Pacific 2020

BACKGROUND PAPER: PRIVATE SECTOR

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Pacific 2020 Background Paper: Private Sector

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Disclaimer

This paper is one of a series of nine background papers written for the Pacific 2020 project, which was conducted by the Australian Agency for International Development (AusAID) in 2005. Pacific 2020 examines various components of the economies of the Pacific, Papua New Guinea and East Timor. It aims to generate practical policy options to contribute to stimulating sustainable, widely shared economic growth in these countries.

This paper is based on the discussion at a round table meeting of regional practitioners and experts, which occurred in June 2005. The findings, interpretations and conclusions expressed in this paper are based on the discussion at this round table, and from a subsequent peer review process. They are not necessarily the views of any single individual or organisation, including AusAID, the Pacific 2020 Steering Group, contributing authors, round table participants or the organisations they represent.

More information on Pacific 2020 is available online at www.ausaid.gov.au.

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SUMMARY

Growth can be promoted through private sector development.

The countries of the Pacific region have gone through an extended period of low or zero economic growth, despite levels of foreign aid that have been among the highest in the world. Both leaders and donors are seeking new ways to ensure higher standards of living for the people in the region and they have identified supporting private sector growth as a central part of a new paradigm to raise growth rates by encouraging investment and entrepreneurship.

With the support of donors, governments are beginning to identify constraints to growth and to formulate reform agendas.

The countries of the region are small and remote. They require policies that promote economic integration with the outside world. This means that communication and transport costs should be kept as low as possible, and legal systems should encourage arms-length contracting. In most countries, however, there has been restricted entry and competition in the telecommunications and transport sectors with the result that communication and transport costs are among the highest in the world. Legal systems are outdated and costly to use, making them available only to foreign investors or to the wealthiest members of local communities.

Investment and growth is further constrained by financial systems that do not effectively fund investment, particularly for the indigenous people of the region, whose main wealth is communally owned land. Financial institutions have found that lending is risky, with the result that they have substantial liquidity but few projects to which they can lend with the full expectation of being repaid. Rural areas have also suffered as a result of remoteness and the failure of governments to supply infrastructure and services to outlying communities.

Although the need for reform has been acknowledged, it has hardly begun in most countries in the region. The role of the state remains central, with state ownership and regulation crowding out private sector activity and raising the costs of doing business. There are promising signs, however. With the support of donors, governments are beginning to identify constraints to growth and to formulate reform agendas. Central to this are:

> partnerships between the public and the private sectors to improve infrastructure and the provision of services currently dominated by the state

> less regulation of private sector activity

> simplified taxation systems

> reformed and modernised legal systems, and

> stronger property rights and a collateral framework for lending.

Both governments and donors should seek new ways to deliver assistance that will involve communities and allow prosperity to spread widely.

Reform requires the energies of visionaries within the region, as well as far-sighted donors.

Much remains to be done, however. Both within the public sector and in the private sector itself, there are forces that profit from the status quo. Resistance to change, as well as inertia, has to be overcome. The reform process cannot be imposed from the outside, although some models of how to start the transformation are beginning to be tested. Nevertheless, governance issues remain a challenge and political instability has had a negative effect on rates of investment in the region.

There is the potential for regional cooperation in such areas as setting regulatory standards, cooperation in air transport, providing agricultural testing as well as providing services such as arbitration.

The time for reform is ripe and requires the energies of visionaries within the region, as well as far-sighted donors, to promote change – not by doing more of what has not worked in the past, but by experimenting with alternative means to bring about transformation that provides prosperity without undermining the underlying strength of Pacific societies.

INTRODUCTION: THE NEED FOR GROWTH IN THE PACIFIC REGION

Existing policies have failed to respond to the aspirations of the Pacific island peoples.

Over the past 20 years the performance of the island economies in the Pacific has been disappointing. Growth has been weak, with per capita incomes either stagnating or declining. Human development indicators show that the Pacific island countries rank poorly in terms of criteria such as health and education. The private sectors in these countries are generally small, investment rates are low, and entrepreneurship is often lacking. There is still extensive state involvement in virtually every country, with poor delivery of services and high-cost, low-quality infrastructure and communications.

Most prices that the average consumer faces in virtually every country in the region are high. People living in the island countries face additional problems.

- The social services provided are either ineffective or unduly expensive, or both.
- Few jobs are created, and the better educated and more entrepreneurial citizens seek better opportunities abroad, draining human capital.
- Domestic and foreign investors are reluctant to invest.
- Poverty is a hard and growing reality.

In short, existing policies have failed to respond to the aspirations of the Pacific island peoples.

A REALISATION THAT 'SOMETHING NEEDS TO BE DONE'

Many Pacific leaders are committed to reforming the business environment.

Increasingly, many of the countries' leaders realise that they are failing to provide their citizens with essential services and that existing policies are not delivering the necessary results. They see private sector development as providing the possibilities for growth and prosperity. There is now general recognition among leaders in Pacific island countries that, without a dynamic private sector, they cannot achieve the increases in prosperity necessary to generate jobs and income opportunities for their people. Many Pacific leaders are committed to reforming the business environment by improving incentives, promoting efficiency and reducing the costs of doing business.

This commitment has manifested itself in regional communiqués. For example, the 2004 Pacific islands Forum Economic Ministers Meeting (FEMM) acknowledged the importance of private sector growth and has stated that private sector friendly policies will be adopted. The FEMM meeting in 2005 reiterated this commitment and specifically mentioned the importance of institutional reforms in such areas as commercial law and collateral in promoting more investment and entrepreneurship.

Yet there is also caution and frustration. Many of the policies were originally implemented on the grounds that the unique characteristics of the countries in the Pacific required the state to play a central role. There is still concern that reform will take place but investment and private sector activity will not follow. Furthermore, in the countries that have taken the first steps towards reform, there is frustration that the anticipated strong private sector response has so far not occurred.

Closer investigation reveals, however, that far-reaching reform has occurred in only a few areas of some economies. In general, countries in the Pacific region remain difficult, costly, high-risk places in which to do business. The result is that investment levels are disappointing and growth has stagnated despite levels of aid from donor countries being the highest in the world on a per capita basis.

WHAT ARE THE SPECIAL CHARACTERISTICS OF PACIFIC ISLAND COUNTRIES?

Small economies need flexibility to adjust to unforeseen events and low transaction costs to reduce the impediments to doing business.

Any generalisation regarding the countries of the Pacific region inevitably involves glossing over their wide variety of topography, culture, systems of governance, and cohesiveness. Yet they also share common characteristics. The countries of the region are small in terms of populations and in most cases in landmass. Yet many are highly dispersed geographically and remote from most of the world's major markets. In most of the countries, tradition, family and cultural ties remain strong. Some of the countries are rich in natural resources and many have a striking physical beauty. Their small size and consequent inability to diversify mean that they are subject to forces outside their control and are vulnerable to economic shocks. In addition, they are vulnerable to natural disasters such as typhoons, tsunamis and earthquakes.

Over the past few years there has been an upsurge in interest in policy issues in small countries, which has generated a number of interesting analyses. These have ranged from claiming that there is little to be concerned about[1] because on average small countries are more prosperous than large countries, to concluding that small, remote economies are inherently uncompetitive because high transaction costs and technical disadvantages mean that trading does not generate viable income[2]. The truth lies in between. Nevertheless, the implications of all the research to date is that economies that are small need flexibility to adjust to unforeseen events and low transaction costs to reduce the impediments to doing business.

WHAT ARE THE POLICY IMPLICATIONS OF THE REGION'S CHARACTERISTICS?

In the Pacific region, policies should seek to ameliorate the region's physical and geographic disadvantages.

To promote competitiveness in the Pacific region, policies should seek to ameliorate the region's physical and geographic disadvantages.

> Remoteness implies that transport and communication should be as low cost as possible.

> Geographic dispersion means that inter-island transport should be as efficient as possible.

> Small market size means that the Pacific island countries must rely on imports for most of their goods, so that trade barriers should be low.

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1 William Easterly and Art Kraay, *Small states, small problems*?, World Bank, Washington, DC, 2002.

2 L Alan Winters and Pedro Martin, *When comparative advantage doesn't matter: business costs in small economies*, Commonwealth Secretariat, London, 2004.

- Their vulnerability to shocks implies that the economies of the region should be as flexible as possible to facilitate rapid adjustment.
- Remoteness requires legal systems that allow arms-length dealings with strangers.
- Financial systems are needed to fund investment.
- Many skills, particularly in the areas of entrepreneurship and technical capacity, do not exist in Pacific island countries, necessitating foreign investment.

WHAT IS INVOLVED IN POLICIES TO PROMOTE PRIVATE SECTOR DEVELOPMENT?

There is not a good understanding of how to promote private sector development or how to implement private sector friendly policies.

Although much has been written about the importance of private sector development, there is not a good understanding of how to promote it or how to implement private sector friendly policies. One of the reasons is that promoting a good environment for private sector development involves a wide range of policies, institutions, both formal and informal, property rights, the rural economy and economic governance. It requires extensive crosscutting policy formation and involves many parts of the public sector in implementing reform.

Incentives and transaction costs determine the way that the private sector organises business activity, structures contracts and undertakes investment. Ultimately, productivity, competitiveness and economic growth depend on incentives faced by the private sector encouraging long-term investments and contracting. If the transaction costs of doing business are high and incentives promote short time horizons the productivity and the efficiency of individuals, small businesses and companies are adversely affected. This in turn harms long-run growth and the ability of the private sector to reduce poverty. A business environment that promotes efficient private sector development requires well-functioning markets that encourage competition. Long-term contracting requires secure property rights, laws and related institutions.

WHAT ARE THE REALITIES OF THE PRIVATE SECTOR POLICIES OF PACIFIC ISLAND COUNTRIES?

Although the details of the business environments vary greatly among the countries in the region, it is not a gross generalisation to say that private sector policies do not reflect what is necessary for entrepreneurship and investment to flourish.

Policies exacerbate rather than ameliorate the natural disadvantages of geography and size.

The Pacific is a difficult high-cost place in which to do business. Furthermore, in most countries, policies exacerbate rather than ameliorate the natural disadvantages of geography and size. Transport costs on a per mile basis are high. Telecommunication costs are among the highest in the world, both for telephone calls and for internet usage. Infrastructure, including power and water supplies, is unreliable and absent in most of the more rural areas of the countries. Pervasive regulation and state control of many sectors inhibits greatly the transfer of resources and their ability to rapidly adjust to changing circumstances. Foreign investors must undertake lengthy and costly procedures before obtaining permission to start doing business. At the same time, there are many distortions in how and where resources are used as a result of special concessions and incentives for investors in the areas of taxation and imports.

The laws that govern commerce are based, for the most part, on English law in force at the time of independence. The result is that access to the legal system is costly and in general available only to foreigners. Furthermore, financial systems do not fund investment effectively, even though there is no shortage of liquidity. Banks describe lending as risky and complain about a shortage of 'bankable projects'. Development banks in the region are generally in a parlous financial state and many provident funds are similarly financially unsound.

Private sector activity is crowded out by government and monopoly activity.

Most Pacific governments own enterprises such as electricity suppliers, airlines, telecommunication companies, trading companies and shipping companies that earn low or even negative overall returns on assets, even businesses that are supposed to be commercial. Most are shielded from the consequences of their own inefficiencies by the monopoly positions they enjoy. In some Pacific island countries, government businesses amount to the equivalent of more than 40 per cent of gross domestic product. In essence, private sector activity is crowded out, sometimes by governments offering services below cost, and sometimes by monopoly through fiat.

If we assume that the combined return on the assets of all businesses in an economy is a fair proxy for economic growth, for a country to generate a growth rate that will lift the prosperity of its citizens, very high rates of return will have to be earned by private sector companies to compensate for the poor performances of the state-run businesses. Investments with very high rates of return are generally associated with high risks and corresponding high failure rates.

WHAT REFORMS HAVE BEEN IMPLEMENTED IN THE PACIFIC REGION SO FAR?

Some countries claim that reform has already occurred and that the private sector has failed to respond. To what extent does this accurately reflect the realities of the Pacific region?

Reform remains in its infancy.

It is true that in some countries there has been the beginning of change and that a very few have taken positive steps to liberalise trade, rationalise government and privatise state enterprises. Yet as recent Asian Development Bank (ADB) private sector assessments and the World Bank Doing Business Indicators show, the Pacific region remains a uniformly costly place to do business in terms of the cost of starting a business, the cost of running a business and the cost of closing a business. Furthermore, utility costs remain high as do communication and transport costs.

The reality is that reform remains in its infancy. In virtually all Pacific island countries, existing policies have not created a business-friendly environment and policies have either ignored or exacerbated the problems of distance and size.

WHAT DOES SUCCESSFUL REFORM MEAN?

Reform implies making the countries easier places in which to do business.

It is important to define exactly what we mean by reform that promotes private sector development. Furthermore, it is important to realise that 'reform' means different things in different countries. Overall, it implies making the Pacific countries easier places in which to do business. Reform entails:

> introducing competition where monopolies previously prevailed, which can often be achieved by eliminating barriers to entry

> implementing regulatory oversight, where monopolies cannot be competed away, and

> ensuring that the public sector exists to provide services to the whole population, not to entrench the interests of the employees of government or state-owned enterprises (SOEs).

Above all, promoting change requires an ongoing policy debate that promotes a vision of the Pacific island countries as low-cost, private sector friendly business environments that exploit their comparative advantage. In the past, initiative often went unrewarded, with the result that many of the most entrepreneurial citizens in the region left to seek opportunities elsewhere. Their abilities were stifled by states that engaged in business activities in which they have no expertise and that fail to provide the essential elements of an environment in which private sector activities can succeed.

That the citizens of the Pacific island countries want greater opportunity is undeniable. A recent ADB survey revealed that one of the primary concerns of the poor in the region was access to markets so that they can sell their goods. The migration of many of the better educated citizens of the region and the success that they achieve in their newly adopted countries are indicators of the frustration that they have with the lack of opportunities at home.

HOW TO IDENTIFY REFORM PRIORITIES

Detailed analyses are essential to identifying specific barriers to private sector development.

To promote a business environment in which entrepreneurship and investment can thrive, existing barriers to private sector development need to be identified. This can be done only through detailed analyses of the barriers to private sector development in individual countries. Recent initiatives by the ADB in conducting private sector assessments and by the Foreign Investment Advisory Service (of the International Finance Corporation, a part of the World Bank Group) through its analysis of impediments to foreign investment contribute to identifying reform priorities. Over the past three years the ADB has commissioned six separate private sector assessments that have been adopted as the basis for private sector country strategies. They have involved a detailed study of how investors and entrepreneurs react to the business environment in the region.

Such detailed analyses are essential to identifying specific barriers to private sector development. For example, in Fiji the private sector assessment concluded that the extensive array of incentives offered to investors encourage capital-intensive investment, even though in Fiji, as in the other countries in the region, capital is scarce and labour is plentiful. Conclusions such as these do not emerge from the use of indicators. In addition, the World Bank Doing Business Indicators are useful statistics for highlighting issues for senior policymakers.

THE ROLE OF DONORS

Official development assistance to the Pacific Developing Member Countries (PDMCs) of the ADB[3] averages around $700 million a year. Across PDMCs there are great variations in the level of aid per person – ranging from over $1000 in Marshall Islands to less than $50 in Fiji. Another feature of the aid to the Pacific is the high proportion of technical assistance in project lending.

Donors' aid programs need to be coordinated ...

The coordination of aid programs between donors is important in providing a coherent program and consistent policy advice to a country. During the past decade the aid programs in the Pacific have often been sponsor-driven and uncoordinated, and have placed pressure on the absorptive capacities of the countries in the region. Often aid has been provided without keeping the interests of the recipient country in mind. For example, a donor initiative in Marshall Islands resulted in planning for a high-cost internet service that was outdated before it could be installed.

In addition, there is a significant danger that the advice of donors is diluted when they fail to emulate it themselves. The chances of countries adopting advice on many policy issues ranging from trade to transport – say, open-sky airline policies – are severely reduced when donors fail to adopt similar measures. For example, recently Australia decided to limit competition on the lucrative Sydney–US airline route in order to protect its national airline.

and to match the countries' abilities to absorb aid.

A further issue centres on the ability of countries to absorb aid. Recent research emanating from the International Monetary Fund points to the need to keep in mind absorptive capacities of the countries receiving aid, not to overtax bureaucratic capabilities and not to distort incentives. This work also suggests that the use of foreign consultants keeps local workers in productive activities rather than working

3 The Asian Development Bank's Pacific Developing Member Countries include Cook Islands, Fiji, Kiribati, Maldives, Marshall Islands, Micronesia, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor Leste, Tonga, Tuvalu and Vanuatu.

for donors, although even here, caution is necessary. A recent ADB private sector assessment highlights the impact of aid on Solomon Islands, where building houses for expatriate aid workers currently offers the greatest return on investment.

WHAT SHOULD BE EMPHASISED IN A REFORM AGENDA?

While the details of a reform agenda for the countries in the Pacific region are highly country specific, the issues are similar in virtually all countries.

STATE-OWNED ENTERPRISES (SOES)

Competition needs to be brought into sectors currently dominated by SOEs or monopolies.

In most countries, state-owned providers of power, water, telecommunications, inter-island sea and air transport, and international sea and air transport offer poor, costly, unreliable services. Furthermore, in most countries the providers have legally entrenched monopolies or they crowd out private sector activity by offering below-cost services that have to be supported through government budgets. In the small number of cases where privatisation has occurred, it was often done by offering long-term monopolies to the private providers, which charge prices that are among the highest in the world.

The price structures of power generation and telecommunication services are often distorted by ill-advised cross-subsidies. To provide low-cost services to households and the outer islands, the business community is charged high prices, which places additional burdens on private sector, the only possible source of growth. Furthermore, the high cost of telecommunications raises the costs of doing business with the outside world.

There is often a focus on technical solutions as opposed to economic solutions to providing services. While it is often true that larger electricity plants or a single provider of telecommunication services would in principle be more efficient, having smaller providers that could compete with each other would bring greater economic efficiency. Although many people claimed the market in Tonga was too small to support more than one wireless telephone operator, the introduction of a second wireless company has resulted in a sharp fall in call charges.

Samoa provides an example of how to begin to reform SOEs. It demanded that SOEs adopt governance criteria that incorporate accountability from their management teams. In addition, it has begun to limit the number of public sector employees on the executive boards of its SOEs, a step that many other countries have failed to initiate. For example, in Vanuatu the number of directors of Air Vanuatu, which is government owned, was recently increased from 16 to 28, even though the airline has only one plane (a Boeing 737) that can undertake international flights. All are entitled to unlimited business class travel as well as travel for their families and earn significant directors fees.

A reform strategy requires bringing competition into sectors currently dominated by SOEs or, in a few cases, to private companies that have been awarded extraordinarily profitable monopolies. There are successful examples – as already noted, the Tonga telecommunications sector. This also illustrates that even small countries can introduce competition.

FINANCIAL MARKETS

Financial market reform requires an effective collateral framework and more credit information on borrowers.

In all countries in the region, the ratio of private sector credit to gross domestic product is low. Financial sectors are dominated by commercial banks, and credit is difficult or impossible to obtain by all but the largest businesses. Reasons for this centre mainly around the poorly functioning framework for pledging assets as collateral and the inability of the vast majority of the Pacific island people to use their main source of wealth – their land.

It is likely that the commercial banks will remain by far the most important suppliers of financial resources in the region for the foreseeable future. Alternative forms of financing require economies of scale that are not available and are probably of questionable usefulness in most Pacific island countries. In all of the countries studied, the ADB private sector assessments identified the weak framework for pledging movable property as collateral as a major factor contributing to the failure of banks to lend to a broad range of investors, and to small and medium enterprises and to rural businesses. In Vanuatu this has been translated into technical assistance to reform the secured transactions system, begun in the second half of 2005. Similar assistance in promoting reform is planned in Solomon Islands, Marshall Islands and Papua New Guinea.

Further financial market reform can be encouraged by increasing the availability of credit information on borrowers. This can be done by assisting with the establishment of credit information systems. The credit bureaus established in Fiji and Samoa, which now provide better information for lenders, have begun to increase borrowers' access to credit.

Financial sector reform, however, does not involve funding by governments or by government institutions. Most government-owned development banks in the region have performed poorly and many are either in a weak financial position or are bankrupt as a result of lending policies based on inadequate knowledge of the projects that are being financed, political influence on lending decisions, or moral hazard problems arising out of the ineffectiveness of the collateral framework.

There are examples of successful initiatives in the region, however. A major commercial bank in Fiji has started a program to attract rural depositors, which has succeeded well beyond expectations. The bank is now considering including the offer of small-scale lending as part of its services. An innovative pilot microfinance scheme by a commercial bank in Vanuatu, which was established with the assistance of the ADB, has been so successful that it is being expanded as a fully fledged bank product. The scheme is being studied by other financial institutions in the region as a model that could be emulated.

The experience of countries that have well-developed microfinance industries is that state involvement is damaging rather than helpful and that sustainability depends on the development of commercial, profitable microfinance institutions rather than institutions supported by donors or by governments. In some countries, however, outmoded usury laws could hamper the development of sustainable institutions. Both Marshall Islands and Solomon Islands have caps on interest rates charged by credit unions. Rather than helping borrowers, such ceilings discourage the evolution of financial systems in the region. They penalise borrowers rather than control lenders and inhibit the growth of microfinance, where high risk and high transaction costs require interest rates of 30 per cent or more a year. For example, the microfinance scheme in Vanuatu charges effective interest rates that are in excess of 40 per cent. While these rates may seem high, they are far lower than those charged by moneylenders. In addition, this level of interest rate does not discourage borrowers who are far more concerned about access to credit than the cost.

THE LEGAL SYSTEM FOR PRIVATE SECTOR DEVELOPMENT

For companies to prosper and grow there must be institutions that allow them to expand from micro-enterprises. The legal system is a critical component of this process as it defines agreements between businesses and facilitates contract enforcement. This facilitation of arms-length transactions allows businesses to grow and move beyond the circle of family, friends or neighbourhood acquaintances in which they initially operated. Business agreements between firms that do not rest on personal relationships often require formalisation to ensure the compliance of both parties. In remote countries dealing with suppliers and customers over long distances, and the growth of foreign trade particularly, requires legal systems that allow for low-cost effective contracting.

Legal systems need to be updated to suit modern commercial activity.

In all countries in the region, legal systems are outmoded and unsuited to modern commercial activity. Problems arise from the laws themselves, from difficulties with enforcement and from the institutions that are part of the legal system, namely the courts and the registries. The laws of Pacific island countries are frequently based on those extant in the United Kingdom or Australia 50 or more years ago. For example, the Companies Act of Solomon Islands is based on the 1948 UK Companies Act. In Marshall Islands there is no bankruptcy law. In Fiji the implementing regulations for the Consumer Protection Act have not been issued, even though the law was passed several years ago, with the result that the commercial banks are unable to comply with the legislation.

It is impossible to know with any certainty the precise costs of a weak commercial law framework, but it is not difficult to imagine the effect on, say, foreign businesspeople and investors when they become aware of the uncertainties involved in contract enforcement. The consequence for the countries in the region is lower levels of trade and investment than could be the case.

Improvement in this area entails defining where problems lie and proposing the reform of laws covering the formation and operation of companies, bankruptcy, contracting, arbitration and registry operation. Arbitration has particular potential, especially given the nature of customary law, where arbitral procedures are often followed implicitly. For example, environmental degradation in Palau was greatly reduced through the intervention of traditional chiefs, who talked about the ancient wisdom of harmony with nature while shaming polluters.

The costs of business registration discourage many small entrepreneurs from registering. This is particularly an issue for those living outside the capitals of Pacific island countries. Since all registries in the region are paper based, and documentation requirements usually require hiring a lawyer, it is little wonder that few rural businesses are formal. Some countries are starting to address the issue. AusAID is assisting in registry reform in Papua New Guinea. The Foreign Investment Advisory Service of the World Bank Group is helping Fiji with its registry system, with a view to modernising it. The ADB has announced a technical assistance program to help Solomon Islands in modernising its companies act. As such initiatives spread across the region, the framework for doing business will be upgraded.

PERVASIVE REGULATION

The bureaucratic processes accompanying investment applications need to be reduced.

Bureaucracy in many of the countries in the region has been described as ‘pervasive’, ‘overwhelming’ and ‘crushing’. Many foreign investors have been so discouraged by the processes accompanying investment applications that they have simply taken their projects to other parts of the world or given up altogether. In many countries the procedures necessary to complete application requirements are not even written down. In some countries there is more than one level of bureaucracy, with businesspeople being confronted by a second set of regulations at the town or provincial level.

The Foreign Investment Advisory Service has been assisting countries in the region to identify and remove some of the more egregious barriers to private sector development in the region. Another approach to reducing regulation that has had success in some former Soviet Union countries requires government departments to justify all their regulations by a particular date. If such justification is not forthcoming or is unconvincing, the regulations lapse.

TRANSPORTATION

Achieving more efficient, cost-effective and competitive transport services is a priority.

Many of the countries in the region are not only remote from major markets in Australasia, North America and Europe but are also widely scattered geographically, with numerous islands that are in some cases thousands of miles apart. Therefore, the Pacific island countries require efficient transport services internally as well as with the outside world. The outer islands depend on air and sea transport links for all commercial activity, including agriculture and tourism.

Unfortunately, the realities of the transport sector, both externally and internally, leave much to be desired. The remoteness of many countries already implies that service is infrequent and costs more than that to large population centres. Following the internal conflicts in Solomon Islands, inter-island passenger services essentially collapsed and cargo movement was curtailed. Donor-supported efforts to revive shipping are under way, but the lack of capacity in government is slowing this down.

In many cases, government policies exacerbate the disadvantages of Pacific island countries. Inefficient ports raise the costs of sea transport. Air transport costs are increased because many countries own their airlines and restrict the access of foreign carriers. Internally, both inter-island shipping and air services are often owned by governments, which crowd out private operators. Infrequent high-cost service harms the tourist sector as well as agriculture and fishing in the outer islands.

When governments get ‘out of the way’, entrepreneurs have responded strongly.

Land transportation services in many countries such as Papua New Guinea, Vanuatu, Fiji and Marshall Islands have sprung up, providing services at reasonable cost that benefit a substantial portion of the population. This sector belies the assertions of those who claim that there is no entrepreneurship in the region. In the few areas where governments have limited the regulation and their presence in the economy, entrepreneurs in the region have responded strongly.

THE PROVISION OF INFRASTRUCTURE

Frequently, the provision of infrastructure is hampered by the inefficiencies inherent in government departments that have limited capacity to implement infrastructure initiatives. In many cases, these problems are magnified by donor procurement rules that have the effect of limiting infrastructure projects to large-scale schemes, usually provided by foreign companies, leading to the so-called ‘aid boomerang’. In the process, opportunities to involve local expertise and employment are lost.

The private sector and communities need to be involved in the provision of infrastructure.

There are, however, imaginative ways to involve the private sector and communities in the provision of infrastructure (roads and small harbours), schools and clinics through the provision of block grants. The communities themselves decide on their priorities and who should provide the services. In the event that the communities themselves provide the services, the funds are disbursed when specified targets are met. Private sector agents can supervise such projects.

THE RURAL ECONOMY IN PRIVATE SECTOR DEVELOPMENT

In most countries in the region most of the population still live in rural areas, which are often perceived as targets for social policies or for agricultural extension services. This view overlooks the potential contribution that the rural economy – small farmers, fishermen, small traders, small-scale distributors and processors – can make. It is an archetypical small business sector. Yet rural entrepreneurs, including farmers and fishermen, suffer disproportionately from a dysfunctional private sector environment.

The effects of high-cost or non-existent infrastructure, limited access to finance, limited transport facilities, high-cost communications and trade barriers are intensified in rural areas. With populations increasing and with virtually no potential to engage in entrepreneurial activities in rural areas, many Pacific islanders are facing the inevitability of migrating to urban areas, thereby putting pressure on urban services. In many countries in the region this migration has resulted in increasing urban poverty and rising social problems.

Often, rural sectors in Pacific island countries are also placed at a competitive disadvantage. For example, many countries offer incentives for foreign investors, which often include duty-free imports of all their inputs, including food. This automatically discriminates against domestically produced agricultural products, something that helps to explain the absence of local produce in many of the tourist resorts in the region.

The potential of successful rural enterprise is great.

However, there are examples of successful rural enterprise that illustrate the potential of the rural sector. A small village on the outskirts of Suva, Fiji, set up a rural cooperative to export a local product – dalo. They formed themselves into a business unit with a board, sales manager and marketing manager and won an indigenous export award. They export dalo worth $12 000 per month and use the profits to educate the village children and provide other benefits to the whole village.

Such examples are all too few, and are often hampered by ineffective infrastructure, poorly designed government policies or negative incentives. Entrepreneurs in Marshall Islands have found that coconut oil is an effective substitute for diesel oil for running generators, machinery and trucks. This has the potential to increase substantially the incomes of copra producers, who are located primarily in rural areas. However, price controls at every phase of the production chain mean that there is little profit and so reduced supply. If these controls were lifted, opportunities for profit and rural incomes could by substantially increased. Agricultural production in Fiji is being harmed by the consequences of the Agricultural Land Trust Act, under which leases that expire have no certainty of being renewed and lessees are not compensated for land improvements. Copra production in Marshall Islands has been adversely affected by a poorly designed compensation scheme and government-run inter-island shipping services that crowd out private sector shipping and arrive haphazardly or not at all.

LAND PROPERTY RIGHTS AND PRIVATE SECTOR DEVELOPMENT

Clearly defined property rights to land is a necessary precondition for long-term economic development.

There is substantial evidence that clearly defined property rights to land is a necessary precondition for long-term economic development. It is difficult to argue against this claim as most industrialised countries have strongly protected property rights, particularly for immovable property, and well-functioning land markets. In virtually all industrialised countries financial markets support the purchase and improvement of property, which constitutes a major portion of the assets of their financial systems. Secure property rights to fixed property encourage investment in land and buildings and promote a more equal distribution of wealth. Countries where property rights to land are not secure have much lower rates of investment and, eventually, growth than they might otherwise have. In most developed countries the bulk of small businesses are started using loans that are backed by land.

A key difference in the Pacific region is that most land remains in customary ownership of kinship groups, a system enshrined since independence in the constitutions of many of the countries in the region. The major source of wealth (the primary asset) for families in the Pacific region is land. Since that land cannot be used as collateral to raise capital, productive, income-earning opportunities, which are the process of development, are forgone.

In many countries in the region, land in the larger towns has been alienated or is being used through clearly defined long-term leases. It is often used as collateral for bank loans in spite the drawbacks of the collateral framework. A possible intermediate step in implementing land reform would be to improve the machinery for recording and transferring this property. Once such mechanisms are in place, they could be adapted to encompass more communally held land.

Many observers see land tenure in the Pacific island countries as an intractable problem – so difficult to solve that politicians and donors are unwilling to tackle it. However, in the longer term it is simply too important for the development of countries in the region to be ignored. Urgent priority should be given to commencing a reform process.

GOVERNANCE AND PRIVATE SECTOR DEVELOPMENT

In some countries in the Pacific, governments and public administrations are weak – to the point of being described as failed or semi-failed states. No country has a public administration or government that could be described as strong. Yet many donor interventions involve dealing with public administrations, implementing complicated projects that require intense interaction with in-country public sector counterparts, and proposing policies that would challenge even highly sophisticated bureaucracies.

Added to weak administration is the problem of filling key vacancies within the public sector. One example comes from Solomon Islands, where numerous reports have identified infrastructure as a key constraint to rapid growth. Donors have expressed willingness to assist the country, and a number of substantial infrastructure initiatives have been planned. However, they are all being delayed by a lack of capacity in the Ministry of Infrastructure, which in January 2005 had only four employees, including the Permanent Secretary. Until there are more staff, the planned projects cannot be initiated. However, as in many Pacific island countries all recruitment for public service vacancies has to take place through the Public Service Department. Eight months passed without any of the positions being filled. The result is that donor projects, which have been ready to commence for several months, cannot get under way and some are in danger of being cancelled.

Another problem is that, while key vacancies go unfilled, overall public sector employment has risen in many countries. In Marshall Islands, government employment has risen by 20 per cent since independence in 1979.

Donors need to keep in mind the difficulties of reform and allow for counterpart weaknesses.

In many countries, governance and capacity-building initiatives are under way. Often this takes the form of installing foreign consultants in ministries with a brief to train counterparts. Bilateral donors have placed large numbers of personnel in governments in many of the countries in the region, including Nauru, Solomon Islands, Papua New Guinea, Fiji and Vanuatu. However, the turnover of both consultants and counterparts alike often limits the effectiveness and sustainability of such schemes. Furthermore, the history of donor projects for enhancing governance in many developing countries is not encouraging.

However, this is not a reason to stop trying to improve capacity. Without effective public administrations dedicated to improving public goods such as the commercial legal framework, improving infrastructure and reducing pervasive state interference, promoting economic development through private sector development in the region would be an even greater challenge than it already is. However, donors need to keep in mind the difficulties of public sector reform, use market-based incentives to the greatest degree possible, and consciously shape project design to allow for counterpart weaknesses.

MONITORING AND MEASURING PROGRESS

Policymakers and reformers have to be able to identify whether their efforts are promoting private sector development.

Any strategy to improve the investment climate in Pacific island countries must involve identifying, monitoring and measuring progress. Policymakers and reformers have to be able to identify whether their efforts are promoting private sector development.

There are two distinct aspects to implementing and monitoring the success of such a strategy. The first is monitoring and measuring the success of individual policies, projects or programs implemented under the strategy. The second is monitoring and measuring the overall effectiveness of those interventions to ascertain whether they contribute to the goals and objectives of the overall strategy.

A strategy's impact is difficult to assess accurately because multiple factors contribute to private sector development, many of which come about independently of the investment climate strategy. It is also difficult because broad results take time to become apparent. It is for this reason that assessments often focus on the success of specific activities or operations. Nonetheless, it may be possible to develop indicators of success that reformers can monitor.

The indicators could be quantitative measures and the opinions of stakeholders and clients. They could be selected, perhaps with the assistance of donors, based on their relationship to the specific objectives and priority areas identified in the investment climate strategy. Quantitative changes in various output and outcome indicators could be a basis for judging the strategy's contribution to improving the investment climate and be compared with results of stakeholder interviews.

Given the difficulties mentioned above, the evaluation should be simple and transparent. Ideally, much would be done on a regular basis with all parties involved.

TAKING ADVANTAGE OF REGIONAL SYNERGIES

Private sector development would benefit from regional cooperation in several areas.

There is the possibility of promoting private sector development in Pacific island countries by taking advantage of regional synergies in several areas.

An initiative to form a regional Chamber of Commerce Association to represent the views of the private sector on a regionwide basis will assist in raising the profile of private sector concerns, as well as provide a forum for discussing private sector issues.

As the private sectors develop, there will be a need for regulation in cases where there are natural monopolies. Regulatory skills in the countries are low and skilled regulators are costly. It is unlikely that in the foreseeable future it will be possible to develop and retain the complex, highly paid abilities this function requires. However, it is possible to supply such services on a regional basis, especially since such skills are well developed in Australia and New Zealand. This would not necessarily imply that decisions would be imposed from outside. Rather, regulatory hearings could be held in a transparent way, with recommendations made publicly and with the governments deciding on implementation.

Low-cost arbitration would make the legal system much more accessible to the citizens of Pacific island countries. A regional arbitration centre or network – which could be virtual rather than having a physical location – could provide this expertise, which does not exist in the individual countries. Donors could contribute to this by assisting in setting it up, identifying arbitration experts, and even providing some of the financing.

Health testing and verification could be established and implemented on a regional basis for both imports and exports of agricultural products and foodstuffs. This would not imply supplanting local sovereignty but rather unifying standards and providing testing and verification procedures. In this way, there would be less uncertainty in the rural sectors of many countries about the processing procedures required for their products to be exported.

BRINGING ABOUT REFORM

Improving the environment for business requires commitment, analysis, persuasion, political action and coordination.

At the moment there is little meeting of minds between government and private sector operators and little understanding of each other's positions. Government officials claim that they have undertaken reform but the private sector has not responded. Private sector operators blame government bureaucrats for their failure to implement reform without admitting the extent to which entrenched private sector interests benefit from the distortions in the economy. Many employed in the public sector also benefit from the extensive role of the state in the economy – from high public sector salaries to overstaffing of ministries and agencies.

Changing minds and attitudes requires more than simply writing reports. Improving the environment for business requires commitment, analysis, persuasion, political action, and coordination at the country level between governments and the private sector, in addition to coordination and support on the part of the donors. In fact, if donors can promote and facilitate dialogue within countries on an ongoing basis, they will be making a major contribution to bringing about change in the region.

This view is held strongly by prominent members of the private sector and civil society in the countries of the region. They see the role of the donor community above everything else as being interlocutors for change, engaging the governments in the region in debate, and promoting the need for private sector development, for freeing up markets and for reducing control and bureaucratic burdens in the economies of the region. In many cases they view the high level of aid as having created dependency rather than dynamism. In their view, aid has delayed rather than promoted reform. They consider that donors have a responsibility to ensure transparency, promote change and coordinate their actions for the benefit of the countries themselves.

An interesting example of such dialogue comes from Marshall Islands, where a series of retreats has been held between members of government and members of the private sector and civil society on what reform means and how to implement it. The first retreats, which were held under the auspices of a facilitator, were devoted to increasing the understanding of group members and their ability to communicate.

Subsequent meetings began to explore reform options and have led to the establishment of a permanent secretariat to ensure that commitments are recorded and evaluated and that progress is tracked. Although the process requires constant effort and resources, it illustrates what can happen when policymakers, donors and private sector operators begin to move past the 'what' to reform and onto the 'how' to implement reform. If these principles are kept in mind by donors, prospects for promoting private sector development in the region will be substantially enhanced.

WHAT CAN BE EXPECTED FROM REFORM INITIATIVES

As the costs and barriers to business decline, economic activity will increase in areas not yet imagined.

It is important to realise that there is no 'magic wand' that can be waved to bring about immediate prosperity in the countries in the region. Even if all of the reform measures identified in this paper were implemented quickly, time would be required for them to begin to make a difference. The business community needs to be convinced that changes will not be reversed before they invest substantial sums in new businesses. Behaviour needs to change to take advantage of new opportunities. It is likely that outcomes will manifest themselves incrementally.

As the costs of doing business decline, however, there will be an increase in economic activity of all types in areas that currently cannot be imagined. The inhabitants of the Pacific region have displayed ingenuity in conducting business in spite of the difficulties of doing so. As the barriers to investment and entrepreneurship decline, the frequency of investment in new opportunities will increase.