# What Small Countries Can Teach the World

Jeffrey Frankel

CID Working Paper No. 232
April 2012

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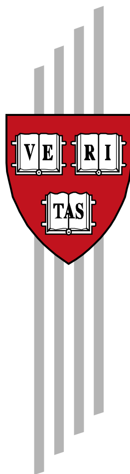


Working Papers

Center for International Development
at Harvard University

Forthcoming, *Business Economics*, April 2012 (National Association of Business Economists, 3,800 words

# What Small Countries Can Teach the World

Prof. Jeffrey Frankel, Harvard University, Feb. 18 + rev. March, 2012

Abstract

The large economies have each, in sequence, offered "models" that once seemed attractive to others but that eventually gave way to disillusionment. Small countries may have some answers. They are often better able to experiment with innovative policies and institutions and some of the results are worthy of emulation. This article gives an array of examples. Some of them come from small advanced countries: New Zealand's Inflation Targeting, Estonia's flat tax, Switzerland's debt brake, Ireland's FDI policy, Canada's banking structure, Sweden's Nordic model, and the Netherlands' labor market reforms. Some examples come from countries that were considered "developing" 40 years ago, but have since industrialized. Korea stands for education; among Singapore's innovative polices were forced saving and traffic congestion pricing; Costa Rica and Mauritius outperformed their respective regions by, among other policies, foreswearing standing armies; and Mexico experimented successfully with the original Conditional Cash Transfers. A final set of examples come from countries that export mineral and agricultural commodities -- historically vulnerable to the "resource curse" -- but that have learned how to avoid the pitfalls: Chile's structural budget rules, Mexico's oil option hedging, and Botswana's "Pula Fund."

Why would one look to small countries for ideas of good policies or good institutions? History shows that big countries don't have all the answers.

In the past, countries looked to the big powers for inspiration when choosing social systems, development strategies, or specific institutions. In the 19th century, for example, Great Britain and its industrial revolution was the model that other countries sought to emulate. Some of its innovations, such as the joint stock company and free trade, are still with us today. Others of its institutions, however, such as the gold standard, did not long survive the end of the century.

### *Large countries as models in the 20th century*

For some nations that gained their independence in the 20th century, the Soviet Union was the country to emulate. Toward the end of the century, of course, the socialist model had lost its appeal. It became evident to all that Russia and the other members of the Soviet bloc had failed miserably. At the same time, East Asian economies had ridden capitalism to prosperity.

Although the issue of market economics versus socialism had been settled by 1990, there remained competing models of capitalism. At the time, many thought the lesson of the 1980s had been that Japan's variant of capitalism was the best model, and that other countries around the world should and would follow it. The model was said to include such institutions as strategic trade policy, administrative guidance, relationship banking, life-time employment, collusive industrial groupings (keiretsu), and corporate governance that seeks to maximize the capital stock and long-term market share rather than short-term profits.[1]

As it turns out, there is indeed such a thing as accumulating too much capital. The Japanese model quickly lost its luster in the 1990s, as the speculative bubbles of the late-1980s burst and the economy sunk into two decades of stagnation.

From this many drew the lesson that the US variant of capitalism had been the best model all along. This included American-style corporate governance: securities markets, rating agencies, accounting standards, generous compensation for CEOs, and pursuit of profitability and share prices rather than sheer size. The United States began the 1990s with military triumph in Kuwait and ended it with the longest economic expansion in its history. Other countries should and would follow the American model.

The American model in turn lost its attractiveness in the decade of the 2000s. The U.S.' reputation for competence and integrity took some heavy blows, starting with the

[1] Vogel (1979) was ahead of his time in hailing the rise of the Japan model. Fingleton (1995) was behind his time. Johnson (1982) became a bible on Japanese administrative guidance and strategic trade policy. Frankel (1993) surveyed the special features of the financial system.

Enron-type accounting scandals of 2001, falling incomes among blue collar workers, the sub-prime mortgage crisis and ensuing recession, massive budget deficits, and disasters in the Gulf of Mexico.

Where should countries look for a model, now? Some will respond "China." It is undeniable that the rate of growth sustained by China over the last three decades is a miracle of history. But I find it difficult to think of many Chinese institutions that I would recommend other countries try to copy.[2] Even today, China's status as the world's second largest economy owes more to the size of its population than to its GDP per capita, which has still to rise above the median level in global rankings.

We are accustomed to looking to large countries for innovations that push out the frontier of governance. But some smaller countries, and countries on the periphery, have experimented with policies and institutions that could usefully be adopted by others.

Small countries tend to be trade-dependent, and open to new ideas. Countries that are small, newly independent, remote, or emerging from a devastating war, often find it easier politically to institute radical reforms, than in the US or other large established countries. Not all the experiments will succeed. But some will. Those innovations that succeed may be worthy of emulation by others.

Let us begin with examples from countries that are small in size, but have relatively high per capita incomes.

***Ideas from Small Advanced Economies***

New Zealand adopted a comprehensive set of liberalization reforms, known as "Rogernomics," after Minister of Finance Roger Douglas, starting in 1984. Perhaps its Labor Party should even be given credit for pioneering the principle that left-of-center governments can sometimes achieve economic liberalization better than their right-of-center opponents.[3] New Zealand's monetary authorities pioneered Inflation Targeting in 1990, originally as part of a larger strategy of holding individual civil servants accountable for yearly goals. Canada in 1991 and then many other central banks over the subsequent two decades followed New Zealand in adopting Inflation Targeting.

Estonia led the way in simplifying its tax system by means of a successful flat tax in 1994, followed by other small countries in Central/Eastern Europe and elsewhere.[4] Switzerland in 2001 put into its constitution the "debt brake;" this was not a rule that the actual budget be balanced, like the impractical Stability and Growth Pact of the euro countries, but rather a rule that the structurally adjusted budget be balanced.[5] Germany

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[2] Williamson (2012).
[3] Nagel (1998).
[4] Including Latvia, Lithuania, and Slovakia. Saavedra (2007).
[5] Danniger (2002).

emulated Switzerland by putting a similar debt brake into its constitution in 2009, and would like the other 16 members of the eurozone to follow suit.

Ireland recognized the importance of Foreign Direct Investment, and encouraged it by instituting a low corporate tax rate. The strategy to become the Celtic Tiger succeeded -- economic growth averaged in excess of 7% per annum between 1995 and 2007 – though the economy did enter an unsustainable bubble toward the end of this period.

Canada has shown how to run a crisis-free banking system; and it is not by breaking up banks that are "too big to fail" into small bits. The Canadian system is concentrated in five large banks, which hold more than 80% of bank assets, but the authorities have never had to bail them out. Public policy in Ottawa does not seek artificially to increase the extent of owner-occupied housing by encouraging loans that the households may not be able to repay: mortgage interest is not tax deductible, a 20% down payment is standard (unless the borrower takes out insurance) and mortgages are "full recourse" loans (defaulting does not let the borrower off the hook). The result is that Canada achieves roughly the same level of home ownership as the United States, but with far less leverage, fewer defaults, and no systemic crises.[6]

Sweden in 1992 showed how to move aggressively to rescue a banking system in crisis while yet taking steps so that the taxpayer eventually gets all or most of his money back.[7] This example helped inspire President Obama's redesign of TARP in early 2009.

More broadly, the Scandinavian countries, after deciding that they had swung too far in the high-spending socialist direction in the 1970s, made some adjustments in the 1990s.[8] The "Nordic model" has by now shown that it is possible to combine a high level of social protection, social services, and corporatist labor relations, with market economics, fiscal responsibility and free trade (except in agriculture). According to Anders Aslund, Denmark was the pioneer in the 1980s, in which case we should call this the Scandinavian model, followed in the 1990s by Sweden under the prime ministership of Carl Bildt. High female participation in the labor force is one ingredient in the formula. Sweden's comprehensive school voucher system may be another.

Norway has the highest ranking in the global Human Development Index. Some will say, "that is easy, Norway has oil." But many countries with oil or other natural resources squander the proceeds. (More on this below.) Norway enacted laws to ensure that its oil revenue was saved in sovereign wealth funds.

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[6] Perry (2010).

[7] Dougherty (2008), Larsen and Giles (2009). The Swedish example is viewed in contrast to the Japanese approach during the 1990s, which was to drag out as long as possible a recognition and resolution of their banks' difficulties, thereby greatly increasing the cost to the nation in the end.

[8] Aslund (2010), Becker (2007), Borg (2010).

The modern Nordics are distinguished by their recognition that they should have tax revenues sufficient to match what they want their governments to spend. Still, Sweden's conservative prime minister 2010 was able to cut taxes on the working poor, reasoning that their incentives are adversely affected by high total marginal tax rates (whereas America's supply siders seem to think that this logic applies only to the rich). Prime Minister, David Cameron, reportedly would like to import this idea to Britain.[9]

In the 1990s, the Netherlands decided that its high level of taxation, labor market regulation, and social protection was keeping employment artificially low. It experimented with reforms to make labor markets more flexible, making part-time work easier in particular. The result was that the Netherlands became the top job-creator in Europe.[10] Crucially, workers are apparently choosing part-time work voluntarily, because it suits their lifestyle, rather than as part of some artificially imposed "work-sharing" scheme.[11] The "Dutch model" provided some of the inspiration for Germany's successful labor market reforms in the following decade.

### *Ideas from Newly Industrializing Economies*

Particularly intriguing are the innovations that come from developing countries, or at least countries that were "developing" when they started. Some of these countries have been so successful that they are no longer classified as developing.

Singapore long ago achieved rich country status, and by 2011 ranked 4th highest in the world in income per capita (PPP adjusted) -- ahead of the United States. It accomplished this unexpected miracle with a unique development strategy. Among its many innovations were a paternalistic approach to saving and use of the price mechanism to defeat urban traffic congestion, subsequently emulated by London.[12]

Famously, Korea in 1957 was at about the same level of income as the newly independent Ghana. Development economists thought the latter had much better prospects. Today Korean income ranks 25th in the world, just ahead of the EU average! Part of the explanation of Korea's industrialization miracle was its commitment to education. The country ranks first in the world in test scores of its 15-year-olds in reading, and second in math after Finland.[13]

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[9] Sumner (2010).

[10] About half of Dutch job creation since the mid-1980s has been part-time jobs taken by women aged 25–49. A 1997 EU survey reported that 72 percent of part-time workers in the Netherland did not want a full-time job instead. Garibaldi and Mauro (2000).

[11] Bosch, van der Klaauw, and van Ours (2009).

[12] Goh (2002), Santos (2007).

[13] The U.S., by contrast, ranks 27th in math, out of 33 countries studied, behind Poland and Russia. (The source is the OECD's *Education at a Glance*, 2009.)

Costa Rica in Central America and Mauritius in Africa each pulled ahead of their respective peers some time ago. Among many decisions that worked out well, both countries have foregone a standing army. The result in both cases has been histories with no coups, and financial savings that can be used for education, investment, and other productive purposes.[14]

Mexico in the 1990s, largely thanks to the leadership of President Ernesto Zedillo, adopted non-partisan federal electoral institutions that subsequently in 2000 allowed the opposition party to take power for the first time and in 2006 were able to successfully resolve a disputed election.[15]

In 1998, Mexico also pioneered the idea of Conditional Cash Transfers (CCT) by launching the program that was originally called PROGRESA and subsequently changed to OPORTUNIDADES. CCT programs have subsequently been emulated by Brazil's Bolsa Familia and many other developing countries. They have even inspired reforms in New York City. The Mexican innovation was two revolutions in one: (1) the specific idea of making poverty transfers contingent on child school attendance and (2) the methodological idea of conducting controlled experiments to find out what policies work in developing countries, which fed into the exciting Randomized Control Trials movement in development economics.[16]

***Ideas from Commodity-Exporting Countries***

Countries that with natural resource wealth have not performed better than those without, a phenomenon known as the Natural Resource Curse.[17] One aspect of the curse historically has been a tendency for exporters of oil, energy and agricultural products no to over-spend in a boom rather than to save. This tendency is part of a more general historical pattern of procyclical or destabilizing fiscal policy among developing countries. Remarkably, however, roughly one third of them have managed to overcome this

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[14] Frankel (2012a). Military spending in Mauritius is only about $6 per capita, equal to 0.45 percent of GDP or 4 percent of spending on education and health. (Brautigam, 1997) One might argue that a remote island country has little need of armed forces. But Mauritius has in fact suffered the loss of territory to external military force. The United States and United Kingdom took the Chagos Islands in order to build the base of Diego Garcia, without the permission of either the islanders or Mauritius. Of course Mauritius was hardly in a position to resist, with or without an army. But small size has not stopped other countries from futile military endeavors.

[15] Henríquez (2006). In contrast, it turned out in November 2000 that the United States had no mechanism to resolve such disputes, other than the preferences of a few critically situated political appointees.

[16] Fernald, Gertler, and Neufeld (2008), Rawlings and Rubio (2005).

[17] Frankel (2012c) surveys the Natural Resource Curse and some possible remedies. One institutional reinforcement against corruption is the Extractive Industries Transparency Initiative. In 2009 Azerbaijan became the first country designated as EITI-compliant, and Liberia became the first in Africa.

weakness since 2000, and to run countercyclical spending policies instead.[18] The star performer in this reversal is Chile. The story has possible lessons not just for commodity-exporters but for all countries.

A variety of innovations has helped Chile to outperform its South American neighbors.[19] Chile's fiscal institutions – structural budget balance with the parameters estimated by independent panels of experts — ensure a countercyclical budget. They are among the mechanisms that are particularly worthy of emulation by other commodity exporting countries, to defeat the Natural Resource Curse.

Chile ran large surpluses during the copper boom of 2003-08, and subsequently was able to ease its fiscal policy substantially in the recession of 2009. This achievement was not solely the result of wise policy-makers choosing the right policies. They were helped by an institutional framework that was put into place in 2000, and that can offer useful lessons for others.[20] Chile's fiscal institutions consist essentially of three rules. First, each government must set a budget target. Second, as in Switzerland, the target is phrased in structural terms: deficits are allowed only to the extent that (i) output falls short of trend, in a recession, or (ii) the price of copper is below its trend. The target for the structural budget surplus was set at zero in 2008 under President Michelle Bachelet, which implied a substantial actual surplus because the oil price was high and the economy was booming. Third, the determination of what is structural and what is cyclical is made by two panels of independent experts who project ten-year trends, outside the political process. The result is that Chile avoids the pattern of 32 other governments, where forecasts in booms are biased toward over-optimism. Chile's institutions explain why it was able to run surpluses in the 2003-07 boom. The United States and Europe failed to do so in part because their fiscal authorities made systematically over-optimistic forecasts during this period of expansion.

Mexico appears again on our list of innovators, for its success in hedging of oil export proceeds on option markets. Producers who sell their minerals on international spot markets are exposed to the risk that the dollar price rises or falls. The producer can hedge the risk by selling that quantity on the forward or futures market. Hedging provides efficient sharing of risk and automatic adjustment to changes in world prices. Futures markets have one serious drawback from a bureaucratic or political point of view. If a government ministry hedges on the futures market, the Minister receives no credit for having saved the country from disaster when the world price falls, but is excoriated for having sold out the national patrimony when the price rises. Better, then, is the hedging strategy employed by Mexico: it uses options to eliminate only the risk of a *fall* in price

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[18] Frankel, Vegh and Vulentin (2011).

[19] The structural budget regime is of course but one of many innovative reforms that Chile has adopted over the last few decades. Many of them have been successful and potentially worthy of emulation. Corbo and Fischer (1994), Edwards and Edwards (1991, 2000), Ffrench-Davis (2010), and); Velasco (1994).

[20] Frankel (2012b).

in the price of oil. In this way it retains the upside risk while reducing the downside risk.[21]

The proceeds of commodity exports should be used to establish sovereign wealth funds that are transparent and professionally managed, in order to assure that future generations share the bounty while investing in assets that earn a higher rate of return than the paltry return on US treasury bills, where most central bank reserves are held. The model that has been touted most widely is the Norwegian Pension Fund (formerly called the Norwegian State Petroleum Fund). But it may not in fact be the best model for most commodity exporters to emulate. One wants a sovereign wealth fund to be placed out of the reach of political influence, and invested solely along financial lines. This is not the practice with Norway's fund, where politicians can dictate constraints based on social goals.[22]

A better model for most commodity exporters is Botswana's "Pula Fund," built on earnings from the sale of diamonds. The fund, invested entirely in securities denominated in other currencies, serves both as a sinking fund to offset the depletion of diamonds and as a buffer to smooth economic fluctuations. Management of the Pula Fund is delegated to independent professionals with instructions to pursue only the financial interest of the people of Botswana, undistorted by any political goals.

***Silver Bullets?***

There is a good reason why the phrase "silver bullet" does not appear in English excepted when preceded by the word "no." The same is true of "panacea."

In highlighting some very specific institutions that could be usefully applied elsewhere, I don't mean to suggest that they can be effortlessly translated from one national context to another. Many countries would not be able to handle the still-large government sectors of the Nordic countries, for example, without corruption or mismanagement. Land redistribution worked well in Japan, Korea and Taiwan after the collapse of the Japanese colonial empire in 1945, but in most other contexts such interference with property rights would inflict lasting damage.[23] It is unlikely that the US political system could successfully implement the sort of flat taxes that have worked in Eastern Europe. When an American politician proposes a flat tax it is invariably accompanied by snake oil promises of impossibly low rates; when he proposes to open up the tax code to simplify it, it comes out more complicated.

I also do not mean to suggest that the examples of good innovations that I have identified are entirely responsible for the success of the economies in which they were made. Countries such as Chile, New Zealand and Singapore have undertaken many reforms not mentioned here. Nor do a few good policies necessarily determine outcomes.

[21] Duclaud and García (2011).
[22] Holmøy (2010).
[23] E.g., Kuznets (1988).

As the example of Mexico shows, a country can have a number of brilliant innovations and still suffer from stagnant growth for other reasons. (It has been crippled by, the relocation of the drug trade from Colombia and by a flood of guns from the U.S.[24]) Ireland and Estonia were among those worst hit by the global financial crisis of 2008 (in part because they had given up monetary independence).

But a country doesn't have to be large like the United States to serve as a model. Small countries are often more free to experiment with new policies and new institutions. The results include some useful lessons for others.

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