Australian Government

The Treasury

Senate Foreign Affairs, Defence and Trade Committee

INQUIRY INTO THE ECONOMIC AND SECURITY CHALLENGES FACING PAPUA NEW GUINEA AND THE ISLAND STATES OF THE SOUTHWEST PACIFIC

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This submission comments on the major economic challenges facing Papua New Guinea (PNG) and the island states of the southwest Pacific. The Australian Treasury (with other Australian Government agencies including the Department of Finance and Deregulation and AusAID) directly assists a number of Pacific governments to develop functioning economic ministries which will contribute to improved economic performance. Treasury staff are currently deployed to the Regional Assistance Mission to Solomon Islands (RAMSI), the Strongim Gavman Program (SGP) in PNG, and the Economic Advice and Governance Assistance Program in Nauru. In addition, through Australia's membership of international financial institutions such as the International Monetary Fund (IMF), World Bank, and the Asian Development Bank (ADB), Treasury has an interest in growth and sustainable development in the region.

INTRODUCTION

Extreme poverty has increased significantly in the Pacific over the last decade. Due to its relative size, most of the region's poorest live in PNG.[1] The development challenges facing our Pacific neighbours are significant. Many are constrained by a combination of factors including geographic isolation, small size, limited resource bases, lack of human resource capacity, uncertain property rights, high population growth, ineffective public accountability institutions, weaknesses in the policy environment and corruption.

Australia has a broad responsibility to help alleviate endemic poverty in our near neighbours, both on humanitarian and strategic grounds. Australians and the international community are also concerned at the potential collapse of democratic institutions and the humanitarian consequences of state failure in the region.

This submission focuses on the importance of economic growth as a key element of a strategy to reduce poverty and ensure state stability. It also draws on our particular experience as an economic policy agency, and our view that sound fiscal management and economic reform are fundamental to achieving sustained growth. Economic growth is important to improving the wellbeing of the people of the Pacific — critical to improving prosperity, maintaining stability and achieving the Millennium Development Goals.

We note the strong two-way connection between a well functioning law and justice system and better economic outcomes. In one direction, law and justice are important to protect private property and to ensure individuals and businesses can confidently invest and transact with one another. In the other direction, across the Pacific, the combination of inadequate economic performance and youthful population for example, is resulting in a large class of unemployed youth who drift to urban centres and can turn to crime. The 2006 riots in Honiara, Solomon Islands and Nuku'alofa, Tonga show how disaffected youth can be used to destabilise political systems.

RECENT ECONOMIC PERFORMANCE

In the last five years, the Pacific region has seen some improvement in economic performance. Strong economic growth is seeing the region take the first steps to match the growth performance of the Caribbean and Africa, after lagging these regions for much of this decade. Melanesian countries Vanuatu (6.8 per cent GDP growth average over last 3 years), Solomon Islands (5.8 per

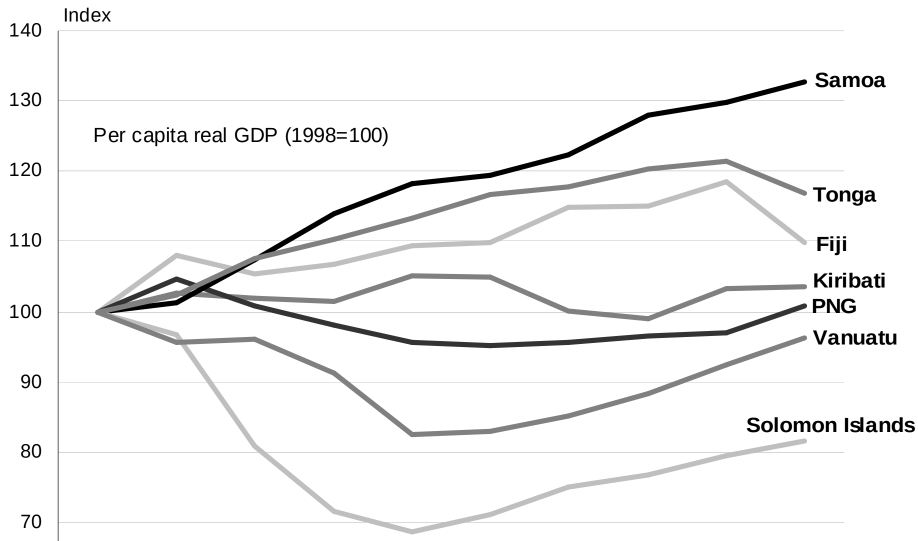
[1] See AusAID, ***Tracking Development and Governance in the Pacific***, August 2008.

cent) and PNG (4.1 per cent) are leading this improvement.[2] Fiji, on the other hand, has contracted significantly since the military seized power in 2006. Looking back further, the region's growth performance has been much more volatile, with periods of economic downturn commonplace.

Strong population growth, particularly in Melanesia, has constrained the extent to which higher growth has translated into improvements in per capita living standards. Population growth rates have exceeded 2.5 per cent on average in Solomon Islands and Vanuatu over recent years, and have grown to 3.8 per cent in PNG. In contrast, Tonga and Samoa have had growth rates at or below 0.5 per cent.[3]

High population growth and volatile economic performance have seen Melanesian countries make little progress in raising per capita incomes over the last 10 years. PNG has stagnated, while Vanuatu and Solomon Islands have declined. Fiji is now unwinding much of the progress it had made in the last decade. In contrast, Samoa and Tonga in particular have made considerable inroads in improving per capita income levels (Chart 1).[4]

Chart 1: Selected per capita growth performance since 1998



Source: IMF, World Bank, and domestic statistical agencies.

Despite recent improvements, the economies of many Pacific island countries (PICs) are narrowly based, leaving them vulnerable to economic shocks, both

[2] For some PICs such as Samoa and Tonga, gross national ***income*** is also a relevant measure, as these countries receive significant remittances which are not captured in GDP.

[3] Source: Asian Development Bank.

[4] For PNG and Vanuatu in particular, these conclusions are somewhat sensitive to the index year chosen. If a longer time period is used, both Vanuatu and PNG appear as 'better off'.

internal and external. Internally, civil unrest and ethnic tension for example can be devastating, as was seen in Solomon Islands prior to RAMSI in 2003. Aggressive natural resource extraction, as is occurring in Solomon Islands forests will present serious adjustment problems as resources are depleted. External shocks such as the removal of trade preferences, international commodity price changes, and changes in tourist numbers can cause hardship for PICs and constrain growth prospects.

The impact of recent shocks to global capital markets on the Pacific region is unclear at this stage. To date, we are unaware of any direct exposure of PICs to sub-prime financial assets, but the returns of pension and provident funds may be affected as local and international share prices fluctuate. Tighter credit markets may affect the plans of foreign investors, including in the mining and gas sectors. Banking services in the region do not appear to have been greatly affected.

Should international growth slow sharply as a result of shocks to global capital markets, this could have implications for PICs. Highly trade-exposed PICs such as Fiji, PNG, Solomon Islands and Vanuatu face risks from a slowing of growth in their major trading partners.[5] Falls in commodity prices will have mixed effects: falling fuel prices will ease pressure on many PICs and help to reduce inflation; base metal price falls may affect the fiscal position of PNG in particular; while falling prices for commodities such as cocoa and copra will also affect the region.

ECONOMIC POLICY SETTINGS IN THE PACIFIC

Well-functioning economic ministries play an important role underpinning improvements to economic outcomes in the region, so that economies are more resilient to shocks and able to respond to changing circumstances. They help set macroeconomic policies to ensure settings are stable and sustainable; they promote responsible fiscal management (e.g. optimal revenue collection; sustainable spending; appropriate prioritisation; spending achieves ‘value for money’; and management of debt); and they also advise on arrangements to improve the efficiency of markets, so that factors of production go to their most efficient uses (economic reform). Improving market efficiency can also be viewed as promoting an environment conducive to private enterprise.

Treasury officials have worked in the economic and finance ministries of several states in the Pacific region for a number of years. They assist in strengthening these core functions and work to build self-sustaining economic ministries. We have had some success in improving capacity in several key

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[5] The respective trade to GDP ratios (2004-2006) are PNG (130 per cent), Fiji (125 per cent), Solomon Islands (around 96 per cent) and Vanuatu (95 per cent). Source: World Trade Organisation Statistical Database.

regional governments, but progress is difficult to measure and needs to be seen from a long-term perspective.[6]

Fiscal Management

Sound fiscal management is important to ensure governments provide services that can improve wellbeing. Limited funds have to be well allocated and delivered efficiently so as to have maximum benefit.

Macroeconomic performance has improved a number PICs in recent years. PNG's recent performance is worth noting, where high commodity prices and better fiscal management have greatly improved the fiscal outlook. Outside PNG, most PICs are running modest budget surpluses or manageable deficits. However, control over public expenditure, management of revenue streams, and management of public debt remain of concern. Poor quality public expenditure is still common.

Some PICs have unusually high public sector expenditure to GDP ratios (in excess of 50 per cent for Palau, Federated States of Micronesia, Marshall Islands, Nauru, Tuvalu and Kiribati). While these high expenditures reflect the fixed costs of government, to some extent, they also indicate that many in the region see the government as an important employer.

There have been several positive developments designed to ensure that resources go to highest priority needs. In particular, we have seen medium term fiscal strategies developed in PNG, Solomon Islands, Fiji and Cook Islands, for example. These strategies outline the overall macroeconomic 'rules' underpinning budgets, and usually provide a framework for addressing budget priorities and dealing with unexpected changes in fiscal conditions. So long as these fiscal strategies are embraced in decision-making and align with development strategies prepared by planning departments, they can have a very positive impact. PNG has also passed a ***Fiscal Responsibility Act*** designed to ensure that all new spending proposals are subject to appropriate Treasury scrutiny, and now publishes an annual Final Budget Outcome.

Considerable improvement in ensuring 'value for money' spending is still required. Poor capacity continues to hinder the effectiveness of governments to improve the wellbeing of their citizens. Better macroeconomic outcomes have not always translated into better spending decisions or outcomes. Spending bottlenecks have moved increasingly to line agencies with lower capacity, continuing to hinder service delivery.

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[6] Part of the region's progress has been in avoiding some poor policy decisions.

State-Owned Enterprises

In many countries, state-owned enterprises are also significant economic actors in their own right. They are often important social symbols of national prestige, with wider community objectives such as job and infrastructure creation, or providing utility subsidies to consumers (e.g. electricity). They may also have strategic aims such as to guarantee transport links.

But these multiple objectives tend to undermine the efficiency and effectiveness of their operations. This impacts not only private households, but also those businesses that rely on essential services such as electricity, with implications for the confidence of private investors.

Management of these enterprises (with their significant revenue flows) may also give rise to governance concerns. They may be captured by elites and frequently lack transparency and accountability. Their economic significance often gives them access to Ministers, which may sideline formal departmental advice. They are often not subject to market or regulatory disciplines. As they are often explicitly or implicitly guaranteed by the state, they also represent risks to the budget. For example they may enter into debt obligations with little government scrutiny or fiscal constraints. If poorly managed they may provide an inadequate dividend stream to their government owners — rather, the state often has to supplement their working capital. Potentially these firms can displace more efficient private firms.

Reform of state-owned enterprises cannot be isolated from efforts to improve fiscal management. In many countries, debates around the size and role of the state in market economies continue, but at a minimum, greater scrutiny of the costs and performance of these enterprises can only improve matters – not least so that these costs can be weighed against opportunities for increased government services elsewhere (or lower taxes).

Economic Reform

Another important role of economic ministries is to advise on the efficient allocation of resources within the economy. Broadly, ‘microeconomic reforms’ are those changes to a country's economic structure that would increasingly put resources to their best uses through improving market function. Alleviating inefficiencies supports faster economic growth. However, the ***status quo*** is often preferred as it satisfies the demands of vested interests. Dealing with these vested interests requires strong state capacity, and is easier in more diversified economies.

In the Pacific region, there is a tension in some countries between fragile democratic institutions and the ability to undertake needed economic reforms. The political economy is such that reforms that would most likely have net benefits can be deferred, particularly where losses are concentrated while gains are thinly spread. Governments often have strong incentives to avoid such decisions in order to maintain voter support. In these environments, reforms can be slow to materialise. Efforts to improve the stability of political systems can improve economic reform prospects.

In fragile political environments, local reformers need to take a long term view, identifying incremental opportunities which are not easily reversed and be prepared to take larger opportunities when they present themselves. Building a constituency for reform to support governments is also important to counterbalance the influence of vested interests. The difficulty is that fragile political environments put a premium on quick results.

Nevertheless, some notable reform progress has been made in several PICs.[7] Recently introduced competition in the telecommunications industries of PNG, Tonga and Samoa have forced down prices and greatly increased mobile phone penetration. In PNG for example, competition in the mobile phone sector added an estimated 0.7 per cent to GDP in 2007 and improved the efficiency and reliability of mobile services. Aviation reform to encourage new entrants has occurred in Samoa, Solomon Islands, Tonga, Vanuatu, PNG and Fiji, lowering fares on many routes and boosting tourism arrivals. While many Islanders outside their capitals have limited access to banking services, microfinance and rural banking are growing in PNG, Fiji and Solomon Islands, for example.

Treasury's assistance to improve economic governance (and thereby economic outcomes) is through long term technical assistance, including 'twinning' arrangements to build the capacity of economic ministries. To improve economic performance, three factors are strong in combination, and more likely to lead to progress. These are: i) a clear vision of what is required by local counterparts that is broadly shared; ii) a capacity to use the assistance provided; and iii) responsive, flexible and expert assistance from development partners. These factors do not guarantee success, but when all are present, prospects are greatly improved.

International Financial Institutions (IFIs) also play a role in championing reform. Australia is represented at the World Bank, ADB and IMF. In this role Australia also represents the interests of a constituency of countries, including several PICs.[8] Our Board representatives influence the strategies and operations of these IFIs, to seek a greater emphasis on addressing the development needs of the Pacific region.

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[7] For an outline of recent telecommunication and aviation reforms, see AusAID's ***Pacific Economic Survey 2008***.

[8] At the World Bank these Pacific countries include: Palau, Kiribati, Papua New Guinea, Samoa, Republic of Marshall Islands, Solomon Islands, Micronesia, Federated States of Micronesia and Vanuatu. At the Asian Development Bank these include: Kiribati, Federated States of Micronesia, Nauru, Palau and Solomon Islands.

Selected Economic Reform Issue - Trade Liberalisation

Trade liberalisation has the potential to contribute to economic development in the Pacific region. In particular, PACER Plus has been advanced as a means to incrementally reduce trade tariffs and foster greater economic integration. Trade liberalisation is part of an outward looking development strategy, drawing on the well known advantages that open markets provide: greater freedom of choice, specialisation and exchange. Internationally orientated economies tend to be more competitive and have stronger economic performance than inward-looking countries.

Trade liberalisation is an important reform objective aimed at increasing trade and enhancing economic welfare, but — as is the case elsewhere internationally — views in the Pacific region differ about likely benefits and costs deriving from further liberalisation. In particular, there are concerns that some countries will have to forego substantial tariff revenues on which they currently rely.[9] From a fiscal sustainability perspective, it will be important for PICs to anticipate revenue shortfalls from tariff reductions and to plan accordingly. For smaller countries that collect a high percentage of revenue on imports as they arrive, replacing tariffs with consumption taxes may limit the benefits of liberalisation.

Selected Economic Reform Issue - Temporary Worker Schemes

Temporary labour schemes have the potential to provide for greater regional economic integration and increased remittances. They also provide a valuable opportunity for PIC workers to experience life and conditions in a developed country — and raise expectations of their own governments on return to their homes. Remittances are also important, as they can improve balance of payments positions and ensure income directly reaches poor communities.

The Australian Government announced a pilot temporary worker program in August 2008 for 2,500 workers over three years from Kiribati, PNG, Tonga and Vanuatu. The Pacific Seasonal Worker Pilot Scheme will test the effectiveness of low skilled labour mobility in advancing Australia's foreign aid objectives through providing employment experience, earnings and skill development opportunities to Pacific workers, while also assisting Australian horticulturists to find workers.

Temporary worker schemes may be an important element of a development strategy, but are unlikely to be a panacea for all the problems facing the region and Pacific countries cannot ignore the need for ongoing domestic reform to create meaningful employment closer to home.

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[9] A recent meeting of PIC officials noted however that "the challenges of developing alternative sources [of revenue] should not be overstated".

FOOD AND FUEL PRICES

International prices of energy, metals, agricultural raw materials and food have all risen strongly over recent years and represent a current economic challenge. With the exception of PNG, PICs are net importers of food and energy and are particularly vulnerable to oil price increases, as oil and diesel imports are the main fuels for power generation and transport. Despite recent easing of fuel prices, this remains a fundamental medium to long-term issue for the region.

High world oil prices pose greater risks to PICs than increases in food prices, but urban households are particularly vulnerable to the mix of price rises. Higher commodity prices can flow through to higher inflation and can adversely affect the balance of payments of net importing countries. Future growth prospects are also affected by the exposure of most PICs to oil price movements.

At the broadest level governments in the region need to allow the price system to increasingly resolve these shortages and ensure utilities are using fuels as efficiently as possible. However, large price changes must be carefully handled. Governments can work through fiscal policy to provide targeted income and food support to the disadvantaged.[10] Monetary and wages policy – particularly for public servants – should be set carefully to avoid food and fuel price increases spilling over into generalised inflation. Open markets, trade liberalisation and a sustainable investment environment are key elements for achieving longer term fuel and food security.

Governments in the region have begun addressing this issue, with mixed results. Samoa has undertaken structural changes to the way it imports fuel, significantly reducing the price of fuel imports. PNG has been relatively successful to date in dealing with the commodity price boom through its macroeconomic policy and a mix of debt retirement and deferred public spending of oil and mineral revenues. Solomon Islands removed all taxes and duties on rice, but the reduction was quickly overtaken by price rises. In Kiribati, efforts to mitigate the extent of price increases to end consumers has seen utilities delay price changes, adding to the losses of these utilities.

[10] This can be particularly difficult however where there are no existing transfer or income support systems, particularly in an environment where government service networks are limited and focussed in the capital.

CONCLUSION

Sustained economic growth, while not an end in itself, is a crucial prerequisite for sustained improvements in wellbeing for the Pacific region. Assisting economic ministries in the region has confirmed that in stable security environments, building sustainable institutional capacity can assist in improving living standards, but it is a long term endeavour.