Pacific Institute of Public Policy

Small can be beautiful: The particular needs of micro states in trade policy

Key messages:

- Washington Consensus-type models largely ignore the diseconomies of scale, distance, geographical fragmentation and vulnerability faced by micro states.
- Recognising that aid spending has a big macroeconomic effect would help focus policies in more useful areas.
- With an increased focus on international trade agreements, domestic trade policy is often forgotten; yet building up the ability of companies to produce for foreign markets is critically important.
- Technical assistance should be more focused.
- Efforts to build productive capacity should focus on equity, infrastructure, disaster insurance and reducing the effects of distance.
- Understanding national and regional specifics requires maintaining policy space in trade agreements; acknowledging the limits of negotiating capacity; encouraging national trade facilitation; and understanding the detailed demands of each country in negotiations.

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Tiny states have for too long been forced to adopt one-size-fits-all trade models. A new way of looking at small economies, tailored to their specific needs, should recognise that aid spending can have a major macroeconomic impact and that markets often fail. Trade policies should take into account diseconomies of scale, distance, geographical fragmentation and vulnerability.

Measuring up – what makes a micro state special?

Academics have proposed various definitions of what makes an economy small, including population; gross domestic product (GDP); per capita GDP; or some combination. Such definitions have their drawbacks: countries with tiny populations can be rich – such as Luxembourg. Countries can be small but not particularly vulnerable – like Ireland. Countries can have a low per capita GDP but a lot of people, as in many sub-Saharan African states.

The Pacific Island Countries Trade Agreement (PICTA) introduces a sub-category of smallness, defining six member countries[1] with populations of less than 100,000 as 'small island states'. But from a global perspective, all the Pacific island states are tiny except Papua New Guinea (PNG) and Fiji. Perhaps the most widely-accepted global definition of micro states is those countries with a population of less than one million, of which there are around 56 including all the Pacific island countries except PNG.

The theory behind the global standard reform model, the Washington Consensus,[2] is highly developed, but largely ignores the diseconomies of scale, distance, geographical fragmentation and vulnerability faced by micro states

In the absence of a new theoretical perspectives such international templates will continue to be foisted upon the Pacific islands (and other countries) – especially with the onset of a host of new trade negotiations.

Until the islands have credible alternatives they will find it difficult to articulate their concerns. A new perspective isn't going to emerge overnight. But it is possible to identify some characteristics of small, developing economies especially with regards to trade (see for example Grynberg and Remy, 2004). It makes sense to try and identify what sort of ideas might be used to analyse them.

1. Currently PICTA defines Cook Islands, Kiribati, Nauru, Niue, Republic of Marshall Islands, and Tuvalu as small island states (SIS).

2. John Williamson coined the term 'Washington Consensus' with the ten key features being: fiscal discipline; redirection of public expenditure priorities toward productive sectors (like primary health care, primary education, and infrastructure); tax reform; Interest rate liberalisation; competitive exchange rate; trade liberalisation; liberalisation of inflows of foreign direct investment; privatisation; deregulation; and secure property rights (see John Williamson, 2000).

Standard models don't work in micro states

Washington Consensus-type models are particularly inappropriate for the kind of small economies found in the Pacific. Most governments are short of cash. Trade liberalisation simply raises administrative costs as Ministries of Finance search for ways to replace tax revenue. The classical argument for trade liberalisation is that barriers should be reduced so that countries can specialise in their area of comparative advantage and trade with each other. Along this line of thinking every country has a speciality – it simply has to seize the chance to fulfil it. This is a potent idea, often misunderstood.

But 'getting the prices right' by reducing distortions like taxes and subsidies doesn't necessarily make economies function efficiently. Comparative advantage is not enough: tiny countries will never overcome the fixed costs of doing business that come from diseconomies of scale and distance. Fijian clothing manufacturers, which could draw on a workforce of a few thousand, were never going to achieve the same efficiencies as China's millions.

Distance and diseconomies are often compounded by vulnerability. In tiny, fragmented, resource-strapped countries earthquakes and cyclones can have a devastating human and economic impact. Dependence on a few exports can be similarly destabilising. Some regional countries may be riding high on the current global commodity price explosion, but don't bet on things staying that way. A Commonwealth index rates all the Pacific island economies as highly vulnerable.[3] Further, relying on comparative advantage could mean getting stuck at the bottom rung of the ladder. Few Pacific countries would be happy specialising forever in coconuts.

So what does work?

The beauty of smallness is flexibility. A country that never had a large industrial base in the first place has less to lose from adapting to changes in the world economy. In a prescient book entitled *The Adaptive Economy*, Tony Killick (1993) argued that countries with flexible economic structures were likely to develop better over the long term. The openness to international trade that results from being small can mean increased volatility. But high levels of trade can also mean faster growth,[4] Some small island states are rich, notably Singapore and Hong Kong.

The global market presents new opportunities. Demand exists at home and abroad for the kind of things that can be produced by Pacific island economies – tourism, fish and some agricultural products. The challenge is to identify and promote Pacific niche industries, which may include services, that are in demand in the global economy. A further challenge is to produce goods and services in enough quality and consistency of supply to satisfy foreign consumers. Government or donor intervention can help solve these 'supply-side' difficulties.

According to Keynesian[5] economics, the state can stimulate economic growth and improve stability in the private sector. Intervention to promote specific types of production is essential and it needn't take the form of digging holes and refilling them, as Keynes light-heartedly suggested. Jokes about filling in holes may not be so funny, as anyone who has travelled by road in the Papua New Guinea bush can testify. Donor spending on infrastructure can help make production more efficient. In addition improvements to information flows can correct asymmetries between buyers and sellers. Seed projects aimed at establishing non-traditional agricultural activities can have a powerful effect: copying by local producers leads to self-sustaining industries.[6] Enhanced trade facilitation can help producers import the things they need and export successfully.

Governments usually find it hard to 'pick winners', yet in a tiny economy it may be easier than elsewhere to target specific activities. Plenty of industries can be ruled out – such as any manufacturing that requires large domestic economies of scale. But many of the islands should, for example, be prioritising niche tourism. Tourism and other exports help overcome diseconomies of scale, since they rely on larger overseas markets. Governments need to retain the tools to promote these areas, such as carefully-chosen tax breaks for the things the industries need. Market forces alone won't do the job.

Generally, import substitution doesn't work in small economies because of the small size of the domestic market. Yet in some areas it can succeed. It seems ridiculous that so many Pacific islanders eat tinned fish. Moreover, the current rise in global commodity and fuel prices makes domestic production more lucrative, and we are seeing some Pacific countries experimenting with locally-grown biofuels.

Getting the policies right

A key issue for Pacific countries is that their key trading partners are also their key aid donors. Little wonder then that intentions of donors promoting trade liberalisation have often been viewed with suspicion. Aid constitutes a huge percentage of Pacific economies. In 2004 the Solomon Islands received aid to the value of over 50% of its GDP; Kiribati, Marshall Islands, Federated States of Micronesia, Palau, Nauru and Tuvalu all received levels of

3. Atkins, J. P., S. A. Mazzi, and C. D. Easter (2000) 'Commonwealth Vulnerability Index for Developing Countries: The Position of Small States', Economic Paper No. 40, Commonwealth Secretariat, London.

4. Easterley, W. and A. Kraay (2000) 'Small States: Small Problems?', World Development, 28(11)

5. Based on the ideas of twentieth-century economist John Maynard Keynes

6. More detail on some of these ideas can be found in Rodrik, D. (2007) *One Economics, Many Recipes*, Princeton, Princeton University Press: 99-119

aid in excess of 25% of their GDP.[7]

The island economies are so tiny that aid can cause a major macroeconomic jolt.[8] The only reason why Vanuatu's economy grew at all in the years after reform was that US$20 million in foreign-currency loans suddenly landed in the economy – an amount worth half of annual government spending and nearly a tenth of GDP[9]. The celebrated economist Milton Friedman referred to sudden cash dumps as helicopter drops. In the Pacific, the impact of donor spending can be more like crashing jets.

Donors and governments should recognise that they will need to start intervening in productive areas to compensate for market failure and to help regional companies add more value. Relying on the magic of the market only works so far. This has a number of implications for trade policy, viz:

Focus on equity

Spreading aid and government spending around each country avoids the macroeconomic boom-bust cycle and brings the poor into the productive economy as consumers and workers.

Build infrastructure

Islanders often want to trade, but getting goods to market is prohibitively expensive. The United States Millennium Challenge Account has shown that wharves, roads and airports can provide a major economic boost.

Reduce distance

Policy should be focused on reducing the problems associated with diseconomies of scale and distance. The cash future for most of the islands lies in services, the biggest part of GDP. More attention should be paid to improving internet access, since online it doesn't matter if a business is in New York or Apia. Anything which can add value, and which does not rely on the physical movement of goods, should be encouraged.

Support local policy making

Often locals know more than they admit, and are cowed by the apparent expertise of outsiders. More trade policy-making should be done by nationals, using culturally-sensitive practices. Since nationals know their own countries, they are more likely to tailor policies to their own needs – including explicit responses to issues like vulnerability, distance, diseconomies of scale and geographical fragmentation.

7. Simon Feeny and Mark McGillveray (2008), 'Do Pacific countries receive too much foreign aid?' Pacific Economic Bulletin, 23:2, online at http://peb.anu.edu.au/peb/.

8. The latest World Development Indicators show that the nine Forum Island Countries for which data is available received aid worth the average equivalent of US$473 per person in 2005 (a figure which is somewhat skewed by the high levels of aid disbursed by the US to the Compact of Free Association states), compared with just US$17 for all low income countries.

9. Based on 1999 GDP and government expenditure.

Make technical assistance more targeted

Technical assistance has become sporadic and unfocused, partly because of a lack of donor co-ordination. Technical assistance should focus more on building productive capacity in areas that are relevant to the country concerned. Ownership by governments would mean greater co-ordination and longevity.

Insure against disasters

Climate change is sending disaster management to the top of the agenda for all countries, not just small ones. Clubbing together to buy regional disaster insurance may be an option. Donors may be able to help.

What does this mean for trade negotiations?

Pacific island governments have an interest in negotiating effective trade agreements. Increasingly, negotiations cover more than just market access. Trade facilitation, for example, aims to improve the flow of goods within and across borders. Trade agreements also help companies to make plans for the future, in the knowledge that market access will remain secure.[10] But the interests of all countries differ from the standard template. There are a number of key issues that should be considered, namely:

Maintain policy space

Broadly, policy space means letting governments do what they need in order to develop. Uncertainty about the future coupled with unexpected events like disasters and trade shocks means that the governments of small countries need even more policy space than most. This means special safeguards should be readily available, and omitting things like government procurement from trade deals with bigger countries from outside the region.

Recognise the limitations of negotiating capacity

Pacific island civil services are tiny, and they don't have the numbers to be able to negotiate on equal terms with big countries. Training and capacity-building may help. Pooling resources and negotiating through the Pacific Islands Forum didn't seem to work with the EPA negotiations. Maybe the best approach is to keep things simple by focusing on a few key areas.

Support trade facilitation at both national and regional level

Efforts by the Pacific Islands Forum Secretariat to regionalise trade facilitation should be supported. Few island countries will be able to meet the advanced standards demanded by developed countries on their own. But more funding is needed at the country level. All countries need funding for food and plant laboratories, better sanitary and

10. Many of the arguments for trade agreements are outlined in 'Beyond Fish and Coconuts: Trade Agreements in the Pacific Islands', published by the Pacific Institute of Public Policy.

phytosanitary architecture and capacity-building for their Customs departments.

Recognise country-specific demands

The standard 'Most Favoured Nation' clause in trade agreements prevents governments from treating countries differently. More flexibility is needed. Pacific countries have a particular interest in labour mobility, since workers are among their main assets. Simply, the country-specific demands in the Pacific island states are so diverse that they require direct attention by donors and trading partners.

Be innovative

For example, consider special investment and tax incentives for Australian and New Zealand firms to relocate to Pacific island countries. The cost to taxpayers may be small compared with the current level of aid spending by donor governments. Such an incentive might be pursued under a trade agreement like the Pacific Agreement on Closer Economic Relations (PACER), and indeed this may be the only advantage of PACER for Nauru, Palau, Federated States of Micronesia and the Republic of Marshall Islands.

Conclusions

The economic performance of the Pacific island countries has been middling at best. In part this is because the islands are so small that they have few examples to follow. The magic of the market can be used to great effect; yet markets are missing in many areas. Large sections of the Pacific population are unaccustomed to market signals.

Recognising that aid spending has a big macroeconomic effect would help focus policies in more useful areas. With an increased focus on international trade agreements, domestic trade policy is often forgotten; yet building up the ability of companies to produce for foreign markets is critically important.

Criticising the Washington Consensus doesn't mean ditching export development. The opposite is true: interventionist policy is needed to develop the export engine. Technical assistance can be more focused. Efforts to build productive capacity should focus on equity, infrastructure, disaster insurance and reducing the effects of distance.

Understanding regional specifics will also require maintaining policy space in trade agreements, since governments can't know all of their future needs. It will also require acknowledging the limits of negotiating capacity; encouraging national trade facilitation; and understanding the detailed demands of each country in negotiations. Few of these things are now practiced in trade talks – yet they must be acknowledged if donors and negotiating partners are serious about development.

Small can be beautiful, but only when trade policy is tailored to the needs of the islands.

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This briefing paper is based on extensive research and interviews with key Pacific stakeholders, and has been subject to peer review. A more detailed background paper on this topic is also available.

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