

Introduction

1.1 Context and Purpose of the Study

This study deals with a pressing economic policy question facing the world's smallest economies: how can small states enhance their industrial competitiveness and alleviate the economic vulnerabilities associated with small country size? There is a widespread perception that small size (i.e. economies with 1.5 million people or less) hinders the achievement of industrial competitiveness. This study seeks to address this issue. The transition from vulnerability to competitiveness is at the forefront of current economic policy debates in small states. To date there is little sign of consensus about the way forward.

These debates centre on the economic consequences of rapid globalisation (see, for instance, Bernal, 2001; Matsis, 2001; Treebhohun, 2001). Interestingly, the positive aspects of globalisation – notably, access to new technologies and markets – appear to receive relatively little attention. Instead, policy-makers are deeply concerned about the decline of domestic enterprises and even industrial marginalisation in an open, integrated world economy. Prominent too are worries about rising unemployment, poverty, crime and related social problems. Globalisation is associated with demanding international markets, falling trade barriers, increasing technological progress, inflows of foreign investment and movement of people. Many small states have adopted economic reform programmes to enable enterprises to adjust to the new international environment. However, the limited supply response from domestic enterprises has led to disillusionment with economic reform and has fuelled fears of industrial marginalisation.

A search for policy options to deal with globalisation has also begun in some small states. Attempts to reverse globalisation through new barriers to imports and foreign investment are largely ruled out. As a result, there is growing interest in policies to improve industrial competitiveness within an open economy paradigm.

This study is based on the premise that globalisation is irreversible and that while country size may be a constraint, it is not an insurmountable barrier to improving competitiveness. Small states have to adopt appropriate measures to realise the gains from international integration, reduce its negative effects and address issues related to country size. Accordingly, small states will need to put in place coherent competitiveness policies to support industrial restructuring; this study seeks to contribute to their development. With international development experience pointing to the limited value of a one-size-fits-all competitiveness policy regime, the study underlines the need to tailor measures to the individual national circumstances of small states and the nature of the enterprises

Box 1.1: What is a Small State?

There are many ways (for example GDP and population) to define a small state. Following the Commonwealth Secretariat (1997), this study defines a small state as an economy with 1.5 million people or less. Accordingly, in this study 47 Commonwealth and non-Commonwealth countries are considered to be small states, along with four somewhat larger states which share many of the physical and economic characteristics of small states in their respective regions (see Table 1.1 for population data). This group also includes a subset of economies (with a population of 200,000 or less) that can be considered micro-states. Such economies face many of the same problems that affect larger small states as well as additional problems arising from their tiny size.

The 47 small state sample is presented below by geographical region and Commonwealth membership (Commonwealth members are shown in italics and the four countries with populations of over 1.5 million are shown in bold type).

Small States by Geographical Region

AFRICA: *Botswana*, Cape Verde, Comoros, Djibouti, Equatorial Guinea, Gabon, *The Gambia*, Guinea-Bissau, **Lesotho**, **Namibia**, São Tomé and Príncipe, *Swaziland* (12)

CARIBBEAN: *Antigua and Barbuda*, *Bahamas*, *Barbados*, *Belize*, *Dominica*, *Grenada*, *Guyana*, *Jamaica*, *St Kitts and Nevis*, *St Lucia*, *St Vincent and the Grenadines*, *Suriname*, *Trinidad and Tobago* (13)

PACIFIC: Federated States of Micronesia, *Fiji Islands*, *Kiribati*, Marshall Islands, *Nauru*, Palau, **Papua New Guinea**, *Samoa*, *Solomon Islands*, *Tonga*, *Tuvalu*, *Vanuatu* (12)

INDIAN OCEAN: *Maldives*, *Mauritius*, *Seychelles* (3)

OTHER ASIA: Bahrain, Bhutan, *Brunei*, Qatar (4)

EUROPE AND MEDITERRANEAN: *Cyprus*, Estonia, *Malta* (3)

Small States by Commonwealth Membership

COMMONWEALTH STATES: Botswana, *The Gambia*, Lesotho, Namibia, Swaziland, *Antigua and Barbuda*, *Bahamas*, *Barbados*, *Belize*, *Dominica*, *Grenada*, *Guyana*, *Jamaica*, *St Kitts and Nevis*, *St Lucia*, *St Vincent and the Grenadines*, *Trinidad and Tobago*, *Fiji Islands*, *Kiribati*, *Nauru*, *Papua New Guinea*, *Samoa*, *Solomon Islands*, *Tonga*, *Tuvalu*, *Vanuatu*, *Maldives*, *Mauritius*, *Seychelles*, *Brunei*, *Cyprus* *Malta* (32)

NON-COMMONWEALTH STATES: Cape Verde, Comoros, Djibouti, Equatorial Guinea, Gabon, Guinea-Bissau, São Tomé and Príncipe, *Suriname*, Federated States of Micronesia, Marshall Islands, Palau, Bahrain, Bhutan, Qatar, Estonia (15)

within them. However, preparation of a detailed diagnostic analysis of the industrial competitiveness record, relevant determinants and specific recommendations for individual small states is beyond the scope of this exercise.¹ Those with specific national and sectoral expertise may more meaningfully do this task at country level.

The present study has a more limited goal: to provide insights into what works (and what does not) in terms of industrial competitiveness policy for small states by synthesising conceptual work, available empirical evidence and lessons drawn from successful cases. Apart from stocktaking, it sets the stage for thinking about a more comprehensive competitiveness policy framework for small states than traditional economic reform programmes. This framework may be more appropriate to competitiveness because it derives from micro-level theories of technical change and enterprise restructuring rather than macroeconomics *per se*. It also highlights additional policy measures to those of standard economic reform programmes, as well as roles for key public and private sector actors in policy formulation and implementation. Hence, the study may be a useful input into both national competitiveness policy exercises in small states and international policy dialogues with bilateral aid donors and multilateral agencies. It may also be of interest to researchers and students concerned with competitiveness, private sector development and post-adjustment strategy issues in small states.

The study addresses four inter-related questions:

- What is the meaning of competitiveness in relation to a small state and its enterprises?
- What is the recent industrial competitiveness experience of small states with globalisation and what factors determine success at a cross-country level?
- What kinds of enterprise strategies, policies and institutions have been adopted by successful small states?
- What principles, actors and measures might underpin the development of future industrial competitiveness policies for other small states?

1.2 The New Policy Focus: Competitiveness as well as Vulnerability

This study of competitiveness in small states comes at a time when the current focus of research and policy attention is on the economic vulnerability of small states. For many years small states, as part of larger developing country groupings, have enjoyed preferential market access, high levels of grant-based foreign aid, longer adjustment periods to international agreements and other special policy measures. However, in recent years globalisation has reduced this preferential treatment, with Uruguay Round liberalisation eroding the coverage of trade preferences available to small states and foreign aid flows to small states declining. Developed countries have become increasingly focused on

countries with high abject poverty, and preoccupied with their own interests such as the war on terrorism and domestic economic problems. If current trends continue, small states are likely to receive reduced foreign aid and less effective market access than ever before. The preferential treatment that is still available is often limited to least developed countries (LDCs) with high levels of abject poverty, a category for which few small states qualify.

In response to this, recent work has tried to show that small states do face specific problems and that their small size can specifically constrain economic development. Several studies highlight the existence of an inverse relationship between country size and susceptibility to economic, political and environmental risks and threats (Commonwealth Consultative Group, 1985; Commonwealth Secretariat, 1997; Streeten, 1993; Briguglio, 1995; Atkins *et al.*, 2001; Grynberg, 2001; Collier and Dollar, 2001; Winters and Martins, 2003).² This literature concludes that small states are more vulnerable than larger economies for the following reasons.

1. They have higher exposure to external shocks because of higher trade openness which causes short-term instability in export earnings and domestic demand.
2. They have less access to international financial markets and concessionary finance due to a lack of creditworthiness.
3. Their transport costs are higher per unit value of goods transported due to their remoteness and the relatively small values of cargoes carried.
4. They are at a disadvantage in attracting foreign investment because they are rated to be significantly more risky.
5. They are dependent on a single product and face reductions in preferential market access due to trade liberalisation under international trade agreements.
6. They are more exposed to serious environmental risks (for example natural disasters, rises in sea-level and marine pollution) due to their geographical location and face large environmental bills.

In an effort to redress the current erosion of preferences and special treatment, arguments based on vulnerability have been taken up with great vigour by small states' representatives in international forums such as the WTO, the EU and the Commonwealth. Calls have been made to insert clauses into current and future trade and aid agreements to highlight the special circumstances of small states, and to provide for special treatment that would redress the current erosion of preferences. However, the outcome of such efforts to date – and the prospects for future success – is at best limited, and even if it were to improve significantly, the underlying trends of globalisation are unlikely to change. Realistically, small states will increasingly have to compete on world markets for exports and foreign investment, and will receive less in aid and special treatment.

This realistic, if slightly pessimistic, prediction has many macro- and microeconomic implications for small states, not all of which can be covered here. This study therefore focuses on the concept that in addition to looking at vulnerability, much more attention needs to be devoted to improving competitiveness in small states, so that they are in a better position to face this new economic environment – irrespective of preferential treatment. Such an argument is not intended to replace the vulnerability issue, which still needs to be pursued, particularly in micro-states, but rather to take a two-pronged approach to dealing with small states' development problems. As such it focuses on practical issues for policy-makers in small states that can be pursued independently and are not reliant on the results of lobbying and advocacy.

The economic imperative for adopting a new strategic focus on competitiveness in small states is reinforced by a growing body of literature on this subject which suggests that current performance is weak in small states. Cross-country and individual country studies highlight the following findings:

- *The relative importance of small states in world exports has declined since the 1950s.* The combined share of the total exports of 35 small states in total world exports fell from 1.2 per cent to 0.4 per cent in the period from the mid-1950s to 2000 (Razzaque, 2002). If the oil-rich small states are excluded, the decline is from 0.7 per cent to 0.2 per cent over the same period.
- *Small states have had weaker manufactured export growth rates and have more limited export sectors than large states.* An examination of 18 small states and 23 large states showed that only three small states (Mauritius, Trinidad and Tobago, and the Bahamas) achieved a respectable manufactured export growth rate of above 10 per cent per year during 1980–1993 and had a manufactured export base of over \$0.5 billion (Wignaraja, 1997:37). Jamaica and Malta had manufactured export bases worth over \$0.5 billion (1993) but recorded slower export growth rates.
- *Unfavourable external factors arising from the international economic environment – outside the influence of small states – help to explain some of their competitive weaknesses.* Many of these are well known in debates on small states. They include declining terms of trade for primary products relative to manufactures; fluctuating international demand; rising protectionism through non-tariff measures in export markets; and new WTO rules which raise market access requirements (Harris, 1997; Razzaque, 2002).
- *Far more important to competitiveness, according to case studies, are factors arising from the nature of the policy environment and other country-level conditions.* The cases of Jamaica and Mauritius highlight contrasting experiences. Jamaica's lagging manufactured export growth rate is in part attributed to unfavourable macroeconomic and political conditions, including high nominal interest rates, insufficient depreciation of the real exchange rate and gaps in export incentives (Harris, 1997; Wint, 2003).

Box 1.2: Economic Benefits from Enhancing Competitiveness in Small States

Competitiveness is by no means a development panacea for small economies but it can significantly contribute to economic development. Several potential economic benefits are associated with improving the competitiveness of enterprises in small economies. These include the following:

1. **Increased exports.** Firms with improved technological and marketing capabilities tend to export more of their output than less dynamic firms. This leads to increased exports and higher foreign exchange earnings.
2. **Faster growth and higher per capita income.** Improved export performance feeds through into faster economic growth via standard multiplier effects, improved resource allocation and dynamic effects of exporting. In turn, faster growth raises per capita income.
3. **More foreign investment.** Small economies with a strong base of internationally competitive domestic firms indicate a better policy environment for the private sector and a good base of suppliers. These conditions reduce the risks associated with foreign investment in small economies, which in turn helps to sustain competitiveness through access to markets, technologies and skills.
4. **Higher employment.** As they export and grow, competitive enterprises tend to increase their demand for labour. This increases employment and helps to reduce the persistent unemployment problems that affect many small states.
5. **Better education and health services.** An internationally competitive enterprise sector implies a high level of tax revenue (via corporation and personal income tax) and hence more resources for investment in schools, hospitals and other public services.

Meanwhile, Mauritius's success is attributed to inflows of export-oriented foreign investment, attracted by competitive investment incentives, cheap and literate labour, a relatively cost-competitive infrastructure and preferential market access to the European Union (World Bank, 1994; Lall and Wignaraja, 1998).

- Furthermore, it is argued that *small firms in small economies are at a major disadvantage compared to large firms in taking advantage of the new export and investment opportunities provided by globalisation* (Bernal, 2001). Small firms are said to find it difficult to attain internal economies of scale (where the unit cost is influenced by the size of firm) and external economies of scale (where unit cost depends on the size of the industry but not necessarily the size of the firm). They are also said to find it difficult

to attain economies of scope (i.e. economies obtained by a firm using its existing resources, skills and technologies to create new products and/or services for export).

Given this poor performance, an effort to focus on competitiveness as well as vulnerability would be particularly pertinent, and would need to concentrate on enhancing the capacity of domestic enterprises, ensuring a supportive competitiveness policy framework and attracting foreign investment. The overall benefits of increased competitiveness to small states are highlighted in Box 1.2.

1.3 Outline of the Study

The remainder of the study is organised as follows.

Chapter 2 provides a simple framework for analysing industrial competitiveness in small states in a rapidly globalising international economy, drawing on recent literature on technology and innovation in developing countries. This framework underlines the dynamic links between technology, firms, industries, policies and institutions in developing competitiveness in small states. It emphasises that competitiveness arises at the level of the firm. The costly investment process involved in the absorption of imported technologies at the level of the firm and the effects of firms' collective learning on industrial competitiveness are highlighted. So too are the importance of national-level factors like a supportive policy framework and the quality of institutions.

Chapter 3 examines the industrial competitiveness experience of individual small states, as well as of geographical regions, income groups and country size classes. It benchmarks the industrial competitiveness of these categories using a Small States Manufactured Export Competitiveness Index and examines some determinants through statistical analysis. To the best of our knowledge, the SSMECI represents the first attempt to provide a comprehensive picture of the competitiveness performance of small states. Comparisons of our results with those of other competitiveness indices by the World Economic Forum (WEF), the International Institute for Management Development (IMD) and the UN Industrial Development Organisation (UNIDO) suggest that international efforts have concentrated on large states and little attention has been paid to small ones.

Chapters 4 and 5 deal with national and enterprise level competitiveness experiences in selected small states. Through case studies of Mauritius and Trinidad and Tobago, these chapters examine the importance of initial conditions, policies, institutional support and firm-level strategies in enhancing competitiveness in small states. Both economies are widely regarded as outliers in their respective regions, having achieved an impressive competitiveness performance. This perception is also confirmed by their relatively high SSMECI rankings.

Chapter 6 concludes with suggestions for enhancing the future competitiveness of small states. The emphasis is on the formulation of a proactive national competitiveness

approach to dealing with the process of globalisation. The suggestions focus on the key roles to be played by enterprises themselves, as well as by governments and business associations.

Table 1.1: Basic Profile of Small States, Most Recent Estimates

Country	Population (2001)	GDP per capita (current US\$ 2001)	GDP per capita (PPP US\$ 2001)	HDI Rank (2003) ^a	HDI Value Index (2003)
Antigua and Barbuda	68,490	9,961	10,170	56	0.798
Bahamas	309,840	15,550	16,270	49	0.812
Bahrain	651,000	12,189	16,060	37	0.839
Barbados	268,190	10,281	15,560	27	0.888
Belize	247,110	3,258	5,690	67	0.776
Bhutan	828,040	637	1,833	136	0.511
Botswana	1,695,000	3,066	7,820	125	0.614
Brunei	344,000	14,088	19,210	31	0.872
Cape Verde	446,400	1,264	5,570	103	0.727
Comoros	571,890	386	1,870	134	0.528
Cyprus	760,650	12,004	21,190	25	0.891
Djibouti	644,330	894	2,370	153	0.462
Dominica	71,870	3,607	5,520	68	0.776
Equatorial Guinea	469,090	3,935	15,073	116	0.664
Estonia	1,364,000	4,051	10,170	41	0.833
Fiji Islands	817,000	2,062	4,850	81	0.754
Gabon	1,260,790	3,437	5,990	118	0.653
Gambia, The	1,340,770	291	2,050	151	0.463
Grenada	100,410	3,965	6,740	93	0.738
Guinea-Bissau	1,225,620	162	970	166	0.373
Guyana	766,260	912	4,690	92	0.740
Jamaica	2,590,000	3,005	3,720	78	0.757
Kiribati	92,810	430	–	–	–
Lesotho	2,061,730	386	2,420	137	0.510
Maldives	280,320	2,229	4,798	86	0.751
Malta	395,000	9,150	13,160	33	0.856
Marshall Islands	52,500	1,937	–	–	–
Mauritius	1,200,000	3,771	9,860	62	0.779
Micronesia, Federated States of	120,230	1,914	–	–	–
Namibia	1,792,060	1,730	7,120	124	0.627
Nauru	10,000	–	–	–	–
Palau	19,500	6,280	–	–	–
Papua New Guinea	5,252,530	552	2,570	132	0.548
Qatar	597,550	27,536	19,844	44	0.826
Samoa	174,000	1,404	6,180	70	0.775
São Tomé & Príncipe	151,100	311	1,317	122	0.639
Seychelles	82,420	6,912	17,030	36	0.840
Solomon Islands	430,760	683	1,910	123	0.632
St Kitts and Nevis	45,050	7,609	11,300	51	0.808

Table 1.1 (continued)

Country	Population (2001)	GDP per capita (current US\$ 2001)	GDP per capita (PPP US\$ 2001)	HDI Rank (2003)^a	HDI Value Index (2003)
St Lucia	156,700	4,222	5,260	71	0.775
St Vincent and the Grenadines	115,880	3,007	5,330	80	0.755
Suriname	419,660	1,803	4,599	77	0.762
Swaziland	1,067,940	1,175	4,330	133	0.547
Tonga	100,720	1,371	–	–	–
Trinidad and Tobago	1,309,610	6,983	9,100	54	0.802
Tuvalu	10,000	–	–	–	–
Vanuatu	201,190	1,096	3,190	128	0.568

Source: UNDP, *Human Development Report 2003*; World Bank, *World Development Indicators 2003*

^aRank out of 175 countries in Human Development Index.