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Inquiry into the role of the private sector in economic growth and reducing poverty in the Indo-Pacific region

Submission to the Joint Standing Committee on Foreign Affairs, Defence and Trade

7th May 2014

Acronyms/Abbreviations

DFAT	Department of Foreign Affairs and Trade
DFID	Department for International Development
EITI	Extractive Industries Transparency Initiative
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
MDG	Millennium Development Goal
M&E	Monitoring and Evaluation
M4P	Markets for the Poor
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
PIC	Pacific Island Countries
PPP	Public-Private Partnership
SME	Small and Medium size Enterprise
UK	United Kingdom
USD	United States Dollar

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A. Introduction

Adam Smith International is a professional services business that delivers real impact, value and lasting change through projects supporting economic growth and government reform internationally. Our reputation as a global leader has been built on the positive results our projects have achieved in many of the world's most challenging environments. We provide high quality specialist expertise and program management capability at all stages of the project cycle, from research and design, to implementation, and monitoring and evaluation (M&E).

Adam Smith International was established in the UK in 1992. We also have offices in Sydney, New Delhi, and Nairobi. In the past decade we have been in the top three largest providers of technical assistance to the UK's Department for International Development (DFID). We also work for the British Foreign and Commonwealth Office and the Swedish development agency Sida, as well as other development agencies including the New Zealand Ministry of Foreign Affairs and Trade. In early 2012 we established an Australian company, Adam Smith International (Australia) Pty Ltd, to strengthen our capability to support the Australian Aid program and to implement projects in the Asia-Pacific region. Since then our work with the Australian Aid program has grown steadily.

The main focus of our work is harnessing the role of the private sector in economic growth and government reform. This submission draws on our extensive global experience in foreign aid programs that seek to develop the private sector, the extractives industries and the infrastructure sectors. It is important to note that we do not work directly for the private sector. Instead, we only work for governments and development agencies that are seeking to stimulate private sector-led economic growth in their countries.

Our submission focuses on sectors and approaches where we believe Australian Aid can be leveraged to achieve the Australian's Government foreign aid objectives. It was prepared by Dr David Carpenter and Jonathan Pell from Adam Smith International (Australia) Pty Ltd with support from colleagues around the world. We would like to thank Professor Mark McGillivray, former Chief Economist of AusAID and Research Professor at the Alfred Deakin Research Institute, for his inputs to the section on Foreign Direct Investment.

We thank the Joint Standing Committee on Foreign Affairs, Defence and Trade for the invitation to provide a written submission and hope that it contributes to debate and discussion.

Adam Smith International

Sydney, 7th May 2014

B. Summary Recommendations

Infrastructure Development

We recommend that Australian Aid be used for:

1. Leveraging private capital in infrastructure development. It should not be used for directly building physical infrastructure.
2. Supporting governments of Indo-Pacific countries to improve their capacity to plan and deliver better infrastructure projects.
3. Supporting governments of Indo-Pacific countries to develop and implement coherent Public-Private Partnership policy frameworks.
4. Providing project-specific support to take flagship infrastructure investments to a financial close.

Extractives (Mining, Oil and Gas)

We recommend that Australian Aid should:

5. Support governments of Indo-Pacific countries to develop better policies, laws and regulations for their extractives sectors, and to build capacity to implement and enforce them.
6. Increase the number of Australian bilateral extractives programs and reduce reliance on multilateral institutions.

We recommend that the Australian Government should:

7. Become a candidate country of the Extractive Industries Transparency Initiative.

Foreign Direct Investment, Economic Growth and Poverty Reduction in the Pacific

We recommend that Australian Aid should:

8. Undertake research and policy analysis that targets this important area to better understand how its aid can help strengthen the enabling environment for Foreign Direct Investment to improve economic growth and poverty outcomes in Pacific Island Countries in particular.

Tax Reform to Support Private Sector Development

We recommend that Australian Aid:

9. Makes tax reform a central feature of its private sector development work.
10. Focuses efforts on: Supporting the development of better tax policies and laws; developing tax policy institutional capacity; and supporting tax administration reform.

The Tourism Sector

We recommend that Australian Aid:

11. Undertakes research to understand better the linkages between tourism, poverty reduction and the equity of growth. The findings of the research should guide DFAT's strategies and programs in the sector.

Urban Development

We recommend that Australian Aid:

12. Continues its focus on rural development in countries where rural poverty remains high and persistent.
13. Also gives consideration to supporting urban development in Indo-Pacific countries experiencing rapid urbanisation. Focus should be on institutional reform and capacity development; urban transport; and urban municipal services.

C. Infrastructure Development

1. In the Indo-Pacific region there are no examples of countries achieving broad-based growth, rising employment and strong human development without also increasing access to infrastructure. The World Economic Forum estimates the global deficit in infrastructure spend at a trillion dollars per year; clearly, developing countries will make up a significant proportion of that. Most governments have inadequate resources and public savings to finance the infrastructure they require.
2. A logical implication we can draw for aid impact in the infrastructure sector is that Australian Aid is best put to use in helping governments fill that financing gap sustainably, rather than it being used to directly build physical infrastructure. Australian Aid money is small when compared to multilateral development banks, private finance and Chinese money in the Indo-Pacific. Australian Aid should therefore be used to leverage private capital.
3. In approaching infrastructure finance there is a unifying theme for Australian Aid and other development agencies: How to drive value from public finance and rapidly expand access to infrastructure.
4. We explore below three areas where we recommend Australian Aid programs should focus to enhance infrastructure development: Better infrastructure planning, Public-Private Partnerships (PPPs) and market development programmes.

Better Infrastructure Planning

5. Countries in the Indo-Pacific often struggle to deliver public projects on time and to cost. Poor governance is the root cause of many of the challenges. Combinations of inadequate planning, poor project implementation and perceptions of corruption among officials diminish the return on capital spend and normally result in a misallocation of public resources. The result is that developing countries typically achieve very poor value for money in infrastructure, and achieve little development impact.
6. Well-structured and targeted Australian Aid can help governments enhance returns on capital budgets. A major roadblock in the efficient delivery of infrastructure projects is actually encountered at the outset: variable and often weak appraisal of proposed projects, with limited means to rank proposals coherently or in relation to sector strategies. A lack of consistent methodology to screen projects for readiness for financing or implementation compounds this.
7. Once projects have been approved, weak adherence to standardised procurement regulations (sometimes intentionally weak) will further deteriorate value and inflate costs. Finally, poor project management combined with low monitoring and evaluation capability means moribund projects often continue to receive funding allocations despite low or non-existent returns. There is much good work that Australian Aid can achieve in helping governments address these issues at all stages in the project lifecycle.

Encouraging Private Sector Investment: PPPs

8. In facilitating PPPs, Australian Aid has a dual role: First of all to assist governments in designing and implementing a coherent PPP policy framework and secondly to provide project-specific support to take flagship investments to financial close, shoring up credibility for this type of investment.
9. Getting the PPP policy framework right upfront is essential if the public sector is to attract sustainable and meaningful investment. Australian Aid can achieve huge impact in this area. The private sector needs reassurance from government that PPPs are more than one off transactions: they need to be based on firm policy foundations and long-term political considerations. For any project to remain commercially viable, the public sector must underpin contingent and ongoing risks and liabilities, and a good PPP policy will recognise that.

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10. Preparing infrastructure for private sector participation necessitates a step change in project governance and project quality. Australian Aid can drive significant value in this process by providing legal, advisory and transaction support on selected projects, helping to institutionalise higher standards of project delivery. Performance and efficiency gains are then driven by the normal commercial incentives faced by project developers and operators. Other things being equal this will lead to a PPP project having stronger (indirect) linkages to poverty alleviation and economic growth than the equivalent publically financed project.
11. Australia has a long-track record in PPPs. Australian expertise can be leveraged through the Australian Aid program to the benefit of countries in the Indo-Pacific region.

Creating investible markets for infrastructure

12. To attract finance projects must be bankable. Typically, bankability is underpinned by a strong willingness of consumers to pay, among many other factors. The need for project finance and bankability places a focus on large pieces of infrastructure where transaction costs are proportionately low. This in turn tends to favour network infrastructure in urban or peri-urban areas. The financing challenge is far greater in the case of distributed or off-grid infrastructure. This leaves a critical gap in service delivery for the rural poor. Attracting private sector investment in infrastructure for the rural poor is significant, and calls for an entirely different approach.
13. One effective way to deliver infrastructure to the rural poor in ways that are scalable and sustainable is to enable the development of markets. This is particularly relevant in the case of expanding access to energy. Sustained access requires that someone pays the full costs of a service. Typically this includes some combination of private and public funding. Whatever the mix, the least cost way to achieve it is often to leverage the capital of private investors and the natural incentives of commerce. Australian Aid can be instrumental in helping governments correct 'market failures' and mobilise small- and large-scale private financing.
14. The barriers to entry for private capital can be low-cost. Often the issues revolve around insufficient rates of risk-adjusted return for investors. Support can be effective when it helps governments instate a coherent framework that addresses these issues: fiscal incentives for market entrants; guarantee facilities to share commercial and sovereign risks; output based contracts for maintenance and operation. Such mechanisms provided by governments within a supportive regulatory and policy framework can overcome the barriers to investment, unleashing the investment power of the private sector.

D. Extractives

1. The extractive industries – by this we mean the mining, oil and gas sectors – are an important part of the economies of many of the Indo-Pacific countries, and many more countries that receive Australian Aid. Examples include Mongolia, Myanmar, Papua New Guinea, Timor Leste, Indonesia and Afghanistan. Extractives are often one of the few sectors in which developing and low-income countries are internationally competitive, meaning that they are a viable sector for Australian private sector investment and foreign private sector investment from other countries.
2. A growing extractives sector has a significant impact on a country's GDP growth, driven mainly by private sector investment and exports. Government foreign exchange earnings, tax revenues and royalty payments from mining and oil companies far exceed proceeds from any other sector in these countries. Increased government revenue collected from the private sector reduces aid dependency. It can be invested in public services such as health, education and infrastructure.
3. However, the extractives sector in most developing countries (and in many developed countries) can present problems. These include lack of job creation (extractives are capital-intensive industries), vulnerability to external economic and commodity price volatility, environmental damage, resettlement of communities, health and safety problems, child labour, disruption to traditional lifestyles, and government and private sector corruption. In some cases these problems can cause or contribute to conflict.
4. With or without Australian Aid, mining and oil sector exploitation will happen in Indo-Pacific. We believe that the debate should not, therefore, be "if" Australian Aid should support extractives, but "how" it should support extractives. The case is compelling and is entirely consistent with the Australian Government's new aid priorities of economic growth and private sector development.
5. Australia has a comparative advantage in leveraging Australian extractives expertise to maximise the positive impacts and mitigate the negative impacts of extractives sector growth. Australia has a world-class extractives sector that is managed and regulated by world-class federal and state-level government institutions. It is the experience and expertise of these institutions in developing, implementing and enforcing extractives sector policies, laws and regulations that should be leveraged to the benefit of Indo-Pacific countries. Adam Smith International regularly works with former Australian public servants on our extractives programs, for example mining tax advice to governments of developing countries being provided by former officials of the Australian Tax Office.
6. We do not believe that the Australian Aid program should provide direct support to extractives companies. These companies have access to capital, technology and human resources, and do not need Australian Aid to help them. Instead, we believe Australian Aid should focus its efforts on supporting governments in Indo-Pacific to develop better policies, laws and regulations for their extractives sector, and build institutional and human capacity to implement and enforce them. Better policy and regulatory environments in foreign countries create investment opportunities for Australian mining and oil companies. Nonetheless, dialogue and engagement with companies should form part of the design and implementation of extractives programs.
7. In this regard, we believe that AusAID's Mining for Development Strategy was sound because it focused on leveraging Australian expertise to improve: 1) Regulation and governance; 2) Extractives revenue management; and 3) Direct benefits to communities. We therefore recommend that, in developing its new Extractives Initiative, DFAT seeks to build on, rather than replace, the Mining for Development Strategy.
8. Given Australian Aid's comparative advantage in extractives we recommend that more bilateral extractives program be considered by DFAT in the Indo-Pacific region. Providing funding to multilateral institutions for extractives programs might be an easy way for DFAT to spend money, but it also

reduces Australian identity and removes the opportunity to specifically leverage Australian expertise in the implementation of these programs.

9. A common feature of extractives-driven economic growth is that the growth patterns that emerge are often not inclusive of all members of society. While growth is positive, it is typically unequal, leaving certain groups of people behind. Government therefore needs to play a critical role in managing revenues effectively and transparently, and developing policies, public expenditure and public investment plans that seek to share the benefits of growth widely across all sections of society. For this reason it is important that Australian Aid extractives programs also include public finance and expenditure aspects, supporting partner governments in spending revenue as well as generating revenue.

10. The Extractive Industries Transparency Initiative (EITI) has proven to be a progressive and relevant global initiative in addressing transparency and accountability issues in the extractives sector. It has moved beyond just revenue transparency to other important aspects of the extractives sector including licensing procedures and information of state-owned companies, for example. While Australian Aid has provided significant funding to EITI, Australia is not yet an EITI candidate country opting instead to undertake a pilot. Meanwhile other countries in Indo-Pacific including Indonesia, Papua New Guinea and the Philippines are candidate countries. We believe it would send a strong signal to the private sector and governments in the Indo-Pacific region if Australia moved beyond a pilot exercise and became an EITI candidate country.

E. Foreign Direct Investment, Economic Growth and Poverty Reduction in the Pacific

1. Economic growth in the Pacific is the low and volatile. Rates of Foreign Direct Investment (FDI) across the Pacific are high by international standards but its impact on economic growth is marginal. Not a lot is known about how to maximise the economic growth effects and positive externalities of FDI in the Pacific. Foreign aid can play an important complementary role, helping catalyse FDI in ways that are not market distorting. The Australian Government should fund research and policy analysis that targets this important area to better understand how its aid can help strengthen the enabling environment for FDI to improve economic growth and poverty outcomes.

2. Economic growth in the Pacific region is the lowest and most volatile of any region in the world including Sub-Saharan Africa[1]. Between 1971 and 2010 economic growth in the small island states of the Pacific was 0.94 percent[2]. Low levels of economic growth and a number of other factors are contributing to an increase in poverty across the region. Around 2.7 million people, or one-third of the region's population, live in income poverty.

3. Due to the high incidence of poverty, Pacific Island Countries (PICs) receive some of the highest levels of Official Development Assistance (ODA) in the world relative to the size of their economies. The average is over 25 percent of GDP across the Pacific. Australia is one of the largest donors providing over AU$ 900 million annually. Despite these high levels of aid, poverty continues to increase and many PICs will not reach their Millennium Development Goal (MDG) targets; indeed the Pacific region is the poorest performing region in the world with regards to MDG achievement. This raises the issue of how best to stimulate growth and reduce poverty across the region.

4. There is substantial evidence that increasing aid will have limited impact on economic growth rates in the Pacific. In highly aided countries with absorptive capacity constraints there are significant diminishing returns to foreign aid. Due to the already high proportion of ODA to GDP in many PICs these diminishing returns will have already set in across the Pacific[3].

5. There are a number of potential drivers of economic growth in the region; these include FDI, remittances, and trade. One of the most important is remittances. The contribution of remittances to small island developing states in the Pacific is particularly significant. Recent research suggests that in the absence of remittances economic growth in the small island states of the Pacific would have been -0.74 percent between 1971 and 2010[4].

6. While there has been some limited research on the impact of aid and remittances on economic growth in the Pacific, there has been almost none on the role of FDI. Recently completed research[5] suggests that FDI could play an important, but as yet unrealised role, in driving economic growth in the Pacific.

[1] McGillivray, M., Naude, W., and Santos-Paulino, A.U. (2010) " Vulnerability, Trade, Financial Flows and State Failure in Small Developing Countries", *J. Dev Stud*, 46(5) 815-827
[2] Feeny, S., Iamsiraroj, S., and McGillivray, M. (2014) "Remittances and Economic Growth: Larger Impacts in Smaller Countries?" *Journal of Development Studies*, first online March 2014
[3] Feeny, S., and M. McGillivray (2008) "Do Pacific Island Countries Receive Too Much Foreign Aid? *Pac. Econ. Bull* 23(2) 166:178
[4] Feeny, S., Iamsiraroj, S., and McGillivray. M. (2014) "Remittances and Economic Growth: Larger Impacts in Smaller Countries?" *Journal of Development Studies*, first online March 2014
[5] Feeny, S., Iamsiraroj, S., and McGillivray, M. (2014) "Growth and Foreign Direct Investment in the Pacific Island Countries" *Economic Modelling*, 37:332-339

7. Average FDI rates in PICs are amongst the highest in the world. FDI averaged 4.86 percent of GDP across the Pacific between 2000 and 2009; this was compared to the global average of 2.86 percent. The lowest FDI/GDP ratios were in Samoa (0.87 percent), the highest in Kiribati (11.42 percent). Despite these high ratios, the contribution of FDI to GDP growth was by far the lowest. On average, in all host countries, a 10 percent increase in FDI is associated with 2 percent higher GDP growth. In PICs, a 10 percent increase in FDI is associated with only a 0.1-0.4 percent increase in GDP growth. PICs clearly have significant problems realising the economic growth potential of FDI.

8. Aside from growth, there are a number of other benefits of FDI. These positive externalities can include: technology spillovers, human capital formation, employment, enhanced trade integration, creation of a more competitive business environment, enterprise development, and environmental spillovers[6]. There can also be significant drawbacks to FDI in certain cases including: deterioration in balance of payments, lack of positive linkages to local communities, social disruption, and the distortion of domestic incentives and concomitant crowding out of employment and domestic firms. Unfortunately little is known about the impact of FDI in the Pacific and much more research needs to be done to understand its beneficial forms.

9. Despite the many barriers to foreign investment across the region (e.g. isolation from markets, lack of infrastructure etc) PICs have managed to attract FDI in a large range of sectors including agriculture (palm oil, copra, sugar, and livestock), forestry, fishing, banking and finance, real estate and tourism. Investments of this type are more likely to have benefits for the poor and contribute to broad based and inclusive growth than large scale capital intensive projects in the extractives sector for example.

10. FDI can also have important economic stability effects, an important concern noting the volatility of economic growth in the region. FDI in the financial services sector may be of particular importance to PICs. A global review of FDI in the financial services sector in developing countries, conducted by the Vice President of the Federal Reserve Bank of New York, suggests that a number of positive externalities accompany such investments, including: improvements in allocative efficiency, technology diffusion, wage spillovers, institution building, altered macroeconomic cycles and improved economic stability[7]. It is interesting to note that Australian banks have a significant presence in the Pacific and it would be instructive to assess the role these institutions play in facilitating economic stability.

11. As noted by the OECD[8] the net benefits of FDI do not automatically accrue to developing countries, many factors affect the nature of the impacts and their magnitude including: education standards, health, trade openness, competition, and regulatory frameworks. In places where the enabling environment for FDI is weak, the presence of financially strong foreign enterprises may not contribute significantly to economic development.

12. Many PICs face significant challenges in the abovementioned areas, particularly in improving governance and institutional quality. Research suggests that institutional quality has a negative and significant effect on FDI volatility[9]. Improvements in institutional quality can lead to significant increases in FDI.

13. Recent empirical research[10] suggests that foreign aid can play an important role in improving the enabling environment for FDI in ways that do not distort the efficient operations of markets and inducing higher FDI flows. Foreign aid was shown to induce higher FDI when invested in inputs

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[6] OECD (2002) *Foreign Direct Investment: Maximising Benefits, Minimising Costs*, Paris: OECD
[7] Goldberg, L.S (2007) "Financial Sector FDI and Host Countries: New and Old Lessons", Federal Reserve Bank of New York, Economic Policy Review, March 2007
[8] OECD (2002) op cit
[9] Buchanan, B.G., Le, Q.V., and M. Rishi (2012) "Foreign Direct Investment and Institutional Quality: Some Empirical Evidence", *International Review of Financial Analysis,* 21:81-89
[10] Selaya, P., and E.R Suneson (2012) "Does Foreign Aid Increase Foreign Direct Investment?" World Development, Vol 40, No.11: 2155-2176

complementary to physical capital. Efforts which increase absorptive capacity allow countries to accumulate more foreign capital without experiencing a drop in domestic private investments or a flight of foreign capital.

14. The abovementioned review suggests that Australia's foreign aid can play an important complementary role, helping to strengthen the enabling environment for FDI across the region. This might help increase economic growth and improve economic stability. FDI rates are high by international standards, but its contribution to economic growth is marginal. More research needs to be done to discover why this is the case. Unfortunately our knowledge of how to optimise the beneficial impacts of FDI across the Pacific is minimal, as is our understanding of the best policy interventions and the optimal composition of aid to complement FDI.

15. We recommend that the Australian Government provide funding for more in-depth research and policy analysis in these important areas. At present PICs are too dependent on aid for growth. The results of FDI-related research, and the policy and programming associated with it, may help reduce this reliance over time. This analysis should draw on international experience, but be grounded in local context.

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F. Tax Reform to Support Private Sector Development

1. When development agencies re-orientate priorities and programs towards the private sector, there is a risk that they lose sight of the important role that governments play in regulating the private sector and collecting taxes from it. We believe that effective and transparent tax administration reform is a pre-requisite for sustainable and equitable private sector development. Furthermore, if a country that is receiving Australian Aid is able to collect more tax from the private sector, it will reduce their dependence on DFAT in years to come. We therefore recommend that the Australian Aid program makes tax reform a central feature of its private sector development work.

2. Tax reform technical assistance properly designed and implemented can result in a transparent, fair and efficient tax system, which provides certainty and confidence for the private sector, this in turn can facilitate private sector development and increasing employment and income. This is especially important when effective and fair development of a particular sector is considered crucial to poverty alleviation, e.g. the extractives sector.

3. Additionally tax reform offers some, or all, of the following benefits:

   » Public services can be financed in a sustainable way, independent of donor financing, enabling governments to provide essential services for the population without recourse to external assistance.

   » The impact of donor financing on tax reform is multiplied many times in that it helps developing country governments help themselves in a way that no other donor support can, i.e. with their own finances, raised on their own account, developing country governments are in a position to support the full range of development initiatives, in health, education, private sector development etc. While other forms of donor support can lead to donor dependency and short-termism, revenue reform supports sustainability and long-termism.

   » Interaction with tax systems leads to more open, transparent and accountable government and politics, and educates society about its rights and obligations in relation to government. Businesses and individuals who pay taxes are financing the government/political system and feel an increased need to hold it accountable.

   » A reformed tax system can be used directly and indirectly to allocate resources to the poorest people in society.

   » More robust and transparent tax systems reduce corruption and there is often a knock-on effect whereby the level of corruption falls across government and society.

   » The need to understand and comply with the reformed tax system can kick-start the development of more sophisticated accountancy, legal and consultancy skills in the economy, which are widely beneficial in the long-term.

Revenue generation and private sector development are mutually reinforcing

4. Developing country governments are typically collecting far less revenue than is required to finance their own development and a satisfactory level of public services. The priority for most Australia Aid tax reform programs will therefore be to increase tax revenue. At the same time, tax reform will usually promote private sector development by reducing compliance costs for taxpayers, and promoting investment through improvements in the tax system's predictability, fairness and transparency. As private sector development takes off, more tax revenue is generated. Revenue generation and private sector development are therefore mutually reinforcing, and this can be reflected in programme design.

5. There has been a tendency at times to think private sector development can be promoted by providing concessions to specific taxpayers or sectors. There is however a wealth of evidence that investment is not promoted by concessions, and indeed that it can be damaged by the lack of predictability and fairness of concessions. Tax concessions to promote private sector development should be avoided.

This is particularly the case with small and medium sized businesses, where emphasis should instead be placed on reducing their tax system compliance costs, given the greater adverse impact that such costs have on these businesses.

Consulting with the private sector in tax reform

6. Tax policy formulation requires widespread consultation and agreement with stakeholders, including the private sector, beneficiary government institutions involved in economic management, e.g. finance, planning, natural resources etc, as well as donors and IFIs, especially the IMF, who generally regard effective and fair tax policy as a condition of their support.

Where Australian Aid should be targeted

7. On Adam Smith International's tax administration reform programs in the Indo-Pacific region and around the world we work with a large number of contracted advisers who were formerly with the Australian Tax Office. Examples include Papua New Guinea, Afghanistan, Liberia and Ghana. Tax administration reform is an excellent example of where Australian expertise can be leveraged to the benefit of developing countries.

8. We recommend that in the context of Australian funded tax reform programs, DFAT focuses on the following priorities:

   » Supporting the development of better tax policies and laws;

   » Developing tax policy institutional capacity – which generally means working with a Tax Policy Unit within Ministries of Finance; and

   » When policies and laws are established or amended, move to supporting tax administration reform, including integrated automation of administration processes by using information technology systems and the development of human resources.

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G. The Tourism Sector

1. The contribution of the tourism sector to economic growth is widely acknowledged. Its contribution, however, to poverty reduction, gender equity and other measures of equity is altogether more complicated. The mechanisms through which tourism contributes to poverty reduction are complex, varied and context specific. There are significant gaps in our knowledge of these mechanisms, despite many years' experience of tourism sector programs being implemented by development agencies.

The economic importance of tourism in Indo-Pacific

2. Tourism is the largest service industry in the world; it directly employs over 200 million people and provides vital foreign exchange reserves for developing country economies. In 2012 international tourist arrivals reached one billion people for the first time in history and total tourism receipts exceeded one trillion US dollars (USD). In contrast to many other industries, global receipts from tourism have grown at an average of 4% per year. Growth in tourism throughout the Asia-Pacific region averaged 6.7% between 1996 and 2006, during which time, the region's global share of the market increased from 15.7 to 19.8%. The continued growth in tourism is particularly important for developing countries. Tourism is the second most important source of foreign revenue (after oil) for the world's forty poorest countries.
3. In the Indo-Pacific region tourism is particularly important. In 2012 the total number of visitors to Pacific Island Countries (PICs) was 1.6 million people, 50% of whom came from Australia and New Zealand. This was up 14% from 2011. Total tourism revenue in PICs exceeded USD 46 billion (almost 11% of total GDP) in 2012.
4. In addition to its direct contribution to GDP and employment, tourism is also a driver of economic growth in developing countries. A longitudinal economic analysis of tourism and economic growth found a positive bilateral causality and positive long run relationship between economic growth and tourism in 90 developing countries. This research confirmed the so-called tourism-led growth hypothesis.
5. If we compare tourism to other drivers of economic growth we see that total receipts from tourism in 2012 (USD 1 trillion) was only USD 350 billion less than the sum of all global foreign direct investment in 2012 (down 18% from 2011) and significantly higher than global aid expenditure, which was only USD 125.9 billion in 2012 (down 6% from 2011).
6. As a tool for poverty reduction, tourism has significant potential. The benefits of tourism are typically consumed at the point of production which can directly benefit communities, further enabling communities who may be poor in material wealth to leverage their historical and socio-cultural assets to generate income. Tourism can also create different networks of operations across complex supply chains, which can provide a multitude of direct and indirect employment opportunities.

Challenges in optimising pro-poor outcomes

7. There are significant challenges facing developing countries when it comes to optimising the pro-poor benefits of tourism and many of these are not understood completely.
8. The lack of human and physical capital investment is a significant constraint. Solid and well maintained infrastructure is critical. Poor countries need to prioritize investments in roads, airports, hotels and other leisure facilities in order to improve infrastructure to a degree that will accommodate international tourists. Human capital development is also an issue. This is particularly important in host communities where local people can be trained to undertake much of the work associated with tourism ventures.
9. Poor regulations and standards is another significant challenge. Tourism needs to be subject to robust laws and regulations which are enforced. These laws must be designed to safeguard the environment and the land and property of local communities. Tourism can create significant tensions; particularly in countries with high proportions of communal land ownership such as those in the Pacific (n.b

approximately 80% of all land in the Pacific is communally owned). The presence of strong and effective institutions is required to ensure livelihoods are not adversely affected by tourism.

10. Economic leakage is another major challenge. If the pro poor opportunities of tourism are to be realised then developing countries need to capture more tourist spending and limit economic leakage abroad. The same applies to host communities. Opportunities to stop economic leakage need to be identified across the tourism value chain.

11. Interestingly, all of these challenges are being directly or indirectly addressed in one way, shape or form by donor programs and the programs of partner governments, but this is not happening in a coordinated fashion. For example, in the Pacific, the Australian government implements projects relating to infrastructure, government institutional strengthening, technical vocation and training, quality assurance, public financial management and government strategic coordination, land tenure, environmental and many others that address the challenges introduced above. However, the extent to which these projects are designed or implemented with a view to optimising the pro poor outcomes of tourism is unclear. Given the significant economic weight of tourism in the Pacific compared to aid (USD 46.7 billion versus USD 2.073 billion) a key foreign aid policy question for DFAT is *wouldn't it be wise to use a proportion of aid in a more strategic fashion to leverage the pro poor benefits of tourism?*

Key problems for Australian Aid to address

12. A critical problem is determining the best way to spend aid money to optimise the pro-poor benefits of tourism. Before this can be done we need to ascertain how the poor are actually benefitting from tourism in the first place (or otherwise). This could include conducting economic research into pro-poor linkages and more specific political-economy research using pro-poor value chain type approaches.

13. The pro-poor linkages of tourism are likely to include:

    » Long-term dynamic effects through the creation of institutions and infrastructure which arise directly from tourism;

    » Direct effects such as employment;

    » Induced effects, such as those that may 'trickle down' and those associated with increased government expenditure on services which benefit the poor; and

    » Indirect effects through non-tourist sectors, such as income to the economy derived from tourism but outside of direct employment, such as products and services supplied to the tourism sector.

14. One of the criticisms of tourism is that its benefits do not reach the poorest people. More needs to be done to foster local linkages and develop backward linkages if the poor are to benefit from tourism. In order to identify these opportunities and the mechanisms for inclusive growth, a market-oriented value chain approach similar to that used in 'markets for the poor' (M4P) type programs could be used to monitor financial flows through the tourism industry in countries of interest to DFAT. This mapping will identify the role and the relative importance that mechanisms such as employment, supply of goods and services, direct sale of goods and services (informal economy), SMEs and taxes and levies play in the lives of poor people in particular socio-cultural and economic contexts.

15. A second research question relates to what we have learned from previous development efforts in the tourism sector and the extent to which this learning is integrated into current and future approaches. While DFAT and other development agencies have invested in tourism-related projects for a number of years, very little evaluative information exists in the public domain on whether these investments have generated the types of returns that the funding organisation would want to see. Additionally, the literature is authored mainly by 'tourism advisers' who could perhaps be seen to have a vested interest in promoting the sector. What is required, therefore, is an objective, impartial and economic-focused

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assessment of the effectiveness of tourism sector programs, that where necessary draws on the expertise of—but is not led by—tourism sector experts.

Undertaking research to inform policy

16. We recommend that DFAT commission combined economic and political-economic research to provide important policy insights, including information on:
    - » The existing economic impact of tourism in Indo-Pacific;
    - » The contribution of tourism to economic growth;
    - » The potential economic and poverty reducing impact of tourism (in various scenarios);
    - » The mechanisms through which tourism benefits different groups of poor people (or otherwise);
    - » The relative importance of those mechanisms;
    - » The extent of economic leakage;
    - » The barriers to addressing leakage;
    - » The institutional and structural barriers to improving pro poor outcomes;
    - » The effectiveness of past and current tourism sector programs;
    - » Value for Money considerations – within the tourism sector, and tourism compared to other sectors; and
    - » The lessons learned from past and current efforts.
17. This information can then be used to develop policy and program options for DFAT and partner governments that have economic growth and poverty reduction objectives. This could include programmatic and aid allocation options and ideas for interventions that target poor people. It could also suggest how aid can be better used to leverage the pro-poor benefits of tourism, including through existing and future programs.

H. Urban Development

1. Rural development has been a centre-piece of the Australian Aid program for many years. In countries such as Lao PDR where rural poverty remains persistent, this is understandable and the focus on rural development should continue.
2. Urban development features less prominently in the Australian Aid program, despite the rapid urbanisation taking place in many countries in the Indo-Pacific region. As countries grow wealthier, the population of cities expands creating hubs which, if correctly managed, can act as engines for economic growth and diversification, offering a thriving private sector which delivers poverty alleviation at the same time as providing new markets for Australian firms.
3. Managing the urban transition, however, is a process fraught with risk. Failure to create urban infrastructure which is capable of sustaining a growing population and able to deal with potential environmental shocks may have the effect of creating a locus for civil unrest and extremism. This emphasises the importance of ensuring that urban infrastructure is designed and managed in a way that is fit for purpose, diffusing benefits throughout the city environment. Private sector participation is a particularly good way of doing this as it allows small and medium sized enterprises to manage infrastructure at a local level, improving accountability and responsiveness, while spreading economic benefit.
4. An investment focus on the urban environment is intrinsically pro-poor. Foreign aid programs in cities have an impact which is magnified by three factors: the concentration of people in the urban area, the typical extreme stratification of incomes common to cities, and the opportunities for economic diversification which are provided by the supply chain benefits of a city location.
5. High impact investment from donors can unleash the private sector to provide a sustainable footing for cities to grow. In doing so it identifies three key areas of intervention, each of which will transform the private sector business environment: urban infrastructure coordination through institutional and capacity reform, urban transport, and urban municipal services.

Managing the Transformation: Institutional Reform and Capacity Development

6. At the heart of the urban infrastructure challenge are institutional and procedural challenges.. This is not primarily an issue of governance, although limited accountability and financial opaqueness are frequently problematic, but rather one of an ability to assess need, plan adequately, deliver effectively and then operate and regulate once the infrastructure is in place. The result of this capacity deficit across the spectrum (both public and local private sector enterprises) is that developing countries are delivering cities which offer poor value for money and sub-optimal living standards for their residents, which in turn affects their economic capacity.
7. Improving the capacity to plan and deliver urban infrastructure has two distinct strands. The first is the work which needs to take place to improve institutional capacity. Developing world cities very frequently suffer from a power gap within their civic architecture, meaning that decision making is fragmented across a number of tiers of government and / or government offices at the same tier. Agreeing on principles of urban development, city master-plans and, most importantly, providing coordination bodies with an ability to act as centres of excellence building a coordinated urban environment.
8. The second part of delivering reform to the planning and delivery environment is delivering capacity enhancement for policy makers (through coordinating bodies) and the local private sector. This is particularly pertinent when it comes to improving existing municipal services through concession. When the concession is tied to capacity enhancements and the transition managed, it is possible to produce an outcome which has the beneficial effects of privatisation without suffering from a decline in quality.

Securing the Supply Chain: Urban Transport

9. Aside from the institutional and capacity environment, the urban transport background a city faces is arguably one of the greatest constraints on its ability to drive economic growth and to support private sector expansion. In this context, urban transport encompasses both the mode of transport (bus, train, ferry, car, etc) and also the channels in which it moves (roads, tracks, waterways). However, without urban transport reform, the entire supply chain of a developing world city breaks down – it is impossible for workers to reach employment (particularly when commuting from low income areas to jobs in high income areas), businesses are deterred by logistical challenges, and import/export markets do not grow. Stimulating the urban private sector is, therefore, heavily dependent on fixing its transport architecture.

10. There are a number of reasons why city transport systems in the developing world tend to be inadequate. The paved road infrastructure is usually based on legacy designs which date to a period before the era of mass urbanisation, meaning they are not designed for high volume traffic, they do not make adequate provision for public transport (through bus lanes, for instance) and they frequently do not serve new areas of the city (which tend to have a prevalence of informal, high density housing).

11. At the same time, few developing countries have the benefit of a maintenance culture which prioritises care of existing vehicle fleets. Providing both maintenance and scheduling support, the latter of which helps vehicles manage their workload by travelling on fewer occasions along routes and at times which will garner peak numbers of passengers. All of these innovations, particularly in the field of public transport, work to reduce congestion and smooth the supply chain giving businesses better visibility and thus creating a more welcoming investment climate.

Getting the Basics Right: Urban Municipal Services

12. Attracting investment and boosting the private sector also requires an emphasis on modern municipal services – particularly in the areas of power, water supply, sanitation & hygiene, and solid waste management.

13. Impact investment in these services offers the private sector economic opportunity on two levels. Firstly, they provide a business environment in which the workforce is healthy, the supply chain works efficiently and business plans and strategies are not disrupted by an inability to take for granted the inputs required for production. At the same time, these businesses require cost foresight and the guarantee of quality that comes from well-regulated municipal services. Secondly, the divestment of municipal services to private sector operators allows for consumers to benefit from improved service as a result of competition while also creating jobs and income for small and medium sized enterprises and the individuals implementing at a local level.

14. It is not the case that private sector involvement must operate in a manner which is not pro-poor. Transferring from a system where the local authorities provide services inefficiently, to one in which the private sector steps in can still be made to align with pro-poor development goals through technical assistance around the regulatory environment.

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