



Theme 3: Investing in quality growth

Theme 3 balances the need for manufactured capital investment, both public and private, to drive economic growth in the Cook Islands, with human and environmental investments, within the real-world context of fiscal, economic, human and environmental limits.

Investment

Investment, both public and private, is a key driver of economic growth in the Cook Islands. Investment both stimulates demand for goods and services and builds the future capacity of local businesses. Driven by a number of major Government projects, investment in the Cook Islands has increased significantly in recent years. This is reflected in the value of building approvals (see Chart 1).

Public investment

Smart public sector investment that facilitates and catalyses private sector investment will significantly accelerate economic growth. To achieve the greatest and most sustainable economic benefit, the Government has to strategically assess where it invests across competing demands.

Chart 1: Building approvals, year to March (\$'000)



Source: Cook Islands Statistics Office, Miscellaneous Stats, March Quarter 2019.



The Government and its donor partners have invested in a number of major infrastructure projects in recent years, with total capital expenditure of \$68.5 million in 2018/19. This includes renewable energy investments in the Pa Enuā, Te Mato Vai and Mei Te Vai Ki Te Vai. Substantial investment has also been put into the Manatua Cable, a major IT infrastructure project. More recently, the Government has ramped up expenditure on roads, drainage and bridges in Rarotonga.

Despite this substantial investment program, and in line with other emerging economies, critical infrastructure constraints remain. The challenge is to identify and resolve these infrastructure constraints to ensure that the Cook Islands economy remains on track and business and industry opportunities are not lost.

Palmerston Island cyclone shelter design



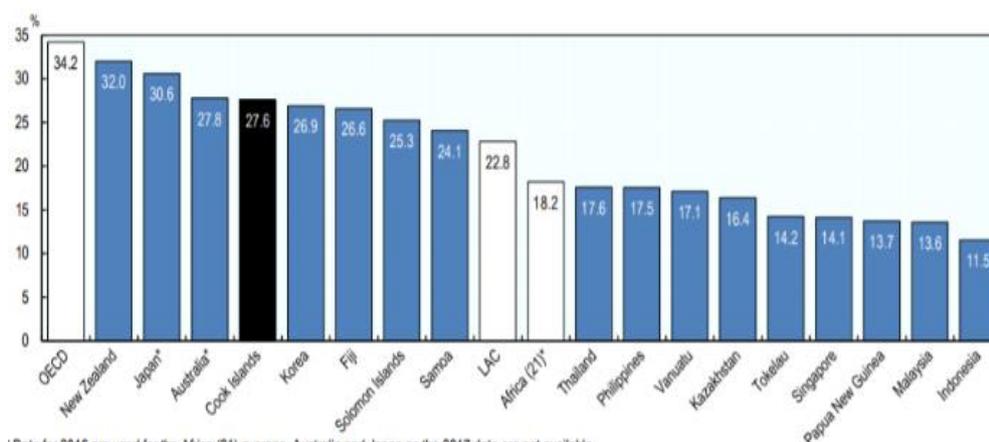
Private investment

While the Government’s role is to invest in critical national infrastructure, private investment (local and foreign) in commercial enterprises is key to driving sustainable economic growth. Investors look at a range of factors when deciding whether to invest in a particular location. These include the general business environment (taxes, regulations), potential profitability, market opportunities and availability, security and cost of infrastructure, secure property rights and skilled labour availability among others.

The Cook Islands Tax Regime

In 2017, the Cook Islands tax to GDP ratio was 27.6 per cent according to the OECD, compared to the OECD average of 34.2 per cent, and below both New Zealand (32 per cent) and Australia (27.8 per cent) (see Chart 2). The OECD review evidences the lack of complexity in the Cook Islands tax structure, notably due to the absence of social security contributions and ‘other taxes’.

Chart 2: International Tax to GDP ratios



* Data for 2016 are used for the Africa (21) average, Australia and Japan as the 2017 data are not available.

Source: OECD.

transfers technology, fosters competition and also contributes to raising productivity and income growth in host countries. The Asian Development Bank and the International Monetary Fund have characterised the Cook Islands regime as unwelcoming — ‘slow, discretionary, dependent on outdated laws, and discourage[ing] foreign investment’.¹

Generally market forces dictate that investment follows where best returns are to be found.

While, anecdotally, there are divergent community views on the desirability of FDI in the Cook Islands, global evidence is clear: it is a source of long-term investment capital, creates jobs,

Fiscal sustainability and spending limits

Sound and responsible management of Government finances is an essential element in creating a stable macroeconomic environment that supports growth. This requires careful balancing of revenues with expenditure, and ensuring sustainable debt levels.

What is a fiscal balance?

The Government's fiscal balance is one way of measuring its financial position. It is calculated as revenue minus operating expenditure (the net operating balance) minus capital expenditure plus depreciation.

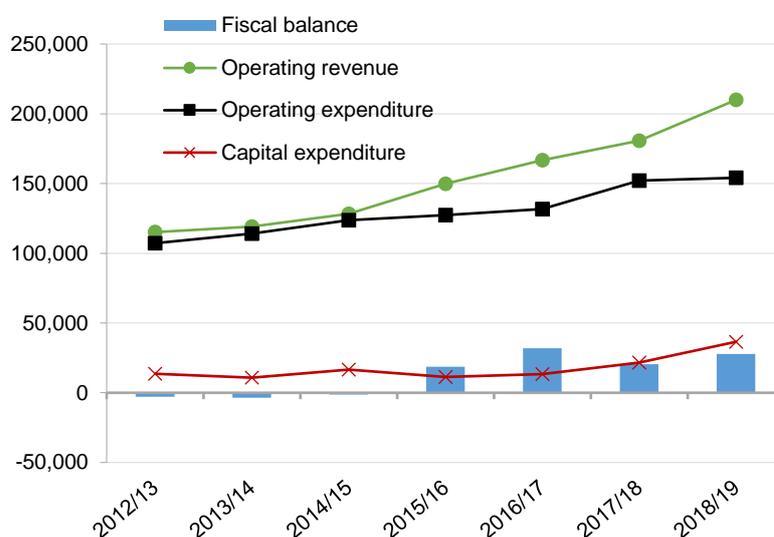
Government finances are robust thanks to strong revenue growth and prudent expenditure management over the last few years (see Chart 3). Revenues have risen faster than operating expenditure, more than enough to offset an increase in capital expenditure. This has had a positive impact on the Government's fiscal

balance, which has been in surplus since 2015/16.

The Government's Medium-term Fiscal Strategy (MTFS)² is designed to deliver sustainable budgets into the future, which account for the economic cycle. This will ensure that Government expenditure does not constrain private sector growth. The Government is adhering to its MTFS fiscal rules, providing the country with a stable macroeconomic environment.

Despite the robust state of Government finances, the size of the infrastructure gap we are facing means that the Government cannot itself fund all the required infrastructure investment without compromising future fiscal sustainability. As such, hard decisions will be required as to what infrastructure is prioritised.

Chart 3: Cook Islands Government revenue and expenditure (\$'000)



Source: MFEM.

Economic limits and capacity constraints

The Cook Islands economy is currently operating above its potential capacity. This implies that additional growth will add to cost of living pressures, labour shortages and housing shortfalls.

Analysis of the Cook Islands nominal output gap suggests that the Cook Islands is currently confronting a positive output gap. While there is no evidence of overheating showing up in the

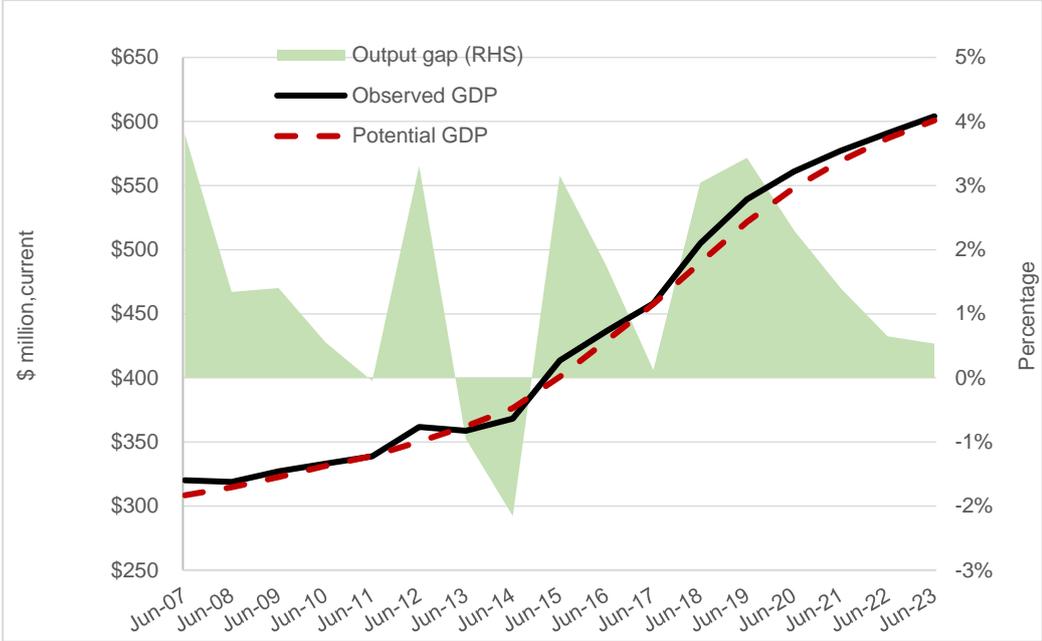
What is the output gap?

The output gap is a measure of the overall level of slack in the economy. A positive output gap means the economy is operating above full capacity. If maintained for an extended period of time, this leads to the build-up of inflationary pressure. A negative output gap means that there is spare capacity, or slack, in the economy due to weak demand for goods and services. An extended period under this situation can lead to deflation and economic recession.

inflation data at present, should the positive output gap continue for an extended period of time, capacity constraints such as labour and skills shortages are likely to worsen, resulting in inflationary pressure.

Forecasts of the output gap indicate that the positive gap will persist over the period to 2023/24, but decline in magnitude over time (see Chart 4).

Chart 4: Cook Islands Output Gap



Source: MFEM estimates.

Human capital

A skills shortage is evident in the Cook Islands which not only affects growth, but is resulting in strong increases in immigration. A recent survey undertaken by MFEM showed that of the 42 businesses that completed the survey, 42 per cent stated that they had current vacancies. Of these, 46 per cent said that these positions had been vacant for more than 3 months. Responses suggest that difficulty in filling positions is occurring both at the highly skilled and unskilled levels.

The survey suggests that there are two constraints occurring – that there is an insufficient number of workers with the required skills to fill highly skilled positions, and that there is an insufficient number of people in general to fill unskilled roles, together with a lack of willingness to undertake these roles. These tight labour market conditions appear to be impacting upon wages, with estimates of wage increases of 8 per cent per year between 2015 and 2018. Economic theory suggests that wage growth as strong as this often results in a wage-inflation spiral whereby higher wages increase demands for goods, which increases the price of goods and in turn increases the need for higher wages.

To ensure that we are able to achieve quality growth, investing in human capital is crucial. There are two providers of tertiary education; the Cook Islands Tertiary and Training Institute, and a regional campus of the University of the South Pacific.

In addition to investing in education, increasing the population will be required to sustain long-term growth. This can either be in the form of attracting the Cook Islands diaspora back from New Zealand and Australia, or through higher immigration.

Investment in a fit and healthy population is also required to ensure that investment in human capital is productive. Obesity is prevalent in the Cook Islands and has the potential to negatively impact upon the sustainability of economic growth over the long-term.

Environmental capital

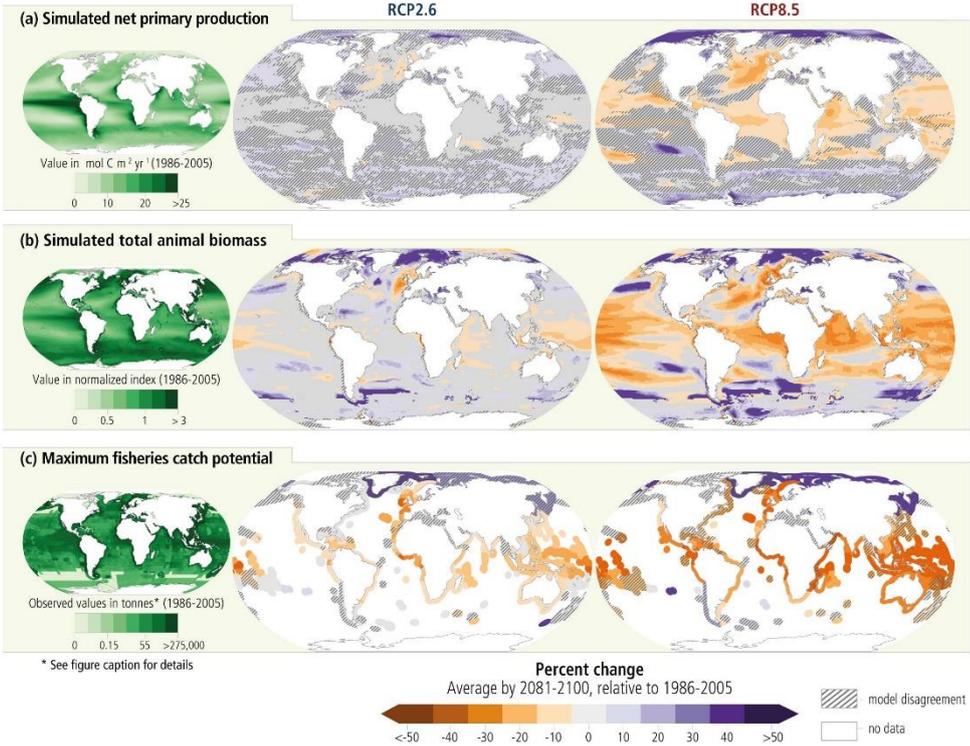
Most economic developments result in increased pressure on the environment. Investment in environmental capital is essential for combating air and water pollution, road congestion and waste and sewage, to relieve the pressures as much as possible.

Climate change, which is the result of historical economic development based on fossil fuels, is placing additional pressure on the world. Scientific research on the speed of global warming is continually updated with predictions of faster and more pronounced changes to the climate.

The latest report by The Intergovernmental Panel on Climate Change (IPCC),³ predicts that surface temperature will increase by between 1.6°C and 4.3°C by the year 2100 with impacts on coastal ecosystems including: intensified marine heatwaves, acidification, loss of oxygen, salinity intrusion and sea level rise. These effects are particularly relevant to the Cook Islands economy.

In mitigation of these impacts, the Government has undertaken a range of environmental investments, for example renewable energy in the Pa Enua, the Mei Te Vie Ki Te Vai sanitation project, the development of a Solid and Hazardous Waste Bill which will include a ban on simple use plastic bags, and improvements in the EIA processes.

Projected changes, impacts and risks for ocean ecosystems as a result of climate change



Source: IPCC

Land limits

Most businesses require a physical location from which to operate, and land for buildings and economic activities. Land plays two key roles. First, as an input into economic activity, and second as security to access finance. Sustained economic growth requires stable, clearly defined, and well-protected property rights regarding land.

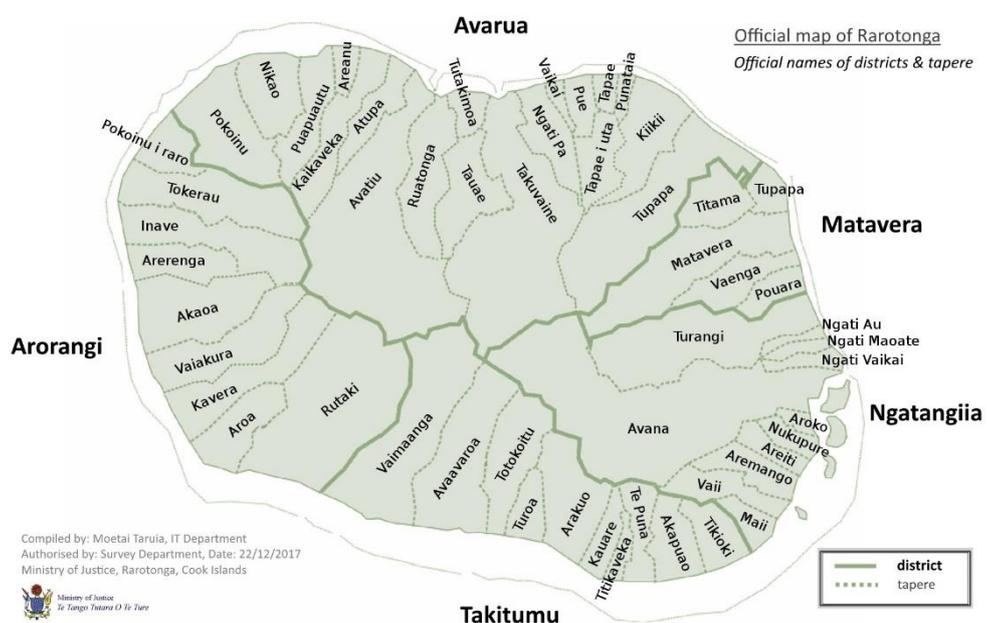
The Cook Islands has a total land area of approximately 240 square kilometers within 2 million square kilometers of ocean, making land a scarce resource. This is especially the case in Rarotonga and Aitutaki following very strong economic expansion over the last few years.

While the commercial banks appear willing to use leasehold land as collateral for a business loan, they have indicated that the process is time consuming and costly, requiring detailed legal review of each lease on a case by case basis.

The simple conclusion is that the complexity and cost of land transactions in the Cook Islands is likely to be a barrier to accessing land for business purposes, for both local and foreign investors. The more difficult question is what can be done to improve the system that doesn't impinge on the customary rights of landowners.

Land tenure system

The land tenure system in the Cook Islands is mostly native freehold title and cannot be sold outright, the exception being leasehold interests which can be sold with the consent of landowners. All lease agreements must be approved by the Land Court, and carry a maximum lease period of 60 years. All children equally inherit their parents' land ownership rights, which has led to the fragmentation of ownership. Exacerbating this is the prevalence of absentee land ownership as a result of substantial outward migration. As a result land transactions can be complicated and costly.



What is the Economic Development Strategy?

The Economic Development Strategy is a high-level plan to guide sustainable economic growth of the Cook Islands over the next 10 years. The Strategy will:

- cover not just economic but also social and environmental matters, to ensure sustainable growth;
- present a shared vision of what the community wants the Cook Islands economy to look like in 10 years' time;
- ascertain business and other opportunities that are worth investing in;
- identify key problems that we can fix; and
- include an action plan with a list of things that will be done to make sure our economic vision is achieved.

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Endnotes

¹ ADB (2015). The Cook Islands: Stronger investment climate for sustainable growth. Asian Development Bank; IMF (2019) IMF Mission to the Cook Islands – Concluding Statement. International Monetary Fund, April 2019.

² CIG (2018). Medium-term Fiscal Strategy 2019/20–22/23. Ministry of Finance and Economic Management, Cook Islands Government, December 2018.

³ "The Ocean and Cryosphere in a Changing Climate".