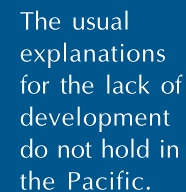
I. Diagnosis and Synopsis

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

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



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

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

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

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

The small size, geographic isolation, and vulnerability of the Pacific economies have been the prime justification for the extensive role of the state in most Pacific developing member countries (PDMCs) of the Asian Development Bank (ADB). Research for this publication supports the argument that the prime cause of poor private sector development (sometimes referred to as PSD) is the extensive state intervention in areas better left to the private sector, coupled with the state's inability to provide the public goods and institutions—in development parlance, the enabling environment—that a flourishing private sector needs. The lack of growth in most countries is related to a massive failure of the state. Erroneous ideas regarding what role government should play have resulted in costly state involvement that exacerbates, rather than ameliorates, problems of geographical isolation and distance.

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

The role of the state in promoting private sector development is to provide the institutions that underlie business activity. The institutions, in turn, define the transactions costs faced by business and, ultimately, the incentives for individuals to undertake entrepreneurial activities.[1] Currently, incentives in the Pacific are poor, transactions costs are high, and the institutions as well as the state are both intrusive and exclusionary for potential and existing businesspeople.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Constraints of the Private Sector in the Pacific

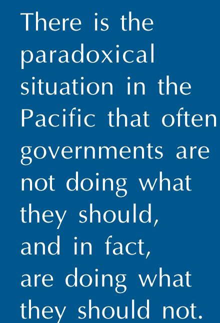
This publication identifies many issues facing the private sector in the Pacific.

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

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

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

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



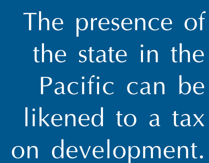
Better governance, minimal corruption, improved regulation, and increased competition would boost capital inflows while reducing the volatility experienced by most Pacific countries. As a result, the private sector would be a larger component of the economy, and as such, assist in the reduction of volatility.

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

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

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

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



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

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

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

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

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

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

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

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

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

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

Poor Investment Policies. A good investment climate has sound macroeconomic management, as well as trade and investment policies that promote openness, productivity, and growth. It allows for financing new investment at interest rates that equilibrate the supply and demand for savings. In addition, it includes good governance, promotion of competition, and prevention of corruption, with a solid foundation of basic physical and social infrastructure. The case for creating a good investment climate is simple. Without a predictable environment for people, ideas, and money to work together productively and efficiently, investment will not occur. The role of government is to provide an environment for entrepreneurs to invest in productive activities. From interviews, it is clear that a good private sector climate and secured transactions framework are missing in the Pacific. It is often expensive to establish and register a business. Incorporation is not easy. Sometimes specific industries are targeted for assistance, while obstacles to investment (e.g., in terms of controls, the composition of ownership or board of directors, etc.) are imposed on others. Targeted industries and subsidies distort decisions and have long-term harmful effects on efficiency, profitability, and the growth of the business sector.

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

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

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

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

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

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

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

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

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

Conclusions

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

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

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

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

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