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Too young to marry: economic convergence and the case against the integration of Pacific states

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Transnational integration of state institutions in the Pacific islands is an active item on the regional agenda. In a recent Senate report, for example, Australia proposed the formation of a Pacific economic and political community (Commonwealth of Australia 2003). In theory, economic integration will raise the gains from trade, increase investment by reducing risk, and lower production costs by allowing the regional movement of resources to their most efficient use. In addition, political integration will relieve small island states of the fixed cost of managing and funding full-service independent governments. Bureaucracies can shrink and free skilled labour for employment in the private sector.

Scholars and policymakers assume that Pacific island integration is appropriate because regional cooperation via the Pacific Islands Forum has a history of success, transnational integration has benefited members of the European Union, and limited integration among developing economies has already occurred in Africa and the Caribbean. Always in search of ways to reverse the Pacific's growth paradox (that is, persistently low growth in spite of generous aid and natural resources), the policy community now sells integration as a fashionable solution to the region's economic problems. Lost in this exuberance over regional organisation is a robust analysis of where integration fits in the development trajectory of Pacific island economies. Global economic convergence establishes a theoretical growth path for island nations, and along this path, institutions must evolve at an optimal pace to support market activity. A mismatch between institutional complexity and level of development stalls further progress along the convergence path. Institutional evolution involves incremental community aggregation through establishment of new cooperative equilibria in society. In terms of convergence theory, transnational integration is successful only in an advanced stage of economic development and institutional evolution. In this context, integration of state institutions across Oceania is a misplaced endeavour that inefficiently consumes leadership focus and political energy.

A Pacific economic and political community as envisioned by Australia and other regionalists will achieve integration in form but not in substance. This insight becomes apparent when proposals for Pacific island integration are placed in comparative perspective with integration initiatives in Africa and the Caribbean. Current focus should instead be placed on integration at the national level. For a state to exercise legitimacy effectively (and non-coercively), the community it governs typically requires a strong sense of national identity. Policies designed to cement national identity and state legitimacy must rest upon a theory of how communities naturally aggregate themselves. Without stronger states, regional governance in the Pacific enjoys no firm foundation to ensure its sustainability and further development.

GLOBALISATION, ECONOMIC CONVERGENCE, AND STATE INSTITUTIONAL RESPONSE

Integration of Oceania implies erosion of the actual and potential role played by Pacific island states. At one extreme is a condition of economic and social autarky, where no communication, trade, or interaction occurs between Pacific island countries. In autarky, the state perfectly controls the inflow and outflow of information, goods, and inputs. The other extreme is full integration, where economic and demographic flows are not regulated, legal and constitutional provisions are fully standardised, and organs of government answer to one transnational state. Globalisation pushes states farther from autarky over time irrespective of those states' intentions. This migration does not necessarily change institutional architecture, but it changes the expectations placed on such architecture. Globalisation increases the payoff from comparative advantage, raises the opportunity cost of inefficient resource allocation, and sparks the convergence of economic preferences across communities. Unless the state willingly incurs heavy deadweight losses to preserve autarky (such as the case of North Korea), the flows of knowledge, technology, and people that drive these changes do not stop.

In this environment, state institutions remain relevant only if they evolve so that entrepreneurs can always capitalise on new market opportunities, and economically displaced individuals can always rely upon a social safety net. Globalisation causes social stress because it constantly redefines market 'winners' and 'losers' in a community. These shifts naturally occur as the geographic scope of market competition widens and the cycle of obsolescence of ideas, products, and technology quickens. The innovation of 'winners' generates economic growth, but the consternation of 'losers' generates political upheaval. 'Winners' must be taxed just enough to compensate 'losers' for their displacement and bribe them not to obstruct market activity (Sala-I-Martin 1997). In terms of traditional neoclassical theory, convergence of state institutions to a global norm reduces the fixed cost of entrepreneurship and innovation across markets. This maximises the surplus 'winners' generate for society and lessens the scarcity of resources available to the state for compensation of 'losers'.

While the endpoint of convergence achieved by globalisation is easily defined and identified in terms of theory, the optimal trajectory and pace of convergence is not. A central change agent within this evolutionary process is the state. If the institutions of state do not change and adapt quickly enough, a dangerous imbalance can occur. In one case, through an unexpected surge in power, the latest generation of 'winners' can co-opt the state to protect newly established monopoly positions. Economic cleavage widens in society because 'losers' receive no displacement compensation and the next wave of disruptive innovation cannot challenge the incumbency of the current 'winners'. Russia offers an example of this phenomenon. In 1992, President Boris Yeltsin removed market controls and state ownership requirements but did not equip institutions to support a transparent system of property rights and to privatise state assets at fair market value. Opportunities for massive arbitrage presented themselves and bore a new class of business élite known as the 'oligarchs'. The 'oligarchs' used violence (unchallenged by the state) to enforce their interpretation of contracts and rigged auctions of state assets to keep new competitors out of markets. As a result, by 1995, Russia's Gini coefficient (a measure of income inequality where zero is complete equality and one is complete inequality) had risen from 0.27 to 0.48 and the poverty rate had increased from two to 50 per cent of the population (Abdelal and Haddad 2001).

In an opposite case of imbalance, in response to new threats of economic dislocation, 'losers' can co-opt the state to reverse the gains of 'winners' through higher taxes and protect the bankruptcy of obsolete enterprises through subsidies and market controls. Equity in income is maintained, but returns to entrepreneurship are destroyed. The opportunity costs of economic insulation increase with globalisation. With no social surplus from innovation to fund transfer payments, the state must intensify market controls and incur higher levels of deadweight loss to maintain the industrial status quo. The gap between actual and potential per capita gross domestic product (GDP) widens. The United Kingdom provides a good example of this phenomenon. Global economic dominance in the United Kingdom, birthplace of the industrial revolution, created a new class of welathy business entrepreneurs. Upset with the wealth disparities this created, an aggressive and vocal labour movement motivated successive governments to implement and sustain generous social welfare policies after the First World War (Palmer and Goodman 1989). The standard rate of income tax increased from six per cent in 1913 to 50 per cent in 1947 and then progressively fell to 30 per cent in 1980 (Daunton 2002). The cumulative annual growth rate of real per capita GDP growth between 1913 and 1980 was 1.37 per cent in the United Kingdom compared with 1.75 per cent in the United States. By 1980, real per capita GDP in the United States was 69 per cent higher (Maddison 1983). In comparison, the effective individual income tax rate in the United States was 12 per cent in 1980 (Congressional Budget Office 1999).

State institutions in the United Kingdom and Russia did not correctly adapt to global shifts and the lag in both countries handicapped economic performance. If institutional change can inefficiently lag global convergence, then can it also inefficiently lead it? If so insistence on modern institutional design in countries not yet in economic takeoff could undermine a state's management of global change. For example, democracy is considered an institutional endpoint of economic convergence (Zak and Feng 2003), but early adoption of it might slow economic development. Democratic institutions sustain themselves only if competing parties find it in their self-interest to respect constitutional limits on power (Weingast 1997). The solution to this collective action problem takes time to achieve. If democracy pre-empts this process, rent-seeking opportunities suddenly expand and unrestrained political competition cannibalises state assets and hinders economic growth (Colombatto 1998). In this context, democracy is only a temporary vehicle for establishment of a new autocratic regime. Barro (1999) supports this empirically. In 1975, 10 African and two Pacific island countries enjoyed more democracy than could be explained by economic and demographic variables. Democratic institutions were inherited at independence despite low levels of economic development. By 1995, the level of democracy in six of these 12 countries had deteriorated to levels that did not meet statistical expectations.[1]

Another expected endpoint of economic convergence is monetary union (Sibert 1997). Adoption of a common currency theoretically increases investment because transaction costs fall, inflationary risk shrinks, and foreign exchange rate risk disappears. Membership is a positive net benefit—though only if there is a sufficient level of economic homogeneity and political collaboration among countries. If economies and national institutions have not converged enough to make this feasible, then premature monetary union can generate opportunity costs that overshadow any theoretical investment benefits. There is evidence that this has occurred in Africa. The East African Currency Board disbanded and the Rand Monetary Area was not able to adopt a common currency because member nations 'lacked the checks and balances in their political institutions…necessary for the credible conduct of monetary policy at the national level' (Guillaume and Stasavage 2000:1403). Countries within the West African Economic and Monetary Union and the Central African Economic and Monetary Community use the CFA franc, but interaction within the currency blocs remains problematic.[2] Variation in terms of national income sources (especially petroleum exports) prohibits a convergence in macroeconomic impact from currency area stabilisation measures. Because member countries surrender control of their monetary policy to the currency union, heterogeneity means that certain economic shocks at the national level go unsterilised (Fielding et al. 2004).

The success of currency unions in Africa is not only hampered by the lack of economic convergence, but also by a lack of common institutional independence and transparency. In a currency union, there is an incentive for member governments to run higher fiscal deficits—a regime can 'free ride' on other members' ability to protect the value of money in the face of its own inflationary policies. This prisoner's dilemma game dooms a monetary union's performance unless there is a strong transnational mechanism that enforces fiscal discipline (that is, coordinates a Pareto optimal solution that is not the Nash equilibrium). For example, a member of the Euro zone faces fines if deficits larger than three per cent of GDP and public debt larger than 60 per cent of GDP persist. Because no such rules are credible in the West African Economic and Monetary Union, member countries game the system and undermine the fiscal restraint required for optimal outcomes. Larger members are able to benefit at the expense of smaller members (Fielding 1996).

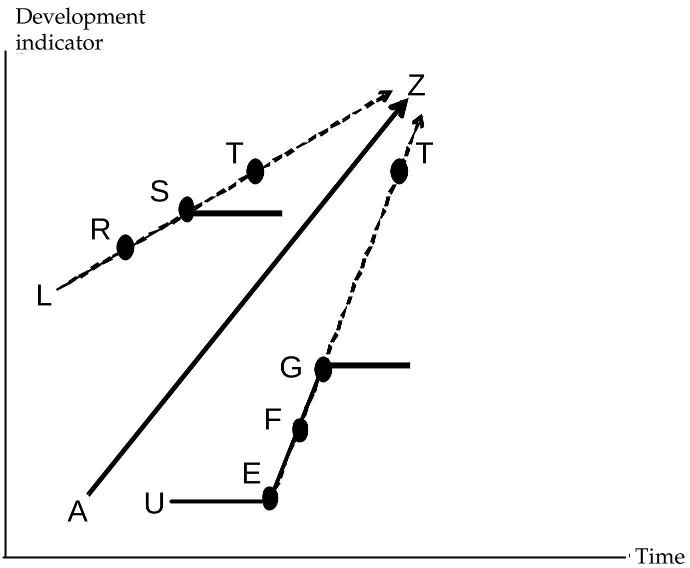
> The conclusion from comparison of the European Monetary Union and West Africa is that the danger of fiscal indiscipline as a result of forming a monetary union is much more likely in West Africa…given the region's history of central banks with limited independence and poor inflation records (Masson and Patillo 2002:409).

In the end, a lack of institutional development casts doubt on West Africa's readiness for a common currency.

As already stated, sustainable economic growth requires institutions that evolve to manage and respond to changes in consumer preferences, market opportunities, and the alignment of 'winners' and 'losers' from economic activity. Natural tendencies toward global economic convergence drive these changes and place pressure on uninsulated economies (Williamson 1996). Insights about optimal institutional evolution are best illustrated in Figure 12.1. Trajectory AZ is the development path of the theoretical 'average country' that evolves in an optimal pattern. Trajectory LZ is the development path of the most prosperous country. Over time, institutional architecture must change to enable continuous economic improvement along the trajectory. Thus, the architecture at point R must evolve to a different design by the time point S is achieved, and must morph yet again as point T is achieved. If the economy reaches point S but institutions have retained the architecture of point R, then performance stagnates as the disruption of market alignment at point S overtakes the ability of point R institutions to maintain Pareto optimal social cooperation (that is, to sustain a Pareto optimal solution in the game between economic 'winners' and 'losers'). In simple terms, this event mimics the United Kingdom's loss of global economic leadership after the First World War.

Trajectory UEZ is the development path of a developing country that encounters economic takeoff. The country begins with no performance improvement over time because of an underdevelopment bottleneck. Exogenous institutional change, though, occurs at point E and performance begins to converge to the average country. Just as with economic change in the most prosperous country, institutions must evolve through points F and G to sustain the trajectory. Two events can halt economic improvement. Momentum generated at point E can be short-lived and performance improvement can outpace capacity for institutional change. If point G performance is supported by point F institutions, then future performance stagnates because the country encounters the same misalignment described for trajectory LZ. This describes recent economic chaos in Russia. The rapid dissolution of communism suddenly enhanced Russia's investment potential (point E), but Yeltsin's government could not implement a system of property rights and transparent

Figure 12.1 Economic convergence and institutional evolution



government fast enough to support higher levels of economic performance (point G). In contrast, momentum at point E might inspire too much confidence. In an effort to artificially speed development, policymakers would impose point T institutions (as observed in the most prosperous country) at point G performance. Paralysed by the unexpected complexity of point T institutions, society would no longer sustain cooperative equilibria in the games between market 'winners' and 'losers' and economic improvement would stop. This potentially describes a correlation between economic malaise and the failure of European-inspired unitary state parliamentary democracy in postcolonial Africa. It might also explain a link between worrisome inflation and monetary union in Africa. The impact of formal integration of government mechanisms across Pacific island states could mimic the failure encountered in these African examples of myopic institutional exuberance.

INSTITUTIONAL EVOLUTION AND INTEGRATION OF THE PACIFIC ISLAND STATES

For Pacific island policymakers, theory must guide practical decision making. Small domestic markets make Pacific island states more reliant on global economic opportunity to extend income than in other developing countries. With higher reliance comes greater vulnerability and an enhanced awareness of global institutional links. This explains early experiments in cooperation among Pacific island states. Momentum began with incorporation of the South Pacific Forum (now called the Pacific Islands Forum) in 1971 as an umbrella organisation for regional coordination. A search for common environmental and resource management strategies induced formation of the South Pacific Regional Environmental Program in 1974 and the Forum Fisheries Agency in 1979 (Rolfe 2000). Countries pooled public investments to create a regional airline, Air Pacific; a regional shipping company, the Forum Shipping Line; and a regional university, the University of the South Pacific (Chand 2003). Smallness and remoteness generated strong incentives for cooperation between island governments, and the region became a forerunner of transnational collective action in the developing world. While not all regional ventures met expectations—such as the failure of Air Pacific to be a regional instead of Fijian airline (see Shibuya 2003)—Oceania's 'network of cooperative institutions is unmatched elsewhere in developing economies in terms of effectiveness (Rolfe 2000).

Regionalism benefits the Pacific islands, but transnational coordination has not sparked the same type of economic takeoff witnessed in Europe. Real per capita GDP (measured in terms of year 2000 US dollars) averaged across the eight independent island states with populations over 90,000 residents (Federated States of Micronesia, Fiji, Kiribati, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu) grew only 0.6 per cent on a cumulative annual basis between 1986 and 2002 from US$1,143 to US$1,257. Real per capita GDP actually fell in the Federated States of Micronesia and the Solomon Islands over this period (World Bank 2005). Concerned by a slow-growth equilibrium and the failure in state institutions it can generate, a new body of scholarship advocates economic integration to break the region's underdevelopment bottleneck. Scollay and Gilbert (1998) use a computable general equilibrium model to predict that a free trade pact with significant reductions in tariffs would increase employment and welfare in all island economies. Stoeckel and Davis (1998) argue that net benefits are even higher when Australia and New Zealand include themselves in the free trade zone. Results such as these fuel support for the Pacific Island Countries Trade Agreement (PICTA—an island nation free trade area), the Pacific Islands Agreement on Closer Economic Relations (CER—an Oceania free trade area including Australia and New Zealand), and Economic Partner Agreements with the European Union (EPAs—preferential trade access for island countries in Europe) (Narsey 2004). Brown and Ahlburg (1999) conclude that liberal allowance for emigration to Australia and New Zealand generates a significant source of income for Pacific island economies. Remittances fund investments that expand domestic production capacity and effectively substitute for foreign aid transfers. De Brouwer (2000) advocates adoption of the Australian dollar by the island states because political uncertainty, limited foreign exchange liquidity, and unexpected global currency shocks would have less impact on the domestic value of money. Duncan (2000) and Duncan and Xu (2002) favour it specifically for Papua New Guinea and the Solomon Islands because of institutional factors. The opportunity costs of funding and staffing a domestic central bank are inefficiently high and political pressure to monetise government debt is too intense.

Advocacy of economic integration by scholars feeds more ambitious arguments for political integration. Work toward a Pacific economic and political community has been proposed by the Australian government. The arrangement would include a common currency (most likely the Australian dollar), a common labour market, homogenous rules for fiscal policy, and standardised legal provisions related to crime, governance, and environmental protection (Commonwealth of Australia 2003). Chand (2003) sees the proposal as feasible if integration is incremental. Successful implementation of free labour, capital, goods, and services flows across national boundaries precedes establishment of a unified financial market, a common currency, and a standard for fiscal policy. Political unification then follows this achievement of a common market. As in the evolution of the European Union, participation by each Pacific island state would be voluntary. The idea of political integration is not new. Moore (1982) argued for a Pacific Parliament whose powers would evolve like that of the European Parliament. Under this scenario, island states incrementally surrender aspects of sovereignty to regional governance as the dialogue between national parliaments and the Pacific Parliament establishes institutional consensus. The benefit of political integration for island states is less financial overhead from government bureaucracy and easier implementation of modern governance tools. In theory, this means that full political independence was an inefficient strategy for Pacific island decolonisation. A recent paper from the Centre for Independent Studies states it bluntly: ‘Had the colonial powers promoted a federation of Pacific states in the 1960s…instead of creating independent states in their own image, the Pacific could by now have been a prosperous region’ (Hughes 2004:10).

A successful history of regional cooperation and potential gains from institutional economies of scale undergird the logic of Pacific island state integration. The purity of this logic, though, is dirtied by the realities of implementation. Free trade generates a net benefit for Pacific island economies in the long run, but new exposure to competition realigns labour, capital, and enterprises in the regional market and generates a new family of economic ‘winners’ and ‘losers’ in the short run. Narsey (2004) predicts that new free trade arrangements in the region will produce unacceptable job losses (especially in manufacturing) and reductions in public revenues. Unable to compensate ‘losers’ with opportunities for income restoration, weak island states will face pressure to backtrack on tariff reductions and market liberalisation. The new jumble of economic ‘winners’ and ‘losers’ could be exacerbated by unified adoption of the Australian dollar as the regional currency. Bowman (2004) shows that, because of intensified trade between East Asia and the Pacific islands, island currencies do not empirically track well with the Australian dollar. Adoption of the Australian dollar might require unwanted structural adjustment in macroeconomic terms. Analysis reveals that the US dollar is more appropriate for a regional currency, but adoption of it would tie island states to a central bank (such as the Federal Reserve) with no interest in the impact of policies on Pacific island communities.

In terms of political integration, a supra-national parliament with majority or super-majority requirements for legislation clashes with precedents of consensus construction and fluid agenda frameworks observed in the Pacific Islands Forum. The issue is one of culture.

> Harmony is the important concept here. Unanimous compromise has the underlying thought that nobody gets left out. … Voting on issues, in circumstances that in the West would be considered normal, is often taken to be offensive and the preference is for voting not to be used as a decision tool (Rolfe 2000:434).

Because decisions are reached in a manner consistent with cultural norms, the Forum enjoys legitimacy among islanders that enables efficacy in the implementation of regional policy. For example, as an explicitly transnational action sanctioned by the Forum through consensus, the stabilisation achieved by the Regional Assistance Mission to the Solomon Islands (RAMSI) earned widespread praise (Hegarty et al. 2004). In contrast, Australia's unilateral deployment of police to Papua New Guinea under the Enhanced Cooperation Program struggled to establish legitimacy. The Supreme Court's unwillingness to uphold legal immunity for Australian officers in Papua New Guinea and tension with the Royal PNG Constabulary hastened an early withdrawal of the police force (*Herald Sun*, 17 May 2005:8; Wakas and Tapakau 2005).

The issue of legitimacy highlights the difference between form and substance in terms of transnational institutions. Australia's proposal for regional integration is the latest in a series of initiatives by metropolitan countries (especially aid donors) that push Pacific islands to modernise state institutions and reform their interface with market activity. Island countries should hurry up and prepare themselves for globalisation to avoid further economic malaise and dependency on aid transfers. Through funding, donors have placed priority emphasis on efficient structures of governance and public administration as part of this preparation (Sutherland 2000). In theory, once the workflow and architecture of state institutions are modernised, transnational integration is easier and island countries benefit from the economies of scale of shared bureaucracy. This insistence on institutional form ignores the link between state effectiveness and legitimacy. Without a high level of coercion (and the public resources required to fund it), a professionally-staffed, modern, transparent state institution cannot implement policy if the relevant community does not accept it as legitimate. Institutions earn legitimacy if they successfully solve collective action problems indigenous to the community. As Larmour (2000) points out in the case of institutional performance in Melanesia, institutional designs imported under the guise of 'modernisation' typically lack legitimacy because they have not evolved enough to overcome the local idiosyncrasies of social coordination problems.

Transnational integration of institutions among Pacific islands is a concept intellectually imported from Europe where incremental surrender of sovereignty has benefited members of the Maastricht Treaty. While regional coordination has been a successful venture in Oceania, cooperation has not become integration—there is as yet no precedent for national sovereignty transfer to a regional supra-national body. In the Pacific Islands Forum, discussion of members' internal affairs of a member is taboo unless invited or approved by the country of focus (the Solomon Islands government's desire, for example, for intervention by RAMSI) (Rolfe 2000). Cooperation without integration, though, does not preclude future fusion of political institutions. Journey toward the 1992 Maastricht Treaty, for example, began in 1951 with the Treaty of Paris, which eliminated cross-boundary trade restrictions on coal, iron, and steel between France, West Germany, Italy, Belgium, Luxembourg and the Netherlands (Trumbull 2003). European Union members are just now voting on a transnational constitution (*New York Times*, 13 January 2005:15). For Oceania, timing is the important issue of integration. Successful political integration of Europe has taken 50 years, and the process started with countries at a much higher level of per capita GDP than the Pacific islands. A rush to integrate Oceania may therefore be an ill-timed institutional vault along the global convergence trajectory of economies in the region.

To underscore this argument, Oceania is compared to the Caribbean where another group of developing island countries is farther along in its integration efforts. Island states in the Caribbean established a free trade area in 1968. In 1973, this evolved into the Caribbean Community and Common Market (CARICOM) which added common external tariffs and tax harmonisation to free trade arrangements (Atkinson 1982). Considered successful, CARICOM enhanced the flow of goods and services between members and strengthened the region's position in global trade negotiations (Levitt 2004). A regional currency was formalised in 1983 with incorporation of the East Caribbean Central Bank to manage the supply of East Caribbean dollars (Worrell 2003). The macroeconomic impact of currency union, though, has not met theoretical expectations—especially since fiscal discipline has not been achieved. Kufa et al. (2003) argue that stability of the currency union is questionable because of the high level of public debt incurred by member governments. This along with a deficit in structural convergence among Caribbean economies implies little or no benefit from regional expansion of the currency union beyond its six current members—Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines (Anthony and Hallett 2000). Efforts to form a West Indies federation were made shortly after Caribbean states won independence in the 1960s and 1970s, but political integration never occurred because benefits were not perceived to justify the surrender of national sovereignty (Padmore 1999). Before Caribbean political integration is possible, citizens of the region must develop a transnational West Indian identity that sparks indigenous solutions to development challenges and endows any supra-national Caribbean institutions with legitimacy to govern (Levitt 2004).

Table 12.1 reveals that the Pacific islands trail the Caribbean in terms of global economic convergence and evolutionary context. Between 1986 and 2002, real per capita GDP (measured in terms of year 2000 US dollars) averaged across 11 independent island states in the Caribbean grew only 1.4 per cent on a cumulative annual basis.[3] Over this period, real per capita GDP grew from US$4,697 to US$5,871 (World Bank 2005). Standard deviation across the country sample fell from US$4,286 in 1986 to US$4,231 in 2002. This result suggests some amount of economic convergence within the Caribbean. Comparatively, the Pacific islands experienced weaker growth (0.6 per cent cumulative annual growth rate) and a lower level of real per capita income (US$1,257 in 2002). In contrast, minor regional divergence occurred as standard deviation across the eight Pacific countries increased from US$541 in 1986 to US$634 in 2002. In terms of Figure 12.1, the Caribbean is closer to point Z than the South Pacific. In addition, aggregate growth performance indicates that, as a regional economy, the Caribbean is evolving in a manner more consistent with convergence theory. In the Caribbean's more advanced state, though, the stability of monetary integration is questionable and first steps toward political integration have not begun. If convergence theory is

Table 12.1 Convergence in the Caribbean and Pacific islands

Real per capita GDP (Year 2000 US$)	1986	1990	1994	1998	2002
Caribbean					
Antigua and Barbuda	6,313	7,618	8,657	9,012	9,157
Bahamas	15,747	15,832	14,510	14,928	15,338
Barbados	8,136	8,580	8,113	9,253	9,176
Dominica	2,519	3,132	3,308	3,722	3,476
Dominican Republic	1,524	1,576	1,724	2,103	2,458
Haiti	751	700	523	504	474
Jamaica	2,511	3,081	3,166	3,081	3,112
St. Kitts and Nevis	3,959	5,236	6,212	7,605	7,427
St. Lucia	2,702	3,933	4,226	4,376	4,143
St. Vincent and the Grenadines	2,069	2,574	2,624	2,878	3,136
Trinidad and Tobago	5,434	4,914	4,908	5,763	6,689
Caribbean average	4,697	5,198	5,271	5,748	5,871
Caribbean standard deviation	4,286	4,255	3,968	4,157	4,231
Pacific islands					
Fiji	1,851	1,867	1,999	2,055	2,253
Kiribati	439	431	461	543	564
Micronesia, FS of	1,916	1,965	2,169	1,837	1,818
Papua New Guinea	611	560	791	687	642
Samoa	1,227	1,185	1,144	1,310	1,485
Solomon Islands	766	788	855	855	585
Tonga	1,263	1,241	1,427	1,471	1,607
Vanuatu	1,071	1,050	1,299	1,239	1,100
Pacific islands average	1,143	1,136	1,268	1,250	1,257
Pacific islands standard deviation	541	559	590	537	634

valid, these observations from the Caribbean suggest that any discussion of currency union or political integration among Pacific island states is dangerously premature. A free trade pact may be the only form of integration worthy of consideration. Oceania's slow growth and economic divergence imply a continued underdevelopment bottleneck within the region (see the line segment UE in Figure 12.1). Breaking the bottleneck requires more internal focus on institutional development by Pacific island governments. Without internal strength, Pacific island states cannot effectively participate in transnational governance and current dreams of institutional integration are an academic distraction.

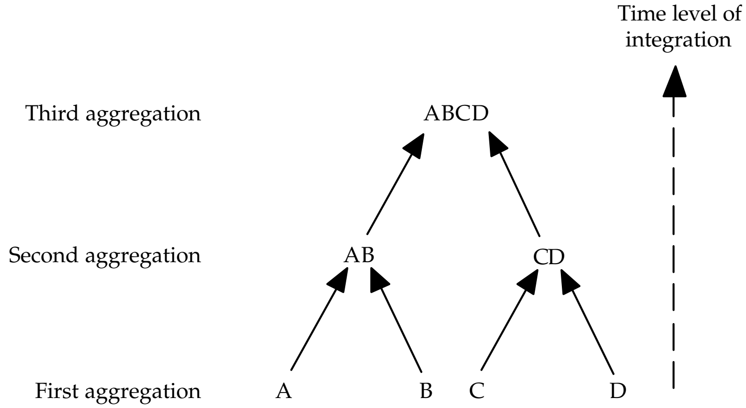
THEORETICAL FOUNDATIONS FOR SUSTAINABLE INSTITUTIONAL INTEGRATION

Opposition to integration of Pacific island states must rest upon a theory of institutional evolution. Such a theory can be grounded in cooperative game theory. If integration is sustainable, then the supra-national institutions formed from it successfully solve transnational collective action problems. Transnational integration can be considered a natural iteration in an evolutionary process of institutional aggregation that complements economic convergence and the pressure of globalisation that fuels it. Rubin (2001) argues that biological natural selection favoured humans who cooperated well in groups. The first phase of social aggregation was therefore a natural outcome of biology. The division of labour and scale economies achieved through cooperation generated a surplus that enhanced survivability and lengthened life. Early human cooperation occurred in small kin-based groups. This fact explains why family groups remain the fundamental unit of collective action in most societies. As human interaction widened and deepened through conflict, intermarriage, and trade, cooperation evolved across family units and formed hierarchies of group membership. For example, this type of evolution occurred in Fiji and leaves footprints in modern social structure and the native language. The fundamental unit of Fijian society is the *i tokatoka*, or extended family. Each *i tokatoka* belongs to a family group known as the *mataqali*. Multiple *mataqali* form a clan called a *yavusa*. A *vanua* aggregates *yavusa* groups for the purpose of political, economic and social interaction. An alliance among *vanua* forms a *matanitu* which is a Fijian tribal state (Lasaqa 1984). Although encouraged by the British colonial authority, the Council of Chiefs represents the latest iteration of community aggregation in Fiji. The council is now an 'apex of the Fijian administration' which 'had not previously existed in any form prior to colonisation because the Fijians had never organised themselves along national lines' (Lawson 1990:801).

The timing of the next level of aggregation is the important theoretical question. Conditions for stability and the time it takes to meet such conditions must be identified for policymakers who seek to manage the integration process. At a basic level, interaction between distinct units of society can be modelled as an infinitely-repeated prisoner's dilemma game (Rubin 2001). A unit can choose conflict or cooperation. Cooperation occurs naturally when the one-time payoff from conflict does not justify the loss of net gains from indefinite cooperation. To explain this dynamic, suppose two clans in a tribal society can interact. Either can raid the other's villages, extract resources, and enhance wealth through confiscation of the 'spoils of victory'. Conflict, though, prohibits an economic relationship that would generate gains from trade for each clan. If the expected present value of gains from trade is higher than the present value of the 'spoils of victory', then cooperation naturally occurs with no coercion. If cooperation is stable, then integration between clans occurs and a new level is added to society's hierarchy of group membership (Figure 12.2). Interaction of clans A and B forms AB and interaction of clans C and D forms CD, where AB and CD are the newest units of aggregation in society. In evolutionary terms, the next level of integration requires cooperation between AB and CD to form ABCD. As long as the stability of cooperation is guaranteed, the time it takes to evolve from one level of aggregation to the next is merely a function of how long it takes candidate integrants to communicate and appraise each other's comparative advantage.

Logically, ABCD only sustains itself if the AB and CD partnerships remain strong. Applied to the issue of Pacific integration, ABCD represents the

Figure 12.2 Hierarchy of community aggregation



transnational institutions of regional governance and AB and CD each represent states that must cement the loyalty of their respective sub-national groups. Aid donors play an important role in the dynamics of this hierarchy because they typically fund an important share of state architecture in Pacific island nations. For example, grants from donors account for 20 per cent, 37 per cent, and 63 per cent of government revenue in Papua New Guinea, Samoa, and the Federated States of Micronesia respectively (Chamon et al. 2005; Komori et al. 2005; Sidgwick et al. 2004). In the context of Pacific integration, two traditional institutional development strategies by donors reveal themselves. A strategy of *regional transformation* initiates and funds the physical institutions of regional governance. Aid donors funding the construction of a Pacific Parliament by subsidising the salaries of Pacific island parliament members would exemplify this type of strategy. A strategy of *state transformation* financially supports modern institutions of state in Pacific island nations. Current examples include the allocation of A$10 million by AusAID to enhance the capacity of Fiji's courts, police, prisons, and Ministry of Justice and New Zealand's provision of a Solicitor-General for the Attorney General's Office of Kiribati (AusAID 2004; NZAid 2002).

A third strategy of *state evolution* is an alternative to the two *transformation* strategies previously mentioned. A *state evolution* strategy is different because it does not directly finance the organs of state. The focus is instead on investment in a national environment that naturally, but indirectly, hastens a state with more legitimacy. In many developing countries, state legitimacy must ultimately come from rural indigenous institutions that already enforce social norms and solve collective action problems. Kenny (1998) offers empirical support for this view with a case from Senegal, and Powell (2004) uses game theory to justify application of the hypothesis to Melanesia. The idea dictates policies that strengthen (or at a minimum do not threaten) the political role of traditional institutions and enable a natural evolution of civil and economic arrangements that consensually invite a stronger institutional role for the state. Projects that enhance the capacity of indigenous institutions and the rural economy to generate income, either directly through the provision of capital or indirectly through the generation of public goods, achieve this goal. Under these arrangements, indigenous institutions simultaneously enhance their wealth and call upon the state to facilitate a market environment that expands incomeearning opportunities. The voluntary surrender of mineral rights to the state by indigenous tribes within Botswana in response to the discovery of diamonds provides an example of how this can occur (Alfaro et al. 2003). Although *state transformation* better characterises the aid strategies of Australia and New Zealand, both countries fund some projects that support *state evolution*. For example, AusAID contributes to the Ha'apai Development Fund in Tonga, which expands infrastructure in outer islands. The fund is governed by a committee that includes local decision-makers (AusAID 2003). This project simultaneously expands rural income potential, makes indigenous leaders stakeholders, and gives the state an obvious opportunity to add economic value and enhance its legitimacy.

Using the lexicon of Figure 12.2, an aid strategy of regional transformation funds the institutions of ABCD, a strategy of state transformation funds the institutions of AB and CD, and a strategy of state evolution separately targets the institutions of A, B, C, and D. The contrast between the transformation strategies and state evolution strategy is a classic tension between 'top-down' and 'bottom-up' development strategies. Certain logic behind the regional transformation and state transformation strategies has merit. Philosophically, their proponents believe that well-designed institutions naturally breed good governance. For example, as already mentioned, de Brouwer (2000), Duncan (2000), and Duncan and Xu (2002) advocate adoption of the Australian dollar by Pacific island states. This policy would enable Pacific island states to enjoy the instant anti-inflationary benefits of a credible Australian central bank and would remove the financial burden on domestic taxpayers of funding the overhead of a central bank. These points underscore two general arguments made in favour of transformation strategies. First, institutional changes can be made fairly quickly when shepherded by the money and technical expertise of donors. Results can be achieved much faster than the incremental nature of state evolution. Second, proposed changes are based on institutional trial-and-error that has already occurred in developed countries. Developing countries can avoid inefficiencies and adopt 'best practices' in terms of institutional design.

Critics of this institution-cum-governance view argue that it dangerously oversimplifies the issue of legitimacy. Kenny (1998:161) argues this in the context of Africa.

> The concentration on the importance of governance…is based on a view of the state as an independent actor rather than as imbedded in a social structure…New institutional structures will fail throughout most of Africa because it is not formal institutional structures which promote state legitimacy, but informal structures and beliefs.

An absence of legitimacy makes the purchase of institutional success expensive for aid donors. The success too is unsustainable because it disappears once aid transfers stop. If a donor is willing to subsidise institutional success *ad infinitum*, then a state transformation or regional transformation strategy might be the most efficient. In this case, however, assimilation, rather than integration, better describes the long-term goal. Integration is an incremental aggregation of pre-existing sovereign units whereas assimilation dissolves the sovereignty of one unit and subsumes its membership into another unit that strengthens its own sovereignty. For example, regional adoption of the Australian dollar will shut down central banks in the Pacific islands and transfer authority over monetary policy to the Reserve Bank of Australia. In theory, the maximum scope of a state's legitimacy correlates with the dimensions of policy that it can potentially control. When the conduct of monetary policy is transferred to a foreign central bank, the ceiling on legitimacy that a Pacific island state can achieve falls a degree. Whereas Australian dollarisation of the Pacific represents assimilation, adoption of the Euro by European Union members describes true integration. The states involved do not struggle to establish legitimacy and the new currency is an explicit expression of European aggregation rather than adoption of an already existent medium of exchange. The lesson for Pacific island aid donors is to be clear on long-term goals. If integration is the goal (at either the national or regional level), institutions that are a product of aggregation must have legitimacy before they will function without external subsidy and management. If assimilation is the goal, then donors must be prepared to assume a permanent financial and administrative burden that bribes the loyalty of the integrated Pacific island community. Failure to distinguish between these goals and align aid projects appropriately will generate another round of disappointment in the performance of foreign assistance in the Pacific.

CONCLUSION

As a region, the island states of Oceania are not ready for transnational integration of institutions. The success of integration in the European Union and the existence of free trade areas and currency unions in the Caribbean can spark misplaced exuberance for integration among Pacific scholars. Integration strategies should be grounded in application of global convergence theory. High levels of per capita income, economic homogeneity, and a strong sense of transnational identity have made the 50 year process of European integration a success. The Caribbean has not evolved to the same point as Europe. For this reason, the stability of the East Caribbean Currency Union is questionable, and no credible movement toward political integration is witnessed. The Pacific islands are one step behind the Caribbean. Many Pacific island states, especially in Melanesia, have failed to integrate communities within their own national boundaries. The legitimacy of the state as a national actor must first be established before transnational integration becomes an initiative worthy of pursuit.

Convergence theory is an imperfect but useful theoretical tool for framing the Pacific islands' development trajectory. Through growth in real per capita GDP, economic convergence speeds a developing economy toward the prosperity enjoyed by countries that exercise global economic leadership. The growth path is supported by a process of institutional evolution that incrementally integrates units of society through establishment of new cooperative equilibria among larger and larger groups. At this time, integration of state institutions in the Pacific would be an artificial and unsustainable leapfrog in the process of community aggregation. Imposition of a relatively advanced institution upon only partially evolved Pacific island economies would generate inefficient complexity and impede the region's ability to break its underdevelopment bottleneck. A 2003 Senate Report suggests a leadership role for Australia in spearheading the construction of institutions for regional governance (Commonwealth of Australia 2003). Australian policymakers should not confuse integration with assimilation. Integration requires patience because Pacific island states must first gain legitimacy among their own polities. Regional institutions of governance will have no chance of sustainability unless this first occurs. An alternative goal for Australia would be assimilation. Adoption of the Australian dollar in the region would be a first step in this direction. A newfound willingness among troubled Pacific states to allow Australian public servants to fill positions in their own government hints at potential acceptance of assimilation if the economic benefits generously compensate for the transfer of administration or sovereignty to Canberra. The charge to the Australian taxpayer of assimilation, though, will be much higher and the commitment much longer than if Canberra chooses a more patient approach of integration and state legitimacy enhancement.

Assuming that assimilation is not a preferred choice, analysis reveals the following takeaways for regional policymakers. The Pacific Islands Forum should continue its tradition of reaching decisions through consensus based on a fluid agenda of discussion. Because this process is consistent with the cultural norms of islanders, the execution of decisions by the Forum carry a needed level of legitimacy. As this legitimacy strengthens itself through iterations of successful cooperative ventures, a stronger foundation for regional integration will develop in the long run. Australian efforts to rush regional integration and make the Forum more aggressive simply reverse the Forum's legitimacy and make it less effective as an agent of collective action. In the short run, the Forum should not waste energy on proposals for currency union or transnational merger of governance and public administration. Discussion of integration should limit itself to free trade pact implementation as envisioned by PICTA and CER. The trade success of CARICOM suggests a hopeful future for these two initiatives.

If foreign donors desire regional integration, they should replace explicit discussion of integration with a domestic focus on changes that endow Pacific island states with more legitimacy among their citizens. These changes likely require constitutional reform that decentralises power and weakens the unitary nature of parliamentary democracies in the region. Transfer of limited constitutional sovereignty to federalised jurisdictions achieves two desirable outcomes. First, the distribution of state spending will be better equalised in geographical terms. This better allocates public good production and theoretically speeds rural income growth. Decentralisation of public finance also reduces the spoils of corruption within the parliament and among bureaucrats in the capital city. Second, transfer of power to local units politically dominated by traditional decision-makers forces the state to cooperate with indigenous institutions. This benefits the state in the long run because policies will be a product of partnership with indigenous institutions that already command the loyalty of local polities. In the end, domestic legitimacy of Pacific island states is a necessary condition for successful transnational integration of Pacific island governance. Island governments and aid donors should sequence their policy initiatives and political energy in a logical way that recognises this fact.

NOTES

1 See Table 5 of Barro (1999). The six countries that performed below expectations in 1995 in terms of democracy were Cameroon, Fiji, Gambia, Kenya, Lesotho and Liberia. The six countries that maintained democracy at or above the expected level were Botswana, Mauritius, Senegal, Tanzania, Zambia, and Papua New Guinea.

2 The East African Currency Board comprised Kenya, Uganda, and Tanzania. It started in 1960 and disbanded in 1972. The Rand Monetary Area consists of South Africa, Namibia, Lesotho and Swaziland. Botswana was an original member but left (Guillaume and Stasavage 2000). The West African Economic and Monetary Union includes Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo. Cameroon, Central African Republic, Chad, Republic of Congo (Brazzaville), Equatorial Guinea and Gabon make up the Central African Economic and Monetary Community (Fielding et al 2004). The CFA BCEAO Franc is the official currency in the West African Union and the CFA BEAC Franc is the official currency in the Central African Community.

3 Because 1986 is the first year for which data are available for the Federated States of Micronesia, it was chosen as the beginning of the sample period for comparison purposes. Since the island states are the focus of comparison, non-island countries in Central or South America were deliberately excluded from the Caribbean sample. Grenada was excluded because of incomplete World Bank data during the 1986–2002 period. Cuba was excluded because of its position as an institutional outlier and its lack of membership in CARICOM.

Comment

Theodore Levantis

Powell has taken an issue which, in his words has become a fashionable solution to the Pacific region's economic problems, and turned it on its head. He is convincing in his opinion that regional integration is misconceived and inappropriate, and his arguments are backed with sound reasoning and a well informed understanding of international parallels. However, the modelling and economic theorising presented appear to be peripheral to the paper—their purpose is to explain principles rather than prove Powell's arguments—so I would have preferred to see this aspect downplayed.

I am convinced that Powell is correct in his conclusions, however, the 'policy community', as Powell describes it, is riding a wave and this quality work is likely to leave little impression in these circles. It will not be until regional integration fails that policy direction will change and a new fashion is embraced.

But will regional integration fail? So long as the Australian government finances the concept, the process will continue. I agree with Powell that it is likely to fail to bring anything to development in the Pacific, and it will do little if anything to improve institutions and lower costs. Instead, the process will divert attention and resources away from priority needs within the Pacific nations.

For example, a free trade pact will do little, if anything, for economic prosperity in the region. The nations of the Pacific have similar economic structures—in particular import/export structures—and do not have the depth and diversity to take advantage of reductions in trade barriers. Exports are dominated by commodities and international tourism, and imports are dominated by manufactures, the bulk of which have no competing industries in the region. Are the small gains in a free trade pact worth diverting scarce resources and scarce skilled public sector labour in these countries to pursuing this objective?

A currency union, for the reasons that Powell outlined, could be disastrous. Moreover, if a Pacific currency is established and then allowed to float, there will be similar consequences of extreme exchange volatility that Papua New Guinea has suffered since the float of the kina in 1995—with devastating consequences for business and investment in that country (see Levantis and Manning 2002). Alternatively, if the Pacific nations were to adopt the Australian dollar, it would enable these nations to maintain the exchange stability that they already enjoy (all countries other than Papua New Guinea peg their exchange rate) but with long-term certainty. However, regional integration is not needed for individual Pacific nations to adopt the Australian dollar.

Pacific nations are separated by thousands of kilometres of ocean and travel between them is difficult, costly, and irregular. Under these conditions it is unbelievable that people in policy circles would consider a common labour market could contribute in any way to development. Only the very top echelon of the labour market would have the means to travel in countries like Solomon Islands, Papua New Guinea and Vanuatu. Most other nations in the Pacific have a community focus of exporting their labour to developed nations, particularly Australia, New Zealand, the United States and Canada. This has been highly successful for Tonga and Samoa in particular and has underpinned their success in human development indicators—despite the absence of a production base, or a potential production base. The export of labour from these nations is not going to divert to poorer neighbouring Pacific countries.

I agree with Powell that transnational public administration will fail to bring benefits for the reasons he has outlined. The Pacific is not like the Caribbean nations, which are in the vicinity of each other, or the European nations, for which international travel can be achieved by car, bus or rail. Having institutional bodies with responsibility across thousand of kilometres of ocean, where travel is so difficult and costly, makes no sense. There are proven exceptions to this—the University of South Pacific is a good example—but to be an exception, the institutions need to be free or relatively free of domestic functions. For example, there cannot ever be central Pacific institutions operating health services, law and order functions, tax collections or primary and secondary education. Statistical collection is one area where it may be worthwhile investigating the merits of integration. However, it is hard to imagine that, in view of the isolation of these nations, integration would be better than direct institutional support in each country from, say, the Australian Bureau of Statistics.

As Powell says, we should first focus on building and strengthening the institutions in Pacific nations before entertaining ideas of integration. The priorities need to be put in order. The best approach for the Australian government to take for assisting the building and strengthening of institutions is to establish supportive alliances with the corresponding institutions in Australia (statistic collections is a good example). It is to the merit of Australian policymakers that some progress has been made in pursuing this path in recent years.