

Growth in African Small States

Dörte Dömeland and Frederico Gil Sander
PRMED, The World Bank

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Abstract

Small states in sub-Saharan Africa have grown more on average in the past decades than their larger counterparts and today have the four highest GNIs per capita in the continent. The domestic markets of large and small sub-Saharan African countries are limited, and investments must be targeted to export markets to exploit economies of scale. Moreover, contrary to island states in the Caribbean and the Pacific, small African states are on average not more exposed to natural disasters than their larger sub-Saharan counterparts. Meanwhile, a small population may actually be an advantage in the African context. This is because small size implies lower ethnic fractionalization, which is associated with stronger political and economic institutions. Strong governance and political stability are two of the key drivers of foreign direct investment in Africa, laying the foundation for high investment rates, economic diversification and the resulting impressive growth rates of several small African states.

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Executive Summary

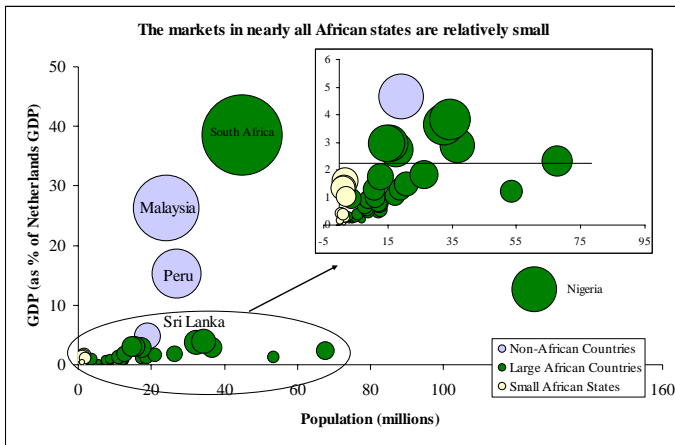
GDP growth of African small states exceeded the average growth rate of sub-Saharan countries and all small states during the last three decades. Between 1970 and 2005, average real GDP growth of African small states amounted to 4.1 percent, which compares to 3.2 percent in sub-Saharan Africa and 3.5 percent in all small states. The average GDP per capita growth rate was twice as high in African small states than in sub-Saharan Africa. Today the four countries with the highest GNI per capita in sub-Saharan Africa (Seychelles, Botswana, Mauritius and Gabon) are all small states. Moreover, in most African small states growth has not slowed down.

The obstacles generally associated with small states tend to apply to all sub-Saharan African states regardless of size. The size of the average sub-Saharan state is small, with the total sub-Saharan African GDP (excluding Nigeria and South Africa) representing about half of that of the Netherlands. Therefore, whether in small or large African states, investments must be targeted towards exports markets in order to take advantage of economies of scale. African small states tend to attract more foreign direct investment. Consequently, they have managed to diversify their export base and are not more vulnerable to terms-of-trade shocks compared to their larger sub-Saharan counterparts. Moreover, African small states face similar exposure to natural disasters than larger sub-Saharan countries, and trading costs for African small states are actually somewhat lower.

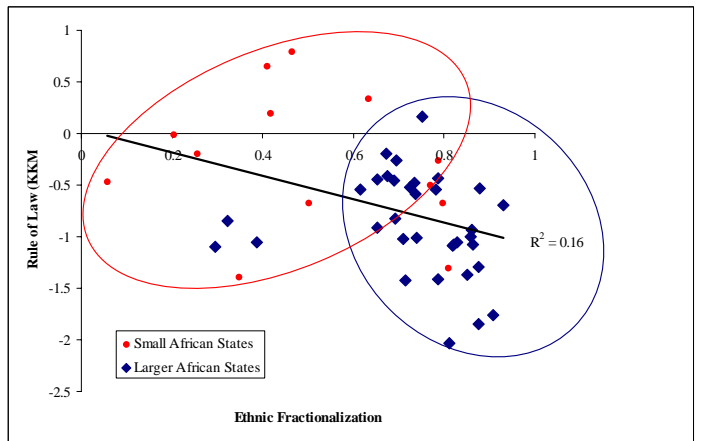
Small states in sub-Saharan Africa may actually enjoy a key advantage over the larger states. As a result of their small populations, small states in Africa tend to be less ethnically fractionalized. There exists substantial empirical evidence that lower ethnic fractionalization is associated with a higher quality of policy and institutions. Indeed, institutional quality of African small states, measured along a series of dimensions, compares on average favorably with the sub-Saharan mean. Since a stable political environment and good governance are among the key determinants of FDI, several African small states succeeded in attracting a substantial share of FDI and are today the main exporters of manufactured goods in Africa. This has translated into high growth rates in the last decades. Today, all IBRD borrowers in Sub-Saharan Africa, with the exception of South Africa, are small states.

Graphs 1-6: African Small States at a Glance

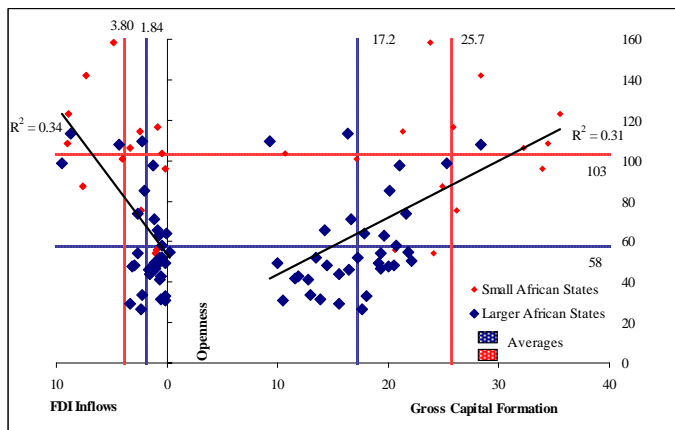
There is no relative size disadvantage in Africa for small states since the markets of all African states is small



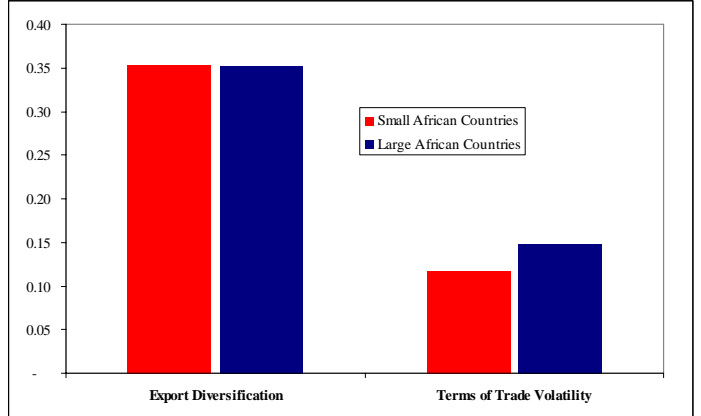
But there may be an advantage to being small: lower ethnic fractionalization, which correlates with better institutions



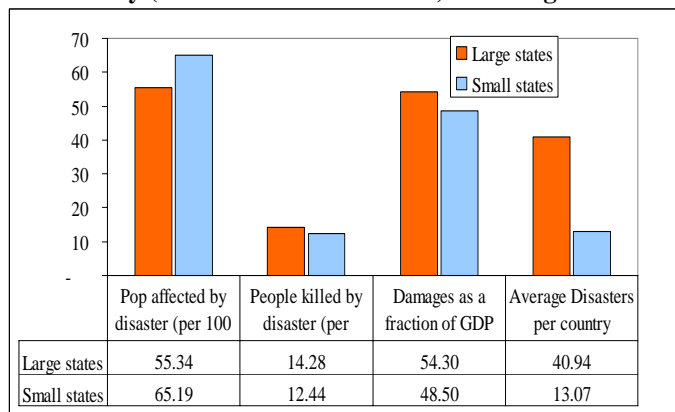
With the advantage of better institutions, small states see more investment, which is targeted to exports.



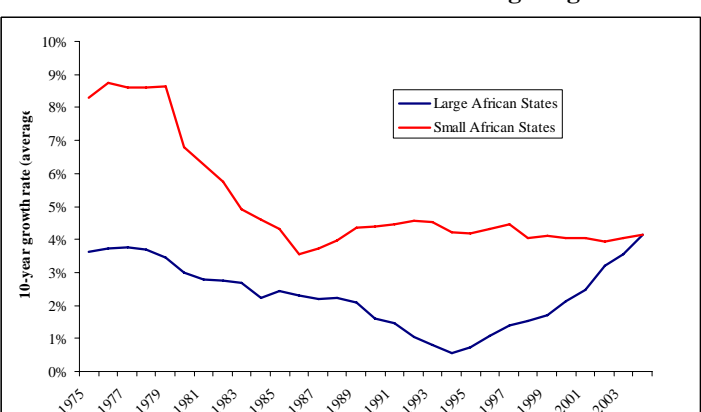
These investments have led to relative export diversification in and lower volatility of the terms of trade in small states...



... which were already no more likely to suffer exogenous volatility (such as natural disasters) than large states.



Higher investment and better institutions in the face of similar market sizes and vulnerabilities led to higher growth.



I. Introduction

1. **Fourteen African countries are classified as small states.**¹ These countries are Botswana, Cape Verde, Comoros, Djibouti, Equatorial Guinea, Gabon, the Gambia, Guinea-Bissau, Lesotho, Mauritius, Namibia, São Tomé e Príncipe, Seychelles and Swaziland.² In contrast to the small states in the Caribbean or the Pacific, African small states constitute a very heterogeneous group. Thus, while there are many lessons to be drawn from the experience of the group of small states as a whole, it is often informative to look at individual cases or at sub-groups to arrive at a fuller picture of the role of size in the past performance and for future development prospects of these countries.

2. **This study examines the growth experience of African small states in comparison to their larger sub-Saharan counterparts.** The starting point is to analyze the constraints generally attributed to small states, such as market size, export composition and vulnerability to exogenous shocks. Since in the African context country size is inextricably linked to ethnic fractionalization, which in turn is known to be related to institutional quality, the study pays particular attention to differences in economic and political institutions between small and large African states.

3. **This study is structured as follows.** In the next section the main characteristics of African small states are presented. The study then turns to a comparative analysis of economic growth to identify patterns and sources of growth in African small states. It assesses determinants of volatility in the final section. Case studies and examples are presented throughout the text. The final section concludes.

II. Characteristics of African Small States

4. **African small states are very a heterogeneous group.** Contrary to groups of small states in the Caribbean, the Pacific or Europe, African small states show a wide range of population and land area from 460 square kilometers in Seychelles to 823,290 square kilometers in Namibia (see Table 1). Some African small states are islands (e.g. Cape Verde, Comoros and São Tomé e Príncipe), while others are landlocked (Botswana, Lesotho, Swaziland). Some of them have valuable natural resources (Botswana, Gabon and Equatorial Guinea), while most others do not. Institutions are generally strong in many African small states such as Botswana and Mauritius, but a few have experienced recurring civil war (Comoros and Guinea-Bissau). As a result, the variation in GDP per capita is substantial, going from US\$367 in São Tomé e Príncipe to US\$8,209 in Seychelles.

¹ This study is part of the project on “Small States: Growth and Volatility in the 1990s”. For the purposes of this study, a small state is defined as a state with a population of less than two million inhabitants in 2003.

² The average population of African small states is more than twice as high as the small states average but less than one-tenth of the size of the average sub-Saharan Africa country.

5. **All sub-Saharan IBRD borrowers, with the exception of South Africa, are small states**, reflecting the fact that small states are on average substantially richer than the average sub-Saharan African country. Similarly, the median GDP per capita of African small states in 2005 US\$2217, more than four times corresponding median of larger sub-Saharan states. African small states are, however, much poorer than the average small state: the GDP per capita of all African small states, with the exception of Seychelles, falls below the small states average.

Table 1. African Small States: Overview 1/

	Population	Area	GDP 2/	GDP per Capita 2/	Rule of Law 3/	IBRD/IDA 4/
		(in square km)	(in USD millions)	(in USD)		
African Small States						
Botswana	1,764,926	566,730	9,350	5,298	0.7	IBRD
Cape Verde	506,807	4,030	1,020	2,021	0.2	IDA 5/
Comoros	600,490	2,230	382	636	-1.0	IDA
Djibouti	793,078	23,180	702	885	-0.9	IDA
Equatorial Guinea	503,519	28,050	3,230	6,416	-1.3	IBRD
Gabon	1,383,841	257,670	8,060	5,821	-0.5	IBRD
The Gambia	1,517,079	10,000	461	304	-0.3	IDA
Guinea-Bissau	1,586,344	28,120	301	190	-1.3	IDA
Lesotho	1,794,769	30,350	1,450	810	-0.2	IDA
Mauritius	1,248,000	2,030	6,450	5,166	0.8	IBRD
Namibia	2,031,252	823,290	6,130	3,016	0.0	IBRD
Sao Tome and Principe	156,523	960	57	367	-0.6	IDA
Seychelles	84,494	460	694	8,209	0.2	IBRD
Swaziland	1,131,000	17,200	2,730	2,414	-0.7	IBRD
Group Averages						
Small African States 6/	1,078,723	128,164	2,930	2,968	-0.4	
Large Sub-Saharan African States	21,400,000	641,912	17,300	627	-0.9	
Excluding Nigeria and South Africa	17,200,000	615,617	7,470	471	-1.0	
Small States	623,339	56,440	3,630	7,179	0.3	
<i>Memorandum Items: 7/</i>						
Benin	8,438,853	110,620	4,287	508	-0.6	
Burkina Faso	13,200,000	273,600	5,170	391	-0.5	
Ghana	22,100,000	227,540	10,700	484	-0.2	

Source: World Development Indicators 2006, unless indicated otherwise.

1/ All variables, with the exception of IBRD/IDA, refer to 2005.

2/ GDP in US dollars at current prices, due to data availability.

3/ Source: Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi. "Governance Matters V: Governance Indicators for 1996-2005." Scores are relative to other countries and are centered at zero.

4/ Indicates whether country is IBRD and IDA borrower in FY07.

5/ Cape Verde is IDA eligible as a result of an exception made for small island economies, for which an exception to the GNI per capita operational cutoff for IDA eligibility (US\$1,025 for FY07) is made.

6/ Small states are defined as states with less than 2 million citizens in 2003.

7/ The population of the countries in the memorandum item corresponds to the 25th (Benin), 50th (Burkina Faso) and 75th (Ghana) percentile of large Sub-Saharan African States.

6. **African small states have a larger population and a larger area than the average small state.** African small states are on average 2.2 times larger than the average small state and the area of some of them, such as Botswana and Namibia, exceeds the sub-Saharan average. African small states are not only relatively large in area, but also in market size. Although the population of African small states is less than one tenth of the population of the average sub-Saharan state, their GDP in 2005 was only a little less than one third of the average larger sub-Saharan African state, when excluding Nigeria and South Africa.

7. **African small states are more open than their African sub-Saharan counterparts** (Table 2). In general, small states tend to be more open, the argument being that trade enables small states to alleviate constraints associated with their small domestic market. However, some African small states tend to have relatively low shares of trade in terms of GDP. The trade share is particularly low in Comoros (trade share of

56 percent) and Guinea-Bissau (60 percent). Both countries are recovering from decades of civil war. In contrast, the trade share of some other African small states, such as Lesotho, Mauritius, Seychelles and Swaziland exceeded the small states' average during the last decades. While these three countries have been open throughout the last two decades, several other small African countries, such as Cape Verde and São Tomé and Príncipe have increasingly integrated into the world economy during the last twenty-five years.

Table 2. Trade Ratios 1/

	1981-85	1986-90	1991-95	1996-00	2001-05	Average	Standard Deviation
African Small States							
Botswana	128	116	94	101	81	104	18
Cape Verde	.	60	65	81	97	76	16
Comoros	66	56	60	51	44	56	10
Djibouti	.	.	115	105	.	109	10
Equatorial Guinea	70	106	107	254	.	135	71
Gabon	111	84	89	88	97	94	12
The Gambia	108	112	127	110	96	111	15
Guinea-Bissau	58	52	48	60	81	60	15
Lesotho	138	139	137	127	155	139	12
Mauritius	99	133	126	127	118	121	13
Namibia	132	121	114	103	94	113	16
Sao Tome and Principe	83	66	109	111	134	101	27
Seychelles	141	136	116	146	184	145	25
Swaziland	161	160	169	171	189	170	13
Group Averages							
African Small States	111	103	105	113	114	109	39
Large Sub-Saharan African States	55	50	58	60	65	58	29
Small States	125	117	118	123	130	120	43
<i>Memorandum Items: 2/</i>							
Uganda	31	22	33	38	41	33	8
Madagascar	30	38	46	55	60	46	14
Togo	106	92	77	76	82	87	13

Source: World Development Indicators, 2006.

1/ Averages of exports plus imports of goods and services as a share of GDP.

2/ The trade ratios of the countries in the memorandum item corresponds to the 25th (Uganda), 50th (Madagascar) and 75th (Togo) percentile of large Sub-Saharan African States in 2005.

8. Many African small states are more diversified than their larger sub-Saharan counterparts. A few African states (Comoros, Guinea Bissau, São Tomé e Príncipe and Seychelles) rely heavily on primary exports (Table 3), while others export minerals and fuel, such as Botswana, Equatorial-Guinea and Gabon. On the other hand, other African

Table 3. Exports Structure 1/

	Food and Agricultural Exports	Ores and Metals Exports	Fuel Exports	Manufacturing Exports	Textile Exports as share of Manufacturing Exports 2/	Index of Export Diversification 1/3/
African Small States						
Botswana	3.0	7.0	0.0	90.0	1.0	0.64
Cape Verde	9.0	1.0	3.0	87.0	35.0	0.14
Comoros	83.0	1.0	0.0	16.0	1.0	0.56
Equatorial Guinea	4.0	0.0	91.0	5.0	0.0	0.80
Gabon	14.0	4.0	79.0	3.0	0.0	0.58
The Gambia	65.0	3.0	0.0	32.0	3.0	0.14
Guinea-Bissau	63.0	0.0	33.0	4.0	2.0	0.53
Lesotho	1.0	0.0	0.0	99.0	94.0	0.20
Mauritius	28.0	0.0	0.0	71.0	58.0	0.10
Namibia	41.0	11.0	2.0	46.0	4.0	0.18
Sao Tome and Principe	66.0	2.0	0.0	32.0	3.0	0.32
Seychelles	94.0	0.0	2.0	4.0	0.0	0.41
Swaziland	46.0	2.0	1.0	51.0	25.0	0.09
Group Averages						
African Small States	33.5	7.4	17.9	41.1	16.4	0.36
Large Sub-Saharan African States	47.2	12.4	14.7	25.5	13.8	0.34
Small States	41.1	2.8	12.3	43.6	9.7	0.28
<i>Memorandum Items: 4/</i>						
South Africa	13.0	24.0	10.0	53.0	3.0	0.05
Niger	11.0	2.0	3.0	84.0	4.0	0.05
Angola	0.0	0.0	94.0	5.0	0.0	0.89

Source: UN COMTRADE (2006).

1/ All variables are 2000-2004 averages and, with exception of the Index of Export Diversification, expressed in percent.

2/ Only includes textile exports that are part of manufacturing exports with SITC classifications 65 and 84.

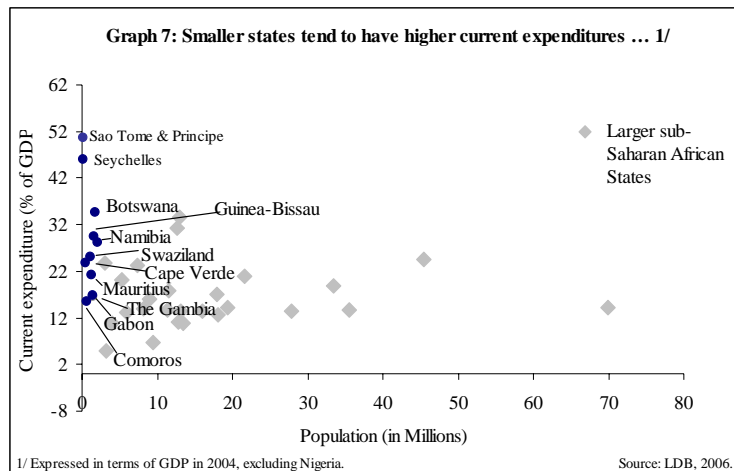
3/ Index is Herfindahl Index (HI), computing the sum of the squared shares of exports attributed to the each industry in total exports of a given country. The index lies between 0 and 1 and assumes lower values if the export structure is more diversified.

4/ The index of export diversification is lowest in South Africa and Niger and highest in Angola among sub-Saharan African countries.

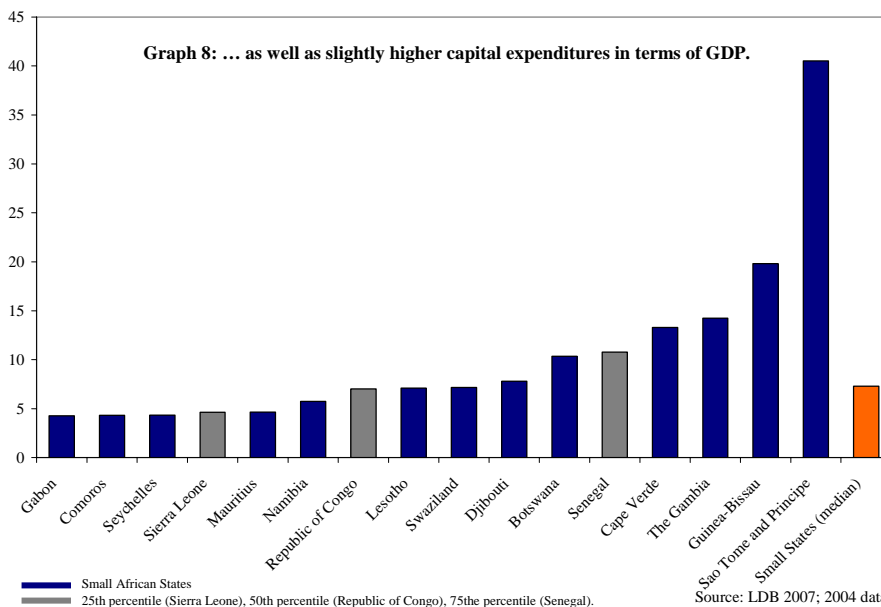
small states, for example Lesotho, Mauritius and Swaziland have managed to diversify their economy by developing a manufacturing export base. Their export diversification index was close to the corresponding index of South Africa and Niger, sub-Saharan Africa most diversified economies in the first half of this decade. Finally, the index of exports diversification would like to be larger for several small states if services of exports were to be included: Cape Verde, the Gambia and the Seychelles export a significant amount of services, in particular tourism and financial services.

9. **African small states contributed substantially to the increase of Africa's manufacturing exports.** Africa's manufacturing exports increased by 6.3 percent annually between 1980 and 2000, which compares to growth rates of 14 percent in Asia and 12 percent in Latin America. This increase was largely the result of significant growth in labor-intensive and resource based semi-manufactures in a few countries, in particular Mauritius (textiles) and Botswana (diamonds). Mauritius increased its value of manufactured exports from US\$115 million to US\$1.2 billion between 1980 and 2000. Botswana earned nothing from manufactures in 1980 but exported US\$6.4 billion worth in 2000.³ There were also increases in the value of manufactured exports in Lesotho, Namibia and Swaziland.

10. **Government spending as a share of GDP is below the small states' average and above the sub-Saharan average** (Graph X). As a result



of economies of scale in the provision of government services, small states tend to have a larger share of government spending in GDP, and this is true for African small states as well. Basic public services generally have a high fixed cost and the public sector wage bill tends to be higher in small states. With the exception of Comoros, the Gambia and



Guinea-Bissau, the share of current expenditure in GDP exceeds, as expected, larger sub-Saharan African average in 2004 of 18.4 percent.⁴ Similarly, the share of current expenditure is higher in African small states reflecting a larger wage bill.

³ See United Nations (2003).

⁴ The median of the share of current expenditures in GDP is 23.5 percent. With the exception of Comoros, the Gambia, Guinea-Bissau and Mauritius, all African small states exceed this median.

11. **Capital expenditures as a share of GDP tend to be slightly larger in small African states.** Expressed as a share of GDP, it has been particularly large in Sao Tome in Principe and Guinea-Bissau, which is likely to be related to investments in the oil sector. Also, Botswana, Cape Verde and the Gambia have a capital expenditure share, close to the 75th percentile of the large sub-Saharan African states. Perhaps surprisingly, sub-Saharan African countries, both large and small, tend to spend a larger share of expenditure on capital than the median small state, which may be a result of the large infrastructure needs in Africa as a whole.

12. **Infrastructure is better, on average, in African small states than in other sub-Saharan African countries.** As a consequence of higher GDP and a larger share of capital expenditure, infrastructure (measured as the paved roads as a share of total roads and the number of telephone lines as a share of population) is substantially better in African small states (Table 5) compared to sub-Saharan Africa overall. Nonetheless, several African small states continue to suffer from a weak infrastructure, in particular Djibouti, Gabon and Guinea-Bissau. Infrastructure and geography have been identified as the main determinants of trade costs.⁵

Table 5. Infrastructure

	Paved Roads (percent of total roads) 2/	Telephone Mainlines per 1000 people 4/	Fixed Line Telephone Costs (per minute) in USD 5/	CIF/FOB ratio 6/
Botswana	35	74	0.6	74
Cape Verde	78	148	0.04	148
Comoros	77	23	0.14	23
Djibouti	13	13	0.2	13
Equatorial Guinea	..	20	0.05	20
Gabon	10	29	0.15	29
The Gambia	35	..	0.27	..
Guinea-Bissau	10	7	0.15	7
Lesotho	18	20	0.02	20
Mauritius	96	285	\$0.03/3min	285
Namibia	14	64	\$0.11/min	64
Sao Tome and Principe	68	47	0.06	47
Seychelles	..	256	0.14	256
Swaziland	..	42	0.05	42
African Small States	41	79	0.17	79
Small States	43	222		222
Sub-Saharan Africa	22	30	\$0.12	30

Source: World Development Indicators, unless indicated otherwise.

1/ Average 1990 -1999.

2/ Data for 2004. In

3/ Data for 1999, with the exception of Botswana, for which 2003 data has

4/ Data for 2003.

5/ ITU World Telecommunications Development Report 2002.

6/ IMF, Direction of Trade Statistics. Average 1990-2004.

substantially smaller than in other regions. Moreover, due to poor infrastructure the difference between fob and farm-gate prices is large in sub-Saharan Africa overall, reducing the competitiveness of overall sub-Saharan African exports. It is likely that the

13. **Transport costs in African small states are higher than the sub-Saharan African average, but below comparable costs in the average small state.** Transport costs, as measured by the cif/fob ratio,⁶ are particularly high in island economies, such as Cape Verde, Mauritius and the Seychelles. Landlocked countries, e.g. Botswana, Namibia and Swaziland also face transport costs above the sub-Saharan average. However, 15 countries in Africa are landlocked and transportation costs among African countries are generally high. As a result, the transport cost differential between African small states and their larger counterparts is

⁵ See, for example, Limão and Venables (1999).

⁶ The cif/fob ratio is a simple summary statistic of cost of carry and freight of imports. The cif/fob ratio gives the value of imports inclusive of carriage, insurance and freight (cif) relative to their free on board (fob) values. The latter is the cost of the imports and all charges incurred in the exporting port. The ratio cif/fob – 1 represents, therefore, the costs of transportation as a percentage of total export value.

better infrastructure observed in small African states partly offsets the somewhat higher international transportation costs.

14. **In addition, African small states are members of customs or monetary unions, which reduces trade costs.** In Africa, all small states have actively sought integration with their neighbors through multilateral agreements. Botswana, Lesotho, Swaziland and Namibia, together with South Africa, constitute the Southern African Customs Union (SACU), the oldest customs union in the world, founded in 1910. Equatorial Guinea and Gabon are members of the Economic and Monetary Community to Central Africa (CEMAC) and share a common currency: the CFA Franc. Cape Verde, the Gambia and Guinea-Bissau are members of the Economic Community of West African States (ECOWAS), established in 1975 to promote economic integration in the region. Guinea-Bissau is a member of the West African Economic and Monetary Union and also uses the CFA franc as its currency. It is interesting to note that the only non-francophone countries to use the CFA franc are two small states (Guinea-Bissau and Equatorial Guinea). Comoros, Djibouti, Mauritius, the Seychelles and Swaziland are part of the Common Market for Eastern and Southern Africa (COMESA), a preferential trading area formed in December 1994 with twenty member states, stretching from Libya to Zimbabwe. Finally, Equatorial Guinea, Gabon and São Tomé e Príncipe are members of the Economic Community of Central African States.

III. Comparative Analysis of Economic Growth

III.1. Patterns of Economic Growth

15. **On average, GDP growth in African small states exceeded the sub-Saharan as well as the small states average.** Between 1970 and 2005, real GDP growth of African small states amounted to 4.1 percent, being substantially above the sub-Saharan African GDP growth of 3.2 percent and the small states average of 3.5 percent (see Table 6). That high growth of African small states is largely the result of strong growth performance of Equatorial Guinea in the second half of the 1990s and the first half of 2000, as well as Botswana's persistent high real GDP growth of on average 7.5 percent. Eliminating these two countries reduces the average growth rate of African small states during this period to 3.8 percent, which is still above the sub-Saharan African average. With the exception of Djibouti, all African small states grew by more the two percent on average during the last 25 years and faced only few episodes of negative GDP growth. Djibouti's growth only increased during the last 6 years when Djibouti's port became the only significant port for landlocked Ethiopia as a result of the Eritrean-Ethiopian Border conflict and when changes in management enabled the Port of Djibouti to position itself as major port and trans-shipment port for the Red Sea.

Table 6. GDP Growth Rates 1/

	1981-85	1986-90	1991-95	1996-00	2001-05	Average	Standard Deviation
African Small States							
Botswana	10.0	12.0	4.1	6.3	5.1	7.5	3.9
Cape Verde	8.6	3.5	5.2	6.4	4.9	5.6	2.6
Comoros	4.3	1.6	0.9	1.7	2.3	2.2	3.2
Djibouti	.	-0.7	-1.8	-0.2	2.8	0.1	2.3
Equatorial Guinea	.	1.4	7.0	33.0	11.0	13.2	18.0
Gabon	2.6	1.7	3.1	1.8	1.7	2.2	5.8
The Gambia	3.2	4.1	2.1	4.5	3.9	3.6	2.9
Guinea-Bissau	6.4	3.8	3.2	1.1	-0.1	2.9	8.1
Lesotho	3.1	5.9	4.0	3.0	2.8	3.7	3.8
Mauritius	4.3	7.4	5.1	5.4	4.1	5.3	1.6
Namibia	-0.2	2.7	5.0	3.5	4.4	3.1	2.7
Sao Tome and Principe	.	1.8	1.6	2.1	3.8	2.4	1.0
Seychelles	0.9	5.6	2.9	6.4	-2.3	2.7	5.3
Swaziland	2.6	10.0	2.9	3.3	2.2	4.3	3.5
Averages							
African Small States	4.1	4.5	3.2	5.6	3.2	4.1	6.4
Larger Sub-Saharan African States	1.9	2.1	0.6	4.7	4.4	2.8	7.8
Small States	2.9	4.6	2.9	4.2	3.0	3.5	5.5
Median							
African Small States	4.1	4.4	3.4	4.0	3.1	4.1	
Larger Sub-Saharan African States	2.0	3.0	2.0	4.0	5.0	3.0	
Small States	2.5	3.2	2.8	4.2	4.1	3.5	
<i>Memorandum Item 2/</i>							
Kenya	2.6	5.6	1.4	2.0	2.8	2.9	2.1
Niger	-2.2	2.6	0.8	2.8	4.0	1.6	5.5
Tanzania	.	5.5	2.0	4.4	6.8	4.5	2.1

Source: World Development Indicators, 2006.

1/ Averages, unless indicated otherwise.

2/ The average growth rate between 2001-05 of the countries in the memorandum item corresponds to the 25th (Kenya), 50th (Niger) and 75th (Tanzania) percentile of large Sub-Saharan African States.

16. Weak growth performance in Guinea-Bissau and the Seychelles contributed substantially to a decline in the average growth rate of African small states after 2000. During the 1998–1999 civil war, Guinea-Bissau’s economy was heavily disrupted, its infrastructure and small industrial sector destroyed, leaving the country heavily dependent on the cashew sector, Guinea-Bissau’s main export commodity. In 2000, world prices of cashew nuts plummeted by more than 50% in 2000, compounding the economic devastation caused by the conflict. After the conflict, real GDP continued to decline and government failure to enact sound policy led to a coup in September 2003. In the Seychelles, increased public spending caused financial difficulties in the early 1990s which, combined with lower tourism revenues following the Gulf War, led to a slow-down in growth. The economy recovered slightly during the mid 1990s as a result of economic reforms, supported by increased tourism and exports of canned tuna. But large government spending on infrastructure projects, coupled with falling revenue, led to budget deficits averaging about 15 percent of GDP between 1996-02. Since 2000 the government has been unable to honor many external obligations, leading to a build-up of external arrears. Since 2003 the government introduced several reform measures, including fiscal tightening, partial trade liberalization, privatization, and introduction of a new pension system. In 2005 and 2006, the Seychelles’ GDP growth turned positive, and in 2006 the Seychelles accessed the international capital markets with a bond issue, demonstrating a return of investor confidence.

17. During the last four years, also growth in Botswana and Lesotho has weakened. Botswana’s growth experience during the last decades has been formidable,

transforming itself from one of the poorest countries in the world at independence in 1966 to a middle-income country. This growth process has been driven by the capital-intensive diamond enclave. Lacking backward-forward linkages, employment growth fell short of growth in production. Today, the mining sector in Botswana employs only 5 percent of the labor force and unemployment in Botswana is high. Consequently, development in more labor-intensive industries has been slow and human development indices are relatively weak. Botswana has also been hit hard by the HIV/AIDS pandemic. According to a 2001 national survey, the HIV/AIDS infection rate for adults is 35.4 percent, adversely affecting human development indices and depressing economic growth. Lesotho achieved growth rates over 3 percent between 2001 and 2003, largely driven by garment exports and benefiting from preferences under the U.S. African Growth and Opportunity Act (AGOA). An appreciation of the real exchange rates uncertainty about Lesotho's duty-free access to the U.S. market related caused by the possible expiration of AGOA and the elimination of textile quotas in January 2005, lead to a slowdown in manufacturing, thereby depressing growth. Lesotho's may have to address a range of adverse developments, such as the expected removal of the AGOA provision in 2007 or the likely impact of HIV/AIDS, in order to convert back to past growth rates.

Table 7. Per Capita GDP Growth Rates 1/

	1981-85	1986-90	1991-95	1996-00	2001-05	Average 1981-2005	Population Growth 1981-2005
African Small States							
Botswana	6.5	8.7	1.5	4.6	5.0	5.2	3.0
Cape Verde	6.4	1.3	2.7	4.0	2.5	3.2	2.2
Comoros	1.6	-1.0	-1.3	-0.5	0.2	-0.2	2.1
Djibouti	.	-6.7	-3.5	-3.3	0.7	-2.8	3.9
Equatorial Guinea	.	-1.0	4.5	30.0	8.4	10.6	2.4
Gabon	-0.6	-1.5	0.0	-0.8	0.0	-0.6	3.0
The Gambia	-0.2	0.2	-1.4	1.1	1.0	0.1	3.4
Guinea-Bissau	4.0	1.1	0.0	-1.7	-3.1	0.1	2.9
Lesotho	0.5	4.2	2.7	1.9	2.7	2.4	1.7
Mauritius	3.3	6.5	3.9	4.2	3.0	4.2	1.2
Namibia	-2.7	-1.8	1.5	0.7	3.0	0.1	2.9
Sao Tome and Principe	.	-0.5	-0.1	0.3	1.4	0.3	2.2
Seychelles	0.0	4.8	1.4	4.8	-3.1	1.6	1.3
Swaziland	-0.5	6.9	-0.3	0.3	0.6	1.4	3.1
Averages							
African Small States	1.6	1.8	0.8	3.2	1.5	1.8	2.4
Larger Sub-Saharan African States	-1.1	-0.7	-1.7	1.7	1.9	0.0	7.3
Small States	1.3	2.7	1.2	2.6	1.5	1.9	1.8

Source: World Development Indicators, 2006.

1/ Averages, unless indicated otherwise.

18. **Growth in per capita terms only slowed down in Guinea-Bissau and the Seychelles.** Higher population growth in African small states depressed their GDP per capita growth below the small states average (see Table 7). Population growth in African small states substantially exceeded the population growth of small states, but was below the sub-Saharan average. Botswana,

Djibouti, Gabon, the Gambia, Guinea-Bissau, Namibia and Swaziland experienced an average population growth of around 3 percent during the last 25 years. In some of these states, such as Djibouti and Gabon, per capita growth rates were negative. In others they were close to zero. Examples are the Gambia, Guinea-Bissau and Namibia.

Cape Verde: Arid land and robust growth

Cape Verde is not only constraint by its size, but also by an acute scarcity of natural resources. The arid and drought-affected archipelago is located in the Sahel zone's western tail-end, approximately 650 kilometers off the Senegalese coast. Less than one-tenth of Cape Verde's entire area is arable and famines have plagued Cape Verde throughout its 500 year history. Struggling to provide for its local population, the country is left vitally dependent on remittances from its extensive émigré community and aid inflows.

The development of a sustainable economic base has become the political platform for the governments since independence in 1974 and several, very different development strategies have been proposed during the past decades. An inward-looking development program, based on central planning and a large public sector, but preserving the country's external competitiveness and aid but external transfers lead to a solid growth rate throughout the 1980s. Although steady migration relieved the demographic pressures of high population growth, key macroeconomic variables started to deteriorate substantially by the late 1980s and unemployment remained high.

At the beginning of the 1990s, Cape Verde launched a far-reaching reform program. Reorienting its development strategy, the government introduced price and trade liberalizations, reduced the size of the public sector and fostered private sector activities. The reform agenda focused on privatization, trade liberalization, financial sector restructuring and tax reform. In the mid 1990s the government actively pursued strategies for diversifying the economy. At the same time it pursued policies aimed at macroeconomic stability, low inflation and a strong fixed exchange rate to the Euro. By the end of 1990s growth accelerated, as a result of tourism development and inflows of workers' remittances, but slowed down in 2000. Leading up to the elections of early 2001, Cape Verde's fiscal situation deteriorated substantially, the structural reform agenda stalled and the progress in macroeconomic stabilization suffered a turnaround.

Cape Verde's commitment to reforms seems to promise an optimistic medium term outlook. In the aftermath of the imbalances in 2000, the government aimed at promoting macroeconomic stability. As a consequence, Cape Verde has experienced robust growth over the last years, with GDP growth averaging 5.7 percent between 2000 and 2005. Today, Cape Verde's economy is dominated by the service sector. Government spending, tourism, transport and commerce accounted for 73 percent of GDP in 2004. Growth is projected to be led by private investment in tourism, public investment in infrastructure and private consumption fueled by inflows from remittances.

Cape Verde's low propensity to export constitutes a major challenge. Despite the relatively high productivity, only 6 percent of the manufacturing firms export. This is due to the fact that most firms are small, labor costs are high, customs and port procedures are inefficient. Finally, Cape Verde's physical isolation and distance from major shipping routes further reduces competitiveness.

20. Industry and services as a share of GDP are larger in African small states compared to the sub-Saharan African average (Table 8). Five African small states, Botswana, Lesotho, Namibia and Swaziland, and Gabon have a share of industry in GDP in excess of the sub-Saharan average. Diamonds and minerals form the economic base in Botswana and Namibia and oil in Gabon. Deprived of large mineral resources, Lesotho and Swaziland built up a substantial manufacturing sector. Lesotho exports clothing, footwear and road vehicles. Since 2000, garment exports from Lesotho to the United States have increased thanks to preferences under the U.S. African Growth and Opportunity Act (AGOA), and have become the main engine of growth. Soft drink concentrate is the largest export earner in Swaziland, which also manufactures garments and textiles. The service sector is above the sub-Saharan and small states average in states that are attractive tourist destinations, such as Cape Verde, Mauritius, Seychelles and São Tomé e Príncipe. Djibouti receives a large share of income through its Port.⁷

Table 8. Sector Shares 1/

	1980-85			1986-89			1990-95			1996-99			2000-05			Average		
	Agr.	Ind.	Serv.	Agr.	Ind.	Serv.	Agr.	Ind.	Serv.	Agr.	Ind.	Serv.	Agr.	Ind.	Serv.	Agr.	Ind.	Serv.
Botswana	10	54	36	6	63	31	5	54	41	3	52	44	3	51	46	5	55	40
Cape Verde	.	.	.	16	19	64	13	21	66	12	18	70	7	18	75	12	19	69
Comoros	35	14	51	39	10	51	38	11	51	41	12	47	38	11	51	38	12	50
Djibouti	.	.	.	3	20	76	3	19	78	4	15	82	.	.	.	3	17	79
Equatorial Guinea	69	9	22	64	9	26	52	22	26	20	70	9	8	87	5	41	41	18
Gabon	6	60	33	9	43	47	8	47	45	7	49	44	8	55	37	8	51	41
The Gambia	36	15	50	32	12	55	27	14	59	32	14	55	32	14	54	32	14	55
Guinea-Bissau	46	15	39	54	17	29	54	11	35	58	13	29	59	12	29	54	14	32
Lesotho	24	26	50	24	29	47	18	39	43	18	41	42	18	42	40	20	35	44
Mauritius	15	26	59	15	33	53	11	33	56	9	31	60	6	30	64	11	31	58
Namibia	11	44	45	12	41	47	11	31	57	11	28	61	11	31	59	11	35	54
Sao Tome and Principe	28	18	55	28	18	55	27	19	54	22	17	60	19	16	65	25	18	58
Seychelles	7	17	76	5	16	79	4	19	76	3	26	71	3	28	69	4	21	74
Swaziland	21	28	51	17	39	45	14	42	44	17	44	39	13	47	40	16	40	44
African Small States	22	28	49	24	27	49	20	27	52	18	31	51	17	32	50	20	29	50
Larger Sub-Saharan African States	35	22	43	35	23	42	34	24	42	35	24	41	32	25	43	34	24	42
Small States	19	27	55	19	26	55	17	25	58	15	26	59	15	28	58	17	26	57

Source: World Development Indicators, 2006.

1/ Agr., Ind. and Serv. refer to the value added by agriculture, industry and services as a share of GDP in percent, respectively. Industry comprises value added in mining, manufacturing, construction, electricity, water, and gas. Data on mining and manufacturing, however, is only available for a small set of African small states.

21. Industry and services increased substantially among some of the best growth performers. Equatorial Guinea, Lesotho and Swaziland substantially increased their industry sector, while services grew in Botswana, Cape Verde, Djibouti, and Mauritius. Also, São Tomé e Príncipe's service sector increased substantially during the last decade. Following years of economic mismanagement, São Tomé e Príncipe started implementing economic reforms in 1999, leading to a boom in tourism and construction. As a consequence, real GDP per capita growth increased from 3.3 percent to 4 percent between 1999 and 2003. The share of the agricultural sector in Gabon and the Seychelles remained largely unchanged, reflecting the relative stagnation these countries

⁷ The share of agriculture in GDP is above 31 percent, the sub-Saharan average, in Comoros, the Gambia and Guinea-Bissau. Comoros is the world's leading producer of ylang-ylang, used for manufacturing perfume, and the second largest producer of vanilla. The main commodity exports of the Gambia and Guinea-Bissau are peanuts and cashew nuts, respectively.

experienced as well as the fact that between 1980-85 services and industry already represented the bulk of these countries' economy.

22. Increases in the service sector have gone hand in hand with urbanization. The share of population living in cities increased substantially in Botswana, Cape Verde, Djibouti and São Tomé e Príncipe between 1970 and 2005 (see Table 9). In Gabon, oil wealth brought benefits to the urban elites which shared them with family members, contributing to a massive rural to urban exodus. Gabon is now one of the most urbanized countries in sub-Saharan Africa. Growth in tourism and transit trade supported urbanization in Gambia, but as a result of the small size of the country and the large number of households participating in agriculture there is considerable seasonal migration.

Table 9. Urban Population 1/

	1970	1980	1990	2000	2005	Change 1970-2005
African Small States						
Botswana	7.8	16.5	41.9	53.2	57.4	49.6
Cape Verde	19.6	23.5	44.1	53.4	57.3	37.7
Comoros	19.4	23.2	28.2	33.8	37.0	17.6
Djibouti	61.8	72.1	76.0	83.3	86.1	24.3
Equatorial Guinea	27.0	27.9	34.8	38.8	38.9	11.9
Gabon	32.0	54.7	69.1	80.1	83.6	51.6
The Gambia	19.5	28.4	38.3	49.1	53.9	34.4
Guinea-Bissau	15.1	17.6	28.1	29.7	29.6	14.5
Lesotho	8.6	13.4	17.2	17.8	18.7	10.1
Mauritius	42.0	42.4	43.9	42.7	42.4	0.4
Namibia	22.3	25.1	27.7	32.4	35.1	12.8
Sao Tome and Principe	29.5	33.5	43.6	53.4	58.0	28.5
Seychelles	39.1	49.4	49.3	51.0	52.9	13.8
Swaziland	9.7	17.8	22.9	23.3	24.1	14.4
Group Averages						
African Small States	25.2	31.8	40.4	45.9	48.2	23.0
Larger Sub-Saharan African States	17.8	23.2	27.9	32.2	34.4	16.6
Small States	36.9	41.7	46.6	49.8	51.3	14.4

Source: World Development Indicators, 2006.

1/ Urban population as a share of total population in percent. Urban population is defined as the mid-year population of areas defined as urban in each country and reported to the United Nations.

III.2. Growth Accounting

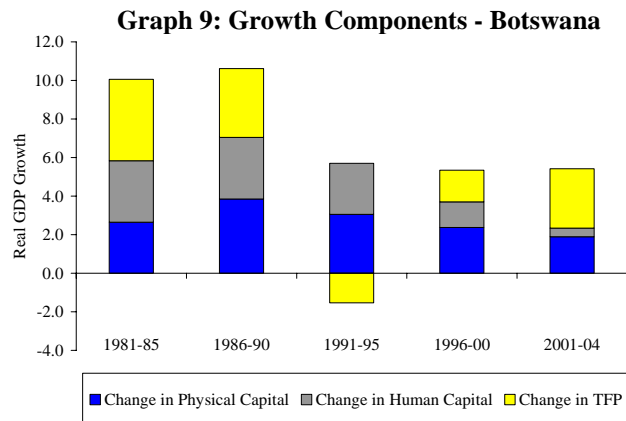
23. This section is limited to Botswana, the Gambia, Lesotho, Mauritius and Swaziland, since data on educational attainment is only available for five African small states. The growth-accounting exercise assumes a Cobb-Douglas Function with a capital share of 0.35, as is standard in the literature (see for example Hall and Jones, 1999). The capital stock is calculated using the perpetual inventory method.⁸ Labor input is adjusted for human capital.⁹ To verify the robustness of our results, we use two

⁸ The perpetual inventory method assumes $K_t = I_t + \delta K_{t-1}$, where I_t is investment and δ is the depreciation rate.

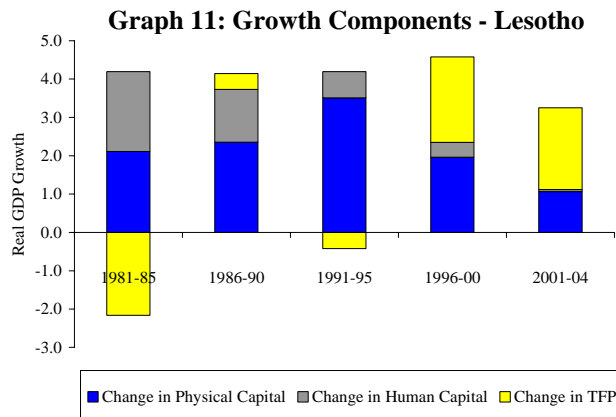
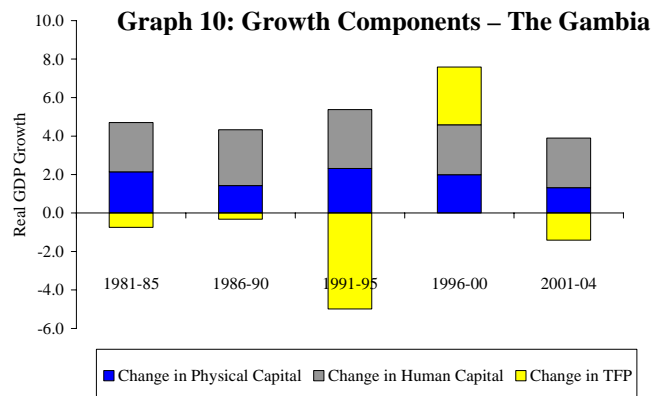
⁹ Following Hall and Jones (1999), schooling is converted into a measure of human capital h through the equation $h = e^{\phi(s)}$, where s is average years of schooling and the function $\phi(s)$ is piecewise linear with slope 0.13 for $s \leq 4$, 0.10 for $4 < s \leq 8$ and 0.07 for $8 < s$. These slopes correspond to average returns of education from microeconomic studies as reported by Psacharopoulos (1993).

different ways of calculating the initial capital stock. Moreover, given the large increase in the mortality rates of Botswana, Lesotho and Swaziland as a result of the AIDS epidemic we also adjust human capital for mortality rates in an alternative specification. Data on real GDP growth and investment is taken from the Penn World Tables, which implies that for certain countries and periods real GDP growth may differ substantially from the figures presented in Table 6. The results of these different specifications and the technical details are presented in Annex 1.¹⁰

24. **Botswana** sustained high economic growth during the 1980s, in the order of about 11 percent per year (see Graph 9). Growth was driven by physical and human capital accumulation, the latter reflecting a strong growth in employment, as well as improvements in TFP. In the first half of the 1990s TFP growth dropped, leading to a decline in output growth. Since the second half of the 1990s, growth in human capital has steadily weakened as result of increasing unemployment and the effects of the HIV/AIDS epidemic.



25. After the severe crisis in the mid 80s and early 1990s, **the Gambia's** growth performance has improved (see Graph 10) since the mid-1990s. In the second half of the 1990s, progress on policy reform, a rebound of tourist activity and favorable weather conditions contributed to a strengthening in output growth. A drought in 2002 induced a drastic drop



in real GDP, depressing the 2001 to 2004 average growth rate. But since 2000, growth in the Gambia has been broad-based, led by agricultural, constructions, hotels and restaurants and communication.¹¹

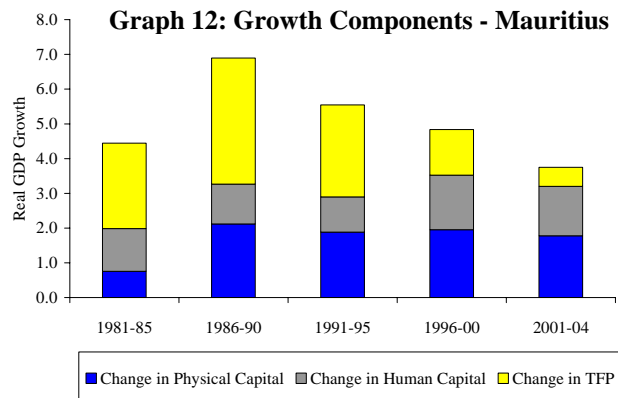
26. Since the early 1990s, **Lesotho** has achieved moderate growth. Growth in 1991-95 was largely driven by capital investment, reflecting substantial public

¹⁰ We use PWT figures to be consistent and allow for comparability with other growth accounting studies.

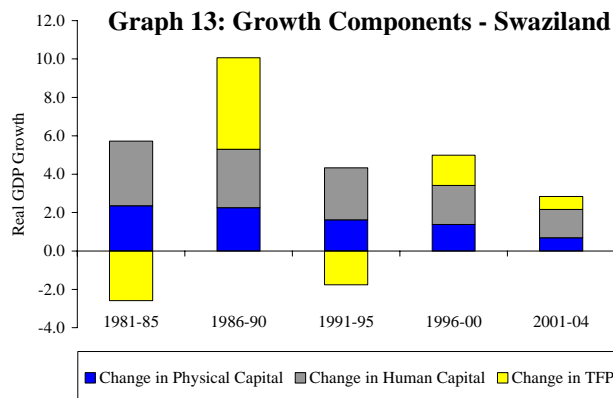
¹¹ See IMF (2006), Country Report No. 06/444.

investment in the Lesotho Highland Water Project (see Graph 11). Towards the end of the 1990s and the beginning of 2000, Lesotho's growth slowed down as a result of a political crisis and adverse exogenous shocks. Since 2000 Lesotho has benefited from preferences under the U.S. African Growth and Opportunity Act (AGOA) and as a consequence garment exports to the United States have increased and become the main engine of growth.¹²

27. When **Mauritius** reached independence in 1968, it was a poor country with a nominal GDP per capita of about US\$260. During the early 1970s Mauritius relied heavily on sugar production and severe cyclones in 1975 and 1980 clearly exposed the country's vulnerability to shocks. To address such vulnerabilities, Mauritius started to diversify its economy since the 1980s. Since then growth has been driven by accumulation of labor and capital as well as a steady increase in TFP (see Graph 12). Employment gained strongly during the 1980s and by the end of the decade Mauritius started importing labor. Capital, largely unutilized after the 1980-81 crash was brought back into production and both public and private investment picked up by the second half of the 1980s, remaining strong throughout the 1990s. The explosive growth in the EPZ sector in the mid 1980s translated into impressive output growth in the second half of the 1980s. Growth in total factor productivity remained strong in the first half of the 1990s, consistent with a tighter labor market and rising real wages leading to capital-labor substitution and the adoption of more productive, labor saving technologies.¹³ In 2001-02, Mauritius economy slowed down sharply, partially as a result of Cyclone Dina. Moreover, capital growth slowed down, reflecting the downsizing in the textile and clothing sector in anticipation of the phasing out of the MFA quotas.



28. Human capital accumulation has been the driving force behind **Swaziland's** growth during the 1980s (see Graph 13). But Swaziland also experienced high investment rates before 1994. Since the opening of South Africa in 1994, Swaziland has lost part of its attractiveness for foreign investors. As foreign direct investment declined, capital accumulation



¹² While the WDI data on real GDP growth would suggest that Lesotho's overall real GDP growth has been driven primarily by factor accumulation (mainly capital), the data from the Penn World Table used for this exercise seem to indicate that the contribution of TFP growth was sizeable, especially in the second half of the 1990s.

¹³ For a discussion, see World Bank (2007), Mauritius CEM.

slowed down progressively in the second half of the 1990s. Unemployment increased from 22 percent in 1995 to over 30 percent in 2001. Higher TFP growth in the pre-1999 period may have been the result of technological spillovers associated with more intensive trading activity. Swaziland's economy is now mainly based on agriculture and agro-processing. Benefiting from preferences under the US African Growth and Opportunity Act (AGOA), the garment sector has emerged as one of the largest employers in the country in recent years.

III.3. Accumulation of Physical and Human Capital

29. Growth in African small states has largely been driven by investment in physical capital. Gross capital formation in African small states during the 1990s was substantial, exceeding the sub-Saharan and the small states average during the 1990s. In particular, Equatorial Guinea, Lesotho and São Tomé e Príncipe underwent large investments relative to the size of their economies. In some African small states, such as Cape Verde, Guinea-Bissau and São Tomé e Príncipe, capital investment was denominated by the public sector. A substantial share of small African states, however, benefited from private sector investment as well, especially through foreign direct investment.

30. Size does not appear to be a constraint for foreign direct investment in Africa. Several small African countries, such as Lesotho, Namibia, Seychelles and Swaziland have been successful in securing substantial volumes of FDI as a share of GDP or capital formation (Table 10). Host country market size may play an important role in attracting FDI in general, especially when the host-country market allows the exploitation of economies of scale for import-substituting investment. However, the market size of most African countries is too small to exploit economies of scale when servicing the host-country market.¹⁴ Only five countries in Africa have a population in excess of 30 million and a large fraction of the population lives from subsistence. As a consequence, the nominal GDP of Africa, excluding South Africa and Nigeria, is less than half that of the Netherlands, and it is necessary to target exports in order to benefit from economies of scale in Africa.

Table 10. Capital Investment

	Gross Capital Formation 1/	Government Capital Expenditure 1/	Net FDI inflows 2/
Botswana	28	15	5
Cape Verde	29	21	2
Comoros	17	7	0
Djibouti	11	7	2
Equatorial Guinea	65	6	49
Gabon	26	7	5
The Gambia	20	8	15
Guinea-Bissau	24	20	2
Lesotho	55	16	11
Mauritius	28	4	1
Namibia	21	5 ..	
Sao Tome and Principe	44	40	12
Seychelles	30	10	8
Swaziland	21	7	-3
African Small States	30	13	8
Small States	28	12	17
Sub-Saharan Africa	21	9	6

Source: World Development Indicators, 2006.

1/ Average 1990 -1999. As a share of GDP.

2/ Data for 2004. As a share of GDP.

¹⁴ See, for example, Scaperland and Balough (1983) and Wheeler and Mody (1992). Elbadawi and Mwegu (1997) show empirically that market size is relatively unimportant in explaining FDI flows to Africa in contrast to GDP growth.

31. A substantial share of FDI has been targeted to the oil and mineral sectors of the economy, benefiting Botswana, Namibia, Equatorial Guinea, Gabon, Guinea-Bissau and São Tomé e Príncipe. Almost 40 percent of FDI to Africa is related to investments in the mineral and oil sector since expected profit rates in this sector, notwithstanding significant risks, are high. Equatorial Guinea, for example, signed a contract for production sharing and exploration of their oil fields in 1990s. In 1992, oil exploration started and natural gas was also identified. In 1999, construction of a US\$400 methane plant started. These costs exceeded the 1996 GDP of Equatorial Guinea.

32. Macroeconomic and political stability enabled Botswana and Namibia to attract FDI not only in the primary sector, but also to diversify their economy. Over two-thirds of private investment in Botswana has been in the mining sector. But Botswana also succeeded in attracting investment in manufacturing linked to the mining sector, such as the cutting and polishing of diamonds. It also attracted export-oriented foreign direct investment in the textile, car and the beef industries. A favorable macroeconomic environment, stable and efficient political institutions, relatively low corruption and high labor productivity as a result of substantial investment in human capital have created an environment favorable to foreign direct investment. Moreover, Botswana is a member of the Southern African Customs Union (SACU), which is also likely to have positively influenced FDI.¹⁵ Similar factors also helped Namibia in attracting diversified foreign direct investments.

33. Lesotho's and Swaziland's location was advantageous for attracting FDI. In the late 1980s and early 1990s, investors wishing to cater to the large market in South Africa circumvented economic sanctions against the country by locating subsidiaries in these small neighboring states. Foreign investors also benefited from the fact that these countries formed part of the common monetary area (CMA) with South Africa and had preferential access to world market and a relatively cheap, but skilled labor.¹⁶

34. Mauritius has actively pursued investor-friendly policies to overcome the constraints of its small market size and lack of natural resources. Mauritius was successful in attracting significant export-oriented foreign investment through the creation of Export Promotion Zones (EPZs) and by providing investors incentives, such as import duty exemptions, zero taxation of dividends and no requirement to form joint-ventures with the government, as was the case in many other African countries. Moreover, a stable macroeconomic and political environment, relative low costs of doing business due to an efficient physical infrastructure and a sound legal system were also key to attract FDI. Finally, labor productivity in Mauritius is far higher than in any other

¹⁵ SACU was established in 1910 as a Customs Union Agreement between the then Union of South Africa and the High Commission Territories of Bechuanaland, Basutoland and Swaziland. With the independence of these territories, the agreement was updated, and on December 11, 1969 it was re-launched as the SACU with the signing of an agreement between the Republic of South Africa, Botswana, Lesotho and Swaziland. The updated union officially entered into force on March 1, 1970. After Namibia's independence from South Africa in 1990, it joined SACU as its fifth member.

¹⁶ Lesotho, Namibia and Swaziland peg their currency to the South African Rand at par under the Common Monetary Area (CMA). Circulating side by side with the national currencies of these three countries, the rand is the legal tender throughout the CMA.

sub-Saharan African country, except for South Africa. Finally, Mauritius also benefited from preferential trade arrangement with the EU and the US.

35. Several, African small states also have pursued active policies to invest in the accumulation of human capital. Unlike physical capital, human capital is not just a part of output that gets converted into productive capital. The production of new human capital rather requires the use of existing human capital. The pupil-teacher ratio, an indicator of investment in human capital as well the quality of education, is substantially lower in African small states compared the sub-Saharan average, reflecting a relatively higher stock of human capital. The higher investment in education is also observed as a higher school life expectancy¹⁷. A student entering school in 2006 is expected to obtain 10 years of education in a small state, compared to a sub-Saharan African average of eight years. This indicator of the future stock of human capital bodes well for the competitiveness of small African states into the future as larger African states catch up on other dimensions.

III.4. The Role of Institutions

36. In the African context, a small population size implies lower ethnic fractionalization. African borders were drawn to a large extent exogenously from ethnic boundaries by the European colonial powers, which resulted on average in higher ethnic fractionalization in sub-Saharan Africa. States that happened to have smaller populations therefore are likely to include a smaller number of ethnic groups, suggesting a strong correlation between small size and ethnic fractionalization. Indeed, the correlation between ethnic fractionalization and small size is quite large in Africa (0.56), but not elsewhere (0.12 overall, including Africa). Since high ethnic fractionalization has been linked to a higher probability of conflict and weaker institutions, “smallness” actually turns out to be an advantage in the African context.

37. Countries with high degree of ethnical fractionalization tend to have weaker governance. According to political economy literature, ethnic fractionalization tends to weaken institutions. The main argument is that ethnic fractionalization may lead to uncoordinated rent-seeking activities where each ethnic group does not take into consideration the effect of one’s group’s actions on the rents of the other group (Easterly and Levine, 1997). Moreover, ethnic fractionalization may weaken the centralization of control and useful checks and balances (Alesina and Rodrik, 1994; Alesina, Baqir and Easterly, 1999), facilitating rent-seeking activities, weakening accountability and opening the door for corruption.

38. In line with the theory, governance is stronger in African small states, partly as a result of lower fractionalization. As shown in Table 11 and Graph 7 below, the institutional quality of the average small African states is higher than the sub-Saharan African average, across all the standard indicators. The indicators show that small

¹⁷ School life expectancy is the total number of years of schooling which a child of a certain age can expect to complete.

African states are less corrupt, have more effective and accountable government, a better regulatory environment and better rule of law overall. This difference between small and larger African states is particularly large in the case of rule of law: ten out of 14 small states fare better than the average sub-Saharan African state.

Table 11. Institutional Quality Indicators

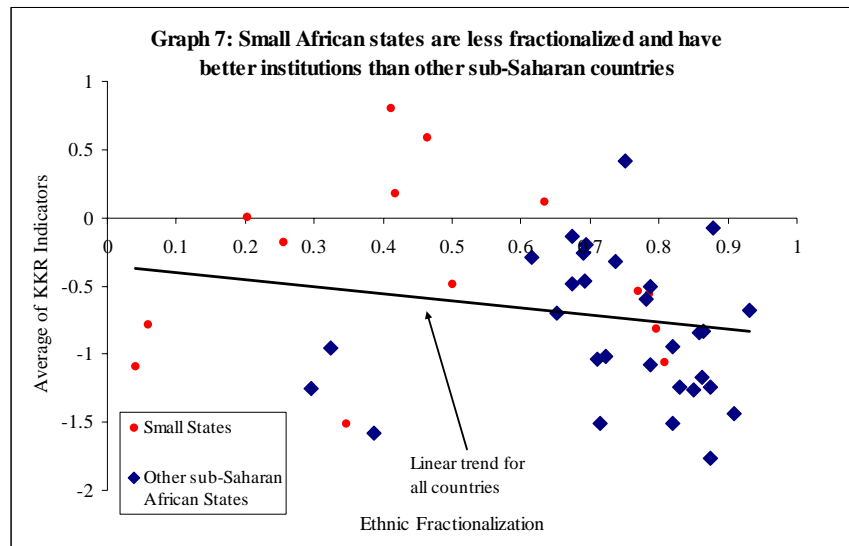
	Voice and Accountability 1/	Government Effectiveness 1/	Regulatory Quality 1/	Rule of Law 1/	Corruption 1/	Corruption Perceptions Index 2/	Economic Freedom Index 3/	CPIA 4/
Botswana	0.7	0.8	0.8	0.7	1.1	5.6	70	...
Cape Verde	0.8	-0.1	-0.2	0.2	0.2	4.6	60	4.09
Comoros	-0.3	-1.6	-1.6	-1.0	-0.9	2.4	...	2.42
Djibouti	-0.8	-0.9	-0.9	-0.9	-0.6	2.4	56	3.14
Equatorial Guinea	-1.7	-1.4	-1.3	-1.3	-1.8	2.1	51	...
Gabon	-0.7	-0.6	-0.3	-0.5	-0.6	3.0	52	...
The Gambia	-0.7	-0.7	-0.4	-0.3	-0.7	2.5	56	3.08
Guinea-Bissau	-0.3	-1.5	-1.1	-1.3	-1.1	2.2	41	2.68
Lesotho	0.3	-0.3	-0.6	-0.2	-0.2	3.2	53	3.51
Mauritius	0.9	0.6	0.3	0.8	0.3	5.1	64	...
Namibia	0.4	0.1	0.1	0.0	0.1	4.1	60	...
Sao Tome and Principe	0.6	-0.8	-0.8	-0.6	-0.8	2.7	...	2.98
Seychelles	0.0	-0.1	-0.1	0.2	0.0	3.6	...	...
Swaziland	-1.3	-0.8	-0.4	-0.8	-0.6	2.5	58	...
African Small States (average)	-0.2	-0.5	-0.5	-0.4	-0.4	3.3	57	3.25
Small States (average)	0.3	0.1	0.1	0.3	0.2	4.1	63	3.42
Sub-Saharan Africa (average)	-0.6	-0.8	-0.7	-0.8	-0.7	2.8	53	3.22

1/ Source: Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi. "Governance Matters V: Governance Indicators for 1996-2005." 2005 scores are shown. Scores are relative to other countries and are centered at zero.

2/ Source: Transparency International (2005). 2005 scores are shown. Scores range from 1 through 10 with higher scores indicating lower perceived corruption.

3/ Source: Heritage Foundation (2006). 2006 scores are shown. Scores range from 0 through 100, with higher scores indicating greater "economic freedom".

4/ World Bank's Country Policy and Institutional Assessment (2005). Scores range from 1 through 6. Data for non IDA-borrowers, although available, is not public. The averages include all countries.



39. **Small African states are also show a remarkable degree of political stability.** As shown in Table 12 below, African small states have high scores in the KKM political stability indicator; only Djibouti is less stable than the average for sub-Saharan Africa. Moreover, the overall average is positive, indicating that small African states are more politically stable than the average country overall. Finally, not only are governments in African small states less likely to be overthrown or challenged in armed conflicts, but political rights in these countries are actually stronger on average than in sub-Saharan Africa. Freedom House's Political Rights Index, for example, shows that political rights in only four small states are more limited than in the average sub-Saharan country.

Moreover, the sample of small states includes three parliamentary democracies, compared to only two among all larger sub-Saharan states.

Table 12. Indicators of Political Institutions

	Political			Political Rights Index	
	Political Stability 1/	Fractionalization 2/	Political System 3/	4/	
Botswana	0.82	0.30	2	2	
Cape Verde	1.09	0.50	0	1	
Comoros	-0.43	...	0	4	
Djibouti	-0.57	0.00	0	5	
Equatorial Guinea	0.26	0.12	0	7	
Gabon	0.18	0.41	0	5	
The Gambia	0.24	0.12	0	4	
Guinea-Bissau	-0.43	...	0	4	
Lesotho	0.34	0.54	2	2	
Mauritius	0.89	0.23	2	1	
Namibia	0.52	0.40	0	2	
Sao Tome and Principe	0.34	...	0	2	
Seychelles	0.64	...	0	3	
Swaziland	0.17	...	0	7	
African Small States (average) 3/	0.29	0.29	0	3.5	
Small States (average) 3/	0.64	0.50	1	2.7	
Sub-Saharan Africa (average) 3/	-0.57	0.45	0	4.3	

1/ Source: Kaufmann, Kraay and Mastruzzi (2006). 2005 scores are shown. Scores are relative to other countries and are centered at zero.

2/ Source: Beck et al. (2001). Refers to the overall fractionalization of the government, as measured by the probability of random pairing between politicians of different parties.

3/ Source: Beck et al. (2001). 2 represents a parliamentary democracy, 1 indirect presidential and 0 represents direct presidential. "Averages" are medians.

4/ Source: Freedom House (2006). Index ranges from 1 through 7, with 1 being the most free.

40. Political stability is reflected in a lower incidence of armed conflict and state failure among the African small states. As shown in Table 13 below, armed conflict is substantially rarer in African small states compared to the average for sub-Saharan Africa. For example, the probability of state failure (which includes coups, but also civil wars, genocides and politicides) is only 3 percent in a small state, compared to 26 percent in the average sub-Saharan state. This substantially lower risk of violence is likely to offset any higher risks from natural disasters in determining volatility, as will be discussed in greater detail in the next section.

Table 13. Indicators of Conflict

	Ethnic Fractionalization 1/	Episodes of State Failure 2/	Episodes of Armed Conflict 3/	Episodes of Major Armed Conflict 4/
Botswana	0.41	0	0	0
Cape Verde	0.42	0	0	0
Comoros	0.04	6	2	0
Djibouti	0.80	0	5	0
Equatorial Guinea	0.35	0	1	0
Gabon	0.77	0	0	0
The Gambia	0.79	1	1	0
Guinea-Bissau	0.81	6	5	5
Lesotho	0.26	2	1	0
Mauritius	0.46	0	0	0
Namibia	0.63	0	0	0
Sao Tome and Principe	...	0	0	0
Seychelles	0.20	0	0	0
Swaziland	0.06	1	0	0
Average (country-year)	0.46	0.03	0.01	0.03
Small States (average)	0.38	0.03	0.00	0.01
Sub-Saharan Africa (average)	0.66	0.26	0.15	0.20

1/ Source: Alesina et al. (2003).

2/ Source: State Failure Task Force (2005). Includes wars, "adverse regime changes" and genocides and politicides.

3/ Source: UCDP/PRIO Armed Conflict Dataset. Armed conflict is defined as a conflict in which one of the parties is the government and in which at least 25 people

4/ Source: UCDP/PRIO Armed Conflict Dataset. A major armed conflict is defined as one in which at least 1,000 people died over the duration of the conflict.

41. **Statistical analysis of the determinants of armed conflict shows that small states are less prone to experiencing conflicts, even when controlling for ethnic fractionalization.** Probit estimates (shown in Tables 14 and 15 below) of the probability of experiencing major armed conflict in a given year, controlling for different measures of ethnic fractionalization, population and income levels, shows that being a small state reduces the probability of conflict by over 10 percent. This suggests that the influence of state size on political stability goes beyond the effect of smaller ethnic fractionalization.

Table 14: Small states are overall less prone to armed conflicts

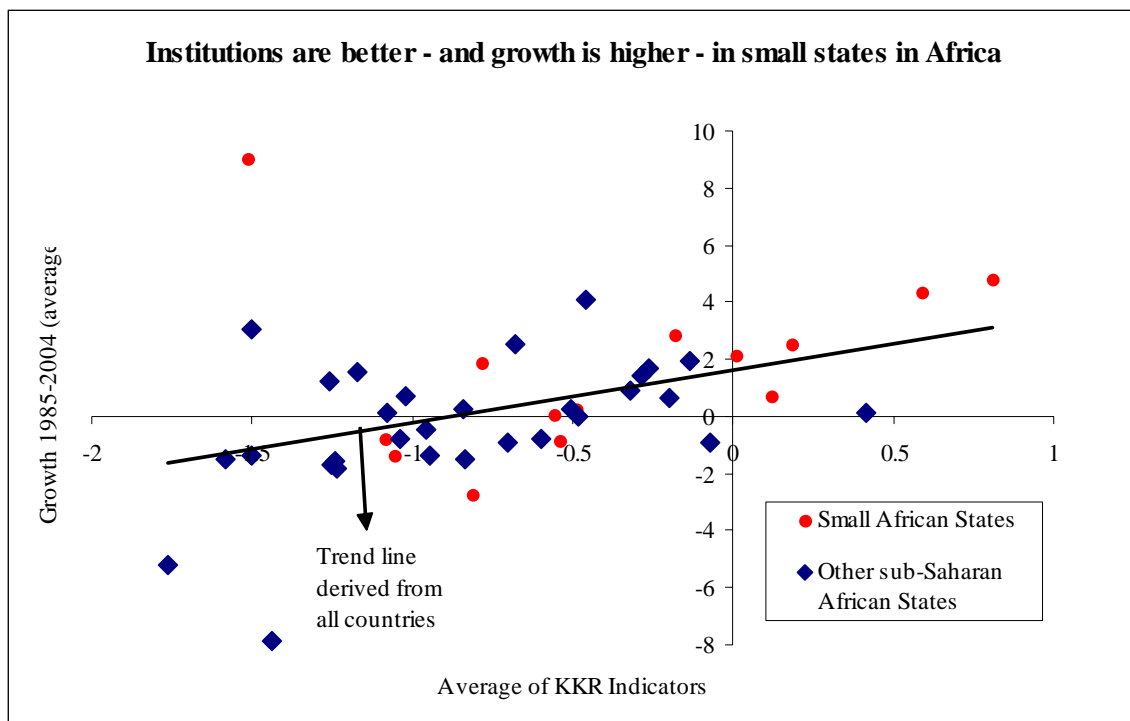
	I	II	III	IV	V	VI	VII
Dep Var:	Major armed conf.	Major armed conf.	Major armed conf.	Major armed conf.	Major armed conf.	Armed Conflict	State Failure
Indep. Vars.							
Small	-1.438***	-1.481***	-1.200***	-1.175***	-1.176***	-0.961***	-1.055***
Ethnic Fractionalization	0.508***		0.665***			0.602***	0.526***
Ethnic Fragmentation				0.439***			
Ethnic Polarization					0.948***		
(log) Income per capita	-0.163***	-0.212***	-0.153***	-0.164***	-0.195***	-0.171***	-0.268***
Population	0.000***	0.000***	0.000***	0.000***	0.000***	0.000***	0.000***
Include Islands?	No	No	Yes	No	No`	No	No
Pseudo r2	0.134	0.132	0.095	0.089	0.102	0.094	0.135
N	5910	6071	4508	3726	3726	4508	4248

Table 15: The effect of size remains when the sample is restricted to Africa

	I	II	III	IV	V	VI
Dep Var:	Major armed conf.	Major armed conf.	Major armed conf.	Major armed conf.	Armed Conflict	State Failure
Indep. Vars.						
Small	-0.769***	-0.755***	-0.834***	-0.804***	-0.911***	-1.098***
Ethnic Fractionalization	0.856***	0.991***			0.432*	0.201
Ethnic Fragmentation			0.078			
Ethnic Polarization				0.791**		
(log) Income per capita	-0.379***	-0.380***	-0.372***	-0.376***	-0.180***	-0.122**
Population	0.000***	0.000***	0.000***	0.000***	0.000***	0.000**
Include Islands?	Yes	No	No	No	No`	No
Pseudo r2						
N	1596	1437	1356	1356	1437	1359

42. **It is likely that the remoteness of small states contributes to their lower probability of experiencing armed conflicts.** Remoteness may reduce the probability of experiencing armed conflict by preventing spillovers of conflicts in neighboring countries. The small state that experienced higher incidence of conflict, Guinea-Bissau, also happened to be in a region prone to conflicts (Liberia, Sierra Leone and Guinea). Thus, while in other contexts remoteness is an obstacle to growth, in the African context it may have also helped reinforce political stability in the African small states.

43. **The results of our analysis lend further empirical support to the extensive literature on the relationship between institutions and economic growth.** The recent literature on economic growth, starting with Hall and Jones (1999) and Acemoglu, Johnson and Robinson (2001), stresses the need of strong institutions for long term economic growth. We observe that the small sub-Saharan African states were able to have better institutions than sub-Saharan Africa overall because they were (generally) exogenously less ethnically fractionalized. The lower fractionalization, combined with remoteness that helped prevent conflict spillovers, resulted in lower incidence of conflict, greater political stability and better governance. These good institutions allowed investors to realize some of the potentially high returns to capital in Africa (considering the low starting points), and made small states more likely to benefit from FDI and private investment more broadly. Meanwhile, better government institutions also meant that governments were more effective, as evidenced by higher levels of human capital and infrastructure. Given the low starting capital levels of African countries, even modest amounts of FDI and other private investment were sufficient to boost growth substantially, as observed in the successes of Mauritius and Lesotho. Graph 8 below, plots the average of KKM's institutional indicators against GDP growth from 1985-2004 for both the small states and other sub-Saharan African states and illustrates the key argument of this section clearly: small states have better institutions, which correlates with their higher growth rates.



IV. Determinants of Volatility

IV.1. Overview

44. **Small African states have shown a similar, if not lower, level of volatility compared to larger African states.** The volatility of GDP growth has been generally lower in the small states, driven by the greater economic diversification observed in those countries. Greater diversification is also likely to account for the lower volatility in terms of trade shocks observed in the small states. On the other hand, small states appear to be similarly affected by natural disasters, but in many cases they have been better able to cope with such exogenous shocks thanks to stronger institutions.

45. **The growth rate of African small states has been less volatile than that of larger African states over the past 25 years.** As Tables 14 and 15 show, volatility of GDP growth (both overall and per capita) was higher in the small states in the earlier years (81-85 and 86-90), but has decreased since 1990 as greater diversification of the economies of the small states began to yield dividends. Given the relationship between growth and volatility,¹⁸ the lower volatility of growth in the small states may also have contributed to their growth performance in the period. Among the small African states, the largest volatility in GDP growth is observed among oil-rich countries (Equatorial Guinea and Gabon), as well as Guinea-Bissau, which as noted earlier has been affected by recurrent conflicts.

Table 14. Volatility of GDP Growth

	81-85	86-90	91-95	96-00	01-05	81-05
Botswana	6.29	5.55	2.07	3.96	1.34	4.41
Cape Verde	...	3.56	3.50	3.27	0.72	3.00
Comoros	4.38	3.83	5.02	2.33	2.56	4.92
Djibouti	...	1.94	3.14	1.84	1.49	2.27
Equatorial Guinea	...	5.13	5.91	...	8.69	7.78
Gabon	8.80	20.73	5.56	13.79	8.35	12.18
The Gambia	3.91	2.82	3.18	2.23	5.15	4.88
Guinea-Bissau	0.96	...	...	1.42	6.56	10.08
Lesotho	4.23	4.58	4.29	5.75	2.60	5.16
Mauritius	2.10	1.64	2.51	2.14	0.53	3.15
Namibia	7.83	5.15	...	2.75	6.30	5.38
Sao Tome and Principe	7.64	8.93	...	4.98	6.19	7.41
Seychelles	4.83	2.78	6.12	4.55	2.80	4.94
Swaziland	4.94	5.02	4.32	1.32	3.16	4.39
African Small States Average	5.08	5.51	4.18	3.87	4.03	5.71
Small States Average	5.73	5.37	4.03	4.34	3.80	5.78
African Large States Average	4.99	5.06	6.13	4.61	4.26	6.24

¹⁸ See Hnatkovska and Loayza (2005).

Table 15. Volatility of per capita GDP Growth

	81-85	86-90	91-95	96-00	01-05	81-05
Botswana	7.36	5.41	2.15	3.77	1.24	4.92
Cape Verde	...	3.63	3.48	3.28	0.73	3.01
Comoros	4.38	3.83	5.06	2.33	2.56	4.81
Djibouti	...	0.72	2.47	1.64	1.76	2.67
Equatorial Guinea	...	5.44	5.84	...	11.40	9.58
Gabon	8.83	17.35	5.67	16.40	8.49	11.54
The Gambia	3.87	2.81	3.10	2.30	5.06	4.85
Guinea-Bissau	0.89	...	...	1.49	6.55	10.21
Lesotho	4.38	4.67	4.26	5.64	2.44	4.94
Mauritius	1.96	1.65	2.37	2.08	0.48	3.20
Namibia	7.35	4.98	4.61	2.70	6.07	5.00
Sao Tome and Principe	7.53	8.82	...	5.07	6.22	7.40
Seychelles	4.95	2.72	6.25	4.55	2.10	4.93
Swaziland	4.93	5.88	4.32	1.31	2.87	4.89
African Small States Average	5.13	5.22	4.13	4.04	4.14	5.85
Small States Average	5.91	5.17	3.91	4.38	3.70	5.82
African Large States Average	5.04	5.01	6.48	4.98	4.44	6.53

46. The lower overall volatility of GDP growth in small African states is mirrored by lower volatility in the terms-of-trade. Except during the earliest period in our analysis (1981-1985), the volatility in the terms of trade in large African countries has been well above that of the African small states (Table 16). This outcome is in spite of the fact that among the small states are oil exporters (Equatorial Guinea and Gabon) that have also experienced very high volatility in their terms of trade. High volatility in the terms of trade has also been observed in Guinea-Bissau, which relies heavily on Cashews as exports, as well as the Comoros and São Tomé e Príncipe. It is also noteworthy that volatility in the terms of trade has been much lower among overall small states, revealing the higher vulnerability of African states overall to movements in commodity prices. The role of diversification of the economy in reducing volatility is clear from the terms of trade data: the small states with volatility in the terms of trade below the overall small states average (Botswana, Cape Verde, Swaziland, Mauritius) are also the most diversified; it is also worth noting how the volatility in the terms of trade declined over time in Botswana, Mauritius, Seychelles and Namibia as these countries diversified.

Table 16. Volatility of the Terms of Trade

	81-85	86-90	91-95	96-00	01-05	81-05
Botswana	14.31	6.64	5.15	2.24	0.41	7.11
Cape Verde	...	0.00	0.00	0.00	7.02	3.48
Comoros	23.89	4.53	37.91	17.22	33.65	24.17
Djibouti	...	...	...	...	...	...
Equatorial Guinea	...	17.27	13.65	0.24	...	12.73
Gabon	14.38	19.46	5.26	17.43	17.11	15.40
The Gambia	11.71	6.73	0.00	0.00	5.29	8.34
Guinea-Bissau	32.53	10.83	22.99	10.52	16.73	21.02
Lesotho	5.83	7.68	7.25	10.33	2.43	7.78
Mauritius	5.46	5.80	1.58	0.95	1.86	4.17
Namibia	12.77	10.91	11.35	3.76	9.98	9.62
Sao Tome and Principe	...	38.62	11.70	15.20	...	22.06
Seychelles	...	12.54	10.20	7.92	0.00	9.40
Swaziland	5.49	7.84	9.67	1.31	7.52	6.59
African Small States Average	14.04	11.45	10.52	6.70	9.27	11.68
Small States Average	8.13	7.61	5.89	3.85	5.61	7.16
African Large States Average	13.95	14.86	13.37	12.96	10.74	14.85

47. Both large and small states in Africa seem to be affected by natural disasters to a similar extent. Although the average proportion of the population affected by natural disasters appears higher in small African states, this is due to Djibouti's large number of floods in the capital and droughts outside of it; when one removes Djibouti from the sample, the average falls to slightly below that of the larger African states. While the extent of overall damage by natural disasters is similar, the number of people killed by disasters is substantially higher in larger African states compared to their small counterparts. This may be due to more severe disasters in larger states, but also on the varying ability of governments to respond to natural disasters. Given the relative strength of institutions in the small states, the latter is likely to be the case to at least some extent.

Table 17. Natural Disasters

	Number affected by disaster per 100 inhabitants	Number killed by disasters per 10,000 inhabitants	Damages by disasters, as fraction of GDP	Number of disasters
Botswana	135.54	6.14	0.40	14
Cape Verde	18.84	8.52	0.90	16
Comoros	82.90	13.18	23.72	18
Djibouti	410.08	10.28	0.98	18
Equatorial Guinea	0.31	0.48	...	1
Gabon	1.32	1.50	...	6
The Gambia	121.10	5.74	0.31	21
Guinea-Bissau	26.63	33.16	...	21
Lesotho	126.74	0.51	0.26	14
Mauritius	102.98	0.69	31.19	20
Namibia	75.21	2.37	0.44	16
Sao Tome and Principe	94.71	18.23	...	3
Seychelles	27.73	1.22	12.14	4
Swaziland	344.78	11.24	8.12	11
African Small States Average	112.85	7.95	7.20	
Small States Average	84.05	19.56	58.25	
African Large States Average	92.39	24.66	8.43	

48. Financial damages arising from natural disasters have also been comparable between small and large African states. As expected, damages in the overall sample of small states, which includes relatively wealthier countries, is far higher than the damages of disasters observed in Africa. Given its low capital basis and greater political instability, financial damages have been limited in both small and large countries.

49. While they do not appear to be disproportionately affected by exogenous shocks, small African states do seem to be better capable of recovering from shocks. In addition to the possibility that small states have fewer deaths from natural disasters because of better response, we find that small states are generally able to recover from crises more quickly than larger counterparts. In Table 18 below we calculated the time that it took countries to recover to pre-crisis GDP per capita levels, where a crisis was defined as any contraction in GDP per capita of more than four percent. As shown in the table, small African states experienced half as many crises on average, and recovered from those crises about 25 percent more quickly than the larger African states.

Table 18. Recovery from Crises 1/

	Average Time to Recovery (years)	Number of Crises
Botswana	...	0
Cape Verde	...	0
Comoros	14.67	3
Djibouti	14.50	4
Equatorial Guinea	7.00	1
Gabon	13.83	6
Gambia, The	7.25	4
Guinea-Bissau	7.40	5
Lesotho	4.00	4
Mauritius	...	0
Namibia	12.50	2
Sao Tome and Principe	...	0
Seychelles	4.00	3
Swaziland	10.00	1
Small AFR	9.7	2.4
Small ALL	8.2	2.1
Large AFR	13.3	4.8

1/ A crisis is defined as a contraction in constant-dollar GDP per capita of more than 4 percent. "Recovery" is defined as the year when constant-dollar GDP per capita returns to the pre-crisis level.

50. The ability of small African states to better cope with volatility also appears to be related to the better quality of their institutions. A regression of institutions (defined as the government effectiveness KKM variable, instrumented by ethnic fractionalization) on the time to recover from crises yields a large and significant coefficient on the institutional variable; a probit regression on the probability of crises also yields a large and statistically significant coefficient on the institutional variable, both on a sample including all countries and one restricted to sub-Saharan Africa. Box XX illustrates the role of institutions in responding to shocks through the examples of two small states (Botswana and Mauritius) and one large state (Mozambique).

**Box 2: Institutional Response to Exogenous Shocks
[to be expanded]**

Botswana: A slump in world market prices for diamonds (1992 – 1994) led to a fall in export earnings, government revenue and economic growth. In response, the government focused on efforts to diversify the economy and took steps to broaden the production base by encouraging more broad-based FDI.

Mauritius: After two devastating cyclones in 1975 and 1980, the government decided to diversify the economy away from the sugar sector and undertook a rigorous reform program.

Mozambique: The extensive damage of a severe drought between 1981 and 1984 was accompanied by a civil war, which helped escalate the number of persons killed by the drought to approximately 100,000.

V. Conclusion

GDP growth of African small states exceeded the average growth rate of sub-Saharan countries. The analysis in this study suggests that small states in Africa are less ethnically fractionalized, which favored the development of better institutions than their larger sub-Saharan counterparts. This has enabled them to attract a substantial amount of foreign direct investment, leading to an average real GDP growth of African small states amounted to 4.1 percent during the last 25 years.

Interestingly, African small states have been affected less by exogenous shocks than their larger counterparts. Whether this is the result of better policy response or a happenstance of geography, is still a matter of conjecture. Some case studies suggest it is the former, but in general, greater economic diversification of African small states has likely reduced their vulnerability to exogenous shocks.

Notwithstanding their relatively strong performance, African small states must continue to build on the past successes in order to sustain high growth rates in the coming decades. Currently, several small states seem to be better positioned in terms of transportation and trade costs than their larger sub-Saharan African counterparts. Moreover, rising growth in neighboring countries could be a further stimulus to growth. However, as Africa grows and institutions and infrastructure in other countries catch up with the African small states, constraints such as economies of scale and higher transportation costs in the island economies are likely to make them less attractive places for foreign direct investment, especially for manufacturing exports. Thus continuing on the path of regional and global integration and institutional reform should be key priorities for the African small states.

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