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Holden, Paul and Holden, Sarah and Malcolm, Bale

Asian Development Bank

2004

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# Swimming Against the Tide?

An Assessment of the  
Private Sector in the Pacific

Paul Holden, Malcom Bale, and Sarah Holden

Asian Development Bank

2004

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# Abbreviations

ADB	Asian Development Bank
AusAID	Australian Agency for International Development
BIS	Bank for International Settlements
CDC	CDC Group Plc. (former Commonwealth Development Corporation)
CIIC	Cook Islands Investment Corporation
CTC	Cook Islands Tourist Authority
DAC	development assistance committee
DBS	Development Bank of Samoa
EEZ	exclusive economic zone
EPC	Electric Power Corporation (Samoa)
ERI	Enterprise Research Institute
ESCAP	Economic and Social Commission for Asia and the Pacific
FDI	foreign direct investment
FFA	Forum Fisheries Agency
GDP	gross domestic product
GNP	gross national product
HDI	human development index
IFC	International Finance Corporation
IFI	international financial institution
ILO	International Labour Organization
MEC	Marshalls Energy Company
MFI	microfinance institution
MFN	most favored nation
MIVA	Marshall Islands Visitors Authority
MOWEPP	Ministry of Works, Energy, and Physical Planning (Cook Islands)
NBER	National Bureau of Economic Research
NGO	nongovernment organization
NHC	National Housing Corporation (Vanuatu)
NPF	national provident fund
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
O&M	operation and maintenance
PDMC	Pacific developing member country
PSA	private sector assessment
PSCE	public sector commercial enterprise

PSD	private sector development
PUB	public utilities board
SBEC	Small Business Enterprise Center (Samoa)
SME(s)	small and medium enterprise(s)
SOE	state-owned enterprise
SPBD	South Pacific Business Development (Samoa)
SPPF	South Pacific Project Facility
TA	technical assistance
UN	United Nations
UNDP	United Nations Development Programme
UNELCO	Union Electrique du Vanuatu (Electricity and Water Company in Vanuatu)
VAT	value-added tax
WIBF	Women in Business Foundation (Samoa)
WTO	World Trade Organization

# Foreword

A robust and vibrant private sector is vital to the Pacific region's long-term economic growth and improved quality of life, and is a necessary condition for sustained poverty reduction. When there is sustained economic growth, per capita incomes rise, employment is created, and government can access additional resources through taxation to provide bridging opportunities to disadvantaged and vulnerable groups who do not benefit immediately. But the private sector can only flourish and create employment opportunities when the environment in which it operates is welcoming to business.

The Pacific islands' natural impediments—such as small market sizes, remoteness, and susceptibility to natural disasters—do constrain business activity in the region. However, while not a great deal can be done to escape the costs associated with these factors, it is possible to create an environment that minimizes the cost of doing business, and encourages both business dynamism and entrepreneurship.

Yet, the economic performance of the Pacific has been disappointing over the recent past decades, despite relatively high public investment rates and generous external funding that are among the highest per capita in the world. The private sector in the Pacific is handicapped by common problems including a weak macroeconomic environment, poor governance, often political instability, extensive state involvement combined with weak regulation, underdeveloped financial markets, and a poor legal and investment policy environment for business.

These factors have created high-cost conditions for business. A combined impact of these barriers appears to be that rates of return on capital are low throughout the region. On a net basis, there have been outflows of private capital in many of the Pacific economies and even though real interest rates are below those in many developing countries in other parts of the world, many in the formal private sector maintain that they are still too high to yield an adequate reward for entrepreneurial effort.

These factors exist in one variant or another in most of the Pacific. A successful strategy to promote private sector development requires the formulation of policies that will reduce the high cost and disabling business environment that currently exists almost throughout the region.

The Asian Development Bank (ADB) has recently launched an initiative to gain sharper insights into the underlying issues inhibiting private sector development in the Pacific. This publication contributes to the discussion by taking a hard look at the problems, evaluating them against international experience and best practices, and raising critical issues. Options and potential solutions to address these are offered to the governments and their development partners.

The report was prepared by consultants with the Enterprise Research Institute of Washington DC, under the direction of Winfried Wicklein, Private Sector Development Specialist, Pacific Department. The project team and ADB are grateful to the myriad of businesspeople, government officials, and development practitioners who contributed through their valuable insights.

While this report does not represent the views of ADB, I am pleased to publish it under the Pacific Studies Series. I trust it will provide interesting, thought-provoking reading, and stimulate useful discussions toward progress in developing the private sector in the Pacific.




Jeremy Hovland  
Director General  
Pacific Department

# I. Diagnosis and Synopsis

The countries in the Pacific vary widely with respect to size, topography, geographic isolation, resource endowments, vulnerability, population, and culture. These island countries are scattered over a vast area that makes up nearly one third of the globe. Many of the countries are the embodiment of the traditional vision of an island paradise. Yet despite what some would consider as idyllic circumstances of sun, sand, and sea, the countries of the region are relatively poor and growth has been disappointing, especially in relation to the amount of external funds that have been invested.

The usual explanations for the lack of development, however, do not hold in the Pacific: the low growth is not because of a lack of savings and capital goods. Countries with high rates of savings and investment—such as the former Soviet Union—have failed abysmally and net domestic investment has not been especially low in many of the Pacific countries. The lack of land does not explain low growth rates. Economies with small landmasses, such as Hong Kong, China and Singapore have achieved growth rates far above the world average, and other small islands, such as Bermuda, Iceland, Mauritius, and Norfolk Island, have also been comparatively successful.



The usual explanations for the lack of development do not hold in the Pacific.

Equally unconvincing is the explanation that low labor skills and poor cultural attitudes toward work make workers unproductive. The high rate of emigration to Australia, New Zealand, and the United States—where workers from the Pacific earn wages many times higher than those earned in their home countries—attests to their productive ability.

Another unsatisfactory excuse for low productivity and income is lack of access to technology. There are few or no barriers to technological exchange in the Pacific, and yet, when technology is installed, it yields disappointing results.

Explanations are needed as to why the highest per capita levels of external funding in the world provided to the Pacific have so far failed to encourage growth in the region.

The small size, geographic isolation, and vulnerability of the Pacific economies have been the prime justification for the extensive role of the state in most Pacific developing member countries (PDMCs) of the Asian Development Bank (ADB). Research for this publication supports the argument that the prime cause of poor private sector development (sometimes referred to as PSD) is the

Erroneous ideas regarding what role government should play have resulted in costly state involvement that exacerbates, rather than ameliorates, problems of geographical isolation and distance.

extensive state intervention in areas better left to the private sector, coupled with the state's inability to provide the public goods and institutions—in development parlance, the enabling environment—that a flourishing private sector needs. The lack of growth in most countries is related to a massive failure of the state. Erroneous ideas regarding what role government should play have resulted in costly state involvement that exacerbates, rather than ameliorates, problems of geographical isolation and distance.

The role of the state in promoting private sector development is to provide the institutions that underlie business activity. The institutions, in turn, define the transactions costs faced by business and, ultimately, the incentives for individuals to undertake entrepreneurial

activities.<sup>1</sup> Currently, incentives in the Pacific are poor, transactions costs are high, and the institutions as well as the state are both intrusive and exclusionary for potential and existing businesspeople.

The private sector in the economies of the Pacific is generally characterized by

- a large informal economy, especially in retailing and services;
- widespread subsistence agriculture and fishing;
- cultivation and export of indigenous root crops;
- export of some specialized agricultural products;
- fishing, as well as licensing, servicing, and supplying foreign fishing fleets within territorial waters;
- widespread but mainly small tourist sectors;

<sup>1</sup> Private sector activity, in this paper, includes services paid for by the state but performed by private individuals or companies that are not public sector employees. However, corporate entities owned by the state are considered to belong to the public sector. Mixed public-private ownership, which generally occurs in the case of privatized utilities, is discussed elsewhere.

- small industries manufacturing products that are costly to transport over large distances; and
- substantial mineral resources—most notably Papua New Guinea and the Solomon Islands, among a few countries.

The private sector in the Pacific faces several difficult issues. Among the most important are

- indirect evidence that low rates of return on capital are endemic in the Pacific;<sup>2</sup>
- extensive service industries supplying the local economy;
- small domestic markets where purchasing power is low;
- expensive transport and communications services such as telephone and Internet connections;
- costly and/or unreliable utility services;
- underdeveloped capital markets—with private sector credit to gross domestic product (GDP) ratios below the average for countries at equivalent stages of development;
- credit markets dominated by few commercial banks;
- below-average borrowing costs compared with the average for developing countries;
- land tenure problems;
- high labor costs resulting from the crowding out of businesses and individual investors by the public sector; and
- a protective and antiprivate business attitude among many in the population.

Modernization is a necessary condition for development but this does not necessarily mean foregoing traditions and customs.

In order not to be left behind, however, the Pacific countries must follow growth-oriented, private sector-friendly policies to ensure that they can capitalize on the growth of the world economy. In many ways, the issues raised here represent the confluence—or conflict—of tradition versus modernization. The countries of the Pacific wish to secure improved opportunities and incomes for their people, but the fundamental question they wrestle with is whether they must modernize—and by implication give up cherished traditions and customs—to do so. The perspective of this publication is that modernization is a necessary

<sup>2</sup> On a net basis, there have been outflows of private capital in many Pacific countries and even though real lending interest rates are below those in many developing countries in other parts of the world, observers in the formal private sector maintain that they are still too high to yield an adequate reward for entrepreneurial effort. There is therefore the paradoxical situation where funding agencies and remittances are financing outflows of private capital.



condition for development but this does not necessarily mean foregoing traditions and customs. Incentive structures can evolve to include local cultural practices, just as they have in other parts of the world.

The countries of the Pacific have already embarked along this journey toward modernization. The key issue to determine is how far along that road do they wish to travel and at what speed.

At the outset, analysis of the business environment involves reviewing the importance of a wide range of factors affecting the private sector, including

- macroeconomic conditions
- trade policy
- the financial sector
- property rights
- regulation
- institutions that underpin a modern market economy
- the role of government in the economy

These factors can profoundly influence the structure and conduct of business as well as how entrepreneurial activity is channeled. They can differ widely among countries, but the fact that many PDMCs reveal very similar symptoms in terms of PSD constraints is striking.<sup>3</sup>

This publication uses the private sector assessments (PSAs) of four Pacific countries—the Marshall Islands (ADB 2003b), Papua New Guinea (ADB 2003c), Samoa (ADB 2003d), and Vanuatu (ADB 2003e)—as a foundation for the themes relevant to the Pacific as a whole. The PSAs reflect a wide variety of conditions and backgrounds that provide a detailed foundation for discussing the issues. The common themes that emerged provide guidance for a strategy that suggests private sector-friendly policies are necessary for both the countries and their development partners, whether multilateral or bilateral.

## Constraints of the Private Sector in the Pacific

This publication identifies many issues facing the private sector in the Pacific.

*State Interference in the Economy.* The size of government, as measured by the ratio of government expenditures to GDP, is greater in the Pacific than in

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<sup>3</sup> This leads to a recommendation that more detailed private sector assessments are necessary in countries that were not examined as part of this exercise.

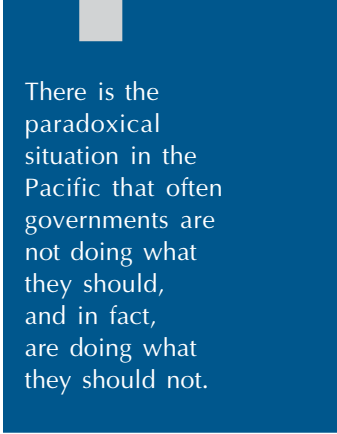
most other developing countries. In many Pacific countries, governments have imposed burdensome regulatory regimes and own many business enterprises, the most important of which have been preserved as monopolies. Although the large and heavy footprint of the state often goes unquestioned, the presumption of the necessity for a large state presence in small countries should be challenged. As a general principle, it is most efficient and least distortionary to private incentives if government intervention in an economy is minimal.

Where public goods require public finance, modern public sector management practices suggest the separation of financing from the delivery of services and introducing, where possible, competition-based private sector participation in services provision even if it is financed by the state. In the Pacific, an improved regulatory regime that allows for competition and the rapid adoption of technical change, combined with the sale of government-owned commercial businesses, would greatly lower costs and decrease the size of the state.

Better governance, minimal corruption, improved regulation, and increased competition would boost capital inflows while reducing the volatility experienced by most Pacific countries. As a result, the private sector would be a larger component of the economy, and as such, assist in the reduction of volatility.

The situation does show evidence of change. Funding agencies are increasingly supporting PDMCs with the development of the private sector through policy dialogue and lending. But such statements are difficult to prove. In spite of some recorded progress, much remains to be done, and some of the more difficult aspects of needed reform have been delayed, such as increasing private sector participation in—and regulation of—state-owned enterprises (SOEs). It will be difficult for the private sector to perform at its full potential and create jobs at the needed rate until these issues are resolved.


*Poor Provision of Public Goods.* The state fails to supply public goods that support an effective and efficient private sector, which fosters secure property rights, a regulatory system that allows contracting with confidence, efficient and low-cost infrastructure, and regulations that are clear and also improve efficiency. There is therefore the paradoxical situation in the Pacific that often governments are not doing what they should, and in fact, are doing what they should not. This reality is a primary contributing factor to the low rates of return on capital.



There is the paradoxical situation in the Pacific that often governments are not doing what they should, and in fact, are doing what they should not.

Energy is a primary concern in the islands and it is no surprise that corporations in charge of the vital infrastructures of electricity generation and distribution are state monopolies, as are telecommunications and water supply. The state also owns and operates other critical infrastructure such as ports and airports. In addition, governments in most island states participate in conventional commercial activities, such as tourism. Ownership is based on the premise that without government intervention, such services would not exist. This notion is incorrect. Private companies can be given subsidies to run services where revenues do not cover expenditures, and given a competitive choice, the results will enhance efficiency.

The effect of extensive government ownership is twofold. Not only does it crowd out the private sector from participating in these activities, but it also raises the costs and lowers the profitability of businesses to the extent that the state-operated businesses are poorly run and provide higher-than-necessary inputs to the business sector. Utility services, telecommunications, and transportation in the Pacific are among the most costly in the world. Rather than ameliorating the problems of size and distance, the presence of the state in the Pacific can be likened to a tax on development.



The presence of the state in the Pacific can be likened to a tax on development.

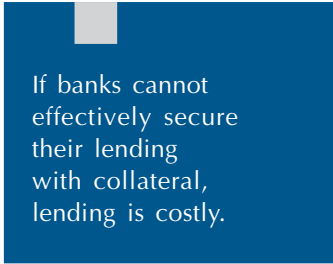
*High-Cost Operating Environment.* The state's poor provision of public goods, inappropriate involvement in services, and interference in the economy combine to create a high-cost operating environment for business. The most common complaint from business communities in the four countries assessed was the high cost of conducting business. Part of the problem arises from the natural characteristics of the countries, namely the increased unit cost of inputs due to remoteness; the difficulty in capturing economies of scale due to small markets; the market power of distribution channel owners; increasing costs; and long, infrequent, and exorbitantly costly communication lines.

These factors may present problems to businesses in the Pacific, but companies in other small, isolated economies have managed to overcome these obstacles. In the Pacific, the effects of isolation and size are compounded by misguided government intervention that further pushes up costs and reduces competition. And when the costs of doing business are high, firms are discouraged from establishing or expanding their business. While little can be done to escape the costs associated with remoteness or smallness, the regulation of business to minimize monopolies—carefully regulating monopolistic elements of business that cannot be made contestable—and having offshore regulators to avoid

regulatory capture are all within the control of government. In these areas, the Pacific countries should strive to introduce international best practices to provide an environment conducive to private sector development.

*Underdeveloped Financial Markets.* The financial markets of the Pacific are underdeveloped and do not provide sufficient support for the private sector. The days when interest rates were set by regulation and the money supply was determined through controls on reserve ratios have passed, but the immature banking industry is probably due, in part, to this legacy. Regional characteristics include

- banking services seldom reaching beyond main urban areas;
- commercial banks having little outreach to low-income households;
- extremely limited credit extended to indigenous entrepreneurs (i.e., little lending to agriculture and fishing);
- large interest rate spreads (with some exceptions);
- informal lending as an important source of finance; and
- emerging microfinance programs that in most countries are still in their infancy.



If banks cannot effectively secure their lending with collateral, lending is costly.

The underdevelopment of the financial sector in the Pacific countries relates to two important factors: severe shortcomings in the secured transactions framework and the incompatibility of the customary land system with secured lending. If banks cannot effectively secure their lending with collateral, lending is costly. For borrowers to access affordable credit, adequate collateral must be on hand. But in the Pacific, the system for using property as security is cumbersome, expensive, and generally unavailable.

The system makes it difficult for land to be used as collateral outside urban areas and generally, land and leases are not regarded as adequate security because the underlying ownership rights of lessors are frequently open to challenge. To deepen financial markets and increase credit availability, these two elements must be addressed. Though some countries in the region have started implementing reforms, most of them have not yet begun. The longer-term aim of reforming property rights is access to developed financial markets that channel funds effectively from savers to investors to stimulate economic development and poverty reduction. While international interventions in the supply of loanable funds are substitutes for financial deepening, they are not long-term solutions and will not assist the development of the financial sector.

*Natural Resource Issues.* Pacific countries are heavily dependent on natural resources for their livelihood. This dependence includes the agriculture and fishing industries as well as industries such as tourism. Resource management is therefore a critical issue for the economic development in the Pacific and relates intimately with land rights issues. To date, there is little evidence of the natural resource endowment being carefully managed.

*Poor Investment Policies.* A good investment climate has sound macroeconomic management, as well as trade and investment policies that promote openness, productivity, and growth. It allows for financing new investment at interest rates that equilibrate the supply and demand for savings. In addition, it includes good governance, promotion of competition, and prevention of corruption, with a solid foundation of basic physical and social infrastructure. The case for creating a good investment climate is simple. Without a predictable environment for people, ideas, and money to work together productively and efficiently, investment will not occur. The role of government is to provide an environment for entrepreneurs to invest in productive activities. From interviews, it is clear that a good private sector climate and secured transactions framework are missing

Experience shows that the fewer special incentives offered, the more likely genuine long-term foreign investment will occur.

in the Pacific. It is often expensive to establish and register a business. Incorporation is not easy. Sometimes specific industries are targeted for assistance, while obstacles to investment (e.g., in terms of controls, the composition of ownership or board of directors, etc.) are imposed on others. Targeted industries and subsidies distort decisions and have long-term harmful effects on efficiency, profitability, and the growth of the business sector.

Governments of the Pacific have tried to tightly control foreign investment, but they must recognize that business is risky and it is inevitable that some foreign investment will fail, resulting in the bankruptcy or exit of new companies. Moreover, in practice, there are no documented examples of “fly by night” investors, except in cases where governments have attempted to give special incentives over and above the foreign investment regime. In fact, experience shows that the fewer special incentives offered, the more likely genuine long-term foreign investment will occur.

*Land Rights Issues.* Land plays a central cultural as well as productive role in Pacific societies, and the form of customary ownership introduces considerable ambiguity regarding land rights and the distribution of rents from land. This is a major economic issue in the Pacific that remains a source of internal dispute. A major constraint on private sector development in the Pacific is unclear land rights and the resulting difficulty in using land as collateral for loans. Over

90% of land remains under customary ownership without formal ownership, precluding it from being used as collateral for loans. Land can be a central source of wealth and is particularly important to the rural community whose primary latent asset is land, but only if there is a system of property rights. In most developed countries, the bulk of small businesses are established using loans that are backed by land. The problems in land tenure in the Pacific include

- unclear ownership and boundaries as a result of lack of recording;
- restrictions on transferability as a result of unclear ownership;
- unclear definition of different land tenure rights;
- weak (and unrecorded) dispute resolution practices; and
- problems of enforcement.

A major constraint on private sector development in the Pacific is unclear land rights and the resulting difficulty in using land as collateral for loans.

A land rights system requires careful analysis to determine exactly how a chain of rights that serves key economic ends can be built. Simply imposing conventional western industrial land tenure patterns cannot solve this problem. The new system must accommodate the customary system of land rights yet permit more land to serve as collateral.

Land is culturally important in the Pacific, and, in truth, holds a special place in almost all societies of the world. The difference lies in the nature of tenure. Consensus-building around a system of land tenure is critical, but it will take time and it must begin now. Secure ownership and the ability to exchange land must exist to create a positive investment climate for small entrepreneurs, in addition to being a precondition for the emergence of financial markets.

Many Pacific countries are cautiously reviewing their land rights systems to adapt to the changing times. But it is a challenging task made more difficult because basic institutions have to be in place before those members of society who need them the most could feel the benefits of changes in property rights. The process has begun and must continue through a series of small, systematic, and conclusive steps toward rectifying the identified shortcomings of existing systems.

## Conclusions

The private sector can flourish and create employment opportunities only if the environment in which it operates is conducive to business. Governments can often create an environment that increases the costs of doing business, reduces profits, and discourages dynamism and entrepreneurship. For these

reasons, the chapter introducing a strategy for change suggests that efforts concentrate on a limited number of issues by focusing on what causes the low rates of return on capital as well as the constraints to business startup and development. These issues include

Strategies for change should focus on what causes the low rates of return on capital as well as the constraints to business startup and development.

- fostering financial sector development for credit to be more readily available for business;
- clarifying land rights and modifying them with respect to cultural preservation and the development of land markets;
- reducing the role of the state in the economies of the region;
- revamping the regulatory regimes for the business environment to be less constrained and monopolies more prudently regulated;
- focusing on the assistance of small-scale rural enterprises.

With concerted efforts, governments and their development partners can ensure the resolution of these critical issues. However, doing so requires considerable time and great effort. Nevertheless, now is a perfect time to start the process.

## II. Introduction

This publication assesses conditions for private sector development in the Pacific developing member countries (PDMCs) of the Asian Development Bank (ADB).<sup>4</sup> It aims to provide an overall private sector assessment (PSA) of the region, which lays out an analytical foundation for strategies to assist PDMCs in promoting their private sector. As part of the process, four detailed PSAs were undertaken in the Marshall Islands, Papua New Guinea, Samoa, and Vanuatu. These PSAs provide the basis for the detailed analysis in the chapters that follow, supplemented by observations based on a large number of reports that have been produced on the region's economies.

The countries in the Pacific vary widely with respect to size, topography, geographic isolation, resource endowments, vulnerability, population, and culture. These islands are scattered over an area that makes up nearly one third of the globe. From the perspective of size and population, the largest country by far is Papua New Guinea, with a landmass slightly larger than the State of California in the United States and a population of 5 million. At the other extreme, Nauru and Tuvalu each have a landmass equivalent to 10% of Washington DC and a population of approximately only 12,000.

There are similar variations in topography. Some are so low-lying that they are threatened with inundation if the worst predictions associated with global warming come to pass. Others have soaring, snow-covered peaks. Resource endowments also vary widely, with Papua New Guinea and a few island economies being endowed with substantial mineral resources. Others, such as Kiribati and Vanuatu, have significant pelagic resources, while others have virtually no natural resources at all.

The region also encompasses a wide diversity of peoples and languages. Here, Papua New Guinea is also the outlier with over 800 different languages and dialects. There are three distinct ethnic groups in the Pacific—Melanesians, Micronesians, and Polynesians—with unique cultures and characteristics as

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<sup>4</sup> The countries in the region include Cook Islands, Fiji Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.



well as wide differences within each group.

Traditionally, discussions of the Pacific have been divided among the three island groups of Melanesia, Micronesia, and Polynesia, with Papua New Guinea regarded as distinct because of its size and resource endowments. For the purpose of this analysis of the private sector, however, these divisions are less useful. This publication is based on an analytical approach that focuses on incentives and institutions. Therefore, it groups countries by themes rather than by geographical or ethnic classification. Some discussion is confined to Papua New Guinea alone, as it is an outlier in the region in so many ways.

## Low Growth in the Pacific: Critiquing the Usual Assertions

Some theories regarding why the Pacific economies have not performed to expectations include the following.

*Lack of Savings and Capital Goods.* Surprisingly, savings rates in the Pacific are not low by international standards. Furthermore, other countries with high rates of savings and investment (e.g., the former Soviet Union) have failed abysmally. This counterargument is bolstered by the observation that if capital is really scarce, existing capital in the region should earn extremely high rates of return. In the Pacific, the opposite is true—rates of return on capital are low and many residents invest their capital elsewhere.

*Lack of Land.* A corollary of the concerns on a country's small size is that land is scarce. However, limited landmass has not inhibited the development of such economies as Hong Kong, China; Iceland; Mauritius; and Singapore to name a few.

*Low Labor Skills and Poor Cultural Attitudes Toward Work Make Workers Unproductive.* Closer examination reveals this explanation as baseless. The high emigration rates in many Pacific countries attest to the attractiveness of places like Australia, New Zealand, and the United States as destinations with higher wages. The same person, with a supposed lack of skills or education, who in his or her country of birth can only earn low wages, can usually find immediate employment upon emigration at a wage that is a large multiple of that received in the originating country. The assertion that there are poor cultural attitudes toward work is contrary to the evidence of prosperity in many Pacific communities in developed countries. This prosperity is a testament to their skill,

adaptability, and willingness to work hard, belying the cultural explanation for low productivity.

*Low Levels of Technology.* Technological advances developed in industrial countries are available in developing countries without the expense of research and development. There are few barriers to technological exchange, and technology is generally available to promote rapid growth in developing countries. Yet, it is often unused, or when installed, yields disappointing results.

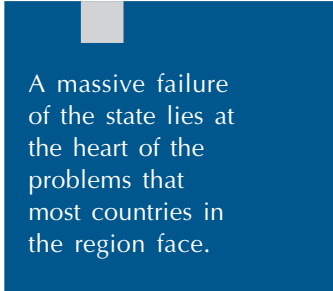
This research therefore, finds an alternative explanation for the poor growth performance in the Pacific and concludes that a massive failure of the state lies at the heart of the problems that most countries in the region face. Misguided notions regarding the role of the state, sometimes supported by the funding community, have resulted in costly government intervention in most of the region's economies. This only exacerbates the problems of geographic isolation and distance, while the state neglects its responsibility to provide the institutions that underpin a modern market economy. These arguments are developed at greater length in the chapters that follow.

## The Private Sector in the Pacific

Identifying precisely what constitutes private sector activity is not a simple task and various attempts to do so have engendered considerable controversy. Many issues have not been resolved, such as

- whether the informal sector should be counted as belonging to the “private sector”;
- the role of subsistence and cash crop agriculture and fishing;
- how corporatized government entities should be treated; and
- whether private contractors working for the government should be treated as belonging to either the public or private sector.

An equally difficult and closely related problem is how to measure the size of the private sector with any degree of accuracy. Simply subtracting the portion of government expenditure from the measure of GDP in the national accounts will not provide an accurate estimate of private sector output because transfers often comprise a significant portion of expenditure. In addition, if the public sector uses private contractors, depending on how GDP is estimated, their value may not be included in the national accounts. Much of the output of the



A massive failure of the state lies at the heart of the problems that most countries in the region face.

informal sector as well as that of rural agriculture and fishing could also be omitted. Statistics on most of these issues are not readily available in developed economies and are rarely available in the developing world. Since Pacific economies are characterized in general by few statistics, data that would provide accurate estimates of the size of the private sector are not available. Furthermore, in states where governance is weak, there are strong incentives for the private sector to operate informally and not provide information on their activities. Inefficient and poorly functioning government departments, including those responsible for collecting statistics, also characterize such states. As a result, the reliability of information from states where governance is weak is especially suspect.

For the purpose of this analysis, however, lack of accurate statistics on the sizes of the region's private sector is not a serious issue. The many commonalities shared by Pacific economies allow a stylized description to be a sufficient basis for a discussion of important issues. Since this publication seeks to promote the private sector in the region, it addresses informal and subsistence issues arising from the set of incentives existing within the region's economies.

In many cases, state activity has crowded out private sector development and damaged growth and prosperity.

This publication considers private sector activity as including services paid for by the state but performed by private individuals or companies that are not public sector employees. Corporate entities owned by the state, however, are considered public sector.

To date, the economies of the region have been dominated by the presence of government. In many cases, state activity—whether in the form of interference in the economy or through owning resources and undertaking activities that are better left to private agents—has crowded out private sector development and damaged growth and prosperity. Funding agencies have often unwittingly contributed to this phenomenon.

The private sector in the economies of the Pacific is generally characterized by

- widespread subsistence agriculture and fishing;
- a large informal economy, especially in retailing and services;
- cultivation and export of indigenous root crops;
- export of some specialized agricultural products;
- fishing and licensing of foreign fishing fleets within territorial waters;
- widespread but mainly small tourist sectors;
- small industries manufacturing products that are costly to transport over long distances;

- substantial mineral resources—most notably Papua New Guinea and the Solomon Islands among a few countries;
- extensive service industries supplying the local economy;
- small markets where purchasing power is low;
- expensive transport and communications services such as telephone and Internet connections;
- costly and/or unreliable utility services;
- underdeveloped capital markets—with private sector credit to GDP ratios below the average for countries at equivalent stages of development;
- credit markets dominated by few commercial banks;
- below-average borrowing costs when compared with the average for developing countries; and
- problems with respect to land tenure.

These issues, which have profound implications for private sector development in the region, will be explored in greater detail in the chapters that follow.

## Private Sector Development, Growth, and Poverty Reduction

The connection between private sector development and economic growth is now widely accepted. There is general recognition that without a dynamic private sector, countries cannot achieve the increases in prosperity necessary to reduce the poverty that afflicts many populations in the region. However, the connection between growth and income distribution is often misunderstood. Many still believe that growth usually necessitates a worsening of equality, particularly in the early stages of a takeoff. Such views are based on the work of Simon Kuznets, a Nobel Prize-winning economist who argued in the 1960s that the effects of economic growth on income distribution change at different stages of development. Specifically, he speculated that income inequality widens in the early phases of economic development, when the transition from the preindustrial to the industrial phase is most rapid, becomes stabilized for a while, and then narrows in the later phases as economies mature.<sup>5</sup>

However, recent studies have largely shown that these concerns are ill founded, diminishing the support for the Kuznets hypothesis. Several recent studies

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<sup>5</sup> The Kuznets hypothesis was based on analytical reasoning rather than data—his evidence was slender, at best. According to Kuznets himself, “the paper is perhaps 5% empirical information and 95% speculation, some of it possibly tainted by wishful thinking.” However, his hypothesis was widely accepted by many development economists.

illustrate that on average, economic growth does not systematically affect income distribution. In fact, it raises the income of poor people to the same extent as average incomes. The evidence is sufficiently convincing that the World Bank concluded that there are no systematic effects of economic growth on income inequality across countries (World Bank 2000). The differences in inequality at a given rate of growth could reflect the fact that the combination of policies and institutions that led to this growth differed across countries, and that these differences in policies matter for income distribution. Further research also shows that there is no evidence that income distribution between countries deteriorates as the global economy expands—the Pacific benefits from the spread of globalization directly and indirectly (Sala-i-Martin 2002).

In order not to be left behind, however, the Pacific countries must follow growth-oriented, private sector-friendly policies to ensure that they can capitalize on the growth of the world economy. In many ways, the issues raised here represent the confluence—or conflict—of tradition versus modernization. The countries of the Pacific wish to secure improved opportunities and incomes for their people, but the fundamental question they wrestle with is whether they must modernize—and by implication give up cherished traditions and customs—to do so.



The Pacific countries must follow growth-oriented, private sector-friendly policies to ensure that they can capitalize on the growth of the world economy.

This publication supports the idea that modernization is necessary for development but not at the cost of foregoing traditions and customs. Incentive structures can evolve to encompass culture, just as they have in other parts of the world. Culture can be defined and formalized to make contractual obligations enforceable. The countries of the Pacific have already embarked on this journey. They have formal (nontraditional) central governments with most of the trappings of governments everywhere. The issue for the Pacific countries is how far along that road they wish to travel and at what speed.

In evaluating the significance of the private sector in promoting growth, this publication also touches on issues that have been at the center of policy debates in the region. It discusses issues such as the role of the state, the effect of size and remoteness, the interaction of markets for goods and services, capital and factors of production, and the appropriate role of funding agencies. One important conclusion is that many disadvantages habitually blamed on distance and smallness are exaggerated. And that some of these negative effects are greatly compounded by ill-advised

policies that reduce factor market flexibility and raise the costs of doing business. In addition, this publication also emphasizes the importance of institutions in promoting an environment where the private sector can flourish.

## Private Sector Assessments in the Pacific: A Framework

PSAs examine the incentives and constraints to private sector activity. At the outset, analysis of the business environment involves reviewing the significance of a wide range of factors related to the private sector. The most important of these are

- macroeconomic conditions
- trade policy
- the financial sector
- property rights
- regulation
- institutions that underpin a modern market economy
- the role of government in the economy

All these factors can profoundly influence the structure and conduct of business as well as how entrepreneurial activity is channeled. However, they can differ widely between countries. In fact, they tend to be country specific and idiosyncratic. What is important in one country may not be so in another. After an initial review of the issues that influence private sector development, more detailed and country-specific analysis is necessary. Undertaking a regional PSA that encompasses many countries requires compromise. As a result, generalization is inevitable.

PSAs undertaken by the authors in the four study countries<sup>6</sup> serve as the foundation for the themes relevant to the Pacific as a whole. These countries reflect various conditions and backgrounds that provide the basis for a discussion of several issues. The common themes that emerged provide guidance for the strategy (Chapter XI), which suggests policies toward the private sector for the governments, as well as international and bilateral development agencies.

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<sup>6</sup> Marshall Islands, Papua New Guinea, Samoa, and Vanuatu.

## Overview of the Report

This private sector assessment of the Pacific is organized along the following lines. Chapter III outlines the methodology used to assess the private sector's business environment in the Pacific. It draws on empirical research that measures the impact of factors traditionally thought to generate growth. The evidence points overwhelmingly to the main determinants of private sector growth as being the institutions that provide the basis for private sector activity and the transaction costs imposed upon businesses. Among these are factors such as governance and political stability, the legal and regulatory system, the viability of property rights and contracting, and dispute resolving mechanisms. The chapter illustrates how factors such as mineral endowments, education levels, macroeconomic stability, and savings rates, have little impact in themselves when the underlying institutional framework is missing.

Chapter IV describes the characteristics of the Pacific economies, including the effects of size, distance, and vulnerability on private sector development in the region. It examines the impact of remittances from overseas workers and international funding, as well as describes the pervasive presence of the state in many of these economies.

Chapter V describes the main issues faced by the private sector in the region, including small market size, the high costs of doing business, and the interaction as well as the role of public and private sectors. A common feature of most economies in the region is the high cost of infrastructure and communication services.

Chapter VI examines the financial markets in the Pacific. While levels of financial development vary among the countries, overall their systems are underdeveloped and rely heavily on bank financing. Interest rates are characterized by fairly large spreads, but interest rate levels are low compared with many developing countries. This chapter briefly describes some existing regional financing schemes as well as the pros and cons of their further expansion. The main theme of this chapter is that property rights issues, both for land and movable property, combine to exclude the local population from access to finance, particularly those in agricultural areas.

Chapter VII focuses on land issues and their impact on private sector development. The issue of land-related property rights is among the most difficult challenges facing the Pacific. In all four study countries, a major portion of land is held communally, making the assignment of identifiable property rights difficult. In most countries, however, there is also a deep spiritual attachment to land

and most people are rightfully wary of introducing freehold tenure, which makes the abrogation of the current owners' claim possible. However, this publication points out that what harms private sector development—and therefore prosperity—in the region is the present pervasive uncertainty and the inability of investors to enter into secure contracts using land. It makes some modest suggestions regarding the beginnings of a process of reform and ways in which a system of movable property could be implemented in a manner that could begin to contribute to transformation.

Chapter VIII looks at the interface between the role of the state in the Pacific countries and how it affects private sector development. It challenges the notion that characteristics of the region imply a large and pervasive state presence and identifies how this attitude has damaged private sector development in the past. The chapter examines policies toward state-owned enterprises (SOEs) and issues surrounding privatization, the legal framework, and infrastructure. It suggests that in many countries, interaction between the state and the private sector constitutes a “dialogue of the deaf” and calls for more contact and cooperation. It also looks at issues of governance and the impact of dysfunctional states on the private sector.

Chapter IX briefly examines some sectoral issues, although the report and analysis do not take a sectoral perspective. There are some fundamental issues related to tourism development, agricultural policies, and management of fisheries that have a profound impact on private sector development in the region.

Chapter X briefly discusses some special considerations in relation to targeted assistance to small-scale rural enterprises, and the need for generic policies governing small and medium enterprises (SMEs).

Based on the analysis, Chapter XI discusses options for governments and donors to promote private sector development, and provides an outline for a private sector development agenda for Pacific governments and funding agencies, respectively. This chapter is largely based on a short separate report prepared to suggest a private sector policy framework and strategy for ADB in the Pacific, making specific recommendations regarding a strategy for interventions toward the development of the private sector. A new ADB private sector development strategy is now being considered and will become part of ADB's Pacific Strategy for 2005–2009.



# III. Analytic Approach

A dynamic private sector is a feature of all countries that have sustained economic growth. Besides promoting general prosperity, a rising GDP is the most effective means of reducing poverty. A flourishing private sector, therefore, is central to efforts at reducing poverty in the Pacific. Although consensus exists on the importance of the private sector, how to ensure that it is able to develop is an issue of contention.

**Table 1. The Relationship Between Growth and Poverty**

Economic Response	% Change in Average Incomes per Year	% Change in Poverty Rate per Year
Strong Contraction	-9.8	23.9
Moderate Contraction	-1.9	1.5
Moderate Expansion	1.6	-0.6
Strong Expansion	8.2	-6.1

Source: Easterly, William. 2001. *The Elusive Quest for Growth*. Cambridge: Massachusetts Institute of Technology Press.

The relationship between economic growth and poverty is clear from Table 1 wherein income growth is strongly correlated with poverty reduction. Private sector development is the most efficient and durable way of achieving this end.

Private sector development promotes efficient economic growth and development and is a source of wealth, dynamism, competitiveness, and knowledge. Beyond its economic merits, however, lie compelling social and political attributes that enhance the contribution private sector development can make more generally to sustainable development, the overriding goal of all development assistance efforts (DAC<sup>7</sup> 1994).

The question is, what promotes growth? And more importantly, what promotes private sector growth?

<sup>7</sup> Development Assistance Committee.

## What Promotes Growth?

Many have advanced theories as to what promotes growth and many have been incorrect. So far, these theories have been limited in their ability to provide a panacea for stimulating growth in the developing world, particularly an appropriate application of these theories by donors to the developing world.

During the 1940s and 1950s, economic theory focused on “filling the gap” or using foreign aid to top up savings with the “necessary” investment to promote a particular level of growth (Easterly 2001). This focus arose from the Harrod-Domar model, which was based on the idea that GDP growth is proportional to the share of investment spending on buildings and machines. But it is based on the assumptions that production capacity is proportional to the machinery stock and that labor is in excess supply. William Easterly has demonstrated that there is no statistically positive relationship between aid and investment and that there is not a one-for-one relationship between increases in aid and investment as a share of GDP. Evsey Domar later disavowed his theory as inaccurate and “filling the financing gap” ceased to be considered important. But the model continues to be used by some international finance institutions (IFIs) to determine the required investment rate for a target rate of growth. In fact, “Domar’s growth model became, and continues to be today, the most widely applied growth model in economic history” (Easterly 2001).

Instead of focusing on investment rates and ways to use aid as a means of bridging the gap, the focus should be on how to create the right incentives for people to invest in the future and shaping the appropriate institutions to support them.

Instead of focusing on investment rates and ways to use aid as a means of bridging the gap, the focus should be on how to create the right incentives for people to invest in the future and shaping the appropriate institutions to support them.

When capital investment seemed to have little impact on growth and Robert Solow demonstrated the importance of technology in the production process, the 1950s and 1960s saw an increasing focus on the importance of boosting technology inputs to stimulate growth. But technology differences across countries do not explain income differences among them. Robert Lucas illustrated that a United States worker would need to have 900 times the number of machines to explain the income differences between the United States and India (Lucas 1990). In reality, the difference is more like 20 times the number of machines.

The failure of poor countries to grow is evidence against Solow's view. Poor countries failed to grow faster than rich.<sup>8</sup> Unfortunately, they have not only grown more slowly, but they are actually losing ground. The reason machines in developing countries are not as productive has little to do with the machines and more to do with incentives and the environment in which the people operate the machines.

The reason machines in developing countries are not as productive has little to do with the machines and more to do with incentives and the environment in which the people operate the machines.

The 1960s saw an increasing concentration on the importance of human capital development (i.e., education). Investment in education may be socially beneficial, but studies have found a tenuous relationship between increasing education and long-run growth (Easterly 2001). In fact, the decline in growth of developing countries occurred when there was a huge educational expansion in those countries.

If the incentive to invest in the future is not there, education will have little impact on growth and will in fact create skills where there is neither technology nor the desire to invest in the technology to be used.

The 1970s introduced the idea that controlled population increases would positively impact economic growth. In other words, population growth imperils prosperity by overwhelming the existing productive capacity to generate jobs and outstripping food production. The thought was that if population could be controlled, the developing world would grow by increasing its productive capacity. But this theory is based on the assumption that an additional person has zero productivity and once again, studies found that there was no significant impact of population growth on economic growth.

A greater population may harm the environment but an additional person is an additional taxpayer for governments and the more babies, the greater the chance of innovative people being born to benefit society. In addition, new ideas will be more beneficial the more people there are to share the benefits and spread the costs, a critical point for most of the countries in the Pacific given their small population size.

The 1980s brought the recognition that IFI loans needed to be linked to policy reforms and this legacy has shaped much of the focus on the private sector to date. There were some successes, but there were problems as well. The

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<sup>8</sup> Paul Romer demonstrated that poor countries were not growing faster than rich.

first problem with lending arose from IFIs and other funding agencies not enforcing the conditions of the loans. The second problem arose from a focus on import substitution and sectoral targeting behind high trade barriers.

Easterly has cited some successes during this time, where GDP growth was positive on average over a period. For example, Ghana, the Republic of Korea, Mauritius, and Thailand experienced positive growth, but these countries are only limited evidence of success. They are also evidence of countries that undertook serious reforms as opposed to others who continued to receive aid but made no reforms. For example, countries with severely negative interest rates received more aid than those with positive interest rates (Easterly 2001).

Unfortunately, incorrect incentives for both parties pervade the donor-recipient relationship. A World Bank study suggests that aid does not influence a country's choice of policies and that funding agencies do not necessarily consider the worthiness of a country's policies when providing aid (World Bank 1998b). The funding agencies' strategic interests determine aid, not the recipients' policy choices. The reward for better policies is only 0.25% of more aid as a percentage of GDP (Easterly 2001). And providing aid does not create the incentive for change. What is most important is a shift from an irresponsible to a responsible government. (An irresponsible government will create the illusion of change to avoid real reform, for instance, through creative accounting.)

IFIs have internal incentives to provide loans. Often a department's budget is determined by the amount of aid disbursed in the previous year. Therefore, low disbursements mean a cut in the budget. Loans then, are often disbursed according to "quota" rather than on project viability. Recipients are aware of this and so they often simply wait for the aid without making reforms. The greater their poverty, the more aid they receive—therefore, there is little incentive to change. And so develops a vicious cycle of lending. Aid should be tied to past performance, not promises of reform.<sup>9</sup> Both ADB and the World Bank are moving in this direction with performance-based lending.

The second problem from this period arose from a focus on import substitution and sectoral targeting behind high trade barriers. The shocks experienced by these countries during the financial crises of the 1980s, exposed the weaknesses of the inward-looking import substitution approach to development and the projected dynamism and growth were conspicuously absent.<sup>10</sup>

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<sup>9</sup> Easterly suggests developing an index to measure past policy performance and doling out aid depending on the country's ranking on that index.

<sup>10</sup> In addition, throughout these phases of development, the state had a central role in directing development and owning key industries in most countries in the developing world.

Given the failure of these attempts, the policies of those who espoused the “Washington Consensus” as the key to a strong private sector response and economic growth—rapid privatization, macroeconomic stability, trade reform, and “getting the prices right”—came into dominance in the early 1990s. It was recognized that this simplified approach did not consider many of the complexities that characterized developing economies. Nevertheless, so many distortions had been introduced by earlier attempts at targeted intervention that proponents of this approach believed that the incentives provided by prices that correctly reflected scarcities would result in rapid private sector growth. However, the private sector response has been disappointing. Small business formation has languished, and informality has increased.<sup>11</sup> All the various components that make up the “enabling environment” for private sector activity were absent.

## What Drives Private Sector Growth?

### *Business Dynamism*

Since economic growth and private sector development are closely linked, identifying factors that encourage the formation of dynamic private sector companies is central to formulating effective policies or programs that promote private sector development and thus reduce poverty.

The concept of “creative destruction” developed by Joseph Schumpeter provides the backdrop for a discussion of private sector development as it is based on the view that dynamism, and thus growth, depends on private sector firms having opportunities and incentives to expand in existing markets and to develop new ones. New firms are created to take advantage of opportunities, which in turn stimulates more competition among existing firms that must either respond to the new challenge or go out of business. This cycle in turn creates new demand that stimulates growth.

In Schumpeter’s view, growth and new firm innovation implies large numbers of new firms being created and others failing. It is this process of “creative destruction” that leads to a dynamic private sector. This “dynamic capitalism”

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<sup>11</sup> “Privatization advocates naively persuaded themselves that these costs could be overlooked because the textbooks seemed to say that once private property rights were clearly defined, the new owners would ensure that the assets would be efficiently managed ... They failed to realize that without the appropriate legal structure and market institutions, the new owners might have an incentive to strip assets rather than use them as a basis for expanding industry. As a result, in Russia, and many other countries, privatization failed to be as effective a force for growth as it might have been. Indeed, sometimes it was associated with decline and proved to be a powerful force for undermining confidence in democratic and market institutions” (Stiglitz 2002).

### Box I. Business Dynamism

An example of the interplay of factors that give rise to business dynamism is provided from the United States by Donald Hicks, who studied a sample of small businesses in Texas over a 30-year period. He found that during this time, the half-life of small businesses had declined by 50%. The average age of businesses in the Austin area, for example, is currently less than 7 years. At the same time, this region has the fastest growing number of jobs and the highest wages in Texas. In other words, a dynamic business environment encourages experimentation and provides strong incentives for success. Defining dynamism is not easy, however. Anyone witnessing the taxi bus industries in some Latin American countries would be hard put not to describe this activity as bustling and apparently dynamic. Yet, dynamism based on the application of energy alone will not lead to sustained growth. It is the combination of energy, management skills, and technology that ultimately results in economic advance.

Source: Hicks, Donald A. 1992. *Beneath the Surface and Beyond the Borders: New Dimensions of Dallas Area Economic Development*. In *State of the Region 1992*. Richardson: University of Texas at Dallas.

of firm formation and growth provides some guidance on how to formulate policies that promote private sector activity. It redirects the focus of private sector policy away from trying to assist businesses through targeted interventions, toward promoting an environment that provides incentives for company formation and growth. The paradox that large numbers of businesses fail in a high-growth economy results from an economic system that encourages experimentation and risk.

It is important to remember that reforms, projects, and other interventions do not create growth, but entrepreneurs and companies do. Higher productivity, the growth of new activities, the restructuring of existing companies, and the formation of new firms must be encouraged in order for reform to be effective in promoting economic growth and reducing poverty. These elements constitute the basic criteria against which any policies or interventions should be judged.

Reforms, projects,  
and other  
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and companies do.

### *Transaction Costs*

An important theme of this analysis is that how businesses are structured and take place is strongly influenced by the transaction costs associated with conducting business. These costs often define how economic activity is organized or whether it takes place at all. Examining these costs makes it possible to

### Box 2. Examples of Transaction Costs

Transaction costs are the costs of arranging, monitoring, and fulfilling contracts. They determine the way business is organized and conducted, and have a strong influence on the time horizons for business planning and investment. Most importantly, they determine how markets function. Market failure usually occurs when transaction costs are prohibitive. Examples of transaction costs include those associated with

- buying and selling goods and services
- raising finance and capital
- obtaining information regarding business opportunities
- obtaining information regarding business associates
- forming and organizing companies
- bankruptcy for creditors
- enforcing shareholders' rights
- entering into contracts
- enforcing contracts
- hiring and dismissing workers
- transporting goods
- importing and exporting goods
- complying with regional and local government regulations
- dealing with government representatives
- securing the ownership of property
- enforcing property rights

obtain insights into the constraints imposed upon businesses, derive the implications for public sector policies, and find ways in which ADB and other funding agencies could assist the governments of the Pacific in promoting dynamic private sector growth. It is the cost of doing business, or the cost of transacting, that frequently determine the way economic activity is organized. Box 2 contains examples of transaction costs.

The relative impact of high transaction costs is felt more by smaller businesses than by larger ones.

By examining private sector development issues through the lens of transaction costs, familiar problems are cast in a different language. But information on transaction costs is limited since collecting data on them is in its infancy.

An important feature of transaction costs and the way they affect the organization of economic activity is that many have significant fixed cost components. Consequently, the relative impact of high transaction costs

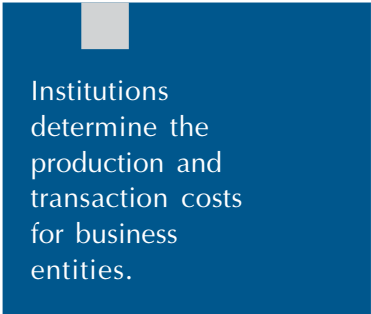
is felt more by smaller businesses than by larger ones. This result has a powerful effect on the size structure of firms. High transaction costs contribute to corruption and cause market failure—when the cost of transacting is high,

markets do not function efficiently or even exist at all. Also, it takes considerable resources to define and protect property rights as well as enforce agreements. It is a society's institutions and technology costs, however, that determine the transaction costs—including the time and related opportunity costs—associated with these efforts.

## *Institutions*

Ultimately, private sector activity is driven by the environment in which it operates. This can be an enabling or disabling environment depending on the incentives provided to the business community by the state and societal institutions. The private sector assessments undertaken for this publication focused on the environment where the private sector operates, the institutions that direct and impact private sector activity, the transaction costs imposed on businesses, and ultimately, the incentives provided to private sector businesspeople. Important elements include

- governance and political stability;
- the institutions that provide the basis for private sector activity (e.g., the legal and regulatory system, the financial system, and infrastructure provision);
- the viability of property rights, contracting, and dispute resolving mechanisms within the legal system; and
- the ability of businesspeople to raise capital within the financial system.



Institutions determine the production and transaction costs for business entities.

Ultimately, factors such as mineral endowments, education levels, macroeconomic stability, and savings rates have little impact in themselves if the underlying institutional framework is missing.

Institutions reduce uncertainty in life by providing a structure in which individuals and organizations can operate. They achieve this by defining and limiting the choices available to individuals. The definitions and limitations are devised to shape human interaction. They are the framework within which human interaction takes place: the “rules of the game.”

Institutions interact with the economy through the impact they have on the costs of exchange and production. Institutions determine the production and transaction costs for business entities. Especially when it is costly to transact, institutions are particularly important. They combine with the standard constraints of economic theory such as supply and demand, to establish the



economic opportunities available to business entities. Organizations are then created to take advantage of those opportunities. Depending on how institutions attempt to modify behavior, however, they can end up creating perverse incentives for organizations and increasing transaction costs. Examples include requiring useless inspections, having contradictory and/or complicated rules, or exorbitant taxes.

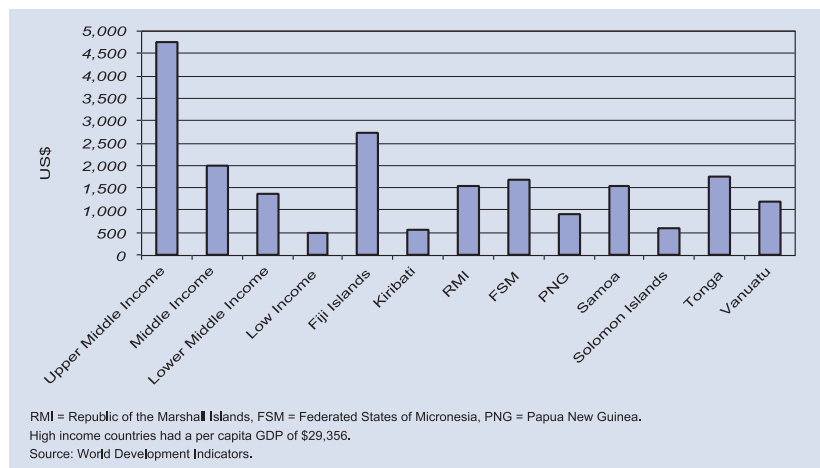
In the Pacific, institutions such as those operating both the legal and financial systems are weak. However, they provide the foundation for private sector activity and are fundamental to private sector growth. In addition, transaction costs are high and there are many barriers to entry for small businesses. Accurate information, however, that identifies precisely the shortcomings and transaction costs facing businesses is inadequate or unavailable in most countries in the region. This publication, therefore, suggests that a trial and error approach that analyzes in detail the conditions facing the private sector on a country-by-country level—not only for the four study countries—will help reveal appropriate private sector development strategies for these countries and for the region as a whole. This approach implies that detailed private sector analysis is a prerequisite for the successful design and implementation of private sector projects.

Given the importance of the operating environment that exists for firms, this publication suggests ways in which the state can commence the task of identifying and removing the most costly barriers to business formation and growth. It emphasizes that the private sector cannot prosper in an environment that does not provide easy access to capital and financing for entrepreneurial activity and it looks at ways in which the state can encourage financial intermediation including contract enforcement, dispute resolution, and the growth of capital markets. This publication identifies the public goods necessary to support business activity, including the provision of infrastructure and the regulation of enterprises at various levels of government, as well as the rationale and limits of public initiatives, particularly with regard to market failure, information asymmetry, and market imperfections.

# IV. Characteristics of the Pacific Countries

As far as economic development is concerned, the Pacific countries mostly fall into the lower middle-income category. The islands are unique, but have inherent similarities given the geographic reality of being small island nations, relatively isolated from the rest of the world. These similarities give rise to issues that the small island nations<sup>12</sup> of the Pacific must surmount if they are to provide economic opportunities for their citizens and encourage economic growth (Charles 1997). The reason these characteristics are important is that the performance and development of the private sector is dependent on them. We will now review these issues to provide the context in which the private sector operates in the Pacific.

Figure 1. Comparative GDP Per Capita, Constant US\$, 2001



<sup>12</sup> There is no single accepted definition of a small country because size is relative. For our purposes we shall use the Commonwealth Secretariat threshold of 1.5 million persons, but will also include Papua New Guinea as it shares many of the same characteristics of smallness.

Figure 2. Sectoral Breakdown of GDP, 2001

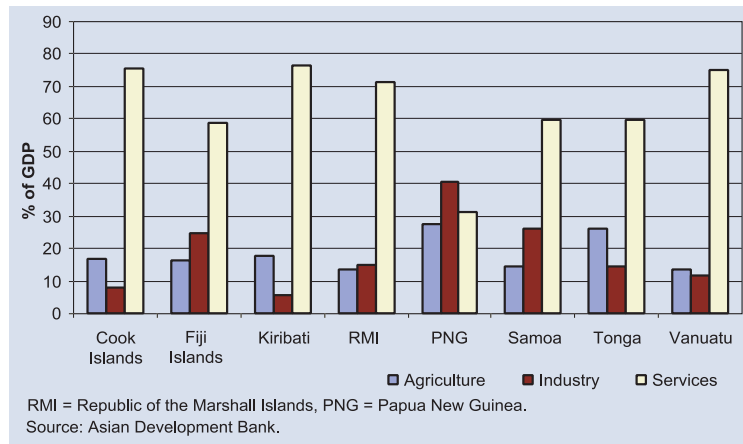


Table 2. Human Development Indicators, 1998

Country	Adult Literacy (%)	Combined Gross Enrollment (%)	Life Expectancy at Birth	GDP Per Capita (US\$)	HDI	Global HDI Rank
Palau	91.4	83.4	69.0	8,027	0.861	46
Cook Islands	93.2	84.8	72.0	4,947	0.822	62
Niue	97.0	83.6	74.0	3,714	0.774	70
Fiji Islands	92.9	81.3	66.5	2,684	0.667	101
Nauru	95.0	79.5	58.2	3,450	0.663	103
Tonga	99.0	83.3	68.0	1,868	0.647	107
Samoa	95.7	85.7	66.6	1,060	0.590	117
Tuvalu	95.0	74.0	67.0	1,157	0.583	118
FSM	71.3	71.4	65.7	2,070	0.569	120
RMI	74.4	71.7	65.0	1,182	0.563	121
Kiribati	92.2	67.8	61.6	702	0.515	129
Vanuatu	33.5	57.4	65.8	1,231	0.425	140
Solomon Islands	30.3	34.7	64.7	926	0.371	147
PNG	28.2	28.6	54.0	1,196	0.314	164
Tokelau	91.0	88.3	69.0	n.a.	n.a.	n.a.

FSM = Federated States of Micronesia, RMI = Republic of the Marshall Islands, PNG = Papua New Guinea.  
n.a. = not available.

Source: United Nations Development Programme (UNDP). 1999. *Pacific Human Development Report 1999: Creating Opportunities*. Suva: UNDP.

## Small Size: Issues and Implications

### *Small Population*

Small islands usually also have small populations, which by definition experience less innovation because there are fewer people to innovate. Further, a cultural dimension of small size in the Pacific is the dominance of village customs that seek to impose a conservative/traditional mold on the village community. Innovators or nontraditionalists can only prosper if they escape this stultifying environment (i.e., by emigrating). In addition, successful businesspersons are required by custom to share their rewards with extended family and church, thus imposing a further “tax” on innovation.

The population of many Pacific countries has been negatively affected by emigration as people leave to pursue opportunities elsewhere. But as the loss of human capital is driven by the economic situation, it creates a vicious cycle as the best people leave and make the situation worse. This phenomenon is particularly detrimental to the private sector, whose dynamism is largely dependent on the entrepreneurs of which it is comprised. As those entrepreneurs leave, so declines the dynamism of the private sector. This departure also impacts those entrepreneurs who choose to stay, as they have a smaller group from which to learn skills and with which to compete. In addition, firms in the private sector are small because they cannot realize economies of scale, are not

**Figure 3. Population of Select Pacific Countries**

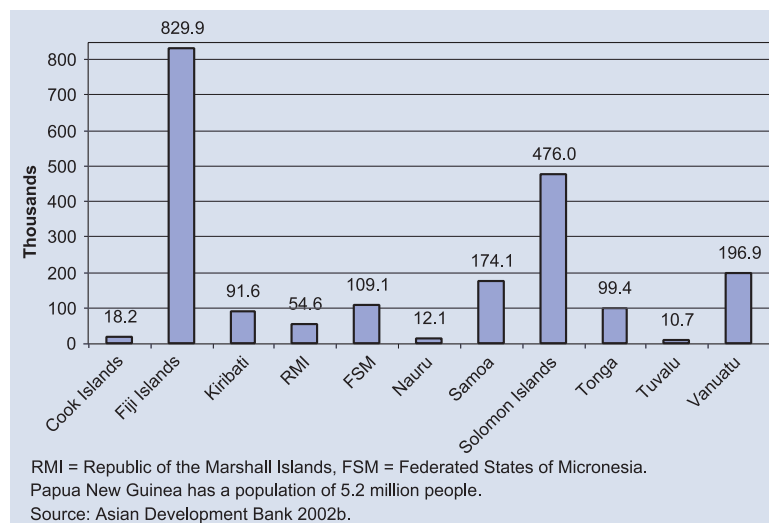
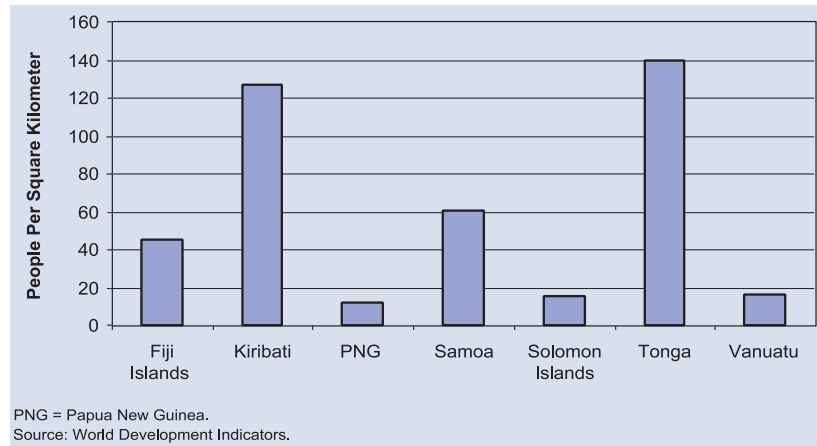


Figure 4. Population Density, 2001



attractive business partners, cannot spend on market intelligence, and cannot invest in new skills and technologies. A weak private sector may even limit the absorptive capacity of small island states for both aid and investment. Because of its size and isolation, the private sector may also lack the skills to generate innovative projects and proposals, or to even manage aid projects financed by donors.

A small population means that the per capita cost to the state is higher.

A small population means that the per capita cost to the state is higher. A small state still needs the same institutions that larger states do, but there is a small population over which to spread the cost and a smaller population from which to draw civil servants. There are economies of scale in operating public services, formulating policy, undertaking regulatory, justice, and foreign affairs activities

that small economies cannot capture. Thus, the per capita cost of the apparatus of the state is higher for small island economies, implying that taxes must be a higher proportion of income than in countries where economies of scale are captured. Further, the quality of civil servants (the working population as a whole) is undermined by the “brain drain” of skilled or educated workers seeking better opportunities abroad.

### ***Small Local Market***

These small populations also have implications for the size of the indigenous market, which by definition is limited in size. The small per capita GDP of many islands also limits the purchasing power of an already small population,

which again negatively affects market size. These size issues all impact producers who are unable to capture economies of scale since the local market is unable to support it. This results in only a few importers entering the market, often putting these companies in a position of monopoly or oligopoly, as in the case of supermarkets.

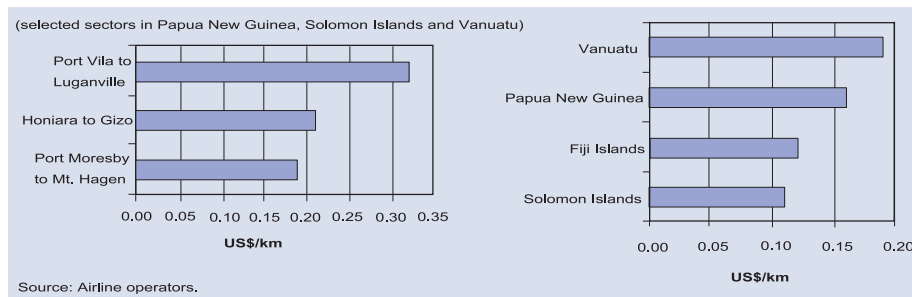
These limitations on producers and importers raise prices, restrict competition, and thus reduce the dynamism of the economy. Small size also means that the resource base of many Pacific nations is restricted. As a result, most Pacific economies have a narrow range of production and exports, and a high concentration of economic activity in one or two products. This concentration exposes them to greater income volatility than larger, more diversified economies. Unfortunately, lack of diversification is associated with high-income volatility because fluctuations in world prices of the dominant product or service impact a larger share of GDP than in the case of a diversified economy.

High transport costs are equivalent to a tax on exports and imports, an obstacle that must be overcome if island economies are to compete effectively with other countries.

### Remoteness and Geographic Dispersal

The Pacific countries are isolated from major markets and many are a collection of small islands scattered over hundred and sometimes thousands of kilometers of sea.<sup>13</sup> This characteristic has significant economic and administrative implications. The economic impact takes the form of both high transport costs resulting from the inaccessibility of foreign markets and small cargo volumes.

**Figure 5. Unit Cost of Air Travel Regionally and between Sydney and Select Pacific Countries, 2001**



<sup>13</sup> Kiribati, for example, has a landmass around the same size as St. Lucia spread over an area approximately that of Western Europe. Its nearest market is Hawaii, 4,000 kilometers away.

Figure 6. Fuel Prices, Select Countries, 2001

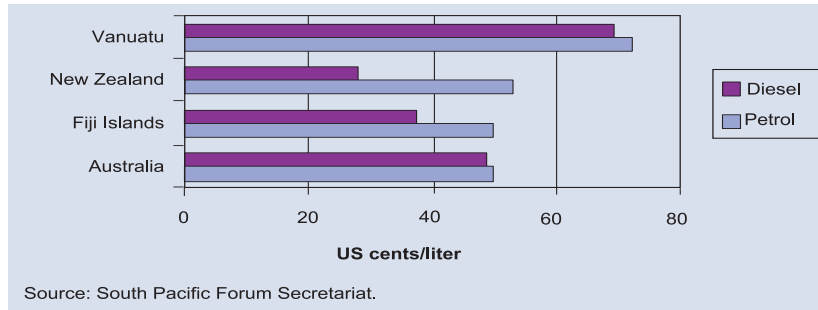
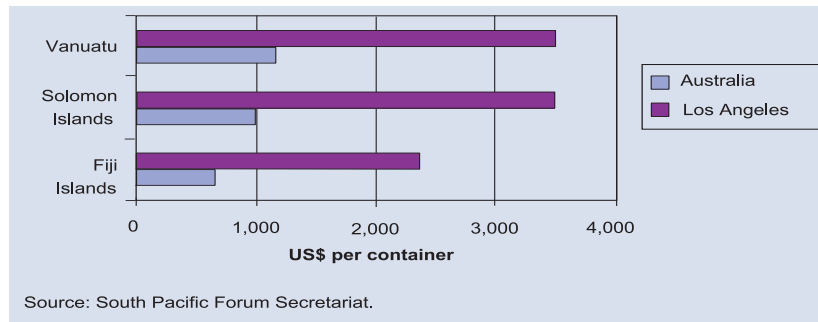


Figure 7. Shipping Rates, Select Countries, 2001



Service is often infrequent and some locations are not served at all. These high costs regularly put freight carriers and airlines in a position of monopoly, which they may try to exploit and thereby further increase costs. High transport costs are equivalent to a tax on exports and imports, an obstacle that must be overcome if island economies are to compete effectively with other countries. From an administrative perspective, the remoteness and geographic dispersal makes governance and the provision of public goods more difficult and costly. At the same time, the cost for tax enforcement increases.

### *Susceptibility to Natural Disasters*

Small islands are inherently more susceptible to climatic and natural events, and most in the Pacific have experienced natural disasters that have affected the entire population and economy. These events include cyclones, floods, earthquakes, tsunamis, and droughts. Such events destroy income and development opportunities, and add an additional element of risk to local businesspeople, the government, and foreign investors. The United Nations

Disaster Relief Organization has estimated that the impact of natural disasters on small island economies has entailed costs in excess of 28% of their GDP. The 1989 cyclone in Vanuatu, for instance, resulted in economic losses equivalent to twice its annual GDP, while the 1997–1998 El Niño drought in PNG affected every inhabitant, left 40% of the rural population in a state of “extreme food shortage,” and reduced per capita GDP from \$1,150 to \$950 in 1997 (World Bank 1998a). In the Fiji Islands, it is thought that natural disasters halved GDP growth between 1982 and 1994—an assessment made prior to the drought in 1997/98, which was the worst calamity it experienced within the given years (ADB 2000a).

### *Limited Access to Capital*

The increased risk of natural and climatic events negatively impacts the private sector by increasing the cost of capital and limiting access to capital and foreign investment. While most Pacific economies are open and stand to benefit from foreign investment, private capital markets perceive small island states to be riskier than larger states, resulting in higher spreads and more difficult access to capital. Some have high levels of public and private indebtedness, which virtually precludes commercial borrowing, and even those with low levels of external debt find commercial borrowing difficult. For a financial institution, lending has many fixed costs—to gather information on creditworthiness, monitor disbursements and repayments, and enforce payments—making the unit cost of a large loan considerably lower than that of a small one. The higher cost of small loans to small economies must then be recouped through interest rate spreads.

For a financial institution, lending has many fixed costs, making the unit cost of a large loan considerably lower than that of a small one.

Foreign direct investment (FDI) is critical in linking more isolated economies to state-of-the-art technology. Moreover, foreign firms are a source of know-how for upgrading the private sector. While some small states receive significant inflows of FDI, most Pacific economies receive less per capita than average. In addition, net private capital flows are either approximately balanced or negative (Table 3). This situation implies that rates of return on capital are not high enough to maintain capital within the region. Small states are especially at a disadvantage in attracting FDI. This disadvantage exists for the same reasons that commercial lenders reject lending to small states even when those states have open economies and sound investment policies—the risks are higher and the returns not commensurate (Collier and Dollar 1999).<sup>14</sup> Better alternatives can

<sup>14</sup> Collier and Dollar have estimated that small states are 28% more risky than the average of all developing countries.



**Table 3. Foreign Direct Investment Outflows (US\$, Million)**

	1996	1997	1998	1999	2000
<b>Fiji Islands</b>	-97	567	569	-131	-100
<b>Marshall Islands</b> (Net private capital flows)	-31.2	-6.0	-1.2	-16.8	-14.7
<b>Papua New Guinea</b>	-76	-74	285	170	-56
<b>Samoa</b>	33	n.a.	-25	-33	-56
<b>Vanuatu</b>	n.a.	50	-33	19	n.a.

n.a. = not available.

Source: Asian Development Bank.

be found in larger, more robust, less-isolated countries. This implies the obligation for Pacific island governments to do everything possible to reduce the risks perceived by foreign investors. Likewise, international financial institutions have the responsibility to ensure that market information is made available to potential investors. This could be done directly by publishing the information themselves, or preferably, by helping strengthen the statistical gathering and analytical ability of local institutions.

### ***Reliance on ODA and Remittances***

Many Pacific states are heavily dependent on flows of official development assistance (ODA) to finance their development program, recover from shocks, or even to finance recurrent government expenditures. This heavy dependence on ODA has implications for the real exchange rate. While Pacific states have received a larger amount of ODA per capita than other developing countries, the flow of ODA to small states has fallen by 30% in recent years (1997–2001) compared with a 24% decline of ODA overall.<sup>15</sup> The effect of the decline in ODA on rates of growth and development has not been estimated, but is expected to be significant. These countries' balance of payments is also impacted by an often-heavy reliance on remittances from expatriates sending money home from abroad.<sup>16</sup>

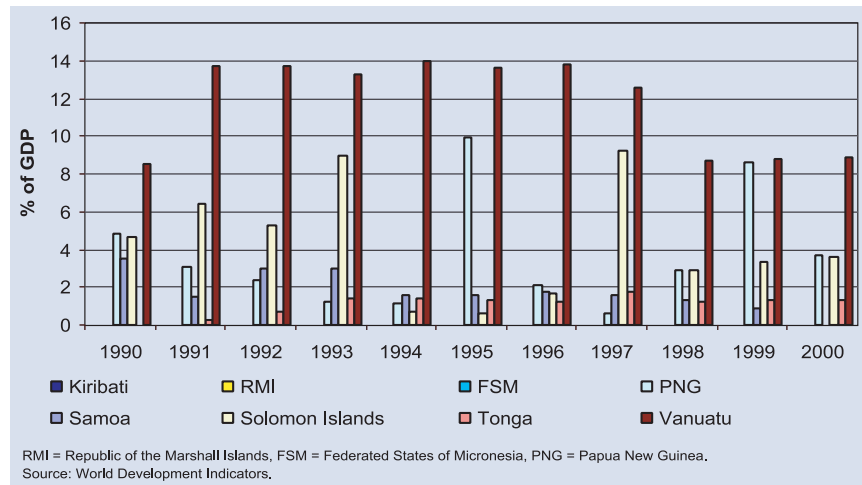
### ***Large Presence of the State***

It is often assumed that given the small size of these nations, the state has a large role to play in many Pacific economies. But state involvement in the economy as well as service provision has failed in the Pacific for the same reason it has failed elsewhere—government ownership and management provides weak incentives for efficiency and good customer service. Many islands have undertaken a

<sup>15</sup> World Bank database.

<sup>16</sup> In Samoa and Tuvalu, remittances average around 19% of their respective GDPs.

Figure 8. Foreign Direct Investment, Net Inflows (% of GDP)



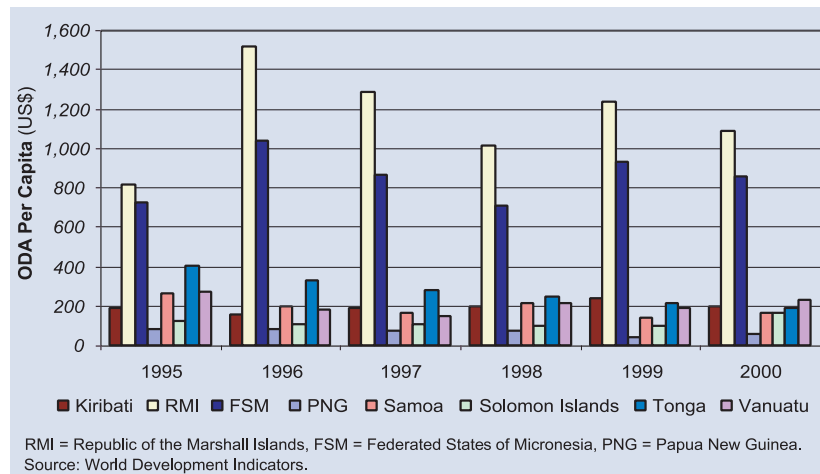
privatization program and have reduced state involvement in the economy (e.g., in the Cook Islands, public enterprises in terms of its share of GDP decreased from around 13% to less than 6%). However, further progress remains to be made. The degree of government involvement in Pacific economies creates inefficiencies by increasing costs to the private sector and hampering growth. Furthermore, it is also widely recognized that competing requirements for infrastructure investment on the one hand, and the need for budgetary probity on the other, can frequently lead to insufficient investment when the state both owns and operates infrastructure providers.

The state does have a role to play in the economy in providing public goods and correcting market failures. But in terms of its relationship with the private sector, it must play a relatively hands-off role other than providing the enabling environment. It does this through enabling legislation such as limiting taxation, developing favorable land policy, ensuring the consistency of government decisions, reducing transaction costs for business, and ensuring the security and enforceability of private contracts. Beyond this role, the state begins to negatively impact the private sector and thereby reduce economic growth.

A related issue is the quality of governance. Governance in the region varies but is generally weak. Democratic procedures, citizen consultation, and transparency in decision making are fragile. Political and country risks in the region are

State involvement in the economy has failed in the Pacific for the same reason it is has failed elsewhere—government ownership and management provides weak incentives for efficiency and good customer service.

Figure 9. Per Capita Official Development Assistance



either very high (e.g., Papua New Guinea and Solomon Islands), high (e.g., Fiji Islands and Vanuatu), or moderate (e.g., Samoa). Political scandals and uprisings are common, and often go unpunished or unresolved.

The state does have a role to play in the economy in providing public goods and correcting market failures.

In addition to the many other disadvantages mentioned, the effect of weak governance is that the Pacific region is often seen as both an unsafe and uninviting area for foreign investment. Poor governance is further manifested in inefficient or misallocated public investment, which has long-term detrimental effects on private sector development. Insufficient allocation of public funds to human resource development, starting with primary education, leads to high levels of illiteracy and poor general skills levels, thus limiting the potential for development of the private sector.

## Myths Concerning Small States

It is often thought that small island nations present a unique case for both governments and the development community because of the inherent qualities of being an island. But many problems appear exaggerated and their adverse economic consequences arise not from the natural features of islands, but rather, from ill-advised policies that purport to address them.<sup>17</sup> In fact, many islands

<sup>17</sup> There remains a palpable tension between traditional and modern choices. The PDMCs are like an elderly person stuck straddling a barbed-wire fence, with one foot on the modern side and the other foot on the traditional side. Whichever way the fall, it will surely hurt.

in the Pacific have unique agro-ecological features and climatic conditions that provide them with competitive advantages over other nations. Despite having a limited landmass, its natural resource base includes fisheries and other marine resources, forests, arable land, and preserved areas suitable for ecotourism (World Bank 1998c). However, this land is poorly developed. Nevertheless, many small countries from a wide variety of cultural, economic, political, and geographic settings (e.g., Bermuda, Iceland, Mauritius, and Norfolk Island) have recorded success at overcoming these disadvantages.

Reporting on small developing economies worldwide,<sup>18</sup> Easterly and Kraay find that island states with populations of less than 1 million are better off than larger states for the following reasons.

- Their GDP per capita is higher than other states.
- They have higher productivity growth rates despite the common misconception that their size limits their ability to exploit increasing returns to scale. In fact, small population size does not decrease growth overall. It only increases population cohesion, which aids in adaptation to change.
- They rely more on trade and generate more rapid growth than other states despite experiencing more volatile growth rates (Easterly et al 1999).

“We have no other option than to try to be smarter than the others.”

Furthermore, Armstrong and Read found that advances in transport and communications technology have helped offset the “smallness” and “remoteness” issues that many small states face (Armstrong et al 1998), which reinforces the importance of ensuring the availability of low-cost transport and communications infrastructure in the Pacific countries.

Small states do experience greater growth volatility. Easterly and Kraay attribute this volatility to increased openness to trade and a higher-than-average trade to GDP ratio, concluding that the benefits of openness outweigh the negative impacts of the higher volatility on growth. Concentration in fewer goods/products and markets also increases volatility, thus the need for policies that encourage diversification. However, the volatility in growth does not correlate with the growth rates experienced by the world as a whole. As can be seen from Table 4, the Pacific countries failed to witness the same positive growth experienced across the globe in the last 10 years.<sup>19</sup>

<sup>18</sup> They included four states from the Pacific: Fiji Islands, Samoa, Solomon Islands, and Vanuatu for which 10 years of GDP data were available.

<sup>19</sup> Note that this observation does not mean that if world growth declines, growth in the Pacific will increase.

Table 4. Correlation Matrix of GDP Growth, 1990–2000

Correlation Matrix	Fiji Islands	Marshall Islands	Micronesia, Fed. States of	Papua New Guinea	Samoa	Solomon Islands	Tonga	Vanuatu	World
Fiji Islands	1.000	0.098	-0.279	0.333	-0.078	0.403	-0.219	-0.548	-0.140
Marshall Islands	-0.098	1.000	0.580	0.023	-0.328	0.403	0.314	0.129	-0.379
Micronesia, Fed. States of	-0.279	0.580	1.000	0.406	-0.073	0.221	0.399	0.618	-0.671
Papua New Guinea	-0.333	0.023	0.406	1.000	-0.172	0.459	0.205	0.249	-0.417
Samoa	-0.078	-0.328	-0.073	-0.172	1.000	-0.507	0.115	-0.407	-0.003
Solomon Islands	-0.403	0.043	0.221	0.459	-0.507	1.000	-0.266	0.185	-0.227
Tonga	-0.219	0.314	0.399	0.205	0.115	-0.266	1.000	0.305	-0.128
Vanuatu	-0.548	0.129	0.618	0.249	-0.407	0.185	0.305	1.000	-0.138
World	-0.140	-0.379	-0.671	-0.417	-0.003	-0.227	-0.128	-0.138	1.000

Sources: Enterprise Research Institute and World Development Indicators online database.

### Box 3. Mauritius: Small, Isolated, Successful

Mauritius is a small island nation in the Indian Ocean, east of Madagascar. It has approximately 2,040 km<sup>2</sup> of land and 1.2 million people. At independence in 1968, its economic prospects looked weak with a per capita GDP of US\$260, high unemployment, and heavy dependence on sugar exports (34% of GNP, more than 95% of total export earnings, and over 50% of total employment). It now enjoys a per capita GDP of \$3,800 and a GDP growth that has averaged over 6% for the last decade. Much focus has been placed on its trade regime (the export processing zone) as an engine of growth. However, the World Bank recently noted:

Mauritius' success over the past 20 years can be attributed to the social cohesion it has achieved in favor of growth, the strength of its institutions, the effectiveness of its implementation and governance, [as well as] a reliable and independent judiciary. This has enabled it to adapt fully to and take advantage of export opportunities in sugar and textiles ... the country is also proof of what can be achieved in Africa given strong political commitment and investment in people and the economy.

Mauritius has also made an effort to diversify, and the economy now has three main pillars: manufacturing, agriculture (sugar now accounts for 7% of employment, 7% of GDP, and 14% of total exports), and tourism. The Government is looking to further expand the services sector by building up the financial services sector.

Tourism in Mauritius has developed gradually over the years, since the early 1970s, to become one of the main growth sectors of the economy. The natural advantages of the country, the friendly people, the high standards of hotels, and political stability are among the factors that have made Mauritius a quality destination for tourism.

The Government has made a concerted effort to balance economic development with environmental preservation for the tourism industry. The country's development strategy includes more investment in the tourism industry (e.g., training, development of the airline, continued environmental sustainability, and inland and ecotourism development).

In a 2001 interview, the Mauritius' Minister of Economic Development said: "Tiny Mauritius has got a very forward approach to regionalism. We want to be the most enthusiastic reformer around, the most enthusiastic liberalizer, and the most enthusiastic regionalizer. That is because we have no other option than to try to be smarter than the others."

Source: World Bank Press Release and the Mauritius Chamber of Commerce.

Small states tend to be financially closed and therefore do not take advantage of the risk diversification afforded by international capital markets. The suggestion is not that financial openness is the answer to growth volatility, but that it helps in insuring against shocks.

Though small states differ from large ones, they should receive the same policy advice as large states. This means that island nations must create an enabling environment for the private sector and be treated by IFIs in the same way as larger developing countries. In other words, the growth lessons from all countries are equally applicable to small states.

# V. Main Issues Faced by the Private Sector in the Pacific

The private sector can only flourish and create employment opportunities if the environment in which it operates is conducive to business. Frequently, governments—deliberately or inadvertently, directly or indirectly—create an environment that adds to the costs of doing business, reduces profits, and discourages dynamism and entrepreneurship. One of this publication's main themes is that state intervention, under the guise of promoting growth, has introduced constraints and distortions that in fact make private sector development more difficult, having the opposite effect than what was intended. Furthermore, state intervention has resulted in rates of return on capital that are below what would be acceptable in most growing economies. Interest rates of return relative to the high interest rates that prevail make relatively few projects profitable in the Pacific economies. The result is that private capital is exported, seeking higher rates of return elsewhere; and the development banks end up subsidizing projects in the countries themselves. The answer to this conundrum is not to lower or subsidize interest rates, but to raise the rates of return on capital.

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## State Interference

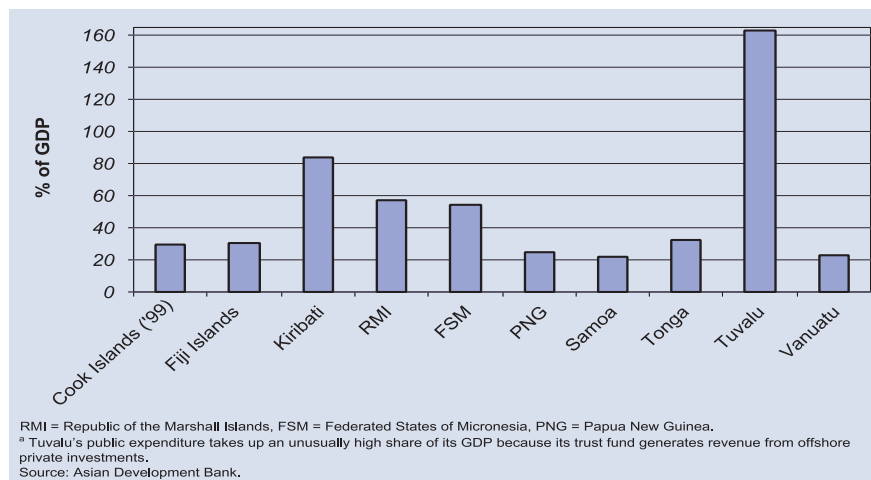
The size of government, as measured by the ratio of government expenditures to GDP, is greater in the Pacific than others in the developing world. In some countries, the ratio of government expenditure to GDP is close to one. (The average for the region is nearly 30% versus less than 14% for other developing countries.) To some degree, this percentage may reflect the higher average cost of producing public goods in small economies, but despite allowing

for this, the presence of government in the Pacific island economies is unusually large.

While Pacific countries exhibit a strong government presence, they also have burdensome regulatory regimes in place as well as a large number of business enterprises owned by government. Neither of these characteristics is captured in expenditure numbers and so the level of state intervention is even higher than what is measured.<sup>20</sup> At the same time, the large and heavy “footprint” of the state often goes unquestioned. However, in view of the state’s propensity to crowd out private sector activity, along with the corresponding adverse effects on growth, the presumption of the necessity for a large state presence in small countries should be challenged.

As a general principle, it is most efficient and least distortionary to private incentives when government intervention in an economy is minimal. For instance, the public finance practices of today look for every opportunity to reduce state involvement in commercial and public goods activities. Where public goods require public finance, the current approach to public sector management suggests separating financing from the delivery of service, and introducing—where possible—competition-based private sector participation in service provision, even if it is financed by the state.

Figure 10. Government Current Expenditure, 2000 (% of GDP)<sup>a</sup>



<sup>20</sup> Unless state-owned enterprises are provided with direct budgetary support, in which case it will be included in the measurement.



While the unit cost of producing public goods on a small scale is high, a large body of research on the Pacific shows that government and private monopolies that are inadequately regulated and whose markets are closed to contestability produce services at unnecessarily high costs. An improved regulatory regime that allows for competition and the rapid adoption of technical change, combined with the sale or liquidation of government-owned commercial businesses, would greatly lower costs, and decrease the size of the state.

As for the argument that economic volatility requires a larger state presence to cushion shocks, sound macroeconomic and sectoral frameworks would provide policymakers with more room to maneuver when the shocks hit. Better governance, minimal corruption, better (lighter) regulation, and increased competition would boost capital inflows while reducing economic volatility. The private sector would be a larger component of the economy and as such, assist in the reduction of volatility.

## Relationship with the Public Sector

The private sector in most Pacific countries is partially crowded out by the dominant presence of the state. Frequently, a public commercial bank and a public development bank dominate the banking sector. And a large public department of civil works or a roads department comprises the construction sector. In their absence, the private sector would be larger. Substantial evidence on the inefficiencies of the latter is provided in the Marshall Islands where the Department of Public Works was disbanded with ADB support. Public works programs were then financed by the public sector, but performed by the private sector. However, for political reasons, the department was reestablished and efficiencies again declined.

Electricity generation and distribution are mostly state monopolies, as are telecommunications and water supply. The state also owns and operates critical infrastructure such as ports and airports. In addition, governments in most island states participate in conventional commercial activities. For instance, in Samoa, even after significant divestiture, the State owns, among others, the power company, the water utility, the airline, a shipping line, an insurance company, and an agricultural supply business, and is a shareholder in the brewery, two computer companies, and a logging company. In Tuvalu, the Government owns both the national bank and the Development Bank of Tuvalu, the Fishing Corporation, the electric and telecommunications companies as well as the media corporation (ADB 2003f). In the Marshall Islands, the state

controls interisland shipping, owns the energy company, the telecommunications authority, the water and sewerage company, an interisland airline, a hotel, a dry dock, the postal service, a development bank, the airport authority, and so on. The same pattern holds throughout the Pacific. Ownership is based on the notion that without government intervention, such basic services would not exist.

The effect of such extensive government ownership is twofold. Not only is the private sector crowded out from participating in these activities, it also raises the cost and lowers the profitability of businesses to the extent that the state-operated businesses are poorly run and provide higher-than-necessary inputs to the business sector. The presence of the state can be likened to a tax on development. Business opportunities and jobs are not created at the rate they would be in the presence of a smaller state. Furthermore, even a smaller state can retain ownership of resources while contracting out to the private sector through competitive bidding, thereby increasing efficiency.

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There appears to be a poor appreciation of this dynamic by policymakers in the Pacific countries. Rather, the common conception seems to be that the state is simply substituting for the private sector where the private sector has been slow to show interest. The chamber of commerce surely has a role in advising government on private sector interest in certain economic ventures.

It must also be said that the generous per capita development assistance to the Pacific over many years (Figure 9) has provided policymakers with a financial cushion allowing them to forego examining and making decisions on difficult issues such as the role of the state in a modern economy. In some sense, funding agencies have aided and abetted the large presence of the state and inhibited the development of the private sector.

The situation does show evidence of change, however. Funding agencies are increasingly supporting governments in the development of their private sectors through both policy dialogue and lending—and some governments are responding. In Samoa, for instance, the 1996 Statement of Economic Strategy laid the foundation for a partnership between the Government and the private sector, and there continues to be commitment to this agreement. The Samoan Government sees its role as establishing the enabling environment for the private sector. But even with progress, much still remains to be done, and some of the more difficult aspects—such as the sale and regulation of SOEs and land

reform—have been delayed. It will be difficult for the private sector to perform at its full potential and create jobs at the needed rate until these aspects are resolved.

## Public Goods

The state is failing to supply public goods that underlie effective and efficient private sectors, such as secure property rights, a legal system that allows contracting with confidence, efficient and low-cost infrastructure, as well as clear and efficient regulations. Therefore, there exists a Pacific paradox where states are often not doing what they should do, and are doing what they should not. The behavior of the state is a primary contributing factor to the low rates of return on capital.

## High Costs

All of these factors combine to create a high-cost operating environment for business. This issue is echoed by the PSAs conducted in the four study countries, where the most common complaint from businesspeople was the high cost of conducting business. Part of the problem arises from the natural characteristics of the countries:

- remoteness from foreign suppliers adding to the unit cost of inputs;
- small markets that mean enterprises cannot capture economies of scale;
- corresponding high costs of distribution channels and wholesale operations that use market power; and
- long communication lines with infrequent air and shipping services.

It is undoubtedly true that these factors present problems to businesses in the Pacific. Nevertheless, companies in small economies elsewhere have managed to overcome these obstacles. In the Pacific, however, the effects of isolation and size are often compounded by misguided government intervention that further pushes up costs and reduces competition, the most important of which are

- high and variable import tariffs with numerous, often nontransparent, exemptions;
- inefficient and poorly regulated government monopolies; and
- a pervasive state presence in business that results in the crowding out of the private sector.

When the costs of doing business are high, firms are discouraged from establishing or expanding. Businesses that can pass on costs, such as those producing nontraded goods or protected import-replacement goods, predominate. However, export-focused businesses, which must compete globally, tend to be fewer, smaller, and be extractive industries based on natural resource endowments such as fish or minerals.

Little can be done to escape the costs associated with remoteness or smallness, but the regulation of business to minimize monopolies, the careful regulation of the monopolistic elements of businesses that cannot be made contestable, and having offshore regulators to avoid regulatory capture, are all within government's control. In these areas, the Pacific should strive to introduce international best practices, providing an environment conducive to private sector development.

The effects of isolation and size are often compounded by misguided government intervention that further pushes up costs and reduces competition.

## Transport Issues

One of the consequences of smallness and remoteness experienced by all Pacific countries is the cost of air and surface transportation. Unit costs are high because of distance from international markets, and small volumes often put freight carriers and airlines in a position of monopoly. In addition, low volumes of interisland traffic within a country make road transportation and coastal shipping costly. High transport costs are equivalent to a tax on all products. They raise the costs of doing business—costs that must be overcome if island economies are to compete effectively with others.

Because of these disadvantages, Pacific economies must do all they can to keep transport costs low. Currently, several states own and operate airlines, a business that is often high cost/low margin, provides unreliable service, and drains the country's treasury. If an airline is required for strategic reasons, a more efficient way to provide the service might be to auction off the rights for the provision of a specified level of service to existing private airlines.<sup>21</sup> Likewise, regulations that restrict coastal shipping to domestic companies raise the cost of shipping goods between the remote islands of the region's countries, harm development

<sup>21</sup> The value of the rights to provide the service may be positive or negative. If negative, the system of auctioning sets the minimum subsidy needed to provide the service. A similar approach can be used for intercoastal shipping where minimum service requirements are needed for noneconomic reasons.

in the rural areas, and encourage migration to already crowded towns. The public policy issue is how to provide the least cost shipping services to outer islands, not how to protect local shipping interests. Poorly run ports and airports with monopoly rights further contribute to transport costs. Finding ways to lower these costs will assist the private sector and ultimately the economy.

High transport costs are equivalent to a tax on all products.

The few examples here illustrate what is possible in terms of reducing the disadvantages from the long distances faced by remote and small island economies. A continual crusade to search out sources of savings in the transportation sector should be one of government's main objectives.

## Finance

The financial sectors in the Pacific are underdeveloped and provide a minimal range of banking services such as demand and savings deposits as well as limited commercial and personal loans. Often a government-owned bank dominates, being the only one providing services to nonurban areas. The days when interest rates were set by regulation, and the money supply was determined through controls on reserve ratios have now passed, but the immature banking industry is probably due, in part, to this legacy.

While there are dangers in generalizing, the following characteristics appear common to the banking system of the region.

- Banking services seldom reach beyond main urban areas.
- Commercial banks have little outreach to low-income households.
- Credit to indigenous entrepreneurs is extremely limited. There is little lending to agriculture and fishing.
- Interest rate spreads are large (with some exceptions).
- Microfinance programs are beginning to emerge but are still in their infancy in most countries.

The underdevelopment of the financial sector in the Pacific is connected to two important and related elements.

*The secured transactions framework.* Lending only occurs where it is possible for the banks to obtain collateral on loans. However, the system for using property as security—particularly chattels—is cumbersome, expensive, and often not available.

*The customary land system.* The system of customary land ownership presents particular challenges to lenders hoping to secure loans against property. It is possible in urban areas with freehold land, but beyond that, with few exceptions, land and leases on land are not regarded as adequate security.<sup>22</sup>

To deepen financial markets and make credit available to more borrowers, the two missing elements noted above need to be addressed. Some countries in the region have started implementing reforms, but most have not yet begun. With respect to secured transactions, the essential feature is granting priority<sup>23</sup> to a lender in collecting against some property of the borrower. This feature goes hand in hand with a legal system that permits the secured party to recover and sell the property in a timely fashion. Critical aspects to support this feature are

The underdevelopment of the financial sector in the Pacific is connected to the secured transactions framework and the customary land system.

- the law providing for the creation of an enforceable security interest against all economically important property—both tangible and intangible;
- the application of the law to all important transactions in which security interests are created;
- the cost of creating such a security interest being low relative to the value of the property;
- the enforcement of the security interest being inexpensive relative to the value of the property;
- the law and the institutions that implement the law allowing the lender to determine before the loan is made, at little cost relative to the value of the property, whether any other lender has a superior claim to the collateral; and
- the secured lender being protected from hidden claims of third parties, such as other creditors, a trustee in bankruptcy, or purchasers of the collateral.

In addition to legal reforms for strengthening the secured transactions framework, credit information is a useful adjunct for lowering the borrowing costs by providing records of payment history. It is also important that governments commit to maintaining recent reforms that freed up financial markets in some PDMCs. The long-term aim should be financial markets that effectively channel

<sup>22</sup> Either because leases are often in shorter terms than private firms need for investment decisions or banks require a secured loan.

<sup>23</sup> Priority is the process by which the lender establishes the priority of the security interest.

funds from savers to investors to promote economic development and poverty reduction. While externally funded interventions in the supply of loanable funds are substitutes for financial deepening (i.e., extending the outreach of financial institutions to new groups of customers), they are not long-term solutions and will not help develop the financial sector. The ultimate goal is to develop a self-sustaining, viable, and accessible financial sector.

The importance of microfinance and the institutions that support it is a popular subject in current development literature. Microfinance institutions are emerging in most countries in the Pacific, but with few—if any—exceptions, existing microfinance schemes do not conform to international best practices, making their long-term viability suspect. Samoa is one country where microfinance has so far been successful and continues to grow, but whether it will become self-sustaining is still uncertain. Yet, in Samoa at least, microfinance is steadily becoming part of the commercial culture. In addition, other financial institutions have emerged to provide lending to those who have “graduated” from microfinance schemes. The nascent nature of the business means that few “graduates” have yet to emerge. Nevertheless, the development of microfinance should be encouraged and piloted in other countries in the region, following international best practices.

## Natural Resource Issues

Pacific countries are heavily dependent on natural resources for their livelihood and are likely to remain so for some time. This reality makes resource management a critical issue for their economic development. Some island nations are rich in minerals and many have forest and fishery resources. The richest tuna fishery in the world is found in the South Pacific and is partly managed regionally. Most countries face issues concerning the distribution of rents from those resources, especially those related to property rights such as common property and customary ownership.

The issue of rights to use and collect rents from land is discussed in greater detail in a later section. Largely, the property rights issues on forestry and fisheries are also discussed.

Land has a spiritual value as well as productive use in Melanesian, Micronesian, and Polynesian societies and the form of customary ownership introduces considerable ambiguity regarding land rights, the distribution of rents from land, and the productivity of the land. This is a major economic issue in the Pacific that remains a source of internal conflict.

*Fisheries.* The Pacific countries have control of large sea resources—some countries have exclusive economic zones that are in the region of 3 million km<sup>2</sup>. Many have chosen to use these resources by leasing out fishing rights to foreign fishing companies. Important progress has been made recently in developing regional approaches to managing the pelagic tuna resources. Transshipment at sea has been prohibited, significantly reducing the opportunities for underreporting while at the same time increasing domestic returns. A cap has been placed on the future number of vessels from distant water fishing nations, and some member countries of the Forum Fisheries Agency (FFA) have agreed to allow access to each other's exclusion zones for domestically registered vessels. Future management of fisheries stocks and maximization of returns will depend on regional cooperation and agreements that allow the pursuit and apprehension across national waters, of illegal fishing boats. The creation of the Tuna Commission in the Federated States of Micronesia should contribute to this regional management effort. Fisheries offer considerable potential for developing domestic fishing industries, but there are many constraints to be addressed and sustainable fishing management systems need to be put in place.

Management of coastal fisheries by state and local regulation is less developed and many government-sponsored development projects in the Pacific have failed. This is evidenced by the reduction in reef fish catches and the overexploitation of high-value species such as sea cucumber, *trochus*<sup>24</sup> and live reef fish.

*Forestry.* The two key characteristics of forestry in the Pacific are poor management, resulting in unsustainable harvesting rates, and poorly structured financial returns for resource owners. Some smaller island nations have been overlogged within a few years (Solomon Islands) while others are in danger of a similar fate if they do not act promptly (Vanuatu). It is not the felling of trees for local use that is the issue, but large-scale commercial harvesting, often by foreign companies. Attention must be focused on establishing a sustainable harvesting plan, the regulatory capacity to enforce it, and a framework for the equitable distribution of royalties. Part of the plan would require long-term agreements with landowners to enforce the regeneration of forests.

All the larger island countries in the region have now developed their own code of logging practices and are in various stages of implementing or enforcing them. Fiji Islands, Papua New Guinea, Solomon Islands, and Vanuatu have undertaken forestry reviews and introduced legislation. Cook Islands, Niue,

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<sup>24</sup> Marine snail of shallow tropical reefs harvested for its thick inner layer of mother-of-pearl used for jewelry and buttons.



and Samoa are currently revising their legislation. There is a regional forest and tree program where the heads of forestry from member countries discuss policies and priorities at bi-annual meetings. In the past, individual countries have acted on some priorities, and the technical and administrative cooperation derived from the meetings is valuable. As with offshore fishing, there remains an issue concerning non-transparent practices in providing licenses and quotas.

The lessons on the management of natural resources are that property rights must be clarified in a way that ensures that competition results in the benefits of resource extraction being shared fairly between the island states and those doing the extraction.

*Minerals.* While some islands have valuable mineral deposits, the richest deposits are found in Papua New Guinea. The major mining issues include the division of royalties between landowners and government at various levels and the social issues emerging from enclave mining projects closing down, leaving many individuals jobless. The difficult environment for long-term investment that currently exists in Papua New Guinea is also an issue. Papua New Guinea is the only producer of oil and gas, and derives some royalties from that. Its adverse investment climate means that this source of revenue is also declining.

The lessons on the management of natural resources for the long-term development of the Pacific nations are that property rights must be clarified in a way that ensures that competition results in the benefits of resource extraction being shared fairly between the island states and those doing the extraction. Lack of clear property rights will hinder the fulfillment of this necessary condition. Second, the rents from extraction, which represent a payment for the depletion of capital, need to be invested in an alternative form of capital so that the aggregate capital stock of the community or country is maintained. Mining in Papua New Guinea, forestry in both Papua New Guinea and the Solomon Islands, and phosphate mining in Nauru, are examples where resource rents have been consumed and/or squandered. Despite the existing large policy and institutional gaps, willing and dedicated governments can meet the conditions. Development partners should encourage such reforms.

## Investment Policy

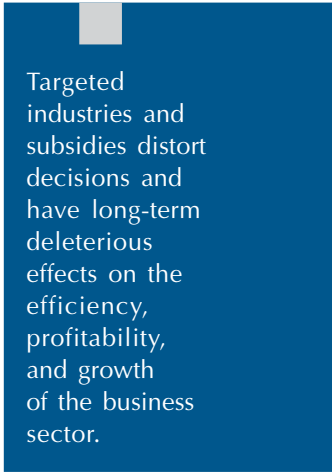
Countries reduce poverty when they undertake two fundamental actions: first, building an inviting investment climate in which private entrepreneurs will invest and generate jobs; and second, investing in the education of people so

they can participate in the economic growth generated by private entrepreneurs, and as they learn business practices, become entrepreneurs themselves.

An enabling investment climate is one with sound macroeconomic management, political stability, and trade and investment policies that promote openness, productivity, and growth. It allows for the financing of new investment at interest rates that equilibrate the supply and demand for savings. In addition, it includes good governance, promotion of competition, prevention of corruption as well as a solid foundation of basic physical and social infrastructure.

The case for creating a good investment climate is simple: without a predictable environment for people, ideas, and money to work together productively and efficiently, private investment, on which rests the hope for long-term growth and productivity, will not occur. The role of government is to provide entrepreneurs with an environment to invest in productive activities. Private firms—small and large, domestic and foreign—operating in competitive markets, are the engine of growth and job creation, and in turn, create wealth and provide opportunities to escape poverty.

From interviews with many businesspersons in several Pacific countries, it is clear that many elements of a positive private sector climate are missing. Not only are the regulations and institutions to support secure financial transactions—the lifeblood of business—missing, but also, many other regulations appear to be cumbersome, unnecessary, and serve no readily identifiable public policy purpose. Often it is expensive to establish and register a business. Incorporation is difficult. Sometimes, specific industries are targeted for assistance, while obstacles to investment, in terms of controls on the composition of ownership or the board of directors, for example, are imposed on others. Targeted industries and subsidies distort decisions and have long-term deleterious effects on the efficiency, profitability, and growth of the business sector.



Targeted industries and subsidies distort decisions and have long-term deleterious effects on the efficiency, profitability, and growth of the business sector.

### ***Why Foreign Investment Is Good***

In many developing countries, including those of the Pacific, foreign investment is a controversial subject. Foreign investors have been accused of exploiting workers and damaging the environment, of corrupting officials and making exorbitant profits. In some cases, these have occurred. Yet as international experience shows, foreign direct investment (FDI)—with its transfer of technical

and organizational skills, best practices, and market access—stimulates rapid growth in incomes for all members of society. And when international flows of capital abate, it is usually the poor in developing countries that suffer the most.

Why do we observe these differing views on FDI? Because the extent to which foreign investment can help or harm the poor depends very much on the business environment provided by governments. Developing country governments maximize the beneficial impacts of FDI when they have a sound operating framework for businesses. In particular, we maintain that a government that wishes to ensure that FDI reaches the poor should

Developing country governments maximize the beneficial impacts of FDI when they have a sound operating framework for businesses.

- allow free entry and exit in its markets to create competition in product and labor markets and give incentives to upgrade productivity;
- promote worker training, and finance infrastructure to increase domestic capacity as well as absorb new and appropriate practices introduced by foreign investors; and
- create a policy framework that encourages the adoption of appropriate social and environmental standards in corporate practices.

### ***Foreign Investment Regulation***

Most countries in the Pacific understand the importance of foreign investment but control it quite closely to avoid repeating unfortunate experiences with foreign investors. Controls are based on the understandable desire to limit the number of dubious—and at times fraudulent—projects that have occurred in the Pacific. There is the common phenomenon of the so-dubbed “two dollar investor,” a small foreign investor who comes to a country in the Pacific with limited capital and attempts to raise most capital locally for a project of dubious viability. To combat this problem, many countries have established complex, costly, and time-consuming vetting and approval systems, which discourage both legitimate investors as well as the less credible investors among them.

In practice, however, governments of the Pacific must realize that business is risky and it is inevitable that some foreign investment will fail, resulting in the bankruptcy or exit of new companies. Moreover, in practice, there are no convincing documented examples of “fly-by-night” investors, except in cases where governments have attempted to give special incentives over and above

the foreign investment regime. In fact, experience shows that the fewer special incentives that are offered, the more likely that genuine long-term foreign investment will occur. There is a risk that offering incentives will result in a “race to the bottom” and a zero or negative sum outcome. That is, if countries compete by offering incentives to foreign investments, it is unlikely that net investment in the region will rise, but rather that one country will divert investment away from another, where potential investors play one country off the other to extract the maximum concessions. In the end, the countries do not benefit. Rather, countries could race to the top by ensuring that their foreign investment environment is simple and transparent so foreign investors can quickly surmount the regulatory and administrative barriers to new investment.

# VI. Financial Markets in the Pacific

There is increasing awareness of the importance of financial markets for promoting economic development. If the financial system does not intermediate between savers and investors, the private sector has no means of financing projects (except for retained earnings and savings, which are generally limited, particularly for small businesses). Furthermore, the financial sector is a vital means of allowing wealth (assets) to be mobilized to provide liquidity for financial capital. Without intermediation, private sector development is hampered in its ability to take advantage of opportunities to invest in profitable projects, which in turn leads to reduced economic growth and poverty reduction. Therefore, the economic development of the Pacific depends largely on financial markets.

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## Financial Markets and Economic Development

Since the early 1970s, revolutionary work in information economics has shown that inefficiencies can arise when one of the transacting parties has superior information concerning the value of any transaction. In such circumstances, intermediaries play an important role. Akerlof (1970), Stiglitz and Weiss (1981), and Bernanke (1983) developed the foundation of the modern theory of financial intermediation, based on the ability of banks and other financial institutions to resolve the problems arising from the asymmetries in information between transacting parties.

The absence of financial intermediation makes evaluating the quality and performance of firms costly for investors. Because many firms and entrepreneurs solicit capital, banks and other financial intermediaries can realize scale economies in obtaining detailed information regarding firms' profitability and investment prospects, thereby greatly reducing verification and monitoring

costs. With the most promising firms and managers getting funds, improved capital allocation fosters growth.

The increasingly detailed theoretical analysis of the close relationship between financial development and economic growth has been confirmed by numerous empirical studies. See for example, Goldsmith (1969) or King and Levine (1993). Findings confirm that financial development and economic growth are closely linked and that the former may actually predict the latter. King and Levine (1993) also found that in 1960, the level of financial development in 80 different countries was correlated with the subsequent average rate of economic growth across these countries over the next 29 years. Their findings provided positive empirical evidence for the argument that financial development predicts economic growth.<sup>25</sup>

## Financial Markets in the Pacific

### *Structure*

Commercial banks predominate in the financial sectors of the Pacific. In many countries, they are foreign-owned. Australian banks are especially active in the region. Banks in general only lend to larger, well-established firms. The effect of this approach on a small firm's flow of funds is worth spelling out. Since all sources of funds—except equity, retained earnings, and trade credit—are unavailable to a small business that wishes to expand, it cannot grow as fast as it would if financial markets were better developed. Moreover, it may have to economize on inventory of all kinds and on investment in capital equipment. Therefore, decisions such as which technology to adopt in production, how much inventory to hold, and whether to expand or not, are determined by personal circumstances and not by the track record of the person running the business and his or her ability to convince lenders of sound ideas.

Compounding the problem for entrepreneurs in the Pacific is that the owner's real estate holdings usually cannot be used as collateral because of uncertainties

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<sup>25</sup> There are, however, two possible sources of error that prevent researchers from using evidence that finance predicts economic growth to conclude that it determines economic growth. First, a common omitted practice could drive both financial development and economic growth variables (e.g., the propensity of households to save). Second, financial markets may anticipate future economic growth and simply be a leading indicator rather than a casual factor. See Rajan and Zingales (1998a) and Rajan and Zingales (1998b).

#### Box 4. Lender/Borrower Transactions in Financial Markets

Several key concepts underlie the financial market structure and determine lender and borrower behavior. Relationships between borrowers and unsecured lenders are fraught with moral hazard issues, arising in situations when the parties in a contract have conflicting interests, and circumstances make monitoring difficult or costly. Self-interest then increases the likelihood that one of the parties will distort information or engage in expedient behavior. For moral hazard to be present, three conditions must be met. First, the parties undertaking the transaction must have divergent interests (e.g., a lender to be repaid and a borrower not to repay). Second, there must be opportunities for transacting that lead to a situation where the divergent interests come into play (e.g., a loan contract). Third, there must be asymmetric information—one of the parties must have better access to the facts of the situation than the other. Borrowers and lenders have asymmetric information about loans—it is impossible for a lender to know the business as well as the borrower. The borrower, therefore, has a much better idea than the lender regarding whether the loan can actually be repaid. In circumstances where the borrower bears no cost of defaulting, the likelihood of default rises. Although lenders could charge higher interest rates to compensate for the risk, problems of adverse selection then occur. That is, since higher interest rates require a higher rate of return—which is in turn associated with greater risk—there would be a tendency for people who are risk takers to predominate among the borrowers. The risk structure of the banks' loan portfolio would be biased towards high-risk borrowers. Under such circumstances, banks generally do not lend to businesses whose owners do not have clear title to large real estate holdings.

regarding land tenure. The limited alternatives available to entrepreneurs with modest personal asset holdings have profound consequences on the efficiency of their businesses and for resource allocation.

The general perception of financial markets in the Pacific is that they do not function effectively. This was confirmed by the research undertaken as part of the four PSAs examined for this publication. However, observations on the banks' manner of intermediation and the companies' financing requirements present a paradox. Several apparently contradictory factors appear to be present.

- Various reports on countries in the region as well as background documents prepared as part of external funding indicate there is a shortage of financing, especially for smaller businesses.
- The financial institutions interviewed for the PSAs stated that they had excess liquidity and that there is a severe shortage of bankable projects.
- The business communities in the countries visited complained about the high levels of real interest rates, which average around 12% per year.

- Most of the larger countries in the Pacific have had net outflows of FDI in several of the past few years (Table 3), implying that the rates of return on investment are modest at best, perhaps supporting the claims of the commercial banks regarding bankable projects.

These observations are consistent with a private sector environment that has a low rate of return on financial capital. It is not necessarily true that all potential investments have low rates of return because government may be crowding out potentially profitable projects or there are profitable projects that cannot be financed. However, the rates of return within the current private sector environment are incapable of attracting or retaining significant private capital, a situation that creates policy implications for private financial markets.

Observations on the banks' manner of intermediation and the companies' financing requirements present a paradox.

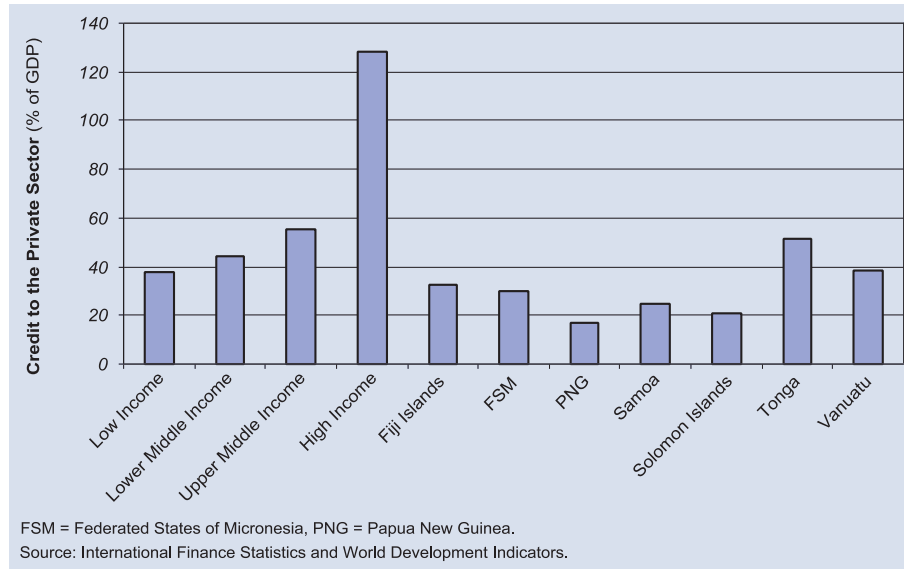
### *Characteristics of Financial Markets in the Pacific*

The financial markets of the Pacific countries are dominated by commercial banks, which tend to lend to established businesses. With the exception of Tonga and Vanuatu, the credit to GDP ratios in the region are below the average for developing countries with similar per capita GDP levels. However, in most countries (with the exception of Samoa) the bankers interviewed indicated that they have excess liquidity and could lend significantly more if there were more bankable projects.

In most cases, banks in the Pacific countries are governed by risk criteria established primarily in Australia, since commercial banking operations are dominated by ANZ<sup>26</sup> and Westpac, both Australian banks. As a result, banking practices tend to emulate those in Australia. In line with risk averse banks in the developed world, there is little lending without collateral. Since neither land nor chattel mortgages provide reliable security, the banks do not lend to any but the larger businesses and tend not to lend to locals since the bulk of their assets are in the form of communally owned land. Therefore, commercial banks in the Pacific prefer to lend against collateral, and confine the bulk of their lending to urban areas because this is where most land leases and freehold

<sup>26</sup> Australia and New Zealand Banking Group Limited.



**Figure 11. Comparative Average Credit to the Private Sector (1996–2000)**

land are concentrated, and most businesses, as well as most private households, are located.

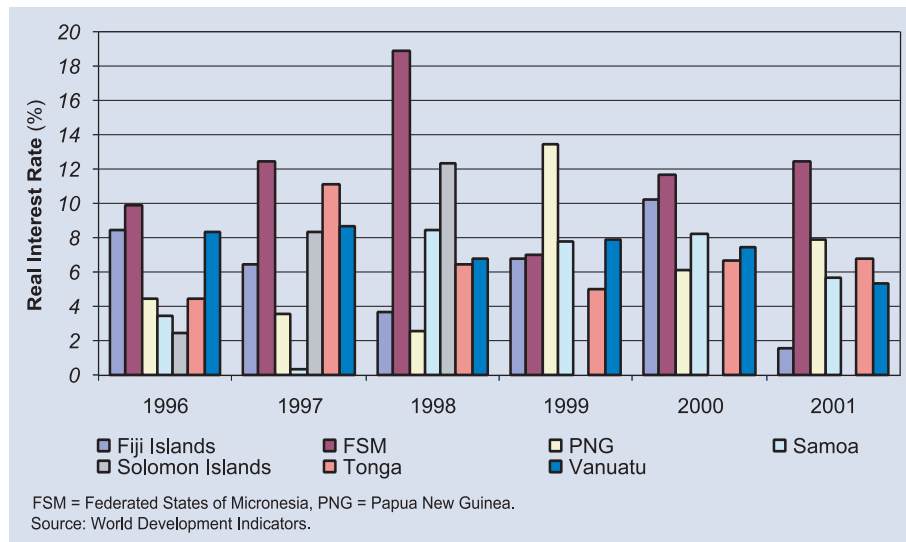
In general, the foreign-owned banks characterize the Pacific as an area where debt recovery is not easy. For example, one of the commercial banks characterized Samoa as its most difficult lending environment because of repayment issues.

For the most part, banks are interested in longer term business financing. Nevertheless, those interviewed indicated that such loans are risky given the combination of a culture where debt repayment is not accorded high priority and securing loans against assets is costly.

Credit information is another problem identified by commercial banks in the Pacific. With some exceptions (e.g., Marshall Islands), competition among the banks have resulted in little sharing of credit histories, with the result that borrowers of dubious quality can often get loans from a succession of financial institutions.

A combination of difficult lending environments combined with the inability to use collateral as security for loans has resulted in conditions in which indigenous people find it especially difficult to obtain finance from commercial banks in the region. Typically, development banks and national provident funds (NPFs) have been the main suppliers of loans to the local population. However,

Figure 12. Real Interest Rates (%), 1996–2001, Select Countries



this situation carries substantial risks for the lending institutions and the viability of pension funds, in the case of NPFs. Arrears at both types of institutions are far higher than at commercial banks, confirming that concerns regarding lending without collateral are warranted. Secured lending is the only means of dealing with the moral hazard issues. Intentions to repay must be backed up with incentives to repay.

### Interest Rate Issues

Interest rates in the Pacific are not high by the standards of many developing countries. In most countries in the Pacific, real interest rates charged by commercial banks to their borrowers are in the region of 10–12% per year. In some countries in the region, development banks and NPFs charge interest rates that are two or three percentage points lower than commercial bank rates. These interest rates are misleading, however. The theme of this chapter is that many people in Pacific countries are excluded from access to finance because of the inadequate institutions underlying financial markets in the region. The interest rates charged are not indicative of the available borrowing opportunities, as they are the rates charged to prime borrowers.

Intentions to repay must be backed up with incentives to repay.

In general, nominal interest rates embody different factors that reflect the incentives and risks faced by lenders. Commercial banks accept deposits and invest these in alternative assets. The first factor, therefore, is the cost of funds, or the rate that banks pay depositors for their funds. The second reflects the alternative investment channels open to banks. Most banks in the region invest

Interest rates in the Pacific are not high by the standards of many developing countries.

some of their funds in foreign securities, primarily denominated in either US or Australian dollars. Since the alternative is to invest locally, local interest rates must reflect exchange risk—except in cases where the US dollar is their currency (e.g., Marshall Islands and the Federated States of Micronesia). A further alternative is to invest in a country's government securities—usually the most secure of the alternatives available locally. Finally, the bank can also invest in local loans. The spreads between each type of investment embody the risk of lending. An additional factor in the Pacific is that lending and deposit rates embody some element of oligopolistic pricing because of the limited number of banks.

As noted earlier, banks are highly risk averse, which is quite understandable and probably reflects sound business practices. All the financial institutions visited indicated that in the event of default, recovery of debt presented major problems. In some countries, such as the Marshall Islands, there are no bankruptcy provisions in the commercial code, and legal proceedings can last

Figure 13. Interest Rate Spread (%), 1996–2001, Select Countries

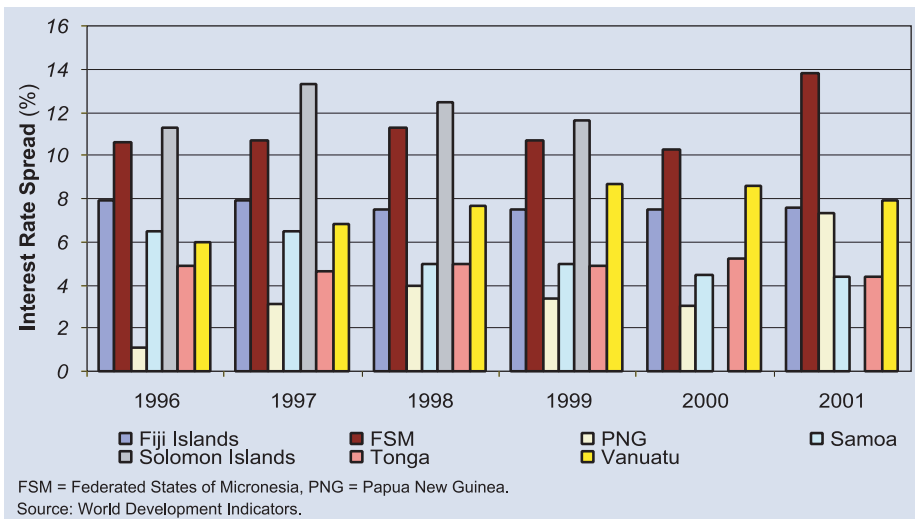
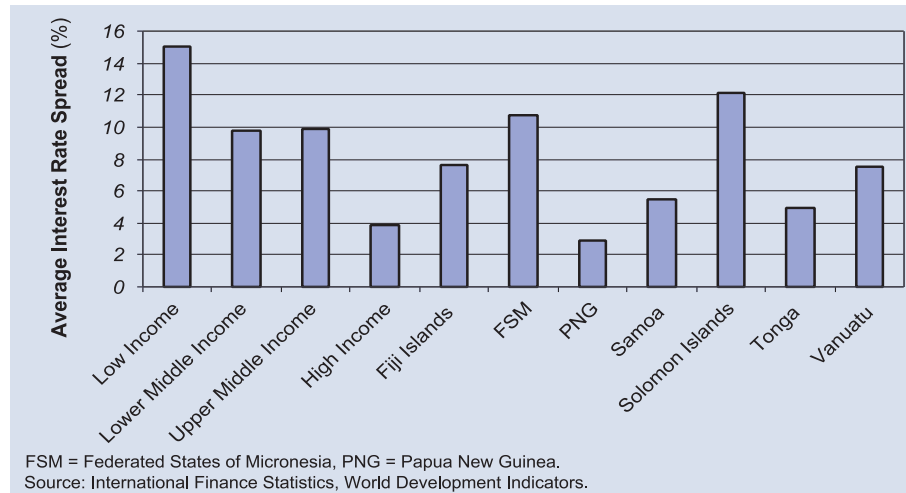


Figure 14. Comparative Average Interest Rate Spreads, 1996–2000



for many years in the event of a company's inability to discharge its debt obligations. In all the other countries visited, bankers reported lengthy proceedings to recover debt.

The result is that most banks require real estate as security. A further idiosyncrasy in the institutional structure that underlies lending in the Pacific is that most countries have a constitutional prohibition of foreigners owning land.

Interest rate spreads in the Pacific are high but less than the average for countries at similar stages of development. In most countries, the difference between borrowing and lending rates average about seven percentage points. While spreads in developed countries averaged less than four percentage points at the end of 2000, it was above 15 percentage points for the group of low income countries, which is about double that of the Pacific countries' (Figure 14). Furthermore, the data reflect lending to the most secure borrowers, as lending rates are usually much higher for smaller enterprises. This substantial interest rate spread reflects a combination of inefficiencies in intermediation and risks on loans. Overall, financial systems in many developing countries appear to be inefficient.

In the absence of detailed research, any explanations as to why Pacific countries have lower spreads can only be speculative. But as competition is not intense among the financial institutions in these countries, there must be some element of oligopolistic market power built into interest rates. The combination of lower overall lending rates and lower spreads, in contrast to other developing

countries, probably reflects the risk aversion of financial institutions in the Pacific, and shows that significant portions of the population are excluded from access to the lending aspect of the financial system.

### *Expanding Collateral*

Under the current institutional framework for lending, there is no credit available to farmers or fishermen. For agriculture, there is no legal framework in which to pledge future crop harvests, because farmers have no standing under the law to make such a pledge. Confusion over customary law and its interface with formal sector law excludes the land owned by farmers from serving as collateral.

The economic impact of collateral is powerful.

For rural enterprises, inventories and accounts receivable cannot serve as collateral unless the borrower is a corporation. This lack of access to credit prevents the growth of an important sector. It also prevents rural businesses from refinancing their unsecured sales through credit, thereby constraining potentially important

financial intermediaries from providing unsecured credit in rural areas. It also biases the system against those whose primary asset is land, which is the majority of the Pacific population. The incentives therefore increase the tendency of rural populations to move to towns, adding to the strain on already stretched infrastructure and social services in the urban areas.

### **Secured Lending**

The economic impact of collateral is powerful (Fleisig 1996 and Fleisig et al 2000). The more and better the collateral offered by the borrower, the lower the interest rate, the longer the time to repay, and the larger the loan relative to income. While detailed legal assessments of the secured transactions framework were not provided by the private sectors of the four Pacific countries analyzed here,<sup>27</sup> their conclusions show that major problems exist. Most importantly that in urban centers

- rural property—whether movable or fixed—cannot serve as collateral for loans; and
- large and economically costly gaps exist in what can be offered as collateral and who can offer it.

<sup>27</sup> ADB 1999. Table 8.1, sets out a convenient assessment of the economic usefulness of land as collateral in different South Pacific countries and recognizes the importance of problems in the legal framework for collateral in limiting access to credit.

### Box 5. The Power of Collateral

The lending terms of credit unions illustrate the effect of a secured transactions framework. In the United States, credit unions offer different loans at different terms depending on the collateral the borrower offers. For instance, they would offer a borrower without collateral a loan with an annual interest rate of about 12.5%, repayable in about 33 months, amounting to as much as 50% of the borrower's income. For a borrower offering movable property as collateral, these lenders would charge lower interest rates and offer longer repayment periods and larger loans relative to the borrower's income. For a borrower offering real estate as collateral, interest rates would drop even more, while repayment terms become longer and loans even larger relative to the borrower's income. Broadly, the more and better the collateral offered by the borrower, the lower the interest rate, the longer the time to repay, and the larger the loan relative to income. Overall, when borrowers offer better collateral to lenders, borrowers pay interest rates about 50% lower, have as much as 11 times more months to repay, and receive loans as much as 9 times greater relative to income. These changes in terms illustrate, unambiguously, the power of collateral. For exactly the same borrower—with the same income, the same credit record, the same loan committee, and often, the same credit officer—these institutions will lend more at lower interest rates for a longer period of time, if collateral is offered, than if it is not.

### Overview

For secured lending, the four Pacific countries that were the subject of the PSAs share a British common law tradition inherited through Australia, New Zealand, or the United States. In addition, Vanuatu also has some French civil code heritage. In all cases, the commercial codes are outdated. Typically, Pacific laws reflect the state of these laws in their parent country at about the time of independence.

The main instruments for providing security on a loan in these countries include the following.

*Statutory and Equitable Mortgages in Real Estate.* A statutory mortgage is filed in the real estate registry. An equitable mortgage is a contract known to both borrower and lender in which the borrower turns over ownership papers to the lender but does not transfer them or register the transaction in a real estate registry. Usually, equitable mortgages have been upheld in case law.<sup>28</sup>

<sup>28</sup> In Vanuatu, liens on property appear to be covered by the French Civil Code, which appears to still apply by virtue of section 93 (2) of the Constitution.

*Company Charge*,<sup>29</sup> including the *Bill of Sale*. This device applies to movable property owned by corporate entities.

*Hire Purchase*. This device applies mainly to new identifiable equipment.

*Leasing*. This device applies mainly to new identifiable equipment.

In the Pacific countries examined for this publication, lenders in urban areas sometimes used the company charge, but would not take collateral located outside town limits. Similarly, land could serve as collateral within large cities, but seldom outside.

It appears that the Pacific economies lack systems for effectively using important classes of property as collateral for loans. In particular, bankers and other lenders do not accept most real estate and any agricultural products (e.g., beef, cocoa, coffee, copra, fish, kava, and timber) as security. The legal framework for secured transactions does not seem to address the key stages for securing loans. In other words, no adequate system exists for allowing lenders to determine the priority of a pledge of assets nor to publicize and enforce security interests in property as collateral for loans.

The Pacific economies lack systems for effectively using important classes of property as collateral for loans.

The lack of such a system presents a major obstacle to linking savers and investors in these economies. Even when countries received substantial inflows from activities like offshore financing (e.g., in Vanuatu), or foreign remittances (e.g., in the Marshall Islands and Samoa), these possible sources of financing cannot reach most small enterprises or rural borrowers. To permit such credit delivery, the legal system must offer an efficient domestic legal framework for debtor-creditor relations in general, and for secured transactions in particular. Even if foreign

investment laws or international conventions appear to cover secured lending, these international business transactions must still use the enforcement system within the country to collect against funds or properties located there.

This section relates a preliminary analysis of the secured lending systems in the Pacific. Broadly, Pacific country legislation does not support an effective framework for secured transactions, and in fact, the secured transactions framework seems incomplete and expensive to use. Further studies should

<sup>29</sup> The company charge is the use of a claim against a company's equipment or movable property as security for a loan. The company pledges those items as a "charge" to collateralize the loan.

### Box 6. The Inherent Problem of Offshore Ventures

The smaller the economy, the more likely is it that large domestic investors will spread their risk by investing in offshore ventures. If the rate of return on capital is low, as it appears to be in the Pacific, this trend will be accelerated. Both explanations are consistent with the observed export of private capital that has occurred in most Pacific economies over the past decade.

A corollary of this phenomenon is that indigenous people with the bulk of wealth that cannot be used as collateral will neither be able to finance investment projects nor diversify their risk. They are unable to raise capital using land as collateral because the land has no value to a financial institution in a customary tenure system where collecting a debt through foreclosure is impossible.

examine this problem in detail. For instance, in Papua New Guinea, Samoa, and Vanuatu, it appears that collateral outside the main cities was unacceptable for loans. In the Marshall Islands, collateral is generally unacceptable to secure credit. Pinpointing the actual deficiencies is a specialized task for experts in security interests and, surely, more research on the details is needed. Interviews should go beyond determining permissible legal transactions and more deeply examine the economic aspects of secured financing.

The preliminary findings in the study countries show that problems in the legal framework for secured lending in Pacific economies result in the exclusion of most equipment, future crops, and much real estate as collateral because they have no economic value to lenders. This has serious implications for private sector borrowers. They typically cannot purchase such property assets on credit, and once they save to buy it, they cannot pledge it to get loans for other property or working capital. The result is that the financing of investment in either fixed or working capital is unavailable to those without substantial liquid resources. And it implies that those who have capital can choose to either continue to accumulate capital, or invest in other countries to spread their risk.

When the legal system inhibits borrowers from offering collateral, operators get much less credit than they need.

When borrowers cannot offer collateral to private lenders, Pacific lenders will react the same way as lenders elsewhere, charging higher interest rates, offering smaller loans, and lending for short periods. As a consequence, when the legal system inhibits borrowers from offering collateral, operators get much less credit than they need. In fact, operators of small farms and businesses may get no credit at all. The refusal of Pacific lenders to alter loan terms when borrowers



offer local collateral is not proof of collateral's ineffectiveness. Rather, this situation arises from problems in laws and legal institutions that govern the use of collateral in these countries.

### *Secured Transactions in the Pacific Economies*

The fundamental distinguishing trait of a secured lending system lies in its ability to grant priority to a particular lender or credit seller by collecting against some property of the debtor. Without such a security interest, a creditor is unsecured. An unsecured creditor has only a general claim against a debtor's property—a claim that gives that creditor no better right to payment than any other unsecured creditor. A legal system that supports only unsecured lending will lead creditors to lend less to any given borrower, for shorter periods, and at higher interest rates. For a system of secured lending to work, it is insufficient for property to just have value. In place must be a legal system that permits the secured party (the lender) to recover and sell the property in a way that realizes as much of the property's market value as possible.

In place must be a legal system that permits the lender to recover and sell the property in a way that realizes as much of the property's market value as possible.

In theory, in all Pacific countries, a creditor can create such a secured loan by creating a security interest against a debtor's property. If the debtor defaults, the collateral can be sold or exchanged, and the security interest of the secured creditor will be satisfied (paid) ahead of the general claims of unsecured creditors. But the mere possibility of such a security interest cannot alone secure the benefits of the system. Rather, the economic usefulness of a legal system for security interests will depend on how well that system fulfills certain key criteria. In particular, the law must provide for the following (Spanogle 1992).

*The creation of enforceable security interests.* This interest should be enforceable against all economically important property—tangible and intangible—by all economic agents and for all significant transactions. The cost of creation must be low, relative to the value of the property.

*Priority that is easily ascertained.* There must be an unambiguous assignment of the order in which secured parties satisfy their claims against the property. The law must protect the secured lender against hidden claims, including those of other secured and unsecured lenders, the government, and the bankruptcy procedure.

*The availability of information on the prior property pledging.* A simple and inexpensive system must make available to the public, information about the priority of any secured party in any security interest against any property.

*Enforcement that is rapid and inexpensive.* Repossession and sale of the collateral must be fast, cheap, and preserve as much of the value of the collateral as possible.

A preliminary analysis of the legal framework for secured transactions in the Pacific indicates that their legal framework does not meet these conditions. Often the features that cause problems have no obvious justification in public policy. Even when they do have a public policy objective, the means of achieving the objective (e.g., tax collection and the protection of workers, debtors, and tenants) can impose a high interest and other fixed fees and reduce the borrower's potential access to credit. Other policy measures could achieve these worthy objectives without compromising credit access.

Each of these stages poses legal problems that limit the system's economic usefulness in the Pacific countries. We discuss these in turn for the main security devices for movable and immovable property.

## ***Problems in Creation***

### ***Movable Property***

Movable property accounts for about 40% of the nonresidential capital stock in industrial countries. Changing the legal framework to permit this type of property to serve as collateral can provide a quick basis for secured lending as well as sales on credit to various credit-starved areas. Leasing, warehousing, the company charge, and mortgages are all examples of security devices—agreements whereby a borrower offers collateral to a lender.

For the Pacific countries, the company charge provisions comprise the main statute on security interests for movable property. This framework has several important limitations. The provisions only deal with registration rules and some narrow priority rules. The law does not address the other stages of a security interest (creation, priority with other security devices, and enforcement). These problems are common to unreformed common law jurisdictions in the industrial countries as well as in the developing world. For instance, Canada, before its reform, had a secured transactions framework based on the company charge filling some of the gaps with case law.

The company charge, moreover, cannot be used by microenterprises or most small- and medium-scale enterprises. The company charge covers only the collateral offered by corporations. It does not apply to using the property of individuals and unincorporated debtors, such as most farmers or informal enterprises, as collateral for loans.

From a preliminary assessment of these laws, the following are typical.

- Businesses can only secure loans with one lender.
- Unincorporated businesses or individuals that make up the large portion of the private sector in the Pacific countries cannot use their inventory as collateral for loans.
- No lender can safely take a business' accounts receivable as collateral.
- Large companies can secure loans with inventory that limits their financing with other lenders.

What is left for secured lending? Large and small companies can use hire purchase provisions to buy new identified equipment on credit, either under a bill of sale or a lease.<sup>30</sup> Because problems arise in determining whether prior encumbrances on equipment exist, equipment financing is largely limited to new equipment. It is possible to undertake international business transactions with borrowers, collateral, or guarantors, abroad, so long as a legal framework governs the transaction. Property located in Australia or New Zealand, for instance, could be used as collateral for operations in Pacific countries. This possibility, however, does little to help locally owned farms and businesses. In many of the Pacific countries, even lease financing is not available because there are no vehicle registries.

## Real Estate

*Basic issues in the borrower's rights to the underlying property.* The basic premise of the following discussion is that customary-owned property cannot be freely transferred outside the indigenous community and in some cases within the indigenous community despite secure knowledge that the transaction will not be challenged. In most Pacific countries, it is against constitutional provisions for foreigners to buy land. Since land is also "inalienable," security interests or liens cannot be enforced against it.

These restrictions can make real estate useless as collateral. The concerns regarding clear identification of private property underlies much donor support

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<sup>30</sup> The hire purchase system lacks the conceptual structure that will provide for modern features such as automatic attachment of security interests in future property and security interests in proceeds.

for land and real estate registration in the Pacific. However, focusing on identification of property treats only part of the problem. To serve as collateral with economic value, the right to land must be alienable (i.e., transferable to another's ownership). The typical project, therefore, focuses on titling and its rights of alienability. In many customary settings, however, fee simple titles do considerable harm to traditional practices. Conventional approaches to land rights ignore the fact that many land rights have value besides title. In the United States, for example, grazing, mining, and drilling rights to federally owned offshore land, have value as collateral. Similarly, lease rights have value: much of the land<sup>31</sup> in Hawaii, London, and New York is leased by those developers wishing to build buildings, striking down the common claim that buildings and the land under them must be transferable together (ADB 2001a<sup>32</sup> and ADB 1999<sup>33</sup>) Moreover, title alone will usually not permit the use of land as collateral. Without a clear system of priorities under the law, an eviction system, and a system of publicizing priorities, owners may have clear title to well-identified land that will never serve as collateral.

For foreign investors, the lack of tenure security is a major constraint to investment.

*Local citizens.* Most Pacific nations give local citizens superior status to foreigners in land ownership as a form of land tenure. Under circumstances where land is “homestead” and cannot be taken away from the occupant, a mortgage cannot be enforced. Many previous reports on land tenure issues in Pacific countries have stated that land held under customary tenure cannot normally be used as collateral for securing a loan. This inhibits investment and the development of a capital market.

*Foreigners.* For foreign investors, the lack of tenure security, either through leases—the only form of tenure permitted to foreigners—or through corporate shares, is a major constraint to investment, especially large-scale investment. Secure tenure requires that rights be clearly specified and enforced. There are numerous examples of threats and some forms of sabotage on tourist resorts that highlight the problem (World Bank 1998d).

Nevertheless, even with security of tenure for foreigners, the secured transactions framework needs to permit land tenure rights other than ownership to serve as

<sup>31</sup> Lack of clear title as an impediment to credit is emphasized in ADB 1999. However, as noted here, addressing title problems without fixing the underlying legal framework for using real estate as collateral for loans will not substantially change access to credit.

<sup>32</sup> Calls for a mortgage system for lease rights. Such a system is set out in modern systems of secured transactions, such as those used in Canada and the United States.

<sup>33</sup> Calls for reforming and clarifying customary treatment of leases in South Pacific countries.

### Box 7. Low Nonperforming Loan Rates: Cook Islands, an Outlier

The Cook Islands stands out as an example where banks have few nonperforming loans—less than 1%. Land can be, and is, foreclosed by banks. The legal system is perceived as providing protection to banks against default. There is, however, a growing local concern that too much land has been transferred through foreclosure. The potential for pressure from the local population to reduce the banks' ability to foreclose exists—a pressure that must be resisted to avoid negative impacts on private sector development.

Source: ADB 2003. *Cook Islands 2001 Economic Report: Policies for Progress*. Manila.

collateral for loans. However, the primitive stage of development of the secured transactions framework in the four examined countries does not provide that. For instance, it is unclear how mortgages on leases may be possible, when case law does not seem to have addressed this yet. In countries like Vanuatu that have a hybrid common law/civil code heritage, there is considerable potential for conflicting interpretation of issues related to the integration of mortgagee rights under equity mortgages, versus lien rights under the French civil code. In many instances, the claims of the landlord with a lien for rents due demote the claim of a mortgagee to a second position. In other words, the rights of the lender are subsumed by the landlord's lien.

### *Problems in Priority*

Priority plays a key role in a secured transactions system. It establishes the order in which claims against the goods serving as collateral will be satisfied in the enforcement procedure. For instance, the creditor with the first priority will have its claim satisfied on sale of the collateral, before a creditor with second priority. Unsecured systems have no system of priority. For lenders, however, establishing their priority against the collateral is crucial. Even valuable property cannot serve as collateral if a lender cannot determine the value of claims secured by the property that have a higher priority than the claim that the lender contemplates.<sup>34</sup> In other words, if there is no registry that records claims on property and the relative priority of those claims, property cannot serve as an effective collateral for loans.

<sup>34</sup> For example, a future kava crop with a minimum value of \$10,000 may be excellent collateral for a \$6,000 loan if no prior claims exist. However, the same crop will be inadequate collateral for a loan of \$3,000 if a prior claim for \$9,000 exists.

## How “Priority” Affects Credit Systems

Priority—the process by which the lender establishes the priority of the security interest—lies at the center of a legal system for secured transaction. It represents a crucial element in determining a property’s value as collateral. Where conflicts of priority exist, as they do in many Pacific countries, secured financing will not take place at all. In default, loans without priority will become portfolios of uncollectible loans. Many development banks in the region take security in the form of collateral when making loans. Their large portfolios of uncollected debts are a testimony to the inadequacy of the collateral framework in the region. By contrast, commercial banks only secure loans with movable collateral when they have substantial additional security amounting to a multiple of the loan’s value.

A secured loan by definition cannot have a conflict of priority. In most Pacific countries, a series of key priorities are not spelled out in the law. A preliminary investigation indicates several possible conflicts, as noted below.

All the alternative security devices that exist—mortgages in law and equity, installment sales, trusts, and leases—have different rules governing the manner in which they operate. This fragmented approach to security interests with various laws covering priority and publicity in different ways for diverse security devices, both increases risk and reduces the value of collateral. Even for company debtors, priority rules are troublesome. The company regulations seem to permit only one charge at a time and do not resolve ranking of priority issues vis-à-vis other security devices, such as legal and equitable mortgages.<sup>35</sup>

Other priority conflicts affecting important economic transactions also remain unaddressed (e.g., priority for loans secured by inventory versus priority given to loans secured by accounts receivable and priority in future crop versus priority of the holder of a warehouse receipt). Some countries such as the Marshall Islands have no bankruptcy laws at all.

If there is no registry that records claims on property and the relative priority of those claims, property cannot serve as an effective collateral for loans.

<sup>35</sup> See, for example, the Vanuatu Company Law section 100 (1), which provides that, “Subject to the provisions of this Part of this Act, every charge created by a company and being a charge to which this section applies shall, so far as any security on the company’s property or undertaking is conferred thereby, be void against the liquidator and any creditor of the company, unless the prescribed particulars of the charge together with the instrument, if any, by which the charge is created or evidenced, are delivered to or received by the registrar of companies for registration in the manner required by this Act within 21 days after the date of its creation, but without prejudice to any contract or obligation for repayment of the money thereby secured and when a charge becomes void under this section the money secured thereby shall immediately become payable.”

Such confusion about priority creates uncertainty and ultimately enormous risk for secured lenders. Any reforms to the system should consider development of a comprehensive secured transactions framework rather than attempt to repair the present system.

### ***Problems in Registration***

The law specifies how priority is established. Two basic legal systems have evolved regarding priority. One establishes priority by possession, the other by publicity. Priority by publicity is the most important system as it allows the debtor to retain possession and use the collateral during the loan's term. The principal system of publicity is that of registration in a public registry.

A first-to-file registration system requires that the law designate the place for filing the security interest. This allows any potential lender to determine quickly whether the collateral offered by the borrower has prior security interests. Knowing these prior security interests permits the lender to assess the collateral value of the property. The typical practice in Pacific countries is to rely on two main registries for security interests, the company registry, and the land registry.

### ***The Rules for Registering***

The typical pattern under versions of the British company law in these countries provides for various types of charges to be registered. The registration list leaves many gaps in information about registration. For instance, it is unclear whether account receivables financing, in the form of small loans, are covered with priority by registration rules, and whether any assignment of accounts receivable must be filed and where. Therefore, setting a ranking of priority against a loan secured with portfolios of accounts receivable collateral appears to require transferring of each individual loan to the lender. It is unclear whether a security interest can have its priority set by registration or whether such registration positions a lender vis-à-vis any other encumbrance. In tourism, for example, where credit card payments commonly comprise the businesses' account receivables, it will be costly to use accounts receivable as collateral for loans.

As a second example, the company registry includes the mortgage, which is also filed at the land registry. Further assessment of the registry system should look into this potential conflict and determine which registration gives priority.

## The Functioning of the System

There appear to be no recent studies of the registry system in the Pacific economies.<sup>36</sup> Whatever the findings, it will be difficult to build technically efficient systems under the requirements of the existing law. An alternative model on which to base reform is provided by examples of viable and sustainable privately operated filing archives such as those in Colombia or Romania. The models from Australia, New Zealand, or the United States should not be blindly adopted, because state-operated solutions that work acceptably in those countries will not necessarily operate as well in Pacific countries. The Romania reform, for instance, used an Internet-based filing system run by nongovernment organizations under the supervision of the Ministry of Justice. Filing is cheap, fast, and efficient.

## *Regulatory Framework for Publicity*

Some key issues must be settled with regard to the registry regulatory framework in any successful reform of publicity. These include decisions regarding

- private versus public or mixed operation;
- limits on the total fees charged;
- expanded Internet-based inscription and search;
- expanded private supply of filing services; and
- the regulation and expansion of filing real estate security interests in the corresponding registry.

## *Problems with Enforcement*

Essential to any system of secured lending is the ability of the creditor, in the event of debtor default, to repossess and sell the property the debtor gave as collateral. A lender will focus on the value of collateral after the costs of sale and seizure. Lenders who face slow and expensive enforcement processes will simply adjust the size of the loan downward relative to the value of collateral.

In developed countries, a borrower could expect to borrow 95% of the value of a new car, 80% of the value of any other type of machinery, and 80–95% of the value of real estate. Similarly, a credit buyer would expect to purchase a car with a down payment 5% of the market value, and a house with a down

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<sup>36</sup> Although a legal review of the secured transactions framework has begun in Samoa.



payment of 5–20%. In such a system, the lender or credit seller expects enforcement of the loan at a cost ranging between 1% and 5% the value of collateral, and in a period ranging between 5 days and 2 months. Such a lender expects to have the full value of the loan covered by the collateral at the end of the enforcement process. There is little systematic analysis of the duration of debt collection in the Pacific. Anecdotal evidence indicates that repossession of movables could take from several months to 2 years. In rural areas, neither movable nor fixed property was acceptable as collateral because it was not possible to repossess and dispose of it.

Previous studies do not appear to have analyzed the applicable collection rules and their costs in terms of the time it takes and fees involved (e.g., notaries, lawyers, court fees, etc.). This information is crucial to determining whether the collection time and costs support the value and the depreciation time of much property. Eviction costs need to be known when real estate is used as collateral, whether fee simple (i.e., the owner has maximum control over the sale, financing, or use of the property), or leases.

### ***Taxes that Affect Registration and Enforcement***

The framework for secured transactions is also heavily taxed either at the security interest's time of creation and registration, or at the time of enforcement (i.e., with the sale of collateral). For instance, in Vanuatu, documents that require stamping include bills of sale (0.6%), declarations of trust (0.25% or 0.5%), and transfers of movable property, such as shares (0.6%) and immovable property (5%). Since modern financing techniques may involve such transactions on a monthly basis, these charges at annual rates can become quite substantial. Taxes set to cover only the system's cost of operation would be preferable and recommended.

### ***Implications of a Defective Secured Transactions Framework***

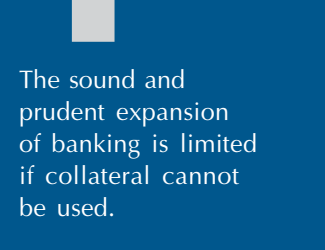
The problems in the framework for secured lending affect every important part of the private sector in these countries. Commercial enterprises, whose assets are nearly entirely inventory and accounts receivable, cannot use these assets as collateral to obtain secured credit and thus have no formal provision for secured credit. Unfortunately, most microenterprise and noncorporate SMEs are particularly impacted by this situation, one that limits development of the banking system in the Pacific.

The sound and prudent expansion of banking is limited if collateral cannot be used. This legal situation forces banks to issue more risky unsecured loans, or more frequently, to lend only to a small fraction of the population. Alternatives

such as development banks and other public sector lenders function poorly and usually result in large losses—for example, NPFs that lend to individuals and companies in the Pacific. These lenders frequently have numerous nonperforming loans in their portfolios, which threaten the foundation of the region's pension systems.

Many foreign banks often complain of excess liquidity and shortage of bankable projects. The result is that they frequently invest significant amounts offshore. A major cause of this problem is the inability of businesses and individuals to pledge assets effectively as collateral for borrowing. Unsecured loans are risky because it is difficult or impossible to liquidate the borrower's assets in the event of default. Collection of an unsecured loan requires that a

court action result in the seizure of the property of the unsecured debtor. Many problems that obstruct the collection of the property providing collateral for a secured loan also block the seizure and sale of property of unsecured lenders. Banks are under constant political pressure to make loans to politically important groups like farmers or operators of microenterprises. In a well functioning financial sector, nonbank financial intermediaries—dealers, cooperatives, and finance companies—would finance such borrowers and banks would refinance these intermediaries. Such loans have considerably less risk than loans made directly to small clients of such organizations.



The sound and prudent expansion of banking is limited if collateral cannot be used.

### *Need for Intermediation*

While specific structures of reformed financial systems vary from country to country, clearly they would be significantly different from the current structure. In most countries, few commercial banks collect deposits and lend to well-established businesses. Riskier projects obtain funds from development banks and NPFs that both have significant portions of their loan portfolios overdue. A reformed system would encourage additional intermediaries such as those described in the previous section to lend to equipment dealers, wholesalers, cooperatives, and microfinance institutions, using the accounts receivable and inventories as security. Since equipment dealers would be in a position to provide capital equipment on leases repayable over several years, the need for longer term financing would be partly satisfied. In addition, microfinance lenders would be able to replenish liquidity through pledging their portfolios as security for loans. The efficiency of intermediation would be greatly enhanced. While these reforms require several years to have their full effect, they do hold the promise of access to finance for the local populations in the Pacific.

## Microcredit

One of the most remarkable developments in financial markets in developing countries over the past 15 years has been the rapid growth in the number of microcredit institutions. They first appeared, almost spontaneously, in several different countries—especially in Bangladesh, Bolivia, and Indonesia in the 1980s and their numbers have since expanded rapidly. Although reliable statistics are unavailable, it appears that there are by now in excess of 10,000 micro-lending institutions around the world.<sup>37</sup> They vary widely in size, from serving a few hundred borrowers to having millions of customers, and there is a wide divergence in operating practices. Microfinance institutions (MFIs) appear to be most developed in Indonesia and Latin America. In the Pacific, microcredit is in its infancy, with few examples so far. Samoa is one country where micro-lending is developing well, but the volume of loans is still small.

In the Pacific, microcredit is in its infancy, with few examples so far.

MFIs provide a wide range of services. The best-known activity of MFIs is providing credit to poorer households and small enterprises, although many also take deposits from households and small enterprises. In addition, some MFIs provide other services, such as insurance or advice and training for their clients. This training is often closely linked to the MFIs' lending activities (e.g., training in

business management, which might make a loan more valuable to the borrower and enhance the chances of repayment). Sometimes MFIs are used as a vehicle to provide nonfinancial services and education (e.g., in health awareness). Samoa has taken the lead in this area, having in place the structure to address one of the critical problems associated with the microfinance movement, namely the failure to develop ways in which borrowers can “graduate” to the next level of funding.

MFIs have attracted widespread support from various funding agencies, including multilateral development institutions, national aid agencies, and private foundations. There is, however, a wide divergence in how they assist MFIs. Some attempt to ensure that the recipients of their assistance achieve “sustainability,” which usually means that the institutions gain the prospect of eventually graduating from donor assistance. Others attempt to ensure MFIs lend at rates that are comparable to, or even below those of commercial banks in the country where the MFI is located. The justification is that the poor should not be forced to borrow at “usurious” rates.

<sup>37</sup> Lack of systematic data is one of the features of the microcredit movement.

The latter approach virtually ensures that MFIs will not become self-sustaining. There is substantial evidence that MFIs that charge less than 30% in real terms per annum will not be successful without continued support. Furthermore, if funding agencies support institutions that lend at rates that are lower than those that are required to ensure sustainability, they “crowd out” the development of financially sustainable microcredit lenders.

Well-designed microfinance schemes that are developed as an integral part of a country’s financial system are an instrument that holds promise in the Pacific where distances are not large, yet sufficiently large population clusters allow transaction costs to become low. The smallness of the Pacific nations and the fact that individuals are known in communities is a point in favor of successful MFIs. On the other hand, family and church obligations that could potentially undermine the prudent use of loaned funds must be considered a risk. The frequent group counseling, peer pressure, and the clear expectation of repayment that is practiced in Samoa are elements of a successful scheme, and to some extent, mitigate the risk of family and church obligations. Given certain conditions, microfinance in PDMCs has the potential to help develop small enterprises and communities move beyond subsistence production and to promote entrepreneurship in urban areas where rural people have migrated. The conditions for success include secured transactions reform, which would allow well run MFIs to replenish their capital base, and integrate into the financial system, so that microbusinesses can graduate to other forms of borrowing. It is for these reasons that a case can be made for encouraging the existence of MFIs within the constellation of financial institutions in the Pacific.

There is substantial evidence that MFIs that charge less than 30% in real terms per annum will not be successful without continued support.

## The Role of Funding Agencies in Supplying Capital

### *Attempts to Substitute for the Lack of Financial Intermediation*

Frustrated by the inability of Pacific financial markets to finance private sector activity, funding agencies have intervened in an attempt to set up institutions that fund business. Various efforts are under way to supply investment capital to companies in the region. For example, the Kula Fund provides equity financing to medium and larger companies in the region. The South Pacific

Project Facility invests in small businesses throughout the region and provides technical assistance. In addition, individual countries, such as Samoa, have externally funded initiatives that supply capital, loans, or loan guarantees.

### Loan Guarantees

Given that reform cannot be accomplished overnight, are government-backed loan guarantees an alternative to a well-functioning secured transactions framework? The answer to this question rests on how guarantees differ from loans in promoting access to credit and how these guarantees change the behavior of borrowers and lenders. If banks refuse to lend because risks are too high, then any guarantor will be assuming risks that banks were unwilling to take. If loans are guaranteed fully and cannot be secured against collateral, then banks lose their incentive to vet loans carefully and borrowers lack a strong incentive to repay. All the problems of moral hazard and adverse selection discussed earlier would still apply.

None of the problems that exist with financial systems in the Pacific are solved by guarantees.

Guarantees shift the risk from primary lenders (i.e., banks), to guarantors. In addition, if banks do not bear some portion of any possible loss, their incentives to carefully process loan applications are greatly weakened. If banks bear a portion of the risk, they will insist on evaluating the loan, thereby raising the transaction costs of loan processing. Processing costs are doubled, unless the institutional guarantor is prepared to pass the responsibility of processing to the institution that stands to lose a smaller portion of the loss in the event of default. In other words, none of the problems that exist with financial systems in the Pacific are solved by guarantees. There is simply no substitute for reform of secured transactions systems if financial markets are to adequately fund small- and medium-sized businesses. The efforts of reformers and the international financial institutions should strongly support financial reform.

### Promoting Microfinance

Initial efforts have begun to assist in establishing microfinance in the Pacific. Two interesting microfinance schemes have developed in Samoa: the South Pacific Business Development (SPBD) and the Women in Business Foundation (WIBF). Both lend primarily to women,<sup>38</sup> the former using group guarantees

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<sup>38</sup> However, cultural and equality considerations notwithstanding, restricting lending to a particular group is always distortionary and damages financial market development.

### Box 8. Promoting Microfinance: The Multilateral Investment Fund

The Multilateral Investment Fund (MIF), a fund attached to the Inter-American Development Bank, has directly supported microfinance institutions in Latin America and the Caribbean, the process having had a profound impact on the development of microfinance. It has been involved in over 50 projects to promote sound and efficient microfinancing practices. This microcredit program has been innovative and successful. The MIF has had a history of identifying microcredit institutions that have the potential for success, providing them with support to ensure that their potential is fulfilled. So good has the MIF been at the activity that it can justly claim to have shaped microfinance in the region and beyond. In several countries, commercial for-profit financial institutions have begun lending to informal entrepreneurs, implying that the mandate for MIF projects to attain sustainability has been achieved.

modeled along the lines of the Grameen Bank.<sup>39</sup> Lending has grown rapidly and there are now many success stories. What is especially interesting about the WIBF scheme is that it has been structured in partnership with another initiative, the small business guarantee fund, run by the Small Business Enterprise Center (SBEC), which allows it to avoid the pitfalls of most such efforts, namely the inability to assist participants in graduating from MFIs. When participants in the microfinance program reach a stage where they require more funding than the program can provide, they may become eligible for assistance from SBEC, which provides loan guarantees and training for small business entrepreneurs. SBEC works with commercial banks to obtain funding for its participants by providing an 80% guarantee against loans. In addition, it has a very “hands-on” approach toward working with participants, regularly visiting their business premises and insisting on their successfully completing courses in all aspects of business management.

### Regional Development Funds

Because of the problems outlined in the earlier sections of this chapter and because of the small size of capital markets in individual countries, longer-term finance is rarely available in the Pacific. To fill this gap, a private equity fund and two regional funds sponsored by international financial institutions (IFIs)

<sup>39</sup> In Latin America, where microfinance is mostly highly developed and where there is the largest number of self-sustaining microfinance institutions, group guarantees are rarely used because of the high transaction costs for borrowers and because they are increasingly seen as ineffective. The high losses experienced by Grameen itself are an illustration of this (Wall Street Journal 2001).

have been established. The private equity fund, the Kontiki Fund, is based in the Fiji Islands. Its capitalization is below that of the larger, IFI-sponsored institutions, but it has been successful, having roughly a 9–10% annual positive rate of return over the past 4 years.

The funds supported by IFIs and other funding agencies are aimed at providing longer-term finance to companies in need of capital. The two most prominent of these are the South Pacific Project Facility (SPPF) located in Australia, and the Kula Fund in Papua New Guinea. Although evaluation of these externally-supported funds is beyond the scope of this publication, from the financial statements of both facilities, it appears that neither is close to achieving sustainability. In fairness, it must be pointed out that operating costs in the Pacific are extremely high and are especially burdensome on organizations that for political reasons are required to engage in ventures over a wide range of countries. Nevertheless, the business model on which these funds are based should be examined to determine whether this is the best way to operate.

There are several options for increasing the flow of investment funds to the region. One is to establish venture funds in individual countries. For example, there is currently a proposal to establish a venture fund in Samoa to address a pressing need for longer term financing, in a country where most businesses appear to be undercapitalized, and therefore, vulnerable to even small downturns in business conditions. In the case of the Samoa venture capital fund, two main challenges must be overcome.

- There is currently no exit mechanism whereby the fund could liquidate its investment for a substantial multiple of its original contribution, although the International Finance Corporation (lead sponsor) expects to develop a self-liquidating instrument.
- The skills necessary for the management of a successful fund are scarce and command rates of remuneration that are much higher than the highest salaries in Samoa. Successful operation of such a fund will probably require employing an expatriate manager at a correspondingly high salary, which will substantially raise the overhead of such a fund.

In other countries, the involvement of IFIs, bilateral funding agencies, and the public sector, in similar types of investment funds has usually been a recipe for failure (Holden 1999a).

In the absence of exit mechanisms and strong management systems, investments of such venture funds are essentially equivalent to subordinated long-term loans

and are usually subject to the same problems as loans from development banks. In general, the loss rates are high, and there have been no cases where such funds have been self-sustaining. One promising mechanism, however, is the establishment of a unit trust vehicle to hold the fund's investments and from which investors could exit through sale of the unit trust shares. At this point, however, there are no such vehicles in the region, apart from the Fiji Islands. But there may be mitigating factors within the Samoan context. If the envisaged fund is a substitute for the Development Bank of Samoa (DBS)'s involvement, loss risks could be reduced through the increased oversight and expertise of the manager as well as the involvement of the board of directors. Even so, losses are likely to be high. There are also significant moral hazard and asymmetrical information issues inherent in the structure of such a fund. Even if it were to go ahead, the longer-term issues regarding financial and capital market development in each Pacific country should be investigated more fully to identify how to address the issues related to financial deepening and intermediation.

## **Making Financial Markets Work**

The conclusion of the preceding discussion indicates that financial markets in the Pacific are not effective in supplying capital to enterprises, and in particular, are biased against smaller enterprises, rural businesses, and the indigenous people's ability to finance their investments and businesses.

The discussion also emphasized, however, that this situation was not the result of most financial institutions' unwillingness to engage in business financing. On the contrary, most senior personnel interviewed indicated that they are anxious to lend to businesses, but that risks are too high. There are many anecdotes of failed investments and unsettled loans.

The experience of the many state-owned development banks supports these observations. Loan loss rates in development institutions (which often lend at subsidized interest rates) are well in excess of what fiscal soundness would dictate. Furthermore, there are some worrying trends in several NPFs that have lent to businesses in the region. In many cases, they carry a significant quantity of overdue loans in their portfolios. Simply making more loanable funds available will not result in previously unfunded projects being implemented. Since loans are often at interest rates that are below market rates, it is clear that interest rate subsidies are not the answer. Furthermore, rates of return on capital appear to be low, as evidenced by the outflow of private capital and the failure to attract FDI.



### Box 9. Lowering the Threshold or Raising the Rates

A recent paper by the Commonwealth Secretariat, *Lowering the Threshold*, suggests that remoteness and high transaction costs imply that funding agencies should develop interest rate subsidies for foreign investors using subsidies provided by commercial banks, but funded by the donors through a new financial instrument. However, the suggestion is based on several questionable assumptions and perceptions. First, the problems in attracting foreign investment to the region appear to result from a number of factors associated with low rates of return on capital, not an unreasonably high “threshold.” Second, the threshold is greatly raised by the various administrative problems associated with regulation of foreign investment that make it difficult and expensive to invest in the region. Third, subsidizing interest rates will not reduce risks to lenders but merely transfer them. Without changing incentives to repay, such a scheme will be little more than a development bank under another guise, with the attendant potential for defaults and bad debts. Shortage of liquidity is not the issue in the region—rather, it is the risks of lending, the costs of investing as well as the limited opportunity within the existing set of constraints. Donor efforts need to be directed at these problems, not supplying more subsidized credit.

Attracting foreign investment depends not on more subsidies, but rather, on reform that improves the investment climate.

The earlier discussions on secured transactions and land issues lead into the direction of improving the security of lending. Other recommendations on reducing the cost of infrastructure services and other factors that currently add to the effects of distance and isolation will reduce the costs of doing business and raise the rates of return on capital. Making the Pacific countries more flexible, allowing them to take advantage of opportunities, will also raise the rates of return. Attracting foreign investment depends not on more subsidies, but rather, on reform that improves the investment climate.

### *Reforms that Are Needed*

The above analysis shows that several improvements in the operation of financial markets are needed to deepen financial intermediation:

- legally defining rights in both fixed and movable property;
- clarifying aspects of land rights, particularly leasehold arrangements, so land can be used in credit transactions;
- simplifying procedures for registering movable property;
- streamlining the courts and developing the system of summary judgment outside the court;

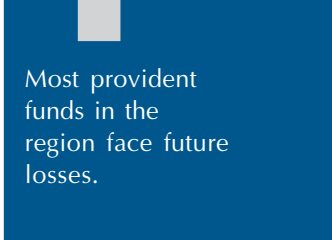
- improving enforcement;
- developing an effective system of credit bureau information; and
- improving or, in some cases, providing bankruptcy procedures.

Analysis of these problems, apart from land, is still in its infancy in the Pacific. Furthermore, implementing them and having patience as the reforms take hold require fortitude and determination, for the process is time consuming.

### *Integration with World Capital Markets*

The Fiji Islands and Papua New Guinea stock markets are among the few sources of liquidity for companies outside the banking systems of the Pacific countries. One option for reform is to integrate the markets of other Pacific countries with these two financial centers. Whether it is realistic to expect other Pacific countries to put aside regional rivalries and cooperate in forming a regional stock exchange is open to question and can only be answered by consultation and discussion.

An alternative technical solution would be to integrate the region through an electronic trading system that would combine the region's embryonic capital markets to form a much more powerful entity. Currently, there are barriers to merging, the most important of which include exchange controls, extremely high telecommunications costs, and problems related to cooperation among Pacific countries. Even so, given the potential for such operations, this possibility is worth exploring further.



Most provident funds in the region face future losses.

### *National Provident Fund Reform and Second-Tier Institutions*

An issue that was raised earlier in this chapter is the dangerous exposure of many national provident funds to loan losses from imprudent investments. With the exception of the Fiji Islands, most provident funds in the region face future losses. For example, the Vanuatu National Provident Fund has a large exposure to the domestic air carrier that is now effectively bankrupt. The Samoa National Provident Fund has arrears in excess of 20% of its portfolio. Similarly, the Marshall Islands Provident Fund carries large potential losses.

The behavior of the funds typifies principal-agent problems. The agent—the manager of the fund—is unable to withstand political pressures from politicians anxious to win the approval of constituents, especially since there is certainty that the principal—the state—will recapitalize the fund. There are extreme

moral hazard issues at work. The interests of the National Provident Fund managers are to make loans using the fund capital, while the interests in favor of the country's long-term benefit is to have a viable pension pool.

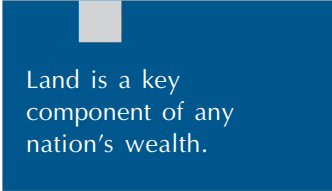
A promising alternative mechanism is the privatization of pensions as in Chile, where the national pension fund was divided into numerous competing private funds investing in certain proscribed securities on behalf of members. Each contributor to pensions in general, holds some portion of the contribution in several pension funds, to minimize risks. An appropriate regulatory regime must be in place, but the model holds promise. Further benefits could materialize if this reform were combined with securitization and secured transactions reform. The pension funds could then become second-tier institutions supplying liquidity to direct lenders such as commercial banks, equipment dealers, and microcredit institutions. Such a model has the potential to increase the supply of long-term capital while at the same time reducing systemic risks. Another suggestion is to pool capital to a single regional provident fund that is professionally managed, possibly offshore, and is independent of political influence from any one country.

# VII. Land Issues

Land is a key component of any nation's wealth. Since the beginning of humanity, civilizations have spent considerable time and energy defining land rights and establishing institutions to administer such rights. Records to document land ownership, assign rights, and indicate transfers of land, were among history's first written documents. Thus, from the beginning of human history, society has had a critical role in securing property rights, facilitating access to land, resolving conflicts, and setting the parameters of land use.

## The Importance of Land Rights

In merely physical terms, most land is used as an input to agricultural production, that in many developing countries, including those of the Pacific, continues to be a key sector that provides the backbone of economic sustenance for the majority of the people. The rights enjoyed by those using land will have an impact on the welfare of the rural population, the amount of output obtained, the level of investment undertaken, the scope of rural-urban migration, and the emergence of a vibrant off-farm economy.



Land is a key component of any nation's wealth.

The impact of giving people property rights to the land they cultivate is demonstrated most clearly by the People's Republic of China. Introduction of more secure property rights has led to impressive output gains as property rights are successively strengthened to facilitate investment and greater transactions in markets. In other words, rural households are less inclined to invest in land they do not securely own. In addition, the ability to use land as collateral in credit markets is usually a precondition for obtaining credit that can then be invested in the rural nonfarm economy. Secure land rights are also critical for the ability to exchange land, and in a broader context, property rights to land and the associated ability to trade land, provides a pre-condition for the emergence of financial markets. In all developed economies, mortgages, and other sources of credit that depend on land as collateral, are the paramount sources of credit. This situation would not be possible without well-defined, secure, and transferable rights to land.

In all developed economies, mortgages, and other sources of credit that depend on land as collateral, are the paramount sources of credit.

Secure ownership and the ability to exchange land are critical for the investment climate for small entrepreneurs, in addition to being a precondition for the emergence of financial markets. It is for this reason that countries where property rights to land are not secure have much lower rates of investment, and eventually, growth, than they might otherwise have. In most developed countries, most small businesses have started using loans backed by land. Property rights are no less important for the welfare of the poor. Indeed, the lack of formal property rights prevents poor people from turning their latent assets into live capital—one reason why the entrepreneurial spirit that is so visible in virtually the entire developing world is not translated into a more inclusive pattern of growth (De Soto 2000). Several empirical studies have related land registration to improved productivity through access to capital (Byamugisha 1998).

Land is important in the lives of the Pacific peoples and plays a role somewhat different from that found in other cultures (Boydell 2001). In addition to its function as the basis for subsistence, it has functions of power and status, spirituality, and cultural identity. Land is inalienable—it cannot be transferred. In truth, land holds a special place in almost all societies of the world.<sup>40</sup> What differs is the nature of tenure. The Pacific countries have encountered difficulties with land because traditional systems have run headlong into modern ones. Land conflicts are often an expression of political nationhood versus tribal organization. Nationhood implies delegating certain responsibilities to the state over communal and individual preferences. Achieving development justifies government primacy in social and economic infrastructure, and part of that is land management and land reform.

Efficient land tenure systems are a necessary foundation for a growing private sector in the Pacific.<sup>41</sup> Some countries in the Pacific are cautiously reexamining their land institutions and laws to see how they can be revamped to meet current needs. They are searching for ways to integrate communal/traditional land tenure systems into national economies in ways compatible with both tradition and a modern (liberal) economy. It is a challenging task made more difficult by the fact that basic institutions have to be in place, before those

<sup>40</sup> Even in developed market economies, one does not have to question commercial farmers much to discover deeply held spiritual views of stewardship and farmer as caretaker of the land.

<sup>41</sup> Land tenure is defined as the rules of possession, use, and conveyance of land.

members of society who need them the most, feel the benefits of changes in property rights. It is hard enough to draft a good property law, but it is even more difficult to create local official land registries and local court systems that serve all citizens. In addition, there is the difficulty of finding the professional skills needed for mortgages, property deeds, land surveys, property valuation, and other institutional services that form part of a land management system. All these factors must be in place before a land market can be expected to play a full role in the development of the private sector and the economy.

The clear assumption from the analysis is that what governments do, and what funding agencies advise and support, really matters to the outcome of land tenure, because these organizations influence the nature of solutions to the problem of land in the Pacific.

Efficient land tenure systems are a necessary foundation for a growing private sector in the Pacific.

## Features of Land Tenure in the Pacific

The vast majority—averaging over 90%—of land in the Pacific is customary land, meaning owned by persons entitled to hold it under their respective customs. Most customs allow land to be held jointly by all members of a kinship group who are descendants of the original occupant or who have acquired, under custom, the rights to the ownership of the land. Some customs allow only ownership by male descendancy, others only female, and still others allow both. All living descendants, regardless of generation, usually have equal ownership rights in the land, and by custom, may participate in decisions on land use. In addition, customary rules of decision making in the Pacific usually require agreement of all persons present—a considerably time-consuming process. Moreover, by law, virtually no land can be alienated from its customary owners.

Often, people other than the custom owners may have secondary rights to the land, such as rights of occupation or passage. Thus, wives, sisters, and daughters of male landowners are permitted to occupy land belonging to husbands, fathers, and uncles. Neighbors are normally allowed passage. Finally, in many Pacific societies, tribal or clan chiefs, big men, and other leaders, by virtue of their status, may assert the right to participate in decisions on the management and use of land in which they have no ownership rights.

Another feature of land tenure is the enormous variation in practice across and even within the countries of the Pacific. There are enormous variations on the

themes, which have arisen from the historical separation of countries and tribes/clans.

The customary tenures in the Pacific were designed in precolonial times for self-sufficient communities with limited mobility and trade that produce most of their own needs. They worked well at that time, but these conditions no longer exist, and customary forms of ownership are no longer serving these societies well. The forms of tenure, which are sustainable for subsistence agriculture, are not ideal for commercial farming in a modern economy. While land conflicts within and between kinship groups were common in earlier times, increasing “Westernization” has raised disputes over customary practices, which appear to be less useful to Pacific society as it transforms. In fact, land disputes appear to be a constant feature of land ownership in the Pacific.

There are many reasons for disputes and conflicts in a customary system where rules are not written and customs evolve:

- identification of customary land owners;
- identification of persons with secondary customary land rights;
- identification of the location, boundaries, and areas of customary land;
- inability to reach a decision on the management or use of land (often because some landowners cannot be found or refuse to participate);
- unauthorized persons making decisions on land (e.g., when male relatives make decisions in a matrilineal system or when decisions are made in the absence of some owners);
- decisions that are misunderstood and later give rise to disputes;
- decision makers later changing their mind, for any reason, in a customary society where agreements have no permanence or finality; and
- distribution of the benefits from land use.

## Land Reform

The process of land reform is a complicated technical and political subject that boasts a huge literature and best left to experts. Yet, efforts to reform land ownership throughout the world have failed more often than they have succeeded. Since customary land tenure does represent a severe constraint on the development of both the private sector and financial markets in the Pacific, it will be discussed here from a secured transactions framework perspective. The issue is how to design a system that unlocks the value of land while preserving its associated traditional values. These possibilities in general, are covered in the following section, while acknowledging the vast variations in the customary

land ownership throughout the region. The discussion below couches arguments in generalities or principle without being country-specific.

## The Problem

The most valuable, and sometimes, the only asset owned by individuals in the Pacific is their customary share of clan, tribal, or family land. Since the vast majority of land remains under customary ownership (i.e., without formal ownership), this situation precludes using land as collateral for credit as lenders cannot take possession of the asset in the event of a loan default. In addition, lack of clarity in the definition of land use rights presents problems for many investors, particularly foreign investors who wish to exercise clear control over land use for the lifetime of their investment. Governments are, therefore, faced with the task of reconciling the conflict between social norms and formal, market-based law, if development is to occur in rural areas.

The mismatch between customary land tenure and imported institutions for dealing with land creates high costs and ties up large amounts of land. As a recent World Bank report notes

The current land law specifies that customary land should be used only for customary purposes, mainly agriculture and communally held housing facilities rather than individually owned homes. While customary law does not recognize the principle of permanent land ownership passing to an individual interest, urban growth is taking place on customary land where customary owners and developers have reached direct agreements. Such agreements should be acceptable and recognized. . . (World Bank 1995b).

The issue is how to design a system that unlocks the value of land while preserving its associated traditional values.

The impact of these problems on private sector development is considerable and immediate, amounting to large costs in time and money.

While land tenure is widely recognized as an issue for most Pacific nations, much criticism is misdirected toward individual freehold ownership.<sup>42</sup> However, the impossibility of freehold land ownership is not critical for private sector development in the Pacific. In fact, much land in industrial countries is held outside freehold ownership and managed by leasing.<sup>43</sup> Leasing, cooperative

<sup>42</sup> The Heads of Government of the Pacific Islands Forum have discussed the issue at every annual meeting from 1995 to 2002.

<sup>43</sup> Large portions of many Western states of the US are owned by the Government, which leases different rights to those lands to different users. Much of the state of Hawaii cannot be alienated and is leased to the present users and developers.



ownership, and condominium tenure are alternatives to outright ownership. Rather, the problems in land tenure throughout the Pacific lie in the following key areas:

Leasing, cooperative ownership, and condominium tenure are alternatives to outright ownership.

- unclear ownership and unclear boundaries, mostly from lack of official recording;
- overly restrictive rules on the transferability of land, mandated because of unclear ownership;
- unclear definition of different land tenure rights;
- weak and unrecorded dispute resolution practices; and
- problems of enforcement.

Questions of land tenure and possible reforms are highly contentious in the Pacific. As noted, much of the controversy lies in the traditional elites' potential loss of power to a national sovereign. Often, land issues appear to be intractable, to the point that politicians and funding agencies are unwilling to tackle them. But land tenure issues will eventually be largely resolved because the desire to raise income by mobilizing the inherent value of land will become an overwhelming imperative that overrides the vested interests of chiefs and other local elites.

Land tenure systems, whether customary or western, are social constructs modified over time to accommodate society's particular needs. When they are no longer useful, they are modified or replaced. Indeed, most countries in the Pacific have modified their land laws over time, but have yet to find a structure that satisfies both the traditional and modern aspects. Given these precedents, a process can be started that takes a series of small, systematic, and conclusive steps toward solving the identified shortcomings of the existing system.<sup>44</sup> The objective is to put in place a mechanism that will gradually lead to a robust land tenure system providing very similar economic incentives and legal backing as those found in the western ownership model, yet will preserve the feature of joint ownership and inalienability.

In designing solutions to land issues, several principles need to be observed to gain the confidence and acceptance of customary landowners.

- Governments need to specify the fundamental problems to be addressed and articulate the goals/outcomes of each step as well as the ultimate objective.

<sup>44</sup> Land disputes have the potential to explode into tribal or ethnic violence. A slow, step-wise process, where each step is resolved, prior to taking the next step, would minimize the probability of aggression.

- A policy framework for reform must be designed and agreed upon.
- The process should be logically progressive and deliberate.
- The process should be participatory and inclusive, based on the community (clan, family, tribe, or village), and will require extensive discussion through a political awareness campaign.
- Existing accepted community organizations, such as councils of chiefs, should play a central role.
- National political institutions should only provide a framework, as well as facilitation, and recording.
- Robust dispute resolution and appeal mechanisms based on local practice, such as the customary reconciliation council, should be put in place.
- Steps should follow a defined process, and agreements reached should be recorded and considered final.<sup>45</sup>
- The Government should announce at the outset that constitutional protections on land would not be altered.
- Ultimately, the choice on whether to opt into the system or stay out should be optional for individual landholding groups.

Under customary ownership, there is neither one landlord/owner, nor often a well-defined set of owners. There are frequently ill-defined boundaries between communal holdings, and there are various traditional ways to manage community land, many of which are disputed within the family of owners. To deal with these problems, the steps in the land restructuring process might be undertaken in the following order.

- Identify rightful claimants to a roughly defined piece of land and record those claimants as common owners in a defined and agreed process.
- Define and record the boundaries to each plot of kinship land with local and adjacent landowners.
- Put in place a formal family/clan governance structure agreed to and operated by the owners to manage that piece of land.

The steps are simple; the process is not. As Box 10 indicates, complications are manifold.

There are many constructive systems and design specifications being developed for land reform within the region, as well as considerable international experience on aspects of tenure that can be combined and tailored for each country to

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<sup>45</sup> In Vanuatu, people do not necessarily accept decisions as final, but expect to be able to renegotiate signed agreements. Publicity campaigns can assist in modifying this attitude and clarifying Government's intent on land restructuring.

**Box 10. Who Owns the Land? Who is Chief?**

The process of clarifying a piece of land's customary owners is fraught with difficulties that must be resolved before recording can begin. In Vanuatu, for instance, ownership is usually defined by kinship and often, the chief manages individual land use. In many areas, coastal landowners provided inland families with land when they were attracted to coastal missionary settlements in the 19<sup>th</sup> century. In the intervening years, other occupants moved onto land vacated by the migrant inland families. In resolving ownership, what time frame should be observed? The migrant coastal families may claim that they only "loaned" land to the incoming inland families. On the other hand, "new" inland families claim they have been both in possession and use of inland areas for over 100 years and should not have to surrender ownership to claims of former inland families. Adverse possession is not part of the legal code, so a method of reconciliation must be found to resolve such issues fairly.

Chiefs play a prominent role in decisions concerning the use and disposition of land and in settling disputes within and between families or clans. Chiefly status is established in different ways, including both heredity and popularity. The role of chiefs will be central in the success of land restructuring. There is therefore considerable value in chieftainship. In the past, some chiefs were deposed by missionaries and replaced by others more receptive to missionary views. The legitimacy of such actions may be subject to challenge as the value of being a chief is realized. It must be remembered that statutes of limitation hold little value as a means of settlement in a society where reconciliation, rather than legal recourse, is the customary solution.

form a workable land system.<sup>46</sup> Critical issues that need to be addressed are identified here. The important point is that governments need to start a systematic, transparent, and participatory land identification and recording system that will be embraced by the large majority of landowners, thereby leading to increased income opportunities for the owners. It may take many years to complete the process, especially with the considerable preparatory work needed, but the point is that a process must begin if countries in the region are to grow. And once success is demonstrated in one area of one country, it will spread over the whole country, and from there, to other countries. The following issues need to be addressed in developing a good land tenure system.

<sup>46</sup> A recent symposium on South Pacific land tenure provided some suggestions (see [www.usp.ac.fj/landmgmt/symposium](http://www.usp.ac.fj/landmgmt/symposium)). Also see Holden 1999b for complementary approaches in Peru, and Paterson 2002, which has also proposed innovative mechanisms for formalizing land tenure.

### ***Recording/Registration***

While it is possible to record and register land under limited conditions, in most Pacific countries, it is cumbersome, difficult, and largely restricted to urban land. Land leases are frequently arranged and sanctioned by a government ministry, but these are neither registered nor transferable.

Registries as well as registration laws and regulations need to be established for they set the foundation for secured transactions. Owners and renters may be given the option to register land and leases, and the market would then determine who did and who did not find it valuable to register. Modern notice-filing registry laws provide for inexpensive and more secured registration systems. Notice-filing registry laws guarantee the filing of information as provided by the parties, and enter it into a secured database. Thus, the registry becomes more secure and less expensive to operate. Such an approach narrows the duties and responsibilities of the registry, so that the system costs less, yet still provides a better secured filing system. The possibility that the registry be administered competitively by the private sector (instead of the present public monopoly) should also be examined.

### ***Transferability and Use of Land***

Another factor that provides market value is the ability to freely transfer a land right. In the Pacific countries, there are restrictions on the transferability of land and land use. Complex and nondurable negotiations to obtain access to land are the norm outside urban areas and land held by custom owners cannot be mortgaged. Some law restrictions, such as limiting people from holding land they do not use may bring benefits to a country, but arrangements that are more flexible need to be designed. Separating ownership rights from use rights as well as defining different use rights, would greatly facilitate a market in land use.

### ***Uncertainty of Land Tenure Rights***

Property rights can only be granted by public law or by the community at large. Therefore, to know the qualities of a land right, people will turn to the law, either statutory or customary. In the Pacific, land rights are based on custom. This gives rise to uncertainty about land use rights. Custom principles are often not publicly known to all interested parties because they are not written and recorded. This lack of publicity is a key difference between statutory law and custom—statutory law is forced to be consistent by the act of publication.

But customs are not written and, therefore, are flexible depending on the circumstances. A party to an agreement cannot know

- when actions of a community's representative become binding on the community;
- when a leader can sign a valid lease; and
- whether the person claiming to represent the community is the authorized community representative.

Customs differ among various groups, but in most cases, customs do not seem to address legal issues (e.g., mortgaging land as security for loans to purchase agricultural inputs). In the Pacific, customs deal primarily with subsistence agriculture issues (Crocombe 1997a) that are a context for uncertainty. Many reports argue that bringing customary law into a statute makes that framework rigid and not adaptable to changes (Crocombe 1995).<sup>47</sup> These concerns, however, are really about the poor operation of a parliamentary system that allows laws to become obsolete, whether reflecting customs or endorsing international conventions. Options for improving how the legislative body operates, rather than excluding customary laws from statutes, may produce a preferable outcome.

### *The Cost of Disputes*

Finally, land market value will be influenced by the costs of resolving land disputes including

- actual process fees
- processing time
- the uncertainty in predicting the outcome of a land dispute
- the uncertainty of a legal resolution being enforced

Ironically, land has become a vehicle for undermining the traditional system. This paradox arises because land disputes in many Pacific countries can be appealed outside the customary jurisdiction of customary authorities (Government of Vanuatu 2001). Often, custom defines land ownership and use. But custom is generally undefined, it changes over time and from island to island. Also, it is not defined and "static" like a legal system.

A land dispute procedure established by law needs to be clear and inexpensive. It must be comprehensive so that it covers all cases. Considerable thought and work by experts in this field is needed to create a fully satisfactory procedure.

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<sup>47</sup> It might also be possible to use the technology of computers and connectivity to post and update customs. Such a "registry" would add some certainty but would not have the force of law.

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## Conclusions

Two major constraints on private sector development are unclear land rights and the difficulty in using land as collateral for loans. The land right system requires careful analysis to determine exactly how to build a chain of rights that serves key economic ends. Simply imposing conventional western industrial land tenure patterns cannot solve this problem. Existing studies of land rights, although often thoughtful, have not focused clearly on these two objectives. Diagnostic and prescriptive studies are needed for each country in the region where the government appears willing to address the issue. Part of the prescription would be a step-by-step action plan for the government to follow.

In addition, the legal framework for secured lending needs to be clarified and updated.<sup>48</sup> The new system must incorporate the customary system of land rights, yet permit more land to serve as collateral. This arrangement requires a diagnostic study and the preparation of a draft law to focus discussion on the issues. Developing a consensus is necessary for the process, but will take time.<sup>49</sup> The process must begin now.

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<sup>48</sup> The desiderata for such systems are set out in several publications available, for instance, at [www.ceal.org](http://www.ceal.org).

<sup>49</sup> An important caveat in undertaking such work is to build a drafting team that includes economists, technical experts, and lawyers, to ensure that the draft meets its economic objectives and is consistent with best technical practice. Similarly, local attorneys should be paired with foreign experts so that the complexities of modern laws governing security in industrial countries can be incorporated.

# VIII. The State and the Private Sector

There is a symbiotic relationship between the state and the private sector everywhere. Any government that hopes to promote prosperity for its citizens must encourage private sector activity. Similarly, the private sector looks to the government to provide the appropriate enabling environment for its development. The overarching theme of this report is that a private sector strategy for government is not about fostering specific companies or sectors. Rather, it is about ensuring that the environment and conditions that affect business and entrepreneurship promote productivity and growth. As a result, private sector issues encompass almost every area of every economy.

Policies that encourage and promote private sector development cannot be imposed—the government and the private sector must play a central role in identifying and agreeing on the problems and priorities for the effective formulation and implementation of private sector policy. Moreover, in this process, both the government and the private sector have obligations: the government neither to erect barriers to business and commercial activities nor to give preferences to individual sectors; and the private sector not to expect preferences, handouts, and special support from the government.

Both the government and the private sector have obligations.

The mutual understanding and cooperation necessary for effective implementation of private sector-friendly policies can only come about through contact, discussion, and feedback. Currently, there appears to be little of this in the Pacific. Often there appears to be an attitude of misunderstanding and mistrust between government and the private sector. On the part of the government, private businesses are viewed with suspicion, while on the part of the private sector, government is viewed as unresponsive and unwilling to listen. On a positive note, however, there is an increasing awareness by governments of the importance of private sector activity and a desire to reverse the neglect and suspicion that many officials acknowledge. Furthermore, most private businesses maintain a strong willingness to cooperate with government to improve the

environment for private sector activity. An example of efforts to improve private sector-government relations is Vanuatu where the Chamber of Commerce organized a weeklong forum in 2002 wherein the business community and the Government held open discussions on issues that were of concern and prepared follow-up briefs aimed at keeping the contacts open.

## **The Role of the State in Private Sector Development**

### ***The State in Pacific Economies***

The state still has a prominent role in most Pacific economies—in some, such as Tuvalu, government expenditure as a percentage of GDP exceeds 100%. In others, such as Kiribati, this expenditure is close to 80% (Figure 10). Although the share of the state in GDP is lower in some other countries, there is widespread state ownership of resources. For example, in Samoa, the State is currently the direct provider of all infrastructure services. In addition, it has either majority or minority ownership in a wide range of businesses ranging from an agricultural supply store to an Internet provider—the State is omnipresent in the productive sector even though it has already gone through significant divestiture. Furthermore, the negative effects of its ownership of enterprises have been felt beyond the inefficiencies of operation—when the state-owned airline ran up crippling losses in the mid-1990s, its costs were covered by cutting government expenditures by up to 25% in areas such as health care and education.

Such examples abound throughout the Pacific. Furthermore, structural problems with public sector budgets arise from the state's pervasive presence. Public expenditure is heavily biased in favor of current outlays reflecting the large share of wages in the total. As a result, infrastructure expenditure is neglected in many countries, even though state monopolies exist and private sector activity is forbidden.

### ***The State and Low Private Sector Growth***

If the state is not supportive of private sector development, no amount of potential can compensate. There is growing evidence that the most plausible explanation for the disappointing failure of most developing countries to grow and prosper is the inadequate institutions that underpin private sector development. Most of these institutions are supplied either directly or indirectly



Table 5. Utility Costs

Country	Electricity <sup>a</sup> (US\$/kWh)	Telephone Call to the US <sup>b</sup> (US\$/minute)
Fiji Islands	0.16	1.10
Kiribati	0.24	2.10
Marshall Islands	0.16	2.00
Micronesia, Federated States of	0.10–0.16	2.00
Palau	0.10	1.50
Samoa	0.18	1.35
Solomon Islands	0.16	1.10
Tonga	0.31	1.20
Tuvalu	0.37 <sup>c</sup>	4.00 <sup>d</sup>
Vanuatu	0.26	1.50
Australia	0.06	0.17

<sup>a</sup> Average commercial tariff, 1999 (World Bank 2002a).

<sup>b</sup> Representative, converted to US\$ using the average exchange rate for 2001 (World Bank 2002a).

<sup>c</sup> ADB 1998d.

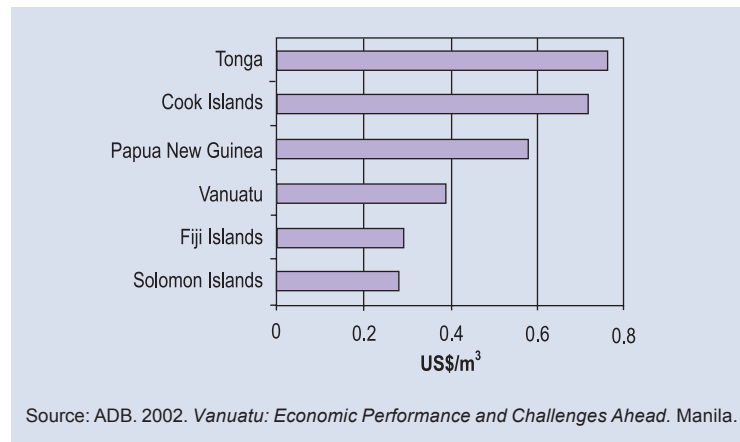
<sup>d</sup> Rate is for the rest of the world. It is US\$2.50/minute to Australia (ADB 2003f).

Sources: ADB and World Bank.

by the state. Public capital, primarily infrastructure, that firms need to complement their capital, such as electric power, water, telecommunications, and the road transport network in Pacific island countries has not been organized in a way that provides these services at the lowest possible cost to the private sector (Table 5).

Some aspects of high costs can perhaps be explained by the remoteness of the countries in the region. But a large part appears to result from state interventions. In most cases, entities supplying infrastructure services are either a department of the state or corporatized entities that are owned by the state. In virtually all cases, these entities are legal monopolies that prohibit any form of private sector competition. The following are a few examples.

- In the Marshall Islands, the state-owned telephone monopoly also has a government-granted monopoly on the provision of Internet services. Although it only offers 48.8k-dialup services, it refuses to allow the TV cable provider to introduce high-speed cable Internet access.
- In the Chuuk state of Micronesia, the corporatized power company was subject to such extreme political interference and mismanagement that services were suspended across the island for 3 months (ADB 1997b).

**Figure 15. Water Consumption Tariffs, Select Countries, 2001**

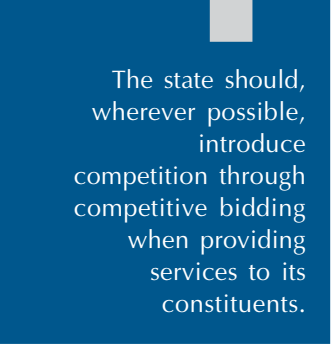
- In Samoa, the corporatized power company does not allow owners of private generators (who install them because of the unreliability of the power supply) to operate them except during power failures, unless they are granted approval from the company. No such permission has been given. Similar restrictions on power generation exist in other Pacific countries.
- In Kiribati, the government-owned public utilities and energy company provide all utilities to the country, but service is poor because of frequent power supply, water, and sewerage problems (ADB 1998b).
- In Vanuatu, the power and water companies are owned by the Government, which has a minority interest, and by a foreign state-owned power company, which delivers a reliable supply of power, but at rates that are among the highest in the world.
- In Port Vila, Vanuatu, port-handling charges are among the highest in the world as one company has the monopoly rights to handle freight.
- Air transport is costly in most Pacific countries because many governments insist on owning and operating their own airlines.

In the Pacific, the state crowds out private sector activity and distorts the market for labor. Often, public sector wages are higher than the equivalent job in the private sector. Since public sector employment also carries with it greater job security, the better workers are attracted to state jobs where productivity is lower. In addition, state employment creates a large constituency with a strong stake in maintaining the status quo, making downsizing and enterprise reforms politically difficult.

States in the Pacific also fail to provide the public goods and institutions that support private sector activity. Broadly, those public goods and institutions minimize transaction costs and promote investment and specialization. Such institutions constitute the foundation of a modern market economy. In most Pacific countries they are weak and do not effectively support private sector activity. Examples are physical infrastructure such as roads, and social infrastructure such as health care and education.

Therefore, the problems observed in the Pacific arise not from inadequate private sector activity per se. Rather, they result from incentives provided by a combination of low-quality and high-cost public infrastructure that not only fails to mitigate the effects of isolation and distance that member countries face, but even exacerbates them.

Moreover, the pervasive presence of the state in the economies of the region is based on an antiquated perception of its role. If the state wants to promote private sector development, it must provide the services required at the lowest



The state should, wherever possible, introduce competition through competitive bidding when providing services to its constituents.

possible cost, and neither provide protected employment nor maintain government monopolies at the expense of efficiency. There are many ways of achieving this goal, but they all involve a search for efficiency and a willingness to use incentives and market mechanisms to achieve it. It does not necessarily mean wholesale privatization, although privatization does yield substantial efficiency gains. It does, however, mean that the state should, wherever possible, introduce competition through competitive bidding when providing services to its constituents.

## Targets and Instruments of Private Sector Development Policy

Developing and implementing a coherent policy toward the private sector is difficult. There are many competing interest groups, some of which will be affected by virtually any policy change. The problem is compounded by the fact that private sector development is difficult to measure and indicators only give indirect information on how the private sector is evolving. In addition, there is a chronic shortage of information on many of the constraints outlined in earlier sections. Nevertheless, the analytical framework developed in this paper indicates that as a minimum, the state has a central role in identifying and reducing barriers to private sector development.

More ambitiously, the state has a role in ensuring that services essential to the private sector function adequately. The limitations of private sector development policy, however, must be recognized. For example, poverty reduction cannot be a direct target of private sector development policy. Rather its impact on poverty reduction will stem indirectly from reducing the number of poor through higher employment and economic growth resulting from an expanding private sector. A pro-poor, private sector policy is one that puts in place the conditions for employment-rich economic growth.

In formulating policy, a careful identification of the targets and instruments of private sector development policy is essential for determining what the state can achieve in this area. It involves promoting private sector development by undertaking reform that strengthens the foundations of business formation, operation, growth, and closure. Earlier discussion highlighted the effects of high transaction costs, burdensome regulation, market failure, inadequate public goods, and poor incentives on the dynamism of the private sector. It indicated that in some areas, such as transport and other public services, inefficient provision amounts to a tax on private sector activity. These areas can be influenced by interventions from the public sector.

A premise of this analysis is that private agents operating in properly functioning markets generally provide superior economic outcomes that maximize the community's welfare. Another is that most goods and services are more efficiently provided by private enterprise. These premises lead one to ask what role can governments play? Overall, in promoting a dynamic private sector and discouraging informality, governments can ensure the stability of the institutional environment in which businesses and markets operate, and address market failure when it occurs.

More specific instruments that are available include

- provision of macroeconomic stability;
- speedy privatization of unwarranted public enterprises and introduction of competition into areas where the state continues to provide services (a competitive solution is desired either through having the private and public sector compete or by ensuring that privatization results in genuine competition);<sup>50</sup>

In promoting a dynamic private sector and discouraging informality, governments can ensure the stability of the institutional environment in which businesses and markets operate, and address market failure when it occurs.

<sup>50</sup> Privatization in its purest form refers to the shifting of the production and ownership of a good or the provision of a service from the government to the private sector by selling government-owned assets. Most definitions of privatization are more expansive, covering virtually any action that involves exposing the operations of government to the pressures of the commercial marketplace.

- adoption of a broad-based and efficient tax system that neither overly burdens economic activity, nor singles out successful firms as targets for tax collection;
- introduction of prudential regulation in areas that are warranted;
- deregulation in areas where governments have no role;
- simplification of regulations;
- provision of well-defined property rights that can be secured at reasonable expense (in virtually every Pacific country, rights for both movable and fixed property are poorly defined, which raises transaction costs and discourages investment);
- enforcement, promptly and efficiently, of a fair and impartial legal system, in particular, to delineate clearly the rules that govern contracting;
- provision of quality infrastructure delivered efficiently;
- ensuring that the costs and time necessary to establish new businesses are kept minimal to reduce the barriers to entry;
- addressing information asymmetries that hamper the development of markets, especially financial and export markets; and
- regulation of “natural” monopolies.

Unfortunately, governments often avoid a framework of this type in favor of direct interventions such as promoting specific sectors of their economies, maintaining government ownership of resources or industries, or directing lending to favored types of economic activity. These activities distort resource allocation, weaken incentives, create instability and uncertainty, weaken property rights, and raise the cost of transacting to the point where much economic activity is either discouraged altogether or directed into areas where gains are severely suboptimal. For these reasons, such activities are minimized in well-run, modern economies.

## State-Owned Enterprises

Discussions of infrastructure issues in the Pacific that appear in various government and funding agency reports exhibit some striking differences in viewpoints and no clear consensus about the scope and nature of the SOE question. Many official reports are critical about past SOE performance but, at least in the case of some countries, sanguine about the future, especially the prospects for improved performance and efficiency through the corporatization of SOEs.

The apparent complacency about the efficacy of future reform efforts, however, is hard to understand. Government provision of public services in most of the Pacific has failed for the same reason it has failed in much of the developing

world—government ownership and management provides weak incentives for efficiency, strong incentives to make political accommodation at the expense of customer service, and political pressures to overstaff and undermaintain. Where the incentives are weak and the difficulties of monitoring high, efficiencies will not be achieved. The prospects for substantial improvements in efficiencies through corporatization are not strong and have proven disappointing elsewhere.

A successful solution to the Pacific’s infrastructure problems must navigate the constraints and challenges that each country presents. A common thread, however, is that in most cases, the solution must deal with a small and relatively undereducated population and a small local market for infrastructure services.

The next section sets out some general principles regarding infrastructure provision.

## Infrastructure Provision: Issues and Approaches

The current, highly centralized model of infrastructure provision, in terms of which the state is the sole financier and provider of services, provides weak incentives for efficiency, diminishes local control, and denies private participation in infrastructure projects. But before any change can take place, numerous issues must be addressed.

### *Integrated Project Design*

Traditional analysis of infrastructure projects includes the evaluation of an array of technical designs, an estimate of rates of return from different designs, and a discussion of project choice. This approach is less appropriate in the Pacific context because it ignores the key features of problems in most of the region. Central issues include:

- What will motivate the provider (the agent) to achieve proper pricing, cost recovery, and maintenance?
- What regulatory framework (monitoring arrangement) determines that benefits actually reach the public?

A well-designed “public service” project must go beyond the traditional approach of analyzing designs at best practice costs. Project design must consider how to

Government ownership and management provides weak incentives for efficiency, strong incentives to make political accommodation at the expense of customer service, and political pressures to overstaff and undermaintain.

align the incentives. How can the operators be motivated to deliver the optimum engineering practices that are assumed in the design phase? The project must consider the nature of the regulatory system and whether competitive market forces can replace regulation. To ensure achievement of project goals, it is necessary to evaluate the overall efficiency of the system—not just technical efficiency—from the perspective of the users of the service. For example, it is incorrect to establish that a centralized water supply is technically more efficient if that arrangement delivers those services at monopolistic prices. Neither is it satisfactory to rely on corporatized entities that have weak incentives for efficiency.

### *Choice of Techniques*

A large number of technically feasible processes can meet infrastructure needs. There are many techniques for generating electricity, disposing of solid waste, or building and repairing highways. There is no unique best practice because wages and interest rates differ among countries.


The key to choosing the best infrastructure practice for a country lies in understanding how the technique relates to both the costs under the “best operation” and the regulatory structure of the particular country. Typically, smaller scale technologies permit more diffused supply, and even though they may not be the lowest cost method of delivering the product, they may result in lower prices and better service because they allow for increased competition. A large-scale electricity generating plant might have a lower delivery price at the generator than a grid supplied by diverse small generating facilities. The single large supplier, however, will not face competitive pressures and will need to be regulated. Unless the regulation is of high quality, monopoly profits and the attendant inefficiencies that monopolies bring will result, even if the monopoly is state-owned.

The alternative, many competing smaller providers with small generating facilities, may produce a more efficient economic outcome even if the underlying minimum technical cost of production is higher. The overall project evaluation, therefore, must assess the feasible regulatory frameworks, including competitive supply, as well as the incentives for adequate maintenance.

Such alternatives need to be explored within the context of small Pacific countries. Technologies in power provision, sewage disposal, and telecoms provision are changing rapidly toward efficient small-scale supply. These are well suited for the countries of the Pacific. Before implementing any large-scale plans for power provision, water supply, telecom provision, or sewage disposal, the feasibility of small-scale supply should be thoroughly explored.

While measures to improve the accountability and efficiency of SOEs are necessary first steps, their impact is unlikely to be sufficiently far reaching in addressing the core problems. These must be tackled by a combination of contracting out, increased competition, regulation, and divestiture.

*Contracting Out.* In virtually every country in the Pacific, there is potential for private operators to be contracted to provide many services that are currently supplied by the state. The government would call for tenders from private companies to provide services on its behalf. Tenders can be either on a positive bid basis, or on a minimum subsidy basis, where the winning bid is awarded to the operator that requires the lowest subsidy. This could be a mechanism for operating an airline if the government wishes to retain ownership.



Technologies in power provision, sewage disposal, and telecoms provision are changing rapidly toward efficient small-scale supply.

*Increasing Competition.* Improving competition usually involves increasing the number of providers. In the power sector, allowing the many private generators that exist across the Pacific to be run without restriction is an urgent first step. This action could then be extended by compelling state power providers to purchase power from private generators at their marginal cost of producing power. Encouraging alternative energy sources on a decentralized basis is a further option.

Similar considerations apply to water and telecommunications services. Currently, arrangements in many countries have led to high prices, which exacerbate the effects of distance and isolation.

*Regulation.* In implementing a satisfactory and effective regulatory regime, any solution must deal with the issues of regulatory capture and the provision of scarce regulatory skills. One solution is the use of an independent, offshore regulator, an issue that is discussed at greater length later in this chapter.

*Divestiture.* Many governments in the region own shares in businesses. Most governments now realize that there is no justification for such ownership and this report recommends that such shares be divested with minimum delay.

## ***The Legal Framework***

Many problems in the legal framework of the Pacific countries affect the provision of infrastructure, especially with respect to debt collection. Major issues are rights to land and collateral.

*Rights to Land.* Determining land rights and the transfer of such rights is problematic in every country in the region. This problem affects the private



provision of all types of infrastructure that are installed in or on the ground. Uncertainties with land raise the risk for the private provider of infrastructure and the use of property or leases as collateral for loans. (The use of property as collateral is unacceptable to virtually every bank in the region for land located outside urban centers.)

*Collateral.* The essence of private project financing lies in breaking up projects into different pieces that can be funded by different lenders, which reduces risk for any individual financier. In industrial countries, this arrangement means finding different lenders who can take different elements of the project as collateral, such as the land, the equipment, and the accounts receivable. Nowhere in the region is this arrangement acceptable as collateral for loans. Moreover, the legal framework for movable property as collateral has other defects that make such property useless as collateral.

Combined, these two problems mean that infrastructure projects throughout the region require government funding or a government guarantee with the attendant principal-agent problems. However, such government involvement diminishes the potential gain from private provision. In private provision, quality control on the financial and management side arises mainly from the inspection of firms by private lenders and financiers. When the state provides the funds, this control disappears.

### **Financing**

Competition is difficult without private participation. And private participation is difficult without private financing. Adequate private financing, however, cannot be obtained within the legal framework of the Pacific countries. Private lenders will not lend to private companies for infrastructure projects unless they have recourse to the underlying collateral. Even if they are willing to lend, the banking regulator, who will seek compliance with both Bank for International Settlements (BIS) norms and standards of bank supervision, will penalize them. Under such a system, banks will lend without collateral only to companies with a strong balance sheet. In the Pacific, that means foreign companies and some existing SOEs.


Such a financing system places strong limitations on any competitive solution that could work for infrastructure in the region. It excludes most domestic firms, as their assets cannot be used as collateral, and therefore puts infrastructure into the hands of foreigners and monopolies. This outcome is undesirable from the economic, political, and public policy points of view.

## *Procurement*

The provisions of IFIs and funding agencies regarding infrastructure projects favor awarding contracts to large companies. This preference can be explicit—by requiring minimum size and experience to do business—or implicit—by requiring conformity to the same audit, performance, and record-keeping requirements for contracts of all sizes. In many cases, however, such requirements are not consistent with the broader development objectives advocated by the very institutions awarding the contracts. Such objectives include the development of domestic capabilities and skills, the promotion of smaller businesses, the involvement of local communities in projects, and the support of stakeholders. IFIs are implementing programs to achieve these goals in many Pacific countries, yet through procurement requirements, are foregoing opportunities to deepen these goals when infrastructure projects are being implemented.

In all Pacific countries, it is important that infrastructure projects be open to procurement by local companies. This change will require modification of the implementation procedures that ensure principals and agents are faced with incentives that promote efficiency and effectiveness as well as discourage corrupt behavior.

For example, rather than enabling a government road agency to do business with small-scale contractors through reforms of agency operating procedures—a process that takes substantial time and has proven to have uncertain prospects for success—program designers can set up an independent contract management agency outside the government. Such an agency can handle the burden of administering and monitoring many small contracts. In this model, the government (the principal) hires an agent on a cost-plus-fee basis to manage small contracts and train small-scale contractors. The agent would then contract directly with small-scale contractors to execute civil works. They can also contract with local consultants—to prepare designs and bidding documents as well as supervise works. Such an agent can also contract with international and local firms to provide training for the tasks for which the local small contractors will compete. These procedures obviously apply to both construction and maintenance tasks. An agent should be chosen based on tenders to ensure competitive and transparent processes, and may be a nonprofit or for-profit firm. Using this methodology aligns the incentives between efficiency and local participation.



It is important that infrastructure projects be open to procurement by local companies.

The private agency model has several important features for the private provision of small-scale infrastructure in contrast to the usual supply-driven approaches. Most supply-driven assistance programs seeking to develop small-scale contracting provide technical assistance and perhaps financing to small contractors without any guarantee to the firm that future business will result. In contrast, the agency model has a demand-driven approach that creates a market for small firms by making procurement accessible to them. It does so by dividing works into many small contracts and providing prompt payments for works completed. Once firms win a contract, they become eligible for training, which is provided by the contract management agency.

This private agency model permits two important efficiencies.

- Private agents can pay employees decent salaries and therefore attract well-motivated, high-caliber staff and streamline procedures for payment and procurement, unlike a government agency.
- International funding agencies and IFIs, not well equipped to audit many small contractors, can monitor private agencies quarterly or even bimonthly, while the agents monitor the small contractors.

### ***Operation and Maintenance***

Access to basic public services remains limited in the Pacific and service provision is low. Like many developing countries with access to external funding for new projects, existing public assets are not properly maintained, and allocations for operation and maintenance (O&M) are inadequate. Rational governments will not spend tax revenue on O&M especially while funding agencies are prepared to build for nothing. Interestingly, the practice of undermaintaining infrastructure and letting funding agencies and IFIs rebuild has been subject to little hard analysis. The practice is less than optimal for funding agencies and recipients together, as it results in the excessively rapid destruction of the capital stock. The analysis of the participating decision makers, however, is less clear.

Funding agencies, especially bilateral agencies, support these projects because there is substantial domestic interest in projects that generate business for their firms. But these firms do not benefit from external funding of operating budgets of recipient countries. This practice helps a few taxpayers in industrial countries a great deal at a small cost to many taxpayers. For obvious reasons, the small group (contractors) lobby strenuously for these programs. At the same time, the recipient country has the choice of spending scarce public revenue on O&M or simply letting funding agencies rebuild deteriorated facilities for nothing—a not unreasonable practice. The “build and deteriorate” model of infrastructure provision is endemic throughout the region.

In earlier years, large IFIs placed conditions on a certain minimum size of O&M. After many years of nonenforcement, however, these conditions are now only rarely placed. It is difficult for smaller IFIs, such as ADB, to act alone on such a matter. But privatizing O&M is a small step forward in remedying the problem of undermaintenance because it creates a domestic pressure group with a strong interest in ensuring that infrastructure is maintained.

### ***Decentralization***

If handled carefully, decentralizing infrastructure provision in many Pacific countries is possible. Local provision of infrastructure is still government handled and subject to the same general problems of incentives and efficiency, so planners must bear this in mind when designing projects. Accordingly, planners face a choice between local or central, and private or public provision of infrastructure and infrastructure services.

In terms of the source for delivering hard and soft infrastructure services, local provision differs from central provision in that local provision often focuses more on local costs and benefits rather than national costs and benefits, thus tending to be more sensitive to the breakdown of locally provided services. For these reasons, local provision of road repair, water supply, and power generation holds promise as an alternative to current practices. On the other hand, local provision of public health services, sewage treatment, and general hygiene may be more problematic because the benefits spread out over groups outside the locality, reducing the incentive for local communities to participate.

Local provision of road repair, water supply, and power generation holds promise as an alternative to current practices.

In addition, financing locally provided services presents some serious difficulties with incentives. Block grants to localities present the possibility of free funding for projects in a certain area. This arrangement leads localities to demand considerably more of such projects than economic benefit would warrant. Cost-sharing only partly mitigates these incentive problems and raises the new problem—that localities have few administrative resources to raise tax revenues in their localities and often very little to tax.

Nonetheless, a combination of decentralization and privatization presents an opportunity for moving forward on infrastructure problems. One simple plan would set standards for infrastructure supply—say quality of roads—and make block payments contingent on meeting such standards. Localities could choose government, customary, or private provision. The central government could then disburse funds based on meeting the quality standards. The central

government could then privatize the process for monitoring these standards. This arrangement would provide a stream of block payments that could be used to guarantee local government payments to local private contractors. Such a guarantee would have value to a formal sector lender because of the ability to take a security interest against the stream of block payments.

A combination of decentralization and privatization presents an opportunity for moving forward on infrastructure problems.

### ***Financing Private Infrastructure with Output-Based Contracts***

Recently, the use of output-based contracts for infrastructure has attracted attention. Such contracts make the payment for infrastructure service a function of the output produced. For example, payments might be linked to measures of water supply quality, the number of electrical connections, or the number of kilometers of resurfaced roads. Such a system focuses the project on the outputs,

not the inputs to the process. Moreover, it presents a simple method of supervising and regulating the provision of infrastructure.

This approach also provides a partial substitute for the defects in the region's secured transactions framework. The service payment from the central government becomes a future asset, which can serve as collateral. That arrangement would permit private providers to get loans for equipment secured by the future flows and thereby enjoy the benefits of collateral—lower interest rates and longer repayment time.<sup>51</sup>

## **Privatization in the Pacific<sup>52</sup>**

State ownership is widespread in most Pacific countries. It goes beyond the entities that were (and in some cases, still are) owned by the state in many other countries—airlines, telecoms, and utilities. State ownership in Pacific

<sup>51</sup> In principle, any government contract, including input-based contracts, could be used as security. The essence of the recommendation is that the combination of output-based contracts together with collateral reform will enhance not only the quality of infrastructure, but also local access to contracts.

<sup>52</sup> The pros and cons of privatization have been long debated and there is now enormous global experience on privatization. More than 10,000 state-owned enterprises (SOEs) in over 80 countries have been privatized in the past 20 years. It is hard to find a country that has not privatized something. Malaysia has sold its National Lottery; Buenos Aires, its zoo; and Czechoslovakia, the guest house of the Communist Party. Countries privatize because it is difficult to bring about (and sustain) enterprise performance in SOEs. Ownership matters, and private owners drive performance in a way that governments cannot. See World Bank 1992 and [www.privatization.org](http://www.privatization.org) for discussions on privatization.

countries extends to businesses that are generally operated by private agents in a nonsocialist world. Examples include companies such as Internet providers, agricultural supply stores, shipping companies, port-handling facilities, oil processing plants, and hotels—the list is long and varied. The rationale for such involvement is that because of size and distance, the state has a central role in the Pacific economies and needs to assert ownership of many productive resources.

Unfortunately, the effect of state intervention is the same as in most other countries. It has resulted in inefficient and high-priced services, which have raised private sector costs, damaged the ability of the Pacific economies to compete, and harmed the development of the private sector.

Wholesale privatization and divestment may be the best strategy, but may not be feasible in the immediate future. First, countries in the Pacific have observed the controversy over privatization in industrial countries and wonder whether it would benefit them. Second, they have been bombarded with policy advice from a wide spectrum of funding agencies and consultants, some of which has been contradictory or not always of the best quality. Third, there is a strong feeling among Pacific citizens that the government should indeed play a key role. For these (noneconomic) reasons, intermediate steps may be necessary.

The primary aim in any action toward SOEs in the Pacific must be to reduce the very high costs and poor performance associated with government-run enterprises. A first step is to introduce competition and efficiency into the sectors where costs are high and quality is low—particularly infrastructure services. For that, cost-related information needs to be collected and analyzed to identify inefficiencies and provide a benchmark.

There is no justification, however, for the state owning such entities as retail outlets, Internet services, and copra oil processing plants. Where these exist, they should be sold or closed as soon as possible. In other areas, alternative organizational structures can be tested. For instance, while the state maintains ownership, operation of such services as power, water, telecommunications, electricity, air transportation services, and shipping could be bid out to private sector operators for fixed periods. In this way, the state (the principal) can monitor the winning bidder (the agent) both through the knowledge of other bids and through the agent's knowledge that the contract will be rebid within a defined time.

The effect of state intervention has resulted in inefficient and high-priced services, which have raised private sector costs, damaged the ability of the Pacific economies to compete, and harmed the development of the private sector.

One argument that is often advanced against such contracts is that the businesses are unprofitable. Since the services are required for social reasons (e.g., outer island shipping), some argue that the businesses, therefore, need to be run by the state. A better alternative is to have private operators bid on subsidy payments, with the winner chosen based on the lowest subsidy bid. Evidence confirms the effectiveness of such arrangements in solving many principal-agent problems that such arrangements entail. In the case of management contracts, able performance occurs when:

A first step is to introduce competition and efficiency into the sectors where costs are high and quality is low—particularly infrastructure services.

- Rewards are linked to performance.
- Governments do not interfere in the running of the entity.
- Contracts are rebid periodically.
- The firms running the entities have a proven track record.
- Governments, not donors, pay contract preparation costs to signal commitment to the contract.
- Markets are competitive or contestable (World Bank 1995a).<sup>53</sup>

Initial privatization should involve rapid divestiture of peripheral businesses that the state has acquired and the introduction of greater efficiency by improving incentives.

At the very least, governments should allow the private sector to run SOEs through competitively won management contracts.

Subsequent steps toward full privatization can be taken as confidence in the system increases and costs decline. Privatization is the unambiguously preferred final solution over partial ownership or contracting out. Governments do not have to own assets to be able to control them through appropriate regulation, and government capital tied up in those assets can be better invested in social infrastructure or in paying debts. Further, global experience has shown that when governments retain a financial interest in a business, it is difficult to keep the business free from political interference.

Yet experience elsewhere, as well as in the Pacific, has also shown that privatization is not a panacea. Vanuatu has reliable electricity and telephone service following privatization but the costs are extremely high and monopolies have been entrenched

<sup>53</sup> A "contestable" market is one where there are no statutory impediments to the entry of new suppliers into that market.

for an extended period. Where markets are very small, regulation may need to accompany privatization where competition is not possible. Regulatory issues and how competition can be increased are set out in the next section.

## Choice of Regulation

Infrastructure provision often involves monopolistic elements. Which elements are monopolistic, however, depends on the technology and contractual techniques used. In most industrial countries, electricity was typically viewed as a “natural monopoly” until it became clear as a technical issue that while the distribution grid required O&M by a sole provider, an improved design could separate the grid from other services such as generation and connection to the grid. That separation permits competitive generation of electricity even though single companies have responsibilities for a regulated net. Even in the net, moreover, there can be different degrees of competition. The central grid monitor may be responsible for all connections to the grid or private contractors may be permitted to make such connections subject to inspection by either state or utility officials. In this way, the entire connectivity issue can be made competitive. Careful design at the outset, therefore, can minimize regulatory burden by promoting the best possible private sector competitive participation in infrastructure supply.

Governments do not have to own assets to be able to control them through appropriate regulation, and government capital tied up in those assets can be better invested in social infrastructure or in paying debts.

Against this background, the discussion that follows identifies some of the many problems created by monopoly arrangements for water, sanitation, and telecoms services that typify many countries in the Pacific. Unregulated monopolies charge more. However efficient they may be in reaping technical production efficiencies, this higher monopoly price distorts resource allocation, slows private sector development, and thus reduces the rate of economic growth. Monopolies are, therefore, regulated.

Unregulated state-run monopolies present additional problems. Since their managers and owners have little profit incentive, they are often slow to innovate and have no motivation to provide good service. Although recent advances in technology have reduced the natural monopolies present in areas like power generation and telecommunications, the size of most Pacific countries makes monopolistic behavior more likely. What, then, are the options for regulation?



### *Local Regulation*

Economically efficient regulation requires substantial technical and accounting expertise. The cost of this expertise is more or less fixed for the type of infrastructure: the same skills are needed to regulate the public sector of, say, New York State as the public sector of a small Pacific nation. This fixed cost weighs more heavily on smaller economies than it would on a larger economy. Regulation, therefore, is relatively more expensive as a solution for Pacific countries. Vanuatu avoids this expense by adopting “informal” regulation, which has resulted in high power, water, and telecommunication prices. By contrast, Samoa has proposed a general regulatory board that seems to be an efficient use of regulatory skills. Nonetheless, regulatory burdens are reduced the more the regulatory activity is handed over to competitive market forces. Regulatory boards can then focus on key issues where competitive solutions are not possible.

### *Foreign Regulation*

One problem of regulation is regulatory capture—the entities being regulated attain a strong influence over the regulatory body. This problem is exacerbated by the smallness of the Pacific economies. It is unavoidable that the regulators and the regulated know each other well and meet socially. This situation complicates the task of arriving at impartial regulatory decisions. One solution would be for the South Pacific countries to pool their regulatory tasks or contract them out to a foreign regulator who would visit regularly. If no South Pacific-wide consensus can be secured, another option would be for individual countries, or perhaps subgroups of countries in the region, to contract out their regulation requirements to a foreign regulatory expert.



The best regulation is a competitive market.

Some cautions regarding this solution are, however, in order. Regulation always involves transfers between the public body and the regulated company, and therefore tends to be controversial. Effective regulators withstand this pressure because they have the backing of many interest groups, their actions are transparent and widely publicized, and they are familiar with the country and industry. The controversy surrounding these decisions does not go away when the regulatory authority is international. It is only the reputation of the regulator as an independent expert and the willingness of politicians to support his decision that gives his decisions legitimacy.

## Competition

The best regulation is a competitive market. Market forces are cheap, unforgiving, and generally provide service wherever it is profitable to do so. Organizing the infrastructure sector so that much provision is competitive has the enormous advantage of promoting a publicly optimal outcome with minimum government intervention. Introducing competition is not a question of ideology or one that requires a yes or no answer. If the process of providing a public good can be made partially competitive, then it will be easier to regulate than without competition.

## Governance and Public Goods Issues

### *Legal Framework*

One of the prime functions of government in promoting private sector development is the provision of a legal framework that supplies the basis for contracting and resolving disputes. There is a wide variation in the quality of laws both within and between countries in the Pacific. As a general observation, most countries have laws that are either outdated or inadequate and require reform. In Samoa, which is moving to revise its commercial law completely, businesses have been operating on a law based on an outdated New Zealand companies act from the 1960s. In the Marshall Islands, the commercial code is unclear and crucial elements such as a bankruptcy code are missing. In Papua New Guinea, the arbitration act dates from 1951, which in turn is based on an English arbitration act passed at the turn of the 20<sup>th</sup> century. Most laws require review and updating.

An additional problem is that in most countries, the codification of the law is inadequate, making it difficult to determine which rules and procedures businesses should follow. This situation encourages corruption by giving discretion to officials. Codification is urgently needed, both to increase the transparency of government and as a first step in modernizing the legal basis for business.

A further legal issue is that Pacific countries are too small to have specialized commercial courts in a situation where out-of-court arbitration and conciliation are uncommon. This situation increases the burden of dispute resolution on the court system and exacerbates the time and cost of obtaining justice. Delays and costs in the legal enforcement of contracts are an impediment to the expansion of contracting and need to be reduced by removing the bottlenecks in the process.

Table 6. Labor Regulation/Conditions

Country	Legislated Minimum Wage (US\$/hr)	Ave. Length Of Work Week (hours)	Paid Holidays (days/year)
Fiji Islands	0.63–1.09	45	13
Kiribati	1.08 <sup>a</sup>	36	13
Marshall Islands	2.00	–	–
Micronesia, Fed. States of	1.35	–	–
Palau	2.50	–	–
Samoa	0.45	40	15
Solomon Islands	0.30	40	11
Tonga	–	40	11
Vanuatu	0.71	40	14

<sup>a</sup> Not legislated.

Source: Forum Secretariat. 2001. Foreign Investment Climate in Forum Countries and World Bank staff consultations.

### *Policy Consistency*

Members of the private sector complain about policy inconsistency on the part of government. To some degree, this issue is part of the democratic process, but is exacerbated in the Pacific, due to the small size of the commercial sectors relative to the total electorate. Moreover, many politicians and bureaucrats do not understand the private sector. The result has been significant policy instability in many countries. In some, such as the Fiji Islands, it has been exacerbated by political instability, which discourages investment and encourages the most enterprising citizens to leave.

Political consistency issues underscore the need for continued consultation between governments and the private sector. Typically, genuine consultations between businesspersons and governments in the Pacific are infrequent and the understanding between the groups is fair at best. One suggested remedy is for funding agencies to finance forums where facilitated interaction can occur.

### *Corruption and Regulation*

Government credibility is a necessary component of confidence regarding the future of a business and thus of private investment. An absence of credibility reduces investment and the returns to capital. Using surveys of the private sector in several countries, the World Bank has created indexes of government credibility. The components of the indexes relate to the predictability of changes

in laws and policies, stability of government, security of property (crime), reliability of the judiciary, and incidence of corruption. Countries that scored high on the credibility index had much higher investment rates and experienced higher economic growth than those that scored poorly. Some Pacific countries scored consistently poorly in the index.

Some countries in the region experience endemic corruption, with Papua New Guinea constituting perhaps the worst example. A recent survey in Solomon Islands also cited corruption as a major impediment to business success.<sup>54</sup> There are reports of corruption in other countries in the region, although its extent is difficult to gauge.

Corruption is a crime of calculation, not passion. When the size of the bribe is large, the chance of being caught small, and the penalty is a mere “knuckle rap” if caught, many officials will succumb to temptation. Simply making the practice illegal does not work unless there is adequate law enforcement. A concerted set of actions plus a change in incentives is the only way to deal with such problems. Robert Klitgaard (1991) maintains that there are three steps necessary to reduce corruption:

- reduce the degree of monopoly control government has over activities or services;
- reduce the discretion granted to government agents; and
- increase accountability on the part of these agents.

Corruption flourishes when regulation is endemic and nontransparent. A reduction in the role of government through deregulation, privatization, lowering tax rates, eliminating selective policies, freeing trade, and making local and national regulations consistent also reduces the potential for corruption. Copies of commercial rules and regulations should be readily and cheaply available so that businesses can keep current and have the information available to fend off bribe seekers. These steps are consistent with others suggested here to promote private sector development.

Political consistency issues underscore the need for continued consultation between governments and the private sector.

<sup>54</sup> John Hardin, technical expert to the Solomon Islands Industries Rehabilitation and Retention Project supported by the International Labour Organization (ILO) and the Industries Rehabilitation and Retention Task Force (IRRTF).

## A Dysfunctional State and Private Sector Development

A question that arises is how could private sector development be supported when the state is dysfunctional? A well-functioning state assists private sector development by providing public goods and institutions that minimize transaction costs and hence promote investment and specialization. The question of what drives states to perform this role is unanswered. Does the private sector drive democratization and good government (as in the Western historical experience), or is private sector development an outcome of democratizing political change? Is macroeconomic stability an outcome of political stability?

Typical responses to a dysfunctional state are:

- short, spot, and “hostage” contracts, barter, and contracting within closed groups; and
- the emergence of stationary and roving bandits.

Corruption flourishes when regulation is endemic and nontransparent.

Economists do not have a suitable definition of the “dysfunctional state” and states that do not work can vary in terms of how they are dysfunctional (e.g., dysfunctional African states that have had Western structures unsuccessfully imposed on top of semisuccessful traditional structures, or post-USSR Russia, which is struggling to form stable institutions from prereform

structures). Some states function well in some respects, but poorly in others. Cuba does not provide a welcoming environment for private sector development but, until recently, delivered social services to its population. Chile, under the Pinochet regime, enabled private sector development, but at a high cost to civil freedom. A crucial policy issue for donors is what can be done to restore functionality, or—in the case of Papua New Guinea or until recently, in Solomon Islands—to stop the state from slipping into dysfunctional behavior. Several questions require answering.

- Is it possible to exploit traditional social structures that tend to be collectivist and may resist market-driven solutions?
- Is it possible to induce (through foreign aid) dysfunctional states to become more functional?
- Is there scope for private collectives to promote markets?
- Why does a spontaneous group not emerge to govern and what are the obstacles to collective political/military action?
- Do modern markets necessarily imply a modern, functioning state?

- Can one start with a large free trade zone administered by a foreign firm under contract, or large foreign enclave companies (mining, petroleum, tourism, etc.), and then allow these to proliferate until they dominate economic activity and coalesce to form a government?

Until there is a better understanding of the causes of state dysfunctionality and the process of creating or restoring functionality, it will be difficult for international funding agencies to achieve dramatic results in driving development, and in particular, stimulating private sector development in these countries.

## Trade Policy for the Pacific

### *Tariff Levels*

There is a wide range of trade policies in the Pacific—from regimes that have low tariffs and few exemptions, such as Samoa, to regimes like the Cook Islands with 18 tariff bands that vary from 0 to 150%, and Vanuatu, which has high and variable tariff rates and numerous exemptions.

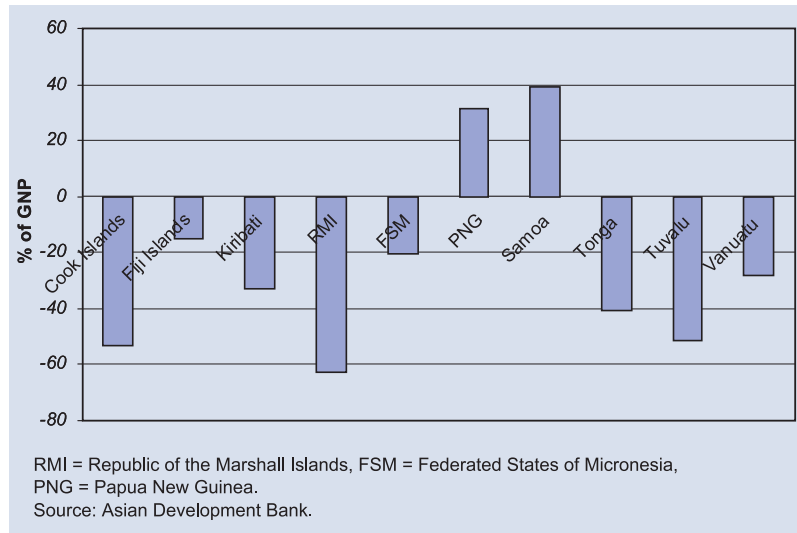
The general case for free trade is strong—for Pacific countries, it is absolutely necessary.<sup>55</sup> Free trade is an essential ingredient of policies that reduce private sector costs. It maximizes Pacific countries' possibilities for capitalizing on their comparative advantage. High tariffs penalize services and agriculture as well as any embryonic export industries by effectively increasing the prices of inputs. Free trade reduces the costs of inputs for the businesses that exist in the region and reduces the price level for everybody, minimizing the costs of the wide range of goods that countries in the region import. If industries need protecting, that is *prima facie* evidence that they are not competitive and resources would be better used in other activities. Further, it is common thinking in international settings that providing short-term protection for start-up firms—the so called “infant-industry protection”—is not good policy, as the protected industry seldom matures into a healthy industry, returning repeatedly to the government for special concessions.

In the study countries with high tariffs, there were numerous complaints about individuals and organizations (including churches) that were abusing exemptions

The general case for free trade is strong. For Pacific countries, it is absolutely necessary.

<sup>55</sup> For an excellent and detailed discussion of trade issues in the Pacific, see ADB 1999. The main arguments of which are summarized briefly in this section.

Figure 16. Trade Balance, 2000

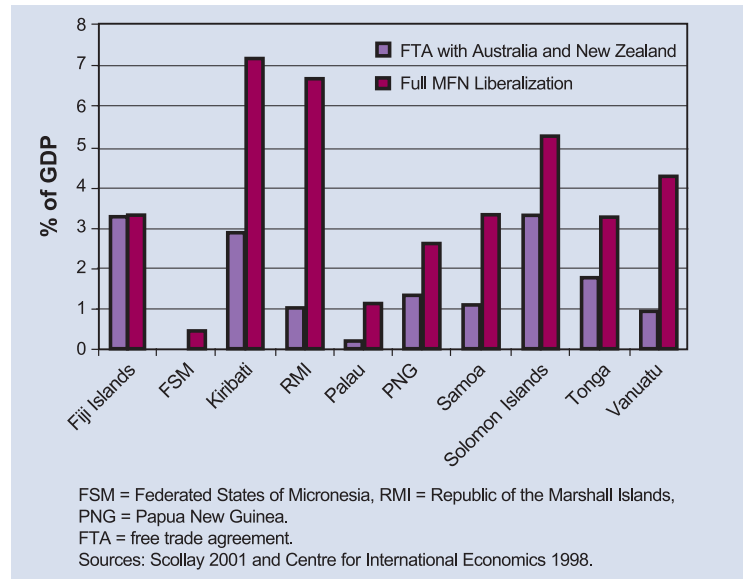


on imports. For example, in the Marshall Islands, there were claims that building supplies supposedly imported for government contracts were diverted to other uses. Similar complaints were registered in Vanuatu. In both cases, these were accompanied by assertions that importation frequently involved payoffs to government officials.

Free trade reduces the costs of inputs for the businesses that exist in the region and reduces the price level for everybody, minimizing the costs of the wide range of goods that countries in the region import.

Similar issues arose in the cases of countries where goods could be imported for export manufacture and then reexported under drawback. In all the countries visited, there were widespread complaints from the private sector regarding competitors not paying duties or obtaining drawbacks unfairly or illegally. While it is hard to judge the validity of such claims, casual inspection of customs receipts give them some credence. Furthermore, drawbacks and exemptions are often awarded to government departments and SOEs, which then use preferential treatment to crowd out the private sector. In the Marshall Islands, government vessels used for interisland shipping obtain fuel at a lower price than some of their competitors. The result has been the dwindling of private shipping.

Such exemptions and drawbacks should be eliminated as part of a plan to reduce tariffs as exemplified by the successful trade reform in Samoa.

**Figure 17. Welfare Gains from Full MFN<sup>56</sup> Liberalization (% of GDP)**

The only way to deal with abuse of exemptions and reduce the temptation for bribery is to change the incentives governing trade. Optimally, this change should reduce or eliminate tariffs and other trade restrictions. There is substantial international evidence that employment lost in sheltered industries is quickly regained through improvements in efficiency and job creation in other parts of the economy. Samoa is a case in point from the region. Following a very substantial tariff reform in which high rates of protection were reduced to three simple tariff benchmarks, the economy grew at rates significantly above regional rates, and registered one of the highest growth rates in the world (ADB 2000b). While growth cannot be attributed to the tariff reductions only, it is clear that they were a major contribution and a catalyst for growth.

### ***World Trade Organization and Regional Trade Agreement Issues***

Most countries in the Pacific are asking what policies they should adopt for the new round of the World Trade Organization (WTO). However, it makes little

<sup>56</sup> MFN refers to "most-favored nation," a technical term describing a World Trade Organization trade arrangement.



It makes little sense for most countries in the region to attempt WTO access through application.

sense for most countries in the region to attempt WTO access through application. The process of applying is costly for the Pacific countries and it will bring them little or no benefit because they are too small to be able to obtain any concessions on the strength of negotiation. Furthermore, it will hardly ever be cost-effective to bring cases before the WTO. Alternatively, Pacific countries can “free ride” on the negotiations of other developing countries and should state that they will accept WTO provisions. Countries in the region will continue to be accorded developing country status. Size and remoteness will bring aid and other benefits regardless of WTO privileges. By reducing or eliminating tariffs unilaterally, they will gain all the benefits that are available without tying up scarce resources and skills in the tortuous process of the WTO round. One approach that could be taken toward the current WTO round of trade talks that would increase access and participation in the WTO is to share the cost of representation in Geneva with other countries in the region or with one of the dominant free trading nations in the Pacific (i.e., Australia or New Zealand).

Regional trade agreements that provide trade preferences for countries within the agreement are also ill advised.<sup>57</sup> They do not direct trade toward low-cost and efficient manufacturers, but can instead result in higher costs. This situation also applies to the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), a one-way trade agreement with Australia and New Zealand. The problem with regional agreements is that their effectiveness usually relies on high external tariffs for those countries outside the agreement. As Australia and New Zealand have reduced tariffs on all imports from all sources, the value of preferences declines. If the industries in the Pacific that are exporting are not competitive by world, rather than regional, standards, investments will be wasted. The difficulties of the Fiji Islands garment industry illustrate this point. As Australia reduces its tariffs on garments, imports from Fiji Islands become increasingly uncompetitive in the Australian market and investment and employment in the Fijian garment industry is threatened. Countries in the region are better served by reducing tariffs unilaterally.<sup>58</sup> Nonetheless, a regional trade agreement signed in April 2003 between forum island countries created a free trade area to be phased in over 10 years.

<sup>57</sup> For a more complete discussion of the pros and cons of free trade areas, see ADB 1999.

<sup>58</sup> In the 1980s in Latin America, Chile refused to join bilateral and regional free trade areas and simply reduced tariffs to a uniform 10% across the board. It has consistently enjoyed the highest growth in that region.

The Pacific Island Countries Trade Agreement (PICTA) fulfills a vision by forum leaders at their first meeting in 1971, when the idea of regional trade integration was on the inaugural agenda. In 1999, forum leaders endorsed in principle the establishment of a Forum Free Trade Area, and directed forum officials to draft an agreement to lower trade barriers between member countries over 10 years. While the PICTA will encourage trade and investment between forum island countries, its economic benefits are likely to be minor. Its importance lies more in the realm of politics where it has now been demonstrated that individual countries within the forum can cooperate on an issue of strategic political importance.

While trade agreements may not be a panacea for the Pacific, agreements that deal with technical issues concerning simplification of trade procedures, standardization of trade regulation, and other trade facilitation arrangements, are beneficial.

One such agreement is the Pacific Agreement on Closer Economic Relations (PACER), a sister agreement to PICTA, signed by the 16 Pacific leaders at their annual forum meeting in Nauru in August 2001. The PACER is a framework agreement providing for the future economic cooperation of the forum region as a whole. It envisages this taking place in stages, with the initial step being a free trade agreement in goods among forum island countries. In the short term, the focus of the PACER is in customs procedures, sanitary and phytosanitary measures, and standards and conformance. The PACER also provides for financial and technical assistance for forum island countries, including capacity building. Clearly, facilitating trade between countries by simplifying, clarifying, and standardizing procedures is a beneficial activity, and one that funding agencies should support—and join, in the case of bilateral funding agencies.

### ***Free Trade Zones***

No country in the region—with the exception of the Fiji Islands—has potential to establish a significant manufacturing base. Nevertheless, in some countries, the notion persists that development is inextricably associated with manufacturing, a belief that has sometimes been supported by funding agencies. As part of an industrialization strategy, free trade zones have been advocated as ways of bringing goods in duty free for processing and reexport. This idea is not sensible. In virtually every country in the Pacific, the size of the labor force is too small, the skills do not exist, and the transportation costs and infrastructure costs are too high to make manufacturing for reexport viable. Rather, the Pacific countries should become free trade zones in their entirety by abolishing or

reducing import duties to low levels, which will then allow them to exploit their comparative advantage in agriculture, tourism, and fishing.

## Foreign Investment Procedures

Foreign investment brings with it substantial benefits in skills, technology, capital, and managerial expertise, and is considered the fastest path to promoting development. Nevertheless, in most Pacific countries, processes involving foreign investors are complex, time consuming, and costly. Tonga, for instance, is considered to have a lengthy approval process (ADB 1996) and even after

The Pacific countries should become free trade zones in their entirety by abolishing or reducing import duties to low levels.

reform of foreign investment regulations, approval of applications from foreign investors in the Fiji Islands can take from 2 months to more than a year to wend their way through the process, by which time many foreign investors have lost interest (ADB 2000a). Similar situations exist in most other Pacific economies.

To some degree, caution regarding foreign investment is understandable because of considerable anecdotal evidence of exploitation or fraudulent projects by the “\$2 investors” (Hughes 1998).<sup>59</sup> The Pacific countries do not attract large multinational companies because they are too small

to be economically interesting. As a result, foreign investors are often of unknown quality or of dubious repute.

Nevertheless, these countries are in competition with each other and with other parts of the world for foreign investors. Procedures in the Fiji Islands or the Marshall Islands contrast starkly with those in, say, Chile or El Salvador where special offices exist to assist foreign investors with all aspects of setting up companies and where the process takes no more than a few weeks.

Some Pacific countries are considering moves to strengthen the vetting and monitoring of new proposals. It is doubtful that a command and control approach is the best way of accomplishing this aim. Fraudulent schemes occur everywhere, and eliminating all fraud would probably result in discouraging most genuine investment. There is also the possibility that intensifying the rules would have the opposite effect. Where complex and often poorly understood systems exist, they become particularly vulnerable to confidence tricksters who get around the system with promises and bribes.

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<sup>59</sup> Hughes maintains that there are no documented cases of “\$2 investors.”

The alternative to intensifying scrutiny would be to simplify and speed up the process, yet reduce the offers of incentives and direct assistance. One of the unfortunate consequences of having direct government involvement in the private sector is that it provides a climate in which fraud thrives.

## Conclusion

The governments of most Pacific countries have taken the view that because of various handicaps imposed by size and isolation, the state needs to take a central role in the economy. The result is widespread ownership of assets, the reservation of particular activities for the state, and widespread regulation. Until very recently, funding agencies have supported this view through numerous loans, grants, and technical assistance that, over an extended period, has amounted to the highest aid flows per capita in the world. The results, however, have thwarted rather than promoted the development of the private sector in the Pacific. The state-oriented strategy has raised infrastructure costs to among the highest in the world, promoted inefficient government ownership in these countries, and failed to promote sustainable economic growth. Costly ownership of airlines has drained government budgets and raised fare levels. In short, the intrusive nature of the state in the Pacific economies has exacerbated rather than alleviated the problems of size and distance, the very rationale on which it is based. Furthermore, in some cases, it is difficult to be confident about the proposed solutions. Reducing the presence of the state by corporatizing government departments into SOEs often amounts to no more than papering over the fundamental inefficiencies rather than addressing the root causes of the problem.

At the same time, states in the region have failed to supply the public goods and institutions that are the foundation of private sector development. Fixed property rights remain extremely problematic, rights for movable property are inadequate to provide effective security for loans, commercial codes are weak, and contract enforcement is often inadequate. Some states appear to be failing and in many cases, regulation is so discretionary as to encourage corruption. Often policies toward the private sector in the region have been variable and inconsistent, resulting in short investment horizons and attracting opportunistic investment, which further exaggerates the suspicion and hostility with which foreigners are viewed.

Reform efforts are under way. Samoa's reform attempts should be encouraging as they illustrate that reducing the role of the state in the economy is possible

In most Pacific countries, processes involving foreign investors are complex, time consuming, and costly.

Samoa's reform attempts should be encouraging as they illustrate that reducing the role of the state in the economy is possible and at the same time promotes rapid growth.

and at the same time promotes rapid growth. ADB, along with other funding agencies, must encourage and support these efforts. Perhaps what is more encouraging is that several governments in the Pacific recognize that growth can be generated by private sector activity and that they are willing to change the business environment toward promoting efficiency and reducing costs. This situation should provide optimism for the future and encourage others in the Pacific to follow suit in reducing the size of their public sectors and creating the enabling environment for the private sector.

# IX. Sectoral Issues

This section discusses the sectors that are fundamentally important to the Pacific and reviews the issues that hamper businesspeople in primary sectors. The paper will make recommendations on how these issues can be overcome so that the state can provide an enabling environment for the private sector that operates in these sectors. The primary sectors are tourism, agriculture and forestry, and fishing.

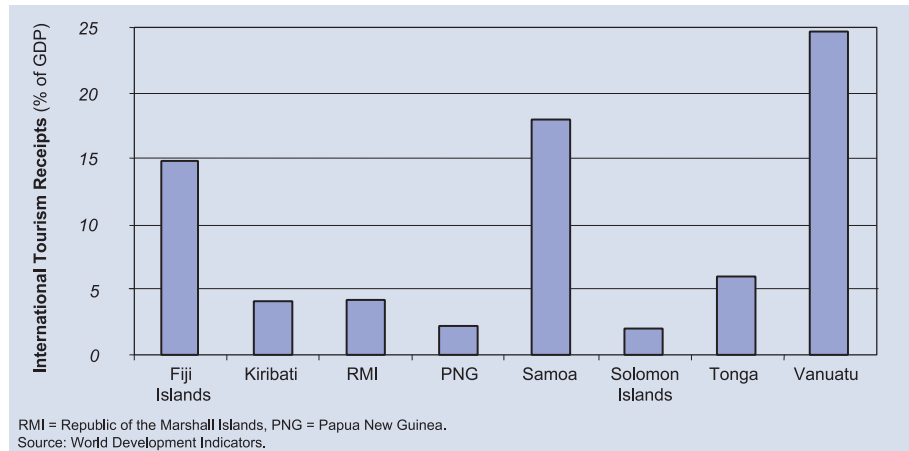
## **Tourism**

Many Pacific countries are idyllic, peaceful tourist spots. Some countries are already attracting tourists and the industry is often an important component of GDP for many Pacific nations. In several countries, however, the true potential of the industry remains underdeveloped, a problem that is exacerbated by the lack of infrastructure support provided to the industry in many countries of the region. For example, wide-bodied aircraft are unable to land in many countries of the region including Kiribati, Federated States of Micronesia, Tonga, and Vanuatu, which effectively cuts them off from being included in main airline routes and thereby increases the costs of getting to these locations. Given the natural physical beauty of many Pacific countries, they have the potential to be premier tourist locations, but they are not. In part, this situation is due to the disabling environment for the private sector that exists.

### ***Benefits of the Tourism Industry***

Tourism has numerous benefits that Pacific countries can tap. Most importantly, the sector has great potential to be a source of income and competitive advantage given the natural resources that most countries in the Pacific possess. The industry can be a major source of employment directly and indirectly through subsidiary activities that support the sector. The industry provides revenue for many service providers including hotels, restaurants, taxis and bus services, the handicraft industry, and the fishing and farming industries. Tourism also increases the rate of return on fixed capital assets such as land and property used by the industry.

Figure 18. Tourism, % of GDP, 1999



## ***Important Elements for a Properly Functioning Tourism Industry***

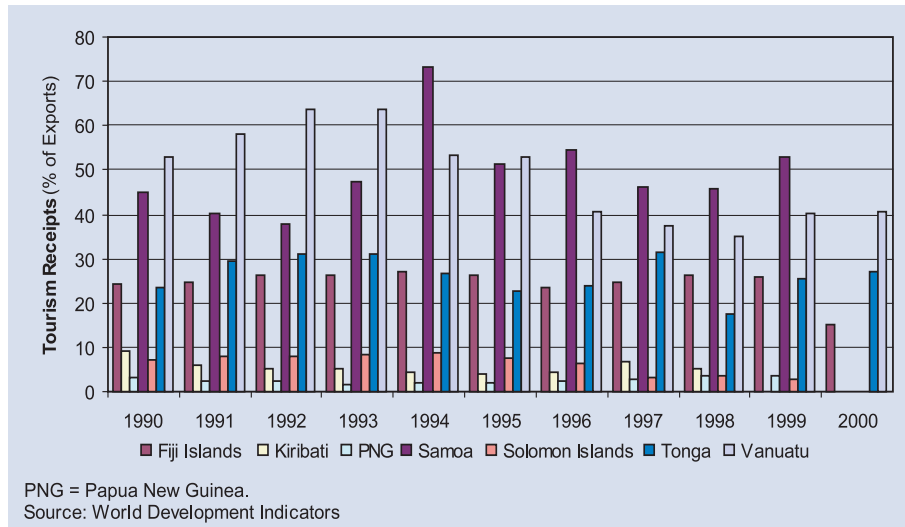
### ***From the Tourists' Point of View***

Unless a country is attractive to tourists as a destination, it is impossible for that country to really develop its tourism industry. A good start would be to look at what is important from a tourist's point of view when considering a vacation and to what extent the state can control it. (Attributes such as physical beauty and pleasant climate are assumed to already exist in most Pacific islands and are therefore, not discussed here, although it should be noted that they are subject to deterioration if not managed and conserved.) The following are critical elements from the tourist's point of view.

***Infrastructure.*** Infrastructure such as the following must be functional.

**Transportation.** The country should be easy to get to and easy to get around, particularly if the country is geographically dispersed (like Kiribati or Vanuatu). The airlines, therefore, must have a convenient schedule that makes it easy to get to and from the destination quickly and easily. Nearly a week in travel time—as is the case of Kiribati and Vanuatu—is too long to expect all but the most determined vacationers to spend. In addition, boats must be available to transport tourists between and around islands easily and safely, and roads must be available and in suitable condition as well.

Figure 19. Tourism, % of Exports, Select Pacific Countries



The more inconvenient the transportation, the less likely tourists will visit. In addition to convenience, the transportation must be priced at a rate that is competitive with other tourist locations. Currently, it is extremely expensive to get to most of the Pacific islands. Given this cost obstacle, tourists are more likely to choose other cheaper and more convenient locations for their vacations. Accordingly, the bulk of tourists in the Pacific countries come from within the region, with Australia and New Zealand being the main sources.

Accommodation. There must be accommodations available for tourists that is of a sufficiently high quality to meet international standards. The cost of this accommodation must also be comparable with other tourist locations. If this accommodation is not available or relatively expensive, tourists will go elsewhere.

Health Infrastructure. The country will be more attractive to a tourist if it is free of most diseases that plague many tropical locations and the medical facilities are of sufficiently high standards in case of an emergency.

Attractions. Consideration must be given to economic development to ensure that it complements the preservation of the environment that is necessary for encouraging tourist visits. But, a location must not only be physically beautiful, it should also have activities for tourists once they get to their location.



### Box II. The Impact of Political Instability: The Case of the Fiji Islands

The Fiji Islands have experienced two major periods of political unrest. One incident occurred in 1987 when there were two military coups, the second incident occurred in mid-2000 when there was an attempted coup. This negatively affected the tourism industry as visitors were put off by civil unrest. In 1987, visitor arrival declined by 26.4%, tourism's share of exports went from 29.9% to 19% of GDP, and tourism receipts declined by 37.3%. In 2000, visitor arrivals declined by 28.3%, tourism's share of exports went from 25.9% to 15.1% and tourism receipts declined by 37.87%.

Source: Asian Development Bank and World Development Indicators.

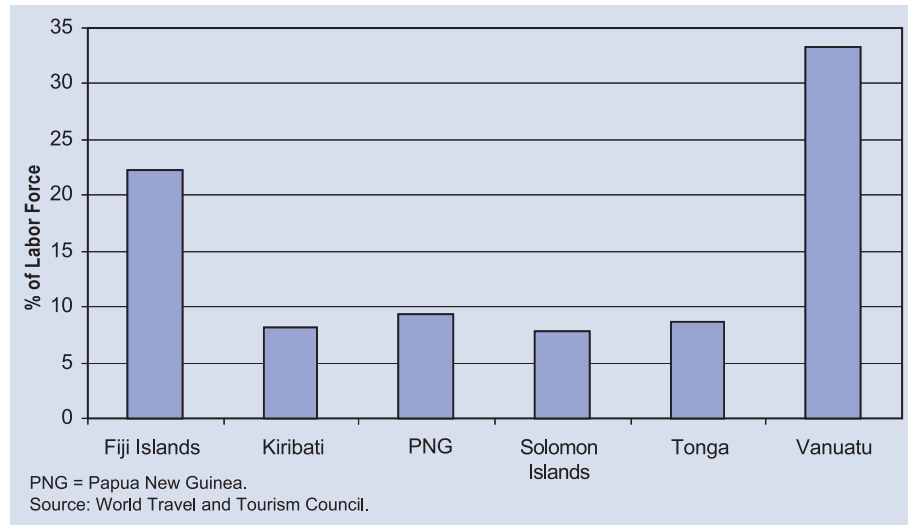
*Stability.* The environment needs to be sufficiently politically stable so tourists do not have to be concerned about physical safety while on their vacation. Political stability is particularly important in the post-September 11<sup>th</sup> world where generally, people are more concerned about unrest. Crime levels should be low for the same reasons.

#### From the Private Sector's Point of View

If a country can sustain a tourism industry by having the necessary features to attract tourists to begin with, the next step is to ensure that the businesses within the industry are not unnecessarily hampered by elements that are within the control of government. Those elements include an enabling environment that has the following characteristics.

*A Favorable Land Policy.* Land issues are complex and often wrapped up with traditional culture in many Pacific countries. (See the following discussion of cultural issues.) It is necessary, therefore, that governments tread carefully in this area by ensuring that there are proper consultations to engage the public in a discussion of the benefits of tourism for economic growth and how to encourage that growth without clashing with traditional culture. Central to these issues is land policy. Land is often closely linked with traditional culture. It is, however, also a critical component to ensuring development in the tourism industry. Ultimately, most investments in tourism are associated with the purchase (or long-term lease) and development of land. To encourage and lower the risk of those investments it is important that the land, in which the investment is made, is secure. Land for tourism development must be available for purchase or lease and not bound up in the customary requirements of the country. If there are customary requirements, however, they must be well known to remove any uncertainty from contracts for tourism development. In other words, it is critical that all parties can confidently invest in tourism because—

**Figure 20. Travel and Tourism Employment (% of Total 2000 Labor Force)**



without security surrounding land agreements—it is costly and difficult to obtain financing for such investments.

*Low-Cost, Available Infrastructure.* Infrastructure must be available so businesspeople can run tourism facilities at par with international standards. In other words, water and electricity must be available continuously, and potable water must be readily available. If these utilities are not available for tourism facilities, it becomes necessary for them to install expensive backup systems. These systems add to the capital and operating costs of tourism development and act as a tax on tourism businesspeople. Poor quality infrastructure can mean the necessity to install backup systems. For example, in Samoa, it is necessary for hotel operators to install expensive surge protection equipment to guard against power variations (ADB 200b) and in Kiribati, electricity provision is so unreliable that backup generators are necessary (ADB 1998b). In Vanuatu, electricity, while reliable, is so expensive that power and water costs add the equivalent of 12–15% to the standard room rate at the upper market hotels.<sup>60</sup> These expenditures reduce the competitiveness of Pacific tourism businesses relative to businesses in countries where the infrastructure is in place, working, and reasonably priced.

To encourage and lower the risk of those investments it is important that the land, in which the investment is made, is secure.

<sup>60</sup> From consultations with local hoteliers.

The airline and airport infrastructure must be developed to allow lower cost options for transporting tourists (e.g., runway facilities that allow wide-bodied aircraft to land). In many Pacific countries, hoteliers, as well as freight users, complain that there are not enough flights while the airlines complain that there are insufficient hotel rooms of the quality desired by tourists to justify more. The major issue is that tourist numbers are too small to support the air services to most Pacific countries, with the exception of the Fiji Islands. In the same way, there are too few overseas tourists to support major hotel developments.

Tourism is successful when there is a coherent national plan and strategy, considerable private investment in facilities combined with equally large public investment in infrastructure, and significant public and private promotion of the destination.

Moreover, there is insufficient demand for tourism services, probably because there are limited tourist facilities and activities, and there has been inadequate promotion of the countries in major potential markets. It is a classic “chicken or egg” problem. Which should come first? The lesson from other countries, such as Fiji Islands and New Zealand, is that tourism is successful when there is a coherent national plan and strategy, considerable private investment in facilities combined with equally large public investment in infrastructure, and significant public and private promotion of the destination.

*Low Taxes.* The taxes on tourism facilities must be at a level that encourages investment. The tariffs on tourism industry inputs must be low enough so as not to tax the industry too much. For example, in Vanuatu, the tax on inputs is high and acts as an indirect tax on the industry.<sup>61</sup>

By imposing this indirect tax, the industry’s growth is limited and future investment is discouraged. In addition, a burdensome tax system creates incentives for trying to avoid it.

*Available Credit.* Credit must be available so local and foreign businesspeople can invest in tourism facilities. Without it, or if credit is only available at high cost, the industry will be limited by what money is available to businesspeople personally or from close acquaintances. The limitation this situation creates becomes obvious. To this end, a framework for secured transactions must be in place in every country in the Pacific. (See previous discussion of secured transactions.) Without it, the private sector is constrained in its ability to fund investments and projects, consequently limiting economic growth. A secured

<sup>61</sup> This is true even though there is zero income tax. The question is the incidence of tax and how it is reflected in the cost structure of the economy.

transactions framework has enormous power to reduce the cost of obtaining funding, and without a framework for securing loans, the cost of financing can become prohibitive—an element critical for the development of any industry, including tourism.

## ***The Tourism Industry: Other Issues***

### **Expatriate Visitors**

For many Pacific countries, emigration of the local population is thought to be a problem. But the islands have a strong traditional culture that emphasizes familial ties and obligations. As a result, many of those visiting the islands are expatriates coming home for visits. These visitors are a benefit to the airlines, but they do not provide the same economic benefits to the tourism industry as traditionally defined tourists. Expatriate visitors do not generally stay in hotels, purchase meals in restaurants, use taxis, or visit local attractions. The airlines often end up catering to these visitors as opposed to the traditional tourists as they form the largest part of the market. Tourist arrivals must be analyzed from the point of view of bona fide tourists to ensure that real tourist numbers are increasing and that promotional efforts are aimed at tourists rather than returnees. Without this analysis, it is impossible to really know what is happening to the tourism industry in the Pacific. In some PDMCs, such as Samoa, detailed data on expatriate visitor arrivals are available and thus their impact to the industry versus a real tourist can be estimated. Nonetheless, expatriate visitors are usually welcome as they bring cash and consumer items for their relatives.

### **The Conflict of Culture**

In the Pacific, traditional culture plays a central role in citizens' lives and is actively preserved. For tourists, cultural aspects of the Pacific are interesting and attractive. But cultural preservation is also seen to be in conflict with the development of the tourism industry. Many people see tourism as having a negative impact on the country and its resources, thereby destroying traditional life. At the same time, tourism is seen as a panacea for the growth and economic development of many Pacific economies. This ambivalence often hinders true development of the tourism industry in the Pacific. The governments are unable to make a true commitment despite paying lip service to industry development, and the citizens often do not help tourism investment by resenting visitors. These sentiments discourage businesspeople from taking advantage of

### Box 12. Tourism Development, Cultural Preservation, and Environmental Protection: The Example of Cirali, Turkey

Cirali is a small village on the Mediterranean coast of Turkey. It is important environmentally because its beaches are traditional breeding grounds for sea turtles, and culturally because the beaches are the site of the Olympos archaeological ruins (an ancient acropolis where natural gases keep flames burning eternally among the rocks). During the 1990s, tourism development in and around the village began to threaten the turtles and the integrity of the Olympos site. A project was started with the aim “to promote environmentally and socially sound development through local participation and planning, promoting traditional and alternative economic activities in Cirali.” The hope was that the project would allow the promotion of tourism while ensuring cultural and environmental sustainability. Attempts were made to ensure local participation. A plan was developed in conjunction with the ministries of Culture, Tourism, and Forestry. Public awareness, training, and discussions formed a central role in the project. Experts on ecotourism offered practical training courses and several beach cleaning days were organized as educational opportunities. Project organizers communicated the importance of protecting the turtles and the surrounding areas as well their potential as a draw for tourists. Sea turtle nests and the number of hatchlings have been on the rise since the project was instituted and both locals and tourists are now aware of the turtles and involved in their protection. In 2000, the project was judged the top 10<sup>th</sup> (out of 110 projects from 700 countries) by the United Nations Human Settlements Programme. The local people are now invested in protecting the turtles and the Olympos site. They see turtles as an asset rather than a nuisance and join tourists in watching the hatchlings make the journey to the sea. One local said, “I waited until 4:30 in the morning to see them. I worry about the animals. Before, sea turtles were just an ordinary animal. Now people know they will attract tourists.”

Sources: Global Environment Facility, United Nations Development Programme, and the World Wildlife Fund.

Governments need to engage citizens in a dialogue to resolve this ambivalence.

opportunities. To this end, governments need to engage citizens in a dialogue to resolve this ambivalence. Settling some of these concerns is also critical from the point of view of land policy, as land issues are often wrapped up with traditional culture in many Pacific countries. In addition, examples of countries with strong traditional culture that have successfully balanced preservation with tourism development need to be studied by the governments (Box 12). These issues will be resolved only by tackling them directly through a national discussion, and by governments following through on commitments to create an enabling environment for business.

## The Role of the State in Tourism

The public sector has a role to play in tourism development in the Pacific countries. This role is fourfold.

*Establishing an Enabling Environment.* It must provide the enabling environment for the private sector as discussed above—they must understand the problems that the private sector faces and remove any bottlenecks so it can operate efficiently and be encouraged. In the face of regional competition and scarce capital resources, an overriding objective for the government must be to create a policy and regulatory environment conducive to tourism development and expansion. From the standpoint of investors, whether in tourism or in other sectors, the environment for doing business becomes attractive when they have confidence in

- the certainty of private contracts;
- the consistency and timeliness of government decisions;
- the provision of reliable and cost-effective infrastructure and services such as power, water, telecommunications, roads, and air connections;
- the reasonableness of fees and taxes charged by government; and
- the availability of credit.

*Facilitating National Dialogue.* The state must facilitate the dialogue surrounding development of the tourism industry to resolve any issues that the citizenry may have with the industry and its impact on the region.

*Developing an Overall Industry Strategy.* The government must work with the private sector and citizens to develop an overall tourism strategy for the country and must adequately fund tourism development and promotion activities. The government must be involved because of the free-rider problem associated with tourism promotion. Importantly, this strategy must be appropriate given the size of most Pacific nations, and targeted toward groups that are more likely to visit. For example, for most Pacific countries, targeting the United States as a whole would not make sense, whereas targeting people living on the West Coast, particularly Los Angeles, would be strategically sound. Governments should develop this strategy in conjunction with industry representatives because there are externalities that require private-public decision making related to the location of tourist facilities. With limited financial resources, tourism infrastructure cannot be constructed wherever development occurs.

*Incorporating Tourism Considerations into Economic Development Plans.* Overall, economic development must be considered within the context of its

impact on the tourism industry. For example, industrial activity might be concentrated in a certain region to limit its effects on the environment and thereby tourism. This industry planning must be incorporated into the overall economic strategy, but any government involvement in the industry must be light-handed.

Finally, it is not a foregone conclusion that PDMCs have an enormous tourism potential. That remains to be seen. But what is known is that without public-private industry collaboration and an inviting business environment for the industry, the potential for traditional broad-based tourism will never be tested.

## Agriculture and Forestry

As noted earlier, the Pacific countries are heavily dependent on natural resources for their livelihood and are likely to remain so for some time. This reality makes the management of agriculture and forestry—the two major land-based activities—important for their future.

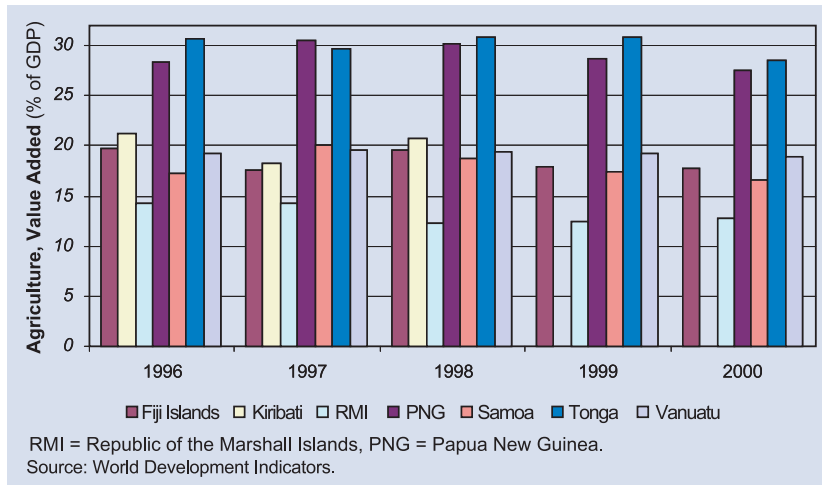
The natural endowment of countries within PDMCs is vastly different. On the one hand, there are the volcanic islands in the west and south that are forest-covered and receive abundant rainfall to wash soil and nutrients down to agriculturally fertile lowlands. Steep upland areas are not cultivated and population pressure on the land is not great. The coral atolls to the north and east, on the other hand, rise only a few meters above sea level, have little agriculture or forests, other than coconuts, and rely on the sea for a large share of sustenance. Their population densities are higher yet their ability to expand food production is more limited.

Traditional use of land has been for current family consumption—food, fiber, fuel, and construction materials—with each family having a plot for a garden and certain harvest rights over a larger area of tribal land. Traditional cropping systems of the Pacific have evolved by human trial and error over long periods.<sup>62</sup> Much land was, and remains, under a “swidden” system of agricultural production—a type of slash-and-burn system that allows large areas to remain fallow for some years before burning and replanting again. Such a system is labor intensive and although sustainable, is not well suited to commercial production. Even today, more than 80% of agriculture is semisubsistence and part-time, with farmers selling surpluses at local stalls. Only in the Fiji Islands

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<sup>62</sup> Archaeologists estimate taro cultivation in Papua New Guinea to be 9,000 years old.

Figure 21. Agriculture, Value-Added (% of GDP)



and Papua New Guinea—and to a lesser extent, Samoa—has larger scale commercial agriculture made inroads into the traditional system.

### Agriculture

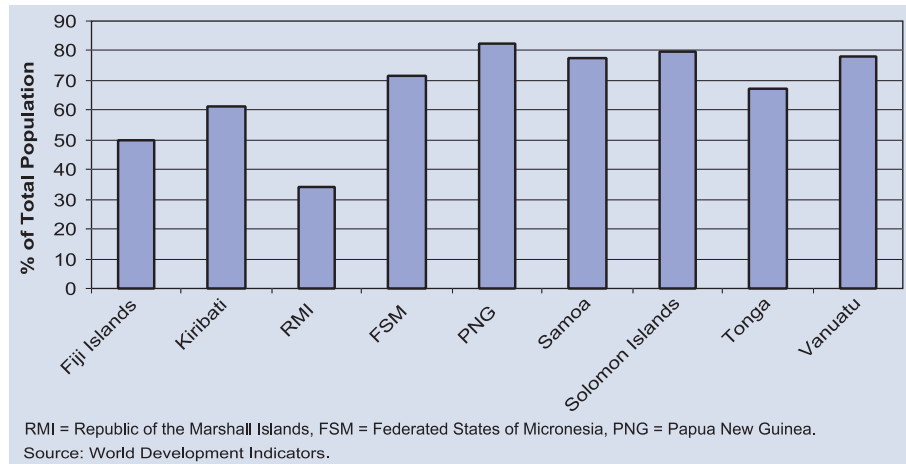
The majority of the population of the Pacific live in rural areas and undertake some form of agriculture as part of their daily life. In the Solomon Islands, a typical example, nearly 80% of the people depend on agriculture for their daily livelihood—their food, shelter, and cash from surplus commodities to purchase daily essentials such as sugar, salt, matches, kerosene, and payment for school fees.<sup>63</sup> Given the share of the population it supports, agriculture is the only sector in the Pacific that has the potential to rapidly affect the livelihood of the majority of the population and impede the flow of rural migrants to the urban centers (a growing problem).

Major crops for subsistence are root crops (cassava, sweet potato, and taro), bananas, a mix of vegetables, and, in some countries, kava. Pork and poultry are also raised, and beef cattle are important in Vanuatu. Some commercial agriculture, mostly plantation-based, has survived the colonial period. Coconuts (copra) are the main crop, but cocoa and palm oil are also produced, and sugar is important in the Fiji Islands. In most countries, the colonial plantations have

<sup>63</sup> While primary education is technically free, in practice parents are required to provide “contributions” to fund schools.



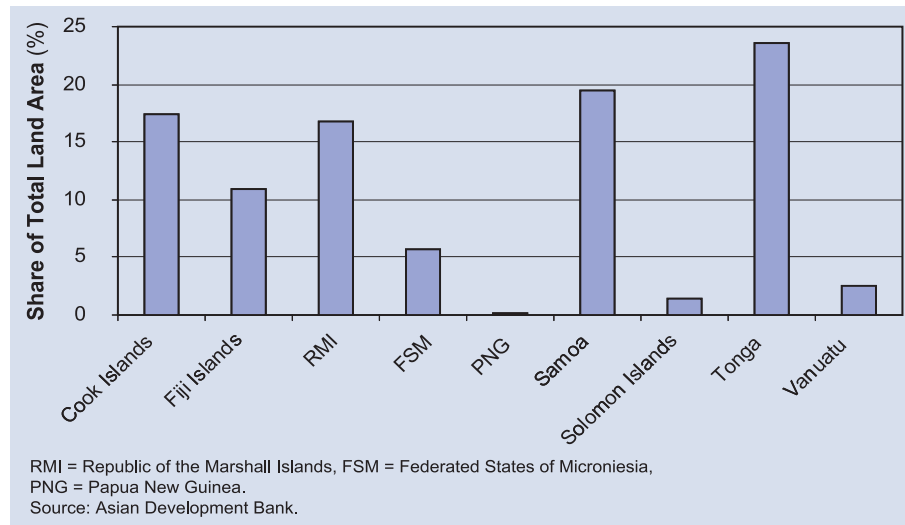
Figure 22. Rural Population, 2001



been returned to customary owners and so smallholders also produce cocoa, coffee, copra, kava, and taro. Virtually all commercial crops are exported either raw or semiprocessed. Most countries are looking for new crops to diversify production. All are producing tropical fruit and off-season vegetables, others are producing sandalwood, organic vegetables, squash (pumpkin), and all seem to be interested in developing vanilla. All are interested in maintaining or expanding agriculture exports, typically the most or second most important export product. In most cases, overseas entrepreneurs with market access have teamed up with island-based growers to develop new crops for export niches.

The inherent variability of agricultural production and exports is a problem for economic management. For this reason, while enhanced agricultural production is a stated government strategic priority in most Pacific countries, official policy also emphasizes a strategy of product diversification, adding value, and producing for niche markets including the organic niche. Given the natural and geographic disadvantages faced by the Pacific, this is a sensible strategy. Governments have been slow to realize the importance of agriculture as an essential component of private sector-led growth. Increasingly, governments regard agriculture as a private sector activity where government intervention should be light and carefully targeted. While many government interventions remain, some Pacific countries have moved forcefully to reform agricultural policies that have hobbled the industry. Gradually, more governments see their role as providing a business environment for agriculture that is conducive to growth.

Figure 23. Arable Land, 1999



Unfortunately, agriculture sector growth in the Pacific has been disappointing. Despite the varied and potentially dynamic picture, with opportunities for diversification, niche product development, postharvest value-adding activities, and modern marketing, agriculture has grown at an unimpressive rate—generally below that of population growth. Much land appears unused or underutilized and despite quality soils and a favorable climate free of many diseases and pests, agriculture underperforms. Low productivity is a concern and it appears difficult to break the low-input, low-return practices.

For funding agencies, the results of financing development in the primary production sectors have been frustrating and disheartening. It is, in fact, difficult to find a single agriculture project by any funding agency that has fully met its objectives.<sup>64</sup> Institutional issues along with sociocultural issues have been identified as the main causes of project failure. Another study found cultural conservatism, lack of secure land tenure, fear of risk-taking with respect to land use, variability of crop yields and prices from new varieties, and government intervention in price stabilization, loans schemes, and taxation, as the major sources of failure with the latter being the most significant (Andrews 1987). Projects targeted at enhancing productivity have been singularly unsuccessful.

<sup>64</sup> For an evaluation of agriculture projects, see ADB 1996a.

Despite considerable external funding to agriculture in the Pacific, there are still very few full-time farmers. Traditional patterns of production and lifestyle remain dominant, with production aimed at subsistence and a little cash and output shared among the extended family or clan. There are examples of indigenous farmers surmounting this model to become successful commercial farmers of export crops, but they are few.

It is difficult to find a single agriculture sector project by any funding agency that has fully met its objectives.

Another important agricultural productivity issue, particularly in Melanesian countries, is gender and the treatment of women. Women undertake most agricultural work in traditional farming systems—planting, weeding, and harvesting—in addition to child care, food preparation, and collection of water. Women provide approximately 45–70% of agricultural labor and make a large contribution to smallholder coffee, cocoa, copra, and rubber production, as well as fishing. “Men’s crops” tend to be commercial crops also. In addition, they concentrate

on land clearing and fencing. There does not seem to be an extension or improved technology program aimed specifically at women producing food crops. Agricultural extension services are not oriented to the needs of women.

Past government policies for promoting agriculture were price supports, subsidized term lending, tariff and nontariff barriers against selected agricultural commodities, input subsidies, income tax exemptions, foreign investment regulations (in some countries farming is restricted to indigenous people), marketing through monopoly boards, and partial or complete ownership of farms and agro-processing facilities by the government. Governments have begun to remove these policies to focus on nondistortionary measures designed to improve domestic incentives for agriculture, but even so, several interventions remain. On the other hand, government financing of public goods needed for agriculture is often missing. Poor roads and communications, expensive ports, uncertain ownership of land, poorly allocated research budgets, weak extension and information systems, an inadequate framework for secured credit, insufficient law and order,<sup>65</sup> and macroeconomic instability have all contributed to poor agriculture sector performance. Samoa has gone the furthest in undertaking agricultural reforms while the Fiji Islands has made larger strides in partially dealing with the serious and politically sensitive issue of land tenure.

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<sup>65</sup> In some countries, theft and destruction of crops has reached serious proportions and threats of violence prevent the harvest of some crops. See ADB 2003c.

Some governments have also used sectoral policies to meet social goals. In the past, certain preferences have been given to agriculture, such as input subsidies and zero tax on agricultural income, on grounds of the perceived social needs of the sector. It is important for governments to resist this temptation, as providing preferential treatment of this nature is poor public policy for the instrument and target are misaligned. Social policy should be targeted at social issues and commercial and sectoral policies should be targeted at commercial and sectoral issues.

Most governments in the region wish to stimulate private sector-led economic growth. In the case of agriculture, many governments appear to equate this objective with attracting foreign investors (ADB 2002c), but relying exclusively on this connection is a mistake.

Rural people of the Pacific make up a majority of the population and represent a huge untapped pool of human resource that collectively own about 95% of the land, in plots ranging from less than a hectare to several hundred hectares. Initially any increase in production will most likely come from existing smallholders responding to improved incentives and margins for their products.<sup>66</sup>

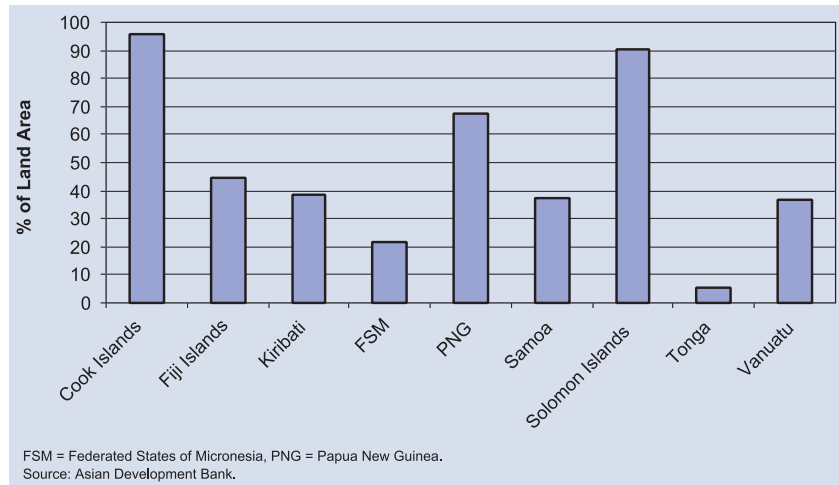
Development experience from other countries that have achieved high agriculture sector growth demonstrates the importance of increasing smallholder productivity and output as one of the most powerful and cost-effective drivers of private sector growth. Continuing efforts to accelerate smallholder-based agriculture sector growth therefore remains a key development objective. The potential for farmers to become involved in export crop production is one of the opportunities for private sector development in the Pacific countries.

Current arrangements for export crops draw on the strengths of the private sector, evade the weaknesses of the public sector, and promote a user-pay approach to extension services and inputs, thus avoiding problems caused by inadequate government budgets. A strong smallholder export crop subsector brings cash incomes into the local economy and creates demand for more goods

Poor roads and communications, expensive ports, uncertain ownership of land, poorly allocated research budgets, weak extension and information systems, an inadequate framework for secured credit, insufficient law and order, and macroeconomic instability have all contributed to poor agriculture sector performance.

<sup>66</sup> For example, all large-scale investments in agriculture over the last 20 years in Vanuatu, whether public or private, have failed (ADB 2002c).

Figure 24. Forest Area, 2000



that in turn promotes further investment opportunities in private farm and nonfarm activities. It is often complemented by the efficient plantation and estate sector, which provides important production, marketing, and processing linkages to smallholders. Policies need to reflect the mutual interdependence of smallholders and plantations.

The ideal for the Pacific would be to transform agriculture over the next 10 years into an effective and efficient driver of economic growth. The sector would be characterized by a vibrant smallholder system coexisting with an efficient commercial plantation sector producing for export, overseas niche markets, and import substitution. It would be more diversified, competitive, and

sustainable than at present, exploiting the Pacific's agronomic suitability for the production of a wide variety of tropical, semitropical, and temperate climate crops and livestock.

To do this, further relaxation of government intervention is needed in activities that could be better performed by the private sector; while more government activity is needed in establishing land laws, securing financial transactions, conducting appropriate research, and financing needed public infrastructure.

Continuing efforts to accelerate smallholder-based agriculture sector growth therefore remains a key development objective.

## *Forestry*

Two key characteristics of forestry in the Pacific are a lack of management resulting in unsustainable harvesting rates and poorly structured financial returns for resource owners. Some smaller island nations have been virtually clear-felled in a matter of few years (e.g., Solomon Islands) while others are in danger of a similar fate if they do not act (e.g., Vanuatu). It is not the felling of trees for local use that is the issue here, but large-scale commercial harvesting, often by foreign companies. Attention needs to focus on establishing a sustainable harvesting plan along with the regulatory capacity to enforce it and a framework for the equitable distribution of royalties. The plan would include long-term agreements with landowners to allow for forest regeneration.

All the larger island countries in the Pacific have now developed their own codes of logging practices and are in various stages of implementing or enforcing them. Fiji Islands, Papua New Guinea, Solomon Islands, and Vanuatu have undertaken forestry reviews and introduced legislation. Cook Islands, Niue,<sup>67</sup> and Samoa are currently revising their legislation. There is a regional forest and tree program where the ministers or heads of forestry from member countries discuss policies and priorities at biannual meetings. In the past, some priorities have been acted on by individual countries, and the technical and administrative cooperation that is derived from the meetings is valuable.

The lessons on the management of natural resources for the long-term development of the Pacific are that property rights must be clarified to ensure that competition results in the benefits of resource extraction being shared fairly between the island states and those doing the extraction. Lack of clear property rights will hinder the fulfillment of this necessary condition. Second, the rents from extraction, which represent a payment for the depletion of capital, need to be invested in an alternative form of capital so that the aggregate capital stock of the community or country is maintained. Mining in Papua New Guinea, forestry in both Papua New Guinea and Solomon Islands, and phosphate mining in Nauru, are examples where resource rents have been consumed and/or squandered. Despite existing large policy and institutional gaps, willing and dedicated governments can meet the conditions. Funding agencies should encourage such reforms.

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<sup>67</sup> Not an ADB member country.

## *Challenges for the Rural Economy*

The rural economy is not performing well and is even in crisis in some countries particularly Papua New Guinea and Solomon Islands (Baxter 2001). A serious concern for government and funding agencies is what actions should be taken

While agriculture is inherently a private sector activity, there are many actions governments can take to stimulate its development.

to modernize rural industries so that they are aligned with global market opportunities and become sources of private sector growth rather than pockets of poverty. As noted earlier, the agriculture sector remains a vital component of the livelihood of the people of the Pacific and is too important to be ignored. While agriculture is inherently a private sector activity, there are many actions governments can take to stimulate its development. Some involve removing present government interventions and others involve adding more government activities. Some are

direct actions in the sector and others are actions in other sectors that affect agriculture and forestry. Overall, the changes mean re-aligning the role that governments provide to the rural sector so that effort is put into providing public goods. In approximate order of importance they are

- moving toward a more formal land use market and introducing some formality into land tenure so that durable leasing agreements can be made and secured financing can be placed over land use;
- providing an intervention-free and regulatory-light business environment that will attract local and foreign investment and be friendly to value-added activities;
- eliminating tax and tariff preferences for agriculture;
- investing in physical and social infrastructure such as roads, ports, health, and education;
- lowering the cost of utilities through reform of the structure, regulation, and ownership of utilities;
- concentrating public services in the sector, such as extension and research on subsistence and semisubsistence farmers, especially women, and not on commercial operators;
- divesting government assets and activities in the sector, and abolishing monopoly marketing boards;
- enforcing commercial codes, regulations, and contracts, especially with respect to logging;
- protecting personal property and providing personal security in countries where theft and violence are a problem; and
- preserving a clear distinction between policies designed to assist social needs versus policies toward a productive sector (in countries where this is an issue).

Making these changes would revitalize the rural economy, create employment opportunities, and allow the rural economy to be an engine of private sector growth. Domestic and foreign investors would find the sector attractive for investment. And the demonstration effect of a few successful countries and a few successful entrepreneurs will serve as a catalyst for further commercial agricultural development by smallholder and part-time families throughout the region.

For funding agencies, complementing and supporting governments will be needed. ADB has some recent successes in pilot projects and using the successful features of these pilots will build a pipeline of agricultural projects in the Pacific (ADB 1998c). A pilot in Papua New Guinea uses private contractors to deliver various demand-driven extension services, provides a fresh-food marketing information system, and establishes an Internet training program for rural residents. Another option may be a “central enterprise” model, as exemplified by oil palm estate and smallholder arrangements in Papua New Guinea. A coffee plantation, for example, could provide a bundled set of services (e.g., inputs, advice, transport, processing, and marketing) to small farmers. Central facilities tend to act as growth poles encouraging multiplier-type investments in commercial enterprises, and as a central point from which to expand transport and other infrastructure services.

But most of all, funding agencies can assist in supporting the extensive reform agenda outlined above. The provision of technical assistance, adjustment financing, and policy and implementation advice is critical to success.

Making these changes would revitalize the rural economy, create employment opportunities, and allow the rural economy to be an engine of private sector growth.

## Fishing

An attribute of being an island is that it is surrounded by water, and in the case of the Pacific, it is surrounded by a great deal, a large portion of which is rich in fish. It is not surprising, therefore, that the fishing industry is considered important to the Pacific countries.<sup>68</sup>

Fishing is important in the Pacific not only because of its contribution to GDP but also for its great potential to contribute to private sector development and

<sup>68</sup> A great deal has already been written on this subject by ADB in several publications, as well as in other sections of this paper; therefore, this section will only briefly cover the critical issues related to private sector development of the fishing resources in the Pacific.



thus to jobs and income. In addition, fish are important from an economic and revenue generation point of view and also because they provide a large portion of the diet in the Pacific.

Fishing in the Pacific can be divided into three types.

*Artisanal Fishing.* Small-scale fishing (excluding sport fishing) generally limited to the nearshore and inland water bodies. It is a strategically important form of fishing because it provides rural employment and helps with poverty reduction.

*Commercial Fishing.* Fishing undertaken on a large, capital-intensive scale. Generally, industrial fishing vessels are the ones licensed to fish in the offshore waters of the region.

Figure 25. Contribution of Fishing to GDP

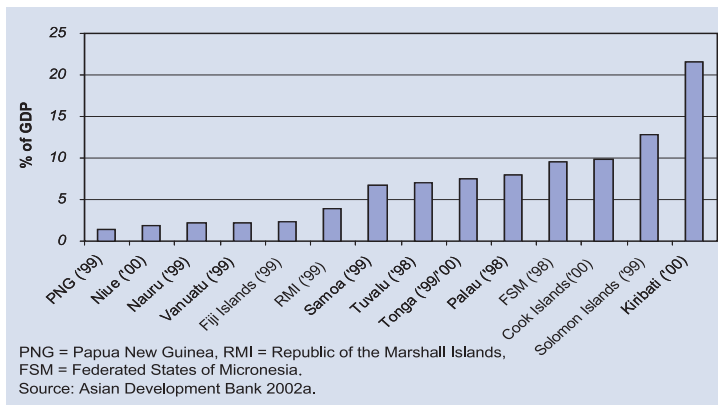


Figure 26. Ranges in Annual Per Capita Fisheries Consumption, 1990s

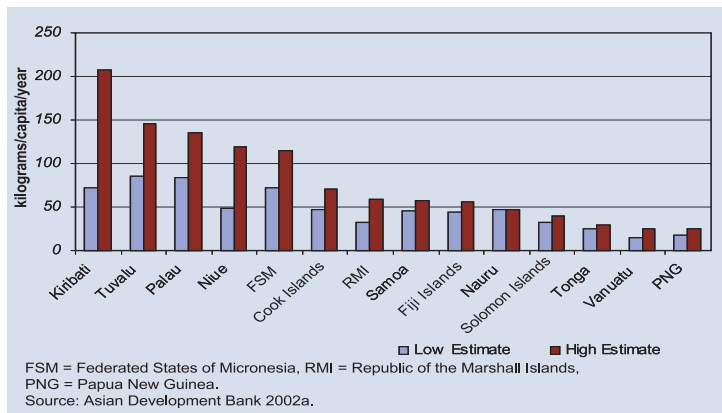


Table 7. Employment in Fishing

Country	Basic Information on Fisheries-Related Employment
Cook Islands	About 22% of the population, or some 4,435 people, were involved in subsistence fishing. The 160 jobs in fisheries represent about 3% of all formal employment.
Fiji Islands	The 6,246 jobs in fishing represent about 2.2% of the 280,505 people formally and informally employed in the country, as reported in the 1996 census.
Kiribati	Of the 7,848 people who had "cash work," 349 people (4.4%) had fisheries-related jobs (e.g., seaweed grower, coastal fisherman, deep-sea fisherman, etc.). About 12% of the households in Kiribati do not fish. Of those that do fish, 17% fish commercially full-time, 22% fish commercially part-time, and 61% fish only for subsistence.
RMI	As estimated, 2.8% of all employment is in fishing.
FSM	In 1997, 10,285 private sector employees were enrolled in the social security system. Of these, 767 individuals (7.4%) were from the fishing sector.
Nauru	There are 100 part-time commercial fishermen, which would be equivalent to 50 full-time fishermen. The census indicated 1,917 formally employed people.
Niue	Around 61% of households performed some form of fishing activity.
Palau	There are 200 commercial fishers and 1,100 noncommercial fishers in a population of 19,000. These fishers represent about 6.8% of the total population.
PNG	About 23% of rural households (out of 130,963) catch fish. Of this, about 60% caught fish for their own consumption, the remainder caught fish for selling as well.
Samoa	In Samoa, 500–600 people appear to be formally employed in the fishing sector. One third of the total number of households in Samoa is engaged in some form of fishing.
Solomon Islands	About 6% of employment in "paid work" is in "fishing and related activities." About 5% of the people involved in unpaid work had fishing as the main activity.
Tonga	Approximately 8% of paid employment is in the fisheries sector and 3.2% of economically active people are in the fisheries sector.
Tuvalu	Fisheries represent around 5.3% of all formal cash employment. Traditional fisheries activity for subsistence represents 19.6% of all traditional activity.
Vanuatu	An estimated 35% of the 22,000 rural households in Vanuatu were engaged in fishing during the 7-day period prior to the census. Of these fishing households, 40% reported selling fish for some form of income.

RMI = Republic of the Marshall Islands, FSM = Federated States of Micronesia, PNG = Papua New Guinea.  
Source: Asian Development Bank 2002a.

*Aquaculture.* The cultivation of fish or shellfish under controlled conditions (e.g., oysters, pearls, etc.).

The Pacific's fishery resources are contained within areas called exclusive economic zones (EEZs), which were established by international treaty during the 1970s and 1980s as a means of controlling the resources in the surrounding waters. EEZs are spread over nearly 19 million square kilometers (km<sup>2</sup>), are 36 times as large as their combined land area, and are more than double the land area of the United States (ADB 1998a). It is here that deep-sea fishing is undertaken and the rights to fish are often sold by the countries. EEZs are not uniformly stocked with fish, however, and there are large variations across the region in terms of the depth of the fishing resource.

As far as commercial fishing is concerned, tuna is the most important species of fish. The western Pacific, in fact, is the most important tuna fishery in the world and it is estimated that the *annual* catch value is worth around (1998) US\$1.9 billion (ADB 2001c). This amount means that tuna alone makes up 11% of the combined GDP of all of the countries in the region and half of exports (ADB 2001c).

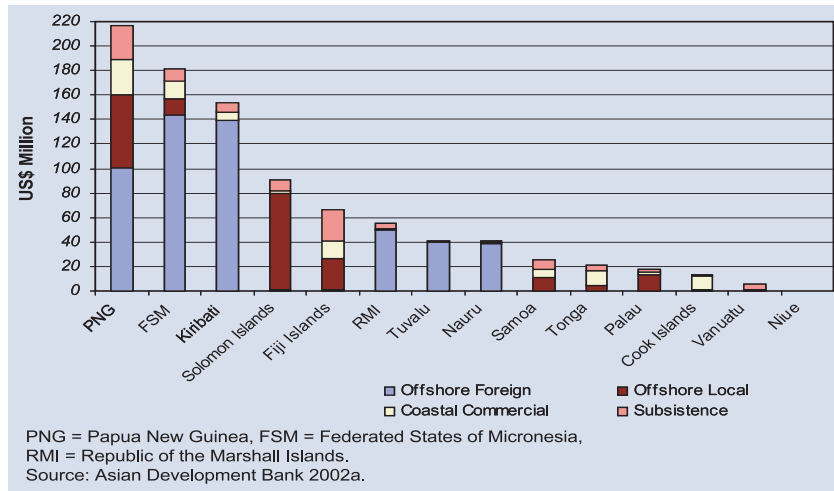
The revenue obtained from fishing in the region is primarily through the US treaty negotiated by the Forum Fisheries Agency (FFA) and bilaterally negotiated agreements between fishing countries and individual PDMCs. The fees are based on the market value of the fish and usually about 4–5% of the value of the fish caught is provided annually to the Pacific governments. There is a lack

**Table 8. Land and Exclusive Economic Zone Areas for the Pacific**

Country	Land Area (km <sup>2</sup> )	Exclusive Economic Zone Area (km <sup>2</sup> )
Cook Islands	240	1.9 million
Fiji Islands	18,333	1.3 million
Kiribati	810	3.5 million
Marshall Islands	181	2 million
Micronesia, Fed. States of	702	2.6 million
Papua New Guinea	462,243	1.6 million
Samoa	2,820	98,500
Solomon Islands	27,556	1.3 million
Tonga	600	680,000
Tuvalu	25.6	900,000
Vanuatu	12,200	680,000

Sources: Asian Development Bank and Secretariat of the Pacific Community.

Figure 27. Estimated Annual Fisheries Production by Value, Late 1990s

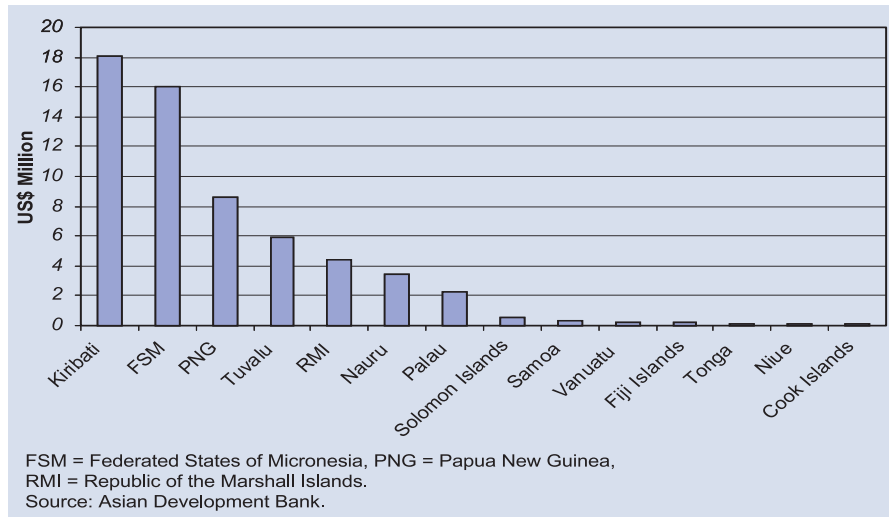


of transparency in setting quotas and rents, and individual countries are secretive and reluctant to involve FFAs. In general, it is considered that agreements are ineffective in capturing the rents associated with the resource (ADB 1998).

Currently, most revenues obtained from the fish resource in the region have accrued to foreign companies. The development of a larger domestic fishing industry by providing the enabling environment for local companies to expand, would result in more of this revenue being captured by the Pacific countries rather than simply relying on the money obtained through access fees.

It is thought that fishing supplies between 21,000 and 31,000 direct and indirect jobs in the region, or 5–8% of wage employment (ADB 2001c). Most formal employment in the sector is related to tuna fishing. The sector, however, also provides an important source of informal employment for many others, particularly those in the outer islands whose catch supplies the local market. The outer islands are suffering from rural-urban migration, and towns are becoming congested. By boosting private sector development in fishing and fish marketing, more jobs could be provided to those in the outer islands and thereby slow urban migration. Funding agencies have encouraged the further development of small fishing in coastal villages, and coastal fishing is an important source of livelihood and food.

By boosting private sector development in fishing and fish marketing, more jobs could be provided to those in the outer islands and thereby slow urban migration.

**Figure 28. Estimated Access Fees from Foreign Fishing Vessels, 1999**

Because fishing is a sector where the barriers to entry for local businesspeople are relatively low, particularly for coastal fishing where capital requirements are not as high, the sector has high potential to be an engine for private sector growth in the region. There are, however, issues that must be considered, including the following.

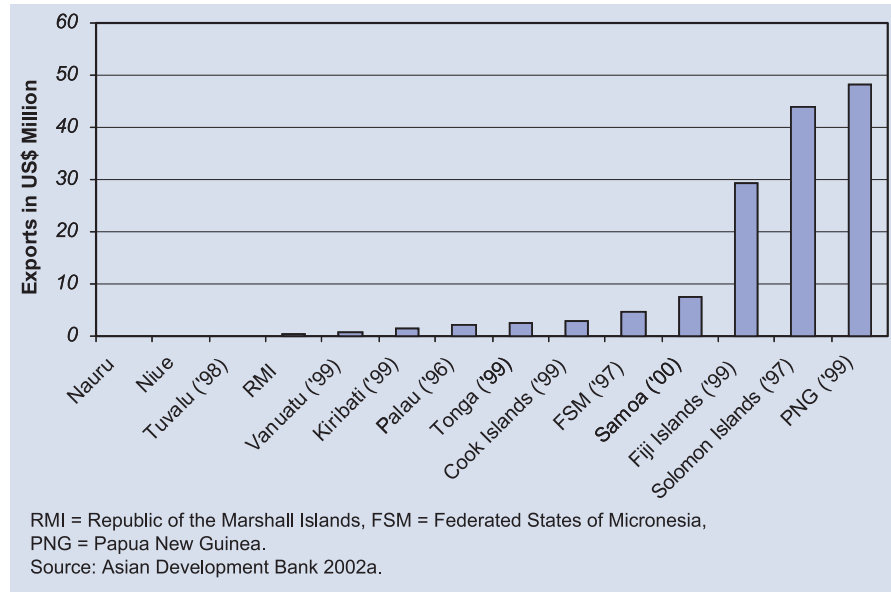
*Ensuring there are appropriate policies to manage the resource.* A growing concern will be overfishing of the resource as human population growth increasingly places pressure on the Pacific fisheries sector. It is important that the Pacific countries undertake appropriate measures to ensure the ownership, sustainability, and economic rents of the fisheries for years to come. This effort will include reevaluating the access fees charged to foreign vessels for fishing rights to ensure that Pacific countries obtain maximum value while sustaining the resource. Enforcing the regulations by policing the fishing rights in the EEZs will be critical, but regulations must be neither too cumbersome nor financially onerous so that they either remove incentives to fish at sustainable rates or could encourage illegal fishing.

Important progress has been made recently in developing regional approaches to managing tuna resources.<sup>69</sup>

- Transshipment at sea has been prohibited, significantly reducing the opportunities for underreporting and increasing domestic returns.

<sup>69</sup> Important since tuna is a migratory fish.

Figure 29. Estimated Values of Fisheries Exports, Late 1990s



- A cap has been placed on the future number of vessels from distant water fishing nations.
- Some of the member countries of the FFA have agreed to allow access to each other’s exclusion zones for domestically registered vessels.

Future management of fisheries stocks and maximizing of returns will depend on such regional cooperation. The management of coastal fisheries by state and local regulation—while equally important from the point of view of jobs and food—is less developed in most islands, and many government-sponsored development projects in the Pacific have failed. Lessons can be learned from these failures and village or district fish management schemes can be developed in some circumstances.

*Facilitating access to credit.* Without capital, private businesspeople are unable to fund their business and drive expansion. As discussed, lack of access to credit is a chronic problem in the Pacific and improvement depends on land tenure and financial sector reform. It is only through access to credit that new entrepreneurs will have adequate incentives to establish a business and existing entrepreneurs will be able to expand their operations.

It is only through access to credit that new entrepreneurs will have adequate incentives to establish a business.

### Box 13. The Response to Overfishing in Vanuatu

Villagers have conducted coastal fish management since the early 1990s. By the late 1980s, it was evident that fishing pressure on coastal resources was leading to resource depletion, especially of trochus, a commercially important coastal product. The Department of Fisheries and the Environmental Unit launched public awareness campaigns to encourage traditional, village-based conservation. The response from villagers was enthusiastic and widespread, and led to the reintroduction of “closed seasons” in 1990 (i.e., assigning a period when catching certain fish species is prohibited). Their success in improving catch rates has led villagers to extend closed seasons from trochus to other species, and to adopt further conservation measures such as bans on night spear fishing. The success of village-based management is higher where traditional authority remains strong in rural areas and where populations have alternative sources of cash income and food during the closed seasons.

*Ensuring the availability of reliable and cost-effective infrastructure.* The private sector cannot get off the ground unless the appropriate infrastructure exists in the country to support it. In the case of fishing, this infrastructure includes harbors, electricity, roads, freshwater, and most importantly, freight services. In Apia, Samoa, even the water supply to the fishing dock is a limiting factor. If fish are caught and the ports and freight services are unable to handle the product and get it to market quickly, huge costs are imposed on businesspeople and those local fisherfolk who are providing the fish. In addition, if the utilities are poorly operated and unduly costly (e.g., high electricity costs, docking fees, etc.) an implicit tax is imposed on that activity and raises the costs of doing business, thereby hindering economic activity.

Government ownership of fishing-related businesses is a major obstacle to private sector development.

*Examining state-owned enterprises.* Government ownership of fishing-related businesses is a major obstacle to private sector development (ADB 1997a). Government-owned businesses are generally not well run and crowd out efforts by the private sector. Privatization of these SOEs, however, is needed and must be carefully structured to ensure an equitable arrangement for both the investor and the country involved. The chapter on privatization examines the issues on selling SOEs.

*Removing industry preferences and protection.* Foreign governments often provide preferential access to their markets for some products from some countries. These preferences give a false sense of profitability to the products and distort investment. When preferences are removed by opening market

#### Box 14. The Impact of No Infrastructure

In Vanuatu, anecdotes abound about how rural enterprise could expand but for the absence of one or two conditions. For instance, there was a budding fish export industry established where a private operator supplied ice and iceboxes to small fishing communities on the outer islands and returned to pick up the fish for export. But capacity to airfreight the produce was unreliable and he lost several shipments that were bumped off flights. As a result, he did not pick up fish from the local fishermen when promised and they lost interest in supplying him.

access to all, the investment and jobs in that activity are often lost, as the industry is not globally competitive. The fishing industry in the Pacific receives this preferential treatment. The region, however, cannot expect this protection to remain as the world moves towards freer trade. General border protection in the form of tariffs, imposed by Pacific governments adds to the cost of inputs for the fishing industry and discourages onshore foreign investment in fishing. It also reduces competitiveness of the local industry in the region. These factors dampen private investment and divert investment in other industries. Short of totally removing tariffs, the protection of inputs to critical industries such as fishing must be removed so that investment and growth are encouraged.



# X. Small and Medium Enterprise Development

## Providing Special Consideration and Assistance for Small-Scale Rural Enterprises

The private sector assessment of the Pacific reveals a strong dependence by the majority of the population on rural-based activities for their livelihoods. Further, the income level of rural people is well below those in urban areas, and in fact, majority of the poor are rural residents or rural migrants to the fringes of major cities. This situation makes it necessary for a private sector strategy to address this often neglected group and provide more direct poverty reduction efforts. While there continues to be a need to assist the poor—especially the poor in rural areas—through social assistance, there is also an argument for assisting the development of commercial opportunities for small and emerging rural businesses.

The argument for rural businesses is based on the need to explore all possibilities for creating viable income-generating opportunities for communities, families, and individuals that would thereby reduce the numbers dependent on social assistance. This approach is especially relevant in the case of “failing states” where the potential for more general business environment reform is low. In such circumstances, operating at the local level, particularly in rural areas, may be the only opportunity to assist businesses. However, this is not an argument for more general direct intervention to *promote* business, but rather a suggestion that pilot projects along the lines of those suggested for SMEs in the section below, could be tried in rural areas, especially in cases where the central administration is in disarray.

Of the many variants of assistance directed to communities and small businesses by the multilaterals, ADB is presently piloting an innovative approach in Papua

New Guinea. The Nucleus Enterprise Project (ADB 2001b) promises to build communities while providing the type of assistance to small and emerging businesses that are likely to succeed. Since it is operating in what is almost an enclave environment, it ameliorates some negative effects of the generally highly unfavorable private sector environment in the country. This project should be monitored carefully as an approach to private sector development, which may be applied to other PDMCs, especially those where the state is dysfunctional.

## Is There a Need for Generic SME Policies?

If small-scale rural enterprises are to be a focus of targeted assistance, a further relevant question is whether there should be specific SME interventions. Any answer to this question should emerge more generally from the justification for SME policies. Much of the rationalization of many SME interventions does not, in most cases, stand up to a careful examination of the evidence.<sup>70</sup> However, it is undeniable that SMEs suffer from particular handicaps because they face higher transaction costs, both on a per unit of output and on a per employee basis than large firms do.

By international standards, there are few large businesses in the Pacific, with the exception of a small number of natural resource companies that operate in Papua New Guinea and other island economies. A specific SME policy would therefore be targeting almost all businesses in the region. Such a policy would be redundant in the sense that the resulting strategy would apply to all SMEs, which constitute nearly all Pacific businesses. Consequently, there is no need for a separate policy for SMEs.

Since nearly all businesses in the Pacific are small or microenterprises, should “traditional” SME policies such as business development services, loan guarantees, incubators, and small business investment funds be an important part of policy in the Pacific? We suggest that it should not be. A major theme of this analysis of the private sector in Pacific

An SME policy would be redundant in the sense that the resulting strategy would apply to all SMEs, which constitute nearly all Pacific businesses.

<sup>70</sup> Arguments include (i) small businesses create more jobs (they do, but they also fail at a much higher rate than larger companies, so they also lose more jobs—SMEs on a net basis do not create a disproportionate number of new jobs); (ii) SMEs are more innovative (research indicates the opposite); (iii) SMEs are more flexible (there is no convincing evidence to support this contention); and (iv) SMEs are more entrepreneurial than large companies (there is no convincing evidence to support this statement).

countries is that previous interventionist “bottom up” approaches to private sector development have produced disappointing results over an extended period. This paper recommends that private sector development policies focus primarily on the enabling environment for business rather than sector-specific interventions. A similar theme is beginning to appear in more recent work on policies toward SMEs. While the strategy should not necessarily rule out all specific interventions, they should be strictly on a pilot basis with very carefully designed success criteria that are directed at output variables such as sustainability, cost per intervention, and contribution to business value added, rather than input variables such as businesses that have been “helped.” Only in this way can the viability of such approaches be tested.

# XI. Toward a Strategy for Private Sector Development in the Pacific

We have discussed the common concerns experienced by many countries in the Pacific that are realizing their earlier policies have failed to bring prosperity to the region in spite of the highest per capita aid flows in the world. Donors are concerned that in spite of their substantial efforts in granting aid to the Pacific islands, poverty has increased in the region. At the same time, policymakers in the Pacific countries fear that reforms designed to open their economies could result in more intense competition and lead to even higher unemployment.

These concerns are understandable. However, Samoa's recent history illustrates that there can be policy shifts, trade reform, and moves toward reducing the role of the state in the economy while promoting rapid growth at the same time. Furthermore, several Pacific governments now acknowledge that growth can only be generated by private sector activity and there are signs of willingness to change the environment for business by improving incentives, promoting efficiency, and reducing costs. This situation provides optimism for the future.

Countries in the region are looking for a way forward and are seeking support (technical as much as financial) from funding agencies to assist in designing and carrying out reforms that would stimulate the private sector and in so doing address the employment/poverty nexus. This circumstance represents an opportunity for individual countries, ADB, and other funding agencies. The

Samoa's recent history illustrates that there can be policy shifts, trade reform, and moves toward reducing the role of the state in the economy while promoting rapid growth at the same time.

private sector assessments undertaken for this publication provide the elements for the development of road maps for Pacific countries.

By following private sector-friendly growth-oriented policies, Pacific countries will ensure that they capitalize on the growth of the world economy. In many ways, the issues raised here represent the confluence—or conflict—of tradition versus modernization. The countries of the Pacific wish to secure improved opportunities and incomes for their people, but the fundamental question they wrestle with is whether they must modernize—and by implication give up cherished traditions and customs—to do so. Modernization is a necessary condition for development but this modernization does not necessarily mean foregoing traditions and customs. Incentive structures can evolve to include local cultural practices, just as they have in other parts of the world. The countries of the Pacific have already embarked along this journey toward modernization. The key issue for Pacific countries to determine is how far along that road they wish to travel and at what speed.

Modernization is a necessary condition for development but this modernization does not necessarily mean foregoing traditions and customs.

## Considerations for Pacific Governments

### *The Countries and Private Sector Development Policy*

While generic problems are widespread, details vary from country to country, and in the case of private sector development policy, effective solutions require thorough investigation. For example:

- Legal systems on which commercial transactions are based are inadequate in most countries. But reform requires microlevel analysis.
- Although land arrangements have many common features across the Pacific, in each country there are crucial and important differences.
- Utility provision is almost invariably high-cost, but arrangements as to which utility services are supplied vary—from government electricity and water departments to high-cost, barely regulated monopolies.
- The weak systems of property rights for both movable property (chattels) and for land, which exclude the large majority of the local population from access to the financial system, require urgent attention, but specific solutions will vary from country to country and will depend upon local conditions, practices, and customs.

These examples illustrate that there can be no substitute for comprehensive country-level analysis in diagnosing and prioritizing local solutions. Further, it is important that differences between Pacific countries be accounted for in any solution. Interventions for reform must take into account cultural traditions of individual countries—there is no single formula to be applied across the region.

Furthermore, the implementation of policies must be based on a high-profile and broad-based discussion of the issues within PDMCs themselves before reform should be attempted—long-lasting and far-reaching change will only be brought about if the Pacific countries are sufficiently convinced that it is the appropriate course to follow. Funding agencies can indicate that they will no longer support failed policies of the past. They can encourage the search for new solutions. They can describe initiatives that have been effective in other countries. But effective solutions can only emerge at the will and leadership of the countries themselves. In addition, aid coordination is essential if policies toward the private sector are to be consistent and carry an unambiguous message.

Improving the environment for business requires commitment, analysis, persuasion, political action, and coordination at the country level between governments and the private sector, plus coordination and support on the part of funding agencies.

Effective solutions can only emerge at the will and leadership of the countries themselves.

- First, no successful strategy can be implemented without the wholehearted support and cooperation of the government of any country where it will be implemented.<sup>71</sup>
- Second, success requires carefully identifying priorities for reforming the enabling environment.
- Third, it requires a prioritization and commitment on the part of funding agencies to make private sector strategy the centerpiece of country programs.

Alternatively, the funding community might seek to convince Pacific countries that changes in policies toward the private sector will lead to improved growth and prosperity. They might achieve this end through initial analysis and discussion at the country level, which can lead to requests for assistance. There is no single path that promotes private sector development. The discussion

<sup>71</sup> The governments must also engage their citizens in a dialogue so there is a general understanding of the need for change and support for it.

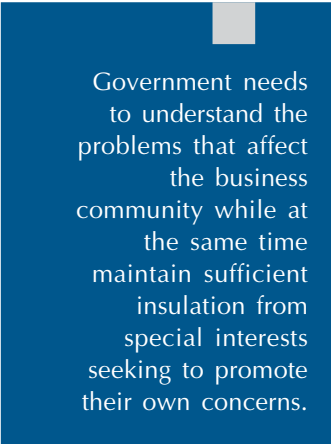
that follows outlines a general approach at the country level, the international donor level, and then, in some detail, options and suggestions for funding agencies such as ADB. In practice, however, the process is likely to be the result of focused interaction, which will not follow any predetermined pattern.

The role of the government in private sector development lies in establishing an enabling environment that promotes long-term contracting and a planning time horizon that is not distorted by political uncertainty. It requires clear rules and the absence of corruption. In some Pacific states, governance is either weak or nonexistent, with several states being on the verge of failing completely. Funding agencies have tried to address issues of governance, but the knowledge of what to do and how to promote good governance is still in its infancy.

For government to provide an environment in which the private sector can flourish, it needs to understand the problems that affect the business community while at the same time maintain sufficient insulation from special interests seeking to promote their own concerns at the expense of economic efficiency. In the final analysis, competition will always bring about the best solution to problems of efficiency, allocation, and growth.

### ***Need for Interaction Between Government and Business***

To appreciate fully the factors that affect private sector development, the government and the private sector need to understand and interact on problems and issues. In addition, the government and the funding agencies must be



Government needs to understand the problems that affect the business community while at the same time maintain sufficient insulation from special interests seeking to promote their own concerns.

prepared to guard against the initial reaction of the private sector to probably request special concessions, often in subsidized credit and protection against competition. A striking feature of the private sector assessments undertaken as part of this regional technical assistance was the low level of communication between the business community and the government in the countries visited, which has resulted in suspicion, resentment, and at times, hostility between the two parties. A unique exception occurred in Vanuatu in October 2002 when the Chamber of Commerce and the Government held a weeklong seminar in which grievances were aired and action plans for future cooperation were developed. On the one hand, this dialogue was clearly constructive, while on the other, there were signs that special interests were being promoted, and calls for subsidized credit and insulation from foreign competition illustrated this point. Nevertheless, Vanuatu's business forum process is certainly a step in the right direction and other Pacific countries

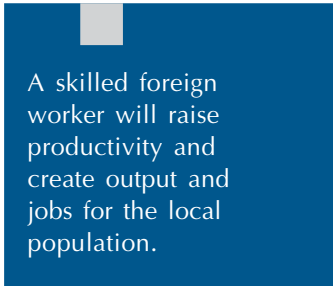
should be encouraged to establish similar mechanisms of dialogue between government and business.

### *The Need for Analysis*

The Vanuatu example illustrates the necessity for the parties involved in such an interchange to have a view of the parameters that define the debate. Nevertheless, without close cooperation between the private sector and the government, many opportunities for improvements in the business environment are foregone. An additional area where understanding of problems and issues is required is the informal sector. The needs of rural communities attempting to start and grow commercial ventures of their own are often virtually ignored by both government and the formal private sector operating in urban areas. Since they do not yet formally exist, they do not have a voice. Yet, policies for such private sector development need to be formulated.

### *Foreign Workers, Foreign Investment, and Incentives*

Most Pacific economies are critically short of skills of all types, which is one of the causes of low productivity in the region. Yet, in most countries, there are restrictions and cumbersome procedures for obtaining or renewing work permits for foreigners who have the needed skills. This policy, like many others implemented with intent to help the economies of the region—whether explicit or implicit—has a contrary effect. It drives down overall productivity levels, keeps salaries low, which in turn encourages the emigration of skilled Pacific workers. Reluctance to approve work permits for foreign workers is based on what is known as the “lump of labor fallacy,” namely that there is a limited amount of work to be divided among the workforce. In terms of this fallacy, it follows that if a worker is brought in from outside, a local must lose a job. The reality is far different, however. A skilled foreign worker will raise productivity and create output and jobs for the local population. In addition, the foreign worker provides an opportunity for skills transfer to local workers. Every country in the Pacific should welcome any skilled foreigner with open arms. Rather than make it difficult for businesses to bring in skilled workers, processes should be simplified and expedited.



A skilled foreign worker will raise productivity and create output and jobs for the local population.

Similarly, the fastest way to upgrade business practices is to learn them from foreign investors. The world abounds with examples of foreign investors bringing improved business practices and methods to developing countries, which are



then learned by locals who use them to start businesses of their own. Foreign investment is one of the best ways for countries to acquire skills and techniques, generate employment, and promote growth. Unfortunately, in much of the Pacific, foreign investment procedures are mired in red tape and delays, onerous registration requirements, and difficulties in bringing projects to fruition. Tales abound of potential investors leaving frustrated and going elsewhere.

### *A Schematic of Government Policy for Private Sector Development*

The first step in promoting country-level private sector development must be a commitment to promoting it and an acceptance by government that sustained growth and prosperity can only be achieved through a dynamic, expanding private sector.

The central theme of any private sector strategy is not fostering specific companies or sectors. It is not whether countries have potential because of endowments of natural resources. Rather, it is ensuring that the incentives and conditions that affect business and entrepreneurship promote productivity and growth.

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As a result, private sector issues encompass almost every area of the economy. In addition, the government is not the only one responsible for implementing a strategy to encourage private sector development. The private sector itself must play a central role in formulating policy, and both have responsibilities—the government must not erect barriers to business and commercial activities; the private sector must not expect special preferences.

The process that the countries could undertake entails

- identifying problems that hinder the development of the private sector, which require significant technical expertise, especially in the early phases (an area where funding agencies can be particularly effective);
- consulting with the private sector to prioritize and reduce the large number of identified problems (including changes in the law or the ways in which services are provided), and communicating this to politicians and the public; and
- consulting a second time with the private sector to maintain enthusiasm and involvement with the implementation of new policies in the design (including feedback mechanisms and quantifiable criteria) and evaluating periodically to monitor implementation.

## *An Agenda for Governments*

The private sector in PDMCs faces numerous challenges. Solving them requires a commitment and action plans (road maps) by governments to address adequately those challenges through regulatory and legislative reform. The agenda is large, and issues of sequencing, selectivity, and priority will arise. Since this report is regionwide, it is not possible to provide detailed country road maps. Rather, in this report, the most important issues are identified in a general context. Individual countries will need to decide what specific actions within a particular issue they should take and in what order the improvements should be made. Priority issues that inhibit private sector development across the region are

- state interference in the economy
- poor provision of public goods
- high-cost operating environment
- underdeveloped financial markets
- land rights issues
- poor investment policies
- natural resource management issues

The agenda is large, and issues of sequencing, selectivity, and priority will arise.

*State Interference in the Economy.* The size of government in PDMCs, compared with other developing countries, is large. Even when it does not constitute a large percentage of GDP, in many Pacific countries, governments have imposed burdensome regulatory regimes on private business and own a large number of business enterprises—many of which are monopolies. Private business is regulated out or crowded out of much business activity. This situation distorts investment and returns to capital, and results in a less efficient economy than one with fewer controls and fewer state enterprises.

Where public goods require public finance, modern practice suggests separating financing from the delivery of service, and introducing, where possible, competition-based private sector participation in service provision, even if it is financed by the state. In the Pacific, an improved regulatory regime that allows for competition and the rapid adoption of technical change, combined with the sale of government-owned commercial businesses, would greatly lower costs, and decrease the size of the state. This then, is the beginning of a reform agenda. It will be difficult for the private sector to perform at its full potential and create jobs at the needed rate until these aspects are resolved.

*Poor Provision of Public Goods.* The state fails to supply public goods that underlie an effective and efficient private sector—secure property rights, a legal system that allows contracting with confidence, and efficient and low-cost

infrastructure and regulations. There is the paradoxical situation in the Pacific where states are engaged in activities where they should not (owning commercial businesses) and are not supplying what they should supply (secure property rights, a well-functioning legal system, low-cost infrastructure, etc.). This misallocation of government effort is a primary contributing factor to the low rates of return on capital, aggravating the problems of size and distance, and acting as a tax on development. Reorienting the role of the state should be an early and continuous agenda item.

*High-Cost Operating Environment.* The most common complaint heard from the business community during country visits was the high costs of conducting business. Part of the problem arises from the size and remoteness of the countries, but these effects are compounded by misguided government intervention and policies that further push up costs and reduce competition. Electricity generation and distribution are typically state monopolies as are telecommunications and water supply, and the state owns and operates critical infrastructure such as ports and airports. These businesses are operated and often owned by the private sector in much of the world. Where monopolies exist, they are regulated, but often, competitive or contestable solutions can be found so that heavy regulation is unnecessary. Novel solutions for small island economies, such as an offshore regulator, could also be considered. When the costs of doing business are high, firms are discouraged from establishing or expanding their business. There is a great deal that can be done to escape the costs associated with the regulation of businesses and monopolies. It is here that PDMCs should strive to introduce international best practice to provide an environment conducive to private sector development.

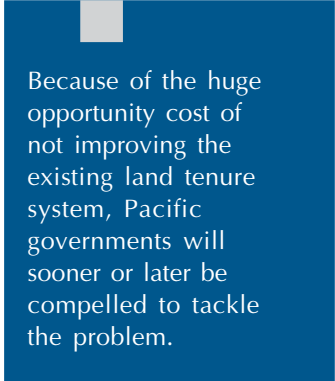
*Underdeveloped Financial Markets.* The financial markets of the Pacific are underdeveloped and do not provide sufficient support for the private sector. While interest rates and the money supply are no longer controlled by fiat, the banking industry is poorly developed—banking services seldom reach beyond urban areas, credit to indigenous entrepreneurs is extremely limited, interest rate spreads are large (with some exceptions), and informal lending substitutes for commercial banking. The poorly developed financial sector is related to shortcomings in the secured transactions framework and the incompatibility of the customary land system with secured lending. When banks cannot secure their lending with collateral, lending is costly. In PDMCs, the system for using property as security is cumbersome, expensive, and often unavailable. To deepen financial markets and increase credit availability, these two elements should be addressed. The longer-term aim should be to strengthen property rights so that financial markets can channel funds from savers to investors to stimulate

economic development. While external funds are substitutes for financial deepening, they are not a long-term solution and will not aid in the development of the financial sector.

*Land Rights Issues.* Secure ownership and the ability to exchange land is needed to create a positive investment climate for small entrepreneurs, in addition to being a precondition for the emergence of financial markets—a situation that does not exist in PDMCs. The institutional framework for land ownership and use (land use, land rights, and land tenure) is one of the most long-lasting, culturally sensitive, and politically controversial issues in Pacific societies. Suggestions to modify customary land systems are extremely contentious and are usually considered by politicians to be too hard to undertake. Yet maintaining the current form of customary ownership comes at a huge economic cost to the Pacific countries. The largest asset of the Pacific region is generally not useable as collateral to raise capital for investment. Over 90% of land in PDMCs remains under customary ownership without formal ownership. In most developed countries, the bulk of small businesses are started using loans that are backed by land or residential property. This facility is not available in the Pacific. The problems in land tenure in PDMCs include


- unclear ownership and boundaries because of a lack of records;
- restrictions on transferability because of unclear ownership;
- weak dispute resolution practices; and
- ineffective enforcement.

Because of the huge opportunity cost of not improving the existing land tenure system, Pacific governments will sooner or later be compelled to tackle the problem. As noted earlier, simply introducing conventional western land tenure systems will not solve the problem in a politically durable way. The new system must closely complement the customary system of land rights yet permit more land to serve as collateral. Many Pacific countries are cautiously reviewing their land rights systems to see how they can be changed to meet present-day needs. But progress is slow, unsystematic, and lacks commitment. It would be desirable—in the interests of private sector development and the wider interests of development, civil harmony, and good governance—for countries of the Pacific to start taking a series of small, systematic, and conclusive steps toward solving the identified shortcomings of the existing land tenure system.



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*Poor Investment Policies.* An enabling investment climate requires many actions from the government. It requires sound macroeconomic management, and trade and investment policies that promote openness, productivity, and growth. While PDMCs are doing much better in this regard, more can be done. In addition, an attractive investment climate requires sound governance, promotion of competition, and prevention of corruption, with a solid foundation of basic physical and social infrastructure. Again, PDMCs have moved in the right direction, but much more is needed. Without a predictable environment for people, ideas, and money to work together, investment will simply not occur. The role of government is to provide an environment for entrepreneurs to invest in productive activities. An environment conducive to overcoming the natural disadvantages of size and distance is not the norm in any PDMC. Importantly, a secured transactions framework is missing, it is usually expensive to establish and register a business, incorporation is not easy, and often, specific industries are targeted for assistance while obstacles to investment are imposed on others.



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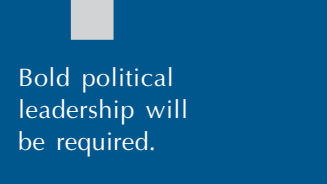
Governments of the Pacific have tried to control foreign investment largely out of fear of business failure from exploitive investors who put little capital at risk. They have generally held the view that investors have to prove their bona fides and often require them to go through lengthy vetting procedures before allowing investments to proceed. Results have been less than satisfactory. The process is haphazard, and at times, governments have been defrauded by investors to whom they have offered special inducements but who have then absconded. Other investors have been discouraged by lengthy review processes and have lost interest. A relatively recent study found no instances of fraud on the part of businesses that were not given special incentives (Hughes 1998). That does not mean, however, that some foreign investments will not fail.

Business is inherently risky and failure is common worldwide. But investors, domestic or foreign, who are willing to put their capital at risk, should be provided an open investment environment where their success depends on the merit of their business and not on the whims or performance of government. In this respect, there is much work to be done by governments in the Pacific in enhancing the environment for business investment. Screening procedures for foreign investors should be minimal and, preferably, all should be welcomed but none singled out for special incentives.

*Natural Resource Management Issues.* Pacific countries are heavily dependent on natural resources for their livelihood. Most are renewable resources but

some are extractive and some are renewable but treated as extractive. These natural resource-based industries are agriculture, fishing, tourism, forestry, and minerals. Resource management and the management of rents from extraction are critical issues for the economic development of countries in the Pacific. There is a great need to develop workable management protocols for the natural resource endowment so that it continues to provide optimal returns not only in the near future, but for generations to come.

This summary when broken down into specific actions represents a formidable agenda for policy change, which will take time and political will to accomplish. Many of the changes are unavoidable if countries genuinely wish to lift their economic performance and provide income-growth opportunities for their citizens. Careful design and community consultation will be needed, along with a clear explanation and expectation of the benefits that will be derived from undertaking the changes as well as the costs of not undertaking them. Bold political leadership will be required.



Bold political leadership will be required.

## Funding Agencies and the Private Sector

Successful implementation of a private sector development strategy will depend on implementing the vision of the private sector as the driver of economic growth. Establishing an enabling environment for enterprise, providing macroeconomic stability, reducing costs, and reducing the interference of the state in the economy, will be the only way to achieve this success. It also depends on convincing the Pacific countries that the state can promote growth by supporting the private sector, rather playing the central role in the economy itself, which effectively crowds out private sector activity. In addition, it is important to convince states that past attempts to promote economic activity and compensate for perceived disadvantages by putting the state at the center of economic activity have had the opposite effect and have damaged and hindered private sector development.

As a general rule, donors focus their respective private sector strategies on a limited range of issues that appear to be the cause of the low rate of return on capital and that lead to the binding constraints to business startup and development. The approach involves promoting the shift in the mind-set of government officials away from seeing the government as a producer of products and services to viewing it as a facilitator of economic output by business. This end can only be achieved through discussion and policy dialogue among

governments, private sectors and the general public. Coordination among funding agencies is critical.

Funding agencies should make private sector development a central part of their overall development assistance strategies in the Pacific. Further, it is important that this be consistent with a broader strategy to promote the private sector in the region and in line with the interventions of other donors—coordination of effort among donors makes aid much more effective. Analysis is best performed by the multilateral institutions, which ideally should feed into the overall donor strategy. This should be based on important general principles such as ensuring political commitment, involving key stakeholders, accounting for local culture, focusing on outcomes and impacts, and designing projects to take account of local implementation capacity.

It takes time to communicate a need for reform. It takes time to implement projects, to show results, to build staff-government relationships, and to build expertise and reputation in specific areas. In focusing on few specific issues, respective funding agencies and governments can collaborate to devise country-specific strategies, and prioritize and implement solutions until the results begin to make themselves evident.

## Considerations for Funding Agencies

### *Funding Agency Involvement in the Pacific*

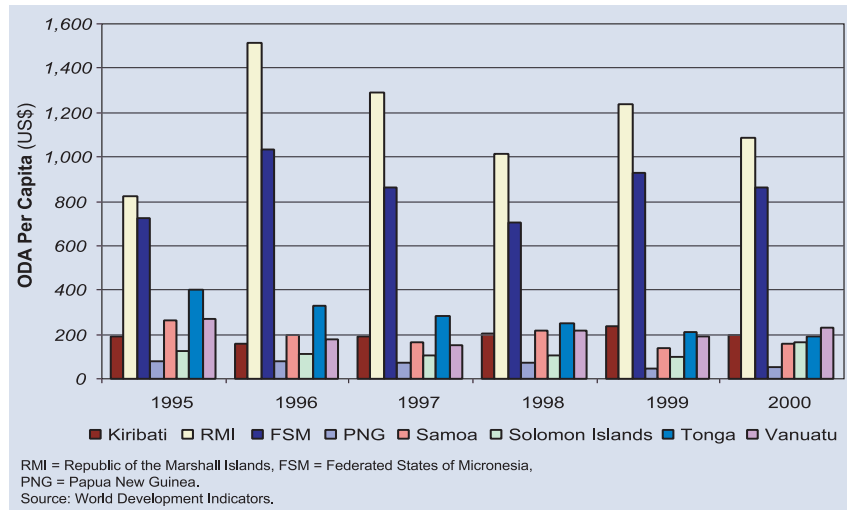
Of the total net disbursement of official development assistance to PDMCs, bilateral sources account for over 80%, with multilaterals being minor players.<sup>72</sup> Official development assistance to PDMCs averages around \$700 million per year. There are great variations across PDMCs in the per capita aid level ranging from over \$1,000 in the Marshall Islands to less than \$50 in the Fiji Islands. Another feature of aid to the Pacific is the high proportion of technical assistance to project lending.

Apart from ADB, and to a much lesser extent, New Zealand, there is something of a vacuum in the area of assistance for private sector development. No other donors are placing a consistent, focused effort on private sector development in the Pacific. Many are undertaking activities that have the potential to influence private sector development—infrastructure, governance, and trade issue projects—but none have private sector development as a consistent priority.

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<sup>72</sup> Yet the multilaterals, with their reputation and “power to convene,” do have a leadership role disproportionate to their financial support.

Figure 30. Official Development Assistance Per Capita, Select Pacific Countries



### Need for Aid Coordination

Coordination of international aid programs among various funding agencies is important in providing a coherent program and consistent policy advice to a country. During the past decade, the aid programs in the Pacific were largely sponsor-driven, often uncoordinated, and placed pressure on the absorptive capacities of PDMCs.

Lack of coordination led to a dependence on aid for financing the capital budget and playing off funding agencies by recipient governments. It also has meant that the effectiveness of some funding agencies' efforts have been undermined by others, especially at the bilateral level. For example, in the Marshall Islands, the Government was persuaded by an IFI (and supported by a loan) to close down a highly inefficient department of public works. A new government came in and announced that it would reconstitute the department. The protests of the IFI were completely undercut by a large donation of road-working machinery to the new department by a bilateral donor. The validity of the IFI view is proven by the fact that the machinery is now largely unused because of poor maintenance and the resulting poor condition of the roads.

While the possibility of a "race to the bottom" exists, there is also a possibility of a "race to the top."

Coordination is improving, however, most notably in Papua New Guinea where a joint strategy is being developed by a team drawn from three major funding



agencies.<sup>73</sup> ADB has played a lead coordination role for several PDMCs, particularly in reform programs. The consultative group mechanism has become a familiar structure through which ADB and the World Bank have brought funding agencies and countries together to agree on priorities and efforts. Consultative group or development partner meetings were convened over the last few years for most countries in the region.

Without aid coordination, especially on some policy issues, the likelihood is a zero sum outcome. For instance, if countries compete by offering incentives to foreign investment, it is unlikely that net investment in the region will rise; rather, one country will divert investment away from another, setting up a “race to the bottom” where potential investors can play one country off against another to extract the maximum concessions. Similarly, without the benefits of lower travel costs, it is unlikely that tourism promotion in the Pacific will lead to an overall rise in visitors. Hotel construction in many countries simultaneously could lead to substantial overcapacity—there is the potential that funding agencies helping individual countries without taking a regional perspective can have an adverse impact on the region as a whole.

While the possibility of a “race to the bottom” exists, there is also a possibility of a “race to the top.” If countries implement investment-friendly policies through systemic reform that offers investors low regulatory barriers, simple and transparent application procedures, low tax rates, and low import barriers, the Pacific as a whole becomes attractive to foreign investors in a self-reinforcing way. This arrangement sets up a virtuous circle in which positive reform in one country induces similar changes in others. Not only will foreign investment benefit from such measures but local investment as well. The Pacific, as a region, could develop an international reputation of being a friendly environment for investment.

Such actions, however, first, depend on government commitment, and second, on funding agencies taking a unified approach to reform in the Pacific. This adjustment also needs to occur in the area of technical assistance, as in the case of the road-working equipment, which also needs to be coordinated. In the countries examined here, the quality of technical assistance varied between excellent and poor. Not only does poor advice dilute the reform message, but there is a danger of advice that is politically expedient, driving out beneficial advice. Furthermore, scarce technical assistance funds are wasted when the same issues are studied by different agencies. Change will occur as a result of

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<sup>73</sup> ADB, AusAID, and World Bank 2003.

focused advice that is technically sound, followed by widespread dissemination that promotes discussion between civil servants, politicians, and the private sector.

Funding agencies should encourage governments to be more active in planning investment and assistance priorities, and integrating this action with national budgets as well as donor interests, funding capacity, and expertise.

## The Voyage Must Begin

The core theme of the strategy for the Pacific is that many interventions, justified on the premise that Pacific countries require special policies because of their size, remoteness, and vulnerability—such as government ownership of lumpy capital investment projects—have had an adverse effect. Rather than ameliorate problems, they have exacerbated them by raising costs and reducing rates of return on capital. Rather than help the Pacific countries integrate more closely with the global economy, policies have added to their isolation.

The strategy outlined here has focused on a relatively small number of issues:

- reducing the role of the state;
- strengthening property rights for movable property as well as for land;
- strengthening financial systems; and
- improving infrastructure by promoting more local involvement in procurement and maintenance.

To obtain results, governments must focus on a few of the most constraining issues. Many issues, particularly land reform and the role of the state, are complex and will require persistence by funding agencies and political will by governments.

Further, even if implemented, such reforms will not fix everything at once. It takes time for an economy to respond to new incentives. It takes time for potential emigrants to realize that new opportunities exist at home rather than in countries to which many of their fellow citizens have migrated. It takes time for financial institutions to adapt their lending practices to the realities of reformed debt collection procedures. And it takes time for the beneficial effects of one policy reform to spill over into other areas or sectors of the economy. That the process may be lengthy is not an argument against beginning reform immediately, but it is important to bear in mind that patience and perseverance

There is no alternative to change if the future and aspirations of the younger generation in the Pacific are to be met.

are necessary. In addition, reform requires a major community information campaign to apprise citizens of the benefits of economic changes for stimulating the private sector.

The voyage must  
begin anew now.

Some strategic directions suggested in this strategy are perhaps controversial because they are not conventional. Since conventional approaches have not worked in the past, more of the same will result in the same unsatisfactory outcomes. Repeating the patterns will lead to more failed aid programs, more hopes dashed, and further cynicism and isolation of the people of the Pacific. There is no alternative to change if the future and aspirations of the younger generation in the Pacific are to be met. The voyage must begin anew now.

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