3. Small Economies and Special and Differential Treatment: Strengthening the Evidence, Countering the Fallacies

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1. Introduction

Small economies present a particular challenge to the multilateral trade regime: will it adjust to arrest their increasing marginalisation in world trade, a marginalisation that is undermining their development prospects significantly? This challenge questions whether emerging international trade rules are damaging the trade and development interests of small economies and, if so, whether derogations from those rules can avert such damage. An answer that more favourable treatment offers small economies the potential for a beneficial means of insertion into world markets is incomplete, however, without considering the negotiating context from which trade rules emerge. Whether or not favourable treatment is likely to result from the interstate bargaining process, determining the rules is the more problematic aspect of the challenge that small economies pose to the multilateral trading system.

This chapter argues that the peculiar economic characteristics of small economies combine to constrain their potential to benefit from the globalisation of markets under currently agreed trade rules. Though supported by recent empirical evidence, these arguments are contentious (see Briguglio, 1995, pp.1615–20; Encontre, 1999, p.265; WTO, 1999; UNCTAD, 2004a; and Grynberg, 2001a, p.289–91 for sympathetic reviews of small economies' special concerns, and Srinivasan, 1986; Streeten, 1993; Easterly and Kraay, 2001; and Page and Kleen, 2004, p.82 for opposing reviews) and require engaging with contrary views refuting that small size undermines trade competitiveness, that vulnerability to external economic shocks and natural disasters has real economic costs, and that small economies' characteristics are peculiar and worthy of specific responses. The chapter goes on to argue that, as the implications of emerging trade rules are realised, the marginalisation of small economies will be exacerbated. Whilst modifying multilateral trade rules is not the only initiative required to address the specific trade and development needs of small economies, it is argued to be vital. The likely economic decline of these states in the absence of favourable treatment will undermine the legitimacy of the multilateral trade regime, particularly its assumption that trade liberalisation on the basis of agreed rules is mutually advantageous. The more significant difficulty, this chapter suggests, is not demonstrating this predicament convincingly but achieving the necessary response as an outcome of trade negotiating processes. Here, the special characteristics of small economies undermine their bargaining power and likelihood of achieving beneficial outcomes from the interstate negotiating processes that determine global trade rules. The chapter concludes that it is not necessarily the case that agreed and emerging international trade rules are beneficial for all states: small economies can make a development case for more favourable treatment.

The economies considered 'small' for the purposes of this chapter are listed in Table 3.1, alongside their key economic indicators.[1]

2. The costs of being small

When trading internationally in a real world characterised by cross-border transaction costs, size **does** matter. Indeed being small, economically, is a meaningful concept only where transaction costs make national economies distinct entities. Thus, being small is integrally related to remoteness and insularity (Salmon, 2003, p.133): a small nation perfectly integrated into a larger contiguous market may not be small economically (Winters and Martins, 2004a, p.148), but a remote or insular nation facing significant transport costs may be. Once the size of its domestic market matters, the trade predicament of a small economy will be compounded by the importance of economies of scale in production (Winters and Martins, 2004a, p.8). Where transaction costs impede trade, small economies will have limited opportunities to benefit from globalising markets.

To understand the logic of the predicament facing small developing economies, consider a state with a small domestic market that faces significant trade transaction costs. Its small domestic market arises from its small population and associated low total GDP. Being small contributes to high transport costs via low and infrequent volumes – costs exacerbated by remoteness or insularity (see Briguglio, 1995, p.1617). Simple economic models can demonstrate that transport costs can stop trade from being feasible in such scenarios (Winters and Martins, 2004a, pp.3–8; see also Srinivasan, 1986, p.211). If limited trade continues, imports of production inputs will bear an excess cost from transport and, where transaction costs prohibit such imports, inputs will be produced domestically at high per unit costs given the small domestic market and consequent inability to exploit economies of scale. Similarly, non-tradable goods like roads and the protection of property rights will be produced domestically at high per unit costs. Wherever higher production and export costs outweigh small states' differential advantages over competitors, even in areas of comparative advantage, their exports will require premium prices in world markets to sell at all (Winters and Martins, 2004a, p.1).

Table 3.1 Small economies and key economic indicators

Small Economy	*Population 2003 ('000s)*	*Land Area (km²)*	*Total GDP 2003 ($US millions)*	*World Trade Share 2000 (%)*	*UN EVI[a] 2000 (ranking)*	*Cmwlth CVI[b] 2000 (ranking)*	*Per Capita GNI 2003 ($US)*	LDC	*SIDS*	*WTO*
Antigua and Barbuda	79	442	757	0.0061	73	8	9,160		☑	☑
Barbados	271	430	2,628	0.0183	82	37	9,270		☑	☑
Belize	259	22,696	928	0.0057	77	22	3,190			☑
Bhutan	874	47,000	645	0.0028	65	20	660	☑		obs
Botswana	1,722	581,730	7,388	0.0350		29	3,430	LLDC		☑
Cape Verde	470	4,033	831	0.0029	16	23	1,490	☑	☑	obs
Comoros	600	2,235	323		24	16	450	☑	☑	
Djibouti	705	23,200	625	0.0032	47	15	910	☑		☑
Dominica	71	751	255	0.0020	18	6	3,360		☑	☑
Equatorial	494	28,051	2,894		22	7	930	☑	obs	
Guinea Fiji	835	18,274	2,251	0.0155	80	25	2,360		☑	☑
Gabon	1,344	267,668	5,605	0.0327	39	54	3,580			☑
Gambia	1,421	11,295	386	0.0035	5	10	310	☑		☑
Grenada	105	344	439	0.0034	60	11	3,790		☑	☑
Guinea-Bissau	1,489	36,125	236	0.0011	19		140	☑		☑
Guyana	769	214,969	742	0.0095	34	17	900			☑
Jamaica	2,640	10,990	7,817	0.0506	94	53	2,760		☑	☑
Kiribati	96	726	58		1	4	880	☑	☑	
Lesotho	1,793	30,355	1,135	0.0065	28	31	590	☑		☑
Maldives	293	298	696	0.0058	92	9	2,300	☑	☑	☑
Marshall Islands	53	181	106				2,710		☑	

Small Economy	*Population 2003 ('000s)*	*Land Area (km²)*	*Total GDP 2003 ($US millions)*	*World Trade Share 2000 (%)*	*UN EVI[a] 2000 (ranking)*	*Cmwlth CVI[b] 2000 (ranking)*	*Per Capita GNI 2003 ($US)*	LDC	*SIDS*	*WTO*
Mauritius	1,225	2,040	5,225	0.0342	86	47	4,090		☑	☑
Federated States of Micronesia	125	702	241				2,090		☑	
Namibia	2,015	824,292	4,658	0.0263		46	1,870			☑
Nauru	13	21							☑	
Palau	20	459	132				7,500		☑	
Papua New Guinea	5,502	462,840	3,395	0.0301	70	55	510		☑	☑
St. Kitts and Nevis	47	261	370	0.0025	37	13	6,880		☑	☑
St. Lucia	161	539	693	0.0050	15	18	4,050		☑	☑
St. Vincent and the Grenadines	109	388	371	0.0024	32	14	3,300		☑	☑
Samoa	178	2,831	323	0.0012	29	5	1,600	☑	☑	obs
São Tomé and Principe	157	964	54		8	1	320	☑	☑	obs
Seychelles	84	455	720	0.0064	14	21	7,480		☑	obs
Solomon Islands	457	28,896	257	0.0018	27	12	600	☑	☑	☑
Suriname	438	163,265	952	0.0058	59	24	1,990			☑
Swaziland	1,106	17,364	1,845	0.0127	87	19	1,350	LLDC		☑
Timor-Leste	810	14,874	314				430	☑	☑	
Tonga	102	650	163	0.0009	11	3	1,490		☑	obs
Trinidad and Tobago	1,313	5,130	10,201	0.0408	78	62	7,260		☑	☑
Tuvalu	10	26			2			☑	☑	
Vanuatu	210	12,189	283	0.0019	71	2	1,180	☑	☑	obs

Small Economy	*Population 2003 ('000s)*	*Land Area (km²)*	*Total GDP 2003 ($US millions)*	*World Trade Share 2000 (%)*	*UN EVI[a] 2000 (ranking)*	*Cmwlth CVI[b] 2000 (ranking)*	*Per Capita GNI 2003 ($US)*	LDC	*SIDS*	*WTO*
Averages-				0.3766 *(Sum)*						
Small economies	743	69,268	1,716				2,748			
All least-developed countries	14,348	411,629	4,736				310			
All middle-income countries	32,151	740,280	64,468				1,920			
High-income OECD countries	38,068	1,265,457	1,177,779				29,310			
World	30,152	626,436	174,790				5,500			

LLDC - recognised by the UN as a landlocked developing country, but not as a least developed country (LDC) obs - country has 'Observer' status in the WTO

[a] United Nations 'Economic Vulnerability 'Index'

[b] Commonwealth Secretariat 'Commonwealth Vulnerability Index'

Source: World Bank (2004), Commonwealth Secretariat (2003), Atkins et al (2000), WTO (2004a), UNCTAD (2003c) and UNCTAD (2004c)

Comprehensive data have now been compiled substantiating this trade predicament of small economies. Analysis by Winters and Martins (2004a) provides strong evidence that businesses in small states face large and significant cost inflation factors relative to firms in the median state, sufficient to undermine their potential for competitiveness even in areas of comparative advantage (Winters and Martins (2004a, pp.130–47), using various indicators of policy quality, find no evidence that economic policy is worse is small states than in large, and thus reject the hypothesis that the revealed inefficiencies are self-inflicted.). Summary results, presented in Table 3.2, indicate that cost inflation factors in micro states exceed 50 per cent in six of 11 key production inputs, and for small states exceed 30 per cent in five of the inputs, relative to the median state. These detrimental competitiveness implications are captured in the cost inflation factors calculated for representative electronics, garments and tourism businesses (Table 3.3): garments manufacturing costs in micro states are estimated to exceed those in the median state by 36.3 per cent, whilst tourism services costs in small states are estimated to exceed those in the median state by 28.5 per cent. Winters and Martins (2004a, pp.118–24) illustrate the damaging implications of their findings by calculating the resultant returns to factors of production in the likely scenario that small states are price-takers in world markets, taking import costs as given and receiving the world price for their exports. Using the example of electronics assembly in a micro state, if infrastructure services costs are also fixed (Winters and Martins (2004a, p.120) argue that this assumption is reasonable, given that the costs recorded in the dataset approximate general equilibrium results.), exports could not be competitive

Table 3.2. Production cost inflation in micro and small economies

Area of cost[a]	*Micro*[b]	*Small*[c]
Airfreight average	31.8	4.1
Seafreight average	219.6	70.5
Unskilled wages average	60.1	31.6
Semi-skilled wages average	22.4	12.1
Skilled wages average	38.0	20.3
Telephone marginal costs	98.5	47.2
Electricity marginal costs	93.1	47.0
Water marginal costs	0.0	0.0
Fuel average	53.8	28.3
Personal air travel average	115.7	56.8
Land rent average	-3.5	-17.2

[a] All figures show the percentage deviation of costs from those in the median economy
[b] 'Micro' economy estimates are based on Anguilla (population approximately 12,000)
[c] 'Small' economy estimates are based on Vanuatu (population approximately 200,000) [source uses 'Very Small' for Vanuatu estimates, and 'Small' for economies the size of Singapore (population approximately 4 million), which well exceeds 'small' in this paper]
Source: Winters and Martins (2004a: 102-3)

Table 3.3 Cost inflation factors in micro and small economies

Industry[a]	*Micro*[b]	*Small*[c]
Electronic Assembly	36.4	14.3
Clothing	36.3	14.3
Hotels and Tourism	57.5	28.5

[a, b, c] See Table 3.2
Source: Winters and Martins (2004a: 119)

Table 3.4 Penalties to value-added in micro and small economies

Factor of Production	*Electronics*		*Clothing*		*Tourism*	
Bearing Penalty[a]	*Micro*[b]	*Small*[c]	*Micro*[b]	*Small*[c]	*Micro*[b]	*Small*[c]
All Domestic Supplies	-38.8	-11.6	-40.1	-12.0	-36.2	-17.4
Value Added	-88.0	-29.2	-86.0	-28.6	-71.9	-34.0
Capital	-245.1	-91.8	-263.9	-99.9	-202.1	-98.4
Labour	-175.5	-62.5	-161.0	-57.3	-116.5	-56.6

[a, b, c] See Table 3.2
Source: Winters and Martins (2004a: 119)

unless capital made losses larger than its profits in the median state or, if capital were remunerated, would not be competitive even if labour earned zero wages. Even in small states, if capital is the residual factor, it must earn near-zero returns if exports in any of the three example industries are to be competitive at world prices (see Table 3.4). Winters and Martins (2004a, p.119) describe their findings as 'devastating'.

These data make concrete the substantial economic costs of being small and remote (Winters and Martins, 2004a, p.102), challenging the argument that being small is not a disadvantage in a globalising world (see Page and Kleen, 2004, p.82; and Read, 2004, p.368). They also challenge ubiquitous assertions that services are less affected by transport and scale costs in small economies (see World Bank, 2002a, p.16; and Page and Kleen, 2004, pp.81–83), offering evidence that services exports can be subject to even higher cost inflation factors than goods exports (Winters and Martins, 2004a, pp.113–6). The findings demonstrate the insufficiency of policy recommendations for small states to specialise in their areas of comparative advantage and trade their way to higher welfare levels. Indeed, argue Winters and Martins (2004b, p.4), comparative advantage need not be enough. Small states, like all states, have comparative advantages; what sets them apart is that even if they specialise in these, trade transaction costs and the inherent inefficiencies of small size may prevent trade from being remunerative. Without remunerative returns to capital, small states will be unable to attract investment; without remunerative returns to labour, human development will be impeded (Winters and Martins, 2004a, pp.119–20). Rather than being 'extreme' (Page and Kleen, 2004, p.79), this analysis simply uses new empirical evidence to verify an existing possibility within conventional economic theory. Small states do have comparative advantages, but these need not be 'operational' (Winters and Martins, 2004a, p.1).

These findings also clarify the types of economic opportunities small states can exploit. Where small economies face world market prices for their exports they are unlikely to be competitive, ruling out the export of generic goods and services. Their export potential is in markets where forms of rent exist or can be created for exploitation. Argues Grynberg (2001a, p.292), '*...while in other economies these quasi-rents constitute a basis for high profits, in small states they are often a precondition for productive commercial activity as rents are necessary to cover inherently high operating costs*'. Examples include scarcity rents in commodity markets, for example Solomon Islands' timber (Grynberg (2001a, pp.291–3) and Encontre (1999, p.267) provide overviews of small economies' rent-based exports), niche market rents from location-specific factors like tropical beaches for tourism in the Caribbean and time zones for data processing in Fiji, and niche market rents from branding as in the cases of Jamaican Rum and Fiji Water (competitiveness in most other exports from small states relies on institutions like trade preferences and tax concessions, discussed below). Rents, however, can be transient (Armstrong and Read, 2002, pp.2–3; and Grynberg, 2001a, pp.293–5). Encontre (1999, p.261) appraises small economies' experience with niche markets as being typically unsuccessful, characterised by commercial ventures with very short life-spans. Thus, whilst small economies certainly have opportunities to benefit from globalisation, competitiveness requires their productive activities to be limited to those serving specialist markets where shifting rents can be created and exploited, so they are far from having stable foundations for their economic development.

At the same time, small economies have the most to gain from international trade (Streeten, 1993, p.198; and Read, 1999, p.9). Their small domestic markets, narrow resource endowments and inability to exploit economies of scale mean that the welfare they can attain under autarky is very low indeed (see, for example, Read, 2004, p.365; Encontre, 1999, pp.268–9; and Burki, 2001, p.10). International trade should offer these states the opportunity to overcome their small size and increase their welfare, but this section has argued that nothing in economic theory guarantees that they will be able to operationalise this potential in the presence of significant transaction costs (Winters and Martins, 2004a, pp.3–8). Their possible marginalisation in the face of globalisation is a pressing concern, particularly because it is they that are most dependent on international trade to improve their economic welfare (Winters and Martins, 2004a, pp.1–2). Small economies have both limited opportunities to benefit from globalising markets and the most to lose from such marginalisation (see Grynberg and Razzaque, 2003, p.30).

3. The costs of vulnerability

Small economies are particularly vulnerable to external shocks from world markets and natural disasters (Atkins et al., 2001, p.63), because of the severe constraints they face in diversifying their production and trade (Briguglio, 1995, p.1616; and Jansen, 2004, p.14; Grynberg and Razzaque, 2003, p.53; Read, 1999, p.7; and Briguglio, 1995, p.1616 argue that small economies' typically limited resource endowments exacerbate this lack of diversification). Thus Atkins et al. (2000, p.1) state, 'There is growing international recognition that high economic exposure, remoteness and isolation, and proneness to natural disasters have a debilitating effect on small economies, despite the fact that some of them exhibit relatively high per capita incomes'. Indeed, their vulnerability index ranks 27 small economies among the 30 most vulnerable developing countries (Atkins et al., 2000, pp.25–33). This section will explore the adverse economic impact of vulnerability on small economies.

3.1 Vulnerability to external economic shocks

A number of small economies' characteristics make them both highly exposed to external economic shocks and extremely vulnerable to consequent adverse effects. First, the limited production possibilities of their domestic economies make small states highly dependent on trade (Briguglio, 1995, p.1616), with trade accounts typically very open (see Figure 3.1) (see also World Bank, 2002b, p.18). Secondly, their production activities and more so their exports are highly concentrated in a very small number of products (see Figure 3.2), with Jansen (2004, p.14) arguing that small economies' export concentrations are very similar to those in least-developed countries (LDCs). Thirdly, small economies' exports are directed to a very limited number of markets (Dehn, 2000c, pp.10, 22; World Bank, 2002b, p.18; UNCTAD, 2003a, p.7; and Jansen, 2004, pp.1, 6). Fourthly, generally the products in which small economies' exports are concentrated are commodities (Jansen, 2004, p.12). UNCTAD (2003a: 5), finds that for the subset of small island only do they face significant challenges in diversifying their

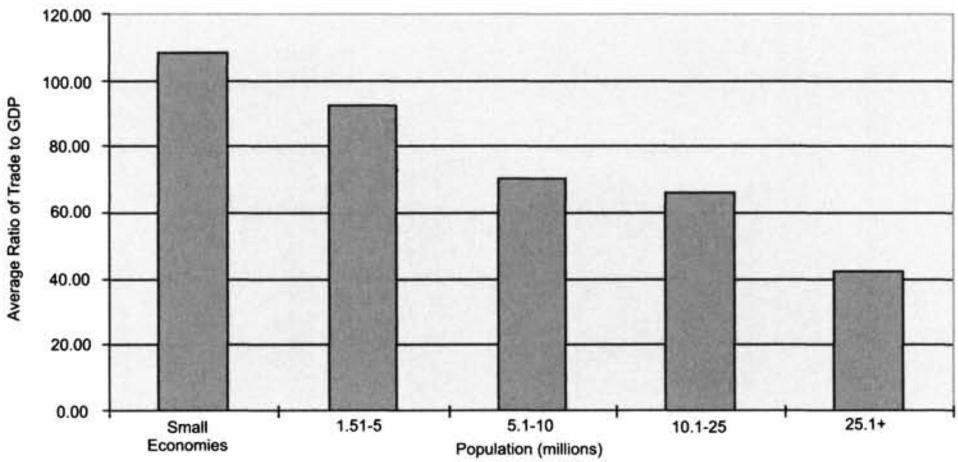

Figure 3.1. Openness to trade in small economies.

Note: The 'small economies' category refers to those countries listed in Table 3.1 for which data were available; the number of observations in each category is 38, 41, 30, 32 and 34 respectively

Source: Jansen (2004) and author's own calculations economic activity and export bases (Jansen, 2004, pp.6–7, 14), the World Bank (2002b, pp.18–9) argues that small economies have '...a smaller pool of human and institutional resources to draw on to help predict, mitigate, and manage the effects of shocks'. Their small financial systems, with little liquidity and constrained access to international capital, also make it difficult for small states to implement macroeconomic policies to smooth the impact of shocks (see World Bank, 2001).

This exposure and vulnerability has a destabilising impact on small economies (Auffret, 2003a, pp.4, 7; Jansen, 2004, p.1; and World Bank, 2002b, p.21). Atkins et al. (2000, pp.5–9) find the income volatility of small states to be the highest in the developing world. Empirical evidence also demonstrates that small states' openness to trade increases the volatility of their output levels and growth rates (Easterly and Kraay, 2001, p.104; World Bank, 2002b, p.18; and Jansen, 2004, pp.1, 6). Their high export concentrations are found to play a major role in exacerbating the income volatility of small states, through terms-of-trade volatility (Jansen, 2004, pp.9–12). Also, extreme concentrations in commodity exports are shown to exacerbate volatility (Dehn, 2000c, p.10). It is widely recognised that such volatility of income and consumption aggregates *does* matter for economic growth and welfare (see Jansen (2004, p.1), who cites the relevant evidence from the literature, as well as Auffret (2003a, pp.4, 7); Collier and Dehn (2001, p.2); Atkins et al. (2000, p.7); and Easterly and Kraay (2001, pp.104–5). On terms of trade shocks, see Dehn (2000a, p.23). On uncertainty and private investment, see the different findings of Dehn (2000b, p.3) and Jansen (2004, pp.3–4). Whether or not other characteristics of small economies work to counteract the negative growth impact of volatility[2] makes it no less true that high volatility in key macroeconomic aggregates like income and consumption affects growth negatively (Read, 2004, p.369). And as Read (2004, p.372) argues, small states' vulnerability to external economic

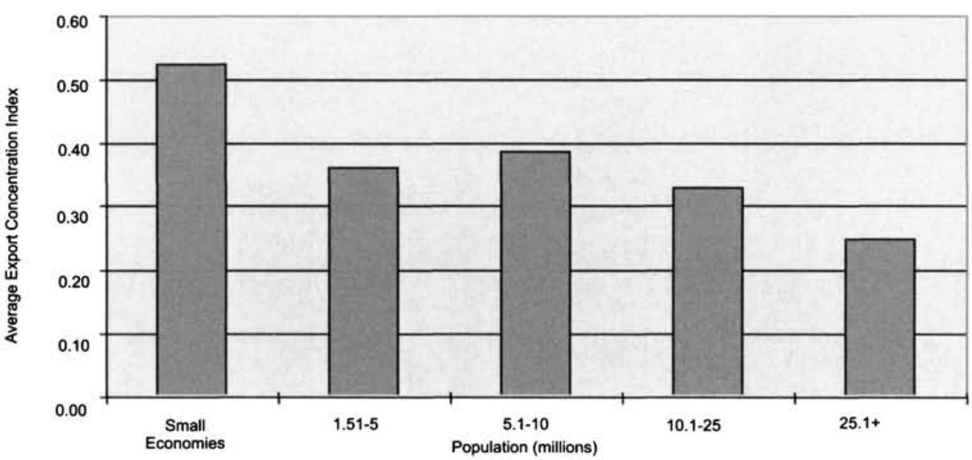

Figure 3.2. Export concentration in small economies.

Note: The 'small economies' category refers to those countries listed in Table 3.1 for which data were available; the number of observations in each category is 27, 33, 24, 30 and 31 respectively

Source: Jansen (2004) and author's own calculations shocks will only *increase* with globalisation and small states' greater integration into world markets.

3.2 Vulnerability to natural disasters

The development prospects of small economies are also constrained by the 'multifaceted' welfare effects of natural disasters (Charveriat, 2000, p.10), to which they are both highly exposed and peculiarly vulnerable. Small states' exposure is geographic, from their typical location within hurricane and cyclone belts, and sometimes seismic activity zones (Charveriat, 2000, pp.47-56; Freeman et al., 2003, p.8; Rasmussen, 2004, p.5; Atkins et al., 2000, p.3; and Auffret, 2003a, p.13). Small states' vulnerability is socioeconomic, arising from the interaction of a number of their characteristics. First, frequently small size means that natural disasters devastate entire countries, hence aggregate effects are marked relative to large states where these are mitigated by regional variations in the impact on economic activity (Charveriat, 2000, pp.21, 39). Secondly, dependence on agriculture for output and exports increases the economic damage of natural disasters, particularly weather events (Charveriat, 2000, p.21). Thirdly, small economies' narrow resource bases and undiversified economic activities and exports concentrate risk (Freeman et al., 2003, p.9). Fourthly, their relatively low incomes impede household and state expenditure capacities on preventative measures. Fifthly, inefficient, incomplete or entirely absent insurance markets reduce scope for managing risk (Rasmussen, 2004, p.4; World Bank, 2001, p.12; and Gurenko and Lester, 2004, p.3).

The exposure and vulnerability of small developing states is evident from the data on natural disasters summarised in Table 3.5. Small states are widely recognised as being the most vulnerable to natural disasters because of their exposure, having the highest frequency of natural disasters in the world relative to population or land area (Rasmussen, 2004, p.3; Encontre, 1999, p.262; International Workshop, 2004, p.2; Atkins et al., 2000, p.30; World Bank, 2002b, p.18; and IMF, 2003, p.7). As these states develop, the economic cost of their natural disasters will rise 'exponentially' (Benson and Clay, 2003, p.76). That prospect, combined with predicted increases in the frequency and intensity of damaging weather events, leaves SIDS estimated to be facing annual losses from natural disasters exceeding 10 per cent of their GDP by 2050 (Freeman et al., 2003, p.8).

Empirical evidence on the economic impacts of natural disasters in small economies shows the significant challenge to trade and development that these pose (for evidence summarised in this paragraph, see Rasmussen (2004, pp.5-11); Freeman et al. (2003, p.11); Charveriat (2000, pp.15-21, 36-9); Benson et al. (2001, pp.12-7); ECLAC and IDB (2000, pp.7-12); World Bank (2002b, pp.25-7); and IMF (2003, pp.10-11). Typically, disasters are associated with immediate sharp contractions in output and GDP growth, contractions exacerbated by the share of agriculture in economic activity. External trade balances worsen substantially, both from the shocks to exports arising from output shocks and damage to trade infrastructure, and from surges in imports

Table 3.5. The extreme vulnerability of small economies to natural disasters 1970-2003

	Incidence of natural disasters			*Population impact of natural disasters*	
Country grouping[a]	*Number of events*[b]	*Events/population (index)*	*Events/land area (index)*	*Number of events with record of affected persons*	*Total affected persons (percentage of 2003 population)*
Small economies	432	1,229	290	303	67.8
*of which:*Africa	177	1,051	174	117	93.2
Caribbean/Latin America	96	1,384	697	67	53.2
Pacific	149	1,652	500	110	47.9
SIDS	285	1,495	882	204	46.6
Other least-developed countries	1,446	175	126	1,130	109.5
Other developing countries	4,126	74	93	3,130	101.1
Developed countries	1,450	140	84	748	5.4
World	7,454	100	100	5,311	88.6

[a] Only countries with at least one natural disaster during 1970-2003 are included, yielding: 37 small economies of which 13 are in Africa, 11 are in the Caribbean or Latin America, 10 are in the Pacific, and 26 are SIDS; 34 other LDCs; 89 other developing (or transition) countries; and 23 developed countries. Data for country groupings reflect weighted averages of the data for the individual countries therein, calculated on the basis of aggregate group data, rather than reflecting simple averages of individual country data.

[b] Only natural disasters involving at least 10 people being killed, at least 100 people being affected, a call for international assistance, or the declaration of a state of emergency are recorded in EM-DAT; 2004 data are excluded because they are preliminary as yet.

*Source:*EM-DAT (2005), World Bank (2004) and UNCTAD (2004c); author's own calculations occurring to underpin reconstruction. Current account deficits worsen, sometimes to 'staggering' dimensions (see, in particular, Rasmussen, 2004, p.8). Public finances worsen also, from higher expenditure requirements and a reduced revenue base. Generally, increased foreign aid and official assistance are insufficient to offset these fiscal impacts. (Freeman et al. (2003, p.14) cite Inter-American Development Bank evidence that an average of 8.6 per cent, and at most 25 per cent, of direct disaster costs are covered by international assistance. Dependence on overseas assistance is itself a form of risk exposure, increasingly unwise as real official development assistance declines, according to Charveriat, 2000, p.1). As a result of foreign borrowing to fund fiscal and current account deficits, typically external debt to GDP ratios increase. Frequently inflation also becomes a concern. Although the proprortion of the population affected by natural disasters in small states is relatively low, it is a significant real cost to the labour force nonetheless. These severe macroeconomic consequences are, of course, in addition to the psychological and social effects of human suffering (see especially Charveriat, 2000, pp.10–12), the impact of which typically is most acute for the poor (see, in particular, Freeman et al., 2003, p.10; and Charveriat, 2000, p.26).

Furthermore, natural disasters can have significant economic effects on small states beyond the short term. Incomplete reconstruction of damaged capital will necessarily reduce future growth, a growth effect that can emerge from a shortfall or delay in reconstruction financing (Auffret, 2003a, p.17; ECLAC and IDB, 2000, pp.13–14; IMF, 2003, p.9; and Charveriat, 2000, pp.13, 22–4). Reconstruction may not even be possible, where factor endowments such as coral reefs are destroyed (Charveriat, 2000, p.23; and ECLAC and IDB, 2000, p.15). The redirection of capital from planned projects to reconstruction imposes an opportunity cost on productive capacity and growth, in the likely event that the marginal improvement of reconstructed over pre-disaster capital is less than would have been the rate of return from the planned projects forgone (Charveriat, 2000, p.23). Moreover, risk reassessments and disaster-induced solvency problems may reduce the investment attractiveness and capacity of vulnerable regions (Auffret, 2003a, p.28; Freeman et al., 2003, p.13; and Charveriat, 2000, pp.23–5). Damage to education and health infrastructure, together with household-level effects reducing access to these services, reduce human capital formation – a foundation for future economic growth (Freeman et al., 2003, p.13; Charveriat, 2000, p.23; and Encontre, 1999, p.262). Vulnerability to natural disasters is also strongly correlated with income and consumption volatility, with consequent welfare effects (Rasmussen, 2004, p.11; Auffret, 2003a, pp.4, 7, 15; and World Bank, 2002b, p.45). In addition, detrimental long-term effects arise from the increases in poverty typically associated with natural disasters ECLAC and IDC, 2000, p.16; and Charveriat, 2000, p.26). There is also evidence that worsening public finances go beyond short-term fiscal deficits, to significant reallocations of public resources away from capital expenditure and social sector programmes (Benson and Clay, 2003, pp.77, 83. See also ECLAC and IDB, 2000, p.15; Charveriat, 2000, p.23; Gurenko and Lester, 2004, p.3; IMF, 2003, p.4; Freeman et al., 2003, p.13; and evidence of the mirroring of this behaviour by donors in Benson and Clay, 2003, p.76). Finally, higher external debt increases the future risk exposure of small states, expanding the debt servicing drain on public finances and possibly increasing the risk premiums that financiers demand (Charveriat, 2000, pp.13, 24; Freeman et al. 2003, p.11–13; and ECLAC and IDB, 2000, p.15).

These considerations make the argument that natural disasters do not affect long-term economic growth highly improbable.[3] If there has been little empirical evidence of long-term lower economic growth in disaster-prone states, not only is it now emerging,[4] but this is largely the result of there being little empirical work at all on the long-term impacts of natural disasters (Rasmussen, 2004, p.11).

Critics contend also that vulnerability to natural disasters is endogenous, implying that policy remedies are readily available to small states at reasonable cost (see Page and Kleen, 2004, p.79). However, small economies face significant impediments in reducing their vulnerability to natural disasters. The constrained governance capacities of state institutions make problematic the formulation and enforcement of vulnerability-reducing regulations (on these prescriptions, see Rasmussen, 2004, p.14; and IMF, 2003, p.13). Continuously shifting vulnerabilities, arising from altered exposure due to climatic changes and from altered vulnerability due to socioeconomic change, exacerbate governance problems by requiring frequent re-evaluations of risks and appropriate preventative measures (see IPCC (2001) on climate change, in particular for SIDS; and Benson and Clay (2003, pp.78–80) and Benson et al. (2001, p.88) on changing socio-economic vulnerabilities). Moreover, the costs of preventative measures can be 'inordinately' expensive (Freeman et al., 2003, p.16). Market inefficiencies ensure that disaster insurance, if available at all, is highly volatile and typically requires prohibitively high premiums in small states (Rasmussen, 2004, pp.12–13; Freeman et al., 2003, p.17; World Bank, 2001, pp.9–10; and Auffret, 2003b, p.13. See also Benson and Clay, 2003, p.78; and Gurenko and Lester, 2004, p.2). Standard policy prescriptions for economic diversification into areas of comparative advantage (see Rasmussen, 2004, p.14; IMF, 2003, p.8; and Freeman et al., 2003, p.15). are of little utility where small size constrains diversification (Charveriat, 2000, p.22), comparative advantages are held in activities – like agriculture and tourism – particularly vulnerable to natural disasters, and more disaster-resistant activities like manufacturing are uncompetitive. As with external economic shocks, therefore, small economies face substantial obstacles in attempting to reduce their vulnerability to natural disasters.

4. The costs of governance

A very important scale economy that small states cannot exploit is governance (see Schahczenski, 1990; and Braun et al., 2002; see Srinivasan, 1986, p.211 for an opposing view). Whilst poor governance, in terms of democracy, stability and the rule of law, is not a pressing issue for small states (see Table 3.6) (see also Winters and Martins, 2004a, pp.130–47; and Collier and Dollar, 2001, p.16. On the relationship between good governance and economic success see Burnside and Dollar, 1997), policy capacity and the costs of best practice are. The substantial capacity requirements and costs of implementing international trade agreements (see Finger and Schuler, 2002, p.501; Michalopoulos, 2002, p.69; and Armstrong and Read, 2002, p.16) are a severe concern for small developing countries, whose human and financial resources are dwarfed by the complex array of international trade disciplines with which they must work (on implementation costs, see Finger and Schuler, 2002, p.501). This section will focus on a further relationship between costly governance and trade capacity critical in small states: the way in which state institutions augment the trade capacity of the private sector.

Economies of scale in governance arise from the population-invariant minimum set of responsibilities a state has towards its citizens and with respect to other states, government functions typically exhibiting high fixed and low marginal costs (Briguglio, 1995, p.1617; Farrugia, 1993, p.221; Encontre, 1999, p.265; and Armstrong and Read, 2002, p.2). Governance in small states is thus generally more costly per capita than in large states (see Hausmann (2004) for evidence of the poor performance of independent states in the Caribbean relative to their dependent neighbours, and Bertram (2004, pp.345–50) for similar findings in the Pacific). Both Murray (1981, pp.245–7) and Armstrong and Read (2002, p.2–3) argue that conventional policy and economic models assume, without making explicit, a minimum state size and administrative resource base which small states fall below. Frequently, these prohibitive costs of adequate governance are mitigated by understaffing among professionals and a reduction in the scope of state responsibilities (Farrugia, 1993, p.222; and Gay, 2004, p.4). Small populations, especially those experiencing skilled labour emigration, present a significant challenge to the recruitment of qualified and experienced officials for public institutions (Briguglio, 1995, p.1617; Murray, 1981, pp.250–4; and Gay, 2004, p.15). The result is 'problematic governance capacity': state officials are severely overstretched relative to their responsibilities, and sometimes relative to their skills and experience, whilst even these limited state responsibilities may be inadequate to the needs of the population in the current global context.

Small states' governance constraints affect the trade capacity of their private sectors, especially given the latter's inexperience in international trade and lack of required

Table 3.6. 2002 governance indicators for small economies

Governance indicator[a]	*Observations*[b]	*Average*[c]
Voice and accountability	40	0.28
Political stability	29	0.32
Government effectiveness	37	-0.17
Regulatory quality	38	-0.22
Rule of law	38	-0.06
Control of corruption	38	-0.09

[a] Estimates range from –2.5 to +2.5, with estimates for the full sample averaging zero

[b] Number of observations varies with missing data

[c] Simple average of estimated scores, none of which are significantly different from zero even at the 10% level

Source: World Bank Institute (2002) and author's own calculations entrepreneurial skills (see World Bank, 2002a, p.29 on the entrepreneurial skills base in Pacific Islands). For example, if a small state's facilitation of trade is ineffective, consumers and exporters will bear costs arising from inefficient customs, standards and quarantine regulations. States may be unable to facilitate the extremely costly certification systems vital for niche marketing (see Vossenaar (2004, pp.74–82) on barriers to entry in niche markets; and Saqib (2003, pp.270–1) on costly certification). Government responsibilities may not feasibly extend to the provision of access to overseas market information – including regulatory information – to their private sectors (English and de Wulf, 2002, pp.160–2; Wilson, 2002, p.428; and Grynberg, 2001a, p.294). That information is a non-rival good that is otherwise extremely costly to individual entrepreneurs, yet is vital for access to transitory niches. Small states may also underachieve in negotiating the product – especially commodity – pathways that are the means by which their private sectors can realise market access abroad (see Wilson (2002, pp.431–2) on technical barriers to trade, and Malua (2003, pp.185, 187) and Vossenaar (2004, p.79) for case studies).

Their problematic governance capacities make it difficult for small states to reduce trade transaction costs through trade facilitation and to negotiate product pathways for their exports – state activities that are vital to the trade capacities of their private sectors.

5. Characteristics in combination

Thus far, this chapter has presented arguments and evidence regarding the significant economic costs imposed on small states by their size, vulnerability to external economic shocks and natural disasters, and problematic governance capacities. In each case, it is through a **combination** of many characteristics of small states that these costs are generated (see also Salmon (2002, p.4) on this point). The small size of an economy, for example, is important only in the context of trade transaction costs such as those arising from remoteness and insularity. Small economies are highly vulnerable to external economic shocks where they are open to trade and have undiversified exports. Similarly, their vulnerability to substantial economic damage from natural disasters results from small economies' exposure to such disasters combined with small land areas, large agricultural shares of production, and incomplete insurance markets. Finally, small economies' governance capacities are problematic for trade in cases where indivisibilities exist in trade facilitation and skilled human capital is scarce.

It follows that cross-country econometric analyses regressing economic growth on any one characteristic – distances to major markets, population sizes, numbers of natural disasters, and so forth – may not yield significant results. Large contiguous states with great distances between capitals will offset the detrimental effects of distance for small insular states. Small states integrated into and contiguous with regional markets will offset the detrimental effects of small domestic markets for small remote states. Large developed states experiencing many natural disasters will offset the detrimental growth impacts of natural disasters on developing countries with small land areas. Because it is combinations of characteristics that engender disadvantages, it is erroneous to treat these characteristics as being separable for analytical purposes (for an example of such an approach, see Page and Kleen, 2004, p.80). For the same reason, it is mistaken to argue as Srinivasan (1986, p.217) does that small economies do not face a special predicament because, 'Many of the problems allegedly faced by small economies are...not peculiar to them', a position echoed by Page and Kleen (2004, p.80). Instead, since it is the combination of many characteristics of small economies that yields the significant economic costs that undermine their trade prospects, states exhibiting those multiple characteristics have a strong case for special consideration. The interaction of characteristics deriving from small size, vulnerability, and governance capacity impedes the potential of small economies to integrate into globalising markets on a competitive basis, and thereby mitigate the constraints on their development posed by size.

6. The limits of regionalism

The standard recommendation for small states to mitigate the deleterious effects of their small size, vulnerability, and governance capacities, is regionalism (see Streeten, 1993, p.197). Thus, for example, the integration of small economies into regional markets is argued to overcome the limits of small domestic markets and the constraints on their exploiting economies of scale (Hausmann, 2004; and Streeten, 1993, pp.197–8). Regional cooperation is meant to mitigate small states' vulnerability to natural disasters, particularly regarding the costs of preventative actions and the capacity to absorb damage. Regional government is proffered as a solution to indivisibilities in governance via the exploitation of scale economies and the regional provision of public goods and infrastructure (Streeten, 1993, p.197; and Schiff and Andriamananjara, 1998, pp.2–3). As Murray (1981, p.247) argues, small states are to be 'scaled up' to suit existing 'doctrines of effective administration'. In the extreme, small states are recommended to cease to be states (see Srinivasan, 1986, p.211). Consequently, the existence of the opportunity for regional integration is argued to make persistent small size an endogenous characteristic, a policy choice for which small states should bear the costs.

It is beyond contention that regionalism has much to offer small economies. It is also readily apparent that small states have recognised these advantages and forged various regional groupings incorporating, to different degrees, integrated markets, natural disaster cooperation, and elements of regional governance (see, for example, South Pacific Forum Secretariat, 2001). However, there are strict limitations on the extent to which regionalism can **solve** the trade predicaments of small economies.

First, full market integration among a region of small economies will not necessarily make those states better off, or more able to compete in global markets. The most obvious reason is trade diversion, with economic models demonstrating that the integration of a group of small economies may reduce their aggregate welfare (Schiff, 1996, pp.11, 32; Read, 1999, p.15; and World Bank, 2002a, pp.10–11). Empirical analysis also calls into question the degree to which geographical regions of small states can be assumed to be regions in economic terms. Bertram (2004, pp.345, 352), for example, provides evidence that the small economies of the Pacific do not form an economic region, and cites similar evidence for geographic regions elsewhere (see also Encontre, 1999, p.265). Eliminating trade barriers, even achieving regulatory harmonisation, will not necessarily eliminate trade transaction costs and forge a large single market in any of the main geographic regions where small economies are concentrated. Substantial transaction costs will persist from remoteness and insularity; aggregating populations yields numbers not only still small in global terms, but also misleadingly implies a single domestic market. On this basis, the World Bank (2002a, pp.7–8) criticises regional integration among Pacific Islands because it will yield a still small 'aggregate' market dispersed over hundreds of islands with extremely high intra-regional transport costs, and virtually identical patterns of economic activity and comparative advantage.

Secondly, regional cooperation is unlikely to alleviate fully the economic costs of vulnerability to natural disasters. Small states are already cooperating to enhance their capacity to provide public goods such as early warning systems, cooperation which could increase to encompass risk pooling (World Bank, 2001, p.13). The degree of risk covariance within regions, however, together with their relatively low income levels throughout, must constrain the potential of regionalism to enhance coping strategies. Moreover, the extremely similar patterns of economic activity and exports within regions of small states suggest that mitigating vulnerability through diversification at a regional level will be problematic. Additionally, the most significant limitations on disaster insurance appear to arise not from inadequate regional cooperation but from weaknesses in global reinsurance markets (see Freeman et al., 2003, p.17; Rasmussen, 2004, p.10; and World Bank, 2001, p.10).

Thirdly, regional government is not a complete solution for governance problems in small states. It offers, and is being used to produce substantial economies of scale in policy development and in negotiations with states outside the region (Winters and Martins, 2004a, p.148; Schiff and Andriamananjara, 1998, pp.2, 29; and South Pacific Forum Secretariat, 2001, pp.507–9). However, the dispersion of regional populations among remote insular land areas inhibits the potential for the efficient regional provision of public goods and infrastructure. Additionally, the recruitment problems posed by small populations and skilled labour emigration are mitigated – not eliminated – at the regional level.

This section contends not that regionalism does not offer opportunities for small states to mitigate the costs imposed by their economic size, vulnerability, and governance capacities, but that these opportunities are limited. Small economies' predicaments cannot be eliminated entirely by regional integration, and it is thus mistaken to attribute this predicament to the policy choices of those states.

With the advantages of regionalism qualified, policy prescriptions shift to global integration for small states (World Bank, 2002a, p.10; and Schiff, 2002, p.18), implying that small states' disadvantages arise from their lack of integration into the global economy (see Page and Kleen, 2004, p.43). By any measure of trade exposure, the degree of global integration of small economies is not deficient nor – as the next sections will demonstrate – will more integration necessarily benefit small states facing inherent challenges to their competitiveness. Instead, what small economies require is a more beneficial means of insertion into international markets than they currently experience.

7. Being ill-equipped to benefit from globalisation

The foregoing sections have explored small economies' peculiar disadvantages in their potential to exploit opportunities arising from globalisation. These constraints on their global competitiveness are persistent, to varying degrees, and condition an expectation of small economies' increasing marginalisation in world trade and declining development prospects. This expectation is not radical, with Winters and Martins (2004a, p.2) arguing that, in the absence of mitigating policies by the international community, small economies will become worse off as the world economy globalises. Encontre (1999, p.269) adds that most SIDS are likely to gain 'little benefit' from the process of multilateral trade liberalisation,[5] with UNCTAD's Officer-in-Charge (2004a, p.v) arguing that SIDS' intrinsic disadvantages means they will be 'unable to seize these [globalisation] opportunities unless certain special measures to compensate their disadvantages are granted to them by their development partners'. Grynberg and Razzaque (2003, pp.52–3) demonstrate that small economies are already being marginalised in world trade flows, while Braun et al. (2002) provide evidence of the declining relative economic performance of newly independent states, such as small economies, largely as a result of the associated decline in the size of their secure market access which the existence of sovereignty – even with open trade policies – necessarily implies (see also Hausmann, 2004. Additionally, World Bank (2002b, pp.2–3) data indicate the declining average growth rate of GDP in Pacific Islands since the 1970s, to a point of virtual stagnation.). Bertram (2004, p.344) finds similar evidence for small independent states in the Pacific, as well as for the whole group of SIDS.

This argument is not about the past growth performance of small economies, and their ensuing current levels of per capita income. Nothing in the argument is invalidated by evidence that small economies are not currently the world's lowest per capita income group, or have not suffered the world's lowest growth rates in recent years (see Easterly and Kraay, 2001, pp.97–8 and Page and Kleen, 2004, pp.80–2 in particular, but also Read, 2004, p.368). As the data in Table 3.7 indicate, the recent historical growth performance of small economies has exceeded that of LDCs. Beyond the averages, it is important to recognise that the relatively better performance of some small economies masks the poor growth record and current low per capita income levels of others. In particular, 16 of the 41 small economies considered in this chapter are LDCs (representing one third of LDCs) (note also that of these, UNCTAD (2004b, p.5) regards seven as 'regressing' economies, and a further four as 'slow-growth' economies), and a further two are land-locked developing countries. Briguglio (1995, p.1615) cautions that per capita income data conceal the reality of small economies' threatened economic viability, and Read (2004, p.365) argues that, 'Globalization represents a particularly significant threat to the continued survival of many successful small island states as

Table 3.7. Average annual GDP growth 1990–2000

Country grouping[a]	*GDP growth rate (%)*	*Per capita GDP growth rate (%)*
Small economies[b]	3.6	1.9
All least-developed countries	3.6	1.1
All developing countries	4.8	3.0
Developed market economies	2.4	1.7

[a] The definition of country groupings is given in UNCTAD (2003c: x)
[b] Simple average, excluding Nauru, Palau and Timor-Leste due to missing data
Source: UNCTAD (2003c) and author's own calculations

independent entities given the greater susceptibility of their economies to changes in the international system'. However, relatively good past economic performance has led some analysts to argue that it is difficult for small economies to 'make a development case' for special and differential treatment (Page and Kleen, 2004, p.82). As Winters and Martins (2004a, p.1) argue, that reasoning is invalid because it is based on historical data only:

> ...ignoring the question of [whether] small countries are likely to be able to respond to the changes brought about by globalisation and the ability of small countries to respond to present and future changes in the global trading system. For small states the policy issue is not past performance but rather whether they are well positioned, given the globalisation of trade, to capitalise and achieve growth rates similar to those achieved in the past.

The validity of a future expectation cannot not be judged on the basis of historical data.

This historical economic performance of small economies occurred in the context of their particular mode of insertion into specific market structures in the global economy in that period. By contrast, expectations about future economic performance must account for recent and imminent changes in the global economy and multilateral trading system, altering both that mode of insertion and the structures of particular markets of interest to small economies. A relevant global economic change, for example, is the declining real value of aid and declining share of it accruing to small economies typically heavily reliant on it. A relevant change within the multilateral trading system would exist if, for example, the selection of markets being liberalised and distortions dismantled were detrimental to the export competitiveness of small economies. Analysts have typically assumed that there must exist advantages of small size – asserting greater social cohesion, bureaucratic flexibility, less popular resistance to change, greater solidarity, fewer vested interests, a disproportionately strong international voice, and freedom from interference by major powers (Streeten, 1993, pp.199–200; Srinivasan, 1986, pp.211, 214; WTO, 2002, p.11; and Armstrong and Read, 2002, p.8) – sufficient to offset small economies' lack of international competitiveness. These advantages, if they exist, need have had no such strong offsetting effects on competitiveness if, instead, the relatively good average growth performance of small economies has arisen from their historically favourable means of insertion in the global economy.

8. Being vulnerable to harm from globalisation

Thus far, this chapter has explored why small economies are poorly positioned to exploit the opportunities emerging from globalisation. Equally critical is the threat that further globalisation of markets according to currently agreed multilateral trade rules will damage the economic welfare of small economies. Underpinning this threat is the dependence of most small states on trade preferences for the feasibility of their key exports to major markets in developed countries (Grynberg, 2001a, pp.274–9). Tariff preferences are already eroding as a consequence of multilateral trade liberalisation and the proliferation of free trade agreements (Schiff, 2002, p.14). In compliance with WTO dispute rulings, small economies also face the imminent modification or dismantling of especially favourable subsidy preference schemes for their commodities.[6] This section will show how preferential access to markets in developed countries has been vital to the economic performance of small states, how vulnerable these states are to preference erosion, and the gravity of the economic consequences of their loss of preferences.

Small economies enjoy a considerable degree of preferential access to the markets of their former colonial and major regional powers, particularly for the tropical commodities that colonial rule structured as their comparative advantages. Small economies' access to preferential arrangements is summarised in Table 3.8.[7] The value of these preferences to small economies has been substantial, flowing through terms-of-trade gains, greater export values and volumes, higher GDP, greater employment (especially in rural areas), a degree of stability in 'farm gate' prices, higher household incomes, and increased government revenue.[8] Reviewing the literature on the impact of preferences, Alexandraki and Lankes (2004, pp.6–7) argue that preferences have enhanced market access relative to the counter-factual of no preferences, encouraged export-driven economic development, and provided valuable transfers to small economies. UNCTAD (2003a, p.7) argues that preferential margins have been sufficient to compensate for the inherent lack of competitiveness of the exports of small – in particular island – economies. Alexandraki and Lankes (2004, p.24) calculate that, among non-LDC developing countries, 11 of the 12 states receiving the highest total preference margins for their exports are small economies (note also that small economies are among the LDCs facing the highest losses from preference erosion, according to Subramanian, 2003, p.12; see also Tangermann, 2000, p.16). These data dispel assumptions that middle-income status alone is sufficient to avert the problems of adjusting to liberalising markets. The findings, reproduced in Table 3.9, indicate clearly the size and importance of trade preferences, with preference margins adding a quarter or more to the value of exports for the top six of these small economies. For sugar, for example, small economies account for nearly 93 per cent of the total ACP sugar quota volume in the EU market, and hold another tenth of that volume again from US sugar quotas (author's own calculations based on data in Mitchell, 2004, pp.31, 39).

Table 3.8 The major preferential trade arrangements of small economies

	EU		*US*			*Canada*		*Japan*	*Australia & New Zealand*
Small economy by region	*Cotonou*	*EBA*	*CBI*	AGOA	GSP-LDC	CARIBCAN	GSP LDC	GSP LDC	SPARTECA
Africa									
Botswana	☑			☑					
Cape Verde	☑	☑		☑	☑		☑	☑	
Comoros	☑	☑			☑		☑		
Djibouti	☑	☑		☑	☑		☑		
Equatorial Guinea	☑	☑			☑		☑	☑	
Gabon	☑			☑					
Gambia	☑	☑		☑	☑		☑	☑	
Guinea-Bissau	☑	☑		☑	☑		☑	☑	
Lesotho	☑	☑		☑	☑		☑	☑	
Mauritius	☑			☑					
Namibia	☑			☑					
São Tomé and Principe	☑	☑		☑	☑		☑	☑	
Seychelles	☑			☑					
Swaziland	☑			☑					
Asia									
Bhutan		☑			☑		☑	☑	
Maldives		☑					☑	☑	
Timor-Leste									
Caribbean and Latin America									
Antigua and Barbuda	☑		☑			☑			
Barbados	☑		☑			☑			
Belize	☑		☑			☑			
Dominica	☑		☑			☑			
Grenada	☑		☑			☑			

	EU		*US*			*Canada*		*Japan*	*Australia & New Zealand*
Small economy by region	*Cotonou*	*EBA*	*CBI*	*AGOA*	*GSP-LDC*	*CARIBCAN*	*GSP LDC*	*GSP LDC*	*SPARTECA*
Guyana	☑		☑			☑			
Jamaica	☑		☑			☑			
St. Kitts and Nevis	☑		☑			☑			
St. Lucia	☑		☑			☑			
St. Vincent and the Grenadines	☑		☑			☑			
Suriname	☑								
Trinidad and Tobago	☑		☑			☑			
Pacific									
Fiji	☑								☑
Kiribati	☑	☑			☑		☑	☑	☑
Marshall Islands	☑								☑
Federated States of Micronesia	☑								☑
Nauru	☑								☑
Palau	☑								
Papua New Guinea	☑								☑
Samoa	☑	☑			☑		☑	☑	☑
Solomon Islands	☑	☑					☑	☑	☑
Tonga	☑								☑
Tuvalu	☑	☑			☑		☑	☑	☑
Vanuatu	☑	☑			☑		☑	☑	☑

Source: EC (2004a), EC (2004b), USTR (2004a), USTR (2004b), USTR (2004c), Trade Point (2005), Government of Canada (2002), Ministry of Foreign Affairs (2004) and Pacific Islands Forum Secretariat (1998)

Small economies' extreme vulnerability to significant economic damage from the loss of preferences arises from the highly preference-dependent structure of their exports and production. This dependence is characterised by the concentration of their exports in a very small number of commodities, the directing of those commodities to a limited range of markets, costs of production that market – rather than preferential – prices would not cover, and a lack of competitiveness in entering alternative productive activities and export markets (UNCTAD (2003a, p.7) argues that these trade patterns for SIDS are similar to those of LDCs). Thus Alexandraki and Lankes (2004, pp.5-6, 11) conclude that preference erosion is a significant source of vulnerability for countries with deep preferential access to major developed-country markets, an undiversified export base concentrated in commodities enjoying preferential access, and high export concentration in those markets where preferences are set to decline. Exemplifying export concentrations, preferential beef exports account for 98 per cent of Botswana's agricultural exports to the EU, with equivalent figures of 97 per cent for bananas from St. Vincent and the Grenadines and 83 per cent for sugar from Mauritius (data from Tangermann (2000, p.10); see also Mitchell (2004, p.19) for data on sugar export concentration).

The economic damage that will ensue for small economies that lose their historically vital preferential access to major markets is estimated to be substantial. Alexandraki

Table 3.9. Preference margins by product for most vulnerable middle-income countries

Country	*Total preference margin*	*Percentage of preference margin accounted for by preferences for:*			
		Sugar	*Bananas*	*Garments*[a]	*Other*
Mauritius	39.9	84	0	13	3
St. Lucia	32.9	0	94	2	4
Belize	29.3	47	23	0	30
St. Kitts and Nevis	28.7	94	0	0	6
Guyana	24.2	95	0	1	4
Fiji	24.1	96	0	1	2[b]
Dominica	15.9	0	97	0	3
Seychelles	12.2	0	0	0	100
Jamaica	9.7	67	8	7	18
St. Vincent and the Grenadines	9.4	0	89	0	11
Albania	8.9	0	0	48	52
Swaziland	8.2	97	0	1	2
Middle-income countries[c]	4.9	42	19	12	27

[a] Garments includes textiles and clothing

[b] Discrepancy in original source

[c] Average for 76 middle-income developing countries, weighted by margin

Source: Alexandraki and Lankes (2004, p.24) and Lankes (2004, p.25) estimate that 11 of the 12 worst affected middle-income developing countries will be small economies, with estimated losses shown in Table 10. Sugar and banana preferences are the main source of vulnerability.[9] For a 40 per cent reduction in preference margins, losses of a fifth to nearly a quarter of total exports are estimated for the most vulnerable small economies, as depicted in Figure 3.3 (assuming a supply elasticity of 1.5). Even with a zero supply elasticity, the losses from a 40 per cent reduction in preference margins as a share of exports, GDP and government revenue, are substantial for these small economies (see Table 3.10).[10] Guyana stands to lose the equivalent of over 5 per cent of GDP, Mauritius nearly 25 per cent of government revenue. Overall Alexandraki and Lankes (2004, pp.8, 26) argue that preference erosion is most acute for SIDS, and that aggregate losses are several times larger for middle-income developing countries than for LDCs. Among LDCs, Subramanian (2003, pp.9–10, 13–4) makes similar findings: small economies are among those with the highest preference dependence, poised to lose most from preference erosion.

In light of the above, it is clear that multilateral trade liberalisation in agriculture will not necessarily make small economies better off. They are significant beneficiaries of current market distortions, will suffer absolute welfare losses when these distortions are dismantled, and have little potential to diversify into economic activities in which

Table 3.10. Macroeconomic losses from preference erosion in most vulnerable middle-income countries.

Country	*Loss as a % of Goods Exports*			*Losses Assuming Zero Supply Elasticity (e=0)*			
	e=1.5	*e=1.0*	*e=1.0*	*Absolute ($US millions)*	*% of Goods & Services Exports*	*% of GDP*	*% of Government Revenue*
Mauritius	-23.7	-19.6	-11.5	-201	-7.2	-4.4	-24.4
St. Lucia	-20.9	-17.2	-9.8	-4	-1.1	--0.6	-1.9
Belize	-19.6	-16.1	-9.1	-18	-4.1	-2.1	-8.0
St. Kitts and Nevis	-19.3	-15.9	-8.9	-3	-1.8	-0.8	-1.9
Guyana	-17.3	-14.2	-7.9	-41	-6.2	-5.8	-17.7
Fiji	-17.2	-14.0	-7.8	-41	-3.8	-2.2	-9.1
Dominica	-12.6	-10.2	-5.5	-2	-1.9	-0.9	-2.3
Seychelles	-9.5	-7.7	-4.2	-10	-1.9	-1.6	-3.7
Jamaica	-8.4	-6.8	-3.5	-46	-1.4	-0.6	-2.2
St. Vincent and the Grenadines	-8.2	-6.6	-3.4	-5	-2.7	-1.3	-4.3
Albania	-7.7	-6.3	-3.3	-10	-1.2	-0.2	-1.0
Swaziland	-7.2	-5.8	-3.0	-21	-1.8	-16.	-5.8

Source: Alexandraki and Lankes (2004: 25-6)

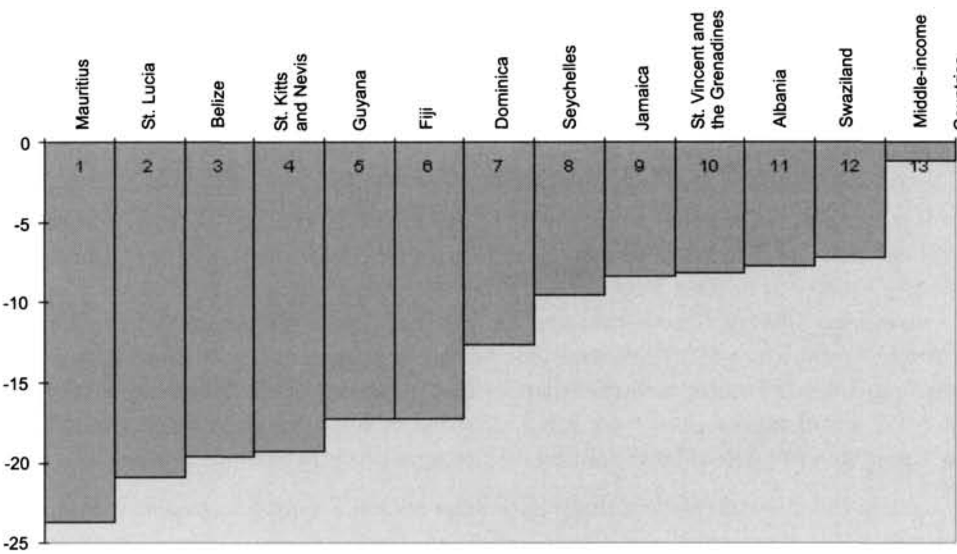

Figure 3.3. Losses from preference erosion as a percentage of merchandise exports

Source: Alexandraki and Lankes (2004, p.25)

their exports will be competitive (see Grynberg and Razzaque (2003, p.52) on the absolute welfare loss to preference dependent states caused by the Uruguay Round; and Mattoo and Subramanian (2004, p.3) for a discussion of the ambivalence of small states to further trade liberalisation). UNCTAD (2003a, pp.16–18, 32) demonstrates that under all feasible scenarios for agricultural liberalisation in the Doha Round, SIDS will suffer absolute welfare losses. Of these, Mauritius, Jamaica and Fiji will suffer the largest losses. Only if general agricultural liberalisation is augmented by providing SIDS with tariff-free access for *all* of their commodity exports to *all* major developed-country markets will they be better off.

The foregoing does not preclude the validity of findings that preference schemes, particularly interventions in EU and US commodity markets related to subsidy preferences, are grossly market distorting and enormously wasteful to operate (see Mitchell, 2004, p.18; Borrell, 1999, p.8; and Oxfam, 2004, p.1). For recipients, such schemes may impose a significant administrative burden (see Panagariya, 2002, pp.1429–30; and Keck and Low, 2004, pp.11–12), impede the efficient allocation of productive resources (Subramanian, 2003, p.2; Page and Kleen, 2004, p.26; and Levantis et al., 2003, p.1), and act as a disincentive to trade liberalisation, including through recipients' reluctance to participate in reciprocal trade negotiations (see Ozden and Reinhardt, 2003, pp.20–21; Panagariya, 2002, p.1416; Keck and Low, 2004, pp.13–14; Alexandraki and Lankes, 2004, p.5; Kennes, 2000, p.99; and Brock and McGee, 2004, p.15). Their persistence may well be driven more by the vested interests of producers, processors and distributors in developed countries, than by the trade interests of declared recipients (see Watkins, 2004, pp.20–5; Subramanian, 2003, p.2; Borrell, 1999, pp.13, 19; Ozden and Sharma, 2004, p.12; and Anderson, 2004, p.6). Furthermore, preferences may have benefited their donors by reducing developing country pressure to free markets in their export interests (see Watkins, 2004, p.41; Panagariya, 2002, p.1430; Page and Kleen, 2004, p.41; Levantis et al., 2003, p.1; and Subramanian, 2003, p.2). That their existence is lamented does not mean that removing preferential schemes will be any less damaging to small economies, however (Levantis et al. (2003, p.2) make a similar argument). Simply because preference dependent states are few and would lose only a fraction of what global welfare would gain from liberalisation (see Mitchell, 2004, pp.26–7; and Panagariya, 2002, p.1426) does not make that loss any less detrimental to the development prospects of small economies.

For preference-dependent states, the alternative policy to pursuing extended preferences is 'adjustment', a term implying that there exists an alternative sustainable development path. Yet, for the reasons outlined earlier, small economies may lack both the potential for competitiveness in exports historically benefiting from preferences and the robust macroeconomic situations to absorb the impact of collapsing industries (see Alexandraki and Lankes (2004, p.5) on factors affecting states' capacities to manage preference losses). Small economies also face significant competitiveness constraints in entering new economic activities and non-preferential markets, arising from combinations of characteristics associated with their small size, vulnerability to external economic shocks and natural disasters, and governance capacity (UNCTAD (2003b, p.20), for example, demonstrates this predicament with respect to the Windward Islands). Certainly, preferences have encouraged small economies to maintain industries which are inefficient by best-practice standards, thus inhibiting their incentives to shift to patterns of production and trade that are sustainable in the absence of preferences (Page and Kleen, 2004, p.28). This chapter argues that, at least in the near future, the feasibility of alternative employments for these production resources should not be assumed automatically.

Salmon (2002, p.11) offers a necessary caution against the kind of reasoning that consists in affirming after the fact that providing preferences was not legitimate for small economies since they have performed well, when their good performance has arisen precisely from those preferences. Small economies have benefited substantially from preferential access to subsidised markets in the developed world, yet their economies are now precariously positioned as these market-distorting subsidies are reduced and non-LDC small economies are set to lose preferential access (Grynberg, 2001a, p.279). Transfers, equivalent to previous preference rents,[11] need not have equivalent effects if channelled through donors' aid administrations according to their development priorities (Page and Kleen (2004, p.65, 91). For an example of this intention, see EC (2005, p.6). Even direct financial transfers (Alexandraki and Lankes (2004, p.27) argue that targeting such transfers would be straightforward) would not necessarily engender the same macroeconomic outcomes (see, for example, the modelling of different compensation scenarios in Levantis et al., 2003, pp.6–8): what small economies lose with preferences is the feasibility of engaging in productive export activities at remunerative prices, with concomitant gains in foreign exchange, employment, and stability of trade and transport patterns. Adequate compensation would therefore involve funding the economic transition to equivalently remunerative export industries, including possibly persistent subsidies to make comparative advantages operational in the near future. A more palatable alternative to donors, discussed earlier, might be the extension of tariff-free access for all exports from all small economies into all developed-country markets. Otherwise, globalisation along the lines of currently agreed multilateral trade rules will make small economies worse off, making a strong development case for more favourable treatment for small economies.

9. Small economies' predicament as a trade concern

At the core of the present economic predicament of small economies is trade: small economies rely on trade to enhance their development prospects beyond the constraints of small size, yet face severe limitations on their potential for competitiveness in world markets. Moreover, their predicament is a relevant concern for trade negotiations; a failure to address it is a threat to the legitimacy of the multilateral trade regime (Grynberg, 2001a, p.305; and Keck and Low, 2004, p.8; Grynberg, 2001a, p.305; and Keck and Low, 2004, p.8). This is not to say that appropriate modifications of trade agreements will be sufficient to alleviate small economies' development problems, nor that other international forums and organisations will not prove vital to this effort (Page and Kleen, 2004, p.70; and Grynberg, 2001b, p.339). The UNCTAD, World Bank, IMF and Commonwealth Secretariat, as well as bilateral and NGO donors, can, and in many cases already are, playing critical roles (see, for example, UNCTAD, 2004a; World Bank, 2003; IMF, 2003; and Commonwealth Secretariat, 2003). But this does not make multilateral, regional and bilateral trade negotiations any less relevant to the predicament of small economies.[12]

Four specific avenues through which current trade negotiations affect the development prospects of small economies are noteworthy here. First, agreed and impending multilateral trade rules threaten to erode or dismantle the preferential access on the basis of which small economies have participated successfully in world markets in the past. Secondly, the selective liberalisation of global markets under multilateral rules omits markets of particular relevance to small economies, notably semi- and un-skilled labour services. Thirdly, elements of agreed multilateral trade rules constrain the policy space available to small states – or the international community – to improve their development prospects. Examples include proscriptions preventing small states – whether from their own resources or international assistance – from offering investment incentives to export industries (see English and de Wulf, 2002, pp.164–9; and Grynberg, 2001a, pp.272, 298) or subsidising transport services. Fourthly, small states are especially disadvantaged in their capacity to challenge the abuse of trade rules by other states; accommodating this weakness in the redesign of rules and the allocation of technical assistance could prove valuable.[13]

Given the importance of trade regimes to the development prospects of small economies, it is often asserted that small economies should embrace multilateral trade rules with greater vigour (see Burki, 2001, pp.9–10; Kennes, 2000, p.9; and World Bank, 2002a, p.3). Such arguments conflate free trade with currently agreed multilateral trade rules. The integration of small economies into an idealised global free market is very different from the insertion of small economies into world markets on the terms of currently agreed trade rules. Emerging from a process of interstate negotiation and bargaining, trade rules are widely recognised as being biased in favour of the economic interests of major powers (see Finger and Winters (2002, pp.53–5) on exclusion of the interests of the weak; Ozden and Reinhardt (2003, p.5) and Oyejide (2002, pp.505–6) on the structural biases in GSP schemes, and Freund (2003, pp.5, 23) on biases in trade agreements between unequal powers). Negotiated rules come with no guarantee of being beneficial to the welfare of any one participant. When small economies 'integrate into the global economy' by becoming subject to multilateral trade rules, the markets of export interest to them and into which they are inserted are not necessarily those that are free, nor will their participation in negotiations necessarily change that (see Ozden and Reinhardt (2003, p.3) for the opposite assumption of effective bargaining power). Thus, for example, small economies are bound by intellectual property rules defined by developed countries in the WTO (see Subramanian, 2003, pp.169–72), but their semi- and un-skilled labour cannot move freely into industrialised markets (Chanda, 2002, p.307). In a later section, this chapter will address the suggestion that the value to small economies of multilateral rules *per se* overrides whatever terms those rules might contain (Page and Kleen, 2004, p.82. See also Armstrong and Read (2002, p.11) for a discussion of small states and trade rules as public goods).

10. The feasibility of favourable treatment for small economies

This chapter has brought together evidence that small economies face substantial challenges to competitive participation in world markets, in support of the contention that the trade of small economies requires more favourable treatment if they are to avoid the imminent prospect of marginalisation (Grynberg and Razzaque, 2003, p.1). This section will argue that such favourable treatment is feasible, and furthermore that it would impose a negligible financial cost on the international community. The only significant cost would be ideological; as Winters and Martins (2004a, p.149) argue, attaining the favourable treatment that small economies require would necessitate '...conscious policy-shifts in the major capitals'.

If small economies were to be accorded duty- and quota-free access for all of their exports in major markets (see Hoekman et al., 2003, pp.10, 19) for equity arguments in support of this inclusion; see also Mattoo and Subramanian, 2004), derogations from WTO rules would be required. It is the current WTO-incompatibility of this necessary discrimination among developing countries that has enabled larger or more competitive developing countries to challenge successfully the existing preferences accorded to small economies. (Successful challenges that some developed countries are using as levers to direct small states into reciprocal trade agreements in order to preserve something of their current preferential access.) The life of tariff preferences is of course finite, their value eroding with multilateral liberalisation, but even finite preferences would provide small economies with a necessary reprieve. WTO rules could also be adjusted to benefit small economies in areas such as the feasibility of their access to and retaliatory measures under dispute settlement (Delich, 2002, pp.76–8), the extent of their benefits from technical assistance programmes (Mattoo and Subramanian, 2004, 6), and the achievement of a degree of rule-ordering of their accession processes (on accession, see Grynberg, 2001a, p.307; Grynberg, 2001b, pp.333–4; and Langhammer, 2000).

In addition to tariff-free access for their exports, small economies would benefit from amendments to specific WTO agreements that are unduly prejudicial to their interests (for a broader framework within which these specific suggestions could fit, see ICTSD (2003) or Keck and Low (2004). Exemptions from subsidies disciplines, for example, are necessary to allow state interventions to overcome market failures that are undermining particular trade opportunities for small economies (Davenport, 2001, p.10). Whilst it is not feasible for small economies to use domestic resources to subsidise their way out of their pervasive cost disadvantages, exemptions from subsidies disciplines would also avert the WTO-incompatibility of subsidies for the trade of small economies that are sourced internationally. Alongside free market access for their exports, Winters and Martins (2004a, p.149) argue that such international subsidisation of small economies' trade is one of the few possible policy responses that could sustain small economies' participation in world markets. A second example is that small economies require long transition periods for the implementation of WTO disciplines, the extreme costs and complexity of which are beyond the current resources, capacity and development interests of small states (Hoekman et al. (2003, pp.5, 16) and Finger and Schuler (2002, pp.493, 501); see also Rodrik (2002, p.8–9) and Page and Kleen (2004, p.56). In place of a fixed transition period, compliance could be required only once state institutions and resources – including any forthcoming technical assistance – are sufficient for implementation to be effective. A final example is provided by current fisheries negotiations. It is vital to the interests of small coastal states that derogations prevent new rules from reducing their revenue from fisheries access fees and associated development assistance, impeding their efforts to domesticate their fisheries industries, and disallowing their support to artisanal fisheries activities (for the details of how fisheries negotiations affect small states, see Grynberg (2003, pp.69–72) and also Vossenaar (2004, p.67).

Incorporating specific derogations from particular rules to target the needs of certain categories of states has extensive precedent in the WTO (see Davenport (2001, pp.4–5) and Grynberg (2001a) for examples of such derogations). Without overarching recognition of the special circumstances of small economies such as that provided by the Doha Declaration and Small Economies Work Program (SEWP) (see WTO, 2001, p.7–8; and also Tulloch, 2001), however, it will prove harder for small states to leverage such derogations in specific negotiating groups. And without overarching tariff preferences or international subsidisation of small economies' trade as the foundation of the international response to the trade predicament of small economies, rule derogations will amount to little more than piecemeal concessions lacking the potential to tackle that predicament effectively.

In pursuing the recognition of their interests in multilateral trade negotiations, small economies encounter opposition even at a conceptual level. Non-discrimination and reciprocity are described as the 'pillars' of the WTO (Freund (2003, p.2), which rule derogations for some states are accused of undermining (Ozden and Reinhardt, 2003, p.4).[1] Yet, as Keck and Low (2004, p.3) state, 'The battle to establish the principle that a set of uniform multilateral rights and obligations among a deeply diverse set of nations could not serve the best interests of all parties was won a long time ago'. What appears to be particularly threatening to proponents of the doctrine that trade liberalisation necessarily advantages all, is the prospect of rule derogations for small economies based on the argument that small states otherwise would not benefit from globalisation (see Page and Kleen, 2004, pp.79–80). Apart from conflating current multilateral rules with free trade, this attitude also supposes faith in free trade to be hopelessly fragile if favourable treatment for small economies, explicable and justifiable *within* economic models of comparative advantage, can undermine it. Still, critics argue that special and differential treatment can only be temporary, if 'equal treatment' is to remain a core principle of the WTO (Page and Kleen, 2004, pp. 46, 77), supposedly invalidating the claims of small economies because their small size, remoteness and exposure to natural disasters are permanent. But, favourable treatment of small economies' trade is not expected to alter fixed features like small size, large distances to markets, and frequent natural disasters (for the contrary position, see Page and Kleen, 2004, pp.15, 46, 80). Such features merely act as identifiers of likely candidates for assistance. Instead, more favourable treatment is intended to alleviate the *effects* that combinations of the characteristics of small economies have on their trade competitiveness. These effects are persistent, but aspects of them may reduce in intensity in the medium term in specific cases, for example if transport costs decline significantly, or if complete and competitive disaster insurance markets develop.

It has been suggested that special and differential treatment, in as far as it detracts from the systemic value of consistent rules, injures the interests of weak participants like small states in the multilateral trade regime (see Page and Kleen, 2004, pp.7–8, 81). However, one cannot extrapolate from the idea that international rules are a public good the argument that small administrations can gain particular benefit from implementing them, without accounting for the cost that complex and often inappropriate disciplines impose. The systemic value of the trade regime to all members could reasonably be expected to be sufficient to absorb the negligible cost of rule derogations for a group of states accounting in aggregate for only a fraction of 1 per cent of world trade (see Grynberg and Razzaque, 2003, p.11). If the rules are inappropriate for small economies, negotiating derogations within the framework of the trade regime supports their interests. The marginal nature of small economies in the world trading system makes incredible claims that more favourable treatment of them would impose significant financial costs on others (see Breckenridge, 2002, p.11). UNCTAD (2003a, p.19) demonstrates for agriculture that free access for the exports of SIDS would have virtually no effect on the welfare of other developing countries; Winters and Martins (2004a, p.150) argue that the costs to the international community of subsidising all exports from small states would be 'perfectly manageable' (see also Davenport, 2001, pp.1, 17–8; and

Stevens, 2002, pp.25–6). The cost to the legitimacy of the international trade regime if it does not adjust to accommodate the trade predicament of small economies may be more substantial, however (Stevens, 2002, p.1; and Drahos, 2004, pp.9–10). The further marginalisation of small economies in world trade will expose the insincerity of the rhetoric of mutually advantageous negotiated trade liberalisation.

11. Small states, negotiating weaknesses

Possessing a good case for favourable treatment in trade negotiations is important, but the value of a good argument arises not of itself but from its contribution to the bargaining power of the states concerned. What weakens small states' prospects of attaining special and differential treatment in multilateral negotiations are their substantial disadvantages in other aspects of bargaining power. Most critically, small economies lack market power, and thus the potential to make credible threats impelling others to negotiate with them (on elements of bargaining power see Drahos, 2004, pp.6–8; and also Mattoo and Subramanian, 2004, p.3). Their intelligence networks, gathering and analysing information about their trade performance and economic interests, also are weak from the extremely constrained research capacities of their bureaucracies and also of the relatively small firms implied by their small market sizes. If market power and intelligence networks are the most important elements of bargaining power, the prospects of small states attaining more favourable trade treatment as a negotiated outcome are bleak.

In an attempt to mitigate this weakness, small states have used their enrolment power to form coalitions among the collection of states that share small, vulnerable or island characteristics. The coalition does not benefit from greater bargaining power through market size, since the aggregated market of members is still insignificant in global terms. But this coalition has used the support of international organisations well, its intelligence networks have been strengthened by the pooling of state and regional administrative resources, and its cohesiveness has strengthened the voice of these states in multilateral negotiations. Cohesion and voice, however, have depended crucially on the inclusion in the coalition of states whose larger populations or economic success lead opponents to question the deservedness of special treatment (Davenport, 2001, p.1; and Hein, 2004, pp.6–7 discuss this point). But these inclusions are vital to the negotiating power of the group. Cohesion depends on including all states perceiving themselves and perceived by the group as small; splitting traditional regions of small states by excluding Papua New Guinea or Jamaica on the basis of population, or Barbados or Trinidad and Tobago on the basis of per capita income, would be extremely costly to group cohesion (see Narlikar, 2003, pp.2, 27–9, 183; including the critical statement: 'Stability of allies is a crucial asset for the weak'). Voice depends on including strong states to lead the group; excluding Mauritius, Jamaica or Barbados on grounds of size or success would cost the group historical leaders, links to information networks in other coalitions, and states with strong economic interests in the Small Economies Work Programme (SEWP) (see Narlikar, 2003, pp.16, 183). If membership were fixed exactly by small population or lower/middle income thresholds, the bargaining power of the coalition would dissipate: critics could be satisfied that no anomalies remained, but equally would no longer have to engage with the group's demands (see Encontre (2004, pp.92, 98) and (Hein, 2004, pp.12–13, 20) for emphasis on the need to strictly define group membership).

This discussion of the negotiating process from which multilateral trade rules emerge should temper suggestions that the continued presence – rather than exit – of small states in the WTO indicates that they must derive a net benefit from its agreements (Page and Kleen, 2004, pp.43, 82). WTO negotiations involve an unrolling of 'consensus', starting with the most powerful economies and progressively incorporating other major players and coalitions until it reaches the periphery – populated by small states – by which time the 'consensus' is a foregone conclusion (see Narlikar, 2003, p.37; Drahos, 2004, pp.11,17; and Brock and McGee, 2004, p.9). Furthermore, the governance capabilities of small states are so constrained that they have little capacity even to assess the implications for their development prospects of the many alternative proposals coming forward. Thus, for small states in multilateral negotiations, concepts like informed choice and cost-benefit analysis are somewhat irrelevant (on this point see Drahos, 2004, pp.4–10; and also Finger and Winters, 2002, p.55). To a limited extent, it is appropriate to characterise international trade rules – for example, liberalisation commitments – as public goods negotiated with the resources of major powers and upon which small states can free ride (Armstrong and Read, 2002, pp.15–6; see also Page and Kleen, 2004, p.82; and Narlikar, 2003, p.37). It is equally feasible, however, that rules determined in the absence of input from small states will prove adverse to their interests, with an alternative characterisation of the process being of small states getting damaged in the cross-fire of negotiations between major powers (Grynberg, 2001b, p.334; Grynberg, 2003, p.70; and Watkins, 2004, pp.16–17).

12. Conclusion

This chapter has presented evidence that the globalisation of markets under existing and emerging multilateral trade rules will damage the trade and development interests of small economies. Arresting their further marginalisation in world trade is not a simple matter of domestic economic 'adjustment' towards productive activities and trade patterns that are sustainable in globalised markets. Instead, characteristics of small economies, centring around their size, vulnerability and governance capacity, combine to yield significant cost disadvantages large enough to undermine substantially these states' capacities to participate in trade on a remunerative basis, even in areas of comparative advantage. Where small economies cannot obtain premium prices for their products abroad, their exports will struggle to be feasible. Any diminished trading success will only compound the deleterious effects of small size on their economic welfare, with increasing marginalisation in world trade being the last thing that small economies can afford.

This chapter has also shown that preferential access to major developed country markets has contributed to the relatively good historical income and growth performances of small economies, preferences that are now being eroded or dismantled. As Armstrong and Read (2002, p.19) conclude, 'Strict adherence to axiomatic multilateralism and the creation of a level playing-field for international trade is therefore likely to deprive small states of many niche opportunities by removing marginal but critically important sources of protection which contribute to their growth success'. At the same time, the significant challenges to their competitiveness posed by their small size, vulnerability and constrained governance make it extremely difficult for small economies to take advantage of new opportunities emerging from the globalisation of markets.

At the current juncture of international trade negotiations, small economies are precariously positioned: certain to lose from the greater liberalisation of markets for their key exports, they lack the bargaining power to achieve more favourable treatment and greater trade-related assistance that might forestall otherwise disquieting economic prospects in the near future. Among the necessary international responses, multilateral trade rules can be adjusted to accommodate the concerns of small economies, but whether major powers will be willing to negotiate this adjustment, and thereby support the legitimacy of the international trade regime, is less certain.

Notes

1. This chapter does not aim to address the appropriate delineation of small economies; such discussions can be found in Davenport (2001, pp.1–2), Atkins et al. (2000, p.4), Hein (2004), Read (1999, pp.2–5) and Encontre (2004). The list in Table 3.1 is of independent developing states with populations under the standard threshold of 1.5 million, excluding those with GNI per capita above US$9,386 ('high income' in World Bank terminology), but including those above the population threshold identified by the Commonwealth Secretariat as exhibiting similar 'small' characteristics (Botswana, Jamaica, Lesotho, Namibia and Papua New Guinea).
2. Easterly and Kraay (2001: 102-8) argue that the negative effect of volatility on growth in small states is offset by the positive effect of their openness to trade on growth, which appears to lead Page and Kleen (2004: 81) to infer that volatility itself does not matter.
3. See Page and Kleen (2004, p.79), whose argument to that effect appears to be based on Encontre (1999, pp.263–4). The latter compares average growth rates with natural disaster incidences in SIDS over two decades, without engaging in statistical analysis to hold other factors constant, to observe only that both high- and low-growth performers experience both high and low disaster incidences.
4. See Freeman et al. (2003, p.11), Charveriat (2000, p.1), ECLAC and IDB (2000, pp.12-6), Benson et al. (2001, p.92) and Auffret (2003, p.28). Benson and Clay (2003, p.76) state, 'Disasters, especially when these reoccur frequently, appear to have longer-term consequences for economic growth, development, and poverty reduction'. Similarly Freeman (2003, p.11) argues, 'The macroeconomic and developmental implications of natural disaster[s] can be both large and long lasting'.
5. The other exception he notes is any SIDS that are able to enhance the global competitiveness of their merchandise exports, which the earlier cited evidence regarding business costs in small economies would appear to make unlikely.

6. See Oxfam (2004, pp.2–3) on WTO disputes and the EU sugar regime, Mitchell (2004, pp.34, 38) on catalysts for change in the US sugar regime, and Laurent (forthcoming, pp.2–9) on WTO disputes and the EU banana regime. Note this chapter will use 'tariff preferences' to refer to preference schemes based on simple tariff concessions, and 'subsidy preferences' to refer to preference schemes based on tariff-free quota access to subsidised markets abroad.
7. See Panagariya (2002, pp.1419–21) on ACP–EU schemes, and Ozden and Sharma (2004, pp.5–6) for an overview of the CBI. Note that in the absence of specific preferential schemes, non-LDC small economies must rely on Generalised System of Preferences (GSP) schemes. The smaller preferential margins available under GSP than under ACP–EU arrangements, for example, is suggested by Tangermann (2000, p.21). See also Grynberg (2001a, p.279).
8. See UNCTAD (2003a, p.18) on the substantial benefits; Ozden and Sharma (2004, p.12) on accruing preference rents; Subramanian (2003, p.2) on terms-of-trade and export gains; Armstrong and Read (2002, p.8) on export multiplier effects; Choraria (2004, p.13–14) for value-chain analyses, Laurent (forthcoming, p.13) and Melville (2003, p.105) on rural multiplier and development effects; and Romalis (2003, pp.10–12) for discussion of the large, significant growth benefits of preferential access.
9. To what extent this vulnerability might be mitigated in the short term by Economic Partnership Agreements, if these preserve aspects of current preferential arrangements (Schiff (2002, pp.15–17), is yet to be seen; but preferential prices will anyway fall as EU reforms to the relevant parts of the Common Agricultural Policy (CAP) commence.
10. Note also that these findings exclude the effects of preference erosion in minor ACP–EU schemes (beef, veal and rum), and in markets outside Canada, the EU, Japan and the US. Thus, the results miss the impact of eroding Australian and New Zealand preferences on Pacific Islands, and the impact of the withdrawal of Multi-Fibre Agreement (MFA) quotas on small economies (Alexandraki and Lankes (2004, pp.6, 10, 18)). Ozden and Sharma (2004, p.3), for example, find that the withdrawal of MFA quotas would be the equivalent of virtually eliminating the benefits of the CBI to garments industries in the Caribbean.
11. These are advocated because they make explicit the aid transfer to recipients previously occurring through preferences, without imposing the global welfare losses of the market interventions underpinning those preferences. See Mitchell (2004, p.27), Borrell (1999, pp.8, 17), Page and Kleen (2004, pp.11, 14, 16, 63), Fowler and Fokker (2004, pp.34–5) and Kennes (2000, p.103).
12. It is, for example, mistaken to argue as Page and Kleen (2004, p.43) do that because trade does not necessarily lead to development, the readjustment of trade rules is not necessarily relevant to the promotion of development.
13. See Wilson (2002, pp.428–31) on non-tariff barriers to trade; and Davenport (2001, p.10) on the importance of protecting small states from anti-dumping and countervailing measures. Protecting small economies from parallel trade-related abuses is also important: see, for example, the OECD's 'Harmful Tax Initiative' which incorporates a protectionist intent in its 'unfair' tax competition provisions, threatening the viability of financial services industries with demonstrated probity in small economies (see Grynberg et al. (2003, pp.2–6, 10–12, 19–23), Armstrong and Read (2002, p.21) and Read (2004, p.371)).

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1 Ozden and Reinhardt (2003: 4).

1 Based on data in UNCTAD (2003c); see also Grynberg (2001b: 330) and Briguglio (1995: 1622), and Collier and Dollar (2001: 23) on higher per capita aid receipts in small states than in large.