THE SMALL STATES OF THE EU

ECONOMIC PERSPECTIVES

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SMALL STATES IN THE EU: ECONOMIC AND POLITICAL PERSPECTIVES

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Layout of the presentation

This presentation is organised in 5 sections, as follows:

- Section 1 is an introduction, stating the purpose of the presentation
- Section 2 presents and discusses some statistics relating to the ten small states.
- Section 3 summarises the pros and cons of EU membership.
- Section 4 deals with the economic prospects of each of ten countries.
- Section 5 concludes the presentation

1. INTRODUCTION

Purpose of the presentation

- The purpose of the presentation is mainly to describe the economic structures and economic prospects of ten European small states and to discuss the benefits or disadvantages that EU membership has offered or will offer to these states.

- Country size is measured in terms of population size, and, as defined here, small states are those with a population of about three million persons or less.

- According to this definition seven EU member states qualify for inclusion in this group, namely Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Malta, and Slovenia. The book also includes two candidates for membership, namely Macedonia and Montenegro. Iceland is also included in view of the fact that it is highly integrated in the EU.

Special constraints faced by small states

- Small states face special disadvantages in view of their small domestic market, their limited natural resources endowments and their economic diversification constraints. Due to these characteristics, these states tend to be highly dependent on international trade, and are therefore highly exposed to external shocks.

- In spite of these constraints, the seven small states members of the EU, register relatively high GDP per capita and have fitted satisfactorily in the EU family of states, side-by-side with larger states, including Germany, Italy, UK and Spain.

Special constraints faced by small states

- The small EU member states had to transpose EU directives and abide by regulations set for all EU members, large and small. It is well known that small states tend to suffer from the problem of overhead cost indivisibility, due to the fact that such costs cannot generally be downscaled in proportion to the population.

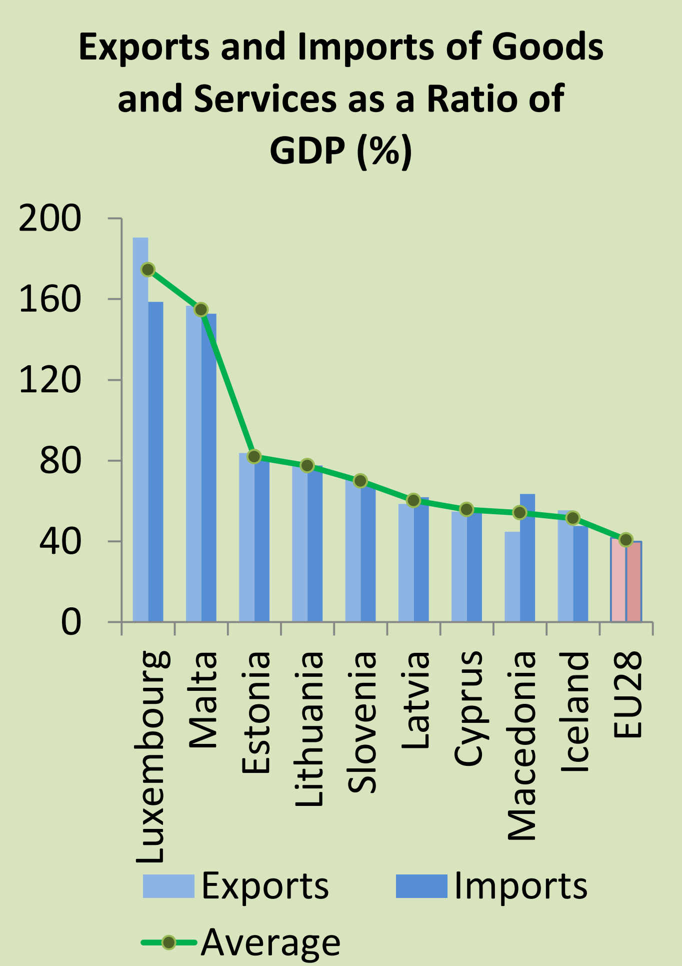
- It is therefore to be expected, that the transposition of these directives and regulations into the body of laws of the respective countries results in higher relative costs for these small states.

2. Characteristics of the EU Small States

Common features: trade openness

- All ten small states are highly open economies. One reason for this is that small states have a small domestic market and they cannot rely on their own market for a critical mass of production of many goods and services.

- In addition, small states tend to be poorly endowed with natural resources and with the consequence that they often depend highly on imports of food, fuel and industrial supplies.

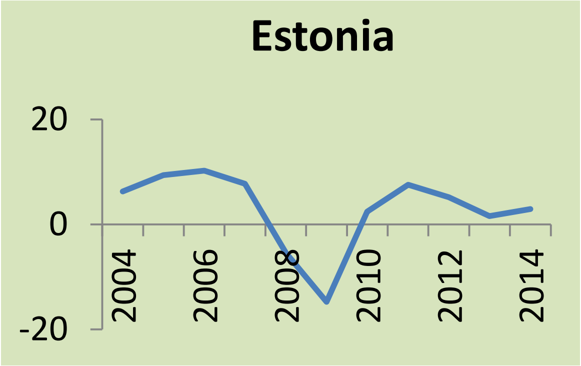


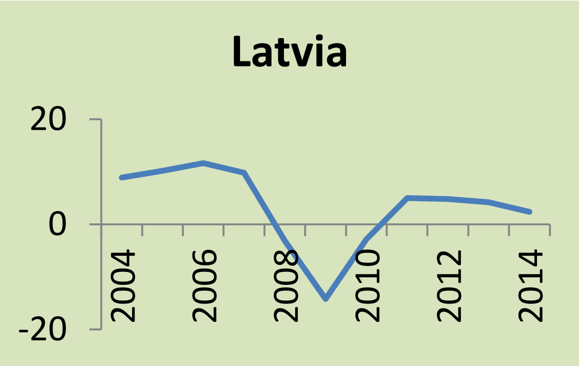
Source: Eurostat database

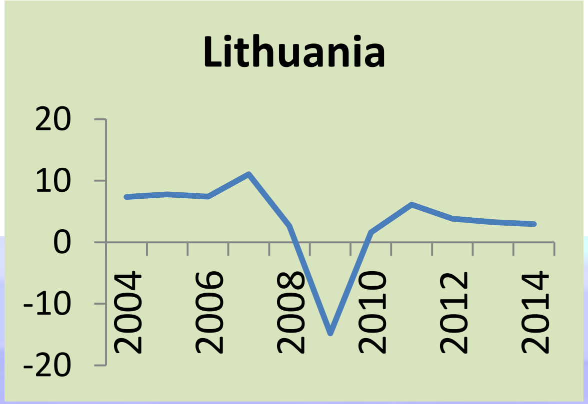
Common features: the 2009 dip

- Due to the fact that these countries export a large proportion of their goods and services to the EU, which was itself highly impacted by the global recession of 2008/2009, they inevitably also experienced a decline in their GDP.

- This 2009 dip occurred in all the ten small states and was clearly visible in the diagrams on the right which pertain to the Baltic States.



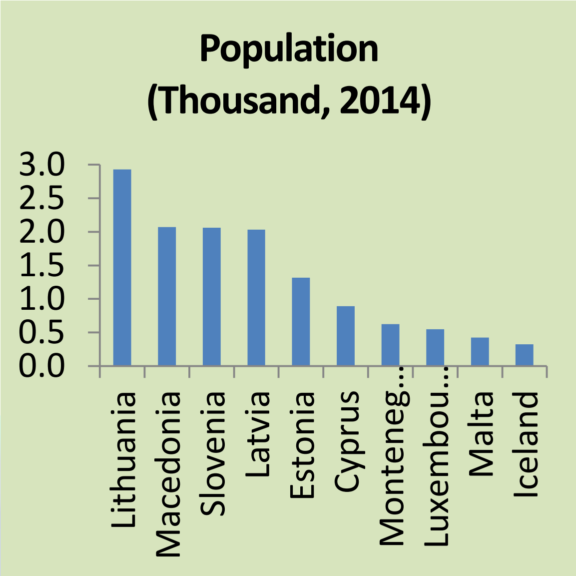


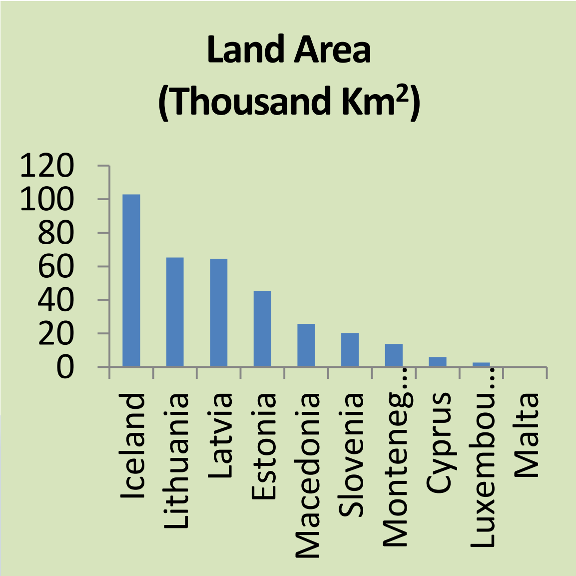


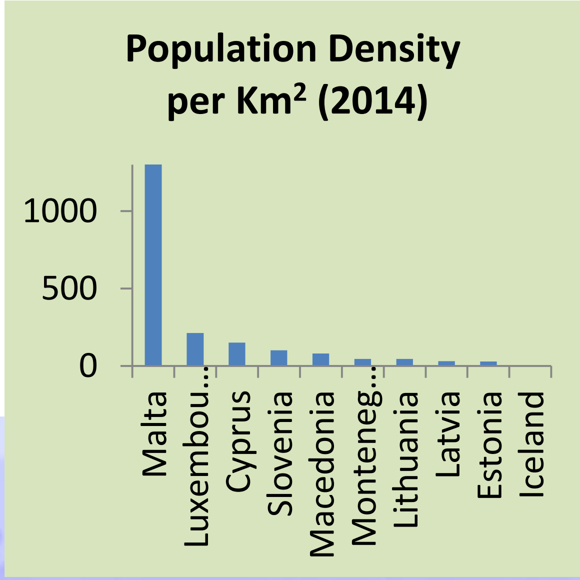
Disparities: population densities

- Although the ten states are all relatively small, they have different population densities, as can be seen in the three figures below.

- Iceland occupies the largest land area but has the lowest population in the group (326 thousand) leading a population density of 3 persons per km^2 . At the other extreme there is Malta, with a land area of 315 km^2 and a population of 425 thousand, so that its population density is over 1300 per km^2 .



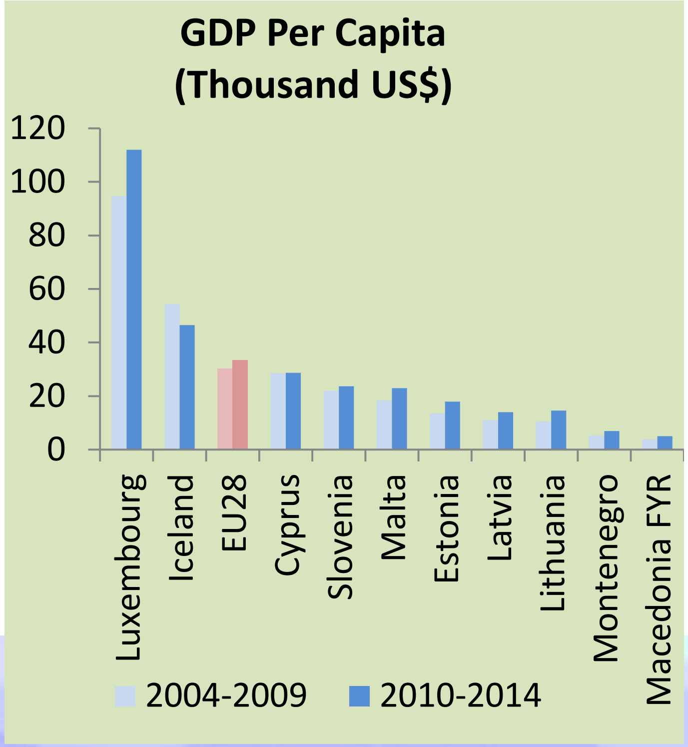




Disparities: GDP per capita

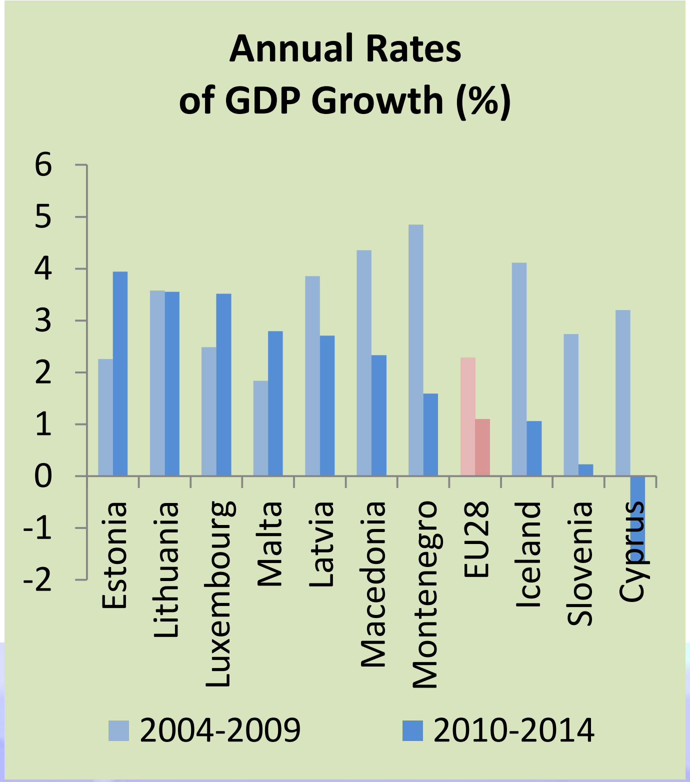
- The GDP per capita of the ten small states also differs markedly. Luxembourg, is by far the highest income generator, with over US$100 thousand per capita (averaged between 2010 and 2014). Iceland follows with over US$40 thousand per capita.

- A similar pattern emerges when income per capita is measure by GNI per capita in terms of purchasing parity standards (PPS), but the income disparities are reduced due to price differences across the ten countries.



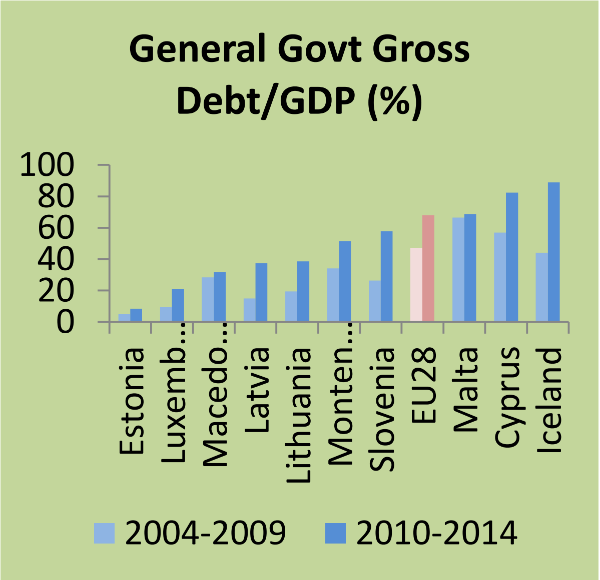
Disparities: GDP growth rates

- The ten small states also differ in their rate of growth, The fastest growing EU member state between 2004 and 2009 was Latvia, with Iceland, Montenegro and Macedonia also registering very rapid growth rates as well, during this period.
- Growth rates between 2010 and 2014 were generally slower when compared to 2004-2009, particularly for Cyprus, Iceland, Latvia and Slovenia, all of which experienced serious financial difficulties in recent years. During the 2010-2014 period, the fastest growing economies were Estonia, Lithuania and Luxembourg.

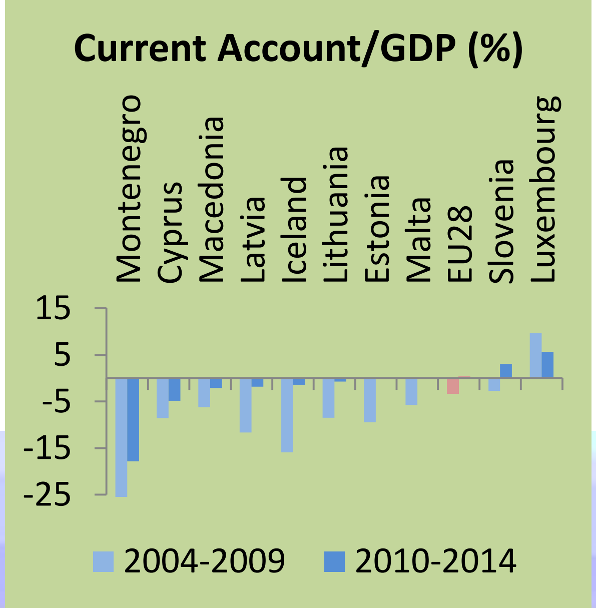


Disparities: macroeconomic instability

- An indicator of instability relates to government finances. The diagram on the right shows that the three island states (namely Malta, Cyprus and Iceland) registered very high debt ratios between 2010 and 2014.



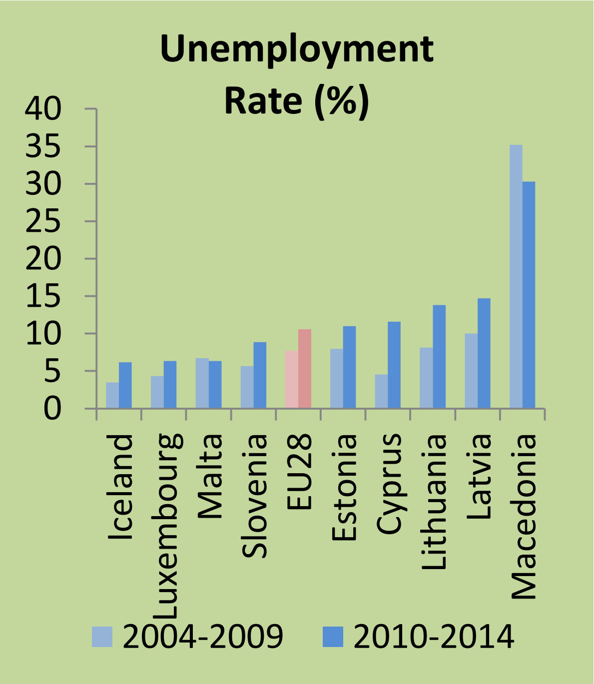
- Another indicator of instability is the current account of the balance of payments. Eight of the ten small states (Luxembourg and Slovenia being the exceptions) registered negative balances on average between 2010 and 2014.



Disparities: macroeconomic instability

- Yet another indicator of instability is the rate of unemployment. The unemployment rate in these states also differed markedly with Macedonia being by far the country with the highest rates.

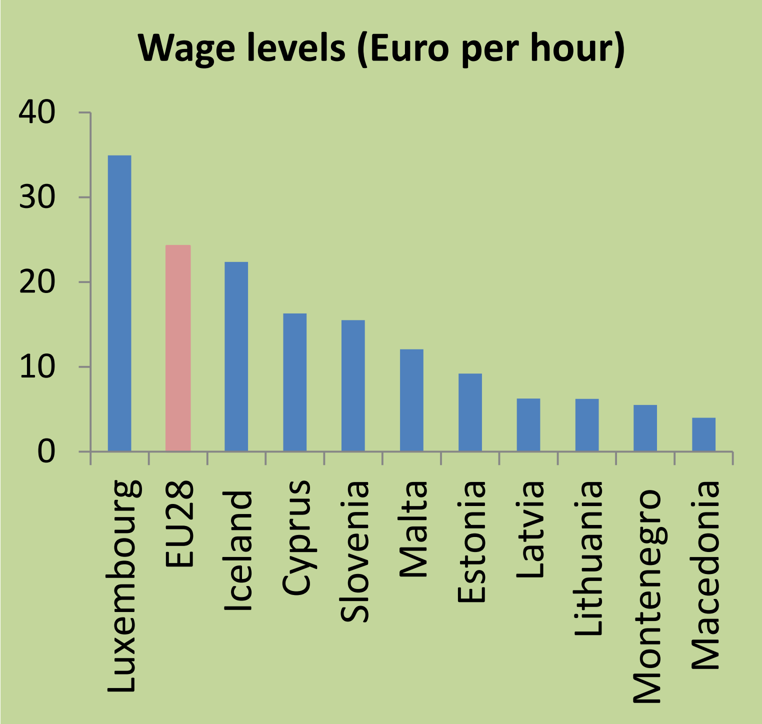
- The countries with the lowest unemployment rates were Iceland, Luxembourg, Malta and Slovenia, which registered rates lower than the EU average.



Disparities: wage rates

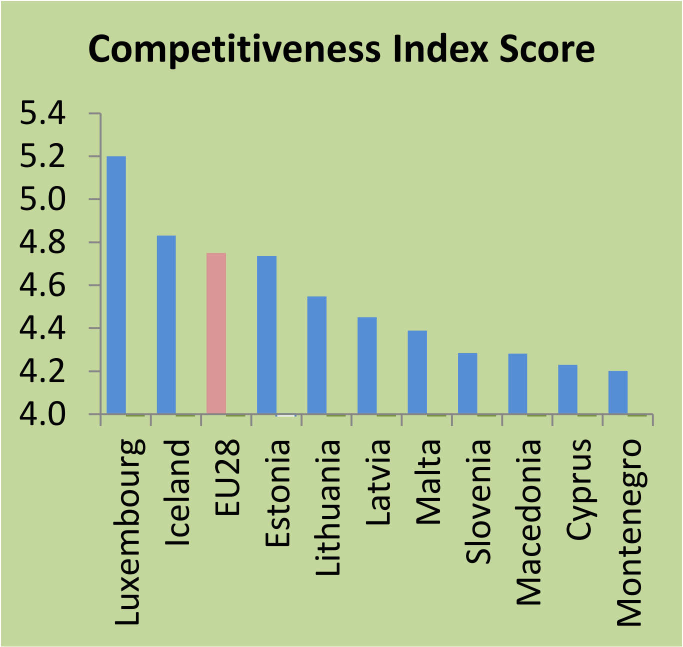
- Another major difference between the ten states relates to their wage rates.

- The pattern is very similar to the GDP per capita of the respective countries, with Luxembourg and Iceland paying the highest wage rates and the Baltic States and the two candidate countries the lowest.



Disparities: competitiveness

- The Global Competitiveness Indicators (with scores ranging between 1 and 7) indicate that Luxembourg and Iceland received scores markedly higher than the EU average. The remaining small states' scores are below the EU average.



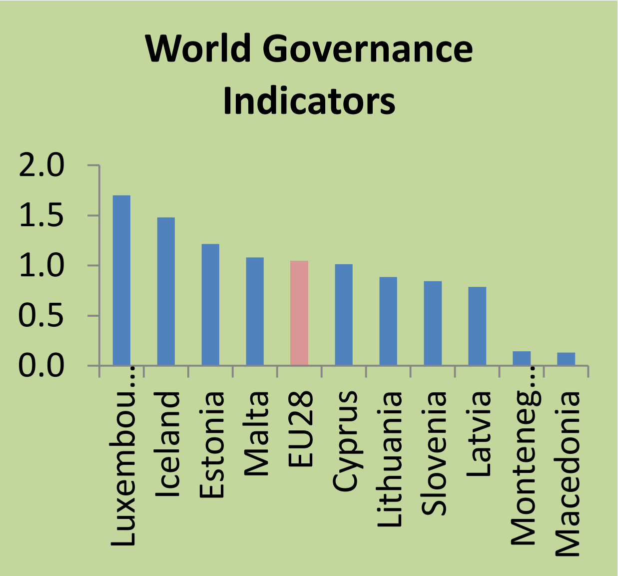
- It is to be noted that in spite of the fact that Luxembourg's and Iceland's wage rates are relatively high, they still exceed the other small states' scores in terms of competitiveness, indicating that labour productivity can more than offset wage costs in fostering competitiveness.

Problematic factors (red highest problem)

Areas of concern	Avg.	CYP	EST	ICE	LAT	LIT	LUX	MAC	MAL	MON	SLO
Access to financing	14.4	24.6	11.0	12.0	11.5	7.4	10.9	18.4	16.1	18.0	14.0
Inefficient government bureaucracy	13.8	18.9	10.3	9.2	14.5	16.6	13.1	9.4	18.5	11.8	15.9
Tax rates	10.4	2.5	18.3	12.0	15.1	14.8	6.8	4.5	4.9	9.5	15.7
Inadequately educated workforce	9.5	2.4	19.7	1.3	9.2	9.3	21.0	10.7	12.3	7.2	2.1
Restrictive labour regulations	7.7	6.1	4.4	1.6	4.4	13.5	18.4	2.3	4.9	5.1	16.5
Insufficient capacity to innovate	7.2	9	9	3.2	8.2	3	8.8	7	13.9	7	2.8
Complexity of tax regulations	6.1	1.1	5.3	5.0	10.2	10.2	4.4	7.7	3.7	5.1	6.3
Inadequate supply of infrastructure	6.0	5.9	7.6	2.4	4.7	3	5.9	6.1	12.1	10.1	2.5
Corruption	5.5	10.1	1.6	1.8	5.4	8.8	0	7	6.1	8.2	0
Poor work ethic in labour force	5.0	3.9	7.4	1	5.6	3.8	4.8	10.1	3.4	7.8	2.4
Foreign currency regulations	3.3	2.3	0.3	28.7	0	0.3	0	0.9	0	0.9	7.9

Disparities: political governance

- The Worldwide Governance Indicators (WGI) have six dimensions of political governance, namely (1) voice and accountability (2) political stability and absence of violence (3) government effectiveness (4) regulatory quality (5) rule of law and (6) control of corruption.

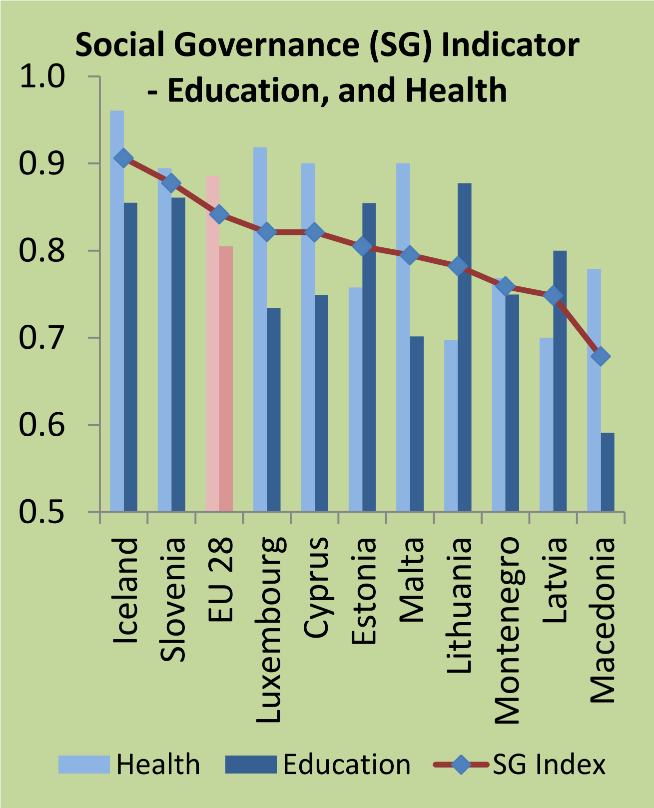


- It can be seen from the Figure that Luxembourg, Iceland, Estonia and Malta have relatively high scores, higher than the EU28 average. Cyprus, Lithuania, Slovenia and Latvia have lower scores than the EU average, but their scores are still relatively high by international standards. Montenegro and Macedonia have the lowest governance scores among the ten small states. The WGI scores range from -2.5 (worst possible) to +2.5 (best possible) and therefore all ten small states register scores higher than the World average.

Disparities: social governance

- It can also be seen that the education scores of Estonia and Lithuania are higher than the EU28 average, while the health scores **of** Luxembourg, Cyprus and Malta are higher than the EU average.

- The non-income HDI (which is a weighted average of health and education scores) is used to measure social governance (SG).



- The SG indicator shows that Iceland and Slovenia have higher scores than the EU28 average. Luxembourg, Cyprus, Estonia, Malta and Lithuania have relatively high SG scores, which are slightly lower than the EU28 average.

Commonalities and disparities

- It can therefore be concluded that the major common feature of the small states relates to their high degree of trade openness and hence their exposure to external shocks. Even here the degree of openness is not the same for all countries with Luxembourg and Malta being the most open among the ten countries. They differ in many other economic aspects.

- In general, these ten countries can be grouped into four categories in terms of their economic, political and social governance. Luxembourg's and Iceland's features render them the most developed, Malta, Cyprus and Slovenia the second-most developed, and the Baltic states the third-most developed. Macedonia and Montenegro, are the least developed among the ten small states.

3. Pros and Cons of EU Membership

Advantages of EU membership: four freedoms

- The major advantages of EU membership mentioned by the ten authors of the chapters in the book which is being launched related to the freedom of movement of goods, capital, services, and people, often referred to as the "four freedoms" between the member states.

- As already explained, small states tend to depend highly on exports due to their small domestic markets and therefore the fewer the barriers to trade the better it is for them. Such a situation permits them to enjoy the benefits of economies of scale. In addition the intense competition that such a situation brings about is likely to also improve the allocation of resources in these states.

Advantages of EU membership: funding

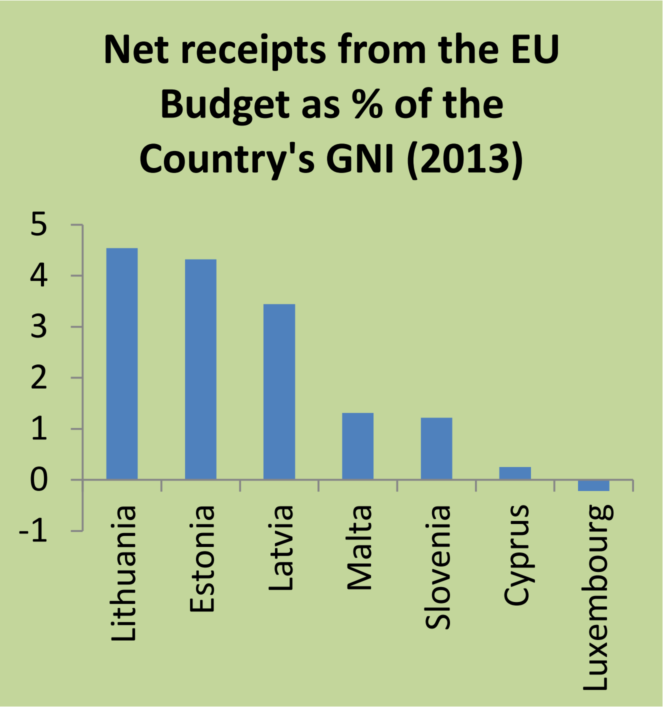
- Another advantage mentioned in most chapters, especially the chapters on the Baltic economies, is that the emphasis by the EU commission on research and innovation, has stimulated and enabled these countries to upgrade their productive capacity. In the case of small states, the main resource of which is the human one, improvement in labour productivity that could result from innovation is of major importance.

- Small states have also been eligible for EU regional and other funds, which have, among other things, enabled these states to successful transpose the EU regulations and directives. Nine of the ten small states covered in this publication, Luxembourg being the exception, received more than they contribute to the EU budget

The advantages of EU membership: funding

- The highest net recipients of EU funds, as a percentage of GNI, were the Baltic States. In Lithuania, the net recipients amounted to about 4.5% of its GNI.

- Montenegro and Macedonia, the two candidate countries, also receive considerable pre-accession funds.



Advantages of EU membership: political factors

- Although the Baltic states receive considerable EU funding, a highly regarded benefit mentioned in the chapters relating to these states is associated with the geo-political realities of the region, where peace, political stability and freedom are of major importance, given their location and their recent past history.

- In the case of Luxembourg, which is a net donor, a major benefit mentioned in the chapter on that country, is that a number of EU institutions are based in this country, including the Court of Justice, the Court of Auditors, the European Investment Bank, the General Secretariat of the European Parliament and some Commission services.

Disadvantages of EU membership: Sovereignty

- As expected, the most important downside of EU membership is considered to be loss of sovereignty. The chapter on Iceland, the government of which withdrew the application for EU membership, and the chapter of Cyprus, the government of which was compelled to undertake austerity measures following the 2012-2013 financial crisis, assign particular importance to this matter.

- In the case of Cyprus, an issue that is stressed by the author of the respective chapter is that the Troika (the European Commission, the International Monetary Fund, and the European Central Bank) imposed measures that greatly harmed the banking sector of Cyprus.

Disadvantages of EU membership: weak voice

- Another disadvantage identified by most authors is the weak voice that the EU small member states have within the EU institutions. Although small states are represented in the EU decision making institutions by a much higher proportion than that of their population to the EU overall population, they do not generally have the political clout to influence major decisions on their own.

- Three main reasons are mentioned in the book namely (a) line-Ministries of small states are small and they do not have enough specialists to engage effectively in international negotiations - sometimes what are normally two or more line Ministries in a large state, fall under one Ministry in some small states (b) their delegations during negotiations are generally small and (b) they are politically and economically weak to pose credible threats in their persuasion strategies.

Disadvantages of EU membership: weak voice

- In addition big states sometimes make side-deals outside the formal decision-making process, something that small states cannot do persuasively **as** they have less to offer in return.

- In some areas, which are still subject to unanimity, small state can in theory exercise a veto.

- These areas include matters relating to taxation, the finances of the Union, aspects of the common foreign and security policy and of the common security and defence policy, citizenship and certain institutional issues notably thee revision of the treaties. In reality, however, small states rarely use the veto as this would incur a high political price, including the possibility of being isolated.

Disadvantages of EU membership: weak voice

- In some chapters of the book there is reference to the Qualified Majority Voting in Council decision-making, suggesting that this would seem to be detrimental to small states as they can easily be outvoted.

- The seven small EU member states covered in this publication, taken together, have less than 3% of the EU population whereas for a decision to be adopted the backing of member states needs to represent at least 65% of the total EU population, together with the assent of at least 16 member states. The blocking minority requires at least four Council members representing more than 35% of the EU population.

Disadvantages of EU membership: voting method

- Generally speaking the voting method is of little importance, and a vote very rarely takes place. This means that, in practice, when a consensus is sought, the voice of the small states could be important, particularly when alliances are formed to push a decision forward.

- However, during a meeting of the EU interior ministers in September 2015, the consensus approach was uncharacteristically abandoned on the issue of emigration, when the majority voting method was used to adopt a plan to relocate 120,000 refugees across the EU, with four eastern European countries (Hungary, Slovakia, Romania and the Czech Republic) being outvoted.

The perceptions of EU citizens

- The opinions of inhabitants in the 7 EU small states (this excludes the two candidate countries and Iceland) vary considerably with regard to the benefits they derive from the EU. The Table in the next page summarises the responses to six questions in response to the 2015 eurobarometer survey (European Commission, 2015).

- The six questions were chosen by the present author because they were considered to capture the attitudes of respondents towards the EU, and relate to (1) trust the EU (2) voice of the respondent in the EU (3) the image of the EU (4) feeling of EU citizenship (5) whether the country benefits from EU membership and (6) whether the country of the respondent could better face the future outside the EU.

The Perceptions of EU Citizens

EU 28 and EU 7 Small States	Do you tend to trust the EU or tend not to trust it?			My voice counts in the EU			Does the EU conjure up for you a negative or positive image?		
	Tend to trust			I agree			Positive Image		
	Score %	Rank SS 7	Rank EU 28	Score %	Rank SS 7	Rank EU 28	Score %	Rank SS 7	Rank EU 28
EU28 Avg.	40			42			41		
Cyprus	23	7	28	19	7	28	24	7	28
Estonia	55	3	8	27	5	23	49	4	8
Latvia	51	4	9	23	6	26	39	5	16
Lithuania	68	1	1	34	4	20	55	1	3
Luxembourg	49	5	11	50	2	9	52	2	6
Malta	62	2	3	60	1	4	51	3	7
Slovenia	41	6	20	42	3	16	37	6	20

EU 28 and EU 7 Small States	Do you feel you are a citizen of the EU			The interests of our country are well taken into account in the EU			My country could better face the future outside the EU			Average score and rank of the six questions		
	Yes			I agree			I disagree					
	Score %	Rank SS 7	Rank EU 28	Score %	Rank SS 7	Rank EU 28	Score %	Rank SS 7	Rank EU 28	Score %	Rank SS 7	Rank EU 28
EU28 Avg.	67			43			58			49		
Cyprus	50	7	26	17	7	27	44	7	26	30	7	28
Estonia	79	3	5	48	4	12	66	4	7	54	4	11
Latvia	69	5	16	31	6	25	55	5	18	45	5	18
Lithuania	78	4	6	57	2	3	74	1	2	61	3	7
Luxembourg	88	1	1	59	1	2	70	2	3	61	2	6
Malta	84	2	2	51	3	6	69	3	6	63	1	5
Slovenia	65	6	19	33	5	24	44	6	27	44	6	21

The Perceptions of EU Citizens

- The EU small states that appear to look at the EU membership most favourably in terms of these six aspects of EU membership just mentioned are Malta, Luxembourg, Lithuania and Estonia in that order, with a ranking among the highest eight in the EU. Cyprus emerged as the country that looks at the EU least favourably among the 7 small states and among the EU28.

- The attitudes of the Cypriot respondents were to be expected, given the austerity and punitive measures imposed by the EU and IMF on the Cypriot people in 2013, possibly the only country expected to rely to a very high extent on a “bail-in” method (making the local depositors pay), **instead of** outside sources to unravel the solvency problems of its banks.

4. Prospects of the Ten Economies

Prospects: The Baltic States

- From what emerges from the chapters relating to Estonia, Latvia and Lithuania, it appears that the economic prospects of these Baltic States are not bleak, although the geo-political tensions in that area and the ensuing uncertainty, as well as the Russian economic problems, may negatively affect their export performance.

- It appears that Estonia's economy will continue to grow in the medium term as the country improves its export performance. The country is characterised by solid public finances, with public debt expected to remain below 10% of GDP.

Prospects: The Baltic States

- In the case of Latvia, growth is also likely to be sustained, mostly by domestic demand, but the country’s sour relations with Russia may have an impact on the domestic economy. A major problem with Latvia is its shrinking labour force. Lithuania’s economy is also likely to remain on course in the medium term, again with domestic demand likely to be the major contributor to growth.

- A worrying possible development in these states is that the increases in wages rates, partially caused by the economic recovery itself is likely to increase labour demand, leading to wage increases which could negatively affect the competitiveness of these countries.

Prospects: Malta and Cyprus

- The prospects of the two Mediterranean states, namely Malta and Cyprus, are very different.

- Malta's economic growth is projected to be sustained in the medium term, driven by strong domestic and external demand, leading to an increase in the number of gainfully employed persons and a reduction in unemployment.

- In the case of Cyprus¸ the effects of the 2013 financial crisis and recession are still being felt, and the Chapter on Cyprus in this publication sheds doubt as to whether the structural reforms and austerity measures imposed on it will lead to sustained growth. However, some projections state the Cypriot economy is set to stabilize itself and even expand gradually in 2015/2016 after a number of years in recession.

Prospects: Luxembourg and Slovenia

- Luxembourg's economic growth rate is expected to be robust in the coming years, driven by domestic and foreign demand. This country is characterised by solid economic fundamentals, but its reputation was somewhat tarnished by the tax rulings aimed at reducing tax liability through a secret corporate tax avoidance scheme for a large number of multinational companies located Luxembourg.

- Economic growth in Slovenia is also expected to be sustained in the medium term but public finances are likely to remain problematic.

Prospects: Luxembourg and Slovenia

- The two candidate countries considered in this publication, namely Macedonia and Montenegro are both likely to remain on the growth path driven by investment, notably in the infrastructure, although both countries may experience public finance constraints.

- In the case of Macedonia, the increase in income inequality in recent years is likely to have negative social impacts. In addition, the political crisis that Macedonia has been going through since the end of 2014, could adversely affect all segments of living and undermines the European perspective of the country.

Prospects: Iceland

- Iceland is still recovering from its devastating 2008 financial crises which led to a severe economic downturn in the following two years and to political unrest.

- The economy has since than recovered mainly driven by domestic demand and a rapid increase in tourism inflows. Wage rates in Iceland are relatively high and are likely to be further pushed upwards with increased demand for labour. Problems have also arisen with regard to government debt, although measures are being taken to reduce its ratio to GDP.

Prospects: Overall

- More detailed analysis of the ten small states are presented in the country chapters.

- The overall impression one obtains from these chapters is that the worse is over and that a period of recovery beckons. It remains to be seen whether these projections materialise.

5. Conclusion

Conclusion: similarities and differences

- This presentation has given an overview of the economies of ten small states members of the EU or associated with the EU. A number of similarities and differences were identified.

- The main similarity is that they all highly economically vulnerable, due to their exposure to external economic conditions beyond their control. In spite of this some of these states are highly successful in terms of their level of GDP per capita and their economic growth, pointing to the fact that appropriate policies can enable vulnerable states to withstand their economic vulnerability.

- However, the analysis presented in this chapter clearly shows that the ten small states cannot be described as a homogenous group. They differ in many aspects, most notably in their stage of development.

Conclusion: pros and cons of membership

- The real and perceived benefits derived by these states as a result of EU membership also converge in some ways, while in others they vary considerably.

- All these states benefit from free access to a single large market, in view of the fact that their domestic market is very small. Most of them also benefit from transfer of funds from the EU.

- However, in the case of the Baltic States geo-political reasons are seen as the major benefits derived from EU membership, in view of their experiences as part of the Soviet Union and their proximity to Russia.

Conclusion: pros and cons of membership

- Luxembourg, though a net contributor of funds to the EU, benefits greatly by hosting a considerable number of EU institutions.
- Malta benefitted greatly from transfer of funds, enabling the island to significantly upgrade its infrastructure.
- Cyprus stands out as an EU member state where the majority of its people think that the EU did not really help Cyprus in times of need, as evidenced from the responses to the 2015 eurobarometer

Conclusion: different emphasis

- Different chapters in the book place different emphasis in their view of the EU. For example the chapter on Cyprus and Iceland assign importance to political factors more than other chapters, whereas the chapters on the Baltic States pay more attention to innovation.

- Malta and Luxembourg, which both have a relative large financial sector, make reference to this sector when discussing the structure and performance of the economy.

- What therefore emerges from this presentation is that we are dealing with a group of countries which are heterogeneous in many aspects, and what mostly groups them together is their small domestic market and their high exposure to external economic conditions.

End of Presentation

THANK YOU
FOR YOUR ATTENTION