

PACIFIC INTEGRATION AND REGIONAL GOVERNANCE

Small economies in a globalising world: the policy challenges ahead

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This paper and its more detailed companion, Winters (2005), are a sequel to work conducted recently with Pedro Martins on the costs of doing business in small economies (Winters and Martins 2004). That research, based on specially collected data, showed that *ceteris paribus* manufacturing and tourism faced very much higher business costs in small isolated economies than elsewhere.

Specifically, data on the costs of transporting exports and imports, the costs of utilities, the wages of different types of labour, taxes and rents, plus categorical evidence on labour shortages, utility reliability and certain policy variables suggested that costs could be 30–40 per cent higher in micro economies than in a ‘median’ economy with 10 million people. If these cost premia can not be passed onto customers (that is, if small economies have to sell their goods and services at world prices), the only way such economies can export is if some component of costs accepts lower returns (incomes) than it would get in the median economy. Converting the premia into such income penalties suggests that, in the absence of any extenuation, capital would

earn negative returns if it were invested in microeconomy manufacturing and had to bear all the costs of local inefficiencies itself. Similarly, even if wages were zero in a microeconomy, total costs in manufacturing would still exceed world prices.

It would be absurd to proclaim that these estimates were unassailable, but their size and the fairly thorough review they received in the November 2004 issue of the *World Trade Review* convinced me that they are qualitatively correct. The next question, therefore, is what the small countries and world community should do about these excess costs. That issue is taken up in this paper, which discusses international trade policy, industrial policy, governance and government for small isolated economies, and trade preferences, aid and migration as responses by the international community. To reveal the punchline, there are no easy solutions for the small countries, but there certainly are helpful steps that many could take on trade policy and on governance, including, in the latter case, very deep integration of their government structures. For the world community, I do not see how we can avoid ultimately talking about migration.

Trade policy

A first reaction to the high costs faced by manufacturing in small isolated economies is that, in order to compensate for these extra costs and for the costs of international trading, these countries need the right to protect their industries.¹ This is completely misguided. The problem is not that imports can get in too easily but the very opposite. Adding barriers to trade will exacerbate not relieve problems of smallness. Even where local industries could be successfully established behind tariff walls, there is nothing in the observation of transaction costs or genuine 'excess costs' of inputs to suggest that such an approach would be economically beneficial. Simple theory has long shown that adhering to comparative advantage maximises real income. The costs identified by Winters and Martins (2004) do not change this, they merely show that for some countries free trade may entail no trade and that for some, possibly the same, countries, maximum income might not be adequate.

A related response has been to suggest subsidising business activity or perhaps investment in order to overcome the cost disadvantages of smallness. There are many arguments in the policymaking literature for subsidising business in an economy. I do not generally agree with them, but, even if I did, smallness adds nothing to them. If you would not subsidise business in a large economy, neither should you do so in an equivalent small one, for precisely the reasons outlined in the previous paragraph. Smallness does not generally introduce marginal distortions that need to be countervailed, but an overall feasibility constraint. If income is insufficient when you maximise it, it will certainly be insufficient when you do not; and in the absence of the market failures usually adduced to justify industrial policy, subsidising manufacturing puts you in the latter category.

The previous paragraph presumes that, although a small economy may face inefficiencies in the transformation of primary factors into final goods and services deriving from its isolation and small scale, these do not represent domestic distortions. That is, while, for example, inefficiencies in power generation may make electricity more expensive than in the median country, it assumes that they are unavoidable and apply equally to all production sectors. If these conditions are not met, standard second-best theory states that, if the fundamental distortions cannot/will not be addressed directly, then a production or trade intervention could be welfare-enhancing (Bhagwati 1971).

The proposition is not that any particular subsidy or tariff would help, however, only that there will be a level that does so. As with large economies, the challenge is finding the distortion and introducing an intervention at the socially optimal level. In small societies this may be even more difficult than in larger ones because of the difficulties of finding disinterested parties and the generally greater power of special interests in small economies. Moreover, the fact remains that addressing the distortion directly is first best, and that if the 'excess costs' are actually non-distortionary, policy interventions will be harmful. For example, if power is unavoidably expensive, small countries do not have comparative advantage in energy-intensive manufacturing. Then, subsidising such manufacturing to compensate for high power costs would be bad economics—it will increase the use of relatively costly inputs and divert other factors from better uses elsewhere in the economy.

What cost disadvantages in small countries are distortions and what just 'natural' handicaps? Scale effects in utilities are natural, but the market power emerging from having few suppliers may be

distortionary. In these cases, however, subsidising the use of monopolised inputs is very unattractive from a distributional perspective. Monopolists inflate their incomes by restricting their supply. Subsidising sectors that use their output adds insult to injury by further enhancing their incomes at the expense of taxpayers: far better is to regulate them more effectively.

A common response to the costs of small scale is to argue that market size should be increased by regional agreements with neighbours. While the intention is correct, the implementation of such agreements is frequently flawed because they are drawn too narrowly. Specifically, if regional agreements are restricted to trade policy, that is, regional trading arrangements which merely provide mutual trade preferences—they are almost certainly doomed. Where the partner country is large, the small country typically just ends up adopting the partner's internal price structure. To the extent that this equals world prices, well and good, but to the extent that the large country has protection, its distortionary effects are merely visited also on the small country. This could offer income gains by giving to the small country higher prices for its exports, although in asymmetric, large–small, regional trading arrangements access to the most protected markets is frequently withheld. For example, the European Union controls small partners' access to its agricultural markets and (until recently) textile and clothing markets. It also, however, means that the small country has to pay protection-inflated prices for many of its imports from the large partner (trade diversion) rather than lower world prices.

Where the trading partner is small, the outcome is almost inevitably economically costly. The polar small-partners model of a regional trading arrangement (see, for example, Winters 2000 or Panagariya 2000) generates only losses: because small partners

cannot satisfy each others' demands, imports continue from the rest of the world, and since neither their prices nor the tariffs they face change, the internal prices of imports do not change, so there is no scope for (welfare-enhancing) trade creation. Trade diversion, on the other hand, continues unabated.

The problem with regional trading arrangements is not that trade with neighbouring countries is free, but that that with other countries is restricted. To enlarge effective market size (and to be able to purchase from the cheapest sources) free trade with neighbours typically comes a poor second to free trade with everyone, or, if one needs the revenue, a low uniform tariff.

It is worth noting that all this analysis presupposes that the small economy has no particular advantage (for example, location) or niche market. The former essentially gives it a cost advantage in some sector, while the latter essentially allows it to charge higher prices than its competitors. Such favoured countries could fare well, and all small countries should aim to achieve such status. The analysis of this paper, however, is predicated on the reasonable assumption that not all will, although it certainly does not imply that none will.

Policy and governance

Winters and Martins (2004) suggested that small countries did not have significantly worse policies than other countries in the few dimensions that they could measure: tariffs, export subsidies and direct taxes.² This was only a very partial list of policies and missed entirely all aspects of governance, so it is worth exploring these dimensions further. Unfortunately we do not have any comprehensive and objective datasets on governance in small countries, but partial sources do not suggest large differences from larger countries. Briguglio et al. (2005) suggest that over 1999–2003 the mean CPIA

(Country Policy and Institutional Assessments) scores for 34 small and 102 larger economies were not far different.³ Small countries were assessed as relatively stronger on financial stability, banking regulation, transparency and governance, but weaker on product and factor markets.

A second source of policy/governance data is the *Doing Business* surveys (World Bank 2004), which for various business-related costs and facilities compares 14 small economies with 131 larger ones. Again the differences in means are not particularly great.

Despite the similarity of means in these measures, however, the small countries should not be complacent. There are wide variances and in a number of cases we know that small countries perform very badly, for example, crime in some Caribbean countries and governmental stability in some Pacific ones. More importantly, it is not difficult to imagine models in which economic activity, especially investment, is more sensitive to governance problems in small economies than in larger ones. For example, small economies offer no advantages in terms of local market opportunities, so there is no offset to any shortcomings in production conditions.⁴ Thus, in terms of policy priorities, improvement in governance and in the costs of doing business must rank fairly high.

One of the major challenges that small economies face in addressing their problems of governance is the difficulty in small polities of avoiding capture by special interests. In small undiversified economies, interest groups are relatively larger and have to deal with only a small number of opponents. This makes the exercise of influence stemming from social status or current economic power easier, with the result that change becomes more difficult. (This argument is due to James Madison in the Federalist Paper No. X of 1788.) In addition, in small economies the costs of favouring special interests cannot be hidden but fall squarely, obviously and relatively

heavily, on the other groups. This could make decision-making more transparent and rational but is equally likely to make it divisive and costly. Add to this some natural social segmentation, for example, on ethnic grounds, and the problems can become overwhelming.

A second, politically incorrect, but statistically inevitable, challenge for small countries, is leadership. If leaders are selected on merit (in whatever dimension), no matter what the underlying distribution of talent, leaders from small countries are likely to be less able than those from larger ones. It is difficult to quantify the cost of the expected shortfall because we don't have well-defined talent-to-performance or performance-to-outcome functions, but its existence is undeniable.

Alesina and Spolaore (2003) explore the consequences of the size of countries/economies by comparing the benefits of size with the costs of trying to meet the conflicting demands of more sub-populations with different preferences as country size increases. Among the benefits of size, they note are the fixed costs of some aspects of government, for example, foreign representation and policy design, and the strong economies of scale in others, such as defence and exercising strategic influence. Large countries can spread these more widely than can smaller ones, and Alesina and Spolaore offer empirical evidence on the extra costs of governments for small countries.

The only realistic answer to these problems of government cost is to combine with other countries in providing these services and economise on the costs of economic management and/or statehood. Such efficiencies are not sufficient to overcome all the disadvantage faced by most small countries, for example, the entire population of the Organisation of East Caribbean States is still well within the definition of 'small'. But there is undoubtedly a case for seeking such efficiency gains as part of the answer. I

also note that in the cases where smallness appears not to matter (for example, for small European nations such as Luxembourg, Liechtenstein and Andorra) the secret appears to be to integrate more or less seamlessly with the neighbouring large countries.

The last observation is important for small states. Combining to produce government services does not mean establishing regional authorities and then maintaining local capabilities to influence and monitor those authorities. It means a genuine pooling of sovereignty with no local shadowing—as, for example, counties maintain no foreign or security policy establishments. This is no mean step—it is essentially political union—and so it relies on mutual trust and on sound regional institutions which ensure that local imperatives are adequately addressed, typically both political and bureaucratic institutions. To many residents of small countries this may seem a high price to pay, but in fact it is no higher than that ‘paid’ by, say, the Victorians and Queenslanders in forming Australia. That it is a ‘price’ is exactly the point made by Alesina and Spolaore: political independence entails economic costs. This perspective raises the question of whether, if political independence is the fundamental problem for small countries, the ‘price’ should be paid by their residents or by the rest of the world? If it is paid by the latter, we are essentially subsidising smallness and should expect more of it.

One innovative proposal from Briguglio et al. (2005) is that even if small countries retain policymaking power to themselves, they could subcontract many of the administrative functions of governments such as issuing driving licenses and paying pensions. This may allow some savings although there may be a trade-off between savings and the choice of contractor. Combining these functions among several small countries would offer some savings

(and could be made approximately reciprocal in a mercantilist sense if each function went to a different economy), but would probably be less cost-efficient than subcontracting to a major economy with very large economies of scale. In the latter, the service would be a net import, which would have to be paid for by transaction-cost-intensive exports, but provided that the price of foreign exchange were set properly comparing prices would allow the right decision to be made.

Finally, under this heading we should note one apparent advantage of governmental fragmentation. The current organisation of world society confers some fixed advantages of statehood which are worth more per head to small than to large economies. These include votes at the United Nations and the World Trade Organization and the right to issue (read ‘sell’) passports, flags of convenience, banking licenses, internet addresses, and so on. To be politically incorrect again, these advantages mostly entail either the management of external costs or the creation of public goods, the expected value of which is, very roughly, equal for each person in the world. Thus it is not clear that allocating such rights equally to each state is optimal. Nonetheless, many small states currently make a living from such sales and if we seek to constrain this by international agreements about, say, banking or shipping standards, we will further increase the pressure to support small state incomes in some other way.

Infrastructure, human capital and service exports

A second way of addressing the excess cost of manufacturing identified in Winters and Martins (2004) is to think in terms of services exports. Among the more successful small economies, niche tourism and financial services are major sources of export earnings.

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These are less handicapped by the excess costs of physical movement than are goods. Success in these areas clearly requires strong governance performance—especially security and regulatory ability, respectively—but if these conditions pertain they are quite promising. I do not believe, however, that they can address all of the income deficits of small economies.

First, the required capital has to be provided. The risk premia faced by small countries are typically higher than one might expect given their governance and economic circumstances. Partly, this may be ignorance on the part of the lenders, but it also reflects real risk phenomena. Even setting aside the apparent higher vulnerability of small remote economies to physical shocks (World Bank 2000), the lack of diversity in small economies increases the risk of economic disruption.

Second, even if capital can be provided for infrastructure, many of the cost disadvantages of small economies in Winters and Martins (2004) are on current expenditure. For example, even if service exports are independent of transportation disadvantages, imports are not. And since ships and planes need to travel back as well as towards a small economy, the savings entailed in service exports may not be that great.

Third, the most favorable case for infrastructure-led salvation is probably communications links. If these are excellent and cheap, the electronic provision of services may become competitive, such as data input, software, tele-services. Even in 'electronic services', however, personal contacts are important (see Chanda 2003), so small remote economies will still be disadvantaged by their high travel costs and long travel times.

Fourth, many service exports require human capital. This not only requires investment but it also requires constant honing, typically through contact with customers and rivals abroad. This, in turn,

raises the specter of migration. Winters and Martins (2004) identified serious shortages of skilled labour in small remote economies both in terms of relatively high wages and reported shortages even among current producers. The reasons are not hard to find: up to a point, the returns to skills are a function of the size of the market that is served, merely in terms of covering the fixed cost of skill acquisition. In addition, there are typically economies of agglomeration for skilled activities—specialisation, stimulation, the transfer of knowledge, and so on. For these reasons, while some skilled workers can certainly be retained in small economies, not least because of the pleasanter lifestyle, their productivity is unlikely to be of the highest order, and the higher the skill level, the greater the deficit.

The 'brain drain' represents a huge challenge to many small countries: Docquier and Marfouk (2005) report that 86 per cent of Guyanese and 83 per cent of Jamaicans with higher education are abroad. These are countries with governance challenges, but even for more successful societies the figures are high, for example, 36 per cent for the Bahamas and 61 per cent for Barbados.

I have argued elsewhere that liberalising the temporary movements of labour within the world economy (Mode 4 of the GATS) promises huge economic gains (Winters et al. 2003a, 2003b). This could be a key factor for very small economies, essentially allowing residents to earn abroad but live and consume at home. Temporary workers from small countries would still be at a disadvantage relative to those from larger ones, however: they would face higher transport costs, smaller networks for finding jobs and easing migratory strains, and higher consumption costs at home. However, particularly if they had preferential access (for example, guaranteed quotas such as New Zealand offers some Pacific Islanders) they may be able to 'out compete' other sources of

labour. Just as with trade preferences, however, the sustainability of the mobility preferences would be a question-mark.

If temporary mobility is to be a long-run solution, there would need to be considerable trust that the receiving larger country would honour the quotas. It would also require trust that that country would encourage (enforce) the temporariness of the labour contracts and not actively screen temporary migrants for permanent places. If these conditions were met, I believe temporary mobility would indeed be a viable means of maintaining some small economies, including providing the incentives for education.

The international community

This section considers what the rest of the world can do for small economies, starting with explicit or implicit subsidies for small countries' trade. It differs from the analysis noted earlier in that the subsidy is now paid by another country so that, while the same distortion is introduced to our small country as before, it is now compensated by a transfer from abroad. The net effect could be an improvement in welfare, although it need not be.

The current tariff preferences for small countries' exports allow them to sell at industrial country markets' tariff-inclusive prices rather than at world prices. This source of rent has historically been very important—as, for example, with banana or tuna exports to the European Union or clothing exports from the Caribbean to the United States. The problems are first that other developing countries have become more hostile to these preferences, as with Latin American challenges to banana preferences and East Asian challenges to those on tuna, and that the more legalistic regime of the World Trade Organization makes them harder to defend than they were

under the GATT. Second, as donors discover new favourites, the preferences of the old are eroded. Third, industrial countries wish, or perhaps are under pressure, to liberalise their trade regimes anyway, so that the benefits of preferences are gradually declining. In all these cases, as rents are reduced, very small economies face large income penalties as Winters and Martins show.

An alternative would be straight income transfers. Here the money would presumably go to the government which would distribute it. This would avoid the production distortion entailed in the trade subsidies, saving resources, but would pose even greater problems so far as governance and incentives to produce were concerned. In either case, one of the main issues for the recipients would be the security of such transfers. As noted, I believe that they would need to be permanent to cover excess costs on current transactions and so could not be dressed up merely as transitional financing to encourage structural adjustment.⁵ Preferences are declining and subsidies are always vulnerable, but unless there was reasonable confidence in their continuing, all manner of short-term rent-seeking behaviour would arise.

A second issue, especially for simple income subsidies (aid) and also for the large remittance flows received by some small remote economies is the cancer of aid-dependence. Perpetual and unconditional income flows appear to be very destructive to the productive economy and eventually to society. *Per se* there is nothing wrong in not working or investing if the money keeps flowing, but it appears that at the same time as work habits decline so do various other social habits, especially if traditional societal structures have been undermined. Hence one observes social malaise not only in dependent island economies of the Pacific, but in the native American reservations in the United States, in pension-dependent societies in South Africa and in some oil states.

Explicit subsidies to micro and very small economies raise their own very particular political challenges. Specifically, many of the cost disadvantages identified by Winters and Martins must also apply to isolated parts of larger countries. These disadvantaged regions are often subsidised via regional policies, as for example, in the United Kingdom, Europe more generally and China. But if small economies were permitted to have export subsidies, one would need to argue explicitly why this privilege should not be extended to parts of larger economies, for if it were it would probably fatally undermine subsidies discipline in the World Trade Organization. The reason is not hard to formulate: within a country, people can move out of uneconomic locations. Ultimately the world must face the possibility that if the current preferences that small countries receive are eroded and their incomes can not be maintained in other ways, many of their inhabitants will seek to move abroad.

Conclusion

The preceding observation poses a trade-off for the rest of the world. On the one hand, the moral case for international policies to support small remote economies is not overwhelming at present. They are not particularly income-poor by world standards nor particularly stagnant, and once one accounts for their attractions as location and the attractions (to many of us) of smaller societies, they do not seem too badly off. True the developed countries have helped to create their current production structures, and changes in developed country policies have contributed to the concerns about their futures, but this is at most a transitional issue. Moreover, many small economies do not appear to be maximising their prospects for essentially governance-related reasons. Plenty of commentators argue that with

sufficient focus small economies could find viable activities and that nothing focuses the mind like the money running out. Thus a case can certainly be made that permanent support for small economies is inappropriate.

On the other hand, I do not believe that all small countries will remain economically viable. Their excess costs are a serious handicap and in an even more closely integrated and sophisticated world economy their disadvantages are likely to grow. For sure some will thrive by good luck or sound judgment, but left to themselves others are likely to decline sufficiently much that humanitarian imperatives arise, and their problems do become those of the world community. If we let them get to this stage, economic rescue will be very expensive and population movement will become almost inevitable. Thus it seems to me that if we believe that small economies do not warrant international support we need to be prepared eventually to let their people move elsewhere if incomes fall too low. Particularly if we limit the relaxation in immigration policy to the micro and very small economies the effects will be very small in aggregate. Around 3.12 million people (0.05 per cent of the world's population) live in countries of below 200,000 population, 6.31 million (0.10 per cent) in those below 400,000 and 28.2 million (0.45 per cent) in those below 1.5 million population.

Notes

- ¹ On transactions costs the argument is implicitly that since high costs curtail exports, policy is required to curtail imports and help producers exploit their domestic markets.
- ² We tried and failed to collect data on VATs and budget deficits.
- ³ The CPIA are assessments by World Bank staff based on a variety of sources. From July 2005 they will be published.
- ⁴ Consider how companies persisted with

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production in China, despite the many instances in which they were unable to protect their assets from local predation. I have not been able to locate any formal tests of the hypothesis that governance matters more for small countries.

- ⁵ Finance to encourage diversification in small economies has not been very successful in the past.

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