Determinants of Economic Growth in Small Countries

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The centrals aims of my thesis is to analyze the existing models of economic growth and see which of them can best explain the growth process of small countries, compare the determinants of growth between small and large countries and analyses if the specific characteristics of small countries is enough to justified the difference on growth process between small and large countries.

The main objective of my research abroad (thanks to SRA award) was to define the broad guidelines for the practical part of my thesis and investigate the main literature on the processes of economic growth. My work was developed in collaboration with Professor Krislert Samphantharak, at GLI.

Small countries (to define small countries we used the statistical technique of cluster analysis applied to the variables population and area) have specific characteristics, with impacts on economic growth, which we believe that differentiates them from the larger countries.

Some specific characteristics of small countries that may influence their growth:

1. Small size of domestic market - many economic activities haven´t successful in small countries due to the small size of the domestic market, which unfeasible the benefits of scale effects. This implies higher unit cost of local production of many goods and services compared to larger countries. The small size of the domestic market also reduces the potential competition due to the existence of a few companies.
2. Limits resource basic - a small area of most small countries implies that natural resources are limited and undiversified, and even with natural resources, there not guarantee that existence national capital sufficient to finance its operation. Small countries, on the other hand, have low population, which constitutes a serious limitation to the domestic labor market.

3. Reduced domestic production and exports and export market concentrated - the small size of the domestic market limiting scale effects and reduced supply of skilled in the smaller countries, which lead to high concentrated production and export poorly diversified. This concentration can lead to excessive dependence on a limited number of economic activities and export markets, thus exposing the economy to exogenous shocks in export prices and creating instability.

4. High degree of openness to trade - the impossibility of producing large varieties of products and services, implies that consumption in small countries is highly dependent on imports. Small countries must necessarily follow policies of economic openness and be integrated into the international economy. This implies greater susceptibility to external shocks. The chronic trade deficit in small countries as a result of high import leads countries to greater openness and dependence on external capital (FDI, remittances, aid and development assistance) that are uncertain by nature.

5. Insularity - the small island states are likely to incur additional shipping costs due to insularity, which increases the importance of maintaining low cost in international trade relations. In the case of countries consisting of several islands, domestic communication can be as costly and difficult as the external. The insularity increases the costs associated with storage due to uncertainties related to the supply and also the opportunity cost of capital.

6. The small size of the population and arable land affects the options available to economic development in small countries, where many fellows the development of the service sector, which in most cases is not required the scale effect and the existence of natural resources.

7. Greater share on GDP of government consumption in small countries, due to the indivisibility of many services by the number of inhabitants and the need for a minimum size of government to work. In many small countries the government is the main employer of skilled labor. Gwartney et al. (1998) argue that large government (measured by consumption expenditure of government) slow the economic growth, because as the size of the government extends there a disincentive effects due higher taxes and loans grows, the government involvement in activities inappropriate, which causes negative returns and affect the process of wealth creation, once, in the public sector the changes process is slower.

8. Economic vulnerability resulting from the small size which limits the ability to use scale effect in many sectors, reduce domestic competition and increases exposure to

external shocks due trade liberalization. Many small countries locate in areas of high frequency of natural disasters such as typhoons, hurricanes, earthquakes and landslides, which increase environmental vulnerability and have consequence on economics activity.

For the practical work we consider the basic neoclassical model and we will empirically analyze the variables to see which have the greatest impact on growth in small countries in comparison with large countries. Example of model:

$$Y = \beta_1 X + \beta_2 Z + \epsilon$$

Where:

Y – Growth of GDP per capita

X – Set of variables always included in the growth regression (Investment as a percentage of GDP, initial level of GDP per capita, the enrollment rate in secondary school, the growth rate of the population)

Z – Variable of interest (representing the factors to be analyzed)

Ɛ – White noise

The variables of interest are grouped into the factors identified as having the greatest impact on economic growth of small states resulting from their specific characteristics. The factors selected were: geographical and climatic, institutions, FDI, tourism, human capital, social cohesion, sectorial specialization and vulnerability.