The Economics of Small States; Observations from Scotland

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In the nineteenth century, states became larger. Italy and Germany were unified. The British and French empires reached their zenith. The United States of America fulfilled its manifest destiny by expanding from sea to shining sea and fought a bloody civil war to remain a single entity.

In the twentieth century, states became smaller. The century began with the collapse of the weakest and most decayed empires, Turkey and Austria-Hungary, and ended with the collapse of the last great empire, that of Russia. 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.

Economics, and economic mis-understandings, provide much of the explanation of these stylised facts. The primary motive of the nineteenth century growth in the size of states 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 small states in 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.

Most people account for the political events I have described through the rise, and fall, of different kinds of nationalism. Nationalism is a complex mixture of ethnic and cultural affinities, rooted in a shared, and often largely apocryphal, history[1]. But while individuals have a need for group identities, 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 English empire and the apparently necessary protection of a great military power. Today, Scots no longer perceive these advantages and are, once again, primarily Scots.

Economic forces were conducive to political integration in the nineteenth century and favoured political fragmentation in the twentieth century. The principal sources of change were in the nature of government and government activities, which turned government from a fundamentally coercive activity into a deliverer of services many of which were best delivered locally; and changes in the global economic environment, which allowed trade blocs to replace empires and enabled small countries to compete globally on the basis of narrow competitive advantages.

The changing nature of government

Max Weber famously defined government as the body which sustains a monopoly of coercion within a defined geographical area[2]. 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 the state was associated with what Norman Angell (1913) would term 'the Great Illusion': 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 and 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 was, in Europe, 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 sensibly doubtful that either problem can be solved by the exercise of external or internal coercive power.

There are evident economies of scale in coercion. As a result, whether one is talking about legitimate governments or criminal gangs, there is a strong tendency towards monopoly in the exercise of coercive power. 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 at the global level. So we see a United States whose coercive power is many times that of any other country in the world, but gains little economic advantage from that power. The frustration engendered by possession of the most powerful military machine ever seen, superbly equipped to wage wars which it will never be asked to fight, is evident when that machine struggles to deal with the threats America actually perceives.

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 a shop or a phone company. The ideological content is steadily draining from European politics: European leaders proclaim their competence rather than their convictions. As with the output of businesses, 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 business.

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 speciality chemicals, precision engineering – even to build an economy based on fish. If, like Iceland, 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.

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. 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 could not efficiently achieve such self-sufficiency. You cannot fight a war with fish or whatever other product provides you with comparative advantage. But in the modern world, you cannot fight a war over fish either; the comparative advantage cannot be appropriated by a bully. Although the coercive power of the United Kingdom was many times that of Iceland, during the Cod Wars there was no practical means of exercising that power. That illustrated again the complex relationship between economic power and coercive force.

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 admiringly about the size of the European economy, I am not sure what significance to attach to the answer. Certainly there is no relationship 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 (the phrase itself is 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, 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 – like Disney or Coca-Cola. More commonly, groups of related firms exploit local competitive advantages – southern Germany's strengths in precision engineering, Korea's high quality low cost production work force. The general lesson for small states from the success of small countries, notably in Europe, is the opportunity to develop growth and prosperity on the basis of quite narrow sources of competitive advantage.

Lessons for the UK devolution agenda

Our demands are increasingly for services rather than for goods and differentiated products tailored to our individual needs. This is why firms like BMW have prospered, and in the richest economies such niche firms have won sales from global volume producers. The global success of these focused firms is a reminder that niche does not necessarily mean local. But it frequently does, especially in services. Services, to repeat, are what we now seek from government; welfare, health, education followed by defence, transport, internal security, and 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.

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.

The context set by the EU is thus a key part of the UK's devolution debate. 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 think 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 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, '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' (Bobbitt, 2002). Seen from this perspective, the arguments both of those who would like Britain to wrest sovereignty back from the EU and those who would like Scotland to reassert sovereignty against the UK are missing the point. They cling to a concept of the nature of government that is no longer relevant.

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. Education and health are necessarily delivered locally, while defence and borrowing benefit from economies of scale. Transport, energy and environmental issues all have aspects on small and grand scales. Industrial and business policies provide the most complex case. Economic competition between European states, and by European states in the global economy is no longer about the capacity to 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. On the other hand, the crony capitalism that is easily characteristic of an economy with a small elite which controls both politics and business - the problem so evident in the financial collapses in Ireland and Iceland - is an equally evident danger. Large and small states are both vulnerable to rent seeking, but in different ways.

Tax and welfare

Tax and welfare are everywhere among the most contentious issues in devolution. 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 from central to state or provincial governments.

The proposed devolution of tax powers to Scotland is the most significant outcome of the negotiations that followed the September 2014 referendum. The 1997 settlement gave Scotland (and Wales) negligible authority over either revenue or overall fiscal balance. The plans now in the course of implementation would raise the proportion of Scottish government expenditure (currently around £40bn) which is raised in Scotland to approximately 60%, although a substantial part is the assignment to Scotland of a pro rata share of UK VAT revenue.

The most significant area of new devolved authority is control over rates (though not structure) of income tax. This gives only limited real freedom to the Scottish government. Both major parties in Scotland are likely to want to spend more and to do so in a more progressive manner. But each of the following would have an impact of around £500m (a little more than 1% of Scottish government expenditure) on revenues:

- one point on basic (20%) rate
- five points on higher (40%) rate
- lowering the higher rate threshold by £10,000
- a zero rate on the first £1000 of taxable income[3]

Reversing the reduction in the additional rate from 50% to 45% (the additional rate is paid by around 15,000 people who currently report a principal residence in Scotland) would probably generate no extra revenue at all; only 1,000 of these additional rate taxpayers would have to discover that they were now resident in England to eliminate any revenue gain.

A draconian package which added five points to every rate and reduced the income level at which higher rate tax became payable to £30,000 (median earnings in Scotland are around £27,000,[4] broadly similar to the UK figure) would raise Scottish government revenue by less than 10% of its current expenditure, less than the amount by which per capita spending in Scotland currently exceeds that of the UK.

It is perhaps not too much of an exaggeration to say that the degree of commonality of welfare provision may now in advanced countries have replaced the monopoly of coercion as the defining characteristic of a state. States provide internal redistribution and mutual insurance between different regions, though the principles of such redistribution, and the extent to which such redistribution is between devolved governments or to individuals varies widely. 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 Europe's larger economies, especially France and the UK.

It is no accident that cross border welfare provision is the most contentious element in Britain's current pre-referendum negotiation with the EU. The planned revision of allocation of powers gives some, but very limited, discretion over welfare provision to the Scottish government. The scope for resentment within the United Kingdom if Scottish benefits differ materially - in either direction - from those operating elsewhere is obvious.

The distribution of UK-raised tax revenues, and the differentiation of welfare provision, are the most predictable elements of future dissension between Scotland and the UK as a whole in the immediate future. It is all about the money. The White Paper published by the SNP government ahead of the referendum, listing the policies which would be pursued in an independent Scotland[5], contains a lengthy wish list; a large majority are things which the Scottish government currently has the power, but not the money, to do. It follows that no degree of devolution could satisfy the demands made or expectations created.

Economics is the driver and the nationalist sentiment follows. These economic origins distinguish today's debates about devolution, statehood and sovereignty from those that dominated post-Westphalian Europe.

Notes

1. 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.

2. In his 1919 lecture 'Politics as a Vocation'.

3. Author's estimates based on HMRC statistics; https://www.gov.uk/government/collections/income-tax-statistics-and-distributions

4. See http://www.gov.scot/Resource/0044/00441139.pdf

5. See www.gov.scot/resource/0043/00439021.pdf

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