# Economics Division Working Papers

## South Pacific

### *Sustainability, Aid and Remittance-dependent Pacific Island Economies: lessons from Africa?*

*Richard P.C. Brown*

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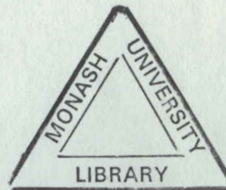



**Key to symbols used in tables**

| | |
|---|---|
| n.a. | Not applicable |
| .. | Not available |
| - | zero |
| . | insignificant |

**Richard P C Brown** is a Senior Lecturer in the Department of Economics, The University of Queensland, St Lucia, Queensland.

**Islands/Australia Program**

National Centre for Development Studies

This paper originates in the Islands/Australia Program at the National Centre for Development Studies. The size, geographic isolation and histories of the Pacific island states create special development problems. Australia plays an important role in the region, both as an aid donor and trading partner. The National Centre for Development Studies has given priority to research on the islands since 1975. The Islands/Australia Program provides policy insights, primarily for Australia in its relations with its Pacific neighbours, but also for the island governments and international agencies. This stream of the Economics Division Working Papers widens the former Islands/Australia Working Paper series. Research on the area is being undertaken by other scholars in the Division. The National Centre for Development Studies continues to disseminate analysis of the island economies through its *Pacific Policy Papers*, *Pacific Research Monographs* and the *Pacific Economic Bulletin*.

# abstract

Two competing lines of criticism of the view that Pacific island economies should strive to promote exports to maintain sustainable income levels are examined. Both neglect either: the spontaneous restricting of many Pacific island economies away from domestic production towards external sources of 'rent' in the form of remittances from family members working abroad and foreign aid; or the dynamics of the internal 'hidden' processes set in motion by these external resource flows. The implications of remittances and aid flows are therefore analysed, both formally and in the light of comparative African experience on the 'hidden' economic processes fostered by these. The spread of the parallel economy, capital flight, and the institutional destruction of the state's planning, administrative and financial capacities are discussed, all of which have far reaching consequences for the longer-term sustainability of the economic structures they feed on. There is clearly a need for these neglected dimensions of structural adjustment to be given their due attention in both the ongoing debate and research on economic policy and sustainable development among the Pacific island economies.

# Abstract

Two competing lines of criticism of the view that Pacific island economies should strive to promote exports to maintain sustainable income levels are examined. Both neglect either the spontaneous reorienting of many Pacific island economies away from domestic production towards external sources of 'rent' in the form of remittances from family members working abroad and foreign aid; or the dynamics of the internal 'hidden' processes set in motion by these external resource flows. The implications of remittances and aid flows are therefore analysed, both formally and in the light of comparative African experience on the 'hidden' economic processes fostered by these. The spread of the parallel economy, capital flight, and the institutional destruction of the state's planning, administrative and financial capacities are discussed, all of which have far reaching consequences for the longer-term sustainability of the economic structures they feed on. There is clearly a need for these neglected dimensions of structural adjustment to be given their due attention in both the ongoing debate and research on economic policy and sustainable development among the Pacific island economies.

# the sustainability of the aid and remittance-dependent Pacific island economies: lessons from Africa?

Recent contributions to the literature on sustainable development among Pacific island economies have challenged the orthodox view that 'Countries as small as the Pacific nations must trade to develop' (Cole and Parry 1986:1), and that economic sustainability can be achieved through the expansion of productive capacity in the export sector. Two distinct, opposing views have emerged.

The first, associated with the theoretical work of Tisdell and Fairbairn (1984, 1985) and Tisdell (1990), denies that the income levels of the growing populations of the small, poor island economies can be sustained through the development of an export sector based either on the production of non-subsistence cash crops or on the exploitation of a non-renewable resource. For them:

> small subsistence economies are capable of only 'temporary' growth once the possibility of trade is available. In the long run population explosion, triggered off by the rise in real income per head, forces the economy to revert back to a subsistence non-growth equilibrium state (Tisdell and Fairbairn 1985:133).

Instead, they argue for achieving a sustainable, self-reliant path of development by '...preserving or fostering subsistence sectors in economic development' (Tisdell and Fairbairn 1984:240).

The second view also denies the feasibility of achieving sustainable per capita income levels by expanding productive activity and trade, but then rejects any notion of an 'involutionist' self-reliant path to sustainable growth among Pacific island economies (see Connell 1988; Bertram and Watters 1985, 1986; Bertram 1986, 1991). It is suggested instead that sustainable income levels are in fact being achieved, and can be sustained 'permanently', through a completely different model of development based on externally generated 'rents' from aid and migrants' remittances. This shall be labelled the 'rentier model'.[1]

This paper examines the implications of incorporating external rent income into the Tisdell-Fairbairn model, and then assesses the likely sustainability of the rentier model in the Pacific island context, drawing on recent experience among

[1] The authors have labelled these as 'MIRAB' economies, an acronym for Migration, Remittances, Aid financed, Bureaucracy (see Bertram and Watters 1985, 1986; Munro 1990).

aid and remittance dependent sub-Saharan African economies. It is argued that dependence on aid and remittances can set in motion a number of hidden economic processes that have significant implications for the stability and longer-term durability of the existing economic structures. These processes should not be overlooked by proponents of the rentier model and need to be further researched and analysed by those concerned with the longer-term development of the Pacific island economies.

## Aid and remittances in the Tisdell-Fairbairn model

Tisdell and Fairbairn (1984, 1985) use a simple Ricardian model to analyse the impact of a trade shock on small, resource poor economies - specifically, Pacific island economies. Domestic output and income ($Y_D$) is a function of population ($P_T$):

$$Y_D = f(P_T)$$

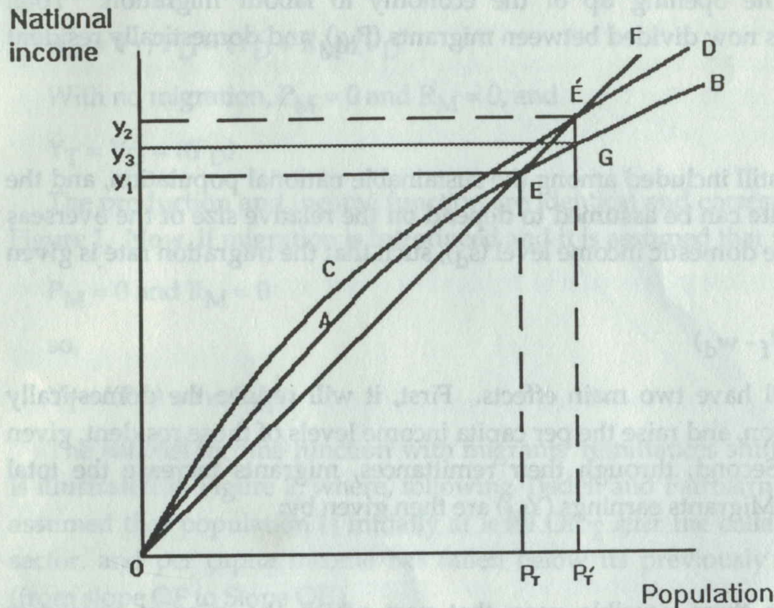
The domestic income or 'wage' ($w_d$) level is classically set as being equal not to the marginal product ($l_d$) but to the average product:

$$w_d = Y_D/P_T$$

and, $l_d = \delta f(P_d)\delta P_d$

A Malthusian relationship between population growth and per capita income levels is assumed to hold, such that a stable equilibrium is given, in Figure 1, by point E on production function OAB in the without-trade situation, with population $P_T$ being sustained at per capita income level $w_d = OY_1/OP_T$ (= slope OF). With the development of a traded-goods sector the production function shifts outwards to OCD and income levels rise causing the sustainable population to increase until a new equilibrium is reached at point E'. Population has risen to $P'_T$, bringing $w_d$ back to $OY_2/OP^1{}_T = PY_1/OP_T$. Now, if it is assumed that the export sector collapses, perhaps due to either an exogenous shock or depletion of the non-renewable export good, and that there is no alternative productive activity, the production function reverts back to its previous position OAB. At point G aggregate income has fallen to $Y_3$ and $w_d$ has declined to $OY_3/OP'_T$. The population can no longer be sustained at its customary level - not, at least, on the present *domestic* resource base.

**Figure 1 Export collapse and a Malthusian adjustment**




Two possible 'adjustments' are then envisaged, enabling the economy to return to its sustainable per capita income level; either it could attract foreign aid to fill the gap between the actual and the sustainable income level necessary to maintain the existing population level, or the population would have to be reduced, through emigration, family planning programs, or, more traumatically through 'starvation until [Malthusian] equilibrium can be established with a lower population' (Tisdell 1984:236). As population declines there will be a movement back along the production function to point E where $w_d$ has risen back to the sustainable level.

Although acknowledging these different possibilities, Tisdell does not work them into his model formally. Nor does he explore the possible consequences of migration not only 'reducing' the population but also giving rise to a return flow of remittances to supplement domestically generated income. Indeed, as migration has become one of the major adjustment mechanisms among some Pacific island economies this case deserves closer examination.

## Migration and remittances

To simplify the exposition it is assumed that the collapse of the export sector coincides with the opening up of the economy to labour migration. Total population ($P_T$) is now divided between migrants ($P_M$), and domestically resident ($P_D$):

$$P_T = P_M + P_D$$

Migrants are still included among the sustainable national population, and the decision to migrate can be assumed to depend on the relative size of the overseas wage ($w_f$) and the domestic income level ($s_d$), such that the migration rate is given by:[2]

$$P_M/P_D = g(W_f - w_d)$$

Migration will have two main effects. First, it will reduce the domestically resident population, and raise the per capita income levels of those resident, given that $w_d > l_d$. Second, through their remittances, migrants increase the total *national* income. Migrants earnings ($Y_M$) are then given by:

$$Y_M = w_f P_M$$

Now, $Y_M$ has three possible uses: that part which the migrant consumes abroad, that part which is saved/invested abroad, and that part which is remitted home ($R_M$).[3]

$$R_M = rY_M = rw_f P_M$$

How migration affects the level of income of the sending country will depend upon the behaviour of these variables. *National* income ($Y_T$) consists of domestic income ($Y_D$) *plus* migrants' remittances ($R_M$):

$$Y_T = Y_D + R_M$$

where, as in the previous case,

$$Y_D = f(P_D)$$

---

[2]As migrants are unlikely to migrate for less than the prevailing domestic income level, and, given the large wage differentials between the Pacific island economies and the main host economies, New Zealand, Australia and the United States, it is reasonable to assume that migrants' income will be higher than the domestic per capita level. Clearly, one should also allow for the costs, both pecuniary and non-pecuniary of migrating abroad, and allow for expected future earnings, including the possibility of an initial period of unemployment abroad, as in the Harris-Todaro model of rural-urban migration in developing countries (Todaro 1969; Harris and Todaro 1970). However, these sorts of refinements, while important in determining equilibrium migration rates, have no relevance to the main points illustrated by simple model.

[3]It would perhaps be more realistic to assume that remittances will be drawn from both wage earnings and, over the longer-term, investment income from savings held abroad. For the purpose of this paper, however, such a refinement is not necessary.

Per capita income, however, now depends upon *national* income, consisting of both domestic income and total remittances, per head of *domestically resident population* ($P_D$):

$w_d = Y_T/P_D = (Y_D + R_M)/P_D$

With no migration, $P_M = 0$ and $R_M = 0$, and

$Y_T = Y_D = f(P_D)$

The production and income function are identical and correspond with that of Figure 1. Now, if migration is introduced and it is assumed that $r > 0$, then

$P_M = 0$ and $R_M = 0$

so,

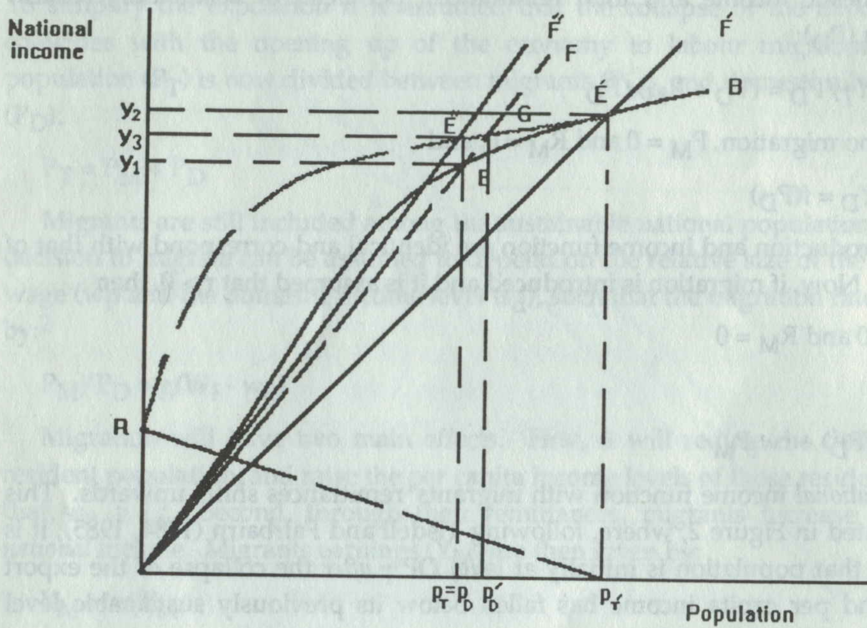
$Y_T = f(P_D) + rw_f P_M$

The *national* income function with migrants' remittances shifts upwards. This is illustrated in Figure 2, where, following Tisdell and Fairbairn (1984, 1985), it is assumed that population is initially at level $OP'_T$ *after* the collapse of the export sector, and per capita income has fallen below its previously sustainable level (from slope OF to Slope OF').

In the absence of migration a Malthusian adjustment will reduce total population to $OP_T$ and restore $w_d$ to $OY_1/OP_T$ at the equilibrium point E. As $l_d < w_d$, a decline in population lowers total output but increases national income per capita, $w_d$.

Now, with a migration adjustment, $w_d$ will rise at a faster rate than in the case of a Malthusian adjustment. This is illustrated in Figure 2 by the remittances curve $P'_TR$ which, for any value of $rw_f > 0$, will slope upwards from right to left. The remittance function $P'_TR$ is then added to the domestic production function OAB to give the national income function ORE'. In other words, as the number of migrating residents, $P_M$, increases there will be a movement back along the domestic production function from point E', and a simultaneous movement up the remittance function $P'_TR$. The combined effect is illustrated by a movement back along the national income function ORE' from point E' towards E". At point E" the resident population has declined to level $OP_D$ (equal to the Malthusian adjustment level $OP_T$). The migrant population ($P_M$) is given by $OP'_T - OP_D$. But, $w_d$ now equals $OE"/OP_D$ and is *above* the previously sustainable equilibrium level, $OE/OP_D$.

**Figure 2 Incorporating migration and remittances**




Clearly, the rate at which the per capita income level of the domestically resident population rises in comparison with the Malthusian adjustment envisaged in the Tisdell-Fairbairn model, will depend upon the relative slopes of the domestic production function ($l_d = \delta f(P_d/\delta P_d)$ and the remittance function ($R_M = rw_f P_M$). The higher the value of $rw_f$, the steeper the latter in relation to the former and the faster will be the rate at which $w_d$ increases as $P_M$ increases. It is important to note, however, that with any value of $rw_f > 0$ a migration adjustment will allow for a higher equilibrium domestic population level at the sustainable income level compared with the case of a Malthusian adjustment. $P_D$ increases in response to the higher $w_d$ - either through increased population, or return migration, or some combination of these - and could continue doing so until $w_d$ has returned to the original, sustainable level (= slope OF) at point G on ORB, with domestic population at $OP'_D$. Alternatively, a per capita income (= slope OF") that is *higher* than the sustainable level is now possible at the previous Malthusian equilibrium population level, $OP_T$.[4]

[4]If a Malthusian relationship is assumed to hold, total population will again increase as in the earlier case when a traded goods sector was opened up, or some migrants, attracted by the increased per capita income back home will return. These dynamic repercussions are not explored further in this paper.

Up to what point migration will actually continue will depend upon a number of micro-level economic and behavioural factors, as well as other institutional factors and constraints prevailing in both the sending and host countries.[5] These are not explored further in this paper, but what is important to note here is that international migration does constitute a very important micro-level response for economies suffering export collapse or other external shocks, which also has implications for the level of income and sustainability of the domestically resident populations of the sending economies. The extent to which the promotion of migration and remittances can be considered as a policy alternative for achieving sustainable development among small, natural resource-poor island economies needs closer examination, and is the subject of later sections of this paper.

## Foreign aid inflows

Another factor that has come to play an important role among Pacific island economies is foreign aid. Tisdell incorporates aid as an income supplement to domestically-generated income in a more recent rendition and extension of the Tisdell-Fairbairn model (see Tisdell 1990: Ch.10). In this, however, aid is treated as an alternative to the reduction of the domestically resident population through emigration, and remittances are ignored. For the sake of completeness, aid flows ($Y_F$), assumed to be some exogenously determined constant (b), are now added to the national income function presented in the previous section:

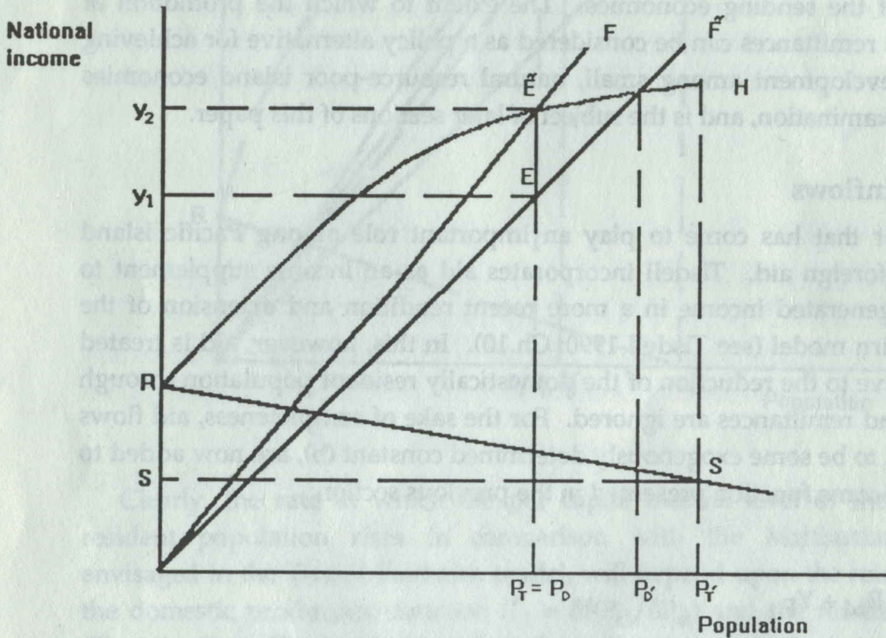
$$Y_F = b$$
$$Y_T = Y_D + R_M + Y_F$$

This has the effect of pushing the national income function upwards as shown in Figure 3, where the foreign aid inflow is given by the horizontal function SS' to which the previous national income function is then added, giving the new national income function OSRH. For each level of $P_D$, a higher sustainable level becomes possible. Assuming a domestically resident population of $OP_D$, per capita income rises above the previous level (= slope OF"). It again becomes possible to sustain domestically, at the income level equal to slope OF, a higher population than previously ($OP'_D$), thus allowing for either less emigration or an increased total population. These dynamic repercussions are not explored here,

[5] If, for instance, one were to assume that individuals will continue to migrate up to the point where the domestic and foreign wage differential is zero, the equilibrium migration rate ($P_M/P_T$) might be given by that point along ORGB where per capita national income ($w_d$) is equal to the foreign wage rate ($w_f$) *less* costs and remittances. There is no reason why this should necessarily coincide with the 'socially optimal' migration rate, which could be determined, for example, by the point at which $\delta f(P_D)/\delta P_D = w_f$ assuming policy makers aimed to maximize total national income.

but whether or not aid levels can actually substitute for migration, from a micro-level perspective is doubtful.[6]

**Figure 3 Incorporating remittances and aid flows**




What needs to be examined, however, is the extent to which the policy makers in the island economies themselves can and do treat aid from abroad as a policy alternative to other forms of 'adjustment' in the face of negative external shocks of the sort considered in the preceding discussion of the Tisdell-Fairbairn model. It is thus to the question of 'permanent' dependence on remittances and foreign aid, as an alternative model of sustainable development for the Pacific island economies that this paper now turns.

[6]It has been suggested, however, that donors, among the host countries in the Pacific region, do treat increased aid (out-) flows as an alternative to increased labour (in-) flows (Bertram 1986; Tisdell 1990: Ch.10).

## Adjustment to a 'rentier economy'

The second, opposing perspective on sustainable development among Pacific island economies is associated with the work of two New Zealand writers, Bertram and Watters (see Bertram and Watters 1985, 1986; Bertram 1986, 1991). They argue that a number of small Pacific island economies have evolved into 'rentier economies' in which international migration and the flow of remittances, increased reliance on foreign aid, and the spread of the state bureaucracy have become the dominant forces in shaping their economic systems. Domestic social and economic changes are treated as exogenously determined. The stagnation or decline of domestic production, it is argued, has to be understood in the wider context, the structural shifts occurring as these economies adjust to a changing external environment.

It has been further suggested, somewhat paradoxically, that in spite of declining production levels and domestic self-sufficiency, and the increasingly externally dependent nature of these rentier economies, they have become sufficiently 'durable and persistent' and 'capable of self-reproduction' to the extent that their dependent economic structures become '...both sustainable, and preferable to a drive for self reliance' (Bertram 1986:809). Government and donor conceived proposals for revitalization and expansion of domestic production through structural adjustment programs, as part of a drive towards domestic self reliance, are dismissed as being incongruent with the actual economic structures. 'National' rather than 'domestic' income becomes the key economic aggregate. Bertram goes even further suggesting that:

> If...island governments and their populations take seriously the plans' pronouncements in favour of self-reliance, then consequences can be severe. Not only are expectations of rising self-reliance in this sense likely to be disappointed, but the pursuit of unattainable goals can involve the squandering of resources, degradation of local environments, and subversion of local cultures (1991:2-3).

Conceptualization of 'sustainability' shifts from the usual preoccupation with fostering domestic productive capacity to assessing the 'durability of existing and future sources of rent income' from abroad - primarily in the form of inflows of aid and migrants' remittances. From an economic policy angle the focus thus also shifts from questions of *generating* internal surpluses for investment and foreign exchange earnings by promoting exports, to one of *mobilizing* existing external rents for domestic consumption.

What distinguishes this from the more orthodox treatments of adjustment policies and sustainable development in developing countries is that phenomena such as international migration, remittances, foreign aid, and the expansion of the state bureaucracy are regarded neither as secondary sources of livelihood for the

mass of their populations, nor as temporary aberrations from some 'ideal' or 'equilibrium' path of development.

'Structural adjustment' also acquires a different meaning. Underlying most orthodox theory on adjustment problems and policies in developing countries is the (often implicit) notion of some 'ideal' equilibrium state towards which the economy needs to be 'adjusted' (Harris 1988). Internal and external economic imbalances are conceived as originating either in some specific endogenous policies or in some external shocks. Instead, what is required is an understanding of the processes of continuous structural transformation and adjustment that these economies are enduring in response to a changing international economic environment.

For instance, the stagnation of production in traditional spheres of economic activity witnessed over the last decade in particular does not necessarily imply any 'lack of adjustment' on the part of the various economic agents involved. For some, previous options become blocked and new opportunities arise. Not all agents are necessarily losers. In response to steadily declining real incomes and worsening socioeconomic conditions in traditional lines of economic activity, individual economic agents as well as governments have had to search for alternative forms of economic behaviour and patterns of resource mobilization. Fiscal and current account imbalances can become an inherent characteristic of these processes and need to be understood as symptomatic of the evolving structures of the economies.

In this way, rentier activities have, for some economies, come to constitute the main determinants of their capacity to sustain their populations. As Connell has argued in relation to the Pacific island economies:

> The much vaunted comparative advantage of [Pacific island economies] lies not in the conventional economic spheres of cheap labour, copra production etc. but in the ability to attract aid and other concessionary finance (which includes remittances from international migration) (1988:86).

It is from this perspective that it has been postulated that:

> the processes of social and economic change...have to be understood in terms of local adjustment to external forces, *rather than as endogenously-driven development* (my emphasis) (Bertram and Watters 1985:501.

This conclusion requires closer scrutiny, for, it contains two important and closely related postulates: *first*, that the structure of the rentier economy (and the evolution of it) has no or little internal dynamic of its own; and, *second*, that the durability ('sustainability') of the rentier economy can be analysed and assessed almost exclusively in terms of the sustainability of its main external sources of

rent - remittances and aid. This is brought out clearly by Bertram when he states that:

> The future sustainability of above-subsistence living standards, and the prospects for future increases in those living standards, hinge upon the durability of existing and future sources of rent income. [and] the development problem for planners and policymakers, is not so much the production of modern, capitalist, tradable-goods-producing sectors within the island economies, as the question of how rent incomes should (a) be made more secure and predictable, and (b) be allocated among members of the island society (Bertram 1986:810).

The main problem with this argument lies with the rather mechanistic understanding of the relationship between external and internal dimensions of the development process; an understanding that is reminiscent of Latin American *dependencia* thinking of the 1970s, in terms of which internal structures were seen as being conditioned almost exclusively by external factors. Although the all-important remittance and aid inflows are 'external' to the domestic economy and are of central importance to its functioning, there is also a need to take account of *internal* economic forces in understanding the process of structural change in such rentier economies. Endogenous economic processes - although associated with and in some instances directly induced by externally-mobilized resource flows - also have an *internal* dynamic of their own. This too needs to be analyzed and incorporated in any assessment of the sustainability of the rentier economy.

The rest of this paper examines two very prominent and interrelated sets of internal adjustment processes, associated with aid and remittance flows to sub-Saharan African economies, that have had significant implications for the functioning of their economies: these are, (i) the growth of the parallel, unrecorded economy; and (ii) the 'decapacitization' of the state bureaucracy. It is argued that there could be some parallels with the Pacific island region which shares a number of similar features.

## Actual adjustments and the unrecorded economy

Privatizing public services, promoting the informal sector, legalizing parallel markets, and improving managerial capacity have become key issues in the policy dialogue between donors and recipients of aid. This is particularly true regarding their perception of the 'lack of adjustment' and, the growth of parallel markets (see World Bank 1989). While the World Bank and other key institutions among the international donor community might acknowledge the existence of growing informal sector and parallel foreign exchange markets in these economies, they tend to ignore their functioning in analysing the actual, ongoing processes of transformation, that are actually occurring in these countries.

A rather idealized view of the informal economy emerges, in which it is often portrayed as a potential source of dynamism and a breeding ground for entrepreneurs, as a possible source of employment for displaced public sector employees, and as an impetus to the expansion of the private sector. Few attempts have yet been made to explain its functioning and its relation to the rest of the economy, especially its interrelationship with and dependence on the public sector and donor funded projects, and the associated rent-seeking behaviour of its principal agents. In the context of the Pacific islands, Bertram is perhaps also guilty of holding a somewhat romantic view of the potential role of the informal economy when he argues that:

> planners might opt for the Pacific equivalent of an 'informal-sector promoting' development process, with various subsidies channelled directly into the village economy with the aim of...attracting labour back into a vital, expanded village sector (1986:818).

There is clearly a need to go beyond simplistic notions of the traditional divide between 'public' and 'private' sectors, of potentially perfect markets being distorted by 'inappropriate' and 'irrational' government interventions and regulations, and of the rational and more efficient private entrepreneur becoming 'crowded out' by excessive state investment. There is a need to understand, and thus explicitly incorporate into the analysis, the nature of the relationship that has evolved between the formal, public sector economy and the informal economy on the one hand, and the role that external factors such as remittances, foreign aid and donor agencies have come to play within these economies on the other.

Orthodox diagnoses, based exclusively on the examination of the officially-recorded macroeconomic aggregates, have failed to adequately consider the implications of some of the more prevalent individual, non-governmental responses to the economic crisis of the 1980s. Most existing analyses tend to concentrate on the appropriate *governmental* policy adjustments (or 'adjustment failures') and the responses to these (but see Van Arkadie 1988; Ghai and Hewitt de Alcantara 1990).

The evolving economic structures of these economies are often largely hidden. The transformation and adjustment processes accompanying the crisis have meant, for instance, that markets have become increasingly fragmented and the various parts of these - public and private, formal and informal - have become increasingly interconnected and interwoven, in places creating rather complex networks of relationships and transactions connecting the public and private sectors, and official and parallel markets. The functioning and behaviour of one cannot easily be analysed or understood in isolation, yet we know very little about the actual functioning of these markets, the channels and mechanisms through which foreign financial flows fuel the ongoing adjustment process. In formulating

economic policies, one cannot therefore rely on general postulates about 'the market' or 'the public or private' sectors, nor about the supposed behaviour of the different agents operating within these. Rather, it is necessary to investigate the specific avenues of accumulation (and their limitations) resulting from the *actual* ongoing processes through which these economies are adjusting and being transformed.

Many developing countries have flourishing 'underground economies', consisting of an informal trade, finance and production sector in which those with privileged access to foreign exchange, bank credits and import licences can earn enormous 'scarcity rents'. There is also very often a sizeable parallel foreign exchange market in which huge volumes of foreign exchange are traded at prices many times above the official exchange rate, predominantly for capital flight and luxury consumption. Much of this foreign exchange is earned through smuggling of exports, or, in the case of some African and Asian countries, by migrant workers in the Gulf states. The same is true in the case of many Pacific island countries, but particularly Tonga, Western Samoa, and Fiji, with large numbers of migrant workers in Australia, New Zealand and the United States (Connell 1980; Ahlburg 1991; Loomis 1990).

For each worker abroad there are a large number of family members and others who depend for their livelihood on the remittances such workers send. Such remittances are often transferred through the informal network, and exchanged on the parallel market (Choucri 1986). From Africa, Sudan is an obvious case in point where only 15 per cent of the remittances are channelled through the banks and captured by the official data. The unrecorded remittances are nevertheless both quantitatively and qualitatively important to the functioning and performance of Sudan's economy (Brown 1992a). Using survey data on migrants' earnings, the Sudan's balance of payments and national income accounts were reconstructed for the period 1978-88. Conservative estimates suggest that the Sudan's *actual* gross national income is approximately 45 per cent higher than the officially recorded data indicate.

Nevertheless, foreign exchange remains scarce in the official foreign exchange markets. Importers and consumers come to rely increasingly on the unofficial, underground market for the supply of goods and services, and an increasing amount of their economies' available foreign exchange earnings are then channelled into the unofficial free foreign exchange market, as the gap between the parallel and official exchange rates widens. Huge 'scarcity rents' are then earned by those with access to foreign exchange or imported commodities, especially when these can be obtained at the official rate of exchange, such as goods imported via commodity aid programs. Smuggling, speculative hoarding

of goods and/or foreign currencies ('currency substitution') can also become important in the underground economy, exacerbating the supply problem and reinforcing the inflationary spiral and depreciation of the domestic currency in the parallel market.

The existence of parallel markets has some very important analytical and policy implications, especially regarding the functioning of the official foreign exchange markets and exchange rate determination, and the inflationary process. Both of these are worthy of closer examination, especially given the importance attached to exchange rate adjustments and anti-inflationary policies contained in IMF and World Bank supported adjustment programs.

In most orthodox analyses, the existence of the parallel foreign exchange market and the premium on the price of foreign exchange traded tends to be explained solely in terms of the demand for foreign exchange for purposes of illegal *trade*, which is seen as arising from inappropriate government interventions in the formal economy. Imbalances in the foreign exchange market are thus analysed in terms of an excess demand for foreign exchange exclusively for 'spill-over' *current account* transactions. The primary objective of exchange rate adjustments and the unification of exchange rates, as well as other related adjustment policies, is then to restore balance in the supply and demand for foreign exchange for *current account* transactions. This ignores the unrecorded export of capital, or capital flight. Most literature on capital flight tends to focus on the larger, commercial borrowers of Latin America. Recent evidence suggests, however, that it is also very significant in other developing countries.

Capital flight is important, not only in terms of its implications for the availability of scarce foreign exchange and capital resources for the country in question, but also for understanding the functioning of the economy and the determinants of its internal and external economic imbalances. The unrecorded transfer of capital abroad represents a very substantial component in the demand for these countries' foreign exchange. It also indicates a substantial, hidden supply of investible savings. Adjusted national accounts data for Sudan suggest that one of Africa's poorest and most heavily indebted countries cannot be said to suffer a shortfall, either of savings or of foreign exchange, from a purely 'national' macroeconomic perspective (Brown 1992a, 1992b).

Again, there is evidence to suggest that capital export from the Pacific islands has also become an important characteristic of their economies. Apart from the massive flight of capital from Fiji after the 1987 coup, other examples include both Western Samoa (Skully 1987) and the Cook Islands (Bertram 1986, 1991). The 'problem' is that the state in such countries has no capacity to harness these

surpluses for productive investment in the domestic economy. Migrants, who need to remit their earnings to support their families, provide the foreign exchange and the transfer mechanisms through which private entrepreneurs can engage in capital flight. In Western Samoa, for instance, it has been noted that:

> There appears to be substantial savings placed in overseas financial institutions, both by Samoans resident overseas *and on behalf of the local Samoans* [my emphasis], which might be attracted to return and finance Samoan investment (Skully 1986:334).

The inflationary process in developing countries is usually interpreted, in orthodox analysis, in terms of the government's lack of fiscal and monetary restraint, which also explain the spillover of demand into the parallel foreign exchange market, and the persistent gap between the official and parallel exchange rates. However, the existence of capital flight implies that the demand for foreign exchange and the gap between official and parallel market prices must also be understood as a function of the *asset demand* associated with speculative 'currency substitution'.

In this situation, the inflationary spiral spreads from the parallel markets into the closely linked formal economy, since severe supply constraints push consumers and investors increasingly into these markets for goods and services. The continuous price increases in the underground economy drive up formal economy prices and costs through both wages and intermediate goods price increases. These affect public and private investment costs alike, as both are dependent on local suppliers, contractors, and so forth, who will tender on the basis of actual (or expected) parallel market prices rather than the official formal sector prices. Rising costs and shrinking profit margins for formal sector investors further fuel inflation, particularly through the associated increases in public sector expenditure and the loss of tax revenue as more private sector activities shift from the formal to the underground economy.

In other words, contrary to the orthodox view that lack of fiscal and monetary restraint on the part of government is the primary source of internal and external imbalance and disequilibrium in the foreign exchange market, it is suggested here that increased public sector deficits and private sector spending can also be induced by the inflationary processes originating in the largely hidden and unrecorded informal economy. From this perspective, internal and external macroeconomic imbalances are, in essence, symptomatic of the spontaneous, ongoing adjustment processes taking place in the form of international migration, the spread of the informal economy and capital flight.

A more systematic approach to these issues in the Pacific island region is clearly required. Identifying and quantifying the unrecorded transactions and

financial flows associated with migrants' remittances would not only improve our quantitative analysis of their economies, but also our understanding of the dynamics of the processes underlying their restructuring.

### Aid and restructuring of the state's economic role

In their exposition of the rentier economy of the Pacific island region, Bertram and Waters (1985, 1986) conceptualize a state bureaucracy that is fostered and maintained by the aid process, and which becomes a central characteristic of the sustainable, rentier economy. A number of recent studies of aid-dependent sub-Saharan African economies suggest that the resource flows associated with the aid process can seriously undermine the capacity of the government to intervene cohesively in the mobilization of the available resources (Morss 1984; Samoff and Wuyts 1989; Brown 1992a; Brown *et al.* 1992). In other words, if African experience is anything to go by, it should not be concluded that the durability of the aid-dependent economies and the capacity of their state bureaucracies to manage them will remain unaffected by the aid flows on which they depend. The sustainability of the rentier economies of the Pacific islands should not therefore be gauged purely in terms of the 'durability of existing and future sources of rent'.

The manner in which governments and the international donor community have responded to the foreign exchange crises facing developing countries, has, in many instances, particularly among the sub-Saharan African countries, undermined the state's capacity to intervene effectively in the economic sphere. Aid has not been forthcoming without conditions. Governments have often been required to reduce their activities, especially in areas such as health, education and other parts of the social and economic infrastructure. By insisting on expenditure-reducing policy reforms as preconditions for assistance, involving, for example, deregulation, privatization, reductions in government expenditure, the elimination of government controls over economic activity and involvement in the production and distribution of goods and services, the institutional capacity of the state to intervene directly in the management of the economy is further undermined.

This has resulted in fundamental changes in the character of the public sector and the financing and management of the services it provides. The erosion of real incomes of public servants in particular has had implications for the performance and social character of the public service. Van Arkadie (1988) refers to the process of 'creeping privatization', as public servants become increasingly unwilling to provide public services without some form of extra private inducement, either from the employer (in the form of 'incentive payments') or from the recipient of the service (often as an outright bribe). Corruption offers another important

source of supplementary income for government employees, many of whom are reported to resort freely to such activities as the selling of government property on the 'black' or underground market; not only are scarce basic commodities sold, but also trade licences, official seals and letterheads, for instance.

Increased dependency on official external financial assistance applies contradictory forces to the state's capacity to manage the allocation and use of scarce foreign exchange resources. On the one hand, the growing importance of official development assistance (ODA) flows as a source of foreign exchange has meant that an increasing proportion of available foreign exchange inflows to these countries has come to be channelled through the various organs of the state apparatus, rather than the private sector. On the other hand, the explosion of 'informal', 'parallel' and 'unofficial' financial relations and markets *within* the formal public and private sectors of these economies, and the growing proliferation of donors and donor conceived, financed and managed projects have gradually eroded the institutional capacity of the official state apparatus to perform its regular administrative functions. Donors and the flow of aid monies have come to play an important part in informal markets, with significant implications for the way in which the financial resources available to the state are used and accounted for.

'Creeping privatization', conceived by some as a positive dimension of the crisis, thus needs closer scrutiny. It tends to reinforce twin notions underlying orthodox interpretations of the nature of informal economic activities, particularly that of the World Bank in its insistence (i) that there is a thriving informal economy that exists *outside* the public sector; and (ii) that civil servants have come to rely principally on such *external*, informal economic activities to supplement their meagre public sector incomes (World Bank 1989). As has been shown very clearly in the case of Tanzania, neither notion is strictly valid (see Samoff and Wuyts 1989). Much so-called 'private' contracting in the informal sector is based on public expenditures and finance, and very often the service is provided by someone with access to public sector facilities and resources. Also, there is a tendency to exaggerate the extent to which it is possible for public sector employees (or any wage earners, public or private) to earn an additional income outside the public sector itself. It is very often the case that the individual engaged in so-called private contracting is paid out of one or another category of public funds. In other words, although the income being earned through the informal activity may well be a legitimate 'private income' for the recipient, it is only possible for the person to earn it because she or he is a *public* sector employee with access to *public* sector facilities, and because *public* finances - defined in the

broader sense to include donor-financed projects - are available for such an activity.

What is sometimes understood as a healthy process of 'spontaneous or creeping privatization' of public services through the expansion of a dynamic informal economy, which governments and donors should encourage and support, could boil down, therefore, to little more than a process of secondary contracting within the public sector itself. This is a process that needs to be understood as a response to the erosion of official salaries associated with the general economic decline and erosion of the formal sector, which in turn exacerbates the institutional decay in the public sector, bringing with it a basic restructuring of financial management and accountability of public expenditures. Such processes can also become associated with the less desirable practices of patronage, bribery and corruption, and can lead to significant shifts in the relative earnings differentials within the civil service.

Donor interventions, whether in the form of ODA financial flows, micro-level projects, or macroeconomic policy conditionality must be analysed and understood in this context. The donor community often takes on functions that normally are the responsibility of the national state. 'Planning' in many aid-dependent African economies has increasingly become an exercise in coordinating the diverse project interventions of the growing community of official donors and NGOs (Morss 1984; Brown *et al.* 1972). The state sector's capacity to function properly is further undermined by the demands placed on its scarce skilled and professional personnel by the numerous and uncoordinated requirements of the endless technical and/or advisory missions of expatriate project consultants, evaluators and so forth. Furthermore, in the face of declining public sector real wages, the best employees are often attracted away from public service to work for expatriate-managed aid projects, sometimes fulfilling the same task on such a project, for a much higher salary, than that which he or she would have been performing in the public sector. Again, a similar problem appears to be emerging in the Pacific island context where Cole and Parry report that 'In some countries most of the time of the leading professional public servants is accordingly taken up with servicing donors' (1986:20).

These sorts of aid-related processes can fundamentally affect the structure, nature and organization of many basic state services, such as health, as well as their financial and managerial accountability. Whether by intent or not, many donor interventions tend to bypass official decision-making structures, and as a result gradually transfer responsibilities for providing basic services from the various organs of the national government to different agents of the international donor community. Thus, public sector finances and the earnings of public sector

employees become increasingly tied to, or constrained by, the conditions and requirements of donor aid agreements.

Within aid projects donors often make incentive payments and pay extra allowances to staff to encourage greater commitment to their projects. As donor funded projects tend to have more resources than other public sector activities, there emerges a sharp discrepancy in the total volume of incentive payments provided in the two types of activities. Actual financial authority for much of the public sector budget is thereby effectively transferred to the donor financed and managed projects, and the accountability of government employees sometimes becomes transferred from their direct state employer to the donor managed project which has become the *de facto* employer. The donor agency, rather than the government, becomes the focus of the attention and the loyalty of many civil servants. This increasing reliance by civil servants on other forms and sources of public finances (including aid monies) or access to public resources (with which to earn extra income) erodes the cohesion of public sector action and adversely affects public sector ethics (Samoff and Wuyts 1989).

These sorts of processes have been found to be very important among the aid-dependent economies of sub-Saharan Africa but remain virtually unresearched in the Pacific island economies, in spite of their being among the highest per capita aid recipients in the world (Cole and Parry 1986). Further research into the interrelationships between aid flows and state sector finances in the Pacific island economies will be needed if policy-relevant conclusions about future capacity-building of the state are to be forthcoming. The processes through which different donor agencies - both official bilateral and NGOs - have become increasingly responsible for the organization, provision and financing of public services need to be properly understood. Any study of the impact of donor interventions in such economies must therefore examine the way in which these different forms of intervention are organized, and how these contribute to the reorganization and allocation of public expenditures. The main argument being advanced here is that donor interventions are likely to lead to the fragmentation of public sector activity by fostering the operation of parallel earning circuits within the public sector and between the donor agencies and the public sector.

## Conclusion

The paper has identified two competing lines of criticism of the orthodox perspective on the need for small island economies to promote their export sectors in order to attain sustainable levels of income for their growing populations. Both are found to be lacking in their neglect either of (i) the spontaneous restructuring

of many Pacific island economies away from domestic production towards external sources of 'rent' in the form of remittances from family members working abroad, and foreign aid; or (ii) the dynamics of the internal, 'hidden' processes set in motion by such external resource flows.

The implications for the Tisdell-Fairbairn model of introducing migration and external resource flows were analysed, showing what effects these could have on national income levels and the sustainable population, and pointing to the needs for these elements of the evolving economic structures of Pacific island economies to be given their due consideration in the debate on the nature of adjustment process and policy options for economic recovery and sustainable development in the region.

While acknowledging that 'rent' income from aid and remittances needs to be treated as an important characteristic of these economies, it was emphasized that African experience and research have demonstrated the importance of taking account of the implications for other 'hidden' processes set in motion in the domestic economy. These include such features as the spread of the parallel economy, capital flight, and the institutional destruction of the state's planning, administrative and financial capacities all of which have far reaching consequences for the longer-term sustainability of the economic structures they feed on. It is essential that these neglected dimensions of structural adjustment are given the attention they deserve in both the ongoing debate and research on economic policy and sustainable development in the Pacific island region.

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