The Economy of French Polynesia: Past, Present and Future

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ABSTRACT

French Polynesia has a history of economic dependence on French public transfers. The dependence on military spending grew during the sixties and seventies due to the atomic testing activities in the Tuamotu archipelago, which ended in 1995. Since then, the official strategy, stated in the "pacte de progrès" in 1993, has been to promote export and tourism revenues, as a substitute for French public transfers. But it was not successful because the adequate policy measures were not implemented to reach this goal: high costs and prices due to protectionist policies and the high cost of public administration and the Pacific Franc's high real exchange rate continue to have negative effects on export and tourism.

Keywords

French Polynesia Development strategy protectionism Dutch Disease, Small island economies.

1. INTRODUCTION

French Polynesia is a group 121 islands of the South Pacific; a French "collectivité d'outre-mer" with an autonomous assembly and government, a president, a flag, an hymn. The French government is competent for money, credit, international relations, higher education, military police forces. The local government is competent for all other matters. The 260 000 people are French citizens and hold a European Union passport. The per capita GDP is, 17,216 euros in 2005, and per capita French public transfers amounts to 4,864 euros, or 28% of GDP (ISPF 2008a). The resources of the public sector (including social security) amount to 71% of GDP in 2003, compared to 49% in France (Institut d'émission d'outre-mer 2006). The French taxpayer pays all military personnel, teachers, professors and policemen (61% of public expenditures). The local taxpayer pays for all other expenses (39% of total public expenditures).

Compared to independent island states of the Pacific, French Polynesia is rich. Depending on the rate of exchange, its per capita GDP appears sometimes higher than New Zealand's. But that would not be the case in purchasing power parity, since the price level is much higher in French Polynesia. The traffic jams in Papeete, the high number of SUVs on the road, the good level of public infrastructure and health coverage and the sophisticated welfare system all seem to point to a "rich" economy. Rich but fragile : a huge trade deficit (imports are 10 times exports in 2007, or 2,6 times including service exports), a poor tourism performance, a weak industry and agriculture and above a high dependence on French transfers. Will French Polynesia remain in the future a rent economy, or will it develop a strong tourism sector, as was the case for Hawaii or Guam when military spending began to decline there ?

The paper will first highlight a history of economic dependence on French public transfers (section 2). In section 3 it will be shown how protectionism and a costly public sector have driven the cost of living and the real exchange rate over the years. In section 4 I show the failure of the import-substitution strategy to develop a strong self reliant economy. Section 5 proposes a strategy for a more self-reliant economy. Section 6 concludes.

2. A HISTORY OF ECONOMIC DEPENDENCE

2.1 Before and after 1964

The first works to build the infrastructure and military bases for the French atomic experiments began in 1964, with the opening of the first international airport on the island of Tahiti.

Before 1964, the economy was based on the revenues from a few export staples: phosphate, coprah, vanilla, mother of pearl. There was a small trade deficit, due to the dwindling phosphate production on the island of Mataiva. Per capita GDP was only a fraction of metropolitan France.

From 1964 on, huge military spending lead to a radical change in the economic structure of the island. The military enrolled local workers to build the facilities in Tahiti and in the Tuamotu islands of Hao, Mururoa and Fangataufa. In 1965 French public transfers amounted to 61% of GDP. In 1975 the military's share of the total wage bill was 35%. In 1980 the public sector (civil and military employees) paid 69% of the total wage bill.

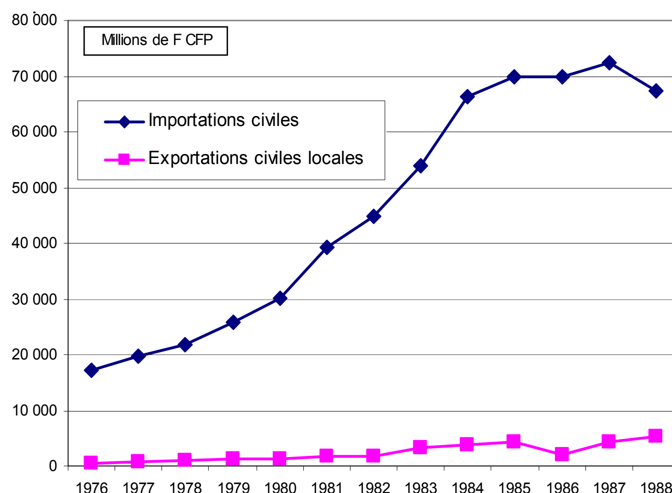

Figure 1. French Polynesia's Imports and exports, 1976-1988
Imports immediately shot up, while exports declined steadily, then picked up slightly with the development of pearl culture beginning in the nineteen eighties.

As a result of the rapid increase in French public transfers, all economic and social indicators grew also rapidly in this period. Infant mortality came down, medical coverage and life expectancy went up. Per capita GDP grew faster than in Metropolitan France, partly reflecting a higher inflation rate.

The local public service grew rapidly after 1974, when the first statute of autonomy was granted to French Polynesia. The local public servants' union managed to obtain similar wages as the French expatriate civil servants, who were paid more than twice the metropolitan rate at that time. As a result, the cost of the local civil service grew exponentially, and this was mainly financed by increasing import duties, i.e., through price inflation of imported goods.

3. PREDOMINANT PUBLIC SECTOR PLUS PROTECTIONNISM ADD UP TO A HIGH COST OF LIVING

Today the public sector's share of GDP is 24%, but the resources of the public sector (French public transfers plus local revenues from import duties and taxes plus social security contributions) amount to 71% of GDP (49% in France). This might well be a world record…

Since most of the local budget is financed by a value added tax and import duties (in the absence of an income tax), the local industry is very much under a protectionist umbrella. On average, import duties amount to about 30% of the total value of imports. A special import tax, called "taxe de développement local (TDL)" is levied on imports that are in competition with locally produced items, such as beer, bottled water, sodas, plastic pipes, windows and doors, screws and bolts, construction materials, boats, car batteries, and so on…In addition there are also quantitative import restrictions, (such as a ban on ham, corned beef and sausages), or imports quotas on oranges, tomatoes and other vegetables. As a result, local prices for the said items are 50% to 100% higher than in Metropolitan France. In 2007 for example, French Polynesia was the 6th most expensive country in the world for the cost of a Big Mac.

As a result of the rapid increase of the average rate of import duties during the seventies and eighties, the local price index grew more than in metropolitan France, at least until 1986. Since 1949, the local Pacific Franc has been linked to the French Franc and then the euro by a fixed exchange rate. This means that the real exchange rate has been going up until 1986. Since the Pacific Franc has been linked to the euro after the end of the French franc, while most export and tourism services go to non European countries (pearls to Japan and China), tourism to the United States, Australia and New Zealand, much closer to Tahiti than Europe), the competitiveness of the export sector has been adversely affected by the rising euro against the US, Australian and New Zealand dollars.

A parliamentary report (Brard 2007) recently revealed some large price discrepancies between French Polynesia and metropolitan prices. Here are a few examples: the prices are 3 times higher for imported yogurt, imported cookies and local tomatoes, two times higher for chocolate bars, liquid shower soap, imported jam, dishwashing liquid, locally made Coca Cola, 62% higher for imported UHT milk, and so on…

4. THE FAILURE OF IMPORT SUBSTITUTION

The rapid growth of French public transfers made it superfluous to consider any development strategy until 1993, when the atomic testing was suspended, and then finally ended in 1995. At that time, import substitution was considered as the most desirable way to enhance the multiplier effect of French public transfers, by minimizing import leakages. In 1988 the president of the local government, Alexandre Leontieff, stated in the French magazine l'Expansion: "import-substitution, our development strategy, seeks to promote the local manufacture of products to satisfy the needs of the domestic market, thus reducing imports".[1]

This strategy led to a very high level of protectionism. In 1996, the average tax rate on imports was 42%, a near world record.

In 1998 the value added tax was introduced, replacing "entrance duties" (droits d'entrée) on imports from the European Union, and a general tax for social security on all imports. As a result the average import duty decreased from 42% in 1996 to about 30% today. But a new import tax was added in 2001, called "taxe de développement local", which is levied specifically on import goods that are in competition with locally produced goods. This tax can reach punitive levels (from 30 to 90%, on top of other general import taxes). It is levied on imports of beer (82%), mineral waters (20%), soft drinks (60%), chocolate (51%), car batteries, plastic tubes, toilet paper, boats, screws and bolts, etc…

This explains the very high level of prices for beverages and other locally produced goods protected by the "taxe de développement local".

Although imports were reduced significantly for a few products (such as beer, soda, mineral water, car batteries, aluminum doors and windows, ham, sausages and corned beef, screws and bolts, toilet paper, plastic tubes, foam mattresses), total imports continued to grow at a fast rate, since the local industry was unable to provide most of what the local demand required, mostly durable consumer goods, such as vehicles, motorcycles, bicycles, TV sets, cameras, radios, computers, and so on. In addition, much of the food is imported, fresh or canned (except corned beef).

Having been in effect for more than 30 years, the import-substitution strategy failed to develop a strong and diversified industrial base, most of the manufactured products being still imported, and the manufacturing industry amounting only to 6,1% of GDP in 2005 (excluding energy, construction, transport and telecommunication), and 8% of total local employment (excluding French state military and civil servants).

This is not surprising of course, since the constraints of distance, the high shipping cost of raw materials and energy, and the lack of scale economies for most products catering to the domestic market, make it very difficult to engage in competitive manufacturing of products for the very small domestic market (260,000 people).

The very few successes of import-substitution (beer, corned beef, ham and sausages, spring water and sodas) entail a very high cost

[1] « La politique d'import-substitution, poursuivie par le Territoire, encourage la production locale des produits qui permettent de couvrir les besoins du marché intérieur en réduisant ainsi les importations » Alexandre Léontieff, President of French Polynesia, l'Expansion N° 320, 18/31 mars 1988

to the consumer. A recent report of a local assembly commission on the high cost of living noted that the retail price of locally made corned beef varies from 321 F to 408 F for a 320 g can, while it would be possible (if it was legal) to sell imported corned beef from Brazil at a retail price of 115 F or from New Zealand at a retail price of 163 F. The cost of manufacturing a can of corned beef in French Polynesia (with local and imported pork) varies between 242 and 282 F.[1] This means that the local cost of producing corned beef exceeds the retail price of the imported product (if its import were authorized). Similar import bans occured in the past for ground coffee (from imported coffee beans) and for pasta. But the consumers' outcry was so loud (especially since the local products were not only more expensive but also of a lower quality), that those bans were finally lifted.

But most importantly, the protectionist policies, together with the high wages of public servants, explain the high cost of living in French Polynesia, and the resulting problems of the export and tourism exports. Because domestic prices have increased faster than foreign (metropolitan) prices, the real rate of exchange of the Pacific Franc relative to the French Franc has been increasing by more than 40% between 1957 and 1986, then slightly decreasing until today. If 1957 is a base year, we can conclude that the Pacific Franc is at least overvalued by more than 20% (see figure 2).

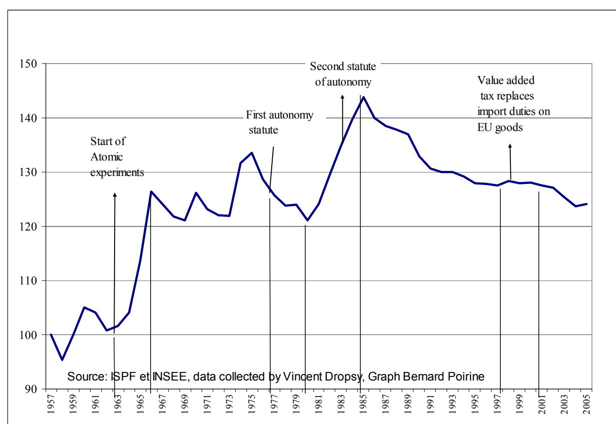

Figure 2. Real exchange rate of the Pacific Franc (ratio of local consumer price index to French consumer price index)

It is safe to say that the protectionist policies have been compounding the problems of the export sector in French Polynesia: the high cost of securing imports, or shipping exports, because of the remoteness of the archipelago from the main import and export markets, has been increased further by the high cost of import duties (which are based on the CIF value of imports, including freight and insurance).

The high price level and the overvaluation of the Pacific Franc hamper the competitiveness of the export and tourism sectors. For example, the high cost of building materials, local or imported beverages, fruits and vegetables, electricity, telephone, internet, makes it difficult for hotels and restaurants to be competitive with other tourist destinations (in contrast, cruise ships are allowed to import free of tax all the food and beverage they need). In addition to tourism, other export services are not competitive. For example, Air Tahiti Nui, the semi-public domestic airways with a fleet of 5 Airbus long haul airplanes, has been loosing money since its beginnings. In 2008 it lost 55 million US dollars, and the local taxpayer has been made to pay $ 916 per household for last year's deficit, even though it benefited from a special subsidy from the French government to buy its airplanes (through a complex tax exemption system called "loi de défiscalisation outre-mer"). This added (to the taxpayer) cost of subsidizing the hospitality and air transportation industries (as well as the copra oil export industry), is a by-product of the already costly (for the consumer) policy of import substitution.

One could ask why in face of such a general failure, the protectionist policy has been kept up until now (especially since 2004, with very frequent government and majority changes occurring, in contrast to the former period dominated by the presidency of Gaston Flosse and his ruling party).

There are several reasons for this:

- the choice to finance the escalating local public sector spending (with public wages higher than in metropolitan France, and a very high cost of the local institutions such as presidency, local assembly, conseil économique et social) mainly trough import duties and value added tax, rather than through income tax or other taxes on capital gains or bequests. For wealthy residents, French Polynesia is a tax haven, but this is paid through import duties by the less well to do people.
- The choice to create a clientele of businessmen devoted to the ruling party, the president being finally the ultimate decider of who benefits or not from a tax or quantitative protection against foreign competition, thereby providing (or not) a lucrative rent on the captive domestic market (because of the lack of domestic competition to speak of). Moreover, such a favor can be granted or suspended at will by the local government, which certainly provides an incentive to please the politicians in every way.
- The misguided belief that promoting the domestic industry through protectionism would ultimately help build a more self reliant economy, less dependent on imports. Rather, the local economy has been more on more dependent on imports, and on the public transfers from France, which pay for a good chunk of the local government expenditures (such as the wages of all teachers, professors, policemen, judges).

5. *PROMOTING EXTERNAL RESOURCES*

5.1 Le pacte de progrès

In 1993, president Mitterand decided to suspend the nuclear experiments. In 1995, President Chirac decided to resume them for a year and then end them for ever.

The local government suddenly became very conscious of the economic dependence of the local economy on military spending. Several studies were made, showing that the end of the military bases in Mururoa and Tahiti would represent a loss of French military spending of approximately one billion euros per year, which would halt economic growth for a long period and possibly

[1] Assemblée de la Polynésie française. Rapport présenté au nom de la commission d'enquête chargée de proposer des mesures d'encadrement des marges et des prix des produits commercialisés et des mesures de contrôle et de répression en cas d'infraction. Rapporteur Hino Tefaarere. 26 février 2009, p. 121.

create a lot of unemployment, since many local civil workers were employed by the military bases. I wrote a book at that time, called "Tahiti: stratégie pour l'après nucléaire" (Poirine 1996) were I recommended a radical change in strategy, from import-substitution to the promotion of exports and tourism services.

In 1993, the local government decided to hold brainstorming sessions to imagine a future for French Polynesia. The aim was to propose a strategy to cope with the next decennia of predicted dwindling public transfers from France. The ensuing document became known as "Pacte de Progrès" (Charte du développement 1993). It contained an estimate of expected external resources from 1995 to 2005, highlighting the need to obtain a faster growth of exports and tourism receipts, to compensate for the decline of French public transfers, following the end of the center for atomic experiment in French Polynesia.

In 1993, Exports and tourism receipts accounted for only 26% of external resources, French public transfers provided the remainder. The official goal was to bring that share to 43% by 2005, by promoting exports (Tahitian pearl, fish, copra oil, vanilla) and tourism. In order to obtain this goal, a fiscal reform was recommended, to lower the share of import duties in the total receipts of the local budget.

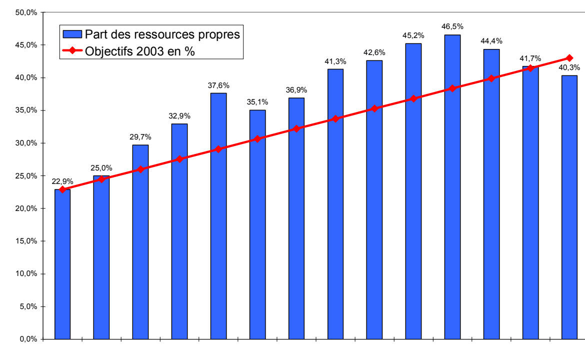

Figure 3: French Polynesia: The share of own external resources (exports and tourism receipts) in total external resources (exports, tourism receipts, French public transfers), 1990-2003. The red line represents the decennial expected goal, the blue bar shows the real performance

The goal for 2003 was attained in 1998 thanks to the rapid growth of pearl exports and tourism receipts. But, from 2000 on and until now, declining pearl exports and tourism receipts led to a decline in the share of external resources from domestic origin, and, worse still, a decline of the total external resources from domestic origin. The failure to reach this goal of developing external resources from domestic origin is due to a decline in tourism attendance, and to a steep decline in the price of Tahitian pearl, French Polynesia's main export.

The main reason for this poor performance of exports and tourism is that, in essence, the protectionist policy has been going on as before, despite a fiscal reform introducing a value added tax in 1998 to replace some of the import duties.

5.2 Toward a new development strategy

It is obvious that since 1993, the official development goals and the real policy decisions have been in complete contradiction. The aim is officially to promote export and tourism in order to become less dependent on public transfers.

But in practice protectionism is still very much in place, the fiscal reform (1998-2001) having in fact replaced high average "across the board" import duties by a "taxe de développement local", much more targeted only to specific imports, and therefore generating less income for the budget, but a much higher degree of protectionism to the benefit of targeted industries, with the result that the export and tourism sectors cannot become competitive, since the causes of the high price level and the overvaluation of the currency have not been treated. In other words, there is no coherent long term economic policy to really promote tourism and exports.

There is a rather stable multiplier of external resources, varying between 2.5 and 2.6 (See Figures 4 and 5), meaning that any increase in external resource results in a proportional increase of GDP, and therefore employment.

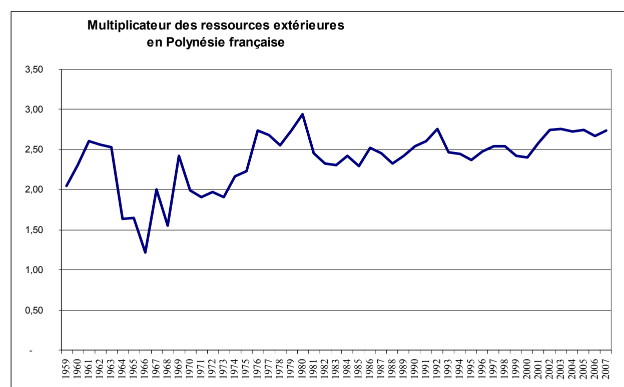

Figure 4: French Polynesia, Multiplier of external resources (ratio of GDP to exports of goods and services and public transfers), 1959 to 2007

Thus, promoting the growth of external resources is the only way to make a small island economy grow (Poirine 1995, Poirine 1996, Crusol, Hein, Vellas 1988, Galbis 1984, Demas 1965) . Because of the Dutch disease effect of public transfers (through the high level of public wages, and the high level of import taxes to finance high wages in the local administration), there should be a real effort to minimize the cost of the public sector and the public corporations (the total resources of all public administrations represent 61% of GDP (IEOM 2006), partly paid by the French taxpayer).

There is a definite need to do away with protectionism, (to minimize the welfare cost to the consumer, to minimize crowding out effects on the non protected sectors, and to steer capital and labor toward the export and tourism sectors). The island of Guam successfully took this road years ago, repealing all import duties, to become a shopping haven for the Japanese tourists (Guam as five times more tourists than French Polynesia with approximately the same resident population).

The overvaluation of the local currency resulting from past inflation and the fixed exchange rate with the Franc and the Euro since 1949 has to be corrected through an exchange rate adjustment. The inflationist effect of devaluation on import prices could be mitigated if a fiscal reform would simultaneously repeal all import duties (30% of the value of imports). The French state could partially compensate the local budget for the lost fiscal revenues in Pacific Franc since the same transfers in euro would provide an increased amount in pacific francs.

Furthermore, the French state could save on the wage bill of State civil servants by keeping their wages unchanged in Pacific Franc

(which would amount to pay them less in euros). The local government could replace import duties with an income tax (less inflationist, and socially more equitable).

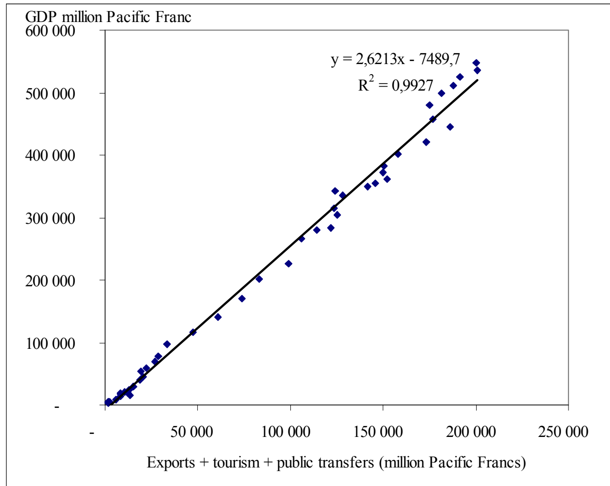

Figure 5: External resources (exports + tourism receipts+public transfers received) and GDP, French Polynesia, 1959 to 2007.

As can be seen from Figure 6, compared to Hawaii and Guam, French Polynesia has much less tourism receipt per capita, but much more public transfers per capita.

It would be possible to do away with French public transfers altogether ($6121 per capita) if only tourism receipts ($2061 per capita) were multiplied by 4 ($8244 per capita). That would mean 4 times more tourists, i.e. 3,2 tourists per capita instead of 0,8 in 2005 (compared to 5,9 tourists per capita in Hawaii, 6,6 in Guam).

This goal of quadrupling tourists per capita is not out of reach, if a correct policy is engaged, with adequate infrastructures (more golfs, congress center, casinos, more promotion, tourist promotion, special zones reserved for natural parks in the lagoons, low cost airplane companies, etc….

6. Conclusion

French Polynesia has been surfing on a high wave of military spending by the French Government for three decades. They have had good short term direct effects (multiplier effects on income and employment) and bad long term crowding-out effects (on inflation, the real exchange rate and the competitiveness of the export and tourism sectors). Political autonomy has transferred the responsibility of economic policy to the local government (except for monetary policy). The choice made by all local governments has been to finance increasing local public spending through higher taxes on imports, rather than by taxing income and wealth, or by curbing public wages. The protectionist policy was even perfected after 2001 with the advent of a new import tax which specifically targets with very high rates imports in competition with locally made products. This has had the effect of driving local prices even higher. This policy is in direct contradiction with the official goal to promote receipts from exports and tourism. The overvaluation of the currency resulting from decades of high inflation rates from 1964 to 1986 makes it difficult to compete with foreign imports (which justifies protectionism), but even harder to compete on world markets for pearl exports and tourism receipts. Only radical reforms, including the end of protectionism and a devaluation, would make it possible to replace a rent economy with a tourism led economy, such as Guam or Hawaii.

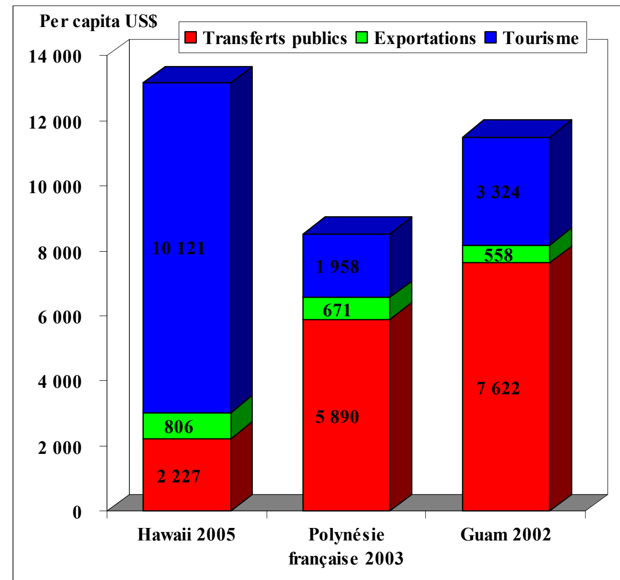

Figure 6: Hawaii, French Polynesia, Guam: External resources per capita

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