

INCLUSIVE AND SUSTAINABLE GROWTH ASSESSMENT

I. RECENT GROWTH, POVERTY, INEQUALITY, AND ENVIRONMENTAL DYNAMICS

1. The 14 Pacific region developing member countries (DMCs) of the Asian Development Bank (ADB) are markedly diverse in their location (distance from major markets) and geographic spread, size (population and land area), and resource endowment. This diversity is also reflected in ADB's current project portfolio and investment pipeline for the Pacific Approach, 2016–2020. Fiji, Papua New Guinea, and Timor-Leste are substantially larger in size than the other 11 Pacific region DMCs (PIC-11)—the Cook Islands, Kiribati, the Marshall Islands, the Federated States of Micronesia (FSM), Nauru, Palau, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Despite an apparent diversity, the PIC-11 share common features, such as smallness, remoteness, and dispersion, which influence their development pathways.

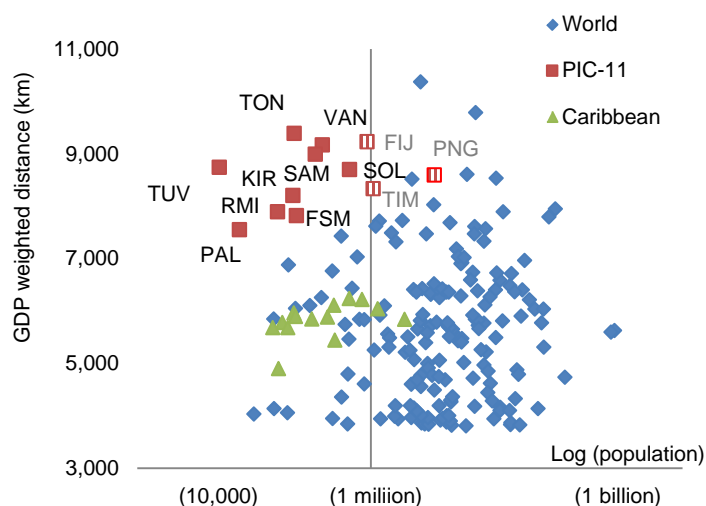
2. This assessment focuses on the PIC-11 given that country partnership strategies are in place for the three larger Pacific region countries—Fiji, Papua New Guinea, and Timor-Leste.¹ These strategies analyze and address in detail the countries' unique challenges and assistance needs, and are based on country-specific economic, poverty, gender, environment, private sector, fragility, and sector assessments.² For the PIC-11, country strategic analyses are prepared and updated annually as part of the rolling country operations business plan process, in addition to this assessment, to inform detailed programming of country support. This inclusive and sustainable growth assessment, together with the country strategic analyses for the PIC-11 and the country partnership strategies for the three larger countries, inform the strategic direction of the Pacific Approach, 2016–2020.

3. **Geographically, the 11 smaller Pacific island countries are among the smallest, most remote, and most dispersed countries in the world.** All of the PIC-11 are among the 40 smallest states in the world by land area. At the same time, the PIC-11 are substantially more remote from major markets (e.g., using gross domestic product [GDP]-weighted distance) than other small island countries, such as those of the Caribbean (Figure 1). Comprising island groups with up to several hundred islands, many of the PIC-11 are also highly internally dispersed, with small populations spread out over vastly distant islands.

¹ For comparison, data for Fiji, Papua New Guinea, and Timor-Leste are provided in the figures and data annexes throughout the assessment.

² ADB. 2014. *Country Partnership Strategy: Fiji, 2014–2018*. Manila; ADB. 2015. *Country Partnership Strategy: Papua New Guinea, 2016–2020*. Manila; ADB. 2016. *Country Partnership Strategy: Timor-Leste, 2016–2020*. Manila. The detailed assessments are available as linked documents to the strategies.

Figure 1: Dual Disadvantage of Economic Geography



FIJ = Fiji, FSM = Federated States of Micronesia, GDP = gross domestic product, KIR = Kiribati, km = kilometer, PAL = Palau, PIC-11 = 11 smaller Pacific island countries, PNG = Papua New Guinea, RMI = Marshall Islands, SAM = Samoa, TIM = Timor-Leste, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

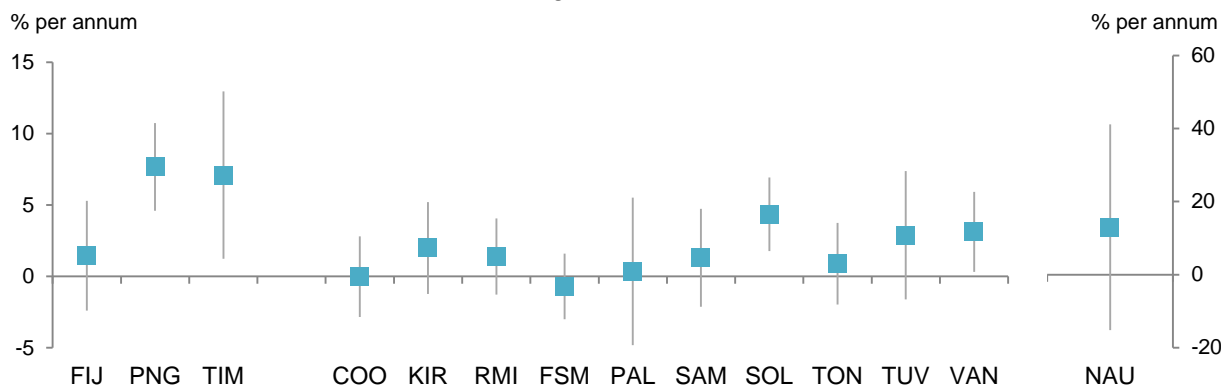
Note: The squares with vertical shading indicate Pacific developing member countries that are not members of the PIC-11. GDP weighted distance measures relative distance of a particular economy from all potential trade partners, adjusting for each partner's market size.

Sources: World Development Indicators, Centre d'Études Prospectives et d'Informations Internationales, and Asian Development Bank.

A. Economic and Environmental Dynamics

4. **Low and volatile growth.** The PIC-11 have seen highly volatile GDP growth during 2006–2015 (Figure 2). For all except Nauru and to some extent Solomon Islands, growth has been on average low, ranging from -0.7% per year in the FSM to 3.1% per year in Vanuatu. Nauru's high average annual growth of 13.0% during this period was characterized by extreme volatility and, in recent years, was driven by externally generated earnings from fishing licenses and the hosting of an Australian-run regional processing center for refugees. Solomon Islands' average growth of 4.4% was driven largely by natural resource extraction (timber and gold). Compared with other ADB subregions, growth volatility in the Pacific was second only to the transition economies of Central and West Asia in the decade from 2006 to 2015 (Figure 3). Over the latter half of that decade, Pacific economies registered the highest volatility, in large part due to the impact of disasters (e.g., Cyclone Evan in Fiji and Samoa in 2012, and Cyclone Pam in Vanuatu in 2015) but also large infrastructure project cycles (e.g., construction of PNG's liquefied natural gas pipeline and road construction in Kiribati). With volatile growth, the PIC-11's record in growing per capita incomes has been mixed. Since 1990, Samoa has achieved the largest rise in GDP per capita with over a fivefold increase, while per capita income in the Solomon Islands only doubled over the same period. On average, the PIC-11 recorded about a threefold increase in per capita incomes in the period from 1990–2015 (Figure 4).

Figure 2: Low and Volatile Growth
2006–2015 average, with standard deviation

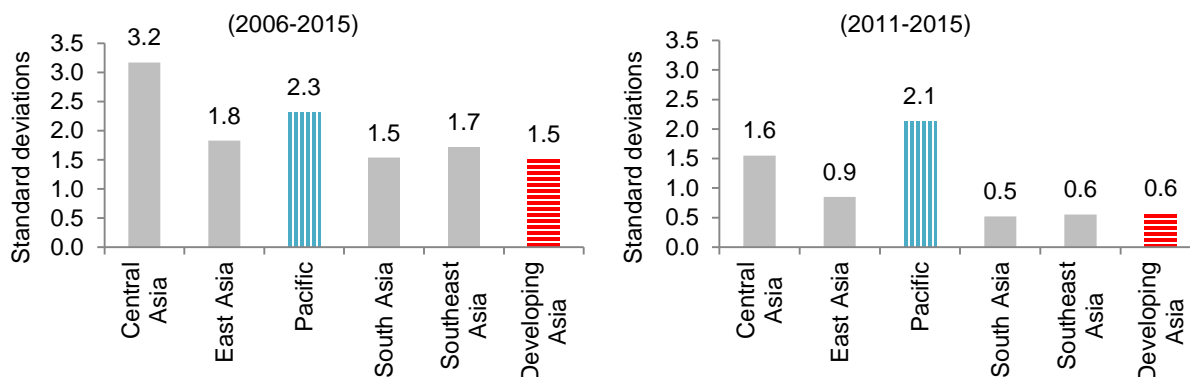


COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, KIR = Kiribati, NAU = Nauru, PAL = Palau, PNG = Papua New Guinea, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, TIM = Timor-Leste, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

Note: High–low lines reflect the range between 1 standard deviation above and 1 standard deviation below the mean over the 10-year period covered.

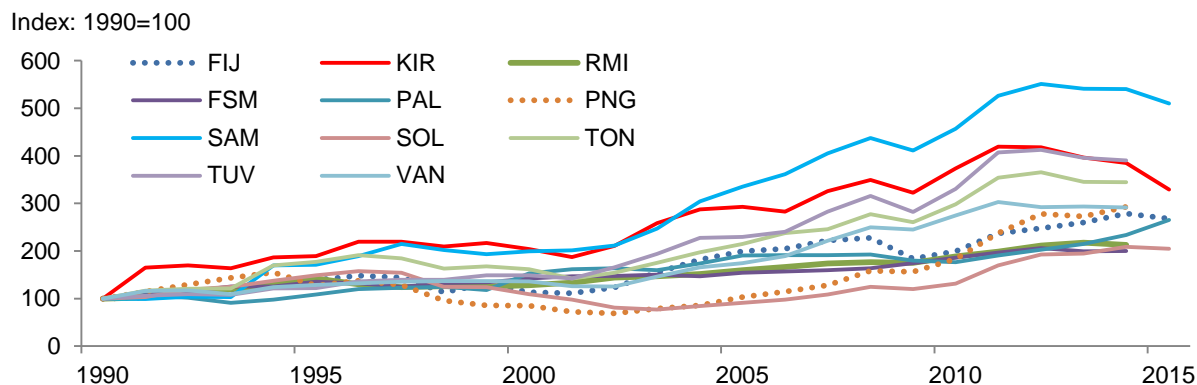
Source: Asian Development Bank estimates.

Figure 3: Standard Deviation in GDP growth



Source: Asian Development Bank estimates.

Figure 4: GDP per capita
1990–2015

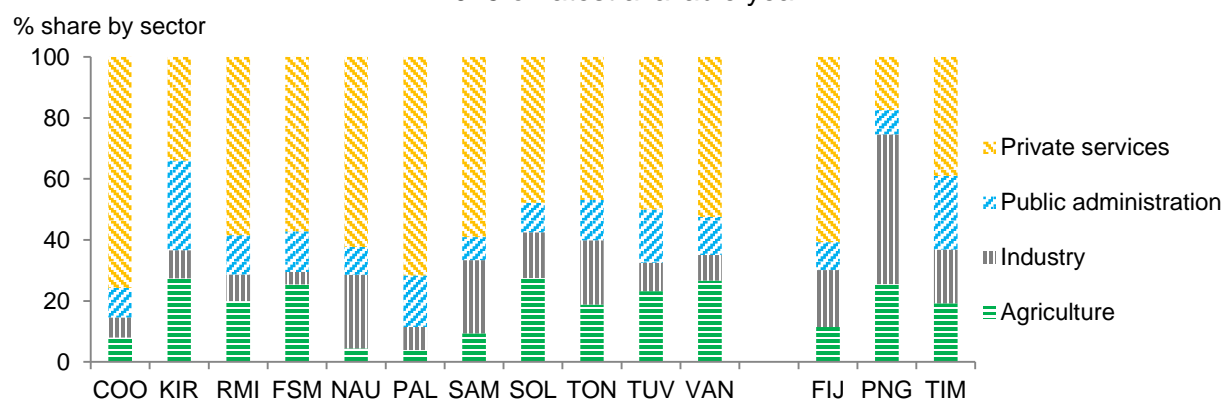


FIJ = Fiji, FSM = Federated States of Micronesia, KIR = Kiribati, PAL = Palau, PNG = Papua New Guinea, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

Source: World Development Indicators online database.

5. **The service sectors dominate the 11 smaller Pacific island country economies.** Services account for at least 60% of GDP in all of the PIC-11, reaching almost 90% in the Cook Islands and Palau, where tourism has developed strongly (Figure 5). Public administrations play a particularly important role in Kiribati, Palau and Tuvalu. The primary sector is important in many of the small island economies and contributes 15%–30% to GDP. PIC-11 economies have relatively small industry sectors that comprise mainly construction and light manufacturing of food, beverages, and tourism-related products such as handicrafts. Industry's share in GDP only exceeds 20% in Nauru (phosphate mining), Samoa (food and beverages, and wire harnesses for automobiles), and Tonga (infrastructure construction and reconstruction).

Figure 5: Composition of Gross Domestic Product
2015 or latest available year



COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, KIR = Kiribati, NAU = Nauru, PAL = Palau, PNG = Papua New Guinea, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, TIM = Timor-Leste, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

Source: Asian Development Bank estimates.

6. **The public sector is relatively large and drives growth in many of the 11 smaller Pacific island country economies.** Public expenditure averages 58% of GDP, compared to 34% for other small states, and is financed by a combination of domestic revenue, aid, external and domestic borrowing, and, in some of the PIC-11, drawdowns from sovereign wealth funds.³ The total public wage bill is similarly high and averages 18% of GDP compared with 10% for other small states. The public sector in the PIC-11 provides on average about 23% of total wage employment and accounts for more than 40% in Tuvalu (Annex 1, Table 5). In addition to the high number of civil servants, public sector pay is often substantially higher than for similar positions in the private sector.⁴ Apart from providing employment, the public sector also plays an important role in driving growth, often through aid-funded development projects. Public debt is a concern in many of the PIC-11, with the joint International Monetary Fund and World Bank debt sustainability analysis indicating a high risk of debt distress in Kiribati, the Marshall Islands, the FSM, and Tuvalu, and a moderate risk in Samoa, Solomon Islands, Tonga, and Vanuatu.⁵

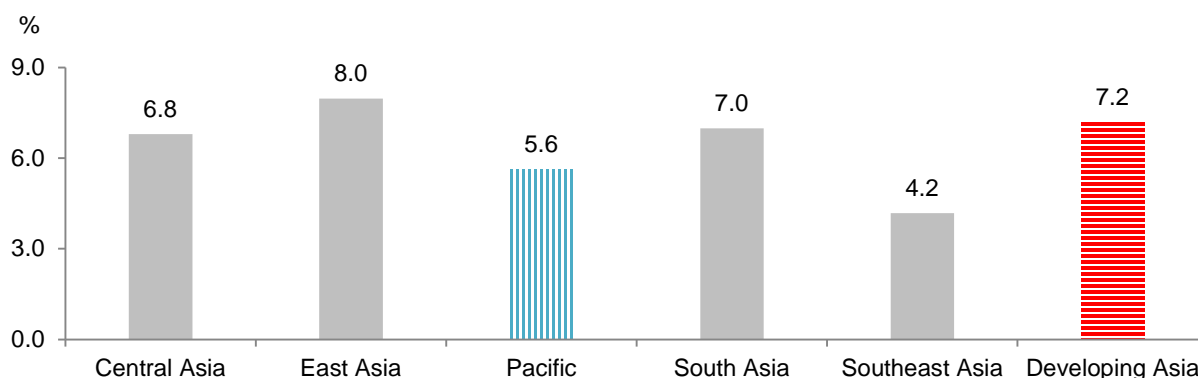
³ The North Pacific countries (Marshall Islands, FSM, and Palau) rely on trust funds largely comprising compact grants from the United States, while Kiribati and Tuvalu have sizable sovereign wealth funds from natural resources (phosphate mining in the past, fisheries in the present). Following depletion of past trust funds, Nauru is setting up a new trust fund to deposit fiscal surpluses from fisheries licenses, secondary phosphate mining, and the refugee processing center.

⁴ For example, the average civil service wage in Tonga is almost double the average private sector wage.

⁵ Nauru has recently joined the International Monetary Fund (and is considered to be at high risk of debt distress). The debt sustainability framework for low-income countries is not applicable to Palau and the Cook Islands (the Cook Islands are not part of the International Monetary Fund).

Overall, however, public debt levels of the PIC-11 (equivalent to about 38% of GDP, on average) are lower than in other small islands countries (57%), particularly those in the Caribbean (73%).⁶ Fiscal policy is a particularly important policy lever to respond to shocks and stimulate the economy in the PIC-11 given that seven of the PIC-11 (except for Samoa, Solomon Islands, Tonga, and Vanuatu) have officially adopted foreign currencies of larger neighboring countries, which use a peg to a basket of foreign currencies.⁷ The use of foreign currencies or currency pegs has provided some degree of price stability, with average inflation in the Pacific being lower than in other subregions in Asia over the period from 2006 to 2015 (Figure 6), except for Southeast Asia.

Figure 6: Average Inflation
2006–2015



Source: Asian Development Bank estimates.

7. Limited economic diversification characterizes the private sector in the 11 smaller Pacific island country economies. PIC-11 economies generally comprise (i) a large informal sector engaged in small-scale agriculture, retailing, and services; (ii) widespread subsistence agriculture and fishing; (iii) cultivation and export of indigenous root crops; (iv) exports of some specialized agricultural products; (v) fishing and licensing, servicing, and supplying foreign fishing fleets within territorial waters; (vi) a small tourism sector; (vii) small light manufacturing industries (e.g., agricultural products, handicrafts); and (viii) substantial government services. Reflective of the limited economic diversification, all of the PIC-11 score between 3 and 4 in the Hirschman–Herfindahl index, which has a scale of 1 to 5, where a lower score represents a more diversified export basket.

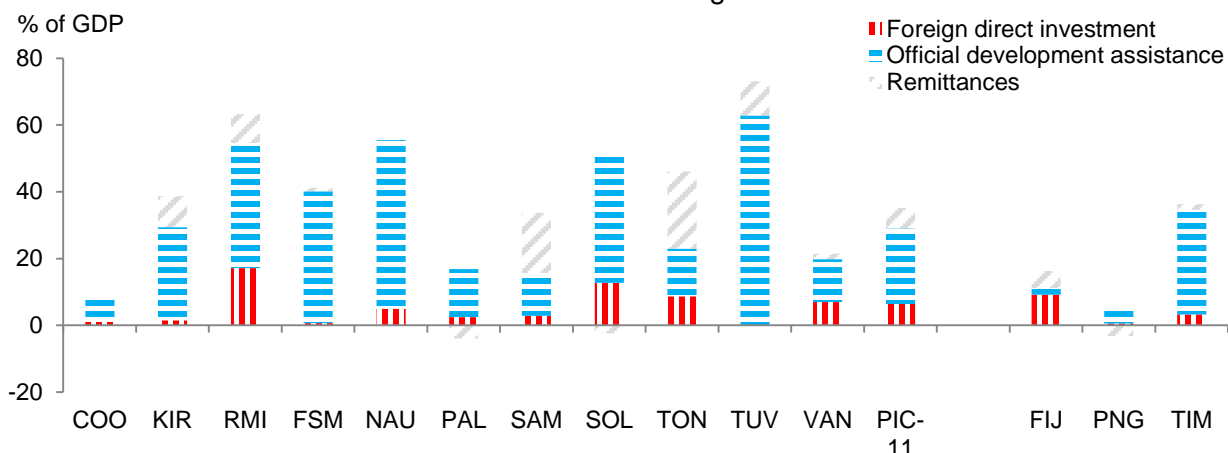
8. The 11 smaller Pacific island country economies are highly dependent on imports and kept afloat by external income. Like other small countries with less diverse production bases, the PIC-11 are highly dependent on imports to meet their needs. Conventional measures of openness, such as trade–GDP ratios, show the PIC-11 to be highly open, which is largely due to high imports. Merchandise exports are limited to: (i) mostly natural resources such as minerals, timber, and fisheries; (ii) goods benefitting from preferential access (sugar, garments, and automotive parts) and preferential pricing (sugar); and (iii) high-value, low-volume products targeted at niche market segments (e.g., Fiji Water and Pure Fiji, Vanuatu beef, Samoan chili). The PIC-11 depend more on exports of services to finance their goods trade deficits (as opposed to exports of goods in most developing countries). These are based on various forms

⁶ G. Hurley. 2015. *Financing for Development and Small Island Developing States: A Snapshot and Ways Forward*. Discussion Paper.

⁷ The Marshall Islands, the FSM, and Palau use the United States dollar; Kiribati, Nauru, and Tuvalu use the Australian dollar; and the Cook Islands uses the New Zealand dollar.

of rent, predominantly (i) tourism earnings; (ii) rents from offshore natural resources such as fisheries, fuels and other minerals; and (iii) foreign savings in the form of remittances and foreign investment, and development assistance. Development assistance is generally high as a percentage of GDP in the PIC-11, while foreign direct investment is typically low (Figures 7 and 8). Remittances vary by country, with Kiribati, Samoa, Tonga, and Tuvalu receiving substantial net inflows.

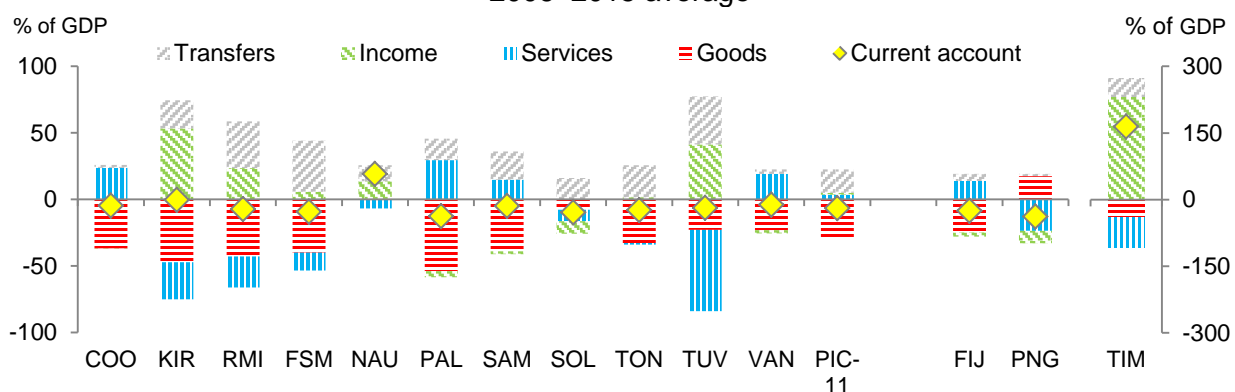
Figure 7: Net Inflows of Foreign Investment, Development Assistance, and Remittances
2005–2014 average



COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, GDP = gross domestic product, KIR = Kiribati, NAU = Nauru, PAL = Palau, PIC-11 = 11 smaller Pacific island countries, PNG = Papua New Guinea, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, TIM = Timor-Leste, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

Source: Asian Development Bank estimates.

Figure 8: Current Account Balance
2006–2015 average



COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, GDP = gross domestic product, KIR = Kiribati, NAU = Nauru, PAL = Palau, PIC-11 = 11 smaller Pacific island countries, PNG = Papua New Guinea, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, TIM = Timor-Leste, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

Source: Asian Development Bank estimates.

9. **The business environment varies considerably among the 11 smaller Pacific island countries.** The World Bank's Ease of Doing Business survey covers eight of the PIC-11: Kiribati, the Marshall Islands, the FSM, Palau, Samoa, Solomon Islands, Tonga, and Vanuatu. The first four of these countries rank in the bottom third of the 189 countries surveyed, from

Palau in 136th position to Kiribati in 149th place. Tonga is the best-performing PIC-11 (78th), followed by Vanuatu (94th), Samoa (96th), and Solomon Islands (112th).⁸ The ranked PIC-11 have particularly low scores in registering property, obtaining credit, protecting minority investors, and resolving insolvency, while starting a business and paying taxes are generally well-performing areas in these countries. The ranked PIC-11, except for Solomon Islands, have made considerable progress in trading across borders since measurement began in 2003. The Marshall Islands, the FSM, Tonga, and Vanuatu have substantially reduced their “distance to frontier”⁹ in getting credit while the Marshall Islands, Palau, Samoa, Solomon Islands, Tonga, and Vanuatu have made it significantly easier to start a business.¹⁰ However, each of the surveyed PIC-11 also lost substantial ground against the world’s leading countries in at least one indicator during 2003–2015.

10. The cost of services is generally high but declining in the 11 smaller Pacific island countries. Businesses and consumers are faced with significant costs for services across the PIC-11. For example, Kiribati, the Marshall Islands, the FSM, Palau, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu all face higher industry electricity tariffs than the mean of other small states.¹¹ In Solomon Islands, the costs are highest and more than double that mean. Recent years have seen a declining trend in electricity bills for businesses across almost all of the PIC-11 (Figure 9). Although these declines coincide with weak international fuel prices, incremental efficiency gains from ongoing reforms in Pacific utilities and investments in renewable energy are also contributing to this positive outcome. While there has been a significant drop in the cost of telecommunications and internet services and a rise in service quality in countries reached by the expansion of fiber optic cables and low-altitude satellite links, the smallest and most remote among the PIC-11 (e.g., Kiribati, Nauru, and Tuvalu) and outer island populations across the PIC-11 have yet to access such links. Interest rates for loans are often substantially higher, if they are available at all, than in larger Pacific region countries, such as Fiji, especially for new customers with unknown credit histories, or when borrowed through microfinance organizations and on remote islands.

11. Populations are small and dynamics mixed, with outward migration playing an important role in many of the 11 smaller Pacific island countries. All of the PIC-11, except for Solomon Islands (37th), are among the world’s 25 smallest countries by population size.¹² Young people (up to 24 years old) make up 50%–60% of the population of the PIC-11, except in the Cook Islands (45%) and Palau (35%). However, what is typically an indicator of rapid population growth is redressed in most PIC-11 by considerable population out migration,¹³ resulting in overall slow population growth, or even stagnation.¹⁴ The typically village-based societies are experiencing rapid urbanization as the draw of jobs, services, and amenities is strong.

⁸ World Bank Group. 2016. *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. Washington, DC.

⁹ The Doing Business “distance to frontier” score measures the gap between a particular economy’s performance and the best performance observed on each Doing Business topic across all economies and years included since 2005 (World Bank. Doing Business. <http://www.doingbusiness.org>).

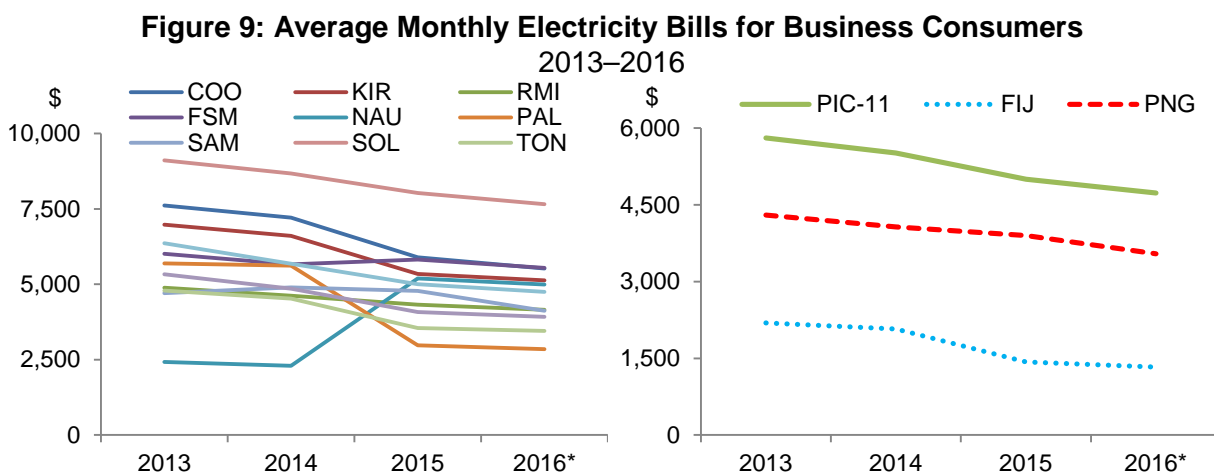
¹⁰ It should be noted that changes in methodology hinder comparisons of exact scores across time; however, the data still shows broad trends.

¹¹ International Monetary Fund. 2015. *Tonga Staff Report for the 2015 Article IV Consultation*. Washington, DC.

¹² The Cook Islands, Nauru, Palau, and Tuvalu have populations below 20,000, followed by the Marshall Islands with about 50,000 inhabitants. Kiribati, the FSM, Samoa, and Tonga have populations between 100,000 and 200,000. Vanuatu’s population is about 265,000 inhabitants.

¹³ Data for 2013 are derived from the Statistics for Development Division of the Pacific Community. None of the PIC-11 shows positive migration trends; instead, net migration is highly negative for the Marshall Islands, the FSM, Samoa, and Tonga, and the Cook Islands and Nauru also show measurable negative crude net migration rates.

¹⁴ Only Kiribati and Vanuatu have population growth rates in excess of 2% per annum.



COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, KIR = Kiribati, NAU = Nauru, PAL = Palau, PIC-11 = 11 smaller Pacific island countries, PNG = Papua New Guinea, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

Note: Data for 2016 are as of June. PIC-11 line corresponds to simple average of electricity bills of business consumers in the 11 smaller Pacific island countries.

Source: Asian Development Bank estimates based on Utilities Regulatory Authority of Vanuatu. *Pacific Region Electricity Bills Comparative Report* (various years).

12. Several of the 11 smaller Pacific island countries are extremely exposed to natural hazards. While only home to about 0.1% of the world population, the Pacific region as a whole (including the PIC-11) faces 2.3% of global disasters, including cyclones, flooding, drought, and earthquakes. Direct impacts include significantly higher average losses of life-years per person due to disasters—the Pacific average stands at 1.2 compared to global low- and middle-income country averages of 0.2–0.4 life-years per person. Similarly, natural disasters have indirect economic and fiscal impacts, with studies showing that an average cyclone reduces per capita incomes by 3.6%.¹⁵ The World Risk Report 2015 identifies Vanuatu and Tonga, in that order, as the two countries with the greatest risk of disaster worldwide, with Solomon Islands following on the fifth rank; Kiribati has one of the world's lowest disaster risks.¹⁶ During 1996–2015, average annual losses from disasters as a percentage of GDP amounted to a very significant 2.9% in Vanuatu, 1.9% in Tonga, and 1.8% in Samoa.¹⁷

13. The 11 smaller Pacific island countries are particularly affected by climate change. With high population shares and many economic activities concentrated in low-lying coastal areas (and given limited land masses), the PIC-11 are particularly affected by climate change. Sea-level rise of up to three times the global average is already contributing to coastal erosion and saltwater intrusion, impacting the coastal cities and communities, while increased ocean temperatures are leading to coral bleaching and destruction of natural coastal barriers. Climate change is also likely to be linked to more frequent and extreme weather patterns including the cyclones, floods, and droughts that affect many of the PIC-11.

14. Economic vulnerability is significant in the 11 smaller Pacific island countries. Reflective of the economic and environmental (including geographic and demographic) dynamics described above, the PIC-11 are among the 30 most vulnerable countries in the world

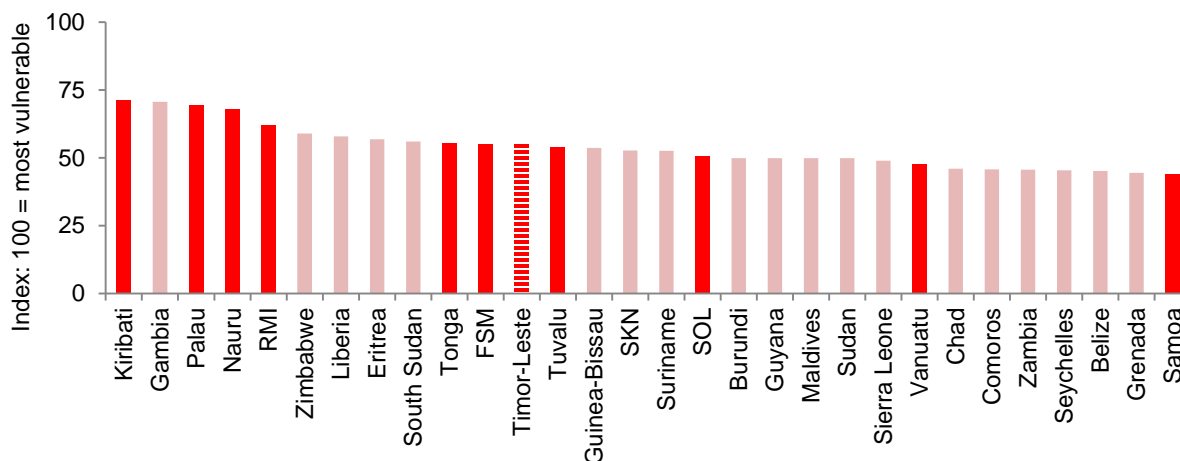
¹⁵ ADB. 2015. *Pacific Economic Monitor*, July 2015 Edition. Manila.

¹⁶ United Nations University and the Alliance Development Works. 2015. *World Risk Report 2015*. Berlin. The report only covers these three PIC-11 countries.

¹⁷ ADB estimates based on the international disaster database (EM-DAT) and World Economic Outlook data.

according to the United Nations' Economic Vulnerability Index (Figure 10).¹⁸ The index rates Kiribati, Palau, Nauru, and the Marshall Islands, in that order, among the five most economically vulnerable countries in the world. Samoa is ranked as the least economically vulnerable country among the PIC-11, but is still one of the 30 most vulnerable countries globally. The vulnerability is also reflected in the high incidence of fragility among the PIC-11.¹⁹ Six of the nine developing member countries ADB classified as facing fragile and conflict-affected situations in 2015 are members of the PIC-11.

Figure 10: Economic Vulnerability Index
2015



FSM = Federated States of Micronesia, RMI = Marshall Islands, SOL = Solomon Islands, SKN = Saint Kitts and Nevis.

Note: The Cook Islands is not covered in the index but experiences similar dynamics.

Source: United Nations Department of Economic and Social Affairs. http://www.un.org/en/development/desa/policy/cdp/lcd/lcd_criteria.shtml

B. Multidimensional Poverty Dynamics

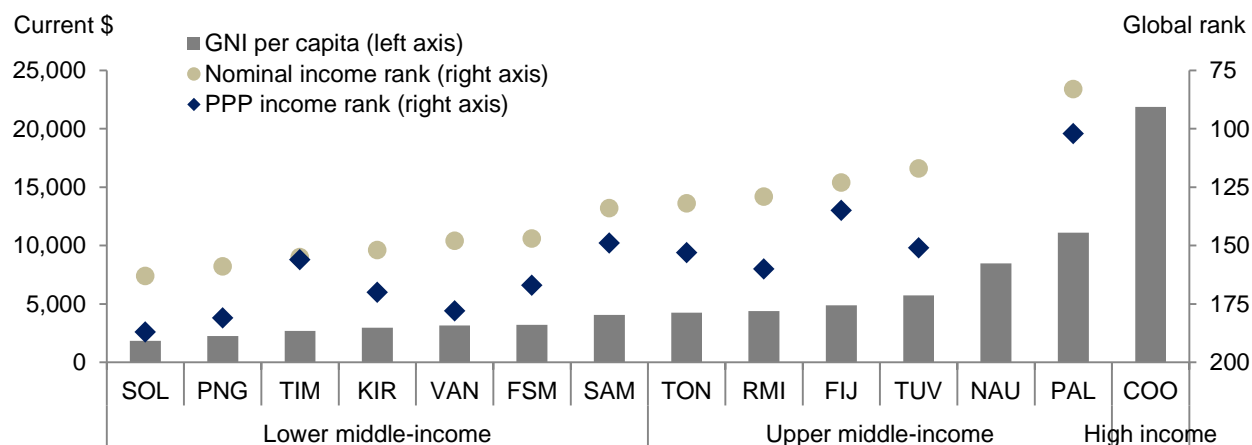
15. Relatively high incomes but substantial variation among the 11 smaller Pacific island countries. All of the PIC-11 are classified as at least middle-income economies; only the Cook Islands has achieved high-income status (Figure 11). However, there is substantial variation in income levels. Gross national income per capita in the Cook Islands (\$21,864) is almost 12 times higher than in Solomon Islands (\$1,830). On average, the per capita income of the PIC-11 is significantly lower than that of other small states (\$5,654) and the average of middle-income countries (\$4,681), despite significant development assistance and remittance inflows that contribute measurably to gross national income in the PIC-11. The middle- and high-income status of the PIC-11 masks lower purchasing power due to high costs of living, as evidenced by lower global income ranks on a purchasing power parity basis compared to gross national income ranks. The impact of cash constraints is, to some extent, tempered by the subsistence lifestyle still lived in the outer islands and in other more remote areas of the PIC-11, and by the provision of free education and health services in many countries.

¹⁸ The index measures structural vulnerability to economic and environmental shocks. It aggregates eight indicators: population; trade-weighted remoteness; export concentration; share of agriculture, forestry, and fisheries; population in low-lying coastal areas; victims of disasters; instability of exports; and instability of agricultural production.

¹⁹ Kiribati, the Marshall Islands, the FSM, Nauru, Solomon Islands, Timor-Leste, and Tuvalu were classified as affected by fragile situations (ADB. 2016. *Development Effectiveness Review 2015*. Manila).

Figure 11: Income Classification

GNI per capita and global income rank, 2014 or latest available year



COO = Cook Islands, FIJ = Fiji, FSM = Federated States of Micronesia, GNI = gross national income, KIR = Kiribati, NAU = Nauru, PAL = Palau, PNG = Papua New Guinea, PPP = purchasing power parity, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, TIM = Timor-Leste, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

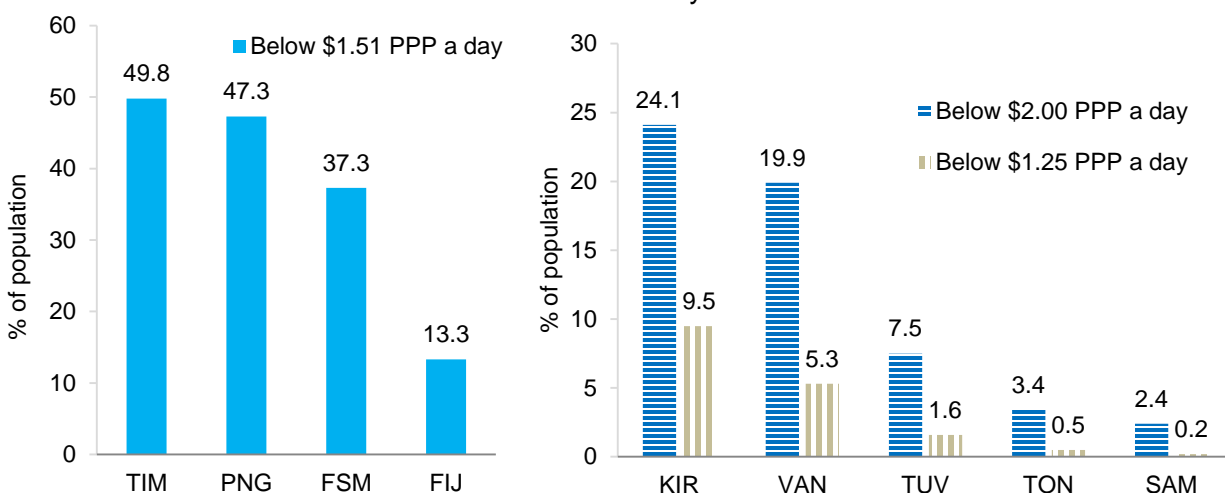
Note: The global income ranking comprises 202 countries (202 = lowest income). Cook Islands and Nauru are not ranked, given the absence of purchasing power parity income estimates.

Source: Asian Development Bank estimates, United Nations data, and World Bank.

16. Poverty measured by national poverty lines is significant but extreme poverty is rare in most of the 11 smaller Pacific island countries. The perception of poverty in the Pacific region varies considerably from other regions in Asia. It is often locally referred to as hardship rather than poverty, and rarely manifests itself in extremes. This should not mask the fact that poverty is widespread across the PIC-11, especially for populations in fast-growing urban areas, on outer islands, and among disadvantaged groups. Data show that basic needs poverty ratios according to national poverty lines are highest in the Marshall Islands, where more than half of the total population lives in poverty. Poverty rates are significantly higher in rural areas, including in the outer islands. However, since national poverty lines vary significantly, available poverty data based on regional and global purchasing power parity poverty lines is more accurate for regional comparisons, despite limited country coverage.²⁰ More than one-third of the population of the FSM lives on less than \$1.51 per day, and a significant share of the population of Kiribati lives on less than \$2.00 per day and of Vanuatu less than \$1.25 per day, while poverty incidence in Tuvalu is low and in Samoa and Tonga very low (Figure 12).

²⁰ Poverty data, like many other statistics across the Pacific region, are scarce and often outdated. A combination of high survey cost, variable protocols used in data collection and data analyses, and less-than-full access to data compromises both diagnosis and policy formulation. Geographical, cultural, and political diversity within the region as well as within countries makes the application of standardized poverty measurement tools and methodologies difficult. Varying national poverty lines, even within countries, make regional comparisons difficult. For example, the national poverty line in Tonga is three times higher than the one in the FSM (2005 purchasing power parity). Poverty data based on national poverty lines is given in Annex 1, Table 3.

Figure 12: Poverty Incidence, Based on Purchasing Power Poverty Lines
Latest available year



FIJ = Fiji, FSM = Federated States of Micronesia, KIR = Kiribati, PNG = Papua New Guinea, PPP = purchasing power parity, SAM = Samoa, TIM = Timor-Leste, TON = Tonga, TUV = Tuvalu, VAN = Vanuatu.

Sources: Asian Development Bank; World Bank. 2016. *Systematic Country Diagnostic For Eight Small Pacific Island Countries: Priorities For Ending Poverty and Boosting Shared Prosperity*. Washington, DC.

17. Inequality is a concern and the impact of growth has been mixed in the 11 smaller Pacific island countries. Perceptions of inequality in the PIC-11, with their strong family and social networks, are often biased. Contrary to the image of egalitarian Pacific societies, the limited data available show that inequality is not significantly lower across the PIC-11 than in other regions. Estimates of Gini coefficients range from 37.2 in Vanuatu to 42.7 in Samoa. Income earned by the poorest quintile ranges from 3.3% in the Marshall Islands to 10.2% in Palau (Annex 1, Table 3). The income share earned by the bottom 40% averages about 18%, slightly above global averages for low- and middle-income countries (about 16%) but below that of high-income countries (about 20%).²¹ World Bank estimates based on very limited data indicate that effects of growth on inequality are mixed. For example, incomes of the lowest-earning decile of the population in Vanuatu seem to have grown faster than the average, while opposite trends are visible for Samoa, Tonga, and Tuvalu.

18. Basic social service delivery is mostly good in the 11 smaller Pacific island countries. Extensive access to schooling, health, and water and sanitation services are leading to high levels of literacy and reasonably high life expectancy (Annex 1, Table 4). Only Kiribati, the Marshall Islands, the FSM, Solomon Islands, and Vanuatu have net enrollment ratios in primary education of below 90%, but they still exceed 80%. Literacy rates are very high across all of the PIC-11, with the lowest rates encountered in Solomon Islands (90%). Most births are attended by skilled health personnel, with only Kiribati, Samoa, Solomon Islands, and Vanuatu having slightly lower rates of 80%–90%. The Cook Islands, Kiribati, and Nauru have life expectancies in the low 60s; the average in all other PIC-11 is substantially higher at about 70 years. A major challenge across most of the PIC-11 is the spread of noncommunicable diseases, which is undermining gains in life expectancy. The Cook Islands, the Marshall Islands, Nauru, Palau, Samoa, and Tonga are among the 10 countries with the highest percentages of overweight or obese people in the world, while all PIC-11 are within the top 20 countries for this indicator. The proportion of the population with this condition ranges from 68% in Vanuatu to

²¹ Average is derived from estimates for Kiribati, the FSM, Palau, Samoa, Tonga, Tuvalu, and Vanuatu only.

81% in the Cook Islands.²² While access to improved drinking water is high (with some variation) across the PIC-11 populations, Kiribati, the Marshall Islands, the FSM, Solomon Islands, and Vanuatu suffer from limited access to improved sanitation. This is especially pronounced in Solomon Islands, as well as in Kiribati where natural constraints and fast urban population growth aggravate the situation.

19. Rural areas, including outer islands, have less access to basic social services. There is some disparity in access to basic social services between urban and rural areas in the PIC-11. In 2012, average access to an improved drinking water source—using the arithmetic mean across all PIC-11—in rural areas stood at 88% compared to 96% in urban areas, while access to improved sanitation facilities was more than 20 percentage points lower in rural areas (58% compared to 79% in urban areas). Differences in clean water access are especially pronounced in Kiribati (87% versus 51%) and, to some extent, in Solomon Islands (93% versus 77%), while access to improved sanitation facilities is particularly limited in rural areas, including outer islands, in Solomon Islands (81% versus 15%) and the FSM (85% versus 49%).²³

20. External shocks negatively impact households' well-being. The food and fuel price shocks in 2007 and 2008 and the global economic crisis of 2008–2009 hit the economies in most of the PIC-11 hard. These aggregate shocks to prices and financial flows in the PIC-11 have a severe impact on households, posing risks to livelihoods and increasing poverty and hardship. For example, micro-simulation analysis based on nationally representative household data for Kiribati and Tonga show that moderate shocks to food commodities, oil, cash crops, or remittances, which occur frequently across the Pacific region, push 1%–6% of the population into poverty and deepen hardship for a significant number of additional households.²⁴

21. The public sector and informal activities are important for employment and income generation in the 11 smaller Pacific island countries. Employment income is an important transmission channel for poverty reduction. Labor force participation rates range from 41% of the working-age population in Samoa to 73% in Tuvalu (Annex 1, Table 5). The public sector is the largest employer in many of the PIC-11, with employment shares above 30% in the Cook Islands, the Marshall Islands, Palau, and Tuvalu. Only in Samoa and Vanuatu is the employment share of the public sector below 10%. Large proportions of the working-age populations in several of the PIC-11 are engaged in informal market activities. For example, more than 50% of the employed in the FSM and Vanuatu and 78% in Solomon Islands carry out subsistence activities. Only the Cook Islands and Palau have highly formalized labor markets; elsewhere, formal employment rates range from 21.7% in Solomon Islands to 74.0% in Nauru. Kiribati and the Marshall Islands have unemployment rates above 30% while the FSM, Nauru, and Palau also experience substantial formal unemployment. The high population share completely outside the formal labor market, and therefore not counted as part of the labor force looking for employment, explains why unemployment rates in many of the other PIC-11 appear moderate.

22. Labor force participation of women is low in the 11 smaller Pacific island countries. Women's participation in the labor force is generally lower than that of men, especially in Samoa but also in the Marshall Islands, the FSM, and Tonga (Annex 1, Table 5). This is indicative of a much narrower range of employment opportunities for women in the

²² World Health Organization. <http://apps.who.int/gho/data/node.main.A897A?lang=en>

²³ ADB. 2015. *Basic Statistics 2015*. Manila.

²⁴ C. Cororaton and D. Knight. 2013. Economic Shocks and Their Impacts on Households: Micro Simulation Results from Three Pacific Island Countries. *World Bank Background Paper*. Washington, DC.

region that reduces their contribution to the economy. An absence of employment income puts women at greater likelihood of being poor and higher risk of getting pushed into poverty, for example through shocks to prices or remittances.

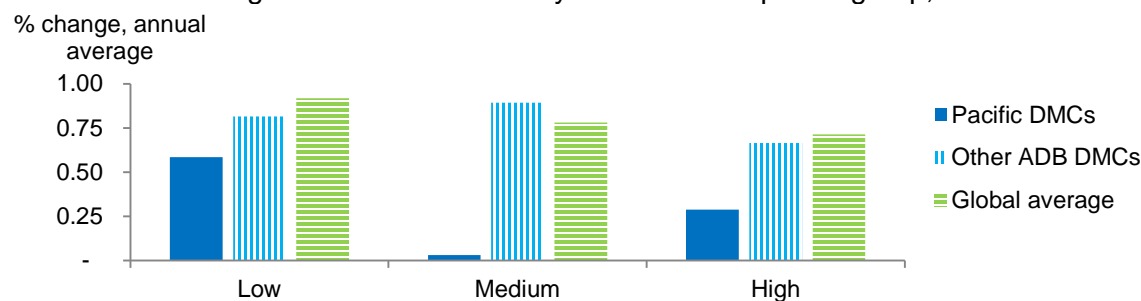
23. Social spending is substantial in the 11 smaller Pacific island countries. Apart from employment, several other transmission channels exist to support poverty reduction efforts. Public education and health spending to build human capital varies significantly across the Pacific region, with many countries allocating substantial resources to both sectors (Annex 1, Table 6). Public spending is supplemented by substantial development assistance for health in many of the PIC-11. Private household spending on health to complement government programs remains relatively low. Lack of data limits insights into the extent of service provision through nongovernment, faith-based, and civil society organizations in both sectors, but qualitative information suggests significant contributions, for example through faith-based organizations and churches in Samoa and Tonga, which can explain lower government spending.

24. Informal mechanisms substitute for formal social safety nets in many of the 11 smaller Pacific island countries. While highly correlated with reduced poverty incidence in global datasets, public social protection spending is in its infancy in the Pacific region with only a few countries sustaining small schemes for older people and/or children. Basic pension systems for public and, to some extent, formal private sector employees exist in most of the PIC-11 but not much beyond that. Similarly, private insurance markets in the PIC-11 are still underdeveloped. Traditionally, the lack of public safety nets and private insurance is substituted by strong community and family networks that constitute pooling mechanisms for risks to the individual household or family member. The methods of resource sharing within these informal networks can range from specialized exchanges among individuals or households to generalized reciprocity in situations of need or communal collection for ceremonial events or community-wide needs. Overseas migration and temporary workers' schemes result in significant remittance inflows that support these networks and responses to shocks in some of the PIC-11. However, these traditional mechanisms are at risk of slowly weakening across the PIC-11, following similar global dynamics, with shrinking family sizes, urban migration, and weaker ties of second- and third-generation overseas migrants.

25. Overall, the 11 smaller Pacific island countries perform well in aspects of multidimensional poverty. Several of the PIC-11 exhibit some of the highest positive differences between gross national income per capita rank and human development index rank in their respective human development groups.²⁵ In part, this reflects significant spending on education and health programs (including aid funded) and the existence of (largely informal) social safety nets. Taken together, income and nonincome dimensions of poverty show that Palau, Tonga, and Samoa (in that order) have achieved high levels of human development while the FSM, Kiribati, and Vanuatu (in that order) exhibit medium human development characteristics. Because of data limitations, the human development index is not calculated for the Cook Islands (estimated to have achieved high human development), Nauru and Tuvalu (medium to high), and the Marshall Islands (medium). However, the PIC-11 have struggled to improve human development outcomes over the past 5 years, lagging significantly behind average increases of comparator countries in Asia and worldwide (Figure 13).

²⁵ The human development index considers a combination of income, health, and education indicators to capture multidimensional aspects of poverty.

Figure 13: Human Development Index Increases
Average annual % increase by human development group, 2010–2014



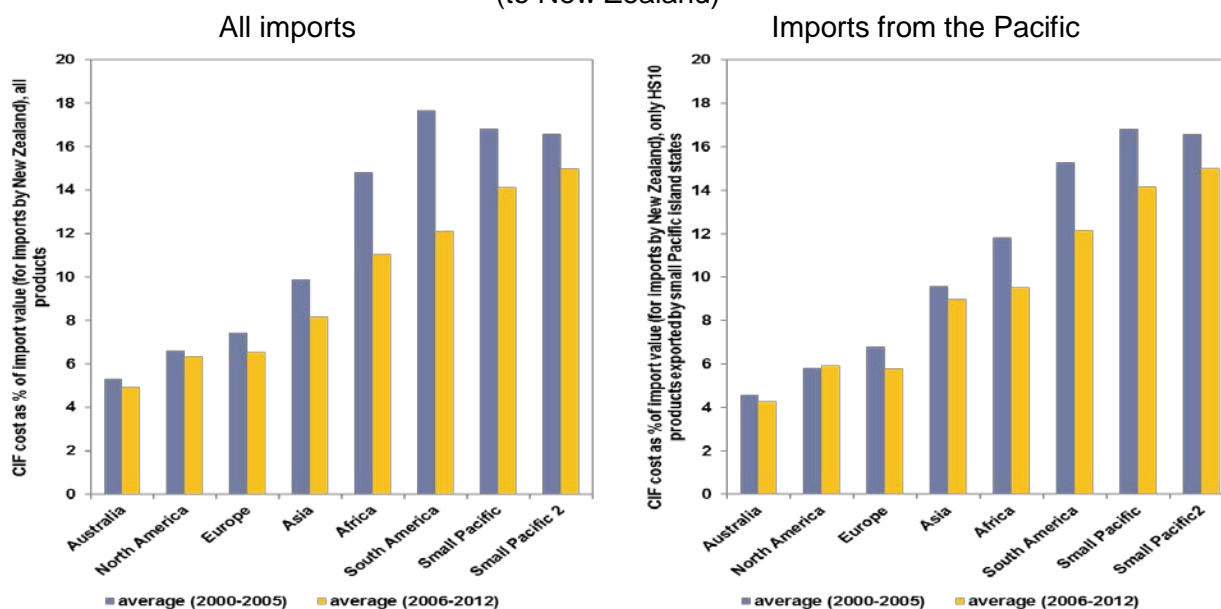
ADB = Asian Development Bank, DMC = developing member country.
Source: United Nations Development Programme.

II. KEY IMPEDIMENTS TO INCLUSIVE AND SUSTAINABLE GROWTH

26. The PIC-11 face a complex interaction of external environmental constraints and internal and external economic dynamics that lead to significant economic vulnerability with low and volatile growth. In turn, this affects the countries' multidimensional poverty dynamics, with risks to livelihoods and human development of their populations (Annex 2).

27. **Geographic and demographic features of smallness and remoteness negatively impact development trajectories.** As described above, the PIC-11 encounter the dual disadvantages of economic geography, i.e., small size and remoteness from major markets. Smallness confers a number of disadvantages that impede competitiveness in the world market. Among them are the inability to explore economies of scale and scope because of small domestic markets and difficulties in industrial clustering; the lack of upstream suppliers and downstream markets, which increases dependence on external sources and markets; and higher transport costs because of small shipment size. Remoteness from major markets, another geographic characteristic of the PIC-11, adds to transport costs because of physical distance, lower likelihood of being on the route of major shipping companies, lack of competition due to smaller volumes and fewer shipping service companies in the region, and infrequent services. This is on top of the limited economies of scale that may arise out of larger shipments to and from larger countries. Even for a relatively close market like New Zealand, transport costs are substantially higher than from anywhere else in the world (Figure 14).

**Figure 14: High Transport Costs
(to New Zealand)**



CIF = cost, insurance, and freight.

Note: Left chart shows the CIF costs as a percentage of import values of all products. Right chart shows the comparison only for products exported by Pacific island states.

Source: Raw data on CIF and free on board import value is from New Zealand Bureau of Statistics.

28. **Smallness and remoteness increase the cost of input factors.** Labor costs are high because of a number of factors. Overall, domestic labor is limited given the small pool of skilled workers; costs of living are high, driven by limited domestic production and high import costs; and reservation wages (i.e., the lowest wage rate that workers are willing to accept for a specific job) are substantial given access to overseas employment opportunities and large remittance inflows in many countries. Limits to quality of life in some of the PIC-11 require premium payments to attract skilled foreign labor or retain domestic labor. Substantial aid and remittance inflows can increase the demand for nontradable goods and services, thereby raising the cost of factors of production, which impinge on the competitiveness of tradable goods. Nontradable goods and services, including services required for production, are also affected by limited economies of scale, high costs of imported raw materials and intermediary goods that are used in the production (e.g., diesel fuel for electricity generation), and high labor costs. As a result of the remoteness, small populations and high input costs in the PIC-11, the development of a manufacturing sector producing generic merchandise goods is extremely unlikely.²⁶

30. **The 11 smaller Pacific island countries experience higher cost in the provision of public goods and services.** The conventional argument is that the large public sector in the PIC-11 needs to be substantially reduced in size because it depends heavily on foreign assistance, crowds out the private sector, and the high wage bill hampers fiscal sustainability. While these issues are often severe and need to be addressed, these arguments fail to take into account that the public sector is also affected by high cost structures and indivisibilities and diseconomies of scale in public service provision largely caused by smallness and remoteness. Geographical dispersion can exacerbate the problem the PIC-11 already face, making service provision to remote populations on outer islands even more costly. Given the size of the

²⁶ A. Winters and P. Martins. 2004. When Comparative Advantage Is Not Enough: Business Costs in Small Remote Economies. *World Trade Review*. 3 (3). pp. 347–383.

economy and geographical dispersion, it is inevitable that most PIC-11 will have a relatively large public sector.²⁷

31. Large aid flows supplement limited domestic revenue potential. Undermined by a small economic base, domestic resource mobilization in the PIC-11 is naturally constrained and insufficient to provide the social and economic infrastructure and services required for achieving a high level of human development and a highly conducive business environment. Development partners provide substantial aid in support of these targets. While this is one important factor that has allowed the PIC-11 to achieve their levels of income and development outcomes, it generates dependencies with a risk of substantial cuts to income, goods, and services should aid flows abate.

32. Losses from disasters caused by natural hazards and climate change further add to risks and costs and affect growth in the 11 smaller Pacific island countries. Disasters, such as droughts, floods, and cyclones, regularly damage productive assets including agricultural crops. Individual households, businesses, and the public sector need to factor in these risks and costs when making investment decisions. Insurance products are often unavailable or prohibitively expensive. Estimates show that damage and losses equal to 1% of GDP cause growth in the Pacific islands to fall on average by 0.3% over 10 years. For the Pacific region, this means that actual damage and losses during 1980–2014 reduced trend growth by 0.7%.²⁸ Another study shows that post-cyclone incomes do not recover for 20 years, effectively pushing the GDP trajectory downwards, and that a 90th percentile event (e.g., wind speeds of up to 19.5 meters per second) can effectively undo 3.7 years of average development.²⁹ Climate change is linked to increased frequency and more extreme weather events, and directly contributes to the cost of providing goods and services, e.g., through the need to climate proof investments and prevent loss of land. Longer-term effects can also undermine sector growth, e.g., tourism can be negatively affected by coastal erosion and coral bleaching.

33. Smallness constrains capacity. Small population numbers imply that the size of the public sector and its subdivisions are small relative to larger countries (despite the relatively large size of the public sector). Often only a few civil servants carry out a specific function, which constrains overall capacity and can lead to highly volatile capacity over time and/or across institutions or their subdivisions. Further, skilled labor needs to be sourced from a small pool of individuals, which also affects the private sector that faces competition for workers (but also managers and entrepreneurs) from the public sector as well as overseas employers. On the public sector side, the resulting limited capacity often leads to incomplete and only partially functioning regulatory frameworks and systems for the allocation and management of public funds to deliver goods and services, as well as for creating and maintaining an enabling environment for the private sector (including credit markets, labor regulation, business law, and appropriate scope of state-owned enterprise activities).

34. Smallness can impact political economy dynamics. Small population numbers can also create complex political economy dynamics, with close familial, communal, and church-

²⁷ V. Horscroft. 2014. Public Sectors in the Pacific Islands: Are They “Too Big” and Do They “Crowd Out” the Private Sector? *Policy Research Working Paper Series*. No. 7102. Washington, DC: World Bank.

²⁸ E. Cabezon et al. 2015. Enhancing Macroeconomic Resilience to Natural Disasters and Climate Change in the Small States of the Pacific. *IMF Working Paper Series*. 15/125. Washington, DC.

²⁹ S. Hsiang and A. Jina. 2014. The Causal Effect of Environmental Catastrophe on Long-Run Economic Growth: Evidence from 6,700 Cyclones. *National Bureau of Economic Research Working Paper Series*. No. 20352. July. Cambridge, MA.

based ties, and the traditional expectations of support that come with these, potentially causing conflict with official roles and professional interests. Thus, any political decision is likely to affect a range of personal interests or those of close relatives and friends. This can blur the lines between and within the public and private sectors, making political economy aspects highly relevant when attempting to change the existing systems and processes.

35. Specific traditional systems and practices can be impediments to growth and development. For example, the issue of land-related property rights is among the most difficult business environment challenges facing the PIC-11. In most of the PIC-11, much of the land is held communally, making the assignment of identifiable property rights difficult. Uncertainty and inability of investors to enter into secure contracts using land have long prevented private investments. Similarly, women are often disadvantaged or, in some extreme cases, prevented from accessing productive assets or decision-making positions. Apart from being discriminatory from a rights perspective, it also limits economic opportunities and growth by further reducing market size and the pool of potentially skilled and entrepreneurial individuals. Reforms to traditional systems and practices need to be carefully designed and managed to ensure disadvantaged population groups are not left worse off.

III. IMPLICATIONS FOR ADB COUNTRY ENGAGEMENT

36. Increasing and sustaining incomes and access to services. ADB's engagement across the PIC-11 aims to contribute to increasing and sustaining citizens' incomes and access to affordable and quality services to reduce poverty and ultimately improve development outcomes. Both the public and private sectors play important roles in providing income-earning opportunities and services to the populations of the PIC-11. Recognizing the strong links between the two sectors—with the public sector providing many of the goods and services that the private sector needs to flourish and, in turn, the private sector providing revenue to fund the provision of these services—ADB's approach should target both sectors to maximize impact on job creation and service delivery.

A. ADB Engagement with the Public Sector

37. Roles of the public sector. First, the public sector directly provides income-earning opportunities to the populations. As discussed above, the public sectors in the PIC-11 are large relative to the countries' sizes and often are the largest employer in the country. Most households, or at least broader family networks, have at least one member who is a civil servant or works on a contractual basis for the public administration, and therefore benefits from the income-earning opportunities directly created by the public sector.

38. Second, the public sector creates the frameworks and systems for providing basic social services including health, water and sanitation, and education to the citizens of the PIC-11. Such social services help lift people out of poverty and generate inclusive growth by building up human capital and thereby allowing individuals to participate in income-generating activities. In addition, social protection systems support individuals that cannot actively manage the effects of economic and social risks, such as disability, old age, sickness, and unemployment, and lift these individuals out of or prevent them from falling into poverty. While varying significantly in scale and coverage across countries, together these basic services form a social safety net that ideally should ensure a basic level of income and services for all citizens, regardless of ability to pay, to achieve the ultimate objective of a better quality of life across the PIC-11. Based on such equity and rights-based considerations, the public sector plays a critical role in fully or partially (i.e., subsidizing) funding these services. This also applies to infrastructure that allows the

population to access the services and often has the character of public or quasi-public goods, which would be underprovided or not provided at all without public sector financing. While the public sector does not have to produce and deliver such services directly to the citizens (this is done by a combination of actors in the PIC-11, including the public sector and its state-owned enterprises [SOEs], private sector companies, and nongovernment community and faith-based organizations), it is often the most important basic service provider in the PIC-11.

39. Third, the public sector creates and enforces the frameworks and systems that allow the private sector to grow and generate income-earning opportunities for the populations of the PIC-11—beyond public sector employment—as well as produce quality and affordable goods and services. Critical elements for such a business climate conducive to private sector development are frameworks that provide for macroeconomic stability; regulatory frameworks for doing business;³⁰ frameworks for the provision of adequate levels of economic infrastructure; and other frameworks that allow the sourcing of affordable and quality input factors for production, including for the labor market. Economic infrastructure includes ports and airports to transport input factors and outputs, power plants for electricity generation, and information and communication technology infrastructure such as fiber optic cables. Input factors for production include financial services, utilities such as electricity and water, skilled labor (linked to social services discussed above) and land, apart from raw materials and intermediate goods.³¹ Private sector development can be supported through horizontal policies that benefit all sectors, such as macroeconomic stability and business climate improvements, as well as vertical policies that are sector specific (e.g., phytosanitary control for the agriculture sector).

40. Similar to social services, the public sector can, and often needs to, play a role in financing the economic infrastructure and services, apart from developing and enforcing the frameworks. Again, some of the infrastructure required for economic activities has the character of public or quasi-public goods, which require public sector financing, while other infrastructure and services can be financed directly by the private sector or in collaboration between both sectors (i.e., some form of public–private partnership). The public sector in the PIC-11 plays a dominant role in the provision of economic infrastructure and services, including through SOEs, but public–private partnerships, private participation in SOEs, and contracting out of provision or parts of provision are increasing.

41. Fourth, the public sector can directly support the private sector through targeted market interventions. The business environment is evolving and, while governments often make good progress in macroeconomic stabilization and structural reforms, this may not be enough to make the economy or a particular sector or product competitive. Even a highly conducive business climate that limits business costs and risks may not always be sufficient. This is particularly the case in the PIC-11 where significant external impediments, most importantly their smallness and remoteness, limit economies of scale and capacity, and increase costs. Governments may need to provide direct support, in parallel with establishing conducive frameworks, to provide incentives for private sector engagement and lift overall competitiveness or that of a particular sector or product.

³⁰ Following the World Bank Doing Business 2016 report, this includes a regulatory framework for starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency (World Bank Group. 2016. *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. Washington, DC).

³¹ Some of the infrastructure is also required for, or shared with, social services discussed above, e.g., road infrastructure that allows the sick to access a health facility or children to go to school. Also, many of the services required as input factors in private sector production, including electricity, water, and financial services, directly benefit the population.

42. **Reducing financing gaps.** To fulfill their roles, the public sectors in the PIC-11 require sufficient financing, which is highly constrained by external impediments and environmental and economic dynamics that result in a small revenue base combined with high cost structures and an elevated exposure to risks. Financing is required to build and maintain sufficient capacity, and fund assets and consumables for the operation and maintenance of services. In this context, ADB's role in reducing the financing gap is threefold: (i) increasing domestic resource mobilization (including the return on public assets); (ii) supporting governments to minimize the need for financing by helping to reduce costs and manage risk; and (iii) supplementing financing, either in cash (project and program lending) or in kind (policy dialogue, technical assistance). These three elements are interrelated and will allow the public sectors to provide employment and access to affordable and quality goods and services for the populations and businesses, which in turn creates the conditions that enable the private sector to grow and create value, resulting in a virtuous circle of inclusive and sustainable growth that enables poverty reduction and a better quality of life for all.

43. **Supporting macroeconomic stability and fiscal sustainability.** Supporting the PIC-11 to improve their macroeconomic policies and achieve greater stability benefits both the public sector (e.g., by reducing financing costs through lower long-term interest rates and lower risks from volatile inflation and foreign-currency-denominated external debt) and the private sector. This includes support to achieving sustainable fiscal positions in the PIC-11, which contributes to macroeconomic stability, and ensure reliable payment of civil service salaries as well as financing of goods and service that benefit citizens and businesses equally. Such support comprises assistance in policy formulation, economic management, public financial management and procurement, revenue generation, and civil service management. Improved fiscal positions, including larger fiscal buffers, and a sound macroeconomic environment also increase the capacity of countries to manage risks from and respond more effectively to economic shocks, natural disasters, and climate change.

44. **Supporting the provision of social and economic infrastructure and services.** Supporting the PIC-11 in setting up the frameworks and systems for social services such as education, health, and social protection and insurance directly lifts the standard of living for the populations in the PIC-11 and/or prevents them from falling into poverty when affected by an external shock. It also indirectly benefits the public and private sectors through a larger pool of skilled and healthy labor. Often, financing that supplements domestic resources is needed for investing in improved access to and financing of salaries, operation and maintenance, and capital investments for the delivery of such services. Further, support to the design, implementation, and enforcement of appropriate public sector management and business environment frameworks and systems is needed to reduce costs and mitigate risks in public service delivery and doing business. Pooling of services, such as in health, higher education, law and justice, and utility regulation and management, across countries can be an avenue to achieve scale and further reduce costs. Investing in renewable energy to lower electricity costs; in information and communication technology as well as air, land, and sea links to improve connectivity; and in urban infrastructure benefits the public and private sectors as well as the countries' citizens who are direct consumers of such goods and services.

45. **Supporting targeted market interventions.** Lastly, supporting the PIC-11 governments in assessing the feasibility of direct market interventions to promote private sector development and growth can be relevant to complementing the other areas of proposed ADB engagement with the public sector. The significant impediments facing the PIC-11 can imply that improved levels of macroeconomic stability and conducive business environments are insufficient. In such

cases, carefully designed government intervention can support competitiveness of the economy as a whole, or in specific sectors or products. Lessons from unsuccessful past interventions imply that market failures need to be clearly understood and policies tailored to address them. The policies further need to be anchored in latent comparative advantages, and sufficient institutional strength needs to be available to design and manage such policies (and at some point terminate unsuccessful ones).³² Historically, tourism, agriculture, and fisheries have been and will remain sectors with such (latent) comparative advantages across the PIC-11, while recent improvements in information and communication technology potentially provide for new opportunities with latent comparative advantages (apart from playing an enabling role for other sectors).

46. **Sector priorities and ADB support models.** For each of the PIC-11, ADB needs to establish its operational priorities based on assessment of the particular development challenges, the governments' own priorities, and the role and engagement of other stakeholders. This is done through country strategic analyses that are part of the annual country operations business planning processes. In regard to models of support, ADB has four avenues to support the public sectors in the PIC-11 in fulfilling their roles: policy dialogue, technical assistance, project lending, and program lending. The choice of model depends on the intervention objectives and comparative advantages of models in a particular context.³³ Often a combination of support is most beneficial, e.g., project investments combined with technical assistance to develop sector reforms that are linked to a program model.

B. ADB Engagement with the Private Sector

47. A large proportion of ADB's engagement with the public sector is geared toward improving the business climate that allows sourcing of affordable and quality goods and services for production within a predictable macroeconomic and regulatory environment. While this is conducive to private sector development, it might not be sufficient for private businesses to flourish, given larger impediments. As mentioned above, direct market intervention by the public sector to support business competitiveness is one option. However, ADB also provides direct support to the private sector in Asia and the Pacific, either by absorbing specific costs and risks for private businesses that make an activity viable or by providing advisory services that build the capacity of private businesses and facilitate access to services that help them grow (or a combination thereof).

48. Generally, the PIC-11 cannot compete with low-value, bulk manufacturing, and strategies that focus largely on supplying the domestic market are also generally unviable (except possibly for some small-scale agriculture). Instead, the PIC-11 need to specialize in the production of high-quality products and services that can absorb the high cost structures and elevated risk exposure.³⁴ Fiji's water and cosmetics products and Palau's tourism industry are examples where this has been done successfully in the Pacific region. Most, if not all, of the PIC-11 have several examples of successful specialized businesses. For such products or

³² Inter-American Development Bank. 2014. *Rethinking Productive Development*. Washington, DC.

³³ For example, program lending, i.e., financing directly into a government's budget, can increase aid effectiveness. However, if, for example, lack of infrastructure is a development constraint but its implementation is a challenge for a particular country because of weak procurement systems, a project lending model that comes with implementation assistance from ADB might be more suitable.

³⁴ This does not necessarily foredoom development in the PIC-11, where small increases in business activity can have large relative impacts. For example, creating 100 jobs in Tonga, a PIC-11 country of average size, in relative terms is equal to an increase in employment of about 1.3 million workers in the People's Republic of China or about 100,000 workers in the Philippines.

services to be successful in the long run they should be anchored in latent comparative advantages, which do not need to be for an entire sector but could just be for a particular, high-quality, high-value market segment. In the PIC-11, latent comparative advantages could be in products and services based on the countries' rich cultures, pristine nature, and healthy ecology, as long as these are kept intact, which requires careful management of agriculture, fisheries, tourism, and other industries to avoid environmental degradation. Products requiring low-cost input factors, such as the tuna canning industry, which relies heavily on inexpensive labor, are unlikely to be sustainable beyond a period of public sector or development partner support.

49. However, often the upfront risks and costs, e.g., for building human resource capacities, surveying markets, developing products, establishing trade networks, and financing initial investments, are prohibitive and prevent the development of such differentiated products and services in niche markets. This is where targeted market interventions can support the development of sustainable private businesses. ADB provides such support through the provision of financing and guarantees to businesses, as well as building the capacity of the private sector (e.g., through training and twinning arrangements for entrepreneurs on financial management or specialized technical skills) and supporting the development of supply or value chains and trade networks. Private businesses also benefit from ADB support to public-private partnerships and efforts to increase private participation in public service delivery (including by SOEs) to take advantage of private sector efficiencies, which deepen the size of the private sector and can help create economies of scale. ADB also directly engages private contractors, and the design of procurement packages can help build the domestic private sector.

50. Looking ahead, expanding and increasing value addition in the tourism sector and in agriculture and fisheries, including through light manufacturing, provide important opportunities for the private sectors in the PIC-11. Information and communication technology advances can open up new opportunities for growth within the technology sector as well as help bridge remoteness in other sectors to establish trade networks and integrate the PIC-11 better with global markets and supply chains. Significant opportunities can particularly arise from increasing economic integration with Asia.³⁵ ADB has developed substantial experience, knowledge, and networks across Asia in its 50 years of operation that can benefit the PIC-11 in seizing such evolving opportunities.

C. Crosscutting Themes for ADB Engagement

51. **Considering fragility.** Fragility reflects a mix of factors, including instability, dysfunction, and illegitimacy, that prevent the functioning of a state, its economy, and society.³⁶ Kiribati, the Marshall Islands, the FSM, Nauru, Solomon Islands, and Tuvalu are on ADB's list of countries with fragile situations, and other members of the PIC-11 exhibit some characteristics of political, economic, and environmental fragility. Fragility impacts on public governance partly because of the difficulty in attracting and retaining needed expertise and an inability to build sufficiently inclusive coalitions that create incentives to invest trust, loyalty, and resources in public institutions. Capacity to perform core state functions therefore remains limited and prospects highly uncertain. As a result, the state is unable to respond consistently and equitably to societal demands, increasing the risk of political instability and (sometimes) violence. Fragility also directly impacts individuals as well as the private sector, increasing risks and costs of doing

³⁵ ADB and Asian Development Bank Institute. 2015. *Pacific Opportunities: Leveraging Asia's Growth*. Manila.

³⁶ ADB. 2012. *Working Differently in Fragile and Conflict-Affected Situations—The ADB Experience: A Staff Handbook*. Manila.

business and thereby undermining growth. The nexus between fragility and poverty is globally recognized, with development issues becoming even more complex and development outcomes even harder to achieve. Reducing poverty and hardship in fragile situations requires specifically tailored development interventions that address core drivers of fragility and support the establishment of viable public institutions. ADB needs to take account of these key challenges arising from fragility at the country level when supporting the public and private sectors across the PIC-11.

52. **Considering capacity constraints and volatility.** Capacity in the public and private sectors across the PIC-11 is highly constrained and volatile, and this is largely linked to smallness and remoteness. This situation requires approaches that limit the need for additional capacity in public sector management as well as private business operations. Next to capacity building, depending on the specific situation, capacity supplementation and substitution are important strategies to increase the sustainability of functions. Reducing capacity needs, e.g., through less-complex solutions, smart solutions using technology, centralization, or pooling of functions, should be considered where possible.

53. **Considering risks from climate change and natural hazards.** Through elevated exposure to climate change and natural hazards, risks are significant across the PIC-11 while resilience of individuals and the public and private sectors is generally low. This results in significant vulnerability to the frequent shocks, pushing countries into debt distress, businesses into insolvency, and individuals into hardship. Developing capacities to manage shocks and increasing the resilience of individuals and assets is therefore fundamentally important for development in the PIC-11. Strategies include building fiscal buffers, developing disaster risk management approaches, integrating disaster preparedness in government planning and budgeting, climate and disaster proofing infrastructure and private assets (e.g., personal property but also agricultural crops), developing social protection and insurance systems, and developing tailored support mechanisms for private businesses.

54. **Considering political economy and cultural factors, and gender.** Political economy factors play an important role in the PIC-11 and can have a significant impact on the success or failure of development interventions. Understanding and managing the political economy environment is therefore critical from design to implementation of support activities. Similarly, traditional and cultural factors can play an important role, e.g., when dealing with hierarchies, land, or gender matters. Land is particularly important given (latent) comparative advantages in the agriculture and tourism sectors across the PIC-11, which both rely heavily on land as an input factor and ADB could consider to support participatory, culturally-sensitive approaches to supporting land use that benefits communities and households while enabling private sector growth to create employment opportunities. Lastly, gender is an important crosscutting theme for ADB's engagement across the PIC-11. Empowering women (and other disadvantaged groups) to become more active in the public and private sectors is important from a rights-based approach as well as from a political and economic perspective.

Annex 1, Table 1: Basic Economic Indicators

Pacific Developing Member Country	Populat ion (‘000)	GDP per Capita (current \$)	GNI per Capita ^a (current \$)	Nominal GDP (\$ million)	Nominal GNI ^a (\$ million)	GDP Growth (% p.a.)			Government Finance		Trust Fund Value (\$ million)	Indepe ndence (year)	ADB Mem bers hip (year)	ADB Financing Eligibility
						Aver age	Std. dev.	Aver age	Reven ue (% of GDP)	Expen diture (% of GDP)				
						2006	2006	2014	2015 ^b	2015 ^b				
Year	2015	2015	2014	2015	2014	2015	2015	2015	2015 ^b	2015 ^b	2015			
Cook Islands	13.1	22,312.9	21,863.8	292.3	...	0.0	2.8	(0.8)	42.7	44.4	...	1965	1976	OCR loan
Kiribati	113.4	1,386.6	2,950.0	157.3	325.8	2.0	3.2	3.4	105.4	106.5	590.0	1979	1974	ADF grant
Marshall Islands	54.9	3,423.7	4,390.0	187.9	232.0	1.4	2.7	(0.7)	55.6	53.5	265.0	1990	1990	ADF grant
FSM	102.8	2,768.6	3,200.0	284.6	333.4	(0.7)	2.3	(2.5)	63.1	58.0	422.0	1990	1990	ADF–OCR loan
Nauru	11.1	9,626.8	8,485.5	107.1	...	13.0	28.2	3.7	95.3	95.3	...	1968	1991	ADF grant
Palau	17.9	14,757.9	11,110.0	263.9	234.3	0.4	5.2	5.7	43.0	38.1	204.0	1994	2003	ADF–OCR loan
Samoa	193.5	4,127.8	4,060.0	798.7	778.3	1.9	2.5	1.3	35.1	39.0	...	1962	1966	ADF grant
Solomon Islands	588.0	1,728.3	1,830.0	1,016.2	1,047.7	4.4	2.6	2.6	46.2	44.2	...	1978	1973	ADF grant/loan
Tonga	103.3	4,184.3	4,260.0	432.4	449.4	0.9	2.9	2.7	37.5	34.8	...	1970	1972	ADF grant/loan
Tuvalu	11.2	2,928.8	5,720.0	32.9	56.6	2.9	4.5	2.0	118.5	112.8	109.0	1978	1993	ADF grant
Vanuatu	277.5	2,664.2	3,160.0	739.3	819.3	3.1	2.8	0.7	23.6	30.7	...	1980	1981	ADF grant/loan
Fiji	867.0	4,761.2	4,870.0	4,128.0	4,314.1	1.4	3.8	4.6	36.0	38.5	...	1970	1970	OCR loan
Papua New Guinea	8,220.3	2,249.7	2,240.0	18,493.1	16,724.5	7.7	3.1	11.6	23.1	26.2	...	1975	1971	ADF-OCR loan
Timor-Leste	1,245.1	1,178.9	2,680.0	1,467.9	3,243.5	7.1	5.9	5.1	86.3	100.5	16,200.0	2002	2002	ADF-OCR loan

() = negative, ... = not available, ADB = Asian Development Bank, ADF = Asian Development Fund, FSM = Federated States of Micronesia, GDP = gross domestic product, GNI = gross national income, OCR = ordinary capital resources, p.a. = per annum, std. dev. = standard deviation.

^a World Bank (Atlas method).

^b Fiscal data reflect 2015 budget projections for Fiji, and latest available estimates for Nauru (FY2014, ended June), Solomon Islands (2014), and Tonga (FY2014, ended June).

Sources: Asian Development Outlook database, Pacific Economic Monitor database, International Monetary Fund, World Bank, and Pacific region developing member country statistics bureaus and central banks.

Annex 1, Table 2: External Economic Indicators

Pacific DMC	Currency	Nom. ER	Real ER	Exports	Imports	Tourism Receipts	Private Remittances	Official Development Assistance	CAB	CAB Excluding Transfers	Top Exports	Top Imports
		(2010 = 100)	(2010 = 100)					2014		2015 ^a		
		2015	2015	2015 ^a	2015 ^a	2015 ^b	2015	2014	2015 ^a	2015 ^a		
Cook Islands	NZ\$	110.5	113.8	5.7	34.0	62.0	...	9.2	33.1	30.7	Fish, pearls	Fuel, food, machines, vehicles
Kiribati	A\$	81.8	73.0	5.1	55.2	2.9	8.3	44.2	25.0	9.8	Coconut oil, copra, fish	Food, fuel, machinery, vehicles
Marshall Islands	US\$	100.0	104.7	22.2	54.7	4.0	12.8	30.5	6.9	(22.9)	Fish, copra, coconut oil	Food, fuel
FSM	US\$	100.0	103.5	14.1	42.1	8.7	7.9	36.9	17.2	(21.9)	Fish	Fuel, food, construction materials
Nauru	A\$	85.3	88.1	30.5	51.3	...	...	16.9	(7.3)	(21.0)	Phosphate	Manufactured goods, fuel, machinery
Palau	US\$	100.0	108.8	3.8	57.6	54.3	0.9	9.3	2.1	(12.6)	Fish	mineral products, food, machinery
Samoa	ST	104.0	105.8	3.4	40.5	17.6	21.4	12.5	(4.8)	(25.8)	Fish, coconut oil, automotive wiring harness	Mineral products, machinery, vehicles
Solomon Islands	SI\$	101.8	113.9	40.2	43.6	6.6	1.3	19.7	(4.5)	(11.3)	Logs, mineral products, fish	Machinery, vehicles, fuel, food
Tonga	T\$	100.9	104.8	1.9	36.9	9.5	27.1	18.7	(8.3)	(34.2)	Food, crude materials, basic manufactures	Crude materials, fuel, machinery
Tuvalu	A\$	82.0	78.2	50.0	81.7	6.2	12.3	92.9	(37.4)	(73.1)	Fish	Food, fuel, construction materials
Vanuatu	Vt	89.5	85.6	8.2	14.5	36.4	3.3	13.2	22.7	18.8	Coconut oil, copra, kava	Machinery, vehicles, food, fuels
Fiji	F\$	91.4	94.7	26.6	46.7	18.0	5.1	2.1	(4.0)	(10.5)	Sugar, gold, mineral water, garments	Fuel, food, machinery, vehicles

Pacific DMC	Currency	Nom. ER (2010 = 100)	Real ER (2010 = 100)	Expo rts	Impor ts	Touri sm Recei pts	Private Remittan ces	Official Develop ment Assistan ce	CAB	CAB Excluding Transfers	Top Exports	Top Imports
Papua New Guinea	K	98.3	110.9	49.6	24.4	0.0	0.1	3.5	4.6	4.6	Gold, agricultural products, petroleum	Fuel, machinery, vehicles
Timor-Leste	US\$	100.0	123.9	3.1	42.9	2.2	3.2	17.7	14.3	(5.1)	Coffee, petroleum	Machinery, vehicles, fuel, steel

() = negative, ... = not available, Aust. = Australian, CAB = current account balance, DMC = developing member country, ER = exchange rate, FSM = Federated States of Micronesia, Nom. = nominal, NZ = New Zealand, US = United States.

a Balance of payments data are as of 2014 for Nauru and Vanuatu.

b Tourism receipts data are as of 2013 for Tuvalu and Vanuatu; 2012 for Kiribati.

Note: Real exchange rate computed on the basis of inflation differentials with assumed primary trading partner country.

Sources: Asian Development Outlook database, Pacific Economic Monitor database, International Monetary Fund, World Bank, Organisation for Economic Co-operation and Development–Development Assistance Committee database, and Pacific region developing member country statistics bureaus and central banks.

Annex 1, Table 3: Poverty Estimates in the Pacific Region Using National Poverty Lines

Country	Population	Basic Needs	Poverty Gap	Food Poverty	Share of Poorest Quintile in National Income/Consumption	Year of Poverty Data
	('000)	Poverty (%)	Ratio (%)			
Cook Islands	15.2	28.4	8.5	2.0	9.0	2006
FSM	863.1	31.4	9.3	11.0	8.5	2005
Kiribati	111.1	21.8	7.2	5.3	7.8	2006
Marshall Islands	54.5	52.7	...	...	3.3	2002
Nauru	10.7	25.1	...	16.0	6.4	2006
Palau	17.9	24.9	6.6	0.0	10.2	2006
Samoa	187.4	26.9	8.2	4.9	9.3	2008
Solomon Islands	626.2	22.7	7.5	10.6	6.7	2006
Tonga	103.3	22.5	7.7	2.0	10.0	2009
Tuvalu	11.1	26.3	6.2	3.4	8.1	2010
Vanuatu	271.1	12.7 ^a	5.6	7.4	7.4	2006
Fiji	102.9	35.2	9.9	7.5	5.4	2008
PNG	7,570.7	28.0	9.0	...	4.5	2009
Timor-Leste	1,306.0	49.9	8.1	29.0	9.1	2007

... = not available, PNG = Papua New Guinea, FSM = Federated States of Micronesia.

^a Estimate of basic needs poverty in Vanuatu is from 2010.

Source: Asian Development Bank, Secretariat of the South Pacific, World Bank, country data.

Annex 1, Table 4: Access to Basic Social Services in the 11 Smaller Pacific Island Countries

Country	Education		Health		Water and Sanitation	
	Net Enrolment Ratio in Primary Education (%)	Youth Literacy Rate (%)	Births Attended by Skilled Health Personnel (%)	Life Expectancy at Birth (years)	Access to Improved Drinking Water (%)	Access to Improved Sanitation (%)
Cook Islands	96.0 (2014)	96.0 (2011)	100.0 (2008)	61.2 (2009–2013)	100.0 (2012)	97.0 (2012)
FSM	83.1 (2014)	95.7 (2010)	90.0 (2008)	70.0 (2010)	88.5 (2010)	56.5 (2010)
Kiribati	82.0 (2011)	98.5 (2010)	86.8 (2012)	62.2 (2010)	90.6 (2009)	31.2 (2009)
RMI	84.1 (1999)	98.0 (2011)	98.3 (2011)	71.8 (2011)	90.0 (2011)	75.0 (2010)
Nauru	93.0 (2013)	96.5 (2011)	97.4 (2007)	61.2 (2011–2013)	98.0 (2011)	98.0 (2011)
Palau	90.0 (2011)	99.7 (2005)	100.0 (2010)	69.1 (2005)	85.0 (2010)	100.0 (2010)
Samoa	97.0 (2012)	98.0 (2011)	80.8 (2009)	74.2 (2011)	96.0 (2010)	98.0 (2010)
SI	87.1 (2012)	89.5 (2009)	85.5 (2007)	70.2 (2009)	84.1 (2007)	17.6 (2007)
Tonga	98.7 (2011)	99.4 (2011)	97.9 (2012)	72.5 (2012)	99.0 (2010)	99.0 (2010)
Tuvalu	95.0 (2012)	98.6 (2007)	97.9 (2007)	69.6 (2010)	98.0 (2010)	85.0 (2010)
Vanuatu	87.9 (2011)	92.1 (2009)	89.4 (2013)	71.1 (2009)	90.0 (2010)	57.0 (2010)
Fiji	99.6 (2013)	99.5 (2008)	99.7 (2013)	65.3 (2007)	96.0 (2010)	83.0 (2010)
PNG	74.0 (2013)	63.0 (2009)	40.0 (2010)	54.2 (2000)	39.7 (2012)	18.7 (2012)
Timor-Leste	91.7 (2011)	82.4 (2015)	29.0 (2010)	67.0 (2012)	70.0 (2012)	39.0 (2012)

PNG = Papua New Guinea, FSM = Federated States of Micronesia, SI = Solomon Islands, RMI = Marshall Islands.

Sources: Asian Development Bank, Secretariat of the South Pacific, United Nations, World Bank, country data.

Annex 1, Table 5: Labor Market Indicators in the 11 Smaller Pacific Island Countries, 2014

Country	Working-Age Population (% of total population)	Labor Force Participation Rate (% of working-age population)			Formal Employment (% of labor force)	Public Sector Workers (% of employed)	Subsistence (% of employed)	Unemployed (% of labor force)
		Males	Females	Total				
Cook Islands	62.4	77.0	65.0	71.0	90.2	31.0	1.8	8.2
FSM	63.2	66.1	48.4	57.3	39.9	24.4	52.4	16.2
Kiribati	61.3	72.4	66.2	59.3	50.2	24.8	27.7	30.6
RMI	57.4	66.3	35.4	51.2	66.7	38.0	3.5	30.9
Nauru	59.2	78.9	49.3	64.0	73.9	25.3	4.1	23.0
Palau	72.4	...	...	68.1	94.0	34.9	2.0	4.1
Samoa	55.7	58.3	23.3	41.3	60.7	5.3	35.6	5.7
Solomon Islands	57.7	63.5	62.2	62.9	21.7	4.2	77.6	3.2
Tonga	56.5	62.7	42.3	52.3	70.6	17.6	28.6	1.1
Tuvalu	61.9	...	...	73.3	47.7	42.2	43.0	16.3
Vanuatu	59.4	80.4	61.4	70.9	38.5	7.7	59.6	4.6
Fiji	66.8	...	...	68.9	72.1	10.1	22.5	6.9
PNG	58.2	62.0	62.4	65.8	55.2	22.8	41.0	6.4
Timor-Leste	54.1	56.1	25.7	41.7	29.1	15.9	69.8	3.6
Pacific average	58.4	...	...	62.7	52.9	19.5	43.5	6.4

... = not available, FSM = Federated States of Micronesia, PNG = Papua New Guinea.

Source: Asian Development Bank, Secretariat of the South Pacific, country census and survey data.

Annex 1, Table 6: Social Spending and Remittances in the 11 Smaller Pacific Island Countries % of GDP

Country	Public Education Spending	Health Spending (2013)		Public Social Protection Spending		Personal Remittance Inflow (2013)
		Public	Private	Older Persons	Children	
Cook Islands	...	...	...	...	...	...
FSM	11.6 (2002)	8.3	1.8	...	...	7.9
Kiribati	...	13.8	2.7	...	...	12.8
RMI	6.7 (2000)	11.4	1.2	...	...	...
Nauru	...	...	...	...	...	...
Palau	7.3 (2000)	7.6	2.3	...	...	0.9
Samoa	5.1 (2008)	6.7	0.8	...	...	21.4
Solomon Islands	9.9 (2010)	4.8	0.3	1.3 (2010)	0.0 (2010)	1.5
Tonga	3.9 (2004)	3.9	0.9	0.9 (2005)	0.0 (2005)	27.1
Tuvalu	7.6 (1990)	19.7	0.0	...	...	12.3
Vanuatu	5.0 (2009)	3.4	0.5	...	...	3.3
Fiji	4.3 (2011)	2.8	1.3	0.77 (2010)	0.6 (2010)	6.4
PNG	...	3.6	0.9	0.1 (2010)	0.1 (2010)	0.1
Timor-Leste	9.5 (2011)	1.2	0.1	1.4 (2010)	0.7 (2010)	...

... = not available, FSM = Federated States of Micronesia, GDP = gross domestic product, PNG = Papua New Guinea, RMI = Marshall Islands.

Source: Asian Development Bank, Secretariat of the South Pacific, World Bank.

Annex 2: Key Impediments to Inclusive and Sustainable Growth

