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Policy reform in small 'remote economies'¹

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Winters and Martins (W&M) ask the question of whether small and remote economies are inherently uncompetitive? They conclude that such economies do indeed face 'huge competitive challenges' and they discuss options for external sources of income that might contribute to the viability of such communities.

These results are based on an econometric analysis of the costs of inputs into international transactions, either those associated with organising the transactions or with non-traded inputs into the production process. The hypothesis tested is that these costs increase as size decreases. Generally the econometric results find strong evidence to reject the null hypothesis that there is no such relationship. Size is measured by population. The regression equations also include some other variables that might contribute to the degree of disadvantage, including policy variables and others that identify features of location. The first comment here concerns the treatment of these additional variables.

The policy variables tested are various tax, subsidy and interest rates. Other policy variables also affect the conditions in which non-traded inputs are provided to production or in which services like shipping and air transport are provided to exporters. These include policy on barriers to entry to relevant markets, for a variety of services markets in particular. The equations include no measures of the nature of these impediments. If the current policies applied in these sectors add to the barriers to entry to these markets, including by foreign suppliers, then prices paid by producers in small economies will be higher than otherwise, and high relative to those in the rest of the world.

This possibility suggests indicators of the policy characteristics relevant to these sectors are worth consideration. Their exclusion from the regression equations may bias the results. If these policy variables are significant and if they are correlated with variables included in the equations then the estimated coefficients on the included variables will be biased. For example, suppose small economies are more likely to adopt restrictive policies with respect to the relevant services, because policy makers there assume that markets for these services are inherently uncompetitive and therefore should be regulated. As explained further below, even in small economies these services can be provided in competitive markets,

¹ Thanks to Jongsoo Kang for assistance. All errors are the author's.

especially when open to trade and investment. However, the effects of their regulatory choices, and the subsequent operation of the regulatory process (including the risk of its capture by private interests), lead to higher prices than might otherwise have been observed. The omission of the services policy variables will then lead to an overstatement of the impact of size alone on competitiveness.

A variety of indicators of the stance of services policy, and the degree of restrictions applied to both domestic and international providers are available. One set of indices was produced by staff of the Australian Productivity Commission, as a result of a joint research project with the Australian National University.² The indices are available for distribution, maritime telecommunications and banking services, as well as for a number of professional services. The maintenance of these indices and the extension of the country coverage, including more small and remote economies, is a topic for further work. However it is possible to use existing data sets to make an initial inspection of the likely significance of the links between size and policy choice, and therefore whether there are risks of biases in the econometric results of W&M.

To test whether the linkage between size and policy choices was worth further exploration, the set of indices for the degrees of restrictiveness in telecommunications markets (RI) was extracted from the Productivity Commission data base (1997 values, higher values indicate higher degrees of restrictiveness) and regressed against population (POP, in log form) as well as dummy variables for income levels (one for GDP per capita of less than \$US 3,000 (D1) and another for incomes between \$US 3,000 and \$US 10,000 (D2)). The result obtained was the following (t values in brackets, a sample size of 136 countries):

$$RI = 0.395 + 0.382D1 + 0.272D2 - 0.035POP$$

$$(9.304) \quad (8.747) \quad (4.768) \quad (3.412)$$

$$R^2 = 0.39, \quad F\text{-value} = 28.47$$

These results suggest there is a significant inverse relationship between size and degree of restrictiveness in policy choices, at least in this sector. That is, smaller economies are more likely to have higher degrees of restriction. If higher degrees of restrictiveness also lead to higher business costs, then the omission of policy variables of this type from the business cost equations of W&M could lead to an overstatement of the effect of decreases in size on business costs.

The income variables are also significant in the equation reported above, suggesting that lower-income countries are also more likely to show higher degrees of restrictiveness. The equation explains a relatively small share of the variation in RI, suggesting a number of other variables are omitted, only one functional form is

² The full set of data and a commentary on their development is available at <http://www.pc.gov.au/research/memoranda/servicesrestriction/index.html>. An earlier description of the methodology is presented in Findlay and Warren (2000).

presented here and the data set is now relatively old. The sample also includes very few of the smallest economies examined by W&M. The data set could be extended and updated, in the process increasing the sample size for a panel approach to the estimation of these relationships. Furthermore results for only one sector have been examined so far and a similar treatment of maritime and distribution services (for which index values are also available) would be of interest.

The second observation about the additional variables included in the W&M equations is the treatment of location. Included in their equations are dummy variables for the distance of the economy from closest population mass of 10 m or more. What might also matter is the distribution of other small economies. These economies could be distributed in a number of ways, some of which could be classified as a 'group', a 'ring' or a 'line'. A group of small economies could be close to each other but all a similar distance from the larger population mass. In the second case, a number of small economies could form a ring around the larger population mass. In the third case, a number of small economies could be spread along a line away from the large population mass.

In all three cases, the possibilities for economising on transportation costs vary. A group of economies could establish a network amongst themselves to consolidate either passengers or freight before moving to the larger population mass (and through there to the rest of the world). The establishment of this network could economise on the costs of reaching the rest of the world. In the second case, the smaller economies could be served by a hub and spoke system operating out of the larger economy, and, while this may reduce the costs of transport between the small economies (which might matter for tourism), it may not affect their costs of doing business with the rest of the world. The possibilities for economising on any part of these costs however are more difficult in the third case. They also depend on the distances involved. However it may be interesting to explore these options, and in further work to include variables that include a wider range of indicators of location, not just remoteness from a larger population mass but also the degree of remoteness from each other.

Taking advantage of these features of location will depend on a degree of policy cooperation. For example, building a network of transport services in any of the cases depends on the degree of openness in transport policies and the ability of providers to experiment with different network structures to see which delivers the lowest cost sustainable option. That degree of openness is typically not present, for example in air transport services where market access options are exchanged in a series of bilateral agreements which inhibit the construction of efficient networks. A regional approach at least will be required to solve this problem.

As W&M point out it is also worth examining the distribution of other large economies in relation to an individual small economy. A small economy, which is surrounded by other large economies, may have more options for participating in competitive markets for transport, telecommunications, electricity and other services, even more than an economy which is remote from all but one other large

economy. Its ability to take advantage of its situation depends on the integration of its services markets with those of its neighbours, and that depends in turn on the policy stance of both the neighbours and small economy.

If these policy variables are important, then a commitment to policy reform in relevant services sectors can be added to the portfolio of measures to sustain small economies that is reviewed by W&M. This policy reform could be organised unilaterally and the econometric work of W&M, including its application to the income effects of changes in transactions costs, provides powerful evidence of the value of reform.

What else might contribute to change in policy and its sustainability? In particular, could these policy changes be organised more effectively in a cooperative manner and in a WTO context? This is the question asked by Mattoo and Subramanian (M&S). As they explain, commitments in the WTO help provide guarantees against later policy reversals and they provide an opportunity to add credibility to a schedule of future reforms. Both contributions could be critical to reform in small economies. M&S also note however that there is not much evidence of the WTO making this contribution, including in services (apart from basic telecommunications, and also with the exception of acceding countries).

To this list of applications of the WTO presented by M&S could be added its use as a venue for confirming regional cooperation on services policy reform. Commitments to take advantage of the features of the location of small economies, as just illustrated, could be designed and negotiated at a regional level and then bound in the WTO, for example.

A key contribution of working in the WTO context is the possibility that it can generate gains in terms of market access, the political benefits of which offset the political costs of reform in sensitive sectors, which might include the services areas just discussed. However, the sort of empirical work reported by W&M, and the significant value they find in the reductions in impediments, could become a basis of revisiting the case for unilateral action in sectors where policy reform contributes to lower business costs and therefore the basis for using the WTO in the manner outlined by M&S without the requirement for meeting conditions on gains in market access.

A further contribution of international cooperation, as M&S point out, is the provision of financial and technical assistance. These contributions are important, especially in dealing with service sector policies, the reform of which often requires the development of new approaches to and institutions for domestic regulation. To this list should be added the general benefit of cooperation in building confidence to undertake reform, by exploring and sharing the experience of others who have taken similar actions for example. Financial and technical assistance would in that case be built on a more solid foundation.

In summary, these papers make a substantial contribution to the policy debate on options for small economies. The empirical work reported by W&M could be an important 'circuit breaker' for the dilemmas identified by M&S. That

work could be developed in a number of ways, including testing for the effects of a wider range of policy variables and for the effects of a wider variable of location variables.

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