

The WTO review of Solomon Islands

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The first World Trade Organization (WTO) review of the Solomon Islands held in September 1998 (WTO 1999) provides timely insights into the severe problems currently confronting its economy. This note examines this review, highlighting important economic policy issues that emerged for the Solomon Islands. In so doing, it also offers lessons on how other island economies within the Asia Pacific region might go about reforming their own economic policies.

This multilateral trade policy review occurred at a time of high interest in WTO membership among Pacific island economies. Vanuatu, Tonga and Samoa are undergoing accession to join neighbouring members Fiji, Papua New Guinea and Solomon Islands. These countries became members by virtue of their past *de facto* GATT membership, thereby avoiding the rigorous demands of the accession process.¹

WTO trade policy reviews

WTO members must be periodically reviewed under the Trade Policy Review Mechanism (TPRM), established as a permanent surveillance feature of the multilateral trading system during the Uruguay Round.² Least-developed

members, like Solomon Islands, are to be reviewed no sooner than every six years.³

These reviews are intended to improve transparency and understanding by members of each other's trade-related economic policies, in the expectation that this will improve the functioning of the multilateral trading system by encouraging members to adopt economic policies more consistent with WTO principles. They are economic reviews, not legal assessments of the consistency of a member's policies with its WTO commitments. They provide insights into the economic effects of a member's trade-related policies, and on policy reforms needed to improve economic performance. Herein lies their real transparency value from the point of view of promoting domestic economic reforms. Since the economic benefits are clear, they are generally pro-trade liberalisation, and thereby provide valuable 'policy assessments' of the extent to which a member's trade-related policies depart from this preferred benchmark.

The value of the reviews is strengthened by their wide coverage. They include all sectors (including services) and examine both macro and microeconomic policies affecting trade and economic performance.

Although WTO members conduct the review through a meeting of the Trade Policy Review Body (TPRB)—the WTO

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General Council in another guise—an independent country economic report prepared by the WTO Secretariat and a policy statement by the member involved serve as the main basis for the review. Although WTO reviews do not make policy recommendations *per se*, the review process constructively examines policies and encourages members to adopt certain reforms that are consistent with WTO principles as seen by other members to be in the economy's best interests. The 'outcome' of the review is summarised in the Chairman's 'Concluding Remarks' to the TPRB meeting. Transparency is enhanced by the WTO publishing the review material, including the Secretariat's report.

These external reviews also provide least-developed member countries with useful technical assistance and guidance on implementing appropriate trade-friendly policy reforms. They can assist governments in promoting policy coherence and in ensuring that their key economic policies are not at loggerheads. While not their intended purpose, the reviews can also serve as a useful vehicle for assessing the capacity of governments to implement economic policy reforms to meet their multilateral commitments, and for identifying areas of possible technical assistance from the WTO Secretariat and other bilateral donors. The Solomon Islands' review was initially requested by the government, presumably with these benefits in mind.⁴

Recovery of the Solomon Islands' economy

The WTO concluded that the key to economic recovery in the Solomon Islands was rapid implementation of comprehensive policy reforms aimed at redressing serious macroeconomic imbalances and structural weaknesses endemic in the economy. The economic malaise of the country reflected

continuous policy neglect from previous governments, and was currently being exacerbated by the East Asian economic crisis. The crisis had hit hard its key timber markets of Japan and Korea, precipitating a collapse in world prices of logs, the Solomon Islands' main export earner and source of government revenue in recent years.

WTO members generally supported the Government's efforts to tackle the problems of unsustainable public debt and to push ahead with its comprehensive Policy and Structural Reform Program. The proposed program, involving macroeconomic and structural reforms centred on private-sector development and export-led growth based on trade and investment liberalisation, provided a good blueprint. However, the WTO report warned against continued slippage in implementing these reforms. It was clearly concerned that reform paralysis would jeopardise economic recovery. The Government of Solomon Islands was therefore urged to press ahead with difficult, but necessary, reforms in key areas to increase economic efficiency.

Some key areas for economic reform

The WTO review placed high priority on the need to rehabilitate fiscal balances through elimination of unsustainable budget deficits that had been financed by excessive central bank lending. Taxation reforms to reduce the over-dependence on trade taxes—tariffs and export taxes—for government revenue, including the introduction of a broad consumption tax like a value-added tax, and strengthened expenditure controls, were seen by members as highly desirable macroeconomic developments. The WTO report saw tax and tariff reforms intertwined.

It was on the structural flaws in the economy that the WTO review nevertheless

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focused. Most members were critical of past import substitution policies and welcomed the Government's support for outward-looking trade and investment policies. The current five-rate tariff structure of from zero to 70 per cent (with even higher composite rates on some products) was—with a simple average of 23 per cent—seen as still too high and uneven. Such an escalating tariff structure leads to highly protected domestic industries. Although WTO members welcomed the country's limited use of non-tariff measures and reliance on tariffs, they encouraged a lower and more uniform tariff structure to promote economic efficiency. The WTO report also cautioned against the use of temporary tariff surcharges—such as the 10 per cent rate introduced in the 1998 Budget—without explicit time limits.

Tariffs and export taxes contributed to the Solomon Islands being a 'high cost' economy, and created an anti-export bias. Such taxes were seen as directly raising input prices and taxation levels, and stifling competition and efficiency. Although duty exemptions were widely available on imported inputs, political interference was a problem and they often benefited vested interests. These undermined the transparency of the tariff structure in potentially distorting ways. There was no transparent system for reducing the direct costs of tariffs on exporters, such as a duty drawback system.

Exports also appeared to be disadvantaged by the country's managed exchange rate, which pegged the SI\$ to a trade-weighted basket of currencies. Although monetary authorities intended to maintain a constant real effective exchange rate, this was not achieved during the 1990s. Despite a substantial nominal devaluation of some 50 per cent over this period, the SI\$ appreciated in real terms by around 30 per cent, reflecting relatively higher inflation rates at home compared

with its major trading partners. This undermined the economy's external competitiveness, and placed additional pressures on its export and import-competing industries. The WTO report therefore supported the 20 per cent devaluation in December 1997. It also suggested that a more flexible and market-determined exchange rate could further improve the economy's international competitiveness and better insulate it from external shocks.

The review also emphasised the need for complementary investment liberalisation, including more transparent and facilitative policies towards foreign direct investment. However, the WTO review cautioned against the use of financially costly investment incentives. These were seen as ineffective and potentially counter-productive as they tended to attract only inefficient activities dependent on government support. Incentives were seldom among the main determinants of business investment decisions. These depended on more important commercial factors, such as the country's political, legal and economic stability, growth potential, proximity to markets, availability of skilled labour at competitive wages, and adequacy of essential infrastructure. Impediments to foreign investment should be removed, along with investment incentives.

Privatisation and greater commercialisation of state-owned enterprises was seen by many WTO members as an important means of improving the economy's efficiency and its attractiveness for foreign direct investment. Key public services, such as electricity, communications and air transport, were expensive and unreliable, and could be more efficiently supplied by the private sector, if opened to foreign investment. Improved provision of such services would also boost key industries in which Solomon Islands is likely to have a comparative advantage, such as tourism.

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Main sectoral issues

Much of the WTO review concentrated on the development of key natural resource-based sectors on which the economy heavily depends. These are mainly timber and fish which, together with agriculture, account for over half of GDP. The WTO report concluded that past sectoral policies had largely failed, and needed urgent reform. Poor management and unsustainable logging of commercial forests—by up to three times sustainable yields—threatened the timber industry's viability beyond 15 years, while its tuna fish stocks were being underutilised. Both are uneconomic outcomes that reduced the Solomon Islands' growth prospects.

The WTO report questioned the economic merit of using trade and investment measures to promote downstream processing of these resources. This included the use of export taxes on unprocessed logs and fish to promote downstream processing, and to tax resource rents. Export taxes, for example, of either 35 per cent or 38 per cent apply to logs, depending on f.o.b. values. These measures, together with localisation policies to make fish and logging licences conditional on domestic processing, were seen as potentially establishing economically inefficient downstream processing industries that may end up costing the economy more than they contribute. They can also undermine conservation by reducing domestic prices, and hence the economic value, of natural resources. The government's intended export prohibition of round logs therefore needed to be reconsidered, the report suggested.

Some WTO members felt that production quotas set at sustainable levels would be a far more effective means of controlling logging. The report also indicated that the government could consider taxing resource rents using stumpage fees on logs felled instead of export taxes, or alternatively by

auctioning logging entitlements. Auctioning, supplemented by effective measures to control for possible collusive behaviour among loggers—such as strong legislation against bid-rigging with appropriate penalties—may offer advantages, including

- improved economic efficiency—logging companies would compete with each other and the right would go to the highest bidder that valued the logs most. Potential entrants would also be allowed, thereby maintaining competitive pressures on incumbents
- log prices and associated economic rents would be market determined, thereby avoiding the temptation to over-tax resource rents, with potentially dire consequences for the logging industry and the economy generally
- the current practice of loggers avoiding export taxes through under-declaring log prices would be overcome and there would be no need for the government to monitor log types or prices—monitoring log volumes is far easier
- the commercial loggers, and not the government, would bear the risk of fluctuating world log prices, thereby making budgets less vulnerable to sudden revenue shifts
- a sounder basis of giving landowners a market-based return would provide incentives for them to better manage and conserve forests.

Tuna catches also needed to be increased to sustainable levels to maximise returns. Government efforts to maintain a local tuna fishing and canning industry needed to be re-evaluated in the light of the industry's poor economic performance and high losses.

The need for more efficient industries

A clear message to emerge from the WTO report is that government policies aimed at generating downstream processing are

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likely to be economically costly if they create internationally non-competitive industries reliant on long-term government assistance. This is the basis of the economic principle of comparative advantage. Domestic processing is only worthwhile if it can be done efficiently. It makes no more sense for the Solomon Islands to can tuna, for example, than it does for Australia to make woollen carpets if the final products can be imported more cheaply from somewhere else. Thus, the best economic outcome may be for the Solomon Islands to focus on producing fresh tuna—using distant water fishing vessels—for canning overseas. Some WTO members were concerned that maintaining these industries with continued government support may not be in the nation's longer term economic interests.

The international inefficiency of fish processing industries in the Solomon Islands is evidenced by its high dependence on receiving large preferences in accessing foreign markets. For example, over 90 per cent of its canned tuna is sold to the United Kingdom under Lomé preferences where it enters duty free and benefits from a tariff preference of 24 per cent. Without these preferences, the industry could not survive in its current form. No export sales are recorded in most-favoured nation markets. It cannot currently compete with more efficient Asian suppliers, such as from Thailand, in proximity markets where much lower tariff preferences are available, such as Australia.

This need for policy changes is further evidenced by the erosion of the country's preferential access as other WTO members embrace most-favoured nation liberalisation. Lomé IV is to terminate in 2000. Moreover, as most-favoured nation rates decline generally, so too will preference margins from such schemes. The reality for least-developed countries is that as most-favoured nation liberalisation spreads, the

more they will need to compete in third markets on an equal footing. Without meeting this challenge, they risk missing for themselves the benefits from non-discriminatory global trade liberalisation.

The WTO review emphasised that existing regional preferential arrangements, such as the Melanesian Spearhead Group Trade Agreement, as well as proposed ongoing initiatives within the South Pacific Forum to establish a free trade area among Pacific island economies, should not be allowed to impede the process of non-discriminatory trade liberalisation. This proviso should be kept in mind when considering the merits of the Solomon Islands entering such a trading arrangement. If, as appears most probable, such an arrangement among Pacific island countries turned out being predominantly trade-diverting, then trade liberalisation and any perceived economic benefits from the arrangement would be illusory. National welfare of individual member nations could be reduced by such a regional arrangement.

WTO members are generally of the view that regional arrangements do not undermine most-favoured nation liberalisation. At the very least, such arrangements should satisfy WTO requirements of covering substantially all trade within a reasonable time period of around 10 years, and not raise trade barriers to non-members (GATT Article XXIV). However, as useful as these requirements are in trying to minimise their adverse effects, it is well known that they alone are not sufficient to ensure that regional free trade areas are beneficially trade creating (Snape, Adams and Morgan 1993). Although one argument for such arrangements is that they could be a first step to wider liberalisation, the evidence is so inconclusive that a cautionary approach to them is probably best policy. Trade agreements among developing countries were found to constitute neither a

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necessary nor a sufficient condition for an open and liberal trade regime (Foroutan 1998). The benefits of Solomon Islands participating in such a free trade area should therefore be verified before joining.⁵

The best approach would be for the Solomon Islands and other Pacific islands countries to pursue non-discriminatory trade liberalisation on their own (Duncan, Cuthbertson and Bosworth 1999). Such unilateral reforms can be successfully undertaken without regional trade agreements which can easily get in the way of genuine trade liberalisation. Although WTO membership is also not essential, this can provide additional benefits to help support domestic trade liberalisation.

The WTO report also raised the possible adverse economic effects on the Solomon Islands of an excessive dependence on foreign aid. It cautioned that such financial flows could obstruct economic restructuring and industrialisation by having similar effects on prices, wages and exchange rates to the 'Dutch disease' phenomenon. The WTO saw a critical need for aid donors to ensure that financial assistance is provided in coordinated ways that minimise these negative impacts.

Conclusion

The WTO Trade Policy Review reaffirmed the need for the Solomon Islands to implement comprehensive trade and other economic reforms. While membership of the WTO can assist in promoting these reforms, being a member alone does not of itself guarantee sensible economic policies—as evidenced by existing WTO members with poor economic policies. The government must take the lead and build community support for the reform process. The WTO review provides some good ideas on where to start.

The review has the potential to contribute to domestic transparency,

thereby promoting the need for domestic economic reforms. This can be a powerful domestic catalyst for trade liberalisation.⁶ Its impact will depend largely on how governments utilise the review process. Used effectively at home by governments, WTO Trade Policy Reviews can become a powerful means by which to facilitate public debate on the economic costs of protection, especially in countries having little domestic transparency of such economic policies.

The Solomon Islands, and other Pacific island economies, would therefore be well advised to implement structural reform as encouraged by the WTO. The official representatives at the Trade Policy Review Body meeting reaffirmed the Government's commitments to economic reforms, and indicated that the WTO review was significantly contributing to that process. However, one important area rejected by the Government concerned the promotion of downstream processing. Officials indicated that the government remained committed to such policies, and believed that export taxes on unprocessed products could play a useful role in this regard. If this is the case, then the Government needed in the very least to ensure that the combined effects of such taxes and high import tariffs on processed products did not provide excessive protection to downstream processors. Otherwise, resources risked being frittered away without any lasting benefit to the economy.

Notes

- ¹ Papua New Guinea became a member of the GATT in December 1994, and is currently being reviewed by the WTO. Fiji was reviewed in 1997.
- ² Annex 3 of the Marrakesh Agreement establishing the WTO.
- ³ The top four trading entities in world

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trade, namely Canada, European Union, Japan and the United States, are reviewed each two years; the next 16 ranked traders every four years; and the remaining members every six years, except that longer periods may apply to least-developed members.

- ⁴ The Trade Policy Review Mechanism also provides for the provision of technical assistance by the WTO Secretariat to help developing members to prepare their own policy statement.
- ⁵ A recent report has confirmed that there are only small economic benefits to the Solomon Islands and other Forum island countries (with four experiencing losses) from forming a free-trade area among themselves (Scollay 1998). It also found that modest non-discriminatory most-favoured nation trade liberalisation would provide for greater gains to all island economies.
- ⁶ The important role that domestic transparency can play in promoting trade-related economic reforms can be seen from Australia's successful experience in using an independent transparency agency, the Productivity Commission (and its predecessors the Industry Commission and the Industries Assistance Commission). It is generally recognised that this institution was very important in Australia's unilateral pursuit of trade liberalisation.

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