Pacific Studies Series

Toward a New Pacific Regionalism

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

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ADB

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Contents

Acronyms and Abbreviations

ACP	-	African, Caribbean, and Pacific
ADB	-	Asian Development Bank
AIDS	-	acquired immunodeficiency syndrome
APEC	-	Asia-Pacific Economic Cooperation
AusAID	-	Australian Agency for International Development
BPOA	-	Barbados Programme of Action
CAA	-	civil aviation authority
CAP	-	Common Agriculture Policy
CER	-	Closer Economic Relations (agreement between Australia and New Zealand)
CPI	-	Transparency International Corruptions Perceptions Index
CRA	-	country risk assessment
CROP	-	Council of Regional Organisations in the Pacific
DWFN	-	distant water fishing nation
EC	-	European Commission
ECOWAS	-	Economic Community of West African States
EEZ	-	exclusive economic zone
EFIC	-	Export Finance Insurance Corporation
EIB	-	European Investment Bank
EPA	-	Economic Partnership Agreement
EPG	-	Eminent Persons' Group
ESCAP	-	United Nations Economic and Social Commission for Asia and the Pacific
EU	-	European Union
FDI	-	foreign direct investment
FEMM	-	Forum Economic Ministers Meeting
FFA	-	Forum Fisheries Agency
FIC	-	Forum island country
FSM	-	Federated States of Micronesia
FTA	-	free trade agreement

FY	-	fiscal year
GDP	-	gross domestic product
GNP	-	gross national product
HDI	-	UNDP Human Development Index
HIV	-	human immunodeficiency virus
HPI	-	UNDP Human Poverty Index
ICT	-	information and communication technology
IMF	-	International Monetary Fund
IPR	-	intellectual property rights
ITU	-	International Telecommunications Union
LDC	-	least developed country
MDG	-	Millennium Development Goal
MERCOSUR	-	Mercado Común del Sur
MFN	-	most favored nation
MSG	-	Melanesian Spearhead Group
NAFTA	-	North American Free Trade Agreement
NGO	-	nongovernment organization
NSO	-	national statistics office
OAG	-	Offices of Auditor-General
OECD	-	Organisation for Economic Co-operation and Development
ONOC	-	Oceania National Olympic Committees
PACER	-	Pacific Agreement on Closer Economic Relations
PASO	-	Pacific Aviation Safety Office
PFL	-	Pacific Forum Line
PFTAC	-	Pacific Financial Technical Assistance Centre
PIASA	-	Pacific Islands Air Services Agreement
PIC	-	Pacific island country
PICP	-	Pacific Island Chiefs of Police
PICTA	-	Pacific Island Countries Trade Agreement
PIF	-	Pacific Islands Forum
PIFS	-	Pacific Islands Forum Secretariat
PIPA	-	Pacific Islands Producers Association
PNG	-	Papua New Guinea
PPTF	-	Pacific Plan Task Force
PREP	-	Pacific Regional Environment Programme
RAMSI	-	Regional Assistance Mission to Solomon Islands
SME	-	Single Market Economy
SOE	-	state-owned enterprise
SOPAC	-	South Pacific Applied Geoscience Commission

SPARTECA	-	South Pacific Regional Trade and Economic Cooperation Agreement
SPASAI	-	South Pacific Association of Supreme Audit Institutions
SPC	-	Secretariat of the Pacific Community
SPREP	-	South Pacific Regional Environmental Programme
TA	-	technical assistance
TRIPS	-	Trade Related Aspects of Intellectual Property Rights
UN	-	United Nations
UNDP	-	United Nations Development Programme
US	-	United States
USP	-	University of South Pacific
WBI	-	World Bank Institute
WCPTC	-	Western Central Pacific Tuna Commission
WTO	-	World Trade Organization

Preface

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

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

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

Foreword

FROM THE ASIAN DEVELOPMENT BANK

Regional cooperation and integration has much to offer the small island economies of the Pacific, given their well-known con straints of remoteness, size, and narrow resource bases. The Pacific is therefore the home of some of the earliest and most long-standing regional organizations in Asia and the Pacific, with the fore-runner of the Secretariat of the Pacific Community established in 1947 and the first meeting of leaders of the (now) Pacific Islands Forum in 1971. Yet the Pacific has a mixed track record on regional cooperation, and for a range of reasons has not experienced the deepening of cooperation and integration that has been evident recently in many other regions.

The decision in 2004 by Forum Leaders to reinvigorate Pacific regionalism and to develop a Pacific Plan for Strengthening Regional Cooperation and Integration was warmly welcomed by the Asian Development Bank (ADB). For ADB, it was natural to see how we could help this important initiative. Thirteen of ADB's developing member countries are also members of the Forum (as are two other regional ADB members—Australia and New Zealand). ADB's Charter calls for special attention to the needs of smaller developing member countries, and to regional cooperation. Importantly, we recognize in the vision of the Forum leaders an opportunity for our developing member countries to better address some of their most important development challenges.

In discussions with the Pacific Islands Forum Secretariat it was agreed that ADB and the Commonwealth Secretariat could make a valuable contribution by strengthening the framework for economic analysis on a new Pacific regionalism, thereby identifying possible Pacific Plan initiatives with significant potential benefits for the people of the region. This report, which was prepared in response to this initiative, provides valuable insights into the reasons why some regional initiatives have worked better than others, where the largest benefits may lie in pursuing strengthened regional cooperation and integration, and why different approaches should be applied to tackling different regional challenges. The report also proposes an approach to addressing the political economy issues inherent in delivering positive outcomes through Pacific regionalism.

The report takes an independent, long-run view of Pacific regional issues and possibilities. It is intended to serve as a background "think piece" in consideration of priorities for the Pacific Plan. Our objective is that the report should be relevant to Pacific Islands Forum leaders as they negotiate the first Pacific Plan in 2005, while also providing a valuable reference point for anyone interested in this topic 5 or 10 years from now.

The report is based on an extensive body of working papers commissioned by a high quality project team. ADB endorses the key messages in this report. However, with a very large and diverse topic to address and finite time and resources, the analysis contained in this report is necessarily general in places and the assessments of possible regional initiatives preliminary in nature. I therefore hope that, like the Pacific Plan itself, this report represents only the beginning of a longer term journey in support of a new Pacific regionalism—a regionalism that better serves the needs and aspirations of the people of the Pacific.

Philip Erquiaga
Director General, Pacific Department
Asian Development Bank

FROM THE COMMONWEALTH SECRETARIAT

The experience of regionalism in the past half century shows us that the process of sharing institutions, resources, and markets between sovereign states is a complex one. We also know that it can be positive but not necessarily always successful. Usually, the major challenges to address on the path to regionalism have been the need for a clear strategic vision, including a clear idea of where the benefits accrue and an understanding of how to manage the costs. Of equal if not greater importance is that the strategic vision is genuinely and fully shared by all stakeholders.

The decision in 2004 by the leaders of the Pacific Islands Forum to develop a "Pacific Plan for Strengthening Regional Cooperation and Integration" was a step toward creating a new and shared strategic vision for Pacific regionalism. To assist the development of the Pacific Plan and to ensure that its recommendations grew out of a strong analytical foundation, the Pacific Islands Forum Secretariat requested the assistance of the Commonwealth Secretariat and the Asian Development Bank.

The involvement of the Commonwealth grows out of a long-standing relationship with the Forum membership. Eleven of the 16 Forum members are also part of the Commonwealth family. The Commonwealth has long supported Forum countries to address their policy challenges in an increasingly complex and globalized world. The Commonwealth is actively engaged with the Forum membership in a range of areas from building economic capacity, especially through trade, to the strengthening of strong, democratic, and just societies. Democracy and development are the twin pillars on which the Commonwealth's work in the Pacific is based.

This report grew out of the efforts of a joint ADB–Commonwealth project team. It surveys the challenges and opportunities facing the Forum membership. It looks to economic theory to highlight lessons for regionalism in the Pacific. It demonstrates that benefits can be secured by the Forum membership from closer cooperation and integration, and proposes ways in which the inevitable costs can be offset. It provides insights from other regions, while showing that the experiences of other regions, however successful they may be, cannot also be introduced in the Pacific region without careful consideration of its own unique history, diversity, and geography.

This report also provides one foundation among others on which to build further discussion of the future of the Pacific region, including ways in which changes toward a regional approach can create benefits for the Pacific Islands Forum membership.

It is to be hoped, therefore, that this report will achieve the goal we set ourselves as authors of contributing significantly to the development and implementation of the Pacific Plan as a blueprint for successful regionalism in the Pacific in the years ahead.

Don McKinnon
Commonwealth Secretary-General

Executive Summary

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

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

What are the challenges facing the Pacific region?

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

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

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

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

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

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

Club theory and some principles for successful regionalism

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

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

The success or failure of a club depends on its benefits exceeding its costs. Economies of scale—the reduction in unit cost resulting from pooling productive capacities—are offset by the costs of collective action. These costs effectively limit the size and scope of a club. In the Pacific, adding more remote countries entails higher diseconomies of isolation—the high cost of shipping goods, services, information, and people to increasingly remote countries across the region. From this tension between scale benefits and distance costs of collective action, the "optimal club" (in this case, a group of countries), can be derived. The composition of the "optimal club" may vary significantly according to the issue or service under consideration.

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

The Lessons of Club Theory for Pacific Regionalism

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

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

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

What are the mechanisms for Pacific regionalism?

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

- *Regional cooperation* comprises dialogue and agreement between governments (e.g., Forum ministerial meetings, declarations, treaties). Implementation of agreements remains at the national level. Benefits include consensus building and information sharing. If cooperation is binding rather than voluntary, it can also strengthen policy coordination and implementation. Costs include setting up and maintaining the cooperative mechanisms themselves, and the cost of moving people around the region for meetings and conferences. These latter costs increase as more isolated countries are involved.

- *Regional provision of services* is defined as the merging of national services at the regional level (e.g., the University of the South Pacific). The benefits include a higher level of services at less total cost, with fewer facilities, greater efficiency, and a higher degree of shared knowledge. The primary cost—much like the cost of cooperation—involves moving goods, services, and people over large distances in the Pacific. The box at next page summarizes key findings from retrospective cost-benefit analyses of important regional service providers in the Pacific (the University of the South Pacific, Forum Line, Air Pacific, and the Forum Fisheries Agency) and in other regions (Air Afrique and bulk procurement of pharmaceuticals in eight regions).
- *Regional market integration* is defined as lowering barriers for goods, services, and people between countries, including nontariff barriers such as nontransparent standards, restrictions on foreign investment or operations, and restrictive visa requirements. The benefits include a larger market for Pacific firms, with more production at a lower cost, more choice for Pacific consumers, and more economic opportunities for Pacific workers. Costs include the adjustment costs for Pacific companies subject to increased competitive pressures. Present or planned market integration arrangements in the Pacific include a free trade agreement among FICs (Pacific Island Countries Trade Agreement [PICTA]), a closer economic relations agreement among all Forum members (Pacific Agreement for Closer Economic Relations [PACER]), and an economic partnership agreement (EPA) between the FICs and the European Union.

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

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

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

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

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

Where is the greatest potential for benefits from Pacific regionalism?

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

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

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

What regional initiatives would be most beneficial?

The report studies a number of regional initiatives that were considered likely to yield high benefits. Preliminary but forward-looking cost-benefit analyses are summarized in the report for a number of regional initiatives that previous literature has pointed to having potential for a "big win," and that merited further analysis. The initiatives recommended are grouped under each of the four key goals of the Forum (and proposed pillars of the Pacific Plan). These examples, however, are by no means a definitive or exhaustive list of possible initiatives.

Good Governance

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

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

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

Economic Growth

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

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

The report also assesses the costs and benefits of

- the *creation of a pacific aviation safety office*, which would have important security benefits for the region, reduce the risk and costs of catastrophic incidents, as well as yield administrative cost savings of approximately US$570,000 over 20 years;
- the *creation of a joint purchasing facility for petroleum products*, with a calculated benefit of US$145 million over a 15-year period;
- *enhanced transparency and harmonization of terms and conditions of access*

arrangements for fisheries—while no quantification is made of costs and benefits, the report suggests that a review of existing fisheries access arrangements, further development of the Western Central Pacific Tuna Commission (WCPTC), and the creation of an open, audited register of bilateral fisheries access arrangements of all FICs, would substantially improve public economic benefits from fisheries;

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

Sustainable Development

The report assesses the costs and benefits of the following.

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

Security

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

Can barriers to change be overcome?

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

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

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

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

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

How can changes in Pacific regionalism be initiated?

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

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

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

In order for a credible process to emerge from the current dialogue, there is a need to combine short-term, confidence-building measures with a decision to negotiate a contractual arrangement between all Forum members that encompasses all four pillars of the Pacific Plan. *Consequently, at the Leaders' meeting in October 2005, this report recommends that Forum leaders agree to full feasibility studies on the first-step, confidence-building measures listed above, and to commencement of negotiation of a Pacific Agreement for Closer Economic Relations (PACER).*

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

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

The objectives of PACER are to

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

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

Without a multifaceted trade and development agreement—one with sufficient scope and pool of potential benefits to offer mutually advantageous terms to all parties—there is a considerable risk that the PACER negotiations based on a goods-only agreement will be unsuccessful. Given the magnitude of FIC imports from Australia and New Zealand, a goods agreement with Australia and New Zealand is likely to impose higher adjustment costs on FICs than the EPA. Similarly, Japan—the second- or third-largest source of imports for many FICs—would be the only major donor to the region with exports subject to any residual import duties remaining in FICs following EPA and a goods agreement under PACER. FICs should consider whether such a situation is sustainable.

How can a new Pacific regionalism be sustained and deepened?

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

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

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

CHAPTER 1

The Basis for the ADB–Commonwealth Study

The Origins of the Pacific Plan

Calls for Change

The decision by Pacific Islands Forum leaders in 2004 to create a Pacific Plan for Strengthening Regional Cooperation and Integration, commonly referred to as The Pacific Plan, originated from two interrelated trends in the Pacific. One is the long history of political support for closer regionalism. The second, more recent in origin, is a growing unease among the Pacific Islands Forum (PIF) membership about the condition of certain countries in the region, and the ability of the Forum—as currently constituted—to take necessary corrective action.

The idea of a closer cooperation and integration among Forum members is not new. While the Forum thus far lacks the legal mandate for economic or political integration (such as the "ever-closer union" provided by the European Union's founding Treaty of Rome), various observers were calling for greater shared sovereignty in the region well before it became a source of concern for donors and governments. Mike Moore, former prime minister of New Zealand, proposed an economic and political community for the South Pacific as early as 1982. A key feature of his proposal was a Pacific Parliament. The Government of New Zealand subsequently commissioned *Towards a Pacific Community*. That 1990 report proposed further discussion of the development of a "community of countries working together to meet the needs and concerns of the region."

Such proposals have tended to originate more in the developed Forum members than in the newly independent Pacific island countries, where there is often a reluctance to see erosion of newly acquired sovereignty. Country leaders, however, have also provided major impetus for stronger regional institutions. Early in the history of the Forum the most pressing issues for the countries were political ones, particularly the larger questions of decolonization, and the more immediate concerns of nuclear testing. Closer cooperation was called for to face these common challenges.

In 1965, Ratu Sir Kamisese Mara of the Fiji Islands led a major push from country representatives to give the existing South Pacific Conference more relevance beyond its existing “advisory” capacity. Mara was also the driving force behind the creation in 1965 of the first indigenously formed “islands only” regional organization—the Pacific Islands Producers Association (PIPA). Formed by Fiji Islands, Tonga, and Western Samoa outside of the domain of the Secretariat of the Pacific Community (SPC), PIPA provided a unified front for negotiating the prices of common agricultural products for export.

From the creation of the SPC at the 1947 “South Seas” conference to the first meeting of the South Pacific Forum[1] in 1971, proposals for a common market, for shared institutions, and even for a common currency among Forum members, have been part of the regional policy dialogue on both sides of the divide posed by membership (or not) in the Organisation for Economic Co-operation and Development (OECD).

Calls for closer Pacific regionalism has acquired a new sense of urgency over the past decade. There has been a growing perception among members of the Forum and in the international community—especially donors—that long-run trends in development indicators were increasingly negative, and that regional action was urgently required. As early as 1993, reports began to express pessimism over the state of affairs in the region. Unsustainable population growth, malnutrition, high unemployment, low economic growth, and increased violence and crime were among the concerns highlighted in these reports.[2] Conflicts in Bougainville and Solomon Islands, and increasing lawlessness in Papua New Guinea (PNG) prompted several observers, from 2000 onwards, to renew calls for stronger regional institutions to help cure the “serious illness” that the islands were facing, in the words of former PNG Prime Minister Sir Julius Chan. These issues will be explored in further depth in the following chapter.

Notable among these reports was a 2003 report by the Australian Foreign Affairs, Defense and Trade References Parliamentary Committee, entitled *A Pacific Engaged: Australia's Relations with Papua New Guinea and the Island States of the South-West Pacific*.[3] In that report, the Committee proposed "the idea of a Pacific economic and political community which recognizes and values the cultural diversity in the region, and the independent nations within it, and takes into account different levels of growth, is worthy of future research, analysis, and debate." As Peebles (2004) notes, this recommendation was the first time that a group of Australian politicians from all parties acknowledged that closer integration with Pacific states could not only form a meaningful part of Australia's future, but also be a vehicle for addressing the region's challenges.

The Road to the Auckland Summit

In August 2003, the PIF heads of government met at Government House in Auckland for the 34th annual Forum leaders' meeting. Among a number of declarations addressing such things as tax competition, the Millennium Development Goals, and liberalization of air services, they agreed that

> …the serious challenges, both old and new, facing the countries of the region warranted serious and careful examination of the pooling of scarce regional resources to strengthen national capabilities. Ideas and proposals being put forward by the Leaders… should be pursued with urgency and with the goal of producing practical outcomes as soon as possible.[4]

To begin the process of tackling these "serious challenges," the Forum leaders agreed to carry out a review of the Forum, conducted by an eminent persons' group (EPG). The EPG was chaired by Sir Julius Chan, former prime minister of Papua New Guinea, and included a number of prominent Pacific leaders and diplomats.[5] Review findings were further discussed by an EPG "reflection group," chaired by Helen Clark, Prime Minister of New Zealand.

The final EPG report[6] was circulated in April 2004. It recognized both the "difficulties" facing the Forum membership, and the stake that all Forum members—from the Small Island States subgrouping to Australia and New Zealand—had in overcoming them as "political partners and equal members" of the Forum. In addition to responding to measures to bring greater clarity, efficiency, and direction to the workings of the Forum,[7] the report proposed a leaders' vision for the Forum that sought to launch a stronger "Pacific Way."

> Leaders believe the Pacific can, should and will be a region of peace, harmony, security and economic prosperity, so that all its people can lead free and worthwhile lives. We treasure the diversity of the Pacific and seek a future in which its cultures and traditions are valued, honoured and developed. We seek a Pacific region that is respected for the quality of its governance, the sustainable management of its resources, the full observance of democratic values, and its defence and promotion of human rights.

To bring this vision into fruition, the EPG report called for a "Pacific Plan" that would serve as a road map for closer regional cooperation between the Forum members. The EPG cautioned that the Pacific Plan could not be seen merely as a “Forum Plan,” but one that involved the entire Pacific community through consultation and ownership. The ambition and clarity of the EPG mandate bears repeating in full.

> We propose to Leaders the endorsement of the Pacific Plan to create stronger and deeper links between the countries of the region. The Plan should identify existing areas of inter-country cooperation, including their strengths and weakness. It should then seek to provide clear recommendations to Leaders on a sequence and priorities for intensified regional cooperation. It should identify the sectors and shared concerns where the region might make the most useful gains from sharing resources and aligning policies. Above all, the Plan should be a vehicle for placing the "big idea" of Pacific inter-dependence squarely at the front of the regional political agenda…
>
> We ask Leaders not only to endorse the concept of the Pacific Plan, but also to be bold and innovative in pursuing it. Greater sharing of resources is the first step. We hope that Leaders will be prepared to go further, to consider regional integration that runs deeper than that established already under regional trade arrangements.

The EPG members sought a Pacific Plan that was not only “based on comprehensive research and analysis” but also on “[thought] outside the boundaries of current political and economic realities” and “engaged with the biggest issues facing [the Pacific] region.” The EPG report sought to launch a process of consultation and deliberation rather than propose a blueprint for closer regionalism. Nonetheless it provided 32 recommendations for the transformation of the Forum. Among the recommendations most relevant to the Pacific Plan was the defining of the Forum's key goals as

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

These key goals are expected to become the four "pillars" of the Pacific Plan.

At the Special Leaders' Retreat in Auckland on 6 April 2004, Forum Leaders endorsed the EPG report's vision for the Forum and its recommendations in the 2004 Auckland Declaration. The subsequent annual Leaders' Meeting, in Apia, Samoa, in August 2004, approved the terms of reference for a Pacific Plan Task Force (comprised of senior Forum government officials and members of key regional organizations). The first of several task force meetings quickly followed. A "Core Group" of leaders was also created to oversee the Pacific Plan process, comprising the immediate past, present, and future chairs of the Forum in consultation with the Forum Secretary-General.

After the Auckland Summit—Expectations and Results

Buoyed by claims that the Pacific Plan was the most important initiative in the Forum's 33-year history and "a landmark along the path to a more cohesive Pacific area,"[8] the reaction to the Auckland Declaration was positive, if slightly guarded. The explicit recognition of democratic values and the defense and promotion of human rights were seen by observers such as Peebles (2004) as commendable. These were issues the Forum had previously avoided addressing. The mandate for a blueprint for closer regionalism—rather than simply the issuing of another mission statement for the Forum[9]—raised expectations. The full support of "dialogue partners" (donors and members of the international community) for the Pacific Plan had a similar effect.

The product of the initial process was a draft Pacific Plan, which was dated December 2004.[10] It provided a large number of regional initiatives to serve as the basis for further discussion and, most importantly, to draw ideas at the country level during country consultations conducted by the Pacific Islands Forum Secretariat. Building momentum by identifying and acting on "early wins" was a key idea of this draft. Recognizing the constraints on resources and political will for regionalism, the working draft divided possible initiatives into a three-tier timeline: early practical benefits, medium-term benefits, and long-term benefits.

This initial draft, however, was perceived by many (including the authors of this report) as falling short of the EPG and Auckland mandate in two important respects. First, the "guiding principles" and "prioritization criteria"[11] of the initial draft did not provide clear and unambiguous criteria for determining which of the many possible regional initiatives should be included in the Pacific Plan. Nor did it spell out an appropriate sequencing.

Second, the inclusion of existing or ongoing initiatives along with several ministerial agreements that had been signed but not yet implemented—with no analysis of why implementation was lagging—seemed to run counter to the EPG exhortation that Pacific Plan initiatives go beyond those already agreed and established under previous arrangements.

The ADB–Commonwealth Study

This study by the Asian Development Bank (ADB) and the Commonwealth Secretariat is intended to help strengthen the analytic foundations for the Pacific Plan process. It will summarize the vast literature on regionalism, development, and cooperation to draw out useful lessons from economic theory for the Forum membership. Guided by its terms of reference, it will aim to do the following.

> Increase participation [and] ownership in regional collective action… Assist, in particular, the Pacific Plan Task Force (PPTF) and member states increase their appreciation of regionalism, including issues related to the costs and benefits of Pacific regional cooperation and integration… Enhance the capacity of the members of the PPTF and the Forum Secretariat to recommend a Pacific Plan underpinned by a clear rationale, including an analytical framework for cost-benefit analysis of regional programs… and facilitate the inclusion of the Pacific Plan resolutions on regional initiatives in the [Pacific island countries,] PICs' national development strategies."[12]

The study takes an independent, long-term view of Pacific regional issues and possibilities. It has been prepared parallel to, but independent of, the Pacific Plan process. It is intended to serve as a separate "think piece" on Pacific regionalism for Pacific leaders and peoples, but one that directly informs decision making on the form and content of the Pacific Plan. Most importantly, it hopes to provide a clear basis for Forum stakeholders to answer three important questions.

1. **Why does the region need a new Pacific Plan?** Even a cursory familiarity with the Pacific region reveals a large number of regional initiatives, institutions, funds, and strategies already in existence. Furthermore, national governments, in conjunction with donor countries, have long been tackling the challenges of the region—in many cases for decades. If the Pacific Plan indeed means "more questions than answers"[13] to the citizens of the region, why divert scarce resources into a new initiative?

2. **What should be in such a Plan?** Any large-scale regional agreement among 16 countries of varying levels of development could potentially include hundreds of different initiatives. However, resources—human, physical, financial, and political—are limited. Resistance to greater sharing of sovereignty is widespread among the newly independent countries of the region, and is certainly not limited to the Pacific. What initiatives would cement, in the minds of Forum stakeholders, the rationale for greater regionalism?

3. **How should the Plan be sequenced?** It has often been said that "implementation is everything." The Forum experience is no exception. Many potentially useful initiatives agreed at the ministerial level founder at the implementation stage. The Pacific Plan working draft provides three columns for sequencing: early, medium, and long-term. But where should different initiatives be placed? How can Pacific Plan initiatives build on one another, rather than risking a chaotic and fragmented process? How does the Pacific Plan process relate to the many other agreements and negotiating tracks that Forum countries are currently engaged in?

Chapter 2 assesses the challenges that the region is facing—a diagnosis of the "serious illness" alluded to by Sir Julius Chan. Chapter 3 explores a subset of economic thought called "club theory," which provides a "first pass" filter for what initiatives should be contained in a high-profile strategy such as the Pacific Plan, and what initiatives are best left for the other opportunities. It will show how regionalism, like many other decisions in economics, is a consideration of economic, political, and social costs versus benefits.

Chapter 4 will expand on the ideas of club theory, and explore in further detail the possible approaches to regional action. It will show how different approaches to regionalism yield different costs and benefits, and how the Pacific region—and others outside Forum membership—have used these approaches with varying levels of success. Chapter 5 will marry the diagnosis of Chapter 2 and the economic framework of chapters 3 and 4 to suggest a number of regional interventions that fit the mandate given by the EPG report and the Auckland Declaration. Chapter 6 will conclude by addressing the important question of how the Pacific Plan can be sequenced to achieve both maximum benefit and maximum sustainability.

The list of working papers and studies commissioned for this report may be seen in Appendix 1.

ENDNOTES

1 The 16 members of the Pacific Islands Forum are: Australia, Cook Islands, Federated States of Micronesia, Fiji Islands, Kiribati, Nauru, New Zealand, Niue, Palau, Papua New Guinea, Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.

2 Cole, R.V., ed. *Pacific 2010: Challenging the Future*. National Centre for Development Studies. Canberra: Australia National University.

3 This section draws from a summary in Peebles (2004).

4 Pacific Islands Forum Secretariat. 2003. Communiqué.

5 In addition to Sir Julius Chan, the EPG included Bob Cotton (former Australia high commissioner to New Zealand and special envoy to Papua New Guinea), Dr. Langi Kavaliku (prochancellor of the University of the South Pacific and a former deputy prime minister of Tonga), Teburoro Tito (former president of Kiribati), and Maiava Iulai Toma (Samoa ombudsman and former ambassador to the United Nations).

6 Eminent Persons' Group. 2004. *Charting the New Pacific Voyage: Eminent Persons' Group Review of the Pacific Islands Forum*. Suva: Pacific Islands Forum Secretariat.

7 Oxford Analytica. 2004. Doubts Frustrate Forum's Integration Efforts. *Daily Brief* (April). Available: www.oxan.com.

8 See Pacific Islands Forum Leaders Approve Plan on Greater Cooperation, *Xinhuanet*. Available: http://news.xinhuanet.com/english/2004-04/07/content_1406202.htm. PM Not Worried by Aussie, NZ Moves. AAP. Available: http://www.thenational.com.pg/0407/nation3.htm.

9 Peebles (2004) notes that the 26th South Pacific Forum in 1995 in Madang, PNG, issued a "Vision Statement" in which "Forum members [would] cooperate in efforts to maintain security, improve living standards, and ensure sustainable development throughout the region."

10 Pacific Plan Task Force. 2004. Working Draft #2 (December).

11 The second working draft of the Pacific Plan listed the guiding principles as (i) increasing the levels of sustainable returns to the Pacific; (ii) ensuring the successful implementation of regional cooperation at the national level; (iii) meeting common responsibilities and providing services cost-effectively; and (iv) developing partnerships with neighbors and beyond. The prioritization criteria were listed as (i) the likely impact on at least one of the four pillars of the Plan, and (ii) the potential for successful implementation and commitment.

12 Asian Development Bank. 2004. *Developing and Implementing the Pacific Plan for Strengthening Regional Cooperation and Integration*. Manila.

13 Taga, Laisa. More Questions than Answers. *Islandbusiness.com*. Available: http://www.islandsbusiness.com/archives/islands_business/index_dynamic/containerNameToReplace=MiddleMiddle/focusModuleID=4654/overideSkinName=issueArticle-full.tpl.

CHAPTER 2
Challenges Facing the Region

Introduction

In the Auckland Declaration, Forum leaders agreed that "the serious challenges facing countries of the region warranted serious and careful examination of the pooling of scarce regional resources to strengthen national capabilities." To face these challenges, "the key goals of the Forum are economic growth, sustainable development, good governance and security and that these goals… should be used as a springboard for stimulating debate on how to shape the region's longer-term future."

In light of this mandate, this chapter will analyze the performance of Forum members—the Forum Island Countries (FICs) in particular—against the four key goals of the Forum, which are expected to become pillars of the Pacific Plan (see Appendix 2). Fundamental questions will be examined.

- What has been the performance of the region—based on common definitions and indicators for each pillar?
- What has been the cost of to Forum members?
- What are the possible reasons?
- How might regionalism help?

This chapter will suggest that poor governance and low growth have imposed the largest *quantifiable* cost on the citizens of FICs, their governments, and development partners. This is not to imply that the pillars of security and sustainable development are unimportant. However, current international development *thinking*[1] highlights the importance of governance and growth as essential preconditions for security and sustainable development. Given the limited resources in the region, governance and growth must be priority challenges for regionalism to address. This chapter will suggest several areas where regional bodies may have significant value-added in addressing the challenges of the region.

There is no intention here of adding to the many recent reports expressing pessimism about the economic future of the region.[2] However, if there are no significant challenges facing the region, or if existing national or regional capacity can deal with the challenges effectively, then there is no economic rationale for a large-scale initiative such as the Pacific Plan. Only an honest assessment of the challenges facing the region will point to areas where regional action may have beneficial impacts.

Governance

Governance in the Pacific

World Bank Institute (WBI) data summarized below in Table 2.1 show that for the 6-year data span governance in the Pacific is slightly worse, on average, than the global median for developing countries. There is significant variation in the data, however, with persistently low governance ratings (i.e. *higher* percentiles) for Papua New Guinea (PNG) and Solomon Islands. Ratings in those countries deteriorated substantially in recent years. The Fiji Islands also saw a significant deterioration (nearly 10%) in its score following the 2000 coup. Only the predominantly Micronesian states and Samoa have seen considerable (more than 5–6%) improvement in their ratings. Little data exist for Nauru, but recent (2002–2004) WBI scores for "government effectiveness" rank it between PNG and Solomon Islands. Other global surveys, such as the Transparency International Corruptions Perceptions Index (CPI), rank only PNG, but its findings are similar to the WBI data.[3]

A similar picture is found in a series of governance assessments by the Asian Development Bank (ADB) at both country and local level, summarized in ADB (2004). While there is no country-by-country ranking, the ADB country governance assessments found that "nearly all Pacific island countries face serious challenges in all areas of governance, and it is hard to avoid a negative tone in detailing the issues revealed or highlighted by [the assessments]."[4]

Table 2.1: 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.

The Costs of Poor Governance

How much has poor governance cost the citizens of these countries? How much better off would they have been if there had been good governance over this period? Before assessing the potential costs of poor governance, two important considerations must be noted.

First, it is extremely difficult to know precisely when governance indicators improve or deteriorate. While extraordinary events such as coups or civil strife precipitate deteriorations in governance indicators, many times such events are the result of (sometimes hidden) buildups in poor governance stretching several years back. Comparative governance data for the Pacific are virtually nonexistent prior to 1995. Several country-specific sources, however, indicate that in a number of states—PNG, Solomon Islands, Fiji Islands, and, to a lesser degree, Vanuatu—poor governance has been endemic for a much longer period than is covered by the WBI or CPI data. Nonetheless, pinpointing exact dates or time periods is an exercise fraught with difficulty.

Second, establishing counterfactuals—economic growth in the presence of good governance—is a difficult task, especially at the country level. Ideally, a country-specific growth trend of good governance—before the deterioration in governance indicators—would be more appropriate. However, in each country discussed below (PNG, Fiji Islands, Solomon Islands, and Nauru) there was either virtually zero per capita growth since independence (PNG, Fiji Islands, and Solomon Islands) or historical gross domestic product (GDP) data were not available (Nauru).

The estimates below are drawn from Duncan (2005), who uses a global average derived from Chauvet and Collier (2004) that estimates the impact of poor governance in developing countries by estimating the loss of economic growth associated with poor policies, institutions, and governance. Chauvet and Collier (2004) estimated that developing countries suffering poor governance (but not civil unrest) record, on average, 2.3 percentage points less gross domestic product (GDP) growth per year than other developing countries. Where possible, an additional comparator country is also discussed below.[5]

Papua New Guinea

According to World Bank statistics, real GDP per capita in PNG was the same in 2003 as it was in 1976, the year following independence. Using the assumptions of Chauvet and Collier (2004), if PNG had not lost 2.3% of annual GDP due to poor governance, the per capita GDP in 2003 would have been United States dollars (US$)1,773 instead of US$881 (actual level in 2003). Thus since independence, poor governance has cost the average PNG citizen US$12,000. For the entire populaton, the aggregrate loss in GDP due to poor governance over the 1975–2003 period was US$52.8 billion.

This already high figure may in fact be an underestimate, if a comparator country, such as Botswana, is considered. Like PNG, Botswana is rich in natural resources—particularly diamonds—which account for around 40% of the country's output. Botswana was a British colony that at independence in 1968 had only 12 kilometers of paved road, 22 university graduates, and 100 secondary school graduates (Acemoglu et al. 2001). Similar to PNG, land in Botswana is collectively owned. Prior to independence, Botswana had a much lower per capita GDP than PNG. Since independence, however, Botswana has experienced much faster economic growth than PNG. It is claimed that Botswana's record as the fastest growing country in the world over the past 40 years is due to good economic policies that are based on good institutions (Acemoglu et al. 2001). Over the 1970–2003 period, PNG per capita GDP growth rate (in constant 2000 US$) averaged only 0.2%, while Botswana's averaged 6.7%. This growth rate is nearly three times the Chauvet and Collier (2004) estimate.

Fiji Islands

Since independence, the Fiji Islands has seen a change from a negative trend (-0.3%) in per capita GDP growth in the pre-1987 period to a slightly positive trend in the post-1987 period (0.02%). This change could be explained by the fact that a period of economic reform followed the 1987 coups. However, the post-1987 period has also been characterized by continuing political uncertainty—culminating in the coup of 2000—uncertainty over access to land, and the out-migration of skilled and highly skilled labor. Thus, the beneficial effects of reforms and the adverse impacts of the coups appear to have cancelled each other out.

If we assume that there has been no growth in GDP per capita in the Fiji Islands since independence and apply the Chauvet and Collier (2004) growth rate, the gap in per capita GDP between independence and 2003 is US$14,000. Under this assumption, estimated aggregate GDP forgone over the same period due to poor governance is US$10.8 billion (in 1995 dollars). On the other hand, if it is assumed that there has been poor governance in the Fiji Islands only since the coups in 1987, the loss in per capita GDP over the 1987–2003 period is estimated to be US$5,456. Aggregate GDP loss over that period is estimated at US$4.3 billion.

Duncan (2005) uses Mauritius as a comparator for the Fiji Islands. Both are small island states with a similar mix of ethnicities and a similar history of colonial administration. At one point both countries were very heavily dependent on sugar production and exports. Strong economic policies in Mauritius, however, focused on a fairly rapid structural transformation of the primarily agricultural economy to an economy in which manufacturing and services are predominant. This contrasts with Fiji Islands' attempts at economic reform, which have had little success except for the development of tourism and the limited growth of garment manufacturing under preferential market access. Over the 1980–2003 period, per capita GDP growth in the Fiji Islands averaged 0.89%. In Mauritius, average per capita GDP growth over the same period was 4.3%. Following the approach in comparing PNG and Botswana, this implies that the Chauvet and Collier (2004) estimate is very conservative.

Solomon Islands

There was reasonably strong growth in per capita GDP, at 2.6%, in Solomon Islands from independence in 1978 to the beginning of the civil unrest. However, on the basis of reports on economic management and corruption in the country (in the logging industry,[6] for example), it appears safe to assume that the country experienced poor governance even during that time. The economy could very well have performed much better, in terms of growth. The cost of poor governance consequently has been estimated for the period 1978–2003, with adjustments for the additional adverse impact of civil unrest.[7] Accordingly, the total loss of per capita GDP over the period 1978–2003 due to poor governance is estimated at US$6,960. Aggregate loss of GDP over the same period is estimated at US$2.8 billion. This is equivalent to 11.4 times the value of Solomon Islands' GDP in 2003. The civil unrest in Solomon Islands over the period since 1997 had a dramatic impact on output and incomes. Actual per capita GDP declined from the historical high of US$850 in 1996 to US$534 in 2002. It is estimated that an additional US$260 million of GDP was lost due to the civil unrest—equivalent to the value of a full year's output in recent years.

The civil unrest has also imposed significant costs on donors (hence on taxpayers in donor countries). As a lead donor in the region, Australia has taken a key role in providing aid to stabilize Solomon Islands through the Regional Assistance Mission to Solomon Islands (RAMSI). Cumulative figures for RAMSI are not yet available. However, data of the Australian Agency for International Development (AusAID)[8] suggests that costs to taxpayers in donor countries have been considerable. The initial budget estimate for the Solomon Islands country program for fiscal year (FY)2004 was Australian dollar (A$)37.4 million. RAMSI was announced midyear, after initial budget estimates, and the new estimate for the Solomon Islands country program that year increased to A$168.5 million. In FY2005, expenditures in Solomon Islands are estimated at A$201.6 million, of which A$92.8 million is the country program and A$108.9 million is "estimated other official development assistance." Apart from AusAID, other government departments (primarily defense and AFP) have borne the costs of poor governance in Solomon Islands. The estimated expenditure of other government departments of A$79 million in FY2004 and A$93.7 million in FY2005 does not capture additional expenditure that is not eligible to be counted as ODA.

Nauru

On the basis of the income received from national trust funds, Nauruans in the 1970s were believed to have the second highest incomes in the world, after Saudi Arabia. While there are no historical GDP data available for Nauru, there has clearly been a dire economic loss suffered by this country due to poor governance. A substantial part of this is the almost complete loss of the trust funds established from the sale of phosphate, and the lack of governance associated with the use of those trust funds. Gosarevski et al. (2004) estimated that if the trust fund monies had instead been invested with conservative commercial investment brokers, they would be valued in today's terms at around US$10 billion. This is a measure, though indirect, of the loss suffered by Nauruans as a result of poor governance. Using a more conservative measure, if the country had invested its phosphate earnings wisely, and they were today worth US$8 billion and earning 4–5% from interest and dividends, the present population of approximately 12,000 would have per capita income of around US$20,000. Instead, per capita GDP is about 1/20th of that amount.

Causal Factors and the Value-Added of Regionalism

Anere et al. (2001) and ADB (2004) point to a number of potential causal factors for the deterioration in governance, including

- concentration of political power in the hands of too few for too long, with competition for power provoking violence;
- strong external pressures (e.g., from governments and donors) leading to lack of commitment or ownership for major governance and reform initiatives;
- strong internal pressures to fulfill traditional obligations to kin and community over national interests, leading, for example, to politicization in public services;
- limited capacity, effectiveness, and civic education of so-called "restraining institutions," such as churches, media, and nongovernment organizations (NGOs);
- a breakdown in linkage between policy making in capital cities and cultural and value systems prevailing in rural areas; and
- scarce technical and managerial skills coupled with largely ineffective training programs, and the widespread use of external consultants in reform programs.

It is important to note at the outset that there is no single panacea for poor governance. Nonetheless, the list of possible causal factors above suggests that regional institutions can have a strong value-added in three areas.

First, *regionalism can help overcome the capacity constraints that prevent governance institutions from functioning properly*. Many, though not all, of these capacity constraints can be linked to smallness. Horscroft (2005) notes that

> …a very important scale economy that small states cannot exploit is in governance… Economies of scale in governance arise from the population-invariant minimum set of responsibilities a state has towards its citizens [as well as] from the high fixed and low marginal costs of many individual government functions.

Horscroft (2005) further notes that conventional policy models assume, without making it explicit, a minimum state size and administrative resource base that small states fall below. Thus the many officials in governance-related activities in the region often operate with resources severely overstretched relative to their responsibilities. Addressing this capacity constraint would be an important step toward improving governance outcomes in the region.

Another attraction of regional bodies is that their funding is often separated from that of national governments. This reduces the chronic cutting-off of funds of institutions, such as public accounts committees and national ombudsman offices, that try to constrain government breaches of the law. Anere et al. (2001) noted this tactic was widespread in Melanesian governments. Capacity constraints of this nature are quite separate from those associated with smallness. Funds for governance institutions are often allocated in principle, yet withheld in practice, arguably for political purposes.

Second, *regional bodies can provide adequate distance from both internal (societal) and external (donor) pressures*. An important constraint on FIC governance, inherent to many small states, is the influence of social obligations. Given the smallness of many FIC societies, it is often a challenge to find people willing to openly punish malfeasance or offer information on an official who in some cases may be a close relative or high-ranking clan member. "Whistle-blowing" may lead to recriminations, both economic (i.e., loss of job prospects in a small market) and personal. These governance obstacles are the negative side of a much more positive role that social ties play in the Pacific. Dobbell (2003) notes that the Pacific islands are "classic strong societies within weak states; the family and the village… are a social support system that impose great obligations but also provides social and emotional capital through family and extended relationships." It is important to note that the smallness arguments regarding capacity and social obligations extend to the larger Melanesian FICs as well, even though their populations are relatively larger. Melanesian FICs contain the highest level of ethnic and linguistic fragmentation in the region, which, as noted in the previous section, acts as a strong constraint on capacity. The large number of ethnic groups implies that social obligations are just as strong as in smaller FICs—much like several small states in one larger state.

At present many of these constraints are being addressed through donor funding and widespread use of expatriates within or supporting major governance institutions. While this strategy may have delayed the deterioration in governance in certain FICs, it may not address more fundamental issues such as ownership of reform, appropriateness of governance institutions, and the criteria by which they operate. The widespread use of donor-funded OECD expatriates of the Organisation for Economic Co-operation and development (OECD) in FIC governance institutions has undoubtedly fed the perception that governance is an issue foisted upon FICs by donors. This perception has effectively prevented many FICs from actively engaging in the governance debate and reaping the benefits of stronger institutions.

Regional institutions can provide an intermediary solution to this dilemma. By employing experts from the region, regional bodies can help overcome suspicions of bias. Perceptions that assistance being provided is without local knowledge and experience of the region's unique characteristics and processes can also be overcome. Further, regional bodies are often the only nondonor institutions in developing countries that pay salary levels 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. To be effective, regional bodies will need to be close enough to the national level that their findings will be taken seriously and, where appropriate, sanctions can be enforced. On the other hand, they will need to distance themselves far enough from the national level to maintain objectivity and an adequate flow of resources disconnected from the electoral cycle. Regional bodies can arguably better tread this fine line between ensuring objectivity and preserving ownership.

Last, regionalism can help design more appropriate "Pacific-owned" governance institutions. An important finding across all four key goals of the Forum, especially in governance and the security discussion to follow, is that the lack of adaptation between customary and modern systems has been a major factor in the poor performance of the region. In some cases, insufficient institutional resources are less of a problem than inappropriate institutional design. The creation of "Pacific-owned" approaches to governance, democracy, and oversight will likely be perceived by Pacific stakeholders as more legitimate if it is undertaken within regional institutions. Since regional bodies are uniquely able to marshal resources and retain staff within the public sector, they are highly appropriate forums for these crucial debates.

Economic Growth

Growth in the Pacific

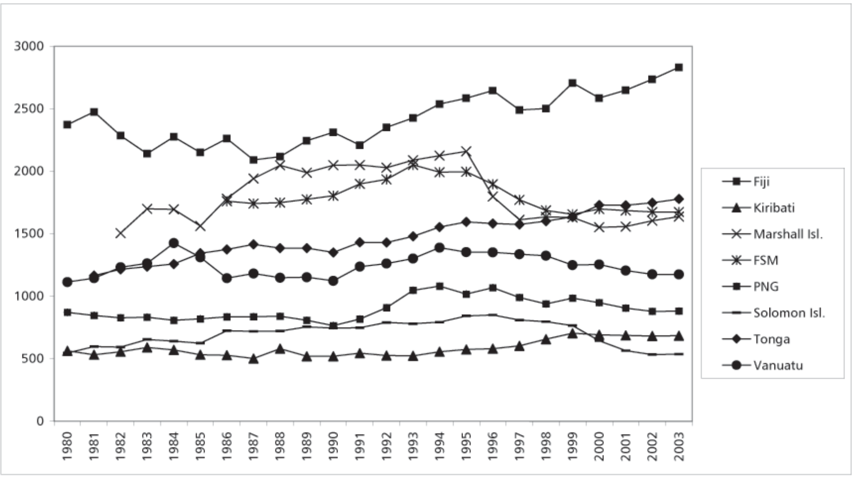
Economic growth in FICs has generally been poor, averaging less than 1.5% per year from 1996 to 2001. Table 2.2 shows that many FICs have struggled to sustain an even, positive overall growth rate. Solomon Islands contracted 14% in 2000, and PNG was in recession for 4 of the 6 years shown. Even where economic growth has occurred, it has often been in fits and starts, driven by unsustainable exploitation of natural resources and one-off investment schemes.[9] Given that population increases in many FICs have outstripped low GDP growth rates, per capita GDP has been largely stagnant or has declined (Figure 2.1).

Table 2.2: Real Growth in Gross Domestic Product in Forum Island Countries (% change on previous year)

	1996	1997	1998	1999	2000	2001
Cook Islands	-0.20	-2.80	-4.20	5.80	9.80	–
Fiji Islands	3.10	-0.90	1.40	9.70	-2.80	2.60
Kiribati	3.00	5.70	5.00	6.20	0.20	–
Marshall Islands	-15.90	-9.40	1.10	0.10	-0.90	1.70
Micronesia, Federated States of	-1.80	-5.10	-2.10	0.90	2.10	1.50
Palau	7.80	0.70	-5.20	–	–	–
Papua New Guinea	7.70	-3.90	-3.80	7.60	-0.80	-2.50
Samoa	7.30	1.20	2.40	2.60	6.90	6.50
Solomon Islands	3.50	-2.30	1.10	-1.30	-14.00	-5.00
Tonga	-0.40	0.10	2.40	3.10	6.70	3.00
Tuvalu	10.30	3.50	14.90	3.00	3.00	4.00
Vanuatu	2.50	1.50	2.20	-2.50	3.70	-0.50
Average	2.24	-0.98	1.27	3.20	1.26	1.26

– = not available. Data for Nauru and Niue are unavailable.
Source: Peebles 2004.

Figure 2.1: Per Capita Gross Domestic Product for Forum Island Country (constant 1995 US$)



Source: World Development Indicators.

This poor performance is echoed in a wide range of economic indicators discussed in Appendix 3, including fiscal weaknesses, low savings rates, high unemployment, high inflation in some FICs, and static or negative private sector performance. Appendix 3 also summarizes the consequences of this weak growth performance for FICs, in terms of poverty, inequality, and limited progress toward achieving the Millennium Development Goals.

Causal Factors and the Value-Added of Regionalism

Smallness and "External" Constraints on Growth[10]

There is strong evidence that the constraints imposed on FICs by their smallness and associated attributes—small populations, small domestic markets, remote and dispersed locations, narrow resource endowments, and frequent natural disasters—act, with governance weakness, as a constraint on growth. This conclusion counters a 2001 paper by William Easterly and Aart Kraay[11] of the World Bank that argued small states did not suffer from their smallness.

In order to evaluate these findings in light of the poor growth performance in the Pacific over the past decade, Sampson (2005) was commissioned for this report to reestimate the Easterly and Kraay regressions using more recent data (1995–2003) and a wider data set (197 countries and nonsovereign states). His detailed findings and a broader discussion of the consequences of smallness may be seen in Appendix 4.

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. FICs also 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. This provides an assurance to investors that capital will earn sufficient returns in high-cost economies. In a preference-dependent economy such as the Fiji Islands, these resource rents from sugar alone total more than 50% of agricultural exports.[12] Since 1995, however, an ongoing process of multilateral and bilateral trade liberalization has continually eroded the value of market access in preference-receiving countries. 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. Data for FDI suggest that the removal of preferences may have deterred investors, resulting in largely negative investment flows and low growth.

Poor governance and insecurity have undeniably lowered FIC growth. However, Sampson (2005) finds that dropping the three FICs that have experienced internal conflict since 1995 (Fiji Islands, PNG, and Solomon Islands) and reestimating the growth equations, improves the growth of the remaining Pacific countries only marginally. Overall growth is still significantly worse than that of any other region. This suggests that other factors not necessarily related to intra-FIC conflict and poor governance are constraining FIC growth.

State Failure and "Internal" Constraints on Growth

Apart from the constraint of small markets, low economic growth outcomes have undoubtedly been exacerbated by state failure in FIC economies. This is most clearly evidenced by the poor performance of state-owned enterprises and the weak private sector in many FICs. Extensive state intervention in areas best left to the private sector has drained public resources and stunted the growth of commercial incentives. ADB (2004) concluded that "erroneous ideas regarding what role government should play have resulted in costly state involvement that exacerbates, rather than ameliorates, problems of geographical isolation and distance." While the lack of capacity of regulatory authorities is undoubtedly an issue, equally important is a lack of political will. In some cases conflicts of interest can block reform.

The Value-Added of Regionalism

To address external constraints on growth, regionalism can provide more lucrative economic opportunity for small economies. FICs are facing a new economic era of global liberalization. The added penalty of smallness implies that unless FICs are able to increase their market access—particularly for factors of production for which transportation costs are generally falling, such as labor—measures such as trade facilitation and investment climate reforms may yield only limited returns.

To address internal constraints on growth, regionalism can provide impetus to open protected markets and build market-friendly regulatory institutions. This is not to imply that widespread deregulation is a panacea for low FIC growth. In fact, in Chapter 4 it will be suggested that the former may easily worsen the latter. In certain sectors, however, especially where production structures or changes in the marketplace mean that small state governments will be clearly unable to provide adequate services or to regulate effectively, market liberalization and a regional approach to regulation merit further study.

Security

Security in the Pacific

Several FICs have seen marked deterioration in their security environments. Some FICs have been moving closer to being "failed states," with governments exercising less and less effective sovereignty over their national territories. In Solomon Islands, the deterioration was so severe as to warrant a regional intervention mission. The Melanesian states in particular—Fiji Islands, PNG, Solomon Islands, and Vanuatu—have all experienced considerable unrest and severe civil conflict in certain cases. This has demonstrated an indirect link between countries suffering from poor governance and those suffering from poor security. Other FICs such as Tonga and Nauru are showing signs of instability and, in the latter case, economic collapse.

Given that governance failures are often at the heart of security crises, the costs of governance (calculated in the Governance section above) can be considered analogous to the costs of insecurity. In certain cases, it is possible to isolate the additional adverse impact of civil unrest.[13] Duncan (2005) calculated that the unrest in Solomon Islands costs its citizens an additional US$260 million in lost GDP.

Most non-Melanesian FICs have seen periods of relative peace. Financial security, however, has become an increasing concern. Table 2.3 summarizes the risk ratings of several FICs covered by the Export Finance and Insurance Corporation (EFIC), an Australian government agency that provides insurance to exporters and issues its own ratings scale (1 to 6, 6 denoting a higher risk). It finds that in nine FICs exporters might encounter serious to moderate repayment problems.

Causal Factors and the Value-Added of Regionalism

Given the multiplicity of factors underpinning security outcomes, it is impossible to draw up a definitive list of every possible cause of the deterioration of security and stability in some FICs. However, a number of studies converge on a unique combination of factors posing a common challenge to FICs.

A Lack of Demographic "Safety Valves." Duncan and Chand (2003) note that the Melanesian states of Fiji Islands, PNG, Solomon Islands, and Vanuatu—those states which have seen increasing insecurity—differ from their Polynesian and Micronesian counterparts in at least one respect. While they share low economic growth and high birth rates, they do not enjoy easy migration to high-income countries. The resulting large pools of underemployed people pose a significant security risk, as they can be easily mobilized by disaffected elites.

Openness and Vulnerability. Like many small states, FICs have high ratios of landmass/coastline and trade/GDP. In some small states this openness provides trade and diversification opportunities. In others, when faced with weak capacity, this openness often translates into a high degree of vulnerability to external threats, such as arms trafficking, pest invasions, and drug/human trafficking. FICs face significant obstacles patrolling and controlling maritime borders and ports of entry. This is reflected in a growing number of potentially dubious economic activities such as money

Table 2.3: Forum Island Country Financial Risk Ratings by the Export Finance Insurance Corporation

Rating	Description	Pacific Countries and Territories	Other Countries
6	Serious problems already occurring	**Solomon Islands Nauru, Marshall Islands**	Timor-Leste, Angola, Nigeria
5	Serious problems likely (or already occurring)		Jamaica, Indonesia, Eritrea, Guyana, Kyrgyz Republic, Lao People's Democratic Republic, Sri Lanka, Viet Nam
4	Moderate problems possible (or already occurring)	**Cook Islands, Federated States of Micronesia, Fiji Islands, Papua New Guinea, Tonga, Vanuatu, Samoa**	St. Kitts, St. Lucia, Argentina , Brazil, Croatia, Ghana, Lebanon, Namibia, South Africa
3	Minor problems possible though unlikely	**Tuvalu, Kiribati, Niue, Palau,** Northern Marianas	Barbados, Malaysia, Thailand, India, People's Republic of China, Egypt
2	Very minor problems possible though unlikely	Tahiti, New Caledonia	Bahamas; Mauritius; Hong Kong, China; Republic of Korea; Taipei,China
1	Payment problems unlikely	American Samoa, Guam, Wallis and Futuna	Australia, France, Germany, Japan, New Zealand, United Kingdom, United States

1 = low risk, 6 = high risk.
Source: Export Finance Insurance Corporation Ratings as of 13 Jauary 2003, from Pacific Islands Forum Secretariat 2003.

havens, sex phone lines, Internet gambling, selling of spurious citizenships, flags of convenience, and video and CD piracy.[14]

Weak Capacity of Law Enforcement. In many FICs facing security problems, there is a general lack of trust in law enforcement institutions. In some countries these agencies suffer from limited training, low capacity to deal with sophisticated high-technology crimes, and deliver limited services to rural areas. The low salaries of police officers and poor governance at high levels of law and order institutions have fed corruption and abuses of law in some FICs to the point where police and military forces have in some cases been the direct cause of insecurity—either through abuse of power, selling weapons, or using extensive brutality.[15]

Ethnic and Social Tensions. Anere et al. (2001) make two important observations about the Pacific. First, arguably no other region in the world has such extreme cultural diversity. Less than 6 million people are divided among over 1,000 different language groups and at least as many cultural groups. Second, ethnic classification, like most social classification, changes with circumstances. Various ethnicities will come together in the face of a common threat, but when the threat subsides, each side is likely to fragment into its component parts. Like many other multiethnic societies, some FICs have suffered from protracted political opportunism, where domestic elites leverage ethnic and social differences to achieve political power or economic gain.

Land Disputes. Growing FIC populations have intensified pressures on land, leading to conflict among groups competing for an increasingly scarce resource. This has led to exploitation of increasingly marginal land, further reducing productivity in the subsistence sector. Many FICs have yet to develop systems to deal with land issues. This is once again an issue not necessarily linked to smallness, and thus very much within the resources of FIC governments. Anere et al. (2001) note that even land transferred between indigenous communities hundreds of years ago remains in dispute. Arrangements are not precise, are usually verbal, and misunderstandings are frequent. Previous attempts to register land have been highly contested and incomplete.

The Value-Added of Regionalism

Regionalism can have a strong value-added in security in three ways. First, *regionalism can provide safety valves for booming populations.* Experience has shown that FICs with labor market access to Forum OECD members have experienced much less insecurity than other FICs. There are multiple issues on both sides that need to be addressed (these will be explored in Chapter 4). However, the need for demographic relief in some FICs is undeniable.

The second and third elements largely echo the governance arguments presented earlier. *Regional bodies can provide crucial capacity and training* to FICs, especially in law enforcement agencies, which are the most visible manifestation of security, or lack thereof. While regional institutions cannot change the basic geographic reality of strong external influence in FICs, pooling resources can help reduce vulnerability. Finally, *regional bodies can help mediate in conflicts and formulate appropriate solutions*. The experience of RAMSI has shown that regional approaches to security crises, rather than a purely bilateral one, can yield large benefits and increase the legitimacy of external interventions. Much like governance institutions, regional security institutions are often seen as more honest brokers for sensitive issues—such as land disputes and interethnic conflict—than external or domestic bodies.

Sustainable Development

Human Development in the Pacific

Composite Measures

Of all four Pacific Plan pillars, sustainable development is arguably the most fluid and all encompassing, with over 100 definitions to date.[16] The idea of sustainable development has broadened considerably from addressing mainly environmental issues to more recent formulations that address the interrelation between economic, social, and environmental goals. To avoid overlap with the other key goal areas of the Forum discussed in this chapter, this section will define suitable development as comprising

- environmental sustainability, including climate change, natural disasters, and natural resource management; and
- human development, including health, education, gender, and culture.

Cross-country data from the United Nations Development Programme (UNDP) suggest that most FICs have struggled to achieve a sustainable level of human development. Of the 175 countries surveyed by UNDP, Table 2.4 shows that only Palau, Cook Islands, and Niue have achieved median or above-median rankings. Three of the largest FICs (Vanuatu, Solomon Islands, and PNG) are ranked toward the bottom of the scale. The average ranking is 110 out of 175.

Health[17]

Health indicators vary considerably across the Pacific, reflecting regional variations in development levels among Polynesia, Micronesia, and Melanesia. The health challenges of the Pacific can be generally divided into communicable/infectious diseases and non-communicable/lifestyle-related diseases. Throughout most of Melanesia and in parts of Micronesia people continue to suffer from infectious diseases usually associated with fast growing, low-income countries. FICs have thus far avoided, however, the worst effects of the global resurgence of previously dormant diseases such as malaria, measles, and tuberculosis. Nonetheless, PNG has seen several recent malaria epidemics with hundreds of deaths, and Vanuatu and Solomon Islands remain high-risk countries for malaria. UNDP (1999) found that influenza epidemics had severe impacts on productivity and on health expenditure, especially in 1996 (New Caledonia, Australia, New Zealand), in 1997 (Fiji Islands, Niue, PNG), and in 1998 (PNG).

Table 2.4: 1999 Human Development Index (HDI)—Forum Island Country Rankings

	Adult Literacy (%)	Combined Gross Enrollment	Life Expectancy at Birth (%)	GDP per Capita (US$)	HDI	Global HDI Rank
Palau	91.4	83.4	69.0	8,027	0.861	46
Cook Islands	93.2	84.8	72.0	4,947	0.822	62
Niue	97.0	83.6	74.0	3,714	0.774	70
Fiji Islands	92.9	81.3	66.5	2,684	0.667	101
Nauru	95.0	79.5	58.2	3,450	0.663	103
Tonga	99.0	83.3	68.0	1,868	0.647	107
Samoa	95.7	85.7	66.6	1,060	0.590	117
Tuvalu	95.0	74.0	67.0	1,157	0.583	118
Micronesia, Federated States of	71.3	71.4	65.7	2,070	0.569	120
Marshall Islands	74.4	71.7	65.0	1,182	0.563	121
Kiribati	92.2	67.8	61.6	702	0.515	129
Vanuatu	33.5	57.4	65.8	1,231	0.425	140
Solomon Islands	30.3	34.7	64.7	926	0.371	147
Papua New Guinea	28.2	28.6	54.0	1,196	0.314	164

GDP = gross domestic product.
Source: United Nations Development Programme 1999.

Perhaps the most worrying increase in infection rates is in sexually transmitted diseases, especially HIV/AIDS. There have been significant increases in HIV cases throughout the region, and in PNG in particular, where the disease is reaching an epidemic "takeoff" point. A recent AusAID study[18] found that estimates of infection rates ranged between 6,000 and 20,000 people, and surveillance updates showed a 48% increase in just 1 year. AIDS is already the major cause of death at Port Moresby General Hospital.[19] A general equilibrium scenario estimated that in a high-case scenario, PNG could lose up to 40% of its labor force and 8% of its GDP.

For most FICs, however, noncommunicable and lifestyle-related diseases remain the biggest health challenge. High rates of diabetes, hypertension, and heart disease—associated with diet and lifestyle, together with cancer, asthma, other chronic obstructive respiratory diseases—have become leading health problems. Type II diabetes has doubled in the region since the 1970s, and the prevalence of obesity is the highest in the world. The diabetes rate in the Marshall Islands is 50% of the population over the age of 50.[20] The case of the Fiji Islands, summarized below from UNDP (1999), provides a sobering warning that is increasingly echoed across the Pacific.

> Some non-communicable diseases have reached epidemic levels in some countries, including diabetes; in Fiji, diabetes cases occupy 15–20 per cent of all hospital beds. Hypertension and other circulatory diseases are also on the fast rise, fuelled by diets high in fats and sugar. Other than its related illnesses, alcohol abuse figures in the number of deaths from accidents and violence. Improved health services and environmental health may therefore improve child survival but not overall life expectancy if more otherwise healthy adults succumb to lifestyle diseases in middle age or die as a result of unhealthy eating, drugs, alcohol, or bad driving.

Education

Trends in education indicators are mixed.[21] Reported rates of net primary school enrollment for FICs are well in excess of the average figure for developing countries. Rates do vary significantly, however, with a low of 56%. However, there are significant weaknesses in both the quality of education (low basic numeracy and literacy rates) and the duration of education (high rates of dropout and repeaters). South Pacific Commission (2004), summarizing the results of a Pacific Islands Literacy Test conducted in 11 FICs, found that proxy measures, such as completion of primary school for literacy

> …suggest that eight PICs have achieved literacy rates of 90% or higher between 1990 and the present. More direct measurements of literacy have returned significantly different results, and these suggest that there is a high level of "hidden illiteracy" resulting in a significant proportion of children completing school but still lacking basic literacy skills.

It is worth noting that education services suffer acutely from the dispersion and isolation of FICs. The example of the Cook Islands is given in UNDP (1999), which noted that if the entire Cook Islands' population lived together, the country would need only one or two middle-sized primary schools and one large college. Instead, to service the many, widely scattered islands, the country has 19 primary schools, 9 colleges, and 6 high schools, with obvious implications for the cost-effectiveness of the education system.

Beyond basic skills, there appears to be a shortfall in many FICs between skills provided to school-leavers and those required by the labor market. UNDP (1999) found that many school-leavers found they had inadequate or inappropriate skills for the few wage jobs that were available, for agricultural work, or for other types of livelihood.[22] Most lack opportunities to upgrade their skills because too few nonformal training programs are available. A large proportion of dropouts cite financial constraints as the main reason for noncompletion of school, illustrating the interplay between low economic growth, low skills training, and gaps in the labor market.

A growing challenge for FICs is providing nonformal education alternatives, such as vocational and technical training. These alternative facilities are often few and far between, and their output is not adequate to address either the needs of school-leavers or the demands of the labor market.[23]

Social Equality

A similarly mixed picture among FICs is found for gender equality. In education outcomes, data from the Secretariat of the Pacific Community (SPC) (2004) indicate that the ratio of girls to boys in primary school is currently above 80 per 100 in all PICs for which data are available. The ratio reaches 90 or above in nine PICs. Similarly positive trends are found for tertiary education, with increasing female-to-male ratios at University of South Pacific campuses. Low ratios persist, however, in tertiary and secondary schools in PNG and Solomon Islands.

Economic and employment outcomes, on the other hand, are somewhat correlated with overall levels of development, but escape easy classification. Table 2.5 shows countries with high percentages of women in paid employment can exhibit vast differences in percentages of women in administrative and managerial positions. The differences between Kiribati and Nauru in these two categories are 5% and 60%, respectively. Nonetheless, evidence suggests that discrimination against women in employment is widespread, as shown by case studies of the Fiji Islands in UNDP (1999), and the low average share of women in nonagricultural sector employment (36% in 2000).

Environmental Sustainability

Climate Change and Natural Disasters

FICs face potentially large and negative economic impacts from climate change. A joint report from the South Pacific Regional Environmental Programme in collaboration with the Global Environment Bureau of the Japanese Ministry of the Environment[24] found that many FICs are already

Table 2.5: Employment Status of Women in Forum Island Countries

	Women as % of overall population	Women as % of economically active population	Women as % of people in paid employment	Women members of parliament	Women as % of administrative and managerial positions	Women as % of professional and technical jobs
Cook Islands	48.5	52	42	1	32	47
Fiji Islands	49.2	33	24	8	10	37
FSM	49.0	35	32	0	15	32
Kiribati	50.5	43	46	0	9	42
Marshall Islands	48.8	27	22	7	32	
Nauru	48.8	41	41	0	69	58
Niue	49.5	44	41	1	32	45
Palau	46.5	39	38	0	24	24
PNG	47.2	42	18	2	12	30
Samoa	47.6	46	19	2	12	47
Solomon Islands	48.1	49	48	1	27	27
Tonga	50.2	51	21	0	19	44
Tuvalu	51.5	33	38	0	16	46
Vanuatu	48.5	49	46	0	13	35

FSM = Federated States of Micronesia, PNG = Papua New Guinea.
Source: United Nations Development Programme 1999.

experiencing disruptive changes consistent with many of the anticipated consequences of global climate change. These include extensive coastal erosion, droughts, coral bleaching, more widespread and frequent occurrence of mosquito-borne diseases, and higher sea levels that make some soils too saline for cultivation of traditional crops. More worryingly, the report found that while many countries were developing adaptive mechanisms to deal with these changes, anticipated future trends implied that FICs would become increasingly vulnerable to food insecurity and reliance on imported food.

FICs are particularly at risk from natural disasters, varying according to their particular geography (Table 2.6). Contrary to assertions made in the small states debate that natural disasters do not have a significant economic impact, impacts of natural disasters on Pacific island economies are evident from property losses and macroeconomic indicators such as GDP growth patterns. UNDP (1999) found that for several years after Cyclone Uma in 1987, for example, Vanuatu had a real growth rate of -9%. In Samoa, cyclones Ofa (1990) and Val (1992) caused real growth rates to drop to -7.5%, -27.9%, and -4.3% in 1990, 1991, and 1992, respectively. Similarly, substantial declines in GDP growth in the Fiji Islands have followed severe natural disasters.

Table 2.6: Forum Island Country Vulnerability to Natural Disasters

Country	Cyclone	River Flood	Tsunami	Earth-quake	Landslide	Drought	Coastal Flooding
Cook Islands	M	M	M	L	L	H	M
Fiji Islands	H	H	H	M	H	H	H
Kiribati	L	–	L	L	–	H	H
Marshall Islands	M	–	L	L	L	M	H
Micronesia, Federated States of	M	L	H	L	H	H	H
Niue	M	–	L	M	L	H	L
Palau	M	–	H	L	–	M	H
PNG	L	H	H	H	H	M	H
Solomon Islands	M	H	H	H	H	L	H
Tonga	H	M	H	M	L	H	M
Tuvalu	M	–	–	L	–	H	H
Vanuatu	H	H	H	H	H	M	H
Samoa	M	H	H	M	H	L	H

FSM = Federated States of Micronesia, PNG = Papua New Guinea.
Risk Ranking: L = Low, M = Medium, H = High, – not relevant.
Source: United Nations Development Programme 1999.

Management of Waste and Natural Resources[25]

Waste management and pollution are widely recognized as major sustainable development challenges facing the Pacific. The rising volumes of solid, hazardous, and toxic waste in the region are putting increasing strain on the limited land area and often-inadequate mechanisms and technologies available for their safe disposal. Although these issues are felt most acutely in the lower-lying atolls of Polynesia and Micronesia, there is evidence that even larger Melanesian countries are beginning to feel the impact of poor waste management. Recycling initiatives have been hampered by financial constraints and lack of awareness. Solid waste runoff is increasingly threatening freshwater sources lying under some FICs, causing a direct health threat to drinking water supplies.

Given the abundance of marine, agriculture, forestry, and mineral resources found in the region and the limited capacity of FIC governments, effective natural resource management has been an ongoing struggle for many FICs. Regional organizations such as the Pacific Regional Environment Programme and the Forum Fisheries Agency have been actively involved in promoting natural resource management and harmonization of national-level practices with the many international objectives and conventions relating to the environment. Despite these efforts it is clear that in many FICs resources have not been exploited at a sustainable rate. Concerns relate to the following.

- **Coastal and Marine Resources**: FICs have seen declining fisheries productivity from overharvesting, reduced access of traditional users to fishing grounds, and increasing environmental damage due to shoreline development.
- **Freshwater Resources**: Poor solid waste management and poor data and knowledge of groundwater systems have resulted in serious problems in maintaining and monitoring water supply quality.
- **Forestry**: Increasing population pressures, unsustainable logging practices, and inefficient processing of forest and tree resources have resulted in widespread depletion of timber and forest stocks. Corruption is a concern in the forestry sectors of some FICs. A report by the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP)[26] found that licenses have been granted to harvest up to 97% of the existing rainforest in Solomon Islands. The same report found that villagers living near unsustainably exploited forests suffered from pollution of drinking and bathing water.

- **Mineral Resources**: PNG, Fiji Islands, and Solomon Islands contain world-class mineral deposits, which contribute significant levels of export earnings—32% of total earnings for PNG (1997), 30% in the Solomon Islands (1998), and 9% in Fiji (1998). However, mining operations, such as Bougainville in PNG, have been the subject of concerns over both environmental degradation and social conflict.

Developments in the forestry and mining sectors suggest that FICs, particularly those in Melanesia, are prone to the so-called "resource curse," in which abundant natural resource revenues fail to contribute to broad-based economic growth.

Causal Factors and Value-Added of Regionalism

There is a significant lack of analytical tools available to assess cause-and-effect issues related to sustainable development. This is due not only to definitional problems, but also because causal mechanisms underlying many specific sustainable development issues—gender, health, youth, poverty, inequality—are still very poorly understood. For the Pacific in particular, the lack of analysis greatly complicates any attempt to formulate effective policy proposals or to assess the full cost of unsustainable development.

This caveat aside, one common thread emerges from the analysis: capacity constraints limit the ability of FICs to respond to sustainable development challenges appropriately, suggesting a strong value-added for regional bodies. Many FICs simply lack the resources to handle the multiplicity of external threats, such as communicable diseases and natural disasters, on their own. Strengthening regional systems to handle these threats, many of which are common throughout the region, can yield benefits for FICs.

For some "internal" threats, such as unsustainable resource management, governance constraints play a clear role. For example, FIC bodies dealing with resource management often suffer from chronic institutional weakness. Providing these institutions with skilled expertise—free from political interference—and institutional objectivity will not solve governance weaknesses, but it can provide transparency and adoption of more appropriate policies. Regional bodies are ideally placed to play a role in such assistance. For literacy and noncommunicable diseases, where governance considerations do not weigh heavily, regional institutions can provide crucial capacity and intercountry networks that national governments would be unable to provide.

Summary: The Erosion of Effective Sovereignty in the Pacific

Falling Short of the Leaders' Vision

Chapter 2 has attempted to document, as far as data constraints allow, the serious challenges facing the Pacific region. Using the four pillars of the Pacific Plan as a guide, it was found that FICs face relatively low levels of governance, low economic growth, growing insecurity, and a lack of sustainable development. Data suggest that shortfalls in the four pillars are not exclusively a Melanesian problem, as some media reports have suggested. It is clear that in many FICs, the Forum Leaders' Vision of a "region of peace, harmony, security and economic prosperity" is an increasingly unlikely scenario, even in the longer term.

Faced with an increasingly complex array of external and internal challenges, and with policy and capacity constraints in a globalizing world, FIC governments are experiencing difficulties in meeting their two essential sovereign functions:

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

In a growing number of sectors, from education to law and order, the ability of many FIC governments to execute both functions is diminishing. Effective sovereignty—the ability of FIC governments and citizens to effectively carry out policies they themselves have chosen—is diminishing, even while nominal sovereignty remains intact.

It is suggested that poor governance and low growth have imposed the largest quantifiable cost on FIC citizens, governments, and development partners. Unless steps are taken in FICs to strengthen the legitimacy and effectiveness of public institutions and generate resources for development, it is difficult to see how security and sustainable development are achievable goals. This is not to suggest that the latter two pillars are unimportant, merely that governance and growth are essential preconditions for security and sustainable development. Given the limited resources in the region, governance and growth must be priority challenges for regionalism to address.

A Rationale for Regionalism

It was found in Chapter 2 that some of the challenges facing the region can be linked to smallness and the capacity constraints facing FIC governments. In other cases, the lack of objectivity and appropriateness of institutions has made them easy to capture by domestic (and foreign) elites, eroding political will for beneficial change. This suggests that regionalism can play a key role in several respects, such as

- overcoming capacity constraints;
- providing adequate distance from both internal (societal) and external (donor) pressures;
- providing more legitimate forums for the design of appropriate, "Pacific-owned" institutions;
- providing demographic "safety valves" and more lucrative economic opportunity for small markets; and
- mediating in regional crises and conflicts.

This analysis, while potentially useful, still leaves many questions unanswered. Out of the countless areas in which regional action potentially could be undertaken, what sort of interventions should be undertaken? In precisely what areas and in what time frame? The following chapters attempt to answer these questions.

ENDNOTES

1 World Bank. 2004. *Development Report*. Washington DC: World Bank; and World Bank. 2003. *Development Report*. Washington DC: World Bank.

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3 Based on four surveys, Papua New Guinea (PNG) scores 2.6 out of 10 (a higher score denotes less perceived corruption), and is ranked 102 out of 146 countries surveyed (1 is least corruption).

4 Asian Development Bank 2004. The assessments covered Fiji Islands, Federated States of Micronesia, PNG, Samoa, Tonga, and Vanuatu (country level), and Fiji Islands, Kiribati, Solomon Islands, and Vanuatu (community/local level).

5 Note: all figures discussed in the following section are in constant 1995 US dollars unless otherwise indicated.

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7 From their cross-country analysis, Chauvet and Collier estimate that civil unrest costs an economy an additional 3.8% of gross domestic product output for each year of the unrest. Therefore, in estimating the costs of poor governance in Solomon Islands for the period 1978–2003, an additional 3.8% was added to the per capita gross domestic product (GDP) for each year from 1997 to 2002. See Duncan (2005) for further details.

8 Australian Agency for International Development (AusAID). 2005. *Official Expenditures at the Activity Level*. Canberra: AusAID.

9 Peebles 2004.

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12 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).
13 From their cross-country analysis, Chauvet and Collier estimate that civil unrest costs an economy an additional 3.8% of GDP output for each year of the unrest.
14 Anere et al. 2001.
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16 For a partial listing, see http://www.gdrc.org/sustdev/definitions.html.
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18 Australian Agency for International Development (AusAID). 2002. *Potential Economic Impacts of an HIV/AIDS Epidemic in Papua New Guinea*. Canberra: AusAID.
19 See Panagelian, Lourdes. 2004. New Momentum in the Fight Against HIV/AIDS. *Pacific Magazine* (July). Available: http://www.pacificislands.cc/pm72004/pmdefault.php?urlarticleid=0020.
20 Whitney, Scott. 2003. Prognosis: Guarded: Pacific Governments are Grappling with Health Threats. *Pacific Magazine* (July). Available: http://www.pacificislands.cc/pm72003/pmdefault.php?urlarticleid=0009.
21 This section draws heavily on Secretariat of the Pacific Community (SPC) (2004).
22 In Solomon Islands in 1996, for example, an estimated 10,000 primary and secondary school leavers were looking for jobs, but for every available wage job at least 10 people were unemployed (UNDP 1999).
23 A survey in the Fiji Islands, summarized in UNDP (1999), found that of eight major non-formal vocational programs, 10,950 applications were received in 1998 for a total of only 4,850 available places. Similarly low capacity and student numbers were found in rural training centers in PNG (11,200), Solomon Islands (1,900), and Vanuatu (300).
24 South Pacific Regional Environmental Programme 2003.
25 This section draws from Barbados Programme of Action. 2003. A Synopsis of Sustainable Development in PICs: The Pacific Regional Assessment and Position for BPOA+10. Version 9th,December. Mimeo.
26 United Nations Economic and Social Commission for Asia and the Pacific. 2000. *Review of the State of the Environment of the Pacific Islands*. Available: http://www.unescap.org/mced2000/pacific/SoE-pacific.htm.

CHAPTER 3

The Economics of Clubs

Introduction

Although individual motivations may vary, people join together to form collective organizations because they believe that greater benefits are available to them through collective action than when they act alone. People might desire collective action to control negative externalities or to encourage the production of positive externalities and public goods. The motivation for collective action is to do things that benefit the people in the collective organization. Although this may seem too obvious to state, it is worth a remark because it provides a way to evaluate the results of collective action. Collective action is successful to the extent that it improves the welfare of those who participate in it. [1]

The evaluation of any grouping—economic, social, or political—begins with a branch of economic theory known as the theory of "clubs." There have been over a hundred individual contributions to club theory since the seminal 1965 paper by James Buchanan.[2] Yet the fundamental lesson, captured in the quote above, remains constant: if a grouping is voluntary, participants must benefit individually, or else the collective disintegrates.

Individual members assess the costs and benefits of joining a collective effort. The sum of these individual decisions dictates whether a grouping is successful or not. Clubs are no different from other goods. Their viability depends on meeting demand from consumers, whether they be governments, firms, or citizens. Despite this singular conclusion, many different clubs exist at many different levels, from small voluntary cooperatives to large intergovernmental institutions. This variety exists because different sized clubs have different characteristics that make them amenable to groupings of different sizes.

The essential element of club theory is that any collective endeavor requires two conditions to be satisfied. First, the club must be self-sustaining. More technically, the additional benefit each member receives from joining equals the cost to the club of allowing another member. Second, the club must provide benefits for each of its members. That is, each member must see an incentive to join a club even if it causes the club to become larger and more costly. This basic conclusion has remained unchanged in over a hundred theoretical contributions since it was first presented in the original Buchanan paper.

Club theory has been applied to a wide range of contexts, including military alliances, international organizations, cross-border infrastructure, and services. This chapter will explore some basic concepts of club theory and offer a number of lessons for the design of club goods in the Pacific region.[3] The chapter will conclude with a historical overview of clubs in the Pacific.

Club Theory in the Pacific Country Context

A number of theoretical adjustments are needed to draw useful lessons for Pacific regionalism from a standard club theory, as outlined in Appendix 5. The theory needs to be adjusted for the following facts:

- club members in the Pacific are countries, not private individuals;
- while potential congestion costs of clubs are important, costs of overcoming distance arguably matter more for the Forum membership; and
- there is a high degree of diversity of incomes and socioeconomic characteristics among Pacific countries.

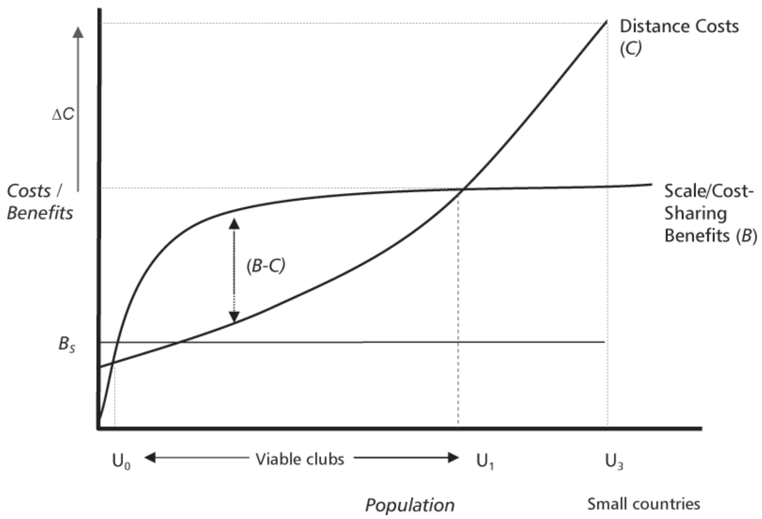
Costs and Benefits of Joining a Pacific Forum "Club"

The trade-off between costs and benefits when joining a Forum "club" are shown in the figure on next page. This graph has four features.

- The horizontal axis ranks countries in decreasing order of population size. Thus larger Pacific countries (Australia, PNG, New Zealand, Fiji Islands) are on the left-hand side of the horizontal axis, and the smaller countries (Niue, Nauru, Tuvalu, Palau) are on the right-hand side.

- While congestion costs for Forum clubs are possible—especially if there is a significant expansion in membership—it is unlikely that congestion will be a major constraint. The high cost of shipping goods, services, and people across the region—the so-called diseconomies of isolation—are a much more relevant constraint for Pacific clubs.[4] These costs are denoted by the C curve in the figure. Given that travel between even the large Forum countries is costly, the diseconomies of isolation are significant even when the number of countries is small. These diseconomies increase exponentially as the smaller and more remote countries are included.[5]
- The benefits of collective action (economies of scale) are shown by curve (B). When large countries join together to produce a club good, there is a large initial increase in scale benefits. As smaller and smaller countries join, these scale benefits remain positive but diminish until they are virtually flat as the club incorporates the smallest countries.
- Any country wishing to join a regional club will incur costs in switching from national to regional goods. These forgone benefits potentially include the economic benefits of trading in sovereignty-related services (finance centers, flags of convenience, and passports), the political benefits of homogeneous societies (ethnicity, etc.), and the benefits of autonomous policy making and implementation. All of these costs, denoted by B_S, can be considered one-off and are irrespective of the size of the regional club.

Cost-Benefit of a Forum "Club"



The optimal size of a club is found by the optimal balance between the economies of scale and the diseconomies of isolation, at the intersection of the B and C curves. Interestingly, there are two optimal club sizes, U_0 and U_1. At U_0, there is a low cost of provision as only large countries are members. However, the corresponding benefits are also low. At U_1, more countries mean higher costs. The benefits are also higher, however. In between U_0 and U_1 lies a spectrum of viable clubs where the net benefits of collective action are still positive. The basic lesson here is that several clubs of different sizes are possible, but the trade-off remains the same.

If the Forum membership decides to include all members (that is, increase membership size to U_3), inevitably the diseconomies of isolation will be higher than the economies of scale. This implies that a transfer will be required, from an external source such as a donor. This transfer is denoted by $\triangle C$.

How do the benefits of sovereignty fit into the picture? These benefits vary for each country and are denoted for a representative country in the figure by B_S. At the outset (U_0) the club may be attractive but its benefits low. Thus sovereignty remains the most rational choice. As the club grows in size, its net benefits provide a stronger and stronger pull until they rise above the benefits of sovereignty. At that point, a country should elect to join the club.

Heterogeneous Clubs

An important aspect not explicitly included in the figure is the question of financing—who pays for the club good? In a standard club theory, the collective good is financed by equal, lump-sum contributions. What happens when users are not homogenous?

The Pacific Islands Forum clearly constitutes a heterogeneous club, with a wide diversity in incomes. The decision of whether a club is attractive to a given country thus depends crucially on whether the country is a net donor or a net recipient. Donor countries, such as Australia and New Zealand, are assumed to be large enough to not require the club good. However, as a donor they shoulder the costs of the collective good, and as more and more remote countries are joined together, the cost of maintaining the club rises sharply. Thus the decision to join, for a donor country, depends on the benefits they derive (however indirectly) from funding the club good, balanced against the costs of funding the good plus the sovereignty they must forego to join the club. For recipient countries, such as the FICs, the situation is much different. Once the club's scale benefits rise above sovereignty benefits, there will always be positive demand from recipient countries, since the recipient countries do not shoulder any of the costs of the club good.

This donor-recipient relationship modifies the conclusion of basic club theory in one important aspect: higher-using members no longer pay the highest rates of toll. In fact, the poorest countries (those least able to pay) will be most likely to make use of the club. This cost asymmetry can undermine decisions about how best to use club resources. The basic formulation, where each member pays in proportion to the amount of use of the club good, ensures that their decision to join is closely linked to a rational assessment of individual needs vis-à-vis the benefits of the club. If, however, a donor member is subsidizing (completely or even partially) the club good, there is a strong—even rational—incentive for a recipient country to join the club even if it does not require its services. While a larger club may be desirable, it intuitively increases costs for the donor, and increases congestion costs among the club membership.

Clearly, developing a toll system that more closely reflects economic costs would constrain this excess demand, but it is also likely to induce exit of marginal users from the club. This implies that the design of club goods—the incentives for members to join, and the way in which they work together—is essential, especially where membership is very heterogeneous.

Historical Overview of Five Pacific Island Clubs

How has this analysis of club theory played itself out historically in the Pacific region? Over the last 30 years there have been numerous examples of both successful and unsuccessful "clubs." Some have been created voluntarily in the postindependence era, and others unintentionally by metropolitan powers as decolonization ebbed in the last quarter of the 20th century.

What is fascinating about the diverse clubs is that some have proven remarkably durable and sustainable, while others have been sources of instability. The experience of Pacific countries as colonial constructs that crossed widely different groups (ethnicity, politics, geography) is mixed. Some, despite occasional separatist rumblings, have stayed together, while others have failed. Some of the postindependence voluntary clubs formed by sovereign Pacific states have remained durable. A review of both experiences will be useful as lessons learned may well instruct consideration of options for a new type of Pacific regionalism.

If one considers a democratic state as a “club,” that club is held together because the advantages of membership stem from the net economic benefits that are accrued to each citizen, and to powerful groups in each country. When a group of citizens feels they are not benefiting from membership of a particular club, they may well attempt to exit the club. As long as membership of a club is based on voluntary agreement, not coercion, there may be no significant exit costs for a group to leave and form a separate entity. In reality, of course, many democratic nation-states are reluctant to allow separation of a group, particularly when the nation-state feels that allowing separation will provide a precedent for further separatist movements, or when the nation-state gains significantly from economic activity in the territory seeking sovereignty. In such cases, sovereignty—or “exit from the club”—can be associated with very high costs, often in the form of armed conflict.

At independence in the Pacific, a number of sovereign "clubs" were created with the support, recognition, and aid of the international community. These were frequently subeconomic in size, with the added disadvantage of physical dispersion of small populations and isolation from major markets. In the most disadvantaged of these nation-states, even aid and trade preferences were insufficient to induce competitive economies. Whatever benefits derived from the global economy came in large measure from remittances, aid, and migration, and from the trade in sovereignty-related services such as finance centers, flags of convenience, and philatelic sales.

Ethnic diversity does not necessarily create the preconditions for the appearance of separatist movements. There have been numerous historical examples in the Pacific and elsewhere where ethnically diverse “clubs” have managed to stay together successfully and flourish. The lessons of success and failure in the Pacific are telling and instructive for those seeking to build a durable regionalism that goes beyond the regional cooperation of the past three decades. In the examples below, diversity, especially ethnic diversity, is a given. What is not a given is the economic benefits of voluntary association in one or other club.

Kiribati and Tuvalu

This is perhaps one of the most interesting historical club experiences in the Pacific. While it is an example of an unsuccessful colonial club, the lessons derived for modern attempts at deepening regional integration could not be greater. Near the end of the colonial era in the late 1970s, present-day Tuvalu was the Ellice Islands part of a British dependency called the Gilbert and Ellice Islands Colony (GEIC). The Ellice Islands were Polynesian. While this made them distinct from the Gilbertese population, such diversity was not uncommon among other Pacific countries. In 1975, however, the Ellice Islands decided to separate from the GEIC prior to independence. The division was achieved amicably through a vote of the population and no serious conflict, armed or otherwise, occurred during the separation.

What is instructive and important is that Tuvalu's separation broke up one subeconomic and very remote unit, the Gilbert and Ellice group, into two even smaller and remote units. This occurred first by its separation from the GEIC in 1975, and was confirmed by Tuvalu's independence in 1978. Tuvalu's independence had always appeared from an economic point of view as irrational because it was clear that Tuvalu would never be sufficiently large to be a viable economic entity. However, with the benefit of hindsight and some understanding of "clubs," Tuvalu's independence was indeed rational. Furthermore, on a net basis this decision was beneficial to not only the political classes in Tuvalu, but to the population as a whole. Tuvalu had a choice of staying in a club that would nonetheless be subeconomic in size, or gaining the sovereignty benefits of forming a club that was even more subeconomic. In the language of economics, the benefits of sovereignty were greater than the cost of the diseconomies of scale associated with that sovereignty.

In retrospect, Tuvalu chose wisely. The commercial value of sovereignty has provided considerable economic benefits—e.g., the sale of its ".tv" domain name, philatelic sales, and fees from fishing fleet access to tuna resources in its exclusive economic zone. Perhaps the most significant benefit has been aid levels that would otherwise not be available to a group of outer islands. Tuvalu, like many smaller Pacific countries, has little else in terms of tradable resources and remains understandably reluctant to sacrifice the commercial aspects of sovereignty. However, there is a slightly larger lesson to be learned from the history of the dissolution of the GEIC than just the economic benefits of sovereignty.

The language of physics rather than economics can better explain the dissolution of the GEIC. While the Gilbert Islands, or Kiribati, is large relative to Tuvalu, its basic economic and political magnetism was not such that it could overcome the twin centrifugal forces of Tuvaluan ethnicity and the economic benefits of sovereignty. Had Kiribati been considerably larger and the pool of economic benefits from club membership been significant for Tuvalu, then these centripetal forces may well have overcome the twin effects of ethnicity and the benefits of sovereignty. This was not the case.

There was, however, another factor that must be considered in properly understanding the economics of the breakup of the Gilbert and Ellice "club." As we shall see below, one of the significant benefits of being part of a larger club stems from the economic benefits of being able to move to a much larger unit and seek gainful employment. It is this source of magnetism that has been one of the main reasons why so many ethnically diverse entities have not broken up. However, Tarawa (the Kiribati capital), as any Tuvaluan would have reasonably calculated at the time of independence, was unlikely to become the source of the gainful employment and opportunities that are found in such places as Suva, Auckland, Sydney, or Honolulu.

Fiji Islands and Rotuma

The relationship between Rotuma and the Fiji Islands is in many ways historically similar to that which existed between Kiribati and Tuvalu. Rotuma, like the Lau group of islands, is Polynesian. Unlike the Lau group, it was not traditionally or ethnically part of the Fiji Islands. Rotuma was part of the Fiji Islands for the convenience of the British colonial administration in Suva. Rotuma, however, despite sporadic secessionist rumblings both before and after the 1987 coups, has never seriously sought independence from the Fiji Islands.

Why has the experience been so different from that of Tuvalu? First, like the Tuvaluans, the Rotumans and Lauans were among the most educated groups in Fiji Islands. Both before and after independence, they have played key roles in the public service. This would intuitively bring pressure for secession. Secondly, Suva has always been an economic magnet for Rotumans, with some 70% of the population living on the main islands of Vitu Levu and Vanua Levu, and only 2,600 living on the island of Rotuma itself. Tarawa was similarly a magnet for Tuvaluans in the days of the GEIC, as Tarawa was the seat of government and the Tuvaluans dominated GEIC civil service. The difference lies in the nature of the magnetism. For

Rotumans in the Fiji Islands, there is the additional pull of nonpublic sector economic benefits that were unavailable to the Tuvaluans in the old GEIC, where the civil service was the largest employer. Independence from the Fiji Islands would have cut Rotuma off from that pool of economic benefits that accrue to a population from movement to a relative metropolis such as Suva.

Another significant example of the principles applying between Rotuma and Fiji Islands occurs between the two small islands of Renell and Bellona in Solomon Islands. Rennel and Belona are Polynesian islands in the very heart of Melanesia. Once again ethnic differences have been present, but the small economic opportunities (compared with, say, Nauru) on these two tiny islands never made an economic case for separation viable. Indeed the presence of a large part of the Polynesian population at White River (the outskirts of the capital Honiara) means that, in the language of physics, Honiara had sufficient economic magnetism to keep ethnically diverse groups in one club.

Cook Islands, New Zealand, and Niue

Perhaps one of the most important examples of a stable club where there is no intention or real movement toward exit is the agreements of free association that exist between both Niue and the Cook Islands, and New Zealand. The residents of both island groups are Polynesian, and Cook Islanders are related to the Maori. The agreements provide the two island groups with relative autonomy in all areas except foreign policy and defense. The most significant economic benefit that accrues to Niue and the Cook Islands is that their inhabitants remain New Zealand citizens with the right of residence in New Zealand and, by extension, in Australia.

This arrangement has meant that the vast majority of both islands' population live in New Zealand. The free movement of people between Cook Islands and New Zealand has been an important safety valve for the former when it faced serious retrenchment in the public service in the late 1990s. Migration allowed Cook Islands to remain politically stable in the face of economic hardship.

The islands' relationship with New Zealand also brings practical problems. Depopulation stemming from unfettered migration has brought both Niue and some of the outer Cook Islands to the very edge of economic viability as sovereign entities. This, too, is an important lesson for a sustainable path to development of a region with limited economic opportunities. If Pacific countries form clubs with much larger economic entities, they need to ensure that while movement of persons strengthens the relationship between them, dysfunctional and unsustainable relationships that result in depopulation are avoided.

Pacific Islands Forum

One of the most successful and enduring "clubs" formed voluntarily by sovereign Pacific countries, together with Australia and New Zealand, has been the Pacific Islands Forum. While obviously not a sovereign entity, it has been a strongly supported "club" since its creation in the wake of French nuclear testing in the Pacific in the late 1960s and early 1970s, when the newly independent states were unable to discuss these issues in the context of the South Pacific Commission. The Forum has endured over a period of 34 years as a club of sovereign states that, by and large, has not interfered directly with the sovereignty of its members. Agreements are generally exhortatory in nature.

In large measure the funding of the regular budget of the Forum has been based on a formula that is related to GDP. Consequently, the bulk of financial responsibility for funding the organization has been left to Australia and New Zealand. FICs have shown a reluctance to bear a greater cost of the Forum, and other regional organizations.

Forum activities are currently in the areas of political and legal affairs, trade relations, and economic affairs. It is in the area of trade negotiations that the Forum has played a vital role in establishing a path to regional integration. It has also handled negotiations of Economic Partnership Agreements with the European Union. At another level, the Forum now has representative trade missions in Auckland, Sydney, Beijing, Tokyo, and Geneva. The first four of these are purely commercial in nature, while the office in Geneva exists due to the absence of diplomatic representation of any FIC at the World Trade Organization.

Forum activities have expanded over time to include those that complement the sovereign activities of its members. The Forum-endorsed Regional Assistance Mission to Solomon Islands, for example, was done with agreement of Solomon Islands.

The lessons of the Forum as a club for Pacific regionalism are that it has succeeded to the extent that it has complemented sovereignty of its members. In other words, the political costs imposed have been low. At no point has the Pacific put its members to the test of imposing sanctions for failure to abide by agreed principles in the way of the Commonwealth's Harare Declaration. Thus the durability of the Forum to this point rests in its consensual approach that offers no substantive challenge to its members, and very low operating costs for FICs. Whether such a voluntary and consensual approach to regionalism can be sustained in the longer term remains to be seen. This is the subject of the following chapter of this report.

Summary: The Lessons of Club Theory for the Pacific

Several important lessons for Pacific regionalism can be drawn from the preceding analysis.

Intervene regionally only where there are significant economies of scale, and avoid interventions where there are significant costs associated with isolation. Given the high fixed costs of setting up regional goods and the high variable costs of servicing remote countries, the diseconomies of distance begin to increase exponentially once provision is moved outside a small circle of closely grouped countries. This implies that the universe of club goods that are sustainable for the Forum membership is quite limited. Given that many Pacific countries are small and isolated, only club goods that yield large-scale benefits, or enjoy low distance costs, will be viable without extensive external assistance. This is especially important if the club is to be voluntary—does not impose high costs, either in terms of the sacrifice of sovereign rights or direct financial costs.

Intervene regionally only where there are significant net benefits over and above national provision. In order for a "club" to remain together, the pool of economic benefits must be of a sufficient order of magnitude to overcome the possible forces of dissolution that stem from the economic benefits of sovereignty. To form clubs with small economic benefits is likely to prove unsustainable. This is especially relevant given that sovereignty is currently the main source of economic and political benefit for many smaller countries in the Pacific.

In the face of high isolation costs, subregional provision may prove optimal. It is worth reiterating that every regional club good has its own cost and benefit structure. For any club good, distance costs of provision are sensitive to its location. Scale benefits, on the other hand, are sensitive to its institutional structure. Given the high diseconomies of isolation in the Pacific, it may prove optimal to break up a larger regional club good into a number of smaller, subregional clubs. While subregional provision may prove optimal to overcome isolation costs, there will be a corresponding loss of benefits as regional goods are broken up into smaller components and the potential for economies of scale is reduced. Likewise, the fixed costs will likely be higher as a number of duplicative institutions will need to be set up on a subregional basis (with possibly an additional regional good to coordinate the subregional bodies). These costs of subregionalism will have to be weighed against potential benefits.

In many cases, special initiatives are essential to assure services are provided to the smallest and poorest states. This will occur for two reasons. First, specific financing arrangements may be necessary to preserve the solvency of regional goods. The capacity weaknesses in many FICs are such that simply pooling together existing capacity will not generate enough scale to provide adequate service throughout the Forum membership. Unless these marginal countries are in a position to provide significant resources to underwrite the expansion of the club and absorb the additional diseconomies of distance, some form of additional financing will undoubtedly be required. This may take the form of external donor aid, or increased access fees for existing larger members. Second, it may be necessary to provide smaller countries with an incentive to join regional arrangements. If there are high barriers to membership—or, conversely, the benefits of sovereignty are particularly high—then some form of specific arrangements will be required to overcome smaller countries' resistance to joining a regional club.

The history of Forum "clubs" reflects many of these important lessons, and has shown that **between Forum members, historically the strongest association arrangements have been based on the movement of people**. Furthermore, the most durable diverse "clubs" are ones where a significant portion of the population of a particular group live in the territory of another. It is the movement of people that taps into the pool of economic benefits through opportunities for club members and remittances for those who have not moved. While movement of persons has been essential to cement relationships in diverse clubs in the Pacific, unfettered and unlimited movement can result in a dysfunctional relationship, where smaller constituents of the group become depopulated.

ENDNOTES

1 Holcombe, R. 2004. A Theory of Collective Action. Unpublished manuscript.

2 Buchanan 1965. For a survey of subsequent contributions see Sandler and Tschirhart (1980), and Sandler and Tschirhart (1997).

3 Only the elements of club theory relevant to Pacific regionalism will be explored. For further information, see the surveys listed above. See Appendix 5: Club Theory—Basic Concepts and Conclusions and a Technical Summary.

4 In this report "distance costs" and "diseconomies of isolation" are used interchangeably.

5 Remoteness here is assumed to be a function of traveling costs, which are in turn assumed to be inversely proportional to population. This is potentially problematic in the Pacific context, where remoteness is a fluid concept, incorporating distance from major hubs and the cyclical business fortunes of the region's transportation sector.

CHAPTER 4

Three Types of Regionalism

Introduction

The 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.[1]

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.[2]

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.[3]

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.[4]

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[5] 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."[6] 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.[7] 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.[8] 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,[9] 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.[10]

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 possibile 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) and Pacific Island Forum Secretariat (PIFS) (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.[11] 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 collectively 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,[12] 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[13]

Air Afrique was created in 1961 by 12 French-speaking African countries[14] 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 Carribean 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.[15] 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.[16]

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.[17] 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.[18]

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.[19] 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 ensue 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[20] 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.[21] 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[22] 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).

CHAPTER 5

Priority Sectors for Regional Action

Introduction

This chapter summarizes the findings of a series of independent studies assessing potential benefits and costs of implementing a variety of regional initiatives.[1] The initiatives were chosen for study because of their perceived potential to yield significant net benefits and enhance economic welfare in the region. The chosen initiatives, however, do not comprise a definitive or exhaustive list of possible initiatives.

Most of the studies are not formal cost-benefit analyses, due to data, time, resource, and other practical constraints. They do, however, represent systematic efforts to identify and assess qualitatively and, where possible, quantitatively, the estimated benefits and costs likely to arise from each of the regional activities studied. Should any of these initiatives be approved for implementation, additional work would be necessary to better define and quantify these preliminary assessments.

The following section briefly outlines the methodology underpinning the separate studies. Thereafter, each of the individual initiatives are presented, with a summary of the critical findings and conclusions from its supporting study. The iniatives are grouped under the pillar of the Pacific Plan to which it would contribute improvement, i.e.,:

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

The penultimate section draws together the main lessons and conclusions from all of the studies of potential regional activities. Finally, the indicative costs and benefits of the proposed initiatives are summarized in tabular form at the end of this chapter.

Methodology

Few of the studies of initiatives summarized below approached the level of a comprehensive cost-benefit analysis. Such analysis would entail systematic identification and valuation of both costs and benefits, and calculation of the net present value (NPV) of the whole stream of estimated benefits and costs over the long term, if not the life of the intervention. Such rigorous methodology generally was not possible due to inadequate information and many uncertainties.

The various studies embraced in varying degree some of the following sequence of basic steps involved in formal cost-benefit analysis.[2]

1. **Decide whose benefits and costs count**. This is the first step in evaluating the costs and benefits of an intervention.
2. **Define target activity**. Clarity is needed here on its prospective functions and outputs, the nature of its likely impacts, and who is likely to be affected.
3. **Identify the counterfactual scenario**. Identification of the likely situation in the absence of the target intervention, which is usually known as the counterfactual scenario, and is most commonly the status quo.
4. **List and explain impacts (qualitative assessment)**. Description of the nature of impacts, and, where possible, explain systematically why and how they are expected to occur—including any interrelationships between impacts. This amounts to a qualitative cost-benefit analysis.
5. **Select measurement indicators of impacts**. Attempt to quantify as many as possible of the key impacts.
6. **Monetize all identified impacts**. This is the most challenging and difficult step in practice, because of its demanding and often unattainable information requirements. Many studies monetized a number of obvious costs, but few attempted to value the expected benefits from the regional interventions studied, in terms of "willingness to pay." Expected impacts in the studies are mostly addressed as financial costs and cost savings, and revenue gained or forgone.
7. **Discount all costs and benefits**. Where values for relevant opportunity costs and benefits can be estimated and allocated to each year over the appropriated time horizon, these should be discounted to obtain an estimate of the NPV of the target intervention. This is also done for the counterfactual scenario. The difference between these would be a measure of the net contribution of the intervention.

8. **Sensitivity analysis**. The choice of the discount rate is sometimes problematic. However, potential concerns can be managed by using alternative discount rates to calculate NPVs and assess the sensitivity of the resulting NPVs and conclusions derived from them.

Appendix 11 provides a more detailed discussion of the conceptual basis for measuring costs and benefits.

Governance

Scope for Regional Institutions to Foster Good Governance in FICs

Chapter 2 highlighted the very high opportunity cost of weak governance in selected FICs. Calculations by Duncan (2005) of the projected opportunity costs of forgone gross domestic product (GDP) over the next 10 years also illustrate the gross potential benefits FICs could achieve by acting to strengthen their governance arrangements, and so avoid or mitigate such costs. These potential benefits over 10 years from 2004 are in the order of US$10 billion for Papua New Guinea (PNG), US$2.4 billion for the Fiji Islands, and US$250–320 million for Solomon Islands.

While there is no panacea for achieving good governance, there are potential regional institutional initiatives that could help strengthen public sector governance by providing specialist expertise not available locally. Objective, impartial advice or management of governance challenges might be provided by such initiatives. Chapter 2 demonstrated that, among other factors, capacity weaknesses compromised the effectiveness of governance institutions in the Pacific.

Within the broad range of possible good governance initiatives, we recommend an initial focus on the priority areas of strengthening economic management and accountability of FIC governments. Four interventions are examined:

- a regional economic and statistical technical assistance facility,
- a regional customs agency,
- a regional panel of auditors, and
- a regional ombudsman.

Regional Economic and Statistical Technical Assistance Facility[3]

Overview

The main areas of economic and statistical technical assistance envisaged for supply by a restructured regional facility are

- **Macroeconomics and tax policy and administration**, including public financial management (i.e., budgeting, accounting, and financial management systems), taxation, and macroeconomic policy analysis;
- **Financial sector supervision**, including supervision and regulation of banking and other financial institutions, insurance (e.g., provident funds and pensions), and action to prevent money laundering;
- **Microeconomics**, including, at minimum, trade, investment, and competition policy; management of state-owned enterprises and natural resources; environmental policy; and education and labor market policy; and
- **Statistics**, including assistance in the collection and compilation of financial statistics, national accounts, balance-of-payments information, and labor market statistics. Additionally, assistance would be provided in constructing price indexes, developing survey questionnaires—e.g., for household expenditure, employment, investment, and population census—and in database construction and management.

Envisaged Role of the New TA Facility

It is important to recognize that assistance in many of the above areas is currently being provided by existing regional agencies, such as

- Pacific Financial Technical Assistance Centre (PFTAC) in Suva, Fiji Islands;[4]
- Economic services in the Pacific Islands Forum Secretariat (PIFS) in Suva,
- Economic and statistical services provided via the Sesretariat of the Pacific Community in Noumea, New Caledonia, and Suva;
- Forum Fisheries Agency (FFA) in Honiara, Solomon Islands; and
- South Pacific Regional Environmental Programme in Apia, Samoa.

A new facility would need to draw on, enhance, in some cases merge, and in total, upscale this existing regional assistance. In addition, donors such as the Australian Agency for International Development (AusAID), New Zealand Agency for International Development (NZAID), and Japan provide substantial related technical assistance on a bilateral basis. International agencies also provide related technical assistance, such as ADB, the IMF (mainly during their Article IV consultations), and the World Bank group. Finally, the OECD Secretariat devotes considerable resources to the compilation and publication of statistical databases. A regional TA facility would need to be actively supported by these partners, and provide TA that is coordinated with and complementary to donor and international programs.

Options for Restructuring Regional Economics and Statistical TA Services

1. **Merge most existing economic and statistical TA resources into PIFS**. The merged facility could be located in the Pacific Islands Forum Secretariat in Suva, which would also consolidate existing PIFS resources devoted to the same subject areas. Negotiations with the IMF and other donors would be required to ensure a smooth handover of capacity from PFTAC to PIFS, and retain significant IMF involvement. The merged facility could be overseen by a deputy secretary-general, with directors heading the separate divisions overseeing the four main classes of services identified above. Divisional staff could comprise one adviser, three project officers, and four technical/support staff. Local offices would be established in several other FICs to enable provision of more direct assistance. Each such local office would be headed by a separate director, and would have a representative from each of the headquarters divisions.[5]

It would be important to assess whether the statistics functions of the merged facility might better be located in the South Pacific Community (SPC) Secretariat at Noumea, in view of the significant statistical services resources already in place there.

2. **Merge most existing economic and statistical TA resources into PFTAC.** As in the first option, it would be desirable to establish local offices in several FICs to provide the needed breadth and intensity of interaction with national departments. If the enhanced PFTAC were to remain outside the oversight of the Forum bodies, strengthening of existing oversight mechanisms, such as a board comprised of FIC reserve bank governors, would be essential to ensure FIC ownership and commitment to the expanded facility.

Qualitative Assessment of Case for Merging Economic and Statistical TA

The primary case for merging the region's economic and statistical TA is the recognition that, prima facie, existing institutional arrangements that are providing such assistance seem to have had little observable impact on FIC performance to date. This is despite sizable amounts of such assistance over the last decade or so.

The current lack of impact reflects, in part, two shortcomings of the PFTAC facility. One is that PFTAC is severely understaffed relative to FIC needs. The second is that PFTAC is not sufficiently "owned" by the region. Pooling existing regional economics and statistics expertise into a single facility, gearing up the operations, and using more local staff could enhance the effectiveness of TA resources by addressing both of these issues. It could harness economies of scale and scope in the supply of TA services. A higher concentration of technical expertise, for example, could lead to more robust advice by stimulating competition of ideas. It could also lead to more local "ownership" of the TA outputs, thereby improving the probability of advice being accepted and implemented.

A merged facility could contribute significantly to FIC economic and social well-being if it succeeds in improving TA quality and accessibility to FICs, thereby increasing the likelihood that advice culminates in effective action. In doing so, it would contribute to FICs achieving improved governance in public sector activities, and improve the regulatory and policy environment for the private sector. The opportunity costs of the merger would likely be miniscule compared with the benefits from strengthening governance (and reducing the very high costs of poor governance).

To assess whether a merged regional facility is likely to be the best way to achieve this contribution will require more comprehensive evaluation. The underlying problems that prompted consideration of restructuring regional economic and statistical TA should be thoroughly evaluated, as should other possible options for resolving them. Existing providers of such TA services in the region will need to be consulted further.

Quantitative Assessment of Case for Creating New Regional TA Facility

The opportunity costs of creating a merged regional TA facility were not assessed comprehensively in the preliminary study. A full quantitative assessment will require, for example, identification of any cost saving for existing agencies, relocation and transfer costs, one-time establishment costs, as well as recurrent operating costs.

The total annual cost of a regional facility, if activities merged into PIFS, are estimated at around F$8 million. Salaries would account for about F$6 million of the total if it is assumed the facility had the following personnel: deputy secretary-general (1), directors (4 in headquarters, 3 in subregional offices), advisors (4), project officers (12 in headquarters, and 12 in subregional offices), and technical/support staff (22). Yearly travel costs and in-country training costs would each account for about F$500,000. Administrative support costs would amount to about F$1 million per year.

Regional Facility to Assist Customs Officials in Collecting Revenue

Overview

A possible means of both improving customs revenue collection and reducing costs of poor governance in FICs would be to develop an independent regional customs facility. Such a facility would specialize in providing customs-related services, such as specialist training for national agencies, information sharing, and on-the-spot surveillance checks of customs import documentation in FICs. Strictly speaking, this would be an intergovernmental facility, complementing the work of national customs agencies and providing services on behalf of all FICs. It would be answerable to a high-level governance body comprising representatives of each FIC. To be effective, the regional facility would require operational independence from executive branches of FIC governments through appropriate governance, institutional arrangements, and resourcing—in much the same way as central banks ensure their operational independence.

Case for Creating Regional Customs Capacity

A preliminary study of customs collection in a sample of FICs was conducted by Professor Ron Duncan to assess whether there is a strong case for establishing such a regional customs facility.[6] Signs of avoidance of customs duty on imports were evaluated through a statistical examination of the reported value and tariff classification of imports into Fiji Islands, Kiribati, and PNG, and their comparison with the reported value of exports from other countries to these three countries.

The following were the main findings of the statistical evaluation of the study.

- In PNG and Kiribati in recent years, undervaluation of imports in customs declaration documents was less likely to have occurred than in earlier years.
- In Fiji Islands, the opposite seems to hold, as there are substantial, persistent patterns of differences in the classification of merchandise that merit further inquiry.[7]

The Fiji Islands findings could be the result of innocent differences in classification between exporting countries and importers, or could point to deliberate evasion of duty payable. Although more disaggregated data on imports are available for Fiji Islands and PNG, it would be difficult even from these data to confirm suspicions.

The study emphasizes that independent, on-the-spot inspections are needed to determine whether importers are deliberately misclassifying or undervaluing (underinvoicing) imports in order to evade the payment of duty, and whether any customs officers are knowingly "overlooking" or accepting such fraudulent acts. Two possible options for achieving such inspections were highlighted by the study.

- **Independent Surveillance Teams**: This is the most common means of reducing evasion of duty payable and corruption in customs operations. Such teams check the valuation of merchandise imported and the classifications of goods for purposes of charging customs duty. The inspections may be comprehensive, or involve a random sample of customs transactions.
- **Independent Inspection Agency**: In Indonesia, where the customs service had been seen as particularly corrupt, the Government recently adopted an effective alternative approach. An independent inspection agency was created that assumed all responsibilities of the customs agency, resulting in a dramatic increase in customs duty collected.

National customs agencies in FICs have an ongoing need for practical training in customs administration, inspection, and enforcement. They also require information sharing to learn from relevant developments in other jurisdictions.

Qualitative and Quantitative Assessment of Implementation Impacts

Independent surveillance teams. Stationing an independent inspection team in one FIC with a mandate to undertake random checks on customs practices in FICs that have tariff regimes, is one means of checking the extent of duty evasion and corrupt practices in the region's customs services. Random audits, combined with severe sanctions for evasion of customs duties, also could be effective in increasing duty collection and reducing corruption. Random audits alone would not be as effective as having a continuous inspection service stationed in each country, but it would be much less expensive. Some checks could be conducted on a random basis while others could target suspected cases.

Independent surveillance teams, as an adjunct to their inspection role, could usefully provide local specialist training to help build the operational capacity of FIC national customs services. They could serve as a conduit for sharing technical information about customs issues and practices, drawing on lessons from international experience.

The cost of creating a customs surveillance team to carry out random checks as well as training programs is estimated at about F$1 million per year. This estimate assumes a surveillance team of four with average salary/benefits costing F$200,000 each (including administrative support costs); an average of five country visits by each staff member for inspection/training purposes costing F$5,000 per visit, or around F$100,000 annually; and office rental and equipment costs of about F$100,000 annually.

Independent Inspection Agency: The services of such inspection agencies are quite expensive. To justify contracting an independent customs inspection agency to assume the role of national customs services throughout Pacific island countries would require strong evidence of corruption and sizable public revenue loss.

The risk of corruption in customs services is highest where average duty rates are high and vary significantly. Accordingly, an independent inspection agency, if used, would likely encounter its largest payoffs in countries where customs regimes have these features, and in the larger countries such as the Fiji Islands and PNG, where a significant amount of customs duty is collected (around F$150 million a year in the Fiji Islands).

Like an independent inspection team, an independent inspection agency could also provide training for national customs agencies and act as a conduit to facilitate information sharing.

Regional Panel of Public Sector Auditors[8]

Overview

An independent, impartial, competent, and properly funded public audit agency is a vital component in the institutional arrangements that all countries, including FICs, need in order to foster and maintain good governance. This requirement also applies to regional and international public sector activities. Governments and legislatures rely on ex post audits of public expenditure, revenue, financial assets, and liabilities to achieve two valuable public benefits:

- Ex post attestation that public sector personnel have used public money and resources for properly authorized purposes, and have met their publicly funded commitments; thus
- encouraging, ex ante, proper use of public resources, and deterring improper use by increasing the perception that public sector personnel will be accountable for proper/improper use via kudos/opprobrium.

Many FICs, however, find it very difficult to attract and retain staff with the necessary skills and experience to carry out the required quality of auditing needed to attain these two important benefits. Professionally qualified, experienced accountancy staff are in high demand and tend to be attracted to larger countries. Wide disparities therefore exist in operational capacities of FIC offices of auditor-general (OAGs).

The merits of adopting a three-phased approach to regional intervention are assessed below. This approach would culminate, if conditions are suitable, in the creation of a regional panel of auditors to provide public sector auditing services, in order to strengthen the quality and quantity of public sector auditing in all FICs. These services would include attestation and capacity-building functions, such as specialist advice and training, and extend to state-owned enterprises as well as to government departments.

Envisaged Regional Audit Intervention in Three Phases

The preliminary study envisages the following three phases of regional intervention to strengthen public sector auditing capacity and performance in FICs.

(i) **Strengthen capacities of OAGs and harmonize standards**. Phase 1 would fund the South Pacific Association of Supreme Audit Institutions (SPASAI)[9] sufficiently to enable it to (a) provide training and secondment programs for national OAGs to strengthen their operating capacities, and

(b) encourage and assist FICs to adopt common standards and institutional frameworks for the role of OAGs. SPASAI's role would remain one of technical support and acting as a clearinghouse for exchanging ideas on audit issues.

(ii) **Create formal Federation of Pacific-Forum OAGs**. Phase 2 would aim to boost further the operational capacities of FIC OAGs by creating the Federation of Pacific-Forum OAGs (superseding SPASAI) with a formal mandate to (a) continue OAG training programs to bolster national OAGs' operational capacity, (b) provide resources and advice to national OAGs to reduce their operational capacity disparities, and (c) consider thoroughly the case for creating a regional panel of public sector auditors. A formal federation could even become directly involved in auditing public sector regional institutions. Alternatively, Phase 2 could upgrade SPASAI to achieve the same ends.

(iii) **Create a fully integrated Regional Panel of Auditors**. Phase 3 could entail FICs devolving to the Regional Panel of Auditors some functions of national OAGs, to act on their behalf. This would be a medium-term option.

Qualitative and Quantitative Assessment of Benefits and Costs

Phase 1: Strengthen capacities of OAGs and harmonize standards. This phase would mark the start of progressive steps to enhance public sector auditing capacities and performance to achieve the benefits mentioned above. The goal of encouraging and enabling FICs to establish a common regulatory framework for OAGs is just one means of helping them enhance their auditing performance. While the SPASAI already has a mandate to undertake the phase 1 functions, it does not have the resources to do so. It needs public funding to carry out this role to any significant extent. The study estimates that SPASAI would require funding to cover the annual costs shown in Table 5.1.

Phase 2: Create a federation of OAGs. While the study expects Phase 1 training programs to reduce disparities in OAG institutional capacities, it foresees these persisting even after a convergence of operational environments has been achieved. Phase 2, therefore, would continue with the secondment arrangements, either under the Federation option or by strengthening SPASAI. Whichever option is chosen, the costs of Phase 1 would continue, and need to be added to the costs of the extra functions envisaged for Phase 2 as shown in Table 5.2.

Table 5.1: Estimated Annual Costs of SPASAI Phase 1 Functions (F$'000)

Item	Estimated Cost per Annum
Operating a small secretariat to manage its enlarged level of activities	1,316
Operating a wider training function	840
Secondments between offices, to provide assistance and facilitate an exchange of expertise[a]	156
Total	**2,348**

SPASAI = South Pacific Association of Supreme Audit Institutions.
a The practical reality is that most of these secondments would need to come from more developed countries like Australia and New Zealand.
Source: White 2005.

Table 5.2: Estimated Annual Costs of SPASAI Phase 2 Functions (F$'000)

Item	Estimated Cost per Annum
Operations to be established in Phase 1	2,350
Minimum operations of national offices within the federation (with a maximum costing of about F$37 million)	26,075
Additional costs of expanded federation office	180
Total	**29,000**

SPASAI = South Pacific Association of Supreme Audit Institutions.
Source: White 2005.

The second item in Table 5.2 represents the estimated minimum required to enable the national OAG functions in each FIC to achieve a suitable level of operational capacity. The estimate is benchmarked on the New South Wales State OAG in Australia, with some adjustments.[10] These figures include existing budget provisions already made for the individual FICs for their national OAGs.

Phase 3: Create Regional Panel of Public-Sector Auditors. Creating a regional panel of auditors with at least some of the functions of national OAGs would have some clear advantages.

- **Independence from Executive Governments**: The Regional Panel of Auditors, provided its funding is assured, would be independent of potentially untoward influence by national governments.
- **Capacity to Audit FIC Regional Bodies**: The Regional Panel of Auditors would be a suitable body to audit regional institutions that develop in the Pacific.

The establishment of a regional panel of auditors should be seen as a medium- to long-term objective that would require a total budget of about F$40 million per annum. This figure is relatively larger than for other governance initiatives, but it includes FICs' current aggregrate expenditures on public sector auditing. Only the Phase 1 costs are additional to FICs' current expenditures.

Regional Ombudsman Office

Overview

An ombudsman is defined as "an official who investigates citizens' complaints against the government or its servants."[11] Over 100 countries throughout the world have ombudsman offices, each with the fundamental role of promoting the principles of administrative justice and good governance. These include several Pacific countries, such as PNG, Samoa, and Vanuatu.

Ombudsman functions often include the following three elements, such as in New Zealand.

- Assess the merits of citizens' complaints about administrative acts and decisions of government agencies—at central, regional, and local levels—and recommend appropriate remedial action by the department or agency concerned.
- Review government decisions to not release official information requested under legislation designed to make it easily accessible to the public—unless there is a strong case that its release would not be in the public interest—and recommend appropriate action.
- Guide and inform employees who have made, or are considering making, a protected disclosure (i.e., whistle blowing).

In carrying out such functions, ombudsmen typically are not empowered to coerce a government department or agency to accept their advice or recommendations. But their advice is often followed. The desired outcomes from these functions are that they

- resolve grievances occurring in the process of public administration;
- improve the accountability of the public sector for its administrative actions and decisions;
- enhance public confidence in public sector administration; and
- promote "open" government by ensuring that official information is released to the public unless it can be demonstrated that the release of specific official information would not be in the public interest (with the onus on government to demonstrate this).

Case for a Pacific Regional Ombudsman

While a few FICs do have a national ombudsman, the majority do not. Creating a small Pacific egional ombudsman office would provide an opportunity for citizens of FICs with no national ombudsman to air their grievances about government administrative acts and decisions. It would also allow the possible constructive resolution of these citizen grievances via the intermediation of the regional ombudsman. It could, in other words, partly fill a gap in current public sector institutions in these countries.

The regional ombudsman office could be quite small (e.g., one resident ombudsman), but still be effective by being able to coopt the services of national ombudsmen for short periods to help the regional ombudsman office carry out its role. Based on estimates for the customs unit (see above), the annual salary costs for the regional ombudsman would be approximately F$200,000 (including administrative support). If the ombudsman undertook a limited number of reports annually, the additional cost of country visits and hiring of short-term experts (if needed) should not exceed F$300,000, bringing total annual costs to F$500,000.

Like national ombudsmen elsewhere, the regional ombudsman would have powers only to investigate, advise, and recommend, with no power to force government departments or agencies to adopt advice given. Even with this limited power of "moral suasion," however, the reports of the ombudsman's office, given a high regional profile, would undoubtedly generate interest and debate within the region and the country in question.

In practice, without specific legislation governing accessibility of official information, a regional ombudsman's role may be limited to dealing with grievances. But even this relatively limited focus would be another factor helping encourage sound public sector management processes and decisions, and good governance.

An issue to be resolved is how best to ensure that a regional ombudsman can operate independently and impartially. This is a vital requirement that is universally recognized as essential for an ombudsman. What this means is nicely explained in the web site of the Republic of Ireland ombudsman office.

> Impartiality requires independence and independence, in turn, requires statutory or legal underpinning, security against arbitrary removal, the power to issue and publish reports with the protection of legal privilege and, finally, adequate resources to do the job.

In most countries the office of national ombudsman is underpinned by specific legislation, and usually reports to the legislature. Both of these features help ensure its independence. To enable a regional ombudsman to operate effectively may require a treaty between FICs backed up by enabling national legislation. This issue requires further study.

Economic Growth

As discussed in Chapter 2, constraints to economic growth in the Pacific arise from a combination of weak governance, limited skilled human capacity, and natural constraints (smallness, remoteness, a narrow resource base). Some priority regional governance responses have been outlined above. This section outlines some possible initiatives that can help address the other constraints to economic growth: limited skilled human capacity and natural constraints. All of the following initiatives include measures to address skilled human capacity constraints by pooling scarce and expensive skills into a shared regional institution.

Three proposed initiatives aim to help FICs generate better returns from two of their key resources—fisheries (through further harmonization of access arrangements), and a young and dynamic but undertrained and underemployed labor force (through the liberalization of regional labor markets and the creation of a regional nurse training facility). Three further proposals seek to minimize the high costs and weak provision of services in two sectors that are vital for small and remote countries—transport (the Pacific Aviation Safety Office (PASO) and joint procurement of petroleum products are proposed) and communications (liberalization of telecommunications markets is proposed).

Any further work undertaken on regional initiatives to address economic growth should carefully consider the ongoing analysis of the likely economic impact and service opportunities offered by the Pacific Islands Air Services Agreement (PIASA). PIASA is a regional market integration agreement signed at the Auckland Meeting. Its aims are to progressively liberalize market access in the FIC airline sector and relax restrictions on national ownership of airlines. PIASA is potentially further reaching than the proposed Pacific Aviation Safety Office in terms of regulatory liberalization, national sovereignty, and economic benefits.

Liberalizing Labor Mobility in the Pacific

Overview

Pacific countries have long experienced permanent migration of their citizens to larger, more developed host countries such as Australia and New Zealand (ANZ) in search of better education, public services, and employment opportunities. To date, immigration policies of these two countries have favored the permanent migration of skilled workers, severely restricting access of unskilled workers. Research commissioned for this report indicates that both the migrants (skilled and unskilled) and their host countries benefit significantly from this type of migration. The research also suggests that current ANZ immigration policy, however, probably represents the worst-case scenario for residents of Pacific island countries because of its detrimental impact on their welfare resulting from the loss of skilled workers. This conclusion appears to hold true even after allowing for the mitigating effect of remittances home.

Summarized below is an analysis in a study carried out by T.L. Walmsley, S.A. Ahmed, and C. Parsons[12] examining whether a more mutually beneficial scenario for host and home countries might be to allow more Pacific islanders to work in ANZ on a temporary basis—e.g., a fixed term of 3 to 5 years. After the fixed term, such temporary workers would be required to leave the host country. Other Pacific islanders would be allowed to take their place so long as the total number at any time does not exceed the increased quotas. The analysis here raises some important issues for consideration of all Forum member countries.

Labor-Mobility Liberalization Options Examined

The study modelled the impact of ANZ increasing their quotas for temporary movement of persons by an amount equal to 1% of their respective labor forces, with the quotas filled entirely by an influx of Pacific island labor on a temporary basis. Outcomes of the policy changes would be achieved in the short-medium timeframe, or approximately 3 years. Scenarios modeled included, notably

- 1% increase in quotas for both skilled and unskilled labor met entirely by a further influx of Pacific island labor,
- 1% increase in quotas for unskilled labor only (met similarly), and
- 1% increase in quotas for skilled labor only (met similarly).

Such a development would be broadly in line with "mode 4" temporary movement of labor between countries envisaged under the General Agreement on Trade on Services (GATS).[13]

Benefits and Costs of the Different Options

Increasing the movement of both skilled and unskilled labor from FICs to ANZ. As shown in Table 5.3, Pacific islanders—both migrants and those remaining in FICs—would experience a net welfare increase of a massive US$1.1 billion in the short-medium term (col. 6, row 3). Pacific islanders working in ANZ would gain the most, nearly US$1.4 billion (col. 2, row 3) and US$168,000 (col. 3, row 3), respectively. But this beneficial impact is offset partly by a welfare loss of almost US$490 million (col. 4, row 3) borne by those remaining at home in the Pacific islands. The loss arises mainly because a 1% rise in temporary migrant-labor quotas for skilled and unskilled workers would reduce FICs' already-stretched skilled workforce by 21%—with consequential effects on productiveness and tax revenue—but would reduce their far more plentiful unskilled workforce by only 2%.

Table 5.3: Bilateral Welfare Changes for 1% Rise in Unskilled and Skilled Labor Quotas (US$ million)

Home Region (1)	Host Region: Australia (2)	New Zealand (3)	Pacific Islands (4)	Other (5)	Total Welfare of Home Region (6)
Australia	302.61	-0.85	1.77	0.00	303.53
New Zealand	-6.88	26.55	0.94	0.00	20.61
Pacific Islands	1,386.10	168.07	-488.02	0.00	1,066.14
Rest of the World	-75.55	-11.31	33.12	-33.10	-86.84
Total Welfare of Host Region	**1,606.28**	**182.46**	**-452.19**	**-33.10**	**1,303.44**

Source: Walmsley et al. 2005

Table 5.3 also shows that ANZ residents (other than temporary migrant workers from the Pacific islands) would also benefit under this scenario of labor-movement liberalization. For example, the welfare of Australians living in Australia would rise by about US$300 million (col. 2, row 1), and the welfare of New Zealanders living in New Zealand by about US$26 million (col. 3, row 2). But labor from all other countries (the rest of the world) resident in the two host countries would experience welfare losses of some US$86 million (cols. 3 & 4, row 4).

Increasing the movement of unskilled labor only from FICs to ANZ. This scenario, as shown in Table 5.4, would still yield large short-medium term welfare benefits for temporary migrants from FICs (almost US$880 million), while also benefiting Australians and New Zealanders living in their own countries, but with no welfare losses to those remaining in FICs.

Increasing the movement of skilled labor only from FICs to ANZ. This scenario, shown in Table 5.5, would still yield significant welfare benefits in the short-medium term for the temporary migrants from FICs (over US$610 million), but would impose severe welfare losses on those remaining in FICs (over US$510 million), and yield significantly less welfare benefits for Australians and New Zealanders living in their own countries. This would arguably be the worst scenario. It would exacerbate the welfare loss to the remaining Pacific island residents, but with relatively little offsetting welfare gains.

These results do not allow for the likelihood of increased productivity of Pacific islanders returning home after temporarily working in ANZ. They are at least broadly indicative of the detrimental welfare impact on FICs of the current situation of permanent migration of skilled labor.[14]

When the researchers allowed for the expected increase in productivity of returning temporary workers under the first scenario, it was found that the higher productivity of returning skilled and unskilled temporary labor would more than offset the welfare losses of Pacific island residents. This would yield a net welfare benefit of about US$18 million. While the higher productivity of returning skilled labor would yield positive welfare gains (about US$124 million), these would be insufficient to offset the above welfare losses from the temporary outflow of skilled labor. In contrast, the higher productivity of returning unskilled labor would yield much larger positive welfare gains (nearly US$400 million).

Table 5.4: Bilateral Welfare Changes for 1% Rise in
Unskilled Labor Quotas **(US$ million)**

Home Region (1)	Host Region Australia (2)	New Zealand (3)	Pacific Islands (4)	Other (5)	Total Welfare of Home Region (6)
Australia	199.84	-0.38	0.07	0.00	199.53
New Zealand	-4.88	17.90	0.04	0.00	13.07
Pacific Islands	775.05	104.13	22.03	0.00	901.21
Rest of the World	-58.62	-6.98	1.88	-19.06	-82.79
Total Welfare of Host Region	**911.39**	**114.67**	**24.02**	**-19.06**	**1,031.02**

Source: Walmsley et al. 2005

Table 5.5: Bilateral Welfare Changes for 1% Rise in Skilled Labor Quotas (US$ million)

Home Region (1)	Host Region Australia (2)	New Zealand (3)	Pacific Islands (4)	Other (5)	Total Welfare of Home Region (6)
Australia	102.87	-0.47	1.70	0.00	103.99
New Zealand	-2.00	8.64	0.90	0.00	7.54
Pacific Islands	611.05	63.94	-510.06	0.00	164.93
Rest of the World	-16.94	-4.32	31.25	-14.04	-4.04
Total Welfare of Host Region	**694.88**	**67.79**	**-476.21**	**-14.04**	**272.42**

Source: Walmsley et al.

Possible Regional Action Suggested by the Research Results

These results suggest that leaders of Pacific Forum countries should examine the possibility of permitting increased quotas of unskilled workers from FICs to work in Australia and New Zealand on a temporary basis for, say, 3–5 years. After this period, they would be required to depart ANZ and be replaced by other unskilled FIC workers. This may be a cost-effective way of assisting FICs to enhance their economic development.

The results also raise the question of whether action to encourage a larger pool of skilled workers in FICs would be another way to mitigate the detrimental welfare impacts from the migration of their skilled workers. One possible measure to consider would be improved training opportunities. One of a number of specific initiatives that would meet this objective, a regional approach to nurse training, has been examined as an example of this approach and is discussed next.

Creation of Pacific Regional Nurse Training Facility

Overview

Nursing is explored to illustrate the potential costs and benefits of a sector-specific temporary labor scheme. There has been a rapid increase in the number of nurses emigrating from developing countries to work for short or long periods in high-income countries. This trend has also been evident in the Pacific region in recent years. Many concerns have been raised about the impact of this trend on the source countries, not least a decline in the quality and volume of health services. But perceived benefits also stem from this international flow of services, most importantly the reverse flow of remittances. The question arises as to whether prospective benefits would be large enough to justify a Pacific island government, or governments, creating a training facility to train nurses to work overseas, as has happened in other countries.

A recent initial study by Professor Ron Duncan assesses both the arguments for—and potential benefits and costs from—creating a publicly-funded regional nurse training facility geared primarily to training nurses to standards that would enable them to work offshore—e.g., in developed countries like ANZ where nurses are in short supply.[15] The main findings of this study are summarized here. It is important to note that the Duncan (2005c) and Walmsley et al. (2005) studies utilized different methodologies and bases, and the resulting estimates cannot be aggregated.

Should Governments Intervene to Create a Regional Nurse Training Facility?

The report notes that in the Philippines—the country with the largest international flow of nurses—the private sector primarily trains nurses to work overseas. Why not similarly leave it to the private sector to decide whether to create such a facility in the Pacific region, guided by market forces and its own assessment of viability? Are there “market failures” and resulting external social benefits that could justify a Pacific island government (or a number of such governments, jointly) either subsidizing a private facility, or establishing and operating such a facility?

Entry Barrier. The Duncan (2005c) study finds that a new private nurse training facility in the Pacific islands would likely have difficulty establishing its credentials and successfully placing its graduates in high-income countries because of the lack of a track record.[16] This situation was seen as a major obstacle to setting up a private export-oriented nurse training facility in the Pacific islands.

In these circumstances, a major argument for a Pacific-wide regional nurse training facility is that the Pacific island governments together could use their collective political bargaining power to negotiate with intended destination governments. They could, for example, create a uniform set of regulations under which nurses would be hired. They could also help ensure the Pacific regional nurse-training facility is accredited with the destination countries, so that its graduates would be recognized.

Such negotiations on the part of Pacific island governments appear to be the only way to overcome this market failure. Otherwise, nurses from Pacific island countries will continue to experience difficulties finding nursing jobs, instead taking on so-called "caregiver" jobs, which are less well paid.

External Benefits Not Reflected in Market Prices. Another possible market failure is that setting up a high-quality nurse training facility to meet the standards of destination countries—assumed to be higher than those in source countries—could have beneficial impacts on the nursing services and health facilities in Pacific countries. Not all nurses trained in the facility would necessarily emigrate. After being trained to higher, international standards, nurses newly trained but not emigrating could well lift health standards in Pacific countries. Further, nurses returning to the Pacific after substantial experience abroad would also help lift Pacific standards of nursing. To the extent facility benefits are not captured by the nurses as higher salaries, the resulting social benefits could justify government subsidies of the training facility.

Regional Provision to Obtain Benefits from Economies of Scale and Scope

There clearly are economies of size and scope in the training of nurses, given the different kinds of nursing functions. To harness these economies, it would make sense to set up a regional facility that would accept enrollments from all Pacific countries. One means of both creating a training facility of sufficient size and scope, and meeting destination countries' certification requirements, would be for a training facility operating in one of the destination countries to establish a facility in a Pacific country. It is not clear, however, if such a facility would need any government subsidy, or one only during an initial establishment period.

Approach to Benefit-Cost Analysis of a Regional Nurse Training Facility

Assessment of the net benefits likely to result from creation of a Pacific regional nurse training facility requires that both private and social benefits and costs be taken into account. Social benefits and costs are those not captured by the nurses' increased income, and by the training costs. Private benefits and costs are the benefits the nurses and their families derive from the training, less the private costs of the training. The government would also participate in private benefits, receiving taxes and perhaps training fees paid by the nurses. Additional training costs may be paid by government.

Whose costs and benefits should be counted and to what extent? Most, if not all, nurses graduating from the training facility would be expected to go overseas to work for a period. Should such overseas workers be regarded as part of the Pacific region's economy and, therefore, their entire net increase in income counted in the analysis as private benefits arising from the training facility? Or should only the remittances back to the region from this income be counted as additional private benefits from creating the facility? The study calculates the net benefits under both approaches.

Assumptions about Benefits: The study makes a series of assumptions about the benefits and costs involved. These include, for example, assumptions about the following aspects of private benefits: (i) the likely increase in wages earned by the emigrating nurses as a result of the training, (ii) how long they would earn the higher wage overseas, and (iii) what is the amount that emigrant nurses are likely to remit annually. In calculating net private benefits, allowance is made for their basic living costs overseas.

Assumptions about Costs: Assumptions about the training costs of a Pacific regional nurse training facility are based on the tuition fees in a similar kind of training organization with no government subsidies.

The analysis assumes that there is a large pool of unemployed or underemployed labor, so that the opportunity cost of an untrained person who remains in a Pacific country is probably close to basic living or subsistence costs. The Fiji Island data were used for estimation.

To allow for the difference in basic living costs between the Pacific region and the overseas host country, the study assumes these are equivalent to the basic unemployment benefits paid a single person in the Fiji Islands and Australia, respectively. The difference between the unemployment benefits and what it actually costs the nurses to live in Australia is assumed to reflect the higher standard of living experienced by the nurses, and therefore is counted as a private benefit received by the nurses.

Counterfactual Scenario: The analysis assumes that, without government intervention to obtain accreditation for a nurse training facility in the Pacific, nurses from the region would find it difficult to obtain overseas employment as nurses. The number of people thus able to gain employment abroad as nurses will be considerably less than if such a training facility existed.

Results of Benefit-Cost Analysis

Based on study assumptions, Table 5.6 shows the results per nurse graduate.

Table 5.6: Benefits and Costs of a Pacific Regional Nurse Training Facility[a] (F$)

Item	Costs	Benefits
Australian nurse's salary (earned over 10 years)		536,800
Less opportunity cost of Fiji Islands employment (over 10 years)	49,700	
Less living expenses in Australia (over 10 years)	229,300	
Net increase in income due to training (undiscounted)		257,800
Net increase in income discounted at 3% per annum		200,000
Net increase in income discounted at 8% per annum		131,200
Tuition fees discounted at 3% per annum	33,100	
Tuition fees discounted at 8% per annum	30,300	

a Assumes emigrants remain part of the Pacific economy.
Source: Duncan 2005.

Counting the entire increase as a benefit arising from the regional facility results in the following.

- The net present value (NPV) of a Pacific island nurse graduate's increased income due to training at the proposed Pacific regional facility and employment overseas as a nurse for 10 years is estimated at about F$200,000, using a discount rate of 3% per annum.[17]
- In contrast, the corresponding NPV of the total cost of tuition fees per nurse graduate is estimated at F$33,100.
- The resultant benefit-cost ratio is 6.0 (i.e., F$200,000/$F33,100).

The corresponding NPV figures per nurse graduate using an 8% per annum discount rate are a net benefit of $F131,000, total tuition fee of F$30,300, and benefit-cost ratio of 4.3.

The study also calculated net benefits considering that only the value of a graduate nurse's remittances from abroad count as benefits from the graduate training facility. It estimated the value of such remittances over a 10-year period, using plausible assumptions based on available evidence, as F$66,700. At annual discount rates of 3%, the total NPV of benefits from these remittances would be F$51,900 (or F$35,400 if discounted at 8%). The resultant benefit-cost ratio at 3% discount rate is 1.6 (or 1.2 at a discount rate of 8%).

Other Impacts and Issues

External Benefits and Costs: It will likely be necessary that trainees of the regional nurse training facility receive practical experience in a hospital. If this is unpaid work, the value of the work can be considered as an external benefit of the project. If, say, third-year nurses are required to undertake 20 hours per week for 50 weeks, and this work is valued at F$2.50 per hour, the total worth of their contribution would be F$2,500 (as compared to the starting salary in the Fiji Islands of F$11,600 for a registered nurse).

It is assumed that nurses trained at the regional training facility would be additional to the number of nurses already being trained. Thus social costs in the form of a decline in the quality of health services due to nurses emigrating should not be claimed against such a facility.

Government Budgets: As far as Pacific government budgets are concerned, to what extent would tax revenues accruing from the additional remittances received from additional nurses working abroad offset the expenditure incurred in establishing and operating a Pacific regional nurse training facility?

The governments would benefit directly to the extent remittances were spent on consumption, and value-added tax (VAT) and/or import duties were in place. If governments meet the tuition costs of the students, per-student total cost over the 3-year period (allowing for dropouts) would be F$34,000. If the governments pay the living expenses of students as well as the training fees, total government financial commitment for each student would be around F$50,000 over the 3-year period.

Minimum size: Economies of size and scope mean that the facility should be of a certain minimum size if it is to provide the necessary breadth and quality of training needed to satisfy accreditation requirements in destination countries. The larger the intake of students, the lower will be the individual costs of training. A facility capable of enrolling 150–200 students appears to be about the minimum viable size. To have a major impact in creating overseas employment opportunities for the large number of young people presently unable to find local jobs, and to be a significant contributor to remittances, the facility would have to be many times larger than this—possibly 10 times this size.

Further Harmonization of Fisheries Access Arrangements

Overview

The focus of an initiative to strengthen fisheries access agreements is on four potential priorities for regional interventions addressing fisheries issues. Three of these priorities concern regional cooperation in negotiating and implementing policies affecting fisheries, notably the interrelated issues of

- harmonization of access arrangements,
- accountability and transparency in all such arrangements, and
- creation and allocation of new property rights for fisheries access.

The fourth priority concerns the institutional arrangements needed to enable continued, or new, effective regional provision of services that address fisheries issues—notably the issue of FFA's future role in relation to the newly created Western Central Pacific Tuna Commission (WCPTC).

Harmonization of Tuna Fisheries Access Arrangements

Fisheries access fees are, at present, usually negotiated as part of bilateral agreements with fishing fleets of individual distant water fishing nations (DWFN). Typically these fees are based on either the current, or last year's catch volume or value, and are understood to entail significant variations in the rates of fees applied to these bases. It also is understood that there are significant variations in total access fee payments received. It is difficult to assess the extent of such variations, or the reasons for them, however, because of a lack of adequate, publicly available information about the majority of fisheries access agreements. Details of these agreements—especially access fee rates and any related development assistance—are not publicly reported. In contrast, fisheries access arrangements under FICs' sole multilateral arrangement, the US Multilateral Treaty on Fisheries, incorporate payment of a fixed fee entitling up to a set number of vessels to fish, and the details are publicly available.

A mix of some or all of the following factors may account for variations in access fee rates, notably differences in.

- DWFN's willingness to pay for access to fish in different EEZs, linked to their estimates of likely economic benefits;
- the history of tuna resource concentrations in each EEZ;
- the negotiating prowess of different FICs, which may allow DWFN's to avoid revealing the full extent of their willingness to pay for access;
- a conditional linkage of bilateral development assistance—maybe informally and secretly—to the outcome of fisheries access agreements;
- FIC domestic fishery development goals—e.g., the desire to establish onshore fish processing and generate employment—that may lead an FIC to accept a lower fisheries access fee rate in return for DWFN help with FIC objectives; and
- possible corrupt practices, including catch underreporting.

Harmonization of fisheries access fees is commonly perceived as a panacea for increased net returns by FICs for access to the highly migratory tuna that FICs temporarily "own" while they are in their EEZs. The grounds for this view is that FIC cooperation in adopting a united negotiating stance with DWFNs would both increase their leverage to negotiate the highest feasible access fee rates, and reinforce this advantage by increasing the contestability of access fees among DWFNs. It is also argued to be an effective way to reduce fiscal risk by reducing the scope for individual discretion, thereby reducing the scope for corrupt practices.

Is harmonizing access fee arrangements the most effective way to improve economic benefits FIC coastal states receive from their EEZ fishery resources, and at the same time reduce potential fiscal risks? This is a fair question that should be systematically and dispassionately addressed as a matter of priority. In so doing, attention must be given to the extent blanket harmonization of access fees would be seen as fairly reflecting often large differences in the value of fisheries access to different EEZs.

But even if such harmonization is found to help reduce fiscal risks associated with fisheries access agreements, a closer look at the potential sources of these risks suggests that it would not be a complete solution. For example, as van Santen and Muller have explained, setting bilateral access fees on a "harmonized" basis exposes FIC governments to fiscal risks from fraudulent behavior.[18]

> [This] basis offers the best potential for cheating. The system requires extensive data, which are difficult and sometimes impossible to verify; there are strong incentives for sustained mis- or under-reporting [by fishers]. Monitoring costs are relatively high.

Transparency and Accountability in Fisheries Transactions

The secrecy currently surrounding FIC government fisheries access agreements exacerbates the fiscal risk, and is inconsistent with the Pacific Islands Forum's Eight Principles of Accountability,[19] which have been endorsed by FIC governments.

Secrecy, together with system features noted above, increases the opportunity and scope for corrupt behavior by those involved in access agreements on behalf of governments.

It would therefore be prudent that FICs ensure that their negotiating practices are consistent with the principles of good governance and sound public sector management. This also would allow more informed negotiations and settlements between FICs and DWFNs.

As a matter of priority, it would be desirable for FICs to cooperate and mandate the FFA to compile and maintain a comprehensive database of bilateral fisheries access agreements—including details of access fee rates and payments. FICs should also mandate FFA to confirm the accuracy of the information by independent professional audits, and make this information publicly available. The outcome of this approach would be the creation of a compulsory, open registry of all FIC bilateral fisheries access agreements, including fee provisions, and effective measures to ensure compliance with the registration requirements.

Long-Term Sustainability of Existing Fisheries Access Fee Arrangements

The present typical fisheries access fee arrangement described above[20] is fraught with risk, as it tends to encourage overfishing and overinvestment in fishing. This risks the biological and economic sustainability of the fishery.

A more suitable arrangement might include, say, a fixed option-value component and a variable economic-rent component that depended on the fishers profitability—in conjunction with more certain, defined property rights.[21] Such arrangements could encourage more sustainable harvesting of fisheries to the benefit of the coastal states and fishers. Rights could be allocated by carefully managed auction. At present, however, such an approach is understood to be not yet feasible for the region due to the risk of collusion among the small number of DWFNs, and the apparent lack of agreement between DWFNs and coastal states on such changes in property rights. Additionally, there is at present no expert auction infrastructure in the region.

This subject is one that member countries will need to start addressing systematically and objectively in the near future. It is already an issue, in the sense that the pending work of the WCPTC is scheduled to address fisheries management issues that touch on this subject.

Future Role of FFA

As a matter of high priority, FICs should review the role of FFA to see what, if any, changes in its focus and organizational arrangements may be required for it to serve member countries most effectively. Three key points need to be kept in mind in considering FFA's future role.

- Given the huge economic disparity between DWFNs and individual FICs, a regional fisheries body (such as FFA) is needed to provide expert advice to all Forum member countries to enable them to negotiate—collectively or individually—on a more equitable basis with DWFNs.

- FFA will need to take more account of the interests of DWFNs in member countries' EEZs, and the need to ensure that future fisheries arrangements are likely to be sustainable—economically and biologically—for both the fishers and the coastal states.
- In order to achieve economically and biologically sustainable fishing arrangements, FFA eventually will likely have to help FICs move toward some sort of Total Allowable Catch (TAC) or equivalent fisheries rights. TACs could be allocated via an auction system once institutional arrangements are developed to minimize the risk of collusion between potential bidders.

Liberalization of the Telecommunications Market

Overview

In a region with highly dispersed populations, remote from major world markets, regular access to cost-effective telecommunications infrastructure and services is a vital requirement for future economic development. Telecommunications service providers currently are mainly state-owned monopolies with exclusive licenses. Access costs typically are high, partly reflecting the relatively low teledensities and high operating costs in the region. International experience shows that liberalizing the market for telecommunications service can be expected to yield significant benefits in the region in terms of lower costs, more efficient services, and service quality improvements.

Market deregulation is not necessarily regional market integration. The former is often done at the national level, on a sector-by-sector basis. However, the benefits of market deregulation among all Forum members would be analogous to an integrated regional market for telecommunications. To manage this integration, a regional regulatory service provider is proposed. In this way, a telecommunications liberalization initiative would encompass more than one type of regionalism: both integration and regional provision of (regulatory) services.

The main findings and recommendations of report on telecommunications deregulation in the region prepared by Professor James McMaster of USP for the Pacific Islands Forum Secretariat are outlined below.[22]

Main Findings

There are major benefits from opening monopoly markets to private sector competition. International case studies of telecommunications deregulation undertaken by the International Telecommunications Union (ITU) and other researchers clearly show the substantial economic benefits that result from opening government-dominated telecommunications monopoly markets to private sector competition by licensing new providers. These benefits take the form of lower prices, improved service quality, a higher level of investment in new infrastructure, more rapid adoption of new technology, increased bandwidth, and improved productivity and efficiency in the use of resources.

All consumers stand to gain and the costs of regulation are tiny. Competitive telecommunications markets will generate sizable net economic benefits to all consumer groups in the Pacific Islands, including urban and rural residential subscribers, private sector business firms, schools and universities, public enterprises, and government departments and agencies.

The value of economic benefits to consumers is sizable. The estimated total value of economic benefits to all consumers in FICs almost all stems from a sharp reduction in international telephone call rates, peak mobile phone rates, and Internet charges. This benefit is what economists term a consumers' surplus, with an estimated annual value of US$66 million,[23] and total value over a 5-year period of US$285.9 million (using a 5% discount rate—US$250.9 million using a 10% discount rate).

The estimates, shown in Table 5.7, are based on FIC revenue data from the *ITU Database 2005* edition, and on total telecommunications revenue for Pacific Island ITU member countries. The estimates also incorporate a set of assumptions about the likely level of reduction of call charges resulting from competition, the response of telecommunications companies to the threat of competition in contestable markets, the profitability of different market segments, and price elasticity of demand for telecommunications services.

It is important to note that these calculations of the level of consumer surplus are based on the limited amount of revenue data. More precise estimates of the economic benefits from competition could be made if the Pacific telecommunications authorities made available detailed historical information on their sources of revenue from different services, and their revenue and cost projections for the next 5 years.

Table 5.7: Benefits to Consumers from Deregulation of Telecommunications (US$ million)

	Consumer Surplus for 1Year	Consumer Surplus for 5 Years Discounted at 5%	Consumer Surplus for 5 Years Discounted at 10%
Cook Islands	0.32	1.39	1.21
Fiji Islands	26.25	113.60	99.50
Kiribati	0.95	4.11	3.60
Marshall Islands	1.43	6.19	5.42
Micronesia, Federated States of	2.61	11.30	9.89
Nauru	0.32	1.39	1.21
Palau	1.74	7.53	6.60
Papua New Guinea	25.20	109.10	96.18
Samoa	1.39	6.02	5.27
Solomon Islands	2.51	10.87	9.51
Tonga	0.00	0.00	0.00
Tuvalu	0.32	1.39	1.21
Vanuatu	2.98	12.90	11.30
Total	**66.07**	**285.80**	**250.90**

Source: Mc Master 2005.

The types of economic costs and benefits to the main stakeholder groups expected from information and communication technology (ICT) deregulation in the Pacific islands are outlined in Table 5.8.

Introducing competition also will lead to improved service quality and a more rapid increase in bandwidth. While the study did not estimate the monetary value of benefits from quality improvements—as gauged by consumers' willingness to pay—it is likely to be substantial. For example, New Zealand's experience with telecommunications deregulation showed that benefits from quality improvements may exceed those from lower call rates.[24]

The longer-term dynamic impacts of deregulation and the development of competitive telecommunications markets will be most beneficial for private-sector development, trade, and investment promotion. They are expected to support the generation of an estimated 20,000 new jobs in ICT-enabled businesses, such as call centers and back-office services.

Table 5.8 Economic Benefits and Costs of Information and Communication Technology Deregulation in the Pacific

Group	Cost	Benefit
Urban Residential Consumers		• Reduced tariffs • Increased consumer surplus • Improvement in ICT service quality • Choice of providers
Rural Consumers	Slower expansion out of fixed-line network to isolated locations that are uneconomic	• Reduced cost of some ICT services • Improved quality of services • Introduction of new wireless services
Private Businesses		• Reduced business ICT costs • Businesses more competitive globally • Expanded use of Internet for business functions • Opportunities for new business process outsourcing contracts
Government and Other Public Utilities		• Reduced cost of ICT services for government departments and public enterprises • Improved Internet services and more rapid introduction of e-government • Increased government revenue from a more rapid growth of ICT total revenue
Regulator for ICT	Need to strengthen regulation to ensure strong competition on a level playing field	
Monopoly ICT Provider	• Loss of monopoly market power • Loss of opportunity to make supernormal profits • Pressure to reduce costs and excess staff • Lower incentive to invest in long-term capital infrastructure • Reduced capacity to repay loans for previous capital investment • Reduced market share • Strong price competition from new competitors • Need to improve productivity	
New ICT Providers		• Opportunity to enter new profitable market • Opportunity to test new technology in small markets
Educational Institutions		• Reduced cost of Internet for e-learning

Source: Mc Master 2005.
ICT = information and communication technology

Regulatory Concerns and Costs

The good news is that international case studies show that a high standard of telecommunications market regulation can be achieved at minimal cost—usually less than 1% of total industry revenue—after introducing competition.

International experience also shows that there is no need to maintain a public telecommunications monopoly in order to cross-subsidize the supply of telecommunications services to rural areas and remote island communities.[25] Instead, universal service goals (of expanding services to rural areas) can be achieved by establishing a universal service fund to finance them. All telecommunications providers are required to contribute to it; the proceeds are used to finance contracting out the supply of universal service obligations to private sector providers.

The study indicates that there are likely to be substantial cost savings and economic benefits for the region if all FICs were to enact a common set of e-commerce laws. Most governments have recognized the need for new laws to support national ICT policy and ICT development plans. Cook Islands, Fiji Islands, and Tonga have made good progress in drafting a set of modern e-commerce laws benchmarked on international best practice.

One potentially significant cost would arise from modifying existing monopoly contracts. A number of FICs have recently renewed long-term monopoly contracts with major telecommunications providers. The economic costs and legal ramifications of modifying or breaking these contracts are not addressed in the study, but merit further examination.

Creating a Pacific regional telecommunications authority could result in significant benefits for the region.[26] Such a regional authority would promote liberalization and fair competition, harmonization of regulations and policies, universal service, fair pricing, access to advanced services, and overall sector development across the region. The benefits would stem from substantial economies of scale and other technical advantages from adopting a regional approach to industry regulation, especially as smaller FICs may be unable to attract professionally skilled ICT regulatory specialists to lead their national regulatory authorities.

Creation of Joint-Procurement of Petroleum Products

Overview

Most Pacific economies are heavily dependent on petroleum imports, which makes them particularly vulnerable to petroleum supply disruptions and price rises resulting from global and regional market conditions.

Although the size of this regional market is significant—about US$100 million per annum at freight-on-board prices, it is not managed in a consolidated manner. The fragmented market, numerous players, and poor economies of scale have resulted in inefficiencies in the supply chain, asset redundancy, and underutilization of distribution vessels. This translates into high costs to end consumers.

In many of these countries, consumer protection mechanisms are in force, with price regulation (in the form of profit and price caps and petroleum pricing templates) attempting to mimic the presence of true competition and maintain fair and equitable prices. While this minimizes the price to consumers and avoids price gouging, it does not address costly flaws and inefficiencies in the supply chain.

The preliminary study by Jared Morris assessed the feasibility of regional and subregional initiatives designed to enable small island member countries to procure their vital petroleum needs more cost-effectively.[27] To this end, two basic options for intervention are examined qualitatively and quantitatively, and compared to the status quo.

1. **Regional Regulatory Agency**. Create a regional regulatory agency to:
    - Set regulations covering petroleum supply, storage, distribution, and usage in the entire region, including market failure, environmental, and health and safety issues for the industry; and
    - Implement and enforce these regulations.

2. **State-Owned enterprise (SOE) Operation of Petroleum Handling, Bulk Storage, and Local Distribution Assets**: An SOE would own and operate petroleum handling, bulk storage, and local distribution assets in each country, as a means to enable long-term, subregional cluster contracts for petroleum supply to be negotiated on more favorable terms. The key components of this option (compared with the status quo) are
    - creation of a regional regulatory agency to carry out the same role as

under option 1.

- secure public ownership and operation of petroleum terminal handling, bulk storage, and local distribution facilities in each small island member country as a prerequisite to the next component; and
- secure beneficial subregional petroleum supply arrangements for three subregional clusters of member countries, by creating a regional business advisory unit with the capacity to implement this strategy.

Practically, the unit would need to be part of the regulatory agency, but would require suitable governance arrangements to manage potential conflicts of interest.

The entrenched market dominance of a petroleum supplier in each small island country, and the absence of effective industry regulation, mean that establishing and enforcing an effective regulatory framework for the industry is a prerequisite to implementing this option.

Option 2 is relatively ambitious, but it sets the upper bounds of a range of possible variants.[28] While option 2 is likely to yield higher benefits, it would also entail higher risks. Chapter 4 case studies pointed out the risk of regional bodies undertaking market activities, and the need for clear commercial objectives and governance arrangements that keep costs at a minimum.

Rationale for Regional Intervention

Many small island states in the region face critical cost and supply constraints for petroleum products, due to both

- market failure in the procurement and supply of petroleum products, with a lack of effective competition for petroleum supplies—usually one dominant petroleum supplier in each country is able to extract a degree of monopoly rents—and a fragmented, inefficient supply chain; and
- regulatory failure, as a result of no effective regulation of this market to moderate the impact of market dominance, reflecting a lack of skilled, experienced regulators and inadequate regulatory frameworks.

Comparative analysis of the different options for intervention follows. The status quo is the counterfactual for this analysis.

1. **Regional Regulatory Agency**. Market failure justifies government intervention. But to counteract it effectively on a national basis requires more staff with a high level of skills and experience in regulatory policy and implementation than most small island states can individually provide. Creating a regional regulatory agency would enable all states to benefit collectively from economies of scale and scope in providing petroleum industry regulatory services for the entire region. This also would have the advantage of harmonizing the regulatory framework for the industry and ensuring greater consistency in applying and enforcing regulations.

2. **SOE Ownership and Operation of Bulk Terminal Facilities**. SOE ownership and operation of petroleum handling and storage facilities in individual countries is designed to ensure the contestability of long-run supply agreements, which is not feasible when a potential supplier also owns these assets. Operating the facilities could be part of a long-run petroleum supply contract, rather than carried out by an SOE.

Subregional petroleum supply agreements. Securing integrated, subregional petroleum agreement for clusters of countries has the potential to improve the purchasing power, shipping logistics, and supplier management framework.

A regional business advisory unit would be created as a separate but associated group within the regional regulatory body. The unit would formulate, negotiate, monitor, and implement appropriate long-run petroleum supply arrangements for subregional clusters of countries.

Nature of Benefits and Costs

The main benefits include avoided costs—such as supplier onshore costs—and financial price risks by adopting suitable hedging strategies. Savings would also comprise bulk procurement discounts, local tanker efficiency, and more effective price control.

The main costs associated with the options are

- construction of bulk terminal facilities;
- personnel costs for analysis of networks and clusters, and for brokerage;
- risk assurance process, including economic, safety, and environmental risks;
- rrice control and market monitoring support;

- terminal operating and maintenance; and
- supplier margins.

Qualitative Assessment of Intervention Options

Option 1, creating a regional regulatory agency, is expected to result in some price benefits because of improved regulatory performance from a better resourced, integrated approach to regulating market dominant suppliers. But it would not address the problem of unnecessarily high supply costs due to inefficiencies in the fragmented supply chain.

Option 2, particularly an integrated, subregional petroleum agreement for clusters of countries, is expected to result in some significant net benefits. In particular, it would enable contestability in letting long-run petroleum supply contracts and more efficient supply chains—both expected to result in lower-than-otherwise prices to petroleum end users. This, in turn, would generate a wider flow of subsequent benefits, including enhancing prospects for economic development in the region.

But option 2, by virtue of SOE ownership and operation of petroleum terminal facilities, also involves some high risks—i.e., undercapitalized, underfunded, or poorly managed SOEs—that need to be managed.

Quantitative Assessment of Options

Costs and benefits have been valued in real terms over 15 years, and the results are summarized in Table 5.9.[29] The streams of costs and benefits have then been discounted by a real discount rate of 7%, with sensitivity testing using discount rates of 4% and 10%.

Conclusions

The above results indicate that the status quo would incur opportunity costs over a 15-year period with an estimated NPV of about US$27 million. The results for option 1 indicate a very small net benefit overall, with an NPV of about US$0.1 million, as reflected in the estimated benefit-cost ratio (BCR) of only 1.01. In contrast, results for option 2 indicate sizable net benefits, with an NPV of about US$104 million overall for the countries assessed, and an estimated BCR of 2.12.

While these results are preliminary and indicative only, they lead the report to recommend that the Forum Secretariat investigate further the possibilities and requirements for developing subregional bulk purchasing arrangements for clusters of countries.

Table 5.9: Net Benefits of Regional and Subregional Interventions: Petroleum Supply

STATUS QUO

	Net Present Value	PV of Capital Costs	PV Total Costs	NPV Total Benefits	BCR
Southern Cluster					
Cook Islands	$ (974,321)	$ -	$ (974,321)	$ -	0.00
Niue	$ (622,483)	$ -	$ (622,483)	$ -	0.00
Cluster Summary	**$ (1,596,805)**	**$ -**	**$ (1,596,805)**	**$ -**	**0.0**
Northern Cluster					
Federated States of Micronesia	$ (18,693,083)	$ -	$ (18,693,083)	$ -	0.00
Palau	$ (1,869,308)	$ -	$ (1,869,308)	$ -	0.00
Republic of Marshall Islands	$ (2,868,294)	$ -	$ (2,868,294)	$ -	0.00
Nauru	$ (124,497)	$ -	$ (124,497)	$ -	0.00
Cluster Summary	**$ (23,555,182)**	**$ -**	**$ (23,555,182)**	**$ -**	**0.00**
Central Cluster					
Kiribati	$ (1,522,946)	$ -	$ (1,522,946)	$ -	0.00
Tuvalu	$ (121,790)	$ -	$ (121,790)	$ -	0.00
Cluster Summary	**$ (1,644,736)**	**$ -**	**$ (1,644,736)**	**$ -**	**0.00**
TOTAL (Status Quo)	**$ (26,796,722)**	**$ -**	**$ (26,796,722)**	**$ -**	**0.00**

REGIONAL REGULATORY FRAMEWORK - PRIVATE SECTOR

	Net Present Value	PV of Capital Costs	PV Total Costs	NPV Total Benefits	BCR
Southern Cluster					
Cook Islands	$ 145,461	$ (46,729)	$ (707,071)	$ 852,531	1.21
Niue	$ 145,885	$ -	$ (34,237)	$ 180,121	5.26
Cluster Summary	**$ 291,346**	**$ (46,729)**	**$ (741,307)**	**$ 1,032,653**	**1.4**
Northern Cluster					
Federated States of Micronesia	$ (182,892)	$ -	$ (2,519,527)	$ 2,336,635	0.93
Palau	$ (349,449)	$ -	$ (2,519,527)	$ 2,170,078	0.86
Republic of Marshall Islands	$ (102,857)	$ -	$ (805,589)	$ 702,732	0.87
Nauru	$ 210,895	$ -	$ (93,723)	$ 304,618	3.25
Cluster Summary	**$ (424,302)**	**$ -**	**$ (5,938,366)**	**$ 5,514,063**	**0.93**
Central Cluster					
Kiribati	$ 207,504	$ (635,649)	$ (635,649)	$ 843,153	1.33
Tuvalu	$ 24,873	$ -	$ (54,406)	$ 79,280	1.46
Cluster Summary	**$ 232,377**	**$ (635,649)**	**$ (690,056)**	**$ 922,433**	**1.34**
TOTAL (Intervention Option 1)	**$ 99,420**	**$ (682,378)**	**$ (7,369,729)**	**$ 7,469,149**	**1.01**

REGIONAL REGULATORY FRAMEWORK - PUBLIC SECTOR

	Net Present Value	PV of Capital Costs	PV Total Costs	NPV Total Benefits	BCR
Southern Cluster					
Cook Islands	Not Assessed	Not Assessed	Not Assessed	Not Assessed	-
Niue	Not Assessed	Not Assessed	Not Assessed	Not Assessed	-
Cluster Summary	**$ -**	**$ -**	**$ -**	**$ -**	**-**
Northern Cluster					
Federated States of Micronesia	$ 78,852,009	$ (7,639,207)	$ (58,217,229)	$ 137,069,238	2.35
Palau	Not Assessed	Not Assessed	Not Assessed	Not Assessed	-
Republic of Marshall Islands	$ 23,703,153	$ (5,841,380)	$ (17,643,682)	$ 41,346,835	2.34
Nauru	Not Assessed	Not Assessed	Not Assessed	Not Assessed	-
Cluster Summary	**$ 102,555,161**	**$ (13,480,587)**	**$ (75,860,911)**	**$ 178,416,072**	**2.35**
Central Cluster					
Kiribati	$ 1,356,492	$ (3,181,020)	$ (10,533,172)	$ 11,889,664	1.13
Tuvalu	$ 499,968	$ (2,040,990)	$ (6,589,841)	$ 7,089,809	1.08
Cluster Summary	**$ 1,856,461**	**$ (5,222,011)**	**$ (17,123,013)**	**$ 18,979,474**	**1.11**
TOTAL (Intervention Option 2)	**$ 104,411,622**	**$ (18,702,598)**	**$ (92,983,924)**	**$ 197,395,546**	**2.12**

BCR = benefit-cost ratio, NPV = net present value, PV = present value.

Creation of Pacific Aviation Security Office (PASO)

Overview

Aviation safety and security are vital public goods, especially for Pacific countries that consist of thousands of islands covering 30 million square kilometres of ocean. Modern air transport is essential for tourism and trade in the region, which enable economic growth and alleviation of poverty.

Even though the region's air transport systems are small, all aspects of their operations must meet international standards of aviation safety and security. These safety and security standards cover four separate but interdependent aspects: (i) flying operations, (ii) airworthiness, (iii) airports, and (iv) security. National civil aviation authorities are responsible for monitoring and certifying compliance by their airlines and/or airports with domestic and International Civil Aviation Organization standards and recommended practices.

Pacific countries, however, generally find it difficult to fulfill the required regulation and oversight nationally, due to diseconomies arising from their small size and the fragmented nature of the aviation industry in the region. All face severe financial limits and shortages of skilled personnel to perform these essential functions, and as a result have often failed to meet requirements. Noncompliance places safety and security at risk, and potentially jeopardizes continued international services.

Creating a regional organization to supply aviation security oversight functions for individual Pacific countries would allow them to take advantage of economies of scale and scope in securing the necessary level and quality of services for them to meet international standards. With technical support and policy advice from ADB, a group of these countries has already taken steps to create and implement a regional agency to provide aviation security services for the region—PASO. These countries are Fiji Islands, Kiribati, PNG, Samoa, Solomon Islands, and Vanuatu.

Case for Regional Provision of Aviation Security Services[30]

All Pacific countries' systems for assuring and regulating aviation security need to be improved to ensure the ongoing viability of aviation in the region. The following are options to achieve the needed improvements:

1. **upgrading individual national capacities**: Full development of each national civil aviation authority (CAA) to provide sufficient capacity to meet standards fully;

2. **outsourcing**: Contracting most functions from independent service providers from more developed countries; and
3. **regional provision**: Development of a cooperative regional service capacity.

Comparative analysis of these options clearly shows why regional provision of aviation security services would benefit the region most.

1. **Upgrading Individual National Capacities**: Relying on individual country resources to meet minimum international standards would require each FIC to employ qualified inspectors in four specialized disciplines—flight operations, airworthiness, airports, and security—and upgrade the diverse legislative, regulatory, and institutional frameworks. While this may be achievable, the small scale of individual country operations would not require full-time employment of these specialists. The result would be excess national capacities and duplication of effort, with high operational costs.

2. **Upgrading Services by Contracting Out**: Relying on outsourcing to the extent needed to increase the level and quality of CAAs would cost far more than the present levels of national expenditures on outsourcing, which experience indicates are inadequate.

3. **Shared Regional Capacity**: By contrast, creation of a regional aviation security agency, such as PASO, would enable development of a shared regional capacity that can become self-sufficient and reduce the unit costs of service provision. The lower unit costs arise from reducing duplication, creating economies of scale and scope, harmonizing regulatory systems, and sharing scarce specialist personnel. For example, a total of five such specialists could provide the necessary services for all the countries that need them in the region.

Over time, a cooperative regional approach to aviation security is expected to be the most effective way to improve air transport safety and security in the region, rather than simply maintaining the status quo. Developing a critical mass of expertise in a regional aviation security body would allow a proactive, more robust approach to planning for the dynamic future needs of the aviation industry and its regulation.[31] A proactive approach means systematically identifying and assessing potential future risks to the industry, and planning how best to avoid them or otherwise deal with them. At present, CAAs typically have little choice but to react to problems as they arise.

Another benefit of a regional agency is that it could supply useful policy and operational advice to governments, as an adjunct to providing technical services. But if such advice is provided, care needs to be exercised to manage potential conflicts of interest that might arise through mixing regulatory execution and policy advice. Protocols can be established and regulate any such concerns.

Pacific Aviation Security Office

PASO now legally exists as a non-profit intergovernmental organization, but is yet to become fully operational. Its legal basis is the Pacific Islands Aviation Safety and Security Treaty. This treaty delegates national authority of national CAAs to PASO, and provides for supervision of its operations by the Intergovernmental Council of Directors, made up of representatives from each member country. The role of the Council of Directors is to set PASO's policies and monitor its implementation and enforcement of technical findings. In effect, PASO will become the technical branch of each national CAA, although implementation of PASO recommendations in each country will remain a national responsibility.

Analysis of Benefits and Costs

PASO is expected to result in the Pacific aviation sector meeting all international standards for civil aviation safety and security regulation and oversight. Creating a single regional organization that replaces and updates the current system of fragmented national authorities is expected to result in economies of scale and scope that will allow PASO to become self-financing and to lower costs and improve service quality.

PASO is expected to become self-financing within 5 years of becoming fully operational. Moreover, it is expected to do so while charging lower service fees than is possible on an equivalent basis via ad hoc outsourcing.

Those expected to benefit directly from PASO include

- governments of PASO member countries, which will be able to rationalize their CAA administrations and thereby lower public sector costs;

- the 43 commercial air transport companies operating a total of some 266 aircraft and employing nearly 4,000 licensed staff, through lower regulatory compliance costs and more responsive CAA services; and
- all users of air transport who will benefit from higher safety and security standards.

Indirect beneficiaries include stakeholders in the tourism industry and related earners, due to the lower risk of a serious aviation safety or security incident, with its attendant very high costs and potentially serious impact on tourism.

It is difficult to quantify the economic benefits of improved safety and security regulation and oversight, since the impact of the project is to reduce the probability of serious incidents of unknown frequency and magnitude. However, some indications of the potential impacts of noncompliance are provided by comparable experiences. Major international air disasters cause approximately a 10% decline in aviation for about a year in ADB developing member countries. Since tourism is responsible for about 20% of the Fiji Islands' GDP, for example, this could be equivalent to a loss of 2.5% of gross domestic product (GDP) per year. Denial of international services (if, for example, flights from Australia and New Zealand were prohibited due to noncompliance with regulations) could have an even greater impact. Given that tourism employs large numbers of low-skilled workers, including a high proportion of women, the potential negative social impacts would be even higher and more widespread.

ADB estimated that cost saving and quality increases associated with PASO, as compared with ad hoc outsourcing, would have resulted in an economic internal rate of return of 27% with Tonga included as a member of PASO.[32] Following the liquidation of its airline, Tonga withdrew from PASO membership, with impacts on the project that are as yet unclear. While it can be expected to reduce PASO's variable costs, it will mean that the main overhead costs will be spread over fewer members, thereby increasing the costs per member. Even so, PASO is still expected to yield a significant internal rate of return.

Sustainable Development

Sustainable development is a broad field covering human development, culture, society, and sustainable natural resource management, among other areas. Within the wide range of possible initiatives, this study highlights two that can help promote Pacific regional identity—a regional sports institute, and a regional intellectual property rights office. A strategic initiative is also highlighted that underpins work toward all human development objectives, including the Millennium Development Goals—a regional statistics office.

Creation of Regional Sports Institute

Overview

Sports can play an important role in fostering economic development and social well-being in FICs, as recognized in the current Pacific Plan. At a social level, encouraging widespread, active community participation in sports can improve health outcomes (both physical and psychological), enhance productiveness, reduce antisocial behavior, and generally foster social cohesion. At an elite and professional level, sports can generate economic benefits stemming from individual or team participation in professional sports in developed countries or top-level international sports events.

Frequent sports interaction and competition between individuals and teams, together with suitable sports facilities and expert training, can significantly enhance the potential development and benefits achievable from sports activities. The ability of many FICs to realize this potential, however, is currently severely limited. Their populations are small and widely dispersed. Additionally, most have limited sports facilities and coaching expertise, and few opportunities for sports interaction with people from other islands.

Creation of the Regional Sports Institute is proposed as a means whereby FICs, by acting together, could help realize the potential economic, social, and health benefits to the region from sports. Possible benefits and costs to the region of creating such a facility have been broadly canvassed in a preliminary study commissioned for this report from the Secretariat of the Oceania National Olympic Committees (ONOC).[33]

The Role of the Regional Sports Institute

The primary role of the Regional Sports Institute would be to support existing regional sports training centers, and similar facilities at the national level. Logistically, it would seem sensible to establish the regional institute as an integral part of the University of the South Pacific network.

As envisaged in the ONOC study, a regional sports institute would focus primarily on developing elite sportsmen and sportswomen as well as their coaches and administrators. It would evolve specialist centers of excellence, and make use of the facilities, talent, and expertise as and where they are already in place. Initial emphasis would likely be on a limited number of sports, probably those with the most popular appeal to young people, current athletes, spectators, sponsors, and broadcasters.

The study emphasizes that before a comprehensive assessment of the likely net benefits of creating such a facility can be undertaken, the following issues would need to be resolved:

- the exact role of the regional sports institute,
- its location, and
- the extent to which its functions should be decentralized.

Qualitative and Quantitative Assessment of Benefits

The study's discussion of the likely benefits and costs of creating a regional sports institute is very general and, at this stage, lacks substantive empirical support. This reflects a general lack of such evidence about the impacts of sports, or sports institutes, on the economic and social well-being of FICs or other developing countries.

While the study envisages the regional sports institute would focus on achieving top-level sporting performances, it cautions that a large base of participation is vital for achieving real success in sports, in terms of the economic and social benefits to the community that make investment in sport truly worthwhile. Achieving this will be a challenge for FICs. To illustrate the kind of positive benefits a regional sports institute could yield in terms of economic production, the study mentions a September 2004 report by the Western Australia Government, which found that "every dollar invested by the State in its Community and Sporting Recreation Fund generated A$2.36 in direct activity and A$6.51 in total activity."

The study implies that creating the proposed Pacific island regional sports institute would help improve public health outcomes by providing incentives for FIC residents to participate actively in sports activities and, thereby, reduce the risk of health problems well known to arise from physical inactivity. As an indication of potentially "large" health-related economic benefits from such a facility, the study estimates roughly that it could generate "an economic benefit to the region well in excess of US$10 million."[34] The study notes US research in 1999 estimating that every "US$1.00 spent on physical activity results in a US$3.20 saving in medical costs."

Qualitative and Quantitative Assessment of Costs

The main costs would comprise substantial funding for incremental and extra capital works for venues, accommodation, and transport, and a "generous" budget for operational purposes for the first 5 years of business. An annual budget of US$30–$50 million is suggested as an approximate estimate of the amount required. The study suggests that this amount is on a par with the current economic benefits thought to be already flowing into the region annually as a direct result of FICs' involvement in sports.

Conclusion

To advance the idea of creating a Pacific island regional sports institute for FICs will require further consideration of several crucial issues, including the underlying objectives for the facility, the scope and prime focus of its role, where it would be located, and the extent to which its functions would best be decentralized (and where). Resolving such issues would enable a fuller, more rigorous assessment of the case for creating a facility. These decisions will also allow for a more systematic analysis of its potential benefits.

Creation of a Regional Statistical Office

Overview

Relevant, reliable, and timely statistical information is an essential element in informed decision making by FIC governments. Such data provide government policy makers and advisors an objective basis to assess social and economic developments. Statistics also help to indicate the need for policy intervention, and the impact of existing interventions. Persons in business and private sector investors often use statistics to help them assess the merits of potential business or investment opportunities. For example, statistics can be used to derive plausible assumptions to underpin analysis of a business opportunity.

Typically, however, FICs find it difficult to attract and retain staff with the necessary skills and experience for compiling and updating the range of statistics needed.

Two possible options are reviewed for creating a regional statistical office to complement those provided nationally by FICs.[35] The discussion is based on a recent preliminary study commissioned for this report from Michael Andrews.[36] Links to the Regional Economic and Statistical TA Facility proposal discussed earlier in this chapter are acknowledged. The scope of statistical tasks discussed here is significantly broader than for that proposal. Nevertheless, the relationship between the two proposals would need to be kept under careful review.

Options for Creating a Regional Statistical Office

Comprehensive Regional Statistical Office. This office would undertake all aspects of statistical functions, such as: (i) collecting base data, like carrying out censuses and other surveys; (ii) compiling "middle level" statistics, such as on migration, employment, external trade, and a consumer price index; (iii) compiling economic statistics required by the IMF; and (iv) compiling social statistics required for poverty studies and the measurement of progress toward the Millennium Development Goals.

Specialist Regional Statistical Office. This office would specialize in a narrower range of functions, such as compiling (i) high-level analytical economic and social statistics, like national accounts and balance-of-payments data, price indexes, and productivity measures; and (ii) major social and economic surveys and data indicators, such as data needed for the Millennium Development Goals presentations. In addition, the office could advise national statistical offices on basic data collection methodology, including development of censuses and household or industry surveys. If adequately funded, the office could take over some statistical activities, particularly balance-of-payments data, now handled by central banks.

By far the preeminent provider (apart from donors) of statistics for the region is the SPC, which both maintains a regional online database Pacific Regional Information System (PRISM) and provides technical assistance to member countries. SPC thus essentially fulfills a number of tasks outlined above. Upgrading SPC's capacity to fulfill a wider range of functions may be an option for a regional statistical body.

Qualitative and Quantitative Assessment of Benefits and Costs

The preliminary study identifies the following potential benefits of implementing either of the above two options for a regional statistical office:

- **greater comparability of statistics** between countries in the region, resulting from opportunities for the office to apply consistent methodologies, classifications, legislation, revisions policy, etc.;
- **more reliable, timely, and accessible statistics**: The publication of such data on a common website may raise the quality (accuracy, consistency, timeliness) and dissemination of major economic and social statistics to national policy makers and the general public, thus improving the economic and social debate in the Pacific region;
- **enhanced management of statistical functions**: The standard of administration of statistical organizations in the Pacific region may be improved by greater attention to priorities, staff recruitment, and training and career paths of national statisticians; and
- **focus to attract development assistance**: The organization would also provide donors with an obvious mechanism for the focus of coordinated assistance to statistics development in the Pacific.

As an indication of the potential value of these benefits, if it is assumed that improved statistical data contributed to better decision making, which, in turn, increased GDP by only 0.1%, the annual flow of benefits to FICs would amount to about US$7 million.

Of the two options, the specialist regional office is favored for several reasons. First, and most importantly, it would be likely to achieve quality improvements in economic and social statistics more quickly. Second, it may be more practicable in view of the difficulty of coordinating all data collections for FICs. As a result, the specialist option is seen as likely to be the more realistic, at least in the near term.

The total annual cost of FICs' existing statistical services is estimated to be in the range of US$7.5–10 million, of which about 60% is funded by FICs.

The comprehensive regional statistical office is estimated to entail an extra cost of about US$4–5 million annually, in addition to the aggregate cost of FICs' existing statistical services, for a total annual cost of US$13–15 million. Simply pooling existing resources in the region thus would not be sufficient to meet the full costs of providing effective statistical services for FICs in the region.

Table 5.10 indicates that a specialist regional statistical office would involve an estimated total annual cost of about US$5.5 million.

Issues

Establishment of either a specialist or comprehensive regional organization would require attention to a number of issues, many of which relate to the national and regional structure of responsibilities that would need to be resolved.

- **Legislation and Management Issues**. These are confidentiality, compulsory supply of data, ownership of source and output data, regional vs. national priorities, coordination with donors and TA providers, and solutions to statistical problems involving organizations other than national statistical offices (NSOs).

Table 5.10: Estimated Total Cost of Specialist Regional Statistical Office (US$'000)

Cost Item	Number of Staff	Costs
Supervisor and Deputy	2	150
Managerial Advisors (statistics, law, planning, advocacy, etc.)	2	80
Source Data Specialists (e.g., survey design, processing systems development, supervision of survey staff, logistics, survey validation and analysis, etc.)	10	400
National Accounts Specialists	3	150
Balance-of-Payments/IIP Specialists	3	150
Publications and Publicity Specialists	1	40
Social Statistics Specialists	5	250
Support Staff	4	80
Steering Committee		50
Communications		4
Travel		200
Other		6
Subtotal	30	1,560
External Advisors		4,000
Total		**5,560**

Source: Andrews 2005.

- **Diversity of FICs and Existing Statistical Operations**: FICs' differing size, physical characteristics, etc., and the differing size and capabilities of statistics operations, spread across different organizations, etc. Diversity may necessitate varied solutions.
- **Staffing**: Qualified staff are scarce and in high demand, and higher salaries are available in other agencies. Staffing a regional statistics office with existing NSO staff would have serious implications for the remaining functions of NSOs.
- **Existing TA Providers**: These have a strong affinity with SPC, with regional statisticians recently requesting that SPC create more economic statistics positions. Also, the proposed upgrade of Pacific Financial Technical Assistance Centre (PFTAC) would undoubtedly play a complementary role in the provision of data and analysis outputs. Overlaps in their functions must be avoided.

Creation of Regional Office to Protect Intellectual Property Rights

Overview

Protecting intellectual property rights (IPRs) may not, at first glance, seem an important issue for small Pacific countries, in contrast to industrialized countries. But the issue is relevant for FICs, due to the Trade Related Aspects of Intellectual Property Rights (TRIPS) agreement reached during the Uruguay round of the GATT. This international agreement calls for the standardization of IPR protection among all members of the WTO and potential new entrants. It effectively requires all developing countries that are WTO members to raise their intellectual property protection level to the standard in force in industrialized countries at the time of negotiation. The requirement is thus a condition of WTO membership.

Fiji Islands, PNG, and Solomon Islands are already WTO members, and Samoa and Tonga have WTO observer status—a precursor to possible future membership. These five countries clearly have an interest in meeting the TRIPS international standard in the most cost-effective way. Each currently has national laws and systems in place to protect IPRs, although they do not yet comply fully with international standards.

For these five FICs at least—and in time others—it is worthwhile assessing the likely net benefits of creating a regional office to provide IP services more cost-effectively in the region. The aim would be to avoid duplication of services and take advantage of potential economies of scale and scope in order to reduce service and compliance costs in the region by harmonizing IP standards and procedures.

In a study commissioned for this report,[37] Susan Farquhar reviewed IPR systems in place in four of the above-mentioned five FICs (Fiji Islands, PNG, Samoa, and Tonga), and assessed the likely financial impact of several options for creating a regional IP facility. The main findings of her cost-benefit analysis are summarized below.

Main Components of IPR Protection

IPR elements include copyright, patents, trademarks, industrial designs, circuit layouts, geographical indications, protection of undisclosed information, and control of anticompetitive practices in contractual licenses. The most important of these for the four FICs reviewed are copyright and trademarks.[38] Systems to protect these IPRs are essentially as follows.

- **Copyright** is generally protected as an automatic right, requiring no application process leading to registration.
- **Trademarks** (along with patents and industrial design), on the other hand, are granted on the basis of an application and examination process, consisting of at least an assessment of compliance with formality requirements and usually also an assessment of compliance with substantive requirements for registration.

The main focus for a regional IP office should therefore be the administration of trademark applications and registrations, with the capacity for their examination as to formality and substantive requirements, and only formal examination of what patent applications might be received.

Current State of IP Operations in Fiji Islands, Samoa, Tonga, and PNG

The IP operations of three of the four countries studied (Fiji Islands, Samoa, and Tonga) may be characterized as having limited resources in both staff and operational equipment, lacking modern administration systems and record management, and largely lacking in relevant personnel skills and training.

PNG differs from the other three in that it has an agency with sole responsibility for IP, and does not have dual responsibility for other registration systems, such as company and business names. The PNG IP office is adequately resourced and is meeting its national requirements efficiently and effectively. It has a modern computerized system for administering trademark applications and registrations and for monitoring the time frames and deadlines associated with their processing. Its staff has high entry-level qualifications and receive adequate training in IP operations.

Options for Creating a Regional IP Office

The preliminary study examined four options for creating a regional IP facility. The options differ in terms of (i) partial or full devolution of national functions (except for enforcement) to the regional office; and (ii) whether the regional office is created from scratch as a new entity, or by transforming an existing national IP office that is already well developed. The options analyzed relative to the status quo (Option 1) are

- **Option 2: Partial devolution** of national IP functions to an existing agency mandated to act for FICs regionally—i.e., receive and process IP applications up to the point of granting registration, but with national agencies still deciding whether to grant registration;
- **Option 3: Partial devolution** of these national IP functions, as in Option 2, but to a new regional facility created to act for FICs regionally;
- **Option 4: Full devolution** of national IP functions, including registration decisions, to an existing agency mandated to act for FIC regionally; and
- **Option 5: Full devolution** of national IP functions, including registration decisions—as in Option 4—but to a new regional facility created to act for FICs regionally. National agencies would be disbanded.

Qualitative Assessment of Options

Partially devolving national IP functions to a regional office (options 2 and 3) would yield similar benefits in terms of reducing duplication of work in national offices, reducing costs to applicants, harmonizing standards, and optimizing IP skills and resources. The main difference between them is that the setup cost of creating a new office from scratch would be considerably greater. If an existing IP office were to be mandated to act regionally for FICs, as envisaged in Option 2, PNG's dedicated national office (Intellectual Property Office of PNG) would be well placed to take on the role of a regional office.

Fully devolving national IP functions to a regional office (options 4 and 5) would be the most complex and costly to establish, but once established would provide the most efficient and effective regional administration of IPRs, with greatest benefits to users of the system. A single application would have effect throughout the region, with consequential simplification and cost reduction of registration, renewal, assignment, and other procedural actions.

For local users of the IP system some form of regional processing of IP applications (whether option 2, 3, or 4) will bring benefits in the form of simpler application procedures. Ideally this would be a single application for the relevant IPR, which would be examined centrally and then, if eligible for registration, could result in protection throughout the region, instead of multiple applications with often varying standards of registrability for the same IPR. The fourth option would bring the additional benefits for IPR owners of single granting and renewal processes instead of the multiple processes required for nationally granted and maintained IPRs.

Quantitative Assessment of Options

The preliminary study undertook an analysis of the changes—compared with the status quo—in financial flows estimated for each of the above four options for providing IP services on a regional basis on behalf of Fiji Islands, PNG, Samoa, and Tonga. The analysis is based on a detailed series of plausible assumptions about the likely changes in staff and costs under the options relative to the status quo.

Based on estimated costs, the study estimates the cost recovery period (in nominal dollar terms) for each of the options as shown in Table 5.11. The income from the collective management of the rights in musical and literary works, as well as that of related rights, would start in the region of half a million US dollars, rising to US$1 million per annum. There would be benefits in the form of annual costs savings, starting at US$24,000 (partial devolution, with an existing IPR agency) and rising to US$61,000 (full devolution, with a new IPR agency).

Wider Economic Benefits

The study was unable to address the wider, much-debated, but difficult issue of how effective protection of IPRs would contribute to FICs' economic well being. For example, there is a long-running international debate about whether industrialized countries are the main economic beneficiaries of IPRs at the expense of consumers in developing countries.[39] One of the major issues in the debate is whether the costs of IPRs for consumers in developing countries is more than offset by direct foreign investments in such countries which is encouraged by IPR protection.

Table 5.11: Cost Recovery Period for Regional International Property Rights Office Options (years)

Option	Cost Recovery Period
Status Quo	
Partial Devolution, with Existing Agency	2
Partial Devolution, with New Agency	15
Full Devolution, with Existing Agency	2
Full Devolution, with New Agency	4

Source: Farquhar 2005.

But regardless of the answer to this wider question, the fact remains that FICs that wish to gain the benefits of WTO membership will need to bring their IPR protection systems up to international (TRIPS) standards. Finding the most cost-effective, acceptable way of doing so—e.g., one of the above four regional options—should be of more than a passing interest to these countries.

Security

The protection of personal safety, freedom of speech, the upholding of fundamental human rights, liberty to travel without undue restriction, and protection of legitimate property rights, affect the economic and social well-being of FICs. The maintenance of law and order is one important contributor to producing national and regional security outcomes, which are true "public goods" (as discussed earlier). As with all such public goods, public financing of their provision is required as it is impracticable to charge beneficiaries for their enjoyment of such security.

Examined below is the potential for FICs to intervene collectively to create a regional training facility to supply services that would contribute directly to achieving international security, with potential spillover benefits for countries in the region.

Creation of Police Training Facility for External Peacekeeping

Overview

One possible area where regional intervention may be able to enhance the economic and social well-being of FICs is in pooling resources to create a regional training facility to supply civilian police training for international peacekeeping. While the prime beneficiaries of deploying these police in peacekeeping operations overseas would be the residents of the host country, FICs could also benefit directly from the supply of more skilled and widely experienced police in FICs when these peacekeepers return home. The increased level of FIC peacekeepers deployed would also yield private benefits such as extra income for peacekeepers and their families during deployments and secondary effects on the economy, including collection of extra taxes.

The Pacific Islands Chiefs of Police (PICP) Secretariat was commissioned for this report to study the benefits and costs to the region of creating such a regional training facility.[40]

Envisaged Regional Police Training

This potential regional intervention entails creating a police-peacekeeper training facility to equip existing FIC police officers with the skills necessary to fulfill international peacekeeping duties.[41] The essential idea is to create within the ranks of FICs' national police forces a pool of officers who have been trained and attained the requisite skills for police-peacekeeping duties as part of an international peacekeeping deployment group. While officers from this regional pool were deployed overseas, their positions in the national police forces would be filled by other police officers. When officers return home at the end of a peacekeeping tour of duty (assumed to be 1 year), they would be reabsorbed into their respective police forces.

This pool of trained police peacekeepers would provide a potential regional response capability from which to draw upon as required internationally, subject to the requirements of national policing. The pool would not be a special "standing police force" group.

Key Assumptions for Assessment Purposes

For the purposes of assessing the costs and benefits of this potential regional intervention, the PICP study used the following assumptions.

- **Location of Training Facility**:A regional police-peacekeeper training center would be established in a FIC, most likely the Fiji Islands given its size, infrastructure, support services, and status as an international air transport hub.[42] As discussed below, facilities could be shared with other regional police or legal training programs.
- **Eligibility Criteria**: Nominees for this training would be accepted only if they clearly already have sufficient skills that training would be expected to enhance to meet United Nations (UN) standards

for police-peacekeeping deployment, including language as well as basic police skills.

- **Training Capacity**. The regional facility would run one training course at a time, with a duration of 4 weeks and catering to up to 50 trainees.
- **Target Response-Capability Pool**. The target outcome of the intervention would be to enable the region to develop and maintain a total police-peacekeeping response capability of 250 civilian police members who would be available for deployment at any one time.

Qualitative and Quantitative Assessment of Benefits and Costs

The study identifies three beneficial outcomes arising from the proposal.

1. **Improved Social and Economic Well-Being for Overseas Trouble Spots**: Law and order and peace would be restored in other areas of the world where peace is fragile, thereby helping provide a climate in which improved social and economic well-being is possible for residents of those areas.
2. **Extra Income for FICs**: The deployment of civilian police-peacekeepers from FICs would result in extra private income by those deployed in international peacekeeping missions, benefiting them and their families at home via remittances, and yielding additional tax income for FIC governments.
3. **Increased National Police Capabilities for FICs**: Both the training and actual international-peacekeeping experience would enhance the ability of the pool of police-peacekeeping graduates to serve their own communities as police officers when not overseas on a peacekeeping mission.

While the first set of benefits are important, from a regional perspective they should be excluded from consideration, except to the extent that contributing to peace abroad also contributes indirectly to peace in the Pacific region. Measuring the value of the latter contribution would be very difficult.

The study suggests that a Pacific peacekeeping force of 250 officers has the potential to yield about US$3 million per annum in extra private income as remittances home by these officers and savings from salary. It sees this extra income entering FIC economies and leading to wider economic benefits to local communities, including extra tax revenue.

The study notes that creating a regional civilian police-peacekeeping training facility in an FIC would also provide an opportunity to make broader use of the facility for general police training in FICs. Additionally, the practical benefits of common training would be further enhanced through delivery to multiple agencies, and multiple disciplines, in a multi-agency environment, such as a regional law enforcement training center. The study was unable to estimate the likely value of such benefits, however.

Costs

The study identifies two main sets of costs arising from this potential regional intervention:

- training facility setup and operating costs, or the direct costs of establishing and operating the training facility, including intraregional travel to and from the facility, and living costs during training; and
- backfill costs—the costs of "backfilling" police positions vacated by members of the pool while deployed on international peacekeeping missions.

Table 5.12 shows estimates of these costs.

A major issue for individual FICs initially would be to recruit and train enough new police officers to backfill personnel deployed on peacekeeping missions.

Another issue that could arise is that staff in the police-peacekeeping pool, in light of their exposure to opportunities overseas, may be interested and able to exit from policing in the region and seek what they see as more lucrative opportunities elsewhere. This is a risk that would need to be managed by national police administrations.

Who pays?

The income generated through deployment in overseas civilian police peacekeeping missions would not be sufficient to recover the costs. This is mainly because the funds generated in payments to officers on peacekeeping missions would be paid to the officers themselves, not to the government of the country providing them. The study states that even if a percentage of the payment were deducted to offset development and operating costs of the facility, this is unlikely to be sufficient to achieve cost recovery within a reasonable time frame.

Table 5.12: Cost of Establishing and Operating a Regional Police-Peacekeeping Training Facility (US$ million)

Activity	Initial Cost	Ongoing Costs
Construct self-contained training facility	10.00	1.5
Salary/backfill costs @ US$6,000 per person per annum	1.50	1.5
Airfares (return economy) @ US$1,500 per person	0.225	0.225
Meals/incidental costs @ US$30 per person per day	2.80	2.80
Uniform and equipment @ US$500 per person	0.125	0.125
Training costs (including training staff) @ US$500 per day x 200 days	1.00	1.00
Training Center personnel costs (excluding training staff) x 10 persons @ US$35,000 per annum	0.350	0.350
Vehicle leasing costs	0.150	0.150
Computer leasing costs	0.125	0.125
Predeployment costs—Selection Criteria (6 x PIC) @ US$5,000	0.030	0.030
Deployment costs (airfares return economy) @ US$2,000 per person	0.50	0.50
Total Costs	**16.805**	**8.305**

PIC = Pacific country.

Donor funding, therefore, would be required, both to establish the regional training center and also to finance its ongoing operational costs. In reaching this conclusion, the study presumes that no individual FIC would consider a long-term, ongoing financial commitment to support this potential intervention. The study envisages that once the training facility is operating, the UN might fund its recurrent costs, although no approach has been made to the UN.

The study concludes that without initial and ongoing direct financial support, the envisaged regional police-peacekeeper training facility would not be financially sustainable. In light of the study's findings, the likely net benefit to FICs of exporting civilian police-peacekeeping services is uncertain, and intervention feasibility would be dependent on financing by other parties.

Summary of Indicative Costs and Benefits of Potential Regional Interventions

	Regional Intervention	Expected Costs (Indicative)	Expected Benefits (Indicative)
1	**GOOD GOVERNANCE**		
1.1	*Regional Economics and Statistical TA Facility*: Merger of currently dispersed economics and statistical TA resources into one regional **TA facility** to bolster national capacities	An indicative estimate of the cost of such a merger is about F$8 million per annum.	While there is *no panacea* for good governance, these four potential regional interventions—both individually and together—could help encourage open and accountable public-sector management practice.
1.2	*Regional Customs Facility*: An *independent* regional customs **inspection team** to complement national agency roles by providing on-the-spot inspections of customs practices and related training, and by sharing information	An indicative estimate of cost of independent inspection team based in 1 FIC & visiting others for on-the-spot inspections and training calculated to be about F$1million per annum.	*Strengthening* **public-sector governance** in this way could be expected to lead to more effective public-sector action and public-expenditure outcomes.
1.3	*Regional Panel of Auditors*: Strengthen phased in a manner of FIC national public-sector audit capabilities via: (i) **training** and **common standards**; (ii) creating an **OAG federation** and funding regional training through it; and (iii) perhaps then creating a **regional panel of auditors** that could audit regional agencies	An indicative estimate of strengthening phases is calculated be Phase 1 = about F$2.3 million Phase 1–2 = about F$29.0 million Phases 1–3 = about F$40.0 million.	These interventions could help FICs avoid the potential high economic costs of poor governance—in terms of future GDP foregone—estimated to potentially total some US$13 billion over 10 years for 3 FICs alone (i.e. PNG, Fiji Islands, and Solomon Islands). These particular cases were studied in view of their past governance failure.
1.4	*Regional Ombudsman Office*: Create an *independent* regional **ombudsman** office to hear citizens' complaints about public-sector actions and decisions in FICs with no such office, and to recommend how to resolve them	Salary costs at F$200,000 (including administrative support) for a single resident ombudsman. Additional costs of country visits and hiring of short-term experts (if needed) should not exceed F$300,000, for total annual costs of F$500,000.	

	Regional Intervention	Expected Costs (Indicative)	Expected Benefits (Indicative)
2	**ECONOMIC GROWTH**		
2.1	*Liberalize regional labor markets.* Increase quotas of unskilled workers from FICs to work in Australia and New Zealand on a temporary basis. Promote sector-specific arrangements for skilled and semiskilled labor.	Cost for regional skills development in FICs would be significant initially (see 2.2), but would return net economic benefits over time. Welfare losses for FICs due to lost skills of US490 million over 3 years.	Total welfare benefits of US$1.1 billion over 3 years. Private benefits for Pacific Islanders of US$1.5 billion over 3 years. Welfare benefits to Australia and New Zealand of US$326 million
2.2	*Pacific Regional Nurse training Facility*: Create a publicly funded regional nurse training facility primarily to train nurses to standards that would enable them to work offshore where nurses are in short supply.	Estimated *total cost* of tuition fees per nurse graduate at the proposed Pacific island regional facility would have an NPV of about F$33,100 (@ a 3% discount rate).	By contrast, a nurse graduate's extra income due to training at this regional facility and 10 years employment overseas as a nurse is estimated to have an NPV of about F$200,000.
2.3	*Further Harmonization of Fisheries Access Arrangements*: (i) Review whether more harmonization of fisheries access fees would create more value for FICs jointly; (ii) Adopt open, audited register of all bilateral fisheries access arrangements (including fees); and (iii) Review longer-term sustainability of FICs' current basis for access fees charged.	Analysis of reviews of existing fisheries access arrangements and the development of the WCPTC—which includes coastal FIC states and DWFNs—raises questions about the *opportunity cost* of the **status quo** continuing and, indeed, its *sustainability* over the longer term.	The suggested **reviews**—and the creation of an open, audited **register** of bilateral fisheries access arrangements of all FICs—are expected to enable answers to these questions, and enable informed proactive action to improve public economic benefits from fisheries.
2.4	*Liberalization of Telecommunications Market*: Create a **regional telecommunications authority** to promote in FICs telecom market liberalization, fair competition, harmonized regulations and policies, universal service, and fair pricing.	Study suggests that the costs of regulatory changes envisaged would be quite small.	Market liberalization as envisaged would benefit FIC consumers over a 5-year period by an estimated US$285 million (@ 5% discount rate).

	Regional Intervention	Expected Costs (Indicative)	Expected Benefits (Indicative)
2.5	*Joint Procurement of Petroleum Products*: Create: (i) a regional **regulatory agency** to regulate private petroleum suppliers; and (ii) **SOE ownership and operation** in FICs of petroleum terminal facilities, and subregional bulk petroleum supply arrangements.	If the **status quo** petroleum supply situation for all FICs continues over the next 15 years, *total opportunity cost* for them estimated to be about US$27 million in NPV.	Creating the regional regulatory agency alone is estimated to yield a very small total net benefit, with an NPV of about US$0.1 million. But implementing both stages, would yield a sizable total net benefit, with an NPV of about US$104 million for the countries assessed.
2.6	*Pacific Aviation Security Office (PASO)*: Create and operate PASO—a regional agency to provide **aviation security services** for the region, encompassing airworthiness, flight operations, security and aerodromes.	Estimated total cost of the PASO operations with 6 member countries is estimated to be about US$800,000 per annum (initially about US$900,000 per annum, before the withdrawal of 1 member).	PASO is a more cost-effective solution to the need for better safety and security regulation in FICs. It was estimated to yield cost savings of 10% yearly with 7 members, and total savings with an NPV of about US$458,000 over 20 years, for an internal rate of return of 27%. With 1 less member, cost savings will be smaller, but sizeable positive net benefit.

	Regional Intervention	Expected Costs (Indicative)	Expected Benefits (Indicative)
3	**SUSTAINABLE DEVELOPMENT**		
3.1	*Regional Sports Institute*: Create a regional sports institute to support (i) *sports-specific regional training centres*; and (ii) *national sport-development units* in FICs.	Study suggests that US$30–50 million yearly would be needed to fund extra **costs** of *capital works* for venues, *accommodation,* and *transport* and *other operational expenses* for the first 5 years of sports institute's operations.	Study estimated that the regional sports institute could generate health-related economic benefits to the region well in excess of US$10 million. Study also suggested that the estimated costs of the institute would be similar in amount the economic benefits already believed to be flowing into the region annually as a direct result of FICs sports involvement.
3.2	*Regional Statistical Office*: Create: (i) a **comprehensive regional statistical office** including all aspects of statistical functions; or (ii) **specialist regional statistical office** with a narrower, more specialized range of functions to complement national statistical services.	Total cost of these two regional statistical office options estimated at comprehensive office = between US$13million and US$15 million per annum, specialist office = about US$5.5 million per annum.	Either intervention's main benefits would be: (i) greater comparability of statistics between FICs; (ii) more reliable, timely, and accessible statistics; (iii) better management of statistical functions; and (iv) a focus to attract development assistance. These results would be expected to lead to better public-sector management decisions in FICs and, thereby, better economic and social outcomes.
3.3	*Regional Office for Intellectual Property Rights (IPR)*: Create Pacific island regional IPR office with partial or full devolution of national functions, in conjunction with an existing IPR agency or as a new one.	Estimated *range* of costs of these regional IPR office options would be: Partial devolution, with an existing IPR agency: initial *extra one-time cost* of about US$80,000. Full devolution, with a new IPR agency: Initial *extra one-time cost* of about US$410,000.	Corresponding to the extra one-time cost, estimated benefits in the form of ongoing costs saving, viz: Partial devolution, with existing IPR agency: *ongoing cost savings* of US$24,000 per annum. Full devolution, with a new IPR agency: *ongoing cost savings* of US$61,000 per annum.

	Regional Intervention	Expected Costs (Indicative)	Expected Benefits (Indicative)
4	**SECURITY**		
4.1	*Regional Training Facility for Police Peacekeepers*: Pool resources to create a regional training facility to provide a response capability of 250 civilian-police for international peacekeeping duties.	*Initial one-time cost* of this facility would be about US$17 million, and have an *ongoing cost* of about US$8 million per annum.	*Private benefits* in the form of remittances home total an estimated US$3 million per annum. Without external funding, the benefits did not cover costs.

FIC = Forum island country, F$ = Fijian dollars, GDP = gross domestic product, IPR = intellectual property rights, NPV = net present value, OAG = Office of the Auditor General, PNG = Papua New Guinea, SOE = state-owned enterprise, TA = technical assistance, US$ = United States dollar, WCPIC = Western Central Pacific Tuna Commission, @ = at, & = and.

ENDNOTES

1 The independent studies, or working papers, are listed at Appendix 1 and can be viewed on the web site of the Asian Development Bank (ADB) (www.adb.org/publications) or at www.pacificplan.org.

2 Adapted from 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.

3 This section is based on analysis and findings in a study Professor Ron Duncan undertook for the Pacific Islands Forum Secretariat (PFIS). See Appendix 1.

4 The Pacific Financial Technical Assistance Centre (PFTAC) was created in 1993 with funding from the United Nations Development Programme (UNDP), International Monetary Fund (IMF), ADB, Australia, New Zealand, and Japan. It is managed on behalf of donors and Forum Island Countries (FICs) by the IMF.

5 For example, the head office in Suva could service Vanuatu and New Caledonia as well as Fiji Islands. Subregional offices could be set up in Port Moresby, Apia, and Majuro.

6 This section is based on analysis and findings in a study Professor Ron Duncan undertook for the PIFS. See Appendix 1.

7 This finding is based on an analysis of import and export statistics using *standard international trade classification* (SITC) codes at the one-digit level.

8 This section is based on analysis and findings in a study Professor Michael White undertook for the PIFS. See Appendix.

9 The South Pacific Association of Supreme Audit Institutions is an embryonic federation of the regions' offices of auditor generals (OAGs).

10 While the Fiji Islands OAG is well developed, it still does not have the capacity to undertake all desirable audit functions.

11 HarperCollins. 1995. *Collins Concise Dictionary*. Third Edition. City: HarperCollins Publishers.
12 Walmsley et al. 2005.
13 In December 1988, members of the World Trade Organization (WTO) decided to include labor mobility in the Uruguay round of the General Agreement on Trade on Services. In particular, they discussed the idea of enabling *temporary* movement of natural persons ("mode 4") between member states.
14 The model does not distinguish between permanent migration and temporary labor movement.
15 Duncan, Ron. 2005. Benefit-Cost Analysis of a Regional Nurse Training Facility. See Appendix 1.
16 By contrast, countries like the Philippines, with a reasonably long history of their nurses working overseas, have been able to establish a reputation for their nurses, and therefore new immigrants find a well-established route for gaining employment as a nurse.
17 This is the extra income *less* the opportunity cost of employment in the Fiji Islands and less the difference in basic living costs between Australia and the Fiji Islands.
18 van Santen and Muller 2000.
19 For example, Principle 4 regarding contracts states that "All government and public sector contracts [are] to be openly advertised, competitively awarded, administered and publicly reported."
20 I.e. with the fee expressed as a percentage of reported value of landed catch.
21 E.g. a total allowable catch quota for a defined period of years.
22 McMaster, James. 2005. *Costs and Benefits of Deregulating Telecommunication Markets in the Pacific*. Prepared for PIFS. The study makes use of the tariff and revenue data available in the April 2005 edition of the International Telecommunications Union Data Base, the *Asia-Pacific Telecommunity 2004 Yearbook*, and many research publications and case studies from websites.
23 This estimate assumes that (i) the telecommunications markets are fully competitive with strong price competition among the providers operating on a level playing field; and (ii) the regulator will ensure that new entrants have access to the fixed line network owned by the former monopoly provider at fair access rental rates.
24 The benefits to New Zealand consumers were improved service availability, in terms of access to new services, fault service response, and new service installation times.
25 Typically such services are subsidized from profits on international calls.
26 The experience of the Eastern Caribbean Telecommunications Authority, which has such a role, supports this view.
27 Morris 2005.
28 It assumes public ownership of such assets would be achieved by building or buying new assets, whereas an obvious lower cost option would be to buy existing privately owned assets. Similarly, the assets owned by state-owned enterprises could be privately operated under a suitable long-term contract (e.g., lease and manage contract).
29 The costs and benefits are expressed in constant dollar terms and do not include nominal increases due to inflation.
30 This section is based on ADB staff analysis and reports on the proposal. See Guild and Costello 2004.
31 This is not feasible for individual civil aviation authorities reliant on outsourcing simply to supply core services.
32 The internal rate of return is the discount rate which if applied to the stream of financial flows of benefits and costs over the project life of the Pacific Aviation Security Office, would result in a net present value (NPV) of zero. In other words, applying any lower discount rates (such as those applied in other studies reported on in this chapter) would still produce a positive NPV.

33 See Appendix 1.
34 This is based on gross domestic product (GDP) per capita data and an assumption that increased participation in sports would on average increase life span by 5 years.
35 Unlike the Regional Economics and Statistical Technical Assistance Facility discussed earlier in the chapter, this statistical body would be focused primarily on compiling and publishing statistics, not providing technical support.
36 See Appendix 1.
37 See Appendix 1.
38 The Fiji Islands and Papua New Guinea each receives in excess of 600 trademark applications per year, most being filed by foreign applicants. Anecdotal evidence suggests many filings are common to the four countries.
39 See Naghavi 2005.
40 See Appendix 1.
41 Experience suggests that such duties would mostly be carried out under the auspices of the United Nations (UN).
42 Indeed the UN has recently announced the Fiji Islands will host one of three regional peacekeeper training centers.

CHAPTER 6

The Political Economy of Change

Overcoming the Barriers to Change

Our analysis in previous chapters has suggested that poor economic governance in a number of FICs—and the instability and occasional insecurity that followed—have imposed very substantial economic burdens on the citizens of those countries. The estimates undertaken by consultants and summarized in Chapter 2 indicate that the benefits of addressing governance issues—estimated at some US$8 billion over 10 years—dwarf by a considerable order of magnitude the benefits from any other key goal of the Forum considered in the Pacific Plan.

There are, moreover, compelling economic and social reasons for addressing this issue on a regional basis, rather than attempting to just strengthen national institutions through bilateral or multilateral programs. In many FICs, existing institutions of governance are themselves underfunded and too small to function in the manner required to address complex governance problems. Even in larger societies there is a reluctance to impose sanctions against those who violate normal international standards of good governance. External strengthening of FIC governance structures through bilateral donor programs carries considerable risk for the donor. *Regionalism offers an effective way of strengthening such institutions.*

Similarly, we have seen that the economic benefits of a policy of providing temporary market access to labor markets of all Pacific Islands Forum members would create very substantial economic benefits for all parties—FICs, and Australia and New Zealand. In the example of nursing, an area of very substantial shortages, a trade and development initiative has been suggested. It is estimated that the benefit to the region from a 1%

opening of labor markets in developed Forum members—filled by FIC workers—would be equivalent to US$1.6 billion, accruing over 3 years.

If these estimates are even approximately correct, then why have the potential beneficiaries of measures aimed at temporary labor movement and improved governance not implemented them on their own? The answer lies in what economists term a "political economy of change" problem. This problem is very much at the heart of the challenge of creating a new regionalism through the Pacific Plan. Like the benefits of trade liberalization, the benefits of good governance and market liberalization are shared by many while the costs are imposed on a few. However, the few losers are often well organized and vocal, and in position to oppose reforms that will result in improvements in governance, or more liberal markets. The potential beneficiaries of good governance are widely dispersed, and often have limited or no understanding of the relationship between their predicament and the absence of good governance.

The question, then, is how to manage the change from the current situation to superior circumstances. In economic theory, the resolution of such a problem is simple enough: the gainers compensate the losers. Such an approach to changes in governance arrangements clearly would be inappropriate. Other methods are needed. Where group consensus is required to reach agreement, however, only one participant need support maintenance of a poor governance regime to block development of alternative governance arrangements that may benefit all.

The region's development partners and the donor community have a significant interest in good governance. Table 6.1 shows that major donors to the region, such as Australia, New Zealand, the European Union, and Japan have devoted substantial amounts of development assistance to FICs where governance and security have been problematic. They can be expected to continue to provide further such assistance for the foreseeable future.

When the donor community acts on a bilateral basis to address governance issues, however, such action is too often seen as direct interference in the internal affairs of sovereign island states. The manipulation of such perceptions by those who benefit from poor governance through orchestrated nationalist reaction to bilateral intervention has occurred in the Pacific as well as in other regions. Bilateral intervention of this type thus

Table 6.1: Grants from Donors to Fiji Islands, Nauru, Papua New Guinea, and Solomon Islands (constant 1995 US$ million)

	Fiji Islands (1973–2003)	Nauru (1975–2003)	Papua New Guinea (1973–2003)	Solomon Islands (1978–2003)
Australia	318	61	7,400	276
European Community	111	10	594	211
Japan	122	5	227	108
New Zealand	20			16
United Kingdom			44	163
Total	**593**	**76**	**8,300**	**778**

Source: Organisation for Economic Co-operation and Development, Development Assistance Committee, online database.

poses risks for the donor community, and donors have considerable interest in mitigating these risks. Regional institutions, however, should in no way be seen as "political cover" for bilateral or international donors, but as the region's best chance for genuinely regional responses to regional and national economic problems. At present there are no economic institutions or policy bodies in the Pacific region that deliberate on the future economic policy of the region.

On the issue of temporary movement of people to satisfy labor shortages in developed countries, the question is why OECD countries do not voluntarily opt for such arrangements given the aging of their populations and their need for labor. The reason may be that while the proposed liberalization of labor mobility is a "win-win" situation for OECD countries and FICs, the current situation is net win for OECD countries. The migration of skilled labor as currently allowed by OECD countries is in effect a transfer of trained human and economic resources from developing to developed countries. This is true even after considering the net benefit of remittances coming back to the host country. The results of research commissioned for this report (Walmsley et al. 2005) indicate clearly that the current situation—severely restricted access of unskilled FIC labor to Australia and New Zealand combined with relatively unrestricted and permanent movement of skilled labor—is a worst-case scenario from the viewpoint of FIC welfare.

Providing an alternative to the current system, predicated solely on migration and the resulting net transfers of wealth, thus faces barriers similar to those confronting a move to good governance. In the absence of any international system of compensation, which is unlikely to emerge, a shift away from the current use of migration to a trade and development approach based on temporary movement to deal with labor shortages in OECD countries requires a wholesale shift in thinking.

To manage the change, it is necessary to devise a mechanism or instrument that allows all Forum members to move away from present suboptimal positions to a position where all parties are better off. The two areas where economic benefits will be substantial for all parties are governance and temporary movement of people. Governance is the issue of greatest immediate concern to Australia and New Zealand, while the temporary movement of people is of greatest interest to FICs seeking gainful and remunerative employment opportunities for their citizens. Nevetheless, FIC citizens will gain from better governance at home, and Australia and New Zealand will undoubtedly benefit from reduced bottlenecks in their labor markets. In this dilemma may lay the seed of an agreement between the parties. However, temporary movement of labor is not likely to be of interest to those five countries (Marshall Islands, FSM, Palau, Cook Islands, and Niue) that have virtually unfettered access to either New Zealand or the United States (US). It is principally in Kiribati, Melanesia, and Tuvalu where this proposal will be of greatest economic and political value.

To manage change from the current situation, a narrow focus on governance and labor movement may not be sufficiently broad. The concerns of all Forum members must in some way be addressed to encourage the entire Forum membership to agree to an instrument for change. The concerns of aid and sustainable development should consequently be addressed in such an instrument. Provision of long-term guarantees of assistance in a contractual arrangement should be of interest to all FICs, with the possible exception of PNG, which already has such a contractual arrangement with Australia.

A departure from the current suboptimal situation must draw on the experience of clubs and the lessons learned as discussed in Chapter 3. The pool of benefits must be large if the participants are to remain in the club and the club is to remain viable. An element that has traditionally cemented relationships and created stable clubs in the Pacific is the right of citizens to move where salaries are more remunerative and where economic opportunities are greater. This element will need to be present in the Pacific Plan to ensure its success and stability.

A Legal Structure for the Pacific Plan

A legal structure for the Pacific Plan could provide a long-term vision, and reflect as closely as possible the key goals of the Forum agreed by leaders—governance, security, economic growth, and sustainable development. A legal structure should also group a set of proposed regional initiatives under each of the four pillars. Such proposed initiatives were examined in Chapter 5. Several of the proposed initiatives should be implemented as soon as possible as short-term, confidence-building measures.

The Long-Term Vision

The long-term vision for the Pacific Plan should see *negotiation of an agreement where all members would make commitments toward good governance in return for a renewable 5-to-10-year aid and trade agreement*.

Aid[1]

There are two reasons why aid commitments are a necessary part of any legal arrangement that is developed between Forum members. First, the assurance of a stable aid relationship between the FICs and Australia and New Zealand would be seen as one of the major benefits to all Pacific island countries. It is not necessarily the volume of development assistance, but its stability, continuity, and predictability that are of considerable value to FICs. The second reason is that, as pointed out in chapters 3 and 4, new regional arrangements agreed under the Pacific Plan will require specific, long-term, and additional financing to ensure their effective establishment, ongoing viability, and capability to deliver on the vision of Pacific leaders.

Relative to their size, aid to FICs—while varying considerably—is high by international standards. Nonetheless, there has been a substantial decline (40%) in total aid to FICs (excluding the "US Compact" countries)[2] since 1980, with PNG—arguably facing the greatest development challenges—seeing a 50% decline. Significant increases since 2003 by both Australia and New Zealand, predominantly focused on Melanesia, only partially offset this long- term trend. Insufficient aid levels are clearly not the primary constraint to improved governance and economic growth performance in the Pacific, but this report does concur with the international consensus (Sampson 2005) that (i) aid can promote growth under the right conditions; (ii) aid is more effective in a good governance environment; and (iii) aid can mitigate the negative effects of adverse external shocks and can increase growth in countries vulnerable to such shocks.

In addition to providing certainty and a tangible commitment to partnership with FICs, a long-term aid commitment would therefore

- reduce the vulnerability of FICs to external shocks;
- assist FICs through technical assistance to renew their efforts to address priority governance weaknesses and to implement policy reforms that create an environment conducive to economic growth; and
- support the development of the skills required to take advantage of more integrated regional markets.

More specifically, this report has argued that regional institutions can play a significant role in helping establish an environment in which good governance and economic growth can flourish. Aid commitments to the regional governance pillar of the Pacific Plan (and, indirectly, to the other Pacific Plan pillars) will be essential to help FICs deliver on the governance commitments also proposed under this agreement.

To achieve the twin goals of stability of the aid relationship and adequate additional resources for Pacific Plan initiatives, FICs and Australia and New Zealand should agree on commitments for a 5–10 year period along the following lines:

1. Australia to give at least 0.08% of its GDP and at least 25% of its total aid budget to Pacific Island Forum countries, with FICs excluding PNG to receive at least 0.03% of its GDP;
2. New Zealand to give at least 0.08% of its GDP and at least 25% of its total aid budget to FICs; and
3. at least 25% of Australian and New Zealand aid to FICs to be provided through regional channels, with clearly identified additional financing earmarked for the implementation of priority Pacific Plan initiatives.

The targets do not necessarily represent optimal levels of aid to FICs. They do, however, represent equal burden sharing between Australia and New Zealand while providing adequate resources for both existing bilateral programs and the additional resource demands of the proposed regional initiatives. They are realistic goals based on recent trends in Australia's and New Zealand's aid to FICs.

Trade

In the coming years, FICs have profound decisions that will need to be made on trade relations among themselves, and with the EU, Australia, and

New Zealand. From the perspective of FIC citizens, the single greatest benefit of trade liberalization cannot come from liberalization of agriculture or industry, but rather from liberalized movement of people and the liberalization of services. As noted in Chapter 4, the one resource that the Pacific countries have in great abundance is youth—a resource that is in increasingly short supply in Australia and New Zealand as well as throughout OECD countries. This constitutes a basis for trade that can be made mutually advantageous if Australia and New Zealand open markets in a targeted and market-friendly way, and take a "trade and development" approach to temporary movement, along the lines of the Kiribati-Tuvalu model of training and employing mariners on EU vessels. While FICs seek access to the ANZ market for their nationals, Australia and New Zealand have quite rightly argued that there is only the most limited market demand for unskilled labor, and that skills are required for market access to translate into gainful employment.

While services are normally considered a “second generation” trade issue in regional integration negotiations (usually following a goods agreement), such an approach may not be possible in the case of the Pacific. Further, Chapter 4 case studies showed that many different approaches to regional market integration are possible, and that it is advantageous to begin with the liberalization that yields the largest mutual benefits. In the example of a regional nursing school, we have focused on what we have called a trade and development approach to temporary movement. In this approach, sectors of mutual interest become the focus of market opening commitments along with the development assistance to increase the capacity to supply the necessary labor. There are a number of such sectors. What is needed is a proactive approach to mutually beneficial trade and development agreements involving the training and temporary movement of Pacific nationals.

Governance

Given the difficulties in measuring governance—let alone compliance with vague definitions of "good governance"—this report will not propose specific provisions for governance commitments. However, one vital element of governance commitments is that Forum members accept the proposed regional governance bodies and endeavor to make them a vital part of domestic economic life. The analysis of Chapter 4, particularly that of regional cooperation, suggested that there are multiple ways these commitments can be formulated, ratified, and enforced.

Nonetheless, without bound commitments from development partners to provide acceptable levels of technical assistance, FICs should avoid making legally bound commitments to good governance. This is not because the objective of good governance is not desirable, but rather because such obligations require the implementation of modern methods of economic management that are very often not available in small and isolated FICs. Failure of governance can be the result of a lack of political will to implement what are very often difficult measures, but frequently such failures can be a direct result of the absence of resources and capacity for the implementation of many of the modern standards that are necessary. While providing some services regionally will lower costs of operation, we have seen from several of the prefeasibility studies that these same services—which are currently provided nationally—are very much underresourced. So much so that, in the absence of additional commitments of external resources to regional approaches, FICs making bound commitments to governance could find themselves violating obligations due to inadequate resources.

Short-Term Confidence-Building Measures

A number of proposals highlighted in this report could, if implemented at the earliest opportunity, provide the political momentum necessary to propel the longer-term vision of the Pacific Plan. If properly implemented, they could build on the recommendations of the EPG report and place the "big idea" of Pacific interdependence squarely at the front of the regional political agenda.

The limited time and resources available to the consultants for preparation of this report prevent fully informed recommendations regarding the implementation of any of the projects that have been considered. What has been undertaken are prefeasibility studies that do indicate several projects worthy of full feasibility study. The studies have provided valuable insights into the nature of regionalism in the Pacific. These studies and insights can quickly lead to initial measures that are consistent with the objectives of the Pacific Plan and will genuinely address the concerns and needs of the region.

Projects worthy of full feasibility studies are recommended below. These recommendations, however, should not be construed as a definitive conclusion regarding any particular intervention.

Governance

The Pacific Plan should contain a central focus on governance. This report has emphasized that there is no single panacea for good governance. However, the scale of losses from poor governance argues that action must be taken in strategic areas for good governance if the deterioration in development indicators throughout the Forum membership is to be reversed.

A package of four initiatives is recommended, aimed at improving economic governance. Each initiative requires a regional approach that will strengthen national capacity. Given the importance of governance to the region, this report proposes that all four elements of the governance "package" be implemented as short-term, confidence-building measures. All these projects could be developed within existing regional organizations without creating another regional body. It is vital, however, that (i) clear arrangements are put into place to ensure their proper functioning, their institutional identities, and their separation from existing regional bureaucracies; and (ii) sufficient capacity be put into place so that existing organizations can absorb these new entities.

Reiterating the fuller analysis of Chapter 5, the recommended initiatives include

1. a regional economic and statistical technical assistance facility;
2. a regional facility to assist customs officials in collecting revenue;
3. a regional panel of public sector auditors; and
4. a regional ombudsman

Economic Growth

To increase economic growth and build momentum toward the longer-term vision for the Pacific Plan, two short-term confidence-building measures should be implemented:

1. harmonized regional terms and conditions of fisheries access, and
2. creation of a pacific regional nurse training facility.

Given the importance of economic growth to the region, four other regional initiatives are recommended for consideration:

1. implementing telecommunications liberalization, with an adequate regulatory framework;

2. create a joint purchasing facility for petroleum products and other essential import items; and
3. expanding labor mobility to other areas, apart from nursing.

The creation of a Pacific Aviation Safety Office is already under way, and deserves priority support from Forum member countries to expedite its early, full establishment.

Sustainable Development

As a first-step confidence-building measure, a regional sports institute would have significant net economic benefits, depending upon its success in training a new generation of athletes and in disseminating sports and sports-related leisure in FICs. Given the high incidence of lifestyle-related diseases in the region and their high economic cost, an optimal policy would be one that combines the training of athletes with bringing sports persons into the region's education system as teachers.

Two other initiatives would have a significant positive impact and merit further study:

1. a regional statistical office; and
2. a regional body to protect intellectual property rights.

Security

As with governance, there is no single panacea to counter rising instability and insecurity, particularly while FIC performance under the other three pillars—especially governance—remains weak. One area where regional intervention may be able to enhance FIC economic and social well-being is in pooling resources to create **a regional training facility to supply civilian police training for international peacekeeping.** The success of the Regional Assistance Mission in Solomon Islands has demonstrated the considerable positive impact on quality of life from improved policing. At the same time, the rising demand for police forces abroad presents an opportunity for local police forces to not only generate revenue but also gain crucial experience abroad. At the country level, there is scope for positive feedback into local policing and improvement of the employment situation.

Trade Agreements and the Pacific Plan

It is crucial that the Pacific Plan be considered in the context of the many ongoing bilateral and regional trade negotiations occurring within the Forum. FICs are in the process of, or are about to begin, negotiating and implementing trade agreements on a number of fronts. These include

- implementation of PICTA (entered into force April 2003),
- the Economic Partnership Agreement (EPA) with the EU (negotiations commenced in 2002),
- WTO Doha Development Round (negotiations commenced in 2001), and
- PACER negotiations (2011, but could be triggered by May or October 2006)

This agenda imposes a very heavy negotiating and implementation burden on FICs, and also raises key issues of the sequencing of negotiations, legal precedents, and participation in various negotiating fora. There are also vital issues of how these contractual arrangements are to be implemented and how they relate to the emerging Pacific Plan. A possible way forward is proposed below for the reconciliation of these negotiations with the Pacific Plan. The proposal aims, as a key outcome, to strengthen regional cooperation and integration in trade matters. Figure 6.1 summarizes the inter-linkage between the different trade agreements.

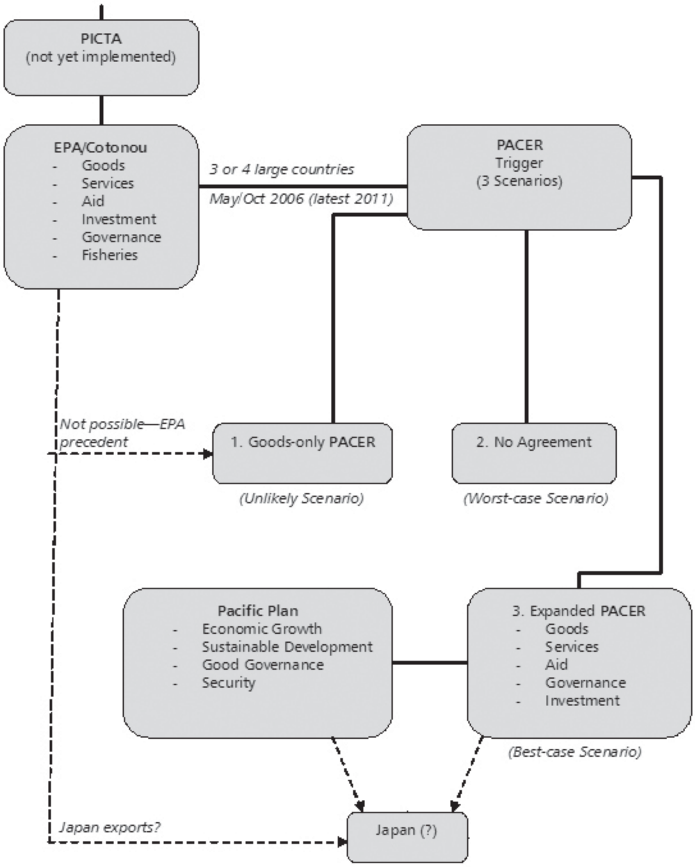
Pacific Island Countries Trade Agreement

While PICTA negotiations are complete, there remain difficult issues over the implementation of obligations under the agreement to eventually establish a free trade area. Implementation of the agreement has slipped due to technical issues, such as rules of origin, and negative lists that have delayed officials.

Economic Partnership Agreements

Pacific ACP (PACP) states have commenced formal negotiations with the EU on a multifaceted agreement covering trade in goods, services, investment, and fisheries. Once the EPA negotiations are completed, PACPs will be party to a contractual EPA/Cotonou agreement that covers aid, trade, political and economic governance, and development. Thus far only three countries are understood to have indicated a desire to negotiate a free trade agreement (FTA) in goods (PNG, Fiji Islands, and Samoa). These negotiations will commence, according to the agreed Road Map, by May or possibly October, 2006. The EPA negotiations envisage a multiple agreement

Figure 6.1: The Pacific Plan and Forum Island Country Trade Agreements



EPA = Economic Partnership Agreement, PACER = Pacific Agreement on Closer Economic Relations, PICTA = Pacific Island Countries Trade Agreement.
Source: Sampson 2005.

arrangement negotiated on an a la carte—i.e., opt-in, opt-out basis—covering goods, services (including temporary movement of persons), investment, and fisheries.

For there to be an FTA in goods between these three, and possibly more, PACPs and the EU, the implementation of PICTA (or the accession of Samoa to the Melanesian Spearhead Group [MSG] trade agreement) is a precondition set by the EU. If the EU and the PACP were to agree to an FTA in goods without first implementing PICTA or extending the MSG to

Samoa, then EU goods would enter PACP markets at a lower rate of duty than that of the PACP neighbors. This would therefore contradict the EU's stated objective of supporting regional trade integration.

Pacific Agreement on Closer Economic Relations

Under the terms of PACER, by April 2011 at the very latest, all FICs need to commence negotiations on an FTA with Australia and New Zealand. If any FIC commences negotiations on a goods agreement with a non-Forum developed country before then, they will automatically trigger the developed country (most-favoured-nation) MFN obligation to enter consultations leading to an FTA under PACER (Article 6.3(a)). For those countries that decide to enter into an FTA in goods with the EU, PACER will be triggered in May or October 2006. At present PACER covers only goods, and there is no obligation on any Forum member to extend negotiations beyond the trade in goods.

If PACER is triggered by Fiji Islands, PNG, and Samoa as a result of EPA in May or October 2006, and there are no changes to the scope of PACER, then Australian and New Zealand trade officials will negotiate a goods-only FTA with these three countries—either bilaterally or as a group. In such case, these three countries can reasonably expect that the negotiations will be more rigorous and concessions required of them more substantial than would be the case if all FICs, including least-developed and small states, negotiated as a group. The remaining FICs will have to negotiate an FTA with Australia and New Zealand by 2011. The precedent established by the negotiations with Fiji Islands, PNG, and Samoa will inevitably determine the shape of the agreement negotiated with the 11 remaining FICs.

A goods agreement with Australia and New Zealand is likely to impose higher adjustment costs on FICs than the EPAs, given the magnitude of Australian and New Zealand imports. Moreover, as the loss of import duties will almost certainly be made up by higher trade-neutral taxes, such as VAT, there is likely to be very limited benefits for FIC consumers and producers. As a result, without a multifaceted trade and development agreement that has sufficient scope and pool of potential benefits to offer mutually advantageous terms to all parties, there is considerable risk that the PACER negotiations based on a goods-only agreement would be unsuccessful.

It must be recalled that the PACER obliges members to commence negotiations on an FTA. If the terms are not deemed to be mutually beneficial, however, then there is no obligation to complete such FTA negotiations with Australia and New Zealand. The likelihood of a goods-only PACER failing will rise the more benefits the EPA negotiations provide. FICs would be reluctant to agree to an FTA with Australia and New Zealand, and incur the very high transition costs, if they receive relatively less benefit than they have achieved in the EU negotiations. In the event of a failure of a goods-only PACER negotiation, Australia and New Zealand exports to those FICs that have goods EPAs with the EU would be permanently disadvantaged in comparison to EU exports. While such an arrangement is WTO-compatible, it is of the most doubtful political viability given the size of Australian and New Zealand economic and political importance in the region.

In many ways the Pacific Plan covers areas currently covered by the Cotonou Agreement. It is this fortuitous and coincidental synergy that creates the possibility for the expanded PACER merging with the Pacific Plan. Indeed the objectives of PACER, as set out in Article 2, state that the parties wish to establish a “framework for the gradual trade and economic integration of the economies of the Forum members in a way that is fully supportive of sustainable development,” and “…to provide economic and technical assistance to the Forum Island Countries in order to assist them in implementing trade liberalisation and economic integration.” Thus the stated objectives of PACER are similar, though not identical, to the four pillars of the Pacific Plan.

The Integration of Japan into Pacific Trading Arrangements

Following the completion of the EPA in goods, and of PACER as it is currently formulated, imports into the Pacific from the EU, Australia, and New Zealand will be duty free. Japan is the second or third-largest source of imports for many FICs. It would be the only major aid donor to the region with exports subject to any residual import duties that would exist in FICs following EPA and a goods agreement under PACER. FICs should consider whether such a situation is sustainable. Given the high short-term costs of adjusting to FTAs with the EU, Australia, and New Zealand, the extra cost of a similar trade agreement with Japan may be quite low. Until the year 2000, Japan, as a matter of national trade policy, did not negotiate FTAs. Japan has now reversed this position, and is in negotiations with a number of neighboring countries.

FICs should also reflect on the appropriate sequencing of the inclusion of Japan in Pacific trade negotiations. It may be administratively burdensome to include Japan, as FICs are already negotiating on so many fronts. But including Japan early in the process will potentially provide substantially greater net benefits from a more comprehensive treaty arrangement in the context of Pacific Plan/PACER negotiations (see Figure 6.1).

A Two-Track "Critical Path"

If Forum members approach the Pacific Plan as simply a series of projects to be implemented without a complementary negotiating structure, there is the considerable risk that the international and donor community will see such an approach as a "shopping list." This approach will gain limited support. If, on the other hand, the short-term interventions are given a framework leading to a new approach to regionalism, with demonstrable evidence that all parties are willing to make bound commitments that address the region's problems in a rigorous and comprehensive manner, then the process is far more likely to gain credibility and support within and beyond the region. Consequently, it is vital that leaders embark on a "**two-track approach**" to Pacific Plan implementation. This approach is summarized in Table 6.2 below.

Table 6.2 A Time Line for Regional Integration

Date	Confidence Building Measures	Negotiating Track
October 2005	Forum Leaders decide to commence feasibility studies of 6–7 confidence-building measures outlined above	Forum leaders agree to negotiate a binding arrangement covering governance, trade development, and aid
November 2005	Forum Secretariat begins feasibility studies	Forum undertakes legal and economic feasibility studies and commences dialogue to develop terms of reference for PACER negotiations
June 2006	Forum finance and planning ministers consider results of feasibility studies	Forum trade and finance ministers consider draft terms of reference for negotiations
October 2006	Forum leaders consider recommendations of finance ministers and decide on implementation schedule	Forum leaders consider recommendations from finance and trade ministers on terms of reference for negotiations
January 2007		Negotiations commence for the expanded PACER.

PACER = Pacific Agreement on Closer Economic Relations

The *first track* should comprise a range of concrete measures that build confidence in the process, and confidence in an emerging partnership that will be mutually beneficial to FICs and Australia and New Zealand. The interventions must not be seen as random projects of dubious economic benefit. They should be seen as being consistent with and an integral part of the *second* or *negotiating track*. It has been argued that the negotiation of PACER, scheduled to begin in 2006, should be broadened to cover the areas of the Pacific Plan—security, governance, growth (including trade and aid relations), and sustainable development. PACER negotiations of such scope would thereby become a genuine and comprehensive Closer Economic Relations agreement between Forum members

In order for a credible process to emerge from the current dialogue, there is a need to combine short-term confidence-building measures with a **simultaneous decision** to negotiate a contractual arrangement between all Forum members that encompasses all the areas that have been described in the Pacific Plan. **Therefore, Forum leaders should, at the next leaders meeting in October 2005, agree to full feasibility studies on a range of confidence-building measures, and simultaneously announce the commencement of negotiations of the Pacific Plan/PACER.**

Resourcing the Two Tracks

If the Forum is to endorse the timetable proposed above, the Forum Secretariat will need a commitment for expanded resources to implement both the feasibility studies as well as the negotiations. A period of 3–5 years will be required, where a significant expansion of personnel and financial resources will be needed for a successful completion of negotiations. While a European Commission (EC)-style expansion at this early stage would be unfeasible and counter productive without supplementation, failure to address the resource needs of the Pacific Plan would place great strain on the Secretariat's current capacity. Pursuit of the proposed timetable without expanded resources could jeopardize a beneficial outcome for the entire Forum membership.

The Democratic Deficit and a New Pacific Regionalism

Once Forum leaders commence the process of deepening Pacific regionalism based on contractual commitments, as proposed above, then an important lesson must be learned from the experience of other regional integration bodies. The most advanced regional integration body is the EC, which has evolved into an extremely powerful institution. The EC, however, is perceived by an increasing portion of the European population—rightly or wrongly—as beyond the direct democratic control of its own population. It is for this, among numerous other reasons, that approval of a new European constitution has proven extremely difficult and contentious in national referendums. There is increasing concern in Europe about the potential devolution of further power to a body such as the EC.

While regional bodies in the Pacific are by no means as powerful as the EC, the process of negotiating a substantial treaty arrangement will heighten perceptions that many of the region's bodies are open to potential capture by donor interests, or by the international bureaucracy that manages them. The analysis of Chapter 4 suggests there is substantial precedent both in and outside the region for such an outcome. The likely future financing arrangements for many regional institutions—involving continuation of current substantial aid transfers—heighten these concerns. How can concerns be assuaged that structures emerging from a "new regionalism" are democratic, rather than a mechanism for increasing control by aid donors and regional bureaucrats?

No easy assurance can be given, and this is an issue that requires considerable research and reflection to avoid a repetition of the type of political reaction that the European experiment is currently experiencing. If Forum leaders wish to pursue a deeper contractual integration, then this question of a **political track** to the integration process should be considered at the earliest possible time. Indeed, the Forum and the CROP agencies do not have a governing structure that incorporates a permanent sitting body of members that reviews the full range of regional activities. To create such a body, even with instruments of "carbon-copy" democracy, would require assuring that representatives of all Forum members have a permanent representative based in Suva. This is necessary as a very first step to a more representative arrangement. The smaller FICs would need assistance to assure that each has a voice in a permanent decision-making and oversight body based at the Forum Secretariat. This could be the first step toward an eventual "Pacific Senate" with elected representatives.

If the region is to seriously pursue a deepening of integration, it is incumbent upon the Forum and its members to commence, at the earliest possible time, a public dialogue on future democratic structures, and allow leaders and citizens to reflect on the appropriate mechanisms of democratic governance.

One conceptual issue that needs to addressed is that of "equality of membership." Will a PACER/Pacific Plan have institutions that treat all members equally? The analysis has so far focused entirely upon the needs of FICs, without addressing whether the institutions that would be created by a PACER would apply equally to all members. Such a question would appear to be rhetoric in nature as "equality before the law" lies at the very heart of international public law. However, several interesting possible anomalies might arise. It has been assumed throughout that the institutions that require strengthening are only those found in FICs. Indeed, the institutions pertaining to governance, security, sustainable development, and growth are strong in Australia and New Zealand, but it is not inconceivable that situations may arise where regional institutions could be called upon to undertake analysis or investigation in Australia and New Zealand. It is hardly inconceivable, for example, that a regional ombudsman could, under certain circumstances, be asked to undertake an investigation in Australia or New Zealand and release a nonbinding report. This consideration—applied across all of the proposed regional initiatives—should seek to ensure that the "rules" of the region's institutions apply equally to all members.

ENDNOTES

1 This section draws heavily from Sampson (2005).

2 The three former US territories—Federated States of Micronesia, Marshall Islands, and Palau—receive long-term financing through their Compacts of Free Association with the United States.

Appendixes

Appendix 1: Working Papers Commissioned by the Asian Development Bank and the Commonwealth Secretariat for the Report—Toward a New Pacific Regionalism

CHAPTER 2	
An Assessment of the Scope for Regional Cooperation, Integration, and Collective Provision on Security Issues	**Graham Hassall** Pacific Institute of Advanced Studies in Development and Governance (PIAS-DG) University of the South Pacific Suva, Fiji Islands
Notes on the Economic Performance of Small States 1995–2003	**Thomas Sampson** Research and Analysis Unit Bank of Papua New Guinea Port Moresby, Papua New Guinea
CHAPTER 4	
A Cost-Benefit Analysis of the University of the South Pacific to the Region	**Michael White** University of the South Pacific Suva, Fiji Islands
South Pacific Forum Fisheries Agency: Benefits and Costs	**Michael Hyndman** Pacific Plan Office, Forum Secretariat Suva, Fiji Islands
Retrospective Cost-Benefit Analysis: Air Pacific and Forum Line	**Jesoni Vitusagavulu** Top Tier Management Suva, Fiji Islands
CHAPTER 5	
Quantitative Assessment of the Cost of Governance Failure in Fiji Islands, Nauru, Papua New Guinea, and Solomon Islands	**Ron Duncan** PIAS-DG University of the South Pacific Suva, Fiji Islands
Valuation of Imports into Fiji Islands, Kiribati, and Papua New Guinea and Avoidance of Customs Duty	**Ron Duncan** PIAS-DG University of the South Pacific Suva, Fiji Islands
A Pacific Regional Panel of Auditors: A Cost-Benefit Analysis	**Michael White** University of the South Pacific Suva, Fiji Islands

A Permanent Economic and Statistical Technical Assistance Body for the Pacific Island Countries	**Ron Duncan** PIAS-DG University of the South Pacific Suva, Fiji Islands
Benefit-Cost Analysis of a Pacific Regional Nurse Training Facility	**Professor Ron Duncan** PIAS-DG University of the South Pacific Suva, Fiji Islands
A Regional Sports Institute: Preliminary Cost-	**The Secretariat of the Oceania National** Suva, Fiji Islands
Pacific Islands Police Peacekeeping Operations: A Cost-Benefit Analysis	**Secretariat of the Pacific Islands** Chiefs of Police Suva, Fiji Islands
Small Island States Bulk Procurement of Petroleum Products: Feasibility Study	**Jared Morris** Pacific Islands Forum Secretariat Suva, Fiji Islands
A Regional Statistics Office for the Pacific	**Michael Andrews** Pacific Financial Technical Assistance Centre Suva, Fiji Islands
Costs and Benefits of Deregulating Telecommunication Markets in the Pacific	**Jim McMaster** University of the South Pacific Suva, Fiji Islands
Regional IPR Office for the South Pacific	**Susan Farquhar**
The Impact of Liberalizing Labour Mobility in the Pacific Region	**Terrie L. Walmsley, S. Amer Ahmed,** and Christopher Parsons Global Trade Analysis Project (GTAP) (University of Purdue, United States) and University of Sussex, United Kingdom
Chapter 6	
Aid to the Pacific: Past, Present and Future	**Thomas Sampson** Research and Analysis Unit, Bank of Papua New Guinea Port Moresby, Papua New Guinea

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[1] 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,[2] 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:[3]

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.[4] 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 inabilities 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.[5] 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 same FICs; and
- integral to internationally agreed frameworks for sustainable development, especially those relevant to small island states, such

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.[6] 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.

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[1] 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.

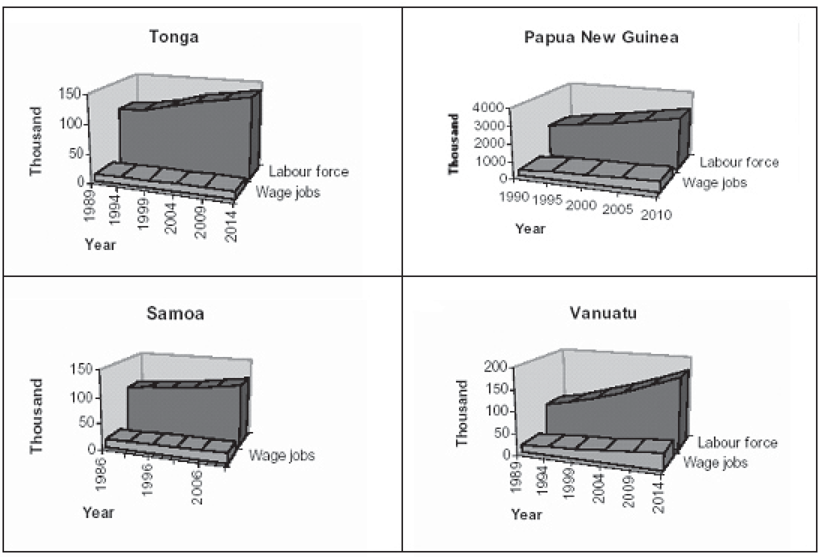
The private sector in many FICs faces high transactions costs, significant regulatory obstacles, and a high level of "crowding out" of investment by the public sector. A large proportion of potentially profitable FIC sectors are effectively monopolized by state bodies to fund general expenditure, further 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[2] 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.[3]

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	–	–
Country Average	**28.5**	–	–

– = 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[1]

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.[2] 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.[3]

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).[4]

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[5] 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 Dependent Variable	(a) Log of Average GDP per Capita 1995–2003	(b) Average Growth in GDP per Capita 1995–2003
Small States	1.09[a]	(0.181)
	-0.807[b]	(0.394)
Sub-Saharan Africa	6.14[a]	(0.143)
	1.29[a]	(0.340)
Asia	6.89[a]	(0.224)
	2.00[a]	(0.427)
Europe and Central Asia	7.72[a]	(0.216)
	3.48[a]	(0.347)
Middle East and North Africa	7.62[a]	(0.239)
	1.48[a]	(0.522)
Western Hemisphere	7.52[a]	(0.143)
	1.64[a]	(0.339)
OECD Countries	2.40[a]	(0.204)
	-0.669[c]	(0.399)
Oil-Producing Countries	0.828[a]	(0.256)
	-0.548	(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.[6]

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.

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 mili-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.

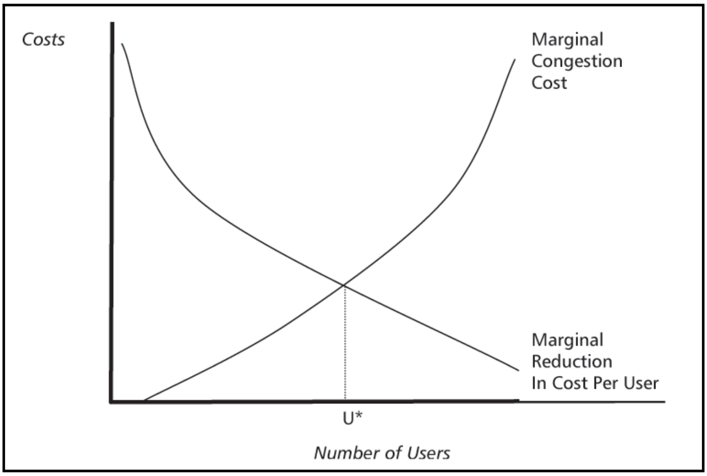
When more members of the community make use of the park, then the park may become overcrowded. These costs are known as *congestion costs*.

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.[1] 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.[2] 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 xi 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 yi, X, and s subject to the resource constraint Fi (•) yielding two first-order conditions,

$$MRS_{iXy} = MRT^i_{Xy}$$
$$MRS_{i\,y}^{\;s} = MRT^i_{sy}$$

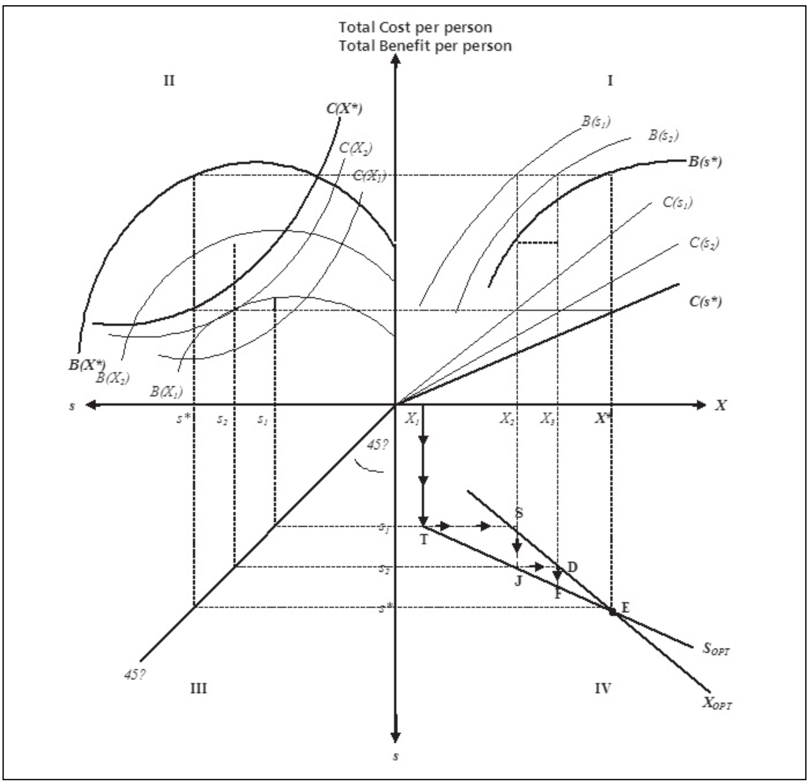
for $i = 1,\ldots,s$ yielding respectively the provision conditions (optimal X) and membership conditions (optimal s).[3] The provision condition states that each member equates the marginal rate of substitution (MRS) between the club good and the *numeraire* private good to the marginal rate of transformation (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.[4]

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.[5]

The graphical representation[6] 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.[7] The upper right-hand quadrant I describes the provision condition. A given membership size (s_1) dictates the position of the benefit and cost curves $B(s_1)$ and $C(s_1)$. 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_1, s_1) to the optimal (X^*, s^*) is denoted by the path X_1TJSDF.

Financing and Tolls in the Buchanan Model

In the homogenous-agent Buchanan model, the implicit price of membership or toll[8] 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 $i = 1,\ldots,s$ 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 $(E^s_i{=}1\, MRT^i_{Xy})$ equal the club's marginal cost of provision *(MRTXy)*. This "finance condition" or "toll condition" can be expressed as

$$kT = \mathrm{MRT}_{Xy}$$

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

$$u\, y(i),\, x(i),\, f\,(1^{s} x(i)\, di,\, X\,),\, i$$

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 *[1, ?]* is put forward, a social welfare function that weights members’ and non-members’ utility (subject to a resource constraint) is maximized.[9]

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:

$$\mathrm{MRS}^{i}_{Xy'} = -1^{s} f_{1}\, \mathrm{MRS}_{fy}\, (i) di$$

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.[10]

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

$$kT = \mathrm{MRT}_{Xy}$$

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.[11]

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.[12]

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.[13]

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.[14]

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 30th 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 neting 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 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"[1]

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,[2] 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).[3]

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.

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[1]

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.[2]

ECOWAS

ECOWAS joins 16 West African countries from Cape Verde to Nigeria.[3] 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.[4]

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.[5]

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.[6] 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.

ENDNOTES

1 This section summarizes the findings of World Bank. 2000. *Trade Blocs*. Washington DC: World Bank.

2 *Cotonou 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"[1] 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.[2] 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.[3]

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.[4] 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.

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.[1] Nonetheless, the gains achieved thus far have been considerable. Studies conducted by the European Commission (EC) *ex-ante*[2] 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.[3] 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%).[4] 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.[5]

The Caribbean Community's Single Market Economy (SME)[6]

Regional market integration is one of three stated objectives in the founding 1973 Treaty of Chaguaramas.[7] 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)[8] 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)[9] 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[10]

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 11th. 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.[11]

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[1] 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. . .[2]

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[3] *plus* any resultant change in *consumers' surplus* as a result of the intervention.[4]

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.[5]

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,[6] 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[7] or government interventions[8] 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:[9]

> 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[10]—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.

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.

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