

## CHAPTER 4

# Three Types of Regionalism

### Introduction

**T**he main lesson of club theory is that regional groupings should intervene regionally only where there are significant economies of scale, and avoid interventions where there are significant costs associated with isolation. This does not shed light, however, on exactly how countries should work together to create benefits and avoid costs. Even within the same sector, such as governance, there are countless ways that countries can pool their resources, each with its own balance of costs and benefits.

The importance of design in effective regional clubs cannot be understated. If regional institutions are properly chosen, designed, and implemented, then club members can capture the benefits of working together at minimal cost. If not, then the costs of working collectively—resources for new bureaucracies, travel costs, and so on—can easily overwhelm benefits. There is the risk that badly designed regional initiatives will merely aggregate, amplify, and transmit the costs of cooperation throughout the club, only adding to the financial burdens of members. This “cost doubling, not cost halving” problem is a risk for any club, however well intentioned. Harmful arrangements can easily endure into the future.

Social norms acquire moral force over time, rules of thumb tend to become habit, and specialized procedures become part of the social fabric of a community. Consequently, an institution can acquire a validity of its own even though it is inefficient and counterproductive, independent of the economic purpose it once arose to serve, and outlasting that purpose. In this way it may become an impediment in the path of fruitful adaptation to a changed context.<sup>1</sup>

This caveat is especially pertinent to the Pacific “club” context. The high variation in development levels among Pacific countries and the great distances between them mean that costs of interaction are especially high. The risk of developing ineffective, unsustainable, or dysfunctional institutions is arguably greater than with a group of more contiguous, homogenous members, each “paying its own way.”

This chapter will review the different ways in which regional clubs can join together to create shared institutions and reap the benefits of collective action. It will explore how getting regionalism “right” is crucial to overcoming the many obstacles facing the region, and how getting regionalism “wrong” has led to problems in the past. It will create a “menu” of approaches by outlining three different types of regional institutions—regional *cooperation*, regional *provision of services*, and regional *market integration*. It will summarize what economic theory has to say regarding the balance of costs and benefits of each one, and how each approach has led to success and failure in the Pacific and elsewhere. The chapter concludes with lessons for getting regionalism “right” in the Pacific.

Every region, including the Pacific, has pursued different types of regionalism at different times. Variation in the balance of costs and benefits of the different types derive from the fact that each is suited to very different challenges. There is, however, a common thread through most successful regional projects. The greatest benefits come from applying the right type of regionalism to the greatest shared challenges facing the region. While this seems obvious, the historical review in this chapter will demonstrate how many regions (including the Pacific) have often opted for regional institutions and approaches that, despite high costs, did not yield the necessary offsetting benefits.

This chapter will argue that in the Pacific context, regional cooperation is insufficient to cope with many of the region’s challenges—despite this being a preferred method of regionalism in the Forum. It will argue that given the Pacific’s unique characteristics, only by moving to “deeper” forms of regionalism—increased regional provision of services and regional market integration—will the Forum create the necessary pool of benefits needed to make regional institutions sustainable and beneficial to its members.

## Regional Cooperation

### **Defining Cooperation**

In general economic literature, “regional cooperation” encompasses virtually every form of interaction between countries. In this report cooperation will be defined more narrowly as the interaction of national governments where implementation is left purely at the national level.

Within this definition, cooperative institutions are those that help overcome problems of coordination, information sharing, mistrust, and commitment between governments. Operationally, this includes conferences, meetings, forums, and other forms of intergovernmental discourse. Dialogue is the key process and coordination measures are the key output—treaties, declarations, strategies, and action plans that outline mutually agreed steps to be taken by national governments. These are usually accompanied by mechanisms to ensure and monitor implementation, such as working groups, monitoring units, and committees.

Since the early days of the Forum, regional cooperation has been a primary vehicle for Pacific regionalism. Beginning in the 1960s, a network of regional organizations has developed to facilitate interaction and coordination between newly independent sovereign states. This network is largely centered on the Pacific Islands Forum. As an intergovernmental body, the Forum is largely directed by decisions taken at annual leaders' meetings, and at regular ministerial meetings covering a range of priority sectors and themes.

Forum leaders and ministers release a nonbinding communiqué at the conclusion of their regular meetings. These communiqués often note and discuss problems, or note progress or lack of progress on particular issues. The issues covered in recent years have ranged from economic reform, security, and fisheries, to nuclear testing, radioactive waste, and environmental issues (see Appendix 6). Forum economic ministers now hold annual meetings in addition to the leaders' meetings, with regular meetings on a range of issues including trade, foreign affairs, aviation, communication, and education. There is also the Forum Regional Security Committee, made up of officials from members' law enforcement agencies.<sup>2</sup>

## **Economic Arguments for Regional Cooperation**

### **The Costs and Benefits of Regional Cooperation**

The primary benefits of regional cooperation derive from building cross-country relationships, aligning beliefs and expectations, cultural exchange, learning from peers, and improving the flow of information between governments. Given the geographic isolation of many Pacific island countries and the high costs of transport and telecommunications, continued face-to-face interaction between Forum leaders and key officials has undoubtedly created strong links between Forum members. Cooperation has also brought benefits in terms of capacity building. Regional meetings have provided exposure for political leaders in a less formal setting than, for example, the United Nations General Assembly, and officials have gained useful practice in managing and documenting meetings, handling disagreements, and drafting conclusions.<sup>3</sup>

These benefits, while undoubtedly significant (especially for newly independent FICs and in the first decades after the colonial era), are also subject to strongly diminishing returns. Given the small size of many government ministries in the region, it is often the same officials who attend different meetings, reducing the benefit of additional meetings. In some cases, regional cooperation leads to a decision to move to a deeper form of regionalism—regional provision of services or regional integration. Deeper forms of regionalism require a high level of trust and confidence among members, and in the right circumstances regional cooperation can help build that trust and confidence.

The costs of cooperation in the Pacific are significant, however. Given the diseconomies of isolation in the Pacific, the costs of holding meetings have been high. This is especially true for meetings that involve the entire Forum membership, or are held in countries that are not major hubs for airlines operating in the region. For example, the cost to the Forum Secretariat alone of holding a ministerial-level meeting, such as the June 2004 Forum Economic Ministers Meeting (FEMM) meeting in New Zealand, was in excess of Fijian dollars (F\$)250,000. This can be considered a relatively lower-cost meeting, as New Zealand is a regional airline hub. The cost of a lower-profile meeting, such as the April 2004 meeting of EPA trade officials in PNG, was roughly equivalent (F\$224,000). The major part of costs for many of these meetings is transportation. Transportation is a one-off fixed cost regardless of the length of the meeting, highlighting the high diseconomies of isolation in the region.<sup>4</sup>

Another, less easily quantified cost, is the burden placed on scarce human resources in government ministries that attend regional meetings. Every day spent at a regional meeting contains an implicit opportunity cost to the government ministry, in that key personnel are away from capitals for long stretches of time. For some outward-oriented ministries, such as foreign affairs and external trade, constant interaction with regional counterparts can be seen as intrinsic to their duties. Opportunity costs are thus lower. For other ministries with a more domestic focus, such as education, health, and local government, these costs may be higher. Conclusions reached in a regional forum are usually generalized across the entire membership and may have limited relevance to the needs of individual countries.

### Implementation and Political Costs

If benefits quickly diminish and costs are consistently large, then why is regional cooperation currently a primary vehicle for Pacific regionalism? One reason is that the cost of regional cooperation has generally been subsidized by either donors or FIC taxpayers. As noted in the earlier chapter on club theory, the Pacific "club" departs from traditional theory, in that the users of club goods—government officials, regional bureaucracies, and experts—are not generally the ultimate source of financing for meetings and conferences. There is thus a strong "price distortion," where key officials have a strong incentive to organize and attend key meetings even if outcomes are not immediately relevant, or if a meeting entails time away from home capitals.

Another reason for the wide support for regional cooperation is that in the overwhelming majority of Forum decisions, there is no compulsion to implement decisions. Accordingly, there is no political cost to failing to implement such decisions. Thus the durability of the Forum has been based on an approach that offers no substantive challenge to its members. This is not to disparage the consensus-driven approach of the "Pacific Way." Economic logic in fact dictates that a decision-making process driven by consensus is optimal for a mixed club such as the Forum (see Appendix 7).

Once consensus has been reached however, the decision to implement or not to implement is crucial. Implementation can either be voluntary or binding. In a voluntary approach, there is zero cost to a member that does not implement the group's decision. A binding approach imposes costs for nonimplementation. This can entail a financial loss, such as a fine, or a political loss, such as blocking a member's future participation in group decision-making councils.

## Implementation in the Forum

In its regional cooperation, the Forum has opted for a voluntary rather than binding approach. While this avoids political friction—and no doubt makes consensus much easier to achieve—it has also diluted the potential benefits of regional cooperation. The benefits of regional cooperation can only be attained and offset its costs if decisions reached are actually implemented. In the Pacific, the obvious strengths of the “Pacific Way” have arguably been diluted by voluntarism, resulting in a record of partial implementation of Forum decisions. With a few notable exceptions, implementation of Pacific club decisions has been left entirely to national governments or to Forum regional bodies. Any type of sanction or penalty for noncompliance has been rare, and monitoring has been generally left to ad hoc committees that have relied extensively on country inputs—and the capacity of countries to produce the necessary reports—for their monitoring activities.

Due to the lack of systematic monitoring, it is difficult to provide direct evidence of noncompliance. One of the few areas where monitoring has recently begun is the biannual assessment of decisions taken at the FEMM. The most recent assessment<sup>5</sup> compiles country responses on the implementation of a range of FEMM decisions from 2002 to 2004. During the assessment, responses were received from less than half of the Forum membership, with incomplete implementation the clear picture emerging. “Lack of political will” and “availability of human, financial, and technical skills” were cited as the most common constraints to the implementation of the Eight Principles. Similar results were obtained for a stock taking of reforms in governance, economic, financial sector, and trade/investment institutions. The fact that the FEMM stock taking is in the public domain and the response rate was below 50% suggests that implementation rates are lower for nonresponding countries.

Appendix 6 summarizes the past 20 years of Forum communiqués on a range of economic issues. The communiqués are largely framed in what may be termed encouraging or exhorting language, and are restricted to endorsing and/or acknowledging the findings of relevant action plans or regional studies. In certain key commercial areas, such as fisheries and shipping, Forum decisions are geared toward concrete actions—e.g., the establishment of the South Pacific Maritime Development Programme. Nonetheless, none of the decisions listed in Appendix 6 are accompanied by any language stating a specific cost to noncomplying countries.

It was noted above that a voluntary approach is likely to require less decision-making time. Governments will more quickly sign on to agreements for which nonimplementation imposes no penalty. Yet it must be considered whether this saving of time and resources compensates for the hidden but significant cost to the region's reputation and development resulting from the Forum's patchy record of implementation.

### **A "Pacific Way" to Increase the Benefits of Cooperation?**

Partial implementation is not unique to the Pacific region. Yet the constraints, inherent and otherwise, facing the region mean that the opportunity costs of reaching decisions that are implemented only partially (or not at all) are uniquely high. Continued interaction and debate have yielded undeniable benefits for the Pacific region. This is especially true for the smallest and most vulnerable states, many of which are attempting to strengthen institutions after only a few decades of formal independence. In the end, though, the costs of cooperation must be offset by significant, tangible benefits.

It is difficult to reconcile voluntarism and its associated record of half-hearted implementation with the large benefits required to offset costs. It has been argued often that "it is the bureaucratic costs of cooperation that need to be attacked, not the cooperation function itself."<sup>6</sup> This report takes no issue with that statement. Given the high diseconomies of isolation in the Pacific, however, significant reductions in the costs of cooperation may be achievable only in the longer term, if at all. It is the benefits of cooperation that must be increased. The lesson here is that cooperation can have net benefits, yet it is clear that the current Forum approach is not optimal. Replacing voluntarism with a uniquely "Pacific Way" of strengthening monitoring and commitment is one way to improve this situation.

There is strong evidence that moving away from a purely voluntary model has enhanced the benefits of regional cooperation in regions outside the Pacific. Appendix 8 outlines how the Mercado Comun del Sur (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.

It is beyond the scope of this report to outline what such an approach might look like in the Pacific. A "Pacific Way" to strengthen implementation will no doubt have to grow out of the region's existing forms of conflict

resolution and prevention. Yet it must have three important elements.

- It must preserve the current consensus-driven, decision-making process to ensure that all Forum countries participate in formulating decisions that may impact them.
- Any legally binding agreement must contain explicit provisions for enough technical assistance to implement decisions. Moving away from a voluntary model brings an important concern: imposing costs for non-implementation may unfairly penalize states with weak capacity. In financial regulation, for example, international bodies have formulated standards and codes not only without the participation of small states, but also at variance with their unique development circumstances. These principles have been made into de facto binding agreements through the use of “name and shame” lists of noncompliers (e.g., OECD’s Harmful Tax Initiative) or incorporated into risk assessments by major institutions (e.g., the Basle Capital Accord). Small states are penalized for not having the capacity to implement an agreement into which they had no input.<sup>7</sup> A stronger Pacific cooperation must not repeat this double penalty.
- The assessment mechanism must be comprehensive but fair. The resources needed to assess compliance in any single country, let alone the entire Forum membership, will be significant. Entrusting the entire task to a single organization will most likely result in a patchy, one-size-fits-all assessment. In the case of the financial standards and codes mentioned above, many were subject to penalties as a result of either highly simplified “tick-box” assessments, or highly subjective qualitative assessments by organizations with little knowledge of the countries.<sup>8</sup> A more feasible alternative is the use of self-assessment—to encourage ownership—coupled with a regular peer review mechanism, to ensure coverage and objectivity. This must be combined with technical assistance to ensure that countries are able to provide an accurate picture of their own and other countries’ compliance.

As a step toward binding commitments, a new Forum method of “peer pressure” could in principle strengthen implementation, while avoiding the hard methods of persuasion that are often used by multilateral organizations and arguably contravene the principles of the “Pacific Way.”

The smaller Pacific states have the greatest stake in moving away from the current voluntary status quo. If a group member does not face any cost for not implementing collective decisions, there is little real incentive for

that member to ensure that group decisions can realistically be implemented. As a result, group decisions become more and more ambitious. Countries face an ever-growing list of action plans and strategies to account for and report on. Their ability to actually implement any given decision thus decreases proportionately. It is clear that any state in the Pacific—especially the smallest ones—attempting to implement all the decisions listed in Appendix 6, while at the same time negotiate a constant stream of new decisions, would very quickly come up against the limits of their resources. Modifying the voluntary model in the Pacific will provide an automatic incentive, whether financial or political, to focus agendas on decisions that bring large benefits and can be reasonably implemented.

## Regional Provision of Services

### **Defining Service Provision**

Service provision, along with policy making, was cited as a key pillar of a country's "effective sovereignty" at the conclusion to Chapter 2. However, governments can choose to pool their capacity to provide services. Regional provision of services is qualitatively no different than outsourcing or devolution of services to private sector providers. The power to make policy remains with national governments. The regional body merely provides selected services. If the service is provided more effectively by a regional or private sector provider, the "effective sovereignty" of a country may be advanced.

Institutions created for regional service provision are most useful when supporting or replacing weak and/or failing national service capacity. Such regional institutions generally require a dedicated physical infrastructure, located in one or more countries in the region, with centralized management and staff. The key distinction from regional cooperation is that the regional body actually replaces one or more functions that are normally provided nationally, rather than merely coordinating them.

The range of services provided can vary enormously, from essential public services such as education, health care, and economic planning, to more commercially oriented activities such as transport and import procurement. A limited number of regional organizations in the Pacific have a primary role as service providers. These include the Forum Fisheries Agency (FFA), the University of the South Pacific (USP), and the Pacific Forum Line.

However, it is often difficult to draw a clear distinction between regional bodies that are purely cooperative and those that are purely service providers. In reality, many are both. For example, regional bodies such as the Secretariat of the Pacific Community (SPC) South Pacific Applied Geoscience Commission (SOPAC), and the South Pacific Regional Environmental Programme (SPREP) both facilitate regional meetings (cooperation) and provide technical services through staff experts (service provision).

### **Economic Arguments for Regional Service Provision**

Is there a strong economic case for providing services regionally in the Pacific? A useful analytical starting point is the literature on public economics,<sup>9</sup> which outlines the instances where public sector intervention can be economically more efficient than the market in allocating resources. The basic argument for public sector provision of goods and services, as well as for the regulation of private markets, should be derived from a diagnosis of market failure. Different aspects of market failure will be explored in this section, but a common underlying idea is that market failure occurs when the market does not allocate resources in an efficient way. Put more simply, the market creates more social costs than benefits. In this scenario, the involvement of a public body may overcome the market failure and result in a more beneficial outcome.

In the case of regionalism, there is a double test of market failure, known as subsidiarity. The principle of subsidiarity states that services should be provided at the lowest level at which efficient and effective provision is possible. Thus, in order to justify service provision at the regional level, there has to be some inefficiency at both the market and the national government levels. Subsidiarity can be assessed by applying two simple questions.

- Is the market providing a service well? If so, then involvement by national governments and/or regional bodies should be minimal.
- Can national or local governments provide the service well? If so, then involvement by regional bodies should be minimal.

There is a third implicit consideration that is perhaps more important. Even if a double market failure has been identified, can regional bodies actually deliver their intended benefits? The caveats in the introduction to this chapter are especially pertinent for service provision, since it generally requires a physical institution and staff, whose incentives can easily become separated from those of the region they are meant to serve.

To establish a convincing case for public sector involvement, you should be able both to point to a market failure and to argue convincingly that the public sector is able to handle the problems involved in a better way. The last part of this requirement is far from trivial; there is no particular reason to believe a priori that actual bureaucrats and politicians will be motivated to take decisions in accordance with the prescriptions of welfare economics and public finance. Recommendations regarding the division of labour between the private and public sectors should take account not only of market failures but also of the possible failures of policy.<sup>10</sup>

Appendix 9 explores the subsidiarity argument, moving from the market, to the national level, to the regional level. It argues that among the Pacific countries, notwithstanding the important qualifications highlighted above, there is indeed a strong economic case for providing some services at the regional level. If efficiently designed, increased regional provision can create large net benefits for the region, especially where capacity constraints in the market and in governments are strongest.

It should be noted, however, that effective regional service provision can potentially involve significantly higher costs than the status quo of national provision, for two reasons. The first is that regional bodies must deal with diseconomies of isolation between FICs that are usually greater than those faced within FICs. The second reason is that the status quo is likely to involve underprovision of services, so merely pooling current resources of FICs will be insufficient to address the problem.

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 establish regional institutions that create large benefits is especially pertinent for the Pacific, since cost recovery and self-sufficiency will only be possible in the longer term, if at all.

## **Case Studies from the Pacific**

In order to test the costs and benefits of service provision at the regional level in the Pacific, separate retrospective cost-benefit studies were commissioned on each of four established service providers in the Pacific: USP, FFA, Air Pacific, and Pacific Forum Line. Each study outlines the original rationale for creating regional capacity in their respective sectors, the means by which national services were consolidated, and the retrospective costs and benefits—qualitative and quantitative. Only a brief summary is provided here. Each is available on the websites of the Asian Development Bank (ADB) ([www.adb.org](http://www.adb.org)) and Pacific Island Forum Secretariat (PIFS) ([www.pacificplan.org](http://www.pacificplan.org)).

### **University of the South Pacific**

USP is the preeminent tertiary education institution in the Pacific. The USP system includes a large number of prestudies, research, and consultancy units that, alongside its degree programs, are considered to be on a par with facilities found in other universities. It has three campuses (the main campus located in Suva, Fiji Islands), extension centers in each member state, and increasingly uses distance education for course delivery.

USP clearly satisfies the subsidiarity criteria at both the market level and the national level. The “market” alternative for tertiary education is classified here as non-Pacific universities. In a few cases, such as the Central Queensland University campus in Suva, there is a subsidiary established within the Pacific islands. At the national level, there are clear constraints against not only a single country developing similar facilities, but also a group of countries creating between themselves a comprehensive tertiary institution. National universities have been established in Samoa, Tonga, PNG, and most recently, in the Fiji Islands. Each, however, has a fairly restricted curriculum. To access the market alternative, most students must travel and study abroad. This study estimates that the aggregate yearly cost of education abroad for students enrolled in USP would be approximately F\$120 million. The annual cost to regional governments of operating USP is less than half that amount, and the cost is retained within the region. In addition, students educated abroad were found to be more likely to permanently migrate, further exacerbating the drain of human resources.

Apart from the cost savings over a market or national solution, USP creates scale benefits in the form of its various units and centers. These both feed off the universities’ physical and human capital and pour financial

surpluses and intellectual energy back into the USP system. It would be difficult to imagine a purely national university in the Pacific that would have the capacity to support a similar level of activity. In all, the study estimates that USP operations generated approximately F\$50 million in 2004, while enabling foreign exchange savings over F\$120 million.

There is, however, a strong caveat: USP operations are, despite its clear financial benefits, still greatly dependent on ongoing donor financing. On one hand, USP's large scale and clear benefits make it a magnet for donor funds in the region: in 2004, USP attracted an estimated F\$24 million in aid. However, as USP grows in size, it incurs larger recurring expenses to maintain both adequate infrastructure levels and a representative student body. In many instances, this requires scholarships and other direct/indirect financing programs. Thus, even an institution that generates significant benefits and is seen by many around the region as a prime example of regional provision of services, is still in large part financially dependent on external sources.

### **Air Pacific**

Prior to the establishment of Air Pacific, the majority of island countries did not have the economic power, market demand, skilled support personnel, support aviation infrastructure, or the support services required to undertake national airline services. Only the Fiji Islands was able to support a national airline, which monopolized the regional aviation market for 17 years prior to the establishment of competing airlines. The parlous state of regional infrastructure—crude and remote airfields, and nonexistent fuel terminals and support personnel—meant that travel costs remained prohibitively expensive. However, there was a recognized need for airline services to more remote FICs, apart from the Fiji Islands. Successive waves of capitalization backed by a consortium including major commercial players such as Qantas, led to an expansion of Fiji Airways (soon to be renamed Air Pacific) from a national airline to a regional one.

Despite its expanded mandate, Air Pacific remained a private company that went through the normal commercial process of growth, with private equity participation from established international and aviation operators. These operators fast-tracked the market penetration capability of Air Pacific to operate regionally, and in the later years, internationally. The financing of Air Pacific was not undertaken through public finances, nor was its managing board exclusively controlled by regional governments.<sup>11</sup> A strong flow of

private capital ensured that Air Pacific's reliance on member government budgets would be minimized. However, the private nature of the firm also led to perceived biases toward the Fiji Islands in its services. This led to the leaders of Nauru, Samoa, Tonga, Solomon Islands, and Vanuatu withdrawing from Air Pacific. These countries then initiated airline ventures of their own, either individually or in partnership with other international aviation companies. These national ventures often negatively impacted FIC government budgets, as scarce finances had to be injected into loss-making airlines to avoid a return to a situation of limited airline service delivery.

The consequence of increased competition for Air Pacific was initially disastrous as well. It experienced recurrent losses as its market share dropped significantly. In response, Air Pacific and its partners undertook a large-scale restructuring that brought the firm back into financial health.

The Air Pacific case demonstrates how any regional service provider faces a difficult trade-off. On one hand, a regional service that is operated along commercial lines and separated from public funding allows a more flexible structure and the potential to weather crises, as Air Pacific did over the past 2 decades. However, this commercial structure, coupled with the inherent market smallness of many FICs, means that the scope of the regional service will necessarily be restricted. This can easily undermine support for regional initiatives, and underscores the need for proper financing arrangements. Individual shareholders, whether firms or governments, must feel that they are receiving adequate benefits from regional service providers.

### **Pacific Forum Line**

The structure of the shipping industry in the region prior to the establishment of the Pacific Forum Line (PFL) reflected the market obstacles of the Pacific: a small number of shipping entities dominating the market, each with significant levels of price control, but acting collectively as a cartel to the detriment of service provision to the Pacific. The high fixed costs of the industry, the smallness of the island markets, and the uneconomical returns generated from servicing these routes dissuaded other shippers from entering the market. The oligopolistic structure perpetuated rent-seeking behavior from other industry agents, such as maritime unions, pushing costs up further and eroding competitive behavior. These barriers led to the failure of purely national shipping lines, which quickly became insolvent. The need for a regional shipping line was clear.

PFL was established in the mid-1970s after a 4-year period of initial study. Even with significant initial capitalization, however, the regional shipping line quickly ran into the same financial constraints that had plagued its national and market predecessors—operating and administrative costs exceeded gross revenue from the outset. Not only was the initial capitalization in retrospect seen as inadequate, but also ongoing costs, such as loading and discharging, were the second-highest cost of operations (after charter hire). This implied that PFL had underestimated the underdevelopment of supporting infrastructure in destination countries.

In the early 1980s, two important actions led to a turnaround in PFL's fortunes. First, after a period of intense diplomatic activity, an injection of funds from Australia and New Zealand arrived to shore up PFL's weak capital structure. Second, a thorough review of PFL operations was commissioned. It found, in the words of the annexed report, that PFL was "trying to be all things to everybody." At the behest of member governments, it operated many unprofitable routes and was incurring huge losses.

The governing structure of PFL certainly promoted this outcome. At the top were the Forum heads of government, overseeing the Regional Shipping Council comprised of ministers in transport and shipping-related fields. Below the Council were shareholders, government officials, the PFL Board of Directors (appointed by regional governments), and finally the General Manager of PFL. While this ostensibly kept the enterprise under public control, it also led to many of its greatest operational difficulties. The findings of the PFL review led to further capitalization through a loan from the European Investment Bank (EIB). PFL subsequently focused on a few key routes, and successfully lowered its costs through negotiations with member states. In sum, the regional service provider strengthened its commercial focus.

### **Forum Fisheries Agency**

The Forum Fisheries Agency (FFA) was created in 1979 to assist FICs in pooling resources, in coordinating with external partners, and in securing the benefits of fisheries stocks through prudent collective management. Over the 25 years since its creation, FFA has played a pivotal role in helping member countries secure and uphold sovereign rights over their respective exclusive economic zones (EEZs). FFA helped negotiate beneficial tuna fisheries access agreements, and assisted the development and negotiation of conservation and management regimes for tuna fisheries in their EEZs. It

also helped monitor and enforce compliance with access agreements and fisheries regulations. More recently, FFA was instrumental in negotiating the creation of a new international body aimed at ensuring that highly migratory tuna stock in their EEZs and adjacent high seas are managed on a biologically and economically sustainable basis.

Despite the difficulties in calculating the precise net benefits of FFA, analysis undertaken for this report by Hyndman (2005) indicates that they have been substantial. The contribution of the FFA to GDP in individual member countries averaged nearly 7% of GDP, with wide variation and estimates as high as 21.5% for Kiribati. FFA played a pivotal role in helping member countries negotiate the US Multilateral Treaty on Fisheries, which came into force in June 1988. While the benefits once again vary widely, Hyndman (2005) estimates that over the 16 years of licensing until the present, member countries have received total payments of almost US\$200 million under the treaty. Total annual payments (expressed as a percentage of total landed catch value) are relatively high and rising, estimated at about 11% in 1988/89 licensing year to over 20% currently.

Since 1979, total expenditure on FFA inputs over the entire 25-year period to 2004 was about US\$75 million. Over this period, member contributions totaled US\$14.2 million (or 19%) of FFA's total funding, with other funding sources providing the remaining US\$60.7 million (or 81%), mostly as development assistance.

How has FFA succeeded where many regional initiatives have foundered in the past? The analysis of Hyndman (2005) points to a number of factors.

First, economies of scale have been clearly identified and exploited. While geographic circumstances vary throughout the region, each FIC faced a common set of challenges in procuring expert information, analysis, advice, and support on fisheries issues. Capacity constraints at the national level and weak commercial incentives for individual countries to encourage sustainable harvesting meant that monitoring, licensing, and regulation could not have been limited to exclusively national levels. In other words, the subsidiarity criteria clearly pointed to a regional solution for fisheries management.

Second, there has been a strong link between FFA activities and the needs of its member states. FFA has helped member countries to collec-

tively develop informed regulatory strategies for their fisheries by compiling, evaluating, and disseminating relevant information to members about

- the region's fisheries,
- existing management practices and their likely impacts on the sustainability of fish stocks, and
- other management options, precedents elsewhere, and their impacts.

While member states' interest in FFA is undoubtedly linked to the importance of fisheries to their economies, there is clear evidence that the proactive role FFA has taken in disseminating crucial information has yielded strong benefits. FFA has also provided a forum for frank, informed discussion about fisheries issues and provided ongoing assessment of relevant issues of interest to FFA member states.

Finally, funding for FFA has not been entirely dependent on a single source, yet steady donor support has been crucial. FFA funding comes from members' contributions, donor support, and fees charged by FFA. However, despite the comparative advantage enjoyed by FICs in fisheries products and the undeniable financial benefits to a number of FICs, FFA is still largely dependent on donor financing, which provides nearly three quarters of total funding.

## **Case Studies from Other Regions**

### **Bulk Procurement of Pharmaceuticals**

Bulk procurement is often cited as an area where regional service provision can achieve economies of scale, especially for groupings of small states with weak individual market power. Due to the commonality of brands and its vital role in sustainable development, pharmaceuticals (along with petroleum) are often mentioned as a possible commodity to purchase in bulk. A recent study evaluated the success and failure of eight programs from around the world,<sup>12</sup> including the Joint Bulk-Purchasing Scheme for the Pacific Island Countries. The study found that in virtually every region there existed a clear need. Prices provided by the market were beyond the purchasing power of national (and private) health care systems. Additionally, there existed little capacity within the individual countries to produce sufficient pharmaceuticals to satisfy demand, let alone undertake new research to develop domestic alternatives, without infringing on global patents. The need for cost-effective medicines was evident.

Despite the fact that regional action clearly satisfied the subsidiarity criteria, the study concluded that only a small number of regional bulk purchasing programs were ultimately successful. One reason was that only a small number of programs actually achieved the forecast economies of scale. Bulk purchasing in most cases was able to achieve modest reductions in prices. However, program volume was often insufficient to attract the best prices—absent significant markups, and the programs were not cost-effective enough to justify the expense involved and demonstrably impact health outcomes.

A second (related) conclusion was that the design and execution of the programs greatly affected their cost/benefit calculus. Programs based on purely voluntary arrangements (such as the Caribbean Pharmaceutical Service and the Central American) suffered from an absence of political and/or financial commitment. This was manifest in a chronic lack of funds for research and procurement as member countries diverted payments intended for collective use to other uses.

These problems were exacerbated by a high cost structure. Even the most successful programs entailed many expenses, such as a permanent, well-resourced secretariat and complex governance/surveillance arrangements to ensure transparent procurement. In several instances, these costs were not foreseen at the outset.

### **Air Afrique<sup>13</sup>**

Air Afrique was created in 1961 by 12 French-speaking African countries<sup>14</sup> to contribute to socioeconomic development in the member states, on the premise that many of the smaller countries could not afford a national airline. The subsidiarity argument seemed to many observers to be evident: civil aviation is a natural sector for cooperation given the high fixed costs of aircraft, airport infrastructure, and human resources planning and development. Airports incur sizable fixed, indivisible costs. The presence of such economies of scale implies that airports serving less than 1.5–3 million passengers will operate with increasing long-term average costs. To this end, the member states signed the Yaoundé treaty of 1961, providing Air Afrique with an exclusive concession to international traffic, while keeping national autonomy for domestic transportation. Bilateral agreements with non-members were negotiated through a joint committee. A majority stake in the airline was equally divided among the signatory countries.

In 2002, however, after nearly 2 decades of persistent financial difficulties, Air Afrique was liquidated. The primary reason for the airline's failure was that it failed to address many of the chronic, underlying problems in the African aviation market, such as high fuel prices and airport taxes, steep insurance premiums due to inadequate safety, and a lack of subcontractors. The latter forced the airline to internalize many basic operations, such as catering and sales. A second set of reasons related mainly to Air Afrique's multistate arrangement. National sensibilities impeded efficiency considerations at nearly every turn. Cash-strapped partner governments often demanded universal service obligations, yet failed to provide compensating financial infusion to the airline. At the time it filed for bankruptcy, Air Afrique had 32 directors (by comparison, General Motors has less than half that number). Managers chose to acquire large, top-range aircraft instead of turbo-prop short-haul planes better equipped to operate on regional routes. All member governments wanted a direct air link to Europe, whereas it would have proved much more cost-efficient to develop Abidjan as a regional hub. Finally, some countries started to free ride on the arrangement, subtly opening their markets to charters from Europe in contravention of the Yaoundé treaty.

### **Lessons Learned**

The case studies within the Pacific and from other regions suggest that even with an intuitively sound strategy, regional provision of services must overcome several hurdles to succeed. Three key lessons for regional service provision are drawn.

- For a regional provider to be successful, the fundamental principle of subsidiarity must be satisfied. Regional bodies must only intervene when market or national public sector bodies cannot effectively deliver the service. Regional bodies have been more successful in traditionally public sector areas, such as education, than in market-oriented commercial activities. When undertaking the latter, clear, commercial objectives and professional business management are essential. The regional arrangement must be robust enough to withstand competition, including from sometimes ill-advised, national-level operations.
- External support—whether from donors or from member governments—is crucial. Capacity weakness in many FICs means that simply aggregating existing national-level resources will create weak and undercapitalized regional service providers. The most successful regional operations may not enjoy financial cost recovery, even in the longer term.

- Clear governance arrangements and shareholder expectations are essential. This is especially important when regional provision entails close member state involvement and the creation of a regional bureaucracy. Governance arrangements must ensure that shareholders feel they have a strong stake in the enterprise, lest they undermine regional providers with competing national services. But arrangements must also ensure that political interference and unrealistic expectations do not detract from overall financial health. The limitations of minority shareholdings need to be clearly spelled out. Specific arrangements, including financing arrangements, for an agreed level of service provision to “uneconomic” routes are necessary to manage the tension between commercial and political objectives.

## Regional Market Integration

### **Defining Market Integration**

The basic definition of market integration is the reduction of barriers between the markets of member countries. Most regional agreements begin with the removal of tariffs on the trade of intraregional goods. However, market integration can go beyond goods to include nontariff barriers, services, investment, and movement of labor.

“Regional market integration” is considered separate from “regional integration” in this report. The latter is more commonly used in economic literature, and generally refers to removing market barriers (market integration) plus the creation of shared institutions, such as central banks and regulatory bodies (regional services provision) to facilitate the freer movement of goods, services, and people. However, this typology reflects the experience of the European Union (EU), where market integration was assumed to yield the highest gains. Service provision was seen as a complementary adjunct since the original member countries were not particularly constrained in critical capacities.

In practice, countries can elect to provide services from a single regional body (or a number of subregional bodies) without breaking down market barriers, except for those goods and services that are intrinsic to the service itself. A degree of standardization across countries is often required to facilitate centralized service provision, but this need not be accompanied by market liberalization.

Examples of market integration in the Pacific include the Melanesian Spearhead Group (MSG—Fiji Islands, PNG, Vanuatu, and Solomon Islands), the Closer Economic Relations (CER) agreement (Australia and New Zealand), the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), and the Pacific Island Countries Trade Agreement (PICTA). The Forum members are also party to several agreements with non-Forum countries, such as the Cotonou Agreement (Forum and African Caribbean Pacific Countries with the European Union) and the Compacts of Free Association (Palau, Federated States of Micronesia, and Marshall Islands with the United States.)

### **Economic Arguments for Market Integration**

The economic literature on market integration is particularly rich, but only the arguments in favor of integration will be briefly summarized here.<sup>15</sup> In this basic formulation, the main costs and benefits of regional market integration are grouped into four main categories: competition-scale effects, trade-location effects, revenue effects, and investment-capital effects.

Competition and scale effects are analogous to the benefits of pooling national services. As noted in the previous section, many small countries lack the market size to support large-scale competitive activity, leading to high prices, low levels of sales, high costs, and a market structure biased toward oligopoly and/or monopoly. Combining markets can reduce monopoly power through more intense competition, yielding three types of gains. The first is a gain to consumers from the downward pressure on prices as monopoly rents are taken away and firms expand sales. The second is the ability of firms to exploit economies of scale due to access to a larger market. The third is a reduction in internal inefficiencies as firms streamline their price-cost margins. The elimination of monopoly rents and the competitive pressure on firms forces them to restructure, and in some cases go out of business, so these adjustment costs must be weighed against the competition and scale benefits described above.

Trade and location effects refer to the changing patterns of trade once intrabloc market barriers have been removed. The classical gains from trade derive from countries importing goods and services from the most efficient (lowest-cost) producer, in exchange for goods and services that they are able to produce relatively efficiently. In the case of a regional trading agreement, if a producer located in a trading partner displaces inefficient production at home, these gains are known as trade creation. However, it is unlikely that

the Pacific region contains the most globally efficient producer. If a regional partner displaces the lowest-cost imports from the rest of the world, then there is the cost of trade diversion. This can happen because the higher-cost goods from the partner country enter duty free under the regional market integration arrangement. The integration arrangement may allow them to undercut the lowest-cost global producer, whose imports are still subject to duties. The potential for trade diversion is the reason regional market integration is generally considered a second-best trade policy, as opposed to global most-favored-nation liberalization.

Revenue effects refer to changes in government revenue that may occur due to regional market integration. The impact is sensitive to a number of factors. If tariffs are lowered (but not to zero), the increased demand for imports from regional partners may in fact increase trade-related revenues. Even if tariffs are reduced to zero, the competitive and scale effects of increased economic growth (and the impact of lower import prices on export prices) may lead to increases in total government revenues. A similar outcome can be achieved by developing alternative sources of revenue, such as a value-added tax (taxing consumption instead of trade). The key considerations then are (i) the impact of market integration on growth, and (ii) how constrained governments are in administering and collecting new taxes.

Investment/capital effects generally refer to the incentive that integrated markets provide for increased capital flows. For example, if integration makes the market more competitive, favoring lower marginal cost sources of production, foreign direct investment (FDI) from firms in partner countries may increase. For developing countries, the creation of a single market, especially if it is accompanied by the creation of shared institutions, may attract higher official flows as donor funds are able to flow to more countries. If integration is extended to labor, remittance flows may be significant, depending on the host-country labor market and barriers to capital flows within the region.

### **Regional Integration in the Pacific**

Over the last several decades, small developing states have joined an increasing proliferation of regional market integration arrangements. Based on their experiences, the literature on market integration has developed methodological caveats that suggest many cautionary lessons for the Pacific.<sup>16</sup>

### Potential Costs-Benefits of an Islands-Only Market Integration

A key finding of the literature on integration is that both the competition-scale effects and the trade-location effects are proportional to the size, level of development, openness, and heterogeneity of member countries. The impact of these findings for the Pacific countries, and for the future of PICTA, are summarized by Scollay (2001).

The general view [is] that the prospects for maximizing trade creation and minimizing trade diversion will be greater the larger the shares of the members in their partners' pre-existing trade, the larger and more diversified the partners' economies, the closer the partners' domestic prices to world prices, and the greater the initial non-uniformity of the partners' tariff structures. It is quite clear that none of these characteristics, with the possible exception of the last, are found among the FICs...

Scollay's findings on PICTA reflect those of other authors, such as Narsey (2001), who found that regional market integration between developing countries—especially between small developing states with tiny populations, low incomes per capita, a lack of transport links and infrastructure, and a similarity of resource endowments—did not yield large trade creation and scale benefits for its members. Furthermore, they found that most benefits were captured by monopolists through trade diversion, rather than through trade creation.<sup>17</sup> Small benefits were also found for revenue and investment, given the marginal levels of trade between Pacific markets—exports to other FICs do not account for more than 5% of the exports of any FIC—the benefits of an islands-only agreement would be minimal.

Despite this, the costs of an islands-only market integration may still be substantial. Narsey (2001) outlines the experience of the MSG market integration, where even a limited number of imports from the Fiji Islands and PNG into Solomon Islands and Vanuatu created significant economic costs for a minority of import-competing producers, and political costs for importing governments. In some instances (e.g., kava and biscuits) the pressures from local manufacturers, under the guise of balance-of-payments problems, led to punitive duties being imposed by the importing countries.

The experience of FICs shows that they have attempted to develop a number of bilateral and subregional trading arrangements for a limited number of goods. However, PICTA has been written, signed, and ratified

but not implemented. MSG has gone further, yet the political costs appear to be overwhelming the economic benefits. The key lesson from the intra-islands experience with regional market integration is that the pool of economic benefits available from trade liberalization in goods is so small that none of the larger economies have pursued either most-favored-nation (MFN) or regional trade liberalization with any commitment.

### **Potential Costs-Benefits of a Forum-Wide Market Integration: Goods, Services, and Investment**

If market integration is extended to the entire Forum membership, and crucially includes Australia and New Zealand (ANZ)—by far the two largest markets in the region—the consideration of costs and benefits changes significantly and varies according to the scale and scope of integration.

If market integration is restricted to goods and services, then it is likely that scale, competition, trade, and location benefits will largely be reaped by FIC consumers and ANZ producers. Due to the small percentage of FIC exports in the total imports of Australia and New Zealand, it is unlikely that consumers there will see significant decreases in the price of their average consumption basket. Nor will they see significant changes in the domestic market due to increased competition from FICs—neither from FIC producers themselves nor from foreign firms based in FICs. The latter would most likely relocate their production to the larger OECD markets if tariffs were lowered.

FIC producers, on the other hand, would likely suffer significant adjustment costs. Due to their scale disadvantage and their relative lack of commercial experience, it is unlikely that FIC import-competing producers would survive in an integrated Forum-wide goods and services market. Several observers, such as Narsey (2005), have predicted that the scale of potential job losses and industry closure under PACER would dwarf the scale of PICTA. Given that FICs have a poor record of growth and job creation, any offsetting competitive and trade effects will most likely arrive in the long term. In the short and medium terms, there will be large adjustment costs for FICs, and increased risk of further alienating public and elite opinion against increased integration.

Thus there may be overall net benefits to a goods-and-services-only integration, but they most likely will be hugely (and unacceptably) lopsided. Similarly, revenue effects would most likely be highly negative for

FICs given the high dependence of FIC finances on taxes related to trade with ANZ. Conversely, given that FIC imports into ANZ are not significant proportions of total ANZ imports, it is unlikely that PACER would severely impact ANZ trade-related revenues.

If integration includes investment, then investment flows from ANZ to FICs should, in theory, increase—both in “old” ANZ-dominated sectors (e.g., trading companies, banks, financial services, major manufacturers), and especially in “new” World Trade Organization (WTO)-compatible areas (tourism, fisheries, timber, information and communication technology [ICT], retirement). However, Narsey (2005) notes that ANZ producers have been reluctant to move outside the “older,” traditional areas, and it is not immediately clear how, in the absence of complementary measures, an integrated market will change this. The preconditions needed to pull investment flows into new sectors, let alone into more traditional sectors—stability and predictability of the business environment, and access to reliable infrastructure, services, and a trained workforce—do not exist in many FICs and cannot be created quickly. The added impact of weak transport links, small markets, and other handicaps identified in Chapter 2 push up the cost and risk of investing in many FIC economies past the threshold of most investors, even those with long experience in the region.<sup>18</sup>

## **Potential Costs-Benefits of a Forum-Wide Market Integration:**

### **Labor Mobility**

If Forum-wide market integration includes labor mobility, then there is potential for large wins on both sides.<sup>19</sup> The benefits to FICs from access to ANZ labor markets include skills development, a wider cultural perspective, higher incomes, and more secure remittances back home. Already, some Pacific economies are almost entirely dependent on remittances from their overseas workers for foreign exchange. Studies show that up to 90% of Tongan households receive remittances, making up 52% of cash incomes. Thus labor mobility will be a key vehicle for promoting sustainable development in FICs.

This benefit, however, will only materialize if labor mobility schemes recognize the risks inherent in skills loss (“brain drain”) and depopulation, issues that are particularly relevant given the capacity constraints in FICs. There is a crucial need for labor market access schemes to ensure that FIC workers return to their domestic markets, that mobility is not a permanent skills loss to the home country. Such schemes also need to ensure that

workers moving abroad are not educated solely at the home country's expense—i.e., that there is no implicit developing-developed country subsidy. Temporariness can be ensured in a number of ways, ranging from financial incentives (bonds, repatriation allowances) to nonfinancial penalties for overstaying.

While these risks remain, there is strong evidence that FIC leaders are still strongly in favor of labor mobility, and that it would provide strong momentum behind a large-scale, Forum-wide regional project. Peebles (2004) notes that as early as 1971, Fijian Prime Minister Ratu Mara suggested that Australia establish a guest worker scheme. The issue was raised at South Pacific Forum labor ministers conferences throughout the 1970s and 1980s. Many FIC governments have seen labor mobility as potential relief for demographic pressures from high rates of population growth, burgeoning youth populations, and high levels of unemployment among youths. Many observers<sup>20</sup> have stated that labor mobility is a “make-or-break issue” for FICs, and a clear litmus test of Australia and New Zealand commitment to both FIC development and Forum regionalism.

For Australia and New Zealand, there are clear benefits from labor migration as well. Like many OECD countries, they are facing a number of economic trends favoring increased labor market openness:

- falling birth rates and rising life expectancy, thus increasing the dependency ratio (the proportion of those dependent on state support to active workers), and the stress on public infrastructure, especially those catering to the elderly;
- rapid economic growth outstripping the growth of the domestic labor force;
- structural change in economies, especially shifts from manufacturing to services, increasing skills mismatches within the labor force;
- geographic immobility, the unwillingness/inability of residents to move within a country to fill gaps in the labor market; and
- changing occupational preferences, where the upward mobility of the domestic labor force results in the unwillingness of resident workers to accept certain low-skilled, low-status, and low-paid work.

The impact of these trends is expected to be large and negative. Labor shortages can slow productivity and per capita income growth. Andrieu (1999) estimates that over the 1998–2050 period, such losses could be in

the order of 10% for the United States, 18% for the EU, and 23% for Japan.<sup>21</sup> A 2003 report by the Boston Consulting Group estimated that by 2020, Australia would face shortages of some 200,000 workers annually.

Perhaps more importantly, labor mobility can be an important element in the development partnership between FICs and OECD Forum members. Recent parliamentary reports<sup>22</sup> acknowledge that labor market access would be a key part of a closer Pacific economic and political community. A 1997 review of Australia's aid policy noted that "labour mobility may prove to be more cost-effective than continuing high levels of aid in perpetuity." Limited access to Australia "... has been argued for as an effective way to assist the very small states whose only export is labour services."

There is already a strong precedent for labor mobility in the region. Peebles (2004) notes that FIC citizens are already vital workers in key industries in the Australian and New Zealand economies. New Zealand has had full access to the Australian labor market since the 1920s. Several Polynesian states (e.g., Cook Islands and Niue) have arrangements to ensure labor market access and benefits in OECD Forum members. Increasing labor market access would not only cement the general global shift toward emphasizing "trade not aid," but also provide—as the historical analysis in Chapter 3 demonstrated—a large enough pool of benefits for the Pacific "club."

## Lessons Learned

Case studies have been prepared on the EU, the Caribbean Community's Single Market Economy, and Asia-Pacific Economic Cooperation, and may be seen in Appendix 10. They provide four key lessons for regional market integration in the Pacific.

- First, if artificial market barriers (customs, technical, fiscal) are high and markets are large enough to provide adequate scale benefits, then market integration can bring large benefits. The intuitive corollary is that smaller countries joining larger markets will experience a relatively larger increase in their welfare.
- Second, regional market integration has many "layers," which include goods, services, investment, and labor. Each provides its own economic benefits and adjustment costs, depending on the market structure of the member countries. In the same way that countries have pursued regional cooperation, service provision, and market integration at different levels and speeds, there is no reason a priori to assume that a

region must begin integration with goods, then move to services and investment, and end with labor mobility.

- Third, liberalizing each of these “layers” requires a complementary set of institutions, or regional service providers, to create the proper enabling environment for the reduction in market barriers. Without functioning institutions, market integration will almost certainly fail. However, these institutions come with caveats and costs of their own (subsidiarity, governance, etc.) outlined in the previous section.
- Fourth, regional market integration brings adjustment costs—economic, social, and political—that can be significant, even where trade flows are small. It is widely noted that the “losers” of reform always have a stronger incentive to organize than the “winners.” Due to ever-present differences in competitiveness, adjustment costs are often unavoidable. Large benefits are needed to overcome them. It is doubtful that FIC integration with Australia and New Zealand will change the reality that the source and destination of exports within the region are, and will likely remain, highly asymmetrical. However, both the CARICOM and PICTA experiences suggest that it is not so much the presence of asymmetrical flows that is politically unpalatable in regional market integration, but rather the absence of offsetting benefits.

## Summary: Toward a New Pacific Regionalism

Economic theory states that a club not only must be sustainable, but also must yield a sufficiently large pool of economic benefits. Otherwise, in the Pacific the “centrifugal forces” of sovereignty will lead to a breakdown of the club, leaving many members who derive stability and well-being from the club worse off. How can a regional club ensure that its shared institutions create large benefits?

This chapter has shown how each of the three types of regionalism has its costs and benefits.

- For *regional cooperation*, the benefits include increased consensus building and policy coordination. Costs include setting up and maintaining the cooperative mechanisms themselves, and the cost of moving people around the region for meetings and conferences. These latter costs increase as more isolated countries are involved.
- For *regional provision of services*, the benefits include a higher level of services provided, fewer facilities, more efficiency, and a higher degree of shared knowledge. The primary cost, much like cooperation, involves

moving regional goods, services, and people over the large distances in the Pacific.

- For *regional market integration*, the benefits include a larger market for Pacific firms, with more production at a lower cost, more choice for Pacific consumers, and more economic opportunities for Pacific workers. Costs include the political and adjustment costs of stronger competitive pressures for Pacific companies, and further exacerbation of capacity weaknesses, especially in public sector bodies.

What does this mean for the Pacific? The region already has many shared institutions, many geared toward regional cooperation and intergovernmental dialogue. Benefits of this cooperation are tangible. The Forum and its Council of Regional Organizations in the Pacific agencies have allowed the region to speak and plan collectively for its future for nearly 4 decades. Is there a need to go beyond the current approach and invest the significant additional resources required?

The analysis in this chapter suggests that there is. It has shown that regional cooperation—like other forms of regionalism—suffers from high diseconomies of isolation. Voluntary dialogue and coordination, while beneficial, brings a high opportunity cost. Continuing to direct scarce donor funds into greater regional cooperation is arguably at variance with the lessons of club theory, that successful clubs must bring large net benefits.

This chapter has shown that in the Pacific and elsewhere, the largest benefits have come from regions focusing on the type of regionalism that addresses their fundamental challenges. For countries in Africa and South America facing challenges to democratic traditions, strong and binding regional cooperation brought big benefits. For countries in the Pacific facing constraints on their capacity, increased regional provision of services brought big benefits. For countries in Europe facing high barriers between their large markets, regional market integration brought big benefits.

Around the world, addressing big challenges with the right tools has brought big benefits. When the challenge-objective link was weakened, or when the regional institutions established were poorly managed, the collective effort was less successful. Another key lesson from the international case studies is that groupings of purely small states often do not create the net benefits needed. Larger partners often are crucial in widening the potential of regionalism. It is for this reason that the three different types of regionalism

must be analytically separated. Since no two regions face the same challenges, there is no reason to assume their approaches will be similar.

Chapter 2 outlined the various obstacles facing the Pacific region, grouped under the four pillars of the Pacific Plan: economic growth, sustainable development, good governance, and security. Of these four pillars, the analysis suggested that low economic growth and governance failures imposed the largest quantifiable cost on the FICs' development. Further, it suggested that in the case of governance, capacity constraints at the national level played a significant role. In the case of growth, countries were constrained by their small markets, isolation, and the effects of multilateral liberalization.

In this context, current Forum regionalism based to a large degree on cooperation can help, but it cannot by itself address the root of the problem. A “deeper regionalism” is needed.

*A Pacific regionalism that speaks to Pacific needs must focus on easing capacity constraints for governments through increased regional provision of services, and creating economic opportunity for Pacific citizens through increased regional market integration.*

More specifically, the analysis suggests that regional service provision in the governance sector and regional market integration for movement of labor would yield the largest quantifiable benefits for the Pacific “club.” While these “key wins” emerge from the analysis, they are not by any means the only provision or integration measures that can create tangible benefits, nor would they alone be sufficient to create the necessary pool of benefits to make the Pacific club both viable and valuable. Chapter 5 will outline a partial list of sectors and initiatives where large regional benefits may be found.

A final key lesson from economic theory is that for Pacific regionalism to yield the necessary pool of benefits, Australia and New Zealand must become meaningful partners in collective institutions with the Pacific countries. Benefits of regional provision of services and market integration, while potentially significant, are highly sensitive to scale. Regional cooperation is arguably less sensitive. The analysis presented in this chapter and the historical overview of Pacific clubs presented earlier have shown that deeper forms of cooperation need large partners to create the necessary pool of benefits. Chapter 6 will propose an approach to facilitate greater ANZ involvement in a deeper Pacific regionalism.

## ENDNOTES

- 1 Bose 1997.
- 2 Summarized by Peebles (2004).
- 3 Hughes 1998.
- 4 Authors' estimates based on Forum Secretariat data.
- 5 Pacific Islands Forum Secretariat. 2004c. FEMM Biennial Stocktake 2004. Forum Economic Ministers
- 6 Meeting, 9–10 June. Suva: Pacific Islands Forum Secretariat. Hughes 1995.
- 7 Grynberg, R., S. Silva, and J.Y. Remy. 2004. Plurilateral Financial Standards and their Regulation at the WTO—The Experience of Small Developing States. *Journal of World Investment and Trade* 5:3, June.
- 8 See Schneider, Benu. *The Road to International Financial Stability: Are Key Financial Standards the Answer?*
- 9 See Sandmo (2002) for a useful introduction to this material.
- 10 Sandmo 2002.
- 11 The major shareholders of Air Pacific are the Fiji Islands Government and Qantas. The other minority shareholders are Air New Zealand and the governments of Solomon Islands, Kiribati, Tonga, Samoa, and Nauru.
- 12 This section summarizes the findings in Center for Pharmaceutical Management. 2002. *Regional Pooled Procurement of Drugs: Evaluation of Programs*. Arlington: Center for Pharmaceutical Management. The study examined the following programs: Organisation of Eastern Caribbean States Pharmaceutical Procurement Service (PPS), formerly known as the Eastern Caribbean Drug Service; Pan American Health Organization Revolving Fund for Vaccine Procurement; Fondo Rotatorio de Medicamentos Esenciales para Centroamérica y Panamá (Revolving Fund for Essential Drugs for Central America and Panama); Gulf Cooperation Council; Arab Maghreb Union; Joint Bulk-Purchasing Scheme for the Pacific Island Countries; Association Africaine des Centrales d'Achats de Médicaments Essentiels; (African Association of Central Medical Stores for Essential Drugs); and Southern African Development Community.
- 13 This section summarizes the findings of Goldstein (2001) and BBC News Online. 2002. *Air Afrique Finally Goes Bust*. 7 February.
- 14 Benin, Burkina Faso, Togo, Central African Republic, Chad, Congo, Cote D'Ivoire, Mali, Mauritania, Niger, Chad, and Senegal.
- 15 The basic argument outlined below draws from World Bank (2002), DeRosa (1998), Scollay (1998) and Scollay (2001).
- 16 This section draws heavily on Scollay (2001).
- 17 Narsey 2001.
- 18 Hughes 2005.
- 19 This section draws heavily from Peebles (2004).
- 20 Dobbell 2003, Peebles 2004, and Senate Foreign Affairs, Defence And Trade References Committee 2002.
- 21 Andrieu 1999.
- 22 Australia Parliamentary Report in Peebles (2004).