OPEN AND NIMBLE

Finding Stable Growth in Small Economies

SUMMARY

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The text of this summary is a work in progress for the forthcoming book *Open and Nimble: Finding Stable Growth in Small Economies*. A PDF of the final, full-length book, once published, will be available at openknowledge.worldbank.org and print copies can be ordered at www.amazon.com. Please use the final version of the book for citation, reproduction and adaptation purposes.

1818 H Street NW, Washington, DC 20433
Telephone: 202-473-1000; Internet: www.worldbank.org

Summary

Size matters for development. Small economies face unique challenges to economic growth, due to their small land mass and lack of resources to develop human capital. They have adapted by being more open to trade—and consequently vulnerable to external sources of volatility, including changes in the global economic environment. Small economies exhibit high levels of specialization in terms of both export destination markets and products, reflecting their need to compete effectively in international markets. Small size also amplifies the impact of another important source of external volatility, natural disasters, by increasing the percentage of a country's land and people exposed to such events when they occur. Aside from external sources of growth volatility, small economies face significant internal challenges to fiscal stability and long-run growth. Small size implies diseconomies of scale in the provision of public goods and therefore these economies face higher costs in providing many government services on a per capita basis. Small economies in the Latin America and Caribbean (LAC) region exhibit low government revenue generation, in line with trends in LAC as whole. Thus, small economies generally—and in LAC in particular—struggle with high public debt burdens.

A new World Bank study, "Open and Nimble: Finding Stable Growth in Small Economies," examines the role of size in the development process, both generally and in the case of small economies in the Latin America and Caribbean (LAC) region. Using working age population as a proxy for country size, the study determines that there are no inherent obstacles to development based on a country's size. Small economies do share certain characteristics that shape their development experiences, and which have contributed to a number of roadblocks to achieving stable growth—including high exposure to external volatility, high debt levels, and low savings. What is evident from a clear understanding of common challenges to growth in small economies is that almost all of these challenges can in fact be minimized with an appropriate policy response.

Characteristics of Small Economies

Smallness has many implications for a country's development, but it is important to note that small size does not necessarily lead to lower growth rates or levels of development in and of itself. Latin America and the Caribbean as a region encompasses a great variety of states—from very large to the extremely small island states in the Caribbean, as well as moderately small states in Central and South America. Additionally, the small economies in the region exhibit remarkably different economic structures, allowing for an analysis of the impact differences in economic orientation might play in small countries. In spite of this heterogeneity, a key finding of the report is that small states in the region (and more generally) face numerous common challenges. Small economic size seems to affect a country's levels of economic openness, ability to access economies of scale, levels of specialization, and emigration rates, which are potentially important for the development process. Indeed, a key theme that runs throughout "Open and Nimble" is that economic size, or the size of an economy's labor force, is related to economic development outcomes, but only indirectly.

Openness to trade and investment is a key characteristic of small economies and may help them overcome any limitations of size. Smaller economies tend to be more open in terms of trade flows and this openness may provide some benefits. For example, openness provides access to a larger market for the goods small economies produce and opportunities to achieve economies of scale in production. Another type of openness is receptiveness to foreign direct investment (FDI), and here the Caribbean is unique. Small Caribbean countries receive relatively large inflows of FDI and there appears to be a negative relationship between size and inflows of FDI worldwide. Even with this relationship in mind, Caribbean FDI inflows relative to GDP have dwarfed those of Latin America and other small economies over the last 40 years. In particular, members of the Organization of Eastern Caribbean States (OECS) lead the region in FDI. This is no coincidence, as countries in the Caribbean have been aggressive in courting FDI through tax breaks and other incentives. FDI inflows are associated with increased growth through knowledge and technology transfers generated by the links between foreign and domestic firms.

Aside from openness, small economies are also characterized by a lack of economies of scale and high levels of economic specialization. High levels of openness have not helped small economies deal with their inherent difficulty in achieving economies of scale. The lack of scale in the provision of public goods is a key reason why they are also characterized by relatively high levels of government spending as a share of GDP. Although high levels of openness do not seem to have led to increased production in goods with economies of scale, openness may be related to the tendency of small economies to exhibit highly specialized export sectors. Small economies typically do not have a large enough domestic market or the human capital and natural resources necessary to produce a large variety of goods. Additionally, because they are small and need to effectively compete in international markets given that they are highly open, small economies tend to have highly specialized export sectors. Finally, small economies also seem to exhibit concentration in terms of export markets.

The Search for Stable Growth in Small Economies

There are three major sets of common challenges to development in small economies: exposure to external volatility; issues of fiscal management; and low long-term savings. Small economies in LAC and globally tend to face high levels of external economic volatility in the form of terms of trade volatility and fluctuations in external demand. This external economic volatility is related to being a highly open and specialized economy. Terms of trade volatility, as well as export specialization, are often associated with broader problem of GDP growth volatility in small economies. This in turn has a negative impact on long-run GDP growth rates and development outcomes. Small economic size and openness leads small economies to exhibit export sectors that are highly concentrated, both in the number of products they produce and the number of countries they trade with. This leads to two main channels by which external volatility increases growth rate volatility in the region. The first is that exporting a limited number of products is associated with higher terms of trade volatility, which in turn is associated with higher growth rate volatility by affecting the value of a country's trade. Secondly, there is some evidence having a limited number of partners is associated with increased growth volatility, because it increases the weight of partner demand shocks in the trade basket of the exporting country.

Small states (particularly small island states) face increased exposure to natural disasters. Although it may not seem to be the case when looking at the raw number of disaster occurrences, small economies face disproportionate vulnerability to natural disasters when considering their size. This is particularly true of small island states, given that most of their production and population centers are likely to be impacted by any given disaster. Natural disasters represent an economically significant source of external growth volatility for small states, particularly small island states like those in the Caribbean, at least in the short run. Moreover, aside from direct impacts on GDP growth, disasters exacerbate many other macroeconomic problems small states face. They create trade and fiscal imbalances that can lead to higher levels of debt, and they may also decrease savings and investment in the region due to the uncertainty they cause. Thus, exposure to natural disasters does not just increase external volatility, but is also a potentially important factor in the remaining two sets of common challenges to small states: fiscal management and low long-term savings rates.

A second set of challenges involve issues of fiscal management. Small economies face challenges of fiscal management and high debt levels due to their inability to obtain economies of scale in the provision of public goods (as well as their exposure to external volatility and natural disasters discussed above, which necessitates unexpected spending). Smaller countries tend to spend more on providing public services due to a lack of economies of scale, which makes government more expensive as a share of GDP. While smallness seems related to higher government spending, countries in LAC face a unique problem when it comes to government revenue generation. On the revenue side, smaller economies in LAC have lower-than-expected revenue generation, partly due to tax policies that might not be optimal for small economies, especially small island economies like those in the Caribbean. However, there also seems to be a regional factor at play, as LAC countries in general exhibit low government revenue generation. These spending and revenue factors combined with the increased cost of natural disasters result in high levels of public debt in LAC small economies.

A final important challenge to long-run growth in small states is low long-run domestic savings rates. Size appears to be negatively related to savings, a particularly curious fact given that small economies are more vulnerable to economic and climatological shocks as just discussed. One potential reason for this is that the high levels of uncertainty in these economies reduce the return on savings. In terms of development, a low savings rate is linked to lower investment, which in turn is linked to lower growth. However, small economies may be supplementing their low levels of domestic savings in an important way with foreign capital.

High FDI Inflows may fill the savings gap, but FDI works differently in small economies. Small states, and particularly small island states like those in the Caribbean, have traditionally attracted large sums of FDI, which in theory could fill the savings gap and result in increased growth potential. Unfortunately, due to the lack of spillovers from FDI, long-run economic performance has not lived up to what might be expected, given the theoretical evidence on the benefits of FDI. New evidence indicates that small size limits the positive spillover benefits of FDI, because small economies are home to only a small number of firms that could possibly absorb technology and know-how from multinational corporations operating within their borders. Simply put, there is not a large enough domestic market to encourage FDI to be more than an export platform and so FDI in small economies often does not lead to the benefits predicted by theory.

Small economies might also be effectively increasing their savings through high levels of remittances. Small economies tend to have a large number of emigrants residing abroad, and these emigrants often send money back to their home country in the form of remittances. To the extent that small countries receive a disproportionately high level of remittances, these funds may function as a substitute for domestic savings or have other growth-enhancing effects. However, although remittances may be associated with positive growth and poverty reduction outcomes, the evidence on their economic benefits is mixed. There is some evidence that remittances may be associated with negative labor market outcomes. Although remittance flows tend to be counter-cyclical and responsive to natural disasters, they might also expose the remittance-receiving country to negative economic conditions in the remittance-sending country.

Policy Implications: Common Challenges, Shared Solutions

Size matters for policy design. While size matters for development, it is not necessarily a determinative factor in development outcomes. What is evident from a clear understanding of common challenges to growth in small economies is that almost all of these challenges can be minimized with an appropriate policy response. Broadly speaking, what emerges from "Open and Nimble" is the need to focus the policy dialogue in small economies in LAC and worldwide on four key areas: external economic vulnerability; natural disaster risks; the challenge of diseconomies of scale in government; and tax system reforms.

There is no way to completely remove external economic volatility. High levels of economic integration and its inherent exposure to the international economic environment are a fact of life for small economies. However, it is possible to reduce external volatility risks from openness by diversifying over time and developing latent diversification. In fact, small countries already seem to exhibit a tendency toward this dynamism, and this ability to rapidly change export products in response to changing global economic conditions is an important form of diversification for small economies. Governments could augment flexibility in the export sector by encouraging new export ventures and ventures into nontraditional product lines. Small economies might also expand the number of export markets they cater to in order to reduce the volatility associated with being highly open. Expanding the number of products produced and markets exported to can be done together—and are often complementary to each other. To achieve these goals of flexibility and diversification for LAC, further regional integration and harmonization of product standards are potentially helpful tools. They can strengthen a country's position in trade agreement negotiations and make the region a more desirable trading partner to the rest of the world. Besides helping to open new export markets, further regional integration in a broader sense has tremendous value for the region in addressing natural disaster risks and helping achieve better fiscal balances. Another way that small states might manage their exposure to volatility is through the choice of exchange rate regime. Maintaining their observed preference for a tightly managed or fixed exchange rate can be beneficial for small economies. In particular, for countries with less than 2 million people, concerns about economies of scale in central banking and the size of the non-tradable sector may indicate that a tightly managed or fixed exchange is more prudent, as it allows such countries to avoid excessive exchange rate volatility with minimal costs.

There are two elements that countries should consider when thinking about policies to reduce the impact of natural disasters—preparation and financing the recovery—both of which can be helped by increased regional integration. In terms of preparation, governments must continue to pool resources and fund region-wide research and forecasting initiatives that seek to understand natural disasters and the specific vulnerabilities of countries in the region. An additional aspect of preparation is ensuring that all infrastructure and public goods are modernized, and built in a way to be as disaster resistant as possible. A second issue is preparing for disaster recovery is preparing for the financing needs of the reconstruction effort. In an ideal world governments in the region would insure themselves fully against the risk of natural disasters; unfortunately, natural disasters present several problems for private insurance markets. It is difficult for insurance companies to reliably asses risk from disasters due to the unpredictability of weather events. Furthermore, there is a large adverse selection problem in that most people and countries buying disaster insurance are located in disaster-prone areas and therefore the pool of purchasers is small and highly vulnerable. One potential solution to this issue is more regional risk-pooling initiatives, such as the Caribbean Catastrophe Risk Insurance Facility, with an emphasis on getting a larger number of countries to participate.

Higher relative costs for the provision of public goods can potentially be addressed through regional integration efforts and innovation in the provision of public services. A natural opportunity for regional integration in the provision of public services is joint investments in transportation infrastructure in order to better connect economies in LAC, particularly those in the Caribbean. More connections between islands would benefit everyone, but transportation infrastructure is expensive; regional cost pooling would make this more feasible. Another area where regional integration could deliver greater economies of scale is public utilities and particularly electricity generation. Utilities are commonly thought to benefit from increasing returns to scale and require large fixed investments that small states may not be able to carry out on their own. Regional integration efforts could also be directed at creating regional institutions and regulatory agencies to pool the costs of governance. Small economies often lack the resources and educated labor force necessary to maintain the government bureaucracy needed to carry out and enforce regulations. Furthermore, such regional regulation agencies and institutions can also give small economies more power to regulate large multinational corporations in their jurisdictions. By presenting a unified front, small economies can prevent a race to the bottom dynamic in terms of relaxing or granting exemptions to regulations.

To address low levels of government revenue generation, governments should focus on making revenue collection more efficient and broadening the tax base rather than simply increasing tax rates. Tax rates in the Caribbean are generally fairly high already, and it is unclear that simply raising rates would help as there are numerous existing problems with enforcement. With that in mind it seems prudent that governments focus on making the tax code more efficient, and on efforts to broaden the tax base. Small economies may benefit from tax regimes that most economists would consider inappropriate for larger economies. For example, small economies typically do not produce many goods and services and rely on imports to satisfy domestic demand. Therefore, small economies' taxes on imported goods are essentially equivalent to national sales taxes, which do not impose production-side distortions that are a source of concern in large economies. In addition, particularly in small island economies, taxes on international trade have the added benefit of being cost effective to administer. Trade taxes can be collected directly at the port of entry, thus avoiding enforcement costs related to administering income taxes or other sources of tax revenues, including value-added taxes.

Small economies should be careful in granting large tax incentives for FDI. Economists typically argue that FDI should be prioritized because it generates linkages between foreign and domestic firms that have spillover effects, such as technology or knowledge transfers. However, countries in the Caribbean have not reliably benefited from the predicted spillover effects and backward linkages from FDI and there is evidence that this related to small size. This suggests that small countries should not incentivize FDI as generously as many currently do. Moreover, foreign companies may make up a much more significant share of the overall corporate tax base in smaller economies than in larger economies. Consequently, incentivizing FDI too generously could lead to a huge shrinking of the tax base, with corresponding losses in revenues. There would also be opportunity costs associated with public investments or the gains from raising national savings if the forgone tax revenues could be saved.

Does economic size matter for economic development outcomes? If so are current policies adequately addressing the role of size in the development process? Using working age population as a proxy for country size, this book systematically analyzes what makes small economies unique. The authors first ask, are small economies less likely to reach high levels of development in the long run? The answer to that question seems to be no, yet the book finds that small economies do share certain characteristics that shape an economy's development experience. In particular, small economies tend to be more open to trade and foreign investment, highly specialized in their export sectors, and show signs of diseconomies of scale in the public sector.

After documenting these characteristics of small economies, the authors analyze how these qualities might impact the process of development. They find that small economies generally experience high levels of economic volatility, have large levels of public debt, and low savings rates. Furthermore the authors find that these appear to be related to the size of a country's working age population and the aforementioned characteristics. While not necessarily bad for economic growth, these issues can represent challenges to development if not addressed.

Reviewing all of the evidence, the authors conclude that there is some scope for policy makers to address the role of size in shaping an economy's development experience. Emphasis should be placed on achieving economies of scale and risk pooling through regional integration initiatives. Furthermore, fiscal and tax policies may need to be rethought in the context of small economies, particularly those that confront frequent and costly natural disasters.

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