© *Enrico Spolaore* DOI: 10.1017/S1474745604002058

Is small really so ugly?

ENRICO SPOLAORE
Tufts University

The number of sovereign states has steadily increased over the past few decades and is rapidly approaching two hundred. Many of these countries are small. The median country size in terms of population is around five million people. Tuvalu, the smallest state with a seat at the United Nations, has 11,000 people. The smallest country in the sample studied by Winters and Martins (W&M) is Niue, a self-governing country in free association with New Zealand, with only 2,000 inhabitants.

The formation of numerous new states over the past decades, and the increasing presence of small states in international organizations – including the WTO, at the center of Mattoo and Subramanian's (M&S's) article – have renewed the economic profession's interest in the economic and political consequences of country size.[1] What are the costs and benefits associated with smaller or larger size? What are the economic and political consequences from being 'small'? In particular, are small states at an economic disadvantage because of the limited size of their domestic markets? Concerns about the economic costs associated with small countries have been raised for a long time. For example, in 1843 the *Dictionaire Politique* of Garnier-Pagès described as 'ridiculous' that Belgium and Portugal should be independent nations, because they were too small to be economically viable.

Small domestic markets may indeed imply large costs in a world of high trade barriers and protectionism, in which the extent of the market is determined by a country's political borders. By contrast, in a world of free trade and international economic integration, small countries can extend their markets by trading with other countries, therefore limiting or even eliminating the costs associated with a small domestic size.

However, even in an open and economically integrated world small countries may face serious economic disadvantages. The authors of these two articles focus on different costs associated with a small size. The two papers differ in the specific issues they address, in their methodology, and in their definition of 'size': population in W&M, share of world imports in M&S. From different perspectives these two contributions provide valuable insights on aspects of the complex relationship between size of countries, international openness, and economic prosperity.

1 Small states have not always been welcome in international organizations. After World War I the League of Nations refused membership to Liechtenstein because of its small size.

https://doi.org/10.1017/S1474745604002058 Published online by Cambridge University Press

W&M investigate whether a small size, in terms of population, is associated with prohibitive excess costs, even in industries in which small countries may have a comparative advantage (electronic assembly, clothing, and tourism). By using cross-country data, they find very high 'income penalties' for each of these industries in very small countries, and conclude that, in the absence of other sources of income, a very small size can imply poverty (in fact, incomes below subsistence level!) even in a world of free trade. W&M claim that, while trade restrictions and autarky would exacerbate the problems faced by small countries, comparative advantage is not sufficient for economic viability in small economies with prohibitive business costs.

M&S focus on countries that have small domestic markets because of small populations *and* low levels of income per capita. The authors are not interested in the direct links between small size and income, but in the systemic problems due to the current incentives faced by small *and* poor countries within the WTO. In particular, the authors are concerned by the increasing veto power given to countries that, because of their small markets, have little bargaining power in bilateral negotiations over trade liberalization, and face perverse incentives with respect to welfare-enhancing reforms. M&S argue that the current role of small and poor countries in international negotiations presents a 'challenge' for international economic integration, and that small poor countries pay a price because of the inefficient mechanisms through which such a challenge is met by the richer and larger countries. They discuss ways in which the interests of small and poor countries could be accommodated to enhance the efficiency and equity of the system.

Both papers stress real and important problems. However, I wonder whether a common trait of the two contributions might be excessive pessimism about the economic consequences of a small country size.

In these comments I will mainly focus on W&M's contribution and their strongly pessimistic conclusions about the viability of export industries in very small countries. I will briefly return to M&S's work towards the end of my discussion.

W&M's useful and intriguing empirical analysis has two parts. In the first part, they regress a number of business costs on size, size squared, and a few controls. Interestingly, they find different relationships between costs and size for different cost variables. In some cases (for example, sea freight costs and wages), they do find a negative relationship between costs and size: smaller countries always have higher costs. In other cases (for example, air freight costs), the relationship is U-shaped: while very small countries face higher costs, the minimum cost is reached at values between 1.5 and 3.5 million inhabitants, after which a larger size is associated with higher costs. A few other costs (e.g., installation costs of telephone lines) turn out to be *higher* in larger countries. The conclusion from this part of the analysis is twofold. On the one hand, a larger size is not necessarily associated with *lower* costs. On the other hand, a *very* small size – say, below the

https://doi.org/10.1017/S1474745604002058 Published online by Cambridge University Press

official Commonwealth threshold of 1.5 million people – does seem to be associated with higher costs for most (although not for all) cost variables under study.

But an important question is then the following: Are these costs higher *because* of the small size of the economies under investigation? Or are they due to *other* characteristics of those small countries? For instance, the authors are well aware that their data set does not allow them to separate the effects of size from those of geographic remoteness. Basically all small countries in their sample are islands or groups of islands in remote locations – that is, far from the main world markets. Successful, highly integrated small states in close proximity to large international markets, such as Andorra, Liechtenstein, Luxembourg, San Marino, etc., are absent from the sample. This omission probably causes the authors to overestimate the costs associated with a small 'country size', while attributing to size costs that may be really due to physical isolation or other characteristics (e.g., political institutions) of the small countries in the sample. The authors do introduce some control variables – such as distance from main ports or island dummies – in order to disentangle the two effects, but they recognize that their data are not informative enough to separate the effects of 'smallness' and 'remoteness'. One would need to extend the data set to include (a) 'non-remote' small countries, and (b) remote regions (e.g., island) within countries.[2] The authors downplay the relevance of this limitation for their analysis, by arguing that their policy interest and focus is on countries that are both small *and* remote. This is a fair point. However, one should be very careful about inferring a stable relationship between size and costs when the effects of 'remoteness' are not properly controlled for. And, of course, from a policy perspective it is crucial to know whether the cost disadvantages identified by W&M are due to (i) excessively small *political* size – which could perhaps be remedied through some forms of political integration, (ii) geographical characteristics, and/or (iii) the interaction between the two sets of factors (political size *and* geography).

The other key question raised by the W&M analysis is: Are business costs in small countries actually so high as to actually *prevent* the existence of viable industries? In the second part of their empirical analysis the authors calculate the excess costs (in comparison to the median country's) that countries of different sizes would face in electronic assembly, clothing, and tourism. They find that while small countries like Singapore (4 million people) would face only slight excess costs (3%–6% above the median country), very small countries like Vuanatu (about 200,000 people) would face cost inflation factors of 14% in electronic assembly and clothing and 28% in tourism, while micro economies like Anguilla (12,000 people) would have cost inflation factors of over 36% in the two

2 A difficult issue is how to deal with small economies that are not fully sovereign but have a distinct administration (and sometime even their own currency) – e.g., Bermuda. These small non-sovereign economies are listed in W&M's Table 1, p. 3, but are not part of the sample used in their empirical work, which is made almost exclusively of sovereign countries.

https://doi.org/10.1017/S1474745604002058 Published online by Cambridge University Press

manufacturing industries, and almost 60% in tourism. The authors calculate that a country faced with such excess costs would be unable to pay its workers *anything* at all as long as it must pay world returns to the other factors of production. That is, local factors of production might end up below subsistence level even with free trade. The only laissez-faire solution, in these dismal circumstances, would be depopulation. These results are surprising, especially if one considers that many very small economies do seem to have viable exporting industries, and, in any case, do not seem to be paying these high income penalties at the moment. In other terms, there is a discrepancy between the microeconomic conclusions of this paper and the macroeconomic outcomes observed in small countries. I must admit that when I first read that a country like Anguilla should not be able to sustain hotels and tourism I felt a bit as I did when I entered my grandma's data in the website *deathclock.com* and found out that her time had 'expired' and she should be dead.[3] But my grandma is happily alive, and many very small economies *do* seem to export successfully and obtain reasonable incomes for their factors of production. If the microeconomics of production is so dismal in small countries, why isn't the macroeconomic performance equally bad? In fact, macroeconomic studies, including the well-known paper by Easterly and Kraay cited by W&M, find that small countries, as long as they engage in international trade, do *not* have lower incomes than larger countries. What's going on? Part of the explanation, as the authors themselves notice, may lie in the fact that some small countries can charge above median prices in niche markets (e.g., tourism in tropical islands). Income transfers from other countries, either directly or through preferential access to their markets, are also likely to play an important role. However, it is also possible that a methodology based on (a) average relationships between size and costs, and (b) fixed input weights may overestimate production costs in very small economies, and induce to over-pessimistic conclusions about the economic efficiency of very small countries in the industries in which they have a comparative advantage.[4] One wonders whether small countries' relatively high incomes can be entirely due to niche markets, external aid, or other forms of rents. The question is whether very small countries can obtain relatively high returns to their factors of production (including labor) by exporting goods and services at international prices, in contrast with the pessimistic conclusions of W&M. A promising avenue of research may be to compare W&M's results with case studies from actual industries in specific small countries.

Of course, in practice it might be difficult to separate efficient provision of goods and services (including tourism and financial services) from 'sovereign' rents. For example, Easterly and Kraay's results about high incomes in smaller countries may

3 deathclock.com calculates the expected time of one's death using that person's expected lifetime *at birth* rather than her expected remaining lifespan (conditional on being alive today). Somebody should have explained Bayesian updating to the designers of this popular internet site.

4 As the authors are aware, an additional factor may be the overestimation of transportation costs when package discounts for holiday travel are not accounted.

https://doi.org/10.1017/S1474745604002058 Published online by Cambridge University Press

be partly explained by the ability of some very small countries to establish themselves as off-shore financial centers and tax havens. On the other hand, only countries with some distinctive cost advantages in terms of political institutions, skilled labor, transportation and communication, etc. can successfully establish themselves as providers of financial services and tax shelters.

Interestingly, W&M note that as legal rents (from preferential access to markets, direct foreign aid, etc.) are reduced, very small states may be induced to obtain rents from 'less social sources', since they are 'inherently difficult to police if their governments are not sympathetic to global objectives' (p. 37).

This last observation hints at the important issue of the systemic costs and benefits associated with a large number of small sovereign states, especially when such states have objectives that may be only imperfectly aligned with those of the international community as a whole. As already mentioned, this theme, from a different perspective, is also at the center of M&S's stimulating discussion. They notice how the current international trade system, with its mercantilist logic of bilateral qui pro quo, gives little bargaining power to small poor countries with limited domestic markets, while providing them with *de jure* and *de facto* veto power to block progress towards trade liberalization and other welfare-enhancing reforms.

I find most of M&S's analysis convincing. However, I am also left with the feeling that their conclusions may be too pessimistic about the economic and political consequences of small size.[5] Small countries can coordinate – both among themselves and with larger countries – to increase their joint bargaining power, and in fact we have witnessed a fair amount of successful coordination among developing countries – large and small – in recent negotiations within the international trade system. And, as W&M hint, small countries may have a range of options to increase their bargaining power, even in isolation. Nonetheless, M&S are probably correct in their skepticism about the ability of larger, richer countries to design efficient Coasian mechanisms to compensate small, poor countries. Domestic political constraints play a key role in limiting richer countries' ability to implement efficient transfers.

An especially important and difficult issue, which is touched upon in both papers, is labor mobility across political borders. If W&M are correct in their pessimistic evaluation of the export perspectives of very small countries, one should expect major labor outflows out of very small countries in the absence of direct transfer of resources from the rest of the world. In fact, depopulation of small isolated economies has taken place in the past (Niue had three times as many inhabitants in the 1960s), and raises serious issues of cultural extinction both

5 Of course, insofar as the 'small size' of a country's domestic market stems from a very low income per capita, it does represent a serious handicap almost by definition – however the problem in that case is not really the size of the economy, but low average income. Small countries with high income per capita are usually highly integrated in world markets and therefore tend not to suffer much from the limitations of a small domestic market.

https://doi.org/10.1017/S1474745604002058 Published online by Cambridge University Press

within the very small states and in the international community at large. Subsidies to prevent such depopulation can be justified on public policy grounds, insofar as diversity of languages, cultures etc. across polities is valued as an international public good.

While permanent migration is perceived as politically problematic, the authors of both papers view temporary movements of workers with great favor. In both papers preferential access in temporary movements of unskilled labor is considered worth pursuing. M&S view it as a politically viable second-best solution in a world that is unlikely to liberalize labor movements multilaterally. W&M point out that very small countries would face costs disadvantages also in this area (high transportation costs, etc.) but could overcome them through preferential access. The key political-economic question, again, is about the incentives faced by richer countries. Policy-makers in large industrial countries might be willing to conclude bilateral agreements on (temporary) labor movements with specific developing countries out of domestic-politics and/or geopolitical considerations. W&M are right when they worry about the long-term sustainability of these preferential agreements.

https://doi.org/10.1017/S1474745604002058 Published online by Cambridge University Press