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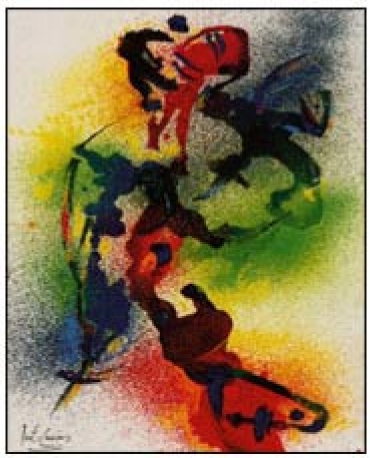

Why small is beautiful. The economic and social policy performance of small vs. big states in Europe

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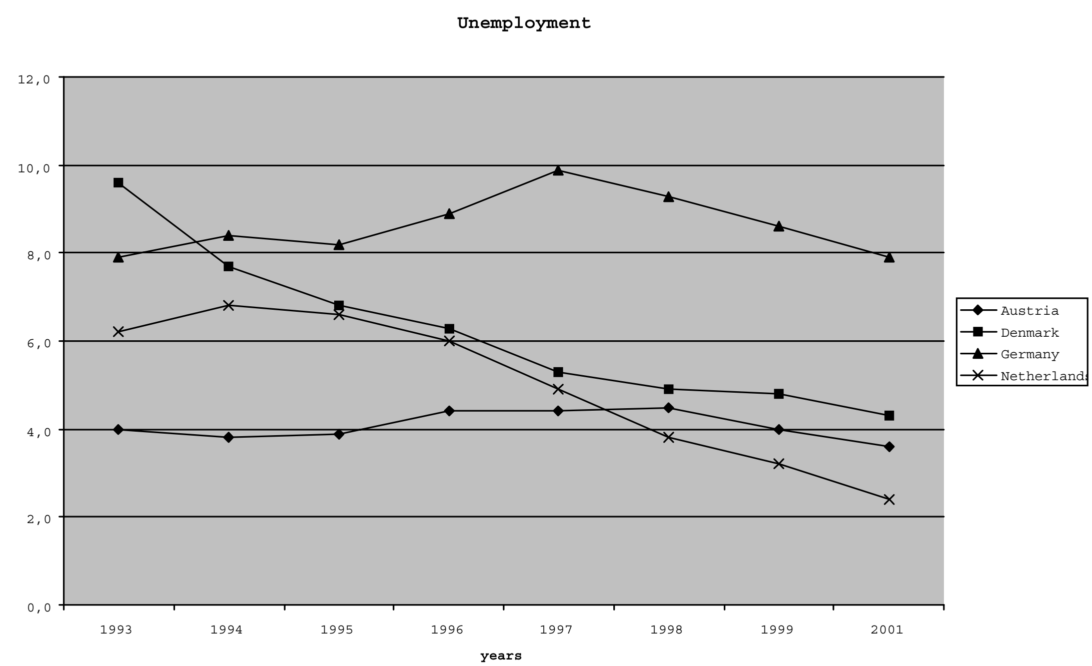
Preliminary remark: Since I do not want to compare small vs. big states in Europe (EU) by means of statistical analysis, I draw on four „cases“ to support my argument on the advantages of small states: Germany, as a big state with big economic problems, and Austria, Denmark and the Netherlands, as small states with divergent, but far above average labor market, general economic and social policy performances. I have not included in my comparison some smaller European states that are not doing so well: Greece, Portugal as southern European states, but also Belgium and Finland. For various reasons, I belief that these are atypical cases. Some other small states not included would strengthen my case (Switzerland, Sweden, Ireland). Austria, Denmark and the Netherlands, apart from being relatively small, represent three distinctive welfare state types, institutional configurations and economic policy traditions. This is how it should be since I want to argue that decisive for performance are less the type of welfare state or characteristic political traditions, but rather size as it affects communication and coordination.

Diagram 1:



1. Introduction:

A casual inspection of diagram 1 generates my question: Are there comparative advantages of smallness? Despite all the discussions about different welfare regimes

or economic "models" which highlight the relevance of variables like partisan politics, economic and other institutions, or even economic style and culture for economic performance, it may well be that the most important variable explaining the differences in economic and welfare state performance could be simply size.[1] Perhaps small countries can do things that big countries cannot do which improve their economic and social policy performance?
In what follows, I will first describe basic economic differences between Germany, as a big country, and three of its smaller immediate neighbors, as successful small countries. All four countries are members of the EU. With the exception of Denmark, they are also parts of the EUROzone. Thus, all countries share a supranational framework. They also have democratic political systems and quite similar cultural backgrounds. The general descriptive part (2) will be followed by a more detailed description of labor market performance (3). After that, I will discuss what I call the "standard economic hypothesis" according to which the better performance of small countries is attributed to their possibilities of effectively, if implicitly, devaluating their currency relative to the big country: Slower wage growth generates cost advantages. These translate into export gains that, in turn, support higher growth and higher employment (4). A brief look at wage and other data will suffice to reject this hypothesis. In the theoretical parts (5-7) of the paper I will go through alternative explanations and arguments to arrive at the following result (to be underpinned by further empirical evidence): Small countries respond to external shocks or internally generated problems more adequately than big ones because the relevant agents are involved in denser, more transparent communication based on mutual assumptions of reliability and a shared sense of vulnerability. In other words, the comparative advantage of smallness is to be found not so much in the ease of achieving consensus based on cultural homogeneity and/or trust, but is rather due to the combination of a shared sense of vulnerability and the lower level of fragmentation in networks of communication, coordination and cooperation.

2. General Description:

Table 1: Territory, population, population density

	Territory (sq. km)	Population 2001 (mill.)	Population /sq. km
A	83,9	8,12	97
DK	43,1	5,35	124
NL	41,5	15,98	385
D	357	82,26	230

There are clear differences both in territory and in population size if one compares A, DK, NL on the one, D on the other hand. However, for believers in hydraulic theories of social development, it should be noted that NL has by far the biggest population density, Germany being second in that respect.

[1] Evidently, size itself is decomposable in two respects, size of territory and of population, with population density forming an important link between the two. We will have to see whether that matters.

Table 2: Open economies:

	Exports (% GDP)	Imports (% GDP)
A	32,5	35,3
DK	35,8	34,2
NL	52,3	48,4
D	28,8	25

All four economies are "open" in the sense of having large shares of imports and exports, with the NL in the lead and Germany – as can be expected from a bigger country – as the laggard.[2] As seen from Germany (in 2001), German imports from the Netherlands are second only to France and amounted to about 8,5% of total imports, Austria is ranked 8th and Denmark is ranked 19th among German import trading partners. German exports to the NL (rank 5) amounted to 6%, to Austria (rank 6) to 5%, to DK (rank 16) to 1,5% of total exports. The NL have a trade surplus, whereas Austria and DK have trade deficits with D.

Table 3: GDP and Growth

	GDP per capita (ppp US$)	GDP growth 1991-2001
A	27800	2,1
DK	29900	2,3
NL	28600	2,8
D	26500	1,5

Source: OECD in Figures, 2002 (ppp – purchasing power parities)

Growth in the 1990s has clearly been lowest in Germany. After unification, Germany also fell behind its neighbors in terms of GDP per head. DK has become one of the richest countries in the OECD. Productivity measured as GDP per hour worked is hardly different between the four countries (in 2002, they form a cluster together with the United States at a level of $38-40 ppp, Weekly Indicators, Economist, Feb 22, 2003). The differences in GDP per capita are therefore largely due to differences in the mobilization of the workforce (see below).

Since, according to standard economic wisdom, the state impairs the efficiency of market economies, it should be of interest that the role of the state – here estimated by the size of total tax burdens - is clearly more extensive in small economies, with tax burdens (measured as shares of GDP) clearly above OECD and EU averages (whereas the German tax burden is slightly above the OECD, but clearly below EU average).

[2] The compensation hypothesis (Katzenstein 1985: 200) according to which the degree of welfare provision by the state is a function of the exposure to world market risks, may or may not hold. This is not the issue here. The issue is the possibility of combining strong welfare states with strong employment and general economic performance.

Table 4: Total Tax Revenue (per cent of GDP)

	1981-85	1986-90	1991-97
A	41.0	41.7	43.2
DK	46.3	49.8	48.8
NL	44.8	45.9	44.5
D	37.8	37.7	37.8
OECD	33.8	35.5	36.1
EU	38.6	40.4	40.9

Source: Carey/Tchilinguirian 2000.

Public spending for welfare state programs follows the same pattern. Small states redistribute a higher share of national income, with observable effects in terms of reducing income inequality and poverty.

Table 5: Public Social Expenditure (per cent of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Austria	25,00	25,26	25,89	27,28	27,98	27,88	27,91	27,04	26,80
Denmark	29,32	30,17	30,72	32,35	33,06	32,41	31,69	30,66	29,81
The Netherlands	27,92	28,10	28,56	28,76	26,85	25,92	25,29	24,88	23,90
Germany	20,29	24,17	25,56	26,37	26,19	26,70	28,06	27,74	27,29

Source: OECD 2001

As in most OECD countries, spending peaked in the mid 90s. German welfare state spending is an exception. It increased significantly and continously after unification and has reached the level prevalent in the small countries. The Dutch welfare state has become leaner—apparently with some consequences in terms of increased inequality, as we will see below.
However, contrary to the theoretical construct of an equity-efficiency tradeoff (Okun 1975) popular among economists, the better economic performance of small countries has not prevented them from realizing more income equality and less poverty than Germany:

Table 6: Inequality and Poverty (mid 90s, changes from mid 80s to mid 90s)

	Gini	Change Gini	P90/P10	Change P90/P10	Poverty rate	Change poverty rate	Poverty gap	Change poverty gap
A	23.8	0.2	3.0	0.1	7.4	1.3	20.7	-6.9
DK	21.7	-1.1	2.7	-0.2	5.0	-2.0	25.2	-0.8
NL	25.5	2.1	3.2	0.4	6.3	3.2	27.3	-5.1
D	28.2	1.7	3.7	0.4	9.4	3.0	25.4	2.5

(All indicators measured in terms of disposable incomes of individuals in households using the OECD equivalence scale and a 50% of median income poverty threshold; *poverty rate* – percentage of population below poverty threshold; *poverty gap* – distance of average poverty incomes from threshold, source: Foerster/Pellizari 2000, p. 75, 94f.)

Again, the evidence is clear. German incomes are more unequal, the share of the poor population is larger than in the smaller countries. The Netherlands are exceptional with regard to the high poverty gap: Although the poverty rate is three percentage points lower than in Germany, the income distance between the poor and the non-poor is larger in the Netherlands. Considering the development of income inequality and poverty, the reduction of social expenditure appears to have contributed to the increase in poverty in the Netherlands, whereas the relative increase in welfare state spending in Germany has not prevented the increase in poverty. Denmark clearly went against the general trend of increasing inequality and increasing poverty from the mid 80s to the mid 90s. Thus, the Danish performance is most remarkable, even in the eyes of the OECD: „Denmark was one of only a handful of countries in which the dispersion of disposable incomes did not increase from the mid-1980s to the mid-1990s (Burniaux et al., 1998; Förster and Pellizzari, 2000). Consequently, disposable incomes were more evenly distributed in the mid-1990s than in any other country... Heady et al. (2001) finds that the Danish transfer system is the most effective among the EU countries in reducing inequality.... redistribution also takes place through public consumption... The value of public services consumed by low-income households is double that of high-income households" (OECD 2002:47).

An interesting point here is that while (in 1995) Denmark was number one in terms of gross public social expenditures (37.6 per cent of GDP at factor costs), Danish *net* social expenditures (including publicly mandated expenditures) are not extraordinarily high (26,9% of GDP, rank 4 behind Sweden, Germany and Belgium among OECD countries in 1997, with an EU average of 24,5 % (Adema 1999: 30)).

One could go on and compare inflation, budgetary deficits, public debt, etc. But on almost any count, the economic performance of small countries in Europe has been better than that of big countries.[3] So let us turn to the theme dominant in the public debate about "models" and "miracles": Labor markets.

3. Labor markets

With regard to unemployment in the 1990s, all three small countries have demonstrated that unemployment can be drastically reduced or held to low levels without following the standard neo-liberal recipe endorsed by the OECD, etc.: Deregulate, reduce public spending, lower labor protection and unemployment benefits, in short: Roll back the welfare state.

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[33] The Maastricht Criteria concern fiscal and monetary performance. Differences between Germany and the smaller countries are unimpressive except for advocates of very low inflation – like the Bundesbank and the European Central Bank. Both do not seem to hesitate when it comes to exorcising the inflationary demon with an additional dosis of unemployment. Exceptionally low inflation in Germany has the effect that similar nominal interest rates will amount to higher real interest rates.

	Budget surplus/deficit			Gross public debt			Consumer prices			Long term interest rates		
							(annual % change)					
	1998	1999	2000	1998	1999	2000	1998	1999	2000	1998	1999	2000
Austria	-2,3	-2,1	-1,3	64,0	64,6	64,4	0,9	0,6	2,3	4,7	4,7	5,6
Denmark	1,2	2,8	2,6	55,8	52,6	48,5	1,8	2,5	3,0	4,9	4,9	5,7
Germany	-2,1	-1,4	1,4	60,7	61,1	60,0	0,9	0,6	1,9	4,6	4,5	5,3
Netherlands	-0,7	1,0	1,8	66,6	62,9	56,9	2,0	2,2	2,5	4,6	4,6	5,4

(Data source: Statistisches Taschenbuch 2002)

Table 7: Unemployment rates (standardized)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Austria	4,0	3,8	3,9	4,4	4,4	4,5	4,0	3,7	3,6
Denmark	9,6	7,7	6,8	6,3	5,3	4,9	4,8	4,4	4,3
Germany	7,9	8,4	8,2	8,9	9,9	9,3	8,6	7,9	7,9
Netherlands	6,2	6,8	6,6	6,0	4,9	3,8	3,2	2,8	2,4

OECD 2002. April 2003 rates (Eurostat July 1, 2003) are: Austria 4.3, Denmark 5.0, Germany 9.4, Netherlands 3.9

Austria has consistently kept unemployment low, Denmark succeeded in reducing unemployment to less than half of the level of the early 90s, the Dutch “employment miracle” started much earlier and has brought back full employment (defined since Beveridge as 3% unemployment or below). German unemployment remains high despite gradual improvement since 1998.
Unemployment rates, even if standardized, can be misleading as comparative indicators of the state of labour markets. The more comprehensive issue is the use a society makes of its labour potential.

Table 8

Employment Rate (per cent of population,15-64)

	1997	*1998*	*1999*	*2000*	*2001*
Austria	67,2	67,4	68,2	67,9	67,8
Denmark	75,4	75,3	76,5	76,4	75,9
Germany	63,8	64,7	65,4	66,3	65,9
Netherlands	67,5	69,4	70,9	72,9	74,1

OECD 2002

Germany has the lowest employment rate, although the difference to Austria is small. Denmark, like the other Scandinavian countries, traditionally has high employment rates, mostly due to the early start of women entering the labor force. The increase of the employment rate in the Netherlands is remarkable, all the more so since part of the “Dutch disease” in the seventies and eighties was the massive early exit of people from the labor market. This exit option has been narrowed. However, the increase of the Dutch employment rate mostly reflects women entering predominantly part-time employment. Since in measuring employment rates, people with very low working hours are counted just as those with full-time jobs, it is illuminating to estimate employment rates in terms of full time equivalents:

Table 8a: Employment Rate (full time equivalents)

	1996	1997	1998	1999	2000	2001
Austria	63,6	63,5	63,8	63,9	63,5	63,4
Denmark	67,0	68,1	67,8	69,7	69,3	69,8
Germany	58,7	57,9	57,7	58,3	58,6	58,6
Netherlands	52,1	54,1	55,6	56,8	57,5	58,1

(population 15 to 64, source: European Commission: Employment Report 2001)

Due to the high share of part-time employment, the Dutch full time equivalent employment rate, although clearly increasing, is still lowest in our comparison.

The effect of a high share of part-time employment can also be observed if we consider average annual working hours (data for Austria are not available): While the general trend of decreasing working hours in most of Europe still seems to continue, the roughly 10 per cent distance between Dutch average annual hours and those in Denmark and Germany remains.

Table 9

Average annual hours worked per person in employment

	1997	*1998*	*1999*	*2000*	*2001*
Denmark	1520	1519	1544	1504	1482
Germany	1513	1507	1496	1482	1467
Netherlands	1380	1364	1345	1381	1346

(OECD 2002. Handle with care: The OECD warns that data on working hours are not comparable)

Table 10
Labor mobilization

	1997	1998	1999	2000	2001
Denmark	55,1	55,0	56,8	55,2	54,1
Germany	46,4	46,9	47,0	47,2	46,5
Netherlands	44,8	45,5	45,8	48,4	48,0

Calculated as in Nickell 1997: employment rate*average annual working hours/2080 hrs; assuming maximal annual working hours to be 40 hrs in 52 weeks.

Pulling together information on workforce participation and annual working hours, we can construct an index of workforce mobilization, measuring the degree to which available potential labor supply is activated in the formal economy. In general, labor mobilization has been low in the continental European welfare states (as is still true for Germany and less so for the Netherlands). High values prevail in the United States and Japan, due to much higher average annual working hours. Danish values reflect the Scandinavian (political and cultural) emphasis on high workforce participation of women and men alike, including older workers, notwithstanding the trend of decreasing working hours. In contrast to the other countries, the employment rate of women has been decreasing in Denmark in the 1990s, but it is still significantly higher. The increase in the Netherlands appears to be most impressive, but a recalculation in terms of full time equivalents shows that while Dutch women are highly involved in the labor market in terms of numbers of persons they are (still) much less so in terms of working hours.

Table 11

Employment rate, women 15-64 years

	1990	*1997*	*1998*	*1999*	*2000*	*2001*
Austria	55,4	58,5	59	59,7	59,7	59,8
Denmark	78,5	69,4	70,3	71,6	72,1	71,4
Germany	56,7	55,3	56,3	56,8	57,7	58,6
Netherlands	53,1	56,9	58,9	61,3	63,4	65,3

OECD 2002

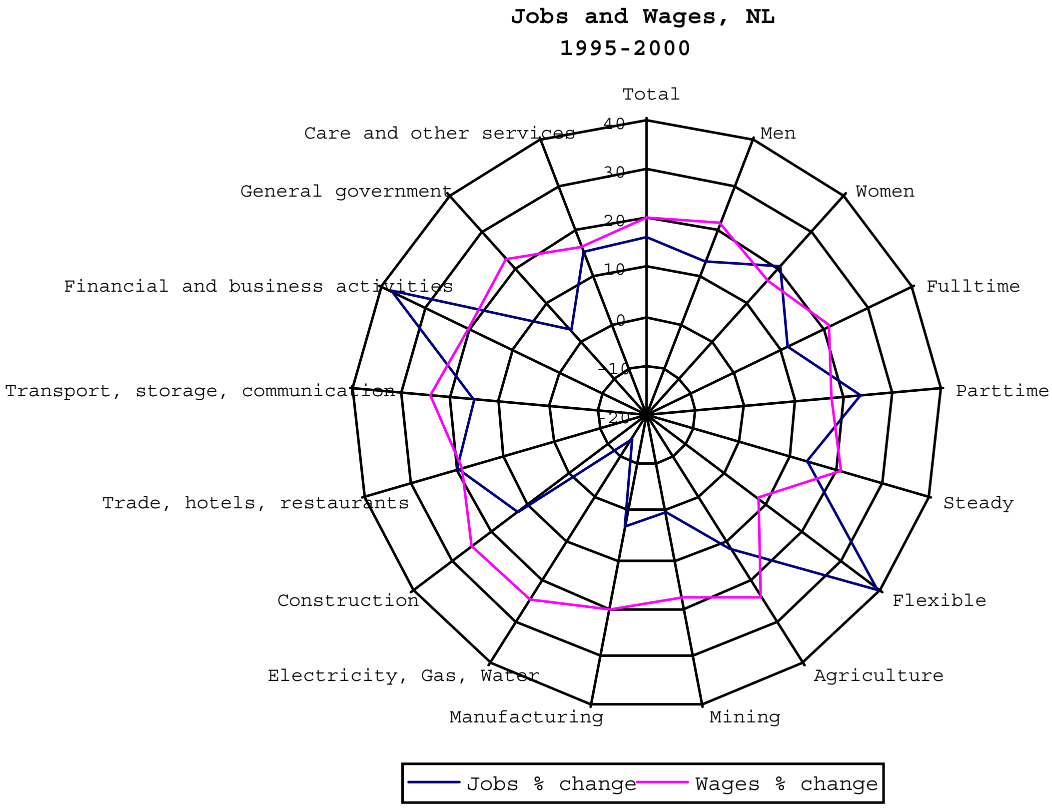
Table 11a

Employment Rate, Women, Full Time Equivalents						
	1996	1997	1998	1999	2000	2001
Austria	51.2	51,3	51,3	51,0	51,0	50,9
Denmark	58,0	59,7	59,8	62,1	62,2	63,0
Germany	45,8	45,2	45,0	45,8	46,1	46,5
Netherlands	34,5	36,6	38,3	40,0	40,5	41,6

(population 15 to 64, source: European Commission: Employment Report 2001)

The Dutch employment “miracle” initially was a catch-up phenomenon: workforce participation of women was low, increased rapidly in the 1990s, but predominantly in part-time jobs. As diagram 2 shows, above average job growth took place for women, part-timers, flexible jobs, in trade, hotel, restaurant services and in financial and business services, with considerable overlap as, most improtantly, “flexible” jobs are held mostly by women. In all but the financial and business services above average job growth coincided with below average wage growth, most clearly for “flexible” jobs. That a considerable part of employment growth took place in low paid jobs is - in the aggregate – reflected in increasing income inequality and post-distribution poverty (Förster/Pellizari 2000).

Diagram 2:



4. Economic explanations:

How can we explain the fact that both general economic, labour market and social policy performances of small European countries are clearly better than in Germany, where Germany can stand for the other big[4] EU countries?

4.1 Standard economic hypothesis

According to a widespread argument, small European countries gained advantages against Germany through an effective devaluation of their currencies against the DM. Even though nominal exchange rates were fixed either by currencies being pegged to the DM directly or by being part of the European Currency System, wage restraint relative to German wages led to export advantages. Small countries thus would have used beggar-thy -neighbor-policies, as Keynes called them: Export trade gains by small countries implied shifting unemployment to the big neighbor while their smallness protected them against retaliatory reactions. As Soskice puts it:
"Wage restraint in a small country is likely to be more successful at reducing unemployment than in a large country. Thus both the Netherlands and Denmark have pursued policies of wage moderation that have brought down unemployment to relatively low levels in the second half of the 1990s, 6.0% in Denmark and 6.3% in

[4] The French performance is usually quite similar to the German one, at least if one discounts German unification problems. Italy seems to be split into a Northern continental type and a Southern laggard type performance. The British case is too complicated to be discussed adequately here (.

the Netherlands in 1996. There are two reasons for this, one stemming from the degree of openness, the other from small size.

(i) The more open an economy, the larger the share of exports and imports in GDP. A given percentage of improvement in international competitiveness (brought about by wage moderation) will normally increase exports and decrease imports by a percentage amount that is independent of the share of exports in that economy´s GDP. This is because the price elasticity of exports or imports relates to competition in individual world markets, which is normally independent of GDP trade shares. Hence a given degree of wage restraint will have a bigger impact on the GDP of that economy the larger the share of exports and imports in GDP in that economy. ...

(ii) The smaller the economy pursuing a strategy of wage restraint, the less likely it is that larger economies will respond to that strategy. The case of the Netherlands and Germany is illustrative. The Dutch strategy has been to set Dutch nominal wages in manufacturing 20% below those in German manufacturing. This has led to Dutch exports to Germany rising. But it does not pay German unions to adopt (significantly more) restrained policies because Dutch exports are too small in quantitative terms." (Soskice 2000: 62f.)

The mechanism suggested is as follows: A fixed exchange rate between the Austrian Schilling, the Dutch guilder, the Danish Krone and the DM is established (directly by central banks or through the European Currency Board). Wages in the smaller countries are set by observing the development of German wages and by staying a significant percentage below them. Cet.par. this pattern of wage formation will result in a cost advantage which translates into increased exports to (W)Germany. West German businesses and unions will not retaliate by competitive cost cutting (by downward adjustment of German wages, etc.) because external competition by its small neighbors is too insignificant.
Thus, small countries can realize an export advantage that results in higher growth. Higher growth generates higher employment. The differences in labor market performance as measured by unemployment rates would be easily explained.

Table 12:

Annual percent change in hourly compensation costs in national currency for production workers in manufacturing

Country	1975-00	1975-80	1980-85	1985-90	1990-95	1995-00
A	5.4	7.9	6.4	5.1	4.9	2.6
DK	6.3	11.1	7.2	5.3	3.8	4.2
NL	4.1	7.6	3.9	2.5	3.3	3.3
D	4.9	7.5	4.7	4.8	5.1	2.4

Source: BLS-News, Sept. 25, 2001.

However, as the data in table 12 show, 1990-95 is the only period in which German wage growth (in manufacturing) clearly exceeded that of its smaller neighbors. These were the years of the German post-unification boom -- and bust. Given the data on wage growth, the beggar-thy-neighbor argument can at best explain the Dutch experience from 1980 to 1995, more exactly for the period from the Wassenaar agreement (1982) to the severe German recession of 1993.

Specifically for the Netherlands, OECD economists describe the mechanism as follows: „As for the role of the external sector in the Dutch model, the positive impact of wage moderation on competitiveness has been accentuated by the exchange rate regime – i.e. the decision to tie the guilder firmly to the DM – and by the fact that the Netherlands is a small, very open economy. The firm link with the DM was a hard-currency option, but in fact over this period Germany has had a much less favorable labor cost performance than the Netherlands and, by following the DM, the guilder, in effective terms, has appreciated by ´only´ 20 per cent. Hence, in terms of unit labor costs, the international competitive position of Dutch firms has improved – that is, the real effective exchange rate of the guilder has depreciated – by over 10 per cent. ... Net exports have contributed, on average, nearly 1/2 of a percentage point a year to GDP growth and the current-account surplus has averaged 4 per cent of GDP over the past 15 years." (OECD 1998: 38)
However, this mechanism can neither explain the continuing impressive Dutch employment growth once German wage restraint had set in nor the performances of DK and A. Although the Danes rejected joining the Euro in a referendum, the krone has remained closely tied to the Euro. Wages grew at a higher rate than Euro-zone wages, but productivity did, too. Thus, the boost in Danish exports, especially in the late 90s, cannot be attributed to an implicit devaluation of the currency (as proposed by Soskice). A similar argument holds for Austria. Schettkat (1999) has examined the development of real and nominal exchange rates and concluded that whereas the real exchange rate of the Dutch guilder against the Deutschmark decreased, it increased for the Danish krone and the Austrian shilling. As the data in table 12 show, wages of production workers grew slightly faster in Austria and clearly faster in Denmark than in Germany from 1975 to 2000 - with the exception of the early 90´s. So we must look for factors other than wage restraint to explain the superior performance of these small economies.

4.2 Economic homogeneity

An alternative explanation relying on economic factors focusses on the combination of a relatively simple economic structure and the ease of political adaptation. In the context of arguing for a new social policy strategy Streeck (1999) uses the positive performance of small countries as evidence for the positive benefits of - what he creatively calls - "supply-side egalitarianism": Underpinned by "competitive and productive solidarity" (instead of old-fashioned "protective and redistributive solidarity") it is to achieve a "rough equality of outcomes" through a "rough equality of initial endowments". Instead of traditional decommodification the objective of social policy should be the "creation of equal opportunities for commodification". All these are nice labels. But it is easy to see that – outside economic models - on markets a "rough equality of initial endowments" normally leads to a quite rough inequality of outcomes, since individuals, their abilities and opportunities are not equal in the real world. Thus, Streeck´s "competitive solidarity" would at best amount to "levelling the playing field" while tolerating considerably higher levels of inequality than Europeans in expanded welfare states are used to. To what extent do our small countries provide evidence in support of Streeck´s argument?
Where exactly can we observe that „(c)ollective identity and interest, especially in relation to the outside world, ...become organized around particular sectors or products, whose fortunes in the world economy become largely identical with those of the territorial communities that produce them"? The standard examples for such a

constellation are Northern Italy, Silicone Valley, etc., but would pork packing in Denmark, ski lift production in Austria or the Dutch transport industry fit under such a description?
„Obviously small countries find sectoral specialization and elimination of institutional rigidities through regime customization easier than larger ones which cannot normally expect their entire population to earn their living mainly in a handful of sectors. *Economic homogeneity*, which tends to go together with small size, has the great advantage that it makes it possible to have rules and social standards that are *both nationally unified and sectorally specialized*. This helps protect governments pursuing customization of regimes in order to make them more flexible and productivity-enhancing, from political conflicts on the necessary and desirable degree of equality of rights and obligations for all citizens. Small and sectorally homogenous countries are also less likely than large and heterogeneous ones to have to impose redistributive obligations on their leading sectors, as inequality tends to increase with sectoral diversity. Governments of countries whose sectoral composition is comparatively homogeneous can also pay more attention to the infrastructural needs of "their" sectors, just as they can traditionally draw on an ample supply of solidarity among their populations that is fed by shared perceptions of a need to stand together and defend the community against much larger and more powerful neighbors. In an international economy governed by fragmented sovereignty, more fragmentation seems to be better than less, and it is a striking fact that the small countries of Europe have recently been doing much better economically and politically than the large ones. Moreover, small countries, apparently paradoxically, tend to be the most vigorous defenders of national sovereignty inside the European Union while at the same insisting on the strictest adherence of all to the principles of a free international market.“ (Streeck 1999: 9)
In other words: Small countries are more successful in the contemporary world economy because they can achieve a better fit between their economies (characterized by a relatively homogeneous sectoral composition) and “customized” political regimes built to enhance international competitiveness. The premise of this argument is that small country economies are less heterogeneous than those of big countries. Since Streeck makes no attempt to show this empirically, his argument remains speculative.

5 Cultural factors

A counterpiece to economic homogeneity is cultural homogeneity. Small countries are taken to be, or to have better chances to be, culturally homogeneous and therefore more integrated in terms of common values. Cultural homogeneity as in a shared religious tradition, for example, has often been cited as a characteristic correlate of ethnic homogeneity in the protestant Nordic countries. One of the implications of cultural homogeneity is assumed to be a high level of trust which, in turn, is an important ingredient of action coordination, especially in situations involving asymmetric information or general uncertainty.
Thus, one possible explanation of small countries´ better performance could run as follows: Smaller numbers of decisive economic and political actors allow for denser communication. Denser communication can lead to shared definitions of situations and can allow agents to build networks supported by mutual trust. This would allow for easier coordination in situations in which purely economic considerations (or

actions guided solely by expected benefits compared to costs) lead to suboptimal adaptation.

5.1 Moral commitments and free-riding

An important example for such suboptimality is freeriding. It prevents the formation of collective agents and, therefore, the production of public goods. How can cultural homogeneity and smallness combine to prevent free-riding? Smallness allows for easier monitoring of activities. Monitoring makes life difficult for freeriders, given standard traditional moral commitments to non-parasitic behavior within "we"-groups. Contrary to Olson´s suggestion that encompassing interest organizations as collective agents have to rely on selective incentives, encompassing organizations in small states are able to rely solely on moral commitments because of the relative ease of monitoring.

5.2 Trust

Prevention of free-riding is linked to trust. The successful formation and stabilization of collective actors and their production of public goods generates trust among individuals in the sense of each being able to expect norm-conforming behavior of others with a high probability. In turn, trust and commitment to shared goals are essential and – if rewarded by better performance - mutually reinforcing factors that make action coordination much easier than, for example, relying on control and the threat of coercion.
However, if trust grows in small social settings (as is generally argued in sociology since Tönnies), the question is how far and under what conditions can relations of trust be extended. There seems to be a dilemma (Eisenstadt 2001: 335). Trust is something fragile. It is primarily generated in small closely knit groups. More encompassing social structures require resources and means that tend to undermine the trust generated in families, kinship groups or small communities.
One possibility is that agents rely on stereotypes. Ethnically and culturally (religion, moral values) homogeneous populations allow for extrapolation of expectations that grew within small groups. We trust a fellow member of a given, for example, because we grew up in that group. We meet people with similar characteristics. We trust them and extend our network of social relations to include them—unless we learn better. By comparison, the threshold for investing trust in people who do not have/exhibit the relevant characteristics is higher.

5.3 Complicating issues

Some complicating issues remain which limit the explanatory power of the cultural homogeneity-trust-hypothesis. Here are just two:
-- If better coordination were merely a matter of size, and factors as trust grow bottom-up, starting on local and regional levels, this should happen in big countries, too. If they do exist on local and regional levels, what are the thresholds/obstacles preventing their growth/extension to the national level?
-- Inglehart´s (1999) world value survey data show that the Northern European countries, Norway, Denmark and Sweden, rank highest in the share of people who trust people, followed by the Netherlands. In all these countries, the share of those who trust people is above 50 %. With the exception of China, all countries with a majority of trusting people are small. In West Germany, this share is a little over 40% (whereas in East Germany, it is only about 25%), in Austria, it is a little over 30%. So

the trust explanation could work, but not for Austria. Inglehart´s data in fact suggest that it is the combination of smallness and religious tradition that is decisive. With the exception of China, all the high trust countries are small and historically protestant[5] – and this is what separates Austria, being historically catholic, from the other three countries in our comparison.

Whatever the support cultural homogeneity, shared moral commitments and trust offer for successful coordination, they all work as background conditions, so to speak, easing -- but not substituting for -- explicit agreements. These have to be worked out and that involves two components. First , promising shared strategic objectives have to be known. Second, agents with divergent interests have to come together, negotiate and agree on such objectives. Knowledge can be gained from experience, observing successful adaptation to new conditions, shocks, etc. in other countries, at other times, or it can be derived from theory. For agents to work out promising agreements, they have to be able to operate in suitable institutions. Rhodes (2001) has analyzed the formation of comprehensive "social pacts".

6 Social Pacts

According to Rhodes (2001), globalization and European integration have created an environment for national economies which requires adaptation combining "wage restraint, ...lower social charges and greater flexibility of work conditions" (Rhodes 2001: 180). These objectives can be reached in a two-pronged approach through reforms of social security systems and positive responses to employers´ demands for increased productivity. Thus, there is a need for both a distributional and a productivity coalition.

Rhodes sums up his analysis: "Building a distributional coalition requires... :

* a national incomes policy that has a degree of flexibility at lower levels so that less productive workers are not priced out of the labour market;
* the relaxation of high levels of security for full-time core workers, in return for greater protection for peripheral (also increasingly central) temporary and part-time workers, as in the Dutch 1996 central agreement on ´Flexibility and Security´;
* a redesign of social security systems to prevent implicit or explicit disentitlement, in relation to two groups in particular: women workers (who are often discriminated against by male breadwinner-oriented social security systems); and those not in permanent, full-time employment who may also be discriminated against in terms of entitlements;
* and a parallel redesign of social security systems to allow a guarantee of access to skill acquisition and social services at any point during the life cycle, especially through education and training.

Constructing a parallel productivity coalition requires...:

* a shift away from legislated or rule-governed labour market regulation to negotiated labour market regulation, e.g. in minimum wages...;
* the development of decentralized components within the national wage bargaining system that provides employers with the possibility of striking productivity-linked deals;
* the agreement on consultation through firm or company concertation that allows for a negotiated adjustment to new demands from markets or technologies;

[5] East Germany is clearly an outlier among the historically protestant countries.

* a shift away from adversarial industrial relations towards a more consensual model;
* and the joint implementation of training mechanisms and priorities." (Rhodes 2001, 180f.)

Rhodes´ argument relies heavily on the Dutch model, a reform package much in line with OECD recommendations. But he fails to point out costs in terms of wage (see Diagram 2 above), job and social security losses, leading to increasing inequality and eroding social security. Are the social pacts required for such reforms feasible if these costs are laid open? Who would want them?

The example of the Netherlands points to one factor: The country was in a deep crisis before the "turnaround" in 1982. Is a crisis required to get the decisive actors together and make them overcome their narrow interest-based perspectives? (Cox 2001) Certainly, in the Dutch case, unions were under enormous pressure and in a weak position in the early 1980s, with the result that at least the initial – and arguably a disproportionate share of the long-term -- costs of reforms had to be carried by labour. If unions are strong, will the not prevent such reforms?

The strength of unions is frequently identified as the major source of both Germany´s recent miserable economic performance and of its "Reformstau", as the inability to deregulate the labour market and cut back social security is called in German media. By contrast, both the Danish and the Austrian cases appear to demonstrate that it is neither necessary to hide the costs of reforms nor necessary to weaken unions (as in Thatcher/Reagan times) to achieve flexible adaptation under new economic conditions. So why did the German version of "democratic corporatism" (Katzenstein 1985) fail, if union strength was not a decisive factor?

How could the Danes maintain a balance of flexibility and security that allowed a substantial reduction of unemployment without collateral social damages?

How could Austria adapt so slowly (Hemerijck et al. 2000) and still perform so well?

7 The negative case—coordination failure in Germany

If Rhodes´ specification of the requirements for successful social pacts is correct, , the extent of coordination involved is considerable. The efforts necessary to achieve such coordination increase as a function of the number of agents with divergent interests involved and the number of arenas in which coordination has to take place. In this perspective, Lehmbruch (1999) offers a plausible account for the German failure to adapt the welfare state and labour market institutions to problems of unemployment, unification, Europeanization and globalization. According to Lehmbruch "the institutional profile of German corporatism" does not support a "negotiated reform of the WS". Rather, it is characterized by a "degree of institutional segmentation that hinders reforms on the basis of integrated negotiations". In addition, the party system in Germany has not played the supportive role that was a precondition for the success of corporatist negotiations in other countries". If Dutch reforms are a model for the recalibration of an over-extended welfare state on the basis of negotiation between collective agents with divergent interests, negotiated reform should include industrial relations, income development as well as fiscal policy, labour market policy and unemployment insurance, public health and pension systems, because all these subsystems are interdependent to a high degree and under equal pressure to adapt. This coordination cannot be accomplished in Germany because there is no arena for sufficiently comprehensive negotiations. The "coalition for work" (Bündnis für Arbeit, a revivalist tripartite gathering of government, business and union representatives) is inadequate, as institutional segmentation has

implied the stepwise but independent development of wage formation, of labour market institutions, of the system of public health insurance and pensions. Each of these subsystems has its specific discourses and rules. These are not, neither directly nor indirectly, sufficiently represented in the “coalition for work”. Although traditional German corporatist principles of organizational parity hold in all these subsystems, the interest cleavages in each are specific and do not articulate to generate an overlap of networks among the relevant agents.
By contrast, the successful social pacts in smaller European countries are characterized by their overarching nature, tieing together different subsystems. In addition, political parties are frequently tied closely into the corporatist triangle and can therefore function as a mediating link between sectoral policy networks. By contrast, the bipartite German party system generates an institutional logic of action at odds with the corporatist arena. In sum, the “Bündnis für Arbeit” was confronted with problems of institutional coordination for which the tripartite constellation was insufficient.

8 Vulnerability

However, the lesson from coordination failure in Germany for understanding the coordination successes in Austria, Denmark and the Netherlands should not simply be that the bigger country has more complex institutional structures and a greater diversity of interests making it difficult if not unlikely to arrive at a comprehensive social pact. After all, if Katzenstein (1985: 31) was correct – and I think he was – to classify West Germany as the big country that came closest to the “democratic corporatism” of the small European states, why has the country lost the capacity to overcome damaging conflicts of interest and appears to be locked into mutual paralysis? Of course, one could argue that the German situation has indeed become more complex after unification, explaining coordination failure as a result of increasing complexity. However, the true reason may be something else. One of the important differences Katzenstein identified between small and big states was a shared sense of vulnerability in the former, a heritage of deep crisis experience. This diagnosis was recently repeated by Hemerijck and coauthors: “In the two most tightly coordinated economies, Denmark and the Netherlands, the 1990s reforms and strategies crossing different policy areas were mutually reinforcing through issue-linkage… They surely benefited from a ´shared ownership´ of policy problems, triggered by the memory of deep crises and policy failures” (Hemerijck/Schludi 2000: 227). Or, again, historical experiences of outside intervention have left policymakers with a “sense of vulnerability” (Hemerijck et al. 2000:192). Thus, priority for adaptation to changed external conditions over pursuit of particular internal interests is easier to establish if there is this shared “sense of vulnerability”. Katzenstein found the “perception of vulnerability, economic and otherwise” even decisive for explaining the economic and social policy differences between small and large states – as he underlined in retrospect - : “Perceived vulnerability generated an ideology of social partnership that had acted like a glue for the corporatist politics of the small European states… Wrecked by intense domestic conflict during the interwar years these states became islands of cooperative politics and coordinated industrial relations after 1945” (Katzenstein 2003: 11)
With regard to pre-unification Germany, it is tempting to use the very same: “West Germany´s corporatism derives as much from openness, dependence and a sense of vulnerability brought about by the diminished size of the Bonn republic after 1945 as

from the implantation of its political parties in fresh democratic soil." (Katzenstein 1985: 201) Certainly, the experience of Nazi dictatorship and defeat and destruction in World War II imprinted this "sense of vulnerability" into the habits and thoughts of those who had lived through that period – and made them behave in ways typical for small country populations. However, the more this experience became second hand memory the harder it became to maintain the "idea of a community of the vulnerable" (Charles Sable, as quoted in Katzenstein 1985: 1999) and to use it in bridging divergent interests. Fortyfive years after World War II, German unification did not lead to a revival of this idea – although some leading Social Democrats tried – but rather to its loss: After unification, vulnerability was something reserved for small countries. Germans felt that they were big players now.

The tragedy – if one wants to use such strong words - of the German case is that the lesson of vulnerability was forgotten at a time when it would have been most important to remember it. The scope of the joint problems of unification, European integration and globalization reached way beyond the horizon of politicians, business and union leaders. The much less depressing irony of the small states´ story seems to be, by contrast, that they could learn to cope successfully with external parametric changes only after experiences of loss and vulnerability that taught them how to reach satisficing internal compromise.

Conclusion

So why is small beautiful? After examining some typical arguments in the literature comparing and explaining the performances of nation states and economies, much of the debate about the relative merits of different types of governments, welfare state and labor market regimes or economic policy traditions seems to contribute less to the understanding of actual performances than size and its implications. Small is beautiful because smallness implies vulnerability and the experience of shared vulnerability enhances the capacity and the willingness to learn. To learn here means simply that in a social constellation involving conflicts of interest but also requiring cooperation, it does not pay to blindly push one´s own interests. Katzenstein`s (1985) emphasis on the connection between smallness, vulnerability and learning was and is well justified. However, whereas Katzenstein maintains that "(w)hile the small states do well enough on average, and under constraints that are at times daunting, performance does not set the small states systematically apart from large ones" (Katzenstein 2003:169), I would hold that the small states actually perform better, too. At least, that is the story of the 1990s.

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