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Private Sector Development and Competition in the South Pacific: A Case Study of Vanuatu

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Abstract

The South Pacific island countries (SPICs) have initiated since the early nineties various reform measures towards economic restructuring their economies. As part of the reforms, a greater role for private sector has been envisaged. In addition to privatization of their commercially non-viable public enterprises, a more friendly climate is being created for private sector development, with emphasis on attracting foreign direct investment (FDI). Together with an already prevailing conducive macroeconomic environment in terms of low rate of inflation and a relatively stable exchange rate, which has been chiefly facilitated in the past by the generous ODA flows avoiding serious balance of payments difficulties, special incentive packages and tax holidays for promoting private domestic investment and FDI are being offered. Despite these efforts, domestic private sector development has been slow. Further, there has been no dramatic increase in FDI flows. On the contrary, in certain SPICs there have been some pull outs. It is obvious that although deregulation measures including privatisation efforts could be the necessary conditions, the sufficient conditions lie elsewhere and they appear to be relating to various restrictive circumstances hampering free functioning of competitive forces. The paper undertakes an analysis of the causes behind the poor private investment climate despite various initiatives to deregulate and privatise and identifies areas for improvements for promoting competition.

Key words: privatization, restructuring, competition, monopolies, governance issues

Introduction

As they enter the twenty-first century, the South Pacific island countries (SPICs) find themselves lagging behind the fast-paced deregulation of economic activities and dismantling of restrictive trade and tariff regimes in all the developing economies. Coupled with these developments, there has been a downward trend in concessional official development assistance (ODA) flows to the developing world as well. Any remaining hopes among SPICs whose dependency on ODA is fairly substantial, that the newly emerging donors, including Japan and Korea would take up the task of maintaining the past aid levels were belied by the South Pacific Forum-Japan summit meeting in October 1997. The summit meeting confirmed the fear that there was no basis for any such expectations, as Japan's current financial difficulties might continue for a while. Furthermore, the currency and financial crises which have engulfed Korea in particular, and the Southeast Asian nations have also sent a harsh message that SPICs have to set their houses in order.

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The fall in ODA flows which were mainly directed in the past to the public sector in SPICs, has been due to revisions in aid policies following an evaluation that the public sector programmes and projects funded by ODA in the past were poorly implemented and ineffective and a direct support to private sector role could be more productive in terms of creation of employment opportunities and higher incomes (JAYARAMAN, 1995b). The near universal acceptance of a change in the philosophy towards greater reliance on market forces was also reinforced by the collapse of the former Soviet Union. In addition to aid fatigue, there have been fiscal pressures as well, in the donor countries which led to gradual reduction in aid levels.

After effecting cuts in their annual budgetary support to SPICs for recurrent expenditures in the early nineties, the bilateral donors in their attempts to maintain their project assistance at the 1990 levels have been finding out ways for ensuring better utilisation of funds. Consequently, they have been seeking, in close collaboration with the multilateral donors including the World Bank (WB) and the regional Asian Development Bank (ADB), certain conditionalities to be met by SPICs. They come under the general prescription of public sector restructuring and reforms and provision of a far greater role for the private sector.

Implementation of reforms in SPICs are at different stages. A greater role for private sector has been envisaged and one immediate avenue has been attempt to privatise the commercially non-viable public enterprises. Additionally, a more friendly climate is being created for private sector development, with emphasis on attracting foreign direct investment (FDI). Together with an already prevailing conducive macroeconomic environment in terms of low rate of inflation and a relatively stable exchange rate, which has been chiefly facilitated in the past by generous ODA flows avoiding serious balance of payments difficulties, special incentive packages and tax holidays for promoting private domestic investment and FDI are being offered. Despite these efforts, private sector development has been slow and FDI flows have not registered any dramatic increases and on the contrary, in certain SPICs there have been some pull outs. It is obvious that although deregulation measures including privatisation efforts could be the necessary conditions, the sufficient conditions lie elsewhere and they appear to be relating to various restrictive circumstances hampering free functioning of competitive forces.

The objectives of the paper are to: (i) undertake an analysis of the causes behind the poor private investment climate despite various initiatives to deregulate and privatise and (ii) identify areas for improvements. The paper is organised into three sections. The first section provides an overview of some recent trends in SPICs in the area of deregulation and privatisation efforts; the second section, specifically focusing attention on Vanuatu, a small island country, which is a tax haven with no exchange controls and a reasonably favourable macroeconomic environment, explores the shortcomings and the last section discusses policy implications.

1. An Overview of Recent Trends in Deregulation in SPICs

Poor Performance of the Public Sector

The SPICs in the last two decades have invested on an average, about 29 percent of GDP per annum in their economy (Table 1). More than 50 percent of this investment was in the public sector (JAYARAMAN, 1995a) Despite these efforts, economic growth has been poor. Relatively long gestation periods, poor implementation and bureaucratic inefficiencies together with some unproductive investments have been cited as the causes of less than optimal returns (World Bank 1993). Further, the trade regimes in terms of restrictions and import licenses and high tariff rates, which are more for revenue purposes than for major import substitution activities, have been hurting exports by creating an anti-export bias.

The expansive fiscal policies, partly encouraged by ODA and partly supported by a belief that indigenous private sector would not be able to undertake commercial activities[1] and there was an absence of individual profit motive as compared to the Asian societies. There is however growing evidence (QALO, 1997) which has belied this particular view point, pointing to the emergence of entrepreneurial talents among the ethnic majority. There can be no denying of the fact that this is due to demonstration effect of successful ventures by the members belonging to non-ethnic communities in Fiji. Some of these have been past employees in successful private sector undertakings and some who have taken early retirement from disbanded government departments and public enterprises, were involved in the growing public sector, in even such extreme commercial activities such as duty free shops, as was in Tonga and travel agency services in Tuvalu, not to speak of the marketing boards for copra and other export crops. Poor performance of these public enterprises have been

Table1. Selected economic indicators for developing Asian and Pacific countries

	Population Thousand 1996	GNP (US$Mil) 1995	Percapita Income US$ 1995	GDP Growth Rate (percent) 1991-1995	Growth Rate in Exports (percent) 1990-1995	Openness Ratio of Exports and Imports to GDP (percent) 1995	Fiscal Defisit (Ratio of GDP) Annual Average (percent) 1990-1995	Current Account Balance (Ratio of GNP) Annual Average (percent) 1990-1995	Inflation Annual Average (percent) 1990-1995
Fiji	807	1895	2440	2.5	3	75	18	- 5	12
Solomon Islands	396	341	910	5.5	19	98	4	- 1	4
Tonga	97	170	1630	3.8	24	55	11	-10	4
Vanuatu	173	202	1200	2.5	9	48	24	-25	6

Source: ADB (1996)

1 There has been a general lack of indigenous private entrepreneurial talents in the SPICs with the exception of Fiji. This particular deficiency has been attributed to the unique sociocultural characteristics that the South Pacific societies are communally oriented on the principle of caring and sharing (SCHOEFFEL 1995).

contributing to fiscal burden, as they were regularly subsidised from the general budgets, cutting down more essential maintenance expenditures. Deterioration in public finances also threatened the excessive credit growth or crowding out of the viable private enterprises. Further, it seriously undermined the limited role of monetary policy in demand management (BROWNE, 1995).

Inflation in SPICs has been generally low, except in the Solomon Islands, which had experienced a double digit inflation during the early nineties mainly due to expansionary fiscal policies. Further, there were no serious and unsustainable current account deficits in the balance of payments since ODA receipts provided the cushion. However, the exports did not pick up in the mid-eighties as the nominal exchange rate was found overvalued. There was a wedge between the nominal and real exchange rates since domestic inflation was still higher than the overseas inflation rate.

Fiji's Example: Public Sector Reforms

The remedies were obvious. Measures aiming at a reduced role for the public sector by closing down the poorly performing public enterprises, and observance of greater fiscal and monetary restraints and a realistic exchange rate management were called for. As it often happens, the political will in sufficient measure was not forthcoming until 1987, when the two military coups provided an opportunity for the technocrats in Fiji to come to the fore, pushing aside past policies and implementing the much needed reforms. Two substantial doses of devaluation amounting to a total of 35 percent of the Fijian dollar were resorted to which was accompanied by a firmly implemented set of income and expenditure policies such that the usual wage fixation in line with price increases was temporarily suspended enabling the benefits of devaluation to flow in full measure (SIWATIBAU, 1993).

A package of reforms was also announced in 1989 for carrying through the reform process in other areas. They included: (i) deregulation of the economy by discontinuing subsidies to those economic activities, where Fiji did not have any comparative advantage and liberalising imports so that domestic prices were brought in line with world prices; (ii) reduction in budget deficits and contributing to public sector savings, thereby releasing resources for private sector growth; (iii) tax reforms towards minimising distortions through rationalisation of tax structure and introduction of a value added tax; and (iv) provision of incentives for attracting FDI in export oriented activities.

Reforms in SPICs

The results were convincing as the country recorded better rates of growth than before and FDI in newly emerging industries such as garments and gold mining as well as in the traditional tourism sector, registered all time increases. The other SPICs drew substantial inspiration from the Fijian experience of putting their houses in order. Since there were no compelling circumstances of the kind Fiji went through in 1987, the urgency was relatively less. However, the message was clear. Added to these developments, the collapse of the Soviet Union and the initiation of deregulation processes in the former centrally planned economies in their transition to market economies gave a further boost to the philosophy of less government with a greater role for the private sector. Specifically, the studies by the multilateral institutions (World Bank, 1993, 1995 and Asian Development Bank, 1993, 1995) and by bilaterals (AusAID 1992, 1993, 1995) and the donors meetings in Paris 1992 and in Suva 1993, 1994 provided further prodding to the SPICs in liberalising their economies.

With no exception, all the SPICs have started their processes: the first step was to do away with the five-year plan documents, giving indications that the government would undertake a minimal programme focusing mainly upon capacity creating physical and social infrastructures, such as roads, ports, power, education and health, leaving the rest to the private sector. Further, the governments withdrew from procurement and export activities by doing away with the list of prohibited commodities and by disbanding the Commodity Boards; this was followed by either privatising or closing down the non-viable manufacturing activities including copra processing and coconut oil mills as witnessed in Western Samoa.

On the trade and tariff regimes front, the issue of import licenses for rice and other consumer goods was discontinued and tariff rates were gradually reduced and import quota system was replaced with ad valorem rates. The SPICs' primary exports, including sugar and copra and manufactured exports such as garments and leather products do not face immediate threat as they are covered by various preferential trade arrangements under the Lome Convention and South Pacific Regional Trade and Cooperation Agreement (SPARTECA), which are to expected to be phased out during the next ten years. However, measures to improve labour productivity and compete with the Asian producers more effectively have begun to receive greater attention.

Action Plan for Liberalisation

Although the reforms are underway in all SPICs, the rate of progress differs from country to country. With a view to stepping up the pace of reforms, the ministers of the South Pacific Forum countries who are responsible for economic policies, met in July 1997 in Cairns, Australia and endorsed an Action Plan describing the activities for implementation during the next 12 months and beyond. Table 2 presents the salient features of the Action Plan, which highlight the need for improving business competitiveness.

Privatisation Process

Privatisation of public sector enterprises of commercial nature would provide substantial benefits including infusion of capital and managerial talents and redirection of these enterprises along commercial principles. As regards commercial and trading enterprises in the public sector such as duty free shops, travel agency and manufacturing enterprises such as copra and coconut oil, the process was not difficult. There were domestic buyers and the prices at which they were sold were attractive to the governments. But what proved difficult was the effort to sell off the more management and technology intensive operations such as the government owned ranches and plantations in Vanuatu, as there were no local buyers and the only option open was to sell to foreign investors.

Table 2. Action plan for provision of policy environment for private sector development

Category	Agreed Agenda
1. Economic Reforms	1. Develop strategies and identify measures for ensuring essential service delivery 2. Consultation with community groups and private sector for strategies development 3. Identify all issues affection business competitiveness by consulting the private sector that can be addressed by policy reform a recommend steps for improving competiveness 4. Policies for improving opportunities for private sector development and employment generation 5. Develop strategies for enhancing efficiency of service delivery and for responding to social impacts of economic structuring
B. Public Accountability	1. Adopt principles of best practice for public accountability, based on concepts of openness with government information and public scrutiny of performance of the government and officials 2. Adopt budgetary processes for ensuring full information to parliament 3. Audit of government accounts, state-owned enterprises and publication of reports 4. Present loan agrements signed with external agencies and guarantees given to parliament 5. Advertise all government / public sector contracts, award competitively and report 6. Punish those who contravene financial regulations 7. Empower Public Accounts / Expenditure Committees to require disclosure 8. Ensure independence of Ombudsman / Auditor-General with adequate resources 9. Ensure autonomy of the Reserve / Central Bank
C. Investment Policies	1. Pursue open, liberal and transparent investment policies 2. Consider problem areas and practical impediments to investment (eg. land tenure, foreign exchange risk and and double taxation)
D. Tariff Policies	1. Work to wards a common goal of free and open trade and investment 2. Rationalise and progressively reduce tariffs with the aim of removing all adverse effects of tariffs on the economies 3. Avoid protective tariffs; if there is a need for government support use other forms of targetted assistance 4. Apply general rate to all goods in circumstances when publically known and clearly defined criteria are met 5. Make available the duty draw back system to exporters 6. Use ad valorem rates except in caes where there are serious valuation problems 7. Levy tariffs on imports at CIF values and not on FOB or Current Domestic Values 8. Levy excise on domestically produced good at the same rate as on goods subject to tariffs for health, social or environmental reasons

Source: South Pacific Forum Secretariat (1997)

The limited indigenous private sector activities have been in simple primary processing and manufacturing of consumer goods and retail activities. Although affirmative action in terms of credit and other support have also contributed to fostering business talents among the ethnic majority, major investments in manufacturing have been rather slow and whatever undertaken was based on outdated technology. Obviously, the economies of scale limitations due to smallness of domestic markets prevented adoption of improved technologies. In these circumstances, FDI is the most preferred way (de MELLO Jr., 1997), as it brings in both capital and enables upgrading the current techniques of production, besides introducing new goods by using local resources which are unique to SPICs for the niche markets abroad. The FDI is not new to the SPICs. All past major activities which are natural resources-based such as mining, sugar milling and tourist resorts and hotel industry were all due to FDI. In recent years, there have been new investments which are still natural resource-oriented. These include joint ventures such as palm oil production, fisheries and fish canning in the Solomon islands with majority holdings by the government. The arrangements have proved beneficial.

Sale of Government Shares

There is considerable merit in the current thinking that government shares in many of the fully owned undertakings as well as in joint ventures should be sold to the public so that the ownership is widely shared. However, there has been some reluctance as some of these undertakings have been bringing in dividends to the government each year, as witnessed in Western Samoa where the government holds shares in the beer and cigarettes manufacturing. Since there has been a need for developing capital markets in the SPICs, offering government shares in the profitable concerns for sale to the public would contribute to creating a market for stocks and eventually facilitate the emergence of such capital markets.

Benefits of Trade Liberalisation

Notable progress has been achieved during the last ten years in SPICs in economic liberalisation and deregulation. Most of the measures related to reduction on tariffs on consumer and capital goods and abolition of quotas and import licenses. Domestic manufacturers, especially in Fiji, which has a far greater manufacturing capacity in many consumer goods such as cooking oil, dairy industry, rice milling, biscuits etc. have to increasingly compete with the liberal imports by improving their production technology and enhancing their productivity. Thus, external competition has indeed brought in certain dividends. As the World Bank Study (1995b) brings out, the impact of deregulation on unemployment was negligible: Those who were laid off by one unit joined other units in the same industry, and there was no movement from one industry to another, thus indicating least disruption requiring re-training and absence of long time unemployment. There were also new employment opportunities in the newly set-up factories in the tariff free factory zones in response to the government incentives to attract FDI.

Domestic Economy Wide Competitiveness

However, the initial gains flowing out of trade liberalisation reforms in Fiji in the early nineties have not been sustained as evidenced in the static number of FDI factories and number of people employed. Domestic private investment has been stagnating since 1990 at 5 percent of GDP each year. There is no question of any crowding out effect of government investment, which has been brought down to 3 percent of GDP resulting in some excess liquidity in the system (JAYARAMAN, 1998a). The World Bank (1995b) rightly stressed the fact, which is applicable to all the SPICs, that the government should, rather than focusing attention on trade liberalisation, take initiatives to improve economy wide competitiveness. Before doing so, the institutional factors have to be looked at.[2] FALLON and KING (1995) have pointed out and highlighted the need for greater attention to these aspects by citing the short-lived impact of economic reforms undertaken by Fiji soon after the military coups of 1987. Their study, referring to the uncertain political situation created by a racially biased constitution which aggravated the animosities between the two major races, made it clear that benefits of such reforms could not be sustained for long unless a stable predictable investment climate based on political stability and well-defined and rigorously enforced property rights was provided by the government.

Institutional Factors

Referring to the contributions of NORTH (1990) and WILLIAMSON (1995), FALLON and KING (1995) observe that long term contracts form the basis for production-oriented activities where fixed and durable assets are employed, as opposed to activities of purely financial nature where short-term assets can be quickly withdrawn and re-deployed at short notice in response to changes communicated by spot markets. Long term contracts require an effective system of regulation, which includes disputes resolution procedures, an independent and effective judiciary and a credible commitment to maintenance of policies and regulations affecting investors. If these conditions are not met, the investors would rather prefer to be foot-loose; they would concentrate on more mobile and less durable assets; and they would employ lower technology. These issues, as now part of governance issues are now receiving wide attention both by practitioners (World Bank, 1992) and academics (WADE, 1995; ISLAM 1996; STREETEN, 1996).

Barriers to Domestic Competitiveness:

Land Tenure

There are barriers to competition within the domestic economies of the SPICs. These relate to: (i) factor markets; (ii) public utilities; (iii) barriers in financial markets. These barriers give rise to various price distortions presenting major impediments to investment,

2 STREETEN (1996) emphasises the importance of institutional factors while referring to transition economies in the East Europe and observes that institutional liberalisation should precede stabilisation and stabilisation should precede the freeing of markets.

whether domestic or FDI. In particular, among the factors the prices of two critically important non-tradable inputs, land and labour do not reflect their true prices in relation to their endowments. The effective supply of land is restricted by the land tenure system (Table 3) under which ownership of a very major proportion is vested in communal clans, other than in Tonga where all lands are vested in the King. There is no market for lands as such in Tonga where leases can be held after negotiation with government authorities.

In the other SPICs, for example in Fiji, the regulations stipulate that no land can be marketed unless the land is already earmarked as freehold (10 percent of total land) or Crown land (7 percent) and only in regard to these two categories are transfers of ownership legally permissible. All other lands have, therefore, to be leased by negotiations by the potential investor with the land owning clans.

The governments are intensively aware that the restrictive land tenure system has had adverse effects on long term investment plans and the issues seem anachronistic in modern economies and they need to be resolved. Many institutional improvements have been attempted under which native lands are brought under a government sponsored body duly empowered with legal and constitutional powers to negotiate and formalise the leases on behalf of the land owning classes for a fairly long period for certain industrial activities.

However, the leases so negotiated and registered are not considered firm and final during the lease period, since the land owners can revoke and sometimes, do seek to re-negotiate fresh terms and conditions. Some hotels and tourist resorts in Fiji which have leased vast areas of land for their facilities and golf courses have been forced to close temporarily to deal with such demands (FALLON and KING, 1995). The associated legal delays in settling these cases have further compounded problems of insecurity of land tenure and uncertainty about property rights, which are now clearly identified as one of the major hurdles to create competitive conditions for private investment.

Table3. Land tenure system in SPICs (Percent of total land availability)

	Communal / Customary Ownership	Crown / Government Ownership	Freehold	Total
Fiji	83	9	8	100
Solomon Islands	97	3	0	100
Tonga	0	100	0	100
Vanuatu	98	2	0	100

In Tonga, although all lands are vested in the Crown, land use rights are conferred on private individuals / corporate bodies.
In Vanuatu, all lands in rural areas are owned by communities, except in designated urban areas where land ownership has been transferred by law with adequate compensation.

Labour Market

The functioning of the labour market is hampered by various factors. The current wage and salaries determination procedures in SPICs in general and in Fiji in particular require that changes in living costs be reflected . As a result, periodical upward revisions are made to take into account rise in the price levels of all imported consumer goods duties on which are subject to periodical increases. The high import duties were levied more for revenue raising purposes than for protecting any local industry or for inviting any tariff factory to get behind the tariff walls. Further, there are restrictions in terms of minimum wage for skilled and unskilled labour. Added to these, there are statutory requirements that employers and employees should contribute certain stipulated percentages of wages and salaries to the national provident funds. The near universal practice in the SPICs of setting wages and salaries in the formal sector by linking with consumer price index changes has created growing gaps between money wage and productivity. Table 4 presents a comparative picture of wage rates

Since the labour productivity in SPICs is not high as compared to other developing countries, the governments have recognised the imperative need to raise general workforce skills, which is a long term process. Until such time, periodical upward revisions in minimum wages would only lead to increases in operating costs which are not commensurate with productivity gains. Reforms including a review of minimum wage legislation and leaving the wage determination to market forces on an enterprise basis, and creation of institutions for upgrading human capital and programmes by providing training in trades and improving skills, require both political courage and pragmatic wisdom.

Table4. Labour costs in SPICs and other developing countries

Country	Average Wage Per Day: US＄	
	Skilled	Unskilled
Indonesia	6	2 to 3
Malyasia	13	5 to 8
China	8	2 to 5
Fiji	10	8
Solomon Islands	5 to 7	5
Tonga	9	8
Vanuatu	16	7

Source: For the Asian countries, CHAKWIN and HAMID (1997)
For the SPICs, Asian Development Bank (1996)

Public Utilities

Public sector monopolies for provision of basic services such as electricity and water have been operating poorly resulting in losses, except in Vanuatu. It is not the cost recovery question, as often thought to be the reason for the financial losses, but it is clear inefficiency, which has led to losses. Raising the rates without improving productivity or by lowering the quality of service may improve financial performance temporarily but would affect profitability of private sector operations and the input costs would be passed on to the consumers. Since these public utilities run by the governments in small markets face no competition and they have no economies of scale to gain from, the only way to improve financial performance is through avoidance of waste by careful management by allowing full freedom to the managers of these utilities. Public enterprises reforms are underway in all the SPICs. The modalities have been in the form of legislative processes by which these public utilities are corporatised and allowed to run on commercial principles under the overall regulatory control of a designated ministry for public enterprises.

All though some thinking is going on whether to hand over the public utilities to the private sector or to a foreign investor on management contract for a fairly long period, as has already been accomplished in Vanuatu in regard to electricity and water, the question is whether the SPICs have already acquired sufficient skills and sophistication in the appropriate ministries to exercise the required regulatory control over the natural monopolies in the private sector. As LAFFONT (1996) notes, the design of regulatory rules and privatisation programmes of natural monopolies should take into account the characteristics of the developing countries: (i) the high cost of public funds, as reflected in the social price of raising one unit of money, which is much higher than in developed countries; (ii) high cost of auditing in the government, as the skills are in short supply; (iii) weak constitutional controls as special interest groups have a sway over political machinery; and (iv) difficulties in making long term commitments. Since there is a problem of asymmetry of information between the private sector natural monopoly and the regulators in the government, the control whatever exercised by the government would be less than optimal. In such a situation, the natural monopoly in the private sector is worse than a public sector monopoly and the ordinary consumers of these essential services such as water and electricity and the production units which consume these infrastruture inputs would be hit hard. Here, one would recall Joan Robinson's observation that the invisible hand can also strangulate (STREETEN, 1996).

In these circumstances, retaining the public utilities in the public sector by corporatising them and improving their financial and accounting procedures and empowering them with greater autonomy with minimal interference from political interference would be a far superior solution than privatisation. This is primarily for the reason that in the case of government-owned public utilities in developing countries, the information asymmetery problem is absent as the government regulators have easy access to information on operations, pricing etc. so that public interests can always be protected (LAFFONT, 1996). This of course, presumes the regulators have adequate skills to exercise the auditing and controlling functions as well as the powers conferred by the enabling legislation.

Financial Markets

The SPICs have a relatively good financial infrastructure in terms of a large number of both foreign and locally owned commercial banks, insurance companies, national provident funds, housing corporations and development banks. The standard indicator of financial deepening (the ratio of broad money to GDP) is also fairly high ranging from 45 to 55 to percent. The interest rates have been deregulated now for some time and the real rates of interest are now positive. However, the intermediation costs are high and as a result, the margin between the commercial banks' deposit rates and lending rates is still large. This has been attributed to various reasons. They range from the prevalent oligopolistic market conditions in the banking structure to high costs of operations by the banks due to costs of communications, expensive expatriate bank management, risky investment and business environment, lack of bankable projects for lending, inadequate security particularly in regard to land, and poor loan appraisal procedures leading to a portfolio of non-performing assets as well as excess liquidity in the system in relation to demand for credit and holding of non-interest bearing excess reserves by the banks and so on.

Improving competitive conditions in the banking industry by opening up to competition from outside as well as achieving better performances of the government's own development bank and other non-banking financial institutions including provident funds and housing corporations which lend to indigenous entrepreneurs will go a long way. In addition, the central banks have to get more active in the money markets towards mopping up the excess liquidity through instruments by issuing securities so that monetary policy can be more effectively implemented.

Role of Government

The term "getting prices right" does not mean total deregulation and leaving price determination to the market forces which are prone to oligarchic market conditions in specific industries can also distort prices.[3] There is a role for the government, which is to facilitate the market forces more efficiently and effectively, given the objective of a kinder and gentler society or any such goal from ethical considerations. In addition to provision of a legal framework and institutions for well functioning of a civil society, the government should provide a market friendly regulatory system which provides for enforcement of property rights and contracts and legal remedies, besides observing appropriate macroeconomic policies. Streeten (1996) observes: "There is nothing in the nature of free markets that either establishes or maintains competition. On the contrary, free markets make for conspiracies against the public, as Adam Smith knew it. Yet the virtue of markets depends on competition."

2. A Study of Vanuatu

Background

The Republic of Vanuatu, which consists of about 80 islands, is located 2300 kilometres east of Australia and has a total land area of 12,200 square kilometres with a population of about 170,000. About 20 percent of the population live in the two main urban centres of

3 Streeten (1996) notes that the term "getting prices right" has undergone curious transformation. In the 1960s it meant that if prices did not reflect true opportunity costs, shadow or accounting prices were to be calculated. Further, as actual prices did not reflect the right price, the government should intervene since the unfettered market forces in a given setting of income and asset distribution would cause distortions from an ethical point of view. This position has now changed and it is held that the government is the source of all distortions and that developing countries should get rid of all state interventions for enabling market forces to determine prices. As markets are neutral institutions that can work either for good or evil, there is a need for government intervention so that markets function for the benefit of people.

Port Vila on the main island of Efate, and Luganville on Santo, the largest island of the country. The rest of the population is dispersed among the other islands which have limited communication facilities. While the two urban centres are marked by thriving tourism activities, with Port Vila, the capital of the country having the most sophisticated offshore finance centre institutions in the South Pacific, subsistence agriculture characterises the rest of the islands. Inadequate transport communications between the islands have inhibited inter-island trade and some of the islands have remained remote and have not been brought into mainstream of economic activities and as result cash economy has still not evolved.

The economy has done well since independence in 1989 from the joint condominium rule of the British and French. Despite the adverse effects of periodical cyclones, which average five to eight a year, each of different intensities affecting some part of the country every time, the economy has grown at 3 percent a year. The year to year fluctuations are, however, considerable. Since the population is estimated to be growing at 3 percent a year, per capita incomes have mostly remained stagnant. However, the subsistence-affluence style of living in the remote islands has kept the nation free from any inadequacies in the availability of food and nutrition. It is only in the urban areas, where modern medicines and processed and imported foods have to be purchased with cash, the stagnant incomes have hurt the natives, known as the ni-Vanuatus.

The national accounts data reveal structurally the economy has been undergoing slight changes in recent years. However, the changes are not significant. The primary sector, including subsistence activities has marginally declined in importance as its contribution is 23 percent to GDP as compared to its contribution of 26 percent in 1983, and the services contribution has also slightly declined from 67 percent in 1983 to 64 percent in 1995. On the other hand the secondary sector (manufacturing, electricity and construction) has increased its share from 8 percent in GDP in 1983 to 14 percent. The economy continues to depend heavily upon its services sector mainly tourism activities, and increases in the construction activities in hotel and resort industry have picked up in recent years after airline connections to Australia and New Zealand have been increased since the late eighties following the acquisition of a 737 Boeing aircraft by the national airline.

Macroeconomic Conditions

The macroeconomic environment has been stable (Table 5). Inflation has remained low. The government followed prudent fiscal policies: the recurrent budget was always balanced until 1993 and the capital budget was met by external aid, consisting of grants and concessional loan assistance from the bilateral governments. The overall fiscal balance contributed to a comfortable external position, although fragile. The external accounts depended on a narrow range of exports of beef, copra, coffee and kava. As the terms of trade have been declining in recent years especially in regard to copra, the export earnings have been declining to a greater extent since copra is the dominant commodity among exports. Imports are about 41 percent of GDP. The trade deficit is more than offset by tourism earnings and official transfers representing external aid. The remittances from overseas is much less significant in the case of Vanuatu, as compared to Polynesian countries. The government followed a very conservative policy in regard to external borrowing until 1996 and the external debt was 23 percent of GDP. Since 97 percent of the country's external debt was concessional debt from multilateral institutions, including the World Bank and Asian Development Bank, the debt service payments were less than 2 percent of total exports and services.

Table 5. Key economic indicators of Vanuatu

Indicators	Average 1980-1990	1991	1992	1993	1994	1995	1996
Annual Growth Rate (percent)	1.4	4.4	1	4	2.6	3.2	3
Per Capita Income Growth Rate (percent)	1	1.5	-1.7	1.3	0	0.7	0.6
Govt. Revenue (percent of GDP)	NA	24.5	24.7	23.3	25.7	26.5	26.4
Govt. Expenditure (percent of GDP)	NA	38.4	33.4	31.5	38	37.5	38.3
Overall Fiscal Balance (percent of GDP)	NA	-13.9	-8.7	-8.2	-12.3	-11.1	-11.9
Gross Domestic Investment (percent of GDP)	32.3	35.5	34.8	34.2	NA	NA	NA
Gross National Saving (percent of GDP)	7.2	7.7	7.5	9.5	NA	NA	NA
Inflation (percent)	NA	6.4	4.1	3.6	2.5	2.3	2.5
Growth rate of Import (percent)	NA	-16.0	1.2	8	2.6	7.2	8
Growth rate of Expons (percent)	NA	-3.2	30.2	-4.2	10.1	13.2	6.7
Currrent Account Balance (percent of GDP)	NA	-10.8	-9.9	-9.7	-9.9	-8.5	-8.7
Foreign Direct Investment (US Million Dollars)	13	25	26	27	30	25	NA
External Debt/GNP (percent)	NA	22.8	23.2	24.8	24.7	NA	NA
Debt/Service Ratio (percent)	NA	1.4	1.3	1.4	1.6	1.5	0.7

Sources: Asian Development Bank (1996)
World Bank (1996)

Investment

Gross domestic investment, as a proportion of GDP has been quite high, averaging at 35 percent each year and about 50 percent of this has been government investment. Since the public investments have been in projects of long gestation nature, the benefits have not been immediately felt. However, it has been estimated the capital output ratio is approximately 10, which is very high by any standards. This raises the question about efficiency of utilisation of funds which went into such projects, although these funds came from external sources without creating any budgetary difficulties. The association of investment and growth has remained doubtful.

Simultaneously with a decline in external aid, from US$55 million in 1991 to $45 million in 1995, especially in regard to withdrawal of recurrent budget support, as well as technical assistance in terms of experts services and teachers from the British and metropolitan powers, there was a new disturbing trend observed in government's departure from the prudent fiscal policies. The recurrent budgets were no longer in balance from 1995 and the capital budgets were in deficit and the gaps were sought to be bridged by domestic borrowing under the Special Project Implementation Schemes. Most of the projects were poorly appraised and were not viable as they were politically motivated.

Revenue Position

Domestic borrowing was found necessary because of the inelastic nature of the tax system, which has been deliberately adopted by the country. There is no direct taxation of any kind either on individuals or companies in regard to income or profits with a view to maintaining the tax haven status. Therefore, the government has to rely upon indirect taxes comprising those on international trade and tourism and a domestic turnover tax of 4 percent, which contribute 75 percent of total domestic revenue, as well as fees such as those on company registration and business licenses which contribute the rest. Import duties have already reached a high at an average at 37 percent on consumer goods, 23 percent on intermediates, 11 percent on capital goods and 151 percent on fuel and 21 percent on automobiles. In addition to import duties, export duties are levied at 3 percent on most goods including copra, beef and coffee, with higher rates on timber and shells. Taxes on tourism include 10 percent hotel tax and departure tax. Any further maneuverability within the current tax system is limited. Further, as a member of the World Trade Organisation, Vanuatu is under obligations to revise its tariff system and thereby its tax structure, to maintain its current revenue levels.

In the context of a strong commitment to retain the current system and not to introduce direct taxation of any kind under the fear that it might scare away the OFC institutions,[4] tax reforms have to be effected within the present system. The government is aware that reforms have to be not only with respect to raising revenues but also with economies in expenditures in the public sector. While realising these requirements, the politicians felt that cutting down the size of the civil service would be sufficient. But the remedies have to be much more comprehensive.

Reforms in the Political Wing of the Government

The civil service in Vanuatu is smallest in comparison with the rest of the SPICs: Only 3 civil servants per hundred country inhabitants as compared to 18 in the Cook islands, 8 in Tuvalu and 6 in Fiji (ADB 1993). On the other hand, the political wing requires immediate attention. The size of the cabinet has been constitutionally fixed at 20 percent of total number of members of parliament. Presently, there are 12 ministers in the cabinet and each

4 The fear is baseless as most of the tax haven countries have followed the practice of exempting the OFCs from direct taxation while subjecting the citizens and local companies to income and company taxation without experiencing discontinuance of OFC activities. It appears that the present system of taxation will continue in the medium term, and reforms if any have to take place within the current tax structure.

minister brings three deputies who have no constitutional status and hence are not accountable to the parliament, from their own parties and they are designated as first, second and third secretaries. They wield considerable power, besides enjoying full perks of the minister, with salaries and housing and chauffeur driven cars. With political instability contributing to four changes in the government in a limited period of two years (1996 -1998), four sets of new cars and four sets of furniture and appliance, have to be imported and the expenditure is substantial. Looking to the smallness of the country, questions are asked whether a size of the cabinet with virtually a total number of 36 members is needed; and whether the size of the cabinet be reduced to 6 or less. These issues fall under the category of governance issues which are treated in detail elsewhere (Jayaraman 1998b).

Public Enterprises

Vanuatu's public enterprise sector (Table 6) consists of departmentally run undertakings of commercial nature such as livestock farms which compete with private sector ranches and cocoa and coffee plantations, statutory bodies set up under parliament acts such as Vanuatu Commodities Marketing Board (VCMB), which has the exclusive right in marketing exports of copra and kava, and Development Bank of Vanuatu (DBV) for assisting indigenous entrepreneurs with loans and National Bank of Vanuatu (NBV), a commercial bank and Air Vanuatu, an international airline and Van Air, a domestic airline. Besides these, the government has got equity interest in several companies ranging from beer production to tour operations.

Public enterprise reforms consist of (i) divesting all shares interests in all companies in which government has minority interest, so that they can be run better if left to private sector; and (ii) rationalising the structures of statutory bodies such as by combining DBV and NBV into a single entity and government companies such as Air Vanuatu and Van Air into a single company. Disbanding of the VCMB, which is the last of the marketing boards in the SPICs, is a difficult decision. It is being argued that the Vanuatu economy still needs some state intervention in agriculture sector from a balanced regional development point of view, since the remote islands still depend upon cash earnings from copra exports. The only solution in the short run appears to be is to improve the financial and management operations of VCMB so that the annual subsidies are transparent and minimised.

Privatisation process is under way for some of the government companies and rationalisation process will understandably take time as the politicians would find loss of opportunities, being chairmen and members on the board of the fully owned corporations and the associated perks and opportunities for personal gains and influence. However, the gains are clear to be seen in terms of less recurrent expenses in terms of subsidies and other periodic bailing out expenses of the continuously losing enterprises and consequent reduction budget deficits, giving rise to emergence of public sector savings. Further, these savings would enable to undertake quality government investments in health and education towards improvement of skills contributing to human capital formation. In the context of decreasing foreign aid, public sector savings have to be stepped up and one clear way is to minimise involvement in activities which can be left out to the private sector for more efficient operations.

Table 6. Commercially oriented enterprises

Fully Owned Companies	Commercial Statutory Bodies
Air Vanuatu Van Air UNELCO (management contract) Tour Vanuatu	Vanuatu Commodities Marketing Board National Housing Authority Development Bank of Vanuatu National Bank of Vanuatu
Commercially Oriented Government Activities	**Commercially Oriented Companies Partially Owned**
Drainage Printing and Stationery Public Works Ports Marine Fleet Forestry Government Stores Government Garage Village Fisheries Projects Civil Aviation Livostock Projects, Abattoirs Postal Service	Bel-Mol Cattle Company Metnesel Estates Limited Melanesian Shipping Lines Mifala Holdings Limited New Resources Limited PacificTextiles Limited Port Vila Fisheries Limited South Pacific Fishing Company Limited Vanuatu Fish Investment Company Limited Vanuatu Tropical Products Limited Vanuatu Livestock Development Limited Vanuatu Abattoirs Limited Vanuatu Brewing Limited Vanuatu Coconut Products Limited Telecom Vanuatu

Source: Asian Development Bank (1997)

Public Utilities

Public utilities in regard to power and water supply are in the hands of a private sector company, Union Electric de Vanuatu (UNELCO), a subsidiary of a Paris based enterprise under a management contract of 40 years which expires in 2011. Although the standard of service is highly regarded in the whole region as the best, the power tariff rates are considered the highest (Table 7). Similarly, the phone rates, charged by Telecom (a joint venture) are also the highest in the region. Although efficiency is certainly a desirable criterion, the investors both existing and potential, find the tariffs unreasonably high. Although the management contract agreements have conferred powers on the government to monitor and regulate the public utilities, they are hardly exercised. The chairman of UNELCO is normally a politician appointed by the government.[5] The board does not have any official from the ministry of finance which is charged with administration of public finances.

Reforms are required to set up a unit in the ministry of finance for monitoring the operations of all public enterprises and public utilities. The unit will also oversee the privatisation activities and advise the minister on all policy decisions. Considering the limited availability of skilled civil servants with expertise in financial matters, there is no need to set up any new body as the existing organisational structures can be strengthened with appropriate technical assistance support from the international institutions who are involved with public sector reform formulation and implementation.

Table7. Comparison of Pacific Island electricity costs, February 1995

Country		US $
Fiji	(Domestic)	0.174
Kiribati	(Domestic)	0.239
Papua New Guinea	(Domestic>100kWH/mo)	0.160
Solomon Islands	(Domestic)	0.131
Tonga	(All)	0.266
Vanuatu	(Domestic>121kWH/mo)	0.345
Western Samoa	(All)	0.165

Source: Pacific Power Association, 1995

Labour Market Reforms

Cost of labour (Table 4) is very high relative to productivity. One of the reasons is the high subsistence living in the rural sector which sets the reservation price. Rural households are not prepared to supply labour unless equivalent money wage is paid. Secondly, high import duties with an average of 37 percent on consumer goods, which are relied upon for raising government revenues in the absence of direct taxation, have pushed up the cost of living in urban areas. The large foreign aid in the past was also partly responsible for government consumption which has driven up costs of labour in the formal sector. Other reasons include the government's minimum wage law, compulsory contribution at 3 percent of wages by the employer to the provident fund, severance pay requirements, restrictions on employment of expatriate skilled labour and increased localisation by employing a higher number of unskilled local labour at greater costs have all resulted in high production costs.

Tax reforms including the introduction of a more neutral value added tax (VAT) would contribute to resource mobilisation by lessening the current reliance on import duties. Reduced tariffs on imported goods with a duty drawback system built in VAT are likely to lead to reduced price levels of consumer goods. Combined with tax reforms, greater enforcement of tax compliance, less number of exemptions and reduced discretionary power of finance minister to grant exemptions would also lead to increase in revenue collection and contribute to streamlining of and reduction in other indirect tax rates such as fees and charges, which are today passed on to consumer. These will have a long term impact on wages and contribute to easing real wage costs. Further, improvements to skills of work force are urgently needed in terms of investments which would contribute to human capital.

5 In fact an ousted prime minister was given this plum job by his successor so as to get rid of him from active politics. The perks of the job are considered to be the highest in the country and much more than what the prime minister would have, as the quarterly board meetings are reportedly held in exotic places, including Paris which is the company's headquarters.

Financial Sector Reforms

Despite a large number of banks and financial institutions, and the absence of any intervention in determining the interest rates by the Reserve Bank of Vanuatu, the spread between the interest rates on deposit and lending is high, ranging between 8 to 10 percent. This spread seems inexplicable in the context of high component of quasi money in the broad money aggregate. The availability of such large financial savings has not led to narrowing of the spread. The reasons attributed are the same as we noted in the last section: the high cost of bank operations, high risks involved in lending, and lack of collateral security for loans when only cash flows are considered for loan approval, non-availability of land as collateral in the face of land tenure problems and absence of good projects.

Appropriate interest bearing instruments have to be developed for the commercial banks to place their excess reserves, which will reduce the cost of holding excess liquidity. This will also enable nominal interest rates to rise for attracting deposits and reduce the spread. Increased competition among the existing number of commercial banks will be necessary by opening the banking sector with liberal grant of licenses, and this will contribute to break the present oligarchic competitive conditions.

Land Tenure

The land tenure problems causing considerable hurdles for long term investment in land intensive private sector operations are quite similar to the ones observed in other SPICs. Some innovations have been employed to circumvent the issues surrounding long term leases. For example, enterprising exporters of expatriate origin have concluded informal nucleus type arrangements with land owning communities for growing squash for exports during its off-season in niche markets in Japan. Under these arrangements, the exporter arranges seed, technical advice and crop loans from DBV to the landowners and buys the crop and exports it. Deductions towards expenses including repayment of crop loan from DBV are duly effected from the payments to squash growers. These arrangements have worked out successfully. However, for long term investments such as tourist resorts in Port Vila and Luganville and in outer islands the problems remain.

The problem of land tenure issues also haunt the government from time to time. The custom law is superior to manmade laws. What was considered a once-for-all settled issue, the land acquisition for the municipal area of Port Vila is being raked up from time to time, especially just prior to national elections once in four years, when the politicians seize opportunities to exploit disgruntled elements. The original land owning clans have been moving up the courts for annulling the earlier settlement under which they were paid cash compensation for purchase of land for constructing roads and public buildings and declaring the land as municipal area falling under the Port Vila urban area. The idea behind is to negotiate some more favourable terms and conditions under which they can have a new system of annual rents which can be raised each year reflecting price level changes or increased cash compensation. These experiences do not inspire any confidence to handle these thorny issues of property rights within the current structure of customary land tenure and custom laws vis-a-vis the legal documents of doubtful enforcement.

One institutional solution has been proposed under which all customary land would be brought under one statutory body on the lines in Fiji, where the Native Lands Trust Board acts on behalf of the land owning communities and negotiates leases and supervises the enforcement of leases and acts as an intermediary between the two parties.

3. Conclusions

Deregulation of economic activities in the otherwise public sector dominated SPICs have released enormous energies from private entrepreneurs. Dismantling old tariff regimes and the efforts to fulfill the membership obligations of World Trade Organization have also sent right signals to private sector. Combined with these developments, special packages of incentives for attracting new investments have also been well received. Although immediate responses are from foreign investors to take advantage of these new opportunities, affirmative action in terms of greater credit support and other special treatment is expected to encourage native entrepreneurial initiatives. Recent evidence suggests that the indigenous private sector efforts will be forthcoming if properly encouraged.

Governments in SPICs have also embarked upon reforms to downsize the public sector by aiming at not only in reducing the size of the civil service but also winding up uneconomical and financially burdensome public enterprises. Although resistance to large scale privatisation of commercial enterprises in the public sector is in evidence as the politicians are likely to lose opportunities for influence peddling and earning rents, increased awareness of mobilising public sector savings in the face of grim prospects of reduced external aid have made the decision makers conscious of the need for reforms.

However, privatisation by itself is not a panacea for all ills. Market forces have to be facilitated to work freely to promote completion. There are barriers of several kinds to competition. Some of them are unique to the SPICs, such as those we see in regard to land tenure. Sooner or later solutions have to be found.

However, there are possibilities of making mistakes. These might include decisions to privatise public utilities which are natural monopolies. Private sector monopolies, unless regulated properly, may be harmful to competitive conditions. Appropriate interventions from the state are needed to exercise regulatory control on monopolistic units. Privatisation is only one element of strategy to promote competition and that is not an end in itself.

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