Policy dialogue

Binding and not-so-binding constraints to economic growth from Vanuatu's productive sectors

Peter Bazeley

Peter Bazeley Development Consulting

There is convergence of opinion that stimulating broad-based economic growth from productive-sector activity is a priority in the next phase of Vanuatu's development. A recent study commissioned jointly by AusAID and NZAID examined some of the issues and options in supporting this objective. While the report (Bazeley and Mullen 2006) also discusses theoretical aspects of achieving equitable growth at scale and the particular challenges of managing long-term agricultural-led growth—and provides a commentary on policy and institutional processes—this article is extracted from its preliminary examination of constraints to growth.

That examination concluded that in the context of Vanuatu's productive sectors experiencing comparative advantages and disadvantages, and in the context of some productive-sector enterprises enjoying relative success, the challenge the country faces is one of working to remove multiple inefficiencies throughout existing value chains (including value-added through policy and donor interventions), rather than recognising critically binding constraints.

Potential for growth

Vanuatu can produce. Its productivity has provided for a stable and peaceful independent nation whose economy has remained relatively sound. It has enjoyed revenue from a diversified base and its agriculture has supported a rapidly growing population.[1]

In terms of its 'modern' economy, Vanuatu's success in converting its assets into macroeconomic growth, attracting inward investment and increasing foreign exchange earnings has not been insignificant. Individual commodities have waxed and waned, and foreign investors have come and gone at different times for different reasons, but in broad terms there remains a relatively robust core of productive capacity that has seen the economy through the peaks and troughs of commodity prices. Not least it has maintained productive-sector viability in the face of the high costs and low returns (compared with world prices) inherent in Vanuatu's geography and scale of production.

The growth rate is not, however, sufficient to support development for such a rapidly increasing population(2.6 per cent per annum) where there is also a desire to enter the modern economy.

Vanuatu does enjoy significant comparative advantage in several productive sectors, which it has exploited successfully for decades

- relative to the population, a large and—with proper husbandry—productive land resource
- pre-existing commercial-sector agricultural investment and processing infrastructure
- relatively low incidence of agricultural pests and diseases
- a maritime environment with useful, if limited, fish stocks
- a unique natural and cultural environment attractive to tourism
- sea ports.

Vanuatu's inherent advantages are, however, probably negated by inherent disadvantages

- small size with none of the economies of scale enjoyed by competitors
- geographical fragmentation with high internal transport and communication costs
- geographical and economic isolation from large markets
- high fixed costs of providing governance and essential services per unit of population
- unique economic and social challenges in the interface between its traditional and modern economies
- frequent cyclones, causing production shocks and restricting the range of viable crop and tree species.

Vanuatu has also had relatively little success in productive-sector innovation in terms of new crops, commodities and processing. There have been grand schemes and new hopes, but few, if any, have proved better or more sustainably profitable than the crops and commodities that have repeatedly shown themselves to be well-suited to Vanuatu's challenging physical and economic environment: copra, cattle, cocoa and, to a lesser extent, coffee and spices, as well as a particular brand of tourism. Kava, perhaps the most traditional crop in Vanuatu, has been developed from a minor domestic crop into an important export commodity. A lesson has to be, as in other business environments: stick to what you do best.

So, in a physical and natural environment that is probably 'advantage-neutral' overall, and with no compelling evidence that there are many unexploited and obvious new niche commodities, how can we enhance the performance of the productive sector such that it contributes more to economic growth?

Growth diagnostics

Contemporary growth literature (see, for example, Hausmann et al. 2006) highlights the variable, seemingly non-linear results achieved from the adoption of Washington Consensus policies[2] in developing countries in the past 15 years and the difficulty in selecting appropriate policy prescriptions for any given social and economic environment. An argument put forward is that, faced with massive policy reform agendas across multiple sectors and institutions, governments have either tried to do everything at once (with consequently insignificant effect on anything) or have selected reforms and investments that were not, in fact, crucial to their country's economy. Binding constraints theory (Hausmann et al. 2006) encourages countries to figure out the one or two most binding constraints on their economies and to concentrate policy and institutional reforms on solving those.

Binding constraints theory starts by assessing the most fundamental inhibitors of growth—high cost of and/or low returns to investment—and develops analytical decision trees from that. Such growth diagnostics at the macroeconomic level have not yet been undertaken in Vanuatu; it is something a World Bank team will be pursuing later. With regard to the productive sector, however, we did not find a binding constraints approach particularly helpful; the really binding constraints on the productive sectors (geography and scale) are obvious and immovable. And an important tenet of binding constraints theory—that currently observed economic activities cannot by definition be suffering irreconcilably from binding constraints—suggests that there are, in fact, probably relatively few critically binding constraints on the productive sectors.

That is not to say, however, that several of the classic impediments to growth are not present: some of the higher-level ones of difficult geography, weak infrastructure, low appropriability and contract enforcement and market failures, are all, sometimes, applicable in Vanuatu.

Given, therefore, that the picture is one of some immovable constraints (geography and size) on one hand but sustained productivity—albeit at suboptimal levels—from agriculture and tourism on the other, our analysis erred towards recognising multiple inefficiencies throughout existing value chains, rather than the identification of binding constraints or missed opportunities.

These are discussed below, but first some caveats.

Some caveats

Property rights, in particular those relating to land, represent a critical issue in any discussion of productive-sector growth in Vanuatu; however, as this was looked at comprehensively in the Land Summit in September, it is not discussed here.

A review of transport was beyond the scope of the study, but the costs and reliability of inter-island transport might serve to limit the extent to which growth can be based more broadly than on the economies of Efate and southeast Santo. It warrants further analysis. If the costs of domestic transport cannot be reduced through the removal of policy and organisational inefficiencies, a major constraint to equitable growth could endure. Such a scenario might suggest the need to rethink how efficient, technologically advanced, fit-for-purpose, inter-island transport is financed.

The issue of human capital is also an interesting one. Although it would be counterintuitive to imagine that Vanuatu doesn't need all the education it can get, growth diagnosticians would be interested in the level of formal-sector underemployment of educated people and might consider whether certain forms of education have run ahead of economic growth. Some productive-sector employers called for a greater emphasis on vocational, rather than academic, education.

Mostly anecdotal evidence of a non-linear production response to increased demand has long been debated in Vanuatu. That is to say, when demand for agricultural products is strong and prices rise there sometimes follows an unexpectedly flat—or sometimes even negative—supply response. The explanation usually given is that once school contributions have been paid (and they can be paid with less effort when prices are higher), there is subsequently a low value attached to the return on additional labour and investment in productive-sector activity. But a robust production response appears when returns to labour and investment are especially high—such has been the case with kava recently.

Perhaps linked to this phenomenon, the importance of Vanuatu's traditional economy (and its interface with the modern economy) must be included in any analysis of growth and the outcomes of growth. Many of the functions of modern growth—well-being, stability, equity, social cohesion and sustainable livelihoods for an expanding population—are also well provided for through Vanuatu's strong and deeply held customary values, including its custom economy.

Finally, the study did not extend to sociopolitical considerations of migration (and accompanying remittances), or rethinking of the potential role of subsidies—for example, in the transport sector or in stimulating demand for goods and services through rural electrification and telecommunications.

Multiple inefficiencies throughout the value chain

Our assessment was, therefore, that generating additional, broad-based growth from the productive sectors is

- not critically inhibited by binding constraints, because there are successful, sustainable and expanding productive-sector enterprises in the commercial and smallholder sectors now as there have been for decades.
- not an issue of finding a new commodity or of identifying new niches *per se*, because a) productivity from existing crops and commodities could be increased significantly if society felt the incentive to do so, and b) Vanuatu has little or no comparative advantage in pioneering such new enterprise—although that might flow from improved economic efficiencies generically.

Rather, we saw the impediment to accelerated and broader-based growth to be multiple inefficiencies, in the economic sense, throughout the value chain, in the private and public sectors, including at the interface with policy and with donors. Efficiency throughout the value chain is essential to Vanuatu's ability to compete in international markets, given the other immovable constraints it faces in terms of geography and lack of any economies of scale.

Policy inefficiencies

Vanuatu's policies have over time resulted in a reasonably stable productive sector that has fared better than that of many of its neighbours. The productive sector is, however, relatively conservative and risk averse, concentrating on well-established technologies and commodities; policies have, it seems, worked against expansion and innovation. Such restraint in the productive sector will probably not allow Vanuatu to overcome its inherent comparative disadvantages in competing against others, in an increasingly globalised marketplace, who are better served by geography and who enjoy considerable economies of scale. To compete in the productive sectors, Vanuatu needs to perform at its most efficient, and that includes efficiency and effectiveness in policymaking and implementation.

Stakeholder opinion is consistent. The critical issues are not so much that there are 'bad' policies *per se*, but that

- policies are inconsistent and too short-lived, resulting in lack of confidence and long-term investment[3] in new productive-sector initiatives. Productive-sector activity (agriculture and tourism) typically has a long lead time before return on investment is achieved, so producers need to feel confident that something for which there is a supportive enabling environment now will still have a supportive enabling environment in several years. (The enabling environment might, for example, relate to economic parameters such as tariffs and exchange rates, or institutional ['rules of the game'] issues such as access to land and other assets and the enforceability of contracts, or organisational issues such as the quality and availability of services.)

- despite a plethora of planning mechanisms (the Comprehensive Reform Program, business forums, the Government Investment Program, Department of Economic and Sector Planning, Department of Strategic Management, Aid Management Unit), policymaking remains insufficiently inclusive, consultative or evidence based, resulting in policies that are not nuanced to the requirements of productive-sector growth led by private-sector investment and trading.
- policies and policymaking are poorly understood by stakeholders. Especially in a small community, opaque policymaking results in misunderstanding, misinformation and suspicion about policies and their impact on different segments of the population.

One observation is that there is a gap—at least in the formal structures and workings of government, but possibly less so in informal networks—between the executive and the political component of policymaking. That gap might be the result of a number of things.

- The fact that, in the political environment that has endured for much of Vanuatu's post-independence history, the drivers of change in terms of economic and social policy stem from, in the first instance, the need for immediately tangible and relatively short-term reaction to constituents' concerns.
- Within the regular functioning of the executive, there is relatively little commissioning of robust, long-term sector analysis or policy studies and little scenario planning around future policy and public investment options. There is precious little capacity to do so: Department of Economic and Sector Planning is preoccupied with administrative matters, including overseeing hundreds of small development projects.
- While development partners often instigate policy and other analyses through short-term consultancies, these can suffer from
  - —lack of ownership by, and involvement of, government and other stakeholders
  - —the debate—and even the information—remaining largely within donor or academic institutions
  - —being narrowly focused or sector specific, dogmatic or misinformed
  - —being inadequately summarised or distilled to capture broad-based interest and understanding
  - —poor quality and quantity of data and statistics.

To achieve robust growth from the productive sectors, more indigenous, consultative and evidence-based policymaking processes need to be supported. This is not new: the Comprehensive Reform Program articulates this need and ambition clearly. It has not been achieved because such processes have not been adequately resourced and supported.

Inefficiencies in the supply of public goods

Goods and services become public goods where the market will not supply them efficiently, effectively or equitably, because of market failures that are reasonably universal and usually predictable (see, for example, Cornes and Sandler 1996). Market failures are, however, much more likely to occur in a small and immature economy such as Vanuatu's than in the larger and more robust economies in which most public goods theories were developed. There needs to be careful assessment of market failures and the required scope and scale of public goods in the productive sectors in Vanuatu; it has enormous bearing on the form, function and funding of public institutions in the productive sector and is relevant to the review of the CRP.

We were told repeatedly how in the aftermath of the 1993 civil service strike, the CRP's 'right-sizing' exercise in the mid 1990s resulted in a failure in the delivery of public goods in support of the productive sectors, to which there has been inadequate adjustment or recovery. The most critical issues would appear to be

- weakening of agricultural extension, information services and smallholder marketing support. As an example of the impact of this, in the early 1990s—as a result of efforts over many years by the then Department of Agriculture to provide smallholders with skills, information and access to markets—the Santo abattoir was exporting seven or more containers of beef a month, of which more than 50 per cent was derived from smallholder cattle. Now the Santo abattoir exports two to three containers a month, of which only 5 per cent is derived from smallholders—with supply (not markets) being the limiting factor.
- Ability to enforce property and access rights and restrictions, particularly in fisheries and forestry, and to regulate industry appropriately.
- The importance of maintaining sanitary and phyto-sanitary controls and certification in support of agricultural exports and protection of imports.
- Suboptimal (in the view of the industry) destination marketing in the tourism sector.

If there is to be broad-based growth, the majority smallholder/rural population has to be engaged and linked to markets. At this stage of Vanuatu's economic and private-sector development, supporting such engagement and market linkages remains in most cases a public good.

Private-sector inefficiencies

The Pacific islands have sustained themselves for generations through private-sector activity and entrepreneurship, whether that be self-sufficiency in food through smallholder agriculture or the economic activity of foreign investment and trading. Much of that trading was, however, historically relatively exploitative and did not face the kind of external competition that today's global market presents. In terms of modern norms of innovation, operational efficiency and corporate social responsibility, Vanuatu's private sector is—with some exceptions—relatively immature.

It is also very small. The principal commercial producers that provide the critical mass and market linkages in agriculture and tourism barely exceed single-digit numbers. This makes industry organisation and the representation of industry to government difficult, partial and subject to inevitable personalisation and perceived conflicts of interest.

To compete, Vanuatu's private sector needs to become better organised, skilled and equipped, develop what economies of scale it can, work to improve quality, market its products more collectively, plan its long-term future and husband the assets on which it depends. There are examples of this, but they are few.

Monopolies and monopsonies remain a common feature of Vanuatu's private sector, perhaps inevitably, but they are incompletely regulated. A number of public–private partnerships exist—some of them quite innovative and successful, but others certainly not. There is ambiguity about the public-good purpose of some government investments in productive-sector activity.

Development needs to get a better handle on private-sector inefficiencies, consider how best to support adjustments to its operating environment such that it becomes better organised and more responsive to market demands, and seek to supply the private sector with the incentives—and perhaps sanctions—needed to promote broad-based and sustainable growth.

Infrastructural inefficiencies

Geographical fragmentation and low population densities imply high infrastructure costs per head of population. Inter-island transport, in particular, needs to be efficient if the productive sector is to engage the rural population. Inefficiencies through the use of old equipment and technology and market-distorting protections in inter-island transport might represent a binding constraint to broad-based growth from the productive sector and need further analysis.

The impact of the imminent Millennium Challenge Account (MCA) investment in infrastructure will be interesting. There is likely to be a difference, in terms of growth outcomes, between infrastructure investments that effectively link a greater proportion of the population to the economy and those that merely improve the quality of existing infrastructure. The MCA focuses, in the main, on the latter.

Although bench-marking studies have concluded that electricity generation in Vanuatu is relatively efficient and of a high quality, it is among the most expensive in the Pacific (Castalia Strategic Advisors and Network Strategies 2004). Oil-based energy is inevitably going to imply high, and rising, costs. Tourism will be relatively energy dependent and intensive; agriculture, forestry and fisheries less so. Energy pricing more generally is distorted by numerous exemptions and concessions.

Donor inefficiencies

Vanuatu is fiscally highly donor dependent, with prominent levels of donor, NGO and civil society activity for the small population and even smaller government resource. With so much to do and so little with which to do it, and at some variance with aid modalities elsewhere, development in Vanuatu is still exceedingly small-project orientated and supply driven. There are more than 400 projects listed in the Government Investment Program database.[4]

Projects continue to have an important role to play in development processes, and we now know more about when they do and don't add value. But an overdependence on supply-driven project modalities invariably results in fragmented development, undermining and/or over-stretching of government processes and capacity, lack of ownership and competition for human and infrastructural resources—sometimes even between donors. Most importantly, project coverage can never be wide enough to impact at a sufficient scale in terms of achieving broad-based growth that engages the majority of the population. Such transformation must be the outcome of properly resourced and sequenced reforms in public policy and cross-sectoral expenditure.

Strong supply pushes and minimal capacity to manage such a large portfolio of projects inevitably results in a culture of 'gate-keeping' development rather than proactively configuring development. Effectively, the system is one of checking that projects can be justified within the scope of broad development frameworks rather than a more deliberate process of assessing how the total resource envelope (including donor resources) can best be configured and deployed to achieve desired outcomes.

A model in which government is more firmly in control (in terms of decision making and resources), a properly constructed medium-term expenditure framework and more effective donor coordination are required to enhance the efficiency and impact of development assistance on economic growth.

Conclusion

Our conclusion was that the concept of binding constraints might not be the most applicable to Vanuatu's productive sectors, although growth diagnostics might yet reveal imbalances in infrastructure, human and economic development (and transport almost certainly warrants further examination in that efficient inter-island transport will be a prerequisite to broad-based growth). Instead we constructed an argument around the need for Vanuatu to overcome its inherent and immovable competitive disadvantages (geography and scale) by reaching greater levels of economic efficiency throughout the value chain.

We highlighted policy inefficiencies, inefficiencies in the delivery of public goods, private-sector inefficiencies, infrastructure inefficiencies and donor inefficiencies as important. In order to address these, more robust, locally owned and transparent analysis of constraints to growth, and of policy and public investment options, needs to be generated and propagated. A deeper and more quantitative understanding is needed of the private sector and its strengths and weaknesses in contributing to broad-based economic growth. This implies a more responsive relationship between government and the private sector—probably implying new institutional mechanisms—and the determination of how policy and public investment can best be configured to support robust but equitable private sector-led growth. It also suggests a need for better sector performance data and information. Donors too must play their part in improving the efficiency and coherence of aid and the modalities of aid.

These issues will not be addressed by maintaining 'business as usual', either on the part of government of through conventional development projects. Certainly, capacity building in units such as the Department of Economic and Sector Planning is warranted. We also need to generate higher-level policy processes that properly engage ni-Vanuatu intellect, that can provide analysis and opinion that is widely respected and that engage with the political components of policymaking as well as they engage with productive-sector stakeholders. Mechanisms for this are discussed in our report.

Notes

1 Although growth in Vanuatu's per capita GDP has not been spectacular, its largely non-monetarised traditional economy has supported a 90 per cent increase in the rural population since independence (from about 95,000 in 1980 to an estimated 180,000 now).

2 The maintenance of macroeconomic stability, creation of sound business environments, enforcement of property rights, integration with the world economy for example.

[3] We include here the type of investment smallholders make in productive-sector activity.
[4] Currently being reviewed.

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Acknowledgments

This article is derived from a report by Peter Bazeley and Ben Mullen on recent work in Vanuatu funded by AusAID and NZAID aimed at informing strategies for future support to economic growth. The opinions are those of the author(s). The Government of Vanuatu is yet to endorse the findings and recommendations of the original report and publication does not imply acceptance. The original report can be obtained from the authors.

The author is very grateful to the many people in Vanuatu in government, donor and civil society organisations and the private sector, who provided their time and opinion during the study, and to Ben Mullen (Uniquest), co-author of the original report, for his comments on an earlier draft of this article.