# FROM INSTITUTIONS TO GOVERNANCE - GETTING THE GOVERNANCE STRUCTURE RIGHT FOR OPTIMAL ECONOMIC PERFORMANCE

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## Abstract

This paper examines the importance of strong institutions, i.e., a strong governance structure, as a cornerstone for reform efforts to promote good governance in the Pacific Island countries (PICs). Operating on the premise that the effectiveness of governance is a function of the quality of the institutional environment in which it is performed, the paper argues that any reform efforts to promote good governance in the PICs should begin by addressing, first and foremost, the institutional roots of the problem in order for these reform efforts to have positive payoffs. In this pursuit, the paper addresses the following questions: What constitutes good governance; how do institutions shape governance; and what institutions are crucial for good governance? The resolution of these questions is important for a better understanding of the complex interface between institutions and the governance process, and for the formulation of strategies for institutional reforms that would underpin good governance, which is critical to the economic growth and development of the PICs.

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## 1.0 Introduction

The role of good governance as a key to economic growth and development effectiveness has been succinctly underlined in a number of theoretical and empirical works. For example, Kaufmann, Kraay and Zoido-Lobatan (1999) have proved empirically the close link between the quality of governance and the level of per capita income across countries. Likewise, both the World Bank and IMF have strongly supported the view that good governance is a key determinant of economic development in the developing countries.[1] However, while the link between governance and economic development is a well-substantiated empirical proposition, there still remains the puzzling question as to why some countries are "better governed" than others, given that they have access to the same levels of technology and other resources. The central contention of this paper is that effective governance is a function of the quality of a country's institutional environment. Therefore, unless reforms to promote good governance are made in concert with actions to improve the institutional environment, the pay-offs from such reform efforts will not be optimal.

The objective of this paper is to examine the importance of a strong institutional framework (i.e., a strong governance structure) as a precondition for efforts to foster good governance in the Pacific Island countries (PICs). This task is not easy for three reasons. First, the dynamics of the governance-institution relationship are complex, compounded

[1] See for example World Bank (2000)

by the multiplicity of factors that bears on this relationship. Second, governance is a broad and multi-dimensional process, involving deep questions concerning the specification of the arenas of governance and the different modes by which governance may be conducted. The third is the difficulty in establishing the causal relationship between institutions and governance. That is, it is difficult to determine whether effective institutions determine good governance, or the other way around. However, as strongly argued in this paper, strong institutions are the precondition for good governance.

The paper is structured as follows. The next section, Section II, unravels the conceptual and definitional issues pertaining to *governance* in an attempt to place in perspective the core elements of good governance and its determinants. The influential role of institutions in the governance process is highlighted. Section III describes the dynamics by which institutions shape governance, underscoring the need for a strong institutional framework for good governance. Section IV addresses the all-important question of what institutions are essential for good governance, and the form that they should take. Section V examines the governance issues in the Pacific Island countries and the reform efforts that the countries have undertaken to promote good governance. It also examines the causes of the failures of these reform efforts. Section VI proposes the way forward for the PICs to develop a credible ‘good governance’ reform program. Section V contains concluding remarks.

## II. GOVERNANCE

### Conceptual and Definitional Issues

Various authors have attempted to define the term 'governance'. According to Bell (2002), for example, governance is defined as "the use of institutions and structure of authority to allocate resources and coordinate or control activity in society". Kaufmann *et al* (1999) define governance as "the traditions and institutions by which authority in a country is exercised". Our preferred definition is the one proposed by ADB (1999), which states that "governance is the manner in which power is exercised in the management of the country's economic and social resources for development".[2] It is important not to confuse 'governance' with 'government'. Governance is a much broader process than government, which is a subset of governance, and may involve state and non-state actors.

Closer analysis of these definitions highlights three important issues implicit in the governance process. The first is the notion that there must be an agent of governance (i.e., someone responsible for governance). This agent could be either the state or non-state actors. It is important to note that the notion of governance does not make any assumption about which agents do the governing, i.e., governance is not the exclusive right of the state or government. Also, the governance agent must have the capacity and authority to 'govern'.

The second implication is that there are defined 'rules' and accepted norms by which governance ought to be conducted and gauged. It implies mechanisms for accountability, transparency, predictability, and participation – the so-called 'pillars of good governance'. Accountability means that agents (the 'governors') can be called to task for their actions. Transparency means that relevant information is accessible at low cost. Predictability means policies, laws and regulations are clear, known in advance, and are uniformly and effectively enforced. Finally, participation means that people are consulted and/or involved in the activities that affect them.

The third implication, which may be controversial, is that governance is concerned directly with sound development management. That is, if the governance process is concerned primarily with the optimal management and allocation of the nation's resources, then governance must have a very important development role to play.

## Modes of Governance

As mentioned earlier, governance is not the exclusive responsibility of the state or government. Non-state actors also play an important role in the governance process. To underscore this point, a brief outline of the different modes of governance is in order. The three modes of governance considered are governance through state authority; governance through the market; and governance through networks, associations and communities. These modes are self-explanatory in themselves, so I will go through them very briefly. These are briefly explained below.

### *Governance through State Authority*

This concept of governance is the most widely known form of governance and it is particularly relevant in the developing world, where the government is the major constitutive element of the governance process. It underlines the important role of the

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[2] In its political context, governance is an all-embracing concept that captures the essence of effective and efficient

state/government in providing the regulatory environment and institutional underpinning to facilitate efficient market exchange. For example, without courts to interpret and enforce agreements, commercial life would become chaotic; without laws to define, and police and courts to enforce them, property rights would be non-existent. Thus, governance through this mode takes place through the interplay of a host of institutional arrangements and policy strategies that the state puts in place.

Inevitably, the state will be a player in any mode of governance. Unlike any other institutions, the state acts in a 'meta-governance' role because it, and it alone, can allocate the rights, regulations, sanctions, the legitimacy, and even the incentives and resources on which other forms of governance depend. In this meta-governance role, the state acts to ensure that the wider systems of governance are operating efficiently, effectively and accountably. Thus, state governance cuts across all modes of governance and is central to the effectiveness of the entire system of governance.

### *Governance through the Market*

The most basic form of governance here is through the forces of competitive markets, i.e., through market exchange and the price mechanism. Under this mode, therefore, the balance of governance and coordinating functions shifts towards greater reliance on markets, private allocation, and contracting. Economic activity is largely determined by the forces of supply and demand, acting to a large degree in a self-regulating fashion.

However, markets are never freestanding. Effective competition in markets requires considerable attention to the codification and enforcement of the 'rules of the

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political leadership permeating all levels of society (Soesaetro, 2000).

game' if anti-competitive and arbitrary behaviours are to be avoided. As already explained, only the state can provide these institutions. It is in this context that the state will always be an important constitutive element of any form of market governance.

### *Governance through Networks, Associations, and Communities*

Governance also includes the activities of formal organisations such as business associations or labour unions engaging in corporatist bargaining with each other and/or with governments. It may also include the activities of informal organisations such as village councils, which administer the social and economic activities as well as the allocation and use of resources in the village.

Other examples of this form of governance include modes that emphasise various forms of public-private collaboration and power sharing, together with the empowerment and engagement of civil society and various forms of community institutions.

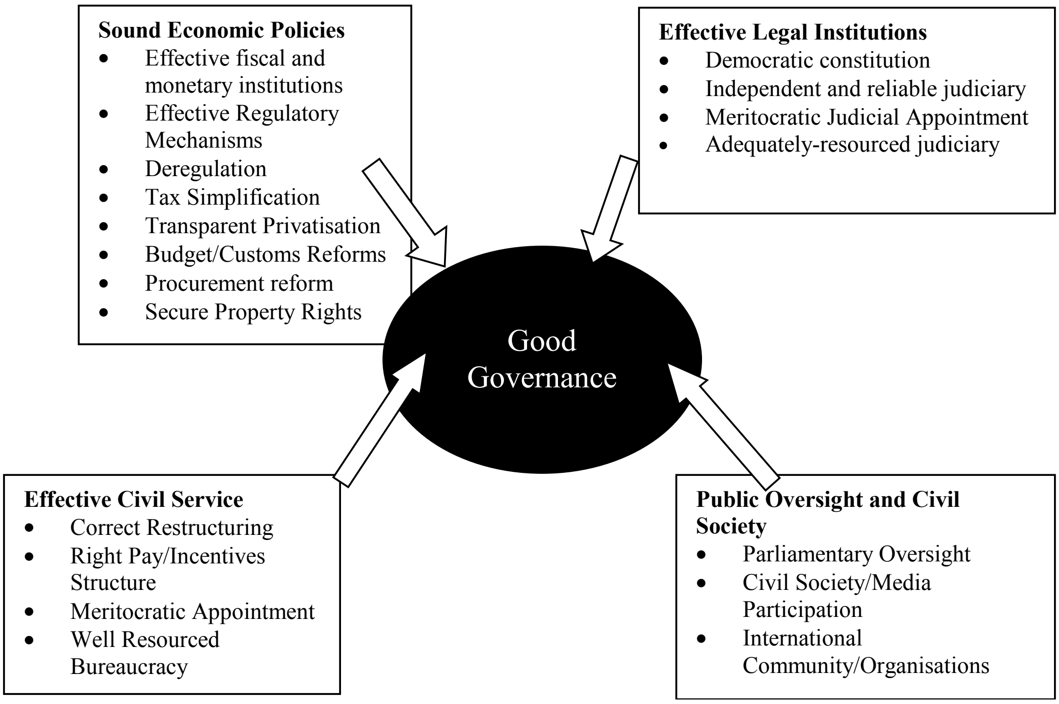
It should be emphasised that the three modes of governance outlined above are not mutually exclusive, as they may overlap with and complement each other. Collectively, therefore, they define the nature, form, and operational efficiency of the country's governance landscape. Although the present analysis focuses primarily on 'governance through state authority' (because of its greater relevance in the PICs context), there is no reason to suppose that the other modes of governance are not implicated. As already explained, state governance cuts across all modes of governance.

## What Constitutes 'Good Governance'?

Having defined governance and the modes by which it may be executed, the next challenging task is to address the issue of what constitutes 'good governance'. In line with the definitions of governance above, ‘good governance’ can be said to materialise if the state is able, through the power and authority vested in it, to allocate the nation’s resources, and coordinate economic activities in an *optimal* manner. The notion of optimality connotes efficiency and effectiveness. It means that governance is conducted within the framework of effective rules and policies that underpin social harmony and sound development. In the context of state governance (which is our main focus), good governance implies the capacity to formulate and implement sound economic policies, to institute effective legal institutions, to ensure public oversight and participation of civil society, and to have in place a credible civil service that provides citizens with an acceptable level of public services in an effective and efficient manner. This is summarised in Figure 1 below.

These constituents of good governance must, however, be gauged against certain predetermined criteria. According to Soesastro (2000), good governance is widely identified with the following attributes: transparency, accountability, efficiency and fairness. These are the ground rules of governance, which must be used to assess governance outcomes. Therefore, good governance does not only mean that the state operates effective policies and laws, but it also means, and more importantly, that it executes those policies and laws of the state in a transparent, accountable, predictable, efficient and fair manner.

**Figure 1: The Core Constituents of Good Governance**




The next most important question is what drives good governance? That is, what makes public actors govern in an effective manner - managing and allocating the nation's resources optimally? A key starting point is to recognise the fact that governance is not carried out in a vacuum, but it is carried out by public actors who are motivated more by the private costs and benefits of their actions than by social and altruistic concerns. Unless the right incentives and constraints are put in place to guide the actions of public actors, the governance process and its outcomes will be of low quality. Institutions play a crucial role in the provision of these incentives and constraints. It thus follows that the quality of governance is only as good as the quality of the institutions that underlie it. The challenge now is how to put in place the right *governance structure* that yields the incentives and constraints compatible with the promotion of good governance. Before addressing this issue, a discussion of the dynamics by which institutions shape the governance process would be in order.

## III. INSTITUTIONS AND GOVERNANCE

So what exactly are institutions and how do they shape good governance, which is critical to economic growth? Various definitions have been proposed for the term 'institutions', but the definition provided by North (1990) appears to be the most popular. North defines institutions as "any form of constraint that human beings devise to shape action." This might involve formal constraints such as rules or national laws, or informal constraints such as conventions and codes of behaviour. Thus, institutions embody the basic rules that govern all public and private actions. It is necessary to underline the important distinction between governance and institutions - a distinction which is often blurred in the literature. While institution is essentially about rules, governance is essentially about the setting, application, and the enforcement and adjudication of those rules. Based on this dichotomy, governance can be viewed as a *flow* variable and institutions as a *stock* variable. Note, however, that irrespective of the precise set of institutions (rules) that governments adopt, good governance is required to ensure that those institutions have their desired effect.

Juxtaposing the definitions of governance provided in Section II and that of institutions above, it is obvious that institutions matter for governance because governance occurs in and through institutions. However, the dynamics and channels by which institutions affect or shape governance is not readily clear. Analytically, institutions ultimately shape governance by shaping actors' preferences and actions; by providing actors with power, authority, and resources; by shaping transactions costs; and by shaping the capacity of the state.

**Institutions as Shapers of Actors' Preferences and Actions**

What agents do and how they act are influenced to a large degree by the constraints, or lack thereof, imposed by the institutional environment in which they operate. Thus, institutions decide the rules of the game that dictate what agents should and should not do, as well as determine the 'penalties' for deviant behaviour or lack of compliance with those rules. These rules, therefore, provide the incentive structure that ultimately shapes the preferences and actions of agents.

In terms of economic governance, institutions and the constraints that they engender have significant bearing on the manner in which the nation's resources are managed by policymakers. For example, if institutions relating to the control of public finances are weak or dysfunctional, governments, as agents of governance, may not be compelled to keep within the legislatively determined budgetary limits, resulting in over-expenditure and misallocation of resources. On the other hand, if the institutions ('the rules of the game') stipulate that the executive will be held accountable for unauthorised expenditures, the tendency (preference) of decision-makers to over-spend or indulge in unruly, irresponsible strategies will be curtailed. A parallel example in the corporate world is the incentive structure provided by institutions (corporate laws and regulations), compelling corporate managers to have as their goal the maximisation of the company's profit and, therefore, shareholders' value.

Another good illustration of institutions as shapers of agents' preferences and actions is the performance of financial institutions in the face of an inadequate prudential framework. One common calamity that affects commercial banks in developing countries is over-lending to a specific, often preferred, class of borrowers, resulting in over-exposure of risks by the banks. This often culminates in serious financial crises, as was the case with East Asian countries in the late 1990s. These risky practices of banks and other financial institutions could be checked and controlled if institutions that set the rules on how the 'game' is to be played within the financial sector are put in place and enforced.

### Institutions as Shapers of the Powers of Actors

Apart from determining the rules of the game, institutions also provide agents with power, authority, and resources. As Levi (1990:407)[3] argues, institutions both contain and create power. For example, the Treasury in most countries is at the apex of the decision-making structure only because the national institutions – the laws, regulations, decrees, and other administrative arrangements – recognise the important role that it plays in the management of the nation's economic resources, and therefore grant it the power, resources, and legitimacy to perform that function. A similar example is the power of the Auditor-General and other oversight agencies. The office of the Auditor-General can only perform its watchdog functions effectively if the institutions

[3] As cited by Bell (2002).

provide it with both the authority and resources to carry out those functions, as well as the means (institutions) to ensure that its work and findings are enforced.

At a community level, a good example is the position of the *ratus* and *matais* in the Fijian and Samoan societies, respectively. These chiefly positions have the power, authority, and resources to oversee the affairs of the community only because the social institutions – customs, norms, taboos, and legends – in which they operate sanction their status and power.

#### Institutions as Shapers of Transaction Costs

One other important role of institutions is that they shape transaction costs. Transaction costs may be defined as the search, information, and enforcement costs of conducting business or market exchange. A good example of this important role of institutions is property rights – one of the institutions that commands a place of importance in modern development economics. By clarifying titles and ownership to property, effective property rights regimes reduce information asymmetry, thereby facilitating the formulation of effective decisions. The reduction in transaction costs and the greater degree of certainty that it generates induces public actors to make productive decisions. It follows, therefore, that institutional innovation aimed at reducing transaction costs is essential for successful economic development.

#### Institutions as Shapers of State Capacity

Institutions enhance state capacity – defined as the capacity of the state to choose and implement policies – by equipping it with the necessary authority and resources. Authority implies that the state has a degree of popular acceptance and legitimacy, as framed by the legal, economic, and social institutions. Resources refer to both the financial resources and the availability of skilled and competent manpower, including the necessary underlying infrastructure that enables the state to effectively formulate and implement its policy strategies. In the context of governance through state authority, for example, the capacity of the government is assisted by having a bureaucracy staffed with qualified and experienced experts and dedicated policy advisers and implementers.

Examples of the channels through which institutions provide the authority and resources, thereby enhancing state capacity, include legislative provisions for a fair and democratic electoral processes, effective rules for staff appointment, promotion, and dismissal in the bureaucracy, and the regulations and/or decrees covering performance standards and ethical behaviour in the workplace. It also includes a range of institutions that facilitate the efficient flow and effective mobilisation of the nation's resources, such as a Constitution, the Public Finance Act and a host of financial regulations and decrees.

All in all, institutions fundamentally affect the efficiency and quality of governance by providing the incentives, rules and constraints, and resources and power that ultimately drive the performance of public actors. Indeed, if the primary concern of governance is about the optimal management and allocation of the country's social and economic resources in a way that fosters sound development, then institutions define the right governance structure.

It is important to note that by shaping governance in the ways described above, institutions affect economic outcomes. For example, by distributing rights to the most efficient agents, institutions can enhance productivity and growth. By affecting the incentives to invest, for example, through strengthening property rights, institutions can affect investment levels and adoption of new technology. By delineating market rights, such as through competition law, institutions limit producer rents and protect consumers from monopolistic prices. Finally, by clarifying rights for the disadvantaged in markets, institutions can directly affect the lives of poor people. For example, giving formal titles to poor people whose occupancy rights were not recognised by lenders allows them to borrow and invest.

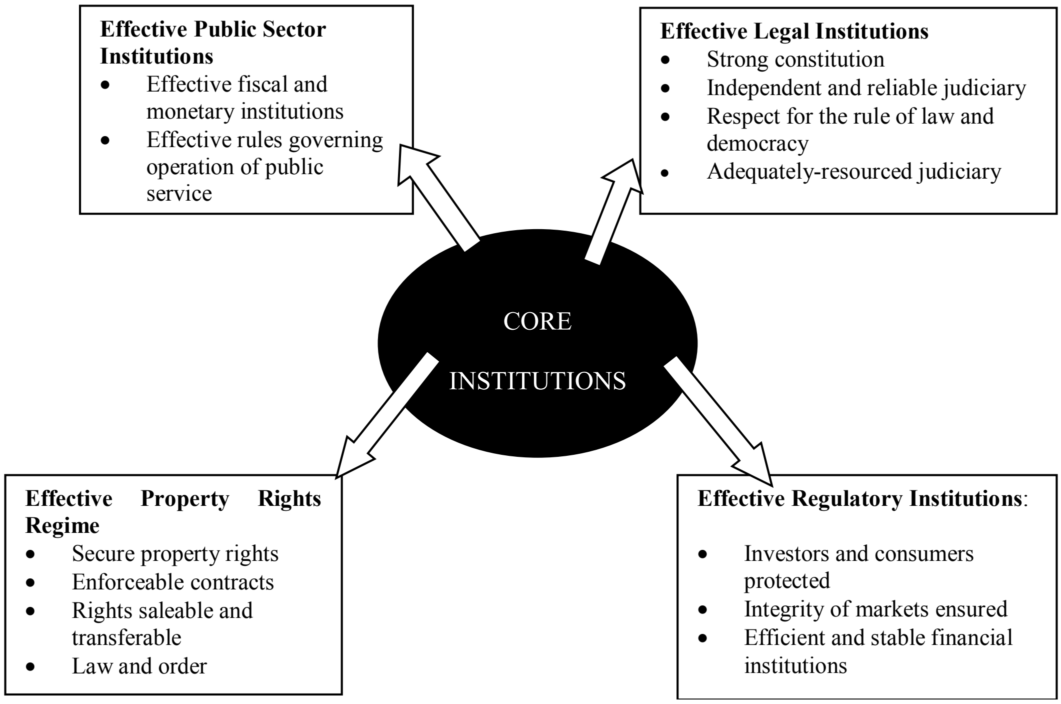
But how does one choose among the vast array of institutions available to select those that should have priority within a particular context? In other words, which institutions are essential for good governance, and hence for high-quality growth and development? These questions are addressed in the following section.

## IV. GETTING THE GOVERNANCE STRUCTURE RIGHT

Identifying those institutions that are crucial for good governance, and hence that would provide the right institutional framework for economic growth and development, is not an easy task. This is because there is no universally applicable mapping of institutions that would suit all contexts and situations. While one can take a cue from the types of institutions in the successful developed countries, there is no reason to suppose that those economies have already exhausted all the useful institutional variations that could underpin healthy and vibrant economies. Nevertheless, there are a number of cross-cutting principles that could be considered in determining an institutional configuration that is universally applicable.

The institutions covered in this paper that are considered to be the key constituents of an institutional structure that underpins good governance are property rights, regulatory institutions, public sector institutions, and legal institutions. These are depicted in Figure 2 below.

**<u>Figure 2</u>: The Institutional Framework of Good Governance**




In making this selection, three main characteristics of institutions were considered: (i) the extent to which these institutions have been applied in successful economies; (ii) the extent to which these institutions play a central role in enhancing the effectiveness of the other institutions; and (iii) the extent to which these institutions affect the entire incentive regime. While it is true that society operates within a complex set of institutions that are intertwined and interdependent, there are institutions that market systems or economic transactions just cannot do without. The four institutions listed above are such institutions.

Therefore, an optimal governance structure is one that is founded on the core institutions above – a strong property rights regime, well-regulated financial institutions, an effective and reliable legal system, and effective public sector institutions. An effective property rights regime is one that is capable of protecting and enforcing property rights, including the protection and enforcement of the exclusivity, saleability, and transferability of those rights. Regulatory institutions are considered to be effective if they are able to protect investors and consumers; ensure the integrity of markets; and promote stability within the financial system. Public services are considered effective if they are underpinned by rules that ensure the implementation of effective public policies, including rules governing the operation of the public service. Finally, legal institutions are considered effective if they are independent from the government and that their independence is guaranteed by law; they have the power and resources to enforce the laws of the nation; and are transparent and efficient. A country that operates within the framework of these core institutions is more capable of ensuring good governance, and to benefit from the positive economic outcomes that would result from it.

## V. GOVERNANCE ISSUES IN THE PACIFIC

In the context of the Pacific Island countries (PICs), the immediate question is how to approach the issues of governance and where the priorities should lie in promoting good governance. The institutions discussed in the preceding section exemplify an ideal template for a durable governance structure that countries should adopt.[4] They provide a good starting point from which to examine and assess the governance capability of the PICs.

Poor governance is generally a major issue in the PICs. The governance crises that unfolded in the Cook Islands, Vanuatu, Solomon Islands, Nauru, and Tuvalu serve to underscore the gravity of the problem and the need for greater commitment by the PICs to good governance.

### Regional Initiatives

The promotion of good governance in the PICs has been on the agenda of the Forum (PICs) Leaders' regional meetings since the 1990s. This led to the signing of a number of important declarations underscoring the PICs' commitment to good governance. These included the *Honiara Declaration* on regional security and law signed in 1992, the *Aitutaki Declaration* on public accountability in 1997, the *Biketawa Declaration* on democratic institutions and the rule of law in 2000, and the *Nasonini Declaration* in 2002. The lastmentioned Declaration reaffirmed the region's commitment to good governance at all levels as a key fundamental strategy for addressing some of the difficult and sensitive issues underlying the tensions and conflicts in the region. These declarations subsequently became the 'working tools' of the Forum Economic Ministers Meeting (FEMM).

At its first meeting in 1997, FEMM adopted the eight principles for best practice in accountability of public funds. These principles focused on the need for the

[4] While countries may already have these institutions in place, in most cases these institutions are either

establishment of processes and systems to inform the decision making process for the formulation of effective policies and to inform the public through timely presentation of reports. They also insisted on openness in financial contractual arrangements, effective action against contravention of financial regulations and the continued monitoring, scrutiny and reporting by statutory bodies and institutions of the state on financial dealings. Added to these eight principles was the IMF's *Code of Good Practices and Transparency*.

Thus, the initial espousal of good governance for the PICs was a response to poor financial and accounting practices. However, following the political and social upheavals in Fiji and the Solomon Islands in 2000, the menu was extended to encapsulate concerns for the need to uphold the democratic processes and institutions that foster political stability and social harmony. This move underlines the region's recognition of the inalienable right of all peoples and communities of the Pacific to live in peaceful co-existence and their right to recourse to law in the peaceful settlement of disputes and conflicts, and the importance of respecting and protecting indigenous rights, cultural values and traditions. The *Biketawa Declaration* codifies these intentions.

A more recent initiative by the PICs that underscores their commitment toward good governance was the establishment in 2002 of the Institute of Advanced Studies for Governance and Development at the University of the South Pacific. One of the core functions of this new institute is the provision of expert advice on governance issues to the governments of the PICs through its research and teaching programs.

On their part, the donors have made good governance a critical precondition of their aid to the PICs. The so-called "pooled governance", as promulgated by the

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impotent or dysfunctional.

Australian Prime Minister during the recent Pacific Forum Meeting of Leaders in Auckland in July 2003, encapsulates that intention.

**Why have the Reform Efforts Failed?**

While there has been a stated commitment to good governance in the PICs, the implementation of the principles of good governance has been very slow, as reported by FEMM in its region-wide stock-take of progress that it carried out in 2000-01. While a number of reasons may be attributed to this shortfall, the basic contention of this paper is that these reform efforts failed because they were carried out hastily and in a haphazard manner without serious efforts to address the institutional roots of the problem first. By implementing these principles of good governance without instituting the necessary governance infrastructure, the PICs have got the reform sequencing wrong, effectively 'putting the cart before the horse'. This has resulted in the stalemate of efforts and success. The governance infrastructure referred to here is one that encapsulates the core institutions discussed in Section IV above. Therefore, before any effort is made to improve governance in the PICs, the authorities must, first and foremost, ensure that the institutions governing the operation of property rights, financial institutions, public sector, and the judiciary are appropriate to the country's circumstances.

What follows is a brief discussion of these core institutions, examining their relevance and effectiveness in explaining the governance problems in the context of the PICs, and the extent to which changes in these institutions could provide solutions to the governance problems.

*Property Rights*

The importance of well-defined and secure property rights as the foundation of sound economic systems is well established. The three forms of rights ownership commonly referred to in the literature are communal ownership, private ownership, and state ownership. While it may be argued that there is no superior ownership structure, private ownership has proved to be the most versatile form of ownership from the perspective of economic growth. The literature is awash with studies providing empirical evidence that countries in which individual property rights are insecure have experienced difficulty in attracting investment and have constrained growth prospects (see, for example, Besley 1995; and Clague *et al* 1999).

Most, if not all, of the countries in PICs retain a communal system of land ownership. In Papua New Guinea, for instance, about 97 percent of the lands are communally owned. In Fiji and Samoa, approximately the same proportion applies. Thus, the problems associated with communal ownership – constrained resource development and free-rider problems, and lack of clear title and ownership - prevail in these communities.

There are two key factors that contribute to concerns regarding the insecurity of exclusive tenure and title over land in the PICs. The first is the lack of reliable records relating to land rights. While most lands in the Cook Islands, Fiji, Kiribati, Nauru, Tonga, and Tuvalu have been registered, in the larger countries (Papua New Guinea, Solomon Islands, and Vanuatu) very little has. The lack of registration means that title to land cannot be easily verified, making it both difficult and expensive for land transactions, such as land sales or transfers, to be carried out. But even in those countries where lands are registered, the records are unreliable. For example, in Kiribati and Tuvalu, registrations are out of date, with many lost, inaccurate, or even forged or otherwise illegally amended. In 1997 the Department of Lands in PNG sacked 30 senior staff for bribery, corruption, and misappropriation in connection with land registration matters.

The second factor accounting for insecure property rights in the Pacific is the poor commitment by the states to protection and enforcement of property rights. This poor commitment shows up either through the governments' failure to apply the force of the law to enforce land lease agreements or through arbitrary changes of the law by the governments.

A good example of where changes of laws have taken place is Vanuatu. Before independence, most of the high quality land in Vanuatu was held in marketable freehold by non-indigenous people. However, at independence, all freehold was cancelled and all land was made the property of the descendants of the indigenous owners. The same thing happened in PNG, Solomon Islands, Samoa, and Kiribati.

So the development of effective property rights in the Pacific has been constrained not so much by the widespread adoption of communal ownership but more by the lack of commitment by the states to protect and enforce property rights, and to put in place a workable system with an incentive structure that effectively caters for the interests of both the communal owners and the potential investors.

From the governance perspective, an insecure land property rights regime as prevails in the PICs is a serious impediment to good governance. It precludes the efficient allocation and mobilisation of resources to productive uses. Moreover, it can create serious agency and coordination problems with disastrous consequences for the nation. The recent crises in Fiji, Vanuatu, and Solomon Islands are manifestations of these agency/coordination problems arising from insecure property rights and the lack of appropriate intervention by the governments of these states to institute workable property rights regimes.

*Regulatory Institutions*

Regulatory institutions play a key role in instilling and overseeing the implementation of a sound financial system. They ensure the integrity of markets, promote stability within the financial systems, and protect the investors and consumers by promoting competition and preventing fraudulent and unfair practices in the marketplace. By defining and making transparent the rules of the game, they provide a level playing field for all players in the economy, in particular investors, thereby facilitating effective exchange and allocation of resources. Moreover, they foster good corporate governance by supplying relevant economic information to stakeholders on the one hand, and by restraining corporate enterprise managers and shareholders on the other hand.

Examples of the regulatory agencies include the central bank, investment and consumer commission, sectoral supervisors and regulators, deposit insurance agencies, and asset management companies. They also include regulatory statutes such as Anti-trust/Competition Acts, Financial Institution Acts, Fair Trading Practices Acts, Common Protection Acts, the Consumers Acts, Procurement Acts, as well as accounting standards.

Poor governance has been a problem in all the PICs and has increased the risks facing government-owned financial institutions and affected their performance. The collapse or near collapse of development banks and commercial banks in Fiji, PNG, Vanuatu, and Tonga in the late 1990s was the result of poor governance within the financial sectors of these economies. Most of the PICs have their own central banks, which have the authority and responsibility to supervise the banks. However, there is a need to enhance the capacity of central banks to conduct banking supervision effectively, through adequate enforcement of prudential regulations, the granting of more autonomy from governments, and the training of staff.

The development of money and bond markets has been hindered by the lack of autonomy and low profitability of central banks. Because of the undeveloped form of the financial sector in these countries, regulatory statutes such as competition laws, fair-trading practices laws, or commercial codes are non-existent in most.

Thus, the financial sector in the PICs is short of an adequate regulatory framework that would underpin its efficient and effective operation. From the governance perspective, the lack of effective regulatory institutions poses serious problems for the optimal allocation and mobilisation of resources and the promotion of good corporate governance, by suppressing information disclosure and good commercial practices. Therefore, unless appropriate regulatory institutions are put in place, any reform efforts to foster good governance within the financial sector in the PICs are doomed to fail. Accordingly, the call by FEMM for a more transparent financial system and banking practices will have limited success.

### *Public Sector Institutions*

The importance of strong public sector institutions is particularly applicable to the PICs, given the dominance of the government in the governance process in these countries. The most important of these institutions are the fiscal and monetary institutions, and the institutions governing the operation of the public sector. The latter includes oversight institutions and rules/regulations pertaining to staff recruitment, promotion, performance standards, and training and career advancement.

The public services in the South Pacific are generally of low quality (Knapman and Saldanha, 1999). It has been shown that an effective incentive structure rarely exists within the public service. The remuneration structure is inadequate, rules for appointment and promotion are not based on merit, performance standards are not set, and policy credibility is low. Because of these factors, productivity in the public service has been low.

One important indicator of the quality of an institutional environment is the prevalence of corruption. While corruption is not an endemic phenomenon in most of the PICs, especially for the smaller island states, it is a particularly serious problem for the bigger island nations such as Papua New Guinea (PNG) and Fiji. The downfall of the National Bank of Fiji in the early 1990s which cost the Fiji taxpayers over F$200 million, or the corrupt tender deal involving the redevelopment of the Jackson International Airport in PNG in 1994, are two of the very serious instances of corruption in the region. The abuse of slush funds by politicians in the form of funding bogus community organisations or non-existent (ghost) infrastructure is another example of systemic corruption in PNG. Another notorious breeding ground for corruption is in the system of recruiting and promoting within the public service, which, in most cases, is based more on political patronage and ideological affiliation rather than on merit – creating a non-meritocratic public service. The latter leads to a bureaucracy that is incompetent, dishonest, and ineffective.

From the governance perspective, a weak public service and the institutions that govern its operations constitute the greatest threat to good governance in the PICs. This is because of the preponderance of the government in the governance arena, and hence of the limited role of the other ‘agents of governance’ in these economies. As such, weak governance within the public service has serious repercussions on the wider systems of governance in the PICs. Therefore, unless the public service and the institutions that govern its operation, such as oversight agencies, are strengthened, efforts to improve the quality of governance in the PICs will yield limited success.

*Legal Institutions*

Legal institutions refer to the array of arrangements and systems relating to the administration and application of law and justice in society. These institutions are of great importance to the ordered functioning of society in so far as they provide the incentives that provoke or prohibit certain actions. Included in this category of institutions are constitutions, legislative processes, electoral systems, and the judicial system. The most important of these is an effective judiciary, as it underpins the credibility of other institutions of the state and of the state itself. All countries rely on the judiciary to hold the executive accountable under the law and to interpret and enforce the terms of the constitution. However, for the judiciary to be really effective, it must be independent, have the power and resources to enforce its rulings, and be efficient.

While in most of the PICs the judiciary enjoys a fair degree of respect for its independence and integrity, in some countries the independence of the court system is far from being unquestioned. This is particularly so when the legislature can overturn the court’s decisions, or when the government has the exclusive right to appoint judges and court officials. Overturning of the court’s rulings occurred in Fiji, Papua New Guinea, Solomon Islands and Vanuatu in the 1990s with respect to court decisions on land rights.

In Kiribati, because of inadequate resources to support the work of the judiciary, some 700 cases have been pending since 1994, leading to a public outcry. The problem is unlikely to get better as, for the fiscal year 2001, the budgetary allocation that the government made to the judiciary was only 0.8 percent of the national budget.

Poor judicial enforcement of contracts has been a major problem in the Marshall Islands and the Federated States of Micronesia (FSM). In both countries the mechanism for dispute settlement has not been working effectively. As reported by ADB (1998), the judiciaries are often reluctant to hear disputes, and if they do hear disputes, they are reluctant to make findings; and if a finding is made, they are reluctant to enforce it.

Instances such as outlined above could do a lot of damage to the effectiveness and integrity of the court system with consequent negative effects on investors' perceptions about the security and enforceability of property and contractual rights.

Thus, there is still a long way for the PICs to go before they achieve a fully credible and effective judiciary system. From the governance perspective, a weak judicial system undermines the entire institutions of governance, thereby inhibiting efforts to foster good governance. The calls, therefore, by FEMM for transparency and accountability will come to nothing if there are no credible means by which the actions of public actors can be checked and brought to account. Only a truly effective judiciary can do this.

## VI. THE WAY FORWARD

As already stated, the quality of governance is only as good as the quality of the institutions that underpin it. Accordingly, efforts by the PICs to promote good governance should begin by addressing the institutional roots of the problem. This calls for the PICs to undertake the necessary institutional reforms and/or innovations that would underpin good governance. However, this raises two critical questions: how may these institutions be acquired, and whether there is an optimal sequence in which institutional reforms ought to be carried out?[5]

### Means of Acquiring Institutions

There are two means by which institutions may be acquired. The first is to copy the types of institutions in operation in the more successful economies. The second possibility is to design institutions from scratch, making them highly specific to local conditions. Specificity implies that the institutional repertoire available in the advanced countries may be inappropriate to the needs of the society in question. Thus, according to this approach, major institutional development by and large requires a process of investigation about local needs and capability.

Neither of these two modes of acquiring institutions is efficacious *per se*, however. Even under the best possible circumstances, an imported blueprint requires domestic expertise and re-adaptation for successful implementation. On the other hand, even when local conditions differ greatly, it would be unwise to deny the possible relevance of institutional examples from elsewhere. There are always benefits in learning from the institutional arrangements prevailing elsewhere, even if they are inappropriate or

[5] Both these issues deserve more coverage and deeper analysis than what is provided in this paper.

cannot be transplanted. Building institutions from scratch is obviously very costly when imported blueprints can serve the purpose. Unwarranted experimenting can backfire if it overlooks opportunities for institutional arbitrage. Thus, the best method of acquiring institutions would be the one that adopts a judicious combination of the two approaches, having regard to their contextual relevance.

It is worth emphasising that institutional change depends crucially on the government's willingness to make such changes. This is what makes it very difficult to bring about institutional change. Leaders are in a strategic position to affect the supply of institutional arrangements and ensure that reforms and innovations are congruent with their interests. Therefore, if people in government benefit from the *status quo*, they will not be willing to make institutional change - unless they can see that they will be better off. A classical example is Thailand where the creation of precise and secure property rights in land was successful because it was in the interests of the elite decision-makers, who were also landowners and land speculators (Feeney, 1993).

### Prioritising Institutional Reforms

The next challenging task is to determine the optimal order in which reforms should be implemented. For example, should reforms of property rights precede reforms of the legal system, or vice-versa? Or should reforms of all institutions be carried out simultaneously? For policymakers, getting the right timing and sequencing of reforms is critical as misinformed decisions can severely impair the effectiveness of the whole reform program.

While there are no generally accepted blueprints that one could use to inform one's decision about getting the right order, it is important to recognise that such things as historical trajectories, stage of development, maturity of existing institutions, and other initial conditions play a crucial role in this decision. Thus, the sequencing of institutional reforms in the developing economies and transition economies is different from that for the developed countries. Even among the PICs, the sequencing pattern may not be the same if these countries differ markedly with respect to their initial conditions.

As argued by Toatu (2003), the optimal approach for the PICs is to start the reform process from the "center" and then move to the periphery. That is, institutional reforms should begin by addressing, first and foremost, the institutional deficiencies within the central decision-making organ, namely, the public service. This makes sense since decisions and policies that the bureaucracy makes have a strong influence on the integrity and effectiveness of the other institutions. For instance, with a corrupt bureaucracy the policies and commitments towards the protection of property rights will be severely undermined. Likewise, with an incompetent and dishonest bureaucracy, the independence and effectiveness of the judiciary will be hampered, possibly because of improper recruitment procedures or due to the inadequacy and unpredictability of resources to support its effective functioning. Thus, an ineffective bureaucracy could undermine the integrity and effectiveness of the entire incentive regime. It is important, therefore, that the rules governing the operation of the public service are reformed first before embarking on the other reforms.

Once reform of the bureaucratic institutions is complete, reforms of the legal system, the property rights regime, and the regulatory institutions can proceed – in this order. The logic of this sequence is obvious. That is, it is imperative that a strong judiciary is in place first, as without it the effectiveness and integrity of both the property rights and regulatory institutions will be inhibited. (But without an effective bureaucracy, ie, strong institutions within the bureaucracy, the effectiveness of the judiciary will be severely undermined, as already explained). It should be emphasised that this suggested reform sequence is not a template that is universally applicable, but it is certainly one that might work best for the PICs.

## VII. CONCLUDING REMARKS

Getting the right governance structure to underpin economic growth and development in the Pacific Island countries is a formidable task. This is because there is no one-size-fits-all institutional framework that would suit all contexts and situations. Each country is different and requires a unique institutional configuration. However, there are cross-cutting principles that may inform decisions on the formulation of an institutional blueprint that is universally applicable. The institutional template discussed in this paper has universal applicability, and may provide a solid basis for efforts aimed at creating an institutional environment that is conducive to the promotion of good governance and, by implication, economic growth and development in the PICs.

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