

Executive Summary

What 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)¹ 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

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, ICT²-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.

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.