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Lessons of smaller states

By Richard W. Rahn
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REYKJAVIK, Iceland.

Why is this cold, rainy land with its stark volcanic landscape, without much in the way of natural resources, one of the wealthiest places on Earth?

Small states, in the past, were most often poorer on a per capital income basis than large states, but in the last half-century many have become much richer then their large neighbors. Among the wealthiest places on the planet, in addition to the United States, we now find Luxembourg, Hong Kong, Denmark and Ireland, none with many natural resources.

In a just-concluded meeting of the Mont Pelerin Society in Iceland, some leaders of small states that have developed very successful economies met with some of the worlds' leading free-market economists and policy institute professionals, partly to discuss what lessons the rest of the world can learn from these small states. Mart Laar, former prime minister of Estonia, was the principle architect of his country's remarkable economic transformation from impoverished vassal of the Soviet Union into one of the world's freest (No. 4 in the world according to the 2005 Index of Economic Freedom) and most dynamic economies. Mr. Laar said he succeeded by following the teachings of Nobel Prize-winning economists F.A. Hayek and Milton Friedman.

After obtaining freedom 15 years ago, Estonia rapidly moved to establish a rule of law, protect private property and create a sound currency. Estonia removed most price controls, discarded useless regulations, privatized most state-owned enterprises and established a free-trade regime. The result has been the largest percentage increase in real per capita incomes of any of the former communist states.

Estonia has now moved on to create the world's first "e-government": Most government operations are on the Internet, and in electronic form. By moving away from bureaucrat paper, Estonis reduced corruption and cost and created much more transparency and accountability. All proposed laws are placed on the Internet before passage so any citizen can review and comment before they are voted upon.

Former Iceland Prime Minister and current Foreign Minister David Oddsson detailed how he took a typical, economically stagnate, Scandinavian socialist welfare state and turned it into an economic tiger by privatizing state industries, freeing labor markets, and reforming the financial structure. Iceland has been engaged in a massive tax reduction (for instance, the corporate tax rate has been cut from 50 to only 18 percent, and the inheritance tax to a maximum 5 percent). Yet government revenues have steadily increased because of the resulting economic dynamism, and the national debt has fallen from 50 percent of gross domestic product to only 15 percent.

One of their greatest success stories was moving from a pay-as-you-go social security system (like that of the U.S.) to a combination of a limited means-tested government system with a private inheritable system, giving Iceland one of the strongest and soundest systems in the world.

Professor Victoria Curzon-Price of the University of Geneva in Switzerland and president of the Mont Pelerin Society argued Switzerland has succeeded because (with the exception of farming) it is mostly a free-trade nation, with strong fiscal and tax competition between cantons. Switzerland is a voluntary, direct democracy, federal contractual state made up of a couple dozen cantons divided on linguistic and religious lines and more than 3,000 communes -- i.e., small towns.

Having most government power at local levels reduces friction among the various groups that make up Switzerland. It allows the people to decide if they wish to live in a commune with a large government and relatively high taxes, like Geneva, or in a low-tax, limited-government jurisdiction.

In her brief for the Swiss system, Professor Curzon-Price argued "the splitting of political units into tiny elements" provides a "huge gain in terms of the legitimacy of the state." And, "a state obtains obedience in one of three ways: repression, bribery and consent. Most modern democratic states end up using, and abusing, the second of these (with the political class bribing marginal voters to maintain power)." Repression and bribery are costly, but neither is needed if the government can obtain the willing consent of the governed, which is best obtained by direct democracy within small political units.

The lesson is that large states can obtain the economic gains small states have made by freeing up their economies. They also can gain greater democratic legitimacy and a more satisfied electorate by devolving power to states and localities.

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