

DRAFT REPORT



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Pacific Island economies

The role of international trade and investment

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Glossary

ADB	Asian Development Bank
ACP	Asia Caribbean and Pacific
AusAID	Australian Agency for International Development
CPA	Country Partnership Agreement
DFAT	Department of Foreign Affairs and Trade
EPA	Economic Partnership Agreement
EU	European Union
FSM	Federated States of Micronesia
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IMF	International Monetary Fund
ITC	International Trade Centre
LDC	Least Developed Country
MSG	Melanesian Spearhead Group
PACER	Pacific Agreement on Closer Economic Relations
PIE	Pacific Island Economy
PATCRA	Papua New Guinea Australia Trade and Commercial Relations Treaty
PICTA	Pacific Island Countries Trade Agreement
PNG	Papua New Guinea
PTA	Preferential Trading Arrangement

SIC	Small Island Country
SPARTECA	South Pacific Regional Trade and Cooperation Agreement
SPS	Sanitary and Phyto-Sanitary
TMNP	Temporary Movement of Natural Persons
TRIPS	Trade Related Aspects of Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
VAT	Value added tax
WTO	World Trade Organization

1

Introduction

PACIFIC ISLAND COUNTRIES (PICS – here taken to mean the developing economy members of the Pacific Forum) and their engagement with the rest of the world have features which are different from many (though not all) other developing economies. These special characteristics could be stylised as follows.

- With the exception of Papua New Guinea, the countries are small isolated islands or fragmented collections of islands: with relatively limited resource bases, their economies are fairly undiversified and quite dependent on imports. Quasi-subsistence agriculture and fishing are often important parts of the economy.
- Geography impedes domestic economic integration as well as integration with the world and regional markets: high costs of internal transport constrain market access and the development of services that would provide incentives for specialisation and shifts away from subsistence production.
- Aid has traditionally been very important and has underpinned large public sectors: it has also supported a significant share of trade, either directly as grants or indirectly through preferential trading arrangements: this has had significant ‘Dutch disease’ consequences for both exporting and import competing activities.
- In some countries, outward emigration and inward remittance flows are very important.
- For many countries exports involve (sometimes unsustainable) exploitation of natural resources (timber, fish) or minerals (oil, gold, copper).
- Taxes on trade (exports and imports) comprise a large share of government revenues, adding to the disadvantage faced by exports that are not associated with significant rents.
- Foreign investment is quite heavily regulated, and there are considerable ‘behind the border’ constraints on investment, including complex customary land tenure systems, obstructive regulation, monopolisation of key sectors, especially transport and communication

services. These constraints also impeded domestic investment in activities targeting international and domestic markets.

Some of the preferences that have provided sheltered markets for exports of some commodities (such as sugar, textiles and clothing and automobile components) have been or are being eroded. Long term trends in fuel prices look to exacerbate the transport cost problem of some Pacific economies, although they are clearly improving the terms of trade of energy and mineral exporters, and creating opportunities for production of fuel substitutes using local tree crops.

Enthused by the strong evidence of the critical role that openness to international trade and investment is playing in the successful growth performance of the more successful developing economies, donors are encouraging Pacific economy governments to reduce policy and institutional barriers to international trade and investment. At this stage, the principal vehicles for doing this appear to be encouraging regional integration, and increasingly, reciprocal granting of trade preferences. There is also continued support for participation in the multilateral trade architecture of the WTO.

Given the particular circumstances of PICs it is worth asking whether trade liberalisation and the particular path currently being pursued makes good sense for the Pacific.

This report considers the following issues:

- While isolation and size might lead Pacific economies to tend more towards autarky than other countries, it is not clear that protectionism is a sensible long-term option: this simply raises the costs of engagement with the rest of the world even further. It is also not clear that protectionism is an easy policy to implement. The ability of the larger Pacific economies to control borders is limited by geography, resources and culture.
- Further, for some economies, there will be continued international competition for access to their natural resources and political support in international forums. The question then is: what is the best way to maximise the benefits from international trade and investment and to minimise the cost? This requires thinking about what complementary actions might be required to realise the gains from greater openness, and what challenges pursuing these avenues might pose in the context of Pacific islands governance and social structures.
- What are the technical and political economy merits of unilateral, regional and multilateral approaches to liberalisation and integration,

and what leverage, if any, the economies can exert in linking trade and development issues in negotiations with larger economies?

- From a purely economic point of view, current regional integration initiatives in the Pacific do not seem to offer much return for the effort involved. What has been, and what might be, achieved with PICTA, PACER, MSG and EPA?
- Unilateral liberalisation on an MFN basis would be the best approach. But some Pacific economies may feel that there are rents or mercantilist gains to be achieved from preferential trade agreements with other parts of the world
 - ... What can Pacific economies hope to achieve from these agreements?
- How much effort should Pacific economies make to engage with the multilateral trade architecture? Given limited capacity (and the higher priority demands for use of this capacity), the ease with which many of the gains from trade can be achieved from unilateral action, and the costs of implementing agreements, what are the net benefits of pursuing a WTO agenda, individually or in concert with other economies?
- What is the logic of approaching broader regional integration initiatives, involving the sharing of institutions, with market integration through trade and investment agreements as the starting point?
- What are the benefits for Pacific Island and developed Pacific economies of liberalisation of the movement of natural persons?
 - Does it help to see schemes to allow such movements as trade in services issues? and
 - What is the case for including such liberalisation in trade agreements?

The principle positions put forward in this report are

- PICs have nothing to gain from retaining barriers to international trade and investment.
- They can achieve nearly all of the standard gains from liberalisation on a unilateral basis: it is not clear that anything much is gained from binding liberalisation to progress on regional trade and investment agreements, even if they include New Zealand and Australia or the European Union.
- However, policy barriers to trade and investment are probably not binding constraints to investment and growth in PICs

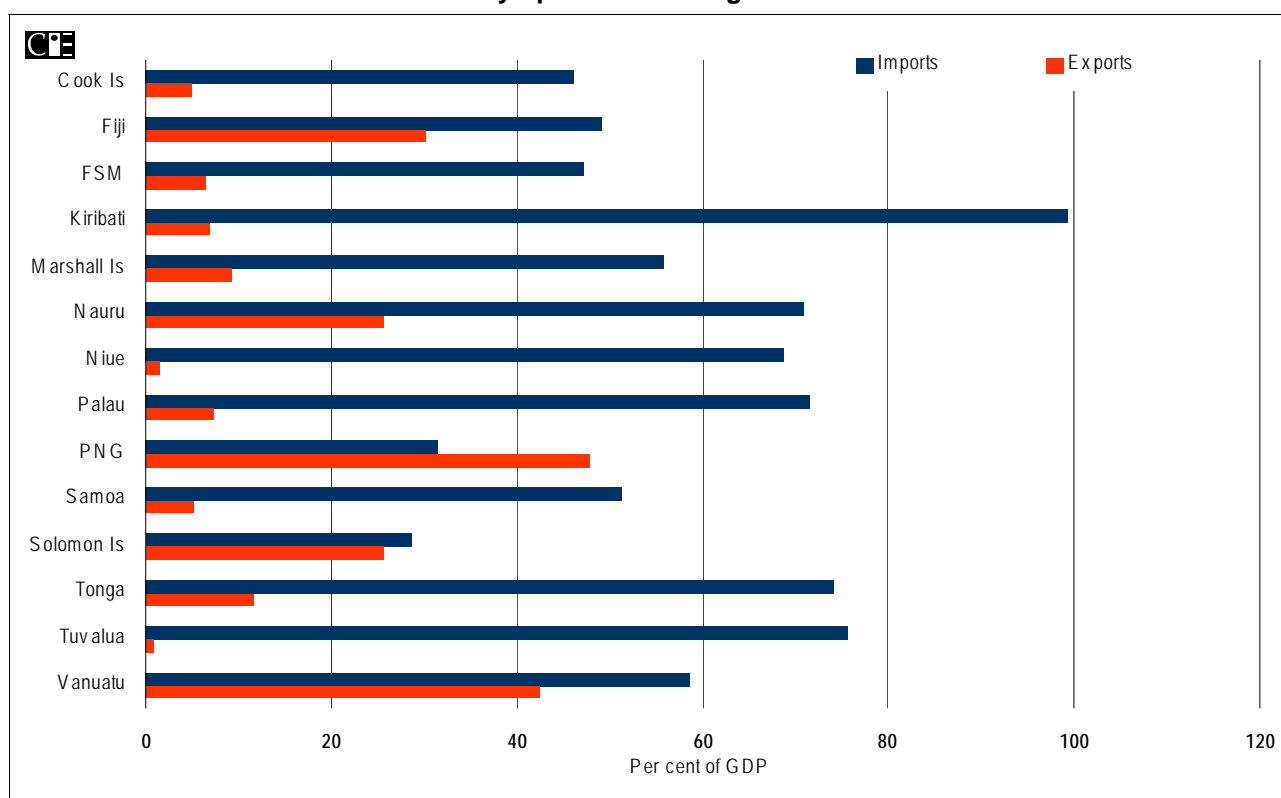
- For some PICs, geographic, resource and size constraints are critical – although technological changes have the potential to reduce the burden of some of these.
- For others, livelihood strategies and informal institutional arrangements that have served well to manage risks and optimise community well-being do not readily lend themselves to a situation in which specialisation and formal contractual behaviour are the keys to future development.
- The costs of sovereignty are high for some PICs, not only in terms of resources that are allocated to running the apparatus of government, but also because of the distractions from dealing with development issues that arise. There is a strong case for assisting PICs to reduce these costs, and a broader approach to regionalism is an important way to address this. But this approach need not be tied to or preceded by market integration, as has been the case in other such initiatives (such as the European Union).
- There is a pretty convincing case for New Zealand and Australia to continue to work on allowing temporary migration of Pacific Islanders to take up work. But this is better addressed as a development issue rather than as a trade in service issue to be negotiated in a trade agreement.
 - Temporary labour migration schemes are too important to be subject to the search for compensating concessions that pervades trade negotiations. It would be much more relevant to discuss them in the context of how New Zealand and Australia support development in the Pacific.
 - The challenge will be how, over time, to sort out the best mix of development assistance aimed at improving job creation in PICs and migration schemes targeting employment of Pacific peoples in the labour markets of New Zealand and Australia.

2

Trade and financial flows

TRADE IS PART OF THE LIFEBLOOD OF PACIFIC ECONOMIES. While they do not contribute much to world trade, PIC's export and import flows are quite large compared with GDP (chart 2.1).

2.1 Pacific Island nations are relatively open considering their size



^a No data is available for Niue.

Data source: ADB (2006).

Over the last decade, the value of recorded exports and imports for the Pacific economies as a group has remained relatively stable, averaging US\$2 921 million and US\$3 316 million, respectively, each year. With the exception of PNG, the economies all run significantly negative trade balances: exports returns finance often quite small proportions of national imports, although as chart 2.1 shows, the extent of the deficit varies significantly across economies.

(Any conclusions about the structure, level and direction of the trade of PICs have to be qualified by recognition of the probable extent of unrecorded trade flows. The infrastructure and institutional capacity to accurately monitor and record trade flows in most PICs is limited, and some policies encourage the use of informal channels. While aid donors do assist in funding both capacity building programs and the costs of monitoring, a proportion of trade flows goes unreported. Where bilateral trade is to or from a larger trading partner, commodity composition and value can be estimated using counterpart figures. But where flows are to a similarly institutionally weak or under-funded environment, the probability that most transactions are recorded can be low.)

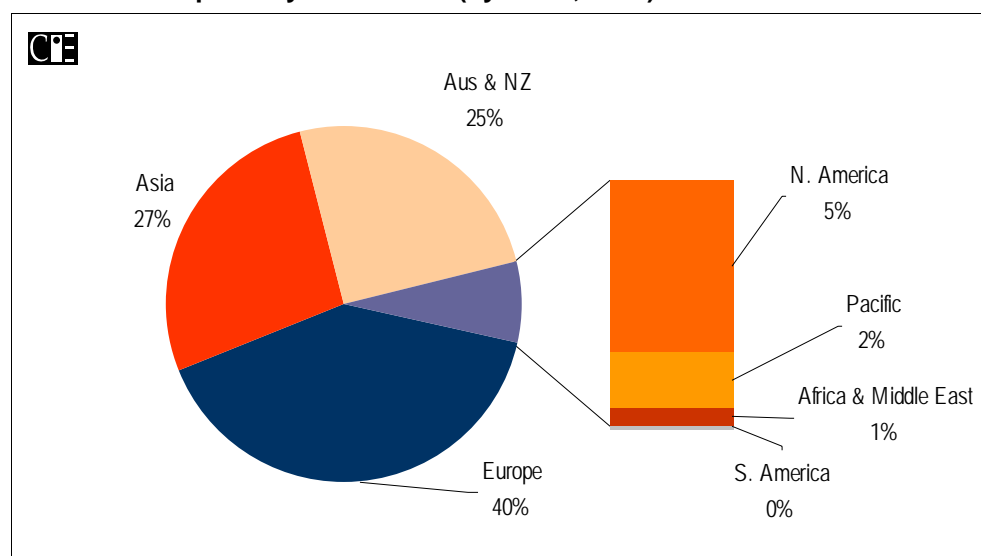
Historical and current trade flows

Historically, trade flows to and from Pacific Island nations have varied across source, destination, commodity composition and relative importance to each economy. The size of each economy, population, landmass and availability of natural resources, including both aquatic and mineral based resources drives some of these trade differences. Trading patterns built up under colonial systems persist, and institutional arrangements, such as currency regimes, and preferential trading arrangements – such as those determined under the European Union’s treaty relationships with Africa, Caribbean and Pacific (ACP) countries – help shape the direction of trade.

Direction of commodity trade

Some of these factors probably help to explain why PICs export more to Europe than to the United States. In 2004, Pacific Island nations’ exports to Europe were 8 times larger than exports by value to North and Central America (chart 2.2). Importantly, the value of formal trade between Pacific Island nations is very limited, accounting for around 2 per cent of imports in 2004.

2.2 Pacific exports by destination (by value, 2004)

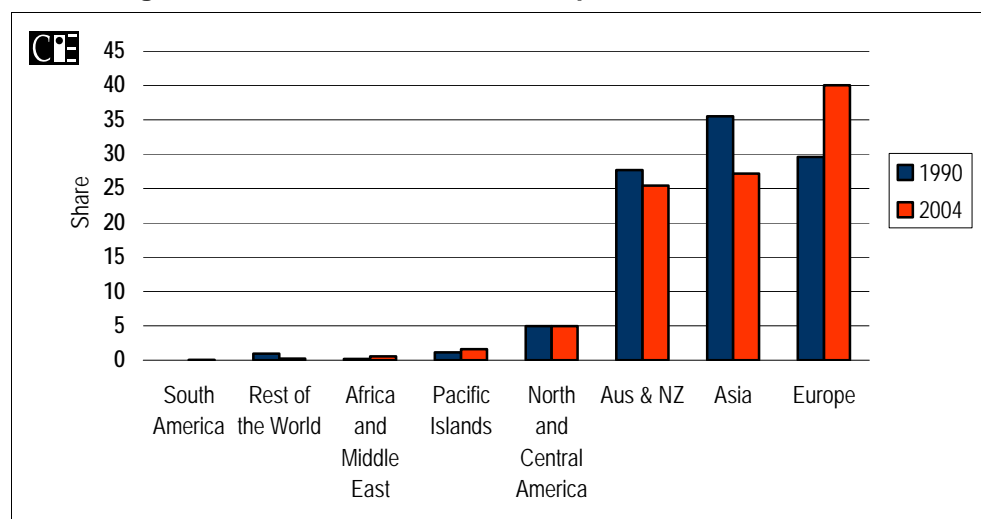


^a Cook Islands, Fiji Islands, Kiribati, Marshall Islands, Micronesia, Fed. States of, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands

Data source: ADB (2006).

There have been some changes in the direction of trade in the last 15 years. As chart 2.3 shows, the share of exports going to Asia and Australia and New Zealand has declined, as the share destined to Europe has increased. However, the share of imports from Australia and New Zealand and Asia has expanded at the expense of the shares accounted for by Europe and North and Central America (chart 2.4)

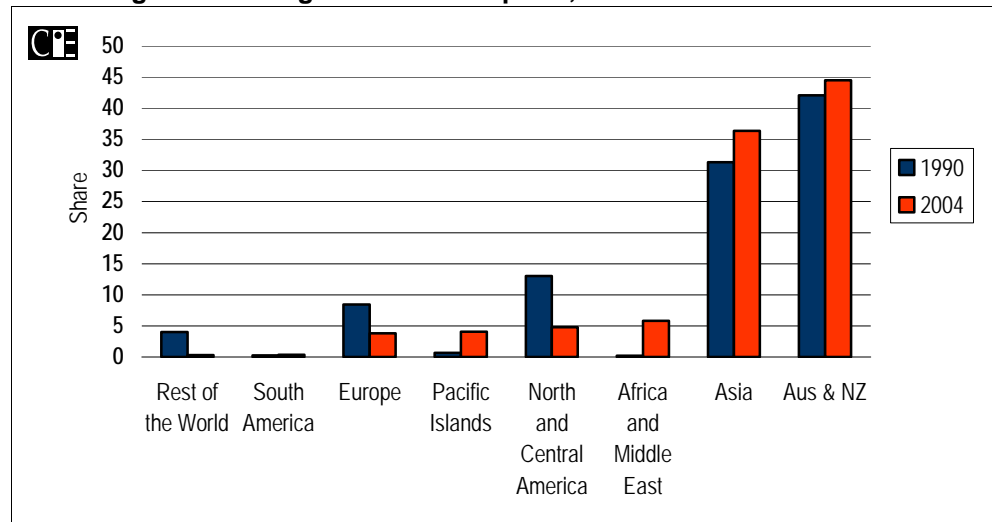
2.3 Changes in the destination of Pacific exports, 1990 to 2004



^a Cook Islands, Fiji Islands, Kiribati, Marshall Islands, Micronesia, Fed. States of, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands

Data source: ADB 2006

2.4 Changes in the origin of Pacific imports, 1990 to 2004

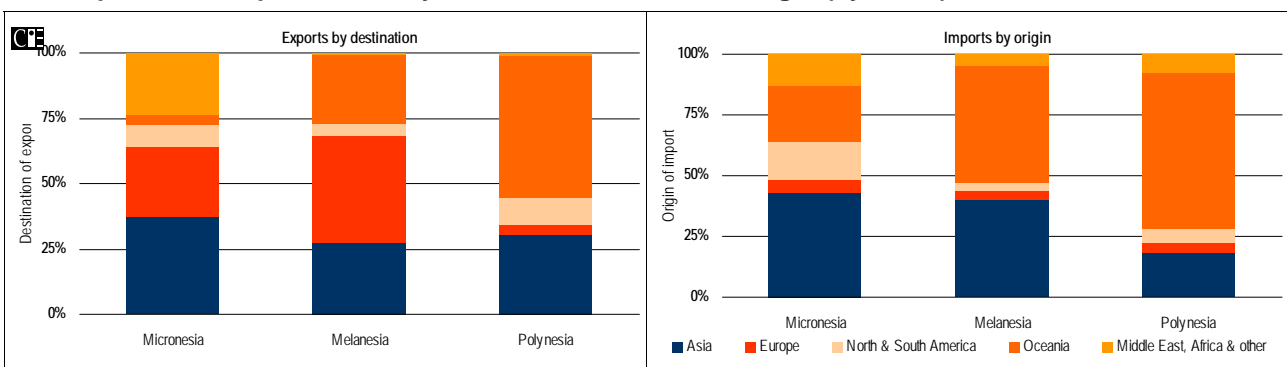


^a Cook Islands, Fiji Islands, Kiribati, Marshall Islands, Micronesia, Fed. States of, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands

Data source: ADB 2006

The directions of trade vary significantly across Pacific economies. As chart 2.5 shows, Melanesian economies as a group export proportionately more to Europe, while over 50 per cent of the exports of Polynesian economies go to Oceania, primarily Australia and New Zealand, which are much more important sources of imports into Melanesia and Polynesia than for Micronesian economies.

2.5 Exports and imports differ by source destination and origin (by value)



^a Data is not available for Niue.

Data source: ADB (2006).

One factor which might be thought to explain some of the variation in directions of trade is the currency regime of each Pacific economy. Nauru, Kiribati and Tuvalu use the Australian dollar, Cook Islands and Niue the New Zealand dollar, and Marshall Islands, FSM and Palau use the US dollar, while Fiji, PNG, Samoa, Solomon Islands, Tonga and Vanuatu have their own currencies. As table 2.6 shows, however, currency regimes may

2.6 Trade shares and currency regimes

Currency regime/PIC	Share of imports			Share of exports		
	Australia	NZ	USA	Australia	NZ	USA
\$A						
Nauru	59.1	0.0	3.4	0.3	0.0	0.5
Kiribati	36.0	8.7	2.5	1.1	0.0	9.0
Tuvalu	10.6	4.0	0.0	0.1	0.0	0.0
\$NZ						
Cook Is	4.3	82.9	0.8	2.6	18.9	4.3
Niue	0.0	97.6	0.0	0.0	100.0	0.0
\$US						
Marshall Is	14.0	3.5	68.1	0.0	0.0	0.0
FSM	8.3	0.0	61.9	0.0	0.0	33.4
Palau	3.0	0.0	0.0	0.8	0.0	0.0
Own currency						
Fiji	27.7	17.8	2.3	19.2	3.7	23.6
PNG	45.2	7.5	2.8	27.7	0.0	1.2
Samoa	9.6	23.1	5.3	60.7	1.6	4.9
Solomon Is	25.3	5.3	1.9	2.2	0.0	0.0
Tonga	10.3	46.7	6.7	1.5	3.9	24.9
Vanuatu	15.5	6.0	0.0	1.2	0.0	0.9

a

Source: ADB (2006).

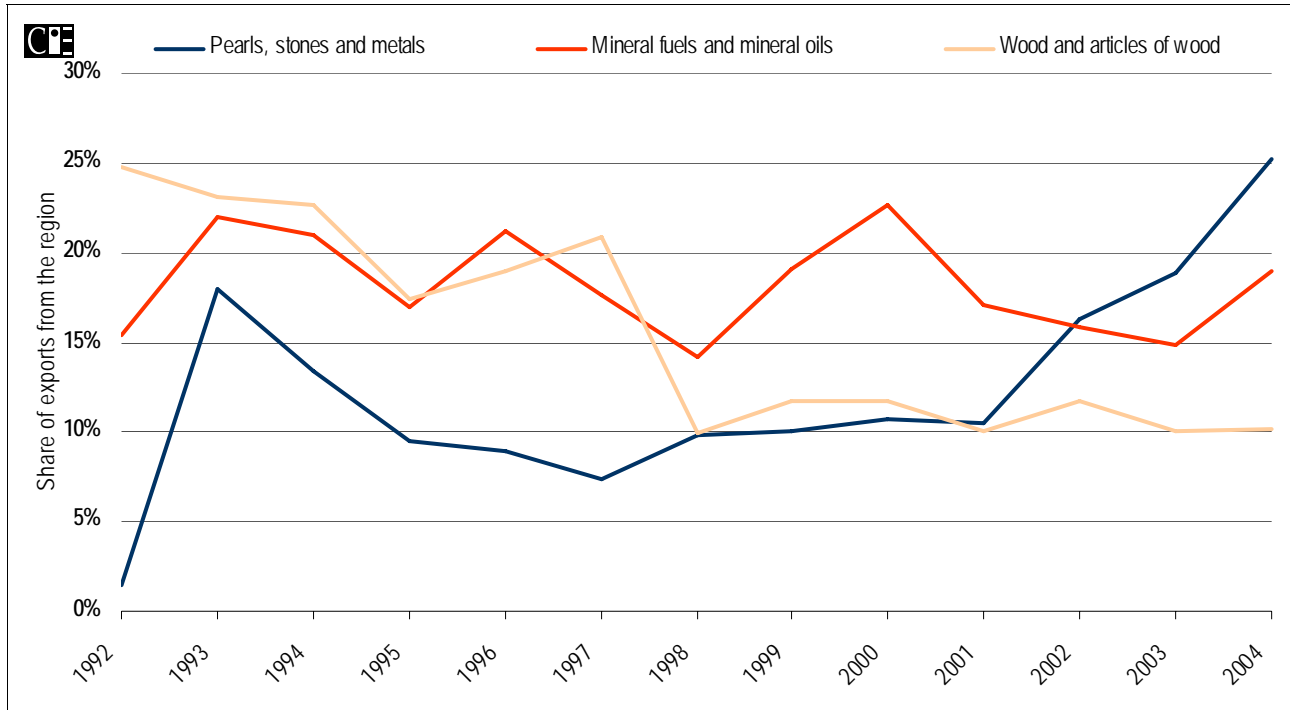
not be a strong explainer of which countries PICs export to, but may have some influence on the origin of imports.

Cook Islands and Niue certainly purchase most of their imports from New Zealand, and Marshall Islands and FSM get around two-thirds of their imports from the US, and Nauru buys 60 per cent of its imports from Australia. However, other countries such as Tuvalu and Palau acquire quite small shares of total imports from the country whose currencies they use, and some countries with independent currencies seem to resort to Australia and New Zealand as major sources of imports (for example PNG and Tonga). Economies that are in some kind of association with metropolitan countries may also receive significant transfers that are tied to importing from the source country: so heavy reliance on that source may be less a function of the ease of transacting in a single currency than of the obligations associated with aid flows.

Composition of commodity trade

Natural resources dominate exports, accounting for 54 per cent of all export earnings in 2004 (chart 2.7).

2.7 Natural resources contribute significantly to export earnings



Data source: STARS UN database.

However, this result is heavily influenced by Papua New Guinea's mining and oil extractions. On a sub-region by sub-region analysis, there is only limited consistency of what is exported. Melanesian (excluding PNG) exports are influenced by Fiji's sugar and garment exports and the Solomon Islands timber products, while Micronesian and Polynesian exports are often skewed by the importation and re-exportation of equipment and capital equipment such as ships and aircraft. That is, trade flows to and from Pacific Island economies are not homogenous. Rather, large variations in the relative size and composition of trade are apparent, even on a country by country basis. Table 2.8 presents information on the principal export commodities of most Pacific economies.

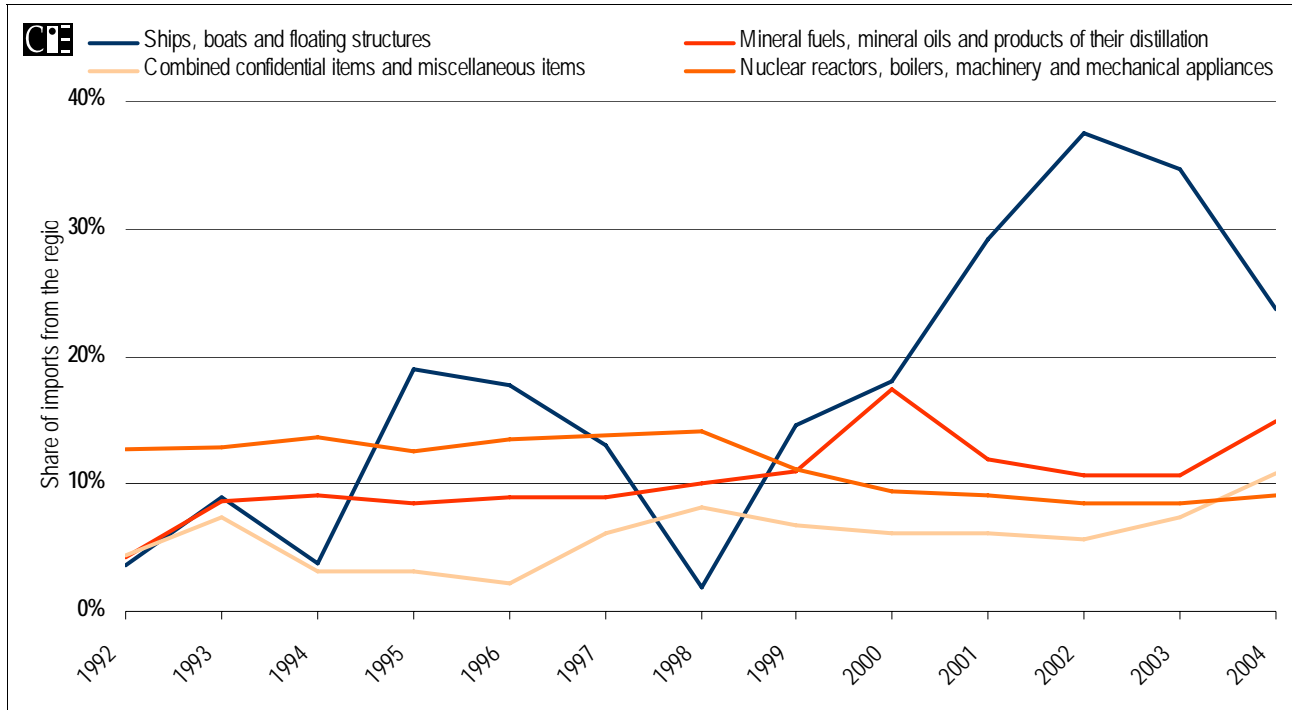
2.8 Principal export commodities

<i>Economy/commodity</i>	<i>Share of exports</i>	<i>Economy/commodity</i>	<i>Share of exports</i>
	%		%
Cook Islands		Marshall Islands	
Fish	38.9	Coconut oil	16.7
Pearls	34.2	Copra	15.0
Fruit and vegetables	2.5	Fish and trochus	8.0
Clothing and footwear	2.1	Re-export of diesel	61.6
Fiji		Samoa	
Garments and textiles	21.7	Fish	47.3
Sugar and molasses	18.6	Garments	25.1
Fish	7.1	Beer	9.8
Gold	6.7	Coconut cream	7.3
FSM		Taro	3.0
Fish	65.4	Solomon Islands	
Garments	22.1	Timber	65.3
Betel nuts	4.9	Fish	17.7
Kiribati		Cocoa	7.2
Copra	27.6	Copra	2.1
Seaweed	11.9	Tonga	
Fish	9.0	Squash	41.4
Palau		Fish	21.7
Garments	24.6	Vanilla	1.0
Fish	13.0	Vanuatu	
PNG		Copra	9.0
Gold	35.2	Beef	7.7
Copper	17.8	Timber	9.0
Crude Petroleum	21.0	Cocoa	1.2
Forest products	5.6		
Palm oil	5.6		
Coffee beans	3.8		

Source: ADB 2006, STARS UN database.

While exports largely consist of minerals, fish, garments and tree crop products, heavy machinery, transportation equipment and fuel dominate imports into Pacific Island nations, accounting for almost 50 per cent of all imports in 2004 (chart 2.8).

2.9 Imports are dominated by heavy machinery, transportation equipment and fuel



^a Nuclear reactors, boilers, machinery and mechanical appliances (HS code 84) includes mechanical equipment such as air-conditioners, fork lift trucks and other manufacturing equipment.

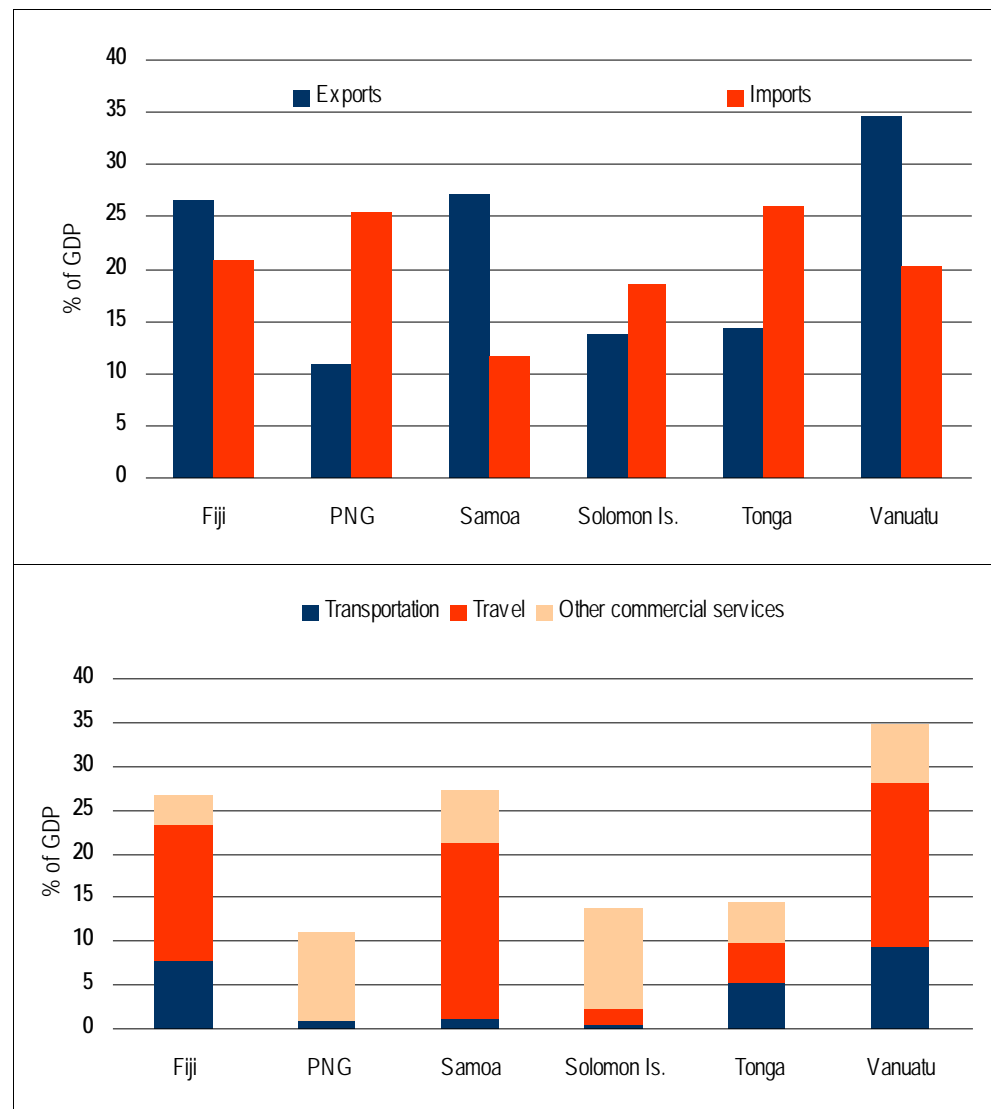
Data source: STARS UN database.

Trade in services

The data available on trade in services in the Pacific region, although limited, suggests that foreign exchange flows from exports of services are significant for some PICs. Chart 2.10 shows data for six of the Pacific region countries. Service exports average 21 per cent of GDP for these countries. As the chart shows, for Fiji, Samoa and Vanuatu, travel services dominate these exports. This largely reflects the importance of tourism in these countries.

Tourism is an activity based firmly on comparative advantage, making use of resources that are abundant and accessible in the Pacific islands, including spectacular scenery, clean environment, isolation and seclusion. The high transportation costs associated with Pacific Island tourism are offset by the remoteness, which contributes to the rarity and pristine quality.

2.10 Trade in services as a share of GDP

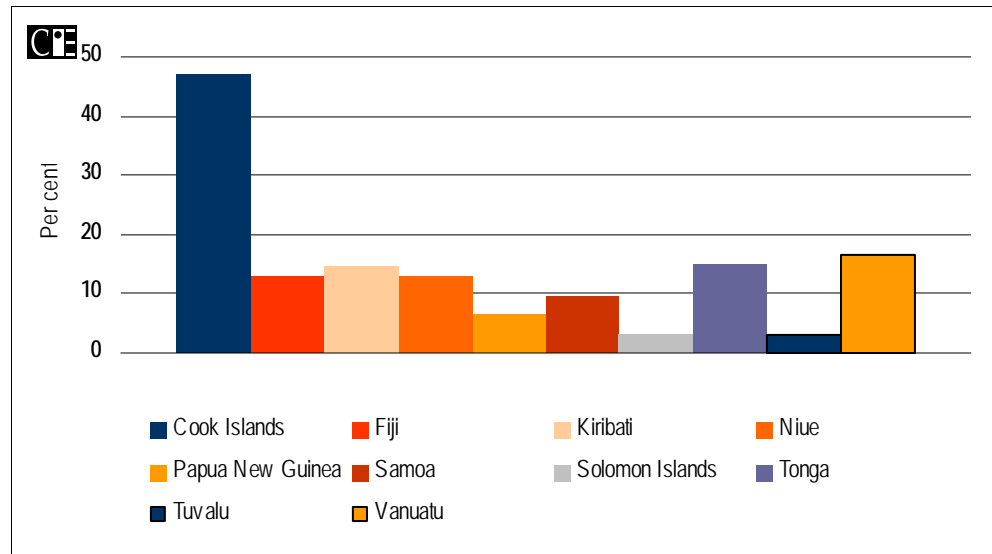


Data source: WTO, ADB 2006.

As chart 2.11 shows, the estimated contribution of tourism to Pacific economies varies from around 47 per cent (Cook Islands) to around 3 per cent (Solomon Islands and Niue). As a recent study prepared for the South Pacific Tourism Organisation pointed out, data on the economic contribution of tourism in the Pacific is very patchy (Milne, 2005), so it is difficult to get a sense of how the full impact of tourism on PIC economies.

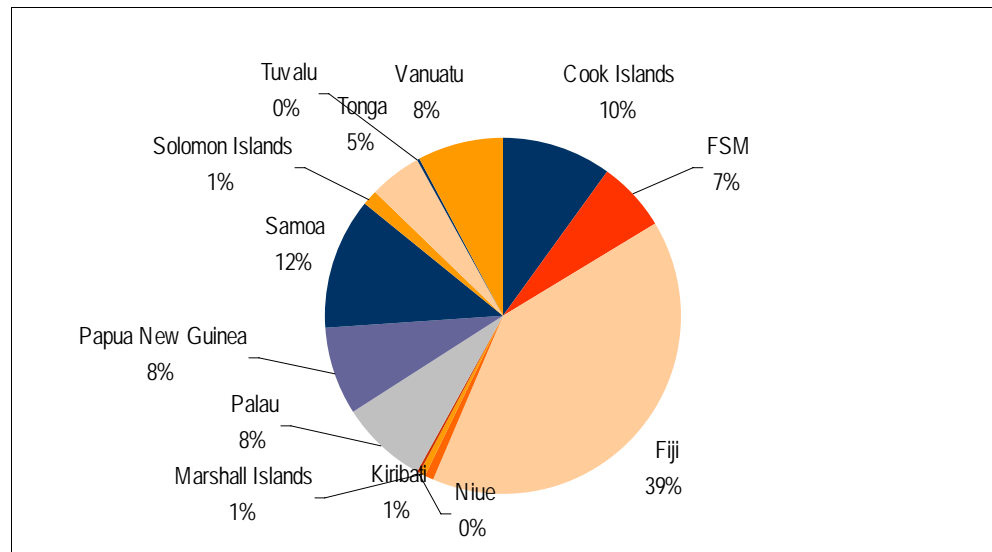
Pacific tourism is growing, but rather slowly: the average growth in arrivals into the economies shown in chart 2.9 between 1995 and 2003 was 3.4 per cent (AusAID, 2006). Fiji accounts for nearly 40 per cent of visitor arrivals into PICs (chart 2.12).

2.11 Tourism as a share of GDP



Data source: South Pacific Tourism Organisation, reported in AusAID, 2006

2.12 Share of visitor arrivals, 2000



Data source: AusAID 2006b, Cleverdon, 2003

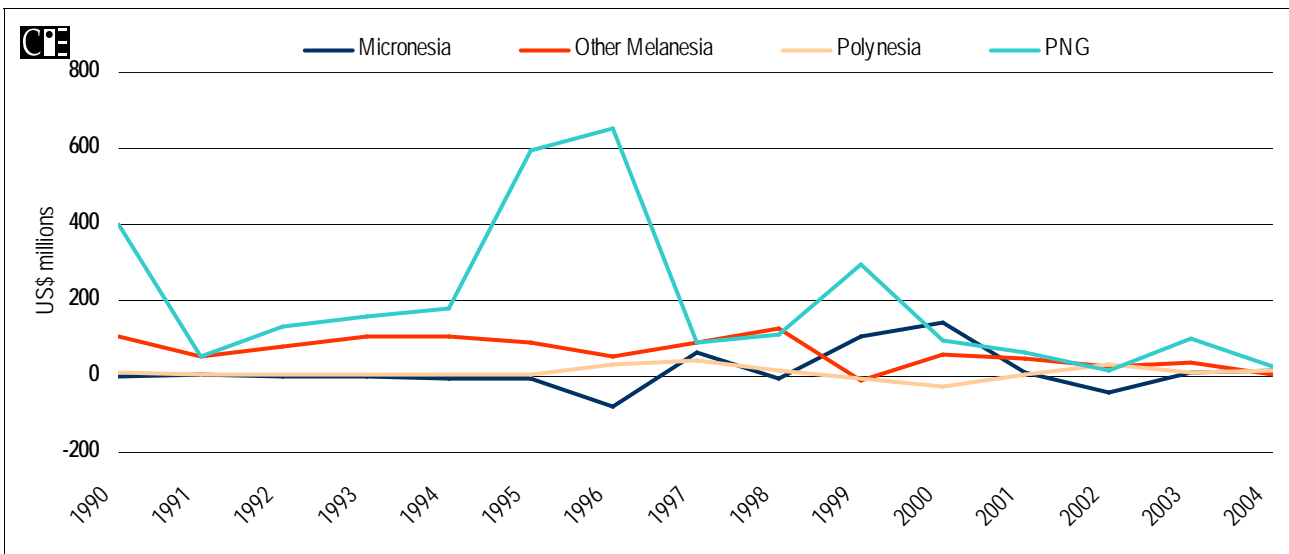
Other flows

Most PICs run sizeable current account deficits: foreign investment, aid and remittances contribute to varying extents to the financing of these deficits, as well as directly and indirectly impacting on the countries' propensities to import and capacity to export goods and services.

Foreign investment

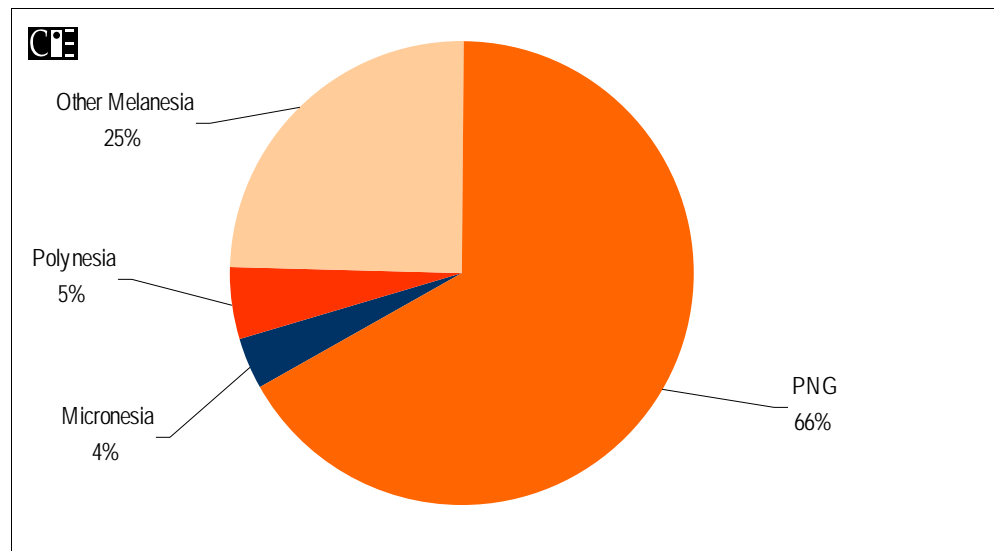
Foreign investment is another source of financing of imports. PNG is the dominant destination for inward flows of foreign direct investment (FDI) in the region: but as chart 2.13 shows, these flows have been somewhat volatile, reflecting expectations of commodity prices and perceptions of the relative riskiness of investing in the country. As chart 2.14 shows, PNG accounts for 66 per cent of the current stock of FDI in the Pacific.

2.13 FDI flows 1990 to 2004



Data source: UNCTAD (2006).

2.14 Shares of FDI in-stocks across the region, 2004



Data source: UNCTAD (2006).

Aid flows, remittances and the sovereignty-related rents

Aid and remittances are also very significant sources of financing of imports into many Pacific economies. Table 2.15 presents some of the available information that gives a sense of the relative size of aid and remittance flows compared with the value merchandise imports and exports. The data are not, of course, directly comparable: a significant share of aid flows funds technical assistance and other services, and the remittance data is as recorded as net private transfers in balance of payments, and almost certainly understates remittances in kind and non-registered flows.

An ADB report on remittances (ADB 2005) presents time series data that confirm that remittances have long been significant in Tonga and Samoa, and are becoming increasingly important for Fiji.

The economic consequences of aid and remittances are quite different. Remittances flow into private hands and fund private consumption and investment (the ADB report argues that a traditional view that remittances are largely used to fund consumption is erroneous). An important share of remittances (although probably unrecorded) is in the form of imports. Aid flows may directly fund import of goods and services: but they are also used directly and indirectly to fund local expenditures, and as such may have important influences on wages and the real exchange rate. Box 2.16 discusses some of the implications of large aid inflows for Solomon Islands, which has seen a very large increase in aid flows in the last few years.

2.15 Trade, aid and remittances, around 2002-03

	<i>Imports</i>	<i>Aid flows</i>	<i>Remittances</i>	<i>Exports</i>
	% of GDP	% of GDP	% of GDP	% of GDP
Cook Islands	46.0	3.5	0.7	4.9
Fiji	49.2	2.3	7.0	30.1
Kiribati	99.4	31.5	12.0	6.9
Marshall Islands	55.8	53.9	0.6	9.3
Micronesia, Fed. States of	47.3	49.7	1.0	6.5
Nauru	71.0	35.5	na	25.5
Niue	68.7	15.1	na	1.5
Palau	71.5	20.5	na	7.3
Papua New Guinea	31.4	6.4	0.2	47.8
Samoa	51.3	10.4	14.2	5.2
Solomon Islands	28.6	25.7	0.0	25.2
Tonga	74.1	16.3	39.2	11.6
Tuvalu	75.6	38.6	35.9	0.9
Vanuatu	58.7	11.7	3.3	42.4

Note: the aid flow data for Solomon Islands is probably a serious understatement, as national accounts and balance of payments data do not seem to be capturing the effects of funding of the Regional Assistance Mission to Solomon Islands. Recent estimates suggest that aid funded development expenditure may now be closer to 75 per cent of measured GDP.

Source: ADB 2006, AusAID 2006

2.16 Managing natural resource rents and aid in Solomon Islands

Countries endowed with natural resources should have a greater potential for growth and wealth than those without these resources. However, an inverse correlation exists for numerous countries between their natural resources booms and per capita growth signifying that these resources are often poorly managed. Several economic reasons are cited in the literature — the difficulty of managing price volatility is one reason, but so is the so-called ‘Dutch disease effect’. A surge in foreign exchange earnings from natural resource exports can lead to an appreciation of the real exchange rate and a depression of output and employment in other sectors producing exports or competing with imports. These changes can be transmitted through an appreciation of the nominal exchange rate or movements in the prices of non-tradeables (good whose prices are not subject to the discipline of international competition). It is quite likely that surging logging exports have had this kind of effect in Solomon Islands. And in the future, without careful management, surges in international assistance could have a similar effect.

In the case of Solomon Islands, where a significant proportion of natural resource revenues accrue to the state, a ‘Dutch disease’ effect is not an automatic consequence of a surge in foreign exchange earnings. When a ‘boom’ accrues to the public sector, adverse consequences occur only if the government translates the surge in foreign exchange income into a fiscal shock. Sterilisation (avoiding the monetary effects of the surge) and stabilisation (avoiding the stimulus to domestic activity) is technically quite easy — although politically daunting — since all the government has to do is to decide not to spend the incremental revenues. It can reduce the impact on the exchange rate, while increasing spending, if the foreign exchange revenues are not used to fund domestic spending: that is the revenues are used to purchase imports of goods and services.

Given the size of foreign assistance inflows that are now targeted at Solomon Islands, there is a serious risk of an aid-induced Dutch disease effect, with serious consequences for rural activities. The problem is, of course, that the government has less room to manoeuvre with respect to donor funds: it may have less control over the time path of expenditures and their composition.

Source Warner and McGregor, 2006

A naïve view of aid flows is that they are to a fair degree exogenous from the recipient’s perspective: influenced by need and performance, and expected to diminish over time. But there are schools of thought that portray being an aid recipient as part of an overarching, if not explicit, long term strategy to finance a significant part of the consumption of some Pacific populations. The MIRAB (migration, remittances, aid and bureaucracy) model presents a way of describing the observed behaviour of some Pacific societies, and how pursuit of transfer payments to fund government and household recurrent expenditures could be seen as a strategy to manage the risks that these societies face and to exploit the full set of resources that they control (Bertram 1986, 1999).

As a number of analysts have pointed out, aid is just one of the flows that can be generated from the fact of sovereignty. Statehood has given some PICs valuable services to trade for aid flows: competition for votes in international organisations, providing locations for military bases all form part of the geo-strategic services described by Poirine (1995) which trigger relatively significant aid flows. For some PICs, the foreign exchange inflows associated with these sovereignty-related services are quite significant. Boland and Dollery (2006) have explored the rental incomes accruing to Tuvalu associated with licensing of fishing vessels from distant-water fishing nations; the leasing and marketing of Tuvalu's top-level domain of '.tv'; philatelic sales; the leasing of blocks of excess telephone numbers; and passport sales. These rents have accounted for up to three-quarters of recurrent revenue in some years, and levels of recurrent government expenditure have been strongly correlated with these volatile flows.

3

Impediments to trade

THERE ARE SIGNIFICANT COSTS ASSOCIATED WITH TRADE to, from and between Pacific Island nations. Explicit tariff and non-tariff barriers, inefficient regulation of transportation communication services, obstructive regulation of private sector activity, risks and uncertainty created by poor macroeconomic management and political instability all impede increases in specialisation and investment that are necessary for growth and expanded engagement with the rest of the world.

Many Pacific economies are small, relatively isolated and geographically fragmented, with their population spread over many islands. Others are simply very small, while the largest, PNG faces considerable challenges from the terrain of its largest land mass. Subsistence agricultural production is often the most significant source of livelihood for the people.

These economies face some daunting constraints to achieving the kinds of economic transformation that have accompanied the improvements in the economic well-being of the populations of less developed countries in Asia. Intrinsicly high internal and external transport costs mean that it is difficult to achieve the scale needed to provide returns to expanded industrial activity: they also raise the costs of further processing to add value to existing primary products.

But these 'objective' constraints to economic transformation, and a continued transition out of subsistence activities, are compounded by a range of institutional and government policy factors. Further, these institutional and policy factors are constraining the PIC's ability to take advantage of developments that are reducing the relevance of the objective constraints, at least with regard to trade in services (see box 3.1).

The self-imposed constraints include the following.

- Poor macroeconomic management and management of natural resources increases the risk and uncertainty of the transition out of subsistence production, and is a deterrent to investment in cash generating activities that are not cushioned by access to large resource rents or protection from competition.

3.1 The new unbundling and trade in tasks

Geography and size have historically placed considerable limitations on the extent to which PICs can participate in the international division of goods production processes that characterised much of the growth in exports of goods of developing countries in the late 20th century. However, changes in information and communication technologies are reducing the 'tyranny of distance' constraints with respect to trade in services. Technology has so reduced the costs of communications and coordination that it is now possible to unbundle and outsource tasks in the service production chain, facilitating a revolutionary growth in trade in services.

Grossman and Rossi-Hansberg (2006) argue that the transformation brought about by changes in communications and information technologies mean that the international division of labour should now be thought of as driven by trade in tasks rather goods. Firms in developed countries are offshoring tasks that: are intensive in use of information technology; where the output is transmittable using this technology; where it is possible to codify what is required; and which require little face-to-face interaction (Baldwin, 2006). Physical location and costs of transport no longer matter in determining the scope for participation in this trade: but ability to acquire new skills and openness to the changes that technology facilitates are critical (Friedman, 2006).

- Poor public investment in, and poor management and maintenance of transport and communications infrastructure exacerbate the costs of doing business. They also make it difficult for rural people to get information about market opportunities and technical and managerial innovations. They also, quite importantly, reduce the access that rural people have to saving and consumption opportunities that might provide stronger incentives to engage with the cash economy.
- Trade policies and taxation impose large direct and indirect taxation on exports, and the main thrust of the countries' efforts in trade policy – participating in regional preferential trade agreements – is having little impact on this impost.
- The limited reach and impact of legal and judicial underpinnings of a market economy in some Pacific economies make it difficult to enter into and enforce contractual arrangements that span space and time. Traditional institutions may make these kinds of interaction feasible within closely knit communities: but some Pacific countries are islands which are ethnically and linguistically heterogeneous, and trust between communities is typically and historically low. People find ways of dealing with the limitations of these institutions, but the absence of widely 'accepted' norms about contractual behaviour add to the risk, uncertainty and costs of doing business.
- Similarly, customary land tenure arrangements have proved quite flexible with respect to transactions within communities: but the lack of

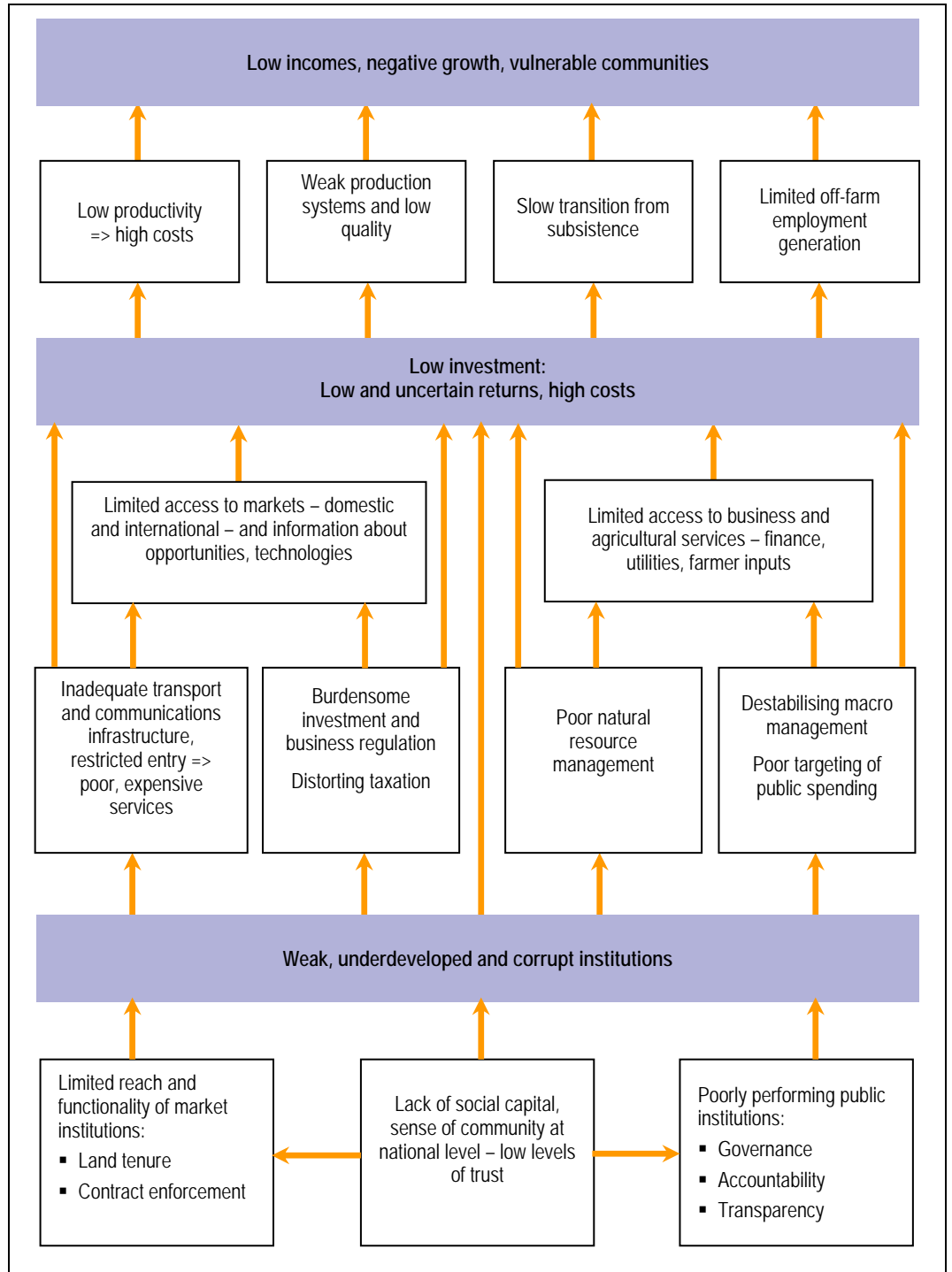
finality and certainty associated with these arrangements deter larger scale investments with long pay-back periods. Capacity and other constraints in the government agencies responsible for land management also raise impediments to investment that might use alienated land that is not (in theory) subject to interactions with customary tenure processes.

These constraints mute the incentives for households and domestic and foreign firms to invest in new activities or productivity enhancements. They exacerbate the conditions that limit the spread of financial services and access to credit that would facilitate the development of the cash economy and intermediate between savers and investors. Cumbersome, non-transparent and inconsistent regulation of business further reduce incentives: this is not helped by continued perceptions of political corruption and incompetence (chart 3.2)

A further challenge to economic growth and increased trade in the Pacific may, paradoxically, come from the efforts of the international community to help the countries develop. Aid commitments and disbursements are quite high for most economies. The use of the foreign exchange inflows to purchase local goods and services provides a stimulus to demand: but it also impacts on the competitiveness of all exporting and import-competing activities through its impact on the real exchange rate. As discussed in chapter 2, a number of Pacific economies face the challenge of dealing with an aid-driven 'Dutch disease' problem.

Many Pacific Islanders thus face an environment in which the returns to the kinds of specialisation that would have to accompany increasing production for domestic as well as international markets are low or very uncertain. They have thus adopted a range of strategies to manage the risks and unpredictability associated with their geographic and geostrategic circumstances. At the household level, diversified quasi-subsistence livelihoods, and communal insurance structures (such as the wantok system) form one part of these strategies as does migration and the perception of migrants as 'part of a transnational corporation of kin' aimed at maximising extended household incomes across different continents (Marcus 1981). Similarly, the investment in maintaining aid flows, as characterised in the MIRAB model, is a state or political class strategy. The continued success of these strategies attenuates the incentives that Pacific societies might face to change the institutional structures that impede specialisation.

3.2 Why Pacific economies' growth is so poor



Source: Derived from Warner and McGregor, 2006

Barriers to increased trade and investment

Tariff barriers

Import tariffs are an important barrier to trade in many PICs. Average tariffs are quite high (table 3.3), and some countries have quite highly differentiated and dispersed tariff structures which do not apply uniformly across goods or classes of importer. For example, Kiribati has some tariff rates as high as 80 per cent, with an average tariff rate of 22 per cent. Niue exempts government owned firms from paying tariffs, and in Solomon Islands implementation of the tariff is characterised by widespread discretionary granting of exemptions and concession. In addition, tariff rates in some countries are highly dispersed.

3.3 Implicit average tariff rates (1994-95)

<i>Country</i>	<i>Merchandise tariff barrier</i>
	%
Cook Islands	10.1
Federated States of Micronesia	1.0
Fiji	11.2
Kiribati	22.1
Marshall Islands	15.3
Nauru	0.1
Niue	8.7
Palau	4.4
Papua New Guinea	13.9
Samoa	17.8
Solomon Islands	10.9
Tonga	15.0
Tuvalu	Na
Vanuatu	22.5

Source: CIE (1998).

Tariffs have traditionally been a major source of revenue in the Pacific. As table 3.4 shows, tariffs have accounted for up to nearly a half of all per cent of revenues in Vanuatu, and over 20 per cent in FSM, Fiji, Marshall Islands and Tonga.

The impact of tariffs as a tax on imports and hence on exports is compounded in some countries by the way that the duties interact with other indirect taxes. Samoa, Fiji, Vanuatu, the Cook Islands and Papua New Guinea are all operating VAT type taxes that avoid the cascading that occurs in countries like Solomon Islands (which has also placed introduction of a VAT on its reform agenda).

3.4 The importance of tariff revenues

	<i>Revenues as a share of tax revenue</i>	<i>Revenues as a share of total revenue</i>
	%	%
Cook Islands	na	Na
Federated States of Micronesia	24.0	3.3
Fiji	32.8	21.9
Kiribati	64.1	22.2
Marshall Islands	35.3	23.70
Nauru	1.0	0.0
Niue	na	Na
Palau	20.0	5.0
Papua New Guinea	22.3	18.0
Samoa	34.0	16.4
Solomon Islands	23.7	14.3
Tonga	30.7	21.2
Tuvalu	45.8	6.7
Vanuatu	57.5	48.1

^a na not available

Source: Scollay, 2001

Non-tariff barriers

It is difficult to get a sense of the extent of non-tariff barriers in the Pacific. The analyses of the impacts of trade liberalisation all seem to focus on tariff reductions: but this does not mean that trade licensing and other restrictions may not be in place.

However, one of the most significant non-tariff barriers to trade imposed by many Pacific Island governments occurs through policies towards transport and communications. As the recent ADB private sector assessment for the Pacific pointed out (ADB 2004):

One of the consequences of smallness and remoteness experienced by all Pacific countries is the cost of air and surface transportation. Unit costs are high because of distance from international markets, and small volumes often put freight carriers and airlines in a position of monopoly. In addition, low volumes of inter-island traffic within a country make road transportation and coastal shipping costly. High transport costs are equivalent to a tax on all products. They raise the costs of doing business – costs that must be overcome if island economies are to compete effectively with others.

Because of these disadvantages, Pacific economies must do all they can to keep transport costs low. Currently, several states own and operate airlines, a business that is often high cost/low margin, provides unreliable service, and drains the country's treasury. If an airline is required for strategic reasons, a more efficient way to provide the service might be to auction off the rights for the provision of a specified level of service to existing private airlines. Likewise, regulations that restrict coastal shipping to domestic companies raise the cost of shipping goods between the remote islands of the region's

countries, harm development in the rural areas, and encourage migration to already crowded towns. The public policy issue is how to provide the least cost shipping services to outer islands, not how to protect local shipping interests. Poorly run ports and airports with monopoly rights further contribute to transport costs.

The same report presents evidence on the very high costs of international telecommunications and internet access that result from monopolisation (often by a state owned enterprise) of the telecommunication sector. The cost of telephone calls to the United States from Pacific economies ranges from six to 20 times higher than the comparable charge in Australia (ADB op cit). These constraints almost completely exclude PICs from participating in the 'trade in tasks' that information and communications technology is making possible.

There are other trade impediments that might fall under the heading of weaknesses in trade facilitation. Financial and capacity constraints make it difficult for PICs to address the standards requirements of international markets. Customs administration and the management of border formalities are often weak, and have to deal with enormous challenges created by the geography of PICs.

Barriers to investment

Barriers to foreign investment fall into two broad categories: policies that discriminate against foreign investors relative to domestic investors, and policies and institutional weaknesses that impede both domestic and foreign investment.

Barriers to foreign direct investment typically fall into three categories (CIE, 2006):

- limits on foreign ownership of businesses in particular sectors
- screening requirements for foreign direct investment such as meeting a public benefits test, and
- operational restrictions that affect, for example, a firm's ability to use foreign directors and bring foreign workers into a country.

These kinds of barrier are quite widespread amongst PICs. As the ADB report on private sector development in the Pacific pointed out:

Most countries in the Pacific understand the importance of foreign investment but control it quite closely to avoid repeating unfortunate experiences with foreign investors. Controls are based on the understandable desire to limit the number of dubious – and at times fraudulent – projects that have occurred in the Pacific. There is the common phenomenon of the so-dubbed “two dollar

investor," a small foreign investor who comes to a country in the Pacific with limited capital and attempts to raise most capital locally for a project of dubious viability. To combat this problem, many countries have established complex, costly, and time-consuming vetting and approval systems, which discourage both legitimate investors as well as the less credible investors among them (ADB 2004).

But these directly discriminatory barriers may not be as problematic as the impediments that apply equally to domestic investment. These include: complex customary land tenure systems, obstructive regulation, monopolisation of key sectors, underdeveloped institutional mechanisms to underpin commercial contracting, unhelpful labour regulation, unclear property rights, weak legal and judicial systems for the enforcement of contracts, inappropriate or badly managed regulation, burdensome and highly discretionary taxation and destabilising macroeconomic management. For some PICs, uncertainty about political stability and the maintenance of law and order are significant deterrents to investment.

These impediments impact on formal sector investors, and also constrain the incentives facing the many quasi-subsistence rural households from shifting into more specialised commercial activities. Poor policy and weak institutions add to some of the more objective constraints faced by Pacific Islanders to make the returns from investment, be it physical or in human capital, very uncertain.

4

Trade liberalisation and regional integration

IT IS HARD TO IDENTIFY any compelling economic arguments for PICs to maintain barriers to international trade and investment. But there will be political costs – and some adjustment costs – for PICs who proceed to reduce these barriers. So it is pertinent to ask if there are preferred ways of approaching the challenges of eliminating these barriers.

Some PICs have attempted unilateral liberalisation of trade (for example, Fiji successively reduced tariffs over the period 1989 to 1997, PNG initiated a tariff rationalisation process following a comprehensive tariff review in 2002, and Samoa has undertaken tariff reductions in its comprehensive program of economic reforms.) However, the main vehicles for strengthening integration with the rest of the world have been preferential trading arrangements (PTAs). These arrangements are now absorbing a lot of attention in the development of the trade policy architecture of the Pacific. In this the Pacific is little different from the rest of the world: a recent report by the Australian Productivity Commission indicated that between 1990 and 2005, the number of preferential trade agreements in force grew from around 25 to 154 (the number of such agreements that had been notified to the WTO was 262).

Pacific Island members of the Pacific Forum are parties to a number of preferential trading arrangements, some of which have been in force for a considerable period. All fourteen economies are parties to the Cotonou agreement, under which the European Union provides non-reciprocal preferential access for nearly all imports from developing economies in Africa, the Caribbean and the Pacific. The fourteen economies also receive non-reciprocal duty free access into Australia and New Zealand under the South Pacific Regional Trade and Cooperation Agreement (SPARTECA). (Papua New Guinea is also party to a reciprocal agreement with Australia, the Papua New Guinea Australia Trade and Commercial Relations Treaty, PATCRA). Papua New Guinea, Fiji, Solomon Islands and Vanuatu provide each other preferential access on some goods under the Melanesian Spearhead Group (MSG) Trade Agreement.

The most recent developments have been:

- the coming into force in late 2002 of the Pacific Agreement on Closer Economic Relations (PACER) between all sixteen members of the Pacific Forum
 - PACER contains no substantive trade liberalisation provisions – rather it establishes a framework for the gradual trade and economic integration of the economies of the Forum members
 - it provides for negotiation of a trade agreement to start in 2011, or earlier if developing economy members negotiate a trade agreement with non-Forum developed countries before then;
- the coming into force in 2003 of the Pacific Island Countries Trade Agreement (PICTA) between the fourteen developing country members of the Forum
 - PICTA provides for tariffs on member country imports to fall to zero by 2012 (or for items on negative lists by 2017)
 - work has started on extending the agreement to cover services, and including some or all of the French and United States Pacific Territories
 - however, not all PICTA signatories have completed ratification of PICTA and only Cook Islands and Fiji have completed domestic requirements and are ready to trade under the agreement – a recent report prepared by the Pacific Islands Forum Secretariat described progress on implementation of PICTA as ‘unsatisfactory’ (PIFS 2006);
- the agreement in 2003 to revise the MSG agreement and adopt a negative list approach to the coverage of tariff preferences by 2005
 - this has the potential to significantly expand the coverage of the agreement; and
- the commencement in 2004 of negotiations of an Economic Partnership Agreement (EPA) with the EU, to replace the trade provisions of the Cotonou agreement.
 - the new agreement is needed because the WTO waiver for the trade provisions of the Cotonou agreement expires in December 2007 (Scollay, 2005)
 - it will provide for reciprocal preferential access between the economies and the EU, but will continue the linkages between trade arrangements, development policies and development assistance

- the EU has signalled, however, that it will only negotiate a preferential agreement with interested PICs if they are members of an operating regional trade agreement (effectively MSG or PICTA).
- The endorsement in 2005 by the leaders of the Pacific Forum of the Pacific Plan for Strengthening Regional Cooperation and Integration as a regional strategy for development which encompasses increased regional provision of services as well as market integration.
 - The Plan aims to strengthen regional cooperation and integration in areas where the region can gain the most through sharing of resources of governance, alignment of policies and delivery of practical benefits.
 - It also aims to strengthen support for current programs and advocate for the needs of small island states, given their limited capacity and fragile and vulnerable environment.
 - The Plan supports expansion of trade in goods under SPARTECA, PICTA and PACER and EPA, and aims to integrate trade in services, including temporary movement of labour, into PICTA, PACER and EPA.

What has been, or is likely to be the impact of these initiatives, and do they constitute a sound strategy for removing barriers to international integration?

Evaluating Pacific preferential arrangements

Whether or not PTAS are welfare enhancing for members is essentially an empirical question – it all depends on the characteristics of the economies and the arrangement itself.

Some broad rules of thumb for an arrangement that simply encompasses trade in goods are that a trade arrangement is more likely to bring gains to participants:

- the higher the initial levels of protection – higher protection means larger gains from displacement of high cost domestic production when protection is reduced. It also means that pre-arrangement imports are lower, reducing the scope for trade diversion relative to trade creation;
- the more intensive is trade with other economies participating in the arrangement – with fewer imports from other countries, the potential for trade diversion is smaller;

- the more competitive are the participating countries compared with non-participants – the costs of any trade diversion will be lower, because the costs of goods produced inside the arrangement are closer to world prices;
- the larger the number of participating countries – this increases the probability that lower cost producers are in the arrangement; and
- the larger the partners – again this increases the probability that the arrangement includes lower cost producers, and preferential access to larger economies increases the scope for scale economy gains and export price increases.

A recent paper prepared for the Australian Rural Industries Research and Development Corporation built on lessons from successful and unsuccessful preferential arrangements to draw a somewhat larger checklist for features that increase the likelihood that a preferential agreement would have positive impacts on members (table 4.1).

Putting all of these guidelines together, it is hard to avoid the conclusion that the preferential arrangements so far implemented by Pacific economies are unlikely to provide much in the way of direct economic benefits. This negative conclusion is supported by more detailed evaluations.

Because SPARTECA is a non-reciprocal arrangement, requiring no reductions in trade barriers by the participating Pacific economies, the probability of benefits would always be very small. A 1992 evaluation of PATCRA also concluded that while reciprocal in principle, the agreement led to limited reduction in trade barriers in PNG, and failed to deliver any of the intended benefits (Borrell, Quirke and Vincent, 1992).

Some Pacific countries have benefited from access to rents associated with preferential access to import markets in the EU. Fiji, Solomon Islands and PNG have all benefited from a margin of preference on canned tuna (World Bank 2002), and Fiji benefited from participation in the Sugar Protocol. (EU sugar transfers have been estimated to have amounted to around 3.5-5 per cent of GDP in the late 1990s.) However, this preferential access does not seem to have helped create a viable sugar industry, as rents have been dissipated via expansion of cane production onto marginal lands and farms distant from processing centres (Chand, 2005). Some countries also benefited from access into the quota protected garment markets in the EU while the Multi-Fibre Agreement was in place: but that source of rent is disappearing, and it is probable that allocation systems helped to dissipate some of this rent.

4.1 Lessons and checklist for 'good' PTAs

<i>Lesson</i>	<i>Checklist rule</i>
Trade benefits are maximised when the price change is maximised	Is the price reduction maximised
Increased competitive pressures can lead to additional benefits, especially for 'problem' industries	Are 'problem' industries included in the PTA?
Comprehensive PTAs create fewer distortions and lower administrative and compliance costs	Is the PTA comprehensive, including substantially all trade that would have occurred under free trade?
Complex and inflexible rules of origin increase the costs of PTAs	Is the rule of origin simple, consistent and flexible?
Significant benefits can be gained by increasing the certainty of the trade and investment environment	Does the PTA increase the certainty for trade and investment?
PTAs can achieve investment liberalisation to the benefit of participating countries	Does the PTA also liberalise investment rules?
Although important, domestic issues should be excluded from PTAs as they can prevent trade liberalisation and provide questionable benefit	Is the PTA free of any 'new protectionist' measures, such as unnecessary environment, labour and market or competition law requirements?
PTA negotiations should be as transparent and inclusive as possible and detailed independent analysis of the costs and benefits should be published	Are the details and consequences of the PTA well understood following a transparent process and independent analysis?
Member countries of PTAs should reinforce their commitment to successful multilateral liberalisation	Have PTA countries reinforced their commitment to the WTO and is there a sunset clause to multilateralise the PTA?
PTAs should extend beyond regional agreements and PTA members should be open to expanding membership and merging PTA groupings	Does the PTA allow for expansion with new members and potential integration

Source: Humphreys and Stoeckel, 2005

An evaluation of a free trade agreement along the lines of what has become PICTA suggested that welfare would decline in four economies (Cook Islands, Kiribati, Samoa and Tuvalu) and that the gains in the other economies would be very small. (Scollay and Gilbert, 1998). A companion evaluation of a free trade agreement that included Australia and New Zealand suggested that the net benefits for the Pacific island economies would be considerably larger (forty times larger), and that all economies would have net gains, if the welfare effects of replacing forgone tariff revenues with alternative taxes were ignored (Stoeckel and Davis, 1998).

These evaluations all assume that the governments of the participating economies accept the logic of reducing barriers to imports – to subject local production to increased competition. This often poses some difficult political economy challenges in small economies: it can be very difficult to resist pressures for special treatment in small societies. Governments in the Melanesian Spearhead Group have been reluctant to expose local producers to competition, and the selection of commodities on which to

provide preferences has focused heavily on goods that member countries do not produce. Where preferences have involved goods that are locally produced, governments have often moved to limit competition from imports.

WTO and multilateralism

Only three of the Pacific members of the Forum are members of the WTO – Fiji, PNG and Solomon Islands. Tonga, which applied for membership in 1995 has completed the accession process and will join the organisation when it ratifies the terms of accession. Samoa applied to join in 1998, and consultations are continuing. Vanuatu, which applied in 1995, was due to accede in 2001, but withdrew its application just before the Doha Ministerial conference, citing ‘technical reasons’.

Vanuatu’s withdrawal has prompted some interesting discussions on the implications of the accession process for small developing economies. Some have argued that it highlights the inherently flawed nature of the process, that it is biased and gives incumbent members enormous powers to extract concessions that would be impossible in a more appropriately balanced and rules-based system (Grynberg and Joy, 2000). Others have argued that, while some members (as is their wont) aggressively pursued strong commitments from the government, most of the demands would have represented sensible policy commitments, looked at from the perspective of what would be good policy for Vanuatu (Bosworth and Duncan, 2002).

What Vanuatu’s experience does highlight, however, is some of the problems inherent in pursuing liberalisation by negotiating trade agreements with other countries.

Many commentators (for example Anderson 1998) have identified benefits which would accrue to new members from membership of WTO, beyond the gains to be achieved from unilateral liberalisation. These include:

- greater and more secure market access for the country’s exports because of the commitments to accord new members the same treatment with regard to market access and treatment of inward investment as all other members;
- availability of the WTO’s dispute resolution mechanism;
- disciplines on domestic policy making to resist claims from special interest groups;

- assistance in strengthening and modernising the regulation of trade and investment; and
- an opportunity to influence global approaches to multilateral trade and investment liberalisation.

However, the largest benefits derive from any support that membership gives to ongoing pursuit of free trade and deregulation of the domestic economy. And there are potential downsides to pursuing integration solely through international agreements.

One downside is the impression that accession processes and international agreements give that the scope and pace of policy changes is being driven more by the interests of other countries than the domestic imperatives for economic development.

This impression is reinforced by the ‘concessions’ approach to trade and investment liberalisation that is part of many negotiation processes linked with the agreements. Under the ‘concessions’ approach, other countries ask acceding countries to make policy changes on the ground of what might seem good for their economies, and not necessarily on the grounds of what might be good for the acceding country. This creates a situation where it may appear logical for the acceding country to defer doing things that are in the nation’s best interest because doing them may seem to offer unnecessary concessions. The logic of trade negotiations fosters the perception that reducing barriers to trade and investment is a concession to be reluctantly granted, in return for similar concessions made by the other parties to the negotiation. This distracts attention from the fact that it is the country that reduces the barriers that gets the big gains. Most of these gains can be achieved by actions taken to reduce barriers to trade and investment on a unilateral basis, independent of any agreements.

One further problem with all trade agreements is their tendency to institutionalise mercantilism – the misleading idea that exports are the end objective of trade and imports are costs of trade. This has happened as attempts to make the notion of trade reform more politically acceptable have stressed the concept of reciprocity.

It has been argued (Tumlrir 1983) that this focus on mercantilism and reciprocity has created a serious flaw in the WTO (more precisely in the GATT) – the flaw being a misstatement of the case for free trade. Tumlrir argues that the people accepted the argument that when every country protects its economy, all countries suffer. But instead of drawing the correct conclusion – that ‘liberal (free) trade is the best policy for all countries’, an alternative that ‘liberal (free) trade is the best policy when all countries

practice it' was put forward, which was ultimately corrupted to 'liberal (free) trade is a good policy *only* if all countries practice it'. It is the corrupted conclusion that underlies the 'concessions' approach described above. As a number of commentators have pointed out, the 'fruitful lie' – that the gains from trade come primarily from being able to export rather than from being able to import – no longer seems to work. The problem seems to be that governments have come to believe the propaganda (Crook, 2006).

Membership of the WTO poses significant institutional challenges for developing economies. Many of the new agreements reached during the Uruguay Round place strong requirements on domestic policy and administrative and regulatory institutions. This in turn has meant that the accession process has become more demanding and time consuming.

Few developing economies, especially the small and less developed economies of the Pacific institutions have developed well-functioning institutions to deal with aspects of international trade in goods and services, such as intellectual property rights, standards, sanitary and phytosanitary controls and procurement. However, WTO membership requires that policies and institutions dealing with these issues be brought into line with the provisions of the main agreements of the organisation.

Meeting this requirement can be very costly to low income countries. A recent study examined how developing countries have addressed the challenge of implementation of certain obligations of membership of WTO, namely the GATT customs valuation agreement, the Agreement on Sanitary and Phytosanitary Standards (SPS) and the Agreement on Trade Related aspects of Intellectual Property (TRIPS) (Finger and Schuler, 1999). It made the following observations:

- Implementation of these agreements involves considerable investments in human and physical capital: these could cost more than the annual development budget in some low income countries.
- The content of the obligations imposed by the WTO take very little cognisance of the circumstances and reform needs of developing countries: they can be 'characterised as the advanced countries saying to the others, Do it my way!' (Finger and Schuler op cit).
- In many developing countries, there was little domestic ownership of the reforms, reflecting in part the limited capacity many low income countries have for full participation in WTO negotiations.
- Within the mercantilist framework within which trade negotiations are viewed, developing countries got very little in return in the market

access parts of the Uruguay Round Agreement in exchange for their commitments on trade rules. (This is largely because the Agreements on Agriculture and Textiles and Clothing involved little in the way of immediate reductions in trade barriers by developed economies).

The evidence on accession to the WTO shows that it can be a time consuming and institutionally challenging exercise. Applicant countries are often expected to enter into stronger commitments under the various WTO agreements than existing members' undertakings. And while there are provisions to allow developing countries additional time to implement certain agreements, there is a tendency to regard to the time taken in the accession process as sufficient additional time for new applicants.

Broadening the approach to regional integration

The challenges faced by developing economies with respect to implementation of WTO agreements have reinforced perceptions that developing economies may have to implement significant agendas of complementary actions to maximise the benefits of integration. Attention is often focused on the development of safety nets to soften the adjustment of groups negatively affected by liberalisation. However, the larger challenge is usually with respect to developing institutions to underpin market transactions and facilitate the specialisation that accompanies trade.

The WTO, in concert with the World Bank, the International Monetary Fund, the United Nations Development Fund, the United Nations Conference on Trade and Development and the International Trade Centre have developed a mechanism, the Integrated Framework for Trade-related Technical Assistance to Least Developed Countries (IF) to mobilise support for eligible economies to mainstream trade into their development strategies. This framework has evolved to address many of the broader institutional and policy issues that effective pursuit of integration exposes.

To date, no PICs have participated in the IF (although Solomon Islands, Kiribati, Tuvalu and Vanuatu are notionally eligible to be beneficiaries). However, other regional integration initiatives are attempting to deal with the capacity and complementary action challenges, and are broadening the agenda of integration beyond the 'traditional' issues of trade and investment liberalisation.

The Pacific Plan for Strengthening Regional Cooperation and Integration has brought the issue of reducing the costs of sovereignty for the small

states of the Pacific into the mix, by proposing the development of shared institutions.

The 2005 report to the Pacific Islands Forum Secretariat entitled 'Towards a New Pacific Regionalism' (ADB-CS 2005) supported a broader approach to regional integration that goes beyond the previous focus on cooperation and market integration to address some of the problems of governance confronted by PICs. It argued that:

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 opportunities for Pacific citizens through increased regional market integration (ADB-CS 2005).

The report evaluated a regional economic and technical assistance facility; a regional customs agency; a regional panel of auditors; a regional ombudsman; a regional nurse training facility; joint procurement of petroleum products; a Pacific aviation security office; a regional sports institute; a regional statistical office; a regional office to protect intellectual property rights; and a police training facility for external peace keeping.

In another initiative, the European Union is engage in negotiations with Pacific States on an Economic Partnership Agreement (EPA) under the Cotonou partnership Agreement (CPA) which replaces the Lomé Convention treaties with Asia, Caribbean and Pacific states. An EPA would bring together issues of economic and trade cooperation, linking support for regional integration, development assistance for improved governance and political engagement.

The focus on governance in the CPA is seen as a challenge to the ways in which the WTO has tried to accommodate the particular circumstances of less developed economies through 'special and differential' provisions. These provisions have tended to allow for delays in implementing actions that are not very institutionally demanding and where the benefits for developing economies are reasonably unambiguous. But they offer little room to manoeuvre on agreements – such as trade in services and intellectual property rights which are institutionally challenging and where the benefits are less readily demonstrated.

von Moltke suggests that:

...by embedding the EU-ACP trade relationship in a substantial political, financial and institutional framework the CPA may lead to the conclusion that economic liberalization without such a framework stands little chance of promoting development, in particular in least developed countries (von Moltke, 2004).

The CPA is placing much stronger emphasis on regional cooperation and integration than its predecessor. (As indicated earlier, it has effectively signalled that it will only negotiate a trade agreement with PICs if they are members of a regional trade agreement.) This may in part reflect a sense that the success of the European Union integration project demonstrates the gains from market integration, and that developing countries could develop similar strategies. It also may also reflect a view that the EU needs partners of critical mass for its processes of political engagement.

Both the Pacific Plan and the proposed EPA are grappling with the challenges that face PICs because of the cost of statehood and maintaining national boundaries for countries that are isolated from the main world centres of population and markets, and are geographically (and sometimes ethnically) fragmented.

Examination of the proliferation of sovereign states after the second World War suggests that the resulting increase in the numbers of flags, borders, armies and monies, and more controls of labour flows and trade, an increasing number of independent judiciaries and more independently determined economic policies has not produced universally positive results (Braun, Hausmann and Pritchett, 2002). The costs of sovereignty are not trivial. PICs face these costs, but have the additional problem that the costs of running the institutions of state (however well or badly they function) are large relative to the size of populations and national income.

Regional initiatives offer one way of spreading the institutional costs over a larger income base, and perhaps increasing the constituency for better performance of state institutions. (The following discussion draws on an informal position paper prepared by the CIE for the Australian Agency for International Development, CIE 2005)).

There are many different types of regional initiatives that require different contributions and responses from the member countries. Initiatives that require few inputs or responses are easy for countries to participate in, while those that require large domestic policy changes or ceding policy making to a regional body must demonstrate large benefits to gain commitment. Participation in dialogue is at the easy end of the spectrum, while establishment of supranational institutions is at the hard end. The key characteristics of initiatives that shape the demands placed on participants are the:

- complexity of commitments and the implications they have for domestic capacity – in terms of human, institutional and financial resources;

- degree of domestic adjustment required for compliance with commitments, including legal, policy and institutional changes and the economic and social adjustments that ensue; and
- extent to which control over policy must be ceded – loss of sovereignty over policy.

Table 4.2 presents a typography of regional initiatives and associated characteristics. Those initiatives which do not overly tax member country capacity, involve limited domestic adjustment, and do not require much ceding of sovereignty are relatively easy to achieve. But these initiatives may have less depth and generate fewer benefits.

Most integration initiatives are ‘works-in-progress’, so that external engagement can help with charting courses with the highest expected returns: but there are certain pre-requisites that are likely to be central to the probability of effectiveness in the pursuit of objectives.

4.2 Characteristics of initiatives by type of initiative

<i>Type of initiative</i>	<i>Capacity required</i>	<i>Domestic adjustment required</i>	<i>Loss of sovereignty</i>
Dialogue, exchange of views and ideas	Technical capacity desirable	None	None
Cooperation on regional issues including peer review on domestic actions which have impacts on the region	Technical capacity to engage Areas to be of common priority	Possible some adjustment	Very little risk of loss
Common or collective stances as a region in global forums	Technical capacity desirable	Possible some adjustment	Some risk of loss depending on issue
Harmonisation and standardisation of domestic policies, ranging from mutual recognition to agreement on common approaches	Technical capacity to engage needed Areas to be of common priority	Potentially high costs of adjustment if systems differ	Potential loss of discretionary power depending on issue
Establishment of regional bodies with authority for regional functions	Funding mechanisms required Technical capacity to engage needed	Possibly required to align with regional approaches	Some due to commitment to regional approach
Authorising regional bodies in the development of policies to which member countries have to commit	Funding mechanisms required Capacity to ensure voice in decisions	Potentially high costs of adjustment to comply	Cede sovereignty in the areas of commitment

Source: CIE 2005

Regional initiatives are more likely to be successful if:

- the countries involved have a common interest and the problem or opportunity is amenable to a regional solution/approach;
- the institutional capacity of the members is commensurate with the complexity of the solution/approach (or can create manageable pressures to boost institutional capacity);

- the size of the group (membership) is appropriate to what needs to be achieved, for example, dialogue based on informal discussion must have limited members;
- independent expert advice is available, and there is a willingness to utilise the resource;
- there is a well functioning physical secretariat to organise the logistics, or effective virtual forums for exchange of information with members willing to take on specific logistics;
- there is internal demand for the initiative – political imperatives and/or market driven imperatives;
- the partners are willing to share information and discuss what may be sensitive matters. In some cases they are willing to cede sovereignty over some areas of former national control;
- levels of economic and institutional development are commensurate with the complexity of the matters covered by the initiative; and
- financial resources are adequate for the task in hand.

It is clearly not within the scope of this paper to evaluate the Pacific Plan or the EPA initiative. But one question that does seem pertinent is the extent to which success in these initiatives is dependent on liberalising regional trade and investment. Clearly the European model was one in which market integration was the critical entry point into the regionalism project. The adoption of regional institutions, and the ceding of broader powers of policy formulation and law making, was facilitated by the demonstrable gains from integration. It is not immediately clear that the same path would be logical for the Pacific. As the earlier parts of this chapter have suggested, the gains from formal regional market integration may not be very great – and in particular they may not yield the mercantilist dividend that could soften up political opposition to more ambitious regional initiatives. So the move from regional cooperation to shared institutions will probably have to be sold on its own merits: which seem very strong.

Unilateralism for trade, regionalism for everything else?

There is no plausible case for PICs to retain barriers to trade and investment. So the question is: what is the best way for PIC's to approach reducing their barriers? Will regional trading agreements help? And how can New Zealand and Australia assist PICs in moving towards deeper integration with the world economy?

Regional agreements covering trade in goods that only include PICs offer very little prospect of economic benefits, nor do they offer much of an appeal to the mercantilism that might help lubricate the politics of liberalisation. It is true that a trade agreement that includes New Zealand and Australia would deliver more benefits than an agreement that just includes the PICs. But the gains will not come from increased market access into New Zealand and Australia, since most Pacific states already have duty free access into these markets. Rather, the big gains will come from reducing the Pacific's own barriers to imports from New Zealand and Australia.

However, much larger gains could be secured if barriers to all imports were reduced, regardless of country of origin. This would ensure that imports come from the most efficient suppliers in the world, and that consumer's choices are not distorted by policy induced wedges affecting relative prices of imports from different sources. Pacific Island countries could get all these gains right now without the pain of negotiating with Australia and New Zealand. This said, the overall gains from liberalising trade – and even foreign investment, are unlikely to be large unless the 'behind the border' impediments to both foreign and domestic investment are addressed. Given the deep-seated constraints to specialisation and investment in many PICs, there is unlikely to be a strong supply response to liberalisation.

The gains from stronger forms of regionalism that target the costs of statehood for small PICs look to be more attractive. But, as mentioned in chapter 2, many PICs earn revenues by trading services that sovereignty enables. Foregoing these rents and sharing the private benefits that they entail will not be straightforward choices for PICs. The limited gains to be reaped from PTAs also suggest that they would not, on their own, provide a very strong platform from which to develop support for stronger regionalism.

Nor, with one important caveat, does it seem that New Zealand and Australia could offer strong inducements to PIC governments to confront the challenges of regionalism by granting market access to PICs under PTAs. This caveat, access to labour markets under an agreement that includes services, is addressed in the next chapter.

5

Temporary movement of natural persons

Most of the discussion so far in this report has dealt with issues concerning flows of goods, services and finance, in the form of international trade, investment and remittances. One further flow, of labour, has been placed in the spotlight in recent years. Governments of some PICs, regional institutions, international financial institutions and academics have argued for New Zealand and Australia to introduce schemes to allow for temporary migration for work purposes for residents of PICs. And some researchers have suggested that future WTO negotiations on trade in services should be broadened to liberalise the movement of unskilled workers from developing countries under the Mode 4 category movement of natural persons (Winters et al 2002).

The Government of New Zealand has recently announced a new seasonal work scheme (the 'Recognised Seasonal Employer Policy) to let Pacific workers fill horticulture and viticulture jobs when no New Zealanders are available (Benson-Pope and Cunliffe, 2006). While the Australian Government has resisted suggestions to do something similar, a Senate Standing Committee inquiry into seasonal contract labour from the Pacific has kept the door open on the subject (Senate Standing Committee on Employment, Workplace Relations and Education, 2006).

A recent report by the World Bank has brought together some of these themes with an examination of the linkages between potential temporary movement of unskilled Pacific workers and the Australian market for seasonal workers in the horticultural sector (World Bank, 2006).

The report argues that seasonal labour migration programs that target the unskilled have the potential to make a material difference to the well-being of significant numbers of PIC workers, their families and communities. It argues that these programs also have the potential to significantly ease the seasonal labour shortages that are currently seen to constrain horticultural industries in Australia and New Zealand. And – perhaps just as importantly – it suggests that such programs would have symbolic value

as a gesture of good will by the region's two major powers towards their Pacific neighbours (box 5.1).

5.1 At Home & Away

The key points made in the recent World Bank report (World Bank 2006) on labour mobility and the Pacific are:

- migration can improve the welfare of migrants, their dependants, and the economies of host and sending countries.
- potential global welfare gains of liberalisation of movement of people could outweigh gains from any remaining trade liberalisation.
- PIC youth population is now 40 per cent of the total, with high unemployment and under utilisation of labour resources. PICs have not been successful at creating sufficient employment in the formal labour market.
- industrialised countries with labour shortages (due to aging population and low fertility rates) can draw on this pool of young people from the PICs.
- Pacific Island labour mobility currently favours skilled workers, whereas higher benefits would flow from greater mobility for unskilled workers.

The report points to evidence to suggest that shortages of seasonal labour lead to quite significant crop losses for the horticulture industry. It goes on to consider factors that could shape construction of a seasonal labour scheme for the Pacific that could ameliorate these shortages, provide significant benefits to workers and their families and mitigate some of the potential costs for New Zealand and Australia. These include:

- choice of workers to ensure that hiring is skill-appropriate
 - the Bank argues that this could reduce the risk that over-qualified workers would be hired who would use the scheme as a stepping stone to permanent migration;
- circular movement of workers to allow good employees to return in subsequent years rather than be offered a one-time only chance at off-shore employment
 - this is expected to reduce the risks of participants violating the arrangement, especially with regard to exiting at the end of the employment period;
- cost-sharing on travel related costs with employers to reduce the fixed costs borne by migrants
 - again to reduce incentives to overstay; and
- commercial viability so that the scheme remains private sector driven
 - this allows the scheme to adjust to changing labour market conditions in destination countries.

Working through the arguments

The arguments in favour of seasonal labour migration programs have not gone uncontested. At least one submission to the Senate inquiry contended quite forcefully that these arguments are fundamentally flawed (Hughes and Sodhi, 2006).

The debate on these proposals is quite complex, and involves a range of economic arguments and political judgments. It may help to try to identify some of the propositions that seem to have become entangled in the discussion. The underlying propositions would seem to include the following.

- Liberalising migration into New Zealand and Australia would improve aggregate welfare in these countries.
- Increasing flows of unskilled workers from the Pacific to New Zealand and Australia will increase aggregate welfare of all Pacific Islanders, including those who stay behind. However, increasing flows of skilled workers would reduce the welfare of those who stay behind.
- There is a case to favour participation of Pacific Islanders over unskilled workers from other parts of the world in temporary work schemes. This is because:
 - temporary work-related migration from the Pacific is a desirable adjunct to domestic Pacific policies aimed at improving development outcomes; and.
 - allowing temporary work-related migration from the Pacific is a desirable adjunct to Australian and New Zealand aid programs for the region.
- It could make sense to bring temporary work schemes into the negotiation of regional trade agreements, including PACER.

Liberalising migration into New Zealand and Australia

Standard economic analysis assuming unregulated factor markets would suggest that liberalising migration increases aggregate welfare of the liberalising country. Immigration increases the productive capacity of the economy, and increases returns to land, capital and those categories of labour whose services complement the labour supplied by migrants. While real wages of those categories of labour whose numbers have increased may fall, the aggregate gains will outweigh these losses.

While temporary work schemes are not the same as permanent migration, many of their effects on destination countries are similar. And that means that they are subject to the same caveats that apply to conclusions drawn about migration from a simple framework.

For example, factor markets, especially labour markets, are in practice regulated, and welfare systems allow considerable numbers of able people to maintain certain standards of living without being employed or earning returns on savings. And governments are not indifferent to the distributional effects of changes that increase aggregate welfare. As Hughes and Sodhi point out, for Australia important ethical and efficiency questions are raised about increasing migration of unskilled workers when large numbers of current residents are currently unemployed.

How well is the economic case for temporary work schemes enhanced by linking it to notions of seasonal labour shortages in horticulture and viticulture industries?

The report of the Australian Senate Committee Inquiry into Pacific Region seasonal contract labour has questioned some of the claims concerning shortages of labour. It argued that on the basis of the evidence it uncovered, producers usually found sufficient labour to harvest crops, and that the annual claim of shortages was more a form of job advertising. The report seemed to suggest that producers did not enjoy meeting the costs involved in finding labour.

One could argue that the seasonal labour 'shortages' horticultural industries complain about are consequences of labour market regulation, taxation and welfare policies. Reasonably generous welfare schemes make the reservation price of unemployed workers quite high relative to the net returns they might get from being involved in temporary work in rural areas.

Or alternatively one could argue that the issue is primarily one of price and comparative advantage. If horticulture and viticulture producers are unable or unwilling to pay a price high enough to attract seasonal workers, then this probably raises questions about the underlying viability of this kind of activity. (The Senate Committee report expressed some degree of puzzlement that firms involved in the heavy investments in these sectors in Australia had not seemed to pay much attention to the issue of labour supply. It noted that favourable tax treatment of managed investment schemes seemed to have played some role in the amount of recent investment.)

And some of the constraints that governments place around migration – permanent and temporary – to address labour market ‘needs’ can erode the gains. A particular example is that these schemes are often subject to tests of the availability of resident labour to supply the specific services being targeted by schemes. As Winters et al point out:

In goods markets, the practice of prohibiting imports when local supplies were available, proved to be one of the very worst elements of import substituting industrialisation. It fostered low quality production and provided guaranteed markets for local imitators of imported goods. The costs of such inefficiencies were mainly visited on other manufacturers, who became uncompetitive because they had to use sub-standard local components. Economic needs tests essentially do the same disservice for services. Poor professional services pervade the economy, reducing efficiency everywhere. The problems are less in very unskilled occupations because foreign and domestic workers are more readily substitutable. But even here, apart from the effects of the restrictions on wage rates, there may be an effect through the fact that even among the unskilled migration tends to select the more able and dynamic (Winters et al, 2002),

What this suggests is that migration schemes may well, for understandable political reasons, be hedged by restrictions that could erode or limit the benefits that destination countries could gain from them. Similarly, restrictions could well reduce the effectiveness of targeting within source countries. (As with quantitative restrictions on imports of goods, the constraints may promote shifts towards higher quality migrants: that is, schemes targeting lower skilled migrants may well end up being dominated by over-qualified participants.) But the fact remains that migration generally has positive welfare implications for recipient countries.

Increasing flows of workers from the Pacific

Most Pacific Island nations have large pools of under-employed and unemployed people of working age. Hughes and Sodhi estimate that there are nearly 1.4 million people in the labour force in PICs who are unemployed or under-employed, about 13 per cent of the total population (table 5.2).

Bringing these people into fully productive employment would clearly have a profound impact on national welfare. How significant might the impact of temporary migration schemes be?

Analysis carried out for the ADB-Commonwealth Secretariat report on integration in the Pacific (ADB-CS, 2005) examined the welfare

consequences of allowing skilled and unskilled workers from PICs to temporarily migrate for work in Australia and New Zealand.

5.2 Employment and under-employment in PICs, 2006

	<i>Population</i>	<i>Formal employment</i>	<i>Unemployment and under-employment</i>	<i>Annual additions to labour force</i>
Papua New Guinea	5,500,000	220,000	1,000,000	150,700
Fiji	890,000	111,100	155,000	20,000
Solomon Islands	540,000	57,500	79,300	16,000
Vanuatu	200,000	23,800	35,300	4,900
Samoa	177,000	50,300	22,500	3,400
Tonga	112,000	15,600	17,100	2,900
FSM	108,000	15,600	16,400	2,900
Kiribati	103,000	9,200	25,000	2,900
North Marianas Islands	80,000	6,000	20,600	1,100
Marshall Islands	59,000	10,100	8,300	1,600
Palau	20,000	9,300	1,500	390
Nauru	13,000	1,100	2,200	350
Cook Islands	12,400	5,800	na	na
Tuvalu	11,600	2,000	1,800	260
	7,826,000	537,400	1,385,000	207,400

Note Formal sector employment, unemployment and under-employment estimated from working age population. It is assumed that only a third of the working age population was available for work.

Source: Hughes and Sodhi, 2006

Table 5.3 summarises the main results of the analysis. It suggests that the total welfare gains to Pacific Islanders and to residents of New Zealand and Australia are quite large. If the program covers unskilled workers alone, the welfare change for residents of the New Zealand, Australia and the PICs is over US\$1.1 billion. When assumptions are made about the beneficial impact of work experience in New Zealand and Australia on workers productivity back in their home, the benefits are larger.

However, the scenarios that generate these benefits involve quite large movements of people, since they involve increasing the relevant workforce in Australia and New Zealand by 1 per cent (box 5.4). In the case of the scenario involving skilled and unskilled workers, it is assumed that just over 120 thousand workers would participate in the scheme, 20 thousand of whom would be working in New Zealand. This amounts to around 2.8 per cent of the working age population of the PICs, but less than 10 per cent of the estimated pool of under-employed. To give some better idea of the scale of the benefits, table 5.3 also shows the total benefits to permanent residents of PICs, New Zealand and Australia for each one thousand workers participating in the scheme.

5 TEMPORARY MOVEMENT OF NATURAL PERSONS

Even this scaling may need to be further qualified when account is taken of the likely nature of temporary migration schemes linked to seasonal harvesting needs. The numbers in table 5.3 are based on an assumption that the temporary workers are employed for the full working year: in practice, schemes may lead to migrants working much less than this. (The World Bank study examines schemes in which migrant workers are employed for periods of 6 to 26 weeks, and the New Zealand program talks of minimum employment periods of 240 hours. If migrant workers only worked for 10 per cent of the working year, the benefits presented in Table 5.3 would have to be scaled back accordingly).

5.3 Welfare changes for 1 per cent PIC labour quotas

Group	Welfare increase under scenario ^a		
	Unskilled quota	Skilled quota	Skilled and Unskilled quota
	US\$m	US\$m	US\$m
Total welfare benefits			
Pacific Islanders			
Working in Australia	775.1	611.1	1386.1
Working in New Zealand	104.1	63.9	168.1
Staying at home	22.0	-510.1	-488.0
All Pacific Islanders	901.2	164.9	1066.1
New Zealanders			
Working in Australia	-4.9	-2.0	-6.9
Working in Pacific	0.0	0.9	0.9
Living at home	17.9	8.6	26.6
All New Zealanders	13.1	7.5	20.6
Australians			
Working in New Zealand	-0.4	-0.5	-0.9
Working in Pacific	0.1	1.7	1.8
Living at home	199.8	102.9	302.6
All Australians	199.5	104.0	303.5
Others	-82.8	-4.0	-86.4
Benefits per thousand workers			
All Pacific Islanders	11.9	3.7	8.8
All New Zealanders	0.2	0.2	0.2
All Australians	2.6	2.3	2.5
Others	-1.1	-0.1	-0.7

^a Assumes that the relevant component of the workforce in Australia and New Zealand is increased by 1 per cent, supplied by workers from PICs on temporary work permit arrangements.

Source: Walmsley, Ahmed and Parsons, 2005

This size issue highlights one of the challenges of this kind of scheme: given the pool of underemployed people in the source countries, the numbers involved would have to be large for the direct migration effects (migrant

incomes and remittances) to have any real impact on the problem. But most schemes involve numbers that are considerably smaller than the available pool.

An important element of the analysis is the role of remittances in transferring some of the benefits to the Pacific Islanders left at home. Remittances have been the subject of some considerable debate: issues such as propensity of Pacific Islanders to make remittances and to sustain them over time have been discussed, as well as the uses (consumption or investment) to which remittances are put. Durability of remissions may not be so much of an issue for temporary migrant schemes, since participants will return home after relatively short periods away. The question of the uses to which remittances are put is perhaps best thought of in the context of the underlying causes of high levels of under-employment in the Pacific in the first place. This is discussed briefly below.

5.4 Analysing the impact of liberalising labour mobility in the Pacific

The main assumptions in the Walmsley, Ahmed and Parsons analysis are:

- participation rates of temporary migrants are the same as their home region;
- labour has the same characteristics as the home region, in terms of skilled/unskilled labour splits;
- wages of migrants are equal to the home wage plus 75 per cent of the difference between host and home wage;
- remittances remain a constant proportion of income, derived from past data;
- all other income (from capital, land etc) accrues to permanent residents;
- foreign and domestic labour are perfect substitutes;
- the quantity of skilled and unskilled labour within a region is fixed and only changes with the movement of capital (sic) from one region to another;
- that there is excess demand for the quota spaces and hence any change in quotas will be filled by the labour exporting region; and
- a revolving door, where temporary workers continually enter and return to their home countries. Unless otherwise stated, no changes in productivities are assumed upon their return home.

The main shock analysed is introduction of a quota for temporary migration from the PICs equal to 1 per cent of the unskilled and skilled labour forces in Australia and in New Zealand. This is equivalent to adding around 80 500 workers to the stock of labour in New Zealand, and 152 000 to the stock in Australia.

Another feature of the analysis is that if skilled workers are included in the scheme, the welfare of Pacific Islanders left at home falls: the impact of withdrawing skilled workers is not offset by the remittances that are assumed to be returned to the home country. (This has implications for the

selection processes for temporary migrant worker schemes: often the most favoured people from developing countries to fill unskilled positions in developed countries are people with skills. They are often best equipped to make the adaptations required in a new working environment, and still benefit from remuneration differentials.)

It should also be recognised that some of the assumptions about substitutability of unskilled labour in PICs and their counterparts in Australia and New Zealand may be quite strong. The analysis proposes that Pacific Island workers could be more productive upon return to their homes after working in Australia and New Zealand. This would suggest that they have learnt work skills that they did not have before. (It also assumes that there are employment opportunities available to them on their return.)

The analysis captures some of the indirect costs of increasing the labour endowments of Australia and New Zealand at the expense of PICs. But it does not include *all* of the costs, such as those incurred in transporting workers, administering the quota schemes (including ensuring exit at the termination of the migration period), and preparing participants to operate in the industries where they will be employed.

Despite these constraints, the analysis provides a quite compelling indication that the benefits to the Pacific of temporary labour migration schemes could be far from trivial. They also show that given the current propensity of Pacific Islanders to share the gains from employment overseas through remittances, the benefits are likely to be spread in part amongst those who stay at home. And the benefits that these schemes deliver are immediate: whereas the evidence suggests that efforts to improve the environment for job creation in the PICs are taking a long time to bear fruit.

Temporary work-related migration and aid and development policies

The Australian Government has argued that any migration related initiatives should reflect principles of non-discrimination. The Australian Department of Foreign Affairs and Trade said in its submission to the Senate Standing Committee (DFAT, 2006):

Australia's membership of the World Trade Organization limits its ability to discriminate in favour of nationals of certain nations ahead of others. Under the core national treatment principle, Australia is obliged to extend to all 149 WTO members no less favourable treatment than it accords to any other Members. Any scheme which granted special access to Pacific Islanders may be open to challenge from other WTO members seeking similar access.

As the Committee's report indicates, this is open to some dispute. But the broader question remains: how do New Zealand (and Australia) benefit from restricting inward work-related temporary migration to Pacific Islanders?

The benefit must lie in a judgment that:

- the people of New Zealand (and Australia) derive a higher utility from improvements in the well-being of Pacific Islanders than of people from other countries; or alternatively
- given some specification of the benefit to be gained from the welfare of other peoples, that temporary migration schemes provide relatively better instruments for improving the welfare of Pacific Islanders than other instruments; or again
- such schemes complement other instruments better in the case of the Pacific than they do for people in other countries.

A logical starting point (logical in the sense that it narrows the range of discussion) is that New Zealand and Australia do have strong humanitarian, economic and strategic interests in the prosperity and sustainability of their Pacific neighbours. There are significant challenges to achieving these goals, and the question is how best New Zealand and Australia can help the people of the Pacific.

Put in its simplest form, we could say that PICs have relatively large pools of under-employed labour with limited industrial skills (this is not to say that the labour is unskilled, just that the skills are appropriate to the economic environment of the islands) and these pools are growing. But PICs are short on complementary factors of production – capital, modern entrepreneurship, skilled labour (and in some cases natural resources) and an institutional framework that supports the contractual arrangements required for investment and specialisation. There are two broad ways in which the current and future well-being of PICs can be improved: facilitating the movement of complementary factors of production to PICs, or the movement of PIC people to locations where the complementary factors are located.

Broadly speaking, New Zealand and Australia's aid programs are trying to tackle the issues through the first avenue, and temporary migration policies are about working through the latter avenue. The question that PICs, New Zealand and Australia are grappling with is: what is the appropriate mix of these approaches? And should the mix be the same for all PICs?

Addressing this question poses a range of quite complex considerations that cover issues of principle and theory, and issues of a more practical nature.

Some issues of principle

The two approaches necessarily interact with each other. They deliver benefits to PICs in rather different ways, with different time frames. They also involve costs to the countries that are offering them, and deliver different patterns of benefits. In principle any menu of these approaches would want to reflect the interactions of these costs and benefits, and the synergies between the approaches. Sorting this out would involve developing an understanding of issues such as the following.

- The nature of impediments to sustainable development in PICs, and the extent to which these impediments are susceptible to policy and institutional reform and injections of development assistance resources:
 - is there a difference, for example between the impediments faced by the smaller and more remote PICs and the larger, better endowed countries?
 - how effective are traditional aid instruments proving to be in helping PICs improve the environment for improving the well-being of their people?
 - the answers here might influence the mix between approaches, and how that mix might vary across PICs
- The contribution that temporary work-related schemes might make to addressing these impediments (given that these schemes will only involve limited numbers of people, we might hope to see some benefits beyond the incomes of participants and the people to whom they make remittances):
 - how would schemes impact on the political economy of reform in source countries, and interact with the demographic processes that are fuelling some of the under-employment problem?
 - what is the experience of other countries where parts of the population work overseas in labour export schemes? Have such schemes, for example, increased or decreased the pressure for reform in these countries? What is the experience in PICs where migration and remittances are important parts of the economy?
- The impact of detailed arrangements for the schemes impact on the net benefits accruing to all countries concerned:

- how much cost would be incurred in ensuring that the schemes are politically acceptable in source and destination countries?
- The scope for a trade-off between aid flows and operation of these schemes:
 - it might be argued that because the bulk of the resource flows accrue (in principle at least) to households rather than governments, the probability of being well used is higher than for aid flows;
 - if the resource flows from these schemes are not well-used (a difficult judgment to make: far harder than in the case of public sector spending!), then it may still be necessary to help countries improve the institutional and policy environment that affects spending, saving and investment decisions of households;
 - there could be a win-win situation if the programs lead to a reduction in wasteful use of resources associated with misallocation of aid flows.

These are not easy matters to grapple with, and a lot of judgment is will be involved. But making them explicit, and seeing temporary migration schemes in a longer term development and growth framework for PICs may suggest ways in which they may need to be structured to have long lasting impacts.

Some practical issues

There is clearly a challenge in the practicality of constructing schemes that negotiate the minefields of immigration and labour market policy concerns in New Zealand and Australia, and have a measurable impact on sustainable development of the people of PICs.

The World Bank has argued that the key objective is to provide opportunities for unskilled workers in the Pacific, and has pointed to the large and growing number of people of working age who are unlikely to find employment in the formal sector. The analysis carried out by the ADB and the Commonwealth Secretariat points out that increasing migration of skilled workers risks worsening the welfare of the Pacific Islanders who remain at home. So the critical feature of any temporary migration scheme appears to be to target the unskilled.

At the same time, it is accepted that unconstrained migration, be it temporary or permanent, is unlikely to be politically acceptable in New Zealand or Australia. So any scheme would have to be quota constrained. Further, proposals recognise that potential employers would have to have a

significant degree of freedom to choose temporary workers, if they are to bear the not-inconsiderable risks of things going wrong.

What this all implies is that there will be very strong incentives for ‘quota migration’ – for the schemes to end up targeting the most skilled and capable candidates. It also has to be recognised that in some ways these schemes are creating rents. Avoiding corruption associated with the allocation of these rents, and behaviour that dissipates these rents, requires certain standards of governance. Most contemporary analysis would suggest that this is a quality that is not well-supplied in those PICs where the problems of under-employment are most pronounced.

A further consideration is that if the temporary labour migration schemes involve numbers of participants that are small relative to the pool of under-employed in PICs, there would have to be significant externalities if a meaningful and sustained contribution to total PIC welfare is to result. If a small group of participants and their extended families are granted a windfall, and if, as implied by some of the proposals, the schemes encourage circularity (that is, to enhance the appeal to employers, and reduce incentives for overstaying) participants are allowed to return in later years, then there is a risk of creating a privileged group of beneficiaries. The previous paragraph hints at the potential for the windfall to be dissipated or appropriated. But more importantly, the impact on the longer term prospects of the majority of Pacific Islanders will be small unless there are spillovers.

One potential source of spillover is that the participants gain workplace and other skills that can increase their productivity in employment back home, and be transferred to other compatriots. Focusing on the acquisition of these skills may have important implications for the way in which work in the destination country is organised.

For example, these skills are more likely to be acquired if participants work in environments where their co-workers already have these skills. It is not immediately obvious that skills that could increase workplace efficiency will be as readily acquired if participants work in a group of similarly unskilled workers, and if workplace disciplines are imposed by employers and contract managers. Similarly, the skills acquired working as a ‘peasant’ labourer in horticulture (to quote one of the horticulturalists consulted by the Australian Senate Committee) may not be all that useful back at home. (It is hard to argue that agriculture in PICs is characterised by poor work skills.) And finally, as discussed above these skills will only provide benefits if the people can find employment back at home: these schemes

cannot substitute for continued efforts in PICs to reduce impediments to employment generating investment.

Temporary work schemes and regional trade agreements

If temporary work-related migration schemes are to be pursued, is there any logic to approaching them within a trade-in-services framework? In principle, the General Agreement on Trade in Services has the potential to interact with such schemes, as it includes service provision through the presence of natural persons as one of the modes of service delivery for which liberalisation commitments can be made.

Most of the commitments that have been made under Mode 4 have been concerned with professional and skilled workers working for multinationals, largely driven by interests in facilitating service delivery under Mode 3, commercial presence. Currently, most if not all temporary employment schemes are handled under the aegis of migration and labour market policies, rather than trade policies, and it does not seem that the GATS seeks commitments that constrain countries discretion in these areas. The Annex to the GATS on the movement of natural persons supplying services under the agreements states that:

The Agreement shall not apply to measures affecting natural persons seeking access to the employment market of a Member, nor shall it apply to measures regarding citizenship, residence or employment on a permanent basis (WTO, 1995).

However, the GATS is somewhat ambiguous on this point, because in some places the wording seems to cover the direct employment of foreign workers by domestic service-providing firms. As the WTO Secretariat has said:

There appears to be room for interpretation whether the foreign natural persons "employed by a service supplier of a Member" also include foreigners employed by host-country companies. While the wording of the Annex does not rule out this possibility, Article I:2(d) of the Agreement seems to cover only foreigners employed by foreign-owned companies (... the Article applies to services provided "by suppliers of one Member, through presence of natural persons of a Member in the territory of any other Member"). Thus, while foreigners would fall under the GATS if they work on a contractual basis as independent suppliers for a locally-owned firm, they would seem not to be covered if they were employees of that firm

This said, there does not seem to be any reason in principle why countries negotiating bilateral or regional trade agreements could not choose to treat temporary work-related migration schemes as a trade in services issue.

Despite the concerns expressed by the Australian Department of Foreign Affairs and Trade, there would seem to be no WTO related constraints on providing preferential treatment for residents of particular countries if this is done in the framework of a WTO consistent preferential trading arrangement.

The more important question is whether negotiations on such arrangements provide the best forum for dealing with the issues that surround such arrangements.

At one level, the political challenges associated with arrangements may indicate that it could be desirable to lock in liberalisation of temporary migration in a binding agreement. But this might create precedents that are difficult to contain when other arrangements are negotiated, or if multilateralisation of service commitments should lie on the table in future WTO negotiations. As the World Bank has pointed out, the case for multilateral and non-discriminatory liberalisation of migration has limited support, and given the degree of regulation in labour markets and operation of social insurance schemes, the economic case is less clear.

This leads to the observation that New Zealand and Australia may well want to discriminate between PICs for developmental and equity reasons, and to maximise the impact of what will always be a fairly limited program. One could envisage, for example, offering preferential treatment to countries whose objective constraints on development are strongest: that is to the countries with binding resource or size related constraints. Alternatively, one could envisage migration becoming a form of assistance to PICs to adapt to long run globally generated environmental change. And, if these schemes are seen as part of New Zealand's and Australia's development assistance programs, it is quite likely that there will be interest in attaching performance criteria to the continuation of the schemes.

Equally important is that it is rather hard to see how approaches to such schemes might play out in the kinds of calculus that usually inform trade negotiations.

As discussed in chapter 4, trade negotiations tend to cast liberalisation by a participating country as a concession that is only given if other participants offer concessions in turn. If this is the perspective through which special arrangements for PICs are viewed, the question then is whether a trade negotiation is capable of putting in play the kinds of 'concession' that New Zealand and Australia might seek for extending or introducing such schemes. (It is interesting to note that the EU seems to have made inclusion

of provisions on TMNP in PICTA as a precondition for inclusion in the EPA: an interesting way of testing the commitment of PIC governments to the principles of a trade-in-services approach to the issue (Pacific Islands Forum Secretariat, 2006)).

Putting it bluntly, it would seem that access to Pacific markets would not be a strong negotiating coin for PICs. What might be of more interest regarding the better endowed PICs could be guarantees regarding non-discrimination with respect to investment in resource development and extraction. But the most plausible trade-offs affected by such schemes would seem to be those dealing with development assistance and regional influence and security. While there is a strong tradition of addressing influence and security issues through trade agreements, it is not so clear that development assistance is best dealt with in a trade negotiations framework.

Conclusion

Some aspects of the discussion of the case for New Zealand and Australia to liberalise temporary migration of people from PICs for work purposes are reasonably incontrovertible. They include the following.

- Many PICs have relatively large pools of unemployed and under-employed labour, and young people make up a large share of this pool.
- Given demographic trends, PICs will continue to experience rapid growth in the number of people of working age.
- Under-employment of this important resource means that the people of PICs are incurring large opportunity costs. Traditional quasi-subsistence livelihoods are unlikely to be able to indefinitely support a large and growing pool of unproductive labour. The lack of employment opportunities in rural areas is fuelling a significant internal migration to urban areas, and in some PICs to rural locations with less intensively utilised natural resources. Both of these flows are causing social problems.
- In principle, temporary migration of unskilled labour to New Zealand and Australia can provide significant benefits to PICs, if programs are able to target these people, and if they are able to work effectively in the occupations requiring limited skills in these countries. Because of PIC's propensity to make remittances, and if schemes can be designed and implemented to avoid overstaying, a reasonable proportion of the benefits of employment will accrue to people in PICs who stay behind.

- Such migration would generate aggregate benefits to current residents of New Zealand and Australia, although the distribution of these benefits might conflict with domestic equity objectives.

Some propositions are less evident. They include the following.

- The long run benefit/cost calculus of such schemes is conceptually superior to removing impediments to domestic employment generating investment in PICs.
- It is possible to construct schemes that negotiate all of the minefields of changes in migration policy and do not seriously erode the benefits to be gained from letting unskilled workers from the Pacific work temporarily in New Zealand and Australia.
- It is feasible and useful to approach these schemes as a trade in services issue in negotiations of regional trade agreements

It is these less evident propositions that will have to be worked through.

New Zealand and Australia have a strong national interest in facilitating sustainable improvements in the well-being of Pacific peoples. Given the current diagnoses of the impediments to doing this, there seem to be two broad options (not by any means exclusive) for approaching this goal:

- moving under-employed people to countries where there are complementary factors of production (primarily capital and entrepreneurship) and sufficiently functional institutional and policy environments that facilitate investment and business activities that create employment opportunities; or
- bringing investment and entrepreneurship and other complementary factors of production to where the under-employed currently reside.

The feasibility of addressing constraints to the second option may vary considerably across PICs, since the nature of the binding constraints may vary across the quite disparate circumstances of these countries. It may also prove to be quite hard to construct temporary migration schemes that effectively reach the desired target population and avoid dissipation of the rents that are associated with them. But this would underscore the case for experimentation with both approaches and assessing the impacts in a consistent way.

While temporary work related migration schemes can readily be classed as falling under the banner of trade in services, it is not clear that they are best approached as such. The logic of these schemes does not easily fit into the 'trading concessions' framework within which trade agreements are negotiated. New Zealand and Australia would probably be unwilling to

bind themselves to the provision of such schemes in legal agreements. And they may for political and development reasons wish to discriminate between PICs with regard to participation in these schemes. Further, building these schemes into the architecture of trade agreements might reasonably be expected to require PICs to liberalise work related movement of people amongst themselves: their willingness to do this is not very clear.

Ultimately these schemes are more about development than trade, and would fit more logically into broader agreements that bring development assistance and strategic concerns into consideration.

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