II. Introduction

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

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

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

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

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

well as wide differences within each group.

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

Low Growth in the Pacific: Critiquing the Usual Assertions

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

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

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

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

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

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

The Private Sector in the Pacific

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

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

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

An equally difficult and closely related problem is how to measure the size of the private sector with any degree of accuracy. Simply subtracting the portion of government expenditure from the measure of GDP in the national accounts will not provide an accurate estimate of private sector output because transfers often comprise a significant portion of expenditure. In addition, if the public sector uses private contractors, depending on how GDP is estimated, their value may not be included in the national accounts. Much of the output of the informal sector as well as that of rural agriculture and fishing could also be omitted. Statistics on most of these issues are not readily available in developed economies and are rarely available in the developing world. Since Pacific economies are characterized in general by few statistics, data that would provide accurate estimates of the size of the private sector are not available. Furthermore, in states where governance is weak, there are strong incentives for the private sector to operate informally and not provide information on their activities. Inefficient and poorly functioning government departments, including those responsible for collecting statistics, also characterize such states. As a result, the reliability of information from states where governance is weak is especially suspect.

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

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

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

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

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

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

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

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

Private Sector Development, Growth, and Poverty Reduction

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

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

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

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

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

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

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

In evaluating the significance of the private sector in promoting growth, this publication also touches on issues that have been at the center of policy debates in the region. It discusses issues such as the role of the state, the effect of size and remoteness, the interaction of markets for goods and services, capital and factors of production, and the appropriate role of funding agencies. One important conclusion is that many disadvantages habitually blamed on distance and smallness are exaggerated. And that some of these negative effects are greatly compounded by ill-advised policies that reduce factor market flexibility and raise the costs of doing business. In addition, this publication also emphasizes the importance of institutions in promoting an environment where the private sector can flourish.

Private Sector Assessments in the Pacific: A Framework

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

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

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

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

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[6] Marshall Islands, Papua New Guinea, Samoa, and Vanuatu.

Overview of the Report

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

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

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

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

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

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

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

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

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

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