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Being small: old and new challenges

Traditional challenges

This chapter reviews the general developmental challenges faced by small states, which relate to their size and location. Earlier literature identifies private sector development, especially in the manufacturing sector, as one of the primary concerns in these states (Winters and Martins, 2005; Briguglio et al., 2006; Pollard, 2007). Due to their small populations, the domestic market size is also small in these countries. As a result, most of the firms in small states are small and medium enterprises with limited opportunities for reaping the benefits of economies of scale and investing in research and development. Hence, unit costs of production are higher as compared to those in larger economies. Also, most small states have a poor investment climate, weak institutions, are remote and lack skilled labour or adequate human capital, which limits access to external capital and constrains industrial development.

Small states are also characterised by lack of competition in product markets. This leads to a misallocation of resources, inefficiencies in production and lack of incentives for innovation. All these factors contribute to high unit production costs for firms in these countries. The high production costs are compounded by high transportation costs due to the remoteness and insularity of many small states. This implies that firms in small states need to charge higher prices to stay in business or else accept lower returns on some part of their costs as compared to those in larger economies.

Winters and Martins (2005) support this view and find that business costs, particularly transport and labour, are significantly higher in small states. Table 2.1 presents their estimated cost disadvantages in transport and labour when compared with a hypothetical median economy with a total population between 10 and 50 million inhabitants. On average, micro (and very small) states face considerably higher size effects, ranging from 22 to 222 per cent. The authors argue that small consignment size, poor infrastructure, lack of competition and weak institutions inflate the costs of trade, and create strong economic disadvantages for these countries.

Table 2.2 presents survey data on business costs according to region, population size and GDP as used by Winters and Martins. The costs of electricity, water and telephone services are higher in micro (population less that 0.4 million) and very small (population between 0.4 and 2 million) states as compared to other countries. Since many countries in the Pacific, Caribbean and sub-Saharan Africa (SSA) are small, these costs are higher there as well.[1] Small states appear to have a greater cost disadvantage in shipping as compared to air transportation. However, the manufacturing labour cost per hour in micro and very small countries is lower as compared to larger countries.

Table 2.1: Estimated cost disadvantages for small economies (%)

Area of cost	*Micro*	*Very small*	*Small*
Airfreight average	31.8	4.1	–1.7
Seafreight average	221.6	71.7	9.4
Unskilled wages average	60.1	31.6	6.6
Semi-skilled wages average	22.4	12.1	2.6
Skilled wages average	38.0	20.3	4.3

Notes: Statistics represent percentage deviation of costs in micro (population<0.4mn), very small (0.4mn<population<2mn) and small economies (2mn<population<10mn) from those in a hypothetical median economy (10mn<population<50mn) based on the econometric analysis conducted by Winters and Martins (2005).

Source: Winters and Martins (2005)

Table 2.2: Survey data on business costs

	Costs of electricity (standard commercial line) in $	*Costs of water (standard commercial line) in $*	*Telephone line rental fee (standard commercial line) in $*	*Telephone rate per min local calls (peak hr.) in $*	*Airfreight cost to London in $*	*Shipping cost to New York in $*	*Manufacturing labour cost per hour in $*
By region*							
Pacific	0.21	3.56	9.3	0.09	798	3,248	1.80
Caribbean	0.16	3.41	20.2	0.06	598	2,977	2.75
SSA	0.37	1.92	6.4	0.12	462	2,706	2.06
LA	0.08	0.62	12.7	0.03	696	1,581	2.86
S. Asia	0.08	0.16	3.7	0.04	387	2,333	0.47
Rest Asia	0.07	0.45	7.4	0.04	709	2,742	2.81
OECD	0.15	1.33	20.0	0.05	446	2,013	13.22
By population							
< 0.4 mn.	0.19	3.86	15.6	0.08	715	3,431	2.61
0.4–2 mn	0.37	0.85	8.20	0.12	517	2,584	0.77
2–10 mn.	0.16	1.94	15.4	0.05	382	1,982	13.6
10–50 mn.	0.13	1.05	11.6	0.06	508	2,240	6.35
> 50 mn.	0.31	1.75	13.0	0.06	867	3,191	12.1
By GDP							
< 0.4 bn.	0.19	4.02	11.0	0.10	818	3,570	2.44
0.4–2 bn	0.17	1.66	11.8	0.03	523	2,687	2.01
2–10 bn.	0.30	2.42	11.2	0.13	433	2,795	0.57
10–50 bn.	0.28	1.14	10.6	0.04	539	1,951	3.57
> 50 bn.	0.09	1.06	16.4	0.05	540	2,186	11.0

Notes: * SSA=sub-Saharan Africa, LA=Latin America, S. Asia=South Asia, bn=billion, mn=million

Source: Winters and Martins (2005)

Industries of small states are price-takers in international markets, and the price they take may be below their average costs (because they cannot exploit economies of scale). A small state's vulnerability to fluctuations in input and output prices is aggravated by its undiversified economic base, which itself is in many cases an outcome of its limited size and the scarcity of human capital.

Table 2.3 provides examples of the high concentration of exports of commodities and services in the Pacific and Caribbean regions. For most economies, the combined share of the first and second commodity/service is over 50 per cent in the total exports of goods and services. Many other small states in different regions exhibit a similar pattern, which indicates the higher vulnerability of these states to internal and external shocks.

Table 2.4 provides a more comprehensive picture of the limited diversification of small economies. Columns (1) and (2) provide information on the number of commodities exported and the concentration index (CI) of small states.[2] The average number of commodities exported by small states in 2003 was 83.79 and the average export concentration index was 0.46. Out of the 51 countries listed below, more than half of the countries exported 50 or less products and 19 had a CI greater than 0.50, which indicates high concentration of the export sector.

Table 2.3: Concentration of export commodities and services (% of total exports, 1997)

Countries	*First commodity or service*	*Second commodity or service*
Pacific		
Fiji	26.3 (tourism)	11.9 (sugar)
Kiribati	34.5 (copra)	18.2 (tourism)
Marshall Islands	38.0 (chilled fish)	7.3 (tourism)
Micronesia, Federal States	40.1 (fish)	9.8 (tourism)
Papua New Guinea	28.3 (gold)	18.7 (crude oil)
Samoa	50.6 (tourism)	4.1 (copra)
Solomon Islands	33.9 (logs)	8.3 (palm oil)
Tonga	28.4 (tourism)	11.9 (squash)
Vanuatu	41.6 (tourism)	14.4 (copra)
Caribbean		
Antigua and Barbuda	61.0 (tourism)	4.6 (re-export of petroleum)
Barbados	54.9 (tourism)	2.8 (sugar)
Belize	27.8 (tourism)	14.2 (sugar)
Guyana	17.9 (sugar)	11.3 (rice)
St Kitts	50.7 (tourism)	12.1 (sugar)
St Lucia	75.6 (tourism)	8.6 (bananas)
St Vincent	43.7 (tourism)	10.5 (bananas)

Source: Commonwealth Secretariat/World Bank Joint Task Force Report (2000)

Table 2.4: Export concentration of small states (2003)

Countries	*Commodities*	*CI*	*Countries*	*Commodities*	*CI*
Antigua & Barbuda	10	0.83	Lesotho	36	0.35
Bahamas	87	0.31	Liberia	13	0.67
Bahrain	127	0.70	Luxembourg	199	0.12
Barbados	96	0.23	Malta	122	0.46
Belize	30	0.39	Maldives	11	0.47
Bhutan	37	0.31	Mauritania	39	0.52
Botswana	121	0.83	Mauritius	157	0.28
Brunei	37	0.30	Namibia	171	0.25
Cape Verde	12	0.48	New Zealand	216	0.16
Central African Rep.	8	0.52	Norway	215	0.42
Comoros	5	0.87	Oman	162	0.67
Congo, Rep.	50	0.72	Panama	76	0.39
Costa Rica	179	0.21	Papua New Guinea	80	0.37
Cyprus	153	0.20	Qatar	119	0.59
Djibouti	31	0.34	Samoa	24	0.68
Dominica	15	0.41	Sao Tome & Principe	8	0.93
Equatorial Guinea	17	0.89			
Seychelles	18	0.72			
Estonia	210	0.12	Singapore	222	0.25
Fiji	96	0.27	Solomon Islands	20	0.65
Gabon	57	0.40	St Kitts & Nevis	17	0.51
Gambia, The	33	0.25	St Lucia	48	0.30
Grenada	22	0.30	St Vincent & the Grenadines	36	0.35
Guinea-Bissau	15	0.76	Suriname	59	0.61
Guyana	76	0.32	Swaziland	144	0.45
Iceland	102	0.37	Tonga	13	0.40
Ireland	221	0.21	Trinidad & Tobago	144	0.36
Jamaica	101	0.63	United Arab Emirates	223	0.49
Kiribati	13	0.85	Uruguay	155	0.20
Kuwait	138	0.64	Vanuatu	14	0.53

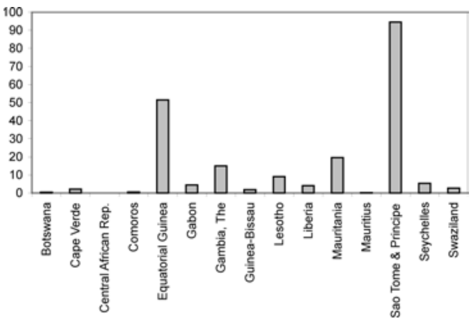
Source: Commonwealth Secretariat (2007)

A weak investment climate, remoteness and excessive exposure to external shocks all act as primary obstacles to attracting investment in these economies. Lack of foreign investment further limits their industrial development and diversification prospects, and creates a vicious circle of declining private sector investment and low diversification. Chart 2.1 presents net foreign direct investment (FDI) flows (as a percentage of GDP) in 2004 to small states in SSA, East Asia and the Pacific, South Asia, the Middle East and North Africa, and Latin America and the Caribbean. Most of the countries in

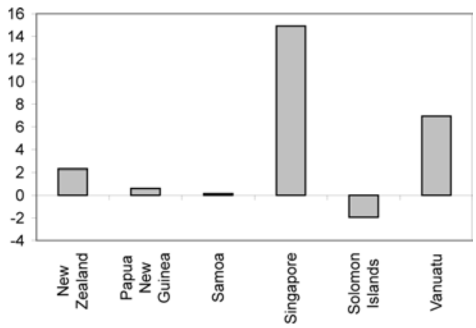
Latin America and the Caribbean have done well in attracting FDI. The average net FDI inflow to small states in the region as a percentage of GDP was 8.2 per cent. However, a majority of countries in other regions appear to have lagged behind significantly.

Limited institutional capacity is another important concern for small states. Small populations and limited economic activity reduce government revenue and constrain the amount governments can spend on public services, human capital, research and development, and strengthening institutions.[3] In addition, a vast majority of small states are remote and located in regions that are prone to natural calamities such as hurricanes and volcanoes (Srinivasan, 1986). These factors hamper economic activity and adversely affect the socio-economic development of these economies.

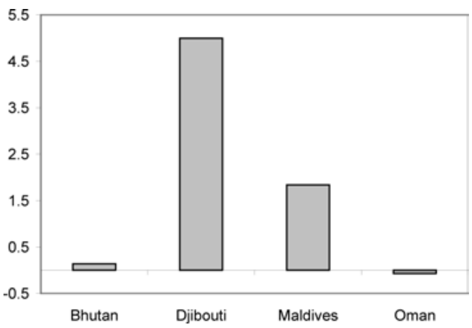
In the context of wider integration, Mattoo and Subramania (2004) argue that small states face systematic problems within the multilateral trading system, despite acquiring significant influence in the system since the Uruguay Round. This is because of



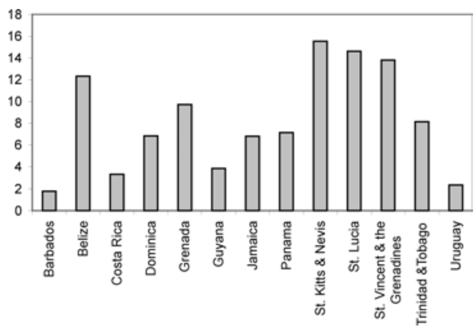
(a) Sub-Saharan Africa



(b) East Asia and the Pacific



(c) South Asia, Middle East & North Africa



(d) Latin America & the Caribbean

Chart 2.1: Net foreign direct investment flows to small states (as a % of GDP) in 2004
Source: Based on World Bank (2006)

their limited bargaining power in trade negotiations and misalignment of their interests with those of the broader trade liberalisation agenda.

New challenges

The Commonwealth Secretariat/World Bank Joint Task Force Report highlighted eight major characteristics of small states. These include remoteness and insularity, a high degree of openness, susceptibility to natural disasters, limited institutional capacity, limited diversification, limited access to external capital, high levels of poverty and inequality, and income volatility. The report focused on four main areas: volatility, vulnerability and natural disasters; strengthening capacity; adapting to changes in the global trading regime; and confronting challenges/availing opportunities from globalisation. It proposed a range of relevant common policy options to tackle these concerns.

The suggested policy options include a combination of correct domestic policy actions, new approaches to regional co-operation, continued external support and assistance from multilateral and bilateral development institutions, and achievable improvements in the external environment. For example, to tackle volatility and economic and environmental vulnerability, it suggests technical and financial donor support. It also highlights the importance of good trade policies, a reduction in regulatory uncertainty and lowering of barriers to exports to increase trade and attract new investment.

The report emphasises that the international community needs to give special consideration to small countries as trade integration continues. To strengthen institutional capacity, both regional and national approaches should be developed. These include providing information to facilitate business decision-making, training, capacity building, strengthening state-business relations and developing competition and regulatory policies. Finally, the report recommends two specific areas for small states to reap the benefits of globalisation and to reposition their economies: (i) strengthening the services sector, and (ii) developing information technology (IT) and electronic commerce. Both these initiatives require appropriate public sector infrastructure and external support from donor countries and multilateral institutions.

The 2006 review of the report finds that in addition to the developmental challenges identified in the initial report, such as remoteness and insularity, vulnerability to natural disasters, limited institutional capacity, a narrow economic base and a high degree of openness, **new** challenges have emerged for small states in recent years. These new challenges are:

- preference erosion for traditional exports;
- international competitive pressures from bigger countries such as China, India and Brazil;
- a rapid increase in the debt burden for various small states;
- increased environmental vulnerabilities;

- youth unemployment;
- security and crime; and
- the HIV/AIDS pandemic.

The review points out that although some small states have implemented aggressive economic reforms, improved the investment climate and governance systems and have strengthened co-operation in regulation and provision of various services, little has been achieved in terms of building resilience to environmental vulnerabilities and introducing natural disaster mitigation and insurance measures. In addition, in many small states progress in economic reforms has been slow and governance and institutions are still weak. However, this is not always the case, as is suggested by the experience of small African countries such as Botswana and Mauritius.

The review suggests that small states need to confront the developmental challenges they face by repositioning themselves in the global economy and creating a comparative advantage in knowledge-based and service industries such as tourism, finance, insurance, health, education and information and communications technology services. This is because some services are less sensitive to high transport and infrastructure costs and provide long-term market prospects. In addition, since these economies tend to have more small and medium-sized firms and no advantages of economies of scale, investing in sectors where demand is relatively price inelastic, such as tourism, will be a good strategy to increase employment, national income and government revenue.

For small countries with high levels of human capital, developing services will help them exploit their comparative advantage based on their skilled labour force. However, in states where the supply of human capital is scarce and educational infrastructure is weak, the review suggests upgrading the education system and increasing the capacity of educational institutions, and replicating the successes of countries such as the Bahamas, Barbados, Malta, Mauritius and Singapore.

The services sector covers a wide range of activities. A well-functioning services sector strengthens employment, productivity and innovation and is key to the overall economic performance of countries (OECD, 2005). It reduces reliance on the agriculture and manufacturing sectors and provides an additional source of growth and employment. Services are even more important for small states given their preference dependence on commodity exports and sensitivity to exogenous shocks, since it helps cushion terms of trade or other macroeconomic shocks. For example, in Singapore the services sector helped to counter the sharp drop in manufacturing output during the recessions of 1981–85, 1996–98 and 2001.[4]

Notes

1. In general, there is high a collinearity between country size, region and insularity (see Winters and Martins, 2005).

2. CI is defined as the sum of the squares of the export shares of each sector and lies between 0 (no concentration) and 1 (maximum concentration).
3. Some small states also experience emigration of skilled workers as skilled labour moves to countries with greater opportunities and higher returns to labour. According to various studies, a significant number of people emigrating from Africa and the Caribbean have tertiary education. However, there are many positive effects of migration including through remittances.
4. Source: Department of Statistics, Singapore, 2001.