

Identifying Binding
Constraints in
Pacific Island
Economies

RON DUNCAN and
HILARIAN CODIPPILY

with

EMELE DUITUTURAGA and
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PREFACE

The emergence of a large number of small states over the past four decades or so (there are presently around 50 states with populations with less than 1.5 million) has led to considerable interest amongst researchers, member governments, and international agencies in their economic and environmental viability. The literature generated in the process has focused on the special problems and development challenges faced by such states, including their prospects for integration with the changing global environment. The study presented here builds upon this literature in examining the binding constraints to development. It is our hope that this study will benefit policy makers, researchers, and the donor community.

Rather than using the conventional ‘saving-investment-production function-growth’ approach, combined with a fiscal, monetary, exchange rate, and regulatory policy framework, the study explores issues that underlie these policies and discusses why policies that work elsewhere may not work in Pacific island countries (PICs). The ineffectiveness of policies may be because of the prevalence of strong cultural traditions that play an important role in areas such as land ownership, sharing of economic resources, protecting the environment, providing a social safety net, fostering social cohesion, and maintaining law and order at the local level. ‘Rules of the game’ defined by such small but complex systems—which coexist with formal government structures—present difficulties for the establishment of a market economy because markets are based on transactions between parties who do not know each other. These traditional systems also have implications for donor-funded projects. A suitable framework and a deep knowledge of such cultural traditions are therefore essential for understanding why market-oriented prescriptions or foreign-aided projects may or may not always work.

In this study, we use a modified form of the analytical framework proposed by Hausman, Roderick, and Velasco (2004), which, in some cases, is extended by the Institutional Analysis for Development (IAD) framework pioneered by Ostrom et al (2001). In doing so, the study makes a radical departure from conventional quantitative approaches and focuses on the ‘deep determinants’ of growth. The study recognizes explicitly the political economy based on cultural traditions in small island economies such as in the Pacific as well as the paucity of economic data in these countries; thus shifting the research effort in a qualitative direction. The research undertaken is presented in this book in the form of analytical country narratives covering political, legal, regulatory, institutional, economic, and cultural factors that have either inhibited or facilitated the development process.

The analytical framework of Hausman, Roderick, and Velasco (HRV) is based on the assumption that an under-performing economy is constrained by mar-

ket imperfections and distortions arising from imperfections and distortions from government interventions or from other market imperfections and from externalities. Removal of all distortions at once is one approach to economic reform, but this requires knowledge of all distortions and also poses the politically impossible task of removing them all at once. This study seeks to identify binding constraints based on investigations in a selected set of small island economies within broad categories of determinants of growth, such as availability of savings, availability of human capital, and returns to investment, aided by a decision tree diagram. It is argued 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 or opportunity cost. Therefore, relaxing that constraint will have the highest payoff. Once it is relaxed, another constraint will become the most binding.

The IAD framework provides a very productive means of gaining an understanding of the behaviour of the groups that have an influence, for better or worse, on economic development within a country. It extends the HRV analysis, which is essentially an economic analysis, into political, cultural, and social areas—what might be called the broader political economy of a country—as constraints on growth may exist at the underlying ‘institutional’ level rather than at the economic level. The IAD framework assumes that most problems in development result from the inability of people to take collective action, especially in regard to the delivery of public goods and the effective management of ‘common pool’ resources.

Four Pacific island countries were chosen for detailed study of the factors underlying their economic success, or lack of it: Fiji, Kiribati, Samoa, and Cook Islands. The choice of the four countries studied was based on two main criteria: economic performance and the geographical, ethnic, and migratory features that distinguish these countries. Fiji and Kiribati have both carried out economic reforms, but not of the comprehensive nature of those of Samoa and Cook Islands. It is of interest therefore to compare the results of the reforms undertaken across the four countries and try to understand the reasons for the different results. For comparative purposes, two small island countries were chosen from outside the Pacific region: Barbados and Maldives. Barbados has been seen as a model for developing countries by virtue of its traditional approach to development over a long period of time, achieving a relatively high level of per capita income and quality of life for its people. Maldives, by contrast, is a case where notable results have been achieved in growth and development in a relatively short period of time, based on a ‘leading sector approach’.

The country visits for this research study were initiated in 2008 and completed in 2010. These country visits provided the opportunity for the two main au-

thors and their associates to interact with policy makers, researchers, and civil society in these countries and carry out in-depth studies on the political economy of the country, covering the political systems, the legal systems, the institutional frameworks, their economic performance, and their governance structures, and the results achieved. The insights gained in the process are reflected in the country chapters and the concluding chapter.

We wish to emphasize that the economic and other data and other presented in the country chapters reflect what was available at the time of the country visits. No attempt has been made to update this information, as the focus of the study is on binding constraints, using available data to support the arguments made. A large number of references have been cited. However, we take responsibility for any errors that remain.

Ron Duncan
Hilarian Codippily

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In conducting the studies in Cook Islands, Kiribati, Fiji, and Samoa, we met with a large number of policy makers, researchers, and members of civil society who generously spent their time in discussions with us. We owe them a great debt of gratitude. Although they are too numerous to acknowledge all of them individually, we wish to mention by name those who have acted as our main interlocutors and counterparts in completing this book.

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ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
A\$	Australian Dollar
ALTA	Agricultural Landlords and Tenants Act
ALTO	Agricultural Landlords and Tenants Ordinance
AusAID	Australian Agency for International Development
BLP	Barbados Labour Party
CEO	Chief Executive Officer
CMA	Civil and Military Affairs (division in Fiji)
CRP	Comprehensive Reform Program
DWFN	Distant Water Fishing Nation
EEZ	Exclusive Economic Zone
ERP	Economic Recovery Program
EMDAT	Emergency Events Database
FDB	Fiji Development Bank
FNPF	Fiji National Provident Fund
FTIB	Fiji Trade and Investment Board
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GNI	Gross National Income
GBE	Government Business Enterprise
HDI	Human Development Index
HRPP	Human Rights Protection Party
HRV	Hausmann, Rodrick, and Velasco
HOM	Head of Ministry
IAD	Institutional Analysis for Development
IAS	Island Aviation Services (Maldives)
IFC	International Finance Corporation
IMF	International Monetary Fund
LDC	Least Developed Country/Less Developed Country
MAB	Maldives Accreditation Board
MDGs	Millennium Development Goals
MMA	Maldives Monetary Authority
MNQF	Maldives National Qualifications Framework
MWSA	Maldives Water and Sanitation Authority
MWSC	Maldives Water Supply and Sewerage Company
NGO	Non-Government Organization
NLTB	Native Land Trust Board
NZ\$	New Zealand Dollar
PASS	People Against Switching Sides
PIC	Pacific Island Country
RBF	Reserve Bank of Fiji
RERF	Revenue Equalisation Reserve Fund
SAARC	South Asian Association for Regional Cooperation

7NDP	Seventh National Development Plan (Maldives)
SIDA	Swedish International Development Agency
SOE	State Owned Enterprise
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement
STELCO	State Electric Company Limited (Maldives)
SUNGO	Samoan Umbrella of NGOs
SVT	Soqosoqo ni Vakavulewa ni Taukei (Party in Fiji)
TVET	Technical and Vocational Education
UNDP	United Nations Development Programme
US\$	United States Dollar
VAGST	Value Added General Services Tax
VAT	Value Added Tax

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Chapter 1 The Analytical Framework

Ron Duncan and Hilarian Codippily

Introduction

Small island states often conjure up images of a tropical paradise. In reality, however, small states often face challenges to their development and even existence that are quite formidable. Unlike large countries, small island states have limited resources and capacity to address the challenges that they face. Nevertheless, some small island states have achieved good economic growth and development and a relatively high quality of life for their people.

The experiences of the Pacific island countries with respect to economic growth and development have not been particularly encouraging; moreover, attempts to uncover the causes of the poor economic performance have not been very successful. This study presents the results of an investigation into the obstacles to economic growth in small island economies in the Pacific. In some cases, obstacles to economic growth have been overcome. In other cases, economic reform attempts have not been successful and economic growth has remained poor. While the focus of the study is the Pacific island countries (PICs), comparisons are made with relatively successful other small island economies, Barbados (in the Caribbean) and Maldives (in the Indian Ocean), to see what lessons their experiences with the development process may have for the PICs.

The analytical framework used for the most part is that provided by Hausmann, Rodrik, and Velasco (2004, 2005, and 2006). The focus of this framework is on identifying the binding constraints to economic growth within a country: a process that relies on the investigator acquiring 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 favourable environment for investment and growth.

The analysis is also informed in part by what has been called Institutional Analysis for Development (IAD). The IAD framework of Ostrom *et al* (2001) has been developed over several years by researchers from the Workshop in Political Theory and Policy Analysis at Indiana University. It provides a very productive means of gaining an understanding of the behaviour of the groups that have an influence, for better or worse, on economic development within a country.

The IAD framework is used to extend the HRV analysis, which is essentially an economic analysis, into political, cultural, and social areas—what might be called the broader political economy of a country. This extension of the HRV framework was suggested by Sugden (2008) who argued that in some of the Pacific island countries the constraints on growth may lie at the underlying ‘institutional’ level rather than being the more obvious economic constraints.

Analytical frameworks

The Binding Constraints framework

The starting point for Hausmann *et al*’s (henceforth called HRV) development of their 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. 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 at once.

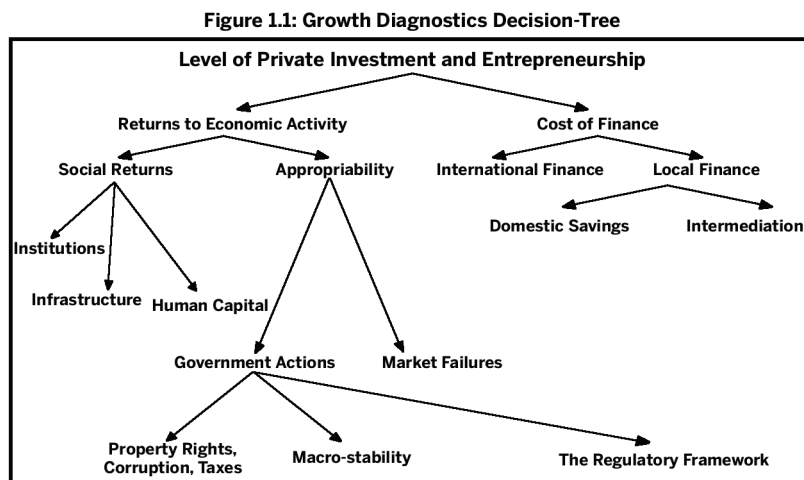
A second approach acknowledged by HRV is to remove whichever distortions it is possible to remove at the time. However, HRV argue that this approach falls foul of ‘second best’ theory; implying that removal of an intervention that does not have the highest opportunity cost may not be welfare-improving. 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 that the largest distortion may not necessarily have the largest welfare impact. The approach favoured by HRV is to identify the binding constraint(s), that is, 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 the possible constraints within broad categories of determinants of growth, such as availability of savings, availability of human capital, and returns to investment. It is argued 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 or opportunity cost. Therefore, relaxing that constraint will have the highest payoff. Once it is relaxed, another constraint will become the most binding. 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. Recognising that investment is the most critical factor in growth, the purpose of the decision tree is to identify whether it is inadequate returns to investment, poor private appropriability of the returns to investment, or the high cost of finance for investment that is the most binding factor to growth. Within each of these possible limiting factors there is 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 parentheses the sub-sets 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 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).

Given the data constraints to representing all of these possible binding constraints within a quantitative framework (such as in linear programming analysis), HRV illustrate the potential use of this decision tree approach in several 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 (see Figure 1.1). This is the approach followed here.



Identification of Binding Constraints

We believe that it is important to give consideration to the possibility that binding constraints may apply to investment across the whole economy or that there may be binding constraints that apply only 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 consist of several islands. 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 the high cost of services. Reducing these costs may not be economically feasible. Still, if assistance is to be provided for development, the biggest payoff will be from concentrating on these constraints. Cultural or political circumstances may make it extremely difficult, if not impossible, to remove the constraints. An understanding of when such circumstances apply is therefore necessary to avoid fruitless, costly attempts at reform.

It is also important to note that the relaxation of one binding constraint can create pressure for relaxation of the next most important constraint—the one with the next highest opportunity cost. For example, if poor 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 an example of this idea in terms of the imputed rental value of customary land being increased by the development of an adjacent road that lowers the cost of getting goods to market, or the opening of the country to international trade leading to increased prices of products that could be grown on the land.

The Institutional Analysis for Development Framework

Duncan and Pollard (2002) and Sugden (2008) give more emphasis to institutional determinants (such as effective constitutions, well-defined and enforced property rights, impartial enforcement of contracts, and law and order) as underlying causes of poor economic performance than does HRV (2005:7) who place emphasis on what Sugden called 'proximate' causes. In recognising that underlying institutional factors may be the binding constraints to growth rather than the more obvious proximate factors affecting investment and growth, Sugden suggests an extension of the HRV decision tree to include an additional 'institutional branch', rather than, as HRV does, to include some institutional factors at the bottom of their decision tree. Sugden suggests the following form for the additional institutional branch of the decision tree:

- human capacity constraints (aid dependence, adverse impacts of civil conflict)
- 'capture' of public resources by the elite ('big man' culture, government 'capture' of government by business, aid dependence)
- lack of social cohesion (divisive constitution, ethnic diversity).

Sugden's 'preliminary, subjective assessment' (2008:234) of the importance of proximate factors and institutional factors in affecting economic performance in the PICs is that 'only Cook Islands and Samoa could be thought of as having an institutional environment conducive to economic growth' so that for these countries 'the binding constraints are more likely to be at the proximate level'. For Marshall Islands, Tonga, Tuvalu, Palau, and Fiji the necessary institutional environment for private investment and economic growth may exist, so that the constraints to economic growth are likely to be proximate constraints on private sector development. For Federated States of Micronesia, Kiribati, Papua New Guinea, Solomon Islands, Timor-Leste, and Vanuatu, Sugden's preliminary assessment is that 'the institutional environment is so weak that the binding constraints to economic growth are very likely to be found at the underlying level'.

However, we would observe that even the existence of some of these obstacles to good economic performance needs to be explained. What explains why an effective constitution is not in place? What explains why a country is aid-

dependent, or why aid is ineffective? It appears that we have to dig deeply into a country's psyche to explain these issues effectively.

We see the IAD framework of Ostrom *et al* (2001) as a very useful way to examine the broader political economy issues that may be inhibiting economic performance and in this way capture the underlying institutional factors that are the foci of Duncan and Pollard's and Sugden's concern. The IAD framework is based on the assumption that most problems in development are a result of the inability of people to take the necessary *collective action*. The delivery of public goods and the effective management of 'common-pool' resources in a society require collective action by society. However, if the established incentives, or rules of behaviour of the society, are such that they provide weak or perverse incentives to individuals or groups within society to act collectively for their common good, the delivery of public goods and management of common-pool resources will be adversely affected.

Public goods are goods or services from which it is impossible to exclude consumers but whose consumption does not detract from their availability to other consumers (non-rival in consumption); moreover, an individual's consumption is not affected by their contribution to producing the good or service. Therefore, there is an incentive to 'free ride' if the good or service is provided privately. National defence, security, fire services, public parks, and basic research are examples of public goods that have to be provided by governments if their provision is not to be sub-optimal.

Common-pool resources are similar to public goods in that it is difficult to prevent individuals from consuming them; however, an individual's consumption does subtract from the amount of the resource available to others (that is, they are rival in consumption). Examples of common-pool resources are natural resources such as fisheries, where exclusion is difficult or there are no property rights to enforce exclusion. Traditional communities have developed informal measures for defining and enforcing property rights over natural resources such as fisheries and forests. Hence, care must be taken that what may appear to be common-pool, or open access, resources are not subject to such traditional measures. But if traditional authority structures have broken down, the rules may not be enforced. In the Pacific, and elsewhere, governments have often taken over the management of natural resources from traditional communities but not put in place effective rules of use and enforcement, so that the resources effectively become common-pool resources subject to the 'tragedy of the commons' (Hardin 1968).

Government budgets may also be treated as common-pool resources in that it may be difficult to prevent politicians from directing government expenditure to their individual use or that of their electorate, to the detriment of the provision of public goods for the benefit of all of society. This kind of behaviour

appears to be widespread in the Pacific. Politicians are elected mainly on the basis of promises of benefits for their clan, rather than on the basis of policies to improve the welfare of all the people. A form of this behaviour is government willingness to fund losses of state-owned enterprises without demanding and enforcing better performance from them. Such 'soft budget' constraints encourage irresponsible behaviour on the part of the management and staff of the state-owned enterprises—a form of moral hazard.

Collective action problems can occur when there is incomplete information; where there is asymmetry in the amount of information held by the parties involved; or where there is a lack of motivation on the part of stakeholders. All of which can generate incentives that prevent individuals from getting together to resolve the collective action problem. These perverse incentives lead to rent seeking, free riding, and principal-agent problems. As Ostrom *et al* (2001:243) comment:

Our theoretical findings demonstrate that applying the concept of ownership and sustainability to actual development cooperation relationships is, in practice, quite difficult. Our analysis shows that motivational and informational problems in aid are very deeply embedded . . . no type of development cooperation is free from powerful perverse incentives.

In adapting their IAD framework to an examination of the performance of the Swedish International Development Agency (SIDA), Ostrom *et al* (2001) asked the following set of questions in evaluating projects that had already been implemented.

- What collective action problem(s) led to the under-supply of public goods or the 'over-harvesting' of common-pool resources?
- What were the incentive problems leading to the lack of effective collective action? and
- Were effective changes made to the 'rules-in-use' that provided the incentives leading to the poor performance?

However, the framework and similar questions can also be used in analysing the effectiveness of the institutional environment and the need for and the type of development assistance that should be provided.

As Ostrom *et al* correctly point out, it is difficult, if not impossible, to change the characteristics of public goods or services or to change the nature (culture) of the community. Therefore, trying to change the incentives (institutions, or 'rules') faced by the people involved is usually the only avenue open by which to achieve a different outcome. But as they also point out, any transformation of the 'rules-in-use' needs to take full account of the characteristics of the community and the physical, economic, political, and social circumstances. Most

importantly, it must be understood that those presently advantaged by the *status quo* will resist any changes in the 'rules' that do not benefit them. Further, aid agencies should be careful not to reinforce perverse incentives or to weaken government incentives to find better policies and institutions.

According to Ostrom *et al*, the evaluation of an implemented project or program or the appraisal of a project or program should analyse the situation in the following sequence: Context, Action Arenas, Incentives, Interactions, and Outcomes. Context refers to the physical situation associated with the project or the problem to be addressed, the attributes of the community, and the 'rules-in-use'. The questions that need to be asked include: What is the culture and history of the community, its social and political characteristics, and its level and distribution of assets? How effective is the community at self-organisation? What is the underlying reason for the collective action problem? Is it under-supply of public goods, or the excessive use of a common-pool resource?

The Action Arenas refer to the various parties who are or who may be involved in the project or in the situation giving rise to the consideration of development assistance and how they interact with each other. How they interact with each other will depend greatly upon the incentives to which they are responding. The incentives or 'rules' may be monetary or non-monetary. Cultural norms may be critical in determining behaviour.

Perverse incentives lead to motivational obstacles to contributing effectively to collective action problems. Motivational problems can arise because: (i) the power relations between groups are asymmetric and those holding the upper hand resist any change that could increase productivity, as it may mean they suffer a loss; and (ii) there is missing information or asymmetry in information between parties. Missing information or asymmetric information about the actions of actors may lead to moral hazard. Missing information or asymmetric information about the characteristics of actors may lead to adverse selection, resulting in selection of inferior individuals or inputs. Missing information may relate to actions that could be taken, with regard to the linkages between actions and outcomes, and with regard to payoffs from actions, for example, with regard to the benefits and costs of privatisation or public sector reform.

Thus, the analysis used in parts of this study has been the 'extended' diagnostics framework drawn from HRV and Sugden. The diagnosis of the proximate factors draws largely on quantitative analysis of the various factors, while the diagnostic analysis of the institutional factors is largely qualitative analysis within the IAD framework. Because country and industry circumstances vary, the research has to be country-specific and requires detailed knowledge of the countries. Therefore, extensive fieldwork was undertaken. It is important to acknowledge, however, that this kind of analysis is 'more art than science' and is

highly dependent upon the analyst's depth of knowledge of the country's circumstances.

The Analytical Country Narratives Approach

The research is in the nature of what Dani Rodrik has called analytical country narratives. Econometric testing of hypotheses of explanations for the presence or absence of growth, including factors of production (land, labour and capital), policies (for example, trade policies), and institutions, has been popular in recent years. Time series econometric analysis within a production function framework may be undertaken to test for the impact of policy changes on growth. However, because of the lack of the necessary time series data it is not possible to do such econometric analysis for the PICs. Sufficient data on the basic production function variables, capital and labour, are simply not available. Tests of the impact of changes in institutional factors on economic growth through cross-country analysis is also not possible, as such analysis requires data on economic growth and the explanatory variables averaged over periods of 10 to 20 years.

But even if these data were available, such econometric testing cannot uncover the details of legislative, regulatory, economic, cultural, and political factors that may be the reasons for the poor economic performance and underpin the resistance to reform. Some of these factors are what Rodrik has called the 'deep determinants of growth' and their study justifies the use of the analytical narratives approach.

Thus the aim of our analysis is to identify the factor or factors that have been the binding constraints on economic growth in the selected PICs and the small island comparators over the past decade or so; or, if there was improved economic performance in any of the countries during this time, what binding constraint(s) was overcome that led to their success. We focus on the period 1995-2008, although the constraints to growth during this period may have been in place prior to 1995 or they may have developed during this period.

Four PICs were chosen for in-depth study (Cook Islands, Fiji Islands, Kiribati, and Samoa). Two comparator small island countries, Barbados and Maldives, relatively successful countries in the Caribbean and the Indian Ocean, respectively, were also studied to see what light their success may throw on the growth difficulties being experienced by the Pacific economies. Below, we discuss the reasons for choosing these particular PICs.

Justification for the Choice of the Four Pacific Island Countries

Four Pacific island countries were chosen for detailed study of the factors underlying their economic success, or lack of it. The choice of the four 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. Fiji and Kiribati have both undertaken economic reforms over the years but not of the comprehensive nature as those undertaken by Cook Islands and Samoa and without any marked improvement in economic performance. It is of interest therefore to compare the results of the reforms undertaken across the four countries and to try to determine the reasons for the different results.

Ethnically, Cook Islands and Samoa are part of what is known as the Polynesian part of the Pacific. Fiji Islands is part of the Melanesian Pacific, while Kiribati is part of the Micronesian Pacific. The Melanesian countries can be described as land- and labour-rich, as they have low population density and much of the land is good agricultural land. Thus, in terms of resource endowments, Fiji Islands is somewhat representative of other Melanesian countries such as Solomon Islands and Vanuatu. Cook Islands is a mix of low coral atolls and volcanic hilly islands. Samoa is better off than Cook Islands in terms of arable land but is 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. Samoans have also had relatively liberal access to New Zealand under quota arrangements, similar to Tonga. Because of the freedom of people movement between Australia and New Zealand, people from Cook Islands and Samoa (and Tonga) 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.

Fiji Islands 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. Recently, however, 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. I-Kiribati have for many years worked overseas as merchant seamen and their remittances have been a reasonably important component of the incomes of their families in Kiribati. Recently, I-Kiribati nurses have been training for work overseas, particularly in Australia.

The Comparator Countries: Barbados and Maldives

For comparative purposes, two small island countries were chosen from outside the Pacific region: Barbados and Maldives. Barbados has been seen as a model for developing countries by virtue of its traditional approach to development over a long period of time, based upon building up its factors of production and governance structures and achieving a relatively high level of per capita income and quality of life for its people. Maldives, by contrast, is a case where notable results have been achieved in growth and development in a short period of time, based on a 'leading sector approach'.

The successful outcome in Barbados has largely been the result of the country's political and social stability, its outward-looking strategy, reliance on markets, and a judicious balance between the roles of government, the private sector, and other stakeholders. The friendly and free enterprise attitudes of the people have also been factors that have attracted private investment and enhanced the development process. Barbados has achieved one of the highest levels of per capita income in the Latin America and Caribbean regions, placing it among the upper-middle income developing countries. In 2007/08 its UN Human Development Index ranking stood at 31, with an average life expectancy of 77 years. Barbados is well placed to participate effectively in the global economy of the 21st century by virtue of its strong and stable institutional framework, its highly educated labour force, dependable infrastructure, and investor friendly business environment.

The story of Maldives reflects a leading sector approach to development, transforming itself from one of the poorest countries in the world to having the highest per capita income in South Asia, within the short span of about 30 years. The two sectors it concentrated its development efforts upon were tourism and fisheries. Today, Maldives enjoys a tourist arrival rate per head of population exceeding that of any other small island state. The fishing industry, which was the lifeblood of the economy for a long period of time, has also made tremendous strides through mechanisation and modernisation of facilities. Through its development efforts, the poverty rate has fallen dramatically in recent years; and the country has achieved the highest education index in South Asia. Lessons of experience from the Maldives are of special relevance to atoll and other small, low-lying countries in the Pacific.

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Chapter 2

Physical, Social, Cultural, and Economic Characteristics of the Pacific Island Countries

Ron Duncan and Hilarian Codippily

Physical characteristics

Defining physical features of the Pacific island countries (PICs) are their small size in terms of area and population, 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, 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 Islands, 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 a sandalwood industry. 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 primary revenue-generating base—and it is often claimed that the forests will be logged-out within a period of 5-10 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, the PICs do not have similar access to the stock. 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 two countries, Fiji and Solomon Islands. However, as a result of the outbreak of violent civil unrest in the Solomon Islands in 1998 the gold mine's operations were suspended for several years. Being also located on the 'rim of fire', Vanuatu is also likely to have gold

and copper and other mineral potential. No doubt, Fiji and Solomon Islands have potential for further mineral 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. Cook Islands has announced that it will commence exploitation of seabed minerals in the near future.

The total population of the PICs is just over 2 million, with populations ranging in size from less than 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. 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.

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. For example, Cyclone Ofa in Samoa in 1990 is estimated to have reduced Gross Domestic Product (GDP) by 7.7 per cent. The two 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 categorised into reasonably well-defined 'culture' areas of Melanesian, Micronesian, and Polynesian, although the boundaries between these categorisations 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 but also the Micronesian societies, which have hereditary authority structures, such as the Royal family of Tonga, the *matani* of Samoa, and the elders of Micronesia. In much of Mela-

nesia, the 'big man' assumed authority of the clan through performance in war or by other means; although, in Fiji, the British colonial administration changed the chiefly structure from a 'big man' structure to a hereditary one by its appointment of hereditary chiefs.

Throughout the PICs most people live outside the few urban centres, 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 activity and earning of 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 80-95 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 often presents problems throughout the Pacific, reflecting, in part, slow progress in land titling systems—with the exception of Fiji, where land titling was developed during colonial rule.

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 indigenous business has often meant finding ways to quarantine the business from such demands.

The communal or extended family systems have, at the same time, benefited Pacific peoples with regard to safety and security. The communal system often acts as a social safety net for its members in times of crisis. It has also been a mechanism for preventing land degradation, protecting the environment, and maintaining law and order at the local level. Communal systems have also served as a means of disseminating health information in some PICs. In effect, these functions have saved considerable public expenditures at the central government level and have fostered greater cohesiveness within local communities.

However, the communal system, with its strong clan loyalties, presents 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. Therefore, PICs are caught up in an evolving conflict between traditional systems and the forces of modernisation.

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 people with a vested interest 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. 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 liberalise their international trade and investment regimes, to privatise their state-owned enterprises, to create more favourable conditions for private investment, and to reduce the use of commodity price stabilisation 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.

Land in the PICs, 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 the 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. 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 lease 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.

Economic Characteristics and Performance

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.

In most PICs, government is relatively larger than in virtually all other countries at similar stages of development and public expenditures constitute an unusually large share of GDP. In general, the civil service tends to be large but has limited skills, while budget and regulatory institutions and processes are weak. Furthermore, service levels are declining and raising government reve-

nues has become more difficult. A related feature of public finances in the PICs is the heavy dependence on foreign aid (World Bank 1998:7-9).

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 commonly 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, earnings on funds held overseas such as trust funds, and aid.

Given their tiny 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 specialise 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 and subsidies, and with the use of resource rents to fund downstream processing.

Fiji is an exception in that it has a substantial industrial sector. In part, this was due to the now-diminished garment industry, which was encouraged through the preferential access that it was granted to Australia and New Zealand through the non-reciprocal trade agreement, SPARTECA (South Pacific Regional Trade and Economic Co-operation Agreement), and 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 somewhat unusual in that it has developed a major tourism industry, now attracting over 600,000 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, Palau, Samoa, and Vanuatu, the economic growth performance of the PICs over the period 1996-2008 has been poor (see Table 2.1). In some cases, real GDP growth has not kept pace with

population growth, leading to declines in GDP per capita (Federated States of Micronesia (FSM), Marshall Islands, and Solomon Islands). As a result of the reasonably fast GDP growth in Cook Islands, Palau, and Samoa, per capita GDP in these countries has increased. The 2.9 per cent GDP per capita growth in Palau and the 3.0 per cent growth in Samoa are particularly noteworthy. Samoa's only decline in real GDP was in 2008, which largely resulted from the global economic crisis. Cook Islands has experienced a longer period of poor growth—from 2005 to 2008. This set-back from its earlier strong performance is discussed in the chapter on Cook Islands. Over the 1996-2008 period, Vanuatu's GDP growth is only just above its high population growth of 2.6 per cent. However, in the period 2003-2008, Vanuatu's real GDP has averaged a very creditable 6.0 per cent, resulting in per capita GDP increasing by 3.4 per cent annually.

The comparatively high rates of growth of per capita income in Cook Islands and Samoa were due in part to the low rates of growth of their population resulting from their substantial emigration and, in Samoa's case, to the substantial remittances sent by its overseas workers. Contrast the performance of Cook Islands and Samoa with that of Kiribati and Vanuatu over the same period. With Kiribati's population growing at 1.8 per cent and GDP increasing at 2.9 per cent, per capita GDP in Kiribati grew by only one per cent per annum. In

Table 2.1: Rates of growth in real GDP, population, and real GDP per capita in Pacific Island Countries, 1996-2008.

Country	GDP growth (%)	Population growth (%)	Per capita GDP growth (%)
Cook Islands	2.7	0.8	1.9
Fiji	1.5	0.7	0.8
Kiribati	2.9	1.8	1.1
Marshall Islands	0.3	0.9	-0.6
FSM	-0.9	0.2	-1.1
Palau*	3.6	0.7	2.9
Samoa	3.6	0.6	3.0
Solomon Islands	1.5	3.1	-1.6
Tonga	1.8	0.4	1.4
Vanuatu	3.1	2.6	0.5

Notes: * Statistics for 2004 to 2008 only.

Source: ADB Key Indicators, Online Database.

Vanuatu's case, population growth of 2.6 per cent resulted in per capita GDP increasing at only 0.5 per cent.

The substantial differences in population growth seen in Table 2.1 are due not only to large differences in emigration rates but also to large differences in fertility rates. Fertility rates (defined as the number of children per woman) in the PICs range from 2.5 for Palau to 5.3 for Solomon Islands. Broadly, the Melanesian and Micronesian countries have somewhat higher fertility rates than the Polynesian countries. Fiji is an exception among the Melanesian countries, as it has quite a low fertility rate due to the substantially lower fertility rate of the large Indian part of the population.

While there are no reliable statistics on income distribution for the PICs, it is reasonable to suspect that income inequality is quite high and 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.

Political characteristics

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 Islands 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. Federated States of Micronesia (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 US (Federated States of Micronesia, Marshall Islands, and Palau) adopted Presidential or hybrid parliamentary/presidential 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 island countries of the Pacific have been formed by 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 existence of many small communities on 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).

Political instability has been a feature of most governments in the Pacific since independence and the instability has been increasing in some countries in recent years. No-confidence votes against the government are a 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 close 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 sector is a feature of most of the Pacific (Transparency International 2004). This clientelist 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.¹

The prevalence of clientelist 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 benefits. It is yet to be seen whether such attempts at electoral engineering will be successful.

However, the question remains as to why clientelist 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 emphasis by governments on increasing the provision of widespread public goods. As noted by Morgan (2005), in Vanuatu predatory rent seeking was 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, wherein differences in political behaviour 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 clientelist politics in young democracies such as the PICs. Keefer's model suggests that clientelism is more likely in societies where the transaction costs of organising 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 organising 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 turnover 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.² A conclusion that could follow from this analysis is that electoral engineering is unlikely to change behaviour—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 organising 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. 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 clientelist politics is endemic. 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 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.

Notes

- 1 Such clientelist politics is not restricted to the Pacific. Keefer (2004) mentions similar behaviour 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 argues that this is because national candidates and parties are more able to make credible promises about the delivery of public good provision.
- 2 In the context of Keefer's (2004) model, this would be the result of an 'unrepeated game'. Whereas a 'repeated game' (that is, continuing face-to-face interaction with the voters) would ensure the credibility of the promises.

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Chapter 3

Binding Constraints to Economic Growth in Fiji

Raijieli Bulatale and Ron Duncan

Country Background

Fiji, sometimes referred to as the gateway to the Pacific islands, consists of about 300 islands, covering a land area of 18,272 square kilometers in the South Pacific. Its population of around 840,000 and economic activity are concentrated on two large islands, Viti Levu and Vanua Levu, which together constitute 87 per cent of the total land area. The land is volcanic in origin. About 80 per cent of the land area is mountainous and not suitable for cultivation; but it is rich in forest and mineral resources and hydroelectric potential. The remaining land is fertile, with considerable potential for agriculture. Fiji is centrally located among its neighbouring Pacific island countries and is considered to be the transport hub of the Pacific. However, it is over 1,500 kilometers from its closest major markets, Australia and New Zealand. Like most of the Pacific island countries (PICs), Fiji is subject to cyclones and droughts and other natural disasters.

With a per capita gross national income (GNI) of US\$3,750, Fiji is the most industrially advanced of the PICs, having developed substantial manufacturing and service sectors.¹ The economy is mainly based on tourism, sugar, other agricultural production, ready-made garments, and, to a limited extent, mineral extraction. Control of government and land is mainly in the hands of the indigenous Fijians, whereas economic activity is dominated by Indo-Fijians. The country's commercial activity is centered around Suva, the capital city, while Nadi, with its international airport and proximity to the major tourist destinations in the country, acts as the tourist hub.

Fiji compares well with many other developing countries in terms of social indicators. Life expectancy at birth is 69 years, while the under-five mortality rate is 18 per thousand. The primary school completion rate is 98 per cent and the gross secondary school enrollment rate is estimated at 82 per cent.⁴

The Structure of the Economy

The cane sugar industry has been at the heart of Fiji's economy and socio-political history for the past 125 years. However, the industry's performance has been declining over the past decade, with the political impasse over the renewal of the 30-year agricultural leases (sugar output declined from 462,000

tons in 1996 to 310,140 tons in 2006 and to 237,418 tons in 2007). Productivity declined as farmers became uncertain about the renewal of the leases and were reluctant to invest amid threats of non-renewal. The threats were manifest during the May 2000 coup when many farmers were forcefully evicted from their land. Many of the expired leases have not been renewed since 1997 and much of the cane land is not being farmed. The number of active sugarcane farmers fell from 20,524 in 1997 to 15,730 in 2006. Another factor depressing investment in the industry was the decision by the EU to phase out its preferential price system for the African, Caribbean and Pacific sugar exporters.

In 2000 the industry accounted for around 13 per cent of GDP but this share has fallen to around 6 per cent. The industry directly employs about 40,000 people. Some estimates claim that the sugar industry directly and indirectly employs around 200,000, around 25 per cent of the formal workforce. Until recently, sugar was the country's main export earner, contributing around 22 per cent of foreign exchange earnings; however, it has been overtaken by the tourist industry. The Interim Government is proposing to restructure the sugar industry with measures being considered for reducing production costs, including increasing productivity using high-yielding cane varieties, increasing the area under plant-cane, and intercropping other crops with sugarcane.

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 developing countries by the high-income countries was reduced through the abandonment of the international Multi-fiber Agreement in January 2006. The only preferential markets for the industry in Fiji are now Australia and New Zealand, as provided for under SPARTECA (South Pacific Regional Trade and Economic Cooperation Agreement).

Employment in the garment industry—mostly female—has fallen from a peak of around 23,000 to less than 5,000. At its peak output in 2001, the garment industry was contributing 31 per cent of total merchandise exports—even more than sugar. However, in 2008 its share of total merchandise exports was only 10.2 per cent. 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 loss of preferential entry the future for the industry is bleak. With its much higher unit labour costs, it cannot compete with the low unit labour cost industries of Asia in the production of standard-technology garment manufacture. Finding a higher value-added product design market niche appears to be its only longer-term hope.

Tourism has been Fiji's fastest growing industry in terms of employment creation and foreign exchange earnings and is now the most important in terms of foreign exchange earnings. Directly and indirectly the industry provides employment to an estimated 45,000 people. Tourism is mainly private sector driven and contributes approximately 25 per cent of GDP. 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, 2000, and 2006. During the 1987 coups, for instance, hotel occupancy rates fell to 25 per cent. Similarly, during the 2000 coup, hotel occupancy rates plummeted to 15 per cent as against the normal occupancy rate of 70 per cent.

Overseas investors have been encouraged to move into the industry through the implementation of reasonably secure 99-year leases on customary land and competitive international and domestic airline services. But the continuing political uncertainty following the 2000 and 2006 coups has been a lead weight dragging down the industry. The current global economic recession and more intense competition from other Pacific island tourist destinations (Cook Islands, Samoa, and Vanuatu) provide additional challenges.

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 increased from a low level in 1999 to around FJ\$500 million in 2005. This boost to consumption and investment expenditure helped to offset the decline from the downturn in the sugar and garment industries; but since 2005 remittances have been declining. The main reasons appear to be the reduction in Fiji Islands' security personnel working in the Middle East, the reluctance of UK recruiters to hire Fijian labour since the 2006 coup, and the depreciation of the US dollar in relation to the Fiji dollar. This latter effect will have been modified by the recent devaluation of the Fiji dollar.

Economic Performance

The Fijian economy has performed poorly for many years. As seen in Table 3.1, real GDP growth since 1996 has averaged close to 2 per cent per annum. According to Rao (2003) the long-term average rate of real GDP growth is about 2.5 per cent. This rate of growth is not much higher than the population growth rate and therefore average per capita incomes have not increased much in real terms since independence. The level of investment is obviously a problem. Total investment since 1996 has averaged less than 20 per cent of GDP (Table 3.1). We know from the experience of the faster-growing developing countries of the past three decades or so that an investment/GDP ratio in excess of 25 per cent is needed for sustained, robust growth and that the bulk of this investment should be in the form of private investment.

Another indicator of Fiji's poor economic performance is the low level of formal employment. There are around 17,000 high school graduates each year, yet there are only around 2,000 additional formal jobs created each year (see Table 3.1). Many of those leaving school and not going on to tertiary training have to rely on the informal sector, including families, for a livelihood. However, the pressures from the un-employed and under-employed would be much greater were it not for the fact that 5-6,000 people have been emigrating annually since the 1987 coups, opening up jobs opportunities for those remaining.

Over the years governments have run fiscal deficits, which have been largely funded from domestic savings in the form of borrowing from the Fiji National Provident Fund (FNPF). As can be seen in Table 3.1, domestic public debt is at a much higher level than external public debt. Since 1996, government borrowings from the FNPF have averaged 71 per cent of the government's total domestic borrowings. In order to maintain FNPF funds as a source of deficit financ-

Table 3.1: Fiji—Key Economic Indicators, 1996-2009

	1996-2000 (av.)	2001-05 (av.)	2006	2007	2008	2009
Indicator Values						
Real GDP growth (%)	2.2	2.4	3.4	-6.6	0.2*	-0.3#
Budget Balance (excludes loan repayments) (% of GDP)	-1.9	-5.0	-2.8	-1.7	-2.1	-3.0#
Investment total (% of GDP)	19.8	18.5	17.0	17.0	na	na
- Public (% of GDP)	7.6	6.8	na	na	na	na
- Private (% of GDP)	12.2	11.5	na	na	na	na
External Public Debt (FJ\$m)	230.7	195.9	448.4	623.6	505.6	531.9
Domestic Public Debt (FJ\$m)	1111.3	1903.3	2446.3	2337.8	2438.6	2605.0
Inflation Rate (%)	3.3	2.8	3.1	4.3	6.6	6.8
Formal Employment (‘000)	112.5	120.0	126.0	128.8	130.2	na
Tourist Arrivals (no.)	294,070	545,145	548,589	539,881	585,031	539,405
Remittances (% of GDP)		4.9	6.2	6.0	6.2	na

Notes: * estimate; # forecast; na = not available.

Sources: Reserve Bank of Fiji, *Quarterly Review*, December 2009; Republic of Fiji, Ministry of Finance and National Planning, *Economic and Fiscal Update, Supplement to 2009 Budget Address*.

ing, the government has strictly controlled the FNPF's off-shore investments. It has also controlled the FNPF's overseas investments as a means of shoring up the level of foreign reserves in support of the fixed exchange rate.

The good performance of tourism over the years can be seen from Table 3.1. The coups of 1987, 2000, and 2006 resulted in declines in tourist numbers and spending, which has meant a huge loss in tourism earnings. However, the industry has been able to rebound quickly each time, although it has meant offering highly discounted hotel rates in order to lure the tourists back. Remittances have provided another source of income growth, helping to make up for the losses of economic output, exports, and foreign exchange resulting from the declines in the sugar and garments industries.

The Institutional Framework

Fiji was under British colonial rule from October 1874—when several chiefs ceded it to Britain—until independence on 10 October 1970. Sir Arthur Gordon, the first British governor, introduced a system of administration that protected the traditional institutions and customary ownership of land. Governor Gordon authorised the importation of indentured Indian labourers to work on the sugar plantations, which saw some 60,000 Indian labourers arrive between 1879 and 1916 on five-year contracts to work on sugar estates owned by the Colonial Sugar Refining (CSR) company of Australia. Given the option of remaining in Fiji following their period of indenture, the majority of the migrant workers elected to stay and work on small (i.e. 5 to 10 hectares) sugar cane farms leased from the indigenous owners. Further immigration from India, but in smaller numbers and at diminishing rates, continued into the late 1930s. Most of the Indo-Fijian business community, the owners of the majority of businesses, are descendants of the later migrants. The introduction of Indians on this large scale changed the political and economic situation of Fiji fundamentally and 'race relations' has been a major factor in Fijian politics for most of the period since the indenture system ended.

The proportion of ethnic Indians in the total population increased from half of one per cent in the first census of 1881 to 51 per cent by 1966, but fell following the two military coups of 1987 to 44 per cent by 1996 and to 37 per cent by 2006, following yet another coup in 2000, which overthrew the second Indo-Fijian majority government. The share of the indigenous population fell from 90 per cent of the total in 1881 to 42 per cent by 1966 but then rose to 51 per cent by 1996 and to 57 per cent by 2007.

After gaining its independence from the UK, Fiji established a Westminster system of government, with two houses of Parliament. Customary ownership of land was entrenched within the 1970 constitution, guaranteeing that in excess of 90 per cent of land and all natural resources remained under the perma-

ment ownership of the indigenous population. 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. Ratu Kamisese Mara was appointed the first Prime Minister. He was revered for holding together bickering tribes as he welded Fiji into a stable, multi-racial nation after 96 years of colonial British rule. 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, under somewhat dubious circumstances, 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 indigenous Fijian-dominated army overthrowing the government two weeks after its appointment. 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). Emigration 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.

A new constitution was introduced by the military-backed government in 1990, 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 in the face of 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. A major 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. Under the 1997 Constitution, the Lower House of Parliament of 70 members was elected by universal suffrage. The Prime Minister (the leader of the party with the majority of seats) headed the Cabinet. The Upper House, or Senate, consisted of 34 members and was appointed by the President. Most of the appointed Senate members were nominated by the Great Council of Chiefs—a strong, traditional, extra-parliamentary body mainly concerned with village-level administration but also very influential in national affairs.

The 1999 general election resulted in the formation of an Indian-backed government with support from small Fijian-backed parties. However, the government was overthrown one year later. The May 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 coup and 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 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. This time, however, the mainly Indo-Fijian opposition agreed to take part in a multi-party cabinet.

The new government was short-lived, as it was overthrown by a military coup in December, 2006. An Interim Government (basically a group of Ministers) established by the military has been in place since that time. The 2006 coup had an adverse impact on the economy, with GDP contracting by 6.6 per cent in 2007. Given that GDP growth averaged 2.5 per cent over the 2001-05 period—which is much the same as the long-term rate of GDP growth (see, for example, Rao 2004)—this means that the loss of GDP in 2007 as a result of the coup was about 9 per cent and the loss in average per capita GDP over 10 per cent.

The 1997 Constitution, under which the Interim Government was attempting to function, was abrogated by the President in April 2009 and a Caretaker Government with much the same structure as the Interim Government was put in its place by the President. The main objectives of the coup, as stated by the military commander and now Interim Prime Minister, are to establish an electoral system that is not racially-biased and to ‘clean up corruption’.

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 major indigenous Fijian party. The outflow of skilled Indo-Fijians has continued—even reinforced by the 2000 and 2006 coups. The prospects of a majority Indo-Fijian government are now very unlikely.

Political uncertainty has continued at a high level since 1987. The political uncertainty and its adverse impact on investment have been reinforced over the past decade by the impasse between the major political parties 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, control over the leasing of custom land was given to a statutory body, the Native Land Trust Board (NLTB). A system was established for 30-year leases of land for agricultural purposes. These leases began to expire in 1997 but renewal of the long-term leasing system could not be agreed between the main Fijian and Indo-Fijian political parties (a majority of 75 per cent of Parliamentary votes was required to change the relevant legislation). Meanwhile, many of the Indo-Fijian tenants have been moved off the (mainly sugar cane) farms and, while some of these

farms are being farmed by indigenous farmers, much of the sugarcane land is lying idle. These production problems in what has been Fiji's primary agricultural activity have been reinforced by the phased loss of preferential prices for sugar exports to the EU over the past three years and by the depreciation of the sugar mills and the mill transport system.

Local government

Prior to the 2006 coup, Fiji had two levels of government—central and local. The central government played the pivotal role in making laws and regulations and in initiating and implementing large-scale projects. Local governments were responsible for the operation of their individual divisions. Administratively, Fiji was divided into four divisions, which were further subdivided into 14 provinces. Each division was headed by a Commissioner appointed by the central government. The divisions were basically agglomerations of provinces and had few administrative functions of their own, but served to foster cooperation among the member provinces in providing services. Each province had a provincial council, which could make bylaws and impose rates (local taxes), subject to the approval of the Fijian Affairs Board, a central government department. The Board would also approve the appointment of the *Roko Tui*, or executive head of the provincial council, who was usually a high chief; although in recent years, commoners have sometimes been chosen.

Following the 2006 coup, all town and city councillors and council personnel were suspended by the Interim Government. Posts were advertised for 'Special Administrators' to replace the town councillors and to fill mayoral positions. Seven special administrators have taken over from mayors to oversee the operations of municipal councils. The Special Administrators are paid by the state and report directly to the Interim Minister for Local Government. The Special Administrators are expected to improve services in the municipalities, which the Interim Government says have been adversely affected by political agendas.

State-owned enterprises

There are around 11 government business enterprises. These are being privatised by the Interim Government. However, the government will be the largest shareholder—a 'Golden Share' arrangement. Fiji also has four Commercial Statutory Authorities. The Interim Government has appointed the Chief Executives and Directors who will manage these operations. Mostly, these government business enterprises have been a drain on the central government budget, requiring subsidies to cover annual losses and needing government finance for investment in infrastructure.

Governance

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 FJ\$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.

Economic and Institutional Reform

Following independence in 1970, Fiji’s first government embarked on a public sector-led growth strategy, together with import tariffs, to provide protection for local industry. However, economic growth rates were less than impressive. The low economic growth rate meant a low rate of growth of government revenue. But instead of reining in expenditure in line with revenues, the government borrowed to finance budget deficits. Faced with increasing levels of foreign debt, in 1986 the then 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 liberalisation, economic deregulation, and investment promotion have been the focus of economic policy since 1987—at least in terms of rhetoric. 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 privatisation, and promotion of exports. But there is a question as to whether there has been much substance behind 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 World Trade Organisation (WTO) in January 1996 and now provides most-favoured nation (MFN) treatment to all trading partners.

But trade liberalisation reforms have been inadequate and incomplete. For example, in 1999, the government committed to lowering its non-protective tariffs to 10 per cent but at the same time said that protective tariffs would be raised to 35 per cent. Government still exercises discretion in imposing import quotas and has placed restrictions on 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 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. The culture changed following the military coups of 1987 when a discriminatory policy 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 has remained relatively large at around 11 per cent of GDP and public sector employees make up around two-thirds of national paid employment. There has been much talk over the years about reducing the public wage bill without much progress made. However, the current Interim/Caretaker Government has made substantial steps towards this objective by insisting on government departments reducing their budgets and by reducing the retirement age for public servants from 60 to 55 years. Overhead costs of public services are high and abuse of public funds has been highlighted by the Auditor General on an annual basis.

Most state-owned enterprises (SOEs) have failed to live up to the expectations of their creators. Many lose money and have to be subsidised, 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 monopolisation of the telecommunications market, which effectively locked Fiji out of the global integration of industrial and service activities, was a prime example (see Duncan 2004a). As the majority shareholder, the government

appeared to be focused on the profits earned from Telecom Fiji and lost sight of the much larger revenues it could earn from growth in the economy with much lower telecommunications costs. This situation has now changed with the Interim Government opening up the mobile phone market to competition. As a result, phone costs have fallen and mobile phone services are now available over most of the country.

Until recently, corporatisation of SOEs, rather than privatisation, was the preferred form of economic reform. Generally, this has proven ineffective, not least because the members of the boards of the SOEs were appointed because of their political connections, not their 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. The Interim Government has announced that it will privatise most of the remaining SOEs. However, it proposes to retain majority shareholding—the ‘Golden Share’—in the enterprises, which does not bode well for efficiency in these organisations unless it opens up the markets to competition.

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 of Fiji's constitutions.

Since 1940 and until recently the 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 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 per cent 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 land legislation required a two-thirds majority in the parliament. However, this was not possible prior to the 2006 coup as the Fiji Labour Party opposition, which relied for the majority of its parliamentary seats on Indian farmer votes, wished to retain the existing ALTO legislation while the then government wished to change to a different system.

The current Interim Government has attempted to overcome this impasse by creating a “Land Bank” into which all native land that the customary owners wish to make available for long-term lease can be lodged. The government will then lease out the land to investors wishing to make productive use of it. This system is similar to the lease-leaseback arrangement that has been in place in Papua New Guinea for a considerable time. The viability of the system will depend upon whether commercial banks have sufficient confidence in it to use the land lease as collateral for loans; which will depend in turn on there being no conditions placed on the transferability of the lease and the government standing solidly behind the lease contract.

Contract enforcement

The coups of 1987, 2000 and 2006, and the continuing political instability, led to the massive flight of human and financial capital, through the emigration of Indo-Fijians. 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 honour contracts. Another form of breakdown in contract enforcement that has had debilitating impacts on investment is the weakness of government enforcement of lease contracts over customary land. Disputes over lease contracts by indigenous landowners have become 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 indigenous voters.

In Table 3.2 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 measure of the effectiveness of contract enforcement, given the maturity of its business sector and the effort that over the past

Table 3.2: Costs of Doing Business in the Pacific

	Ease of Doing Business World Rank		Starting a business (days)		Registering property (days)		Enforcing contracts (in % of debt)	
	2009	2008	2009	2008	2009	2008	2009	2008
Fiji Islands	39	34	46	46	68	68	38.9	38.9
PNG	95	89	56	56	72	72	110.3	110.3
Samoa	64	56	35	35	147	147	19.7	19.7
Solomon Is.	89	85	57	57	297	297	78.9	78.9
Tonga	43	40	25	32	108	108	30.5	30.5
Vanuatu	60	67	39	39	188	188	74.7	74.7
Australia	9	10	2	2	5	5	20.7	20.7
New Zealand	2	2	1	12	2	2	22.0	22.0

Sources: The World Bank Group, *Doing Business 2009* and *Doing Business 2008*.

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.

Assessing Binding Constraints

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 (see, for example, Rao 2004). Admittedly, during this period Fiji has experienced the several coups, the severe 1997 drought, and several cyclones and flooding of varying intensity. As a result of the country's poor economic performance, 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 (see Chand 2007, Narsey 2008). This increase is reflected most starkly in the estimated 15 per cent of the population living in squatter settlements, particularly in and around the capital, Suva.

Fiji is the only PIC with reasonably comprehensive information on investment. These data show the total investment/GDP ratio declining from a peak of 26.6

per cent in 1981 to less than one-half that level in the five years following the 1987 coup. It rose to a peak of 27 per cent in 1998, before declining sharply in 2001 and 2002 following the May 2000 coup, and increasing subsequently to 18-20 per cent up to 2005 (see Table 3.1). It is highly likely that the ratio has been much lower since the December 2006 coup.

In most years, private investment has accounted for around two-thirds of total investment (although this was not the case in the five-year period following the 1987 coup). Therefore, fluctuations in total investment are largely explained by fluctuations in private investment. Thus, the coups must be seen as largely responsible for the large fluctuations in private investment and in part responsible for the low levels of private and total investment. However, the generally much lower levels of total investment since 1981 also need to be explained. Policymakers in Fiji have long set as a goal attaining an investment/GDP ratio of 25 per cent. Since 1981 this goal has been reached only once. And for much of the time the ratio has been much below this level. The primary objective of this analytical narrative is to explain this poor investment performance.

The other two parts of total investment are government public investment (such as in transport infrastructure) and investment in the public sector (which covers investment in SOEs). Part of the explanation for the poor investment performance must lie in the high level of investment that has gone into public enterprises. If these enterprises were in private hands, additional funds would be available for the government to invest in public infrastructure (both physical and human); which has performed poorly over the years and whose poor performance must also be an inhibiting factor facing private investment.

But while the coups and the large share of government capital expenditure going into supporting state-owned enterprises are likely causes of the poor economic performance, they are only 'proximate' causes. The absence of a viable leasehold system for native land for agricultural and other purposes is another important obstacle to investment. But the resistance to the establishment of a viable regime is also likely to be a proximate constraint that has an underlying cause that needs explanation. Resistance to trade liberalisation and to public sector reform also needs explanation.

Thus we turn now to look at the likely binding constraints among the sets of possible 'proximate' factors listed by HRV—access to finance, inadequate returns to private investment, and appropriability of returns on investment—and also examine the performance of the underlying institutions through the IAD lens.

Access to finance

HRV list several areas in which to look for constraints on investors' domestic access to finance as possible binding constraints on investment and economic

growth: low domestic savings, poor availability of collateral, controls over bank lending, and risks of banking crises. As far as the costs of access to international finance are concerned, HRV point to the possibility of country risk, restrictions on foreign investment, and regulations on the capital account as being areas that should be examined.

According to bank deposit interest rates in Fiji, 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 and 2005 and 0.64 in 2007. Hence, scarcity of domestic savings does not appear to be limiting investment; rather, the problem is likely to be the lack of bankable projects to make productive use of the savings.

The lack of collateral is a constraint on investment, especially for small businesses. The problems that have been experienced with renewing the leasehold system for the long-term leasing of native land for agricultural purposes have made such leases even more risky as collateral. Even before the expiry of the 30-year agricultural leases began in 1997, the leases did not provide good collateral. Good collateral requires that the leases be fully transferable through sale, inheritance, etc. However, it was a condition of the leases that transfers had to be approved by the NLTB. This condition undermined the value of the collateral as far as commercial lending organisations were concerned. Any new leasehold system adopted should make the leases fully transferable. An ideal leasehold system for native land would embody the following features: leases over custom land to be available to all (indigenous and non-indigenous, locals and expatriates); leases to be available for long periods (up to say 99 years, as is the case with leasing of land for non-agricultural purposes, such as for resorts); leases to be fully transferable; and leases and lease rentals to be established by the market (in part so that lending bodies know the market value of the lease offered as collateral). But while the lack of collateral is a constraint on investment, particularly in agriculture, we have to look for the underlying problem giving rise to this constraint.

Controls over bank lending have generally not been a constraint on private investment. However, controls over lending and controls over international capital movements have been adopted following the coups in order to preserve foreign reserves, which the Reserve Bank of Fiji (RBF) sees as its major objective. For instance, since the December 2006 coup the RBF has managed commercial bank lending through directions over what lending is to be approved. Broadly, lending for establishment of export businesses has been encouraged while lending for consumption that is likely to be used for imports has been discouraged in order to reduce the trade deficit and protect foreign reserves. In recent years the RBF has also attempted to reduce the trade deficit by raising interest rates and thereby dampen borrowing for consumption, based on a belief that the economy is being driven by consumption. However, if, as seems to

be the case, the major economic problem is the lack of investment, then attempting to rein in consumption is only a short-term fix to what is a long-term problem.

While between the 2000 and 2006 coups the government ran relatively large fiscal deficits in attempting to improve growth performance, the deficits were primarily financed by borrowing from the Fiji National Provident Fund—another form of private savings. As a result, the government was able to reduce the foreign debt/GDP ratio from an average of 22.4 per cent in 1990-94 to 3.4 per cent in 2005. In September 2006 the Fiji government made a bond issue for the first time in many years (for US\$150 million or about FJ\$300 million)—presumably to finance the 2006 fiscal deficit. The bond issue was oversubscribed ten-fold. This borrowing increased the external debt/GDP ratio to 7.3 per cent in 2007. This is still a very low level of foreign debt and under normal circumstances Fiji would not have any problems in borrowing from overseas. However, because of the coup, perceptions of sovereign risk may reduce its ability to borrow or raise its borrowing costs. But, generally, the country's access to international finance has not been a constraint on access to finance for investment.

The risk of a banking crisis is negligible as the commercial banks in Fiji are for the most part branches of major banks in Australia, New Zealand, and Papua New Guinea. The parent banks are well-managed and well-regulated; and have not been threatened to a significant degree by the global financial crisis.

The Fiji Trade and Investment Board (FTIB) has the responsibility for approving foreign investment. Similar to other Pacific countries, there exists some trepidation about overseas investors. Fiji restricts foreign investment but offers tax incentives to investors in preferred activities. Several investment areas are reserved for Fijian nationals; and investors must meet certain conditions before investing in some of the other activities. Foreign investors are discouraged from acquiring controlling interests in or taking over established, locally-owned enterprises. These restrictions do dampen overseas investor interest, as do the onerous regulatory requirements. But generally, Fiji can be considered to be reasonably open to foreign investment. However, the coups and the RBF's responses in terms of capital controls must give rise to some apprehension in the minds of overseas investors over whether they will be able to repatriate their profits and capital without constraint.

Inadequate returns to private investment

HRV's suggestions of areas to look for factors leading to inadequate returns to private investment include: (i) geographical factors that raise the cost of investment; (ii) poor human capital; (iii) poor infrastructure and high-cost essential services; (iv) high costs of labour market interventions; (v) and high business risks.

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 internationally successful ventures are possible, as evidenced by the growth of tourism. Fiji Water, a bottled water enterprise, has been very successful in exporting to the US and Europe; and there are several successful cosmetics manufacturers that sell mainly to tourists and overseas.

The availability of skilled labour has clearly become a problem since the 1987 coups, with many skilled Indo-Fijian professionals and tradesmen emigrating permanently in that time. The 2000 and 2006 coups have only served to sustain the emigration 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, caregivers, 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 favourable investment environment and the offer of jobs there would be less incentive to leave. One of the aims of the Interim Government is to remove racist policies and forge a 'multicultural society'; in attempting to achieve this objective the government is appointing non-Fijians to positions in the public service that had been reserved for Fijians.

Poor infrastructure and the 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, have provided 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 SOEs and are reasonably reliable but are high-cost, as elsewhere in the Pacific. The joint government/private sector monopoly of telecommunications was an important constraint on development of economic activities because of the extremely high cost and poor availability of internet, mobile phone, and fixed-line telephone

services. However, the internet and mobile phone markets have recently been opened and charges and availability have improved markedly. Unfortunately, the monopolistic pricing of telecommunications inhibited entrepreneurs in Fiji from taking advantage of the significant reductions in such costs enjoyed by other countries; for example, it 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. This has now changed with investment in activities such as call centres taking place. Farming activities should also be able to take advantage of the services offered by mobile phones and the internet.

Regulatory costs for investors are substantial in Fiji. As the *Doing Business* information in Table 3.2 shows, the costs of enforcing a contract, i.e. recovering a debt, takes over one year on average and creditors only recover an average 62 per cent of the debt. These statistics reflect poorly on the law and justice system. The loss of human capital is also reflected in the poor performance of the public service, which impacts adversely on private investment through the application of the regulations applying to investment approvals. There have been many attempts and much rhetoric about improving the performance of the public service, particularly the approval process for investment, but to little avail.

'Core' business risks have increased with the deterioration of law and order during the period since 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, security costs for businesses have also increased significantly. Anecdotally, law and order problems are said to have increased since the 1987 coups, due to a greater tolerance of crime ('what's good for the goose is good for the gander'). However, it is more likely that the poor economic and employment growth on the one hand and the burgeoning youth cohorts in the population on the other are primarily responsible.

Appropriability of investment returns

HRV see the possibilities for investors having difficulty in appropriating fully the returns on their investments as being due to either government failure or market failure. Government failure may take the form of micro-economic risks such as insecure property rights, poor contract enforcement, corruption, high taxes or inefficient taxation structure, and high expected expropriation risk or 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 may take the form of large externalities that the firms are unable to capture, coordination failure, too little technology adoption or 'self discovery', and weak public incentives for entrepreneurship.

We have seen above that insecure property rights, especially to land and public service jobs, poor contract enforcement, and corruption are endemic problems in Fiji. On the surface, government has to accept responsibility for these constraints on investment. However, the important question is the extent to which they are explained by underlying problems.

Macro-economic risks to the appropriability of investment returns 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 resulted in steadily increasing public debt. By 2006, the public debt/GDP ratio had grown to an unhealthy level of 52.2 per cent, resulting in debt servicing charges of 22.3 per cent of the 2006 Budget. In 2007, the first year of the Interim Government, the corresponding figures were 50.3 per cent and 28.5 per cent.

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—reaching 13.2 per cent in 2005, 23 per cent in 2006, and 20.1 per cent in 2007. These adverse movements in the public debt and the current account raised speculation about a devaluation of the currency. Rather than devaluing the Fiji dollar immediately following the coup, when it would have helped to protect Fiji's most important foreign exchange earner, tourism, the dollar was not devalued until April 2009 (by 20 per cent)—by which time the adjustment to the 'external shock' of the coup and the consequent 'smart sanctions' placed on the Interim Government by Fiji's major tourist source markets (Australia, New Zealand, and the US) had been expressed through business losses and increased unemployment.

Of greater concern to investors over the past two decades has been increased sovereign risk in the form of political instability, which must increase the costs of borrowing. As noted earlier, the 1987 coups led to substantial emigration 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. 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.

Underlying Institutional Constraints: Through the IAD Lens

The lack of collateral due to the impasse over the renewal of the leasehold system for native land and the need for an improved leasehold system, the loss of human capital due to the coups, poor infrastructure and high-cost essential services, the resistance to reform of the public sector and the resistance to trade liberalisation, and law and order problems linked to the poor investment environment and the coups appear to be constraints on investment and growth. However, they appear to be proximate constraints, due in turn to primary, underlying constraints, rather than primary constraints themselves. What may be the underlying constraints? Here we look into this question through the Institutional Analysis for Development framework lens.

The IAD framework assumes that most problems in development are a result of the inability of people to take the necessary *collective action* for the delivery of public goods and the effective management of common-pool resources. If the established incentives, or rules of behaviour of the society, are such that they provide weak or perverse incentives to individuals or groups to act collectively for their common good, the delivery of public goods and management of common-pool resources will be adversely affected. Ostrom *et al.* (2001) argued that difficulties in gaining collective action can occur when there is incomplete information available to the parties, where there is asymmetry in the amount of information held by the parties involved, or where there is a lack of motivation on the part of stakeholders—all of which can generate incentives that prevent individuals from getting together to resolve the collective action problem. These perverse incentives result in rent seeking, free riding, and principal-agent problems.

According to Ostrom *et al.*, users of the IAD framework should analyse the situation in the following sequence: Context, Action Arenas, Incentives, Interactions, and Outcomes. Context refers to the physical situation of the problem to be addressed, the attributes of the community, and the 'rules-in-use'. The questions that need to be asked include: What is the culture and history of the community, its social and political characteristics, and its level and distribution of assets? How effective is the community at self-organisation? What is the underlying reason for the collective action problem?

The Action Arenas refer to the various parties who are or who may be involved in the project or in the situation giving rise to the consideration of development assistance and how they interact with each other. How they interact with each other will depend greatly upon the incentives to which they are responding. The incentives or 'rules' may be monetary or non-monetary. Cultural norms may be critical in determining behaviour.

Perverse incentives lead to motivational obstacles to contributing effectively to collective action problems. Motivational problems can arise because: (i) the power relations between groups are asymmetric and those holding the upper hand may resist any change as it may mean they suffer a loss; and (ii) there is missing information or asymmetry in information between parties. Missing information or asymmetric information about the actions of actors may lead to moral hazard. Missing information or asymmetric information about the characteristics of actors may lead to adverse selection, resulting in selection of inferior individuals or inputs. Missing information may relate to actions that could be taken, the linkages between actions and outcomes, and the payoffs from actions.

(i) *Context*

Since independence in 1970, the interface between traditional and modern authority systems has faced considerable challenges in Fiji's democratic evolution. The Fijian cultural ethos of the supremacy of the *vanua*, *lotu*, and *matanitu* maintains a stranglehold over the Fijian psyche.³ In this worldview, the Fijian is bound to serve his/her chiefs, the church, and the Fijian administrative body that oversees the running of the 14 provinces. In return, the chief, as custodian of all moral authority, wisdom, resources, and prestige, will ensure all aspects of village life function efficiently and the distribution of wealth is according to accepted 'traditional' protocols.

This conception of culture/tradition has sustained its legitimacy through oral tradition, accepted cultural norms and practices, and shared communal values, and is reinforced through the teachings of the Methodist Church. Thus has the *status quo* been maintained in which the traditional chiefly elite continue to wield power, enforce traditional provincial loyalties through kinship ties, and perpetuate the people's acceptance of their traditional—and thereby divine—right to ownership of all land, sea, air space, resources, and people within his/her *matanitu* (traditional governing domain or confederacy).

Under Sir Arthur Gordon's paternalistic colonial policies in the 1800s, the chiefly elite—particularly the eastern chiefs—consolidated their power bases and legitimacy by successfully promulgating the myth of cultural homogeneity amongst Fijians (Lawson 1997, Macnaught 1982) and chiefly authority that was of divine origin. Although the 'traditional' governance administered by chiefs replaced 'club-law' with paternalistic ethics or values, the individual was still firmly encapsulated within the confines and dictates of a communal framework.

With the help of the institutional structures established by Governor Gordon,⁴ the chiefly elite became a trusteeship of sorts in which 'the village was a haven, ensuring all would be cared for in sickness and old age, and

providing a framework for the feasts, songs, exchanges and pageantry that gave meaning to Fijians' lives . . . this security cost[ing] personal freedom in the Western sense' (Denoon, *et al.* 1997:269-70).

However, such a state-within-a-state system ultimately benefited the chiefs and not commoners. The commoners were ruled by chiefs, obliging them in their demands for labour, food, *masi* (tapa cloth), money, and obedience in accordance with Fijian custom, which now had the force of law. Communalism effectively stunted the Fijians' ability to individually embrace the opportunities offered by modernity, including a more egalitarian, transparent, accountable, and participatory approach to decision-making and governance.

Perhaps one of the most conspicuous aspects of the decolonisation/independence period was the native Fijian's inability to function effectively outside the communal values, ethics, and lifestyles that were the basis of his existence. So steeped was he in 'traditional' ways of thinking and behaving that he was unable to adapt to the changes brought about by decolonisation and independence. For him, the *vanua*, the *lotu*, and the *matanitu* were the three broad parts of society that his life revolved around. In each of these entities, the Fijian saw things from the traditional perspective—that is, the Fijian versions of land, religion, and government.

For the ordinary native Fijian, despite the presence of an increasing Indian population (and other races) and an encroaching capitalist economy, chiefly authority and its dictates were what gave meaning to life. Democracy, multiracialism, the cash economy, and the new independent nation did not matter much as long as chiefly authority was visible at the leadership helm—and visible it was in the 'larger-than-life' personalities of the eastern chiefly elite such as Ratu Sukuna, Ratu Edward Cakobau, Ratu Kamisese Mara, Ratu Penaia Ganilau, and Ratu George Cakobau.

With the privilege of traditionally-ascribed leadership status, experience as government functionaries in the colonial administration, strong chiefly kinship ties, and the colonial legacy of neo-traditional institutions, these leaders have sustained chiefly rule into the 21st century. Despite the preponderance of educated commoner Fijians in positions of authority/responsibility by the time British rule ended in 1970, allegiance to the ethics of traditional Fijian governance such as subservience to chiefly and religious moral authority, loyalty to kinship ties and the *vanua*, faithfulness to the Church, and allegiance to and upholding of things 'traditional' still held precedence.

(ii) *Action arenas and incentives*

Clearly, the values of traditional Fijian governance/leadership inevitably

clash with the values found in democracy and the good governance agenda. For instance, unquestioning loyalty and obedience to and trust in traditional chiefly authority are being challenged by values such as impartiality, freedom of expression, and individual rights. Moreover, the stereotyped and romanticised view of the supremacy and continuity (therefore ‘rightness’ and ‘God ordained’) of Fijian ‘tradition’ is in stark contrast to universal ethics of equality, liberty, and tolerance. In the new order, the Fijian culture of generosity to one’s kin and community results at times in nepotism, cronyism, favouritism, provincialism, and difficulty in individual accumulation of capital and other material possessions.

Indeed, a significant dilemma continues to be the inability of the Fijian to make a separation between modern work and traditional non-work spheres and the ethics on which each is founded. To further compound this ethical dilemma, the chiefly Fijian elite—with some exceptions—does not expect the *tauvanua*⁵ to differentiate morally between the two paradigms and act accordingly. It has often suited the chiefs to reinforce people’s subservience to traditional social obligations and communal values within both spheres.

The fact that Fiji, as with most other Pacific Island nations, is a small country further aggravates this problem—the inability to separate loyalties to kin and the state. Having gained legitimacy and advantages (such as unbounded access to resources, power, prestige, wealth, and other opportunities for self-aggrandisement), the traditional chief’s vested interests in the governance of Fiji is a stake too high to relinquish easily to democratically elected leaders—whether Fijian commoners or other races.

(iii) Interactions

Clearly, the challenge of demarcating the interface between traditional and democratic socioeconomic and political spheres for Fiji’s indigenous leaders has been a root cause of the political upheavals. For instance, various reforms identified as financially viable and beneficial for Fiji’s ailing economy are interpreted as attempts to destabilise one or all of the three pillars of indigenous society if chiefly interests are endangered. Since 1970, this ‘siege mentality’ has been a powerful defense mechanism for traditional chiefs and has never failed to evoke extreme nationalistic fervour. Protection of chiefly interests has been the reaction to recommendations for land liberalisation,⁶ right-sizing of the public service, and privatisation of underperforming SOEs,⁷ to name a few examples. Individual Fijian economic empowerment, particularly through control over land, is often perceived as a threat to sustained social coherence and communalism. In the traditional scheme of things, this would ultimately mean that deference, allegiance, and support (in cash or kind) for the chief, the church, and the government would diminish considerably, if not disappear altogether. After all, a chief is only as

good as the popular support, deference, and allegiance received from his/her people.

The civil service is now comprised mainly of indigenous Fijians. Many were recruited through the Affirmative Action policies of the nationalist governments led by Prime Ministers Rabuka and Qarase. Senior posts in the civil service were reserved for indigenous Fijians. In other cases, indigenous Fijians have gained civil service posts through nepotism, cronyism, and other discriminatory means. The blurring of traditional and democratic loyalties has resulted in endemic corruption and an inefficient, bloated bureaucracy that has cost almost 85 per cent of the national budget to run. Until the recent actions taken by the military government to reduce the numbers of civil servants and the public service wage bill, previous efforts to downsize the civil service have come to naught.

Political scientists, historians, and others (see Firth 2006, Firth and Fraenkel 2007, Fraenkel 2009, Lal 1992, 2002a, 2002b, Naidu 2000, Norton 2000, Tarte 2002) confirm what citizens of Fiji know from experience: democracy will only be accepted if indigenous Fijians (especially chiefs) win elections. This is the reason the 2006 military coup, staged by military commander Frank Bainimarama, was perceived as a departure from the norm. Since the 2006 coup, Bainimarama has challenged the gatekeepers of the *vanua*, *lotu* and *matanitu*. The Great Council of Chiefs was suspended in 2007. In the interim government's 'clean up campaign' against alleged, rampant, and institutionalised corruption, suspensions and dismissals of civil servants and SOE board members were carried out. Indo-Fijians have been appointed to key government positions. In 2009 the powerful Methodist Church was not granted a permit to hold its annual conference, thus depriving the organisation of its main revenue-raising activity.

The military's Civil and Military Affairs (CMA) division has been actively involved in 'truth campaigns' whose primary objective is 'demystifying culture' and the alleged exploitative ideological foundations of traditional indigenous society. The CMA's 'truth campaigns' were launched before the December 2006 coup and saw military personnel travelling to the 14 provinces with propagandist material. The campaign's objective was to 'expose the deceptive fallacies' surrounding the *vanua*, *lotu*, and *matanitu*, which the military alleged has fooled indigenous Fijians for generations and has been the root cause of all political instability and the 'coup culture'. The campaigns also addressed what the military deemed as the pervasive culture of corruption. The CMA argued that corruption was embedded in the traditional governing structure, with tentacles extending into the modern state through elite networks amongst indigenous Fijians, church executives, and businessmen. Prime Minister Qarase's proposed Qoliqoli Bill and the Truth and Reconciliation Bill were also targeted as being corruptly pro-elite and

pro-2000 coup supporters. The CMA is still active in its 'community outreach programs'.

On another front, the rising New Methodist Church has attracted a huge following with its extremist anti-establishment pulpit messages and activities. Pastor Atunaisa Vulaono, who headed this new church, is the younger brother of the first military-appointed Police Commissioner, Commodore Esala Teleni. The New Methodists are a breakaway faction from the powerful Methodist Church and are critical of Methodist ideologies and practices. Vulaono preached against mindless subservience to corrupt traditional practices and leaders, enforced tithing and giving to Methodist Church coffers, Methodist Church fundraising, and *yaqona* drinking, and put forward other controversial ideas that directly challenged the traditional *status quo*. The 'Jesus Strategy' adopted by the Police Force to combat crime, used Christian outreach messages, activities, and rallies and was heavily influenced by New Methodism.

Attempts at social engineering by the current administration have also led to the production of a 'Road Map' to sustainable democracy whereby various reforms aim to achieve a more egalitarian and non-racial Fiji. The main instrument in the 'Road Map' is a change in the electoral process to move away from communal seats—a majority of which are for indigenous Fijians—to a 'one man one vote' electoral system. Recent analyses (see Firth, Fraenkel and Lal 2009, Appana 2005, and Ratuva 2000, 2005) have labeled the military as the 'new vanua', which will be a significant catalyst in the reconfiguration of Fiji's institutions, power structures, and relationships. It is evident that today, more than ever before, Fijian society is deeply fragmented and both the inter-ethnic and intra-ethnic cleavages have further disintegrated into several sub-factions.

Pacific commentators (see Durutalo 2007, and Lawson 1991, 1996) argue that, along with chiefs, traditional governance mindsets also consolidate the power and interests of new allies—the emerging commoner indigenous Fijian elites and Indo-Fijian and foreign businessmen. This consolidation has extended the extent of 'state capture' whereby these elites exert undue influence over the modern democratic state and its governing machinery, colluding with public and private officials to extract advantages and access to common pool resources.

(iv) *Outcomes*

In the economic arena, the collapse of the National Bank of Fiji, the investment debacles of the Fiji National Provident Fund, flaws in the lending criteria, procedures, and repayments of the Fiji Development Bank, the dubious dealings of Fijian Holdings,⁸ and the alleged SDL vote-buying via the

Ministry of Agriculture's Affirmative Action Farming Assistance scam, are glaring examples of how state capture by society's elites can wreak havoc on a fragile state's economy. The agriculture scam, dubbed by High Court Justice Nazhat Shameem as the biggest scam in Fiji's history, saw multi-million dollar pay-outs by the first Qarase Interim Government to gather votes for the 2000 general elections.

Established in 1976 as a government-owned commercial bank, the National Bank of Fiji collapsed in 1996 due to various factors such as: introduction of new services, staff expansion (mainly indigenous Fijians), quadrupled advances (mainly to indigenous Fijians) and non-performing loans. The build-up of non-performing loans resulted from poor lending criteria and procedures that favoured privileged groups. The bad and doubtful debts, equivalent to approximately 8 per cent of GDP, were written off by the Rabuka Government in an attempt not to publicise the financial crisis. This action fueled much bitterness and exacerbated ethnic divisions amongst Fiji's workers, who had to carry the tax burden (see Lodhia and Burritt 2004).

An instance of failure of one of the FNPF's high-risk ventures is the development of the Momi Bay Resort, which was to be one of the largest integrated tourist ventures in Fiji with a total project value of FJ\$225 million (involving the development of a 250-room, five-star hotel, a nine-hole golf course, and a golf club house). But the project has been struggling since early 2007 due to lack of funding and other issues. The project had been divided into two phases with Stage 1 owned and managed by a New Zealand project developer, Matapo Limited (financed by Bridgecorp), and Stage II by Muanirewa Resort Ltd. Stage 1 was financed up to FJ\$90 million from contributions by stakeholders of Matapo Ltd, together with funds provided by a Fiji National Provident Fund (FNPF)/Fiji Development Bank (FDB) syndicate, which provided a total loan facility of FJ\$74 million (FNPF contributed FJ\$54 million and the FDB FJ\$18 million). The Unit Trust of Fiji also provided a loan of FJ\$12 million to Muanirewa Resort Ltd for the purchase of 422 acres of land required for Stage II. However, Matapo Ltd. ran into financial difficulties after Bridgecorp, which had poured FJ\$106 million into the Momi Bay project, collapsed in 2008. FNPF, as first mortgagee holder, tried to auction off the troubled resort in late-August 2009 in the hope of recovering FJ\$80 million from the sale. However, it was unsuccessful as the highest bid passed in was FJ\$41 million; negotiations are continuing. Bridgecorp investors have now been advised by Pricewaterhouse Coopers that only 10 cents in the dollar will be recovered.

In the political arena, astute political strategists enlist traditional chiefs into parties as election candidates for the obvious advantage of capturing votes in return for perks for their confederacies. This perpetuates the chiefly elites' access to the state's resources and the forging of new inter and intra-ethnic

alliances to maintain the *status quo*. Clientelist politics is the inevitable outcome and a fundamental cause of the Tragedy of the Commons inflicted on the state's resources.

The Soqosoqo ni Vakavulewa ni Taukei (SVT) Party (1992-99) was the political vehicle of the Great Council of Chiefs and was seen as the party that would unite all indigenous Fijians. It was endorsed by the powerful Methodist Church and had the backing of the Provincial Administration. As in all Fijian political parties that have existed since 1970, the power triad of the *vanua*, *lotu*, and *matanitu* is a framework that must be subsumed into the modern political party in order to gain legitimacy, acceptance, and votes.

Conclusion

It can be concluded that the primary reason for the difficulty in achieving economic reform in Fiji has been the lack of motivation to take collective action and that the reason for this is the adherence of the indigenous Fijians to the *vakavanua* lifestyle/mentality, wherein cultural obligations/allegiances are given priority over any other obligations or considerations.⁹ Any action that can be construed as an attempt to weaken the power of the chiefs is resisted strongly.

Access to national government has been seen as just another means of gaining control over the nation's resources. Therefore, efforts to improve the efficiency and governance of the public sector (the civil service and the SOEs) are resisted because they would diminish the ability of the elite to control the resources managed by the public sector. Actions to promote individual enterprise, such as trade liberalisation and providing more secure individual access to land, are resisted because they would also weaken the power of the chiefs.

It may be argued that giving such emphasis to Fijian cultural influences as binding constraints ignores the important roles that the Indo-Fijian community has played in economic and political life. As noted above, however, the Indo-Fijian business elite have been co-opted to become a part of the ruling class. This is mainly because of the financial resources they provide. When the smallholding, Indo-Fijian cane farmer-supported political party has gained power briefly, it has been quickly thrown out by stirring up ethnic tensions among the indigenous population. There has also been the struggle between the indigenous landowner institutions and the Indo-Fijian cane farmers over the economic rents given by the EU to Fiji through the subsidised prices for Fijian sugar exports. But, in a sense, the inter-ethnic struggles over political power and the economic rents are side shows to the main issue—the clash between the traditional and introduced systems. If the Indian labourers had not been brought to Fiji, the clash between the two systems would still exist.

It can be argued that many of the actions taken by the military government since the December 2006 coup have been designed to break down the traditional institutions that have supported the chiefly elite. Looked at in this light, these actions may be justified on the grounds of improving the prospects for economic growth and improving income and wealth distribution. However, the important questions are whether these actions will be successful or whether they will ultimately succumb to widespread resistance; or whether there is a better means of achieving these goals? The institutional reforms being carried out by the current government, although noble in their ideals, are being carried out unilaterally; and history has shown that little in the way of changing cultural and social norms and structure can ever be achieved and sustained through force.

Thus, the military government is trying to bring about a revolutionary change in Fiji society—to change it from a traditional society to a ‘modern’ society. In the words of North, Wallis, and Weingast (2009), the military government is trying to change Fiji from a *natural* state to an *open access order* state. In *natural* states—which the writers claim currently include most countries and people—elite groups hold power and tightly restrict the access of most people to resources and institutions; in *open access orders*—essentially democratic, market-based societies—there is open competition to all resources and institutions. However, as regards what the military government is attempting to do in Fiji, North (2008) argues that:

The transfer of institutions from open access orders to natural states cannot, in and of itself, produce political and economic development. Indeed, to the extent that institutional forms are forced onto societies by international or domestic pressure but do not conform to existing beliefs about economic, political, social, and cultural systems, the new institutional forms are likely to work less well than the ones they replace.

Therefore, the military government has a long road to travel if it is to achieve its aims, as it will have to change cultural norms and societal understandings in order to bring about the desired result. We know from historical experience that cultural norms change very slowly. Therefore, what may be accomplished in moving the Fijian society *towards* an *open access order* state while working within existing cultural norms and understandings?

In thinking of alternative approaches, can we learn from what has happened in other countries in similar circumstances? One country with a similar chiefly system that has achieved outstanding economic success is Botswana. Writing on the underlying reasons for Botswana’s economic success, Acemoglu, Johnson and Robinson (2001) argue that if institutional reforms do not undermine the power bases and resources of chiefs, they will not see themselves as ‘political losers’. More importantly, traditional leaders will not feel that their leadership

position is under threat and therefore even be accommodating of change. According to Acemoglu *et al.*'s comprehensive analysis, when institutions curb the traditional elite's powers and the range of distortionary policies that they can pursue, it is more likely that good policies will result. Constraints on political elite are also advantageous in two other ways: first, they reduce the political stakes and help to ensure political stability because when such constraints are in place, fighting to control the State apparatus is less attractive; second, by having the constraints in place, other groups 'have less reason to fear expropriation by the elites, and are more willing to delegate power to the State' (Acemoglu *et al.* 2001: 21).

Following the Botswana model, traditional political elite such as the Fijian chiefs would be constitutionally exempted from participating in national politics and governance. Instead, chiefs would only oversee the governance and economic development of their 'koro' (villages), 'tikina' (village groupings), and 'yasana' (provinces) with financial assistance from the State.

Would Fijian chiefs respond positively to such change? Despite their failings within the current institutions, some traditional leaders have been exemplary visionaries and dignified humanitarians. Successful community initiatives spearheaded by traditional chiefs include the Tutu Project in Wairiki, Taveuni,¹⁰ the Maroroya and Iteni Trust Funds, in Nakawaga village, Cakaudrove,¹¹ the Lutu Cooperative Association, Lutu village, Wainibuka,¹² and the tourism developments brokered by the Yasawa chiefs.¹³

However, one must not forget that deconstructing existing traditional institutions and ideologies inevitably takes a long time, needs a great deal of community consultation, and may well have unintended consequences. These warnings apply to the attempts by the current government and any other approaches taken.

Notes

- 1 World Bank Development Indicators database (measured using the Atlas method). The GNI per capita in Purchasing Power Parity terms is estimated at US\$4,240.
- 2 *Ibid.*
- 3 The 'three-legged stool' was a phrase coined by Fijian statesman, the late Ratu Sukuna, to mean: the *vanua* (the land or the chief—for Fijians believe that the chief is the land), *lotu* (church—largely the Methodist Church) and *matanitu* (government or the native provincial government). These

are the three pillars upon which the peace, stability, security, prosperity and sustainability of indigenous Fijian society is said to be built. Protecting these pillars has been the *raison d'être* of Fijian traditional governance. In times of societal crises and upheavals, the powerful manipulative rhetoric of nationalist demagoguery by Fijian traditional (or other) leaders will always rouse passionate support if the populace becomes convinced that any or all of the three pillars is under attack from 'foreign' elements. Fiji's post-Independence political history has shown that chiefs, other leaders, and other elite groups have used this political stratagem as a rallying tactic. Indeed, it has effectively ensured that inter and intra-ethnic cleavages continue to widen.

- 4 These included the neo-traditional hierarchy of power found in the Native Administration and Great Council of Chiefs; Gordon's Native Laws; and the Land Ordinances of 1880.
- 5 This is the term for a 'commoner' Fijian; one who is not of chiefly birth.
- 6 The 1950s case of the *Viti Kabani* economic enterprise by a group of Fijian farmers led by Apolosi Ranawai, a commoner Fijian from Ra, is a good example of the way in which efforts to promote individual enterprise has been handled. News of the economic empowerment that *Viti Kabani* gained spread like wildfire throughout Fiji, leading to a swelling of membership in this native agricultural cooperative. Fijians realised, much to the dismay of the chiefs, church, and colonial masters, that individual advancement was possible outside the confines of the village communal setup. Fearing growing dissension against traditional authority structures and the social relationships embedded within the cultural framework, Ratu Sukuna and the colonial government convicted Ranawai of embezzlement and exiled him to nip the problem in the bud.
- 7 The situation in the SOEs has been little different from that in the civil service with cronyism determining most appointments.
- 8 In the Senate sitting of 18 May, 1993 (pages 731 to 748), Senator Manu Korovulavula moved a motion for the Senate to call on government to carry out an investigation into the method adopted by the Board of the Fijian Holdings Limited to allow limited liability companies to buy shares in the company (FHL) without the knowledge of the 14 Provinces. Senator Korovulavula stated that the motion was brought on a point of principle to reveal less-than-honest dealings of people in positions of power, knowledge, and trust. FHL was primarily created to be owned by the Provincial Councils, Fijian people, and Fijian institutions. Comprising of Fijian professionals, academics, businessmen, and senior executives from the private and public sectors, the FHL advisory body was to recommend trade and

commercial enterprises that Fijians could engage in. The Great Council of Chiefs' unanimous decision was that FHL be owned by 14 Provinces, NLTB, and the Fijian Affairs Board. However, the irony was that, according to the 1992 annual report, 14 provincial Councils and two Fijian institutions, the NLTB, and the Fijian Affairs Board (FAB) held only 30 per cent of total shares while elite Fijians and their family limited liability companies held 70 per cent. Sen. Korovulavula reported to Senate that senior members of FHL who utilised the opportunity, did not advise the 14 Provincial Councils that they could borrow 3-4 times more from the Fiji Development Bank than the amount of shares that they already had in FHL.

- 9 The literal translation of *vakavanua* is 'matters of the land'; a *vakavanua* attitude or mentality is often taken to mean one in which a person behaves or thinks in the Fijian customary or traditional manner—the 'Fijian way of doing things'.
- 10 The Marist Training Centre in Tutu, Taveuni, is a self-sustaining, fully-functional, rural training centre headed by Father Michael McVerry. Each year, scores of young men from the Cakaudrove province, aged between 18 and 23, apply for an opportunity to be trained at Tutu in agriculture, carpentry, basic mechanical and electrical work, and the very popular and successful 'Young Farmers' Course'. The criterion for entry is simple: plant at least 1,000 yaqona plants on your own land. This activity must be verified by letters from parents and the head of the *mataqali* (landowning clan) stating that the young man is free to use the land for commercial farming. Throughout the four years of the course, students alternate between farming and learning at Tutu and time spent in the village working on their farm. The main aim of the course is to train and help young men from Cakaudrove to establish themselves as farmers. Upon graduating the young farmers are given certificates and a bank pass book containing the money they have saved over the four years spent at Tutu. Graduates from Tutu have been known to produce up to one million dollars worth of harvest in a year, which they share and take back to their villages. Clearly, the support of the village chiefs and elders is a vital ingredient in the success story of Tutu graduates.
- 11 Nakawaga village in the Cakaudrove province has set up two trust funds—Maroroya (which translated means 'to keep') and Iteni ('Eden')—from income earned through taro and yaqona sales from the villagers' communal plantations. The chiefs and elders hold village meetings to make decisions on how the funds are used. Primarily, the funds provide a pool of ready resources directed towards the education costs of village children, Methodist Church levies, and other village developments. The trust funds are au-

dited by a reputable accounting firm in Suva and all fund activities are decided on by a committee.

- 12 Lutu Cooperative is an indigenous community-based business venture that has run a lucrative taro-exporting business for the past 20 years. Revenues obtained have contributed enormously to the welfare of the families in Lutu village, located in the hills of Naitasiri. The success and sustainability of the venture throughout two decades has been attributed to Lutu's strict adherence to traditional leadership and each villager making a contribution to the welfare of the community. The Lutu story is proof that visionary traditional leaders can become vital change agents who can transform their communities for the better.
- 13 Yasawa is one of the fastest-growing tourist destinations in Fiji. With proper stakeholder consultation, the establishment of resort developments has not caused social and cultural tension amongst the locals; nor later on between the locals and foreign investors and tourists. The role of village chiefs and elders at this initial contact point has been extremely important. For instance, in the village of Namara the efforts by village chiefs and elders in the initial phase of development have resulted in the enhancement/enrichment of cultural practices. Moreover, traditional protocols are strictly adhered to. In a way, tourism has directly and indirectly strengthened the communal bond—thanks to the foresight of traditional leaders.

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Chapter 4

Binding Constraints to Economic Growth in the Cook Islands

Emele Duituturaga and Ron Duncan

Introduction

The Cook Islands economy had a period of unbroken growth from 1978 until 1994; the fastest and most sustained rate of economic growth of all the Pacific island countries (PICs). From 1982 to 1994 the average annual real GDP growth rate was 4.5 per cent. This good performance was, to a large extent, based on tourism, with source countries spread around the globe, including North America and Europe. However, the economy ran into severe financial difficulties in the mid-1990s, as a result of which a comprehensive economic reform program was implemented. Following the reforms, the country returned to good growth, which has been maintained until recently.

Cook Islands has been seen as one of the star performers in the Pacific. However, all may not be well in this part of the 'Pacific paradise'. Except for 2007, there has been almost no growth in Gross Domestic Product (GDP) over the past five years. The population of Cook Islanders is continuing to decline, especially on the outer islands where there is little in the way of formal employment; infrastructure has depreciated as a result of years of budget stringency; dependence on expatriate labour to service the tourism industry is increasing; there is concern about the loss of Cook Islands culture; and higher wages for locals and expatriates have tended to push up the price of consumer goods (Vitchek 2008).

In this chapter, we examine the reasons for the economic difficulties of the 1990s, the important factors underlying the success of the reforms and their impact on the economy, and what more could be done to improve the country's economic performance and overcome some of the difficulties now being experienced.

Country background

Cook Islands is a country comprised of 15 small islands situated in the South Pacific. Thirteen of the islands are inhabited. The islands form two groups: the North Cook Islands group, which are of atoll formation and with very limited agricultural capacity; and the South Cook Islands group, which are of volcanic origin with reasonably fertile soils. The total land area is 241 square kilometers.

As is the case of all PICs, Cook Islands has a large Economic Exclusive Zone of 1.8 million sq. km. But being situated in the South Pacific, the tuna fishery capacity is more limited than for those countries in the North Pacific.

Similar to other PICs, Cook Islands frequently experiences cyclonic activity, which can inflict considerable damage on housing and infrastructure, damage productive activities, and cause physical harm and sickness. According to the international Emergency Events Database (EMDAT), the five most serious storms to have hit Cook Islands occurred in 1987, 1997, 2001, 2005, and 2010. Over the February–March period of 2005, five cyclones of varying intensity hit Cook Islands, causing massive damage to infrastructure and agriculture. The frequency of these events and their economic impact has to be taken into account when any assessment is made of the economic performance of the PICs.

Demographics

The main island and capital is Rarotonga, home to the majority of the population. Migration from the outer islands to Rarotonga is increasing population density on the main island and rapidly depleting the numbers living on the outer islands. From the 1996 census it was reported that around 60 per cent of the Cook Islands' population was resident on Rarotonga. By the 2006 census the share had increased to 72 per cent. The subsistence livelihoods and the limited access to basic services on most of the other islands are 'push' factors behind the rural-urban migration taking place.

The ease of access for Cook Islanders to New Zealand—and subsequently to Australia—has meant a strong migratory flow to New Zealand over the years, to the point where there are many more Cook Islanders living in New Zealand than in Cook Islands. In the 2006 New Zealand census, 58,000 people self-identified themselves as being of Cook Islands Māori descent. The total estimated population in Cook Islands in March 2009 was 21,000 (Government of Cook Islands 2009). However, the 'resident' population (i.e. those considered to be 'normally' resident in Cook Islands) was estimated at only 12,000. This difference between the so-called total population and the 'resident' population has a large impact when making estimates of economic parameters such as per capita GDP. The difference between the two population estimates appears to be largely due to the census capturing those resident overseas but visiting friends and relatives in Cook Islands.

The recent historical peak in Cook Islands' population was reached in 1971, when a total of 21,322 was recorded. At this time, Rarotonga had an estimated population of 11,478, while the two largest outer islands in terms of population—Aitutake and Mangaia—held populations of 2,855 and 2,081, respectively. These were also peak population numbers for the two outer islands. At the 2006 census the total population of the country had fallen to 19,570, while

Rarotonga's population had increased to 14,155—its highest level. Aitutake's population had fallen to 2,204, while Mangaia's population was recorded at only 640.

Governance

Cook Islands was a British protectorate from 1888 and later was administered by New Zealand. In 1965 it was granted self-government 'in free association with' New Zealand—a status that gave Cook Islanders New Zealand citizenship and the right of unrestricted movement to New Zealand. Therefore, Cook Islanders have free access to reside, work, and draw social security benefits in 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. There is also a 15-member House of Ariki (Chiefs) composed of six Ariki from Rarotonga and nine from the outer islands. The House of Ariki advise the government on land use and customary issues. There are Island Councils, headed by a mayor, on all the inhabited outer islands.

Albert Henry (of the Cook Islands party) was elected as the first Prime Minister in 1965. Henry held the position until 1978, when he was succeeded by Tom Davis following accusations of vote rigging. 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 scrutinising 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) has 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.' A 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). Further, the 1994-97 so-

called ‘Wine Box’ inquiry in New Zealand into the issuing of Cook Islands’ tax certificates to New Zealand businesses led to Cook Islands being dubbed the ‘Crook Islands’ (Transparency International 2004).

A recession, government over-spending and unsustainable increases in public service employment and wages, and the consequent build-up of foreign debt led to a fiscal crisis in 1995-96 and subsequently to an Economic Recovery Program (ERP) that resulted in the number of government departments being reduced from 52 to 22, the privatisation of many government services, and the redundancy of approximately 60 per cent of public servants. It is estimated that around 18 per cent of the total and ‘resident’ population migrated in the 1997-99 period. However, according to Transparency International (2004) and Cromcombe and Jonassen (2004), nepotism remains extensive in the public service and the concentration of business and the concentration of wealthy businessmen in parliament means that the business sector wields a large degree of political power.

These claims of continued corruption may be disputed, however. 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.

Economic Structure, Performance and Policies

The economic structure

As can be seen from Table 4.1, services have been by far the most important sector of the economy of Cook Islands for many years. As noted above, this is due to the important role that tourism has played. The fourth column of Table 4.1 headed ‘Trade’ is included as a proxy for the role of the tourism sector in the economy. ‘Trade’ includes Services sub-sectors of wholesale and retail services, restaurants and accommodation, and transport and communication, sub-sectors that primarily reflect the impact of tourism. The fifth column headed ‘Public administration’, which is recorded as part of the Services sector, is included to show the impact of the reforms on the government sector.

Table 4.1 shows that there has basically been little change over the years in the GDP shares of the main sectors—Agriculture and Fishing, Industry, and Services. Agriculture has fluctuated somewhat, due mainly to the impacts of cyclones. The Manufacturing sector has shown a slight uptrend, probably due to growth in clothing and canned fruit exports. Within the Services sector, however, the mid-1990s reforms caused a major shift from government services to the private sector, with the share of public administration declining from 26.9

per cent in 1995 to less than one-half of this proportion at 12.8 per cent in 2001. It is to the credit of the government that the share of public administration was maintained at around 13 per cent until 2008 when government expenditure was

Table 4.1: Cook Islands—Changes in Sectoral Shares, 1990-2008 (% of GDP)

Years/ Sector	Agriculture & Fishing	Manufacturing/ Mining	Services	Trade	Public Admin.
1990-94	18.5	8.0	73.5	35.6	24.9
1995	9.5	7.6	83.0	29.9	26.9
1996	11.0	7.5	81.5	43.4	22.8
1997	11.6	7.2	81.2	45.8	18.7
1998	14.3	8.3	77.4	43.1	17.0
1999	14.6	8.2	77.1	43.5	15.1
2000	13.0	8.1	78.9	49.6	13.0
2001	11.2	8.1	80.7	52.6	12.8
2002	12.0	7.8	80.2	52.8	13.2
2003	14.9	8.4	76.6	51.0	12.9
2004	13.3	9.0	77.6	52.1	12.8
2005	12.4	8.3	79.3	53.9	12.9
2006	11.3	8.6	80.1	53.4	12.6
2007	11.9	9.4	78.7	53.7	13.5
2008#	11.7	9.9	78.5	53.0	15.3

Source: ADB (2009). The data are presented with a break at 1994 as the data from 1995 onward are not comparable with those of preceding years due to differences in data sources and methods.

Notes: # - provisional data.

increased as a result of the sharp increases in food and fuel prices and the beginning of the global financial crisis.

The main economic sectors in Cook Islands are tourism, agriculture (copra, papayas, fresh and canned citrus fruits, and coffee), marine resources (fish and black pearls and pearl shells), handicrafts, and offshore financial services. There is only limited manufacturing, comprising mainly fruit processing and clothing.

Tourism has been the leading sector for a long time, with tourist arrivals growing from 10,000 in 1976, to 49,000 in 1998, to 88,400 in 2005, and to a peak of 97,300 in 2007. The rapid growth in tourism was made possible by the Government's initiatives in building a new airport, encouraging the public and private sectors to provide tourist accommodation, and allowing Air New Zealand to bring in the tourists.

From the establishment of the 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, when they comprised 92 per cent of total merchandise exports, pearl exports suffered a sharp downturn in 2002, as the result of the contamination of the pearl farming areas due to over-stocking, and competition from French Polynesia. Pearl export revenues are now only one-tenth of what they were at the peak. As a result, total exports are only one-quarter what they were in 2000. In 2005, fresh and chilled fish (mainly tuna) became the most important export. This small, locally-based industry has only been developing since 2002 but has not grown strongly due to its high cost. Still, pearls and fish comprise the island's most important merchandise exports.

The large numbers of people from Samoa and Tonga living in Australia and New Zealand, as well as in other high-income countries such as the US, regularly remit part of their incomes in cash and in kind, and these remittances have played an important part in these economies over a long period. Cook Islanders do not appear to have a similar tradition with respect to remittances. According to data in Connell and Brown (2005), remittances going through formal financial channels are insignificant in Cook Islands. However, remittances delivered through informal channels could be substantial, especially given that the NZ dollar is the official currency, the costs of remitting funds through the financial system are so high, and the reduction in air fares between New Zealand and Cook Islands—which is reflected in the growth in visiting friends and relatives among tourist arrivals.

Economic performance

Key economic indicators for Cook Islands presented in Table 4.2 serve to illustrate the changing fortunes of the economy over the period 1990 to 2008. The economy grew robustly during the period 1990 to 1994, with real GDP increasing on average at 5.8 per cent per year. As shown in Table 4.1 the Services sector is by far the largest sector and therefore it was growth in services mainly driving the growth in the economy. As shown later, growth in tourism played a role in the rapid GDP growth; but, as well, growth in public administration supported by grants (primarily from New Zealand and Australia) and (unsustainable) external borrowings also played an important role. External public debt increased very sharply from 6.3 per cent of Gross National Income (GNI) in 1990 to 92 per cent in 1991, and to 104 per cent in 1992.

Table 4.2: Cook Islands—Key economic indicators, 1990-2008

Indicators/Periods	1990-94	1996-99	2000-04	2005-08
Real GDP growth – total (%)	5.8	-0.2	6.8	2.2
- Agriculture	3.0	14.9	6.5	-5.9
- Industry	10.4	5.5	11.7	7.7
- Services	6.3	-2.5	6.1	3.4
Per capita GDP (current NZ\$)	7,165	7,878	11,877	13,446
Budget balance (% of GDP)	-0.8#	-3.1	-1.3	2.9
External public debt (% of GNI)	67.7	98.1	54.2	36.7+
Inflation rate (%)	4.8	0.2	3.6	4.0
Grants (% of total revenue)	15.6	14.9	11.8	18.8

Source: ADB (2009) and Cook Islands Statistics Office (2009).

Notes: Data for 1995 are mostly not available.

Average of years 1991 to 1994

+ For year 2005 only, the latest data available.

The financial crisis that hit in 1995-96 shows up in the indicators for that period (Table 4.2), with total real GDP and Services sector growth declining, despite strong growth in agriculture. External public debt rose sharply again as external agencies funded the reform and adjustment in response to the crisis. External public debt increased to 98.5 per cent of GNI in 1995 and to 141.2 per cent in 1996, but declined to 129 per cent in 1997. In 1996 and 1997 the economy experienced deflation, resulting in almost zero inflation over the 1996-99 period. As well, per capita GDP in current dollar terms fell sharply in 1995 and 1996. Per capita income only recovered to the 1994 level in current dollar terms in 1998.

Grant aid received by the Cook Islands, mainly from New Zealand and Australia, is at a comparatively high level, averaging around NZ\$1,000 per head in many years. By comparison, Papua New Guinea receives around A\$50 per head in grant aid from Australia. The aid from New Zealand supported the high levels of government expenditure prior to the crisis and during the crisis years. It fell back to lower levels in the 2000-04 period of strong growth but has risen again in recent years with the poor economic conditions being experienced by Cook Islands.

Strong economic growth in the 2000-04 period (6.8 per cent) saw per capita GDP rise to over NZ\$13,000 in current dollar terms. Again, this growth was driven by the Services sector; but this time it was primarily the private sector, mainly tourism, that was behind the improved performance. The reforms un-

dertaken achieved their purpose of shifting substantial economic activity from the public sector to the private sector. It is estimated that the private sector's contribution to GDP (including the informal sector) grew from 59 per cent in 1995 to 83 per cent in 2001. If the informal sector is excluded, the formal private sector's contribution is estimated to have grown from 49 per cent in 1995 to 74 per cent in 2006. Tourism's share of GDP is estimated to have risen from 20 per cent in 1988 to 50 per cent in 2006 (ADB and AusAID 2008).

Except for 2007, the recent period of 2005 to 2008 has seen all sectors of the economy performing poorly. Real GDP growth was 9.5 per cent in 2007, largely due to growth of 12 per cent in the services sector. Construction and tourism performed extremely well in that year. Agriculture declined throughout the four-year period. No doubt the cyclones experienced in 2005 were reflected in substantial falls in agricultural GDP in 2005 and subsequent years. The years 2005, 2006, and 2008 were years of negative or close to zero GDP growth, with all sectors doing badly. Tourist arrivals fell significantly in 2008, reflecting the beginning of the impact from the global financial crisis. Inflation rose substantially in 2008 (to 7.8 per cent), no doubt as a result of the sharp run-up in fuel and food prices.

The Economic crisis and the Economic Recovery Program

Nuclear testing in the Pacific in 1995 and adoption of the NZ dollar in the same year, immediately followed by appreciation of the NZ dollar against the US dollar and Japanese yen, resulted in a sharp decline in tourism. On top of this, the large external government borrowings in support of years of public sector growth,¹ wasteful public expenditure, and public investment in highly speculative commercial ventures resulted in the fiscal and financial crisis of 1995-96. As we have seen, external public debt increased very sharply—from 6.3 per cent of GNI in 1990, to 92 per cent in 1991, and to 104 per cent in 1992.

For many years, successive governments had used public sector employment as a means of delivering political patronage and, especially on the outer islands, as a form of social security. The unsustainability of this behaviour was masked by the buoyancy of the tourism industry, the generous aid flows, revenues from the offshore finance industry, and borrowings. The economic contraction in 1995 was triggered by a loss of confidence in the local Cook Islands currency, whose rapid growth had underpinned rapid government expenditure and growth in fiscal deficits and the national debt.

Between 1987 and 1995 the Cook Islands government issued its own currency in parallel with the New Zealand dollar. In the beginning, the local currency was backed by 100 per cent foreign reserve holdings in a Currency Board arrangement. But in 1989 the foreign reserves requirement was lowered to 50 per cent for most notes and coins and to only 5.0 per cent for the CI\$3 note. As a result,

there was basically no discipline over the supply of local currency (see Burdekin 2008 for a history of the operations of the Cook Islands currency board).

The accelerating currency issuance and increasing fiscal deficits led to a loss of confidence in the local currency in 1994. The two foreign banks, ANZ and Westpac, tightened credit in mid-1994 and at the end of 1994 both banks refused to convert Cook Islands dollars to New Zealand dollars. The Currency Amendment Act of 1994-95 was passed and the New Zealand dollar was made the sole monetary unit. With the withdrawal of the Cook Islands currency, the money supply fell sharply and deflation resulted. The loss of confidence and deflation resulted in a severe decline in economic activity. The fiscal and monetary crises, and with the national debt sharply higher, led to calls for assistance with reform.

At the beginning of March 1996 an assessment was made of the country's financial and economic situation. It became clear that the government would not be able to meet its financial commitments up to the end of the fiscal year. The critical situation provided the impetus for a thorough approach to public sector reforms, development of a new economic strategy, and adoption by Cabinet of the *Path to Recovery: Reform Agenda*, the first comprehensive document outlining the Government's intention for economic reform.

In response to the fiscal crisis, an Economic Recovery Program (ERP) was introduced in mid-1996, supported by the ADB. The ERP had three main elements: public sector reform (emphasising fiscal responsibility and improved public sector management); promotion of the private sector (reforming the leading sectors such as tourism, 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).

To a large extent the reform design was adopted from the New Zealand model and largely driven by external advisers, even though the Office of the Public Service Commissioner and the Office of the Prime Minister (OPM) were responsible for implementing the reform program, with the assistance of the Ministry of Economic Management and Finance (MFEM) and the Office of the Solicitor General.

To support the momentum of the ERP, with respect to facilitating private sector growth and curbing government intervention, core legislation was passed that included the Public Service Act, the Public Expenditure Review Committee and Audit Act, the Ministry of Finance and Economic Management Act, The Local Government (Rarotonga) Act, and The Value Added Tax and Income Tax Acts. These important Acts were reviewed, revised, and passed within a span of one year—a monumental task.

As a result of this process, a number of radical changes took place, resulting in:

- A reduction of the powers and responsibilities of the Public Service Commissioner;
- Downsizing of the public service;
- Changes in the salary scale for the public service;
- Hiring and firing of public servants became the responsibility of Heads of Ministries (HOMs)/CEOs;
- HOMs and CEOs were given increased powers and became virtually responsible for administering their individual agencies;
- A business/corporate orientation for government agencies;
- Budgets were to be based on service delivery and outputs; and
- Changeover from cash accounting to accrual accounting.

In an effort to reduce government expenditure, downsizing of the public service was made a major component of the reforms. Public service numbers fell drastically from 3,200 prior to the reforms to 1,500 in 1997. But this resulted in many former public servants leaving for New Zealand (net outward migration in the July-December 1996 period was 1,612, compared with average net inward migration of 550 annually over the 1992-95 period). Out migration slowed considerably in 1997 to around 20 per month but permanent emigration, primarily to New Zealand, has continued. As we have seen, the estimated 'resident' population of Cook Islands is now less than 12,000 and there is significant in-migration from other PICs and elsewhere to take up employment opportunities in the tourist industry.

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 value-added tax (VAT), which replaced the turnover tax. However, proposed reductions in import tariffs were not adopted until the 2007 budget and there are still high rates on several items. Cook Islands abandoned its independent monetary system and adopted the New Zealand dollar as its currency in 1995. A new Ministry of Finance and Economic Management was established to oversee the Budget, and the powers of the Audit Office were strengthened significantly.

Ports, hotels, the quarry, and waste management were privatised as part of the reform program. The privatisation of hotels became a very significant factor in the subsequent development of the tourism industry (ADB 2002). However, there is still a long way to go with respect to privatisation of state-owned enterprises (SOEs), particularly utilities, telecommunications, and ports and harbours; rather, the focus has been on corporatisation of these entities. In the case of the telecommunications utility, a private/government joint venture monopoly was established (Telecom NZ – 60 per cent, Cook Islands government – 40

per cent). However, liberalisation of the telecommunications market is now under active consideration.

As a result of the prudent fiscal policies adopted and other actions,² external debt has been reduced significantly (see Table 4.2). The latest figures available are for 2005 and in that year external public debt was equivalent to 36.7 per cent of GDP. However, the reduction in the debt level has come at the expense of the maintenance and expansion of the country's infrastructure. This means that there is a considerable backlog in maintenance and the private sector's development is inhibited by the absence of needed infrastructure (ADB and AusAID 2008).

The economy performed well over the six-year period from 1999 to 2004, led by expansion of the private sector—tourism, in particular. GDP growth in real terms averaged 6.1 per cent over this period. Government statistics record the per capita GDP growth rate as averaging 3.5 per cent during this period and 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 was estimated at 20,200 while the resident population was 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 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.

In the next section we look into the success of the mid-1990s reforms and the factors underpinning this success.

Why were the reforms so successful?

Given that the Cook Islands' economy grew so robustly over such a long period (from 1982 to 2004, real GDP growth averaged 4.5 per cent), it would be hard to argue that there were substantial binding constraints to economic growth in place. As noted above, government—and aid—was playing a very prominent role in the economy during this time. It could be argued, therefore, that this high level of government participation was needed to ensure that the economy grew so vigorously over such a long period in the face of all the disadvantages to which Pacific island countries are subject. However, the government intervention ultimately became partly responsible for the financial crisis of 1995-96. It was agreed by the government and the broader community that reform to reduce the government's role was desirable. Therefore, in this section we attempt to identify the reasons for the success of the 1990's reforms. But it is clear from the economy's performance over the past 5-7 years that the economy

could be performing better. So in a later section we look at whether there are binding constraints now affecting growth.

Who were the key actors championing the reforms? What were their motivations for pushing the reforms? Are there lessons from the reform process that could be useful for future reforms? The information on which the following discussion is based was mostly collected from in-depth interviews and discussions with people in Rarotonga during a field visit in February 2009.

The Cook Islands Party (CIP) governed from independence in 1965 to 1978 under Prime Minister Sir Albert Henry. The Democratic Party (DP) then held power under Sir Tom Davis before the CIP returned to power under the leadership of Sir Geoffrey Henry for another decade, from 1989 to 1999. Hence, Sir Geoffrey Henry was the Prime Minister in the lead-up to the crisis and during the reform period. The CIP's dominance came to an end in November 1999 with the resignation of Prime Minister Joe Williams. Williams had led a minority government since October 1999 when the New Alliance Party (NAP) left the government coalition and joined the main opposition Democratic Party, which led to the Democratic Alliance party (DAP) leader Dr. Terepai Maoate being sworn in as prime minister in November 1999. He was succeeded by Dr. Robert Woonton in February 2002. When Dr Woonton lost his seat in the 2004 elections, Jim Marurai took over and has remained the Prime Minister until now.

It was said that, throughout his time in office, one beacon guided the leadership of Sir Albert Henry: 'the Cook Islands for the Cook Islanders'. His strong leadership instilled pride and gave confidence that they, the Maori Polynesians, were capable of running their own country. Sir Geoffrey Henry, who was to follow in Sir Albert's footsteps, referred to him as 'my hero'. The sentiments of self determination continued to echo throughout the CIP manifesto and policies but, as the study found, in later years the quest for self-determination was to the detriment of the economy. As Sir Geoffrey Henry admitted: 'I was driving too hard, wanted change too hard; I lost touch of financial management'.

It was the common view of those interviewed that the key 'champion' of the reforms was Sir Geoffrey Henry. Sir Geoffrey had entered politics in 1972. Although initially he stood as an independent MP, Sir Geoffrey later joined the CIP and eventually took over its leadership. From the interview with him, it was clear that Sir Geoffrey Henry was driven by the belief that Cook Islands was for Cook Islanders and not an 'outpost of Wellington'. His strong feeling at the time was that Cook Islands was still being governed by Wellington. His ultimate aim was for Cook Islanders to manage their own affairs. He was so driven by the idea of 'crystallizing their image on the international stage to be recognised as a sovereign nation and not as a province of New Zealand' that, in pursuit of this goal, he focused very much on the role of Foreign Affairs during his time in office.

Sir Geoffrey wanted a parliamentary system that had, at its core, Cook Islands' customs and their own style of representation. He had love and passion for his country and saw that they were at a cross roads. Beginning to lose their language, they were becoming more New Zealand citizens and less Cook Islanders. He was intent on developing the pride of his people in themselves—the beginning of nationhood and nation building.

Sir Geoffrey stated that the reform process was clear in his mind. It was an economic and fiscal necessity; but he wanted Cook islanders to participate, decide for themselves and own their decisions, and have pride in sorting out their problems by themselves. His oft-used phrase was: 'The best-governed are the least-governed'. He said: 'We had successfully dismantled Wellington but were colonising our own people in the islands. We were worse than "mummy government"'.

In the interview, Sir Geoffrey acknowledged that basically he was at fault for the development of the crisis by allowing finances to drift, through leaving matters in the hands of his Financial Secretary; although he described himself as having no time for sloppiness. When he became Prime Minister and Minister of Finance, he was determined to break the colonial pattern of administration. There were four icons of colonial administration that he targeted: Treasury, the Public Service Commission, the Prime Minister's department, and the Public Works department. He set about to dismantle public works; changed the status of Treasury to be just another department and not 'overlord of the country'; and the same with the Public Service Commission. All this happened during the 1996 reforms.

Public consultation, participation, and ownership

A feature of the reform approach was the effort to achieve collective ownership of the reforms through national retreats. In March 1996, aware of the impending cash flow crisis, the government called together a grouping of concerned private sector and community representatives to discuss the issue. Out of that meeting came a clear signal from the community that they would cooperate in finding a solution to the economic crisis if government would consider their views and concerns in developing a reform package. This meeting heralded the beginning of annual national retreats to discuss common concerns and reconcile differences.

The first national retreat was a three-day national 'brainstorming' held at the Rarotongan Hotel in March 1996, tasked, among other things, to consider the speed of public service reduction and cutbacks in government expenditure. Participants included various stakeholders—business people, trade unionists, traditional leaders, government officials, and representatives of the wider community. They formed working groups to generate proposals to deal with the

crisis. The working group of businesspeople suggested ways of reducing government expenditure; the Cook Islands Public Service Association led a group on developing an efficient public service; and a third group submitted proposals for labour market and public sector reforms.

During the retreat it became apparent to the government that they could not afford the luxury of a three-year period during which to cut back government expenditure. The expenditure reductions would have to be achieved within one financial year. Salaries and wages would have to be cut by over 50 per cent; and across-the-board cuts were proposed for all government departments in the latter part of the 1995/96 financial year. As a result, the government endorsed the fast tracking of the ERP within a period of 12 months. From this locally-owned process a broad consensus was reached on actions to deal with the crisis. This process also led to the preparation of the reform document *Path to Recovery: the Reform Agenda*.

In the interview Sir Geoffrey Henry made reference to the retreat:

We envisaged the creation of a national development council with representatives from the private sector, businesses, Ariki, sub-chiefs, and NGOs. This was an open budget process. In the past, the budget was a secret; no one knew until budget night. At the retreat, we all looked at it, tore it apart before the formal budget document went to Cabinet. It became clear to me that we had for some time been following the New Zealand process. So what we actually did was talanoa,³ consulted, sought differences, shared our common vision, and shared the journey. In undertaking reforms, it is always important to go to the people—the ones feeling the pain to speak up.

In 1997, the government, acting on community recommendations, set up the National Development Council, which comprised representatives from the broad spectrum of society. Among other policy and advisory responsibilities, it became a prime concern of this body to oversee the annual appropriation of the budget to the various Ministries. In effect, this action affirmed the government's commitment to better transparency and accountability in the management of the affairs of the country.

The main benefit of these opportunities for broader community consultation has been the increased social contact between government and the community on affairs of the State.

The role of NGOs and civil society

Downsizing the public service led to an increased role for providers of services in the private and community sectors. For instance, NGOs such as the Red Cross, Child Welfare, National Council of Women, and the Punanga Tauturu

(a women's counselling and refuge centre) took up roles and delivered key outputs that once were the responsibility of government ministries. The National Council of Women worked alongside the Women's Division of the government to implement the National Policy for Women on the outer islands and in the three main villages on Rarotonga. The Child Welfare organisation supported and managed the public health arm of community clinics for mothers and babies in villages and islands. The Red Cross and other health-related NGOs conducted health training workshops throughout the country.

The Cook Islands Association of Non-Government Organisations (CIANGO) is not functioning effectively; it has little recognition and funding support from government and donors.

Resistance to the reforms

Most of those interviewed recalled the reforms as a very painful part of their history. They considered that the government had put national interest over families and individuals. Many had begun to resist the reforms but were threatened with removal if they did not 'toe the line'.

A lot of problems were experienced. New CEOs were expected to take up their positions without training. There was confusion and conflict in the changing responsibilities of the Public Service Commission and the powers devolved to the Heads of Ministries (HOMs). There was devolution of services to the outer islands with the appointment of an Island Secretary; but, again, with no training, it broke down in the first year.

The study found that many had, at first, welcomed the introduction of the reforms, but then realised the overwhelming problems that came with the process. HOMs and CEOs were given substantial powers and responsibilities in terms of public resources and public funds. They could approve their own travel, approve purchases of goods and services, engage consultants, hire and fire, reward staff with bonuses, accept tenders, and so forth.

The HOMs are appointed by Cabinet but have an employment contract with the Public Service Commissioner. Their performance agreement is signed with the Minister. This led to conflict between contractual obligations and political patronage. There were allegations of HOMs abusing and mismanaging public resources and recruiting employees based on nepotism rather than merit. Employees who did not follow instructions given by HOMs, engaged in corrupt practices, or reported corrupt practices, were threatened with dismissal or, in most cases, were fired.

Other areas of current concern are the lack of legislation, financial instructions and guidelines, and financial management procedures that make HOMs ac-

countable for their actions. For example, there are no provisions in the Finance Act that penalize the HOMs for overspending budgets or deviating from priority needs. This encourages HOMs to do whatever they wish as they know that they will not be held accountable for their actions. All of these factors were said to have had a detrimental impact on the delivery of goods and services to the public.

Many people lost their jobs in the public sector. Redundancy reached 60 per cent. A key component of the ERP involved the establishment of a Transition Service with ancillary projects funded through the New Zealand aid agency. Transition Services included retraining assistance, small business advice, other private sector initiatives, and a community action program that mobilised village-level community support structures. The transition assistance measures were implemented from March 1996 to June 1997 to respond to the first round of redundancies in July 1996. However, it was reported that most Cook Islanders receiving redundancy packages did not take advantage of the transition assistance but left for New Zealand.

Lessons from the reform process

The important lessons drawn from this examination of the 1990s' reform program are the following:

- (i) **Successful reforms are led by visionary and determined leaders.** Strong political leadership in Cook Islands saw the reforms through. The chances of successful implementation are increased in a stable political environment in which the champions of reform can remain focused and do not have to risk jeopardising the aims of reform in order to retain power. Equally important, the reforms must be supported by technically competent managers who can drive the reforms from the top down.
- (ii) **Local ownership is vital for successfully implementing reforms.** In the Cook Islands the reforms became locally-owned through the multi-stakeholder approach and sustained dialogue. Shared responsibility for the reforms was achieved through participatory public consultations, including national retreats. A sense of self determination and taking ownership of the country's development was prominent in the discussions.
- (iii) **The 'big bang' approach may not always be appropriate.** Unlike Samoa, Cook Islands followed the New Zealand 'big bang' radical downsizing approach to the reform of the public sector, which led to relatively large-scale emigration and the exodus of skills. This result was in large part due to the ease of emigration to New Zealand. However, in view of the financial crisis, the community's judgment was that the reforms had to be undertaken quickly.

- (iv) **Civil society can have an important role in economic reform.** Civil society can have an important role in sustaining reforms, particularly in advocating and meeting community needs, especially at the village and community levels where the reach of the central government is limited. Reform need not be the exclusive domain of the State but rather may best be a collective responsibility.

Are there current binding constraints to good economic growth?

As noted earlier, Cook Islands' economic performance since 2004 has been poor, except for 2007 when an exceptional growth rate of real GDP of 9.5 per cent was recorded. However, there was negative growth in 2008 and it was anticipated that there will be minimal GDP growth in 2009 and 2010 (ADB 2010). In 2007 all sectors did well, apart from agriculture. Manufacturing, construction, wholesale and retail trade, restaurants and accommodation, transport and communication, and finance and business services all grew strongly. But in other years since 2004 the economy has been buffeted by external forces, such as the cyclones in 2005, the sharp increases in food and fuel prices in 2007 and 2008, and the global financial crisis in 2008 and 2009. However, these are difficulties that the economy has experienced in the past and still performed well.

Therefore, it is pertinent to examine whether there exist binding constraints to better performance. The approach taken is the same as that adopted in other studies in this publication; that is, using the decision tree approach of Hausmann, Rodrik, and Velasco (2005). Hence, below we examine whether there are binding constraints in the areas of access to finance, returns to investment, and the appropriability of capital and investment returns.

Access to finance

Here we look at the availability of savings, both domestic and foreign. Deposit savings 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 apparently remit little of their earnings back home. Therefore, remittances have not been a source of local savings.

The two major commercial banks, Westpac and ANZ, which are branches of major banks operating in Australia and New Zealand, provide over 90 per cent of loans (ADB 2008). Interest rate spreads are 3-4 per cent, similar to Australia and New Zealand. Deposit rates are also similar to those in Australia and New Zealand. The adoption of the New Zealand dollar in 1995 and the openness of the banking sector and the openness of the economy to movement of people

and savings mean that interest rates have to be competitive with overseas rates. However, both banks continue to borrow from their parents as their 'loan books' are several times larger than their deposits, which indicates that local savings are still scarce. But the willingness of the banks to bring in funds to finance investment in Cook Islands confirms that investment is no longer savings-constrained. Bank loans are mostly secured through leases held over customary land, which means that the country has an effective regime for leasing custom land that provides full security for the landowners and the lessees (ADB and AusAID2008).⁴

The joint ADB-AusAID report (2008) also notes that contracts are well-enforced in Cook Islands through a legal system that is modeled on New Zealand's. As well, the legal system enforces competition through a system that is similar to the 'light-handed' approach adopted by New Zealand.

As noted earlier, external debt grew to very high levels before the crisis. In large part it was resistance to the rapid growth in loans 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. Both external debt and public debt were sharply reduced back to the levels operating before the expansion of public borrowing that led to the crisis.

But the recent economic difficulties led to a large budget deficit in FY2009 and a large deficit was also planned for FY2010 (ADB 2010). In October 2009 the ADB announced a loan of US\$10 million for budget support to assist the economy recover from the global economic crisis. The loan is to be used for needed infrastructure and for welfare support—in effect, a stimulus package.⁵ The increased public borrowings have clearly been adversely affecting the country's creditworthiness. As an indication of problems, in August 2009 the ratings agency Standard and Poor's downgraded its outlook for the Cook Islands from stable to negative, due to uncertainty about prospective tourism numbers and the country's increased debt exposure.

Inadequate returns to private investment

As noted above, economic performance is much poorer in the outer islands where there are extremely limited opportunities for private sector activities, reflecting in part the high cost of providing infrastructure and services to these areas. But as well, the high level of government intervention has 'crowded out' private sector activities. Still, the loss of population and the developing welfare dependency means that most of the outer islands are unlikely to provide a basis for private sector development. On the other hand, the enhanced provision of international airlines services in recent years has enabled the growth and expansion of the tourism sector, including in Aitutaki. Hence, geography is not a

limiting factor provided that there are good investment opportunities available.

Human capital was 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 locally. But this mobility of labour means that pay rates have to be internationally competitive; which means that Cook Islands tourism and other economic activities cannot be as low-cost as other Pacific island countries where wages are much lower.

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 Rarotonga and Aitutaki, on which the rapidly growing tourism industry is well serviced by international and domestic airlines.

Labour market interventions have not presented obstacles to investment and development. According to the *Doing Business in 2010* database (World Bank and IFC 2010), labour market legislation and regulations present few difficulties to hiring and firing workers. Work permits are relatively easy to obtain. Still, there is rising concern about the increasing number of expatriates now in the country (estimated at around 10 per cent of the population) working in the tourism sector. One concern is that this could reduce the attractiveness of Cook Islands as a tourist destination. After all, exploiting the uniqueness of a tourist destination is its main advertising tool.

The country's infrastructure is badly run down due to the curtailment of expenditure on public capital and maintenance since the reforms were implemented in order to reduce the public debt. The public debt had been sharply reduced but the government is now facing difficulties in borrowing for these purposes. Therefore, high infrastructure costs and lack of infrastructure will inhibit private sector investment.

Utilities are provided through state monopolies. There was a considerable degree of privatisation as part of the reform program but this was not extended to utilities, which were corporatised rather than privatised—which means that they are still susceptible to political interference and likely to be inefficient and high-cost. The most important piece of privatisation needed is to open up the

telecommunications market. This is apparently under consideration by the government. The benefits of opening up at least the mobile phone market should be obvious to all, given the substantial benefits flowing from the opening of mobile phone markets in five other PICs (Chand and Duncan 2008).

Given the country's reliance on tourism, maintaining this industry's international competitiveness should be among the primary concerns of government. Therefore, it has to try to prevent cost increases or generate cost reductions in those areas over which it has control. Given the country's use of the New Zealand dollar, cost increases cannot be ameliorated through changes in the exchange rate and will affect exports, including tourism, directly.

Appropriability of capital and returns on investment

Taxes and tax rates generally do not appear to be a constraint on investment. Company tax for local companies is 20 per cent. For foreign-registered companies it is 28 per cent. However, there do not appear to be significant barriers to joint ventures with foreign investors. There is no capital gains tax and no tax on interest paid on bank deposits. The VAT appears to be successful, raising 40 per cent of total tax revenue in FY2006. Most tariffs have been removed from imports. However, a few high tariff rates remain in place. These should be removed as soon as possible as they increase the costs of doing business.

Certain activities, including fishing, are reserved for local businesses. But there is sufficient flexibility in the application of the system that foreign investors are able to enter. Still, resistance to foreign investment is increasing and this may lead to a more restrictive Investment Code, which is administered by the Development Investment Board (ADB and AusAID 2008).

Risks to the appropriability of capital or of returns on investment from government failures at the macro and micro level appear to have changed significantly since the 1996 reforms. The kinds of government behaviour that led to the sharp growth in public expenditure and public debt—including the risky economic ventures of the government—that triggered the economic reforms have not resurfaced. It has been argued that the clientelist behaviour has not disappeared, however (see Crocombe and Jonassen 2004). Although there remains talk about widespread political corruption, 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 it 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. The black pearl industry has been badly damaged by pollution caused by the issuing of too many permits, but 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 was lifted with the opening up of this market and the entry of Pacific Blue in 2004.

Conclusions

The National Sustainable Development Plan (2007-2010) set out to achieve a 15-year visionary framework called *Living the Cook Islands Vision: a 2020 challenge*. The plan set out the national vision and identified strategic outcomes and priority goals for implementation. The plan recognised the importance of private sector-led economic growth in meeting the government's goal of economic growth averaging at least 3.5 per cent per year over the medium and long term in order to double GDP (to NZ\$600 million) by 2020. It was recognised in the plan that the economy is based on only a few industries and is highly susceptible to external forces, both natural and economic. Cook Islands has limited scope to expand or diversify its economic base, although there may be potential for deep-sea mining and this possibility is presently being explored. Depopulation continues as a major problem, with Cook Islanders continuing to emigrate, especially to New Zealand—given airfares as low as NZ\$200.

There is some concern about the increased dependence of tourism on the New Zealand market, by far the most important source, and the reduced dependence upon the 'long-haul' markets: Europe, North America, and Japan. This concern is based on the fact that long-haul tourists stay longer and spend more (ADB and AusAID 2008). The concern may be warranted. However, the New Zealand market held up very well during the 2008 downturn, while the decline was all due to declines in the other markets. Pacific Blue has shown its confidence in the New Zealand market in announcing in May 2010 that it would begin a fourth weekly flight between Auckland and Rarotonga in July, thereby adding over 9,000 extra seats on a yearly basis.

While there were very positive results from the earlier reform program, its recent performance and the economic outlook suggest that Cook Islands will have to work hard to return to good economic performance. The government now faces the challenge of building on its past achievements to enhance further the environment for private sector-led growth.

Development of the outer islands is a key priority for the current government. But their potential for economic growth is highly constrained by their geo-

graphical isolation and small populations. Thus, the current relatively large share of government expenditure in infrastructure investment and welfare payments going to the outer islands is unlikely to generate development and maintain the existing populations. Therefore, making the recent ADB budget support conditional on the government reforming its welfare payments to the outer islands is a sensible move.

Political instability does appear to pose problems. The reform period of the 1990s and the period of good growth that followed it were periods of stable government. However, there have been four coalition governments headed by three Prime Ministers over the past five years. Coalition governments make reform difficult as disagreements over reform policies give rise to further political instability. It is important that the politicians keep in mind the damage that macro-economic instability can inflict.

The poor status of infrastructure and the need for infrastructure development in support of the tourist industry appear to be the major constraint to getting back to good growth rates. But the government is clearly under stress in raising finance for such infrastructure expenditure due to the recent poor growth performance; and it appears that the risk premium lenders are demanding has increased. Therefore, the ADB loan for spending on infrastructure is well-directed.

Finally, it is critical that the tourist industry maintains its international competitiveness. The armoury that the government has to assist in this direction is limited, given the use of the NZ dollar and the ease of emigration to New Zealand. Therefore, it is important that the government does whatever it can to reduce domestic costs, such as through lowering tariffs and opening up utility markets, such as telecommunications.

The government has some tough decisions to make in bringing about reform in the welfare system and in redirecting infrastructure expenditure to the main tourist islands of Rarotonga and Aitutaka. In working towards these reforms, the lessons from the earlier reform period should be borne in mind: particularly the need for strong leadership and the desirability of building local ownership for the reforms.

Notes

- 1 The public sector grew by an average 6 per cent p.a. between 1982 and 1994, resulting in its share reaching 76 per cent of GDP in 1995. By August 1997, the public sector had declined by 55 per cent (ADB 1999).

- 2 The so-called Manila Agreement (a debt restructuring facility) cut Cook Islands external public debt by about one-half. There were further write-downs of debt by France in 2004 and by Italy in 2006. The Italian loan had been obtained by the government in order to build a luxury resort.
- 3 A Polynesian term for telling stories and exchanging ideas in a non-confrontational setting.
- 4 Leases over custom land run for up to 60 years.
- 5 The funds are to be used in part to reform the country's welfare program, which presently is poorly targeted and provides assistance to many who do not need it.

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Chapter 5

Binding Constraints to Economic Growth in Samoa

Emele Duituturaga and Ron Duncan

Introduction

Samoa undertook comprehensive economic reforms beginning in the 1990s: one of three Pacific island countries (PICs) to do so (the others were Cook Islands and Vanuatu). Samoa's economic growth has subsequently been reasonably strong and this improved performance appears to be directly related to the reforms. It is important to understand why it was possible for the successful implementation of reforms in Samoa, as such understanding may assist with economic reforms in other Pacific island economies. It is also important to understand which of the reforms were most influential in improving economic growth. Further, it is of interest to know whether there are constraints to even more rapid economic growth. As in the other case studies, the analysis is undertaken within the Hausmann, Rodrik and Velasco (HRV) framework (Hausmann *et al.* 2004, 2005, 2006), which focuses on identifying the binding (most limiting) constraints to growth within an economy.

Country background

Ethnically and culturally, Samoa is part of what is known as the Polynesian Pacific. Its population totals around 180,000, most of which (around 140,000) live on the main island, Upolu. Most of the others live on Savai'i, which has a largely agricultural economy. However, there is continuing domestic emigration from Savai'i to Upolu. It is estimated that due to the rapid, long-term emigration for employment overseas, about as many Samoans reside overseas as live in Samoa. Because of the high emigration rate, Samoa's population growth rate is low—around 0.5 per cent—although its fertility rate remains high—above 4.0.

Samoa has had relatively liberal access to New Zealand under a quota arrangement (currently, 1,100 per year, provided that they have a job that they can go to, plus other conditions). Because of the freedom of people movement between Australia and New Zealand, Samoans living in New Zealand have free access to Australia. The relatively large numbers of Samoans 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.

Since independence in 1962—the first PIC to gain its independence—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.

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 recognised with the adoption of the 1995 Electoral Amendment Act. This legislation obliges candidates to specify their party allegiance, with the objective of enhancing 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). However, in 2005 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. The long dominance of the HRPP has given rise to concerns that it has fostered corruption and political patronage. For instance, there is a high frequency of appointments to high office from among the Party’s supporters as well as the favouring of 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 con-

victions. Of course, this may mean that there is a high level of undetected cases of corruption. Transparency International (2004) was also concerned about the clientelist behaviour of the government. Another concern was over vote buying, which, in the strong family-oriented and reciprocal culture of Samoa, has given rise to 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.

Economic performance and policies

The Samoan economy has performed well following the economic reforms in the mid-1990s (see Table 5.1). Between 1995 and 2008 Samoa's real GDP increased on average by 3.8 per cent—the highest average rate of GDP growth in the Pacific during this period. This commendable performance has to be viewed against the backdrop of the economic toll from natural disasters that took place at the beginning of the 1990s. Cyclone Ofa in 1990 and Cyclone Val in 1991 devastated the agricultural sector and severely damaged housing and other economic infrastructure. Cyclone Ofa alone caused a real GDP decline of 7.7 per cent, and the two cyclones together led to a real GDP decline of 2.5 per cent per year during 1990-93.

Although the PICs are prone to such natural disasters, these two cyclones occurred within a short space of time. As a result, the damage caused went beyond the physical damage. Farmers lost the motivation to go back to cultivation, and it took a great deal of effort to get them back to farming their lands. Then in 1994, the taro blight disease almost wiped out Samoa's main agricultural crop—which allowed other PICs to move into this lucrative export market. After a respite of about ten years, another cyclone, Heta, hit Samoa in 2004. The tsunami in September 2009 was the latest reminder of the burden on good economic performance resulting from natural disasters in the Pacific. Notwithstanding these setbacks, Samoa has shown considerable economic resilience.

The recovery from these natural disasters and the robust increase in GDP since the mid-1990s, together with the slow population growth as a result of emigration, has meant that Samoa's real GDP per capita has increased by a very healthy 3.0 per cent per annum over this period. GDP per capita in real terms is estimated to have increased from US\$1,000 in 1995 to over US\$2,000 in 2008. As a result, Samoa could soon graduate from its status as a Least Developed Country.

Good economic growth was maintained in 2006 and 2007, with real GDP increasing at 6.2 and 6.4 per cent, respectively. However, the past two years have

been very difficult as a result of the high food and fuel import prices in 2008 and the global economic crisis in 2009, which adversely affected exports, remittances, and tourism earnings. As a result, real GDP is estimated to have declined by 3.4 per cent in 2008 and by 0.8 per cent in 2009. The tsunami that hit American Samoa, Samoa, and Tonga in September 2009 also damaged Samoa's economic growth performance in late 2009 and 2010, as well as causing considerable loss of life and damage to villages and tourist facilities.

The public sector dominates economic activity in Samoa; however, while still small, the private sector has been expanding since the comprehensive economic reforms were implemented. 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 Gross National Income (GNI). In 2008, remittances were equivalent to about 25 per cent of GDP and have been increasing relative to national output (see Table 5.1). 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.

Growth in formal employment has remained weak despite the good overall economic performance but the recent growth of tourism in Samoa has opened up new formal employment opportunities. Yazaki EDS, the Japanese-owned firm manufacturing automotive wiring harnesses for export, is the largest private sector employer (with a high of 4,000 in 1996, but more recently 1,500-

Table 5.1: Samoa—Key economic indicators, 1990-2008

Indicator	1990-93	1995-99	2000-04	2005-08	1995-08
Real GDP growth (%)	-2.5	3.9	4.9	2.4	3.8
Budget balance (% of GDP)	-19.0#	-0.2	-1.3	-0.4	
External public debt (% of GDP)	100.0	71.0	57.2	43.0*	
Inflation rate (%)	6.0	Na	6.0	5.7	
Formal employment ('000)	na	Na	na	53.4	
Remittances (% of GDP)	na	Na	18.4	24.1	

Source: ADB (2009).

Notes: # only for years 1992 and 1993.

* only for years 2005 to 2007.

na = not available

2,000). Similar to the garment industry in Fiji, the development of Yazaki Samoa was based on the preferential market access provided by Australia and New Zealand to the PICs through the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA)—a non-reciprocal trade agreement signed in 1981. Yazaki Samoa was established in 1991 to produce components for the Australian car manufacturing industry and began significant exports to Australia in 1995.

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 (Sialoa 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 policies

The severely deteriorating economic situation that led to the mid-1990s economic reform program can be seen from the performance of economic indicators over the 1990-93 period. For 1992 and 1993 the fiscal deficit averaged 19 per cent of GDP and external public debt averaged 100 per cent of GDP over the 1990-93 period. During this time the current account deficit averaged 13 per cent of GDP. These figures show the difficulties that the government had got itself into through excessive expenditure, particularly through its subsidising of loss-making state-owned enterprises (SOEs). As a result, it had to resort to heavy foreign borrowings. Consequently, 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.

The Government's 1996/97 *Statement of Economic Strategy* outlined the major economic reforms to be undertaken, including trade and investment liberalisation, financial sector liberalisation (removal of controls on credit and interest rates, and strengthening of the central bank), public service reform, and corporatisation and privatisation of SOEs. Between 1987 and 1996, 21 SOEs had been either divested or liquidated. 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. 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. Economic reforms have also included the divestment of agricultural marketing boards and the removal of price subsidies for major crops.

Financial sector liberalisation 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 and in 2004 the liberalisation of international airline services. Between 2002 and the end of 2007, mobile phone access increased from 1.5 per cent of the population to 46 per cent, and internet use increased from 2.2 per cent of the population to 4.5 per cent (Beschoner 2008). There is now almost 100 per cent physical mobile phone coverage of the country. The opening up of the international airlines market involved the sale of the international routes of the state-owned airlines, Polynesian Airlines, to Pacific Blue and allowing competition from other international airlines such as Fiji's Air Pacific. In the wake of this introduction of competition, international airline fares have fallen by up to 50 per cent.

However, the pace of reform has not always been sustained. In particular, reform of the SOEs has lagged (Sialaoa 2003, ADB 2007, IMF 2007). Also, since 2000 there has been a loosening of macroeconomic policies. The government budget has been under pressure because of the continued funding of losses of SOEs, overspending by government departments, and increased public sector investment, particularly in infrastructure—including construction for the South Pacific Games in 2007—as well as significant increases in public service salaries in July 2005 (Sialaoa 2005).

Despite the improved investment legislation as part of the reform program, foreign investment remained close to zero. This lack of response was a puzzling and frustrating issue for government. But with the improved overseas airline services, as the result of the establishment of the Pacific Blue/Polynesian Airlines and Air Pacific/Polynesian Airlines joint ventures in 2004, there are now many more direct flights from Australia and New Zealand. The tourist hotel occupancy rate has soared, inducing interest from international hotel chains. Samoa has constraints on foreign investment in the form of obligations to include local investors in any foreign investment. However, the government relaxed this restriction to allow 100 per cent foreign ownership in the case of resort hotels.

Identifying binding constraints

There is no doubt that Samoa's economic growth performance has improved considerably since the mid-1990s. This improved performance has been closely linked to the comprehensive economic reforms undertaken. How important were the reforms? Which of the reforms were most influential in the improved

economic performance and how were they able to be implemented? What are the binding constraints to even better economic performance? In attempting to identify the binding constraints that were restricting economic growth in Samoa and that may be still restricting growth, we first look for economic constraints within the HRV framework. Later, we examine the role that political and cultural influences may have played, or still play, in underpinning the binding constraints.

HRV identify three areas in which to search for binding constraints to growth: limited access to finance; inadequate returns on investments; and limitations on the capacity of investors to appropriate the returns on their investments. HRV list several areas in which to look for constraints on investors' domestic access to finance as possible binding constraints on investment and economic growth: low domestic savings, poor availability of collateral, controls over bank lending, and risks of banking crises. As far as constraints on access to international finance are concerned, HRV point to the possibility of country risk, restrictions on foreign investment, and regulations of the capital account.

The areas that HRV suggest as possible causes of inadequate returns to investment include: geographical factors; poor human capital; poor, high-cost infrastructure and essential services; labour market interventions that impose high costs on businesses; and high business risks. Poor appropriability of investment returns may be linked to government failure or market failure. Government failure may be due to institutional failure in enforcing contracts, corruption, a too-high or inefficient tax structure, or the risk of appropriation of capital or returns on capital. Government 'failure' may also be in the form of macro-economic policy failure such as unsustainable fiscal and current account deficits, unsustainable public debt, unsustainable monetary policy, and sovereign risk such as political instability. Or it may be in the form of micro-economic policy failure such as restrictions on trade, which may inhibit the adoption of improved or new technology, or restrictions on labour movement (such as restrictions on the use of skilled expatriate labour). Market failures may also hinder appropriation of the returns on investment. These may be in the form of large production externalities or weak incentives for entrepreneurship (such as the traditional communal system in the Pacific).

Binding constraints in the mid-1990s

Prior to 1994, information on Samoa's GDP is very scant. According to data compiled for the Asian Development Bank's (ADB) *Key Indicators* series, GDP in constant prices fell 10 per cent over the period 1990 to 1993. The budget was in deficit to the extent of 16.2 per cent in 1992, 21.9 per cent in 1993, 7.6 per cent in 1994, and 7.0 per cent in 1995. The decline in GDP during this period was directly due to the cyclones of 1990 and 1991. The budget deficits were the result of the increased expenditure to rehabilitate the infrastructure damaged in

the cyclones. Public expenditure rose from an average of 45 per cent of GDP in the late 1980s to 83 per cent of GDP in fiscal year 1992/93 (ADB 2000:23). The government expenditure on rehabilitation eased by 1994/95 but then public finances were adversely impacted by the government's assumption of the debt of Polynesian Airlines, which had run into financial troubles in 1994 and accumulated debt equivalent to about 20 per cent of GDP.

As a result of this expenditure blow-out, public and publicly guaranteed debt rose from US\$91 million in 1990 to US\$157 million in 1994 and to US\$168 million in 1995. However, the impact on the budget of this large public debt was not significant, as most of the debt was in the form of concessional loans from the international financial agencies. Nevertheless, the high level of debt, the government's large role in the economy, and the inability of the economy to grow and be in a position to cope better with these adverse natural events led to concerns about the management of the economy.

External and internal pressure for reform in response to this poor economic performance led to the government's 1996/97 *Statement of Economic Strategy*, which outlined a major set of economic reforms to be undertaken, including trade and investment liberalisation, financial sector liberalisation (removal of controls on credit and interest rates, opening the capital account, and strengthening the central bank to improve prudential supervision), public service reform, and corporatisation and privatisation of SOEs.

Significant reforms of the taxation and import tariff regimes were undertaken over the 1998-2000 period; although there was clearly an intention to reform trade policy prior to this as in 1994 a value added general services tax (VAGST) of 10 per cent was adopted to take the place of customs duties. Overall, the income tax system was broadened and exemptions were reduced. Financial liberalisation began on January 1, 1998 with the removal of all credit ceilings and interest rate controls. New governance arrangements were developed for the corporate sector in the form of the revised Private Companies Act of 2000 and for SOEs in the form of the SOE Umbrella Bill. Later, in 2001, there was the Public Bodies Accountability Act and a subsequent policy paper on 'SOE Ownership, Performance, and Divestment', which laid out the principles for divesting those SOEs not deemed 'strategic' (Airport Authority, Electric Power Corporation, Samoa Ports Authority, Samoa Water Authority, and Samoa Shipping Corporation). But implementation of the divestment framework has proven difficult (IMF 2007).

An ADB (2007) report argues that the binding constraints on growth in the early 1990s were macro-economic in nature. In support of this claim, the report cites the high inflation rate, which at times exceeded 20 per cent, the distortion of the trade regime due to the high and variable levels of tariffs, and the high fiscal deficit. However, it is difficult to find support for the idea that it was

mainly macro-economic management issues that were constraining growth in the early 1990s. The poor GDP performance in the early 1990s was directly due to the cyclones and the macroeconomic crisis that the government found itself in was due to its management of the after-effects of the cyclones. However, it does appear reasonable to argue that the reforms were triggered by the economic management problems of the government and that they directed the government's attention to the important performance issues that it should be dealing with in order to improve the country's economic growth, rather than being so involved in the economy through government businesses. No doubt it was important to adopt fiscal and monetary policies that would provide the private sector with a stable environment for investment and this macroeconomic stability was achieved in the early period of the reforms.

The difficult position that the government found itself in during the early 1990s was the direct result of natural disasters. However, the underlying problem was that the economy was not growing sufficiently strongly to provide the revenues needed to cope with such disasters. Hence, the real constraints on growth that the government had to tackle were the ones that were responsible for the poor performance of the economy even prior to the natural disasters of the early 1990s.

In the period immediately following the reforms, the country's improved economic performance appears to be related to factors other than the reforms. Turning to Table 5.2, it can be seen that real GDP declined on average by 2.5 per cent in the 1990-93 period, when the economy was so heavily affected by the cyclones. The average rate of growth was 3.9 per cent over the following five years and reached a peak 4.9 per cent in the 2000-04 period. In the four years to 2008 the growth rate has averaged only 2.4 per cent. The lower rate of growth in the 2005-08 period was mainly due to the decline in real GDP of 3.4 per cent in 2008 as a result of the difficult external circumstances: the high food and fuel prices and, later, the global financial crisis. The improvement in GDP growth in the 1995-99 period was due to the rapid 7.0 per cent increase in services GDP. The fastest growing services sector in

Table 5.2: Samoa—average real GDP growth rates, by sector, 1990-2008 (%)

Sector	1990-93	1995-99	2000-04	2005-08	1995-2008
Agriculture		1.9	-4.2	-0.2	-1.0
Industry		-0.5	9.7	1.6	3.8
Services		7.0	4.9	2.4	5.3
Total	-2.5	3.9	4.9	2.4	3.8

Source: ADB (2009).

this period was trade, which mainly represented wholesale and retail trade. However, it is not clear what was responsible for this increase in these services. According to ADB (2009), the only major change in the economy recorded in this period was the substantial increase in exports to Australia beginning in 1995. In 1994, Samoa's exports to Australia were valued at US\$0.5 million and total exports amounted to only US\$4.5 million. In 1995 and subsequent years, exports to Australia totaled over US\$50 million and accounted for over 80 per cent of Samoa's total exports. The only possible explanation for this growth in exports to Australia is the establishment of the Yazaki Samoa factory under the SPARTECA preference regime for the purpose of manufacturing parts for sale to the Australian automobile industry. However, there is no growth recorded in the manufacturing sector consistent with the growth in Yazaki's exports. Thus, there appears to be a problem with the statistical recording. Hence, it appears that it was Australia's preferential trade policy that drove Samoa's growth in the 1995-99 reform period, rather than the reforms; just as Fiji's growth in the early 1990s was driven by the establishment of its garment industry under the SPARTECA preferential regime. Perhaps the reformed environment in part led to the factory being set up in Samoa rather than elsewhere.

In the 2000-04 period, both industry and services did well, growing at 9.7 per cent and 4.9 per cent, respectively. In the period 2004-08, growth slowed in both areas, largely as a result of the decline in GDP in 2008 due to the global economic crisis. However, the economic growth that has taken place since 2000 has been rather narrowly-based. The three sectors of the economy that have grown fastest and are now the largest are Trade, Transport and Communications, and Construction. According to Sialaoa (2005), economic growth in the first half of the 2000s was driven by construction and tourism. The tourism was mostly in the form of overseas Samoans visiting relatives and friends. Growth in the construction sector was due mainly to construction of church residential buildings and government spending on facilities for the holding of the 2007 Pacific Games and the construction of the new Development Bank building. As well, through guarantees provided by the Development Bank and the National Provident Fund, the government supported the development of a four-star resort hotel. Thus, it would appear that Samoa's good growth in the first half of the 2000s was largely dependent upon its overseas workers and government expenditure, rather than the economic reforms. As Sialaoa (2005) noted, 'the growth of private sector investment has been very slow'.

Therefore, it is reasonable to argue that up to 2005 the binding constraints to economic growth through private sector development had not been overcome. Many reforms were implemented but these do not appear to have contributed significantly to growth up to that point, although the macro-economic reforms served to stabilise the economy.

The introduction of competition in international airline services in late 2004 seems to have been the trigger to unlocking the potential of the tourism industry. As can be seen from Table 5.3, up to 2004 the growth in tourism numbers was not substantial. However, in 2004 and the years following up to the global recession in 2008, there was significant growth in tourist numbers. Following the opening-up of international airlines services, there has been much greater interest by international hotel chains in building resorts in Samoa.

5.3: Tourist arrivals, 2000 to 2008 ('000)

2000	2001	2002	2003	2004	2005	2006	2007	2008
87.7	88.3	89.0	91.9	98.2	101.8	115.9	122.3	121.5

Source: Samoa Ministry of Finance.

Current binding constraints

It appears likely, therefore, that while macro-economic instability was a problem prior to the mid-1990s' reforms, it was probably not the binding constraint to private sector growth. The lack of competition in international airline services appears to have been the binding constraint on private investment in tourism and related activities. Infrastructure development on the main island and the opening of the telecommunications sector 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 SOEs may not be a binding constraint, as entrepreneurs may still be able to develop profitable ventures in 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 constraints as there is no possibility that competitive substitutes can be found. The same also appears to be true of telecommunications monopolies with respect to many economic activities, as government can effectively prevent the operation of telecommunication competitors and substitutes. Thus, as Duncan (2004) has argued, the monopolisation of Pacific telecommunications until recently effectively locked out the PICs from the 'second industrial revolution' of the 1980s and 1990s when cheap telecommunications allowed firms to locate different activities in those countries with the lowest costs. The low-cost telecommunications allowed firms to run globally-dispersed activities economically from a central office. The PICs may have missed out on the great wave of industrial fragmentation but, hopefully, there are still some activities in which they may be able to find market niches now that their telecommunications costs are much lower.

But what are the other constraints that inhibited private sector development in the 1990s and do so currently?

The ADB (2007) report argues that the binding constraints to improved growth currently are micro-economic in nature, including the following:

- Too much state intervention in the form of monopoly SOEs, which is raising business costs;
- Property rights, particularly to land, are not well-defined. A system for secure leasing of custom land would provide a more secure basis for business development, including in agriculture, as well as collateral for access to commercial credit;
- The financial sector is ‘thin’ and the cost of finance is high, which is related to the weak property rights to land and the consequent lack of security for loans;
- The commercial legal system is costly;
- The failure of the agricultural sector due to weak property rights and excessive state intervention in agricultural production;
- The approval process for foreign direct investment (FDI) is opaque and *ad hoc*. Barriers to the hiring of skilled expatriates need to be relaxed; secure land leases should be made more easily available to foreign investors; and investment incentives should be eliminated and instead the government should focus on making the investment environment more enabling and low-cost so that it becomes more internationally competitive;
- Consultation between the government and the private is poor.

This is a substantial list and does not provide any priorities for action with respect to relaxing the constraints. Below we use the HRV framework to see what possible constraints there may be to the development of the private sector and what the priorities should be for tackling them.

Access to finance

Do the large fiscal deficits and government borrowings in the early 1990s mean that in the period leading up to the reforms and subsequently the government inhibited domestic investment by soaking up domestic savings? 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 liberalised as part of the reform program. However, over the period from 1995 to late 2008 there were no 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. From late 2008 there was a sharp reduction in official inter-

est rates as part of the government's fiscal and monetary response to the global economic crisis.

While Samoa has by far the highest deposit interest rate among the PICs, its rate is on a par with rates in Australia and New Zealand—which would seem to be desirable to prevent the outflow of savings to these neighbouring countries, provided there are investment opportunities within the country. Thus it would appear that private investment in Samoa has not been constrained by a scarcity of domestic savings.

There are two foreign-owned and two locally-owned commercial banks. There is also a state development bank and the National Provident Fund. The National Provident Fund lends to Samoans, using their fund contributions as security for the loans. The commercial banking sector is dominated by Australian commercial banks. Hence, the risk of a banking crisis is not a constraint on lending. Credit ceilings were eliminated as part of the 1990's economic reforms.

As far as the availability of collateral to support borrowing is concerned, Sialoa (2001), ADB (2007), and IMF (2007) note that land tenure remains insecure in Samoa. With around 80 per cent of land subject to communal ownership, long-term leasing to individuals or corporations is the only feasible way in which such land can fulfill its economic potential. However, such leases are difficult to arrange and to enforce. Hence, land leases over custom land are of no use as collateral for loans and of little use as a basis upon which to build a business. None of the commercial banks in Samoa lend against leases over customary land. There has been some improvement in the availability of secure long-term leases of customary land for resort development in response to the blossoming tourism industry. Still, for small investors the ability to access credit is difficult without good collateral. Both ADB (2007) and IMF (2007) argue that the high cost of finance—primarily due to the lack of collateral—is a major constraint to faster growth.

Thus it appears that the lack of a regime within which to provide secure, long-term leasing of custom land is a significant constraint on economic growth because of the way in which it restricts both domestic and foreign investment.

Inadequate returns to private investment

There is no doubt that all PICs labour under the high costs of their remoteness from major markets and major transport routes as well as the smallness of their domestic markets. For these reasons they have to find and develop international market niches in which they can earn prices high enough to cover their cost disadvantages. For this reason too they need to reduce the costs that they can affect to as low a level as possible. They should also try to take advantage of

those markets that are not impacted by physical distance. Hence, they should make the best use possible of markets that are based on telecommunications. It is for this reason that opening up the telecommunications sector has been so important in the Pacific.

While Samoa's geographical situation is similar to that of other PICs, it is better placed with respect to agricultural pursuits than the atoll and reef islands. 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 road infrastructure has also helped in 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.

Infrastructure and essential service costs do appear to be high and reducing returns to investment. These high costs appear to be largely a result of government involvement in the activities. Electricity is a high-cost and unreliable government-operated service, which means that businesses have to invest in back-up facilities. According to ADB (2007), there is considerable scope for improvement in the efficiency of other infrastructure and essential services through reducing government intervention in these activities. These include ports, airports, domestic shipping, and domestic airlines. The benefits flowing from the opening up of international airline services and telecommunications should lend encouragement to introducing competition into these other activities and thereby reduce business costs.

Education and training 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.

Appropriability of capital and investment returns

The risk of appropriation of a foreign investor's capital or returns on investment does not appear to be high. While according to Transparency International (2004) there are concerns about corruption, it does not appear to be at a significant level and should not adversely affect investment. As part of Samoa's reform program, investment legislation was substantially reformed. But the regulatory and judicial costs of doing business in Samoa are still relatively high by international standards and have not been improved for several years. For instance, according to the World Bank/International Finance Corporation's *Costs of Doing Business* surveys, the amount of time taken to register a property (147 days) and the time taken to enforce a contract (455 days) was the same in

2009 as it was in 2006. Both ADB (2007) and IMF (2007) argued that the environment faced by foreign investors in starting a business in Samoa is difficult, including the restraints on use of skilled expatriate labour.

There was one improvement in the business regulatory environment in 2009. Samoa's new Company Act simplified the business start-up process. It reduced the start-up process by four procedures, 26 days, and more than 75 per cent of the costs of starting a business. Furthermore, according to *Doing Business 2010*, the new law also removed the minimum capital requirement and simplified various other procedures.

Thus it appears that the environment for foreign investment is not especially friendly, with the rules and their application rather opaque and the restrictions on visas for expatriate workers constraining their use. Unwillingness to welcome skilled expatriate workers can have a dampening effect on the introduction and application of new and improved technologies that could reduce costs and open up new markets.

What binding constraints have been overcome?

It is difficult to find support for the idea that it was mainly macro-economic problems that were constraining growth in the early 1990s. The poor GDP performance in the early 1990s was directly due to the cyclones and the macroeconomic crisis that the government found itself in was due to its management of the after-effects of the cyclones. However, it does appear reasonable to argue that the reforms that were undertaken were triggered by the economic management problems faced by the government. They directed the government's attention to the important economic performance issues that it should be dealing with in order to improve the country's economic development, rather than being so involved in the economy through government businesses. No doubt it was important to adopt fiscal and monetary policies that would provide the private sector with a stable environment for investment and this macroeconomic stability was achieved in the early period of the reforms.

The difficult position that the government found itself in during the early 1990s was the direct result of natural disasters. However, the underlying problem was that the economy was not growing sufficiently strongly to provide the revenues needed to cope with such disasters. Hence, the binding constraints on growth that the government needed to tackle were the ones that were responsible for the poor performance of the economy even prior to the natural disasters of the early 1990s.

It appears that it was Australia's preferential trade agreement, SPARTECA, that drove Samoa's growth in the 1995-99 early reform period. Further, Samoa's good growth in the first half of the 2000s was largely dependent upon its

overseas workers' remittances and government expenditure, rather than the economic reforms. Therefore, it appears that up to 2004 the binding constraints to economic growth through private sector development had not been overcome. Many macro-economic reforms were implemented but these do not appear to have contributed significantly to growth up to that point, although the reforms served to stabilise the economy. However, the introduction of competition in international airline services in late 2004 seems to have been the trigger to unlocking the potential of the tourism sector.

The ADB (2007) report appears to have pinpointed the major binding constraints to faster economic growth in Samoa. But the major question is that of the necessary sequencing in addressing the constraints. Several of the constraints the ADB report identifies are very closely related. Unless there is security of land tenure such that commercial banks are willing to accept it as collateral for loans, credit will not be available to domestic and foreign investors, including in the agricultural sector. The key is to make the leases fully transferable so that the commercial banks are willing to use them as collateral—as the Fiji experience demonstrates. The 'thin financial sector' that the ADB report identifies is also closely related, as without the capacity to have secure title to land as the major form of collateral, a country cannot really develop a mature financial sector—land titles are by far the major form of collateral for commercial loans.

As the ADB report says, the failure of the agricultural sector to develop is a major factor underlying the poor economic growth in Samoa over many years. This failure is also closely tied to the absence of secure individual title to customary land—which comprises around 80 per cent of all land—and, in turn, the absence of collateral for access to commercial credit.

The other binding constraints that the ADB report identifies appear secondary to the absence of secure individual title to land and the related issues. The higher costs inflicted on business by the existence of SOEs, the inefficient legal system, and the inhibitions on foreign investment are obstacles to business, but they are not such severe obstacles to growth as the lack of secure title to land and its related issues. Nor would removing them contribute much to growth in the absence of the secure individual access to land that would allow investors to take advantage of their relaxation. Therefore, it appears that providing secure individual title to native land is the most important priority for reform. Improved access to commercial credit, a more developed financial sector, and improved agricultural productivity will follow as a result of mobilising land for development through providing tenure security. Making provision for long-term leasing of native land appears to be the best way of mobilizing native land for development, as has existed in Vanuatu since independence, as has existed in Fiji since the colonial administration, and as has recently become available in Papua New Guinea through the passage of amended land legislation.

According to the reports of the IMF (2007:13) and ADB (2007:33-4) the Samoan Government has begun public consultations on the way forward in making custom land generally available for lease.¹ Reform of tenure over custom land is a very sensitive issue and will need to be addressed carefully. Much can be learned about how to approach reform in this area from the experience of Papua New Guinea in reforming its legislation applying to the leasing of custom land (see Yala 2010). However, the Samoan Government itself has already been able to undertake considerable economic reform from which lessons can be drawn. Therefore, in the next section we examine the reforms undertaken in the past two decades in Samoa to see how the reforms were carried out and what lessons there may be for land and related reforms.

The Political Economy of reform in Samoa

The governing Human Rights Protection Party (HRPP) dominates Samoan politics. It first came to office in 1982, led by the late Hon. Tofilau Eti Alesana, and has been in power on a continuous basis since 1991. Hon. Tuilaepa Lupe-soliai Sailele Malielegaoi was appointed Prime Minister in November 1998 after Hon. Tofilau resigned due to failing health.

The HRPP was established in 1979 and, at its inception, became the official opposition party to the government of the day led by Prime Minister the Honourable Tupuola Efi. That government, through its use of the powers of a Commission of Inquiry as a political instrument to cause the arbitrary and prejudicial dismissal of senior public servants, gave rise to the name of the new political party—the Human Rights Protection Party. In 1981, with government finances exhausted, a wage increase sought by public servants could not be met. This resulted in a Public Servants' Association's general strike in 1981, which lasted for three months. Basic foodstuffs were in acute short supply. Samoan people were forced to stand in long queues to buy basic necessities such as rice and canned fish. The low pay of civil servants and the hardships faced by the general populace led to growing discontent with the Tupuola Efi government. In December 1982, when the HRPP took over government under the leadership of Hon. Tofilau Eti Alesana, it was faced with the massive task of rebuilding the national economy and replenishing the government's coffers.

Later, there were further setbacks to the economy as a result of major natural disasters. In 1989, heavy floods caused extensive damage to the country's roads and bridges. This was followed by cyclones Ofa in 1990 and Val in 1991, and the gale force winds of Lyn in 1993, which caused unprecedented devastation within the space of a few years to the whole of Samoa. As well, in 1993 taro blight wiped out the taro industry, the country's most important export. The HRPP placed greater emphasis on villages and rural districts, economic development, and safeguarding the integrity of the Samoan culture and traditions.

The thrust of the HRPP reforms was to achieve good roads, electricity, piped water, and overall improvement of life in the villages and rural areas.

The strong Samoan identity has featured prominently in sustaining the reform program. Samoan culture is referred to as *Fa'a Samoa*, the Samoan Way, an all-encompassing concept that denotes the obligations that a Samoan owes to family, community, and church, and the strong sense of pride in Samoan identity and the respect that it commands.

Fa'a Samoa is also evident in the existing dual legal system: the Western-style legal system administered by the police force and the justice department as part of the central government, and the traditional system administered at village level through the village councils—the local government. Members of the village council (*fono*) are elected from and by members of each village. A government representative, called the Mayor, presides over the village council. The 1990 Village Fono Act gives village councils authority over village law and order, health, and social issues. There have been instances where the two systems come into conflict but, generally, they work smoothly.

The traditional leaders, with *Matai* titles, are heads of their family units and hold the land titles. They are also the only people eligible to stand for parliament; so there is a strong link between government decisions and their implementation at the village level. Within each village, every family has a *Matai* who is a member of the *fono* and represents the interests of the family. The *Matai* is responsible for everything that involves the family: land, assets, disputes, and well-being. There are some 18,000 *Matai* in Samoa, both males and females. Up until 1991 it was only possible for *Matai* to vote in parliamentary elections. It thus became a relatively common practice for prospective parliamentary candidates to ensure that members of their constituency received titles so as to increase their share of the vote. Universal suffrage was introduced in 1991.

Samoan cultural tradition hinges on reciprocal obligations between extended family members and between the *Matai* and their people. This strong sense of reciprocity has often come under scrutiny from the Western perspective of corruption, nepotism, and clientelist politics. Nonetheless, the strong Samoan cultural foundation has played a crucial role in implementation of the reform agenda. In the interviews undertaken for this study, this point was strongly asserted by the current Prime Minister Tuilaepa and the Deputy Prime Minister Hon. Misa Telefoni. The Public Service reform champion, Faamausili Dr. Matagi alofi Luaiufi, was adamant that the reforms were successful due to their united front and collective pride in *Fa'a Samoa* and the staunch belief in their cultural values and identity. The Acting Chief Executive Officer for the Public Service Commission, Mika Kelekolio, agreed that culture played a large part in making the hard decisions more palatable and helping people buy into the vision.

The reform process, which began in the late 1980s, was revitalised in 1993 in the recovery from the 1990–1991 cyclones, when Samoa's first *Statement of Economic Strategy* presented the framework for an economic and public sector reform program aimed at promoting private sector development and improving the efficiency of the public sector. As observed by Knapman and Saldanha (1999), the reform program was implemented in a gradual, sequenced manner. The late Prime Minister Tofilau Eti was described as a visionary and decisive leader and, although he had limited education, he was someone who listened well. Under his leadership, the reform period from 1991 to 1998 was considered 'the years of sacrifice': no frills, no benefits, no increments. He asked civil servants to sacrifice their entitlements for the benefit of the country. His vision was focused on rebuilding the country and the economy, and on everyone enjoying the benefits of economic growth. Due to Tofilau's ill health, Tuilaepa took over the reins of leadership and continued with the economic and public sector reforms.

Prime Minister Tuilaepa is considered to be the driving force behind the reforms. He is an economist by profession, having obtained a Master of Commerce degree from the University of Auckland, the first Samoan to do so. Hon. Tuilaepa was the Deputy Prime Minister and Minister of Finance under Hon. Tofilau Eti. This smooth leadership transition contributed to continuity in the reform program.

As Minister of Finance in 1998, Hon. Tuilaepa pushed Prime Minister Tofilau for reforms and he credits Tofilau for having full confidence in his advice and the smooth handover when he became Prime Minister. He said that it was relatively easy to push through reforms such as the corporatisation of telecommunications, which he considered his major reform achievement. By retaining the Finance portfolio after taking over the Prime Ministership and championing the financial sector reforms, Tuilaepa pushed reform commitments in this area with the support of senior management in Treasury.

A leading Treasury official who championed the economic and financial reforms was Epa Tuioti, Financial Secretary during the period from 1990 to 1999. In reflecting on his motivation for supporting the reforms, he mentioned having attended international meetings where references were made to the 'Pacific Paradox' of low growth despite high levels of aid (World Bank, 1993), and finding it uncomfortable to be at the receiving end of the criticism. This made him quite determined to 'break away from the pack' (as he put it) to do something different. His motivation was to demonstrate that 'they' could do it. In this regard, he realised it would not happen overnight and that it was best to start with his own portfolio in financial management and, as a central agency, he would then be able to demonstrate the value of reforms to line agencies. He felt strongly that he could not tell other ministries to change without first reforming his own ministry.

The reforms commenced with the introduction of the value added goods and services tax (VAGST) in 1993. There was opposition through public demonstrations but the reforms had solid support from the Prime Minister and Cabinet. Resistance to reform came from opponents from within who questioned the need for wholesale changes rather than fine tuning. Epa Tuioti reflected that there were numerous internal discussions and that he had invested in developing good relations with other CEOs. This, he stressed, was a key lesson: in order for reforms to be successful, they needed the cooperation of stakeholders; and he worked hard at ensuring that line ministries were engaged.

Accompanying the economic reforms were reforms to restructure the public service: the reduction of ministries from 27 to 14 and the introduction of employment contracts for the top two layers of management. The Chairperson of the Public Service Commission at the time was Hon. Fiame Naomi Mata'afa, the first woman to serve in Cabinet under Tofilau Eti. Fiame Naomi was Minister of Education for 15 years (three terms) and is the current Minister of Women, Community and Social Development. She is one of the most senior members of Cabinet and the only female member. She is the daughter of Samoa's first Prime Minister and was pursuing studies in New Zealand when she was recalled by her extended family to take up one of her father's titles. Following her father's death, her mother became Member of Parliament for the constituency of Lotofaga. Subsequently, Fiame Naomi took over as the member.

As Chair of the Public Service Commission and Minister of Education, Hon. Fiame Naomi drove the education reforms, including introducing a key policy change of use of the Samoan vernacular as a language of instruction. Her motivation for supporting the reforms was that her father had died and she was expected to return to Samoa to take up his role, which she did in 1985. At the time, she saw that the country was faced with a very serious financial crisis and needed change. Hon. Fiame Naomi stated that it was a partnership that drove the reforms, assisted by the executives who worked closely together in managing the crisis and who made a big push for tangible evidence of the benefits.

Implementing the public service reforms at executive level was reform champion Faamausili Dr. Matagalofi Luaiufi, former CEO of the Public Service Commission, who had been hand-picked by Prime Minister Tofilau Eti in 1998 to drive the public service reforms. Dr. Matagalofi considered Tofilau to be visionary in recognising her leadership potential and entrusting her to drive the public service reforms. She had studied in the UK and was greatly influenced by Margaret Thatcher's reforms. But she was determined that the Samoan reforms would be driven from within; she believed that ownership was a strong factor in the success of the reforms. What motivated Dr. Matagalofi was being a change agent. Having the backing of the Prime Minister and the Chairman of the PSC, she was able to drive the reforms through. She stated that it helped

that parliamentarians were supportive, as they wanted to see changes in the public service. Taking advantage of the parliamentarians' support, they conducted public consultations to inform the public of the reforms.

Another reform champion identified by this study was Brenda Heather-Latu, former Attorney General, who worked closely with Dr. Matagi alofi and Epa Tuioti in providing support to the reforms and led the development of the necessary enabling legislative frameworks such as deregulation. She was a member of the Cabinet Steering Committee and gave day-to-day support to the executives leading the legal and regulatory implications of the changeover. The whole government was in a fever of reform and even though they would hit obstructions from Ministers and ministries, the reform fever and political support from the Prime Minister meant they were able to push the reforms through.

Brenda Heather-Latu stated that, for her, one of the incentives to promote reform was the availability of donor funding support, especially from AusAID; so that they were able to maximize all the opportunities available, such as having access to consultants in Canberra to draft legislation. The mood was generated by opportunities. Demonstrated benefits such as completion of airport, roads, and bridges helped. She also credits the success of the reforms to culture—the Samoans' strong sense of identity. She stated that donors would try to roll out a reform template; but they would receive a violent reaction. A great deal of trouble was taken to negotiate and customise the reforms: this, she said, was the main reason for success.

Public consultation, participation, and ownership

Processes were undertaken to plan, design, and implement the reforms. There was a Cabinet Steering Committee that provided oversight and kept Cabinet well informed. The close liaison between the officials, including ensuring that supporting legislation was aligned to the reforms, worked well.

Wide public consultations and an effective public relations strategy contributed to broad acceptance of the reforms. There was strong communication of the purposes and nature of the economic reforms, specifically, the formulation and dissemination of the *Statement of Economic Strategy*. This involved a public information campaign with the participation of the local financial community, which generally approved of the financial sector reforms and expressed satisfaction with the consultative process. Meetings were held in Samoan to explain the benefits of the reform program. Evidence of infrastructure development such as airports, roads, and bridges helped to convince the public of the benefits of the reforms.

NGOs in Samoa operate under SUNGO—the Samoan Umbrella of NGOs. There is general agreement on the importance of a well-led and fully-

empowered umbrella organisation and SUNGO has earned recognition as a strong, vibrant organisation providing excellent leadership, resources, and essential human resource development and training for all NGOs. SUNGO's efforts have been recognised in lifting NGO accountability and record-keeping and enabling access to essential funding from donors. While NGOs have contributed to the shaping of strategies adopted by the government, and SUNGO feels that there has been a greater attempt by the government to consult with NGOs, it is felt that it is largely to rubber-stamp what the government has already decided.

Overcoming resistance to the reforms

The Samoan reforms were primarily resisted by civil servants, who were under the threat of job losses resulting from the reduction of ministries. Ten CEOs lost their jobs as a result of the reforms. When the HRPP government introduced the VAGST, it was met with street protest marches. Further protest marches were held in 1997 and 1998 in efforts to oust the HRPP government. However, due to the political will and support of Cabinet and parliamentarians, the reforms were pushed through. Redundancies were minimised by redeployment. Although there was resistance to the use of employment contracts for senior management, opening up the top two levels of CEO and Assistant CEO by putting people on three-year performance contracts, created career paths. Pay increases as high as 46 per cent have also made public service positions more attractive.

Poor performance by government workers has been a hindrance to implementing reforms and development projects. The introduction of performance contracts for the top two management levels of government and a robust appraisal system were introduced to promote better civil service performance. External advertising of job vacancies made these positions more competitive and not exclusive to civil servants. Earlier in the reform process, there was an explicit strategy to recruit young graduates and New Zealand-born Samoans as part of the strategy of opening up to competition.

Discussions undertaken for this study found widespread views that there are aspects of the reforms that have neither been fully undertaken nor completed, such as the privatisation of SOEs and complete decentralisation of the authority exercised by the Ministry of Finance and Treasury. In particular, CEOs in the line ministries have not been given the full financial delegation promised. There are also questions as to whether the benefits of the reforms have trickled down to the village level. Some of those interviewed argued that a social impact assessment study is warranted to answer this question.

Potential obstacles to further reform

The HRPP's long-term hold on power in Samoa is leading to some disquiet. There is a view that the government has been in power for too long and does what it wants. The recent 'road switch' is an example of where there has been strong opposition from the public and the business community, but the government is said to have railroaded it through. Only time will tell whether the HRPP is able to continue to withstand such opposition. The recent formation of the People against Switching Sides (PASS) movement and the formation of new political parties reflect mounting public opposition and it will be interesting to see how this will be manifest in the 2011 elections.²

Another potentially explosive issue, which has raised opposition, especially from NGOs and SUNGO, is the exploration of options for the leasing of customary land. A strong view upon which opposition is based is that customary land will be lost to big business. Although there have been public consultations, there is growing opposition to land registration and leasing and it will be difficult to persuade villagers to allow their land to be leased for long-term investments.

Conclusions

The idea that it was mainly macro-economic problems that were constraining growth in the early 1990s does not appear to be sustainable. The poor GDP performance in the early 1990s was directly due to the cyclones and the macro-economic crisis that the government found itself in was due to its management of the after-effects of the cyclones. However, it does appear reasonable to argue that the reforms that were undertaken were triggered by the economic management problems of the government and that they directed the government's attention to the important economic performance issues that it should be dealing with in order to improve the country's economic development. No doubt it was important to adopt fiscal and monetary policies that would provide the private sector with a stable environment for investment and this macroeconomic stability was achieved in the early period of the reforms.

However, the underlying problem for the government was that the economy was not growing sufficiently strongly to provide the revenues needed to cope with such disasters. Hence, the binding constraints on growth that the government needed to tackle were the ones that were responsible for the poor performance of the economy, especially in agriculture, even prior to the natural disasters of the early 1990s. However, the introduction of competition in international airline services in late 2004 seems to have been the trigger to at least unlocking the potential of the tourism sector through private sector development.

The ADB (2007) and IMF (2007) reports appear to have pinpointed the major binding constraints to faster economic growth in Samoa. But the key question is that of the necessary sequencing in addressing the constraints. Several of the constraints that these reports identify are very closely related and follow on from one another. Unless there is security of land tenure such that commercial banks are willing to accept it as collateral for loans, credit will not be available to domestic and foreign investors, including in the agricultural sector. The 'thin financial sector' is also closely related, as without the capacity to have secure title to land as the major form of collateral, a country cannot really develop a mature financial sector. Therefore, it appears that providing secure individual title to native land is the most important priority for reform. Improved access to commercial credit, a more developed financial sector, and improved agricultural productivity will follow as a result of mobilising land for development through providing tenure security. Making provision for the long-term leasing of native land appears to be the best way of mobilising custom land for development.

The Samoan government has begun public consultations on the way forward in making custom land generally available for lease. Reform of tenure over custom land is a very sensitive issue and will need to be addressed carefully. However, the Samoan government itself has already undertaken considerable economic reform from which it can draw lessons with respect to how to go about land reform.

Prominent in the reforms that have been successfully undertaken was strong, visionary leadership and the alignment of purpose and the partnership between public sector leaders at political and senior civil service levels. The key players had common backgrounds: they were technically qualified, had studied overseas, were convinced of the need for reforms, and were strong in their cultural identity. They worked as a tight team. Additionally, continuity in leadership was crucial for an enabling reform environment.

The chances of successful implementation are increased in a stable political environment in which the champions of reform can remain focused and do not have to risk jeopardising reform in order to retain power. There must be political will for the reform policies and, equally important, the political leaders must be supported by technically competent executives and managers who can drive the reforms from the top down and operationalise them through the machinery of the government.

Further, shared responsibility for the reforms was achieved through public consultations that brought all the stakeholders together to determine the implementation of the reforms. Moreover, culture has been a foundation for building and sustaining reforms. Samoa has engineered its own model of development in which they have been able to package reform with a strong and proud Samoan identity.

If Samoa is to design and implement a system for the long-term leasing of custom land, a 'champion' of the reform, possibly preferably a political champion, will have to arise. This will involve someone or a group of leaders becoming convinced of the long-term benefits of the mobilisation of custom land through leasing; and they will have to be supported by senior officials who are equally convinced of the benefits of such a system. Hence, the next task is to make a convincing case of the benefits of a system for the long-term leasing of custom land.

Notes

- 1 The ADB has begun a technical assistance project on Promoting Economic Use of Customary land in Samoa, which is assisting with improvement of the land administration system and the availability of information on customary land titles and boundaries.
- 2 The PASS group formed in opposition to the government's controversial decision that the country would switch from driving on the right-hand side of the road to the left-hand side. After several protests and petitions, PASS filed a legal challenge alleging, *inter alia*, that the switch was a breach of the right to life (enshrined in Article 5 of the Constitution). This challenge was rejected by the Supreme Court. A last-minute plea from PASS to postpone the switch was rejected by Cabinet, and, as of 7 September 2009, cars drive on the left in Samoa, the first country to switch the flow of traffic from one side of the road to the other since Iceland and Sweden in the 1960s.

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Chapter 6

Kiribati: A Political Economy Analysis of Constraints to Economic Growth

Ron Duncan

Introduction

This study of the constraints to economic growth in Kiribati combines the use of the binding constraints approach of Hausmann, Rodrik, and Velasco (2004, 2005, and 2006) and the Institutional Analysis for Development (IAD) approach of Ostrom *et al* (2001). The focus of the Hausmann *et al.* approach is on identifying the binding constraints to economic growth, with the expected outcome a listing of priorities of where to focus economic reform efforts in order to establish a favourable environment for investment and growth. But the Hausmann *et al.* diagnostic approach does not provide much assistance to understanding of how to go about overcoming the binding constraints. Therefore, the IAD framework is used here to extend the Hausmann *et al.* analysis into a study of the political economy of Kiribati in order to gain an understanding of the interactions between the economic, political, cultural, and social characteristics of the country. (See Chapter 1 for a fuller discussion of the Hausmann *et al.* and IAD approaches.)

The IAD analysis is expected to provide insight into whether the economic constraints identified by the Hausmann *et al.* analysis are an outcome of obstacles to growth at the underlying 'institutional' level rather than the economic constraints identified through the Hausmann *et al.* framework being primarily responsible for the difficulties experienced with achieving economic growth. As the IAD analysis also provides understanding of the incentives to which the various stakeholders are responding, it is also expected to provide insights into how these incentives may be changed in order to achieve changes in the economic constraints.

This chapter first provides an overview of the economic performance and policies of Kiribati—one of the poorer performing economies in the Pacific. It then uses the Hausmann *et al.* framework to identify the binding constraints to better economic performance. The binding constraints analysis is followed by a study of the political economy of Kiribati within the IAD framework to gain an understanding of the primary actors in the economy, the incentives that are dictating their behaviour, whether and how their behaviour is leading to the economic constraints observed, and of how the incentives, or institutional 'rules of behaviour', may be changed in order to change the economic con-

straints. The IAD analysis described here was the outcome of in-country interviews and discussions that are more fully reported in Duncan (2009).

Country Background

Kiribati, a former British Colony, comprises 33 small atoll islands spread out over a vast ocean area of 3.5 million square kilometers, which is the largest exclusive economic zone (EEZ) of all the Pacific island countries. Its location is also unique as it is the only country in the world that straddles both the equator and the international dateline. In contrast to its marine resources, the country 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 estimate of Kiribati's population in 2009 was 99,500 (ADB 2010). The total fertility rate (average number of births per woman) is still high at 3.4 (2005 estimate) and therefore the population is still growing fairly rapidly (estimated to average 1.8 per cent annually in recent years). As a result, the population is relatively young, with the population aged 0-14 years estimated at 35.8 per cent in 2008. Rural-urban migration has been rapid and it was estimated that 43.6 percent of the total population was residing in the capital South Tarawa in 2005. It is likely that the percentage is now even higher. The resulting high population density on South Tarawa 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 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 a recent 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 patronage politics than with the power of traditional authority.

Economic performance and policies

Economic performance

As can be seen from Table 6.1, the past five years have been tough years for I-Kiribati. Real GDP growth has been close to zero. Therefore, with population increasing, real GDP/capita has declined by 1.7 per cent annually over this period, which wiped out the annual gain of 1.5 per cent over the previous five years. The high global fuel and food prices of 2007-08 contributed to the decline in real GDP and real GDP per capita, and are also reflected in the recent high current account deficit. Per capita Gross National Income (GNI),¹ which includes overseas earnings on the Revenue Equalisation Reserve Fund (RERF) and remittances, was estimated at US\$2,040 in 2008. This compares with US\$2,820 for Samoa and US\$1,040 for Papua New Guinea. The Australian dollar is the official unit of currency and the main medium of exchange.

While they do not have easy emigration access, remittances are 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 nurses are also training in an Australian aid-funded scheme, with the intention of them working overseas and providing remittances.

Over the 2002-2006 period, Gross National Income (GNI) averaged around 85 per cent more than GDP (ADB 2009) because of the remittances from overseas workers, revenues from licences to distant water fishing nations to fish for tuna in Kiribati's EEZ, and earnings on the RERF.² However, all of these sources of

Table 6.1: Kiribati—Key economic indicators, 1990-2009

Indicator	1990	1995	2000-04	2005-09
Real GDP growth (%)	2.1	-1.0	3.1	0.2
Real GDP/capita growth (%)	-1.3	-2.4	1.5	-1.7
External public debt (% of GNI)				10.5
Inflation rate (%)	10.2	4.1	2.1	4.4
Current a/c balance (% GDP)				-16.4
Remittances (% of GDP)				6.4

Source: ADB (2010).

overseas revenue were adversely affected by the global economic crisis. Because global trade suffered in the crisis, employment of merchant seamen has been depressed, as has the demand for tuna. The earnings on the RERF were also badly hit by the global economic crisis, although earnings on the Fund have recently recovered to some extent.

It is estimated that the services sector contributes about 63.5 per cent of total value added, while agriculture and fishing contribute about 27.5 per cent and the industrial sector about 9 per cent (ADB 2010). 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).

Public services and essential services are very high-cost activities because of the widely dispersed islands and the small communities living on them. On these sandy, low-lying islands there is very limited capacity to manage waste, which, along with the poor situation with basic services, limits their attractiveness for most forms of private investment.

The private sector is very small, mostly consisting of wholesale monopolies, retailers, and transport firms. Government is the major employer. As well as its employment of public servants, the government operates around 28 state-owned enterprises (SOEs) in most economic activities.³ 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) noted, government employment in Kiribati is seen as a way of distributing income to extended families. In the early 1990s the government offered several SOEs for sale but, while offers were made, all sales 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 I-Kiribati to work for an individual, as it is seen as demeaning. It was also noted that individualism is frowned upon in this highly egalitarian society.

Economic Policies

Direct (income and company tax) and indirect taxation (import taxes) averaged only 36 per cent of total government revenue in 2006. The major part of government revenue comprised fishing licence fees (33.5 per cent) and draw-

down from the RERF (24 per cent). With prudent management and favourable investment markets, the RERF built up significantly over the years; but since 2001 drawdowns from the Fund have been used to buffer fluctuations in government revenues, which are highly volatile due, in particular, to fluctuations in fishing licence fees and in exchange rates.⁴ 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 government revenue) to A\$46.6 million in 2001 (54 per cent of total revenue). They were been relatively low and declining in the 2004-2006 period—falling to A\$33.5 million in 2006.

Purfield (2005) has described how government expenditure rose sharply in 2001, leading to drawdowns from the RERF. Expenditure has continued to increase faster than revenue and RERF drawdowns have continued. Together with the generally lower stock markets values over the past decade, the value of the RERF as a store of value for future generations is under a serious cloud (ADB 2009).

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. As noted above, there are some 28 government business enterprises (GBEs) operating in export and import activities, housing, manufacturing, tourism, banking, transport, communications, and essential services. Most of these make losses consistently and are subsidised directly or receive concessional loans underwritten by the government. While it is not clear from the budget details, the sharp increase in 'Other' expenditure in 2001 and subsequent years was most likely due to the need to cover the losses on the SOEs. The government also subsidises copra production through support of copra prices, both to compensate for the very high outer island transport costs and when world copra prices decline. As Throsby (2001) has noted, the extent of SOE operations and the direct and indirect government support of SOEs must have a chilling effect on private business. However, privatisation of SOEs continues to be strongly resisted.

There appears to be little effort on the government's part to make the SOEs more efficient by, for example, reducing the obvious 'over manning' of positions. As noted in ADB (2002), jobs in the public service and public sector, which account for over two-thirds of wage employment, are seen as a means of community income support in recognition of the relatively low numbers of formal jobs. As a result of their large share of the formal workforce, public sector employees are a strong political force. It seems that the existence of the SOEs and control of their prices essentially form part of the government's efforts to satisfy society's demand that government meets all their needs.

Public investment is mainly financed by donor grants and concessional loans from international financial agencies. As a result, public debt is not significant.

Foreign aid is a very important part of Kiribati's government financing. 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 private sector is very small, mainly comprising passenger buses, small retail stores, fish and vegetable marketing and food stalls, second-hand clothing, travel agencies, a hardware store, and exporters of marine products such as tropical aquarium fish. The profusion of small passenger buses that transport people around South Tarawa points to an area of private sector growth, even though prices are controlled. The private sector is also involved in inter-island shipping services, with most run by churches and villages. This form of private sector participation could be a reflection of the collectivist nature of the society, whereby it is more comfortable with developing private enterprises run in a cooperative manner rather than by individuals.

As Kiribati uses the Australian dollar and sources most of its imports from Australia, the inflation rate is linked to Australia's and has been reasonably low and stable and stable. However, the high food and fuel prices of 2007 and 2008 must have raised prices considerably as Kiribati is almost completely dependent on petroleum products for power and transport and I-Kiribati have become dependent upon rice as a dietary staple.

Identifying binding constraints to private investment

Access to finance

The relatively large size of the RERF—valued at A\$632 million in 2005 and equivalent to around six times the size of GDP—together with the large amount of foreign aid received and an average foreign debt to GDP ratio for 2005 to 2009 of 10.5 per cent (Table 6.1), savings availability for the public sector has not posed any problems.

The only commercial bank in Kiribati is the Bank of Kiribati Limited, a partnership between the Government (25 per cent) and the Australian and New Zealand Bank Limited (75 per cent). There is no central bank and the country uses the Australian dollar. The Reserve Bank of Australia sets interest rates. Therefore, if domestic savings were insufficient to finance private investment, the ANZ bank would be easily able to fill any gap. However, the inability to use customary land as collateral for commercial loans and difficulties in securing long-term access to land (see below) must seriously impede private investors in efforts to establish businesses.

Inadequate returns to private investment

Low returns on private investment do appear to be a constraint on economic growth and to arise from several sources. As noted above, the dominance of SOEs across the economy inhibits private enterprise. This inhibition is likely to take various forms. First, business costs are raised due to the monopoly of SOEs over the supply of goods and services needed as inputs by the private sector. Second, private sector business costs would be indirectly raised through the government subsidising the operations of the SOEs and thereby squeezing out expenditure on public infrastructure that would otherwise benefit the private sector. Third, while causation may also run in the other direction, the pervasiveness of SOEs appears to have created a dependency culture so that people are unwilling to consider the privatisation of SOEs or to consider employment in the private sector.

Similar to other PICs, Kiribati labours under the difficulties posed by its small and widely scattered population and resulting high costs of essential services. However, also similar to other PICs, it has a relatively large population concentration on South Tarawa and Kiritimati and it should be possible for viable private sector activities to develop on these islands if other conditions were favourable.

Because of the huge distances over which the country's islands are spread, it might be expected that attempting to reduce communications costs to as low a level as possible would be a preeminent consideration. However, opening up the telecommunications sector to competition in order to reduce telecommunications costs and increase the quality of communications and its availability appears to confront obstacles. There are two mobile phone providers, both government-owned, which are said to be "in competition". Negotiations with the Irish mobile phone company, Digicel—which is now operating in five Pacific island countries—have apparently taken place. But as yet there has been no progress on opening the sector to private competition. It was claimed that the prospective entry of Digicel had already led to improved services by the government monopoly telecommunications enterprises—which lends support for the idea that contestability, even the threat of competition, can be important in improving performance in SOEs.

The scope for investors to earn adequate returns is restricted by the laws applying to foreign investors. Foreign investors must apply to the Foreign Investment Commission, which evaluates applications according to the provision set out in the Foreign Investment Act of 1985, the Foreign Investment Regulation of 1986, and the Foreign Investment Policy of 1996. All proposals put to the Commission are considered under the following guidelines:

- The potential employment of I-Kiribati;
- Net export contribution;
- Balance between local resource exploitation and the size of the foreign investment;
- The potential for transferring to I-Kiribati foreign managerial and technical skills required in the enterprise;
- The extent of competition with local enterprises; and
- The impact on the social and natural environments.

The Foreign Investment Commission may approve foreign investment plans in which the capital input is less than A\$250,000; larger investments must be referred to the national cabinet. It is said that restrictions are only imposed on foreign investment where local expertise or industry already exists (for example, handicrafts) or where the local, natural or social environment could be adversely affected. However, it is obvious from the extent of legislation and the multiple criteria applying when foreign investment applications are being considered that there is ample room for arbitrary decision making that will inhibit such applications.

It was reported that the government opened trading of seaweed to the private sector in 2003.⁵ Previously, the SOE, Atoll Seaweed, which is under the Ministry of Fisheries and Marine Resource Development, was the sole purchaser of seaweed. Similar to copra, seaweed is regarded as a 'socio-economic' activity. Therefore, the government sets the price at which seaweed is purchased. As a result, Atoll Seaweed has received government subsidies since it began. Given that the price paid for seaweed is fixed at a level above the world price, it is highly unlikely that the private sector would be interested in purchasing and exporting the product. It is no wonder that there have been no licences issued other than to Atoll Seaweed.

However, there was a welcome relaxation of the foreign investment policy with the entry in 2004-05 of the Fijian firm, Punjas, into the wholesaling and retailing sectors. The entry of Punjas was apparently facilitated by the financial problems suffered by the SOE wholesaler and retailer as a result of the development of many small roadside stores. It was noted from the discussions that initially there was opposition to the entry of Punjas, on the grounds that bringing in foreign capital and workers would take away jobs from locals; however, the opposition has apparently died down. The lower prices for goods have received a positive public reaction and Punjas is apparently doing well. However, the SOE wholesaler/retailer, BKL, (Bobotin Kiribati Limited) remains in business. This appears to be at least partly on account of the fact that it has responsibility for ensuring that there are adequate stocks of basic foodstuffs for the outer islands in the event of emergencies.

A shortage of human capital does not appear to be a constraint on private investment. There are around 2,000 school leavers each year but only around 500 jobs are available—mostly in the public sector (Republic of Kiribati, *no date*). The quality of education in the school system is generally poor. However, if investment in the very small private sector were to attempt to grow, there should be sufficient high school graduates of quality available for training. 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) and for nurses to work in Australian hospitals; but these training activities cover a relatively small number of the available labour force.

Appropriability of returns to investment

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. There is no system of leasing of native land for private investment, although this is matter that has received some consideration by the Government. Thus it is presently very difficult for investors, particularly foreign investors, to gain secure access to land.

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 by Transparency International. 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 (2004) noted that there were no procedures for dealing with improper behaviour in the public service and so there had been little enforcement of good governance processes. There had also been 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 Inquiry had been tabled or debated in Parliament. As well, there had been no parliamentary action on the adverse reports received from auditors on the performance of the many government business enterprises. Further, 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 does appear 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 Pacific island countries. 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”.

Toatu (2001) also reported that the judiciary is under-resourced and that there are significant delays in the settlement of court cases. This criticism is supported by the World Bank Group’s *Doing Business 2009* information (World Bank Group 2009), which shows Kiribati taking almost two years on average (660 days) to enforce a contract. This information reflects very poorly upon the legal system and suggests that the appropriability of investment returns is poor. More generally it is consistent with the antipathetic attitude towards private enterprise.

From the above diagnostic analysis of possible binding constraints, it appears that poor access to finance, poor investment returns, and poor appropriability of investment returns could be constraints to better economic performance. However, these factors may be symptoms of underlying factors that are inhibiting the government taking collective action towards adopting institutions and policies that will lead to improved economic performance. Therefore, in the next section there is an examination of the political economy of Kiribati within the IAD framework.

The Political Economy of Reform in Kiribati

As regards the cultural characteristics of the Kiribati society, there is a very strong ethos of egalitarianism—even to the extent that working for the government is preferred to working for private businesses, as doing the latter is seen as helping individuals raise themselves above the rest of the community. Also, showing external signs of success such as in the form of larger houses or new cars is frowned upon. The culture is described as paternalistic, very conservative, collectivistic, and consensual (Sofield 2002). The needs of the community are placed well ahead of the needs of the individual. In this respect, the Kiribati society is unlike the Polynesian and Melanesian societies, where chiefly or ‘big man’ authority is much more important. Within the village communities, the consensus reached in discussions in the meeting houses (*maneaba*) must be respected.

The elders of the village/clan have had strong moral authority. However, their authority over island affairs has been reduced in recent times. Younger, better-educated leaders, such as those coming from the churches, now have more say in island affairs. It was noted in discussions that there are signs of a lessening of

the role of the *maneaba* in island/village affairs. As an indication of their reduction in importance it was said that *maneaba* can be observed in disrepair and used to store copra; taking away the traditional place for the elders to meet.

The lessening of the role of village meetings and the consensus they generate could point to several possibilities. It could point to people looking outside the village for opportunities and for leadership—a difference in viewpoint that may be derived in part from the increased education and travel. It may mean that people are depending less upon a collectivistic life style and are willing to rely less on government provision. But it may also mean that generating collective action within communities to overcome collective action problems could be at risk.

Similar to other Pacific island societies, reciprocity is an important aspect of culture in Kiribati, where it is called *bubuti*. Given the rapid rural-urban migration taking place in Pacific countries and the increasing familiarisation of indigenous people with market-based societies—with their emphasis on individualism and individual wealth creation—indigenous people are more and more attempting to become entrepreneurial and develop their own business activities. However, the culture of sharing still holds strong sway and can pose a significant hindrance to the development of indigenous business enterprises. People interviewed in Kiribati remarked that *bubuti* was indeed a significant obstacle to the development of indigenous businesses, as people with wealth were expected to share it with their extended families in various ways, such as not charging relatives for goods and services provided and through the support and education of relatives' children.

The people of Kiribati are described as very conservative. Given their heavy dependence on government, they also appear to be very averse to risk. Such risk aversion is understandable. Kiribati has a very fragile environment and the people are living a quite precarious existence. Therefore, their aversion to the risks that may be associated with change can be appreciated.

IAD analysis: action arenas, actors, and incentives

As described in Chapter 1, analysis within the IAD framework should follow the sequence: Context, Action Arenas, Incentives, Interactions, and Outcomes. Context refers to the physical situation associated with the project or the problem to be addressed, the attributes of the community, and the 'rules-in-use'. The Action Arenas refer to the various parties who are or who may be involved and how they interact with each other. How they interact with each other will depend greatly upon the incentives to which they are responding. The incentives or 'rules' may be monetary or non-monetary, positive or perverse. Cultural norms may be critical in determining behaviour. The incentives and interactions will determine the outcomes. Reaching different outcomes will depend upon whether the incentives and interactions can be changed.

Various actors, action arenas, and incentives can be identified in relation to past attempts at privatisation and the promotion of the private sector in Kiribati. First, there is the government, which is dependent upon electorates with a strong preference for SOEs and is the employer of most of those holding formal sector jobs. Public sector employees are clearly a major political force. Those working for SOEs will likely be strongly resistant to privatisation because they fear losing their jobs. They and public servants have little practical knowledge of the private sector; and their communal culture, risk aversion, egalitarianism, and apprehension of individualism promote antagonism towards the idea of private sector competition.

The President is a primary actor. Kiribati has a mixed Presidential/Parliamentary system, with the President elected for a four-year term in a separate presidential election between members of parliament (MPs) nominated by the elected representatives. The Cabinet is chosen by the President from among the sitting MPs in the governing party. In undertaking any reforms the President has to carry the Cabinet, party members, and coalition members along with him. The current President, Anote Tong, has been in a strong position as the governing party has numerical strength. He has said that he will not run for a third term—a possibility that is open to him. Thus the decision not to run for a third term may give him more freedom to act; but he still has to worry about carrying his party with him and they will be concerned about being re-elected.

It was stated over and over in discussions that politicians are strongly beholden to their constituency. They are expected to provide jobs for them. For example, ministers are expected to make appointments to the public service from within their electorate. Moreover, politicians are expected to look after the “every needs” of the people. One interviewee compared this situation to Samoa, where the *maati* are elected to national parliament but they also have strong authority within the village; in Samoa, therefore, what is decided in parliament can be more easily enforced at the individual and village level.

However, in Kiribati, cabinet Ministers clearly have considerable discretionary power, which enables them to provide support to people in their electorates. Efforts to promote a more efficient public service, an effective land rights system, good governance of SOEs, or regular auditing of the accounts of ministries or SOEs would have the effect of reducing this discretionary power. Thus Ministers would have incentives not to support such reforms.

SOEs also appear to be a part of the strong clientelist politics that exists in Kiribati.⁶ The SOEs are under various Ministries and the relevant Ministers appoint the members of the boards of the SOEs.⁷ According to people interviewed, the board members are primarily political appointees, frequently from the Minister’s constituency. Moreover, in the appointment of board members

there is little concern for knowledge or expertise about the SOE's activities. Therefore, it appears that any effort to have more appropriate appointments made to boards or to improve corporate governance within SOEs will face considerable resistance.

The managements and boards of the SOEs also have an incentive to be antagonistic towards the idea of privatisation and private sector development. They will likely act in concert with their employees and politicians to resist moves in these directions. Because board members are mostly drawn from the Ministers' electorates, they are most likely to be influential people within their communities who can gain support for the Ministers at election time. For the board members the sitting fees of A\$50 per day are probably an important source of income (by comparison, A\$100-200 per week appears to be a good income from fishing).

The private sector is a stakeholder in attempts to promote a better environment for private investment but is presently a very small part of the economy and therefore has little political leverage. Unlike most other PICs, there is even little in the way of branches of overseas firms. There is also very little in the way of a middle class who have generated wealth through private sector activity and therefore would have a vested interest in the development of the private sector. One of the few areas of individual private sector activity by I-Kiribati, the ownership of the buses that are the major form of land transport, was to a large extent developed by retired senior public servants who most likely have a closer affinity with maintaining the existing dependence upon SOEs than with private sector development. As has been shown, private business development faces significant obstacles, principally in the form of the difficulties in acquiring secure access to land and the consequent difficulty in accessing credit, existence of monopoly SOEs in most arenas of possible activity, which tends to 'crowd out' private sector activity, as well as price controls and controls over foreign investment.

Members of the Island Councils also wield considerable discretionary power, as they issue licences for business development and set some prices, such as bus fares. (As noted by one interviewee: "If a business wishes to obtain a license to set up in a particular area, all members of the island council have to carry out the inspection and all have to be paid 'sitting allowances' for the visit. Usually, none of them have any expertise in the prospective business.").

Bringing about reform to improve the private investment environment will require acceptance of changes by the community. As noted previously, aversion to the risks associated with change is to be expected in a society that has been established under such precarious conditions. Moreover, in a society where individualism is frowned upon to such an extent and the government is looked to so comprehensively to provide goods and services, having the public

accept the promotion of private enterprises and the privatisation of SOEs is a “hard sell”.

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

Analysis of the Political Economy

The collective action problem that appears to underlie the unwillingness to promote the private sector in Kiribati is the individual society member’s belief that the benefits they gain from their dependence on the state outweigh their private costs. The state’s resources are therefore seen as a common-pool resource. The revenues earned from the investments of the RERF and the tuna fishing license fees, as well as donor aid, provide the “common pool”. The continuation of the collective action problem is made possible by the pervasiveness of the patron-client politics that exists between the politicians and their constituencies. Perverse incentives operate with respect to society, politicians, public servants, the boards, management and staff of SOEs, and members of the Island Councils. Given the present ‘rules-in-use’, is it possible to change the expectations of society or the behaviour of politicians?

“State capture” by the elite does not appear to be a significant issue in Kiribati. As noted above, patron-client politics in order to achieve political office is pervasive. But it does not appear to result in huge gains by the few at the cost of the rest of society. The political importance of maintaining the widespread state distribution of common-pool resource seems to limit elite capture.

If the collective action problem is to be overcome, individuals in society and the politicians have to see that the benefits of collective action to bring about the reforms outweigh the costs to them as individuals. The problem is that the costs to individuals of giving up their dependence upon the state are very obvious while the benefits of economic reform in terms of more jobs, higher incomes, and improved public services are highly uncertain.

Given the very limited extent of private sector activity in Kiribati, the prospects for the development of the private sector understandably look poor. People question why investors would be interested in Kiribati and where the capital to take over SOE activities would come from? The general antipathy towards foreign investors increases the difficulties of attracting foreign investment. However, second guessing what opportunities may arise if SOEs are privatised and a more investor-friendly environment—including for foreign in-

vestors—is developed is not the role of the bureaucrat or the economist. That choice has to be left to those who are willing to take the risks of investing their own money in entrepreneurial activity.

Despite the widespread resistance to economic reform, the situation does not appear to be altogether hopeless. There are some hopeful signs: for example, the acceptance of the introduction of the wholesaler/retailer, Punjas, from Fiji, and the discussions with the mobile phone firm Digicel over its entry. In both cases the lower prices and better quality of the goods and services provided due to the introduction of competition have an important “demonstration” effect. In the case of Punjas, the lower prices have already gained approval. In the case of the proposed introduction of Digicel, most people in the Pacific are now well aware of the very high costs and poor quality of government monopoly telephony providers; hence it is a relatively easy case of market opening. In the case of the privatisation of SOEs and the opening of other markets to competition it will be important to make the best case to the public how they will benefit from market competition.

Another positive factor for economic reform is the increased number of people going overseas for education and work. Overseas workers such as seamen and nurses and those going overseas for study can observe the benefits of market competition in other countries in terms of lower prices and higher quality. However, there is no denying the point made in the interviews that, upon returning to Kiribati, these people are subject to societal pressures to conform to the existing social attitudes.

Therefore, it appears that neither inadequate returns on investment or poor appropriability of investment returns are the binding constraints. Our judgment is that the dependency on government developed over the years is the primary inhibiting factor and that a robust private enterprise sector will not develop until decisive action is taken by the government to get out of business activities and to promote a positive environment for private investment. Poor access to collateral such as securitisable land rights and the poor access to capital that results or the high level of business costs will not become the binding constraints until the dependency mind-set is overcome. Public education about the welfare costs of government dependency and the benefits that allowing the private sector to develop will bring appears to be the only solution to the country’s problems. Someone of authority has to lead this campaign and the President is in the best position to lead.

Conclusions

While there is limited availability of security for commercial credit due to the present inability to securitise title to communal land, limited access to credit is presently not a binding constraint as this is overridden by other factors. Nor

are the obviously poor returns on private investment and the poor appropriability of the returns on investment binding constraints. The binding constraint presently appears to be the fact that the public has a dependency mindset that favours government business activities over private enterprise. It is perhaps arguable whether the long dependence upon government and SOEs has led to this conservative welfare stance rather than the conservative welfare stance leading to the strong dependency upon government. But the key issue is how the dependency may be overcome.

An interesting question to ask is why the development of this society in its very precarious physical environment has not led to a strong ethos of individualism. One can appreciate that communalism, with its ethos of sharing, has a strong attraction in an environment where storage of food is very difficult. But why should this reliance on the clan transfer over to a reliance on the government? The most likely answer is that the formation of a national government has led to the belief that government resources are there to be captured by the village chiefs for sharing among the clan. The problem with the development of dependence upon government is that it becomes so suffocating of individualism. This is the classic dilemma experienced by the fourth-world indigenous peoples in developed countries. Such countries are able to afford welfare to the disadvantaged indigenous minority but the irony is that the welfare ends up suffocating individualism and total dependency upon government results.

In these cases, research into and public education about the welfare costs of such activities and the benefits and costs of alternative approaches seem to be the main ways to ensure their removal. But as seen from the other studies on successful economic reform in the Pacific and in other small countries, a range of facilitating conditions need to be in place for the changes to take place.

Notes

- 1 As measured by the Atlas Method.
- 2 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 and to underpin government revenues when the phosphate deposits at Banaba Island were exhausted. By the end of 1979 when phosphate mining ceased and Kiribati gained its independence, the Fund was valued at A\$69 million. The value of the Fund, which is held in overseas securities and equities, has since increased about ten-fold—although its value has recently been reduced through the poor performance of stock markets and securities and drawdowns to cover budget deficits.

- 3 The ADB's 2002 Pacific Islands Economic Report on Kiribati (ADB 2002) noted that there were 32 SOEs. However, information on the number of SOEs in the country varies. The differences may depend on how SOEs are defined, such as whether joint ventures between the government and a private enterprise are included. Notwithstanding the uncertainty, there are a relatively large number of SOEs; most importantly, they occupy most of the 'space' that is usually occupied by the private sector. The SOEs have been mostly loss-making activities requiring government subsidies and/or government guaranteed loans to remain liquid: payment of debts to SOEs (including by Ministries and by other SOEs) is poor and apparently becoming worse.
- 4 Kiribati uses the Australian dollar.
- 5 Although, according to a Ministry of Fisheries and Marine Resource Development report on its first six months' of activities in 2007, Atoll Seaweed was shown as holding the only licence to purchase seaweed.
- 6 According to an index of patron-client politics in the Pacific, constructed by Duncan and Hassall (2007), Kiribati and Federated States of Micronesia are the two Pacific states where clientelism is most prevalent.
- 7 Sitting allowances are received by board members: A\$50 per day for members and A\$55 per day for the chairman. Board members are appointed for up to three years.

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Chapter 7

Barbados: A Long Journey to Success

Hilarian Codippily and Ron Duncan

This chapter draws some lessons from the success of Barbados in attaining a relatively high level of per capita income and quality of life. Not surprisingly, some recent publications refer to Barbados as a model for small island developing states.¹ However, as described below, it has only attained this status after a long period of economic and social development. A modified form of the Hausman, Roderick, and Velasco (HRV) approach is used in this chapter as a broad framework for analyzing how binding constraints were identified and addressed, and to discuss the main drivers of change.

Country Background

Barbados has emerged in recent years as a prime destination in the Caribbean for high-end tourism and offshore financial services. Tourism, together with manufacturing and other services, has helped Barbados achieve a per capita GDP of US\$12,500 (2006)—one of the highest in the region and placing it among the upper-middle income developing countries. Its HDI rank is 31, and life expectancy is around 77 years. Furthermore, Barbados' human and education development indices rank it as first in the Latin American and Caribbean region. The number of Internet users stands at 54.6 per 100 people, compared to 55.4 in the UK. These and other achievements in the quality of life of the population reflect the cumulative results of a long and steady period of slow to moderate economic growth and investment in human capital since the mid-1940s (see Table 7.1 for comparative indicators).

Barbados functions as a constitutional monarchy, with a British Westminster style parliamentary democracy, and has the third oldest parliamentary system in the Western Hemisphere. The country gained independence in 1966. The ruling party at the time of the field visit to Barbados in 2008, the Democratic Labour Party, had been returned to office in January 2007, and was headed by the late Prime Minister David Thomson.

Barbados is the most easterly of the Caribbean islands, located some 2,575 kilometers (1,600 miles) south east of Miami, Florida. With a population of close to 280,000 living in an area of 431 square kilometers, Barbados has the highest population density (650 per sq. km.) in the Caribbean. The country is largely flat and low lying, and mostly made up of soft marine deposits of coral limestone. Although it does not have major land/mineral resources, it is

endowed with beautiful beaches, a warm tropical climate, and clean Atlantic air.

Following the arrival of British settlers in 1627, and the introduction of sugar-cane in 1637, Barbados was a sugar-dependent economy for over 300 years. But the diversification of the economic base away from sugar, to one featuring strong tourism and manufacturing has indeed been far-reaching. The contribution of sugar to GDP has declined from about 20 per cent of GDP in 1965 to a little over 2 per cent during the past few years. Currently, agriculture accounts for 6 per cent of GDP, industry for 16 per cent, and services, including tourism, for 78 per cent of GDP. Barbados' GDP, estimated at about US\$3.8 billion, exceeds that of small island economies in the Caribbean, Indian and African Ocean, and the Pacific Ocean, with the exception of Trinidad and Tobago and Mauritius.

Apart from sugar refining and rum distilling, Barbados' diversified manufacturing sector includes food processing, beverages, tobacco products, wearing apparel, furniture, plastic products, cement, non-metallic mineral products, fabricated metal products, machinery and equipment, and electronic components. The tourist sector has a wide range of hotels catering to the high-end tourist market as well as to budget tourists. The number of tourist apartments has shown a significant increase in recent years. Long-stay tourist arrivals reached

Table 7.1: Selected Latin America and Caribbean Countries – Social and Economic Indicators

Country	GNI Per capita	Life Expectancy	HDI Rank	Educ. Index	H & PE Rank*
Barbados	12,523#	76.6	31	0.956	9
Jamaica	3,952#	72.2	101	0.792	72
Trinidad and Tobago	13,892#	69.2	59	0.872	62
Argentina	5,150	74.8	38	0.947	54
Chile	6,810	78.3	40	0.914	70
Mexico	7,830	75.6	52	0.843	55
Venezuela	6,070	73.2	74	0.872	76

* Health and Primary Education Rank.

GDP per capita (2006) (see IMF Staff Report page 1).

Sources: World Bank *World Development Indicators 2008* (for per capita GNI 2006); UN *Human Development Report 2007/2008*; and *The Global Competitiveness Report 2007/2008*.

about 575,000 in 2007. Since 1992, cruise passenger arrivals have been generally higher than stay-over arrivals.

Barbados is an open economy, with the total value of imports and exports of goods and services exceeding GDP by about 30 per cent. The country's major export markets are the US, Trinidad and Tobago, and the UK—which are also the major sources of imports, in that order.

The Analytical Framework

The development experience of Barbados presents some useful lessons about how a small island state identified constraints to development and addressed them in a systematic manner. As described below, some constraints, such as the lack of adequate infrastructure, were addressed over long periods of time, while others such as policy-related constraints required short periods of time. In this chapter, the Barbados experience is analyzed retrospectively, using a modified Hausman, Roderick, and Velasco (2005) approach as a broad framework, guided by its growth diagnostics decision-tree methodology to the extent possible. We cover a period of 50 years to show that a number of components of the decision-tree are relevant to the Barbados experience, such as constraints posed by the state of infrastructure, the level of human capital, and the cost of finance (see Figure 1.1). The use of this methodology helps us to better understand when and how constraints were removed sequentially over a long period to promote growth and development. As noted in Chapter 1, no attempt is made to present a quantitative analysis in terms of the HRV framework due to the lack of data covering long periods. There is also no quantifiable information indicative of the distortions created by wedges between social and private valuations of economic activities called for by the HRV framework. Thus, the analysis of the constraint removal process is qualitative in character, and is presented in the form of an analytical country narrative in the following sequence: institutions, human capital, infrastructure, and so on, appearing from left to right in the bottom half of Figure 1.1.

Identification of Binding Constraints

The identification of binding constraints to development in Barbados, from the standpoint of promoting growth and development and maximising welfare for the population as a whole, can be traced back to the 1940s; and the period 1946 to 1960 can be regarded as one of economic and political transition (see Downes 2001). The black-dominated Barbados Labour Party (BLP) won the elections held in 1946 and set about political and institutional change as a means of achieving economic change. Policy makers at that time foresaw a bleak future faced by Barbados' sugar-based economy, largely controlled by the white agro-commercial elite (Downes 2001). In response, they set about formulating a series of development plans aimed at economic diversification and growth, in the

course of which binding constraints to the attainment of plan objectives were addressed, though not specifically in HRV terms.² The public sector projects included in these plans laid the foundation for private sector participation in diversification and economic growth. In the course of these planning processes, two main constraints focused upon were the lack of human capacity, especially professional and technical skills, and the lack of adequate infrastructure.

Formal development planning began in 1946, with the preparation of the *Ten Year Plan for Barbados: Sketch Plan of Development 1946 to 1956*. This plan, prepared by a committee appointed by the Government, was essentially a list of projects that sought British Government Grants under the Colonial and Welfare Act passed in 1945 (see Emtage 1967: 206-7). This plan was followed by two medium-term plans 1952-57 and 1955-60. The focus of these plans and projects was on the development of social infrastructure, comprising health care, education, water supply, and housing—mainly targeted on building an educated and healthy labour force. The two medium-term plans emphasised the Government's objective of diversifying from a sugar-based economy into manufacturing and tourism by encouraging direct investment. The Government's approach to development planning was largely indicative in nature: offering fiscal and other incentives to the private sector to promote investment and growth, supported by the creation of a few institutions. The passing of the Barbados Development Act of 1955 and the establishment of the Barbados Development Board in 1957 provided the main institutional mechanisms for diversifying the economy. The establishment of the Tourist Board in 1958 provided a further impetus to economic diversification (see Downes 2001).

The development plans since the 1960s have presented the policy goals of government:

- The diversification of the productive structure of the economy, intended to reduce the heavy dependence on the sugar industry;
- The creation of new employment opportunities through economic diversification;
- The provision of social services: health, sanitation, education, housing, transport, and social security;
- The achievement of balanced and sustainable economic growth and development; and
- The development of the human resource base to boost productivity and competitiveness.

The 'champions of development' at that time played a dominant role in Barbados' political and economic transformation. Sir Grantley Adams led the political process for gaining independence from Great Britain. Soon after independence in 1966, Prime Minister Errol Barrow, who had a clear vision for the fu-

ture of Barbados, led the economic reform program to diversify the Barbadian economy, building upon the initiatives and development plans of the 1940s and 1950s. In 1971, the Central Bank was set up under the leadership of Sir Courtney Blackman, who developed the institution into one with a high level of professional skills (with a staff of 244 at the time of this study), during his tenure of three consecutive five-year terms. He set in motion an economic management approach to deal with emerging economic challenges, backed by the work of the Central Bank's economic research department.

All three leaders mentioned above were alumni of Harrison College, an elite institution founded 275 years ago. This college is sometimes referred to as 'The Cradle of Leadership'. As noted by Blackman (2008), the Barbadian experience fits snugly into Rostow's 'Stages of Growth', which postulates that the establishment of preconditions for an economic 'take-off' requires:

. . . that a new elite—a leadership—must emerge and be given the scope to begin the building of a modern industrial society . . . it is essential that the members of the new elite regard modernization as a possible task, serving some end they judge to be ethically good or otherwise advantageous. (p. 5)

It is noteworthy that all Prime Ministers of Barbados since Independence have been graduates of Harrison College, except for the late Prime Minister, David Thompson, who assumed office in January 2008. So were the Governor Generals except for Dame Nita Barrow (see Blackman 2008).

Following the decision-tree methodology illustrated in Figure 1.1, let us proceed to an analysis as to whether or not the elements included in the figure were binding constraints to growth and development; and, if they presented obstacles to growth, how they were overcome. We start with institutions, human capital, and infrastructure.

The Institutional Framework

Barbados inherited a well-developed institutional framework from colonial times. At the apex is a parliamentary system, which is bicameral, comprising a House with 30 members, elected every five years, and a Senate with 21 members, appointed by the Governor-General on the advice of the Prime Minister and the Leader of the Opposition. The legal system, which is well developed, is based on English common law and statutes and exercised by the Attorney General, the Chief Justice, Puisne Judges, and Magistrates. The highest court of appeal is the Privy Council in England. The judiciary is completely independent of the legislative and the executive functions. However, the executive and the legislative branches of government are linked through the Westminster-type parliamentary system, in which cabinet ministers who perform executive functions are also members of the legislative assembly.

Barbados has only one level of government, i.e. the central government. For administrative purposes, Barbados is organised into 11 parishes and the capital city of Bridgetown. Although there are no local governments in Barbados, there are a number of statutory boards, which carry out activities commonly assigned to local governments, and 16 extra-budgetary funds, which are established by law and financed through earmarked revenues. There are, in addition, 19 central government units supported by the state budget, and one government agency, i.e. National Insurance, with an individual budget (see IMF 2007). Statutory boards, few in number, are legally separate entities from government and may carry out commercial or non-commercial activities. Government activities are largely focused on core functions. The Government does not engage in commercial activities, except in certain strategic areas such as the investment in the Hilton Hotel, which was a forerunner to major private investments in the tourism sector, or the Caribbean Broadcasting Corporation.

How effective is the institutional framework in promoting economic growth and development? The general consensus among policy makers, the private sector, other stakeholders, and historians is that the institutional framework, far from being a constraint, has been and is supportive of growth and development through a free-enterprise system. The rule of law is strictly enforced; and since the riots of 1937, there has been no occasion for police action. Except for this event, Barbados has enjoyed a long period of social and economic stability; and this has been the main pre-condition for attracting private investment.

The main public sector institutions responsible for overseeing governance are: the Auditor General's Department, the Attorney General's Department, the Public Accounts Committee, and the Ombudsman. Nevertheless, initiatives were under way to improve governance. To strengthen the governance oversight function, the Government has set up a seven-member Governance Advisory Board. Integrity legislation and a Code of Ethics for the public service are currently being drafted. Further, the Office of the Ombudsman is being strengthened. There are no private institutions performing 'watchdog' functions, except for the trade unions.

As regards *clientelist politics*, there is no tangible evidence of politicians pursuing their own interests rather than national interests, more so due to checks and balances in a tripartite 'consensus society' consisting of the government, the trade unions, and the private sector. Government expenditure allocations have been largely directed toward the provision of public goods for the benefit of the wider community. Close to 25 per cent of government expenditure was allocated to education and health in 2007-2008. In addition, about 22 per cent of government expenditure was allocated to social security, welfare, housing, community services and amenities, and social services. There is no evidence of significant targeted transfers to voter groups—which is evident from some of the social infrastructure provided to the community at large. For example, ac-

According to the 2000 Census, 97.3 per cent of households had access to water supply, and 81.8 per cent of households had adequate toilet facilities. Another example is the investment in roads, as a result of which the proportion of paved roads is 100 per cent.

Macroeconomic management in Barbados has been generally sound and free from radical swings in policy. As a result, the macroeconomic framework has been predictable and has ensured a level playing field to support steady growth over a long period. The Barbadian economy grew at the modest rate of 3.9 per cent per year over the four-year period ending 2007, but growth was expected to slow to about 2.3 per cent in 2007 (see Table 7.2). The projected decline in the growth rate reflects, in part, the global slowdown affecting Barbados' major trading partners; tourism receipts, in particular, were expected to weaken.

Total investment averaged a healthy 25.5 per cent of GDP during the four-year period ending 2007, with the major share contributed by the private sector. However, total investment was projected to decline slightly to around 22 per cent of GDP in 2008, as private investment was expected to decline, due in part to an expected slowdown in the market for luxury houses and weaker capital inflows. The authorities had brought the budget deficit under control from a high of 4.2 per cent of GDP in 2005 to 1.9 per cent of GDP in 2007. Nevertheless, the budget deficit was expected to widen to about 2.6 per cent of GDP owing to an increased level of social assistance, a higher tax credit threshold, and a price rebate on diesel for selected sectors (see IMF 2008).

Two worrisome developments that had emerged were the high inflation rate, estimated at 8.1 per cent in 2008—reflecting the higher price of oil—and the increase in external debt, estimated at 41.2 per cent of GDP in 2008; although the external debt level is moderate by Caribbean standards. This level of external debt reflects, in particular, the high levels of current account deficits over the past five years and the consequent foreign borrowings. Likewise, the level of domestic public debt remains high as a cumulative result of fiscal deficits over a long period.

At the time of the visit, the authorities were continuing to address economic problems associated with a difficult external environment and the relatively high level of public debt. Table 7.2 below provides key indicators reflecting recent economic developments. The authorities had discussed with the IMF (in July 2008) a set of measures to deal with the economic difficulties. Accordingly, the authorities had agreed to: (i) focus fiscal policy on support for vulnerable groups and on identifying measures to lower public debt and support external sustainability over the medium term; (ii) focus monetary policy on containing inflation expectations by making further reductions in interest rates, contingent on signs of a sharper slowdown in demand; (iii) use wage negotiations under a tripartite framework to help contain second-round price pres-

Table 7.2: Barbados—Key Macroeconomic Indicators, 2004-2008

	2004	2005	2006	2007*	2008#
Indicator Values (US\$ million)					
GDP (at current prices)	2,817	3005	3191	3,409	3791
Government Revenues	947.8	1010.6	1139.3	1219.4	1339.9
Government Expenditures	1009.8	1139.1	1203.3	1283.2	1439.4
Government Budget Balance	-62.0	-128.5	-64.0	-63.8	-99.5
Exports of Goods & Services	1,507	1836	1994	2149	2326
Imports of Goods & Services	1,819	2144	2187	2310	2575
External Current Account Balance 3/	-350	-385	-279	-245	-324
Gross International Reserves	595	619	598	775	800
Macroeconomic Balances (% of GDP)					
Budget Balance	-2.2	-4.2	-2.0	-1.9	-2.6
External Current Account Balance+	-12.4	-12.8	-8.7	-7.2	-8.5
Gross Domestic Investment	23.7	24.8	26.6	26.8	22.1
- Public	7.5	6.9	7.6	7.5	5.6
- Private	16.2	18.0	19.0	19.4	16.5
National Savings	11.2	12.0	17.9	19.6	13.6
External Savings	12.4	12.8	8.7	7.2	8.5
External Debt^	39.5	41.3	43.4	39.6	41.2
Domestic Public Debt (Central Govt.)	59.8	62.8	65.2	70.4	69.7
Other Indicators					
Real GDP Growth (%)	4.8	4.3	3.3	3.4	0.6
Inflation Rate (%)	1.4	6.1	7.3	4.0	8.1
Terms of Trade (% change)	-3.4	-5.9	-3.8	-0.3	-3.5
Gross Reserves (months of imports)	3.9	3.5	3.3	4.0	3.7
Unemployment Rate (%)	9.6	9.1	8.7	7.4	8.1

* Preliminary

Projected

+ Includes net investment income and net current transfers.

^ Includes public sector and non-financial private sector debt.

Sources: IMF Article IV Consultation--Staff Reports, 2007 and 2008; and Government Statistical Service.

asures; and (iv) focus financial sector policies on strengthening banking regulation, oversight of the non-bank sector, and cross-country cooperation among regulators and supervisors so as to further develop the country's role as a financial centre in the Caribbean. The Government was also intensifying some of its programs, especially in the construction sector, to reduce the unemployment rate, which was moderately high at around 8 per cent—although still much lower than levels of over 20 per cent in the early 1990s.

A notable feature of Barbados' macroeconomic framework has been its fiscal policy stance, which has directed budgetary expenditures to productive purposes. As noted earlier, a total of around 47 per cent of government expenditure has been allocated to education, health, social security, welfare, housing, community services and amenities, and social services, while close to 12 per cent has been allocated to economic services. The allocation to defence and security amounted to 4 per cent of government expenditure in 2007-2008. Given the relatively high level of public debt, a share close to 22 per cent of total expenditure has been allocated to redemption of public debt and lending.

Another notable feature of Barbados' macroeconomic policy framework is its fixed exchange rate policy. Since 1975, the Barbados dollar has been pegged to the US dollar at the constant rate of US\$1.00=B\$2.00. In the context of a severe erosion of international competitiveness in the late 1980s, an adjustment in the exchange rate, in line with the 'Washington consensus', seemed appropriate from the standpoint of simultaneously boosting exports, improving the allocative efficiency of imports, and raising government revenues via trade taxes. However, the authorities adopted the alternative approach of defending the exchange rate through an appropriate mix of fiscal, monetary, and wage policies. The IMF Article IV Consultation mission of 2007 found Barbados' real exchange rate to be broadly in line with fundamentals, but observed that competitiveness could become a problem if inflation remained above that of partner countries, without a corresponding improvement in fundamentals. The IMF Article IV Consultation mission of 2008 made a similar assessment. This mission observed that while Barbados' exchange rate is not far from its equilibrium, domestic policy adjustments would be needed to contain external imbalances over the medium term.

Thus, Barbados faced a new set of constraints and challenges, and the authorities were grappling with adjustment processes and strategies to place the economy on a path of moderate and sustainable growth. In particular, the Government moved rapidly to deal with the impact of the global economic crisis through the establishment of a Tripartite Working Group (government, labour unions, and employers) to advise on policy measures. The Government accepted the following proposals from the Group:

- The establishment of a Council of Economic Advisers;
- A fiscal stimulus package equivalent to 1–1.5 per cent of GDP for projects with high social and environmental impact and job-creation potential;
- Foreign borrowing to support the foreign reserves and retiring of maturing foreign debt;
- Intensified marketing of tourism products;
- A loan to employers in the form of a deferment for one year of employer contributions to the National Insurance Scheme (repayable over five years at 3 per cent interest);
- Timelier payments to small businesses for work done for the government;
- Establishment of a fund for training and retraining of workers;
- Construction of low-income housing units;
- The removal of VAT on building materials for first-time home owners;
- Special incentives to help boost the cultural industry;
- Legislative amendments to make Barbados a more attractive international financial centre; and
- A proposal to increase rates for water consumption to help conservation.

Human Capital in Development

The importance of human capital in the development process has been realised by Barbados policy makers over the past three centuries. Among policy statements made from time to time, the following statement by Sir Clifford Husbands, Governor General of Barbados, in his Throne Speech of 2003 typifies the thrust of government policy towards human capital development.

The development of Barbados' most valuable resource, the talents of our people, is fundamental to my Government's central objective of transforming Barbados into a fully developed society in the shortest possible time. My Government is therefore firmly committed to the goal of having one university graduate in every family by the year 2020.

According to a study conducted by Boamah (1996), it was estimated that human capital contributes between 20 and 48 per cent to economic growth in Barbados. A more recent study by Moore (2006) uses annual data from 1970 to 2004 to provide a historical assessment of university education on output, and to forecast the likely effect of having a graduate in every household upon national output. The study estimates that if the target of a graduate in every household is achieved, it could add an additional 1.2 percentage points to annual real output growth.

In addressing the human resource capacity constraint, Barbados has had the benefit of building upon the work done in this area during 300 years of British

colonial administration. As a result, Barbados has one of the oldest and highest quality education systems in the Caribbean, with its origins dating back to the establishment of charity schools by two British planters in 1686. At the time of the country visit Barbados had 80 primary schools, with an enrollment of approximately 26,600 pupils and 1,560 teachers; 23 government secondary schools with an enrollment of 20,430 students and 1,300 teachers; and eight assisted private secondary schools with a student population of 1,315 and 97 teachers (see Government Information Service). In addition, there are seven post-secondary institutions that offer vocational and technical training. For a long time, a program called Edutech has played a significant role in the education sector. This is a comprehensive education reform program for primary and secondary schools, with the objective of preparing youth for the world of work.

University education is provided at the Cave Hill Campus of the University of West Indies, established in 1963. Annually, it produces around 670 graduates at the bachelor's degree level, 125 graduates at the master's degree level, and six to seven graduates at the doctorate level. A large number of students proceed to foreign universities and research institutes for post-graduate studies.

The education system in Barbados, augmented by overseas training, has produced a wide range of professional and technical skills needed for the export-oriented, outward-looking domestic economy. The central decision-making agencies, namely the Ministries in charge of Finance and Economic Affairs and the Central Bank, have benefited greatly from human resource development activities in Barbados. The Ministry of Economic Affairs, for example, had 18 officers with master degrees and 12 with bachelor degrees. At the Central Bank, out of a total staff complement of 244, four had PhDs, 28 had master degrees, and 23 were qualified up to bachelor degree level. In addition, there were several other officers who had professional qualifications in accounting, banking, management, law, information technology, and other relevant fields. The economic research department, in particular, was well staffed. The estimated numbers of professionals in selected skills for the country as a whole, as of September 2008, are shown in Table 7.3 below.

These achievements are indeed phenomenal and have been made possible by the Government's recognition of the importance of building human capital from the standpoint of enhancing productivity and growth. As noted by Downes (2001), in 1960/61, government recurrent expenditure on education was B\$4.0 million (15.3 per cent of total expenditure), and climbed to B\$305.2 million (21.7 per cent of total expenditure) by 1999/2000. This increase represented an annual growth rate of 5.2 per cent in real terms (adjusted for inflation). Capital expenditure on education grew at a real rate of 6.4 per cent over the same period.

Table 7.3: Selected Skills

Profession	Number
Engineers*	571
Certified Accountants#	600
Doctors	423
Dentists	83
Economists	45
Lawyers	528
Teachers (Tertiary Education)+	476
Information Technology Professionals	636
Total	3,362
Selected Skills per '000 Population	9.1

* Includes all types of engineers.

In addition there are an estimated 1,500 uncertified accountants.

+ Only includes the Samuel Jackson Prescod Polytechnic, the Barbados Community College, and the University of West Indies, Cave Hill Campus.

Sources: Census data and relevant institutes.

In sharp contrast to the Government's emphasis on building human capital and allocating large outlays to education—which essentially relates to the input side—there is no adequate database in a single agency on the outputs and stocks of human capital. The construction of such a database merits consideration, and calls for the setting up of a simple institutional arrangement for close monitoring of outputs of critical skills, including the types mentioned in Table 7.3, as well as in/out migration of people with such skills. Data on the numbers of professionals in various fields could be easily obtained from the respective institutions (medical board, dental board, the Institute of Chartered Accountants, etc.). Given the importance of critical skills for economic development and growth in a globalised economy, collecting and storing of information on critical skills would form an important building block for human resource planning.

Infrastructure

As in the case of the human resource constraint, Barbados has had the benefit of addressing this issue by building upon the work done by the British colonial administration in this area to support the requirements of a plantation economy. A series of public sector projects included in the development plans since

1946 have produced an impressive set of results. In the roads sector, an extensive network of roads, including a major highway that connects all the main transport arteries, covers the entire island. Electricity supply is highly reliable, and services are provided throughout the island by the Barbados Light and Power Company. Also, as noted earlier, 97.3 per cent of households have access to water. As a result of investments in the telecommunications sector, Barbados has the most modern telecommunications sector in the Eastern Caribbean, with state-of-the art digital technology and fibre optic systems, and high-speed Internet services. With regard to external trade and transport, Barbados is well served by the Bridgetown Port for sea transport and by the recently upgraded Grantley Adams Airport, which handles an estimated 2.3 million passengers per year. Thus, from a private investor's point of view, the infrastructure facilities available today do not present a constraint on their activities. As shown in Table 7.4 below, Barbados ranks ahead of the other countries in the table in overall infrastructure as well as in typology, with the exception of Chile, which ranks better than Barbados in road infrastructure.

In sum, the strong institutional framework, the high level of human capital development, and adequate infrastructure facilities have ensured adequate returns to investment.

Private Appropriability of Returns to Investment

Guided by the decision-tree in Figure 1.1, we now focus on the Government's actions in support of private sector appropriability. One of the main sources of comfort to the private sector has been the close cooperation between the gov-

Table 7.4: Quality of Infrastructure, Selected Latin America and Caribbean Countries (Rank out of 131 countries)

Country	Roads	Ports	Airport Infra.	Electricity	Telephones	Quality of Overall Infrastructure
Barbados	41	23	18	22	17	26
Jamaica	58	28	40	70	82	58
Trinidad & Tobago	74	93	63	65	54	64
Argentina	84	94	113	95	55	80
Chile	22	34	31	39	59	30
Mexico	59	91	60	82	65	69
Venezuela	92	117	93	91	78	105

Source: The Global Competitiveness Report 2007/2008.

ernment, the private sector, and the trade unions through meetings and consultations. These consultations are conducted at two levels. First, prior to the annual budget formulation, the Prime Minister convenes a general meeting with representatives of the private sector and the trade unions to brief them on the state of the economy and to discuss current economic problems. Second, tripartite meetings between the government, private sector, and the trade unions are convened periodically (once every two months, on average) to candidly discuss major economic and social issues. Because of this relationship, these stakeholders form a 'consensus society' in reaching some form of common ground. The private sector has a favourable perception of the appropriability of returns to investment, conditioned principally by the enforcement of property rights, lack of corruption, the status of taxes and tax incentives, macro-stability, and the regulatory environment.

The Government has ensured that *property rights* are strictly enforced. This has provided the needed security to private investors, both local and foreign, and has been a significant factor in attracting foreign investment. Up to now there has been no restriction on the purchase of land by foreigners. However, this issue may become a matter of political debate, as some have recently begun to express displeasure at the purchase of land by foreigners.

There has been no tangible evidence of *corruption* in recent years, and the level of concern about potential corruption has been rather low—which has, in turn, impacted favourably on the cost of doing business. The 2007 Index of Economic Freedom provides scores for countries by types of freedom, including freedom from corruption, with a theoretical maximum of 100 for each type. The freedom from corruption score of 69 for Barbados compares favourably with those of developed countries such as the US (76), Japan (72), and Germany (82), but at the same time the score indicates the need for a watchful eye on the potential for corruption. The comparative scores for the selected coun-

Table 7.5: Freedom from Corruption, Selected Latin America and Caribbean Countries (Score out of 100)

Country	Freedom from Corruption
Barbados	69
Jamaica	36
Trinidad and Tobago	38
Argentina	28
Chile	73
Mexico	35
Venezuela	23

Source: The Heritage Foundation, 2007 Index of Economic Freedom.

tries in the Latin America and Caribbean region are shown in Table 7.5. Chile is the only country from the set that scores higher than Barbados.

The *taxes and tax incentives regime* has been, on the whole, supportive of private investment. The corporation tax under the Income Tax Act applies to all companies incorporated or registered in Barbados, and any foreign company that carries on business or has an office or place of business in Barbados. Resident companies, i.e. those managed and controlled from Barbados, are taxed on their world-wide income. Non-resident companies are taxed only on income derived from business conducted in Barbados. The standard corporation tax rate has been progressively reduced in recent years to 25 per cent. This rate may be reduced to 20 per cent under proposed legislation. As of 2006, the basic rate of income tax was 20 per cent, applied to the first B\$24,200 of taxable income. Taxable income in excess of B\$24,200 is taxed at a rate of 35 per cent. In arriving at the taxable income, various allowances are taken into account (see PriceWaterhouseCoopers 2006 for further details).

International trade taxes have not been excessive and have averaged around 9.5 per cent of government revenues. Custom duties are based on the Common External Tariff (CET) of the Caribbean Common Market (Caricom). The *ad valorem* rates for most goods range from zero to 20 per cent, with goods considered as luxury items levied at higher rates. However, inputs for agriculture, horticulture, fishing, and manufacturing industry are exempt from customs duty. Certain goods such as computers are also exempt from customs duty.

Both imported goods and locally produced goods are subject to a VAT of 15 per cent. However, a reduced rate of 7.5 per cent is applicable to lodging provided by hotels, inns, and guesthouses. Certain services such as education, medical services, and financial services are exempt from VAT.

The government has been offering a wide range of tax incentives to encourage private investment since the 1950s. These incentives have been instrumental in generating a healthy rate of private investment, averaging 18.2 percent of GDP during the four-year period 2004-07 (see Table 7.2). Under the Barbados Development Act of 1955, a wide range of fiscal incentives were offered, mainly comprising duty-free imports, tax holidays, accelerated depreciation allowances, and reduced rent (see Downes 2001). Similar incentives were offered by the Tourist Board established in 1958, designed to encourage foreign investment, as domestic savings and investment were perceived to be inadequate to develop the tourist sector (see Downes 2001). With progressive additions over the decades, by the mid-1990s, the range of fiscal incentives included:

- Tax holidays ranging from 6 to 10 years depending on local value added;
- Export allowances in the form of rebates on corporation taxes on export profits (other than exports within Caricom), ranging from 35 to 93 per cent;

- Investment, initial, and annual allowances for businesses making capital expenditure on plant and machinery or on an industrial building or structure;
- Export development expenditure in terms of which 50 per cent of expenditure in developing markets outside Caricom may be deducted from taxable income;
- Tax incentives under the Hotel Aids Act for capital expenditure relating to hotels, which may be offset against the profits in the year of expenditure, and to the extent underutilised, carried forward up to nine years;
- Market development allowances amounting to an additional expenditure of 50 per cent in tourist promotion, which may be deductible from taxable income.

(See PriceWaterhouse 1994, Chapter 4, for a more detailed description of tax incentives, as well as non-tax incentives such as duty-free imports, subsidised industrial parks, and export credit guarantees).

At the time of the visit the set of incentives for new investments included:

- A ten-year tax holiday, with a 2 * per cent tax rate thereafter;
- Exemption from import duties;
- Full repatriation of capital, profits, and dividends;
- Low-cost, subsidised factory space available within ten fully-serviced industrial sites;
- Cash grants for worker training;
- Free consulting services from the Barbados Investment and Development Corporation; and
- Duty-free access to the US, Canada, and the EU.³

For many years, Barbados has maintained a stable macroeconomic framework, which provided additional confidence to private investors. However, as noted above, there has been a setback in the macro-economic situation as a result of the difficult external environment and a relatively high level of debt. The authorities are addressing the relevant issues with advice from the IMF, as noted above.

The overarching objective of Barbados' *regulatory framework* is to facilitate the setting up and operation of private enterprises, whilst ensuring transparency, accountability, and good governance. A recent study found setting up business in Barbados to be a relatively simple process and that, on balance, the number of procedures, time, and cost involved compared favorably with other regional and international jurisdictions (see Archibald *et al.* 2005). As shown in Table 7.6 below, Barbados is ahead of the selected countries, except for Jamaica, in terms of the number of procedures for starting a business and the duration in-

volved. As regards the cost of starting a business and the minimum capital required, Barbados ranks with the OECD countries. Included in this study is a comparative table (see Archibald *et al.* 2005:21, Table 7) that also shows Barbados compares favourably with other small island developing states.

Table 7.6: Indicators on Costs of Starting a Business, Selected Latin America and Caribbean Countries

Country	No. of Procedures	Duration (Days)	Cost (% of GNI per capita)	Min. Capital (% of GNI per capita)
Barbados	7	36	14.2	0
Jamaica	7	31	15.5	0
Trinidad & Tobago	9	43	1.1	0
Argentina	15	32	15.7	9.3
Chile	10	28	10.0	0
Mexico	8	58	16.7	16.4
Venezuela	13	116	15.0	0

Sources: Archibald *et al.* (2005), for all countries except Trinidad and Tobago; World Bank and International Finance Corporation; and Doing Business 2007 (which reflects 2006 data), for Trinidad and Tobago.

The study by Archibald *et al.* also draws attention to a number of areas in which the regulatory framework could be improved. First, it suggests that the government should find ways of simplifying the process of registering small business, highlighting in particular the importance of doing so for accessing various incentive schemes. Second, it draws attention to the relative inefficiency of the Barbadian VAT registration process compared to that of Jamaica, and points to the need for re-examination of the system. Third, the study notes the constraints within the Town and Country Planning Department experienced by entrepreneurs seeking to establish business premises, and suggests reorganisation. The study also draws attention to delays experienced by businesses in obtaining some licenses (e.g. liquor licenses), which can often constitute serious setbacks.

According to perspectives provided by a few private entrepreneurs, the procedures for trading across borders involved in getting export goods on board or unloading imports are essentially standard ones, consisting of compliance with

required documentation (bill of lading, certificate of origin, invoices, customs forms, etc.). The time taken ranges from two to eight days, including the time taken to obtain a container. The cost of 'red tape' is estimated at around 1 to 2 per cent of the value of imports or exports. However, the process of registering a property needs a moderate amount of time (apart from the process of starting a business noted above). There are five basic procedures to be followed in the registration of property with the Land Commissioner. The process takes a minimum of three months as it includes the requirement of publishing a notice in a newspaper for 60 days to make the public aware of the registration of a particular property.

In sum, notwithstanding some of the current problems of inflation and the relatively high level of public debt, which are being addressed, it can be concluded that favourable performance in each of the areas mentioned above has ensured private appropriability of the returns to investment.

Cost of Finance

Over the past several decades, Barbados has recorded a healthy national savings rate, reaching close to 20 per cent of GDP in 2007, before an estimated decline in 2008. This level of saving has provided a solid base for domestic investment, which reached about 27 per cent of GDP in 2007. Domestic intermediation has worked well in Barbados and, as a result, the country has a sound and profitable domestic banking system that is able to weather moderate shocks (IMF 2008). The banking system is well insulated from the offshore sector; and a new deposit insurance scheme is a welcome addition to the safety net. The institutional framework of the financial sector comprises the Central Bank of Barbados, six commercial banks, 35 cooperative credit unions, and a number of life and general insurance companies. The offshore sector comprises over 4,000 firms employing around 3,000 people and generating over US\$100 million per year.

The domestic banking sector, with a weighted average deposit rate of about 5.3 percent, has been fairly successful in mobilising domestic savings. Over the years, it has provided considerable support to the private sector, thus contributing to the growth and diversification of the economy. This has been made possible by a conscious Government policy of not resorting to domestic bank borrowing to finance its deficits; government domestic borrowing has primarily been from non-bank sources (e.g. from the National Insurance Scheme). The weighted average of lending rates by the commercial banks to the private sector is around 10.7 per cent, and the resulting cost of finance is not considered to be excessive. Joint ventures or foreign-owned companies have access to foreign loans at lower rates.

Other Constraints

A growth constraint faced by many small island states is *physical vulnerability*, for example, as a result of proneness to hurricanes. This constraint is reflected in substantial fluctuations in growth rates. Barbados is no exception, although hurricanes are somewhat infrequent, with an estimated average 'hit' about once in every 27 years. The last major hurricane that hit Barbados was hurricane 'Allen' that struck on August 4, 1980. It was a category 3 hurricane with winds up to 125 mph, and caused heavy damage. Early warning systems and disaster management systems are in place now through the services of the Caribbean Disaster Emergency Response Agency (CDERA) headquartered in Barbados.

Another constraint to development that has emerged in recent years is that of HIV/AIDS. The estimated prevalence rate in Barbados increased from 1.3 per cent in 2001 to 1.5 per cent in 2005—about the same level as in Jamaica. However, this rate is still lower than that of Trinidad and Tobago (2.6 per cent), and the Caribbean regional average of 1.6 per cent. The National Strategic Plan of Barbados 2005-2025 identifies HIV/AIDS as one of the major threats to its success, as it endangers the country's human capital, putting productive capacity and economic growth in peril. This issue is being addressed with assistance from a recently approved World Bank Second HIV/AIDS Project (US\$35 million).

A constraint of a different kind faced by many small island developing states (and some large states) concerns cultural factors. In contrast to the Pacific Island states, cultural obligations inherent in extended family systems are virtually non-existent in Barbados, and consequently cultural factors are not considered to be constraints to development. Distance to markets is also not considered to be a constraint, as some 43 per cent of exports are directed to the US and Trinidad and Tobago, and another 18 per cent to other Caribbean countries. The UK is the only distant market, but this trade route had been in operation for the past three centuries. In any event, distance is not a major factor, as Barbados' level of global connectivity, especially for online and off-shore business, is relatively high. High-speed Internet is widely available and has grown at a phenomenal rate during the past two years, with the number of internet users standing at close to 55 per thousand. The informatics industry has been developed over the past 15 years, and e-commerce has emerged as an important present and future development opportunity. Even as far back as the mid-1980s, Barbados had found a niche market in providing word processing facilities for New York publishing houses, taking advantage of the services of its educated labour at much lower wages rates vis-à-vis the US. The number of fixed-line and mobile subscribers per 100 people stood at 117 in 2006, and the cost of a three-minute telephone call to the US was US\$1.95.

Learning from the Barbados Experience

Let us now turn to the important question as to what we can learn from the Barbados experience in the identification and removal of constraints? There are at least five important lessons that can be learnt from the Barbados experience, which may be summarized as follows.

1. The *institutional framework* has been the foundation for investor confidence. Far from being a constraint, the institutional framework has been and is supportive of economic development and growth and development through a free-enterprise system. There is no tangible evidence of politicians pursuing their own interests rather than the national interest, largely due to the checks and balances in a tripartite ‘consensus society’ consisting of the government, the trade unions, and the private sector. Also, there has been no evidence of interference or tampering with the institutional framework. This stability has contributed to the predictability of the investment climate. In other words, the country has enjoyed a long period of social and economic stability, mainly due to a strong and effective institutional framework; and this has been the main precondition for attracting private investment over the years.
2. Investment in *human resources* has perhaps been the most important driver underlying Barbados’ record of economic growth and development over the past 50 years. In the late 1940s, policy makers foresaw a bleak future for Barbados’ sugar-based economy, largely controlled by the white agro-commercial elite. In response, they set about formulating a series of development plans aimed at economic diversification and growth, in the course of which binding constraints to the attainment of plan objectives were addressed. One major constraint identified was the lack of human resources to diversify and modernise the economy. In addressing this issue through development plans and projects on health care, education, water supply, and housing—mainly targeted to building an educated and healthy labour force—Barbados has had the benefit of building upon the work done in this area under 300 years of British colonial administration. The education system in Barbados, augmented by overseas training, has indeed produced the wide range of professional and technical skills needed to service domestic needs, as well as the requirements of working within a global economy. The country has not experienced a major ‘brain drain’ problem as professional and technical personnel are provided with attractive compensation packages.
3. Barbados has well-developed *infrastructure facilities*, ranking among the best in the Latin America and Caribbean region, which work very effectively in meeting the needs of the private sector as well as household needs. As in the case of the human resource constraint, Barbados has addressed

the infrastructure constraint by building upon the work done by the British colonial administration in this area to support the requirements of a plantation economy. A series of public sector projects included in successive development plans since 1946 have produced an impressive set of results. The private sector has no major concern with respect to access, coverage, quality, and reliability of infrastructure services.

4. The private sector has a favourable perception of the *appropriability of returns to investment*, conditioned principally by the enforcement of property rights, lack of corruption, the status of taxes and tax incentives, macro-stability, and the regulatory environment. The strict enforcement of property rights has provided the needed security to private investors, both local and foreign, and has been a significant factor in attracting foreign investment. Also, the general absence of corruption has impacted favorably on the cost of doing business. The tax structure and the current set of tax incentives are generally supportive of private investment. Likewise, Barbados' regulatory framework facilitates the setting up and operation of private enterprises, whilst ensuring transparency, accountability, and good governance. A recent study found setting up business in Barbados to be a relatively simple process and that, on balance, the number of procedures, time, and cost involved compared favourably with other regional and international jurisdictions. However, macro-stability has seen a setback in recent years as a result of the difficult external environment and a relatively high level of public debt. The authorities are continuing to address the relevant issues with advice from the IMF. However, the high level of public debt is not perceived by the private sector as an impediment to investment.
5. As regards the *cost of finance*, the domestic banking sector has provided considerable support to the private sector, thus contributing to the growth and diversification of the economy. This has been made possible by a conscious government policy of not resorting to domestic bank borrowing to finance its deficits; any domestic borrowing has primarily been from non-bank sources.

In sum, the success story of Barbados has largely been the result of the country's political and social stability, its outward-looking strategy, reliance on markets, and a judicious balance between the roles of government, the private sector, and other stakeholders. The friendly and free enterprise attitude of the people has also been a factor that has attracted private investment and enhanced the development process. Barbados is well poised to participate effectively in the global economy of the twenty-first century by virtue of its strong and stable institutional framework, a highly educated labour force, dependable infrastructure, and an investor friendly business environment. The National Strategic Plan of Barbados 2006-2025 calls upon Barbadians to show unity of purpose,

strength of conviction and clarity of vision, not merely to survive but also to prosper. As stated in the Plan, Barbados faces three broad challenges:

- Unleashing the full potential of its people and securing the whole-hearted commitment of all generations, classes, and races and to building a prosperous, peaceful and inclusive Barbados;
- Re-positioning Barbados competitively, and in a way that preserves the Barbadian identity in the new global economy; and
- Securing the environmental future by building a green economy.

The National Strategic Plan sets out a clear vision for Barbados by 2025, which is: ‘A fully developed society that is prosperous, socially just, and globally competitive’.

Notes

- 1 The Economic Commission for Latin America and the Caribbean, *An Analysis of Economic and Social Development in Barbados: A Model for Small Island Developing States*, 2001; and Courtney Blackman, *The Practice of Economic Management. A Caribbean Perspective*, 2006, Chapter 22.
- 2 Looking back, this was in line with the development philosophy in many developing countries at that time for meeting basic needs and building the necessary social and economic infrastructure for sustainable economic growth. By the 1970s, there was a gradual shift of focus to the ‘private sector as the engine of growth’ with the government playing a supportive role. However, the pendulum swung back partially by the 1990s, recognising the roles of stakeholders in development, with the government’s role in the core functions of maintaining macroeconomic stability for efficient investment, providing institutional infrastructure such as property rights, peace, law and order, and regulations, providing the necessary social and economic infrastructure, and protecting the environment.
- 3 Fuller treatments of the tax regime can be found in the relevant government publications and periodic publications by PriceWaterhouseCoopers (e.g. Tax Facts and Figures 2006).

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Chapter 8

Maldives: A Leading Sector Approach to Development

Hilarian Codippily and Ron Duncan

Introduction

This chapter draws some lessons from the success of Maldives in transforming itself from one of the poorest countries in the world to having the highest per capita income in South Asia today. These lessons are of special relevance to atoll and other small low-lying countries. The landmass of Maldives consists of 26 atolls, featuring 1,192 low-lying coral islands dispersed over an area of 90,000 sq. km. The dispersal of land and its people have been major constraints to development. However, the dispersal of land, in turn, can be promoted to attract tourists to remote and tranquil settings. These features, together with sandy beaches, tropical waters, and unique coral formations, have constituted the natural capital in creating resorts for high-end tourism in Maldives.

Maldives today enjoys a stay-over tourist arrival rate of about 683,000 per year, exceeding that of other small island developing states. Maldives may well be described as a 'Water World' with 92 island resorts spread throughout, up to some 250 km. from the airport, and linked to the main island Malé and others through the services of hundreds of ferry boats (dhonis) crisscrossing the waters. It has attained this status in the relatively short period of about 30 years. A modified form of the Hausman, Roderick, and Velasco (HRV) approach is used in this chapter as a broad framework for analysing how binding constraints were identified and addressed, and for discussing the main drivers of change.

Country background

The Republic of Maldives, consisting of atolls and small, low-lying, coral islands, forms a chain 820 km. in length and 130 km. at its widest point, and is located in the Indian Ocean, south-west of Sri Lanka. Most of the islands are very small; only a few have a land area of more than one sq. km. The average elevation is about 1.6 meters above mean sea level. The population of Maldives, estimated at little over 300,000, lives on 198 islands—apart from the 92 resort islands, which were originally uninhabited. The capital of the Maldives is Malé, an island with a total land area of about 2.6 sq. km. (one square mile), where one-third of the population lives. Sound economic management, strong tourism growth, and the mechanisation of the fishing industry have helped Maldives to develop from one of the poorest countries in the world to a lower-

middle income country with a per capita GNI of US\$3,010 (2008)—the highest in South Asia—within the short span of 30 years. The poverty rate has fallen dramatically in recent years from about 40 per cent in 1997 to 16 per cent in 2005. Its HDI rank is 100, the life expectancy is 68 years, and the education index is 0.86 (see Table 8.1).

Table 8.1: Social and Economic Indicators, Selected South Asian Countries

Country	GNI per capita (2006)	Life Expectancy	HDI Rank	Educ. Index
Maldives	3,010	68	100	0.862
Sri Lanka	1,310	75	99	0.814
India	810	64	128	0.620
Pakistan	800	65	136	0.466
Bangladesh	450	64	140	0.503
Nepal	320	63	142	0.518
Bhutan	1,430	65	133	0.485

Sources: World Bank, *World Development Indicators 2008*; and UN *Human Development Report 2007/2008*.

The Maldives functions as a republic with a unicameral People's Council, or Majlis, with 50 members. Elections are held every five years; 42 members are elected by popular vote and eight members are appointed by the President. Maldives was never colonised but was a British Protectorate. The country gained independence in 1965.

The story of Maldives' rapid development can be traced back to the first few years after independence. At that time, the Maldivian economy depended heavily on the export of dried fish, called 'Maldivian fish', which, in crushed form, adds flavour to food preparations in South Asia. About 90 per cent of the Maldivian fish was exported to Sri Lanka. However, with the reduction of Maldivian fish imports by Sri Lanka in the early 1970s, the need for economic diversification came into sharp focus. Under the leadership of Ibrahim Nasir, who became the first President of Maldives in 1968, the country began diversifying its economy through market-oriented policies and development programs, focusing in particular on fisheries and tourism, its leading sectors. This was an approach originally proposed by Albert O. Hirschman in 1958, who envisaged 'development as a chain of disequilibria'. The 'leading sector' growth strategy, recommended by Hirschman and Lauchlin Currie, in essence means increasing

the growth rate of a few key, potentially dynamic, sectors; thereby pulling the rest of the economy along through inter-sectoral linkages (see Hirschman 1958:65-73, Hanson 1976:1-12). The approach was said to be of special significance to countries with limited technical and administrative capacity, where efforts could be more fruitfully focused on a few sectors rather than spreading such capacities too thinly across all sectors.

The fishing industry was the lifeblood of the economy for a long period of time, and it still employs half the Maldivian workforce. Unlike in the case of the Pacific Islands countries, no licences are issued to Distant Water Fishing Nations (DWFNs) for fishing in the Maldivian Exclusive Economic Zone (EEZ) of some 900,000 sq. km.—although some licenses were issued in the past to joint venture companies. The present government's policy is to encourage fishing by domestically registered companies; and all fish caught is processed domestically. The industry has benefited from a major revolution through the mechanisation of fishing vessels since 1974, as it enabled fishermen to travel much farther than in sailboats. The industry received a further boost through the introduction of freezing and canning facilities. This was made possible through foreign investments from Japan, and projects supported by the World Bank and the Japanese Government. As a result of these investments and technological progress in the fisheries sector, the fish catch increased dramatically from around 13,000 metric tons in 1960 to about 184,000 metric tons in 2006.

All fishing activities are carried out by the private sector, with the state playing a supportive role. The pole and line method is the most commonly used technique, engaging some 1,300 to 1,400 motorised vessels. Skipjack accounts for about 80 per cent of total catch, followed by yellow fin tuna, big-eye tuna, and other species. Fish is exported in fresh, chilled, frozen, dried, salted, and canned forms, with the major export markets being Japan, Thailand, the EU, and Sri Lanka. As a Least Developed Country (LDC), Maldives currently enjoys duty-free access to the Japanese and EU markets, and preferential access for dried fish exports to Sri Lanka under the South Asian Association for Regional Cooperation (SAARC). At the time of the country visit in 2009, there were some concerns that these benefits will be lost or reduced upon full graduation from LDC status in January 2011. According to UNCTAD criteria, Maldives has now graduated from LDC status (see UNCTAD website on LDCs).

In the case of tourism, the key actions were: the leasing out of uninhabited islands for up to 25 years for resort development; building an airport with the assistance of the World Bank; and, initially, reliance on charter flights to bring in the tourists. With the development of tourism, more airlines began to operate on a competitive basis. Today, tourists are served by 20 charter airlines and eight scheduled airlines.

The first tourist resorts were opened in 1972, with the setting up of Kurumba Village and the Bandos island resorts. Since then, 90 more resorts have been developed. Once tourists land at Malé airport, they are ferried by boat to their resorts. Typically, each resort consists of a service area in the middle of the island with restaurants, meeting areas, a reception/lobby, sports facilities, a medical centre, and a staff area; tourist accommodation is scattered around the service area; and sandy white beaches surround the complex. There are no roads, nor vehicles, but footpaths are in place for people to move from one area to another. Maldives also has hotels, guesthouses, and live-aboard safari vessels. The country's major source markets for tourism are Italy, the UK, Germany, France, and Japan.

Tourism accounts for about 28 per cent of GDP and more than 60 per cent of foreign exchange receipts on goods and services. Manufacturing (which largely serves the domestic market) and fisheries account for 6.8 per cent and 4.2 per cent of GDP, respectively. However, their roles are reversed in exports, with fish products accounting for about 98 per cent of exports and 11 per cent of foreign exchange receipts (the dominant share is accounted for by tourism). With the expiration of the Multi-Fibre Agreement in December 2004, no garment exports were made after January 2005.

The total value of imports and exports of goods and services exceeds GDP, primarily due to the high value of tourism receipts. Apart from lease rents and tourism taxes, import duties constitute a major source of revenue. The import tariffs are low for basic consumption goods, ranging from 5 to 20 per cent of the c.i.f. value. Tariffs range from 10 to 25 per cent for goods essential for domestic industries, while they are set at 100 per cent for motor vehicles and components and 50 per cent for cigarettes. Plastic packaging materials are levied a tariff of 200 per cent due to environmental concerns.

With a per capita GNI of US\$3,010, Maldives is well on the path to joining the ranks of the upper-middle-income countries.¹ However, the implications of graduation from LDC status are under consideration. These include the loss of tariff-free (otherwise 24.3 per cent) and quota-free access to the EU's tuna market. The government has opposed graduation in the past on grounds of continuing vulnerability and the need to implement transitional measures.

The Analytical Framework

The rapid transformation of the Maldivian economy over the past 30 years presents some useful lessons about how a small atoll country identified constraints to development and addressed them in a systematic manner. In this chapter (as in the case of Barbados), the Maldives experience is analysed retrospectively, using a modified Hausman, Roderick, and Velasco (2005) approach as a broad framework, guided by its growth diagnostics decision-tree methodology to the

extent possible. We cover a period of 30 years to show that a number of components of the decision-tree are relevant to the Maldives experience, such as constraints posed by the state of infrastructure, the level of human capital, land dispersal, and the cost of finance. The use of this methodology helps us to better understand when and how constraints were removed (or used positively, as in the case of land dispersal) over a long period to promote growth and development. As noted in Chapter 3, no attempt is made to present a quantitative analysis in terms of the HRV framework due to the obvious lack of data covering a long period. There is also no quantifiable information indicative of the distortions created by wedges between social and private valuations of economic activities. Thus, the analysis of the constraint removal process is qualitative in character, and is presented in the form of an analytical country narrative. Maldives has all the elements applicable to a typical small island state, except for one special characteristic, i.e. land dispersal.

Identification of Binding Constraints

The identification of binding constraints to development in Maldives is of fairly recent origin. It was set in motion by an enthusiastic Italian traveler, George Corbin, who visited South Asian countries in 1971 to discover new opportunities and ‘virgin’ islands. He, together with Kerefa Ahmed Naseem of the Maldivian High Commission in Colombo, Sri Lanka, traveled to Maldives in October 1971, an outcome of which was the realisation of the great potential of Maldives as a prime tourist destination. At the same time the visit raised awareness of constraints or logistical challenges (absence of hotels, poor transportation, and the lack of essential infrastructure) and, on a larger scale, the constraints in developing tourism. This visit paved the way for subsequent visits by Italian tourists and others; and in turn led to the opening up of the first two island resorts, Kurumba Village and Bandos.

Once the tourist potential was realised, the government moved decisively to progressively remove constraints to the development of the tourist sector. In brief, the key actions were as follows:

- The leasing out of uninhabited islands to private entrepreneurs (mostly local) for the development of resorts, subject to their paying a lease rent, based on bed capacity, and a bed tax amounting to US\$6 per tourist per night (now revised to US\$8);
- Building a new airport with the assistance of a World Bank loan;
- Securing the services of foreign airlines (mostly charter flights in the initial stage) to bring in the tourists; and
- Attracting foreign professionals and labour to work in Maldives.

Concurrently, actions were taken by the government to modernise the fishing industry. Thus, the focus was on the two leading sectors, tourism and fisheries,

to achieve rapid economic growth, while due attention was paid to other productive sectors and social sectors.

The development of the Maldivian economy was guided by a series of national development plans up to the current Seventh National Plan 2006-2010 (7NDP).² Constraints to development were clearly identified in all these plans. Thus, for example, the Fourth Development Plan (1994-1996) notes that:

The large number of widely dispersed small island populations greatly increases the cost of providing infrastructure. A town of 246,000 people (equivalent to the population of Maldives at that time) could be served by a single hospital and a handful of clinics; a similar provision in Maldives would not be practical. The inherent constraints imposed by distance and small populations likewise affect the provision of other infrastructure facilities such as education, energy, transport, and telecommunications.

The Fourth Development Plan also notes other constraints such as the high cost of transport within Maldives because of the long distances between islands and the high unit costs of transporting small volumes of goods to small populations; the lack of natural resources; the lack of lakes, rivers, or streams; the small amount of arable land—only about 10 per cent of total land area; and the lack of technical skills. Nevertheless, it notes the development potential of the Maldives, consisting of a huge Exclusive Economic Zone of close to 900,000 square kilometers, unique physical attributes that cater to tourists seeking a comfortable location, sun, sand, and one of the world's richest coral gardens (7th largest in the world), the time zone advantage for offshore and financial services, and the enterprising spirit of the Maldivian people.

The Plan states that the ultimate objective of development is to achieve sustained improvement in the material and non-material circumstances of the population, and notes the need for economic growth to manifest itself in increased per capita incomes, equitable distribution of national income, employment creation, improved access to social services, and strengthening national and social cohesiveness. The Plan lists the priorities for development under four headings:

- Economic management and development;
- Social development;
- Institutional development; and
- The environment.

The current 7NDP also recognizes the above-mentioned constraints to development, and notes additional ones such as the devastation caused by the tsunami, the extreme dependency on imported fuel, drug abuse, the weak legal framework for development, and eroding moral and social norms. The 7NDP

in some respects goes beyond previous plans in form and content by providing a more comprehensive 'guidance system' in the form of a comprehensive set of principles, policies, and strategies under the rubric of 'Creating New Opportunities'. A key feature has been the extensive consultation with stakeholders throughout Maldives to ensure national ownership, and enhance the public-private partnership in development, already in place.

The guiding principles of the 7NDP are: (i) national ownership; (ii) enhance trust and change; (iii) provide economic opportunities for all; (iv) promote gender equality; (v) ensure environmental sustainability; (vi) respect and promote human rights; (vii) enable private and civil society participation; and (viii) achieve results. The 7NDP sets out 12 important goals and 88 targets across four areas: economic growth, social equity, environment protection, and good governance. Detailed sets of policies and strategies are spelled out to achieve the goals and objectives. The 7NDP places a strong emphasis on achieving the MDGs (for details, see Seventh National Development Plan and World Bank, Maldives: Joint Staff Advisory Note on the Poverty Reduction Strategy Paper 2007).

National leaders have played a dominant role in the development of Maldives over the past 30 years. President Maumoon Gayoom, who assumed office in 1978, provided leadership for a period of 30 years, winning six consecutive elections. It was a period of notable political stability and rapid and sustained economic development, led by tourism. During this period, foreign investment played a significant role, especially in the development and management of tourist resorts, and in the modernisation of fisheries. However, some have been critical of President Gayoom's role, characterising him as an autocrat who limited democratic freedoms. President Mohamed Nasheed, who assumed office in October 2008 after a major election victory, has pledged to eliminate corruption, improve healthcare and communications to the outer islands, and reduce government expenditure. He has also promised to convert the presidential palace into the country's first university.

Let us now use the decision-tree methodology to analyse whether any of the factors included were binding constraints to growth and development; and if they presented obstacles to growth, how they were overcome. We start with institutions, human capital, and infrastructure.

The Institutional Framework

There are two levels of government i.e. the central government and local government. The latter is based on the country's natural division into 26 natural atolls, featuring 1,192 islands, of which 198 are inhabited. These atolls have been grouped into 21 administrative divisions, comprising 20 atolls (outside Malé) and the capital city of Malé. Each atoll is administered by an Atoll Chief ap-

pointed by the President. Plans are currently under way to group the 20 atolls outside Malé into seven provinces and to strengthen the participatory approach to development. The functions of government are carried out through 16 ministries, in addition to the President's Office, the Attorney General's Office, and the Human Rights Commission. The Maldives Monetary Authority (MMA) reports directly to the Minister of Finance. The ministries and the MMA are staffed with well-qualified and competent officers, especially at the senior level; but they are few in number in relation to the tasks to be carried out. Most of the senior officials are trained at the undergraduate or graduate level, mainly in the UK, India, Malaysia, and Sri Lanka. The training programs have been financed either by the government or through bilateral or multilateral assistance programs.

Unlike in many other small island developing countries, Maldives was a British protectorate only from 1867 to 1965 and did not adopt a common law or British law culture. Moreover, the Maldivian legal system has evolved at a slow pace over the centuries. As a result, there is a wide gap between existing practices and what international obligations require, leading to immense pressure on the legal system for swift changes (see 7NDP p.186). In the current structure of the judiciary, the High Court is the highest authority in the administration of justice according to traditional Islamic Law (Shari'ah), and consists of a Chief Judge and a number of judges appointed by the President. The institution functions directly under the President. Thus, the High Court is not an independent body of the State. However, according to the Constitution, 'the judges are independent, and subject only to the Constitution and the law'. The lower courts function under the Ministry of Justice (an Executive body) and not under the High Court. There are 204 such courts in the islands.

How effective is the *institutional framework* in promoting economic growth and development? The general consensus among policy makers, the private sector, and other stakeholders interviewed is that the institutional framework has been and is very supportive of growth and development through the private sector, especially in tourism and fisheries. The rule of law is strictly enforced.

Good governance is highlighted as a key development objective in both the Fifth National Development Plan (1997-2000) and the Sixth National Development Plan (2001-2005) (see ADB 2001). Priority goals of government as stated in these plans are to establish a modern public administration, a comprehensive and transparent set of laws, and an impartial and competent judiciary. The 7NDP moves the agenda further by adopting the goals of strengthening good governance and democracy in the Maldives through complementary reforms in the system of local government at the atoll and island levels. Involving the island communities in the decision making process will be crucial in promoting island development through more accountable and responsive governance systems. However, progress in achieving good governance systems has been rather

slow, in part due to shortages of skills, which is a constraint to modernising the public sector. In particular, public financial management and accountability are at a nascent stage; but progress is being made.

With regard to *clientelist politics*, there is no tangible evidence of politicians pursuing their own interests rather than national interests, particularly under President Gayoom's 30-year leadership, which focused sharply on national development. This is reflected in government budgets over the years. For example, over 25 per cent of government expenditure was allocated to education and health in the Budgets for 2007 and 2008. Further, large allocations totaling 31 per cent of government expenditure in 2007 and 21 per cent in 2008 were made to social security, welfare, and community development programs. There is no evidence of significant targeted transfers to voter groups. Rather, budgetary allocations were provided for improvement of living standards for the nation as a whole. For example, 83 per cent of households have access to a water supply and 59 per cent of households have improved sanitation facilities—which represents significant advances on the situation prevailing prior to the major water supply and sanitation projects mentioned below.

Economic development in the Maldives has benefited greatly from the long-term vision of key policy makers, and has resulted in strong economic performance over the past 30 years. These economic gains are reflected in improved human development indicators and an increase in per capita income to the level of lower-middle-income countries—from one of the 20 poorest countries in the world during the 1970s, with a per capita income of less than US\$100 dollars. Real GDP growth averaged 8.9 per cent per year during 1980-1989, and 8.1 per cent per year during 1990-1997. Even in recent times, the Maldivian economy has recorded a steady growth performance, averaging 7.0 per cent per year during the 11-year period 1998-2008. The main contributions to the increase in real GDP (at 1995 constant prices) during this 11-year period came from government administration (25 per cent), transport and communications (24 per cent), and tourism (21 per cent). Real GDP growth estimates and other key macro-economic indicators are provided in Table 8.2 below.

However, the national accounts are not complete; official estimates of gross fixed capital formation (GFCF) are not available, although progress has been made to develop such estimates. A UNDP assistance program includes technical assistance to estimate the GFCF-based capital goods imports, the output of the local shipbuilding industry, and investments in all sectors other than households. Although work in this area has been carried out over the past few years, estimates of the GFCF have not yet been included in official national accounts estimates. Consequently, national accounts estimates on sources and uses of funds, including those of domestic savings, are not available.

The macroeconomic framework, supported in the past by a judicious mix of exchange rate, fiscal, and monetary policies—up to about two years ago—provided a level playing field to support steady growth over a long period, especially in tourism development. As a result, private entrepreneurs enjoyed some measure of predictability of outcomes relating to their investments and returns, thereby enhancing their level of confidence in investment decisions. However, at the time of the country visit Maldives was experiencing macroeconomic instability, mainly due to expansionary fiscal policy arising from post-tsunami reconstruction expenditures and a major pre-election increase in the government wage bill. The global economic crisis had also adversely affected tourist arrivals, especially from Europe. Tourist arrivals declined by about 10 per cent during the period January-May 2009 as compared to the corresponding period in 2008, with adverse impacts on government revenues and foreign exchange earnings.

The country's *exchange rate system*, which is a conventional peg against the US dollar, has been well managed. The exchange rate has been steady in recent years at Rufiyaas 12.8 per US dollar, but is coming under pressure as gross foreign reserves have declined to a level equivalent to about two months of import cover. There is no exchange control legislation in the Maldives and, as a result, residents and non-residents alike may freely import and export capital through the foreign exchange market. Residents do not require approval to maintain foreign currency accounts, either in Maldives or abroad. With regard to foreign investment, prior approval of the government is required, and an annual royalty is levied, based on a rate(s) negotiated between the government and the investor. Maldives avails itself of the transitional arrangements of the IMF's Article IV consultations, but maintains no restrictions on payments and transfers for current international transactions.

The generally prudent macro-economic stance, together with generous amounts of concessional donor financing, enabled Maldives to maintain manageable budget deficits up to about 1998, but *fiscal policy* has tended to be expansionary since then. Following some expenditure restraint, the deficit was progressively reduced to 1.6 per cent of GDP by 2004. Unfortunately, on December 26, 2004, Maldives was hit by the disastrous tsunami, which cost many lives and inflicted damage equivalent to 62 per cent of GDP. The subsequent surge of reconstruction activity, especially in 2005 and 2006, led to a widening of the deficit (see Table 8.2 below). Further, government expenditure rose to a high of 66 per cent of GDP in 2007, primarily due to increases in the civil service wage bill and in social welfare contributions—widening the fiscal deficit. As noted in the World Bank's *Public Expenditure Review* of 2002, Maldives had among the highest number of government employees per head of population in the developing world (about one civil servant for every 13 Maldivians), and the situation has not changed significantly since then.

Table 8.2: Maldives—Key Macroeconomic Indicators, 2004-2008

	2004	2005	2006	2007*	2008#
Indicator Values (US\$ million)					
GDP (at current prices)	776.5	749.7	915.4	1054.0	1258.7
Government Revenues and Grants	267.6	360.4	480.8	613.5	762.3
Government Expenditures and Net Lending	279.9	442.0	542.8	696.4	884.5
Government Budget Balance	-12.3	-81.6	-62.0	-82.9	-122.2
Exports of Goods & Services	688.6	484.5	777.1	877.1	1,053.1
Imports of Goods & Services	-722.2	-868.6	-1046.5	-1234.8	-1586.4
External Current Account Balance+	-122.3	-273.0	-302.0	-412.1	-637.6
Gross International Reserves	204.4	187.1	232.2	309.1	241.3
Macroeconomic Balances (% of GDP)					
Budget Balance	-1.6	-10.9	-6.8	-4.7	-12.6
External Current Account Balance+	-16.2	-35.9	-40.3	-39.1	-50.7
External Debt	42.7	57.3	49.1	69.6	82.6
External Debt – Government	30.5	34.0	32.4	37.0	39.0
Domestic Debt – Government	12.6	18.7	18.5	19.0	22.7
Other Indicators					
Real GDP Growth (%)	9.5	-4.6	18.0	7.2	5.8
Inflation Rate (Malé) (%)	-1.7	1.3	2.7	6.8	12.0
Gross Reserves (months of imports)	2.9	2.1	2.3	2.2	2.1
Exchange Rate: Rufiyaa per US\$ (average)	12.8	12.8	12.8	12.8	12.8

* Preliminary.

Estimated.

+ Includes net investment income and net current transfers.

Sources: Maldives Monetary Authority, Monthly Statistics 2008; IMF Staff Report for the 2008 Article IV Consultation.

With advice from the IMF, the Maldivian authorities are taking measures to contain or reduce expenditures and to raise revenues, as for example through a revision of electricity tariffs and leasing out 30 additional islands. The IMF has provided advice on broadening the tax base through: (a) a business profits tax and a personal income tax; (b) an *ad valorem* tourism tax in place of the fixed-rate tax of US\$8 per bed night, which is too low, especially for high-end tourists (see IMF Staff Report for the 2008 Article IV consultation); and (c) a VAT to largely replace import duties. The IMF has also drawn attention to the risks to macro-economic stability posed by the expansionary fiscal stance and has underlined the need to contain or reduce fiscal expenditures.

Monetary policy in the Maldives has been aimed at achieving and maintaining price stability, using an exchange rate peg with the US dollar as the intermediate target in a manner conducive to balanced and sustainable growth of the national economy. The main policy instruments used are the Minimum Reserve Requirement, Central Government Treasury Bills, and Re-purchased and Re-discount facilities. The MMA is the government's agent for the issuance and management of Treasury Bills. The MMA is also responsible for implementing a wide range of prudential regulations (see the MMA website for further details). As noted in the 7NDP, one of the policy goals is for the MMA to achieve full operational autonomy and transform into a fully independent central bank, so that exchange rate and monetary policy decisions can be made solely on economic criteria. The IMF is currently providing technical assistance to help achieve this objective. The MMA is also focusing on a set of strategies to strengthen the capacity of financial institutions and broaden and deepen the financial sector.

The increased rate of inflation in 2007 and 2008 is a cause for concern, which the authorities are trying to address. So too is the rising level of public debt, both external and domestic. In 2008, external public debt stood at an estimated 82.6 per cent of GDP (see Table 8.2). The significant increase in the external debt-to-GDP ratio in 2007 and 2008 largely reflects private sector borrowing for resort construction and, to a much lesser extent, public sector borrowing for post-tsunami reconstruction activities. According to IMF projections, the external debt-to-GDP ratio was forecast to climb to about 95 per cent by 2010 and diminish thereafter, as several projects would be completed and repayments begin (see IMF 2008).

Another cause for concern has been the rising unemployment rate. The only source of information on employment is the nation-wide Census. According to the 2006 Census, the unemployment rate increased significantly from 2 per cent in 2000 to 14 per cent in 2006. Unemployment is particularly acute among young people. As noted in the 7NDP, 40 per cent of young women and over 20 per cent of young men are unemployed. The high unemployment rate reflects structural issues in the labour market, such as strong preferences for white col-

lar or government jobs and a general aversion to low- or semi-skilled jobs, rather than a lack of job opportunities.

To address the unemployment issue, the Government is formulating a National Employment Strategy targeted at job creation, improving the skills of young people, better job matching, and establishing a legal framework for promotion of right to work, occupational health and safety, and protection of the rights of employers and employees. The aim is to focus attention on realising optimal returns on investments in human capital.³

Human Capital in Development

The initiatives in economic diversification in the late 1960s brought into sharp focus the crucial need to address human resource constraints, a major barrier to sustainable economic development. Professional and technical skills, in particular, were minimal at that time. Unlike some of the other successful developing countries (e.g. Barbados), Maldives had a very low base to start from. According to Maldivian traditions, children aged three and upwards were educated in Islamic 'Makthab' classes, typically using a single large room or under the shade of a tree. The first western-style school, the Majeediya School, had been established in 1927. However, a start was made during the 1970s on a program of rapid human resource development.

Formal education was concentrated in the capital city of Malé until as late as 1978. However, President Gayoom, who assumed office in 1978, immediately set in motion a program to build a school on every atoll. The first school outside Malé was opened on South Miladhunmadalu Atoll in March 1979. Since then the number of schools has grown to a total of 124, of which 25 are located in the main population center of Malé. By 1998, the adult literacy rate had reached 98 per cent.

In the Maldives, virtually all children attend five years of primary school and the majority attends seven years of basic education (comprising five years of primary and two years of secondary). The net enrolment rate for primary education is 100 per cent. Secondary education is in two parts: three years of lower secondary leading to the 'O' level examination and two years of upper secondary leading to the 'A' level examination, both of which are set in the UK. In the case of tertiary education, initiatives to concentrate sub-degree tertiary education and training in the Maldives College of Higher Education began in 1998. These initiatives brought together teacher education, health sciences, management and administration, technical education, hotel and catering, and maritime training. Since courses range from a few weeks to two years, estimates of enrolment are not very meaningful. In recent years, enrolments have been evenly split between males and females (see World Bank's *Public Expenditure Review* (2002) for further details). The medium-term objectives during the 1990s were to:

- Complete the universalisation of basic education;
- Move towards universal access to secondary education; and
- Ensure that there is an expanding tertiary sector and opportunities for higher education abroad.

The following statement by President Gayoom on July 26, 1999 captures the essence of the then government's policy towards human capital development:

Ten years of formal schooling will be the minimum standard throughout Maldives . . . A system for the provision of technical skills needed for achieving and sustaining social economic development will also be established.

The current 7NDP includes a wide range of policies and strategies (11 for primary and secondary schooling and four for higher education). In broad terms, these cover improving access, quality, effectiveness, efficiency, and organisational productivity, curriculum reform, promotion of health, nutrition, safety, and life skills, and expanding the skill base of the labour force to meet market demand and the development needs of the nation. The 7NDP envisages the transformation of the Maldives College of Higher Education into a university and increasing the number of scholarships offered by the government and the private sector. The school system in the Maldives has produced a trainable labour force for specialised training to meet the critical professional and technical needs of the country. Internet use has grown very rapidly during the past few years. The number of Internet users in 2007 stood at 8.9 per 100 people, ahead of India (7.1), Sri Lanka (3.7), and Bangladesh (0.3), but lower than Pakistan (10.6)(see NationMaster.com).

Technical and vocational education and training (TVET) currently in place are demand driven, accessible, beneficiary-financed, and quality-assured. In specific terms, TVET is designed to meet the needs of society, a growing economy, enterprises, and employment for young people. A Maldives National Qualifications Framework (MNQF), established by the Maldives Accreditation Board (MAB), provides a system to ensure sustainable and strategic solutions for national training needs as well as for the perceived employment mismatch for both the formal and informal sectors, with special attention on youth. In a recent batch of trainees, 50 per cent were trained for the tourist sector, 39 per cent for the construction sector, and 8 per cent for fisheries and agriculture.

Up to now, higher-level education and training abroad has been financed by parents of students, the government, or donor agencies and has been the main source of supply of professional and technical personnel. Some programs have focused on training in narrow technical skills such as marine engineering and aviation, which have greatly helped the economic diversification program. Others have focused on producing doctors, nurses, community health workers,

and paramedical and management personnel, which are aimed at improving the quality of life of the population.

Training in other disciplines has been funded by several donor agencies. Between 1977 and 1997, the government sponsored 851 students in first-degree courses and above. Public expenditure on education as a percentage of GDP (7.7 per cent) and total government expenditure (17.8 per cent) is comparatively high, both in relation to other countries in the region and other developing countries. Notwithstanding these efforts, more than half of the skilled workers employed in the Maldives are expatriates. Together with semi-skilled workers, there are a total of about 85,000 registered expatriates working in the Maldives, in addition to an almost equal number of local workers. The procedures for obtaining work permits are fairly streamlined; it takes about one month to obtain a permit. However, in the wake of the rising unemployment, adverse reactions by locals to the employment of expatriate workers have begun appear, especially over the past two years.

Detailed information or estimates of professionals in specific critical skills (engineers, doctors, accountants, lawyers, economists, etc.) are not available—although some broad groupings by skill category were collected in Census 2006. In part, this lack of information reflects the difficulty of gathering information from a highly dispersed population and the constant in/out migration of professionals. A profile of broad categories of critical skills is shown in Table 8.3 below.

Table 8.3: Selected Skills

Profession	Number
Engineers, architects, and related professionals	421
Business Professionals	1037
Modern Health Associate Professionals *	70
Legal Professionals	280
Higher Education Teaching Professionals	1181
Computer/Information Technology Professionals	375
Total	3364
Selected Skills per '000 Population	11.1

* In addition, there are over 2,800 traditional medical practitioners and faith healers.

Source: Census 2006, list of occupations by ISO 4-digit level.

Thus, in contrast to the Maldivian Government's emphasis on building human capital and allocating large outlays on education—which essentially relates to the input side—there is not an adequate database on the output and stocks of human capital. Notwithstanding the difficulties noted above, construction of such a database merits consideration and calls for the setting up of an institutional arrangement for close monitoring of the output of critical skills from educational institutions, as well as in/out migration of people with such skills.

Infrastructure

Unlike in the case of an island state with one or two contiguous land areas, providing infrastructure facilities for the 198 inhabited islands and a gradually increasing number of tourist resorts on other islands was recognized by the government to be a formidable problem at the beginning of the diversification program. In tourist transport, for example, the task was not only to provide roads and transport facilities from the airport to a hotel but also building a land-water transportation network consisting of paved roads, jetties, power boats, ferries (dhonis), and sea planes to carry tourist traffic from the Malé airport to and from multiple resort destinations, some of which are over 100 miles away.

The approach to addressing the infrastructure constraint is an example of a public-private partnership. The government assumed responsibility for providing the airport, jetties, and related transport facilities, while the private sector played the complementary role of providing basic infrastructure within the resorts and in augmenting water transport through high-speed boats. The traditional boat building industry, which had been servicing the fisheries sector for centuries, also had an important role in constructing ferryboats for transporting tourists to and from the resort islands. The mechanisation of the traditionally handcrafted dhoni in 1974 was a major milestone in meeting the demands of the fishing industry as well as the tourism sector. There are now around 500 speed-boats and 40 seaplanes servicing the tourist sector, and an estimated 2,000 dhonis servicing the fisheries and tourist sectors.

Given the importance of transportation, successive development plans and budgets up to about the mid-1990s allocated large shares to transportation. In 1995, for example, the share allocated to transport in total government expenditure was equivalent to 5.7 per cent of GDP, compared to 4.7 per cent for education and 3.7 per cent for health. As a result of investment in the transportation sector, Maldives today has 88 km. of paved roads: 60 km. on Malé, 14 km. on Addu Atoll, and 14 km. on Laamu Atoll.

The seaport for international trade and transport is located in Malé. Maldives National Shipping Ltd., which had owned 80 ships in the 1970s, and played a dominant role in international shipping at that time, faced mounting losses and

its activities have been greatly reduced. The private sector continues to provide local and inter-island passenger and cargo services by sea.

Maldives did not invest in an international airline. Rather, it has relied on foreign airlines for passenger traffic and air cargo. Currently, a wide range of some 20 chartered airlines and eight scheduled airlines provide the needed air transport. There are five airports in the Maldives, of which two are international (Malé and Gan). The Malé Airport handles about 1.5 million international passenger movements and 0.2 million domestic passenger movements per year. Inter-island air services are provided by Island Aviation Services Ltd. (IAS), which is fully owned by the Government. It operates a small fleet of turbo-prop aircraft on its domestic routes from Malé to Gan, Hanimaadhoo, Kadhdhoo, and Kaadedhdhoo and an international route to Thiruvananthapuram, India. In August 2008, the Airline Division of IAS Ltd. was renamed as the 'Maldivian'. The Maldivian has no competition on these relatively 'long' routes (by island standards), but the fares charged are considered to be moderate and reasonable. For shorter routes, two private companies, the Maldivian Air Taxi and the Trans Maldivian Airways, provide seaplane services for transfer of tourists from Malé International Airport to the resort islands.

Electricity supply is very reliable, with the State Electric Company Limited (STELCO) providing the service throughout Malé. STELCO is a state-owned organisation founded in 1949 for the generation and supply of electricity. Other islands in the Maldives have their own power generators. The telecommunications sector also works well. As a result of sustained private investment, mobile cellular networks have expanded rapidly in recent years to reach a subscribership of around 90 per 100 persons. Inter-atoll communications are conducted through microwave links, and all inhabited islands are connected with telephone and fax services. International communications are served by submarine fiber-optic cable and satellite.

As regards water supply and sewerage, the low-lying nature of the terrain, which is also generally porous, proved to be a major constraint. The main source of fresh water is the aquifer that floats on saline water about two meters below ground level. The water supply was susceptible to pollution up to about 1988, mainly due to the absence of environmentally sound sewerage disposal systems. As a result, water borne disease was a major cause of illness and death in the Maldives. However, this problem was eliminated in 1988 through the Malé Water Supply and Sanitation Project, completed with donor assistance. The project was relatively large in scope for a small island and involved the laying of 46,000 metres of sewer pipes, the construction of nine pumping stations, and a system of ocean discharge pipes to dispose chemically-treated sewage into the deep ocean surrounding Malé. By 1997, a total of over 50,000 metres of sewage pipes had been laid in Malé. A number of improvements have been made since then with assistance from Germany, the EU, and the Saudi Fund.

The resorts have their own water supply and sewage systems to serve the tourists. Typically, water is provided from desalinated seawater or from bottled drinking water. In Malé, the main agency responsible for water supply and sewerage is the Malé Water Supply and Sewerage Company (MWSC), a joint venture between the Maldivian Government and a European company. MWSC has installed desalination plants with a total capacity to produce 2,000 tonnes of water per day. The MWSC is operationally effective, achieves complete cost-recovery, and has proved to be sustainable, as Malé residents are able to pay for the services. The Maldives Water and Sanitation Authority (MWSA) serve the other atolls.

Infrastructure provision is one area in which the government has been identifying development constraints and addressing them in a systematic manner. One major constraint to the quality of life is the severe overcrowding in Malé, the home to over 100,000 people within an area less than one square mile, and where the occupancy rate had risen close to 16 per dwelling by 1998. To address this problem, the government embarked on an ambitious land reclamation and urban development project known as the Hulhumale Project, within the capital region and about 1.3 km. from Malé. Its land area is more than three times that of Malé and has an elevation of two meters above mean sea level, which is more than that of Malé. The land area is well zoned, demarcated into social, infrastructure, commercial, and residential areas. The roads are broad, well paved, and well laid out. A fair number of apartment complexes have already been completed and are occupied. This island will eventually accommodate 150,000 people and was estimated to cost over US\$350 million.

Another major constraint is the dispersal of islands and the resulting difficulty of providing basic services. Many islands have subsistence communities of less than 500 people. To address this problem, the government has defined five Regional Development Centres to provide better infrastructure services.

Investment in infrastructure by the Maldives over the past 30 years has played a very supportive role for private sector activity. The general perception in the private sector is that the current state of infrastructure facilities does not act as a constraint to their activities. In sum, the strong institutional framework, the high level of human capital development, and the adequate infrastructure facilities constitute the first set of factors (shown in the HRV decision tree) that have ensured adequate returns to investment.

Private Appropriability of Returns to Investment

Guided by the HRV decision-tree, we now focus attention on the government's actions in support of private sector appropriability. On the whole, the private sector has a favourable perception of the appropriability of returns to investment, conditioned principally by the enforcement of property rights, the

simplicity of the tax regime, and the regulatory environment, in addition to the macro-economic stability discussed above. According to informal views expressed by the private sector, investments in resorts can be recovered in about five years, while those in tourist transport and shops can be recovered in one year. The level of corruption is an issue, but there is a general awareness that the new government is committed to eradicating corruption.

The government has ensured that *property rights* are strictly enforced for the small share of private land in the Maldives, where most of the land is owned by the state. As described in the 7NDP, land tenancy can be separated into three categories: (i) land held under waqf (trust principles under Islamic Shari'ah); land owned by private individuals; and land owned by the state and granted to individuals for residential, commercial, or other purposes. Land in the second category, although limited, has been increasing, particularly in Malé and other urban areas. Such land can be bought or sold. The issuing of tenancies under the first category has virtually stopped. It is possible for individuals to acquire ownership of land by purchasing it from the state. Recent changes relating to land transactions are governed by the Land Act (1/2002), which is based on the traditional view of land and its focus is on processes and procedures for holding, acquiring, and transferring land, mainly for residential purposes. All land for resorts is held under lease, and leasehold rights are strictly enforced. This enforcement has provided the needed security to private investors, both local and foreign, and has been a significant factor in attracting foreign investment.

The *revenue and tax regime* in the Maldives is perhaps one of the simplest and has been very investor friendly. There are no personal taxes, corporate taxes (other than a bank profit tax), or capital gains taxes. However, it appears difficult to maintain such a tax regime in the wake of rising recurrent expenditures and a heavy tax burden on the tourism sector. In the Budget for 2008, the main sources of tax revenue, estimated at 20 per cent of GDP, were import duties, essentially revenue tariffs, and tourism taxes, which together accounted for over 90 per cent of total tax revenues; other sectors were largely untaxed. The main sources of non-tax revenues, estimated at 34 per cent of GDP, were land rent, resort lease rent, and transfers from SOEs, which together accounted for over 80 per cent of total non-tax revenues. Thus, the 2008 Budget estimates of tax and non-tax revenues together amounted to a high level of nearly 54 per cent of GDP (See IMF Staff Report of the 2008 Article IV Consultation, July 30, 2008). However, according to the latest revised estimates, the total of tax and non-tax revenues is estimated to be below 50 per cent of GDP, largely due to a fall in tourism revenues, which were adversely affected by the global downturn that began in 2008.

Revenues from tourism are based on capacity and use—comprising an annual lease rent (or bed rent) based on the resort bed capacity, and a bed night tax. The 'bed rent', which has to be paid at the beginning of each year, averages

around US\$4,000 per bed, but can vary from around US\$2,000 to US\$25,000 per bed, depending on the quality/category of the resort, regardless of the level of occupancy. The amount of the rent payable is negotiated with the government at the outset of the investment. The bed night tax is an occupancy tax amounting to US\$8 per tourist. However, as noted above, proposals to widen the tax base are under consideration from the standpoint of restoring fiscal stability.

The overarching objective of the *regulatory framework* is to facilitate the setting up and operation of private enterprises, whilst ensuring transparency, accountability, and good governance. The level of achievement of this objective is reflected in the World Bank/IFC *Doing Business 2009* Report, which ranked Maldives at 69 among 181 countries, which places it ahead of most developing countries as well as European countries such as Greece and Poland. Maldives also ranks higher than other South Asian countries. As shown in Table 8.4, the number of procedures for starting a business is the least among South Asian countries, and so is the duration. There is a minimum capital requirement for investment in the Maldives, but investors do need start-up capital in any case, especially in the tourism sector.

Table 8.4: Indicators of Costs of Starting a Business—Selected South Asian Countries

Country	No. of Procedures	Duration (Days)	Cost (% of GNI per capita)	Min. Capital (% of GNI per capita)
Maldives	5	9	11.5	4.8
Sri Lanka	4	38	7.1	0.0
India	13	30	70.1	0.0
Pakistan	11	24	12.6	0.0
Bangladesh	7	73	25.7	0.0
Nepal	7	31	60.2	0.0
Bhutan	8	46	8.5	0.0

Source: World Bank and International Finance Corporation, *Doing Business 2009* (which reflects information gained in 2008).

As regards trading across borders, informal observations gained from a few private entrepreneurs are that the procedures for trading across borders involved in getting export goods on board or unloading imports are essentially standard ones, consisting of compliance with required documentation (bills of lading,

certificates of origin, invoices, customs forms, etc.). However, performance on trading across borders has been rather poor. Maldives ranks 121 amongst 181 countries in terms of the criteria for judging the effectiveness of trading across borders. In the case of exports, eight documents and 21 days are needed on average to complete the task. The cost to export is estimated at US\$1,348 per container. In the case of imports, nine documents are required and it takes 20 days to complete the task. The cost to import is also estimated at US\$1,348 per container. By comparison, Singapore has the fewest number of documents (4) to complete for exports and Fiji has the highest (13). As regards the cost per container, Singapore has the lowest (US\$439) and Guineau-Bissau the highest (US\$2,349) (see *Doing Business in Small Island States*, p.53 for Maldives and pp. 21-2 for comparative indicators).

Transparency International (TI) provides some indication of the level of *corruption* in Maldives. The comparative scores for the selected countries in the South Asia Region are shown in Table 8.5 below. Bhutan receives the highest ranking, followed by India and Sri Lanka. Maldives occupies the mid-point in the ranking of the seven South Asian countries in the table. Maldives is ranked 115 in the global TI ranking of 171 countries for 2008, indicating a relatively high degree of corruption, comparable to some of the other South Asian countries. As noted above, the new President has pledged to eliminate corruption.

Table 8.5: TI Corruption Perception Index 2008—Selected South Asian Countries

Country	Corruption Perception Index
Maldives	2.8
Sri Lanka	3.2
India	3.4
Pakistan	2.5
Bangladesh	2.1
Nepal	2.7
Bhutan	5.2

Source: Transparency International Secretariat, Berlin.

In sum, it can be concluded that favourable performance in most of the areas mentioned above has ensured private appropriability of the returns to investment in the past; but sustaining the incentive structure is a challenge, which

must be addressed by restoring macro-economic stability—with advice and possible financial assistance from the international financial institutions (IFIs).

Cost of Finance

Maldives has a rather narrow financial sector, which is dominated by the banking sector. The sector consists of five commercial banks: the Maldivian Commercial Bank, a fully locally-owned bank; branches of three partly state-owned regional banks, the Bank of India, Bank of Ceylon, and Habeeb Bank; and the branch of an international bank, the Hong Kong and Shanghai Bank—all of which are overseen by the MMA. The non-bank financial institutions include the general insurance companies, a specialised housing institution, and money services businesses. The MMA is the primary source of finance for the government's fiscal operations, while the commercial banks provide credit and foreign exchange to the private sector. As at the end of May 2009 total deposits in the commercial banks (from all sources) stood at Rf.7,104 million in local currency and Rf.7,590 million in foreign currency. For deposits over three years, commercial banks offer interest rates ranging from 3.0 to 6.5 per cent. With inflation running at 12 per cent in 2008 and at over 10 per cent in early 2009, these interest rates are negative in real terms, acting as a disincentive for savings. Thus, getting inflation under control so as to ensure that real interest rates are positive is a key task that needs to be addressed in the context of a program to restore macroeconomic stability. As regards lending to the private sector, the commercial banks offer rates ranging from 8 to 13 per cent for domestic currency loans, and 5.5 to 13 per cent for foreign currency loans. In the case of lending to the public sector, the lending rates vary from 5.5 to 13 per cent. The spread between deposit and lending rates are rather low compared to those of the Pacific Islands countries.

Notwithstanding the recent boom in private sector credit, with a 40 per cent increase in 2007, access to credit for businesses other than resorts, fisheries, and construction is perceived to be somewhat problematic. In 2008, close to 80 per cent of the commercial bank credit was advanced to tourism, fisheries, and construction. Access to credit tends to be especially limited for small businesses, because of collateral requirements and a reported track record of defaults in the past, which has led to stringent bank loan conditions. However, since the enactment of the recent Land Act of 2002, it has become easier for individuals to purchase land from the Government and use such land as collateral for banks loans. The banks also accept land leases as collateral for bank loans. The 7NDP recognizes the need for further modifications and streamlining of laws and regulations for the use of land for economic activity. Given the inadequacy of credit from domestic sources in relation to demands from the directly productive sectors, most of the resort owners have obtained credit from foreign banks for the development of resorts, using land leases as collateral.

Other Constraints

As in the case of other small island states, Maldives is vulnerable to *natural disasters*. A particular source of concern is that Maldives is the country with the 'lowest highest point' in the world. Maldives was one of the countries most severely affected by the tsunami of December 26, 2004. Over 35 of the inhabited islands were badly damaged and close to 30,000 people were displaced, with 12,000 rendered homeless. According to a joint World Bank-ADB-UN assessment, total damage was estimated at US\$470 million, equivalent to 62 per cent of GDP (see 7NDP).

As noted in the 7NDP, the tsunami exposed the true vulnerability of the Maldives and the difficulties it faces in providing disaster management and mitigation services to its scattered population, tourist resorts, and industrial islands. A major constraint in this regard was the lack of coherent plans for disaster management and tested frameworks for establishing operations centres to handle the crisis. The 7NDP (pp. 114-5) sets out four policies and 18 strategies for disaster management. The policies are as follows:

- Institutionalise disaster management and mitigation and enhance disaster management capacity;
- Make Maldivians safe and secure from natural disasters through information dissemination, and planning and coordination of national response actions;
- Alleviate and eliminate risks to life and property from natural or man-made hazardous events; and
- Deliver prompt and efficient relief and support in the event of a hazard.

Programs and projects are currently under way to implement these policies and related strategies.

Another major concern in the Maldives is that its low-lying islands are very sensitive to the predicted impacts from climate change (see 7NDP pp. 108-9). The predicted sea level rise by 2100, combined with increases in extreme weather events, would make Maldives one of the countries most vulnerable to climate change and sea level rise. In response to these sources of vulnerability, Maldives became a party to the United Nations Framework Convention on Climate Change (UNFCCC), and was the first country to sign the Kyoto Protocol. Maldives has also prepared a National Adaptation Program of Action and a related set of policies. The President has announced that Maldives will become the first carbon-neutral country in the world. As a fall-back position, some consideration is also being given to moving Maldivians to safer territory in the future, to countries such as India, Sri Lanka, and Australia, by purchasing land through a sovereign wealth fund. Other environmental problems include

beach erosion and solid waste disposal, which are more complex than in most other island states, given the low-lying nature of the islands and their wide dispersion.

The alarming increase in *drug and substance abuse* observed among young people in recent years has also become a constraint to development (see 7NDP p.11). The reported number of drug abuse cases tripled between 2001 and 2006. Addressing the drug abuse and trafficking problem is a top priority of the government. A national campaign to root out the drug menace has been initiated, and concerted efforts are being made to coordinate the necessary actions.

Distance to markets is not considered to be a constraint to economic growth, given the long established contacts with Japan, the EU, and Thailand for fish exports—the major export commodity—and the quality of fish exported. Fish is exported in frozen, fresh, and processed forms, and on preferential terms, as noted above.

Learning from the Maldives Experience

What we can learn from the Maldives experience in the identification and removal of binding constraints to growth? There are at least six important lessons of relevance for small island economies that can be derived from the Maldives experience. These may be summarised as follows.

1. The series of development plans clearly identified constraints that are more severe than in a typical small island state—particularly the vast dispersal of islands and their very low-lying nature—and set the stage for a pragmatic approach as to what could be done in terms of harnessing the potential of the two leading sectors, fisheries and tourism. The dispersal of islands was in effect transformed into a ‘resource’ for providing remote and tranquil tourist resorts. This goal was accomplished in a cost-effective manner by inviting the private sector to develop the resorts, supported by essential infrastructure facilities provided by the government. Unlike some island states, Maldives refrained from investing in an international airline. Charter flights and international airline services were relied upon to bring in the tourists.
2. Maldives followed a participatory approach to development. There was wide consultation with all major stakeholders prior to the preparation of development plans. The implementation of these plans is a good example of effective public-private partnerships. The government provided the necessary infrastructure, leaving the directly productive sectors to private entrepreneurs.
3. The human resource constraint was recognized to be a major constraint, particularly with respect to professional and technical skills. This issue has been addressed partly through a rapid expansion of educational facilities and partly

by attracting expatriate labour on a large scale, with minimal registration formalities. Today, there are as many expatriates as the domestic work force, and, as noted above, the procedures for obtaining work permits have been fairly straightforward.

4. Macro-economic stability has played a major role in promoting private sector-led growth. The macro-economic framework, supported by a judicious mix of exchange rate, fiscal, and monetary policies, has provided a level playing field to support steady growth over a long period, especially in tourism development. As a result, private investors enjoy some measure of predictability of outcomes relating to their investments and returns, thereby enhancing their confidence in investment decisions. The country's exchange rate system, a conventional peg against the US dollar, has been well managed. There is no exchange control legislation and, as a result, residents and non-residents alike may freely import and export capital through the foreign exchange market.

However, Maldives began to experience macro-economic instability mainly due to an expansionary fiscal policy arising from post-tsunami reconstruction expenditures and a major pre-election increase in the government wage bill. The global financial crisis has also affected tourist arrivals, especially from Europe, with adverse impacts on fiscal revenues and foreign exchange earnings. It is expected that the dialogue initiated with the IFIs in June 2009 will lead to a program of financial assistance. Given the severity of the crisis, the urgent task ahead is to restore macro-economic stability through an appropriate mix of policy instruments and development programs.

5. The appropriability of returns to investment has been perceived to be favourable by the private sector. This is due to the enforcement of property rights, the simplest possible tax structure, consisting mainly of import duties, lease or bed rent and a bed tax, and the ease of doing business in the Maldives. However, tax reforms are under consideration to broaden the tax base, especially through the introduction of a business profits tax, an income tax, and a VAT, to increase revenues and restore fiscal stability. Foreign banks have largely financed private investments, as access to domestic credit has been limited.
6. Environmental issues are very high on the development agenda in the Maldives. The projected sea level rise is a major concern. Maldives became a party to the United Nations Framework Convention on Climate Change (UNFCCC) and was the first country to sign the Kyoto Protocol. Maldives also responded rapidly to the post-tsunami reconstruction effort, coordinating assistance from a number of donors.

In sum, the success story of Maldives has largely been the result of adopting a

pragmatic approach to planning, based primarily on the development of fisheries and tourism and a judicious balance between the roles of government and the private sector and other stakeholders. The friendly and free enterprise attitude of the people has also been a factor that has attracted private investment and enhanced the development process. Maldives is on a path to creating new opportunities and becoming an upper-middle-income country and enhancing its role as an effective partner in the global economy of the twenty-first century. This goal is achievable by virtue of its approach to development, its outward-looking policies, its stable macro-economic framework, the educated labour force supplemented by expatriate labour, its dependable infrastructure, and investor-friendly business environment.

Notes

- 1 Currently, lower-middle-income countries and upper-middle-income countries are separated at a GNI per capita of US\$3,595.
- 2 The acronym 7NDP is used to avoid confusion with the Sixth National Development Plan (SNDP).
- 3 See the 7NDP, p. 10.

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Chapter 9 Conclusions

Ron Duncan and Hilarian Codippily

Introduction

We assume that it is possible for most Pacific Island countries (PICs) to grow faster than they have over the past 2-3 decades. There are many factors that could be preventing the faster economic growth that would lead to improved living standards for the majority of the population. But not all such factors are equally important; nor should they have equal priority with respect to reform; and nor are they likely to be the same across all PICs.

Reform programs have paid little attention to identifying the most limiting constraints on economic growth and therefore there has not been sufficient attention paid to the issues that should receive priority in the reform process. Most reform programs identify all possible factors holding back economic progress within countries and attempt to overcome these constraints without acknowledging the possibility that some factor, or factors, could be preventing progress of reforms on all other fronts. This research intends to help fill this gap in knowledge by identifying any such obstacles to economic reforms in several Pacific countries and thereby place the countries and the development assistance agencies in a better position to implement reform programs.

As well as identifying the binding constraints to economic growth in four of the PICs—specifically, Cook Islands, Fiji, Samoa, and Kiribati—there is analysis of the political economy of reform in Fiji and Kiribati through the use of the Institutional Analysis for Development (IAD) framework. This framework recognises that the binding constraints to growth may go deeper than the economic constraints that, on the surface, appear to be the problem. This framework helps to understand the political, social, and cultural factors that may be preventing the needed collective action to overcome the binding constraints. This analysis should also assist in understanding how to go about making the needed changes to overcome the binding constraints.

This set of studies is also an effort to see what the PICs may be able to learn from successful small island developing states in other regions: the Caribbean and the Indian Ocean. Specifically, the development experiences of Barbados and the Maldives are studied to understand the reasons for their success and to see what lessons there may be for the PICs from the actions that their governments have taken.

Three of the PICs in the southern Pacific—Cook Islands, Samoa, and Vanuatu—have been performing well in recent years, recording substantial per capita income growth. Interestingly, these countries implemented comprehensive economic reform programs (CRPs) in the 1990s, following significant fiscal and financial difficulties. These CRPs, which were led by the Asian Development Bank and supported by the IMF and aid donors, were based on what became known as the Washington Consensus. This fact is of interest because the so-called Washington Consensus set of reforms, focused on market-oriented incentives, macro-economic stability, and outward orientation, has come under much criticism because of its perceived failure in regions such as Latin America, sub-Saharan Africa, and the former-Soviet Union republics due to lack of attention to underlying factors in the socio-political structure.

Unfortunately, other southern Pacific island economies have not been performing nearly as well as these three. The fact that the three PICs doing well are those that implemented a CRP raises several questions. Does the performance of these PICs provide justification for the Washington Consensus reform process, which essentially argued for a comprehensive range of reforms to be undertaken at much the same time? Were all the reforms actually implemented in the three countries? Were particular reforms more or less important? What does their experience tell us about the sequencing of reforms? What lessons may there be from the experience of these three PICs for other PICs, including lessons on how to implement reforms? Because of the widespread perception that it is virtually impossible to achieve rapid economic growth in the PICs, it is extremely important to document closely what has taken place in these better performing PICs, and, most importantly, why the improved performance has been possible. The binding constraint framework appears to be a good framework within which to answer these questions. Unfortunately, it was not possible to include a study of Vanuatu, so only the experiences of Cook Islands and Samoa are analysed.

Fiji and Kiribati are two of the PICs that have not been performing well in terms of economic growth. Binding constraints analysis was carried out on these two countries. As well, IAD analysis was also undertaken on these two countries as it is suspected that the obstacles to growth lie much deeper than the fairly obvious constraints on private investment.

Lessons from Barbados and Maldives

There are several key points that stand out from the development experiences of Barbados and Maldives. First, in both countries the constraints to development were identified right from the beginning of their being given independence. Second, there were plans developed to overcome the constraints and the plans were followed. Third, from the beginning, both countries had leaders who were strongly committed to the development process and the develop-

ment plans; and there was political stability over a sustained period. Fourth, both countries were welcoming of private investment and put in place the necessary institutions to support the private sector, such as enforcement of the rule of law.

From the late 1940s, policy makers in Barbados saw that there was a bleak economic future for the country, given its reliance on the sugar industry. Soon after independence in 1966, Prime Minister Barrow led an economic reform program to diversify the economy. Some of the constraints to diversification and development, such as infrastructure and lack of human capacity, were necessarily addressed over a long period. Others, such as policy-related constraints, were addressed quickly. Barbados now has an extensive road network; and it is reported that 97.5 per cent of its people have access to safe water; and it is said to have the most modern telecommunications network in the Caribbean.

Barbados was fortunate in that education was given importance over a very long period under colonial administration. This initial condition has proven to be critical to having a good skills base in both the public and private sectors. In 1960-61, government expenditure on education was 15.3 per cent of the total; by 1999-2000 the share had increased to 21.7 per cent. Education still has high priority in the government's development planning. The target has been set of there being a university graduate in every family by 2020, which is expected to add an additional 1.2 percentage points to the country's annual growth.

In the Maldives the government recognised early on that it had to modernise its existing fishing industry and develop its infant tourism industry. The constraints to these developments were recognised and plans implemented to overcome them. A participatory approach was taken toward the development process and there was wide consultation with all stakeholders. Here again, committed leadership and political stability were important, with President Gayoom in office for 30 years (1978-2008). Foreign investment has been encouraged to play a leading role in the development of tourism and the fishing industry, backed by strong enforcement of the rule of law. As well, the long-term leasing of state land has been made possible for both domestic and overseas investors; such leases are able to be used as collateral for commercial loans.

The critical importance of human capital in the development process was also recognised in the Maldives. A program of rapid human resource development was begun in the 1970s. By 1998 the adult literacy rate was 98 per cent. It was also recognised that if the economy was to diversify and develop quickly that domestic skills should be supplemented by overseas labour. Therefore, the application process for work visas for expatriate labour has been made as smooth as possible.

It appears that there are important lessons for the PICs in these development experiences. Of course, some of the facilitating factors may be very difficult to achieve, such as political stability. Moreover, without political stability it may well be impossible to undertake long-term development plans such as the development of infrastructure and human capital; and without these in place, there may be little payoff to other initiatives such as developing a long-term leasing regime for native land and facilitating foreign investment. Hence, one can see that initial conditions and the sequencing of reforms are critical.

However, as seen from the studies into binding constraints in the PICs, some of the development plans that have been successful in Barbados and the Maldives have been replicated in some of the PICs with some success. We now turn to a review of the analysis of binding constraints in the Pacific and the lessons to be learned for other PICs.

Lessons from the Pacific

Cook Islands and Samoa carried out extensive economic reform programs in the wake of financial crises in the mid-1960s, following which they experienced substantial periods of good economic growth. Both countries had in place strong political leadership committed to the reforms and political stability, as well as bureaucratic support for the reforms. Both countries also used public consultation in the form of national retreats or summits to good effect to promote ownership for the reforms. These were all factors underpinning the successful policies implemented in Barbados and the Maldives.

However, the widespread interpretation of the success of the reforms in Cook Islands and Samoa does not tell the full story. The Cook Islands had experienced good economic growth at least as far back as 1982. Indeed, over the period 1982-2004 real GDP averaged 4.5 per cent p.a.; which includes the poor growth during the mid-1990s crisis. Hence, it is difficult to make an argument that significant binding constraints to economic growth were in place and were removed by the mid-1990s reforms, allowing good growth to take place. It appears that the government caused the financial crises by its poor management.

It may be argued that the very high level of aid that Cook Islands has received over many years, especially from New Zealand, was responsible for the good economic growth dating back to at least 1982. But if so, this would be the first country to have recorded such significant benefits from aid.

Cook Islands has not performed well economically over the past five years. This is due at least in part to the global economic crisis and the adverse impact that it has had on tourism. But there appear to be other problems retarding growth and which may be regarded as binding constraints. Cook Islands has a native land leasing system in place that encourages local and foreign invest-

ment, and a judicial system that supports private investment. However, because of the fiscal stringency that the government adopted to pay down the public debt that led to the financial crisis and the recent poor economic growth, maintenance of infrastructure and development of new infrastructure to support the tourism industry is inhibiting further private investment. Also, while some SOEs were privatised as part of the 1990s' reform package (hotels, ports, and waste management), the high costs of the remaining SOEs (especially telecommunications, ports, power, and water) are a burden on both government and the private sector.

Cook Islands has managed to undertake substantial economic reforms in the past and needs to do it again. However, the key question is whether the political economy is suitable for a repeat performance. But with four coalition governments under three presidents over the past five years, there must be doubt that the critical factors of strong and committed political leadership are in place.

The chapter on Samoa's binding constraints comes to different conclusions than others about the impact of the widespread reforms of the mid-1990s on its subsequent economic performance. Rather than the improvement in performance being due to the reforms, it appears that it was the automobile harness exports from the Japanese firm, Yazaki, to Australia under the preferences provided by SPARTECA that drove Samoa's growth over the 1995-99 period—similar to the way in which the Fijian garment industry developed quickly under SPARTECA's preferential arrangements. Of course, it may be argued that it was the widespread economic reforms in Samoa that encouraged the Japanese firm to locate there rather than elsewhere. But unfortunately there were no other private sector responses to the reforms.

Moreover, the later period of economic growth in the first half of the 2000s was largely due to remittances that funded substantial church building and government spending on construction for the South Pacific Games and on a joint-venture resort hotel. Again, there was little in the way of widespread private investment that one should like to see from the reforms. Thus, it appears that up to 2005 the binding constraints to private investment had not been overcome. While many reforms were implemented, they do not appear to have removed the binding constraints.

The introduction of competition in international airline services in the latter part of 2004 appears to have been the key to unlocking the potential of the tourism industry, which has grown rapidly since that time. Further, this reform was supported by the introduction of competition in the telecommunications industry, the making available of long-term leasing of land for resort hotel construction, and the provision of infrastructure for tourism and related activities.

So far, the sources of economic growth in Samoa are narrowly-based—focused on tourism and related industries. What are the binding constraints to diversification and even better economic performance in the future? Aside from customary land now being available for long-term leasing for resort hotels, long-term leasing of custom land (comprising 80 per cent of total land area) is not available for other activities, particularly agriculture. Until this constraint is relaxed, it appears that there will not be widespread local and foreign investment. The government has begun public discussions about the development of a regime for the long-term leasing of custom land. But there is strong resistance to the idea. Samoa has been able to develop and implement major economic reforms in the past and knows what it takes to make it happen. Will it be able to overcome this binding constraint which appears to have held back private sector investment and economic growth for decades?

Other reforms, particularly overcoming the high costs of public utilities (ports, airports, domestic shipping, and domestic airlines) and inhibitions on foreign investment, are needed. But the potential magnitude of pay-off to such reforms will not be realised until the binding constraint limiting secure access to land is removed. Sequencing of reforms is essential!

Fiji and Kiribati are two of the Pacific island economies that have not performed very well. They are highly contrasting economies in terms of the level of diversification, with Fiji having a well-diversified economy across agriculture, manufacturing, and services and Kiribati primarily comprising governmental activities and little of anything else aside from subsistence activities. But the binding constraints to better economic performance in both appear to be in the form of what has been described as underlying or fundamental political economy constraints rather than ‘proximate’ economic constraints. Until these underlying constraints are removed, attempting to overcome the more obvious economic constraints will not be successful.

In Fiji the primary difficulty in achieving sustained, effective economic reform has been the lack of motivation to undertake collective action that will weaken the village-level power of the chiefs, which translates into power at the national level. Essentially, there is a resistance to modernisation, which is seen as diluting the power of the chiefs. The inter-ethnic political struggles over political power and economic rents (from EU sugar preferences) are really side-shows to the main game: the clash between traditional and introduced economic systems. If the indentured Indian labourers had not been brought to Fiji, the clash between the two systems would still exist.

It can be argued that the actions taken by the military government since the December 2006 coup have been designed to break down the traditional institutions that have supported the chiefly elite. These actions may be justified on grounds of improving the prospects for economic growth and improving in-

come and wealth distribution. But will these actions be successful or will they ultimately succumb to widespread resistance; or is there a better means of achieving these goals? Observers of the history of development such as North (2008) are pessimistic that such enforced changes can be effective.

In considering alternative approaches, we have been attracted by the approach taken in Botswana—a country with a similar chiefly system that has achieved outstanding economic success. The constitutional arrangements adopted did not undermine the power bases and resources of the chiefs and therefore they did not see themselves as political losers and were accommodating of the changes. Following the Botswana model, the Fijian chiefs would be constitutionally exempted from participating in national politics and governance. Instead, they would only oversee the governance and economic development of their particular village or province, with financial assistance from the State. Of course, such political and social engineering through constitutional reform is highly uncertain in its outcomes and there would likely be undesirable unintended consequences. But if the people's desire for improved wellbeing is sufficiently strong and they are supportive of such change, it is worth a try.

In Kiribati the full range of economic binding constraints to growth appear to be in place: access to credit is limited, returns on private investment are very poor, and there is poor appropriability of returns on private investment. However, these are clearly not the primary obstacles to better economic growth. They are dominated by the welfare-dependency mindset that prevents collective action to adopt economic policies that would lead to improved economic performance. The necessary collective action is not taking place because the costs to individuals from collective action to adopt reform policies that entail foregoing dependence on the state are perceived as outweighing the benefits of the reforms. Moreover, the costs to individuals of giving up their dependence upon the state are very obvious while the benefits of economic reform in terms of more jobs, higher incomes, and improved public services are highly uncertain. This is the classic dilemma of fourth world peoples in developed countries such as Australia, Canada, and the US.

How can the dependency mindset be overcome? What we have learned from this study about successful reform is that such change needs a strong political leader to champion the reforms, a bureaucracy that is able to support the leader, a politically stable climate in which the leader and the bureaucracy can undertake the needed changes, and widespread public consultation supported by analysis of the costs and benefits of the changes. Without these conditions in place, the needed changes may well not eventuate.