

Pacific Studies Series



Executive Summary

Toward a New Pacific Regionalism

An Asian Development Bank—Commonwealth Secretariat
Joint Report to the Pacific Islands Forum Secretariat

ADB



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Preface

This report was prepared for the Pacific Islands Forum Secretariat (PIFS) in Suva, Fiji Islands. The report is one output of an Asian Development Bank (ADB) technical assistance project (TA 6226 REG): “Developing and Implementing the Pacific Plan for Strengthening Regional Cooperation and Integration.” The Commonwealth Secretariat provided parallel funding to the Project.

The lead author of the report was Dr. Roman Grynberg, Deputy Director of Trade and Regional Cooperation at the Commonwealth Secretariat. He was assisted by Michael Hyndman, a cost-benefit analyst contracted by ADB, and Sacha Silva, an economist contracted by the Commonwealth Secretariat. Consultants from PIFS and the Pacific region provided valuable inputs for the report. Bill Costello was the ADB task manager.

The report is published in three volumes. Volume 1 is the Executive Summary. Volume 2 is the main report. Volume 3 contains the working papers commissioned for the report—a series of independent studies assessing potential benefits and costs of implementing a variety of possible regional initiatives. A list of the working papers is at Appendix 1. Volume 3 has not been printed in hard copy. It is available on the websites of ADB (www.adb.org) and at www.pacificplan.org.

This report analyzes issues and possibilities for a new Pacific regionalism, in the context of the commitment of Pacific Island leaders to create the Pacific Plan for Strengthening Regional Cooperation and Integration. It argues that good governance and economic growth are the highest priorities of the four key goals of the Forum. It highlights the challenge of Pacific Plan initiatives generating large benefits in a region facing small economies of scale and high diseconomies due to isolation, and discusses the importance of Australia and New Zealand markets for generating larger economic benefits from regionalism. The report discusses different objectives for regionalism (including provision of services and market integration), and notes that varied approaches and subregional groupings will be appropriate for meeting different objectives. Initial assessments of possible regional initiatives are presented under the proposed four pillars of the Pacific Plan. Among other benefits, those initiatives would contribute to strengthening economic management and accountability; to lowering cost and more effective regional transport and communications markets; and to creating regional employment opportunities. The report also discusses the likely barriers to the creation of a new Pacific regionalism. It suggests a binding instrument based on mutual obligation and involving trade, aid, and governance commitments. This agreement would reinforce the vision of Pacific leaders, and allow all Forum members to benefit from a new Pacific regionalism, resulting in significant gains for the people of the Pacific.

This Asian Development Bank (ADB) and the Commonwealth Secretariat report was prepared for the Pacific Islands Forum Secretariat in support of an ongoing Forum process for a new Pacific regionalism. This process includes the 2004 Auckland Declaration and leaders' decision to develop and implement the Pacific Plan for Strengthening Regional Cooperation and Integration ("the Pacific Plan"). Inputs to the Pacific Plan formulation process have provided a number of options for Pacific regionalism, and several potentially beneficial regional initiatives. Nonetheless, the Pacific Plan process itself has not included a rigorous economic analysis. Such analysis is vital given the constraints on resources, time, and political capital in the region. This report seeks, therefore, to provide a strong analytical foundation upon which Forum leaders can prioritize and sequence regional initiatives.

What are the challenges facing the Pacific region?

The analytical foundation for a new Pacific regionalism begins with an assessment of the challenges facing the region. The Pacific Plan should address the most significant challenges facing the region in a way that adds value to existing national and regional capacities. Many Forum Island countries (FICs) face serious challenges in providing for their people the four key goals of the Forum:

- economic growth,
- sustainable development,
- good governance, and
- security.

This study estimates that poor governance in Papua New Guinea (PNG), Fiji Islands, Solomon Islands, and Nauru has resulted in nearly United States dollars (US)\$75 billion in forgone income in those countries since independence. This study argues that *an appropriate approach to addressing the four pillars for the Pacific Plan is to consider good governance and the creation of economic growth the highest priorities and necessary prerequisites for achieving the Forum's security and sustainable development objectives.* Regionalism can help FICs address governance challenges by providing specialized expertise not available locally. It can also help by providing suitable, impartial advice or management of governance challenges.

Some—but certainly not all—of FICs’ economic difficulties in facing outstanding challenges can be linked to smallness. The human capacity constraint confronting FICs is becoming increasingly important as modern requirements of business and government become more complex. Faced with policy and capacity constraints in a globalizing world, FIC governments are experiencing difficulties in meeting their two essential sovereign functions:

- formulating and enforcing effective and appropriate national policies; and
- providing essential services such as health, education, and policing.

The “effective sovereignty” of FICs—their ability to effectively carry out chosen policies—is being eroded. The Pacific Plan can reverse this trend and reinforce the “effective sovereignty” of FIC governments by increasing FIC access to high quality services, including policy and technical services, through delegating more specialized functions and by broadening economic opportunities.

Club theory and some principles for successful regionalism

When assessing Pacific regionalism, the economic theory of clubs contains important lessons. Club theory has been applied to a wide range of contexts, including military alliances, international organizations, and cross-border infrastructure and services. Clubs—groupings of agents, firms, or countries—have different characteristics that make them amenable to different groupings. Yet any collective endeavor or club must satisfy two basic conditions.

- A club must be self-sustaining.
- A club must provide a large enough pool of net benefits for each of its members.

The success or failure of a club depends on its benefits exceeding its costs. Economies of scale—the reduction in unit cost resulting from pooling productive capacities—are offset by the costs of collective action. These costs effectively limit the size and scope of a club. In the Pacific, adding more remote countries entails higher diseconomies of isolation—the high cost of shipping goods, services, information, and people to increasingly remote countries

across the region. From this tension between scale benefits and distance costs of collective action, the “optimal club” (in this case, a group of countries), can be derived. The composition of the “optimal club” may vary significantly according to the issue or service under consideration.

The diseconomies of isolation are particularly high in the Pacific. Only regional initiatives with large-scale benefits will be sustainable. Often subregional initiatives will produce more viable “clubs.” Four principles for Pacific regionalism, based on lessons from club theory, are highlighted in the box below.

The Lessons of Club Theory for Pacific Regionalism

- Intervene regionally only where there are significant economies of scale. Avoid interventions where there are significant costs associated with isolation.
- Intervene regionally only where the market cannot provide the good or service, and where there are significant net benefits over and above national provision.
- Subregional provision may prove optimal in the face of high isolation costs.
- Specific initiatives are essential in many cases to assure services are provided to the smallest and poorest states. (Explicit subsidies for commercial provision of services are an example.)

The report’s examination of the history of selected Pacific island “clubs” is instructive. Historically, the strongest association arrangements have been based on the movement of people. *It is the movement of people that taps into the pool of economic benefits provided by a club, often through employment and remittances.*

In the Pacific (as elsewhere), there will inevitably be a tendency to favor marginalist, incremental approaches. Yet overcoming the inevitable “speed bumps” on the road to intergovernmental cooperation requires strong economic momentum. A political strategy based on the harvest of early practical benefits is essential. Early “wins” will need to be of sufficiently large magnitude to attract interest and serve as the basis of future interventions.

What are the mechanisms for Pacific regionalism?

There are three ways in which countries of the region can work together. Each balances economies of scale and diseconomies of isolation in a different way.

- *Regional cooperation* comprises dialogue and agreement between governments (e.g., Forum ministerial meetings, declarations, treaties). Implementation of agreements remains at the national level. Benefits include consensus building and information sharing. If cooperation is binding rather than voluntary, it can also strengthen policy coordination and implementation. Costs include setting up and maintaining the cooperative mechanisms themselves, and the cost of moving people around the region for meetings and conferences. These latter costs increase as more isolated countries are involved.
- *Regional provision of services* is defined as the merging of national services at the regional level (e.g., the University of the South Pacific). The benefits include a higher level of services at less total cost, with fewer facilities, greater efficiency, and a higher degree of shared knowledge. The primary cost—much like the cost of cooperation—involves moving goods, services, and people over large distances in the Pacific. The box at next page summarizes key findings from retrospective cost-benefit analyses of important regional service providers in the Pacific (the University of the South Pacific, Forum Line, Air Pacific, and the Forum Fisheries Agency) and in other regions (Air Afrique and bulk procurement of pharmaceuticals in eight regions).
- *Regional market integration* is defined as lowering barriers for goods, services, and people between countries, including nontariff barriers such as nontransparent standards, restrictions on foreign investment or operations, and restrictive visa requirements. The benefits include a larger market for Pacific firms, with more production at a lower cost, more choice for Pacific consumers, and more economic opportunities for Pacific workers. Costs include the adjustment costs for Pacific companies subject to increased competitive pressures. Present or planned market integration arrangements in the Pacific include a free trade agreement among FICs Pacific Island Countries Trade Agreement (PICTA), a closer economic relations agreement among all Forum members Pacific Agreement for Closer Economic Relations (PACER), and an economic partnership agreement (EPA) between the FICs and the European Union.

Key Lessons from Retrospective Cost–Benefit Analysis of Regional Service Providers

Regional bodies should only *operate when market or national public sector agencies cannot effectively deliver the service*. FIC shareholders in the regional service provider (usually governments) should not undermine the regional provider by establishing competing national services or relying heavily on extra-regional services.

Clear *governance arrangements* and *shareholder expectations* are essential to ensuring national support and viable regional operations. Governance arrangements should promote national ownership of the regional provider but also agreement among all shareholders on common objectives and strategic choices. Political interference and unrealistic expectations must not be allowed to detract from agreed objectives and overall financial health.

For commercially oriented regional activities, clarity of *commercial objectives* and *service expectations* is critical to success. As necessary, the balance between these objectives should be explicitly addressed. Funding mechanisms for any non-commercial service should be clarified, and the limitations of minority shareholdings need to be spelled out. Professional business management is essential.

External support—whether from donors or member governments—is crucial. For public service providers, capacity weaknesses in many FICs mean that simply aggregating existing national-level resources will create weak and undercapitalized regional service providers. Full cost recovery may be possible in the most successful regional operations with a revenue stream, but only in the medium or longer term.

Where is the greatest potential for benefits from Pacific regionalism?

The region already has many shared institutions. Some provide services at the regional level, but most are geared toward regional cooperation, such as intergovernmental dialogue. Voluntary dialogue and coordination, while beneficial, brings a high opportunity cost. Continuing to direct scarce donor funds into greater regional cooperation is arguably at variance with the lessons of club theory, which show that successful clubs must bring large net benefits. Analyses and case studies from both within and outside the Pacific suggest that Pacific regionalism must move beyond regional cooperation in a range of fields if significant benefits are to be achieved.

In the Pacific and elsewhere, *the largest benefits have come from focusing on the type of regionalism that addresses their fundamental challenges*. For countries in West Africa and South America facing challenges to democratic traditions, for example, strong and binding regional cooperation has brought big benefits. For Caribbean countries facing constraints on their capacity, increased regional provision of goods and services brings big benefits. For countries in Europe facing high barriers between their markets, regional market integration has brought big benefits.

A Pacific regionalism that speaks to Pacific needs must focus on easing capacity constraints for governments through increased regional provision of services, and on creating economic opportunity for Pacific citizens through increased regional market integration. The report suggests that weak governance capacity has imposed perhaps the largest economic burden on citizens of many FICs. Similarly, a carefully constructed policy of providing temporary market access to labor markets of all Forum members would create very substantial economic benefits for all parties. A key conclusion of the study is that for both service provision and market integration, *to create the necessary pool of benefits and an optimal Pacific “club,” Australia and New Zealand must become meaningful partners with FICs*.

What regional initiatives would be most beneficial?

The report studies a number of regional initiatives that were considered likely to yield high benefits. Preliminary but forward-looking cost-benefit analyses are summarized in the report for a number of regional initiatives that previous literature has pointed to having potential for a “big win,” and

that merited further analysis. The initiatives recommended are grouped under each of the four key goals of the Forum (and proposed pillars of the Pacific Plan). These examples, however, are by no means a definitive or exhaustive list of possible initiatives.

Good Governance

No single solution exists for weak governance. However, many FICs face critical weaknesses in the key area of economic management, which is an essential requirement for good governance. The costs of a package of four strategic economic management initiatives have thus been assessed.

- *A regional economic and statistical technical assistance* for such areas as macro-economics, tax policy and administration, financial sector supervision, microeconomics, and statistics. This would entail strengthening and supplementing the functions currently performed by the Pacific Financial Technical Assistance Centre (PFTAC), while enhancing FIC ownership of the Facility, at an estimated annual cost of F\$8 million.
- *Regional capacity to assist customs officials* in collecting revenue, with an estimated annual cost of Fiji dollars (F\$)1 million.
- *A regional ombudsman*, with power to assess the merits of citizens' complaints about administrative acts and decisions of government agencies, including alleged violations of the Forum Eight Principles of Accountability, and to recommend remedial action. Advice of the ombudsman would not be legally binding. Annual cost estimated at F\$500,000.
- *A regional panel of auditors*, which would strengthen audit capacity in three phases, would have an initial additional cost of F\$2.3 million per annum:
 1. training and common standards;
 2. creation of an offices of auditor-general (OAG) federation, and funding of regional training programs; and
 3. creation of a regional panel of auditors that could audit national and Pacific regional agencies.

The offsetting benefits of these four critical interventions would be a reduction of the potential costs of continued poor economic governance to Pacific islanders. For PNG, Solomon Islands, and Fiji Islands, the potential of these benefits is estimated to be US\$8 billion (discounted over a 10-year period).

Economic Growth

The report analyzes the welfare impacts of *increasing labor market access between Forum members*. The impact is modeled on Australia and New Zealand (ANZ) increasing their quotas for temporary movement of persons by an amount equal to 1% of their respective labor forces. The quotas would be filled on a temporary basis by FIC workers. The analysis found that increasing the temporary movement of both skilled and unskilled labor from FICs to ANZ would yield very large total welfare benefits (about US\$1.6 billion over 3 years) and large benefits for the temporary FIC migrants (US\$1.3 billion) and ANZ residents (US\$300 million). There would, however, be considerable cost in welfare lost by FIC citizens at home (almost US\$490 million) due to losses in skilled labor.

In order to reap the benefits of temporary labor migration while avoiding FIC welfare losses, it is proposed that Forum members ensure as far as possible that labor flows from FICs to ANZ are both *additional*—there is adequate FIC capacity to both train and replace migrating labor—and *temporary*—FIC migrant workers return home with higher skills. This is particularly critical if labor mobility includes skilled labor. Liberalizing unskilled labor only yields a slight gain for FIC citizens at home (US\$22 million) at a cost of a slightly reduced overall benefit for FIC migrants (US\$775 million), as compared to a scenario where skilled labor mobility is also included. Substantial attention to skills formation in FICs should therefore be central to a plan to generate the maximum benefits for all Forum members from enhanced labor market access.

The report also assesses the costs and benefits of

- the *creation of a pacific aviation safety office*, which would have important security benefits for the region, reduce the risk and costs of catastrophic incidents, as well as yield administrative cost savings of approximately US\$570,000 over 20 years;
- the *creation of a joint purchasing facility for petroleum products*, with a calculated benefit of US\$145 million over a 15-year period;
- *enhanced transparency and harmonization of terms and conditions of access arrangements for fisheries*—while no quantification is made of costs and benefits, the report suggests that a review of existing fisheries access arrangements, further development of the Western Central Pacific Tuna Commission (WCPTC), and the creation of an open, audited register of bilateral fisheries access arrangements of all FICs, would substantially improve public economic benefits from fisheries;

- *liberalization of telecommunication markets*, with benefits calculated at US\$286 million over a 5-year period, and costs of market-friendly regulation calculated at less than 1% of revenues; and
- *a regional nurse training facility*, both for domestic and export purposes, with a calculated 6.0 ratio of benefits to costs. A nurse's extra income over 10 years is estimated to have a net present value of F\$200,000, while tuition costs would be F\$33,100.

Sustainable Development

The report assesses the costs and benefits of the following.

- *A regional sports institute*. Cost is estimated at US\$30–50 million over 5–10 years. Benefits include the potential positive impact on health indicators in the Pacific—estimates in some regions suggest such benefits are three times the costs—and remittances from internationally successful athletes.
- *A regional statistical office*. Costs are estimated at US\$13–15 million per annum for a comprehensive office, and \$5.5 million yearly for a specialist office. The yield would be the significant but unquantifiable economic benefits of more reliable statistics and management of statistical outcomes.
- *A regional body to protect intellectual property rights*, with a calculated net benefit of nearly US\$1 million per year.

Security

The report provides an assessment of the costs and benefits of *a regional training facility to supply civilian police training for international peacekeeping*. The facility would train policemen for countries in the region as well as for a Pacific contingent of policemen for peacekeeping missions undertaken by the international community. The initial one-time cost of the facility would be about US\$17 million, with recurrent costs of about US\$8 million per year. The Pacific Islands Chiefs of Police Secretariat estimated that the facility would yield private benefits in the form of remittances home totaling about US\$3 million annually, as well as additional and potentially much greater public security and training benefits for FICs.

Can barriers to change be overcome?

Potential benefits of the above initiatives under the Pacific Plan are large. The benefits of addressing the problems of governance dwarf by a considerable order of magnitude the benefits from any other activity considered above. Similarly, permitting temporary access to all FIC labor markets would create very substantial economic benefits for all parties—provided labor movement is both temporary and additional to the existing FIC labor force. However, agreement on any of the above regional initiatives will have to overcome considerable opposition. For both good governance and labor liberalization initiatives, the benefits will be shared by many. The few losers, however, are often well organized, vocal, and in a position to effectively oppose reforms.

To manage the change and establish a Pacific Plan it is necessary to devise a mechanism that allows all Forum members to move away from present suboptimal positions to positions where all parties are better off. This may be best achieved through mutual obligation, based on a legal instrument that links the key elements of the proposal. This approach would see negotiation of an agreement where all Forum members would make commitments toward good governance. In return, a renewable 5–10-year aid and trade agreement would be provided. An aid, trade, and governance approach would reinforce the Auckland Declaration vision of Forum leaders and constitute the longer-term framework for the Pacific Plan:

- *Aid commitments* are needed to create adequate scale and sustainability of initiatives to meet the Forum's goals. It is not necessarily the volume of development assistance, but its stability, continuity, and predictability that are of considerable value to Pacific island states. A stable and continuous supply of well-focused aid will help FICs address poor governance and create an environment supportive of economic growth. This report proposes that significant and guaranteed bilateral aid flows be supplemented with specific additional resources for agreed Pacific Plan initiatives. Overall aid flows to FICs (with equal burden sharing) from Australia and New Zealand amounting to 0.08% of each country's gross domestic product (GDP)—with at least 25% of this budget allocated to regional initiatives—would be realistic goals based on recent trends in aid from the two countries.
- *Trade commitments* should center on a package of opportunities for gainful employment for trained FIC nationals through training and temporary movement arrangements throughout the region. These arrangements will no doubt have strong impacts on output and population size in the islands, in some cases further exacerbating capacity constraints. Yet the

current situation—severely restricted access of unskilled FIC labor to Australia and New Zealand combined with relatively unrestricted and permanent movement of skilled labor—is a worst-case scenario from the viewpoint of FIC welfare outcomes. A managed trade and development approach to migration is needed, with adequate resources for training facilities. Otherwise, labor flows will simply continue to deplete scarce existing capacity in FICs.

- *Governance commitments* should ensure that Forum members endeavor to make both domestic and regional governance standards a vital part of domestic economic life. Given the resource requirements of good governance, however, FICs should avoid making legally bound commitments to good governance without clear means of financing the obligations and bound commitments from development partners to provide acceptable levels of technical assistance.

How can changes in Pacific regionalism be initiated?

To increase the chances of success, the Pacific Plan should follow a two-track negotiating process. The first track should comprise a range of concrete measures that build confidence in the process, as well as confidence in an emerging partnership that will be mutually beneficial to FICs and Australia and New Zealand. The interventions must not be seen as random projects of unclear economic benefit. The interventions should be consistent with and an integral part of a second, negotiating track.

A selection of the highest yielding initiatives assessed in this report could, if implemented as first-step, confidence-building measures, provide the necessary momentum for the longer-term vision of the Pacific Plan, for example:

1. **governance:** The “package” of four governance initiatives—the economics/statistics technical assistance facility, the ombudsman, assistance to customs, and a regional panel of auditors;
2. **economic growth:** Harmonized terms and conditions for fisheries access arrangements, and the establishment of a regional nursing school;
3. **security:** A regional police training institute; and
4. **sustainable development:** A regional sports institute.

In order for a credible process to emerge from the current dialogue, there is a need to combine short-term, confidence-building measures with a

decision to negotiate a contractual arrangement between all Forum members that encompasses all four pillars of the Pacific Plan. *Consequently, at the Leaders' meeting in October 2005, this report recommends that Forum leaders agree to full feasibility studies on the first-step, confidence-building measures listed above, and to commencement of negotiation of a Pacific Plan/Pacific Agreement for Closer Economic Relations (PACER) agreement.*

In order to provide stronger legal backing to the Pacific Plan, the current process should be merged with an expanded PACER. Some FICs are in the process of (or are about to begin) negotiating and implementing trade agreements on several fronts.

- the Pacific Island Countries Trade Agreement (PICTA),
- the Economic Partnership Agreement (EPA) with the European Union,
- the World Trade Organization (WTO) Doha Development Round, and
- PACER Negotiations, which are due to begin in 2011 but could be triggered by EPA negotiations between May and October 2006.

The objectives of PACER are to

- "...establish a framework for the gradual trade and economic integration of the economies of the Forum members in a way that is fully supportive of sustainable development"; and
- "...provide economic and technical assistance to the Forum Island Countries in order to assist them in implementing trade liberalisation and economic integration."

Thus the stated objectives of PACER, though not identical, are similar to the four pillars of the Pacific Plan.

Without a multifaceted trade and development agreement—one with sufficient scope and pool of potential benefits to offer mutually advantageous terms to all parties—there is a considerable risk that the PACER negotiations based on a goods-only agreement will be unsuccessful. Given the magnitude of FIC imports from Australia and New Zealand, a goods agreement with Australia and New Zealand is likely to impose higher

adjustment costs on FICs than the EPA. Similarly, Japan—the second- or third-largest source of imports for many FICs—would be the only major donor to the region with exports subject to any residual import duties remaining in FICs following EPA and a goods agreement under PACER. FICs should consider whether such a situation is sustainable.

How can a new Pacific regionalism be sustained and deepened?

If the Forum is to endorse the timetable proposed above, *an expanded resource commitment to the Forum Secretariat will be needed to allow the Secretariat to implement both the feasibility studies and the negotiations.* While a major European Commission (EC)-style expansion would be unfeasible and possibly counterproductive, the action plan and timetable proposed above would place great strain on the Secretariat's current capacity. Pursuit of the proposed timetable without expanded resources could jeopardize a beneficial outcome for the entire Forum membership.

A key consideration in creating a deeper Pacific regionalism is addressing the "democratic deficit." The recent experience of the European Union Constitution and its rejection by two founding states provides a sober warning to the Pacific. While regional bodies in the Pacific are by no means as powerful as the EC, the process of negotiating a substantial treaty arrangement would heighten the perception that many of the region's bodies are potentially open to capture by donor interests, or by the international bureaucracy that manages them. When creating a new, deeper regionalism, the Forum must provide a check to ensure that structures emerging are democratic.

Creating a permanent sitting body that oversees the range of the Forum's activities and acts as a strong mechanism for regional organization accountability to member states might be a first step toward a more representative arrangement. This would involve all Forum members having a permanent representative based in Suva; the costs and benefits of such a body need to be assessed. However, increased oversight and perhaps a "political track" will become necessary as Pacific regionalism deepens and broadens.