First published August 1999

ISBN 971-561-253-9

Publication Stock No. 080499

Published by the Asian Development Bank
P.O. Box 789, 0980 Manila, Philippines

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AMI	–	Air Marshall Islands
AMU	–	Asset Management Unit
AusAID	–	Australian Agency for International Development
BVDC	–	Business Ventures Development Corporation
CBS	–	Central Bank of Samoa
CIDB	–	Cook Islands Development Bank
CRP	–	Comprehensive Reform Program
DBV	–	Development Bank of Vanuatu
EMPAT	–	Economic Management and Policy Advisory Team
ERP	–	Economic Reform Program
ESCAP	–	Economic and Social Commission for Asia and the Pacific
FSM	–	Federated States of Micronesia
FSP	–	Financial Sector Program
FY	–	Fiscal Year
GDP	–	Gross Domestic Product
GNP	–	Gross National Product
ICSI	–	Investment Corporation of Solomon Islands
IMF	–	International Monetary Fund
MFEM	–	Ministry of Finance and Economic Management
MOU	–	Memorandum of Understanding
MTBF	–	Medium-Term Budget Framework
NBV	–	National Bank of Vanuatu
NDC	–	National Development Council
NPF	–	National Provident Fund
NZODA	–	New Zealand Overseas Development Authority
OECD	–	Organization for Economic Cooperation and Development
OPO	–	Office of Pacific Operations
PAT	–	Policy Advisory Team
PDMC	–	Pacific Developing Member Country
PERCA	–	Public Expenditure Review Committee and Audit Act
PFTAC	–	Pacific Financial Technical Assistance Centre
PSC	–	Public Service Commission

PSIP	–	Public Sector Investment Program
PSRP	–	Public Sector Reform Program
PSU	–	Private Sector Unit
RIF	–	Reduction in Force Program
RMI	–	Republic of the Marshall Islands
RRP	–	Report and Recommendation of the President (ADB)
SIPEU	–	Solomon Islands Public Employees' Union
SOEs	–	State-Owned Enterprises
SOEMU	–	State-Owned Enterprises Monitoring Unit
TA	–	Technical Assistance
UNDO	–	United Nations Development Organization
UNDP	–	United Nations Development Programme
UNICEF	–	United Nations Children's Fund
US	–	United States
VAT	–	Value-Added Tax
VNPF	–	Vanuatu National Provident Fund

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Foreword

The 1990s has been a decade of major change for the Asian Development Bank and its Pacific Developing Member Countries (PDMCs). As the Bank has transformed itself from being primarily a project lender to being a broad-based development institution, a wave of economic, public sector and governance reform has broken on most PDMC shores. The Bank has assisted the reform process through provision of program loans and technical assistance.

This book presents the results of an assessment of Bank assistance to reform efforts in six PDMCs. The assessment was undertaken at the request of the Board of Directors of the Bank by an interdepartmental task force consisting of Cedric Saldanha (Chairperson, Office of Pacific Operations), Louis de Jonghe (Office of Pacific Operations), David Edwards (Economics and Development Resource Center), Manabu Fujimura (Economics and Development Resource Center), Michael Heppell (staff consultant, Strategy and Policy Office), Bruce Knapman (staff consultant, Office of Pacific Operations), and Salvatore Schiavo-Campo (Senior Advisor for Governance and Public Management). A summary report was prepared on the basis of individual country reports, which involved missions to the Cook Islands (October 1998), the Republic of Vanuatu (October-November 1998), the Federated States of Micronesia (January-February 1999), the Republic of the Marshall islands (February 1999), Solomon Islands (February 1999), and Samoa (March 1999). These reports are published in order to make the findings available to the Pacific community, external funding agencies, and the public at large.

Special acknowledgment is made of contributions to the individual country reports by Manabu Fujimura (Samoa, Vanuatu), Michael Heppell (Cook Islands, Federated States of Micronesia), and Salvatore Schiavo-Campo (Samoa, Vanuatu).

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1 AN OVERVIEW

1.1 Introduction

During the period 1995-1998, the strategic focus of the Asian Development Bank's operations in Pacific Developing Member Countries (PDMCs) shifted from sector and project lending to support for macroeconomic stabilization and structural adjustment, and public sector and governance reform. This was in response to specific economic conditions in various PDMCs and related responses by their governments, as described below. It was also consistent with the Bank's revised Strategy for the Pacific (ADB 1996), which was adopted in October 1995. This strategy notes that it is important that the Bank first assist PDMCs to get their economic policy and governance environments right, thus ensuring that follow-up sector and project investments achieve due returns. Hence, during 1995-1998, program lending in support of economic, public sector, and governance reforms assumed a significant proportion of the Bank's lending in the Pacific.

In late 1998, the Board of Directors requested the Management to assess this change of operational focus, and evaluate the Bank's assistance to date for reform programs in the Pacific. An interdepartmental task force undertook the evaluation of Bank assistance to six PDMCs: Cook Islands, Federated States of Micronesia (FSM), Republic of the Marshall Islands (RMI), Samoa, Solomon Islands, and Vanuatu. This chapter summarizes the assessment of the task force with regard to the following aspects of the reform programs in each country: (i) the context and triggers for the reform programs; (ii) the process of design, including the extent of ownership, participation and coordination of external assistance; (iii) the scope and content of the programs and their appropriateness to country circumstances and capacity; and (iv) implementation progress and results to date. From this assessment, a series of lessons for future application is drawn and presented in a concluding

chapter, which follows the chapters that present the individual task force reports on each of the six country programs evaluated.[1]

Some important caveats with respect to the conclusions of these evaluations should be noted. First, the reform programs are long-term processes that cannot be expected to have dramatic impacts on the quality of life in a period of two to three years. Second, the Bank's assistance is but one factor within the larger reform process, albeit often a very significant factor. The reform process is typically volatile, and is affected by substantial social and political pressures. Therefore periodic stalemates and occasional backtracking may occur. The task force's view is that this is to be expected in any country undertaking economic, public sector, and governance reform. The objective of the Bank must be to remain involved as a catalytic and facilitating agent, using its leverage to ensure that progress is maintained despite intermittent setbacks.

1.2 Context and Triggers of Reform

While the 1970s may be broadly described as the "decade of independence" for the Pacific, the 1980s were substantially the "decade of big government". Government expenditure as a percentage of GDP grew to one of the highest in the world, assisted by high aid inflows. Unfortunately, the quality of economic management did not always keep pace with the growth in expenditure, and concern grew over the "Pacific Paradox" - low rates of economic growth despite high levels of foreign resource inflows and high rates of investment. Paradoxical or not, the failure of output growth to outpace population growth was the fundamental long-term development problem addressed in the 1995 South Pacific Forum plan of action, which consisted of a range of economic and public sector reforms aimed at promotion of sustained growth (Duncan et. al. 1999). Urgency was added to reform efforts in a number of PDMCs in the mid-1990s, owing to the rather sudden development of macroeconomic instability. Fiscal crises catalyzed a wave of reform initiatives across 7 of the 12 PDMCs being assisted by the Bank.

[1] The country reports are presented as they originally appeared. Any major events subsequently affecting the reform processes are footnoted.

(Table 1.1 lists the program loan amounts to 6 PDMCs).[2] Thus the 1990s have emerged as the "decade of reform".

Table 1.1: Program Loans to PDMCs

PDMC	Date of Program Loan Approval	Loan Amount
Cook Islands	26 September 1996	$ 5.00 million
FSM	29 April 1997	$17.68 million
Marshall Islands	30 January 1997	$12.00 million
Samoa	19 February 1998	$ 7.50 million
Solomon Islands	27 August 1998	$25.00 million
Vanuatu	16 July 1998	$20.00 million

Source: ADB files.

The reform programs have been triggered by factors that are internal and external to each economy, although each factor has had a varying degree of influence in different countries.

- **Overwhelming debt burdens and a ballooning public sector create fiscal crises**. In the cases of the Cook Islands and the Solomon Islands, years of poor economic management, and unwarranted public sector growth, led inevitably to unsustainable budget deficits funded by domestic and external borrowing that led to unmanageable debt burdens. In parallel, an expanding public sector had crowded out private investment. While Vanuatu never had a debt burden of proportions similar to that of the Cook Islands or Solomon Islands, the external debt grew rapidly between the mid-1980s and mid-1990s, and unplanned provident fund payouts led to a similar fiscal crisis in 1998. The fiscal crises in these countries were so severe that it was not difficult to catalyze public support for the reform process.

[2] Nauru is the seventh PDMC being assisted by the Bank in its reform program. It is not covered by this book since the Bank's assistance was only approved in December 1998.

- **The prospect of declining external aid**. The governments of RMI and FSM did not adjust public expenditure to step-downs in United States Compact funding (although within the FSM federal system there was variation in this regard between the four states, while the national government's finances remained sound throughout because it retained 50 percent of shared revenue and 100 percent of the substantial fishing license fees). Expenditure levels, including heavy subsidies to state-owned enterprises (SOEs), were increased, with budget deficits being funded by external borrowings. In the RMI case, the limit to such borrowings was reached in 1995-1996 when government financial reserves were virtually exhausted and the Compact block or untied grant funding to 2001 had been almost fully collateralized. Recognizing the need for urgent fiscal adjustments, the RMI and FSM governments adopted reform programs, assisted by the Bank.

- **The Asian financial crisis**. Substantial falls in exports to the Asian region following the mid-1997 financial crisis have compounded the economic crises, particularly for Solomon Islands and, to a lesser extent, Vanuatu. Both countries have depended on Asian markets for their major commodity exports. While not the primary trigger of the reform process, the Asian financial crisis exacerbated their deteriorating macroeconomic situations.

- **Public pressure and political recognition of the need for reform**. The increasingly vocal peoples of the Pacific are now on occasion demanding greater accountability and transparency from their governments, and have voiced these demands by electing reformist governments into office. Solomon Islands and Vanuatu peoples have clearly been seriously disillusioned with the quality of governance of their past administrations, and public pressure and election results led the concerned governments to adopt the reform process. Such public pressures also encouraged other member governments of the South Pacific Forum to reinforce earlier commitments to reform

> by endorsing, in September 1997, an economic action plan that covered tax and trade policy reform, pursuit of liberal and transparent investment policies, civil service reform, and corporatization and privatization of SOEs. In addition, the Forum Leaders subsequently adopted eight accountability principles as a means to improve governance.[3]

Ideally, developing countries in the Pacific should not await the onset of an economic crisis to initiate the reform process. Waiting to do so limits the scope of options available to the government, and necessitates drastic action (as against carefully phased and sequenced initiatives) such as severe budget cuts, which then result in further initial destabilization to the economy. Samoa has been able to address reform on an ongoing basis without waiting for a crisis to trigger the process. The reform process in this country began in the late 1980s and, following recovery from natural disasters in 1990-1991, was revitalized in a situation of relative economic calm in 1996. The reform process has since been ongoing and the Bank's program loan which focuses substantially on the financial sector and SOEs, is just another step in this carefully sequenced government-led process.

In regard to the desirability of reforming in a situation of economic calm, the Bank needs to strengthen its own economic monitoring function so it can more effectively assist PDMCs to preempt fiscal and economic crises. The lack of reliable and timely macroeconomic data is endemic to the region. As part of its ongoing

[3] These are: (1) Budget processes, including multi-year frameworks, to ensure Parliament/Congress is sufficiently informed to understand the longer term implications of appropriation decisions; (2) the accounts of governments, state-owned enterprises and statutory corporations to be promptly and fully audited, and the audit reports published where they can be read by the general public; (3) loan agreements or guarantees entered into by governments to be presented to Parliament/Congress, with sufficient information to enable Parliament/Congress to understand the longer term implications; (4) all government and public sector contracts to be openly advertised, competitively awarded, administered and publicly reported; (5) contravention of financial regulations to be promptly disciplined; (6) Public Accounts/Expenditure Committees of Parliament/Congress to be empowered to require disclosure; (7) Auditor General and Ombudsman to be provided with adequate fiscal resources and independent reporting rights to Parliament/Congress; (8) Central Bank with statutory responsibility for non-partisan monitoring and advice, and regular and independent publication of informative reports.

assistance for the reform programs in the Pacific, the Bank has made improved economic statistics and monitoring priority areas. However, there is still much to be done, particularly with regard to building in-country capacity, and institutionalizing ongoing dialogue with governments on macroeconomic trends. The Bank has also initiated annual budget expenditure reviews in selected PDMCs starting in mid-1999.

1.3 The Process of Program Design

In assessing the process of program design, the task force specifically examined four issues: (i) the degree and scope of conceptual analysis that led to the design of the programs; (ii) the involvement and ownership of governments, and participation of key stakeholders in the design process; (iii) coordination with other external funding agencies; and (iv) the extent and mix of Bank inputs in the preparatory process.

1.3.1 Development of the Conceptual Framework

The triggers of reform have substantially influenced the conceptual design of the programs. In most cases this trigger has been a fiscal crisis (Figure 1.1, p.23). Thus, the first step of government has been to appeal to external funding agencies for initial and urgent fiscal support to tide over the crisis. Such agencies, including the Bank, have taken the opportunity to engage the government in examining the root causes of the fiscal crisis, viz. economic policy and management, poor governance, and an out-of-control public sector. In most cases, this process has culminated in the preparation of a reform framework that includes a conditionality matrix covering the key factors that need to be addressed. This framework has then become the subject matter of a Consultative Group Meeting (in the cases of Cook Islands, RMI, FSM, Vanuatu) or a more informal meeting (as in the case of the Solomon Islands) at which the government and external funding agencies have agreed on the framework for reform and related external support.

In virtually every case, the design of the reform program was preceded by a Bank-produced economic report (the exception being Samoa). The report provided comprehensive economic data and

analyzed the state of the economy. These economic reports thus provided, in large measure, the conceptual basis of the reform program. Their finalization became the opportunity to engage the government on the critical factors influencing economic stagnation and deterioration, and related options for stabilization and adjustment.

Notwithstanding the above, most reform programs were designed under some degree of time pressure, given the crisis circumstances that had triggered the initiation of the reform process. Thus the level of analysis of every aspect touched by the reform process has not been of similar depth and detail. For instance, analysis of the details of how governments worked has been generally inadequate, and therefore the specific constraints to greater efficiencies and effectiveness of the public sector have not been clearly identified. There has also been inadequate inquiry into the capacities of the private sectors of small island economies to provide the assumed responses to public sector downsizing and the liberalization of policy frameworks. As noted in Duncan (1999), the relatively undeveloped state of the institutions needed to support private sector activity is a key feature of PDMCs. These inadequacies have not substantially compromised the relevance and quality of the reform programs; however, had such analyses been undertaken in disciplined fashion, they would have contributed to improved design, to more effective sequencing of the reforms, and to more systematic provision of supporting technical assistance (TA) from the Bank and other funding agencies.

1.3.2 Engendering Participation and Ownership

The stronger and more sustained the ownership of reform programs, the greater their credibility, the more effective their implementation, and the greater the likelihood that reform-related changes will be durable. The World Bank Operations Evaluations Department has established that the extent of ownership predicted the satisfactoriness of program outcomes in three-fourths of all cases, with most deviant cases explained by exogenous shocks (World Bank 1992).

Most PDMCs have taken strong local ownership of the reform programs (Box 1.1). In the Cook Islands, FSM and Vanuatu, national summit meetings played a key role in engendering the national

Box 1.1 Ownership and Participation

For the *Cook Islands*, ownership was high, primarily because there was strong support from top political leaders, and because substantial and effective public participation in, and commitment to, the reform process was created and institutionalized. A National Development Council and annual National Retreats were crucial mechanisms in this regard.

In the *Federated States of Micronesia*, the initiative for reform was largely external, but general participation in, and ownership of, the reform process was established through a series of national and state summits. Ownership at the outset of the reform program was high; but subsequently ownership has fallen as the political and personal costs of reform have risen.

In the *Republic of the Marshall Islands*, ownership did not extend much beyond an externally-advised President, as became evident following his unexpected death in late 1996. Political leadership now tends to present the reform program as an external imposition, and there is widespread questioning amongst politicians and officials of the merits of reform strategies.

Samoa exhibits a very high extent of ownership because reforms have been largely local initiatives, have been undertaken out of conviction of their appropriateness, have received strong support from top political leaders and officials, and have been formulated through a broad consultative and participative process.

Ownership is high in the *Solomon Islands* because reforms have been initiated by a new democratically-elected government that campaigned on a reformist platform. However, there is not bipartisan political support, and government still needs to build support amongst the largely rural population.

Ownership is also high in *Vanuatu*, with strong public participation and a convergence of local ownership around the central theme of improved governance. Support has been bipartisan.

consensus on the need for reform, thus enabling the governments to proceed with reform agendas that would otherwise have been unpalatable to the general population. In Solomon Islands, a general election brought in a new Government that was essentially elected on a reformist manifesto. In Samoa, the reform process began in the late 1980s and has always been primarily internally driven. In RMI, however, the extent of ownership was limited.

Within all six PDMCs, the role of a "champion" or group of champions of the reform process cannot be understated. In all of them, the top political leadership personally championed the reform and thus engendered strong political and public commitment. In the Cook Islands and Vanuatu, bipartisan support was achieved and facilitated comprehensiveness of the reform program. The senior political cadre as a group owned and supported the reform process in most cases.

The typical process of design from the point of view of ownership and participation, falls into four distinct phases: (i) an initial consensus within the country on the need for reform, with the polity crystallizing this consensus into a national reform action plan; (ii) the formation of task forces or reform committees to oversee and guide the reform process; (iii) negotiation with the Bank and other external agencies on time-bound reform commitments in exchange for budgetary and TA support; and (iv) the fielding of teams of external consultants to support the reform process and related capacity building.

1.3.3 Coordination among External Funding Agencies

Coordination of external assistance has been at a high point in the Pacific over the last four years, mainly because a consensus has evolved on some basic development strategies. It is now generally accepted that the primary focus of development assistance, at this point of time, must be to help PDMCs get their economic policies and governance institutions in order. Most bilaterals have also supported the important leverage role of the multilaterals with respect to persuading governments to reform their policies and introduce good governance measures. This was particularly apparent in the cases of Vanuatu and Solomon Islands where major bilaterals such as Australia, France, New Zealand, and the European Union actively promoted the Bank's leadership in coordinating support for the reform programs. For the Cook Islands and Samoa, New Zealand is a major bilateral, and worked closely with the Bank on supporting the reform program. In RMI and FSM, the Bank has coordinated with the United States (US) government.

In general, the bilaterals left the negotiation of the reform framework and matrix to the Bank. The Bank ensured that they were consulted, and that the International Monetary Fund and the World

Bank were also involved and kept informed. Once the reform framework and matrix were agreed and presented to the funders at a Consultative Group Meeting, the bilaterals moved in to offer various grant assistance to help implement specific reforms. Examples include New Zealand's assistance to Vanuatu and Solomon Islands on tax reform, and Australia's assistance for strengthening budget management processes in these countries.

1.3.4 Bank Inputs into the Preparatory Process

Bank inputs for the reform programs have generally been consistent from country to country. The typical project preparation TA has not been used; rather, advisory TA projects and/or intensive Bank staff interaction and negotiation with governments on the range and scope of reforms have been the precursor interventions to formulation of the program loans. In most cases, country economic reports have been prepared as an underlying analytical exercise. However, the most significant Bank input variable leading up to the successful negotiation of an acceptable policy reform matrix has been the generally high level of trust that has existed between the Bank's staff and the governments. While consultants have been used to assist in specialized areas, their contributions have been highly variable, with governments consistently preferring to deal directly with Bank staff in formulating the reform programs.

Generally, three preparatory missions have been needed prior to finalizing program design and the loan documentation for approval — an identification mission, a fact-finding mission, and an appraisal mission. Preparatory time ranged from 3 months in the Cook Islands to 15 months in Vanuatu, though the latter took the longest due to an election and change of government midway through the process. The median has been 6 months. This would generally be considered a tight timeframe for development and negotiation of rather complex reform agendas and related conditionalities; however, except in the case of Samoa, the reform programs were addressing fiscal crises that required fast action.

The range of expertise available within the Bank's program preparation teams has generally comprised macroeconomists, financial analysts, and social dimensions specialists. There has been an understandable bias towards the macroeconomic aspects of re-

forms, given that the reform programs were responding to fiscal crises. Nonetheless, it must be accepted that the public sector reform aspects of these programs could have been undertaken more thoroughly and effectively, and that the Bank would have done well to equip itself with a stronger complement of public sector management expertise.

The experience of the six reform programs indicates that the specific expertise of the lead officer of the Bank is not important. It is critical, however, that this officer be one who understands the workings of government; has the trust and respect of the government; and is equipped with strong analytical, communication, and negotiation skills.

1.4 Scope and Content of the Reform Programs

1.4.1 Macroeconomic Stabilization

The initial emphasis of the reform programs in five of the six countries (Samoa remains the exception) has been on addressing macroeconomic instability, beginning with bringing the fiscal situation under control. Thus, the governments have downsized the public sector and reduced budgetary outlays, improved revenue streams with revised taxation and tariff systems, and initiated privatization of SOEs that are a drain on the budget and can be sold. Efforts also have focused on improving the enabling environment for the private sector. Appendix 1 summarizes the design of the six reform programs.

In the Cook Islands and Solomon Islands, for instance, the trigger was a deep and severe fiscal crisis, coupled with an increasingly unmanageable debt situation. Accordingly, the immediate focus and emphasis of the reform programs has been aggregate fiscal discipline with substantial efforts to balance the budget and restructure and repay the debt as early as possible. Numerous actions were initiated on revenue enhancement and expenditure control. In addition, the Cook Islands and Solomon Islands have taken extensive action to address their debt problem by negotiating with creditors to restructure the debts. The Cook Islands has also introduced legislation to ensure fiscal responsibility and transparency are maintained.

Going beyond the initial balancing of the budget, it remains debatable as to how much has been achieved in these countries in the area of allocative efficiency. Linking the annual budget with multi-year public investment programs and thus ensuring integration of the recurrent and development budgets depends on strong analytical capacities within planning and finance ministries, and on committed political action to follow through with the difficult decisions on which sectors should suffer and which should gain. In addition, the countries must still address the efficiencies and effectiveness of public management. Most countries in the world that have attempted the introduction of sophisticated output-based budgeting have stepped back from such a course, accepting the necessity of first getting basic accounting and budgetary systems right. The short supply of requisite human resource skills is the main constraint.

In Vanuatu, while the fiscal situation has been worrisome, there have been other motivations for the reform process, including stagnant economic growth, the need to counter the economic impacts of the Asian financial crisis, and public demand for better governance. Thus, the focus of government has been primarily on good governance, public management efficiencies and effectiveness (including improving public expenditure management), and creating an environment more conducive to private sector-led development.

However, actions on aggregate fiscal discipline have been an important and essential part of the overall economic reform process in Vanuatu. The need for continuing financial infusions into failing government-owned institutions, as well as continued budget deficits and growing external borrowing, have required the introduction of strong fiscal discipline. Extensive legislative provisions have been adopted to ensure continued fiscal responsibility. New tax and tariff regimes have been introduced. And program-based budgeting has been adopted, accompanied with related public management provisions for predictability, accountability and transparency. Going beyond this first step of fiscal crisis management, the government is now addressing adjustment issues in the economy. Actions range from liberalizing investment laws to restructuring the financial sector and diversifying the economy.

In the RMI and FSM, the fiscal situation has also not been in crisis mode in the sense that a sovereign default was imminent; but

substantial capital and recurrent expenditure commitments have been incurred in non-viable government investments and unsustainable subsidies using future US Compact funds. This has required a substantial and immediate reduction in fiscal outlays, particularly downsizing government. However, the scope of reform has extended to economic policy, looking at the medium-term need for economic diversification and employment creation through development of small private sectors. Restructuring of heavily aid-dependent and government-dominated economies remains the very substantial challenge of the reform programs in these two countries. It is a challenge that may have to encompass the prospect of adjusting living standards in accordance with reduced aid funds.

1.4.2 Good Governance

The second most significant trigger of reforms in the PDMCs has been widespread disillusionment of the public with the quality of governance (Figure 1.1). This disillusionment has been expressed through election results in Vanuatu and Solomon Islands, two countries with strong governance components in their reform programs. The other opportunity for representatives of the people to express their unhappiness with the state of governance has been through the national summits held in the Cook Islands, FSM, and Vanuatu. The summits were public and bipartisan exercises, and the occasion for the public to vent their frustrations with continued misgovernment. The messages offered were accepted and provided a strong basis for developing and ensuring public acceptability of the consequent reform programs.

Initiatives to improve governance have included a review of the functioning of parliament; instituting formal separation of functions between the public service and parliamentarians; strengthening accountability of the public service to parliament and to the public; and revitalization of key good governance institutions such as the offices of the auditor general, the attorney general and the ombudsman. Numerous legislative enactments have been passed in the Cook Islands and Vanuatu to enshrine the principles of transparency, accountability and equity (Box 1.2).

Box 1.2: Governance-related Legislation

Cook Islands' Economic Restructuring Program

The Ministry of Finance and Economic Management Act (MFEM Act) required the Government to maintain operating expenses within the limits of the Government's internal revenues and to publish statements of its fiscal and economic strategy in advance of its budgets being drawn up.

The Public Expenditure Review Committee and Audit Act (PERCA Act) created an independent committee endowed with wide powers to review all aspects of public finance so as to ensure transparency of national and local bodies, and provided for the adoption of "generally accepted international accounting principles" throughout the Government.

The Public Service Act gave heads of ministries the power and responsibility to staff and manage their departments according to "good employer" principles so as to achieve defined outputs integral to their own performance contracts.

Vanuatu Comprehensive Reform Program

The new Government Act defined the boundaries between the political leadership and the public service.

1.4.3 Public Sector Efficiencies and Private Sector Development

Ultimately, reform must be judged on the basis of its impacts on the daily lives of the people the government serves (Figure 1.1). The critical targets must remain the much-needed increases in incomes and employment, and improvements in human development indicators. These are achieved through attaining macroeconomic stability and good governance, which are an essential foundation for sustainable development; but they must be built by improving public sector efficiencies and effectiveness and encouraging private sector-led investment and growth. It is these that are the two key sources of improved living standards.

The Leadership Code established enforceable standards of ethical behavior of politicians, senior public servants and other leaders.

The Ombudsman Act strengthened public accountability and supported the Leadership Code, by giving the Ombudsman's Office broad jurisdiction over administrative action, including in respect of public enterprises. This Act also introduced a mediation role in respect of complaints, and strengthened the Government's responsibility to respond to Ombudsman investigations.

The Public Finance and Economic Management Act reformed the budgetary process and established greater transparency in fiscal management. It provided a more comprehensive and internally consistent framework for the conduct of fiscal operations and clarified the Government's powers in respect of taxation, expenditure, borrowing, and provision of guarantees.

The Expenditure Review and Audit Act strengthened fiscal oversight and performance accountability to Parliament, including through the establishment of an Expenditure Review Committee.

The Public Service Act professionalized the public service and strengthened the powers and independence of the Public Service Commission. This reform has led to the removal of political interference in public employment decisions, and the introduction of merit-based promotions.

The Remuneration Tribunal Act established the Tribunal, providing consistency and discipline in the setting of salary levels.

Five of the six reform programs evaluated attempted to address the areas of public sector efficiencies and effectiveness, some more comprehensively than others. The Cook Islands, Solomon Islands and Vanuatu have designed into their reform programs initiatives to improve their public sectors, including: (i) rationalization of the number and organization of various departments and agencies (Box 1.3); (ii) introduction of performance accountability either in the form of output or program-based budgeting (Cook Islands and Vanuatu) or results-oriented management with related incentives (Solomon Islands); (iii) introduction of meritocracy and professional human resource management; and (iv) redesign of business processes. While RMI and FSM have undertaken substantial public sector downsizing and some rationalization, their public

Box 1.3: Solomon Islands
Reform of the Public Service

Situation in 1997

- Unproductive and demoralized public service staff
- Weak service delivery
- Absence of fiscal controls resulting in large deficits and arrears
- Lack of direction and performance orientation throughout Government
- No accountability for use of public resources or funds

Medium-Term Reforms (1998-2000)

- Cut in payroll cost of about SI$14 million (about 9% of payroll)
- Balanced budget (small surplus achieved in 1998)
- Medium-Term Budget Framework linked to Medium-Term Devt. Strategy
- Tight centralized controls on government finances
- Institutional Strengthening Unit formed within Prime Minister's Office
- Ministry secretaries on performance contracts with specific deliverables
- Executive development program for senior officers and managers
- Measurable output targets in ministry budget submissions
- Streamlining/simplification of public service employment processes
- Rationalization of public service employment laws and procedures
- Re-engineering of work processes and structures in key ministries
- Elimination of backlog of national government accounts and audits

Additional Reforms Envisioned by 2002

- All heads of departments/senior staff on performance contracts
- Mechanisms in place for measuring and validating ministry/staff performance
- Deliverables of ministries and departments publicized in media
- Upgraded government accounting systems and skills
- Performance/value-for-money audits by the Auditor-General's Office
- Financial incentives for good performance of officers and staff
- NGOs and stakeholders involved in evaluations of ministry performance
- Elimination of backlog of accounts and audits of state-owned enterprises

sector reforms have been less comprehensive. The Samoa program focuses on reform of the financial and public enterprise sectors as one component of a broader economic reform program.

The design of interventions to improve the public sector generally has failed to take adequate account of the need for proper pacing, sequencing and absorptive capacity. This has been for two reasons. First, the priority objective of the reform programs has been macroeconomic and fiscal stabilization. In this context, the focus has been on urgency and on reducing public expenditures, sometimes even at the expense of public sector effectiveness. In the downsizing effort, some good staff have been lost or the wrong positions have been sacrificed. Second, public sector reform implies substantial institutional change - change in management perspectives, in employee attitudes, in the substitution of outmoded, inefficient behaviors and processes with more productive ones. This requires careful design to take account of the fact that people and institutions generally resist change. They need time to acquire new skills, and to integrate new values and motivations. Also, bringing in new systems assumes parallel and supporting changes in a multitude of aspects within the institution. For instance, an output-based budgeting system presumes changes have been made in the results- orientation of management, in related incentive systems, and in supporting accounting systems. If these elements have not been adequately addressed, the introduction of an output-based system is not sustainable — as is happening in the Cook Islands.

Private sector development efforts have been initiated in all six countries. The initiatives may be categorized into two areas: (i) revision of policies affecting private sector investment; and (ii) privatization of government-owned commercial enterprises, where the private sector should most appropriately be undertaking the commercial activity.

With respect to revising policy frameworks to make them more conducive to private sector investment, all six PDMCs have made significant achievements. New foreign investment legislation has been passed in the Cook Islands, FSM, and Vanuatu. The tax and tariff regimes in the Cook Islands, Solomon Islands, and Vanuatu have been adjusted to encourage private investment and exports. Outdated laws, regulations and sector-specific policy frameworks have been rationalized in the Cook Islands and Vanuatu. And financial sector reforms have been introduced in the Cook Islands,

Samoa, Solomon Islands, and Vanuatu to make this key sector more responsive to private sector needs.

Progress in privatization has been slow, though significant achievements are coming on stream as the reform programs take root and gain maturity. All six countries' governments realize that they have no comparative advantage in undertaking commercial activities, and that selected public services can be contracted out, thus ensuring greater efficiencies and effectiveness. The contracting out of government services is more easily undertaken than the privatization of government-owned enterprises. Thus, all six countries are making major advances in the contracting out of services such as power, water, sanitation, and telecommunications. The process of privatization is slower as private entrepreneurs are generally reluctant to take over unprofitable enterprises, particularly given the typical constraints facing private sector activity in these economies: small internal markets, distant external markets, high cost labor, and vulnerability to natural disasters.

1.5 Implementation Progress and Results of the Reform Programs

The Bank typically designs its assistance around a reform matrix that consists of a series of actions (or "conditionalities") within the government's own larger reform program. The reform measures are time-bound, and a selected few become triggers for the release of the various tranches that comprise the program loan (Appendix 1). If implementation is to be judged by the timeliness with which conditionalities are being fulfilled, most countries are generally successful to date. The program loans to the Cook Islands and to FSM have been closed with the release of the second tranches. The loan to the Cook Islands was closed in a timely manner, with 86 percent of the 110 reform measures included in the reform matrix completed as of December 1998. In the FSM case, the second tranche was partially released on a timely basis, but full release occurred 12 months behind schedule owing to delays in passage of legislation by two states. In early March 1999, 78 percent of the reform measures included in the reform matrix had been completed. The second tranche of the RMI loan was released one year behind schedule, and the third tranche was still to be released in March

1999, when 56 percent of conditionalities had been completed. The loans to Samoa, Solomon Islands and Vanuatu have been the most recent (February, August and July 1998, respectively) and are progressing smoothly. The Vanuatu program involves three tranches, with the second instalment of the first tranche being released on a timely basis and 57 percent of the conditionalities fulfilled by early 1999. Both the Samoa and Solomon Islands programs are on schedule, with 65 percent and 59 percent, respectively, of the conditionalities having been fulfilled by March 1999.

As is to be expected, progress in implementation in each country has had its pluses and minuses. Some difficulties have been created by the design of the reform programs inasmuch as they have been ambitious in the context of constrained local capacities. In other cases, the key constraint has been political and social resistance. Reformist governments with slender majorities have had to tread carefully, always trying to manage opposition from specific groups and to soften the impact of the reforms on the population at large, in order to ensure that they retain public support. An overview of the quality of implementation of the six reform programs is provided below. Appendix 2 summarizes achievements and remaining concerns and challenges.

- *Samoa* has the best track record. There is strong local ownership, and the reform program is clearly focused and appropriately sequenced. There has been significant progress in strengthening the prudential and regulatory framework of the financial sector (which is the target of the reform program), and there is tangible development of financial markets with the lifting of interest rate and credit control, the introduction of indirect instruments of monetary policy in place of direct controls, the abolition of the foreign exchange levy, and the development of a forward foreign exchange market. One SOE has been privatized, another is to be corporatized. Major improvements have been seen in the accountability and transparency of most SOEs, though the pace is slower than was expected.

- *Vanuatu* may be classified as the next most successful program to date. Bipartisan ownership and public

support continues for the reform program after an elapsed time of about 18 months. Fiscal balance is expected to be achieved next year; the number of ministries has been reduced from 34 to 9; a new value-added tax has been successfully introduced; the public service has been restructured, and professional and performance accountability initiated. A new legislative framework for good governance has been introduced and tangible benefits are evident in greater transparency in government decisions. The Development Bank of Vanuatu has been closed and its assets and portfolio taken over by the successfully rehabilitated National Bank of Vanuatu. The regulatory frameworks governing private sector investment have been liberalized. The critical constraint remains local capacity and the key concern the extent of dependence on external consultants.

- *Solomon Islands* best demonstrates how a determined reformist government, in spite of huge obstacles, is still able to take a country successfully down the reform path. Despite political uncertainties (the government has a small majority), human resource constraints, and a huge debt overhang it has inherited from a past government, the Government has stabilized the economy, brought recurrent expenditure under control, restructured public debt, reduced public service expenditure by 8 percent, and introduced a professional and performance orientation in its public service. The public accountability, transparency, and openness of this Government is in sharp contrast to the economic management style of the previous Government, and this has gone a long way in reinstating the confidence of the international community and the local public in the potential of the country. Three SOEs are due to be privatized, and attempts are underway to revive the private sector.[4]

[4] During June-August 1999, the reform process was disrupted by the Guadalcanal insurgency.

- The *Cook Islands* was one of the first reform programs supported by the Bank in the Pacific and one of the most comprehensive. A huge cut has taken place in the public service (57 percent of staff separated over 1996-98), but the number of ministries at 22 is still too numerous for a small economy (Table 1.2). While progress is being made towards fiscal balance, the situation is still fragile. The passage of legislation establishing principles of fiscal responsibility, improved accountability, and transparency has been a significant development, although questions have been raised about the lack of contestability in the government's handling of one major asset sale. On the other hand, the new laws have allowed public and parliamentary debate of this issue. The introduction of a performance orientation in public expenditure management is an achievement, though the durability of the recently introduced output-based budgeting and accrual accounting systems is in doubt due to constraints in local capacity.

- The *FSM* reform program was also one of the first supported by the Bank in the Pacific. The focus has been substantially on fiscal reform, and extensive public service downsizing in the four states has been achieved (Table 1.2). This has strengthened state finances and has left them better placed to adjust to any future reduction in external grants. Achievements have also included privatization and contracting out of some departmental activities and the transfer of power, water and sanitation to public utility authorities. However, national and state leadership did not gain the complete commitment of some state legislatures to the reform process, and there has been a loss of momentum in the reform process as the political and personal costs have mounted. The process of downsizing of the public sector could have been handled better in terms of how payouts were made, transition-preparation for those separated from service, and monitoring of the process.

- The *RMI* reform program, like the FSM one, is focused substantially on fiscal reform. A 33 percent downsizing of the public service has been achieved with the number of ministries down from 10 to eight (Table 1.2). Other fiscal measures taken included a three year wage freeze, elimination of subsidies to some public enterprises, a rationalization of tariff structures, and the establishment of a trust fund for durable revenue generation for recurrent expenditures. In addition to fiscal progress, a significant achievement has been privatization of shipping services and actions being taken on other privatization options. Unfortunately, after the death of the incumbent president, the momentum of the reform program has slowed. Other factors influencing slow progress include the forthcoming 1999 elections and an atmosphere of confidence that the Compact re-negotiation will be successful.

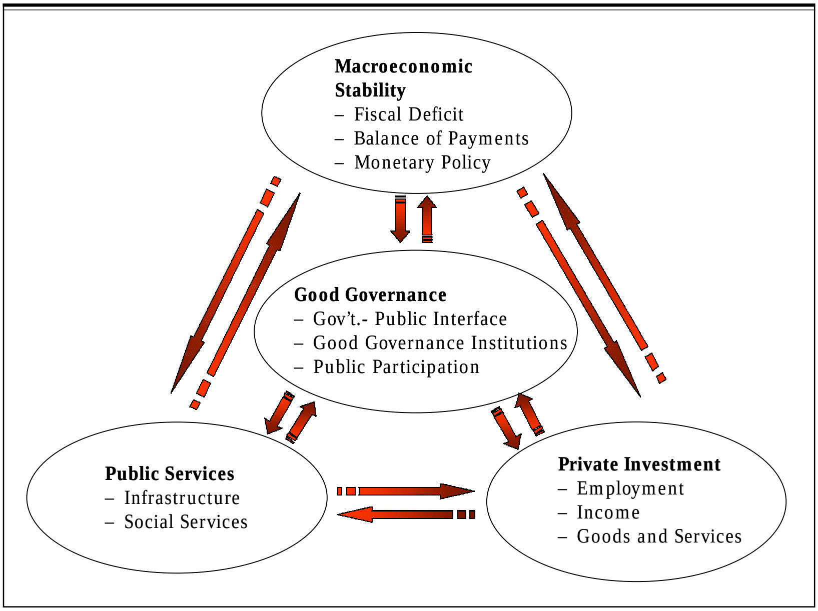
Table 1.2: Public Service Size

Country	Pre-reform	Post-reform	Percentage Fall
Cook Islands	3,153 (Mar 96)	1,341 (Oct. 98)	57
Fed. States of Micronesia – Total	8,001 (96)	5,060 (Jan. 99)	37
– National Government	750 (96)	572 (Jan. 99)	24
– Chuuk State	2,800 (96)	2,107 (Jan. 99)	25
– Kosrae State	794 (96)	658 (mid-98)	17
– Pohnpei State	1,633 (96)	1,027 (Jan. 99)	37
– Yap State	1,069 (95)	696 (Jan. 99)	35
Marshall Islands	2,303 (Oct. 95)	1,539 (Mar. 99)	33
Solomon Islands	8,700 (96)	8,150 (Mar. 99)	6
Vanuatu	4,250 (Jan. 98)	3,825 (Feb. 99)	10

Notes: Pre-reform figures for FSM are the highest reported in various Bank documents. There is uncertainty about the correct baseline figures for the national government, Yap and Pohnpei. Figures for the National Government refer to employment under "FSM Unrestricted Funds" and exclude employment under "Federal Programs and Refundables". Solomons figures refer to central government employment.

The following six chapters provide the detailed assessments of the country reform programs. Each assessment leads to conclusions that are specific to the country's situation and to some that have general application. Lessons learned are presented at the end of each chapter and then synthesized in a concluding chapter.

Figure 1.1: Reform Triggers and Medium-Term Goals



2 THE COOK ISLANDS

2.1 Introduction

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

2.2 The Macroeconomic and Governance Context

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

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

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

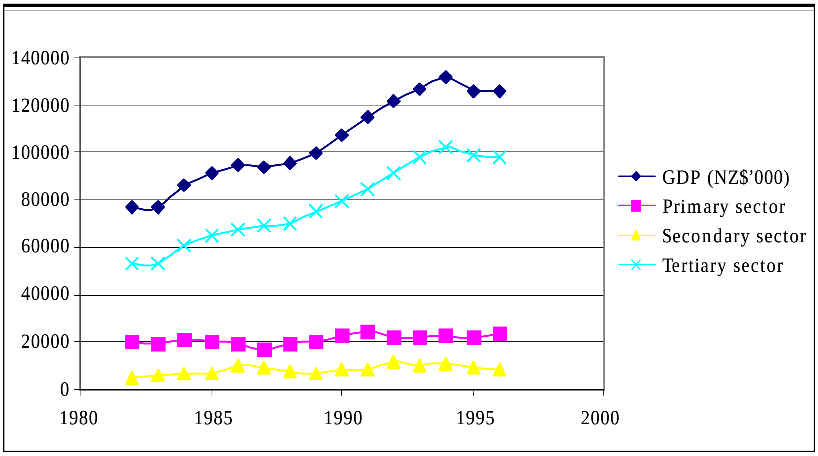
In 1995-98, the economy has been in recession as a result of contractions in tourism and the public sector. Visitor numbers fell 16 percent in 1995, following a reduction in international airline services and adverse publicity over French nuclear testing and a dengue fever outbreak. Despite some recovery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

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

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

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

Figure 2.1: Cook Islands: GDP at 1990 prices



Source: Cook Islands Statistics Office.

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

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

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

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

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

2.3 The Process of Program Design

2.3.1 Ownership and appropriate participation in the design process

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

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

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

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

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

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

2.3.2 *Partnership and consultation with other external funding agencies*

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

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

2.3.3 *Effectiveness of internal processing procedures*

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

Box 2.1 The New Public Sector Legislation

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

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

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

2.4 The Content of the Program

2.4.1 The Economic Reform Program

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

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

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

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

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

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

- the creation by the DIB of a ‘one-stop shop’ to help foreign investors navigate through Government regulations.
- the facilitation of access to finance through reform of the Cook Islands Savings Bank, and the improvement of access to business advice.
- the introduction of new legislation on land tenure that would seek to make traditionally owned land more accessible for economic development while accommodating the legitimate concerns of traditional land owners.
- facilitating growth in the three leading productive sectors of tourism, agriculture and marine through a range of measures.

- In the area of social equity and sustainability (in addition to creation of the Transition Ministry)
  - the devolution of political power and responsibility for management of Government funds to outer island representative bodies.
  - the preparation of a comprehensive national training needs assessment as the first step in preparation of a human resource development plan.
  - the formulation of a retirement savings plan for private and public sector employees.
  - the introduction of environmental impact assessments.
  - the integration of gender issues into development planning and public service recruitment.

2.4.2 Rationale and appropriateness of loan amount

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

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

2.4.3 Consistency with country and Pacific strategy

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

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

On content, the Strategy observes:

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

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

2.4.4 Relevance and focus

There can be no doubting the ERP's relevance and focus. Prior to ERP, the Cook Islands public service was by far the largest amongst PDMCs: in 1990, there were 18.2 government employees per 100 residents, compared to the next highest figure of 8 per 100 for Tuvalu. Moreover, service delivery was poor, with many employees effectively on a welfare payment for little work effort. Public enterprises were inefficient, and government's commercial decision-making

questionable (most notoriously in the case of the Sheraton/ Vaimaanga Hotel). The wage bill and debt servicing constituted unsustainable fiscal burdens, the lightening of which demanded public sector reform.

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

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

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

2.4.5 Sustainability considerations

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

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

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

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

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

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

2.4.6 Likely impact on governance

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

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

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

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

2.5 Implementation

2.5.1 *Tranche conditions*

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

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

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

2.5.2 *Secondary conditions*

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

Fifteen of the conditions remained incomplete in October 1998. Some of these were in progress (notably divestment of the Vaimaanga Hotel); and in the case of the condition requiring legislation to simplify the land tenure system, it is understandable that

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

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

2.5.3 Use of loan and counterpart funds

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

2.5.4 Effectiveness of monitoring

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

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

2.6 Results

2.6.1 Outputs

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

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

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

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

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

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

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

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

Under the MFEM Act, heads of ministries are responsible for ensuring that funds are expended for the purpose of providing certain specific outputs, and for supplying monthly accounting reports to the MFEM. There is now considerable awareness amongst heads of the importance of outputs and results, and the importance of

regular measurement of actual performance. This change in attitude is an important step toward greater professionalism in the public service, which is necessary to improved formulation and implementation of economic and social policies. Also, the wider community is now keenly interested in the particular outputs and services that Government will deliver in exchange for the revenues that it receives.

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

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

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

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

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

There are tight restrictions on cash that are preventing Government from providing the funds agreed to under the output budgeting system. This lack of predictability of financial resources has

caused the system effectively to collapse into a one-line program budgeting system under which heads of ministries have a legitimate reason for failing to deliver agreed outputs. Performance assessment then becomes difficult.

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

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

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

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

The current budget difficulties add urgency to the task of pursuing public service reform. Government has announced its intention to undertake further reform, but it must be noted that the pace

and drive for change have eased in late 1998 in advance of the elections due in early 1999. Until a public service reform program is formulated, it is difficult to see how the incomplete ERP matrix condition for a comprehensive national training needs assessment can be usefully undertaken.

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

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

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

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

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

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

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

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

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

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

2.6.2 Impacts

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

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

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

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

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

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

2.7 Looking to the Future

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

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

- The design of a comprehensive reform program needs to

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

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

    - plan for effective monitoring against targets.

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

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

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

3 FEDERATED STATES OF MICRONESIA

3.1 Introduction

The Public Sector Reform Program (PSRP) Loan of $18 million to the Federated States of Micronesia (FSM) was approved in April 1997, and was to be released in two tranches of $10 and $8 million. The loan involved adjunct technical assistance of $0.92 million to support implementation. A TA of $540,000 was provided to supplement TA No.2294-FSM, Policy Advisory Team for Economic Management (the so-called EMPAT team). This added a third resident adviser to the team, and was aimed at supporting PSRP implementation at the State level and increasing government capacity to monitor the impact of PSRP. A second TA (No.2786-FSM) of $380,000 provided assistance in the development of an investment promotion plan and a review of the financial sector aimed at fostering private sector development.[8] The PSRP loan compared with US grant assistance under the Compact of Free Association of $78 million in the fiscal year ending 30 September 1997.

3.2 The Macroeconomic and Governance Context

FSM's ongoing efforts at economic reform should be seen as the latest in a long line of adjustments that the indigenous population has had to make from first European contact in the early sixteenth century, through several colonial administrations, to political independence under the Compact of Free Association with the

[8] Other recent TA included TA No.2538-FSM, Improved Budget Management (approved 5 March 1996 for $480,000); TA No.2758-FSM, Improved Economic Use of Land (approved 4 Feb. 1997 for $550,000); TA No.2832-FSM, Fisheries Management and Development (approved 23 July 1997 for $934,000); and TA No.2983-FSM, Performance-based Public Resource Management (approved 26 Jan. 1998 for $988,000). EMPAT II also began in October 1998.

United States. The contemporary governance and economic environments are largely the creation of an interaction between the post-1945 US influence and indigenous societies.

A system of government on the lines of the US model was adopted when Chuuk, Kosrae, Pohnpei and Yap federated in 1979. The states have substantial autonomy, with individual constitutions determining the balance of power between the executive, legislative, and judicial branches of government, and between the national, state, and municipal levels of government. The government structure adds a complicating dimension to efforts at improving governance.

Beginning in 1962, the US funded a substantial physical and social infrastructure development program and an expansion of public administration. This continued under the Compact of Free Association, which provided for annual base, or "block", grants of \$60 million in FY1987-FY1991, \$51 million in FY1992-FY1996, and \$40 million in FY1997-FY2001, at least 40 percent of which had to be spent on capital projects. Additional grant assistance is given to education, health, energy, and communications services provision; and services and programs such as the US Postal Service, weather services, Federal Aviation Administration and Federal Deposit Insurance Corporation are provided free. Duty free access to US markets is generally available for goods with a domestic value added exceeding 30 percent of output. Finally, FSM people have unrestricted access to live and work in the US. In November 1999, formal negotiations are due to begin over provisions of the Compact expiring in 2001. By the latter date, over \$1,240 million in grants will have been disbursed, a figure approximately equivalent to \$830 per person per year.

The growth performance and structure of the FSM economy largely reflect the impact of the large, changing financial transfers under the Compact.[9] The simple average of the annual real GDP growth rate in 1986-98 is estimated at 1.6 percent, but there is considerable year-to-year variation as Compact funds have been first made available and then stepped down on the five-year cycle. Given annual resident population growth at around 1.5 percent, living standards have stagnated. The extent to which these standards are underpinned by aid flows is indicated by the 1993 estimate that the

[9] ADB, 1997a, provides a detailed analysis of the FSM economy up to that time.

immediate cessation of Compact assistance in 2002 would produce an overnight drop in per capita GDP from about $1,445 to $300.[10]

The booming sector effect of aid is evident in the economic dominance of the public sector, which in 1996 accounted for 62 percent of non-subsistence GDP. The 1994 Census showed that the primary sector accounted for only 9 percent of formal sector employment, whereas the public sector accounted for 49 percent. Those employed in the national public administration and in public enterprises received wages averaging close to $10,000 per annum - over three times the private sector level. Those employed in state public administration received wages 70 percent higher. The unemployment rate averaged 16 percent, ranging from a high of almost 20 percent in Chuuk to a low of 10 percent in Yap. Almost half of the unemployed were under 25. In this context, emigration, especially of relatively unskilled labor, has been, and remains, a crucial safety valve. In 1994, 5,742 FSM people resided abroad (mostly in Guam and the US), compared with a resident population of 105,500.

The extent to which aid has permitted consumption to exceed the level that domestic production possibilities and international trading opportunities alone would permit is evident in the national and the external accounts. In 1996, total final consumption expenditure was 143 percent of GDP, with government consumption 91 percent and private consumption 52 percent. In 1991-95, the trade deficit averaged around 70 percent of GDP. The current account deficit exclusive of official transfers averaged 80 percent; but inclusive of transfers, the current account was in surplus equivalent to 6 percent of GDP. Following two years of recession in 1996-98, the current account deficit exclusive of transfers fell to 17 percent of GDP in FY1998, and the balance inclusive of transfers rose to 31 percent of GDP. As the Bank's 1996 Economic Report observes, official flows "have underwritten a major structural balance of payments deficit" (ADB 1997a, p.12).

The dependence of government on external financial assistance is shown in Figure 3.1, which presents consolidated data (that is, national plus state). In FY1997, after the second stepdown in Compact grants and some success in increasing domestic revenue, total external grants still accounted for 61

[10] Reported by the Office of Insular Affairs, US Government, http://www.doi.gov/oia/chapter7.html.

percent of total revenue and grants (compared to 64 percent in 1995 and 83 percent in 1988).

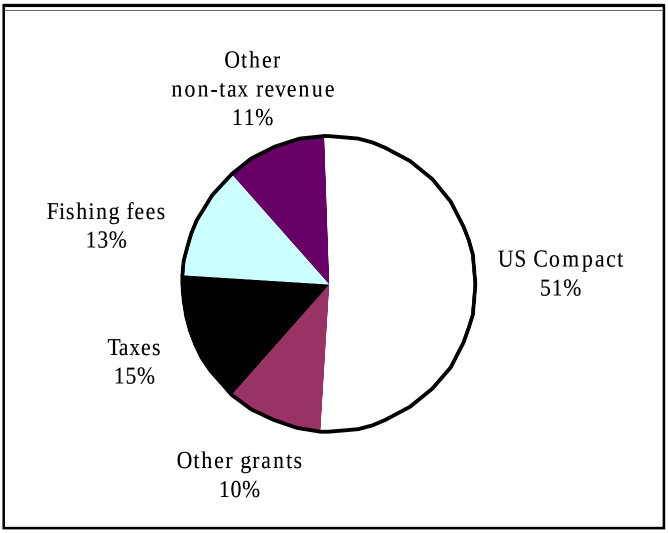
The overall balance of the consolidated government finances moved from surplus into deficit in fiscal years 1991-93, back into surplus in fiscal years1994-95, and again into deficit in 1996-97. However, as the documentation for the last Consultative Group of Donors' Meeting reveals,[11] the consolidated outcomes conceal considerable variation in the fiscal performance of the five governments during the 1990s. The state of Chuuk did not adjust to the first Compact stepdown, instead increasing expenditure on wages and salaries and goods and services. Years of recurrent budget deficits were financed by an accumulation of a stock of arrears that by FY1995 was equivalent to 46 percent of recurrent expenditure. The consequent financial crisis forced a belated fiscal adjustment that generated recurrent surpluses in FY1996 and FY1997. Pohnpei State similarly increased personnel and travel expenditure and ran recurrent budget deficits, though some reduction in other recurrent expenditure categories occurred. Arrears accumulation left the state in financial crisis in FY1998 and compelled the adoption of stronger adjustment measures. In contrast, both Kosrae and Yap states exhibited fiscal discipline, running recurrent budget surpluses in the aggregate during the period FY1991-FY1997. All state governments were alike, however, in their willingness to borrow overseas and to invest the funds in public enterprises that are yet to be profitable.[12]

Throughout the 1990s the finances of the national government remained sound. It retained 50 percent of shared revenue and 100 percent of substantial fishing license fees, and played a relatively limited role as a service provider. Given this and the pressures on state government finances, it is not surprising that revenue-sharing has emerged as a major issue in national-state government relations. The split of shared revenue was recently changed to 30 percent to the national government and 70 percent to the state governments; but the additional 20 percent to the states is earmarked for education and health projects, and the states are seek-

[11] FSM Report to the Consultative Group of Donors, Adjusting Toward a Private Sector-Led Economy, 26 January 1998.

[12] In excess of $15 million was the estimated loss in 1996 (EMPAT Report on Public Enterprise Reform, 1997).

Figure 3.1: Structure of Revenue and Grants, FY 1997 (%)



Source: FSM Report to the Consultative Group of Donors, Adjusting Toward a Private Sector-Led Economy, 26 January 1998.

ing a 20-80 split plus a share of the fishing license revenue. Their case is strengthened by the existence of $15 million in unappropriated revenue in the national government budget for FY1999.

The economic outlook in the medium term is clouded by the prospect of further reductions in Compact grants from 2002.[13] Further fiscal adjustments forced by reductions would impact negatively and quickly on living standards. The private sector development that must be relied upon to generate income and jobs will take time, and cannot realistically be expected to provide the material living standards that large aid flows have made possible.

[13] If re-negotiations of block grant funding are unsuccessful, the Compact provides for an additional two years of funding at the average level of the 15 year period 1986-2001.

3.3 The Process of Program Design

3.3.1 Ownership and appropriate participation in the design process

For the PSRP, the FSM national government was to be advised by an economic management and policy advisory team (known as EMPAT), which was financed by the Bank through TA 2294-FSM. The first EMPAT team of two resident macroeconomists arrived in FSM in May 1995, and identified the management of reductions in Compact funding as the major economic policy issue. Responding to the team's advice, the political leadership initiated the First FSM Economic Summit, which was held in Kolonia, Pohnpei, in November 1995. It was open to the public, broadcast on radio and television, and included national and state government representatives, politicians, traditional leaders, and representatives from non-government organizations, the private sector, and educational institutions.[14] Each of the 244 official participants joined one of six working committees on agriculture, commerce and industry, health, education, marine resources and tourism. Private papers were presented and speeches made by politicians and representatives of traditional leaders and the private sector; and plenary sessions were held with a view to generating a consensus for change. The overall goal, objectives, strategies and processes of economic reform were outlined for the first time, and a commitment to reform was expressed in a Summit communique. A video tape was prepared and widely distributed.

The reform program was presented to a Consultative Group meeting in Manila in December 1995 (see section 3.3.2); and the national summit was followed by four similarly organized state summits, three within three months, and one in August 1996.[15] Utiliz-

[14] Government of the Federated States of Micronesia, Proceedings of the First Federated States of Micronesia Economic Summit, November 20-24, 1995.

[15] Kosrae State Summit, Commitment to the Challenges, Tofol, Kosrae, 22-24 January, 1996; Yap State Summit, Mobilizing for Sustainable Economic Progress and Social Cohesiveness, 29 January - 2 February, 1996; State Government of Pohnpei, Proceedings of the First Pohnpei State Economic Summit, May 6-9, 1996; State Government of Chuuk, First Chuuk State Economic Summit, Proceedings, 12-15 August, 1996, Weno, Chuuk. The Chuuk summit was delayed due to impeachment proceedings against the Governor.

ing the technical advice of the EMPAT team, each summit confirmed a commitment to the reform strategy agreed upon at the national summit and, within this framework, reached a consensus on state-specific policy reforms and development strategies, and on the need for the prompt formulation and implementation of action plans. The proceedings and findings of all summits received extensive media coverage. Mini-summits were also held at the municipal government level. As a result, community awareness of the nature of FSM's economic problems and the need for reform grew, and soon became an independent source of pressure on governments to act.

However, it should be noted that at the point at which the National Summit product was presented to the Consultative Group meeting, the participative process failed to be synchronized with the political process. While state governors signed a commitment to the program proposed in the Summit, two state legislatures interviewed did not debate the program and consequently did not vote to accept or reject it. For them, the reform program was in large part a top-down imposition, "an alien arrangement" made without much state input and presented as a fait accompli - abide by the conditions of the loan or be excluded. Consequently, commitment on the part of state legislatures is far from complete and the prospects of the reform program being vigorously pursued to an effective conclusion are not as good as they might be. In fact, in both Pohnpei and Kosrae, the legislatures indicated that they were about to enter a process of review of some of the impositions of the loan agreement, particularly with regard to conditions of employment. In a nation like Micronesia, where state politicians take their jobs very seriously and debates are broadcast, producing a situation in which state politicians considered that they had been bypassed was unfortunate. Clearly, though, it was not for the Bank to promote the loan to state legislatures. The "champions" should have been the President and the State Governors.

During 1996, each government established task forces that reportedly reviewed the structure and functioning of the public services, prepared public sector investment programs, and developed the Public Sector Reform Program (PSRP) matrices that were to become the design summary and monitoring device for the 1997 program loan. The Bank-supported EMPAT team played a crucial advisory role in these processes.

There have been no further summits since the first round in late 1995-early 1996; but there have been several symposia on reform topics (such as leadership, banking, fisheries and investment promotion), and there are plans for state and national summits to be held following the March 1999 national elections and prior to Compact negotiations.

3.3.2 Partnership and consultation with other external funding agencies

The reform strategies developed at the November 1995 National Economic Summit were presented to a Consultative Group (CG) meeting in Manila on 6 December.[16] At this meeting, the delegations from Australia, Japan, the United States, the ADB, the IMF and the World Bank expressed their support both for the wide-ranging participative process through which the PRP had been formulated and for its general content. Subsequent CG meetings have been held in Manila on 28 October 1996, and in Tokyo on 26 January 1998, with international representation extending to include the People's Republic of China, France, New Zealand, the Forum Secretariat, PFTAC, UNDP and UNICEF.

3.3.3 Effectiveness of internal processing procedures

Bearing in mind that formulation of program assistance to FSM necessitated visiting four widely dispersed island groups and negotiating with five governments, processing procedures were efficient. Fact finding was completed between 18 August and 5 September 1996, with a follow-up mission during 18-22 October. Appraisal was conducted between 23 November and 5 December 1996. Loan negotiations were undertaken over 10 days in late March-early April 1997; and Board approval for the loan was granted on 29 April. Loan agreement was finalized on 23 May and became effective on 27 June.

[16] FSM, The Road to Reforms and Responding to the Challenges, papers prepared for the CGM.

3.4 The Content of the Program

3.4.1 The Public Sector Reform Program

The PSRP was developed as a subset of the broader economic reform program. The overall goal was the "Transformation and development of a more efficient FSM economy as the end of Compact funding approaches". The five key outputs of the PSRP were to reduce the size and operating costs of the civil service; to increase domestic revenue generation; to restructure government operations; to restructure public enterprises; to mitigate social and economic impact; and to foster development of the private sector. The various activities expected to generate these outputs, together with quantitative targets, were described in five individual matrices and a consolidated PSRP matrix. The five matrices so consolidated contain 122 separate policy actions. Key actions are discussed below. Allied to the program loan was a planned expansion of the EMPAT team to assist with reform implementation and to improve governments' capacities to monitor the social and economic impacts of the reform program.

All of the conditions for release of the first tranche were satisfied before loan approval in April 1997. Release of the second tranche originally was scheduled for March 1998 and required the satisfaction of a subjective general condition and three specific conditions (Appendix 1). The general condition was that "sufficient progress has been achieved and maintained in carrying out the respective reform programs as set out in the second tranche column of the policy matrices" (para 69 of the RRP). The three specific conditions that had to be met by the national government and at least two of the states before any release of funds were: (1) reduction in the number of public service employees as specified in the matrices; (2) passage of foreign investment laws at national and state levels; and (3) enactment of amendments to the Gross Revenues Tax, and of a new Customs Act.

The time frame for loan release put pressure on (1) the identification and agreement of key factors in the relationship between national and state levels of government; (2) the identification of core areas of government which had to be resourced and how the services in these core areas would be most effectively and efficiently delivered; (3) the whole question of participation and the production

of a careful information program so that the electorate was cognizant of what was happening; and (4) an orderly process whereby the public sector moved to its reformed state.

Three risks were identified as potentially preventing successful implementation and effectiveness of the reform program: (1) a lack of domestic expertise and institutional capacity; (2) a loss of political will; and (3) a failure of the private sector to replace the public sector as the engine of growth. The first risk was to be minimized through the use of EMPAT and counterpart training (though EMPAT originally did not have a public administration expert as a member). The second risk was to be reduced through making retrenchment of public servants voluntary and transparent. The third risk was a given: only time would tell how responsive the small private sector would be to public enterprise reform and an improved economic policy environment.

Key reform actions included:

- **Establishment of task forces on government restructuring to determine fixed targets for realistic and sustainable staffing needs.**

  The organizational arrangements for, and the composition of, these important task forces are not provided in the policy matrix. Task force reports would be expected to analyze current public service staffing patterns and functions, and to identify government activities that could be eliminated, privatized or transferred to other service providers. They would present a broad picture of the public sector and its reformed role, given various funding scenarios; an assessment of the jobs that should be done by local public servants and those that might require expertise from outside Micronesia; and flexible targets for realistic and sustainable staffing needs. The reports would then be expected to form the basis of each government's public sector reform program.

  If task force reports were produced, they were not available to the Task Force mission.

- **Reductions in personnel and conditions of employment of public servants accompanied by freezes on recruitment, promotions and reclassifications.**

  The purpose was to reduce the wage bill by a given amount, to produce balanced budgets. The specifications were very detailed, eliciting a number of problems, which include:

  - A lack of clarity about the reformed core functions of government and the organizational arrangements required to fulfil them.

  - An absence of a consideration of alternative ways of effectively delivering particular services (e.g. in the education sector through the merging of schools and reduction in teacher numbers, rather than a uniform reduction in contact hours).

  - An absence of an effective mechanism to ensure that the downsizing was applied consistently across government and that the new establishment levels were held.

  - An absence of any incentives to the continuing workforce to increase its productivity and make up for the reduction in resources. The reduction in conditions of employment was unremittingly negative - retrenchment, freezes on promotion and job reclassification, time off in lieu of overtime payments, restrictions on leave accruals, a freeze on automatic step increases, reduced wages or days worked, or both. On the output side, some workers were being asked to do their original jobs as well as the jobs of those retrenched. There was an alternative - the same reduced cost of payroll in the budget with more staff retrenched. Better rewards could then have been provided for those remaining. Those rewards could have been linked to productivity gains. Only staff unable to produce improved levels of productivity would suffer the proposed negative consequences.

- **Mitigation of the impact of retrenchments through early retirement schemes and provision of counselling and training services.**

  Retirees were all to be given an option of a lump-sum payment of two years' salary, together with counselling and training. Unfortunately, insufficient attention was paid to the latter, and a key governance challenge of the reform program went unmet, namely to ensure that there was real understanding of the consequences of individual actions related to the program before any concerted action was taken to implement it.[17] Additionally, the suggestion that retrenched public servants could find alternative employment in the domestic private sector was unduly optimistic, given so much private sector activity was dependent on a public sector that was to be downsized. Many people who took the package - and they could only obtain the lump sum payment if they presented a business proposal - were without prior business experience and faced a difficult environment in which to start new entrepreneurial ventures.

3.4.2 Rationale and appropriateness of loan amount

As observed in the RRP (para 53), the loan was in large part aimed at financing the one-off, up-front costs of early retirement schemes. The original request from the national government in March 1996 was for $15 million to cover the direct costs of these schemes plus the costs of related counselling and retraining in each of the states. In October 1996, it was established that the national government was seeking an additional $3 million to fund the up-front costs of its own retirement scheme, bringing the total re-

[17] In Micronesia, much of the less skilled part of the workforce would have had no prior experience of sudden access to large sums of money. For them, an offer of an apparently substantial sum of money to leave employment might well appear irresistible. The extended family dependent on that person's income, armed with a realistic explanation of life after the capital sum had been exhausted, might make a different decision. For the designers of a reform program, the downside of too much realism is the possibility of insufficient applicants for a voluntary package. If that were to occur, however, a more Micronesian solution to a very difficult problem might be formulated.

quested loan amount to $18 million. Distribution would be as follows: $5.3m to Chuuk, $4.2m to Pohnpei, $3.5m to Yap, $2.0m to Kosrae, and $3.0m to the national government. Bank staff involved in processing the loan emphasized that it was to be seen in the context of the overall economic reform program, and not simply as a means of financing a public service downsizing.

In the RRP (para 62), it is observed that:

> *The size of the loan is based on the scope and the costs of the policy reforms, the importance and urgency of the reforms, and the state of public finances.*

Details of the costing of reforms and of the fiscal targets aimed at are not available from Bank files or any other source. Presumably, some calculations were made by the EMPAT team of the extent to which the wage bill had to be reduced in order to adjust to the 1 October, 1996 reduction in Compact funding. The funding reduction was $15 million, equivalent to approximately 25 percent of consolidated personnel expenditure in FY1996. Under the PSRP, workforces were to be reduced from FY1996 levels by 25 percent in the case of the national public service, 29 percent in Chuuk, 13 percent in Kosrae, 25 percent in Pohnpei, and 28 percent in Yap. No without-loan reform scenario seems to have been presented.

3.4.3 Consistency with country and Pacific strategy

Both the rationale for the program loan and the content of the PSRP are consistent with the Bank's Pacific strategy, and the specific country strategy:

> *Policy reform and improved economic management are the overall strategic objectives of Bank operations in FSM...During the 1996-99 period, a first priority is stabilizing public finances (FSM Country Strategy, p.54).*

3.4.4 Relevance and focus

The PSRP's general relevance is clear in that public service downsizing, public enterprise reform, and facilitating private sector-led development are accepted objectives identified at the

November 1995 National Summit. The focus is on public service downsizing in the short term, as a means of addressing the need for reductions in expenditure on personnel. There is relatively little attention given to public enterprise reform and private sector development beyond requiring a number of reviews. Nor is there any attention given to the fundamental issue of revenue-sharing between the national and state governments - an issue on which the program loan could have potentially provided some leverage.

3.4.5 Appropriateness and sustainability

The PSRP design provided for a public service downsizing, but left to be determined the more difficult task of identifying what services governments should provide in the future, deciding how government operations could be restructured to deliver these services, and formulating an action plan with a timetable. The services of an expert in public administration should have been acquired at the design stage, in order to assist in the undertaking of this task. (An expert eventually was recruited, and arrived in FSM in January 1999).

In the absence of an agreed basic framework of government post-reform, there is a risk that a public sector reform program will strip too far in some areas and not far enough in others. This stricture applies both to levels in a hierarchy (removing too many managers, key personnel and key classes of personnel) and to the capacity of an organization to continue to deliver core services at an appropriate service delivery level. In FSM there was a strong case for planning the government sector from a base of what the country could afford from its own revenue streams. Such a level would require only the most productive of the workforce and the most accomplished managers. Consequently, it would be important in any public service downsizing program that this core of the workforce was not eroded at all.

3.4.6 Likely impact on governance

There is little attention to the quality of governance in the PSRP. This is surprising, since poor fiscal policy formulation and implementation, particularly weak public expenditure management, was the core problem that the reform program addressed, and the Bank's governance policy was adopted in October 1995.

3.5 Implementation

3.5.1 Actions to date

As noted above, actions required before first tranche release were completed before loan approval, but release of funds was delayed until August 1997. Subsequently, all five governments drew down their shares of the $10 million to finance their early retirement programs.

Conditions for second tranche release were not fully met on schedule (March 1998) as a result of delays in downsizing of the national public service and in the passage of foreign investment acts. In July 1998, a review mission recommended a partial drawdown of $4 million be allowed for the national government and Yap and Kosrae, but not for Chuuk and Pohnpei because the required foreign investment legislation had not been passed. Additionally, in Pohnpei's case, legislation to raise additional taxation revenue and to enable privatization had not been passed, and OPO judged that the state was reneging on the spirit of the PSRP by engaging directly in commercial activities. The review mission recommended that the program loan's closure date be extended to May 1999 to allow Pohnpei time in which to comply with tranche conditions. The remaining second tranche conditions had been met by March 1999.

3.5.2 Use of loan and counterpart funds

Counterpart funds equivalent to $14 million have been utilized for the funding of the one-off costs of the early retirement schemes, which began in late 1997 and were almost complete by early 1999.

3.5.3 Process and organizational arrangements

Two key elements in any process of public sector reform are the existence of a champion and a mechanism to ensure that there is a "driver" which ensures that the timetable and objectives are adhered to. Access to public relations skills are extremely valuable so as to ensure that voters understand that the harsh actions have to be taken for a demonstrable future good (though providing such access is rarely part of even highly participatory reform programs).

In early 1999, no clear champion or driver of PSRP was evident, and there seemed to be little attention being paid to managing a continuing media campaign promoting the program.[18]

No clearly articulated and comprehensive plan of public sector reform was evident in early 1999 either. EMPAT advises both levels of government on fiscal and public sector reform, but has been operating without a plan of where the reform program is going and how it is going to get there. The Consolidated PSRP policy matrix is only a set of conditions that must be realized to ensure the release of loan moneys; and the EMPAT work plans consist of items like "advisory and technical support for improved personnel management" that would not normally be part of an action plan. This reflects the composition of the EMPAT team which, until the arrival of the public administration expert in January 1999, was made up entirely of economists.

Given the constitutional circumstances of FSM, the organizational arrangements for EMPAT are not ideal. It is located at the national level in the national capital and, as far as the State governments interviewed were concerned, advises the national Government. Visits by members of the EMPAT team to assist the States have been infrequent.[19] The terms of reference for EMPAT endorse the view that the national Government directs EMPAT, with the work program formally being determined by the President and actually by a Steering Committee consisting of the national Secretaries of Economic Affairs, Finance and Administration and Foreign Affairs. Though individual members of EMPAT have been allocated specific

[18] The most often used "driver" of a reform program is the head of finance and the mechanism used is some kind of expenditure review committee operating through the budget and chaired by the head of finance. Co-opted onto the committee are heads of other key "spending" departments in the government. In a federal situation such as FSM, there seem to be two alternatives to make such a mechanism work. A collaborative effort could be mounted in which the President or his delegate and each governor form the committee and review all budget expenditures. Alternatively, the program might be driven from the national level with the national budget providing incentives in the form of additional grants to encourage the states to adhere to the agreed program. In the FSM situation, the national legislature and not the President has power to distribute current account budget surpluses in any way it considers fit. Consequently, a mechanism would need to bind the national legislature into the process.

[19] The Reform committee in Pohnpei, the island on which the national capital is situated, told the Task Force mission that it had received only one visit in the past nine months from its EMPAT representative.

state governments to assist, in a federal system the objectives and means of national and secondary levels of government are not necessarily in harmony, especially in the significant area of fiscal transfers. Consequently, the EMPAT team, from time to time, must experience a conflict of interest in advising the national and state levels of government.

Organizational arrangements for EMPAT have also been complicated by the way in which additional technical assistance for improved budget management has been introduced. Given that this assistance focuses directly on the reform program, it would appropriately be located within the EMPAT team and thus be integrated with the team's program. Instead, 13 months of international consulting services aimed at making performance based budgeting systems operational in at least two budget offices were organized under a Budget Task Force consisting of the five Directors of Budget.[20] In the successor TA,[21] the task force was to liaise with the Secretaries of Finance and Administration and of Economic Affairs, and the heads of finance and planning departments in the states. This subsequent TA was expected to coordinate its activities with the EMPAT team whose activities are directed by a different national level Steering Committee. The EMPAT team is directed by one committee, which is entirely national level. The Performance Based Public Resource Management team reports to a different task force, none of whose members are on the former Steering Committee, but which has both national and state representatives on it. There is thus some confusion over who is driving the reform program.

The consequences of not comprehensively addressing public sector reform issues at the outset can be illustrated in two ways. The first example relates to the mechanics of government-wide downsizing programs that continue to meet effective service delivery requirements. In the reduction in the number of government departments, in some states, the personnel function has been merged into the responsibilities of Departments of Finance. A strong personnel function usually ensures that a downsizing program does not release staff who are still needed, and that it is applied equitably. It is also assists departments with mergers and reorganizations,

[20] TA2538, Improved Budget Management Project, approved 14 March 1996.

[21] TA2983, Performance-based Public Resource Management approved 26 January 1998.

makes proposals to ensure that any incentives attached to increased productivity consequent on the downsizing are appropriate, and assists departments to develop human resource management programs to ensure that there is no long term reduction in the quality of public service delivery. Merged into the Department of Finance and Administration, the personnel function becomes subsidiary to finance rather than an equal partner. Evidence for this is the Pohnpei Department of Finance and Administration Secretary's observation that personnel was her third priority. Two years into the program, she would be turning to address personnel issues after she has resolved the state's macro-economic and financial priorities.

A second example relates to the situation of the broad accounting function throughout government. There are few qualified accountants in FSM, reportedly none in Kosrae. Consequently, there is a great need to improve the competencies of accounting staff in government, as there is a dearth of accounting personnel in the private sector. The needs are greater than can be addressed by the training requirements of the two performance based budgeting specialists provided for in the technical assistance project mentioned above.[22]

3.5.4 Effectiveness of monitoring

Under the oversight of the Vice President of the national government, the PSRP has been monitored by State Public Sector Reform Committees and by EMPAT. The latter reported to a Steering Committee of the Secretaries of Economic Affairs, Finance and Foreign Affairs, and was required to submit quarterly reports to the Bank. Additionally, progress has been assessed through a joint Bank-national government review in March 1998 and Bank missions in July and November 1998. Reports have been presented to the Consultative Group Meetings.

There are simple criteria to judge the performance of a monitoring function. Reports must be timely, accurate and focused on those indicators which relate to success criteria. They should also be sufficiently regular to enable management to ascertain quickly

[22] Regular auditing of public accounts has been outsourced to one of the Big Six accountancy firms operating out of Guam. Its audits of Kosrae accounts over 9 years notes poor internal controls, transactions not being approved appropriately and a number of other omissions suggestive of poorly operating accounting functions.

that a set of activities is proceeding according to plan. Judged on this basis, performance has been unsatisfactory.

3.6 Results

3.6.1 Participation and ownership

There has undoubtedly been significant participation in, and ownership of, the reform process. Painful cuts in state public service workforces and pay levels have been made quickly (see section 3.6.2). Further public service reforms are under consideration, such as a new Public Employment Act in Pohnpei that would place all public servants on three-year contracts. There is a growing recognition that the dependency mentality engendered by decades of high aid levels is detrimental to long-term development prospects.

Nonetheless, there is a danger that the reform process has lost momentum. Political commitment seems to have waned, as indicated by the way in which the national level early retirement program was implemented (see section 3.6.4), the way in which national budget surpluses are used by Congress members for local projects that are not regarded as a priority at state level, the reluctance on the part of some state legislatures to pass required legislation, and a marked dissatisfaction on the part of at least two state legislatures with the program. Some politicians and senior officials talk of the reform process ending or winding down in 1999, and some harbor the hope that Compact funding will be maintained at an acceptable level after 2001. Public support for reform seems to have eroded.

There is now a need for the reform process to be revitalized. In this regard, the post-election summits planned for later in 1999 will be an opportunity for presentation of a vision and an elaboration of comprehensive strategies.

3.6.2 Public service downsizing and government finances

Strengthening of government finances is the core of the PSRP, with public service downsizing the primary means (output 1), supplemented by increased domestic revenue generation (output 2). National government departments have been restructured and

reduced in number from 11 to 7, though in a rather ad hoc manner. Government departments in Pohnpei have been reduced from 14 to 7. The major nationwide effort has been in reducing staff numbers and pay levels.

Presenting a clear and precise description of workforce reductions is hampered by differences in the baseline numbers and final target levels reported in the PSRP documentation. This reflects weaknesses in monitoring and reporting already referred to. Nonetheless, data indicate that significant downsizing of public service workforces has been achieved: approximately 25 per cent in Chuuk; between 11 and 17 percent in Kosrae; between 22 and 37 percent in Pohnpei; between 26 and 35 percent in Yap; and between 7 and 24 percent in the National Government. In addition, Chuuk has cut wage rates by 20 percent, Kosrae has imposed a 12.5 percent wage cut, Pohnpei has introduced a 10 percent pay cut following a 20 percent cut for seven months in FY1997, and Yap has restricted overtime and annual leave accrual (though no wage cuts have been imposed).

There is one caveat to the downsizing achievement as far as the national government figures are concerned. This concerns the category of employment that is taken as relevant for the purposes of monitoring and assessment. The category used by the Bank and EMPAT is "FSM Unrestricted Funds", but there is an additional category of "Federal Programs and Refundables". A different picture of what has happened to employment in the period 1995-99 emerges if the total of these categories is considered. The total on the national government payroll has risen from 733 in January 1995 to 807 in February 1999.

It is also important to recognize that local ownership of public service reforms was evident in the fact that substantial staff cuts were made before the implementation of the early retirement schemes, which began with the availability of program loan funds from August 1997. The vast majority of retirements under the schemes thus occurred in calendar year 1998. An up-to-date summary table of retirements by state and for national government is not available; but the EMPAT I draft final report provides numbers as at the end of September 1998: Chuuk 288; Kosrae 107 (plus 50 volunteers awaiting a decision); Pohnpei 146; Yap 75 (all mandatory); National 86 (plus 43 volunteers awaiting a decision). These add to a total of 702 retirees.

The impact of staff cuts on service delivery is unknown, but there has been a reported drop in staff morale as a result of paycuts – and because some public servants have been compelled to undertake two or more jobs while being paid for one. On the other hand, some state government departments are beginning to examine alternative ways of producing services. For example, caretaking responsibilities for schools might be contracted out to local communities in Kosrae.

The PSRP also set targets for revenue increases: 20 percent for Chuuk; 5 percent for Kosrae; 20 percent for Pohnpei; 30 percent for Yap; and 40 percent for the national government. The new Customs Act became effective on 1 October 1997, and was projected to increase revenues from that source by 35-40 percent. The lack of accessible data on actual budget outcomes for FY1997 and FY1998 prevents comment on achievements in this area, just as it prevents an assessment of reductions in recurrent expenditure resulting from public service downsizing. However, the EMPAT I Draft Final Report notes that state taxes and fees in Chuuk in FY1998 increased on FY1997 levels by 24 and 13 percent, respectively; and that they showed a "substantial drop" in Kosrae. Outcomes for the other states are unknown.

3.6.3 Public enterprise restructuring

The third output of PSRP involves the restructuring of approximately 33 public enterprises and the privatization of some. The EMPAT team has provided assistance in identification of departmental functions that could be corporatized or privatized; and the Performance-based Public Resource Management TA involves the establishment of a framework for monitoring the performance of public enterprises. Some departmental activities have been privatized or contracted out, and the states have transferred power, water and sanitation services to independent public utility authorities, with a view to introduction of a user pays approach to service delivery. Otherwise, there has been little progress. There is a need to develop a comprehensive policy framework and an associated action plan.

3.6.4 The Early Retirement Schemes

The fourth output of PSRP is the mitigation of the negative social and economic impact of public expenditure adjustment. Tracer studies were supposed to have been done of personnel taking the package, and were provided for under the loan and belatedly under EMPAT II. However, they were not underway in February 1999. Information from the Island Tribune and interviews in Kosrae and Yap indicates that packages were consumed quickly, that relatively few retirees accessed training programs once they were available, that few businesses were established, and that the majority of these businesses failed. These conclusions need to be verified by reliable survey data but, in retrospect, the original expectation that "a considerable number [of voluntary retirees] will be younger with the energy, initiative and appropriate education to make a success in the private sector" (paragraph 53, RRP) appears over-optimistic.

Some advantages taken of the spirit of the early retirement scheme at the national level are of concern.[23] Had there been agreement about the core functions of government and the machinery of government to fulfil them, including organizational arrangements that reduced the opportunities for one individual to be in a position to grant a favor to another individual, it is unlikely that such a concern would have arisen.

[23] By 15 January 1999, 90 national government servants had taken the retirement package. Among them were the Attorney General, the Director of Court Administration, the Chief Public Defender, the Chief Clerk, a Commissioner of Revenue, a Chief of Immigration, and the National Planner. One of the conditions of a person taking the package was that his or her job was regarded as redundant. The Attorney-General's Department lost its head, the Attorney General, the head of that part of the department responsible for running the federal courts, the Chief Public Defender and the Chief Clerk. Surprisingly, the December 1998 listing of national public servants includes a Secretary, Department of Justice, a Director of Court Administration and a Chief Clerk. There does not appear to be a Chief Public Defender, the office of which is staffed by two contract consultants. It is reported that the former Attorney General, who is not a permanent public servant but is appointed by the President for the lifetime of the present government, is now receiving contract work from the Government.

3.6.5 Private Sector Development

The fifth output of PSRP is fostering the development of the private sector. Two notable changes have occurred. First, there has been a liberalization of interest rate controls. Second, a new Foreign Investment Act came into effect on 1 January 1998, and complementary legislation has now been passed by all of the states. This will potentially improve the investment climate by separating national and state jurisdictions over granting of foreign investment permits, streamlining and shortening the approval process, and automatically providing expatriate worker authorizations. There has been a number of recent private sector investments in tourism resorts, tuna long lining, and apparel manufacture. However, for potential improvements in the investment climate to be realized, a number of constraints need to be eased. "The biggest constraint to increased foreign investment is the continuation of a very high level of government interference with the commercial sector" (Business and Government Strategies International, TA No. 2786-FSM, Investment Promotion and Financial Sector Review, 20 November 1998). Other constraints include uncertainty about future economic stability, pending the outcome of Compact negotiations; problems in gaining secure and transferable access to land; inadequate, high-cost transportation links; inadequate physical and social infrastructure; and small market size.

In the meantime, contraction of the public service has caused a contraction in the private sector because so much private sector activity depended on sales to the public sector. The absence of national accounts after 1996 prevents quantification of the aggregate outcome.

3.6.6 Governance

In a democracy like FSM, reform programs, if they are to be successful, need to be nurtured over a number of years, years often well in excess of the conventional term of one government. It is unhelpful if, as has happened in Kosrae, the reform program is an election issue and those perceived to be associated with the program fail to be re-elected.

In the FSM reform program, there have been few if any "wins" for the state political leaders to demonstrate to the electorate that,

while the pain was necessary, there were also some gains. No provision was made in the program to maintain an effective media campaign to explain the necessity for the reforms as positively as possible. With little attention being paid to improved services, the outcome was one of unremitting pain. Opportunities to alleviate this through a judicious use of the national level budget surpluses were dissipated on projects of particular interest to the national level politicians.

The impacts of the program lie in three broad areas: impacts on government budgets, impacts on the quality and cover of service delivery, and impacts on individuals directly affected by the changes. Not surprisingly, with a predominant focus on reducing costs to balance the budget, there has been a strong focus on the first of these impacts throughout the program. There has been no attention to the impacts on service delivery, other than the recent attention to the introduction of performance criteria in the budget papers. Service priorities and departmental operations to deliver particular services were not addressed at the design stage, and consequently capacity building at the service delivery level has been neglected. It appears that the majority of lower paid retirees were under-prepared for the change. For those who decided to remain in public employ, there are no studies of the impacts of the program on their work and productivity. Again, it appears that there is resentment at the changes to their conditions of employment, accompanied by a perception of an increase in job requirements.

The organizational arrangements whereby the Bank-funded EMPAT and performance-based budget teams report to two different committees with quite separate memberships make the location of responsibility for managing and driving the reform program unclear. An effective reporting system has not been established, despite the fact that technical assistance accompanying the loan was specifically set up to improve the monitoring of the social and economic impacts of the overall economic reforms. This situation needs remedying immediately.

A national champion with broad-based support and a mechanism for driving the program are not apparent. As noted above, the evidence suggests that the National Government has circumvented the key requirement of reducing staff numbers.

The reform program has paid little explicit attention to governance issues. In terms of accountability, the mechanisms for an

effective system are in place. The diminution of the system probably lies in the inexperience of legislatures of what their roles are and how to exercise them. The two legislative bodies that the review team had access to both contained speakers and other members who were very keen to exercise their responsibilities effectively. Both States had expatriate legal advisers. What both needed was a development program to enable legislative members to conduct their review functions more effectively and to be appraised of the kinds of powers that they can exercise. Only then would there be an appropriate balance between the legislative and executive branches of government.

3.7 Looking to the Future

In sum, PSRP started well, with a sensible basic design given the urgency of bringing the fiscal situation under control. Governments have made considerable progress in implementation. But design was less strong on establishing effective internal mechanisms to ensure that momentum was maintained. Participation at the outset was good and would have been enhanced if there were a better mechanism to institutionalize it through the political process. The design also ignored the important point of making the program politically as palatable as possible by providing some wins, and by ensuring that there was an effective media campaign to continue to promote the importance of the program to the future of FSM. The program design did not do enough to change the focus of the EMPAT team to include public service delivery alongside its economic foci. Nor did it do enough to ensure that State governments were supported with at least the same level of independent advice as their national colleagues, and that there were mechanisms to distribute surpluses to ameliorate some of the negatives of the reform program, should such surpluses occur.

Now the reform program seems to have lost its way. Commitment and support for the program need to be strengthened. The political key to reigniting the reform process is the threat of the Compact re-negotiations. FSM has now had one experience of the pain of a significant cut. The potential future pain, promoted on the basis of something like a zero-based budgeting exercise, could present a concentrated focus for the electorate that pressure needs

to be maintained on the public sector to reduce costs, improve productivity and deliver on a service delivery charter. The scenarios can be produced by the EMPAT team. It will probably require support to help convert the messages into coherent and effective political action. Completion of a reignited reform process will require not only further public service reform (as opposed to simple downsizing), but also translation of the commitment to public enterprise reform into a coherent policy framework with an associated action plan, and ongoing improvement of the private sector policy environment.

Key lessons that emerge from the FSM reform experience are:

- Public sector reform is more difficult than simple fiscal constraint. It should be planned at the design stage by experts in public administration in a small developing country context, identifying clear end points for the reform program, some of which must represent definite benefits.

- Retrenchment programs should be components of a public sector reform program, and thus be based on a clear specification of the desired future form of government. They should be designed with reference to local culture and make effective provision for education on managing life after retrenchment.

- Where retrenchment is elective, strong mechanisms are needed to ensure that it is applied according to the design and intent of the program.

- There should be consistency between program goals and actions taken (reference the use of surplus revenue at the national level for politically-motivated projects).

- Other key factors in a successful reform program include:

    - a high profile champion.

    - a mechanism to drive the program (which is usually the budget).

- organizational arrangements for technical assistance that fit in with the above mechanism (a popular arrangement being a Cabinet level “razor gang”).

- good synchronization between the champion, the driving mechanism and the political process in the sense that the political process is used to endorse and reinforce the need for actions taken.

- an effective public relations campaign to promote the program and emphasize the need for it and the achievements of it.

- identification of clear and relevant performance indicators and a regular and effective program of reporting.

- a participatory/accountability mechanism for the governed to keep the governors on track.

4 REPUBLIC OF THE MARSHALL ISLANDS

4.1 Introduction

The Public Sector Reform Program (PSRP) Loan of $12 million to the Republic of the Marshall Islands was approved in December 1996, to be released in three tranches. Adjunct technical assistance was provided that aimed at supporting PSRP implementation in three specific areas: (a) program coordination ($515,000); (b) institutional strengthening of the transport sector ($575,000); and (c) establishment of a private sector unit ($760,000). The loan amount compared with external grant assistance, mostly under the Compact of Free Association with the United States, of $40 million in the fiscal year ending 30 September 1997.

4.2 The Macroeconomic and Governance Context

Marshall Islands 1996 Economic Report (ADB 1997b) provides a comprehensive analysis of economic development performance, problems and policy issues up to 1996. The central challenge identified in the report was for a heavily aid-dependent, public sector-dominated economy to adjust to reductions in external grants under the Compact of Free Association with the United States. These reductions occurred in 1992 and 1997; and, subject to the outcome of re-negotiation of Compact funding in 1999, further reduction could be anticipated in 2001. The magnitude of the adjustment required is indicated by the fact that in the period FY1991-FY1995, US grants accounted for an average 71 percent of total government revenue and 59 percent of total expenditure. The budget deficit before grants averaged 65 percent of GDP, and after grants a still unsustainably high 16.5 percent.

The budget deficits of the early 1990s resulted from a failure to adjust to the 1992 Compact stepdown. Instead, capital

expenditure increased, high subsidies to public enterprises (especially Air Marshall Islands) remained, and the public sector payroll grew. The number of public sector employees increased by 53 percent between 1991 and 1995 - from 2,671 to 4,086, compared with private sector figures of 4,168 and 4,724, respectively. By the end of September 1995, with government's financial reserves run down to $3 million (from $47 million in 1991) and external debt at $141 million (134 percent of GDP), the incumbent President recognized the need for urgent fiscal adjustment. A Policy Reform Program that focussed on fiscal stabilization was developed with assistance from a Bank-funded Policy Advisory Team and presented to external funding agencies in December 1995 (see sections 4.3 and 4.4).

Given that public administration (including health and education services) accounted for 27 percent of GDP in 1995, and that public enterprises were prominent in transport and communications, finance, manufacturing and electricity and water, fiscal adjustment was bound to have a significant, negative impact on the level of economic activity. Following annual growth of 3-4 percent during the early 1990s, RMI's real gross domestic product (GDP) fell sharply by 7.8 per cent in 1996 and by 5.0 percent in 1997, according to the Office of Planning and Statistics. In 1998, it is estimated to have fallen by a further 5.0 percent, to about $57.5 million in 1991 prices. With population growing at 3.5 percent per annum, real GDP per capita has fallen 41 percent in the 1990s - to an estimated $913 in 1998 (Figure 4.1). There are no recent data on GNP, but in 1990-96 net factor income receivable from overseas averaged 6.4 percent of GDP (World Development Indicators 1998). Income distribution was, in the words of the 1996 Economic Report (ADB 1997b, p.47), "highly skewed". In 1991, average income in the outer islands was 47 percent of that in Majuro and 32 percent of that in the island of Ebeye, Kwajalein atoll. The richest 20 percent of the Majuro population received average incomes of over $3,000, whereas the poorest 20 percent received $840.

Declines in output during 1995-98 reflected not only the cuts in government expenditure and employment made under the Policy Reform Program, but also the poor performance of agriculture and fishing. Agriculture and fishing output contracted by 20 percent in FY1996-FY1997, and fell again in FY1998 because of the effects of typhoon Paka (December 1997) and El Nino. Copra production continued to be adversely affected by low producer prices, inter-island

transport problems, and an aging tree stock. Food and livestock production fell. Fishing production contracted when unprofitable government-owned long-line and purse-seiner vessels ceased operations in FY1996. In line with the economic recession, the inflation rate fell from almost 10 percent in FY1996 to 5 percent in FY1997, and an estimated 4 percent in FY1998.

In 1999, economic activity has recovered as a result of aid-funded roadworks employing about 300 people and, more importantly, growth in the fisheries sector. A reduction in domestic fuel prices was the catalyst for a substantial increase in the foreign purse seiner fleet. Fishing license fees are expected to rise to over $4 million, compared with $1.8 million in 1998; and on-shore spending by crews has stimulated the services sector. A loining factory that will provide 300 jobs is to be built. Bank technical assistance to the fisheries sector has been instrumental in the process leading to these developments.

Substantial progress toward fiscal stabilization was made in FY1996 and FY1997, as public service downsizing, the reduction or elimination of subsidies to state-owned enterprises, and a major drop in capital spending combined to generate overall budget surpluses equivalent to 20 and 4 percent of GDP, according to IMF estimates. These surpluses were used to make loan repayments and, in FY1997, to reduce arrears. The budget for FY1998 aimed at continuing the fiscal adjustment, estimating a surplus equivalent to 11 percent of GDP would be achieved through a 17 percent cut in expenditure. A 5 percent drop in revenue and grants was expected, given the deferment of revenue-raising actions that originally were to have been incorporated in the budget. However, in March 1998 a supplementary budget provided for a 13 percent increase in expenditure on the estimated level, $6.5 million from general funds and $2.2 million from anticipated assets sales that have not eventuated. In addition, revenue receipts were running below the estimated level. Data on the actual outcome in FY1998 are not yet available, but it is likely that an overall deficit was realized, rather than the large surplus needed to cover net amortization of external debt, which stood at $125 million at the end of FY1997.

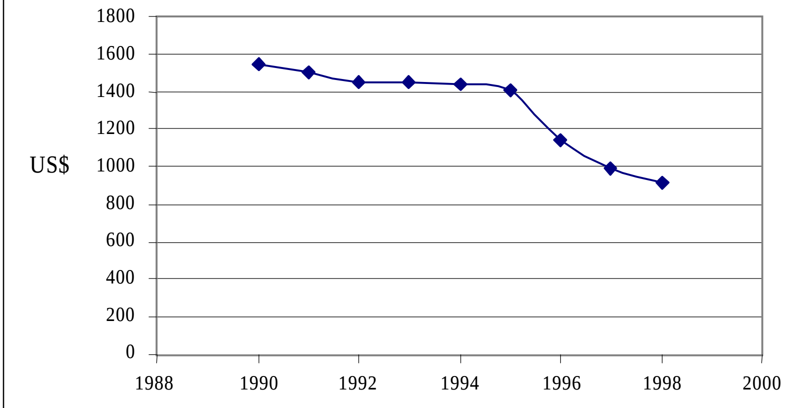
The absence of timely, reliable and comprehensive statistics on government finances is one aspect of a lack of transparency in government decision-making, which is also on occasion notable for

its unpredictability.[24] However, government is ultimately accountable at the ballot box. Elections to the Nitijela (parliament) are due in November 1999, and a government that holds a slender majority is now in election mode. In early March, it announced a substantial rise in the copra subsidy, a cut in the general tariff rate from 12 to 5 percent, and large cuts in the tariff rates on alcohol, tobacco and soft drinks. (The general rate had been increased from 10 to 12 percent in 1996 as a revenue-raising measure). There seems to be considerable confidence amongst politicians and government officials that the need for further fiscal adjustment shall be forestalled by increased external aid from Taipei,China, which RMI recognized in late 1998, and by a successful re-negotiation of Compact funding. Belief in the latter outcome has been encouraged by a US Department of Defense assessment of the US Army Kwajalein Atoll (USAKA)/Kwajalein Missile Range (KMR) as a "national asset" because of its unique suitability for full-scale testing of long-range missiles and intelligence gathering, and its importance for space programs.[25] The Compact provides for automatic renewal rights of the lease on Kwajalein for 15 years after expiration of the current lease in 2001.

[24] Audits of General Purpose Financial Statements for the fiscal years of 1995 and 1996 conducted by Deloitte and Touche note a lack of comprehensiveness in accounts, inadequacies in accounting records, and inadequacies in internal control structures. G. Vaughan-Jones, Review of Progress in Implementation of Budget Reforms, Republic of Marshall Islands, (TA2755-RMI, n.d.), notes "improvement of all elements of financial management [is] an important necessary initiative for the Marshall Islands". The Minister of Finance observes: "Our financial records are in terrible condition (17 major exceptions in the audit opinion)" (Tony A. de Brum, Minister of Finance to Peter Sullivan, Vice President (East), 5 January 1999). Up to the end of 1997, no executing agency for Bank loans had ever submitted the required audited annual project accounts.

[25] Testimony of Stanley O. Roth, Assistant Secretary of State for East Asian and Pacific Affairs, Asia Pacific Subcommittee of the House International Relations Committee, 1 October 1998.

Figure 4.1: Real GDP per capita (1991 prices)



Sources: Office of Planning and Statistics, *Marshall Islands Statistical Abstract 1997*; staff estimates.

Funds permitting, government is supportive of a sympathetic interpretation of section 11 of the Constitution of the Marshall Islands (1983), which refers to the functions of the Public Service Commission:

> *[The Commission] shall take account of the need to recruit and train an efficient staff, to afford reasonable opportunities of employment for Marshallese and to act consistently with government economic and social policy bearing in mind that conditions of employment in the public service are a major element in the general well-being of the Marshall Islands.*

4.3 The Process of Program Design

4.3.1 Ownership and appropriate participation in the design process

During late 1995, the government of RMI developed a Policy Reform Program with assistance from a Bank advisory team that arrived in Majuro in July.[26] The program focussed on fiscal stabilization and tax reform, privatization of public sector enterprises, public service reform, and stimulation of private sector development. The public service reform component was based largely on a UNDP study – the Boag study - that was begun in January 1994 and adopted by Cabinet and the Nitijela in December 1995.[27] In the latter month, the program was presented to, and endorsed by, the first RMI Consultative Group Meeting in Manila. Subsequently, it formed the basis of the Public Sector Reform Program (PSRP), which reportedly included those reforms that the RMI government was ready to implement and that were adjudged to have a chance of actually being implemented over the next two to three years, with technical assistance.

The Program Matrix was presented by the RMI President to his Cabinet and approved prior to signing of the MOU on 31 May 1996. Beyond this, a one-day workshop, and some radio broadcasts, there seems to have been little concerted effort to communicate reform objectives and strategies to the legislature or the public at large. With the death of President Kabua in late 1996, impetus for reform was lost. The first National Economic and Social Summit in Majuro was not held until January 1998, and then was at the request of the funding agencies' 1997 Core Group meeting in Fukuoka. Summit papers were translated into Marshallese and circulated amongst summit participants, and proceedings were broadcast on the radio. This was the first major step taken to address communication gaps identified within the Government and between Government and the general public. There have been no summits since the first, and none is planned.

[26] TA 2295-RMI: Policy Advisory Team, approved for $2.5 million on 31 January 1995.

[27] Peter Boag, Public Sector Management Improvement Program, November 1995 (2 volumes). This study followed earlier studies of public service rationalization – the 1988 Aries Report and a 1994 World Bank study.

It remains the case that the reform process is seen essentially as a public service downsizing instigated by the President of the day, implemented through a Presidential Committee on Rationalization of the Public Service established in October 1992, chaired by the Chief Secretary of the Office of the President, and informed by the UNDP study and PAT advisers. The Committee, later renamed the National Steering Committee, presented targets to Cabinet and the Nitijela for approval, and then informed Secretaries of Ministries of the required, across-the-board cuts in numbers. Secretaries were expected simply to comply. They still complain that there was inadequate attention paid to organizational structure and function, and to individual ministeries' staffing needs, let alone to effective service delivery. It is telling in this regard that the Boag study notes with reference to its downsizing estimates that "Obviously no discussions have been held with the Ministries concerned".

4.3.2 Partnership and consultation with other external funding agencies

The Bank has been holding Consultative Group meetings for RMI since the December 1995 meeting mentioned above. The third meeting was held on 30 January 1998 in Tokyo and, like previous meetings, served to inform external funding agencies on design and implementation issues and to identify priority areas for assistance. During the process of formulation of the PSRP, the Bank consulted with, and sought feedback from, the IMF and the World Bank.

4.3.3 Effectiveness of internal processing procedures

Processing procedures were completed relatively quickly. Fact finding was completed from 18 to 31 May 1996, loan appraisal from 9 to 18 September, and loan negotiations were completed on 18 November, 1996. Disbursement of the first tranche occurred on 6 February 1997.

4.4 The Content of the Program

4.4.1 The Public Sector Reform Program

The overall, long-term goal of the PSRP is to stimulate private sector-led economic growth. This is to be done through the achievement of three primary objectives: short-run stabilization of government finances; ensuring long-term structural stability in government finances; and creation of an enabling environment for the private sector. The first two primary objectives have related secondary objectives of increasing revenue, reducing recurrent expenditure by 20 percent during the Program period, and improving management of funds under government control. The third primary objective has the two related secondary objectives of reducing government involvement in the economy and improving the regulatory environment. Fifty-nine reform actions to attain the objectives are specified in a policy matrix: 38 relate to the first two primary objectives; and 21 to the third.

The first tranche of the $12 million loan was released upon loan effectiveness, reflecting the fact that 15 policy actions in the policy matrix were already completed. Thus, according to the RRP (para 5 of Appendix 1), "The goal of stabilization of Government finances was achieved by the beginning of FY1997, on 1 October 1996...by increasing revenues, and reducing expenditures". The active part of PSRP is therefore made up of 44 policy actions, 40 of which explicitly address the second and third primary objectives. Six actions are second tranche conditions and three are third tranche conditions (Appendix 1).

The first three second tranche conditions – to downsize the public service, end subsidies to Air Marshall Islands, and continue the three-year wage freeze – are the key actions to reduce government's recurrent expenditure. The Reduction in Force (RIF) program provides retrenched public servants with a lump-sum payment of 3-9 months' pay, depending on length of service, and monthly maintenance payments over a three-year period, calculated according to the benefit rules of the Marshall Islands Social Security Administration. Other key, non-tranche actions contributing to strengthening public finances from the revenue side include improving tax and customs administration; reducing tax arrears; simplifying the import duty schedule, with a basic duty of 12

percent and eight other rates between 5 and 150 percent; reducing exemptions from import duties and the Gross Revenue Tax; and doubling the petrol tax.

The fourth second tranche condition concerning the establishment of a Financial Reserves Trust Fund as a long-term source of recurrent revenue is worthy of special mention. It drew its inspiration from the Tuvalu Trust Fund that began in 1987 and has operated successfully since, providing around 20 percent of government's annual recurrent revenue. The introduction of the Fund concept into the RMI PSRP represents an acknowledgement of the severe development constraints confronting this ultra-small atoll economy, and the consequent limitations to private sector activity and bankable development projects.

Compared with the first four second tranche conditions, the condition requiring a reduction in the numbers on the Air Marshall Islands Board, and the third tranche condition requiring a tax on rental income from commercial building, seem trivial.

The original and plausible expectation was that, with reform and the Bank's program loan, there would be an economic recession in 1996-98, the depth of which would be reduced in comparison with the reform-but-no-loan scenario as a result of the RIF payouts. Thereafter, economic recovery would depend on the strength of the private sector's response. Both the Boag report and the RRP acknowledge that the private sector would not be able to quickly absorb many, if any, retrenched public servants.[28] The RIF program, including a counselling and training component, was expected to mitigate the impact of retrenchment.

Three risks are identified as potentially preventing successful implementation and effectiveness of the reform program: (1) insufficient capacity in government; (2) a loss of government commitment to the pace of reform as opposition grew with the retrenchment of public servants; and (3) a failure of the private sector to respond to reforms as expected. The first risk was to be minimized through the use of Bank technical assistance. A Program Coordinator was to be assigned to the Rationalization Committee. TA

[28] Projections in Marshall Islands 1996 Economic Report (p.45) were that real GDP would fall almost 50 percent in 1996-2001, before modest recovery on the back of increased government expenditure made possible by completion of debt repayments and continuation of Compact funding into 2002 and 2003.

in institutional strengthening of the transport sector was to be provided. And a Private Sector Unit was to be supported. The second risk was to be reduced through a 1997 public information campaign, and through the provision of a safety net for retrenched public servants (the RIF program). With regard to the third risk, separate TAs were to design strategies expected to improve the policy environment in the fisheries and tourism sectors.

Although both the Boag report and the RRP refer to the need to produce a quality public service, the design of the PSRP reflects an overriding concern with the achievement of a more affordable public service through reductions in the number of ministries, outsourcing of some services, and cuts in staff and operating budgets. There is no discussion of the basic framework of a post-reform government that can more efficiently and effectively deliver the services required by a rapidly growing population. From the outset, therefore, the PSRP ran the risk of cutting staff too far in some areas and not far enough in others, potentially creating hierarchical imbalance (removing too many managers, key personnel and key classes of personnel) and diminishing the capacity of an organization to deliver core services at an appropriate quality level. With the focus on downsizing, the likelihood was that the target number of 1,484 would become an end in itself, rather than a signpost on the way to achieving the goals of public service reform.

Public service downsizing alone was considered hard enough. As the RRP notes:

> *The issue of what is affordable is difficult to address, in the light of the considerable uncertainties in RMI's future.*
>
> *The decision on the extent of downsizing was made more difficult in the absence of any reliable data on the actual size of the civil service (Appendix 1, paras 28,29).*

The numbers given in the Boag report are shown in Table 4.1. Following an immediate cut in government employees through termination of the school-feeding program and privatization of services in Public Works and the Ministry of Transport and Communications, the report recommended a further cut in "Core Government" numbers to 1,484, a 5 percent annual decrease in the average wage rate, and a 3 percent annual decrease in operations bud-

gets. Roughly 38 percent was thus to be cut from the public service budget over a five-year period. The Rationalization Committee endorsed the target number of 1,484; and the March 1996 interim budget cut wages by 5 percent for the 22 percent of employees receiving over $10,400 per annum, and reduced appropriations for ministries' operating expenditures by 3 percent. The PSRP reduced the timeframe for downsizing to one year.

It should be acknowledged that the Bank sought to provide a stand-alone, small-scale advisory TA to assist with implementation of civil service reform.[29] This was to provide an analysis of the current civil service organization and prepare a detailed, timebound action plan which would, amongst other things, identify required parliamentary approvals and legislative action and training and counselling needs of retrenched public servants. However, there was an 11 month delay in the start of the TA (from July 1996 to mid-1997), largely because of sluggishness in Bank processing attributed to staff changes; and the chosen consultant was in country for under two months.

4.4.2 Rationale and appropriateness of loan amount

The background diagnosis presented in the RRP is as comprehensive as data limitations permit. Government was unable to continue to pay the existing public service workforce, subsidize public enterprises, service the external debt, and still deliver the current level of services. Fiscal projections for FY1996-FY2003 presented in the 1996 Economic Report and revised in the RRP are the best available demonstration of the quantitative dimensions of the required fiscal adjustment and its negative impact on income. If anything, the bleakness of the medium-term economic outlook is understated because the impossible demands placed on private sector growth are not spelled out. It has been estimated that, in the absence of growth in public sector employment, the private sector in RMI would have to grow at a sustained 10.6 percent per annum just to absorb new entrants into the workforce (ADB 1998a, p.75). The PSRP is presented as a means of providing "at least some longer

[29] TA No.2599-RMI: Civil Service Reform Implementation, approved 2 July 1996 for $100,000.

term hope" and, through provision of loan funds, softening the impact of reform-induced recession (RRP, para 32).

Table 4.1: Public Service Downsizing

	Oct. 1995	Oct. 1995	Oct. 2000	% Reduction (total to new core)
	Total Govt.	Core Govt.	New Core	
Employees	2,125	1,739	1,484	30.2
Total wages	21.7	15.21	10.77	50.4
Operations	10.6	10.55	9.09	14.2
Total recurrent	32.3	25.76	19.86	38.5

Source: Peter Boag, Public Sector Management Improvement Program, November 1995 (2 volumes).

The loan amount of $12 million is "based on the scope and the costs of the policy reforms, the importance and urgency of the reforms, and the critical state of public finances" (RRP, para 84). The amount is divided as follows: $5.5 million for the RIF program; $4.0 million for paying off Air Marshall Islands' commercial debt; and $2.5 million for the Financial Reserves Trust Fund. The first number was estimated on the basis of expected retrenchments. The second represented two-thirds of AMI's outstanding commercial debt. The third number likely seemed an appropriate amount for seed-funding the Trust. With regard to the allocation of $4 million to pay off commercial debt of the ailing AMI, there was presumably some confidence that professional management, a change in the constitution of the board of directors, and assistance in developing an aviation policy would turn the enterprise around.

4.4.3 Consistency with country and Pacific strategy

Both the rationale for the program loan and the content of the PSRP are consistent with the Bank's Pacific and country strategies:

Policy reform and improved economic management are the overall strategic objectives of Bank operations in RMI...During the 1996-99 period, a first priority is stabilizing public finances. The Bank will also support investments in public sector reform and private sector development (Country Strategy, p.50).

4.4.4 Relevance and focus

The PSRP's general relevance has been acknowledged above. It has an explicitly limited focus, as explained in the RRP (Appendix 1, paras 3, 4):

While [the] three primary objectives are necessary to address the short-term fiscal constraints and create an environment for sustainable growth, these objectives alone are not sufficient to achieve that growth. The PSRP therefore is a program with a limited focus designed to create a stable macroeconomic framework which will contribute to the overriding objective of the creation of an improved enabling environment for private sector-led economic growth.

To attain these objectives, reforms are included in three areas: the public service, fiscal policies and the transport sector. The main rationale for the inclusion of these three areas...is that all three have a large impact on public sector finances, and reforms in all three are necessary to achieve private sector-led economic growth.

Reform actions extended to improving the regulatory environment, but did not address all of the issues raised in a Bank review of private sector operations in the Marshall Islands.[30] This review concluded that "the private sector environment is constrained by lack of long-term funding for project finance, a deficient legal environment, a lack of respect for the court, and a lack of enforcement of laws, rules and regulations, in particular [those] related to duties and taxes".

[30] RMI: Country Programming Mission – Review of Private Sector Operations, 5 February 1996.

4.4.5 Appropriateness and Sustainability

The PSRP design covers what was accepted by the President and some officials, on advice from the PAT team, as a necessary public service downsizing. As noted above, it does not address the more difficult task of identifying what services government should provide in the future, deciding how government operations could be restructured to deliver these services, and formulating an action plan with a timetable. Nor does it provide a mechanism ensuring that the reform program is marketed to the public and private sectors, the legislature and the public at large. The absence of such a mechanism, combined with an initial weakness in participation and ownership, plus the Constitutional recognition of the public service as an employer (section 4.2), raises doubts about the durability of any downsizing. In these circumstances, the Bank and its advisory team are readily cast in the dual role of enforcer of undesired reforms and scapegoat.

4.4.6 Likely impact on governance

Governance is dealt with in the PSRP insofar as it involves the regulatory environment, which is described in the RRP as "currently nontransparent with many discretionary powers vested with the executive branch of the Government" (Appendix 1, para 16). Specific actions to improve transparency and predictability of decision-making include the third tranche condition to remove company registration from Cabinet hands and make it the sole responsibility of the Registrar of Corporations; a review of policy and procedures concerning hiring of foreign workers; improving procedures for issuing of business licenses to foreign investors and passing new legislation to provide standard international protection for such investors; establishing an Ombudsman's office; and creating legislation and procedures to ensure security of land leases (Appendix 1, C2).

More generally, it should be noted that legislation has not been codified or published in the past three years and that departmental regulations have never been codified or published. This basic requirement of good governance is not mentioned in the PSRP.

4.5 Implementation

4.5.1 Actions to date

At the time of loan effectiveness, three revenue-raising actions and 11 expenditure-reducing actions had already been satisfied. Conditions for second tranche release were not fully met on schedule (September 1997), because of Government's sudden removal of Air Marshall Islands' chief executive officer and a failure to downsize the public service to 1,484 employees. In the event, release occurred one year later, after a new CEO had been recruited for AMI, and on the basis that the Bank (1) effectively waived the tranche condition requiring an AMI board of five (there were seven members), and (2) granted a waiver that transferred two second tranche conditions into the third tranche box. One of these was the 1,484 target, which government undertook to meet in 1999. The other was the establishment of the Financial Reserves Trust Fund: government had set aside $300,000 as its contribution, but had not passed the required legislation.

In early March 1999, 30 of the 59 policy matrix actions were completed and remained in place, three had been completed but subsequently reversed, and 26 remained incomplete. The reversals concerned rationalization and raising of import duties, the reduction of copra subsidies, and the number of AMI board members. Included in the incomplete category are all of the revised third tranche conditions. Five pieces of legislation are yet to be passed, and the public service downsizing target has not been met (though the number had dropped from 2,303 in October 1995 to 1,607 at the end of 1998). The condition requiring imposition of a tax on rental incomes from commercial buildings will have to be waived if the third tranche is to be released, since it was to be met through introduction of value-added tax legislation, which has been withdrawn from the Nitijela.[31]

[31] By the end of March 1999, all legislation except for that concerning company registration had been passed; and Bank staff were confident that third tranche conditions would be met on schedule.

4.5.2 Use of loan and counterpart funds

Paragraph 104 of the RRP states that: "The Borrower will ensure that the Counterpart Funds withdrawn from the Special Account to be established for the purpose of the loan, will be used for (i) financial support for civil servants retrenched from the public service under the RIF program, (ii) supporting retirement of AMI's accumulated commercial debts, and (iii) supporting the establishment of the Financial Reserves Trust Fund". This requirement has been complied with, but actual allocations to the three categories have not corresponded exactly to the program loan tranching schedule. Air Marshall Islands has received $4.37 million instead of the scheduled $4.0 million because of an apparent oversight by the executing agency (the Ministry of Finance). This has provided a windfall to the management of a cash-strapped AMI and, together with the strengthening of the SDR exchange rate, has left the RIF program $0.5 million short of its intended allocation.

4.5.3 Effectiveness of monitoring

The RRP (para 105) noted that the Bank "will monitor closely the implementation and impact of the Program, including future policy, institutional and financial developments, and any other changes likely to have an effect on the Program. The Office of Planning and Statistics will be charged with the design and implementation of a monitoring program". The Bank has undertaken the monitoring task as planned, and this has been facilitated by the appointment of a PSRP Coordinator from mid-1997 (though the contract surprisingly contains no requirement for regular reporting to the Bank). In addition, under the Loan Agreement, the RMI Government is required to submit semi-annual reports on progress to the Bank. This has been done. However, there is no evidence that the Office of Planning and Statistics has designed and implemented a monitoring program, or that it has effectively pursued the task of tracking retrenched public servants. As in the FSM reform program, anecdotal evidence is the only basis for establishing what has happened to these people. Nor has the RMI government forwarded operational and financial statements of AMI to the Bank on a monthly basis.

4.6 Results

4.6.1 Participation and ownership

From the beginning of the PSRP, it is doubtful that participation and ownership have been strong enough to underpin a sustained reform effort. The public service downsizing was very much a top-down initiative of the late President's, supported by external advice. After the President's death the Bank's Policy Advisory Team became marginalized, at least in part because of a reported failure to gain the trust and respect of the new leadership.

In 1999, the prospect of aid from Taipei,China and a belief that Compact funding will be re-negotiated mean that a government in election mode is unlikely to revitalize the reform process. Enough may be done to ensure release of third tranche funds, and thus to retain credibility with external funding agencies (including Taipei, China).

4.6.2 Public service downsizing and government finances

Strengthening of government finances is the core of the PSRP, with public service downsizing the primary means. The Nitijela's Interim Budget (Appropriation Act FY1996) imposed staff ceilings and cancelled 178 existing vacancies. Then, under the first phase of the RIF program, the Ministry of Social Services was disbanded, with 53 staff being transferred to other ministries, and 179 cooks and 33 administrative staff receiving three months' notice. Under the second phase, a further 103 public servants were given notice. Thus 315 personnel within the jurisdiction of the Public Service Commission (which does not include police and education) were "RIFFED" by 31 August 1997 - all of them funded out of General Funds, not Federal Program funds earmarked for special projects. In addition, there was a 5 percent across-the-board pay reduction for salary brackets over $10,400 p.a.; and Public Works was merged with the Ministry of Resources and Development, thereby reducing the number of ministries from 10 to 8. 1998 updates on downsizing have been made painstakingly from the Ministry of Finance payroll by the PSRP Coordinator, and show that there were 1,607 government employees at 4 December 1998, compared with 2,303 on 27 October 1995. This represents a 30 percent reduction.

The impact of staff cuts on service delivery is unknown, although efficiency gains in Health have enabled the maintenance of the pre-reform level, according to the Secretary. Generally, no measures have been taken to improve staff productivity.

The annualized savings in recurrent expenditure from the downsizing are estimated to be in excess of $4.2 million; and if the 1,484 target is hit will rise to $5.1 million. Expenditure on personnel out of General Funds has fallen from $15.0 million in FY1996 to $11.1 million in FY1998, or 26 percent, according to Ministry of Finance data, coming in below original budget estimates. During the same period, total recurrent expenditure out of General Funds has fallen from $29.2 million to $22.7 million, or 22 percent, so that the share of personnel expenditure has fallen from 51.4 percent to 48.9 percent. Personnel expenditure in FY1998 absorbed 47.8 percent of domestic revenue.

The public service downsizing has thus contributed significantly to a strengthening of public finances. This does not mean, however, that fiscal worries are over, and some cautionary observations are in order. As noted above, the RRP asserts that "The goal of stabilization of Government finances was achieved by the beginning of FY1997, on 1 October 1996...by increasing revenues, and reducing expenditures". The aide memoire of a review mission 25 September - 10 October 1997 repeated the claim: "the overall fiscal position of the Government seems to have stabilized". But less than a year later deferred liabilities of between $3 and $8 million surfaced, and a Bank consultation mission was referring to a present crisis of Government finances that threatened to derail the ongoing economic and financial reforms. The 12.5 percent pay reduction approved by Cabinet as an emergency measure in 1998 was abandoned following a public outcry.

Appropriations to subsidize government agencies actually have increased from $1.34 million in FY1997 to $1.63 million in FY1999: although appropriations for the Majuro Water and Sewer Company, government shipping operations and AMI have been eliminated, subsidies to the Ebeye Power Plant and Tobolar have been maintained, and those to the Marshall Islands Visitors Authority and the government-owned Outrigger Hotel increased. Government has also announced an intention to buy two new aircraft for Air Marshall Islands, though AMI's poor financial position would probably prevent its realization. The 1999 budget was passed by the

Nitijela one month after the start of the fiscal year, without estimates of the outcomes in FY1998. It reportedly includes only one line appropriations by ministry and, for the first time, an unexplained $1.2 million contingency provision.[32] The March 1999 announcement that the general import duty will be lowered from 12 to 5 percent and that the copra subsidy will be increased has been made without apparent consideration of the budget implications; and represents a reversal of earlier PSRP policy actions.

4.6.3 Public enterprise restructuring

The Private Sector Unit is charged with the task of reviewing public enterprises and identifying privatization options, with the assistance of a team of consultants. This work is in process. Following Bank TA in the transport sector, the privatization of domestic shipping services is proceeding. Generally though, there is some doubt that there will be further effective action, given the expiration of the PSU Coordinator's contract in April 1999, and some reluctance on government's part. Attempts to make AMI profitable are ongoing, but its financial position is fragile. Potential commercial lenders would not expect to be paid off by the Bank a second time.

4.6.4 The Reduction in Force program

The precise number of public servants RIFFED by the end of 1998 has not been reported, but the number is in the vicinity of 350. In the absence of the planned monitoring by the Office of Planning and Statistics, it is not known what has happened to these people. The anecdotal evidence is that none has returned to the outer islands as expected, perhaps partly because there is no way in which they could receive their monthly maintenance payments if they were to return. The retrenched have either stayed in Majuro or joined family in the United States, where Marshallese can find unskilled jobs, such as those available in Tyson's chicken processing plant in Arkansas. The planned training and counselling component of the PSRP never eventuated.

[32] A copy of the budget was not available for the mission to examine.

4.6.5 Private sector development

The third objective of the PSRP is creation of an improved enabling environment for the private sector. Actions in pursuit of this objective are pending or indefinitely postponed. In the meantime, contraction of the public service has caused a contraction in the private sector because so much private sector activity depends on sales to the public sector. Particularly in the retail trade sector, businesses extended credit to public servants against future wage payments.

One positive development noted in section 4.2 has been the growth in the fisheries sector, in which a stand-alone Bank TA has played a crucial initiating role. Though not directly linked to the PSRP, this TA benefited in its early days from the Policy Advisory Team's efforts in changing government thinking about the role of the private sector in economic development. Another positive development, which is the outcome of TA linked to the PSRP, is the privatization of domestic shipping referred to above.

4.7 Looking to the Future

Although progress has been made in the Marshall Islands, the reforms have been slower in coming than originally expected, and the reform process has now lost momentum. Key lessons that emerge from the RMI reform experience are not diminished in importance because they are familiar:

- There needs to be strong government ownership of the reform program if it is to succeed. Governments and economies cannot be reformed by external agents; they must reform themselves.

- There needs to be strong community-wide participation in the reform process that is informed and encouraged by an effective public relations program that markets the reforms.

- A public service retrenchment program should be based on a clear specification of the desired future form of government.

- The design of a reform program should pay careful attention to the identification of key performance indicators that are relevant to the aims of the program, and to the information demands that such indicators make. For example, where an objective is the strengthening of public finances through reducing the absorption of resources by the public service, personnel expenditure is an indicator that is both more relevant and more easily measured than the number of civil servants.

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 re-ignited 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 per cent 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.

6 SOLOMON ISLANDS

6.1 Introduction

The Public Sector Reform Program (PSRP) Loan of $25 million to Solomon Islands was approved in August 1998, and was to be released in two tranches of $15 million and $10 million. In addition, a TA loan of $1 million was provided to assist in implementation of government's privatization policy, and a TA grant of $600,000 was provided to assist in strengthening of public sector management.[37] The loan amount compared with total external grants and loans averaging $45.5 million per annum in the period 1993-97.

6.2 The Macroeconomic and Governance Context

Between 1980 and 1995, Solomon Islands' real Gross Domestic Product (GDP) grew at the average annual rate of 4.1 percent. This growth was led by the export of fish, logs harvested from the natural forest at an unsustainable rate, copra, palm oil, and cocoa. With population growing at a rapid 3.4 percent per annum, average annual growth in per capita GDP was only 0.7 percent. In the mid-1990s, the Human Development Index was the second lowest among PDMCs. The rural population, which constitutes 86 percent of the total, has a per capita income about one quarter of the urban level; and 45 percent has received no schooling.[38]

The period 1990-97 was characterized by very poor governance and serious fiscal mismanagement that led to balance of payments and inflationary pressures, regular currency devaluations,

[37] Loan No. and TA No.3061, Strengthening of Public Sector Management (approved 27 Aug. 1998).

[38] ADB 1998b provides details. This report was a joint ADB-AusAID project.

suspension of trading in government securities, and a loss of business confidence. In late 1997, government domestic and external debt were each 30 percent of GDP, and government arrears were approximately 11 percent of GDP. The past two years however, have seen a dramatic shift in culture and practice within the public service. In mid-1997, when the newly elected Government assumed office, public confidence in Government and the economy was at its lowest point, and external funding agencies were reluctant to provide any further assistance to the country. On the fiscal side, years of profligate spending and capricious grants of tariff exemptions and remissions had resulted in a Government without the funds to pay its bills or even to service its debts to official and private creditors. While large arrears piled up (including to the Bank), audits and controls were abandoned on Government expenditures. The public service was demoralized, and hardly any office of Government could be regarded as functioning in a satisfactory manner. The new Government was faced then with the daunting task of rebuilding its resources and reputation from a very low base.

The government that won office in August 1997 faced the immediate task of stabilizing the macroeconomic situation, a task made even more difficult by the impact of the Asian financial crisis on log export prices. Log exports that were mostly destined for Japan and Korea constituted 50 percent of merchandise exports and provided 20-30 percent of government revenue; but they fell rapidly in value in the latter half of 1997. Confronting the prospect of a balance of payments crisis, government devalued the currency by 20 percent on 15 December. It already had initiated a Policy and Structural Reform Program in October, which aimed at achieving private sector-led growth and public sector reform.

The Solomon Islands economy remained in recession in 1998. After dropping by an estimated one percent in 1997, real GDP fell by over 2 percent.[39] Government finances and the balance of payments position were weak, the financial system remained stressed, inflation remained double-digit, and unsustainable harvesting of the forest resource continued. Business confidence remained very low. Revival of the financial sector was central to a restoration of investor confidence, and needed to be underpinned by the negotiation of a domestic debt restructuring program.

[39] Official national accounts have not been produced since 1984.

Prior to the delayed presentation of the budget in April 1998, government took a number of initiatives to increase revenue and contain expenditure. There was an immediate cancellation of tax exemptions and remissions that did not involve legally binding agreements. A simplification of the tariff system was completed and introduced. Income taxes were revised in order to broaden the tax base and improve equity, and a range of other revenue-raising measures was adopted. On the expenditure side, government instituted a public service wages freeze, restricted payment of allowances, and froze all recruitment in advance of further actions aimed at downsizing and streamlining the civil service. It also began a limited clearance of domestic and external arrears. The 1998 budget projected a current surplus of SI$15.8 million, and a near-zero overall balance. A reduction in domestic and external arrears was planned on the assumption that necessary funds could be raised through privatization, some borrowing from the National Provident Fund, and external borrowing.

In the event, domestic revenue fell short of budget expectations and day-to-day cash availability dictated expenditure levels. Given that efforts at public service downsizing were delayed and that the wage bill increased by 6 percent on the 1997 level, and given the priority assigned to debt servicing, the enforced cuts largely fell on departmental operations expenditure. This exacerbated the acknowledged problems of the poor quality of public services and deteriorating infrastructure. Nonetheless, debt and non-debt arrears were reduced by a total of SI$87.1 million. This was made possible in the first instance by grants from Papua New Guinea and Taipei, China, which permitted clearance of arrears on outstanding Bank loans and thus made a new Bank program loan feasible. First tranche funds were then used for further arrears clearance. In addition, arrears to the National Provident Fund were securitized. The net result was that the overall public debt level increased slightly from SI$941.8 million at the end of 1997 to SI$943.1 million at the end of 1998. Domestic debt totaled SI$401.7 million, external debt SI$509.6 million, and trade creditor and other arrears SI$31.8 million. The 1999 budget aims at a current surplus of SI$17.9 million, and an overall deficit of SI$26.7 million to be financed from external borrowing. Additional PSRP expenditure on arrears settlements totals SI$92.2 million, funded by asset sales of SI$29.2 million and further external concessional borrowing of SI$63 million.

The performance of the Solomon Islands economy in 1999 and beyond will depend on the international economic environment, and on the extent to which government can successfully tackle the inherited fiscal crisis and implement its program of economic reform. The outlook for commodity prices in general, and log prices in particular, is not encouraging. On the positive side, the Gold Ridge gold mine will be in full production in 1999, and the Asian crisis has led to lower prices on intermediate inputs.

Government has made progress in restoring macroeconomic stability by servicing its domestic debt and paying arrears, which it plans to clear entirely by the end of 1999. Its hold on power remains tenuous, however. The Solomon Islands Alliance for Change is a coalition of six partners holding 26 of the 50 seats in the unicameral national Parliament. This slender majority constitutes a political impediment that has to be confronted and managed as part of the process of implementing and consolidating reforms. There is a particularly difficult trade-off between improving public financial management and maintaining support of the backbenchers. The latter represent the populations of nine provinces, which also have their own provincial governments. These are supported in part by grants from the national government and have a full complement of ministries and ministers.

6.3 The Process of Program Design

6.3.1 Ownership and appropriate participation in the design process

From the outset, the PSRP was a home-grown initiative championed by an energetic, independently minded Prime Minister and supported by a core of reformist politicians. The Solomon Islands Alliance for Change that won office in August 1997 had presented itself to the electorate as a group intent upon restoring macroeconomic stability, improving public sector performance, and facilitating private sector development in a good governance environment. Alliance policies in the broad were presented to Parliament in November in a Statement of Policies by Solomon Islands Alliance for Change 1997-2001. The Government already had established a Policy and Structural Reform Committee (PSRC) chaired by the

Prime Minister, and consisting of four ministers, the Governor of the Central Bank, and the Presidents of the Chamber of Commerce and Employers and the Public Employees Union. Supported by a secretariat within the Prime Minister's Office, PSRC was to co-ordinate the reform process and direct the work of two task forces made up of permanent secretaries. Task Force 1 focussed on public finance, microeconomic reform, and preparation of a medium-term development plan.[40] Task Force 2 worked on public sector reform. Technical advice to the task forces was provided periodically by ESCAP's Pacific Operations Centre. Also, the December 1997 draft of Solomon Islands 1997 Economic Report (ADB 1998b) became a basic reference on economic conditions and policy options. By the end of 1997, the PSRP had been formulated and presented in an Inception Report.

Following the mandate given at the election, the government focussed its attention on the work of the task forces. In the first few months, considerable effort had to be directed at the preparation of the 1998 budget in a situation where relevant domestic expertise was in short supply and comprehensive and reliable data on government finances were absent. There was some Bank-funded technical assistance to design a public relations campaign aimed at explaining the rationale for and nature of proposed reforms; and Bank staff promoted the development of a mechanism for public participation in the reform process. But a new administration preoccupied with an economic crisis, holding a slender majority, and immediately subject to no-confidence motions was cautious. Aside from the work of the PSRC and the task forces, and media coverage of external funding agencies' support for the PSRP, political leaders have tried to build support for reform through informal, personal consultations with key organizations, most notably with the influential trade union movement (both the Public Employees Union and the Council of Trade Unions).

It was not until November of 1998 that a National Summit was organized to review progress and encourage greater public involvement in the reform process. Representatives of government at national and provincial levels, public enterprises, private business,

[40] Subsequently, in May 1998, preparation of a medium term development strategy was assigned to a separate task force (Task Force 3), and microeconomic reform and private sector development was assigned to Task Force 4.

churches, non-governmental organizations, and the community at large met over three days to discuss the PSRP and the newly-developed Medium Term Development Strategy and Public Sector Investment Program (both of which had been prepared with Bank technical assistance). Proceedings were discussed on radio and in the two major newspapers. Generally, though, the Government has not devoted much effort to building public support for reforms through the media, which provide easy outlets for the views of the opponents of the PSRP.

6.3.2 Partnership and consultation with other external funding agencies

In late 1997, the Government sought the assistance of external funding agencies in its reform efforts and in meeting its budgetary and balance of payments crises. Both advice and funding were sought from the ADB, the World Bank, NZODA and AusAID. In the initial period, funding agencies were hesitant to come forward with ready assistance, given their fresh memories of economic mismanagement and anti-agency sentiments under the previous government. The Bank, however, began to work closely with the new Government to shape a reform agenda and to design a program loan that would address its immediate financial requirements. The program loan provided the catalytic effect of bringing bilateral funding agencies to the party and enabling the Government to develop a track record of reform that would be sufficient to justify new lending from other multilaterals such as the World Bank and the European Union.

The Bank has also co-ordinated with the key bilateral agencies, the European Union, the Pacific Financial Technical Assistance Centre, and ESCAP's Pacific Operations Centre. The first consultative group meeting of funding agencies was convened by the Government in March 1998, and strongly endorsed the PSRP Inception Report. The Bank assisted in financing and organizing the second meeting, which the Government held in May 1999.

6.3.3 Effectiveness of internal processing procedures

The processing procedures for Bank assistance have been efficient, taking approximately six months from the initial

reconnaisance mission (February 1998) to loan approval (August 1998). Loan effectiveness was delayed from September until November, however, because of a shortage of funds under the ADF Commitment Authority. First tranche release occurred on 16 November 1998.

6.4 The Content of the Program

6.4.1 The Public Sector Reform Program

In contrast to the reform programs in the Cook Islands, Federated States of Micronesia, Republic of the Marshall Islands and Vanuatu, the PSRP was in large part designed by the Government, with some technical assistance from ESCAP and the Bank. Once the Bank became involved, the PSRP was formulated into the familiar Bank policy matrix after a dialogue between the Bank and the Government in which the latter was clearly in the driver's seat. There was little change in content of the components of PSRP that became the Bank-funded Public Sector Reform Program.[41] More emphasis was given to the need for a social safety net for redundant public servants and monitoring the PSRP impact on vulnerable groups than Government alone might have given. The crucial Bank role was to support the PSRP with funds and targeted technical assistance.

The overall goal of the PSRP is "To place the economy of Solomon Islands on a sustainable track and to improve efficiency and performance in the public sector". The subsidiary purposes are (1) to reform and reduce the size of the public sector to a level commensurate with the contraction of logging to sustainable levels; and (2) to shift the balance of economic activity away from the public sector to the private sector. The five key outputs are to (1) reduce the size and operating costs of the civil service; (2) increase domestic revenue generation; (3) restructure government operations to improve efficiency and effectiveness and sell or liquidate several major state-owned enterprises; (4) strengthen governance

[41] The Policy and Structural Reform Program encompassed reforms in education, health and forestry in addition to those areas covered by the Bank-funded program.

institutions in order to promote greater transparency and accountability and to reduce opportunities for corruption in the public service; and (5) mitigate negative social or economic impact of adjustment in public expenditure. Sixty-five actions to be undertaken in pursuit of these outputs are detailed in the policy matrix, grouped under the four headings of macroeconomic and fiscal reforms, public sector management reforms, privatization of state-owned enterprises, and strengthening of governance institutions.

Eight of the 39 actions to be completed after loan approval are specified as second tranche conditions (Appendix 1):

- Payroll costs are reduced to a level that will not exceed SI$130 million on an annualized basis, subject to an adjustment for 1998 inflation acceptable to the Bank. (This is to be done through public service downsizing, which in turn is to be a part of a public service re-engineering exercise).

- Obtain Cabinet approval of budget limits established for the annual expenditures of each ministry in accordance with the terms of the Medium-Term Budget Framework (MTBF), and ensure that the MTDS, Public Sector Investment Program (PSIP) and MTBF are consistent with each other.

- Apply competitive and transparent recruitment, selection, and appointment procedures for all PS staff including prior public notification of vacancies, application of objective selection criteria, and application of equal opportunity principles.

- 1999 budget submissions for at least four ministries will include verifiable performance targets.

- For all SOEs, Cabinet approves action plans for liquidation, restructuring, corporatization, divestment, and/or privatization.

- Invite market offers for at least 6 SOEs, finalizing the sale or liquidation of at least 3 of such enterprises.

- To issue guidelines for the SOEs that establish a corporate governance framework to enhance management and promote accountability.

- To prepare an action plan to improve the effectiveness of the Auditor General's Office.

Overall, the program is well-designed, with policy actions clearly explained and targeted, and tranche conditions that are pertinent to program objectives. However, given the political context and severe human resource constraint within which the PSRP has to be implemented, the timeframe for implementation seems short.

6.4.2 Rationale and appropriateness of loan amount

The rationale for the loan is that it helps a new administration to consolidate a reform program already under way. The loan amount of $25 million is "based on the scope and the costs of the policy reforms, the importance and urgency of the reforms, and the state of the public finances of the Borrower" (RRP, para 69). Specifically, the loan amount permitted clearance of approximately 63 percent of government arrears (about $23.8 million); the financing of public service retrenchments ($1 million); and incremental costs of hiring staff to implement reforms ($200,000). The absence of reliable data prevents preparation of a convincing medium term macroeconomic framework.

6.4.3 Consistency with country and Pacific strategy

Both the rationale for the program loan and the content of the PSRP are consistent with the Bank's Pacific and country strategies. The latter notes:

> *there remains a need to implement a structural reform program that includes objectives to reduce the size and cost of the public sector; improve the effectiveness of planning and budgeting systems; and restructure expenditure to focus on maintenance programs, technical capacity, and HRD. Priority should also be given to*

forestry management and ensuring that adequate revenues are collected from commercial logging and fishing (p.56).

6.4.4 Relevance and focus

The PSRP's relevance is indisputable and its focus is clear. The Solomon Islands 1997 Economic Report (ADB 1998b, p.158) observes that "Government needs to close the gap between revenue and expenditure as its first priority", and goes on to identify fiscal governance and privatization/corporatization as key areas of reform. The need for a forest policy is also highlighted in the report, and recommendations are made in respect of agriculture, fisheries and human resource development. These areas are not covered by the PSRP itself, but are being addressed separately with assistance from other external funding agencies.

6.4.5 Appropriateness and Sustainability

It is accepted that the human resource constraint in Solomon Islands is especially severe. The implementation of the PSRP therefore inevitably must draw on external technical assistance. There are consequent concerns that officials may lose control and ownership of reforms, and that therefore the reforms may not prove durable. Related to this is the possibility that the gap between domestic capabilities and skills requirements may be widened by the importation of inappropriate technology.

These concerns are allayed by domestic ownership of the reform program and the careful design of Bank technical assistance. As noted above, there has been no doubt as to who is managing the reforms. Strong local ownership has improved the prospect of sustainable change. In addition, the design of the PSRP appropriately allows for the gradual introduction of a performance orientation in the public service, without including what would be a premature attempt at introducing performance-based budgeting. Rather, the focus is on re-establishing functioning cash management and accounting systems. The design of PSRP-related technical assistance is also aimed at making sure that it remains advisory and responsive, with consultants being provided on short-term and intermittent bases, working with local counterparts. In this regard, additional

Bank TA is being provided to facilitate implementation of a needs-based training program for public servants. Obviously, filling the skills gap is a long-term process, and reliance on TA will be needed in the interim.

6.4.6 Likely impact on governance

Fourteen actions aimed at improving governance are specified in the fourth governance strengthening section of the policy matrix. They include preparation of national government accounts; ongoing external audit of these accounts and those of state-owned enterprises; preparation of a plan to improve the effectiveness of the Auditor General's Office; preparation of a report on means of strengthening the Ombudsman's and Leadership Code Commissioners' Offices; and several measures to make government decisions on tendering, asset sales and tax exemptions and remissions transparent.

In addition, there are governance-improving actions specified under the public sector management reforms section of the policy matrix. Successful implementation of these and the above-mentioned actions will increase the accountability, predictability and transparency of public administration.

6.5 Implementation

6.5.1 Actions to date

Many of the actions in the policy matrix were reported as completed before loan approval - 26 out of 65 to be precise. Of the 39 actions to be completed after loan approval, 20 are not scheduled for completion until end-March 1999 or later, including four of the second tranche conditions. Of the 19 actions scheduled for completion by the end of 1998, 12 were completed, 6 were incomplete, and one had been adjusted at the request of Government. Amongst the incomplete actions was the second tranche condition to reduce public service payroll costs to a specified level (Appendix 1). The adjusted condition was the revenue-enhancing action to contract the services of an internationally reputable pre-shipment inspection company. Cabinet, acting on technical advice funded by

AusAID, decided in favor of strengthening the Customs Division, on the grounds that the latter offered more durable and greater net revenue gains.

Implementation of reform measures in the policy matrix is ongoing, but some difficulty in meeting three second tranche conditions concerning payroll costs and privatization of state-owned enterprises can be anticipated. This is discussed further in section 6.6.

6.5.2 Use of loan and counterpart funds

The $15 million disbursed under the first tranche has been utilized in clearing debt arrears and arrears in payments to trade creditors and regional and international bodies.

6.5.3 Effectiveness of monitoring

Internally, the PSRC monitors progress in implementation of the PSRP. More frequent monitoring of macroeconomic and fiscal reforms is undertaken by the Monthly Monetary Management Meeting - the 4Ms Committee - which consists of staff of the Central Bank and Ministry of Finance, and the Secretary of Agriculture and Fisheries. Both the PSRC and the 4Ms Committee have been meeting as scheduled, though the meetings have not always had a full attendance.

Throughout the implementation period, the responsible desk officer has monitored progress, receiving copies of all progress reports prepared by the four task forces, and of minutes of the PSRC and 4M meetings. The Solomon Islands Government is due to present the first quarterly report on progress, and will be supported in this task by the services of a public sector reform monitoring specialist made available under the Strengthening of Public Sector Management TA. The first six-monthly meeting of the Bank and the Government to review PSRP implementation is scheduled for June 1999, to coincide with a Donors' Consultative Meeting in Honiara.

6.6 Results

6.6.1 Participation and ownership

Strong domestic ownership of the reform program has been an outstanding feature from the beginning. The reforms are driven by a group of politicians spearheaded by a committed Prime Minister. There is support from a small group of senior and middle managers in the public service, and there is widespread support from a public that wants honest government after experiencing years of corrupt and incompetent government. An active press is quick to report any misdeeds by politicians and civil servants that come to light. The PSRC provides an institutionalized mechanism for participation in the reform process by representatives of the private sector and trade union movement, and is an important forum for debate between these representatives, politicians, public servants and external advisers. The 1998 National Summit served to involve the wider community in the process more directly.

This does not mean that the reform path is free of obstacles and walked willingly by everyone. The Prime Minister is compelled to devote considerable time and energy to keeping the Solomon Islands Alliance for Change in power; and it must be acknowledged that there is a consequent risk that the distinction between the old and new governments will be blurred. A complicating dimension was added when the Minister of Finance was dismissed in July 1998, joined the Opposition, and disavowed his previously strong support for reform.[42] Additionally, the Prime Minister and his Cabinet have had to confront considerable obstructionism from some senior public servants adversely affected by the reforms, and from the Solomon Islands Public Employees' Union (SIPEU), which called a general strike in June 1998 on the grounds that it had not been

[42] Four other government supporters crossed the floor with the Minister of Finance, giving rise to a motion of no confidence in the Prime Minister. SIAC survived the motion on the casting vote of the Speaker. One member of parliament could not get to Honiara from an outer island because the Solomon Airlines flight that day was delayed. It is not known which way the member would have voted. Early in 1999, as part of its transparency policy, the Government published a list of tax exemptions and remissions which included exemptions from export duty of four log shipments by Success Company. The principal of the company is reportedly very supportive of the Prime Minister.

consulted about public servants' redundancy packages.[43] SIPEU has not participated in the PSRC proceedings subsequently. There are also complaints heard about the lack of adequate representation of indigenous business through the Chamber of Commerce and Employers; and some provincial government officials feel left out of the reform process. It already has been noted above that the Government is not using the media to sell its reformist message as well as it might.

6.6.2 Macroeconomic and fiscal reforms

The most important objective of the PSRP is to achieve macroeconomic stabilization through eliminating arrears on public debt, maintaining a balanced recurrent budget, and adopting a supportive monetary policy stance. Significant progress has been made. Immediate actions to raise revenue and contain expenditure are detailed in section 6.2. Arrears on domestic debt are on track to be cleared by the end of 1999, and arrears on external debt have been cleared except for two contested amounts owed to the Export Finance Investment Corporation of Australia and Marubeni corporation. Expenditure in 1998 was confined to a revenue level that was below budget expectations, partly because of long delays in arranging technical assistance for strengthening of the Inland Revenue and Customs Divisions. Underpinning improved expenditure control and cash management is the ongoing revival of the accounting system, a revival in which technical assistance from AusAID and the European Union is crucial. In addition, the first steps have been taken toward improved co-ordination in the preparation of the recurrent and development budgets. The Medium Term Development Strategy 1999-2001 and associated Public Sector Investment Program were completed in early 1999 with TA from ADB, UNDO and ESCAP. Monetary policy was tightened in 1998.

There is still much to be done in order to consolidate the gains made so far and to permit the non-personnel expenditures that have of necessity been sacrificed during the adjustment process. The domestic debt burden remains untenably large and the commercial banks are yet to be persuaded to agree to debt restructuring beyond their current acceptance of 6 percent on Treasury bills. The 15 per-

[43] The call was ignored by many public servants.

cent reduction in 1998 payroll expenditure to SI$131 million was not achieved because of long delays in public service downsizing. The actual outcome is not known for sure, but a tentative initial estimate was that payroll expenditure rose to $155.5 million, possibly because of a rise in the wage bill for the police who, like the teaching service, are quarantined from downsizing efforts. The public service downsizing that occurred finally in March 1999 is estimated to save just SI$13 million, or 8.4 percent of the estimated 1998 wage bill. This will not be sufficient to attain the payroll objective originally specified in the 1999 budget framework; but even this much saving may be threatened by pressures for rehiring of retrenched public servants, for lifting of the nominal wages freeze, and for payments of allowances to which officials had become accustomed during the tenure of pre-reform administrations. Moreover, total revenue collections in early 1999 continued to run below budget estimates, despite revival of the Revenue Enhancement Group. Inland Revenue collections alone were above expectations.

6.6.3 Public sector management reforms

A report by a working group of Task Force 2 on restructuring of the public service was submitted to the PSRC in June 1998.[44] Completed with the assistance of Bank consultants, and involving consultation with each of 19 departments, the report identifies cost savings of SI$16.6 million through restructuring, redefinition of the permanent secretary position, sharing of administrative and accounting staff by "partnering" ministries, and capping some allowances. It presents an implementation plan that spells out the steps of a restructuring process aimed at cost-effective, responsive provision of government services. Phase 1 of public service reform began with the dis-establishment of senior positions and the creation and filling of a reduced number of senior positions. It then extended down to junior positions and ended in early March 1999. One hundred and three vacant public service positions were abolished and 447 public servants were made redundant. In total, this is a cut of 7 percent in central government employment. The time

[44] Policy and Structural Reform Programme, Report by Sub-Task Force II to the Policy & Structural Reform Committee, Re-Structuring the Public Service, June 1998.

taken to complete Phase 1 was much longer than originally envisaged owing to legal challenges, opposition from affected public servants, and delays in appointing a new head of the Public Service Division.

Redundant public servants are entitled to a minimum separation package equal to two weeks' pay for each year of service. They are also entitled to receive assistance with meeting school fees for any children for one year. A Transition Unit offers counselling and advisory services (including management of redundancy payments), assists with job-seeking, and arranges training.

Phase 2 will involve a review of organizational strategies, implementation of system wide changes and institutional strengthening. As part of the 1999 budget process, the first steps in linking inputs with outputs were taken, with the identification and publication of performance measures in four ministries. An Institutional Strengthening Unit has been established within the Public Service Division and will work with the existing Institute for Public Administration and Management to design and implement an executive development program. Performance agreements for Secretaries of Ministries are being developed.

A solid start to public service reform has been made, but continued effort is required to avoid slippage and to implement the remaining reforms. Nothing less than a sea change in attitudes and culture is required in a public service workforce that had become accustomed to being paid regardless of attendance or effort. This in turn requires senior and middle management to provide clear direction and to personally demonstrate work discipline. Progress is being made in the latter regard, but there are still examples of officials in key positions who are conspicuous by their absence.

6.6.4 Privatization of state-owned enterprises and private sector development

A State-Owned Enterprises Monitoring and Performance Unit has been established in the Ministry of Finance, with support from a Bank TA loan of $1 million. The review of SOEs has moved slowly, however, primarily because of opposition from the political appointees on the boards of SOEs administered through ministries, and from the chairman of the board of the government-owned holding company, Investment Corporation of Solomon Islands

(ICSI).[45] The sale of ICSI's 60 percent share in the oil palm operation, Solomon Islands Plantations Limited, to the minority shareholder, Commonwealth Development Corporation, has been under negotiation for some months, but is yet to be finalized. After initial delays, the sale of the bulk of ICSI's 58 percent share in Solomon Telekom to the National Provident Fund is imminent. Two unprofitable businesses, the Livestock Development Authority and National Shipping Services, have been liquidated, though the Government subsequently has announced its intention to become involved in provision of shipping services to the provinces.

The involvement of the private sector in Task Force 4 has permitted effective communication of business community concerns over such matters as tax, customs and labor law and administration, and the role and operation of the Foreign Investment Board. The latter's appearance and effectiveness has improved markedly in 12 months, though greater transparency is still required. Further rationalization of the tariff bands is also proposed. However, the private sector feels a need for greater participation in the decision-making process, and remains skeptical about the permanency of improvements in the Government's payments system and the governance environment.

6.6.5 Strengthening of governance institutions

As indicated in the previous paragraph, there has been an improvement in the governance environment under the new administration. Government accounts are being brought up to date for external audit; accountability and transparency in the use of foreign aid have improved according to external funding agencies; and Government has published lists of beneficiaries of duty remissions and exemptions. Amendment of the Lands and Titles Act is expected to increase transparency of disposal of government land. Publication of reports by the Public Accounts Committee and the

[45] The Broadcasting Commission, Electricity Authority, Water Authority, Postal Corporation, Livestock Development Authority, Port Authority and Commodities Export Marketing Authority are administered through ministries. ICSI owns Solomon Airlines, National Shipping, Sasape Marina, Solomon Islands Printers, and is part owner of Solomon Islands Plantations, Kolombangara Forest Products, Solomon Telekom and Solomon Taiyo (a tuna cannery).

Auditor General's Office is anticipated. In general, there is a perception that government is more open than hitherto.

Against this, there has been no effective action to prepare the envisaged plan for strengthening the Auditor-General's Office. Planned action to increase the transparency of public tendering has not occurred. The status of a report on strengthening the offices of the Ombudsman and Leadership Code Commissioner, due in March 1999, is unknown. The functioning and effectiveness of the legal, judicial and parliamentary systems are acknowledged by the Prime Minister as areas in need of attention. Fundamentally, there is uncertainty about the extent to which the need to maintain Government's fragile hold on power will force compromises of good governance principles. It is too early in the reform process to draw a firm conclusion on this issue.

6.7 Looking to the Future

Progress has been made in difficult circumstances and against considerable resistance from opponents of reform. Much remains to be done in a timeframe that is extremely tight. Key lessons that have emerged from the experience so far are:

v Where government owns a reform program that it has commenced of its own volition, a program loan with well-focussed conditions can effectively support the reform process.

  funds can assist macroeconomic stabilization.

 w conditions can provide a means of maintaining commitment in the face of pressure from the opponents of reform.

  conditions can send a message to the private sector that reforms are credible.

 Even in situations of fiscal and economic crisis and significant opposition, a public service retrenchment program can be implemented as a component of a broader-scoped, longer-term public service reform program.

    - targeted and well-managed technical assistance can play an important supportive role in the design and implementation of such a program.

- Effective communication of the reform program's rationale, objectives and achievements is essential to the maintenance of public support, especially where there is no institutionalized participation mechanism (such as an annual summit).

    - in this regard, special attention needs to be given to the majority rural population.

7 REPUBLIC OF VANUATU

7.1 Introduction

The Comprehensive Reform Program (CRP) Loan of $20 million to Vanuatu was approved in June 1998, and involved adjunct technical assistance of $1.2 million for institutional support to two central agencies implementing CRP (the Department of Strategic Management and the Ministry of Finance and Economic Management).[46] The first tranche was to be released in two parts, the first part of $10 million upon loan approval and effectiveness following satisfaction of 10 conditions, and a second part of $5 million as an incentive subtranche ("First Tranche, 2nd Release Condition") upon satisfaction of 5 conditions originally targeted for June-September 1998. The second tranche of $5 million was scheduled for release, subject to 7 conditions, by October 1999. At the time of loan approval, the CRP loan was equivalent to 2,545 million vatu, which compared with an annual average level of total official development assistance to Vanuatu of 4,000 million vatu in 1992-95.

7.2 The Macroeconomic and Governance Context

Between independence in 1980 and 1995, Vanuatu achieved average annual growth in real Gross Domestic Product (GDP) of 3 percent - a rate only slightly above the population growth rate of 2.9 percent. This was accomplished in the context of a generally stable macroeconomic environment in which the inflation rate was

[46] This TA constituted Phase II of a three-year program. The $630,000 Phase I TA - TA No.2984-VAN: Institutional Support to Central Agencies for the Comprehensive Reform Program - was approved on 29 January 1998 as an interim support arrangement, following a November 1997 dissolution of Parliament and the calling of general elections for March 1998.

around 4 percent, external balance was maintained under a fixed exchange rate regime, and budgetary deficit financing was modest. The governance environment was complicated by an inheritance of two very different administrative traditions from a French-British colonial condominium government, which had "left the indigenous population ill equipped with the skills required of a modern economy, and highly dependent on external inputs" (ADB 1997c). In addition, in the 1990s, the quality of governance worsened as ministers appointed relatively large numbers of often poorly qualified political advisers and personal staff, who effectively substituted for professional public servants. Parliament became largely ineffective, meeting irregularly, and unable to hold the Executive accountable for its actions. Corruption grew and law enforcement was weakened.

During 1996-98, Vanuatu's economic performance has deteriorated, some fiscal fragility has become evident, and political instability has contributed to some disarray in macroeconomic policy. There are no reliable national accounts data after 1995, but estimates provided by the Statistics Office suggest that real GDP growth has slowed from 3.5 percent in 1996, to 1.7 percent in 1997, and to about minus 2 percent in 1998.[47] The slowdown is the result of declining activity in the manufacturing, electricity and construction sector, compounded in 1998 by a substantial drop in primary sector production and sluggishness in tourism. The traditional exports of copra, beef, timber and cocoa have fallen because of the direct and indirect impacts of the Asian crisis and currency devaluations in Papua New Guinea, Solomon Islands and Fiji. Tourism has been affected by the declaration of a state of emergency during the January 1998 Port Vila riots, which occurred after publication of an ombudsman's report questioning the soundness of investment decision-making at the Vanuatu National Provident Fund (VNPF). These riots, and another change in government in March, further eroded investor confidence.

In 1996, two changes of government occurred (after November 1995 elections), and in mid-year a fiscal crisis appeared imminent. It was averted primarily by postponement of planned expenditures, including compensation payments to ex-public servants who went on strike in 1993-94 and were fired, capital injections into

[47] New accounts became available in mid-1999.

the National Bank of Vanuatu and the Development Bank, and other development expenditures. Reliable government finance statistics presented in a standard international format are not available, but IMF estimates indicate an overall budget deficit of 519 million vatu, or 1.8 percent of GDP, was the final outcome. The 1997 budget embodied a tight fiscal policy stance predicated on cost savings from public sector reform and increased revenue from removal of duty exemptions. The former did not eventuate, and domestic revenue actually was 8 percent below the budget estimate; but external grants were up on the 1996 level, while development expenditure was down. The overall budget deficit was estimated by the IMF at 199 million vatu, or 0.7 percent of GDP, though later government figures indicate a deficit of 1.8 percent of GDP.

Developments in early 1998 threatened to undermine macroeconomic stability. Following the January riots, the government of the day allowed unconditional withdrawal of retirement savings from VNPF, which led to a demand from members for 3,600 million vatu, 2,400 million of which was actually disbursed in February-April. Since VNPF itself could only provide 1,100 million vatu, Government as guarantor had to make up the shortfall, leaving it with a projected overall budget deficit of 4,100 million vatu, or 14 percent of GDP. Given the implications of the payouts for the balance of payments, and recent devaluations in Fiji and Solomon Islands, it was not surprising that a run on the currency began. Capital outflow combined with reduced exports of goods and services and higher import spending to cause a drop in foreign exchange reserves - from almost six months of import cover at the end of 1997 to 3.5 months at the beginning of April 1998. On 27 March, the governor of the Reserve Bank, on the last day of his term of office, unilaterally announced a 20 percent devaluation, but this was reversed on the same day by the Minister of Finance.

The new government that took office on 30 March sought to restore credibility to macroeconomic policy. A new Reserve Bank governor was appointed and the previous government's reversal of the devaluation decision endorsed. Monetary policy was tightened through the replacement of the 10 percent statutory reserve deposit requirement with a 16 percent prescribed asset ratio, and a substantial rise in the Reserve Bank base lending rate. Foreign exchange controls were effectively imposed on capital transactions. Though the devaluation reversal and the maintenance of capital controls

initially intensified speculative pressure, the monetary tightening persuaded the public of government's determination to defend the vatu and facilitated a recovery in the foreign reserves position. Pressure to maintain a tight monetary stance in the immediate future will arise from VNPF payouts yet to be made, payments to public servants retrenched under the CRP, and the net inflationary impact of tariff reform and the introduction on 1 August of a value added tax.

Approximately 87 percent of the projected 1998 budget deficit of 4,100 million vatu is one-off expenditure arising from payments to the 1994 strikers, the VNPF payout, and CRP-related payments funded by ADB. The underlying budget deficit is 1.7 percent of GDP (Vt29,700 million), and largely reflects the intention to almost double expenditure on law and order and increase development expenditure. Indications in early November 1998 were that, despite a shortfall in domestic revenue, the actual overall deficit was likely to be around 3,000 million, or 10 percent of GDP, as CRP-related and other loan-financed expenditure fall short of their estimated levels, and recurrent expenditure also comes in under budget (Table 7.1). The underlying deficit is expected to be under one percent of GDP. Public debt will reach 10,100 million vatu, or 34 percent of GDP, at the end of the year.

In the Budget Policy Statement for 1999 that was presented in October, there is no projection of an overall deficit. However, a reduction is implicit in an expected move to balance between domestic revenue and expenditure and a reduction in development expenditure that is to be entirely financed by external concessional loans. The stated budget intentions will be hard to fulfil. In particular, a 6.3 percent rise in domestic revenue in the context of a forecast 4.5 percent growth in nominal GDP is implausible. Additionally, pressures for wage increases may threaten the anticipated 10.5 percent reduction in domestically-financed expenditure (Table 7.1). The growth forecast is a revision downwards from the 7 percent growth rate in nominal GDP that was presented in the 1998 budget papers, which became available in June. No forecast is offered for inflation in 1999; but assuming it will be in the range of 3-4 percent, real GDP growth is expected to be slow, at 0.5-1.5 percent.

Table 7.1: Vanuatu Budget Estimates 1998 and 1999 (Vt million)

	1998 Budget	1998 Estimates	1999 Estimates
Domestic revenue	7,162	6,782	7,207
Foreign grants	1,430	549	n.a.
Total revenue & grants	8,592	7,331	
Domestically-financed exp.	9,255	8,148	7,200
Foreign-financed exp.	3,457	2,183	n.a.
Total expenditure	12,712	10,331	
Deficit	4,120	3,000	
Foreign Financing			
– ADB	1,800	1,311	
– Other	707	371	
Domestic Financing			
– VNPF	1,600	1,595	
– Other	13		
Discrepancy		277	
Memo Item:			
Domestic revenue			
less domestically-financed			
expenditure (Vt m.)	-2,093	-1,366	7
(% of GDP)	-7.0	-4.6	0.0

Note: Aid in kind is excluded from the figures.

Source: Government of Vanuatu, Budget Policy Statement, October 1998.

7.3 The Process of Program Design

7.3.1 Ownership and appropriate participation in the design process

Against a background of stagnant average income and the 1996 fiscal uncertainties, the government that took office in October 1996 sought to introduce a variety of cost-saving measures into the 1997 budget, and announced its intention to undertake a major reform of the public service. The Council of Ministers was subsequently persuaded by the Bank that reform needed to extend beyond the public service to include public enterprises and the

creation of an enabling environment for the private sector. This broader scope for reform was expressed in a Memorandum of Understanding signed by Government and the Bank in February 1997. The MOU included a request for the assistance of external funding agencies in the formulation and implementation of a Comprehensive Reform Program (CRP).

From the outset, government adopted a participative and consultative approach that was overseen by a National Task Force chaired by the Prime Minister and including two senior Government ministers. Two task teams were established, each including 18 representatives from non-government organizations, the Council of Chiefs, church groups, trade unions, and private business. One team focussed on economic reform and was chaired by the Prime Minister; the other examined public sector reform and was chaired by the Deputy Prime Minister. The teams were supported by a technical secretariat within the Prime Minister's Office, which consisted of a ni-Vanuatu (indigenous) person as full-time CRP co-ordinator and several external advisers. Technical assistance was also forthcoming from ESCAP's Pacific Operations Centre and bilateral funding agencies.

During the period March-April 1997, the task teams prepared a number of papers on reform issues, seminar discussions of short reports on the issues were conducted in Bislama, and a weekly newspaper column and radio broadcasts were used to facilitate nationwide involvement. A draft CRP document was generated from this process and presented at a National Summit on 26-27 June. The Summit was attended by 300 representatives of government, the private sector, and the wider community, and broadcast live throughout the country. Following debate and some amendments, the document was endorsed as the basis for future action, and subsequently approved by the Council of Ministers. It outlined a vision and a set of strategies for economic and social development: the major components were stable government (macroeconomic stability, good governance and public sector reform); private sector development; and social equity and sustainability. A key mandate was the convening of Annual Summits as a means of providing the community with an opportunity to review progress in the implementation of the reform program.

7.3.2 Partnership and consultation with other external funding agencies

The February 1997 MOU included a request that ADB take the lead role in co-ordination of external assistance to the reform program. Accordingly, the Bank organized a Consultative Group Meeting in Noumea, New Caledonia on 31 July 1997 at which the CRP document was presented. Funding agencies were unanimous in their support both for the participative process through which the CRP had been formulated and for its content. The Bank was asked to assist in the preparation of a CRP matrix that would serve as a monitorable action plan. This assistance was provided in September as part of the fact-finding mission for a proposed Bank loan.

Since implementation of the CRP began in August 1997, there has been ongoing consultation and close co-ordination with external funding agencies, especially AusAID and NZODA. Special attention has been given to ensuring that the various programs of technical assistance are complementary in their support for the CRP. A program co-ordinating committee is expected to be established for this purpose.

7.3.3 Effectiveness of internal processing procedures

From the fact-finding mission, through the appraisal and post-appraisal missions, to loan agreement, the processing procedures for Bank assistance to Vanuatu seem to have been efficient and effective. Appraisal was completed between 17 November and 3 December 1997; and post-appraisal was undertaken between 20 April and 1 May 1998. Board approval for the loan was granted on 16 July. Loan agreement was finalized on 6 August and the first disbursement of $10 million made the following day. The only noticeable delay - between appraisal and post-appraisal - was the unavoidable result of the November 1997 dissolution of Parliament and the calling of a general election for March 1998. As explained below, while the speed of processing helped create and sustain the momentum for reform, it carried some costs in terms of public understanding that surfaced later.

7.4 The Content of the Program

7.4.1 The Comprehensive Reform Program

The CRP Matrix that Government developed in September 1997 was subsequently reformulated into a Program Loan Reform Matrix. It should be noted that the Program Loan Reform Matrix is smaller than the CRP Matrix, leaving out (1) two columns on monitoring mechanisms and risks and assumptions, and (2) some policy areas, strategies and actions that are to be implemented. The reformulation into the smaller matrix reflected the decision to give Bank priority to assisting public sector reform, improved governance, strengthening of public financial institutions, and institutional strengthening.

In addition to its apparent over-optimism, a notable feature of the reform scenario is its focus on real GDP growth alone. Given that the ultimate concern is with real GDP growth in per capita terms, some attention might have been paid to population growth - especially since it is so high in Vanuatu. An annual increase of approximately 3 percent means the population doubles every 24 years, placing increased pressure on land, environment and government.

Three subsidiary objectives corresponding to the three major components of the CRP are listed in the Program Loan Reform Matrix:

- Redefine the role of Government and enhance the quality and delivery of its policy, regulatory, and development services.

- Increase the productivity and growth of the commercial and private sector in both the urban and rural areas.

- Support improvement of social development indicators, particularly for the disadvantaged and rural population.

The achievement of these objectives involves the production of 46 “Program Outputs”, with the primary focus being on redefining the role of government and improving public sector performance. Nine of these outputs were conditions for loan approval and release of the first part of the first tranche. Six required the enact-

ment of legislation; and the others involved the establishment of a department to co-ordinate the CRP process, the appointment of an independent, professionally qualified board of directors for the National Bank of Vanuatu, and a start to the implementation of a formally adopted strategic business plan for the National Bank.

It is surprising that the phrase "to the satisfaction of the Bank" was not routinely added to the six conditions involving new legislation, in order to ensure that formal compliance was matched by acceptable content. In the case of one of the loan conditions, namely "Enact the Foreign Investment Act to create a favorable environment for private sector operations", there has been compliance in that an Act has been passed. However, schedules were added immediately prior to presentation to Parliament that are contrary to the spirit of CRP and discouraging of foreign investment (see section 7.6.4). Similarly, there is no evidence that other key pieces of legislation were discussed with the Bank prior to presentation to Parliament.

There are five conditions for the release of the $5 million second part of the first tranche - the so-called incentive subtranche that effectively is a second tranche. Two require enactment of legislation. Two require formation of a Development Committee of Officials and appointment of managerial staff to the National Bank. The most demanding requires a 10-15 percent public service downsizing by 1 September 1998. In this regard, it is noteworthy that the ADB economic report observes:

> *Vanuatu has amongst the lowest number of Government employees per hundred country inhabitants...[3, compared with 18 for the Cook Islands in 1990]..public sector reform does not necessarily have to start with, or have a compelling imperative to, immediately reduce the size of the public service. Reductions in the public sector employment may well occur, but as a result of rationalization of the role of Government and its activities. (ADB 1997c, pp.104-105).*

Be that as it may, the downsizing conditionality is specified ambiguously. The output is described as "Reduce total number employed in public sector by between 10 percent and 15 percent", whereas the expected impact refers to "public service rightsizing" (emphasis added).

There are seven second tranche conditions that require establishment of an Expenditure Review Committee, a government remuneration tribunal, and a decentralization committee; the absorption of "good" Development Bank loans into the National Bank's portfolio; and the development of plans in the areas of management improvement, national infrastructure, health and education.

Given the central role the Vanuatu National Provident Fund has played in the macroeconomic instability of 1998, and given that rehabilitation of the Fund is a major component of financial sector reform, one or more of the conditions listed in the Program Loan Matrix might have been considered for elevation to the status of a tranche condition. Also, it is surprising that there is no specific mention of the Vanuatu Commodities Marketing Board in the matrix, given its economic importance and poor financial performance (despite the heavy taxes it reportedly imposes on rural producers).

As indicated above, the CRP is more ambitious than would appear from the Program Loan Reform Matrix alone. Law enforcement, commercialization and privatization of public enterprises, and private sector development (through improving access to land, for example), all receive greater coverage. Issues such as labor relations and gender and development are included. Of particular importance, is a commitment to "Improving the reliability and affordability of inter-island shipping by, amongst other actions, progressively allowing foreign competition in the coastal shipping market". Under Schedule II of the new Foreign Investment Act, inter-island shipping is identified as an area reserved for ni-Vanuatu.

7.4.2 Rationale and appropriateness of loan amount

The loan amount proposed in the RRP is for the funding of the one-off costs of (1) restructuring and rightsizing of the public sector, (2) restructuring and rehabilitating Government-owned financial institutions, and (3) fiscal stabilization (that is, reducing the need for an inflationary domestic financing of the budget deficit). The allocation of the $20 million to these is 35 percent, 40 percent, and 25 percent, respectively. Release of the first tranche of $15 million was expected to occur in two stages in 1998, and to finance 44 percent of the budget deficit. Other foreign aid was to finance a further 17 percent, and domestic borrowing the remaining 39 percent. In the event, only the first $10 million of the first tranche will

be released in 1998, and will fund 44 percent of a reduced deficit, which apparently will be overfinanced (see Table 7.1).

The authorities are confident that the ADB loan will permit the necessary structural and fiscal adjustments, and that a move to recurrent budget balance shall occur in 1999, followed by a surplus in 2000 – with development expenditure being financed by foreign grants and concessional borrowing. It should be noted, however, that even though revenue estimates have been revised downwards since mid-1998, nominal increases of 6.3 and 8.7 percent are still forecast for 1999 and 2000, respectively, compared with nominal GDP increases of 4.5 and 5.4 percent. These are optimistic. Additionally, domestically-financed expenditure is forecast to fall 10.5 percent in 1999 and to increase by 3.3 percent in 2000. It has to be acknowledged that, at base, the absence of reliable information prevents preparation of convincing macroeconomic projections. The budget deficit on a cash basis will need to be monitored closely as the key indicator of government's changing fiscal position. For this to occur, it is essential that line-item budgeting be re-introduced alongside the new program classification.

7.4.3 Consistency with country and Pacific strategy

Both the rationale for the program loan and the content of the CRP 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... It also involves strengthening*

the institutional capacity of governments to develop and implement better policies themselves...

...public sector reform and the promotion of private sector activity have been identified as key strategic areas (ADB 1996, pp.23,26).

The program loan is also consistent with the country strategy:

The strategy envisages a more active role for the Bank to support the Government's ongoing efforts at liberalizing the economy and carrying out policy changes to improve its efficiency. This is to be accomplished by strengthening the public service and policy environment to support further reforms of the economy; supporting the efficient development of economic infrastructure (physical, social and financial) by both public and private sectors; and catalyzing more private sector investments (Country Strategy, p.72).

7.4.4 Relevance and focus

The CRP's relevance is clear. Though public service downsizing is not the self-evident imperative it was in the Cook Islands case, there is an unquestionable need for reform that includes the replacement of unqualified political appointees and the creation of a professional ethos in the public service. Public enterprise reform is also an accepted need, with many government-owned entities operating at a loss, and the Development Bank and National Bank insolvent. If government fulfils its core functions efficiently and effectively, including that of creating a stable macroeconomic environment, the prospects of the private sector performing to its potential are enhanced.

The CRP is a wide-ranging and ambitious program that places heavy demands on ni-Vanuatu politicians, officials, and the wider community. Convergence has occurred on the key theme of improving governance. The Bank's priorities in assisting the reform process are clearly stated in the RRP.

7.4.5 Appropriateness and Sustainability

It is accepted that the human resource constraint in Vanuatu is especially severe. The formulation and implementation of the CRP therefore inevitably have relied, and will continue to rely, on relatively large numbers of expatriate advisers: 42 consultants are identified in the October 1998 report on CRP implementation.[48] There are consequent concerns that ni-Vanuatu officials may feel a loss of control and ownership, and that self-reliance will be undermined. Such concerns make even more urgent the tasks of capacity building and development and implementation of a human resource development plan, which are recognized in the CRP as long-term exercises. They also draw attention to a basic program design issue, namely the appropriateness of any proposed importation of foreign technologies. The gap between domestic capabilities and skills requirements obviously is widened if new, more sophisticated systems are introduced. There is no clear evidence that the design of the program was informed by an assessment of the evidence on other developing countries' experience with reform - except for the Cook Islands example.

7.4.6 Likely impact on governance

A key outcome expected of CRP is improved governance. Proposed measures to increase the accountability, transparency and predictability of government, and to increase participation of the wider community in the business of government, include

- Passage of new legislation (the Government Act, the Public Finance and Economic Management Act, the Expenditure Review and Audit Act, the Public Service Act, the Leadership Code Act, the Ombudsman Act).

- Selection of Directors-General on merit.

- Independent functioning of the Public Service Commission.

[48] The RRP notes that "it is anticipated that further financial and technical assistance will be provided beyond the initial three-year time frame to ensure the sustainability and effectiveness of the reforms" (paragraph 71).

- Strengthening the office of the Auditor General.
- Strengthening the judicial system and the Public Prosecutor's Office.
- Organization of National Summits to review CRP progress.

Finally, although there may be reservations about the appropriateness of the technology transfer involved, and alternative ways of achieving the desired outcome exist, the introduction of program budgeting under CRP encourages public servants to focus on the provision of services, as opposed to drawing salaries and spending available budgets. It would also enhance transparency to the extent that the cost of various government programs is actually clarified (see section 7.6).

7.5 Implementation

7.5.1 Actions to date

The Consolidated Report on CRP Implementation Accomplishments that was prepared for the 1998 National Summit (originally scheduled for 20-22 October 1998 but delayed to 3-5 November because of a coalition reshuffle) provides a detailed description of achievements since implementation began in August 1997. Officials continued to work on implementation between the dissolution of Parliament in November and the formation of a new coalition government in March 1998. The immediate preoccupation was restoration of macroeconomic stability; but this was accompanied by further implementation of the CRP that was conducted in the context of active public consultations and included the first National Task Force meeting in July.

The nine conditions for loan release were satisfied formally with the establishment of the Department of Strategic Management, the commencement of restructuring the National Bank, and the June 1998 passage of new legislation. However, as mentioned above, the new Foreign Investment Act was passed with the late addition of two schedules, which clearly violate the letter and spirit of the CRP

by prohibiting foreign investment from a range of sectors in the economy. Schedule 1 states in reference to a number of sectors that "ni-Vanuatu will not be granted a business license should they either intend to form a partnership with, or in association with a foreign investor(s)". This is not a legislative change worthy of support and underlines the importance of adding to legislative conditionalities the phrase - "to the satisfaction of the Bank". The Vanuatu government has formed a working committee to review the legislation.[49]

All first tranche second release conditions have been met, except for the 10-15 percent downsizing of public service employment. In late October, 232 retrenchments from a workforce of 4,250 had been achieved. Plans are in place for further cuts, but implementation is complicated by the quarantining of health and education (for which no net reduction is to occur), and by possible de facto quarantining of the police force. There is therefore an implied cut for the remainder of the public service of 25 percent. Implementation of other reform measures in the Program Loan Reform Matrix is ongoing. The fundamental interest now lies in how effectively the changes introduced so far translate into improved governance and economic management.

7.5.2 Use of loan and counterpart funds

Counterpart funds were to be utilized for the funding of the one-off costs of (1) restructuring and rightsizing of the public sector, (2) restructuring and rehabilitating Government-owned financial institutions, and (3) fiscal stabilization. These have been the uses of the $10 million released to date.

7.5.3 Effectiveness of monitoring

The Vanuatu Government monitors implementation of the CRP through the Department of Strategic Management and the National Task Force, and reports on progress through the media and National Summits. This has been an impressive aspect of CRP implementation. Quarterly program reports are to be submitted to the Bank; and six-monthly reviews are to be conducted by the Bank and

[49] The legislation was amended in mid-1999.

representatives of Government and the major external funding agencies. Standard reporting requirements for technical advisers funded by the Bank are in place, and monitoring is conducted from the South Pacific Regional Mission office in Port Vila.

7.6 Results

7.6.1 Participation and ownership

This is a major and critical strength of the reform process in Vanuatu. Public consultation and media coverage have been continuous. The holding of Annual Summits has involved stakeholders from various segments of society, and allowed wide-ranging and open critique of the Government's stewardship of the reform process. Encouragement of a deep involvement of private sector and non-government organizations in the process has catalyzed their commitment to it.

Some of the important consequences of this participative approach include:

- The relatively smooth introduction of difficult reform measures such as civil service downsizing and the introduction of VAT.

- A public at large that is increasingly vocal about its expectations of government, thus ensuring continuing progress to greater transparency and accountability of government.

- A reform process that is substantially internally driven, and that is responsive to the country's development priorities as perceived by the general populace.

- Facilitation of government efforts to mobilize and coordinate external support for CRP.

7.6.2 The public sector and governance

The key theme of the CRP is redefining the role of government and facilitating an improvement in accountability, transparency and performance of government. It is the theme to which the population has responded most favorably—the central hope of the program, around which local ownership has converged. In public management, the CRP has four parts: (i) simplifying government; ii) improving public servants' autonomy and efficiency while reducing their number; (iii) modernizing formal rules; and (iv) improving fair, effective and uniform enforcement of rules and regulations. All of these changes are aimed at the ultimate objective of more effective public service provision.

Simplification of government has occurred through a reduction in the number of ministries from 28 to nine. There has been some internal restructuring within the nine ministries. In addition, there has reportedly been progress in the introduction of performance measures and their monitoring in some departments. This exercise will undoubtedly contribute to the streamlining of operating processes and the improvement of service effectiveness. The intention to introduce corporate plans is welcome, but should be kept very simple and indicative.

Public servants' autonomy and efficiency have already improved substantially:

- The selection of the Directors-General on the basis of competence and merit, and the good and independent functioning of the Public Service Commission (PSC), are two highlights of the internal administrative reforms. Any backtracking on these would jeopardize the success of the reform, create lasting skepticism in the public administration and among the population.

- The process of retrenchment so far seems to have been effective and fair, with individuals judged on the basis of merit and only five complaints lodged with the PSC from 232 retrenchments (one of which was successful). Retrenchment of at least 10 percent of the total number of employees (approximately 430 persons) implies a cut of 25 percent in sectors other than education and health (for

which no net reduction in personnel is envisaged). Also, delicate issues are at stake for the police force, further complicating the prospects of reaching the target. It is important that, following retrenchment, there are mechanisms assuring that (1) the government workforce will not grow back thereafter (a prescriptive and normative wage bill ceiling for each ministry and department is being incorporated into the budget process); and (2) other aspects of the administrative reform are strengthened further (as discussed below).

Modernization of formal rules and new legislation has been extremely rapid, as envisaged in the CRP and required by the Bank loan. Twenty-two pieces of legislation have been passed. In hindsight, however, the speed of formulation and presentation of new laws and regulations has entailed a number of problems:

- There has been inadequate local expertise to cope with the complex requirements of introducing the reform program. This has led to an unavoidably high dependence on expatriate experts. In this connection, there are several means of improving technical assistance: (1) more precise specification of performance measures by which the contributions of advisers may be assessed; (2) greater involvement of ni-Vanuatu managers in the selection process; (3) use of a diversity of sources of advice, particularly taking account of advisers' capacity to appropriately respond to the specific realities of Vanuatu; and (4) ensuring that the skills recruited match actual requirements. In this context, the preparation and implementation of a human resource development strategy is a deservedly high priority on which government is acting.

- The speed of formal rule-making has made it difficult to adequately explain to the population the key aspects of the reform, thus weakening the impact of the remarkable and unusual process of consultation followed by the Government since early 1997.

- Parliament has been required to approve complex legislation with little scrutiny and reflection. Reasons include the sheer volume of legislation in a restricted timeframe, the lack of an effective parliamentary committee system, and inadequate supporting staff and administrative resources. It is essential for good governance that Parliament enjoy the same autonomy over its staff, budget, and administrative resources as is given to any other state entity-naturally, within the limits consented by the budget.

It is in rule enforcement—effective, predictable, transparent and fair—that the major concerns lie. Problems in this area long pre-dated the CRP, and have generated broad skepticism among the population, concerning both public malfeasance and basic law and order. Vigorous and visible action, however, can remedy this skepticism quickly, if sustained. The five key links in the enforcement chain are the Auditor-General office, the Ombudsman office, the public prosecutor's office, the judiciary and, of course, the police:

- With the appointment of a new qualified Auditor-General, there are prospects for better and more aggressive functioning of the Auditor-General office-notwithstanding its financial and human resource limitations. However, these prospects cannot materialize if the other links in the enforcement chain do not work better as well.

- The Ombudsman Office has been exceptionally active in Vanuatu, partly to fill the vacuum caused by weaknesses in the other areas. It is therefore reassuring that after some delay a new Ombudsman Act was passed on 26 November 1998.

- The Public Prosecutor's Office is being strengthened with external assistance. Prospects for improved functioning exist, but greater resources are clearly necessary as well. The most important and urgent step in this regard is the appointment of a permanent ni-Vanuatu public prosecutor.

- The functioning of the judicial system, particularly the Supreme Court with its present leadership, is encouraging, especially in view of its severe resource and staff limitations. It is to be hoped that these limitations in the future can be eased, and that in the interim the judiciary's resources are protected.

- Most importantly, an effective police force subject to civilian authority and responsive to citizens' needs is crucial for economic activity and public efficiency. A strategic review conducted with external assistance has concluded that a separate military or paramilitary force is unnecessary and highly undesirable in Vanuatu, and that the police force requires a total staff of 680 to function properly in its diverse roles (which include immigration, prisons, and fire-fighting). Hence, the retrenchment required under the program from the present size of 635 is particularly contested. There is also reportedly a sense of demoralization among the police from having been insufficiently consulted and not brought into the process of restructuring as a full partner. On the other hand, the dissatisfaction with police services is strong and widespread among the government and the public alike. These complex issues can probably best be resolved by a coordinated restructuring and strengthening process, based on partnership and full consultation with the police and citizenry, and benefiting from an external review of staffing needs, current availabilities, and appropriate training requirements.

7.6.3 Fiscal management

Considerable progress in improving fiscal management has been made in a short period:

- The passage of the Public Finance and Economic Management Act established the legislative framework for responsible fiscal management, clarifying the roles of Parliament, the Council of Ministers, and the Minister of Finance in decision-making, and establishing the principles guiding fiscal policy.

- A Government Remuneration Tribunal Act to determine public sector salaries and allowances has been passed.

- A reduction and simplification of import duties and business license fees have been accomplished, and a Value Added Tax introduced.

- A process of extending budget coverage to incorporate all development projects has begun.

- Performance concepts have been introduced into public administration in association with the adoption of program budgeting.

However, several issues require further attention in order to consolidate the gains from these changes :

- Macroeconomic databases remain inadequate, making it difficult to adhere to the requirements of the Public Finance and Economic Management Act, and to conduct economic and policy analysis. Technical assistance with a strong training element is the only hope for durable improvement in this area.

- Restoration of fiscal balance remains a fundamental policy objective and challenge.

- Also, rehabilitation of the Vanuatu National Provident Fund is recognized as an essential element of ensuring fiscal stability. This hopefully can now proceed following amendments to the relevant legislation.

- Tariff reductions and introduction of the VAT have been accomplished despite severe time and human resource constraints, but will need to be protected through ongoing staff training and associated efforts to ensure compliance. The impact on the price level also needs monitoring.

- Considerable further effort is needed to consolidate the extension of budget coverage, so that the Government

Investment Program presents only economically and socially viable projects with assured and identified funding for the coming year, and reasonable prospects for two subsequent years. Also, the total cost of each project must be clearly identifiable before its inclusion in the budget. Finally, a start must be made on the difficult but essential task of quantifying the recurrent costs of development projects.

- In order to ensure effective expenditure control and transparency, it is essential to present, at least at the Ministry level, the economic classification of expenditure alongside the new program classification, and to impose a post-retrenchment wages and salaries ceiling. Currently, in the absence of personnel recruitment controls and given the reporting format of "program budgeting", there is a risk of loss of expenditure control in general, and of the wage bill in particular. It is understood that government is working towards a presentation of economic classifications at the departmental level.

- Program budgeting is a new system that will take longer than expected to implement, and that makes substantial demands of domestic capacities that are acknowledged to be severely limited. Not surprisingly, program budget narratives for 1998 are incomplete, sometimes do not correspond completely with sectoral strategies, and contain performance measures that are a mixture of output, process and outcome indicators, most of which are not monitorable. In the next stage, it will be essential to cost programs accurately, and to define meaningful and monitorable indicators, focusing on a few selected government activities for which this is a realistic exercise given the domestic capacity constraint. An independent, expert and in-depth review of the workings of the public financial management system could provide useful support.

7.6.4 Economic reform and growth

Reform of the financial sector is central to the private sector development component of the CRP, and focuses on the restructuring and streamlining of government owned financial institutions (DBV, NBV and VNPF), and the enactment of related legislation to ensure their sustainable effectiveness. Significant progress to date includes:

- The Financial Institutions Restructuring Steering Committee is operational and is supervising the restructuring of financial institutions.

- A local Project Manager has been appointed to implement the strategic business plan for the restructuring and rehabilitation of the three financial institutions. The Project Manager reports to the Steering Committee.

- The Development Bank of Vanuatu has been merged with the National Bank of Vanuatu to create a commercially viable bank. This process has been facilitated by the transfer of DBV's good loans to the NBV as of 30 October 1998 and the bad loans portfolio to the Asset Management Unit. AMU was created by an Act of Parliament in June 1998 to manage and recover bad debts from DBV, NBV, and VNPF. An externally recruited General Manager is in place now and the office is fully operational.

- An externally recruited Managing Director took up his post with the NBV on 28 October 1998, and the other three senior officers are expected to be in post in November 1998.

- The VNPF Act has been amended in the November session of Parliament in order to restructure and focus the Provident Fund on its main functions of contribution management and benefit payments.

Concerns and challenges remain however:

- NBV is insolvent and its recapitalization requirements need to be assessed. To become an efficient and effective bank servicing the needs of ni-Vanuatu, the bank needs a renewed focus on client relationships, especially those involving services to the outer islands.

- The capacity for monetary management is relatively weak and there is a recognized need for institutional strengthening of the Reserve Bank. (The concept of a currency board is worthy of investigation).

- Related to the foregoing concern, banking legislation and supervision require improvement.

- The Credit Union League, which plays an important role in the outer islands, feels excluded from the financial sector reform process.

Tax and tariff reform has made a positive contribution to improving investor confidence in the economy and its management. However, the economy is characterized by imperfect competition, including monopolies with price-fixing power, and is open to collusive political-economic arrangements. Consequently, tariff reductions and introduction of the VAT apparently have provided some opportunities for unwarranted price rises. Especially in the outer islands, these have gone unchecked in the absence of any price monitoring mechanism.

Plans for privatization of public enterprises should also be informed by an awareness of the market structure and pay due regard to the regulatory framework required to protect the public interest. The need for utilities and telecommunications regulation is recognized in the CRP, and the World Bank has assisted in preparation of a policy framework for these areas. Planned corporatization of Civil Aviation, Ports and Marine, and the Post Office will also involve design of a regulatory framework. As in many other areas of the public sector, implementation capacity is the major concern.

The worst outcome of the reform process so far is the Foreign Investment Act in the form that it was passed. Schedules I and II of

the Act are contrary to the letter and spirit of CRP, will discourage foreign investment, and will hamper Vanuatu's efforts to join the World Trade Organization. The Act itself is sound, but the Schedules need to be revised.[50] A drastic reduction in the reserved areas is urgent and essential. Inter-island shipping and kava exports, among others, are areas where restrictions of competition will be especially damaging to the Vanuatu economy.

This last observation is made at a time of recession for the Vanuatu economy, when prospects of recovery to a sustainable rate of economic growth (of perhaps 3 percent per annum) depend heavily on a recovery of private sector confidence and investment.

7.7 Looking to the Future

Government has made considerable and rapid progress in implementation of an ambitious reform program, and has demonstrated a commitment to completing this implementation. A strong partnership between the Bank and Government has been forged, and the Bank loan has been crucial to funding adjustment costs and avoidance of macroeconomic instability. Although implementation of the CRP is in its early stages, and an assessment of its economic and social impacts will need to be made at a later date, there are some key lessons that emerge from experience so far:

- When new legislation is a tranche condition or required policy measure deemed crucial to the success of a reform program, the phrase "to the satisfaction of the Bank" should be included in the program matrix, and prior agreement with government should be reached to consult the Bank on the draft bill.

- Program design should take account of the inverse relationship between the speed of passing new legislation and the effectiveness of its implementation.

[50] As already footnoted, this has happened.

- Given the first two lessons, a more proactive involvement of the legal counsel is needed at all stages of program design and implementation.

- Reforms need to be more carefully designed and phased to take account of domestic capacities; and appropriate specialized expertise must be utilized

  - In particular, the experience of developing countries with public sector management methodologies should be assessed and reflected in appraisal.

- Full account needs to be taken of the imperfectly competitive market structures of small island economies and appropriate regulatory frameworks designed.

- Renewed attention needs to be paid to population growth in those countries where population is doubling every two decades.

8 LESSONS LEARNED

The Bank's experience in supporting economic, public sector, and governance reform in the Pacific using the program loan modality provides some key lessons.

8.1 Political Commitment, Ownership, and Participation

The most significant success factor of Bank assistance for reforms in the Pacific is also the most obvious: political commitment to and ownership of the reform program is essential. Externally imposed reform measures (conditionalities) that have little government ownership are doomed to certain failure. The experience in the Pacific has amply demonstrated this. Reform programs have emerged in many of the Pacific countries only consequent to the election to office of reform-oriented political parties. However, reform is a destabilizing process as it involves change; it also inevitably demands pain from various segments of society - the temporary pain of adjustment involved in moving to a more effective economic framework, right-sizing the public sector, and bringing in a cost-conscious government. No government undertakes such a process without some risk of becoming so unpopular that it loses its mandate to rule. Thus, much courage, patience, and commitment on the part of government are needed. The Bank must be sensitive to and understanding of these realities.

Another complicating issue is that the benefits of the reform process sometimes do not surface until many years after implementation starts. However, non-governmental stakeholders inevitably expect to see immediate, tangible impacts. Thus it is critical for reformist governments to involve key stakeholders in the design of reform programs, and to maintain their commitment by keeping them continually informed of the process and envisaged impacts. The national summits in the Cook Islands, FSM, Solomon Islands,

and Vanuatu (supported and in some cases financed by the Bank) have been most useful in obtaining and maintaining public support. Also, keeping the process as transparent as possible, and keeping the public informed at every major juncture, goes a long way to bolstering support for the reform process. This serves the dual purpose of involving the public and, by doing so, more deeply committing the incumbent government to the path of reform.

8.2 Design Issues: Scope, Phasing, and Pragmatism

When designing a program loan, a simple scope ensures that the program content is clear to all, and implementation is realistic and within local capacity. Some program loans designed in support of reforms in the Pacific have been too complex and too ambitious in terms of time targets. The designers were obviously well intentioned. The objective was to use the opportunity of a reformist government, or an influential "champion" of reform being in power, to effect as many reforms as possible. This was the "window of opportunity" approach and was, consciously or unconsciously, preferred to the option of moving gradually but with the distinct possibility that the "champion" may be out of office a couple of years hence and the opportunity lost. The reform programs in the Cook Islands, Solomon Islands, and Vanuatu were, in some areas, designed beyond the capacity of the implementing government. Nevertheless, the reforms these governments have instituted over the first 18 to 24 months in office, and the public support they have mobilized for the reforms, will make it very difficult for successor governments to reverse them.

The reform programs have encountered some implementation difficulties due to internally conflicting objectives, unrealistic time targets, and inappropriate sequencing of measures. For instance, the objective of achieving urgent fiscal stabilization has taken precedence over other reform components. Hence, downsizing has been undertaken urgently (given the critical state of some governments' finances) without adequate attention to allocation priorities (particularly education and health) or technical efficiency. The result is the loss of valuable staff skills in areas of economic priority and the elimination of useful, constructive activities, both of which will be difficult to re-establish in the future.

In terms of phasing or sequencing, it is of little value to attempt introducing performance-based budgeting if basic costing and accounting systems are not in order to provide timely feedback; or for that matter, if basic accounting skills are not available to government. The issue here is how to use a window of opportunity to introduce much needed reform, while keeping the reform package realistic, pragmatic and achievable.

The more complex the scope of reforms, the more critical it is to pace and sequence the reforms carefully. Two key factors must be taken into account: capacity and culture. Both can easily run a reform program aground if it does not take due account of their realities; and both are often and easily taken for granted. Internal reform leaders become enthusiastic, forgetting that institutions and people need time to adjust and change. External advisors take for granted skills and capacities that possibly are available in their own countries. Useful but difficult principles to practice in this regard are: "keep it simple"; "tackle a few though significant and relevant reforms at a time", "think through the sequencing with the implementors", and "allow for testing and adjustments". It is important to lay out a sequence of reform actions that leads to tangible and specified outcomes and impacts, taking account of cause-effect linkages, and then to focus on achieving success with the initial phase. Follow on stages should come only when the initial phase has proven successful.

8.3 Need for a Long-term Perspective

While macroeconomic, governance, and public sector reform are inevitably long-term processes, the Bank's program loans that support them are generally disbursed during a two to three year timeframe. This raises two related questions: How does the Bank ensure that it remains actively involved and maintains its leverage with the government though all program monies are disbursed and the loan is closed? How does the Bank help maintain continuing enthusiasm for ongoing reform within government, when the incentive of tranche conditionalities attached to loan disbursements no longer exists?

Four key lessons in this regard have emerged from the Pacific experience. First, staff communication channels with the highest

levels in government must be cultivated and nurtured, and through them, a relationship of trust and partnership; this ensures the durability of the Bank's influence beyond the disbursement period. Second, and consequent to the first lesson, the Bank must seek to ensure high quality staff inputs and greater staff continuity in operational assignments; changes in staff responsibilities, while inevitable from other perspectives (career growth, turnover), can still be minimized through appropriate human resource policies that recognize, support and reward engendering strong long-term Bank relationships with government. Third, the package of assistance must combine a mix of loan and technical assistance, as well as follow-up project loans and TAs that help the government address spillover and sequential needs. Fourth, coordinated inputs from external agencies in a long-term framework that supports continuity of the reform process is invaluable for ensuring continuing government commitment to reform.

8.4 Distinguishing Between Inputs, Process, Outputs and Impacts

The Bank's reform matrices that support government reform programs often fail to clearly distinguish between different types of targets. Some are input targets (e.g. the government commits to allocate more resources to a particular service); others are process milestones (e.g. the establishment of a consultative mechanism to prepare a specific piece of legislation); and still others are outputs and impacts (e.g. the passing of legislation and its ensuing benefits). Clarifying these allows the program designer to sequence them appropriately and to clearly delineate the priorities.

One of the most significant lessons from this evaluation is the need to continuously focus on impacts. A reform program often and necessarily includes various levels of reform actions, influencing and building on each other. However, in the final analysis, the government must be able to demonstrate to its citizens that the impacts of these actions (some of which may initially be painful) are actually beneficial through better service provision, or lower prices, or improved employment and other income-earning opportunities. Thus, the government must establish and manage an information system which tracks the implementation of the reforms, and which

permits the analysis and publication of the resulting impacts as and when they occur. Analysis of impacts needs to extend to an assessment of who benefits and who loses, in order that government may address any inequities. A government will not be remembered by the people for the reforms it undertook, but for the impacts it achieved.

8.5 Timely and Reliable Information

Information is one of most critical inputs in the reform process, and the one most commonly inadequate in the Pacific. Timely and reliable information is needed on the government's macroeconomic and public service performance. Without an information infrastructure, critical analyses, audits, fiscal target setting, budgetary allocations, and performance incentives would not be possible. If the need for reform is not urgent, governments and funding agencies should initially focus on this variable. An essential principle of development applies: begin with basics.

8.6 The Influence of Culture

Outsiders often have difficulty understanding the cultural factors that permeate and influence social processes in the Pacific Islands, how they vary from one country to another, and how these influence the reform process. The greater the internal ownership of the reform program, the better it is suited to take account of cultural factors. Some of the latter may be used to advance the reform process; others may need to be taken into account so that they do not hinder the process; and some may display features that both help and hinder the reform process. One example of a social institution that may constrain the reform process is the Melanesian "wantok" system, which can make demands of politicians and public officials that conflict with the requirements of their formal, national roles. On the other hand, that same system may be a source of useful social support for those retrenched under a reform program. Another example is the varied customary land tenure systems, which are often seen as a constraint to optimal land use and a deterrent to foreign investment, but which are valued in their own right by

Pacific islanders. Reformers need to recognize and understand such cultural factors, address them overtly in a participatory manner, and "manage" them sensitively. Participatory approaches to the introduction of reform measures, particularly those that are culturally sensitive, are essential to ensure sustainable solutions.

8.7 Use of Long Term Advisers and Consultants

Consultants and external advisers are often engaged for economic advice and capacity building. However, the results are far from encouraging. Some programs have been in progress for more than three years, with many thousands of dollars spent on consultants, but with little to show in institutional and human resource capacity building. Some important issues and related lessons have emerged from the Pacific experience. First, given constrained human resources capacity in the Pacific, the need for consultants is often inevitable. However, there are options in regard to how they can be used: as long-term advisers, in line positions; or as short-term, periodic inputs. These options must be carefully evaluated, keeping in mind at all times that the reform program must remain locally owned and managed. A key indicator of consultant effectiveness should be the extent of local ownership he or she is able to engender. Second, it is important to clarify whether the consultant is fulfilling a line function or whether the mandate is to build capacity. If it is the latter, technical expertise is not a sufficient qualification for the job. Proven success in transferring skills and supporting participative capacity building are essential requirements. Third, the Bank must assure the government that consultants it offers have the right breadth of experience and demonstrated exposure to a variety of reform approaches. Otherwise, there is the substantial risk that reform approaches adopted by the country are dictated not by disciplined analysis of needs and assessment of options, but by the narrow experience of the long-term adviser.

The larger issue is the need for the Bank to strengthen its policies and systems for the engagement and management of consultants. Consultancy contracts should be drafted not only in terms of expected inputs and tasks, but also in terms of precise and tangible outputs and expected outcomes. Consultants' performance must be more closely monitored by government and Bank staff, on

the basis of the outputs delivered. And sanctions for inadequate performance should be specified in contracts and enforced. Staff must have adequate time to supervise consultants and should be held accountable for the performance of TA outputs and outcomes.

8.8 Bank Staffing and Supervision

The Bank can improve its staffing and supervision of assistance for reform programs in several areas: (i) more effective monitoring of economies and of the reform process; (ii) a wider mix of expertise made available for design and supervision, with particular emphasis on public sector management; (iii) staff quality and continuity in assignments; and (iv) staff accountability, particularly for performance of TA support. The structure of the Office of Pacific Operations (OPO), which combines the programming and project functions, has substantially contributed to a more holistic and broad-based approach to development issues in the Pacific. It has been fortuitous that the reform processes in the Pacific were coincidental with the establishment of OPO and its new organizational structure in 1995. This enabled the Bank to respond more flexibly, broadly, and effectively to the reform trend in the Pacific. There is clear accountability within OPO for individual country support; the support provided is more easily tailored to country needs without competing internal agendas; transaction costs involved in having separate programs and projects functions are minimized; and staff experiences with reform programs in one country are more easily shared with other countries in the Pacific.

8.9 Conclusions

The Bank's developmental role may be defined in terms of three facets: its areas of concern, its areas of influence and its areas of operations. As a major development partner in the Asia-Pacific region and given the nature of development, the Bank's areas of concern span a very wide context. Within this context, the Bank's areas of influence are narrower and its areas of operations still narrower, generally due to the need to balance its role vis-à-vis other external agencies in the region, and given its own constrained resources. The

Bank is fortunate that in the Pacific, these three facets of its development role overlap substantially. The Bank is accepted as the major multilateral in the Pacific. The focus of its concerns, influence and operations remain broad, ranging from macroeconomic stability to good governance to the provision of essential services to the rural poor. This gives the Bank substantial leverage in its work with the PDMCs, leverage that can and is being put to valuable use.

Much credit must be given to PDMC governments that have committed their countries to the reform process. The reform initiatives have been substantially internally generated, and committed political effort has gone into maintaining the reform momentum. The funding agencies have responded appropriately, with the Bank generally taking the lead in developing the reform framework as a basis for external assistance. Some reform programs have been overly ambitious. On the other hand, in retrospect, the reform programs have usefully capitalized on initial enthusiasm, and have generated substantive policy, legal and institutional gains even in those cases where the momentum is now slowing. Results achieved to date have justified the Bank's change of strategic focus in the Pacific.

The reform programs in the Pacific have only recently begun. Being change processes, they are long-term in nature. Sustainable change must be evolutionary change, allowing time for internalization and institutionalization of new modes of behavior and operation. The programs must also be and remain "continuous learning" processes. There are no ready formulae, recipes or models that have all the answers and which can assure success. There are, however, important principles that must be respected and used in designing and implementing these reform processes. This chapter has attempted to identify some of these principles based on recent experience.

Reform Programs in PDMCs: Design

PDMC	Coverage	Tranche Conditions	Prioritization/ Sequencing	Scheduling Pacing	Monitoring Mechanisms	Technical Assistance
Cook Islands (loan approval Sept. 1996)	• Public sector reform • Promotion of private sector growth • Social equity and sustainability • Governance • 110 policy matrix actions	Eight 2nd tranche: • comply with Finance & Economic Management Act • draft Public Sector Investment Program acceptable to ADB • enact amendments to Income Tax and Turnover Tax Acts • enact Act establishing the Development Investment Board • complete agriculture policy & strategy statement • complete marine resources policy & strategy statement • complete tourism policy & strategy statement • legally decentralize a large measure of political and economic power to Vaka & Island Councils & where appropriate village-level bodies	• Priority to public service down-sizing • Simultaneous undertaking of most policy actions	• 55-60% cut in public service employees between May & Sept. 1996 • Tranche conditions to be met between end Sept. 1996 & end July 1997	• Quarterly reports from Govt. to ADB; Program Monitoring Committee chaired by Govt., including ADB & NZODA reps., meeting every 6 months; Bank missions	• $740,000 for Cook Islands Development Bank; $251,000 for the Development Investment Board.

Reform Programs in PDMCs: Design *(con'td.)*

PDMC	Coverage	Tranche Conditions	Prioritization/ Sequencing	Scheduling Pacing	Monitoring Mechanisms	Technical Assistance
FSM (loan approval April 1997)	• Size & operating costs of public service • Domestic revenue generation • Public enterprise reform • Mitigation of social & economic impact of reforms • Private sector development • 122 actions in 5 policy matrices	Four 2nd tranche: • Sufficient progress achieved & maintained in carrying out reform programs as set out in policy matrices • Reduction in number of public servants as specified in policy matrices • Passage of foreign investment laws • Enactment of Customs Act and amendments to Gross Revenue Act	• Priority to reducing costs of public service & implem-entation of early retire-ment schemes • Simultaneous undertaking of most policy actions	• Tranche conditions to be met by March 1998 • All actions to be completed by March 1999	• Monitoring by State Public Sector Reform Committee; quarterly reports to ADB by Bank-funded advisory team; joint Bank-Govt. reviews; Bank missions	• $540,000 to supplement Policy Advisory Team for Economic Management; $380,000 for development of investment promotion plan and review of financial sector.
RMI (loan approval Jan. 1997)	• Stabilization of Government finances in short run • Long-term structural stability of	Six 2nd tranche: • Reduce Government employees from 1,650 to 1,484 & provide compen-sation as per agreed formula • End all subsidies to Air Marshall Islands except for	• Priority to public service down-sizing	• 2nd tranche conditions to be met by Oct. 1997	• Monitoring program to be designed by Office of Planning & Statistics; Govt. to provide semi-annual	• $515,000 for program coordination; $575,000 for institutional strengthening of the transport

Reform Programs in PDMCs: Design *(cont'd.)*

PDMC	Coverage	Tranche Conditions	Prioritization/ Sequencing	Scheduling Pacing	Monitoring Mechanisms	Technical Assistance
	Government finances • The private sector enabling environment • 59 actions in policy matrix	interest payments on 2 Dorniers • Continue 3 year wage freeze for civil servants introduced in March 1996, excluding normal promotions • Establish a Financial Reserves Trust Fund… • Reduce the Board of Directors of Air Marshall Islands from 9 to 5 members, ensuring at least 2 are from the private sector • Establish a Private Sector Unit in the Office of the President for a period of no longer than 2 years Five 3rd tranche: • Impose a tax on all rental incomes on commercial buildings • Establish a Road Users Trust Fund… • Establish a Marshall Islands Airport Authority… · Transfer all airport management functions to the new Authority	• Simultaneous undertaking of most policy actions	• 3rd tranche conditions to be met by April 1998 • All actions completed by Oct. 1998	reports; Bank missions.	sector; $760,000 for establishment of private sector unit.

Reform Programs in PDMCs: Design *(cont'd.)*

PDMC	Coverage	Tranche Conditions	Prioritization/ Sequencing	Scheduling Pacing	Monitoring Mechanisms	Technical Assistance
Samoa (loan approval Feb. 1998)	• Financial sector liberalization • Strengthening of Central Bank, National Provident Fund, Development Bank and prudential and regulatory framework • Privatization/ corporatization of state-owned enterprises (SOEs) • 62 actions in policy matrix	Six 2nd tranche: • Remove foreign exchange levy • Secure agreement, satisfactory to ADB, between Central Bank and Treasury on providing a more secure income stream to the Central Bank • Amend the Financial Institutions Act 1996 so as to include prudential guidelines for the National Provident Fund and the Development Bank… • Ensure that external audits of all SOEs in which the government holds a majority share are carried out on an annual basis… • Divest all government equity in 8 specified SOEs • Corporatize Post and Telecommunications Dept. under a commercially oriented Board of Directors	• Financial sector reform & phased public enterprise reform imple-mented as components of a sequenced economic reform strategy	• 4 tranche conditions to be met by end 1998, & 2 by end 1999 • All actions to be completed by end 1999	• Financial Sector Program Coordination Committee to prepare semi-annual reports to ADB; Bank review missions	• $950,000 for institutional strengthening of Central Bank, National Provident Fund, and Development Bank.

Reform Programs in PDMCs: Design *(cont'd.)*

PDMC	Coverage	Tranche Conditions	Prioritization/ Sequencing	Scheduling Pacing	Monitoring Mechanisms	Technical Assistance
Solomon Islands (loan approval Aug. 1998)	• Macroeconomic stabilization • Public service reform (including mitigation of social impact of downsizing) • Public enterprise reform • Public sector governance • 65 actions in policy matrix	Eight 2nd tranche: • Reduce payroll costs to SI$130m. or less on an annualized basis, subject to an adjustment for 1998 inflation acceptable to ADB • Obtain Cabinet approval of budget limits for annual expenditures of each Ministry in accordance with Medium Term Budget Framework; & ensure that MTDS, PSIP & MTBF are consistent • Apply competitive & transparent recruitment, selection & appointment procedures in recruitment of all public service staff… • 1999 budget submissions for at least 4 selected ministries to include verifiable performance targets • For all SOEs, Cabinet to approve action plans for liquidation, restructuring, corporatization, divestment &/or privatization	• Priority to restoration of macro-economic stability through a sequence of actions, followed by public service restructuring & privatization of SOEs, & actions to improve fiscal governance	• Tranche conditions to be met by June 1999 • All actions to be completed by Dec. 1999	• Progress reports of Govt's four reform task forces; minutes of the Policy and Structural Reform Committee and the Monthly Monetary Management Meeting; quarterly reports from Govt. to ADB; Bank missions	• $1m. loan to assist in implementation of privatization policy; $600,000 grant to strengthen public sector management.

Reform Programs in PDMCs: Design *(cont'd.)*

PDMC	Coverage	Tranche Conditions	Prioritization/ Sequencing	Scheduling Pacing	Monitoring Mechanisms	Technical Assistance
		• Invite market offers for at least 6 SOEs, finalizing sale or liquidation of at least 3 • Issue guidelines for SOEs that establish a corporate governance framework in order to enhance management & promote accountability • Prepare an action plan to improve the effectiveness of the Auditor General's Office				
Vanuatu (loan approval July 1998)	• Governance • Fiscal management • Public service reform • Reform of public financial institutions • Private sector development • Mitigation of social impact of reforms	Five 2nd tranche: • Enact and implement new VAT law • Reduce total number employed in public sector by between 10 & 15 percent • Establish & operationalize a Development Committee of Officials consisting of all director-generals to coordinate Government-wide policy & technical	• Priority to improving governance through establishing the required legislative framework, & to improving financial and economic management	• 2nd tranche conditions to be met by Sep. 1998 • 3rd tranche conditions to be met by June 1999 • All program outputs to be produced by	• Dept. of Strategic Management & National Task Force; quarterly reports to ADB; six-monthly reviews by Bank, other external funding agencies, & Govt. reps.;	• $1.2m. in support of Dept. of Strategic Management and Ministry of Finance and Economic Management.

Reform Programs in PDMCs: Design *(cont'd.)*

PDMC	Coverage	Tranche Conditions	Prioritization/ Sequencing	Scheduling Pacing	Monitoring Mechanisms	Technical Assistance
	• 46 program outputs in policy matrix	advice to the Council of Ministers • Enact legislation for & establish an asset management unit • Externally recruit & appoint a new general manager, operations manager, human resource manager, & senior credit officer (for the National Bank) Seven 3rd tranche: • Establish with adequate staffing & resources & operationalize the Expenditure Review Committee to scrutinize public expenditures • PSC & DSM to develop & start implementing a management improvement plan for all government agencies… • Establish under legislation a government remuneration tribunal…	• Simultaneous actions on a broad front	June 1999 (except for 3 expected between Jan. 2000 & Dec. 2002)	monitoring by ADB's Regional Mission office in Port Vila	

Reform Programs in PDMCs: Design *(cont'd.)*

PDMC	Coverage	Tranche Conditions	Prioritization/ Sequencing	Scheduling Pacing	Monitoring Mechanisms	Technical Assistance
		• Establish a Master Plan for national infrastructure development • Amalgamate into the National Bank of Vanuatu the good loans of the Development Bank… • Complete a comprehensive review of health and education policies and services, & require ministers to develop 5 year action plans.. • Establish a decentralization commission to develop policy & implementation for decentralized governance				

Reform Programs in PDMCs: Results

PDMC	Implementation Progress	Achievements	Concerns/ Challenges
Cook Islands – loan approved Sept. 1996; funds used to retire Govt.'s short-term liabilities & for general budget support	• Loan closed on timely basis. • 86% of policy matrix actions completed Dec. 1998.	• Strong local ownership and participation from the outset • A move toward fiscal balance by reducing the number of public servants by about 60 percent over the period 1996-98. • The passage of key legislation establishing principles of fiscal responsibility, improved accountability, and transparency to be followed by heads of departments and Government. • The establishment of the Public Expenditure Review Committee to review all aspects of public finance. • Introduction of the concept of performance orientation in public expenditure management. • Progress in creating an environment conducive to private sector growth. • Avoidance of a threatened period of serious macroeconomic instability.	• A still fragile fiscal situation • Passage of a 1998-99 budget that was not in compliance with legislative requirements and that relied on unspecified asset sales to fund current expenditure. • Incomplete public service reform, with the number of ministries (22) and public servants (1,340) still too high for a population of 16,500. • A lack of transparency and contestability in government's handling of a key asset sale. • The lack of attention to regulatory arrangements in the sale of government-owned natural monopolies. • Doubts about the durability of output-based budgeting and accrual accounting systems, and the capacity to deliver effective performance monitoring. • The failure to reduce the size and cost of Parliament, and the associated public concern over politicians' real commitment to improved governance.
FSM (national & 4 state govts.) – loan approved April 1997; funds used for early retirement payouts	• Loan closed after 1 year delay in full release of 2nd tranche.	• Establishment of general participation in, and ownership of, the reform process through a series of national and state summits.	• The failure to gain the commitment of some state legislatures to reform, and to develop a mechanism that institutionalized participation in the reform process.

Reform Programs in PDMCs: Results *(cont'd.)*

PDMC	Implementation Progress	Achievements	Concerns/ Challenges
	• 78% of consolidated policy matrix actions completed March 1999.	• Substantial public service downsizing and pay cuts in the four states during 1996-98, with Bank-funded early retirement schemes operative from late 1997. • A strengthening of state government finances as a result of the downsizing and some revenue-raising measures. • Downsizing of that part of the national public service funded from FSM Unrestricted Funds. • Privatization and contracting out of some departmental activities, and the transfer of power, water and sanitation to public utility authorities. • Some liberalization of the financial sector and the passage of new foreign investment legislation that potentially will improve the investment climate.	• A loss of momentum in the reform process as the political and personal costs have mounted. • The lack of attention at the design stage to governance, the basic framework of government post-reform, and the effective long-term delivery of public services (now being addressed). • The lack of attention at the design stage to the fundamental issue of revenue-sharing between the national and state governments (currently under review). • Deficient monitoring of, and reporting on, the reform program. • Inadequate attention paid to preparing people to manage large voluntary retirement payouts of two years' salary. • The impact of wage cuts and increased workloads on public service morale. • Anomalies in the implementation of the early retirement scheme at the national level. • The need to develop a comprehensive policy framework and an associated action plan for public enterprise reform and private sector development (now being addressed).

Reform Programs in PDMCs: Results *(cont'd.)*

PDMC	Implementation Progress	Achievements	Concerns/ Challenges
RMI – loan approved Jan. 1997; funds used for early retirement payouts, retirement of AMI debt, & support of Trust Fund	• One year delay in 2nd tranche release. 3rd tranche yet to be released. • 56% of policy matrix actions completed March 1999.	• A 30 percent downsizing of the public service and a reduction in the number of ministries from 10 to 8. • A three-year public service wage freeze. • Annualized savings in recurrent expenditure from the downsizing and freeze in excess of $4.2 million. • Elimination of direct subsidies to some public enterprises, most notably to Air Marshall Islands. • A rationalization of the tariff structure and some improvement in taxation compliance. • A start to the establishment of a trust fund as a means of durable revenue generation for government. • The establishment of a Private Sector Unit in government that is reviewing public enterprises and identifying privatization options. • Effective action to privatize domestic shipping services. • Regular reporting to the Bank on implementation of the PSRP. • Facilitation of the Bank's successful technical assistance to the fisheries sector.	• A lack of participation and ownership beyond the Presidential level at the outset of the PSRP, and a failure to develop these subsequently to ensure a sustained reform effort. • A consequent slowness in implementing PSRP following the death in late 1996 of President Kabua. • A loss of momentum in the reform process ahead of the November 1999 elections and in an atmosphere of confidence that (1) Compact re-negotiation will be successful and (2) substantial new external assistance will be provided by Taipei,China. • Worrying fiscal developments, including a crisis in government finances in 1998, a rise in appropriations to subsidize government agencies in the last two years, and the inattention to the budgetary implications of the March 1999 announcements to reduce the general import duty and raise the copra subsidy. • The lack of attention at the program design stage to governance, the basic framework of government post-reform, and the effective long-term delivery of public services.

Reform Programs in PDMCs: Results *(cont'd.)*

PDMC	Implementation Progress	Achievements	Concerns/ Challenges
			• The limited action to date on corporatization/privatization. • The failure to design and implement the counselling, training and monitoring of retrenched public servants as planned. • The impact of public service downsizing on staff morale and service delivery. • The failure to take actions in pursuit of the objective of creating an improved enabling environment for the private sector.
Samoa – loan approved Feb. 1998; funds used to cover fiscal costs of reforms	• Generally proceeding smoothly. • 65% of policy matrix actions completed March 1999.	• Strong local ownership of a clearly focused and sequenced reform program, especially in respect of financial sector reforms. • A well-designed financial sector program encompassing governance-improving measures, formulated through a generally effective consultative process, and promoted through a public information campaign. • Significant progress in the development of financial markets. • Progress in strengthening the prudential and regulatory framework of the financial sector. • Privatization of one state-owned enterprise (SOE) and the imminent corporatization of another; the undertaking of considerable preparatory work by the newly-established State Enterprise Monitoring Unit; and an	• Insufficient attention in program design to the implications for financial development of small size, and a consequent overstatement of the potential benefits from financial sector reform. • Implementation of some reform actions, especially those affecting privatization/ corporatization of SOEs, at a pace slower than planned. • Inadequate and ambiguous division of responsibility in corporate governance of public enterprises. • The possible placement of all public employees on fixed-term contracts, and effective removal of central control and monitoring of Government personnel, without a cautious assessment of the

Reform Programs in PDMCs: Results *(cont'd.)*

PDMC	Implementation Progress	Achievements	Concerns/ Challenges
		improvement in the accountability and transparency of most SOEs. • Effective use of the technical assistance provided for strengthening of Government financial institutions.	consequences that is informed by varied international experience and appropriate advice.
Solomon Islands – loan approved Aug. 1998; funds used to clear debt & other payments arrears	• Proceeding. • 59% of policy matrix actions completed Feb. 1999.	• Passage of a new Financial Institutions Act. • Cancellation of tax/duty exemptions and remissions, except those that are legally binding. • A substantial reduction in arrears on public debt. • Confinement of recurrent expenditure within the recurrent revenue level. • Considerable progress in restoring a functioning accounting and auditing system. • Improved co-ordination in the preparation of recurrent and development budgets. • Public service downsized by 7 percent and a saving of 8 percent on payroll expenditure made in the context of a longer-term re-engineering of the public service. • Progress in privatization of two state-owned enterprises. • A shift toward a performance orientation in the public service. • A notable improvement in the governance environment.	• The effort required to hold on to power in a situation where the coalition government has a slender majority, and the consequent risk that efforts to improve governance will be compromised. • A loss of impetus to reform in the face of (1) sustained opposition from politicians and public servants adversely affected by the changes, and (2) a lack of enthusiastic support from a sufficient number of those senior and middle level public servants who remain in employment. • The related threat to gains made so far in macroeconomic stabilization (particularly through a failure to contain the public service payroll to the desired level). • The difficulty of implementing the policy on state-owned enterprises because of opposition from the boards of those enterprises.

Reform Programs in PDMCs: Results *(cont'd.)*

PDMC	Implementation Progress	Achievements	Concerns/ Challenges
Vanuatu – loan approved July 1998; funds used to cover adjustment costs of public service reform, rehabilitation of Govt.-owned financial institutions, & fiscal stabilization	• Second tranche released on timely basis. • 57% of policy matrix actions completed Dec. 1998.	• Strong public participation and a convergence of local ownership around the key theme of improved governance. • A reduction in the number of ministries from 34 to 9 and of public servants by 289. • An improvement in public servants' autonomy and efficiency through the selection of Directors-General on the basis of merit, the independent functioning of the Public Service Commission, and the introduction of a performance orientation. • The establishment of the legislative framework for improved governance (Leadership Code Act, Public Finance and Economic Management Act, Expenditure Review and Audit Act, Ombudsman Act). • The beginning of the process of preparing a public investment program, including aid-financed projects. • The introduction of a value added tax, and simplification and reduction of import duties and business license fees. • Progress in financial reform through restructuring of the National Bank and Development Bank, and amendment of the Vanuatu National Provident Fund Act.	• The difficulty of maintaining political consensus in coalition government and the associated threat to political stability. • Limited Parliamentary scrutiny of legislative change and restricted explanation of such change to the public • most concerning is the last-minute addition of schedules to the Foreign Investment Act that are contrary to the letter and spirit of CRP and that will discourage foreign investment (though government is reviewing the legislation). • Weaknesses in law enforcement. • The severity of the human resource constraint; the heavy reliance on external advisers and some consequent resentments and feelings of loss of ownership; and the absence of a human resource development strategy. • The delay in completing the public service downsizing and the need to ensure there are credible mechanisms in place that will prevent later rehiring. • The need for institutional strengthening of the Reserve Bank, for improvement of banking legislation and supervision, and for an assessment of the National Bank's capital adequacy.

Reform Programs in PDMCs: Results *(cont'd.)*

PDMC	Implementation Progress	Achievements	Concerns/ Challenges
			• The apparent exclusion of the Credit Union League from the financial sector reform process. • The inadequacy of macroeconomic data bases, the difficulty of conducting standard fiscal analyses, and a poor economic outlook.

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