

## **The Economics of Small States**

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

In the nineteenth century, states became larger. The dominant political events were the expansion of empires, the unification of Germany and Italy, the emergence of the United States of America.

In the twentieth century, states became smaller. The century began with the collapse of the weakest and most decayed empires, Turkey and Austria-Hungary. In the second half of the century, the membership of the United Nations grew from fifty to two hundred. A majority of the current members of the European Union are countries that have only recently become independent states.

In this lecture, I shall propose an economic explanation of these stylised facts. Broadly, I will claim that the primary motive of these nineteenth-century developments was the belief that economic prosperity was founded on securing political control over natural resources. That belief was largely mistaken. Those who held it massively overestimated the importance of resources in economic development, and failed to recognise that market access was not inevitably bound up with political union. Nor did they appreciate that the military costs of securing resources, and maintaining control over the associated territory without the consent of the local population, would come greatly to exceed any economic benefits.

The twentieth century would give small states the opportunity to achieve prosperity on the basis of narrow specialisation in a global economy. Such states would also benefit from the greater capacity of homogenous communities to reconcile economic dynamism with social cohesion. As a result, some of the small states of Western Europe would, in the course of the twentieth century, move from being among the poorest countries in the world to be among the richest.

There is always resistance to economic explanations of behaviour and events, and my thesis will encounter that resistance. Most people account for the political events I have described through the rise, and fall, of different kinds of nationalism. Nationalism is, as is widely recognised, a complex mixture of ethnic and cultural affinities, rooted in a shared history. Often, as for Scotland, much of this history is apocryphal.<sup>1</sup>

Individuals have an evident need for these group identities, but the identities they emphasise change. The Scots have been British when it suited them, and Scottish when it suited them. In the nineteenth century, Scots as Britons gained access to the British empire and the apparently necessary protection of a great military power. Today, Scots no longer perceive these advantages and are, once again, primarily Scots.

There is nothing reprehensible about this opportunism. To think otherwise is to believe that national identity is somehow innate, perhaps essentially racial in origin, rather than a social construction which is the product of a particular time and place. We all know where this thinking

can lead. That is why so many intelligent people today resist nationalist sentiment of all kinds.

I hope that sceptical, even cynical, view of nationalism will be sufficient answer to those who regard what I have to say tonight as a separatist manifesto. A debate on separatism is also a debate on sovereignty, and the concept of sovereignty plays a large role in both popular and academic discussion of constitutional affairs. But I will argue that concepts of sovereignty are a product of that nineteenth-century view of the state, and are largely irrelevant to the – mostly economic – issues of modern politics. The badges of sovereignty – embassies and national armies – have little more than symbolic importance in modern Europe.

My thesis is that economic forces were conducive to political integration in the nineteenth century and favoured political fragmentation in the twentieth century. I will attribute the change to three principal sources; changes in the nature of government and government activities; to changes in the global economic environment; and to changes in the nature of economic development. I'll consider each of these headings in turn.

### ***The changing nature of government***

Max Weber famously defined government as the body which sustains a monopoly of coercion within a defined geographical area.<sup>2</sup> And the nature of nineteenth-century government followed that definition. Military expenditure was the largest component of government spending.

Typically the next largest component was interest, which represented the costs of past wars.

This view of the nature of state was associated with what Norman Angell would term 'the Great Illusion':<sup>3</sup> the idea that nations could increase their prosperity by gaining resources through territorial conquest. That idea has a long history. And in a world of little or no economic growth, where the principal means of enhancing wealth was to steal it from someone else, there is much sense in that view.

The industrial revolution, which made economic growth possible, and the rise of democracy, which required that national wealth be widely shared, would transform that position, (although it would only change perceptions more slowly). Wealth creation within the framework of security of property and institutions would provide a larger and more enduring source of prosperity than grabbing land, resources or treasure. The Great Illusion would, at least for Europeans, be finally dispelled in the ruin of Europe in 1945, the collapse of overseas empires that followed – and in the rapid recovery of European economies from the destruction of their infrastructure.

Conquest fails the modern test of cost benefit analysis. So what was once our Ministry of War is now our Ministry of Defence – and this change is not mere euphemism. The dominant items in government budgets today are not war and its aftermath, but social security, education and health.

The internal dimension of coercive power was as important as the external. Nineteenth-century government imposed a social and political order of doubtful legitimacy by force. This structure would, in Europe, be overtaken by the rise of democracy. Modern government rules by general consent, or at least acquiescence, and cannot rule without it: an elected (and re-elected) British government could not successfully implement a poll tax. Internal coercion is applied, essentially, to a psychopathic minority.

In describing government in this way, I am describing modern Western Europe. Most of the rest of the world is closer to Weber's description. There the state is usually a coercive agency deployed by, and largely in the interests of, a ruling group. The modern term 'failed state' – as in Afghanistan or Somalia - describes the absence of even a temporary monopoly of such coercion. Even in the United States, both the nature and the perception of government are different: a difference exemplified in the use of the phrases 'war on terror' and 'war on drugs'. Both of these phrases ring uncomfortably in the ears of most Europeans, who are doubtful that either problem can be solved by the exercise of external or internal coercive power.

It is obvious that these are very considerable economies of scale in coercion. Whether one is talking about legitimate governments or criminal gangs, there is a strong tendency towards monopoly in the exercise of coercive power. In fact an economist would naturally classify the exercise of coercion as a natural monopoly. It is prudent to join the

winning gang: and if the largest gang can use its power to gain more resources for itself, it can reinforce that power.

The natural monopoly did, in due course, come about. So we see a United States whose coercive power is many times that of any other country in the world, but gains no economic advantage from that power. The frustration engendered by possession of the most powerful military machine ever seen, superbly equipped to fight wars which it will never be asked to fight, is evident when that machine struggles to subdue Afghanistan.<sup>4</sup> The relation between economics and coercion in the modern world is more complex than was once thought.

But modern Europeans rarely want their governments to kick ass. Nor do they want to spend much on preparations for that activity. As a proportion of overall public spending, defence is well behind social security, education and health. What modern Europeans expect their government to do is to provide schools and hospitals, and to assure their physical and economic security. The notion of government as a hostile, coercive force, still widely encountered in the United States, has very little resonance in Western Europe.

European government is an economic agent, like Tesco. The ideological content is steadily draining from European politics: European leaders proclaim their competence rather than their convictions. As with Tesco we judge government mainly by the quality of its output and the perceived competence of its management. And in general, we judge it less favourably than we judge Tesco.

## ***Changes in the global economic environment***

These changes in the role of the state occurred, and were partly associated with, changes in the global economic environment. In the twentieth century, it became possible to build a prosperous economy based on mobile phones, on speciality chemicals, precision engineering – even to build an economy based on fish. If your principal product is fish, then as an autarchic state you are poor, but as a state in a global trading environment, you are rich. On this central truth of international economics have been built some of the greatest economic success stories of the twentieth century.

It is probably best to set Iceland to one side for the moment – though there are many lessons, positive and negative, from Iceland's recent and historic experience. But Switzerland and Finland, for example, were among the poorest countries in the world in the nineteenth century.<sup>5</sup> In the twenty-first century, they are among the richest. Inhospitable terrain, adverse climate, absence of minerals, are no longer disadvantages. The resourcefulness that such unfavourable physical factors engendered is a positive boon.

The key development making such growth possible has been the dissociation of trading alliances from military alliances. So long as the belief that prosperity depended on control over resources was prevalent, such an association was inevitable. In any conflict self-sufficiency in resources and industries was indispensable. A war-going nation needed to be self-sufficient in resources, food and industrial capacity.

Small states would not efficiently achieve such self-sufficiency. You cannot fight a war with fish. But the balance of advantages has changed. In the modern world, you cannot fight a war over fish. Although the coercive power of the United Kingdom was many times that of Iceland, in the cod war there was no practical means of exercising that power. That complex relationship between economic power and coercive force again.

Military power does not imply prosperity, or vice versa, and it is difficult to give intelligible meaning to the concept of national economic power. When the European Union is described as a free trade zone of 300m people, I understand the significance of what is said; when people who describe it add together the gross domestic products of the member states to talk about the size of the European economy, I am not sure what significance to attach to the answer. Certainly there is no relationship whatever between size of state and *per capita* income.

The prosperity of small states is a direct consequence of globalisation. Finland and Switzerland manufacture no cars, though they consume many. They do make textiles, but as high end speciality products for a world market. The automobile industry itself, the poster child of globalisation, is a surprising refutation of the common thesis that globalisation benefits the big battalions (I repeat the phrase as a reminder of how common is the mistaken use of military analogy).

In the 1960s, the three largest car manufacturers had more than half the world car market: today they have less than a third. The share of the largest ten producers once 85%, is now less than 75%. However it

is measured, concentration in the global automobile industry has steadily decreased since the market became global. The big beneficiaries from globalisation have not been GM and Ford, whose market shares have fallen considerably, but companies like Hyundai and BMW, which have been able to develop market niches on a world scale and have, in consequence, to become major producers.

In the modern global economic environment, economic success depends not on scale but competitive advantage. Such competitive advantage may be held by individual firms – the Disneys and Coca-Colas. More commonly in Europe, groups of related firms exploit local competitive advantages – southern Germany’s strengths in precision engineering, Korea’s high quality low cost production work force.

We should be looking at Scotland’s economic future in these terms. The lesson from the success of other small European countries is the opportunity to develop growth and prosperity on the basis of quite narrow sources of competitive advantage.

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

That brings me to changes in the nature of economic growth itself. We tend to think of economic growth as meaning more stuff. Our statistics focus on volume of output: environmentalists and anti-consumerists argue, as they have done for centuries, that excessive claims on world resources must bring economic growth as we have known it to a halt.

But at the levels of prosperity which have been achieved in modern Western Europe, growth is mostly about better, not about more. Richer people have better cars rather than more cars. Imelda Marcos may have owned 3000 pairs of shoes, but she had still not expanded her shoe collection in proportion to her income or wealth, and was rightly regarded as a freak. In Britain over the last thirty years, average household food expenditure has increased in real terms but our intake of calories per head has gone down. In Scotland today, obesity is a disease of the poor rather than of the rich.<sup>6</sup>

Better stuff not more stuff. That changes the nature of both private and public consumption. We require that more and more of our expenditure goes on the environment, in its broadest sense: on making the country we inhabit a nicer place to live. Our demands are increasingly for services rather than for goods and differentiated products tailored to our individual needs. That is why firms like BMW have prospered, and in the richest economies such niche firms have won sales from global mass producers. Their global success is a reminder that niche doesn't necessarily mean local. But it frequently does, especially in services. And services, to repeat, are what we now seek from government. Welfare, health, education: then we find defence: followed by transport, internet security, environmental services.

With privately produced goods and services, of course, the organisation of production adapts to the nature of the market. Boeing and Airbus assemble aeroplanes for the world from single facilities at

Seattle and Toulouse: haircuts are, and always will be, locally produced and delivered. The adaptation of the location of production to the needs of the customer is equally relevant to public consumption. The level of organisation appropriate for elementary education is lower than the level of organisation appropriate for higher education; most environmental issues are best dealt with at very local levels, but some at very aggregate levels. And so on.

Trade policy needs to be handled at high level. And so does monetary policy. In an era of global finance small states need to be part of a trade bloc and an actual or *de facto* monetary union. The experience of governments everywhere is that the levels at which it is most efficient to collect taxes are higher, on average, than the levels at which it is most efficient to make expenditure decisions. Even for large states, jurisdictional and enforcement problems for corporation tax and the taxation of income from capital are becoming increasingly severe. The mismatch between efficient tax raising and efficient expenditure allocation is why federal states generally have a system of distribution to state or provincial governments.<sup>7</sup>

That matching of service delivery to efficient scale changes what we mean by sovereignty. Weber's definition emphasised the coercive role of the state: along with coercion went monopoly. But if coercion is no longer the defining characteristic of state action, the requirement of monopoly falls away also. We can envisage multiple layers of government operating within a single local area, each delivering the

services in which they have a competitive advantage. And that is what, increasingly, we observe.<sup>8</sup>

The word sovereignty derives from the word sovereign. Nobles exercised authority at the authority of the king and governed their territories through that authority. The analogy in a world of many governments requires that both supranational and subsidiary governments operate under licence, as it were, from sovereign government

The reality of this is licence is obvious in the United States. The Civil War was an assertion of federal sovereignty. Within living memory, a conservative President used federal troops to enforce desegregation against the governments of southern states. In the same time scale, military force was used in the Belgian language riots in the 1960s and the Quebec emergency of 1973. But the world has moved on. It is hard to imagine these Belgian and Canadian events happening now. Belgium will continue to drift quietly apart and Quebec can secede if it wants.

In modern Europe power depends not on coercion but consent. The coercive power of the UK government might be used, as it has been in Northern Ireland, to enforce order in the face of violent disagreement within Scotland itself. But it is inconceivable that such power would be used to enforce UK authority in the face of disagreement between Scotland and England.

The powers of the Scottish government are those the people of Scotland want them to be. If it does not feel like this today, it is partly

because there is no real agreement among the people of Scotland on what they do want them to be. Scotland is still learning to come to terms with devolution and the Scottish government is still a long way from testing the limits of its authority.

We celebrate tonight the appointment of Neil MacCormick as President of the David Hume Institute. In an important contribution to this debate, MacCormick has written of post sovereignty, observing that neither the UK nor the EU can claim sovereignty.<sup>9</sup> Like virginity, he suggests, sovereignty can be given up or taken away without being bestowed on anyone else. But this analogy misses an important aspect of the issue. Virginity is an all or nothing concept, but sovereignty is not. If sovereignty is the capacity to act without the agreement of other governments, then every government, even that of the United States, faces serious limits on its sovereignty. I think the concept of sovereignty is a distraction from the main issues of debate, whether the debate is about Scotland's relationship with the United Kingdom or the United Kingdom's relationship with Europe. Modern European governments are economic agents and relationships between them are necessarily consensual.

And this is the answer to those who may have thought at the beginning of this lecture that the growing authority of the EU contradicts my thesis. The EU is a layer of government which appropriately wields authority on issues for which the appropriate level is the European. There

are not many such issues, but internal and external trade policy are at or near the top of the list.

That view of the EU sees it for what it is – a bureaucracy with limited, well defined functions. Not everyone wants to see it that way: officials and politicians who operate at the EU level naturally try to seize what powers they can from other levels of government, with modest success. They often seek to create the appearance of a traditional Weberian state at European level. That means European involvement, and ultimately control, of internal and internal security, foreign and defence policies. These advocates make little progress in these areas, and are likely to continue to make little progress.

But in Philip Bobbitt's words, I think 'it is a failure of imagination, however, to assume that the only thing that will replace the nation-state is another structure with nation-state like characteristics. It is in some ways rather pathetic that the visionaries in Brussels imagine nothing more forward-looking than the equipping of the EU with the trappings of the nation state'.<sup>10</sup>

Many people in Britain are still wedded to the concept of the modern democratic nation state as it developed through the nineteenth century. That modern state used democratic institutions to legitimise its monopoly of coercion. The post-modern state which is succeeding it is primarily an economic agent which gains legitimacy through its effectiveness in the delivery of services.<sup>11</sup> Many people in Britain remain hostile to the European Union and many of those who support the EU count themselves

among Bobbitt's pathetic visionaries who want to reproduce the nation-state at a European level.

The character of the modern state, as it emerged and grew in the nineteenth century, was predicated on the assumption that economic success was based on control over resources, and depended on market access which needed to be sustained by military power and diplomatic skills. For most Europeans that concept died in the bloody and destructive twentieth century.

But it is easy to understand why such a concept lingered, and lingers, longer in Britain. We were victors amongst that blood and destruction: but from a longer term perspective we were really among the losers of the two great wars of the twentieth century. The competition between nations that the modern concept of the state promoted was destructive of the very economic gains the modern state hoped to secure.

But the economic competition between European states in the twenty-first century is not about the capacity of mobilise divisions and dreadnoughts, but about the capacity to acquire economic rents by selling mobile phones and speciality chemicals. Economic success is not achieved by armies on broad fronts, but predicated on the development of relatively narrow competitive advantages in firms and groups of firms. In this modern competition, some of the major winners have been small states whose economies have been able to pursue their strengths without the paralysis created by conflict between large, established vested

interests: the paralysis the Thatcher government partially destroyed in the UK but is so evidently persistent in Europe's other large economies in France, Germany and Italy.<sup>12</sup>

The First Minister has sought to inaugurate a national conversation. That debate is largely about economics – and should be – but is about the wrong economic issues. If the debate about European integration lacks imagination, as Bobbitt asserts, so does the argument about Scotland's role in the world. That argument too rarely rises above the level of 'it's our oil' and 'you cannot survive without English subsidies'.

To listen to that argument is to hear the most powerful case against any Scottish autonomy at all. If our national conversation reduces to a preoccupation with whether we would get more money without working for it from international oil companies or the English taxpayer then we are truly not fit for self-government. My objective tonight has been to take that national conversation to another level.. I have tried to frame the debate in a context that looks to economic history to understand the present and looks to analysis to understand how that present might evolve.

I haven't had time to talk about the ways in which the welfare systems of smaller countries have exploited the greater sense of solidarity in smaller communities to provide economic security without creating the substantial excluded minorities which are characteristic of all the four larger economies. I have, however, talked about the ways in which the focus of the post-modern state has switched from internal and external

coercion to service provision: and about the subtleties of determining the level at which service provision should be matched to citizen – and customer – needs.

That emphasis on the customer reasserts the degree to which government is now an economic actor, rather than a political one. I have described how we judge the qualities of government by management and consumerist criteria rather than ideological and citizen criteria. I have described how questions about the efficiency of service delivery have replaced questions of legitimacy of the exercise of coercive authority as the questions that define the boundaries of state action. And I have looked to a future in which efficiency, as well as legitimacy, is defined by responsiveness to local and individual needs. These are the terms in which I believe we need to address Scotland's role in the world and its relations with Europe, the UK and the international community.

I look forward to a national conversation on these issues.

4241

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<sup>1</sup> Scotland is an interesting case study for competing theories of nationalism. The position taken here is closer to the ethno-nationalism of Smith (1998,2000) and Tamir (1993) than the account of Gellner (1983, 1997) which continues to stress the equation of state and nation.

<sup>2</sup> In his 1919 lecture 'Politics as a Vocation'

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<sup>3</sup> Angell (1913)

<sup>4</sup> See Hammes (2006): Smith (2006) provides a similar analysis from a UK perspective

<sup>5</sup> See Maddison (2001) for long term growth rates of many economies.

<sup>6</sup> Kay, (2008) *Financial Times* discourses the evidence on growth and resource use

<sup>7</sup> See the survey by Oates (1999)

<sup>8</sup> Alesina and Spolaore (2003) is the best source on the relationship between government function and state size

<sup>9</sup> For the debate on sovereignty and post-sovereignty inaugurated by MacCormick, see MacCormick (1999), Connolly (2002), and Tully (1995).

<sup>10</sup> Bobbitt (2002)

<sup>11</sup> The concept of the post modern state is first expounded by Cooper (2003). Bobbitt's market state has a similar character.

<sup>12</sup> The most powerful analysis of this remains Olson (1982)