



# Pacific Trade Issues



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# **Pacific Trade Issues**

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# Abbreviations

A4T	–	aid for trade
ACP	–	African, Caribbean, and Pacific (Group of States)
ADB	–	Asian Development Bank
EPA	–	Economic Partnership Agreement
EU	–	European Union
FIC	–	Forum island country
GSP	–	Generalised System of Preferences
ICT	–	information and communications technology
PACER	–	Pacific Agreement on Closer Economic Relations
PDMC	–	Pacific developing member country
PICTA	–	Pacific Island Countries Trade Agreement
SARS	–	Severe Acute Respiratory Syndrome
S&D	–	special and differential
US	–	United States
VAT	–	value-added tax
WTO	–	World Trade Organization

# Foreword

In September 2007, the Asian Development Bank (ADB) and the World Trade Organization hosted the conference Mobilizing Aid for Trade: Focus on Asia and the Pacific. This report was prepared to bring a better understanding of contemporary trade issues in the Pacific region. It updates earlier ADB *Pacific Studies Series* publications on trade, reviews both existing and possible trade agreements, and examines “aid for trade” interests in the context of Pacific economic policies.

This report was written by Professor Ron Duncan, Executive Director, Pacific Institute of Advanced Studies in Development and Governance, University of the South Pacific, Suva, with editorial assistance from Melissa Dayrit, and prepared under the supervision of Stephen Pollard, Principal Economist, Pacific Department.

I am pleased to publish this report under the *Pacific Studies Series*. May it contribute to better policies for facilitating trade throughout the Pacific region and beyond.



Philip Erquiaga  
Director General  
Pacific Department

# Executive Summary

**W**hat is the best trade policy for small Pacific states? Some have subscribed to the multilateral liberalization through the World Trade Organization (WTO), while others have engaged in subregional trade agreements. The Forum island countries (FICs)<sup>1</sup> have negotiated an FIC-only trade agreement in the form of the Pacific Island Countries Trade Agreement (PICTA). There is also the South Pacific Regional Trade and Economic Cooperation Agreement, the nonreciprocal, preferential agreement with Australia and New Zealand. Furthermore, negotiations are soon to conclude on an Economic Partnership Agreement (EPA) with the European Union (EU), and negotiations will soon begin between the FICs and Australia and New Zealand on what could be a comprehensive agreement covering other areas as well as goods trade under the Pacific Agreement on Closer Economic Relations (PACER).

A trade agreement among small developing states such as PICTA or the Melanesian Spearhead Group is unlikely to be welfare-enhancing. In fact, it is more likely to set back the promotion of free trade in the FICs because of the great propensity for trade diversion and tariff and investment diversion to the more advanced states. This results in income divergence and increased antagonism against free trade.

A trade agreement between the small Pacific states and a large developed country or countries would much more likely be welfare-enhancing as the risks of trade diversion outweighing trade creation effects are much less likely. While both the EU (through the EPA) and Australia and New Zealand (through a negotiated PACER agreement) offer the Pacific countries development assistance in various forms—including trade facilitation—an agreement with Australia and New Zealand is likely to

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1 Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Together with Australia and New Zealand, they form the Pacific Islands Forum.

generate greater benefits for the Pacific countries because the EU is a minor trading partner and looks likely to remain so. However, the “hub-and-spoke” problem of investment going mainly to the EU or to Australia and New Zealand will affect both agreements. Nevertheless, the intensity of the Pacific’s trading relationship with Australia and New Zealand should mean much larger net benefits from a PACER agreement than from an EPA. Further, with effective trade facilitation—particularly to overcome quarantine barriers—the large potential for agricultural exports to Australia and New Zealand can be realized.

Trade liberalization with the rest of the world is likely to be the most beneficial policy for Pacific countries to follow, whether done unilaterally or by joining the WTO. Unilateral liberalization would mean that the costs of being a WTO member would not be incurred. However, unilateral liberalization would mean that the protection of the WTO against WTO-inconsistent practices by members would not exist. Still, a problem with joining the WTO is the preferential special and differential (S&D) treatment accorded to developing member states. S&D treatment in the form of assistance with trade facilitation or trade policy development is a positive measure. However, S&D treatment allowing slower reductions in protective barriers against imports or lower reductions in tariffs is not really a favor as this only supports government efforts to retain costly trade interventions.

Once trade liberalization is identified as an important policy reform, the most important issue would be the identification and removal of the binding constraints to its adoption. These may be institutional, economic, policy-related, or cultural, among others—including the opposition of vested interests. Within the Pacific, opposition to open markets is very strong and supported by vested interests, ideology, and cultural beliefs. Economic issues also constrain the response to changes in the terms of trade through trade liberalization, such as insecurity of land tenure and poor access to credit. Limitations on market access may also constrain exports, but quarantine restrictions on agricultural exports and domestic import restrictions that raise the costs of exporting are much more pressing.

One concern frequently raised by those who oppose trade liberalization is the loss of tariff revenue through the reduction or elimination of tariffs. However, studies have shown that the possible loss of tariff revenue is generally tiny. Alternative government revenue sources such as a value-added tax or excise taxes on “sin” goods such as alcohol and tobacco are

more preferable than tariffs because they are less economically distorting, less regressive, and, in the case of excises on “sin” goods, can have beneficial social effects.

As far as the future of Pacific exports is concerned, the future appears to lie mainly in the development of niche markets, whether in tourism, ICT<sup>2</sup>-related services, labor services, manufactured goods, or even agriculture. Tourism is the ultimate niche market, as all countries have some unique characteristics. Where international airline services have been opened, resort hotels are given secure leasehold tenure to customary land, there is openness to foreign investment, and the necessary infrastructure is provided. Pacific countries are beginning to see tourism drive economic growth. The Pacific countries have been hamstrung in developing ICT-related activities because of the way this sector has been monopolized. However, ICT monopolies are being removed in some countries with positive results for the export of services.

Because of their low levels of investment, rapid growth in working-age populations, and the limited resources for developing formal employment opportunities outside government (particularly in the ministates), the export of labor services to high-income countries will be a significant activity in Pacific economies for many years to come. However, exporting labor services cannot make a large contribution to reducing unemployment and underemployment in the larger Pacific countries. These countries have to meet the challenge of developing an encouraging environment for investment if they are to see substantial increases in formal employment.

The Pacific countries are trying to have temporary labor movement included in the EPA, but the EU has so far shown no interest in agreeing to this. On the other hand, the prospects for including temporary labor services in PACER are beginning to look more promising.

Aid for trade (A4T) has become a topical issue in recent times and appears to be essential in helping some developing countries make the most of the market access that has been or will be provided through trade agreements. Of particular interest for Pacific countries is trade facilitation to help them overcome the quarantine and quality barriers to their development of niche agricultural export markets in Australia, New Zealand, and the United States. Potential also exists elsewhere for these exports as in Japan and the EU.

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2 Information and communications technology.

The Asian Development Bank (ADB) has been considering the place of A4T in its activities. An important point to keep in mind is that A4T should not be considered in isolation from ADB's other activities. If assistance is given for A4T, it should be because it is a priority over all other possible forms of assistance. While it is very important to recognize that binding constraints to supply responses to changes in the terms of trade should be overcome, care should be taken in translating this into ADB programs. Identifying the binding constraints to economic growth is key to setting priorities for *all* ADB activities. If A4T is essential for overcoming binding constraints to a country's economic growth, A4T should receive priority. The question for ADB management is whether addressing these constraints is a priority for ADB, or whether other development partners are in a better position to provide assistance.

# Introduction

This report summarizes the issues on trade policy in the Asian Development Bank (ADB)'s Pacific developing member countries (PDMCs),<sup>1</sup> as raised in earlier ADB *Pacific Studies Series* reports (ADB 1998, 1999) and discusses recent developments in trade policy and trade matters of interest to the PDMCs. Recent developments in trade policy of interest to the PDMCs include:

- The Pacific Island Countries Trade Agreement (PICTA), a preferential trade agreement covering merchandise trade between Pacific island countries, which was signed in 2001;
- The Pacific Agreement on Closer Economic Relations (PACER), an agreement between the 14 Forum island countries (FICs) and Australia and New Zealand, which was signed in 2001;
- The World Trade Organization (WTO) Doha Development Round, which started in 2001; and
- Negotiations over the Economic Partnership Agreement (EPA) with the European Union (EU), which started in 2001.

Matters of particular interest to the PDMCs, some of which are closely tied in with negotiations over these various trade arrangements, include the so-called “labor mobility” issues such as the temporary movement of natural persons under the WTO’s Mode IV of trade in services, the temporary employment of unskilled Pacific workers in Australia and New Zealand, and the possible inclusion of trade in services in the PICTA and PACER agreements. Other issues discussed in this report include the declining value of existing preferential trade agreements, “aid for trade” (A4T), constraints on market entry (particularly sanitary and phytosanitary [S&D] barriers), the great proliferation of bilateral and regional trade agreements, the increasing importance of tourism for the PDMC economies, and related issues such as the opening up of international and domestic airline services.

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<sup>1</sup> Cook Islands, Fiji Islands, Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

# Summary of Earlier ADB Analyses

The 1998 ADB report *Improving Growth Prospects in the Pacific* outlines some general theoretical relationships between trade policy and economic growth. In the seminal Solow–Swan neoclassical economic growth model (Solow 1956, Swan 1956), there is no trade, and growth takes place through factor accumulation and exogenous technological change. Extension of the neoclassical model to include trade increases the level of income and has a temporary impact on the rate of growth (Srinivasan and Bhagwati 1980).

In the endogenous growth models, creation of new knowledge and technology as outcomes of profit-seeking activity becomes the source of long-run growth (e.g., Romer 1990). These models also allow government policies to affect the long-run growth, for better or worse. The ADB report argued that the standard “spillover” endogenous models, with their focus on scale effects and high-growth sectors, have little relevance for ADB’s PDMCs. Instead, PDMCs were urged to remove obstacles to foreign investment, as this would lead to enhanced human capital and the introduction of productivity and growth-improving technology. Openness to international trade also increases the economy’s exposure to market forces and exerts pressure for the adoption of institutions (such as property rights) and policies (such as trade, investment, and competition policies) that will foster a more market-oriented and less risky environment for investors. Because of the resulting reduction in the risk-adjusted rate of return on investments, the share of value added available for labor will increase. Increased import competition can also serve as a “backdoor” means of reforming labor markets, as the removal of the bargaining over the monopoly rents of protection will lead to increased labor productivity.

The 1999 ADB report *Pursuing Economic Reform in the Pacific* went into further detail regarding trade policy reform in the PDMCs, given the

increased attention to a trade agreement among the FICs and between the FICs and Australia and New Zealand. Also, the possibility of a WTO-eligible regional agreement with the EU was being considered.

The 1999 report argued that the chances of a preferential trade agreement among the FICs being, on balance, welfare-enhancing, were slim, unless import barriers in the rest of the world were substantially relaxed. This is so because the likelihood of trade diversion is high, as free trade among the FICs would divert trade from lower-cost imports from the rest of the world to higher-cost imports from other FICs, leading to the development of internationally uncompetitive enterprises. The most diversified of FIC economies (i.e., the Fiji Islands and Papua New Guinea) are highly likely to be the major beneficiaries of the agreement.

A preferential trade agreement between the FICs and Australia and New Zealand would be more likely to be welfare-enhancing because imports from Australia and New Zealand would be closer to world-best prices. However, many products imported by the FICs would not be least-cost. Therefore, unilateral liberalization by the FICs with the rest of the world would be most welfare-enhancing in terms of improvements in allocative efficiency, as this would minimize the import “tax” on exports (i.e., import barriers raise the costs of import-competing and exporting activities). As well, there would be the even more important “dynamic” gains from trade due to openness to investment, technology, skills, and ideas.

One concern over trade liberalization addressed by the 1999 report was that reducing import restrictions, particularly tariffs, would mean a substantial reduction in government revenues unless replacement sources of revenues were found. Moreover, putting in place a new tax system would take some time. Another concern addressed was that resources moving out of industries losing protection would move out of the country, given the region’s proclivity for labor and capital to emigrate. On the first point, the report argued that compliance with payment of customs duties in developing countries is generally poor because of the extensive use of exemptions granted as favors to businesses. There are, as well, the problems of customs officers misclassifying imports to reduce duty rates and importers under-invoicing to avoid duties. The report noted that movement to a lower and less variable duty regime can lead to revenue collections not falling by as much as anticipated because there is less incentive for such discriminatory behavior.

However, reductions in tariffs could still pose a problem for government revenues, and the phasing of Samoa's reforms were cited as a good example to follow. Samoa introduced its value-added tax (VAT) regime several years before it introduced its substantial trade liberalization, by which time the VAT regime was well established.

On the second point, the report suggested that there may be a good case for institutional reform at the same time as trade policy reform to reduce the likelihood of resources leaving the country. Resources are invested in protected industries because, in large part, the monopoly rents granted by the protection means that their returns on investment are high enough to more than offset the risks of investing in the country. Therefore, to reduce the investment risks and the rate of return required for investors to want to invest, it is necessary to improve the investment climate.

The report concluded that unilateral liberalization would be the best option for the PDMCs. It argued that the PDMCs could act "as if" they were members of the Asia Pacific Economic Cooperation or the WTO, without having to bear the high administrative costs of being a formal part of these organizations. However, it has to be recognized that being a member of the WTO has advantages in resolving trade disputes with other members. For example, with regard to the FICs developing agricultural export industries, quarantine barriers pose a considerable obstacle, and often these restrictions are not genuine. The WTO offers a scientific forum for evaluating whether a quarantine barrier is justified because of a genuine risk to the country's own industry or whether it is only a means to prevent imports.

# Trade Agreements among Small Developing Countries

In 2001, the FICs negotiated a preferential trade agreement, the PICTA. PICTA is purely a merchandise trade agreement with tariff reductions phased in over a long period—up to 10 years for the least developed FICs<sup>2</sup> and 13 years for the three FICs that have a Compact of Free Association with the United States.<sup>3</sup> Negative lists are allowed, and these are very extensive in some cases (e.g., in Papua New Guinea). Protection of “developing” industries is also allowed, as are safeguards such as anti-dumping measures for balance of payments reasons. PICTA was signed by nine FICs in 2001 and came into force in 2003. But to date, only the Cook Islands, Fiji Islands, and Samoa have national legislation in place and are ready to trade under the agreement.

PICTA was seen as a “stepping stone” toward more multilateral trade liberalization. The idea that trade liberalization should be a gradual process to limit disruption and structural adjustment was first in the minds of the parties to the agreement. However, the lack of progress in implementing the agreement suggests that seeing PICTA as a “stepping stone” to further liberalization may be a highly optimistic assessment. Moreover, the perception that the agreement could be a “training ground” for businesses and governments completely misunderstands the political economy of trade reform.

The FICs are mostly very small economies with similar exports (mostly agricultural) and little trade between them. Empirical studies show that the benefits from PICTA would be minimal.<sup>4</sup> Moreover, there is the strong

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2 Kiribati, Samoa, Solomon Islands, and Vanuatu.

3 Republic of the Marshall Islands, Federated States of Micronesia, and Palau.

4 See, for example, Scollay et al 1998.

possibility that the outcome of the agreement could be negative on balance because of the high likelihood of trade diversion. That is, the preferential removal of tariffs on higher-cost imports from member countries would allow them to displace lower-cost goods previously imported from countries outside the bloc.<sup>5</sup> As noted earlier, trade diversion effects would be less likely if the bloc lowered its barriers to trade with the rest of the world.

The adverse impacts of this kind of trade agreement are likely to be even worse than envisaged above. The governments of the importing countries no longer receive tariff revenues from the imports that come from within the trade bloc. Essentially, the tariff revenue is transferred in large part to the exporting firms in member countries and, to some extent, to domestic consumers. As we have seen from experience with the collapse of the East African Community and the problems encountered in the attempted formation of the customs union among the Caribbean states, the more advanced of the developing country grouping tend to receive most of the investment generated by the new trading bloc and, therefore, receive most of the “transfer” of the tariff revenue. Hence, the more industrially developed of the FICs will likely benefit from PICTA at the expense of the others. The same forces that cause trade diversion also lead to income divergence between members of the trade bloc. The outcome is likely to be antagonism against trade liberalization in these countries, setting back progress. Therefore, rather than being a “stepping stone” toward fuller trade liberalization, PICTA is likely to be a “stumbling block.”

Trade liberalization is not a popular policy in the PDMCs and is strongly resisted by state-owned enterprises (of which there are many in most PDMCs), the branches of international companies that have been set up under import protection mechanisms, and most nongovernment organizations, which apparently do not see that in resisting trade liberalization, they are supporting the use of very regressive taxes and punishing potential export industries. Hence, with this set of forces arrayed against trade liberalization, it must be given the best chance for it to progress. Introducing trade liberalization through PICTA appears to be the worst option to take.

Those not in favor of trade liberalization under PICTA, or under any other agreement for that matter, often cite the loss of tariff revenue as a reason for not adopting such policies. As previously noted, preferential

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5 As opposed to trade creation where, because of the lowering of trade barriers between countries within the trade bloc, lower-cost partner country imports displace higher-cost domestic production.

trade agreements do transfer tariff revenue between countries within the trade bloc. Because of concerns over the loss of tariff revenue, the Pacific Islands Forum Secretariat recently commissioned a report on the likely tariff revenue loss by the eight smaller members (i.e., Kiribati, Republic of the Marshall Islands, Federated States of Micronesia, Nauru, Niue, Palau, Tonga, and Tuvalu). The report reviewed conclusions from previous studies in the light of recent trade information, and looked at effective mechanisms for recovering the loss in tariff revenue because of the adoption of PICTA. It was concluded that PICTA would mean only a minor loss of tariff revenue (less than 2% of government revenue), which could be easily covered from other revenue sources such as increased “sin” taxes and the use of a VAT.

The above criticisms also hold for subregional preferential trade agreements such as the Melanesian Spearhead Group which was originally formed between Papua New Guinea, Solomon Islands, and Vanuatu, and later included the Fiji Islands and New Caledonia. This trade agreement began with three commodities being granted free entry (one for each country). Through the years, the number of commodities included in the agreement has grown to over 160. However, it appears that whenever a domestic industry believes that its market is being taken by imports, there is an appeal for protection against the imports—an appeal that is usually granted. Hence, recent years have seen the “tinned beef war” between the Fiji Islands and Papua New Guinea as well as the “biscuit war” and the “kava war” between the Fiji Islands and Vanuatu. The unwillingness of these governments to abide by the trade agreement illustrates the lack of conviction at the political level in the region about the benefits of trade liberalization.

The most important actions that Pacific countries could take as a group would be to realize the economies of scale and other benefits from adopting the regionalization measures proposed under the Pacific Plan. These would be much more effective than any Pacific-country-only trade agreement. Besides achieving economies of scale, regional bodies that provide public goods (such as a competition policy body or regional audit or customs authorities) would have a much larger pool of skills to draw from. Moreover, regional bodies should achieve a measure of independence from the “small country” problems that these countries face in trying to implement the checks and balances that lead to good governance.

# Trade Agreements with Large Developed Countries

**A**s members of the Pacific Islands Forum, the FICs have begun to engage with large developed countries in negotiations over regional trade agreements such as the ongoing negotiations over an EPA with the EU and the upcoming negotiations over PACER with Australia and New Zealand.

## **Pacific Agreement on Closer Economic Relations**

PACER is a framework agreement that establishes the guidelines for the future development of trade relations among the 14 FICs and with the two developed country members of the Pacific Islands Forum, Australia and New Zealand. It also touches on trade agreement negotiations with the EU and the United States (US). In a sense, PICTA is the first agreement to be established under PACER. Under PACER, negotiations over a preferential trade agreement between the FICs and Australia and New Zealand were to begin 8 years after PICTA came into force (that is, 2011). However, negotiations may begin earlier by mutual consent or if they are triggered by the FICs commencing negotiations over preferential trade agreements with other developed countries, such as the EPA negotiations with the EU.

In providing a framework for the gradual development of trade and other economic cooperation among the FICs and between the FICs and other countries, PACER acknowledges that individual FICs may find it in their interest to move at a different pace in developing closer integration

with other countries. This provision was affirmed in a recent speech by the Australian Foreign Minister, Alexander Downer, who stated:

PACER holds the prospect of a comprehensive, region-wide free trade agreement. But there may be some countries that would like to develop their relationship with Australia at a faster rate and in ways that go beyond the scope of PACER.

To encourage even greater commitment to good governance and economic growth in Pacific countries, we might be able to strike bilateral agreements with particular countries to give them more support in return for a greater commitment to reform. Simply providing more aid money will not solve the Pacific's problems, but we should support real reform efforts.

Such agreements would set clear targets for economic and governance reforms. In return, we would offer opportunities for greater economic integration with Australia.

Under the agreements, we could provide more aid targeted at economic growth or, in some cases, the establishment of trust funds. We could offer assistance with attracting investment and promoting trade; help Pacific countries meet Australian import requirements for their export products; and provide assistance with infrastructure projects that help build the capacity to trade.

We would also look to place more Australian officials in advisory or line positions in the public service in Pacific countries to help plan and implement the agreed reforms.

The conclusion of such agreements would send a strong signal to the region about our commitment to the Pacific and our strong support for real reform.

This can be read as an open invitation to the FICs individually to begin negotiations—with Australia at least—over an agreement for close economic relations that go beyond merchandise trade and could involve trade in services and freer labor movement, as well as development assistance of various kinds. There is already a provision within PACER for Australia and New Zealand to give financial and technical assistance for establishing trade facilitation measures for the FICs.

According to modeling work undertaken, for example, by the Centre for International Economics (1998), a preferential merchandise trade agreement between the FICs and Australia and New Zealand offers many times larger net benefits to the island countries than does PICTA. The additional gains largely flow from lower-cost imports displacing higher-cost domestic production in the Pacific countries. With the structural adjustment away from inefficient industries, displaced resources flow toward activities that reflect the countries' comparative advantage. Besides the structural adjustment effects on the previously protected labor and capital, the key concern is the ability of the economies to respond to the changes in relative prices. This response will depend largely on whether internal constraints to the supply response exist. Hence, it is critical that as part of the trade liberalization, policy makers identify and remove any binding constraints on responses to the relative price changes. These binding constraints may be in the form of institutional, policy, and regulatory obstacles, as well as economic obstacles in the form of human capital and credit access constraints.

Because of the large share of Australian and New Zealand imports in the total imports of most FICs, a preferential trade agreement between the FICs and Australia and New Zealand will significantly impact on the customs duties collected by those FICs that impose tariffs. As Narsey (2003) has argued, however, the FICs can protect a substantial part of their government revenues collected from this source by converting import duties into excise taxes on "sin" (e.g., alcohol and tobacco) and luxury goods (e.g., luxury cars), and raising the level of taxes on these goods—for health reasons in the case of the former, and for equity reasons in the case of the latter. For those countries that do not presently have a VAT regime, introduction of this form of taxation, which is usually less regressive than a tariff regime, could also help compensate for any revenue loss.

## A Pacific Economic Partnership Agreement

Negotiations between the EU and the Pacific African, Caribbean, and Pacific (ACP) Group of States over an EPA were to begin in 2002 and to conclude by 31 December 2007.<sup>6</sup> This deadline was set in the trade provisions of the Cotonou Agreement, the replacement for the Lome IV

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<sup>6</sup> This date coincides with the expiry of the World Trade Organization waiver for the current regime under the Cotonou Agreement.

Convention, signed in 2000. Whereas the preferential, nonreciprocal provisions of the Lome Convention were found to be incompatible with the provisions of Article XXIV of the General Agreement on Tariffs and Trade, the regional EPAs between the EU and the ACP countries were to be reciprocal agreements. However, even with the deadline for the end of negotiations over the EPAs looming, almost no progress has been made on an EPA with the Pacific ACP countries.

Both Scollay (2002) and Narsey (2003) note that the EU is an insignificant source of imports for most Pacific ACP countries and conclude that it is likely to remain so. For example, the EU's share of the Fiji Islands' total net imports is around 2%. Therefore, providing free entry to EU imports is not significant in itself. The important point is that providing such preferential entry will trigger demands for similar preferences to Australia and New Zealand under PACER and to the US under the Compact agreements. However, of the Compact countries, this would only be of concern for the Marshall Islands as the Federated States of Micronesia and Palau have tariff levels close to zero.

The main trade issues for the Pacific ACP countries in the EPA negotiations are the Fiji Islands' exports under the Sugar Protocol with the EU; the export of canned tuna—which currently concerns the Fiji Islands, Papua New Guinea, and Solomon Islands (although other Pacific ACP countries are investing in tuna-canning facilities); and the temporary employment of vocationally skilled workers in EU countries.<sup>7</sup> Because they have such little interest in exporting to the EU in the absence of preferential arrangements, the Pacific ACP countries have focused on the export of labor services—an export activity that is not much affected by the high international trade costs of these remote countries. The other major interest for the Pacific ACP countries in an EPA is the provision of development assistance that the EU has promised under the Cotonou Agreement.

The Common Agricultural Policy of the EU is being reformed under pressure from within the EU and from the WTO, and the preferential price granted to ACP countries for their quota of sugar exports is being reduced. Similarly, the margin of preference on canned tuna is to be reduced. These reductions in import preference will lead to significant adjustment pressures

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7 In the case of the Fiji Islands, its sugar exports account for more than 80% of its total exports to the European Union.

in these industries in the Pacific ACP countries. In requesting quotas for the temporary entry of skilled workers in the hospitality industry, health care industry such as nurses, and construction industry such as carpenters and plumbers, the Pacific ACP countries are attempting to broaden the definition of General Agreement on Trade in Services Mode IV “temporary movement of natural persons,” which presently covers only highly skilled workers such as doctors.<sup>8</sup>

Largely as a result of the lack of any progress on the temporary entry of Pacific workers, the negotiations over a Pacific EPA are stalled.<sup>9</sup> With the end-2007 deadline approaching, consideration is now being given to what might take place in the absence of a negotiated EPA. One option is for the EU to apply to the Pacific ACP imports, the Generalised System of Preferences (GSP) tariffs that apply to all developing countries. There are three levels of tariffs under the GSP:

- The standard tariff that applies to all developing countries;
- The “Everything But Arms” regime that applies to countries identified by the United Nations as least developed countries<sup>10</sup> and which allows duty-free and quota-free access to imports; and
- The so-called GSP+ regime, for which no ACP states are eligible.

Under a GSP regime, the product of main concern is canned tuna, where the Fiji Islands and Papua New Guinea would have to export to the EU on the same basis as other developing countries. Solomon Islands would have preferential status. However, a major problem with the Pacific ACP countries being given access to the preferential GSP or “Everything But Arms” regimes is that these arrangements are not reciprocal. The developing countries are not required to undertake any trade liberalization.

8 Immigration issues are matters for individual EU states, not the European Commission. However, the Commission has agreed to assist the Pacific ACP states in their negotiations with individual EU countries on this matter.

9 Subsequent to this paper being presented, the European Commission initialed interim agreements with the Fiji Islands and Papua New Guinea concerning market access and development cooperation. This interim agreement is open to any other Pacific ACP state. Under the interim agreement, the EU will reduce tariffs by 100%, but with phased reductions for sugar and rice. The Fiji Islands and Papua New Guinea expressed intentions to completely remove tariffs on around 80% by value of their goods trade with the EU over a 15-year period. The interim agreement was negotiated on the basis that the full EPA would be agreed by the end of 2008.

10 At present, Kiribati, Samoa, Solomon Islands, and Vanuatu have been identified as least developed countries. However, Samoa will shortly lose its least developed country status.

In that event, they will continue with policies that prevent them from participating in the trade and economic growth that comes from economic integration with the rest of the world.

Other options in the absence of an EPA by the end of 2007 are to request an extension of the WTO waiver or to agree on an EPA with only a generalized framework identified with detailed negotiations to be concluded later. The extension of the WTO waiver is unlikely because of the lack of sympathy for the EU from other WTO members, on the basis of setting a bad precedent. Therefore, it may be best for the Pacific ACP countries to agree on an EPA by the end-2007 deadline, which leaves open negotiations on the transition arrangements for sugar and tuna, and the possibility of temporary employment of workers. This would provide the countries immediate access to the development assistance (including assistance with trade facilitation) that the EU promised on the condition that sensible economic policies are adopted.

But this kind of agreement would only show the fact that the EPA and PACER agreements are being negotiated in the wrong order. The large gains from trade liberalization—and the large structural adjustments, except for the Fijian sugar industry—will be associated with the PACER negotiations. Also, as the PACER agreement stipulates, and Minister Downer's recent statement affirms, development assistance will be available, including assistance with trade facilitation, as a consequence of the Pacific ACP countries adopting economic policies that promote economic growth. The negotiations over the economic policies that Pacific ACP countries will adopt in exchange for various forms of development assistance are likely to be more detailed under the PACER negotiations. Therefore, negotiating these arrangements first before turning to the EU for requests for development assistance appears to be desirable.

# Multilateral Trade Liberalization

Presently, the Fiji Islands, Papua New Guinea, Samoa, Solomon Islands, and Tonga are members of the WTO. However, their accession has been negotiated under the usual WTO preferential practice of allowing developing countries to maintain higher tariff levels and reducing them more slowly than in the case of developed countries. By liberalizing their trade with the rest of the world through the WTO, the Pacific countries would gain improved market access without transferring tariff revenue to Australia and New Zealand or to the EU. Accession to the WTO also “locks in” the commitment to trade liberalization because the WTO provides both sanctions and rewards (i.e., technical and financial assistance to improve human resource capacity and assistance with policy development). PICTA does not provide similar means to overcome the time inconsistency problem that subsequent governments will not follow the same policy, as there is no sanction and rewards regime in PICTA. The WTO also provides protection against actions taken by member countries that are not consistent with WTO policies.

The transaction costs of accessing the WTO are relatively high, particularly for small countries. However, the transaction costs of negotiating EPAs have also been high and they will be for negotiating a preferential trade agreement under PACER as well. Small countries could gain most of the benefits from WTO membership without joining the organization through unilateral trade liberalization. However, they would not have access to the financial and technical assistance available through the WTO. They would also not have access to the kind of protection that the WTO dispute resolution mechanism provides. Nevertheless, the supposedly favorable “special and differential” treatment that developing countries receive in the WTO does not really do them a favor, as this only serves to prolong the costs incurred by having distortive import restrictions in place.

Trade liberalization is not the reason some low-income countries are falling further and further behind in relative per capita income terms. The reason for their poor performance is largely because they are not liberalizing their trade regimes and are marginalizing themselves from developments in the rest of the world.

Ultimately, the negotiation of a preferential trade agreement between the FICs and Australia and New Zealand on the one hand, and with the EU on the other, will involve the exclusion or restriction of some exports in which the FICs have a comparative advantage. Preferential trade agreements between high-income countries and developing countries often allow free access for all commodities except those that the developing countries are best at producing. For example, under the South Pacific Regional Trade and Economic Cooperation Agreement, Australia allows free entry to all exports from the Fiji Islands, except sugar, which is banned. Beef exports from Vanuatu (its premier export) are subject to an EU quota. Thus, the chances for the FICs to gain free access for their exports are likely to be better in a WTO negotiation than in a bilateral negotiation with a developed country.

Bilateral agreements with developed countries also hold the threat noted regarding PICTA—that investment will tend to concentrate in the most advanced country. This is the so-called “hub-and-spoke” problem where the “hub” country—in this case, the high-income country or countries—is the focus for investment as it has preferential access to all the “spoke” countries.

# Discussions on Topical Trade Issues

**B**elow, several recent developments affecting the PDMC economies and topical trade issues are discussed in an examination of what they might mean for trade policy and economic development in the PDMCs. These topics include the recent growth of tourism in the Pacific, the growth in overseas employment by Pacific islanders, health and food safety issues with respect to agricultural exports, and the concept of “aid for trade.”

## Tourism in the Pacific

Tourism has become a sector of increasing importance in the Fiji Islands, especially as the sugar industry has withered as the result of the nonrenewal of land leases to Indo–Fijian farmers by the indigenous landowners, and with the sharp decline in the garment industry because of the loss of preferential entry to the US because of the expiry of the Multi-fiber Arrangement and the decline in tariff assistance given to the garment industry in Australia and New Zealand. The tourism sector of the Fiji Islands was set back sharply by the 1987, 2000, and 2006 coups. However, it quickly recovered from the 1987 and 2000 coups, and will recover again once political stability is restored. The tourism industry in the Fiji Islands has no doubt been assisted by the impact of the Bali bombings, especially affecting Australian tourists, and by the SARS<sup>11</sup> scare. However, the industry has also benefited from increased competition in international air services to the Fiji Islands and by the reasonably secure, long-term leases provided to resort hotels.

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<sup>11</sup> Severe Acute Respiratory Syndrome.

More recently, the tourism industry has become a key driver of economic growth in other Pacific states, particularly the Cook Islands, Samoa, and Vanuatu. The surge in tourist numbers in these countries has been most noticeable since 2004, coinciding with the period when international air services to these countries became more competitive. But again, the existence of secure, long-term leases of custom land for resorts, openness to foreign investment, and privatization of hotels in the case of the Cook Islands, has been very helpful. Interestingly, the Cook Islands, Samoa, and Vanuatu were the PDMCs that undertook comprehensive economic reform programs in the mid-1990s with assistance from ADB. A general point that can be made from the growth in tourism is that it illustrates the importance of niche markets for these economies that have such high international trade costs. After all, tourism is the ultimate niche market. All countries have some unique characteristics that they can highlight to differentiate their tourist “product.”

What does the growing importance of tourism for PDMCs mean for their trade policies? For those PDMCs that have not yet taken advantage of this opportunity, there is a clear message:

- Open up international air services (and most likely internal transport services);
- Provide effective airport infrastructure;
- Provide resorts with secure long-term land tenure and develop equitable contracts with landowners; and
- Be open to foreign investment.

Most PDMCs do not have a high absorption capacity for waste and, therefore, environmental considerations will always limit manufacturing. Hence, besides agriculture and fishing, service activities will be high priority areas for exports. For example, provision of education and medical services is a likely development. A critical element in developing some service exports is to have an efficient telecommunications sector. The PDMCs have been hamstrung for many years in developing telecommunications-related activities because of the monopolistic arrangements most of them put in place. Fortunately, these monopolies are being dismantled in several countries with spectacular results. For example, Samoa now has several Internet service providers and has opened its mobile phone sector. As a result, Internet and mobile phone use has expanded rapidly. The Fiji Islands is in the process of opening up its mobile phone and Internet sectors.

## Exporting Labor

In the past, when populations outstripped the capacity of the land to feed the people, Pacific islanders set out in search of new islands to settle—which they obviously did very successfully. They are no longer able to do this as sovereignty has been declared over all the land on the planet. Moreover, population growth was much slower in those days than over the past 50 years or so, when the world’s population has experienced very rapid growth as the result of a unique set of events: safer water and sanitation, and immunization against infectious diseases, leading to lower infant and maternal mortality and longer life expectancy. Today, Pacific populations are increasing at annual rates of growth as high as 2.5–3.0%. In the absence of substantial investment in the communally owned land, there is no possibility of agricultural productivity increasing at a similar rate to maintain per capita food consumption. But unless special arrangements are made, in a communalistic society, there is an absence of secure individual title to land, an absence of savings, and little or no capacity to borrow, and therefore little incentive for entrepreneurship, investment, and individual effort.

The increased food demand from the increasing populations must be satisfied by increasing the farmed area. Otherwise, people would have to leave the village to try to find work in the towns or work overseas. In a sense, therefore, Pacific peoples are still “on the move.” In Tonga, for instance, remittances comprise over 50% of gross national income. The share is about 20% in Samoa and it is growing rapidly in the Fiji Islands. About 90% of Cook Islanders live overseas, and much the same holds for the micro-island states of Niue, Nauru, Tokelau, and Tuvalu. Thus, most people from these small, remote communities live and work elsewhere and are educated with this objective in mind. They regularly send remittances to their families and church. Moreover, they return on holidays frequently, and some eventually return permanently when they retire. People from the US Compact countries can freely move to the US.

But the same is not true for the larger Melanesian countries—Papua New Guinea, Solomon Islands, and Vanuatu—that do not have easy migration access to Australia, New Zealand, and the US. In these countries, literacy rates are significantly below those with relatively easy access to metropolitan countries. Parents do not have the incentive to educate their children as they cannot migrate and job opportunities in the country are few.

However, pressures are building to allow temporary immigration for employment for even these countries. Two effects are at work. First, there is the aging of populations in the higher-income countries. Moreover, with their incomes increasing, people in these countries are less inclined to do the “3D” (i.e., dirty, difficult, and dangerous) work. Second, there is a “youth bulge” in Pacific countries, especially Kiribati, Papua New Guinea, Solomon Islands, and Vanuatu—countries where formal employment is low and growth of formal jobs is very slow. Because of these two effects, there should be a happy coincidence of interests between the high-income countries of the Pacific region and the developing Pacific countries. New Zealand, which has long allowed free entry of people from the Cook Islands and Niue, and relatively liberal entry of migrants from Samoa and Tonga, is testing a temporary, seasonal, unskilled worker scheme for labor from Vanuatu, as well as from Samoa and Tonga. Australia is said to be observing how this scheme progresses.

Where migration is possible, Pacific islanders educate their children to migrate to market-based societies. In most cases, they perform just as well economically as the rest of the host country population. They send remittances to their families for village celebrations and other obligations; that is, they retain strong links to their village community and are thus able to return when they wish. Most smaller Pacific countries are unlikely to ever be so economically viable to be able to support growing populations. Therefore, they will continue to need outward migration and financial support from their relatives working overseas or from foreign aid that provides for essential infrastructure. Outward migration seems to be a necessary dimension of their future. But this does not mean that the migrants lose their identity or the cultural values of their communities. In fact, they will have the rich opportunity to enjoy the best of both worlds returning for holidays or when they retire.

For the larger Pacific states such as the Melanesian countries, labor mobility can still be important, as it is presently in the Fiji Islands.<sup>12</sup> However, it is unlikely to play as important a role as in Samoa and Tonga, or in the ministates. For the larger Melanesian countries, ensuring private investment of sufficient scale to create employment opportunities that match the numbers of secondary and tertiary education graduates will remain their biggest challenge.

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<sup>12</sup> In the Fiji Islands, remittances from nurses, teachers, caregivers, and army and security personnel working overseas have recently become the second largest foreign exchange earner next to tourism.

With respect to the interaction between labor mobility and trade policy, the Pacific Islands Forum Secretariat is trying to generate enthusiasm for including trade in services, particularly labor services, into the PICTA, PACER, and EPA with the EU. As far as PICTA is concerned, most Pacific countries have little to offer each other with respect to making a deal on merchandise trade or services trade. If labor is free to move in PICTA countries, the same effect as mentioned earlier is likely to be observed; that is, skilled people will move to the more advanced countries, contributing to the present “brain drain.” The EU has so far expressed no interest in including provisions for temporary employment of semiskilled migrants in the Pacific EPA. The best opportunities for Pacific labor mobility appear to lie with Australia and New Zealand within the PACER framework.

## Aid for Trade

In the 6<sup>th</sup> WTO ministerial meeting held in Hong Kong, China in December 2005, an Aid for Trade Initiative was proposed. The main objective of the initiative is to provide A4T assistance to countries as a parallel measure to support the WTO Doha Round. The rationale for A4T is that some developing countries need assistance to take advantage of market access opportunities offered to them as the result of the Doha and previous WTO Rounds. In recent years, there has been a realization by the development assistance agencies that the supply response of many developing countries to the opening of markets in the higher-income countries has been poor and that this is often because of supply constraints (“binding constraints”) in the country. Unless these obstacles are overcome, the countries will not be able to take advantage of the market openings in other countries.

Assistance of this form appears eminently sensible. For example, Pacific countries have not been able to participate in the virtual revolution in exports of high-value agricultural products that has occurred in recent years (McGregor 2007). McGregor (2007) highlights a very important issue in developing Pacific agriculture: overcoming the sanitary, phytosanitary, and quality barriers facing agricultural exports into developed country markets. He points to the unrealized market opportunities for Pacific agricultural products in the substantial Pacific islander populations residing in countries such as Australia, New Zealand, and the US. In addition, he notes that there are also unrealized market opportunities for unique Pacific island products elsewhere, such as in the EU and Japan.

Overcoming the sanitary and phytosanitary barriers requires scientific data to demonstrate that the importation of Pacific agricultural products does not pose a threat to the agricultural sector of importing countries or to demonstrate the kind of quarantine treatment that will be most effective in rendering the imported products harmless, without reducing their quality. Besides the needed scientific input, Pacific countries have to attract potential importing countries to carry on effective negotiations over market entry. Because of the Pacific islands' relatively small size, gaining the attention of importing countries is difficult. Trade facilitation of this form appears necessary if agricultural exporting is to have a place in the economic development of the PDMCs.

What does this concern for A4T mean for ADB's activities? While it is very important to recognize that binding constraints to supply responses to changes in the terms of trade should be overcome, care should be taken in translating this into ADB programs. Identifying the binding constraints to economic growth should be essential to setting priorities for all ADB activities. If A4T is key to overcoming binding constraints to a country's economic growth, then obviously A4T should receive priority. The question for ADB management should be whether addressing these constraints is a priority for ADB, or whether another development agency is in a better position to provide assistance.

Thus, ADB management should not be considering whether to establish a special mechanism to address A4T issues. If A4T is considered a priority issue for the PDMCs or other member countries, then it should take priority in ADB's overall assistance program.

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## About the Book

This report was prepared for a conference hosted by the Asian Development Bank and the World Trade Organization entitled "Mobilizing Aid for Trade: Focus on Asia and the Pacific." It seeks to bring a better understanding of contemporary trade issues in the Pacific region.

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ADB aims to improve the welfare of the people in the Asia and Pacific region, particularly the nearly 1.9 billion who live on less than \$2 a day. Despite many success stories, the region remains home to two thirds of the world's poor. ADB is a multilateral development finance institution owned by 67 members, 48 from the region and 19 from other parts of the globe. ADB's vision is a region free of poverty. Its mission is to help its developing member countries reduce poverty and improve their quality of life.

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