

Chapter 5

Private Sector Development

5.1 The Enabling Environment

The economic reform of the mid-1990s created the enabling environment needed for private sector expansion. The private sector has responded and, on the main islands, filled the void created by contraction of the public sector.

Business and competition has flourished

Cuts to public expenditure and public enterprises helped lay the foundation by reducing the crowding-out effect that had drained finance and labor from the private sector. A low level of government regulation and red tape has also been a feature of the enabling environment and has played an important role in facilitating the transition toward private sector-led growth. The light-handed approach to regulation has allowed the entry of new competitors and reduced the cost of doing business.

With several notable exceptions, especially in utilities, direct government intervention in the economy is relatively limited, with commerce and trade largely left to the private sector. Importantly, most businesses do not need to be licensed, the main exceptions being for banking, shipping, and air services. This facilitates business entry, while the registration processes do not necessarily impede the private

sector. There are, for example, no restrictions on the entry or location of pharmacies.

The cost of doing business is acceptable, though hard data to confirm this does not yet exist

The costs of doing business in the Cook Islands appear to be low. This reflects, in part, the generally well-functioning commercial and judicial systems based on New Zealand laws and practices. The legal system functions reasonably effectively, and property rights are well protected. Contracts are observed and legally enforceable, and although there are no bankruptcy laws, creditors may legally recover debts or secured collateral. The legal infrastructure and codified laws for conducting business appear very satisfactory, and this certainty boosts business and investor confidence. Entry into business services, e.g., legal and accountancy services, is good. As a result, access to the services is also good.

While the costs of doing business do not seem to impede business in the Cook Islands, this remains largely untested empirically. The World Bank maintains a database on the costs of doing business covering 175 countries, which includes 10 Pacific island economies that generally rank poorly.⁶³ As the Cook Islands is not a World Bank member, it is not covered. Obtaining indicators of the costs of doing business along the lines of the World Bank database would be useful for verifying the observation of a favorable environment in the Cook Islands.⁶⁴

New commercial legislation is planned

To strengthen the enabling environment further, the Government intends to introduce additional commerce-oriented legislation, including the (i) Consumers Guarantee Act, covering the sale and supply of goods and services;

⁶³ These are the Fiji Islands, Kiribati, Federated States of Micronesia, Palau, Papua New Guinea, Republic of the Marshall Islands, Samoa, Solomon Islands, Tonga, and Vanuatu. The database (available at www.doingbusiness.org) covers the topics of starting a business, dealing with licenses, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business.

⁶⁴ The Pacific Islands Forum Secretariat has commenced such an exercise, and indicators for all member economies including the Cook Islands should be available in 2007.

(ii) Fair Trading Act, establishing the Office of Consumer Commissioner to protect consumers from unfair trading practices; and (iii) Small Claims Tribunal Act forming a small claims tribunal. By providing low-cost dispute resolution and clearer rules of appropriate behavior, this suite of legislation may strengthen consumer protection and help avoid the large backlog of commercial matters in the courts, which is currently being addressed by introducing more sittings that are frequent.

In practice, the effectiveness of these initiatives will depend on the necessary financial and personnel resources being in place for monitoring and enforcement. Legislation already in place to deal with such marketing behavior as pricing, receives little financial support. Because of this, it falls short of its objectives. Partial implementation has its downside (as discussed below); adding to the regulatory task without adequately funding it would have a downside.

The Government is also considering introducing a commerce act to establish a commerce commission aimed at safeguarding competition. The latest version of the bill (May 2004) is a comprehensive piece of legislation that mirrors similar pro-competitive legislation in New Zealand and Australia.⁶⁵ It establishes competition rules to (i) outlaw restrictive trade practices resulting in a substantially lessening of competition, as well as the illegal use of market power; (ii) govern mergers and acquisitions, price controls, and authorizations and clearances; (iii) improve access to “services, facilities, infrastructure, and networks;” and (iv) provide legal, civil, and criminal remedies.

While such an agency would be at home in a highly developed economy, its practicability and effectiveness in a very small country like the Cook Islands is questionable.

⁶⁵ An earlier version of the legislation, dated May 2002, is less ambitious and preferred by the Cook Islands Chamber of Commerce (CICC). It suffers, however, from the same practical drawbacks and this would substantially exceed domestic capacities for implementation and enforcement.

A commerce commission is proposed, but it would exceed domestic supervisory capacity and do more harm than good

This is mainly because the business environment is neither sophisticated nor complex, and the country has very few people with the economic and legal skills needed to correctly interpret and apply such legislation and to staff the commerce commission competently. Overseas experience confirms that such commissions are very costly to operate and can generate substantial legal cases and judgments, which not only require access to highly skilled individuals but are often costly to businesses, government, and the community. They can also produce outcomes that—even if legally justifiable, and despite best intentions—may not always make economic sense and can therefore actually erode community welfare.

Such legislation as proposed, if applied ineffectively or incorrectly, may end up harming rather than enhancing competition. It may unnecessarily raise transaction costs in the economy and this can be used by well-resourced businesses, notably well-established operators, to stymie competition. While effective pro-competitive legislation can contribute to competitive markets, its role is very much secondary to maintaining open and contestable markets. This is best achieved by minimizing government regulation, which is a relatively low-cost, low-risk approach to safeguarding competition. The proposed sophisticated legislation should be a low priority for the Cook Islands.

**An enhanced
ombudsman
may suffice**

A more practical and useful alternative to creating a commerce commission may be to consider strengthening the role and effectiveness of the ombudsman in commercial matters, such as monitoring and policing complaints on restrictive trade practices.

The Ministry of Internal Affairs sets maximum wholesale and retail prices on a wide range of basic food and household items, under the Control of Prices Act 1966.⁶⁶

66 Commodities covered include corned beef and mutton, mackerel and sardines in natural oil and tomato sauce, rice, flour, spaghetti, baked beans, tinned stew, coffee, milo, cocoa, tea, milk, sugar, cabin bread, cream crackers, butter, eggs, sea-freighted vegetables, cooking oil, baking powder, washing powder, soap, and matches.

Wholesalers and/or retailers (often one and the same) are required to submit prices for approval per shipment—detailing importation, freight, and other costs—as pre-determined wholesale and retail margins are allowed on these items. The Government approves the list of controlled items. The labor union in particular is calling for it to be extended to include new products, e.g., frozen foods, noodles, and toilet paper.

The competitiveness of the wholesale and retail food sector in the Cook Islands renders such price controls generally unnecessary, and their coverage certainly should not be expanded. Despite their intuitive appeal, price controls may inhibit competition and price discounting on these items. Setting controlled prices at the theoretical optimum is very difficult. If they are set too low, retailers and wholesalers will be discouraged from selling items and/or they will need to be cross-subsidized by placing higher prices on other food items. Price controls can act as price leaders and encourage a general understanding among sellers not to sell below the set price. There are indications of this problem, as retailers and wholesalers seem generally to sell at maximum prices, though more variability would normally be observed in a competitive situation. Very little funding is provided for implementing the act, and it is probably inevitable that controlled prices are either too high or too low.

Competitive markets constrain prices and ensure that consumers get the lowest possible prices by compressing average wholesale and retail margins, as well as ensure the best trade-off between quality and price. These competitive pressures would apply almost universally in Rarotonga. They can also be expected to apply generally in the outer islands given the variety of retailers in operation or the ability to buy directly or through relatives from retailers in Rarotonga or overseas. Overseas experience shows that removing price controls usually encourages price discounting because it mobilizes competitive forces.

Price controls have largely outlived their usefulness, as enhanced competition is a better alternative

5.2 Managing Foreign Investment

Foreign investment has been vital

Foreign direct investment (FDI) has played a vital role in recent growth and development. Given the Cook Islands' very small savings base, FDI is an essential source of funding for the investment needed for development. FDI has mainly reflected its close links to New Zealand and, to a lesser extent, Australia, the origins of a number of successful private sector participants who have since become permanent residents. A number of Cook Islanders returning to establish their businesses has complemented this. Attracting FDI to kick-start the economy was a high priority of economic reform and a highly successful initiative.

DIB has played an important role

The Development Investment Board (DIB) administers the Development Investment Act in fiscal year (FY) 1996, which governs all foreign investment, and an Investment Code passed in 2003. The act contains general regulations and the requirements to be met to establish new enterprises. DIB must approve and register all foreign investment projects with 33.3% or more overseas equity, including investment in other projects by approved foreign investors.⁶⁷ DIB is financed from the budget with a current expenditure of about NZ\$500,000, including investment promotion and marketing.

DIB attempts to provide a complete service to investors. Once investment is approved, the immigration service automatically issues entry, residency, and work permits for the foreign investor and expatriate staff for a maximum of 3 years (then renewable). Tax holidays for both domestic and foreign investors ceased some 5 years ago. While investors may import capital equipment and raw materials free of

⁶⁷ Development Investment Board (DIB) approval is granted with binding conditions that prevent foreign investors from engaging in other commercial activities without approval, which requires DIB approval to vary their foreign enterprise registration. Foreign investors may exceed approved investment limits, provided the original proposal is unaltered. A joint venture project that commenced as a local investment but which subsequently exceeds the 33.3% foreign equity threshold needs DIB approval.

tariff, this incentive is largely redundant following the recent removal of tariffs on most products except motor vehicles.

The investment legislation provides that Cook Islanders be given priority and reserves a potentially wide range of activities for them. At first sight, this list appears overly restrictive.⁶⁸ However, foreigners are allowed to purchase existing businesses in reserved activities where (i) the owner has unsuccessfully tried to sell to a local investor at a realistic commercial price; (ii) demonstrable demand for that activity exists but no Cook Islander is currently carrying on that business or has the resources to carry out the specific project, e.g., specialized construction; (iii) there is foreign capital investment of at least NZ\$1 million in Rarotonga or NZ\$500,000 elsewhere; or (iv) investment is to develop a niche market. Joint ventures with local investors are also encouraged, including in reserved activities where the share of local ownership is a factor considered in deciding whether to grant approval. Equity shares are left to the parties to determine, and full foreign ownership is allowed. FDI in reserved activities is also permitted if the proposed project would generate a demonstrable net economic contribution to the country such as local employment, the transfer of new skills and technology, capital injection, export earnings, import substitution, trade generation, tax revenues, and the promotion of value-added processing of domestic raw

FDI faces a seemingly restrictive reserve list

68 Reserved investment areas are commercial agriculture or food production, pearl farming, commercial aquaculture or harvesting of pearl shell, shellfish, or other reef or lagoon products, commercial fishing, fresh fish processing or exporting, and fish bait production; food processing, including freezing and drying, and bottling of drinks; screen printing; garment manufacture; making traditional handicrafts, recordings of cultural performances, and jewelry; visitor accommodation; motor vehicle rentals; diving operations; water-sport operations; tourist tours or transfers; ecotourism; cinemas; cultural attractions; bakeries or pastry shops; grocery retail outlets (including sundry stores, superettes, and supermarkets); motor vehicle dealers; restaurants, cafés, or other operations for food preparation and sale; sale of computers; trucking and cartage operations; taverns or public bars; duty-free shops; laundry or dry-cleaning; Internet cafés; audio or video production, sale, or hire; and hairdressing salons, beauty parlors, and health spas.

materials. Priority foreign and domestic investment areas are agriculture, marine resources, and tourism. While foreigners wishing to sell a business must first try to sell it to a local investor, this does not seem to have deterred FDI. DIB has until now applied the legislation liberally in line with the Government's post-reform priority of attracting foreign investment.

The Investment Code could be more transparent

The Investment Code is complex and potentially restrictive, providing broad discretion to DIB to approve FDI using largely opaque processes. The Investment Code would be improved if it were simplified, DIB discretion were reduced, and the expansive reserve list were more clearly defined and, preferably, narrowed. It could provide for varying maximum foreign equity limits for certain activities, if thought desirable, but should make all other FDI subject to monitoring rather than approval. Although not a World Bank member, the Cook Islands may wish to have the Foreign Investment Advisory Service review and advice on its investment rules and procedures, including the revised 2006 Investment Code, to help refine the legislation.

A proposed revision of the Investment Code is very restrictive, and changes must be managed carefully

Although FDI has successfully promoted growth, resistance to FDI appears to be rising. There is greater interest in providing local investors more opportunity to participate in development. Based on public submissions, DIB has prepared but not released revisions to the Investment Code that aim to tighten FDI restrictions.⁶⁹ Future investment policy is to focus on Cook Islanders taking the lead in business development, especially in reserved activities.⁷⁰ It proposes giving Cook Islanders priority in investment and business ownership, and requiring FDI to contribute to the country's economic development. Joint ventures are to be encouraged. It

69 DIB. 2006. Trade in Goods and Services for the Proposed EPA. PowerPoint presentation by Terry Rangi. September.

70 Category 1 reserved areas are activities to be kept exclusively for Cook Islanders, such as pearl farming and budget accommodation. Category 2 activities are reserved for Cook Islanders but subject to exceptions, such as hotel accommodation and grocery retailing.

is proposed that any foreign shareholding would require DIB approval, thereby scrapping the 33.3% minimum threshold for FDI approval, and approved foreign enterprises could not be sold within 5 years. FDI proposals would also need to be better structured to cover niche areas not covered by Cook Islanders.

While attitudes turning against FDI are somewhat understandable, care is needed to ensure that they do not translate into an overly restrictive FDI regime. This would be especially worrying at a time when FDI may be falling for other reasons, such as the declining competitiveness of the economy. FDI remains essential for growth and development. Foreign and domestic investment are really complements—not substitutes—so that curbing FDI may well end up restricting domestic investment, thereby reducing total investment at the expense of growth and job opportunities. It may also adversely affect employee conditions, as foreign investors now pay higher wages than domestic enterprises.

**Changes must
be managed
carefully**

Restricting FDI would also reduce competition in the economy, including in tourism and related services, which would be counterproductive from a national welfare perspective. Calls to limit FDI should thus be viewed cautiously. While many calls may be based on the best of intentions and reflect genuine concerns that foreigners are displacing local investors and taking over the economy, these concerns may be exaggerated out of simple self-interest. It is in the interests of incumbents, including foreign investors already established in the Cook Islands, to argue for greater FDI restrictions as this would reduce competition and market contestability.

**Restricting
FDI would be
anticompetitive**

Moreover, that foreigners can only lease land in the Cook Islands, not own it, is a safeguard against foreign ownership that should not be overlooked.⁷¹ Foreigners can

**The land lease
system works
reasonably
well for FDI**

71 Curbing FDI also reduces demand for leasehold land, thereby not only reducing opportunities for Cook Islanders to lease land at higher prices to foreign investors, but lowering lease returns from domestic transfers as well.

lease land for up to 60 years. Joint ventures with foreign investors are common, especially in tourism, whereby the local investor frequently provides the land. Although not as flexible or as good as freehold property from a foreign investor's point of view, or as bank collateral, leasehold transfers have worked well and have not greatly deterred investment, including FDI.

The legal system for land leases works reasonably well. It is administered by the Lease Approval Tribunal, which is staffed by experienced magistrates from the New Zealand Maori Land Council and follows its procedures covering leasehold transfers. While, on expiration of the lease, the land reverts to the owner, leases are usually renegotiated and extended, though renewal is usually for 30 years, not 60.⁷² Cook Islanders seem to have quickly adapted to commercial signals and have increased returns from leasing land to investors.⁷³ Many landowners now live offshore. Commercial lease payments usually comprise a lump sum up-front, an annual rental payment, plus a share of gross receipts (normally 1.5% but sometimes higher). Efforts are underway to reduce the lease period from 60 to the 25–30 years that apply in New Zealand.

The Unit Title Act, passed in 2005, should facilitate FDI in real estate

Largely to facilitate the revival of the failed Vaimaanga tourist facility by a local investor living in New Zealand, the Unit Title Act was passed in 2005 to enable strata titling of block apartments or units. This should facilitate FDI in real estate by allowing overseas residents to buy apartments as investments or holiday homes. It may also encourage residential investment of a speculative nature, and any adverse impacts from such speculation should be monitored.

72 Major land users, such as resorts, therefore frequently renegotiate to extend the lease period well before expiration to obtain security of tenure. Leased land is also subject to succession (inheritance) rights.

73 When selling property, the vendor can assign the lease on sale or sell with a sublease arrangement whereby the impending owner negotiates new lease arrangements with the landowner.

5.3 Maintaining Competitiveness

Maintaining competitiveness is essential for the Cook Islands' continued prosperity. The economy's competitiveness is determined by its cost structures. If these become too high relative to its trading partners, it adversely impacts the economy's performance, especially since it is heavily orientated outward toward dependence on tourism. Though consumed locally by foreign visitors, tourism services are usefully viewed as exports that are particularly sensitive to the country's international competitiveness. Maintaining tourism demand requires competitive input and output markets to ensure that resources are used efficiently and costs are minimized. This is especially so in the Cook Islands and other small, isolated economies, which have inherently high-cost structures.⁷⁴ Inefficiency caused by government intervention would only compound these cost pressures.

Countries with their own currency may be able to withstand the adverse impact of rising costs on international competitiveness through real depreciation of their currency (whereby the nominal exchange rate depreciates sufficiently to offset inflation and higher domestic prices relative to major trading partners). Because the Cook Islands uses the NZ dollar, it has no exchange rate mechanism with which to offset any increase in its cost structure and so maintain its international competitiveness. Thus, domestic cost escalation is transmitted directly onto exports, including tourism.

Moreover, the Cook Islands is exposed to the risk of the NZ dollar appreciating, which would be dictated by New Zealand's competitiveness and economic performance, independent of developments in the Cook Islands. The Cook Islands must therefore stay sufficiently flexible to be able to contain its costs and so maintain international competitiveness even in the face of a currency appreciation.

Competition, competitiveness, and growth are intertwined

The Cook Islands, using NZ dollars, lacks an exchange-rate mechanism to maintain international competitiveness.

74 Winters, Pedro, and Martins. 2004.

Competitiveness is now challenged by an appreciating NZ dollar, and tourism may be especially sensitive

Recent exchange rate movements of the NZ dollar may have reduced the Cook Islands' international competitiveness.⁷⁵ The NZ dollar, buoyed by foreign investment and export earnings, has appreciated substantially. As of March 2008, the real effective NZ dollar exchange rate was 17% above its 20-year average.⁷⁶

The exchange rate directly affects the tourism sector. An appreciating NZ dollar will tend to make the Cook Islands more expensive for tourists relative to other destinations. For example, the appreciation of the NZ dollar against the United States (US) dollar may be one factor behind the recent decline in visitors from the US and difficulty achieving the preferred air link to Los Angeles. The appreciation of the NZ dollar may also affect the Cook Islands' attractiveness as a holiday destination for New Zealanders, as it will improve the competitiveness of overseas holiday destinations elsewhere. A real appreciation in NZ dollar will also encourage resources in the Cook Islands to leave export activities (e.g., tourism) and move into non-tradable services.

Tourism competitiveness is vital to the economy

Although the tourism industry has expanded impressively, its future is uncertain. Whether it continues to grow, at what pace, and whether the eventual landing is soft or hard, will depend largely on its capacity to remain internationally competitive. Global tourism can be volatile, as visitors constantly seek new destinations and different lifestyle experiences. Competition for tourists has increased, including from such destinations within the region as the Fiji Islands, Samoa, and Vanuatu, which have a significant competitive advantage in terms of lower wages. Although political uncertainties in the Fiji Islands have benefited the Cook Islands by diverting international tourists, this

75 Note that the high dependency of the Cook Islands on imports means that any loss in international competitiveness resulting from the real appreciation of the NZ dollar would have been cushioned by the corresponding reduction in import prices.

76 International Monetary Fund. 2006, p. 6.

advantage may be short lived. Like other regional economies that have tourism potential, the Cook Islands must manage costs carefully.⁷⁷

Rising costs are inevitable as industry expansion fuels the bidding up of land, labor, and capital costs. Some costs will inevitably have to be passed on to tourists through higher prices. However, the competitiveness of the international tourism market severely limits the extent to which this can be done. While the Cook Islands has substantial natural beauty and is a wonderful holiday destination, it does not have a monopoly on these assets, either within the region or beyond. Thus, if costs were to escalate too much, the tourism sector may end up pricing itself out of the market. Cost pressures therefore need to be contained as much as possible to retain international competitiveness. While good tourism promotion may be able to compensate to some degree for adverse movements in international competitiveness in the short run, this is far more difficult in the longer term.

While total arrivals have grown on average by almost 5% annually over 2000–2005 and by 6% in 2005, their composition has changed substantially toward short-haul tourists from New Zealand. The share of these tourists during this period expanded from 27.4% to 48.8%, while the other main short-haul source, Australia, saw a decline from 15.1% to 11.3%. In the same period, long-haul tourists from Canada, Europe, and the US, each declined in absolute numbers and their combined share fell from 45.2% to 24.6%. The share of Europeans, the second largest group behind New Zealanders, fell from 29.4% to 18.2%. In FY2006, although all visitor arrivals rose by 5.5% to almost 90,000 and those from New Zealand increased by 18.4%, other markets declined by 7.5%. This is a worrying trend, as the long-haul tourists tend to spend more and stay longer. While this shift has undoubtedly many reasons such as airline scheduling, it may also indicate that the

A falling long-haul share may indicate emerging problems

77 Footnote 72, p. 35.

Cook Islands is facing difficulties maintaining international competitiveness. If this is the case, and if it continues, it may eventually affect New Zealand numbers.

**Poor air links
to the US are
a concern**

Air New Zealand is the only international airline regularly serving the Cook Islands.⁷⁸ It ceased direct flights from Los Angeles to Rarotonga some years ago, and the service was later provided via Tahiti. Previously, there was a direct flight from Canada and the Hawaii-based carrier Aloha Airlines started flying to Rarotonga in 2005, but since then both operations ceased. The direct flight between Rarotonga and Los Angeles was reintroduced in March 2007 with Cook Islands providing a financial guarantee to Air New Zealand for the viability of the route. Statistics for 2007 showed that there had been no marked increase in tourist arrivals, therefore the Government intends to continue its arrangement with Air New Zealand.

**Limited
international
air schedules
probably
reflect
sustainability
fundamentals**

The Government-funded Cook Islands Tourist Corporation needs to address these issues, understand, and communicate the reasons for them. Perhaps the country's comparative advantage has drifted from long-haul flights. Alternatively, Americans have decided to stay closer to home. It is important to understand the message on market fundamentals provided by these recent trends, rather than see international air schedules as the sole explanation. It is a reasonable assumption that routes will be flown if they are commercially viable and, if they are not flown, there are good reasons why not. Paying financial incentives to induce Air New Zealand to resume direct Los Angeles–Rarotonga–Auckland flights to offset its losses on the route should not be contemplated. Such subsidies are unlikely effective and could end up being very costly per additional tourist arrival.

78 Pacific Blue provides flights from Brisbane, Australia to Rarotonga via New Zealand.

As long as New Zealand visitors expand sufficiently to offset falling numbers from elsewhere, tourism growth will continue. However, becoming too dependent on tourists from one country creates vulnerability to a contracting market should the New Zealand economy falter. Effective tourism marketing and promotion may help sustain development, and the Tourism Master Plan, recently updated for 2005–2015, suggests geotourism as the new focus of promotion.

**Increasing
reliance on
Kiwi tourists
may raise
vulnerability**

Farming black pearls, concentrated in the island of Manihiki (population 500–600) has lost international competitiveness. After peaking in 2000 at NZ\$18.4 million, exports had dropped to NZ\$1.6 million by 2005, and the former Cook Islands Development Bank, which had directed funds into the industry, suffered large losses from bad debts. The number of farmers has fallen from 110 to around 50.

**Pearl farming
faces cost
pressures
and a difficult
future**

The industry's contraction reflects mismanagement and declining competitiveness accentuated by NZ dollar appreciation. Issuing too many pearl-farming licenses (originally 202) led to overstocking of pearl shells well above the recommended 4,000 shells per hectare and resulting ecological problems in the lagoon.⁷⁹ Tahiti's flooding the market with low-cost pearls has also lowered world prices when the Cook Islands was losing international competitiveness from the appreciating NZ dollar and the People's Republic of China began the large-scale production of freshwater pearls.

In an effort to revive the pearl industry, which is domestically owned almost totally, the Government has recently established the Pearl Authority. However, it is difficult to see the pearl industry recovering quickly without improving its competitiveness. Perhaps, the best immediate option is to develop domestic sales to tourists further.

79 Permits continue to be issued for 5 years at a cost of NZ\$20 per hectare, which encourages overstocking.

Efforts were made to favor the local fishers, but they have fallen short of expectations

Fishing licenses for distant-water fleets were terminated in 2000 to encourage domestic fishing, and only boats owned by Cook Islanders can be licensed (though an unlimited number of licenses are available). Each licensee may commercially charter up to three foreign boats (usually US boats from Palau) to fish in domestic waters. They must unload in the Cook Islands, with transshipment at sea prohibited. Netting by the purse-seining technique is prohibited.

These efforts to support the local fishing industry have fallen short of expectations, and the fishing industry has contracted sharply in recent years. Exports fell from NZ\$8.3 million in 2003 to NZ\$3.4 million in 2005. As well as competitiveness problems, accentuated by exchange rate appreciation, fish stocks have been depleted. The number of boats has dropped to around 30. The fishing fleet now consists of larger freezer boats operating in the north that mainly sell tuna to the American Samoan cannery. Southern boats, including those from Rarotonga, operate fresh fish boats that sell locally, though a few loin fish at sea for freezing.

5.4 Factors Affecting Competitiveness

Structural reforms improve competitiveness

Many factors determine a country's cost structure and hence its international competitiveness. Ensuring competitive domestic markets for inputs (including labor) and outputs so that markets allocate resources to their most efficient uses is important for minimizing costs. Microeconomic reforms to improve market efficiency and competitiveness are usually called structural reforms. They cover a wide range of policies designed to remove impediments to market efficiency. Of course, sound macroeconomic policies and political stability are also fundamental to a well-functioning and competitive economy.

An open trade regime is paramount. Evidence demonstrates that trade liberalization improves resource-use efficiency and promotes growth. Open economies consistently outperform closed ones. Sheltering domestic industries from foreign competition through tariffs and other import restrictions encourages inefficient industries and creates an economy with high costs and low international competitiveness. Trade barriers penalize efficient industries, which often produce exports, through higher input prices, as well as force up consumer prices.

**Trade
liberalization
promotes
growth**

Understanding the economic proposition that import barriers are a tax on exports is vital to accepting the need to reduce protection to promote exports. This point can be made in several ways:

**Import
barriers
(tariffs) tax
exports**

- Tariffs and import barriers raise production costs (e.g., the costs of inputs and machinery), and exporters such as tourism operators cannot pass on these costs in international markets.
- What a country gains from trade is the ability to import the things it wants. If imports are the rewards for exporting (which finances their purchase), import barriers that reduce these rewards must also reduce the rewards for exporting.
- Protecting import-substitution industries attracts labor and capital resources into these assisted sectors from less-assisted export activities, which causes them to contract.
- Trade taxes prevent countries from specializing in what they can produce relatively easily and importing what that they have difficulty producing.

Thus, providing easy access to imports is an engine to promote exports, including tourism services.

Tariffs are a bad way to raise revenues

Tariffs are often used to raise government revenue. However, despite their simplicity and superficial attraction, tariffs are an inefficient and economically costly tax. They distort production patterns and the efficiency of resource use by discriminating against imports and favoring domestic producers, and by penalizing exporters. Far less-distorting revenue measures are available. For example, excise taxes on consumer goods tax local and imported items equally, and therefore, do not offer the protection provided by tariffs.

While many tariffs have been reduced, protective tariffs retained

The Government eliminated tariffs on most products from 1 July 2006, citing its commitments under the Pacific Island Countries Trade Agreement to remove most tariffs by 2013. This reduced the Government's collection from consumers and downstream processors of imports by some NZ\$6 million annually. However, protective tariffs were retained, especially on a number of agricultural products. These included tariffs of (i) 50% on fresh, chilled, or frozen pig meat and edible offal, including that of pigs; (ii) 10% on all vegetables (25% on beans); (iii) 10% on manioc, taro, and similar tubers; (iv) 10% on nuts; (v) 75% on fresh coconuts and 10% on desiccated coconut; (vi) 10% on dried or fresh fruits, but 75% on fresh or dried bananas, dried pineapples, fresh papaws, and fresh or dried citrus fruit other than oranges, mandarins, lemons, limes, or grapefruit. Imports of eggs by sea are dutiable at a tariff of 50% but duty free if imported by air. Eggs and pig meats are tariff free if not imported into Rarotonga. Tariffs were also retained on pearls (ranging from 10–100%), bottled water (10%), and soft drinks (40%). In effect, many damaging elements of the tariff regime—the protection provided to local producers—were retained.

Trade protection is not a good policy

Since the Cook Islands lost preferential access to New Zealand, agriculture exports have contracted, as has the sector generally. Given the country's size and land-availability limits, its agricultural future is to service the domestic market, catering especially for resort and restaurant

requirements for fresh fruits, vegetables, and such livestock products as poultry, eggs, and pork. Indications are that such agriculture is growing—even flourishing in some areas, such as in Aitutaki. Most farmers (95%) are noncommercial part-timers who rely on off-farm income.

Protection for agriculture penalizes consumers and the tourism sector on which agriculture heavily depends for its survival. Moreover, it encourages economic inefficiency by attracting land, labor, and capital resources from other activities, including tourism, thereby harming national welfare. Farmers already enjoy very high natural protection through high importation costs, especially for perishables. It is preferable that farm protection be replaced by targeted efforts to improve farm productivity and hence the competitiveness of the industry. For example, the Government has a key role to play in providing such public goods as agricultural research, extension, and training services, as it can be hard for private sector suppliers to emerge in these areas.

The Ministry of Agriculture no longer crowds out the private sector by supplying fertilizers or chemicals (except for cyclone relief), and now several firms supply these inputs. Seeds and fuel are supplied privately to farmers. However, the ministry still hires out some farm machinery such as tractors to farmers, which is an activity best undertaken by the private sector.

Tariffs have been retained on fuels: NZ\$0.28 per liter on petrol, NZ\$0.22 per liter on diesel, 25% on aviation fuel, 20% on lubricating oils and greases, and 10% on most other fuels. While governments almost universally tax petroleum products as a substantial revenue source, such taxes impose distortions by taxing producers, including exporters, using fuels as inputs. This can be particularly important for the Cook Islands, with its remoteness and high transport costs. These tariffs should be minimized subject to revenue considerations.

**Support to
raise farm
productivity
is preferable**

**Tariffs on fuel
add to the
Cook Islands'
remoteness**

Tariffs on vehicles benefit the rich

Like taxes on petroleum products, motor vehicle tariffs tax producers. This is the case where they are used as inputs, such as in the transport of goods or passengers, or as rentals, or taxis. High tariffs on used vehicles are a substantial impost on businesses, including tourism-related ones that use them as inputs. Business investors, including foreigners, may apply to DIB to import vehicles tariff free, but this is available only for initial purchases or fleet expansion, not for vehicle replacement. Tariffs on buses, cars, and trucks are generally zero for new vehicles but then increase substantially for older vehicles and secondhand cars with large engines. The rates are complex, high, and structured to encourage the purchase of new or almost new vehicles and, in the case of cars, those with small engines. For example, used cars with an engine capacity below 1,000 cubic centimeters (cc) attract a tariff of 40% or NZ\$2,000, whichever is lower. The tariff rises to 100% or NZ\$4,000, whichever is lower, if the car is 10 years old or older.

Environmental concerns can be better targeted

The tariffs on vehicles are seen as desirable to reduce air pollution and the problem of disposing of old cars. However, cars are defined as old with the fairly low age of 5 years, which is much stricter than in many developed countries. Motor vehicle tariffs penalize poorer consumers and businesses who prefer to buy older vehicles. They tend to benefit instead the richest consumers and businesses, who can afford to buy new ones and then resell once the vehicles are old—with the benefit of a penalty on imported vehicles of a similar age. It would be preferable to address the environmental problem of concern directly through, for example, a levy on the disposal of used vehicles and regulations to control smoky vehicles.

Beer tariffs are largely protective

A mixture of specific and ad valorem tariffs applies to sin products such as tobacco (e.g., NZ\$162.00 per 1,000 cigarettes), wine (mainly NZ\$4.00 per liter), spirits (either NZ\$36.40 or NZ\$30.30 per liter of alcohol, depending upon alcohol content), and beer. The tariffs on imported beer of normal alcoholic content (2.5% or more) of NZ\$21.75 per liter of alcohol is almost thrice the excise

duty on domestically produced beer, which is NZ\$0.40 per liter of beer (equivalent to about NZ\$8.00 per liter of alcohol, assuming 5% alcohol content). This difference of NZ\$13.75 is equivalent to a specific tariff that would be very high in ad valorem terms. While there are no domestic commercial manufacturers of tobacco products but only informal producers, the tariffs on tobacco products are protective in that there is no equivalent tax on domestic production.

Since the remaining tariffs are relatively high and selectively protect domestic production, they are likely to adversely affect production patterns and the efficiency of resource use. Tariffs on food commodities penalize tourist-related activities. They are also regressive taxes, falling disproportionately on poorer consumers, who tend to spend a higher share of their income on food. Thus, further tariff reforms should be considered. The Government has reduced tariffs on pork, fresh fruits and vegetables, and soft drinks from 1 July 2007.

Apart from tariffs, trade barriers are minimal. There are no import licenses or quotas. The Customs Service works relatively efficiently and does not impede imports. Transaction value (free on board), on which tariffs are levied, is rarely questioned; where highly suspect, imports are still cleared with details referred to the treasury for audit. Tariffs must be paid before clearance. Goods are processed and cleared manually, but as operations are small, the lack of electronic clearance has not hindered imports. Pre-clearance facilities exist for reputable importers and service about half of imports. Clearance times are usually less than half a day, as a declaration lodged in the morning usually enables goods to be collected in the afternoon. Customs conducts simple risk analysis based on importer's reputation and source of imports, with less than 5% of imports physically inspected. The Customs Service licenses customs brokers. However, most major importers (retailers) employ import clerks. Private, bonded warehouses are licensed for major importers

**Tariff reform
is needed**

**Nontariff
barriers are
absent**

of tobacco and alcohol. Customs staff numbers have been reduced from 32 in the mid-1990s to 5. Consultation with the business community raised no reports of customs corruption or the need for informal or side payments. Abolishing most tariffs should further simplify customs operations by reducing the scope and incentives for tax evasion from misclassification and under-invoicing.

Taxation. An efficient business taxation system that does not impede or overly tax the private sector is an important determinant of competitiveness. This covers not only the tax rates and associated deductions, but also any compliance costs imposed on businesses.

The company tax system is generally sound

Company tax rates of 20% are relatively generous. However, a higher rate of 28% applies to foreign-registered companies. Mainly the two Australian bank branches pay this rate. While in principle this is likely to be a disincentive for foreign investors, it will be the case only if the Cook Islands tax rate exceeds the bank's home country rate, which in Australia is 30%. This is because, while the Cook Islands has no double-tax agreements, companies registered in Australia and New Zealand receive a tax credit at home for company tax paid in the Cook Islands. Thus, reducing the tax rate on Australian-registered companies would effectively shift revenue from the Cook Islands to Australia. Dividends paid to domestic shareholders are deductible to avoid double taxation. The 20% company tax rate is below the maximum personal income tax rate of 30%. This may facilitate tax avoidance by encouraging companies to retain earnings instead of paying dividends. There is no capital gains tax, and interest on bank deposits is exempt from income tax. A 15% withholding tax applies to dividends paid overseas.

Immediate deductibility of capital expenditure (including buildings) introduced in 1997 was terminated in Rarotonga from 2006 and from 2011 on other islands. Such accelerated depreciation, seemingly overly generous, may

have encouraged firms to substitute capital for labor, and hence introduced distortions into the economy.

A key aspect of the mid-1990s economic reform was the introduction of the 12.5% value-added tax (VAT). This comprehensive indirect tax on goods and services is a necessary complement to direct taxes and this has lessened dependence on tariffs. In FY2006, VAT contributed some 40% of total tax revenue. Modeled on the New Zealand equivalent, it appears to work relatively smoothly. The system of tax credits and refunds seems to work well, and exports are zero rated. Compliance costs on business do not seem excessive, even for small enterprises.

VAT functions well with acceptable compliance costs

VAT is also levied uniformly on imports and correctly based on the landed-duty-paid price. Collection seems to work smoothly. A system deferring payment for 1 month exists for approved importing companies, of which there are currently about 110. This is an open list, and any importer is eligible.

Since food, tourism, and restaurant services incur VAT, a large share of government receipts come from tourists. VAT is also levied on offshore financial services.⁸⁰ The industry believes this disadvantages itself relative to major overseas competitors, such as the British Virgin Islands, Samoa, and Vanuatu, which follow the convention of zero-rating such transactions for VAT because services are exported to overseas clients. The industry has contracted substantially in recent years. This matter should be reviewed to assess the extent of any such disadvantage and if it is justified. The Government reduced company registration fees from NZ\$500 to NZ\$300 in May 2006 to support the industry.

⁸⁰ The offshore financial services industry comprises six trustee companies, most being branches of offshore firms. The industry mainly operates asset-protection trusts for American and European clients. Until February 2005, the Cook Islands was on the Financial Action Task Force's list of noncooperative countries and territories. It was removed from this list, subject to monitoring until July 2006, following the adoption of antimoney-laundering legislation and improved supervision by the Financial Services Commission.

The labor market is flexible, but labor costs are high, and a labor shortage has emerged

Labor Market. Labor market flexibility to provide for competitive wage rates and employment-related costs is essential to maintaining international competitiveness. This is particularly important for the Cook Islands in that it has no exchange rate mechanism with which to improve competitiveness and so may depend to an unusually high degree on real wage flexibility to offset any loss of international competitiveness. The labor market seems flexible, with wages, including overtime and working conditions, set by supply and demand and largely negotiated between employee and employer. The minimum wage, recently raised from NZ\$4–5 per hour, is generally below hourly rates paid in Rarotonga and Aitutaki even for unskilled workers. Employment oncosts are acceptable, and employers may dismiss poorly performing employees relatively easily.

The Cook Islands has, by far, the highest wages of any independent Pacific island country. Average minimum salaries are said to be NZ\$7 per hour, with higher rates of NZ\$8–9 per hour common in the tourism sector. However, these relatively high wages seem to have been matched so far by labor productivity. Cook Islanders are generally well educated, and many have been trained overseas. Thus, higher wage rates have been sustainable without undermining international competitiveness.

The labor market has become increasingly tight, and this has supported wage growth. The tighter conditions are due to a continuing decline in the number of residents, rising demand, a shortage of trained workers, and—according to some employers—the reluctance by Cook Islanders in general to take unskilled jobs such as in tourism. Cook Islanders living in New Zealand and Australia have been unwilling to return and leave behind their better and improving job prospects and opportunities there. Even the unemployed can be reluctant to return and give up their entitlement to relatively high welfare payments.

While higher domestic wages benefit existing employees in terms of their take-home pay, a possible downside is that wage increases may outstrip productivity improvements and result in declining competitiveness. This is especially so for the labor-intensive tourism sector, which could jeopardize the sector's growth, thereby reducing labor demand and job opportunities and encouraging employers to shed workers to retain competitiveness. It could also encourage a shift to foreign workers who would be prepared to work for lower wages than are Cook Islanders.

**Rising wages
could be
damaging**

In a small tight labor market dominated by tourism, higher wages in the industry could quickly flow through to higher wages in other private sector activities. This is akin to the "Dutch disease," in which a major exporting sector provides windfall revenues and crowds out other activities by attracting labor and capital and bidding up wages and interest rates. Developments in tourism are therefore of concern for the whole economy and not just for the industry itself. It is important that wage pressures be managed with the full range of potential consequences in mind.

Although the competitiveness of tourism and related services is affected by many costs, wage rates and employment conditions have a major bearing on these industries due to their labor intensity and need to operate outside normal working hours. Faced with labor shortages and rising wages, the tourism sector in particular has turned to employing foreign workers, especially Fijians and Filipinos. This has helped keep labor costs affordable.

**Foreign
workers help
maintain
competitive-
ness**

The temporary employment of foreign workers is facilitated by immigration rules. Foreigners with entry and residence permits for over 6 months may obtain work permits if employers can demonstrate they have advertised unsuccessfully for Cook Islanders and that none are available with the requisite skills or qualifications. Indications are that these requirements are not restricting foreign employment. Employers may recruit expatriate workers from overseas

under these arrangements if the employer agrees to meet repatriation expenses for the employee (and family) and identifies a local counterpart to work with the expatriate as a trainee. Such entry and residence permits are initially issued for a maximum of 1 year but can be extended with 2-year renewals. Foreign workers dismissed by their sponsored employer may, in principle, be employed by another employer, subject to meeting the same requirements. In practice, however, this is unusual. Tourists on visitors' permits, which are generally extendable up to 6 months, may work in the hospitality industry if the employer has been unable to find a suitable Cook Islander. DIB-approved foreign investors are granted entry, residence, and work permits of up to 3 years for expatriate staff, which are renewable.

Tighter restrictions on foreign labor could slow growth

As with FDI, opposition to foreign workers is rising, with some calling for greater restrictions. This primarily reflects intentions to create greater job opportunities for locals, as well as social concerns about the country's changing population composition, as Cook Islanders emigrate to New Zealand and Australia under open entry and work arrangements. However, in an increasingly tight labor market, restricting foreign workers is likely to accentuate shortages and wage increases, thereby adding substantially to domestic cost pressures in tourism and other labor-intensive industries, including most services. This could jeopardize the Cook Islands' international competitiveness and growth prospects. A constitutional limit holds the number of foreign nationals with permanent residency to 500, and demand substantially exceeds the 60 or so remaining places.⁸¹

The Cook Islands, unlike most other Pacific island economies, is fortunate to have open access to New Zealand and Australia. This provides an important means by which

81 There are currently about 440 permanent residents. New Zealanders may apply for permanent residence after living in the Cook Islands for 1 year. For all other nationalities, the minimum period is 3 years. Permanent residents enjoy the same access to Australia and New Zealand as Cook Islanders.

Cook Islanders can improve their opportunities and welfare by choosing to live in highly developed countries. Many have taken advantage of this, with up to an estimated 70,000 living abroad, some 45,000 of them in New Zealand. Many choose to live abroad, even if at the lower end of the income scale in those countries, presumably because they feel better off than in the Cook Islands.

Giving Cook Islanders this choice, however, has social implications for the country. One is the ongoing decline in the local population. Maintaining this choice almost inevitably requires the Cook Islands to have an open immigration policy, including access for foreign workers, to mitigate some of its economic consequences. Otherwise, the country would likely depopulate more quickly, worsening the labor shortage and costs of having a very small domestic market. Seen another way, imposing immigration restrictions may reduce emigration pressure on Cook Islanders. However, denying Cook Islanders these opportunities or trying to force them to return would likely be counterproductive. The best way to get them to stay or return is to provide a sound, efficient, and competitive economy that offers business and employment opportunities, including in skilled areas. Moreover, some encouraging signs show that this approach can be successful, with anecdotal evidence suggesting that Cook Islanders have become more interested post reform in returning to start businesses.

An important aspect of a country's flexibility and ability to minimize cost pressures is to have a mobile labor force that can relocate from islands with limited or declining job prospects to those where jobs are plentiful. The best alternative to foreign workers in Rarotonga could be outer islanders. While this again raises social issues and is complicated by the customary land tenure system, such mobility could be encouraged. One way this could be done is by providing subsidized public housing to those moving to Rarotonga but without customary land access.

Foreign workers are the flipside of open access to New Zealand

Banking is competitive

Access to Credit. The competitive banking sector has provided substantial credit to the private sector, thereby facilitating growth and competitiveness. Two branches of major Australian banks, Westpac and ANZ, account for over 90% of loans (Westpac is by far the larger). The third bank, the state-owned Bank of the Cook Islands (BCI), has improved operations but continues to struggle with very limited access to deposits.

Both Australian branches have borrowed overseas to supplement domestic funds to meet credit demand.⁸² Interest rate spreads have narrowed and at 3–4% are greatly similar to Australian levels. Commercial loans, especially in tourism and related services, represent a major share of both branches' loan books, as do housing loans, the main area of recent growth.⁸³ Commercial loans are short term (below 10 years) and usually secured against land (lease) collateral. The collateral and legal foreclosure processes appear to work satisfactorily and have not hampered bank lending. The share of nonperforming loans held by banks is low at less than 5%.

Banking supervision meets international standards

Banking soundness is enhanced by having the two foreign branches prudentially supervised by the Australian Prudential Regulatory Authority as well as by the Cook Islands' Financial Supervisory Commission, which also supervises BCI. Banks, including foreign branches, must be licensed by the Financial Supervisory Commission to operate in the Cook Islands to ensure prudential soundness in accordance with the Basel core principles on banking supervision. The number of licenses is not fixed, and entry into banking is open to any applicant meeting the prudential requirements.

82 This was accentuated recently by the Government's withdrawal of NZ\$13.2 million to repay an offshore debt. Total overseas borrowings are estimated at NZ\$65 million, equivalent to some 50% of the money supply (M3—broader money aggregate that includes M1; M2; large time deposits; and commercial paper, liquid government monetary instruments, and others in lieu of currency).

83 Bank of the Cook Islands (BCI) has a lower share of commercial loans and a higher share of housing loans.

Interest rates in the Cook Islands mirror international trends as banks borrow offshore to supplement domestic sources of loan funds. In addition, Cook Islanders already deposit what is thought to be substantial funds in New Zealand, and if local banks fail to match offshore rates, they will lose more local savings.

BCI commenced operations in July 2001 as a merger of the Cook Islands Savings Bank and the Cook Islands Development Bank. BCI currently operates as a retail commercial bank, focusing on smaller domestic investors. It is free from government interference in its operations, and demonstrates good transparency and accountability. It nevertheless struggles to make a profit.

This is partly because BCI has to meet the Government's community service obligation and provide branches in the outer islands. Maintaining these loss-making branches—except Aitutaki, where both ANZ and Westpac operate sub-branches—requires BCI to cross-subsidize them from the Rarotongan branch. The Government provided for the first time a payment of NZ\$100,000 to BCI in the FY2007 budget to meet these costs in part. Funding loss-making branches through the budget rather than by cross-subsidies is likely to improve efficiency, accountability, and transparency. However, a further improvement would be to tender competitively the provision of loss-making branches in the outer islands to the three banks and to fund this cost through the budget.

Whether or not the banking market is large enough to sustain three commercial banks in the long term is uncertain. BCI's small market share means it is unlikely to impose any competitive pressure on the two major banks. Government involvement in such a commercial activity carries risk, including the potential for state favoritism and a breakdown in corporate governance. Although not a high priority, the Government may wish to consider divesting itself of BCI and using the funds to finance alternative

**The state
bank is
now more
transparent**

**The need for a
state-owned
bank is
doubtful**

public investments that would contribute more to national welfare.

The two importer–suppliers of fuel compete with each other

Efficient Access to Fuel. The efficiency of the fuel market is likely to have a major bearing on private sector competitiveness, given the transport intensity of the Cook Islands. There are two fuel importer-suppliers in Rarotonga, each locally owned and with its own storage depot.⁸⁴ The larger one has an estimated two-thirds market share and imports diesel, petrol, and aviation fuel, which it sells to Air Rarotonga.⁸⁵ Until recently, Mobil Fiji owned the storage facilities, but the operator recently purchased these under a 2-year exclusive arrangement to buy from Mobil. The other supplier has a joint venture with BP/Shell and currently supplies diesel to Te Aponga Power Authority.

Regulated maximum prices are high

Both suppliers import relatively low volumes, mainly from Singapore through the Fiji Islands using small tankers. Their relatively high prices seem to reflect high shipping costs to Rarotonga and the lack of economies of scale. The Government sets maximum wholesale and retail prices for diesel and petrol using an agreed template based on the costs of buying and shipping from the Fiji Islands and including local distribution margins (wholesale and retail), based on submissions per shipment received from the major importer–supplier.

Sufficient competition negates the need for price regulation

Competition seems to negate the need for price regulation, which in any event may make things worse by inhibiting competition and price discounting. All retailers seem to sell at the maximum regulated price. Retail outlets are numerous, including dedicated service stations and gas pump facilities at many corner shops. Though not

84 In 2001, Reef/Excil also started importing fuel into Aitutaki from New Zealand in 20,000-liter International Standards Organization tanks, displacing shipments from one Rarotongan supplier. Fuel is cheaper in Aitutaki than on Rarotonga.

85 A third company, Juhi that is a local joint venture with BP/Shell, supplies aviation fuel to Air New Zealand.

independent, but rather linked to the suppliers, they provide ample competition, so regulating wholesale and especially retail prices would seem to be unnecessary and undesirable.

Shipping. The Ports Authority is a statutory corporation (Ports Authority Act FY1995) that maintains and operates the port at Rarotonga and facilities at Aitutaki, where the ships are unloaded at sea and the containers transported by barge to the wharf. In Rarotonga and Aitutaki, the authority provides marshalling services to move and store containers at the port after unloading and to load containers onto privately operated trucks for transporting from the port. It also operates one tug off Rarotonga. Stevedoring activities are conducted by the private sector except in Aitutaki. Port docking and unloading appear to work efficiently, with international ships generally unloaded within 2–3 days.⁸⁶ The port in Rarotonga levies fees to recover costs (i.e., berthage, wharfage, cargo dues, marine service fees, electricity supply charges, and equipment charges).⁸⁷

Most port activities are provided by the private sector

The authority has made a small profit in recent years in the Rarotongan port, which partly subsidizes losses at Aitutaki (NZ\$300,000 in FY2008). The Government foregoes dividends from the authority in return for the authority's financing of infrastructure and operation of the Aitutaki port. Cargo handling at Rarotonga has increased substantially and includes containerized freight, break bulk items (timber, cement, vehicles, and building materials), and bulk fuel, which is piped to the three storage depots. As only two international ships generally arrive per month, and interisland services are limited, substantial excess capacity exists at the Rarotongan port.⁸⁸

86 Port efficiency was enhanced recently by the introduction of a large forklift.

87 These charges are claimed to be comparable to those of other ports in the region.

88 Fiscal year (FY) 2004 recorded 89 port arrivals by general carriers (31 international), 20 by tankers, 30 by cruise vessels, 142 by yachts, and 258 by fishing boats.

Domestic shipping is cross-subsidized

Domestic interisland shipping services do not pay berth or wharf fees or cargo dues to contain the costs of these services. In FY2008, the revenue forgone amounted to NZ\$113,186. Domestic shipping is therefore cross-subsidized by users of international shipping services. Domestic shipping operators also receive fuel excise free. All other government subsidies to domestic shipping were removed in 1986. Only one locally owned company that is operating two boats provides domestic shipping services to the outer islands, following the recent closure of a second company. These services run irregularly depending on demand, and improving services is a Government priority. A more efficient way of providing such services would be to contract out a specified basic shipping service on unprofitable outer island routes through competitive tender.

Entry into shipping is generally unrestricted, with limited cabotage allowed

The Ministry of Transport must license domestic and international shipping operators. Licenses are valid for 2 years. License numbers are unrestricted, and requirements mainly cover safety. Entry is thus relatively open, which is important as it makes the shipping market contestable. Domestic interisland shipping is, however, reserved generally for majority-owned Cook Island companies.

International shipping companies are restricted from servicing interisland routes except for the main domestic shipping route from Rarotonga to Aitutaki. Prohibiting cabotage on other domestic routes prevents the international shipping lines that service Rarotonga from also providing domestic services, except to Aitutaki. Allowing cabotage would open up domestic routes to international shippers, likely raising competitive pressures to the benefit of outer islanders.

Two companies, Pacific Forum Line and Reef/Excil, which were licensed in 1998, currently provide international shipping services from New Zealand to Rarotonga and

Aitutaki.⁸⁹ A third company recently ceased operations. Prior to 1998, only one company—the National Shipping and Chartering Line, which is a domestic consortium partly owned by the Cook Islands’ Government—provided international shipping services. Although the industry is thin, competition appears to have improved post-reform, and the markets are contestable. While shipping rates to the Cook Islands are high—NZ\$5,500 per 20-foot container, or more than double the NZ\$2,500 from New Zealand to Fiji—the small volume of cargo handled and the small ships and containers makes this unavoidable to some extent.⁹⁰ Moreover, as the Cook Islands has few merchandise exports, there is little cargo back loading, and most containers return to New Zealand empty, further adding to unit costs.

The Ministry of Transport must approve maximum domestic and international cargo rates. The main criteria used for approving freight rate increases are the fuel adjustment and currency adjustment factors. Regulating prices based on costs reduces incentives to lower costs and improve efficiency. Moreover, though only maximum rates are set, this likely reduces incentives for competition and, in practice, the shipping companies tend to charge maximum rates. Deregulating cargo rates, both domestic and international, would therefore enhance competition. This development is

**The control
of freight
rates is
inappropriate**

89 The Pacific Forum Line is run on commercial terms by the South Pacific Forum and operates services between Fiji Islands, New Zealand, Rarotonga, Samoa, and Tonga; Australia and Rarotonga (via Fiji Islands or New Zealand); and from People’s Republic of China; Republic of Korea; Taipei, China; and to Rarotonga via New Zealand. Reef/Excil is a consortium of the New Zealand companies Reef Shipping Group and Ocean Link and the Cook Islands’ Excil Holdings, which is jointly owned by General Transport (a local stevedoring and transportation company) and three major retailers and wholesalers (Foodland, Measco, and Cook Islands Trading Corporation). As such, the local companies each have a one-twelfth equity holding in Reef/Excil. It operates one ship (Southern Express) between Auckland, Rarotonga, and Aitutaki.

90 Ships entering the Rarotongan port are limited to 100 meters in length and to using 20-foot containers. Using larger ships (up to 150 meters) and containers (up to 30 foot) would reduce freight rates by as much as 25% but require substantial capital costs to expand port facilities. The feasibility and commercial viability of such an expansion would need to be assured to go ahead.

most likely to emerge on the international routes, given the presence of two operators and the potential entry of others. In the event that prices are deregulated, price monitoring could be used to gauge the effectiveness of competition and weigh the need for a more interventionist approach.

Anticompetitive concerns in shipping may be overstated

While the ownership of Reef/Excil, which handles about 65% of the shipping, by several major local retailer–wholesaler–importers may raise anticompetitive concerns, these are tempered substantially by the operation of a major shipping competitor and the fact that individually, and as a group, they own a relatively small share of Reef/Excil.

Air Services. The Airports Authority is a statutory corporation responsible for administering the main airport, both international and domestic, at Rarotonga and the domestic airport at Aitutaki.⁹¹ In recent years, it has run a small cash surplus but with a significant financial loss due to large depreciation items. Its Rarotongan operations cross-subsidize losses in Aitutaki Airport of around NZ\$600,000 annually. The authority’s fire station is required to service the community at an estimated cost of NZ\$280,000 annually. The only government funding is the return of a proportion of the departure tax (NZ\$16 out of NZ\$30).

Most airport services are contracted out, but landing charges are high

The authority maintains about 100 staff responsible for airport operations, such as security, fire safety, and simple maintenance. Many services have been contracted out, such as mowing, fencing, duty-free retailing, and certain maintenance work. Terminal space is leased at commercial rates to Air New Zealand and the domestic carrier, Air Rarotonga, which provide their own check-in, baggage handling, and refueling services.

Landing charges account for three-quarters of the authority’s revenue. They are the region’s highest and the

91 The Government recently decided that the Airports Authority would administer all Outer Island airports, but the framework for implementation has yet to be decided.

world's fourth highest (e.g., NZ\$1,500 per landing for a Boeing 737 and NZ\$8,000 for a Boeing 747). Few aircraft movements and the lack of economies of scale seem to be the main reasons.

Entry into the airline industry, both international and domestic, is unrestricted but subject to the operator being licensed as airworthy by the Ministry of Transport (Air Services Licensing Act 1984). Licenses are unlimited in number and are valid for 5 years. The Cook Islands adopted New Zealand safety standards in 2002 (Civil Aviation Act) and, since 2003, the ministry has contracted the New Zealand Civil Aviation Authority to perform these services. Landing slots are unallocated as airline movements are few. Plenty of terminal space exists to allow new carriers to provide check-in and other auxiliary services.

The lack of cabotage restrictions means that international carriers operating in the Cook Islands would be permitted to carry domestic passengers. Foreign operators are allowed to provide domestic air services on any route, making the market for domestic and international air services open and contestable.

Locally owned Air Rarotonga, which commenced operations in 1978, provides several daily scheduled passenger, cargo, and charter services from Rarotonga to Aitutaki, and at least weekly services to seven of the outer islands (Atiu, Mangaia, Manihiki, Mauke, Mitiaro, Penhryn, and Pukapuka).⁹² Some 70% of passengers are tourists traveling the Rarotonga–Aitutaki route; other routes are claimed to be unprofitable. Domestic airfares on all routes are controlled based on costs and benchmarked with fares of similar regional routes, and must be approved by the Ministry of Transport.

The regulation of domestic airfares appears unwarranted; it could be anticompetitive and may deter new entrants.

Entry into the airline industry is lightly restricted

Although there is only one domestic operator, cabotage is permitted, and price regulation seems unwarranted

⁹² Air charter services are also provided on demand to neighboring Pacific island countries including Niue, Samoa, Tahiti, and Tonga.

Because mainly tourists drive demand, travel is likely to be relatively price elastic, such that competitive pressures to entice tourists to fly to Aitutaki and other islands will constrain prices. Moreover, under current arrangements, passengers traveling the Rarotonga–Aitutaki route cross-subsidize unprofitable services provided by Air Rarotonga to the outer islands. A more efficient means of providing basic air services to the outer islands, once desired standards are clearly defined, would be to periodically—say, every 5 years—contract out by competitive tender their provision with a subsidy funded from the budget. This would remove the cross-subsidy, thereby reducing the fares in the Rarotonga–Aitutaki leg, with clear advantages for Aitutaki and the tourism sector generally.

Power supply is a statutory monopoly of the Te Aponga Uira Power Authority

Te Aponga Uira Power Authority. Te Aponga Uira Power Authority is responsible as a statutory monopolist for generating, transmitting, and distributing electricity in Rarotonga and Aitutaki. Legislation prevents anyone else from selling electricity, though generation for own use is permitted. Power is expensive, at least partly, for lack of economies of scale and because of the need to use diesel generators. Power prices have escalated recently in line with rising world fuel prices. Technical losses are relatively high at 13% (4% on generation and 9% on distribution).

Te Aponga must cross-subsidize residential users

Te Aponga sets tariffs based on cost recovery. While the Government requires no dividend, the authority must meet community-service obligations and charge socially based tariffs. It does this by cross-subsidizing residential use from commercial use by a substantial NZ\$0.15 per kilowatt hour (kWh).⁹³ All residential users, irrespective of

93 Tariffs were increased from 1 October 2006, largely for residential users. Residential consumers face a 3-tier tariff structure of NZ\$0.41 per kilowatt hour (kWh) for the first 60 kWh, NZ\$0.61 per kWh for 61–240 kWh, and NZ\$0.70 per kWh for higher usage. The previous rates were NZ\$0.39, NZ\$0.56, and NZ\$0.65 per kWh. Tariffs for commercial users were increased from NZ\$0.65 to NZ\$0.66 per kWh, while for “demand” customers (larger users such as the major resorts), the tariff remained at NZ\$0.54 per kWh. Because usage is based on a 30-day period, residential consumers usually pay the lower rates.

income levels, benefit from the cross-subsidy, and hence the practice assists poor households inefficiently. The size of the cross-subsidy to residential consumers places competitive pressures on Te Aponga, as major commercial users and resorts have the option of generating their own electricity. They are required by Te Aponga to install their own backup generators in case of supply problems. While adding to the costs borne by commercial users, self-generation is feasible should Te Aponga's prices become uncompetitive. Moreover, the authority faces stiffening competition in the residential market for cooking and hot water from the solar-power systems that are already very popular and imported bottled liquefied petroleum gas, whose tariff of 10% is less than that for diesel.

By not requiring excise on diesel, the Government subsidizes Te Aponga's operations by some NZ\$1.6 million annually (the diesel excise rate of NZ\$0.22 multiplied by consumption of 7.2 million liters). In principle, all electricity users are thereby effectively cross-subsidized, but it is possible that the excise concession to Te Aponga does not reach consumers and instead it is eaten up by supply inefficiencies. Private operators wishing to self-generate electricity must pay excise on diesel, which places them at a disadvantage.

Te Aponga has cut costs and improved efficiency. Staffing has been reduced from 41 to 8, and an additional, more efficient generator is being installed. Diesel is purchased and supplied by 12-month tender from one private fuel operator. However, extending the excise concession for self-generation—or reducing or removing the tariff on diesel and removing the tariff on imported bottled liquefied petroleum gas—would mean greater competition for Te Aponga.⁹⁴ Further efficiencies may be achieved by

**Government
subsidizes Te
Aponga**

**Contracting
out
generation
may help**

⁹⁴ This assumes that the excise concession is itself desirable. An alternative approach would be to remove the excise concession to Te Aponga. While this may be preferable economically, it is not considered a viable option at this stage.

periodically contracting out privately, by competitive tender, generating electricity including generator maintenance. This would leave Te Aponga responsible for transmitting and distributing power, buying electricity from the private generator at the contracted price.

Removing cross-subsidies would help

Improving Te Aponga's efficiency and removing cross-subsidies favoring residential consumers would benefit private businesses. Power costs are a substantial input into most service industries, including tourism. They will always be high in the Cook Islands, and businesses must work around these costs by adopting measures to economize on electricity use. As power prices rise, the saving incentives will increase. At the same time, the economic viability of alternative energy sources such as wind power is being examined with the support of the Pacific Islands Applied Geoscience Commission (SOPAC) that is preparing a feasibility study of wind power on Rarotonga.

Telecom Cook Islands. Telecom Cook Islands (TCI), 60% owned by Telecom New Zealand, has had a telecommunications monopoly by virtue of an exclusive government joint-venture licensing arrangement.⁹⁵ This authorizes TCI to be the sole provider of network services to, from, and within the Cook Islands. The first agreement was for 10 years, and the second, for 5 years, expired on 1 July 2006. The legislation creating TCI (Telecommunications Act 1989) requires it to be as profitable and efficient as comparable businesses and to exhibit and promote social responsibility in protecting community interests. Telecom charges must be approved by the Cabinet.

Government ownership of TCI has traditionally been seen as a means of generating government revenue

95 In 1997, the Cook Islands' Government sold 20% of its shares in Telecom Cook Islands (TCI) to Telecom New Zealand and used the funds to purchase the physical assets of Cook Islands Telecommunications Assets, Limited, which included the former international service assets of the Cable & Wireless subsidiary.

from dividends. As a milking cow, TCI has been highly profitable, earning rates of return on equity well in excess of 50% and paying sizeable dividends to the Government (e.g., NZ\$2.1 million in FY2007).⁹⁶ However, while the statutory monopoly has helped profitability and dividends, this has come at the expense of local consumers, including businesses, which face high telecommunication charges and, in some areas, inferior services. International calls have been used to cross-subsidize local calls, which are time charged at NZ\$0.10 per 10 minutes. Over 60% of TCI revenue is from international calls, with 65% from business customers.

The Government is now more concerned with the sector's efficiency and has generated gains for the economy by lowering prices. National calls were reduced by 50% in May 2004, and international calls have been lowered since 2000, including a 20% cut in September 2003. Increased competition from new technologies is also lowering telephone prices. While international callback services remain prohibited, competition has increased from much cheaper voice-over-the-Internet services (e.g., Skype) since broadband was introduced. In September 2006, TCI introduced hourly caps on international calls of NZ\$5 to New Zealand and NZ\$10 to many other destinations, including Australia.

Telecom New Zealand reportedly offered the Cook Islands Government NZ\$4 million to renew the monopoly.⁹⁷ The Government should open the telecommunications sector to competition by letting the exclusive license lapse and removing restrictions on providing competing services, such as international callback. This would promote competition and market contestability

Government ownership of TCI creates conflicts of interest, but government attitudes are changing

The TCI monopoly should not be renewed

96 It has been reported that TCI makes an annual NZ\$8-million profit from just 12,000 users, equivalent to NZ\$667 per user (Saarinen 2006). This estimate is consistent with actual dividend payments on the Government's 40% share.

97 Saarinen. 2006. While unsubstantiated, this allegation, if true, would indicate the extent of rents (excess profits) received by Telecom New Zealand from the TCI monopoly.

by enabling new competitors such as Internet service providers.

As TCI owns the network, the amount of additional competition would depend on entrants obtaining competitive access to the network. TCI can be expected to resist increased competition strenuously. The Cook Islands Government should ensure this does happen, either using its equity and management stake or through regulatory action. One option is to establish an independent regulator to enforce an access regime through legislation, but this would probably be unworkable in the case of the Cook Islands because it would exceed enforcement capacity. The Government could instead monitor telecom charges and may consider applying some simple price regulation, such as capping TCI's rate of return, if competition remains insufficient.

5.5 Priorities and Strategies

Maintain public sector reforms

Fiscal Discipline and a Small Public Sector. The previous section reviewed the successful turnaround of the private sector and provided some suggestions where further policy reforms could stimulate ongoing growth. Mainly, continuing previous reforms is needed, such as ensuring fiscal discipline and a relatively small public sector with little or no commercial activity by government. The impressive gains to date could easily be lost if the excess spending and other inept practices of the early- to mid-1990s were allowed to creep back in. Fiscal discipline takes time to achieve but can be quickly lost if commitment wanes. In this respect, enshrining these key principles into the national planning scheme via a private sector development strategy may help provide some assurances against this happening through complacency or changing political priorities.

More could be done to contract out to the private sector through competitive tendering various internal functions of government, such as cleaning, gardening, and

repairs to roads and water facilities. This can be expected to improve efficiency and reduce costs. Currently, debt is low, allowing for fiscal expansion and appropriate spending on the infrastructure to support private sector led growth. Safeguards against re-emergences of fiscal imbalances due to assumption of excessive borrowing exist in the Ministry of Finance and Economic Management Act of 1995/1996. These, however, could be amplified were appropriately targeted policy-based rules and guidelines adopted to complement the legislation at operational level as was done in the mid-1990s through the indicators established under the Manila Agreement.

Deregulation. Among the top structural reform priorities should be to abolish controls on maximum wholesale and retail prices for basic food and household commodities. A lesser reform would be to abolish price controls on retail sales and to retain wholesale price controls on only a greatly reduced list of items. Similarly, regulated maximum prices on petrol and diesel should be terminated at least for retail sales. The same applies to the regulation of domestic and international shipping cargo rates as well as of domestic air services. In these cases, temporary price monitoring could be introduced to oversee the removal of price regulation and ensure that the transition works competitively.

The expired TCI monopoly on telecoms should not be renewed. Te Aponga prices should be balanced to remove the large cross-subsidy provided to all consumers and replace it with a more targeted system to cushion poor households from rising electricity prices. Contracting out power generation by competitive tender may also provide a long-term path to efficiency gains.

Tariff Reform. Further import tariff reforms on agricultural and food items, as envisaged by the Government, should be accelerated. Moreover, tariffs on motor vehicles should be restructured to mitigate or

Remove most price controls

Allow competition with TCI

Hasten tariff reform

remove the penalty on importing nearly new vehicles, subject to offsetting initiatives being introduced to target environmental problems. The large protective tariff on alcoholic beverages, especially beer, should be reduced or replaced by an excise tax.

Think twice before restricting foreign workers or FDI

Managing FDI and Foreign Workers. FDI and foreign workers have played important roles in the resurgence of the private sector and recent economic growth. While foreign investment and workers are always very sensitive socially and often generate strong if mixed emotions, placing greater restrictions on them may be shortsighted and could impose considerable costs by slowing economic growth.

Because of the importance of FDI for growth and development, the Government and DIB may wish to reconsider recent efforts to introduce restrictive FDI policies. One option would be to obtain advice from the Foreign Investment Advisory Service on proposed changes to the Investment Code. Data on FDI approvals indicate that FDI may already be slowing.

Any FDI restrictions should be transparent and nondiscretionary

Should restricting FDI become government policy, this should be done openly and transparently with minimal DIB discretion. It would be best done lightly by either issuing a well-defined and narrow negative reserve list and/or by raising registration fees for foreign investors from the current level of NZ\$750. Improved FDI data would also help—in particular tracking actual FDI by monitoring actual FDI, rather than just FDI approvals in non-reserved areas.

Calls to substantially curb foreign workers are likely to be shortsighted and, in the longer term, impact negatively on the country's growth prospects. Restrictions may hasten depopulation, which is happening because many Cook Islanders choose to live in New Zealand and Australia, where they judge their prospects to be brighter. This trend is almost certainly going to continue under current conditions. It may, however, be slowed or reversed if the Cook Islands

economy performs robustly and creates business, employment, and other opportunities to retain and attract back Cook Islanders.

Restricting access to foreign workers would involve considerable economic risks. However, if the Government decides to do so, it is important that the restrictions not be too severe. Foreign workers could be restricted by imposing a quota, which could be set at the existing level, preferably with an inbuilt annual growth factor. Any such quota should be determined transparently and set at the commencement of each year. The simplest method for allocating the quota among employers would be on a first-come, first-served basis, but this could disadvantage employers wishing to employ foreign workers toward the end of the year after the quota is filled. Rights to the quota could be issued instead by tender and be tradable and transferable. Instead of imposing a quota, the fee for work permits could be increased. However, this would have the disadvantage of curtailing mainly unskilled foreign workers and thereby discriminating against employers who need such employees.

Agree on a Private Sector Development Strategy. A well-enunciated private sector development strategy should be an integral part of the national planning framework. Such strategy should specify in broad terms the role of the private sector in national development and the policy framework to be provided by the Government.

While the private sector controls the means of production and decides how much to invest and what to produce, it is the Government that sets the rules and conditions by which business operates. Government failure in this role would impede the efficiency and development of the private sector, which would be unable to maximize its contribution to economic growth. A good starting point for developing a private sector development strategy is therefore to develop such a framework to ensure that the respective roles of the private and public sectors are clearly defined.

**An agreed
framework
for private
sector
development
is important**

Such a framework could usefully adopt the following principles:

- The private sector should be defined as the key user of domestic resources and driver of economic growth.
- Achieving and maintaining international competitiveness should be seen as the overriding policy objective.
- The Government's role should be that of a facilitator to ensure that an enabling environment exists for efficient private sector operation with minimal government intervention, except where necessary, such as to ensure that sensible environmental standards are set and enforced.
- The Government should not compete with the private sector but instead leave all commercial activities to it.
- Markets should be seen as the main means of allocating resources among alternative uses, and the Government should try to make markets as contestable and competitive as possible, abstaining from providing selective assistance favoring one activity or sector over another or trying to influence market outcomes by picking winners.
- Trade and investment liberalization to maximize resource-use efficiency should be seen as an integral part of the country's development and growth strategies.

**Consensus
builds
ownership but
has its limits**

In preparing a private sector development strategy, it is important that the views of as many stakeholders as possible be obtained. This helps build ownership for the strategy and thereby helps implementation. Yet, consensus building has its limits. It is impossible to please all parties when developing a particular strategy, and even private sector participants are likely to have different views depending on their own

situations and vested interests. Therefore, the Government, advised by bureaucrats, must ultimately decide on an appropriate strategy and the necessary economic and other policies to implement it to maximize national welfare.

While this approach may make some worse off in the short term, or even in the longer term, the overall gains from such reforms should outweigh the losses and stimulate growth and employment. This would enable the Government, through appropriate tax and welfare transfers, to better look after the unfortunate who have not directly benefited from growth. Initiatives could include upgrading services, such as education, to empower people to gain from private sector development. However, care is needed to ensure that policies aiming to redistribute the economic pie do not inadvertently shrink it, as this would be detrimental to the Cook Islands' economy upon which all depend.

**Government
can compensate
those who do not
benefit from
economic
growth**