are higher than they would be otherwise. By not being open to foreign investment, new technologies, skills, and ideas that could help to overcome their natural disadvantages may well be excluded. For example, the widespread adoption of telecommunications monopolies, resulting in high costs of transmitting information to and from the rest of the world and within the country, is particularly disadvantageous at a time when cheap information transmission is playing such an important role in the location of economic activities. Similar problems exist with inter-island shipping, where national or provincial governments own ships they protect against competition.

[5] Fiji Water has done extremely in developing its export market, especially in the United States. Exports are estimated to have increased from F$45.7 million in 2003 to F$60.8 million in 2004, and are expected to increase to F$85.6 million in 2005. The firm is expecting to triple its production capacity through investment now being undertaken.

A strategy for overcoming problems of geographical and economic isolation is deep integration of PICs, especially with their closest developed neighbours, Australia and New Zealand. There is renewed interest in regional pooling of resources in transport infrastructure such as shipping and aviation—a concern relating to PICs' geographical isolation. There is also wider discussion of the benefits of deep economic integration of the small Pacific states with Australia and New Zealand, stimulated by the recent publication of an Australian Senate report on aid in the Pacific (Australia 2003). Economic integration with Australia and New Zealand could extend beyond open trade and investment to freer migration of labour and the adoption of regional economic institutions such as a single central bank and a common currency such as the Australian dollar. The regional trading arrangements PICs have entered into (such as the Melanesian Spearhead Agreement and the Pacific Island Countries Trade Agreement—PICTA) are limited and designed to proceed slowly. They offer little scope for improving human welfare while having potentially significant costs in the sense of creating antipathy towards further trade liberalisation.

While PICs share many economic characteristics, they are different in other respects and not necessarily able to follow the same development path. Some are much smaller and more isolated than others, for example. The atoll island countries have limited prospects for agricultural development when compared to the land-rich Melanesian countries and, because they find it difficult to absorb waste, are limited in the industrial activity that can be undertaken.

However, even for the smallest and most isolated PICs, being open to trade and investment is important. Prohibitively high transport and production costs prevent them from benefiting much from exports. The other side to this is that domestic industries have high levels of natural protection against imports. Thus, providing tariff or other import protection to domestic industries only serves to raise the costs to other producers and consumers already suffering the costs of isolation and small markets. It may be argued that removing the tariffs protecting domestic industries will eliminate a key component of government revenue. However, tariff revenue can be easily replaced with a value-added tax. Or, if there are few local industries a flat revenue tariff will accomplish the same task while having lower compliance costs than a value-added tax.

Openness to foreign trade and investment is just as critical for the larger PICs. As noted above, given their geographic isolation and smallness, many PICs can never hope to compete in open markets in the supply of unprocessed primary commodities—with the possible exception of tuna. The only way they can benefit from trade is by establishing markets for differentiated products with prices that more than compensate for high production costs. To achieve this goal, these PICs must benefit from the skills, technology and ideas that flow from free enterprise and openness to foreign trade and investment.

It is possible that without an appropriate institutional environment the response to trade and investment liberalisation will be limited. A concern is that potential investors cannot acquire sufficiently secure title to the land they need to make investments viable. They will only therefore invest if insured against this risk by government subsidies or other assistance.

Fiji has shown the way for other PICs in developing individual leasehold tenure within the framework of customary ownership. Other countries could follow this example, maintaining customary ownership and the peoples' relationship to the land as well as making land available for more productive investment. However, there are problems with Fiji's system—such as the monopoly of the Native Lands Trust Board over the allocation of leases and the limited transferability of the leases—which have to be resolved if Fiji is to create a more favourable investment environment. Insecurity over land for investment is widely blamed for Fiji's low investment to GDP ratio, which is now one-third what it was in the 1970s. Other PICs are examining and implementing ways to mobilise land for productive activities.

Insecurity of individual tenure to land is very likely limiting growth in the productivity of agriculture in PICs through depressing individual effort and access to credit and thus investment. If the land-rich countries of Melanesia are to prosper and to have improved food security, economic growth must be built upon robust growth in the rural sector. Thus, investment in research and development of new and improved crops and improved farming systems are important, as are improved access to markets and rural services. Agricultural departments and agricultural research are under-resourced and under-developed in PICs and could benefit from more government and agency support. However, without security of tenure, only research into technologies with rapid pay back periods will be worthwhile. Also, benefits of investment in infrastructure will be limited.

As AusAID's (2004) *Food Security Strategy* argues, openness to imports is an important component of a food security policy. Imports can be a cheaper and more effective means of meeting consumers' food needs than domestic production. They can also complement domestic production and provide price and quality discipline for domestic producers. While food self-sufficiency from domestic production should not be the goal of policy, this production should be as efficient as possible—this will only be achieved through effective agricultural research and development policy.

But for land-poor, atoll island countries, domestic agricultural production may be able to play only a small role in achieving food security, given the limited scope for increases in agricultural productivity. For some of these countries, food security may be best achieved through increases in incomes from non-agricultural activities. However, for some of the smallest, most isolated micro-states that face the highest costs in international trade, making the most of agricultural resources may be the best food security strategy. For some of these states, community-sustaining donor aid and remittances may be the only way to maintain viable communities.

The shift to more open economies will take time: time to change views towards markets and the private sector; time to develop the institutions that underpin effective markets; and time to adjust the economic structure. The role of development assistance partners in facilitating this shift needs to be researched and prioritised. Consideration of the type of assistance required during the adjustment period is also needed. While countries performing poorly need help to avoid reforms adversely affecting the most disadvantaged, assistance should not reinforce existing obstacles to the economy moving onto a higher economic growth path.

There is a strong commitment by development assistance partners to overcoming HIV/AIDS in PICs. Judging by experience in other developing countries, HIV/AIDS poses significant risks to Pacific economies and populations. However, malaria has been an ongoing cause of substantial human costs in Melanesian countries through its high incidence of mortality as well as through the hidden debilitating impacts on physical and mental development of its peoples and the adverse effects on investment. Unfortunately, there has not been a similar commitment to overcoming malaria in the region as there has been in the case of HIV/AIDS.

The increasing incidence of infectious disease in several Pacific countries is alarming. The reduction in infectious diseases in developing countries, even in the least developed, that led to substantial reductions in infant and maternal mortality and increases in life expectancy, basically resulted from providing increased access to clean water and sanitation (what some have called the greatest advance in medical history). That infectious diseases are increasing in PICs sends the signal that they are going backwards in providing access to clean water and sanitation. If aid has been effective anywhere, it has been in its contribution to providing clean water and sanitation throughout the developing world. Therefore, it appears that development assistance could make a significant contribution to improving the investment climate in the Pacific by refocussing its efforts in these areas.

5. The role of donors in achieving higher growth

PICs are not performing to their potential. Some, particularly the micro-states, face an uphill battle because of high business costs and limited scope for diversification. Yet there is no reason to saddle themselves with weak policies too. Others, notably the states of Melanesia and the larger Polynesian countries, have the potential to be strong, independent and prosperous. Whether they will achieve this depends on their capacity to adopt appropriate institutions and policies. This section looks at what the donor community can do to support PICs in achieving higher growth.

5.1 The application of good aid principles

The poor economic growth rates of PICs (Section 3) suggest that the effectiveness of aid has been limited. Whilst the evidence is nowhere near robust enough to suggest that aid should be curtailed, it does highlight the need for aid to be used more effectively.

Regional donors acknowledge that improvements are needed. For example, ADB (2004) noted that their past programs failed to adequately account for the importance of broad consultation and strong political ownership of reform, and the need for deliberate, well structured approaches to building institutional capacity. It also hinted at excessive use of consultants, contributing to unsustainable outcomes. The World Bank (2005) says it has focused too much on inputs (usually technical assistance) and failed to specify and monitor against clear, achievable objectives. It says it has not invested enough in developing relationships and following through with implementation of recommendations. AusAID (2004) notes different lessons, particularly the importance of investing in the right sectors and retaining flexibility. Other donors have remarked on the agency's tendency to use technical assistance (particularly Australian) to the exclusion of other forms of assistance.

Lessons from other parts of the world that have resonance in the region are poor alignment of donor and recipient government policies, frequent proliferation of donor activities and insufficient policy coherence within and among donor activities.[6] Together,

[6] Indeed, OECD/DAC figures show an extraordinary proliferation of projects in just one sector—education—between 1997 and 2003. Although the figures are inflated by small French projects, there have been no less than 109 education sector projects in this period in Vanuatu, 70 in Samoa, 50 in Tonga, and 46 in Kiribati.

these lessons point to a new agenda for donors in at least four areas: enhancing demand for changes in institutions, policies, and service delivery; improving donor coordination; better aligning donors' assistance with recipient countries' development strategies; and improving the monitoring of donor performance.

5.1.1 Participation and the demand for change

The changes needed to establish effective institutions that support private sector-led growth and to strengthen service delivery will challenge many vested interests. Indeed, the high concentrations of government-to-government aid in the region have helped to limit the debate about change to government and donors, rather than to extend it to the broader populace. Moreover, the weak performance of labour-intensive and export industries deprives PICs of an important constituency for good governance—that is, businesses with a vested interest in open markets. Whilst donors are rightly concerned about local political ownership for change, this is difficult to achieve; the incentives simply are not sufficiently strong.

The key to achieving change in PICs is to support the demand side of the equation, in particular mobilising electorates to demand better performance from governments. For donors this means engaging far beyond the usual confines of central agencies. It means encouraging consultation and participation in the design and evaluation of public policy, stimulating greater levels of communication between governments and electorates, and seeding effective and informed engagement by the media.[7] It also means ensuring there is adequate feedback to electorates on progress with policy implementation and clear incentives for the electorate to press their governments to improve quality of services. Critically, it also means donors need to understand when their support undermines these natural forms of accountability within a country, for example, by reducing the need for governments to raise taxes, and therefore to explain themselves to taxpayers, or by pre-empting the resolution of a crisis through premature assistance.

For donors, this kind of participation requires a substantial investment of time and (often local) expertise. Yet donors often cut corners, impose inflexible deadlines, vest responsibility for consultative processes with inexperienced agents, and speak only with counterparts in central agencies rather than the broader population. Such practices must change if donors are to cultivate local demand for change.

5.1.2 Donor coordination

The limited information available on donor coordination indicates that coordination remains problematic and impedes attempts by donors to support development across the region. Ideally, coordination should be imposed on donors by an effective government aid coordination unit. In the Pacific, however, these units often face capacity constraints. A first step is therefore to ensure that appropriate support is available to aid coordination units in governments in PICs.

On the supply side, some donors are making sensible moves in experimenting with harmonising programs (New Zealand, Australia and the United Kingdom), in decentralising their operations to the region (World Bank and ADB), and in holding regular informal meetings. But there is no systematic attempt to monitor coordination across the region, so donors remain unaccountable for their actions. A regular, formal,

[7] Critically, this has been one of the key innovations of the processes of creating locally-owned Poverty Reduction Strategies elsewhere in the developing world. Such processes are based around a broad-based consultation with electorates. They are designed to be nationally-developed documents, not run-of-the-mill policy pronouncements.

and, preferably independent, assessment of levels of coordination would help to establish targets and benchmarks.

The risks of deterioration in donor coordination are high, given the likely increasing role of new donors in the region. Established donors have perhaps been too insular in their efforts. Substantial work is needed on their part to engage the new donors and to share lessons. Considerable humility is required—even established donors cannot point with confidence to the effectiveness of their efforts. Indeed, even established donors frequently remain unwilling or unable to share information about their intentions and activities.

5.1.3 Alignment with recipient countries' policies and approaches

Governments in the region are small and generally weak in technical capacity. Donors' preference for projects exacerbates this by bypassing established systems, imposing alien procedures, undermining traditional accountability processes, and generally increasing transaction costs faced by recipient governments. Were more donors to adopt programs—including sector-wide programs—this potentially damaging impact of behaviour could be reduced. Moreover, by using established government systems and local processes of accountability, systems would be strengthened.

This approach demands a major change in mindset by donors. It means that the favoured, frequently *ad hoc*, approach of supporting individual technical assistance opportunities and projects should increasingly be replaced by more complete, medium-term programs. The key point is that donors need to come in behind comprehensive, plausible and well-planned strategies that have been developed by recipient governments. Without this level of recipient engagement, the risk is that donor activities will continue to parallel, rather than support, government processes. Alignment should not stop at matching policies and processes. It must also address more effectively the capacity constraints inherent in the region's governments. Here, donors must pay more attention to the ability of PIC governments to pay for and effectively staff their often swollen bureaucracies. Over-large public services are a feature of the region.

5.1.4 Performance monitoring

The absence of systematic monitoring of donor performance in the region severely reduces the potential impact of donor funding. Particularly in the area of support to governance, where there is so little clear guidance on how to engage, donors have to be more systematic in approach. They must establish clear monitoring frameworks in advance of implementation and, ideally, these frameworks should build on established local systems. At the very least, they should include a significant role for the proposed beneficiaries of their programs. They must share this information widely, so the lessons of all donors can inform choices and donors are encouraged to become more accountable. ADB, AusAID and the World Bank are all committed to improving monitoring their new strategies. At a minimum, this information needs to be shared publicly.

A further challenge is noteworthy: the quality of impact data such as the indicators used for the MDGs is weak across the region. The absence of necessary data is likely the main problem, but comparability of data across countries is also problematic, so benchmarking is seldom feasible. A significantly enhanced effort is required to generate accurate, easily accessible statistics on development progress.

5.1.5 Do no harm

The principle of 'do no harm' has become standard in dealing with post-conflict environments. In essence, it provides explicit recognition that such situations are inherently complicated, and that even well meaning donors can make matters worse. As section 2 notes, aid effectiveness research suggests that the long-term consequences of poorly executed aid can also be harmful. This suggests that donors need to adopt a clear means of assessing the risk that their programs will undermine long-term progress. Such an approach should be developed and implemented through a collective effort between all donors, with appropriate input from the recipient countries themselves.

5.2 Support for better governance

The primary challenge for donors is how to support better governance in the Pacific. There are no easy or quick fixes. Collective experience demonstrates the importance of strong local ownership of, and demand for, reform, which relies on a much more effective level of engagement of local communities than has been practiced to date (by donors and recipient governments). Reform cannot be forced on governments by donors, which also means addressing the danger of elite capture. Winters (2005) notes that the small, undiversified economies are particularly prone to elite capture of aid and highlights the divisiveness it can cause.

Yet the region is littered with good locally-owned policies that have not been implemented. So a focus on implementation is needed. This means ensuring that implementation is transparent, accountable and consistent with agreed priorities. Mentoring assistance to those charged with implementing policies would be helpful. A more engaged and better-informed civil society, a vibrant and independent media, and a competent and effective government statistical capacity are essential. Essential, too, is support for the evolution of more appropriate political systems that challenge the disastrously high levels of political instability associated with many nations in the region. Little can be achieved without strong local pressure for change. Where this is absent, donors should restrict themselves to supporting research and education.

Support to encourage stronger management of public expenditure and reduce corruption is essential to governance reform in PICs. Even here, however, the challenges are not so much about the technical qualities of the governmental systems as they are about understanding the pressures on those systems and the minimum requirements necessary to address those pressures. For example, there is an increasing level of concern that over-complex systems of budgetary management are being established, with little realistic hope of developing countries ever being able to properly resource and manage them (see, for example, Grindle 2004). This is a risk for small countries, which do not have the scale to accommodate and stimulate specialisation and which are afflicted by substantial brain drain.

Since donors have little scope to press reluctant governments and their electorates to change, it is essential that they become sufficiently nimble to exploit opportunities when they present themselves. This might come in the form of a more accommodating government, reform-minded ministers and senior civil servants, or even through a sudden collapse in service standards or a fiscal crisis. Such responsiveness can only be achieved if donors have a better understanding of the way societies in small states operate, cooperate, and compete, and a far stronger understanding of their political economies. In turn, this requires knowledge about the countries concerned: knowledge that in many cases is most likely to be reside with local people.

5.3 Support to improve the investment climate

The institutional changes necessary to support private sector growth across the region were documented in the ADB (2004) report *Swimming Against the Tide* and will be a focus of AusAID's Pacific 2020 report at the end of the year. The ADB report concludes that a successful strategy to promote private sector development in the Pacific will require sound macroeconomic policies, more appropriate regulation of business—including reduction in the numbers of uncontested monopolies—and effective legal and regulatory frameworks.

Both the ADB and World Bank have shown strong leadership in analytical products to support change in this area. Both are following up with technical assistance to support that change. Such analysis and support remains essential. Moreover, an important characteristic of much of this work is its amenability to outcome measurement. Donor input in this area is an obvious place to start with a more disciplined, results-based partnership with PICs.

While some necessary changes, notably in relation to regulations, can be relatively quickly addressed, others, such as the development of more effective financial markets—consequent largely on the capacity to collateralise land—or, indeed, the reduction in political instability, will take far longer to realise. The issue for donors is to support PICs in developing clear, prioritised strategies for encouraging investment in areas in which they have (i) comparative advantage and (ii) niche products for which premium prices (that compensate for the innate high costs of conducting business) can be charged.

5.4 Support to service delivery

Stronger governance and improved investment environments will, over time, bring about robust per capita growth rates that allow serious progress towards improved living standards for all and improved political stability. But they will take time to have an impact. During this time, the majority of the population will continue to experience poor quality services and young people will continue to be unemployed. So there is a strong case for maintaining a focus on service delivery.

Recent research from the World Bank suggests that funding for services in the region may not be the main constraint. Rather, weak governance undermines the ability of governments to invest productively in health, education and infrastructure. There is scope for donors to redouble their focus on opportunities that exist to improve service quality, particularly across areas such as decentralisation of delivery, strengthened public expenditure management, and better control of corruption. Also, scope exists to improve the accountability of service delivery agents themselves, building on experiments with accountability by providing information to client groups.

Also in the area of service delivery, interest is now being shown in opportunities to reduce costs and improve effectiveness of services through regional actions (including through the Pacific Plan). This is an important for donors; their sustained, informed and sensitive engagement with the Pacific Plan will help to build support amongst regional governments.

5.5 Donor coordination

Donor nations can help not only through the direct investments undertaken through their aid programs. They can also support development by ensuring their domestic policies are consistent with improved policies in the PICs. In particular, donors' trade policies can often be restructured to support the kind of outward-looking, open trading regimes that will be necessary in the PICs for sustained growth.

An opportunity exists in relation to market access for overseas workers from the region. The temporary movement of labour around the world is thought by many observers to be key to the economic prospects of the developing world, particularly small island states with high birth rates and very limited domestic employment opportunities (Winters *et al*, 2003). Accredited training of Pacific Islanders in skilled occupations such as nursing, teaching and the building trades could benefit both the PICs and the metropolitan countries.

6. Implications for the Australian aid program

AusAID's *Pacific Regional Strategy* (2004) provides a broad framework for engagement with the region over the next decade. Its focus on governance is appropriate, as are its four themes: (i) stronger broad-based growth; (ii) more effective, accountable and democratic government; (iii) improved law and justice and security; and (iv) enhanced service delivery. The DAC (2004) peer review of the Australian program concluded that Australian support was of a high quality, particularly in HIV/AIDS, approaches to fragile states, peace building, and conflict resolution. Internal reviews, too, have endorsed the focus of core elements of the program.[8] New departures, such as the Regional Assistance Mission to Solomon Islands (RAMSI), have also been broadly welcomed.

Nonetheless, over the past two years the weakness of the region has become more pronounced and the threats this poses more acute. Analytical insights, too, have moved on—there is a clearer view about the deficiencies in the region's investment climate. The high cost of intervention when conflict and state breakdown occurs has been demonstrated by RAMSI and, in different ways, in Nauru. In short, the true, fundamental nature of governance challenges has become more apparent. The impact these weaknesses have had on growth prospects, and therefore on stability and security, is palpable.

As the previous section argued, this requires a shift in the approach of all donors, focusing more on good aid practice, governance and the investment climate, and making sure service delivery becomes more efficient and effective. More broadly, developed countries need to pay attention to coherence of policies, in particular trade in services.

For the Australian program, donor-wide shifts are relevant. Since Australia's foreign policy interests are closely tied to the region's fortunes, the development program must continue to contribute effectively to government policy objectives. In the opinion of this review, this requires action in the following eight areas.

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[8] A cluster evaluation of public sector reform programs in the Pacific region conducted in 2003 found that four out of five programs were satisfactory or above.

6.1 More effective integration of the growth objective

Australia's objective of a prosperous, secure and stable Pacific region will be most effectively met through encouraging higher levels of growth. Indeed, unprecedented levels of five to seven per cent growth are needed to ensure improved living standards for all, to make a significant dent in poverty and to improve political stability. Over the next decade, the Australian program needs to develop more effective ways of addressing and integrating this growth objective.

The pre-conditions for more rapid, sustained growth are: (i) removing obstacles that prevent the majority of the population from participating fully in the economic growth process; and (ii) creating a private investor-friendly environment. In this effort, governments have important roles in enhancing the physical and social infrastructure and providing the necessary regulatory framework to ensure healthy competition.

Recommendation: First, country strategies need to focus more explicitly on growth and identify how it is generated and shared, particularly in labour-intensive and export sectors. This analysis must address the issue of how growth can be stimulated and should directly address the question of aid quality, that is, the degree to which aid spending could threaten growth. Second, Australian country strategies should ultimately come in behind credible, costed, country-owned growth strategies. Where these do not exist, Australian aid should look for opportunities to support their development.

Just as country strategies must be explicit about the growth linkages of their proposed investments, so too must they improve the quality of their poverty analysis and, crucially, links between this analysis and the proposed program. Meeting this objective demands better information on numbers and trends in poverty and inequality. These should form the basis of regular updates on the extent of regional poverty. Because regional social security networks are complex and can change quickly, so too numbers of poor people and local concentrations of poverty can change rapidly. Where such information does not exist—which is true for the majority of PICs—additional support for national data gathering on poverty is required.

6.2 Build human capital for progressing governance

While specific policy responses for strengthening governance in the region may not yet be clear, elements of the process are unequivocal. In general, the quality of education, at all levels, must be improved if Pacific peoples are to participate fully in the opportunities offered by domestic and global markets in the 21st Century. They must also be able to understand their rights and responsibilities as electors and monitor the performance of their governments. In particular, good governance will demand strengthened human resources in three core areas: leadership, institutional analysis and policy analysis. The shortfall in leadership skills in small countries is to some extent inevitable. Nonetheless, it is such an important area that efforts to overcome this weakness must be a priority. With policy and institutional analysis, regional institutions simply have not been able to generate sufficient, high-calibre individuals to staff central agencies, think tanks and consulting groups.

Recommendation: There should be a detailed review of the education systems in each country to identify weaknesses leading to the poor outcomes identified by the World Bank (World Bank 2004). Besides this, three other areas require attention:

1. A systematic leadership development program needs to be developed in conjunction with relevant regional bodies.
2. A program of development of policy analysis skills should be established, perhaps mainly through an external tertiary institution. Such a program would profit from close links with policy areas of developed countries in the region, including Australia and New Zealand. The issue of appropriate (that is, attractive) remuneration on return to home countries will need to be addressed as part of this program.
3. A need to build up the capacity of the IMF-managed *Pacific Financial Technical Assistance Centre* to establish a larger, dedicated team of public finance and statistical experts, based, potentially, across three sites in the region, perhaps broadening the scope beyond conventional IMF practices. Such a resource would establish a regional mechanism for solving some of the skills shortages that prevent governments from undertaking effective public financial management and collecting and publishing the reliable statistical information essential for effective analysis and policy making.

6.3 More effective performance monitoring and management

The challenge of supporting improved governance, a stronger investment climate and higher growth in the region is complex. With no blueprints, let alone consensus on what might work, it is essential that there be a comprehensive performance management system in place for the assistance program. Such a system must track activities, isolating success factors and reasons for failure. Insights should be shared internally as well as with other donors and with recipient governments.

Recommendation: The commitment in AusAID's *Pacific Regional Strategy 2004–2009* to improve performance measurement is timely and appropriate, and the appointment of a regional performance adviser will improve AusAID's capacity in this area. Given these commitments, AusAID should soon be able to demonstrate changes to its performance monitoring system. Internal improvements notwithstanding, there is also a strong case to support the development of an independent regional capacity to monitor aid effectiveness. This would help establish benchmarks for donor performance and strengthen accountability for recipients and donors alike. Elements of such performance monitoring may be implemented through the monitoring system to be established within the Pacific Plan.

6.4 An enhanced focus on public sector management

Reform of public sectors in the region is essential to improve the environment for private sector growth and to enhance the efficiency of public services. Variants of the Australian model of public sector reform appear applicable in PICs, albeit at much reduced levels of complexity and resource intensiveness. In particular, Australian systems are noted for the strength of their budget systems and the effectiveness of their public expenditure management. Australian government agencies with expertise in these areas, especially the Australian and state and territory departments of Finance and Treasury, have begun to engage more coherently across the region. Importantly, other donors recognise the value of Australian experience and expertise.

But there is scope for the Australian program to play a stronger, leading role in relation to public sector reform. To do this, the program needs to build on expertise in the technical areas of public sector management. It must also be seen to adapt these skills so they are more appropriate in developing country contexts, particularly to accommodate the smaller, less technically advanced nature of regional systems and their limited access to resources. At the same time, more attention is needed on the demand side of public sector reform. This will require imaginative, innovative approaches to engaging civil society and to challenging vested interests, particularly those associated with the region's overlarge public sectors.

Recommendation: Australia should consider how it could play a more authoritative role in supporting public sector reform in the region. This is likely to require action on several fronts. In discussion with other donors, it needs to explain and assert its intentions to lead in this area, including clear statements about the (lengthy) time horizons over which this type of engagement will be necessary. In Australia, new relationships between AusAID, the departments of Finance and Treasury, relevant state and territory governments, and educational bodies will be needed to generate the technical advice to support this strengthened focus, and possibly to train the technical staff needed in PIC governments. More innovative relationships will be needed with civil society across the region, to harness and focus demand for change. Links with the World Bank and the ADB will also need to be strengthened to allow Australia's new intent to be guided by international experience. Benchmarking and performance monitoring will be essential to demonstrate to electorates the benefits of, and scope for, public sector reform.

6.5 Leading donor coordination

The challenge of coordinating donors working in the region is significant and growing. A greatly increased effort is required if the detrimental impacts of multiple, uncoordinated donor programs are to be prevented. From the donors' side, such coordination is rightly the preserve of the Australian program—it has the aid infrastructure, the scale and the proximity to do this. Moreover, as one of the leading donors to both the IDA and the ADF, it has the financial credibility and authority to play this role.

Recommendation: If Australia is to play such a role, it will need to invest more heavily in understanding the structure, motivations and modalities of regional donors. It will also need to pay far greater attention to its own capacity to integrate with other donors; credibility will be at stake if Australia cannot practice what it preaches. Clear indicators of the quality of coordination will need to be developed and used to measure performance.

6.6 Confronting vulnerability

Even where governments follow correct procedures for strengthening their economies, they are still liable to setbacks caused by natural disasters. This was amply illustrated by cyclone Hetta wiping several percentage points of GDP growth from an otherwise well-managed Samoan economy in the early 2000s. While Australia provides generous and prompt assistance for these emergencies, there may be scope for additional policies that enable recipient governments to play a greater role in managing emergencies.

Recommendation: One possibility for greater self-management is self-insurance, whereby countries could establish trust funds to be used only in the event of a natural disaster or external shock such as a commodity price shock. These funds could be made up from windfall gains realised by the countries themselves, for example, from fishing revenues and from donor funds. Another possibility is more in the way of insurance provided by donors, such as in the form of a 'Pacific Vulnerability Fund'. This fund could apply across the region and be accessed by governments that experience particular external shocks, subject to the agreement of a fund management group that includes donors and civil society representatives, and has a clear set of guidelines on when payouts could be made.

The fund could be replenished in two ways—through direct injections of cash from donors to support crises, and through the diversion of funds from other uses. In the latter case, for example, the fund could be supplemented by donors when a recipient government was deemed to be likely to use funds inefficiently. For example, if corruption cases were not being prosecuted, and a donor felt it would not be wise to maintain funding to a sector program, the funds could still be earmarked for use by the government but placed in the vulnerability fund.

6.7 Integrating regional governance

Regardless of their quality, small governments are more expensive than large ones. The reason is that fixed costs, such as developing new policy, are shared amongst fewer taxpayers. This fact-of-life for PICs is one motivation that lies behind the development of the Pacific Plan and its attempts to establish regional (shared) approaches to providing a range of government functions. However, the trade-off is, in some sense, a loss of sovereignty.

Recommendation: The Australian program lacks a coherent analytical framework to determine whether, in any given case, regional or country-specific solutions are appropriate. Using the analytical work completed for the Pacific Plan as a guide, AusAID should develop a clear framework of its own. This could lead to significant changes in the way assistance is delivered.

6.8 Building partnerships in the Australian program

The effectiveness of Australia's aid program suffers from Australia being the dominant power in the region. Its position inevitably attracts scepticism of its motives and resentment of its authority. But the Australian program risks exacerbating this situation through some of its work practices. Much Australian-sourced technical assistance is supplied through large contracting companies. These companies are highly efficient at procuring and deploying expertise. The problem is they can complicate the management and accountability of that expertise. This happens when TA is formally responsible not to the recipient government but to their contractor. The perception—whether accurate or not—is of a parallel management and accountability structure over which recipient governments have little authority. Such perceptions have been entrenched by the almost exclusive use of Australian expertise, and by a lack of clarity about Australian objectives.

It is commonly claimed that Australia aid is boomerang aid, implying that benefits accrue to Australians and Australia because the goods or services provided are sourced in Australia. This is a nonsensical statement that does not recognise that goods or services have been delivered to the recipient country. The correct issue is whether the goods and services delivered have maximised the value of the aid funds.

The key issue is whether there would be benefit in untying aid so it could be sourced from outside of Australia as well—including from within the recipient countries. This review believes there would be benefit in fully untying Australia's aid and opening it up to international tender.

Recommendations: A major new effort is warranted to strengthen the image and practice of Australian aid to the region. A greater diversity of technical advice is needed, including from the region itself. Improved ways are needed of using technical assistance, whereby recipient governments become more instrumental in their management. As well, Australia should be clearer about its objectives, in particular its strategic objectives, in the region. Finally, Australian aid should be fully untied.

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Glossary

ADB	Asian Development Bank
FSM	Federated States of Micronesia
MDGs	Millennium Development Goals
NGO	Non Government Organisation
PICs	Pacific Island Countries
PICTA	Pacific Island Countries Trade Agreement
RAMSI	Regional Assistance Mission to Solomon Islands
RMI	Republic of the Marshall Islands
SPC	South Pacific Community
UNDP	United Nations Development Programme
VAT	Value Added Tax