Policy dialogue

Pacific trade liberalisation and tariff revenues

Uwe Kaufmann
School of Economics, University of Adelaide

One of the issues most often raised in discussions of the Economic Partnership Agreement (EPA) between the European Union and Pacific island countries and the Pacific Agreement on Closer Economic Relations (PACER) Plus negotiations between Australia and New Zealand and Pacific island countries is the impact on the Pacific islands of the reduction or elimination of the revenue they collect from tariffs. The expected tariff revenue losses Pacific island countries will suffer are being used more and more often to criticise these proposed agreements. Because it serves the interests of the protected industries in Pacific island countries to present a negative picture of the trade agreements, they focus on the loss of tariff revenue. Many non-governmental organisations (NGOs) are also antagonistic towards trade agreements involving Pacific island countries, claiming that they will face serious negative consequences if they sign up. Their key concerns include: 'a dramatic loss of government revenue', 'potential job losses and business closures' and 'higher taxes for the poor' (PANG 2009a:5). It is argued that because of the loss of government revenue due to trade liberalisation, governments 'will have to cut services (like health and education) to their peoples' (PANG 2008). Further, governments will have no choice but 'to downsize their public sector—putting more people out of work. Any loss of jobs for nurses, teachers and public servants would place an added burden on women who work in these sectors and increase the push to migrate' (PANG 2009b:1).

Law professor Jane Kelsey (2004b:10) writes in the *People's guide to PACER* that '"free trade" agreements are a new form of colonization'. Kelsey lists several 'protections' that 'would have to go'—one of which should make her think of its implications, as she states that '*tariffs*…are a tax that makes imports more expensive than locally produced goods so as to protect local producers who can't otherwise compete, and to provide governments with revenue'.

We therefore pose some questions to Kelsey and the NGOs that use her services, as well as to the governments that provide tariffs to industries that 'can't otherwise compete': who pays for the more expensive imports as the result of the imposition of tariffs or non-tariff barriers on imports? Would it not be a good idea for consumers to pay less for higher-quality goods and have more disposable income for other goods and services? As we have seen before the reform of telecommunications markets

in the Pacific, local industries that do not have to worry about competition have no incentive to invest in better-quality, lower-cost, consumer-friendly products or production methods. Could the additional disposable consumer income resulting from the lower prices of imports increase business opportunities for Pacific islanders—not only for domestic industries but for those who distribute the imports?

With regard to food security, the Pacific Network on Globalisation (PANG 2009a:5) argues that there will be a 'reduced ability to support the agricultural sector' due to trade liberalisation. This issue is, however, addressed in the Interim Partnership Agreement (IPA) signed between the European Union and Papua New Guinea and Fiji, which gives an idea of the European Union's approach. In the IPA, with respect to food security, it is stated that

> the Parties acknowledge that the removal of barriers to trade between the Parties, as envisaged in this Agreement, may pose significant challenges to producers in the agricultural and food sectors and agree to consult with each other on these issues…and…where compliance with the provisions of this Agreement leads to problems with the availability of, or access to, foodstuffs or other products essential to ensure food security of a Party or Pacific State and where this situation gives rise or is likely to give rise to major difficulties for such a Party or Pacific State, that Party or Pacific State may take appropriate measures. (Council of the European Union 2009:Article 46, p.77)

Chapter 6 of the IPA also includes exceptions to tariff reductions, with Article 42 as a 'General Exception Clause' to accommodate the necessity to protect public safety and public morals or public order, to protect human, animal or plant life, or to secure compliance with laws and regulations not inconsistent with provisions of the agreement. These include privacy protection for individuals, safety, customs enforcement and the protection of intellectual property rights. Other exceptions are related to the import/export of gold and silver, the protection of natural artistic, historical or archaeological values, the conservation of exhaustible natural resources (for example, domestic restrictions on the production or consumption of goods), domestic supply or consumption of services, and domestic investors. The exception clause also applies if the reason is inconsistent with Article 23 on 'National Treatment'—provided that differences in treatment are valid and are applied to ensure effective or equitable imposition or collection of direct taxes with respect to economic activities, investors or service suppliers from the European Union or the Pacific island countries. Article 43 gives further exceptions with respect to national security. The IPA with the European Union and the PACER agreement with Australia and New Zealand address not just all the claims and fears of the Pacific island countries and NGOs in one way or the other, but more importantly address all common barriers to trade identified by the World Trade Organization (WTO) and by the Trading Across Borders section of the World Bank's (2009a) *Doing Business Report 2009*.

As most of the arguments against trade liberalisation in Pacific island countries are based on the perceived problems arising from reductions in tariff revenue, section two of this article takes a closer look at the revenue structure of Pacific island countries, while section three reviews potential tariff revenue losses from the EPA and PACER. Section four analyses alternative revenue sources for Pacific island countries.

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The revenue structure of the Pacific island countries

Tariff revenue is still one of the main sources of government revenue for several Pacific countries (Table 1). The table shows total government revenue and grants as a percentage of gross domestic product (GDP) and customs revenue as a percentage of total government revenue. The revenue raised by a value-added tax (VAT),[1] if in place, is reported as well as its share of total revenue.

The total of revenues and grants as a percentage of GDP is extremely high in Kiribati and Niue—more than 90 per cent. In Tuvalu, the percentage is even higher than the country's GDP. Fiji and Palau have the lowest percentages—at 24.1 per cent and 27.6 per cent, respectively. In most Pacific island countries, the total of revenue and grants as a percentage of GDP is between 30 and 36 per cent.

In several countries, customs revenue is more than 20 per cent of total revenue and grants. Nauru's reliance on customs revenue is by far the highest at 61.2 per cent. In the majority of countries the share is below 17 per cent. In some countries—for example, Federated States of Micronesia (FSM), Palau, Papua New Guinea, Marshall Islands and Samoa—the share is below 10 per cent, indicating a much broader diversification of government revenue and weakening dependency on customs revenues. This point is underlined by the average level of tariffs applied on all products, which, not surprisingly, is lower in those countries where the share of customs revenue is low. The opposite is true for countries with high average tariff levels, such as Fiji and Vanuatu, where average tariffs are about 40 and 25 per cent, respectively (International Trade Centre 2009).

Several countries have adopted a VAT, which contributes significantly to total revenue (Papua New Guinea excepted) and offers an option for diversification away from customs revenue dependency.

Potential revenue loss from trade liberalisation

The potential loss in tariff revenue due to the implementation of the IPA/EPA and PACER has been the subject of several studies. Filmer and Lawson (1999) and Narsey (2004) measured the cumulative revenue losses from potential free-trade agreements, including EPAs and PACER. Scollay, Gilbert and Collins (1998) estimated tariff revenue losses from free-trade agreements including PACER. In a recent study by Watergall Consulting Limited (2007), the potential losses of revenue (as percentages of total tax revenue) from preferential trade agreements, including the EPA and PACER, were estimated.

The findings of Scollay, Gilbert and Collins (1998), Filmer and Lawson (1999) and Narsey (2004) are summarised (Table 2). The three studies show partially different results (for example, PACER's impact on Fiji), but agree on the impact of the EPAs. Filmer and Lawson (1999) and Narsey (2004) 'mostly' agree that an EPA will cause only marginal tariff revenue losses.

There are two exceptions—namely, Kiribati and Vanuatu—where the tariff revenue loss is considered to be relatively high.[3] For PACER, there is no obvious consensus. For example, for Fiji, Filmer and Lawson (1999) predict a 15 per cent tariff revenue loss, whereas Narsey (2004) estimates 52 per cent and Scollay, Gilbert and Collins (1998) make an estimate of 66 per cent. For Samoa and Vanuatu, there are similarly inconclusive results. One reason for the differences could be that the studies were

Table 1 **Statistics relating to government revenue, 2008**[2]

Country	Total revenue and grants/ GDP (%)	Average tariff rate (%)	VAT rate (%)	Customs revenue/ total revenue and grants (%)	VAT/total revenue and grants (%)
Cook Islands	34.2	7[a]	12.5	11.2	31.9
Fiji Islands	24.1	39.55	12.5	16.4	31.4
Federated States of Micronesia (2006)	59.1	4.21	-	6.4	-
Kiribati	90.9	17.22	-	13.6	-
Nauru (2007)	82.9	n.a.	-	61.2	-
Niue (2006)	90.0	n.a.	-	21.4	-
Palau (2006)	27.6	3.02	-	6.7	-
Papua New Guinea	36.1	4.88	10.0	5.5	8.3
Republic of Marshall Islands (2007)	65.2	9[a]	-	7.6	-
Samoa	32.5	7[a]	12.5	9.4	23.1
Solomon Islands	65.9	13.05	-	25.0	-
Tonga	35.7	24.09	15.0	27.5	36.2
Tuvalu	126.0	15[a]	-	21.8	-
Vanuatu	30.1	25.13	12.5	23.0	27.5

n.a. not applicable, - zero, [a] average customs duty for 2006 according to Watergall (2007).

Notes: For Tonga, the average tariff rate applied on agricultural products (ATAoAP) is 60.07 per cent and the average tariff applied on industrial products (ATAoIP) is 18.15 per cent; for the Federated States of Micronesia, ATAoAP is 4.42 per cent and ATAoIP is 4.19 per cent; for Kiribati, ATAoAP is 49.21 per cent and ATAoIP is 15 per cent; for Palau, ATAoAP is 1.68 per cent and ATAoIP is 3.11 per cent (medical products, according to Watergall Consulting Limited [2007] are tariff free); for Papua New Guinea, ATAoAP is 19.32 per cent and ATAoIP is 2.48 per cent; for Marshall Islands, according to Watergall Consulting Limited (2007), the duty rate for food is 5 per cent, for most other products it is 8 per cent and variable higher rates are applied on tobacco, alcohol and fuel; for Samoa, according to Watergall Consulting Limited (2007), import duties are declining gradually; for Solomon Islands, ATAoAP is 39.18 per cent and ATAoIP is 8.84 per cent; for Tonga, ATAoAP is 60.07 per cent and ATAoIP is 18.15 per cent; for Vanuatu, ATAoAP is 90.05 per cent and ATAoIP is 14.49 per cent. According to Watergall Consulting Limited (2007), Samoa, Fiji and Vanuatu have adopted the six-digit HS system for customs classifications, while Solomon Islands is using the HS02 system and is in the process of changing to the six-digit HS system.

Sources: Watergall Consulting Limited, 2007. *Responding to the revenue consequences of trade reforms in the forum island countries*, Final report (September), Watergall Consulting Limited, Port Vila, Vanuatu; International Monetary Fund (IMF), 2009. *International Finance Statistics (IFS) 2008*, International Monetary Fund, Washington, DC; World Bank, 2009b. World Development Indicators 2008, The World Bank, Washington, DC; Asian Development Bank (ADB), 2009. *Key Indicators 2008*, Asian Development Bank, Manila; United Nations Statistics Division (UNSD), 2008. *National Accounts 2008*, Statistics Division, United Nations, New York. Average tariff rates were derived from the International Trade Centre (2009).

undertaken for different periods and different assumptions and methods were applied. The tariff revenue loss is expressed in three ways: in terms of the percentage of total tariff revenue (Scollay, Gilbert and Collins); in terms of the percentage of total cumulative tariff revenue (Narsey); and in terms of the percentage of total cumulative revenue (Filmer and Lawson). This does not, however, explain why Narsey and Filmer and Lawson agree on the impact of the EPAs but not on the impact of PACER.

For example, for the impact of PACER on Kiribati, Scollay, Gilbert and Collins (1998) report a revenue loss of 58 per cent, Filmer and Lawson (1999) report a revenue loss of 52 per cent and Narsey (2004) reports a revenue loss of 82 per cent. The differences are not surprising as the estimates were made using different base years. Interestingly, the results are similar when the researchers estimate the tariff revenue losses from the implementation of the EPA. Although there are these differences, the three studies indicate that the loss in tariff revenue will be more significant for PACER than it will be for the EPA, which can be justified by the fact that trade between

Table 2 **Estimated tariff revenue losses from preferential trade agreements**

	Scollay, Gilbert and Collins (1998)		Filmer and Lawson (1999)		Narsey (2004)	
Country	EPA	PACER	EPA	PACER	EPA	PACER
Cook Islands	n.a.	46	2	22	n.a.	n.a.
Fiji Islands	n.a.	66	1	15	1	52
Federated States of Micronesia	n.a.	5	0	1	n.a.	n.a.
Kiribati	n.a.	58	14	52	13	82
Nauru	n.a.	75	2	95	n.a.	n.a.
Niue	n.a.	29	0	38	0	98
Palau	n.a.	18	0	0	n.a.	n.a.
Papua New Guinea	n.a.	52	0	7	n.a.	n.a.
Republic of Marshall Islands	n.a.	7	0	2	0	8
Samoa	n.a.	72	3	17	14	67
Solomon Islands	n.a.	48	0	7	n.a.	n.a.
Tonga	n.a.	67	3	44	n.a.	n.a.
Tuvalu	n.a.	n.a.	17	50	n.a.	n.a.
Vanuatu	n.a.	41	9	32	13	73

n.a. not applicable

Notes: Scollay, Gilbert and Collins (1998) report the loss of tariff revenue in terms of the percentage of total tariff revenue; Narsey (2004) calculates the loss in terms of the percentage of the total cumulative tariff revenue; Filmer and Lawson (1999) report the percentage loss of total cumulative revenue.

Sources: Scollay, R., Gilbert, J. and Collins, D., 1998. *Free trade options for the forum island countries*, Report prepared for the Pacific Islands Forum Secretariat, Suva, Fiji Islands; Narsey, W., 2004. *Trade liberalisation and fiscal reform: towards a negotiating framework for Economic Partnership Agreements with the European Union*, Report for the Pacific Islands Forum Secretariat and the Pacific ACP Trade Experts Advisory Group Meeting, Suva, Fiji Islands; Filmer, R.J. and Lawson, T., 1999. *The Fiscal Implications for Forum Island Countries of Alternative Proposals for Regional Free Trade Areas*, Pacific Islands Forum Secretariat, Suva, Fiji Islands.

Australia and New Zealand and the Pacific island countries is much greater than trade between the European Union and the Pacific island countries. The example of Kiribati, however, shows that there is need for further research on the potential tariff revenue losses.[4]

The estimates of tariff revenue losses from Watergall Consulting Limited's (2007) study are presented (Table 3). Tariff revenue losses are estimated for three liberalisation scenarios: 100 per cent, 80 per cent and 67 per cent of the tariff lines by volume. Watergall Consulting Limited (2007) finds that the size of the tariff revenue loss in the short term will depend on Pacific island countries' adaptation to the PACER and IPA/EPA arrangements. In the worst-case scenario (100 per cent liberalisation), it will take 10 years for the countries to regain the pre-liberalisation revenue-to-GDP ratios in the absence of other measures.

This study suggests almost no tariff revenue losses should be expected from trade liberalisation with the European Union. Moreover, the 17 per cent reduction of tariff revenue in Vanuatu is low compared with the 32 per cent estimate by Filmer and Lawson (1999) using the same measurement base.[5] Watergall Consulting Limited's (2007) PACER estimates for Fiji, Nauru, Kiribati and Tonga (for example) are also much lower. Therefore, this more recent study shows that some Pacific island countries have already adjusted their fiscal systems towards a more liberal trading

Table 3 **Tariff revenue losses for trade liberalisation scenarios** (percentage of GDP)

	EPA			PACER		
Countries/tariff lines	100%	80%	67%	100%	80%	67%
Cook Islands	0	0	0	6	6	5
Fiji Islands	0	0	0	2	2	2
Federated States of Micronesia	0	0	0	1	0	0
Kiribati	0	0	0	13	12	9
Nauru	0	0	0	5	n.a.	n.a.
Niue	0	0	0	5	4	4
Palau	0	0	0	0	0	0
Papua New Guinea	0	0	0	1	1	1
Republic of Marshall Islands	0	0	0	5	n.a.	n.a.
Samoa	0	0	0	9	9	9
Solomon Islands	0	0	0	3	2	2
Tonga	0	0	0	15	10	10
Tuvalu	0	0	0	4	3	3
Vanuatu	1	1	1	17	15	11

n.a. not applicable
Notes: The 100 per cent, 80 per cent and 67 per cent scenarios refer to the extent of reduction of tariff lines, by volume. The assumptions are: no change in trade flows, no externalities and an oligopolistic business environment.
Source: Watergall Consulting Limited, 2007. *Responding to the revenue consequences of trade reforms in the forum island countries*, Final report (September), Watergall Consulting Limited, Port Vila, Vanuatu.

environment by diversifying their government revenues away from a dependency on tariffs.

How best to adjust to trade liberalisation?

Recent studies, such as Watergall Consulting Limited (2007), suggest that gradual tariff reduction should be accompanied by tax diversification and thus by fiscal reforms. Moreover, tariff exemptions should be reduced or eliminated as far as possible. Fiscal reform can also be used to improve equity and minimise administrative costs for customs. To compensate for the tariff losses, a range of revenue raising measures can be considered. These include excise taxes, general consumption taxes such as the VAT, income tax and corporate tax. In reforming their fiscal regimes, Pacific island countries should set as a major goal improving the effectiveness of their customs and other tax-collection agencies, including improvement in compliance, as discussed below.

Excise tax

An excise tax is a tax levied on specific goods, whether domestically produced or imported. Excise taxes are thus consistent with the WTO's rules, on which the IPA/EPA and PACER trade liberalising arrangements are based—that is, that any tax or duty has to be imposed on domestic and foreign products in order to comply with the WTO's non-discriminatory rule.

Excise taxes are commonly used as a so-called 'sin tax'—a tax on goods that have important social costs, such as tobacco and alcohol. Excise taxes can also be applied to goods such as luxury cars and jewellery and are in effect a tax on the wealthy members of society. These goods are not very price sensitive (inelastic demand) and are thus very effective revenue raisers. Excise taxes can therefore serve a social agenda in terms of improving equity by taxing the rich and reducing the consumption of goods such as alcohol and tobacco, which have adverse health effects, as well as providing revenue to meet healthcare costs.

Personal income and corporate taxes

Income and corporate taxes are components of a tax regime. It has to be kept in mind, however, that personal income taxes presently add little to total tax revenue in Pacific island countries. Moreover, an increase in corporate taxes can be seen as a counter-productive step since the ultimate goal of trade liberalisation is to ensure greater international competitiveness of industry. An increase in corporate tax will reduce the competitiveness of the domestic industry and the attractiveness of the economy for investors. Further, corporations commonly treat a corporate tax as a turnover tax and attempt to pass on the tax increase to consumers through a price increase. An increase in the corporate tax to offset a tariff reduction will therefore ultimately reduce the welfare-improving effect of the tariff reductions.

Consumption taxes: the VAT[6]

The easiest consumption tax to implement is the VAT, which is already in place in some Pacific island countries. The VAT is also an effective way to adjust for potential tariff revenue losses. Many trade liberalisation opponents argue that imposing a VAT will increase the pressure on the poor, as the VAT is a regressive tax. First, however, the VAT is not necessarily more regressive than the tariffs it replaces, which are often imposed on goods that the poor spend a large proportion of their income on. Second, while not desirable, the VAT can be set at different rates for different products, with lower rates for products heavily

consumed by the poor. Therefore, when introducing a VAT, several key issues need to be considered—namely, the threshold for payment of the VAT, exemptions and zero ratings, and VAT audits.

Probably the most important issue and the main cause of failure of a VAT in small developing countries is the choice of the tax threshold. The threshold identifies the taxpayers who have to register for VAT in terms of their annual turnover. Ebrill, Keen, Bodin and Summers (2001) identify the best threshold to be zero if not for the administration costs faced by governments. The threshold should be high enough to avoid excessive registration of taxpayers, as this can easily overwhelm the capacity of Pacific island countries' customs and inland-revenue authorities. At the beginning, therefore, a high threshold should be adopted. This allows Pacific island countries' customs and revenue authorities to concentrate their limited resources on the 'large taxpayers'. Once the VAT is successfully implemented and depending on their resources, Pacific island countries can gradually lower the threshold to capture a higher tax base and increase revenues.

Generally, zero ratings and exemptions should be avoided, simply because they can overwhelm the customs and revenue authorities dealing with claims and refunds. A large number of zero ratings and exemptions increases administration costs and increases pressure on the large taxpayers as they have to bear the costs as customs and revenue authorities' resources have to be withdrawn. This also applies to VAT audit programs. Before introducing the VAT, it needs to be understood that VAT audit, registration, and so on will run smoothly and do not need to be reinforced through an extensive audit program, which would increase costs hugely. Keeping the above in mind, a good VAT regime should have a high threshold, broad coverage, few or no exemptions and special procedures for the issuance of VAT refunds to exporting firms. For registration and auditing, a simple computerised tax system should be used for detection, control and enforcement.

In the more developed Pacific island countries such as Fiji or Cook Islands, and the largest economy, Papua New Guinea, VAT systems are already in place; the administrative costs of adjusting the VAT to the needs of the fiscal system should be relatively low in these countries compared with countries such as Kiribati, which do not have a VAT in place. In countries such as Kiribati and other very small Pacific island countries, where most of what is purchased for consumption is imported, it might be preferable to have a flat tariff on all imports. This would be essentially equivalent to a VAT.

Complementary reforms

Customs and other tax-collection agencies in the Pacific need to undergo reforms. Although their role in collecting tariff revenue will diminish due to trade liberalisation, customs administrations will remain an important part of government revenue collection since they will be collecting most of the VAT through imports. Therefore, customs administrations need to be efficient. The chances are good that due to the lowering of tariffs and non-tariff barriers, trade will increase. Therefore, the collection of VAT and remaining customs duties should be made as easy as possible and should thereby improve trade facilitation.

Walsh (2006) recommends four major changes in devising a framework for complementary reforms to taxation regimes

1. establish coherent trade policies and clear legislative support
2. adopt simple, transparent procedures in order to minimise abuse in the form of corruption

3. shift to substantial reliance on taxpayer self-assessment
4. introduce incentives and organisational structures that promote integrity and effectiveness in customs administration; customs administrations must be given a clear mandate and be free of political interference and have adequate resources to carry out their tasks, which are the promotion of trade flows and increases in government revenues.

With the help of Australia, New Zealand and the European Commission, the Pacific Islands Forum Secretariat should develop a strategy for reform of government revenue regimes that could be adopted by all Pacific island countries.

Conclusions

Trade liberalisation by Pacific island countries is not about Australia and New Zealand 'exploiting their dominant economic power and capacity' in 'pursuit of ideological and economic self-interest by bullying the Pacific Islands into commitments they do not want' (Kelsey 2004a:41). Pacific island countries do wish to benefit from the trade liberalisation movement taking place around the world. Yes, there will have to be adjustments in the production and financial structure of their economies. Trade liberalisation has to tackle the vested interests promoted by protection in the form of tariffs and non-tariff barriers. Those inefficient activities currently benefiting from protection will have to make adjustments, but other more efficient activities, employing even more people at higher incomes, will develop in their place.

This article has addressed the typical claims of trade liberalisation opponents with regard to potential revenue losses. Estimates of the potential impact of the EPA and PACER on tariff revenues vary from study to study due to the different assumptions made and the different times at which the estimates were made. Compared with earlier studies, the latest study of tariff revenue losses (Watergall Consulting Limited 2007) suggests that potential tariff revenue losses have been declining significantly. This indicates that Pacific island countries have already started to adjust their fiscal systems towards trade liberalisation. One of the steps that six countries have taken is the introduction of a VAT. If implemented wisely, this tax can be effective in offsetting tariff revenue losses. Combined with an excise tax on 'sinful' goods, such as alcohol, tobacco and luxury goods, tariff revenue losses can be overcome while serving a social agenda.

Notes

1 Summarising all sales taxes under a VAT—for example, Tonga's consumption tax.
2 Unless indicated differently.
3 For Samoa, Narsey (2004) calculated a loss of tariff revenue equivalent to 14 per cent of total cumulative tariff revenue.
4 For a discussion of the estimates obtained by Scollay, Gilbert and Collins (1998) and Filmer and Lawson (1999), see World Bank (2002).
5 Even though Filmer and Lawson (1999) measure the loss in terms of the percentage of total cumulative revenue.
6 For an interesting discussion, see Grandcolas (2004) on the VAT in Pacific islands.

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