SMALL STATES: ECONOMIC PROBLEMS AND PROSPECTS

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INTRODUCTION

This paper concentrates on the economic problems and prospects of small states and their international policy implications. It touches also on the inter-relationships between economic and security issues.

The size of states has important implications for their development prospects. Large-scale production and organization provide great cost advantages in most economic activities. Scale advantages can be had not only in manufacturing, agriculture and services but also in marketing, transportation, high-level training, administration, and research and development.

Some of the constraints posed by small domestic markets and small populations can be eased by outward-looking economic policies and economic integration with neighboring states. In some sectors too, such as agriculture, optimum sized production units are possible even if production takes place mainly for the domestic market. And where there is population pressure on land, intensity of production could compensate for small acreage. In relation to mineral resources, the level of endowment in relation to land area need not be less than in larger states. With the extension of the Exclusive Economic Zone (EEZ) under the Law of the Sea Convention and taking into account prospects for other favorable factors - climate, beaches and marine resources - small island states need not be in a disadvantageous position in resource endowment per capita relative to larger states, even though their population densities tend to be higher.

Small states do not stand out as being in any unfavorable position among developing countries in per capita income. However, even with relatively high levels of per capita income, small states tend to remain weak in terms of total economic size as well as bargaining power. Moreover, being relatively open, they are particularly vulnerable to external shocks and cyclical fluctuations in the world economy. Transformation to a more diversified and stable economic structure is more difficult for small states

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and may be impossible for mini-states. Thus, even with relatively high per capita incomes, small economies may continue to be characterized by economic instability and vulnerability. For these states, therefore, per capita income is not an adequate indicator of level of development.

SMALL STATES AND THEIR CHARACTERISTICS

Many attempts have been made to delineate a special grouping of small states for economic purposes, but a generally accepted definition has not emerged. Although a precise classification would be necessary if special measures are to be adopted by the international community to help small states, for purposes of analytical study a more flexible approach may be desirable since the definition adopted could be related to the particular problem being studied. For economic studies, a population of one million is a good limit since almost all states within this group tend to experience the special economic problems associated with small size. Above one million, the problems do not go away but only apply less severely and more selectively. It is worth noting that in the past, cutoff points of 10 or 15 million population have been used in some studies. However, over time lower limits have tended to be adopted. Of 136 developing countries for which relevant data are available, as many as 52 countries have populations of less than one million.

Small states are fairly diverse in economic characteristics. There are wide variations in their income per capita, land area, and population density. A particular feature of small economies is their openness. Limited domestic market opportunities and a narrow resource base have encouraged greater attention to international trade. while the ratio of imports to GDP is about 20 percent for all non-oil developing countries, it is about three times as high for states with populations of less than one million. This openness is characterized by product and market concentration. Product, as well as export concentration, is to be expected in view of the narrow resource base and the need for specialization to secure scale economies in production, marketing, transportation and distribution. Even in the case of agriculture, the resource base tends to be limited by the lack of climatic and soil variation. And to utilize export market opportunities in large countries for a particular crop may require production levels which absorb a large proportion of the land in a small state.

This high dependence on external trade while providing enlarged economic opportunities causes great exposure to vicissitudes in the international economy. The problem is compounded by the fact that many of the products concerned are either of agricultural or mineral origin for which unstable world market prices are normal. In many cases diversification from a high dependence on primary products has increased the importance of activities such as tourism and financial services. But even these industries are sensitive to such factors as changes in the level of economic activity in the tourists' home countries, changing popularity of different tourist resorts and unsettling political developments in the host region.

Other circumstances contribute to economic fragility. Many island small states are in the typhoon or hurricane regions - e.g., the Western Pacific and the Caribbean - and it is not unknown for a large proportion of their crops to be destroyed by storms. Similarly, plant diseases, pest or drought could cause pervasive damage because of small land area and unvaried cropping patterns.

Many of the small states in the world are islands. Small islands tend to be the smallest of the small in terms of land area, population and gross national product and are usually more densely populated. They also have a very high dependence on invisible earnings, notably tourism, to finance their import needs.

Some island small states suffer from remoteness not only from major population centers but also from other islands in the region. The volume of freight and other traffic between remote islands and potential trading partners is often inadequate to ensure a regular economical shipping service, and in the absence of such a service trade opportunities remain unexploited, thus perpetuating isolation and the economic infeasibility of a transportation service. Technological changes, such as the use of container or container cellular vessels and long-range wide-bodied aircraft, have tended to increase transportation difficulties.

The extension of the EEZ under the Law of the Sea Convention has been a particular boom to island states as it has considerably enlarged the marine zone from which they can exploit fisheries and other resources. However, their limited capacity to exploit such an expanded potential makes the significance of the EEZ for small states rather longer-term.

ECONOMIC PROBLEMS

Development Criteria

The fact that the relative per capita incomes of small states do not stand out as very unfavorable has generated some complacency regarding the development difficulties of these states. We have already mentioned that per capita income is not adequate to indicate the degree of transformation to a diversified and resilient economy. Moreover, administration costs including security costs tend to be relatively higher resulting in high levels of taxation. For these and other reasons per capita income figures do not give a true picture of living standards. They do not, for instance, give a good indication of the quality of life. Lack of variety in the social life and the absence of some kinds of specialized service, particularly in the fields of higher education, health, etc., mean that in small states high levels of income are required to compensate for the absence of some amenities.

International Environment

Due to historical and other factors, some of the small states have received relatively favorable treatment in relation to trading arrangements and allocation of concessional finance. However, it is possible that the international economic environment for small states' development is becoming less favorable. The disturbed world economic situation in recent times has had a severely adverse effect on the economies of small states. The structure of their economies made these states particularly vulnerable to the adverse international economic forces. Between 1980 and 1982 export earnings in nominal terms fell by 38 percent in Tonga, 26 percent in Guyana and Western Samoa, 23 percent in Papua New Guinea and 16 percent in St. Lucia. Diversification into services did not provide much stability since tourism, the main service industry, is also very sensitive to the level of economic activity in source countries. In Barbados, for instance, in the same period the number of tourist days fell by 20 percent.

The economic stresses faced by small states have not been eased by more liberal capital flows to facilitate the adjustment process. Small states shared very little in the increased commercial lending to developing countries that took place after the first oil price increase. The commercial banks have had little interest in smaller countries and the latter generally have insufficient expertise and capacity to make effective use of capital markets. It is also the case that small states have greater need for concessional finance. But since concessional assistance to developing countries has not been expanding and since there is a tendency for an increasing proportion of it to be distributed on a bilateral basis in support of trade and other donor interests, the advantage small states had in the allocation of this assistance is being eroded. Evidence in support of this trend is shown in a later section dealing with aid.

Vulnerability

One issue of particular interest to small states is the need for international arrangements to assist in cushioning poor countries from external and internal shocks. Some global and sub-global arrangements exist, e.g., the IMF Compensatory Financing Facility, Stabex under the Lome Convention, multilateral food aid provision under the World Food Programme, and various ad hoc arrangements for disaster relief and other emergencies. However, these arrangements remain piecemeal, uncoordinated and in other ways inadequate. They need to be rationalized and strengthened to ensure a sufficient minimum level of assistance to small states.

Major scope exists for improvement in the compensatory arrangements to stabilize export earnings. The stabilization of foreign exchange earnings is crucial to the development process in small states, with their more open economies. Proneness to natural disasters, and the pervasive effects of these on small economies are other reasons for emphasizing the need for this form of assistance.

The recent world economic recession highlighted the need for fundamental improvements in the compensatory financing arrangements in the international system. Pending such basic reform, improvement of the IMF Facility is one way in which progress could be made early. This is partly a question of increasing the overall resources available to the IMF for this type of lending. A specific proposal which has frequently been advocated is that compensation should be made on the basis of full loss from trend levels of earnings. Small states have a vital interest in this proposal. Under the Lome Convention, where disadvantaged states are treated more liberally, small states and Least Developed Countries both receive special consideration. Since the adoption of preferential arrangements face special difficulties under the IMF, general liberalization of the IMF facility is one way in which small states could benefit.

In recent years, the Facility has been adapted to cover tourist earnings and steep rises in the cost of food imports. Both these improvements are very relevant to the needs of small states. The inclusion of price changes in imports generally would be a further improvement. In short, an effective system of compensatory financing must take into account all factors causing sharp changes in the capacity of developing countries to import in real terms. Improved compensatory financing arrangements, and in particular, the urgent liberalization of the IMF Facility, are pivotal for the future development of small states.

Trade Policy

Since the future development of small states depends significantly on maintaining and improving access to external markets, protectionism and its relaxation is another international policy area of great significance to small states. As we mentioned though, the access problems of small states have been eased to some extent by preferential trading arrangements. Under the Lome Convention, the ACP member countries, among which are many small states, receive fairly free access to the EC markets for virtually all manufactured goods and liberal access for some agricultural ones. Commonwealth South Pacific islands benefit in addition from favorable access to the Australian and New Zealand markets through the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA). Similarly, some Commonwealth Caribbean countries benefit in the U.S. market from the preferential access provisions of the Caribbean Basin Initiative (CBI).

However, in these preferential arrangements, the access conditions offered are not as open as they appear. Restrictions remain even though the level of import penetration that could come from the recipient states is small in the huge EC and U.S. markets. In the case of the Lome Convention safeguard clauses permit the introduction of restrictions when exports to the EC from a particular source increase substantially. The implementation of these safeguard provisions against Mauritius, a small island state, in connection with her garment exports, indicates the stringent way in which the safeguard provisions are being applied. In the case of the CBI, products of significant export interest to small Caribbean states, such as garments and footwear, have been excluded from the arrangement.

While continuing to seek preferential access and guaranteed markets for their exports in their traditional markets, small states should also join with developing countries generally in seeking better access conditions on a global basis. Progress in such wider access could encourage in the long-run less reliance on preferential arrangements with particular countries, which could not only encourage dependence but also help to build rigidities and inefficiencies in the beneficiary countries' production structures.

Regionalism

Small states have been trying to secure scale benefits through regional cooperation in economic, social, educational and administrative activities. The difficulties that regional integration movements have faced, especially during the recent recession, have led to some disenchantment with them. However, in evaluating these movements, too much attention has been paid to progress in freeing trade and the benefits from that process. When wider considerations are taken into account the full benefits become clearer. In the Caribbean, for instance, regional cooperation through the Caribbean Development Bank has made a substantial contribution in increasing resource flows to member countries, and especially to the smaller ones. And beyond economic to wider cooperation, great contributions have been made in such areas as shipping, civil aviation, technological research, education and health. One should also take account of the strength which can come from joint bargaining with major states and large companies. Regional cooperation provides a framework within which, especially in the absence of deep ideological division among members, small states can feel less need for economic and military protection from major countries.

Aid

Per capita aid receipts for small states tend to be above the average for developing countries. In fact, this situation largely applies to capital inflows generally. However, these figures probably reflect need rather than a favored position, but even if it is the latter, the indications are that this may not continue. In recent years, the proportion of aid going to small states has declined. In 1983, these countries accounted for 8.8 percent of total ODA disbursements from all sources, compared with 9.3 percent in 1980. While small low-income countries have on average maintained their share - and the least developed countries among them have increased theirs - in some individual cases receipts have fallen sharply.

The inability of small states to benefit from scale economies in most areas supports the case for concessional finance at higher levels of per capita income than is generally the case. The difficulties in securing private foreign finance are a further justification for concessional finance. There is an economic rationale, therefore, for the favorable position these countries hold in aid distribution. But political factors may also be relevant: their position as independent states with a voice in the international system; their strategic location; and their traditional ties with donor countries.

Looking to the future, there are grounds for serious concern about the evolution of policies governing official resource transfers. First, the overall trend in official resource transfers looks disquieting. After a period of virtual stagnation in aid flows a declining trend is now emerging. This will affect all states with strong claims for such transfers: low income and small states. But for small states, there are other developments in aid policy which could be adverse.

The multilateral institutions are finding it increasingly difficult to secure adequate resources, and the earlier trend towards a larger role for these institutions is now being reversed. In the IMF, quota allocations, which determine the upper limit of the credits which can be provided, have been derived on a basis which is slightly favorable to small states. But the Fund's overall resource position in relation to its basic objectives has become inadequate over time. Its quotas in relation to world trade are now about a third of what they were in the early 1960s. Thus, even though the upper limit of provision to individual countries has been expanding, this increase is not commensurate with need. The overall resource constraint, together with the revolving nature of the resources, means that the Fund is now less able to support the balance-of-payments needs of individual countries. In the current situation, therefore, where many large developing countries, especially the highly indebted ones, are making large demands on IMF resources, some 'crowding out' of small states seems likely and may already be taking place. Such a development would reflect the weak political position of small states rather than the extent of their needs; it must be guarded against.

At the World Bank, small states are facing some problems which may worsen because of resource constraints. The International Development Association (IDA), the Bank's soft loan affiliate, adopts a strict per capita income criterion for eligibility for its lending to the poorer developing countries. When these countries attain a per capita income of $806 (1982 dollars) they automatically lose that eligibility. Though the figure is adjusted over time to take account of inflation, and while it may be an appropriate qualifying limit for highly concessional assistance generally, it is inappropriate for small states since, for reasons mentioned before, they need concessional assistance even at relatively high levels of income. IDA is facing a tight resource position and the critical need for its loans in other parts of the world - in Sub-Saharan Africa and Asia - makes it difficult to secure a more liberal attitude to small states. A more flexible eligibility criterion is clearly needed, which would ensure that small states are only graduated when they have adequate access to alternative sources of external capital.

A further problem with the World Bank's policy of 'graduation' is that countries with per capita incomes in excess of $2,800 (1982 dollars) are made ineligible for its non-concessional lending. The current difficulties faced by highly indebted middle-income countries in securing finance from private sources raises the question of the general appropriateness of this limit. For small states, which normally have limited access to private finance, this limit poses a special problem. It is in the interest of middle income small states such as Barbados for this limit to be reviewed to reflect their particular circumstances.

The trend towards a decline in multilateral development assistance is unhelpful for development generally. This trend has a particular significance for small states. Being less important as trading partners to donors and in other ways less influential in the world, they could be adversely affected by a decline in multilateralism; greater exercise of power, influence and trading interests in aid allocation is likely to damage the interests of small states such as Barbados for this limit to be reviewed to reflect their particular circumstances.

Also, increased bilateralism has a bearing on security considerations. Small states, because of their weakness, are more likely to be subject to influence and control. Multilateralism provides an international environment which reduces the risk of small states becoming clients or satellites of large states.

PROSPECTS

The long and deep recession, from which the world has now emerged only partially, has been particularly severe on small states. As open economies the small states' prospects would depend very much on the vigor of the world economy.

In the longer-term, developments such as the extension of the EEZ would have a positive impact on small island states, although the benefits are likely to accrue only slowly. The current rapid pace of technological change may also bring benefits. If it increases living standards and leisure, then financial services and tourism will be given a boost. Prospects for small states in export manufacturing might improve with greater possibilities for small firms offered by the new technologies, as for example, in software services. However, the ability of small states to get into 'high-tech' industries is by no means yet clear and it may be that technological change will make industrialization more difficult both for poorer developing countries and small states.

In many small states there is considerable scope for expanding food production. Prospects could improve with the greater adoption of high yielding varieties and other technological improvements. But more important still are the possibilities for policy improvement[1]. Family planning has a significant role to play in economic development and the available evidence indicates that there has been good progress in small states in this area due to better education, communication and greater urbanization.

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[1] See Persaud, B."Agriculture in the Economic Development of Small Economies" in [1] for a further discussion of these issues. The volume also contains discussion of problems of other sectors, as well as problems of a general kind in relation to small economies.

However, even with these favorable factors, for many small states, especially those with populations of less than a million, economic transformation will remain difficult and the need for economic assistance will remain high.

If world growth were to remain sluggish and unstable, these developments would tend to encouraged developed country protectionism and erratic capital flows to developing countries; most countries will be encouraged to protect themselves from external vicissitudes by more self-sufficient and inward-looking policies. These developments would have particularly severe effects on small states whose scope for a more self-reliant development strategy is very limited.

If however, conditions do return to those of pre-recession times, small states could make as much progress as they have made in those times except if declines in aid and increases in protectionism loom larger. Prospects would also improve if the scope for improved economic management is realized. More export orientation with greater attention to strategies that will help to penetrate Northern markets, greater backing for the private sector and local entrepreneurs, and efficient food production could contribute much to economic development. But even with improved management and favorable external factors, states with populations of less than a million, particularly those with less than half a million, with poor resource endowment and with additional disadvantages such as remoteness, will continue to need special measures to assist them.

At present no special programme of measures exists to assist disadvantaged small states. A few of these states are included in the UN category of Least Developed Countries. However, including more small states in this group is not a satisfactory solution to the problem. The disadvantages of smallness are distinct enough to warrant separate treatment. Even though there are obvious difficulties in creating too many disadvantaged categories, a strong case exists for creating a new category of Low Income Small States. The criteria for inclusion may include population level (probably less than half-a-million), income per capita and selected structural characteristics.

The concerns of this grouping would be to ensure certain minimum levels of concessional assistance, the provision of a pool of experts with expertise not normally available to small states, and assistance for special problems arising from transportation difficulties, remoteness, inadequate diplomatic representation and shortage of skills for effective negotiations with external agents. Wider recognition of the special economic difficulties faced by small states is needed. A process of research and discussion will, therefore, be necessary before meaningful negotiations can begin. Small states and concerned international organizations should begin now to press the case for such a grouping.

Small states have a very strong interest in a stable and prosperous world economy. There is also the need to look for ways in which small states' interests could secure greater projection in the international arena. The

Commonwealth, with its large membership of small states, has served as a forum for airing these states' problems. It is also giving practical help in improving diplomatic representation. But it seems that more formal processes for the wider representation of these states' interests are now needed.

CONCLUSION

Small states face a number of constraints in their pursuit of economic development. They are denied scale economies in many economic and public service activities. Regional cooperation and more outward-looking economic policies can to some extent reduce these disadvantages.

Per capita income is a poor indicator of levels of development for small states. Economic transformation to a more self-reliant and diversified economic structure is much more difficult in these states and is achieved at much higher levels of per capita income.

Other economic characteristics which are important in considering the prospects of small states are their tendency to adopt more open economic policies and to develop reliance on a narrow range of economic activities to provide foreign exchange earnings. Concentration on activities such as primary products and tourism which are sensitive to changes in the level of world economic activity maintains weakness and instability. The pervasiveness of the effects of natural disasters increases vulnerability.

Some of the circumstances facing small states are favorable. In relation to resource endowment, while size may result in a narrow base, there is no reason to expect less endowment in relation to geographical area, and the considerable extension of the EEZ under the Law of the Sea Convention has put them in a potentially favorable position. In addition, many small tropical islands have the advantage of good climate and beaches.

Small states have also to some extent been helped by the policies of major countries. Resource flows to them on a per capita basis tend to be higher than for developing countries generally. Groups of them enjoy preferential access in their exports to the EC, the US, and to Australia and New Zealand.

For small economies, weakness exists in relation not only to larger countries but also to foreign firms, which for ministates need not even be large. Small states are also exposed to foreign adventures with predatory political and economic intentions. Economic activities such as tourism and financial services encourage such predatory intentions. Many small states have a high dependence on external sources for food and energy. This aggravates vulnerability to external circumstances. External dependence on these essential commodities could have security implications.

In view of their vulnerability, small states have sought economic security through regional cooperation and economic cooperation arrangements with major countries. Both have provided economic benefits but protective economic arrangements with major countries could compromise efficiency and independence.

The economic prospects of small states are highly dependent on trends in the world economy. With full and sustained recovery, progress would resume in small states. Of longer term significance are factors such as the extension of the EEZ; increased leisure and tourism; trends in resource flows; the pace and direction of technological change; and the scope for improved domestic policies and for more effective population control. But these are not likely to change the prospects for small states substantially. Many small states, particularly those with populations of less than half a million, are likely to remain weak and vulnerable. On the other hand, if the world economy remains unsettled with growth generally weak, then the general prospects for small states would be worse.

The characteristics, problems and prospects of small states confirm the need for special measures to assist them such as increased concessional flows, more open markets, improved arrangements to stabilize foreign exchange earnings and expanded technical assistance to strengthen their capacity to bargain with external agencies and to provide them with scarce specialized skills.

The special needs and problems of the poorer small states would justify the establishment of a special UN category of Low Income Small States for which a special programme of international assistance measures could be designed. The criteria for inclusion might include population size, per capita income and selected structural characteristics.

Graduation from IDA and the IBRD lending on the basis of a strict per capita income criterion is very harmful to the development prospects of small states, and a more refined set of criteria which take into account the structural characteristics of states are required. In any case, small states should not be graduated from IDA and the IBRD until there is assurance that they have adequate access to alternative sources of capital. Small states have a special interest in reversing the decline in multilateral cooperation since they are more susceptible to leverage and influence in bilateral relations with large states. On the whole their interests need to be much better represented in forums concerned with international development cooperation. They have a strong interest particularly in improved arrangements for the stabilization of export earnings, in rolling back protectionism and in expanding concessional flows.

The economic and security problems of small states are to some extent connected. Economic weakness implies weak security. Depending on national objectives, small states have a delicate diplomatic role in trying to ensure that protective and stable external economic arrangements with major partners do not compromise independence. One way of assisting this objective is to develop arrangements with other major powers which could provide a countervailing influence. But where cooperation with a major country has a wide coverage and includes military cooperation, the security implication could be important. It could pose threats to neighboring states and be seen as political interference in Third World countries.

Regional cooperation, especially in the absence of ideological plurality, could provide an environment which would reduce the need for protective arrangements with major countries of a type which could weaken independence.

REFERENCE

[1] Jalan, B. (ed.), *Problems and Policies in Small Economies*, Croom Helm, 1982.