

Making Room for the Private Sector

Composition of the Private Sector

The private sector comprises all activities other than those undertaken by ministries, PEs, and other government entities. Churches and households form part of the private sector, as do a variety of income-earning activities ranging from incorporated businesses to small-scale activities, such as a family's sale of fish on the street or at the local market. This chapter is concerned with the income-earning activities of the private sector—what they are and how their contribution to sustained economic growth can be enhanced.

In examining the income-earning activities of the private sector, it is helpful to draw a distinction between formal and informal activities. This distinction is important because the needs of the two forms of activity can be very different.

Informal activities comprise those persons and families engaged in subsistence and semi-subsistence activities in the rural areas and those working in urban areas without formal employment arrangements. Formal activities usually involve regular wage and salary employment, but they also include activities run as a business that go beyond being just a by-product of subsistence living. Formal activities are normally undertaken by businesses that are incorporated or licensed to do business, are registered with the local authorities and pay government fees and taxes.

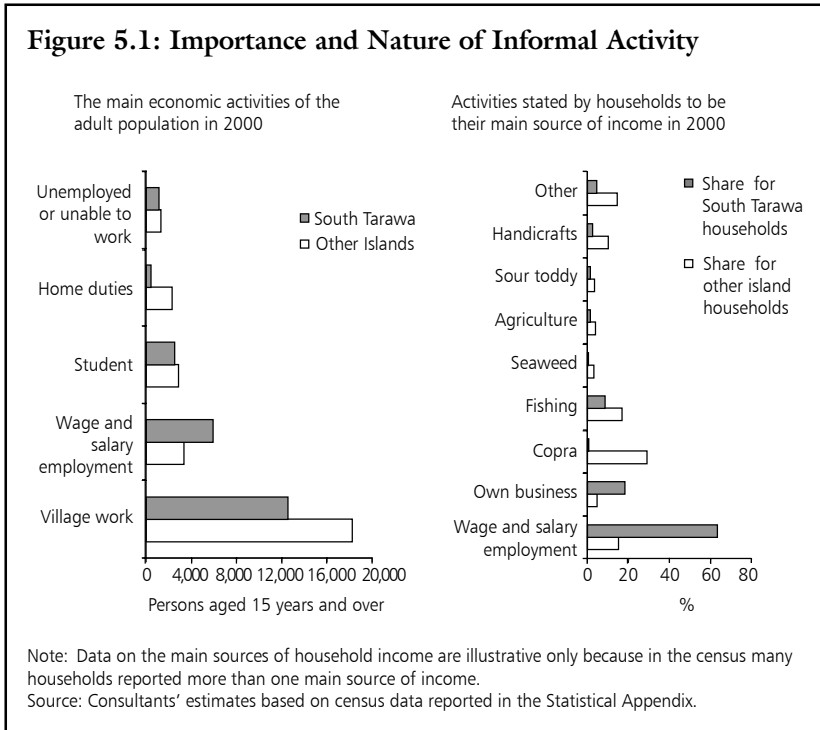
Most people earn at least some income from informal activity. The 2000 census found that more than 30,000 adults, or around 60% of the adult population, are engaged in village work (see Figure 5.1). This comprises informal, private sector activities. In contrast, the census found that less than 10,000 or 20% of adults were engaged in formal wage and salary employment, most of which is in the public sector. It is estimated that less than 4% of all adults are engaged in formal, private sector activities. This means that for every adult engaged in formal private sector activity in Kiribati, another 15 or so adults are engaged in informal private sector activity.

Informal activities are particularly important in the outer islands where they provide most people their only opportunity to earn cash. The most important informal activities there are copra harvesting, fishing and handicrafts (which include weaving), followed by seaweed farming, sour toddy, and other agricultural activities. In South Tarawa, an individual's own business provides the main source of informal activity, with fishing also important (Figure 5.1).

While only a small part of the adult population is engaged in formal private sector activity, formal wage and salary employment is highly sought after because of the relatively high pay rates. Formal sector incomes are redistributed widely through the community, with the result that the sector supports far more people than are directly engaged. But the system of redistribution is not entirely egalitarian and those families with formal sector employment tend to have higher cash expenditure levels than those without.

Because the calculated monetary equivalent of nonmonetary incomes in informal activity is relatively low, the total value assigned to informal activity is much the same as the total value of formal private sector activity. Preliminary estimates of the MFEP suggest that informal activity may account for 20% of GDP while formal, private sector activity probably accounts for around 15% of GDP.

Formal private sector business activity has shown good growth in recent years. In 1995, private sector businesses accounted for 18% of total wage and salary employment, and by 2000 this figure had grown to 25% (Figure 5.2). This amounts to an annual growth rate of 10%, much of which was in small-scale manufacturing (mainly clothing and food), construction, and transport (mainly private buses



and shipping services) that more than offset a contraction in agriculture, fishing, and business services.

This growth appears to have continued in South Tarawa and the Line Islands. In the capital, there has been a further expansion in clothing manufacturing that now employs around 100 people; construction has expanded as government projects have created new opportunities; the number of rooms at private hotels has increased; and new restaurants, nightclubs, and bakery businesses have opened. In the Line Islands, the main development has been the significant expansion on Kiritimati (see Annex D) and Tabuaeran centered on tourism activities (associated with increased frequency of visits by cruise ships together with a continuing flow of sports fishers flying in from Hawaii). In the outer islands generally, there has been a shift of retailing activities away from island cooperatives to private retailers.⁵⁶

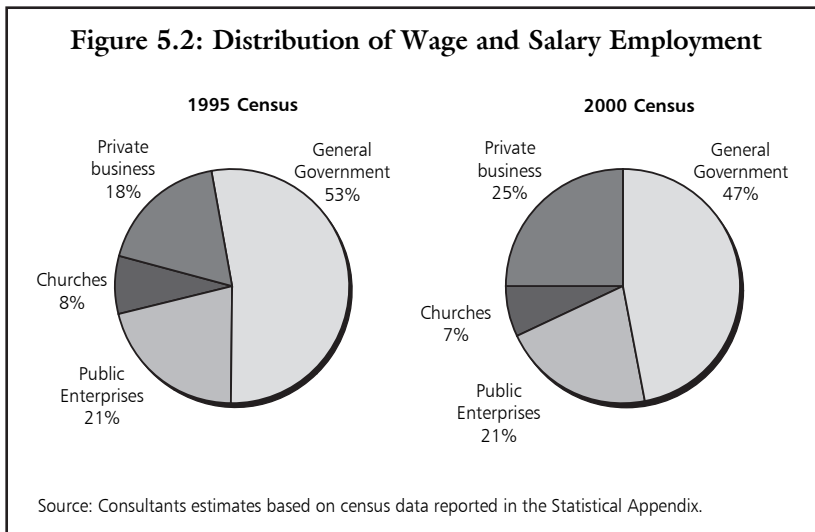


Table 5.1 summarizes the scope and nature of private businesses. Most are involved in retailing and wholesaling, the conduct of bus and shipping operations, and provision of basic services. Important services provided by the private sector include accommodation, restaurants and bars, mechanical and electrical repairs, representation of seafarers and fishers, and the operation (mainly by churches) of secondary schools and colleges. Private businesses are typically small to medium size, with an average annual wage and salary bill of \$28,000.

One of the important characteristics of the formal private sector in Kiribati is the extensive competition it faces from larger PEs and some ministries as described earlier. The private and public sectors are effectively direct competitors in the wholesale and retail sectors, shipping, small-scale construction, hotels, and some small-scale manufacturing (e.g., upholstery and furniture manufacture). PEs operate in many sectors where private business could successfully operate under the right conditions, such as the export of marine products and the provision of electricity, water, and telecommunications. The broad engagement of PEs in business is reflected in the wide scope of the PEs (Table 5.1).

Table 5.1: Comparative Profile of Formal Private and Public Enterprises in 2001

Main Business Activity	Private Business				Public Enterprises			
	Number of Businesses	Implied Annual Wages and Salaries		Number of Businesses	Implied Annual Wages and Salaries		Average Per Business (\$'000)	
		\$'000	Share of Total (%)		\$'000	Share of Total (%)		
Agriculture	0	0	0	1	226	3	226	
Marine products	8	198	4	25	3	427	5	
Trade	57	1,624	30	28	6	1,017	13	
Transport	18	506	9	28	4	1,988	26	
Construction and engineering services	2	157	3	78	0	0	0	
Utilities	0	0	0	4	1,106	14	276	
Manufacturing	6	118	2	20	2	51	1	
Services	51	2,123	39	42	10	3,202	41	
Cooperatives	10	123	2	12	0	0	0	
Not specified	37	527	10	14	0	0	0	
Total	189	5,376	100	28	29	7,791	100	

Source: Consultants estimates based on Census data report in the Statistical Appendix.

In most areas, PEs are substantially larger than their private sector competitors. Although reliable data are scarce, PEs are on average about 10 times the size of private businesses in terms of payments to employees (Table 5.1).

In addition to competing for customers, PEs compete with the formal private sector for some important inputs to production. This is particularly the case for labor, where PEs are at an advantage because they can afford higher rates of pay. Although there are six or seven times as many formal private undertakings as PEs, and employ in total 50% more persons, their total wage and salary bill is only two thirds that of the PEs (Table 5.1).

There is little private foreign investment. The major recent private investments have been the purchase by ANZ Bank of a share of BoK (to replace the departing Australian bank, Westpac) and the development of a base on Kiritimati Island for an experimental Japanese space shuttle. In a typical year, total private direct investment is less than \$0.5 million.

What Holds the Private Sector Back?

There are many inherent handicaps to private sector development in Kiribati, such as the long distances to major markets, the small and dispersed local population that restricts local markets, and the narrow natural resource base. These factors are likely to prevent the Kiribati economy diversifying to support an extensive private sector as seen in better-endowed Pacific island economies.

The private sector is also constrained by a range of human-made handicaps. Of note are the uncompetitive wage rates, the use of the Australian dollar as the national currency, and the operation of PEs.

The ready access of the public sector to buoyant government revenue has helped support wages in the public sector well above incomes available from most alternative activities. Contributing factors to this situation are “cost of living adjustments” independent of productivity improvements, and pay rates linked to qualifications and years of service rather than productivity or merit.

The possibility of securing a well-paid public service position, or the ability to share in the income from a job held by a relative, lessens the incentive to pursue alternative forms of earning income. The private sector can find it hard to match such salaries and employ the right staff, limiting the resource base available for private sector activities. Further, the wages and salaries that have to be paid can make the cost of operations too high—a particularly important problem for activities seeking to export or compete against imports, such as agriculture and fishing. The result is that opportunities available to the private sector are not fully utilized.

The opportunities to work overseas and associated remittances can have a similar constraining effect on the domestic private sector. For some, the wage rate or income sought domestically is influenced by the higher level of wages that a seafarer, fisher, or other offshore worker can hope to earn. Also, remittances from offshore supplement income, which adds to the wage or income level that must be available before a person is induced to work. These problems affect participation in both formal and informal activities.

The use of the Australian dollar as the national currency limits the flexibility of the economy to improve its competitiveness through depreciation of the currency.⁵⁷ In the present currency situation, Kiribati's ability to compete internationally is limited to areas where it enjoys a cost advantage because of its endowment of marine resources, or where informal sector labor is prepared to accept low rates of pay, or where high transport costs offer some natural protection from imports.

Many of the human-made handicaps facing the private sector revolve around the performance of PEs. It is generally acknowledged that some PEs are failing to provide goods and services of an appropriate price or quality, even though they have a critical role to play in supporting the economy. Poorly performing PEs can undermine the private sector for the following reasons.

- They require financial support, which diverts funds from alternative uses important to the private sector, such as infrastructure provision, or they require a higher level of taxes than need otherwise apply. Unnecessarily high taxes reduce the purchasing power of households and, if levied on business, can act as a direct constraint to expansion.
- They can fail to provide essential services, such as shipping, air freight, telecommunications, and electricity, at a reasonable cost and/or level of service. This makes it harder for import-competing and export activities to become internationally competitive and for informal activities to evolve into formal activities. This problem is particularly noticeable in the provision of services to the outer islands, where high cost and/or poor reliability can prevent suppliers accessing markets in South Tarawa.
- They crowd out the private sector by taking up opportunities that could otherwise be pursued by private business. Examples of this problem are found in the retail and wholesale sectors and the provision of shipping services.

- They tend to be poor payers for goods and services supplied by the private sector and this makes it harder for private businesses to operate. Several PEs with poor financial performance owe creditors considerable sums.

Some PEs are also protected from competition by statutory monopolies that exclude the private sector from important areas of the economy. For example, the Public Utilities Board (PUB) has a statutory monopoly to supply water and electricity on South Tarawa. The electricity supply is subject to numerous disruptions and the cost is high by regional standards. Yet businesses and households seeking to install their own generator for permanent supply or even as a back-up generator must seek the approval of the PUB.⁵⁸ The Solar Energy Company has a statutory monopoly to supply solar energy systems to outer islands. The Kiribati Insurance Corporation has a statutory monopoly to provide insurance services (although it may choose to allow competition) and the Kiribati Provident Fund holds a monopoly on the provision of superannuation.

Other PEs are protected by nonstatutory, policy-based monopolies. These include the BoK, Air Kiribati with respect to domestic air services, the Plant and Vehicle Unit that has a monopoly over the supply of vehicles to ministries, and the Ministry of Works and Energy that has an effective monopoly over the conduct of small maintenance work for ministries (because it controls maintenance funds).

Poorly performing ministries can also undermine the private sector if they fail to ensure that important services are in place. There are some activities in the economy that the private sector cannot be relied upon to initiate without government involvement. Unless the ministries intervene to ensure that such activities do happen, important gaps can emerge in the economy. Ministries need not actually undertake the activities, but they need to at least facilitate them.⁵⁹

The rules and regulations of the public sector need to take into account the commercial realities affecting the private sector. For example, it is important that the price controls currently applying to fuel, bus fares, and some basic food and household items allow opportunity for a reasonable profit. A sound case can also be made to remove price controls in areas where there is strong competition

in the supply of these goods and services, such as for buses and basic foodstuffs on South Tarawa.

A further issue is the role of Island Councils. Councils have the power to levy license fees and charges for revenue raising purposes. Some Councils levy very high charges that appear to rise as perceived profitability rises and are unrelated to the levels of service provided by Councils. This can amount to an unreasonable imposition on private business. Some Councils also play an active role in business, for example, in transport and retailing, directly crowding out private sector activity.

In contrast to the local government revenue system, the revenue system of the central Government is reasonably efficient and probably does not present a major impediment to the private sector.⁶⁰ The main exceptions are the imposition of a high withholding tax on foreign investment, the levying of tariffs on a number of business inputs, and the considerable variability in tariff rates.⁶¹

The limited land area is in itself an important constraint on private sector development. But it appears that systems for obtaining access to the very limited land on South Tarawa are operating reasonably well. There is considerable leased land on South Tarawa that can be traded and a land titling system is in place. Obtaining access to land is more of a problem on Kiritimati where lengthy administrative delays in allocating Crown leases are a potential constraint to the development of the island.

The finance sector is dominated by PEs and because some are taking advantage of their monopoly position (e.g., by overcharging or paying too low a return on deposits), the price of capital is probably higher than it should be. But the supply of capital appears to be more than adequate. Leases of land are now accepted as security by lending institutions, as is a public sector wage or salary. These innovations have done much to ensure that funds are available for business investment. Nevertheless, the considerable reserves held offshore by the financial sector indicate that the use of domestic credit for development is still constrained by factors other than the level of domestic savings.

A final human-made handicap, mentioned in several parts of this report, is a widely held and generally negative attitude to the private sector that has tended to deter the emergence and expansion

of formal private business. This attitude appears to have cultural origins, and is only likely to change slowly. There are signs, however, that more positive attitudes to the private sector are gradually taking root, as more people make the transition from informal to formal modes of risk-taking enterprise.

Reducing the Handicaps Facing the Private Sector

The handicap created by high public sector wages cannot be readily corrected. But its impact could be lessened over time if there were an improved alignment between public sector wages and productivity levels. Improved human resource management systems can help in this regard by facilitating merit-based appointment. It would also be assisted by a tighter focus on performance of both the general government and PE sectors.

The human-made handicap most open to correction is the wide scope and inefficient operation of the PEs. The crowding out of the private sector could be reduced by efforts to limit the scope of the PEs. Improved performance of the PE sector would generally help lift the performance of the private sector (both formal and informal activities).

It is very difficult to present a sound justification for maintaining all the existing monopolies indefinitely. But immediate removal of these monopolies may be impractical in many cases, as new regulatory systems may be required before the exemptions could be removed. This is the case for financial sector PEs (BoK, KPF, and the Kiribati Insurance Corporation). The MFEP is preparing an appropriate regime for the sector with the aim, among others, of facilitating competition.

In some areas, it is difficult to expect new competitors to emerge even if restrictions are relaxed because of the high cost of entry (e.g., telecommunications and domestic air services). But some smaller-scale activities of PEs, in which private suppliers are already operating, could be readily opened to competition. For example, the right of the PUB to prevent the establishment of own-use generating systems could be removed to facilitate the use of

small-scale generators and solar systems. Also, the provision of vehicles by the Plant and Vehicle Unit and of certain maintenance work by the Ministry of Works and Energy could be opened to competition.⁶² A ready example of the potential benefits of such reform is provided by the South Tarawa bus system that was previously government run but is now run efficiently and profitably by the private sector.

The performance of the PEs would be improved by opening them to competition and providing for improved supervision and monitoring of their performance by the Government. Such supervision and monitoring could be used as a basis for a system of rewards and sanctions that could provide better incentives to PEs. Unprofitable PEs competing against the private sector should be allowed to close and be replaced by private sector providers.

There are a number of other broad measures that the Government can provide to help all private enterprises offset the handicaps they face. For example, sustaining good land management systems can help reduce the constraints created by traditional systems of land ownership. Innovative sources of credit can be used to help overcome any problems faced in using land as collateral for bank loans. Efficient transport and telecommunication systems can help correct for the long distances between islands.

There are a number of subsidies provided to the outer islands to facilitate their economies. Direct subsidies include a freight subsidy funded by a 3% levy on imports (valued at \$1.3 million in 2001) and a copra price subsidy (valued at \$4 million in 2001). Some subsidies are provided indirectly via the PEs. For example, capital and/or operating subsidies are provided to Kiribati Shipping Services Limited and Air Kiribati to help fund outer island transport, the Kiribati Copra Cooperative Society Limited receives operating subsidies, and at least initially a capital subsidy is being provided to the new copra mill which it is hoped will increase returns to copra cutters.

It is important that such subsidies are provided in a targeted and efficient manner so as to make their maximum contribution to the private sector. The copra price subsidy should not become a deterrent to the adoption of more efficient management practices

(e.g., of replacing old trees) or of labor being reallocated to activities offering better long term prospects (e.g., seaweed farming or fishing). The presence of two competitive private shipping lines and a church-run line presents the opportunity to put out to open tender the subsidies provided to Kiribati Shipping Services Limited. Similarly, airlines such as Air Marshall and Air Fiji could be allowed to compete for the subsidy provided to Air Kiribati.

The small size of the economy makes it particularly vulnerable to market power problems.⁶³ These are most likely to arise when a market is controlled by a monopoly, but they can also arise when there are only few suppliers. In this instance, the main concern relates to the market power of PEs, notably BoK, TSKL, and PUB. Both the BoK and TSKL appear to have earned excessive profits in the past, meaning their charges were much higher than could have been sustained in a competitive environment, while PUB provides a low quality and expensive service.⁶⁴

Regulatory initiatives can be employed to help correct these problems. For example, a policy or legislation on competition, with measures to prevent unnecessary restrictions to competition and to guard against the abuse of market power, would provide a basis for the promotion of competition in the economy. A simpler and more sensible initial response would be to consider using the existing Prices Ordinance (that is used to set price controls on some goods) to set limits on the prices and charges of monopoly enterprises of concern.⁶⁵

Private Sector-led Growth: When, How, and How Much?

Despite recent good growth, the formal private sector is still small. Informal activities will provide the main source of private sector activity for some time. There is scope to expand informal activities through exporting or import-competing activity. For example, there is physical capacity to increase copra exports because poor pest control is resulting in significant crop losses and not all coconuts are harvested. The import-competing activities largely rest on the expansion of the sale of local food in South Tarawa. For

example, local fresh meat and, at the right price, fresh fish can be expected to displace some of the large imports of tinned meat and fish.

Many actions required to increase informal private sector activities will have to come from the Government. For example, rat control requires a coordinated approach best led by government. Increasing the fish supply to South Tarawa requires infrastructure (e.g., cold storage) and government intervention is probably needed to coordinate the provision of such infrastructure. It is important that the considerable subsidies provided by the Government to assist outer island economic activity are well targeted to enable informal activities to maximize their potential.

Within the Government, there appears to be a general fear of the private sector because of a concern that successful enterprise will enrich a few people at the expense of the community. The economic benefits of profitable businesses providing improved services, paying taxes, increasing employment, saving, and reinvesting profits are not widely perceived. As noted earlier, attitudes are slowly changing as more people gain direct experience of business. The sector can be expected to continue to grow as existing businesses mature, as rising cash income levels increase market opportunities and allow village economies to become more sophisticated, and as new opportunities are pursued (for example in marine resource development, and on Kiritimati). However, the private sector will remain the junior partner of the public sector for the foreseeable future.

A necessary condition for active government support of the private sector appears to be more confidence within the Government and the general community in the merits of private sector activity. As long as the private sector is seen as some kind of threat to equitable distribution and there is limited voter support for improving the business environment, it will be accorded a low priority. Developing confidence in the private sector is probably best pursued gradually through incremental change rather than attempts at radical reform.

The private sector itself needs time to learn new ideas, to build up its capital base, and to gain experience in running businesses. Consultations with entrepreneurs during the present study pointed to a tendency for private operators to focus on their existing business

and not branch out into new, unfamiliar areas. Developing the willingness to diversify, attracting new market entrants, and allowing them to grow will take time. A useful move would be to make greater use of the existing skills and experience within the private sector. At present training courses in running business are conducted by public servants and there is little involvement of those with experience in running a private business.

Foreign direct investment is small and with the exception of marine resources and the tourism industry on Kiritimati and Fanning Island, major new foreign investments are unlikely. There are many countries competing for foreign investment that offer a broader resource base, larger markets, better priced services, and proximity to export markets.

The Government undertakes important market development initiatives, but there is a tendency to treat the information collected with secrecy. For example, considerable research has been undertaken into the establishment of a pearl industry. Rather than freely releasing this information and fostering a private sector-led pearl industry, the Government is considering forming a government corporation to control the industry and provide the Government a return on its investment in research. The international experience is that the taking of research findings forward to commercial realization, when substantial capital must be placed at risk, is a role best suited to the private sector.

It is probably impractical for the PEs to withdraw quickly from their current areas of operation. But it is important that that they seek to maximize their performance. There is also an opportunity for certain restrictions on competition by the private sector to be relaxed. A sound case can also be made for restricting the entry of PEs into new areas. For example, as much room as possible should be made for the private sector on Kiritimati, where inward migration is rapidly increasing the number of people seeking work.

Improving the services standards of PEs and lowering their prices would benefit from actions in two main areas. The first is the establishment of a mechanism for monitoring their performance, which was discussed in detail in the previous chapter. The second is to put in place regulatory-backed controls on prices. In this respect, there is value in reviewing the Prices Ordinance (CAP 75) to examine

its suitability as a tool for regulatory control. One issue is whether responsibility for the legislation could be usefully transferred from the Ministry of Commerce, Industry and Tourism to the MFEP to take advantage of the latter's role in helping supervise all PEs.

The worst case scenario is probably when an unprofitable PE competes with the private sector and is provided with capital injections to compensate for its inefficiency. It would be preferable to avoid the provision of such funds and instead to allow such a PE to close down, as is the case with the Atoll Motor and Marine Services Limited (some activities are being shut down and some will be absorbed by Bobotin Kiribati Limited).

Reducing the activities of PEs and relaxing the restrictions on competition with them by the private sector is likely to take considerable time. One reason is the need to implement complementary legislative reform. For example, a precondition to allowing competition to the financial PEs is the establishment of new financial institutions legislation. But some initiatives, such as allowing more competition with the PVU and the Ministry of Works and Energy could be implemented quickly. In exposing these organizations to competition, the key issue to be faced is the future of any excess staff.