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Reply to the commentators

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We are grateful to our commentators for their insightful contributions on our paper. We shall not respond to them one-by-one but rather very briefly address the main themes of the commentaries taken as a group.

Overall the commentaries reinforce our view of our results. There are clearly some serious remaining methodological challenges in identifying the costs of smallness and we agree with our colleagues on many of the next steps empirically – for example, to enlarge the sample, to study specific industries across a range of countries, to try to unpack the efficiency effects of size and to explore whether size necessarily entails inefficient regulatory policies. On the other hand, we remain persuaded that there really is a substantive issue here. While there are doubtless large margins of error around our size relationships, we find it difficult to believe that the basic pattern is illusory. We should remind readers, however, that our exemplar countries are *very* small – populations of 12 thousand for 'micro' economies and 200 thousand for 'very small'. By the time we reach population sizes of over a million the size effects we identify have become relatively small.

The commentators are right to confront us with the fact that very small economies continue to survive – and, indeed, that is the intellectual challenge. However, we do not find it an overwhelming one. It is the case that many of the smallest economies have very few exports: for example, Niue ($0.24 million compared with imports of $3.1 million), the Marshall Islands ($7 million compared with $68 million), and Cook Islands ($9 million compared with $51 million).[1] They essentially survive on other flows such as remittances and aid, with aid per head of $1,470, $171, and $1,155, respectively (compared with China and India at $1 per head). Mauritius, one of the success cases cited is relatively large compared with many of our countries (population 1.2 million) and is widely credited with having succeeded precisely because, nearly uniquely, it handled the exploitation of trade preferences well. Thus, while we agree that a careful analysis of the income sources of some of these small economies is warranted, it is far from obvious that they survive on the basis of exporting at world prices.

Several comments deal with the theory underlying the disadvantages of smallness. We welcome Tony Venables' clarification of our simple motivating model. We certainly did not wish to imply that wages were exogenous either in theory or in practice, as, indeed, our discussion of general equilibrium in Section 6 shows.

1 PITIC and ADB (2001).

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We also agree that there are severe interpretational challenges with our wage equations, and that we should view them primarily as descriptive devices. But it is worth reiterating that only one of the income penalties that we report in Table 6 (that for capital) relies on the wage equation.

Satish Chand takes us to task severely, but we suspect that our differences with him are more apparent than real – at least so far as fundamental conclusions are concerned. We explicitly do not dispute that adhering to comparative advantage will maximize the incomes of small economies, merely that it is all that one needs to consider. Hence we do not find his model convincing, since it does not cope with the *real* costs of international trade. If trade absorbs real resources, the offer curve faced by a small country producing at point T in his figure will be kinked – flatter than p^* above T and steeper below. That is, it will lie inside p^* and possibly inside A as well.[2] On policy we do not advocate preferences or income subsidies but rather, like Professor Chand, suspect that the answer will eventually lie in population movements and the non-pecuniary attractions of small societies.

Finally, on subsidies, we do not find the case for subsidizing industry attractive. However, there is a world of difference between subsidies financed by external sources, say via preferences or income transfers, which could increase income, and those financed by taxing local citizens or imposing tariffs. As we argue in the paper, we see nothing in the size relationship that increases the strength of the traditional and largely discredited arguments for locally financed subsidies.

We are grateful to all our commentators; their contributions provide a most useful context and interpretation for our work. We do not view the paper as the last word on small economies. Rather we hope that it helps to pose a long-standing policy question in a new empirical light and that it will encourage reflection and further research.

Reference

Pacific Islands Trade and Investment Commission and Asian Development Bank (2001), *Business Investment Guide to the Pacific Islands*, Sydney, Australia: PITIC.

2 Neither, incidentally, will real trade costs reverse the direction of trade in a two-good model (whichever way trade flows, one incurs costs associated with both F and C) nor would using a curved PPF in our figure 2 affect the basic argument.

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