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Vanuatu: Country Partnership Strategy (2010-2014)

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Sustaining Growth

A Private Sector Assessment for Vanuatu

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Abbreviations

ADB	–	Asian Development Bank
ADR	–	alternative dispute resolution
AusAID	–	Australian Agency for International Development
AVL	–	Airports Vanuatu Limited
CRP	–	Comprehensive Reform Program
DMC	–	developing member country
FSM	–	Federated States of Micronesia
GBE	–	government business enterprise
GDP	–	gross domestic product
MAQFF	–	Ministry of Agriculture, Quarantine, Forestry, and Fisheries
MFEM	–	Ministry of Finance and Economic Management
MIA	–	Ministry of Internal Affairs
MIPU	–	Ministry of Infrastructure and Public Utilities
MTNVB		Ministry of Trade and Ni-Vanuatu Business
NISCO	–	Northern Islands Stevedoring Co.
NBV	–	National Bank of Vanuatu
NZAID	–	New Zealand Agency for International Development
PacLii	–	Pacific Islands Legal Information Institute
PMO		Prime Minister's Office
PNG	–	Papua New Guinea
PPP	–	public-private partnership
PPSA	–	Personal Property Securities Act
PPSR	–	personal property securities registry
PWD	–	Public Works Department
RMI	–	Republic of the Marshall Islands
SOE	–	state-owned enterprise
ST	–	Solomon Telekom Company Limited
TCC	–	Tonga Communications Corporation
TEU	–	twenty-foot equivalent unit
UK	–	United Kingdom
UNELCO	–	Union Electrique du Vanuatu Limited
VANWODS	–	Vanuatu Women Development Scheme
VCMB	–	Vanuatu Commodities Marketing Board
VCPL	–	Vanuatu Coconut Products Limited
VFSC	–	Vanuatu Financial Services Commission
VIPA	–	Vanuatu Investment Promotion Authority

NOTE: In this report, "$" refers to US dollars unless otherwise stated.

Foreword

Assisting our Pacific developing member countries (DMCs) to promote environments that encourage private sector development is a core focus for the Pacific Department of the Asian Development Bank (ADB). Significant effort and resources are being devoted to helping our Pacific DMCs identify constraints to private sector-led growth, prioritizing policy actions, and implementing reform. The process commences with analytical work on constraints to private sector growth, comprehensive discussions of the findings with various stakeholders, including from the government and the private sector, and publicizing the results. The findings and recommendations inform ADB's country assistance strategies, and are ultimately translated into reform activities. In many Pacific economies, reforms are now underway in the areas of improving the efficiency of state-owned enterprises and improving the delivery of public services through public–private partnerships, modernizing commercial legal frameworks, and improving access to finance.

Sustaining Growth: A Private Sector Assessment for Vanuatu is the eleventh in a series of private sector assessments undertaken by the Pacific Department for its member countries over the past 6 years. This report updates the analysis of the earlier private sector assessment for Vanuatu published by ADB in 2004 and tracks the evolution through time of the business environment in the country. I note with great pleasure that the findings of this report show that Vanuatu is one of the countries that is making substantial progress in reforming many of the key areas affecting the private sector. This report concludes that Vanuatu has made great strides in the deregulation of air access, the opening up of telecommunications to competition, and in embarking on commercial legal reform. Vanuatu's growth performance over the past 5 years has been stellar, although a number of challenges remain—both structural and of an external nature. Yet, the government appears to be dedicated to carrying out further reform initiatives, particularly in the areas of rural and microfinance and business law reform, which ADB is strongly committed to supporting.

I wish to convey my thanks to the Government of Vanuatu and to the numerous members of the private sector who shared their valuable time providing background information to the authors and discussing the findings in the process of producing this report. The Vanuatu Chamber of Commerce was especially proactive in organizing meetings and providing insights to the problems facing the private sector in Vanuatu. An earlier version of this report was presented to the National Business Summit in June 2008, and I thank the participants for their valuable feedback. I also wish to thank Winfried Wicklein and Jeremy Cleaver for managing this project; the authors Paul Holden, Laure Darcy, and Terry Reid, editor Deborah Dangay, and managing editor Melissa Dayrit, for their efforts in preparing this report; and the Australian Agency for International Development, which provided cofinancing under the Pacific Private Sector Development Initiative. I trust that the findings of this report will provoke constructive discussion and provide useful material for the government in the design of further policy reform initiatives.

S. Hafeez Rahman
Director General
Pacific Department

Summary and Recommendations

A. Recent Developments in the Economy

Vanuatu's economy has expanded rapidly over the past few years. Growth has come primarily from the construction, tourism, and agriculture sectors, but has its roots in improved economic policy and a gradual improvement in the quality of institutions.

Vanuatu has had one of the fastest growing economies among the Pacific island countries in the recent past. Although growth performance was disappointing in the years following independence, recovery began in 2003, and the economy has expanded steadily since then. Real annual gross domestic product (GDP) growth has averaged about 6% over the past 5 years. It rose by 7% in 2006, 6.8% in 2007, and is forecast to have increased by approximately 6% in 2008. In 2007, per capita gross national income, adjusted for purchasing power parity, was $3,410. Over the past few years, the purchasing power parity-adjusted annual growth rate has exceeded 2%, after having declined at an average annual rate of 1.1% during the 1990s. Although it is unlikely that Vanuatu will escape some fallout from the global economic crisis, at the end of the first quarter of 2009, little effect had been registered. The latest International Monetary Fund projections see real growth of 3.5% for 2009.

Figure 1: Vanuatu Growth Performance (%)

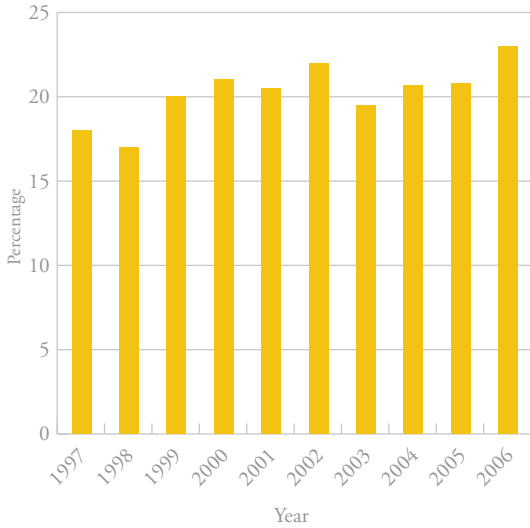
GDP = gross domestic product.
Source: Asian Development Bank.

1. Growth in Key Sectors: Construction, Tourism, and Agriculture

Vanuatu has experienced a substantial expansion in the real estate market, fueled at least in part by spillovers from property booms in Australia and—to a lesser extent—New Zealand. Vanuatu has been better placed than other Pacific island countries to take advantage of this extension of demand because it has a well-developed network of estate agents, property developers, and mortgage financing. In addition, investing in vacation property and retirement homes in Vanuatu has become more convenient and feasible, thanks to improved air connections from Australia and New Zealand.

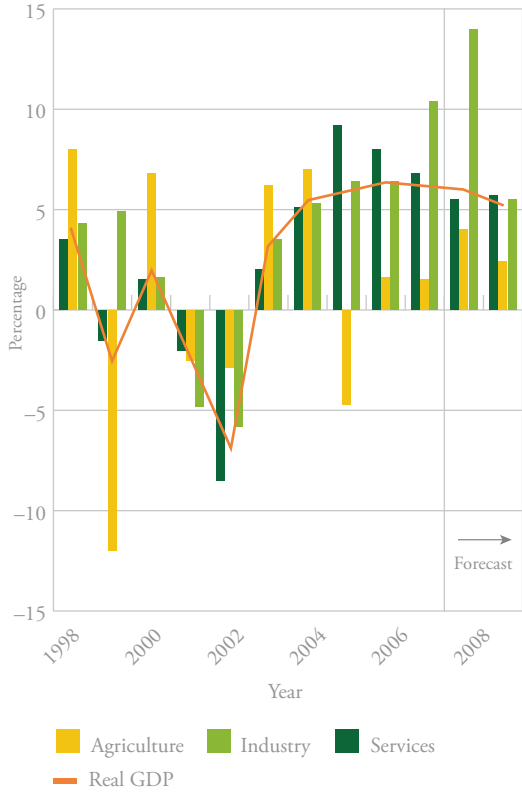
Gross domestic capital formation in the past few years has averaged over 20% of GDP—the highest in Pacific island countries. Although a sectoral breakdown of investment is not available, it is likely that much of this investment has gone into construction and other real estate related activities. Investment in property has led to substantial increases in land prices and a boom in construction, adding significantly to Vanuatu's growth rate. A potential downside is that if prices retreat in Australia and New Zealand, Vanuatu

Figure 2: Gross Fixed Capital Formation (% of GDP)



GDP = gross domestic product.
Source: Asian Development Bank.

Figure 3: Real Gross Domestic Product and Sector Growth (Annual Percentage Change)



GDP = gross domestic product.
Source: Reserve Bank of Vanuatu Quarterly Report.

could be adversely affected by recent property market developments around the world.

Vanuatu's tourism industry has also experienced rapid growth. Visitor arrivals have increased steadily, and the country appears to have been successful in attracting relatively high-spending tourists. The airline industry was recently opened to competition, bringing downward pressure on airfares and substantially increasing capacity. The number of tourists arriving by air rose by nearly 14% in 2007, and by over 16% in 2008. Remarkably, despite the global economic slowdown, tourist arrivals by air in January 2009 were 28% higher than in January 2008. Over the past few years, there has been a very large growth in the number of cruise ships visiting Vanuatu: the number of arrivals has tripled over the past 5 years. Anecdotal evidence suggests that these rose by nearly 40% in 2008 after increasing by 60% in 2007. A growing number of tour ship visitors later return as tourists, which bodes well for future tourism growth.

Agriculture is another important component of the economy, constituting about 20% of GDP. Some 60% of the population is engaged in a mix of subsistence and cash-based agriculture. An important part of future economic development will involve bringing a much larger proportion of the population that is primarily in subsistence activities into cash-oriented agricultural development.

Some agricultural subsectors are performing well, although there is considerable variation in the growth of different types of outputs. The cattle industry, in particular, has been expanding rapidly, largely because of a growing smallholder system of raising cattle. Furthermore, substantial investments are being made to improve the quality of breeding stock. Vanuatu beef is exported to countries throughout the region, including Australia and New Zealand. Kava exports are also growing rapidly. In other subsectors, however, agriculture is stagnating, often as a result of government interference.

2. Improved Economic Policy and Institutions

The recent strength of Vanuatu's economy has its roots in improved economic policy and in a gradual improvement in the quality of institutions. In particular:

- There has been much more **political stability** and continuity than there was in the 1990s and the early years of the 21st century.
- **Macroeconomic management** has been sound. Inflation has been controlled, as monetary aggregates—while rising—have been contained despite booming growth.
- The **fiscal accounts** have improved markedly, with budget surpluses recorded in some years. In addition, the debt-to-GDP ratio has declined by one third.
- Improved **policies toward the private sector** have signaled that the government intends to make Vanuatu a country in which investors can have confidence. Key improvements include:

  - *Competition in the airline industry.* Vanuatu recently opened its air transport market to international airlines, creating competition that has resulted in significantly lower airfares and higher tourism arrivals. Recent figures illustrate the extent of this increase: international tourist arrivals were nearly 30% higher in January 2009 than in January 2008. These results reinforce the wisdom of opening the country to additional foreign airlines, and demonstrate the benefits of greater competition. In another positive step—and as a result of the pressures placed on the airline by greater competition—the government is considering options for restructuring Air Vanuatu.

  - *Competition in the telecommunications sector.* The government issued a license to a foreign mobile telecommunications operator to provide services in competition with Telecom Vanuatu, the state-owned telecommunications company. This has led to a significant increase in coverage and a decrease in prices.

  - *Strengthened regulation of existing monopolies.* A Utility Regulatory Authority Act was passed recently. This Act establishes a new regulatory authority to monitor the power and water concessions.

  - *Some divestiture.* The government has reduced the state's holdings in the abattoir.

  - *An extensive commercial legal reform program.* The government has passed a new personal property securities law and is close to having the supporting electronic registry in place. It is engaged in extensive reform of the laws governing business, including the Companies Act, the Trustee Act, and the bankruptcy framework. Once completed, these initiatives will result in Vanuatu having a modern commercial legal framework that is tailored to the needs of the country and the structure of business transactions.

The recent strength of Vanuatu's economy has its roots in improved economic policy and in a gradual improvement in the quality of institutions.

B. Constraints to Sustained Growth

Despite recent economic expansion and some positive reform initiatives by the government, Vanuatu faces a number of significant constraints to sustained growth.

In many sectors, the cost of doing business is extremely high. Infrastructure services are high-cost and often inefficient. Unnecessary regulation

and interference are still all too common. The constraints summarized below undermine Vanuatu's competitiveness and restrict private sector growth.

Infrastructure investment by government has been too low to provide an adequate foundation for private sector development.

Infrastructure services are poor or high-cost or both. In almost every area, costs are among the highest in Pacific island countries. Infrastructure investment by government has been too low to provide an adequate foundation for private sector development. The regulatory framework for infrastructure is weak and requires substantial upgrading. There are major constraints in the following areas:

- *Maintaining transportation infrastructure.* The domestic shipping industry urgently needs upgrades to its legislation, regulation, and safety as well as increased services to outlying islands and some upgrades to wharf facilities; the commercial ports have the highest costs in the Pacific even though their efficiency is among the lowest; and the road network is inadequate and poorly maintained.
- *Providing air services.* Airports are in good condition, but high airport charges and limited capacity are depressing Vanuatu's competitiveness as a tourist destination. In addition, the national air carrier, Air Vanuatu, remains a drain on the country's budget.
- *Lowering telecommunications costs*. While telephone charges have fallen sharply with the arrival of competition, internet charges for businesses are still among the highest in the world. However, government recently announced the issuance of three new licenses for the provision of internet and other telecommunication services, which should lead to better service and lower prices.
- *Generating power.* A private monopoly generates electricity. Power is reliable in communities that have access to it, but rates are high, and the availability of electricity outside major urban centers is very limited.
- *Delivering water and sanitation services.* Consumers in Vanuatu have good access to water and sanitation services, but costs are high. However, growth pressures are beginning to be felt in urban centers, especially Port Vila, where informal settlements, increased population, and much greater traffic volumes are beginning to overwhelm existing facilities. Heavy rain now leads to urban flooding and threatens sanitation and the water supply.

Weak governance and intrusive state interventions are reducing productivity. The most pressing problems are due to the government's actions in the following areas:

- *Operating state-owned enterprises.* Vanuatu's state-owned enterprises (SOEs) are performing poorly, which reduces efficiency and productivity in the economy. The code of governance for the SOEs does not encourage transparency or accountability, and the framework for monitoring their performance does not function effectively.
- *Regulating and controlling agricultural commodities.* The Vanuatu Commodities Marketing Board (VCMB) is inefficient and unaccountable; it has an adverse impact on the industries it regulates. The VCMB has been criticized by stakeholders, and there is said to be substantial political interference.
- *Operating the Agricultural Development Bank.* Recently formed, the bank poses risks to Vanuatu's financial system, in part because it is

not subject to the regulatory authority of the Reserve Bank or the Vanuatu Financial Services Commission (VFSC). Furthermore, it appears that the personnel managing the bank have no background in banking and no expertise in agriculture.

- *Providing a framework for competition.* Government policy does not promote competition effectively. As a result, many critical services are provided by unregulated monopolies, and consumers' rights are not well protected.
- *Legislating wages and employment conditions.* New amendments to the Employment Act will add substantially to the cost of employing workers in Vanuatu, and are likely to have a particularly negative effect on small businesses, including those owned by ni-Vanuatu.

The commercial legal framework is complex, outdated, and difficult for most users to access. It does not encourage business transactions. Many laws governing commerce are based on outdated legislation that has long since been modified. Significant reform initiatives are underway, however. Panels of local and international consultants are working with the government to prepare various bills for submission to Parliament, including a new Companies Bill, a Trustee Bill, and a Bankruptcy Bill. Considerable progress has been made with the circulation of discussion papers on both company and insolvency law reform. A draft Companies Bill has also been circulated for feedback and consultations are ongoing. The VFSC and the Chamber of Commerce are actively involved in facilitating the consultation process. In early 2009, Parliament repealed legislation that could have conflicted with the Personal Property Securities Act. Parliment will receive the Companies and Insolvency Bills for consideration in late 2009. Despite this recent progress, constraints in the legal framework continue to create problems in the following areas:

- *Starting and running companies.* Provisions in the existing Companies Act make it difficult and costly to establish and operate a business.
- *Closing down companies.* An outdated and overly complex bankruptcy regime makes it difficult to wind up an insolvent company.
- *Operating trusts.* The current legal framework for trusts does not fully protect the rights of beneficiaries.
- *Using and enforcing contracts.* The laws governing contracting do not provide a robust framework for entering into contracts, settling contract disputes, or enforcing contracts.
- *Complying with burdensome regulations.* Regulations for starting and running businesses are burdensome and involve substantial duplication of effort, which leads to delays and raises costs.

The commercial legal framework is complex, outdated, and difficult for most users to access. It does not encourage business transactions.

- *Accessing information about the legal system.* The only complete, reliable source of information about Vanuatu's legal system—a regional online database—is not being kept up-to-date with recent reforms.

Access to finance and financial services is becoming increasingly important to sustain long-term growth. New investment will need to be supported by expanded access to credit and financial services. Major constraints exist in the following areas:

- *Expanding access to credit and financial services.* Although private sector credit has been rising rapidly, the overall data contain some large

transactions that distort the picture. Many businesses report difficulty in accessing credit, and the costs of borrowing rose during the first quarter of 2009. Furthermore, lending has been too focused on property and construction. An additional problem is that non-property related lending is directed primarily at large firms, while smaller firms struggle to find financing. Access to financial services is being extended by the National Bank of Vanuatu's pioneering microfinance and smart banking initiatives that could significantly expand access to financial services among previously unreached populations.

- *Reducing the high cost of borrowing.* Interest rates remain high on lending for business activities and consumer loans, but are expected to decline as the new personal property securities reforms take effect.

New investment will need to be supported by expanded access to credit and financial services.

- *Reforming the personal property securities framework.* Parliament recently passed the new Personal Property Securities Act, which will improve borrowers' ability to pledge movable property as collateral, thereby reducing lending risks. Problems remain, however, with the registration of security interests.
- *Revisiting the Offshore Finance Centre.* Although it still generates a significant amount of revenue, the Offshore Finance Centre's economic impact is declining. Without substantial restructuring, its future is uncertain at best.
- Smaller institutions such as the Vanuatu Women Development Scheme (VANWODS) have achieved substantial success in providing micro loans and other services in recent years. They have begun to intermediate deposits and increasingly provide sophisticated lending products. However, as deposit taking institutions, these organizations should come under the regulatory mandate of the Reserve Bank.
- *Preparing for the impact of the international financial crisis.* Vanuatu is not likely to remain untouched by the crisis, which could affect the value of offshore funds, revenues from remittances and tourism, and bank assets.

The **land leasing system** is not effective. Growing tension about land lease issues is causing conflict and increasing the risks of investing in property. Landowners, investors, and policymakers face problems in a number of areas:

- *Determining land ownership and resolving disputes.* Substantial uncertainties exist about the rightful ownership of customary land.
- *Leasing and the protection of landowners' rights.* Land leasing has arisen as a major area of controversy and dispute, in part because customary landowners' rights are not well protected under the current system. Landowners do not always fully understand the implications of lease agreements. In addition, lease structures contain potentially damaging incentive problems and may be unfair to the heirs of current landowners.
- *Reducing high transactions costs for leasing.* High transactions costs and delays in leasing land pose major obstacles to investment.
- *Improving land administration.* Land records are difficult to access and are often unclear about the status of rightful ownership.

The analysis in this report is based on a view that "private sector development" does not refer to a specific part of the economy. Instead, private sector development serves as an overarching theme that encompasses almost every aspect of productive activity. There is a great deal of evidence that the most efficient way to achieve growth is to have the supply of virtually all

services driven by the private sector, as long as there is competition or effective regulation. For example, many infrastructure services can be supplied by the private sector even if they are funded by the government. Private sector involvement in all areas of economic activity is especially important in small island economies, although it is sometimes difficult to achieve.

A country's business environment determines the health of the private sector; the health of the private sector, in turn, drives entrepreneurship and investment. The government has a central role to play in creating a business-friendly environment. Government involvement—through actions such as financing or providing infrastructure, improving access to finance, and providing a modern commercial legal framework—is critical for promoting investment and entrepreneurship. Infrastructure determines how costly it is to communicate and transport people, goods, and services. Access to finance allows investment opportunities to be funded. The commercial legal framework affects the way entrepreneurs respond to opportunities, the way businesses are organized, and the amount of informal activity that occurs. A healthy business environment is one in which many businesses are established, but inefficient businesses are not kept alive artificially.

C. Recommendations for Policy Reform

Vanuatu has established a foundation for sustained economic growth. To achieve that growth, however, the country needs to create a more business-friendly environment by enacting carefully targeted reforms. These will also have the effect of increasingly bringing the subsistence sector of the economy into cash-based activities.

Although the Government of Vanuatu has shown courage and determination in pushing through reforms in some areas, further changes are needed. The recommendations of this report are not comprehensive, but instead focus on the priorities identified by the analysis of the authors.

Upgrading infrastructure. Infrastructure reforms should focus on lowering costs, upgrading quality, and improving maintenance. To do that, Vanuatu needs to strengthen regulation and promote competition. The authors of this report recommend that the government:

Growing tension about land lease issues is causing conflict and increasing the risks of investing in property.

- Expand the law for privately financed infrastructure projects to include a broad range of sectors, and implement the provisions of the act without delay.
- Rehabilitate the road network, and increase expenditures for maintenance. Contract out road maintenance by carving out several companies from the Public Works Department and giving them a pipeline of work for a fixed period.
- Review, without delay, the concession arrangements for the Port Vila wharves. Develop a new port site in Port Vila, and seek new operators both for the new port and its stevedoring services.
- Urgently review regulatory issues and safety standards for the domestic shipping industry. Create a maritime safety authority to establish and enforce safety standards. Develop a formal arrangement to contract out shipping services to remote communities not currently visited by ferries.

- Contract out management, air traffic control services, firefighting, and aviation security at the three international airports.
- Restructure Air Vanuatu, and franchise out the domestic air routes that require operating subsidies (as was done successfully in Fiji).
- Continue liberalizing the telecommunications sector, particularly internet services.
- Undertake a tariff study of the electricity industry and open tariff negotiations with Union Electrique du Vanuatu Limited (UNELCO), the unregulated private sector operator. Introduce regulation in the electricity industry. Organize a competitive tender for the Luganville concession when it comes up for renewal in 2010, and use this process as a model for tendering in other infrastructure subsectors.
- Accelerate plans to attract private sector management for the smaller piped water networks.

Infrastructure reforms should focus on lowering costs, upgrading quality, and improving maintenance.

Improving governance and reducing the role of the state. The government needs to reduce its intervention in many areas of the economy, and should reform or abolish ineffective state-owned institutions. Specifically, the authors of this report recommend that the government:

- Restructure the state-owned enterprise sector. Establish a new legal framework for SOEs and improve their effective oversight by providing the Ministry of Finance and Economic Management with the authority and information it needs to do so. Reform corporate governance arrangements, and prepare as many SOEs as possible for divestiture.
- Abolish the Vanuatu Commodities Marketing Board without delay.
- Place the Agricultural Development Bank under the regulatory authority of the Reserve Bank. Consider folding the mandate of the bank into the National Bank of Vanuatu, which is professionally run and has the nationwide network to oversee agricultural sector loans.
- Establish a well-functioning legal framework that promotes competitive behavior. Create an institution to regulate activities and sectors where there are natural monopolies. Enact and enforce consumer protection legislation.
- Repeal the newly passed amendments to the Employment Act.

Modernizing the commercial legal framework. The government should press forward with its current initiatives to reform the commercial legal framework, which will give Vanuatu one of the best legal structures in the Pacific for establishing, running, and closing down businesses. In particular, the authors of this report recommend that the government:

- Enact the proposed new Companies Bill, which will encourage businesses to form companies rather than operate as sole traders.
- Enact the proposed new Bankruptcy Bill, which will introduce modern, streamlined procedures for winding up companies and dealing with personal bankruptcy.
- Amend the Trustee Act to provide clear directions and controls for trustees, to ensure that beneficiaries' rights are fully protected.
- Reform laws governing contracts to provide consistent, modern rules governing the use and enforcement of contracts. In the medium term, make it a priority to establish laws governing

arbitration, so that alternative dispute resolution mechanisms can be used.

- Streamline regulatory procedures for both local and foreign investors seeking to start and operate businesses.
- Ensure that the database operated by the Pacific Islands Legal Information Institute—which is currently the only complete source of information about Vanuatu's legal system—is kept up-to-date with recent changes.

Expanding access to finance. The focus should be on improving access to credit, especially for small businesses, and on reducing the proportion of lending directed at property and construction. The authors of this report recommend that the government:

- Implement the final phases of the new Personal Property Securities Act, which will increase access to credit by making it easier for borrowers to pledge movable assets as collateral, thereby reducing risks to lenders.
- Support the National Bank of Vanuatu's microfinance initiative and smart banking program.

Reforming the land leasing system. Vanuatu needs to focus on improving the land leasing system to make property rights in land more secure for both customary landowners and those leasing land. The authors of this report recommend that the government:

- Establish a registry of customary landowners who wish to lease their land. Limit the period of time during which potential owners can file claims to land being leased to speed up the resolution of ownership disputes.
- Provide advisory services to all members of a landowning family or clan to educate them about the implications of lease agreements and to reduce uncertainty about the validity of leases.
- Establish guidelines for lease agreements that specify relatively low up-front payments and require annual payments to constitute a larger proportion of the total amount paid to avoid disinheriting future generations.
- Establish rules and laws to clarify customary landowners' rights-of-way on leased property, especially their access to the sea.

Vanuatu needs to focus on improving the land leasing system.

- Issue guidelines for restructuring lease payments (to base payments on a combination of rent and royalties), to ensure that landowners benefit from the success of businesses established on their land. Clarify procedures for negotiating formulas that will provide customary landowners with a share of capital gains from subdivision.
- Link lease payments to changes in the consumer price index to eliminate the need for leases to be renegotiated every few years (which should reduce transactions costs). Enact legislation making it an offense for owners to demand payments or other concessions from lessees that are not contained in the lease contract.
- Speed up efforts to digitize land records and make them searchable electronically. Establish an out-of-country backup of the land records.

II Upgrading Infrastructure

Infrastructure services are poor or high-cost or both. In almost every subsector, costs are among the highest in the region. Substantial upgrades and cost-reduction measures are urgently needed.

Infrastructure plays a vital role in generating economic growth and providing a foundation for private sector development. Without reliable electricity, for example, businesses have to invest in costly back-up facilities. Widely available, affordable telephone services connect users in Pacific island countries with remote areas in their own countries and with distant markets abroad. Efficient road, air, and sea connections are critical to the movement of goods and to tourism sector development.

Infrastructure plays a vital role in generating economic growth and providing a foundation for private sector development.

For many years, Vanuatu has suffered from inadequate physical infrastructure as a result of insufficient government investment. Costs for electricity, water, and port services in Vanuatu are among the highest in Pacific island countries. Further problems are created by Vanuatu's regulatory framework for infrastructure, which is ineffective and needs to be strengthened.

The country is implementing a number of significant reforms, which should introduce greater competition and regulation in the provision of infrastructure services. The reforms are also likely to boost the amount of investment available for infrastructure projects. In November 2007, Parliament passed the Utility Regulatory Authority Act, establishing a regulatory authority for power and water concessions. In addition, the government also passed the Privately Financed Airport Infrastructure Projects Act ("PPP Act") to facilitate private investment in airport infrastructure. This bill, which focuses on build–operate–transfer and build–operate–own forms of contract, introduces a more predictable and transparent procurement process for public–private partnerships (PPPs), and should therefore encourage private participation. While it is limited in application to airport infrastructure, its procurement process could be applicable to other forms of concession contracts for infrastructure services, and the Government of Vanuatu should seek to extend its application while making the institutional arrangements for executing PPP contracts more explicit. Looking forward, it will be important for the government to access strong project development expertise so that a pipeline of bankable PPP projects can be prepared.

This chapter summarizes various aspects of Vanuatu's infrastructure and presents recommendations for reform. Major constraints exist in the following areas:

- **Maintaining transportation infrastructure.** The road network is inadequate and poorly maintained; the commercial ports have the highest costs in the Pacific even though their efficiency is among the lowest; and, although it provides good coverage and affordable rates, the domestic shipping industry has serious safety problems.
- **Providing air services.** Airports are in good condition, but high airport charges and limited capacity are depressing Vanuatu's

competitiveness as a tourist destination. The national air carrier, Air Vanuatu, remains a drain on the country's budget.

- **Lowering telecommunications costs.** While telephone charges have fallen sharply with the arrival of competition, internet charges for businesses are still among the highest in the world. However, government recently announced the issuance of three new licenses for the provision of internet and other telecommunication services, which should lead to better service and lower prices.
- **Generating power.** A private monopoly generates electricity. Power is reliable in communities that have access to it, but rates are high, and the availability of electricity outside major urban centers is very limited.
- **Delivering water and sanitation services.** Consumers in Vanuatu have good access to water and sanitation services, but costs are high. Growth pressures are beginning to be felt in urban centers, especially Port Vila, where informal settlements, increased population, and much greater traffic volumes are beginning to overwhelm existing facilities. Heavy rain now leads to urban flooding and threatens sanitation and the water supply. Road congestion is also increasing in Port Vila due to a much greater volume of traffic arising from vehicle purchases and the larger volume of tourists.

A. Transportation: Inadequate and Poorly Maintained

The quality of Vanuatu's transportation infrastructure is generally poor and—even in areas where facilities are available—maintenance is often inadequate. These conditions raise transport costs and add to the costs of doing business.

Box 1: The Millennium Challenge Corporation: Vanuatu Compact

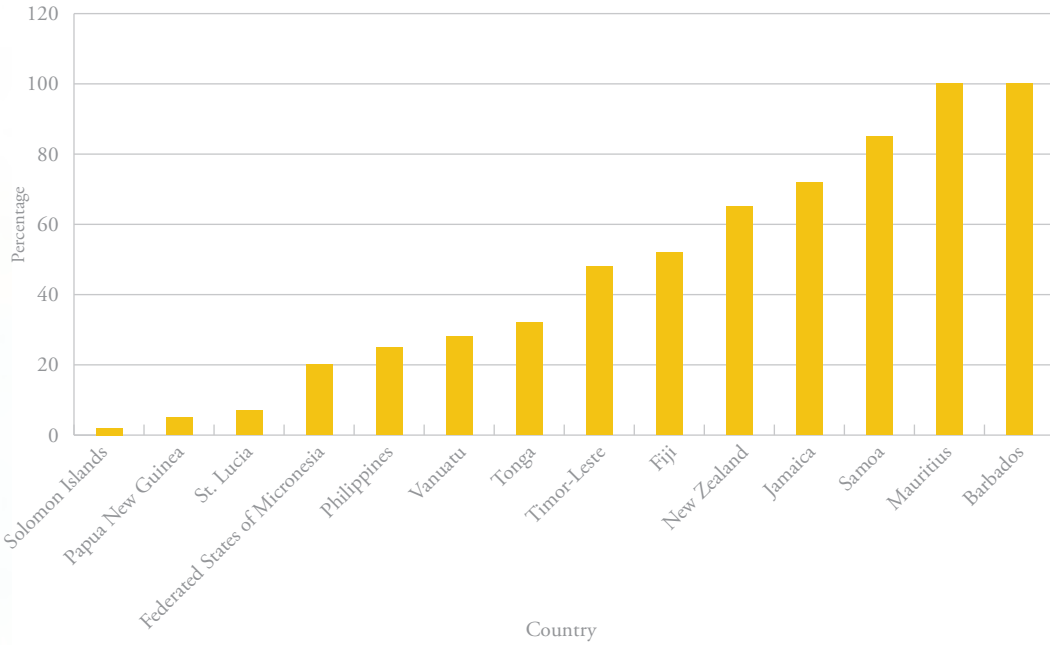
Vanuatu signed a compact with the Millennium Challenge Corporation in 2006, paving the way for a $66 million grant to finance transport infrastructure and capacity building at the Public Works Department of the Ministry of Infrastructure and Public Utilities. Construction of the Efate ring road has now begun; it will be one of several roads built or rehabilitated under this funding arrangement.

1. Roads Need Construction and Rehabilitation

Vanuatu's road network is inadequate and poorly maintained; the government should both extend the network and increase expenditures for maintenance. The road network density is low, and only 20% of the roads are sealed. Sealed roads are limited to a short radius from the urban centers of Port Vila and Luganville, while all other roads, including the Efate ring road, are gravel. Many of the smaller outer islands have no roads. Low expenditures on maintenance have accelerated the deterioration of the road network. The Public Works Department (PWD) estimates that maintenance expenditures have historically been less than 10% of the total amount needed.[1] As part of Vanuatu's compact with the Millennium Challenge Corporation, however, maintenance expenditures will increase to Vt500 million ($4.4 million) in 2008 and will remain at this level annually through 2011. This will allow significant rehabilitation of the road network, which is an urgent priority. The Australian Agency for International Development's (AusAID's) Transport Sector Program is also supporting upgrades to the road network and is building the PWD's capacity to maintain it.

[1] The annual maintenance requirement for the road network is estimated by the PWD to be Vt1.2 billion ($10.6 million), but the allocation in 2006 was less than Vt100 million ($0.9 million).

Figure 4: Paved Roads (% of Total Roads)



Sources: Central Intelligence Agency World Factbook and World Bank World Development Indicators.

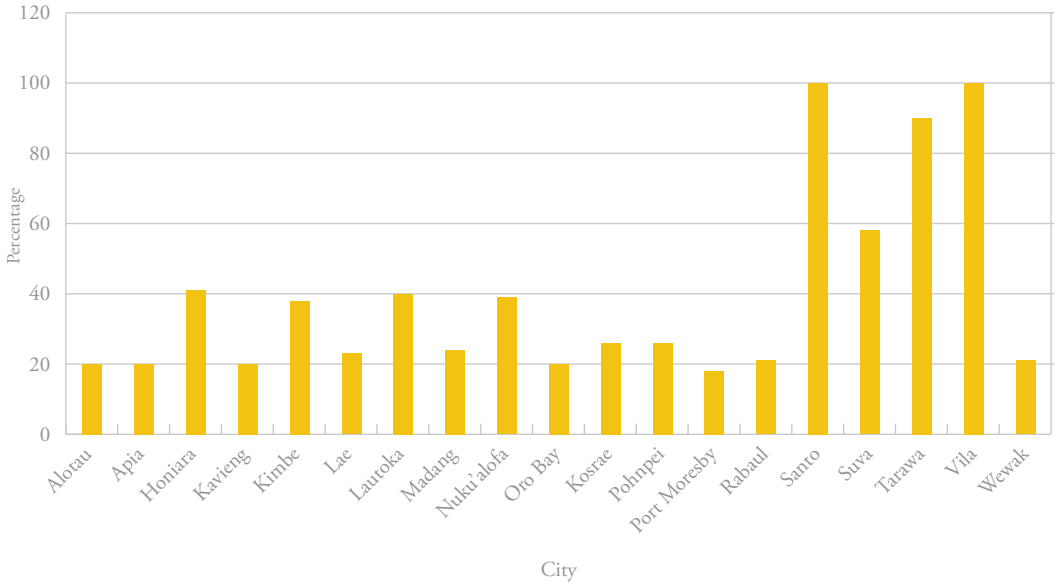
Urban road infrastructure is increasingly inadequate. Traffic congestion is rising as vehicle ownership becomes more widespread, and flooding is a constant problem after heavy rains. At this point, the planning process for urban road construction and rehabilitation is not functioning satisfactorily, and no comprehensive long-term investment plan is in place.

The PWD estimates that 60% of maintenance (in terms of value) is performed by private firms under contract, which is far higher than the average in Pacific island countries. Most of this work is undertaken in Espiritu Santo, Efate, and Malekula; private sector capacity outside these islands is limited. The remaining maintenance work is carried out by PWD staff using donated equipment that is over 15 years old. The PWD believes that a program to contract out more of the road maintenance work to its own staff members (of which there are 72), following the model of the Samoa Ministry of Public Works, could be successful in Vanuatu. To do this, several maintenance companies would need to be carved out of the PWD. Each company would be given a pipeline of work for a fixed period; at the end of this period, the companies would compete on equal footing with all service providers. To ensure the success of such a program, road maintenance expenditures would need to be guaranteed at an adequate level, which could be achieved by pooling user charges into a dedicated fund. The government should actively pursue both of these measures within the context of a larger restructuring and corporatization of the PWD. Other functions currently executed by the PWD—such as the management of three piped water networks at Luganville, Lakatoro, and Isangel—could also be contracted out to the private sector or to privatized units of the PWD.

2. Ports Need Regulation and Competition

Vanuatu has two commercial ports: one in Port Vila and one in Espiritu Santo. Both are the responsibility of the noncorporatized Department of Ports and Harbors (also

Figure 5: Stevedoring Charges ($/TEU)



TEU = twenty-foot equivalent unit.
Source: AusAID and Vanuatu Ministry of Finance and Economic Management.

called the Ports Authority) of the Ministry of Infrastructure and Public Utilities (MIPU). Ports in all other outer islands, none of which are operated commercially, are the responsibility of the PWD, which is also under MIPU. These are generally in poor condition.

The operation of the two commercial ports has been contracted out to the private sector on a concessional basis. Port Vila has three wharves. The main wharf takes international cargoes and cruise ships; the Ports Authority owns it but contracts out all services to a private company, Ifira Wharf and Stevedoring. There are two domestic wharves: one owned outright by Ifira, which operates it as a commercial enterprise, and one owned and operated by the private sector. Both domestic wharves are run down and need to be rehabilitated. The Espiritu Santo port is owned by the Ports Authority but operated by the Northern Islands Stevedoring Co. (NISCO); it is also in disrepair and represents a safety hazard to people, cargo, and ships.

The cost of moving goods through Vanuatu's commercial ports is the highest in Pacific island countries, even though the ports' efficiency is among the lowest. High port costs are harming Vanuatu's competitiveness. In terms of both costs and delays in moving goods, Port Vila has the worst performing port in the Pacific region. Port Vila's charge for clearing a 20-foot container is $1,000—by far the highest in the region. By contrast, at the least expensive port (Port Moresby), the same charge is $200. Port Vila also has the slowest turnaround time: 17 days compared to 3 days in Port Moresby. This combination—high fees coupled with delays caused by ships waiting to enter the port—substantially adds to costs, which is particularly damaging in a small, remote island economy that depends on importing and exporting goods for its prosperity.

Stevedoring charges at both of Vanuatu's commercial ports are seven times higher than in Port Moresby (Figure 5). These charges, which are established by unregulated monopolies, have a significant impact on the cost of importing and exporting. There is a pressing need for a far-reaching review of the ports' concession

arrangements, particularly the Ifira contract, which recently received a 50-year extension on a noncompetitive basis. Additional stevedoring operators are needed urgently.

In the longer term, Vanuatu should develop another port site in the vicinity of Port Vila, which would provide competition. The case for establishing another port rests on several considerations: (i) the very limited capacity of the existing port, (ii) inadequate container storage, and (ii) the unavailability of one of the three existing wharfs for 5–8 days per month when priority is given to cruise ships.[2] When the new port is developed, it is essential that new operators be sought for both the port and the stevedoring services.

The current monopolies for the ports and associated services will require effective regulation to bring down costs and improve efficiency.

Ongoing regulation is needed. While a new port will eventually provide competition, the current monopolies for the ports and associated services will require effective regulation to bring down costs and improve efficiency. The regulatory burden will be reduced when the Port Vila monopoly is broken, but it will not disappear.

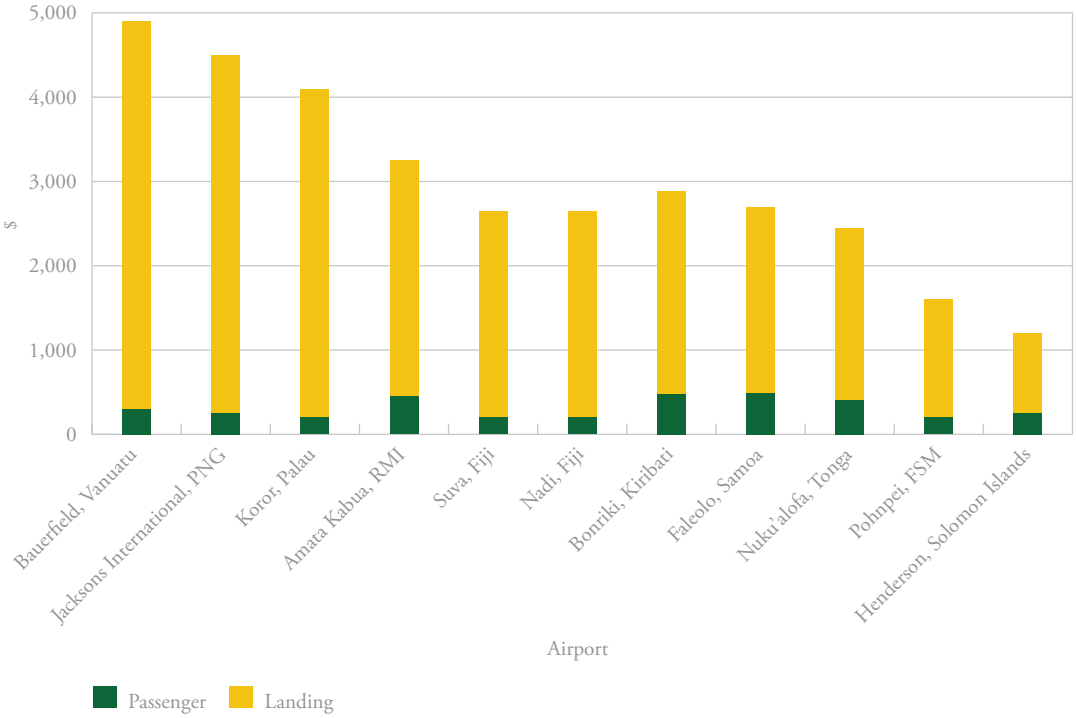
3. Issues Related to Domestic Shipping Services

Domestic shipping services in Vanuatu are 100% privately operated. There are 20 private shipping companies operating a total of 28 vessels, two of which are owned by the government.[3] Apart from the two government-owned vessels, which are about 2 years old, most of the domestic shipping vessels in Vanuatu are small and old. All inhabited islands are reached by shipping services, although areas of some islands have infrequent service or no service at all. According to a recent survey,[4] 90% of domestic users are satisfied with the frequency and capacity of the services. Oversupply of shipping capacity[5] and intense competition among service providers has led to affordable freight rates and passenger fares. Overall, the industry is profitable, earning 10% on equity with an average load factor of 60%–65%.[6] Profits, however, are at the expense of safety, and are therefore unsustainable.

The lack of enforcement of safety standards keeps service quality low and the risks of existing services high. There are numerous reports of violations of international safety standards, and there is a real possibility of tragic accidents occurring on interisland ferries. A recent inspection found four vessels in violation of safety standards. The Asian Development Bank (ADB) is working with the New Zealand Agency for International Development (NZAID) and the government on this issue, which should be an urgent priority. The authors of this report recommend that the government: (i) review safety standards for the domestic shipping industry, (ii) streamline legislation related to safety and economic requirements for maritime and shipping activities, and (iii) create a maritime safety authority to establish and enforce standards. The government should also develop a formal arrangement to contract out shipping services to remote communities not currently visited by ferries.[7] These measures

[2] An upgrade of the government-owned wharf in Port Vila will begin in 2009 and will increase berthing capacity, but storage capacity will remain a major constraint.
[3] An additional nine vessels are owned by the private sector, but are not currently in operation.
[4] NZAID. 2008. *Vanuatu Inter-island Shipping Study.* Wellington.
[5] Capacity is 80,000 tons per year but demand is approximately 50,000 tons.
[6] NZAID. 2008. *Vanuatu Inter-island Shipping Study.* Wellington.
[7] Torres, Ureparapara, and Tafea Province.

Figure 6: Total Landing and Passenger Charges ($)



RMI = Republic of the Marshall Islands, FSM = Federated States of Micronesia, PNG = Papua New Guinea.
Source: Air New Zealand Landing and Passenger Charges 2004.

could also be supported by restoring Radio Vanuatu shortwave services and—where feasible—extending mobile phone coverage.

B. Air Transport: A Vital Lifeline

Air links with other countries serve as a vital lifeline. Increased competition among airlines has led to lower prices, but other parts of the air transport system—particularly airport services—are depressing Vanuatu's competitiveness.

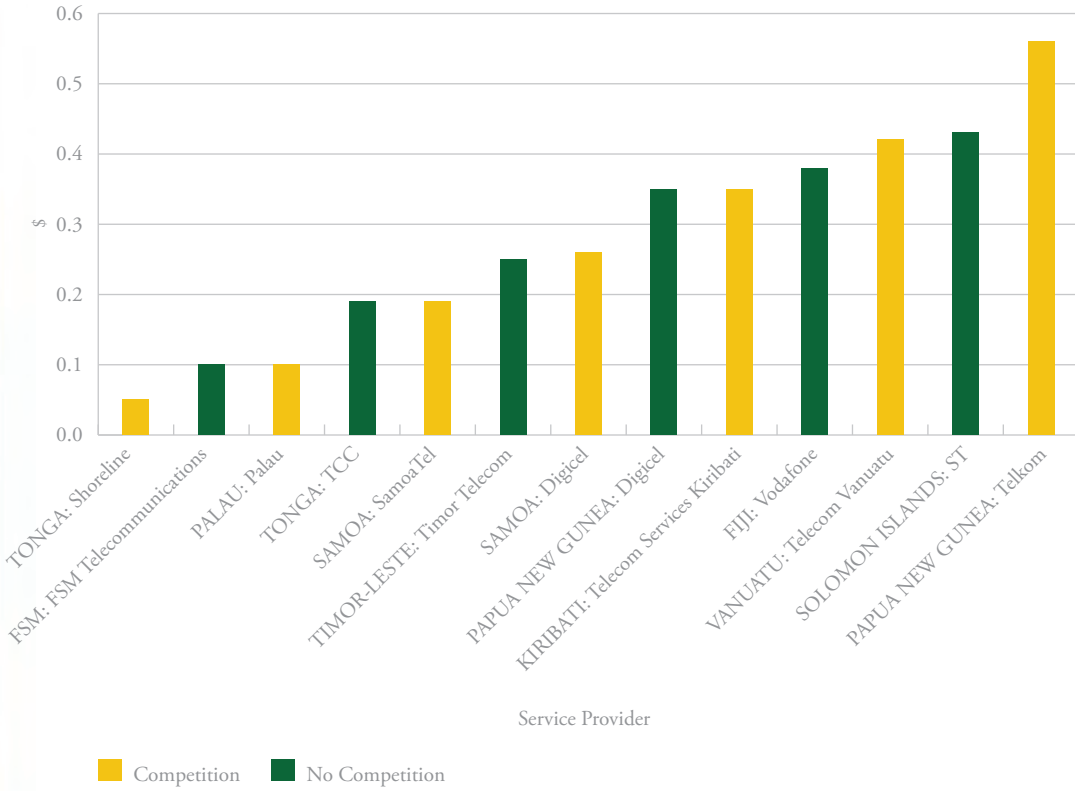
1. Airport Costs and Capacity

Vanuatu has international airports in Port Vila and on the islands of Espiritu Santo and Tanna. There are also 26 airfields on the outer islands, which remain under government ownership and are managed by MIPU. The state of the airports, particularly the three international airports, is reasonable.

Airports Vanuatu Limited (AVL), a government entity that was corporatized in 2000, manages the international airports. AVL is also responsible for airport management, air traffic control, aviation rescue, firefighting, and aviation security at the three international airports. Airport charges are among the highest in Pacific island countries; this keeps airfares high and depresses Vanuatu's competitiveness as a tourist destination, particularly compared to Fiji. To lower costs, the management, air traffic control, aviation rescue, firefighting, and aviation security services should be contracted out to the private sector.

The Bauerfield International Airport at Port Vila has now reached its maximum capacity at peak times; it will not be able to handle the increased arrivals that are expected once additional international routes are liberalized. To address this constraint, AVL is currently exploring

Figure 7: Cost of Peak Mobile Calls ($ per minute)



FSM = Federated States of Micronesia, ST = Solomon Telekom Company Ltd., TCC = Tonga Communications Corporation.
Source: World Bank.

Note: Prices and exchange rates effective September 2007. In some cases operators offer per minute, per 2-minute, or per 30-second rates. Some have introduced per second billing. Where more than one rate provided by a company (for example, mobile-to-mobile and mobile-to-landline), a simple average was taken.

options for a public-private partnership (PPP) to upgrade the Bauerfield airport facilities (including hangars, aprons, luggage handling, and commercial buildings) and to extend the runways to their topographical limits. Because tourism is so important to Vanuatu's economy, airport capacity and cost problems are hindering private sector competitiveness

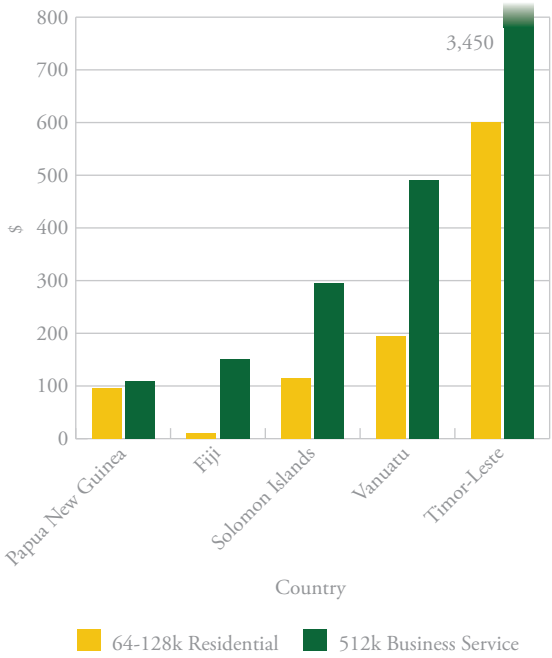
2. Expansion of Air Services

Vanuatu is served by five international airlines, including the national carrier, Air Vanuatu. These airlines provide links with major markets in Australia, Fiji, New Caledonia, New Zealand, and Solomon Islands. Air Vanuatu competes directly with Air Pacific's twice-weekly Nadi–Port Vila service and with Pacific Blue's twice-weekly Brisbane–Port Vila service. Both of these routes are key international segments. Pacific Blue, a low-cost airline, launched a Brisbane–Port Vila service in September 2004, and in 2 years, managed to secure a one-third share of the Australia–Vanuatu market. Pacific Blue's success came largely at the expense of Air Vanuatu. Overall passenger numbers have increased rapidly as a result of the lower fares; since 2004, the number of passengers traveling between Australia and Vanuatu has grown by 35%. International tourist arrivals were nearly 30% higher in January 2009 than in January 2008. These results reinforce the wisdom of opening the country to foreign airlines and demonstrate the benefits of competition.

However, Air Vanuatu remains a drain on the country's budget and needs to be restructured, as evidenced by the pressures placed on the airline by increased competition. As the government considers restructuring Air Vanuatu, options may include forming a joint venture with a private partner, perhaps similar to the PolyBlue joint venture between Polynesian Airlines and Virgin Blue in Samoa.

In addition to providing international service, Air Vanuatu owns and operates Vanair, the country's domestic carrier. Vanair operates 29 domestic routes, only two of which are profitable. It continues to require an operating subsidy. Air Vanuatu should contract out the domestic routes that require subsidies, perhaps using a franchising scheme such as the one used successfully in Fiji, where private operators have taken on domestic routes in exchange for a performance-based subsidy.

Figure 8: Cost of Internet Connection ($ per month)



Note: Fiji and Papua New Guinea allow internet competition. Solomon Islands, Timor-Leste, and Vanuatu do not.
Source: World Bank.

C. Telecommunications: Liberalization Underway

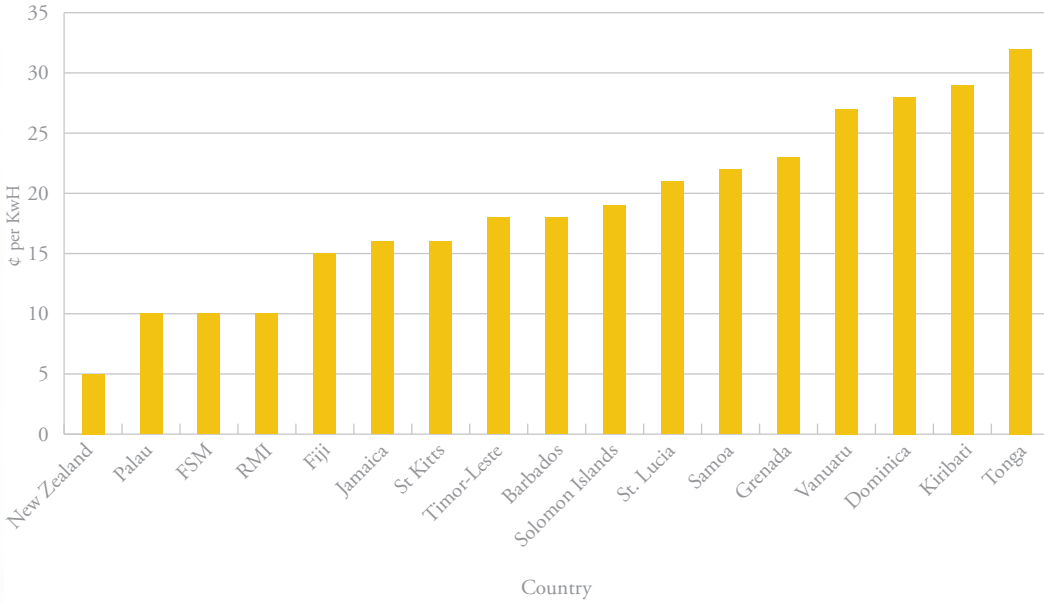
Vanuatu is liberalizing the telecommunications sector and strengthening regulatory authority, but internet charges remain high, which is harming business at a time when commercial links with other countries are expanding rapidly.

The arrival of competition is reducing telephone charges in Vanuatu, and although internet charges for businesses are still among the highest in the world (several times those in Fiji, for example), the goverrnment recently announced the issuance of three new licenses for the provision of internet and other telecommunication services, which should lead to better service and lower prices.

In late 2007, the government reached a settlement agreement with Telecom Vanuatu Limited that effectively phased out the company's monopoly on all telecommunications services—fixed line, mobile, internet, microwave voice, and data links. In the first quarter of 2008, Digicel was awarded the first new mobile license in Vanuatu. Within 6 months of operation, the company provided coverage to 75% of the population. Costs have also fallen significantly, providing strong evidence of the benefits of competition. Previously, Vanuatu's mobile communications costs were among the most expensive in the region, but—as in many other countries—the mere threat of competition resulted in dramatic price declines. Cheaper, more accessible mobile communications are providing an important boost to commercial activity throughout the country. The authors of this report recommend that the government continue with telecommunications reform, with particular emphasis on further liberalization of internet services.

The amended Telecommunications Act was passed in November 2007. The Act creates a stronger regulatory authority, which is being

Figure 9: Average Electricity Tariffs (¢ per KwH)



RMI = Republic of the Marshall Islands, FSM = Federated States of Micronesia.
Source: World Bank.

established within the Ministry of Finance and Economic Management (MFEM). A telecommunications regulatory specialist will staff the authority for an initial 12-month period, during which the government will consider merging the responsibility for telecommunications regulation with the duties of the new Utilities Regulatory Authority overseeing the power and water sectors.[8]

D. Power: Competition and Regulation Needed

The communities served by power concessions have reliable service, but rates are high. Electricity outside major urban centers is very limited. The government should continue with reforms that will introduce greater competition and improve regulation.

A private company operates concessions that supply reliable power to Port Vila, Luganville, Malekula, and Tanna. Electricity elsewhere in Vanuatu is extremely limited—only 27% of the population has access to safe, reliable power. Vanuatu's power sector is operated by UNELCO Suez, which also operates the water supply system in Port Vila. UNELCO was awarded the first power concession for Port Vila more than 70 years ago. The company supplies power to four population centers through three different concession contracts: one for Port Vila (which runs until 2031), one for Luganville (which runs until 2010), and one for Malekula and Tanna (which runs until 2022). The Malekula and Tanna operations are loss making and are cross-subsidized by users in other cities. The Port Vila and Luganville operations extend about 15 kilometers from the municipal boundaries.

The concession contracts have resulted in reliable power supplies to the communities served. The average tariffs, however, are among the highest

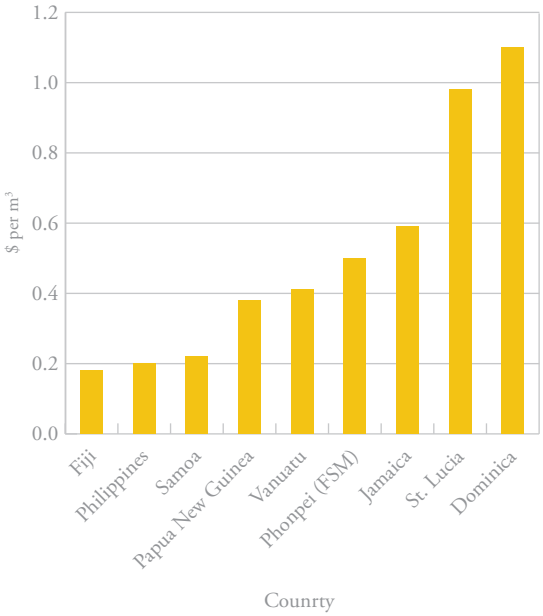
[8] NZAID and the World Bank will fund capacity building.

in Pacific island countries,[9] even though system losses are among the lowest. This can be explained in part by the absence of a government tariff subsidy, such as those that exist in other countries. More importantly, however, high tariffs are due to ineffective regulation and to a lack of competition for the concessions, which would keep downward pressure on tariffs. High power prices impact all areas of the economy, particularly tourism, where the cost of electricity makes up a significant portion of room charges. Since the tariff formula has not changed since 1998, the authors of this report recommend that the government undertake a tariff study of the power sector and then open tariff negotiations with UNELCO.

Vanuatu is taking steps to improve regulation and expand access to electricity. The 2007 Utility Regulatory Authority Act strengthens regulatory oversight of the power and water sectors. The act established a new regulatory authority under MFEM that is responsible for managing the concession contracts. In the same year, the government issued the National Energy Policy and Rural Electrification Master Plan to help expand access to electricity in rural areas. The decision to regulate electricity generation is a welcome development, but electricity regulation is a complex task, and the government should seek international assistance to implement it.

A pilot project is currently underway at Port Ory[10] that empowers the community to take full responsibility for operating and maintaining its own electricity generating facility. If successful, the Port Ory pilot could be a pioneering model for community-based rural electrification in other areas of the country. The government also intends to organize a competitive tender for the Luganville power concession when it comes up for renewal in 2010. The authors of this report support the government plan, which would be a positive step in introducing competition into the market. The Luganville approach could also establish transparent PPP tendering procedures that could then be replicated for use in other sectors.

Figure 10: Average Water Tariffs ($ per m^3)



FSM = Federated States of Micronesia.
Source: World Bank.

E. Access to Water and Sanitation

Vanuatu has good access to water and sanitation, but consumers' costs are high. The government should continue its restructuring plans, particularly its effort to attract private sector management for the smaller piped networks.

[9] Tariffs are adjusted monthly; domestic user rates in February 2008 were Vt32.66/kWh (approximately $0.36/kWh). Electricity tariffs are set on a uniform basis across the three concessions operated by UNELCO. The tariffs charged are derived from a base rate tariff, which is indexed quarterly for changes in the costs of fuel, labor, and equipment.

[10] Under the arrangement, electricity consumers—who are metered on a prepaid card operated system—will be allowed to pay for electricity either with cash or with coconuts delivered to the mill, or both.

Vanuatu ranks high among developing countries in its access to water and sanitation; over 80% of the population is served by piped networks. UNELCO Suez operates the water system in Port Vila under a concession contract that runs until 2014. As is the case for power, the UNELCO concession has resulted in an efficient and reliable supply of water, but at a cost to consumers that is higher than in neighboring countries. UNELCO recovers the full cost of service through the tariff, although there are claims that these prices reflect lack of effective regulation. In addition, the rapid increase in population in Port Vila, and to a lesser extent, in other urban areas, is putting increased pressure on water, sanitation, and drainage. Heavy rain increasingly results in urban flooding. Pressure on sanitation facilities is rising, and investment in future water supply could be insufficient.

The rapid increase in population in Port Vila, and to a lesser extent, in other urban areas, is putting increased pressure on water, sanitation, and drainage.

The PWD operates the water supply in all other locations. Using UNELCO's levels of efficiency as a benchmark, the PWD has embarked on a plan to restructure its three piped networks. The result has been a remarkable improvement in revenue collection and an operating profit of Vt9 million ($0.08 million) in 2007 (compared to an operating loss in 2006). The PWD should accelerate its plan to attract private sector management for these smaller piped networks.

Improving Governance and Reducing the Role of the State

The state plays a substantial role in the economy. Intrusive government interventions and weak governance of state-owned institutions are reducing productivity.

The state plays a prominent role in the economy of Vanuatu. In many areas, however, government interventions and policies are harming economic growth and hindering private sector development. The government owns 20 enterprises, has recently established the Agricultural Development Bank, and regulates agriculture through the Vanuatu Commodities Marketing Board. In addition, the government's approach to competition may actually discourage the growth and competitiveness of consumer markets. This chapter focuses on problems in the following areas:

- **Operating state-owned enterprises.** Vanuatu's SOEs are performing poorly, which reduces efficiency and productivity in the economy.
- **Regulating and controlling agricultural commodities.** The Vanuatu Commodities Marketing Board is inefficient and unaccountable; it has an adverse impact on the industries it regulates.
- **Operating the Agricultural Development Bank.** Recently formed, the bank poses risks to Vanuatu's financial system.
- **Providing a framework for competition.** Government policy does not promote competition effectively. As a result, many critical services are provided by unregulated monopolies, and consumers' rights are not well protected.
- **Legislating wages and employment conditions.** New amendments to the Employment Act will add substantially to the cost of employing workers in Vanuatu, and are likely to have a particularly negative effect on small businesses, including those owned by ni-Vanuatu.

A. State-Owned Enterprises: Inefficient and Poorly Governed

Vanuatu's inefficient state-owned enterprises provide low rates of return, reducing growth and efficiency in the economy. The government should improve oversight and prepare as many state-owned enterprises as possible for divestiture.

The government has 20 SOEs, known as government business enterprises (GBEs). These enterprises are owned in whole or in part by the government, and are engaged either in commercial activities or in the provision of public services. Of Vanuatu's 20 SOEs, 10 are companies established under the Companies Act; the government is a minority shareholder in 5 of the 10. The other 10 SOEs were created through special acts of Parliament; 4 of these are corporatized entities.[11] Most of Vanuatu's SOEs pursue commercial activities.

All but a very few of Vanuatu's SOEs are inefficient; this inefficiency reduces growth and raises the cost of doing business in the country. The SOEs drain budgetary resources and reduce productivity in the economy. Based on limited financial data made available to an ADB-financed review team in 2006, it appears that

[11] Corporatization, which creates an SOE out of a government agency or department that previously delivered a service, is intended to introduce greater transparency, efficiency, and accountability. This method is most often used to establish SOEs that deliver core public infrastructure services, most notably power, water, sanitation, telecommunications, broadcasting, postal services, airports, and seaports.

the productivity of Vanuatu's SOEs is low. It is safe to assume that most SOEs that are majority-owned by the government are earning very low or negative rates of return on the capital and resources that they are using.

The code of governance for Vanuatu's SOEs does not encourage transparency or accountability, and the framework for monitoring their performance does not function effectively.

The SOEs subject to the Companies Act are required to file annual financial reports with the Vanuatu Financial Services Commission. Since 2006, however, only three of them have submitted the required reports. The SOEs created by acts of Parliament also have reporting requirements, which typically involve submitting annual financial reports to the Auditor General. Most SOEs are not in compliance with this

Table 1: Government Shareholding of Government Business Enterprises

Government Business Enterprise	Government Shareholding (%)	Shareholding Ministry
Government Business Enterprises Under the Companies Act		
Air Vanuatu	100	MFEM, MIPU, PMO
Airports Vanuatu	100	MFEM, MIPU
Global Trading and Manufacturing	31	PMO
Ifira Wharf and Stevedoring	34	MIPU
Metensel Estates	99	MFEM, MAQFF
Northern Islands Stevedoring	10	MIPU
Telecoms Vanuatu	33	MIPU, MFEM
Vanuatu Livestock Development	100	MFEM, MALFFQ
Vanuatu Post	100	MFEM, MIPU
Corporate Government Business Enterprises Under Their Own Acts		
National Bank of Vanuatu	100	MFEM
National Housing Corporation	100	MIA
Vanuatu Broadcasting and Television Corporation	100	PMO
Vanuatu National Provident Fund	100	MFEM
Noncorporatized Government Business Enterprises Under Their Own Acts		
National Tourism Office	100	MTNVB
Vanuatu Financial Services Commission	100	MFEM
Reserve Bank of Vanuatu	100	MFEM
Asset Management Unit	100	MFEM
Utility Regulatory Authority	100	MFEM
Vanuatu Commodities Marketing Board	100	MTNVB

MAQFF = Ministry of Agriculture, Quarantine, Forestry, and Fisheries; MFEM = Ministry of Finance and Economic Management; MIA = Ministry of Internal Affairs; MIPU = Ministry of Infrastructure and Public Utilities; MTNVB = Ministry of Trade and Ni-Vanuatu Business; PMO = Prime Minister's Office.
Source: Ministry of Finance and Economic Management.

requirement. Weak corporate governance also contributes to the SOEs' poor performance. Directors are selected by the shareholding ministries, but the appointments are rarely made on the basis of professional qualifications. In addition, directors' fees and expenses are well above prudent standards.[12]

The accountability of the SOEs is further complicated by the fact that, even though in principle one ministry is in charge of each SOE, in practice the SOEs face overlapping accountability to multiple ministries. The Ministry of Finance and Economic Management (MFEM) has created a GBE unit that is nominally responsible for overseeing the SOE portfolio as a whole. The unit, however, is not legally empowered to request financial reports from the SOEs or to provide any management or governance inputs. Vanuatu's Parliament should pass a bill formally empowering the GBE unit; without such a bill, the unit will remain ineffective.

Vanuatu's SOE sector needs wholesale restructuring. The government should establish a new legal framework, reform corporate governance arrangements, and implement the terms of the 1998 Comprehensive Reform Program (CRP), which advocated privatization of all SOEs that could be more efficiently run by the private sector. A restatement of the government's SOE ownership and divestiture policy, as stated in the CRP, could be a useful starting point. Reforms should include the removal of civil servants and ministers from SOE boards, a transition that could begin with the elimination of sitting fees and other benefits for civil servants serving on SOE boards. As is the case in any country embarking on SOE reform, success will require strong political will from the highest levels of government.

While laudable progress has been made in opening up some SOE monopolies (e.g., telecommunications) to competition and in privatizing the abattoir, the privatization of other SOEs (e.g., Air Vanuatu) remains highly sensitive. Moreover, attempts by MFEM to strengthen its SOE oversight by preparing the draft Public Enterprise Bill have been obstructed at the political level.

Vanuatu's SOE sector needs wholesale restructuring. The government should establish a new legal framework, reform corporate governance arrangements, and implement the terms of the 1998 Comprehensive Reform Program.

MFEM's original draft of the Public Enterprise Bill was intended to draw on the principles of the New Zealand model used in Fiji and Samoa. The draft bill, however, has undergone substantial revisions as a result of government consultation. The revised draft lacks some essential provisions needed to make it effective, specifically: (i) a requirement that SOEs operate as successful businesses, (ii) a provision requiring directors to be appointed on the basis of professional qualifications and to be clear of conflicts of interest, (iii) restrictions on ministers serving on boards, and (iv) a process for documenting and compensating in full any community service obligations.[13] In its current form, the proposed Public Enterprise Bill

[12] The National Bank of Vanuatu stands out as an exception, largely because its directors are not appointed at the discretion of its responsible minister, but rather are selected based on specific qualifications listed in the founding act.

[13] Community service obligations are noncommercial activities that governments require SOEs to carry out, even though the user charges for these activities typically do not cover their costs.

would only obligate SOEs to submit financial reports to the GBE Unit; it would not address more substantive governance and management weaknesses. In summary, amendments to the current draft[14] of the bill will reduce the accountability of the SOEs. The bill is unlikely to encourage changes in the behavior of the ministers or the SOE boards that would result in an improvement in the performance of the portfolio.

The VCMB has been strongly criticized because its actions have an adverse impact on the industries it regulates.

Given the substantial amount of capital utilized by the SOEs and the low rates of return they generate, it is essential for MFEM to be given the authority and data it needs to perform its oversight role effectively. The government should enact a more robust public enterprise bill that squarely addresses the SOEs' current governance weaknesses, outlines a framework for managing community service obligations, and unambiguously obligates the SOEs to function as successful and efficient businesses. Moreover, given the purely commercial nature of several majority-owned SOEs, the government should prepare as many as possible for divestiture.

B. The Vanuatu Commodities Marketing Board: Constraining the Growth of Agriculture

The Vanuatu Commodities Marketing Board has an adverse impact on the industries it regulates. It should be abolished immediately.

The Vanuatu Commodities Marketing Board (VCMB) was established in 1982, with initial funding from the European Union, to improve the quality of copra and to stabilize copra prices. The first commodity to be controlled was copra, followed by cocoa and kava. The VCMB subsidized prices at levels that were unsustainable; as a result, its resources were exhausted by 1999. At that point, the government transferred kava marketing to the private sector, and then followed by transferring copra and cocoa marketing. Even though these industries prospered under private sector control, they were brought back under the jurisdiction of the VCMB in 2003.

The VCMB has been strongly criticized because its actions have an adverse impact on the industries it regulates. A recent analysis of the VCMB's effect on the copra industry[15] reported on the results of interviews with stakeholders. Overwhelmingly, stakeholders indicated that the VCMB is inefficient and unaccountable, that it imposes a substantial financial burden on the industries it regulates (particularly on small-scale farmers), and that it does not assist in the industries' development. There is also said to be substantial political interference in the VCMB.

The VCMB has not produced audited accounts in 7 years. An incomplete audit in 2007 revealed that the board is insolvent and that it does not have sufficient funds to pay its debts without imposing large additional levies on farmers. The audit also revealed that financial oversight is extremely weak and that a substantial amount of funding from development partners cannot be accounted for.

Further complications are created by government ownership of Vanuatu Coconut Products Limited (VCPL), which is managed by the VCMB. This arrangement leads to numerous

[14] The reviewed draft is dated 2 May 2007.
[15] AusAID. 2007. *Strategic Review of the Coconut Industry and Commodities Marketing in Vanuatu.* Canberra.

conflicts of interest, discourages private production of copra, and lowers the efficiency of an industry that could be making a substantial contribution to Vanuatu's growth. VCMB revenue is used to support VCPL and the activities of its board.

After reviewing the activities of the VCMB and conducting interviews with the private sector, the authors of this report recommend that the VCMB be reformed or abolished as a matter of priority.

C. The Agricultural Development Bank: Risky and Ineffective

The recently formed Agricultural Development Bank poses risks to Vanuatu's financial system. The government should place it under the regulatory authority of the Reserve Bank and consider merging it with the National Bank of Vanuatu.

The Vanuatu Agricultural Development Bank Act of 2006 calls for a government-owned lending institution to be established for the purpose of making loans for agricultural development. The government has provided capital, and the bank has established an office in Port Vila. Initially, it focused on payroll loans, but recently it has started making loans to farmers. There are a number of concerns, however, about the way the bank is regulated and about the banking and agriculture expertise of its staff.

The history of government-owned financial institutions in Vanuatu has not been auspicious. The Development Bank of Vanuatu had to be liquidated in 1998 because of large losses arising from poor lending policies, political interference, and mismanagement. Similarly, the National Bank of Vanuatu (NBV), the government-owned commercial bank, had to be restructured, and a substantial amount of nonperforming assets had to be transferred out of its portfolio. NBV is now under professional management and is performing well.

NBV's return to profitability demonstrates that government ownership is not an automatic barrier to good performance by financial institutions, but history shows that caution is warranted. Experience—in Vanuatu and many other countries around the world—shows that an essential feature of well-run government-owned financial institutions is that they are managed at arms-length by professional bankers. This is not the case for Vanuatu's Agricultural Development Bank. Many of the bank's personnel have limited or no background in banking. They also lack agricultural expertise. Until recently, the Agricultural Development Bank's only current activity was providing payroll loans in Port Vila. It has now commenced making agricultural loans in the provinces, but there are substantial concerns regarding its expertise.

The history of government-owned financial institutions in Vanuatu has not been auspicious.

An additional—and particularly worrisome—concern is that the bank does not fall under the Financial Institutions Act because it was established by a separate act of Parliament. As a result, it is not automatically under the supervision of the Reserve Bank of Vanuatu. Sound principles of regulation suggest that the regulation of banking institutions should be consolidated under one institution. For this reason, and because of the problematic history of government-owned financial institutions in Vanuatu and elsewhere, the Reserve Bank should be appointed as the supervisor of the Agricultural Development Bank. In addition, the government should consider folding the Agricultural Development Bank's mandate into NBV, which is professionally run, and has the nationwide network to oversee agricultural sector loans.

D. Establishing a Framework to Promote Competition

Vanuatu urgently needs a strong competition framework. The government should establish a well-functioning legal framework that promotes competitive behavior, provide consistent regulation of monopolies, and adopt consumer protection legislation.

Competition is the key to an economy that functions effectively. Competition enhances productivity and ensures an efficient allocation of resources. In Vanuatu, as in many other Pacific island countries, government policy does not do a good job of promoting competition. Many vital services are provided by a single firm, either private or publicly owned, often under the umbrella of unregulated monopoly rights granted by the government. In addition, there is very limited protection of consumers' rights. Where there should be competition, there is government intervention.

Vanuatu needs a robust competition framework to ensure that monopoly power is not abused and to promote higher productivity. Competition policy should discourage anticompetitive practices such as price-fixing and the abuse of market power, and should provide legal protection for consumers.

1. Regulation of Monopolies

An effective competition framework must include regulation of monopolies. Even when unregulated monopolies are efficient in keeping costs low, they invariably result in higher prices. This distorts resource allocation and reduces the rate of economic growth. Monopolies at Vanuatu's ports, for example, have led to very high costs and high levels of inefficiency. Effective regulation could limit the high monopoly profits and promote higher productivity, which would help bring down costs and improve efficiency. The monopoly arrangements for water, electricity, and telecommunications in Vanuatu also create enormous problems, as many have recognized. Despite recent advances in telecommunications competition (which have resulted in sharply lower prices), as a general rule, Vanuatu's small size makes monopolistic behavior more easily attainable than in larger countries. One solution might be to use a transparent tendering process modeled on the one organized for the Luganville power concession (Chapter II) to introduce competition into various sectors.

Vanuatu should establish some type of regulatory agency to oversee activities and sectors where there are natural monopolies. This will be challenging, because economically efficient regulation requires substantial technical and accounting expertise. The cost of this expertise is more or less fixed; the same skills are needed to regulate monopolies in high-income countries as in developing countries such as Vanuatu. This fixed cost weighs more heavily on a small economy like Vanuatu than it does on a larger economy like Australia. One sensible way to economize on technical and accounting skills would be to establish a general regulatory board for Vanuatu, charged with regulating multiple industries. Another option would be to adopt some form of regional regulation. Regardless of the regulatory method chosen, the most efficient solution would be to rely—to the extent feasible—on competitive market forces to ensure the lowest possible prices and the greatest efficiency, leaving the regulatory board to focus on key issues in areas where competitive solutions are not possible.

2. The Legal Framework for Competition Policy

Vanuatu does not have an adequate competition law framework. The country needs legislation that would allow for formal reviews of actual or potential monopolistic behavior. The legislation should specify norms; violation of these norms would trigger investigations of potential abuse

of market positions. It should also establish rules and enforcement mechanisms under which a regulatory body would operate. This approach would require distinguishing carefully between traded and nontraded goods: the former are subject to at least the threat of competition from abroad, while the latter are not. The authors of this report suggest that in Vanuatu, competition policy should follow the "rule of reason" approach to evaluating market power. This approach emphasizes the need to have low impediments to trade and investment, which implies low trade and regulatory barriers throughout the economy.

There is very little legislative protection for consumers' rights in Vanuatu. The Sale of Goods Act of 1893 provides some protection, but only covers contracts for the sale of goods; it does not cover services provided to consumers. In many other jurisdictions, legislation specifies fundamental consumer rights and stipulates remedies for cases where consumers have been misled or deceived by commercial practices. As part of a modern competition framework, Vanuatu should adopt and enforce consumer protection legislation.

3. Price Controls and Price-Fixing

While price-fixing is a fundamental concern in a small economy, the price control mechanisms Vanuatu currently has in place may, in fact, discourage growth and investment. The Price Control Act, passed in 1988, establishes a framework for the control of prices. However, it is not specific about the types of goods that may be controlled, leaving wide discretion for the Price Control Bureau, which is charged with administering the Act. The Act also created the Price Advisory Committee, which must be consulted about any proposed legislation that will affect or otherwise control prices. Ultimately, the regulation of prices has the adverse effect of distorting the market, eventually leading to shortages in the supply of goods. For this reason, it would be far more effective for Vanuatu to promote effective market functioning with a system that does not attempt to control prices directly, but does prohibit practices (such as price-fixing) that are anticompetitive and that hinder market development.

The price control mechanisms Vanuatu currently has in place may, in fact, discourage growth and investment.

E. Amendments to the Employment Act: Damaging to the Economy

If the new amendments to the Employment Act become law, they will have a strong negative impact on Vanuatu's economy. They should be repealed.

Amendments to the Employment Act were passed in December 2008. These amendments contain labor provisions that are among the most generous in the world. The revised Act is not yet gazetted, but if the new provisions become law, they will greatly increase the cost of employing workers in an economy where formal employment is still at a premium. They will threaten the existence of many firms, especially small businesses, by giving them substantial additional contingent liabilities in the form of severance payments. New benefits mandated by the amendments will greatly add to the cost of employing workers. The consequences will be far-reaching:

- Unemployment will become widespread.
- Many firms will become bankrupt.
- Women will be excluded from the workforce.
- The economy will lose competitiveness.
- Economic growth will be sharply reduced.
- Labor will be replaced with capital equipment.

Modernizing the Commercial Legal Framework

Vanuatu's commercial legal framework is complex, outdated, and difficult for most users to access. The government should press forward with current efforts to reform this framework.

Vanuatu's legal complexities are at least partly the product of the country's historical development. Both the English and the French have administered Vanuatu; as a consequence, the law—including commercial law—is based on a complicated mix of sources. The evolution of the legal system in the recent past has been driven primarily by acts of Parliament and their associated regulations and, to a lesser extent, by precedents derived from the decisions of courts in Vanuatu. The commercial legal framework is also based on the customary laws of Vanuatu; various British and French laws, including English common law; and the principles of equity,[16] which will continue until repealed by the Vanuatu Parliament.

The country's commercial legal framework is currently undergoing reform with ADB support, primarily at the behest of the Vanuatu Financial Services Commission (VFSC). Several panels of local and international experts have been established to review legislation and recommend changes to specific aspects of the legal framework. More must be done, however, if commercial laws are to be effective and if they are to support private sector development. Vanuatu needs to remove uncertainty and gaps from the legal framework. For example, government departments should exercise a minimal amount of discretionary power when applying rules.

This chapter discusses major weaknesses in the commercial legal framework, and presents recommendations for reform. Key constraints exist in the following areas:

- **Starting and running companies.** Provisions in the existing Companies Act make it difficult and costly to establish and operate a company.
- **Closing down companies.** An outdated and overly complex corporate bankruptcy regime makes it difficult to wind up an insolvent company.
- **Operating trusts.** The current legal framework for trusts does not fully protect the rights of beneficiaries.
- **Using and enforcing contracts.** The laws governing contracting do not provide a robust framework for entering into contracts, settling contract disputes, or enforcing contracts.
- **Complying with burdensome regulations.** Regulations for starting and running businesses are burdensome and involve substantial duplication of effort, which leads to delays and raises costs.
- **Accessing information about the legal system.** The only complete, reliable source of information about Vanuatu's legal system—a regional online database—is not being kept up-to-date with recent reforms.

[16] Equity is the name given to a set of legal principles that supplements strict rules of common law in jurisdictions following the English common law tradition. These principles are applied in situations where the pure application of common law rules would result in an unjust or unfair result. An important distinction between the law and equity is the set of remedies each offers: the common law remedy is monetary damages, while equity enters injunctions directing someone either to act or to forbear from acting, as well as orders for specific performance of obligations. Often this form of relief is, in practical terms, more valuable to a litigant. For example, a plaintiff whose neighbor will not return his only milk cow, which had wandered onto the neighbor's property, may want that particular cow back, and not just its monetary value.

A. The Legal Framework for Companies

Provisions in the current Companies Act effectively limit growth. Bold reforms are needed to make Vanuatu more business-friendly.

A number of legal structures are available to businesses in Vanuatu. The "sole trader"[17] is the most commonly used structure, because it is convenient and accessible, and because it meets the primary needs of small businesses (which predominate in Vanuatu). Sole traders face very few legal formalities; they need only meet the requirements of the Business Names Act of 1990 and the Business License Act of 1998.

In countries with well-developed legal frameworks, the sole trader—which has no existence separate from its owner—often evolves into a limited liability company. In Vanuatu, however, this is not a common practice because incorporating a company under the existing Companies Act remains protracted and expensive. The transformation from sole trader to company should be a simple, effective procedure. Vanuatu should promote this process.

Companies established by local and offshore international investors are formed under different acts and are subject to different rules. The Companies Act (Cap 191) applies to all local companies. It was revised and consolidated in 1988, with subsequent minor amendments. Despite its nominal modernity, the Act is based on the 1948 United Kingdom (UK) Companies Act and contains a number of provisions that compel businesses to meet outdated requirements. None of the amendments to this Act have succeeded in eradicating provisions that are cumbersome and costly for businesses. In short, the Act is not conducive to the development of a modern commercial company base. A further constraint is that the administrative procedures associated with the provisions of the Companies Act are not applied consistently. The extent of this administrative discretion deters sole traders from incorporating, preventing them from gaining the advantages of assuming the legal identity of a company.

Administrative discretion deters sole traders from incorporating, preventing them from gaining the advantages of assuming the legal identity of a company.

A panel of experts is currently reviewing the Companies Act. In July 2008, the panel distributed a discussion paper outlining options for reform; feedback has been collected and considered. The panel circulated an exposure draft to all stakeholders, enabling them to comment before the bill is finalized and enacted by Parliament. The government will submit the bill to Parliament in 2009. The proposed Companies Bill represents a bold reform effort that will make Vanuatu more business-friendly. It should be passed as soon as feasible. It will introduce a modern commercial framework that will encourage businesses to form companies rather than operate as sole traders.

To be effective, the new Companies Act will need to

- introduce a simplified incorporation process devoid of administrative discretion to ensure that companies can be formed quickly and without great expense;

[17] A sole trader, also known as a sole proprietor, is a type of business entity that legally has no separate existence from its owner. Hence, the limitations of liability enjoyed by a company or a limited liability partnership do not apply to a sole trader. All debts of the business are debts of the owner.

- introduce an appropriate and graduated disclosure regime that is consistent with regional and international best practices;
- codify directors' duties to assist directors and ensure greater accountability;
- remove the compulsory audit requirement for private companies;[18]
- introduce a solvency test to replace the current complex provisions relating to capital maintenance and distributions to shareholders; and
- provide an appropriate framework for shareholders' rights.

These proposed reforms will improve the cost and viability of the company as a business structure and legal entity in Vanuatu.

Like much legislation governing commercial dealings in Vanuatu, the bankruptcy regime is overly complex and outdated.

B. Bankruptcy and Insolvency: Costly and Difficult

Vanuatu's bankruptcy regime is complex and outdated. The government should adopt a modern, simple approach that will provide workable options for insolvent companies, establish legal safeguards for creditors, and allow bankrupt individuals to start again.

In addition to the challenges faced in starting and running a company in Vanuatu, it is also difficult and costly to close down an insolvent company. Like much legislation governing commercial dealings in Vanuatu, the bankruptcy regime is overly complex and outdated. It relies on archaic English legislation, although in theory, Vanuatu's constitution also allows French insolvency laws to be used. In practice, however, it is unclear how the French laws apply, which creates further uncertainty. A new approach is needed if Vanuatu's commercial sector is to develop. A modern and effective commercial legal framework should support a simple approach to bankruptcy: it should provide workable options for insolvent companies to wind up, establish legal safeguards for creditors, and allow bankrupt individuals to discharge their debts and start again.

A specialized panel of experts is currently reviewing Vanuatu's bankruptcy regime. The panel distributed a discussion paper to stakeholders; an exposure draft is being finalized for circulation. In 2009, the government is scheduled to present a new bankruptcy bill to Parliament. The bill will introduce streamlined processes and procedures for personal bankruptcy and will establish a system for winding up companies that is simple, cost-effective, and easy to administer. The new bankruptcy system will also provide maximum returns to shareholders and creditors, and will facilitate international cooperation to address cross-border insolvency, thus making it easier for foreign creditors to enforce their rights. It represents a major advance in removing the uncertainty of Vanuatu's current bankruptcy regime, replacing it with a system that will meet the country's current and future needs.

C. The Legal Framework for Trusts

Vanuatu's legal framework for trusts does not fully protect the rights of beneficiaries. It should be reformed.

Trusts, particularly discretionary trusts, are widely used in Vanuatu, but the legal system does not fully protect the rights of beneficiaries.

[18] This requirement does nothing more than raise the cost of operating formal companies in Vanuatu. It provides a strong disincentive for sole traders to incorporate. The authors of this report strongly support removing this requirement.

Currently, this area of law—which is governed by the UK Trustee Act of 1925—relies on outdated legislation that does not reflect international best practices. While the law nominally regulates the obligations of trustees who hold and manage property for beneficiaries, in practice, trustees often fail to fulfill these obligations, harming the interests of the beneficiaries.

Vanuatu's trust legislation should be amended to incorporate the international best practices that underpin the operation of trusts in advanced economies. An expert panel has commenced a review of the current Trustee Act, and is preparing and circulating a draft bill for consideration in late 2009. The law should reflect recent major advances in trust law—it should include clear directions and controls for professional trustees and provide a statement of trustees' duties that mirrors the complex nature of modern business and investment. Ultimately, Vanuatu's trust framework should enhance beneficiaries' ability to monitor and influence trustees' decisions.

D. Laws Governing Contracting: Complex and Expensive to Use

Laws governing contracting are inaccessible, complicated, and not relevant to the private sector. Vanuatu should establish a clear and consistent legal framework for using contracts, settling contract disputes, and enforcing contracts.

There is very little local, or "tailored" contract law in Vanuatu, and the legislation underpinning the contract law framework does not provide a robust legal environment for entering and enforcing contracts. Instead, as in the case of most other laws affecting business in Vanuatu, contract law is based on outdated and inaccessible rules. The problems are further compounded by delays in the execution of judgment orders in contract dispute cases; these delays add to the cost of doing business.

To operate effectively, the private sector needs reliable contract laws. Clear and consistent laws ensure that business contracts are enforced. This reduces uncertainty for entrepreneurs and investors entering into business relationships, thus encouraging new business ventures and investment. A modern statement of rules would make contracting simpler, encourage people to use contracts as a business tool, and enable contractual arrangements to be enforced rapidly. Such a statement would also have the potential to assist in the resolution of disputes. In the event of a breach of contract and judgment, enforcement should occur quickly to minimize or eliminate unnecessary expenses. Vanuatu's private sector would use contracts more widely if the country had modern laws governing the use and enforcement of contracts—the country should address this issue in the medium term.

The contract law framework does not provide a robust legal environment for contracting and enforcing contracts.

There has been little attempt to codify Vanuatu's common law rules governing contracts. The only legislation codifying current contract rules is the UK Misrepresentation Act of 1967, which is outdated and inadequate. Much of the law governing contracts in Vanuatu, as in other British Commonwealth jurisdictions, relies on antiquated UK court judgments that are difficult to understand and to access. Key legislation is from the 19th century. The Sale of Goods Act, for example, dates from 1893, and the Factors Act, which deals with various aspects of mercantile agents, dates from 1889. Clearly, this outdated legislation is not conducive to modern business practices.

Internationally, there has been a sharp increase in the use of alternative dispute resolution (ADR) mechanisms such as mediation, negotiation, and arbitration. These alternative methods offer many advantages over the traditional court resolution process. They provide parties with more options, allow the parties to decide who will mediate disputes, offer greater flexibility, and have much lower costs than court processes. Evidence suggests that adopting an ADR model increases the overall use of commercial contracts and improves enforcement.

Local and international investors seeking regulatory approval to open and operate companies in Vanuatu must comply with unnecessarily burdensome regulations.

The adoption of an ADR model, however, requires sound legislative underpinning. This can be achieved by codifying the rules that govern the formation of contracts and by adopting an arbitration act that provides a framework for arbitration procedures and clearly specifies the legal status of arbitral awards. The countries that operate the most effective arbitration systems ensure that arbitral awards are binding between the parties with limited or no recourse to the courts and that the enforcement of arbitral judgments does not involve any further substantive hearings on the matter. In addition, these laws provide for foreign arbitral awards to be enforced within the country. In the medium term, as part of its review of the contract framework, Vanuatu should make it a priority to adopt this type of arbitration legislation.

E. Burdensome Regulations: An Obstacle to Investment

Unnecessarily burdensome regulations pose an obstacle to investment in Vanuatu. The government should streamline regulatory procedures for investors seeking to start and operate businesses.

Local and international investors seeking regulatory approval to open and operate companies in Vanuatu must comply with unnecessarily burdensome regulations. Substantial duplication of effort is required, which leads to delays and raises costs significantly.

Local investors starting businesses in Vanuatu must deal with several government departments, and are often required to visit the same department several times. The country has not yet made efforts to consolidate these procedures, although current efforts to reform the Companies Act will help reduce delays and costs. ADB and the World Bank are cooperating to assist the government in establishing new procedures for local investors starting companies.

Foreign investors also face obstacles when applying to establish businesses in Vanuatu. Foreign investment is regulated under the Foreign Investment Act of 1998, which provides a framework for all international investors establishing companies that operate in Vanuatu. The Act allows foreign investors to launch new businesses and purchase existing businesses; it provides an effective and transparent system for assessing and approving foreign investors' applications. While the Act has improved application procedures, in practice, there are still significant duplications in the approval process. These duplications should be eradicated.

A 2001 amendment to the Foreign Investment Act established the Vanuatu Investment Promotion Authority (VIPA). VIPA's role includes approving investment applications and

monitoring the activities of foreign investors. The Foreign Investment Act also gives VIPA a substantial regulatory role—this regulatory role hinders the authority's effectiveness in promoting Vanuatu as a place to invest. The government appears to focus more on business regulation than business promotion. Foreign investors are often frustrated by the cost and time it takes to obtain government approvals to establish and run businesses. Interviews with stakeholders identified a significant number of potential investors who became discouraged and decided to invest elsewhere. Vanuatu should enact regulatory reforms to ensure that the documents supplied to VIPA are sufficient to determine approval or disapproval of an application. The same information should not be required by other agencies, since duplication slows the approval process, frustrating or even deterring foreign investors from establishing businesses in Vanuatu. The government is working with the International Finance Corporation to streamline the processing of investment applications and to rationalize regulatory requirements.

F. Access to Information About the Legal System

The only complete, reliable source of information about Vanuatu's legal system—a regional online database—needs to be kept up-to-date with recent legal reforms.

It is difficult for the private sector to access information about Vanuatu's legal system. Currently, the most important legal information resource is an online service provided by the Pacific Islands Legal Information Institute (PacLii). This website acts as a database for all current laws in Pacific island countries; it includes legislation, court judgments, and other related resources. While there are other websites that provide some legal information, none of them are comprehensive. The advantage of the PacLii service is that it stores all the information in one place. It is also the only reliable source of legal information for users not based in Vanuatu.

If the PacLii service is to succeed, laws must be posted as soon as they are passed by Parliament, and court judgments must be posted with expediency. Delays in posting information create uncertainty about the service's reliability and relevance. This uncertainty has a negative impact on the private sector, because investors, businesspeople, judges, and policymakers need ongoing, up-to-date legal information, and they depend on PacLii to provide it.

The authors of this report recommend strongly that the government release the compilation of laws to PacLii as soon as possible.

Vanuatu recently completed a full compilation of existing laws, including laws related to the commercial sector. To date, however, this compilation has not been posted on the PacLii website. The authors of this report recommend strongly that the government release the compilation to PacLii as soon as possible, to ensure that the site remains current and that all users have access to a full range of legal information.

V Expanding Access to Finance

To support new investment and keep the economy growing, Vanuatu's financial sector needs to expand access to credit and financial services.

Financial markets in Vanuatu are dominated by commercial banks, although there are also some small finance companies. There are four commercial banks. Three of them—ANZ, Westpac, and BRED—are foreign owned, and one—the National Bank of Vanuatu—is currently owned by the government. BRED, which is owned by a French holding company, is the most recent entrant, having been established in 2007. As pointed out in Chapter III, the government has also established the Agricultural Development Bank. In addition, there are some smaller institutions, such as VANWODS, that provide microfinance and other services.

There are some significant financial sector constraints to private sector development in Vanuatu, but there are also some promising initiatives and reforms underway. This chapter focuses on:

- **Accessing credit.** Although access to credit in Vanuatu is strong, lending is too focused on property and construction. An additional problem is that non-property related lending is directed primarily at large firms, while smaller firms struggle to find financing.
- **Reducing the high cost of borrowing.** Interest rates remain high on lending for business activities and consumer loans, but are expected to decline as new reforms take effect.
- **Expanding access to financial services.** NBV is pioneering microfinance and smart banking initiatives that could significantly expand access to financial services among previously unreached populations.
- **Reforming the personal property securities framework.** Parliament recently passed the new Personal Property Securities Act, which will improve borrowers' ability to pledge movable assets as collateral, thereby reducing the risks of lending.
- **Revisiting the Offshore Finance Centre.** Although it still generates a significant amount of revenue, the Offshore Finance Centre's economic impact is declining. Without substantial restructuring, its future is uncertain at best.
- **Preparing for the impact of the international financial crisis.** Vanuatu is not likely to remain untouched by the crisis, which could affect the value of offshore funds, revenues from remittances and tourism, and bank assets.

A. Access to Credit

Business lending in Vanuatu is too heavily focused on property and construction, and large companies' credit needs are met at the expense of small businesses.

The ratio of private sector credit to GDP in Vanuatu is approximately 50%. This ratio is one of the highest in Pacific island countries, and it compares well with other countries at Vanuatu's stage of development. In 2008, credit to the private sector expanded extremely rapidly, rising by about 40%. However, these data hide the impact of a small number of large transactions on private sector credit. In particular, a large loan to UNELCO in 2008 raised the overall expansion of credit substantially, which explains the fact that even though the ratio of private sector credit to GDP was rising rapidly, many businesses reported difficulty in obtaining loans. As a result of this large transaction and the

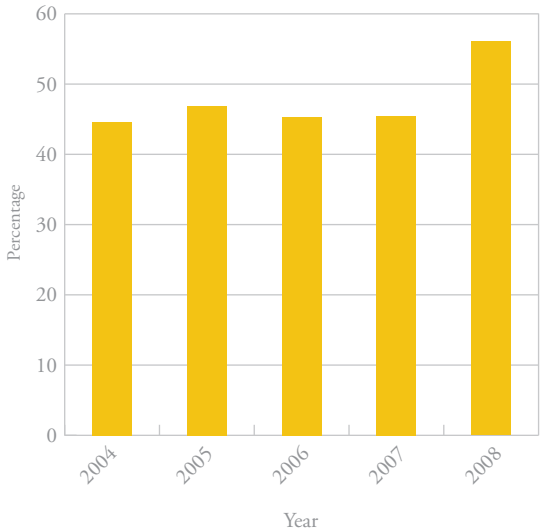
continued property and construction boom, and because a large proportion of cash is being held outside the formal banking sector, the liquidity position of the banking system is very tight. The Reserve Bank has reduced statutory reserve requirements to provide additional liquidity to the banks.

Over the past few years, credit expansion has focused primarily on property and construction. Lending to the construction industry currently constitutes about one third of total lending to the private sector (excluding mortgages). In 2003, only 16% of lending was for housing and land; by 2007, this figure had risen to over 30% of total private sector credit.

By contrast, lending for business activities not related to property and construction declined in relative terms during the last 4 years for which figures are available. Between 2003 and 2007, total private sector lending rose by 60%. If credit for property and construction is excluded, however, this figure is only 28%. These statistics confirm findings from interviews with the private sector—that the availability of non-property related business lending is still limited.

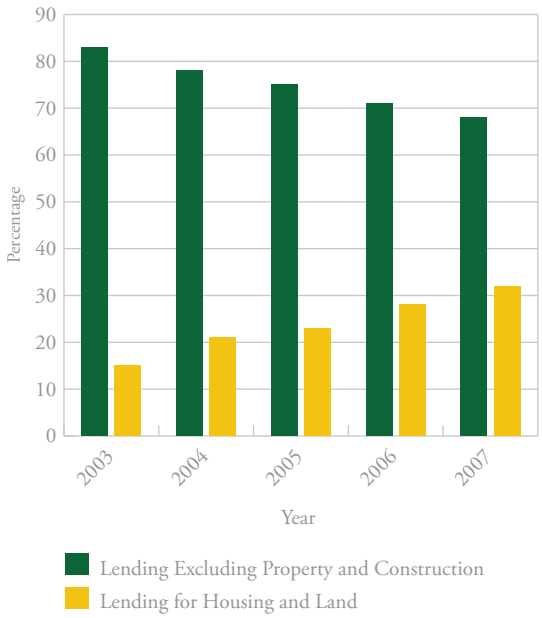
In light of recent developments in property markets around the world, the focus of Vanuatu's bank lending on property is of concern. Essentially, the rate of expansion for non-property related lending is much slower than the rate of expansion of nominal GDP. This trend implies that the bulk of GDP growth is occurring as a result of activities related to the property market. In addition, non-property related lending is primarily directed at large firms; smaller firms are struggling to find financing.

Figure 11: Domestic Credit to the Private Sector (% of GDP)



GDP = gross domestic product.
Source: World Bank.

Figure 12: Property and Non-Property Lending (% of Total)



Source: Reserve Bank of Vanuatu Quarterly Bulletin.

B. The High Cost of Borrowing

Interest rates remain high on lending for business activities and consumer loans, but are likely to decline as new reforms take effect.

Over the past 4 years, lending rates have declined gradually, as have spreads. The weighted average deposit rate offered by commercial banks is approximately 2% per year, but for fixed-term deposits, it is over 4%. Although the weighted average lending rate in Vanuatu is only about 10%, it is heavily influenced by the preponderance of housing loans. During 2008, interest rates on mortgages ranged from 7% to 10%. Interest rates for business and consumer loans were substantially higher, averaging 18% or more. In the first quarter of 2009, there was further upward pressure on lending rates. The Vanuatu National Provident Fund, which in the past placed most of its surplus funds with the banks, began investing directly in construction and other projects. As a result, it has had fewer funds to place with the banks, which has led to higher lending rates to businesses and consumers.

The National Bank of Vanuatu is pioneering a microfinance initiative that is proving to be successful at a number of different levels.

Interest rates contain a significant risk component because of the problems in Vanuatu of pledging movable assets and recovering them in the event of default. Over time, the implementation of the new Personal Property Securities Act (described in Section D of this chapter) should result in a decline of the interest rates charged on business borrowing.

C. Financial Services: Expanding Access

Large portions of Vanuatu's population, particularly in rural areas, have not traditionally had access to financial services. Two new National Bank of Vanuatu initiatives have the potential to change that.

1. Microfinance: A Pioneering Initiative

The National Bank of Vanuatu is pioneering a microfinance initiative that is proving to be successful on a number of different levels: it is providing greater access to financial services in a number of islands, paving the way for other new financial instruments, and is expected to have a strongly positive impact on financial sector development in both rural and urban areas. Following a pilot activity in Tanna, the microfinance initiative has been expanded to reach other islands. ADB provided support for both the pilot program and the expansion efforts.

The microfinance initiative does not require formal collateral, but it does provide strong incentives for repayment. After a borrower has applied to the bank for a loan under the program, and once a loan officer has approved the application, the borrower's chief confirms and endorses a list of collateral offered by the borrower. If the borrower does not repay the loan, the chief makes every effort to repossess the collateral. In addition, the chief acknowledges that NBV will not lend to other people in the village, thus creating community pressure for repayment.

To date, with a default rate close to zero, this initiative has delivered nearly $5 million in credit to people who previously had no access to credit. It has reached a broad spectrum of the population—borrowers range from small farmers to craftspeople to traders. It has also extended the credit chain, providing previously disadvantaged groups with access to credit. With the benefit of microfinance loans, for example, traders have been able to extend credit to their customers, many of whom are women.

The success of NBV's microfinance program illustrates the feasibility of creating other instruments to increase the funds available for microfinance. While the current world financial crisis illustrates some of the dangers of securitization, the vast majority of securitized instruments in most countries around the world are financially sound. If carefully structured—and once the personal property securities framework is fully in place in Vanuatu—microfinance loans could be securitized. NBV could, for example, issue securities backed by the loans of its microfinance program, which would enable it to move these loans off its balance sheet and attract additional liquidity.

Some other smaller institutions such as VANWODS have achieved substantial success in providing micro loans and other services in recent years. They have begun to intermediate deposits and increasingly provide sophisticated lending products. However, as deposit taking institutions, these organizations should come under the regulatory mandate of the Reserve Bank.

2. Smart Banking: Bringing Finance to Rural Areas

Following the success of the Tanna microfinance pilot, NBV is planning to introduce an innovative smart banking initiative in several islands. This program will establish smart cards that will allow local agencies to make electronic payments and collect deposits. For example, it will enable teachers to receive their salaries electronically, rather than making expensive and time-consuming trips to the nearest NBV branch to collect their pay. The introduction of smart card technology in rural areas could bring financial services to a significant portion of the population that previously had no access to such services.

In addition, because it is expected to lead to a greater number of transactions, smart banking technology has the potential to have a positive impact on the profitability of NBV's branches.

NBV is the only financial institution in Vanuatu with the capacity to bring financial services to a substantial portion of the population. It has 21 branches, 19 of which are in rural areas. Many of the rural branches are operated as a community service, since their revenues do not cover their costs. Rural branches will act as hubs for smart banking. By providing services through subagents—such as local trading stores, schools, and post offices—the program will further increase to financial services. The smart banking initiative also has the potential to improve financial intermediation at the local level: as the level of funds deposited increases, NBV's branches can recirculate the funds by making more microfinance loans.

The introduction of smart card technology in rural areas could bring financial services to a significant portion of the population that previously had no access to such services.

D. The Personal Property Securities Framework: The Benefits of Reform

The recently passed Personal Property Securities Act will increase access to finance. By allowing borrowers to pledge movable property as collateral, the Act will reduce lenders' risks, especially the risks of lending to small businesses.

Vanuatu has enacted a new Personal Property Securities Act (PPSA). The PPSA replaces legal forms such as company charges with an approach to commercial transactions that creates a property right called a security interest, which may attach to personal property regardless of the form of the transaction (e.g., pledge, assignment,

Box 2: What is a Security Interest?

The Personal Property Securities Act allows a security interest to cover collateral that

- is tangible or intangible, presently owned by the debtor or acquired in the future;
- changes over time, as in the case of inventory and receivables of a merchant or the materials used in a manufacturing process;
- includes products of the original property, as in the case of the offspring of livestock;
- arises from immovable property such as crops or minerals; and
- includes the proceeds of the collateral, such as accounts created from the sale of inventory, cash paid on account, insurance payments, or replacement of the original collateral by like items.

or chattel mortgage). The PPSA calls for an electronic filing archive, known as the personal property securities registry (PPSR), to be created. The purpose of the PPSR is to provide a notice of security interests and establish the priority of each security interest to the collateral in question. In the event of default, this registry will provide essential information about who has the right to repossess and sell the property that has been pledged as collateral. At the time this report was prepared, the registry had not yet been installed, even though in principle the PPSA requires all new registrations of security interests to be recorded in it. Work on installing the registry is proceeding rapidly, however.

Once the personal property securities framework is in place, it needs to be publicized so that potential users will be aware of its new features.

The PPSA significantly streamlines the process of repossession. The person or company to whom collateral has been pledged can seize the property and dispose of it in a manner that maximizes proceeds, without having to go through the courts. The amount realized through the disposal is then used to offset the debt, with the balance returned to the borrower or to other secured creditors.

Once the personal property securities framework is in place, it needs to be publicized so that potential users will be aware of its new features. In particular, the Vanuatu Financial Services Commission (VFSC) should

- launch a public information campaign, preferably through the Chamber of Commerce, to educate potential entrepreneurs about the new Act and the registry; and
- conduct outreach to potential offshore creditors such as suppliers, credit sellers, and companies dealing with Vanuatu's exports and imports. These stakeholders will have strong incentives to use the law, but may not learn of the recent changes unless there is targeted outreach.

The VFSC should also establish forums to gather feedback from users of the PPSR on how the new framework is functioning in general and on their experiences using the electronic registry in particular. The authors of this report strongly recommend that, toward the end of 2009, the VFSC lead a team in conducting a further review of the functioning of the PPSA, to ensure that it is working effectively. The review should address the following outstanding issues: (i) expanding the PPSR to include notices of tax liens, judgments, personal bankruptcies, and corporate insolvencies; and (ii) prioritizing tax liens, judgments, bankruptcy, and insolvency with secured creditor rights by using the standard first-to-file rule.

E. Looking for a New Role: The Offshore Finance Centre

Vanuatu's Offshore Finance Centre generates a significant amount of revenue, but its economic impact is declining. Without substantial restructuring, its future is uncertain.

The Offshore Finance Centre currently focuses on serving international companies incorporated under Vanuatu's 1992 International Companies Act. These companies, which are not permitted to conduct business locally, form the majority of international companies currently registered in Vanuatu. In contrast to the existing domestic Companies Act, the International Companies Act supports a more modern approach to incorporation and regulation. International companies may be formed quickly and are required to meet a minimum of requirements. The Act contains much less onerous reporting requirements, as well as a solvency test regime.

The VFSC supervises the Offshore Finance Centre. In addition to ensuring compliance with the international company framework, the VFSC is responsible for administering various other statutes, including the Trust Companies Act (Cap 69), the Prevention of Frauds Act (Cap 70), the Mutual Funds Act of 2005, the Unit Trusts Act of 2005, and the Insurance Act of 2005. The VFSC also administers the Protected Cell Companies Act of 2005, which provides for the incorporation and regulation of protected cell companies. The VFSC is currently drafting a foundations bill and is in the final stages of drafting a company trust and service providers bill. The latter will follow the international standards adopted by the Offshore Group of Banking Supervisors, of which Vanuatu is a member. There have been a number of legislative initiatives undertaken in this area recently; various new bills are being introduced and several more are planned.

While a significant amount of revenue is still earned from the Offshore Finance Centre, its importance as a percentage of GDP is falling. This decline is likely to continue. The value of offshore centers such as Vanuatu's is diminished by the international financial community's concerns that these centers are tax havens or possible repositories of illegal funds. Furthermore, recent investigations and arrests of participants in the Vanuatu center will almost certainly have a discouraging effect on its future growth, regardless of the merits of the ongoing cases. Given the determination of many high-income countries to close down tax havens, the future of the Offshore Finance Centre is at best uncertain, unless there is substantial restructuring.

The value of offshore centers such as Vanuatu's is diminished by the international financial community's concerns that these centers are tax havens or possible repositories of illegal funds.

F. The International Financial Crisis: Could It Reach Vanuatu?

Vanuatu is not likely to remain untouched by the international financial crisis.

The financial crisis that was triggered by the collapse of the subprime mortgage market in the United States has roiled financial markets around the world. Stock markets have fallen dramatically, as have property values in many countries. There are concerns in Pacific island countries that the effects of the financial crisis could spill over into the region. Certainly, the offshore investments held by superannuation and trust funds in Pacific island countries have

lost value. Remittances and tourism revenues are likely to fall as well, as economic activity declines in Australia, New Zealand, and the United States. Declining tourism revenues, along with shrinking revenues from remittances, could have an adverse impact on Vanuatu's economy. To date, however, Vanuatu's tourism industry continues to perform well. Air passenger arrivals in January 2009 were 28% above those of January 2008.

Despite the crisis, however, the banking systems in most Pacific island countries appear to be sound. In Vanuatu, prudential regulation has been effective. The country's banks have strong ratings and do not appear to be under the type of threat that has led to the bankruptcy of financial institutions in developed countries. Vanuatu may well suffer indirectly, however, as the crisis drives many high-income countries into recession. As pointed out earlier, the country's financial system has lent heavily for property purchases and construction. If the property market declines in conjunction with similar declines in Australia and New Zealand, Vanuatu's banks could find themselves holding substantial amounts of illiquid assets.

Reforming the Land Leasing System

VI

Vanuatu's current system for leasing land is not effective. Growing tension over land lease issues is causing conflict and threatening future investment and growth. The need for reforms is pressing.

This chapter focuses on the importance of improving Vanuatu's land leasing system to make property rights in land more secure, both for customary landowners and for those leasing land. This issue is growing in importance. Although a significant amount of land has been leased over the past decade, customary landowners increasingly resent not sharing the large profits that lessees have realized as a result of the property boom in Vanuatu.

Construction and property development have made significant contributions to Vanuatu's growth, and commercial banks hold a major portion of their assets in mortgages on land leases and property. It is therefore essential that land ownership and land leases not be subject to dispute and dissatisfaction. No country has managed to achieve sustained prosperity without stable and clearly defined property rights in land. Societies with secure fixed property rights and widespread land ownership tend to have both greater prosperity and a more equitable distribution of income and wealth. In Vanuatu, this issue is becoming increasingly contentious as customary landowners express their dissatisfaction with current arrangements.

Resolving sensitive issues related to land ownership and lease arrangements in Vanuatu will be neither easy nor rapid. In all countries, developing a system of fixed property rights takes time and extended negotiation. Despite the challenges, there are many benefits to making the system just and predictable, and to ensuring that costs are low for establishing ownership or entering into leases. A strong system of fixed property rights will

- ensure secure ownership and property rights that are predictable and enforceable;
- support property transactions;
- allow property to be mortgaged; and
- enable mortgages to become financial instruments, which will promote financial market development.

Construction and property development have made significant contributions to Vanuatu's growth, and commercial banks hold a major portion of their assets in mortgages on land leases and property.

Land issues in Vanuatu, as in other Pacific island countries, are especially difficult to deal with because land is not only communally held, but is also closely related to identity.[19] AusAID is currently engaged in a long-term land administration project, which should improve land records and recording of land transactions. Nevertheless, Vanuatu should not

[19] This feeling is encapsulated in the phrase "when you look at the person you see the land; when you look at the land you see the person."

delay in tackling contentious issues related to land leases. Unless these problems are solved, the country's long-term prosperity will be compromised. The guiding principles for any changes in land policy should be developed by the ni-Vanuatu themselves. Regardless of how the system evolves, however, it is important that predictability and certainty be attached to land holdings, land leases, and land investment.

After a brief description of the structure of land ownership in Vanuatu, this chapter analyzes the current land-related issues facing landowners, investors, and policymakers. It discusses problems in the following areas:

The guiding principles for any changes in land policy should be developed by the ni-Vanuatu themselves. Regardless of how the system evolves, however, it is important that predictability and certainty be attached to land holdings, land leases, and land investment.

- **Determining land ownership and resolving disputes.** Substantial uncertainties exist about the rightful ownership of customary land.
- **Leasing and the protection of landowners' rights.** Land leasing has arisen as a major area of controversy, in part because customary landowners' rights are not always well-protected under the current system.
- **Reducing high transactions costs for leasing.** High transactions costs and delays in leasing land pose a major obstacle to investment.
- **Improving land administration.** Land records are difficult to access and are often unclear about the status of rightful ownership.
- **Addressing the future.** Although the 2006 National Land Summit served as a first step in reforming Vanuatu's system of fixed property rights in land, many of its resolutions have not yet been implemented. Much remains to be done.

A. The Structure of Land Ownership

Land is held under customary ownership laws, which regulate all transactions related to land owned by ni-Vanuatu.

In Vanuatu, land has traditionally served as a source of subsistence, a source of power and status, and a source of identity and culture. The traditional land tenure system has ensured that all family and clan members have had access to land; it is consistent with the country's strong kinship bonds and with customs that encourage traditional sharing of economic wealth. This communal approach has allowed Vanuatu society to avoid deep poverty by providing an informal social support network. Nevertheless, the pressures of development and the growing desire of the ni-Vanuatu to participate in the country's market economy have led to radical changes in patterns of landholding in some parts of the country, particularly Efate.

Only ni-Vanuatu and the government can own land legally. Government holdings are small, representing only about 2% of total land area—the balance is held under customary title. Customary law regulates all transactions relating to land owned by ni-Vanuatu, including how land may be sold, exchanged, licensed to others, and inherited.

To use customary land for its own purposes, the government typically negotiates leases with customary landowners. The government has, however, voluntarily or compulsorily

acquired land from customary owners to use for infrastructure, including roads and airports, and to use for other government needs (such as offices) in Port Vila and Luganville.

B. Problems Related to Land Ownership

Substantial uncertainties exist about the rightful ownership of customary land, including competing and overlapping claims for land holdings.

1. Disputes About Land Ownership

Under customary law, disputes about the ownership of land are settled by the chiefs of the locality in which the land is situated, often advised by senior members of the village. If the land under dispute straddles more than one village, the chiefs of all the villages are involved. If the land is large in area or importance, other chiefs may also participate in the decision making. Although customary law does not have a formal system for appeals, if the land under dispute is important or heavily contested, the parties or chiefs may take the issue to more influential chiefs in the area of the island where the land is situated, who will judge the merits of the case again.

After Vanuatu's independence, legislation allowed disputes about the ownership of customary land to be determined by island courts, with appeals to the Supreme Court. The courts were deluged with such disputes, leading the Chief Justice to announce that the Supreme Court would not accept any more land appeals. An alternative had to be found. In 2001, Parliament passed the Customary Land Tribunal Act, which provides a formal structure for resolving land disputes. This formal structure exists within the framework of customary law—it is an alternative, but not a substitute for the customary system for resolving land disputes.

Under the Act, village chiefs are authorized to appoint tribunals to adjudicate disputes about ownership and land boundaries. Members of the tribunals are required to be knowledgeable about the customs of the area and independent of the parties to the dispute. The Act specifies two levels of appeal: (i) the decisions of the village tribunal can be appealed to a tribunal appointed by the council of chiefs in the area in which the land is situated, and (ii) a final appeal can be brought before a tribunal appointed by the island council of chiefs. Although this system functions effectively in some areas of the country, a number of problems have arisen: adjudicators are often not independent, it is difficult to enforce decisions, and many stakeholders do not understand the procedures involved.

In 2001, Parliament passed the Customary Land Tribunal Act, which provides a formal structure for resolving land disputes.

There are competing and overlapping claims for land holdings. Resolution of ownership disputes is difficult, in part because there is no statute of limitations on claims to ownership. In other parts of the world, successful resolution of land ownership claims almost always involves a cut-off point after which ownership cannot be challenged.[20] Until this problem is solved in Vanuatu, uncertainty about land ownership will continue.

2. Leasing When Ownership is Uncertain

There are instances in which people purporting to be the rightful customary owners lease land, even though there are other claimants. These

[20] In countries where a Torrens system is in force, the government provides compensation to owners who can prove ownership rights that were not uncovered before the cut-off date (if the original disposition of the property proves to have been incorrect).

additional claimants sometimes subsequently dispute leases that have already been signed. These cases can take years to resolve through the courts. Further confusion in the land leasing framework arises because, if ownership of the land is in dispute before the lease is signed, the Minister of Lands has the legal power to grant leases by ministerial edict. Since a significant portion of the land investors want to lease is in dispute (or becomes in dispute), there have been many cases where the minister has signed leases for land without the owners having had an opportunity to discuss or agree to the lease. The rent monies from such land are to be held in trust until the true owners are determined, but so far the disputes about land ownership have been so intense and protracted that resolution has rarely been reached.

Since a significant portion of the land investors want to lease is in dispute (or becomes in dispute), there have been many cases where the minister has signed leases for land without the owners having had an opportunity to discuss or agree to the lease.

To help solve this problem, the government should establish a registry of customary owners who wish to lease their land. To ensure that those wishing to lease are the rightful owners, there should also be an extensive publicity campaign (which would include radio and on-site notifications) to inform all potential owners that the property in question is being claimed. The government should place strict limits (perhaps 12 months) on the time period during which potential owners can come forward with claims. At the end of this period, the land tribunals should make a ruling about the land's rightful owner. This ownership should then be registered, following the principles of a Torrens system.

C. Leasing: The Rights of Customary Landowners

Land leasing has arisen as a major area of controversy. Changes are needed to allow both owners and lessees to benefit from successful land leasing.

Under the terms of the Land Leases Act (Cap 163), customary landowners have the right to lease land to foreigners with the approval of the government. Lease arrangements, however, often do not adequately protect the rights of customary landowners. Steps need to be taken to address problems in a number of key areas, described as follows.

1. Assistance for Landowners

Local lawyers and land experts have expressed concern that landowners do not always fully understand the implications of lease conditions. For example, many landowners do not appear to be fully aware that once their land is leased, they lose user rights and often rights-of-way over the land. An additional problem arises from the communal nature of land ownership in Vanuatu. Often, some members of a landowning family or clan sign leases even though other members of the family have not been informed of the transaction. In some cases, the family members not involved object when they learn about a lease agreement. This raises uncertainty about the validity of the lease. To address this issue, the Ministry of Lands should provide advisory services to all members of the landowning family or clan, to ensure that everyone is fully aware of the terms of the lease and of the implications of those terms.

2. Protection for Future Generations

Because of the lengthy terms of land leases in Vanuatu (rural leases typically have a 75-year term, while urban leases have a 30- to 50-year term), it is important to ensure that leases are fair not only to current generations of the landowning family, but also to future generations. So far, this problem has largely gone unrecognized. Land leases in Vanuatu typically involve a large upfront payment followed by annual rents that are often only a very small fraction of the total value of the lease (usually 1%–2% per year). Some leases contain no provisions for rent review. Lessors often spend the upfront lease payments on consumer goods, most of which do not last long enough to be passed on to the next generation.

There is a real danger that many of the leases signed in the past several years in Vanuatu, as in other Pacific island countries, could be contested by disaffected relatives in coming decades. While in theory, the negotiation of leases should be left to the participants, the Ministry of Lands could help avoid many future problems by establishing principles for structuring leases. These principles should stipulate that no more than a small percentage of the lease payment be paid upfront and should require annual payments to constitute a much larger proportion of the total amount paid.

3. Access to the Sea and Rights-of-Way

An additional problem is that leases do not protect customary landowners' rights-of-way. This is a particular problem when oceanfront property is leased, since the customary landowners lose their access to the sea. This issue is becoming pressing, especially because when leases were issued, many landowners were not aware that they would lose their rights-of-way. Local newspapers contain many letters from aggrieved landowners who resent losing sea access. In some areas (including the island of Tanna[21]), dissatisfaction has led to violence, with lessees being forced off the land they had leased.

Urgent clarification is needed to address the widespread and growing resentment over rights of sea access. In many countries, the seashore is considered common property, and rights of access are guaranteed. To ensure that current and future leases are sustainable, the government should establish rules or change laws to clarify the rights and obligations of customary landowners, lessees, and other potential users of beachfront property.

The Ministry of Lands could help avoid many future problems by establishing principles for structuring leases.

4. Gains From Strata Title and Subdivision

Until Vanuatu introduced the Strata Title Act in 2003, subdivision was a costly and lengthy process. The Strata Title Act, which was designed to reduce delays, supersedes previous legislation related to subdivision. In a fashion unique among Pacific island countries, strata title legislation is used to facilitate, but not regulate, subdivisions. The Act allows primary leaseholders to subdivide the land they have leased and to reap the profits accordingly. Customary landowners, who have no formal right to object

[21] Land disputes are notoriously complicated. The discussion in this report should not be interpreted as attempting to judge the rights or wrongs of any particular case. However, the sheer number of letters in local newspapers regarding land rights illustrates the extent to which this issue has aroused passions. For example, in December 2008, one newspaper invited comments under the title "Losing a Grip on Paradise." It provoked hundreds of responses, most of which reflected resentment about loss of control over land. "To begin, a news report on the closure of a successful resort on Tanna. It is a cautionary tale showing what can happen when there is conflicting custom claims and yet the government enables investment to proceed. There are no winners." *The Vanuatu Independent.* 2008. Losing a Grip on Paradise. 14–20 December.

to this practice, are unable to prevent subdivision. Because property prices in Vanuatu have risen sharply over the past few years, many primary leaseholders have made substantial capital gains through strata title subdivisions. The landowners have not shared in these gains. Unsurprisingly, this situation has led to significant resentment by landowners. In an attempt to rectify the imbalance, the Land Leases Act was amended in 2007 to specify that landowners should benefit from capital gains that occur on leased land. The Land Leases Act is vague about the exact process by which this should occur, however, and only specifies a range for the compensation the landowners might receive.

If customary landowners benefitted from the success of businesses established on land they have leased, there would be far less conflict created by landowners' perceptions that they have been shortchanged.

5. Fair Compensation

If customary landowners benefitted from the success of businesses established on land they have leased, there would be far less conflict created by landowners' perceptions that they have been shortchanged. The Ministry of Lands should explore mechanisms by which this could occur. One option would be for lease payments to be based on a combination of rent and royalties (with royalties being paid as a percentage of the sales of businesses situated on leased land). This approach would allow customary landowners to share in the prosperity of successful businesses.

Some leases require that lessees who make improvements to the land they have leased be compensated by the landowners for costs they incur. Although anecdotal evidence indicates that clauses stipulating such compensation payments are rare, the few that do exist have the potential to cause uncertainty and confusion. If the landowner cannot raise funds to compensate the lessee, does the lessee have the continuing right to use the land? So far, this issue has not been clarified.

D. High Transactions Costs for Leasing

The high cost of obtaining a lease is a major obstacle to investment in Vanuatu. Reforms are needed to reduce these transactions costs.

Investors in most Pacific island countries cite the cost of obtaining a lease as a major obstacle to investment. Vanuatu is no exception. The process of identifying landowners and negotiating the terms of a lease is often time-consuming because of the number of people involved (due to the communal structure of land ownership). Uncertainty is increased by the fact that some landowners may be living in other countries.

Once landowners have been identified and the terms of the lease have been agreed upon, the law usually requires investors to obtain official approvals. This involves another round of delays and almost always compels investors to use costly local lawyers. All leases in Vanuatu have to be approved by the Minister of Lands. The Strata Title Act has sped up the process but, as described above, it leads to other potential problems.

Transactions costs are further increased by the need to renegotiate lease payments. Many leases contain provisions for lease payments to be renegotiated every few years, but they rarely contain any guidance or formulas for doing so. This leaves lessees involved in costly renegotiations without any certainty about the amount of their future payments. Eliminating the need to renegotiate leases every few years would help reduce transactions costs. One mechanism would be for lease payments to be

adjusted automatically as the consumer price index changes. Such adjustments—combined with royalty payments and shares of capital gains for landowners—would make leases fairer to landowners and more predictable for lessees. Nevertheless, this would not address the issue of landowners using force to extort higher payments from successful lessees. Parliament should enact legislation making it an offense for owners to demand payments or other concessions from lessees that are not contained in the lease contract.

E. Land Administration: Inadequate Records

Land records in Vanuatu are inadequate. If the land system is to function more effectively, the country must improve land administration.

Lawyers in Vanuatu report that land records are difficult to access and are often unclear (i.e., it is not apparent who the rightful owners are or where land boundaries lie). Some reform is underway. Records are being digitized and made searchable electronically, but it will be a long process. The Ministry of Lands should establish an out-of-country backup of land records, since Vanuatu is vulnerable to typhoons and other natural disasters.

F. Addressing the Future: The National Land Summit and Next Steps

A National Land Summit held in 2006 served as a first step in reforming Vanuatu's system of fixed property rights in land. Efforts continue, but much remains to be done.

The government convened the National Land Summit in 2006 in response to growing tension over land issues. The purpose of the summit was to formulate land policy for the future. The summit's conclusions were encapsulated in 20 resolutions that reflected participants' consensus on how land issues should be addressed, including a resolution recommending that the Land Leases Act be amended. This was done in 2007 with an amendment that entitled customary landowners to a share of the proceeds of capital gains earned through subdivision. The amount of this share, however, was not specified. The Act states that customary landowners are entitled to receive up to 10% of capital gains from subdivision, but the exact amount is to be negotiated between landowners and lessees. The decision to provide landowners with a share of the benefits of land appreciation is a positive step, but the Act's lack of specificity has the potential to cause further problems. In addition, the 2007 amendment to the Land Leases Act does not address the issue of lessees accruing unrealized capital gains.

Lawyers in Vanuatu report that land records are difficult to access and are often unclear (i.e., it is not apparent who the rightful owners are or where land boundaries lie).

Another of the summit's resolutions recommended placing a moratorium on new subdivisions and halting the issuance of strata title leases. This recommendation has not been implemented; strata titles continue to be issued. Since the Minister of Lands must approve all leases, there is at least tacit official approval for the practice of continuing to issue subleases.

A large project has been launched to reform land administration policy in Vanuatu, with support from AusAID. An NZAID-funded project has also been established to assess the functioning of the customary land tribunals; the scoping mission for that project was completed in 2008.

VII Conclusion

Over the past 5–6 years, Vanuatu has been one of the most rapidly growing economies in the Pacific region. While the construction boom has been partly responsible for the expansion, fundamental reforms have been implemented that have already enhanced growth and significantly improved the business environment in the country. Moreover, the government has expressed a strong committment to pursuing continued reform to promote private sector development in the country, which augurs well for the future.

This report contains a number of suggestions for reform. In the medium term, implementing them will raise the sustainable growth rate.

This report contains a number of suggestions for reform. In the medium term, implementing them will raise the sustainable growth rate. To address the immediate binding constraints, the report recommends implementing the following reforms as priorities:

(i) **Upgrading infrastructure** is necessary to ensure sustained long-term growth, as it has experienced under investment for a prolonged period and urgently requires additional resources. To the greatest extent possible, this should be done using private sector solutions, such as PPPs.

(ii) **Introducing competition policy** to regulate power and port charges to reduce monopoly profits in these areas, especially since Vanuatu has the highest electricity and port charges in the region. In the longer term, these monopolies should be addressed by bringing in additional power providers (including for alternative energy) and constructing another harbor near Port Vila.

(iii) **Rationalizing the SOE portfolio, including divestiture, PPPs, and upgraded governance** will raise productivity and enhance the long term sustainable growth rate of the economy.

(iv) **Reviewing the land leasing system** to ensure the sustainability of current and future leases, particularly as significant tensions are developing in this area.

(v) **Proceeding with commercial legal reform** by bringing legislative drafts to Parliament and passing them into law as soon as feasible. This will help Vanuatu become a better place in which to do business.

While the global financial crisis brings short-term uncertainty, these measures should increase Vanuatu's ability to weather the storm and add to the future prosperity of the country. Significant progress has been made over the past few years in implementing measures that enhance growth prospects. The commitment of the government to reform continues, and if existing measures and future plans are implemented, Vanuatu will continue to be one of the fastest growing economies in the region.

Sustaining Growth: A Private Sector Assessment for Vanuatu

Vanuatu is establishing a foundation for sustained economic growth. The government has signaled its intention to make Vanuatu a more business-friendly environment for private sector development, with sound macroeconomic management and improved policies toward the private sector, but much remains to be done. This report outlines major constraints to private sector-led growth, which are undermining Vanuatu's competitiveness. It recommends high-priority reforms to address these constraints.

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