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Special Section on the Competitiveness of Small States

GUEST EDITORIAL INTRODUCTION

Serge Allegrezza
Director, National Institute of Statistics and Economic Studies (STATEC)
Luxembourg
serge.allegrezza@eco.etat.lu

Lino Briguglio
Department of Economics & Islands and Small States Institute
University of Malta, Malta
lino.briguglio@um.edu.mt

and

Enrico Spolaore
Tufts University, Medford, MA
USA
enrico.spolaore@tufts.edu

Abstract: This is the editorial introduction to the guest special section in *SST* 2(1) on the competitiveness of small states, based on five papers that were presented at a conference on this subject in Kirchberg, Luxembourg, in April 2018.

Keywords: competitiveness, diplomacy, foreign direct investment, Luxembourg, Malta, Montenegro, small states

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Scope of this special section

This special section of *Small States and Territories* contains five papers dealing with different aspects of competitiveness and focusing on the small states of the EU. The papers were originally presented at the Conference on "Competitiveness Strategies for the EU Small States", held in Luxembourg in April 2018, and organised by the National Institute of Statistics and Economic Studies (STATEC), the Observatory for Competitiveness (Ministry of economy) of Luxembourg and the Islands and Small States Institute of the University of Malta (STATEC, 2018).

The objective of the conference was to discuss competitiveness strategies appropriate to the small states of the EU, in view of their special constraints and opportunities. For the purpose of the conference, the EU small states were considered as those with a population up to 3 million, namely Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Malta and Slovenia. Competitiveness issues pertaining to three candidate small states (namely Albania, Montenegro and Macedonia) as well as Iceland, were also addressed.

The importance of competitiveness

The need for small states to be competitive is conditioned by their small domestic market, which compels them to be highly dependent on international trade and extraordinarily open to international competition. Competitiveness strategies therefore occupy a significant policy focus in the small states of the EU. Such strategies require inputs from various sources, including the private sector, the government, trade unions and civil society. Private enterprise, which is often the main engine of income creation, is at the front-line for successful participation in international markets. However, the efficiency of resource allocation in a country and the availability of skills, knowledge and innovative practices necessary to sustain the competitiveness of enterprises are national-level considerations. In this regard, the public sector plays a crucial role. Good economic governance may also serve as an attraction for foreign direct investment (FDI), which in turn could promote transfer of technology. Given that competitiveness has industrial relations, social and environmental dimensions, trade unions, employers' associations and civil society (including environmental NGOs) should also be involved in the drawing up of a national competitiveness strategy (Briguglio & Cordina, 2004).

The themes considered

The five papers included in this special section all touch on these considerations. The themes covered by the papers include (in the following order): competitiveness constraints faced by a transitional small economy, with reference to Montenegro (Katnic and Boskovic), limitations relating to attracting foreign direct investment (FDI) in small states (Velickovski and Petreski), the advantages of flexibility and speed of adjustment in the governance of small states (Baldacchino), the relationship between competitiveness and economic resilience (Briguglio and Vella), and the need for collaboration between small states in their diplomatic efforts to foster competitiveness (Dookeran and Mohan).

Problems of a small state in transition

The article by Katnic and Boskovic focuses on Montenegro: a small Balkan state with a population of some 625,000 inhabitants. At the time of writing this introduction, there are five EU candidate countries: Albania, North Macedonia, Montenegro, Serbia and Turkey, the first three of which have a population of less than 3 million. All three countries can be considered as having a transitional economy, in the sense that all three are in the process of upgrading their economic and political institutions so that they could eventually become EU member states.

Montenegro was part of socialist Yugoslavia until 1992, and formed part of a two-member federation with Serbia until 2006. Accession negotiations with the EU began in 2012. According to the authors, Montenegro could realistically meet membership criteria and become an EU member by 2025 (EU Commission, 2018).

In line with the general theme of this issue, Katnic and Boskovic argue that competitiveness is of particular importance to Montenegro in view of its small domestic market and therefore the inevitable challenge of finding markets outside its borders. Like many other small states, Montenegro is highly exposed to external shocks and faces economies of scale constraints, as well as limitations in administrative capacity.

The authors refer to a significant issue experienced by the EU small candidate states, namely the role of personal connections and small networks; this is a condition which has its own benefits, but which could also facilitate corruption, cronyism and state capture by interest groups. Montenegro would need to control and tackle these issues on its path to joining the EU. Corruption works against competitiveness, especially when state consumption and state regulation are intended for purposes that are not in the interest of long-term sustainable growth. In the case of Montenegro, which does not have a long-standing democratic tradition, building an institutional framework that fosters entrepreneurship is not an easy task. The authors argue that the country must therefore exert a special effort to develop an effective administrative setup and an efficient regulatory framework in order to foster entrepreneurship and innovation to meet its competitiveness challenges.

The authors contend that, in spite of the various downsides faced by a small economy, many small countries succeed economically. In this regard, they consider Luxembourg as a potential model. They attribute the success of this small country to its commercial integration with the European Union, free movement of people, availability of transferable technologies, good economic governance and appropriate institutional frameworks. The authors suggest that these same attributes indicate the path that should be followed by Montenegro.

Attraction of FDI

Small countries generally are disadvantaged in terms of attracting Foreign Direct Investment (FDI) in view of their small domestic market and limited natural resource endowments. Such investment is often an important contributor to the growth and development of the recipient country. Of course, one expects that, everything else remaining equal, domestic and foreign investments are more likely to be attracted by in a country that is well-governed economically and enjoying political and social stability compared to a badly governed and socially unstable country. Other factors which serve to attract investment are good quality infrastructure, including telecommunications, and a culture conducive to doing business, which are factors associated with good economic governance (e.g. Read, 2008; 2018). A number of small countries, including Luxembourg, Singapore and Malta, manage to attract substantial FDI, even though they lack natural resources and have a relatively small domestic market.

Velickovski and Petreski refer to the extensive literature on the factors that affect FDI inflows. They assess the relationship between competitiveness and FDI, utilising data from 60 countries. Their results suggest that the two variables are related, keeping everything else constant.

Interestingly, the authors show that the positive relationship between competitiveness and FDI is weakened or wiped out for a small country, suggesting that, because of their size, small countries need to undertake extra efforts to improve their competitiveness in order to attract FDI. The authors document that EU member states manage to attract a higher rate of FDI than non-members, and argue that this is likely to be due to the advantages of integration, even after controlling for the countries' level of development and their economic institutions, which are also affected by integration.

Flexible specialisation and governance in small jurisdictions

The special governance skills pertaining to a small jurisdiction are explored by Baldacchino, who argues that flexible specialisation and adaptation could dictate and drive a considerable amount of actions and decisions in small jurisdictions, often leading to the promotion of competitiveness. Flexibility requires a form of leadership based on speedily taking advantage of opportunities, as soon as they may arise. The author argues that the smaller the state or territory, the greater the likelihood that external factors dominate its domestic, internal economic affairs. Baldacchino develops this argument with a focus on Malta, and considers that a strategy of flexible specialisation is the best form of management in a fast changing scenario characteristic of small states (also Baldacchino, 2014).

The paper gives various examples of flexible specialization in small jurisdictions and proceeds to explore how such an approach could lead to the creation of competitive niches in spite of the fact that small countries often have limited natural resources endowments. The author makes ample reference to Malta, a country which has been generally managed to exploit opportunities and to offer itself as a low-risk platform to export-led investment fuelled by foreign technology, serving foreign markets and shifting from a 'third world' to a 'first world' country: much like a Singapore of the West.

The author associates 'flexible specialisation' with 'strategic pragmatism,' referring to the successes of Singapore, where location and the prior exposure and experience as a regional port brought into existence a cosmopolitan and entrepreneurial society, wary of its existence surrounded by much larger countries, but being able to service these same countries with its superior infrastructure, logistics and knowledge capital.

Resilience and competitiveness

Briguglio and Vella discuss the relationship between resilience and competitiveness in the EU, with a focus on the small member states. The authors argue that small states need to be economically resilient to make up for the fact that they tend to be highly exposed to external shocks, and they need to be competitive in view of their high dependence on exports, resulting from the small domestic market constraint (Briguglio, 2016).

The authors explain that economic resilience is associated with good economic, social and political governance, enabling countries to reduce or withstand the harm of external shocks, to which small states are highly exposed. The findings produced by Briguglio and Vella indicate that the EU small states are highly exposed to external shocks and that the most economically vulnerable EU small states tend to register relatively high resilience and competitiveness scores. This would seem to suggest that economic resilience and competitiveness are related and that their policy framework enables them to withstand or reduce the harmful effects of their exposure to economic shocks.

Competitiveness and international diplomacy

Dookeran and Mohan invite their readers to consider the association between competitiveness and diplomacy, arguing that competitiveness is not exclusively an economic issue. The authors base their argument on the foreign policy aspect of competitiveness, requiring the coordinated action of the state, business community and civil society. Such diplomatic activities often occur at the World Trade Organisation (WTO), which promotes the concept of competitiveness in the global market, and where global dialogue on competitiveness and economic development takes place routinely.

Small economies participate actively in such a dialogue, as they have a vested interest to be involved, seeking special treatment in view of their economic vulnerability (Lee, 2009; Grynberg, 2006). The authors argue that, while small states have fewer resources to devote to the tasks of diplomacy and effective interaction with other states, this deficiency can be reduced by alliances and networks, given the large number of small states with common interests. The authors refer to the European small states which they consider to be in a position to convey vital lessons relating to competitiveness to the attention of other small states in the world.

Downsides and upsides of small country size

The Luxembourg conference mentioned above considered many small-state issues other than those treated in the papers included in this special section. (The presentations are posted on the web site of the Observatory of Competitiveness, freely available at: https://odc.gouvernement.lu/en/actualites/mes-actualites/2018/Conference-Small-States.html.) These include tax policy, niche politics, entrepreneurship and productivity, tourism competitiveness, competitiveness indicators, monetary policy and migration. Two papers discussed the suitability of competitiveness indicators across countries, given that, *a priori*, a small market could hinder competitiveness. Another paper dealt with the ability of some small states, notably Singapore and Luxembourg, to 'punch above their weight'. Yet another dealt with the strategic influence of small member states on the design of European competitiveness policies. The conference thus covered a wide range of small state concerns and achievements, leading to vibrant discussions as to whether small country size is a boon or a disadvantage.

Aspects of this broader debate on the costs and benefits associated with small size also emerge in the five papers included in this publication. As we can infer from the analyses of these articles, it is acknowledged that small states face a number of constraints in view of their small size. But these conditions should not be viewed as deterministic obstacles. We should not expect that small states would necessarily underperform in terms of competitiveness and economic growth, provided that effective economic and political governance are in place, fostering openness and integration in the global markets (Alesina & Spolaore, 2003).

Institutions, notably regulatory ones, are assigned major importance in this special section, as a requisite for the promotion of competitiveness (Farrugia, 2007; Bräutigam & Woolcock, 2001). Institutions tend to be very costly per capita in a small state, given that they involve relatively high overhead costs, a problem which in the case of the EU small member states, is to a degree attenuated by EU funds, pointing to one advantage of integration.

An issue that emerges in some of the papers relates to state involvement in promoting competitiveness, given that conditions in small states are, to a large extent, conditioned by developments outside their control. The attraction of FDI, referred to by Velickovski and Petreski, flexible specialisation in governance, argued by Baldacchino, the building of economic resilience, declared by Briguglio and Vella, the control of corruption, advocated by Katnic and Boskovic, and small state alliances in diplomacy, urged by Dookeran and Mohan, all require a degree of state involvement, giving a sense of direction to macro-economic policy. But, as Baldacchino argues, many uncertainties lurk in the future of economic development; therefore, small states may "have no choice but to sham and fake their development planning". Still somehow, they manage to get along by "grasping opportunities if and when they arise, even if these may have little traction with any existing plans." Muddling through and plodding along may not be elegant policy manoeuvres, but effective ones nonetheless.

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