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## Opportunities for small states

Despite the obvious disadvantages, some studies suggest reasons for optimism for small states. For example, Spolaore (2004) argues that previous studies like Winters and Martins (2005), might be overestimating the costs of being small. He observes that high costs associated with small size may in reality be due to physical isolation or remoteness and/or other political characteristics rather than actual size.<sup>1</sup> This view is supported by Armstrong et al. (1998) who do not find evidence that growth is determined by population size once initial income and regional effects are taken into account.

The findings of Easterly and Kraay (1999) suggest that small states engaging in international trade do not necessarily have lower incomes and productivity than larger countries. This could be because of the ability of small states to charge above median prices in niche markets, for example, tourism in tropical islands, or because of income transfers/preferential treatment from other countries (see unique products, below). Their analysis further shows that although the per capita GDP growth rates of small states is very volatile, the average growth rate is no lower than that of larger countries.<sup>2</sup> Easterly and Kraay argue that this is because the disadvantages of volatility are outweighed by the advantages of trade openness reaped by these countries, and also because the correlation of their economic fluctuations with world business cycles is low.

Small states have certain advantages because of their size. For example, small initiatives in the right direction and reasonable levels of investment can have a large and quick impact on the social and economic structures of the economy. The competitiveness approach (as in Winters and Martins) focuses on micro foundations of firm performance, and particularly on operating costs. However, there is more to development than firm-level costs. Different market and co-ordination failures exist at aggregate levels that need to be solved, and require effective and flexible action from the public side. This can, at least in theory, be done more effectively in smaller economies (although political systems also matter).

At the same time many small countries have cohesive populations, which allow them to adapt better to change (Kuznet, 1960). Hence, while there are many challenges that small, particularly low-income, states face, there are optimistic arguments about prospects in very small economies. The authors suggest that small states can overcome their inherent cost-based disadvantages (emphasised in the Winters and Martins study) by ensuring to benefit from the following:

**Unique products:** In the analytical discussions on disadvantages of small states, countries are assumed to produce identical products, that they will never specialise in unique products and that everybody consumes the same products. Clearly products are **not** identical and can be associated with certain brand names (for example, Jamaican rum, St Lucia hotels, Trinidad and Tobago tar and organic bananas from the Organisation of Eastern Caribbean States, OECS). These products are distinct and the price a country charges depends on the distinctiveness or uniqueness of the product (that is, the elasticity of substitution) compared to its competitors as well as on consumer preferences. If consumer preferences are sufficiently rigid, higher prices can offset higher (operating) costs for differentiated products.

**Human capital development:** Governments need to stimulate human capital development, which is important to increase productivity and innovation and also helps in creating brand names or other 'firm-specific assets'. As is known from the literature, firm-specific assets are amongst the major determinants of outward foreign direct investment (FDI). By using outward FDI, small islands can own the brand name/firm-specific assets while relocating physical production elsewhere, and in this way earn a large return in the form of profits/dividends/interest payments from abroad. The question is how to create relevant firm-specific assets? St Lucia shows that there is no lack of talent in very small economies (for example, Nobel prize winners Sir Arthur Lewis and Derek Walcott make St Lucia the country with the highest density of Nobel prize winners). An alternative is to attract owners of firm-specific assets/brand names to their economies by improving infrastructure and providing various types of incentives.

**Improved communications and learning effects:** Firms are locked into transactions not only based on cost-efficiency but also on trust and credibility. Seemingly inefficient exports may occur if the involved parties have a good working relationship and/or the costs of switching from a trading partner are high. Thus, firms in small states need to develop good communications and credibility with international firms, and pursue active marketing of their products. Also, over time, clusters of specific industries may form in small economies becoming competitive through learning effects (offsetting other operating cost disadvantages) – but they would not seem efficient on the basis of operating costs alone.

**Migration and remittances:** People can migrate (in some African, Caribbean and Pacific countries they have done so in great numbers over the past 50 years; such migration is even greater in smaller economies), benefiting the source country in terms of additional exports and inward finance. For instance, workers can migrate, work for more efficient firms abroad and then send back remittances. In fact, such diasporas abroad are linked to the expansion in exports of services, for example, exports of cultural services.

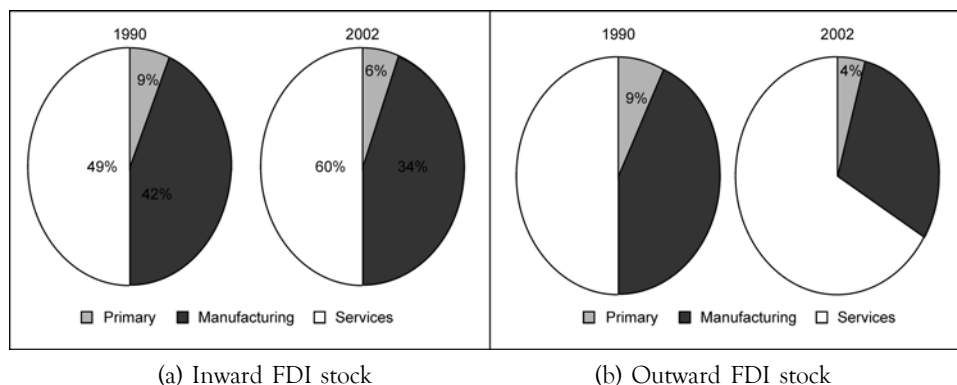
**Promoting services:** As mentioned earlier, manufacturing is likely to be less competitive in very small economies, because this type of industry is associated with decreasing costs curves (in addition to decreasing cost curves in industries producing manufacturing inputs). However, there are certain activities, for example, education and tourism,

where costs are likely to be offset by consumer preferences. Thus, developing a strong services sector can help to counter some of the problems associated with a weak manufacturing sector, spurring employment and income growth.

In fact, considering the buoyant growth in many large economies, especially those in Asia, vast opportunities exist for small states to develop their potential in services. Global demand for knowledge-based business services, that is, services that provide knowledge-intensive inputs to the business processes of other organisations and firms, is growing very quickly as organisations all over the world undertake efforts to adapt to changing technological, economic and social conditions to enhance productivity and competitiveness.<sup>3</sup> Growth in the cross-border outsourcing of knowledge-based business services is estimated to have been increasing at more than 20 per cent in recent years (Conrad, 2007).

Similarly, the demand for quality healthcare, education and tourism is also increasing rapidly. For example, around 25,000 students from China go abroad annually for higher education and this number is expected to rise in the future as the Chinese economy continues to expand. Further, with sustained economic growth, China is predicted to become the fourth largest source of tourists in the world by the World Tourism Organization, with almost 100 million tourists travelling abroad each year by 2020.<sup>4</sup>

Foreign investment in services is also on the rise (see Chart 3.1). The contribution of the services sector to inward and outward world FDI stock increased from 49 per cent to 60 per cent and 47 per cent to 67 per cent, respectively, from 1990 to 2002. In contrast, the shares of both the primary and manufacturing sectors to world FDI stock decreased during the same time period. The United Nations Conference on Trade and Development (UNCTAD) (2004) reports that whereas FDI in manufacturing is increasing in the capital- and technology-intensive sectors, FDI in services is growing in the capital as well as the labour or human resource-intensive sectors. The prospects for a further increase in FDI in services appear to be bright according to the Global Investment Prospects survey conducted by UNCTAD. Most of the respondents to the



**Chart 3.1:** Sectoral distribution of FDI stock in the world, 1990 and 2002

Source: UNCTAD (2004)

survey expected future FDI to be geared more towards services, particularly, transport, banking, and insurance and management.

Small states need to seize new opportunities arising in the services sector, but must also enhance productivity levels in existing services sectors by adopting appropriate policies and reforms relevant to their economies. Since international competition in services is growing, small states should focus on developing those services in which they have a competitive edge, for example, tourism, financial and legal services, education etc.

## Notes

1. Winters and Martins (2005) acknowledge in their paper their inability to separate size effects from those of geographical remoteness due to their limited dataset.
2. Easterly and Kraay's definition of small states, which they call as 'microstates', is countries with a total population of one million people or less.
3. Source: *Knowledge-intensive business services – what future?* European Foundation for the improvement of Living and Working Conditions, Ireland. Available online at: <http://www.eurofound.europa.eu/emcc/content/source/eu05011a.html> [accessed 23 May 2008]
4. Source: *Making Singapore Asia's Leading Provider of World Class Services* (2002) Report of the Economic Review Committee Sub-Committee on Service Industries, Ministry of Trade and Industry, Singapore. Available online at: [http://app.mti.gov.sg/data/pages/507/doc/ERC\\_SVS\\_Part1.pdf](http://app.mti.gov.sg/data/pages/507/doc/ERC_SVS_Part1.pdf) [accessed 23 May 2008]