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The challenges faced by small national economies

Report[1]
Committee on Economic Affairs and Development
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Summary

About half of the Council of Europe member states can be considered as small economies. They are confronted with specific development problems and socio-economic vulnerabilities due to their small domestic markets, limited diversification of local production and exports, high dependence on foreign markets, insufficient local resources, weaknesses in public and private sector capacity, difficulties in managing cross-border capital flows and attracting investment, as well as susceptibility to population movements and natural disasters.

The global financial and economic crisis has affected small economies particularly strongly. It has highlighted the importance of good governance in underpinning development and the need to ensure sound macroeconomic fundamentals, economic diversification, stronger institutional capacity and competitiveness, optimal use of local resources, adequate transport and energy interconnections, and steady human progress.

The report pleads for raising awareness and stimulating the public debate on the development challenges faced by small economies both in these countries and among their international partners – states and organisations. International organisations can play a very helpful role in ensuring a level playing field and greater solidarity between small and big actors on the global economic scene, as well as in assisting capacity building in small states.

1. Reference to committee: Doc. 11975, Reference 3599 of 2 October 2009.

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A. Draft resolution[2]

1. Council of Europe member states differ significantly in terms of size, level of development and the policy challenges they are confronted with. In considering economic and social policy issues, much attention tends to focus on large economies whilst the particular characteristics, development problems and vulnerabilities of small national economies often get overlooked. Because about 21 of the 47 member states with a population of less than 4.5 million can be considered as small national economies, the Parliamentary Assembly believes it is necessary to raise awareness and stimulate the public debate on this issue both in these countries and among their international partners – whether they be states or organisations.

2. Moreover, as the Council of Europe seeks "to achieve a greater unity between its members for the purpose of safeguarding and realising the ideals and principles which are their common heritage and facilitating their economic and social progress", it is necessary to ensure that the development potential and capacity of the smaller states is fully exploited, through adequate policy choices at national and European levels.

3. Although their economic and social profiles vary considerably, all the small Council of Europe member states have been heavily affected by the global financial and economic crisis and some, faced with particularly serious problems (such as Iceland, Latvia and Moldova), needed emergency assistance. The crisis has highlighted these countries' economic and social vulnerability, which is due to a combination of factors: small domestic markets, limited diversification of local production and exports, high dependence on foreign markets, insufficient local resources, weaknesses in public and private sector capacity, difficulties in managing cross-border capital flows and attracting investment, as well as susceptibility to population movements and natural disasters.

4. The Assembly therefore insists on the importance of good governance through institutions, human resources and legal set-up in underpinning development. It views efforts to ensure sound macroeconomic fundamentals, to diversify national economy, to strengthen institutional capacity, to build up competitiveness, to optimise use of local resources, to secure adequate transport and energy interconnections, and to foster human progress as the key drivers of long-term and sustainable development strategy for small states.

5. The Assembly is convinced that small economies have no choice but to be open to investment, trade, new ideas and change by constantly adapting and transforming their economies in order to raise living standards, enhance the quality of life of their population and secure the benefits of globalisation in the increasingly liberal global trading environment. It believes that international organisations can play a very useful role in ensuring a level playing field and greater solidarity between small and big actors on the global economic scene. They can also assist capacity building in small states.

6. Given the importance of the financial sector to the development of small economies, the Assembly points to the need to seek a better balance between financial services and the rest of the economy. It is particularly concerned about the prevalence of monopoly (private or public) situations with a risk of market distortions and undue influence of vested interests in small national economies. It also stresses the need to get budget deficits under control and to return to a balanced budget situation. Resorting to domestic rather than external borrowing would increase resilience of national economies to external shocks.

7. The Assembly notes a growing public concern over the quality of life and the sustainability of development. It underscores a huge economic potential of the environment sector in this respect, not least through the emphasis on green and cultural tourism, as called for in its Recommendation 1835 (2008) on sustainable development and tourism: towards a quality growth. The Assembly, moreover, considers that small states could lead the way in Europe by testing green development options.

8. The Assembly believes that in order to fully tap their development potential, small states need to enhance their human capital through social policies. Moreover, they should seize opportunities of the economy of speed rather than the economy of scale by using e-governance and high technologies that make it possible to boost efficiency, create new jobs, make information more accessible and help transform competitors into partners, irrespective of their size or location.

2. Draft resolution adopted unanimously by the committee on 6 October 2011.

9. The Assembly therefore invites the small Council of Europe member states to:

9.1. build a national consensus around the efforts towards constant improvements in the functioning of justice systems and the rule of law, macroeconomic stability, tax administration and public resources management, social services, entrepreneurial activity, personal security, civil society participation, transparency and accountability;

9.2. closely monitor the role of monopolies, oligopolies and monopsonies play in their economies and, if necessary, to reassess their policies on privatisation and regulation in order to spread economic well-being more evenly across the population and to fully involve the private sector in the implementation of national development strategies;

9.3. seek the closest possible regional ties, alliances with other small states and partnerships with multilateral development institutions and international organisations such as the European Union and the European Investment Bank (EIB), the Council of Europe Development Bank (CEB), the European Bank for Reconstruction and Development (EBRD), the International Monetary Fund (IMF), the World Bank and the World Trade Organization (WTO);

9.4. use public-private collaboration and the support of multilateral development banks in exploiting new technologies to fully boost national welfare systems, infrastructure and regulatory frameworks;

9.5. consider ways of not only improving the regulation and transparency of financial services they provide, but also of using them to develop other types of domestic economic activity, thus gradually reducing the reliance of national well-being on the financial sector;

9.6. use fiscal incentives to encourage microcredit schemes, to ensure a fair access of all economic players, especially small entrepreneurs, to financial resources and to promote socially responsible investment policies so that a sufficient share of corporate profits is reinvested locally;

9.7. accord high priority to the provision of affordable, accessible and efficient services for education, training and health care;

9.8. accelerate a shift towards the green economy through a dedicated national strategy and investment in this field;

9.9. put in place policies and incentives for retaining highly skilled members of the population and attracting back to the country those who have emigrated;

9.10. foster investment in recycling waste and its transformation into energy and new resources;

9.11. develop their transport and energy interconnections by, as appropriate, taking full advantage of their European Union membership or Eastern Partnership facilities, action plans for the development of Trans-European Networks and the related financing schemes through the EIB loans and European Union funds, including the Structural Funds and the Cohesion Fund.

10. The Assembly also invites the relevant international organisations to assist capacity building in small national economies and to take into account the latters' specific needs in their work on policy advice and development strategies.

B. Explanatory memorandum by Ms Coleiro Preca, rapporteur

1. Introduction: aims and scope of the report

1. The Council of Europe comprises 47 member states which differ significantly in terms of size, development capacity and the policy challenges they are confronted with. In discussing economic and social policy issues, much attention tends to focus on large economies whilst the particular characteristics, development problems and vulnerabilities of small national economies often get overlooked. However, as the Council of Europe seeks "to achieve a greater unity between its members for the purpose of safeguarding and realising the ideals and principles which are their common heritage and facilitating their economic and social progress",[3] it is necessary to explore how the development potential – and capacity – of the smaller states could be best exploited through smart policy choices at national and European levels.

2. It is difficult today to make a clear-cut distinction between small and medium-sized national economies, as "smallness" is a relative concept. Most analysts use population size as a key measurement to this end,[4] although other indicators such as territory size and gross domestic product (GDP) can also be taken into account. Moreover, location and in particular the insularity of some small economies are important additional factors to consider.

3. Since the onset of the economic crisis, small economies have been faced with serious difficulties diametrically opposed to their size and some small economies (Iceland, Latvia and Moldova) needed the International Monetary Fund's (IMF) emergency assistance. There is no single factor that has caused these difficulties, as each country is unique and has its own specific economic features. However, it is possible to identify a number of problems common to all. We shall therefore endeavour to highlight policy options that could assist fully fledged and harmonious development of small economies. In so doing, we shall also look at the role international organisations can play in ensuring a level playing field and greater solidarity between small and big actors on the global economic scene.

4. The rapporteur wishes to thank several experts from the University of Malta,[5] notably Dr Rose Marie Azzopardi, Professor Lino Briguglio (Director of the Islands and Small States Institute) and Dr Gordon Cordina, who contributed to the discussion on small national economies during the meeting of the Committee on Economic Affairs and Development in Malta on 28 May 2010.

2. Definition of smallness and some general characteristics of small economies

2.1. How small is small?

5. For the purposes of this report, we shall subdivide small Council of Europe member states (21 out of 47) into two categories: small states, namely those with a population of less than 4.5 million (Albania, Armenia, Bosnia and Herzegovina, Croatia, Georgia, Ireland, Latvia, Lithuania, Moldova, Slovenia, and "the former Yugoslav Republic of Macedonia") and microstates, those with a population of less than 1.5 million (Andorra, Cyprus, Estonia, Iceland, Liechtenstein, Luxembourg, Malta, Monaco, Montenegro and San Marino). Croatia and Georgia are the biggest of the small states thus defined, with populations of about 4.5 million, and Monaco is the smallest, with a population of slightly above 33 000.

6. Small size also means small domestic markets. In terms of economic indicators, small economies' GDP per capita varies from US$1 630 in Moldova (the smallest in Europe) to US$108 831 in Luxembourg[6] (the highest in Europe) and their share in world GDP ranges from around 0.014% (Malta and Moldova) to 0.54% (Luxembourg).[7]

7. As a consequence of their economic openness, most small economies were particularly exposed to the global financial and economic crisis, leading to:

– large economic contraction (–18% in GDP for 2009 in Latvia, –14.2% in Armenia, –7.5% in Ireland);

3. Extract from the Statute of the Council of Europe (Chapter I – Aim of the Council of Europe, Article 1).
4. Some analysts use 10 million people as an upper limit, others use a ceiling of 1.5 million people.
5. Faculty of Economics, Management and Accountancy.
6. World Economic Outlook, April 2011, International Monetary Fund.
7. Compared to about 4% for Germany, 3% for France, the Russian Federation and the United Kingdom, and 2.5% for Italy.

– widening budget deficits (reaching respectively 14.6% and 17.7% in 2009 and 2010 in Ireland, and from 7.9% in Latvia to 2.5% in Moldova and in "the former Yugoslav Republic of Macedonia" in 2010);

– growing public debt, unemployment (as high as 43% in Bosnia and Herzegovina, 32% in "the former Yugoslav Republic of Macedonia", 17% in Lithuania, 14% in Ireland, according to the latest available data) and the volume of non-performing loans (about 19% in Latvia and Lithuania, 17% in "the former Yugoslav Republic of Macedonia" and Moldova, and 12.5% in Georgia).

8. However, the economic rebound has been equally notable, especially in central and eastern European small economies where positive growth rates were registered in 2010 (except for Croatia). On average, their growth rates are projected to be around 3% in 2011 (notably 5% in Georgia and 4.5% in Armenia and Moldova) according to the estimates of the European Bank for Reconstruction and Development (EBRD).

2.2. General characteristics of small economies

9. Although there is a general lack of consensus on whether country size matters for development, many experts argue that small economies are inherently different. The main reasons for this are that small countries have a very modest resource base, are highly dependent on external trade and resources, and are thus more exposed to exogenous shocks. Furthermore, small countries are generally not able to benefit from economies of scale and are unable to fully diversify their activities. Their economies are highly dependent on foreign investment but their size limits their negotiating power. Additional constraints are their limited access to funding from international markets and their vulnerability to capital flight, volatility of remittances (particularly important for Albania, Armenia, Bosnia and Herzegovina, Georgia, "the former Yugoslav Republic of Macedonia" and Moldova), "brain drain" and environmental changes (notably in the insular states such as Cyprus, Iceland, Ireland and Malta), as well as migration-related challenges.

10. Frequently, small national economies have a well-developed and dynamic tertiary sector, mainly centred on tourism (Croatia, Cyprus, Malta) or financial services (Estonia, Ireland, Luxembourg). The economic crisis has led to a slowing down of these sectors, either because of a drop in the number of tourists or as a result of financial and banking market contagion. Still, a highly performing banking sector in Luxembourg makes this country one of the world leaders in economic prosperity measured in GDP per capita. Moreover, trade with other countries is vital for small economies and constitutes a significant part of overall economic activity.

11. Close relationships with the European Union are essential – either through the European Economic Area arrangements (Iceland and Liechtenstein), the Central European Free Trade Agreement (Bosnia and Herzegovina, Croatia, Moldova, Montenegro and "the former Yugoslav Republic of Macedonia"), association agreements (Bosnia and Herzegovina) and accession negotiations (Croatia, Iceland, Montenegro and "the former Yugoslav Republic of Macedonia"; Albania has applied for membership) – or membership (Cyprus, Estonia, Ireland, Latvia, Lithuania, Luxembourg, Malta and Slovenia), in particular of the eurozone (Cyprus, Estonia, Ireland, Luxembourg, Malta and Slovenia). Andorra, Monaco and San Marino have special arrangements with the European Union on the use of the euro as their currency.

12. As small players not only on the global but also on the European scene, small and microstates generally cannot afford substantial expenditure to guarantee their security and to protect their interests in the face of external threats. Co-operation on a regional basis helps to overcome most of these shortcomings.

2.2.1. Economic crisis and the diversification of the economy

13. Faced with the current economic crisis, a number of European countries have had to turn to the International Monetary Fund and the European Union for financial assistance over the years 2009 to 2011, a move that seemed inconceivable only five years ago. Several eurozone economies (Greece, Ireland, Portugal) have been particularly affected and other countries with small economies, such as Iceland, Latvia, Moldova and more recently Bosnia and Herzegovina, needed emergency EU/IMF loans to get through the crisis, whilst Armenia and Georgia are under active IMF-supported programmes. It is therefore necessary to take a closer look at these difficulties.

14. Those small economies which managed to diversify more their national economy have withstood the economic crisis better than those which relied on just a few main economic sectors. Several countries have invested in sectors with a high added value, such as pharmaceuticals, electronics, new technologies or communications. Some of these sectors have been less affected by the crisis and have been able to endure the economic difficulties to varying degrees.

15. Conversely, countries such as Latvia and Armenia, the economies of which are less diversified, have suffered severely from the economic crisis, with their GDP shrinking (by respectively 18% and 14.2%) and their fiscal deficit soaring (respectively at 9% and 7.5% of GDP). In Armenia, the economy is dependent on a very limited number of sectors, all of which have been affected by the crisis (construction, mining, remittances). In these countries, as in some larger ones, the structural and institutional weaknesses, deficient regulatory frameworks and governance problems are seen as major obstacles to the diversification of the economy.

16. The industrial sector has suffered a similar fate. On a steady downward curve compared with the tertiary sector, industry is nonetheless still a key sector in certain countries, such as Lithuania (30%) and Armenia (36%) amongst others. The difficulties inherent in restructuring the industrial sector, fluctuations in external demand and the collapse of certain sectors have multiplied the effects of the crisis. For example, Lithuania, which has been successful in transforming its industry towards electronics, biotechnologies and chemicals, but has indulged in a credit boom, has been severely affected by the crisis. Overall, the Baltic states (Estonia, Latvia and Lithuania) experienced the most significant overheating before the crisis and the biggest growth improvement in 2010, as well as industrial recovery in early 2011.[8]

17. A squeeze on small and medium-sized enterprises (SMEs) and the recreation of oligopolies, observed since 2009, are not encouraging signs for the diversification of European economies; quite the opposite. There has been a rise in mergers and acquisitions in the banking and in the air transport sectors. Such mergers pose a real threat to competition, benefiting certain small national economies which previously had an economic advantage in sectors where a variety of economic players existed side by side.

18. The rapporteur is convinced that maintaining and enhancing diversification of the economy is a fundamental factor for the long-term economic success and competitiveness of small national economies. This diversification should be encouraged by economic initiatives, such as loan facilities for small and medium-sized and innovative enterprises working in sectors with a high added value representing the economic attractiveness of many small states. In parallel, continued efforts are needed to pursue structural reforms towards removing economic imbalances and fiscal rigidities.

2.2.2. Importance of the financial sector

19. The banking sector was the first victim of the financial crisis. Several national banks had to be rescued by the public authorities, which in some cases opted for nationalisation. National economies whose financial sectors were either very large or extremely exposed to toxic assets have been the hardest hit by the financial crisis. This is what happened to Latvia, Luxembourg, Ireland and especially Iceland, whose economy, hit head-on by the economic crisis in October 2008, collapsed. The excessive risk-taking led certain banks to the brink of bankruptcy.

20. The shakiness of the banking sector compounded the collapse of the real estate market bubbles as a result of problems encountered in obtaining finance to buy property. It should be noted that the high level of dependence on the financial sector of the economy and the large proportion of the financial market contaminated by toxic assets led to financial meltdown in these small national economies and to recession. The most telling example is that of Ireland, the former “Celtic Tiger”, which is today experiencing serious difficulties.

21. Nevertheless, it should be noted that these small national economies, whose economic activity is very much geared to banking services, will almost certainly have to deal with new challenges brought about by the financial crisis. Over-concentration of the financial sector inevitably leads to the emergence of systemic banks which render small national economies more vulnerable to credit bottlenecks and crunches.

22. Similarly, the disproportionate size of a domestic banking sector in relation to the rest of the economy not only gives the banks a huge role and responsibility for the financing of national enterprises but may also be a big source of concern due to risky external operations. Thus, for instance, Cypriot banks own assets of more than seven times the national GDP and are largely exposed to Greek sovereign debt, which puts an enormous pressure on the entire country’s economic health and its credit rating.[9]

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8. EU10 Regular Economic Report, April 2011, World Bank.

9. Cyprus’ rating was downgraded in July 2011 owing to the perceived weaknesses of its banking sector and the domestic political upheaval over an austerity programme. Cypriot banks hold some 6% of the Greek sovereign debt (compared to 8% for France and 9% for Germany); their assets as a share of GDP ratio (over 700%) compares poorly with the major eurozone economies such as France and Germany (where the ratio is less than 400%).

23. It is necessary not only to put banking establishments on a sound footing, but also to protect consumers and savers hit by the financial crisis and the sometimes irresponsible behaviour of certain banking institutions. Governments need to strengthen the supervisory powers of the regulatory authorities to ensure sustained financial and macroeconomic stability, adequate consumer protection, improved risk management and balanced credit growth. Along with this supervision there must be genuine political oversight via parliaments representing the people.

3. Inbuilt constraints, challenges and opportunities for development

24. As noted above, there is no systematic tendency for small or micro-economies to underperform. Indeed, some small countries manage to do better than others by exploiting niche sectors and transforming constraints into opportunities.

25. A small-scale domestic market, high fixed costs and limited economies of scale somewhat reduce competitiveness in a global context. This is certainly a major challenge for attracting long-term foreign investment and avoiding capital flight. Besides, global financial markets tend to see small states as more risky than larger states, which translates into higher cost of borrowing and more difficult access to external financing. Optimising the investment environment for both domestic and foreign players is therefore paramount. Moreover, small domestic markets tend to be characterised by a greater presence of natural monopolies, notably in utilities where relatively large overhead costs do not permit more than one entity to viably supply. As there is a real risk of pricing distortions and market abuse, competition/regulatory authorities and public oversight bodies need to be particularly vigilant.

26. Although greater reliance on imports of strategic materials and goods, such as energy resources and food products, can be seen as constraints, they can also be viewed as compelling reasons to invest in the development of trade capacity, logistical networks, transport interconnections, renewable energy sources and selected agricultural activity. The smallness in this context rimes with greater flexibility and adaptability to the new, growing or changing demand on international markets whilst also enabling to secure sustainable supplies for domestic needs.

27. The smaller the economy, the greater the opportunities for small and medium-sized businesses to provide specialised services and customised goods – against the odds of the globalisation which is spreading uniform standards and products. With adequate domestic regulation and export support, SMEs can reap the benefits of the European Union's internal market. Furthermore, membership and rules of the World Trade Organization (WTO),[10] as well as information technologies and electronic commerce, provide small countries with extended opportunities for international trade. However, the diversification and competitiveness of small economies on the global scene is and will remain a key challenge for development.

28. In confronting the challenges and opportunities of globalisation, small states often lack the institutional capacity to participate fully in international finance and trade negotiations whose outcomes can strongly affect their economies. To overcome, at least partly, this handicap, small states need to continuously monitor policies and approaches that work or not for them and share that experience. Another important way to tackle limited capacity is to enhance their regional co-operation as far as possible and seek more support from the multilateral development institutions for such co-operation, in particular among smaller states. A regional co-operation approach would also help the pooling of resources and capacities, including in the private sector. Multilateral institutions can also help improve policies for utilities regulation and competition in response to country-specific needs and political realities.

29. In a domestic context, government size and public administration costs are relatively higher in small states as compared to large states. Quality of governance is therefore particularly important. Its success could be measured by the ability to provide good public infrastructure, efficient public services and an adequate regulatory framework. As sufficient interconnections for energy, communication and transport sectors are essential for both the population and business sector, small states should be encouraged to continuously invest in these areas. Moreover, because the state is a key domestic investor, in many small countries there is a strong case for it to subsidise or provide strong public support to the development of vital infrastructure and the most promising economic sectors, not least in order to underpin long-term growth, decent living conditions and a rational approach to the environment.

10. Out of the 21 small countries covered in this report only Bosnia and Herzegovina, Montenegro and Serbia are not yet members of the WTO.

30. Volatile economic growth, investor perceptions, limited institutional capacity, extreme climatic events and in some cases insularity often expose small economies to exogenous shocks over which they have little or no control, making small countries highly vulnerable. Risk mitigation should therefore be a central part of development strategies – mainly through capacity building, diversification, innovation and regional co-operation (for instance risk-pooling arrangements) – in the public and private sectors. In addition, it is essential to avoid internally generated instability and policy mistakes which can have longer lasting and more pervasive effects than they would in larger states. These factors help to increase resilience to shocks.

31. Yet perhaps the most acute question in small economies is posed by "brain drain". Attracting and preserving a qualified labour force requires the public authorities to ensure a high level of education, employment, social cohesion, public services and, more generally, living standards. These public policy areas should be considered as priorities for development and good governance, which in turn help build a sustainable livelihood and a solid economic platform for small but open society.

32. Given the variety of factors in play and the individual characteristics of countries, small states need to assess their strengths and weaknesses in the context of globalisation and, if necessary, to proceed to a strategic global repositioning of their economies. They need to create enabling environments and provide adequate public policy support (such as through training, education and regulatory frameworks) to encourage new activities, many of which are likely to be in the service sectors. Some states might further need to seek external support and advice to achieve repositioning or structural adjustments.

4. A closer look at selected countries

33. Cyprus and Malta have small territories and populations – by our criteria they are microstates. Cyprus has a surface area of 9 300 km2 and is home to 753 000 people, while Malta has a surface area of 316 km2 and a population of 408 333 people. Despite their small size and limited natural resources, Cyprus and Malta have achieved remarkable economic growth (leading to eurozone membership) and excellent social indicators by ensuring macroeconomic stability, export-orientation, openness to foreign investment and gradual liberalisation, exploiting international market niches (especially as popular tourism destinations and highly dynamic financial centres), encouraging entrepreneurship and emphasising education, as well as provision of wide-ranging social services.

34. Lately, however, activities of the pivotal tourism and financial sectors have come under severe pressure from the global economic crisis. Moreover, in the case of Cyprus, an internal political discord over the austerity programme and an explosion at the country's largest power plant in the summer of 2011 are likely to negatively affect medium-term economic prospects.

35. Ireland is a relatively bigger economy among the small states with a population of 4.4 million, which has earned its reputation as a "Celtic Tiger" as a result of particularly buoyant growth in the 1990s. Economic dynamism and policy choices (notably low corporate taxes and incentives for investment in high added value sectors) have allowed for spectacular diversification in manufacturing and gains in the quality of life but also resulted in an overheating of the economy during the second half of the last decade. The latter led to a property bubble, banking and sovereign debt crises, a recession, a steep rise in unemployment, repeated credit downgrading and ultimately an emergency assistance programme by the European Union and the IMF. A major problem for the country was a high concentration of international financial services providers (akin to the situation in Luxembourg and, up to a point, Cyprus and Malta), inadequate risk assessment and in the end too generous a guarantee extended by the Irish Government to the nationally-owned banks. Whilst the aviation sector worldwide was going through one of the hardest crises in its history, the Irish low-cost carrier Ryanair hit record figures in passenger numbers and profits in 2011.

36. Similarly to Ireland, the three Baltic states – Estonia, Latvia and Lithuania – were until recently applauded for their success in restructuring national economies on the path to the European Union. Having overcome the spillover effects of the Russian crisis of August 1998, these small economies pursued a reorientation of their trade towards western European and global markets and indulged in a bank-driven consumption and construction boom. The global credit crunch was a hard test for the fundamentals of the three countries, whose economies shrank at double-digit pace in 2008 and 2009. To recover from the recession, these countries opted to restore macroeconomic balance and competitiveness through a painful internal devaluation (with drastic cuts in spending in the public sector), a rise in taxation levels and increased borrowing (for budgetary support).

37. The picture for the three Baltic states is mixed: despite the hardship, Estonia succeeded in keeping sovereign debt low, excelling in e-governance, accumulating budgetary reserves during "good times", and joining the eurozone (in January 2011) and the OECD (in 2010); Latvia remains under financial perfusion and

tight supervision by the IMF and the European Union, but its economic growth has bounced back; and Lithuania is grappling with structural adjustments to sustain a socio-economic balance and efforts to improve its air connections with other capitals of Europe (following the bankruptcy of a flag carrier in early 2009). The three are experiencing export-led but jobless recovery and some industrial expansion; the three are seeing a further shrinking of their population due to economic emigration and low birth rates. Their economic credibility is solid but prospects remain uncertain – unless there is a serious rethinking of social policies, a stronger push to diversify energy supplies and the industrial base, and a greater attention to regional development.

38. The tiny state of San Marino, with a population of around 30 000 on a territory of 61 km2, is completely surrounded by Italy. Its economic prosperity – much higher than the neighbouring region of Italy – greatly relies on banks, insurance industry, tourism and the activity of the public sector, as well as on about 6 000 people commuting from Italy to San Marino to work. Needless to say its relationship with Italy, its geographical neighbour and main commercial partner, is vital. However, in recent years, this relationship has deteriorated and the economy is in crisis because of a dispute with Italy, which views San Marino as a tax haven even though it has been taken off the OECD's "grey list" of states not conforming to rules against tax fraud.[11] Moreover, Italy is still stalling ratification of a bilateral agreement on the avoidance of double taxation (signed in 2002). The rapporteur hopes that a mutually satisfactory solution will soon be found.

39. Among the small Balkan states after the break-up of the former Yugoslavia (Bosnia and Herzegovina, Croatia, Montenegro, Slovenia and "the former Yugoslav Republic of Macedonia"), the development paths and track records have varied significantly. All of these states took advantage of the tourism sector but have reaped disparate results due to the state of local infrastructure and services. Slovenia is clearly a regional leader and a very active trading hub. Its cautious consensus-based approach to economic management and reform paid off and paved the way to a rapid accession to the European Union and subsequently the eurozone. Croatia is the next best performer firmly on track to join the European Union. A greater regional convergence and co-operation, determined action against organised crime, continued improvements in business climate, taxation mechanisms and transport links, as well as efforts to boost employment and skills (especially for youth), would no doubt boost and help attract more much-needed foreign investment to all of these countries.

5. Policy recommendations and concluding remarks

40. Although smallness is a relative concept, there are strong reasons to consider a combination of cross-section factors that call for policy makers' attention. Clearly, a conjunction of small domestic markets, limited diversification of local production and exports, high dependence on foreign markets, insufficient local resources, weaknesses in public and private sector capacity, difficulties in managing transborder capital flows and attracting investment, as well as susceptibility to natural disasters, all lead to higher economic vulnerability of small states. As we have seen from this report, the profiles of small Council of Europe member states differ considerably. Hence an approach seeking standard solutions would not do justice to the many individual problems and uniqueness of small states, nor would it recognise that some of the problems faced by small states are also relevant to other countries. Your rapporteur therefore prefers to offer some general policy recommendations aimed at stimulating the public debate on the issue both in small countries and among their international partners – states and organisations.

41. Small economies have little choice but to be open to international trade. They need to be open to investment, exchanges and new ideas. They must constantly adapt and transform their economies in order to optimise living standards and the quality of life of their population, make best use of limited local resources, and secure the benefits of globalisation and the increasingly liberal global trading environment. Clear signals about the direction of regulatory policies and national priorities are necessary to guide – or reassure – entrepreneurs and to attract new investment.

42. However, this openness comes at a price of greater vulnerability to external factors and events beyond the control of small economies. Although there is no sure recipe, ensuring sound macroeconomic fundamentals, diversifying the national economy, enhancing institutional capacity, building up competitiveness and improving human capital are the most important drivers of long-term and sustainable development strategy. Close regional ties, alliances with other small states and in particular partnerships with multilateral development institutions and international organisations (such as the European Union and the European Investment Bank (EIB), the Council of Europe Development Bank (CEB), the EBRD, the IMF, the World Bank and the WTO) are gateways to solidarity at all times and especially in times of crisis.

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11. See also the motion for a resolution on "Good economic relations between Italy and San Marino" (Doc. 12412).

43. Given the importance of the financial sector in general, and recently the spillovers from the global financial crisis, on small economies, thought should be given as to how well-regulated, transparent and value-for-money financial services could be used to stimulate or pave the way for other types of economic activity, gradually drifting away from the excessive reliance of national well-being on the financial sector. Because diversification normally occurs as a consequence of development, fiscal incentives may be necessary to secure a fair access of all economic players, especially small entrepreneurs, to financial resources and to promote socially responsible investment policies so that a sufficient share of corporate profits are reinvested locally. Microcredit schemes could be particularly relevant and should therefore be encouraged.

44. As appropriate, small states should not hesitate to reassess their policies of privatisation and regulation for the sake of more broadly shared economic well-being and more adequate participation of the private sector in the implementation of national development strategies. This is all the more important in the context of a need to constantly enhance efficiency and competitiveness, especially given the risk of market distortion due to the tendency towards monopolistic market practice (private or public).

45. Your rapporteur, moreover, wishes to insist on the importance of good governance to underpin development in small states. This notably covers a synergy of functioning institutions, high-integrity professionals and the rule of law which together enable the existence of national justice systems, macroeconomic stability, sound tax administration and public resources management, social services, entrepreneurial activity, personal security, civil society participation, transparency and accountability. We should also stress the need to get budget deficits under control and seek to return to a balanced budget situation. A national consensus on the efforts of good governance is thus paramount.

46. With growing public concern over the quality of life and the sustainability of development, there is huge economic potential in the environment sector, not least through the emphasis on green and cultural tourism. In this context, the rapporteur wishes to recall the highly pertinent recommendations contained in the Assembly's report on "Sustainable development and tourism: towards a quality growth".[12] Small states could lead the way in Europe by testing green development options. A shift towards the green economy will require a whole new strategy and dedicated investment in order to convert local population and businesses to working, living and consuming differently.

47. Research on the opportunities that information technology can bring to small countries suggests that e-commerce and e-governance can provide a major impetus to their development, notably for those countries with a well-educated workforce. Banking on the economy of speed rather than the economy of scale, the use of high-end technology yields efficiency, creates new jobs, makes information more accessible (to both the general public and businesses) and, in a globalised economic system, can help transform competitors into partners irrespective of their size or location. In order to fully exploit new technologies to boost national economies and welfare, adequate infrastructure, and regulatory and oversight frameworks are essential. Public-private collaboration and support of multilateral development banks could prove highly relevant.

48. Particularly important for small states are good transport and energy interconnections. Small European Union member states could thus take advantage of action plans for the development of transeuropean networks and the related financing schemes through the EIB loans and EU funds, including the Structural Funds and the Cohesion Fund. Other countries in the EU's neighbourhood could seek to develop their interconnections via the Eastern Partnership facilities.

49. To fully tap their development potential, small states need to acknowledge the importance of human capital. A better educated, healthier population is likely to be more entrepreneurial in raising its income and welfare and exploiting new job opportunities, while using efficiently the resources at its disposal and enabling the country to build a basis for the development of a knowledge-oriented economy. High priority should therefore be accorded to the provision of affordable, accessible and efficient services for education, training and health care.

12. See Recommendation 1835 (2008) and Doc. 11539.