Small States: Not Handicapped and Under-Aided, but Advantaged and Over-Aided

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Small states have long been viewed by international organizations as a special category with special handicaps requiring special assistance. The United Nations has created an Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries, and Small Island Developing States. The very wording makes it clear that the UN regards small developing states that are landlocked or islands as being on par with the least developed countries. A very substantial academic literature has been devoted to small states, to which the World Bank and Commonwealth Secretariat have made contributions. They constituted a Joint Task Force that submitted a report in April 2000, *Small States: Meeting Challenges in the Global Economy,* proposing an agenda for assisting such states in various ways, including increasing foreign aid (World Bank 2000). This report was followed in 2005 by a review of progress on the 2000 agenda, *Towards an Outward-Oriented Development Strategy for Small States* (Briguglio, Persaud, and Stern 2005), henceforth referred to as the World Bank-Commonwealth review. This review also suggested increasing foreign aid. In 2006, the Independent Evaluation Group (IEG 2006) of the World Bank produced an evaluation of World Bank assistance to small states. During that same year, the World Bank also commissioned four regional studies of small states, which formed the basis of

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a subsequent book, *Small States, Smart Solutions* (Favaro 2008). Finally, in 2008, the World Bank released *The Growth Report*, also known as the Spence Commission report, which devoted a special section to small states (World Bank 2008).

Economic theory suggests that small states may have intrinsic disadvantages (Easterly and Kraay 2000, Alesina and Spolaore 2003, World Bank 2008). The provision of public services may have indivisibilities that yield increasing returns to scale, so small states suffer from scale diseconomies. Returns to private investment may also have increasing returns to scale, which may be difficult to realize in small states. Small size may limit an economy's scope for diversification. Many small states are islands or landlocked, and face problems of remoteness. Small states produce only a few items and import the rest, and so are relatively open economies, and hence more exposed to trade shocks. They are disproportionately exposed to natural hazards like hurricanes.

However, empirical studies do not, in general, find concrete evidence that smallness is a disadvantage. Among developing countries, small states actually have a higher GDP per capita than all states (IEG 2006, World Bank 2008). So, while small states may have some special disadvantages, they clearly have some special advantages too. This undercuts the rationale for viewing them as a special category requiring special assistance. To propose additional foreign aid in view of the disadvantages, while ignoring the advantages, does not make sense.

Most recent studies define small states as those with a population of less than two million.[1] There are 50 such small states. The World Bank-Commonwealth review also covers Jamaica and Namibia, which have slightly over two million people each. Many studies exclude oil-rich countries like Brunei, Bahrain, and Kuwait, and small European states like Luxembourg and Lichtenstein. The list of small states covered in the World Bank-Commonwealth review is given in Table 1.

Does Size Really Matter?

Several studies (Easterly and Kraay 2000, World Bank 2008) show that small developing states have higher gross national income (GNI)

[1]The World Bank-Commonwealth review (Briguglio, Persaud, and Stern 2005) and *Small States Smart Solutions* (Favaro 2008) use 2 million as the population cut-off for small states. Other studies use different cut-offs: 1.5 million in the World Bank's IEG (2006) evaluation, and 4 million in Winters and Martins (2004).

TABLE 1
SMALL STATES 2005: POPULATION AND
GROSS NATIONAL INCOME PER CAPITA

	Population (m.)	GNI per capita ($)
Africa		
Botswana	1.765	5,180
Cape Verde	0.507	1,870
Comoros	0.600	640
Djibouti	0.793	1,020
E. Guinea	0.504	2,700*
Gabon	1.384	5,010
Gambia	1.517	290
Guinea-Bissau	1,586	180
Lesotho	1,795	960
Mauritius	1,248	5,260
Namibia	2,031	2,990
S. Tome & Principe	0.157	390
Seychelles	0.084	8,290
Swaziland	1.131	2,280
Pacific and Asia		
Bahrain	0.727	14,370
Bhutan	0.918	870
Brunei	0.374	23,600*
Fiji	0.848	3,280
Kiribati	0.099	1,390
Maldives	0.329	2,390
Marshall Is.	0.063	2,930
Micronesia	0.110	2,300
Palau	0.020	7,630
Qatar	0.813	23,200
Samoa	0.185	2,090
Solomon Is.	0.478	590
Timor-Leste	0.976	750
Tonga	0.102	2,190

continued

TABLE 1 (*continued*)
Small States 2005: Population and Gross National Income per Capita

	Population (m.)	GNI per capita ($)
Caribbean		
Antigua & Barbuda	0.081	10,920
Bahamas	0.323	15,800
Barbados	0.270	16.400*
Belize	0.292	3,500
Dominica	0.072	3,790
Grenada	0.107	3,920
Guyana	0.751	1,010
Jamaica	2.657	3,400
St Kitts & Nevis	0.048	8,210
St Lucia	0.166	4,800
St Vincent	0.119	3,590
Suriname	0.449	2,540
Trinidad &Tobago	1.305	10,440
Mean	5,180	
Median	2,990	

Notes: Gross national income (GNI) is GDP plus net factor income from abroad.
*Data for these states were omitted in the World Bank-Commonwealth review. They are taken from CIA (2005) and are not included in mean and median for the small states.
Sources: Briguglio, Persaud, and Stern (2005); CIA (2005).

per capita than large ones.[2] Indeed, differences among small states are more dramatic than average differences between small and large states. This suggests that size is not a key determinant of outcomes. The main issues are elaborated below.

[2]GNI is slightly different from gross domestic product in that it includes net factor income from abroad.

Small States Are Relatively Rich, Not Relatively Poor

The World Bank-Commonwealth review shows that the mean GNI per capita of small states in 2005 was $5,180 (Table 1). By contrast, the mean GNI per capita for all developing countries was $1,753. Even the mean for all middle-income countries, $2,647, was lower than the small country average.

Of the 43 small developing states, only seven were low-income countries (classified by the World Bank as having GNI per capita below $875 in 2005), and of these Bhutan has subsequently graduated to middle-income status. This hardly suggested that small states were especially handicapped. As many as six small states in the study were high-income countries, defined as having GNI per capita exceeding $10,126 in 2005. Three of these were rich in oil and gas (Brunei, Bahrain, and Qatar). Three others achieved high-income status by harnessing financial services and tourism (Antigua/Barbuda, Bahamas, and Barbados).

A study of small states (Easterly and Kraay 2000) also showed that, after controlling for location, small states were richer in per capita GDP than large ones. Being open economies with high trade dependence, their GDP was relatively volatile. But the same openness that increased volatility was also an advantage that tended to provide high GDP per capita. This study concluded that small states should be treated exactly as all others, with no special benefits.

Not a single small state in the Caribbean or Pacific is a low-income state. Even the worst-governed countries in the region, such as Guyana and Surinam, are middle-income countries. The absence of any low-income small state in the Caribbean is striking, given that the region is peppered with small island states. The only low-income country in the Caribbean is Haiti (GNI per capita of $453), and it is not small—it has a population of over 8 million (World Bank 2007).

Most striking is the picture in Africa. This is the poorest of all regions. Yet the average per capita GDP of small states in Africa in 2005 was $2,930, against $627 for large African states. So, small states were, on average, more than four times as rich as large ones in this region. The poorest countries in the world get ultra-soft aid from the IDA window of the World Bank, while better-off countries have to borrow at quasi-commercial terms from the bank's IBRD window. In Africa, every quasi-commercial IBRD borrower—except South Africa—is a small state. That drives home their relative affluence (Domeland and Sander 2007).

In the eight countries of South Asia, one of the poorest regions, the richest and third richest states in 2005 were both small—Maldives ($2,390 per capita) and Bhutan ($870 per capita). Much poorer in per capita terms were India ($730), Pakistan ($690), Bangladesh ($470), and Nepal ($270).

Disproportionately few small states are both heavily indebted and poor. Of the 41 countries covered by the Heavily Indebted Poor Countries (HIPC) initiative, only five are small—Comoros, Gambia, Guinea-Bissau, Guyana, and Sao Tome and Principe. So, one-fifth of all countries (41 out of 208) are HIPCs, but only one-eighth of small states (5 out of 41) are in this category. Many small states have a relatively high public debt/GDP ratio, but these include middle-income and high-income states, especially in the Caribbean.

A recent study (World Bank 2005) found no statistical correlation between per capita income and the population of small states after controlling for life expectancy, trade openness, inflation, and the size of government.

The World Bank-Commonwealth review (Briguglio, Persaud, and Stern 2005) showed that in 1990–2005, small states had on average slower economic growth (3.5 percent per year) than all developing countries (4.2 percent). However, another study (Easterly and Kraay 2000) found that in 1960—95 small states grew as fast as large ones. The Spence Commission (World Bank 2008) concluded that small states did not on average have lower incomes or slower growth than large states.

Within Africa, the poorest region, small states have averaged 4.1 percent GDP growth since 1980, much higher than the 2.8 percent recorded by large African states (Domeland and Sander 2007). The worst small performers have been highly aided middle-income Pacific islands, of which Marshall Islands, Micronesia, Palau, Solomon Islands, and Vanuatu experienced a fall in per capita income in 1998–2002 (Duncan and Hakagawa 2007).

Small and Large States Have Comparable Policies and Institutions

High incomes are generally correlated with better policies and institutions. This might lead us to expect that small developing states, which are much richer than large ones, should have better policies and institutions. In fact the differences between small and large states do not seem significant. In any event, small states cannot be said to suffer from weaker policies and institutions, and this cannot be a rationale for giving them high levels of aid.

The World Bank-Commonwealth review looks at World Bank ratings for 16 different aspects of policy and governance, which are combined into an index called the Country Policy and Institution Assessment (CPIA). The CPIA ratings for 34 small countries and 101 large countries among World Bank borrowers are much the same. The small states are better in financial stability, banking regulation, business regulatory environment, transparency and corruption, and property rights and rule-based governance. They are weaker in macroeconomics, debt and fiscal management, trade barriers, human resource development, and revenue mobilization. On balance, there is no evidence that small states are particularly disadvantaged in policies and governance.

A similar conclusion—that small and large states have roughly comparable policies and institutions—is reached by a study comparing policies in small and large states, focusing on policy parameters such as import tariffs, export subsidies, and direct taxes (Winters and Martins 2004).

In Africa, the poorest and worst governed of all regions, small states score consistently better than large states in respect of voice and accountability, government effectiveness, regulatory quality, rule of law, and corruption (Kauffman, Kraay, and Mastruzzi 2005). The CPIA index of the World Bank ranks small African states at 3.25 out of 5, just above large African states (3.22), though below the level (3.42) of small states as a whole (Domeland and Sanders 2007). As measured by the Global Competitive Index, small Caribbean countries rank relatively high in voice and accountability, but score below par on other indicators such as rule of law, corruption, government effectiveness, and regulatory quality (Kida 2007).

Differences in Income among Small States Are Large

In Africa in 2005, per capita GNI ranged from $180 in Guinea-Bissau to $8,290 in Seychelles. In the Caribbean, per capita GNI varied from $1,010 in Guyana to $15,800 in the Bahamas (see Table 1). These huge differences among small states suggest that policies and institutions matter more than size.

Policies and Institutions Matter Most

The literature suggests that there are three key determinants of small state performance: geographical location, natural resources, and policies and institutions. Of these, the first two cannot be changed. But the third can. We have many examples of countries where good policies and institutions have overcome disadvantages in location and factor endowments, and also other cases where poor policies and institutions have produced poor outcomes.

Geographical Location

First, consider geographical location. This determines distance to export and tourist markets, transport costs, and ease of integration with neighbors. Small states are mainly islands or landlocked, and both categories undoubtedly suffer from disadvantages in this respect. The disadvantages vary dramatically from region to region. The challenges faced by remote Pacific islands are very different from those faced by Caribbean islands close to the United States, which in turn are different from those faced by landlocked mountainous countries like Bhutan. Many Caribbean small states may be islands, but they are close to the United States and to this extent they actually have a transport advantage, not disadvantage, over large African or Asian coastal states.

European small landlocked states—Luxembourg, Andorra, Lichtenstein—are surrounded by large, rich states that provide good markets and excellent infrastructural links with the global economy. So they are well off, and do not suffer from any infrastructural disadvantage. Landlocked states in developing countries are not so fortunate, yet the small ones fare much better than large ones. In Africa, the small landlocked states (Botswana, Lesotho, and Swaziland) are well linked to the big market and good infrastructure of South Africa, while larger landlocked countries in the region (Burkina Faso, Central African Republic, Chad, Mali, Malawi, Niger, Zambia, Zimbabwe, and Uganda) mostly have neighbors with smaller markets and weak infrastructure, and suffer accordingly. In Asia, the only small landlocked state fares much better than large ones: tiny Bhutan is much richer ($870 GNI per capita) than larger landlocked states like Nepal ($270 per capita) and Laos ($430 per capita). Latin America does not have any small landlocked states: Bolivia and Paraguay are both large.

Natural Resources

Second, consider natural resources, of which the most important are minerals and agricultural resources for tropical crops. Many small states are commodity exporters. Gabon, Equatorial Guinea, and Trinidad and Tobago are blessed with oil and gas; Mauritius, Fiji, Barbados, and several Caribbean countries have excellent agroclimatic conditions for growing sugar. Several Caribbean islands export bananas, and Guinea-Bissau exports cashew. All islands have fish in the surrounding seas.

Donor policies in the past have aimed to encourage the export of commodities. Substantial aid and trade preferences have focused on developing and protecting commodity exports. Yet recent experience demonstrates that the most important natural resource of small states is often tourism potential—weather, scenery, and beaches that can attract tourists. Many studies—including the Spence Commission report—fail to focus on this.

Policies and Institutions

Third, consider the role of policies and institutions. The very large number of small-state successes suggests that good policies and institutions can overcome disadvantages arising from geographical location or factor endowments. Very small states have exceptionally high disadvantages in transport, infrastructure, and governance costs (Winters and Martins 2004). Despite this, three very small states in the Caribbean have become high-income countries (Antigua and Barbuda, the Bahamas, and Barbados). These countries have no great mineral or agricultural endowments, but their policies and institutions have attracted enough foreign investment, financial services, and tourism to make them rich.

However, other small states that have suffered from poor policies and governance (such as Guyana and Surinam) have been among the weakest performers in the Caribbean. In Africa, small states with good policies and institutions (notably Botswana and Mauritius) have prospered, while those with weak governance and policies (Comoros, Guinea-Bissau) have remained poor (Domeland and Sander 2007).

Small African States Have Better Governance

Domeland and Sander (2007) show that the probability of state failure in 1965–2005 (through coups, civil wars, genocides) was only

3 percent in small states against 26 percent in the average Sub-Saharan African state. The political rights index (Freedom House 2005) for small states was 3.5 against 4.3 for large African states (decreasing numbers show greater rights in this index). In this period, only one small state—Guinea-Bissau—suffered from serious civil war, a phenomenon that was more common in large African states. The same study analyzed the relationship between GDP growth and institutional quality. Indicators for institutional quality were taken from Kauffman, Kraay, and Mastruzzi (2006). The rate of GDP growth was positively correlated with increased institutional quality.

Small African States Have Fewer Crises and Overcome Them Faster

Domeland and Sander (2007) show that in 1965–2005, small African countries on average suffered 2.4 economic crises (defined as a contraction of more than 4 percent in per capita GDP in constant dollars), while large ones averaged 4.8 crises. This is a significant difference. But averages should not be allowed to conceal the fact that the quality of governance makes an enormous difference, and matters more than mere size. Of the14 small African states, four well-governed ones suffered no crisis at all, whereas Gabon suffered six, Guinea-Bissau five, and Lesotho four. The time for recovering from a crisis—defined as return to the pre-crisis level of per capita GDP in constant dollars—was 9.7 years for small states against 13.3 years for large states. But among small states, Comoros and Djibouti took almost 15 years, in stark contrast with Botswana and other well-governed states that never had a crisis (Table 2).

Impact of Natural Resources, Good Location, and Foreign Aid

Equatorial Guinea is not noted for good governance, but its oil wealth has nevertheless taken it to middle-income status. However, such countries tend to suffer from high inequalities, and revenues from natural resources do not reach the poorest.

In the Caribbean, geographical proximity to U.S. markets is a major advantage for tourism and trade. Because of this, even relatively poorly governed states in the region (Guyana, Surinam) have become middle-income states.

The Pacific small states display many weaknesses in policies and governance. They are particularly weak in regard to property rights. Many are reluctant to allow land to be owned by outsiders. This is a

TABLE 2
YEARS TAKEN TO RECOVER FROM
ECONOMIC CRISES IN AFRICA, 1965–2005

	No. of Crises 1965–2005	Average Years for Recovery
Botswana	0	0
Cape Verde	0	0
Comoros	3	14.67
Djibouti	4	14.50
Eq. Guinea	1	7.0
Gabon	6	13.83
Gambia	4	7.25
Guinea-Bissau	5	7.40
Lesotho	4	4.00
Mauritius	0	0
Namibia	2	12.50
Sao Tome & Principe	0	0
Seychelles	3	4.0
Swaziland	1	10.0
Average Small African	2.4	9.7
Average Small Global	2.1	8.2
Average Large African	4.8	13.3

SOURCE: Domeland and Sander (2007).

major reason why registering property can take 513 days in Kiribati, 188 in Vanuatu, and 147 in Samoa. By contrast, it takes just 2 days in nearby New Zealand. Weak governance in the Pacific also shows up in inordinate delays in settling contract disputes. The time taken is on average 775 days in Micronesia, 660 days in Kiribati, 455 in Samoa, and 430 in Vanuatu. By contrast, the average in New Zealand is 109 days (Duncan and Hakagawa 2007). Despite such weaknesses, all Pacific island states have risen to middle-income status because of massive aid flows.

Most Policies That Work in Large States Work in Small Ones Too

These include good macroeconomic policies, a good business climate, human capital development, economic openness, and good governance. Small states that score well in these parameters have also fared well in GDP (World Bank 2005). However, small states also have specific advantages and disadvantages. So, apart from good macro policies and business climates, they require specific policies and institutions targeted at minimizing their inherent disadvantages and maximizing their inherent advantages. The next two sections elaborate their disadvantages and advantages.

The Inherent Disadvantages of Small States

In this section we consider five disadvantages of small states: high infrastructural costs, high public service and institutional costs, high costs of tertiary education and limited opportunities for high-skilled employment, high exposure to natural hazards, and high volatility of GDP.

Small Countries Have High Infrastructural Costs

One study (Winters and Martins 2004) examined the extent to which business costs for exports were higher than in median-size countries (population 10 million) for four categories of small states: micro (under 12,000 inhabitants), very small (under 200,000), threshold (under 1.6 million), and small (under 4 million). The study found that the cost disadvantages—reflecting higher charges for transport, utilities, and skills—were modest for countries with up to 4 million population. But the disadvantages worsened rapidly as size diminished, and was very high for the "very small" and "micro" categories. Micro states where such business costs are 30–40 percent higher will find it difficult to compete in manufacturing even with very low wages. Their viability lies in finding economic niches (such as tourism) that make high costs affordable.

Small States Face High Public Service and Institutional Costs

The share of government consumption in GDP is higher in small states (19.4 percent) than in large ones (15.7 percent), in part because the fixed costs of many government services—such as defense, bank supervision and higher education—are high (Favaro

TABLE 3
HIGHER COST OF EXPORT PRODUCTION IN SMALL STATES
(PERCENT DEVIATION OF BUSINESS COSTS
FROM THOSE IN MEDIAN ECONOMY)

Industry	Micro	Very Small	Threshold	Small
Electronic Assembly	36.4	14.3	5.0	2.7
Clothing	36.3	14.3	5.1	2.7
Hotels/Tourism	57.5	28.5	11.9	6.2

SOURCE: Winters and Martins (2004).

2008). Government administrative and technical capacity tends to be limited in states with very small populations.

Small states have devised innovative ways to overcome scale diseconomies. For example, the states of the eastern Caribbean have formed a multicountry central bank, a common court system, and a common telecom regulatory authority. The Pacific small states have created a common University of the South Pacific. The West African states have created a telecom authority and an economic community (ECOWAS) to promote regional integration. Francophone states have created monetary unions in West Africa and Central Africa respectively, and use a common currency (the CFA franc). This has reduced costs while improving monetary policy, professionalism, and quality of supervision (Favaro 2008). Regional approaches hold promise in other areas such as hurricane insurance, disaster preparedness and training, negotiating fishing royalties and rights, and harmonizing health and environmental standards. Central America has a regional airline, TACA. A similar approach could enable other regions to create viable airlines, shipping services and telecom services (which, however, should compete with international providers and not become local monopolies). Small states can benefit from regional approaches to training, higher education and skill development.

High Costs of Tertiary Education, Limited Job Opportunities for High Skills

Universities and technical training institutions need a minimum size to attract suitable staff and students. Small states are less able than large ones to tap the spillover effects of universities and high-tech production. Those that create skills often suffer a brain drain. The problem is worst in countries where poor policies have reduced economic growth and job opportunities. The percentage of college graduates who migrate is as high as 86 percent in Guyana and 83 percent in Jamaica (Docquier and Marfouk 2005).

Natural Hazards Cause Disproportionately High Damage

In Africa, disaster damage as a proportion of GDP averaged 58.25 percent in small states against 8.43 percent for large states (Domeland and Sander 2007). Hurricanes are annual threats in the Caribbean and Pacific. In Grenada, Hurricane Ivan in 2004 caused damage estimated at 200 percent of GDP (Independent Evaluation Group 2006). Such extreme tragedies do not occur in large states with multiple regions

Small States Have Higher GDP Volatility

Small states are typically dependent on a few economic activities, and a boom or bust in these sectors can propel GDP up or down much more than in large countries. Such countries are generally relatively open economies, highly sensitive to changes in the global economy. Volatility (measured as the standard deviation of the growth rate of per capita GDP) is 3.9 in small states, as against 1.4 in low-income countries and 1.5 in middle-income countries (World Bank 2005).

However, Africa, the region that is poorest and most dependent on commodity exports, is an exception. While volatility of GDP growth is high in Africa, it was lower between 1981 and 2002 in small states (5.85) than in large states (6.63). In Africa, some larger states are relatively undiversified commodity producers. Many small states are more diversified, since even a modest amount of tourism or industry creates substantial diversification out of commodity production. In 2000–05 in Africa, the share of agriculture in GDP in small states was 17 percent against 32 percent in large states, and the share of services in GDP was 50 percent in small states against 43 percent in large states. For the same reason, small African states had lower terms-of-trade volatility than large states (Domeland and Sander 2007).

The good news is that volatility is declining. Volatility of GDP for all small states has declined steadily from 5.91 in 1981–85 to 3.70 in 2001–05, and volatility of terms of trade from 8.13 to 5.61 (World Bank 2005). This reflects, among other things, the diversification of economies into services, reducing traditional dependence on commodity exports. The share of services has increased in virtually all small states. Dwelling exclusively on the disadvantages of small states would be a mistake. Small developing states also have several inherent advantages.

The Inherent Advantages of Small States

In this section we consider 12 inherent advantages of small states over large ones: (1) they have relatively homogenous populations; (2) small island states are relatively insulated from spillovers of violence from neighbors; (3) small states get disproportionately large benefits from foreign investment; (4) a single mineral windfall in small states can offset many failings; (5) they have exploited tax arbitrage opportunities; (6) they have benefited from niches like military bases and lightly regulated financial centers; (7) they get disproportionately large benefits from migration and remittances; (8) they get disproportionately large benefits from tourism; (9) they can export items that are usually nontradable; (10) they get disproportionately large benefits from the Law of the Sea; (11) infrastructural investments in small states quickly reach most of the population; and (12) they get disproportionately large trade preferences.

More Homogenous Populations Mean Fewer Ethnic Tensions

Civil conflict is widespread in Africa overall, but homogenous populations in small states result in fewer ethnic tensions. This is a major finding of Domeland and Sander (2007). Ethnic and tribal tensions are sources of civil unrest and poor governance in many developing countries. But in Africa, ethnic fractionalization is far less in small states than large ones. This is correlated with better institutional quality and greater political stability, and represents a huge advantage for small states. Of the 14 small states in Africa in the period 1965–2005, only one—Guinea-Bissau—suffered major armed conflict, defined as the death of more than 1,000 people over the duration of the conflict. The contrast with large states like Sudan and Democratic Republic of Congo is graphic.

Islands Are Isolated from Spillovers of Violence

Domeland and Sander (2007) show that small states are less prone to armed conflict than large ones even after controlling for ethnic fractionalization. Many small states are islands, whose isolation protects them from the spread of violence from neighboring countries. The only small African state to suffer repeatedly from major armed conflict is Guinea-Bissau, a mainland country whose problems may have been exacerbated by spillovers of violence from nearby troubled states such as Guinea and Sierra Leone

Small States Benefit Disproportionately from Foreign Investment

A single big mine, bank, or hotel can have a significant impact on GDP and jobs in a small country, whereas it would have little impact in a large country. The average Foreign Direct Investment (FDI) per capita in small states is very high. It ranged from $164 to $290 per capita in small states between 2000 and 2004, and the levels are high even excluding FDI in oil-rich countries such as Trinidad and Equatorial Guinea (Table 4). By contrast, the average for all developing countries ranged from $34 to $40 per capita. For all low-income countries—some of which are very large—it ranged from a pathetic $5 to $7 per capita. Booming India got $5 billion of FDI in 2004, but this represented under $5 per capita.

Mineral Windfalls Can Offset Many Failings

FDI flows mostly to small states with good policies and governance, as exemplified by Botswana and Mauritius in Africa. However, even badly governed states can attract FDI if they have oil. Even a small oil discovery by global standards will raise GDP sharply in small states. This will not be the case in large states. However, mineral windfalls are a two-edged sword. They yield hefty royalties, but these may encourage elite capture of the benefits, and hence worsen governance. Poor people in such states may gain very little even if GDP booms.

Tax Arbitrage Attracts Foreign Investment

Many Caribbean and Pacific states have low direct taxes, some-

TABLE 4
Foreign Direct Investment in Small States
(US$ per capita)

	2000	2001	2002	2003	2004
Africa	58	90	88	186	190
Africa minus Eq. Guinea	51	14	65	77	63
Pacific/Asian	25	22	13	17	8
Caribbean	294	317	290	353	391
Caribbean minus Trinidad	229	226	201	279	288
All Small States	**164**	**195**	**180**	**267**	**290**
All Developing	34	35	31	31	40
All Low-Income	5	4	7	6	7

Source: Adapted from Briguglio, Persaud, and Stern (2005).

times close to zero. Mauritius's tax-free treatment of portfolio investors has attracted many global players. Mauritius has a double-taxation avoidance treaty with India, so foreign investors use subsidiaries in Mauritius to get tax-free access into India. Small states in Europe—Jersey, Ireland, Estonia, Lichtenstein, Monaco—have long used low direct taxes to attract investors, and have often been criticized as tax-avoidance havens by large countries. By attracting FDI that would not otherwise have come, low tax rates in small countries can garner more revenue than higher tax rates do elsewhere.

Economic Niches and Regulatory Arbitrage

Many small states—Bahamas, Barbados, Mauritius, Antiqua and Barbuda, Bermuda, Cayman Islands—have become rich by creating lightly regulated niches in various financial services. This is regulatory arbitrage as distinct from tax arbitrage, though in practice the two can be closely related. Light regulation has, however, led to accusations that these countries have become havens for tax evaders, and money launderers who assist the operations of drug dealers and terrorists. In response, these countries have greatly increased the transparency of their financial operations. This has not cost them the loss of their financial niches, and shows that they are more than just money-laundering havens.

Small island states may also occupy a very special military niche. They may be strategically located from a military viewpoint, and so some have become military bases for great powers. Such military bases have enabled small Pacific states such as Micronesia and Palau to become middle-income countries. By contrast, U.S. military bases contributed only marginally to large Asian economies like the Philippines.

Disproportionate Benefits from Migration and Remittances

Because of curbs on immigration in rich countries, proportionately more of the workforce of small countries can migrate than that of large countries. One percent of a small country means maybe 10,000 migrants, who can be assimilated abroad. But 1 percent of a country like India means 10 million people, much too large to be admitted even over decades. Some small countries have preferential arrangements for migration. Citizens of the Cook Islands have a right to move to New Zealand, and those from the Marshall Islands and Federated States of Micronesia can move freely to the United States. One bizarre consequence is that the Cook Islands represent the only case in the world of population falling by 3.4 percent per year in 1995–2004 through migration. Ironically, this has helped increase GDP per capita of those that remain at home by 6.5 percent per year. This is clearly possible only in very small states (Duncan and Nakagawa 2007).

Remittances make an important contribution to the GDP of all developing countries, but are disproportionately high in small states. In the period 2000–2004, they ranged from 3.1 to 3.5 percent of GNI in small states overall. This was higher than the range of 1.5 to 2.0 percent for all developing countries (Table 5). The highest proportions were recorded in Caribbean small states, where remittances ranged from 5.2 percent to 7.0 percent of GNI.

Given limited job opportunities in remote Pacific states, they can prosper by encouraging the migration of citizens, who then send home remittances (the example of the Cook Islands given above is an extreme one but indicates what is possible). Fiji and Kiribati are

TABLE 5
FOREIGN REMITTANCES AS PERCENT OF GROSS NATIONAL INCOME, 2000–04

	2000	2001	2002	2003	2004
Africa, Small	3.2	3.1	3.1	2.8	2.5
Pacific/Asia, Small	3.7	5.9	4.6	3.9	3.4
Carib. Small	5.2	5.89	6.64	7.0	7.0
All Small	**3.1**	**3.5**	**3.5**	**3.4**	**3.5**
All Developing	1.5	1.6	1.9	2.0	2.0

SOURCE: Adapted from Briguglio, Persaud, and Stern (2005).

focusing on training citizens for nursing and other occupations that have a demand abroad (Duncan and Nakagawa 2007). As small states become prosperous, job opportunities will increase, and they should be able to attract back earlier emigrants, even highly skilled ones (as India and China have done).

Disproportionate Benefits from Tourism

The big story of the last decade is the sharp rise in tourism globally, which has transformed the economic prospects of small states. Tourism requires no subsidies or preferential treatment by donors. It has a far greater future potential than traditional commodity exports or manufactured exports dependent on trade preferences (such as textiles exported from Mauritius or Fiji to the European Union). The average share of tourism in exports receipts is now 45 percent in Asia/Pacific, 30 percent in the Caribbean, and 20 percent in Africa. The comparable figure for all developing countries is just 7.5 percent. On average, the services sector now accounts for 65 percent of GDP in the Caribbean, against 45 percent for developing countries as a whole (Kida 2007). Thanks to tourism, Seychelles has by far the highest per capita income in Africa ($8,290) and Maldives has by far the highest per capita income in South Asia ($2,390).

Tourism rises with prosperity. So, growing world prosperity is steadily driving more and more tourists to exotic locations. This feeds into the comparative advantage of small island states, which have proportionately the most beaches, coral reefs, and exotic scenery. The small states of the Caribbean are close to the biggest market—the United States—and that gives them a great advantage over large states in other continents. The crowding of traditional tourist destinations is now driving tourists to remote locations in search of beaches that are not overcrowded. Indeed, the search for "getting away from it all" means that the remoteness of Pacific islands, long viewed as a major obstacle to development, has been transformed into an advantage (see Table 6). All the Pacific island states (except tiny Kiribati) have enjoyed a remarkable tourist boom in recent years (Duncan and Hakagawa 2007).

Small States Export Items That Are Usually Nontradable

Water and electricity are usually considered nontradables. But Bhutan has harnessed its hydel potential to sell electricity to India, and this is by far its largest export. Indeed, hydel exports have enabled this once-poor country to overtake India in GNI per capita and attain middle-income status. Lesotho's main export is of water to South Africa (World Bank, 2005). The United Nations may view small landlocked states as especially disadvantaged, but they also have a special advantage—they alone are able to export water and

TABLE 6
Tourists in Pacific Island States, 1998–2005
(in Thousands)

	1998	2001	2002	2003	2004	2005
Cook Is.	48.6	74.6	72.2	78.3	83.3	87.7
Fiji	371.3	348.0	397.9	430.8	507.0	532.0
Kiribati	5.7	4.8	4.3	3.7	2.9	2.8
Micronesia	13.4	15.3	19.1	18.2	19.0	n.a.
Samoa	77.79	88.3	89.0	92.3	98.2	101.9
Vanuatu	52.1	53.3	49.5	50.4	61.5	69.1

Source: Duncan and Nakagawa (2007).

hydroelectricity in quantities large enough to boost GDP substantially.

Disproportionate Benefits from the Law of the Sea

The Law of the Sea gives islands and coastal states an exclusive maritime zone covering a radius of 200 miles, within which they have sovereign rights for marine life (mainly fish and shrimps) and minerals on or under the seabed (mainly oil and gas). The exclusive economic zone of island states can be several times larger than the islands themselves. This is not possible for large states. Many island small states are significant exporters of fish. Equatorial Guinea and Trinidad and Tobago are small states that have become rich with the discovery of offshore oil deposits that would have been considered only modest for a large country. Technical advances in deep-water drilling have greatly increased the potential of exclusive maritime zones, and hence increased the potential of island states.

Infrastructural Investments Reach Most of the Population

Small states may have scale diseconomies in creating international telecom links or ports or airports. But once such infrastructure is created in a small state, the bulk of the population will be relatively close to it and can access it. This is not the case in large states.

Disproportionately Large Trade Preferences

Most countries in Africa and the Caribbean get preferential access to the European Union. For decades, this has enabled small states in these regions to get prices well above global rates for exports of sugar and bananas, and duty-free quotas for apparel. From 1976 onward, the European Union gave substantial aid as well as special trade preferences (low-duty entry into a highly protected, high-price market) for the members of the Lome Convention. These countries were the ex-colonies of European powers in Africa, the Caribbean, and the Pacific, but not Asia. The Asian exclusion eliminated most large developing countries such as India, Indonesia, and Pakistan, and so the Lome Convention disproportionately benefited small states. So did its successor convention, the Cotonou Convention. In 2001, the European Union announced a policy of duty-free access called Everything but Arms for least developed countries—many of which are small.

The Caribbean Basin Initiative of the United States provided substantial preferences from 1983 onward to the region. Regional preferences were further deepened by the Caribbean Basin Trade Partnership Act of 2000.

Since small states produce very few items, they export much of what they produce and import much of what they consume. Hence they have a relatively high trade/GDP ratio. Their merchandise exports as a proportion of GDP rose from 30 percent in 1990 to 32 percent in 2005, according to the World Bank-Commonwealth review. The ratio in all developing nations used to be much lower—16 percent in 1990—but shot up to 31 percent in 2005, only marginally below the ratio for small states. This is largely because of the export boom in large Asian countries, above all China. Large Asian exporters—China, India, Vietnam, and others—do not qualify for the trade preferences that small states enjoy.

However, trade preferences are a two-edged sword. They may provide support to small states unrelated to their comparative advantage, and hence distort the economy. Besides, the gradual reduction of trade barriers, multilaterally (via the WTO) and regionally (via NAFTA, CAFTA), means that the advantage conferred by preferences is eroding rapidly. The Cotonou Convention has been ended, to conform to WTO rules. This has produced pains of transition in several small states, who need to switch to services that do not require external props.

Finally, we turn to foreign aid. Here too, small states have benefited disproportionately. This has not been mentioned by the studies financed by aid agencies, and has also been ignored by the Spence Commission (2008).

Small States Are Highly Aided Relative to Large Ones

By grouping small developing island states and landlocked developing states with least developed states, the United Nations continues to press for high levels of aid to small states to offset ostensible disadvantages. In fact the small states are not disadvantaged and under-aided. They are advantaged and over-aided.

A World Bank evaluation (IEG 2006) showed that the average net aid received by small states was $201.1 per capita, as against only $12.3 per capita for all developing countries and $18.1 per capita for all developing countries excluding China and India. In other words, small states averaged more than 16 times as much aid as developing countries as a whole.

Measured as a proportion of gross national income, average net aid was 14.8 percent for small states as against just 1.1 percent for all developing countries. That is, small states got 14 times as much aid in relation to their GNI (Table 7). These are gargantuan differences, not small ones. There is no agreed definition of how much aid is too much. But if "too much" has any practical meaning at all, it should surely apply to states getting 14 to 16 times the developing country average.

TABLE 7
SMALL STATES GET MUCH MORE AID THAN LARGE ONES, 2006

	Net Aid as Percent of GNI	Net Aid per Capita ($)
Average Small States	14.8	201.1
Average Developing States	1.1	12.3
Average Developing States minus China & India	1.2	18.1

SOURCE: IEG (2006).

A very different picture is painted by the World Bank-Commonwealth review of 2005. It suggests distress on the part of small states. It says small states have suffered from declining aid flows since 1990, and that the decline has only partially been offset recently (Table 8).

Table 8 shows that average aid to small states generally declined after the early 1990s, while aid rose to developing countries as a whole. Hence the share of small states in total aid declined from 3.7 percent to 2.6 percent. The implication drawn by the review is that small states have not been treated well, and deserve a surge in aid. However, the review is silent about the fact that, after such supposed

TABLE 8
Official Aid to All Developing and Small States
(US$ Millions)

	1990–1992	1993–1995	1996–1998	1999–2001	2002	2003	2004	Average 2002–04
All Small States	2,320	2,378	2,166	1,780	1,854	1,822	2,289	1,988
All Developing	62,300	64,000	55,800	57,700	65,600	76,700	85,500	75,900
Aid Share of Small States	3.7%	3.7%	3.9%	3.1%	2.8%	2.4%	2.7%	2.6%

Source: Briguglio, Persaud, and Stern (2005).

discrimination, small states still get 16 times as much aid per capita as all developing countries. It is intriguing that the review has tables giving some per capita indicators of small states (such as foreign investment par capita) but avoids having a table for aid per capita.

I have calculated aid per capita for small states using data from the review itself, and compared it with per capita income in Table 9. This reveals huge incongruities that defy economic logic.

Table 9 shows that small states get aid on a scale that defies any principle that should guide the distribution of aid. Some incongruous outcomes:

- Low-income countries are defined by the World Bank as those with GNI per capita of less than $875 in 2005. But aid per capita to three Pacific countries exceeded this threshold—Palau ($1,250), Micronesia ($945), and Marshall Islands ($905). Aid alone was high enough to make them middle-income countries.
- Not a single small state in the Caribbean is a low-income state. Yet aid per capita in this region exceeded $50 (and often $100) for virtually every state, against the developing country average of $12.30.
- Several rich small states received astonishingly high aid. Barbados ($16,500 GNI per capita) received $63 per capita as aid. St Kitts and Nevis ($8,210 GNI per capita) got $188 per capita as aid. Dominica got the most per capita aid of all, $319, but it is not a low-income country—its GNI per capita is a comfortable $3,790. By contrast, Haiti, a larger state that happens to be the poorest in the region ($450 per capita), got only $60 aid per capita.
- Many low-income countries received very little aid. India ($730 GNI per capita) got just $2 aid per capita; Bangladesh ($470 GNI per capita) got $9; Pakistan ($690 GNI per capita) got $11; and Nepal ($270 GNI per capita) got $16 of aid per capita.[3]
- In the poorest region, Africa, relatively well-off small states received proportionately more aid than large, poorer states. Seychelles ($8,290 GNI per capita) got $107 per capita aid; Cape Verde ($1,870 per capita) got $247 aid per capita; and Djibouti ($1,020 per capita) got $93 aid per capita. By contrast, aid per capita was only $7, $22, $27, and $39, respectively, for Cote D'Ivoire ($870 per capita), Kenya ($540 per capita), Ethiopia ($160 per capita), and Tanzania ($340 per capita).

[3]No data are listed in World Development Indicators for Afghanistan. Sri Lanka had $ 1,160 per capita income in 2005, second highest in south Asia.

TABLE 9
Aid and GNI per Capita for Small States, 2005

	GNI per capita ($)	Aid per capita ($)
Botswana	5,180	20
Cape Verde	1,870	247
Comoros	640	45
Djibouti	1,020	93
Eq. Guinea	2,700	48
Gabon	5,010	24
Gambia	290	41
Guinea-Bissau	180	59
Lesotho	960	47
Mauritius	2,990	13
Sao Tome & Principe	390	203
Seychelles	8,290	107
Swaziland	2,280	50
Bhutan	870	83
Fiji	3,280	59
Kiribati	1,390	192
Maldives	2,390	76
Marshall Is.	2,930	905
Micronesia	2,300	945
Palau	7,630	1,250
Samoa	2,090	184
Solomon Is.	590	146
Timor-Leste	750	180
Tonga	2,190	225
Vanuatu	1,600	156
Antigua & Barbuda	10,920	86
Bahamas	15,800	15
Barbados	16,400	63
Belize	3,500	48
Dominica	3,790	319
Grenada	3,920	112
Guyana	1,010	132

continued

St Kitts & Nevis	8,210	188
St Lucia	4,800	54
St Vincent & the Grenadines	3,590	59
Suriname	2,540	33

SOURCE: Calculated from Briguglio, Persuad, and Stern (2005); CIA (2005).

- The average aid per capita to small states ($210) is higher than the entire GNI per capita of larger poor nations, such as Burundi ($100), Democratic Republic of Congo ($120), Liberia ($130), Malawi ($160), Eritrea ($170), and Guinea-Bissau ($180). The last-named of these, Guinea-Bissau, is itself a small state and extremely poor, but gets only $59 of aid per capita. Rich small states in Africa get much more.
- High levels of aid have not resulted in proportionately higher rates of growth in small states. The Word Bank-Commonwealth review shows that small states have, despite huge dollops of aid, averaged GDP growth of only 3.5 percent per year over 1990–2005, against 4.2 percent per year for all states. Indeed, many of the fastest-growing states in recent years have been large countries—China, India, Vietnam—that get very low levels of aid per capita.

The World Bank-Commonwealth review shows how unsatisfactory growth has been in the most highly aided region of all, the Pacific states. "Small states in the Pacific have experienced sluggish growth, consistent with longer-run trends. Only in Samoa and Tonga have per capita incomes kept pace with income-level comparators, while countries such as the Marshall Islands, Micronesia, Palau, Solomon Islands, and Vanuatu all saw falls in per capita income over the 1998 to 2002 period" (Briguglio, Persaud, and Stern 2005: Favaro 2008). However, the review neglects to mention that poor growth in these countries was accompanied by the highest aid flows per capita in the world. Duncan and Hakagawa (2007) show that, in 1995–2004, per capita income growth was negative in highly aided states such as the Marshall Islands (–4.6 percent), Micronesia (–0.6 percent), Solomon Islands (–3.5 percent), and Vanuatu (–1.6 percent). Surprisingly, the World Bank-

Commonwealth review suggests that this is a case for more aid. In fact it is a graphic demonstration of the failure of high-aid policies.

The Way Ahead

The literature on small states suggests several ways in which they can tackle some of their inherent disadvantages. The World Bank-Commonwealth review (Briguglio, Persaud, and Stern 2005) covers this ground rather well, and so does Favaro (2008). But both of these ignore the veritable Niagara of aid that has been showered on small states, with dubious results. However, the studies do throw light on new directions that may achieve better results.

- Trade preferences once enjoyed by small states are eroding. Many have highly distorted economies created by external props. Small states need to diversify into activities that are sustainable in the long run, and these are mainly services. Aid can be redirected to assist the transition.
- The historically high trade/GDP ratio and trade volatility of small states was due mainly to dependence on commodities and preferences. A shift to unsubsidized services, especially tourism, is now diversifying their economies and reducing volatility. Tourism clearly has the most long-term promise. It converts the traditional disadvantages of remoteness and isolation into an advantage—getting away from it all.
- Investment in telecom is vital. Cheap telecom has made possible the offshoring of many services from developed countries to small states, abolishing the historical disadvantage of distance and remoteness. The Internet has also facilitated the import of—and local use of—services like telemedicine and distance education. E-governance in Cape Verde has significantly improved governance.
- Many small states have occupied financial niches. Many more can attempt to do the same. This does not requite foreign aid.
- Migration has been accompanied by substantial remittances that have strengthened many small states. This should be encouraged. Specific training schemes can improve the employability of migrants, especially in health care (there is a major shortage of nurses in many developed countries). Remittances have eroded the case for rising foreign aid.

- At a more global level, the most important reform could be a major liberalization of temporary movement of workers under Mode 4 of WTO negotiations on services (Winters 2005). Temporary movement poses the fewest political problems for countries receiving the migrants. It also increases benefits to the sources of migration, which get not only remittances but the improved skills that migrants pick up abroad and bring back.
- The World Bank is currently devising group hurricane insurance for Caribbean countries. This approach can reduce economic damage and volatility on account of natural disasters.
- Donors need to harmonize their aid to small states, to reduce duplication. This will also ease the strain of reporting to several donors in countries that happen to suffer from a shortage of administrative capacity. Harmonization will also reduce donor overheads, which are high in relatively small loans.
- Regional approaches can enable small countries to reap substantial scale economies in government services, infrastructure, and human development.

Many of these approaches require no aid at all. Others have the potential to use existing aid flows more effectively. The future development agenda should, therefore, abandon the traditional focus on increasing aid. Rather, it should focus on ways to reduce such aid, which is already excessive.

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