

Pacific Islands Brief

PIDP Pacific Islands Development Program

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Binding Constraints to Economic Growth in the Pacific Islands: Some Comparative Insights

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What can Pacific island countries learn from successful small island economies in other parts of the world? To answer this question, the approach to economic growth and development of four Pacific island countries—Cook Islands, Fiji, Kiribati, and Samoa—is compared to that of Maldives and Barbados. Both are small island economies that have identified and overcome their binding constraints to economic growth, resulting in long periods of strong economic performance and improvements in general welfare.¹

Of the four Pacific island countries studied, Fiji and Kiribati have carried out economic reforms, but not the comprehensive type of reforms undertaken by Samoa and Cook Islands. Therefore, as well as the comparison with Maldives and Barbados, we compare the results of the reforms attempted across the four Pacific countries to gain a better understanding of the reasons for the different outcomes.

Lessons from Barbados and Maldives

Barbados' impressive economic performance is largely the result of the country's political and social stability, its outward-looking strategy, reliance

on markets, and a judicious balance between the roles of government, the private sector, and other stakeholders. The friendly attitude toward free enterprise has also been a factor that has attracted private investment and enhanced the development process. Barbados has achieved one of the highest levels of per capita income in Latin America and the Caribbean, placing it among the upper-middle income developing countries. Barbados is well placed to participate effectively in the global economy of the 21st century by virtue of its strong and stable institutional framework, its highly educated labor force, dependable infrastructure, and investor-friendly business environment.

While not enjoying the same political stability as Barbados, Maldives has been transformed from one of the poorest countries in the world to having the highest per capita income in South Asia. Over some 30 years its development efforts concentrated on tourism and fisheries. Today, Maldives enjoys a tourist arrival rate per head of population exceeding that of any other small island state. Its fishing industry, which was the lifeblood of the economy for a long period of time, has also made tremendous strides through mechanization and modernization. The Maldives' poverty rate has

fallen dramatically in recent years; and by 2005 the country had achieved the highest education index in South Asia.

There are several key lessons that stand out from the development experiences of Barbados and Maldives. First, in both countries the constraints to development were identified at independence. Second, plans were developed and followed to overcome the constraints. Third, from the beginning, both countries had leaders who were strongly committed to the development plans; and there was political stability over a sustained period. Fourth, both countries were welcoming of private foreign investment and built the necessary institutions such as security of land rights and impartial contract enforcement.

From the late 1940s, policymakers in Barbados saw a bleak economic future for the country if it continued to rely on the sugar industry. Soon after independence in 1966, the Prime Minister led an economic reform program to diversify the economy. Some of the constraints to diversification and development, such as infrastructure and lack of human capacity, were necessarily addressed over a long period. Others, such as policy-related constraints, were addressed quickly. Today Barbados has an extensive road network, 97.5 percent of its people have access to safe water, and it has most modern telecommunications network in the Carib-

bean. Government is striving to have a university graduate in every family by 2020.

In the Maldives, a broadly participatory development process was embraced. Government recognized early on that it had to modernize its fishing industry and develop its infant tourism industry. Committed leadership and political stability were important, with President Gayoom in office for 30 years (1978-2008). Foreign investment played a leading role in the development of tourism and the fishing industry, backed by strong enforcement of the rule of law. The long-term leasing of state land has been made possible for both domestic and overseas investors; such leases may be used as collateral for commercial loans.

The Maldives also recognized the critical importance of human capital, and by 1998 the adult literacy rate reached 98 percent. Policymakers saw that if the economy was to diversify and develop quickly, domestic skills should be supplemented by overseas labor. Therefore, government streamlined the application process for expatriate worker visas.

In drawing on these lessons for the Pacific economies, it must be recognized that the local context and some of the facilitating factors may be very difficult to duplicate. For example, without policy continuity it may well be impossible to undertake long-term development plans such as the develop-

ment of infrastructure and human capital. Lacking this continuity, there may be little payoff to other initiatives such as developing a long-term leasing regime for custom land and facilitating foreign investment. Hence, one can see that initial conditions and the sequencing of reforms are critical.

Economic growth performance in the Pacific

With the recent exceptions of Cook Islands, Palau, Samoa, and Vanuatu, the formal economic growth performance of the Pacific economies over the period 1996-2008 has been poor (see table on page 3). In some cases, real GDP growth has not kept pace with population growth, leading to declines in GDP per capita. By way of contrast, with the reasonably fast GDP growth in Cook Islands, Palau, and Samoa, per capita GDP has increased. The 2.9 percent GDP per capita growth in Palau and the 3.0 percent growth in Samoa are particularly noteworthy. Samoa's only recent decline in real GDP was in 2008, which largely stemmed from the global economic crisis. Cook Islands experienced a longer period of poor growth—from 2005 to 2008. Over the 1996-2008 period, Vanuatu's average GDP growth is only just above its high population growth of 2.6 percent. However, in the period 2003-2008, Vanuatu's real GDP averaged a very creditable 6.0 percent, resulting in per capita GDP increasing by 3.4 percent annually.

Table 2.1: Rates of growth in real GDP, population, and real GDP per capita in Pacific Island Countries, 1996-2008

Country	%GDP growth	% Population growth	% Per capita GDP growth
Cook Islands	2.7	0.8	1.9
Fiji	1.5	0.7	0.8
Kiribati	2.9	1.8	1.1
Marshall Islands	0.3	0.9	-0.6
FSM	-0.9	0.2	-1.1
Palau*	3.6	0.7	2.9
Samoa	3.6	0.6	3.0
Solomon Islands	1.5	3.1	-1.6
Tonga	1.8	0.4	1.4
Vanuatu	3.1	2.6	0.5

Statistics for 2004 to 2008 only.

Source: ADB *Key Indicators*, Online Database.

The comparatively high rates of growth of per capita income in Cook Islands and Samoa were due in part to the low rates of growth of their population resulting from their substantial emigration and, in Samoa's case, to the substantial remittances sent by its overseas workers. Contrast the performance of Cook Islands and Samoa with that of Kiribati and Vanuatu over the same period. Kiribati's population grew at 1.8 percent and GDP increased by 2.9 percent, so per capita GDP in Kiribati grew by only one percent per annum. In Vanuatu's case, population growth of 2.6 percent resulted in per capita GDP increasing at only 0.5 percent.

Inter-Regional Comparisons

How well has the Pacific experience mirrored Barbados and Maldives? Overall, reform programs in

the Pacific have given insufficient attention to identifying the most limiting constraints on economic growth. There has not been enough attention paid to the issues that should receive priority in the reform process. Most reform programs attempt to identify all possible factors holding back economic progress within countries and seek to overcome these constraints, without acknowledging the possibility that some other missing factor(s) could be preventing reform on all other fronts.

Successful economic strategies in Barbados and the Maldives have been replicated in Cook Islands and Samoa with some success. They carried out extensive economic reform programs in the wake of financial crises in the mid-1990s, following which they experienced substantial periods of good economic growth. Both countries had in place strong political leadership committed to the reforms, po-

litical stability, and bureaucratic support. Both countries also used public consultation in the form of national retreats or summits to good effect to promote 'public ownership' of the reforms.

However, the widespread interpretation of the success of these reforms in Cook Islands and Samoa does not tell the full story. The Cook Islands had experienced good economic growth at least as far back as 1982. Indeed, over the period 1982-2004 real GDP averaged 4.5 percent per annum, which includes the poor growth during the mid-1990s crisis. Hence, it is difficult to make an argument that significant binding constraints to economic growth were in place and rapidly removed by the mid-1990s reforms, allowing good growth to take place. It appears that policy misjudgments caused the financial crises and the resulting poor growth.

It may be argued that the very high level of aid that Cook Islands has received over many years, especially from New Zealand, was responsible for the good economic growth dating back to at least 1982. But if so, this would be the first country to have recorded such significant benefits from aid.

Cook Islands economic performance over the past five years is not impressive. This is due at least in part to the global economic crisis and its adverse impact on tourism. But there appear to be other problems retarding growth and which may be regarded as binding constraints. Government's fiscal stringency to pay down public debt that contrib-

uted to the financial crisis in the 1990s has led to poor infrastructure maintenance and little new infrastructure to support tourism. This, in turn, appears to be inhibiting further private investment. Also, while some state-owned enterprises were privatized as part of the 1990s' reform package (hotels, ports, and waste management), the high costs of the remaining government businesses (especially telecommunications, ports, power, and water) are a burden on both government and the private sector.

To its credit, Cook Islands managed to undertake substantial economic reforms in the past and needs to do it again. However, the key question is whether its political economy is amenable to a repeat performance. With four coalition governments working under three prime ministers over the past five years, there must be some doubt as to whether the critical factors contributing to enlightened policy continuity are presently in place.

Analysis of Samoa's binding constraints to economic growth and the impact of major reforms of the mid-1990s comes to different conclusions than those that are widely believed. Samoa's improved economic performance was not so much the result of reforms per se. Rather, it was the automobile harness exports from the Japanese firm, Yazaki, to Australia under the preferences provided by SPARTECA (South Pacific Regional Trade and Economic Cooperation Agreement) that drove Samoa's growth over the 1995-99 period—similar to

the way in which Fiji's garment industry developed quickly under SPARTECA's preferential arrangements. Of course, it may be argued that it was the widespread economic reforms in Samoa that encouraged the Japanese firm to locate in Samoa rather than elsewhere. But, unfortunately, there were no other private sector responses to the reforms.

The later period of Samoa's economic growth in the first half of the 2000s was largely due to remittances that funded substantial church building, government spending on construction for the South Pacific Games, and on a joint-venture (government/private) resort hotel. There was little in the way of private investment that one would like to see resulting directly from the reforms. Thus, it appears that up to 2005 the binding constraints to private investment had not been overcome.

Introduction of international airline competition in the latter part of 2004 energized the tourism industry, which has grown rapidly since that time. This reform was supported by the introduction of competition in the telecommunications industry, the availability of long-term land leases for resort hotel construction, and the provision of improved tourism-related infrastructure.

To date, the sources of economic growth in Samoa are narrowly-based—focused on tourism and related industries. What are the binding constraints to diversification and even better economic per-

formance in the future? Aside from customary land now being available for extended resort hotel leases, long-term leasing of custom land (comprising 80 percent of the total land area) is not available for other economic activities, particularly agriculture. Until this constraint is relaxed, it is unlikely that local and foreign investment will flourish. The government has begun sensitive public discussions about the introduction of long-term land lease regimes, but there is strong resistance to the idea. Samoa has been able to develop and implement major economic reforms in the past and knows what it takes to make it happen. Whether Samoa will be able to overcome this binding constraint, which appears to have held back private sector investment and economic growth for decades, remains an open question.

Other reforms, particularly to overcome the high costs of public utilities (ports, airports, domestic shipping, and domestic airlines) and inhibitions on foreign investment, are needed. But the potential pay-off to such reforms will not be realized until the binding constraint limiting secure access to land is remedied. Proper sequencing of reforms is essential!

Intra-Regional Comparisons

Fiji and Kiribati are highly contrasting economies, with very different resource endowments. Fiji has a well-diversified economy across agriculture, manu-

facturing, and services while Kiribati's economy primarily comprises governmental and subsistence activities. The binding constraints to better economic performance in both economies appear to be in the form of underlying or fundamental political economy constraints rather than 'proximate' economic constraints. Until these underlying constraints are removed, attempting to overcome the more obvious economic constraints will not be successful.

In Fiji the primary obstacle to achieving sustained, effective economic reform has been the lack of motivation to undertake collective political action that will weaken the village-level power of the chiefs, which translates into power at the national level. Essentially, there is a resistance to modernization, which is seen as diluting the power of the chiefs. The inter-ethnic political struggles over political power and economic rents (from EU sugar preferences) are really side-shows to the main game: the clash between traditional and introduced economic systems. If the indentured Indian laborers had not been brought to Fiji, the clash between the two systems would still exist.

It can be argued that the actions taken by the military government since the December 2006 coup have been designed to break down or eliminate the traditional institutions that have supported the chiefly elite. These actions may be justified on grounds of improving the prospects for economic growth and improving income and wealth distribu-

tion. But will these actions be successful or will they ultimately succumb to widespread resistance; or is there a better means of achieving these goals?

An alternative approach taken in Botswana—a country with a similar chiefly system—has contributed to outstanding economic success. The constitutional arrangements adopted there did not undermine the power bases and resources of the chiefs. They did not see themselves as political losers and were accommodating of the changes. In brief, if the Botswana model were followed, Fijian chiefs would be constitutionally exempted from participating in national politics and governance. Instead, they would only oversee the governance and economic development of their particular village or province, with financial assistance from the State. Of course, such political and social engineering through constitutional reform is highly uncertain in its outcomes and there would likely be undesirable unintended consequences. But if the people's desire for improved wellbeing is sufficiently strong and they are supportive of such change, these adaptations may be worthy of consideration.

In Kiribati the full range of binding constraints to formal sector economic growth appear to be in place: access to credit is limited, returns on private investment are very limited, and there is poor appropriability of returns on private investment. However, these are clearly not the primary obstacles to better economic growth. They are dominated by a preference for tradition that precludes collective

adoption of policies that would lead to improved economic performance.

The necessary collective action is not taking place because the costs to individuals from collective action to adopt reform policies that entail foregoing dependence on the state are perceived as outweighing the benefits. Moreover, the costs to individuals of giving up their reliance upon the state are very obvious while the benefits of economic reform in terms of more jobs, higher incomes, and improved public services are highly uncertain.

Conclusion

Across the Pacific, 'Rules of the game' defined by small but complex systems—which coexist with formal government structures—present significant difficulties for the establishment of market economies. These traditional systems also have implications for donor-funded projects. A suitable framework and a deep knowledge of such cultural traditions are therefore essential for understanding why market-oriented prescriptions or foreign-aided economic development projects may or may not work.

The lessons from this study of successful reform suggest that transformative change needs strong political leadership to champion the reforms, a supportive bureaucracy, and a politically stable climate for policy continuity in which the leadership and

bureaucracy have sufficient time to undertake needed changes. Widespread public consultation supported by analysis of the costs and benefits of the changes is also critical. Without these conditions in place, the needed reforms may not eventuate.

This paper is an overview of the analysis and arguments presented in a more detailed forthcoming publication by the Pacific Islands Development Program.

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1 The binding constraints to economic growth framework, developed by Hausmann, Rodrik, and Velasco (2004, 2005, and 2006), is the analytical framework used to examine the experiences of the six countries. In the case of two countries, Fiji and Kiribati, the analysis is extended by use of the Institutional Analysis for Development (IAD) framework pioneered by Ostrom et al (2001). In using the IAD framework, the study focuses on the 'deep determinants' of growth, recognizing the importance of a country's political economy in its economic performance. The research is presented in the form of analytical country narratives covering the political, legal, regulatory, institutional, economic, and cultural factors that have either inhibited or facilitated the development process. The country visits for this research study were initiated in 2008 and completed in 2010. As such, the analysis presented reflect the findings of the study during the respective country visits.

PIDP Pacific Islands Development Program

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