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Economic Growth of Small Developing States—A Literature Review

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Economic Growth of Small Developing States—A Literature Review

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ABBREVIATIONS

EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
OECD	Organisation for Economic Co-operation and Development
PIC	Pacific Island Country
SDS	Small Developing States
SGN	Staff Guidance Note
SIDS	Small Island Developing States

Executive Summary

The objective of this paper is to review existing literature on economic growth in small developing states (SDS) and to assess the contribution of IMF publications as well as internal IMF papers and documents on these issues. The report contains a review of external (i.e., non-IMF) literature on the factors that affect economic growth in small states, as well as a range of IMF publications and internal documents written between 2010–2019. The review assesses the Fund's contribution to the literature on growth in small states and considers the extent to which both the external and Fund literature have been integrated in the IMF's general policy framework.

The paper states that over the evaluation period, Fund staff made important contributions to the economic literature on SDS, particularly in identifying policy solutions intended to address problems associated with economic instability and growth of SDS. While the external literature on growth in SDS, was heterogeneous, IMF publications and internal policy papers and guidance notes were more focused on the inherent characteristics of SDS as constraints for growth, notably their small size and their high degree of trade openness, features that were also identified in external work. The focus of most Fund literature on fiscal and exchange rate management suggest that the authors sought to follow the main IMF policy thrust at the global level and apply it to SDS with some tweaks relating to the specificities of these states. Fund publications could benefit by more actively encouraging collaboration of Fund staff with external researchers and external research institutions, so as to seek peer-review outside the IMF hierarchy.

A difference between the external literature and the Fund's own work identified in this paper relates to the importance assigned to social repercussions of economic growth, which tended to feature more frequently in the external literature. Although inclusiveness, equity, poverty reduction, social safety nets and income distribution were mentioned in the Fund's literature, it is apparent that these were postscripts as if to acknowledge that social hardship could possibly ensue in the short run as a result of remedial action, such as fiscal tightening.

The paper proposes enhancements in the Fund's approach to an SDS research in four areas which can help both extend and deepen Fund engagement with SDS members and close important gaps.

First, there is scope for the IMF to scale up international attention to the wide range of particular challenges faced by SDS both through an extension of analytical work and particularly through international advocacy, in particular remedial measures to counter SDS' limited ability to benefit from economies of scale.

Second, evidence from the external literature suggests that there is ample further scope for the IMF to both deepen and better nuance its analysis of the role of governments in SDS in promoting competitiveness, including finding possibilities for viable production of niche products, where competitiveness rests mainly on quality and uniqueness.

Third, there is considerable room for strengthening internal coordination of the Fund's research and analytical work on SDS. Such coordination could take more advantage of research synergies on issues that are common across regions. This would include issues which are not strictly economic, particularly social considerations and the need to enhance human capital through education and health.

I. INTRODUCTION

1. **The objective of this paper is to review existing literature on economic growth in small developing states (SDS);[1] and to assess the contribution of IMF publications as well as internal IMF papers and documents in supporting economic growth and employment in these states.** The report is organized in five sections. Section II presents a review of external (i.e., non-IMF) literature on the factors that affect economic growth in small states. Section III reviews a range of IMF publications as well as selected internal IMF papers and documents, including policy papers, SDS-related Staff Guidance Notes issued in 2014 and 2017 and other IMF documents prepared as part of the Funds' engagement prepared during the IEO SDS evaluation period from 2010–2019. The review describes key issues covered, assesses the Fund's contribution to the literature on growth in small states, and considers the extent to which both the external and Fund literature have been integrated in the IMF's general policy framework. Section IV provides an overall assessment of the Funds' work.

II. REVIEW OF EXTERNAL LITERATURE

A. Are Small States Different from Larger Ones?

2. **A number of studies argue that in matters relating to economic growth, there is no need to consider small states as a separate category, and that policies that promote growth are useful for small as well large states.** A paper, often cited in this regard, is that authored by Easterly and Kraay (2000). The authors tested whether small states are any different from other states in terms of their income, growth, and volatility outcomes. The results they produced indicate that keeping other relevant factors constant, small states tend to have higher per capita GDP than other states, which according to them, contradicts the often-used argument that small states suffer from an inability to exploit increasing returns to scale. The authors also found that per capita growth of small states does not differ systematically from that of other states. The authors, however, admitted that small states do have greater volatility of annual growth rates, in part due to their higher degree of trade openness, which on balance has a positive net effect on growth. They conclude that small states are no different from large states, and so should receive the same policy advice that large states do.

3. **A similar argument is proposed by Anklesaria Aiyar (2008), who contends that empirical studies do not, in general, find concrete evidence that smallness is a disadvantage in matters related to economic growth.** The author maintains that small states in general actually have a higher GDP per capita when compared to other developing states, and

[1] The Fund has 34 SDS members with populations of 1.5 million or fewer. The SDS grouping excludes small states defined as advanced market economies and fuel-exporting countries classified by the World Bank as "high income." The 1.5 million population threshold is also used by the World Bank (https://www.worldbank.org/en/country/smallstates/overview) and The Commonwealth (https://thecommonwealth.org/our-work/small-states). SDS accounts for 18 percent of Fund membership.

that while small states may have some special disadvantages, they clearly have some special advantages too. The author concludes that this undercuts the rationale for viewing them as a special category requiring special assistance.

4. **Armstrong and Read (2002a; 2003) argue that empirical research on the growth implications of size is inconclusive**, irrespective of definitions of size, the sample data sets and the stratification of data. The paper concludes that size is not a systematic barrier to economic growth and, in addition, that the economic performance of some small states outstrips that of many larger states.

5. **Briguglio, in various publications (e.g., Briguglio and others, 2009; Briguglio, 2016) contends, in countering the above arguments, that the fact that a number of small states perform well economically does not mean that they do not face major economic constraints,** including limited possibilities in reaping the benefits of economies of scale and high exposure to adverse shocks. The author maintains that the economic growth outcome in these states depends on various favorable and adverse factors, and can be positive overall, particularly if the right policies are adopted to withstand the mentioned economic drawbacks. This matter will be discussed further below.

B. Relevance of the Policy Environment[2]

6. **A number of studies deal with the connection of macroeconomic policy-frameworks and economic growth in small states.** This issue is often discussed in connection with economic resilience referring to the ability of an economy to withstand the adverse effects of external shocks. Two studies in this regard are Briguglio and others and others (2009) and Briguglio (2016). These studies show that small states, even if highly vulnerable economically, can nurture growth and competitiveness if they adopt the right economic policies, aimed at enabling the country to withstand, adjust to or recover from adverse shocks. The authors constructed an index of economic resilience, with policies that lead to macroeconomic stability as one of the components.[3] According to the authors, macroeconomic stability relates to the interaction between an economy's aggregate demand and aggregate supply. If aggregate expenditure in an economy moved in equilibrium with aggregate supply, the economy would be characterized by internal balance, as manifested in a sustainable fiscal position, low price inflation and an unemployment rate close to the natural rate, as well as by external balance, as reflected in the international current account position or by the level of external debt.[4] Such a situation, the authors argue, would allow economies to have room for maneuver when hit by adverse shocks.

[2] A number of papers on policy-induced growth in small states, were written by IMF staff members. These are considered separately in Section 3 of this paper.

[3] The resilience index, as constructed in Briguglio (2016) includes: (i) macroeconomic stability; (ii) prudent market flexibility; and (iii) political, social and environmental governance.

[4] There are many studies that refer to the high debt/GDP ratios of small states, especially those in the Caribbean region e.g., Dodhia, 2008; Sahay and others, 2006; Rustomjee, 2016).

Addressing market flexibility, the authors argue that the science of economics views markets and their efficient operation through the price mechanism as the best way to allocate resources in the economy.[5] If markets adjust rapidly to achieve equilibrium following an external shock, the risk of being negatively affected by such a shock will be lower than if market disequilibria tend to persist. The authors juxtaposed the vulnerability and resilience indices that they constructed, and classified countries according to their vulnerability and resilience scores, thereby deriving what they called the Vulnerability and Resilience framework. The results indicated that those small states with high vulnerability scores but also with high resilience scores tended to perform well economically. Conversely, those small states that were badly economically managed, and therefore registered low resilience scores, tended to be amongst the worst performers among all states globally.

7. **Jayaraman (2006) also writes about economic resilience building in small states.** The author contends that sound macroeconomic policies are key requirements for building economic resilience in small states to enable them to withstand the impacts of exogenous shocks, including weather and related disturbances. The author further argues that the capacity of small states to attain economic growth in the midst of adversities often undergoes serious setbacks due to frequent policy slippages, which exacerbate domestic and external imbalances. As policy prescriptions, Jayaraman highlights macroeconomic reforms involving fiscal consolidation, financial liberalization, enhancement of domestic competition and promotion of international competitiveness. In addition, resilience would be strengthened with effective utilization of aid, reduction of wastage and inefficiencies, prevention of corruption and encouragement of foreign direct investment (FDI). According to the author, these are standard prescriptions suitable for large and small states, but they are especially important for small states due to their high degree of economic vulnerability.

C. Economies of Scale, Unit Costs, and Competitiveness

8. **Most authors writing on small states acknowledge that their limited ability to reap the benefits of economies of scale, an inherent feature of these states, poses major constraints on their growth.** This argument is sometimes used to explain the level of competitiveness of small states, the high cost per unit of providing public goods, and the overhead cost indivisibilities in regulatory institutions. However, some authors (e.g., Armstrong and Read, 2003, Easterly and Kraay, 2000) downplay such constraints, stating that this is outweighed by other factors, citing inter alia a high degree of openness to trade, a high propensity for human capital formation and, in some cases, an advantageous location.

[5] Briguglio (2016) used the word "prudent market flexibility," to emphasize that a free market does not mean the law of the jungle, referring to the problems that arose as a result of the lack of regulatory control in the financial market which led to the 2008/09 global economic crisis.

9. **Although the assumption of economies of scale constraints is put forward when discussing small states, very few studies actually test this assumption.** Briguglio (1998) used a production function approach to test whether country size affects cost per unit of manufactured products and found that large states benefit from economies of scale in manufacturing, as expected. Winters and Martins (2004) found that small states experience high costs, even in areas where they can enjoy comparative advantage (such as tourism). However, Spolaore (2004) contended that Winters and Martins did not really show that relatively high costs were due to size, stating that their results may be questionable as they did not keep other things constant, such as remoteness. Spolaore observed that successful, highly integrated small states in close proximity to large international markets, such as Andorra, Liechtenstein, Luxembourg, and San Marino were excluded from the sample.[6]

10. **Briguglio and Cordina (2010) argue that there are many factors that could work against competitiveness in small states, other than economies of scale constraints.** These include excessive government involvement in production (which tends to crowd out private investment), monopolized markets, inadequate infrastructural services, and lack of balance between wage levels and productivity. However, the authors argue that, in spite of these drawbacks, some small states still manage to compete with larger ones in some areas, notably in services, where scale economies are not of major importance.

11. **Briguglio (2017a) tested the relationship between economic resilience and competitiveness.** The author argues that competitiveness and good economic governance go together. Using data on economic resilience derived from Briguglio (2016) and data on competitiveness, derived from the Global Competitiveness Indicators, the author found that competitiveness and economic resilience are highly correlated across countries, with the economically successful small states recording relatively high scores on both indices. The author took this to imply that the small states that adopt good economic governance may not only be enabled to withstand or reduce the harmful effects of their exposure to economic shocks and their limited abilities to reap the benefits of economies of scale, but also to be competitive.[7]

12. **Baldacchino (2019) attributes the success of some small states in attaining competitiveness to flexible specialization**. According to the author, this enables many small states to secure good outcomes by being nimble at grasping opportunities, if and when they may arise in the evolving or abruptly changing scenarios that characterize small states. The author argues that a number of small countries, including Malta, Singapore, Bermuda, and Hong Kong, do not have naturally available and exploitable economic resources. Baldacchino contends that the manner in which these states attain competitiveness is by adjusting to circumstances quickly and flexibly, thereby taking advantage of their small size.

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[6] On this issue, see also, Wignaraja and Joiner (2004; 2006).

[7] Similar results were obtained in Briguglio and Vella (2019) with a focus on the EU small states.

13. **The success of some small states in being competitive, while others are not, is treated in Wignaraja and Joiner (2004),** who contend that many small states are highly preoccupied with competitiveness in view of their need to export a relatively large proportion of their sales. This reality has, according to the authors, fueled studies on appropriate policy responses to the effect of globalization on these states. The authors argue that most well-known competitiveness indices are not appropriate to assess the competitiveness of small states, and for this reason they devise an alternative index for this purpose. The authors found, not surprisingly, that the European small states (such as Malta and Estonia) perform well, as do other regional small state "powerhouses," such as Fiji, Mauritius, and Trinidad and Tobago. However, the authors contend, the tiny microstates record a particularly weak competitiveness performance, suggesting that even within the world's smallest economies, country size matters for competitiveness. Factors like the lack of domestic markets, technical manpower, and lack foreign direct investment may help to explain the poor performance of microstates.

14. **Very often countries can be competitive in one sector and not so in another**. One would expect that small states face major constraints in sectors which depend on mass production to be viable, as is the case of many manufactured and agricultural products. This could possibly explain why some small states do not manage to compete with larger ones in manufacturing but do so in services, notably tourism and finance, where mass production is not a major requirement for competitiveness. Croes (2011) argues that there is evidence that a competitive tourism development strategy is growth enhancing, permitting small destinations to generate income and employment. When discussing financial services, Dharmapala and Hines (2009), affirm that small countries that depend highly on such services tend to enjoy rapid economic growth, and contend that sensible tax policy options are associated with the quality of governance. The authors conclude that good governance enhances the competitiveness of small states in this sector, suggesting that low tax rates alone are not sufficient inducements to foreign investment.

15. **Even in manufacturing and agriculture there may be opportunities for small states to produce goods competitively by seeking niche markets.** As Bourne (2004) argues, the strategic significance of niche products is that they are resistant to scale economies, compete mainly on the basis of quality and uniqueness and are amenable to flexible production arrangements. Fiala (2019), and Punnett and Morrison (2006) provide various examples of successful niche-market ventures which are suitable for small states.

D. Trade Openness Vulnerability and Volatility

16. **In studies on small states, many authors consider trade openness as a factor that positively affects growth.** Armstrong and Read (2002a; 2003) contend that small states necessarily have a high degree of trade openness due to their small domestic markets. Easterly and Kraay (2000), while admitting that trade openness can lead to GDP and terms of trade volatility, argue that their greater openness on balance has a positive effect for growth. Similar arguments are proposed in Alesina and others (2000; 2005). Some authors, while admitting that trade openness is good for growth, also consider that such a condition renders small states

highly exposed to external shocks, leading to GDP growth and terms of trade volatility (Briguglio, 1995; Briguglio and Vella, 2016).[8]

17. **Although various authors acknowledge that small states are generally exposed to external shocks, more so than larger states, due to their high dependence on international trade and narrow range of exports, there is no general agreement that such a condition hampers growth.** Armstrong and Read (2002b; 2003) actually argue that there is a positive relationship between economic vulnerability and economic growth, based on the vulnerability index proposed by Briguglio (1995). It should be noted that Briguglio, the originator of the index, never argued that vulnerable states do not grow fast—Briguglio's argument has consistently been that small states can be highly vulnerable to external shocks, but they could adopt policies to withstand such shocks, and many well-performing small states in fact do so (Briguglio, 2016).

18. **Closely related to vulnerability is the issue of volatility of small economies, either in their terms-of-trade or in GDP growth.** As already indicated, the arguments derived from the literature generally led to the conclusion that while openness may be good for growth, with a few dissenting opinions, it also has negative effects by generating volatility (Briguglio and Vella, 2018). This leads to the question as to why volatility is undesirable. There are various reasons for this, including that fluctuations can generate a welfare loss and others through the negative effect of uncertainty (economic, political, and policy-related) (Loayza and others, 2007). In addition, volatility may usher in a higher risk of policy failure (Gavin and Hausmann, 1996; Fatás and Mihov, 2013), including fiscal and monetary policies that intensify rather than calm the trade cycle. Furthermore, volatility may also lead to lower growth, ceteris paribus (Ramey and Ramey, 1995); Hnatkovska and Loayza (2005). Although openness leads to growth volatility, Briguglio and Vella (2018) argue that this can be mitigated by good economic and political governance and this may explain why some small economies do not exhibit a high degree of GDP growth volatility even though they are highly open. The basic argument in this regard, according to Briguglio and Vella (2018), is that an economy highly exposed to adverse external shocks would be prone to GDP growth volatility but this could be dampened as a result of good economic policies. Conversely a country which is not highly exposed to external shocks may still register volatile growth due to bad domestic governance.

19. **Many authors refer to the environmental vulnerability of small states resulting from ecological and meteorological factors because of their topography.** In the vulnerability indices produced by the Commonwealth Secretariat (Atkins and others, 2000) and by Briguglio (2016), proneness to natural disasters is included as one of the index components. Studies that utilise a proneness to natural disasters variable in growth equations often find that such disasters have negative effects on public finances and on growth (Mitchell and others, 2017; Rasmussen, 2006). Due to the fact that many small states are prone to natural disasters, some

[8] However, Down (2007) argues to the contrary, stating that for these countries international trade integration may have eased rather than accentuated domestic economic volatility.

authors discuss the need to strengthen disaster management in such states. Jayaraman (2006) points out that the economies of small states in the Caribbean and the Pacific regions are frequently affected by natural disasters, and such occurrences lead to the contraction of output, pressures on the balance of payments and on government budgets. The author suggests that measures conducive to reducing the adverse consequences of natural disasters include improving preparedness, better management of the environment, improved use planning, and provision of relief measures involving non-government organizations. Natural disasters in small states and policies conducive to reducing their harmful effects are also discussed in Marto and others (2018), Roberts and Bonne (2019), and Zhang and Managi (2020).

E. Other Factors Associated with SDS Growth

Geographical Location

20. **A number of studies identify geographical location as a factor affecting economic growth in small states.** One explanation is that the greater the distance of a small state from main commercial centers, the higher are the foreign trade costs, amongst other things, reducing competitiveness of exports and FDI attraction. Brito (2015a) contends that although there is no general agreement in empirical studies on the effects of country size on economic growth, there is consensus that geographic distance from major markets is a principal economic growth disadvantage in small states. Armstrong and Read (2006) also assign major importance to location as a determinant of growth. They argue that small states located in high-growth geographical regions generally exhibit higher rates of growth and levels of per capita incomes. Nevertheless, they note, the success of Mauritius demonstrates that geographic isolation is not an insuperable barrier to growth.

21. **Changing trade patterns and** information and communications technology **(ICT) may reduce the remoteness disadvantage.** Gibson (2019) contends that although remoteness can account for the slow rate of economic growth in the Pacific Island countries, these countries may have become potentially less remote in recent years as world economic activity shifted towards the East. The author concludes that such reduction in connectivity remoteness could emerge as an important factor relating to growth. Favaro and Peretz (2008) argue that advances in ICT may be used to offset the problems posed by geography, although many small states have telecommunication regulations that hinder competition, and impede access to low-cost, high-quality international communications. The authors argue that, therefore, introducing competition in telecommunications is one of the policy reforms with the highest payoffs for small states.

Tourism

22. **Many small states, particularly island ones, depend highly on tourism and this industry is mentioned in several studies as conducive to economic growth of small island states.** The positive contribution of tourism to economic growth is treated in Narayan and

others (2010) and Everett and others (2018) for the Pacific small island states[9]; by Cannonier and Galloway Burke (2019) and Apergis and Payne (2012) for the Caribbean small island states; and by Seetanah (2011) for island economies in general.

23. **International tourism is an export of services and therefore a high degree of reliance on this industry has the advantages or disadvantages associated with a high degree of trade openness in general.** While it is an important source of income and employment in small island states, it can also lead to environmental degradation and social discomfort (Archer and others, 2005). Recent studies on what has become known as "overtourism" present discussions on the risks of a country being too dependent on this industry (Goodwin, 2017; Martín and others, 2018). The experience of the COVID-19 pandemic, with its devastating impact on the tourism sector, has clearly demonstrated the validity of this concern.

Institutions and Governance

24. **A number of papers relate economic growth in small states to their institutional setups.** Bräutigam and Woolcock (2001) argue that because small countries are economically vulnerable, the quality of their institutions matters even more than it does for large countries. The authors' main message is that small countries with high quality institutions appear to manage their risks and opportunities in ways that yield higher rates of economic growth and stability. A similar argument is put forward by Farrugia (2007) who contends that the need for institutional capacity building for development is essential for small island states, more so than larger ones, due mostly to the former's high degree of exposure to exogenous shocks. Brown (2010) identifies what he calls binding constraints that adversely affect the Caribbean small states' institutional development, including that the per capita cost of public administration is higher than in larger economies, the limited pool of skilled human resources to perform the vital roles of the public service and a lack of depth in specialization. Similar arguments are proposed in Gomez (2004).

25. **Associated with the question of institutions, is the issue of political governance.** It is generally assumed that good governance is conducive to economic growth, although several studies do not collaborate this presumption empirically (Rodrik, 2008; Kurtz and Schrank, 2013). However, even if good political governance and economic growth are positively correlated, there is no systemic indication that such governance in small states is generally worse that in large states. Some authors (e.g., Veenendahl, 2019; Anckar, 2020) contend that in a typical small state there are circumstances that work in favor of democracy, such as a high degree of social cohesion and others that work against it, such a high degree of political clientelism. The relationship between good political governance and country size was tested empirically by Curmi (2009), using the World Bank's Worldwide Governance Indicators, and the results suggest

[9] Cheer and others (2019) however are not so confident that tourism in the Pacific Island countries is good for economic growth.

that the stage of economic development of a country, and not its size, seems to be the major explanatory variable in this regard.

Domestic Competition

26. **Monopoly and cartel practices are often associated with inefficiency which would hamper economic growth. A small domestic market is likely to nurture such practices, and therefore this matter should be an important factor when discussing growth in small states.** To date, not much has been written on this matter, and this variable does not feature in empirical growth models relating to small states, possibly due to measurement problems. However, some authors argue that small states face special competition constraints (Armstrong and Read, 2003, Briguglio, 2017; Gal, 2001). Briguglio (2017b) makes the point that in a small domestic market, dominance by one or a few firms is common. In such markets, natural monopolies in utilities, such as electricity, telephony, gas and water, are prevalent due to the relatively large overhead costs which are difficult to scale down in proportion to the population and may not permit more than one entity to viably supply the service. This may also apply to private business, due to the poor chances of success of setting new business in goods and services already supplied by existing firms.

27. **Associated with small domestic markets, especially in the case of islands, is the occurrence of market failure**. This challenge, highlighted by Cordina (2007) and Baldacchino (2020), is due to a number of factors, including the existence of relatively large reliance on public goods and the externalities associated with social and environmental effects. In such cases, market forces cannot be relied upon to ration supply and demand, and competition law and policy would be irrelevant.

Innovation

28. **Although innovation is often considered a major driver of economic growth, mostly through its effect on productivity (Ahlstrom, 2010; OECD, 2007), this variable hardly ever features in empirical models of growth in small states.** However, a number of studies identify limitations faced by small states in fostering innovation in production. Kattel and others (2011) argue that there are major constraints facing small states in this regard, especially because the promotion of innovation requires administrative capacity which tends to be constrained due to the small population pool. Similar arguments are put forward in Qureshi and te Velde (2008) and Crespi and others (2017). Some studies on small states, though not referring directly to innovation, refer to the resourcefulness of islanders, though here again no empirical tests were conducted on this matter. Baldacchino and Bertram (2009), writing about what they call strategic flexibility, explain how individuals, household units, corporate entities and complete jurisdictions, seek to exploit opportunities and maximize economic gains in a turbulent and dynamic external environment.

The Social Dimension

29. **Studies on the social dimension of SDS generally attempt to show that these states have specific characteristics which can be beneficial to economic development while others are detrimental in this regard.** For example, Alesina and Spolaore (1997) writing about social cohesion, argue that larger population may involve less homogeneity, because the cultural differences and the distance between the preferences of individuals are probably positively correlated with country size. This matter is also discussed by Brito (2015b), who contends that small states tend to develop a very integrated society with very complex relationship networks allowing a high degree of interpersonal communication and efficient flow of information between government and private enterprises, strengthening the relationship between the two sectors. This matter also features in various studies by Armstrong and Read. In their 2003 paper, the authors consider social cohesion as a positive factor for economic growth, as this could foster consensus in economic management and policy making and rapid responsiveness to external change, both of which would have positive growth effects.

30. **On the other side, close knit societies may be highly susceptible to clientelism.** However, Armstrong and Read contend that divisive rent-seeking behavior based upon family ties or clientelism may also be prevalent in small states because of the more frequent close contacts between decision makers and constituents in small societies. In the same vein, Briguglio (1995) argues that a situation where people know each other well and are often related to each other may compromise impartiality and efficiency in public administration by for example interfering with the promotion and recruitment of the workforce, and not on merit. This matter is hardly ever tested empirically in small-state literature, because of the problems faced in measuring social cohesion. Jenson (2010) in discussing the matter with a focus on small states, refers to the difficulties of measuring social cohesion, mentioning the problems faced by Easterly and others (2006) in finding data for their attempt to correlate social cohesion with economic growth.

31. **Petzhold (2020) contends that policies in small island developing states (SIDS) are highly influenced by their specific conditions, shaped by issues of small scale, and external forces to which these states are exposed.** Features of social self-organization, collective action and levels of trust within a society—often understood as "social capital"—can create enabling conditions for adaptive governance and increase small states' resilience to forces outside their control, including climate change, to which small island states are highly vulnerable. The author further argues that the different features of social capital can be critical elements for sustainable adaptation in SIDS, depending on their specific adaptation needs and socio-political contexts.

32. **The connection between social capital and economic growth in small states has been investigated in various studies**. Baldacchino (2005) argues that an appreciation of 'social capital' theory makes for a more informed understanding of how many (though not all) small states manage to generate a commendable standard of living. Briguglio (2016) contends that improvements in social conditions, a requisite for improvement in social capital, could reduce the harm arising from a small country's exposure to external shocks because it affects the extent to

which relations within a society are properly developed, enabling an effective functioning of the economic apparatus without the hindrance of civil unrest.

33. **Closely linked with social cohesion and social capital is the topic of human capital, which is an essential input for economic production.** Various authors including Barro (1991) and Sala-i-Martin and others (2004) found evidence that there is a positive correlation between human capital and the growth rate of GDP per capita across countries. Armstrong and Read (2003) contend that human capital is a critical source of economic growth generally and can be expected to be a very important factor for small states given their small population. The same authors (2004) maintain that the accumulation and utilization of human capital—education, training and "learning-by doing," which is often identified as being a key factor in growth—may be a critical determinant of the underlying comparative advantage of some small states. Given that they cannot hope to compete with low-cost labor-intensive exports from more populous developing countries, small states must focus instead on enhancing labor quality through human capital formation to increase productivity and raise domestic value-added. Baldacchino (2019) echoes Armstrong and Read's argument that human capital is a key "conditioning" variable for small state development. Beine and others (2008) however, observe that small states often lose human capital as a result of the skill and brain drain leading to a loss of a larger proportion of their skilled labor force. The authors argue that small states are successful in producing skilled natives but not so successful in retaining them.

34. **Soobratty (2016) argues that a system of education for a sustainable society has a pivotal role to play to support a cohesive society, equipping small states with the necessary inclusive mechanisms for managing conflicts**. Crossley and others (2011) referring to the small states of the Commonwealth, contend that these states face distinctive educational challenges arising from their size, highlighting the need for these states to respond meaningfully to major external shocks and challenges, especially in the economic, environmental, cultural and political domains. A strong case can therefore be made for continued special focus on the needs and opportunities of small states. The author refers to education as providing opportunities and challenges in building resilience in the face of such challenges.

35. **Policies relating to health are also associated with growth and resilience building in small states.** Azzopardi-Muscat and others (2016) referring to the small European Union (EU) member states, discuss institutional set-ups for the provision of public health, and argue that institutional costs in this regard are very costly for small states. The authors contend that EU membership has brought significant public health reforms, transformation in the regulation of medicines and development of specialized training for doctors, positively affecting the policy-making process, networking opportunities and capacity building. Overall stakeholders in the small EU member states have a positive outlook regarding their health system Europeanisation experience, calling for the need for improved consideration of the specificities of small health systems. This health aspects of small states are also addressed in Azzopardi-Muscat and Camilleri (2018) who investigated whether there are any associations between country size

and a cross-section of 184 countries. They found that small states faced particular challenges depending on the regions, some of which are the result of a small population.

36. **Health and education are both associated with social development and feature prominently in the Human Development Index.** These aspects of social development are important for all countries, but especially so for small states. One reason for this is that small states tend to be highly dependent on the human input, given that many of them have limited natural resources endowments.

37. **Social policy in general, with reference to small states, is addressed in Bertam (2010) who defines it as policy that shapes the long-term structure and functioning of all social groups for which the small state is their economic, cultural and political "home" and source of identity.** The author contends that vital dimensions of social policy in small states are concerned with mediating linkages and relationships between the home-resident population (and its government), on the one hand, and the outside world, on the other. The domestic factors include taxation, which is essential in financially supporting social policy. These external factors include fiscal funding from overseas aid, and emigrant diasporas remittances. The combination of a large government sector relative to population, accompanied by a limited productive base, rendered many small states often reliant on external factors. The author argues, therefore, that there is scope for comparative investigation of the specificities of small states with regard to social policy.

Loss of Trade Preferences

38. **An issue that is often mentioned when discussing growth prospects of small states is the loss of trade preferences, which occurred since the mid-1990s as a result of the World Trade Organization's (WTO) rules.** This aspect is not generally tested empirically, because of data problems. However, it is extensively discussed in Smith (2009), Palayathan (2004) and Grynberg and Remy (2003), with the main conclusion being that Small Vulnerable Economies[10] face special circumstances and therefore the WTO should take cognizance of these special characteristics in its international trade rules.

39. **Some studies deal with the effect of trade liberalization in general on the economic performance of small states.** Mellor (2019) contends that with tariff barriers declining throughout the world, current trading advantages enjoyed by the Pacific Island nations are being eroded. Heron (2008), on the other hand, maintains that the nature and severity of the impact of economic liberalization are not particularly unique to small states, and that small states that are highly dependent on trade preferences can adopt policies to withstand the effects of such a global change.

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[10] Small Vulnerable Economies (SVE) is the term used for small states within the WTO. Eligibility of a country to be considered as an SVE is not based on population size but on the country's share of world trade.

Foreign Direct Investment

40. **A factor that is generally considered to be conducive to economic growth is FDI.** Read (2008) argues that FDI is potentially a critical contributor to growth and development of small states, as in addition to increasing the stock of capital in the country, these flows embody additional complementary growth factors, including technology, know-how and managerial expertise. In their study, Jayaraman and Choong (2010) obtained strong empirical evidence of a positive and significant relationship in the short and long term between FDI and economic growth in Vanuatu. However, Feeny and others (2014) argued that growth returns from FDI to the Pacific region has, on average, been very small, though positive. A number of explanations for this finding are provided, including some empirical evidence that FDI displaces domestic investment in that region. With regard to the Caribbean, Kolstad and Villanger (2008) contend that the small states in the region do not suffer from low inflows of FDI—on the contrary, Caribbean countries receive more FDI than comparable countries in other regions. The authors argue that FDI in the Caribbean appears particularly sensitive to political stability, and conclude that efforts to improve the investment climate of countries in the region should focus on this aspect.

41. **Another source of investment flows into a number of small states, particularly in the Caribbean region, is citizenship by investment programs (CBIs).** According to Keane and Haughton (2020) the proceeds from these flows can be conducive to economic growth in small states if invested well, particularly for infrastructural development. On this matter, Cover-Kus (2019) argues that it is important that small states capitalize on the opportunities presented by CBIs, advocating that CBI returns should be invested in the sustainable and resilient development of their countries. However, the same author admits that these programs can facilitate money laundering, tax evasion and other criminal activities, and it is therefore important to intensify scrutiny of these programs.

Aid and Remittances

42. **There is considerable debate about the efficacy of aid in generating economic growth in large and small states.** Some authors (e.g., Collier and Dollar, 1999) argue that financial aid can help small developing states grow and reduce poverty, but only if these states pursue sound economic policies. They further argue that broad policies that work for large countries should also work for small ones. Other authors, particularly those writing about aid flows to the Pacific small states, (e.g., Jayaraman, and others, 2016), associate aid with Dutch Disease in small states which have their own currencies. However, Fielding (2013) argues that the Dutch Disease could be avoided if the inflows of funds lead to increases in capital stock in the traded goods sector. On this issue, Hansen and Headey (2010) contend that the effect of aid in small states depends on its absorption. When aid forms a large proportion of the inflow resources, there does appear to be sufficient focus on absorbing the resource flows, but not when there are other important sources. Feeny and McGillivray (2013) in examining the impact of

aid on real per capita income growth in SIDS, conclude that aid fosters economic growth in these countries but with diminishing returns.

43. **Some authors (e.g., Aiyar, 2008) assert that small states already receive too much aid, and it does not make sense to propose additional foreign aid in view of these states' disadvantages, while ignoring their advantages.** Guillaumont and others (2018) also conclude that the level of aid received by small developing states is relatively high considered either per capita or as a ratio to gross national income. According to these authors, the rationale for this relatively high level of aid is grounded in their high degree of economic vulnerability.

44. **Another source of unrequited income flow relevant to economic growth in small states is remittances.** Jayaraman and others (2011) found a positive and robust effect of remittances in two small Pacific states (Samoa and Tonga), According to the authors, this impact occurs via increased liquidity in the banking system, which, in turn, increases credit to the private sector. Sami (2013) concluded that there is an important causal relationship in the short and long term, between remittances and economic growth and the banking industry in Fiji. These studies indicate that remittances inflows may not only be conducive to economic growth but for developments in the banking sector as well.[11] However, Jayaraman and others (2016) found that remittances, like aid, may have contributed to the so-called Dutch disease in Fiji due to the effect on the currency appreciation, thereby eroding competitiveness in the tradable goods sector. A similar argument was put forward by Bourdet and Falck (2006) with regard to Cape Verde.

F. Conclusions

45. **In the foregoing review of the external literature, various factors were identified as having an effect on economic growth in SDS**. Some of these are inherent or quasi-inherent in small states, including economies of scale constraints, location, population size and to an extent high dependence on external trade and exposure to natural disasters, which therefore cannot be changed, or are very difficult to change, by government policy. Other factors are policy-induced, such as macroeconomic management.

46. **Factors that may explain the different findings by different authors include data availability, the countries included in the analysis, the methodological approach utilised, and the time period covered.** However, inherent factors such as economies of scale limitations, which also affect competitiveness, as well as trade openness and geographical location, were identified as affecting economic growth in many of the studies featured above. The economies of scale constraint implies that policy implementation is likely to be costlier for SDS than is the case for larger countries, a factor that should be given major importance in the Fund's policy advice to SIDS.

[11] Gani (2011) also found a positive effect of remittances on growth in the Pacific region, but the relationship lacked statistical significance.

47. **The inherent disadvantages of SDS, everything else remaining constant, should lead to serious impediments to competitiveness and economic growth**. In reality, however, economic policy measures could enable SDS to attain satisfactory growth rates, possibly more so than larger developing countries, particularly when latter are badly governed. There are two major literature strands in this regard. The first interprets the positive growth outcomes of a number of small states as proof that small country size does not merit special policy consideration, given that statistics show that small states are not, as a group, laggards in terms of growth. The second deduces that small states are highly disadvantaged, but policy measures leading to robust macro policy frameworks and good economic governance can lead to positive growth outcomes.

III. REVIEW OF IMF LITERATURE

48. **This section traces the evolution of the Funds' research and policy work on SDS growth, reviewing a selection of IMF internal and external papers related to growth challenges in these states.** Broadly this literature captures several important thrusts of the IMF's overall approach to growth in SDS. The section first considers two overarching staff research papers, the first of which was prepared in 2008, just prior to the 2010–2020 evaluation period and the second published in 2015, about mid-way through the evaluation period. Subsequently, the section reviews two substantive regional policy papers prepared in 2013 and 2016, focusing on Caribbean and Pacific SDS respectively; three policy papers produced between 2013–2017, covering macroeconomic policies in small states, selected policy issues and challenges faced by SDS in addressing natural disasters and climate change. Finally, the section briefly reviews two Staff Guidance Notes (SGNs), issued in 2014 and in 2017, which offer policy guidance to staff working on SDS, on growth and related policy challenges in SDS.

49. **Prior to 2009, and with few exceptions, the literature on SDS' growth and associated economic policy and development challenges originated and proliferated largely outside the IMF.** The IMF effectively joined the discussion on small states economics from 2009, with IMF researchers having the advantage of drawing on the extensive literature on small states which had grown exponentially during the 1990s and 2000s. Initially appearing as IMF working papers, this work evolved over time to include a number of books, policy papers and Staff Guidance Notes. The contribution of the IMF on the factors that affect economic growth focused mostly on economic governance, including fiscal policy, exchange rate management and related institutional arrangements. Since approximately 2017, there has been a further acceleration in the number and range of IMF working papers, although since the emergence of a five-pronged "GROWTH" policy guidance framework, attention specifically to growth challenges has tended to become more granular across the five pillars of this framework.

A. Pan-SDS Research Papers

50. **Two IMF research papers in 2008 and 2015, respectively, point to the IMF's growing interest in growth and related challenges in SDS as a country group.** The first of these, authored by Ota and Medina Cas (2008), focusses on the fiscal characteristics of small states

which can influence the implementation of sound policies. The authors referred to a number of specificities of small states including economies of scale constraints, relatively large public sector, and high degree of trade openness, which could lead to high exposure to external shocks. The authors also refer to the erosion of trade preferences and natural disasters which contributed to rising debt in some SDS, particularly those located in the Caribbean. On the basis of this discussion the authors draw policy recommendations for small states including fiscal tightening to reduce the dangers stemming from high public debt and economic volatility. They argue that fiscal tightening could boost flexibility and create space in response to shocks, and present evidence linking better and more effective governance policies that could lead to lower public and external debt in small states. The authors contend that improving government effectiveness can usefully support fiscal adjustment in small states, and, in addition, that controlling the size and cost of government can make government more efficient and more effective in achieving its principal functions in the delivery of goods and services. The study also upholds the view that fiscal discipline underpins the credibility of the fixed exchange rate regime, which exist in the majority of small states, with regression results showing that a fixed exchange rate regime is correlated with lower public debt in their sample of countries. In the view of the authors, as the exchange rate regime is well designed, the fixed exchange rate can underpin growth and reduce transaction costs. The authors insist that that neither a fixed nor a flexible exchange rate regime should be used to address the fiscal imbalances and high public debt many small states had—this matter should be addressed primarily through fiscal adjustment.

51. **A second pan-SDS paper, developed mid-way through the evaluation period, by Cabezon and others (2015) also refers to the unique characteristics of SDS, focusing on those that make fiscal management more challenging than elsewhere.** Most importantly, the indivisibility of expenditure on the provision of public goods and public sectors, which are the main employers, introduces rigidities into budgets, tilting the composition of spending toward recurrent outlays. The authors argue that this leads to limited fiscal resources and high recurrent spending, possibly crowding out private investment in growth-enhancing areas. They further contend that SDS generally—and particularly fragile SDS and commodity exporters—face greater revenue volatility than other country groups owing to their exposure to exogenous shocks and narrow production bases; and also often lack the capacity to dampen revenue volatility because of difficulties relating to shallow domestic banking systems, with limited access to international capital markets. A negative consequence is often resort to procyclical fiscal policy. In this regard, the authors refer to fiscal anchors (such as debt and deficit targets) to help smooth spending and isolate budgets from revenue volatility. It also helps to properly assess a country's underlying fiscal position, which is sometimes masked by headline fiscal balances. The authors also recommend fiscal buffers to create possibilities for spending on infrastructure and human capital, including education and health. Mobilizing revenues by bolstering administrative capacity and reforming the domestic tax system is also needed to increase fiscal space to meet critical development spending needs while improving the business environment. In practice, according to the authors, these reforms need to be tailored according to the particular country circumstances.

52. **The authors also argue that reform of wage bills, public servants' benefits, and revenue administration should be included in the fiscal package, and that involvement of public resources to support loss-making, inefficient public sector enterprises should be reduced.** To this end, exploring opportunities to outsource service delivery to the private sector is warranted, where possible. Such a policy would improve the business environment and attract private investors from abroad. The authors also maintain that, although higher capital spending is good for growth, it is less so when it expands deficits too much and raises debt unduly. A conclusion that emerges from this study is that the impact of capital spending on growth is stronger in Asia and Pacific small states than in other small states, consistent with their larger development needs. The authors state that their results suggest that there is a non-linear relationship between debt and growth, that is, while low levels of debt are good for growth, high levels are not.

B. Regional Analysis

53. **The IMF has also produced a number of regional papers covering growth and related policy challenges in regions in which the IMF's SDS members are concentrated.** For example, in IMF (2013), Acevedo and others argue that the Caribbean small states, while sharing many features of other small states, have specific characteristics that negatively affect growth and fiscal balances, including the instability associated with the aftermath of the 2008/09 global crisis and the high and increasing costs of frequent recurrence of natural disasters. The authors state that many cost disadvantages are structural, but some are policy driven, singling out high labor costs which had grown faster than productivity, and high utility costs due to inefficiencies, lack of investments, and/or monopolistic structures in power generation and distribution. All this led to deep-rooted competitiveness problems, which in turn gave rise to high current account deficits, high debt ratios and slow growth. The authors advocate fiscal adjustment to correct for domestic and external imbalances, but, they argue, the smallness and vulnerabilities of these countries make adjustment exceptionally difficult. A comprehensive strategy would have to overcome important political economy constraints. The Fund was considered as having a role in such a difficult adjustment exercise, but the authors argue, collaboration with other institutions would be beneficial to help alleviate any "stigma" attached to Fund-supported programs. The study urges for Caribbean-wide regional surveillance exercise, referring to the success of the Caribbean Regional Technical Assistance Center for delivering technical assistance in a regional framework, which appeared to be a Caribbean preference. A region-wide approach would take the spotlight off any individual country's failure to succeed and could marshal peer support, both for countries to learn from each other and to form a united front against political obstacles.

54. **A more recent IMF publication focusing on the Caribbean is Srinivasan and others (2018), which contains a number of chapters dealing with challenges facing Caribbean policy makers.** The book discusses policy options for promoting sustained and inclusive economic growth, arguing that the Caribbean economies need to improve their fiscal positions, their thin financial market and their monopolistic structures for this purpose. The

authors also refer to the prevalence of violent crime in some Caribbean small states, which, the authors argue, tends to negatively affect investment and growth. The book also deals with the need for regional collaboration and deeper integration with Latin American countries in dealing with these challenges, and to reducing economies of scale constraints. This could also be conducive to improve the Caribbean SDS ability to withstand their economic vulnerabilities.

55. **In regard to Pacific SDS, Khor and others (2016) discuss the factors that affect economic growth in these countries and provide an overview of the policy issues and challenges they face.** The study seeks to identify policies that could help to raise growth performance in a way that is both inclusive and sustainable. It argues that the slow rate of growth of Pacific SDS can be partly explained by the region's unique characteristics, including small populations and small internal markets, remoteness, vulnerability to natural disasters and climate change, narrow production bases due to smallness and therefore economies of scale constraints. These are inherent features, but the authors argue, economic policies also matter. These include weak macroeconomic policy frameworks, which led at times to unsustainable exploitation of natural resources, weak policy implementation capacity, limited financial depth, laws and customs that limit the flexibility of product and factor markets (for example, land tenure), high levels of public debt in some countries, and high dependence on foreign aid and remittances. Political instability also hampers investment and the development of sound institutions.

56. The authors state that while there is broad agreement about the factors that have contributed to slow growth in Pacific Island countries (PICs), it is less obvious how these constraints can be overcome. The major challenges with regard to growth in PICs, according to the authors, are to put in place policies that promote macroeconomic stability and debt sustainability, attracting FDI and strengthening institutions. The right balance needs to be found between the need to build fiscal buffers to enhance resilience and funding development spending. The authors consider regional collaboration as very useful to mitigate the economies of scale constraints, enhance competition, protect and promote regional interests, and allow greater specialization in areas of comparative advantage.

57. Three other Fund staff papers focusing on the Pacific SDS are Yang and others (2013), Tumbarello and others (2013) and Cabezon and others (2019). The last-mentioned paper deals with natural disasters and climate change in the PICs arguing that these events worsen countries' fiscal positions and damage growth prospects. The authors calculate that in the region, for damage and losses equivalent to 1 percent of GDP, growth drops by 0.7 percentage points in the year of the disaster. The paper also discusses a multi-pillar framework to enhance resilience to natural disasters at the national, regional, and multilateral levels and the importance of enhancing countries' risk management capacities. The IMF's Asia and Pacific Department also publishes a regular periodical, titled *Asia Pacific Monitor,* with write-ups on various issues relating to the SIDS in the region.

C. Policy Papers

58. **Building on the IMF's SDS research and regional analysis, the IMF has also prepared three particularly important policy papers addressing macroeconomic policy challenges in SDS.** The first of these, published in 2013 (IMF, 2013a) focusses on macroeconomic issues in small states and implications for Fund engagement. It provides a comprehensive framework for examining the growth-related and other challenges of small states, including limitations on their ability to reap the benefit of economies of scale leading to higher costs per capita, limited diversification possibilities and exposure to natural disasters.[12] The paper refers to the small domestic market of SDS, often compelling them to rely highly on exports and therefore rendering them highly exposed to external shocks. Their limited capacity often constrains their ability to diversify tax revenue, leading them to rely heavily on trade taxes. A common problem identified in this paper stems from high levels of public debt resulting from fiscal imbalances. The main policy prescription advocated by the study is sustained fiscal consolidation and exchange rate flexibility. Another broad issue highlighted in this policy paper relates to the financial sector of SDS, which is often underdeveloped in many SDS and therefore cannot play its full role in managing volatility and fostering growth. Moreover, SDS' commercial banks often provide a captive market for government financing, causing the financial sector soundness to become closely linked to fiscal sustainability.

59. **The policy paper also argues that small states experience substantially higher costs of natural disasters relative to the size of their economies—roughly triple that in larger middle-income countries.** It suggests ways as to how SDS can strengthen their disaster risk mitigation and responsiveness by, inter alia, identifying and integrating natural disaster risks into macro frameworks, ensuring sufficient fiscal space and flexibility within their fiscal frameworks to help redeploy spending rapidly, and exploring how to promote insurance coverage. The paper also describes the manner in which the Fund engages with small member states through surveillance, program and financial support, and capacity building, noting that country teams for small states tend to be smaller and more junior. It concludes that a continuing analytical work program is important to better understand issues such as growth under-performance and how policy advice and program design could help these countries to reinvigorate their growth strategies.

60. **A second paper (IMF, 2015a) updates and builds further on the 2013 policy paper. It deals with macroeconomic developments and selected issues in SDS** and describes the economic outlook for these states referring to economic vulnerability and slow growth. The paper produces three in-depth studies and related policy recommendations with respect to three challenges namely, fiscal management, exchange rate devaluation and financial inclusion. With regard to fiscal management, it contends that expenditure rigidity and revenue volatility in the face of limited fiscal buffers often result in procyclical fiscal policy, requiring efforts to streamline

[12] On this issue, see IMF (2016).

and prioritize recurrent spending to create fiscal space for capital spending. The quality of expenditure could be improved through fiscal anchors and public financial management reforms.

61. **When discussing exchange rate devaluation, the paper maintains that the effects of devaluation are not significantly different between small and large states, including its impact on growth, but the transmission channels are different.** Devaluation results in lower consumption and higher investment in small states and its effectiveness can be strengthened by complementary wage and anti-inflation policies. It can also lead to improved competitiveness. As regards financial services, it acknowledges that in many small states the banking sector is typically small and highly concentrated. In such cases lack of competition constrains the effective delivery of financial services. For lower-income small states in particular, weak financial inclusion limits access to credit, with consequences for investment and growth. The paper recommends that where possible, small states should foster competition as a way to develop financial inclusion.

62. **A third major policy paper (IMF, 2016) focusses on the role of the IMF with regard to resilience to natural disasters and climate change in SDS.** The paper argues that small developing states are disproportionately vulnerable to such calamities. The document states that on average, the annual cost of disasters for these states is nearly 2 percent of GDP—more than four times that for larger countries. As expected, the paper contends that disaster proneness has major macroeconomic repercussions, including debt problems, hence the Fund's interest in natural disasters. A range of macroeconomic pro-active policy approaches are proposed in the document including disaster response, risk reduction and preparedness, integrated into core investment and debt management frameworks.

D. Staff Guidance Notes

63. **The evolution of IMF research and policy work on growth and macroeconomic policies in SDS has also been reflected in two IMF SGNs relating to work on SDS, namely, IMF (2014) and IMF (2018).** These documents draw together the analytical and policy threads from earlier Fund research and policy papers on SDS as well as issues identified in the external literature. They emphasize that the main areas of concern of the IMF with regard to SDS focused on improved growth performance, through the improvement in economic governance relating mainly to fiscal policy, exchange rate management, promotion of competitiveness, and public sector efficiency.

64. **The guidance notes refer to the unique economic characteristics and constraints faced by SDS and provide operational guidance on policy advice offered by the IMF to SDS members, together with information on the manner in which these states may make use of Fund facilities and instruments, program design, capacity building activities, and collaboration with other institutions and donors.** Both SGNs identify the special characteristics and vulnerabilities of these states, suggesting that the Fund considers small country size as an element meriting special analysis and advice. At the same time, the Fund

acknowledges that SDS are heterogeneous in terms of economic development and therefore a one-size-fits-all policy advice is not appropriate.

65. **Both documents also highlight themes emphasized in the external literature as crucial challenges and underlying vulnerabilities for SDS.** These include: first, SDS' volatility due to inherent factors that render these states highly exposed to shocks, including external economic changes, natural disasters and climate changes; and second, challenges in strengthening economic resilience, building on an insight in an earlier IMF paper that resilience is not only associated with economic solutions but also with public institutions and good governance in general, calling for a balance between setting fiscal anchors and allocating sufficient budget resources this purpose, while promoting social consensus on the appropriate sequencing of development projects.[13] The 2017 SGN in particular singles out resilience as one of the main pillars of policies conducing to stability and growth, noting that small states experiencing higher macroeconomic volatility due to shocks including frequent natural disasters, and macroeconomic policies should aim at enhancing the ability of SDS to recover from such shocks; and emphasizing the importance of resilience building of SDS in fragile situations.[14]

66. **Both SGNs also highlight the role of the public sector and call for public sector reform, given that in many small states the public sector is relatively large with extensive economic intervention and owning key economic assets.** This, in turn, affects the fiscal sustainability of many small states. The staff guidance for teams working in small states relates to a large extent to rebalancing of public and private sector roles, with a closer working relationship between the two sectors, including levelling the playing field for new private sector entrants. There is considerable emphasis on fiscal sustainability and the creation of room for maneuver in order to enable SDS to withstand and recover from adverse economic shocks, including natural disasters and climate change.

67. **The two guidance documents include information as to how the characteristics of small states could shape Fund surveillance and financial support, program design, capacity building activities, and collaboration with other institutions and donors.** The documents use the acronym GROWTh. to refer to five key thematic areas as central to the policy dialogue. These are: (i) **G**rowth and job creation, (ii) **R**esilience to shocks, (iii) **O**verall competitiveness, (iv) **W**orkable fiscal and debt sustainability options, and (v) **Th**in financial sectors. These documents caution that in applying this guidance, staff should continue to tailor their engagement to specific country circumstances. They also emphasize that given limited policy analysis capacity in small states, the emphasis of staff analytical work should be on immediate policy-relevant issues rather than on basic research. According to the IMF guidance, this exercise should be supported by improved information systems and data, and policy prescriptions that

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[13] See IMF (2013b).

[14] The IMF had issued a Staff Guidance Note on the Fund's Engagement with Countries in Fragile Situations (IMF, 2012), as well as a policy paper on the IMF Engagement with Countries in Post-Conflict and Fragile Situations (IMF, 2015d).

require analytical toolkits, which should be provided by fund staff to small states authorities for policy analysis.

68. **Reflecting similar analysis in the external literature, both SGNs note the importance of social concerns, such as inclusiveness, equity, poverty reduction, social safety nets and income distribution.** The 2017 SGN makes several references to the need for the Fund to consider social matters,[15] but such considerations are not discussed in any depth and seem to be inserted as a general caution to reduce the possible social damage of economic reforms.[16] Social concerns, including inclusiveness and income distribution, have also been given more importance within the Fund recently. Remarks by former IMF Managing Director Christine Lagarde and by the current Managing Director Kristalina Georgieva attest to this tendency. Lagarde wrote that policymakers should enhance resilience and inclusion at home to benefit all (Lagarde, 2019) while Georgieva stated that economic reforms should consider offering new opportunities that reduce excessive inequality (Georgieva, 2019).

E. Assessment and Conclusions

69. **Over the evaluation period, Fund staff made important contributions to the economic literature on SDS, particularly in identifying policy solutions intended to address problems associated with economic instability and growth of SDS.** In general, IMF documents, including external publications as well as selected internal documents including the 2014 and 2017 SGNs, cover an expansive range of key policy challenges identified in the external literature.

70. **While the external literature on growth in SDS, described in Section II, was heterogeneous, IMF publications and internal policy papers and guidance notes were more focused.** The external literature can be grouped under three main headings, namely those that emphasize structural SDS' weaknesses and adopt a quasi-fatalistic stance as if these handicaps cannot be overcome, those that argue that SDS can mitigate their disadvantages and handicaps by appropriate policies, a stance similar to that taken by staff, and those that conclude that small states are no different from larger states in so far as economic policy is concerned. By contrast IMF literature and analytical work emphasized the role of economic governance, with a focus on fiscal policy and exchange rate management, while acknowledging that these states face special inherent constraints, associated mostly with small population size, a high degree of trade openness and proneness to natural disasters.

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[15] See paragraph 33, with regard to fragile states; paragraph 39 with regard to measures to develop or strengthen social safety nets to limit the potential equity implications of fiscal adjustment; and paragraph 64 relating to poverty reduction strategies and social safeguards in IMF-supported programs.

[16] Following the 2008/2009 global crisis, external and internal discussions on the IMF's neoliberal stances, which placed fiscal consolidation, financial openness and curbing the size of government as major policy prescriptions, there was considerable debate as to whether these policies really lead to economic growth and whether their social impacts should also be given more importance by the Fund (see Ostry and others, 2016).

71. **In addressing challenges to growth,** IMF documents consistently proposed policy recommendations for fiscal adjustments aimed at creating room for maneuver for SDS to respond to adverse external shocks and suggested that weak governance (or low government effectiveness) is associated with higher total public and external debt. These documents also highlighted that fiscal adjustment can be growth-supportive in small states, especially if implemented through cuts in current primary spending rather than revenue increases. They argued that given the limitations on monetary policy in SDS, fiscal policy is crucial since it is one of the few policy options SDS have to respond counter-cyclically to economic downturns and shocks. Furthermore, these documents emphasized that fiscal policy underpins the credibility of the fixed exchange rate regimes of most small states.

72. **IMF papers considered the inherent characteristics of SDS as constraints for growth, notably their small size[17] and their high degree of trade openness, features that were also identified in external work.** However, the IMF work generally placed more emphasis on the need for policy-induced changes to promote economic growth and to facilitate good economic governance in general. The focus of most Fund literature on fiscal and exchange rate management suggest that the authors sought to justify the main IMF policy thrust at the global level, and apply it to SDS with some tweaks relating to the specificities of these states. Here, however, Fund publications could benefit by more actively encouraging collaboration of Fund staff with external researchers and external research institutions, so as to seek peer-review outside the IMF hierarchy.

73. **Overall, the two guidance notes capture a number of conditions prevailing in SDS which are also dealt with in the external literature, particularly GDP growth volatility mostly due to exposure to shocks and proneness to natural disasters.** In the face of this reality, the Fund's research output and guidance notes relating to SDS advocated a number of policy responses, generally aimed at reducing domestic and foreign sector imbalances—prescriptions which also feature in the external literature, especially that on economic resilience. It should be said, however, that the Fund, in its proposed remedial actions, placed more emphasis on policy measures associated with economic governance than the external literature in general. This can be explained by the fact that whereas the external literature mostly emanated from academic institutions, with various research interests, the IMF remit focused mainly on macroeconomic and financial sector issues.

74. **Another difference between the external literature and the Fund's own work, including the guidance notes, relates to the importance assigned to social repercussions of economic growth,** which tended to feature more frequently in the external literature. Although inclusiveness, equity, poverty reduction, social safety nets and income distribution were mentioned in the Fund's literature and guidance notes on SDS, one gets the impression that

[17] Jahan and Wang (2013) drawing on IMF publications, emphasize this point by stating that "small states have one common problem: they face constraints because of their size."

these were postscripts as if to acknowledge that social hardship could possibly ensue in the short run as a result of remedial action, such as fiscal tightening.

75. **Overall, IMF publications, internal policy papers and guidance notes contributed important value-added to the literature on SDS**, principally in terms of the importance of robust macroeconomic policies frameworks and rigor in assessing the effects of fiscal policy on growth and competitiveness. The IMF literature also emphasized the role of good economic governance in these states, underscoring the fact that such governance in of major importance for SDS in particular, in view of the inherent constraints that are faced by these countries**.**

IV. OVERALL ASSESSMENT

A. Major Role Played by the IMF

76. **The IMF analytical work, selected policy-related papers and SGNs described above points to two broad strands relating to growth and stability in SDS, namely that which refers to conditions not of the authorities' own making, and that which refers to situations which emanate from government policy.** The first strand relates to inherent conditions, including economies of scale limitations leading to high per unit costs, a small domestic market leading to a high degree of reliance on exports, proneness to natural disasters and climate change vulnerability. The second strand refers to policies that can lead to improved economic governance including macroeconomic management and resilience building in general. A common theme in this regard is the need to control the size and cost of government.

77. **In putting forward this agenda, the IMF made a very important contribution to instil a sense of economic discipline in SDS.** In this regard, SDS have benefitted considerably from IMF support in terms of the quality of analytical work. Although SDS form a very small proportion of the global economy, the IMF's engagement in matters relating to financial and exchange rate policies in SDS also contributed to the effective operation of the international monetary system.

B. The COVID-19 Pandemic

78. **The very harmful impact of the current COVID-19 pandemic on the economies of all countries, including SDS, is giving rise to a major rethink about economic management in times of crises and has illustrated that large as well as small states are vulnerable to such an occurrence.** The pandemic has brought about unprecedented disruptions in international trade, particularly affecting travel and tourism, from which many SDS generate considerable income and employment, even where domestic rates of infections are low. In addition, the pandemic has negatively affected international financial flows, again with high negative impacts on SDS who derive income from financial activity. The IMF of course has had a major role to play in this regard, particularly in terms of emergency disbursements to address SDS balance of

payments problems in the short term and, more importantly, to offer guidance and policy prescriptions for the medium and long terms.[18]

79. **The pandemic is also leading to a reconsideration of the role of government in the economy in all countries of the world, large and small.** Direct government intervention, leading to unpresented budget deficits and debt ratios, are being condoned, if not encouraged, to avoid severe economic downturns, and the ensuing high unemployment rates and increased poverty. Issues relating to the changing role of government in withstanding external shocks is likely to be particularly relevant for SDS being as they are routinely exposed to such shocks, and where the public sector already tends to be pervasive. It is likely that this matter will be the subject of extensive debate in the coming years and could affect IMF thinking on the role of government in SDS for short-term recovery measures.

C. Gaps and Opportunities

80. **Notwithstanding the important role played by the IMF in guiding and assisting SDS improve their economic governance, particularly from 2013, there remains scope to further enhance IMF analytical work as well as internal policy guidance**. Doing so can help address several issues identified in the external literature. Building on evidence from the latter and as reflected earlier in this paper, enhancements in the Fund's engagement in four areas can help both extend and deepen Fund engagement with SDS members and close important gaps.

Constraints Relating to Institutional Development

81. First, there is scope for the IMF to scale up international attention to the wide range of particular challenges faced by SDS, as reflected in Section II, both through an extension of analytical work and particularly through international advocacy. A major constraint faced by small states, identified by the Fund and by the external literature relate to SDS' limited ability to benefit from economies of scale. The challenge is briefly identified in IMF research and in the two SGNs, generally with regard to production, but is underplayed and inadequately addressed in other respects. Most importantly, scale limitations also constrain the ability of small states to accelerate institutional development. While the IMF provides technical assistance to member countries for building and strengthening institutions, SDS require special treatment in this regard due to the high cost per capita associated with this task. Resilience building, often mentioned in IMF documents relating to SDS, requires a substantive and complex institutional framework to foster good economic governance, including financial oversight, regulatory systems for utilities, energy and communications, control of abuse by dominant firms and by cartels, preparedness systems in connection with climate change and natural disaster, and land use planning. Such an institutional framework is costly per capita for SDS and in addition requires expertise which may not be available in these states. Malta and Cyprus, two small EU member states, were able to build much of such framework using EU funds, but most other SDS lack the human and financial

[18] Maret (2022).

resources to do so, including those in the middle- and high-income strata, finding it difficult to access concessionary finance.[19] The support of the donor community is therefore called for in this regard and Fund documents often refer to this constraint. However, they draw insufficient attention to the binding constraint this poses for most SDS and place little onus on the donor community to help these states develop sustainable institutional frameworks for resilience building and improvement in economic governance.

Role of Government in Promoting Competitiveness

82. **Second, there is ample further scope for the IMF to both deepen and better nuance its analysis of the role of governments in SDS in promoting competitiveness.** The external literature clearly illustrates that in most SDS, government has a major role to play in economic affairs. In the Fund's analytical work as well as in both SDS guidance notes, the Fund has often encouraged a larger role for the private sector and a smaller one for the government in directly productive activities. Although the production of commercial goods and services is to a large extent an enterprise issue, and it is the individual undertaking at the micro level that needs to find ways to compete effectively, the public sector has a major role to play in this regard, not least of which by taking a lead to place competitiveness on top of the policy agenda, and in removing business bottlenecks when these occur. Moreover, SDS would typically need a higher degree of government intervention than larger ones due to the relatively high incidence of market failure, a greater need to stabilize economic activity owing to SDS' high degree of proneness to shocks, and greater exposure to environmental risks, including those associated with climate change.

83. As explained above, the external literature acknowledges that competitiveness tends to be constrained in small states, mainly as a result of scale limitations. This implies that in sectors where mass production is not vital for efficiency, such as in some type of services, small states may succeed in competing with larger ones. However, as indicated in the literature, even in manufacturing and agriculture, small states may find possibilities for viable production of niche products, where competitiveness rests mainly on quality and uniqueness.

Strengthening Organizational Coordination

84. **Third, there is considerable room for strengthening internal coordination of the Fund's research and analytical work on SDS.** Growth and competitiveness are multifaceted, involving issues which are not strictly economic. Economic research and analysis on this matter can therefore be combined with and informed by research in various non-directly economic

[19] The four EU member states with a population not exceeding 1.5 million, namely, Malta, Cyprus, Estonia, and Luxembourg, all benefited from the importance assigned to Institutions by the EU. The four states received relatively high scores in the 2019 Global Competitiveness Index and in its first pillar titled "Institutions," compared to other states with the same population thresholds. Source: http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf.

factors. As indicated in this report, in the literature on small states social considerations are often assigned major importance for growth and competitiveness, one reason for this being the high reliance of these states on the human input for economic development. In addition, due to their high degree of trade openness, productive efficiency is of primary importance for these states, and for this to be sustained, improvements in human capital are essential. In turn, education and health play a major role in human capital. Improvement in human capital is also conducive to innovation, which is crucial for competitiveness. Thus, the IMF research effort may require improved inquiry on, and coordination with, research on the social dimension of small states and on other ancillary factors which sustain growth and competitiveness.

85. Currently there is no SDS department within the Fund. SDS affairs are taken care of by several area departments, mainly the Western Hemisphere Department and Asia and Pacific Department, with the Strategy and Policy Review Department coordinating SDS activity. Specific divisions within these area departments carry out considerable work on SDS' issues through policy papers focusing on their respective regions. IMF staff have also produced some research papers on small states, more generally as can be seen from the references section of this report, but much less than in the external literature on SDS. The latter suggests that SDS face multiple common challenges in building a sustaining resilience, confront especially acute—and often common—challenges in managing volatility and in coping with shocks from large natural disasters and from climate change; and due to their economic structure and small size are very well placed to learn from and share lessons of good practice in dealing with these challenges. These factors elevate the imperative for the Fund to coordinate research work across all small states and to transcend the geographical limitations imposed by the area department model used by the Fund.

Strengthening Analysis and Research

86. **Fourth, the external literature on SDS issues suggests that there remains extensive opportunity for the Fund to deepen and extend its research and analytical work on SDS in collaboration with other entities on this matter.** There is particular opportunity to deepen assessments and comparative studies on the challenges and opportunities to enhance private sector development, options to enhance competitiveness, and issues and challenges in establishing regulatory institutional frameworks that take account of the unique challenges that SDS face in establishing these.[20] There is a dearth of cooperative analytical work between the IMF and other international institutions on SDS-related issues. There are various examples of institutional cooperation between, for example the World Bank and the Commonwealth, collaboration among agencies within the UN system; and collaboration among international research institutions in investigating the challenges of SDS, and the Fund's involvement in such collaborative efforts will increase the usefulness of its analytical work.

[20] The IMF recognized the need for a scaled-up analytical work program on SDS issues in 2013 (see IMF, 2013a, paragraph 82). However, and while a wide range of working papers were produced on SDS-related issues (see IEO, 2022; and Rustomjee, Balasubramanian, and Li, 2022), it is unclear to what extent a formal program of analytical work was taken forward.

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