OBSTACLES TO ECONOMIC GROWTH IN SIX PACIFIC ISLAND COUNTRIES

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Chapter 1

Introduction

This report presents the results of an investigation into the sources of, and obstacles to, economic growth in the small Pacific island economies. The analytical framework is that provided by Hausmann, Rodrik, and Velasco (2005). The focus of this framework is on identifying the binding constraints to economic growth within a country, given that the investigator has detailed knowledge of the country context. The outcome of this diagnostic approach is expected to be a listing of priorities of where to focus economic reform efforts in attempting to establish a favorable environment for investment and growth.

The starting point for HRV's development of the framework is the assumption that an under-performing economy is one in which "market imperfections and distortions are rampant" and where these imperfections and distortions may arise from government interventions or from market imperfections and externalities. These distortions create a wedge between social and private valuations of economic activities. As noted by HRV, one approach to economic reform is to attempt to remove all distortions at once. But this requires knowledge of all distortions and also poses the politically impossible task of removing them all together. A second approach described by HRV is to remove whichever distortions it is possible to remove at the time. However, HRV argue that this approach falls foul of "second best" theory; implying that removal of an intervention that does not have the highest opportunity cost may not be welfare improving. Another approach to economic reform is to remove the largest distortion first, and then the next, and so on. But HRV argue against using this approach as it requires knowledge of all distortions and because the largest distortion may not necessarily have the largest welfare impact. The approach favored by HRV is to identify the binding constraint(s), i.e. to focus on the reforms "where the direct effects can be reasonably guessed to be large".

HRV outline an approach to identification of the binding constraints to growth within a country. This approach pushes the investigator into examining in detail

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the possible constraints within broad categories of determinants of growth, such as availability of savings, availability of human capital, returns to investment, etc. HRV's approach is followed in this study in an effort to see what light it may throw on the generally poor economic performance of the small island states of the Pacific. A sample of six Pacific states was chosen for the study.

This first chapter provides a broad introduction to the physical, cultural, social, and economic characteristics of the Pacific island countries (PICs).[2] It also introduces the six Pacific island countries that are the focus of the study. The second chapter describes the political arrangements in the six selected countries and discusses recent developments in their politics and governance and the impact of these developments on economic performance. It goes on to describe some of the institutional arrangements within the countries. Chapter three discusses the economic structure of the six PICs and their policy environment and outlines the economic reforms that have been attempted over the past decade. Chapter four is the core part of the report in which the various possible constraints to growth are analyzed and judgments are made about the binding constraint(s). Chapter six concludes with a cross-country discussion of the findings.

Physical, social, cultural, and economic characteristics of the Pacific island countries

Physical characteristics

Defining physical features of the Pacific island countries (PICs) are their tiny size in terms of area and population (except for Papua New Guinea), their remoteness—spread out widely across the vast Pacific ocean—and their vulnerability to natural disasters (including cyclones, tsunamis, earthquakes, and droughts). However, there is also great physical diversity among them, with some having extensive areas of fertile, arable land; others have mountainous terrain and poor soil fertility; and others are groups of poor fertility, low rainfall, atolls and reef islands.

Other endowments of natural resources also differ markedly: Fiji, Solomon Islands, and Vanuatu have substantial forests, although logging has changed the extent of these resources substantially. Vanuatu once possessed valuable stands of sandalwood that have largely disappeared, although efforts are being made to re-develop sandalwood forests. Fiji's timber resources are now largely made up of introduced pine and mahogany plantings (Fiji's mahogany forests, planted up to 40 years ago and now being harvested, are said to be among the most valuable in the world). Solomon Islands still has very large areas of native timber. However, logging has been going ahead at a rapid pace for the past 15 years or so—mainly because this has been the government's main revenue-generating

[2] Much of the economic discussion of the Pacific island countries deals with the 14 island countries that are members of the Pacific Islands Forum: Cook Islands, Fiji, Federated States of Micronesia, Kiribati, Nauru, Niue, Palau, Papua New Guinea, Republic of the Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Australia and New Zealand are also members of the Pacific Islands Forum.

base—and it is often claimed that the forests will be depleted within a period of 10-15 years.

All PICs have access to large Exclusive Economic Zones (EEZs) since the ratification of the Law of the Sea Convention, which gave them exclusive rights over the sea area extending 200 nautical miles from their shorelines. Tuna are the main fisheries resource in the Pacific and the Pacific tuna stock is the world's largest. However, because it is migratory, and because of the differences in the size of their EEZs, not all PICs have similar access to the stock (see Table 1). All Pacific island communities, especially those living in coastal areas, depend to some extent on their inshore fisheries for their sustenance as well as the earning of cash income.

Mining, principally gold, is of importance in only three Pacific island countries, Papua New Guinea, Fiji and Solomon Islands. However, since the outbreak of the violent civil unrest in the Solomon Islands in 1998, the gold mine there has suspended operations. Being also located on the "rim of fire", Vanuatu is also likely to have gold and copper mining possibilities. No doubt Fiji and Solomon Islands have potential for further discoveries. The Pacific seabed is said to be rich in other minerals; however, harvesting of these resources depends upon the development of the necessary technological capacity.

As Table 1 shows, Papua New Guinea is the only reasonably large Forum Island Country, with a population of 5.6 million. The remainder total just over 2 million and range in size from around 2,000 in Niue to about 850,000 in Fiji. Population density varies widely across the countries, with land-rich countries such as Fiji, Solomon Islands and Vanuatu having very low densities and others with high (Kiribati and Marshall Islands) to very high population density (Nauru and Tuvalu). Life expectancy is in the 60-70 years range, except for Papua New Guinea where it is below 60 years. In Purchasing Power Parity (PPP) terms, per capita incomes range from US$5-7,000 for Cook Islands, Fiji, Samoa, and Tonga, while the rest have a per capita income much less than US$5,000.

Table 1: Basic Indicators for Forum Island Countries

Country	Land area (sq km)	Population ('000) (2004)	Population density (people/km^2)	Income per capita (PPP, 2004US$)	Aid per capita (2003 US$)	Life expectancy at birth (2003)
Cook Islands[a]	240	14	58	5,000	..	72
Fiji	18,270	848	46	6,092	61	70
Kiribati	730	98	134		191	63
Marshall Islands	181	60	331	1,600[e]	991	70[e]
Fed. Sts. Micronesia	702	127	181	2,000[f]	923	69
Nauru[a]	21	13	619	5,000[b]	..	63
Niue[a]	260	2	8	3,600[c]	..	..
Palau	460	20	43		1,295	
Papua New	452,860	5,625	12	2,564	40	57

Guinea						
Samoa	2,830	179	63	5,694	186	70
Solomon Islands	27,990	471	17	1,773		70
Tonga	720	102	141	7,236	270	71
Tuvalu[a]	26	11	423	1,100[d]	..	68
Vanuatu	12,190	215	18	2,893	154	69

Notes: The most recent data available has been used; .. indicates unavailability of data; [a] these countries are not members of the World Bank, thus their data has been sourced from *The World Fact Book*; data accessed online on 16 March, 2006; [b] per capita GDP for Nauru is for 2001; [c] data on per capita GDP for Niue is for 2000; [d] per capita GDP data for Tuvalu is for the year 2000; [e] data on per capita GDP (data for 2001) and life expectancy for Marshall Islands are taken from *The World Fact Book*; data for per capita GDP for FSM is for the year 2002 and was taken from *The World Fact Book.*
Source: Unless otherwise stated, the source for all data is The World Bank's *World Development Indicators* online. Data accessed on 15 March 2006.

Some of the PICs have been badly affected by disasters, some natural, others man-made. These disasters, in the form of cyclones, droughts, coups, and civil strife, have had a devastating effect on their economies.[3] For example, Cyclone Ofa in Samoa in 1990 is estimated to have reduced GDP by 7.7 per cent. The 1987 coups in Fiji are estimated to have reduced GDP in 1988 by 11 per cent. After comparing the economic impact of coups and cyclones in Fiji, Chand (2000) concluded that the former have been far more devastating; coups, much like civil strife, create distrust between communities and thus hurt entrepreneurial activity, the effects of which linger for decades. In contrast, natural disasters such as cyclones bring communities together, while inducing increased demand, particularly for new construction. Institutions and policy are impotent in preventing natural disasters but would appear to have a pivotal role in averting conflict.

Cultural and social characteristics

The PICs can be categorized into reasonably well-defined "culture" areas of Melanesian, Micronesian, and Polynesian, although the boundaries between them are blurred and there has also been a very large degree of inter-marriage with later immigrants of Asian (Chinese, Japanese, Korean, and Vietnamese) and European (such as Australian, British, French, and German) origin.

The countries fall into two broad groups with respect to the traditional structures that existed before the advent of the European colonial administrations. There are those, principally the Polynesian societies, which have hereditary authority structures, such as the Royal family of Tonga and the *matai* of Samoa. In much of Melanesia, the "big man" assumed authority of the clan through performance in war or by other means. Although, in Fiji, the British colonial administration

[3] Vulnerability Indexes constructed by SOPAC are shown for the six PICs in the Annex Table. These indexes are based on a consideration of vulnerability to physical and economic shocks. All except Vanuatu are rated as "highly vulnerable" or "extremely vulnerable". By comparison, the rating of Vanuatu as "vulnerable" seems surprising, given the prevalence of cyclones and earthquakes and its dependence on primary commodity exports.

extended the chiefly system, which was introduced in one part of the Fiji Islands by a Tongan invader, to the whole of Fiji.

Throughout the PICs most people live outside the few urban centers, largely within a communal arrangement that has very strong affiliation with the land and involves a high degree of sharing. The livelihoods of most of these communities is a mixture of subsistence and cash income, with the share of cash income increasing as demands for education, health, and modern amenities increase. While the share of the area of land held under customary tenure is very high in these countries (upwards of 80-90 per cent), the most fertile and most easily reachable land was made freehold during the colonial regimes and therefore the indigenous population often no longer controls it. Vanuatu is an exception, as a condition of independence was the handing back of all alienated land to its indigenous owners. However, gaining secure, individual access to land held under customary tenure presents problems throughout the Pacific.

The sharing of wealth within communities also creates problems for the development of enterprise within these communities. What seem to the outsider to be unreasonable demands by relations and others within the community for the income and assets of a budding entrepreneur have ruined many developing enterprises. For example, the advent of a wedding or funeral can lead to requests for the donation of a farmer’s draught animal for the celebration. Success in business has often meant finding ways to quarantine the business from such demands.

Economic characteristics

As noted above, the bulk of the population in the PICs lives in the rural areas and earns a mixed subsistence/cash income. However, the agriculture and forestry sectors generally account for only 20 to 30 per cent of GDP. Besides being due in part to the low productivity of communally-based activities, this low share of GDP is due partly to the notorious problem of the under-counting of the value of subsistence production. With a few exceptions, the PICs have small industrial sectors, often encouraged and sustained through the use of import restrictions and government business enterprises. The majority of exports are natural resource-based: agricultural (copra, coconut oil, cocoa, fruit, kava), marine (fresh and canned fish, pearls, seaweed), forestry (timber), and mining (gold). Because there is little complementarity between the exports of the PICs, inter-island trade is a tiny component of their total trade. Most countries operate a substantial merchandise trade deficit, with imports upwards of five times the value of exports. The difference is financed by remittances, tourism receipts, and aid.

Given their size and their isolation from major markets, small states face higher costs of commodity trade (Winters and Martin, 2004). The narrow resource base of many of the PICs has so far seen them specialize in a few commodities, which in turn makes them vulnerable to shocks such as natural disasters and adverse changes in their terms of trade. On the whole, industries that take root tend to be those requiring minimal economies of scale such as small-scale agriculture, boutique tourism, and assembly activity such as food packaging and clothing. Some import-competing industries survive with high levels of protection, subsidies, and with resource rents that fund downstream processing.

Fiji is somewhat of an exception in that it has a substantial industrial sector. In part this is due to the growth of its garment industry, which was encouraged through the preferential access that the Forum Islands Countries have to Australia and New Zealand through the non-reciprocal trade agreement, SPARTECA, and in part due to the provision of tax-free zones and tax-free factories. Fiji is also a major hub for re-exports to the rest of the Pacific. As well, it has a reasonably large food processing industry that exports to other PICs. Fiji is also somewhat unusual in that it has developed a major tourism industry, now attracting over 500,000 tourists per year. This industry was built on Fiji's proximity to Australia and New Zealand and its well-developed international airline, Air Pacific.

With the recent exceptions of Cook Islands and Samoa the economic growth performance of the Pacific countries has not been such as to lead to substantial increases in real per capita incomes over the period 1995-2004 (see Table 2). In fact, in four cases—FSM, Marshall Islands, Solomon Islands, and Vanuatu—real per capita GDP fell. Table 2 shows that between 1995 and 2004 the GDP of Cook Islands grew by an annual average rate of 3.1 per cent while the corresponding figure for Samoa was 4.1 per cent. Per capita GDP in Cook Islands and Samoa grew by 6.5 and 3.1 per cent, respectively; however, the very high rate of growth of per capita income in Cook Islands was due to the decline in population experienced.

Fertility rates (defined as the number of children per woman) within the PICs range from 2.5 for Palau to 5.3 for Solomon Islands; but the differences in the rates of growth of population are not only due to the substantial differences in fertility rates; they are also due in large part due to emigration. With the exception of Fiji, the PICs with low population growth rates, say one per cent and below (Cook Islands, Federated States of Micronesia, Samoa, and Tonga), have been those that have had easy access to foreign labor markets.[4]

Some might say that the economic performance of the PICs, in keeping up with their high population growth rates, has been fairly good, particularly in the Melanesian countries and those other countries without easy emigration access to metropolitan countries. However, it is suspected that income inequality is quite high in the PICs and is increasing, particularly because those in privileged monopoly positions are doing well. Therefore, it is likely that people in the lower-income groups are not doing as well as the average income per capita figures suggest.

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[4] Fertility rates amongst the two major ethnic groups in Fiji differ considerably (see Booth *et al*, 2006). Moreover, the ethnic Indians have been emigrating in large numbers, with 4-5,000 leaving annually since the 1987 coups.

A fundamental problem for these countries is their inability to attract investment. Investment data are only available for four of the PICs, and even for these countries the data are very limited. However, anecdotal evidence suggests that investment rates are poor throughout the Pacific. It was not always so in Fiji, as in the late 1970s Fiji had an investment/GDP ratio near 30 per cent. Since then the ratio has been declining and was around 10 per cent a few years ago. It has since recovered to around 18 per cent, although 8 percentage points of this is private investment and much of the remainder is investment in state-owned enterprises (SOEs). Explaining the poor investment performance is clearly a major task of this study.

Table 2: Rates of growth in GDP, population and GDP per capita, 1995-2004

Country	GDP growth (%)	Population growth (%)	Per capita GDP growth (%)
Cook Islands	3.1	-3.4	6.5
Fiji	2.6	1.0	1.6
Kiribati	4.1	2.3	1.8
Marshall Islands	-2.0	2.6	-4.6
FSM	-0.5	0.1	-0.6
Nauru	na	2.4	na
Samoa	4.1	1.0	3.1
Solomon Islands	-0.8	2.7	-3.5
Tonga	2.2	0.5	1.7
Tuvalu	3.3	1.3	2.0
Vanuatu	1.0	2.6	-1.6

Notes: na - Data not available.
Sources: ADB *Key Indicators,* Online Database; World Bank, *World Development Indicators,* Online Database, Booth et al (2006).

Justification for the Choice of the Six Pacific Island Countries

Six Pacific island countries were chosen for detailed study of the factors underlying their economic success, or lack of it: Cook Islands, Fiji, Federated States of Micronesia (FSM), Kiribati, Samoa and Vanuatu. The choice of the six countries studied was based on two main criteria: economic performance and the geographical, ethnic, and migratory features that distinguish these countries. Cook Islands and Samoa were included because they have achieved relatively good economic performance since undertaking comprehensive economic reforms in the 1990s. Vanuatu also undertook comprehensive economic reforms at much the same time but has since seen little improvement in its economic performance. It is of interest therefore to compare the reforms undertaken across the three countries and try to determine the reasons for the different results. The other three countries have undertaken various economic reforms over recent decades but these were not as comprehensive as in Cook Islands, Samoa and Vanuatu, and there has been little in the way of improvements in economic performance as a result.

Ethnically, Cook Islands and Samoa are part of what is known as the Polynesian part of the Pacific. Fiji and Vanuatu are part of the Melanesian Pacific, while FSM and Kiribati are part of Micronesia. As noted earlier, the Melanesian countries can be described as land- and labor-rich. Kiribati is comprised of a very large number of mainly atolls and reef islands, while Cook Islands is a mix of low coral atolls and volcanic hilly islands. FSM and Samoa are better off than Cook Islands and Kiribati in terms of arable land but are not as land-rich as the Melanesian countries.

As a self-governing entity in free association with New Zealand, Cook Islanders have free access to reside, work, and draw social security benefits in New Zealand. Samoa has also had relatively liberal access to New Zealand under a quota arrangement (1,100 per year, provided that they have a job that they can go to and other conditions). Because of the freedom of people movement between Australia and New Zealand, people from Cook Islands and Samoa living in New Zealand have free access to Australia. The large numbers of people from Samoa living in Australia and New Zealand, as well as in other high-income countries such as the US, have regularly sent back part of their incomes in cash and in kind, and these remittances have played an important part in the Samoan economy over a long period. Cook Islanders do not have a similar tradition with respect to remittances.

While they do not have easy migration access, remittances are also important in Kiribati because of the relatively large number of seamen working in the merchant navies of various countries. This activity is encouraged through formal training of seamen in Kiribati. Kiribati is also proposing to train nurses with the intention of them working overseas and providing remittances. As the FSM is a former UN Trust Territory of the United States, its people have the right to work in the United States; however, remittances do not play a large role in the economy. Fiji has seen large numbers of Indo-Fijians leaving permanently since the 1987 coups but there does not appear to have been a noteworthy volume of remittances generated by these emigrants—at least as shown in official figures.[5] However, in the past five years or so the remittances received by Fiji have grown rapidly as a result of the sharp growth in the overseas employment of indigenous Fijians as nurses, teachers, soldiers, security personnel and care givers. This employment is largely of a short- to medium-term nature. Finally, Vanuatu people have had very limited movement overseas and remittances play little role in the economy.

[5] World Bank (2006: Ch. 3) presents data from a household survey in Fiji that shows that ethnic Indian remittances per household are quite substantial—although not as large as recent remittances to indigenous households. This suggests that ethnic Indian remittances may be mainly brought in informally.

Chapter 2

The Politics of the Six Pacific Island Countries and the Impact on their Economic Performance

Introduction

The objective of this chapter is to describe briefly constitutional and parliamentary system development in the six selected Pacific countries since independence, and to discuss the political, institutional, and economic impacts that appear to result from the electoral outcomes. There is a focus on the adverse economic impacts of the high level of political instability in some of the six countries and on the apparent extent of corruption.

Independence in the Pacific began well after World War II and was largely driven by UN pressure, which was stimulated in turn by changes in opinions, including in the colonial powers themselves (Crocombe 2001). The first country to become independent was Samoa (then Western Samoa) in 1962. Cook Island became self-governing in association with New Zealand in 1965. Nauru followed in 1968, and Fiji and Tonga became independent in 1970 (although Tonga, a monarchy, had a high degree of independence under the British protectorate). Niue became self-governing in association with New Zealand in 1974; Solomon Islands and Tuvalu became independent in 1978; Kiribati gained independence in 1979; and Vanuatu in 1980. FSM (1990), Marshall Islands (1990) and Palau (1994) became independent in association with the United States.

Constitutions were developed and written within each country. However, they mostly followed the constitutions of their former colonial powers. Thus, countries becoming independent from Australia, Britain, and New Zealand adopted parliamentary systems similar to the Westminster system, while those countries that had been under the control of the United States (FSM, Marshall Islands, and Palau) adopted Presidential or hybrid systems. Kiribati, a former British colony, also adopted a constitution combining aspects of presidential and parliamentary systems. Changes have since been made to constitutions and electoral systems in several of the countries, with the intention of improving electoral outcomes, including reducing political instability and increasing the participation of women in government.

To a large extent the countries of the Pacific have been formed from combining many small, largely autonomous, communities. As a result, the leaders of these communities are still seen as playing a large part in providing for their communities, especially if they are elected to national office (Crocombe 2001). The strong local community demands and the lack of ideological positions with respect to political activity, and the resulting lack of ideologically-based political parties, result in a high level of “individual flexibility” with regard to political allegiance. Where they exist, political parties are therefore largely a matter of convenience for the formation of government. Politicians are not bound together by an ideology but rather by the desire to hold power and thereby gain control over public resources. Another outcome from the strength of local communities in the election of politicians is that, apart from a political elite who are able to be re-elected over unusually long periods, there is a very high turnover of politicians (50 to 60 per cent turnover at elections is common).[6]

Political instability has been a feature of most governments in the Pacific since independence and the instability seems to have been increasing in some countries in recent years. No-confidence votes against the government are popular means of removing governments and various measures have been taken by governments to avoid such votes, including having parliament not meet for several months. As a consequence, some parliaments meet for only a few days a year and deliberation of legislation suffers. Various constitutional and legislative measures have also been adopted in attempts to restrict "party hopping" and political instability, as well as foster the development of political parties. Few of these measures have met with much success.

Many researchers have attempted to explain the political instability in several of the PICs and the corruption that appears to be prevalent in many of them as resulting from the relationships developed between "big men" and the people who vote for them. Much of this literature has been written about Papua New Guinea. However, nepotism in the form of preference in the handing out of projects, contracts, and jobs in the public service is a feature of most of the Pacific (Transparency International 2004). This clientelism or "predatory rent seeking" model of politics appears to describe well what happens in the electoral process and in the formation and performance of governments following elections. The voters (clients) expect that if their candidate (patron) is elected that he/she (mostly he) will deliver benefits in some form. This model of the political system can be expected to lead to politicians concentrating on delivering individual benefits rather than widespread public goods. Often this may require the politician going outside public sector rules, which becomes corruption.[7] There is a formalized version of this bypassing of normal public sector norms in the widespread use of discretionary funds (commonly known as "slush funds") that are allocated to politicians through the budget but where the politicians make the spending decisions, bypassing normal administrative procedures (Pitts 2002: 42).

[6] Fiji is an exception in some respects in that political parties are fairly stable and there is little party hopping and not a high turnover of politicians. However, this political party stability is based on the ethnic Indian-indigenous Fijian racial divide, and so at the heart of the stability and the lack of party hopping is the desire to hold power by appealing to ethnic differences.

[7] Such clientelism politics is not restricted to the Pacific. Keefer (2004) mentions similar behavior in Africa, Asia, and Latin America. It is also not restricted to developing countries but appears to be much less common in developed countries. Keefer (2004) argues that this is because national candidates and parties are more able to make credible promises about the delivery of public good provision.

The prevalence of clientelism politics in Papua New Guinea, the resulting lack of genuine political parties, and the high degree of political instability has been attributed to the personal and group (clan) loyalties within this highly ethnically and geographically fragmented society (see, for example, May 1997, Reilly and Phillpot 2002, Reilly 2004, and Morgan 2005). However, such small-group political loyalty in a geographically and/or ethnically fragmented society is characteristic of many PICs and the PNG analysis is relevant to these other countries. An outcome of this analysis of the results of elections in these countries is to introduce forms of electoral systems that would encourage candidates to seek to win support from a wider cross section of their electorate. It is argued that this would result in the adoption of policies that deliver more widespread public benefits. It is yet to be seen whether these electoral engineering attempts will be successful.

However, the question remains as to why such clientelism politics persists in these countries? Why do voters keep on electing politicians who, in aggregate, only deliver the continuing impoverishment of the majority of the population? There appears to be little movement towards governments increasing the provision of widespread public goods. As noted by Morgan (2004), in Vanuatu predatory rent seeking is becoming worse, not diminishing, accompanied by the break up of a reasonably strong party system, a greatly increased number of independent candidates with narrow political agendas, and increased political instability.

There is developing interest in the study of the relationship between parliamentary and electoral systems, political performance, and the economic performance of the country—a field known as political economics (see, for example, Persson and Tabellini 2003). However, unlike Persson and Tabellini (2003) where differences in political behavior and economic performance are seen as stemming from the design of the electoral system or the parliamentary system, or both, the analysis of Keefer (2004) appears to offer some deeper insights into the factors underlying these relationships, including the development of clientelism politics in young democracies such as the PICs. Keefer’s model suggests that clientelism politics is more likely in societies where the transaction costs of organizing voters is high, where the ideological differences between parties is slight, and where it is difficult to provide credibility for the promises made to potential voters.

In ethnically and geographically diverse societies such as the Melanesian countries and those PICs comprised of many small island communities, the transactions cost of organizing voters is very high and therefore there is a tendency for candidates to develop very close relationships with their clan before the election with promises of specific benefits to be delivered following the election. The geographical distances between the small communities and perhaps a history of clan rivalries make the transaction costs of appealing to wider groups of voters very high. The high transaction costs could also explain the large number of candidates standing for elections, where there is a high probability of being elected with a small percentage of the vote. Indeed, in these circumstances there could be an incentive for elected politicians to maintain these high transaction costs in order to increase the probability of their re-election. This could be one explanation for the lack of enthusiasm by PIC governments to spend money on improving transport and telecommunications infrastructure and thereby improve communications within these fragmented societies.

Frequent face-to-face contact with the voters who put them into office is one means for the elected politician to provide credibility for their promises. Enforcing close contact between the elected politician and their home village is also a means for the electors to pressure their representative to supply the promised benefits. The lack of recognition of this relationship by elected officials could also explain the high degree of turn-over of politicians in some of the PICs. Once elected, politicians become attracted by the benefits of urban life and do not maintain contact with the electorate. In Solomon Islands, for example, where the turn-over of politicians is very high, politicians are known as "four-year birds" as it is claimed that they only return to their electorate at election time.[8] A conclusion that could follow from this analysis is that electoral engineering is unlikely to change behavior—in particular, to force candidates to try to appeal to a wider group of voters and provide more widespread public benefits—and that reducing the transaction costs of organizing wider groups of voters could be more important.

Another feature of politics in the PICs is that a few politicians manage to maintain office for a very long time—in contrast to the high turnover of incumbents in the remaining seats—despite in some cases facing charges or allegations of corruption. In light of Keefer's analysis it may be argued that these people are able to make credible promises about the delivery of benefits to their voter support. These long-lived politicians are sometimes seen as "big men" in the Melanesian context. More often they manage to attain cabinet-level positions in government and thus have close access to the public purse. This may assist them in giving credibility to their promises.

Keefer's analysis also provides insights into the high and widespread degree of corruption in these young democracies. It also suggests that the related insecurity of property rights, and the preference for targeted transfers (particularly through public investment, where there is the greatest scope for "grand corruption" and where the transfers can be directed very specifically), rather than expenditure on widespread public goods, will be features of countries where clientelism politics is endemic.[9] Whereas Clague *et al* (1996) had suggested that politicians who are insecure about their tenure will be less willing to protect property rights and strengthen law and order to enforce contracts, Keefer (2004) suggests that in an

[8] In the context of Keefer's (2004) model, this would be the result of an "unrepeated game". In a "repeated game", continuing face-to-face interaction with the voters would ensure the credibility of the promises.
[9] The preference for targeted transfers in clientelist states suggests that this could be a good measure of the extent of corruption and of the inefficiency of policies.

environment of clientelism support for the provision of institutions that will improve property rights security and contract enforcement is unlikely as it would only serve to undermine the payoff to rent seeking activity.

In the same vein, Robinson and Verdier (2002) and Robinson and Torvik (2002) show that clientism can explain the use of inefficient policies and Robinson and Torvik (2002) argue that clientelism helps to explain the prevalence of incomplete infrastructure projects in such countries. Elected politicians can make credible promises to their voters by confining their promises to building infrastructure located within their clan's area or to jobs for their clan. These promises cannot be matched by challengers but are highly inefficient forms of government activity. According to Robinson and Torvik (2002), infrastructure projects are left incomplete as an incentive for the voters to return the incumbent as only he will have an incentive to complete them. If the incumbent is not returned, the projects will remain incomplete as the new member will have an incentive to begin projects in his own electoral stronghold.

Cook Islands

From 1888 Cook Islands was a British protectorate and later was administered by New Zealand. In 1965 it was granted self-government "in association with" New Zealand, which gave Cook Islanders the right of unrestricted movement to New Zealand. Cook Islands has a unicameral parliamentary system. Elections are held at four-yearly intervals and the elections for the 24 seats are conducted on a plurality-majority (first past the post) basis. Initially, Cook Islands had a fair degree of political stability with a two-party political system. However, after the formation of a third party in the 1990s, political instability increased: political allegiances became much more fluid, and there have been more and more frequent changes of government. As a result the opposition has become "…too preoccupied with over-turning incumbent governments to play much role in scrutinizing legislation" (Fraenkel, 2005). The party hopping has been encouraged by the creation of Assistant Minister positions (now Under-Secretaries), and "slush funds" for politicians have grown increasingly larger (Crocombe and Jonassen 2004).

As well as the increase in political instability, it is claimed that corruption has increased substantially (Crocombe and Jonassen 2004). Crocombe (2001: 515) described how "The Cook Islands in 1995 appointed as its auditor a man who was the architect of schemes whereby the Cook Islands deprived if not defrauded other governments". The Transparency International report on the Pacific island countries noted that the main forms of corruption in the Cook Islands were: "…political appointments of poorly qualified public servants without transparent processes; conflicts of interest in awarding contracts and licenses; nepotism; excessive travel by ministers and public servants; the granting of immigration permits without transparent processes; lack of respect for the rule of law" (Transparency International 2004). The 1994-97 "Wine Box" inquiry in New

Zealand on the issuing of Cook Islands' tax certificates to New Zealand businesses led to Cook Islands being dubbed the "Crook Islands" (Transparency International 2004).

Government over-spending and the build-up of foreign debt and the public service led to a fiscal crisis in 1996 and subsequently to a Comprehensive Reform Program that resulted in the number of government departments being reduced from 52 to 22, the privatization of many government services, and the redundancy of 60 per cent of public servants. Around 15 per cent of the population migrated in 1996-97. Since then there has been fairly good economic growth and employment for all those who wish to work.

According to Transparency International (2004) and Crocombe and Jonassen (2004), nepotism remains extensive in the public service and the concentration of business and the concentration of wealthy businessmen in parliament mean that businesses wield a large degree of political power. However, these claims of continued corruption may be disputed. As part of the 1996 reforms, changes to the Audit Act strengthened significantly the powers of the Audit Office and the staff of the Audit Office was increased from four to 23. Most of the new appointments were from Australia and New Zealand. Since then, only a few cases of corruption have been uncovered and these have been prosecuted successfully. Currently, the Ombudsman is under investigation and has been suspended.

Fiji[10]

Fiji was under British colonial rule from 1874. From 1879 to 1916, over 60,000 indentured Indian laborers were brought to Fiji to farm and harvest sugar cane. After the indenture system ended, many Indians elected to remain in Fiji and took up farming as tenants on customary-owned land.

Following independence in 1970 and operating under a first-past-the-post voting system, Fiji was ruled by Fijian-dominated governments but with some Europeans and Indians included in the cabinet. In 1977, with the Indian share of the population increasing and a split in the indigenous vote, an Indian-backed party gained a slight majority of the seats. However, the Governor General asked the defeated Prime Minister to form a minority government. Ten years later, in 1987, an Indian-dominated coalition won the election and was appointed to government. The new government was short-lived, however, with the Fijian-dominated army overthrowing the government two weeks after its appointment. The GDP fell by 11 per cent in the following year, the currency was devalued, wages declined, unemployment rose, government efficiency deteriorated, and corruption grew (Crocombe 2001). Migration of skilled Indo-Fijian workers rose sharply to 5-6,000 a year, which led to considerably reduced service standards, including in the public service.

[10] This section draws mainly on Fraenkel (2005).

A new constitution was introduced in 1990 by the military-backed government, which reserved the positions of President and Prime Minister for indigenous Fijians. A communally-based voting system was introduced with 37 Fijian communal seats and 27 Indo-Fijian communal seats, ensuring indigenous governments. However, with the splitting of the Fijian vote and domestic and international pressures a new constitution was introduced in 1997. This constitution brought in an Alternative Vote system with a split-format ballot paper allowing voters to indicate support for party-endorsed preference schedules. The objective of the voting system and the constitution, which included a provision for a multi-party cabinet (with all parties gaining more than 10 per cent of seats being entitled to cabinet positions according to their share of seats), was to foster political parties not based on race. However, the 1999 general election resulted in the formation of an Indian-backed government with support from small Fijian-backed parties.

This government was overthrown one year later. The 2000 coup was led by civilians but had the backing of a special army unit that had been set up by Sitiveni Rabuka—who had led the 1987 coups and later was Prime Minister from 1990 to 1999. After the 2000 coup was put down by the military, the overthrown government was replaced by an interim government that was democratically returned to power in 2001 under the 1997 Constitution. Throughout the five-year term of this government, the constitutional provision for a multi-party cabinet was not implemented, being challenged several times in the courts by the Indo-Fijian opposition. The May 2006 general election resulted in the return of the Fijian-backed government. However, this time the Indo-Fijian opposition has agreed to take part in the multi-party cabinet.

The Alternative Voting system has not led to a reduction of the racial voting but rather appears to have reinforced it. As a consequence of the continuing Indo-Fijian emigration and the lower fertility rate of the Indian population, the Fijian population is now well in the majority and the election of 2006 gave a clear majority to the Fijian-led government. The outflow of skilled Indo-Fijian labor has continued—even reinforced by the 2000 coup.

Political uncertainty has continued throughout the period since 1987. The political uncertainty and its adverse impact on investment have been reinforced over the past decade by the impasse over the renewal of the system for the leasing of the customary-owned land for agricultural purposes. Prior to 1940, customary-owned land was leased to the Indian farmers by the customary owners themselves. However, in 1940 a system was introduced that gave control over leasing to a statutory body, the Native Land Trust Board (NLTB). A system came into being for the leasing of land for agricultural purposes for 30 years. These leases began to expire in 1997 but a renewal of a long-term leasing system could not be agreed between the main Fijian and Indian political parties (a majority of 75 per cent of Parliamentary votes is required to change the relevant legislation).

The impasse continues. Meanwhile many of the Indo-Fijian tenants have been moved off the farms and, while some of these farms are being farmed by indigenous farmers, much of the sugarcane land is lying idle. These production problems have been reinforced by the prospective loss of preferential prices for sugar exports to the EU and by the depreciation of the sugar mills and the mill transport system.

Transparency International (2001) reported that kick backs for public services, bribery of public officials (e.g., customs, income tax), nepotism, undue influence of public officials, inappropriate public procurement, abuse of public funds, and conflicts of interest were prevalent in Fiji. The loss of about F$200 million in the mid-1990s through the then Fiji National Bank, a government enterprise, had been the most notorious case of the misappropriation of public funds prior to the Transparency International report. These funds were subsequently repaid from government revenue. Since then there have been several significant occurrences of abuse of public funds such as the multi-million dollar loss through the Public Works Department, the so-called Agricultural Scam, involving the use of public funds for vote buying, and the illegal allocation of fishing licenses. The Transparency International report noted that Attorney General and Public Accounts Committee reports rarely result in prosecutions. Despite being the largest of the PICs, Fiji suffers the "small country" problem of governance checks and balances not working effectively because of the close family and personal relationships between people who are in positions responsible for supervising, auditing, and sanctioning.

Federated States of Micronesia (FSM)

FSM is an independent country in free association with the US. Prior to independence, FSM was part of the US Trust Territory of the Pacific. The four states of the Federation are spread out over 3million square miles of ocean located north and south of the equator. Therefore, travel between the states is expensive and infrequent and the operation of central institutions is also difficult and costly.

The constitution of FSM was drafted in 1975 and approved in 1979. The 1975 Micronesian Constitutional Convention was set up to draft a constitution for all the parts of the Trust Territory, however, the Northern Marianas, Palau, and Marshall Islands decided to opt out and form separate countries. As Underwood (2004) says, "the FSM is the rump state of the ill-starred effort to keep Micronesia under one banner". While designed along the lines of the US presidential system, the FSM Constitution provides for the election of the President and Vice President from among the elected members of the Congress rather than through popular vote. According to Petersen (2004), this congressional control over the President is designed to act as counter to the Executive being the main interlocutor with the US Government.

Given its widely dispersed islands, together with the cultural and linguistic differences between the four states comprising the Federation (Chuuk, Kosrae, Pohnpei, and Yap), the FSM Constitution cedes most government functions to the states rather than the federal government. Some of the States also have municipal governments, which makes for a very heavy load of government for a small country to bear (though not as heavy as Palau, which ended up with 16 states for a population of around 30,000). There are no political parties in the FSM Congress and politics is state-centered rather than formed around political parties. Because the state of Chuuk has the largest population (around one-half of the total), it has the largest delegation in Congress and thus has control of the Congress and usually elects the President.

The 14 members of the Congress, around one-half of whom are from Chuuk, have the responsibility of distributing government revenue (mainly US Compact funds and fishing license revenue), half of which must go to the four states according to the constitution. As there are no political parties there is no formal opposition in Congress to question legislation and government actions. The 14 senators largely act as state delegations.

Like most other Pacific island states, the small close-knit communities in FSM make the effective implementation of good governance checks and balances difficult. Corruption is perceived to be large scale and extensive. Crocombe (2001: 520) reported that Stephen Myerson, who established the White Collar Crime Task Force in FSM in 1995 (at US insistence) found "a cultural distaste for addressing public problems and differences directly, openly and democratically . . .and that a small band of thieves runs the FSM Congress". Transparency International (2004) noted that "misappropriation of public money by politicians on national and state level is perceived to be widespread". Corruption is believed to be most prevalent in the state of Chuuk. According to Transparency International (2004), "within the past two years, three national senators from Chuuk and a former speaker have been charged with misappropriation of funds". However, as of 2004 the charges were still pending. Moreover, in 2004 the new Congress would not approve the re-appointment of the Attorney General who had brought down the indictments against the senators. In 2003 the Congress debated a bill to provide amnesty to anyone who had stolen funds from the national government since independence.

Clearly, such evidence and perceptions of corruption must inhibit investment. Moreover, as Transparency International (2004) notes, there is a tendency for people to invest any savings offshore. As well, businesses stated that they had been squeezed out by politicians who own businesses but also control business licensing and regulations.

Kiribati

Kiribati comprises 33 small atoll islands spread out over a vast ocean area of 3.5million square kilometers, which is the largest exclusive economic zone (EEZ) of all the Pacific island countries. However, it has no exploitable mineral resources, the limited arable areas on the atolls and reef islands are of low fertility, there is a scarcity of fresh water, and there is poor waste absorption capacity.

The Kiribati Constitution adopted at independence in 1979 combines aspects of presidential and parliamentary systems, with the President and the unicameral Parliament (*Maneaba)* of 41 members holding four-year terms. The President is the head of state as well as the head of government, a combination of positions that in recent years has raised questions over conflicts of interest. Political parties exist but there is no constitutional role for an opposition. Political parties are essentially loose associations formed around particular individuals or in response to specific issues. Traditional authority is still important, although its importance is declining. Its national manifestation is the Council of Elders. In the last election, the elders of the island constituencies played an important part in the selection of the government, as the party that came second in the number of seats won was able to have the elders convince their member to change parties. However, these actions may have had more to do with clientelist politics than with the power of traditional authority.

Transparency International (2004) reported that corruption occurs at all levels of society, though most notably in government—which is not surprising given its major role in the economy. Nepotism, bribery, and vote buying were seen as the most common forms of corruption. A concern noted was the increasing intervention of China and Taiwan in the electoral process in the form of support for the major political parties.

The "small country" constraints on the implementation of effective governance mechanisms seem to be particularly important in Kiribati. Transparency International noted that there are no procedures for dealing with improper behavior in the public service and so there is little enforcement. There is also little parliamentary debate and follow up action on Attorney General and Public Accounts Committee reports. Moreover, since 1995 none of the reports from Parliamentary Committees of Enquiry have been tabled or debated in Parliament. There is no parliamentary action on the adverse reports received from auditors on the performance of the 28 government business enterprises. And while it reports on the results of elections, the Electoral Commission has never produced a report on the conduct of national elections.

Transparency International (2004) noted that the judicial system appears to have integrity. Since independence, the Chief Justice of the High Court has been an expatriate, which is a means of overcoming the "small country" problem in the courts: a mechanism that is widely used in the PICs. However, Toatu (2001) notes that there are considerable delays in the settlement of court cases in Kiribati; a matter of “justice delayed being justice denied”.

Samoa

Since independence in 1962, Samoa has had a Westminster model of parliamentary democracy combined with elements of Samoan custom and tradition. There are 49 seats in a unicameral parliament with elections at five yearly intervals. Elections are held on a first-past-the-post basis but with block voting in some electorates. Prior to the adoption of universal suffrage in 1991, only *matai* (chiefs, the titled heads of families) were able to stand for parliament and to vote. But this resulted in the rapid growth of *matai* titles. While there is universal suffrage, it remains the case that only *matai* are allowed to stand for parliament, except for two seats reserved for citizens of non-Samoan origin.

The first formal political party, the Human Rights Protection Party (HRPP), was established in 1979, and political parties have been in operation since that time. However, political parties were only formally recognized with the adoption of the 1995 Electoral Amendment Act. This legislation obliges candidates to specify their party allegiance, in order to enhance the development of political parties.

The HRPP first won office in 1985 and, apart from a brief period in 1986-87, has maintained its hold on government. It has achieved this domination in part by attracting members from other parties and from the usually large number of independents. One of the ways in which it is seen to have done this was by increasing the size of the cabinet from eight to 12 in 1991 and creating new Under-Secretary positions for government backbenchers (Fraenkel 2005). In 2005, however, the government introduced legislation to restrict ‘party hopping’. By developing its large majority, the HRPP has been able to dominate policy making, even to the point of changing the constitution without needing votes from non-party incumbents. However, the long dominance of the Party has given rise to concerns that it has fostered corruption. Its behavior, in terms of using the ‘fruits of office’ to maintain its majority, is consistent with the clientelist model of politics outlined above. There is a high frequency of appointments to high office from among the Party’s supporters as well as favoring supporters in the awarding of government contracts.

The 1994 audit report of the Controller and Chief Auditor (CCA) cited numerous examples of corruption within government departments and among politicians, including cases of fraud, collusion, conflicts of interest, and misuse of government land, equipment, and staff. About one-half of the cabinet members were said to be involved. The report was shelved and the CCA was sacked. Subsequently, the constitution was changed to restrict the term of appointment of the CCA to three years and no instructions were given for the grounds on which the Prime Minister could recommend that the occupant be sacked. Thus, the independence of the CCA has been severely compromised.

Transparency International (2004) reported that bribery of customs officials and police were the most frequently reported forms of corruption. However, Transparency International noted that there was also a high frequency of convictions. Of course, this may mean that there is a high level of undetected cases of such corruption. Transparency International (2004) was also concerned about the clientelist behavior of the government. Another concern was over vote buying, which, in the strong family-oriented and reciprocal culture of Samoa, has raised substantial debate over what is legitimate gift giving and what is illegal vote buying. As part of its recent comprehensive reforms of the public sector, the government has introduced laws, parliamentary standing orders, policies, and guidelines to curb corruption. The main issue is the extent to which these checks will be enforced.

Vanuatu

Prior to independence in 1980, Vanuatu (previously known as New Hebrides) was jointly administered by France and Britain under the Anglo-French Condominium established in 1914. The Condominium led to the creation of separate colonial structures (police, legal, and administrative), separate French and English-speaking schools, and strong social cleavages. These cleavages were reflected in strong Anglophone and Francophone political cleavages that persist to this day.

Legislative authority is vested in a Westminster-model, unicameral parliament, with 52 members elected under universal suffrage for four years from 14 multi-member constituencies. The Prime Minister is elected by the members of parliament. The President, the republic's head of state, is elected for five years by an electoral college comprised of the parliament and the presidents of Regional Councils, and local government bodies (Political Parties of the World 2005). The National Council of Chiefs (NCC), a body of traditional leaders, is recognized by the Constitution and may be consulted on any legislation, particularly with respect to matters of tradition and culture. In practice, however, the NCC is rarely consulted but there are frequent calls for the traditional chiefs to play a larger role in national government.

Two major political parties existed at independence. The strong, centralist Vanua′aku Pati (largely Anglophone) was in control at independence, opposing separatist/federalist (largely Francophone) movements. However, over time the number of political parties has increased greatly, as well as the number of independents elected. In the 1987 general election the two major parties won 45 of the 46 seats. Following the 2002 elections there were nine political parties represented in parliament as well as five independents.

The Vanua′aku Pati began to fragment in 1988 and subsequently lost office in 1991, leading to the formation of, generally unstable, coalitions in order to form government. In the period 1991-2004 there were at least 16 changes of government. The political instability has been mainly generated by competition over ministerial posts and access to public resources to satisfy the demands of constituencies. The major casualties of the political instability of the 1990s have been parliamentary oversight (resulting in the stripping of public assets by the political elite), law making, and policy formation and implementation. The political instability has also been accompanied by the politicization of the public service and the associated erosion of standards of service and ethics.

The 2004 election results reflected increased voter interest in minor parties and independents (26 independents were elected out of a House of 52) and concern for local issues, rather than interest in broad topics such as economic reform (Morgan 2004). The deterioration of public services has led to disillusion with national government and pressure on national politicians to focus on gaining benefits for their electors rather than on provision of broad welfare benefits.

The period 1996-98 saw severe political instability and financial turmoil, resulting from dubious financial deals undertaken by the Executive. The government changed five times in 1997-98. In 1998 there were riots over the losses suffered by the Vanuatu National Provident Fund (VNPF), which were identified by a report from the Ombudsman's office. The resulting capital outflows from Vanuatu led to large losses of official reserves, capital controls, and concern over devaluation. Because of the losses suffered by the VNPF, the Reserve Bank of Vanuatu was forced to refinance it. The fiscal crisis resulted in adoption of the Comprehensive Reform Program, led by the Asian Development Bank.

However, again during the term of Prime Minister Barak Sope in 1999-2001 several dubious financial schemes were initiated by the PM. In February 2000, following losses of foreign exchange—in part due to the poor foreign investments of VNPF—the Reserve Bank of Vanuatu (RBV) had to reintroduce exchange restrictions on the capital account. The RBV also had to refinance the VNPF again in 2001.

According to Transparency International (2004), corruption in Vanuatu is most closely linked with the actions of MPs, the public service, the VNPF, and the police. However, corruption does not attract much public condemnation. Politicians who have faced damning allegations in reports from the Ombudsman's office continue to be re-elected and to hold high office. This lack of public concern is attributed to differences in perceptions about what constitutes corruption in the still very traditional society; but it must also have a lot to do with the strongly clientelist style of politics that has developed.

In 1997, the first Ombudsman in Vanuatu, Marie-Noelle Ferrieux-Patterson, initiated court action against 23 serving and former MPs. She accused Prime Minister Serge Vohor and members of his cabinet of criminal conspiracy and taking bribes in return for illegal acts. In response, the cabinet petitioned the President to dismiss her; however, the Supreme Court refused the petition. As

Crocombe (2001: 515) reported: "*the government repealed the Ombudsman Act, enticing the support of the ruling coalition by increasing parliamentary allowances. A public opinion poll of 2,500 people showed that over 99 per cent disagreed with the government's action . . . A new government in 1998 supported the Ombudsman in principle but did not act on her reports, and when her contract expired in 1999 she was replaced by a man who was charged with theft from the government bank.*"

The power of the Ombudsman's office was significantly weakened by the adoption of the 1998 Ombudsman Act, which removed its right to go directly to the Supreme Court to have its recommendations for prosecutions acted upon. It now has to depend upon the willingness of the Public Prosecutors office to proceed with charges. At the time of the Transparency International (2004) report, there had been no prosecutions under the 1998 Act.

Other attempts at prosecuting corrupt officials have met with a similar fate. For instance, Crocombe (2001: 515) wrote: "*The Vanuatu government appointed a commission of inquiry into corruption. Its first report recommended that the minister of finance be sacked for fraudulent dealings, so the commissioner was sacked and the commission was closed, and the minister of finance remained! Neither the three more reports the commissioner had ready to release, nor the other nine he was writing, ever saw the light of day*."

Barak Sope, Prime Minster from December 1999 to April 2001, forged two government guarantees and was convicted and sentenced to three years. He was subsequently pardoned by the President on grounds of ill-health but was re-elected to parliament the following year and continues to hold positions in the cabinet. The frequency with which Presidential pardons are granted can be seen to substantially undermine the effectiveness of the law and justice system.

Transparency International (2004) reports that the Auditor General's office is independent but that there is little parliamentary interest in its reports. The judiciary is also seen as competent and having integrity, especially at the higher levels where there is substantial independence through the use of expatriate judges. The Public Prosecutor's office and the Police are not so well thought of, suffering considerable political interference and lacking skills and resources.

Chapter 3

The Economic Policy and Institutional Environments of the Six Pacific Island Countries

Introduction

Following independence from the colonial powers, the new national governments in these primarily clan-based PICs took on many of the productive activities outside of agriculture, as well as utilities and major infrastructure such as transport facilities. Manufacturing, largely in the form of minimal processing activities, was widely supported through protection. This approach to development, with government playing a major role in productive activities and use of trade barriers to promote import substitution, was in vogue at the time of the PICs' independence in the late-1960s and early 1970s. However, unlike in other developing countries, in the Pacific there is a reluctance to move away from this development paradigm and thus there is a lack of intellectual and political support for private markets.

The communal system, with its strong clan loyalties, does present difficulties for the establishment of a market economy because markets depend heavily upon transactions between parties that do not know each other. The close clan ties on the one hand and the long-standing distrust of other groups on the other hand mean that there is little of the kind of trust (social capital) that is needed in a market economy.

As North (1994) argued, established monopoly positions support existing belief systems and inhibit learning about different belief systems. Many of those who have become well off in the PICs have largely acquired their wealth due to government-created monopoly positions through, for example, restricting trade and investment, or from privileged positions in parastatal organizations. Therefore, in the Pacific there is a virtual absence of vested interests in open markets. As most of the relatively small private sectors have been established behind trade barriers, existing private sector interests are generally antagonistic towards opening the economy to trade and investment as this would mean increased competition for them. The frequent too-close relationships between the private sector interests and politicians in these small economies increase the difficulty of achieving micro-economic reform.

The difficulties that development assistance agencies have experienced in trying to assist PICs to liberalize their international trade and investment regimes, to privatize their state-owned enterprises, to create more favorable conditions for private investment, and to reduce the use of commodity price stabilization schemes and agricultural and development banks appear to stem largely from this antipathy towards open markets. The antipathy towards open markets also helps to explain the lack of interest in establishing secure property rights and ensuring impartial enforcement of contracts. In general, it appears that development assistance agencies have not understood the lack of interest in open markets, secure property rights, and impartial enforcement of contracts and have not given sufficient attention to how to progress economic reform in such circumstances.

Property rights to land

The way in which a country's property rights are defined determines to a large extent the resource allocation pattern and, by extension, the level and nature of economic development. For example, without an appropriate property rights environment, farmers will have little regard for future land quality. Furthermore, without proper institutional protection, farmers will be reluctant to invest in land for fear of losing the value of investments made.

In the PICs, land, particularly land outside urban areas, is mostly held under customary ownership, to which there is strong cultural attachment. When population growth rates were very low, increasing land productivity was not important—especially in the Melanesian countries with abundant fertile land relative to their populations. However, with increases in fertility rates and reductions in mortality and the resulting rapid population growth, there is a need to increase land productivity. In the absence of some form of leasehold tenure to make land available to individual investors, customary ownership is most unlikely to be the basis for rapid increases in productivity and economic growth.

Secure, long-term leasehold over land can provide the same set of incentives for investors as freehold tenure does. That is, with full transferability of the lease and therefore with the right to the benefits generated by investment of capital and time, the lessee will have the ability to borrow against the lease as collateral, and incentive to invest both capital and personal effort to an optimal level. The shorter the lease and the less secure the right to the land the lower the incentive to invest capital and effort and the further away will production be from the optimal level.

Given Pacific people's attachment to the concept of customary ownership of land, it appears that the most desirable way to create secure individual tenure is to create a system of long-term leasehold within the customary system. However, the leases must have full transferability to ensure that they can be used as collateral for commercial credit. Through the development of its leasehold system for customary land, Fiji was able to maintain a large sugar industry based on smallholder farmers and is sustaining a large and growing tourism industry. In Cook Islands a fully transferable leasehold system also allows development of private enterprise activity. This appears to be the way forward for the PICs. Unfortunately, in Fiji's case, in recent years many of the agricultural leases have not been renewed at the expiry of the leases and the renewal of the leasehold system itself has become a “political football” between the major political parties, creating huge uncertainty within the agricultural sector.

Impartial contract enforcement
The lack of interest in the PICs in establishing clear property rights and impartially enforcing contracts is evident from the International Finance Corporation’s (2006) *Doing Business* database. Estimates of the costs of registering property and resolving contract disputes in five of the six PICs are shown in Table 3. Estimates are also shown for New Zealand, one of the best performing countries in the world with respect to these performance measures. These appear to be good measures of the regulatory processes of government and of the effectiveness of the courts. As shown there, the transaction costs of registering property and settling contract disputes in the PICs are extremely high, especially the latter. In these countries it takes well over one year to settle a contract dispute—in the case of FSM, two years. The legal and court costs of settling disputes chew up between 60 and 80 per cent of the debt, except for Samoa. These high transaction costs would cause an investor to think twice about starting a business.

Table 3: Costs of Doing Business in the Pacific

	Registering Property (days)	**Settling Contract Disputes (days)**	**Settling Contract Disputes (costs as %age of value of the debt)**
Cook Islands	na	na	na
FSM	na	775	77
Fiji Islands	48	397	62
Kiribati	513	660	71
Samoa	147	455	15
Vanuatu	188	430	64
New Zealand	2	109	11

Source: International Finance Corporation, *Doing Business 2007: how to reform*, 2006.

In the Melanesian countries (Papua New Guinea, Fiji, Solomon Islands, and Vanuatu) a “culture” of compensation claims has developed, whereby if investment projects such as mines or tourist resorts on customary land are successful, the landowners claim additional benefits to those agreed in the contract. Unfortunately, in many cases the governments have not stood behind the contracts and have allowed the compensation claims to proceed. These contract disputes have increased the uncertainty of the investment climate.

Below we detail the economic activities of the six PICs and describe the situation with respect to property rights and contract enforcement. We also discuss the economic policies followed in the countries and outline the economic reform programs that have been implemented and their outcomes.

Cook Islands

The five main economic sectors in Cook Islands are tourism, agriculture (copra, papayas, fresh and canned citrus fruits, and coffee), marine resources (fish and pearls and pearl shells), offshore financial services, and local industry and services. Over recent years tourism has quickly grown to become the leading sector, with tourist numbers up from 10,000 in 1976, to 49,000 in 1998, and to 87,700 in 2005 (see Table 4). From the establishment of the black pearl industry in 1989, black pearls quickly became the country's most important merchandise export. However, after reaching a peak in exports of NZ$18.4 million in 2000, the industry suffered a sharp downturn as the result of the contamination of the pearl farming areas and competition from French Polynesia. In 2005 pearl exports were only NZ$1.6million. In 2005, fresh and chilled fish (mainly tuna) became the most important export. This locally-based industry has only been developed since 2002.

Table 4: Tourist numbers in the six PICs, 1998-2004 ('000)

	1998**	2001	2002	2003	2004	2005
Cook Islands	48.6	74.6	72.2	78.3	83.3	87.7
Fiji*	371.3	348.0	397.9	430.8	507.0	532.0
FSM* **	13.4	15.3	19.1	18.2	19.0	na
Kiribati	5.7	4.8	4.3	3.7	2.9	2.8
Samoa	77.9	88.3	89.0	92.3	98.2	101.9
Vanuatu	52.1	53.3	49.5	50.4	61.5	69.1

Source: South Pacific Tourism Organisation, *Annual Report 2005*.
*Figures for Fiji for 2004 and 2005 are Fiji Visitors Bureau estimates.
**1998 figures are International Visitor Arrivals from country statistical offices.
***All figures for FSM are International Visitor Bureau estimates.

Large external government borrowings in support of years of wasteful public expenditure and public investment in highly speculative ventures resulted in a fiscal crisis in 1995-96. In 1996, foreign debt was 141 per cent of GDP (see Annex Table). In the wake of the fiscal crisis of early 1996, a structural adjustment program was introduced in mid-1996, led by the ADB. The reform program had three main elements: public sector reform (emphasizing fiscal responsibility and improved public sector management); promotion of the private sector (reforming the leading sectors, improving the competitive environment, and improving access to land); and ensuring equity and sustainability (protecting vulnerable groups, ensuring environmentally sustainable growth, and mainstreaming gender issues).

In an effort to reduce government expenditure, downsizing of the public service was a major component of the reforms. Public service numbers fell from 3,200 prior to the reforms to 1,500 in 1997 (net outward migration in the July-

December, 1996 period was 1,612, compared with an average net inward migration of 550 annually over the 1992-95 period). Out migration slowed considerably in 1997 to around 20 per month but the movement of people, primarily to New Zealand, has continued.

Changes in the tax system were also introduced as part of the economic reforms. A lower and flatter income tax regime and lower company tax rates were adopted, together with a VAT, which replaced the turnover tax. However, proposed reductions in import tariffs have not been achieved. Cook Islands abandoned its independent monetary system and adopted the New Zealand dollar as its currency. Further, the government agreed not to borrow for seven years. A new Ministry of Finance and Economic Management was established to oversee the Budget, and the powers of the Audit Office were strengthened significantly.

Hotels, ports, the quarry, and waste management have been privatized as part of the reform program. The privatization of hotels has been a very significant factor in the development of the tourism industry (ADB 2002b). However, there is still a long way to go with respect to privatization of GBEs; rather, the focus has been on corporatisation. In the case of the telecommunications utility, a private/government joint venture monopoly was established—similar to so many other PICs. Overall, the private sector has performed very well since the implementation of the reforms. According to the ADB (2002b), in 1982 the private sector produced only one-third of total output but by 2000 it was producing nearly 60 per cent.

As a result of the prudent fiscal policies adopted, external debt has been reduced significantly. The latest figures available are for 2002 and in that year external debt was 55.6 per cent of GDP. It is likely that it has fallen substantially in the meantime as in 2002 the public debt stood at 40 per cent of GDP, while in 2005 it is shown as being 12 per cent of GDP. One of the reasons for the financial crisis of 1995-96 was the collapse of a government project to construct a major resort hotel and consequently there was a large non-performing loan to an Italian bank. The debt has recently been renegotiated and, as a result, the public debt fell significantly: from NZ$72 million in 2004 to NZ$30 million in 2005.

The economy has performed well since 1999, led by expansion of the private sector—tourism, in particular. GDP growth in real terms averaged 6.2 per cent over the 1999-2004 period. Government statistics record the per capita GDP growth rate as averaging 3.5 per cent during this period and the per capita GDP reaching NZ$12,878 in current dollar terms in 2005 (Government of Cook Islands 2006). However, the per capita GDP figure is measured in terms of what is called “total population”, which is different from the “resident population” estimate. “Total population” in 2005 is estimated at 20,200 while “resident population” is estimated at 12,400 (Government of Cook Islands 2006). If per capita GDP is measured in terms of the resident population, the figure for 2005 is NZ$20,970. There is pressure in New Zealand to reduce the financial assistance going to Cook

Islands. The use of the total population measure of per capita GDP by the Government of the Cook Islands may have something to do with this pressure.

Property rights and contract enforcement
Land in Cook Islands is owned by clans and sale of land is prohibited, except to government for public purposes and in some cases to churches. Individuals in landowning groups may claim occupancy rights but only as long as they continue to reside in Cook Islands. Over time, Cook Islands has developed a leasehold system for its customary land that allows leasing to individuals within landowning groups, to permanent residents, to Cook Islanders and their spouses jointly, and to a company, including foreign companies. All leases are subject to approval by the Leases Approval Committee (Browne 1994). Leases are fully transferable, which means that they can be used as collateral for accessing commercial credit.

Unfortunately, Cook Islands is not included in the *Doing Business* database to know how well the courts are enforcing contracts.

Fiji

Fiji is the most industrially advanced of the economies of the PICs, with substantial manufacturing and services sectors. The economy was developed on the back of a sugar industry that employed indentured labour from India during the late 1800s and early 1900s. The industry developed into a smallholder operation with mostly Indian farmers working leased customary land. The performance of the sugar industry has been declining during the past decade as a political impasse has developed over the renewal of the 30-year agricultural leases (sugar production has declined from 462,000 tons in 1996 to an estimated 290,000 tons in 2006). Productivity declined as farmers became uncertain about the renewal of the leases and were reluctant to invest. Many of the expired leases have not been renewed since 1997 and much of the cane land is not being farmed. Another factor depressing investment in the industry has been the decision announced by the EU to phase out its preferential price system for the African, Caribbean and Pacific sugar exporters.

A garment manufacturing industry was built up during the late 1980s through preferential imports into Australia and New Zealand and the adoption of tax-free factories and export-processing zones. However, preferential entry is an artificial basis for the development of economic activity and the garment industry in Fiji has declined sharply as the protection provided to garment industries in the high-income countries has been reduced through the elimination the Multi-fiber Agreement. Currently, additional assistance is being provided to the Fiji garment industry by Australia in the form of reduced Rules of Origin requirements and financial aid for adjustment and training. However, with the continuing loss of preferential entry it is unlikely that the industry will be able to survive in its present form. With its much higher unit labour costs, the industry cannot compete with the low unit labour cost industries of Asia in the production of standardtechnology garment manufacture. Finding a higher value-added product design market niche appears to be its only longer-term hope.

The rapid growth of tourism in Fiji has helped to compensate for the decline in the sugar and garment industries, although the sector suffered serious setbacks as a result of the coups in 1987 and 2000. Overseas investors have been encouraged to move into the industry through the implementation of reasonably secure 99-year leases on customary land. However, the continuing political uncertainty following the 2000 coup and the growing uncertainty over the resort hotels' access to the inshore areas for tourist activities are dark clouds hanging over the industry.

External income has been bolstered in recent years by rapid growth in the numbers of indigenous Fijians moving into overseas employment in areas such as nursing, care giving, teaching, and army and security jobs. Remittances have increased from a low level in 1999 to around F$300 million in 2005. This boost to consumption expenditure has helped to offset the decline from the downturn in the sugar and garment industries. Investment in housing and education has also benefited from these remittances (World Bank 2006).

Economic reform programs

Following independence in 1970, Fiji's first government embarked on a public sector-led growth strategy together with import tariffs providing protection for local industry. However, economic growth rates were less than impressive. A low growth rate means a low rate of growth of government revenue. Instead of reining in expenditure in line with revenues, the government borrowed to finance budget deficits. In 1986, faced with increasing levels of foreign debt, the Alliance Government made a shift in economic policies from an import-substitution strategy towards an export-oriented strategy. While the shift in policy had already begun, the contraction of the economy arising from the coups of 1987 added impetus to the move to an export-led growth strategy.

Trade liberalization, economic deregulation and investment promotion has been the focus of economic policy rhetoric since 1987. From 1989 Fiji adopted a phased program to eliminate quantitative import barriers and reduce tariffs, deregulate financial markets, remove statutory wage guidelines and promote enterprise bargaining, reform the tax regime to give a larger role to indirect taxes, reform public enterprises to promote corporatisation and privatization, and promotion of exports. But there is a question as to whether there has been substance to the rhetoric?

Fiji rapidly removed import licensing requirements and quantitative restrictions. Fiji also undertook a radical shift in its tax system, streamlining import duties and implementing a Value-Added Tax (VAT) system. These changes were designed to reduce the price-distorting effects of the tax system and to broaden the tax base.

Fiji became a member of the WTO in January 1996 and now provides Most-Favored Nation (MFN) treatment to all trading partners.

Since 1990 the focus of policy reform rhetoric has been trade liberalization but reforms have been inadequate and incomplete. In 1999, the government committed to lowering its non-protective tariffs to 10 percent but at the same time said that protective tariffs would be raised to 35 percent. Government can still exercise discretion in imposing import quotas and has placed restrictions on a number of imports that may compete with local goods. Since 1999, successive Fijian governments have rolled back trade reforms and there has been inconsistency in the setting of tariffs (Duncan *et al*, 1999). It is difficult to say whether the trade policy reform that has taken place has led to more internationally competitive industries that exploit Fiji's comparative advantage. The fact remains that Fiji's export performance has remained poor due to lack of investment and Fiji has not been able to diversify its merchandise export base to any great extent.

Fiji's fiscal deficit stood at 0.6 per cent of GDP in 1999 but increased to 5.6 per cent in 2002. Fiscal deficits of about this magnitude have been maintained since. The government said that the increased deficits resulted from the need to follow an expansionary fiscal policy to restore confidence and set the foundations for growth following the 2000 political crisis. In light of the affirmative action policies adopted favoring indigenous Fijians, a skeptical analyst might observe that the increased expenditure was aimed at support for the government's electoral base. Financing of the deficit led to a build up of debt, which stood at 37 per cent of GDP in 1999 but had increased to 47.7 per cent of GDP by 2002 and to 53.7 per cent in 2004.

While real GDP growth averaged close to 4 per cent in the 2002-04 period, it subsequently slumped to 0.5 per cent in 2005. As Table 2 shows, Fiji's per capita GDP growth has averaged only 1.6 per cent over the 1995-2004 period. Without the substantial emigration of Indo-Fijians following the 1987 coups, it would have been even lower. Although, in the absence of the political crises experienced in 1987 and since then, and the consequent loss of skilled labour and capital flight, the economic performance may well have been much better.

Public sector

Fiji's civil service had a fairly good reputation in terms of implementing government policies, which was derived from its culture of public service and objectivity during the colonial government era. This changed following the military coups of 1987 when a policy of positive discrimination was adopted—appointing and promoting indigenous Fijians in the civil service. This policy helped to create a culture of mediocrity and racial bias in the civil service, compromising the principles of efficiency, transparency and good management.

The public service wages and salaries bill remains relatively large at around 11 per cent of GDP and public sector employees make up two-thirds of national paid employment. Overhead costs of public services are high and abuse of public funds is highlighted by the Auditor General on an annual basis. The government has maintained that it wishes to reduce the public service wage and salary bill to close to 9 per cent, which is the internationally accepted benchmark. However, the government has a “no-redundancy” policy and any mention of public service cuts are criticized by the public service unions.

Most government business enterprises (GBEs) have failed to live up to the expectations of their creators. Many lose money and have to be subsidized, and those that earn a positive rate of return on their assets do so not because they are efficient and productive competitors in the market, but rather because the government shelters them from competition. The joint government/private sector monopolization of the telecommunications market, which has effectively locked Fiji out of the global integration of industrial and service activities, is a prime example (see Duncan 2004a). As majority shareholder, the government appears to be focused on the profits earned from Telecom Fiji and has lost sight of the much larger revenues it could earn from growth in the economy with much lower telecommunications costs.

Corporatisation of GBEs, rather than privatization, has been the form of economic reform adopted. Generally, this has proven ineffective, not least because the members of the boards of the GBEs are appointed for their political connections, not their technical skills. Public sector reforms have also encountered strong resistance from unions and political parties that have labour as their base. The two largest public sector unions, the Fiji Public Service Association and the Public Employees Union, have been the biggest stumbling block to reform of both the civil service and public enterprises.

Property rights

The insecurity of land tenure underlies much of the uncertainty of investing in Fiji. Land and other natural resources, including marine resources, are mostly customarily owned. Non-indigenous investors can only legitimately make use of these resources if the ethnic Fijian owners give them permission to do so. Customary land ownership and its inalienability have been entrenched in all three of Fiji's constitutions since independence.

Since 1940 the Native Land Trust Board (NLTB) has been the sole agent for the management of customary land. In the period 1966 to 1977 agricultural leases came under the Agricultural Landlord and Tenant Ordinance (ALTO) and from 1978 to 1997 they were under the Agricultural Land and Tenants Act (ALTA). Following revisions to ALTA, all leases granted after 1st September 1977 had to be for a minimum duration of 30 years. The holders of leases granted before this date (the great majority of which were for a term of ten years under ALTO) were entitled to a single extension of 20 years under ALTA. While no provisions were made for the renewal of leases in ALTA, it was generally assumed that the respective interest groups would renegotiate the land leases. However, what was thought to be a minimum of 30 years became, for many Indian farmers, a maximum tenure when their leases began to expire in 1997.

By 2005 over 80 per cent of agricultural leases had expired. Initially, the NLTB and the landowners were disinclined to renew the leases, with some landowners hoping to take up sugarcane farming. Between 1997 and 2001, only 26.6 percent of cane-based land leases were renewed to existing tenants. Around 50 per cent of the leases were taken over by members of the landowning units. Subsequently, a greater proportion of the agricultural leases have been renewed to the Indian tenants or their family members.

Any reform of the ALTA legislation requires a two-thirds majority in the parliament. However, this has not proven possible as the Fiji Labour Party opposition, which relies for the majority of its parliamentary seats on Indian farmer votes, wishes to retain the existing ALTA legislation while the Government wishes to change to a different system. Hence, the leasing of customary land for agricultural purposes remains in political limbo.

Contract enforcement

The coups of 1987 and 2000 and the continuing political instability have led to massive flight of human and financial capital, specifically Indians from both the public and private sectors. The quality of public and private services based on skilled labour has suffered as a result. The loss of human capital has been accompanied by substantial losses of financial capital, with many Indo-Fijian businesses moving to other countries.

The discrimination against Indo-Fijians in the public sector is effectively a form of government refusal to honor contracts. Another form of breakdown in contract enforcement that is having debilitating impacts on investment is the weakness of government enforcement of lease contracts over customary land. Disputes over lease contracts by indigenous landowners are becoming more common, with claims for additional “compensation” arising when business developments on the leased land are seen to be successful. By its weakness in strictly enforcing these contracts, the government is undermining the investment environment. Such government inaction appears to result from its desire to appease its indigenous voters.

In Table 3 Fiji scores better than the other PICs with respect to the number of days that it takes to register a business. However, its performance is surprisingly poor with respect to the measures of the effectiveness of contract enforcement, given the maturity of its business sector and the effort that over the past decade has gone into developing an investor-friendly set of legislation. The high costs of contract enforcement must adversely affect potential investors. The workings of the courts need to be brought into line with the government's attempts to promote domestic and foreign investment.

Federated States of Micronesia

FSM is comprised of in excess of 600 small islands. These are widely dispersed across the Pacific, giving FSM one of the largest EEZs among the PICs (see Table 1). The large number of islands, their small populations and their geographic dispersion means that provision of public services is very costly.

The total population of FSM at the 2000 Census was 107,000. Of these, 61,800 were in the 15-65 working age group, of which only 15,900 (25.7 per cent) were formally employed. Thus, much of the economy, particularly in the outlying islands, is based upon subsistence farming and fishing. The main exports are marine products, primarily tuna, garments, betel nut, kava, and copra. Annual imports are around seven times the value of exports and mainly consist of fuel and consumption goods. The tourism industry, which is quite small (12-15,000 annually), is largely oriented towards wreck diving.

About 55 per cent of the formal employees are in the public sector. Formal employment numbers hardly changed over the 1997-2004 period, including in the private sector. There are few local enterprises beyond the wholesale, retail and service sectors and these are mainly built on servicing the large public sector. Only those enterprises with monopoly power appear to prosper. Infrastructure is in a shabby state. Costs of transport are very high, in part because of the large distances between the states. The monopoly position of Continental Micronesia airlines also contributes to the high transport costs.

The economy is heavily dependent upon US Compact aid, accounting for a projected 43 per cent of total government revenue in 2005. Taxation, with income tax, sales tax and tariffs equally important, makes up about one-quarter of total revenue. Other grants (17 per cent) and fishing access fees (11 per cent) are the other major components of government revenue (FSM National Government 2006). While migration, primarily to the US, seems to be quite high (a guesstimate is around 700 per year), remittances play little role in the economy.

Under the Compact of Free Association with the US, which was implemented in 1986 (Compact I), an economic aid package of annual grant assistance was agreed for a 17-year period (1987-2003). During this period about US$2.1 billion (in 2003 dollars) of foreign aid was received, including non-US multilateral and bilateral aid. Under Compact I the funds were provided mainly as budget transfers and were subject to few restrictions. Little accountability of the expenditure of the aid funds was necessary and the level of documentation required by the US was limited to a description of the project. Compact II was agreed in 2003. Under this financial package the level of aid was significantly reduced and the conditions attached increased.

Economic reforms
Under Compact I, the level of funding was reduced at five-yearly intervals. Because economic growth in FSM has been largely driven by the US aid funds since the implementation of the Compact, these five-yearly step-downs in funding have meant economic adjustment to the changes in the funding levels. The second step-down in Compact I funds in 1997 was much sharper than the first step-down in 1992 and forced a major review of government expenditure. The FSM government received assistance from the Asian Development Bank to prepare for the reduction in funding.

In the Public Sector Reform Program (PSRP) adopted in 1997, the main form of adjustment was an early retirement program for public servants. As well, there was a merging of government departments and reductions in working hours. As a result, real GDP growth was negative for the following three years (ADB 2005).

Land tenure and contract enforcement
One of the most serious impediments to investment in FSM, particularly foreign investment, is the difficulty of obtaining secure land tenure. For this reason a project that requires a large tract of land, such as a resort hotel, appears almost impossible to implement. Land is customary-owned and cannot be sold to people who are not citizens of FSM. There are provisions for leasehold of custom land and foreigners or foreign-owned firms may lease land but this requires permission from all the clans involved. Moreover, most of the land has not been surveyed, mapped, registered or titled and therefore land boundaries are often subject to dispute.

FSM is rated very poorly in terms of its capacity to enforce contracts (see Table 3). It is estimated that on average it takes 775 days to settle a contract dispute through the courts and that creditors on average only receive 29 per cent of the debt owed. This is a poor reflection on the courts and perhaps on the government's support for seeing justice done through the courts.

Kiribati

As noted in Table 2, GDP growth has averaged 4.1 per cent over the 1995-2004 decade and, with population growing at around 2.3 per cent, this means that per capita GDP has been increasing at 1.8 per cent annually. However, Gross National Income (GNI) averages around 70 per cent more than GDP because of the remittances from overseas workers (mainly seamen and nurses), fishing license revenues, and earnings on the Revenue Equalisation Reserve Fund (RERF).[11] The growth rate of GNI was 4.9 per cent over the decade 1992-2001,

[11] The RERF was established in 1956 by the British administration of the Gilbert and Ellice Islands to accumulate savings from the taxation of phosphate sales, to provide government revenues when the phosphate deposits at Banaba Island were exhausted. By the end of 1979 when phosphate mining ceased

higher than GDP, but was more volatile than GDP because of the volatility of earnings on the RERF and fishing license fees.

Services are estimated at about 75 per cent of GDP and agriculture and fishing about 10 per cent. According to the 1995 Census, less than 20 per cent of the working-age population was in paid employment and almost 80 per cent of these were working for the government (national government 39 per cent, public enterprises 26 per cent, and island councils 12 per cent). Hence, most people have a subsistence or mixed subsistence/cash livelihood (copra, fishing and seaweed production are the main forms of cash income).

At the 1995 Census, about 40 per cent of the population was living in South Tarawa, the main island. Given the continuing rapid rate of rural-urban migration, the percentage is now likely to be greater than 50 per cent. The resulting high population density on South Tarawa (1,800/sq.km in 1995) is placing great pressure on the provision of public services and there are increasing environmental and health pressures; the fouling of the fresh water lenses, the main fresh water source, and the pollution of the inshore lagoon, a major food source, are causing significant health problems. The high fertility rate and population growth has led to a very young population, with around 41 per cent now less than 15 years of age. Thus, the demands on the education system are substantial.

Public services and essential services are very high-cost because of the widely dispersed islands and the small communities living on them (33 atolls and reef islands scattered across 5,000 km of the central-western Pacific Ocean). On these islands there is very limited capacity to manage waste, which limits their attractiveness for private investment.

The private sector is very small, mostly consisting of wholesale monopolies, retailers and transport firms. Government is the major employer, operating 28 government business enterprises (GBEs) in most economic activities. The quality of the public sector is said to have improved over the past ten years because of the increasing number of university graduates employed in the public service and rising to senior positions (Transparency International 2004). The government has made half-hearted attempts at public service and public enterprise reform. However, it has been reluctant to implement reform in either area because of concern over the loss of jobs. As the Asian Development Bank (2002) said, government employment in Kiribati is seen as a way of distributing income to extended families. In the early 1990s the government offered several GBEs for sale but while offers were made all fell through because of the conditions, largely related to employment, that the government placed on the sales. A related cultural factor was said to be the unwillingness of Kiribati people to work for an individual, as it is seen as demeaning.

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and Kiribati gained its independence, the Fund was valued at A$69 million. The value of the Fund has since increased about ten-fold.

Economic policies
Direct and indirect taxation averages only about 20 per cent of total government revenue. The major part of government revenue comprises fishing license fees and income from the RERF. With prudent management and favorable investment markets, the RERF has built up significantly over the years and draw downs from the Fund have been used to buffer fluctuations in government revenue, which is highly volatile due to fluctuations in fishing license fees (in particular) and in volumes and prices of copra exports. For example, over the 1991-2001 period, fishing access fees averaged A$23 million, but ranged from A$6.2 million in 1996 (9.9 per cent of total revenue) to A$46.6 million in 2001 (54 per cent of total government revenue). Duncan (2004b) has suggested measures that can be adopted to stabilize these revenues.

As noted previously there are 28 GBEs operating in export and import activities, housing, manufacturing, tourism, banking, transport, communications, and essential services. Many of these are subsidized directly or receive concessional loans from the Bank of Kiribati. The extent of GBE operations and the direct and indirect support from the government must have a chilling effect on private business, which has not grown in relative terms (Throsby 2001). Only the Bank of Kiribati and Telecom Services Kiribati Ltd. earn a higher rate of return than the RERF (Throsby 2001). The government also subsidizes copra production through support of copra prices, both to compensate for the very high outer island transport costs and when world copra prices decline.

Public investment is mainly financed by donor grants and concessional loans from international financial agencies. Its conservative macro-economic management and significant foreign reserves has helped Kiribati to maintain fiscal and external balance over the years. Kiribati uses the Australian dollar and sources most of its imports from Australia. Thus, inflation is linked to Australia's and has been moderate and stable.

Property rights and contract enforcement
Land sales are only allowed between I-Kiribati, and then only subject to the consent of the Land Court, which applies the following strict conditions: the land to be sold is surplus to the needs of the seller and family; the buyer has a genuine need; and there is no other suitable land on the island. However, according to Toatu (2001) there is a lack of commitment by the state to the protection of land rights. Toatu (2001) also reports that the judiciary is under-resourced and significant delays in the settlement of court cases result. This criticism is supported by the *Doing Business 2007* information that shows Kiribati taking almost two years on average to enforce a contract and 513 days to register a transfer of land (see Table 3).

Samoa

The public sector dominates economic activity in Samoa; however, while still small, the private sector has been expanding rapidly since the comprehensive economic reforms began in the mid-1990s. The main merchandise exports are fresh fish (tuna), kava, coconut products, auto harnesses, and garments, while tourism and remittances are the major earners of foreign exchange and the major contributors to GNI. In 2005, remittances accounted for about 26 per cent of GNI. About two-thirds of households still rely on a mixture of subsistence and cash income. Estimated subsistence production is about one-half of agricultural output. However, growth in formal employment has remained weak despite the good overall economic performance (see Table 1). Yazaki EDS, the firm manufacturing automotive wiring harnesses for export, is the largest private sector employer (with a high of 4,000 in 1996, but more recently around 2,000-2,500). Similar to the garment industry in Fiji, the development of Yazaki was based on the preferential market access provided by Australia and New Zealand to the PICs through the SPARTECA trade agreement. However, the winding down of tariff regimes in Australia is also reducing the value of SPARTECA to this activity in Samoa.

As is the case with all of the PICs, natural disasters take a considerable economic toll. Cyclones Ofa and Val in 1990 and 1991 devastated the agricultural sector in Samoa and severely damaged infrastructure. There was an estimated 7.7 per cent decline in GDP from 1989 to 1990 as the result of the damage inflicted by Ofa. In 1994 taro blight almost wiped out Samoa's then main agricultural crop, which allowed other PICs to move into its export markets. Another cyclone, Heta, hit Samoa in 2004.

While an estimated 70 per cent of adults have attended secondary school, the key challenge for education policy is to improve the still low levels of functional literacy and numeracy (Sialaoa 2001, 2005). However, many of those parents who can afford to do so educate their children to migrate for employment in metropolitan countries of the Pacific, including Australia, New Zealand, and the US. The resulting remittances raise the income levels of the family members remaining in Samoa.

Economic reforms

The 1996/97 "Statement of Economic Strategy" outlined the major economic reforms to be undertaken, including trade and investment liberalization, financial sector liberalization (removal of controls on credit and interest rates, and strengthening of the central bank), public service reform, and corporatisation and privatization of GBEs. As part of the economic reform program, there was a large reduction in tariffs in 1998; except for vehicles, alcohol, and tobacco, the highest tariff rate now applied is 20 per cent, as compared with 60 per cent previously. In 1994, in the lead up to the tariff reform, a value added general services tax (VAGST) of 10 per cent was adopted. The VAGST was subsequently increased to 12.5 per cent and on October 1, 2006, it was increased again to 15 per cent.

Financial sector liberalization began in 1998. Controls on credit and interest rates and on the capital account were removed, while at the same time there was a strengthening of prudential supervision. Despite the concerns expressed at the time about the interest rate spread increasing (Sialaoa 2005), in fact interest rate margins have declined. Domestic bank competition is strong with four commercial banks as well as the Development Bank of Samoa. Reforms in 2003 included the opening up of the telecommunications and postal sectors. In September 2005 the number of fixed and mobile phone customers reached 36,500, about three times the number in 2002 (Sialaoa 2005). Economic reforms have also included the divestment of agricultural marketing boards and the removal of price subsidies for major crops.

The economic reforms appear to have led to improved economic performance. Samoa had two years of six to seven per cent GDP growth in 1995 and 1996 and another two years of growth at similar levels in 2000 and 2001. The downturn in tuna harvests from mid-2002, cyclone Heta in January 2004, and the subsequent drought help explain the disappointing GDP growth of 1.5 per cent in 2002/03 and 3.5 per cent in 2003/04. Real GDP growth for 2004/05 is estimated at 6.5 per cent. The boom in the construction industry in preparation for the 2007 South Pacific Games is partly responsible for this upswing in GDP, as well as the improved harvests from tuna fishing and agriculture. Because of the improved economic performance over the past decade, GDP per capita in real terms is estimated to have increased from US$1,000 in 1995 to around US$2,000 in 2005. As a result, Samoa is scheduled to lose its status as a Least Developed Country within three years.

However, the pace of reform appears to have slowed since 2000/01. In particular, the reforms of the GBEs have lagged (Sialaoa 2003). Also, since 2000 there has been a loosening of macro-economic policies. Since 2000 the government budget has been under pressure because of the funding of losses of GBEs, overspending by government departments, and increased public sector investment, particularly in infrastructure—including construction for South Pacific Games in 2007—as well as significant increases in public service salaries in July 2005 (Sialaoa 2005).

The fiscal deficit has been increasing since 1999 (1.4 per cent in 1999 and 2000 to 2 per cent in 2004), reversing the trend of the previous three years. A deficit of about 4.5 per cent is expected for the 2005/06 financial year (Sialaoa 2005). Because of the recent heavy government expenditure, the government has said that it will issue bonds to provide the needed finance for the 2005/06 Budget, instead of financing the deficits from drawing down government deposits with the Central Bank as previously (Sialaoa 2005). Inflation averaged just under 3 per cent over the period 1995 to 2001. Since 1999, however, there has been an uptrend, largely because of rising petroleum prices and the higher domestic food prices as a result of the damage to food crops from cyclone Heta in 2004 (Sialaoa 2005).

Despite the improved investment legislation established as part of the reform program, foreign investment has apparently remained close to zero. This lack of response has been a puzzling and frustrating issue for government. However, international air services have recently become more competitive. As the result of the establishment of the Virgin Blue/Polynesian Airlines joint venture ("Polynesian Blue" started on 30 October 2005), there are now direct flights from Brisbane, Sydney and Melbourne in Australia. Polynesian Airlines is also code-sharing with Fiji's Air Pacific on the Nadi-Apia route and Air New Zealand has flights to Apia. With the improved airline services, the tourist hotel occupancy rate has soared to near capacity, and international hotel chains are showing interest in the construction of resorts in Samoa (see growth in tourism in Table 4).

Land tenure and contract enforcement
Sialaoa (2001) noted that land tenure remained insecure in Samoa. Samoa has had little success in attracting foreign and domestic investment, despite the substantial reforms, including reform of its investment laws. However, as can be seen from Table 3, the regulatory and judicial costs of doing business remain relatively high, especially in terms of the number of days taken to settle a contract dispute.

Table 3 shows that the costs of investing in Samoa are still high. Moreover, Samoa has constraints on foreign investment in the form of obligations to include local investors in any foreign investment, which must be a significant obstacle to overseas investors. However, it is possible that the government will relax this restriction to allow 100 per cent foreign ownership in the case of resort hotels.

Vanuatu

Around 80 per cent of the Vanuatu population resides in rural areas, primarily on a subsistence basis, and it is estimated that they account for 20 per cent of the GDP. The formal wage sector accounts for only 18 per cent of the total working age population (15-64 years). The public sector is the largest employer. The off-shore financial sector, established under the colonial administration in 1971, accounts for about 10 per cent of GDP. Since independence in 1980, GDP growth has only kept pace with population growth. The poor access to basic services in the rural areas has been pushing people towards the urban centers (there is 4.2 per cent population growth in urban areas as compared to 2.6 per cent growth in the rural population). However, in the absence of the poor access to residential land in urban and peri-urban areas the rural-urban drift would be even greater.

The principal merchandise exports are copra, cocoa, beef, timber, and kava. Prior to the ban on kava exports to Europe and the US, exports of kava were growing strongly.[12] With the ban still in place, the major overseas markets for kava are

[12] German pharmaceutical companies claimed that drugs made from the roots of the kava plant were causing kidney and liver damage. Subsequent chemical tests have shown that material other than roots from the kava plant has different chemical properties to those of the roots.

now Fiji and New Caledonia. Tourism is of growing importance, with tourists mainly coming from Australia and New Zealand; however, Vanuatu is a high-cost destination and until recently its only air services were supplied by the national carrier, Air Vanuatu. The recent adoption of an 'open skies' policy to allow Pacific Blue to compete against Air Vanuatu has led to increased tourist numbers (see Table 4).

Vanuatu is highly susceptible to natural disasters. It averages 2.6 cyclones per year and around 2,000 earthquakes are recorded each year. In 2002, an earthquake caused considerable damage in the capital, Port Vila. The main cocoa producing area sustained considerable damage from Cyclone Ivy in February 2004.

Economic reforms

Prudent macroeconomic policies were followed for much of the 1990s (resulting in low inflation, healthy foreign reserves, and low debt levels) but political instability and poor governance of public institutions created considerable problems for macro-economic management in the late 1990s. The fiscal deficit rose sharply to a high of 9.4 per cent of GDP in 1998 and was 7.1 percent in 2001 (however, by 2003 the deficit had been reduced to 1.8 per cent and there was a fiscal surplus of 1.2 per cent of GDP in 2004). Public debt grew from 27 per cent of GDP in 1997 to around 40 per cent in 2002. The pressure on the budget of the increasing debt level was not severe as most of the country's public debt is external and is concessional.

In July 1998 a Comprehensive Economic Reform Program (CRP) was introduced with the ADB in the lead role. The reforms included trade liberalization and reform of the financial sector and the tax system, promotion of the private sector, and provision for social equity. Tariffs were reduced on average by 22 per cent. A VAT of 12.5 per cent was introduced in place of the manufacturing turnover tax and the reduction in tariffs.

The financial sector reforms included the introduction of indirect market-based instruments for monetary management, strengthening of supervision of commercial banks and other financial organizations, and restructuring of public financial enterprises. At the time, the non-performing loans of the Development Bank of Vanuatu (DBV), the National Bank of Vanuatu (NBV), both state-owned banks, and the VNPF amounted to VT2 billion. The NBV and the VNPF were recapitalized and the DBV was closed.

Other reforms included a revised Public Service Act and the establishment of a Leadership Code. The bulk of the reforms were legislative in nature. In total, the reforms involved 22 pieces of legislation.

While the macro-economic situation has improved considerably since the CRP was introduced—with the inflation rate kept within the 2-3 per cent range, low fiscal deficits, lower interest rates, and reasonable levels of foreign reserves—there has been little noticeable supply response to the reforms and the economic growth performance has not improved. There is widespread unhappiness with the outcome of the CRP. Because of the low growth and lack of benefits arising from the CRP, there could be strong public pressure to expand government expenditure, resulting in a return of the macro-economic problems.

Land tenure and contract enforcement

The Vanuatu Chamber of Commerce reported the results of a survey of businesses in 2001 on major inhibitors of investment. The respondents claimed that policy instability, corruption, lack of confidence in the legal system's capacity to protect investment, particularly land-based investment, lack of access to credit, and the high cost of business inputs were the main constraints to investment (ADB 2002a). In the *2000 Labour Market Survey* difficulties in obtaining secure long-term leases to land, the high cost of utilities and transportation, and high taxes were reported by businesses to be major factors inhibiting investment (Government of Vanuatu 2000). These survey results are supported by the information in Table 3 on contract enforcement.

All land in Vanuatu is held in perpetuity under customary ownership or by government. At independence (in 1980) all freehold land was converted to customary ownership and a system of long-term leasehold was established. Freeholders were allowed to apply for long-term leases on the land but the leases were subject to agreement by the landowners. Foreign investors are allowed to hold leases. The leases are usually for 30 years and are transferable. However, this relatively short length of lease detracts from its value as collateral.

While he notes that the system of awarding leases has worked reasonably well, Ward (1994: 105) comments that the system "appears hazardous, even capricious, in some respects . . . The transfer of leases has been contentious in some cases, in Vila as in the rural area, with factors other than economic ones intruding". Ward (1994) points to the willingness of government leaders to use the provision of the constitution that allows them to revoke residency permits without providing the reasons to expel expatriate investors as having serious consequences for investors' confidence. Pierre (1994) also notes that the biggest obstacle to rural development is disputes over custom ownership.

Mobilizing land for productive purposes has become a topic of interest recently and public discussion of the balance between cultural and economic interests is taking place. Therefore, there is a chance that security of property rights to land will become less of an obstacle facing investors.

Chapter 4

Analysis within the HRV Framework

Introduction

The Hausmann, Rodrik and Velasco (HRV) framework focuses on finding the binding (most limiting) constraints to growth within an economy, with the objective that overcoming these constraints should receive priority in reform programs. HRV argue that there are usually many factors hindering improved economic growth but that it is necessary to remove the most constraining first for a reform program to be effective. This framework is similar to the logic of linear programming, which identifies the most binding constraint as the one with the highest shadow price. As circumstances differ from country to country, the most limiting factor in one country is not necessarily the most limiting factor in another.

The framework HRV suggest for diagnosing the most limiting constraint is in the nature of a decision tree. Recognizing that investment is the most critical factor in growth, the basis for the decision tree is to identify whether it is inadequate returns to investment, poor private appropriability of the returns to investment, or high cost of finance for investment that is the most binding factor to growth. Within each of these possibly limiting factors there are a sub-set of factors, each of which could be the main obstacle to investment and growth. The suggested decision tree takes the following form, with the factors in parenthesis the sub-set of factors that HRV say could be the most limiting:

(a) Inadequate returns to investment (geographical factors that raise the cost of investment, poor human capital, poor infrastructure and high-cost of essential services, high costs of labour market interventions, and high business risks)
(b) Poor private appropriability due to:
    - Government failure (micro-economic risks such as insecure property rights, poor contract enforcement, corruption, high taxes or inefficient tax structure, and high expected expropriation risk; macro-economic risks such as unsustainable fiscal and current account deficits, unsustainable public debt, unsustainable monetary policy, and political instability or sovereign risk)
    - Market failure (large externalities, coordination failure, too little technology adoption or "self discovery", and weak public incentives for entrepreneurship)
(c) High cost of finance due to:
    - High cost of access to domestic finance (low domestic savings, poor availability of collateral, controls over bank lending, risk of banking crisis)
    - High cost of access to international finance (high country risk, restrictions on foreign investment, regulations on the capital account).

Absent the capacity to represent all of these possible binding constraints within a quantitative framework (such as linear programming analysis), HRV illustrate the potential use of this decision tree approach in three countries by logically working their way in quantitative and qualitative terms along each of the branches of the decision tree to see which of the subset of factors may be the binding constraint in each country. This is the approach followed here for the six PICs.

We believe that it is important to extend the HRV analytical framework a little to give consideration to the possibility that binding constraints may apply to investment across the whole economy or there may be binding constraints that apply to individual industries. Take, for example, the relaxation of a government monopoly in international airline services, which we believe to have been a binding constraint on development of the tourism sector in some of the Pacific countries. Such an intervention could be a binding constraint for only a few industries. Alternatively, a monopolistic telecommunications sector or insecure land tenure could be binding constraints to investment across most of the economy.

It should be recognized that while binding constraints may be identified, it may be too costly to overcome them or too politically difficult to do so. Most of the PICs are comprised of several islands in some cases up to many hundreds of islands in others. In some cases there are numerous small, sparsely populated islands far from the main island. In these cases the binding constraint may well be the high cost of transportation and communication or other services. Reducing these costs may not be economically possible. Still, if assistance is to be provided for development, the biggest payoff will be from concentrating on these constraints.

We believe that it is also important to note that the relaxation of a binding constraint can create pressure for relaxation of the next most important constraint. For example, if provision of infrastructure is the binding constraint, relaxation of this constraint could create pressure that did not exist previously for improvements in the security of individual access to land, which may be the next priority for reform. Chand and Duncan (1997) presented this idea in terms of the imputed rental value of customary land being increased by the development of an adjacent road, or the opening of trade increasing prices of products that could be grown on the land.

The aim of our analysis is to identify the factor (or factors) that was the binding constraint to economic growth in the selected PICs over the past decade; or if there was improved economic performance in any of the six during this time, what binding constraint(s) was relaxed to explain their success. We focus on the period 1995-2004. The constraints to growth during this period may have been in place prior to 1995 or they may have developed during the period.

We examine conditions in each country in turn

Cook Islands

Cook Islands can be considered a recent economic success story since following the implementation of the reforms in 1996 the economy has done exceptionally well. Over the three-year period 1995-97, GDP in current prices declined by 19.8 per cent and in real terms by 5.8 per cent. By contrast, during the 1989-94 period real GDP had grown at an average rate of 5.5 per cent.[13] In the recent 1998-2004 period real GDP has increased on average by 6.1 per cent and per capita GDP in terms of "total population" has increased at an average rate of 3.5 per cent (Government of Cook Islands 2006). As noted in the previous chapter the "resident population" (defined as "those normally resident in the Cook Islands") is less than the total population figure. In 1998 the estimated resident population was 500 less than total population. By 2004 the gap had widened to 6,800. In resident population terms, therefore, between 1999 and 2004 real per capita GDP increased 59 per cent—an average annual increase of 9.8 per cent.

Therefore, what needs to be explained is the reason for the downturn in the economy over the 1995-97 period.

The loss of population and labour certainly poses problems for Cook Islands' future. However, according to our fieldwork, much of this out-migration is movement of less skilled labour from the outer islands to New Zealand to take advantage of unemployment and other social security benefits in New Zealand. Labour from other Pacific countries such as Fiji and from the Philippines is being brought in to replace the loss of skilled and less-skilled workers. This pattern of migration from outer islands is consistent with the difficulty experienced throughout the Pacific of generating economic growth in the sparsely populated, outlying islands or regions. Most of the economic growth in Cook Islands is taking place on the main island, on which the rapidly growing tourism industry is well serviced by international airlines. (The good growth that has taken place in tourist numbers since 1998 can be seen in Table 4).[14] But despite the regional disparity in the country's economic performance in the period since the reforms, it should be regarded as a significant success. Therefore, our objective was to see what changes took place that led to this success.

Scarcity of savings

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[13] Crocombe (1995: 19) notes that in the 1980s Cook Islands had the fastest economic growth of all the Pacific island countries.

[14] We argue that rapid growth in tourist numbers in Cook Islands, Samoa and Vanuatu followed the opening up of international airline services to these countries. It may be argued that the growth in tourist numbers was related to factors other than the relaxation of this constraint, such as the Bali bombings and the SARS scare. While our hypothesis should be tested more thoroughly, we base our conclusion on two points: first, the fact that the two countries that do not have open international airline competition—FSM and Kiribati—have experienced no growth in tourist numbers; and second, that tourism growth in Cook Islands, Samoa, and Vanuatu took place following the relaxation of the monopoly, which occurred at different times in the three countries.

Here we look at the availability of savings, both domestic and foreign. As can be seen from the Annex Table, deposit interest rates declined sharply from very high levels following the adoption of economic reforms (from 6.7 per cent in 1995 to 2 per cent in 2004). Lending rates were also at very high levels before the reforms, standing at 15.2 per cent in 1995. Hence, domestic savings appear to have been scarce before the reforms. While large numbers of Cook Islanders have migrated, they remit little of their earnings back home. Therefore, remittances have not been a source of local savings.

External debt (mostly public debt) grew to very high levels before the crisis—reaching a peak of 141 per cent of GDP in 1996. In large part it was resistance to the rapid growth of borrowing from overseas that led to the financial crisis and the adoption of the reform program. Therefore, it appears that domestic and overseas savings were a constraint on investment prior to the economic reforms. While both external debt and public debt have been sharply reduced—external debt had fallen to 56 percent in 2002 and public debt had declined to 12 per cent of GDP by 2005—the availability of domestic savings still appears to be somewhat of a problem as the commercial banks (ANZ and Westpac) are bringing in funds to lend locally and their 'loan books' are several times larger than their deposits. However, the willingness of the banks to bring in funds to finance investment in Cook Islands confirms that investment is no longer savings constrained. The availability of collateral also does not appear to be a constraint, given the robustness of borrowing.

Expected returns on investment

As noted above, economic performance is poorer in the outer islands, reflecting the high cost of providing infrastructure and services to these areas. On the other hand, the enhanced provision of international airlines services in recent years has enabled the rapid growth of the tourism sector (see Table 4). Hence, geography is not a limiting factor providing that that there are good investment opportunities available.

Human capital was also not a factor limiting profitable investments prior to the reforms as Cook Islanders have been able to take advantage of the New Zealand education system and to migrate to New Zealand and elsewhere if suitable job opportunities were not available. Moreover, labour market interventions have not presented obstacles to development. According to the *Doing Business in 2006* database (World Bank and IFC 2006), labour market legislation and regulations present few difficulties to hiring and firing workers. Crocombe's (2000) point that the relationships between business people and politicians are too close is consistent with this finding as such relationships should lead to a business-friendly environment.

Appropriability of returns to investment

Risks to the appropriability of returns to investment from government failures at the macro and micro level appear to have changed significantly since the 1996 reforms. The kind of government behavior that led to the sharp growth in public expenditure and public debt and the risky economic ventures of the government that triggered the economic reforms have not resurfaced. As noted in the previous chapter, political instability remains a problem and it has been argued that the clientelist behavior has not disappeared (see Crocombe and Jonassen 2004). However, lessons about the importance of macro-economic stability appear to have been learned.

Micro-economic risks in the form of insecurity of property rights and impartial contract enforcement also appear not to be a hindrance to invest, as Cook Islands has a long-term leasehold system for its custom land that appears to operate well, judging by the willingness of commercial banks to lend. While there remains talk about widespread political corruption (Crocombe and Jonassen 2004), this does not appear to be supported by the fact that the Audit Office was considerably strengthened as part of the reforms and, despite the considerable independence the Audit Office has enjoyed, very few cases of corruption have been brought and all have been successfully prosecuted.

Entrepreneurship appears to be alive and well in Cook Islands as evidenced by the local activities in the form of tourism developments. While the black pearl industry has been badly damaged by pollution, its rapid development was also evidence of a willingness to innovate and take risks.

In summary, therefore, it appears that the binding constraint to investment and economic growth in Cook Islands in the years leading up to the fiscal crisis was the constraint on savings—both domestic and international—largely as a result of poor governance. Once the economic reforms took hold, governance improved, and overseas savings became available, the limiting constraint on investment in the tourism sector became the availability of international air services. This constraint has been lifted with the opening up of this market and the entry of Pacific Blue.

Fiji Islands

Real GDP per capita in Fiji grew on average by 1.6 per cent over the 1995-2004 period (Table 2). The GDP growth rate of 2.6 per cent in this period—during which Fiji experienced the 1997 drought and the 2000 coup—was only slightly lower than the 2.9 per cent average growth in the 1990-94 period. As various commentators have noted, the Fijian economy has been unable to grow faster than 2-3 per cent over the past two decades or so (e.g. Rao 2004). As a result, average per capita incomes have grown very slowly. Further, income inequality appears to be growing, as the proportion of the population living in poverty appears to be increasing—this is reflected most starkly in the estimated 13 per cent of the population living in squatter settlements.

Fiji is the only PIC with reasonably comprehensive information on investment. These data show the total investment/GDP ratio declining from 25-30 per cent in the late 1970s to around 10 per cent in the late 1990s, and improving subsequently to near 18 per cent currently. In recent years only an estimated one-quarter of total investment has been private. Around one-half has been made by GBEs and the other one-quarter has been public investment. The primary objective of the analysis is to explain this poor private investment performance.

Scarcity of savings
According to bank deposit interest rates, the banks have not been experiencing a scarcity of domestic savings. Deposit interest rates have declined steadily from 3.2 per cent in 1995 to the very low level of 0.4 per cent in 2004. While the government has been running large fiscal deficits since the 2000 coup, they have been primarily financed by borrowing from the Fiji National Provident Fund—another form of private savings. Around 70 per cent of the FNPF is now invested in government bonds. As a result, the government has been able to reduce the foreign debt/GDP ratio from an average of 22.4 per cent in 1990-94 to 7.7 per cent in 2004. This is a very low level of foreign debt and it appears that Fiji would not have any problems in borrowing from overseas. In fact, in September 2006 the Fiji government made a bond issue for the first time in many years (for about FJ$300 million)—presumably to finance the 2006 fiscal deficit—and it was oversubscribed ten-fold. It can be concluded, therefore, that scarcity of savings is not a factor constraining economic growth in Fiji and hence low expected returns on investments or poor appropriability of investment returns are constraining investment.

Expected returns on investment
As is the case for all PICs, because of its small domestic market, international markets have to be the major focus for investment in Fiji. However, its isolation from major markets makes the costs of international trade very high. But successful ventures are possible, as evidenced by the growth of tourism. Fiji Water, a bottled water enterprise, has been quite successful in exporting to the US and Europe, and there are several successful cosmetics exporters.

The availability of skilled labour has clearly become a problem since the 1987 coups, with many skilled Indo-Fijian professionals and tradesmen migrating permanently since that time. The 2000 coup only served to sustain the migration flow. Because of the lack of investment and employment, many indigenous workers have been seeking overseas employment in recent years. These workers are mostly nurses, teachers, and army and security personnel. The loss of these skills has lowered the returns on investment; however, their loss cannot be seen as the primary factor constraining investment as, with a more favorable investment environment and the offer of jobs, there would be less incentive to leave.

Poor infrastructure and high costs of essential services lower the returns to investment in many areas. The approximately 400 km road that circles the main island, Viti Levu, has no doubt been a high return investment because of its contribution in opening up business opportunities. However, road transport to the interior of the island is limited and generally of poor quality. The many small, scattered islands of Fiji and their low population densities make inter-island shipping high-cost and thereby constrain most economic activities in these areas.

The infrastructure supporting the tourist industry is one bright spot. The international airport at Nadi and the domestic airports throughout the country serve the tourist industry well. These, together with the well-run local international air carrier, Air Pacific, and airlines from Australia, Korea, and New Zealand, provide a solid base for tourism and rapidly growing resort hotel development. These infrastructure and services could be the basis for profitable activities of other forms. But other activities may well need similar kinds of infrastructure and services to be developed.

Essential services such as power and water are provided by GBEs and are reasonably reliable but are high-cost, as elsewhere in the Pacific. The joint government/private sector monopoly of telecommunications has been an important constraint on development of economic activities because of the extremely high cost of internet, mobile phone, and fixed-line telephone services. Telecommunications charges have recently been reduced following considerable pressure from the private sector and households; however, even the present prices are still many times higher than in high-income countries. Legislation now before parliament to open up the telecommunications sector is likely to be very beneficial. Unfortunately, the monopolistic pricing of telecommunications has inhibited entrepreneurship in Fiji from taking advantage of the significant reduction in such costs enjoyed by other countries; for example, it has prevented investors in Fiji from taking advantage of the country's time zone relative to Australia and the English language abilities of its younger population, especially Indo-Fijians.

Regulatory costs for investors are substantial in Fiji. As the *Doing Business* information in Table 3 shows, the costs of enforcing a contract, i.e. recovering a debt, takes over one year on average and creditors have to pay 62 per cent of the debt in court costs and legal fees. These data reflect poorly on the law and justice system.

"Core" business risks have increased with the deterioration of law and order following the 1987 coups. The need for increased private expenditure on security of person and property has increased business costs. Duncan and Sharma (2005) showed that private expenditure on security by well-off households was up to twice what they paid in tax for public security protection. Doubtless, business costs for security have also increased significantly.

Appropriability of investment returns

Macro-economic risks to the appropriability of investment do not appear to have been a constraint on investment over the past decade, although recent developments in this area are not encouraging. The continuing use of fiscal deficits to maintain government services has resulted in steadily increasing public debt. The public debt/GDP ratio has grown to an unhealthy level of 50 per cent, resulting in debt servicing charges of 27 per cent in the 2005 Budget. Although taxation compliance has improved, the slow growth of the economy has meant that government revenues have been growing slowly, while the growth in debt servicing charges has reduced the government's capacity to provide public services. Reflecting the fiscal deficit financing, the current account deficit has also been increasing. These adverse movements in the public debt and the current account have recently raised community concerns about a devaluation of the currency. Such concerns could raise the likelihood of devaluation.

Of greater concern to investors over the past decade has been sovereign risk in the form of political instability. The 1987 coups led to substantial out-migration of Indo-Fijians. Doubtless, there was substantial flight of financial capital as well as the loss of human capital. The 2000 coup, involving the forced removal of the second Indo-Fijian government after only one year in office, only reinforced these trends. Accompanying the political instability has been the inability of the two major political parties (formed along indigenous Fijian and Indo-Fijian lines) to resolve the impasse over the system for the leasing of customary-owned land for agricultural purposes. The non-renewal of expired 30-year leases to a very significant number of Indo-Fijian sugarcane farmers since 1997 has resulted in a substantial decline in sugar production. This lack of security of tenure must have also severely inhibited the development of other agricultural activities and is in marked contrast to the security of tenure available to the foreign investors in the tourism industry.

As noted earlier, there is not an absence of entrepreneurship in Fiji, unlike in some of the other PICs studied such as Kiribati and FSM. However, there are substantial forces operating against its development. These include the discrimination against Indo-Fijian farmers. As well, the tendency for the formation of monopolistic GBEs must inhibit the development of entrepreneurship through crowding-out of private sector engagement as well as through attracting talented people into these monopolistic activities. The all-too-often need for government subsidies of loss-making GBEs also crowds out the government's capacity for funding needed infrastructure.

In summary, therefore, the binding constraints to investment in Fiji appear to lie in the area of appropriability of the returns to investment. The main problem appears to be the continuing political instability, which has been associated with an impasse over the renewal of the agricultural leasehold system and discrimination against Indo-Fijians. By contrast, the tourism sector has grown rapidly—except for temporary setbacks due to the coups—based upon reasonably secure, long-term property rights to land, competitive international and domestic air services, and good airport infrastructure. Investment growth in other areas of the economy appears to need similar treatment.

The continuing political instability in Fiji is not a binding constraint in the tourism industry, as the industry has flourished, except for short periods—admittedly resulting from political instability. However, as far as the tourism industry is concerned, the land leases provided for tourist resorts are under different legislation to that for agricultural leases. The renewal of the agricultural leases has become a political football between the two major parties and it is for this reason that political instability is the underlying problem for development of the agricultural sector, which should be a "growth engine" for the economy (Duncan 2006).

Federated States of Micronesia

GDP in constant dollar terms declined by 0.5 per cent annually over the ten-year period 1995 to 2004, which means that, with average annual population growth over this period of around 0.1 per cent, real per capita GDP has declined by 0.6 per cent annually (Table 2). Government activity dominates the economy, but this domination is not well reflected in the employment figures. In 2004, national and state government and public enterprise employment totaled around 12,000, while there were around 7,000 employed in the private sector (FSM National Government 2006). While the private sector shares of GDP and employment have grown (the private sector share of GDP has increased from 34 per cent in 1987 to 41 per cent in 2003, and the private sector share of employment has grown from 29 per cent in 1987 to 42 per cent in 2003), this growth has been driven in large part by the inflow of US Compact funds and its expenditure by the government. Thus, private sector activity is almost exclusively in the non-traded goods and services sectors, i.e. the retail and wholesale and services sectors, and not in the main productive sectors—agriculture, fisheries, and tourism (ADB 2005).

In 2004 state government employment accounted for 58 per cent of total government and GBE employment. National and state government expenditure consistently exceeded the total of tax and other revenues and grants over the 1997-2005 period. This was despite the fact that grants, mainly US Compact monies, were consistently in excess of tax and other revenues by upwards of 100 per cent.

Scarcity of savings
Scarcity of domestic and foreign savings does not appear to have inhibited investment in the past decade or so. Interest rates on deposits have been reduced significantly in that time (from 5.3 per cent in 1995 to 1.0 per cent in 2004). Also, while foreign debt was at the high level of 61 per cent of GDP in 1995, it had been reduced to 25 per cent by 2003 (see Annex Table). Commercial bank loans average only about one-quarter to one-third of deposits held by the banks.

Lending rates have been held at very high levels—15 per cent in 1995 and 15.4 per cent in 2004, resulting in the interest rate spread increasing from 9.7 per cent to 14.4 per cent—but these high rates are very likely a reflection of the high sovereign risks facing investors (discussed below) rather than a mechanism to limit borrowing because of a shortage of savings.

The current account balance has deteriorated significantly over the past decade. In 1995 there was a current account surplus of 6.7 per cent of GDP. However, by 2004 the current account was in deficit to the tune of 17.8 per cent of GDP and 13.2 per cent in 2005. These movements reflect the excessive government expenditure during this period, which led to a fiscal deficit of 9.8 per cent in 2004. While these trends may in other circumstances signal difficulties for investors in accessing foreign savings, it is probably more a reflection of an aid-dependent economy 'gaming' its chances of receiving aid through excessive expenditure.

Expected returns on investment

Scarcity of human capital is not restricting investment in FSM. People from FSM have free access to the US and could receive high-level training there and return home if well-paid jobs were available. Clearly, this is not the case. Migrants tend to remain in the US. The geography of the country no doubt means high business costs. Also, as noted in Chapter 3, infrastructure is in a shabby state. The reportedly high level of corruption described in Chapter 2 could well be a factor in this state of affairs, as corruption reduces the impact of government expenditure on infrastructure: generally, bidding on infrastructure contracts is the area in which 'grand corruption' mostly takes place around the world. Costs of transport are very high, in part because of the large distances between the states. However, the monopoly position of Continental Micronesia airlines only adds to the costs of travel and must be an impediment to the development of the tourism sector. FSM could take lessons from the contribution that freeing up international air travel has made to tourism and economic growth in Cook Islands and Samoa. However, as argued below, this may not be the binding constraint with respect to the development of the tourism industry.

The ADB (2005) identified 25 government enterprises and 25 or more other government "commercial" activities in FSM. The latter are mostly corporatised GBEs and enterprises whose shares are mostly held by national or state governments. Hence, state dominance of the productive sectors of the economy is pervasive. The ADB (2005) report notes that all of the "economic summits" that have accompanied economic reform attempts since 1999 have strongly endorsed reduction of government involvement in commercial activity. However, as of 2005, no privatization of GBEs had taken place and the "planned public sector enterprise transformations in the four States had been adjusted to one in each state rather than the two originally planned" (ADB 2005: 76).

The existence of these GBEs should not pose a threat to entrepreneurial activity through competitive pressures as they are no doubt very pedestrian and inefficient in their approach to business activities. However, the very extensive range of GBEs must inhibit private enterprise in several other ways; for example, through raising business costs due to their monopoly power over the supply of goods and services needed as inputs, through the government having to subsidize their operations and thereby squeezing out expenditure on public infrastructure, and through competition for savings. Thus, such an extensive range of protected GBEs with low or zero productivity can perpetuate a “low growth trap”.

Appropriability of investment returns
The pervasiveness of GBEs and the large flow of US aid appear to have created a dependency culture so that people are unwilling to consider the privatization of GBEs and to establish private sector activity that is not supported by government expenditure. This could be considered as a market failure that lowers the return on investment or that reduces the incentives for private entrepreneurship.

ADB (2005: 82-3) notes that there are great difficulties in gaining secure access to land to establish a business: both for foreign investors as well as for domestic investors wishing to start businesses in states other than their home state. As a result, access to capital from commercial lenders is restricted. Adding to these difficulties in establishing a business are the government failures that make appropriation of investment returns costly. As shown in Table 3, it is estimated that, among the PICs shown there, FSM averages the highest number of days taken to settle a contract dispute—775. This government failure is also reflected in the estimate that the creditor receives only 23 per cent of the debt after settlement. Therefore, it is unlikely that potential investors will wish to subject themselves to such costly court enforcement procedures, or they will find other ways to settle disputes.

In summary, unlike in Cook Islands and Samoa, liberalizing airline travel to FSM cannot be the catalyst for improved performance in tourism as the difficulties of gaining secure, long-term access to land constrain the construction of resort hotels by both local and overseas investors. Having appropriate infrastructure is also a key part of the recipe for the tourism industry, in particular, and for other private enterprise activities more generally. The major airstrips in the four FSM states are too short for even medium-sized jets and their extension and improvement of airport facilities would also be essential for tourism development. However, this constraint is also dominated by the difficulties of obtaining secure land tenure for hotel and other business development.

The pervasiveness of GBEs and the aid dependency that has allowed the reliance on GBEs to be maintained also appears to reduce the demand for security of access to land. The apparent complementarity of these two issues leads to the conclusion that if FSM is to establish the necessary conditions for improved economic performance it would be desirable to place more emphasis on educating the public about the high costs of reliance on GBEs and the benefits to be gained from mobilizing access to land. Opening up the areas in which the GBEs are operating to competition would also reduce the opportunities for corruption and make more government revenue available for infrastructure.

However, dominating all these constraints to investment appears to be the patron-client politics practiced in FSM, described in Chapter 2. The lack of interest of politicians in privatizing GBEs, in providing security of property rights for investors, and in enforcement of contracts appears consistent with Keefer's (2004) argument that politicians operating in such an environment will have little interest in these issues because doing so will undermine their ability to rewards their constituents. The primary issue, therefore, is how to move from this situation to one where politicians have more interest in the provision of public goods for the whole community.

Kiribati

In some years, the GNI of Kiribati is almost double its GDP because of the external revenues generated from income earned on the RERF, EEZ access fees, remittances earned by overseas workers, mainly seamen, and sales of passports. The volatility of these external revenues, particularly fishing license fees and income earned on the trust fund, is the major determinant of changes in economic performance. Foreign aid is also very important. Over the three years 2000-02, official grants and loans from abroad amounted to A$105 million—accounting for 30 per cent of annual budget expenditure and equivalent to around one-third of GDP (Republic of Kiribati, *no date*).

The economy is dominated by the government. Two-thirds of the 10 per cent of the population who work in the cash economy are employed in the public sector. GBEs have been set up in most sectors of the economy, including tourist hotels, copra and fish processing, a fish farm and a poultry farm, and the local airline. The GBEs have been mostly loss-making and the large subsidies necessary make expenditure on keeping them financial an important driver of GDP growth. This continued subsidization is possible because of the availability of the fishing access fee and trust fund revenues. However, privatization of GBEs continues to be strongly resisted.

Scarcity of savings

The relatively large size of the RERF—valued at A$632 million in 2005, equivalent to around six times the size of the GDP—and with a foreign debt to GDP ratio in 2002 of 7.5 per cent, savings availability for the public sector has not posed any problems. As far as private savings are concerned, deposit interest rates have been declining (from 2.5 per cent in 1995 to 1.5 per cent in 2004), indicating no constraint on investment from that quarter.

Expected returns to investment and their appropriability

Human capital appears to be a constraint with an enrollment rate in Form 6/Grade 12 of only 16.1 per cent in the period 1999-2002 (see the Annex Table).

However, few of those trained to higher levels are able to find paid employment. There are around 2,000 school leavers each year but only around 500 jobs are available (Republic of Kiribati, *no date*). Hence, training is demand-constrained rather than supply-constrained. Training is available for those wishing to work on overseas merchant and fishing vessels (including a seven-month training program run by Japanese fishing companies for seamen to work on fishing vessels). A nurse-training centre is also being set up to train nurses for overseas employment.

Low returns on private investment and poor appropriability of investment returns appear to be constraints on economic growth and to arise from several sources. As noted above with respect to FSM, the dominance of GBEs across the economy inhibits private enterprise through raising business costs due to their monopoly over the supply of goods and services needed as inputs and through the government having to subsidize their operations and thereby squeezing out expenditure on public infrastructure. Even more importantly, the pervasiveness of GBEs appears to have created a dependency culture so that people are unwilling to consider the privatization of GBEs or to consider employment in a competitive market environment.

Similar to other PICs, Kiribati labors under the difficulties posed by its small and widely scattered population. However, similar to other PICs, it has a relatively large concentration of population on South Tarawa and Kiritimati and it should be possible for viable private sector activities to develop on these islands.

As can be seen from Table 3, the appropriability of private investment returns is very poor. According to these estimates, it takes on average 513 days to register a business, 660 days to settle a contract dispute, and creditors can expect to recover only 29 per cent of the debt upon settlement. These estimates reflect very poorly upon the legal system. But more generally they are consistent with the antipathetic attitude towards private enterprise.

Which of these constraints—low returns or poor appropriability—is the binding constraint? Our judgment is that, similar to FSM, the clientelist political situation underlies bother of these factors. Until political behavior is changed there is little chance of movement away from the dependency upon government that has developed over the years or towards improved access to secure land rights and credit.

Samoa

As noted in Chapter 3, Samoa's economic performance has improved since the adoption of economic reforms beginning in 1996/97. This improved economic performance has followed trade, investment, and financial liberalization, privatization of GBEs, public service reform, and taxation reform. The economic reform program appears to have had good government support throughout, and strong local involvement in both design and implementation of the reform components.

The deteriorating economic situation leading up to the mid-1990s economic reform program can be seen in the 1990-94 average figures in Annex Table. During this period the fiscal deficit averaged 12.4 per cent of GDP, the current account deficit averaged 13 per cent of GDP, and foreign debt averaged 96 per cent of GDP (of which 86 per cent was public debt). These figures show the difficulties that the government had got itself into through excessive expenditure, particularly through its subsidization of loss-making GBEs. It had to resort to heavy foreign borrowings (in 1993 foreign debt reached a peak of 163 per cent of GDP). As a result there was substantial external pressure for reform; although there was not the threat of a fiscal crisis in the form of devaluation, as international reserves averaged a healthy 7.8 months of imports over the period 1990-94.

Scarcity of domestic savings

Does this mean that in the period leading up to the reforms the government had restricted domestic investment by soaking up domestic savings and this was restricting private investment? The performance of domestic interest rates since the reforms suggests that this was not the case. In the period 1990-94, lending rates averaged 13 per cent and deposit interest rates averaged 6.8 per cent. Interest rates were liberalized as part of the reform program. However, over the period 1995-2004 there has not been significant changes in these rates, against a background of generally positive fiscal and current account balances and a very substantial reduction in public sector borrowing.

Remittances have continued at increasingly higher levels. Lending rates declined to 9.8 per cent in 2004 while deposit rates have settled at 5.1 per cent. As a result the interest rate spread has declined from 6.2 per cent to 4.7 per cent. While Samoa has by far the highest deposit interest rate among the sample of PICs (see the Annex Table), its rate is much on a par with rates in Australia and New Zealand—which would seem to be desirable to prevent the outflow of savings to these neighboring countries, providing there are investment opportunities within the country. Thus it would appear that private investment in Samoa has not been constrained by a scarcity of savings.

Expected returns on investment

Education does not appear to have been a constraint on growth. Indeed, there appears to have been considerable investment in education over a long period for the purpose of family members moving overseas for work because of the limited opportunities for highly paid domestic employment. This is made possible in large part by the fairly generous quota on migration to New Zealand.

As far as the impact of other factors on investment returns is concerned, Samoa's geographical situation is similar to other PICs, although it better placed with respect to agricultural pursuits than the countries comprising atoll and reef islands such as FSM and Kiribati. With respect to infrastructure, the completion of the road sealing on Upolu, the main island, means that it has become a much more integrated economic entity, with people from surrounding areas moving to markets and employment in Apia. The improved infrastructure has also led to the development of tourist facilities (Sialaoa 2003). Economic growth is now centered on the main island and on the capital Apia and the area surrounding Apia. Approximately 40 per cent of the population lives in and around Apia, and 70 per cent of the country's GDP is generated in this area.

Appropriability of investment returns
As noted in Chapter 3, investment interest in Samoa has been disappointing, particularly foreign investment in tourism. There are regulatory as well as other difficulties facing investors, such as the time that it takes to settle a contract dispute through the courts (see Table 3) and the requirement to include local partners, as well as the difficulty of obtaining secure long-term rights to land. However, the opening up of international airline services in 2005 appears to be assisting the development of the tourist sector (see Table 4). Given the relaxation of this constraint, investors now appear much more interested in Samoa as an investment location. The opening of the telecommunications sector in 2003 also appears likely to be an important catalyst for development (Samoa now has four Internet Service Providers). As data in the Annex Table shows, there was rapid growth in internet use between 2000 and 2003. It is likely that growth in internet use has been even faster since 2003, given casual observance of the use of mobile phones and internet cafes.

In summary, it appears likely that while macro-economic instability was a problem prior to the mid-1990s' reforms, it was probably not the binding constraint. Government business monopolies appear to have been the binding constraint to private investment, in particular the government airline. Infrastructure development on the main island likely complemented the opening up of international air services to competition in fostering investor interest in the tourist sector. In some cases the existence of monopoly GBEs may not be a binding constraint, as entrepreneurs may still be able to develop profitable ventures in other areas that do not rely heavily on the services provided. However, in the case of tourism, an airline monopoly in the Pacific can dominate all other possible constraints, as there is no possibility that competitive substitutes can be found. The same can be true of telecommunications monopolies with respect to many economic activities as government can effectively prevent the operation of telecommunication competitors.

Vanuatu

As described earlier, over the period 1991-97 Vanuatu experienced a series of financial difficulties—mostly arising from political malpractice—leading to the Comprehensive Reform Program (CRP) adopted in 1997-98. While the macro-economic situation has improved considerably since the CRP was introduced—with the inflation rate kept within the 2-3 per cent range, low fiscal deficits, lower interest rates, and reasonable levels of foreign reserves—the economic growth performance has not improved. To what extent was the decline in average per capita GDP from 3.7 per cent in the period 1990-94 to negative growth of 1.2 per cent in the 1995-99 period and minus 2 per cent growth in the 2000-04 period due to the government mismanagement affecting investment through reducing the availability of savings, or raising concerns about political instability, or apprehensiveness about devaluation? Why have the reforms in Cook Islands and Samoa been followed by better economic performance but not in Vanuatu? Or is Vanuatu now on the road to better growth?

Scarcity of savings

Scarcity of savings does not appear to have been a constraint to private investment. Deposit interest rates have fallen sharply from their average of 5.7 per cent in 1990-94 to less than 2 per cent since 1999. This decline is consistent with the fact that there is excess liquidity in the banking system, with commercial banks holding large non-interest bearing deposits with the RBV. The excess liquidity in the banking system is also consistent with the views expressed by the business sector that lack of confidence in the legal system's capacity to protect investment, particularly in land-based investment, and lack of access to credit are major constraints to investment (ADB 2002a). The business sector's lack of confidence in the judiciary enforcing contracts is also consistent with the information on contract enforcement in Vanuatu in Table 3. That is, investment is not constrained by a scarcity of savings but more likely by the high risks to investment from government failure to protect them.

Expected returns on investment

As regards the level of returns to investment, Vanuatu is no doubt a high-cost environment, given its small population, which is scattered throughout many small islands, as well as its geographical location and its vulnerability to natural disasters. Its Anglophone and Francophone dichotomy, as well as its many local dialects, must also impose social and business costs. However, some of these features can be positives in terms of business opportunities, such as its unique natural environment, its location in terms of time zones, and the French language facility of a large part of the population.

Human capital is poor, as indicated in the Annex Table by student enrollment in Form 6/Grade 12 (only 11.7 per cent during the period 2000-03). The low level of skills raises difficulties within the public service with respect to finding people capable of undertaking management tasks; tasks that are becoming more and more complex. However, in areas of government services such as teaching, more teachers are being trained than the government is able to provide jobs for. For example, in 2005, 250 teachers graduated but none were employed. This is a result of poor management of existing government finances on the one hand, with a misallocation towards training scholarships for teaching, and, on the other hand, a problem resulting from the slowly growing economy with the government being limited in its ability to fund public services.

As noted in the previous chapter, formal wage employment accounts for only 18 per cent of the working-age population and the public sector is the major employer. Therefore, as far as employment in the private sector is concerned, the sector is small and growing slowly and thus few jobs become available for skilled workers. Is this low level of private sector employment the result of lack of demand for skilled workers or lack of supply of such workers? The *2000 Labour Market Survey* (Vanuatu National Statistics Office 2001) reported that 59 per cent of businesses interviewed said that they experienced difficulty in recruiting skilled workers. Chand (2002) noted that minimum wages in the public sector are approximately equal to the median monthly salary of skilled agricultural and forestry workers. These high public sector wage levels must have a crowding-out effect on private sector development. However, a characteristic of education throughout the Pacific is that where opportunities for employment exist within the country or there are possibilities for employment outside the country, parents are willing to invest in their children's education. Therefore, it is likely that private sector employment is demand-constrained rather than supply-constrained.

The Vanuatu Chamber of Commerce survey of businesses (reported in ADB 2002a) found that the high costs of business inputs were one of the major inhibitors of investment. Poor, high-cost infrastructure must lower the returns to investment in Vanuatu. Vanuatu's proposal that was accepted for funding under the US Millennium Challenge Account (MCA) recognizes these obstacles and the MCA will be primarily funding investment in infrastructure, particularly transport infrastructure.

As of August 2001, the state wholly owned 17 enterprises and held equity in another ten. The economic reforms have not accomplished much in the way of privatization of these GBEs. An area in which there has been a recent change is in the opening up of international air services and removal of the monopoly of the highly inefficient, government-owned Air Vanuatu (in 2004). This move appears to have led to increased interest in tourism (see the increase in tourist numbers in 2004 and 2005 in Table 4). However, this may mean that secure access to land for securing access to credit, development of transport infrastructure, and resort hotel development will become the binding constraint (see Chapter 3).

Appropriability of investment returns

Sovereign risk, in the form of concerns about unsustainable fiscal deficits resulting in devaluation, does not appear to have been a major problem. The fiscal deficit did climb to high levels in 1998 and 2000. However, foreign reserves did not change so as to suggest that there was a likelihood of devaluation. Also, while the foreign debt/GDP ratio rose to a peak of 38.5 per cent in 2002, this is not a high level. Moreover, most of this debt is on concessional terms, as indicated by the foreign debt-servicing share of the budget being at or below 3 per cent throughout the period under review (see the Annex Table). The problems were more by way of governance failures, such as in the "looting" of the Development Bank of Vanuatu, the National Bank of Vanuatu, and the Vanuatu National Provident Fund, and the government's excessive expenditure. The fact that this poor governance did not lead to capital flight likely reflects investors' beliefs that the government would be bailed out by the international development assistance community—which indeed it was.

From this review, major obstacles to private investment and growth in Vanuatu appear to be the following: difficulties in obtaining secure, long-term rights to land; poor contract enforcement through the judicial system; the difficulties that these two problems present in raising loans from commercial lenders both in Vanuatu and abroad; and the high costs of business inputs, including infrastructure and services. Which of these is the binding constraint to investment, in general, or in particular industries?

As noted, in Cook Islands and Samoa, as well as in Vanuatu, the opening up of international air services has stimulated growth in the tourism sector. Given the increased supply of tourists, this may well stimulate demand for better property rights for the construction of tourist resorts. In Cook Islands and Samoa the supply of better property rights does not appear to have presented difficulties. It remains to be seen whether this will be so in Vanuatu. The holding of a Land Summit in Vanuatu in September, 2006, indicates that there is now substantial interest in the question of land mobilization. For tourism, as well as for other sectors, improved infrastructure and lower-cost services, particularly transport and telecommunications services, are important and may well be the binding constraints across the economy.

Generally, therefore, it appears that it is important for the government to move on the privatization of GBEs and thereby lower the costs of business inputs and make additional government funds available for infrastructure improvements. However, as in FSM and Kiribati, the strong patron-client form of politics that has developed in Vanuatu—as described in Chapter2—appears to be the primary binding constraint that underlies these other major obstacles to investment.

Chapter 5

Conclusions

This review of economic performance in six Pacific island countries within the HRV framework illustrates strongly HRV's point that country context is very important. Certainly, our confidence about the conclusions that we have reached would be higher if we had much more detailed understanding of each of the countries studied. While discussions about the economic problems of the PICs are often in a context that assumes a high degree of uniformity, our conclusions about the binding constraints in the six countries show that there are some substantial differences between them in terms of the binding constraint to investment and economic growth.

We conclude that clientelist politics was the binding constraint in the case of FSM, Kiribati, and Vanuatu; poor macro-economic management, perhaps driven by clientelism, was the binding constraint in Cook Islands; in Fiji, we conclude that it is the continuing political instability; and in Samoa the loss-making, state-owned international airline appeared to be the binding constraint to the tourism sector that the government has been keen to see developed.

The recent liberalization of international airline services into Vanuatu has also been accompanied by increased tourist numbers. Opening up international air services has also been important for the development of the tourism sector in Fiji, although not as important as in Cook Islands and Samoa, as Fiji had developed an internationally competitive airline over a long period by competing in other international air services markets. The conclusion that opening up international air services (and domestic air services where these are necessary) was important for the tourism sector reinforces our point that there is a need to look at the possibility of specific binding constraints for particular industries, as well as identifying binding constraints such as lack of access to savings that may apply across the whole economy.

In those countries where economic performance has been poor, such as FSM, Kiribati, and Vanuatu, pervasive government monopolies appear to be important obstacles to improved private sector development. The prevalence of GBEs in the PICs and the fact that these are generally loss-making with a consequential need for government subsidies and government expenditure on their investment requirements means that government expenditure for infrastructure is squeezed. However, the removal of GBEs is politically very difficult as they are an important component of the clientelist politics of the Pacific as are the insecurity of land tenure, the poor contract enforcement, and the often wastefully inefficient expenditure on infrastructure. Indeed, we conclude that in FSM, Kiribati, and Vanuatu the patron-client form of politics practiced is the binding constraint to economic growth.

Scarcity of savings did not seem to be a binding constraint, except in Cook Islands in the period before the economic reforms, where it appears to have resulted from the macro-economic mismanagement that eventually led to the economic reforms. In the other countries there has been an excess of liquidity due to the lack of investments with good returns or difficulty in the appropriability of the returns. Cook Islands still appears to have difficulties in accumulating domestic savings. However, this is not presenting problems as overseas savings are being made available because of the improved investment returns in the country. The commercial banks in Cook Islands could follow Samoa and raise deposit interest rates to similar rates in Australia and New Zealand to reduce the outflow of domestic savings.

Education also does not appear to have been a constraint on growth. Indeed, investment in education for overseas employment is a feature of PICs that have good access to metropolitan countries, as evidenced by the differences in investment in education between those countries from which people have relatively easy exit and those countries where they do not. In the Annex Table the percentage of children enrolled in Form 6/Grade 12 is shown for the six countries. The percentages for those countries with easier exit—Cook Islands, Fiji, FSM, and Samoa—are much higher than in the two countries that do not have easy exit—Kiribati and Vanuatu.

As far as returns to investment are concerned, the geographic features of these small island states generally make their participation in international trade very high-cost. However, it must be stressed that the possibility of very low telecommunications costs can place them on level footing with other countries in certain activities, as it would make their geographical isolation irrelevant—or even an advantage. It could be argued that the PICs need access to low-cost telecommunications more than any other group of countries. Therefore, it is most unfortunate that so many of them have shut themselves off from the opportunities available by persevering with monopolistic telecommunications arrangements when there is no economic rationale for single-operator facilities.

In order to have productivity growth that comes from larger-scale activities, these countries must participate in international trade. However, they cannot achieve the scale necessary to compete internationally in standardized, low-value products such as undifferentiated agricultural products. Therefore, in agriculture, and elsewhere, they must establish international market niches that will allow them to charge prices that will cover their high international trade costs. For this to happen they must be open to trade and investment to allow access to global technological developments and to new ideas from overseas. Tourism is the exploitation of a market niche, as effectively all countries are unique. However, some tourist areas may have a higher "uniqueness premium" than others.

A feature of most of the PICs is that they are made up of several, even numerous, small, sparsely populated islands. This feature means very high costs of business inputs and reduces the potential returns to investment. These low returns may be the binding constraint to investment in many cases and it is highly likely that the binding constraint cannot be relaxed. But it is still important to identify the binding constraints, as this will be a useful guide to development assistance if it is to be provided. However, as Fiji has shown, outlying islands have become vibrant tourist destinations because of the availability of domestic air services. But for some locations the "uniqueness premium" may not be sufficient to offset the high business costs of their location.

Political instability *per se* only appears to be a binding constraint in Fiji. However, the clientelist politics that underlies the political instability—and the corruption that is often associated with it—is giving rise to binding constraints. As discussed in Chapter 2, clientelist politics pervades the PICs, resulting in conflicts of interest in the awarding of contracts, nepotism, and corruption, rather than the provision of widespread public goods. As we noted there, Keefer (2004) has hypothesized that politicians operating in such an environment will prefer not to support security of property rights and contract enforcement as the establishment of these institutions will undermine the payoff to rent seeking activities. This hypothesis appears to be supported by political behavior in most of the six states and particularly in FSM, Kiribati, and Vanuatu. Besides creating possible binding constraints in the form of insecure property rights and poor contract enforcement, low-return public investments and the adverse impact of corruption on such investments lead to other binding constraints.

A question that was posed by the inclusion of Cook Islands, Samoa, and Vanuatu in the countries studied was why Vanuatu does not appear to have benefited from comprehensive reforms as Cook Islands and Samoa appear to have done. It appears that the patron-client politics that has grown so considerably in Vanuatu over the past 15 years or so has resulted in the kinds of constraints discussed in the previous paragraph. For their part, Cook Islands and Samoa seem to have realized that this kind of behavior by government is inimical to private investment.

International airline deregulation has taken place in all three countries and all three appear to have benefited in terms of the recent development of their tourism sectors. Cook Islands appears to be most advanced in following the path of Fiji for tourism development by providing a "package" of good infrastructure, competitive airline services, and security of tenure for hotel resort investment. It remains to be seen whether Samoa and Vanuatu can take the next steps to ensure the development of this industry. For Vanuatu at least, it is likely that access to secure tenure for infrastructure and resort hotel development may now be the binding constraints to development of the tourism sector. With all land in Vanuatu under customary ownership, relaxing this constraint may prove challenging. For all four countries, the important question is whether they can extend these development "packages" to other economic activities.

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