



Executive summary

Report origins

The ADB has been taking a hard look at its PDMC strategy.

For several years now, the Asian Development Bank (ADB) has been taking a hard look at its Pacific developing member country (PDMC) development strategy. A 1996 ADB report concluded, among other things, that

- although the standards of living in most PDMCs were relatively high, they were vulnerable because of the extensive reliance most had on aid, remittances, and preferential trade arrangements;
- despite substantial aid flows (27 percent of GDP between 1980 and 1992), economic performance was disappointing; and
- success rates of loan and technical assistance projects were significantly lower than the Bankwide average.

Country problems have been identified.

A 1998 ADB report noted a number of emerging problems, including

- poor economic performance combined with high population growth, and high and rising unemployment;
- corruption and abuse of public office;
- unsustainable exploitation of natural resources; and
- inhospitable environment for private, especially foreign, investment in terms of physical, human, and policy architectures of most PDMCs.

Drawing from both theory and PDMC experience, this report stresses the importance of liberalizing trade and investment as well as making labor markets more flexible, and establishing greater security of property rights.

Countries themselves have recognized a need for change.

The PDMCs have recognized and are tackling the economic, environmental, and social pressures confronting them. In 1995, the 16 South Pacific Forum island countries (FICs) embraced a plan of action involving market-friendly policies widely accepted as economically sensible, albeit politically difficult to implement. This Action Plan has been endorsed at subsequent meetings of the South Pacific Forum Leaders and the South Pacific Forum Economic Ministers, and several countries have taken significant steps towards implementing the plan.

The questions are about detail and emphasis.

ADB, other multilateral agencies, and bilateral donors are all strongly behind this mutually supportive commitment. Thus, the problems are not so much about direction, commitment, and support; rather they are about content, detail, and design.

Problems of isolated location, small size, and unreliable nature are reasons for good policy, not excuses for poor policy.

The commitments reflect a realistic appreciation of the physical features of the PDMCs. That they are small, vulnerable to sometimes quite potent forces of nature, and located as far away from major consuming and producing points as possible are recognized as facts of life. The Action Plan appears to be a commitment to make the absolute best of these facts of life and not to resign to poor economic performance because of them.

Framework

Market-friendly policies are now the dominant paradigm.

The past 20 years have seen a widespread acceptance of the importance of open trade, macroeconomic balance, flexible labor markets, a limited role for government in the production of goods and services, and an expanding role for the private sector in many activities long thought to be the province of government.

Experience from applying this paradigm is generally positive ...

The experiences from applying this paradigm in developed and developing countries alike are generally encouraging and much has been learned about policy design, sequencing reform, and implementation. However, many of these lessons—for example, secure property rights, enforceable contracts, and accepted accounting conventions—have been drawn from countries with well-developed market institutions and systems of government that apply on a nationwide and even international basis. Moreover, both officials and participants in the private sector of these countries are familiar with the institutions and systems.

... but largely restricted to countries with established market institutions.

With the emergence of former Soviet Union members as individual countries seeking to trade and do business with the Western world has come a realization that the encouraging experiences with market-based, open, decentralized policies depend on systems of economic governance and supporting institutions that barely exist in former communist countries. Thus, institutions and the role of economic governance are now increasingly recognized as keys to development (for example, papers on the New Institutional Economics in the *American Economic Review*, May 1998; in April 1998 the World Bank distributed a report *Enhancing the Role of Government in the Pacific Island Economies*).

Most PDMCs are similar to transition economies in that private sector activities and supporting institutional arrangements—such as property rights—are not well developed.

Question: Does institutional development need to accompany policy reform in the PDMCs?

Could the nature of the institutions existing in PDMCs be a reason for the apparently disappointing impact of aid-supported investment and technical assistance? If this is the case how, if at all, can the ADB assist in the evolution of market-based institutions? If the sequencing and timing of policy reform is now much better understood, are there equivalent lessons to be learned about the sequencing of efforts to promote institutional development? Coming to economic reform at this point, it makes good sense for the PDMCs to learn what they can from the experience of others.

Institutions need to evolve. Settling the “right” mix of institutions, people, and policy is an evolving, fluid process depending on such things as experience, technology, and culture. While the emphasis on institutions may be new and perhaps more formal, the insight that institutions matter is not new. Both domestic effort and external assistance have tackled all three components for many years. The issues are more of a continuing search for balance, content, and emphasis—to find an appropriateness for the needs of the times. The institutions and processes that have evolved to manage aid flows may well be very good for doing that. The question is: Are they appropriate institutions for managing modern private sector development?

Similarly, communal land management systems and codes of tenure may be effective ways of balancing social and economic pressures for closed communities relying on traditional agriculture and fishing. But modern methods of production involving capital, and different ways of mobilizing that capital, require property rights and contract enforcement, dispute settlement processes, and sanctions that are efficient, internationally recognized instruments.

Report is part of a search process. This report is part of this search process. Importantly, the PDMCs have agreed on an objective—to achieve market development and competitive and sustainable investment in support of economic growth. There is also agreement on a plan of action to do this. As part of a framework or search procedure, the task is to look at what has been tried, what works, and what does not. Taking a lead from recent literature and experience, the approach involves searching for institutions more intensively than would have been done in a similar project conducted, say, five years ago.

Investment

Private sector investment is crucial ... Property rights, enforceable private contracts, bankruptcy procedures, and accounting standards are all elements of the social and investment environment. Similarly, the reliability and consistency of the application of law have

been shown to be as important as the law itself. Where public investment has performed poorly in terms of promoting growth and employment, and where the sources of public investment funding are vulnerable, private investment—whether domestic or foreign—will be crucial for future sustainable economic growth.

... for both foreign ...

Foreign direct investment (FDI) can generate benefits for host countries in forms of increased output, exports and foreign exchange, tax revenue and employment, as well as access to improved technology, new skills, improved access to export markets, and social and physical infrastructure. But domestic investment is important also. Indeed, one of the ironies in recent years with public service cutbacks in some PDMCs has been the propensity for former public servants (potential domestic investors) to invest their separation packages in Australia or New Zealand—all this in circumstances where special arrangements and efforts were under way to promote FDI.

... and domestic investment ...

... but faces perceived constraints.

Recent studies indicate that the availability of finance at competitive real interest rates is not a constraint on private investment. So what is the problem? The absence of secure land tenure is one, so is the uncertain and discretionary nature of investment approval and administration. Distance from markets, their small size, and vulnerability to the whims of nature and the like, and few profitable investment opportunities in many PDMCs are concerns natural, and appropriate to raise. But there is little evidence that this is the case and, whatever the substance of such concerns, they provide no basis for not striving for the best set of policies and supporting institutional arrangements. Location and nature are quite constant, but policy and the investment environment can be changed.

Investment climate can be improved.

The options for improving the investment climate include

- limiting the role of public investment;
- providing a secure environment, including law and order, and a secure access to land;

- providing good infrastructure;
- ensuring that contracts are enforceable; and
- maintaining consistency, transparency, and automaticity of rules.

Focus government involvement ...

There has been a strong tendency in the PDMCs for government involvement in business activity, either by means of government business enterprises, through joint ventures with domestic or overseas investors, or indirectly through the provision of tariffs and subsidies of one kind or another. In part, this involvement can be viewed as a matter of necessity forced by a lack of basic institutions needed for private sector investment. Joint ventures and tariffs or subsidies can be seen as the means by which government underwrites the risks that face private sector investment when the necessary institutions are not in place. Without taxpayers carrying the risks, the private sector would not be involved.

In part too, such intervention is often a case of the government trying to “pick winners” or create comparative advantage in particular activities. Government involvement in business in the PDMCs has a very sorry history, however. Nowhere has this been more costly than government efforts related to tuna fishing. While most of the PDMCs have substantial tuna resources, this does not mean that they have a comparative advantage either in all forms of tuna fishing, or in tuna processing. Some of these activities are highly capital-intensive and demand certain skills and services.

... on institution building and good governance.

Generally, government intervention of this kind is a matter of doing too much of the wrong things and not enough of the right things. Providing tax breaks and subsidies can be an easy, politically profitable work for government, with even some short-term payoffs. The crucial job of institution building and provision of good governance is plain hard work but with substantial long-term economic benefits.

Trade policies

Aid and remittances fund a large share of imports.

Reflecting the large flows of aid (except for Fiji Islands) and remittances (for Cook Islands, Samoa, and Tonga), exports are typically only a fraction of imports. Important export items are services (Tonga and Samoa), sugar (Fiji Islands), copra (Kiribati, Tuvalu, and Vanuatu), fish (Samoa and Solomon Islands), coconut oil (Samoa), timber (Papua New Guinea and Solomon Islands), squash (Tonga), garments (Fiji Islands) and gold and copper (Papua New Guinea). There is little trade among the PDMCs. Australian and New Zealand trade is important, but so is trade with Asian and European countries.

General experience in trade liberalization has been positive for employment and revenue.

Reviews of the literature about experiences with trade liberalization indicate the following general conclusions.

- Trade liberalization will not overcome the adverse effects of poor macroeconomic management.
- The question of whether there is a “best time” to liberalize trade is not settled, with the caveat that there is probably no “bad time.”
- The adjustment and unemployment consequences of trade liberalization are typically benign.
- Even for countries that rely on trade taxes for revenue, trade reform—defined in terms of a low uniform and transparent tariff—need not hurt revenue as
 - conversion of duty exemptions to a low transparent tax can gather revenue without distorting production;
 - trade is attracted into formal and efficient channels and away from informal channels and smuggling; and
 - over the long term economic and trade growth should expand the tax base.

Domestic not external reasons underpin trade reform.

While disciplines of the expanded World Trade Organization (WTO) are likely to be stronger for existing members (Solomon Islands, Fiji Islands, and Papua New

Guinea) and proposing members that currently have observer status (Samoa, Tonga, and Vanuatu), the main reasons to open trade are entirely domestic.

To some extent, tariffs are taxes on aid and remittances.

Does the strong case for open trade, which has been established through both theory and experience, apply without qualification to the PDMCs? Two qualifications warrant discussion. The first has to do with the role and composition of imports and particularly the sources of funding for importing. For some countries—Kiribati, Marshall Islands, Samoa, Tonga, and Vanuatu—imports are funded mainly by aid flows and remittances. Thus, tariff has little in the way of protective effects and serves mainly as a way of appropriating for direct government revenue part of the aid and remittances. To the extent that export industries are hurt, it is more a hurt inflicted by the crowding out—“Dutch Disease”—effects of aid and remittances than by taxes on trade.

Institutional arrangements to support adjustment with low transaction costs are not well developed.

The second qualification relates to the nature of institutional arrangements. The main point in trade reform is to bring about a switch from inefficient activities that can exist only by taxing consumers and other production towards activities that can stand on their own in an international environment. But if the institutional arrangements to support such activities are not well developed, this payoff to trade reform is likely to be slow in coming.

On the first mentioned qualification, there are good grounds for establishing a nontrade tax base along the lines followed by the Cook Islands and Samoa. Pending establishment of that base, there are grounds for tariff reform along the lines of a lower and more uniform tariff that can be completely dismantled once an alternative tax base is established. This approach has been adopted by Samoa where a value-added tax introduced in 1994 paved the way for a substantial tariff reform in 1998. The Cook Islands also successfully introduced such a tax modeled along New Zealand lines.

Resources mobilized by trade and public sector reforms need a supportive institutional and policy environment.

Several issues arise in assessing the second qualification. On the one hand, there are serious concerns that, in the absence of a hospitable institutional and policy environment, resources moving from formerly protected industries will not relocate in the country concerned. This is a special concern in some PDMCs where a tradition of migration and overseas employment has established networks and opportunities for overseas investment. The same might be said about public service reform. In the case of the Cook Islands, for example, former public servants have taken their severance packages to New Zealand to invest.

Open trade provides both incentives for and sources of institutional reform.

On the other hand, institutions and institutional arrangements are something that evolve and respond. Open trade provides both access to institutions and the pressures and incentives to develop them. This reasoning suggests that priority should be given to both trade reform and institution building.

Preferential trade arrangements were important in the past ...

Trade policy in the PDMCs has been built around a number of preferential trading arrangements. The Lomé Convention has provided preferential markets free of duty for sugar from Fiji Islands and for canned fish from Solomon Islands. The South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) has given preferential entry to Australia and New Zealand for garments from Fiji Islands and automobile harnesses from Samoa. The upside of this arrangement has been access to high-priced, protected markets. European, Australian, and New Zealand consumers have made significant transfers to these countries through these mechanisms. The downside is that industries that would have difficulty operating in open company have been encouraged to grow. To the extent that this has happened, preference revenues are not benefits to the country but are used up in covering higher costs. The Fourth Lomé Agreement (Lomé IV) runs its course in the year 2000. Some European country members are concerned that renewal

... but raise concerns now

along the same lines only will continue this dependence on preferred markets—a dependence that also disadvantages efficient developing countries that could compete without preference.

There are also concerns that any value of preferential arrangements will diminish as trade barriers fall as part of the WTO commitments and the emerging acceptance of open trade. Finally, there is the concern that preferential arrangements under the Lomé Convention will not be sanctioned by WTO. To meet these last mentioned concerns, some European countries have proposed that least-developed member countries be accorded preferences on an individual basis. The strategy for the PDMCs in these circumstances is complex. Preferential treatment can be a valuable source of rent but only if industries are internationally competitive. If suppliers need the preference to compete, then by definition rents have become soaked up in costs and wastes. The countries that gain most from preferences are the ones that have free trade at home.

Options include other forms of aid ...

The options seem to be

- take the preferences while they are there but recognize that the long-term freeing up of trade will require adjustment; and
- seek aid in some other form when negotiating the next Lomé Agreement.

... and free trade agreements.

In discussions about what to do as the current Lomé arrangement runs out, two other options have been put on the table. The first involves a free trade agreement (FTA) among the PDMCs. The second would be to extend such a FTA to include Australia and New Zealand.

An assessment of these options suggests that the gains from a PDMC FTA would be trivial. While an FTA with Australia and New Zealand would offer more, the main benefits depend on the next move to open trade generally.

Competition in domestic markets comes from home and abroad.

In the case of goods that can be easily traded, a policy of low or no external trade barriers is at the same time a “no fuss” or “no cost” domestic competition policy. So long as domestic distribution channels are unrestricted by business licensing and the like, budding domestic monopolists have scant opportunity and there is little need for price control and similar regulation.

Nontraded goods raise special issues.

What about goods and services such as water, electricity, and telecommunications? In this regard the issues confronting the PDMCs are similar to those facing many governments—albeit in a smaller scale. Many lessons are being learned about unbundling such services and subjecting some to competition—for example, the production and supply of electricity—and regulating those not easily exposed to competition, such as transmission of water or electricity.

The primacy given in the past to government provision of these essential resources is now seen to have had less to do with them being natural monopolies than with achieving equity in their availability. Typically, such equity involves consumers in easy-to-supply areas subsidizing those in outlying areas where service provision is more costly. Equity can be achieved only through the price mechanism if there is a monopoly supplier. Where a government monopoly is involved, inevitably inefficiency abounds. But avoiding the use of the price mechanism by giving income subsidies directly to consumers is politically difficult. Introducing competitive tendering for franchises to supply outlying areas may be worth trying where competition in production and supply is introduced.

Labor markets

Employment opportunities need to expand with population.

In the PDMCs, formal sector employment has grown much more slowly than population so people have remained in the subsistence sector or joined the ranks of the unemployed in towns and cities. In some cases

(Cook Islands, Samoa, and Tonga), emigration has been the employment safety valve. There are not many examples where a private formal sector has expanded employment opportunities.

Young labor needs

- capital
- ideas
- training
- technology
- entrepreneurship.

Population growth rates remain high and, with greater access to international communications, aspirations of younger people coming onto the labor market are changing. Formal sector job opportunities need to expand. If this does not happen, the social problems associated with unemployment—hardship, crime, violence, and youth suicide—are likely to increase. This need not happen; indeed similar cohorts of young people in the market have been the basis for growth in Asia when combined with capital, ideas, technology, and entrepreneurship.

This does not seem to be happening in the PDMCs and the only labor-intensive activities of note are the garment industry in Fiji Islands, the motor harness factory in Samoa, fish canning mainly in Solomon Islands, and tourism operations in several countries. Why are such activities not more widespread and expanding rapidly? Restrictions that might make it difficult to hire and train people, such as minimum wage regulations, and the regulation of working hours and conditions (including barriers to dismissal) are possible explanations but they do not seem to be significant.

Pacific islanders can get work in Australia, New Zealand, and United States ...

Another explanation is that the public sector is “crowding out” the private sector by driving up wages and providing a form of on-the-job training of little relevance to private sector production. Yet if it was a “crowding out” problem, most people would have jobs—this is not the case. Relatively large numbers of people want work but cannot find it, at least not in their own countries. Many Pacific island people have family members who have moved to other countries to combine with other people’s capital, ideas, and technology in mutually beneficial and profitable activities. Capital and ideas are at least as mobile as people; why have they not moved to combine with people in the PDMCs?

... why not at home?

Certainly, governments have done much in the way of providing special concessions and incentives to encourage this to happen but with little success. The main emerging explanation appears to be in institutional arrangements—particularly in the way management and labor interact. The concessions and special deals appear inadequate to offset an institutional environment not suited to formal labor markets. Indeed, such arrangements both reflect and feed on institutional weakness and are vehicles for patronage and favor based on connections and not merit. Why is it that people who interact well with management in labor forces in Australia, New Zealand, and United States do not do so well at home where, on the face of it, it should be much easier? Is it because management is poorly trained? Is it because culture and familiarity discourage discipline and routine? Is it because education systems are inadequate? The answers to these questions remain open. It is not sufficient to lay the blame on unproductive labor—management is also an issue.

Wrapping up

Over the past few years, there has been an intensive search for reasons to explain the disappointing economic performance of the PDMCs and, by implication, the disappointing results from development aid. Some analysts see the issue in terms of policy failure; others believe that aid and remittances have caused the public sector to “crowd out” private investment and production; others worry that low incomes sadly reflect the unfortunate reality of little wealth.

Institutions appear to be the elusive ingredient in economic progress.

There is something to each of these explanations; yet they do not get to the heart of the matter. The proposition in this report is that the poor economic performance of the PDMCs reflects the institutional environment. It is believed that, with an appropriate institutional environment, per capita incomes in the PDMCs could move to levels several times higher than at present. In a sense, such an environment is an important aspect of the

Pending institutional development, reform priorities need to match the institutions that exist.

social capital of a country. Without it, policy reforms are unlikely to have the payoffs hoped for.

Several PDMCs are undertaking stabilization and structural adjustment programs with the assistance of one or more multilateral agencies. Priorities include public sector reform, improving investment guidelines, and liberalizing trade. In the PDMCs, there appears to be little interest in creating the basic institutions to support markets, and these reform priorities tend to confirm rather than overcome this lack of interest. For whatever reason and whatever the collective decision-making processes that apply, institutional options that would improve people's lives are being ignored.

The lessons of experience point to ways of remedying this situation:

- applying reforms on a wide front—from trade policy to macroeconomic reforms—so that winners and losers are widespread; and
- encouraging the training and use of local economists and supporting them within the bureaucracy from political changes (the Federated States of Micronesia and Samoa are providing useful examples).

Secure property rights are an important market institution but the list is infinite.

If institutions are the key to development, the logical questions to raise are what does the term cover and what actions can be taken to encourage the development of appropriate institutions? To answer the first question, the most commonly used examples of institutions are secure and transferable property rights, enforceable and impartially enforced contracts, and internationally acceptable accounting standards. But institutions extend to an almost infinite number of rules, sanctions, understandings, and customs. That people drive on the same side of the road when traveling in the same direction, for example, is a very simple rule that greatly increases the efficiency of road travel. The effective conduct of commercial and community life depends on numerous such codes of conduct.

Open trade increases both demand for and supply of institutions.

While up to a point institutions can be “borrowed,” for the most part the recent literature has them evolving according to demand and supply. Community participation is increasingly seen as a way of articulating such demand and supply. One approach is to consider factors that will increase the demand for good institutions. On this score, access to international markets and technology, and good infrastructure have a role to play in raising the returns from sensible cooperation through good institutions. Interest groups (such as trade unions and industry groups), which are important in some countries, do not seem to be as important in the PDMCs in shaping institutions and policies. Instead, power seems to be exerted at a local level by local leaders.

For the time being, local control over land seems binding.

Concentration of power at the local level, particularly in the form of control over land, appears to be inhibiting the development of property rights conducive to economic development. Lack of enforcement of contracts, even to the point of considerable threat to persons as well as property in Papua New Guinea, makes private investment very difficult.

National leadership and articulation of benefits from cooperation at the national level are needed.

The main issue with respect to the supply of institutions critical to the promotion of private investment is how to reach decisions that are superior to those arrived at through the exercise of individual rationality. One answer is national leadership supported by information about the benefits of such institutions. Giving credibility to the reforms by “anchoring” or “locking in” the reforms by commitments to an international peer group also seems important.

Important cooperation is emerging at Forum leaders’ level.

The Forum Leaders’ and Forum Economic Ministers meetings appear to be starting to fulfill these roles. The Forum Leaders have adopted an Action Plan for economic reform and have begun to see the reforms implemented. They have given priority to establishing investor-friendly guidelines for foreign investors. In this effort, they have been supported by the Forum Secretariat

and by the Foreign Investment Advisory Service (FIAS), which is providing advice about investment guidelines suitable to the region's circumstances. They are also being supported by the South Pacific Project Facility (SPPF), which is providing examples of how to evaluate potential investments and sources of finance. In doing that, SPPF is pointing to where the weaknesses are in the investment environment.

Hopefully, the Action Plan has the full support of the leaders and governments of the Forum island countries. If this is so, the Forum Leaders and Forum Economic Ministers meetings should be providing support and encouragement to their efforts. It is important, therefore, that they are, and are seen to be, in full "ownership" of the reforms.

Set the foundations first by providing ...

... secure tenure, commercial code, and contract enforcement.

The Action Plan adopted by the Forum Leaders is reasonably comprehensive. However, it seems clear that certain reforms should take priority. The most important need is development of the basic institutions for private sector development. Therefore, the Forum Leaders should move beyond their present focus on foreign investment guidelines to providing secure forms of property rights to land, a commercial code that establishes a sound basis for making contracts and for dispute settlement, and the judicial enforcement of contracts in an impartial manner. Ensuring good governance, in particular the minimization of discretionary decisions by politicians and bureaucrats, is an important counterpoint to the impartial enforcement of contracts.

The development of secure individual title to land is obviously difficult and will take time. A framework within which this institution can grow should be developed soon along the lines set out in the report. At the same time, governments have to establish firm control over the enforcement of contracts with landowners and to ensure that there are appropriate sanctions for contract infringement.

Donors' roles:

- **supporting constant reform priorities**
- **developing legal infrastructure**

As far as the donors are concerned, support for the reform process now under way through the medium of the South Pacific Forum appears highly desirable. As well, it appears desirable not to promote reform priorities in the PDMCs that are inconsistent with the priorities adopted by the Forum leaders. Support for the Forum leaders' agenda can be given through FIAS and SPPE. As well, the Economic Management Policy Advisory Teams should be able to provide within-country support, especially by training locals and assisting in the compilation of information about the benefits of reform to assist the governments in their reform efforts. More resources could be devoted to the development of the legal infrastructure, including the training of judges, lawyers, and other personnel involved in the legal process.

- **assisting in land titling and description**

Technical assistance and training could also be given to support the development of land titling where progress appears possible. Assistance with the preparation of an appropriate commercial code where needed would also be helpful. In particular, assistance should be given in designing contracts that will minimize disputes where customary landowners are involved. Problems that need to be dealt with involve intergenerational sharing of the payments for the use of the land, resolving conflicts between different claimants to the land, and dealing with biodiversity and environmental degradation issues.

Ultimately, the countries themselves have to be able to make well-informed choices about the kinds of assistance that they need and how this assistance should be employed. This situation will come about only through empowering countries by developing within them a core of skilled policy advisers working within effective processes and institutions. Then the countries themselves can drive the potential contributions of a wide range of donors.