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**Working Paper**

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WIDER Discussion Paper, No. 2001/37

**Provided in Cooperation with:**

United Nations University (UNU), World Institute for Development Economics Research (WIDER)

*Suggested Citation:* Bräutigam, Deborah; Woolcock, Michael (2001) : Small states in a global economy: The role of institutions in managing vulnerability and opportunity in small developing countries, WIDER Discussion Paper, No. 2001/37, The United Nations University World Institute for Development Economics Research (UNU-WIDER), Helsinki

This Version is available at:

<https://hdl.handle.net/10419/52812>

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Discussion Paper No. 2001/37

## **Small States in a Global Economy**

The Role of Institutions in Managing  
Vulnerability and Opportunity in  
Small Developing Countries

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and Michael Woolcock<sup>2</sup>

July 2001

### **Abstract**

Small states have always been more vulnerable in the global economy. This is so because trade comprises a larger proportion of their economic activity, and because they lack the power to set the terms or make any of the rules that govern globalization. Studies of small states tend to focus on the nature of their vulnerabilities, without considering that these countries have managed external pressures in different ways. Globalization brings opportunities as well as risks, and a more integrated global economy may enable smaller states to adapt quickly to changing conditions, and to more readily pursue strategic development policies.

Keywords: small island economies, growth, governance

JEL classification: F01, O19, O40

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This study has been prepared within the UNU/WIDER project on Globalization and the Obstacles to the Successful Integration of Small Vulnerable Economies which is directed by Dr Mansoob Murshed.

UNU/WIDER gratefully acknowledges the financial contribution to the project by the Ministry for Foreign Affairs of Finland.



## Introduction

Small states have always been more vulnerable in the global economy. This is so not only because trade comprises a larger proportion of their economic activity than it does in large states (see Table 1), but because they lack the power to set any of the terms or make any of the rules that govern globalization. Yet studies of small states tend to focus on the nature of their vulnerabilities, without considering that these countries have managed external pressures in different ways (Amstrup 1976: 176). Moreover, smallness need not always be a liability. Globalization brings opportunities as well as risks, and a more integrated global economy may enable smaller, more 'nimble' states to adapt quickly to changing conditions, and more readily to identify and pursue strategic development policies. The key question then becomes: Under what conditions does smallness become a liability or an asset?

Drawing on a unique data set on governance, growth, social development, and inequality, we examine various hypotheses about the reasons for the development performance of small developing countries in the 1960-98 period. We define small countries as those with populations of five million or less in 1998, along the lines of recent research by Collier and Dollar (1999). We also examine, using case study evidence, a subgroup of countries that share the same medium-high rank in the Commonwealth Secretariat's 'Composite Vulnerability Index'. We argue that although they tend to be equally exposed to the risks and opportunities of globalization, small states differ internally. In particular, different histories and strategic choices have built different sets of institutions in small countries, and these institutions affect how globalization is mediated in each country. Having explored these issues as they pertain to both large and small countries, we then seek to discover whether we can identify institutional differences that distinguish small countries that are successful at making sure that their citizens benefit from the foreign investment and trade opportunities provided through globalization, from those that are not. Our primary findings can be summarized as follows:

1. The differences between small and large countries are real, but concentrated in relatively few variables. Small countries experience more volatile growth rates and are more aid and trade dependent, when controlling for regional location, the initial level of economic development, the rate of growth, and a number of other variables. Small countries are clearly more vulnerable to rapid fluctuations in the fortunes of the global economy.
2. There are no significant differences between small and large countries in terms of the quality of their institutions. However, precisely because small countries are more vulnerable, the quality of their institutions matters even more than it does in large countries. Put another way, high quality institutions in small states matters more in terms of managing already high levels of globalization (i.e. helping to sustain high growth rates and low growth volatility) than in attaining additional levels of global integration. We show that small countries with high quality institutions of conflict management and state capacity have less growth

volatility, and that those with stronger state capacity in particular are more likely to enjoy higher rates of economic growth.<sup>1</sup>

These results have important implications for business groups and the international development community. Small countries have traditionally been highly dependent on trade, but investors seem to be indifferent to the quality of their institutions, which are so important not only in their own right but instrumentally for maintaining economic (and political) stability. Of greater concern is the fact that while aid donors are accurately targeting poor countries, their funds to small countries appear to go to those with institutions that are significantly worse than those who are less aid dependent. While this could be read as a good thing if aid dependence was indicative of funds going for institutional reform, a more plausible—and troubling—explanation is that considerable sums of aid money are being wasted in small poor countries that do not have the institutional infrastructure in place to use it effectively. Closer attention to the institutional environment in small developing countries is likely to help both stabilize and increase growth rates, and thus make an important contribution to poverty reduction and social concerns (such as health and education).

We structure the paper as follows. In Section 1 we review some of the literature that has explored the economic, social, and political differences between small and large states, and then consider the possible reasons why some small states might be able to manage the risks and opportunities of globalization better than others. In Section 3, the heart of the empirical analysis, we use regression analysis to test some of the arguments submitted in Section 1, focusing on institutions at the state level. Section 4 explores three case studies of small, vulnerable countries in more detail, to demonstrate how some small countries embarked on a path that led them to develop the kinds of institutions that seem to make a difference in managing globalization, while others did not. Section 5 offers some conclusions.

## **1 Is small beautiful? Small states and large states**

How do small states differ from large states in ways that might be relevant for understanding varying responses to globalization? Researchers have argued—often in contradiction to each other—that small states differ from larger states on economic, social, and political factors. They may have higher per capita incomes and productivity levels, and better human development indicators, yet have higher poverty and inequality. They are also said to have greater economic openness, higher volatility in growth rates, and higher levels of aid intensity per capita. A variety of studies on the political aspects of smallness argue that small states in general tend to have greater political centralization and possibly higher corruption levels. They also have larger public sectors, weaker state capacity, higher unit cost of public services, and the handicap of a much higher level of perceived investment risk than objective indicators

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<sup>1</sup> In results not presented, it is also possible to show that, since the late 1970s, small countries have enjoyed a greater improvement in the quality of their institutions than large countries. The time-series data on which this claim rests has been faulted by numerous critics (ourselves included), hence our decision to exclude it from our analysis. This data is separate from that which we have employed elsewhere in this paper.

would suggest. Some researchers argue that small states are more flexible and can adjust more quickly to rapid changes.

Studies of small states often ask the question: is small beautiful? Streeten's 1993 review is one of many that have ranked the evidence for and against this question. Streeten argues that small states in general seem to depend more on the export of raw materials and to lag behind larger states in the development of a manufacturing base (1993: 197). Their greater openness and small size make an initial stage of import substitution industrialization very difficult. But small countries even more than large need to take advantage of the international economy. For them, exporting provides their only option to capture economies of scale (198). However, Streeten suggests that small may be beneficial: he also finds that small countries grow faster and have higher productivity than larger countries, and he argues that small countries seem to be *more* equal, 'indicating greater social cohesion' (199). They also generally land better terms in foreign aid: 'one of the most well-established generalizations in the foreign assistance field is the so-called small country effect, according to which aid per head increases, and the terms of aid improve, as the size of the country declines' (200). Streeten also suggests that collective action problems may be solved more easily in small countries where free-riding is more visible and people tend to know each other and meet face to face (200). Their small size should also make many transaction costs lower: information should flow more easily, and principal-agent problems should be fewer, with greater ease of supervision. And although they may be more vulnerable to the risks of natural disasters and trade instability, small countries may also be more flexible and resilient.

Easterly and Kraay (2000) also explored whether or not small states 'suffer from their smallness' (2013). Controlling for OECD status, oil production, and location by continent, Easterly and Kraay found that 'microstates' (those with populations under 1 million) are 'richer and have higher productivity levels' (2014) than large states. Small states also have better infant mortality statistics, educational attainment, and life expectancy (2017). The ratio of trade to GDP in these small states was 54 percentage points above average, showing their high degree of openness (2018), yet microstates were 'not particularly open to financial flows' (2024). Because of their relatively greater external exposure and an accompanying instability in their terms of trade, microstates (and possibly small states as well) tend to have growth rates that are much more volatile than other states. Yet at least in the group of microstates studied by Easterly and Kraay, this higher volatility does not lead to lower *average* growth rates for small states than for larger states with less volatility, suggesting that something is compensating for these swings in fortune.

In contrast to the optimistic conclusions of Easterly and Kraay, a study commissioned by the Commonwealth Secretariat found that small countries (those with populations of 1.5 million and below) seem to have larger problems, in particular, higher poverty and inequality, as well as greater vulnerability to shocks (Commonwealth Secretariat, 2000: 16). This may be a reflection of factors such as the fact that the widely dispersed populations of some small island states are spread over a number of islands, while the major economic activities are found mainly near the capital. In addition, they note that many small states are located in hurricane-prone regions, or are subject to the threat of volcanic eruptions.

Collier and Dollar (1999) examine the relationship among policies, growth and aid in small states. They find that when poverty levels and population are controlled, small

states (those with populations of five million and below) generally receive more aid, on average, and that this aid does not seem to depend on the quality of their economic policies. However, this aid may be helping small countries compensate for another difference between small and large countries: an unwarranted perception of risk. Ratings done by risk agencies consistently rank small countries as more risky for investors than an objective review of their policy stance and history would support.

Most of the empirical research on the differences between small and large states has explored differences in economic and social variables. However, researchers have noted several possible differences in the way small and large states are governed, and the type of institutions they have. Peter Katzenstein (1985) has argued with regard to the smaller states in Western Europe '[s]ize affects ... both economic openness and the characteristics of the political regime' (80). In small countries, Katzenstein continues, 'political centralization tends to be greater and political arrangements tend to be more closely knit' (80). The small countries he examined all tended toward corporatist political arrangements, integrating major stakeholders in important government policy deliberations.

However, it is possible that these close-knit political arrangements and centralization can lead to higher levels of corruption in small countries, as their officials may be more accessible to clientelist and 'old boy network' pressures. Farrugia (1993) emphasizes these potential side-effects of small scale in his exploration of the 'special' environment faced by high level bureaucrats in very small states. He suggests that relationships are more 'closely knit' and 'highly personalized (221)'. Requests for patronage and special treatment may be more frequent, since officials frequently run into people informally. This may not necessary involve corruption; personal ties are likely to be stronger in small states, but this may work toward moderate policies, particularly if people are educated in the same schools and basically all know each other. In a similar vein, Armstrong and Read (1998) point out that small states may have 'a greater degree of social homogeneity, cohesion, and identity which encourages the formation of social capital... through the development of social and civic institutions' (570). They also note that these close ties may also promote clientelism and rent-seeking.

In general, small states tend to have proportionately larger governments. Public sector wage bills in the Commonwealth Secretariat group of small countries were considerably higher at 31 per cent of GDP than in larger states, which averaged 21 per cent of GDP (Commonwealth Secretariat, 2000: 17). As the Commonwealth Secretariat study points out, part of the explanation is likely to lie in the fact that small countries have few economies of scale, which raises the cost of providing public services. However, the economies of scale argument regarding the public sector is challenged by studies that do not find a productivity disadvantage due to increasing returns to scale in the economy in general (Easterly and Kraay 2000).

The larger public sectors found in small states could also be related to the fact that small countries have more open economies. In general, countries that have more openness to trade historically have larger, rather than smaller, public sectors, with the extra spending required by efforts to cushion their citizens from the impact of greater volatility and the risks associated with greater flexibility (Cameron 1978; Rodrik 1998b). These larger public sectors may also be behind the seemingly superior ability of small states to adjust to external shocks (Streeten 1993).

Addressing the impact of volatility and risk requires a capable state, but research suggests that in general, small countries may have weaker state capacity. The Commonwealth Secretariat's recent survey of the experience of small developing states with populations under 1.5 million found that the weak state capacity they observed was probably related to the special problems faced by small countries (2000: 17). Small countries may have smaller pools of qualified people to select from in staffing their bureaucracies (Streeten 1993). As noted above, small countries receive disproportionately more aid, but high levels of aid intensity have been correlated with poor quality of state institutions, an effect that holds even when economic decline is controlled (Bräutigam 2000a). This might disproportionately affect the quality of governance in small countries that receive high levels of aid. When combined with poverty, low levels of public sector capacity (whether or not aid is involved) may create a vicious circle for small countries, particularly when it constrains their ability to influence the outcome of negotiations over the terms of their participation in the new financial and trade architecture (IMF, WTO) that will 'profoundly affect' their trade-dependent economies (Commonwealth Secretariat, 2000: 18).

## **2 Why might some small states succeed at globalization?**

Small states succeed at globalization when they are able to combine economic competitiveness, continual innovation, and increasingly higher value-added production, with reductions in poverty and improvements in key socio-economic indicators such as health, longevity, literacy, and social violence. While inequality may rise when those with more desirable (and scarcer) skills are able to bargain successfully for higher wages, distributive policies in successful globalizers will soften the social impact of glaring inequality.

As with large countries, small countries with macroeconomic stability, open to the skills and innovation benefits possible from joint ventures, and some kinds of foreign direct investment, are likely to do better than others at integrating with the global economy. Yet compared with the variety of studies that try to determine how small and large states differ, there is much less empirical research on the reasons why some small states do better than others. A study by Armstrong and Read (1998) reports that regional location constitutes the principal explanation of growth performance among small states. Having abundant natural resources, and strong financial and tourism sectors, also were important for growth, while having a large agricultural sector tended to work against economic growth. Their study did not consider performance in areas other than growth.

Study after study has documented the greater vulnerability and openness of small countries compared with large. Smallness clearly provides the extra challenge of maintaining social stability in the context of the more volatile environment they face by being highly trade-dependent. In general, the quality of state institutions can go far in explaining the variety of growth and human development performance found in developing countries. Two kinds of political institutions seem particularly important: those that reflect higher levels of state capacity, and those that manage social conflicts. There are many reasons to think that these kinds of institutions might make even more of a difference in the ability of small and vulnerable states to manage the impact of globalization.



## 2.1 State capacity

The rise of the East Asian ‘miracle’ focused attention on the *quality* of state intervention, not merely whether the state intervened or not (Wade 1990; Evans 1995). Recently, this theme has been revisited with the much longer time series data now available on developing countries, and the compilation of several new indicator sets that give measures of bureaucratic quality, rule of law, and corruption. Research by Knack and Keefer (1995), and more recently by Campos and Nugent (1999), suggests that bureaucratic quality and other governance indicators are important in explaining growth. In a related study, Fedderke and Klitgaard found that ‘higher [bureaucratic] efficiency is associated with higher educational levels, lower levels of land and income inequality, and lower ethnolinguistic fractionation’ (1998: 472). Easterly’s (2000) work has shown that good institutions can help mediate the latent social conflicts associated with ethnic and economic inequality. Econometric research at the World Bank suggests that the influence of high quality public institutions may exceed the impact of good economic policies in explaining development performance (proxied using growth and reductions in infant mortality) (World Bank 1997a).

Effective state institutions are likely to be critical in mediating the impact of globalization in small developing countries. A well-working bureaucracy is important for formulating and implementing economic and social policies. Such policies enable countries to upgrade their skill bases, manage their interactions with foreign investors and sources of technology, negotiate better packages in trade agreements such as the WTO or the Lomé Convention, and devise ways to cushion their populations from the instability that accompanies openness.

## 2.2 Reducing social conflict and instability

A second strong theme in the literature on successful globalizers is the importance of institutions that ameliorate the social impact of instability and mediate conflicts. Among the institutions that might have this effect are democratic rules that enable countries to ‘institutionalize’ their conflicts through the democratic system, while affording various important social groups a voice in the decisions about adjustment. Other important institutions are likely to be those that protect human rights; the rule of law; greater equality (through land access, or redistributive taxation); and social insurance.

Early examples of these kinds of institutions can be found in the small social democracies of Europe. Forced to be highly open to trade and capital flows by their small size, Europe’s small countries concentrated on enhancing their ability to adjust flexibly to external conditions, while protecting their populations from the insecurity generated by continual adjustment. As Peter Katzenstein puts it, ‘elites in the small European states, while letting international markets force economic adjustments, choose a variety of economic and social policies that prevent the costs of change from causing political eruptions. They live with change by compensating for it’ (1985: 24).

Compensating for change in Europe’s small countries required a larger but more ‘nimble’ state, better social protection, and a capable bureaucracy to implement strategies of continual adjustment. A number of studies have found that states that are more open to trade also have larger governments, presumably to manage, and

compensate for the costs of, continual adjustment (Rodrik 1998b). In a recent article, Art Goldsmith (1999) argues that the African states with the largest public sectors, Botswana and Mauritius, are also two of the continent's most consistently good performers. Small countries with more activist states may be better able to cushion the social impact of vulnerability.

In a series of recent publications, Rodrik (1998a; 1999; 2000) demonstrates the importance of the institutions states use to manage conflict, and links this to their ability to successfully navigate economic shocks. Rodrik uses indicators for 'the quality of governmental institutions, rule of law, democratic rights, and social safety nets' to represent institutions of conflict management. These institutions establish the rules and practices that can soften the distributional impact of the adjustment required by external shocks, and seem to have allowed countries with rules already in place to adjust more rapidly (and, presumably, equitably). A related factor might be that stronger social protections engender more trust in the government and its ability to protect their basic needs. This could reinforce 'social capital' (Woolcock 2000) and help to underpin adjustment with stability (and a human face).

While democratic polities *in general* do not preside over faster growing economies, they are able to provide more stability in growth rates over time (Rodrik 2000) and ensure lower levels of inequality. The lessons of this study remain highly relevant today. As Rodrik (1998a: 28) concludes in his review of the adjustment experience of the 1970s:

An increasing number of developing countries are integrating themselves with the international economy. As the Asian financial crisis demonstrates vividly, this will increase their exposure to shocks. Therefore, it will be all the more important to develop institutions that mediate social conflicts. The results of this paper indicate that participatory and democratic institutions, the rule of law, and social insurance are all components of a strategy to enhance resilience to volatility in the external environment.

Is this true as well of small developing countries? In the next section we attempt to find out.

### **3 Data analysis**

The preceding discussion lays a foundation for exploring the nature and extent of empirical differences between small and large countries, and for testing our arguments pertaining to the importance of institutions that enhance state capacity and conflict management. Here we revisit some of the questions regarding the differences between small and large countries, and explore some of the possible explanations for differences among small countries themselves.

There is little agreement over what actually constitutes a 'small' country. Recent research by Easterly and Kraay (2000: 2014) on 'microstates' includes those 'having an average population over the period 1960-1995 of less than one million'. Others have used population figures of one and a half million (Commonwealth Secretariat, 2000); three million (Armstrong and Read 1998); five million (Collier and Dollar (1999), and ten million (Kuznets 1960; Streeten 1993). We use the figure of five million (1998 population) as our cut-off, since this is approximately the median population of all

countries in the world. Globalization we define as integration with the global economy, as measured by trade as a proportion of GDP, trade openness, and direct foreign investment. We also consider the ‘quality’ (as opposed to the ‘quantity’) of globalization, as measured by the degree to which exports are based on manufacturing (rather than resource extraction).

The major contribution of this paper is its exploration of governance variables as a possible explanation of the differences between small and large countries, and among small countries. We consider the quality of governance using a comprehensive aggregated data set recently compiled by Kaufmann, Kraay, and Zoido-Lobaton (KKZ) (1999). These authors have compiled six measures of governance: ‘Voice and accountability’; ‘Political instability’; ‘Rule of law’; ‘Government effectiveness’; ‘Controlling corruption’; and ‘Regulatory burden’. We examine each of these dimensions to discern whether there are differences in governance between small and large states.

We then further develop two broad categories of governance—Conflict Management and State Capacity—that we propose are vital for countries seeking to negotiate the challenges and opportunities of globalization. Various plausible measures can be proposed for each of the two aspects of governance. *Conflict management* refers to institutions such as democracy, human rights, free press, collective bargaining arrangements, social programs, and rule of law, which collectively entail clear procedures, mechanisms for information dissemination, support for weaker groups, and independent forums in and through which differences can be resolved. On the basis of their comprehensiveness, we have selected ‘voice and accountability’ and ‘rule of law’ from the KKZ list of variables to best measure *conflict management*. Proxies for *state capacity* could include size of government, absence of corruption, quality of bureaucracy, and nature and size of national tax base. We have selected two aggregated variables from KKZ—‘government effectiveness’ and ‘controlling corruption’ (again, for reasons of comprehensiveness)—to best capture *state capacity*.

Our dependent variable is development performance in small states in a context of increased globalization. By ‘development performance’ we mean the trajectory and stability of economic growth rates attained over the 1960-98 period. We also examine various measures of education (primary and secondary enrolment) and health (life expectancy and under-five mortality). Details of the specific data used are provided in Appendix 1.

We begin by examining 24 different social, economic, and governance variables, gathered from a sample of 102 small and 105 large countries<sup>2</sup> (a population of 5 million in 1998 being the cut-off point). These variables are presented in Table 1, and show that, on the face of it, small countries have:

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<sup>2</sup> Technically these countries should actually be called ‘economies’ since the full data set includes overseas territories such as Reunion. In most of the substantive calculations, however, data was only available for bona fide countries, so we have retained that term throughout our analysis and discussion.

- \* higher economic inequality
- \* slower improvement in primary education
- \* lower child mortality rates
- \* longer life expectancy
- \* higher levels of foreign aid
- \* stronger rule of law and
- \* higher levels of foreign investment
- \* higher trade quantity
- \* lower trade quality
- \* higher growth volatility
- \* more political stability
- \* less corruption than large countries.

Of course, these differences in means may not be a function of size per se, but rather some other factors. We can test for this using simple regression analysis. Accordingly, Tables 2a presents results from regression analysis on the socio-economic variables, controlling for initial level of development, rate of economic growth, and regional dummies; Table 2b does the same for the governance variables, but also controlling for land inequality and ethnic fractionalization (joint proxies for social divisions). This analysis whittles down the number of variables on which small countries actually differ from large countries to:

- \* growth volatility
- \* trade quantity
- \* foreign aid.
- \* foreign direct investment
- \* trade quality, and

This suggests that while governance per se is not significantly better or worse in small countries, it nevertheless still matters a lot, given that small countries have a demonstrably more volatile relationship with the global economy than large countries. It can reasonably be argued that the high growth volatility of small countries is directly related to the nature and extent of their engagement with the global economy.

In the next stage of the analysis—Table 3—we investigate whether growth volatility, foreign direct investment, and foreign aid remain high in small countries, even after controlling for initial wealth, economic inequality, economic growth, globalization (trade quality and quantity), regional dummies, and two sets of governance variables—Conflict Management, measured by the ‘voice and accountability’ and ‘rule of law’ variables, and State Capacity, measured by the ‘government effectiveness’ and ‘control of corruption’ variables.

The results show that, controlling for quality of institutions in addition to standard socio-economic variables, small states remain significantly different from large countries on just two dimensions: growth volatility and aid share. In these regressions, growth volatility is shown to be negatively related to country size and positively related to the absence of democratic decision-making institutions. Levels of direct foreign investment are positively related to levels of trade and government effectiveness (the sub-Saharan Africa dummy is strongly negatively significant, suggesting a conspicuous anti-Africa bias on the part of foreign investors). Foreign aid flows are allocated as one might initially expect—primarily to small, poor, slow-growing, high-trade economies—but, despite their rhetoric regarding the importance of human rights and anti-corruption, donors seem largely indifferent to the quality of government in the countries to which

they lend: if anything, they give to more democratic countries, but not to those with strong rule of law, who are less corrupt, or have high-quality public institutions. Our results suggest that donors would likely see a greater return on their ‘investments’ if they allocated resources to those small countries seriously trying to bring about positive improvements in their quality of governance.

In the final series of regressions, we restrict our sample just to small countries. Because the number of countries with full data is rather small at this level, the four institutional variables are entered separately into the various regressions (since they are naturally somewhat correlated with one another). Again, however, we see that institutions of conflict management and state capacity matter. Small countries with superior state capacity (controlling for initial wealth, inequality, region, and levels of globalization) have higher growth rates (Table 4a), while all four conflict management and state capacity variables are positively related to growth stability (Table 4b). Importantly, foreign investors seem indifferent to the quality of institutions in small countries (none of the institutional quality variables is significant for FDI; results not shown), whereas aid donors seem to actively seek *bad* institutional environments (Table 4c). An optimistic reading of this result is that donors are giving money to these countries in the hope of strengthening their institutional infrastructure; a more pessimistic—and arguably more realistic—interpretation is that considerable sums of tax-payer funds and private donations are being squandered in less-than-optimal institutional environments. Either way, it is clear that investors and donors alike would better serve both their own interests and those of their clients in poor small countries if they took more serious consideration of the institutional quality prevailing in the countries in which they are operating (or would like to operate).

#### **4 Case studies**

How might small countries develop superior institutions, and how can these institutions help them ameliorate vulnerability and take advantage of opportunity? Quantitative cross-country comparisons are useful in many respects, but they are less helpful in addressing these types of questions. In this section we briefly compare three small countries, Mauritius, Jamaica, and Sierra Leone. All three fall into the same ‘higher medium vulnerability’ category, according to the Commonwealth Secretariat. Yet all three have dealt differently with the risks and opportunities presented by their openness and geography. Given space considerations, we can examine only very superficially the presence and not the workings of the major institutions hypothesized to help ameliorate the impact of vulnerability, as they comprise aspects of state capacity and conflict management. Clearly there are many other factors that might be affecting performance in these countries, but our purpose is to illustrate a plausible story that focuses on institutions. First, we establish the development performance for each country since 1970. Given different starting points, we establish this performance as the difference between levels in 1970 and in 1997. Then, we explore which relevant governance institutions were established in each country, over time, and finally we discuss the extent to which these stories conform with our hypotheses.

We need to introduce these cases with a brief discussion of the decisions each country made regarding the economic policies that promote efficient globalization. These vary sharply. Mauritius had far less government ownership of the economy, compared with

Jamaica. Both had intervention, but in Mauritius it was generally targeted toward improving the country's position in its global interactions, or toward improving the equitable distribution of the fruits of globalization. In contrast, Jamaica's stance toward globalization has been characterized as "unfocused... merely following to a limited extent world economic fashion" (King 2000). Sierra Leone in contrast did little either to intervene effectively, or to promote private investment. In particular, the three countries also made different decisions regarding strategies of manufacturing for export, one of the possible pathways out of the extreme vulnerabilities suffered by countries that are inherently small, and dependent on commodity exports. The decision the government in Mauritius made to use its abundant unemployed labor in labor-intensive manufacturing for export, while underwriting social security for the population in general, has been key to the island's success, as was its early and successful stabilization after the economic turmoil of the late 1970s and early 1980s. Jamaica, on the other hand, has been a "reluctant reformer" (King 2000) with sluggish growth rates and far less structural change. Governments in Sierra Leone have done almost nothing to improve the quality of the country's global economic links.

As for development performance, as Table 5 shows, all three countries have experienced improvements in life expectancy and infant mortality since 1970, with Jamaicans gaining double the number of years gained by Sierra Leoneans, and Mauritians tripling the latter's gains. Mauritius also had far greater improvement on infant mortality, although by 1997, Jamaica had the lower rate. On income per capita measures expressed in 1987 US\$, both Jamaica and Sierra Leone have declined since 1975, while Mauritius has more than doubled its real GDP per capita. Economic policies are certainly central to the stories here. But can the differences in the ability of these three countries to manage their vulnerability be partly explained through variance in the institutions of state capacity and conflict management?

*State Capacity.* One aspect of state capacity is the ability of the state to assure domestic and foreign investors that it will carry out its financial obligations. One way to explore this is through credit ratings given by firms like Institutional Investor, which rates countries from 0 (low) to 100 (World Bank 1997a). A glance at the credit ratings for 1981-83 suggests that Mauritius (at 19.0 compared with Switzerland's 95.2) was only marginally above Jamaica (at 15.9), while Sierra Leone stood at 8.2. Over the next ten years, however, Mauritius improved its rating by an average 2.34 points per year, the most dramatic improvement of all the rated countries. Jamaica also improved, but only by 0.77 points per year, while Sierra Leone declined at an average -0.09 points per year. While this is a narrow view of state capacity, it does suggest that Mauritius's ability to manage its economic affairs, and therefore its vulnerability, is likely to be superior to the other two.

State capacity is also affected by the broad quality of the educational system that feeds graduates into the bureaucracy. In 1980, fifteen years or so after independence, Mauritius had a 93 per cent primary enrollment, and 50 per cent secondary. Jamaica was even better, at 103 per cent primary enrollment, and 67 per cent secondary. But Sierra Leone was enrolling only 54 per cent in primary school, and only 14 per cent in secondary (World Bank 1997a). Both Jamaica and Mauritius had a sufficient base from which to draw their civil servants, while the base in Sierra Leone was much thinner.

*Conflict Management.* The second set of institutions are those that should help countries manage the conflicts engendered by globalization. Here we look primarily at democratic

decision making, but also at instruments of social policy, as reflected in levels of household inequality, and social insurance.

All three countries were once British colonies, and all three have experienced substantial and gradual enlargement of suffrage and inclusion of local people in governance. Jamaica had a long history of representative government, dating from the 18th century. Legislative council elections were held in Mauritius in 1886, although the franchise was severely limited. Sierra Leone held its first legislative council elections in 1924, electing Africans to the council (Collier, 1982, 39). At independence, all three adopted democratic constitutions. Mauritius (independent in 1968) and Jamaica (independent in 1962) maintained their democracies over time, despite some rough spots. Sierra Leone had a lively multiparty competition until 1978, when an authoritarian leadership adopted a new constitution, making Sierra Leone a single party state.

Since 1972-73, Mauritius has averaged '1' on the Freedom House measure of political liberties, and '2' on the Freedom House measure of civil liberties, the same score held by the United Kingdom, making it among the most 'democratic' of small developing countries (Freedom House, 2000). Over the same period, Jamaica averaged a more modest but still low '2' on political liberties and '3' on civil liberties, while Sierra Leone has averaged '5' on political liberties and '5' on civil liberties. If democratic institutions help ameliorate the impact of trade liberalization and engagement with the global economy, Mauritius should benefit the most, while Sierra Leone should find little help.

To what extent did institutions in each country ameliorate or reinforce inequality, another possible aspect of conflict management? Again, data is poor in this area, and we have no data at all for Sierra Leone. We have figures on Gini coefficients of income inequality for Jamaica from 1991: 41.1, and from Mauritius, where income inequality was reduced during the 1980s, resulting in a household Gini coefficient of 37 in (year). Both of these are relatively low, particularly when compared with small Latin American countries such as Nicaragua (50.3) and Panama (56.6). In Mauritius, the idea of equality and equity has been honored, not just given lip-service, by political leaders, who emphasize social justice as one component of their strategy for balancing a complicated multi-ethnic society. Jamaica has shifted between a stronger socialist approach (under Michael Manley's People's National Party (PNP), 1972 to 1980) and a more conservative approach under the Jamaica Labour Party (JLP) led by Edward Seaga, 1980-1989. The reelection of the PNP in 1988 continued many of the moderate policies of Seaga. For most of their post-independence histories, Mauritius and Jamaica have been governed by parties that emphasized ideas of social justice and moderate redistribution, and that put considerable resources into social spending. Sierra Leone's leadership was not generally so disposed.

An effective social safety net is a final component of a system of conflict management. Unfortunately, we lack quantitative data to compare each country's history of social insurance. Studies suggest, however, that Mauritius and Jamaica have had a relatively long history of social protections, while the safety net in Sierra Leone depended on subsidies and controls on the price of rice sold in the urban areas, a feature that served to keep the price low for rural producers. In Mauritius, social expenditures (education, health, universal old age pensions, housing and social assistance, and food subsidies) absorb about 40 per cent of government spending, and this pattern has lasted for four

decades or more (Bräutigam 2000b). Mauritius has a compulsory contributory pension system, and in 1983, the country passed an unemployment relief act that provided minimum, means-tested payments to unemployed heads of households. Social services in Jamaica make up a smaller percentage of public expenditure, averaging 31 per cent between 1980 and 1998 (King 2000: 31).

These three cases suggest the broad differences between countries that are similarly vulnerable to the risks and open to the opportunities in the global economy. Full exploration of these cases would no doubt reveal many factors to explain the different development outcomes. Economic policy choices certainly differed strongly, and this is a fundamental aspect of development outcomes. But it is also clear that Mauritius, as the most successful ‘globalizer’ of the group, also had the strongest institutions, particularly those reflecting levels of state capacity, and of ability to manage social conflicts.

## **5 Conclusion**

Small countries will remain vulnerable to an unpredictable global economy. But while they cannot control the winds of economic fortune that beat at their borders, they do have some control over the shape of their own domestic rules and institutions. Control is a relative term, however. Our results suggest that high quality institutions can make a difference in the ability of small countries to manage the threats and opportunities of globalization. But if we are certain of one thing about institutions, it is that they change slowly. Still, the trend over the past twenty years has been one of moving the state out, reducing the role of government. The preliminary results of this project suggest that as much or more attention needs to be paid to the reasons why so many states have poor capacity, and the ways in which state capacity can be strengthened.

We also need much more creative thinking about the ways in which states can manage their societal conflicts, create trust in their institutions, and maintain their ability to protect their vulnerable populations from the instability that accompanies openness. The European experience is one that should be studied for its possible lessons for today's small countries. Small countries in Europe combined economic flexibility and openness with democracy and social insurance. Yet these successful strategies may be difficult to replicate today in many developing countries. There is always a trade-off, and in this instance, the trade-off came from higher taxes to finance social protections for flexible workers. Under relentless pressure to remain competitive and to trim their spending, even Europe's social democracies are finding that the demands of integration are putting pressure on their social safety nets.

There are a number of problematic methodological issues that surround research on small states in the developing world (Knack and Azfar 2000), but evidence from a variety of sources and approaches strongly suggests that institutional quality matters in large and small countries alike. It matters even more in small countries, however, given their high degree of exposure to—and weakened power to influence—the turbulence of the global economy. Small countries with high quality institutions appear to manage these risks and opportunities in ways that yield higher rates of economic growth and stability, and thus social development. Foreign aid donors and investors seeking to make a difference and a profit should therefore focus more judiciously on institutional quality issues.



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Table 1  
Summary of Differences Between Large and Small States

Variable	N	Mean	SD	Variable	N	Mean	SD
<i>Size (&gt; &lt; 5M in 1998)</i>				<i>Initial GDP/c (ppp)</i>			
Large	108			Large	98	2562.49	2655.70
Small	102			Small	72	3153.76	3793.73
<i>Region (dummy)</i>				<i>Annual growth rate</i>			
SS Africa	49			Large	99	1.46	2.73
E Asia/Pac	35			Small	76	1.38	2.49
<i>Ethnic fractionalization</i>				<i>Growth volatility</i>			
Large	84	42.56	30.94	Large	99	4.63	2.34
Small	29	38.31	26.41	Small	76	6.57**	4.18
<i>Economic inequality</i>				<i>Aid (% GDP)</i>			
Large	95	38.87	9.51	Large	84	5.97	8.39
Small	46	42.83**	9.85	Small	81	12.92**	17.69
<i>Land inequality</i>				<i>FDI (% GDP)</i>			
Large	72	63.56	16.24	Large	96	1.36	1.70
Small	38	66.91	15.69	Small	75	3.08**	3.76
<i>Primary education</i>				<i>Trade quantity (% GDP)</i>			
Large	90	82.95	21.79	Large	99	62.60	35.94
Small	54	83.72	18.41	Small	75	108.78***	46.80
<i>Improving primary ed.</i>				<i>Trade quality (dummy)</i>			
Large	88	5.44	16.47	Large	100	0.44	0.50
Small	50	0.38**	12.44	Small	79	0.28**	0.45
<i>Secondary education</i>				<i>Voice &amp; accountability</i>			
Large	87	61.66	24.65	Large	107	-0.06	1.00
Small	52	66.21	20.15	Small	66	0.11	0.89
<i>Improving secondary ed.</i>				<i>Political instability</i>			
Large	86	10.83	20.28	Large	102	-0.12	0.96
Small	49	7.22	24.91	Small	53	0.17*	0.86
<i>Mortality (&lt;5 years)</i>				<i>Government effectiveness</i>			
Large	105	82.13	74.63	Large	102	-0.08	0.96
Small	85	60.65**	64.38	Small	54	0.11	0.75
<i>Mortality decline</i>				<i>Regulatory burden</i>			
Large	96	-52.64	20.00	Large	106	-0.00	0.86
Small	54	-53.78	18.46	Small	60	0.01	0.79
<i>Life expectancy</i>				<i>Rule of law</i>			
Large	106	63.31	11.01	Large	106	-0.08	0.94
Small	91	66.08*	9.64	Small	60	0.15+	0.88
<i>Improving life exp.</i>				<i>Control of corruption</i>			
Large	103	13.65	8.69	Large	102	-0.09	0.94
Small	91	12.52	8.23	Small	53	0.16*	0.81

+ p<0.07

\* p<0.05

\*\* p<0.01

\*\*\* p<0.001

See Appendix for explanations of data.



Table 2a  
Socio-Economic Development Variables and Country Size

Dependent variables*	<i>Economic inequality (log Gini)</i>	<i>Primary education (% increase)</i>	<i>Under 5 mortality rate (log)</i>	<i>Life expectancy (log)</i>	<i>Growth volatility (log)</i>	<i>FDI (log)</i>	<i>Trade quantity (log)</i>	<i>Trade quality (dummy)</i>	<i>Aid share (log)</i>
<hr/>									
Independent variables									
<i>Small state (dummy)</i>	0.11 (2.60)*	-3.37 (1.26)	0.02 (0.28)	0.009 (0.67)	0.36 (4.49)***	0.82 (4.05)***	0.59 (8.22)***	-0.23 (3.60)***	1.48 (6.77)***
<i>Initial GDP/c (PPP) (log)</i>	-0.05 (2.16)*	-2.34 (1.53)	-0.73 (14.59)***	0.09 (10.91)***	-0.08 (1.77)	0.001 (0.01)	0.09 (2.00)*	0.12 (3.14)**	-1.53 (10.92)***
Table 2a, Continued...									
<i>Median growth rate</i>	0.005 (0.58)	0.46 (0.64)	-0.10 (6.13)***	0.01 (5.09)***	-0.06 (3.89)***	0.04 (0.92)	-0.002 (0.17)	0.07 (4.80)***	-0.16 (3.78)***
<i>S-S Africa (dummy)</i>	0.13 (2.18)*	2.63 (0.70)	0.64 (5.46)***	-0.19 (10.35)***	-0.06 (0.58)	-0.87 (3.09)**	-0.04 (0.39)	-0.28 (3.05)**	0.37 (1.31)
<i>E Asia / Pacific (dummy)</i>	0.008 (0.13)	-3.16 (1.44)	0.001 (0.01)	-0.02 (1.03)	-0.09 (0.73)	0.24 (0.77)	0.12 (1.08)	-0.14 (1.43)	-0.09 (0.27)
<hr/>									
N =	130	128	164	170	170	152	164	157	148
R <sup>2</sup> =	0.201	0.080	0.778	0.779	0.182	0.207	0.343	0.360	0.603
* p<0.05	** p<0.01	*** p<0.001	Absolute value of t-statistic in parentheses						

\* These nine variables are those that show statistically significant differences (p<0,05) between the means of large and small countries (see Table 1).



Table 2b  
Governance Variables and Country Size

Dependent variables*	<i>Political instability</i>	<i>Rule of law</i>	<i>Control of corruption</i>
Independent variables			
<i>Small state (dummy)</i>	0.202 (1.11)	0.096 (0.60)	0.239 (1.38)
<i>Log of initial GDP/c (PPP)</i>	0.574 (6.28)***	0.617 (7.57)***	0.735 (8.44)***
<i>Land inequality (log)</i>	-0.925 (3.07)**	-1.256 (4.61)***	-1.22 (4.36)***
<i>Ethno-linguistic fractionalization</i>	-0.002 (0.55)	-0.002 (0.78)	-0.001 (0.27)
<i>Sub-Saharan Africa (dummy)</i>	-0.364 (1.38)	-0.307 (1.34)	0.061 (0.24)
<i>East Asia / Pacific (dummy)</i>	0.224 (0.86)	0.350 (1.47)	0.156 (0.63)
N =	77	80	77
R <sup>2</sup> =	0.575	0.649	0.650
* p<0.05      ** p<0.01      *** p<0.001	Absolute value of t-statistic in parentheses		

\* These three variables are those that otherwise show statistically significant differences (p<0,05) between the means of large and small countries (see Table 1).



Table 3  
Development Variables Regressions

Dependent Variable	Growth volatility (log)	Foreign direct investment (log)	Aid share (log)
<i>Socio-Economic Variables</i>			
Small state (dummy) (3.00)**	0.451 (4.93)***	-0.060 (0.21)	0.952
Initial GDP/c, PPP (log) (7.67)***	0.094 (1.61)	-0.194 (1.14)	-1.502
Economic inequality (log)	-0.269 (1.56)	-0.024 (0.05)	-0.369 (0.65)
Median growth rate (2.67)**	-0.010 (0.42)	-0.027 (0.39)	-0.213
Sub-Saharan Africa (dummy)	0.214 (1.92)+	-1.238 (3.87)***	0.409 (1.13)
East Asia/Pacific (dummy) (2.21)*	0.043 (0.37)	-0.113 (0.33)	-1.011
<i>Globalization Variables</i>			
Trade quantity (log) (3.13)**	0.019 (0.25)	1.055 (4.48)***	0.942
Trade quality	0.157 (1.57)	-0.499 (1.72)	-0.227 (0.65)
<i>Governance Variables</i>			
Conflict Management			
<i>Voice and accountability</i> (1.91)+	-0.173 (2.51)*	0.078 (0.37)	0.425
<i>Rule of law</i>	0.065 (0.68)	-0.062 (0.23)	-0.060 (0.19)
State Capacity			
Controlling Corruption	-0.185 (1.43)	-0.466 (1.22)	-0.569 (1.20)
Government effectiveness	-0.157 (1.15)	0.926 (2.32)*	0.277 (0.58)
N =	110	105	89
R <sup>2</sup> =	0.539	0.404	0.694
+ p<0.07	* p<0.05	** p<0.01	*** p<0.001

Absolute value of t-statistic in parentheses

Table 4a  
Economic Growth and Governance in Small Countries

<i>Dependent Variables</i>	<i>Economic Growth (median 1960-98)</i>			
	(1)	(2)	(3)	(4)
<i>Socio-Economic Variables</i>				
Initial GDP/c, PPP (log)	0.226 (0.41)	0.091 (0.16)	0.461 (0.91)	0.564 (1.20)
Economic inequality (log)	-0.761 (0.48)	0.104 (0.06)	0.972 (0.56)	1.002 (0.61)
Trade quantity (log)	0.604 (0.76)	0.120 (0.14)	1.074 (1.26)	1.143 (1.47)
Trade quality	0.745 (0.85)	0.865 (0.98)	0.432 (0.49)	0.350 (0.42)
Sub-Saharan Africa	1.344 (1.33)	0.814 (0.86)	1.126 (1.21)	1.294 (1.49)
East Asia/Pacific	1.730 (1.95)+	1.353 (1.51)	0.366 (0.39)	0.339 (0.39)
<i>Governance Variables</i>				
Conflict Management				
<i>Voice and accountability</i>	0.651 (1.20)			
<i>Rule of law</i>	0.682 (1.39)			
State Capacity				
Controlling corruption	0.879 (1.98)+			
Government effectiveness	1.079 (2.43)*			
N =	33	32	29	30
R <sup>2</sup> =	0.304	0.297	0.394	0.454
+ p<0.07	* p<0.05	** p<0.01	*** p<0.001	Absolute value of t-statistic in parentheses

Table 4b  
Growth Volatility and Governance in Small Countries

*Dependent Variables*

*Growth Volatility (log)*

	(1)	(2)	(3)	(4)
<i>Socio-Economic Variables</i>				
Initial GDP/c, PPP (log)	0.175 (1.25)	0.257 (1.82)	0.144 (1.33)	0.067 (0.60)
Economic inequality (log)	0.474 (1.18)	0.122 (0.32)	-0.051 (0.14)	-0.088 (0.22)
Trade quantity (log)	0.096 (0.48)	0.213 (1.04)	-0.044 (0.24)	0.069 (0.37)
Trade quality	0.260 (1.18)	0.282 (1.35)	0.382 (2.05)+	0.337 (1.71)
Sub-Saharan Africa	-0.270 (1.06)	0.173 (0.77)	0.136 (0.69)	-0.057 (0.28)
East Asia/Pacific	-0.447 (2.00)+	-0.181 (0.85)	0.105 (0.53)	0.010 (0.05)
<i>Governance Variables</i>				
Conflict Management				
<i>Voice and accountability</i>	-0.403 (2.95)**			
<i>Rule of law</i>	-0.416 (3.58)**			
State Capacity				
Controlling corruption	-0.501 (5.31)***			
Government effectiveness	-0.504 (4.75)***			
N =	33	32	29	30
R <sup>2</sup> =	0.388	0.471	0.643	0.578

+ p<0.07 \* p<0.05

\*\* p<0.01

\*\*\* p<0.001

Absolute value of t-statistic in parentheses

Table 4c  
Foreign Aid and Governance in Small Countries

<i>Dependent Variables</i>	<i>Aid Dependence (log of aid as share of GDP)</i>			
	(1)	(2)	(3)	(4)
<i>Socio-Economic Variables</i>				
Initial GDP/c, PPP (log)	-1.300 (2.94)**	-1.071 (2.56)*	-1.310 (3.56)**	-1.489 (4.21)***
Economic inequality (log)	0.108 (0.08)	-0.355 (0.30)	0.046 (0.04)	0.044 (0.04)
Trade quantity (log)	0.051 (0.08)	0.692 (1.02)	0.458 (0.71)	0.482 (0.81)
Trade quality	-0.256 (0.37)	-0.026 (0.04)	0.243 (0.39)	0.262 (0.44)
Sub-Saharan Africa	-0.472 (0.57)	-0.098 (0.15)	-0.204 (0.32)	-0.574 (0.94)
East Asia/Pacific	-0.651 (0.85)	-0.365 (0.53)	0.004 (0.01)	-0.009 (0.01)
<i>Governance Variables</i>				
Conflict Management				
<i>Voice and accountability</i>	-0.380 (0.84)			
<i>Rule of law</i>		-1.003 (2.39)*		
State Capacity				
Controlling corruption			-1.340 (3.54)**	
Government effectiveness				-1.444 (3.78)***
N =	30	29	26	27
R <sup>2</sup> =	0.539	0.617	0.687	0.705

+ p<0.07 \* p<0.05

\*\* p<0.01

\*\*\* p<0.001

Absolute value of t-statistic in parentheses



Table 5  
Case Study Country Comparisons

Factor	Country: Jamaica	Mauritius	Sierra Leone
-----			
Years added to life expectancy			
at birth, 1970-1997	6.5	9.2	3.2
-----			
Reduction in deaths, infant			
mortality rate, 1970-1997	37	44	24
-----			
Infant mortality rate, 1997	10	20	182
-----			
Change in GDP per capita			
(1987 US\$) 1975-1997	-152	1654	-97
-----			
Average annual ranking,			
political & civil liberties			
Freedom House, 1972-99	2, 3	1, 2	5, 5
-----			
Average spending on social			
services, % total,			
1980-1998	31	40	n/a
-----			
Adult literacy rate, 1998	86	84	31
-----			

Sources: United Nations Development Program (1999); World Bank (1997b), King (2000), Bräutigam (2000b).

Appendix:  
Explanation of Data and Sources

Many of the variables used in this paper come from the dataset on social cohesion, institutions, and growth compiled for Ritzen, Easterly and Woolcock (2000), hereafter REW. Where necessary they were supplemented by additional socio-economic data maintained in the World Bank's World Development Indicators (World Bank 2000) database. The exact description and source of each variable used in this paper are outlined below.

Variable	Description	Source
Population	As of 1998	World Bank (2000)
Ethnic fractionalization		REW, originally from World Handbook of Political and Social Indicators, 1972
Economic inequality	Gini	REW, supplemented with most recent data from World Bank (2000)
Land inequality		Deininger (1999)
Primary education		World Bank (2000)
Secondary education		World Bank (2000)
Under 5 mortality	deaths per 1000	World Bank (2000)
Life expectancy		World Bank (2000)
Initial GDP/c (ppp)		REW
Annual growth rate	Median of 1960-98	Derived from REW
Growth volatility	SD of annual growth rate	Derived from REW
Aid share	% of GDP	World Bank (2000)
Foreign direct investment	% of GDP	World Bank (2000)
Trade quantity	% of GDP	World Bank (2000)
Trade quality	dummy variable; 1 if manufac. > 60% of exports	World Bank (2000)
Voice and accountability		KKZ (1999)
Political instability		KKZ (1999)
Government effectiveness		KKZ (1999)
Regulatory burden		KKZ (1999)
Rule of law		KKZ (1999)
Control of corruption		KKZ (1999)

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Camera-ready typescript prepared by Anna Kervinen at UNU/WIDER  
Printed at UNU/WIDER, Helsinki

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ISSN 1609-5774  
ISBN 952-455-198-5 (printed publication)  
ISBN 952-455-199-3 (internet publication)