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

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

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State Interference

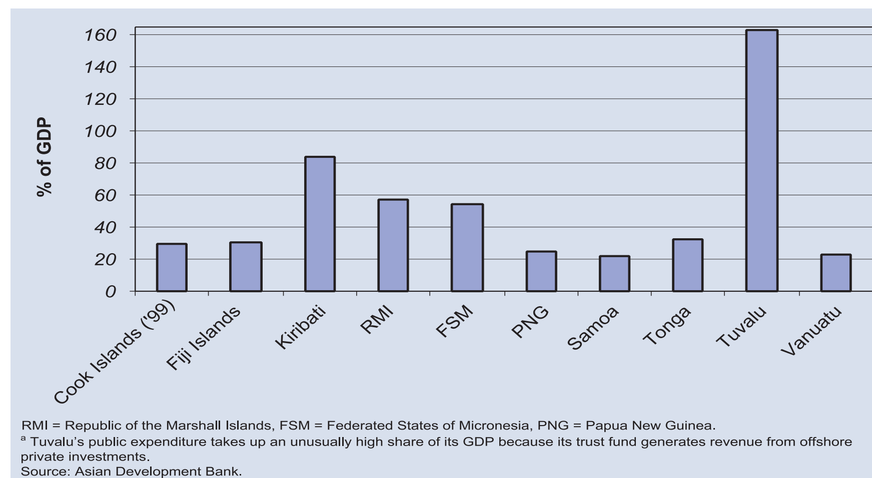
The size of government, as measured by the ratio of government expenditures to GDP, is greater in the Pacific than others in the developing world. In some countries, the ratio of government expenditure to GDP is close to one. (The average for the region is nearly 30% versus less than 14% for other developing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

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

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

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

Figure 10. Government Current Expenditure, 2000 (% of GDP)[a]



RMI = Republic of the Marshall Islands, FSM = Federated States of Micronesia, PNG = Papua New Guinea.
[a] Tuvalu's public expenditure takes up an unusually high share of its GDP because its trust fund generates revenue from offshore private investments.
Source: Asian Development Bank.

[20] Unless state-owned enterprises are provided with direct budgetary support, in which case it will be included in the measurement.

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

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

Relationship with the Public Sector

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

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

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

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

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

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

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

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

Public Goods

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

High Costs

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

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

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

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

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

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

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Transport Issues

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

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

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

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

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

Finance

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

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

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

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

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

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

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

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

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

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

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

23 Priority is the process by which the lender establishes the priority of the security interest.

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

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

Natural Resource Issues

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

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

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

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

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

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

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

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[24] Marine snail of shallow tropical reefs harvested for its thick inner layer of mother-of-pearl used for jewelry and buttons.

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

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

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

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

Investment Policy

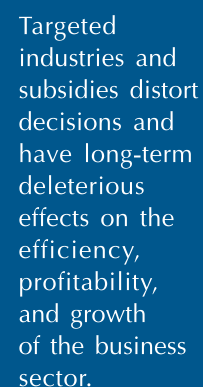
Countries reduce poverty when they undertake two fundamental actions: first, building an inviting investment climate in which private entrepreneurs will invest and generate jobs; and second, investing in the education of people so

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

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

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

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



Why Foreign Investment Is Good

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

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

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

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

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

Foreign Investment Regulation

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

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

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