



DEVELOPMENT COMMITTEE
(Joint Ministerial Committee
of the
Boards of Governors of the Bank and the Fund
On the
Transfer of Real Resources to Developing Countries)



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DC/2000-04

March 24, 2000

**SMALL STATES: MEETING CHALLENGES
IN THE GLOBAL ECONOMY**

Report of the Commonwealth Secretariat/
World Bank Joint Task Force on Small States

EXECUTIVE SUMMARY

Attached for the April 17, 2000 meeting of the Development Committee is the Executive Summary of the report of the Commonwealth Secretariat/World Bank Joint Task Force on Small States. It is to be considered under item 2.A of the Provisional Agenda. Ministers are requested to comment on this subject in their circulated statements.

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Executive Summary

1. The report of the joint Commonwealth Secretariat/World Bank Task Force sets out a contextual framework in which to consider development problems peculiar to small states. Each small state is unique, and needs to address its development prospects in the context of its own cultural, historical, and social realities. There are also differences between regions. But most small states share a number of common characteristics. Assistance to small states can be made more effective with a better understanding of these characteristics and the development problems they pose. The report presents a range of common relevant policy actions for small states and the international community. The report also collects together more specific work programs (“frameworks”) on small states issues prepared and submitted to the Task Force by a number of multilateral institutions, including the World Bank and Commonwealth Secretariat.

2. Among the world’s sovereign developing states with populations of less than 1.5 million people, 41 are members of the World Bank, more than 30 are eligible for Bank Group borrowing, and 29 are members of the Commonwealth. The incomes and stages of development of these states vary widely, from very poor African countries such as Guinea-Bissau (with per capita GNP of \$160) to wealthy countries such as Brunei, Cyprus, Malta, and Qatar (with per capita GNP of more than \$9,000). While there is no special significance in the 1.5 million population threshold, it provides a useful starting point. But no single definition is adequate, and the Task Force does not recommend the creation of a special category of small states. Countries should be regarded as lying along a size continuum, with a number of larger states sharing some or all of the same characteristics.

Work and consultations of the Task Force

The Task Force’s Interim Report was circulated in October 1999. It noted further work to be carried out before production of a final report. The Interim Report was discussed and welcomed in November 1999 by the Commonwealth Ministerial Group on Small States and Commonwealth Heads of Government. The Interim Report was also circulated widely for comment, to small states and development institutions and published electronically.

In continuing consultations, the Task Force received many comments from multilateral organizations as well as from small states, including a substantial written submission from the CARICOM Secretariat. The Task Force has drawn on these contributions as it completed its work. In particular, the last stage of the Task Force’s work was guided by the discussions at a major global conference arranged by the World Bank and the Commonwealth Secretariat in London on 17–18 February 2000. That conference focussed on the four areas for further work identified in the Interim Report: tackling volatility, vulnerability and natural disasters; strengthening capacity; issues of transition to the changing global trade regime; and new opportunities and challenges from globalization. The final report of the Task Force draws extensively on the discussions and conclusions at that conference.

What makes small states different? Their special development challenges

3. The report concludes that developing small states do share a number of characteristics that pose special development challenges. They are especially vulnerable to external events, including natural disasters, that cause high volatility in national incomes; many of them are currently facing an uncertain and difficult economic transition to a changing world trade regime; and they suffer from limited capacity in the public and private sectors. More specifically, the following characteristics define the special development challenges and vulnerabilities that many small states face.

- ***Remoteness and isolation.*** Of the developing small states, three out of four are islands and in some cases widely dispersed multi-island states, others are landlocked, and some of them located far from major markets. For many small states, like those in the Pacific, high transport costs make it harder for them to turn to world markets to compensate for the drawbacks of the small size of their domestic markets. And small domestic markets combine with large distances from other markets to reduce competition and its spur to efficiency and innovation.
- ***Openness.*** A high degree of openness to the rest of the world brings benefits. But it also means that small economies are heavily exposed to events in global markets, and developments in the global trade regime, over which they have little if any influence. They also tend to rely more heavily on taxing imports as a source of revenue, leading to difficulties as tariffs are reduced.
- ***Susceptibility to natural disasters and environmental change.*** Most small states are in regions susceptible to natural disasters such as hurricanes, cyclones, drought and volcanic eruptions, which typically affect the entire population and economy. Some are threatened by global environmental developments. Since most of such adverse events affect the entire population, risk pooling at the national level is not feasible.
- ***Limited diversification.*** Because of their small domestic markets, many small states are necessarily relatively undiversified in their production and exports. Where one dominant activity has declined, it has tended to be replaced with another. This adds to vulnerability to changes in the external environment.
- ***Poverty.*** There is some evidence that poverty levels tend to be higher, and income distribution more uneven, in smaller than in larger states. Where this is so, income volatility can create additional hardship as the poor are less able to weather negative shocks to their incomes.
- ***Limited capacity.*** While weaknesses in both public and private sector capacity are a key problem for most developing countries, smallness of size adds a further dimension to the challenge. This is further compounded in states, like the Pacific islands, where the internal distances are large and the population is scattered. In the public sector small states face diseconomies of small size in providing public services and in carrying out the business of government, and tend to have relatively larger public sectors than other developing countries. As they face the challenges and opportunities of globalization small states are also finding they do not have sufficient

institutional capacity to participate fully in international finance and trade negotiations—the outcomes of which can profoundly affect their economies. In the private sector, as already noted, lack of diversification and domestic competition can hold back successful development.

4. Many of these factors combine to make small states' economies especially vulnerable, and in particular they affect:
 - ***Income volatility.*** Overall, the range of per capita incomes and rates of growth are not significantly different in small and large developing countries. However, the residents of small states experience higher volatility in their incomes—the standard deviation of annual real per capita growth in small states is about 25 percent higher than in large states. This reflects several of the factors listed above—their high levels of exports and imports and low diversification in production and trade which leaves them exposed to fluctuations in world markets, and their susceptibility to natural disasters
 - ***Access to external capital.*** Access to global capital markets is important for small states, and is one way to compensate for adverse shocks and income volatility. But the evidence is that private markets tend to see small states as more risky than larger states, so that spreads are higher and market access more difficult.

THE WAY AHEAD: CHALLENGES AND OPPORTUNITIES FOR SMALL STATES; POLICIES AND EXTERNAL ASSISTANCE TO ADDRESS THEM

5. The Task Force has concluded that addressing these challenges successfully will take a combination of the following: correct domestic policy action; in some cases new approaches to regional co-operation; continued external support and assistance from multilateral and bilateral development institutions; and improvements, where achievable, in the external environment. In particular, the Task Force has studied in detail four areas of special relevance to successful development in small states: how best to tackle volatility, vulnerability and natural disasters; issues of transition to the changing global trade regime; strengthening capacity; and key challenges and new opportunities arising from globalization. In these areas the report identifies an ongoing work program of actions, analysis, and new initiatives for the states themselves and for the international community. All these conclusions are consistent with views expressed during the extensive consultations carried out by the Task Force, and in particular with the conclusions reached at the global conference held in London in February 2000.

Tackling volatility, vulnerability and natural disasters

6. The Task Force has identified the following actions to help small states deal with problems of income volatility and natural disasters.
 - The work carried out by the Commonwealth and other organizations in analyzing the vulnerability of small states and deriving vulnerability indices for developing countries demonstrates that most small states are considerably more vulnerable than

larger developing countries. This vulnerability should be taken into account in programs of assistance provided by the multilateral development, finance and trade institutions.

- The vulnerability and special characteristics of small states, and weak capacity in the private sector, contribute to perceived riskiness and difficulty in attracting private investment flows. A relatively high level of official assistance is therefore appropriate for small states where they have policies in place for such assistance to be effective, as is the continued application of flexible graduation procedures at the multilateral institutions.
- The strong risks and consequences of natural disasters in many small states require new approaches by the states themselves and the international community. Donor support for disaster mitigation, for example in infrastructure, can have a high pay-off. The work by the World Bank on new approaches to disaster mitigation and insurance in the Caribbean is very relevant, as is the Bank's intention to co-operate with states in the region to develop and support regional risk-pooling arrangements, to complement improved disaster mitigation and prevention measures (for example, in the context of the ProVention Consortium) which can greatly reduce the costs of disasters when they occur. Similar approaches, that build on this experience, should be extended to other areas.
- Many small states remain dependent on commodity production, and it would therefore be useful if the International Task Force on commodity price risk management could pay attention to issues and commodities of relevance to small states in its future work. Many small states are exposed to different risks, however—for example, fluctuations in volumes and tourism earnings and different land tenure systems—and these will need a combination of different approaches.
- Many small states have vulnerable physical environments as well as vulnerable economies. As development takes place it will be crucial to ensure that it is sustainable, by protecting the environment at the same time. Mistakes have been made in this area, for example in insensitive tourism development and over-exploitation of non-renewable resources. This environmental vulnerability is compounded by the likely impact of climate change for some small states, particularly those in the Pacific. It will be important for donors and international agencies, including the World Bank, to continue to support small states in this regard, both with advice and finance.

Issues of transition to the changing global trade regime

7. Small states must adapt, indeed transform, their economies to secure the benefits of globalization and the increasingly open global trading environment—trade policy for small states, as for other developing countries, needs to be seen as part of sound overall economic development strategy. Clear signals about the direction of trade and regulatory policies and the length of transition periods will be needed to guide the process and to attract new investment. Action wherever possible to reduce or remove barriers to small states exports will also be helpful.

- The work of the Task Force has shown that many small states will face special difficulties in making this transition and will need time to adjust to changes in the external trade regime, and sequence changes in their economies. The particular vulnerabilities of many small states should be recognized as justifying special consideration to deal with the issues that are crucial to transformation of their economies, including length of transition periods, as the global process of trade liberalization, and removal of special protective regimes, continues. It would be useful to review the current process of WTO accession as it affects small states to see if the problems and costs these countries face in the process can be reduced.
- Another issue related to WTO participation is the lack of adequate resources to participate fully in international trade negotiations. The Commonwealth, through its permanent trade advisers in Geneva and Fiji, already provides assistance of this type to its member countries. It will continue to do so and has expressed a willingness to take a lead in expanding such facilities. The EU is financing an ACP countries' bureau in Geneva to facilitate relations and negotiations with WTO and UNCTAD. Additional support would be welcome, as is the recent creation of an "Advisory Centre on WTO Law". The WTO should examine other ways to help, for example by allowing groups of small states to be represented collectively at discussions where they wish to do so.
- Trade liberalization can have major fiscal consequences for small states. The IMF should continue to take a pragmatic approach to the advice it gives to small states that risk losing a major source of fiscal revenue as tariffs fall, recognizing that for some open, small economies low, flat-rate tariffs may be a component of an efficient tax system. However, as small states move to more service-based economies, they will need to adopt broader-based consumption taxes. They will also need technical assistance from the IMF and others in tax administration.

Strengthening capacity

8. Small states and those providing support for them need to continue to address problems of limited capacity, both in the private and public sectors. Specific issues to pursue in this context include the following.
 - There is a continuing task of accumulation of knowledge about policies and approaches that work and do not work for small states, and sharing this knowledge and experience among states both within and across regions.
 - An important approach in tackling limited capacity in small states is to develop regional approaches wherever feasible. The multilateral institutions and other donors should reinforce existing programs by enhancing their lending and non-lending services to encourage and support such co-operation, particularly by assisting regional organizations dealing predominantly with small states.
 - To help develop private sector capacity, both regional and country approaches are needed, including providing information to facilitate business decision making, training, and encouraging formation of networks and associations of entrepreneurs. Another aspect of limited capacity where the multilateral institutions can also help is

dealing with utilities' regulation and competition policy; issues of considerable importance with the prevalence of monopoly or oligopoly suppliers in small states.

- Activities and requirements of a multiplicity of donors place heavy and unnecessary burdens on limited administrative capacity in many small states. This was well illustrated by a recent study by the World Bank Operations Evaluation Department. This problem needs to be addressed by a new approach building on principles of partnership and country leadership that underlie the Comprehensive Development Framework approach. Donors and international agencies should join together country by country, in country-led partnerships to align their objectives, rationalize their support and simplify and harmonize their procedures to reduce these burdens. Helping build country capacity and forging of closer working relationships with regional organizations would help in this regard.
- Building institutional capacity needs to be undertaken in close consultation with recipient agencies and tailored carefully to their particular needs. Experience in the Pacific suggests the need for a long-term commitment by donors to strengthen generally weak institutional and human resource capacity. Further, the design of capacity building activities needs to be flexible and responsive to a country's needs and political realities

New opportunities and challenges from globalization

9. Some small states will need external support and advice as they seek to reposition their economies. They need enabling environments and the right kind of public policy support—for example in training and education, and creating regulatory frameworks—to encourage new activities, many of which will be in the service sectors. In this context actions in two specific areas will be important for many small states.
- One new area in the service sector where some small states have been successful is in the provision of onshore and offshore financial services. Such financial services have come to be of substantial importance to their economies. For a variety of reasons offshore financial centers have come to be a matter of concern to the international community. There is a clear need for improvements in financial operating practices and regulatory standards, and also a need to take action to prevent financial and tax crime and to address concerns about harmful aspects of tax competition. Improvements in these areas can benefit small states as well as reduce risks to the international banking and financial system. Many small states are already cooperating in international efforts to combat money-laundering. Assistance by multilateral institutions and others in strengthening financial sector regulation and supervision will be important. Because of their potential international impact offshore centers are currently the subject of scrutiny by the OECD's Forum on Harmful Tax Competition and the Financial Stability Forum (FSF). This is causing concern for a number of small states because of lack of representation in the OECD and FSF and lack of adequate consultation on the matters being addressed. At the London conference in February 2000, the OECD indicated its willingness to engage constructively with small states on tax competition issues and to respond to their call for a multilateral discussion. It is important for all these issues to be considered in

international fora where small states themselves have a voice so that their interests can be taken into account.

- Finally, work on the opportunities that information technology and electronic commerce can bring to small isolated states suggests that these technologies can be a major source of help in their development. But success requires the correct public sector infrastructure, crucially a regulatory framework that will deliver high quality/low cost telecommunications services. It is important to note that this provides a challenge in which many small states will need external support from the multilateral development banks and others.

SPECIFIC ACTIONS BY MULTILATERAL INSTITUTIONS

10. The more specific World Bank and Commonwealth Secretariat frameworks set out in Part II of the report focus on knowledge accumulation and dissemination, institutional capacity building, including support for regional approaches, risk management, and the management of transition.
11. The World Bank framework centers around helping small states develop and implement effective strategies to reduce poverty by applying the general principles of country ownership, participation, partnership and a holistic approach to diagnosis and policy development to their special characteristics. While the work programs for small states are prepared in the context of individual country diagnosis and country assistance strategies, the special problems of vulnerability and transition underscore the need to link lending and non-lending services to encourage institutional and policy reform. More specifically, the Bank's framework includes:
 - continuing a flexible approach to graduation policy, including from IDA, that takes into account the special circumstances of small states, ensuring that none is graduated prematurely;
 - reducing transactions costs for small states by actively promoting better donor coordination, and by exploring for small states the full flexibility in the use of its new lending instruments, such as adaptable program loans (APLs) and learning and innovation loans (LILs);
 - supporting private sector development as small states seek to transform their economies in the process of transition and to meet the challenges of globalization, especially in terms of education and training, creating improved regulatory frameworks, and infrastructure development – and in the policies and investments needed to exploit the opportunities that information technology and electronic commerce can bring;
 - supporting regional initiatives as an important way for small states to overcome diseconomies of scale in the public and private sectors;
 - helping to lower the costs of natural disasters, including the provision of loans for disaster-proof infrastructure and exploring new approaches to Bank support for risk pooling and disaster insurance; and

- in partnership with small states, continuing attention to cross-cutting issues and to accumulating and sharing of relevant knowledge generated within the Bank and outside—using mechanisms such as a Bank-wide thematic group, development of a World Bank small states web site, and arranging regular meetings where representatives of small states can share experiences and discuss new developments. These actions will be coordinated with existing capacities, such as SIDS/Net, a UNDP-based network, dedicated to small island developing states.
12. The Commonwealth framework commits to maintain and, where possible, expand overall levels of support for small states development, in terms of both advocacy and provision of technical assistance. In particular, it targets advice on vulnerability and risk management, trade negotiations, capacity building for regional organizations involving small states, focusing on its preparedness to:
- sharpen its advocacy role and to pursue commitments from the UN system and others to include vulnerability as an additional criterion in determining their treatment of small states on issues such as graduation, aid flows, development strategies and investment;
 - assist in the development of national and regional capital markets, stock exchanges and commodity risk mechanisms;
 - take a lead in the strengthening of facilities in Geneva to assist small states in their dealings with WTO, and provide support for these countries in their relations with the EU under the successor agreement to the Lomé IV Convention;
 - provide support for capacity building in regional organizations dealing predominantly with small states;
 - take a lead in broadening the Trade and Investment Access Facility to provide policy advice and technical assistance and promote trade-related investment in small states in order to allow them to exploit the opportunities afforded by globalization;
 - explore ways of further expanding the Commonwealth Private Investment Initiative to provide venture capital-type funds and mobilize financial flows to small states; and
 - seek agreement on a mechanism to track implementation of commitments and proposals by partner organizations, regarding their treatment of small states.
13. Partner organizations are also developing their responses toward small states. Part II of the report includes frameworks submitted to the task force by the following organizations: IMF, WTO, EU, UN, UNDP, UNCTAD, and major regional development banks. Indications of action by them include:
- Eligibility for access to resources under the IMF’s concessional facility closely follows IDA eligibility; the IMF will also continue to give countries facing balance of payments difficulties access to the Fund’s financial facilities and loans; and a wide range of technical assistance will continue to be provided. The IMF has been consulting with UNDP and other donors on the establishment of a regional technical assistance center in the Caribbean, similar to the one already in place in the South Pacific.

- The EU is: financing an ACP office in Geneva to assist member countries in their dealings with WTO; will take into account the dimensions of vulnerability when determining its programs toward small states; has developed a Disaster Prevention, Mitigation and Preparedness Programme to assist countries vulnerable to natural disasters; is supporting transition of the most banana-dependent economies by improving competitiveness of the banana sector, by creating new activities to replace traditional banana production, by financing new infrastructure and by retraining labor; and is creating a new Investment Facility for the support of private sector development in ACP countries.

Conclusion

14. Small states share a number of special development challenges in the global economy. The Task Force report, as summarized above, lists ways in which these challenges can be met. In some cases relevant actions are already under way. In others the report identifies useful initiatives that should be pursued. And in others the Task Force has been able to do little more than set out issues that should be addressed. The Task Force commends this as an agenda for the future. Tackling it successfully will take a combined effort by small states themselves and by the international community.

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