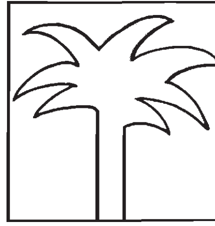

Getting the institutional environment right for investment and growth in the Pacific

Teuea Toatu

Operating on the premise that effective institutions are crucial for optimal economic performance, the study explores the following questions: which institutions are necessary for high-quality growth and development, and what form should they take? How are these institutions acquired? What is the optimal sequence for implementing institutional reforms? The resolution of these issues is important for a better understanding of the role of institutions in the growth process in the Pacific island countries, and for the formulation of strategies for implementing growth-oriented institutional reforms and/or innovations.

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The premise that institutions matter for economic growth is not a mere theoretical construct; it is a well-substantiated empirical proposition. Rodrik, Subramanian and Trebbi (2002), among others, have firmly established the primacy of institutions over all other growth determinants. According to these economists, institutions 'trump' everything in the growth process—including geography, trade, and policy. This finding reinforced the results of an earlier study by Easterly and Levine (2002). An earlier study was carried out by the author (Toatu 2001) using data for several Pacific island countries, the results of which are buttressed by the above mentioned studies.[1]

The increasing focus on the importance of institutions does not mean that other, long recognised, determinants of economic growth—physical capital, human capital, technology and sound policies—are not important in the growth process. The point is that without effective institutions, the potential contributions of these resources

will be severely inhibited. For instance, what is the point of adopting policies that attempt to promote private sector development when property rights are ill-defined and contracts cannot be enforced? What is the point of investing in education when job opportunities in the public sector are limited, and the private sector, the only other source of employment, is constrained by institutional deficiencies? What is the point of having good laws when they cannot be enforced or applied consistently and independently due to the lack of an appropriate incentive structure within the bureaucracy, resulting in corruption?

So, what exactly are institutions and why are they so important for economic growth?

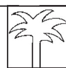
Institutions

The term 'institutions' is an abstract and multi-dimensional concept. North defines institutions as 'any form of constraint that human beings devise to shape action' (1990:4). They might involve formal constraints such as rules or national laws, or informal constraints such as conventions, customs and codes of behaviour. Thus, institutions embody the basic rules that govern all public and private actions—from individual property rights to the ways in which communities deal with public goods.

The generality of this definition poses problems for empirical analysis. The definition may be narrowed to include only specific legal bodies or procedural mechanisms, such as regulatory agencies and standard-setting bodies. Alternatively, a broad definition may be adopted which covers every 'rule' of society—from customs and taboos to constitutional rules and commitment devices such as a balanced budget amendment, currency boards, and official decrees. The notion of institutions commonly used by the economics profession pertains largely to property rights, the rule of law, regulatory institutions, legal institutions and effective government—the 'economic institutions'.[2] These are the institutions that are intertwined and closely identified with economic activity. The present analysis focuses on these institutions (without prejudice to the equally important role that other institutions play in the wider economic process).

Definitional issues aside, an important question is how do institutions affect economic outcomes? A good starting point is to consider the economic functions that institutions play. According to the World Bank (2001), institutions perform three important economic functions.

- Institutions channel information about market conditions, goods and participants. Good information flows help entrepreneurs identify high return activities and potential business partners, and assess their creditworthiness. They also help governments regulate well. Institutions falling within this category include accounting firms, credit registries, and government regulations on the freedom of the media.
- Institutions define and enforce property rights and contracts, determining who gets what and when. Awareness and protection of rights to assets and income are critical for market development, including the rights of the private sector in relation to the state. Also important is the availability of the means for effective settlement of disputes and enforcement of property and contractual rights. Examples of such institutions include constitutions, judicial systems, and the full array of social networks.
- Institutions can increase competition in markets. Competition gives people incentives to do better, spurring innovation and economic growth. Examples of such



institutions include regulations governing financial institutions, competition laws and commercial codes.

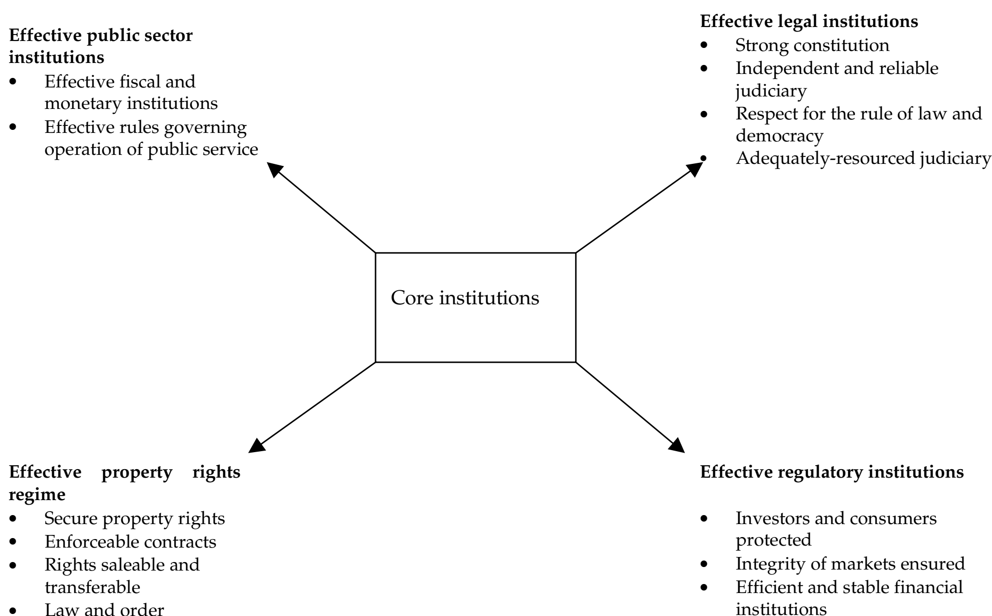
Through these three functions, institutions affect the distribution of assets, incomes, and costs, as well as the incentives for economic agents and the efficiency of market transactions. By allowing property rights to be distributed to the most efficient agents, institutions can enhance productivity 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 high prices. 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 critical for high-quality growth and development?

The 'core' institutions

Identifying those institutions critical to growth and development is not straight-forward. There is no universally applicable mapping of institutions that would suit all contexts and situations. While one could take a cue from the types of institutions prevailing

Figure 1 **An ideal institutional framework for economic growth and development**



Source: Toatu, T., 2003. *From institutions to governance—getting the governance structure right for optimal economic performance*, Working Paper, Asia Pacific School of Economics and Government, The Australian National University, Canberra.

in industrialised economies, 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 here are property rights institutions, regulatory institutions, public sector institutions and legal institutions (Figure 1). These are the 'core institutions' or the 'superstructures' of the country's institutional environment.

In developing this representation of core institutions, three main characteristics of institutions are considered

- the extent to which these institutions have been applied in the successful economies
- the extent to which these institutions play a central role in enhancing the effectiveness of the other institutions
- 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 those institutions without which market systems or economic transactions cannot function. The four institutions noted in Figure 1 are such institutions. This grouping is not far from that of which President of the World Bank, James D. Wolfensohn perceived as the most critical institutions, when he said

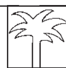
> Without the protection of human and property rights and a comprehensive framework of laws, no equitable development is possible. A government must ensure that it has effective systems of property, contract, labour, bankruptcy, commercial codes, personal rights laws, and other elements of a comprehensive legal system that is effectively, impartially, and cleanly administered by well-functioning, impartial, and honest judicial and legal systems (World Bank 2001:117).

A strong institutional environment requires 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 effective if they are able to protect investors and consumers, ensure the integrity of markets, and promote stability within the financial system. Public service organisations 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 independence is guaranteed by law, has the power and resources to enforce the laws of the nation, and is transparent and efficient. The corollary, therefore, is that a country that operates within the framework of these core institutions is more likely to attract investment and to benefit from the wider economic effects that it would generate.

The discussion, draws on experiences from the Pacific island nations and the problems faced by these economies as a result of the lack of, or weaknesses in these institutions.

Property rights

The importance of well-defined 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 one



superior ownership structure, private ownership has proved to be the most versatile form of ownership from the perspective of economic growth. This is because private ownership embodies the efficiency-enhancing characteristics of completeness, exclusivity, transferability, and enforceability (Banks 2003). Many studies have provided 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, Clague et al. 1999).

With almost all of the countries in the Pacific adopting a communal system of ownership the security of property rights is a major issue in Pacific island countries. In Papua New Guinea, for instance, about 97 per cent of land is communally owned (Crocombe 1997). The same proportion applies for Samoa and Fiji. It is important to note, however, that effective individual property rights to land can exist within a communal ownership regime through the establishment of a leasehold system.

The widespread adoption of a communal form of tenure in the Pacific island countries without an appropriate mechanism in place to facilitate the development of alternative ownership systems has serious repercussions for the establishment of an effective property rights regime. On the one hand, such an ownership system inhibits the full realisation of individual ownership by constraining the extent to which property rights can be sold, transferred or enforced. For instance, in some of the Pacific island countries, notably Cook Islands, Federated States of Micronesia and Tonga, no proprietary rights can be bought or sold (with the exception of government transactions for public purposes). Even in countries where the purchase and sale of land is permitted—Kiribati, Fiji, Papua New Guinea and Samoa—such transactions are only permitted between nationals (Crocombe 1997). However, this is not as straightforward as it appears as other members of the clan or extended family can veto, and thereby nullify, any transaction.

On the other hand, communal ownership renders difficult the delineation of property title. The fact that under this system of ownership everyone has equal rights to the property means that the assignment of title to an individual or sub-component of a clan is virtually impossible. The multiplicity of claims on property means that there will be continuous competition for titles. This is one of the main reasons why most of the customary lands in the Pacific island countries are not formally registered, since registration essentially involves exclusion. It is also one of the reasons why investment has been low. The lack of clear title means that land cannot be used as a collateral for investment loans. There have been, however, some disastrous experiments in using communal land as security by some of the countries in the region. For example, there was a reported case in the Solomon Islands where the development bank used land titles as security for rural loans but, when the borrowers defaulted, the bank could not sell or use the title to recoup the loans (Asian Development Bank 1998).

A major impediment to property rights security in the Pacific island countries is the lack of clear title and exclusive tenure, which arises mainly because of the widespread adoption of communal ownership in these countries. There is, however, another dimension to this problem which is equally important, namely, the lack of explicit commitment by governments to protect and/ or enforce property rights. Before we look at this second problem, let us examine the first problem in greater detail.

While most lands in the Cook Islands, Fiji, Kiribati, Nauru, Tonga and Tuvalu have been registered, the larger countries (Papua New Guinea, Solomon Islands and Vanuatu)

have seen very little registration (Crocombe 1997). The lack of registration means that title to land cannot be easily verified, making land transactions both difficult and expensive. 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, even forged or otherwise illegally amended. In 1997, the Papua New Guinea Department of Lands sacked 30 senior staff for bribery, corruption and misappropriation in connection with land registration matters (Asian Development Bank 1998).

A good indicator of the poor commitment by the states to protect and enforce property rights is the manner in which laws have been changed arbitrarily or where court decisions have been overruled by governments, as in the case of 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 (Crocombe 1997). The same thing has happened in Papua New Guinea, Solomon Islands, Samoa and Kiribati.

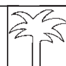
So the development of effective property rights in the Pacific has been constrained not only by the widespread adoption of communal ownership but also by the lack of commitment by the states to protect and enforce property rights, and to put in place a workable system with an incentive structure that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

Regulatory institutions

The axiom that a financial system is only as strong as its governing practices, the financial soundness of its institutions, and the efficiency of its financial structure has been vindicated by the financial crises of the past decade occurring in East Asia, Ecuador, Mexico, Russia, Turkey and Venezuela (Das and Quintyn 2002). Regulatory institutions play a key role in instilling and overseeing the implementation of a sound financial system. By making the rules of the game transparent, a level playing field is available to all, particularly for investors, thereby facilitating effective exchange and allocation of resources. Moreover, good corporate governance is fostered 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 these institutions include regulatory agencies such as central banks, investment and consumer commissions, sectoral supervisors and regulators, deposit insurers agencies, and asset management companies. They also include regulatory statutes such as Anti-trust or Anti-competition Acts, Financial Institution Acts, Fair Trading Practices Acts, Common Protection Acts, Consumers Acts, Procurement Acts and accounting standards.

Poor governance in the financial sector has been a general issue in all the Pacific island countries and has increased the risk for, and affected the performance of, government-owned financial institutions. The near collapse of commercial banks in Fiji, Papua New Guinea, Vanuatu and Tonga in the late 1990s was the result of poor governance within the financial sectors of these economies (Chand 2001). The non-existence of most of the 'core' regulatory institutions may be ascribed as one of the key contributing factors for these failures. While most of the Pacific island countries have their own central banks, which have the authority and responsibility to supervise commercial banks, 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 staff training.



The financial sector in the Pacific island countries lacks 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. Unless appropriate regulatory institutions are put in place, any reform efforts to foster good governance within the financial sector in the Pacific island countries are doomed to fail.

Public sector institutions

Public sector institutions include those government institutions that underpin the effective management of the country's social and economic resources, the most important of which are the fiscal and monetary institutions (Toatu 2003). These include a central bank and/or a currency board, economic council, budget committee, and the relevant national laws such as the Public Finance Act.

The rules governing the public service or civil service are another important component of this class of institutions. In the Pacific island countries, the government plays a commanding role over the economy, and thus the performance of the economy is largely dictated by what the government does. In this respect the effectiveness of the government, as measured by the effectiveness of the public service and the quality of the people it employs, is of crucial importance to the performance of the economy.

It is important, therefore, that the rules/institutions governing the operation of the public service are strengthened. These rules include regulations relating to staff recruitment, promotion and dismissal, remuneration, productivity guidelines and performance standards, codes of behaviour, social insurance, and training and career advancement. In essence, these rules constitute the institutional environment of public officials, and hence the incentive structure that drives their performance. It thus follows that if these institutions/rules are inadequate or improperly applied, the quality of the public service is compromised, as would be the quality of government policies and their implementation. If these policies and programs are of poor quality, the effective management of the nation's economic resources would be severely inhibited.

Public service organisations in the South Pacific are generally of low quality (Knapman and Saldanha 1999). According to this report, effective incentive structures rarely exist within the public services of these economies. 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. Productivity in the public service has been generally low.

One important indicator of the poor quality of an institutional environment is the prevalence of corruption. While corruption is not endemic in most of the Pacific island countries, especially in the smaller island states, it is a particularly serious problem for the bigger island nations such as Papua New Guinea 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 Papua New Guinea in 1994, are some of the serious instances of corruption in the region (Kavanamur 1999). The abuse of slush funds by politicians in the form of funding bogus community organisations or non-existent infrastructure is another example of systemic corruption in Papua New Guinea (Chand 2001). 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

than on merit, creating a non-meritocratic public service. The latter leads to a bureaucracy that is incompetent, dishonest and ineffective.

Legal institutions

Legal institutions refer to the array of arrangements and systems relating to the administration and application of law and justice in society (Rodrik 2000). These institutions are of great importance to the ordered functioning of society insofar as they provide the incentives that provoke or prohibit certain actions. Included under this class of institutions are the constitution, legislative processes, the electoral system and the judicial system.

An effective judiciary is often the most important element of the legal system, 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, with the power and resources to enforce its rulings, and efficient. Independence from the executive arm of government is the most important of these conditions. Without this independence, the court system will be a sham, and there will be no effective recourse for restitution of legal matters, such as disputes or breaches of contracts.

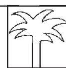
The effectiveness of the judiciary also depends on its decisions being enforced. In practice, this means that other branches of the government must consent to provide the resources needed for enforcement. The crucial components of these resources are a competent police force and an adequate prison system.

Another important component of judicial effectiveness is organisational efficiency, essential to avoiding long delays in clearing cases. This requires that the judiciary be adequately endowed with resources. Also, it may require the adoption of rules and laws that are simpler to interpret and apply. The adoption of simpler rules and laws has two main advantages. First, it places fewer demands on judges, and it is both cheaper and more likely to be accurate. Second, it facilitates monitoring of judges and so reduces the likelihood of bribery and the influence of politics in the judiciary process.

While in most of the Pacific island countries the judiciary enjoys a fair degree of respect for its independence and integrity, for some countries the independence of the court systems is far from being unquestioned. This is particularly so when the legislature can overturn the court's decisions and rulings, or when the government has exclusive rights to appoint judges and court officials. Court's rulings have been overturned in Fiji, Papua New Guinea, Solomon Islands and Vanuatu in the 1990s with respect to decisions on land rights (Asian Development Bank 1998). 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 (Macdonald 1996). The problem is unlikely to get better as, for the fiscal year 2003, Kiribati's budgetary allocation to the judiciary is only 0.8 per cent of the national budget (Kiribati 2002).

In the Marshall Islands and the Federated States of Micronesia, poor enforcement of contracts has been a major problem. In both countries the mechanism for dispute settlement has not been working effectively. As reported by the Asian Development Bank (1998), 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.

There is still a long way to go before Pacific island countries achieve a fully credible and effective judiciary system. A weak judicial system undermines all



institutions of the state, thereby inhibiting efforts to promote economic growth and development by constraining productive economic activities.

The way forward

The quality of institutions matters a great deal for investment and growth. Accordingly, Pacific island countries need to undertake the necessary institutional reforms and/or innovations that would underpin economic growth. However, this begs the question of how institutional improvements can be made, and whether there is an optimal sequence in which institutional reforms ought to be carried out?[3]

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 successful economies may be inappropriate to the needs of the society in question. Thus, according to this approach, major institutional development requires a process of investigation about local needs and capability.

Neither of these two modes of acquiring institutions is optimally effective. 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. Building institutions from the ground up is obviously very costly when imported blueprints can serve the purpose. The best method of acquiring institutions could be to adopt a judicious combination of the two approaches, having regard to 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 élite decision makers, who were also landowners and land speculators (Feeny 1993).

Prioritising institutional reforms

The next challenge 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 could inform one's decision about getting the right order, it is important to recognise that such factors as the country's historical trajectory, stage of development, the maturity of its existing institutions, and other initial conditions play a crucial role in this decision. The sequencing of institutional reforms in the developing economies and transition economies is different from that for the developed economies. Even among the Pacific island countries, the sequencing

may not be the same if these countries differ markedly with respect to their initial conditions.

The optimal approach for the Pacific island countries is to start the reform process from the 'centre' and then move to the periphery (Toatu 2003). 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 the decisions and policies made by bureaucracy 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 before embarking on other reforms.

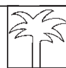
Once reform of the bureaucratic institutions is complete, reforms of the legal system, the property rights regime, and the regulatory institutions can proceed—in this order. It is imperative that a strong judiciary is in place first, as without it the effectiveness and integrity of both the property rights and regulatory institutions will be inhibited. But without an effective bureaucracy, that is, strong institutions within the bureaucracy, the effectiveness of the judiciary will be severely undermined. 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 Pacific island countries.

Concluding remarks

While several studies (including Rodrik et al. 2002 and Easterly and Levine 2002) have provided compelling evidence for the primacy of institutions over other factors in the growth process, they provide little useful information to inform decisions on the development of an appropriate policy framework for institutional reforms that should be implemented to promote growth. We know that institutions matter for economic growth, but this does not necessarily mean that we also know which institutions are crucial for high-quality growth and development. Neither does it mean that we know the form that these institutions should take and the optimal sequence in which they should be implemented. This paper has sought to fill these gaps in respect of the Pacific island countries. It is argued that establishment of effective arrangements for the core institutions—the bureaucracy, the judicial system, the property rights system, and the regulatory system, in that order—is most important for placing these countries on a path to higher economic growth.

Notes

1. For instance, one of the author's regression results shows that an increase of one standard deviation in the level of security over property and contractual rights has the potential to increase income growth rates of the Pacific island countries by approximately 3 percentage points annually.
2. It may be argued that institutions such as property rights and contracts are of legal origin. These institutions are regarded as economic institutions because of the essential role they play in the operation of a market economy system.
3. Both these issues deserve more comprehensive treatment than is possible in this paper.



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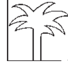

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