

5 SAMOA

5.1 Introduction

The process of economic policy reform in Samoa began in the late 1980s, with the support of a Bank loan.³³ Interrupted by severe natural disasters in 1990-91, the process was reignited in 1996, drawing on the experience of the earlier reform effort (see section 5.3.1). Financial sector and public enterprise reform are components of the new reform program, and are supported by the Bank's Financial Sector Program (FSP) loan of \$7.5 million, approved in February 1998 for release in two tranches of \$4 million and \$3.5 million. The loan involves adjunct technical assistance of \$950,000 aimed at strengthening capacity in three key financial institutions - the Central Bank, the National Provident Fund, and the Development Bank of Samoa.³⁴ In addition, a separate Bank-financed TA has been provided to facilitate the corporatization and privatization of state-owned enterprises.³⁵ The program loan compares with external grants to Samoa in 1997 of approximately \$29 million.

5.2 The Macroeconomic and Governance Context

Samoa's Human Development Index (0.578) is above the PDMC average (0.545) because its population is relatively well educated; but its economic growth performance has been disappointing. New national accounts show a trend growth rate in real GDP of one percent per annum for the period 1994-98, which is the same as the annual growth rate of the resident population. GDP per head

³³ Loan No.995-SAM: Agricultural Development Program, approved 28 November 1989 for \$15 million.

³⁴ TA 2989-SAM, Strengthening of Government Financial Institutions.

³⁵ TA 2788-SAM, Implementation of Privatization.

at the end of the period was approximately US\$1,100. However, remittance flows are significant: GNP per head is estimated to be at least 14 percent higher than GDP per head. Survey analysis of migrant communities shows that remittances are much greater than suggested by official balance of payments data and that, contrary to conventional wisdom, they do not decline with the passage of time (Brown 1998).

Following several natural disasters in the early 1990s, the real GDP growth rate rose to 6.8 percent in 1995 and 6.0 percent in 1996, but dropped to 1.3 percent in 1997 and 1.1 percent in 1998. The 1997-98 growth slowdown was attributable to declining production in the agriculture and manufacturing sectors, which account for 10 and 15 percent of GDP, respectively. Food crop production fell because of the effects of a mild drought. The decline in manufacturing was especially severe, reflecting both a drop in beverages production and a restructuring of a Japanese-owned automotive parts plant that exports to Australia. In contrast, stimulated by the opportunity to sell tuna to a canning factory in American Samoa and to Japan the value added of the fisheries sector increased by 54 percent between 1996 and 1998, reaching 6 percent of GDP. During the same period, value added increased by 13-16 percent in four sectors - commerce, transport and communications, finance, and public administration. These sectors account for 19 percent, 12 percent, 6 percent and 9 percent of GDP, respectively.

Since 1994, Samoa has run a substantial merchandise trade deficit and a current account surplus because of contributions from tourism receipts, private remittances, and official grants. The overall balance of payments moved from deficits in 1992-94 to increasing surpluses in 1995-98. This was largely the result of increased tourism receipts and remittances, and a drop in the capital account deficit as government loan repayments arising from post-cyclone reconstruction and the Polynesian Airlines financial crisis tapered off. At the end of 1997, gross foreign reserves covered 6 months of goods and services imports, the external debt/GDP ratio was 72 percent, and the external debt service ratio was 10.7 percent. Import coverage was unchanged towards the end of 1998. The nominal effective exchange rate of the tala, which is pegged against a basket of six currencies, appreciated in 1995-97, but depreciated during 1998 by over 5 percent. In real terms, the depreciation was greater. Samoa's inflation rate fell to 2 percent from 7 percent in 1997.

The budgetary situation has improved since FY1995, when an overall deficit of 7.4 percent of GDP was recorded. The overall balance moved into surplus in FY1996, and remained in surplus in 1997. Though a small deficit was budgeted for 1998, the estimated outcome was a surplus of 1.7 percent of GDP. This primarily reflected lower than expected development expenditure. The consequent rise in government deposits with the Central Bank permitted strong growth in credit to the private sector without acceleration in broad money growth. In the fiscal year ending 30 June 1998, while net foreign assets rose by 18.0 percent and credit to the private sector increased by 17.4 percent, the broad money supply increased by 8.3 percent, compared with 13 percent in 1997. During the year, the commercial banks' loan portfolio with the private sector and public institutions shifted in composition away from personal loans towards loans to the primary and secondary sectors. The weighted average lending rate of commercial banks remained fairly steady around 13 percent throughout 1998, as has the weighted average deposit rate, leaving an interest rate spread of approximately 8 percent.

An expansionary fiscal policy stance has been adopted in FY1999. In the revised budget for the year, the Government planned a small overall deficit of 0.4 percent of GDP. Revenue is expected to increase by 11.9 percent on the level in FY1998, with losses from the impact of tariff reform more than outweighed by greater non-tax revenue and revenue from income, excise, and value-added goods and services taxes. It should be noted, however, that revenue forecasts are predicated on real GDP growth of 3-4 percent, when 2-3 percent is more likely. External grants, which constituted 26 percent of total revenue and grants in FY1998, are expected to rise by 40.7 percent, contributing to a rise in total revenue and grants of 19.4 percent. Total expenditure is forecast to increase by 27.5 percent. Current expenditure is to rise by 21.7 percent, primarily because of increased expenditure on operations and maintenance. Allocations to health, education and public works are also scheduled for significant increases, whereas wages and salaries are set to fall from 44.0 to 36.7 percent of total current expenditure. Development expenditure is expected to rise by 26.8 percent in line with the increased provision of external grants. The planned rise in support for public enterprises and statutory authorities from 3.6 percent in FY1998 to 4.2 percent of GDP is of concern, given that

Government is seeking to restrain expenditure and improve its quality.

The Government's commitment to economic reform, enunciated in *A New Partnership: A Statement of Economic Strategy, 1996-97*, was reaffirmed in the revised strategy for 1998-99, *Strengthening the Partnership*. The strategy aims at encouraging private sector-led economic growth by maintaining a stable macroeconomic environment, reforming the public sector, and improving the enabling environment for the private sector through financial sector liberalization, tariff and tax reforms, and the establishment of a forum for an exchange of views between the Government and business. The party in power, the Human Rights Protection Party, holds a large majority in Parliament, and is led by a strongly reformist Prime Minister, who is also the Minister of Finance. It is also acknowledged that the governance environment historically has been the best amongst PDMCs, and that it has improved in recent years, partly because policy actions like tariff reform have removed easy opportunities for corruption. The prospects of an effective, ongoing commitment to economic reform are therefore good.

In the short to medium term, growth may be adversely affected by the impact of falling tuna prices, reduced demand from the American Samoan cannery, and the indirect effects of the Asian financial crisis on exports and remittances (through reduced economic activity in Australia and New Zealand). Against this, growth will be boosted by aid-funded public infrastructure projects. In the longer term, provided the economy is not subject to severe external shocks, economic growth at a modest, sustainable rate of 2-3 percent per annum can be achieved. This will permit an increase in average income of around 2 percent annually, and will generate jobs for the 500 new entrants to the labor force each year. Such a growth outcome will require durable improvements in the performance of the agricultural sector, continued expansion in fisheries, and realization of the potential for further manufacturing and tourism development. Samoa's attractiveness to foreign investors will need to be enhanced through removal of the current complexities and delays in the investment approval process and provision for secure access to land when it is needed.

5.3 The Process of Program Design

5.3.1 Ownership and appropriate participation in the design process

The Financial Sector Program is one component of a broader economic reform program that is described in the Statement of Economic Strategy published in early 1996 and updated in early 1998. A striking feature of the program as a whole is that it is designed, owned and driven by Samoans. This was not the case with an earlier attempt at reforming the agricultural sector that was supported by the Bank program loan referred to in section 5.1. Though acknowledged by the Bank and Samoan authorities as ultimately effective in supporting agricultural reforms, the Agricultural Development Program did not have strong local ownership at the outset, and in hindsight was regarded as too ambitious in both scope and implementation time. This experience made political leaders and government officials more mindful of the importance of local ownership of reforms, and of the need to carefully focus, sequence and pace reform actions.

The present reform program is championed by the Prime Minister, who retained the Finance portfolio when taking over the prime ministership in late 1998. He is widely regarded as a strong leader committed to implementation of the program. The Treasury is the main source of senior and middle managerial support for the reform program. Under the leadership of the present PM, it has been responsible for the consultative formulation of the Statement of Economic Strategy and its dissemination, and the corresponding effort of line departments to draft their strategic corporate plans. The latter have become a vehicle for introducing public servants to the concept of service orientation. In some ministries, such as Health, the strategic plans are being translated into action plans at divisional level.

The design process for the Finance Sector Program was initiated by a Government request for assistance at the Bank's 1996 Annual Meeting. It involved consultation and communication between the Central Bank of Samoa, the Treasury, the three commercial banks, and the private sector; and it built on previous reform actions. With regard specifically to the finance sector, in 1995 the Government sold its equity in a commercial bank and privatized

the government-owned savings bank. Early the following year, it strengthened the regulatory framework for financial institutions by passing the Financial Institutions Act, which gave the Central Bank the authority to impose monetary controls on non-bank financial intermediaries. Prior commitment had also been made to privatization and corporatization of state-owned enterprises: between 1987 and 1996, 21 SOEs were liquidated or privatized.

Both financial sector liberalization and public enterprise reform had long been advocated by external funding agencies. Liberalization was first encouraged during the 1984 processing of ADB and World Bank assistance to the Development Bank of Western Samoa, and was reiterated in a 1995 evaluation study of an earlier Development Bank loan. During a reconnaissance mission for a sixth Development Bank loan, the Bank advised the Government that financial sector liberalization was a necessary condition for further loan assistance to the financial sector. A 1996 World Bank mission that reviewed the financial and public sectors advocated an accelerated implementation of reforms.

5.3.2 Partnership and consultation with other external funding agencies

A number of multilateral and bilateral agencies have been, and remain, involved in assisting financial sector reform, privatization and corporatization, and institutional strengthening of the Treasury. Throughout the design and implementation stages, the Bank has coordinated closely with these agencies, especially the IMF.

5.3.3 Effectiveness of internal processing procedures

The 1996 Government request for assistance and consideration of a program loan was followed by a concept clearance paper in June 1997 and a Fact-Finding Mission in July. Loan negotiations were completed by January 1998, and a loan agreement reached in March. The first loan disbursement occurred on 1 June 1998. Once begun, processing was efficient and effective.

5.4 The Content of the Program

5.4.1 *The Financial Sector Program*

The Financial Sector Program has the overall goal of private sector-led economic growth and employment generation through efficient mobilization and allocation of resources. It is daringly precise in specifying as a measurable indicator an average annual growth in GDP "at about 4% over the next 5 years vis-a-vis an estimated 3% growth in GDP in the without Program scenario" (Logical Framework in the RRP). The specified objective of the Program is really two separate objectives: (1) the promotion and establishment of sustainable market-based financial sector policies; and (2) privatization/corporatization of the SOEs. Five pertinent indicators are identified as a collective measure of progress in achieving these objectives. These are:

- As a result of increased competition among financial institutions interest rates spreads are expected to decline from an average 7.5 percent (October 1997) to about 6.5 percent during the Program period.
- The ratio of Reserve Money to Quasi Money, as a measure for financial intermediation, is expected to decline from 63.6 percent (March 1997) to below 50 percent by 2001.
- Budget revenues through sale of SOEs are expected to increase by about S\$ 8 million over the Program period.
- Capital productivity of SOEs as measured by aggregate rate of return on assets increases from a negative one percent (end 1996) to about 3 percent by 2001.
- Net profits by SOEs (excluding utilities) by end of Program period compared to a net loss of S\$ 8.3 million (end 1996).

The five outputs that lead to the achievement of the Program objectives are:

- Financial sector liberalized and financial markets promoted and established.
- Central Bank of Samoa strengthened (shifting from direct to indirect instruments of monetary control).
- Prudential and regulatory framework strengthened.
- National Provident Fund and the Development Bank of Samoa strengthened.
- State-owned enterprises privatized and/or corporatized.

The 62 activities to be undertaken in order to produce the outputs are specified in a Development Policy Matrix. Forty-three activities relate to the financial sector component of the Program, and 19 to the SOE component. Six activities are second tranche conditions (Appendix 1). They are clear and meaningful, though there is a question mark on the ownership of the condition requiring amendment of the Financial Institutions Act to provide prudential supervision of nonbank financial institutions, notably the National Provident Fund and the Development Bank of Samoa (see section 5.6).

The financial sector component of the Financial Sector Program is well designed and written. However, given that the RRP demonstrates considerable awareness of the previous program lending experience in Samoa, of program loans for financial sector reform in DMCs, and of other Pacific economies' experience with indirect monetary management, it is surprising that there is no specific mention of the implications of small size, including for market structure.

The smallness of the Samoan economy means the banking sector is oligopolistic. There are only three commercial banks, one of which owns 70 percent of total bank assets, and which could be assumed to play the role of market leader. Given that the Program targets a reduction in the interest rate spread of one percentage point as a result of increased competition between financial institutions, some analysis of how this increase was to come about might have been expected. Such an analysis could have addressed the issue of unrestricted offshore borrowing and reasons why it might or

might not be an acceptable means of introducing contestability into the banking sector. Instead, either there is an implicit assumption that the financial sector is as inherently competitive as it is in developed countries (with existent lack of competition attributed to direct credit controls alone); or there is an implicit argument that the interest rate spread will be reduced through some mechanism other than straightforward competition. One simple mechanism would be goodwill on the part of commercial banks, perhaps combined with moral suasion from the Central bank. Another more complicated one would be that the introduction of a market-based interest rate policy improves the quality of project appraisal by potential borrowers, thus reducing the cost of bank operations.

A second surprising omission is that there is no discussion of the implications for financial development of the near-absence of an informal credit market in Samoa, though the absence itself is recognized in the RRP. The absence appears to be the result of Samoans' access to remittances from relatives overseas. As a result of these omissions, there is a tendency to overstate the potential impact of the financial sector reforms - a tendency that is underpinned by some selective and dubious comparisons with other Pacific island economies.³⁶

5.4.2 Rationale and appropriateness of loan amount

Loan funds of \$7.5 million cover a substantial share of the total fiscal costs arising from the Financial Sector Program. These costs are the incremental budgetary cost of issuing Central Bank bills (\$1.9m over the 3-year program period); the loss of revenue from elimination of the foreign exchange levy (\$1.3m annually); and loss of revenue from the planned corporatization of the Posts and Telecommunications Department (up to \$5.7m annually). The rationale advanced in the RRP is that a program loan thereby will support the financial sector and public enterprise reforms. The implicit argument is that the Government's fiscal position at the end of the program period will be stronger as a result of the reforms,

³⁶ For example, it is asserted that the 1995 domestic credit/GDP ratio in Samoa "is currently far below the regional norm"; but the countries referred to included Papua New Guinea and Solomon Islands, which were running large budget deficits at the time.

and that consequently the direct and ongoing fiscal costs of the Program will be well covered.

5.4.3 Consistency with country and Pacific strategy

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

The provision of loan funds will...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 (ADB 1996, p.23).

The program loan is also consistent with the country strategy: Financial sector reforms should be an important priority (Country Strategy p.75).

5.4.4 Relevance and focus

The RRP uses the standard economic argument for financial liberalization, which is based on the assumption that the pre-reform condition is one of financial repression: "there is considerable unsatisfied demand for bank financing for viable private sector projects" (RRP, para 115); and "the Program will directly support low-income households through improved availability and access to credit" (RRP, Appendix 6, para 1). However, if there were substantial financial repression, we would expect to find an informal credit market filling the credit gap. In fact, as noted above, the informal credit market in Samoa is insignificant. This point does not seem to

have been pursued sufficiently in Program design. It may be that credit market failure was not significant to begin with. “A large number of credit applications filed with domestic banks” (RRP, para 115) is not synonymous with effective demand for funding viable projects. Nor is an allegedly relatively low private sector share in bank lending (27 percent) automatic proof of financial repression or credit market failure (RRP, p.31, footnote 2). This is not to say that financial sector liberalization is undesirable. It is only to suggest that its potential economic impact may have been exaggerated in the Samoan case.

The Financial Sector Program is misnamed in the sense that it includes two sets of reforms that are not explicitly linked, namely the financial sector reforms and reform of state-owned enterprises. There is thus a risk that the focus could blur, even though each is of undoubted importance and explicitly included in the Statement of Economic Strategy.

5.4.5 Appropriateness and sustainability

Generally, the reform actions of the Financial Sector Program are appropriate and can be expected to generate sustainable changes beneficial to the Samoan economy. Program design was informed by the lessons learned from previous lending experience in Samoa, namely the importance of sound sectoral analysis, clear objectives and performance indicators, prioritized actions, and flexibility of implementation in the context of a changing economic environment. Well-sequenced manageable changes introduced and implemented by competent and vigorous local leadership are likely to be durable. As one commercial banker expressed it, Samoa has a record of making things work. One action that is of debatable benefit is the proposed extension of output-based budgeting to the Central Bank of Samoa (see section 5.6.5 for a discussion of the budget system).

5.4.6 Likely impact on governance

The Program is expected to contribute to improved financial sector governance through (1) strengthening of Central Bank of Samoa (CBS) autonomy; (2) separation of the Offshore Financial Sector from the CBS; and (3) strengthening of prudential regulations

and their supervision. Actions aimed at improving corporate governance of state-owned enterprises include the review and amendment where necessary of the legislative framework, ensuring compliance with all legislative requirements, improving managerial autonomy, and ensuring annual external audits. General issues of governance and public sector management are outside the scope of the Financial Sector Program, but are central to the wider reform program. It is in this context of program assistance in general, and of systemic issues in Samoa, that comments are made in sections 5.6.4 and 5.6.5 below.

5.5 Implementation

5.5.1 Actions to date

Forty of the 62 actions listed in the Development Policy Matrix were completed by the end of February 1999. Of these, 16 were completed prior to Board consideration of the loan - three of them in 1996. There have therefore been 24 actions completed subsequently, with 21 still to be completed.

Progress in meeting second tranche conditions has been slower than expected. The foreign exchange levy has been removed a little behind schedule (Appendix 1). The other two financial sector second tranche conditions have yet to be completed, though they are being addressed. Two of the other three SOE privatization/corporatization second tranche conditions are scheduled for the second and fourth quarters of 1999. The third condition involving corporatization of the Posts and Telecommunications Department was due to be met in the fourth quarter of 1998, but was re-scheduled to be met on 1 July 1999. In general, progress has been slower on public enterprise reform than on financial sector reform.

The technical assistance provided for the strengthening of Government financial institutions is ongoing on an occasional basis, has been provided in a timely and flexible manner, and has generated the expected advisory outputs. A notable feature of the TA in general, acknowledged by advisors, is that it is managed by Samoans.

5.5.2 Use of loan and counterpart funds

The first tranche of \$4 million was released in two instalments. Counterpart funds have been placed in a Treasury account with the Central Bank and used to cover the fiscal costs of the Program reforms. In addition, approximately \$1 million has been earmarked as a line of credit for the Development Bank.

5.5.3 Effectiveness of monitoring

The executing agencies for the program loan are the Treasury and the Central Bank of Samoa. Co-ordination and monitoring are the responsibilities of a Financial Sector Program Coordination Committee, consisting of the Minister of Finance, the Financial Secretary, the Governor of the Central Bank, and the general managers of the Development Bank of Samoa and the National Provident Fund. This Committee is expected to meet monthly and to prepare semiannual progress reports to the Bank on the basis of separate reports from Treasury and the Central Bank. Although formal meetings have not been held, informal consultations take place. The first progress report, due in December 1998, was received in May 1999.

The Bank undertook a full-fledged review of the Program in October 1998 and plans on at least one additional review prior to release of the second tranche.

5.6 Results and Main Concerns

5.6.1 Participation and ownership

As observed in section 5.3.1, the Financial Sector Program is one component of a broader economic reform program championed by the present Prime Minister and supported by Treasury and senior staff in key line ministries. There has been strong communication of the purposes and nature of economic reforms within government. Under the leadership of the present PM, Treasury has been responsible for the consultative formulation of the Statement of Economic Strategy and its dissemination, including the Financial Sector Program component. The latter has involved a public information campaign and the participation of the local financial

community, which generally expresses both satisfaction with the consultative process and approval of the financial sector reforms.

There are, however, some exceptions to this last statement. One concerns the proposed prudential guidelines on disclosure requirements and management of commercial banks' foreign exchange exposure, which the banks feel have been developed, unusually, without adequate consultation between themselves and the Central Bank of Samoa. Another exception is that the management of the National Provident Fund feels the consultative process was deficient in their case. It is unenthusiastic about the Program's proposed extension of Central Bank supervisory powers to the Fund through amendment of the 1996 Financial Institutions Act. This lack of enthusiasm seems to be shared by Treasury itself on the grounds that NPF (and the Development Bank of Samoa) are 100 percent government-owned, and therefore do not require Central Bank supervision. Treasury and the Central Bank seem to be at odds on this issue and, in consequence, compliance with a second tranche condition (Appendix 1) has been delayed.

Generally, ownership of the privatization/corporatization of SOEs is not as solid as that of financial sector reforms. There is opposition from some Ministers on SOE boards, who do not want to give up their seats.

5.6.2 Financial sector reform

Progress has been made in the promotion and development of financial markets. Interest rate controls were lifted in January 1998, permitting banks to change from a flat lending rate of 12 percent to a range of risk-adjusted rates between 11 and 15 percent. Credit growth ceilings were also removed. The liquid asset ratio has been phased out as a direct instrument of monetary control and replaced by indirect control through auctioning of Central Bank bills (though the bills market is understandably thin). The levy on foreign exchange transactions has been removed and commercial banks have been allowed to provide forward exchange cover. The National Provident Fund and the Development Bank of Samoa also have adopted market-based interest rate policies, though NPF is still lending at concessional rates to some SOEs.

Financial sector liberalization is well received both by financial institutions and the business sector as it has brought market

discipline to both lenders and borrowers. In the case of the three-year old National Bank of Samoa, it is regarded as offering an opportunity to succeed through servicing small borrowers and depositors. Differentiated interest rates have led to a more efficient intermediation of loanable funds. The quality of financial information from borrowers has improved, with commercial banks running public seminars on how to prepare and present business accounts.

However, there has been only a slight reduction in the spread between the average lending rate and the average deposit rate. It was 7.5 percent in October 1997, and after increasing in early 1998, returned to 7.5 percent in July 1998. In March 1999, the spread was 7 percent for the National Bank of Samoa and 7.5 percent for the ANZ Bank and the Pacific Commercial Bank. Commercial bank credit expanded by 18.8 percent in 1998, but this occurred through an increase in the amount of credit to a limited number of borrowers (approximately 20 percent of borrowers hold 80 percent of outstanding loans), not through an increase in the number of borrowers. The composition of commercial bank lending has not changed. Limited competition among the three commercial banks may prevent the benefits of financial liberalization from reaching the intended targets. On the saving mobilization side, financial sector reforms have had no discernible impact to date, as Samoans continue their long-standing preference for perfect liquidity, holding both tala and US dollars.

With regard to actions taken to strengthen the Central Bank of Samoa (CBS) and its prudential supervision, the Offshore Banking Act has gone to Cabinet and money laundering legislation has been drafted. Amendments to the NPF Act have been made that formally make the interests of Fund members paramount and permit some offshore investment. A planned actuarial review of the NPF portfolio is expected to be completed in 1999. Most importantly, as noted in the preceding section, there has been not yet been an amendment of the 1996 Financial Institutions Act, so that the Central Bank can extend its supervisory role to include NPF, the Development Bank, and other non-bank financial institutions.

Another key outstanding issue is the securing of an agreement between Treasury and the Central Bank on a long-term funding arrangement for CBS. This is a second tranche condition scheduled for the third quarter of 1998. After initial delays, a policy paper has been prepared by an adviser under the TA project attached to the

Program loan. In May 1999, Bank staff expected that a formal memorandum of understanding between Treasury and the CBS would be signed around mid-1999.

5.6.3 Public enterprise reform

Reform of SOEs has progressed slower than planned, largely because of political obstacles arising from the fact that Ministers sit on SOE Boards. Corporatization of PTD - a second tranche condition scheduled for the fourth quarter of 1998 - was delayed by Cabinet decision in April 1998. Corporatization under the Private Companies Act is now scheduled for July 1999, with Cabinet selecting a board of three to five members. This will be a test case for moving toward merit-based selection of SOE Board members. Privatization of only one of the designated 8 SOEs has occurred to date, making it difficult to satisfy this second tranche condition by the fourth quarter of 1999. The sale of the Government's 66 percent shareholding in Samoa Breweries is in process.

The State Enterprise Monitoring Unit has undertaken a considerable amount of preparatory work, but it is now operating with only one full-time employee. There is a plan to make SOEMU an independent authority reporting to Cabinet, but this is some time away from implementation.

The accountability and transparency of most SOEs has improved. SOEMU records show that audited accounts of 10 of the 19 fully Government-owned SOEs are available for 1997. A further three have audited accounts for 1996. Three of the remaining six have not submitted accounts since 1994; and three apparently have never submitted accounts for audit.

Corporate governance concerns remain. Basic "arm's length" principles of good corporate governance of public enterprises are:

- The role of Government is to specify the mandate of the public entity, and to assure robust accountability and audit.
- Boards should be composed of persons not associated with the government (and should under no circumstances include ministers—who would otherwise exercise potentially conflicting roles).

- Boards' function should be to set policies and approve budgets, personnel plans, and major strategic decisions.
- Management should have the authority to manage and the responsibility and accountability that goes with such authority.

One or more of these basic principles is commonly not adhered to at this stage of the reform program. This is a systemic issue, not a problem of personalities. Most of the relevant actions in the Financial Sector Program are yet to be completed.

5.6.4 Governance

In Samoa, corruption has not been as significant a problem as in most developing countries; and, importantly, opportunities for corrupt practice have diminished as an indirect result of the ongoing simplification of the tariff system. It is known that regulatory complexity is a major source of corruption everywhere and that regulatory streamlining is accordingly the strongest single anti-corruption measure. There is a consensus that civil servants are honest and that overall accountability and transparency in government is good and has improved. Furthermore, as noted above, local ownership is strong, as manifested among other things by the public managers' effective supervision of the work and contribution of expatriate advisors.

All in all, as far as Government operations are concerned, the situation is positive. Program lending did not cause such an outcome, which is home-grown, but it has clearly served to encourage and help the strengthening in governance. However, as noted in the preceding sub-section, there is room for improvement in the current corporate governance regime. More generally, a free and professional media is essential for good governance.

5.6.5 Public sector management

Some cautionary comments are in order in regard to the change in the budget system, and to proposed reforms in tax administration and the civil service.

Concerning the budget system, output budgeting was initially introduced into Samoa in 1995 at the urging of external consult-

ants who have been active elsewhere in the Pacific. Although Samoa is only one of four countries in the world to have chosen such a system, a respondent stressed that “the budget process was in such bad shape that it needed a strong jolt.” Also, while output-budgeting was widely reported as unsuccessful in its first years of operation, it has since been substantially simplified to reduce its costs and partly adjusted to local capacity. The current simplified version has fostered performance orientation in certain sectors (e.g., public works), and warrants pursuing on a selective basis. However, further reflection appears advisable concerning four key issues:

* Output measures can be dysfunctional when the quality of the activity is paramount. (For example, using the number of Cabinet policy papers as a measure of performance of economic and planning staff is widely regarded in the literature on performance measurement as worst practice).

- In sectors where the link between output and outcome is indirect and unclear, outcome indicators would produce a more robust dialogue on performance.
- The current Treasury plan to move toward medium-term expenditure programming - along the lines of the Australian model (rolling 1+3) - deserves strong support, provided that the level of disaggregation of the forward estimates is realistic. In the particular case of Samoa, it is a timely move owing to the good quality of economic management. But effective medium-term expenditure programming will be hampered if it has to coexist with across-the-board output budgeting. The link from policies to expenditures normally passes through programs, not outputs. Of course, aggregating classes of outputs can result in effect in a form of program budgeting; but it would then be a serious problem to continue to use output indicators of performance when the practical operation of the system demands the use of outcome and process indicators. (The importance of an effective medium-term perspective for the budget process is one of the many reasons why all OECD countries but one have considered and rejected output budgeting).

- Finally, the envisaged move toward accrual accounting raises grave misgivings, given that it is acknowledged that fiscal discipline has been protected by the continuation of a cash-based accounting system. The Samoan authorities would probably be able, over time, to implement accrual accounting. However, the actual efficiency or allocative benefits would probably be minimal, and the costs (including the transaction costs) would certainly be vast. One interlocutor correctly explained that a move to accrual accounting is dictated by the internal logic of output budgeting, and identified as a problem the “lack of interest by the Cabinet” in these technical changes. It appears that the technical means are being allowed to dominate the policy ends. In other countries, a similar lack of interest by the political leadership proved justified when the change turned out to be costly and without demonstrable benefit. That said, a number of partial accounting improvements with a genuine payoff should be considered: an accrual accounting system for debt; reporting of contingent liabilities; and selective asset registers (focussing on assets that particularly need protection).

On balance - because of the good impact of the budgeting innovations in specific sectors, the major outstanding issues, and the high cost of errors in this delicate area - it would be advisable for the Samoan authorities to conduct an in-depth assessment of the current state of the budgeting and accounting system and of options for the future, with a view to setting out a strategic plan for public expenditure management modernization. In this exercise, it would be essential for the authorities to obtain a “menu” of diverse views, and inform themselves of a variety of actual OECD country experiences.

With regard to tax administration, there is a clear recognition of the need for improvements. Current weaknesses do not stem from public corruption but from the extensive avoidance and evasion facilitated by the openness of the economy and labor mobility. Given that openness and mobility are to be encouraged, improvements in tax administration should generally be sought from raising the cost of evasion and the rewards for responsible fiscal behavior. This ge-

neric prescription cannot be made more specific except through a major analytical effort for that purpose. However, the openness of the economy makes it difficult to envisage effective improvements in tax administration without some appropriate changes in the tax structure.

Following the New Zealand model of civil service reform, first the departmental chief executives, and later their deputies, were placed on a contractual basis. One consequent advantage was that salaries could then be raised sufficiently to induce highly competent individuals to join or remain in the system. An evaluation by the Public Service Commission is currently ongoing, with a view to possibly placing all public employees on fixed-term contracts and, in effect, removing all central control and monitoring of government personnel. This is an area of great risk and concern. In the budgeting area, innovations have been closely supervised and modified by a cautious Samoan leadership conscious of capacity limits and of the risks of mistakes. The same caution and awareness (informed by a knowledge of relevant international experiences) need to be brought to bear on the complex and long-term process of civil service reform.

To take one example, at present there seems to be no recognition of the potential fiscal implications of a move to fixed-term contracts combined with full departmental autonomy in matters of personnel. In the absence of a hard subceiling on the departmental wage bill, the new system would jeopardize aggregate expenditure control. If it were instead combined with a wage bill constraint, it could lead to underspending on needed operations and maintenance and in time produce either the "African syndrome" of a bloated workforce without any resources to work with, or an overpaid elite obsessed with preserving its status. The independence and integrity of professional judgements would be compromised by the need to be "responsive" to a political official on whom contract renewal depends. Nor is it clear how departmental autonomy on hiring and wages combined with fixed-term contracts would work in practice in a small society where family and kinship ties are particularly strong.

A competent and honest public service is an unusual and vital asset in a developing country, is a key reason for the sound economic management of Samoa, and has been an important contributor to good governance. Before any irreversible changes are

made in the existing personnel system, a major fact-finding and scenario-simulation exercise informed by the lessons of varied international experience and by competent advisers would be essential. A broad consultation process of the sort undertaken in formulating the economic reform strategy would be equally important for the formulation of any far-reaching civil service reform program. Thereafter, any changes the Samoan government concludes are appropriate would have a much better chance to work and to be sustainable.

5.7 Looking to the Future

As a sub-set of a comprehensive, sequenced and Samoan-driven economic strategy, the Financial Sector Program is approximately halfway through its implementation period. Substantial progress has been made. Some concerns remain, most notably the slow progress in privatization/corporatization of SOEs. General lessons that emerge from the experience so far include:

- Strong local ownership is of fundamental importance to the successful implementation of a reform program.
- Design and implementation of a reform program in a stable macroeconomic environment makes it easier for governments to take a consultative/participatory approach, to sequence and pace reform actions in the light of domestic capacities, to make and manage adjustments in reform actions, and to communicate the aims and achievements of the reforms.
- Chances of successful implementation are increased in a stable political environment in which the champions of reform can remain focussed and do not have to risk jeopardizing the aims of reform in order to retain power.
- Design of reform programs needs to pay more attention to the consequences of small size, and the uniqueness of each country's economic and social structures.

- Design of reform programs also needs to pay serious attention to a diversity of views and experiences in the area of public sector management and assess their relevance for individual small states.