The Welfare State in Microstates and Small States

Paper for UNRISD Workshop on Social Policies in Small States
Geneva, 1-2 October 2007

Geoff Bertram
School of Economics and Finance
Victoria University of Wellington, New Zealand
Geoff.Bertram@vuw.ac.nz

Introduction

I have been asked to prepare for this UNRISD workshop a thematic paper on the welfare state, to sit alongside separate papers from other authors dealing with "consensual democracy and social corporatism", "social cohesion", and "power of jurisdiction".

That there will be a good deal of overlap across at least three of these four topic areas is immediately obvious. A welfare-state regime will usually go together with (and flow from) consensual democracy and social cohesion. "Power of jurisdiction", however, seems at first sight to have a separate identity, being concerned primarily with the relationship between the small state and the external world, whereas the other three topics could easily be construed as having more to do with the internal dynamics of the small state and the distribution of income, wealth and status within it.

This tension between the inward-looking discourse of the welfare-state literature and the outward-looking power-of-jurisdiction paradigm will be central to the provisional conclusions reached in this paper. Vital dimensions of social policy in small states, and especially microstates, are concerned with mediating linkages and relationships between the home-resident population (and its government) on the one hand, and the outside world on the other. These external linkages include:

- Fiscal funding: many small-state governments' ability to provide services, employment, and social transfers rests upon a transnational tax base (in which I include here those aid donors whose funding shows up on the revenue side of the government financial statements);

- Diasporas: microstate societies' emigrant diasporas remain effectively part of the client/target base for social policy over long periods of time, and the migration-remittance process is on occasion more important for economic development than the more familiar issue of domestic saving and investment. So long as diaspora members retain microstate citizenship and the right of return, they are effectively part of the set of individuals and groups to whom social policy applies, if social policy is understood as policy that shapes the long-term structure and functioning of all social groups for which the small state is their economic, cultural and political "home" and source of identity;

- Outside influences on the style and substance of social policy: social policy in microstates is driven to a considerable extent by external expectations, demands and pressures, imposed by international agencies, news media, and aid donors, including former colonial powers which see their own reputations bound up with the international "personalities" of their former colonies. The "power of jurisdiction" literature frames this as an area for opportunistic response by microstate policymakers; the "vulnerability" literature sees it as an aspect of dependency; the traditional welfare-state literature is apt to overlook the issue by simply assuming that social policy is driven by internal forces and coalitions.

A "welfare-state regime" will here be identified with a set of government policies and expenditures aimed to secure, to individuals or groups within the client community, measurable benefits - some material and some intangible - which those individuals or groups could not secure directly by participation in the market economy. Relevant functions of the state which can be categorised under this heading are the payment in cash of income transfers (often including part at least of the public-sector payroll) and the provision in kind of key basic services (health, education, housing).

At the outset, how are we to locate the "welfare state" concept relative to the general perception that small states and islands have, by virtue of their size (and in the case of islands, their "islandness"), a distinctive propensity to operate in a socially cohesive, consensual, responsive fashion? Use of the term "welfare state" carries the implication of formal institutions of government delivering social outcomes from the "top-down", and of a public sector which is clearly separate from the "private-sector" realm. In this paper, accordingly, I shall focus on formal institutions carrying out functions delegated to them by the social collective. This will require some discussion of the extent to which state policy exhibits autonomy relative to the operation of informal social and cultural networks, as well as of the extent to which local political movements and coalitions actually enjoy policy autonomy in a globalised economy.

Casual observation suggests that the formal public sector performs a wide diversity of roles in small states, and especially microstates. Some small island societies rely heavily upon government as the primary source of income and economic dynamism. Take, for example, Connell's (1992) account of Woleai Atoll in the Federated States of Micronesia, where two-thirds of households had members employed in government and the government wage and salary bill was ten times the size of revenue from the largest export product, copra. Here the public-sector payroll is a *de-facto* vehicle for income transfer payments.

Other small states, in contrast, have scorned reliance on the state to underwrite social welfare, and have given priority to private-sector initiative and income generation. Consider, for example, Kersell's (1987 p.106) description of the Cayman Islands: "Cayman is … a bastion of free enterprise,… of an earlier, purer form than Bermuda's. There is little creeping welfarism – no workmen's compensation, unemployment or social insurance, no community or youth service…"

These two examples reflect differences in the mix of public-sector versus private-sector transfers on the credit side of each territory's external balance of payments. Woleai's which in sovereign-state terms means the FSM's) balance of payments is heavily funded by official grants from offshore, and these funds flow into the domestic economy through the channel of public-sector wages and salaries. Government on Woleai is an intermediary in a much larger transnational "welfare state" arrangement under which external donors (mainly US taxpayers) sustain living standards on the island by government-to-government grants which have the character of social welfare transfers. To credit the Woleai public sector as a welfare-state in its own right would be to misconstrue its character, since the dynamics driving and funding its distributional activities are exogenous, not driven by any local democratic project of social construction.

In the Cayman Islands, the credit side of the balance of payments is equally dominated by transfers, but these transfers come through private-sector channels as a by-product of the country's role as an offshore financial centre. The economy is awash with private cash, which flows out to the wider population via employment in hotels, restaurants, shops, banks, company offices and other service providers. Government's role in this setting is residual, providing and policing the framework of law and property rights required for the financial sector to work efficiently, but with no redistributive role and only limited need for public provision of infrastructure. The absence of a welfare state in Cayman is as much an artefact of exogenous forces as is the presence of the expenditure side of a welfare state in FSM[1].

In order to identify and delineate a research agenda on the character and role of the welfare state in small states and microstates, this paper starts with conceptual issues, then considers some key hypotheses derived from or thrown up by a review of the literature, then foreshadows a possible future programme of historical and empirical work on microstate experience.

The conceptual issues are:

- What are the main working definitions of a welfare state?

- Where did the welfare state come from historically and to which particular historical problems was it a response?

---

[1] For more thorough discussion of the "MIRAB" character of the FSM economy see Cook and Kirkpatrick (1998).

- What sorts of states are <u>not</u> welfare states?

Key hypotheses from the literature are that

- The welfare state is a genus within which are found several species (Esping-Andersen 1990, 1996), which implies that we should be alert for new specimens with distinctive characteristics;

- the importance of the welfare state varies with population size: smaller states are argued to have larger public sectors with a more "defensive" social-policy role (Cameron 1978, Katzenstein 1985);

- small societies are more solidaristic and resourceful in their ability to solve social problems from below rather than from above (Richards 1982);

- the sort of institutions which are essential for successful development have far more of an activist-state flavour than the familiar Washington-consensus package (Khan 2007);

- the institutions that are observed today in small states and microstates are heavily conditioned by historical path-dependence, and in particular by colonial experience (Feyrer and Sacerdote 2006; Acemoglu et al 2007).

The discussion in the this paper will heavily qualify the second of these, strongly support the last, generally favour the fourth, and suggest that the third, if true, points to a need to escape from the rhetorical trap of "welfare state" terminology. In turn, this points to a need for more taxonomic research along the lines of the first hypothesis.

Defining and Characterising the Welfare State

The welfare state emerged historically as a top-down solution to the problem of how to secure social protection and security in the context of an urbanised capitalist economy, with large masses of wage-labour subjected to the depersonalising forces of a commodified labour market, and faced with serious hardship in the event that paid employment were lost for reasons outside the worker's control (injury, sickness, firm closures, layoffs in recessions).

Alongside the insecurity of wage labour once it had become separated from the rural economy (where subsistence could generally be secured by involution) were the issues of providing means of survival for the old (since retiring workers leaving the labour force moved into economically-idle status in the cities, often without support available from extended kin networks) and for the dependents of workers. These in turn led to public provision of health and education.

Barr concedes that (1986 p.5)

> The concept of the welfare state … defies precise definition… First, the state is not the only source of welfare. Most people find support through the labour market for most of their lives… Individuals can secure their own well-being through private insurance; and private charities, family and friends also provide welfare. Second it does not follow that if a service is financed by the state it must necessarily be publicly produced….. Welfare is thus a mosaic, with diversity both in its source and in the manner of its delivery….. [T]he term 'welfare state' can … be thought of 'as a shorthand for the state's role in education, health, housing, poor relief, social insurance and other social services' [citing Ginsburg].

Central to definition is the determination of some limit on what makes a state a welfare state, as distinct from other sorts of states. Proponents of the minimalist state in Enlightenment thinking, exemplified by Adam Smith's classic statement, sought to limit the state to three legitimate roles: defence, justice and public works (Smith 1776 Book IV Chapter IX paragraph 51):

> All systems either of preference or of restraint, therefore, being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord. Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men. The sovereign is completely discharged from a duty, in the attempting to perform which he must always be exposed to innumerable delusions, and for the proper performance of which no human wisdom or knowledge could ever be sufficient; the duty of superintending the industry of private people, and of directing it towards the employments most suitable to the interest of the society. According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings: first, the duty of protecting the society from violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expence to any individual or small number of individuals, though it may frequently do much more than repay it to a great society.

The key qualification in this passage from Smith is right at the start: "all systems either of preference or of restraint being completely taken away". The welfare state emerged from the attempt in European and North American societies (and especially in the United Kingdom) to achieve this removal of "preference or restraint" in order that the "system of natural liberty" could flourish. The welfare state was, somewhat ironically, entailed philosophically by the Enlightenment at the same time as it was driven into existence historically by the aftermath of the Industrial Revolution.

To remove all trace of "preference", the income distribution across classes and across individuals must be in accord with some underlying scheme of justice in distribution. To remove all "restraint", it is necessary to prevent or countervail any exercise of market power which impinges upon the efficient allocation and productive use of resources, as well as to end those government interventions which are designed to benefit particular vested interests at the expense of the nation as a whole. Income redistribution and market regulation become preconditions for Smith's system of natural liberty in any setting where the existing distribution of wealth is unjust or where monopoly imposes allocative inefficiency on markets.

To achieve Smith's preconditions of natural liberty in the historical setting of nineteenth- and twentieth-century England turned out to require a remarkable expansion of the scope and powers of the state, both to redistribute income in pursuit of social justice and to regulate monopoly in pursuit of market efficiency as well as social justice.

In addition, Smith's identification of public works as one of the three legitimate areas of state activity opened up an ever-growing category of public goods which are more efficiently provided by the public sector than the private, because of the likelihood of undersupply if such works were left to private initiative, and the opportunity to reap economies of scope and scale by universal public provision.

Smith's case for "public works" thus became, from the nineteenth century on, extended to the direct provision in kind of education, healthcare, and sometimes housing, for the mass of the population. (Direct provision in kind of these basic services was usually considered less fiscally burdensome than paying monetary income supplements to disadvantaged households and relying on them to spend the money wisely[2].)

Consequently when Barr (1987 pp.6-7) laid out his "minimum" statement of what the British welfare state comprised, he included not only social security benefits in money terms (in turn comprised of national insurance and non-contributory benefits) but also "benefits in kind" - the National Health system, the education system, and public housing. In sum he estimated the expenditure of "the welfare state" thus defined at £85,722

---

[2] Besanko and Braeutigam (2005) pp.113-116 show analytically the case for vouchers over subsidies in provision of publicly-supported housing. Mill (1910) pp.8-11 provides the classic statement of the argument that the benefits of education cannot be appreciated until education itself has been acquired, whence relying on the uneducated to choose education *ex ante* will be inefficient. "It is better to be a human being dissatisfied than a pig satisfied; better to be Socrates dissatisfied than a fool satisfied. And if the fool, or the pig, are of a different opinion, it is because they only know their own side of the question…. Capacity for the nobler feelings is in most cases a tender plant, easily killed, not only by hostile influences, but by mere want of sustenance; and in the majority of young persons it speedily dies away if the occupations to which their position in life has devoted them, and the society into which it has thrown them, are not favourable to keeping that higher capacity in exercise…. Utilitarianism … could only attain its end by the general cultivation of nobleness of character."

million, out of total public spending of £163,400 million in 1986/87 – roughly half.

Similarly Mkandawire (2006 p.1), having defined social policy as “state intervention that directly affects social welfare, social institutions and social relations”, includes among the elements of social policy “direct government provision of social welfare through, for example, broad-based education and health services, subsidies and benefits, social security and pensions, labour market interventions, land reform, progressive taxation and other redistributive policies”. Mkandawire notes that the development of social security was inextricably linked with the rise of successful industrial economies in Europe, and he makes a case for universalistic provision of social security as a key part of the effort to eradicate poverty in developing countries.

The notion that the state has responsibility for the welfare of its citizens became part of the UN’s 1948 *Universal Declaration of Human Rights* which sets out several specific sets of rights that are potentially relevant to this paper: the right to migration (Article 13), to “social security” and “dignity and the free development of personality” (Article 22), to a fair wage, equal pay for equal work, and the right to organise (Article 23); to “a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control’” (Article 25); to free primary education (Article 26); and to participation in cultural life and possession of intellectual property (Article 27).

Of these, Townsend (2007 p.vii) emphasises the right to social security and the right to an “adequate” standard of living. These define the minimal welfare state, forming Component I in my Figure 1 below.

Free primary education and access to advanced education, along with universal healthcare, gives a second component of a possible welfare state, Component II.

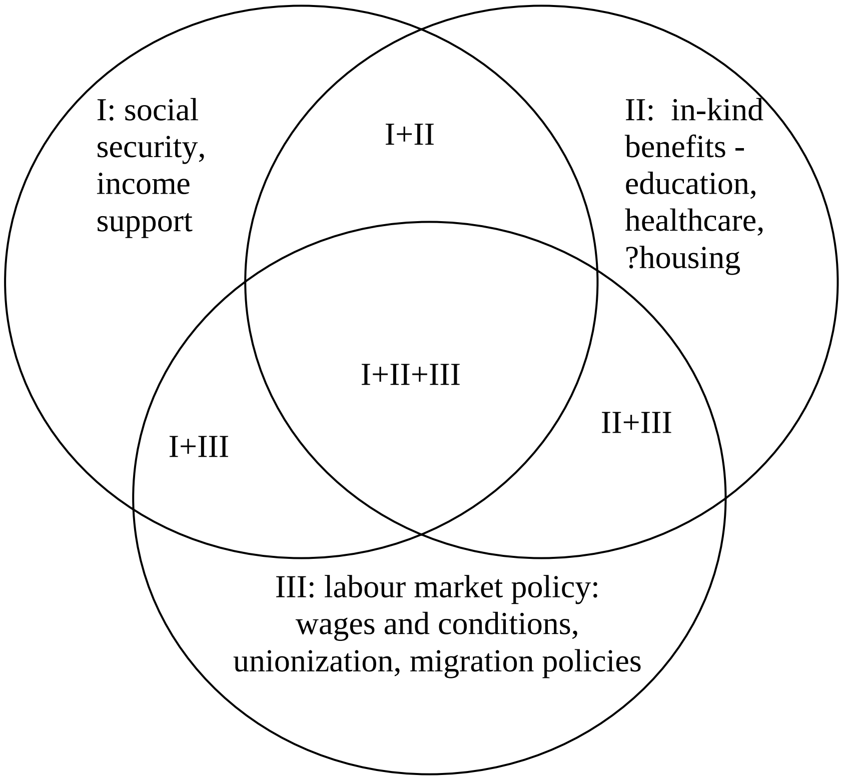
Adding some of the labour-market rights including migration, “just and favourable conditions of work”, and unemployment protection, adds component III.

In a welfare state of type I the state’s responsibility is to fund and organise income support for individuals or groups who have been unable to achieve “adequate” living standards in the marketplace.

In a welfare state of type II the state takes responsibility for underwriting the education (human capital acquisition) and health of new generations entering the labour force and the community – effectively an investment in the future and in widening people’s horizons.

Clearly there is a large zone of overlap, I+II, into which fall many actual OECD welfare states.

Figure 1
The Welfare State Menu



In region III of Figure 1 the focus of social policy expands to regulation of workplace practices and responsibility for the life-cycle prospects of the small state's citizens wherever they may be in the global system; in the overlapping parts of the diagram I+III, II+III, and I+II+III the social-security and education functions become linked to labour market dynamics and outcomes.

Pure type-III welfare states are rare amongst large economies, but could potentially be found in microstates in which living standards and life prospects hinge upon migration and in which public services are undeveloped or routinely accessed offshore. In the microstate setting, involvement of social policy with the labour market seems inescapable because of the widespread role of out-migration, both as a positive path of upward mobility and as a safety valve in the face of falling incomes, health, education or other indicators of social welfare at home. Migration potentially replaces a state-funded safety-net as a refuge for the destitute and the unemployed; reducing the residual social-welfare clientele of non-migrants for whom remittances are inadequate to meet the government's target living standard for its citizens.

It should be possible to map actual small states and microstates onto Figure 1 in much the same way as they are mapped onto modes of economic development in Bertram (2006) and Baldacchino and Bertram (2008).

Some Issues in the Literature

Multiple Species

The diversity of possible welfare-state combinations in Figure 1 above renders problematic any unified concept of "the" welfare state. Marshall (1950), writing in an era of strong policy consensus throughout the Western developed countries in favour of a government commitment to underpinning material living standards and providing citizens with access to education and healthcare as of right, saw the welfare state in terms of social citizenship and inclusion – a natural outgrowth of the democracy and rising living standards that were in turn the fruits of industrialisation.

Observing the emergent welfare states of the 1950s, Titmuss (1958) divided them into two generic species: residual and universalistic. Esping-Andersen (1990) offered a cross-cutting classification into three types of welfare states on the basis of their function in relation to the interests of key power elites and/or social classes: conservative (corporatist/Bismarckian), liberal, and social-democratic. In doing so he acknowledged the coexistence of a variety of historically based (path-dependent) models of the welfare state, and threw into doubt the "modernization" thesis of institutional convergence driven by the common imperatives of industrialised society.

Esping-Andersen's (1990) approach sits easily alongside the path-dependent model of historically-evolving class coalitions developed by Moore (1966) to account for institutional divergence rather than convergence over time, leading to a multiple-equilibrium capitalist world of coexisting alternative types of state. Esping-Andersen's subsequent (1996) comparative study of East Asian, Latin American and Eastern European states, against the benchmark of the apparently crisis-ridden European, North American and Antipodean ones, expanded the menu by adding an East Asian "Confucian" model of "familialistic welfare" (1996 pp.23, 267) and a "social investment" model with dynamic growth-oriented objectives rather than the traditionally more static, defensive concept of social security (1996 p.25).

At the broadest level, some writers seem to equate the welfare state simply with a large state sector, whether measured in terms of the tax ratio to GDP (Cameron 1978) or the ratio of state-sector employment to the total labour force.

Esping-Andersen (1990 p.19) cautions that "[a] focus on spending may be misleading. Expenditures are epiphenomenal to the theoretical substance of welfare states". And two pages later (1990 p.21), "The welfare state cannot be understood just in terms of the rights it grants. We must also take into account how state activities are interlocked with the market's and the family's role in social provision. These are the three main principles that need to be fleshed out prior to any theoretical specification of the welfare state". The promised theoretical specification, however, fails to materialise in any clearcut form in his book.

This leaves us with a problem when we come to interpret the tax and spending aggregates in the government finance statistics of small states. Looking back to the passage from Adam Smith above, his three duties of the sovereign defined the minimalist state of neoliberal theorists such as Nozick (1974). Defence of the realm, and a narrow reading of both administration of justice and conduct of public works, yield a state which exists purely to facilitate the individual in the pursuit of his or her own interests, and takes no responsibility for the level or distribution of income that results from the outcomes of individual actions. These functions constitute the non-welfare-state core of any government budget.

Starting from this core, it is common to assume that adding functions to the state's mandate is the main source of increases in the size of government, so that a large public sector relative to the economy as a whole serves as an indicator of a "welfare state"[3]. However, a simple ranking of states by the ratio of government revenue or expenditure to GDP will not necessarily identify welfare states at the top and neoliberal states at the bottom of the list. Some disaggregation will be essential, and this will require identification of those governmental functions which lie outside the "welfare state" envelope, as well as some qualitative account of what makes a small state a small <u>welfare</u> state.

Does Size Matter?

Prasad (2007 p.12) identifies Cameron (1978) as the starting point for the literature on the welfare state in small countries. Cameron's discussion of the expansion of the government is cast primarily in terms of the "extractive role of government" in raising taxes to finance ever-expanding activities in "provision of social services and of transfers for the unemployed, the sick, the elderly and the poor" (1978: 1243). Cameron addresses the question "whether the openness, or exposure, of a nation's economy to the international marketplace stimulates an expansion in the role of government" and answers in the positive (1978 Figure 2, p.1256), reporting a strong positive relationship between economic openness (the ratio of exports plus imports to GDP) and size of government: "apparently, governments in nations with open economies have sought to counter the effects of external dependence by expanding their control over the domestic economy through the 'nationalization' of a large part of consumption" (1978: 1253).

---

3 For example Prasad (2007: 12) cites Baker's (1992) finding that "countries with large public sectors have more equitable levels of prosperity amongst the population".

Cameron noted a general tendency for country size to be inversely related to openness, but then failed to control for country size in his regression analysis (1978 Table 1 p.1252) leaving it unclear to what extent the coefficient showing how the size of government relative to GDP varies with openness is actually instrumenting for size or for openness.

There is a familiar argument that governments in small countries can be expected to command a relatively large share of GDP simply because of indivisibilities in essential administrative functions, and diseconomies of scope and scale in the provision of public goods as country size falls. This is ignored by Cameron, as he conflates size and openness together in the concept "small open economies" for the purposes of his discussion of the link from openness to large government (1978 p.1256). On p.1257 he offers one potentially size-related proposition (relatively high levels of industrial concentration leading to an increased need for regulation) but again makes no attempt to separate out the effect of size from the effect of openness.

Cameron (1978: 1259) advanced also the proposition that the welfare state involves a trade-off of greater equality for lower investment and hence (by implication) slower growth. He presented, however, no empirical evidence for this last claim. A high tax burden to fund a large government sector is simply presumed to crowd-out private investment.

Cameron's causal chain runs from economic openness to a situation in which "governing elites are likely to feel compelled to use public policy to confront the challenges posed by the international economy", and hence to a relatively high tax burden to fund compensatory redistributive transfers in favour of the losers from openness. He identifies a variety of modalities through which this function may be performed but suggests that the options available to smaller economies are more limited simply because of their lesser weight in the world economy, which renders protectionism and neo-mercantilism difficult (1978: 1260):

> Governments use a variety of policy instruments to shelter their economies from the competitive risks of the international economy. Some states adopt explicitly neo-mercantilist policies (Katzenstein, 1978, pp. 879-920); others favor certain enterprises, whether in the private or public sector, as "national champions" (Vernon, 1974, Ch. 1); still others adopt a variety of industry-specific protectionist measures. Each type of policy has occurred in one or more of the nations considered here during the past decade. However, neo-mercantilism, support of "national champions," and protectionism are often ineffective for nations with open economies, given their small size relative to some of their most important trading partners. For such nations, another type of response is more feasible - one which is more defensive in character and involves a relatively large public economy. Governments in small open economies have tended to provide a variety of income supplements in the form of social security schemes, health insurance, unemployment benefits, job training, employment subsidies to firms, and even investment capital. Prompted in part by the incentive to maintain price competitiveness of export goods in the world market and accentuated by the social structural features generated by economic openness, this expansion of the role of government in the

> distribution and consumption of national income has dramatically enlarged the scope of the "tax state" in contemporary advanced capitalist society.

It is arguable that the absence from Cameron's country sample of any state with less than four million inhabitants leads him too readily to suppose that smallness necessarily reduces opportunities for strategic policies such as neomercantilism, national champions, protectionism or subsidies. The prominence of "defensive" political strategies of the sort directly identified with the orthodox welfare state – social security, unemployment benefits, employment subsidies to firms, and so on – towards the small end of Cameron's sample should not be mechanistically projected as a simple trend that continues below (say) the one-million mark. We return to this issue in a later section.

Katzenstein (1985, 2003) focuses on the emergence of a "partnership ideology" out of a set of converging objective factors common to small states in general:

> Small size was a code for something more important…. What really mattered politically was the perception of vulnerability, economic and otherwise. Perceived vulnerability created an ideology of social partnership that had acted like a glue for the corporatist politics of the small European states. (Katzenstein 2003 p.11).

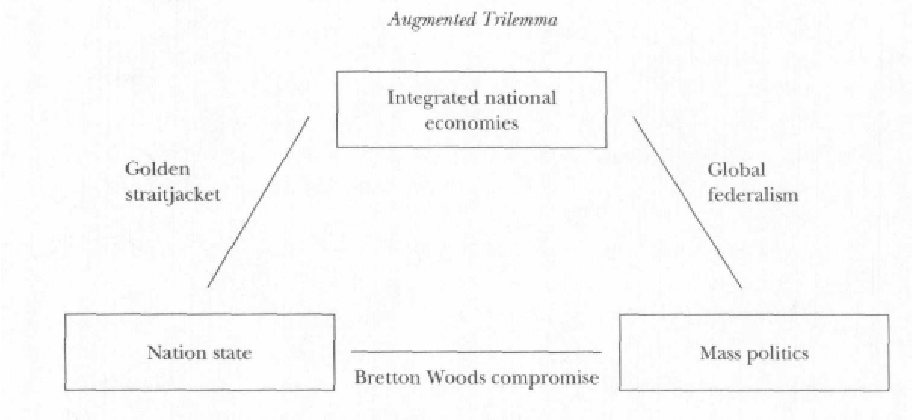
Small states, Katzenstein argues (2003 p.12), have exhibited "more international liberalisation, more domestic compensation and more flexible adaptation" on the basis of "the ideology of social partnership, the centralisation of politics and the voluntary and informal cross-issue policy coordination that set the small states apart from the large ones". The outcome is that "economic flexibility and political stability are close cousins" (2003 p.15), with political stability flowing from positive experience of the benefits provided by government. In European small states, "over half a century the policies of compensation have created a political base and enhanced trust in the polity", with "encompassing coalitions, many winners and a high-confidence politics" (2003 p.19).

These positive attributes of smallness are linked, in Katzenstein's account, to "the remarkable learning capacity of small states" (2003 p.17). As he sees it, "small size favours debate and learning and economic openness and international vulnerability mean control over fewer resources and the probability of greater loss. Hence the environmental conditions in which small states operate are particularly conducive for high learning" (2003 p.16). In addition, "small size permits the setting of clear priorities, being rigid on matters of priority and flexible on all others" (2003 p.24) – an ideal basis for negotiating with larger outside parties.[4]

---

[4] The theme of small-state responses to globalisation has remained of interest to economic historians See, e.g., the papers presented to the 13th Economic History Congress, Buenos Aires 22-26 July 2002, in the session **"**International integration and globalisation - governance strategies of small countries since the late XIXth century" http://eh.net/XIIICongress/cd/programme-sessions-detail3.htm . Several of these papers are shortly to appear in Margrit Müller and Timo Myllyntaus (eds.)

The issue of domestic policy response to globalisation appears also in Rodrik's (1997, 2000, 2005) discussion of what he terms the "political trilemma of the world economy" which, although not cast in terms of small economies, has resonance as a counterpoint to Katzenstein:



> The three nodes of the trilemma are international economic integration, the nation state, and mass politics. I use the term 'nation state' to refer to territorial-jurisdictional entities with independent powers of making and administering the law. I use the term 'mass politics' to refer to political systems where a) the franchise is unrestricted; b) there is a high degree of political mobilization; and c) political institutions are responsive to mobilized groups.
>
> The implied claim [of the trilemma] is that we can have at most two of these three things. If we want true international integration, we have to go either with the nation state, in which case the domain of national politics will have to be significantly restricted, or else with mass politics, in which case we will have to give up the nation state in favour of global federalism. If we want highly participatory political regimes, we have to choose between the nation-state and international economic integration. If we want to keep the nation-state, we have to choose between mass politics and international economic integration.
>
> …
>
> The essential point is this: once the rules of the game are set by the requirements of the global economy, the ability of mobilized popular groups to access and influence national economic policymaking has to be restricted…. The price of maintaining national jurisdictional sovereignty while market become internationalized is that politics have to be exercised over a much narrower domain. (Rodrik 2000: 180)

In an earlier work Rodrik (1997 Appendix 1) argued that in a globalising world the bargaining power of labour in each country would fall due to the ability of capital to move to locations which offered low wages with high productivity. This increase in the elasticity of demand for labour would reduce the ability not only of workers to organise to improve their

---

Pathbreakers: Small European Countries Responding to Globalisation and Deglobalisation, Bern: Peter Lang, 2007.

conditions, but equally the ability of their national governments to intervene in their favour, since footloose transnational capital can always move its operations to other, competing jurisdictions. This reasoning drove Rodrik to essentially the same conclusion as Katzenstein: the role of the state in a globalised economy becomes defensive and compensatory, refraining from confronting transnational capital in any pro-active sense but acting to top-up low wages by increased provision of transfer benefits in cash and kind. An expanding welfare state, in short, is conceived of by these authors as a reflection of weakness and dependency in the face of global forces which are beyond the local jurisdiction's power to control once the fateful choice of openness has been made.

Like Cameron and Katzenstein, Rodrik has a frame of reference which does not really extend to very small jurisdictions. He is thinking of political units of such a size that the labour force is fixed in place while capital and goods flow increasingly freely across the borders of the state. As labour conditions are then depressed by the shift of relative power from labour to capital, domestic redistributive policies become inescapable if national government is politically accountable to the local "losers" from globalisation. From here the logic of Rodrik's analysis leads him to an argument for global federalism, on the basis that only at global level can the balance between popular forces and capital be made more equal again.

In sum, there are a number of highly influential studies arguing that social corporatism and centrality of welfare-state provision (whether conservative, liberal, or social-democratic, in Esping-Andersen's (1990) typology) are most prominently encountered in smaller states for which globalisation presents the greatest instability and uncertainties, and where a political premium consequently attaches to social security in the face of adverse economic shocks.

However, these writings on "small states", which limit their case studies to countries well above the one-million mark, suffer from a lack of engagement with the experience of the large number of small jurisdictions which lie around or below that threshold. More representative of writers whose focus is at the very-small-state level is Richards (1982), who emphasises the prevalence of solidarity and consensus in small communities, quotes Benedict's dictum that "the criteria of scale for territories are land and population; the criteria of scale for a society are the number and quality of role relationships", and focuses on (Richards 1982 p.155)

> small-scale societies which are also micro-states – i.e. they are small, independent communities. They are tolerably self-contained in all social respects and inclusive, possessing their own organs of political representation and a self-conscious political identity.

The three case studies chosen by Richards were Faroe Islands, Malta and the Isle of Man – two of them sub-national jurisdictions (Faroes and Man) and one an independent nation-state (Malta).

Richards argues (1982 p.158) that

> the very fact of smallness in general terms means a tendency to greater homogeneity and particularism in society. This is not accidental; it follows on from the economic circumstances of small independent communities and is then accentuated by their social characteristics…. One of the cardinal features of life in small polities is the ubiquity of government. In a small state one cannot progress very far in any public or business activity without running into government in some shape of form…… [T]he whole social field is smaller. Whereas in a large-scale society political relationships are only partial relationships, they are much more inclusive in a small one…… A small governing elite is not, of course a peculiarity of small states. The relative power of decision-making in micro-polities tends to be compounded, however, by the coincidence and interlocking of role relationships among the established elite. Decisions in the economic, political, and legal fields have a pervasiveness which they lack in larger societies. This is because people are connected to each other in so many different ways and because the implementation of decisions can be more readily checked on and enforced by economic, legal, political and social pressures. This pervasiveness of politics and governmental authority … is one of the most marked features of such polities.

The legitimacy of political authority, a key factor in Katzenstein (1985), is inversely related to size, in Richards' view (1982 p.159): "it is often easier for the citizen of a small polity to perceive a relation between his own self-interest or understanding of 'the good' and that of the general or public interest….[L]arger states are more likely to generate multiple or pluralist loyalties to the various 'communities' within the wider society. By contrast in the small state the pressures towards conformity and homogeneity are more likely to produce a feeling of loyalty to the idea of a single integrated community."

Richards sums up (1982 p.170):

> It is the combination of the societal homogeneity and particularism associated with smallness; the strong self-conscious feeling of a collective identity asserted against the outside world; the more intimate relationship of state and society; the difference between formal constitutional theory and political reality; the prominence of personality politics; the peculiar nature of the political parties and cleavage systems; the relatively muted role of opposition – it is all these factors located together within a discrete area which give the micro-state its separate and distinctive character…. Persons whose loyalties are divided between the conflicting sides [in the deep conflicts that occur within these communities] have a vested interest in the maintenance of peace and the limitation of disharmony in a way that is not easily found in large scale modernised political systems.

This personalisation of policy suggests a significant discordance between the traditional welfare state of the large industrialised countries and the operation of policy in the micro-state setting. The traditional welfare state works with disembodied aggregates and is designed to affect large, homogeneous aggregates of citizens. As it emerged in its various forms in Europe and North America, it was a formal-sector set of institutions and practices applied in the context of broad impersonal forces - industrialisation, proletarianisation, commodification of labour, alienation and anomie.[5] The welfare state provided a substitute for the security that individuals had previously experienced through the informal mechanisms of family, clan, and community in pre-industrial society.

Because of economies of scale and scope, industrialisation has historically proceeded most dramatically in economies with population sizes above a threshold somewhere between 5 and 10 million. At these population sizes, statistical measures of welfare become relevant[6] and depersonalised policy interventions such as universal benefit entitlements become an efficient policy response. Similarly, as population size increases economies of scale in provision of public goods such as health and education become more obvious and it is efficient to install specialised facilities to cater to these needs with the citizenry enjoying access as of right (with or without payment of user fees).

In contrast, in small populations – think of Tuvalu with its 12,000-odd people – deprivation and its consequences are expressed individually and often confronted and resoved at the level of the village community. The need for the state to deal impersonally with large aggregates is reduced, meaning that universal benefits may be less effective than well-targeted support measures; while at the same time diseconomies of scale in providing specialised health and education facilities make it uneconomic to sustain a complete portfolio of services locally. (For specialised health problems, transporting the patient to a larger country's facilities is the rational course of action, and giving local students scholarships to pursue advanced study in larger countries makes more sense than trying to sustain world-class educational facilities at home. The increasing international mobility of people reinforces these considerations.)

Considerations such as the above suggest that the welfare state as an institutional construct in its traditional form is likely to be <u>less,</u> not more, prominent in very small than in larger polities, because

- The informal networks and personalistic support mechanisms for which the formal welfare state is a substitute are both more widespread and more likely to persist in very small states;

- Industrialisation and commodification of labour power tend to be limited in very small economies because of the absence of

---

5 Esping-Andersen (1996 p.3): "the advanced Western nations' welfare states were built to cater to an economy dominated by industrial mass production."

6 Esping-Andersen 1996 p.9: "[the welfare state's] ideals of universalism and equality emerged with reference to a relatively homogeneous industrial working class." The same author notes the organisation of welfare policies around a statistical one-income "model family". Both these are faced with disintegration in the post-industrial era.

economies of scope and scale in production and because of the incomplete proletarianisation of the labour force (which encompasses retention of membership in networks of kin, clan, village and community and the successful reproduction of informal support networks within society to provide the first line of social-security protection);

- Public-goods provision by the state becomes narrower in scope in very small communities because services requiring highly-specialised facilities (e.g. universities and research institutes) and/or subject to large economies of scope and scale (hospitals, specialist surgery) are more "footloose" (by footloose here I mean apt to locate in higher-yielding locations in larger countries, with the client base becoming internationally mobile in order to access the services – the service itself, in other words, is outsourced). Note here the funder-provider split issue: insofar as it is the willingness to fund health and education that distinguishes the welfare state, rather than the direct provision of the services in kind, to insist that provision of the service must take place within the home territory as a defining part of the definition of a welfare state is problematic.

To study the impact of globalisation on local politics, an ideal laboratory is in fact the very small economy and polity – "below the radar" for Katzenstein, Cameron and Rodrik. At the microstate level, countervailing power is exercised against the negative side of globalisation in a variety of ways that depart significantly from the defensive, redistributive welfare-state paradigm of those authors. First, labour becomes footloose alongside capital: workers move to high-wage locations as capital moves the other way; in the process forces are set up which should ultimately, if reproduced on a larger scale, tend to equalise working conditions across countries, not necessarily on terms wholly favourable to capital. This in essence is the outcome which Rodrik had in mind in his advocacy of global federalism, but the mechanism is the market process of migration rather than the political project of constructing a global state.

Second, the domestic tax base in microstates is commonly too small to sustain internal policies of redistribution. A self-contained welfare state requires some group in the community with high taxable capacity, from whom revenue can be extracted to pay benefits to the disadvantaged. But the essence of being small is that the entire population shares much the same set of circumstances, driven by external forces. The redistribution that is required to compensate for negative effects of globalisation is redistribution across countries, from the "winners" to the "losers" - not the redistribution within the nation-state that is the focus of Cameron, Katzenstein and Rodrik. The function of the would-be redistributive state in a microstate is to find ways to tax richer countries for the benefit of its client home community.

This involves a fundamental strategic re-orientation relative to the conceptual approach of Katzenstein. Far from being defensive, the successful micro-welfare-state is of necessity pro-active, seeking means of drawing upon the taxable capacity of the metropolitan economies to fund transfers to the microstate's citizens. The mechanisms through which this process of implicit international taxation operates are many and varied, but two are of clear salience: "aid", and trade subsidies by means of preferential trading arrangements.

Smallness becomes overwhelmingly important in this context. When a large country extracts economic surplus from a smaller one the process is generally perceived, especially by the population of the territory from which surplus is being removed, as a predatory exercise of superior power and force – what used to go by the name of imperialism. When the power relationship is reversed, however, the political dynamics are entirely different. Surplus flows (if and when it does) from the large and powerful to the small and powerless by the consent of the former's governing coalitions. Such consent is easiest to secure and sustain when the recipient population is small and the resulting tax burden on the donor population correspondingly light.

One empirical relationship to focus on here is the per-capita flow of aid to states of various sizes – not simply Cameron's (1978) relationship of tax revenues to GDP, although that will also be of interest. The difficulty of achieving high per-capita aid transfers to large populations is dramatically apparent in the case of India, which as Collier and Dollar (2002) have pointed out, has the strongest case for increased development aid on a marginal-productivity basis, but is in fact near the bottom of the global per-capita aid list because a population of one billion is intimidatingly large relative to the rich world's taxable capacity.

Fiscal Openness

Cameron's (1978) sample of 18 countries was limited to OECD member states, of which the smallest was Ireland, and the same limitation of case studies to states with more than three or four million population is found in Esping-Andersen (1990, 1996). In all these states, government is funded primarily by taxes on domestic output and income. There are no major aid-recipient governments and no major royalty-earners in Cameron's sample (his data end at 1975, when Norway was only just embarking on its role as an oil economy). To extend Cameron's regression results out of sample and down to microstates is likely to involve crossing an important qualitative threshold as external revenues rise in importance.

Very small territories run into tax resistance from rich donors only at far higher per-capita aid flows than do large territories, and this is one of the central fiscal facts of life in microstates, both for confronting crises and for underwriting the daily operations of government. Efficient financing of any welfare state involves securing revenues from those sources whose reaction to being taxed has the least impact upon levels of activity and allocation of resources in the local economy (the so-called "Ramsey principle"). Of all the sources of revenue available, the most efficient in this sense is offshore.

In the data, one relevant relationship to look for here is the proportion of total government expenditure that is financed by offshore grants as distinct from local taxpayers. A hypothesis following directly from the above discussion is that government payments of transfers in cash and kind to the home population will be greatest in those microstates which have the readiest access to offshore grant and/or royalty funding of the fiscal budget, while restrictions on such grant financing (and on other forms of rent transfers) will induce corresponding restrictions on the extent of welfare-state-type expenditures. The "financing question" long familiar in welfare-state debates in large countries moves, in the microstate setting, from a closed-economy to an open-economy frame of reference.

This is not a new phenomenon: Bertram and Watters (1985) noted a longstanding pattern of "colonial welfarism" in the Pacific since the 1940s, as colonial powers such as New Zealand and the United States sought to raise living standards in their territories, as part of the transition to decolonisation.

A central finding of the Bertram and Watters MIRAB research in the 1980s was the "jaws effect" that opened up in the government finances of New Zealand-related territories from the 1940s on as expenditures on public services and public-sector wages and salaries rose far above onshore revenue (cf Bertram 1993). To see whether the jaws effect appears historically elsewhere, and if so, whether it has persisted, requires further empirical work.

Economic openness is fundamental not just for size of the government, but for its role and modus operandi

As already emphasised, the standard conceptual starting point of the welfare-state literature is the closed economy of traditional mainstream economics. Capital and labour stand in contradiction to one another, in a social setting whose structural architecture is historically derived from preceding historical transformations in the agricultural sector and the structural shift of employment and output from agriculture towards industry. This economic transformation brought with it a transformation of class structure, with the rise of a large class of blue-collar workers, in the context of a wage-labour market which commodified the individual and his or her labour power. The welfare state in its various forms was an attempt to ameliorate various consequences of the unfettered operation of capitalist markets, especially factor markets. Esping-Andersen (1996) identifies two aspects in particular:

- The distribution of income via the market which left some groups and individuals unable to sustain a standard of living appropriate to membership in the modern society; this comprises both payment of monetary transfers to individuals who lack sufficient purchasing power, and direct provision in kind of services such as health and education which are often more efficiently supplied by the state than the market; and

- The decommodification of labour that becomes possible when individuals can sustain their living standards without recourse to the market, so that participation in the labour market becomes a matter of genuine choice rather than absolute necessity.

The microstate and small-island setting exhibits three major points of difference from the OECD societies reviewed by Esping-Andersen (1996):

- The fact that they are open, not closed, systems – open both to world commodity prices and to world factor markets - means that in place of a potentially-zero-sum[7] distributional contest between classes, there is far greater focus on negotiated deals with the outside world, from which the local economy and society can emerge collectively as winners. The payoffs to domestic cooperation are high when it wins spoils from outside, since the distributional question then becomes a matter of dividing up these spoils in a manner that sustains and reproduces the social and political compacts which underpin the microstate's negotiating position, rather than of taking from one group to give to another. The microstate typically pursues pareto gains for its citizens through redistribution of wealth from the outside world to the microstate. The central characteristic is the ability to manage domestic spoils distribution without creating local losers, even if there is disagreement over how <u>increments</u> to income and wealth are to be allocated across the population.

- The political histories of most microstates and small islands commence from major historical turning points, preceded by long histories of being embedded in colonial empires. The recent emphasis in the economic literature on the importance of path-dependence in explaining the economic and institutional structure, and economic performance, of contemporary political units (both national and sub-national jurisdictions) (Acemoglu et al 2002, 2007; Bertocchi and Canova 2002; Engerman and Sokoloff 1997; Feyrer and Sacerdote 2006; Hampton and Christensen 2002; Kapur and Kim 2006; Moore 1966; Nunn 2007) points to colonial experience and the decolonisation moment in each entity's history as fundamental to the present institutional setup. More recently the transition experience in Eastern Europe and the former USSR has

[7] One should not, obviously, always think of welfare-state distributional measures as zero-sum. The efficiency argument for state provision of basic services such as education and healthcare, which have strong public-good characteristics and where quality assurance can often be best maintained through state control, is often stronger in smaller communities than in larger. And welfare states do seem to have superior growth performance, enlarging the cake as well as re-cutting it. However, any scheme of redistribution must, by definition, have a source somewhere for each dollar that reaches a recipient.

been the focus of a similar literature for those societies (Blejer and Skreb 2001; Petrova 2007).

- De-commodification of labour is not as serious a social issue in small islands and microstates as it is in larger entities, because of the lesser degree of specialisation of labour and the greater residual linkages between urban and rural populations and economies. Until very recently in most cases, and still today in many, both blue-collar and white-collar wage and salary earners retain(ed) access to family enterprises in the subsistence sector to which they could retreat in times when alternative employment opportunities were closed to them. The employed worker in a microstate has generally two alternatives to accepting the existing employment conditions: emigrate, or involute. As time has gone on and transnationalisation of kin, community and village networks has proceeded, emigration has increasingly become the default strategy of choice, with involution as the final resort. The point here is that the existence of both these exit doors from the waged and salaried workforce makes the issues of wage levels and work conditions less politically stressful in small states. Especially when the migration door is open, local employers face the discipline of metropolitan wage rates as the benchmark for local rates of pay, giving workers greater leverage in bargaining than they could obtain by organised union activity in closed economies of the same size. Insofar as labour organisation in closed economies was intrinsic to the emergence of Esping-Andersen's "liberal" and "social democratic" welfare states, one should not expect to find the same political dynamics prevailing in microstates and small islands.

What, then, are the dimensions in which the microstate government or SNJ local authority plays an active role in determining and promoting the material and social well-being of its citizens in the microstate context? In short, what is the "crafting of political economy" in which the state is engaged? Baldacchino and Milne (1999 p.6) argue that while size per se has no particular direct significance on economic performance, for better or for worse, *policy* does matter, and small states seems to enjoy some comparative advantage in policymaking: "it is ironically the small and ignored jurisdiction that often understands the new ferociously competitive rules of international political economy faster than do the large, the comfortable, and the established." Many of the most valuable resources small island states are able to deploy to secure their living standards in the modern world economy are intangible and consequently hard to identify and measure: legal resources, culture, identity, geostrategic location, tourist-friendly climate in combination with currency and visa rules, tax-haven status, ship-registry provision, isolation itself (as in Nauru's provision of detention-camp facilities for would-be boat people captured by Australia – an echo of St Helena's role as Napoleon's prison), citizenship of larger countries (fundamental to migration access in many cases), membership of international trade treaties on favourable terms, and so on.

None of these look at first sight like welfare-state measures. The use of jurisdictional leverage to secure gains for the collectivity of citizens from participation in the global marketplace on favourably-negotiated terms is something to which all states and SNJs aspire, and indeed is one major reason for the existence of the modern nation state itself, as Rodrik (2000) notes. The important point is that very small states and SNJs seem to be better at this, and their economic and social strategies therefore revolve more around articulation of the local system with the global one, than around policing and ameliorating a closed-economy process of primitive capital accumulation.

A reflection of this comparative advantage is the relatively large role of transfers in financing the balance of payments in very small states. Bertram and Poirine (2007: 342) report that of 55 small (under one million population) island economies in their dataset, only twelve had earnings from commodity exports sufficient to fund more than 50% of total imports of goods and services. Fifteen were tourism-led; five funded their imports mainly from remittances and aid combined; another fifteen were aid-funded, eight relied on offshore finance combined with high-value tourism, and one (Kiribati) relied on rental income from a trust fund.

From the point of view of a study of state welfare provision, these data on balance-of-payments funding can be re-cast in terms of the long-standing literature on the financing of the welfare state (O'Connor 1973; Glenneister 1983; Barr 1987 Chapter 7). In a closed-economy framework this is primarily a matter of the tax burden to be borne in order to sustain various levels of welfare provision. In an open small-economy setting, in contrast, a substantial share of the fiscal revenues of government tend to come directly from externally-sourced transfers: development aid and budgetary grants, royalties on fisheries and other natural resources; rentals on military bases; philatelic and web-domain revenues. Correspondingly the government is able to sustain a level of expenditure well in excess of what could be afforded on the basis of domestic tax revenues alone.

Since there are also large private-sector transfer payments entering these economies in the form of remittances and investment income, the state is only one of (at least) two conduits through which international purchasing power is distributed to the home population. A potentially interesting question is whether the state's distributions are structured so as to equalise the final distribution of income and wealth, taking account of remittance incomes received and diaspora assets held by certain groups or families in the home population, or whether a universalistic approach applies to the distribution of the government's transfer income (with remittance and other privately-received income added on top).

In Tuvalu in the 1980s, for example, employment in the government sector seems to have been allocated on a universalistic basis so that most families had one public-sector worker on a wage or salary funded largely from offshore transfers (mainly aid). Families which also had a member overseas working as ship's crew would thereby gain some margin in their income for the period of the seafarer's (limited) term of employment.

It is likely to be worthwhile to assemble government finance statistics to identify

- the extent to which the total fiscal budget is funded from offshore via grants, royalties and subsidies;

- how aid is transferred into home purchasing power for the population at large – via straightforward transfers, via government purchases from local enterprises, or via direct payment of wages and salaries to individuals employed by the state sector?

- the proportion of government expenditure disbursed as wages and salaries to public sector employees and the relationship of the public payroll to the private-sector one;

- the share of particular public services supplied in kind (particularly education and health) in the government budget;

- the size of the public sector relative to the total economy.

A related issue is the elasticity of migration with respect to local incomes and opportunities. A high migration elasticity or propensity means that the level at which social-security income support levels (including possibly public-sector wage rates) are set will have a significant impact on the numbers of beneficiaries. When the size of the recipient group is endogenous because of migration, the relevant benchmark for "adequacy" of home living standards is apt to be not so much an absolute poverty line or assets line, but rather the opportunity value of labour on the world labour market – in which case the responsibility of the home government for providing transfer payments sufficient to achieve this living standard locally is diluted by the ability of individuals to secure their living-standards rights for themselves by moving.

For microstate citizens, the welfare state often operates at more than one level and in more than one location, since migration access to a metropolitan country (often the former colonial power) usually entails access to that country's welfare-state benefits. The welfare-state benefits to which Pacific islanders aspire are those available in Australia and New Zealand, and the issue is to get over whatever thresholds there are for entitlement to them.

Large diasporas gain their income from a mix of wage employment, business income, and welfare-state transfers in the host country, with the balance amongst varying by place and time. Remittances provide the financial linkage back to the home community – and fungibility means that remittances out of social welfare benefits are indistinguishable from those funded out of wage packets.

A research programme on the flows of funds passing through migrant diasporas would clearly be worthwhile, albeit challenging to undertake.

Activist vs Defensive/Compensatory Welfare States

Economists working on economic development have paid increasing attention to institutional and governance issues in recent years. Two themes in particular from that literature are relevant to the present enquiry:

- The distinction usefully made by Khan (2007) between "market enhancing" and "growth enhancing" governance arrangements;

- The importance of critical past events in a world of path-dependence, emphasised recently by Acemoglu et al (2007).

Both of these lines of thinking represent departures from the orthodox "modernization" model which associated institutional quality positively with level and growth of income per capita, and asserted a causal link back the other way from institutions to growth.

Khan suggests that the "new Washington consensus" (as described by Kremer 2004 p.222) has used the wrong set of explanatory variables in its regressions linking institutions and growth, and that the appropriate variables would be ones that measured the extent to which institutional arrangements are supportive of rapid learning, technological innovation, and political stability in the face of rapid externally-driven change.

Khan describes the central preoccupations of international agencies such as the World Bank and IMF in their promotion of institutional reform since the 1980s as the quest for "market-enhancing governance" which "focuses on the role of governance in reducing transaction costs to make markets more efficient." He lists five key governance goals in this policy framework:

- Achieving and maintaining stable property rights

- Maintaining rule of law and effective contract enforcement

- Minimising expropriation risk

- Minimising rent-seeking and corruption

- Achieving transparent and accountable provision of public goods in line with democratically-expressed preferences

All of these, it will be noted, fall within Adam Smith's minimalist state.

In contrast, "growth-enhancing governance focuses on the role of governance in enabling catching up by developing countries in a context of high-transaction-cost developing country markets. In particular, it focuses on the effectiveness of institutions for accelerating the transfer of assets and resources to more productive sectors, and accelerating the absorption and learning of potentially high-productivity technologies." Khan lists (2007 p.4) three key institution-building goals in this context:

- Achieving market and non-market transfers of assets and resources to more productive sectors;

- Managing incentives and compulsions for achieving rapid technology acquisition and productivity enhancement;

- Maintaining political stability in a context of rapid social transformation.

Khan's empirical work finds that market-enhancing governance, as measured by the standard Knack-IRIS[8] and Kaufman[9] indices of institutional quality, is statistically unable to distinguish between successful and unsuccessful developing countries[10]. In contrast, he argues, historical inspection of experience with "growth-promoting strategies" in the 1960s and 1970s strongly suggests that growth-enhancing governance was a necessary condition for the success of those strategies in East Asia, and its absence was the main reason for failure of the strategies in Latin America and South Asia.

The governance characteristics identified by Khan bear a clear family resemblance to the political features of successful small states in Katzenstein's work. Khan's checklist includes:

- Government agencies must be able to impose discipline in the policy-driven allocation of resources, in the same way as competitive markets discipline firms – that is, non-performance leads directly to withdrawal of resources (Khan 2007 p.16). "Growth-enhancing governance [in success stories] required monitoring resource use and withdrawing resources or support from sectors of firms that proved to be making inadequate progress …. The difficult part of growth-enhancing governance is to implement and enforce difficult decisions about resource withdrawal when performance is poor." (Khan 2007 p.17).

- There is no particular unique set of governance capabilities applicable to all countries; rather, "the governance capabilities have to be *appropriate* for ensuring that the growth-enhancing

8 Available at http://ssdc.ucsd.edu/ssdc/iri00001.html
9 Available at http://www.worldbank.org/wbi/governance/pubs/govmatters3.html
10 Khan (2007) points out that most regression studies include developed along with developing economies, and obtain strongly positive coefficients. His tables and scatter plots for 1980-1990 and 1990-2003 on pp.10-14, however, demonstrate that "converging" and "diverging" developing countries have essentially the same institutional scores, so that new-Washington-style institutional reform is not a sufficient condition for improved growth performance..

interventions are effectively implemented and enforced" (Khan 2007 p.16).

- Some minimum level of centralisation is required: "the agencies involved in monitoring and enforcement are sufficiently centralized to be able to internalize all the costs and benefits of implementing the strategy" (Khan 2007 p.17).

- Enforcing difficult decisions "requires a compatibility of the required governance tasks with the internal power structures of the country…. Growth-enhancing governance is helped if political factions are too weak to protect non-performing industries and sectors. If political factions are strong and there are many of them, its becomes relatively easy for failing firms to buy themselves protection by offering the share a part of their rents with factions that offer to protect them…. [However] growth-enhancing governance can be moderately effective even in the presence of strong political factions, provided there is a political settlement that allows the political demands of factions to be satisfied through centralized transfers. This can reduce the incentive of factions to capture rents by protecting rent-recipients who are willing to pay…" (Khan 2007 pp.17 and 19).

All of the above characteristics are associated with the social-corporatist arrangements common in small states. Smallness in and of itself imposes the centralisation, political settlement and unsustainability of factional resource battles that are the aims of Khan's governance programme.

Where the Khan approach (and the Katzenstein one, for that matter) falls short is in the implicit closed-economy starting point and the resulting focus upon growth in GDP per capita as the overarching aim to which strategies and governance arrangements are oriented. In the micro-state setting the relevant goals are growth in <u>consumption</u> and in <u>wealth</u> (access to long-term consumption) neither of which bear any necessary close link with domestic <u>production</u> as measured by GDP. Rents are fundamental to economic success, and for many microstates and islands these rents arise from external sources, not from internal transfers associated with the industrialisation-based growth strategies that remain the focus of Khan's account.

The rents arise not by a process of government protecting local firms, but rather from a partnership of government and local entrepreneurs to identify or create, and then occupy, high-value niches in the global economy. The resulting incomes are returned to the home economy through both public and private conduits: public-sector payments when the rents arrive in the form of aid or similar budgetary grants and/or royalties; and private when the transfers come as remittances of repatriation of income earned abroad. (As the Cayman Islands example at the beginning of this paper showed, the private conduit can be a full substitute for the governmental one.)

The details of economy-enhancing governance that apply to microstates and islands thus differ from the menus of Khan and Katzenstein in matters of detail, even if some of the central pillars are the same:

- centralisation of decision-making in a context of a strong consensual political settlement that underpins the legitimacy of the collective agencies that drive and direct resource allocation into high-productivity uses

- a focus on rapid learning and adaptation to respond to external threats and opportunities

- ability to take and implement hard decisions when external resources fall away.[11]

- Solidarity overriding factionalism at times of crisis, providing a resilience of civil society in the face of the sort of shocks that would destabilise politics in larger entities.

Conclusions

Looking in very small developing countries for replication of the Scandinavian model of a welfare state may not be a good starting point, especially if we give credence to the proposition that there is a qualitative threshold of smallness around the one-million-population mark, below which social, economic and political formations acquire a distinctive character (Bertram and Poirine 2007). The classic welfare states of Europe, and particularly the ones that are the subject of the work of authors such as

[11] It is noteworthy that the most dramatic fiscal retrenchment programmes, in terms of mass dismissals of public-sector employees, tend to be encountered in small-island settings, and are carried through usually with minimal political fallout. One example is the Tongan fiscal crisis of 2006: "Following a 6-week strike in July-August 2005, the government agreed to a settlement with the unions calling for civil service wages to be raised by 70 percent over two years, at a full annual cost of about 7 percent of GDP. To contain the medium-term fiscal impact of the settlement, the government launched a voluntary redundancy program in the last weeks of the fiscal year ending in June 2006, which resulted in an 18 percent reduction in civil service staffing - about 3 percent of Tonga's total labor force" (IMF 2007a p.4). An even more severe fiscal retrenchment and stabilisation programme was imposed by the Cook Islands Government in 1996: "Between March 1996 and October 1998, the number of public servants declined by 57 percent. The decline in GDP during 1995-1998 was not matched by an equivalent decline in per capita income. Following the public service retrenchments, many Cook Islanders exercised their option, as New Zealand citizens, to migrate. In the three years from 1996 to 1998, there was a net migration of 3,328 people - 18 percent of the 1995 resident population." (Asian Development Bank 2000 p.1; see also Gani and Duncan 2007). The retrenchment cut total government expenditure by one-third from the 1995/96 to the 1996/97 fiscal year, with wage and salary spending falling by 37%. Political stability and the electoral system were maintained without stress through this experience. (In Tonga the retrenchment was followed by riots in downtown Nuku-alofa, but these were linked more with political unrest over slow constitutional reform than with the fiscal squeeze.)

Katzenstein (1985, 2003) and Esping-Andersen (1990) are large relative to the group of states and territories that are the subject of this paper.

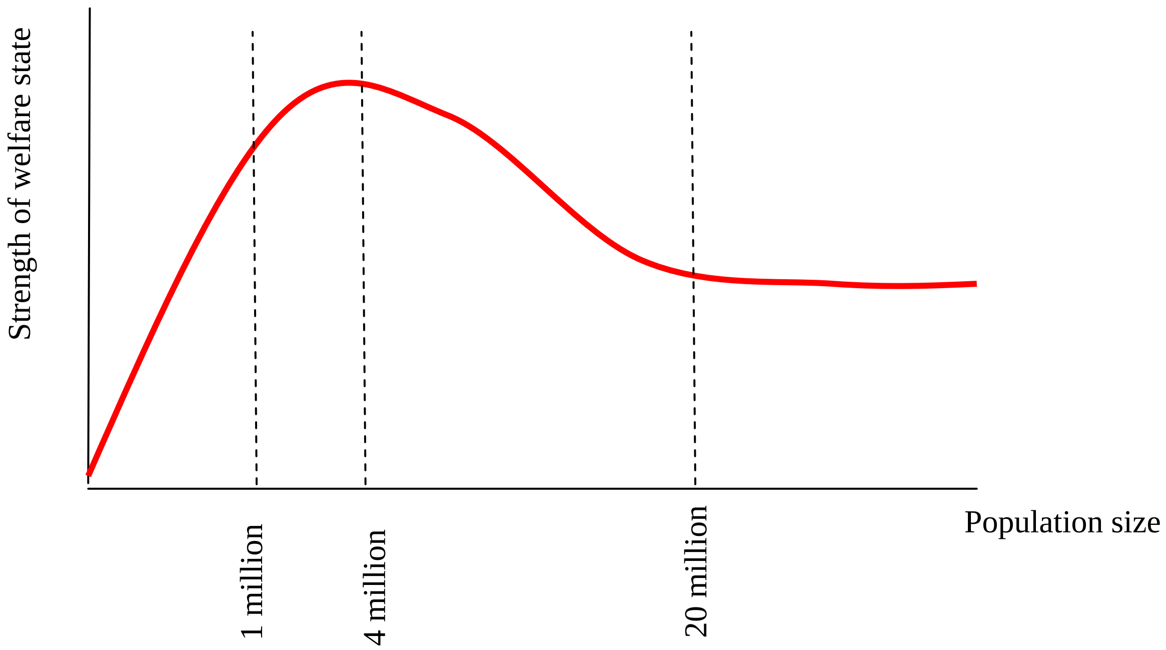
An immediate difficulty is the well-attested tendency of small polities to operate with a greater degree of informality and bottom-up social solidarity than is encountered in the larger industrialised nations where the welfare state originated.

A second major difference is history. The personality of the modern state in many very small jurisdictions flows from key events taking place in the era of global decolonisation from 1950 to the 1980s. Insofar as the nature and purposes of government in microstates have been defined historically by metropolitan powers exercising strong influence via colonial rule, aid provision, or ongoing political integration or quasi-integration (the French Dom-Toms being examples of the former, and limited self-government arrangements in the Pacific territories of the USA and New Zealand examples of the second), present-day micro-jurisdictions have a qualitative dimension to their policymaking that is reflective of the character of the metropolitan power in whose orbit they move. Not only is this a positive process connected with the maintenance of valued centre-periphery relationships; it is also the case that microstates are particularly vulnerable to metropolitan sanctions when they embark on an independent course of policy development, as Grenada discovered in 1983 (and the Cook Islands the same year, when New Zealand successfully threatened to withdraw citizenship from Cook Islanders if a fishing agreement was signed with Taiwan).

Third, since it seems that population size correlates positively with some forces which favour the welfare state but negatively with others, it is unlikely that a linear inverse relationship will exist between population size and prevalence of formal state welfarism across the whole size spectrum. The need for social security mechanisms may indeed increase as population size falls – but the endogenous ability of a society to respond to that need by informal bottom-up mechanisms based on family, community, and personal relationships rises sharply at some point on the descending-size scale, reversing the trend towards greater state provision of welfare and substituting away from such formal mechanisms towards a greater reliance on social networks and personalistic relationships.

This suggests the relationship between the prominence of welfare state institutions and population size shown in Figure 2:

Figure 2



The population thresholds in this diagram are impressionistic at this stage. Four million is the smallest country in Cameron's (1978) sample from which he derived a linear relationship between "openness" (the ratio of trade to GDP) and the share of tax revenues in GDP. Katzenstein's (1986) book similarly makes the case for smaller states to exhibit greater social cohesion and welfare-state corporatism on the basis of a survey of countries with populations above 3-4 million. Hence in Figure 2, over the range from 3-4 million and an arbitrary 20 million I have drawn the Cameron-Katzenstein relationship of welfare-statism rising as population falls. But to the left of 3-4 million I have hypothesised that this relationship cannot be extrapolated out of sample into the population size range below 1 million, because in this size bracket the countervailing advantages of informality and non-governmental social networks provide an increasingly efficient and cost-effective substitute for the welfare state.

In the extreme case at the left-hand end (Pitcairn Island with its population of around 50) it becomes meaningless to speak of a welfare state – Pitcairn Islanders routinely travel to Australia, New Zealand or the United States to access most government-provided services, and the means by which budgetary grants from New Zealand and the UK are disbursed to enable island residents to purchase the imported goods and services which underpin living standards on the island are not the formal benefits or social-security provisions of the welfare state, but highly-personalised payments for services provided.

If the extreme case is accepted as an anchor at the left-hand side of the diagram, it is obvious that the Cameron-Katzenstein relationship must have a maximum at some point – I have put it at around the 3-4 million mark in the diagram. A number of microstates around the one-million population mark have elements of partial-welfare-state about them (Mauritius, Fiji) but they are less clearcut than countries around the four-million mark.

Of eight states in the world between 1.8 million and 3.1 million population only two – Slovenia (2 million) and Armenia (3 million) – come close to the levels of industrialisation and economic development generally associated with the welfare state, and neither would qualify as a leader in terms of state welfarism. (Uruguay, a well-established welfare state from the early twentieth century, has 3.5 million; New Zealand and Ireland - both stronger welfare states than Uruguay, though similarly exposed to Katzenstein's external instability - have 4.1 million each.)

Fourth, although Cameron's story of a shift away from strategically pro-active structural policies towards defensive redistributive policies as size falls may work for OECD economies the size of Ireland and above, the relationship probably reverses as the analysis moves to microstates. The role of government in microstates has certainly a defensive dimension, but it also has a strategic orientation along the lines of Cameron's "national champions" model. The process of economic speciation described in Bertram and Poirine (2007) involves close interaction between government and private agents to achieve a coordinated focus on the promotion of a chosen leading sector, with an accompanying social compact around the distribution of the rents flowing from successful speciation.

Speciation policy is not defensively redistributive but pro-actively distributive, and this difference is significant in terms of common perceptions of the welfare state as a matter of "dependence". A familiar theme of the small-states literature is a lament about dependence; indeed, it forms an integral part of the "Vulnerability Index" used by the United Nations and the Commonwealth Secretariat. But dependence is not to be confused with success in securing rents: one is defensive, the second is pro-active, as is evident in Baldacchino and Milne's (2000) and Hampton and Christensen's (2002) case studies.

The colonial combination of a large governmental sector relative to population, plus often a limited productive base, left microstate economies that were inevitably quite reliant upon state employment and aid funding, but it is not necessarily helpful to construe the issue in terms of compensation for the social costs of globalisation. Globalisation under colonialism, after all, consisted of insertion of the state as a carrier for capitalism, albeit accompanied sometimes by regulatory measures to restrain the worst excesses of metropolitan capital. In the post-colonial era there was enormous structural inertia associated with the large public sectors left behind; such institutional persistence is the essence of path-dependence.

There is, in short, scope for comparative investigation of what the balance is in individual microstate policymaking between the defensive and the pro-active bases for government transfers, in-kind benefits, and wage/salary payments. This clearly will require a good deal of sifting of country-specific qualitative as well as quantitative information, of the sort available in the IMF *Staff Country Reports*.

Insofar as the pro-active model plays an important role, the use of the descriptor “welfare state” in relation to microstates may well be undesirable and counterproductive. The term “welfare state” is by now well embedded in a discourse of defensive redistribution in the face of threats posed by global capitalist development. Conceiving of microstate jurisdictions as mini-welfare-states could well impact negatively on donor perceptions and hence operate against the actual jurisdictional resourcefulness of microstate governments.

References

Acemoglu, D., Johnson, S. and Robinson, J.A., 2002, "Reversals of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution", *Quarterly Journal of Economics* 117(4): 1231-1294, November.

Acemoglu, Daron, Simon Johnson, James A. Robinson and Pierre Yared, 2007, *Reevaluating the Modernization Hypothesis*, NBER Working Paper 13334, August.

Asian Development Bank, 2000, *Country Economic Review: Cook Islands*, October 2000, CER: COO 2000-10, at www.sprep.org/att/IRC/eCOPIES/SUSTAINABLE%20DEVELOPMENT/ADB/CI_%20economy_%20report.pdf

Baker, Randall, 1992, "Scale and Administrative Performance: the Governance of Small States and Microstates", Chapter 1 in Randall Baker (ed), *Public Administration in Small and Island States*, West Hartford, CT : Kumarian Press, pp.5-25.

Baldacchino, Godfrey, and Geoffrey Bertram, "The Beak of the Finch: Insights into the Economic Development of Small, often Island, Economies", forthcoming in *Small States: Economic Review and Basic Statistics* 12, 2008.

Baldacchino, Godfrey, and Simon Milne, 2000, *Lessons from the Political Economuy of Small Islands: The Resourcefulness of Jurisdiction*, Basingstoke: Macmillan and New York: St Martin's Press.

Barr, Nicholas, 1987, *The Economics of the Welfare State*, London: Weidenfeld and Nicholson.

Bertocchi, Graziella, and Fabio Canova, 2002, "Did Colonization Matter For Growth?: An Empirical Exploration into The Historical Causes of Africa's Underdevelopment" *European Economic Review* 46(10): 1851-1871, December.

Bertram, G., 2006, "The MIRAB Model in the Twenty-First Century", *Asia Pacific Viewpoint* 47(1):1-13.

Bertram, G. and R. Watters, 1985, "The MIRAB Economy in South Pacific Microstates", *Pacific Viewpoint* 26 (2): 497-519, September.

Besanko, D.A. and R.R. Braeutigam, 2005, *Microeconomics*, Hoboken NJ: Wiley and Sons, second edition.

Blejer, Mario I, and Marko Skreb (eds), 2001, *Transition: The First Decade*, Cambridge MA: MIT Press.

Cameron, D.R., 1978, “The Expansion of the Public Economy: A Comparative Analysis”, *American Political Science Review* 72(4): 1243-1261.

Collier, P. and Dollar, D., 2002, “Aid Allocation and Poverty Reduction”, *European Economic Review* 46: 1475-1500.

Connell, John, 1992, “The Backdoor of Bureaucreacy: Employment and Development in Yap and Woleai Atoll, Federated States of Micronesia”, Chapter 12 in Baker, Randall (ed) 1992, *Public Administration in Small and Island States*, West Hartford, CT: Kumarian Press, pp.174-192.

Cook, P. and C. Kirkpatrick, 1998, “Labor Market Adjustment in Small Open Economies: The Case of Micronesia”, *World Development* 26(5): 845-855, May.

Engerman, Stanley L. and Sokoloff, Kenneth L., 1997, “Factor Endowments, Institutions, and Differential Paths of Growth Among New World Economies: A View from Economic Historians of the United States”, in Haber, S. (ed) *How Latin America Fell Behind: Essays on the Economic Histories of Brazil and Mexico*, Stanford University Press, pp.260-304.

Esping-Andersen, Gosta, 1990, *The Three Worlds of Welfare Capitalism*, Princeton NJ: Princeton University Press.

Esping-Andersen, Gosta, 1996, *Welfare States in Transition: National Adaptations in Global Economies* London: UNRISD and SAGE Publications.

Feyrer, James, and Bruce Sacerdote, *Colonialism and Modern Income – Islands as Natural Experiments*, NBER Working Paper 12546, September 2006.

Gani, Azmat and Ron Duncan, 2007, “Constructing a governance index for Cook Islands, 1985–2005”, *Pacific Economic Bulletin* 22(2): 104-118, peb.anu.edu.au/pdf/PEB22-2Gani+Duncan.pdf

Glenneister, H., 1983, *Paying for Welfare*, Oxford: Martin Roberston.

Hampton, Mark and John Christensen, 2002, “”Offshore Pariahs? Small Island Economies, Tax Havens and the Reconfiguration of Global Finance”, *World Development* 30(2): 1657-1672, February.

IMF, 2007a, *Tonga: Staff Report for the 2007 Article IV Consultation*, 25 June 2007, http://www.imf.org/external/pubs/cat/longres.cfm?sk=21293.0 .

Katzenstein, Peter J., 1985, *Small States in World Markets: Industrial Policy in Europe*, Ithaca: Cornell University Press.

Katzenstein, Peter J., "*Small States* and Small States Revisited", *New Political Economy* 8(1): 9-30, 2003.

Kersell, John E., 1987, "Government Administration in a Small Microstate: Developing the Cayman Islands", *Public Administration and Development* 7(1): 95-107, January-February.

Kersell, John E., 1992, "An Overview of the Concept of Smallness", Chapter 20 in Randall Baker (ed) 1992, *Public Administration in Small and Island States*, West Hartford, CT : Kumarian Press, pp.290-302.

Khan, Mushtaq H., 2007, *Governance, Economic Growth and Development Since the 1960s*, DESA Working Paper 54, ST/ESA/2007/DWP/54, August, http://www.un.org/esa/desa/papers/ .

Kremer, Michael, 2004, "Comments and Discussion (Ending Africa's Poverty Trap)" *Brookings Papers on Economic Activity* 2004(1): 217-222, Spring.

Marshall, T.H., 1950, *Citizenship and Social Class* Oxford: Oxford University Press.

Mill, John Stuart, 1910, "Utilitarianism", in *Utilitarianism, Liberty and Representative Government* Everyman Edition, London: Dent and Sons.

Mkandawire, Thandika, 2006, *Transformative Social Policy: Lessons from UNRISD Research*, UNRISD Research and Policy Brief 5, Geneva.

Prasad, Naren, 2007, *Research Proposal and Project Document: Social Policies in Small States*, UNRISD, Geneva, June.

Moore, Barrington Jr, 1966, *Social Origins of Dictatorship and Democracy; Lord and Peasant in the Making of the Modern World*, Boston: Beacon Press.

Nozick, Robert, 1974, *Anarchy, State and Utopia*, Oxford: Blackwell.

Nunn, Nathan, 2007, "Historical Legacies: a Model Linking Africa's Past to its Current Underdevelopment", *Journal of Development Economics* 83(1): 157– 175, May.

O'Connor, James, 1973, *The Fiscal Crisis of the State*, New York: St Martin's Press.

Petrova, V.P., 2007, “Civil Society in Post-Communist Eastern Europe and Eurasia: A Cross-National Analysis of Micro- and Macro-Factors”, *World Development* 35(7): 1277–1305, July.

Raadschelders, Julie Bivin, 1992, “Definitions of Smallness: A Comparative Study”, Chapter 2 in Randall Baker (ed) 1992, *Public Administration in Small and Island States*, West Hartford, CT: Kumarian Press, pp.26-33.

Richards, Jeffrey, 1982, “Politics in Small Independent Communities: Conflict or Consensus?”, *Journal of Commonwealth and Comoparative Politics* 20(2): 155-171, July.

Rodrik, Dani, 1997, *Has Globalization Gone too Far?*, Washington, D.C. : Institute for International Economics.

Rodrik, Dani, 2000, “How Far will International Economic Integration Go?”, *Journal of Economic Perspectives* 14(1): 177-186, Winter.

Rodrik, Dani, 2005, “Feasible Globalizations”, in Michael M. Weinstein (ed.), *Globalization: What’s New?*, New York: Columbia University Press.

Schahczenski, Jeffery J., 1992, “Development Administration in the Small Developing State”, Chapter 3 in Randall Baker (ed), *Public Administration in Small and Island States*, West Hartford, CT: Kumarian Press, pp.34-48.

Selwyn, Percy, 1980, “Smallness and Islandness”, *World Development* 8(12): 945-951, December 1980.

Smith, Adam, 1776, *An Inquiry into the Nature and Causes of the Wealth of Nations*, first published 1776, Cannan edition (1904).

Titmuss, R., 1958, *Essays on the Welfare State*, London: Allen and Unwin.

Townsend, Peter, 2007, *The Right to Social Security and National Development: Lessons from OECD Experience for Low-Income Countries*, Issues in Social Protection Discussion Paper 18, Social Security Department, International Labour Office, Geneva, January.