Small Middle Income Countries – Lessons from the Small Advanced Economies

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Outline

- Observations about Small Advanced Economies
- Common policy themes
- New Zealand’s reform experience
- Short note on two economies in crisis - Greece and Ireland
- Some concluding observations

Small countries ranked by size and meeting IMF definition of advanced economy

Country	Population	GDP/Cap (USD)
Iceland	322,000	45,536
Malta	417,000	22,872
Luxembourg	542,000	110,424
Cyprus	881,000	24,761
Estonia	1,286,000	19,032
Latvia	2,036,000	15,205
Slovenia	2,059,000	22,756
New Zealand	4,479,000	40,481
Ireland	4,776,000	45,621
Norway	5,096,000	100,318
Singapore	5,399,000	54,776
Slovak Republic	5,411,000	17,706
Finland	5,451,000	47,129
Denmark	5,591,000	59,191
Hong Kong SAR	7,244,000	37,777
Israel	7,871,000	37,035
Switzerland	8,003,000	81,324
Austria	8,484,000	48,957
Sweden	9,635,000	57,909

Observations about small advanced countries

- Profound differences but important similarities between the 19 SACs
- Great differences in:
  - Resource endowments (New Zealand, Norway) v's (Singapore, Israel, Hong Kong)
  - Location of the 19: 3 in Asia (NZ, Singapore, Hong Kong), Israel, 15 in Europe
  - Historical legacies: 3 FSU, 3 were once British colonies, some with centuries of independence; some are homogeneous, others very diverse over a range of features
- Performance indicators for group of SACs (2014):
  - Average income p.c. of US$47000 v's $36000 for large advanced countries
  - 7 out of the top 10 advanced economies are small
  - Ave growth rate for SACs since 1980 was 3.2% v's 2.6% for the large advanced economies – with variations among the group
  - SACs have held their collective share of global GDP since 1980 while share of large advanced economies has dropped
- So: Being a small country does not prohibit having an advanced economy

Material drawn from "What can Singapore Learn from other small Advanced Economies", David Skilling, Lee Kuan Yew School of Public Policy, Singapore March 2015

SAC policy themes

- Openness
  - All are highly open to global economy – they accept the local economy will not sustain growth
  - Common strategy is to take advantage of the global markets but by very different means according to circumstances
    - Natural resources (NZ, Norway)
    - Attracting foreign business activities and direct investment (Sing. HK, Israel)
    - Innovation in global growth industries (Switzerland)
  - Some are at the forefront of global competitiveness indicators (WB surveys)
- High levels of R&D spending for most of them
- Emphasis on innovation, human capital and 'knowledge capital'

Policy themes

- Macro-economic discipline
  - Fiscal discipline for low debt ratios and debt sustainability, managing shocks, and macro-stability
  - Low inflation in support of the strategy for global engagement and competitiveness
- Regulatory policies to support flexibility in key markets
- Managing shocks and risks from volatility
  - sovereign wealth funds
  - disaster preparedness
- Focus on the balance between the sectors exposed to international competitive pressure and the sheltered domestic sectors – including the public sector

The New Zealand case study 1984 - 1994

- Once the third richest country in 1951 but by 1984:
  - 30 year relative decline from 20% above OECD average to 1/3rd below
  - GDP per head (productivity) grew only ½ OECD average for 20-30 years
  - 10 years to 1984 growth 0.2% pa (OECD ave. 1.8%)
  - Fiscal deficit 9.5% GDP
  - External deficit 10%
  - 12% of GDP and 17% of investment controlled by government departments with commercial functions: requiring subsidies, not paying taxes or dividends and mostly providing poor services
  - Rising unemployment
  - Government debt over 50% GDP
  - High interest rates and strong inflationary pressure

Out of step with OECD-wide policy responses to address stagflation and structural adjustment

- Macroeconomic instability
- Growth strategy based on large energy infrastructure investments that failed
- High & uneven tariffs and import controls
- East European styled controls on wages, prices and interest rates
- Tax system with highly variable rates and many exemptions
- Legacy of slow adjustment to the loss of the British market
- Failure to adapt to 1970s oil shocks –

Policy response 1984 – mid 1990s

- Devaluation, removal of foreign exchange controls ‘clean’ floating exchange rate
- Removal of controls on imports
- Aligning and reducing tariffs
- Tax reform – comprehensive VAT, removed exemptions in income tax, cut income tax rates
- Independent central bank targeting inflation
- Refocusing welfare system on need

Policy response

- Deep review and re-prioritisation of expenditure
- Radical reform of public financial management system
- Comprehensive reform of the state sector management
  - Commercial activities became state enterprises under private sector company law
  - Ministries and departments restructured, downsized and put under a performance management system
  - Semi-autonomous ‘agencies’ (everything else) created with modern management and governance arrangements
  - Govt science research put into new governance arrangements to promote innovation and technology transfer
- Privatisation
- Extensive regulatory reform to make economy more flexible – competition policy, labour market

Legislative basis for reform

- State Enterprise Act – made all government owned business into companies under private sector company law and subject to general commercial law, made more independent from ministers. Subsidies removed.
- State Sector Act – fundamental changes to the governance and performance management of the ministries aimed at greater efficiency and effectiveness
- Public Finance Act - budget appropriations for outputs linked to outcomes, international accrual accounting standards and financial reporting
- Fiscal Responsibility Act to require transparency, a multi-year plan and resist deficits and debt
- Reserve Bank Act – established independent monetary authority and inflation targeting

Results - economy

- GDP/ person grew 2.5% p.a. for 10 years compared with 0.5% in 10years to 1984
- Economy wide productivity measures improved dramatically in the economic reform period (labour productivity gain was in the 2.5-3% range in the three cycles during 1985-2000)
    - The gains were greatest in the industries where reforms were most comprehensive, in particular agriculture, transport and communications.
- Rapid drop in unemployment after rising sharply after 1987 crash to around 11% but trended down to 6% by 2000 and on down to 3.5% by 2006
- Inflation below 2% - had previously been over 10% between periods of price controls
- Net public debt fell from 50% to 20% of GDP in 4 years

Results - fiscal

- Big shifts in priorities
  - Public sector staff numbers halved
  - Cash requirements for operating departments dropped 3-4% in one year alone
  - Better control of aggregate expenditure
  - Accountability and transparency vastly improved
  - Sharp break in expenditure trends
    - 6% fall in government expenditure/GDP 1991-1994
    - Fiscal surpluses for 15 years after 1994

Reflections on NZ case study

- Its radical appearance reflects in part
  - the difficult situation in which it was introduced
  - how far out of step with mainstream OECD – IMF policy thinking New Zealand had got and
  - a strategy by a new government to re-position New Zealand in the global economy
- It illustrates one country's application of the policy themes summarised above from the SACs
  - Openness and flexibility
  - Fiscal responsibility
  - Concern to manage volatility
  - Focus on productivity and innovation
- The reforms were maintained through changes of government in the 1990s but some elements were rolled back in the 2000s (regulation of some utilities, labour market, public sector employment)
- But it was long ago – today's agenda still reflects these priorities

The politics of New Zealand's 1980s-90s reforms

- **Broad acceptance of a problem**
  - Consensus across the parliament that change was needed once the previous government fell
  - Strong communications about need for change – initially at least
  - The program spanned three elections and two governments

- **Political judgement** about what can be done, what cannot and what has to be:-
  - Labour govt. removed subsidies to farmers but gave big pay increases to employees in state sector unions
  - The National govt reformed the labour market and squeezed the public service
  - Skill in implementation of reform - early wins and political packages that balanced rewards and pain

- **Political outcomes**
  - The government that began the reforms increased its majority at the next election in 1987, but
  - Internal tensions in the Labour govt between the reforming ministers and the membership of the party became unmanageable - the government broke down internally in 1988
  - National govt huge majority dissolved so PM fired the Minister if Finance;
  - The reforms were over but the changes were embedded for years to come

A note on the crises in Greece and Ireland

- Greece - Did not learn the lessons of the small advanced countries
  - Financial collapse
  - Unemployment 30% disposable incomes fell 25%
  - Failed over many years to build an economy that could compete in global markets
  - Fiscal irresponsibility: large deficits resulting in 130% debt to GDP ratio before the crisis
  - Corrupt and inefficient public sector and weak revenue base
  - Neceasry is so sever as to seem politically impossible
  - Looking to others for bail outs

- Ireland – the Celtic Tiger
  - Extraordinary success in export driven growth that transformed into a property and finance bubble
  - Wrecked by irresponsible government macroeconomic policies and regulatory policies that fuelled the bubble
  - Rising again today following years of painful adjustment – consistent with the policy themes of SACs

See Donovan and Murphy, "The Fall of the Celtic Tiger"

Insights from the SSA-SMIC research

- Clear evidence that the issues that have mattered for the small advanced countries are central to the SSA-SMIC agenda
  - Openness
  - Constraining the size of the sectors that are protected from global competition
  - Macro-stability
  - Building resilience to volatility
  - Focus on productivity improvement
  - Human and knowledge capital enhancement
  - Innovation
  - Clever political management and building consensus around a long term program

Final comments

- Moving out of the middle income group is harder than getting into it
  - The challenge is to move from 'catch-up' economic management and structural change to continuing dynamic productivity improvement.
  - Even Singapore finds dynamic change and productivity improvement a challenge and it is at the centre of policy concern in New Zealand today
- Small countries have to live with the consequences of their smallness and not act as if they are big: They must:
  - be well-managed, prudent, agile,
  - learn to live with the volatility that smallness brings and
  - take best advantage of their unique circumstances