

Executive Summary

Purpose of this Report

The Asian Development Bank (ADB) coordinates the preparation of periodic updates of economic and social conditions in its Pacific developing member countries (DMCs) as part of its Pacific Studies Series. The last update for the Cook Islands was prepared for 2001. This *2008 Social and Economic Report* updates the Series as part of a broader effort by ADB in partnership with Pacific DMCs to focus on endemic constraints to improvements in public and private sector productivity in the region. This broader effort supports the in-country participatory formulation of policies and institutions that work in favor of poverty reduction, as well as the local formulation of strategies to win over any stakeholders who may not immediately accept reform.

**This report
examines the
constraints to
development
to guide
policy
formulation**

The purposes of this report are to (i) provide an underlying assessment of development constraints and opportunities; (ii) prepare medium-term macroeconomic management and fiscal target indicators; (iii) present a private sector assessment and advise on establishing an enabling environment for a competitive private sector; (iv) present a review of pro-poor service delivery; and (v) provide a basis for policy consultations to facilitate the achievement of pro-poor policy outcomes and to help the people and governments reach critical decisions on adopting and implementing appropriate policies. The report is intended to help guide both public policy formulation in the Cook Islands and the preparation of donor strategies, including ADB's 2008–2012 country partnership strategy.

Social and Economic Setting

Social conditions are high by developing country standards, and there has been good economic growth

Life expectancy in the Cook Islands is high at 71 years; infant mortality is low at 15–20 per 1,000 live births; immunization rates reach almost 100%; secondary school enrollment rates exceed 90%; adult literacy is high; and most Millennium Development Goals have been met or will be met by 2015. These achievements reflect a long history of heavy government investment in health, education, and welfare buttressed by a good natural resource base and benefits of close integration with New Zealand. A substantial improvement in the quality of economic and public sector management since the financial crisis of the mid-1990s also underpins relatively high living standards. For understandable reasons, the Cook Islands now looks to New Zealand to set its benchmarks for service standards, opportunities, and incomes.

Real gross domestic product (GDP) per head has increased by more than 3.5% per annum (p.a.) on the average since the commencement of economic reform in the mid-1990s and is now more than \$10,000.¹ The key drivers of growth are expanding tourism and rising household spending, which have reduced unemployment on the main island of Rarotonga to low levels. Rising numbers of foreign workers are required to meet the needs of the island's expanding private sector. The second largest island by population, Aitutaki, has also benefited from tourism-led growth and is now a sustainable center of private sector activity.

The fiscal position is sound

Economic growth led by the private sector has boosted government revenue; this, combined with tight fiscal management, has reduced the debt of the national Government (the Government) to a low level. The

1 Gross domestic product (GDP) is the income earned in a country, some of it by nonresidents.

Government now has the financial capacity to fund public infrastructure projects that have been put under pressure by an expanding economy and demands for higher standards of service.

Perhaps, the biggest current development challenge is the long-term decline in the population of indigenous Cook Islanders. Those holding Cook Islands residency also hold New Zealand citizenship and can freely access the New Zealand and Australian job markets and the New Zealand health, education, and social security systems. More than three times as many Cook Islanders live overseas than in the Cook Islands.

The predominant migration flows have been from the outer islands to Rarotonga to New Zealand and beyond. Standards of social services, notably education, are generally believed to be important determinants of migration, and migration has also responded to changes in the economic benefits of the Cook Islands. Economic management and social service delivery therefore have important contributions to make in sustaining the population and identity of Cook Islanders.

Despite its overall success, economic reform has successfully generated private sector-led growth only in Rarotonga and Aitutaki. Elsewhere, the private sector has not responded or perhaps been unable to respond to the new business environment. In general, the main impact the mid-1990s reform had in the outer islands was an exodus of people. There was no offsetting gain in economic sustainability as the public sector continues to dominate the island economy and crowds out prospects of sustainable private sector activities. This crowding-out effect has grown, not eased, since the reform. Public sector and welfare payments funded by the Government now provide the future source of economic activities on most outer islands. Some of them will face the prospect of economic dependency, while others have already reached that point.

A falling resident population is a key challenge that calls for economic growth and better services

The outer islands have failed to achieve economic sustainability

Sustaining Growth

Economic reforms have been central to growth

The economic reform program was very successful in creating an enabling environment required for private sector growth. This is evident in the improvements of private sector-led economic growth, falling unemployment, and the business community's reasonably favorable assessments of the operating environment. Key achievements were the (i) reduction in excess employment in the public service and an associated correction of public servant pay rates, (ii) reduced involvement of the public sector in business activities, (iii) adoption of a modern tax system centered on the value-added tax and the reform of import duties, (iv) strengthening of the financial system through reform of the state bank and improved supervision, and (v) more open stance toward foreign investment and workers.

Continued gains in productivity are required

These reforms lifted the productivity of the economy's factors of production—labor, capital, and land—while providing for the supply of additional labor and capital from overseas. Some signs indicate that the international competitiveness of the economy may have declined recently. These signs include an apparent decline in foreign investment and a substantial drop in long-haul tourist arrivals. Sustaining growth requires ongoing vigilance to lift productivity and ensure the availability of capital and skilled labor. Such efforts will help bolster the international competitiveness of the economy and provide the capacity needed to meet rising demand for the country's goods and services.

Tourism will likely remain as the main driver of growth

Tourism will likely remain as the driver of economic growth and will remain concentrated in Rarotonga and Aitutaki. Land suitable for agriculture exists in Rarotonga and the Southern Group of outer islands. Experience, however, suggests that the economy's strengths are elsewhere and agricultural activity will be limited to the sale of fresh fruits and vegetables to Rarotonga and Aitutaki and small niche market opportunities (e.g., sales to Honolulu of maire, from

whose leaves are fashioned garlands, and coffee exports from Atiu). A key factor behind this is the regionally high cost of labor and the availability of more attractive employment alternatives (e.g., in tourism or the public sector).

Pearl farming on Manihiki will remain the main private sector activity in the remote Northern Group of outer islands if issues on farm management are addressed and world prices are favorable. Other potential contributors to private sector activity in the Northern Group include offshore fishing, fish processing, and handicrafts. Nevertheless, the scale of these activities will likely remain relatively small. Public sector employment will remain the dominant source of income in the Northern Group, as in the Southern Group (excluding Aitutaki).

Raising the productivity of infrastructure is an important step toward sustaining overall economic growth. The tight fiscal management necessary to correct the Cook Islands' very high debt levels and the absence of a clear planning framework for infrastructure have contributed to a backlog of works. Roads, water, sewerage, electricity, and harbors and ports in Rarotonga and Aitutaki are potential constraints to growth over the medium term. Existing infrastructure tends to impose unnecessarily high costs on users and, in some cases, is unable to meet new demands at a reasonable cost or standard (e.g., water in Aitutaki or liquid waste disposal in Rarotonga).

A number of structural barriers in the economy have the potential to become significant constraints to growth. Most import duties were removed with the fiscal year (FY) 2007 budget, but some were retained. Protective tariffs are provided for certain locally produced goods in an attempt to reduce the competitiveness of imports and hence support local producers, especially in agriculture and drink manufacture. The difficulty is that these protective tariffs feed into the cost structure of the tourism industry and reduce its competitiveness. Furthermore, they tend to

**Public
infrastructure
needs
upgrading**

**Structural
barriers
warrant
review**

lock scarce local labor and capital into areas of the economy with low productivity and questionable long-term prospects. Such protective tariffs would better be phased out to allow resources to move to their most productive use. Some tariffs have been kept on inputs to production to boost revenue, such as for vehicles, and again they tend to reduce the economy's competitiveness.

While price controls are generally overused, action on telecommunications would be justified

An extensive regime of price controls covers most basic food items and fuel. The intention of these controls is to keep key items affordable. However, they can force prices up—and indications exist that they do—and tend to shift profit margins from one item to another rather than actually reducing the overall cost. From a public policy perspective, price controls can be justified only when effective competition is lacking. Few, if any, of the items currently controlled meet this criterion, at least in Rarotonga and probably also in the outer islands. A better way to keep goods affordable is to provide for a competitive business environment. Effective competition can be relied upon to minimize costs to society, but current administrative mechanisms inevitably impose additional burdens on society through market distortions and administrative costs.

While there is a tendency to over-regulate prices, one key area of the economy genuinely needs better price supervision. Telecom Cook Islands has a monopoly and for many years has earned very high profits by overcharging. Such a monopolistic behavior reduces the economy's competitiveness and has adverse social effects. Legislative monopoly has recently expired, and prices for certain international services have been reduced. It is important that regulatory changes be made to lock in these benefits while facilitating the entry of new suppliers and removing any remaining overcharging. Similar changes in electricity supply are warranted, though the potential benefits are not as great as in telecommunications.

Education and training have important roles in maintaining growth. Local labor is in short supply, imposing a potential constraint on growth. Adult education and further improvements in educational standards have the potential to lift labor productivity to underpin a move to higher-valued activities (e.g., in tourism). Better education and training can also contribute to growth by helping keep residents in the Cook Islands so they are available to meet the needs of the labor market. Education is particularly important for the outer islanders to take advantage of the better opportunities offered by the main centers of Rarotonga and Aitutaki.

Education and training have roles to play in maintaining growth

Managing Foreign Involvement

The makeup of the country is changing as the number of foreign workers and investors rises; people of Cook Islands descent continue to depart; and fertility rates decline. The foreign, non-tourist population was estimated at 1,000 through the 1990s. Updating the estimate of the foreign, non-tourist population is largely guesswork, but it now appears to have roughly doubled to 2,000, or 10% of the total population.

Foreign involvement in the country is increasing

Some community members are concerned about the flow-on effects of a rising foreign presence, including the potential erosion of the Cook Islands' identity. This has a social dimension as the culture is seen to be at risk. It is also seen to have a commercial dimension, reflecting concerns that the tourism industry may suffer if the Cook Islands' image is lost. Some foresee that Rarotonga and Aitutaki may evolve into high-density tourism destinations with little involvement with, or connection to, Cook Islands Maoris other than through rental payments on leased land.

There is a range of potential responses to this development issue. At one extreme is a ban on further foreign involvement and at the other extreme is the free flow of foreign labor and investment. The first extreme

While tighter controls may stall growth, free entry poses dangers to national identity

would probably see economic growth stall as there would be no additional labor to meet growing demand. It would also carry the risk of the Cook Islands' economy losing its competitiveness and actually contracting if local labor were too forceful in taking advantage of the opportunity created to increase pay rates. The opposite extreme would minimize the economy's cost structure by keeping wages down and probably maximize economic growth. However, rising foreign investment could bring about very large changes in the nature of the Cook Islands as foreign presence grows, especially if Cook Islanders continue to leave for better wages overseas.

The current approach is a middle ground

The current approach is a middle path. Foreign workers are allowed where local skills are not available, and foreign investment is allowed under certain conditions, mostly outside of the reserved areas for local businesses. Both foreign workers and investors pay fees, which lightly control the entry.

Efficiency, accountability, and transparency can be improved

The guiding policy framework lacks clarity and coordination. This can give rise to uncertainty and inconsistencies. For example, it has been proposed that immigration fees on foreign workers be reduced, thereby facilitating access for foreign labor. At the same time, the Development Investment Board has been moving toward tighter controls on access by foreign investors. The rules adopted to guide implementation have been generally well applied, but they are open to abuse and the impacts of the current policy are not being monitored (e.g., the extent of foreign ownership cannot be measured).

A more open and clearly defined system would improve efficiency, accountability, and transparency. Support for local labor and business owners to upgrade their skills so they can play a more prominent role in the economy is probably also important to finding balance on this issue.

Tightening current controls on foreign involvement—a proposal that is already well advanced—could be achieved

through various means. For example, higher fees are one option for limiting access. Quotas could be set for foreign labor or partial bans could be applied for certain skills, industries, or islands. Some options are better than others, and potential impacts should be analyzed openly and discussed. All efforts will work best if applied openly and transparently.

Managing the Public Sector for Results

The Government now has in place one foundation required for managing public resources effectively and efficiently. The progress made is readily evidenced by substantial improvement in the Government's financial position and in the quality of financial management across the public sector. Steady progress has also been made in raising effectiveness and efficiency through improved budgeting practices and agency planning built on the foundations provided by modernized public sector legislation.

Demands on the public sector are rising, and there is a need for the public sector to respond by continuing to focus on results. The community demands higher service standards, higher incomes, and more opportunities. The aspiration appears to be to reach New Zealand standards while preserving the Cook Islands' modernized lifestyle in Rarotonga and maintaining a more traditional lifestyle in the outer islands. At the same time, a declining share of government revenue to GDP requires tighter prioritization of government expenditures.

For the Cook Islands, the priorities for government expenditure are likely to lie in economic infrastructure, education, and health. A backlog of infrastructure work needs to be addressed. Considerable potential exists to raise educational standards, and doing so is important to meet the needs of the economy. The health sector faces the challenge of a rising incidence of noncommunicable diseases.

**Gains are
apparent
across the
public sector**

**Community
aspirations
continue to rise**

**Priorities
are health,
education,
and
infrastructure**

Public debt could rise to 35–40% of GDP by 2026

Health sector funds could be reallocated to generate better value for money, notably from curative to preventative health cares. Education also shows some potential for reallocating sector funds toward primary and secondary education. But the potential to upgrade educational standards and the economy's need is so great that the emphasis may more usefully be placed on increasing the sector's share of total expenditure. For physical infrastructure, a larger share of expenditure is required to make up for the recent low levels of funding. Infrastructure expenditure proposed under a recently prepared Infrastructure Master Plan could see net general government debt rise to more than 20% of GDP by 2026.

With welfare and wage payments as low priorities, agreeing on realistic service standards is important

Expenditures in low priority areas need to be trimmed. Welfare payments, which are large and poorly targeted, provide one likely opportunity for future savings. Expenditure constraint may need to go beyond the functional level to address the overall composition. In this respect, the key is to control the wage bill, allowing spending to shift to capital and maintenance sides.

Improvements can also be made to the ways how government operates. For example, key issues in developing infrastructure include the procurement process, management weaknesses within agencies, low cost recovery on public services, and problems faced in devolving responsibilities to island councils. The competitive outsourcing of infrastructure works to the private sector has the potential of being an important response to these problems, requiring further rethinking of the division of responsibilities between the public and private sectors.

All expenditure decisions face the need to establish realistic standards of services across the country. Improvements to services in the outer islands inevitably come at the expense of improvements in Rarotonga and Aitutaki, thereby accentuating the gap between these centers' standards and those of New Zealand, to which people appear to aspire.

The bigger the gap between Cook Islands and New Zealand standards, the larger the population outflow that imposes its own costs on the country would be.

Questioning the weighting of expenditure in favor of the outer islands appears to be reasonable. The average allocation for operating costs for health, education, and infrastructure in the outer islands is about double the allocation to Rarotonga on a per head basis. Moreover, it has been proposed that some 60% of infrastructure funding over the next 5 years would be for the outer islands. This allocation appears out of line with 19% of the population and 14% of formal employment located in the outer islands in 2001, both of which would since have declined.

One remaining gap in public sector management is the establishment of a systematic process for assessing performance. While the budget sets out a work plan with targeted results and performance measures for the outputs of each ministry, they are not scrutinized systematically. The management system established for ministries requires the Public Service Commission to review progress in delivering these outputs regularly, but no such review is undertaken. Many performance measures are unrealistic—too high to be of use in the annual review. Heads of ministries are subject to performance review, but without ministry-level information, the review can be only superficial. This means that the cycle of inputs, activities, and outputs required to feed back into reformulation in subsequent years is weak at best and, at worst, completely absent.

Implementing the recently finalized National Sustainable Development Plan (NSDP) 2007–2010 would greatly assist the adoption of a performance management system. NSDP sets out the national vision and goals, as well as the direction to be followed by the lower-level plans (sector strategies, corporate plans, and the annual budget). The plan presents an important opportunity to reinvigorate the broader engagement of the community in using public sector

**Systematic
performance
assessment is
needed, as is
implementation
of the national
plan**

resources. Some barriers have formed to achieving a focus on results in the public sector. Opening the system to scrutiny is likely to be a part of the solution to this problem.

Addressing Disadvantages

Outer islands suffer lower service standards and less opportunity than Rarotonga

No studies of the poverty situation in the Cook Islands have been done, but it is widely accepted that the key equity issue is the disparity between Rarotonga and the outer islands. This is reflected in development indicators and a steady flow of residents to Rarotonga. Providing small, far-flung communities with a full array of social services is difficult and expensive, but the disadvantages suffered by outer island communities go beyond lower service standards. With the departure of public sector jobs in the mid-1990s, along went people and skills. Some communities now stay alive only through welfare payments and accepting responsibility for grandchildren. A widely held aspiration is to achieve more evenly spread economic growth and social development across all islands.

Gender imbalances and vulnerability exist in all communities

Beyond this general pattern of outer island disadvantage, vulnerable members of the community include people who are least able to help themselves, whose issues go unheard, and who often have special needs and require extra help. The causes of vulnerability include the breakdown in the traditional family support systems, emigration of caregivers, rising cost of living, and ruinous social and community obligations. The vulnerable are elderly, unemployed, single parents, children, and physically challenged, as well as smaller numbers of squatters and crime victims.

Another general pattern of disadvantage is by gender. By regional standards, the women of the Cook Islands rank well. Their main disadvantages are their relatively restricted opportunities for economic and political participation, generally lower earning capacity, and remaining subtle forms of gender bias.

The Government's response to the disadvantaged rests on providing services to the outer islands and welfare payments. It will be difficult to make further substantial progress toward addressing the present imbalance in living standards through funding alone. Funding already favors the outer islands to the point of overfunding in some cases. However, some progress could be made by setting and meeting minimum standards of services, addressing inequities among islands in funding for key services, and finding a more workable approach to decentralization that gives local communities a greater role in decisions affecting the outer islands.

The outer islands could be granted more voice

Welfare payments are high, and this appears to be a key reason for the Cook Islands' lack of any sizable group of very poor people. However, much more could be done to focus the system on supporting the disadvantaged. Almost all payments are made without any means testing (i.e., without determining need), and it is perhaps a misnomer to describe it as a welfare system. For example, payments are made for 1,464 elderly and 4,943 children with the only criteria being age and residency, while only 227 people receive payments for infirmities and 43 for destitution. In addition, even funding for these small groups is not according to strict needs-based definitions. For example, tiny but food-rich Mauke is home to 18% of destitute cases while generally poorer Pukapuka and Penhryn, together with Manihiki, account for only 2%.

Welfare payments could be better targeted

Improving Governance

The quality of governance remains one main risk to continued development and an area warranting renewed efforts. A key consideration is the absence of action to advance constitutional reform. A review of the constitution was released in 1998, but few recommendations were implemented. Frequent changes of government and the associated political instability have probably undermined the quality of government with follow-on effects on emigration

Constitutional reform is an outstanding issue, as is devolution, which has been largely reversed

and economic growth. Political patronage remains an ongoing risk that has been exaggerated by the (i) weaknesses in the parliamentary system, (ii) ability for ministers of the crown to act outside the accountability framework, (iii) absence of a clear planning framework to guide the use of public funds, and (iv) gaps in performance management under the budget process.

A key component of reforms in the mid-1990s was the transfer of formal authority to decide and implement decisions from the center to the periphery. At the time and several years thereafter, this transfer was considered critical for the sustainability of the country. Specifically, the Government was to devolve some key resource management and public administrative control to island councils, and to provide a fully functional and effective form of self-government for each island, provided with clear and open lines of responsibility and communications with the restructured central Government in Rarotonga. The actual extent of devolution fell short of this intention. Lacking the support of a clear policy framework, devolution outpaced the development of local capacity from a low state, with the result that the devolution that did occur has largely been reversed. The balance of power between central and island governments probably has a significant effect on the quality of island services. Although devolution is a difficult area for making progress, there is value in revisiting these issues and seeking a sustainable approach.

Other measures that could support accountability and transparency include (i) making budget documents more readable; (ii) publicly releasing the reports of the independent budget committee; (iii) reducing the use of payments on behalf of the Crown; (iv) adopting codes of conduct for members of Parliament, civil servants, and officers of public enterprises; and (v) imposing tighter controls on public enterprises and appointing ministry heads to curb a tendency toward politicization.

Summary of Key Findings

- Living standards are generally high. Private sector-led growth has been achieved, driven by tourism. Economic reforms and improved public sector management have been critical to achieving a turnaround along the Cook Islands' development path.
- The need to pursue international competitiveness is ongoing. Structural reforms are warranted, notably to the protective tariff regime and to promote competition in key industries (e.g., telecommunications). Infrastructure investment in the main centers of Rarotonga and Aitutaki is also needed.
- Foreign investment and workers will continue to be required to meet economic needs and to replace departing Cook Islanders. An intended tightening of access rules is likely to put growth at risk. The important national goal of preserving the identity of the Cook Islands must be balanced with the needs of the economy.
- Economic prospects are poor in most outer islands, where living standards are lower than those in the main centers. The outer islands already generally receive a lot of public funding, and further increases are unlikely to prevent their long-term population decline. Yet funds could be distributed more equitably, and more control in the use of public funds could be provided to communities.
- Education plays an important role in building the skills needed for the economy, particularly through expanded vocational training. Ongoing efforts are still required to improve the quality of lower schooling.

- More demands are likely to be placed on the health sector with the rise in lifestyle diseases. Much stronger preventative action is important for controlling this trend.
- The nation's fiscal position is sound; the machinery of government is relatively sophisticated; and the Government is well placed to fund development. Infrastructure, education, and health are the expenditure priorities.
- The disadvantaged deserve more support. Considerable public resources exist that could be used to help the disadvantaged, notably through the better targeting of the welfare system.
- There is an underlying need to maintain the large gains made in governance. Some signs indicate that the damaging attitudes of the 1990s remain, and a tightening of safeguards is prudent.
- Maintaining strong economic indicators can benefit from a multi-year fiscal framework. The adoption of prudent targets for benchmark indicators would help guide policy planners to achieve sustained robust macroeconomic performance.