The political economy of small states

Small states in world markets
- It is impossible to generalize about how well small states do in the global economy. Visions of an ‘arc of prosperity’ and of an ‘arc of insolvency’ are equally misleading.
- Small states do face some common challenges but how well they do depends on the policies and institutions they adopt.
- Small states are particularly vulnerable to global economic pressures.
- They have fewer macro-economic levers than large states, since any economic stimulus can easily leak out into other economies.
- They cannot deal with asymmetrical shocks (affecting just one sector or region) as easily as large states as they are less diversified.
- They have smaller domestic markets, which means that they have a high ratio of foreign trade.
- If they have their own currencies, they are vulnerable to speculation.
- If they are in currency unions or pegged to other currencies, monetary policy is out of their control.
- They depend on inward investment.
- They need to attract and keep highly skilled people, who are increasingly mobile.
- This means that they need to adapt flexibly to change.

Adaptability
- Small states, however, be better able to adapt than larger states because:
  - They have shorter lines of communication;
  - There is a sense of common purpose;
  - Their policy systems are more flexible;
  - Their administrations are smaller and more integrated.
- On the other hand, they may be less flexible because:
  - There could be a tendency to group-think;
  - Vested interests might be more powerful in a small system;
  - The search for consensus could deter new policy thinking.
- This means that institutions and modes of policy-making are critical.
- There are multiple ways of adapting but, to simplify, we can identify two.

The market liberal state
- The market liberal state seeks to adapt to the needs of capital investment
- Taxes, especially on business and high earners, are low.
• As a consequence, welfare and public services are provided at a low level.
• Labour markets are deregulated and flexible.
• Wages are flexible, both upwards and downwards.
• Economic cycles are steep, with periods of high and low unemployment.
• Cyclical inward and outward migration balance labour market requirements.
• The result is sharper social inequality.
• Critics note that it may result in a ‘race to the bottom’ as other states reduce their taxes and welfare states in order to regain their competitive advantage.
• They also argue that the model promotes low-paid and low-skilled employment.
• Examples of the market liberal state are found in the Baltic states.

The Social Investment State
• In the social investment state model, public spending is seen, not as a drain on the productive economy but as investment in it.
• There is a focus on developing human capital.
• Many small states have large public sectors.
• These help stabilize the economy.
• They provide public goods that the private sector does not, especially in the absence of larger firms. These include education, training and research and development.
• Social investment states, because of their emphasis on human capital, may also avoid stark social inequality.
• There is some evidence that inequality harms economic growth.
• Social investment states therefore have higher levels of taxation. This is inescapable. The idea that social investment will pay for itself so allowing higher revenues from the same levels of taxation is wishful thinking.
• The social investment model does not, however, eliminate deprivation. Social and income support policies are still needed for that.
• The social democratic investment state is one that places emphasis on social inclusion and more equality.
• Examples of social investment states are found in the Nordic countries.

Social Partnership and Government
• The market liberal state requires limited government and negotiation among actors.
• The social investment state requires a more active public sector and public policies.
• There is often a system of social partnership based on tripartite negotiation among government, business and trades unions.
• This can assure wage stability (and thus competitiveness) and control inflation, focusing on real and not nominal wages.
• Negotiation can be extended to the ‘social wage’ in the form of public and welfare services, which may compensate for lower individual wages rises.
• Partnership can overcome collective action problems and produce adjustment at a lower cost than letting economic cycles run their course.
• Partnership takes numerous forms. There has been a move from ‘corporatism’, which was restricted to business, unions and government, and could be rigid, to ‘lean corporatism’, ‘competitive corporatism’, ‘social dialogue’ and ‘social partnership’, which are more flexible.
• Partnership can operate at multiple levels, sectoral and territorial.
• The centre-piece is often a system of labour relations but other social groups may in included.
• Social investment also requires government to acquire policy and strategic capacity, allowing it to invest in the future (for example in preventive spending).

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