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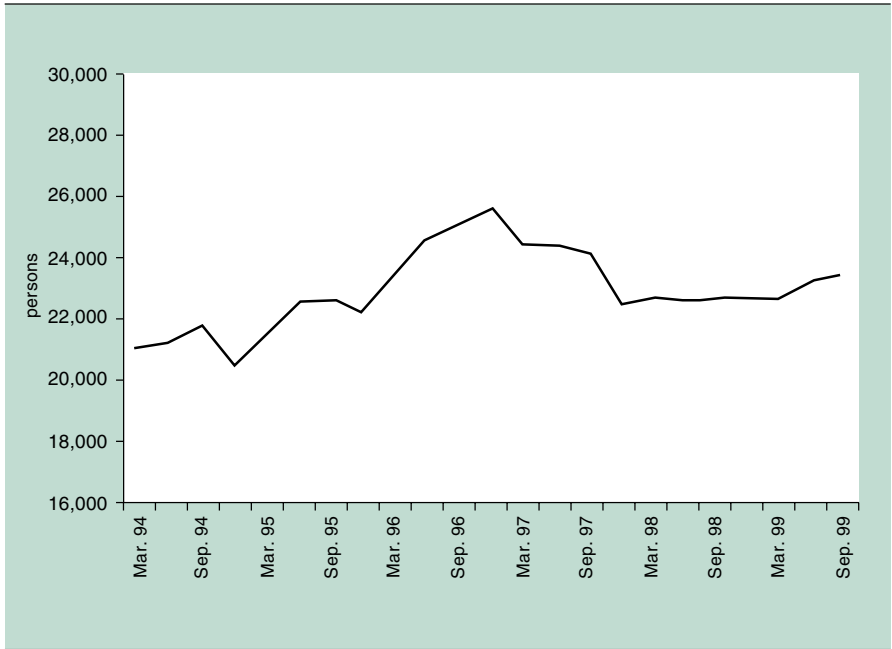
Macroeconomic Performance and Policies

Economic Growth

From 1985 to 1989 the economy recorded modest economic growth of about 2.5 percent, reflecting the benefits of economic reforms initiated in the mid-1980s, strong tourist receipts, external assistance, and substantial remittances. In the 1990–92 period, however, the economy contracted substantially, devastated by the impact of cyclones in February 1990 and December 1991. Economic recession in Samoa's major trading partners also constrained prospects through effects on tourist activity, certain exports, and remittances.

Government expenditure associated with cyclone rehabilitation entailed a very substantial increase in public investment and large overall government budget deficits from 1992 to 1995. Government expenditure and net lending as a percentage of GDP peaked at over 80 percent in the fiscal year 1992–93. The cyclone rehabilitation expenditure was a major factor contributing to economic recovery in 1993. However, the economy contracted again in 1994, reflecting lower (but still substantial) government expenditure associated with the rehabilitation program and a halving of exports as a result of the taro leaf blight disease in the taro crop.

The economy grew strongly in 1995 and 1996, due to agriculture's recovery in 1995 and increases in fish and copra exports and export processing and strong growth in tourism in 1996. Growth weakened again in 1997, reflecting lower expenditure on cyclone rehabilitation projects, a mild drought, and a reduction in exports from the Yazaki factory (which produces motor-vehicle wiring harnesses for the Australian market). However, the fishing sector recorded growth of 21 percent in 1997. The overall growth rate picked up to about 3 percent in 1998, with a further growth in the fishing sector of around 27 percent and strong growth in the transport and communications sector, the finance and business services sector, and, to a lesser extent, in other commerce and public administration.

Figure 2.1 **All Industries Formal Employment, 1994–1999**

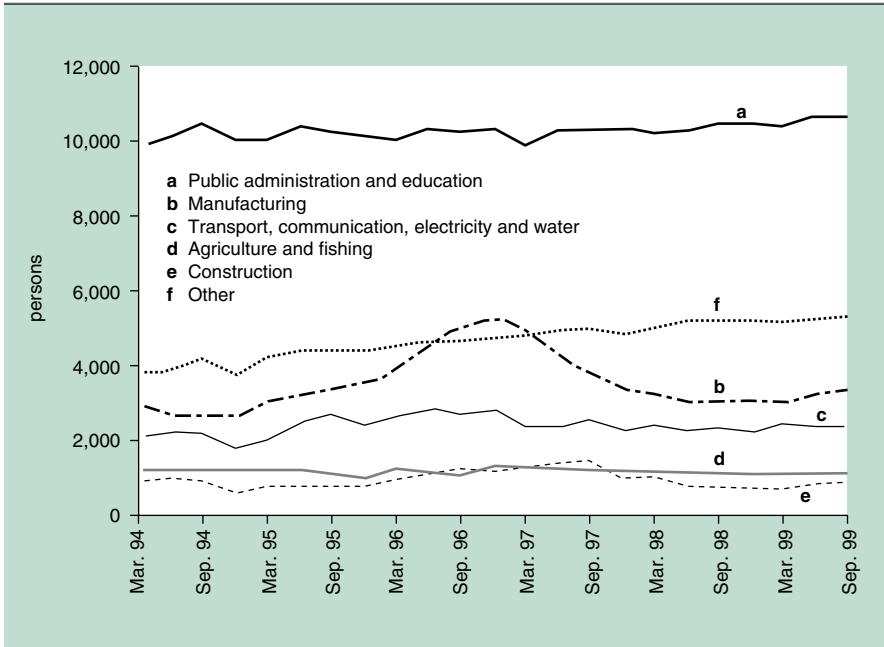
Source: National Provident Fund.

Growth picked up further in 1999, led by continued strong performance in the fishing, construction, and commerce sectors and continued growth of public administration and tourism. Growth of up to 5 percent is expected for 1999 as a whole. The growth of fish exports has been remarkable, with the fishing sector's share of GDP increasing from around 4 percent in the 1994–96 period to 7.4 percent by mid-1999. The strong aggregate growth performance has been achieved despite weakness in agriculture and some manufacturing activities.

Strong growth is expected over the next few years, reflecting a very substantial public investment program, further expansion of the fishing sector, and the stimulus from economic reforms.

Employment

Total formal sector employment is currently around 23,000 persons. Overall employment growth in the formal sector since the mid-1990s has been relatively weak (Figure 2.1). This largely reflects job losses at the Yazaki factory, as reflected in manufacturing employment figures (Figure 2.2). The employment figures probably also understate employ-

Figure 2.2 **Formal Employment by Industry, 1994–1999**

Source: National Provident Fund.

ment in the fishing sector, which has grown substantially in the past two years and probably employs about 700 people directly.

Most of the workforce is still employed in the agriculture, forestry, and fisheries sectors, reflecting the importance of subsistence activity (Table 2.1). It is notable that the share of the workforce employed in agriculture, forestry, and fishing declined substantially from 1971 to 1981 but rose again over the following 10 years. It is expected that the agriculture, forestry, and fishing share of employment has declined over the 1990s or at least not risen from the level indicated in 1991. The share of the workforce in wholesale and retail trade is likely to increase following the recent financial and tax reforms as well as that in long-line fishing, reflecting the recent rapid growth in that sector.

Unemployment is difficult to define or measure in Samoa, because excess labor is usually absorbed into the subsistence sector. According to the 1991 census, the unemployment rate was about 1.5 percent for men and 3.2 percent for women. It is likely that this mostly reflected the concept of frictional temporary unemployment, but it may also be the case that many people are effectively underemployed in their daily activities, to the extent that they would be capable of undertaking more demanding and more valuable activities if these were available.

Table 2.1 **Employment by Industries, 1971, 1981, and 1991**

Industry	1971	1981	1991
	%	%	%
Agriculture, forestry, fishing	67.3	60.4	63.0
Mining	0.2
Manufacturing	2.2	1.8	2.8
Electricity & water	0.7	1.1	1.5
Construction	4.3	5.5	4.8
Wholesale & retail trade	6.4	4.4	4.4
Transport & communication	3.3	3.3	4.5
Financial & business services	0.6	3.1	3.2
Social & personal services	15.3	19.8	15.6
Other	0.0	0.7	0.0
Total percent	100	100	100
Total number	37,740	41,506	42,494

Note: .. magnitude of zero.

Sources: EMPLA 1992; United Nations.

Samoa has a relatively young population, with a relatively large number of youth not completing secondary education. This implies a large number of people joining the workforce each year, with the potential for social problems burgeoning if opportunities do not match expectations. The traditional culture may struggle to absorb the youth into the subsistence lifestyle, particularly as they acquire a better education. However, there is sometimes a danger of becoming unduly alarmist about such issues. It is normally the case that employment follows population growth, provided government policies are supportive rather than distorting or repressive. In this respect recent policy reforms are conducive to economic growth and increased employment opportunities.

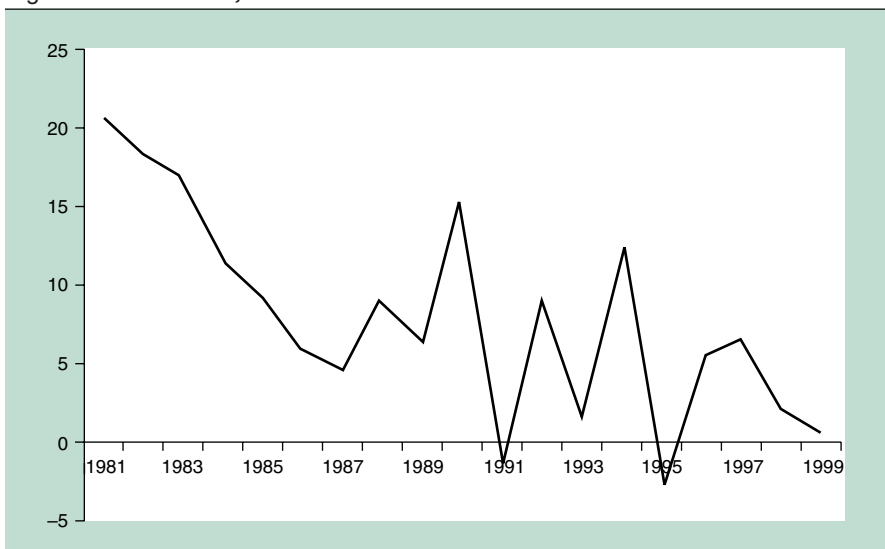
In the past, emigration has also been an important source of employment and this is expected to continue. One resulting disadvantage is that valuable skills are not readily available in Samoa, but the counterpart to this effect is that those same skills may be more valuable in other countries and continue to contribute to the substantial flow of remittances. There is often a tendency to conclude that overall emigration is bad and that the remittances are not sustainable. This conclusion should be carefully assessed, as the empirical evidence is that remittances are relatively large and very stable. Further, as the economy develops, there is a good chance that many Samoans who emigrate will return with capital and improved skills to establish enterprises in Samoa. There are present examples of this in the business sector. It is considered that the education system needs to take serious account of the skills that would equip Samoans to find good employment in countries to

which they may migrate as well as to take advantage of opportunities in Samoa.

Prices and Wages

Inflation has declined substantially over the past two decades. In the 1980s, a policy of gradual depreciation of the currency each year and the impact of higher inflation in Samoa's trading partners were the main factors affecting the inflation rate, although at times the impact of local food shortages was important. With imports constituting about half of the consumer price index, exchange-rate policy has an important impact on inflation. The spikes in inflation in the 1990s reflect the impact of local factors such as food shortages and local tax changes. The better average performance in the 1990s reflects the impact of more modest depreciation of the currency and the substantial tariff cuts in 1998 and 1999.

Figure 2.3 **Inflation, 1981–1999**



Source: Central Bank of Samoa.

Price controls on basic foodstuffs, household products, and fuel have been a longstanding feature of the economy. Some goods were removed from the price control list in early 1999, but controls still apply to a wide range of both imported and domestic goods and fuel. With the exception of fuel, the controls are applied by specifying maximum wholesale and retail margins. For freezer goods the maximum wholesale

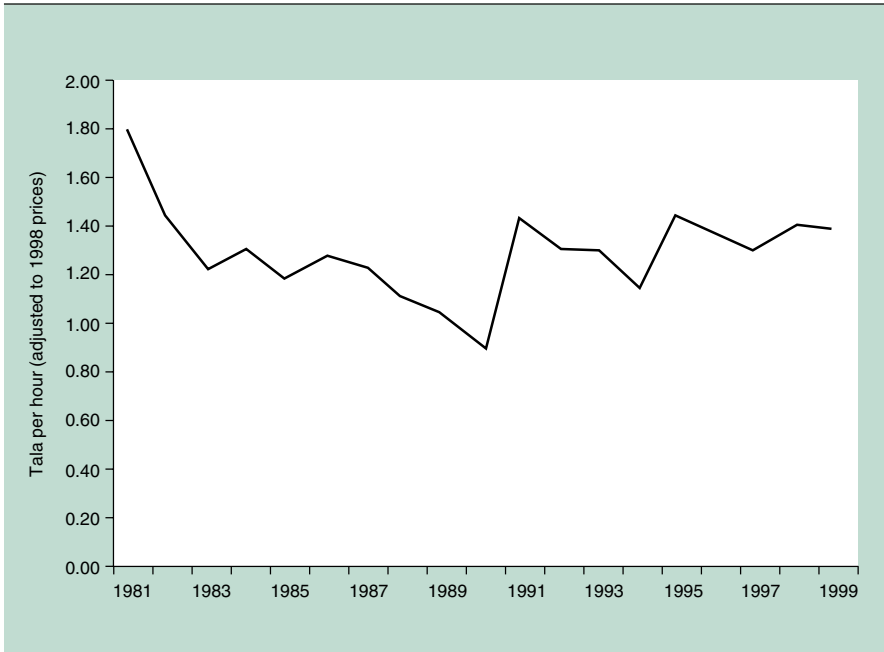
margin for Upolu is 15 percent and for retail it is 22.5 percent. Other goods have respective wholesale and retail margins of 12.5 percent and 20 percent. Higher margins are allowed on Savai'i.

The price of fuel is set by the Treasury based on an exclusive five-year contract with Mobil that links the price to the world price on a monthly basis. This arrangement may be effective in ensuring a close link to world prices, but there have been many complaints about the quality of fuel and there is no monitoring mechanism in place to address the problem. There are also problems with the effect the contract conditions have on the incentive to invest in adequate refueling facilities at the wharf. To realize fully the benefits from such an arrangement, the Government has to ensure effective monitoring of the contract and facilitate provision of adequate facilities.

With the exception of rural areas, price controls for household products are no longer considered necessary and may hinder competition by providing a focal point for pricing. There are five major wholesalers on Upolu and most people have good access to transport. It is understood that price controls will apply for another 1–2 years and the matter will be reviewed to determine if they are still necessary. There is considerable support for deregulation and the new fair trading legislation, in conjunction with the competition that exists, should be sufficient protection for most consumers. One regulatory aspect that needs urgent attention, however, is the absence of any legal provision to prohibit price-fixing among competitors. Such a provision is especially important when there is a major effort to contract out government services using a tender or similar competitive process.

Minimum adult (over 18 years of age) wages are SAT\$1.40 per hour in the private sector, among the lowest in the Pacific. Minimum wages have applied since 1974 and are subject to periodic reviews, with modest changes occurring every few years. Real minimum wages have declined substantially since 1980 (Figure 2.4).

From an employer's perspective the cost of labor has to reflect the productivity of that labor, whereas from an employee's perspective the wage rate has to reflect the value of the next best opportunity available. In the manufacturing sector, labor is not very productive relative to competitors in large foreign markets. However, low relative productivity reflects a combination of things, including the technology and capital employed and the scale of operations, as well as employee skills. Where Samoa has a natural advantage associated with its resources such as fish or certain agricultural products, or because of preferential access to large markets, the cost of labor is not a binding constraint. Market inquiries confirmed that productivity of labor in the manufacturing sector

Figure 2.4 **Real Minimum Wages, 1981–1999**

Sources: Department of Labor correspondence; Department of Statistics.

was low relative to Asian locations, but adequate given access to preferential markets. Similarly, labor productivity relative to wages paid was considered reasonable in key private-sector service activities.

Table 2.2 summarizes wages and salary levels by major occupation in the private sector. Given that wages are relatively low and that there are alternative opportunities in the subsistence sector or through migration, it is clear that lower real wages are not likely to have much impact on increasing employment in the formal sector.

Table 2.2 **Annual Gross Salary in the Private Sector by Occupation, 1999**

Employment category	Annual salary
	SAT\$
Senior managerial	24,960–104,000
Middle management, professionals	12,480–31,200
Skilled trades	8,320–18,720
Semi-skilled	4,160–8,320
Unskilled	3,120–4,160

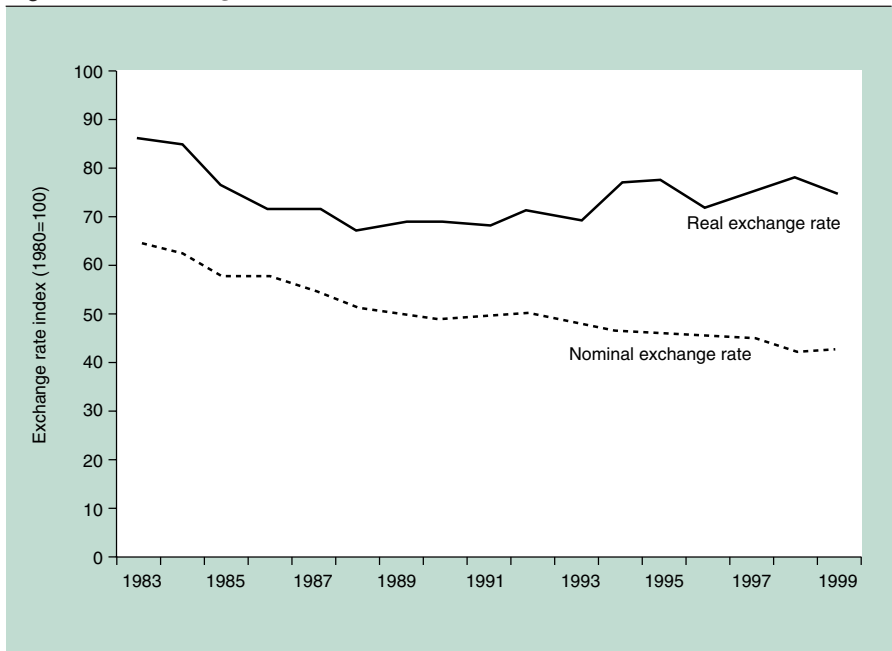
Source: Department of Labor correspondence.

Exchange Rates and the Balance of Payments

The exchange rate of the Samoan currency, the tala, is managed by pegging it to a trade-weighted basket of the currencies of its major trading partners, of which the New Zealand dollar and US dollar are the most important components. In the 1980s, both the nominal effective and real effective exchange rates were allowed to depreciate each year, providing a continuing boost to international competitiveness (Figure 2.5). However, in the 1990s, nominal depreciation has been more modest and there has been slight real appreciation.

It is important to recognize that in an economy highly dependent on imports and without indexed wages, exchange-rate policy has a major impact on inflation and real wages, as well as on the balance of payments, through changes in relative prices. Given Samoa's economic circumstances, it is not likely that lower real wages would have a great impact on employment opportunities, in the absence of complementary developments. From this perspective the recent real appreciation of the currency is not a major issue. In 1998 and 1999, however, there were

Figure 2.5 **Exchange Rates, 1983–1999**

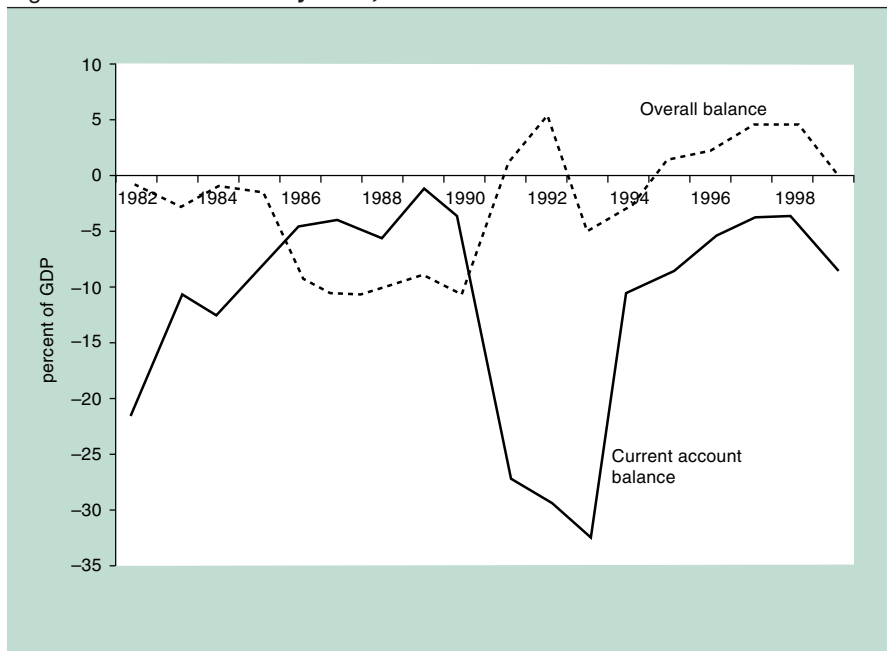


Source: Central Bank of Samoa.

major cuts in tariffs and removals of exemptions that have created pressures in the manufacturing sector. Tariff cuts of such a magnitude are normally accompanied by a currency devaluation to ease adjustment in the import-competing sector and to avoid balance-of-payments pressures. Although the trade deficit has widened since 1996, there do not appear to be major pressures on the balance of payments (Figure 2.6), although there are pressures in the manufacturing sector and a case can be made for a greater focus of exchange-rate policy on competitiveness, especially when it is recognized that tariffs for genuine business inputs need to decline further.

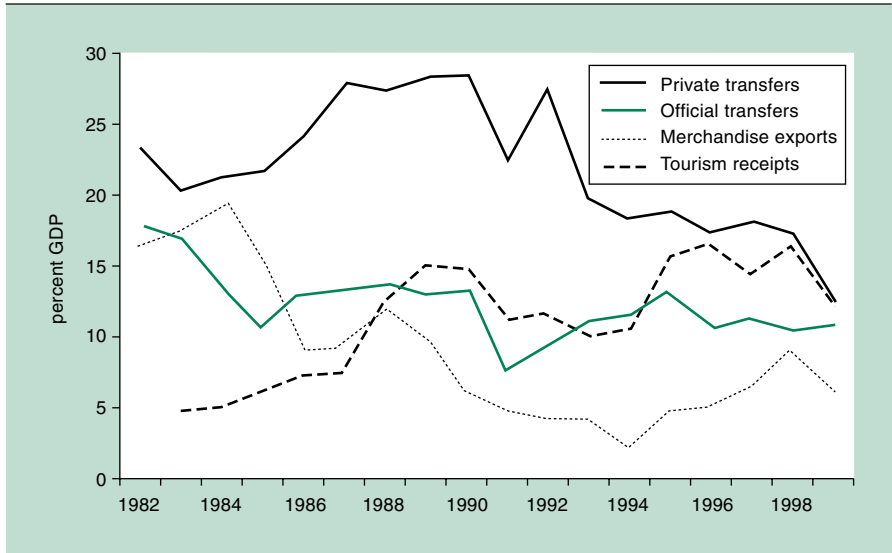
Remittances (private transfers) have traditionally been the major source of external income but have declined in relative importance in recent years (Figure 2.7). Aid has also been very important, averaging over 10 percent of GDP for the past two decades. Tourism receipts have grown from 5 percent of GDP in early 1980s to 10–15 percent of GDP in recent years. In contrast, merchandise exports declined substantially from the early 1980s to the mid-1990s, but recently have shown improvement.

Figure 2.6 **Balance of Payments, 1982–1999**



Note: Current account balance excludes official transfers.

Sources: Central Bank of Samoa.

Figure 2.7 **Current Account: Key Components, 1982–1999**

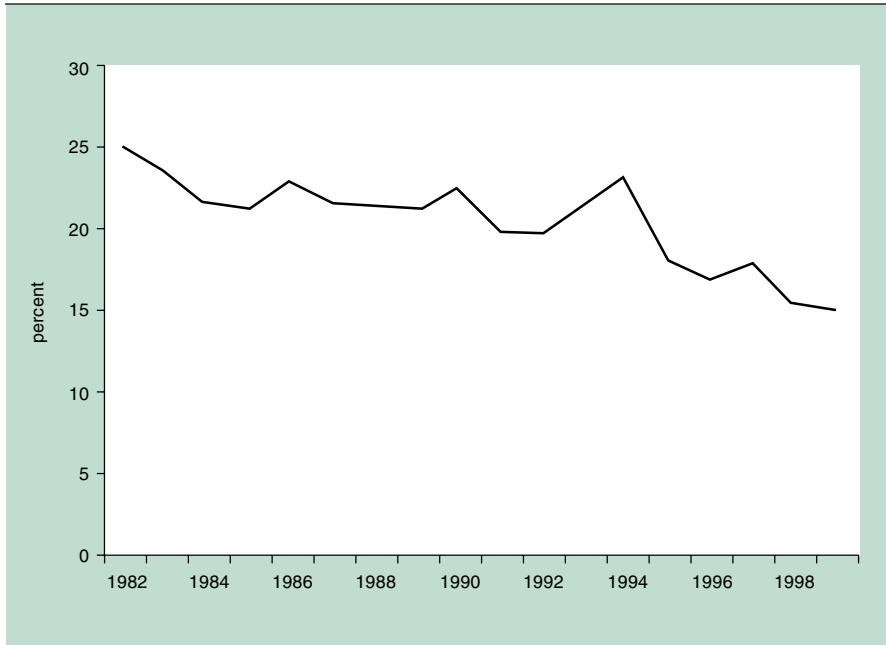
Sources: Central Bank of Samoa.

Structural Changes and Sectoral Developments

The most important structural change in the economy has been the decline in the relative importance of subsistence activity in real GDP. The subsistence share of GDP has declined from around 25 percent in the early 1980s to around 15 percent in 2000 (Figure 2.8). The trend has been particularly evident in the second half of the 1990s. However, the employment data indicate much slower growth in formal sector employment, suggesting that most people are still strongly reliant on agriculture and that there has been an improvement in productivity in the formal sector.

It is not possible to present data on output by sector in a consistent manner over a long time frame. However, reliable sector data have been available since 1994 and the sector performance is summarized in Table 2.3. The main developments are a decline in the importance of agriculture and other manufacturing and the growth in fishing and in commerce (mainly retail and wholesale trade activities).

Over a longer time frame it is worth noting that the combined share of commercial bank and nonbank total lending to agriculture, forestry, and fisheries was around 18 percent in 1990 and had fallen to 8 percent in 1999. This represents quite a substantial structural change in lending to productive activity.

Figure 2.8 **Subsistence Share of GDP, 1982–1999**

Sources: World Bank 1997; Asian Development Bank 1995b.

Table 2.3 **Sectoral Shares of GDP, 1994 and 1999**

	1994	1999 ^a
	%	%
Agriculture	15.4	12.9
Fishing	4.3	7.3
Food & beverages manufacturing	3.7	3.9
Other manufacturing	16.9	10.0
Construction	6.9	6.8
Electricity and water	2.7	2.4
Commerce	12.2	15.7
Hotels, restaurants	2.3	2.4
Transport, communication	9.6	10.8
Public administration	9.5	10.6
Finance and business services	5.8	6.3
Ownership of dwellings	4.2	3.8
Personal and other services	7.1	7.6
Total	100.0	100.0

Note: a. as of June 1999.

Source: Samoa Treasury Department.

Reform Strategies

Following the period of cyclone rehabilitation, the Government developed a comprehensive economic reform program. In 1996, it released its first Statement of Economic Strategy (SES), *A New Partnership*, and has subsequently released two further SES's, *Strengthening the Partnership* in 1998 and *Partnership for a Prosperous Society* in 2000. The Statements have replaced the traditional five-year development plans and are much briefer and more effective in communicating policies and strategies.

The first SES emphasized the need to maintain macroeconomic stability and called for private-sector-led economic growth based on a "new partnership" between the Government and the private sector involving extensive consultation. The strategy also entailed improving the efficiency and accountability of the public sector, improving the performance of public enterprises through privatization and corporatization, human resource development, tax and tariff reforms, and financial market reforms.

The SES was updated in 1998, with similar themes and more detail for some aspects, particularly with respect to financial sector liberalization and tariff and tax reforms. The SES released in 2000 continued the emphasis on macroeconomic stability, public-sector efficiency, improved education and health standards, and a strong private sector. In addition, the current strategy emphasizes the importance of reinvigorating agriculture and fisheries, the promotion of sustainable tourist development, and the importance of a revitalized village economy in achieving better economic and social outcomes.

An important feature of the reform strategies has been the extensive consultation that has been undertaken in their preparation and implementation so far. The private sector had good access to the Government and key departments in making policy suggestions and advising on the detail and pace of reforms. Since 1997, the Government has been providing annual grants to the Chamber of Commerce and the Manufacturers' Association to strengthen their organizational capacity.

Key aspects of the reform strategies are reviewed in this and other chapters.

Macroeconomic Policy—Key Developments

In the second half of the 1980s, the Government achieved substantial surpluses in the overall government budget, reflecting the impact of increased domestic revenue and increased aid in the form of both project and Export Earnings Stabilization System funds. Throughout this period, reasonable macroeconomic stability was achieved, underpinned

by substantial aid flows and a conservative approach to government expenditure. Inflation averaged 7 percent and commercial lending rates were in the range of 14–19 percent. The real exchange rate depreciated by about 10 percent, in cumulative terms. This represented the continuation of an approach to exchange-rate policy since the early 1980s that normally meant modest depreciation of the nominal and real effective exchange rates each year.

In the first half of the 1990s, fiscal and monetary policy was dominated by the response to the two cyclones in February 1990 and December 1991 and the subsequent rehabilitation program. Initially, this meant large increases in government expenditure, substantial budget deficits, and tight monetary conditions overall. In the second half of the 1990s, the budget position has been consolidated, macroeconomic stability has been good, there has been strong growth of credit to the private sector, and inflation has been reduced to less than 1 percent in 1999. Changes in the nominal and real effective exchange rate have been much smaller than in the 1980s, although there has been a small loss in competitiveness in the 1990–99 period as a whole. A comprehensive financial liberalization program was initiated in early 1998. So far the impact of financial liberalization has been relatively modest in terms of overall aggregates relative to the situation in the two years prior to the reforms.

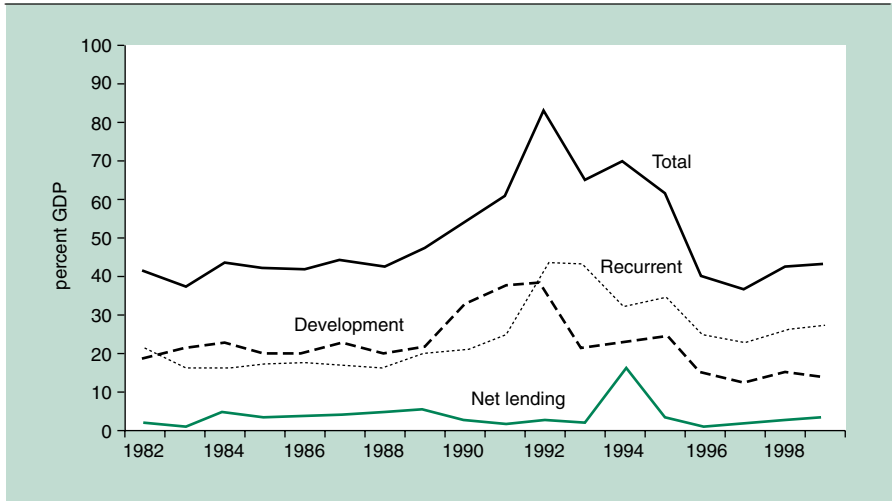
Fiscal Expenditure Aspects

In the second half of the 1980s, substantial fiscal surpluses were realized, leading to a buildup of government deposits in the banking system. However, the cyclones in early 1990 and late 1991 had a dramatic impact on infrastructure and economic activity and necessitated a large rehabilitation effort. As a result, the fiscal situation in the first half of the 1990s was dominated by cyclone-related reconstruction activity. The cyclone rehabilitation efforts led to a sharp increase in public expenditure, which rose from an average of around 45 percent of GDP in the late 1980s to 83 percent of GDP in the fiscal year 1992–93 (Figure 2.9). Rehabilitation pressures had eased by 1994–95, but public finances were then affected by the Government's assumption of the large debt obligation of Polynesian Airlines. The fiscal situation has since stabilized.

High levels of government expenditure led to very large fiscal deficits. In 1992–93 the fiscal deficit peaked at 22 percent of GDP, but by 1995–96 modest surpluses were being achieved (Figure 2.10). The 1999–2000 budget entails an expected deficit of 3.4 percent of GDP, largely reflecting a sizeable reduction in external grants.

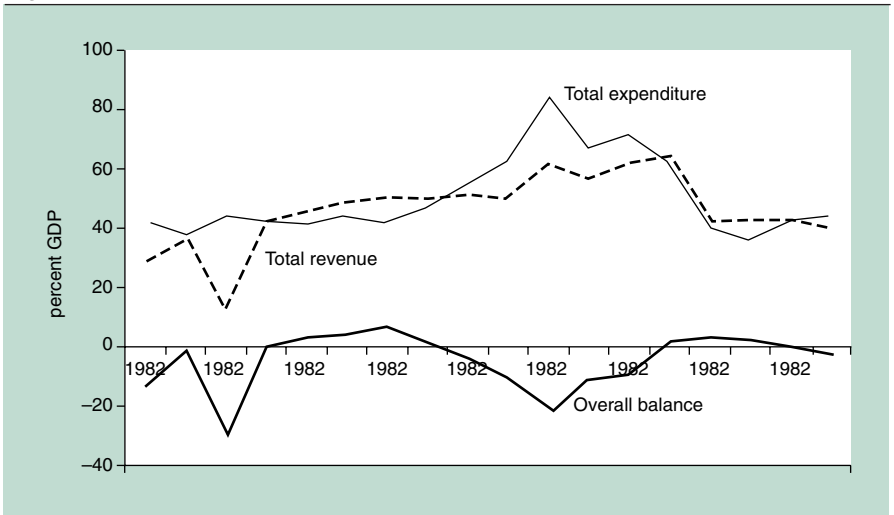
From 1991–92 to 1993–94 the Government relied heavily on external

Figure 2.9 **Government Expenditure, 1982–2000**



Source: Central Bank of Samoa.

Figure 2.10 **Government Budget, 1982–2000**



Source: Central Bank of Samoa.

financing, mainly on concessional terms from international agencies. Net external borrowing increased to 12–14 percent of GDP in the early 1990s. As the overall deficit declined, domestic financing tended to become more important, with the notable exception of the 1999–2000 budget. Most of the external financing was on concessionary terms, so that the external debt burden has not been a problem. At the end of 1998, total external debt was around 73 percent of GDP, with around 94 percent of the debt being government debt, most of it on concessionary terms.

By 1995–96 the fiscal situation had stabilized and a small overall budget surplus was realized, mainly reflecting a strong revenue performance. A small surplus was again realized in 1996–97, for the same reason. The original budgets in these years had anticipated budget deficits of 3.9 and 2.9 percent of GDP, respectively, suggesting that the outturn had a significant contractionary impact.

The 1997–98 budget provided for a surplus with respect to current expenditure and revenues and a near-balanced position overall. The estimated outturn was an overall surplus of 2.4 percent of GDP and a current surplus of around 6 percent of GDP. The result mainly reflected lower than expected expenditures. A feature of the 1997–98 budget was the introduction of an output-based Performance Budgeting system. In line with the Government's priorities, the resources allocated to both health and education were increased (Table A14) and financial liberalization reforms were announced.

The 1998–99 budget also provided for a modest current surplus and near overall balance. Provisional figures suggested that the outturn would be similar to budget expectations. The budget contained major changes to the tariff and tax system, with major cuts to most tariffs and a phasing out of the incentives scheme (discussed in more detail in the section on tariff and tax reform). Health and education remained priority sectors.

For 1999–2000, a surplus of 3.4 percent of GDP is being budgeted for the current position and a deficit of 3.2 percent of GDP for the overall budget. Given the budget outcomes in the previous three years and in view of the fact that the overall deficit is related to development expenditure that will be financed by concessional borrowing, the budget position is considered reasonable and manageable in terms of its macroeconomic impact. The domestic borrowing requirement is expected to be negative, contributing to a buildup in government deposits in the banking system.

The 1999–2000 budget contained further important tariff and tax reforms and continued to emphasize health and education as priorities. Major development projects that were signaled to start in 2000 were a SAT\$35 million rural water-supply project spread over three years and

a major asset project funded by the World Bank entailing around SAT\$56 million spread over three years. The World Bank project would include upgrading the airport runway and terminal facilities as well as bridges and roads throughout the country. Other major infrastructure projects that were underway in 1999 were the OPEC-funded bulk fuel storage tanks and Japanese-funded Apia wharf developments. There was also significant building activity underway in the private sector, with the construction of new chanceries for Australia and New Zealand, a major office development funded by the Accident Compensation Board, and other investments in the manufacturing sector.

The Government has recognized the importance of fiscal prudence in providing the foundations for macroeconomic stability. An additional issue, however, is the size of the Government and its role in the economy. Over the longer term it is considered important to ensure that government expenditure does not dominate the formal economy in the way it has in the past. This has been recognized in the SES, but many departments and officials still struggle with the concepts and implementation and in some cases are undertaking activities that should be the concerns of the private sector. These issues are considered in more detail in subsequent chapters.

Tax and Tariff Reforms

Overview of Reforms in the 1990s

The Government has implemented a number of important tax and tariff reforms in the 1990s and particularly in the 1998–99 and 1999–2000 budgets. The recent tariff and tax reforms reflect the objectives of pursuing an open trade policy and an economically efficient taxation system.

Key reforms in the first half of the 1990s were the simplification of the income tax system so that most individuals did not have to submit a tax return and the introduction of a value-added goods and services tax (VAGST) in 1994. The former reform meant that for most workers the income tax on wages was effectively a payroll tax and this greatly simplified the administration of the personal income tax system. The introduction of the VAGST laid the foundation for subsequent reforms to the tariff system. Some changes to tariff rates were made in 1990, 1994, and 1996. The most significant changes were to lower the rates on some essential items and to lower the rate for raw materials from 42 percent to 35 percent.

Prior to the recent tariff and tax reforms, an extensive tax and tariff incentives policy had been in place. Under the Enterprises Incentives

and Export Promotion Act, domestic and export enterprises were able to obtain extensive tax and duty concessions. Investment incentives were available for a wide range of business activities, including agriculture and agricultural processing, fishing, forestry, handicrafts, factories of any kind, flowers and plant stock for export, hydroponics, research and development, banking, international shipping, hotels, insurance, telecommunications, international airlines, and private hospitals. The incentives included income tax holidays; concessional tax rates; and exemptions on customs and excise duties on raw materials, building materials, imported machinery, and vehicles. Market inquiries confirmed that the private sector regarded the duty concessions as the most important incentive provided.

The tariff structure entailed duty rates in *ad valorem* terms (for almost all products) levied on a *cif* cost, insurance, freight (Brussels) basis. They comprised a basic rate of 50 percent; 60 percent for luxury-type products; 35 percent on most inputs to production; 20 percent for various parts and other products; 10 percent on certain food and household goods such as butter, cheese, most meat and sporting goods; 5 percent on certain other food, insecticides, and seeds; and 0 percent on certain basic foods such as rice, flour, sugar, salt, milk, canned fish, some meat, medicines, and fertilizer. A 10-percent VAGST was payable on all consumption, including imports, with exemptions for local primary (unprocessed) production, financial services, bus and taxi services, and a zero rating applied to exports, hospital, and educational services. The tariff concession system meant that duty collected was only about two thirds of what would have been collected in the absence of the concessions.

The dispersion of tariff rates according to whether products are consumption goods or used as inputs has a basis in terms of optimal taxation theory, where key principles are that business intermediate inputs should not be taxed at all and luxury goods should have higher tax rates than basic consumer products such as food. However, this theory applies to the taxation of both domestic and imported products; when it is applied in practice by levying tariffs (as opposed to a general goods and services tax), it can lead to important distorting effects by encouraging inefficient domestic production.

These distortional effects can be offset by applying appropriate excise taxes. However, the excises that applied in Samoa were mainly on luxury consumer products. This meant that the tariffs had protective effects, as reflected in the development of several industries involved in the processing of raw materials such as basic iron and steel products and processed food. The system also entailed high administrative costs and strong incentives to underreport values and use other means to

Table 2.4 **Summary of Tariff and Tax Changes in 1998–1999 and 1999–2000****1998–99 budget**

Major cuts to most tariffs as per Table 2.5, but some items at 0 percent moved to higher brackets (such as beef, potatoes, onions, tea, canned fish, fertilizers, disinfectants, insecticides, various agricultural equipment, machinery, and parts)

Increases in the tax-free threshold and the threshold at which the marginal rate of 20 percent applies

Removal of most excise taxes, with the exception of excises on alcohol, soft drinks, tobacco, petroleum products, and automobiles with an engine capacity greater than 2,000 cc

Removal of 1-percent foreign exchange levy

Introduction of a small business VAGST tax exemption threshold for businesses with an annual turnover of less than SAT\$52,000

Effective enforcement of taxation on the commercial income of churches

Phasing out of incentives scheme and abolition of tax concessions for new ventures

GATT (cif) valuation of import base rather than Brussels (cif) method

Increases in a range of fees and charges, such as motor vehicle registration and wharf charges

Implementation of price control orders and monitoring arrangements to ensure that effects of tariff cuts are passed on

1999–00 budget

Further cuts to import duty rates as per Table 2.5

Further increases in the tax-free threshold, the threshold at which the marginal tax rises to 20 percent, and the threshold at which the top marginal tax applies and reduction in the top marginal tax rate from 35 to 29 percent

Reduction in the company tax rate from 35 to 29 percent and the taxation of trust income in the same way and at the same rate as company income

Exemption of dividends from income tax

Introduction of more rapid depreciation of all plant and equipment (3 years) and buildings (5 years) for future acquisitions

Increases in taxes on petrol from 28 to 37 sene per liter, diesel from 26 to 38 sene per liter, and jet fuel from 18 to 21 sene per liter

Increases in stamp duty charges and for fees for loans guaranteed by the Government

Introduction of refundable deposit of 10 sene on certain drink bottles and cans and 10 sene per bag on plastic bags

Source: Samoa Treasury Department.

Table 2.5 **Tariff Rate Changes in 1998–1999 and 1999–2000**

Examples of key items	Old rate	1998–99 budget	1999–00 budget
Certain basic foods, medicine, fertilizer, Bibles	0	0 ^a	0 ^a
Milk, cream, seeds, insecticides, garden tools	5	5	5
Butter, cheese, most meat, cooking gas, sporting goods	10	10	10
Computers, most mechanical parts, tools, larger buses	20	15	10
Most business inputs	35–42	15	10
Most consumption goods	50–60	20	10–20 ^b

Notes: a. Various agricultural inputs were at 0 and were increased to 5, 15, or 20 percent in 1998–99, then reduced to 10 percent in 1999–00. In 1998–99, tariffs on fertilizers, disinfectants, and insecticides were increased from 0 to 5 percent; tariffs on agricultural pumps, ploughs, cultivators, seeders, and other appliances and tractors were increased from 0 to 15 percent; and tariffs on tires and tubes were increased from 5 percent to 20 percent.

b. Those relating to building, construction, certain industrial inputs, furniture, floor coverings, linen, air conditioners, fans, television, electrical wiring, tractors, and special purpose vehicles were reduced to 10 percent.

Source: Samoa Treasury Department.

avoid the payment of duty, including smuggling. Much retailing and wholesaling activity was effectively shifted offshore to American Samoa.

The Government recognized that the investment incentives policy was creating economic inefficiencies and inequities and that the tax concessions approach had generally not been effective in promoting efficient investment and facilitating economic growth. Major tax and tariff reforms were introduced in the 1998–99 budget and further reforms in the same direction were included in the 1999–2000 budget.

The tariff and tax reforms were expected to mean improvements in equity, transparency, and certainty in the application of tariffs and revenue laws and to enhance economic efficiency and growth prospects. The tariff changes over the two budgets are summarized in Tables 2.4 and 2.5.

Assessing the Effects of the Reforms

Generally the reforms have been well regarded by the business community and have contributed to a reduction in inflation. In terms of economic efficiency, the general direction of the reforms is also supported. However, there are a number of issues that need some consideration before further changes are made.

An important principle in assessing the economic efficiency of a tax system is that genuine business inputs in the form of raw materials, intermediate goods, and capital expenditure should not be taxed at all. In addition, taxation should focus on consumption rather than income

or production in order to reduce inefficiencies in savings decisions. This efficiency principle also needs to be balanced by equity considerations and externality-type effects when tax changes are made. The tax and tariff reform package has been designed with these various considerations in mind and is generally considered to be an effective reform.

However, one aspect of the reforms is that there are many sectors that are now paying a 10-percent duty on business inputs, whereas prior to the reforms they paid nothing because of the concession system. The concession system was so widespread that it applied to virtually all manufacturing activity, some parts of which are now under pressure as a result of the reform. Further, investment proposals in manufacturing have dried up. For agriculture, there were various inputs where a zero tariff applied rather than the concession system and these were increased to 5 or 15 percent in the 1998–99 budget. Tires and tubes for tractors were increased from 5 to 20 percent. In 1999–2000 reductions were made to a maximum of 10 percent. From a strict economic efficiency perspective it would have been preferable not to increase these tariffs and to have addressed concerns about the lack of taxes in agriculture directly with an income tax.

The point is that the concession system could not be justified in economic efficiency terms, but zero tariffs and other taxes on all genuine business inputs can be justified. Indeed, the validity of this point seems to have been recognized in the tariff cuts to some capital items and construction materials. However, consideration should be given to reducing the tariffs on genuine business inputs to zero as soon as possible.

As to equity, the lifting of the tax-free threshold and the continued exemption of fresh food from the VAGST are progressive in themselves in terms of their impact on lower income groups. However, the reduction in marginal income tax rates in conjunction with the scale of the reductions in excise tax and duties for luxury products is not likely to have progressive effects on income distribution. The scale of the reductions is well illustrated in the 1998–99 Budget Statement (p. 90):

The combined effects of these cuts mean that the price of some goods will drop significantly. For example, the combined duty and excise on a new car with a landed value of \$20,000 was previously \$25,000, but will now be only \$4,000. The combined duty and excise on a television set worth \$500 was previously \$370 but will now be only \$8. On corrugated iron with a landed cost of \$100 the duty and excise will drop from \$35 to \$15.

Further Reform Considerations

In addition to equity considerations, another important efficiency principle in the design of taxes for consumption goods is that, because it is not possible to tax leisure directly, there should be relatively higher taxes on complements to leisure. In recognition of these considerations, there is a concern that excise taxes on luxury products should not have been reduced as much as they were. In addition, from an equity perspective there would not appear to be any case for further reductions in the marginal tax rate for some time.

One example of a tax/charge that should be increased further is the airport departure tax, which is currently only SAT\$30 for all travelers. Although this was recently increased from SAT\$20, it is still relatively low and tourists should be quite comfortable with paying rates similar to that levied in Australia or the US.

It has been suggested that tariffs on genuine business inputs should be reduced to zero. However, cars and building materials and certain other household items have both business and personal uses and it is not administratively efficient to develop a system to identify the separate uses. Thus, further tariff cuts should apply only to products that are most likely to be mainly for business use.

It should be noted that primary production (agriculture, fishing, and handicrafts) and income earned by ministers of religion are not taxed. The exemption of low-input agriculture and fishing may have been valid on equity grounds in the past, but the recent changes to raise the tax-free thresholds to SAT\$10,000 make such an argument redundant now. In addition, the exemption for primary production means that high-income commercial farming and fishing are operating free of any substantial tax. This is clearly not justified from an economic efficiency perspective.

The 1998–99 budget signaled a commitment to enforce the existing provisions that make the commercial income of churches subject to income tax. However, it is still the case that the income of ministers of religion is not taxed. It is understood that the average income of many ministers of religion is many times that of their constituents, so that from an equity or economic efficiency perspective the tax-free status cannot easily be justified. It is also notable that ministers of religion did not always enjoy official tax-free status, as the exemption was only formally introduced in 1988. In return for the fair payment of taxes, all individuals benefit from the various services provided by the Government either free or at very low prices (roads, law and order, education, health services, telecommunications, and other utilities). Given these considerations, it is not unreasonable for the community to expect that

all residents should make a reasonable and equitable contribution to such government services. Changing the tax status of ministers of religion would, however, be likely to meet widespread community resistance; effective consultation with the community would clearly be needed before changes were made. The key point is that such matters should be made transparent to the general public so that effective consideration can be given to an appropriate policy.

As noted, the tax system may at times need to take account of externalities (the unpriced costs some individuals impose on others because of their actions). The introduction of a container deposit scheme and a tax on plastic bags in the 1999–2000 budget is an example of a tax response to environmental problems caused by packaging. It may be that other measures such as educational awareness and litter fines would have been a better mechanism, but the situation is difficult to evaluate with the information available.

It is recognized that taxes on alcohol, soft drinks, and tobacco are levied for both revenue and health reasons. As will be noted in the chapter on education and health, the major health issue is the damage caused by excess weight and the preference many people have for certain foods, especially fatty foods, that are highly damaging to health. Consideration should be given to levying higher tariffs or excises on the main imported and local products that are not considered to be components of a healthy diet.

The introduction of more rapid depreciation of capital is considered to be an important change and one that will contribute to economic efficiency. It is often not well recognized that immediate write-off of all genuine business capital with full carry-forward of all genuine business losses is consistent with economic efficiency and indeed can be especially helpful to business in the early stages of an operation. It would, however, be most effective to allow immediate write-off as part of a package where other reforms were introduced, such as removal of the tax-free status of commercial agriculture and fishing.

Although depreciation policy has changed, in early 2000 the Internal Revenue Department had still not changed its depreciation schedule. It was also the case that the Trade and Investment Promotion Unit had not adjusted its promotional material to highlight this important policy change.

In relation to other desirable changes, in the following chapter it is suggested that the stamp duty system needs to be streamlined and not used as a means of raising revenue.

The right of the Minister of Finance to grant deferrals of duty and excise remains a weakness. In accordance with the criteria of transparency, equity, and certainty of application, this right should be repealed.

In terms of administration of the tax system, one important issue is ensuring the prompt refund of VAGST for sectors that have zero rating. It is often difficult for government officials without relevant business experience to appreciate the administrative and financial costs and pressures that ensue when the tax office is slow to refund money that is genuinely due. Improvements in this area would help to generate good will for the government in its relationship with the private sector as well as making it easier for business to survive and prosper.

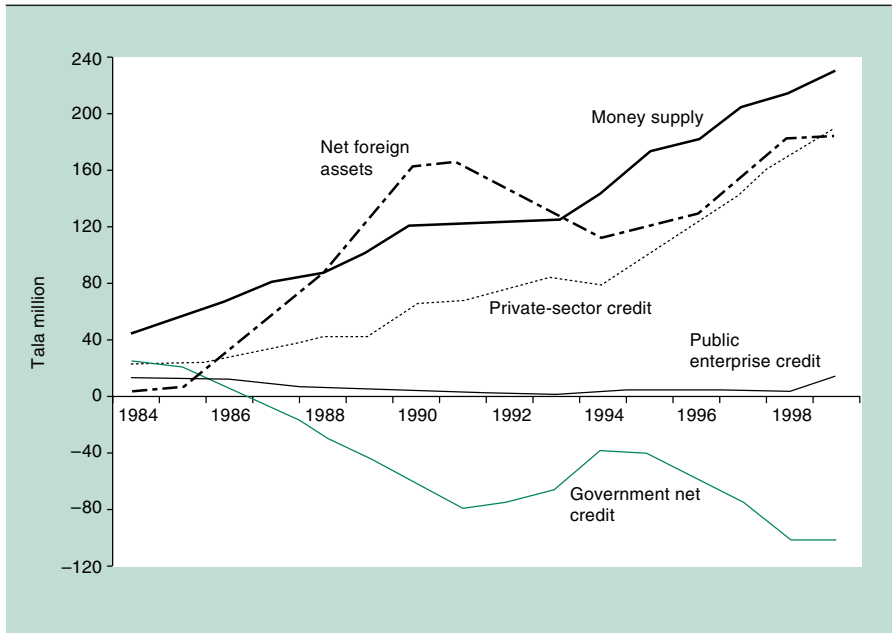
Another suggestion that may be worth investigating is to simplify the tax base for small to medium-sized businesses. In the 1998–99 budget, businesses with a turnover of less than SAT\$52,000 were made exempt from collecting the VAGST and forwarding it to the Internal Revenue Department (but not from paying the VAGST on purchases). This is considered likely to lower overall administration costs without an adverse impact on economic efficiency. Advice from the Internal Revenue Department was that 10 percent of registrants (the larger companies) pay 80 percent of VAGST and about 40 percent pay 90 percent of VAGST. A variation of the exemption concept for small business would be to estimate, based on sales revenue, the value-added tax base of businesses with a turnover above SAT\$52,000 but below a reasonable higher limit (up to the 60 percent of businesses that only pay 10 percent of VAGST) and apply an appropriate annual levy. An objection process could be available for those who consider that this would disadvantage them and they could be allowed to operate under the existing system if they preferred. Such a scheme could greatly reduce administration costs for both Government and business.

In relation to the income tax, it is the case that a fringe benefits tax formally applies: cars, rent, or any other noncash income are taxable at the same rate as cash income. However, inquiries confirmed that this provision was not being effectively enforced by the Internal Revenue Department. It is likely that more effective enforcement could yield considerable revenue.

Monetary Policy Aspects

The large inflow of aid in the second half of the 1980s enabled the Government to build up sizeable deposits with the banking system, so that net credit to Government became negative in 1987. The negative credit position of the Government increased each year until 1993, then declined substantially in 1994, but still remained negative. This was despite substantial overall deficits being recorded in the 1992–95 period. In the 1995–98 period, the Government's deposits with the banking system

Figure 2.11 **Money Supply, Net Foreign Assets, Government Net Credit and Private Credit, 1984–1998**



Source: Central Bank of Samoa.

built up again and remained at relatively high levels through most of 1999. A large negative net credit position of Government can be a feature of developing countries, particularly in a period of substantial external aid.

In the wake of the cyclones, the main aim of monetary policy was to promote financial stability and, in particular, avoid a resurgence of inflation. Soon after Cyclone Ofa hit in early 1990, average interest rates for lending reached about 17 percent. The Central Bank of Samoa lowered interest rates administratively to 12 percent to aid recovery, but in early 1991 requested commercial banks to restrict lending to a set level and to give priority to lending for productive purposes. The tight monetary conditions and increased food supply were reflected in a negative inflation rate in 1991. In December 1991 Cyclone Val struck, causing extensive damage. In the first four months of 1992, the Central Bank initiated emergency credit arrangements for reconstruction purposes only and contained overall credit growth such that broad monetary growth was less than 1 percent in 1992 and around 2 percent in 1993.

In 1994, the overall money supply increased by 13 percent, as Government reduced its net deposits substantially to help finance its budget

while private-sector credit declined in total. In 1995, the position was reversed, with rapid growth of credit to the private sector, a small buildup of government deposits, and a buildup of net foreign assets, leading to growth in the money supply of around 22 percent. In the 1996–99 period, private-sector credit continued to grow at a rate of 17–18 percent, while the net credit to the Government declined and was reflected in a substantial buildup of government deposits. The overall money supply grew at an average rate of 7.6 percent in the 1996–98 period and was growing at an annual rate of about 11 percent in the third quarter of 1999.

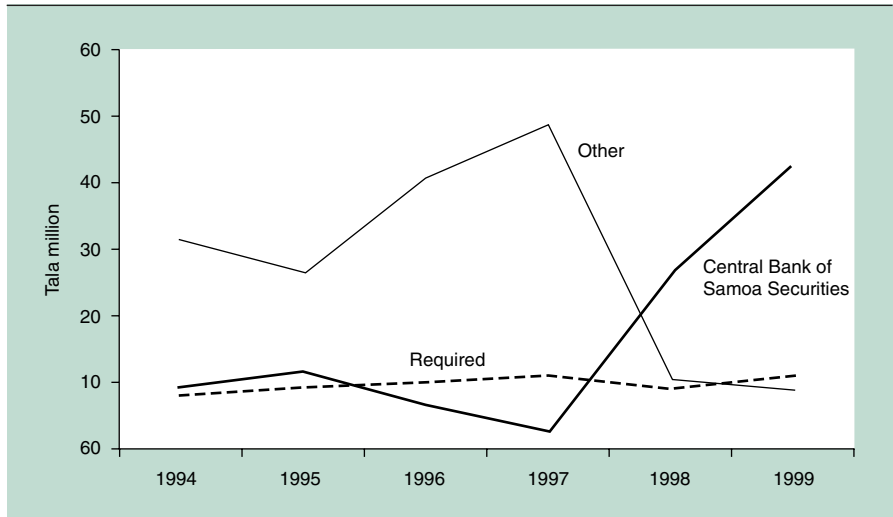
Prior to the financial liberalization program that was introduced in January 1998, the Central Bank controlled monetary conditions by direct and indirect quantitative controls on lending and direct controls over commercial bank interest rates. The indirect controls included requirements for a statutory reserve ratio and a liquid assets ratio. Although the Central Bank could control commercial bank lending, it had no direct control over the nonbank financial institutions.

An important issue for the Central Bank in the immediate period following liberalization was the level of excess liquidity in the banking system and the need to reduce this liquidity to ensure that credit growth was not excessive. In mid-1995 the excess liquidity of the banks was substantial, as reflected in commercial balances at the Central Bank in excess of requirements. However, the issuance of Central Bank securities since early 1998 had by September 1999 soaked up most of the excess liquidity (see Figure 2.12). This was a good outcome in the immediate period following liberalization, but it also introduced an additional problem in terms of the cost of servicing the securities (see section on Central Bank reforms).

In recent years, the objective of monetary policy has been to keep inflation below a target level (at present 3 percent) while maintaining adequate foreign reserves (at present a target of six months' import cover), facilitating adequate lending to the private sector, and holding the real exchange rate roughly constant, so as to maintain international competitiveness. These objectives have been broadly achieved in the past two to three years. However, it could be argued that the small real exchange-rate appreciation should at least be reversed to complement the incentive effects of tariff reform (see also the section on exchange rates and the balance of payments).

Experience with financial liberalization in many countries is that it normally leads to a strong credit boom which can lead to balance of payments pressures and subsequent inflationary effects. There is evidence of strong credit growth in Samoa's private sector, particularly in the wholesale and retail trade sectors and for the purchase of land and

Figure 2.12 **Commercial Banks' Balances with Central Bank and Holdings of Central Bank of Samoa Securities, 1994–1999**



Source: Central Bank of Samoa.

construction. This is not necessarily a problem, but will need to be monitored by the Central Bank to avoid macroeconomic imbalances. This is all the more important given that current fiscal policy is likely to have an expansionary impact.

Given the stage of economic development in Samoa, it would be preferable if the increased access to credit that has occurred meant increased finance for efficient productive activity rather than for consumption. In a market-based financial system, it is not really the role of the monetary authorities to direct the allocation of credit across sectors. However, there is a role for the Government to ensure that there are no distortions in the tax system or with industry policy such that increased credit supports inefficient economic activity or excessive consumption in an environment where domestic savings need to be encouraged.

Financial Reforms

Rationale and Expected Effects

In 1996, the Government announced plans to establish a market-based financial system. The reforms were to be supported by a loan from the Asian Development Bank (ADB). Prior to the introduction of the reforms,

interest rates were set administratively and the money supply was controlled through statutory reserve and liquidity ratio requirements. Since there was significant variability in inflation, this meant there were wide swings in real interest rates and at times significant imbalances in the supply and demand for credit.

In this system, the major problem was the adverse effects associated when credit rationing occurred. Another problem was that prudential controls were inadequate and did not extend to the nonbank financial institutions, of which the most important were the National Provident Fund and the Development Bank of Samoa (DBS). This alleviated some of the impact of rationing. The loan pricing of such institutions did not allow for the pricing of credit risk, however, and interest rates were determined internally, without an effective linkage to market conditions. This reduced access to credit for projects with higher risk and affected the ability of the Central Bank to influence monetary conditions. The lack of external supervision of the nonbank financial institutions also raised concerns about the integrity of the financial system. The banks tended to favor the lowest-risk borrowers and had little incentive or ability to compete. In addition, in the 1993–96 period, interest rates on deposits were negative, adversely affecting the incentive to save. Over time, such a system means that the economy's most productive opportunities are not effectively exploited and economic growth prospects are thereby lowered.

The financial reforms that have been implemented were based on instituting a more market-based role for the Central Bank, with the removal of direct credit and interest controls complemented by appropriate legislated changes and institutional improvements. The aim was to achieve a more efficient and more competitive financial sector to facilitate economic growth and a strong private-sector performance.

Outline of the Reforms

The financial reforms have comprised the following steps:

- Removal of all credit ceilings and interest rate controls on January 1, 1998.
- Gradual phasing out of the liquid assets ratio by end-September 1999.
- Use of auctions of Central Bank bills as the primary monetary policy instrument.
- Permission to banks to make forward exchange contracts from mid-1998 and removal of a 1-percent levy on foreign exchange sales on January 1, 1999.

- Removal of certain foreign exchange controls associated with current account transactions.
- Permission for approved entities to operate as foreign exchange dealers effective August 1999.
- Closure of the export financing facility, which provided funds at subsidized rates mainly for agricultural exporters.
- Strengthening of the capacity of the Central Bank to manage liquidity and undertake prudential supervision and strengthening of the capacity of the National Provident Fund and DBS.

The statutory reserve deposit has been redefined as a direct proportion of bank deposits and set at 5 percent, slightly less than prior to the reforms. There are still a number of foreign exchange controls. These include requirements for all net foreign exchange proceeds from exports to be repatriated by selling them to a resident commercial bank, no foreign exchange lending by resident commercial banks without approval, some controls on repatriation of profits and travelers' funds, and various controls relating to the capital account.

It is notable that the reforms did not formally entail improved prudential control of the nonbank financial sector, which prior to the reforms was a more important source of credit to the private sector than the banks. However, the key nonbank financial institutions have moved to risk-based lending procedures and have strengthened their credit policy guidelines and their institutional capacity. Agreements were also reached on external monitoring arrangements in late 1999. Implementation was expected in 2000.

Assessing the Effects of the Reforms

Financial liberalization can be difficult to implement effectively, particularly where the objectives include competition and the market is very small. The designers of the reform program suggested a number of effects that they considered could occur as a result of the reforms to the financial sector and to public enterprises. Some of these effects, such as the impact on overall economic growth, inflation, and government recurrent expenditure, are virtually impossible to isolate from other influences in the economy. However, it is useful to review a number of monetary indicators before and after the financial reforms to try to determine if there has been a discernible impact. Some key indicators are presented in Table 2.6 for the two years prior to the reforms and the period from January 1998 to end-September 1999 (on an annualized basis).

Table 2.6 **Indicators of Monetary Conditions, 1996–1997 and 1998–1999 inclusive**

	1996–97	1998–99
Private sector credit growth annual average	10.6	13.6
Average inflation	6.2	1.5
M1/M2	32.1	30.4
Weighted average lending/deposit interest rate margin	7.0 ^a	7.6 ^b

Notes: a. December 1997.

b. December 1999.

Source: Central Bank of Samoa.

It is notable that private-sector credit (from both commercial banks and nonbank financial institutions) has been growing at an annualized rate of 13.6 percent in the period 1998–99 inclusive, compared with a rate of 10.6 percent in the two-year period prior to the reforms. This is an encouraging development given the reduction in average inflation from more than 6 percent to 1.5 percent in the same period.

Another aspect of financial liberalization is the increased incentive it provides for people to use the formal financial system and to increase their holdings of fixed-term deposits. Some indication of this is provided by the ratio of narrow money (M1) to broad money (M2). This ratio has declined on a before and after basis, although it should be noted that it was declining on a trend basis prior to the reforms so that it is too early to make a definitive assessment about this aspect of financial development.

Following the deregulation of interest rates, banks initially introduced base lending rates of 11.75 percent to 12 percent, with additional risk margins of up to about 2 percentage points. However, rates subsequently declined to 10.5 to 11.5 percent by end-September 1999, depending on the bank, but with the scope for slightly wider risk margins. This has meant a slight widening of the average margin between lending and deposit rates from around 7 percent prior to deregulation to 7.6 percent in December 1999. This is not necessarily a bad thing, to the extent that it reflects more effective pricing for risk and improved access to credit for certain private-sector projects that would not otherwise have had such access. Further, market inquiries suggested that competition in the finance sector has increased following deregulation.

It is also of interest to examine real deposit and lending rates over the 1990s. Table 2.7 provides data on nominal deposit and lending rates, inflation, and real deposit and lending rates for 1989–1999. As is often the case with systems that administer interest rates directly, real interest rates displayed considerable variability prior to deregulation and at times

Table 2.7 **Nominal and Real Interest Rates, 1989–1999**

	Nominal deposit rates	Nominal lending rates	Inflation	Real deposit rates	Real lending rates
	3 months	Base		Base	3 months
1989	12.0	17.0	6.2	5.7	10.2
1990	8.3	13.3	15.1	-5.9	-1.6
1991	8.3	14.8	-1.3	9.7	16.3
1992	6.4	12.9	8.8	-2.2	3.8
1993	5.5	12.0	1.7	3.7	10.1
1994	5.5	12.0	12.1	-5.9	-0.1
1995	5.5	12.0	-2.9	8.7	6.3
1996	5.5	12.0	5.4	0.1	6.3
1997	5.5	12.0	6.9	-1.3	4.8
1998	5.5	11.25–11.5	2.2	3.2	8.9–9.1
1999	5.5	10.75–11.5	0.7	4.8	10.0–10.7

Sources: Central Bank of Samoa; various Bulletins.

large negative rates were observed, particularly for savings. Negative interest rates are not likely to be a feature of a liberalized financial system and rates have been positive since deregulation.

In terms of an immediate stimulus to the economy, it would normally be expected that the key reform was the removal of credit controls. It must be recognized, though, that the Central Bank credit controls did not apply to the nonbank financial sector and that the National Provident Fund was a major source of credit. It is useful to examine lending to the private sector in more detail and over a slightly longer time frame. Data on the distribution and growth of credit to different sectors for both bank and nonbank credit are presented in Tables 2.8 and 2.9.

For the bank sector, private-sector credit growth was 19 percent in 1998 and 17.6 percent on an annualized basis for the first three quarters of 1999. This is less than the average of 22 percent for the 1995–97 period, which was boosted by strong growth in building activity that reflected the impact of the rehabilitation program. However, it should also be recognized that inflation is considerably lower since the introduction of financial liberalization, suggesting that the impact has been more significant in real terms (assuming the velocity of circulation of money was reasonably stable over the time frame).

For the nonbank sector, which was not restrained by official credit controls, private-sector credit growth was 10.2 percent in 1998 and 8.0 percent for the first half of 1999 on an annualized basis. This compares with an average growth rate of 5.7 percent for the 1995–97 period and 4.4 percent in 1997.

Taken together the data suggest that in the mid-1990s, the nonbank

Table 2.8 **Commercial Banks' Loans to Private Sector, 1994–1999**

	1994	1995	1996	1997	1998	1999
	percent of total					
Agriculture, forestry and fisheries	2.1	1.4	1.5	1.1	2.0	2.4
Manufacturing	24.1	24.6	19.6	17.1	17.4	13.4
Building and purchase of land	23.4	39.4	30.4	42.0	39.7	38.5
Electricity, gas and water	0.1	0.1	0.1	0.2	0.1	0.2
Trade	15.8	15.2	17.7	9.5	13.5	17.5
Transportation, storage and communication	4.6	4.6	6.6	4.6	6.2	5.8
Professional and business services	6.9	6.4	13.4	11.9	11.1	12.1
Other including other personal	23.0	8.3	10.7	13.6	10.1	10.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
Total in Tala million	75.8	99.1	117.3	137.7	163.8	185.4
Total growth		30.7	18.4	17.4	19.0	17.6 ^a
Inflation rate	12.1	-2.9	5.4	6.9	2.2	0.3

Note: a. annualized.

Source: Central Bank of Samoa.

Table 2.9 **Nonbank Financial Institutions' Loans to Private Sector, 1994–1999**

	1994	1995	1996	1997	1998	1999
	percent of total					
Agriculture, forestry and fisheries	14.7	14.4	14.5	14.2	14.2	13.5
Manufacturing	3.7	5.3	5.4	5.6	5.0	3.9
Building and purchase of land	41.7	41.5	42.9	46.1	48.9	50.0
Trade	14.5	13.2	12.3	11.4	12.2	12.0
Transportation, storage and communication	5.5	3.5	4.2	3.6	2.9	4.3
Professional and business services	3.8	5.4	5.1	4.7	4.0	3.7
Other including other personal	16.1	16.7	15.3	14.9	13.5	12.6
Total	100.0	100.0	100.0	100.0	100.0	100.0
Total in Tala million	133.3	142.1	150.7	157.3	173.4	183.8
Total growth		6.6	6.1	4.4	10.2	8.0 ^a
Inflation rate	12.1	-2.9	5.4	6.9	2.2	0.3

Note: a. annualized.

Source: Central Bank of Samoa.

sector was a larger source of credit than the bank sector, but that bank-sector credit has been growing at a much faster pace prior to and since the financial liberalization reforms. At this stage it appears that financial liberalization has had a modest impact on aggregate private-sector credit growth in the bank sector and a stronger impact in the nonbank sector, compared with the situation prior to the reforms. However, as a result of more rapid credit growth in the bank sector for a number of

years, it is now similar in size to the nonbank finance sector in terms of total credit outstanding.

Turning to the sectoral impacts, for the bank sector the main developments in 1998 and 1999 have been a reduction in credit for manufacturing activities and, to a lesser extent, the residual "other" category and a substantial increase for wholesale and retail trade businesses. There has been a small increase for agriculture, forestry, fisheries; transport; storage; and communications. However, the increase for retail and wholesale trade means that the share of credit in the third quarter of 1999 was similar to the level in 1996 prior to a substantial contraction in 1997. For the nonbank sector, the main sectoral development has been an increased share of lending for building and the purchase of land.

With respect to auctions of securities, regular auctions were conducted in 1998 and 1999, with the three commercial banks lodging competitive bids and more than 90 percent of auctions being fully subscribed. There has been very little bidding by nonbank financial institutions and as of October 1999 no secondary trades had occurred, although this is not surprising in such a small market. As excess liquidity is removed and a computerized system is developed, and as the Central Bank will only discount Central Bank securities at one percentage point above the maximum of the yield at issue or the yield at last auction, there should eventually be some growth in the interbank market as banks manage their liquidity on a day-to-day basis.

Good progress has been made with a capacity-building program at the National Provident Fund and the DBS. Both entities have moved to a policy of full market-based interest rates and established improved credit policy guidelines. In the case of the National Provident Fund, the rate had been 9 percent for virtually all lending, regardless of risk—a major weakness given that it is a superannuation fund for members and not a development bank. It has now adopted a base rate of 10.5 percent, with risk-weighted margins normally up to 2.5 percentage points. As a consequence, the average interest rate is 12–13 percent and comparable to market rates. Similar changes have been made at DBS, with a key change being the elimination of all concessionary lending to agriculture.

In summary, the impact of financial liberalization on credit expansion in the private sector has been positive so far. Unexpected outcomes have been the substantial reduction in inflation, much of which can be attributed to exchange rate policy and tariff cuts and an increase rather than a decrease in interest margins. It is very early in the financial reform process and at this stage there are no major concerns with what has been implemented so far.

Economic growth is currently quite strong, but this strength is largely provided by the dramatic expansion of the fishing sector, which probably would have grown even in the absence of the reforms (see Chapter 9). The economy grew in real terms by 1.4 percent in 1997 and 3.1 percent in 1998. The fishing sector grew by 21 percent in 1997 and 27 percent in 1998. If the fishing sector had instead grown at 3 percent in each of these years and other sectors recorded the same actual growth as realized, then the overall economic growth would have been 0.6 percent in 1997 and 1.2 percent in 1998. From this perspective it could hardly be argued that the reforms have boosted overall economic growth in these years. From market inquiries and assessment of sectoral GDP and lending data, one of the main impacts of the tax and tariff reforms and the financial liberalization reforms so far has been a boost to the retail and wholesale trade sector and a reduction in manufacturing activity.

Although it is difficult to demonstrate that the reforms have boosted overall economic growth, the reforms are still considered to have entailed important benefits, particularly in terms of improving the relationship between business and Government and achieving a consensus view on economic strategies. In addition, the benefit to many individuals and businesses of greatly improved access to finances should not be underestimated. The reforms are also expected to provide a platform for strong growth in the near future.

Central Bank Reforms

It is notable that the Treasury holds some deposits with the Central Bank and substantial foreign assets in its own accounts. As of end-September 1999, the Treasury had some SAT\$69 million in net foreign assets and around SAT\$20 million in deposits at the Central Bank, while the Central Bank had net foreign assets of some SAT\$102 million. This separation of the foreign reserves is unusual and may create bad impressions about the independence and effectiveness of the Central Bank.

An additional complication is that the introduction of a market-based monetary policy in January 1998 has meant increased costs in servicing the securities. The Central Bank has increased its holdings of Central Bank securities from less than SAT\$3 million in late 1997 to SAT\$42 million in September 1999. At present, the Treasury is funding the interest costs of these securities from the budget, with the funding being sourced from an ADB loan.

The balance sheet of the Central Bank may need strengthening, as it has no government securities and it has significant liabilities in

the form of sizeable Treasury deposits. Further, it does not appear to have sufficient assets to service the ongoing costs of Central Bank securities.

As the financial system develops, the balance sheet of the Central Bank will be of interest to financial institutions and will affect their assessments of the likely risk and effectiveness of the financial system. Assessment of the balance sheet of the Central Bank, including the adequacy of foreign reserves, and of the ability and efficiency of the Central Bank in undertaking securities transactions to influence monetary conditions, is normally an aspect of country risk assessments of major foreign lenders and investors. It is considered that the present arrangements, where not all of the foreign reserves are under Central Bank control and the Bank has difficulty in servicing outstanding securities from its own assets, would generally be regarded as a weakness by major sources of foreign funds. Normally this would mean a higher risk premium and cost of capital than would otherwise apply, although it is true that there are probably not many serious large-scale foreign investment inquiries.

The arrangements are also inconsistent with the fundamental principles underlying the budget and public-sector reforms that have been underway for some time. These principles include clear objectives, operational autonomy, and effective accountability for performance. Under the present arrangements, the operational autonomy of the Central Bank is clearly restricted and the accountability for monetary policy is blurred because of the current financial and operational roles of the Treasury. In early 2000, the Government was well advanced in considering these issues, with technical assistance from international agencies. In particular, options were being developed to either strengthen the balance sheet of the Central Bank or create a financing arrangement with similar effect.

There is also a problem in determining the appropriate size of the auctions of Central Bank of Samoa bills. Forecasts of government receipts and payments are needed on a weekly basis to assist in estimating liquidity requirements, but the Treasury has experienced difficulties in preparing such forecasts.

Although the financial sector reform program provides for the extension of prudential supervision by the Central Bank of the nonbank financial institutions, formal arrangements have not been established. Although an in-principle agreement has been reached, appropriate amendments to the Financial Institutions Act and to the separate Acts for both institutions have yet to be made.

Other Financial Reforms and Issues

A long-term strategy for full liberalization of foreign exchange controls is being developed. A phased gradual approach is recommended, given the limited level of development of financial markets and institutional capacity in Samoa.

In December 1998, a number of amendments were made to the National Provident Fund Act. These included provisions to make the interests of members paramount; to allow the fund to invest up to 10 percent of its investment funds offshore; to allow the fund to invest for longer than 12 months without prior approval of the Minister of Finance; and to allow members to withdraw their account balance at retirement in one lump sum from age 55, as well as allowing withdrawal prior to this age under certain circumstances.

The change to make the interests of members paramount is important, as provident funds can often get involved in local investments for development purposes that are contrary to maximizing the returns to members. In early 2000, there was a proposal for an equity fund to be established in Samoa with donor support. Government and donor-funded equity funds may be important for economic development purposes, but it is considered that they are not likely to provide commercial risk-adjusted returns to the funds invested. Consistent with the explicit requirement to make the interests of members paramount, the National Provident Fund should only be involved in equity investments where good risk-adjusted returns will be made for members. Economic development should not be a consideration of the fund where there is any conflict at all with maximizing the returns to members.

The relaxation of the restriction on offshore investment is also welcomed. However, if proper prudential controls are in place and the interests of members are paramount, there should be no separate limits on the proportion of funds that can be invested offshore. Such controls on offshore investment are also in conflict with the objective of a market-based, competitive financial system.

Finally, the impact of allowing members to withdraw all of their funds at retirement from age 55 will elevate the importance of prudential controls and actuarial capacity at the National Provident Fund.