2 THE COOK ISLANDS

2.1 Introduction

The first PDMC to receive a Bank program loan was the Cook Islands. The Economic Restructuring Program (ERP) Loan of $5 million was approved in September 1996 and involved adjunct technical assistance of $740,000 for the Cook Islands Development Bank and $251,000 for the Development Investment Board. Prior to the ERP Loan, approval had been given to a (complementary) program of technical assistance (TA) for institutional strengthening in financial and economic management. This program was designed in collaboration with New Zealand Overseas Development Assistance (NZODA), the Pacific Financial Technical Assistance Centre, and the ESCAP Pacific Operations Centre.[5] Both the ERP and the TA program were due for completion at the end of 1998. At the time of loan approval, the ERP loan was equivalent to NZ$7.2 million, which compared with previous levels of total official development assistance to the Cook Islands of NZ$15-17 million annually.

2.2 The Macroeconomic and Governance Context

During the period 1982-94, the Cook Islands' real Gross Domestic Product (GDP) grew fairly steadily at an average annual rate of 4.5 percent. Given that resident population grew at one percent per annum, this translated into per capita GDP growth of 3.5 percent. Tourism and a public sector that relied heavily on aid and foreign borrowings were the engines of growth. The primary and secondary sectors recorded little expansion (Figure 2.1). Growth was

[5] TA No. 2424-COO: Strengthening Institutional Capacity for Financial and Economic Management, approved 17 October 1995; and TA No. 2750-COO: Strengthening Institutional Capacity for Financial and Economic Management (Phase II), approved 27 January 1997.

concentrated in Rarotonga, the seat of government and home to 59 percent of the population. While GDP per capita (US$5,300) and the Human Development Index (0.985) were the highest among the PDMCs at the time, GDP per capita in the outer islands varied between 13 and 50 percent of the national average.

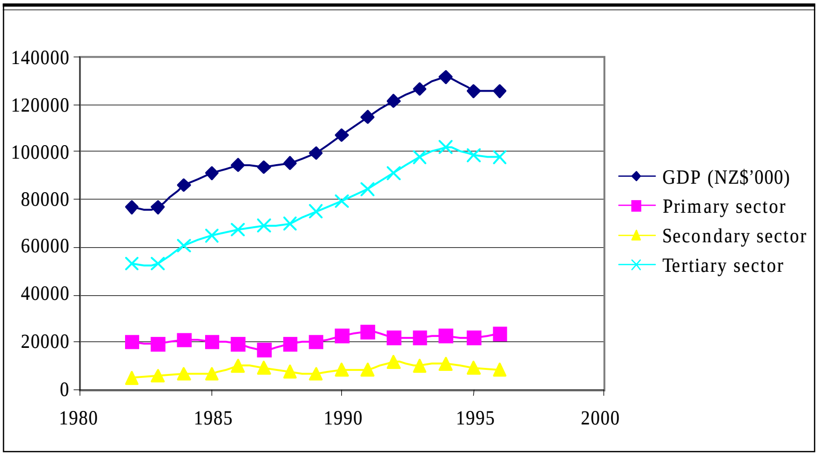
In 1995-98, the economy has been in recession as a result of contractions in tourism and the public sector. Visitor numbers fell 16 percent in 1995, following a reduction in international airline services and adverse publicity over French nuclear testing and a dengue fever outbreak. Despite some recovery subsequently, numbers in 1997 remained 13 percent down on the peak 1994 level; and in the first three quarters of 1998, they had fallen 8 percent on the comparable period in the preceding year - though it should be noted that visitor days did not fall to the same extent.

At the same time that tourism went into decline, a financial crisis emerged as a result of years of unsustainable fiscal expansion involving a growing wage bill, an expanding welfare system, and surging capital expenditure largely funded by external borrowing. Such a crisis - and the earlier currency crisis that led to the replacement of the Cook Islands dollar by the New Zealand dollar in April 1995 - had been forecast in an ADB economic report researched in October 1993 and published in July 1995 (ADB 1995). Also, the risk of crisis was recognized in the Memorandum of Understanding (MOU) that was signed by the Bank and the Cook Islands Government in Rarotonga on 21 June 1995 and that formed the basis of the TA assistance for strengthening institutional capacity in financial and economic management. Nonetheless, the poor financial management systems actually in place meant that the Government was surprised by the suddenness and severity of the crisis. Rather than responding with expenditure cuts and/or tax increases, it began accumulating arrears and "borrowing" funds from government-owned entities.

By early 1996, it had become clear that fundamental policy changes were unavoidable. The ERP was formulated and led to substantial public service downsizing. Between 1993-94 and 1996-97 level, when New Zealand budgetary aid ceased and revenue fell 37 percent, total government expenditure fell by 50 percent. The wage bill fell by 31 percent.

Real GDP growth was minus 4.4 percent in calendar year 1995 and minus 0.2 percent in 1996. In fiscal year 1997/98, it is estimated

Figure 2.1: Cook Islands: GDP at 1990 prices



Source: Cook Islands Statistics Office.

to have been minus1.8 percent, and is forecast to be minus one percent in 1998/99. This economic contraction has not been as severe as that envisaged in the Report and Recommendation to the President (RRP), primarily because the wage bill reduction was less than expected.[6] Nor has the actual decline in GDP been matched by an equivalent decline in per capita income. Since Cook Islanders are New Zealand citizens, they have the option of accessing the New Zealand and Australian labor markets and health, education and social security systems – and they have done so following the public service retrenchments. In 1996 and 1997 an estimated 1,600 persons – 8 percent of the population – left the Cook Islands.

Authorities now expect a recovery to a real GDP growth rate of 3.0 percent per annum by 2002/03, on the assumption of sustained growth in the tourism, agriculture and marine resources sectors. This is a plausible medium-to-high growth scenario.

The 1996 financial crisis was symptomatic of a poor governance environment. According to resident commentators, many of the appointments to the public service had been political, and misuse of power by ministers and public servants was common

[6] The RRP forecast was for real GDP to fall by 5.4 percent in 1996 and 15.8 percent in 1997, before recovering by 4.7 percent in 1998.

(Crocombe and Crocombe 1998). Improved governance therefore required a substantial transformation in the performance of the incumbent government, which had been in power since 1989, and which was to remain in power for the planned duration of the ERP.

2.3 The Process of Program Design

2.3.1 Ownership and appropriate participation in the design process

As indicated in section 2.2, it was a financial crisis that triggered the preparation of the ERP. A three-day national "brainstorming" retreat was held at the Rarotongan Hotel in March 1996. The participants included businesspeople, trade unionists, traditional leaders, government officials, and representatives of the wider community. They formed working groups to generate proposals for dealing with the crisis. A group led by businesspeople suggested ways of reducing government expenditure; a group led by the Cook Islands Public Service Association developed a vision of an efficient public sector; and a third group submitted proposals for labor market and public sector reform. A New Zealand-funded financial secretary who had arrived in January, and the ADB-funded financial and economic management (FEM 1) team that had arrived in early March, provided technical advice. From this locally-owned process a broad consensus was reached on actions to deal with the crisis.

The following measures were in place by mid-1996 (Economic Insights 1998):

- Large numbers of public servants were forced to retire.
- There was a temporary, across-the-board pay cut of 15 per cent for Members of Parliament and public servants, effective 1 March 1996.
- The wages and salaries of Members of Parliament and public servants were cut for two months (May-June) by a further 50 per cent (the wages and salaries withheld were paid back by Christmas 1996).

- Non-personnel costs were reduced.
- Ten assistant ministerial positions were eliminated.
- Most overseas diplomatic positions were eliminated.
- Funding for planned international events was reduced or canceled.
- State-owned hotels and several other state-owned enterprises were put on the market.
- Three key pieces of public sector legislation were enacted to improve fiscal discipline and public accountability – the Ministry of Finance and Economic Management Act (MFEM Act), the Public Expenditure Review Committee and Audit Act (PERCA Act), and the Public Service Act (see Box 2.1).
- Output-based budgeting and accrual accounting – first proposed in the June 1995 MOU – were adopted for fiscal year 1996-97.

In addition, the brainstorming retreat began the process of preparing the reform document Path to Recovery- The Reform Agenda, Cook Islands Government's Public Sector and Economic Reform Program (June 1996), to which the FEM1 team made a major contribution. The key feature of this document, which was published and distributed, is the definition of a new role for Government.

The strategic response to the problem of structural weaknesses and imbalance is clear. The public sector should be reduced in size, releasing resources to other sectors while a policy environment is created which encourages private investment, employment creation and export-led growth.

2.3.2 Partnership and consultation with other external funding agencies

The Path to Recovery and more detailed supporting papers were presented to external funding agencies at a Consultative Group Meeting that was initiated and organized by ADB in Suva, Fiji in June 1996. The agencies, including those who already had committed to the three-year program of institutional strengthening of financial and economic management, offered their support to the broader reform program that the paper explained, and agreed to continue to coordinate their contributions, with ADB taking a leading role. The ERP matrix evolved from this meeting, formalizing the reform measures already taken, and adding to them (see section 2.4).

A second Consultative Group Meeting was held in Noumea, New Caledonia in July 1997 to assess progress in implementation of the ERP. In the interim, a Program Monitoring Committee consisting of representatives of the Cook Islands Government, NZODA, and ADB had been established to review progress on a six-monthly basis. Additionally, the Bank and NZODA had agreed to conduct a formal review of progress by the second quarter of 1997, prior to second tranche loan release, and to conduct a project completion review. Bank missions in January, April and July 1997 involved close collaboration with NZODA.

2.3.3 Effectiveness of internal processing procedures

Beginning with the fact-finding mission for the strengthening of the institutional capacity for financial and economic management in June 1995, the processing procedures for Bank assistance to the Cook Islands seem to have been generally efficient and effective. The FEM1 team was in place in March 1996. Loan appraisal was completed between 5 and 15 August 1996, and Board approval for the loan was granted on 26 September, with first tranche release of $US3 million on 2 October. The release of the US$2 million second tranche was expected to be on 31 July 1997 at the time of appraisal, and slipped only slightly to 29 September.

Box 2.1 The New Public Sector Legislation

The ***Ministry of Finance and Economic Management Act*** (the "MFEM" Act) was enacted in July 1996. It specifies in considerable detail the process of budget formulation, the fiscal disciplines that the Government must adhere to and the information that must be made public and presented to Parliament. Most significantly the MFEM Act requires the Government to maintain operating expenses within the limits of the Government's internal revenues until debt levels are reduced and to publish statements of its economic and fiscal strategy in advance of budgets being drawn up.

The ***Public Expenditure Review Committee and Audit Act*** (the "PERCA Act") was enacted in July 1996. It created an independent committee appointed by the Queen's Representative in Executive Council (ie effectively Cabinet) endowed with wide powers to review all aspects of public finance. The purpose is to ensure transparency of national and local government bodies. It also provides for the adoption of "generally accepted (international) accounting principles" throughout the Government. PERC reports to Parliament.

The ***Public Service Act*** was enacted in June 1996. It defines the powers and responsibilities of the Public Service Commission and senior public sector managers. Significantly it gives heads of ministries the power and responsibility to staff and manage their departments according to "good employer" principles to achieve defined outputs integral to their own performance contracts. The intent is to free senior managers from undue political interference, although for constitutional reasons heads of ministries are appointed by the Cabinet.

2.4 The Content of the Program

2.4.1 The Economic Reform Program

The ERP Matrix begins with a statement of the overall objective:

> *The national ERP seeks to facilitate the transition of the Cook Islands economy from one in which the public sector is dominant, productivity is low and market*

> *signals are weak, to one which is led by a competitive and growth-oriented private sector. The overall objective is to achieve economic recovery and sustainable growth while ensuring that the negative economic, social and environmental effects of the reform and restructuring process are mitigated to the maximum extent possible.*

Three "Policy Areas and Objectives" - Public Sector Reform, Promoting Private Sector Growth, and Social Equity and Sustainability - are identified, and associated strategies and some 110 policy measures are listed. In addition to the measures mentioned in section 2.3.1, the following were introduced (Economic Insights 1998):

- In the area of public sector reform
  - a reduction in the number of Government Ministries from 52 to 22.
  - the creation of a special Transition Ministry to assist the large number of public servants (about 60 per cent of the number employed or around 2,000) who would have to find alternative employment, with assistance to be coordinated and delivered through community-based organizations.
  - the formalization of consultation among the Government, business and other interested parties in the community with regard to budget and policy formulation.
- In the area of private sector growth promotion
  - the revision of the income and company tax rates along with the basis for calculating company profit; and introduction of a value added tax (VAT) to replace the gross revenue tax and a private import tax paid on non-resale imports.
  - the creation of a new Development Investment Board (DIB) and enactment of a new Investment Code that

was to reduce restrictions on foreign capital and increase transparency in its treatment.

- the creation by the DIB of a ‘one-stop shop’ to help foreign investors navigate through Government regulations.

- the facilitation of access to finance through reform of the Cook Islands Savings Bank, and the improvement of access to business advice.

- the introduction of new legislation on land tenure that would seek to make traditionally owned land more accessible for economic development while accommodating the legitimate concerns of traditional land owners.

- facilitating growth in the three leading productive sectors of tourism, agriculture and marine through a range of measures.

- In the area of social equity and sustainability (in addition to creation of the Transition Ministry)

    - the devolution of political power and responsibility for management of Government funds to outer island representative bodies.

    - the preparation of a comprehensive national training needs assessment as the first step in preparation of a human resource development plan.

    - the formulation of a retirement savings plan for private and public sector employees.

    - the introduction of environmental impact assessments.

    - the integration of gender issues into development planning and public service recruitment.

2.4.2 Rationale and appropriateness of loan amount

The loan amount proposed in the RRP was seen as a strategic contribution to financing the adjustment process that the Cook Islands Government was committed to. It sent a clear signal to the public and external funding agencies that the Bank was prepared to offer material as well as verbal support to the reform process. It underpinned the Bank's leadership role in coordination of contributions from external funding agencies; and, in the words of the RRP, it gave "an opportunity to attach policy conditionalities to ensure that political or other pressures do not cause the reform program to become diluted". The implicit argument here is that the program loan and associated conditionalities could help the domestic champions of reform to overcome any resistance from various interest groups.

As to the financing itself, the focus was to be on supporting that part of ERP aimed at promoting private sector growth. Counterpart funds were to be utilized for (1) retirement of a part of Government's short-term liabilities to domestic private sector creditors; (2) promotion of private business through the Business Ventures Development Corporation that was to be established through TA to the Cook Islands Development Bank (CIDB); and (3) an equity injection into the CIDB. Given that at the end of February 1996 the projected budget deficit was NZ$7 million, outstanding arrears were NZ$30 million, and other government debt totaled NZ$170 million, a NZ$7.2 million loan by itself would not have bridged the fiscal gap. In this regard, the Bank's subsequent role as an honest broker in the September 1998 debt restructuring negotiations in Manila has been crucial. Of four creditors (France, Nauru, New Zealand and, pre-eminently, Italy), three offered write-offs, lower interest rates, and extended maturities (France being the exception because of domestic legal requirements).

2.4.3 Consistency with country and Pacific strategy

Both the rationale for the program loan and the content of the ERP are consistent with the Bank's Pacific and country strategies. On the rationale, the Strategy for the Pacific states:

The Bank's influence over policy and the reform process is more readily effective when a loan is being processed... The provision of loan funds will therefore be used to facilitate the broader reform process. Such efforts will be designed in the context of system-wide reforms and with the full cooperation of the government and other external agencies (ADB 1996, p.26).

On content, the Strategy observes:

the Bank should make its assistance more effective in helping create an environment that will lead to improved productivity, increased private sector investment and sustained economic growth. This implies a focus on ensuring that better policies are put in place both at the macro and sector level... It also involves strengthening the institutional capacity of governments to develop and implement better policies themselves...
...public sector reform and the promotion of private sector activity have been identified as key strategic areas (ADB 1996, pp.23, 26).

The operational strategy for the Cook Islands emphasizes (1) support for public sector reform; (2) creation of a policy environment that facilitates private sector investment; and (3) developing social and physical infrastructure to promote private sector growth and the development of the outer islands. "A major focus of the strategy, over the short- to medium-term, is on strengthening institutional capacities in such critically important areas as financial and economic management".

2.4.4 Relevance and focus

There can be no doubting the ERP's relevance and focus. Prior to ERP, the Cook Islands public service was by far the largest amongst PDMCs: in 1990, there were 18.2 government employees per 100 residents, compared to the next highest figure of 8 per 100 for Tuvalu. Moreover, service delivery was poor, with many employees effectively on a welfare payment for little work effort. Public enterprises were inefficient, and government's commercial decision-making questionable (most notoriously in the case of the Sheraton/ Vaimaanga Hotel). The wage bill and debt servicing constituted unsustainable fiscal burdens, the lightening of which demanded public sector reform.

Reducing the size and improving the performance of the public sector was essential to promoting private sector development through creation of an enabling environment and provision of physical and social infrastructure. As noted in the 1995 ADB report:

> *Opportunities for development exist, mainly in the small- to medium-scale in sectors including tourism, agriculture, fisheries, light manufacturing and support services...the focus on large-scale, government-sponsored investment efforts may not be sustainable or beneficial in either the short or the long term. Instead, available resources should be exploited in manageable areas. Although this is a slower road to development, it is one that is more sustainable, improves living standards more evenly and involves resources that the country possesses (ADB 1995, p.3).*

The ERP appropriately focused on reforming and reorienting the economy to put it on the slower, sustainable development path. The three-year FEM TA program already in place was aimed at a complementary strengthening of institutional capacity that hopefully would ensure consolidation of improvements in financial and economic management.

2.4.5 Sustainability considerations

The 1995 MOU identified four critical problem areas that inhibited more effective financial and economic management in the Cook Islands. Three of these were a dearth of statistics, poor organizational arrangements and weak managerial processes, and the lack of fully articulated development and macroeconomic strategies linked to the budget process. But first on the list was

> *a desperate shortage of personnel qualified in the disciplines and skills required... The bulk of public service entrants appears to have received on average only about*

> *six years of secondary level education. Within the central agencies, at least, this is an inadequate educational background for staff expected to understand and adopt modern analytic and managerial techniques.*

The MOU recognized the urgent need for capacity building (hence the FEM TA), and for a medium term plan for recruitment and training of staff with appropriate tertiary qualifications (included in the ERP). In the meantime, an amalgamation of existing small units 'so as to create larger and more effective economic policy and planning units' was suggested as a means of reaching 'the "critical mass" needed to ensure that public policy staff work together effectively'.

Given the acknowledged skills shortages and weak managerial processes, the decision to introduce output budgeting, accrual accounting and a performance management system seems very ambitious. Output budgeting assumes a fairly competent capacity to identify and measure outputs, and to produce output costs and the consequent management reports and variance analyses. It also assumes a competent management that is able to understand management reports based on performance. Even where these assumptions are warranted, such a program would normally take between 6 and 10 years to introduce effectively, and would create a high demand for specialized consultancy assistance, especially in the information technology area. In the Cook Islands, historically, the public service had been unable to produce an annual input-based budget on time, and had experienced great difficulty controlling costs and cash expenditures. The decision to pursue such an ambitious program obviously widened the local skills gap, accordingly increased the need for long-term TA, and made sustainability of improvements in financial and economic management more difficult to achieve within the planned timeframe.

In retrospect, program design in this regard appears to have been unduly influenced by the New Zealand model. It would have been beneficial to have assessed the track record of this model in developing countries, calling on relevant expertise in both public expenditure management and public administration.

2.4.6 Likely impact on governance

A key outcome expected of ERP was improved governance. A range of measures was to be introduced to increase the accountability, transparency and predictability of government, and to increase participation of the wider community in the business of government.

The passage of the PERCA Act (Box 2.1) established a Public Expenditure Review Committee to investigate issues of abuse and other issues referred to it by any citizen of the Cook Islands - though there was no requirement for the government to act on or formally respond to the Committee's recommendations. Also, under the MFEM Act (Box 2.1), government was required to publish and make available to the public its economic and fiscal strategies, and the budget papers. These were to be discussed with a National Development Council (NDC) set up in late 1996 and consisting of business, NGO, traditional and Church leaders. Though the NDC was not formally included in the ERP matrix, it was designed to be the focal point for consultation with the community. The Committee's comments were to be public. In addition, annual National Retreats were instituted to discuss budget strategies; and service delivery was devolved to local councils.

Output budgeting was expected to remind public service managers that they were service providers who were accountable for spending their budgets to produce identified outputs. The way the budget was to be presented also potentially enhanced transparency inasmuch as the cost of the various government programs was clarified. However, output budgeting was not a necessary condition for the introduction of a performance orientation into the public service.

Design of the ERP and the Program matrix was not informed by the involvement of a governance expert. A baseline assessment of how government was organized and operated, and a mapping out of what governance improvements could be expected and monitored was therefore absent.

2.5 Implementation

2.5.1 Tranche conditions

The eight tranche conditions for second release were satisfied formally and generally in a timely manner. Three required the passage of legislation; one required compliance with recent legislation; and four required preparation of documents (Appendix 1). The fundamental interest now lies in the effectiveness and durability of the reform initiatives represented by these conditions.

There has been slippage with regard to the key condition that the operational budget satisfies the requirements of the MFEM Act. The 1998-99 budget projects an operating deficit that is to be funded by unspecified asset sales, yet the budget papers declare this is fiscally responsible. In the case of the 1997-98 budget, the initial appropriation showed an operating balance as required by the Act; but this reflected over-optimistic revenue projections. The actual outcome was an operating deficit of NZ$3 million.

The draft of a medium-term Public Sector Investment Program was completed on schedule and in a manner acceptable to the Bank; but it appears that this has been a one-off event, with neither subsequent updating or integration into the budget process. There is a similar concern over the implementation of strategies for the key productive sectors. With regard to the last tranche condition, there has been a clear government commitment to devolution of public service delivery to island councils, which now receive a one-line appropriation in the budget to fund all services. There is some doubt, however, that the councils are expected and able to account for their revenue receipts on an outputs basis.

2.5.2 Secondary conditions

In addition to the eight tranche conditions, some 102 policy measures to be taken are listed in the ERP matrix. The vast majority was implemented in a timely fashion, which represents a noteworthy achievement under difficult circumstances.

Fifteen of the conditions remained incomplete in October 1998. Some of these were in progress (notably divestment of the Vaimaanga Hotel); and in the case of the condition requiring legislation to simplify the land tenure system, it is understandable that progress had been slow, even with completion of a 1996 report on land. However, there clearly was some distance to go in respect of ensuring that output budgeting became an effective management tool; and a major concern remained over effective implementation of the condition that transparent and contestable guidelines are established and followed for asset sales. The non-transparent 1997 sale of the government-owned Rarotongan Hotel to a local businessman at a knock-down price of NZ$3.25 million that does not have to be paid for 10 years has been the subject of a PERCA report, and is detailed in Economic Insights (1998 pp.23-24). To clear a debt on the hotel, Government sold 20 percent of its shareholding in Telekom (Cook Islands) to Telekom (NZ), giving the latter majority ownership, without putting any regulatory framework in place.

The Development Investment Board has been active for one year following a one-year delay in making it operational, and is working effectively to promote foreign investment in the Cook Islands. However, the new Investment Code remains to be produced.

2.5.3 Use of loan and counterpart funds

As noted above, counterpart funds were to be utilized for (1) retirement of a part of Government's short-term liabilities to domestic private sector creditors; (2) promotion of private business through the Business Ventures Development Corporation (BVDC) that was to be established through TA to the Cook Islands Development Bank (CIDB); and (3) an equity injection into the CIDB. Some of the funds were used for the first purpose, but no funds were used for the second and third purposes due to the abandonment of the BVDC proposal and the delay in the privatization decision on CIDB. Instead, funds were used for general budgetary support.

2.5.4 Effectiveness of monitoring

The Cook Islands Government monitored implementation of the policy measures in the ERP on its own account, and was expected to submit quarterly progress reports to the Bank. These appear to be unavailable at present. The Government also chaired a Program Monitoring Committee that included representatives of the Bank and NZODA. This Committee met at least every six months to review progress.

The Bank reviewed phase 1 of the FEM TA and structured phase II to address identified weaknesses. Several missions were undertaken in 1997 that permitted the monitoring of this second phase and the implementation of ERP. In general the monitoring mechanisms were effective in terms of frequency and feedback.

2.6 Results

2.6.1 Outputs

The ERP was implemented in a generally efficient manner, with all but 15 of 110 policy measures listed in the ERP matrix completed in a formal sense. In terms of achieving the desired outputs the record is mixed. Achievements include:

- **Local ownership from the outset, and the creation of substantial and effective public participation in, and commitment to, the reform process.**

An outstanding achievement of the ERP is the creation of active, ongoing community involvement in the business of government. The Government has made a serious effort at increasing two-way communication between it and the general public. Draft budgets are provided to the National Development Council (NDC), an advisory body and think tank; and they are made available to the public for comment and criticism. The Government's economic and financial policies are publicly released as part of this process. Regular National Retreats are held between the government and the community; and an active media contributes to the communication process. Such participation mechanisms have underpinned the move to a more responsive, accountable, and transparent government. A prime example of responsiveness is the formation of a Political Reform Commission in 1998 in response to community concern over the number of politicians and relatively high representation of outer islands. In addition, participation has been increased through fiscal devolution to local - including outer island - councils, making them responsible for management of government funds that can be spent according to local priorities.

- **A move toward fiscal balance by reducing the number of public servants by about 60 percent over the period 1996-98.**

At the time of the 1996 financial crisis, 15 per cent of the total population and 60 percent of the formal workforce were employed by the central government, there were weak controls on public expenditures, and the allocation of resources was biased towards political agendas rather than community need. As a result of the ERP's downsizing of the public service, government now employs approximately 9 percent of the resident population; and the number of ministries has dropped from 52 to 22.

- **The passage of key legislation establishing principles of fiscal responsibility, improved accountability, and transparency to be followed by heads of departments and Government.**

(1) The MFEM Act requires the Government to maintain operating expenses within the limits of the Government's internal revenues and to publish statements of its fiscal and economic strategy in advance of its budgets being drawn up. (2) The PERCA Act created an independent committee appointed by Cabinet, and endowed with wide powers to review all aspects of public finance so as to ensure transparency of national and local bodies. It also provides for the adoption of "generally accepted international accounting principles" throughout the Government. However, there is no requirement for the Government to act on or formally to respond to PERC's recommendations. (3) The Public Service Act gave heads of ministries the power and responsibility to staff and manage their departments according to "good employer" principles, so as to achieve defined outputs integral to their own performance contracts.

- **Introduction of the concept of performance orientation in public expenditure management**

Under the MFEM Act, heads of ministries are responsible for ensuring that funds are expended for the purpose of providing certain specific outputs, and for supplying monthly accounting reports to the MFEM. There is now considerable awareness amongst heads of the importance of outputs and results, and the importance of regular measurement of actual performance. This change in attitude is an important step toward greater professionalism in the public service, which is necessary to improved formulation and implementation of economic and social policies. Also, the wider community is now keenly interested in the particular outputs and services that Government will deliver in exchange for the revenues that it receives.

- **Progress in creating an environment conducive to private sector growth**

Distortions in the tax system have been reduced with the removal of the turnover tax, changes to the personal income and company tax systems, and the introduction of the value-added tax. With the "one-stop shop" arrangements under the Development Investment Board, impediments facing foreign investment have been reduced; and basic support services for small business are more readily available. The reduction in the size of the public sector has permitted some "crowding in" of the private sector. Since 1996, government-run hotels, liquor outlets, television and radio broadcasting, printing, heat treatment of fruits and vegetables, sale of agricultural equipment, and dental and surveyor services have been privatized. More generally, there has been a shift in public perception away from seeing government as the key institution (the "mummy" state) towards seeing the public itself as central.

- **Avoidance of a threatened period of serious macroeconomic instability (see below under Impacts).**

However, concerns remain over ERP's effectiveness in regard to non-delivery of some outputs, the apparent fragility of some reforms, and the domestic capacity to consolidate and sustain gains from reform in the absence of technical assistance. These include:

- **A fragile fiscal situation, with government experiencing a cash crisis that has undermined output budgeting.**

There are tight restrictions on cash that are preventing Government from providing the funds agreed to under the output budgeting system. This lack of predictability of financial resources has caused the system effectively to collapse into a one-line program budgeting system under which heads of ministries have a legitimate reason for failing to deliver agreed outputs. Performance assessment then becomes difficult.

- **Passage of a 1998-99 budget that is not in compliance with legislative requirements and that relies on unspecified asset sales to fund current expenditure.**

As already noted, the 1998-99 budget is not in compliance with the MFEM Act, and there is considerable uncertainty over the revenue forecasts. An operating deficit is forecast, following the 1997-98 deficit, and is to be financed by proceeds of unspecified asset sales. There is no mechanism in place to ensure that government fulfils its legal requirement (other than action by the Solicitor-General), and a consequent risk that gains in fiscal responsibility and respect for the law will be lost.

- **Incomplete public service reform, with the number of ministries (22) and public servants (1,340) still far too high for a population of 16,900.**

Public service downsizing was done very rapidly in a crisis situation. Ideally, it should have been preceded by the design of a serious public service reform program. Presently, there is no compelling vision for such a program, goals have not been established, and there is no plan of action (with an output appropriation in the budget). Further downsizing of general government is necessary, for the Cook Islands public service still remains large by regional and international standards in terms of numbers of ministries, employee numbers and especially the wage bill. The latter has fallen by around half as much as the former under ERP, because cuts in public service numbers were concentrated among lower paid staff, notably wage workers, and because restructuring involved reclassification of many retained employees into more senior positions. Several ministries with a total staff of 700-800 would be an appropriate target.

The current budget difficulties add urgency to the task of pursuing public service reform. Government has announced its intention to undertake further reform, but it must be noted that the pace and drive for change have eased in late 1998 in advance of the elections due in early 1999. Until a public service reform program is formulated, it is difficult to see how the incomplete ERP matrix condition for a comprehensive national training needs assessment can be usefully undertaken.

- **A lack of transparency and contestability in government's handling of asset sales, notably in respect of the sale of the Rarotongan hotel to a local business at half its market value and with a ten-year grace period on any payment.**

The sale of the Rarotongan hotel has been the subject of a PERCA report, which concluded that government could not claim that the transaction was carried out in a "fully arms length, transparent and contestable manner". It was clearly against the spirit and letter of the ERP.

- **The lack of attention to regulatory arrangements in the sale of government-owned natural monopolies**

The transformation of Telekom (Cook Islands) into a private and unregulated monopoly, in order to raise funds for clearing the debt on the Rarotongan hotel prior to its sale, has been referred to earlier in this chapter. Government has also announced intentions to sell other key monopolies, notably those operating the Rarotongan and Aitutaki airports (the Airport Authority), electricity generation and transmission (Te Aponga Uira) and the port (the Ports Authority). The intention seemed to be to sell without putting control mechanisms in place. Managing a public monopoly so that it maximizes efficiency and hence minimizes costs is difficult. But it is even harder to manage a private monopoly because it faces a much stronger incentive to increase profits at the expense of the public. The experience with the Telekom sale underscores the need for proper attention to regulatory arrangements in advance of any further privatization of natural monopolies.

- **Doubts about the durability of output-based budgeting and accrual accounting systems, and the capacity to deliver effective performance monitoring.**

Before ERP, Government already had considerable difficulty in controlling costs and cash expenditures under an inputs-based budget. The attempted shift to output budgeting and accrual accounting in a country with only a few qualified government accountants widened the gap between domestic skills possessed and skills required, and of necessity increased reliance on outside technical assistance. Despite the best efforts of advisers under the FEM TA, and the redesigning of phase II so that it placed greater emphasis on training, it is now accepted by all stakeholders that capacity-building objectives have not been realized - with the notable exception of the statistics area of MFEM. There is little comprehension amongst senior and middle-level public servants of the concept of output budgeting. Ministries other than MFEM have been little affected by the FEM TA and continue to be several months late in their submissions of monthly financial reports, creating problems for MFEM in exercising tight control over public finances. While the 1998-99 budget estimates are the first attempt at presenting financial statements on an accrual accounting basis, they are incomplete in their coverage, imply two estimates of the operating balance, and are not presented in a format consistent with the IMF system of Government Finance Statistics. The conclusion of Economic Insights (1998, p.33) is apposite:

> *Continuing improvements will need to be made to the quality of the Government accounts if the Government, the finance community and donors are to effectively monitor financial conditions and if public accountability is to be enhanced.*

Another serious capacity constraint involves the Public Service Commission (PSC), which has only three professional staff for monitoring and appraisal of the performance of the heads of ministries. The appropriateness of making PSC the agency for performance assessment is an issue; but in any case, monitoring that extends beyond looking at compliance with budget limits to careful assessments of the efficiency of output delivery has not been possible to date.

- **The failure to reduce the size and cost of Parliament, and the associated public concern over politicians' real commitment to improved governance.**

Community and business groups remain disappointed by the failure to reduce the size and cost of Parliament, and see it as indicative of an underlying weakening of commitment to improved governance. The burden of public service downsizing fell most heavily on lower-paid employees who were relatively concentrated in the outer islands, while politicians' allowances remained intact except for the temporary cut in 1996. The fate of the recommendations of the Political Reform Commission, which include one for the downsizing of Parliament, will be a key test for government.[7]

2.6.2 Impacts

At the macroeconomic level, it is not possible formally to establish the counterfactual proposition of what the path of the Cook Islands economy would have been in the absence of the ERP. Nonetheless, it is reasonable to conclude that: (1) the ERP and the 1998 debt restructuring have helped the Cook Islands largely avoid a threatened period of serious macroeconomic instability; (2) even in a deteriorating external environment, the public service downsizing has had a much smaller impact on the level of economic activity than originally envisaged; and (3) the ERP has created conditions more conducive to private sector-led sustainable economic growth.

The process of reform inevitably disadvantaged some groups directly, and measures were taken to mitigate the negative impact on them. The major disadvantaged group was the group of retrenched civil servants. Accordingly, in March 1996, the Government established the National Transition Committee to oversee and advise on social support measures for surplus public servants. In addition, a NZODA-funded transition consultant was fielded in May 1996 to advise on assistance measures for public servants declared redundant; and a NZODA-funded Transition Service was established to provide financial support, counseling, small business advice, and

[7] Prior to the June 1999 elections, the Government was still considering the recommendations.

a community action program. In the event, the Service was little utilized, for the simple reason that large numbers of retrenched civil servants emigrated to New Zealand and Australia.

In 1996 and 1997, an estimated 1,600 persons emigrated. These persons can access the welfare systems and job markets of Australia and New Zealand, and may be a source of future remittances and investment. However, the emigration has left some problems in its wake. Apart from the reduced tax base, population decline has undermined the delivery of social services in some areas. For example, smaller class sizes have made it exceedingly difficult for some schools to remain financially viable, especially those that are mainly dependent on fees and user charges for their funding. There has also been some concern over an apparent deterioration in health indicators. It is not possible to determine to what extent the ERP has achieved a reallocation of government expenditure towards health and education, because of changes in budget format, lack of data on the use of aid funds, reorganization of the Ministerial structure, and devolution. However, in response to community pressure, Government has announced it will examine expenditure allocation as part of further public sector restructuring.

The Ministry of Works, Environment and Physical Planning monitored the environment impact of the ERP. A report produced in June 1998 identified no significant adverse effects.

2.7 Looking to the Future

Several lessons for design and implementation of Bank assistance to PDMCs emerge from this review of the Cook Islands ERP:

- In the context of a fiscal crisis and in partnership with government and other external funding agencies, the Bank can generate the critical initial momentum for an economic reform process, and can support that momentum through the provision of program loan funds. However, the Bank should be in a position to anticipate crises, to formulate considered responses where a crisis seems imminent, and to engage in “pre-emptive” policy dialogues in other cases.

- The design of a comprehensive reform program needs to

    - draw upon a wide range of relevant expertise (particularly in public sector reform/governance and public expenditure management in a small developing country context).

    - carefully and realistically sequence reform actions over time (in the knowledge that the reform process extends beyond the three years of program lending).

    - plan for effective monitoring against targets.

    - pay proper attention to regulatory arrangements in advance of any privatization of natural monopolies.

- It is essential to plan public sector reform – as opposed to simple downsizing – at the design stage on the basis of an overall vision of how the public sector should look and perform in the long term, an associated set of goals, and an implementation plan with a timetable.

- Models from developed countries are unlikely to be appropriate to island economies, so that their suitability needs to be investigated thoroughly, with special attention paid to domestic administrative capacity.