

VIII. The State and the Private Sector

There is a symbiotic relationship between the state and the private sector everywhere. Any government that hopes to promote prosperity for its citizens must encourage private sector activity. Similarly, the private sector looks to the government to provide the appropriate enabling environment for its development. The overarching theme of this report is that a private sector strategy for government is not about fostering specific companies or sectors. Rather, it is about ensuring that the environment and conditions that affect business and entrepreneurship promote productivity and growth. As a result, private sector issues encompass almost every area of every economy.

Policies that encourage and promote private sector development cannot be imposed—the government and the private sector must play a central role in identifying and agreeing on the problems and priorities for the effective formulation and implementation of private sector policy. Moreover, in this process, both the government and the private sector have obligations: the government neither to erect barriers to business and commercial activities nor to give preferences to individual sectors; and the private sector not to expect preferences, handouts, and special support from the government.

Both the government and the private sector have obligations.

The mutual understanding and cooperation necessary for effective implementation of private sector-friendly policies can only come about through contact, discussion, and feedback. Currently, there appears to be little of this in the Pacific. Often there appears to be an attitude of misunderstanding and mistrust between government and the private sector. On the part of the government, private businesses are viewed with suspicion, while on the part of the private sector, government is viewed as unresponsive and unwilling to listen. On a positive note, however, there is an increasing awareness by governments of the importance of private sector activity and a desire to reverse the neglect and suspicion that many officials acknowledge. Furthermore, most private businesses maintain a strong willingness to cooperate with government to improve the

environment for private sector activity. An example of efforts to improve private sector-government relations is Vanuatu where the Chamber of Commerce organized a weeklong forum in 2002 wherein the business community and the Government held open discussions on issues that were of concern and prepared follow-up briefs aimed at keeping the contacts open.

The Role of the State in Private Sector Development

The State in Pacific Economies

The state still has a prominent role in most Pacific economies—in some, such as Tuvalu, government expenditure as a percentage of GDP exceeds 100%. In others, such as Kiribati, this expenditure is close to 80% (Figure 10). Although the share of the state in GDP is lower in some other countries, there is widespread state ownership of resources. For example, in Samoa, the State is currently the direct provider of all infrastructure services. In addition, it has either majority or minority ownership in a wide range of businesses ranging from an agricultural supply store to an Internet provider—the State is omnipresent in the productive sector even though it has already gone through significant divestiture. Furthermore, the negative effects of its ownership of enterprises have been felt beyond the inefficiencies of operation—when the state-owned airline ran up crippling losses in the mid-1990s, its costs were covered by cutting government expenditures by up to 25% in areas such as health care and education.

Such examples abound throughout the Pacific. Furthermore, structural problems with public sector budgets arise from the state's pervasive presence. Public expenditure is heavily biased in favor of current outlays reflecting the large share of wages in the total. As a result, infrastructure expenditure is neglected in many countries, even though state monopolies exist and private sector activity is forbidden.

The State and Low Private Sector Growth

If the state is not supportive of private sector development, no amount of potential can compensate. There is growing evidence that the most plausible explanation for the disappointing failure of most developing countries to grow and prosper is the inadequate institutions that underpin private sector development. Most of these institutions are supplied either directly or indirectly

Table 5. Utility Costs

Country	Electricity ^a (US\$/kWh)	Telephone Call to the US ^b (US\$/minute)
Fiji Islands	0.16	1.10
Kiribati	0.24	2.10
Marshall Islands	0.16	2.00
Micronesia, Federated States of	0.10–0.16	2.00
Palau	0.10	1.50
Samoa	0.18	1.35
Solomon Islands	0.16	1.10
Tonga	0.31	1.20
Tuvalu	0.37 ^c	4.00 ^d
Vanuatu	0.26	1.50
Australia	0.06	0.17

^a Average commercial tariff, 1999 (World Bank 2002a).

^b Representative, converted to US\$ using the average exchange rate for 2001 (World Bank 2002a).

^c ADB 1998d.

^d Rate is for the rest of the world. It is US\$2.50/minute to Australia (ADB 2003f).

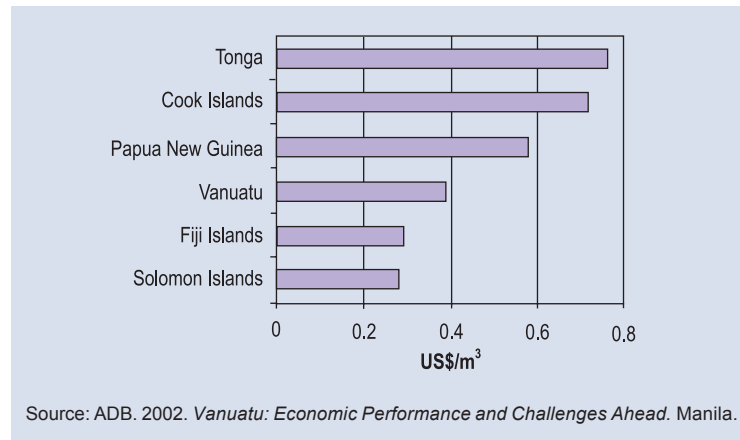
Sources: ADB and World Bank.

by the state. Public capital, primarily infrastructure, that firms need to complement their capital, such as electric power, water, telecommunications, and the road transport network in Pacific island countries has not been organized in a way that provides these services at the lowest possible cost to the private sector (Table 5).

Some aspects of high costs can perhaps be explained by the remoteness of the countries in the region. But a large part appears to result from state interventions. In most cases, entities supplying infrastructure services are either a department of the state or corporatized entities that are owned by the state. In virtually all cases, these entities are legal monopolies that prohibit any form of private sector competition. The following are a few examples.

- In the Marshall Islands, the state-owned telephone monopoly also has a government-granted monopoly on the provision of Internet services. Although it only offers 48.8k-dialup services, it refuses to allow the TV cable provider to introduce high-speed cable Internet access.
- In the Chuuk state of Micronesia, the corporatized power company was subject to such extreme political interference and mismanagement that services were suspended across the island for 3 months (ADB 1997b).

Figure 15. Water Consumption Tariffs, Select Countries, 2001



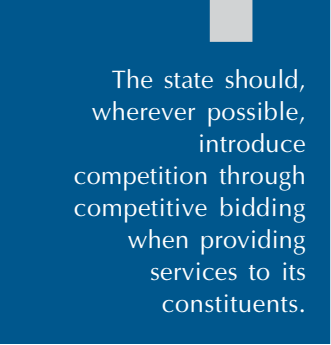
- In Samoa, the corporatized power company does not allow owners of private generators (who install them because of the unreliability of the power supply) to operate them except during power failures, unless they are granted approval from the company. No such permission has been given. Similar restrictions on power generation exist in other Pacific countries.
- In Kiribati, the government-owned public utilities and energy company provide all utilities to the country, but service is poor because of frequent power supply, water, and sewerage problems (ADB 1998b).
- In Vanuatu, the power and water companies are owned by the Government, which has a minority interest, and by a foreign state-owned power company, which delivers a reliable supply of power, but at rates that are among the highest in the world.
- In Port Vila, Vanuatu, port-handling charges are among the highest in the world as one company has the monopoly rights to handle freight.
- Air transport is costly in most Pacific countries because many governments insist on owning and operating their own airlines.

In the Pacific, the state crowds out private sector activity and distorts the market for labor. Often, public sector wages are higher than the equivalent job in the private sector. Since public sector employment also carries with it greater job security, the better workers are attracted to state jobs where productivity is lower. In addition, state employment creates a large constituency with a strong stake in maintaining the status quo, making downsizing and enterprise reforms politically difficult.

States in the Pacific also fail to provide the public goods and institutions that support private sector activity. Broadly, those public goods and institutions minimize transaction costs and promote investment and specialization. Such institutions constitute the foundation of a modern market economy. In most Pacific countries they are weak and do not effectively support private sector activity. Examples are physical infrastructure such as roads, and social infrastructure such as health care and education.

Therefore, the problems observed in the Pacific arise not from inadequate private sector activity per se. Rather, they result from incentives provided by a combination of low-quality and high-cost public infrastructure that not only fails to mitigate the effects of isolation and distance that member countries face, but even exacerbates them.

Moreover, the pervasive presence of the state in the economies of the region is based on an antiquated perception of its role. If the state wants to promote private sector development, it must provide the services required at the lowest



The state should, wherever possible, introduce competition through competitive bidding when providing services to its constituents.

possible cost, and neither provide protected employment nor maintain government monopolies at the expense of efficiency. There are many ways of achieving this goal, but they all involve a search for efficiency and a willingness to use incentives and market mechanisms to achieve it. It does not necessarily mean wholesale privatization, although privatization does yield substantial efficiency gains. It does, however, mean that the state should, wherever possible, introduce competition through competitive bidding when providing services to its constituents.

Targets and Instruments of Private Sector Development Policy

Developing and implementing a coherent policy toward the private sector is difficult. There are many competing interest groups, some of which will be affected by virtually any policy change. The problem is compounded by the fact that private sector development is difficult to measure and indicators only give indirect information on how the private sector is evolving. In addition, there is a chronic shortage of information on many of the constraints outlined in earlier sections. Nevertheless, the analytical framework developed in this paper indicates that as a minimum, the state has a central role in identifying and reducing barriers to private sector development.

More ambitiously, the state has a role in ensuring that services essential to the private sector function adequately. The limitations of private sector development policy, however, must be recognized. For example, poverty reduction cannot be a direct target of private sector development policy. Rather its impact on poverty reduction will stem indirectly from reducing the number of poor through higher employment and economic growth resulting from an expanding private sector. A pro-poor, private sector policy is one that puts in place the conditions for employment-rich economic growth.

In formulating policy, a careful identification of the targets and instruments of private sector development policy is essential for determining what the state can achieve in this area. It involves promoting private sector development by undertaking reform that strengthens the foundations of business formation, operation, growth, and closure. Earlier discussion highlighted the effects of high transaction costs, burdensome regulation, market failure, inadequate public goods, and poor incentives on the dynamism of the private sector. It indicated that in some areas, such as transport and other public services, inefficient provision amounts to a tax on private sector activity. These areas can be influenced by interventions from the public sector.

A premise of this analysis is that private agents operating in properly functioning markets generally provide superior economic outcomes that maximize the community's welfare. Another is that most goods and services are more efficiently provided by private enterprise. These premises lead one to ask what role can governments play? Overall, in promoting a dynamic private sector and discouraging informality, governments can ensure the stability of the institutional environment in which businesses and markets operate, and address market failure when it occurs.

More specific instruments that are available include

- provision of macroeconomic stability;
- speedy privatization of unwarranted public enterprises and introduction of competition into areas where the state continues to provide services (a competitive solution is desired either through having the private and public sector compete or by ensuring that privatization results in genuine competition);⁵⁰

In promoting a dynamic private sector and discouraging informality, governments can ensure the stability of the institutional environment in which businesses and markets operate, and address market failure when it occurs.

⁵⁰ Privatization in its purest form refers to the shifting of the production and ownership of a good or the provision of a service from the government to the private sector by selling government-owned assets. Most definitions of privatization are more expansive, covering virtually any action that involves exposing the operations of government to the pressures of the commercial marketplace.

- adoption of a broad-based and efficient tax system that neither overly burdens economic activity, nor singles out successful firms as targets for tax collection;
- introduction of prudential regulation in areas that are warranted;
- deregulation in areas where governments have no role;
- simplification of regulations;
- provision of well-defined property rights that can be secured at reasonable expense (in virtually every Pacific country, rights for both movable and fixed property are poorly defined, which raises transaction costs and discourages investment);
- enforcement, promptly and efficiently, of a fair and impartial legal system, in particular, to delineate clearly the rules that govern contracting;
- provision of quality infrastructure delivered efficiently;
- ensuring that the costs and time necessary to establish new businesses are kept minimal to reduce the barriers to entry;
- addressing information asymmetries that hamper the development of markets, especially financial and export markets; and
- regulation of “natural” monopolies.

Unfortunately, governments often avoid a framework of this type in favor of direct interventions such as promoting specific sectors of their economies, maintaining government ownership of resources or industries, or directing lending to favored types of economic activity. These activities distort resource allocation, weaken incentives, create instability and uncertainty, weaken property rights, and raise the cost of transacting to the point where much economic activity is either discouraged altogether or directed into areas where gains are severely suboptimal. For these reasons, such activities are minimized in well-run, modern economies.

State-Owned Enterprises

Discussions of infrastructure issues in the Pacific that appear in various government and funding agency reports exhibit some striking differences in viewpoints and no clear consensus about the scope and nature of the SOE question. Many official reports are critical about past SOE performance but, at least in the case of some countries, sanguine about the future, especially the prospects for improved performance and efficiency through the corporatization of SOEs.

The apparent complacency about the efficacy of future reform efforts, however, is hard to understand. Government provision of public services in most of the Pacific has failed for the same reason it has failed in much of the developing

world—government ownership and management provides weak incentives for efficiency, strong incentives to make political accommodation at the expense of customer service, and political pressures to overstaff and undermaintain. Where the incentives are weak and the difficulties of monitoring high, efficiencies will not be achieved. The prospects for substantial improvements in efficiencies through corporatization are not strong and have proven disappointing elsewhere.

A successful solution to the Pacific’s infrastructure problems must navigate the constraints and challenges that each country presents. A common thread, however, is that in most cases, the solution must deal with a small and relatively undereducated population and a small local market for infrastructure services.

The next section sets out some general principles regarding infrastructure provision.

Infrastructure Provision: Issues and Approaches

The current, highly centralized model of infrastructure provision, in terms of which the state is the sole financier and provider of services, provides weak incentives for efficiency, diminishes local control, and denies private participation in infrastructure projects. But before any change can take place, numerous issues must be addressed.

Integrated Project Design

Traditional analysis of infrastructure projects includes the evaluation of an array of technical designs, an estimate of rates of return from different designs, and a discussion of project choice. This approach is less appropriate in the Pacific context because it ignores the key features of problems in most of the region. Central issues include:

- What will motivate the provider (the agent) to achieve proper pricing, cost recovery, and maintenance?
- What regulatory framework (monitoring arrangement) determines that benefits actually reach the public?

A well-designed “public service” project must go beyond the traditional approach of analyzing designs at best practice costs. Project design must consider how to

Government ownership and management provides weak incentives for efficiency, strong incentives to make political accommodation at the expense of customer service, and political pressures to overstaff and undermaintain.

align the incentives. How can the operators be motivated to deliver the optimum engineering practices that are assumed in the design phase? The project must consider the nature of the regulatory system and whether competitive market forces can replace regulation. To ensure achievement of project goals, it is necessary to evaluate the overall efficiency of the system—not just technical efficiency—from the perspective of the users of the service. For example, it is incorrect to establish that a centralized water supply is technically more efficient if that arrangement delivers those services at monopolistic prices. Neither is it satisfactory to rely on corporatized entities that have weak incentives for efficiency.

Choice of Techniques

A large number of technically feasible processes can meet infrastructure needs. There are many techniques for generating electricity, disposing of solid waste, or building and repairing highways. There is no unique best practice because wages and interest rates differ among countries.


The key to choosing the best infrastructure practice for a country lies in understanding how the technique relates to both the costs under the “best operation” and the regulatory structure of the particular country. Typically, smaller scale technologies permit more diffused supply, and even though they may not be the lowest cost method of delivering the product, they may result in lower prices and better service because they allow for increased competition. A large-scale electricity generating plant might have a lower delivery price at the generator than a grid supplied by diverse small generating facilities. The single large supplier, however, will not face competitive pressures and will need to be regulated. Unless the regulation is of high quality, monopoly profits and the attendant inefficiencies that monopolies bring will result, even if the monopoly is state-owned.

The alternative, many competing smaller providers with small generating facilities, may produce a more efficient economic outcome even if the underlying minimum technical cost of production is higher. The overall project evaluation, therefore, must assess the feasible regulatory frameworks, including competitive supply, as well as the incentives for adequate maintenance.

Such alternatives need to be explored within the context of small Pacific countries. Technologies in power provision, sewage disposal, and telecoms provision are changing rapidly toward efficient small-scale supply. These are well suited for the countries of the Pacific. Before implementing any large-scale plans for power provision, water supply, telecom provision, or sewage disposal, the feasibility of small-scale supply should be thoroughly explored.

While measures to improve the accountability and efficiency of SOEs are necessary first steps, their impact is unlikely to be sufficiently far reaching in addressing the core problems. These must be tackled by a combination of contracting out, increased competition, regulation, and divestiture.

Contracting Out. In virtually every country in the Pacific, there is potential for private operators to be contracted to provide many services that are currently supplied by the state. The government would call for tenders from private companies to provide services on its behalf. Tenders can be either on a positive bid basis, or on a minimum subsidy basis, where the winning bid is awarded to the operator that requires the lowest subsidy. This could be a mechanism for operating an airline if the government wishes to retain ownership.



Technologies in power provision, sewage disposal, and telecoms provision are changing rapidly toward efficient small-scale supply.

Increasing Competition. Improving competition usually involves increasing the number of providers. In the power sector, allowing the many private generators that exist across the Pacific to be run without restriction is an urgent first step. This action could then be extended by compelling state power providers to purchase power from private generators at their marginal cost of producing power. Encouraging alternative energy sources on a decentralized basis is a further option.

Similar considerations apply to water and telecommunications services. Currently, arrangements in many countries have led to high prices, which exacerbate the effects of distance and isolation.

Regulation. In implementing a satisfactory and effective regulatory regime, any solution must deal with the issues of regulatory capture and the provision of scarce regulatory skills. One solution is the use of an independent, offshore regulator, an issue that is discussed at greater length later in this chapter.

Divestiture. Many governments in the region own shares in businesses. Most governments now realize that there is no justification for such ownership and this report recommends that such shares be divested with minimum delay.

The Legal Framework

Many problems in the legal framework of the Pacific countries affect the provision of infrastructure, especially with respect to debt collection. Major issues are rights to land and collateral.

Rights to Land. Determining land rights and the transfer of such rights is problematic in every country in the region. This problem affects the private

provision of all types of infrastructure that are installed in or on the ground. Uncertainties with land raise the risk for the private provider of infrastructure and the use of property or leases as collateral for loans. (The use of property as collateral is unacceptable to virtually every bank in the region for land located outside urban centers.)

Collateral. The essence of private project financing lies in breaking up projects into different pieces that can be funded by different lenders, which reduces risk for any individual financier. In industrial countries, this arrangement means finding different lenders who can take different elements of the project as collateral, such as the land, the equipment, and the accounts receivable. Nowhere in the region is this arrangement acceptable as collateral for loans. Moreover, the legal framework for movable property as collateral has other defects that make such property useless as collateral.

Combined, these two problems mean that infrastructure projects throughout the region require government funding or a government guarantee with the attendant principal-agent problems. However, such government involvement diminishes the potential gain from private provision. In private provision, quality control on the financial and management side arises mainly from the inspection of firms by private lenders and financiers. When the state provides the funds, this control disappears.

Financing

Competition is difficult without private participation. And private participation is difficult without private financing. Adequate private financing, however, cannot be obtained within the legal framework of the Pacific countries. Private lenders will not lend to private companies for infrastructure projects unless they have recourse to the underlying collateral. Even if they are willing to lend, the banking regulator, who will seek compliance with both Bank for International Settlements (BIS) norms and standards of bank supervision, will penalize them. Under such a system, banks will lend without collateral only to companies with a strong balance sheet. In the Pacific, that means foreign companies and some existing SOEs.


Such a financing system places strong limitations on any competitive solution that could work for infrastructure in the region. It excludes most domestic firms, as their assets cannot be used as collateral, and therefore puts infrastructure into the hands of foreigners and monopolies. This outcome is undesirable from the economic, political, and public policy points of view.

Procurement

The provisions of IFIs and funding agencies regarding infrastructure projects favor awarding contracts to large companies. This preference can be explicit—by requiring minimum size and experience to do business—or implicit—by requiring conformity to the same audit, performance, and record-keeping requirements for contracts of all sizes. In many cases, however, such requirements are not consistent with the broader development objectives advocated by the very institutions awarding the contracts. Such objectives include the development of domestic capabilities and skills, the promotion of smaller businesses, the involvement of local communities in projects, and the support of stakeholders. IFIs are implementing programs to achieve these goals in many Pacific countries, yet through procurement requirements, are foregoing opportunities to deepen these goals when infrastructure projects are being implemented.

In all Pacific countries, it is important that infrastructure projects be open to procurement by local companies. This change will require modification of the implementation procedures that ensure principals and agents are faced with incentives that promote efficiency and effectiveness as well as discourage corrupt behavior.

For example, rather than enabling a government road agency to do business with small-scale contractors through reforms of agency operating procedures—a process that takes substantial time and has proven to have uncertain prospects for success—program designers can set up an independent contract management agency outside the government. Such an agency can handle the burden of administering and monitoring many small contracts. In this model, the government (the principal) hires an agent on a cost-plus-fee basis to manage small contracts and train small-scale contractors. The agent would then contract directly with small-scale contractors to execute civil works. They can also contract with local consultants—to prepare designs and bidding documents as well as supervise works. Such an agent can also contract with international and local firms to provide training for the tasks for which the local small contractors will compete. These procedures obviously apply to both construction and maintenance tasks. An agent should be chosen based on tenders to ensure competitive and transparent processes, and may be a nonprofit or for-profit firm. Using this methodology aligns the incentives between efficiency and local participation.



It is important that infrastructure projects be open to procurement by local companies.

The private agency model has several important features for the private provision of small-scale infrastructure in contrast to the usual supply-driven approaches. Most supply-driven assistance programs seeking to develop small-scale contracting provide technical assistance and perhaps financing to small contractors without any guarantee to the firm that future business will result. In contrast, the agency model has a demand-driven approach that creates a market for small firms by making procurement accessible to them. It does so by dividing works into many small contracts and providing prompt payments for works completed. Once firms win a contract, they become eligible for training, which is provided by the contract management agency.

This private agency model permits two important efficiencies.

- Private agents can pay employees decent salaries and therefore attract well-motivated, high-caliber staff and streamline procedures for payment and procurement, unlike a government agency.
- International funding agencies and IFIs, not well equipped to audit many small contractors, can monitor private agencies quarterly or even bimonthly, while the agents monitor the small contractors.

Operation and Maintenance

Access to basic public services remains limited in the Pacific and service provision is low. Like many developing countries with access to external funding for new projects, existing public assets are not properly maintained, and allocations for operation and maintenance (O&M) are inadequate. Rational governments will not spend tax revenue on O&M especially while funding agencies are prepared to build for nothing. Interestingly, the practice of undermaintaining infrastructure and letting funding agencies and IFIs rebuild has been subject to little hard analysis. The practice is less than optimal for funding agencies and recipients together, as it results in the excessively rapid destruction of the capital stock. The analysis of the participating decision makers, however, is less clear.

Funding agencies, especially bilateral agencies, support these projects because there is substantial domestic interest in projects that generate business for their firms. But these firms do not benefit from external funding of operating budgets of recipient countries. This practice helps a few taxpayers in industrial countries a great deal at a small cost to many taxpayers. For obvious reasons, the small group (contractors) lobby strenuously for these programs. At the same time, the recipient country has the choice of spending scarce public revenue on O&M or simply letting funding agencies rebuild deteriorated facilities for nothing—a not unreasonable practice. The “build and deteriorate” model of infrastructure provision is endemic throughout the region.

In earlier years, large IFIs placed conditions on a certain minimum size of O&M. After many years of nonenforcement, however, these conditions are now only rarely placed. It is difficult for smaller IFIs, such as ADB, to act alone on such a matter. But privatizing O&M is a small step forward in remedying the problem of undermaintenance because it creates a domestic pressure group with a strong interest in ensuring that infrastructure is maintained.

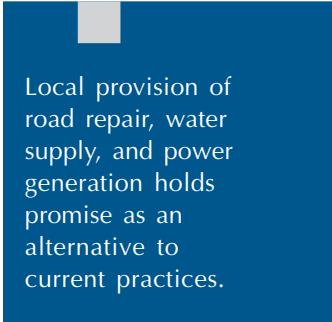
Decentralization

If handled carefully, decentralizing infrastructure provision in many Pacific countries is possible. Local provision of infrastructure is still government handled and subject to the same general problems of incentives and efficiency, so planners must bear this in mind when designing projects. Accordingly, planners face a choice between local or central, and private or public provision of infrastructure and infrastructure services.

In terms of the source for delivering hard and soft infrastructure services, local provision differs from central provision in that local provision often focuses more on local costs and benefits rather than national costs and benefits, thus tending to be more sensitive to the breakdown of locally provided services. For these reasons, local provision of road repair, water supply, and power generation holds promise as an alternative to current practices. On the other hand, local provision of public health services, sewage treatment, and general hygiene may be more problematic because the benefits spread out over groups outside the locality, reducing the incentive for local communities to participate.

In addition, financing locally provided services presents some serious difficulties with incentives. Block grants to localities present the possibility of free funding for projects in a certain area. This arrangement leads localities to demand considerably more of such projects than economic benefit would warrant. Cost-sharing only partly mitigates these incentive problems and raises the new problem—that localities have few administrative resources to raise tax revenues in their localities and often very little to tax.

Nonetheless, a combination of decentralization and privatization presents an opportunity for moving forward on infrastructure problems. One simple plan would set standards for infrastructure supply—say quality of roads—and make block payments contingent on meeting such standards. Localities could choose government, customary, or private provision. The central government could then disburse funds based on meeting the quality standards. The central



Local provision of road repair, water supply, and power generation holds promise as an alternative to current practices.

government could then privatize the process for monitoring these standards. This arrangement would provide a stream of block payments that could be used to guarantee local government payments to local private contractors. Such a guarantee would have value to a formal sector lender because of the ability to take a security interest against the stream of block payments.

A combination of decentralization and privatization presents an opportunity for moving forward on infrastructure problems.

Financing Private Infrastructure with Output-Based Contracts

Recently, the use of output-based contracts for infrastructure has attracted attention. Such contracts make the payment for infrastructure service a function of the output produced. For example, payments might be linked to measures of water supply quality, the number of electrical connections, or the number of kilometers of resurfaced roads. Such a system focuses the project on the outputs,

not the inputs to the process. Moreover, it presents a simple method of supervising and regulating the provision of infrastructure.

This approach also provides a partial substitute for the defects in the region's secured transactions framework. The service payment from the central government becomes a future asset, which can serve as collateral. That arrangement would permit private providers to get loans for equipment secured by the future flows and thereby enjoy the benefits of collateral—lower interest rates and longer repayment time.⁵¹

Privatization in the Pacific⁵²

State ownership is widespread in most Pacific countries. It goes beyond the entities that were (and in some cases, still are) owned by the state in many other countries—airlines, telecoms, and utilities. State ownership in Pacific

⁵¹ In principle, any government contract, including input-based contracts, could be used as security. The essence of the recommendation is that the combination of output-based contracts together with collateral reform will enhance not only the quality of infrastructure, but also local access to contracts.

⁵² The pros and cons of privatization have been long debated and there is now enormous global experience on privatization. More than 10,000 state-owned enterprises (SOEs) in over 80 countries have been privatized in the past 20 years. It is hard to find a country that has not privatized something. Malaysia has sold its National Lottery; Buenos Aires, its zoo; and Czechoslovakia, the guest house of the Communist Party. Countries privatize because it is difficult to bring about (and sustain) enterprise performance in SOEs. Ownership matters, and private owners drive performance in a way that governments cannot. See World Bank 1992 and www.privatization.org for discussions on privatization.

countries extends to businesses that are generally operated by private agents in a nonsocialist world. Examples include companies such as Internet providers, agricultural supply stores, shipping companies, port-handling facilities, oil processing plants, and hotels—the list is long and varied. The rationale for such involvement is that because of size and distance, the state has a central role in the Pacific economies and needs to assert ownership of many productive resources.

Unfortunately, the effect of state intervention is the same as in most other countries. It has resulted in inefficient and high-priced services, which have raised private sector costs, damaged the ability of the Pacific economies to compete, and harmed the development of the private sector.

Wholesale privatization and divestment may be the best strategy, but may not be feasible in the immediate future. First, countries in the Pacific have observed the controversy over privatization in industrial countries and wonder whether it would benefit them. Second, they have been bombarded with policy advice from a wide spectrum of funding agencies and consultants, some of which has been contradictory or not always of the best quality. Third, there is a strong feeling among Pacific citizens that the government should indeed play a key role. For these (noneconomic) reasons, intermediate steps may be necessary.

The primary aim in any action toward SOEs in the Pacific must be to reduce the very high costs and poor performance associated with government-run enterprises. A first step is to introduce competition and efficiency into the sectors where costs are high and quality is low—particularly infrastructure services. For that, cost-related information needs to be collected and analyzed to identify inefficiencies and provide a benchmark.

There is no justification, however, for the state owning such entities as retail outlets, Internet services, and copra oil processing plants. Where these exist, they should be sold or closed as soon as possible. In other areas, alternative organizational structures can be tested. For instance, while the state maintains ownership, operation of such services as power, water, telecommunications, electricity, air transportation services, and shipping could be bid out to private sector operators for fixed periods. In this way, the state (the principal) can monitor the winning bidder (the agent) both through the knowledge of other bids and through the agent's knowledge that the contract will be rebid within a defined time.

The effect of state intervention has resulted in inefficient and high-priced services, which have raised private sector costs, damaged the ability of the Pacific economies to compete, and harmed the development of the private sector.

One argument that is often advanced against such contracts is that the businesses are unprofitable. Since the services are required for social reasons (e.g., outer island shipping), some argue that the businesses, therefore, need to be run by the state. A better alternative is to have private operators bid on subsidy payments, with the winner chosen based on the lowest subsidy bid. Evidence confirms the effectiveness of such arrangements in solving many principal-agent problems that such arrangements entail. In the case of management contracts, able performance occurs when:

A first step is to introduce competition and efficiency into the sectors where costs are high and quality is low—particularly infrastructure services.

- Rewards are linked to performance.
- Governments do not interfere in the running of the entity.
- Contracts are rebid periodically.
- The firms running the entities have a proven track record.
- Governments, not donors, pay contract preparation costs to signal commitment to the contract.
- Markets are competitive or contestable (World Bank 1995a).⁵³

Initial privatization should involve rapid divestiture of peripheral businesses that the state has acquired and the introduction of greater efficiency by improving incentives.

At the very least, governments should allow the private sector to run SOEs through competitively won management contracts.

Subsequent steps toward full privatization can be taken as confidence in the system increases and costs decline. Privatization is the unambiguously preferred final solution over partial ownership or contracting out. Governments do not have to own assets to be able to control them through appropriate regulation, and government capital tied up in those assets can be better invested in social infrastructure or in paying debts. Further, global experience has shown that when governments retain a financial interest in a business, it is difficult to keep the business free from political interference.

Yet experience elsewhere, as well as in the Pacific, has also shown that privatization is not a panacea. Vanuatu has reliable electricity and telephone service following privatization but the costs are extremely high and monopolies have been entrenched

⁵³ A "contestable" market is one where there are no statutory impediments to the entry of new suppliers into that market.

for an extended period. Where markets are very small, regulation may need to accompany privatization where competition is not possible. Regulatory issues and how competition can be increased are set out in the next section.

Choice of Regulation

Infrastructure provision often involves monopolistic elements. Which elements are monopolistic, however, depends on the technology and contractual techniques used. In most industrial countries, electricity was typically viewed as a “natural monopoly” until it became clear as a technical issue that while the distribution grid required O&M by a sole provider, an improved design could separate the grid from other services such as generation and connection to the grid. That separation permits competitive generation of electricity even though single companies have responsibilities for a regulated net. Even in the net, moreover, there can be different degrees of competition. The central grid monitor may be responsible for all connections to the grid or private contractors may be permitted to make such connections subject to inspection by either state or utility officials. In this way, the entire connectivity issue can be made competitive. Careful design at the outset, therefore, can minimize regulatory burden by promoting the best possible private sector competitive participation in infrastructure supply.

Governments do not have to own assets to be able to control them through appropriate regulation, and government capital tied up in those assets can be better invested in social infrastructure or in paying debts.

Against this background, the discussion that follows identifies some of the many problems created by monopoly arrangements for water, sanitation, and telecoms services that typify many countries in the Pacific. Unregulated monopolies charge more. However efficient they may be in reaping technical production efficiencies, this higher monopoly price distorts resource allocation, slows private sector development, and thus reduces the rate of economic growth. Monopolies are, therefore, regulated.

Unregulated state-run monopolies present additional problems. Since their managers and owners have little profit incentive, they are often slow to innovate and have no motivation to provide good service. Although recent advances in technology have reduced the natural monopolies present in areas like power generation and telecommunications, the size of most Pacific countries makes monopolistic behavior more likely. What, then, are the options for regulation?

Local Regulation

Economically efficient regulation requires substantial technical and accounting expertise. The cost of this expertise is more or less fixed for the type of infrastructure: the same skills are needed to regulate the public sector of, say, New York State as the public sector of a small Pacific nation. This fixed cost weighs more heavily on smaller economies than it would on a larger economy. Regulation, therefore, is relatively more expensive as a solution for Pacific countries. Vanuatu avoids this expense by adopting “informal” regulation, which has resulted in high power, water, and telecommunication prices. By contrast, Samoa has proposed a general regulatory board that seems to be an efficient use of regulatory skills. Nonetheless, regulatory burdens are reduced the more the regulatory activity is handed over to competitive market forces. Regulatory boards can then focus on key issues where competitive solutions are not possible.

Foreign Regulation

One problem of regulation is regulatory capture—the entities being regulated attain a strong influence over the regulatory body. This problem is exacerbated by the smallness of the Pacific economies. It is unavoidable that the regulators and the regulated know each other well and meet socially. This situation complicates the task of arriving at impartial regulatory decisions. One solution would be for the South Pacific countries to pool their regulatory tasks or contract them out to a foreign regulator who would visit regularly. If no South Pacific-wide consensus can be secured, another option would be for individual countries, or perhaps subgroups of countries in the region, to contract out their regulation requirements to a foreign regulatory expert.



The best
regulation is
a competitive
market.

Some cautions regarding this solution are, however, in order. Regulation always involves transfers between the public body and the regulated company, and therefore tends to be controversial. Effective regulators withstand this pressure because they have the backing of many interest groups, their actions are transparent and widely publicized, and they are familiar with the country and industry. The controversy surrounding these decisions does not go away when the regulatory authority is international. It is only the reputation of the regulator as an independent expert and the willingness of politicians to support his decision that gives his decisions legitimacy.

Competition

The best regulation is a competitive market. Market forces are cheap, unforgiving, and generally provide service wherever it is profitable to do so. Organizing the infrastructure sector so that much provision is competitive has the enormous advantage of promoting a publicly optimal outcome with minimum government intervention. Introducing competition is not a question of ideology or one that requires a yes or no answer. If the process of providing a public good can be made partially competitive, then it will be easier to regulate than without competition.

Governance and Public Goods Issues

Legal Framework

One of the prime functions of government in promoting private sector development is the provision of a legal framework that supplies the basis for contracting and resolving disputes. There is a wide variation in the quality of laws both within and between countries in the Pacific. As a general observation, most countries have laws that are either outdated or inadequate and require reform. In Samoa, which is moving to revise its commercial law completely, businesses have been operating on a law based on an outdated New Zealand companies act from the 1960s. In the Marshall Islands, the commercial code is unclear and crucial elements such as a bankruptcy code are missing. In Papua New Guinea, the arbitration act dates from 1951, which in turn is based on an English arbitration act passed at the turn of the 20th century. Most laws require review and updating.

An additional problem is that in most countries, the codification of the law is inadequate, making it difficult to determine which rules and procedures businesses should follow. This situation encourages corruption by giving discretion to officials. Codification is urgently needed, both to increase the transparency of government and as a first step in modernizing the legal basis for business.

A further legal issue is that Pacific countries are too small to have specialized commercial courts in a situation where out-of-court arbitration and conciliation are uncommon. This situation increases the burden of dispute resolution on the court system and exacerbates the time and cost of obtaining justice. Delays and costs in the legal enforcement of contracts are an impediment to the expansion of contracting and need to be reduced by removing the bottlenecks in the process.

Table 6. Labor Regulation/Conditions

Country	Legislated Minimum Wage (US\$/hr)	Ave. Length Of Work Week (hours)	Paid Holidays (days/year)
Fiji Islands	0.63–1.09	45	13
Kiribati	1.08 ^a	36	13
Marshall Islands	2.00	–	–
Micronesia, Fed. States of	1.35	–	–
Palau	2.50	–	–
Samoa	0.45	40	15
Solomon Islands	0.30	40	11
Tonga	–	40	11
Vanuatu	0.71	40	14

^a Not legislated.

Source: Forum Secretariat. 2001. Foreign Investment Climate in Forum Countries and World Bank staff consultations.

Policy Consistency

Members of the private sector complain about policy inconsistency on the part of government. To some degree, this issue is part of the democratic process, but is exacerbated in the Pacific, due to the small size of the commercial sectors relative to the total electorate. Moreover, many politicians and bureaucrats do not understand the private sector. The result has been significant policy instability in many countries. In some, such as the Fiji Islands, it has been exacerbated by political instability, which discourages investment and encourages the most enterprising citizens to leave.

Political consistency issues underscore the need for continued consultation between governments and the private sector. Typically, genuine consultations between businesspersons and governments in the Pacific are infrequent and the understanding between the groups is fair at best. One suggested remedy is for funding agencies to finance forums where facilitated interaction can occur.

Corruption and Regulation

Government credibility is a necessary component of confidence regarding the future of a business and thus of private investment. An absence of credibility reduces investment and the returns to capital. Using surveys of the private sector in several countries, the World Bank has created indexes of government credibility. The components of the indexes relate to the predictability of changes

in laws and policies, stability of government, security of property (crime), reliability of the judiciary, and incidence of corruption. Countries that scored high on the credibility index had much higher investment rates and experienced higher economic growth than those that scored poorly. Some Pacific countries scored consistently poorly in the index.

Some countries in the region experience endemic corruption, with Papua New Guinea constituting perhaps the worst example. A recent survey in Solomon Islands also cited corruption as a major impediment to business success.⁵⁴ There are reports of corruption in other countries in the region, although its extent is difficult to gauge.

Corruption is a crime of calculation, not passion. When the size of the bribe is large, the chance of being caught small, and the penalty is a mere “knuckle rap” if caught, many officials will succumb to temptation. Simply making the practice illegal does not work unless there is adequate law enforcement. A concerted set of actions plus a change in incentives is the only way to deal with such problems. Robert Klitgaard (1991) maintains that there are three steps necessary to reduce corruption:

- reduce the degree of monopoly control government has over activities or services;
- reduce the discretion granted to government agents; and
- increase accountability on the part of these agents.

Corruption flourishes when regulation is endemic and nontransparent. A reduction in the role of government through deregulation, privatization, lowering tax rates, eliminating selective policies, freeing trade, and making local and national regulations consistent also reduces the potential for corruption. Copies of commercial rules and regulations should be readily and cheaply available so that businesses can keep current and have the information available to fend off bribe seekers. These steps are consistent with others suggested here to promote private sector development.

Political consistency issues underscore the need for continued consultation between governments and the private sector.

⁵⁴ John Hardin, technical expert to the Solomon Islands Industries Rehabilitation and Retention Project supported by the International Labour Organization (ILO) and the Industries Rehabilitation and Retention Task Force (IRRTF).

A Dysfunctional State and Private Sector Development

A question that arises is how could private sector development be supported when the state is dysfunctional? A well-functioning state assists private sector development by providing public goods and institutions that minimize transaction costs and hence promote investment and specialization. The question of what drives states to perform this role is unanswered. Does the private sector drive democratization and good government (as in the Western historical experience), or is private sector development an outcome of democratizing political change? Is macroeconomic stability an outcome of political stability?

Typical responses to a dysfunctional state are:

- short, spot, and “hostage” contracts, barter, and contracting within closed groups; and
- the emergence of stationary and roving bandits.

Corruption flourishes when regulation is endemic and nontransparent.

Economists do not have a suitable definition of the “dysfunctional state” and states that do not work can vary in terms of how they are dysfunctional (e.g., dysfunctional African states that have had Western structures unsuccessfully imposed on top of semisuccessful traditional structures, or post-USSR Russia, which is struggling to form stable institutions from prereform

structures). Some states function well in some respects, but poorly in others. Cuba does not provide a welcoming environment for private sector development but, until recently, delivered social services to its population. Chile, under the Pinochet regime, enabled private sector development, but at a high cost to civil freedom. A crucial policy issue for donors is what can be done to restore functionality, or—in the case of Papua New Guinea or until recently, in Solomon Islands—to stop the state from slipping into dysfunctional behavior. Several questions require answering.

- Is it possible to exploit traditional social structures that tend to be collectivist and may resist market-driven solutions?
- Is it possible to induce (through foreign aid) dysfunctional states to become more functional?
- Is there scope for private collectives to promote markets?
- Why does a spontaneous group not emerge to govern and what are the obstacles to collective political/military action?
- Do modern markets necessarily imply a modern, functioning state?

- Can one start with a large free trade zone administered by a foreign firm under contract, or large foreign enclave companies (mining, petroleum, tourism, etc.), and then allow these to proliferate until they dominate economic activity and coalesce to form a government?

Until there is a better understanding of the causes of state dysfunctionality and the process of creating or restoring functionality, it will be difficult for international funding agencies to achieve dramatic results in driving development, and in particular, stimulating private sector development in these countries.

Trade Policy for the Pacific

Tariff Levels

There is a wide range of trade policies in the Pacific—from regimes that have low tariffs and few exemptions, such as Samoa, to regimes like the Cook Islands with 18 tariff bands that vary from 0 to 150%, and Vanuatu, which has high and variable tariff rates and numerous exemptions.

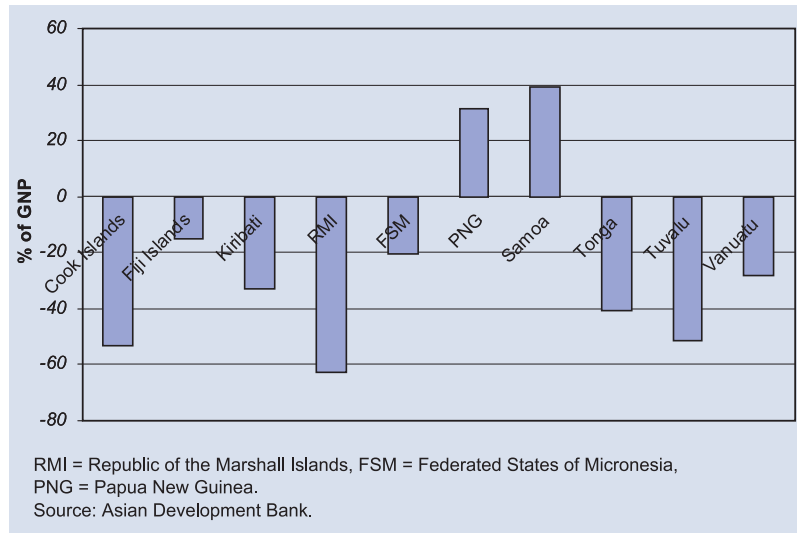
The general case for free trade is strong—for Pacific countries, it is absolutely necessary.⁵⁵ Free trade is an essential ingredient of policies that reduce private sector costs. It maximizes Pacific countries' possibilities for capitalizing on their comparative advantage. High tariffs penalize services and agriculture as well as any embryonic export industries by effectively increasing the prices of inputs. Free trade reduces the costs of inputs for the businesses that exist in the region and reduces the price level for everybody, minimizing the costs of the wide range of goods that countries in the region import. If industries need protecting, that is *prima facie* evidence that they are not competitive and resources would be better used in other activities. Further, it is common thinking in international settings that providing short-term protection for start-up firms—the so called “infant-industry protection”—is not good policy, as the protected industry seldom matures into a healthy industry, returning repeatedly to the government for special concessions.

In the study countries with high tariffs, there were numerous complaints about individuals and organizations (including churches) that were abusing exemptions

The general case for free trade is strong. For Pacific countries, it is absolutely necessary.

⁵⁵ For an excellent and detailed discussion of trade issues in the Pacific, see ADB 1999. The main arguments of which are summarized briefly in this section.

Figure 16. Trade Balance, 2000



on imports. For example, in the Marshall Islands, there were claims that building supplies supposedly imported for government contracts were diverted to other uses. Similar complaints were registered in Vanuatu. In both cases, these were accompanied by assertions that importation frequently involved payoffs to government officials.

Free trade reduces the costs of inputs for the businesses that exist in the region and reduces the price level for everybody, minimizing the costs of the wide range of goods that countries in the region import.

Similar issues arose in the cases of countries where goods could be imported for export manufacture and then reexported under drawback. In all the countries visited, there were widespread complaints from the private sector regarding competitors not paying duties or obtaining drawbacks unfairly or illegally. While it is hard to judge the validity of such claims, casual inspection of customs receipts give them some credence. Furthermore, drawbacks and exemptions are often awarded to government departments and SOEs, which then use preferential treatment to crowd out the private sector. In the Marshall Islands, government vessels used for interisland shipping obtain fuel at a lower price than some of their competitors. The result has been the dwindling of private shipping.

Such exemptions and drawbacks should be eliminated as part of a plan to reduce tariffs as exemplified by the successful trade reform in Samoa.

Figure 17. Welfare Gains from Full MFN⁵⁶ Liberalization (% of GDP)

The only way to deal with abuse of exemptions and reduce the temptation for bribery is to change the incentives governing trade. Optimally, this change should reduce or eliminate tariffs and other trade restrictions. There is substantial international evidence that employment lost in sheltered industries is quickly regained through improvements in efficiency and job creation in other parts of the economy. Samoa is a case in point from the region. Following a very substantial tariff reform in which high rates of protection were reduced to three simple tariff benchmarks, the economy grew at rates significantly above regional rates, and registered one of the highest growth rates in the world (ADB 2000b). While growth cannot be attributed to the tariff reductions only, it is clear that they were a major contribution and a catalyst for growth.

World Trade Organization and Regional Trade Agreement Issues

Most countries in the Pacific are asking what policies they should adopt for the new round of the World Trade Organization (WTO). However, it makes little

⁵⁶ MFN refers to "most-favored nation," a technical term describing a World Trade Organization trade arrangement.

It makes little sense for most countries in the region to attempt WTO access through application.

sense for most countries in the region to attempt WTO access through application. The process of applying is costly for the Pacific countries and it will bring them little or no benefit because they are too small to be able to obtain any concessions on the strength of negotiation. Furthermore, it will hardly ever be cost-effective to bring cases before the WTO. Alternatively, Pacific countries can “free ride” on the negotiations of other developing countries and should state that they will accept WTO provisions. Countries in the region will continue to be accorded developing country status. Size and remoteness will bring aid and other benefits regardless of WTO privileges. By reducing or eliminating tariffs unilaterally, they will gain all the benefits that are available without tying up scarce resources and skills in the tortuous process of the WTO round. One approach that could be taken toward the current WTO round of trade talks that would increase access and participation in the WTO is to share the cost of representation in Geneva with other countries in the region or with one of the dominant free trading nations in the Pacific (i.e., Australia or New Zealand).

Regional trade agreements that provide trade preferences for countries within the agreement are also ill advised.⁵⁷ They do not direct trade toward low-cost and efficient manufacturers, but can instead result in higher costs. This situation also applies to the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), a one-way trade agreement with Australia and New Zealand. The problem with regional agreements is that their effectiveness usually relies on high external tariffs for those countries outside the agreement. As Australia and New Zealand have reduced tariffs on all imports from all sources, the value of preferences declines. If the industries in the Pacific that are exporting are not competitive by world, rather than regional, standards, investments will be wasted. The difficulties of the Fiji Islands garment industry illustrate this point. As Australia reduces its tariffs on garments, imports from Fiji Islands become increasingly uncompetitive in the Australian market and investment and employment in the Fijian garment industry is threatened. Countries in the region are better served by reducing tariffs unilaterally.⁵⁸ Nonetheless, a regional trade agreement signed in April 2003 between forum island countries created a free trade area to be phased in over 10 years.

⁵⁷ For a more complete discussion of the pros and cons of free trade areas, see ADB 1999.

⁵⁸ In the 1980s in Latin America, Chile refused to join bilateral and regional free trade areas and simply reduced tariffs to a uniform 10% across the board. It has consistently enjoyed the highest growth in that region.

The Pacific Island Countries Trade Agreement (PICTA) fulfills a vision by forum leaders at their first meeting in 1971, when the idea of regional trade integration was on the inaugural agenda. In 1999, forum leaders endorsed in principle the establishment of a Forum Free Trade Area, and directed forum officials to draft an agreement to lower trade barriers between member countries over 10 years. While the PICTA will encourage trade and investment between forum island countries, its economic benefits are likely to be minor. Its importance lies more in the realm of politics where it has now been demonstrated that individual countries within the forum can cooperate on an issue of strategic political importance.

While trade agreements may not be a panacea for the Pacific, agreements that deal with technical issues concerning simplification of trade procedures, standardization of trade regulation, and other trade facilitation arrangements, are beneficial.

One such agreement is the Pacific Agreement on Closer Economic Relations (PACER), a sister agreement to PICTA, signed by the 16 Pacific leaders at their annual forum meeting in Nauru in August 2001. The PACER is a framework agreement providing for the future economic cooperation of the forum region as a whole. It envisages this taking place in stages, with the initial step being a free trade agreement in goods among forum island countries. In the short term, the focus of the PACER is in customs procedures, sanitary and phytosanitary measures, and standards and conformance. The PACER also provides for financial and technical assistance for forum island countries, including capacity building. Clearly, facilitating trade between countries by simplifying, clarifying, and standardizing procedures is a beneficial activity, and one that funding agencies should support—and join, in the case of bilateral funding agencies.

Free Trade Zones

No country in the region—with the exception of the Fiji Islands—has potential to establish a significant manufacturing base. Nevertheless, in some countries, the notion persists that development is inextricably associated with manufacturing, a belief that has sometimes been supported by funding agencies. As part of an industrialization strategy, free trade zones have been advocated as ways of bringing goods in duty free for processing and reexport. This idea is not sensible. In virtually every country in the Pacific, the size of the labor force is too small, the skills do not exist, and the transportation costs and infrastructure costs are too high to make manufacturing for reexport viable. Rather, the Pacific countries should become free trade zones in their entirety by abolishing or

reducing import duties to low levels, which will then allow them to exploit their comparative advantage in agriculture, tourism, and fishing.

Foreign Investment Procedures

Foreign investment brings with it substantial benefits in skills, technology, capital, and managerial expertise, and is considered the fastest path to promoting development. Nevertheless, in most Pacific countries, processes involving foreign investors are complex, time consuming, and costly. Tonga, for instance, is considered to have a lengthy approval process (ADB 1996) and even after

The Pacific countries should become free trade zones in their entirety by abolishing or reducing import duties to low levels.

reform of foreign investment regulations, approval of applications from foreign investors in the Fiji Islands can take from 2 months to more than a year to wend their way through the process, by which time many foreign investors have lost interest (ADB 2000a). Similar situations exist in most other Pacific economies.

To some degree, caution regarding foreign investment is understandable because of considerable anecdotal evidence of exploitation or fraudulent projects by the “\$2 investors” (Hughes 1998).⁵⁹ The Pacific countries do not attract large multinational companies because they are too small

to be economically interesting. As a result, foreign investors are often of unknown quality or of dubious repute.

Nevertheless, these countries are in competition with each other and with other parts of the world for foreign investors. Procedures in the Fiji Islands or the Marshall Islands contrast starkly with those in, say, Chile or El Salvador where special offices exist to assist foreign investors with all aspects of setting up companies and where the process takes no more than a few weeks.

Some Pacific countries are considering moves to strengthen the vetting and monitoring of new proposals. It is doubtful that a command and control approach is the best way of accomplishing this aim. Fraudulent schemes occur everywhere, and eliminating all fraud would probably result in discouraging most genuine investment. There is also the possibility that intensifying the rules would have the opposite effect. Where complex and often poorly understood systems exist, they become particularly vulnerable to confidence tricksters who get around the system with promises and bribes.

⁵⁹ Hughes maintains that there are no documented cases of “\$2 investors.”

The alternative to intensifying scrutiny would be to simplify and speed up the process, yet reduce the offers of incentives and direct assistance. One of the unfortunate consequences of having direct government involvement in the private sector is that it provides a climate in which fraud thrives.

Conclusion

The governments of most Pacific countries have taken the view that because of various handicaps imposed by size and isolation, the state needs to take a central role in the economy. The result is widespread ownership of assets, the reservation of particular activities for the state, and widespread regulation. Until very recently, funding agencies have supported this view through numerous loans, grants, and technical assistance that, over an extended period, has amounted to the highest aid flows per capita in the world. The results, however, have thwarted rather than promoted the development of the private sector in the Pacific. The state-oriented strategy has raised infrastructure costs to among the highest in the world, promoted inefficient government ownership in these countries, and failed to promote sustainable economic growth. Costly ownership of airlines has drained government budgets and raised fare levels. In short, the intrusive nature of the state in the Pacific economies has exacerbated rather than alleviated the problems of size and distance, the very rationale on which it is based. Furthermore, in some cases, it is difficult to be confident about the proposed solutions. Reducing the presence of the state by corporatizing government departments into SOEs often amounts to no more than papering over the fundamental inefficiencies rather than addressing the root causes of the problem.

At the same time, states in the region have failed to supply the public goods and institutions that are the foundation of private sector development. Fixed property rights remain extremely problematic, rights for movable property are inadequate to provide effective security for loans, commercial codes are weak, and contract enforcement is often inadequate. Some states appear to be failing and in many cases, regulation is so discretionary as to encourage corruption. Often policies toward the private sector in the region have been variable and inconsistent, resulting in short investment horizons and attracting opportunistic investment, which further exaggerates the suspicion and hostility with which foreigners are viewed.

Reform efforts are under way. Samoa's reform attempts should be encouraging as they illustrate that reducing the role of the state in the economy is possible

In most Pacific countries, processes involving foreign investors are complex, time consuming, and costly.

Samoa's reform attempts should be encouraging as they illustrate that reducing the role of the state in the economy is possible and at the same time promotes rapid growth.

and at the same time promotes rapid growth. ADB, along with other funding agencies, must encourage and support these efforts. Perhaps what is more encouraging is that several governments in the Pacific recognize that growth can be generated by private sector activity and that they are willing to change the business environment toward promoting efficiency and reducing costs. This situation should provide optimism for the future and encourage others in the Pacific to follow suit in reducing the size of their public sectors and creating the enabling environment for the private sector.