

Trading preferentially and protection

Is it good for Pacific Island Countries?

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1. Introduction

The trade policy agenda in Pacific Island Countries (PICs) has certainly become crowded, as the cast of players involved in regional trade politics and negotiations has become larger. In fact it is commonplace around the world that players such as commercial firms, non-governmental organisations (NGOs) and international bodies like the World Trade Organization (WTO) are becoming actively involved in trade negotiations at the regional level. Consequently apart from the state, other voices are exerting attention-grabbing influence in the conduct of regional trade politics. While firms have always played an important role, the rise of NGOs proclaiming that they are acting in the interests of society presents an additional challenge in the move towards a more liberal trading system. The demonstrations by NGOs at the WTO Ministerial Conferences in Singapore (1996), Geneva (1998) and the US (1999) are well known. It is also well known that such huge interest from NGOs led the then Director-General of WTO, Renato Ruggiero, to announce an enhanced plan for cooperation with NGOs (WTO, 1998).

Penjueli and Morgan (2010) argue that a regional trade agreement of PICs such as the Pacific Agreement on Closer Economic Relations (PACER) Plus would not meet the needs of the PICs and that such an agreement would displace '... domestic production and imports from other countries and [add] further to the considerable trade imbalances [of] many Pacific countries' (p. 219). The authors of this article represent the Pacific Network on Globalisation (PANG), a Suva based NGO. The article is in fact a response to an earlier article by Kaufmann (2009) justifying the benefits to PICs of signing PACER Plus with Australia and New Zealand. The crux of the argument by Penjueli and Morgan (2010) rests on the basic idea that a preferential trade agreement (PTA) like PACER Plus would not meet the needs of the PICs.

In this paper we argue that the lines of reasoning both Kaufmann (2009) and Penjueli and Morgan (2010) have used are flawed. The paper disagrees with Kaufmann (2009) that an agreement with Australia and New Zealand will bring *maximum* benefits to PICs and questions the basic issue raised by Penjueli and Morgan (2010) and PANG. From the publications of PANG it is unclear whether it supports unilateral trade liberalisation, although its opposition to a regional trade agreement among PICs and Australia and New Zealand is obvious. While we agree with the opposition to such a trade agreement, the reasons PANG argues cannot go unchallenged. Such reasons could prove to be seriously detrimental if carried over to challenge unilateral liberalisation, which seems most likely to be the case for opponents of free trade. Most of the arguments raised by PANG wrap themselves up in the language of job preservation, national sovereignty and infant industries. It seems that PANG and law professor Jane Kelsey, the key author of its various reports (2004a and 2004b) ignore the logic of the economic case for free trade and as a consequence, end up revealing the old and now discarded mercantilist rules.

2. The idea of a preferential trade agreement (PTA) for PICs

PTAs are once again fashionable. The first wave of PTAs started in the 1950s and 1960s; the last decade has witnessed an unprecedented proliferation of agreements. Although WTO is non-discriminatory with respect to the application of trade policy in goods, services and intellectual property, both the General Agreement on Tariffs and Trade (GATT) and its successor WTO allowed preferential or regional trade agreements among a division of members. Thus many countries agreed to commitments on a regional basis as well as multilaterally. Since 1948, more than 400 PTAs have been notified to the GATT or WTO, of which 227 are currently in force (as at December 2008). Among those in force, 143 were notified under GATT Article XXIV, 27 under the Enabling Clause, and 57 under GATT's Article V (WTO, 2008).

It was natural for PICs – including Australia and New Zealand – to create trade agreements suited for the Oceania region. The creation of the South Pacific Bureau of Economic Cooperation in 1971, and subsequently the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) in 1981 between Australia, New Zealand and PICs marked the beginning of an era of regional collaboration in trade. It is also interesting that Australia and New Zealand saw the need to develop a closer and deeper economic integration. This came through the implementation of the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA). This agreement between Australia and New Zealand was essentially based on bringing down the tariff and non-tariff barriers (Scollay et al., 2011). Later the formation of the Melanesian Spearhead Group (MSG, comprising Fiji, Solomon Islands, Papua New Guinea and Vanuatu within the PICs) Trade Agreement in 1993 signalled the changing attitude towards the importance and benefits of liberalisation. Regional cooperation was further developed in association with an urge to reduce trade barriers through the Pacific Island Countries Trade Agreement (PICTA), a free trade agreement formed in 2001 by the PICs. PICTA is still having difficulty, as some of the countries, notably the Republic of Marshall Islands and Palau, have not signed PICTA and the Federated States of Micronesia has signed but not ratified. These countries' lack of interest in PICTA is understandable; for historical reasons they are much closer to the USA and under the US Compact of Assistance scheme they receive significant benefits.

More recently, ongoing negotiations in PACER Plus (initially begun as PACER) and an economic partnership agreement (EPA) with the European Union (EU) have generated extensive interest and

debate. The provisions in the EPA triggered the negotiations under PACER Plus when Fiji and Papua New Guinea signed interim EPAs, largely to ensure continued access to the EU market for their sugar and fish exports.

3. Preferential trade agreements: areas of concern

A country's being part of a PTA may give an impression that it is actively involved in trade liberalisation. Yet such liberalisation may not be the best form of liberalisation for a country committed to reducing tariffs. The key problem with a PTA is that member countries remove tariffs on imports of their partners' goods, but retain their own restrictions on imports from non-member countries. So the tendency to equate a PTA with free trade is erroneous (Viner, 1950; Panagariya, 1996). What exactly are the potential consequences of PTAs for PICs? There are several downsides. The rich theoretical and empirical literature in this area provides a compelling case against PTAs between an economically small region and the larger nations (Viner, 1950; Bhagwati, 1971, 1991, 1993; Baldwin & Venables, 1995; Bhagwati & Panagariya, 1996; Winters, 1996; Krishna, 1998; Panagariya, 1999, 2000; and Bhagwati, 2008, among others). There are two sets of issues here; the first question deals with the static analysis effects while the second question is what Bhagwati (1991) has phrased as dynamic path questions or whether the PTAs can be regarded as 'stumbling blocks' or 'building blocks'. In the case of the latter issue, while some researchers claim that these agreements can be important in moving towards global free trade, others have fiercely opposed regional agreements as a potential threat to the multilateral trading system.

First is the issue of welfare analysis, where Viner (1950) pioneered research, especially in examining the static welfare analysis. Here, he showed that the net welfare effect depended on trade creation and trade diversion. In a more recent contribution in this area, Bhagwati and Panagariya (1996) conclude that PTAs are mostly welfare reducing because member countries may end up with severe losses, due to a substantial amount of trade diversion. The underlying argument against PTAs here is that they could divert trade from non-member countries who may be cost efficient to relatively inefficient member countries. When this happens, it disrupts the efficient allocation among countries. It is as simple as this; not all trade liberalisation is good. So it is perfectly possible that a country, having liberalised under a regional agreement such as PACER Plus, then experiences trade diversion, which harms it, instead of improving its gross national product.

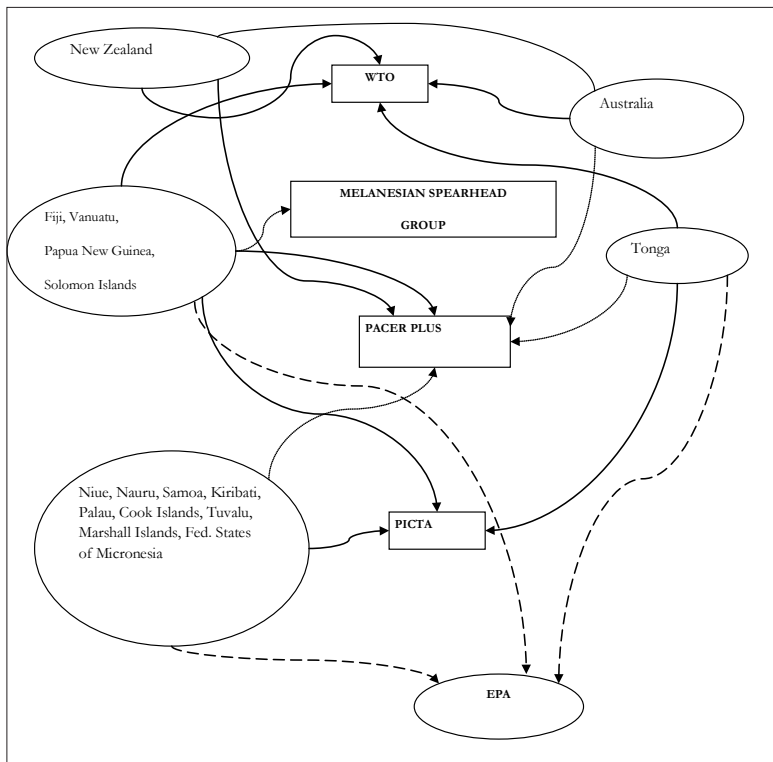
Later, Wonnacott and Lutz (1989), Summers (1991) and others opposing Vinerian theory argued that if PTAs are formed by natural trading partners (this being defined as those having a high initial volume of trade among them), trade creation benefits will outweigh the trade diversion effects, allowing members to benefit. This view, however, has been disputed by Panagariya (1996) and Bhagwati and Panagariya (1996). They show that a high volume of initial trade can be a major loss to a member country, and the initial high volume, rather than being natural, may be due to preferences. In further support of RTAs, Krugman (1991) and Frankel, Stein and Wei (1995) have argued that small distance and thus, reduced transportation costs, should characterise beneficial natural trading partners. Bhagwati and Panagariya have also deemed this view to be incorrect (1996) as they show that a country is better off forming a PTA with a distant country rather than a regional or neighbouring country when these two countries are otherwise the same. Furthermore, the increase in the number of PTAs raises technical problems, particularly due to overlapping PTAs. One, when a country enters more than one PTA, a single commodity is subjected to different tariff rates due to different PTAs. Two, tariffs on commodities depend on where the product originated from, i.e. the

rules of origin. As countries sign multiple and crisscrossing PTAs, the trading system is likely to be chaotic. This prompted Jagdish Bhagwati to call this phenomenon the 'spaghetti bowl' problem. He aptly summarises the problems associated with this phenomenon in these terms (2008:69):

The complexity that the spaghetti bowls create for international trade causes distortions in trade and investment. Much energy and resources must be expended to discover the optimal sourcing of large numbers of components with a view to minimizing the cost of manufacture plus transportation and the different tariffs and charges levied by origin.

Various issues such as different schedules for phasing out tariffs, different rules of origin, exclusions, conflicting standards and other regulations and policies are fundamental in the spaghetti bowl (Pangestu & Scollay, 2001; Menon, 2009). A sketch of the spaghetti bowl for the South Pacific (Oceania) region is shown in Figure 1. It includes only the PTAs within the Oceania region and with one another.

Figure 1 Spaghetti bowl in Oceania



While Australia and New Zealand have their own PTAs with nations other than the Oceania region (for example, Australia–New Zealand; Australia–Chile; Australia–USA; Australia–Malaysia; New Zealand–Singapore; Australia–Singapore; Australia–Thailand; New Zealand–Thailand; Australia–Papua New Guinea) PICs are negotiating for an EPA with the EU. Bhagwati (2008) has argued that PICs could be forced into signing this due to the loss in preferences granted and consequently market access provided by the EU until now. As the sketch shows, establishing which product is whose based on arbitrary rules of origin would be a muddled undertaking and impossible ambiguities will be numerous. Empirical research is needed to determine how big a problem the 'spaghetti bowl' really is in the case of PICs.

Secondly, is the issue of whether PTAs can be regarded as ‘stumbling blocks’ or ‘building blocks’. Are PTAs stepping stones for PICs to global free trade? Or should they be seen as a threat to the multilateral trading system? If PICs commit to PTAs such as those discussed in section 2, one may ask whether that will increase or decrease the process of reducing trade barriers toward the goal of reducing multilaterality. At the moment the answer to this question is not clear. PICs have undertaken or are currently negotiating a higher level of commitments on a regional basis than has been the case multilaterally. So it is evident that PICs’ attention and limited resources available to use in trade negotiations have been diverted towards PTAs rather than multilateral reforms. Only Fiji, Papua New Guinea, Solomon Islands and Tonga are full members of the WTO. Most PICs are intent (for either economic and/or political reasons) on liberalising regionally rather than multilaterally as it seems trading of tariffs is an important aspect of trade liberalisation. It is also evident that PICs are less interested in WTO talks because they want to keep tariffs to outsiders. The stalled Doha round may have also jeopardised this momentum. There is also a likelihood that formation of PTAs could lead to a rise in new interest groups opposing multilateral tariff reductions and effectively becoming long-term obstacles to multilateral liberalisation.

4. What remains of the case for protection?

Is there anything new under the sun for the proponents of protectionism? The simple answer is unequivocally, nothing. From time immemorial, we have come across a long list of protectionist arguments. Bhagwati’s initial contributions in the area of international trade show that these are mostly second-best arguments. The first-best arguments never involve protection and ample evidence exists that small countries will wither behind protective barriers (Dornbusch, 1992). While the theory of the costs of protection was mainly developed by Meade (1955), Corden (1957) and Johnson (1960), much has been refined since then. However, the core issues surrounding the costs have remained intact: misallocations in production and consumption and the prediction that heavily protected developing countries will continue to suffer disproportionately higher welfare losses. In any case protection has hardly enjoyed any intellectual respectability. For example, according to Nobel laureate Paul Samuelson (2005:243):

Economic history and best economic theory together persuade me that leaving or compromising free trade policies will most likely reduce future growth in well-being in both the advanced and less productive regions of the world. Protectionism breeds monopoly, crony capitalism and sloth. It does not achieve a happy and serene society.

Samuelson’s statement is indeed a reflection of the status of academic debate at this point in time. There is now general consensus that open economies grow faster than closed economies (Romer; 1986, Lucas, 1988 ; Romer, 1992; Barro & Sala-i-Martin, 1995; Edwards, 1997). The reason for such a consensus in favour of trade liberalisation is based on the conclusions of a number of studies claiming that outward-oriented economies have performed better than inward-oriented countries in terms of economic growth (Dollar, 1992; Sachs & Warner, 1995; Edwards, 1998; Krueger, 1998; Vamvakidis, 1999; Frankel & Romer, 1999; Lee, Ricci & Rigobon, 2004; Dollar & Kraay, 2004). These studies represent key research within the large literature assessing the economic benefits of abandonment of import substitution strategy in pursuit of export promotion strategies. This change in outlook in trade policy gained momentum mainly in the 1970s due to the increasing criticisms levelled against import substitution industrialisation in influential works like Balassa (1971) and Little, Scitovsky and Scott (1970).

5. What is the best option for PICs?

The benefits of liberalisation are now well documented in the literature. Dornbusch (1992) provides several channels through which trade liberalisation could bring benefits: improved resource allocation in line with social marginal costs and benefits; access to better technologies, inputs and intermediate goods; an economy better able to take advantage of economies of scale and scope; greater domestic consumption; and availability of favourable growth externalities, like the transfer of know-how; and a shake-up of industry that may create a Schumpeterian environment especially conducive to growth. Trade restrictions will end up restricting growth and produce a loss of real income. This will go on as long as the economy is protected. The argument that protection will protect jobs is an economic folly. While protection, in the short term, may help jobs in the protected industry more than would otherwise be the case, it does not mean that protectionist measures can increase the total volume of employment in the economy. In fact, it would be to the contrary. While job losses are likely from import competition, the solution to this is not trade restriction but other policies to help workers adjust.

Unilateral trade liberalisation is the first best form of liberalisation to free up trade and realise maximum gains. While it may be true that unilateral trade liberalisation could only occur if policy makers are convinced that such benefits outweigh the gains from preferential trade agreements, there still remains a powerful case for countries to pursue free trade regardless of what other countries may do. The intentions of PICs are clear. They want to liberalise but only regionally and that means free trade amongst them. This may be an indication of evidence that PICs appreciate and understand the benefits of freeing up trade. So the sooner they are convinced that this can be achieved unilaterally and the serious downsides with PTAs, the better it will be for PICs.

6. Concluding remarks

It has been known from the time of Adam Smith that the best way of reducing tariffs would be to do so unilaterally. However, from the perspective of political economy, we know this is not so easy. Special groups seeking protection will always be with us and thus will constitute a continuous source of new avenues of attack. This is true for the PICs as well. The well-known dispute between Fiji and Vanuatu on kava and biscuits was driven by powerful business interests. Attention appears to focus on the loss of tariff revenues in PICs while no consideration is given to the fact that increase in trade flows would increase revenue from taxes on sales and increase in income taxes due to higher consumption as a result of lower prices of tradables. It is true that those tariffs have helped create a source of revenues, and changes in trade policies have contributed to the concerns, but this is at most a transitional issue. Trade liberalisation is not an end in itself. It is thus critically important to consider what PICs are losing in the long term as a result of protection.

PTAs, on the other hand, have had major implications for a rules based multilateral trading system. It is now becoming clear that in order to maximise social welfare, liberalisation based on preferential trade is certainly not the first best form of liberalisation. A successful conclusion of the Doha Round of the WTO could go a long way in enticing PICs in this area. In fact, developing countries such as PICs could be worse off under a complex system of overlapping PTAs. Existence of other PTAs by Australia and New Zealand with countries outside the region and the possibility of similar new ones would lead to a situation where weak PIC economies can easily be marginalised. Also, the possibility of gains from major trading partners would be eliminated under such a scenario due to

costly trade and investment diversion. Consequently non-discriminatory trade and gradual unilateral liberalisation remains the best option for PICs in order to maximise welfare.

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