

# STATE OF THE FALKLAND ISLANDS ECONOMY

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Policy Unit, Falkland Islands Government



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## Abbreviations

£	Falkland Islands Pound
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FIDC	Falkland Islands Development Corporation
FIG	Falkland Islands Government
FIMCO	Falkland Islands Meat Company Limited
FKP	Falkland Islands Pound
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GNI	Gross National Income
GVA	Gross Value Added
IMF	International Monetary Fund
Kg	Kilogram
MPA	Mount Pleasant Airport
n/a	Not available
NPISHs	Non-Profit Institutions Serving Households
OECD	Organisation for Economic Co-operation and Development
RPI	Retail Price Index
SAERI	South Atlantic Environmental Research Institute
UK	The United Kingdom
USD	United States Dollar

## 1. Introduction

The Falkland Islands economy has performed well in recent years. Oil was discovered in 2010 on the Sea Lion field and production for the world markets is currently planned for 2019. Further oil and gas exploration took place from 2010 to 2012 giving a boost to the local economy and a new round commenced in 2015. At the same time, fisheries revenues have been strong and lamb and mutton exports growing. Cruise ship visits have also started to recover after several years of decline. The economy has witnessed impressive, although volatile, growth. Unemployment rates are low enough to be the envy of most countries in the world and the government free of debt.

However, there is some uncertainty regarding the future of the economy. Oil prices began declining mid-2014 and have since fallen by over 50 per cent. It is not clear how far they will continue to fall. Although major oil producers have seemed so far unwilling to cut production, Premier Oil has already announced a downscaling of the Sea Lion plan. The downscaling is a realistic response to market conditions and a way to manage risk involved in the Sea Lion project. If oil prices continue to decline and companies start to scale down production, frontier locations like the Falkland Islands might be among the places oil companies put on hold.

Rural population has been declining since the 1980s and the very low population density poses a challenge for rural economy and the traditional agricultural sector.

The Falkland Islands also continues to face chronic challenges typical to small and remote economies. Maintaining transport links to the rest of the world are already challenging without political obstacles. The economy is still based on just a few commodities and is vulnerable to their world market prices.

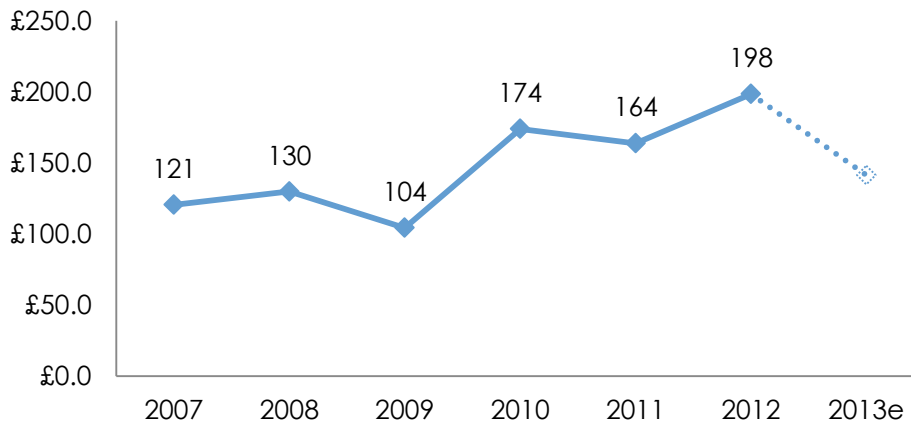
This report provides an overview of the Falkland Islands economy. It briefly analyses the key issues and challenges starting from a macroeconomic and trade overview, and then moves on to households and government before briefly discussing the key industries. Finally competitiveness and competition issues are analysed.

## 2. Macroeconomic overview

Traditionally an agricultural community centred on sheep farming, fishing has now become the most important industry in the Falkland Islands in terms of its contribution to GDP. This process started in the 1980s after the establishment of a fisheries conservation zone. However, large scale fishing in the Falkland Islands waters may have been going on earlier than this albeit in far less controlled manner. Another major transformation in the economy has been the arrival of the hydrocarbons industry. This was particularly visible during the period 2010-2012 when an oil and gas

exploration campaign was carried out by several companies and exploration rigs were present in Falkland's waters.

Both fishing and hydrocarbons industries in the Falklands are volatile in nature. Climatic factors, changes in catch, and world prices affect revenues from fishing, whereas the oil and gas industry is project based with the scale of activities varying from year to year. These are also reflected in the gross domestic product (GDP) of the Islands (see figure 1). Double digit growth and decline figures are common. Although the 2007-2012 GDP graph appears to show a strong growth trend this picture is misleading. The high GDP achieved in 2010-2012 was temporary in nature due to the oil and gas exploration campaign. It is expected that GDP for 2013 will have dropped significantly, by about £50 to £70 million to a level comparable to pre-2010 figures, with 2014 figures on a similar level. GDP per capita peaked at around £77,000 in 2012 which is very high by international standards. However, companies in fishing often have joint foreign owners and hydrocarbons companies are mostly owned by foreign shareholders. In addition, most of their wages are paid to non-residents who may never even visit the Falklands onshore. This characteristic of these offshore industries means the GDP per capita figure overestimates the amount of wealth created for people living in the Falkland Islands. Gross National Income (GNI) gives a more realistic picture and was £39,000 per capita in 2012. For the same year (2012), the Census recorded average annual income to be £23,000 (Policy Unit, 2013).



**Figure 1. Gross domestic product in millions of FKP 2007-2012 with 2013 estimate (at 2012 constant prices)**

The volatility of Falkland Islands GDP can be easily seen in comparison with other countries (see figure 2). In comparison to neighbouring South American countries and the United Kingdom, over the period 2007-2012 the Falkland Islands had the most extreme annual decline and growth rates in GDP. In general the Falkland Islands GDP had a growth trend more similar to South American countries rather than the slow growth experienced in the United Kingdom and other advanced economies. However, if accounting for 2013 and 2014, after the oil exploration campaign in the Islands, the overall growth level in the Falkland Islands since 2007 would have probably reduced to the level of South America or lower.

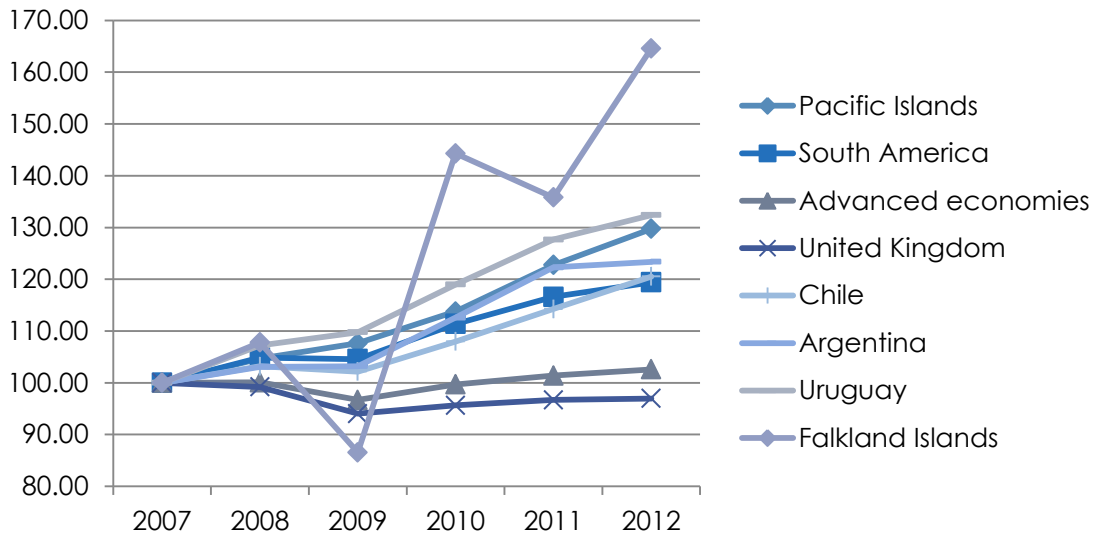


Figure 2. Indexed real GDP growth in selected territories and groups of territories (2007=100). Source: FIG and IMF (2015)

In 2012 fishing and hydrocarbons industries accounted for over half of the GDP (see figure 3). With the addition of the construction industry, which varies according to the timing of major projects, these are the main causes of volatility in GDP. Apart from these the economy is more stable, though in a small economy the activities of just one company can easily create big fluctuations in industry level figures. Agriculture has for several years contributed only a few percent to the Islands' GDP but, unlike fishing, is an important source of employment onshore. It is also the backbone of the rural economy. The rest of the economy consists of mostly services and government activities. Many of these, e.g. transportation, storage, and scientific and professional services, also provide support services to fishing and oil and gas companies.

The Falkland Islands depends on a small number of economic activities, mainly fishing, sheep farming, tourism, and increasingly oil. Because most goods consumed in the Falkland Islands are imported this makes the Islands highly integrated in the world economy. The economy is vulnerable to yield and world market prices of fish, wool, and meat. The government wishes to diversify the economy to decrease volatility and risk, but this is difficult for a small economy with limited resources to benefit from economies of scale. Nevertheless some success has been achieved in promoting a knowledge economy linked to the Islands unique environment, for example the establishment of SAERI.

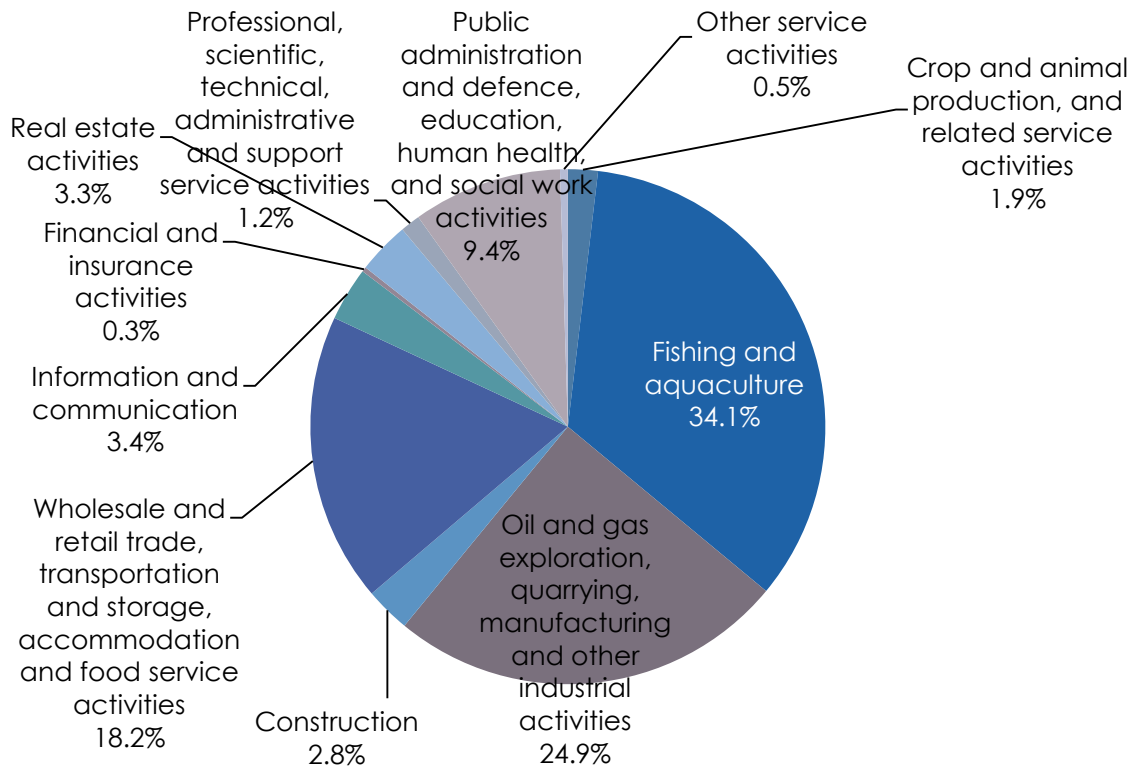


Figure 3. Gross domestic product by industry in 2012

According to National Accounts data, total compensation of employees<sup>1</sup> in the economy has been higher than gross operating surplus<sup>2</sup> (see figure 4). Half or more of the gross value added (GVA) in the economy is distributed to employees. This means employees benefit relatively more from economic activities compared to business owners. However, for 2011 and 2012 this figure was considerably lower than for 2007-2009. Instead in 2011 and 2012 gross operating surplus was high, over 40 per cent. This was due to oil and gas industry and a good fishing year, which are both more capital intensive industries and thus pay high returns to capital compared to employees. In 2012 about £102 million was paid out as compensation of employees, whereas the size of gross operating surplus in the economy was £84 million. Out of the £102 million about £38 million was received by households taxed in the Falkland Islands. The remaining part is mostly explained by foreign fishing crews and staff and directors of companies in the hydrocarbons industry. In the United Kingdom, compensation of employees' share of GVA was 54 per cent in 2011 which is comparable to the Falkland Islands (Marks & Sweet, 2013). Gross operating surplus, however, was only 28 per cent. The reason for this difference in gross operating surplus is the high amount of taxes on products and imports in the United Kingdom (such as value added tax), which amount to much less in the Falkland Islands.

<sup>1</sup> Compensation of employees includes gross wages as well as all retirement and medical service contributions paid by employers.

<sup>2</sup> Operating surplus measures the surplus from the process of production (deducting compensation of employees, intermediate consumption, and the effect of taxes on production and imports and subsidies from output) before any taxes on profits or rent paid on financial assets, land or other natural resources (European Communities et al., 2009).

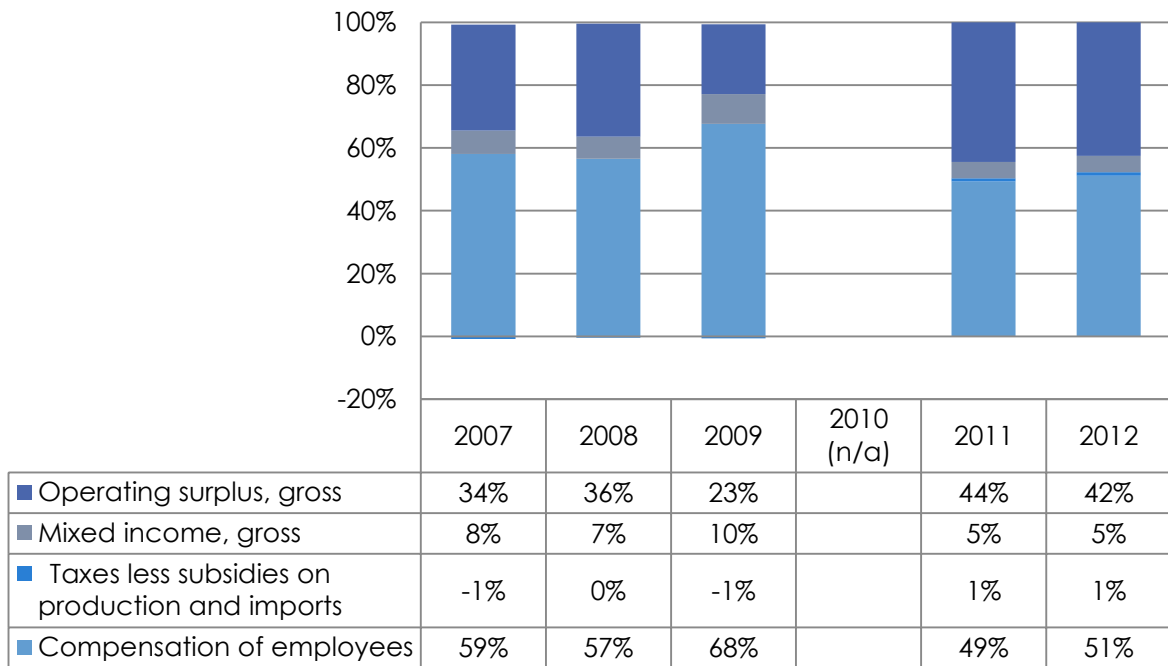


Figure 4. Generation of income as percentage of gross value added. 2010 figures are not available.

Inflation in the Falkland Islands, as measured by the retail price index (RPI) has been relatively high on some years and low or negative on some (see figures 5 and 6). The RPI itself is quite volatile and often influenced by fluctuations in just a few products. The availability and price of single products in the Falkland Islands can change considerably during a year. The gross domestic product deflator is an alternative measure of inflation derived from national accounts. Unlike the retail price index it measures wider changes in prices of both business and consumer goods and services. In 2007-2010 it had a similar trend to the retail price index but shows less overall increase since 2007. During 2013 and 2014 inflation levels have been more modest.

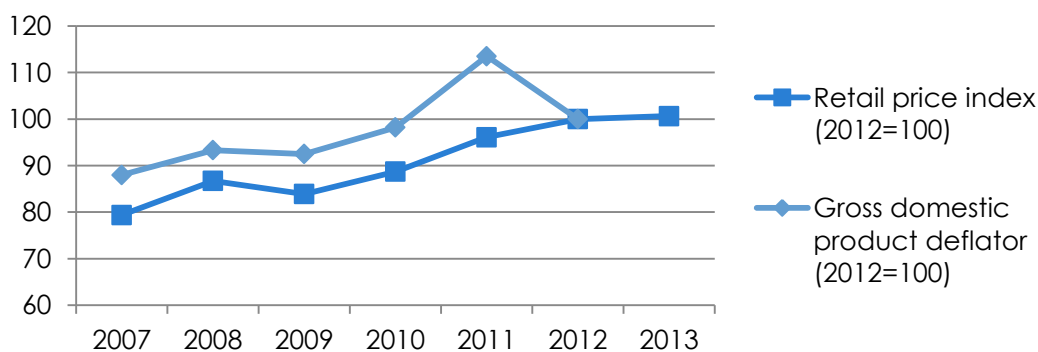


Figure 5. Inflation measured by retail price index and gross domestic product deflator



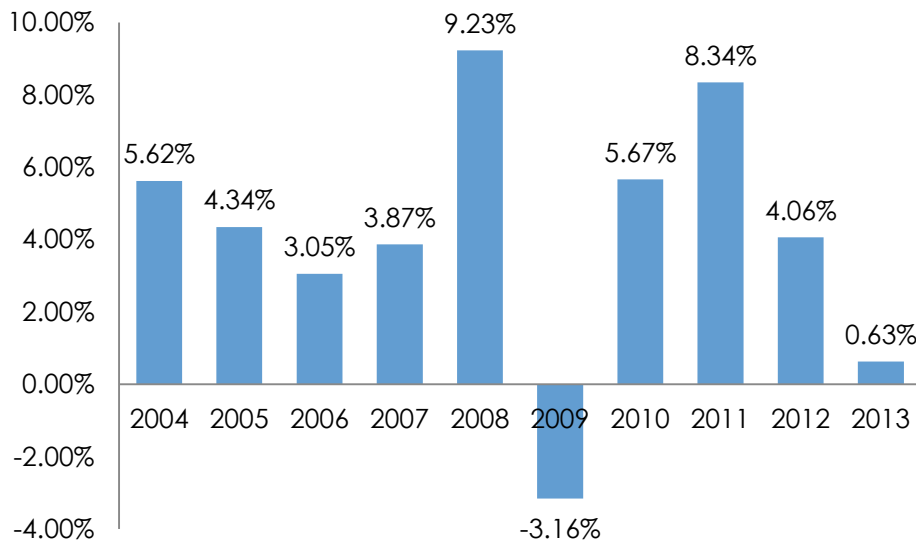


Figure 6. Year by year change in retail price index

### 3. Trade

As a limited amount of goods are produced on the Islands itself, most need to be imported. This includes petroleum products, food, vehicles, machinery, construction materials etc. The Islands have limited transport links to the rest of the world, with regular shipping services to South America and the United Kingdom. Trade is restricted by the limited linkages which are vital to the population of the Islands.

The United Kingdom is the main import trading partner of the Falkland Islands. About 87 per cent of all imported goods came from the UK in 2012 (Customs and Immigration, 2013) with the rest of the £34 million recorded by Customs<sup>3</sup> imported mostly from Chile and Uruguay. These are the places of loading and actual production of the goods may have taken place elsewhere. The total for imported goods in 2012 was estimated at around £136 million including bunker fuel and other imputed adjustments excluded from the Customs statistics. Bunker fuel is by far the largest imported good in terms of value.

The value of imported services was approximately £260 million in 2012 (see table 1). Support services to oil and gas extraction made up £167 million of the figure. Again the figures are temporarily high because of oil and gas exploration. A considerable amount of the rest is estimated to be services for the transport industry and fishing e.g. repairs and maintenance carried out overseas, container handling and cold storage services by foreign companies. The total value of all imports was £396 million.

<sup>3</sup> Excluding bunker fuel

Table 1. Value of imported goods and services in 2012 in FKP.

Imports	Goods	Services
Agriculture, forestry and fishery products	£ 794,000	£ -
Ores and mineral; electricity, gas and water	£ 81,000	£ -
Food products, beverages and tobacco; textiles, apparel and leather products	£ 7,851,000	£ -
Other transportable goods, except metal products, machinery and equipment	£ 112,020,000	£ -
Metal products, machinery and equipment	£ 15,210,000	£ -
Constructions and construction services	£ -	£ -
Distributive trade services; accommodation, food and beverage serving services; transport services; and electricity, gas and water distribution services	£ -	£ 26,921,000
Financial and related services; real estate services; and rental and leasing	£ -	£ 3,096,000
Business and production services	£ -	£ 226,841,000
Community, social and personal services	£ -	£ 3,620,000
<b>TOTAL</b>	<b>£ 135,956,000</b>	<b>£ 260,478,000</b>

Fish products have been by far the largest exported good. According to Customs and Immigration data the value of fish caught in the Falkland Islands in 2012 was £184.5 million (Customs and Immigration, 2013). Almost all of this was exported. This value is highly volatile depending on fish catches and world prices. For example, in 2009 the value was just £76.4 million.

The second largest exported good is wool, which accounted for £5.4 million in 2013 (Agricultural Advisory Committee, 2014). Wool exports are much more stable compared to fish. However, the total value has been decreasing since a peak year in 2011 of £6.5 million and is also affected by world prices. Lamb and mutton exports have been increasing over the years generating over £2 million of export revenues (FIMCO, 2013). There have been small irregular beef exports with the last shipment in 2010, but most produced beef is not exported due to strong domestic demand. Tourism was estimated to generate around £9.5 million in 2012 (Falkland Islands Tourist Board). Most of this was generated from arrivals by air rather than by sea.

Other services are exported but limited data is available on them. Exports as estimated from national accounts are shown in table 2. Comparing this data with table 1 shows a trade deficit of £176 million, or 80 per cent of the value of exports. However, most of this is related to oil and gas exploration and reflects investment into oil and gas assets which are meant to generate revenues in the future, rather than final consumption of goods and services. Excluding imports of support services to oil and gas extraction, the trade deficit shrinks to around £9 million. Again excluding support services to oil and gas extraction value of imported goods and

services would correspond to 116 per cent of GDP. This is similar to other small countries like Seychelles (115 per cent in 2013) or Lesotho (114 in 2012) but smaller than Singapore (173 in 2012) or Hong Kong (224 in 2012) (The World Bank, 2014). Exports in the Falklands were 111 per cent of GDP similar to Macao (109), Maldives (111) and Ireland (108). Such high figures mean the Falkland Islands are very much integrated into the world economy. The economy is highly dependent on just a few export products and the demand for them in key markets.

Table 2. Exports of goods and services in 2012 in FKP.

Exports	Goods	Services
Agriculture, forestry and fishery products	£ 202,505,000	£ -
Ores and mineral; electricity, gas and water	£ -	£ -
Food products, beverages and tobacco; textiles, apparel and leather products	£ 3,125,000	£ -
Other transportable goods, except metal products, machinery and equipment	£ 422,000	£ -
Metal products, machinery and equipment	£ -	£ -
Constructions and construction services	£ -	£ 200,000
Distributive trade services; accommodation, food and beverage serving services; transport services; and electricity, gas and water distribution services	£ -	£ 8,558,000
Financial and related services; real estate services; and rental and leasing	£ -	£ -
Business and production services	£ -	£ 3,965,000
Community, social and personal services	£ -	£ 2,026,000
<b>TOTAL</b>	<b>£ 206,052,000</b>	<b>£ 14,749,000</b>

## 4. Government

The Falkland Islands Government has a strong financial position. The government has successfully followed a fiscal policy of no public sector borrowing and reserves at least 2.5 times annual operating budget. Revenues and expenditure have been generally balanced (see figure 7) although in recent years there has been a significant surplus. This has been mostly due to increased corporation and personal tax revenues due to oil exploration, including revenues from farm-in deals which have generated one-off corporation tax revenues.

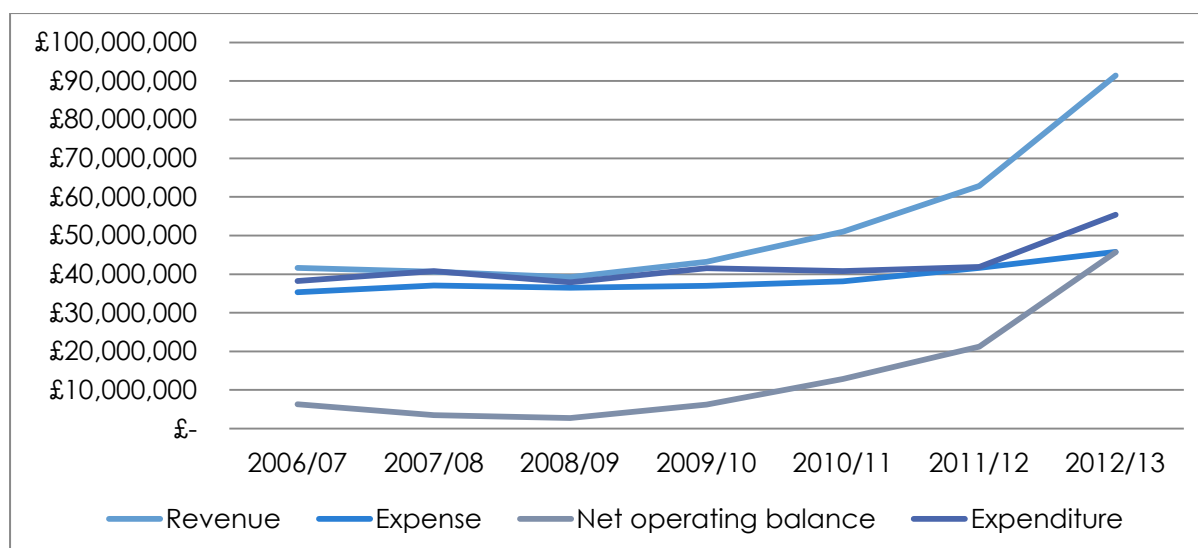


Figure 7. Government net operating balance and expenditure in FKP (according to GFS 2014 definition<sup>4</sup>).

The most important sources of revenues, fishing licence fees, corporation and personal tax have all been volatile. Figure 8 sums up total revenues by type between the financial years 2006/07 and 2012/13 which gives them a fairer treatment. Taxes on income, profits, and capital gains consist mostly of corporation and personal tax, with corporation tax revenues about 1.5 times the size of personal tax over the period. Together the fishing industry and oil and gas exploration account for over half of corporation tax. Tax revenue as percentage of GDP was around 10.7 per cent over the period 2007-2012. This suggests a moderate tax burden compared to countries like the United Kingdom (25.3 per cent in 2012) and Chile (19.0 per cent in 2012). However including fishing licence fees these revenues were 21.2 per cent of GDP<sup>5</sup>. Property income has been mostly from fishing licences which alone covered 24 to 38 per cent of government annual revenues over the period. Expenses have been more stable with almost half going to use of goods and services and about one third on compensation of employees in the financial year 2012/13 (see figure 9).

<sup>4</sup> The fiscal statistics presented in this report are compiled according to GFS 2014 (see IMF, 2014) definition and may thus be different from the official FIG Treasury figures. They include the general government excluding special funds (such as Retirement Pensions Fund) and Consolidated Fund.

<sup>5</sup> The government receives direct revenues from the fishing industry through licence fees and corporation tax. Although licence fees are formally considered rent received by owners of natural resources, the government imposes a burden on the fishing industry through a combination of licence fees and corporation tax. In the Falkland Islands licence fees form a relatively large share of government revenues. Thus including both gives more insight for comparative purposes.

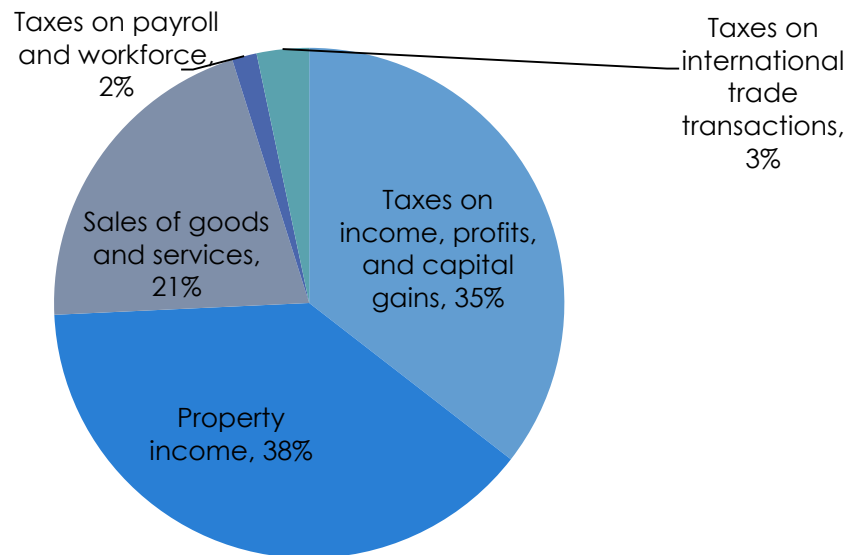


Figure 8. Government revenues between financial years 2006/07 and 2012/13 by type.

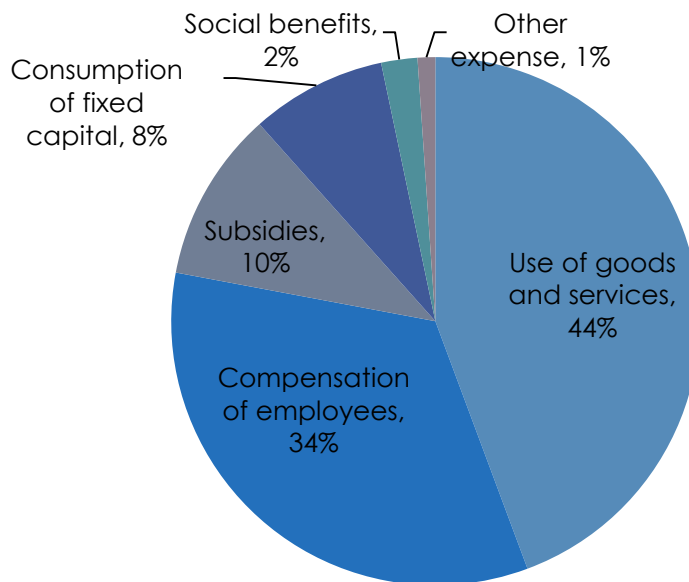


Figure 9. Government expenses during financial year 2012/13.

In 2012 Falkland Islands Government final consumption expenditure, which measures how much goods and services the government provides for free for the benefit of the public, was 14 per cent of GDP. This is less than countries like United Kingdom (22 per cent), Norway (21 per cent), Iceland (25 per cent), and Germany (19 per cent) but higher than Chile (12 per cent), and St. Kitts and Nevis (11 per cent) (The World Bank, 2014). However, comparison is complicated by the fact that in 2012 GDP was temporarily higher than normal due to oil exploration. Without oil exploration government final consumption would have been around 19 per cent of GDP. This would be much more in line with the developed world (19% for countries with very high human development (UNDP, 2013)). Government spending on education has been around 4-5 per cent of GDP before oil exploration and under 3 per cent during

the 2010-2012 oil and gas exploration period (see figure 10). In absolute terms education spending has remained fairly constant (see figure 12). The 2007-2009 figures are slightly below Germany and slightly above Chile. Nevertheless educational attainment in the Islands is relatively low. Tertiary attainment was around 19 per cent in 2012 and slightly less than in 1996 (Policy Unit, 2013). This is clearly below the OECD average of 33 per cent (OECD, 2014). Almost all OECD countries have been able to significantly increase their tertiary attainment rates over the past 10 years but the Falkland Islands have not followed this trend.

Health spending as percentage of GDP was on the rise before oil exploration started (see figure 11). It was slightly below Chile but well above St. Kitts and Nevis and Fiji. In absolute terms it has been more volatile than education spending (see figure 10). Overall, in terms of both education and health, public spending is lower compared to some European countries as a percentage of GDP.

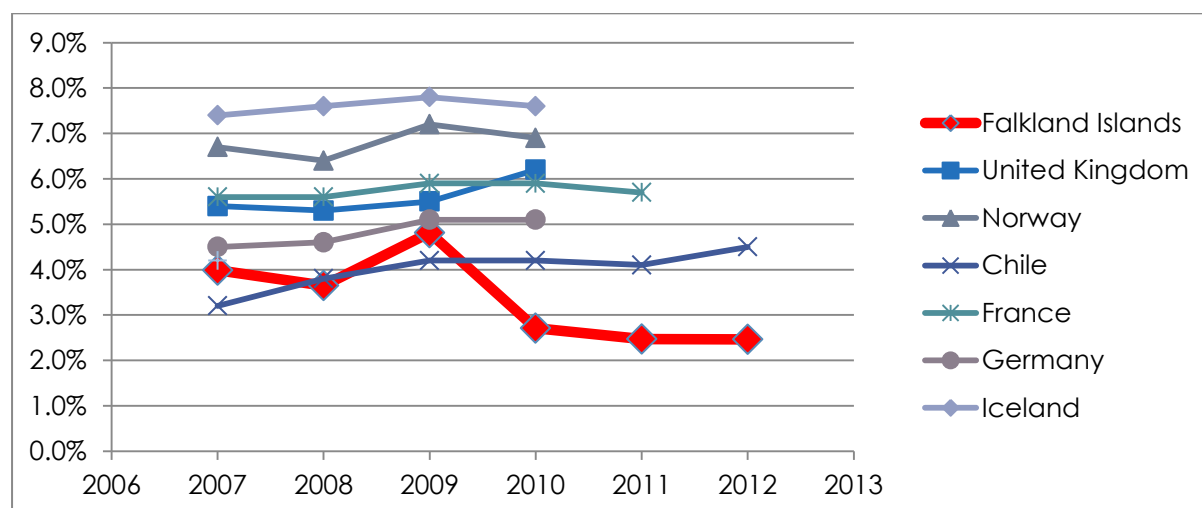


Figure 10. Public spending on education as percentage of gross domestic product. Source: FIG and the World Bank (2014)

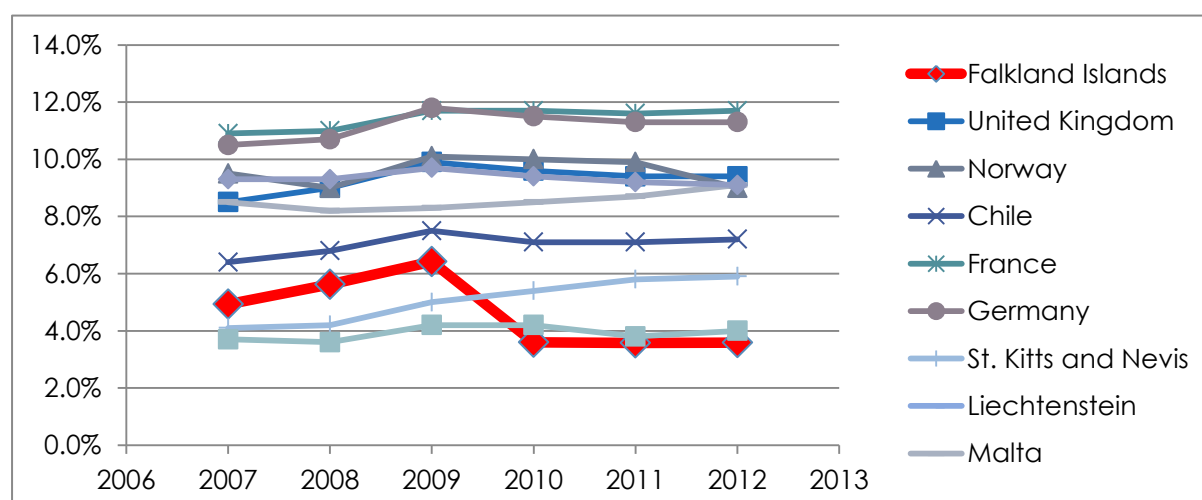


Figure 11. Public spending on health as percentage of gross domestic product. Source: FIG and the World Bank (2014)

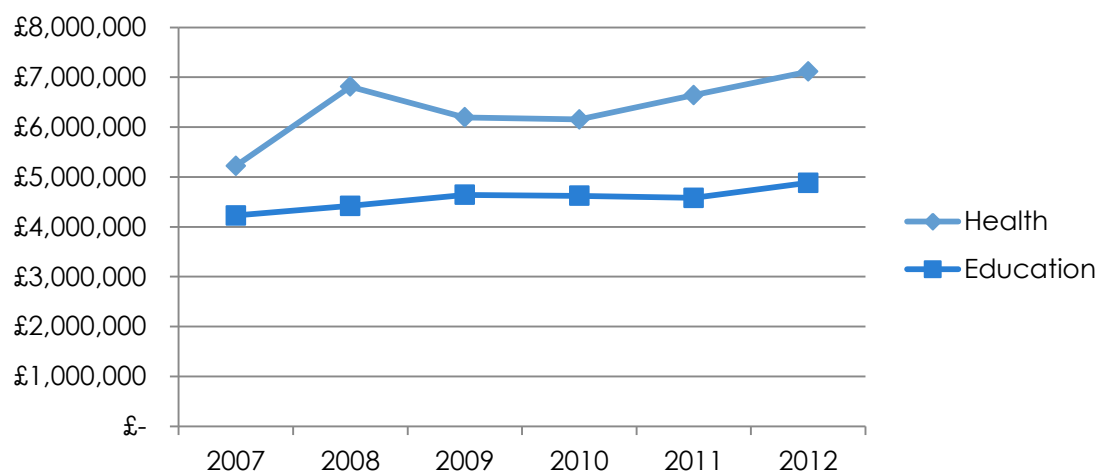


Figure 12. Government spending on health and education in FKP (according to GFS 2014 definition).

## 5. Demographics, household income and employment

According to the 2012 census the Falkland Islands population excluding MPA was 2562 (Policy Unit, 2013). Including civilians living at MPA increases the population to 2931 and military personnel to around 4000 people. Population increased throughout the 1980s and 1990s but has since remained fairly stable since the early 2000s. During the first half of the 20<sup>th</sup> century the population was higher than in the 1980s but started to decline in the 1960s, 1970s (Policy Unit, 2013). After the 1982 conflict the Islands' population started to grow again.

At the time of the 2012 census the total dependency ratio<sup>6</sup> was 38. This is a healthy figure meaning that the population at working age is sufficiently large enough to support pensioners and children. The situation is different from other developed countries such as the United Kingdom (52.7) or Japan (59.6) that are more likely to face difficulties in supporting their non-working population in the future (UNDP, 2013). The overall figure for countries with very high level of human development is 50.3 and very few countries have a ratio as low as the Falkland Islands (ibid.). Some of these are small islands states like Trinidad and Tobago (38.6) and Mauritius (39.6) or countries with big immigrant labour force such as Qatar (18.3) or Singapore (35.4). In the Falkland Islands, the low dependency ratio can in part be explained by the relatively large share of immigrant workers, 588 work permit holders in 2012 (or 30 per cent of the labour force) (Policy Unit, 2013). The dependency ratio for Falkland Islanders (Falkland Islands Status) only was 53 in 2013 i.e. more similar to other developed countries. Without a large immigrant labour force the Falkland Islands might be threatened by similar age structure related challenges as other developed countries in the near future. At the moment the pension fund is not sufficient to cover

<sup>6</sup> Ratio of population under the age of 15 and over 64 to population aged 15 to 64.

pension payments and needs to be supplemented from other sources. With a higher dependency ratio this would be much harder to do. The size and structure of the population in the future is highly dependent on the structure of the economy, with the hydrocarbons industry and the volume of immigrant workers brought in to work in the Islands being key factors.

At the time of the 2012 census the average annual gross income was £23,000 and median wage £17,500 (Policy Unit, 2013). Income inequality as measured by Gini coefficient<sup>7</sup> post-taxes and transfers was 0.36 which is comparable to the United Kingdom but higher than other European countries like Norway (0.26) and Germany (0.28) (UNDP, 2013). Average gross income in rural areas is slightly less than in the capital Stanley, £21,000 versus £23,300. It's worth pointing out that many households in rural areas consume part of their own production or may practice barter trading with other farming households. Because of this, rural household income from Census data may underestimate the real income of these persons. This may also skew the overall income statistics.

Unemployment is low in the Falkland Islands. Figure 13 shows how over the past eight years number of unemployed has fluctuated between 10 and 25. Even peak unemployment rates have been barely over one per cent of the population aged 15 to 74. Such low unemployment is on one hand good but can also be an obstacle for the economy. Indeed local businesses often highlight the shortage of labour (see FIDC, 2014). This also explains the large immigrant labour force. Immigrant labour fills in both low paying jobs in sectors such as accommodation, food, and construction, as well as high paying expert positions where the required skills are not found locally.

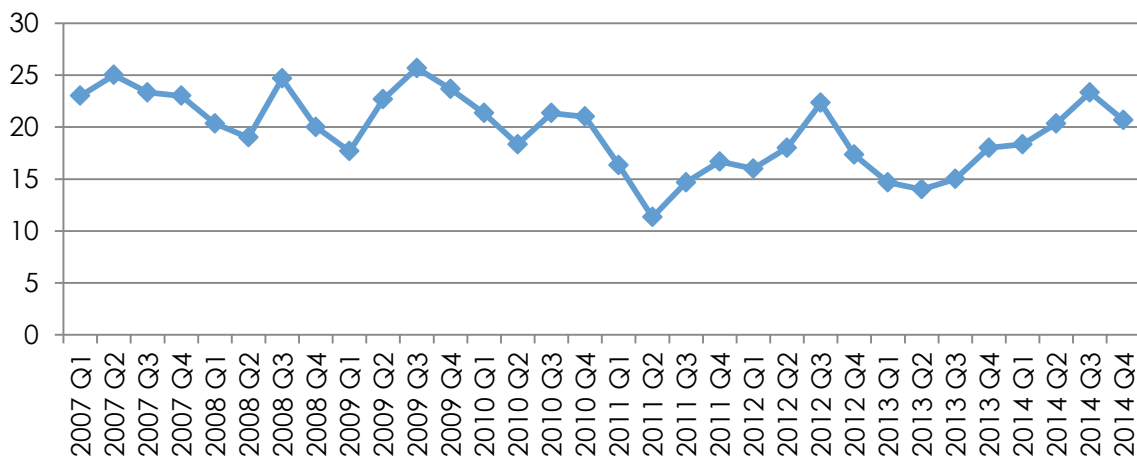


Figure 13. Average quarterly unemployment (number of persons unemployed)

<sup>7</sup> Gini coefficient is a number between 0 and 1 describing income inequality in a population. A value of 0 means all individuals receive same level of income and 1 means one individual receives all income while others receive no income.



Total final consumption in the Islands was £58 million in 2012, or £22,600 per capita<sup>8</sup>. This means the value of all goods and services consumed in the Falkland Islands, whether paid for or not by the consumer and not used as inputs for other goods. About half is attributed to households' consumption and goods and services supplied by the government each (see figure 14). Government collective final consumption which means services provided to the whole society for free such as road maintenance or security was about £6,100 per capita. Government individual consumption which is goods and services, including benefits, given directly to selected individuals such as education and health was £5,100 per capita. This means the government provided £11,300 worth of goods and services per capita<sup>9</sup> to the benefit of the public for free. On top of this £1,600 per capita was invested into infrastructure, buildings, machinery, tools and other capital goods. Non-profit institutions provided £300 per capita worth of goods and services and households themselves paid for £11,100 per capita worth of goods and services.

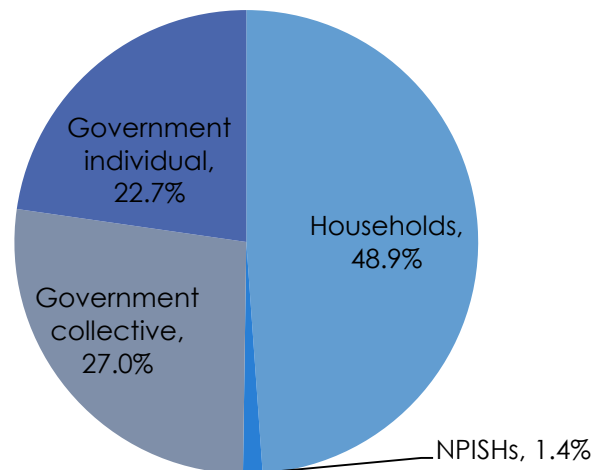


Figure 14. Final consumption in 2012 by type.

## 6. Gender

Falkland Islands have a very high labour participation rate by international standards for both men and women. According to the 2012 census labour force participation<sup>10</sup> is 86.6 per cent for men and 77.7 per cent for women (Policy Unit, 2013). Not only is unemployment low but many people also have second jobs. In countries with very high human development the figures are 68.7 and 52.7 respectively (UNDP, 2013).

Gender pay gap as measured by the difference between women's gross hourly wages to men's gross hourly wages in the Falkland Islands is around 21 per cent of men's average gross hourly wage. Considering high labour participation this is a bit surprising. The average across EU countries was 16.4 per cent in 2012 (Eurostat). Only

<sup>8</sup> Based on population of 2562.

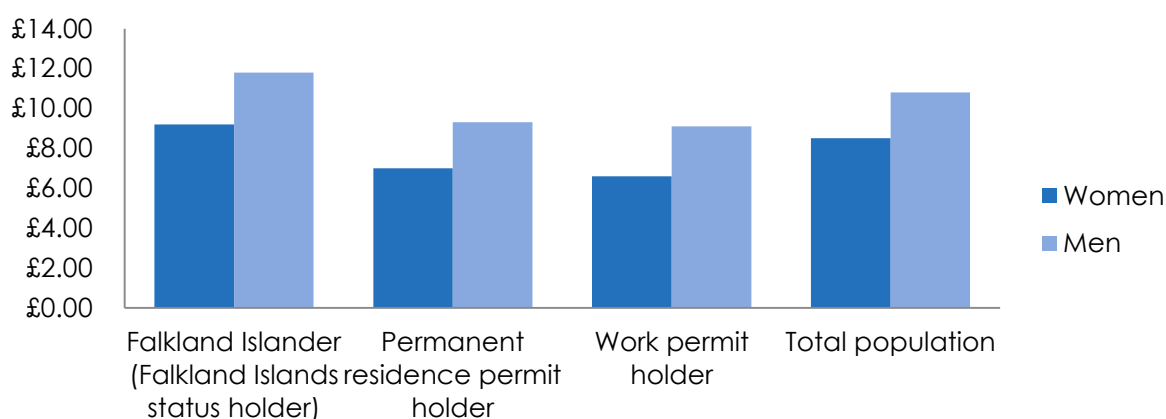
<sup>9</sup> For a population of 2562.

<sup>10</sup> Percentage of population aged 16 and over working

five EU countries have a higher gap than Falkland Islands. The gender pay gap is particularly big for work permit holders (27 per cent) compared to the gender pay gap amongst Falkland Islanders (Falkland Islands Status, 22 per cent) (see table 3). When all immigration statuses are included the gap is reduced because of the large share of work permit holders, who generally are men earning less than Falkland Islanders (Falkland Islands Status), which brings down the average for men (see figure 15). Finding out why the gender pay gap is higher in the Falkland Islands than the EU average would require further study. There may be several explanations such as pay discrimination towards women, different education levels, and women and men working mostly in different industries and being attracted to different types of job which attract different salaries, each of which may be worth paying attention to.

**Table 3. Estimated average gross hourly wages and gender pay gap in FKP. Source: Census 2012 data**

	Women	Men	Gender pay gap
<b>Falkland Islander (Falkland Islands status holder)</b>	£9.2	£11.8	22 %
<b>Permanent residence permit holder</b>	£7.0	£9.3	25 %
<b>Work permit holder</b>	£6.6	£9.1	27 %
<b>Total population</b>	£8.5	£10.8	21 %



**Figure 15. Estimated average gross hourly wages for women and men by immigration status in FKP. Source: Census 2012 data**

## 7. Agriculture

Sheep farming has been a traditional form of livelihood of the Islands since the 1850s. Wool has been exported for years but lamb meat and mutton has been increasingly exported over the past 10-15 years. Small exports of beef have been made on irregular basis but most beef is consumed domestically. Nevertheless agriculture's relative importance in the whole economy has been decreasing and in 2012 accounted for only about two per cent of GDP. This has been more due to growth in the fishing and hydrocarbons industries rather than decline in agriculture

per se. Agriculture is still one of the biggest employers with around 189 people employed in 2012 (Policy Unit, 2013). It is also the backbone of the rural economy and one of the few industries earning export revenues. It is also important for local culture and Falkland Islands identity. However, in the past 30 years the Falkland Islands have gone through a process of rural-urban migration. In 1986 almost half of the Falkland Islands population lived in rural areas (Falkland Islands Government, 1986), but in 2012 only about 14 per cent<sup>11</sup> (Policy Unit, 2013). At present only around 350 people live in rural areas which poses a challenge for the rural economy and provision of infrastructure and services to rural areas.

Wool still remains the most important agricultural product with an estimated value of £5.4 million in 2013 (Agricultural Advisory Committee, 2014). Total greasy wool production has been declining over the past 15 years as has the number of sheep (see figure 16). At the same time however, wool quality has been improving, increasing the value of wool produced. Almost all of the wool is exported and revenues thus depend on world market prices. Because of these reasons the total value of production has not decreased in a similar manner as the production volume (in nominal terms) (see figure 17).

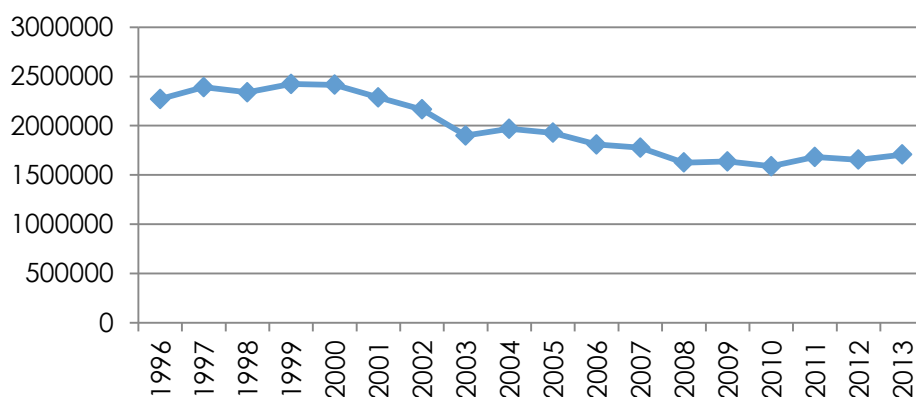


Figure 16. Total greasy wool production (kg). Source: Agricultural Advisory Committee (2014)

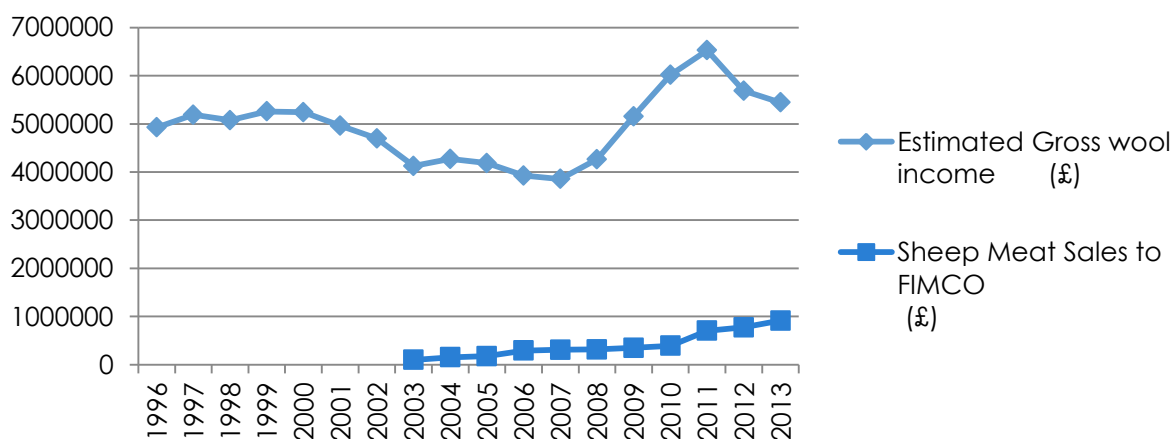


Figure 17. Revenue from wool and sheep meat in FKP. Source: Agricultural Advisory Committee (2014)

<sup>11</sup> Excluding MPA

Large scale export of lamb and mutton began after the establishment of the Falkland Islands Meat Company (FIMCO) in 2003. FIMCO is a government subsidised abattoir that produces for both domestic and export markets. Although most of their output is exported they have, at least up to now, needed government subsidies. The main destination for lamb and mutton is Europe, while offal is exported to Egypt and skins to Hong Kong.

Apart from wool, sheep meat, and beef, small amounts of other agricultural goods are produced for the domestic market such as pork, eggs, and vegetables. The official figures are likely to underestimate agricultural production since it is common for households to produce for their own needs or for barter trade with others. The Falkland Islands are largely self-sufficient in lamb meat, mutton, and beef, but other types of meat are imported. Part of vegetables consumed in the Islands is produced locally but most other agricultural and food products are imported from overseas to make up the shortfall. Although many households produce their own vegetables there are a limited number of commercial producers. Expanding local vegetable production might increase competition and push prices down. This in turn could encourage fresh vegetable consumption with health benefits. However, the challenging environment can be a barrier for expanding vegetable production in the Falklands.

## 8. Fishing and aquaculture

Measured by GDP, fishing is the most important industry in the Falkland Islands. In 2012 it contributed 34 per cent to GDP. On the other hand it does not translate to similar levels of employment onshore. Almost all of the crews working on the shipping vessels come from other countries and in 2012 only 58 Falkland Islands residents considered Fishing as their primary employment (Policy Unit, 2013). The Falkland Islands fishing fleet is mostly owned by joint ventures between Falkland Island companies and foreign owners. Completely foreign owned vessels, particularly jiggers, also operate in Falkland Islands waters. Therefore, a considerable share of the benefits of fishing goes to actors outside the Islands. Nevertheless, the Islands also benefit from fishing in many ways. Fishing licence fees are typically the biggest single source of government revenues, apart from non-regular corporate tax revenues relating to hydrocarbons farm-in deals. The licences have generated between £10 and £30 million per annum since first charged in 1987. Fishing companies are also considerable contributors to corporate tax revenues, about £1-4 million per year which typically means 30-45 per cent of total corporate tax collected. On top of these there are indirect benefits to the onshore economy through the goods and services fishing fleets acquire locally.

Squid consisting of Falkland's calamari (loligo) and illex makes up most of the fisheries catch in volume and value. Illex, which is mostly caught by South Korean and Taiwanese jiggers, has had huge variations in annual catch from practically none to over 100,000 tons in past years. Falklands calamari which is normally sent to Spain is much more stable. Apart from squid, various species of finfish is also caught, rock cod, hake, hoki, and toothfish being the most important in terms of value. Toothfish, although caught in relatively small volumes compared to squid is highly valuable and its world market price has been increasing quickly over the past ten years. Toothfish and Falkland's calamari are the only export products where the Falkland Islands have a considerable share of the world market. According to FAO data Falklands' market share in 2011 was 8 per cent of toothfish and 13 per cent of loligo species<sup>12</sup> globally traded volume (FAO, 2014). Loligo market shares have been declining after being over 40 per cent in 2003. Aquaculture shows great potential in the Islands but has been small scale so far. Funded by a government grant, SAERI are now examining the potential for the sustainable, commercial exploitation of a greater range of inshore marine resources.

## 9. Tourism

The Falkland Islands have unique wildlife and a relatively untouched natural environment. These together with military history are points of interest that draw tourists to the Islands. Most tourists arrive on cruise ships and stay a limited period of time, normally from the morning until afternoon. The number of cruise passenger arrivals grew from a few thousand in mid 1990s to over 60,000 during the 2008/09 season (Falkland Islands Tourist Board). After this passenger numbers started to decline due to economic downturn in the main markets in North America and Europe and adverse weather conditions on some years. By the 2012/13 season the number of arrivals had reached a new low of 29,500. Though detailed statistics are not yet available, passenger figures would appear to have started to pick up again over the past two seasons.

Apart from cruise ships, visitors also arrive at the Islands by air. In 2012 these amounted to approximately 7,800 tourists out of whom 1,900 were leisure tourist arrivals, and their numbers have been growing even after the financial crisis in North America and Europe (Falkland Islands Tourist Board). They also stay in the Islands for longer than cruise ship arrivals.

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<sup>12</sup> Ommastrephes sagittatus and loligo species FAO category.

In terms of spending, according to 2012 Tourism Statistics by the Falkland Islands Tourist Board, tourists<sup>13</sup> arriving by air were estimated to spend £7.8 million and cruise ship visitors £1.7 million on the Islands in 2012. This means that tourist arrivals by air, although lower in number, generate greater revenue for the Islands. The reason for this is that tourist arrivals by air stay on the Islands much longer (on average 15.9 nights) compared to cruise ship arrivals that generally stay a few hours. On the other hand, looking at leisure tourist arrivals by air only, the total revenue is, at £1.1 million, lower compared to cruise ship arrivals. Total spending by cruise ship arrivals has declined slightly since peak years but spending by arrivals by air has been growing quickly.

In a 2009 study it was estimated that the tourism industry contributed to just under 5 per cent of the Falkland Islands' GDP in 2007 (Acorn Consulting Partnership Ltd, 2009). The study has not yet been updated using the latest national accounts data, but it is possible that tourism's share of GDP was slightly lower in 2012. Though total spending by tourists has been increasing, this has been likely offset by growth in oil and gas exploration.

## 10. Hydrocarbons

Exploration rigs operated by various oil companies in the Falkland Islands carried out an exploration campaign in 2010-2012. Oil was first discovered in 2010 in the Sea Lion field north of the islands. Production itself is yet to take place but the current plan of Premier Oil is to start production from Sea Lion in around 2019. The Sea Lion oil field is estimated to contain about 390 million barrels of oil. In the meantime oil companies have commenced a new round of exploration in March 2015 targeting prospects of 1.3 billion barrels of oil.

The magnitude of oil exploration has been significant compared to other economic activities in the Islands. Activities directly related to oil and gas exploration were estimated to make up about a quarter of GDP during the 2010-2012 period. On top of this are the positive impacts on other industries. According to a Socio-Economic Study of Oil and Gas Development in the Falklands (Regeneris Consulting, 2013) GDP in the Islands could increase up to 500 per cent if Sea Lion production starts as planned. However, in November 2014, Premier Oil announced a scaling back of the Sea Lion oil field into about half of the original size. This means the effect would be significantly smaller but nevertheless it could still have a transformational impact on the economy. It would provide many opportunities to local and foreign businesses and increase employment opportunities. Government revenues could go up by

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<sup>13</sup> 'Tourists are non-residents of the Falkland Islands travelling to the country for at least one night and for not more than once consecutive year for leisure, business and other purposes' (Falkland Islands Tourist Board, p. 6)

over one hundred million pounds during the peak years. However, the oil companies would also face many constraints such as infrastructure and particularly labour. The study estimated that a few hundred new employees may need to be brought to the Islands to satisfy labour demand of hydrocarbons production. At present it would be difficult for the Islands to accommodate this additional immigrant work force. There is already a recognised shortage of housing in Stanley.

High oil prices during 2013 and the first half of 2014 supported plans for production and further exploration. The government has also received tax revenues from a farm-in deal concerning the Sea Lion field, and has been undertaking a lot of work with respect to oil preparedness. Nevertheless, future oil prices are difficult to forecast and the second half of 2014 saw a considerable drop in prices. Brent oil price dropped from over 110 USD in June 2014 to about 50 USD in January 2015. The price has since slightly recovered and is currently at around 55 USD per barrel. Uncertainty regarding oil prices makes hydrocarbons industry in the Falkland Islands risky. If oil prices continue to drop, remote locations with no proven history of oil production might be among the projects to be abandoned or delayed. In short to medium term, oil prices may affect the timing of the start of projects. However, in the long-run there is also uncertainty of future energy markets which may have an effect on demand for oil.

## 11. Oil dependency

In 2012 total consumption of refined petroleum products in the Falkland Islands was around £113 million, most of which is bunker fuel. This means refined petroleum products make about 18 per cent of the cost structure of economic activities<sup>14</sup> in the Falkland Islands and 9 per cent of household consumption. These figures are based on 2012 data with high oil prices similar to the first half of 2014. The most oil intensive industries are electricity generation, tour operators, transport, and fishing (see figure 18). For example, a thirty per cent drop in oil prices from 2012 levels<sup>15</sup> would mean a decrease in costs to producers of goods and services equivalent to 5 per cent of total costs or 17 per cent of GDP. In absolute terms this would mean £34 million saving<sup>16</sup> in cost of refined petroleum products. Households would save about £2.6 million or 9 per cent of their total consumption if oil prices were reduced by 30 per cent below 2012 levels. These estimates are based on a static situation where demand and supply of all goods and services and prices of all other goods and services are fixed. In reality economic actors would adjust their behaviour to changes in the price of inputs which would again affect how much they would be

<sup>14</sup> Percentage of 2012 intermediate consumption

<sup>15</sup> Average annual Brent spot free on board price in 2012 was 111 USD (U.S. Energy Information Administration, 2015). A thirty per cent drop would mean a price around 77 USD.

<sup>16</sup> Out of this £12 million would have been within the hydrocarbons exploration industry itself.

willing to supply and at what price. As such multiplier effects are also ignored. Nevertheless this highlights the importance of petroleum products to the local economy. Since most goods are imported into the Islands, cost of transport is an important factor in the cost of goods sold. Even though the hydrocarbons industry would suffer from low oil prices, other industries in the Falkland Islands could potentially benefit from it.

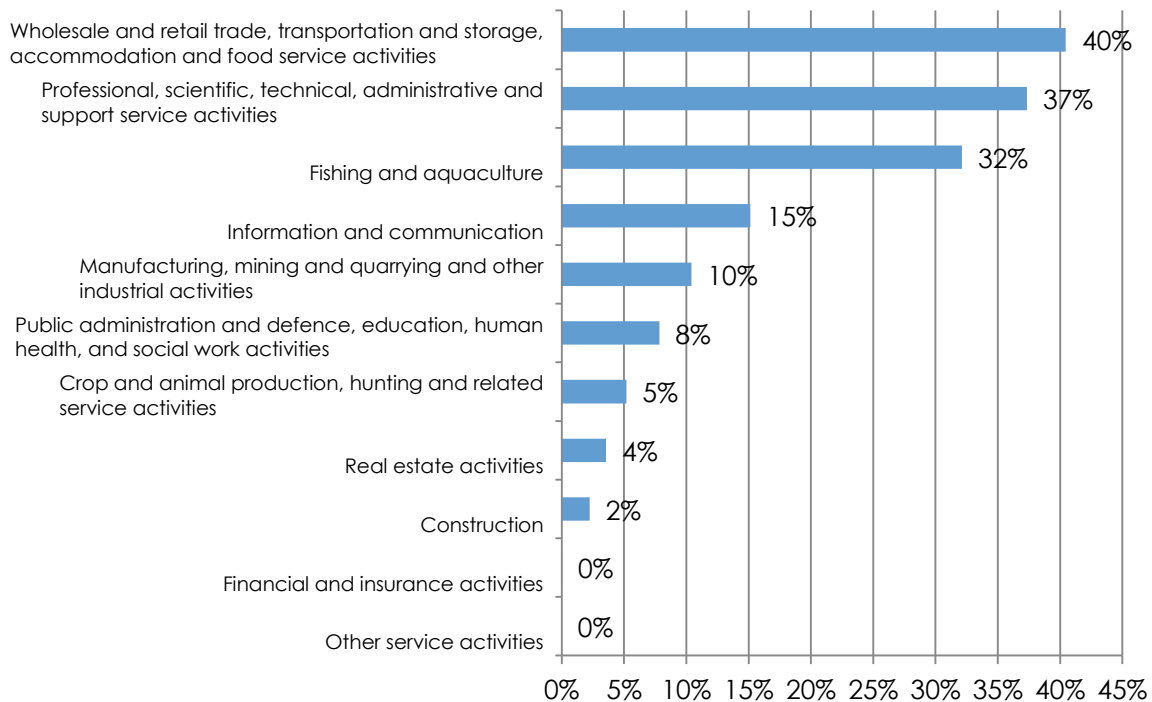


Figure 18. Refined petroleum products as percentage of intermediate consumption in 2012.

Further evidence of the economy's dependency on oil can be seen by looking at the retail price index (RPI). There seems to be a correlation between change in RPI and change in Brent oil price (see figure 19). This reinforces the view that the cost of oil is a significant component in the retail price of many consumer goods. Preliminary analysis suggest a 1 per cent change in Brent oil price would be followed by a corresponding 0.06-0.08 per cent change in retail prices.

In the 2014 business climate survey (FIDC, 2014) the three most cited obstacles to businesses were freight costs, cost of fuel, and air links. Lower oil prices have the potential to reduce the cost of all these. However, limited competition may mean that lower oil prices do not always transform into lower prices for the consumers of these services. Low rate of change of inventories in the Islands, such as fuel stocks, may also mean that lower oil prices show up in purchasers' prices of many goods after a considerable delay.



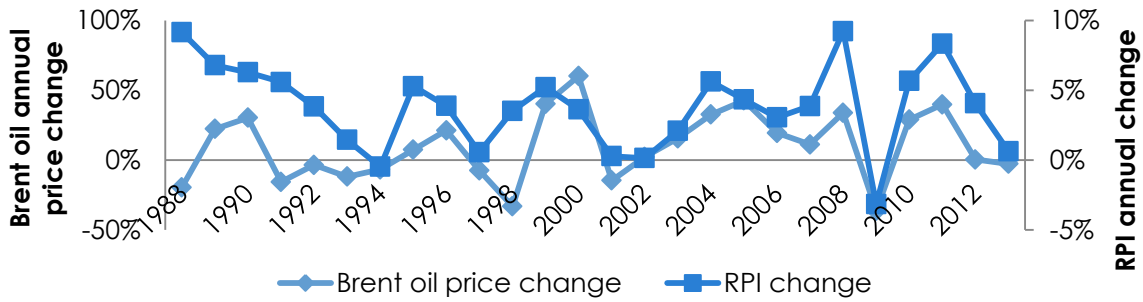


Figure 19. Change in annual mean Brent oil price change and year by year change Falkland Islands retail price index for December. Source: FIG and U.S. Energy Information Administration (2015)

## 12. Business environment and competitiveness

Distance to markets and transport are frequently cited by Falkland Islands businesses as their biggest obstacles. In the 2014 business climate survey (FIDC, 2014) freight costs (48 per cent of respondents), air links (31 per cent), shipping (27 per cent), and distance to markets (23 per cent) were cited among the main barriers to doing business. Remote location certainly poses one of the greatest challenges for the Falkland Islands economy. Small population means that economies of scale cannot be achieved in transport linkages and they remain infrequent and costly.

Other obstacles mentioned among the main five obstacles to growth by businesses include shortage of skilled labour (27 per cent), access to finance (23 per cent), taxation (22 per cent), cost of electricity (21 per cent), external politics (20 per cent), and telecommunications (20 per cent).

As suggested by the very low unemployment rate it is difficult for businesses to recruit labour. This is also a reason for a large immigrant labour force. According to the 2012 census (Policy Unit, 2013) there were 588 work permit holders on the Islands. If oil production takes off the industry may create several hundred new on-shore jobs (Regeneris Consulting, 2013). Filling these positions (or back-filling those positions left vacant as people already in the Islands take up new jobs) will inevitably mean attracting more immigrant labour.

There is currently only one private bank on the Islands which limits financial options for businesses. In addition to this Falkland Islands Development Corporation, a quasi-autonomous government funded body, also provides loans to businesses and some work is currently underway to assess the feasibility of a credit union. A possibility to invest more government reserves into the local economy has been studied. These are currently held by United Kingdom based investment funds. Investing them locally would help businesses access finance but the downside would be increased risk to

public finance. The funds would be more dependent on the Falkland Islands economy just like other government revenue sources.

The Falkland Islands levy a corporate tax on company profits. The Corporation Tax rate is set at 21 per cent for companies with profit up to £1 million and 26 per cent for profits over £1 million, as well companies involved in oil and gas exploration. Most companies in the Islands have a profit of less than £1 million and thus fall under the lower tax rate. Comparing to other countries such as Chile (20 per cent), Brazil (25 per cent), Uruguay (25 per cent), United States (40 per cent), United Kingdom (21 per cent), and France (33.3 per cent) the tax rate for small businesses is not particularly high (KPMG). The higher tax rate is slightly over the global average (23.6 per cent) whereas the lower rate is comparable to the EU average (21.3 per cent) (Ibid.). Globally and also in the EU, corporate tax rates have been declining for some time. However, decreasing corporate tax rate when the economy is doing well and has near full employment may not yield desired benefits to the economy. For example, the intention of lowering corporate taxes may be to encourage local businesses to grow. But what may happen instead in a full-employment economy is that businesses do not grow due to labour (and possibly market) constraints. Instead business owners achieve additional income and government revenues decrease. In the case of an economic downturn, the government would then have less reserves to rely on and less tools at their disposal since corporate tax has already been lowered. It might also increase some prices. For example, there might be more investment in to real estate pushing housing prices further up or more competition for labour pushing wages up without really improving labour productivity.

### 13. Competition

One of the biggest economic challenges for small island states is ensuring healthy competition in the economy. In the Falkland Islands there are many goods and services that have only a handful of providers. In some cases there may be just one provider (see table 4). Some of these are statutory monopolies regulated by FIG while some are just simply sole providers in a small marketplace. Where there are companies that have monopoly powers in the economy it is possible that some may charge excessive prices or intentionally limit their supply to maximise profits. A lack of competition can also unintentionally hinder the development of some sectors of the economy.

Table 4. Examples of goods and services with just one provider in the Falkland Islands.

telephone and internet	insurance
electricity	flights to South America
banking	flights to UK
petrol and diesel	domestic flights
taxi services in Stanley	local shipping and ferry
satellite television	quarry
printing services	local newspaper

Net operating surplus as percentage of market output was used as a rough indicator of sectors where producers might have monopoly powers. Companies with excessive price setting power are likely to show high profits, although the high profits can also be hidden as excessive wages or other expenses. Different industries cannot be compared as they have different cost structures and business models. Some industries are labour intensive showing lower percentage of operating surplus to output ratio, whereas capital intensive industries should naturally show higher percentages. Different businesses also circulate working capital in a different way. For example, the retail sector normally has high rate of change for stocks sold at small margins resulting in low operating surplus to output ratio. Thus, instead of comparing different industries, each industry was compared to the corresponding industry in the Euro area. Such comparison is of course influenced by business cycles in different economies and should ideally look at long-term averages.

The ratio of net operating surplus to market output was 8.6 per cent for the whole Falkland Islands economy in 2012. It was lower than the corresponding figure 14.2 per cent for the Euro area in 2009, even though Europe was suffering an economic downturn at that time. For some industries the ratio is similar in the Falkland Islands and the Euro area such as fishing, manufacturing, construction, wholesale and retail trade (including repair of motor vehicles), and administrative and support service activities. One industry in particular, information and communication, shows indications of excessive profits. Another such industry is transportation and storage, though the difference is smaller. On the other hand, some industries are far behind the Euro area. These include agriculture, accommodation and food service activities, and financial and insurance activities. These results should be treated with care and there may be many possible explanations for these differences.

In addition to suppliers that may have excessive price setting power in a small economy the reverse, i.e. monopsony, is also possible where only one (or a few) purchasers exist for goods and services produced by many. In general, competition, competition policy, and regulation of monopolies in the Falklands are issues that need to be studied further, and are highlighted in the Islands Plan (FIG, 2014).

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