THE IMPORTANCE OF INSTITUTION BUILDING IN SMALL ISLAND STATES

Nadia Farrugia*

Abstract. This paper argues that the need for institutional capacity-building for development is essential for small island states, more so than larger ones, due mostly to the former’s high degree of exposure to exogenous shocks. Given that small island states tend to depend heavily on international trade, an appropriate institutional set-up for such states would need to be one that promotes competitiveness. Given also that small island states are highly exposed to external shocks, their institutional set-up should promote economic resilience. In addition, given that environmental concerns are so closely interlinked with economic development in small island states, it is essential that the institutional set-up in these states promotes sustainable development. However, the paper also recognises that weaknesses in institutional capacities is a common constraint shared by small island states and this poses a major challenge in responding to the changing international trade environment.

Introduction

It is often postulated that a positive relationship exists between the quality and performance of institutions on the one hand and economic growth and development outcomes on the other. For example, Rodrik et al. (2002:11) found that the “estimated direct effect of institutions on incomes is positive and large”. Besides this direct impact, there is also an indirect impact on growth and economic development, associated with an increase in investment attractiveness, better policies, better management of conflicts and an increase in the social capital stock of a community. All these factors have a recognised positive influence on growth. Jutting (2003:19), who carried out an extensive literature review on studies that

---

* Nadia Farrugia is lecturer at the Economics Department of the University of Malta.

---

§ This paper is a revised and updated version of a paper presented at the GDN 2006 Annual Development Conference, “Institutions and Development: At the Nexus of Global Change” held in St. Petersburg.
deal with the impact of institutions on selected development outcomes, concluded that “most of the studies suggest a strong and robust relationship between institutional quality and growth and development outcomes”.

This paper contends that the need for economic and institutional capacity-building for development is essential for small island states, more so than for larger ones, due mostly to the former’s high degree of exposure to exogenous shocks (Briguglio, 1995; UNCDP, 2000; Atkins et al., 2000; and Crowards, 2000). The paper argues that given that small island states tend to depend heavily on international trade, an appropriate institutional set-up for such states would need to be one that promotes competitiveness. Given also that small island states are highly exposed to external shocks, the institutional set-up in these states should also promote economic resilience building. In addition, given that environmental concerns are so closely interlinked with economic development in small island states, it is essential that the institutional set-up in small island states promotes sustainable development.

The paper is structured as follows. Section 2 describes the special characteristics of small island states. Section 3 argues in favour of the need for institution building for small island states while Section 4 discusses the connections between institutions and governance credibility. Section 5 deals with regional and international aspects of institution building. Section 6 concludes the study.

The Special Characteristics of Small Island States

Small island states (with a population of about 1.5 million or less) are by no means a homogenous group of countries. They vary by geography, physical, climatic, social, political, cultural and ethnic character, and stage of economic development. Yet they tend to share several common characteristics that identify them as a distinct group. The characteristics of small island states are documented in Briguglio (1995), UNCTAD (1997), Atkins et al., (2000), and Crowards (2000), amongst others.

Farrugia (2004) derived a series of stylised facts from the main observations on small island states, as compared to larger states,
concluding that small island states tend to have:

- a higher degree of openness to international trade;
- larger current account deficits;
- a higher degree of concentration of exports and imports, due to limited diversification possibilities;
- a higher sectoral concentration;
- a greater dependence on foreign sources of finance;
- a larger public sector;
- higher degree of proneness to natural disasters;
- higher transport costs;
- higher degree of volatility in output growth;
- higher degree of instability in export proceeds.

Many studies provide empirical evidence, in the form of economic vulnerability indices, to show that due to their inherent characteristics, small island states are more exposed to external shocks than other groups of countries (see Briguglio, 1995; Briguglio and Galea, 2003; Farrugia, 2004). Cordina (2004) focusing specifically on vulnerability and growth, derived a series of stylised facts with regard to the macroeconomic dynamics of small island states. He shows, amongst other things, that vulnerability is a relevant concept for small island states. He argues that these states are likely to exhibit higher degrees of economic vulnerability than larger countries, either by being relatively more exposed to shocks and/or by being more susceptible to the effects of such shocks.

Economic vulnerability is mostly attributable to a high degree of economic openness and a high degree of export concentration. A high degree of economic openness increases susceptibility to economic conditions in the rest of the world, while lack of diversification possibilities with regard to productive activities, especially in the export sector, renders a country dependent on a very narrow range of goods and services. Exposure to exogenous shocks is likely to constitute a disadvantage to economic development, by magnifying the element of risk in growth processes. Cordina (2004) shows that increased risk can adversely affect economic growth as the negative effects of downside shocks would be commensurately larger than those of positive shocks. The high degree of fluctuations in GDP and in export earnings registered by many small island states is considered as one of the manifestations of such exposure (see Atkins et al., 2000). Economic smallness and vulnerability tend to be
associated with an increased volatility in per capita income growth over time (Cordina, 2004).

Small island states also tend to be environmentally vulnerable. The IPCC Fourth Assessment Report (2007) states that small islands, whether located in the tropics or higher latitudes, have characteristics which make them especially vulnerable to the effects of climate change, sea-level rise and extreme events.

However, in spite of their economic vulnerability, many small island states manage to generate a relatively high GDP per capita when compared to other developing countries. This phenomenon was termed as the “Singapore Paradox” by Briguglio (2003), referring to the reality that Singapore is highly exposed to external shocks, and yet this island state has managed to register high rates of economic growth and high per capita GDP. Briguglio (2003, 2004) explains the “Singapore Paradox” in terms of the juxtaposition of economic vulnerability and economic resilience. In the methodological approach proposed by Briguglio (2003, 2004), economic vulnerability was confined to inherent features which are permanent or quasi-permanent, while economic resilience was associated with man-made measures, which enable a country to withstand or bounce back from the negative effects of external shocks. Briguglio refers to this type of resilience as “nurtured”. Cordina (2004) shows that economic resilience may take the form of higher savings and investment which may occur in the wake of pronounced uncertainty and may enable small island states to achieve high levels of economic development.

**Institutions and Development**

“Institution building” may be defined as a catch-all concept that encompasses a wide variety of goals that have always been at the core of overcoming underdevelopment (Graham, 2002). These goals include enhancing governance, which includes the making and enforcing of rules and laws; improving public administrative and regulatory systems, which includes the provision of public services, such as water and roads; and more efficient and equitable provision of public goods and services, which range from defence to education and health.
Institution Building in Small Island States

Institutions and Competitiveness

Institutions have a key role in influencing the competitiveness of small island states. As already explained, small island states tend to be very open to international trade, and therefore institutions need to create an conducive operational environment for businesses in order to enable them to take advantage of the globalisation process. This is also essential to foster the success of economic development initiatives which identify and encourage local human resources to develop their capabilities so that they can effectively contribute to the development process. It should be noted that the institutions that help increase the competitiveness of states should not be limited to government entities but also extend to the private sector.

The argument that the role and functions of institutions in small island states have a key role in influencing the level of competitiveness of a country is put forward by Gomez (2004), who refers to the Belize experience. He asserts that state competitiveness is a function of three factors: (i) the prevailing international political economy, (ii) the state’s relationship to the global political economy, and (iii) the patterns of macroeconomic policy coordination that support these relationships. In this context, Gomez argues that competitiveness requires policy and institutional frameworks within a country to facilitate the successful integration of that country into the global economic system.

The role of institutions in this regard was also discussed by Treebhoohun (2004) with regard to Mauritius and its National Productivity and Competitiveness Council (NPCC). This institution has been instrumental in enhancing the competitiveness standing of the country. Treebhoohun stresses that the most important role of the NPCC is to improve the local business environment, including through legal provisions, national policies, and access to specific services—including finance and institutional support.

This involves, amongst other things, reviewing the role of institutions to support businesses and the role of the government as the regulator and synergising institutions to better support the private sector. He explains that the NPCC assigns centre stage to productivity improvement, on the basis of a consensus between the social partners.
Mavris (2004) describes the situation in Cyprus, where the institutional set-up is fairly well-developed. He argues that the Cyprus Productivity Centre was instrumental in inculcating a culture of productivity on the island. The Cyprus Institute of Technology and the Cyprus Research Promotion Foundation help to promote scientific and technological research and innovation, while the Human Resource Development Authority of Cyprus enhances entrepreneurship.

Suliman and Jaggi (2004), focusing on human resources aspects of competitiveness, argue that an enabling operational environment is essential for the success of economic development initiatives to identify and encourage local human resources and to develop their capabilities to effectively contribute to the development process. The authors explain how the Entrepreneurship Development and Enterprise Creation Programme (EDECP) initiated in the small state of Bahrain in 2000, helped instill an entrepreneurial culture in society and in sensitising support institutions, thereby creating an enabling operational networking environment for development and growth of SMEs.

Institutions that help increase competitiveness include government as well as private sector entities. Mavris (2004) states that in Cyprus, private sector institutions which help enhance competitiveness include the Cyprus Chamber of Commerce and Industry, which aims to reinforce private initiative as the backbone of the economy and maximises the contribution of the business community to the country’s progress, and the Cyprus Employers’ and Industrialists Federation, which, amongst other things, aims to defend and promote the system of private enterprise and free market economy.

**Institutions and Resilience-Building**

As has been stated above, small island states are highly exposed to external shocks. It therefore follows that an appropriate institutional set-up should be put in place to build economic resilience.

Rodrik (1999) carried out a study of a large sample of developing countries, and found compelling evidence that adjustments to shocks will tend to be worse in countries with weak institutions. Consequently, such countries will experience larger declines in growth rates following
adverse shocks. He also mentions the financial crisis in East Asia, where South Korea and Thailand, with stronger institutions and more open and participatory political regimes, handled the financial crisis significantly better than other countries.

Briguglio et al. (2006a) hypothesised that elements of shock-absorbing and shock-counteracting resilience in an economy can be found in macroeconomic stability, microeconomic market efficiency, good governance and social development. All four areas, as will be illustrated below, indirectly imply the need for appropriate institutions for resilience building.

Macroeconomic stability, shown by internal balance (indicated by a sustainable fiscal position, low price inflation and an unemployment rate close to the natural rate) and by external balance (indicated by the international current account position or by the level of external debt), cannot be attained without having sound economic institutions (Satyanath and Suramanian, 2004). These include independent central banks, ministries which pursue sound domestic and external policy goals, as well as a host of other institutions, such as institutions of financial regulation. By preserving the reputation of the central bank, appropriate institutional set-ups also promote financial system credibility. This is vital in a country which requires the maintenance of adequate foreign exchange reserves (Worrel et al., 2005). Small island states, which tend to operate fixed exchange rate mechanisms, as documented by Worrel (1992) and Vella (2005), require an adequate supply of foreign exchange reserves to safeguard the external value of the currency, and thus the need of credible financial institutions is essential in this regard. Moreover, it is equally important that finance ministries be authoritative and highly regarded for the technical quality of output, since their role is more influential than that of the monetary authorities (Worrel et al., 2005).

Microeconomic market efficiency, which refers to the flexibility and speed with which markets adjust to achieve equilibrium, also calls for appropriate institutions. Fast market adjustment is likely to permit the economy to absorb external shocks and to recover quickly. Downes (2005), who authored a paper on market reform and resilience building in small developing countries, quotes Posner (1998) and Williamson
(1998), to illustrate the link between microeconomic market efficiency and institutions. Posner (1998) indicates that the market “may depend on the establishment of an environment in which legal rights, especially property and contractual rights are enforced and protected”, while Williamson (1998) argues that, within a market economy, the institutions of “good governance” require the specification of the rules of the game, namely, well-established property rights and clear public policies.

Good governance, which relates to issues such as rule of law and property rights, is basically an institutional issue as it is related to the judicial and political system. Without these institutions it would be relatively easy for adverse shocks to result in economic and social chaos and unrest and the effects of vulnerability would be magnified. On the other hand, good governance can strengthen an economy’s resilience. Also, when there is political order, there is security for property rights, rendering it in the interests of private agents to invest, to labour, and to generate higher levels of income (North and Thomas, 1973). This point is also made in Downes (2005), who argues that in the context of competition policy and privatization, the “institutions of good governance” are exceedingly important since they delineate a role for the state while allowing private agents to engage in transparent contractual arrangements.

Social development, which indicates the extent to which social relations in a society are properly developed, enabling an effective functioning of the economic apparatus without the hindrance of civil unrest, also implies the existence of an appropriate institutional framework. Such development requires good social institutions, the core systems of which are those providing education and health services. Institutions are needed to change information into productive knowledge (North, 2005). Also quality improvement of education (at all levels, formal and non-formal) requires institutional capacity to plan, manage and reform the education system (Troost and Hadley, 2004).

Cultural institutions are also important in this regard. The 2005 Mauritius International Meeting on the 10-year Review of the Barbados Programme of Action (MIM) called for national cultural policies and legislative frameworks to support the development of cultural industries and initiatives, arguing that there is a need to strengthen cultural institutions
Institution Building in Small Island States

and industries in small island developing states for national and regional development and to achieve international competitiveness. Cultural institutions and industries are viewed as areas in which small island developing states have a major comparative advantage and can be used to build up social and economic resilience.

The 2005 Mauritius Declaration gave major importance to economic resilience building in small island states and asserted that institutional capacity building is essential towards this end. The document states that several small island developing states have made strides in developing their capacity to trade, but economic vulnerabilities remain high and thus special efforts should be made by the international community to strengthen the resilience of these countries. The Declaration states also that small island developing states have committed themselves to promote sustainable development, eradicate poverty and improve the livelihoods of their peoples by implementing strategies that build resilience and capacity to address their unique and particular vulnerabilities. It continues to state that it in order to strengthen the resilience of small island developing states, it is important to identify practical ways for capacity building and regional approaches and strategies, with the assistance of international development partners.

Institutions and Sustainable Development

In 1987, the United Nations Commission on Environment and Development (the Bruntland Commission) drew attention to the fact that economic development often leads to a deterioration, not an improvement, in the quality of people’s lives. The Commission, therefore, called for sustainable development which it defined as development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

Sustainable development has three major characteristics, namely a focus on the long term consequences of current activities, an ethical foundation oriented towards upholding the interests of future generations and the need for consensus-building to resolve conflicts between different interests. There is thus a need for strong political commitment to sustainable development values, from all layers of authority, including the government and local authorities and the trade unions (Adkin, 2005).
The degree to which the above can be achieved, depends amongst others things, on the enabling frameworks offered by local, national and international institutions. This principle has been incorporated in Agenda 21, adopted by the United Nations Conference on Environment and Development (UNCED), meeting in Rio de Janeiro in 1992, and in the Barbados Plan of Action for Sustainable Development.

Agenda 21 (Chapter 7) states that: “The ability of a country to follow a sustainable development path is determined by the capacity of its people and its institutions. ... Specifically, capacity building encompasses the country’s human, scientific, technological, organisational, and institutional capabilities. The fundamental goal of capacity building is to enhance the ability to evaluate and address the crucial questions related to policy choices and modes of implementation among development options. ... As a result, the need to strengthen national capacities is shared by all countries. The overall objectives of endogenous capacity building in this programme area are to develop and improve national and related sub-regional capacities and capabilities for sustainable development ...”

This need to develop institutions for sustainable development in small island states has been clearly stated in the Barbados Programme of Action for the Sustainable Development of Small Islands States (BPoA), which concluded that capacity-building, amongst other things, was essential for sustainable development (United Nations, 1994, para.11; Koonjul, 2004). The subject was also discussed extensively during the 2005 Mauritius International Meeting.

Given that sustainable development is multifaceted it is important to ensure coherence in government policy. An appropriate institutional set-up is important in this regard. Institutional capacity is also required to mainstream sustainable development policies into national and local policies. The Agenda 21 chapter on sustainable development strategies states that “Governments [...] should strengthen national institutional capability and capacity to integrate social, economic, developmental and environmental issues at all levels of developmental decision-making and implementation” (UNCED, 1992, Par. 8.12).

In addition, sustainable development requires participatory arrangements, which would be impossible to conduct without appropriate
institutional capacity. Participatory arrangements are important in defining the objectives of sustainable development, in integrating economic, social and environmental policies, and in fostering ownership of sustainable development policies in societies since they help to reconcile different interests and integrate stakeholders in decision-making.

The UN and OECD’s guidelines on sustainable development strategy processes state that these should be backed by high-level political commitment and adequate institutional capacities (United Nations, 2002; OECD-DAC, 2001, IIED, 2002). This point is further emphasised by Steurer and Martinuzzi (2005) who state that sustainable development strategies combine aspects of formal planning and incremental learning and that put strong emphasis on institutional factors of policy-making.

While institutional set-ups for the promotion of sustainable development are important for all countries, be they small or large, rich or poor, these are especially needed in the case of small island states given their special sustainable development constraints, and given that in small countries, the interrelationships between economic, social and environmental goals are highly interlinked (Roberts, 2006).

**Institutions and Governance Credibility**

The possibility of institutional failure is, according to Farrugia (2004) more likely to occur in small island states. Scialabba (2004) also states that weaknesses in institutional capacities is a common constraint shared by small island developing states and pose a major challenge for many small island developing states in responding to the changing international trade environment. She points out that analyses carried out by FAO showed that the main problems regarding capacity building in small island states include lack of sufficient legal frameworks and limited human resources.

Typically, government failure occurs when government intervention goes beyond the traditional role of providing public goods and creating the institutional, legal and policy framework for the private sector to operate (Downes, 2005). There are two aspects of government failure:
1. failures of commission, where the government engages in action which worsens economic performance (for example, state enterprises which raise the cost of doing business; costly regulatory requirements);

2. failures of omission, where the government fails to undertake activities to improve economic performance (for example, neglect of social infrastructure; failure to address underlying economic ills), or where the state does not engage in developmental or social transformational activities which would advance the socio-economic welfare of the people of a country (Krueger, 1990).

In small developing countries, both failures of commission and omission are significant and have a retarding effect on the developmental process. Due to the limited labour market, it is difficult to find sufficiently skilled personnel to undertake key governmental functions. Delays and inaccuracies in some services raise the costs of transacting with government institutions. The inability to access funds means that several areas of activities (road construction, maintenance of buildings, etc) are neglected. The small size of these countries also means that a small group of elite persons have a significant amount of economic and political power which can have a distorting impact on economic activities. Furthermore, inappropriate government economic policies can result in reduced resilience in small developing countries. The costs of a small error in a small developing country can be much higher than in more developed countries (Downes, 2005). For this reason, small island states must try that bit harder to instil credibility in their institutional set-ups.

An analysis of institutional quality in small states, carried out by the present author, did not find that the quality of institutions in small states is inferior to that in larger states. The analysis involved simple correlations between population size and indicators of institutional quality, proxied by the World Bank Governance Indicators (Kaufmann et al., 2007). Correlations were performed for each of the six dimensions, that is, voice and accountability, political stability, government effectiveness, regulatory quality and control of corruption, as well as for the average of these six dimensions. All results showed a negative correlation, albeit low, between these indicators and population size, indicating that there is no evidence that small states in general have an inferior institutional quality when compared to larger states.
These results do not negate the fact that the probability of institutional failure is higher in small states, especially given that in such states it is harder to draw efficient and experienced public administrators due to the limited manpower base (Briguglio, 1995).

Regional and International Aspects

Regional Cooperation

Regional cooperation in developing institutions is very important for small states in order to pool resources, to ensure that costs are spread and to avoid duplication of effort. In the case of representation in international negotiations, such as within the WTO, regional institutions can also strengthen the voice of small states as a group.

Briguglio et al. (2006b) argue that the economic success of small states is critically dependent on enhancing regional cooperation. They argue that given their small size, individual small states will inevitably be unable to deliver the necessary government regulatory and service functions required of a modern state.

It is therefore vital that small states put increased emphasis on regional cooperation including developing regional institutions for higher education, environmental protection, fisheries protection, regulation and enforcement, air traffic control, utility regulation, procurement of regional air and shipping services, preparing model legislation, cross-border crime prevention, international negotiations, foreign representation, and cultural and investment promotion.

The Role of the International Community

International organisations have an important role in assisting small island states in their efforts to build solid institutional set-ups and in building the required capacity, in order to be able compete in world markets and thus promote their economic growth and development.

The 2005 Mauritius Declaration states that the international community and development partners can support small island developing states in
building resilience and achieving sustainable development by helping them create an enabling environment to facilitate trade, investment, capacity-building.

There are a number of reasons why small island developing states are particularly in need of international support in this regard. Briguglio (2004) argues that small island states deserve special consideration by the international community on the grounds that institutional capacity building in such states involves relatively high costs per capita due to indivisibilities in overhead expenditures.

Encontre (2004) calls for favourable treatment from development partners in terms of technical assistance for institutional capacity-building, in order to help small island states reduce their most critical structural handicaps, which have already been discussed above. Likewise, Palayathan (2004) called for technical and institutional support to small island states by the international community due to the rapid loss of preferential arrangements experienced by these states.

**Conclusion**

The paper illustrates the fundamental need for appropriate institutional set-ups in small island states, given their special characteristics. It was argued that small island states tend to depend heavily on international trade, thus, an appropriate institutional set-up for small island states would need to be one that promotes competitiveness.

Small island states are also highly exposed to external shocks, thus, the institutional set-up in small island states should promote resilience. Furthermore, small island states tend to be very environmentally fragile with environmental concerns closely interlinked with economic development, and therefore, it is of paramount importance that the institutional set-up in small island states promotes sustainable development.

The advantages of regional and international collaboration were highlighted in order to pool resources in areas where going it alone will be relatively expensive. The paper also recognised that weakness in
institutional capacities is a common constraint shared by small island states, which poses an additional challenge in responding to the changing international trade environment.

It was therefore argued that the international community has an important role in assisting small island states in their efforts to build solid institutional set-ups and in building the required capacity.

References


