

# The Economics of Small States

**John Kay**

David Hume Institute, 21<sup>st</sup> October 2008

# The evolution of modern Western Europe

## *Components of former federations*

Czech Republic

Slovakia

Slovenia

Estonia

Latvia

Lithuania

## *Former colonies*

Cyprus

Malta

Poland

Hungary

Romania

Bulgaria

# The evolution of modern Western Europe

## *Earlier fragmentations*

Norway/Sweden

Finland/Russia

Ireland/UK

## *Potential fragmentations*

Belgium

Catalonia/  
Basque Country

UK

## The thesis

The growth of large states in the nineteenth century was driven by the belief that economic prosperity was the product of success in competition for the control of physical resources.

The revival of small states in the twentieth century is made possible by exploiting competitive advantages through free trade.

In the context of the greater ability of smaller more homogeneous societies to provide economic security without compromising economic dynamism.

# From the nineteenth to the twenty-first century

Change in the nature of government

Change in the global economic environment

Change in the nature of economic development

## The late nineteenth-century error

Economic prosperity depends on the control of physical resources.

In fact, such control frequently has disadvantageous economic and political consequences.

# The change in the nature of government

Weber's nineteenth-century conception of government was as the body which asserted a monopoly of internal and external coercion.

Modern European government is primarily a provider of services and of economic security.

# Change in the global economic environment

Globalisation and trade liberalisation allow exceptional prosperity based on the pursuit of narrow competitive advantages on an international scale without common political institutions.

## The late twentieth-century error

Globalisation favours the big battalions.

In fact, globalisation enables firms with competitive advantage to operate on a world scale.

## The changing structure of the world car business

|  | 1969      | 2002       |
|--|-----------|------------|
| Share of largest three current producers | 51%       | 36%        |
| Share of largest three producers in 1969 | 51%       | 33%        |
| No of producers over 1 m vehicles        | 9         | 14         |
| Share of largest 10 producers            | 85%       | 75%        |
| Share of producers over 1m vehicles      | 84%       | 80%        |
|  | (9 firms) | (14 firms) |
| No of firms with 1% market share         | 15        | 17         |

# Typical European competitive advantages

Southern German precision engineering

Northern Italian design based clusters

Swiss speciality chemicals

Finnish/Swedish telecommunications technology

## **Change in the nature of economic development**

Modern European economic growth is not about 'more stuff' but better stuff.

That means services and finer differentiation.

Government is just another service provider, judged by output quality and managerial competence.

# Optimal provision of government activities

## *Services*

|                      |  |
|----------------------|--|
| Defence              | large scale economies                                  |
| Health and education | negligible scale economies,<br>locally driven services |
| Social security      | solidarity based                                       |

## *Funding*

|                   |  |
|-------------------|--|
| Tax collection    | substantial economies in<br>geographical aggregation |
| Financial markets | scale economies, but<br>exhausted at low levels      |

## Relevant background

|                                 |                               |
|---------------------------------|-------------------------------|
| Post-sovereignty                | Neil MacCormick, James Tully  |
| Post-modern states              | Robert Cooper, Philip Bobbitt |
| Optimal state size              | Alberto Alesina               |
| Nature of welfare<br>capitalism | Gøsta Esping-Andersen         |

## After Weber

With the end of coercion as the distinguishing feature of government, comes also the end of monopoly.

Legitimacy gains meaning, sovereignty loses it.

Legitimacy is the product of competence.