

# Appendixes

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## Appendix 2: Defining and Measuring the Four Pillars

It is often difficult to make clear methodological distinctions between the four pillars: governance, economic growth, sustainable development, and security. While each pillar covers a number of unique issues, the overlap between them is substantial. It is often impossible to separate, for example, what is a purely economic growth outcome from a sustainable development outcome. Similarly, any given intervention—such as the creation of stronger statistics capacity, or lower telecommunications tariffs—will have ramifications across all four pillars. Some pillars contain the other pillars as preconditions. For example, most commonly accepted definitions of sustainable development include economic growth, good governance, and to a certain degree security issues. Adding to the methodological problems is the potentially vast literature on any given pillar, greatly complicating any effort to derive common definitions in a brief summary.

### **Governance**

There is no single universal definition of “governance” (let alone “good governance”), largely because governance issues have figured prominently in the research agenda of international finance and development institutions only within the past decade. The definition most recently used by Kaufmann (2003) will be considered here, where governance is defined as below.

...the exercise of authority through formal and informal traditions and institutions for the common good, thus encompassing: (1) the process of selecting, monitoring, and replacing governments; (2) the capacity to formulate and implement sound policies and deliver public services; and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them.

Kaufmann (2003) distinguishes between “poor governance” and “corruption,” where the latter is defined as the abuse of public office for private gain, and is a much more restricted notion than poor governance.

The notion of governance remains fairly broad and abstract. The quality of indicators and measurement is thus an issue. The data are largely based on qualitative surveys from a variety of organizations, such as commercial

risk rating agencies, multilateral organizations, think tanks, and nongovernment organizations, which in turn compile responses from experts, firms, and citizens. Despite the substantial country coverage, the data are subject to significant margins of error and a high degree of cross-correlation between individual variables. This implies that cross-country comparisons and country-specific rankings should be interpreted with caution. Further, given that research on governance is still in its infancy, rigorous data about past levels of governance (before 1995) are extremely scarce, especially for the Pacific.

The World Bank Institute (WBI) governance data<sup>1</sup> are considered the most robust and comprehensive available. WBI data cover 209 countries and territories for five time periods (1996, 1998, 2000, 2002, and 2004), and are drawn from 37 separate data sources constructed by 31 different organizations. A similar quantitative measure is compiled by Transparency International,<sup>2</sup> which regularly publishes its composite Corruption Perceptions Index covering 90 countries. Both WBI and Transparency International have data for Forum Island Countries (FICs). However, most ratings are based on a single source, adding further caution to the data caveats previously expressed. Apart from these two global datasets, a number of organizations publish qualitative reports on governance. Such reports for the Pacific are few in number, but often provide a more in-depth picture of governance issues at the regional and country levels.

The WBI data are divided into six indicators:<sup>3</sup>

1. **voice and accountability** measures political, civil, and human rights;
2. **political instability and violence** measures the likelihood of violent threats to, or changes in, government, including terrorism;
3. **government effectiveness** measures the competence of the bureaucracy and the quality of public service delivery;
4. **regulatory burden** measures the incidence of market-unfriendly policies;
5. **rule of law** measures the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence; and
6. **control of corruption** measures the exercise of public power for private gain, including both petty and grand corruption and state capture.

Table A2.1 from Sampson (2005) summarizes the WBI data. All countries were ranked for each year and for each governance dimension, and then their percentile rank was calculated (lower percentiles indicating better governance). For FICs, the average percentile ranking was calculated for each year from 1998 to 2004. The table includes only those countries rated on at least five of the six governance dimensions in a given year.

**Table A2.1: Forum Island Country Governance Ratings  
(percentile ranking)**

	1998	2000	2002	2004	Average 2000–2004
Fiji Islands	47	56	47	54	53
Kiribati	59	46	44	46	46
Marshall Islands	58	62	55	51	56
Micronesia, Federated States of	56	57	50	41	49
Papua New Guinea	65	67	71	76	71
Samoa	58	40	33	35	36
Solomon Islands	64	81	84	84	83
Tonga	64	60	64	58	60
Tuvalu	–	22	27	42	31
Vanuatu	57	61	58	52	57

– = not available.

Source: Sampson 2005.

## Security

The meaning of security has broadened in recent years from a predominant focus on military-political issues. Non traditional issues related to the environment, economics, transnational crime, and human rights have increasingly found their way into the more traditional definition largely focused on military defense of the state.<sup>4</sup> This expanded definition is more commonly referred to as “comprehensive security.” Hsiung (2000) characterizes comprehensive security as a two-part shift away from the state as the central unit of analysis. The first shift is toward a focus on the external community and the “global” threats it represents, such as communicable diseases, organized crime, systemic financial crises, and climate change. The second trend is an inward shift from the state toward individual citizens. This notion is more commonly referred to as “human security.” The term originated in a 1994 report of the United Nations Development Programme (UNDP) that outlined seven distinct elements of human security:

- economic,
- food,
- health,
- environmental,
- personal/physical,
- community, and
- political.

Clearly there is much overlap between this definition of comprehensive security and the sustainable development pillar—as well as the pillar of economic growth if one takes a narrow definition of “economic security.” Hassall (2005) notes that in the Pacific

...security is closely linked with generating conditions that free people from fear and misery arising from various causes... [where] current threats to stability are more often linked to domestic failures of governance and inability to meet aspirations for development and economic advance.

While acknowledging that security has become a multifaceted concept, to avoid overlap with the other three pillars, this report will focus on those aspects of security that relate to dedicated law and order institutions—e.g., police, military, border enforcement, customs, and intelligence services—as well as the more dramatic manifestations of insecurity—e.g., terrorism, transnational crime, civil conflict, secessionist movements, and domestic political instability.

Much like governance, the definition and assessment of human and/or comprehensive security has only recently emerged as a major focus for international institutions. Thus the literature, data, and analysis of security issues are highly limited and sporadic in availability.

There are no global data sets that allow cross-country comparisons, let alone quantitative assessments over time, based on the above definition of comprehensive and/or human security. This is no doubt due to the complexity of the definition itself. However, there is an increasing number of independent rating companies that undertake in-depth country studies and issue country risk assessments (CRAs), expressed in the form of a single index or a rating. These country ratings are usually made publicly available and provide some level of comparability between countries. Wide CRA

coverage is provided by a number of firms including the following.

- Standard and Poors Rating Group
- Moody's Investor Services
- Fitch ICBA
- Control Risks Information Services (CRIS)
- Economist Intelligence Unit (EIU)

These ratings, while echoing the qualitative assessment above, are limited. Given the enormous amount of data and country expertise required, CRAs are largely geared toward investors, and generally focus on factors that might impact a country's ability to repay debt on time and in full. While this financial risk is an important element of security, it covers only a subset of the factors underpinning security.

More useful assessments of security risks and scenarios are provided on a qualitative, country-specific basis by governments, private organizations, and academic institutions. While they generally do not allow comparisons across time or countries, they often provide a richer security analysis than CRAs, and wider coverage for Forum members.

## **Growth**

The methodological debate over economic growth is as old as the economics profession itself. It is beyond the scope of this report to summarize the entire debate over what is considered desirable or undesirable economic growth. One must be cautious about interpreting narrow definitions or indicators as strict measures of economic "health," well-being, or standard of living. For the purposes of this report, growth will be defined as a *sustained increase in per capita gross domestic product (GDP)*, as an indirect measure of the economy's capacity to produce and satisfy the material aspirations of its growing population. A number of related macroeconomic variables will also be considered. This report will also consider the degree to which GDP growth has resulted in a more equitable distribution of income, which is not necessarily captured by the level of increases in per capita GDP.

Numerous macroeconomic growth indicators will be considered:

- growth rate of GDP—overall and per capita, i.e., the level of economic activity;
- trade balance—the economy's reliance on external markets and its vulnerability to external fluctuations;

- government fiscal balance—the balance between expenditure and revenue;
- public debt burden—the financial solvency of the public sector;
- savings level—reflecting the capacity to fund future investment;
- inflation—reflecting changes in the costs of basic consumer items and purchasing power;
- foreign direct investment—the attractiveness of FIC economies to outside capital;
- private sector development; and
- unemployment rates.

As with all four pillars, analysis of economic growth in the Pacific is hampered by a lack of timely, comparable, and accurate statistics. Most analyses reflect data that are in some cases only 5 years old. For many FICs, time series data stretching back a decade are rare, even for commonly cited statistics such as GDP. The availability and level of aggregate statistics are heavily weighted toward larger FICs, such as Papua New Guinea (PNG), Fiji Islands, and Solomon Islands. For inequality and poverty indicators, data are even more scarce and contested. This report will draw on a number of qualitative assessments.

## **Sustainable Development**

Of all four Pacific Plan pillars, sustainable development is arguably the most fluid and all encompassing, with over 100 definitions to date.<sup>5</sup> Perhaps the best known is the definition adopted by the seminal 1991 World Commission on Environment and Development (also known as the Brundtland Commission), which defined sustainable development as that “which meets the needs of the present without compromising the ability of future generations to meet their own needs.” More recent formulations define three broad components—economic, social, and environmental, implying that in the search for material well-being (i.e., economic growth) societies should seek to balance the needs of the social and environmental components.

This report will address those aspects of sustainability that are

- not explicitly covered by the governance, security, or growth pillars of the Pacific Plan;
- linked to indicators for which data are available for some FICs; and
- integral to internationally agreed frameworks for sustainable development, especially those relevant to small island states, such

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as the 1994 Barbados Programme of Action (BPOA) and the follow-up 2005 Mauritius Strategy.

This definition will address the management of

- climate change, including natural and environmental disasters;
- natural resources, including waste, marine, energy, and biodiversity;
- health, including communicable and lifestyle diseases; and
- social equality, including education and gender.

Much like the other three pillars, there is no single, internationally accepted indicator that addresses every aspect of sustainable development. Perhaps the best known indicator is UNDP's Human Development Index (HDI), drawn from its annual *Human Development Report*. The HDI measures a country's development level in terms of whether its citizens enjoy a long and healthy life, a decent standard of living, and a decent level of education.<sup>6</sup> UNDP also publishes region-specific reports on an intermittent basis. The most recent report for the Pacific is dated 1999. This report will summarize the findings of a number of organizations that compile data on separate subsectors, and a number of reports that take stock of the Pacific for the Barbados Programme of Action (BPOA). It is worth mentioning again, however, that robust data for the Pacific is scarce, especially on health and social issues. Quantitative, comparable, cross-country data sets are virtually nonexistent. Given the importance of natural resources for FIC exports, data on resource management are more widely available, though the presence of conflict in the larger exporters, such as PNG and Solomon Islands, has compromised the quality, coverage, and timeliness of data in these countries.

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1 See <http://www.worldbank.org/wbi/governance>

2 See <http://www.transparency.org>

3 These are explained in more detail in Appendix D of Kaufmann et al. (2005).

4 This section draws from Hsiung (2000) and ESCAP (2001).

5 For a partial listing, see <http://www.gdrc.org/sustdev/definitions.html>

6 Available at <http://www.undp.org>. Summarized from Peebles (2004).

## Appendix 3: Growth in the Pacific Islands

Reflecting heavy concentrations in exports and import dependence, *trade balances* in Forum island countries (FICs) (excluding Papua New Guinea [PNG]) are all negative. *Government expenditure* has been a significant portion of GDP (over 70% in the case of Kiribati, Marshall Islands, Federated States of Micronesia (FSM), and Tuvalu) with no discernible downward trend. While this reflects the many inherent handicaps on private investment in FICs, there are signs that this high level of public intervention is unsustainable. *Fiscal balances* of central governments have typically been negative and subject to severe fluctuations. Public debt levels (while small by global standards) have reached significant percentages of exports and GDP in five FICs. While there are little data available, surely *domestic savings* rates have been low, despite nominal improvements in capital markets and modest income levels. While *inflation* has been trending downward in the region, it remains at double-digit levels in Solomon Islands, PNG, and Tonga, with a large increase in the Fiji Islands after the 2000 coup. *Foreign direct investment* (FDI) has remained static or negative, with no FIC maintaining a steadily growing level of FDI. Levels instead show significant volatility, especially in resource-rich economies such as PNG and Solomon Islands (Table A3.1).

Data on *unemployment levels* are scarce for FICs, but available data suggest rates over 10% are common, and that rates for youths aged 15–24 are much higher. Employment opportunities in the formal economy are limited, and FICs exhibit high ratios of economically inactive populations, especially among women (Table A3.2).

**Table A3.1: Foreign Direct Investment in Forum Island Countries (US\$ million)**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Fiji Islands	5.2	103.6	91.2	67.5	69.5	2.4	16	107	-33.2	0
Kiribati	0.4	0.4	-0.8	.04	–	–	–	–	–	–
PNG	117	104	62.0	57	455	111.3	28.6	110	296.5	130
Samoa	3	5	5	3	3	4	4	3	2	0
Solomon Islands	15	14	23.4	2.1	2	5.9	33.8	8.8	9.9	9.9
Tonga	0.4	1	2	2	2	2	3	2	2	2
Vanuatu	25	26	26	30	31	33	30	20	20	20
Total	166	254	208.8	162	562.5	158.6	115.4	250.8	297.2	161.9

— = not available, PNG = Papua New Guinea.

Source: Peebles 2004.

**Table A3.2: Economically Inactive Population in Forum Island Countries in 2000 (% of population)**

	Female	Male
Cook Islands	52	30
Fiji Islands	62	17
Kiribati	22	9
Marshall Islands	69	20
Micronesia, Federated States of	68	41
Nauru	54	35
Papua New Guinea	32	14
Samoa	60	23
Solomon Islands	20	14
Tonga	59	17
Tuvalu	14	15
Vanuatu	21	11

Source: Peebles 2004.

The level of *private sector development* in many FICs remains low. A recent Asian Development Bank (ADB) report<sup>1</sup> found that the FIC private sector is generally characterized by

- a large informal economy, especially in retailing and services;
- widespread subsistence agriculture and fishing;
- cultivation and export of indigenous root crops;
- export of some specialized agricultural products; and
- widespread but mainly small tourist sectors.

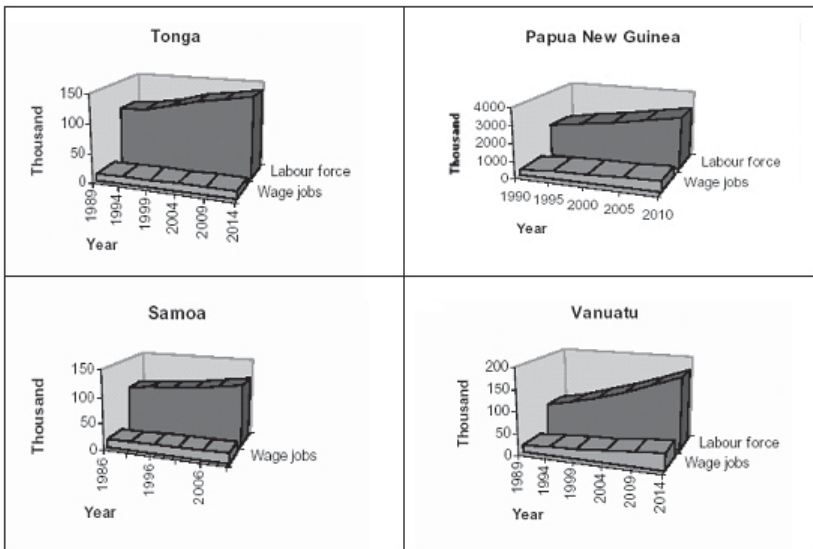
The private sector in many FICs faces high transactions costs, significant regulatory obstacles, and a high level of “crowding out” of investment by the public sector. A large proportion of potentially profitable FIC sectors are effectively monopolized by state bodies to fund general expenditure, further restricting the scope of private sector development.

Comparative quantitative data on *income inequality*, such as the Gini coefficient, are not available for FICs. However, qualitative reports such as Anere et al. (2001), Pacific Island Forum Secretariat (PIFS) (2004), and recent United Nations Development Programme (UNDP) Human Development Report indicate that income gaps are rapidly developing between small pockets of FIC populations with access to education and migration opportunities, and the vast majority of the population who are unable to access these resources. The increasing gaps between haves and have-nots in

FICs have been linked to rising tension and criminal activity. For urban elites with access to the public sector, rent-seeking behavior and poor governance have further fueled tension over unequal distribution of wealth, especially in resource-rich FICs. In PNG for example, the richest 10% of the population enjoys 23 times the share of income of the poorest 10%.

These labor market asymmetries are likely to persist well into the future due to high population growth and a lack of broad-based economic growth. UNDP (1999) projected widening gaps between labor force and wage job growth (Figure A3.1). The largest gaps were not restricted to Melanesian countries, with Samoa and Tonga seeing large projected deteriorations in their workforce-to-jobs ratios.

**Figure A3.1: Growth Prospects for Wage Employment in Selected Forum Island Countries**



Source: UNDP 1999.

Although extreme *poverty* is generally absent in the Pacific island countries, there is evidence that hardship and hunger not only exist, but are increasing. A recent assessment<sup>2</sup> of the Pacific's progress in reaching the Millennium Development Goals (MDGs) summarized a number of poverty and hardship studies undertaken by ADB. It concluded that hardship is much more widespread than generally thought, with at least 20% of households in 12 of 13 FICs studied suffering from basic needs poverty (defined as the inability to meet the cost of food and other basic needs and services essential for a minimum standard of living). In the most disadvantaged FICs, the proportion is estimated to exceed 33%. Cross-country data (Table A3.3) suggest that the incidence of basic needs poverty averages approximately 28% across all countries studied.<sup>3</sup>

**Table A3.3: Percentage of Households Below the National Poverty Line**

	National	Urban	Rural
Cook Islands	12.0	–	–
Fiji Islands	25.5	27.6	22.4
Micronesia, Federated States of	27.9	29.5	32.9
Kiribati	50.0	51.0	50.0
Marshall Islands	20.0	–	–
Papua New Guinea	37.5	–	–
Samoa	20.3	23.3	17.9
Tonga	22.3	23.6	22.8
Tuvalu	29.3	23.7	23.4
Vanuatu	40.0	–	–
<b>Country Average</b>	<b>28.5</b>	–	–

– = not available.

Source: South Pacific Commission 2004.

#### ENDNOTES

- 1 Available: <http://hdr.undp.org/statistics/data>
- 2 South Pacific Commission 2004.
- 3 This does not imply that 28% of families were going hungry or experiencing absolute poverty. Rather, they regularly faced demands for cash to satisfy basic needs (such as food, school fees, and community obligations) that outstripped their income (South Pacific Commission 2003).

## Appendix 4: Smallness and “External” Constraints on Growth<sup>1</sup>

There is strong evidence that the constraints imposed on Forum island countries (FICs) by their smallness—small populations and small domestic markets—combined with remote and dispersed locations, narrow resource endowments, and frequent natural disasters, act as a constraint on growth. This conclusion counters a 2001 paper by William Easterly and Aart Kraay of the World Bank that argued small states did not suffer from their smallness.<sup>2</sup> Controlling for region, oil exporter, and Organisation for Economic Co-operation and Development (OECD) status, Easterly and Kraay concluded that among 157 countries, from 1960 to 1995, small states had higher incomes and relatively similar growth rates compared to larger states.<sup>3</sup>

In order to evaluate these findings in light of the poor growth performance in the Pacific over the past decade, Sampson (2005) reestimated the Easterly and Kraay regressions using more recent data (1995–2003) and a wider data set (197 countries and nonsovereign states). Sampson’s data set includes 59 ministates (population less than 2 million), 48 small states (< 1 million), 40 “microstates” (<500,000), 27 “mili-states” (<250,000) and 16 “nano-states” (<100,000). Eleven FICs were included in the data set (no data was available for Niue, Kiribati, and Tuvalu). Sampson found that regressing average growth in GDP per capita on region, oil exporter, OECD membership, and a small state dummy, the latter exerted a negative effect significant at the 5% level. Table A4.1 shows that using an updated dataset, being a small state reduces average growth by 0.81% per year, contrary to the findings of Easterly and Kraay (2001).<sup>4</sup>

How might the supposed disadvantages of smallness have led to lower FIC growth in the past decade? One potential answer is that the costs of smallness are especially punitive for FICs, and that these costs have acted as a brake on investment, growth, and competitiveness. It is worth recalling that the classical gains from trade arise from greater specialization and allocation of resources toward their most profitable and efficient use. This classic notion of trade, however, does not account for the possibility that costs in a trading economy might be subject to a floor high enough that increasing trade results in a narrow set of traded goods and hence lower economic growth. A seminal 2004 study by Alan Winters and Pedro Martins<sup>5</sup> showed that small economies, especially those with the smallest populations, face large and significant cost inflation relative to firms in a median-size country, summarized in Table A4.2.

**Table A4.1: Reestimating the Income and Growth Regressions of Easterly and Kray**

Variable	(a)	(b)
Dependent Variable	Log of Average GDP per Capita 1995–2003	Average Growth in GDP per Capita 1995–2003
Small States	1.09 <sup>a</sup> -0.807 <sup>b</sup>	(0.181) (0.394)
Sub-Saharan Africa	6.14 <sup>a</sup> 1.29 <sup>a</sup>	(0.143) (0.340)
Asia	6.89 <sup>a</sup> 2.00 <sup>a</sup>	(0.224) (0.427)
Europe and Central Asia	7.72 <sup>a</sup> 3.48 <sup>a</sup>	(0.216) (0.347)
Middle East and North Africa	7.62 <sup>a</sup> 1.48 <sup>a</sup>	(0.239) (0.522)
Western Hemisphere	7.52 <sup>a</sup> 1.64 <sup>a</sup>	(0.143) (0.339)
OECD Countries	2.40 <sup>a</sup> -0.669 <sup>c</sup>	(0.204) (0.399)
Oil-Producing Countries	0.828 <sup>a</sup> -0.548	(0.256) (0.828)
R2	0.59	0.16
N	194	194

GDP = gross domestic product, OECD = Organisation for Economic Co-operation and Development, R2 = Robust standard errors in parentheses.

a Significance at the 1% level.

b Significance at the 5% level.

c Significance at the 10% level.

Sources: Easterly and Kray (2001), and Sampson (2005).

**Table A4.2: Product Cost Inflation in Micro and Small Economies (percent inflation relative to firms in a median-size country)**

Area of Cost	Micro Economies	Small Economies
Airfreight Average	31.8	4.1
Sea Freight Average	219.6	70.5
Unskilled Wages Average	60.1	31.6
Semi-Skilled Wages Average	22.4	12.1
Skilled Wages Average	38.0	20.3
Telephone Marginal Costs	98.5	47.2
Electricity Marginal Costs	93.1	47.0
Water Marginal Costs	0.0	0.0
Fuel Average	53.8	28.3
Personal Air Travel Average	115.7	56.8
Land Rent Average	-3.5	-17.2

Sources: Winters and Martins 2004 and Horscroft 2005.

What impact might this finding have on small states, and FICs in particular? FICs are especially small. Using the definitions in Sampson (2005), 10 out of 11 are small states and 8 out of 11 are microstates. The same paper found that on average, FICs suffer from higher levels of remoteness than in any other region. Sampson (2005) found that remoteness had a strong and negative effect on growth. Perhaps more importantly, like many small developing states, FICs have enjoyed preferential market access that has allowed them to overcome the cost handicaps of smallness and exploit sufficient value-added for economic activity to exist in their countries. Preferential access generates an income transfer from donor countries (usually more developed countries with large markets) to exporters in the recipient country. This provides an assurance to investors that capital will earn sufficient returns in high-cost economies. Grynberg and Silva (2005) found that for many small states, including several FICs, the additional rents earned through preferential access are significant, totaling nearly United States dollar (US\$)1.4 billion annually in sugar, beef, bananas, textiles, and clothing alone. In a preference-dependent economy such as the Fiji Islands, these resource rents from sugar alone total more than 50% of agricultural exports.<sup>6</sup>

Since 1995, however, an ongoing process of multilateral and bilateral trade liberalization has continually eroded the value of market access in preference-receiving countries. Most important for FICs are:

- reforms of the European Union (EU)'s sugar regime under the Common Agricultural Policy (CAP),
- challenges to EU-FIC fisheries agreements, and
- expiration of the Multi-Fibre Agreement on Textiles and Clothing.

The findings of Winters and Martins (2004) suggest that this decrease in the income transfer to small-state exporters will have a negative impact on growth given the large penalties to value-added in a competitive economy. Unfortunately, the hypothesis that removal of preferences has resulted in lower FIC growth since 1995 cannot yet be rigorously tested since the reform of preference regimes has either not yet occurred (i.e., sugar), or has occurred too recently to discern any possible impact (i.e., clothing and textiles). However, data for foreign direct investment in FICs suggest that the removal of preferences may have deterred investors, resulting in largely negative investment flows and low growth. For industries such as tourism, where classical theory suggests that FICs might have a comparative advantage, the cost inflation for microeconomies reaches

57.5%. This implies that new investment has not been able—and may never be able—to fully replace the engine of economic growth once provided by trade preferences.

Poor governance and security have undeniably lowered FIC growth. However, Sampson (2005) finds that dropping the three FICs that have experienced internal conflict since 1995 (Fiji Islands, Papua New Guinea, and Solomon Islands) and reestimating the growth equations, improves the growth of the remaining Pacific island countries only marginally. Overall growth is still significantly worse than that of any other region. While many observers attribute the low growth to poor governance, as noted earlier in this chapter, governance in the Pacific is on average no worse than in other regions. Governance alone is insufficient to explain why countries that have seen relatively large increases in their governance indicators—such as Samoa and Tuvalu—have still failed to attract significant levels of investment and remain at less developed countries levels of per capita income. This suggests that other factors not necessarily related to intra-FIC conflict and poor governance are constraining FIC growth.

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#### ENDNOTES

- 1 This appendix draws heavily on Sampson (2005).
- 2 Easterly and Kraay 2001.
- 3 Easterly and Kraay concluded that the positive effects of greater openness were largely offset by the negative effects of income volatility and higher initial income.
- 4 Sampson (2005) found that country coverage partly explains the difference between his results and those of Easterly and Kraay (2001). The income effect of small size remained highly significant for the subset of countries not included in Easterly and Kraay (2001). However, there was also evidence that the more recent time horizon, covering a period of poor performance in Forum island countries (FICs) in particular, may have also been a factor. Using a data set drawn from the World Bank, Sampson (2005) found that there was a positive and significant relationship between smallness and growth for the period 1980–1994, but a negative and significant relationship for the period 1995–2003. A factor in this shifting trend is the especially poor performance of FICs. Non-oil exporting and non-Organisation for Economic Co-operation and Development Pacific states are poorer than similar small states in all other regions except Sub-Saharan Africa. A mini-state and microstate had similarly significant negative effects to small state, while the impacts of ministate and nanostate status were not significant.
- 5 Winters and Martins 2004.
- 6 Grynberg and Silva 2005.

## Appendix 5: Club Theory—Basic Concepts and Conclusions and a Technical Summary

### **Basic Concepts and Conclusions**

Club theory rests on a number of crucial assumptions. First, economic agents form groups to confer cost-sharing benefits upon each other. Second, collective action entails costs that limit the size and scope of a club. From this tension between the costs and the benefits of collective action, the final *optimal club* is derived.

To begin with an intuitive example, consider the choice between a private good and a club good: a private backyard and a community park. (This draws from an analogous “swimming pool” example in Holcombe [2004]). Each provides “green space” that gives a certain amount of pleasure to the consumer. One key difference between the choices lies in the financing. In a private backyard, all costs are fully paid by the owner. In a community park, on the other hand, the costs of purchase, maintenance, and upgrade are paid collectively through taxation. Let us assume that at the outset all users have their own backyards. Each person derives an individual benefit from having his or her own backyard—the ability to dictate its exact design, a wish to feel more secure walking outdoors at night, and so on. These are *benefits of sovereignty*—the value of individual ownership.

When a user moves from a private backyard to a community park, he or she can no longer dictate its shape or design—they forgo the benefits of sovereignty. But if one assumes that all users have the same taste in park requirements and park use, and *if there are only a small number of park users*, then moving from a private to a public good might not be a wholly negative switch. In fact, moving to a public good means that the enjoyment of the outdoors is now cheaper, thanks to the collective, cost-sharing arrangement. Materials used for the maintenance of the park can now be bought in volume, group, often at lower cost. Maintenance crews can be hired collectively, again often at a lower rate than if they were hired individually. These benefits are known as *economies of scale*, the decreases in cost that come from larger volumes, or a higher concentration, of production.

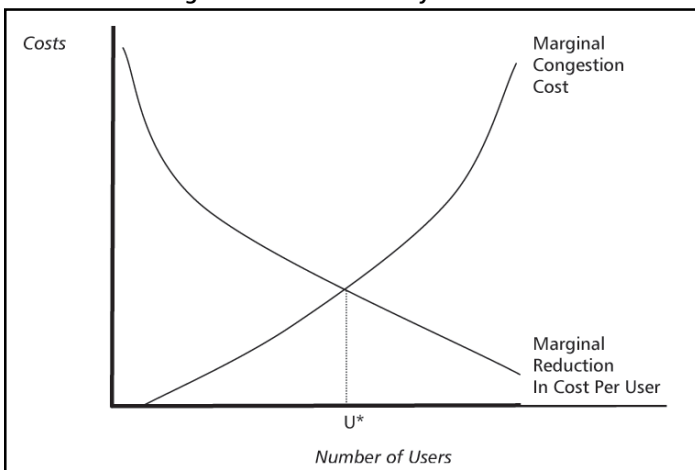
When more members of the community make use of the park, then the park may become overcrowded. These costs are known as *congestion costs*.

These costs can rise to the point where they begin to overwhelm the scale benefits. In the extreme, when the park becomes very congested, a potential user may cease to use it and instead consume the private good—even though more and more people are sharing the costs. Using the typology developed thus far, the economies of scale have failed to compensate for both the congestion costs and the loss of the benefits of sovereignty. There is thus an optimal size of the sharing group that can use a public good.

A simple graphical representation of the basic model described above is shown in Figure A5.1, which presents the basic trade-off between economies of scale and congestion costs (sovereignty benefits will be included later). Congestion costs are represented by the *marginal congestion cost curve*, which is upward sloping since increases in the club membership impose greater and greater crowding costs on the rest of the members. (The MC curve intersects the horizontal axis due to the assumption that low numbers of users impose little or no crowding costs.)

The economies of scale are represented by the *marginal reduction in cost per user curve*, which is downward sloping since pooling productive capacity into a collective club good brings cost-reducing benefits. Intuitively, as the club expands—as  $U$  becomes larger and larger—costs per user decline due to burden sharing, but congestion costs increase. There is an optimal number of users,  $U^*$ , where the two costs are balanced. In a sense, the club is breaking even at this point. If club size is less than  $U^*$ , further expansion of a club could still bring net benefits. Above  $U^*$ , congestion costs begin to overwhelm cost savings from additional users.

Figure A 5.1: Club Theory: Basic Model



The above analysis implicitly assumes a fixed club “facility”—a park of a certain size, or a swimming pool that lets in a certain number of users. The club facility size can always be increased to lower congestion costs. Of course the costs of expanding and maintaining a larger facility will have to be spread among the club members. In the extreme, as the facility expands more and more, it may not be feasible to continue increasing its size indefinitely. In the community park example used earlier, users may elect to limit its size for safety considerations. Similarly, one cannot continue to add lanes of traffic to accommodate additional cars on a highway because it makes it too difficult to change lanes and use entry and exit ramps. Eventually, the best solution is not to continue expanding the amount of the public good, but rather to build a second one. Eventually, two smaller clubs will be more cost-effective than one gigantic club, as two smaller roads will be more cost-effective than one large road.

### Technical Summary

Club theory lies between the neoclassical models of private property—where all goods are privately consumed and used, and exclusion is costless—and purely public goods, where consumption is not rivalrous and exclusion is not feasible.<sup>1</sup> Nobel Laureate James Buchanan’s seminal 1965 paper set out to map a “general theory... which covers the whole spectrum of ownership-consumption possibilities” between the purely private and public extremes. It also aimed to “determine the membership margin, so to speak, the size of the most desirable cost and consumption sharing agreement.” This appendix sets out the basic Buchanan (1965) model and two useful extensions—membership heterogeneity and efficient tolls.

### Basic Buchanan Model

The basic Buchanan model assumes two goods (a private good and a club good) and agents whose tastes and endowments are homogenous.<sup>2</sup> The private good is the *numeraire* good, while the club good is the impure public good. The representative agent  $i$  has a utility function indicated by

$$U^i = U^i(y^i, X, s)$$

Consumption of the private good is denoted by  $y^i$ . The per-member club good utilization rate  $x^i$  is the same for all members and is equal to provision (i.e., no wastage). Thus  $Ex^i = X$ , where  $X$  denotes the size of the club facility. The utility function is assumed to be increased in  $X$  and  $y^i$ . Membership size  $s$ , however, is assumed to have initially positive effects

(the “camaraderie” effect), but these decrease after a threshold membership is attained (the “crowding” effect). Here the Buchanan model departs from traditional neoclassical notions of private property by stating that the utility an individual receives from the consumption of a club good depends upon the number of other persons with whom he/she must share its benefits.

Each member maximizes his or her utility subject to a resource constraint,

$$F^i(y^i, X, s) \geq 0$$

which, by intuition, depends positively on  $X$  and  $y^i$  and negatively on  $s$ , due to the cost-sharing properties of club goods.

Assuming continuity and twice-differentiability, the representative member chooses optimal levels of  $y^i$ ,  $X$ , and  $s$  subject to the resource constraint  $F^i(\bullet)$  yielding two first-order conditions,

$$\begin{aligned} MRS_{iXy} &= MRT_{Xy}^i \\ MRS_{r^i s} &= MRT_{sy}^i \end{aligned}$$

for  $i = 1, \dots, s$  yielding respectively the provision conditions (optimal  $X$ ) and membership conditions (optimal  $s$ ).<sup>3</sup> The provision condition states that each member equates the marginal rate of substitution (MRS) between the club good and the *numeraire* private good to the marginal rate of transformation (MRT) between the two goods. Put differently, each member equates his/her marginal benefit of the club good to the marginal cost to the club of providing an additional unit to him/her.<sup>4</sup>

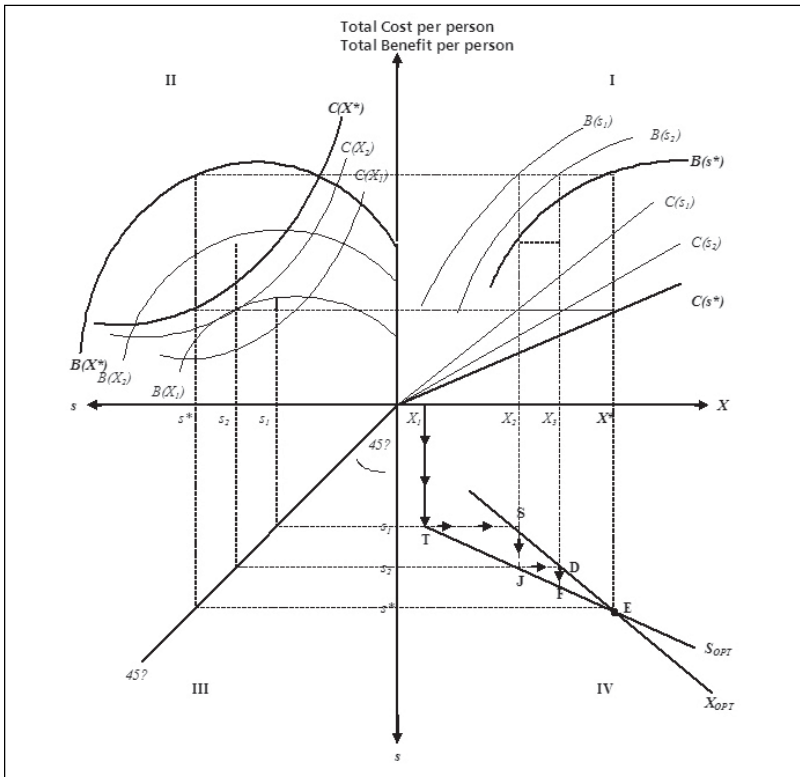
The membership condition equates the MRS between membership size to the analogous MRT. In order to be induced to join at the margin, the cost-sharing benefits of joining must be offset by the additional crowding costs imposed by an additional member.<sup>5</sup>

The graphical representation<sup>6</sup> in the Figure A5.2 shows the interaction of the membership and provision conditions. It depicts the equilibrium conditions of the Buchanan model in a four-quadrant setting. The axes are labeled according to  $X$ ,  $s$  and the total cost/benefit per user. The cost and benefit curves reflect the above assumptions of diminishing marginal benefits and constant returns to scale for the cost function.<sup>7</sup> The

upper right-hand quadrant I describes the provision condition. A given membership size ( $s_j$ ) dictates the position of the benefit and cost curves  $B(s_j)$  and  $C(s_j)$ . The tangency of the slopes of these two curves determines the optimal level of provision  $X_2$ . The increase in provision of the club good attracts more members ( $s_2$ ), which lowers the benefit and cost curves to  $B(s_2)$  and  $C(s_2)$ . The optimal combinations of  $X$  and  $s$  satisfying the provision condition trace out an  $X_{opt}$  curve in the lower-right hand quadrant IV.

The upper left-hand quadrant II describes the analogous membership condition. Here the focus is on optimal membership sizes that maximize per-person benefits. Benefit curves  $B(X)$  now exhibit negative returns once crowding sets in, and the cost curves  $C(X)$  are rectangular hyperbolas, reflecting the cost-sharing assumption. Increasing membership size  $s$  shifts both curves upward, causing the benefit curve to become increasingly

**Figure A 5.2: Graphical Representation of the Buchanan Model**



Source: Sandler and Tschirhart 1980.

concave. Similarly, the tangency points of  $B(X)$  and  $C(X)$  determine optimal  $X^*$  and  $s^*$  that satisfy the membership condition, tracing out an  $s_{opt}$  curve in quadrant III. At this tangency point, the club is both solvent and provides incentives for each of its members to remain part of the club.

The tangency point of the  $X_{opt}$  and  $s_{opt}$  curves gives the equilibrium satisfying both first-order conditions. The progression from the initial  $(X_p, s_p)$  to the optimal  $(X^*, s^*)$  is denoted by the path  $X_I T J S D F$ .

### Financing and Tolls in the Buchanan Model

In the homogenous-agent Buchanan model, the implicit price of membership or toll<sup>8</sup> is equal for all agents at  $C/s$ , where  $C$  is the cost of providing the good,  $s$  denotes membership size, and  $Eci = C$  for for  $i = 1, \dots, s$  by assumption. The provision cost  $C$  can be expanded into a cost function  $C(X, s)$  that is analogous to the utility function in that it captures both the provision and crowding effects.

The first-order Buchanan provision conditions state that the club is solvent if members' payments ( $E_i^s = I MRT_{Xy}^s$ ) equal the club's marginal cost of provision ( $MRT_{Xy}$ ). This "finance condition" or "toll condition" can be expressed as

$$kT = MRT_{Xy}$$

where  $k$  is the average utilization rate and  $T$  the average per unit toll. Under assumptions of homogeneity this finance conditions yield efficient tolls and a solvent club.

### Membership Heterogeneity

The relaxation of the homogeneity assumption adds a degree of complexity to the basic Buchanan model. The symmetrical relationship between utilization and cost sharing is no longer valid once club members have different incomes, tastes, and/or willingness to pay for the club good. Different members will derive different utility from consuming the same unit of the club good. Decisions surrounding membership, provision, and cost sharing become more difficult to reach owing to the aggregation of diverse preferences.

Following models by Sandler (1984) and DeSerpa (1977), the population is now assumed to be uniformly distributed over a vector  $[1, s]$  so that

membership size is now continuously differentiable. The population is ordered along  $[1, s]$  by their willingness to pay for the club, as measured by their net gain from membership, which is assumed to be invariant from the size of the club or the degree of congestion. Since utilization rates differ, member utility is now denoted by

$$u_y(i), x(i), f(I^x(i) di, X), i$$

where the integral is the club's total visitation rate. An analogous non-members' utility rate (which is by assumption not impacted by visitation) is derived. Once the rank ordering  $[I, ?]$  is put forward, a social welfare function that weights members' and non-members' utility (subject to a resource constraint) is maximized.<sup>9</sup>

The membership and provision conditions are essentially analogous to the Buchanan model: members still join if they see net benefits to doing so, and if the club remains solvent after they join. It is the toll condition that differs:

$$MRS_{X^y}^i = - I^x f_I MRS_{f_y}^i(i) di$$

The toll condition is now subject to the visitation rate. With heterogeneous agents sharing a club good, all individuals pay the same congestion-internalizing toll (they all feel the “pinch” of rising congestion), but total tolls paid by various members differ according to each member's revealed intensity of utilization (the number of visits made). High demanders visit more often but may or may not pay more in total tolls, given the distribution of income or willingness to pay among the club membership.<sup>10</sup>

Another formulation in Oakland (1972) considers the toll condition expressed earlier:

$$kT = MRT_{X^y}$$

where  $k$  is the average utilization rate and  $T$  the average per-unit toll. When members are heterogeneous, a club satisfying this condition is solvent. When heterogeneity is introduced, however, the toll may fail to self-finance the club. This occurs whenever average costs exceed marginal costs (increasing returns are present). The condition stated above assumes that no individual consumes the entire amount of the shared good, i.e., that  $x^i < X$

for all  $i$ . When this does not occur, financing problems can arise from free-riding behavior by the group of full utilizers.<sup>11</sup>

### **Discriminatory Clubs**

A further extension of the heterogeneity literature (in a nongame-theoretic setting) is the formation of so-called *discriminatory clubs*, in which members consume both the shared good and the characteristics or attributes (e.g., income) of the other members. In the basic model by DeSerpa (1977), each member brings a vector of characteristics that can increase or decrease utility, according to each member's taste. Heavier users provide the club with more of their attributes than less heavy users. Intuitively, the total level of any given membership attribute depends on (i) the utilization rate of each member and (ii) the endowment of the given attribute to each member.<sup>12</sup>

DeSerpa models a club in which there is a preexisting membership. Each member must decide a level of usage from zero to one and each pays according to usage level. The club produces a public good that the membership exactly pays for. However, the membership itself creates a second public good, consisting of a usage-weighted sum of the characteristic vectors of each member. Thus the utility of a single member depends on the level of the club-produced public good, the level of the member-characteristics public good, and the cost of membership.<sup>13</sup>

As with the earlier heterogeneity extensions, the discriminatory club model does not fundamentally change the Buchanan first-order provision conditions. A member will still choose to consume the club good only if their marginal benefit of participation equals the club's marginal cost of providing the shared good to that additional member. The difference is that each member is now consuming a "club package" consisting of the original shared good *as well as other members' characteristics*.

A further extension by Basu (1989) notes that these club packages, or "association goods," provide utility both in the form of a club facility and the status associated with being admitted. In this scenario, a purely financial profit-maximizing club entrepreneur may choose to raise fees from members with higher incomes but less desirable social qualities in order to cross-subsidize the membership of poorer but more desirable attributes. There is, however, a dilemma: since the club membership is an association good, the act of admitting less desirable members may change the status

rating of the club, and make everybody less willing to pay the lower membership fee. Thus excess demand may exist in equilibrium with profit-maximizing agents, and any attempt by the club to eliminate this excess demand by taking in more members may make people less eager to join and thus lower the club's profits.<sup>14</sup>

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ENDNOTES

- 1 This section draws heavily on Buchanan (1965), Scotchmer (2002), Sandler and Tschirhart (1980), and Sandler and Tschirhart (1997). The following exposition of the Buchanan model follows Sandler and Tschirhart (1997).
- 2 The Buchanan model and its subsequent variations in the literature also deal with issues of partitioning of agents within an economy between different clubs. This strand of analysis has not been included in the following exposition. Similarly, the literature on exclusion costs in clubs is not summarized; it is assumed that in the Pacific context the club goods are a priori restricted to countries in the region and the exclusion costs are negligible.
- 3 Both are expressed in terms of the *numeraire* private good.
- 4 This is alternately known as the “break-even” condition: if at the margin the club is self-financed when providing the club good, the sum of its member payments must equal the club's marginal costs (Sandler and Tschirhart 1980). This assumption will be relaxed later.
- 5 These marginal benefits are normally negative due to crowding, while the corresponding marginal costs are also negative due to the cost-sharing assumption.
- 6 From Sandler and Tschirhart (1980).
- 7 Recall that the cost curves reflect the “break-even” condition at the club level rather than the personal level, so they exhibit constant returns to scale. Similarly, the benefit curves exhibit diminishing returns but remain positive as the club as a unit benefits from a larger membership, even if it causes discomfort at the agent level from higher “crowding.”
- 8 This term is likely derived from the earliest papers on self-financing highways as collective goods by A.C. Pigou (1920) and Frank Knight (1924), considered a precursor of the modern literature on clubs.
- 9 See Sandler (1984) for all equations and derivations.
- 10 Sandler and Tischart (1997). It is worth mentioning that most models with heterogeneous agents fail to find a Pareto-optimizing competitive equilibrium. This issue is explored in depth in Sandler and Tischart (1980). It will not be explored in the Pacific context as a heterogeneous club is assumed as given.
- 11 Sandler and Tischart (1980).
- 12 Sandler and Tischart (1980). The recognition of nonhomogenous agents within a group is known as nonanonymous crowding, versus the anonymous crowding formulation in the Buchanan model.
- 13 Biglaiser and Friedman (2004).
- 14 Basu 1989.

## Appendix 6: Selected Excerpts from Forum Communiqués 1980–2004

### **Development Policies**

**1989:** The Forum considered reports from the Committee on Regional Economic Issues, and from the Regional Committee on Trade. These addressed a broad range of economic and development matters of concern to member countries. The Forum agreed there was a need for member governments to explore new trade and investment policy initiatives to promote national development. It recognized the importance of the GATT/Uruguay Round of Multilateral Trade Negotiations. **(Para 7)**

**1994:** The Forum stressed the need to adopt a global perspective in regard to the development of economic policies, in particular ensuring the achievement of maximum sustainable economic returns on the region's resources, enhancing development of the private sector, responding to changing global economic conditions, increasing the level of value-added production, and developing regional approaches to international trade. **(Para 13)**

**1995:** The Forum supported a number of national policy measures and regionally based activities which would contribute to the aim of *Securing Development Beyond 2000*. These included:

- (i) Securing the potential benefits of globalization by enhancing competitiveness through promoting price stability (low inflation); avoiding artificial distortions to the prices of domestic resources (land, labour, capital); reducing trade taxes and import duties, which adversely affect export competitiveness; and removing implicit and explicit barriers to foreign direct investment.
- (ii) Adopting and implementing the investment principles agreed to by APEC members, as a signal to potential investors of the region's serious intentions to promote and encourage foreign direct investment.
- (iii) Working towards implementation of trade reform measures as required by GATT/WTO, including by replacing nontariff barriers with tariffs, and setting a time frame for minimizing tariff levels.

- (iv) Promoting trade both within and outside the region by harmonizing and standardizing administrative procedures in the areas of customs and quarantine, labeling and packaging, phytosanitary and other sanitary requirements, export/import controls, exchange controls and technical standards.
- (v) Improving public sector efficiency and cost-effectiveness by rationalization of public services; attention to policy coherence and commitment to the principle of good governance; and strengthening cooperative relationships between government Ministries and agencies.
- (vi) Improving aid management and regional cooperation by endorsing the Proposed Regional Strategy.
- (vii) Recognising the valuable contribution of the agricultural sector to domestic food security, export development, incomes and employment and the need for positive measures in support of agricultural development, including minimising price distortions and promoting agricultural research and information dissemination, for both marketable and subsistence crops.
- (viii) Enhancing development by the adoption and maintenance of appropriate and sustainable fiscal policy settings.
- (ix) Placing greater emphasis on population management strategies as a fundamental way of accelerating development.
- (x) Ensuring that development strategies place appropriate emphasis on the promotion of outer island and remote community development.

**(Para. 18)**

**1998:** The Forum recognized the special circumstances of the smaller Forum member countries in the implementation of economic reforms under the Action Plan and the need for strong support for their reform processes by regional organizations and the donor community. **(Para. 14)**

### **Regional and Global Trade Issues**

**1984:** The Forum agreed in principle to promoting duty free and unrestricted access for handicrafts traded between Forum Island Countries, to be implemented on a bilateral basis. **(Para. 16)**

**1988:** The Forum noted members' dependence on the export of certain agricultural and other commodities. It expressed concern that the proliferation of trade distorting policies that characterize the present international trade regime represents a substantial trade and economic burden, particularly on the economies of the developing countries in the region. The Forum noted the importance of the Uruguay Round in addressing the question of reform of the agricultural and commodity trading systems. It called for participants in the negotiations to take full advantage of the mid-term review of the Round by agreeing to early reform action, particularly in tropical products and agriculture. **(Para. 11)**

**1996:** Leaders agreed that tariff policies should be reviewed in the light of the need to liberalize trade in the region, consistent with the global liberalization focus, and supported measures that countries can undertake without compromising other national policy objectives. **(Para. 8)**

**1997:** Leaders acknowledged the importance of public accountability to economic development and agreed to implement legislation, supported by administrative measures to counteract undesirable financial activities in the region, noting that such activities undermined development. Leaders reaffirmed their commitment to free and open trade among the Forum Island Countries through tariff reform and to ensuring investment transparency. They confirmed their support for the creation of Free Trade Area amongst Pacific countries. They agreed to cooperate closely particularly at the sub-regional level in improving air and shipping services and in addressing other impediments to increased trade and investment. **(Para. 6)**

**1999:** Leaders recognized the "spearhead" role of the Melanesian Spearhead Group (MSG) Trade Agreement in liberalizing trade and agreed that one of the key strategies for dealing with globalization and trade liberalization is to establish a regional free trade agreement. **(Para. 7)**

Leaders endorsed in principle a free trade area among Forum members noting that this would be implemented in stages over a period of up to 2009 for developing Forum Island Countries (FICs) and 2011 for the smaller island states and least developed countries. The Forum tasked the Officials to negotiate the details of the draft agreement, including negative lists and measures to provide for the application of the arrangements to Australia and New Zealand. **(Para. 8)**

**2001:** Leaders, at this historical 30<sup>th</sup> anniversary meeting of the Forum, endorsed the outcomes of the Forum Trade Ministers Meeting held in Apia, Samoa, from 27 to 28 June 2001, in particular the recommended texts of the Pacific Agreement on Closer Economic Relations (PACER) and the Pacific Island Countries Trade Agreement (PICTA), which were opened for signature at Nauru on 18 August 2001. The Forum hailed these agreements as providing a basis for increasing regional integration and as a means to effectively prepare members' economies to respond to globalization. It looked forward to ratification of the agreements as soon as possible by sufficient states to enable them to come into force by the next Forum. **(Para. 7)**

### **Governance and Accountability**

**2000:** Leaders endorsed the outcomes of the 2000 Forum Economic Ministers Meeting (FEMM), held in Niue from 24–25 July and the FEMM review. In particular, the emphasis on supporting a whole-of-government approach, applying rigorous impact assessment, and undertaking consultation in the design and implementation of economic reform was supported. The Forum also reiterated its commitment to the FEMM Eight Principles of Good Governance and pursuit by members of the Forum Economic Action Plan, which is intended to improve members' environment for sustained growth. **(Para. 19)**

The Forum noted the economic impact analysis of the unrest in the Fiji Islands and Solomon Islands, which highlighted the economic and social costs and the collateral impacts for members on trade, transport services, and use of regionally owned infrastructure. It also endorsed the importance of the following additional measures identified by FEMM as having a role in ensuring political and economic stability:

- (i) pursuit of economic reform in an effort to provide a sound economic basis upon which social development can be based;
- (ii) consulting widely with all stakeholder groups to improve transparency and promote ownership of development;
- (iii) assessing and addressing the full range of economic and social impacts of policy proposals to minimize socioeconomic disparities;
- (iv) progressive implementation of measures to promote good governance, including the Forum Eight Principles of Accountability; and

(v) addressing land issues that remain unresolved. **(Para. 20)**

**2002:** The leaders endorsed the FEMM's report and their efforts to improve economic management in the Pacific. They agreed that there was pressing need to address the internal economic weaknesses in island economies to better withstand international economic downturns and take advantage of global growth. They also agreed to a need to refocus attention on issues of good governance, use of broad-based consultation and socioeconomic impact assessments, and improving the business environment. **(Para. 3)**

### **Private Sector**

**1992:** The Forum stressed the importance for member governments to recognize the impact of global macro-economic trends on their open economies and their susceptibility to external change. It again stressed the importance of putting in place effective, domestic economic policies, with recognition of the vital role that an effective private sector should play in ensuring economic growth. A sound investment strategy was vital for ensuring the maximum development of local resources and for encouraging foreign investment into FICs. The Forum noted the critical need to maintain substantial resource flows to FICs. **(Para. 31)**

Of critical importance to the region was the development of its people. In this regard, the strengthening of educational opportunities particularly vocational and postsecondary education is critical. **(Para. 32)**

The Forum stated that while many issues needed action at the national level there was a vital role for regional action, in support of national objectives. It reiterated that regional development activity was best addressed through the application of a regional development strategy for the Forum Island Countries which is being developed by the Forum Secretariat. This would encourage the optimal use of resources directed to the areas most in need. The Forum noted the importance of dialogue and consultation in the development of the strategy, particularly with member governments and in cooperation with the South Pacific Organizations Coordinating Committee and the region's partners. **(Para. 35)**

**1994:** The Forum agreed that the private sector had an important role to play in the reforms now being undertaken in the region and for this reason the private sector needed to be strengthened to enable it to lead the next stage of growth. It recognized that if the private sector is to play its role in

full, the appropriate critical mass is necessary and because of differing circumstances, the rate of private sector development will vary from country to country. The Forum directed the Forum Secretariat to undertake a greater facilitating role in providing policy advice to member governments in these areas. **(Para. 11)**

**1997:** In the first FEMM which was held in Cairns, Australia, on 11 July 1997, leaders agreed that the implementation of the Action Plan would require strong commitment by all members to create a policy environment to encourage private sector development and enhance the competitiveness of their economies. This should include the development of tourism particularly in the Forum Island Countries with limited and no exploitable resources, noting the potential of the coming millennium to tourism development in the region. **(Para. 5)**

**1999:** The Forum recognized the value of lessons learnt through sharing the experiences of its members and how these could enhance the success of members' economic reform programs. The FEMM process provided a valuable opportunity for peer review in this area and should therefore be continued. Leaders reaffirmed their support for private sector action in ensuring sustainable development and the importance of engaging the private sector in economic policy discussions. The Forum also highlighted the need to ensure that economic reform discussions take account of social safety net needs and the desirability of enlarging the dialogue to involve consultation with civil society. **(Para. 11)**

Leaders recalled their discussions in Pohnpei on the fundamental importance of education and training in enhancing the adaptability of Pacific islanders to a rapidly changing world and region and, in particular, to economic reform. **(Para. 12)**

## **Regional Air Services**

**1995:** Leaders endorsed the outcomes of the Joint Meeting of Aviation Authorities and Operators, and the recommendations of ministers responsible for aviation meeting as the South Pacific Regional Civil Aviation Council. Leaders considered these recommendations provided an appropriate framework within which governments and airlines could work together, both at a national level and regionally, to improve further the performance of

the aviation industry in supporting national economic development and social needs in the South Pacific.

### **Telecommunications**

**1998:** Recognizing the importance of efficient and effective communications services for both national and regional development, the Forum agreed to convene a Forum Communications Policy Ministerial meeting. The aim of the meeting will be to promote competitive telecommunications markets and, taking into account social and rural/urban equity concerns, discourage unwarranted cross-subsidization between service sectors; work toward the development of a cooperative approach to information infrastructure and regulatory services; and examine developments in relation to international settlement rates for telecommunications services. **(Para. 12)**

### **Small Island States**

**1985:** The Forum recognizes that special emphasis on meeting the needs of the Smaller Island Countries should be given through support of their national development strategies and through preferential treatment in regional programs. The Forum noted the critical need for whatever economic potential exists in the SICs to be explored and developed to the full. **(Para. 25)**

**1987:** The Forum reaffirmed its support for the special measures to be taken to assist in the development of those of its member states classified as Smaller Island Countries. **(Para. 30)**

**1991:** The Forum recognized the special development requirements of the Smaller Island States of the Forum and recommended that the international donor community take these into account when providing assistance to those Forum members. **(Para. 10)**

### **Forestry**

**1994:** The Forum warmly welcomed the agreement between the prime ministers of Australia, Fiji Islands, New Zealand, Papua New Guinea, Solomon Islands, and Vanuatu:

- (i) to work toward a common code of conduct governing logging of indigenous forests, to which companies operating in their countries will have to adhere;
- (ii) on the need to increase urgently monitoring of logging and exports of timber;

(iii) that senior officials will meet within the next 2 months to begin implementing these decisions. **(Para. 6)**

**1996:** The Forum endorsed action to date by member countries to implement the South Pacific Code of Conduct for Logging of Indigenous Forests in Selected South Pacific Countries, and called for continuing efforts by all Forum members to manage their forests sustainably.

## **Fisheries**

**1989:** The Forum expressed its profound concern at the damage now being done by pelagic drift net fishing to the economy and environment of the South Pacific region. Given the catastrophic effects of this fishing technique on the lives of the peoples of the South Pacific, the Forum adopted the Tarawa Declaration. Through the Declaration the Forum

- (i) resolved for the sake of this and succeeding generations of Pacific peoples to seek the establishment of a regime for the management of albacore tuna in the South Pacific that would ban drift net fishing from the region; such a ban might then be a first step to a comprehensive ban on such fishing;
- (ii) determined, to this end, to convene an urgent meeting of regional diplomatic, legal, and fisheries experts, to develop a convention to give effect to its common resolve to create a zone free of drift net fishing;
- (iii) called on the international community to support, and cooperate in, the urgent conclusion of a convention establishing the zone;
- (iv) resolved that individual member states of the South Pacific Forum will take all possible measures in the interim to prevent drift net fishing within their waters, and to otherwise actively discourage operations of driftnet fishers;
- (v) further resolved that member states acting individually and collectively will take what action they can within relevant international organizations to contribute to the cessation of this harmful form of fishing;
- (vi) commended the Republic of Korea for its decision to cease drift net fishing in the region; and
- (vii) called on Japan and Taipei, China to follow this example, and abandon immediately their damaging drift net operations. **(Para. 10)**

The Forum recognized the urgent need for closer cooperation among all Forum members in order to protect and preserve their fishery and other marine resources as effectively and cost-efficiently as possible. The Forum therefore directed the Forum Fisheries Agency to investigate, promote, and

implement the design and development of an Integrated Programme of Regional Fisheries Surveillance. **(Para. 12)**

**1990:** The Forum continued to give high priority to the more effective management and better utilization of marine fishery resources in the region and adopted a number of decisions on issues of immediate concern and importance.

- (i) **Control of Long Drift nets in the South Pacific:** The Forum (a) endorsed the Convention for the Prohibition of Long Driftnets in the South Pacific; (b) called on all interested parties to accede to the Convention or its protocols as appropriate; (c) welcomed Japan's decision to cease drift netting 1 year in advance of the date stipulated in UNGA Resolution 225; and (d) directed that every effort be made to find means to involve Taipei, China in negotiations for a management regime for South Pacific Albacore Tuna.
- (ii) **Multilateral Fishing Arrangements with Japan:** The Forum (a) recorded its disappointment at Japan's continuing reluctance to enter into substantive negotiations toward the conclusion of a multilateral fisheries access arrangement, which would protect fisheries resources and the interests of all parties; (b) renewed its call to Japan to resume negotiations; and (c) directed the FFA to strengthen and develop regional strategies for improved fisheries management.
- (iii) **Minimum Terms and Conditions for Access by Foreign Fishing Vessels:** Forum members agreed to give high priority to the implementation of the revised Minimum Terms and Conditions as the basic standard of access to the FFA members' EEZs.
- (iv) **Western Pacific Purse Seine Fishery:** The Forum (a) noted with concern the potential threat to the western Pacific fisheries by the increased purse seine effort and (b) endorsed the need to control the number of purse seine vessels licensed to fish within the EEZs of FFA members in the western Pacific fishery.
- (v) **Ratification of the Law of the Sea Convention:** The Forum urged all member countries, as a matter of priority, to take measures to ensure the entry into force of the Law of the Sea Convention. **(Para. 10 )**

**1992:** The Forum having recognized the urgent need for closer cooperation amongst Forum members to protect their fisheries, noted the work completed on a treaty on reciprocal and joint surveillance and enforcement at the 22nd Forum Fisheries Committee meeting in Niue in May 1992. It confirmed support for the Niue Treaty on Fisheries Surveillance and Law Enforcement in the South Pacific Region. Forum members in a position to do so signed the Treaty. **(Para. 46)**

**1994:** The Forum agreed that multilateral approaches will be strengthened to promote the sustainable exploitation of fish stocks within the region. Toward this end, there is the need to define sustainable catch levels for all fisheries based on the precautionary principle; for countries to work together to enhance the monitoring and policing of fishing; to obtain fair prices for the fisheries resource; and to exploit opportunities for value-added production. The Forum urged all member countries to continue to play an active role in the UN Conference on Straddling Fish Stocks and Highly Migratory Fish Stocks. **(Para. 8)**

**1995:** In the light of the outcomes of the UN Conference on Straddling Fish Stocks and Highly Migratory Fish Stocks, the Forum considered that comprehensive regional fisheries management arrangements, and a structure consistent with UN Conference outcomes to administer them, should be developed as a matter of urgency. The Forum registered its view that these management arrangements must be based on a precautionary approach to ensure the sustainable exploitation of the region's valuable tuna resources. **(Para. 11)**

**2004:** Leaders, recognizing the importance of fisheries to the Pacific economies and people, agreed to seek increased sustainable returns from fisheries resources including through the increased participation of resource owners in the fishing industry. Domestic industry development was seen as an important means of increasing returns to Pacific countries.

### **Cooperation with External and Regional Partners**

**1991:** The Forum recognized the importance of continuing high level economic discussions between Forum Island Countries and the region's major development partners. It was pleased to note the firm resolve shown by all those interested in South Pacific development to foster greater levels of cooperation, coordination, and policy dialogue. In this regard a number of

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important issues were identified for further development of policies and programs. These included the role of the private sector recurrent cost issues of aid delivery, progress in the development of strategic planning and policy formulation capacities, human resources development including higher education and training and refinement of aid consultative mechanisms. It was fundamental that all agencies involved in these activities in the region continued to work closely together, coordinating their efforts to the greatest extent possible. **(Para. 4)**

The Forum agreed that the region should continue to promote links with the rest of the world, including non-Forum territories in the Pacific, that links should continue to be strengthened with groupings such as APEC and PECC and that the relationship between the Secretariat and the ASEAN Secretariat should continue to be fostered. The Forum joined others in the international community in urging all participants in the Uruguay Round to commit themselves to a comprehensive and successful end to the negotiations this year and underlined the importance of fair trading systems to Forum member countries. **(Para. 6)**

## Appendix 7: The Economic Optimality of the “Pacific Way”<sup>1</sup>

Club decisions can either be made by unanimity/consensus or by some departure from unanimity, ranging from majority rule to a dictatorship. In a cooperative setting, what is the optimal way of making decisions? Political decisions are usually made by majority rule, thus the majority who supported a policy expect to benefit from it, and the minority who opposed the policy will be worse off. Majority rule is thus imposed on a minority. Majority rule is arguably cost-effective. Since only 51% of the countries need agree, the cost of decision making is lower than if 100% were required to agree. However, there is often no way of guaranteeing that the benefits received by the majority are greater than the costs imposed on the minority, so an inefficient, or suboptimal, decision may be made.

In a club that seeks to avoid inefficient decisions, or does not want its decisions to make any individual member worse off,<sup>2</sup> the alternative is unanimous agreement by consensus. Here every country agrees to any change, and by their agreement, each member signals that the change improves their well-being. Consensus brings the benefits of higher group cohesion, even if the resources required in such things as meeting time and negotiating capital are greater.

Pacific cooperation has been guided in principle by consensus decision making. This approach is widely known as the “Pacific Way,” described below by a former Deputy Secretary-General of the Forum:

When formed in 1971 [the Forum] adopted an informal style based on the “Pacific Way.” There were no formal rules for the conduct of its meetings, and that is still the case today... Among these are shared principles of engagement (consultation, consensus, unhurried decision-making, taking care not to cause offence and resolution of disputes by diplomacy rather than adversarial contest) as well as core values (collective well-being, mutual respect, reciprocity, sensitivity to individual conditions).<sup>3</sup>

Besides its obvious cultural resonance for Pacific Islanders, the “Pacific Way” reflects an optimal economic logic for a regional club as diverse as the Forum membership. Given the heterogeneity of Forum members in terms of

income, geography, history, and ethnicity, it would be difficult to envision a majority voting system that, over repeated interactions, different external and domestic contexts, and different issues, would ensure that the costs to the minority are consistently less than the benefits to the majority. In the Forum, consensus has likely meant that meetings have required more time and resources than would be required with simple majority rule. However, given that the additional per-day costs of meetings are relatively minor compared to the fixed setup costs, the strong additional benefit of a consensus-driven approach is undeniable.

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**ENDNOTES**

- 1 This section draws from Holcombe (2004), from a framework developed in Buchanan, James, and Gordon Tullock. 1962. *The Calculus of Consent*. Ann Arbor: University of Michigan Press.
- 2 In the language of economics, this is known as a Pareto-optimal decision-making process.
- 3 Sutherland 2004.

## Appendix 8: Lessons in Regionalism from Other Regions'

There is strong evidence that moving away from a purely voluntary model has enhanced the benefits of regional cooperation in regions outside the Pacific. The MERCOSUR grouping in Southern America, the European Union, and Economic Community of West African States (ECOWAS) all have used binding cooperation to reinforce their commitment to shared principles.

### **MERCOSUR'**

The Mercado Común del Sur (MERCOSUR) was formed in 1991 by four countries in southern Latin America: Argentina, Brazil, Paraguay, and Uruguay. Along with the creation of a common market, a common concern in the region was the protection of democracy, reflecting its members' experiences with military dictatorship in the 1970s and 1980s. From its founding, MERCOSUR members maintained an informal rule that made democracy a condition of membership. This commitment was put into practice in April 1996 when the commander of Paraguay's armed forces was said to be contemplating a military coup. The bloc's four presidents reportedly quelled the rumored coup with a strong joint statement that democracy was a condition of membership in the bloc, the "Presidential Declaration on the Democratic Commitment in MERCOSUR."

Two months later MERCOSUR amended its charter to formally exclude any country that "abandons the full exercise of republican institutions." Its protocols set the full validity of democratic institutions as an indispensable condition for the existence of the MERCOSUR agreements, and set procedures for consulting on violations. If there is rupture of the democratic order in one of the states, the other countries will consult with the affected state. If these consultations prove ineffective, the other countries will decide on the nature and extent of measures to apply. Sanctions, from suspension of the right to participate in the organs of the various agreements, up to suspension from MERCOSUR, may be applied. The protocols specify that measures will be adopted by consensus and communicated to the affected state, which will not participate in the decision-making process. Such measures will cease once it has been verified that democratic order has been fully reestablished.

## **European Union and the ACP Group**

The 4-decade old aid partnership between the European Union (EU) and the 77 countries of the African, Caribbean and Pacific (ACP) Group yields useful lessons for strengthening regional cooperation between countries. The EU-ACP relationship is noted for its nonreciprocal trade benefits for ACP states with additional aid packages. However, beginning with the Lomé IV conventions in 1990–2000, the consensus that good governance was essential to development prompted many observers to call upon the EU and the ACP to make aid allocations conditional upon recipient countries' respect for governance principles.

The results are enshrined in the Cotonou Agreement, the successor to the Lomé I–IV agreements. The Cotonou Agreement is a multifaceted aid, trade, and investment agreement that is predicated on ACP countries' respect for human rights, democratic principles, rule of law, and good governance. The Cotonou Agreement was approached with caution due to the complexity of arriving at universally accepted criteria for assessing governance, and the danger of allowing too much scope for arbitrary opinions in this assessment. The compromise reached was that the first three elements (human rights, democratic principles, and rule of law) were seen as “essential elements,” where failure to implement these norms could provide grounds for suspension of EU aid. After a common definition was established, good governance was included as a “fundamental element.” Contrary to the “essential elements,” a state facing governance problems will not have to fear a suspension of aid, with the notable exception of “serious cases of corruption.” Consultations, requested by either party, can be organized. If these do not result in solutions, measures appropriate and proportional to the seriousness of the situation shall be adopted. Suspension would be a measure of last resort.<sup>2</sup>

## **ECOWAS**

ECOWAS joins 16 West African countries from Cape Verde to Nigeria.<sup>3</sup> ECOWAS was conceived as a means to advance economic integration and development, and is intended to lead to the eventual establishment of an economic union in West Africa. There were concerns during its formation that chronic political instability in some ECOWAS member countries and internal conflicts could prove even greater obstacles to economic development than market barriers.<sup>4</sup>

To address this issue, ECOWAS leaders adopted two important defense protocols in 1978 and 1981. These protocols call for mutual respect and

noninterference in internal affairs, and the establishment of a regional mechanism for mutual assistance in defense matters. Uniquely, these protocols place equal weight on threats from without and within. They state in Article 4 that ECOWAS is compelled to intervene in “internal armed conflict within any Member State engineered and supported actively from outside likely to endanger the security and peace in the entire Community.” The protocol thus allows for legitimate intervention in the internal affairs of member states.

These provisions have facilitated efforts aimed at the resolution of regional conflicts initiated by ECOWAS. The ECOWAS Monitoring Group (ECOMOG) was established initially on an ad hoc basis as a multinational peacekeeping/peace enforcement force, and was the first such group to be established by a regional body. ECOMOG teams are normally comprised of military units or technical experts from ECOWAS member states. ECOMOG was principally responsible for the restoration of peace in Liberia in 1997. In addition, ECOMOG forces have been deployed to Guinea-Bissau, Sierra Leone, and Cote d'Ivoire to address conflicts in those states.<sup>5</sup>

A further demonstration of the strong commitment of ECOWAS to shared principles—and its willingness to impose a cost for members that violate them—is its response to recent developments in Togo. In response to an attempted coup d'etat in Togo in February 2005, ECOWAS voted to impose sanctions that included travel bans against members and officials of the Togolese Government; suspension of all diplomatic, military, and civilian links; recall of ambassadors of member states of ECOWAS in Togo; and the enforcement of an arms embargo.<sup>6</sup> Within a month, the sanctions were lifted with immediate effect following the announcement of elections in Togo and assurances of transparency by the Togolese Government.

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ENDNOTES

- 1 This section summarizes the findings of World Bank. 2000. *Trade Blocs*. Washington DC: World Bank.
- 2 *Coronou Infokit: Essential and Fundamental Elements (20)*. Maastricht: European Centre for Development Policy Management.
- 3 Economic Community of West African States (ECOWAS) members are Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.
- 4 ECOWAS paper.
- 5 From: Bureau of African Affairs. 2002. *The Economic Community of West African States (ECOWAS)*. United States (US) State Department Fact Sheet. Washington DC: US State Department.
- 6 See *The Guardian (Nigeria)*. 2005. Togo: ECOWAS Sanctions May Start on Monday. 20 February. Available: <http://www.afrika.no/Detailed/8461.html>.

## Appendix 9: Economic Arguments for Regional Service Provision

### **Can Services Be Provided by Pacific Island Markets?**

For the purposes of this report, “the market” is loosely defined as any “agent”—firm, private citizen, or voluntary organization—that lies outside the public sector (i.e., governments and intergovernmental bodies). The economic arguments for market provision are well known and will be summarized only briefly.

- There is an *efficiency* argument: because nonpublic sector agents operate—in principle at least—in a competitive environment, they have an automatic incentive to allocate resources to the use that has the highest value for consumers. If market entry is free, then the number of service providers will increase up to the point to where total supply meets total demand and the price of services equal the break-even point for the service providers. All excess profits are whittled away by higher competition. Companies will sell their products at a price equal to the cost of production (marginal cost). There is a stronger incentive for the private sector to be more efficient and generate a better return on capital.
- There is a *cost* argument: since market participants are (again, in principle) not dependent on taxpayer funds for their existence, their costs are private rather than public. As such, the failure of any single firm or voluntary organization is not a direct cost to society via increased taxes.

The number of services provided by the market in the Pacific is arguably less than in many larger, more developed countries. Political considerations, and the colonial structure inherited by many Pacific island economies—in itself a “big government” model—have undoubtedly played a key role in this. Yet, there are also structural reasons, largely a product of the unique geography and characteristics of the region. (Many of these characteristics were examined in Chapter 2.)

1. **Small, High-Cost Markets.** The high transactions costs in the Pacific, stemming from the islands' small, isolated, and internally fragmented markets, greatly constrain the ability of market agents to bargain and hence capture the gains from trade that are usually associated with

market activity. This problem of “incomplete markets”<sup>1</sup> implies that activities left purely to the voluntary or private sector will be as small, fragmented, and isolated as the markets they are serving. Even where market opportunities exist, credit markets may be too shallow or underdeveloped to provide finance to market participants at interest rates that permit sustainable investment.

2. **Asymmetric Information:** The classic gains from trade are based on an assumption of full information. That is, market agents (producers and consumers) are fully informed of prices in the market, product characteristics, etc. Again the isolation, fragmentation, and difficulties in communicating across the large distances of the Pacific mean that information about price changes, profit making opportunities, and competitive threats may be intermittent and of low quality.

3. **Equity:** The market outcome promises efficiency, but it offers no guarantee of justice or fairness. While this is not normally classified as a market failure, redistribution and equity are often as important, if not more important, socially than prices that are above marginal cost. Entrusting services to the market makes their availability to citizens more dependent on income.

4. **Natural Monopolies:** If markets are inherently isolated and high-cost, the number of firms that are necessary to bring about a zero profit competitive market outcome will be unsustainable. The economic structure will converge to a natural oligopoly (a small number of firms) or a monopoly, since only larger firms will be able to produce on a scale large enough to overcome the market constraints.<sup>2</sup> Prices will be above marginal cost and so-called “monopoly rents” will exist. The normal competitive mechanisms that keep producers focused on consumer needs—such as free entry and full information—will be weakened.

If services are left to the Pacific market, economic theory suggests that private “natural monopolies” might emerge. Such a monopoly (or oligopoly) would produce too few goods and charge prices that are too high. Also, a narrower range of products than would be socially optimal would be produced. If the service in question is inherently fragmented, production levels are low, and the service is required by only a small number of people, then this outcome is not necessarily problematic. However, if the service is considered essential and has universal coverage—provision regardless of

ability to pay—is highly valued, then leaving service provision to the market in the Pacific implies high, monopolistic prices and a greatly restricted scope of provision.

One alternative is to subcontract services to market providers who are based outside the region. Large private multinationals, for example, are generally based in developed economies where the size of their home market creates the necessary scale benefits. They then establish low-cost subsidiaries to serve smaller, more fragmented or underdeveloped markets. In many developing countries these private multinationals are the only nongovernment bodies that have the critical mass of resources to operate profitably in high-cost countries. Many Pacific island governments already subcontract services, such as audit and research, to private multinationals. However, there is evidence that the cost of this type of market-provided service is prohibitively high relative to national budgets. The cost of hiring the services of a partner of a major multinational auditing firm, for example, can run into several thousand United States dollars per day.

### **Can Services Be Provided by Pacific Island Governments?**

The case for national provision of services rests on the assumption that governments can aggregate enough resources to overcome the problems posed by small and isolated markets. By taking provision away from the market, the necessary cost-reducing scale can be reached, overcoming the chronic risk of gaps in the market coupled with high prices. By creating centralized capacity, countries can instill the bargaining and information sharing that would occur in a more integrated, contiguous market. A common, public institution can use monopoly rents to cross-subsidize markets and attract higher levels of financing to ensure more universal, uniform coverage of essential services. Creating national institutions can allow countries to provide services to pursue social goals that are not necessarily related to profit maximization. For essential services such as education and health care, there is the added dimension of service reliability.

For you as a consumer it is always a good thing to have a permanent supplier to serve you, particularly if the good in question is an individualized service where quality depends on the supplier's knowledge about your personal characteristics. For most ordinary consumer goods this is a matter of little importance. If your hairdresser or local pizza supplier decides to close down or goes bankrupt, it does not seriously upset your life. The situation is

likely to be different with your school, hospital, or retirement home. In some areas of life we might attach some value to institutional stability, and this may more easily be ensured by government than by private ownership.<sup>3</sup>

Why might national provision not be optimal to deliver services in the Pacific? First, governments in the region often do not have the capacity to overcome the cost constraints imposed by their countries' demography and geography. While the internal fragmentation of many Pacific island countries means that central governments may provide services such as utilities, budgeting, and infrastructure more efficiently and widely than the market, they are still constrained by the smallness of their countries—eight Forum members have populations below 100,000. Twelve FICs have populations below 500,000.

Unless the government has the capacity to produce the inputs into its services—e.g., medical equipment, or heavy infrastructure—the cost of service provision is usually at market prices or above market prices (if inputs are imported). However, governments are often subject to universal service obligations and legal requirements to charge below-market prices for their services. As a result, the diseconomies of scale that hamper service provision at the national level in the Pacific do not manifest themselves in high prices, as the usual economic theory would predict. They are manifest in underprovision. For many Pacific island countries, the reality of public service provision is that of “shell providers.” In this situation, fixed costs are largely underwritten by donors or government funds, but the service does not generate enough revenue or attract sufficient external funding to maintain an adequate ongoing level of service. In this scenario, prices are slow to adjust and resources are scarce, and it is the level of the service that inevitably adjusts downward.

Service provision thus becomes a fiscal “black hole,” where often significant amounts of funding are directed to the service infrastructure, yet these resources never reach the critical mass needed to overcome the basic cost constraints of the economy. Governments can attempt to shift the burden by taxing other parts of the economy. This often results, however, in nothing more than a transfer of the cost burden to another, perhaps more vital, part of the economy. National provision may not solve the market failure problem. By adding another layer of cost, it may in fact exacerbate it.

The second reason why national provision might be inadequate in the Pacific context is institutional capture and inefficiency. Public sector production is not inherently inefficient, but costs are not independent of organizational behavior. Recall that an element of subsidiarity is that public providers must still follow optimal pricing, otherwise the benefits of removing services from the market will fail to materialize (and other undesirable costs may emerge). Moving services from the market to national provision brings the risk of institutional capture, where the incentives at the national level are strong. This is due to a number of factors, including the smallness of Pacific island countries, the difficulty in overcoming principal-agent problems in closely knit societies, and the ongoing political turmoil in some FICs. This is not to imply that services should automatically be devolved to either the market or to regional bodies. Rather, that institutional governance is essential to ensuring that national provision delivers desirable social outcomes at the lowest possible cost. Policy failure is as intrinsic to subsidiarity as its market failure counterpart.

### **Can Services Be Provided by Pacific Regional Institutions?**

The case for regional provision of services rests on many of the same arguments as national provision, but on a larger scale. Regional service providers have access to several member countries' resources as well as to donor funds (which in some cases have a special regional component that can be accessed by regional bodies). The economies of scale implied can be several orders of magnitude larger than the national level. The potential for gains in information sharing increases exponentially as regional institutions may have a wider perspective on the shared challenges of the region, and can transmit best practices more easily and effectively.

In the case of the Pacific island countries, this argument has special relevance. Many of the smallest and most vulnerable Forum members lack a critical mass of domestic capacity to provide ongoing services to their populations. Given the high fixed costs of many essential services, this implies that in the Pacific context regional institutions can provide services where national governments simply would be unable to do so. Pooling national capacities of Pacific island countries alone could create a service provider that enjoys the scale benefits of a service base of approximately 6 million people, rather than (in some cases) less than 100,000. If the regional service provider incorporates Australia and New Zealand, then the potential scale benefits increase 4-fold—likely more given the higher per capita incomes and broader tax base in these countries.

There is also scope to reduce policy failure. Since regional bodies are in principle institutionally separated from national governments, they can prevent many of the costs associated with institutional capture. If regional bodies are perceived as being better governed than their national counterparts, their larger size can attract more finance into the region, both private and donor. Also, regional bodies are often the only nondonor institutions in developing countries that pay salaries between those of national governments and private sector firms. They are thus able to retain expertise and lessen the “brain drain” of talented public sector officials.

Intuitively, the costs of regional provision are higher. With the benefits of larger economies of scale come larger diseconomies of isolation. Regional bodies must provide services across the entire region, rather than within just a single country. Given that in most cases the diseconomies of isolation are larger between countries than within them (Kiribati being the primary exception), the costs of regional provision can be much higher than a simple sum of national provision. Furthermore, given the reality that services in the Pacific are often under-provided or not provided at all, creating regional institutions will require more than pooling resources currently flowing into national provision. In many cases, these resources will be insufficient. Pooling them may simply reinforce the market failure, but at the regional level.

This implies that resources for regional institutions will have to be additional, especially for short-term fixed costs and medium-term recurring costs, as the institutions develop their capacity and expertise. The promise of regional institutions lie not so much in saving governments and donors money in the short term, but ensuring that future expenditures are more effectively spent in the longer term. The key lesson is that the need to create regional institutions that create large benefits is especially pertinent for the Pacific, since cost recovery and self-sufficiency will only be a possibility in the longer term, if at all.

Another key cost may be a regional version of institutional capture. This could originate from either member states or from the regional bureaucracy itself. While regional institutions are technically separate from governments, there is always the possibility that governments will pursue their national interests within and at the expense of regional institutions. Avoiding this “political capture” requires a healthy relationship between the governing body—usually comprised of member states and often weak at seeing the

“big picture”—and the management/staff of regional institutions. Analogous to its political counterpart is “bureaucratic capture.” Even where regional institutions have the best of intentions and are subject to no special sociological constraints, the diverging incentives of regional bureaucracies and their national constituencies can create additional costs.<sup>4</sup> Again, a key lesson is that institutional governance is absolutely crucial to effective service provision. To ensure objectivity, regional bodies usually are not subject to the same electoral influences and oversight mechanisms as many of their national counterparts. Yet this presents an additional risk of capture that derives not from the closeness of bureaucracies to socioeconomic influences at the national level, but from their distance.

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#### ENDNOTES

- 1 Based on Arrow (1971).
- 2 In the economic literature, this argument is known as “increasing returns”: where average cost is decreasing throughout the range relevant for market equilibrium (or at least through a substantial portion of that range).
- 3 Sandmo 2002.
- 4 For an theoretical illustration, see Banerjee, Abhijit. 1997. A Theory of Misgovernance. *The Quarterly Journal of Economics* 112: 1289–1132.

## Appendix 10: Case Studies in Regional Integration and Cooperation from Other Regions

### **The European Union Common Market**

The European Union (EU) is widely considered to be the most successful modern experiment in regional market integration. The removal of the internal market barriers within the EU, the largest market in the industrialized world, has been a nearly 5-decade process. It is a process that is still very much ongoing, as evidenced by the recent debate over the proposed EU services directive.<sup>1</sup> Nonetheless, the gains achieved thus far have been considerable. Studies conducted by the European Commission (EC) *ex-ante*<sup>2</sup> provided partial estimates—by type of barrier and industry—that market integration could provide up to 4–7% of GDP in welfare gains. Similar results were forecast for employment (an increase of 1.8 million jobs) and budgetary/external balances. European Commission (EC) studies forecast that the largest gains came not from the initial dismantling of customs procedures, but from reductions in non-tariff barriers: technical (product standards, technical regulations), fiscal (value-added tax (VAT) rates, accounting standards), and protected public sector procurement.

The *ex-post* benefits, while not as large as the initial EC reports predicted, have been impressive nonetheless. As early as 1996, the EC estimated a cumulative net gain of 174–207 billion ECU for the period 1988–1994 as a direct result of EU market integration. This, according to the Commission's figures, resulted in an increase of 1.1–1.5% of GDP for 1994—from ECU 3.83 trillion in 1989 to ECU 4.12 trillion in 1993, an increase of ECU 290 billion.<sup>3</sup> While the creation of the single market has not led to the full convergence of per capita incomes, the economic impact on poorer accession countries has been dramatic. Expressed in terms of the EU-15, GDP per capita has increased from 1960 to 2000 in Spain (59% to 81%), Portugal (39% to 74%), Greece (43% to 67%), and Ireland (64% to 96%).<sup>4</sup> The impact on Ireland is even more dramatic considering that it has nearly converged with the more developed EU founding members.

The experience of EU labor market integration provides some interesting additional insights. Despite nominally free movement of labor within the EU, cross-border residence has remained very low, despite the fact that many countries (e.g., Portugal) acceded to the EU when their per capita incomes were well below the EU average. While the impact of tight immigration laws after the 1970s has certainly influenced this outcome, it also

suggests two lessons. First, other factors apart from economic opportunity—such as language and ethnicity—influence decisions about whether to migrate or not. Secondly, the income-enhancing effects of market integration may provide a strong incentive to remain in the home country, as Ireland, Spain, and Portugal—formerly large net exporters of labor, and now net importers—clearly demonstrate.<sup>5</sup>

### **The Caribbean Community's Single Market Economy (SME)<sup>6</sup>**

Regional market integration is one of three stated objectives in the founding 1973 Treaty of Chagaramas.<sup>7</sup> The lessons from market integration in the Caribbean provide a number of cautionary lessons for the Pacific. The original founding treaty only covered the initial stages of integration (free trade in goods and a common external tariff). Following a period of stagnation in the 1980s, however, spurred by other regional initiatives such as the North American Free Trade Agreement (NAFTA), Caribbean Community (CARICOM)<sup>8</sup> members took concrete steps to revitalize their integration process. Members set the goal of a CARICOM single market and economy, with accompanying harmonization of macroeconomic policies and monetary integration. Yet, a decade later, progress has been slow. Goods trade continues to face barriers, and liberalization of services, capital, and labor has barely begun.

Jessen and Rodriguez (1999) outline a number of factors behind the slow pace of market integration.

- While many CARICOM members share similar characteristics (smallness, openness, narrow export base, heavy reliance on trade taxes), there is still significant variation within the region. Three of its 15 members (Trinidad and Tobago, Jamaica, and Barbados) account for almost 80% of the common market's GDP. The members of the Organisation of Eastern Caribbean States (OECS)<sup>9</sup> account for 10%. As most intraregion exports originate from the relatively larger and more developed countries, the issue of the distribution of benefits from market integration has been a critical obstacle.
- The export mix among CARICOM countries is concentrated in a small number of commodities (fuels, minerals, sugar, and bananas), implying that the gains from trade between CARICOM states are limited. While intraregional trade appears to be more diversified than extraregional exports, it is still highly asymmetrical. One country (Trinidad and Tobago) accounts for almost 70% of total intraregional exports.

- A key factor in the slow pace of liberalization in goods and the virtual stagnation of negotiations toward greater services, labor mobility, and capital is the presence of larger non-CARICOM trading partners in the region. Jessen and Rodriguez note that while efficiency and welfare gains undoubtedly exist within the region, the scarce negotiating capacity in CARICOM is often focused on more lucrative market access in North America and the United Kingdom.

The CARICOM experience in many ways echoes the FICs' difficulties with The Pacific Island Countries Agreement (PICTA). Part of the reason for the slow pace of integration lies no doubt with institutional constraints, and the fact that integration in the Caribbean was often undertaken in a context of national protectionism and economic stagnation. However, Jessen and Rodriguez conclude that

... a regional market of United States \$15 billion cannot act as a primary engine for the Caribbean countries, since it offers only limited opportunities for the development of tradable goods and services at competitive prices and quality... CARICOM members have been acutely aware of the limitations posed by their small markets.

### **Asia-Pacific Economic Cooperation<sup>10</sup>**

Since the first ministerial meeting in Canberra in 1989, APEC has evolved from an intergovernmental cooperation forum to a regional mechanism to implement trade and investment liberalization and facilitation. Among its many successes was the collective response to the currency crisis of 1997, and the coordinated security measures implemented after September 11<sup>th</sup>. Many observers note that these successes stem from (i) the fact that APEC is still guided by its Heads of Government meetings, obviating the need for time-consuming hierarchy of approval for proposals; and (ii) the relatively small bureaucratic burden of the APEC institutional structures themselves.

However, APEC has been notably less successful in attaining its stated goal, trade liberalization, in part due to the very success factors listed above. The APEC vision of “open regionalism”—unilateral domestic liberalization coupled with nondiscriminatory external arrangements, once hailed as the future of regionalism, has thus far failed to increase intra-APEC trade flows. Oxley (2005) notes that two key factors have slowed APEC trade liberalization.

- APEC has a relatively lean bureaucratic structure vis-à-vis other regions. While this helps to reduce the costs of cooperative activities, it has often meant that there is no institutional structure to back up liberalization measures and monitor commitments by member states. These capacity constraints mean that APEC has focused on voluntary liberalization based on self-assessment and little external oversight.
- The effects of the Asian currency crisis, while partially muted by quick APEC action, were still significant. The negative shocks from the crisis diverted significant political attention away from market liberalization. APEC members were unwilling to liberalize their trading regimes during often-severe recessions. Thus, even a market integration holding potentially large benefits is still hostage to external events.

Despite the slow pace of liberalization in goods, services, and investment, there is one area in which APEC has forged ahead: labor mobility. The APEC Business Travel Card (a multiple entry visa in “credit card” form) has been introduced in a number of APEC states, accompanied by the streamlining of visa entry processes for short-term visitor visas and temporary residence applications for key business personnel. While this initiative is still restricted to business executives and intracorporate transferees, many World Trade Organization observers have recognized the significance of the APEC scheme for global and regional negotiations on the temporary movement of labor.<sup>11</sup>

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#### ENDNOTES

- 1 See BBC News Online, *Services Liberalization Sparks EU Row*. Available: <http://news.bbc.co.uk/2/hi/business/4277511.stm>.
- 2 Emerson et al. 1988.
- 3 Davidson 2000.
- 4 Barry 2003.
- 5 Hoeller and Louppe 1994.
- 6 This section summarizes the findings of Jessen and Rodriguez (1999).
- 7 The other two objectives are (i) to coordinate members states' foreign policies and (ii) to pool together scarce resources through functional cooperation.
- 8 Caribbean Community members: Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Monserrat, Saint Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Surinam, and Trinidad and Tobago.
- 9 Organisation of Eastern Caribbean States: Antigua and Barbuda, Dominica, Grenada, Monserrat, Saint Lucia, St. Kitts and Nevis, and Trinidad and Tobago.
- 10 This section summarizes findings from Oxley (2005).
- 11 See for example Chaudhuri, Mattoo and Self. 2004. *Moving People to Deliver Services: How Can the WTO Help?* World Bank Policy Research Working Paper No. 3238. Washington DC: World Bank and Winters, Walmsley, Wang, and Grynberg. 2002. *Negotiating the Liberalization of the Temporary Movement of Natural Persons*. Discussion Paper 87. Brighton: University of Sussex.

## Appendix 11: Conceptual Basis for Measuring Costs and Benefits

### **Inputs Purchased: Value as Opportunity Costs**

Potential regional interventions by FICs member country governments inevitably use resources that could be used to produce other goods or services. For example, the suggested Regional Panel of Auditors would require resources to operate (e.g., factor inputs such as labor, materials, land and equipment). Because these resources would be unavailable to be used for other purposes, the Panel's operations would involve opportunity costs. In concept, these opportunity costs are equal to the value of the goods and services that the resources would have produced if used in the best alternative way.

In practice, as Boardman et al<sup>1</sup> explain, the normal way to measure the value of such resources used is to rely on the direct budget outlay required to purchase them. In some circumstances the direct budget outlay does equate with the conceptually correct measure of opportunity costs, but not in others. The suitability of direct budget outlay data as a measure of opportunity cost—and any adjustment needed to convert it into a suitable measure—depend largely on conditions in the market where the resources are purchased. The situation may be summarized as follows (based on Boardman et al):

- (i) *Efficient market for resource with minimal price impact:* Where a resource used in the intervention is purchased from an efficient market and the purchase has minimal impact on its market price, the budget outlay is a suitable measure of its opportunity cost.
- (ii) *Efficient market for resource but noticeable price impact:* Where a resource used in the intervention is purchased from an efficient market but the purchase affects its market price, this price change needs to be taken into account in calculating the opportunity cost. Typically budget outlays will overestimate slightly its opportunity cost in such cases.
- (iii) *Inefficient market for resource:* Where there is a market failure in the market supplying a resource required for the intervention, budget outlays may substantially overstate or understate the opportunity costs of an intervention. The budget figures would overstate the cost if monopoly rents were being charged, but understate it if prices were heavily subsidized.

In summary, Boardman et al state that

*The general rule is that opportunity cost equals expenditure less (plus) any increase (decrease) in social surplus occurring in the factor market. . . .*<sup>2</sup>

In this definition, the change in “social surplus” due to an intervention is defined as the *sum* of any change in *producers’ surplus* as a result of the intervention<sup>3</sup> *plus* any resultant change in *consumers’ surplus* as a result of the intervention.<sup>4</sup>

An important general point to remember is that opportunity costs relate solely to resources that must be forgone today and tomorrow for an intervention to occur. Resources whose use have already been forgone are sunk costs that no longer can be used in alternative uses and so no longer have an opportunity cost.

### **Outcomes: Value Costs and Benefits as “Willingness to Pay”**

People’s willingness to pay is the correct conceptual basis for measuring a regional intervention’s outcomes in terms of benefits and/or costs to producers and consumers. Boardman et al defines the value of these benefits and costs as follow:

Benefits are the sums of the maximum amounts that people would be willing to pay to gain the outcomes that they view as desirable; costs are the sums of the maximum amounts that people would be willing to pay to avoid outcomes that they view as undesirable.<sup>5</sup>

In valuing the impact of a regional intervention, analysts need to consider its impact in *primary markets* (i.e., markets that are directly affected by a regional intervention) and *secondary markets* (i.e., markets only indirectly affected), and to distinguish whether such markets are *efficient* or *inefficient*. Based on Boardman et al,<sup>6</sup> the general rules for valuing outcomes in these different market circumstances are essentially as follows.

- (i) *Impacts on Efficient primary Markets:* Benefits or costs arising in an efficient primary market as the direct result of a regional intervention should be valued as the change in social surplus plus (less) any increase (decrease) in revenue to the governments of the member countries involved, and their regional entity.
- (ii) *Impacts on Inefficient Primary Markets* If market failures<sup>7</sup> or government interventions<sup>8</sup> distort product markets affected by a regional intervention, value any benefits or costs similarly. Reliably calculating the social

surplus, however, is now more difficult. In principle, some adjustment will need to be made to offset these shortcomings in reflecting willingness to pay.

(iii) *Impacts on Efficient Secondary Markets.* If a regional intervention's impact on primary product markets do not cause a secondary market price change, the secondary market can be ignored. But if it does result in changes in secondary market prices, then

- if primary-market impacts are measured using a demand curve with other prices held constant, social surplus changes in the secondary market will need to be deducted from those calculated in the primary market to yield the correct impact on the primary market; otherwise
- if primary market impacts are measured using a demand curve that does not hold other prices constant, the secondary market impacts can be ignored.

(iv) *Impacts on Inefficient Secondary Markets.* If a regional intervention's impacts on primary product markets do not cause a secondary market price change, the secondary market effects can be ignored. But when secondary markets are distorted, its full impact (costs and benefits) cannot be measured solely from effects in primary markets. In principle, this means that impacts on distorted secondary markets should be valued separately, although in practice this may be very difficult to do.

Boardman et al conclude:<sup>9</sup>

The concept of opportunity cost helps us to value the inputs that policies divert from private use; the concept of willingness-to-pay helps us to value policy outputs. The key to valuing outputs is to identify the primary markets in which they occur. When outputs are not traded in organized markets, ingenuity is often needed to infer supply and demand schedules... For this purpose, various shadow pricing techniques ... are often needed. Costs and benefits that occur in undistorted secondary markets are typically very difficult to value, but generally need not, indeed, should not, be added to costs and benefits that are measured in primary markets. Doing so will usually result in double counting.

A basic point to bear in mind—as noted by Boardman and Hunt 1997<sup>10</sup>—is that cost-benefit analyses generally assume implicitly that (i) resources used in a target intervention otherwise would have been used in their most best productive uses, and (ii) the target intervention uses (or would use) the resources most productively.

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**ENDNOTES**

- 1 Boardman, A.E., D.H. Greenberg, A.R. Vining, and D.L. Weimer. 1996. *Cost-Benefit Analysis: Concepts and Practice*. Prentice Hall: Upper Saddle River, New Jersey.
- 2 Ibid, p.69.
- 3 “Producers’ surplus” is defined as the aggregate total revenue less the aggregate total variable costs of the market supplying a given level of output. Note this concept differs from aggregate profit which equals aggregate total revenue less aggregate total costs (not just total variable costs).
- 4 “Consumers’ surplus” is defined as the difference between the aggregate sum consumers actually paid for a given level of good or service less the aggregate sum they would have been willing to pay for the good or service, if required.
- 5 Ibid, p.76.
- 6 Ibid., see Table 3.1 “Rules for measuring social benefits and costs of government interventions in markets,” p. 93.
- 7 A market failure exists, for example, where a supplier can obtain monopoly rents in a product market, or where the market price does not reflect the value of an external cost (e.g., pollution) or benefit.
- 8 A government intervention, for example, could be a subsidy that masks the true willingness to pay for a product.
- 9 Ibid., p.92.
- 10 Boardman, A.E. and A.L. Hunt. 1997. *Review of Methodologies for Estimating the Welfare Impacts of Corporatisation and Privatisation*. Auckland: Uniservices Ltd., p.36.