

**Professor John Kay, “The Economics of Small Countries – Searching for Scotland’s Comparative Advantage”: 21 October 2008**

The title of this seminar seemed very timely coming as it did just a week after the effective nationalisation of the Royal Bank of Scotland and the about-to-merge Lloyds TSB and HBOS, and the apparent disintegration of what had seemed to be one of Scotland’s comparative economic advantages. But in fact John Kay’s talk took a quite different, much more historical and long-term perspective on his theme, stretching across the nineteenth and twentieth centuries.

The starting point was a contrast between the earlier of these centuries, in which states became larger, motivated by a perceived need to gain control of natural resources, backed up by military power; and the later, in which states grew smaller, but prospered nonetheless by way of narrow specialisation and free trade in a global economy, with economic dynamism and social cohesion going together. Kay argued that the concept of sovereignty, which had gone with the nineteenth-century state, was largely irrelevant to modern states driven by their economies. Market access was not bound up with political union, and the costs of coercive maintenance of that union might come to exceed any economic benefits.

Three changes were important in the emergence of these smaller states: (1) in what governments did; (2) in the global economic environment; and (3) in the nature of economic development.

- (1) Government, at least in Europe, had switched from principally coercive to economic functions, from compulsory to consensual modes: power was applied only to the psychopathic minority. The coercive model still had purchase outside Europe, however, and could even be exemplified by the USA’s “wars” on terrorism and drugs. But European governments were judged by the quality of their services and outputs, and the competence and efficiency of their financial management, just like a company such as Tesco.
- (2) Global trade liberalisation did not benefit only the big battalions. It also allowed exceptional prosperity to emerge based on the international pursuit of narrow local advantages, which could not be taken away by the exercise of coercive power.
- (3) Economic growth had come to be about better rather than merely more, responding to demand for differentiated goods and services tailored more to individual needs. Services in any event tend to have to be local.

All this meant that only in certain areas – monetary unions, federated states – was there a need for high-level aggregation. Different services needed different levels of government, varying from high to low and local. Defence exemplified the large, education the local. In this arguments about sovereignty were not very relevant. European Union levels of government might be needed for matters of trade, but not for foreign affairs or defence. But the European Union should not aspire to become a state. Likewise, within the United Kingdom, the debate should be framed around the levels of

government needed for the performance of economic functions, judged by consumer criteria rather than ideology or nationalism. Small-scale states led to economic success. Scotland's relations with the United Kingdom, the European Union and the rest of the world need to be assessed in these terms of what would best develop the country's competitive advantages.

A number of points were raised in the ensuing discussion.

In response to a question about the issues needing global government, Professor Kay identified carbon trading as one, but thought the financial market to be more difficult. There needed first to be discussion of what present regulation may have failed to achieve and what are the evils to be targeted. Another questioner argued that sovereignty was not just attached to the state and raised the issue of self-determination on issues of resources, dealing with multi-national corporations and nuclear weapons. Professor Kay pointed out that none of the issues mentioned were capable of control by any single actor; they would instead be resolved by negotiation between governments, industries and others. He took the follow-up point that this meant government being in essence a collective negotiator. In answer to a further suggestion that the contrasting fortunes of Scotland and some small states such as Norway showed the enabling capacity of sovereignty, Professor Kay pointed out that Norway's success resulted from negotiation and consent through international treaties and other instruments. Asked whether success was dependent on free trade and economic growth, Professor Kay replied that while a degree of free trade was needed for growth, competitive advantages were what promoted growth, not vice versa. A further question was whether government could have an impact on the creation of specialism, through for example tax regimes or subsidy. Professor Kay thought government's role was to look for really competitive industries which needed, not its money, but negotiators to help them in international trade, promotion, and the provision of skills and training. In Scotland that might include financial services, life sciences, energy services and premium food and drink. Turning to a question about the shape of government by which competitive advantages might be optimised, Professor Kay suggested that multiple levels would be involved, both above and below that of the present Scottish Government. He accepted a further point, however, that small states might be about more than economics. Asked whether in the light of his analysis Scottish universities were wise to seek further government funding rather than raising income through student fees, Professor Kay thought the answer was implicit in the framing of the question. On whether the Scottish advantage in the financial sector could survive the loss of head office functions, Professor Kay suggested that we would have to wait and see. Finally, Professor Kay responded to a question about how to reconcile the levels at which government would be most efficient with popular consensus and the democratic process by observing that coercion must be a minor element; but this was not the same as saying that we always arrive at the most efficient outcome through a process of negotiation.

As the summary above may suggest, the debate stimulated by Professor Kay's characteristically lucid and penetrating analysis was heavily informed by the current situation in Scotland, where the devolved government's ultimate goal is the re-establishment of an independent, sovereign state in the teeth of opposition from the

United Kingdom government, and disaster has over-taken two of the country's oldest and most significant financial institutions. But it seemed to this observer that while this context to some extent sharpened participants' focus it may also have narrowed their vision. Professor Kay was not setting out to answer the question of whether an independent Scotland would be better off, or, conversely, whether as a result of the financial meltdown Scottish independence had become unthinkable. The important point was really the general need – whether in the United Kingdom, the European Union or the world at large, and regardless of the current economic outlook – to analyse what government was for and what it could do, and how that might most appropriately be carried out at a variety of possible levels. That was necessarily a process for negotiation, and any apparent resolution would inevitably be merely a pause in the discussion. For a start, advantages may cease to be such – financial institutions may collapse or the oil run out – and the system(s) must retain capacity to respond to change and movement. In the end, implicit in Professor Kay's repeated doubts about the usefulness of ideas of sovereignty was a challenge to the very idea of the state as the basis for our structures of government. If that perception is right, then it is not so much whether the state should be large or small as the need for government and the varying levels at which it may be most effectively performed.

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