VANUATU*

A. Introduction

Vanuatu applied to join WTO in 1995 but shelved an agreed package at the Doha Ministerial Conference in 2001. A number of problems with the process led to the current suspension of accession. This study is an attempt to examine these problems and draw lessons from the experience. It is also an effort to determine how much autonomy Vanuatu had during the accession process as well as some of the likely effects of the previously agreed package on the economy and policy environment. Accession is unlikely in the near future. Yet, however uncertain politicians are about the gains from WTO entry, they are mostly aware that Vanuatu must eventually join if it is to keep pace with changes in the world economy. Exclusion from global trading arrangements would likely worsen trade performance and ultimately economic growth.

Section A of this paper provides an outline of the scope and methodology. The main question concerns the extent to which Vanuatu can use WTO to impose a useful policy regime, and to what degree the Government can influence this policy environment. Policy autonomy is crucial for a small, vulnerable economy with LDC status.

In section B, an overview is given of the economy during the past decade with relevance to WTO entry. The accession process was largely a product of, and was integral to, a structural adjustment process initiated in 1997 by the Asian Development Bank (ADB). This report is thus partly an assessment of that structural adjustment. One of the conclusions is that the adjustment took too little account of Vanuatu's unusual characteristics, including its small size, vulnerability, limited range of exports, high costs and the subsistence nature of much of the economy. This insensitivity to local features was the result of a one-size-fits-all approach that employed a policy package more appropriate to larger economies.

Section C examines the accession process and outlines why the move to take up WTO membership was shelved. In part, the reason was too little public and political awareness; however, more importantly, the process was simply too complicated, drawn out and resource-intensive. Vanuatu also suffered because larger WTO members were worried that granting any concessions would set a precedent for more important trading partners. The accession process was flawed in that it tried to intervene in sensitive areas about which those members making demands knew little, with the complicated nature of land ownership being a case in point.

A prime benefit of WTO membership is that it offers Vanuatu the chance to set up a consistent long-term policy regime. Section D argues that entrenching sensible economic policies will reduce political interference, put in place useful economic

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incentives and ensure that businesses face a predictable policy future. However, Vanuatu must choose this policy regime, and it must be compatible with its export development strategy, which includes the possibility of subsidies and infant-industry protection. The existing accession package and the tariff regime established during structural adjustment led to a sub-optimal tariff structure. Any future accession must accommodate existing policy plans.

1. Theoretical framework

It is important to establish the theoretical perspective underlying the study. As WTO entry affects society and political structure, the report draws on sociology as well as economic theory. In particular, the study is influenced by the concept of "reflexive modernization", a broad-based attempt to illuminate both the positive and negative changes in modern international society. The idea of reflexivity is most commonly associated with the work of sociologist Anthony Giddens.[164] Many analyses suggest that States are swept along by irresistible global forces such as increasing capital and trade flows, whereas Giddens' analysis can be used to suggest that we have partial control over the process of internationalization. We possess this limited control because the institutions and structures within the international economy are of our making, not manufactured by some external phenomenon. Reflexivity consists of reacting to these institutions and structures.

Applying the concept of reflexive modernization to trade would suggest that worldwide trade rules are at the same time created by purposeful human processes but also reflexively, subject to human influence. While emphasis is often placed on the inevitability of globalization and the impossibility of small States influencing their relation within it, Giddens' analysis can be used to show that States are able to influence their relationship within international trade. Repeatedly emphasizing the inexorable nature of the process can even encourage a sense of resignation among small players, in turn undermining their ability to negotiate.

The concept of reflexivity provides a useful point of access to WTO accession. The image can be used as a methodological tool to illuminate the extent of Vanuatu's policy autonomy inside the multilateral trading regime. How far can Vanuatu determine its future economic and trading arrangements? Does Vanuatu's accession simply reflect the demands of existing member countries or is there some space for manoeuvre? To what extent was Vanuatu – as potentially the first LDC to accede since the Uruguay Round – capable of changing the conditions for future entry of other LDCs?

In outlining the lead-up to accession and the outcomes, the study examines how reflexivity operates. In other words, it explains to what extent Vanuatu was able to act autonomously within the WTO accession procedure and by how much future domestic policymakers will be able to decide national strategy. Of course, one of the perceived benefits of WTO entry is precisely that it limits room for manoeuvring by preventing

[164] A. Giddens, 1990, *The Consequences of Modernity*, Stanford, Stanford University Press. The concept of reflexivity has also been applied to economics by theorists such as John Maynard Keynes and George Soros.

special interests from interfering in policy and, hence, removes autonomy from governments. This issue is dealt with in section D.

2. Why policy autonomy matters

According to the ESCAP study on trade and investment (No. 49), entitled *Facilitating the Accession of ESCAP Developing Countries to WTO through Regional Cooperation*, "a critical factor in ensuring a smooth accession process was for each acceding country to direct and maintain ownership of the accession process" (p. 2).

Ownership is particularly important for Vanuatu, since a lack of domestic governmental influence over the accession process led to the deferral of WTO entry at the Doha Ministerial Conference in 2001 for political reasons following the completion of the final accession package. Vanuatu's membership in WTO is likely to be completed only with the consent of civil society. Public awareness and support can only be achieved if the country owns the process, both before and after accession.

Policy autonomy is particularly important for small, exposed economies that need adaptability in times of hardship. Vanuatu has a population of only 200,000 and its remote location in the south-west Pacific means it is geographically distant from its trading partners. The country ranks top of 111 countries on the Commonwealth Secretariat index of economic vulnerability owing to the recurrence of earthquakes and tropical cyclones. It is this vulnerability, rather than simply a low per capita GDP, that gives Vanuatu its United Nations LDC status. Removing important policy advantages – such as the ability to raise subsidies in response to a temporary decline in commodity prices – could have a stultifying effect on the economy.

As the economics literature shows, for some States that are at an early stage of development, with imperfect international competition and the potential for increasing returns to scale, it is rational to permit subsidies or protective tariff rates for a short period. Optimal growth can be achieved only with the option of exercising such autonomy over policy. As will be shown later in this paper, the negotiations over Vanuatu's accession involved demands that would have denied it access to such policy tools.

During Vanuatu's accession process, members of the working party argued that as a non-member the country did not have access to special and differential treatment provisions aimed at developing nations. The original provisions for special and differential treatment can be found in GATT 1947, Articles XVIII, XXXVI, XXXVII and XXXVIII. Further special and differential treatment provisions exist in the so-called 1979 "enabling clause", the 1999 agreement on waivers of Article I of GATT 1994 for developing countries, as well as under the WTO Agreements on agriculture, sanitary and phytosanitary measures (SPS), textiles, technical barriers to trade (TBT), GATS, TRIPs and TRIMs.

Clauses allowing for special treatment were included precisely because less-advanced economies need flexibility in policy-making. WTO is supposed to allow deviation from the "one-size-fits-all" approach. Denying such differential treatment to the smallest and least-advantaged potential member begs the question of why the provisions are included if they are not used.

B. Economic overview

1. Comprehensive reform programme

In 1997, the Comprehensive Reform Programme (CRP) was introduced with assistance from ADB with the objective of making government more efficient and raising economic growth. Political instability in the mid-1990s created fiscal problems, culminating in riots over the news that the Government had been misallocating resources from the Vanuatu National Provident Fund (VNPF), the State pensions account. CRP was aimed at bringing the country back from political and social disorder. The opportunity was taken to enact structural economic reforms alongside political and civil service reorganization, despite the economic problems being policy-related rather than structural.

As in a number of other developing countries, structural adjustment was linked to trade liberalization and WTO accession. Although the WTO membership process began in 1995, its explicit advocacy under CRP provided the main impetus for accession. The efficacy of CRP was crucial to garnering public support for a new policy regime and providing support for the economy during its transition to WTO membership. CRP can be judged on three criteria:

2. Government performance
Public expenditure and privatisation
Macroeconomic aggregates

Five years after the programme began, the results remain mixed. Without CRP, economic policy would probably have remained highly inconsistent and it is unlikely that the economy would have maintained the performance of the previous decade. A more modern public sector will help Vanuatu's position within the international trading regime. Government performance has improved in some ways, with fewer extended family (*wantok*) appointments to civil service positions and a more meritocratic system of hiring and firing. Policy has become less susceptible to the influence of special interests. The introduction of a free press has rendered ministers and civil servants more open to scrutiny.

However, many public servants and ministers feel that, after the initial period of encouragement, they have been left under-resourced and with a new set of problems. Government was never big, with public expenditure averaging only 27 per cent of GDP during the 1990s. ADB has pointed out that in 1990 Vanuatu had one of the lowest ratios of government employees per capita among Pacific island economies, at three per 100 inhabitants of the country. This compared very favourably with the Cook Islands at 18.2, Tuvalu at 8 and Fiji with 6 per 100 inhabitants.[165]

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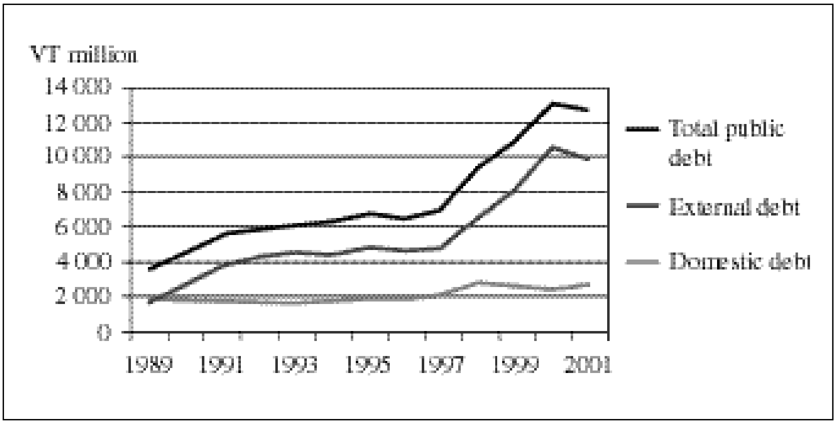
[165] *Vanuatu: Economic performance, policy and reform issues,* Asian Development Bank Pacific Studies Series, 1996: 103.

Despite the small size of the Government, CRP ushered in a period of privatization aimed at altering the structure of government revenue and shifting more economic activity to the private sector. However, as recent economic theory has shown, institutions are as important as ownership.[166] Most major privatized government enterprises simply moved from the status of a publicly accountable monopoly to a private unaccountable monopoly. In a small economy such as Vanuatu, the institutional capacity for effective regulation will always be difficult to achieve.

In such a small market, there is little room for competition and government officials often have a vested interest in maintaining supernormal profits among former public firms with which they maintain close relations. Companies operating in areas crucial to overall efficiency (or example, Air Vanuatu, Telecom Vanuatu Limited and UNELCO, the electricity and water utilities company) have little incentive to reduce prices, which are among the highest in the Pacific.

From a situation of relatively low indebtedness in 1996, CRP left Vanuatu with an external borrowing problem. The external stock of debt, mostly ADB foreign currency loans as part of CRP, ballooned in 1997 (figure I) and had reached 31.2 per cent of GDP by 2002, compared with 15.6 per cent of GDP in 1990.[167] A predicted expansion in GDP growth has not materialized, leaving Vanuatu with a substantial debt obligation but little means of generating new revenue for repayment. The Department



Source: Vanuatu 2003 Government budget.

Figure I. Public debt, 1989-2001

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166 For example, see J. Stiglitz, 2002, *Globalisation and its Discontents*.

167 Vanuatu's small size makes data collection easier and less prone to large errors than is the case with many larger developing countries, but problems remain. Generally, data on the domestic economy are less reliable than international data. Trade statistics are derived from the ASYCUDA customs database, although importers are believed routinely to misclassify some products. Banking and finance statistics are generally seen as among the most reliable, although figures from the Reserve Bank of Vanuatu and the Department of Statistics sometimes conflict.

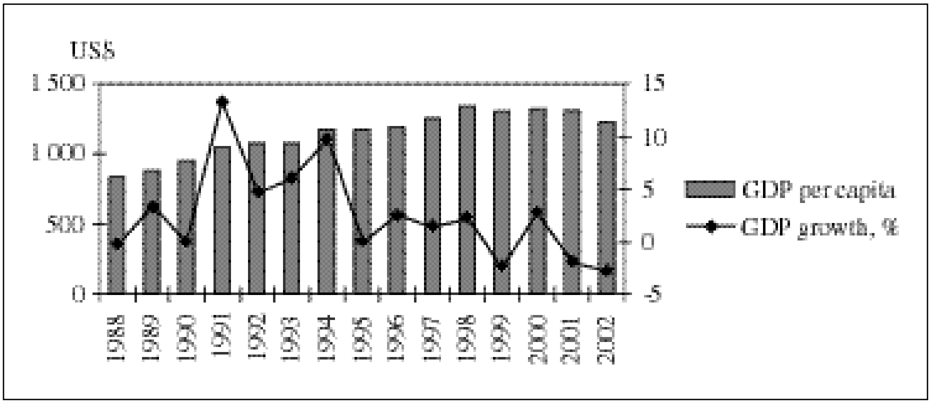
of Finance predicts that total interest payments will have risen to 8 per cent of domestic revenue by 2007 from a projected 7 per cent in 2003. Not only does the debt stock consume a growing amount of vital domestic resources, it also rules out a number of policy choices such as currency devaluation. This limits Vanuatu's policy autonomy.

Measured by macroeconomic aggregates, CRP has also fallen short of its targets. According to a 1996 ADB study: "In the second period (of the reform programme) between 2000 and 2005, the fruits of reform really begin to 'kick in' and GDP growth accelerates to an average rate of 5.8 per cent".[168] GDP growth has declined since CRP began. While the fall in GDP growth was partly due to a fall in exports and internal issues such as the riots in 1998 over the misappropriation of revenue from the National Provident Fund, CRP was aimed partly at equipping Vanuatu for dealing with such potential problems.

3. Gross domestic product

GDP expanded at a modest annual rate in the past two decades. During the 1980s, the annual GDP growth averaged 3.2 per cent, rising to an average of 3.7 per cent in the 1990s despite volatility resulting from fluctuations in tourism, changing demand for agricultural products and serious weather events.

GDP per capita, which currently stands at around US$ 1,200 (figure II), has stagnated since the mid-1990s and has declined in recent years owing to the continuing high birth rate, improved health standards and the recent slowdown in GDP growth. It should be noted, however, that four-fifths of the population are subsistence farmers living on the 81 outlying islands. The cash economy is located mostly in just two towns: (a) the capital Port Vila on the island of Efate and (b) Luganville on the island of Espirito Santo.



Source: Department of Statistics.

Figure II. GDP growth and per capita GDP

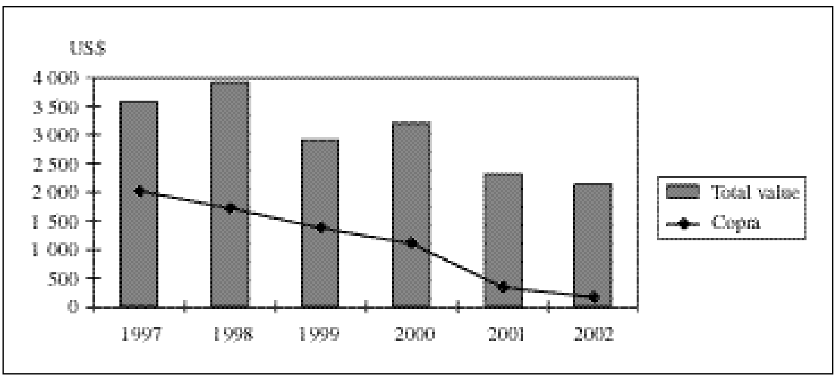
[168] Asian Development Bank, op. cit.: xv.

4. Trade

(a) Exports

Vanuatu has a lower ratio of exports to GDP than any other Melanesian economy and proportionally one of the smallest export sectors of the Pacific island economies. The economy has been able to produce only a limited range of exports. In the latest three-year period for which statistics are available, four products – copra, kava, beef, and timber – made up 73 per cent of export earnings. Copra was the biggest export in terms of value during the past two decades, although dependence on the commodity has fallen as the export sector has diversified. However, a halving of the world price of copra between 1997 and 2001 is still a major explanation for an increase in the trade deficit during the period under review. Recent trends for the main exports are shown in the annex. I.

The latest figures from the Department of Statistics show that Vanuatu's overall domestic exports fell from VT 3.2 billion (US$ 24.7 million) in 2000 to VT 2.3 billion (US$ 17 million) in 2001 (figure III), extending the general decline of recent years. During 2001, exports were worth only 7 per cent of GDP.



Source: Department of Statistics.

Figure III. Overall exports and copra exports, 1997-2001

Exports have shifted away markedly from the European Union to Australia in recent years figure IV. This is largely due to a decline in the value of copra sales to the European Union, but it can also be attributed to the recent ban by some European countries on kava-derived products owing to reports of liver-related illnesses.

Case study: The Kava industry

The prohibition of kava in developed countries has reduced exports by Vanuatu and hurt the country's economic growth; however, the Government has insufficient resources to challenge the ban. WTO entry may better enable Vanuatu to deal with similar future barriers to exports of its products.

Kava is a root used in Pacific societies as a traditional beverage. Infused in water and drunk fresh, it induces relaxation. Its biological home is Vanuatu, although the plant, of which there are over 80 cultivars in the country, is grown by other Pacific island nations. A late 1990s boom in the use of kava as a herbal alternative to manufactured relaxants prompted many Vanuatu farmers to begin planting large quantities of the crop for export. Kava represented 22 per cent of the overall value of domestic exports in 2001, and during the past five years has comprised a yearly average of 14.8 per cent of exports.

The ban resulted from reports from Germany in 2001 that 30 to 40 people had become ill or died after taking kava-derived herbal supplements. Following the German action, other European countries as well as Canada and Singapore restricted or prohibited kava imports. In addition, Australia, New Zealand and the United States either partially banned the product or issued warnings against it. Health agencies argued that products involving extracts from the kava plant had contributed to liver disease.

The impact of the ban on the economy was thus severe, contributing to a decline in GDP growth during 2002. An estimated one-third decline in kava exports during 2002 cut a fifth from Vanuatu's total yearly export earnings. Not only is the export of kava itself important to the economy, but the fall in overseas sales has resulted in domestic oversupply and lower prices as farmers try to sell excess produce.

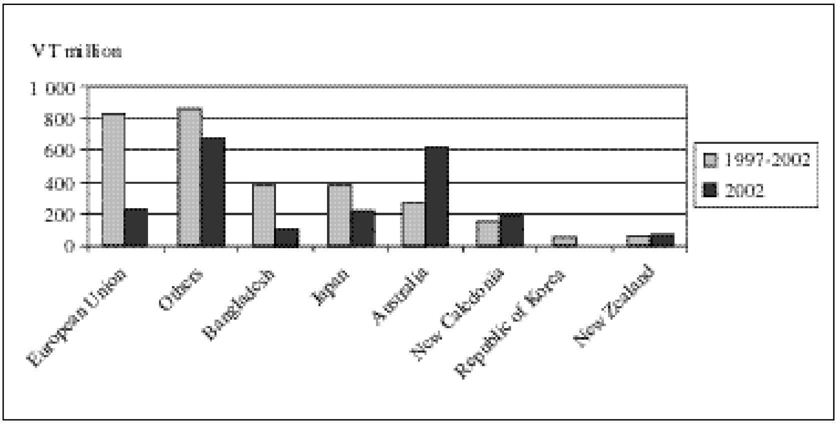
Some commentators have alleged that European and global drug multinationals lobbied for prohibition because the natural sedative was beginning to rival benzodiazepines like Prozac and Valium. Doubts surround the true cause of the casualties in Germany, with reports suggesting that one of the victims was an elderly alcoholic. Other countries banned kava without evidence of similar cases within their own borders.

Kava has been drunk traditionally in Vanuatu for many centuries with no adverse effect on physical well-being. The country has normal levels of liver health. Scientists suggest that poor processing of the product by selected developed country firms is to blame for the few health problems, rather than the raw product itself.

While the ban may or may not be justified, it is possible that it constitutes an illegal trade barrier. The truth is unclear and, in the meantime, exports of a key commodity crop have collapsed with a severe effect on the economy. The Government can do little to challenge the ban as it lacks funds for international legal action or a scientific study.

WTO membership might have allowed Vanuatu, with other Pacific WTO members such as Fiji, the opportunity to challenge the decision using the WTO dispute settlement mechanism. Currently, Fiji is considering a legal challenge but Vanuatu can take no part in the action. The benzodiazepine lobby would probably have been less willing to push for a ban on products exported by a group of WTO members. However, Fiji's influence is weakened because it is acting alone. Vanuatu and other exporters of the crop were considered too small and under-represented to be able to raise a serious challenge.

Vanuatu is likely to remain particularly exposed to overseas challenges to the standards of its agricultural exports because it is small and lacks technical and marketing experience. WTO membership would not only help reduce the chances of succumbing to powerful developed country lobbies, it would also enable Vanuatu to legitimately claim in advance that it was complying with strict international agricultural and food safety standards.



Source: Department of Statistics.

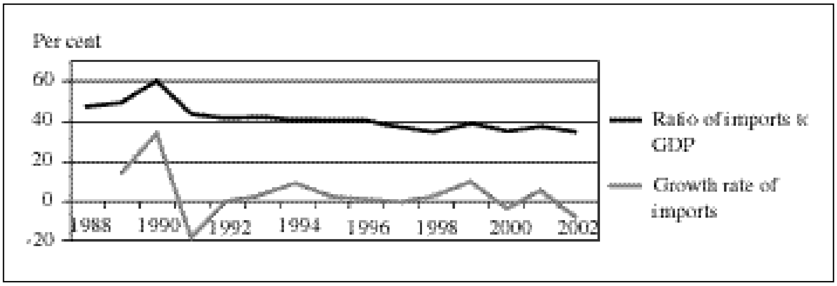
Figure IV. Annual exports

During recent years, Vanuatu had free access to the European Union under the Lomé convention and the 2001 "Everything but Arms" initiative for LDCs. The weak export performance in the region during that period suggests that Vanuatu does not need improved market access to the European Union from WTO entry.

(b) Imports

A limited manufacturing base means the import bill is large. Receipts from exports usually cover around a third of imports, and the economy has run a current account deficit every year since independence in 1980. More than half of the goods usually come from Australia and New Zealand, but in 2001 the proportion of imports coming from those two countries climbed to 72 per cent. The rise in trade with neighbouring Australia and New Zealand lends some support to the view that regional trade may yield bigger gains than ensuring continued market access to the European Union or the United States.

Despite assertions by some international agencies that the import substitution policy of the past two decades has failed, available data provide some evidence to the contrary. Real imports per capita fell 14 per cent between 1995 and 2001. The ratio of imports to GDP fell from 52 per cent in 1983 to 38 per cent in 1998 (although it had climbed slightly by 2000), while imports grew by an average annual inflation-adjusted rate of only 0.3 per cent between 1983 and 2001 (figure V). Coupled with the fact that the economy became more diversified under the hitherto blanket protectionist tariff regime, these data provide support, although not conclusive, for the case that carefully targeted protection of some infant industries may yield further gains. This does not advocate the continued protection of inefficient industries in which Vanuatu has no comparative advantage.



Source: Department of Statistics.

Figure V. Growth rate of imports and ratio of imports to gross domestic product

5. Balance of payments

Within the current account (table 1), the trade deficit is partly offset by a surplus in services, with tourism accounting for around half of the earnings from services. Tourism arrivals have increased steadily during the past decade since the new international air terminal opened in Port Vila. The ethnic disturbances in Fiji during 2000 boosted visitor numbers but there was a concomitant decline in 2001 and 2002 (figure VI). Most visitors come from Australia.

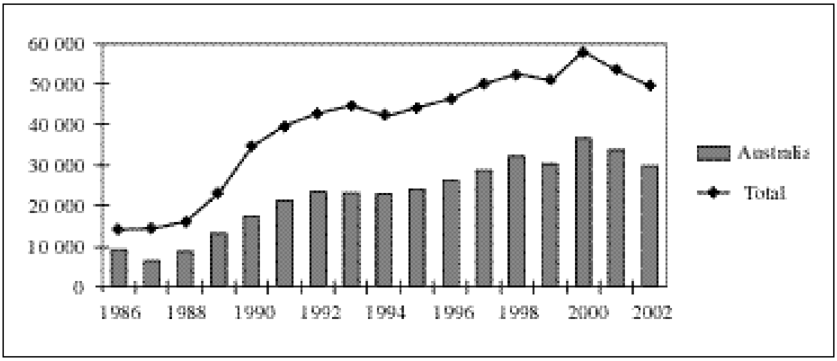
Copra has rivalled tourism as a net foreign-exchange earner as a significant number of tourist operations are foreign-owned and some revenue is sent overseas. Earnings from copra are also the major source of cash in poor rural areas. However, the multiplier effect from tourism earnings is likely to be larger as most funds are spent in the developed urban areas where the circulation of money is higher. Within the capital account, aid flows dominate capital transfers, with roughly half of the aid

Table 1. Balance of payments, 2002

(Unit: VT million)

Category	Revenue
Current account	
Balance on merchandise trade	-7 989
Balance on services trade	3 843
Balance on investment income	-556
Net current transfers	2 814
Capital account	
Capital transfers	
General government	889
Other sectors	435
Financial account	353
Net errors and omissions	-211
Gross official reserves	4 854

Source: Reserve Bank.



Source: Department of Statistics.

Figure VI. Tourist arrivals

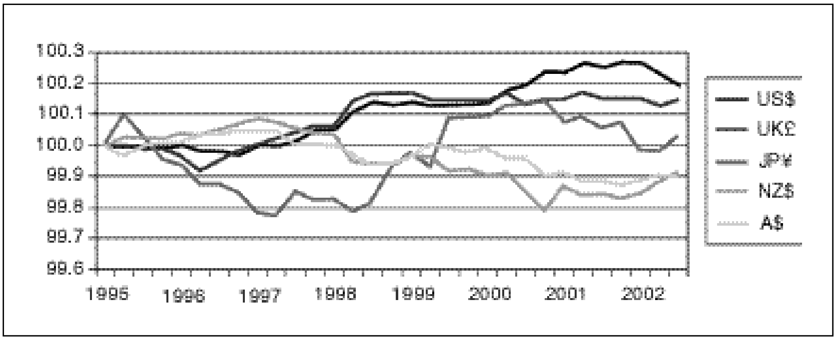
payments going to the Government and half going to other sectors. Australia is the biggest donor, while the European Union, France, United Nations and ADB also contribute. Net private investment flows are strongly negative, and Vanuatu has found it increasingly difficult to attract investment in recent years owing to difficulties with land tenure and overseas fears about political stability. Foreign exchange reserves covered around five months of imports during 2001, and the 2002 budget predicted that this level of cover would remain similar during the next five years.

6. Inflation

Inflation has been lower in recent years than in most neighbouring countries including Fiji, Papua New Guinea and Solomon Islands. Between 1990 and 2001, the average annual rate of increase in Vanuatu's consumer price index was 3.1 per cent. As a small, open economy and an importer of consumer products, Vanuatu is dependent on world prices, in particular those in Australia and New Zealand where inflation has likewise remained low and stable during recent years. The likelihood of currency stability, a continued high proportion of imports to GDP and sound monetary policy mean that inflation is likely to remain steady in the near future. Concerns have been raised, however, about the accuracy of inflation figures. Anecdotal and other evidence suggests that the true figure has been slightly higher in recent years.

7. Currency and financial sector

During the past eight years the nominal rate of the vatu has depreciated slightly against the US dollar and pound sterling and has appreciated marginally against the New Zealand dollar and Australian dollar. The vatu operates in a "crawling peg" system against a weighted basket of currencies, the composition of which the Reserve Bank keeps secret and which is occasionally adjusted. Calculations show that the real effective exchange rate has diverged significantly from the nominal rate in recent years, implying the existence of inflation that is not accounted for in the consumer price index.



Source: Department of Statistics.

Figure VII. Unit of foreign currency per Vatu, indexed to 100 in 1995

Vanuatu is the busiest tax haven in the Pacific, which is arguably one of the few areas where the economy has a true comparative advantage. Significant flows of funds arrive from Asian countries (e.g., Hong Kong, China) which are within a similar time zone. The financial sector employs over 400 people, a substantial proportion of the working population in the capital Port Vila. The two main foreign consumer banks, ANZ and Westpac, are attracted partly by the ability to operate on a tax-free basis. They would be unlikely to provide consumer services at existing prices, or possibly not at all, if significant new taxes were introduced on their operations.

Vanuatu's reluctance until now to comply with international information-sharing agreements has been criticized by the Organization for Economic Cooperation and Development and it would possibly conflict with any WTO multilateral agreement on investment. Concerns have been raised that the financial sector represents an avenue for money laundering. While this is always likely to be a problem with tax havens, the issue has been prominent following a recent scandal involving the proceeds from a global lottery fraud. Changes aimed at improving Vanuatu's international reputation have included making the Reserve Bank the regulator of the banking industry as well as passing tighter laws on the proceeds from crime entering the country. Critics also charge that Vanuatu does not gain enough from the large sums of money that pass through its financial institutions. Apart from employment, the only benefit is the revenue from small annual business licences. One suggestion for raising revenues is a small tax based on the declared balance of institutions registered with the Reserve Bank. This would be easy to administer and would attract much-needed revenue for the Government.

8. Summary

Structural adjustment and economic liberalization were integral to the WTO accession process. However, before the introduction of CRP, Vanuatu had few of the macroeconomic problems often associated with small developing countries. GDP growth had been stable and positive for almost two decades. Public debt was small. The fiscal situation was relatively well managed and inflation was low and predictable.

Unemployment was not a significant problem. Although there was a persistent and large current account deficit the capital account of the balance of payments was boosted by significant aid flows.

Although the economy was in trouble before structural adjustment, CRP has failed in most of its objectives. It was thus a missed opportunity. The standard policy set of privatization, tighter spending and trade liberalization failed to accommodate Vanuatu's unusual situation. The slow pace of development since independence can be attributed to features peculiar to many Pacific island economies such as a restricted export base, high internal and international transport costs, and small geographical size. Vanuatu's vulnerability must also be given special consideration.

Import substitution was not a complete failure. Given the narrow export base and opportunity for improved policy-making, carefully-targeted infant industry protection may yield further gains.

Trade with neighbouring economies has increased markedly over recent years. United States' trade flows have always been negligible while trade with the European Union, traditionally the biggest export partner, has fallen significantly. In addition to access to the European Union and the United States, efforts should be made to improve and diversify regional trade, possibly within the Melanesian Spearhead Group Free Trade Agreement (MSG-FTA) (see annex II), the Pacific Island Countries Trade Agreement (PICTA) and with East Asian countries.

Vanuatu already has free access to the European Union and will negotiate a new economic partnership agreement with the European Union under the Cotonou Agreement as part of the Pacific region. Vanuatu is restricted in the number of products it can export, and because the value of exports is very small – US$ 17 million in 2001 -large demand already exists for many products that it currently offers.

Any new set of policies induced by WTO entry must be designed to minimize further disruption to a now fragile macro economy. Such polices must allow sufficient flexibility to accommodate Vanuatu's vulnerability, small size and high level of costs. Reductions in bound tariff rates from Vanuatu can only be directly reciprocated by concessions in other areas, such as a lengthy transition period in order to adopt new rules. Increasing the volume of market access to developed WTO members such as the United States and the European Union is not a prime attraction for Vanuatu.

As a very small underdeveloped island economy, Vanuatu must retain autonomy over tariff and subsidy policies, at least during the transition period to WTO accession. As section C suggests, the WTO accession process must empower Vanuatu to force through a positive long-term policy environment rather than restrict its policy options.

C. Accession process

Although Vanuatu still holds WTO observer status, its accession is unofficially on hold following the withdrawal of the agreed terms at Doha. WTO officials were particularly keen to complete Vanuatu's accession at Doha, the start of the so-called “development” round, as countries from three official levels of development would enroll at the same time. The other two were China, as a developing country, and newly industrialized Taiwan Province of China. Vanuatu would have been the first LDC to join since the establishment of WTO following the completion of the Uruguay Round in 1994. Establishing the WTO development credentials was seen as important, following the decline in credibility at Seattle.

Vanuatu politicians suspended WTO accession largely for populist reasons, as a general election was due the following year. The ruling coalition was keen to secure support from influential businesses ahead of the election, particularly as economic growth was weak. There was an explicit appeal to the populist anti-globalization sentiment in order to win votes. Some observers have even suggested that the politicians purposefully waited until WTO entry was almost finalized before withdrawing, in order to achieve the maximum populist electoral benefit. The WTO Accessions Office claimed not to have been notified of the reason for the decision.

Much of the impetus for joining WTO appears to have been that it would enhance Vanuatu’s global recognition; the commercial implications of accession were understood only at a late stage. Little study was conducted on the short- and long-term welfare benefits and costs, while the policy effects were never fully appreciated. Government estimates suggested that administrative and travel costs related to accession were an estimated VT 20 million (US$ 150,000). These funds came from the government budget rather than directly from donors.

The annual payments to WTO by observers were also considered unaffordable and had reached CHF 23,070 by 2003. While a donor might be found, the total outstanding amount of CHF 168,420 in unpaid fees – about the same as the entire annual budget of the Department of Trade – represents, at the very least, an unwelcome psychological hurdle. Assuming Vanuatu receives a fixed annual sum of aid, any foreign donor payment for WTO entry would divert funds from other important areas.

The shelving of accession at the final hour despite the existence of a previously agreed upon package raises questions over communication between the delegation and politicians. The head of the Vanuatu delegation admitted that public awareness of WTO was weak and that politicians were not kept fully informed of decisions.[169] It did not help that the public service operates a two-tier system, with departments separate from ministries. One lesson that should be learnt from this situation is that accession must be accompanied by a vocal publicity campaign. Membership cannot be sprung on the public and politicians at the last moment.

The decision to withdraw can also be blamed on the complicated and resource-intensive nature of the information request process. As suggested in the ESCAP *Studies in Trade and Investment* (No. 49): “It is also commonly recognized

[169] Department of Trade research has shown that either most businesses do not know what the World Trade Organization is or they consider it irrelevant. A number of government departments are likewise ignorant of the functions of the World Trade Organization.

that the fact-finding stage of information by the working party is too long, too inquisitorial in nature, frequently repetitive and uncoordinated".[170]

Vanuatu could not, and still cannot, afford a permanent mission in Geneva. The delegation consisted of the Director of Customs, the Director of Trade and two part-time external consultants who were barred from some meetings because they were not Vanuatu citizens. The Minister of Trade was only periodically involved. A lack of manpower meant that the negotiating party had little time to communicate with politicians. Without specialist technical and legal back-up, negotiators themselves found it hard to understand complex jargon. On some issues policy had to be made on the hoof rather than a formal negotiating position agreed beforehand.

If small developing countries are to negotiate favourably, and if WTO is to be considered a truly rules-based system, they need either much better support or a far simpler accessions process. This could be achieved if a team of personnel was made available specifically to assist smaller countries; however, the existing Advisory Centre on WTO Law is a small step in the right direction. Tighter regulations must be established on governing the resources involved in the negotiation process – perhaps including a limit on working party and delegation numbers and a time limit for bilateral and multilateral offers – so that no party is at a disadvantage. LDCs such as Vanuatu cannot afford a full-time comprehensive team of negotiators based in Geneva, and it is evident that rather than simply signing up for a free and fair system, any potential new member must fight for favourable terms.

The process is stacked in the favour of developed incumbents who can baffle applicants with jargon and out-manoeuvre them by virtue of superior resources. Among small countries, the lack of administrative and technical capacity is a major obstacle to successful membership and constitutes an issue quite separate to the economic impact of joining. There should be no pretence that by maintaining a high administrative and technical cost of membership, incumbent members have anything but their own interests at heart.

1. Precedence and most-favoured nation treatment

Part of the explanation for Vanuatu's withdrawal is that politicians considered many conditions too commercially damaging in the short term. Some large countries were reluctant to treat Vanuatu as they should – as basically irrelevant for bilateral trade – because granting concessions would set a precedent for more important trading and investment partners. Of course, most-favoured nation (MFN) treatment and non-discrimination constitute the raison d'être of WTO. It is well established within trade theory that a regime based on rules avoids welfare-reducing trade disputes and reduces incentives to engage in activities such as dumping and subsidies. Entering a binding agreement not to raise tariffs can increase aggregate welfare. The same rules must therefore apply to all members of any arrangement.

[170] M. Duncan and R. Duncan, 2002, in *Facilitating the accession of ESCAP Developing Countries to WTO Through Regional Cooperation*, ESCAP, New York.

However, in many cases, countries went beyond the bounds of the WTO Agreement. For example, the Cairns group of agricultural exporters demanded that no country using agricultural subsidies be allowed to join WTO. This action is not, however, stipulated by the WTO Agreement. In some instances, bigger countries deliberately tried to mislead Vanuatu over the efficacy and legality of agricultural subsidies. It was argued that because the Stabex funds provided under the Lomé IV Convention were aid, they could not be used as agricultural subsidies. As pointed out in a paper by two key delegation members, Roman Grynberg and Roy Mickey Joy, Vanuatu had to argue the contradictory position that it was forced to use the funds to subsidize exports, but at the same time that the Government freely chose to use the Stabex funds as subsidies.[171]

The United States showed particular severity with Vanuatu despite the almost total absence of bilateral trade between the two. In one area, this strictness could have worked to Vanuatu's advantage. Under bilateral negotiations the United States demanded that Telecom Vanuatu Limited (TVL) open up to competition at the end of its contract in 2012. Vanuatu argued that ending the monopoly agreement would have reduced incentives for the company to invest in important infrastructure. However, it is unclear that TVL is undertaking enough investment in infrastructure in any case. Electricity, telecommunications and water costs are among the highest in the Pacific. TVL only completed installation of the mobile phone network (which is limited to three small geographical areas) in May 2002. Renegotiating the monopoly agreements of both TVL and the utilities company, UNELCO, a tthe end of their contracts is thus of paramount importance.

However, the demand by the United States for a reduction in tariffs to around 15-25 per cent, compared with Vanuatu's offer of an average 49 per cent, would have been more damaging, as is shown later in this paper. American negotiators also argued against a two-year transition period to adopt TRIPs legislation and train officers. The United States was especially opposed to the use of special and differential treatment provisions, arguing that because Vanuatu was not a member of WTO it was not eligible.

Wholesale and retail trade was another area in which the United States made unreasonable and unnecessary demands. It was not in Vanuatu's interests to deny greater access to foreign retail firms, but other Pacific island nations had more to lose since small local shops were on the restricted list. A number of countries, including Tonga, urged Vanuatu not to accept this request in case it was again used during their own accession.

Vanuatu's only town – with a population of 36,000 – is unlikely to ever become a market or labour pool big enough to be of interest to attract serious investment from the United States. Bilateral trade fluctuates from year to year and is never worth more than about US$ 1 million. It has been suggested that the United States was being so

[171] R. Grynberg, and R. M. Joy, 2000, "The accession of Vanuatu to the WTO – lessons for the multilateral trading system", *Journal of World Trade, Vol.* 34, No. 6, December 2000, pp. 159-73. NB: Vanuatu does not use funds from its recurrent budget as subsidies.

firm in its demands because it was negotiating with China at the same time and did not want any concessions made to Vanuatu used against it.

WTO has taken a number of measures to avoid similarly intrusive demands in future. Most notably, document WT/L/508, recording a decision made on 10 December 2002, outlines a number of ways in which the LDC accession process can be streamlined. These measures will undoubtedly help other countries to avoid some of the problems encountered by Vanuatu. They are mostly too late to be of immediate use in Vanuatu, first because the package has already been agreed and any renegotiation would be limited. Second, many members of the Vanuatu Government are likely to remain suspicious of WTO despite such changes.

One area in which document WT/L/508 may help is in technical assistance. WTO members and the Secretariat itself have become much more willing to extend help in this area following the difficulties faced by acceding LDCs. Given the technical nature of much of the accession process, such assistance is vital. However, the type of technical assistance given is crucial. Pledges must cater to the demands of individual countries rather than simply follow a generic pattern. Technical assistance must meet several criteria for it to be effective. It must be requested, rather than foisted upon the country by an international agency. It must be practical, not simply a written report by a short-term consultant. In addition, it should involve training so that the activities can continue after the programme ends. Consultants must be based in the country concerned for the duration of the assistance and should, if possible, be nationals of the country concerned.

2. Trade and tax regime

Before CRP, reform import duties were as high as 207 per cent while nearly two-thirds of tax revenue came from trade taxes. There has never been any income tax. A range of other compulsory flat-rate business taxes has generated much of the remainder of government revenue. Policy makers built in this dependence on trade and business taxes for a reason; the cash economy in Vanuatu is very small and the cost of administering and collecting taxes high. Customs compliance is notoriously difficult, while the fragmented nature of the country has left much policing and law enforcement to traditional rule.

The dependence on tariffs, however, produced several inefficiencies. The discretionary system of exemptions that accompanied it was open to abuse, and rendered the business and policy environment unpredictable. Reliance on import duties also made it harder for policy makers to usefully protect infant industries; tariffs were high on most goods, whether consumer, intermediate or capital. For example, Vanuatu has protected its alcohol and ice cream producers for 20 years despite having no obvious potential comparative advantage in these areas. Lastly, dependence on tariffs made consumer goods more expensive and raised overall costs.

The existing tariff schedule is designed mostly around collecting revenues rather than on economic incentives. The tariff reductions under WTO accession took little account of volumes of goods traded, or effective protection rates, which had never been calculated.[172] It is likely that a uniform reduction in a number of nominal rates would distort the rate of effective protection. Tariffs on consumer goods had fallen from 47 per cent in 1990 to an average of 15 per cent by 2003. Falls in tariffs on intermediate and capital goods were less. By mid-2003, average tariffs were 20 per cent, although wide-ranging exemptions probably lowered this figure to between 10 and 15 per cent.

Value-added tax (VAT) was introduced in 1998 as part of the ADB reform process, which also abolished export taxes and simplified the business licensing scheme. Without the reforms a goods offer would have been impossible under WTO. VAT and tariffs now constitute the two main sources of recurrent government revenue, with administrative fees and charges holding a distant third place.[173] As table 2 shows, tax revenue from goods and services increased during the WTO accession phase while revenues from import duties declined.

Table 2. Domestic revenue as a percentage of total tax revenue

(Unit: Percentage)

Revenue source	**1997**	**2001**
Import duties	53	34
Goods and services taxes	36	51
Administrative fees and charges	–	8

Source: Government budget, 2003.

The thinning of the tax base restricted Vanuatu's ability to make lower bound tariff offers during WTO accession. While CRP had attempted to reduce dependence on import tariffs, paradoxically by abolishing a range of other taxes and licences it actually made tariffs more important as a source of revenue and, hence, as a bargaining point. Vanuatu had less to offer during WTO accession than it might have had before the introduction of CRP. In addition, by binding tariffs at arbitrary rates that did not reflect the economic fundamentals, the process restricted the future ability of the Government to set optimal policy. In yet another sense, Vanuatu's ability to act. autonomously during and after the accession process was reduced.

3. Investment regime

Vanuatu was forced to overhaul its investment regime during WTO accession despite there being few trade-related reasons for doing so. Article XVI of the GATS stipulates that:

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172 The difference between the value added in sector X at domestic prices and the value added in sector X at international prices, that is:

ERP $= \frac{V_D - V_I}{V_I}$ where V_D = domestic value-added and V_I = international value-added.

173 Vanuatu's budget is divided into recurrent and development expenditure. Overseas grants comprised 9 per cent of total government revenue in 2001.

> "If a member undertakes a market access commitment in relation to the mode of supply referred to in subparagraph 2(a) of Article I, and if the cross-border movement of capital is an essential part of that service itself, that member is thereby committed to allowing such movement of capital...".[174]

Although a specific interpretation of the "movement of capital" was absent at that time, Vanuatu was still obliged to liberalize further and change the way it dealt with incoming investment. This had a number of advantages. Before CRP and WTO accession, investment rules were opaque, often arbitrary and subject to discretionary judgment by politicians. There was no explicit policy on incoming foreign investment. One particular barrier to overseas investment was the so-called "green letter", which allowed the Minister of Immigration to revoke residence permits without the need to provide a reason. The victim had no right of appeal.

Following the CRP reforms, and as part of the WTO process, the investment environment became more rules-based and decisions less subjective. The 1998 Foreign Investment Act, No. 15, which was a consequence of the CRP process, was further revised in 2001 with the result that the Vanuatu Foreign Investment Board was replaced by the Vanuatu Investment Promotion Agency (VIPA), whose focus was now intended to be on promoting investment rather than vetting and regulating.

Land represented a particularly controversial area in which WTO members requested changes to the investment system. Vanuatu's strong traditions mean that land is attached to large extended families who consider it a source of security and stability. Freehold land ownership was abolished with independence in 1980, and the usual arrangement for an investor is a 75-year leasehold agreement. It would be politically impossible for a government to force through any Bill aimed at making land ownership freehold.

A succession of foreign advisers and multilateral institutions has argued that the absence of freehold constitutes an unwelcome barrier to investment. However, this argument is undermined by the fact that substantial real estate investment occurred during the two decades after independence. Also, as any Hong Kong or central London resident knows, as long as returns are sufficiently high in the medium term, investors do not require a lease that is held in perpetuity.

Disagreements over land rights, however, do present a problem to investors. These disputes are partly a result of the absence of historically firm boundaries between plots. To that end, the Government has set up a number of land arbitration panels aimed at resolving the often long-standing quarrels over ownership. The answer is not to make firm rulings on the freehold foreign ownership of land. Resolving these arguments will take time and sensitivity, and local ni-Vanuatu must be seen to own the process rather than it being forced on the country by outsiders.

[174] R. Grynberg and R. M. Joy, 2000, p. 164.

The WTO process can be seen to have resulted in a "one-size-fits-all" investment policy that had little relevance to Vanuatu. It was in neither the interests of WTO members nor Vanuatu to force through a ruling on land. Members of the working party knew little about the intricacies of property ownership in Melanesia, while most WTO members are unlikely ever to buy land in Vanuatu. It would have been politically suicidal and socially unsustainable for the Government to have enacted a major reform of the land laws. Yet, Vanuatu was still unable to persuade members of the merits of its case. An intrusive and generic accession process meant that the only option for the Vanuatu delegation was to directly refuse to concede any ground on this issue.

4. Summary

WTO members were keen for Vanuatu to accede since the country would have been the first LDC to join WTO proper. Yet, the onerous nature of the accession process and lack of leeway ultimately led to Vanuatu's withdrawal. The Government can take part of the blame, but it would not have been able to exploit popular opposition to WTO-inspired policy adjustment had the process been handled more sensitively and with greater public involvement.

Many policies were inappropriate, while the public and politicians were allowed scant ownership. The inflexibility of membership precluded local influence. Accession was also simply too difficult to understand. The haste to accede meant that many of the consequences of accession were overlooked until the final hour.

The problem of precedence represented a further obstacle to Vanuatu's accession. Although too small to be of much consequence to most members, some members felt that they had to force Vanuatu to comply with strict demands because they did not want to yield concessions to bigger economies.

Reforms to the tax and trade regimes for WTO membership removed a number of distortions. However, these reforms narrowed the tax base and made government revenue more volatile. The reforms also made it harder for Vanuatu to negotiate.

WTO-inspired investment reforms made the approvals process less arbitrary and prompted the investment promotion authority to become more focused on marketing. However, a number of requests from WTO members showed them to be ill informed and politically impracticable. In fact, it is questionable whether WTO should interfere with land ownership, an issue central to the social fabric of Vanuatu.

D. Economic impact

1. Regional trade agreements

Vanuatu's performance in regional trade arrangements provides lessons for WTO accession. First, the arrangements indicate what could happen when trade is further liberalized. Second, the experiences show that regional trade arrangements are only a precursor to multilateral liberalized trade.

The proposed Pacific Island Countries Trade Agreement (PICTA) had not been ratified by Vanuatu by April 2003, while the South Pacific Area Regional Trade and Economic Co-operation Agreement (SPARTECA) has been of little significance and is due to end in 2005.

The main bloc with implications for Vanuatu is the Melanesian Spearhead Group (MSG), formed in 1988 to foster cultural and political cooperation between Papua New Guinea, Solomon Islands and Vanuatu. The MSG Free Trade Area (FTA), created in 1993, allows 150 tariff lines to be traded duty-free between the four members. Fiji joined MSG-FTA in 1998, while New Caledonia is an observer. By 2005, the Agreement is intended to cover all goods although some will be protected using negative lists.

The immediate benefit of MSG-FTA to Vanuatu was mainly through beef exports, which are sent mainly to Papua New Guinea and Solomon islands. Kava has been exported to Fiji since 1997. The existence of MSG-FTA resulted in an increase in CIF exports from US$ 20,000 in 1993 to a peak of US$ 2,326,000 in 1997. Exports to MSG as a proportion of total exports are higher than exports by other MSG countries. Available data show that trade creation outweighed trade diversion in the years following the formation of MSG-FTA.

As the table 3 shows, during the four years following the inception of MSG, frozen beef exports to MSG members rose from 4 mt to 133 mt while exports to the rest of the world fell from 33 mt to 9 mt. Frozen beef exports to MSG increased from about 10 per cent in 1994 to 94 per cent of total frozen beef exports in 1997. Thus, trade was diverted from other countries to within the MSG. However, the overall effect of MSG was to create trade, and frozen beef exports increased from 37 mt in 1994 to 142 mt in 1997. This is above the rate of increase for total exports during the same period.

Table 3. Exports of frozen beef to the Melanesian Spearhead Group and rest of the world

(Unit: metric tons)

Year	Papua New Guinea	Solomon Islands	Fiji	Melanesian Spearhead Group	ROW[a]	World[b]
1994	0	4	0	4	33	37
1995	0	22	0	22	17	39
1996	52	21	0	73	0	73
1997	42	91	0	133	9	142

Source: Pacific Islands Forum Secretariat MSG Trade Review 1999.

[a] ROW = rest of world excluding MSG.

[b] Includes MSG.

Vanuatu suffered from MSG after an increase in cheap imports threatened to seriously damage the revenue of a number of local companies. Amid Fijian protests, Vanuatu and Solomon Islands negotiated emergency protective tariffs on six MSG products (canned corned beef, fruit juice, ice cream, wood and timber products, toilet paper and furniture) in October 2002 with the aim of protecting local industries for three years. One problem with MSG is that its member economies have similar compositions, rendering potential gains from trade small. WTO entry, in theory, should enable Vanuatu to realize the benefits of trading with several more differentiated partners, particularly in East Asia, where Vanuatu currently conducts little trade. WTO entry must ensure that gains from MSG are not undone; Vanuatu is the only active member of the group that is not a WTO member. However, there is little reason to belief that the trade creation effect experienced under MSG-FTA would unravel, given the quality of Vanuatu beef and the proximity to MSG economies.

It is important to emphasize just how small the industrial sector is in Vanuatu (table 4). Most industrial subsectors comprise only one or two companies, and the emergency MSG protective tariff rates negotiated during 2002 each corresponded specifically to the demands of one company. While the short-term impact of opening up to international competition is a common complaint from businesses in countries acceding to WTO, in Vanuatu the closure of even one major company would constitute a major blow to employment and aggregate economic growth. WTO entry could be expected to raise unemployment over the short term in manufacturing, construction, retail and wholesale, hotels and restaurants, and finance and insurance. Together, these sectors comprise 47 per cent of employment. To a greater extent than in many larger economies, the Government must ameliorate the near-term employment effects of trade liberalization.

Table 4. Formal sector employment

Industry	Number of employed
Agriculture, forestry and fishing	748
Manufacturing	1 273
Electricity and water	156
Construction	838
Retail and wholesale trade	2 466
Hotels and restaurants	1 631
Transport and communication	1 027
Finance and insurance	455
Other business services	532
Government	4 475
Other services	671
Total	**14 272**

Source: Vanuatu 2000 labour market survey.

2. Policy consistency

WTO entry represents an opportunity for Vanuatu to entrench useful economic policy for the long term. In the past, policy has been unstable owing to frequent changes of government and a high turnover of staff in the public sector. Enacting laws based on WTO rules that are internationally enforced can put in place a consistent set of policies that will help economic growth. A coherent strategy has a number of advantages. By providing protection for a specified period for those industries that enjoy the potential for higher returns to scale, companies can achieve a firm comparative advantage. A consistent strategy helps avoid unnecessary changes of direction by preventing the interference of special interests. Setting a credible deadline for the ending of infant industry protection, for example, forces companies to aim toward increased efficiency. WTO membership can be used to enforce this credible deadline. Establishing a guiding principle for export development also makes it easier for departments to formulate policy and coordinate actions with other departments.

Vanuatu is too small to compete on the world market in high-end manufacturing or large agribusiness operations, although it can export a number of potentially lucrative niche products such as organic coffee, organic root crops and high-quality beef. Focusing policy on establishing Vanuatu's true comparative advantages over the long term means that inefficient or low value-adding companies are encouraged to reinvest in more useful areas.

Any policy regime, however, must be of Vanuatu's choosing. As explained in section C above, many of the policies that would have resulted from proposals put forward during the initial accession period were inappropriate. It is crucial that Vanuatu has the autonomy under the accession process to decide policies that fit its specific circumstances. This is not an escape from hard-but-necessary liberalization, but the recognition of Vanuatu's peculiar situation.

During 2002, the Department of Trade, Industry and Investment launched its export development strategy, a set of objectives aimed at arresting the decline in exports during recent years. If Vanuatu accedes to WTO, any accession package must accommodate this existing strategy. It involves establishing actual and potential areas of specialization relative to trading partners, helping industries in these areas to grow, and increasing global and regional integration where it helps Vanuatu. This will involve a period of targeted protection and assistance for selected infant industries. The bound tariff rates agreed under the previous accession package would probably need to be renegotiated under any new accession package.

3. Special and differential treatment

Successful implementation of the export development strategy as a WTO member would require leeway in economic policy-making – specifically, recourse to several special and differential treatment provisions. WTO document WT/L/508 allows, for the first time, special and differential treatment for LDCs.

It is a fallacy that the best strategy for every developing country is rapid and total liberalization. In the ESCAP *Studies in Trade and Investment* (No. 49), two of the authors argued that, in effect, developing countries usually undermine their own economic welfare during negotiations by seeking recourse to special and differential treatment.[175] The authors suggested that what were seen by potential members as economic costs – such as tariff reductions and lower subsidies – were in fact benefits, while recourse to special and differential provisions undermined economic growth over the long term. According to the authors, sensibility was positively correlated with liberalization. Incumbent WTO members know what is in the best interests of applicants.

The authors proposed that: "In their role as economic managers, Governments can be broadly depicted as sensible, super-sensible and non-sensible... Super-sensible governments... actively promote unilateral trade and economic liberalization at home by resisting protectionist pressures and implementing ongoing trade reforms that substantially exceed their WTO commitments".[176] As Vanuatu balked at the final hurdle it is presumably considered non-sensible.

If it were true, however, that rapid and total liberalization is always the best policy, then there would be little to negotiate. Incumbent WTO members could just order acceding members to abolish tariffs and subsidies, lower non-tariff barriers, privatize all government-run enterprises and open up capital accounts. The result would be an increase in welfare.

Of course, liberalization is not a byword for common sense. Like most developed country governments, LDCs such as Vanuatu are not entirely liberal in economic policy. Governments rightly deviate from the "cookie-cutter" method. Developing countries do not join WTO because they want another entity to make policy for them. They join for the perceived benefits such as market access, a fixed policy regime and other related gains.

A further reason why wholesale immediate liberalization is inappropriate is that infant industry protection and subsidies have been proven to raise domestic welfare under certain circumstances. Both empirically, as seen in many East Asian countries, and theoretically, as suggested by the New Trade Theory, strategic trade works under imperfect competition and the possibility for increasing returns to scale.[177] Small, highly-underdeveloped economies such as Vanuatu must be permitted to learn from the development success stories.

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[175] Duncan and Bosworth, op cit.: 13.

[176] Ibid.: 13.

[177] The classic papers include: J. Brander and B. Spencer, 1985, "Export subsidies and international market share rivalry" in *Journal of International Economics*, No. 18, pp. 83-100; and P. Krugman, 1984, "Import protection as export promotion: international competition in the presence of oligopoly and economies of scale" in Kierzowski (ed.). *Monopolistic Competition and International Trade,* Oxford, Oxford University Press.

Vanuatu simply could not accept many of the changes demanded by many WTO members. An immediate reduction in tariffs to 15-25 per cent would have thrown Vanuatu's tiny private sector into competition with globally competitive neighbouring economies and probably would have made many businesses bankrupt. The fall in tariff revenue would have forced high taxes on an already weak private sector. As shown in section B above, the tax regime is already struggling with changes to the revenue structure. It is likely that the swift abolition of price supports to the majority of farmers who live in outlying islands would have left them without any income.

Reducing tariffs has the ultimate aim of increasing competition, which carries a number of benefits including the more efficient allocation of scarce resources. However, in small economies such as Vanuatu's, trade liberalization can actually reduce competition because there is little incentive for new companies to enter the market. Entry costs are high and potential revenues are low. The most likely outcome is a single incumbent monopoly or oligopoly. This is the case in the Vanuatu wholesale market, where two large companies dominate the import of consumer goods.

Therefore, simultaneously with current account liberalization, there must be some domestic impetus toward competition. The problem is that the protection necessary to encourage domestic competition is often hostile to external liberalization. The answer is to sequence reforms correctly, which means first instituting measures such as cutting start-up costs, introducing antitrust legislation and diversifying the economy. External trade liberalization can then take place. In summary, there is a counter-intuitive result; increased protection and a delay in trade liberalization can actually increase competition.

Case study: Vanuatu Commodities Marketing Board

WTO entry would hasten reform of the Vanuatu Commodities Marketing board (VCMB). Reform could reduce political interference and enhance competition, but a transition period would be necessary to help farmers move into new areas.

VCMB is a statutory body whose remit is to set domestic prices for copra and cocoa, approve licences for production and market Vanuatu commodities abroad. It is responsible for buying all copra from Vanuatu's coconut farmers, who form a significant proportion of the 80 per cent of the population living in outlying islands.

Prior to the 2001 general election, the Union of Moderate Parties (UMP) promised farmers that, under an UMP Government, VCMB would purchase copra at around US$ 185 per metric ton (mt). For this to be viable, VCMB claimed the world price would have to be at least US$ 350 for it to break even. Following an UMP victory, however, the international price of copra kept falling, hitting a low of around US$ 175/mt.

The continuation of effective price supports to farmers with only sporadic funding from government resulted in near-bankruptcy by early 2003. Insufficient funds existed for the board to purchase all farmers' produce. The fall in incomes caused popular discontent.

As with marketing boards in many other developing countries, the political nature of VCMB has undermined its performance. It has little incentive to market Vanuatu products abroad because it possesses a domestic monopoly. During the 1990s, when VCMB won a steady stream of revenue, it ceased attempts to find new markets and often squandered the proceeds of high prices instead of building reserves for when prices fell.

Dependence on copra has made it harder for farmers to diversify into new areas. They see little reason to grow root crops when a guaranteed price is provided for copra. This has undermined exports and reduced internal trade, resulting in lower economic growth.

Political influence and the low international price combined during 2002 to halt all exports of copra. A local coconut-oil processing company, COPV, stepped in to buy copra from VCMB, which claimed this created jobs for indigenous ni-Vanuatu. However, there were equivalent lay-offs at the stevedoring company, Niscol. Selling locally is claimed to result in less shrinkage during shipment and thus a higher price. COPV, however, has insufficient capacity to process the 600 mt a week of copra that VCMB has to offer.

VCMB cannot be abolished overnight. Political opposition would be too strong and many farmers depend solely on family-owned copra plantations. Most ni-Vanuatu are subsistence smallholders who occasionally sell produce when they need cash. They do not possess the commercial experience for speedy changes in output.

However, WTO entry, with a suitable transition period, would help spur useful reform of VCMB, while government could position itself outside the process. The board could then take on a purely administrative role, leaving more prices to the market and marketing to private institutions. Government could use some of the resources it previously used propping up prices to help farmers move into other areas.

As is well known, Australia and the Cairns group of agricultural exporters insist that no country can join the WTO if it maintains export subsidies. During accession, Australia required Vanuatu to leave its ES1 schedule blank. This would have meant that VCMB could not have maintained copra export subsidies using government revenue or external grants.

WTO entry would make it harder for VCMB to exclude foreign ownership of domestic industry, as it currently does through tight control of licences. New investment in the production of agricultural commodities would spur competition and improve efficiency. Levels of equipment and expertise in the industry are low, and technology transfer borne out of new foreign investment would enhance productivity.

A transition period of several years to WTO membership is vital. During this period and afterwards the government must have the autonomy to impose subsidies when necessary to support rural livelihoods. However, the impact of WTO membership on VCMB could be worthwhile. Gradually exposing some commodity production to market prices and diversifying agricultural exports should support rural incomes and help enhance Vanuatu’s export performance.

4. Summary

Judging by the regional trade agreements of which Vanuatu is a member, further trade liberalization must by managed carefully. The challenge is to retain the gains made through the MSG-FTA in the form of enhanced exports, while the domestic economy must be strengthened to allow companies to compete effectively on the international marketplace.

Industry is so small that the fortunes of individual companies have a major impact on the overall economy. About half of employment is in sectors that would be affected by WTO entry.

One major benefit of WTO entry is the embedding of useful economic policy for the long term. Infant industry protection only works if it has a credible deadline and if protection is gradually reduced. WTO entry could be used to enforce such an environment.

This long-term policy must be chosen by Vanuatu rather than forced upon it by incumbent members. Any new accession package must be compatible with the existing export development strategy.

It is likely that Vanuatu would need recourse to special and differential treatment provisions. It has been argued, in particular by the United States, that these provisions cannot be used. However, speedy liberalization throughout the economy is unrealistic and misguided. Government must decide its own policies, and commit to these policies for the long term under a framework enforced by the WTO. These policies are likely to include non-liberal measures such as protection and subsidies.

WTO entry would likely help reform of the Vanuatu Commodities Marketing Board, an entity responsible for buying and marketing copra output. But this reform must still permit the occasional use of subsidies, or overseas aid, to support poor farmers.

E. Conclusions

Vanuatu was a victim of the cookie-cutter approach to structural adjustment and trade liberalization that afflicted a number of other underdeveloped economies in the 1990s. From macroeconomic stability and a manageable debt situation, the economy is now growing more slowly than during the last two decades, while foreign debt is a growing problem. The comprehensive reform programme has restricted policy options and further increased resentment toward international agencies including WTO.

The possibility must be entertained that Vanuatu will never experience an East Asian-style boom. It is too small, isolated and geographically fragmented while it is unlikely to attract significant investment in high-value-added areas. An improvement in the rate of development is possible and the country can learn from the economic success stories, but policies spurred by WTO accession must accommodate Vanuatu's special circumstances.

One of the main lessons of Vanuatu's WTO experience is that acceding small economies must enjoy greater influence over accession. This would ensure that their special circumstances are taken into account. Membership failed to a large extent because there was insufficient political and public ownership, while the process was so complicated and drawn-out that it was beyond the capability of a team of just a handful of full-time officials. Had Vanuatu been allowed greater ability to decide the terms under which it joined, membership might have been successful. The irony is that accession failed not because any WTO economy stood directly to lose, but because bigger countries feared that concessions granted to Vanuatu could be used elsewhere. A tiny, poor country became sidelined from a key institution of the world economy for no tangible economic reason.

This negative experience has had subsequent repercussions for policy. Politicians, having realized the potential populist gains from insularity, are now less amenable toward regional trade agreements and economic partnerships. For example the Melanesian Spearhead Group Free Trade Area faces problems following Vanuatu's negotiation of emergency protective rates on several local products, while Vanuatu delayed ratification of the Pacific Island Countries Trade Agreement.

Ensuring that Vanuatu maintains control over policy may not lead to perfection, but the experience of structural adjustment suggests that too much outside influence may be worse. Rapid and total liberalization are inappropriate. There must be some capacity for periodic subsidies to support small farmers. Cutting tariffs significantly in a short space of time would be politically impossible and most businesses would be unlikely to survive the shock. If duties cannot fall to zero straight away, then it makes sense to establish useful protection for infant industries over a specific period. Land, a particularly sensitive area throughout Melanesia, cannot be made subject to private ownership overnight on a freehold basis. Leasehold does not represent the main barrier to investment.

It seems unnecessary for WTO members not to have granted access to special and differential treatment. This is aimed precisely at LDCs like Vanuatu, and if it is argued that only members can use it, then its utility is diminished. The United States refusal to grant a transition period for membership was also a key reason for the failure of accession. The economic transformation would be so great that flexibility is essential to allow companies and the government to adjust to the new environment.

At the beginning it was asked: To what extent was Vanuatu able to demonstrate a reflexive relationship within the international trading regime? Were Vanuatu WTO negotiators able to act autonomously and how much, if the country had joined, would future policymakers have been able to decide national strategy?

The answer to the first question is that Vanuatu enjoyed little sovereignty during the accession process. Any capacity for reflexive action proved limited. A small and weak country was steamrollered by bigger opponents. And neither would Vanuatu have enjoyed sufficient policy choice after membership. It was denied the opportunity to subsidize copra farmers, while some bound tariff rates were too low for flexibility in the face of any sudden decline in government revenue.

Nevertheless there were small areas in which Vanuatu could exercise some autonomy and reflexive influence. It was able to achieve an average bound tariff rate well above the 15-20 per cent demanded by the United States. Subsequently the government has lowered tariffs as it has seen fit, demonstrating that it is committed to trade liberalization on an appropriate timescale.

Vanuatu, despite its tiny size, may also have been able to influence the future accessions of underdeveloped countries. WTO officials and members of working parties on the accession of LDCs are likely to be more careful about their future demands, both on an administrative and substantive level. Vanuatu's withdrawal of accession at the last minute, at Doha, may have embarrassed the WTO. Members that bear in mind the legitimacy of the WTO will be keen to avoid a repeat of that experience.

Some parts of the accession package would have worked to Vanuatu's advantage. As was suggested above, one of the most crucial benefits was the establishment of a long-term policy environment with which politicians found it difficult to interfere. However inappropriate were some of the conditions agreed under the final package, at least economic policy would be difficult to change at short notice.

Global presence on trade disputes is particularly important for small economies. The case of kava shows that access to the dispute settlement mechanism might prove useful. Even if bringing an action were too expensive and time-consuming, lobbying groups may prove more wary about challenging the export standards of a group of WTO members. Concordance with global sanitary and phyto-sanitary standards would further help the export of agricultural and food products.

As in a number of other countries, Vanuatu's commodities marketing board, the VCMB, has suffered from political intervention and its monopoly status has distorted prices for key commodities. The board is unsustainable in its present state. WTO membership, given a transition period, could be used to enact useful reform with minimal political fallout. Exposing copra and other commodities to market prices would improve efficiency, while opening up the market to foreign ownership would help technology transfer, competition and overseas marketing.

Vanuatu is burdened with some of the highest utility prices in the Pacific region. These costs are one of the biggest barriers to development. Under the GATS, Vanuatu was urged to end the monopoly agreements on telecoms, water and electricity. This would have boosted competition and reduced prices, improving efficiency in many areas. The argument that ending the monopoly agreement would have reduced incentives to make new investments is questionable since it is unclear that UNELCO and TVL have been investing much anyway. The monopoly agreements are in effect a licence to gain supernormal profits.

Vanuatu can benefit from WTO entry, and the country must keep open the option of membership if it is to stay in step with changes in the world economy. If it does not, it will be left behind. In any case the several trade agreements with which the country is involved must be WTO compatible. However the delay in accession lies not primarily with poor negotiating by Vanuatu, but with a restrictive and over-demanding membership process. Perhaps the inability of Vanuatu to join on appropriate terms has been a drawback for all parties. If WTO members do not cater more to the specific needs of small underdeveloped economies, Vanuatu will not be the last to withdraw.

Annexes

I. RECENT EXPORT TRENDS

Copra

In recent years Vanuatu has enjoyed a prolonged period without serious cyclone damage. Coconut yields have generally improved, resulting in a general increase in production. However, according to 2001 annual statistics, copra export in this period recorded a low of 14,258 mt, compared with 29,634 mt exported in 2000. The fall was mainly due to the reduction in world export prices and limited shipping services to the main producing areas. Despite efforts to diversify exports, copra remains the principal export revenue earner for the country. Bangladesh was the main export market in 2001.

Cocoa

Cocoa earnings fell 56.4 per cent to VT64 million in 2001 from VT147 million in 2000. This was mainly due to a drop in production of 48.8 per cent between 2000 and 2001, attributable partly to the limited nature of shipping services to the main provinces.

Beef

Beef exports fell to VT239 million in 2001 from VT380 million in 2000. First quarter figures for 2002 show a decrease in exports compared to the previous quarter because of market difficulties in neighbouring pacific islands. Smallholders welcomed a rise in exports of live cattle to Indonesia in 2001. Beef exports have been hampered by quota restrictions on exports to the European Union.

Kava

Kava exports increased to VT503 million in 2001 from VT478 million in 2000. Despite healthy demand from Fiji, New Caledonia and other Pacific Islands, demand from Vanuatu’s larger markets, the United States and European Union, looks likely to decline further due to reports of liver-related diseases from the processed derivatives of the kava plant.

Timber

Timber exports recorded a steady decrease from 1998 to 2000, reflecting a general decline from all overseas markets including Australia, Japan, New Caledonia and Taiwan. The main explanation was the fall in market prices in 1999 and the lower production level in 2000.

Cowhides

Cowhide exports declined to VT39 million in 2001 from VT47 million the year before. Exports to the traditional markets, Australia and Japan, dropped to nil from 1998-2000.

II. PREFERENTIAL AND REGIONAL TRADE ARRANGEMENTS

Vanuatu had not yet ratified by April 2003 the Pacific Island Countries Trade Agreement (PICTA), a regional free-trade area due to be phased in over the next decade. Vanuatu can also potentially join the Pacific Agreement on Closer Economic Relations (PACER), a treaty aimed at expanding economic cooperation.

Under the 2000 Cotonou Agreement, Vanuatu as part of ACP is committed to the negotiation of new WTO-compatible trade arrangements with the European Union that will come into force in 2008. New reciprocal Economic Partnership Agreements between ACP and the European Union will replace existing non-preferential trade arrangements. Cotonou must comply with article 24 of the GATT on territorial application, frontier traffic, customs unions and free-trade areas.

The SPARTECA agreement between the Pacific islands, Australia and New Zealand provides duty-free access for Vanuatu agricultural products into the Australian and new Zealand markets. Vanuatu, however, faces difficulty in complying with the strict standards required.

The Melanesian Spearhead Group involves bilateral trade agreements within the region. An MSG Free Trade Area is due to take effect by 2003 for Fiji and Papua New Guinea and 2005 for Solomon Islands and Vanuatu.