

# Economic context and policy approaches in small advanced economies

*David Skilling*

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## 1. Introduction

This paper describes the recent and current performance and policy settings of small advanced economies, as well as the emerging challenges and opportunities facing small advanced economies. The paper is supplemented by a deck of slides that describe various measures of small advanced economy performance and policy settings.

This paper will identify key elements of the small economy experience and policy approach, with particular emphasis on those features that are shared by successful small advanced economies. It will provide a sense of the underlying motivation for economic policy choices that various small country governments have made. It will describe current policy debates across selected small country governments, and how small country governments are responding to emerging challenges and opportunities.

This initial paper will provide a foundation for subsequent analysis and recommendations for Northern Ireland.

The paper is structured as follows. Section 2 introduces the small advanced economies group, and discusses the performance of small advanced economies over the past few decades. Section 3 describes the key common features in small country economic policy approaches that have contributed to this strong performance. Section 4 describes key elements of the current economic context in small advanced economies, and the economic policy approaches and debates seen across small advanced economies as they respond to emerging challenges and opportunities. Section 5 contains selected small country case studies, describing their performance, policy approaches, and current issues and debates: the countries considered are New Zealand, Singapore, Ireland, Denmark, and Finland. Section 6 concludes.

## 2. Small advanced economy performance

This section introduces the small advanced economies group (and the large advanced economies, which serve as a comparator group) and describes some of the stylised facts of small country performance on a range of economic and social outcomes.

I define small advanced economies as selected IMF advanced economies with populations of less than 20 million people. I have constructed a group of 15 small advanced economies that I use in analysis, because they provide a good sample of geographies, economic structures and sizes, and also illustrate common small country themes. For this analysis, I add Estonia to make a group of 16 small countries. I also construct a comparator group of 10 large advanced economies; IMF advanced economies with populations of more than 20 million people. These countries are described in Exhibit 1.<sup>1</sup>

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<sup>1</sup> Note that the analysis and insights presented in this paper do not change in a material way if a different population threshold is chosen (for example, 10 million rather than 20 million).

The first observation to make is that small advanced economies tend to have relatively high levels of per capita income, and a few small advanced economies have particularly high levels (Exhibit 3). Although there is clearly a significant distribution of income levels across the small advanced economies group, the top-performing small advanced economies dominate the rankings.

These strong per capita income measures are the result of strong small country GDP growth rates over the past few decades, and particularly over the past 25 years. Exhibit 4 shows that there has been a distinctive edge, of around half a percentage point, in GDP growth in small advanced economies over the larger counterparts. This strong performance has been reasonably broadly-based across the small advanced economies group (Exhibit 5), although several small Northern European economies have generated sluggish growth performance since 2000.

It is useful also to look at the variation in growth models across countries. Some small advanced economies have relatively high per capita income primarily because of high hours worked, rather than because of high labour productivity levels – which, on average, are about the same as in the large advanced economies group (Exhibit 6).

Exhibit 7 decomposes per capita income levels into its two component parts: hours worked per capita and labour productivity (per hour worked). There is significant variation across the group. One interesting dimension of variation is the marked difference between mature small economies (generally in Europe) and more recently developing small advanced economies (Israel, Singapore, New Zealand, Estonia) that have relied more on labour force growth than labour productivity growth.

Exhibit 8 notes the contributions from labour productivity and hours worked to GDP growth over the past 15 years. Strong growth countries such as Singapore, Hong Kong and New Zealand have benefited from strong growth in the labour input; countries like Ireland have benefited from strong productivity growth, importantly driven by the MNCs that have invested. The overall insight is that labour productivity is a key growth engine for small advanced economies.

Another important characteristic to note is that the GDP growth trajectory of small advanced economies tends to be more volatile: small advanced economies are more exposed to external shocks, and have less in-built resilience as they are less likely to have a fully diversified economic structure. Exhibit 9 shows that small economies have a higher standard deviation of this growth rate since 1980. And Exhibit 10 illustrated the experience of advanced economies through the global financial crisis, by measuring the slow down and then the pick-up in growth rates. In general, small advanced economies had a deeper crisis experience (most particularly in countries like Estonia and Iceland). Countries like New Zealand were buffered by strong demand growth from Asian emerging markets like China.

In addition to these headline measures of economic performance, small advanced economies tend to do well on measures of the extent to which the gains from growth are broadly shared. For example, small advanced economies have done well in terms of labour market performance; on average, unemployment rates across the small advanced economies group have tracked consistently under those of larger advanced economies by a couple of percentage points. Exhibit 10 describes the 2015

unemployment rate across the advanced economies group, which is slightly skewed by the unemployment legacy of the crisis in small countries such as Ireland and Finland.

Exhibit 11 notes the income distribution across advanced economies: many small advanced economies have low measures of inequality, although countries such as Singapore, Hong Kong, and Israel have high measures of income inequality. Income distribution outcomes are a matter of policy choice, rather than anything intrinsic to small advanced economies.

### 3. Small advanced economy policy approach

The group of small advanced economies is a diverse group of countries that on the surface have many significant differences in economic approaches: Singapore has a different economic model from Denmark; Switzerland is very different from New Zealand; and so on. But there are some common elements that are shared across high performing small advanced economies, and that distinguish successful small economies from their less successful peers.

Small advanced economies confront common challenges and opportunities, which stem from their acute exposure to the external environment. This has a profound influence on how small advanced economies approach economic policy: they are trying to respond to similar challenges, although the specific way in which they do so will vary according to local economic and political context.

Because context matters, it is not helpful to talk about specific ‘best practice’. But there are some general themes and insights that are consistently observed across high performing small advanced economies. This section describes some of the common themes or properties of high performing small advanced economies (which in turn are supported in various ways by specific policy settings).

In particular, high performing small advanced economies are characterised by active international engagement; strong, sustained investment in knowledge, innovation and human capital; as well as strong policy foundations that provide the support for economic success.

#### *Active international engagement*

Small economies have to develop a well-performing external sector in order to generate strong economic outcomes – the domestic market is too small to get the required scale and specialisation. Indeed, there are substantial differences in productivity levels between domestic and externally oriented sectors; this is true across advanced economies, but is particularly true for small advanced economies with a limited domestic market. International engagement is at the core of small country economic policy; this is both an outcome but also a core element of the strategic policy approach.

Exhibits 14 – 17 report several measures of international economic engagement. The levels of international engagement by small advanced economies are substantially higher than for larger economies, and the growth in international economic activity has also been stronger. This is the case for both exporting as well as cross-border direct investment. The small economy group time series

suggests an acceleration in international intensity from the late 1990s, partly reflecting strong global growth and the integration of emerging markets (and also reflecting some of the specifics of the export footprint of these countries). The nature of the international engagement model in small advanced economies has also shifted over this period, with increased focus on outward direct investment.

Many small countries have also benefited substantially from inward direct investment, notably Ireland and Singapore who have placed this at the centre of their respective economic strategies.

Large multinational firms play an important role in small advanced economies in driving international expansion (as well as contributing significantly to productivity and innovation). Exhibit 18 reports that small advanced economies produce more large companies per million population than do their larger economy counterparts. The international activity of these small country firms is a central part of strong external engagement by small advanced economies.

Policy can make an important contribution to international engagement. This can occur in indirect ways, through policy foundations and investing in innovation and human capital (discussed below). There are also some direct policy contributions that can be made. As will be discussed in more detail in the country case studies, small advanced economies are actively involved in developing a portfolio of external relations (such as through trade agreements) and developing an enterprise support system that is focused on international expansion by firms.

#### *Investing in innovation & human capital*

Successful small advanced economies are characterised by heavy investments in knowledge, innovation and human capital. It is commonly observed that small economies, because they have limited resources, act to ensure that they make the most of their people. This focus on knowledge and human capital has been central to the way in which small advanced economies, from Switzerland to Singapore, have built a distinctive international competitive position. This capability is necessary to support the competitive positioning of high cost small advanced economies in the global economy.

Many small advanced economies, notably countries like Finland and Israel, invest very heavily in R&D (Exhibit 18). There is variation across the group (New Zealand is towards the bottom), and in the way in which innovation is undertaken (some like Ireland and Singapore rely on R&D intensive MNCs). The time series of R&D spending suggests an increased investment in R&D from the mid-late 1990s (Exhibit 19), which enabled small economies to transform the export structure (moving into higher value, higher growth categories).

One other measure of the domestic innovative capacity of small advanced economies is provided in the World Economic Forum's Global Competitiveness Report (Exhibit 20). Small advanced economies tend to perform well in the overall competitiveness rankings. But for advanced economies it is the performance on the innovation and business sophistication measures that are particularly relevant. Many of the high performing small economies, such as Switzerland and several Nordics, perform particularly well on this innovation measure. In contrast, countries such as Singapore, Estonia, and New Zealand perform less well.

In addition to these substantial investments in innovation, small countries also prioritise investment in human capital. Consider the strong performance of small advanced economies on the World Economic Forum's Human Capital Index, a composite measure of multiple dimensions of human capital (Exhibit 21). This performance is due to a combination of strong formal education systems, as well as technical/vocational training and high quality schools, universities, and research institutions. Many small economies are currently investing in initiatives to prepare their existing and future workforce for the workplace of the future, recognising that disruptive change is on the way. Singapore, Denmark and Ireland are good examples.

### *Strong policy foundations*

In general, small advanced economies rank highly on the various indexes of policy quality and the business environment. As just a few examples, small advanced economies have consistently dominated several international measures of competitiveness (including the World Economic Forum's Global Competitiveness Report noted above); the World Bank's 'ease of doing business' index, the various OECD measures of regulatory quality, World Bank measures of governance and so on.

Small economies understand the importance of efficiency and flexibility, so that they are able to respond quickly to shocks and structural changes. This is an important part of both the economic dynamism of small economies as well as of economic resilience. One interesting dimension of this approach to flexibility is in terms of active labour market policy and a well-developed system of social insurance that allocates risks efficiently and supports the rapid movement of labour across an economy. Denmark and the Nordics are a good example of this approach, as is Switzerland.

However, despite these good policy foundations, it is important to note that domestic sectors in many small economies lag in productivity and innovation – and frequently are less competitive – than their larger counterparts. There are inevitable inefficiencies in the behaviour and performance of small domestic markets. However, labour markets and externally facing parts of the economy are generally productive and flexible in small economies.

There are also regularities in terms of small country macroeconomic policy. These common features reflect the competitive discipline imposed on small economies by the high degree of openness to the global economy.

For example, most small advanced economies are conservative on fiscal balance and in terms of the public debt stock. This is because they are aware that they are more exposed to shocks, have lower margin for error, and are subject to greater capital market discipline than is the case for larger economies like the US, Japan, Italy and France. Exhibit 22 notes that the structural deficit for the small advanced economies group has been consistently lower than for large economies; and Exhibit 23 notes that the level of gross public debt is generally lower in small economies than in large economies. Small economies need to earn credibility, and have limited margin for error on macroeconomic policy.

Interestingly, however, many successful small advanced economies (particularly in Europe) have high levels of government spending and tax (Exhibit 24). In contrast, Singapore and Hong Kong have

relatively low levels of government spending, although some of this difference is due to compulsory private saving for retirement (and government spending in these economies is increasing). One likely reason for this regularity is to enable small economies to provide a buffer against shocks. Academic research shows that, in general, more open economies have higher levels of government spending.

However, there is downward pressure on government tax and spending levels in many small economies due to concern about slowing growth and cost competitiveness. This is currently an area of policy focus in countries like Denmark and Finland. And there has been a pronounced downward trend in corporate tax rates – this is true across developed countries, but particularly in small advanced economies.

Small advanced economies also tend to be conservative on the current account position, with most small advanced economies running sustained current account surpluses. As a consequence, many have substantial net foreign asset positions. This partly reflects strong international performance, as well as a desire to avoid exposure to foreign creditors (a resilience argument).

#### *Strategic coherence*

The discussion above notes the common themes in high-performing small advanced economies. However, there is no single policy agenda, and small countries choose to compete in a variety of ways. For example, Denmark successfully follows a high tax, high wage, innovation-based model, whereas Hong Kong pursues a low tax, light regulation model with an emphasis on world-class infrastructure and leveraging its proximity to China. These models are very different, but both have generated strong economic outcomes.

So small country performance is less about the policy specifics than the way in which these policies are packaged together for the specific context – that is, it is about the strategic coherence of policies. Although the specific ways in which small countries compete vary according to context, the notion of a deliberate strategy to position their countries is a unifying theme across small countries. In many small countries, there will be a clear sense of the national value proposition and the basis on which the country competes in the global economy.

Small countries have benefited from a more positive, supportive external environment over the past few decades. But at least as importantly, they have responded appropriately to the changing global environment. The strong performance of small countries is largely a matter of deliberate choice and management. It is those small advanced economies that have positioned themselves most appropriately for the challenges and opportunities of globalisation over this period that have done best. In contrast, those countries that did not engage with, and respond to, these global forces did not perform well (such as Greece).

One dimension of this positioning is a deliberate development of key strengths in the economy that provide a source of distinctive competitive advantage. These can be ‘horizontal’ factors, such as tax, location, human capital, business environment, or infrastructure. Or it could be more ‘vertical’ in nature, organised around key sectors. Most successful small advanced economies will have a limited number of deep clusters with dense backward and forward linkages, and in which there is something

distinctive about the country. These clusters of economic activity often provide the focus for a coordinated approach to policy. Small countries are sometimes said to be ‘doomed to choose’; they cannot be world class in everything, and there is a premium on developing distinctive competitive advantage in some areas.

#### *Overall*

Small advanced economies have out-performed their larger economy counterparts over the past 25 years. They are competitive, innovative and dynamic – as well as generating good social outcomes and wellbeing. They have been responsive and agile in response to shocks, and have been well adapted to the period of intense globalisation over the past few decades.

However, there are some downsides to small size. Small economies are more volatile, and are more exposed to shocks with have little margin for error. Whereas large economies can continue to pursue poor policies for some time, small economies face greater discipline. And if things go wrong in a small economy, things can unwind very quickly. Greece, Iceland, and Ireland are recent examples. And in Finland, a well run small economy, a series of shocks has led to a sustained period of very weak growth.

The next section considers the emerging challenges and opportunities facing small advanced economies, the likely implication for their performance, as well as the emerging policy responses.

## 4. Current economic and policy context in small advanced economies

Small advanced economies reflect the health and functioning of the global economy because of their acute external exposure. The period of intense globalisation over the past few decades, based on a liberal, rules-based system – with the integration of emerging markets and strong global growth – was supportive of small country performance. This contrasts sharply with previous periods such as the 1970s when many small advanced economies struggled.

Indeed, it is hard to imagine a more positive environment for small economies. However, there is a new normal prevailing in the global economy in the post crisis period (which I date from 2011). This section describes the key characteristics of the changed economic context.

#### *Post-crisis small economy performance*

Many small advanced economies experienced a rapid slowdown in economic growth during the global financial crisis in 2008/09 (Exhibit 10). Growth rates were about 8% lower in 2009-11 relative to 2007-09. In general, the crisis was deeper for small advanced economies because of their more substantial external exposure. For several small advanced economies, such as Estonia, Ireland and Iceland, the crisis was very deep. But most small advanced economies responded quickly (structural reform, fiscal consolidation), and resumed growth relatively quickly.



However, the trend rate of growth for small advanced economies since 2011 has been much weaker than was averaged in the pre-crisis period (Exhibit 26). The average growth rate was 1.8% lower between 2011-15 than between 1995 and 2007. And over the past 18 months, there has been a weakening of the small economy growth trajectory. Small advanced economy growth rates are around 2.0% in the year to Q1 2016. And stripping fast recovering Ireland and Iceland out of the average reveals an underlying growth rate of 1.8% across the group (Exhibit 27).

There are small country bright spots: fast-growing Ireland and Iceland, and strong growth from Sweden (Exhibit 28). But in general, small advanced economies are slowing: this is particularly the case for the small countries outside of Europe, which are more exposed to weak emerging market growth.

The growth rate difference between small and large advanced economies has reduced in the post-crisis period. Indeed, over the past two quarters, the average growth rates in small and large advanced economies has essentially converged (Exhibit 29). The convergence is historically unusual outside periods of global economic stress. My interpretation is that this reflects a more challenging global environment that is particularly demanding for small economies.

The growth forecasts by the IMF, the OECD and others suggest that this weak small advanced economy performance is likely to continue for the next several years (Exhibit 30).

It is also instructive to take a growth accounting perspective to the reduced GDP growth trajectory. There has been a marked decline in labour productivity growth across the small advanced economies group, relative to the large country group (Exhibit 31). This is even more marked than the secular decline in labour productivity growth that has occurred across many large advanced economies, as noted by the OECD and others. This slowing in labour productivity growth is likely connected to declining export growth, which has been an important productivity engine for small economies (discussed below).

#### *Changed global economic context*

This performance is indicative of structural change in the functioning of the global economy. Indeed, the post-crisis environment is distinctively different in terms of the strength and functioning of the global economy. I structure this conversation around changes to the demand side of the global economy and changes on the supply side.

- weak global economy

Global economic growth has been markedly lower since the crisis, in both advanced economies and emerging markets. This is projected to persist for some time; the IMF, the OECD and other international institutions have consistently lowered their growth forecasts as the global growth recovery has remained weak. In Europe, there have been particular challenges. This weak global recovery process is expected to continue.

This sluggish global recovery has contributed to very weak growth in cross-border trade. Indeed, world trade growth is at levels that have not been seen for several decades. Exhibit 32 notes that world trade

has been flat over the past 18 months, particularly due to weak emerging market imports. The WTO forecast that this will continue. And UNCTAD also recently forecast that cross-border flows of direct investment will slow in 2016 after a strong 2015 on the back of international M&A activity.

This weakening in global trade and investment is also due to factors such as reshoring activity and the relocation of global supply chains, a rising incidence of protectionism, and so on. But weakness in the global economy, particularly from emerging markets, is having a significant impact. The slowing intensity of globalisation has a disproportionate effect on small advanced economies.

The macro environment for small economies has also become more challenging, particularly as a consequence of ultra-loose monetary policy in the core countries. Measures like QE in the US and the Eurozone has placed significant pressures on small advanced economies, notably though placing upward pressure on small economy exchange rates.

- supply side pressure

In addition to the demand-side weakness observed in the global economy, there are also significant developments on the supply side that are having an impact on the competitive position of small advanced economies. For example, there is greater competitive intensity in knowledge intensive activities in which small advanced economies have typically had strong positions, as emerging market firms develop a stronger presence. This is affecting international growth by many small advanced economy firms.

The greater mobility of supply chains (and of firms, people and capital more generally) also poses a competitive threat to high cost small economies. There are risks to economic activity relocating away from small economies, as well as challenges to small economies in capturing value from this activity (for example ensuring that it is well integrated into the domestic economy). Some of the pressures on globalisation, such as rising protectionism, are also changing the location choices of firms in ways that disadvantage small economies: for example, firms are increasingly seeking to place themselves in large consumer markets (GE's 'localisation' initiative is one recent example of this).

There is also rapid change in new technologies and business models, in part due to the disruptive effects of digital, automation, the 4IR, and so on, and consumer preferences are also changing rapidly. This more volatile business environment poses particular challenges for small advanced economies: in some cases, because scale matters. But more importantly, small economies are particularly exposed to these shocks because small advanced economies tend to be less diversified (small country export and economic structures will tend to be concentrated on a few areas of competitive strength). If there is a firm or sector-specific shock, this can have a disproportionate impact on a small economy. As will be discussed at greater length below, Finland is an example of a small economy that was subject to a material idiosyncratic shock.

However, emerging technologies such as automation, robots, 3D printing, the 4th industrial revolution, and so on, provide new opportunities for small advanced economies, particularly those with a high wage and cost structure. Small advanced economies, notably the Northern Europeans and Singapore, tend to

have relatively high manufacturing shares, and may benefit from this greater potential to grow manufacturing activity in high cost economies.

*Common themes in policy responses across small advanced economies*

There is a widely-shared sense across small advanced economies that this low growth ‘new normal’ will require a new set of policy approaches in order to generate strong economic and social outcomes.

Small economies have a track-record of policy innovation and have responded well to previous challenges. And both in terms of the crisis response and over the past few years, there has been a determined policy response to the new challenges and opportunities of structural change in the global economy. Note that small economies cannot respond with demand-side policies (such as fiscal stimulus) in the same way that larger economies can, but need to focus on structural, supply side policy responses.

This section identifies the key themes in this policy response, which are then discussed in more specific detail in the case studies that follow below. To structure this discussion, I consider policy responses at three levels: economy wide, cluster/sector focused, and enterprise-level.

- Economy-wide

As noted previously, most small advanced economies have well-regarded policy foundations. However, the challenges of the post-crisis environment have led to a renewed focus on improving the quality of these policy settings. There is an acute awareness of the need to strengthen productivity, improve cost competitiveness, and address issues with respect to economic risk and resilience.

There are a few strands to this policy response. First, there has been a strong focus on fiscal consolidation, and reducing the stock of public debt. This is partly a response to the speed with which the fiscal positions in many small advanced economies unravelled during the global financial crisis (even in well managed countries like New Zealand and Finland), as well as a sense that small economies face tight capital market discipline. A focus on fiscal discipline is seen to strengthen economic resilience in small countries and make them better able to meet the next shock.

Another motivation is to improve the cost competitiveness of economies: the Nordic countries, for example, have very high levels of government spending and tax rates, which have become an issue in a slow growth economy and with growing competitive pressures in international markets. There is downward pressure on government spending in many advanced economies in Europe.

Second, there are many instances of structural reform agendas to lift productivity in small advanced economies. Productivity Commissions have been established over the past several years in countries such as Norway, Denmark and New Zealand to identify specific priorities for policy reform to lift productivity growth. These often have a focus on the non-tradable sector, where much of the employment growth has been over the past two decades, to improve the flexibility and efficiency in these sectors. For the most part, the identified policy priorities are a myriad of small distortions (there are few big bang policy reforms left).

However, in economies like Singapore, there is a major strategic attempt to rotate to a productivity-led economy. A range of policy levers are being used; from encouraging innovation and human capital, to supporting increased business investment, and altering the price and supply of low cost immigrant labour.

Third, many small economies are taking increasingly structured approaches to their portfolio of external relationships. From New Zealand to Denmark and Ireland, many governments are deploying emerging market strategies to diversify their international footprint. Aspects of this can be done through formal arrangements (such as FTAs), but there is also significant activity in enterprise agencies (such as export promotion bodies) to better support firms to expand into international markets.

- building competitive advantage at sector/cluster level

Small economies have tended to invest behind positions of competitive strength, in key sectors and clusters, to develop positions of advantage. There are ongoing efforts in the post-crisis environment. Investments in innovation and human capital continue to be a priority. For the most part, this spending has been quarantined from the material reductions in government spending. There are also deliberate attempts to build innovation clusters, and to attract economic activity in new sectors: Singapore, the Netherlands, Israel, and Ireland are particularly active in this space.

In many small countries, notably Denmark, the Netherlands and Singapore, there are active efforts to take advantage of the opportunities from the 4<sup>th</sup> Industrial Revolution (such as Denmark's Production Panel,<sup>2</sup> the Smart Industry initiative in the Netherlands,<sup>3</sup> and through Singapore's Committee on the Future Economy,<sup>4</sup> which will be discussed below). There is a focus on new sectors that are not well established, and which are more mobile and less scale-sensitive (digital, creative, etc).

Economic risk and resilience is moving up the policy agenda in the post-crisis environment. There is focus on ensuring that countries have a reasonably diversified portfolio of strengths at sector/cluster level, and that these clusters are well positioned to absorb shocks. The experiences of small economies such as Norway, Finland and New Zealand are instructive in terms of the issues and the policy approaches that are useful in this regard (from building labour market flexibility to deliberately investing in a pipeline of new strengths).

- enterprise level

Large firms make an important contribution to small advanced economies as was noted above. However, balanced contributions need to come from medium and smaller sized firms as well. In small economies, there are frequently challenges in achieving new firm growth (start-up rates are frequently respectable, but the process of scaling up rapidly – which necessarily involves expanding into international markets – is challenging). There is also concern in many small economies that the existing large enterprises are frequently mature companies, and that there are fewer high growth new firms. In

<sup>2</sup> <https://www.evm.dk/english/publications/2015/15-05-27-production-councils-summary>

<sup>3</sup> <http://www.smartindustry.nl/en/>

<sup>4</sup> <https://www.qov.sg/microsites/future-economy>

response to these concerns (and the observation that new high growth sectors involve significant start-up activity), there has been substantial firm-level policy activity in many small advanced economies.

Some of this is focused on generating a stronger eco-system for innovative start-ups (such as Start-Up Delta in the Netherlands,<sup>5</sup> multiple start-up focused initiatives in Singapore, the development of incubators in Switzerland, and so on). FDI attraction efforts are also focusing on smaller, but high growth potential firms. These initiatives include financial and logistical support, but often extend to regulatory changes – for example, Singapore has made changes with respect to financial market regulation to better allow innovation in fintech.

There are also many efforts in enterprise agencies, to better focus their efforts on activities that generate more material firm growth outcomes. Looking across high-performing systems in small advanced economies, there is a common theme of increased focus on high growth potential firms. Rather than working with a large portfolio of firms, there is more intense support provided to firms with assessed high growth potential. Examples of this approach include New Zealand, Ireland and Scotland. The support provided to firms is increasingly non-financial in nature. Frequently the evidence suggests that the binding constraint on growth by firms in small advanced economies is management capability and aspiration, in-market intelligence and support, and so on. This is where enterprise policy is increasingly focused.

## 5. Selected case studies

This section provides more detail on the current economic context as well as policy approaches and debates in five selected small advanced economies: Singapore, Ireland, Denmark, Finland and New Zealand. These case studies should be read alongside the comparative data presented in the Exhibits. Exhibits 34-38 also provide country-specific detail on GDP growth over the past 20 years as well as forecasts for the next few years.

### **Singapore**

Since independence in 1965, Singapore has been a remarkable economic success story – growth rates averaged 6-7% from the 1970s until the 1990s. Core to Singapore’s success was deliberately positioning Singapore as an attractive hub for regional activity in Asia: strong, stable government, low tax rates, infrastructure and human capital, and so on. Interestingly, there was genuine concern in Singapore at its independence in 1965 as to whether a small city state would be economically viable.

Singapore has progressively moved up the value chain: from basic manufacturing, to petrochemical refining and higher value added manufacturing, to professional and financial services, life sciences and so on. It is now actively pushing into advanced manufacturing and disruptive digital technology. It is a major financial centre, is home to many MNCs, and attracted more FDI from the US than China.

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<sup>5</sup> <https://www.startupdelta.org/>

After a sustained period of very strong growth, Singapore is now at a transition point. It is now at the income frontier, having generated substantial catch up growth and successfully navigated the middle income trap. The economic policies it adopted through this process were very well suited to a period of intense globalisation. But Singapore's growth rates are now slowing for structural reasons (few catch up growth opportunities remaining, land constraints) as well as cyclical reasons (a weak regional and global economy). Singapore's current growth rates are around 2%, and the official projections are for growth in the 1-3% range (Exhibits 28, 38).

Policy is now explicitly aimed at shifting from an input driven economy to a productivity led economy; it is well-recognised that Singapore's growth model is overly reliant on labour force growth. Singapore has imported a substantial labour force: high-income professionals as well as construction workers and domestic service staff. This has generated substantial growth, but there are political and other constraints on further population growth.

In 2010, the Economic Strategies Committee process set a target to achieve annual productivity growth of 2-3%, more than double the historical average.<sup>6</sup> It also set out a strategic policy direction for achieving this. For example, Singapore has been reducing the rate of inward migration (to reduce the incentive to grow through cheap labour), has been identifying new growth sectors in which it can carve out a position, continues to build infrastructure and a network of external relations (including through FTAs), and is encouraging firms to invest in new technology and business processes. The government is also investing substantially more in R&D.

However, progress towards increased labour productivity has been slow. Indeed, Singapore's labour productivity growth has been essentially flat over the past several years; partly because of a subdued external environment, but also because of a lack of pick up in the domestic economy.

In response to these challenges, there is an active process of policy debate underway with action on multiple fronts. Singapore's Committee for the Future Economy has started an intensive process to develop a perspective on updating the economic strategy for Singapore.<sup>7</sup> This is expected to report at the end of the year, but there are some emerging themes (in addition to the policy initiatives mentioned briefly above).

In particular, there is an emphasis on ensuring that workers are equipped with the right skills and that Singapore is an attractive location for these new industries. The Singapore government has recently established the SkillsFuture programme.<sup>8</sup> A key element of this is the SkillsFuture Credit scheme, in which citizens aged 25 and older will receive \$500 to enrol in courses to upgrade their skills from this year (there is significant flexibility in the courses that qualify for this scheme). Other programmes include subsidies for workers and employers, when working adults switch careers.

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<sup>6</sup> The report and recommendations are available at <http://www.mof.gov.sg/Resources/Economic-Strategies-Committee-ESC-Recommendations>

<sup>7</sup> <https://www.gov.sg/microsites/future-economy>

<sup>8</sup> This was announced in the 2015 Budget speech: [http://www.singaporebudget.gov.sg/budget\\_2015/BudgetSpeech.aspx](http://www.singaporebudget.gov.sg/budget_2015/BudgetSpeech.aspx) For more information, refer <http://www.skillsfuture.sg/>

There is also significant activity around the Smart Nation initiative, which involves a range of activities from the use of big data in the government, to acting as a testbed for new technologies, to actively building innovation ecosystem in Singapore.<sup>9</sup>

Relatedly, Singapore is working to build a stronger pipeline of growing Singapore firms that are expanding into international markets: there are some large Singapore companies, many in partial government ownership (as a legacy of its development model). However, there are fewer local firms that have broken into international markets. Singapore's enterprise agencies are focused on creating more globally competitive companies.

### **New Zealand**

The salient features of the New Zealand economy are that it is small, physically remote, and with a large agriculture sector. New Zealand is one of the lower per capita income countries in the advanced economies group, with below average levels of labour productivity and above average levels of hours worked per capita.

New Zealand was one of the most regulated, protected countries in the OECD until the early 1980s. It had responded to the shocks of the 1970s, including the loss of preferential market access to the UK in 1973 – when the UK joined the then EEC, by adopting inward-looking policies. However, from 1984 on, New Zealand undertook radical economic reform – and is now routinely ranked as one of the most efficient, flexible, and lowest cost economies in the world.

The OECD has noted that the 'great New Zealand' mystery is the absence of economic growth even after the establishment of world-class economic policy reforms. There are two categories of reasons frequently advanced. First, geography. New Zealand has one of the lowest export shares in the small advanced economies group (30%): this largely reflects its remote geography and resource endowment. There are some new strengths (tourism, digital, creative), but New Zealand is disadvantaged by the absence of a regional economic hinterland. New Zealand was early into the FTA game and has secured FTAs with many important partners (including Australia, China, and ASEAN). But geographic remoteness continues to constrain New Zealand's economic potential.

Second, New Zealand has adopted a hands-off approach to economic policy and has not attempted to deliberately develop strengths in its economy (and particularly to compensate for some of the issues associated with being small and remote, where scale and specialisation may not easily form). Deliberate economic strategy has not been part of the mainstream economic policy debate in New Zealand, a marked difference with many other small advanced economies.

There have been some recent steps: slightly increased investments in R&D (although still modest by international standards), an increased focus on enterprise policy, and so on. But the key driver of New Zealand's economy over the past 20 years has been waves of migration (currently running at about 1.3% of the resident population) as well as construction and real estate. New Zealand also benefited from

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<sup>9</sup> <https://www.ida.gov.sg/Tech-Scene-News/Smart-Nation-Vision>

strong Chinese demand for primary produce over the past several years, which moderated the impact of the global financial crisis.

There are several themes in the current policy debate that are instructive. First, New Zealand established a Productivity Commission in 2010 with a mandate to undertake analysis to inform recommendations to government on actions to raise productivity (established out of concern that productivity growth had been persistently low).<sup>10</sup> The work of the Productivity Commission has been focused primarily on the non-tradables sector. Examples of inquiries that it has completed include: reducing costs in the residential construction sector; inquiries on coastal shipping and ports (among other things, looking at opportunities for consolidation); and consideration of services sector productivity

Second, on international strategy, New Zealand's remote geographic location means that it has had to invest heavily in building international relationships with a wide range of countries in Asia and beyond. This includes negotiation of FTAs and other formal agreements, as well as other structured approaches to engaging in markets (such as the 'NZ Inc' strategies).<sup>11</sup> New Zealand also provides a good illustration of some of the new developments in enterprise policy: NZTE, the New Zealand enterprise agency, has developed some innovative programmes, such as the Focus 700.<sup>12</sup>

Third, innovation and the 'weightless economy'. Partly in response to New Zealand's remote location, the government is investing NZ\$1.5 billion in a nation-wide fibre network to better connect New Zealand to global markets. There are also related initiatives to encourage the growth of capital markets, including publicly-supported venture capital funds and the creation of a sovereign wealth fund, as well as the support of incubators and the attraction of foreign entrepreneurs.

## **Ireland**

Ireland has a distinctive economic trajectory relative to many other small advanced economies in Europe. Income levels and growth rates had lagged Ireland's small economy peers in the decades after WWII, despite a better decade in the 1970s. It was the poor economic performance in the 1980s that catalysed the transformation of Irish economic policy and the creation of the Celtic Tiger economy. A working bipartisan agreement on economic policy in 1987 led to an economic model that emphasised low corporate tax, aggressive FDI attraction efforts, leveraging its position in the EU, as ways to overcome Ireland's economic peripherality.

Ireland has some national champion companies (such as Kerry, CRH), but its economic success over the past few decades has been largely due to attracting FDI. The large amount of inward FDI has boosted productivity (as firms brought in technology and capability), exports, employment, and also led to substantial migration flows (after a long experience of exporting people to the world). The FDI attraction (and economic policy more broadly) is focused on several high priority clusters nominated in

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<sup>10</sup> For more information on the Productivity Commission: <http://productivity.govt.nz/>

<sup>11</sup> <https://www.mfat.govt.nz/en/trade/nz-inc-strategies/>

<sup>12</sup> [www.nzte.govt.nz](http://www.nzte.govt.nz)



the government's Enterprise Plan (e.g. ICT, life sciences, agrifood, international financial services, engineering/industrial products).

There have been many serious efforts to better integrate the operations of domestic and foreign firms, and to build deep clusters in Ireland around these activities. However, in general multinational activity remains relatively separate from the rest of the Irish economy – this constrains dynamism and reduces resilience, as these activities are not deeply embedded into the Irish economy.

Irish economic history, and many of the core elements of its economic strategy, will be familiar to this audience. However, there are a few themes in the recent Irish policy debate that strike me as particularly instructive.

On external relations, Ireland – as with many other small advanced economies – has been diversifying its international footprint. For example, the rotation away from the UK into European markets after EU accession. The US has become an increasingly important market, for both trade and investment, and there are also initiatives underway to bolster Irish engagement with Asia. This diversification strategy is important given the economic and political risks in Europe, as well as the likely growth profile of other markets. Ireland's geography will shape its economic relationships, but there is good reason to actively build a broader portfolio.

Second, Ireland is continuing to develop an active economic strategy that acts to coordinate various economic instruments. In particular, the Enterprise Plan 2025 (mentioned above) provides a useful focal point for action by various agencies. The Action Plan for Jobs is also providing policy focus. Similarly, Ireland is also currently developing a National Skills Strategy to respond to these new challenges in labour markets. The goal is to better align the education system with the likely future demand for skills.<sup>13</sup>

Third, Ireland's enterprise policy, particularly through agencies such as Enterprise Ireland and Science Foundation Ireland, is generating good outcomes. There are interesting innovations in the way in which programmes are designed and delivered, such as a tighter focus on high growth firms and a tighter relationship between research excellence and commercialisation, which are helping to grow more globally competitive Irish firms.

## **Denmark**

Denmark is one of the richest countries in the world, on the back of strong labour productivity performance, but it has been at the bottom of the advanced economies GDP growth rate rankings over the post-2000 period. And although Denmark managed well through the crisis, it has struggled to generate strong growth rates in the post-crisis period.

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<sup>13</sup> Background information is available in the Enterprise 2025 strategy, available at <https://www.djei.ie/en/Publications/Enterprise-2025.html> and in the Action Plan for Jobs 2016: <https://www.djei.ie/en/News-And-Events/Department-News/2016/January/18012016.html>

Denmark has deliberately built a flexible economy that is capable of adapting to shocks, both at an aggregate and a household level. Denmark combines flexible labour markets with strong social insurance as well as strong macro policy. In terms of fiscal policy, it has combined high levels of government spending with a disciplined fiscal balance position.

Denmark has a well-established, well-performing international sector: its levels of exports and outward direct investment are in the middle of the small advanced economies average. At a firm level, this international activity is dominated by relatively large, mature firms: Moller-Maersk, Carlsberg, Novo Nordisk, Lego, Vestas, and so on. Denmark ranks well in terms of multinational companies on the Forbes Global 2000 rankings on a per capita basis. These internationally-oriented firms are sophisticated and dynamic. Denmark reports high levels of R&D spending (about 3% of GDP) and scores well in terms of survey measures of innovation and business sophistication.

But there is substantial variation in productivity levels across sectors in the Danish economy; productivity in the manufacturing sectors is about twice that of many domestic services sectors.<sup>14</sup> Over the past decade in Denmark (as in other advanced economies), there has been a reallocation of labour: the fastest growing areas of employment have been in relatively low productivity sectors (away, for example, from manufacturing into domestic services). This resource reallocation has constrained the potential for headline GDP growth in Denmark.

And Denmark does not perform as well on a range of measures of economic dynamism. Its rates of start-up behaviour are about average, but have been falling over time. And the level of venture capital activity is also low.<sup>15</sup> Compared to some of its neighbours (such as Sweden and Finland), Denmark has not produced many scale up companies. Denmark is lagging in producing new firms that grow aggressively.

In response to these domestic and external challenges, there are several strands of current policy focus that are of particular interest. First, Denmark has been actively developing a structural reform agenda and continuing with fiscal consolidation efforts. For example, a Productivity Commission provided a series of recommendations on structural reforms to raise productivity and improve cost competitiveness in 2012/13.<sup>16</sup> Many of these recommendations have been accepted. Relatedly, there is focus on government spending and tax rates – both to strengthen the fiscal position as well as to remain competitive in the new economic context (Denmark has been losing export market share in key markets and sectors, which was becoming a source of concern).

Second, economic dynamism is becoming more of an area of policy focus to strengthen economic growth. Productivity growth needs to come from a broader range of firms. There are increased efforts to strengthen venture capital markets, to scale up Danish firms, and to take advantage of new technologies (such as those associated with the 4<sup>th</sup> industrial revolution).

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<sup>14</sup> *Creating Economic Growth in Denmark Through Competition*, McKinsey & Company, November 2010.

<sup>15</sup> *Science, Technology & Industry Scoreboard 2015*, OECD; OECD, *Economic Survey: Denmark, 2014*.

<sup>16</sup> <http://produktivitetskommissionen.dk/media/133600/Kommissoriet%20p%C3%A5%20engelsk.pdf>

For example, the Production Council was set up in October 2014 to draw up recommendations to strengthen the development of Denmark as an attractive country for production.<sup>17</sup> Manufacturing has been an important part of the Danish economy, making significant contributions to employment and exports, but there was concern that Denmark was falling behind some of its regional peers. There was also a view that some of the developments in advanced industries (the 4<sup>th</sup> Industrial Revolution) might provide an opportunity for Denmark to create a stronger position of competitive advantage.

Third, Denmark has developed an export strategy that is emphasising growth into emerging markets.<sup>18</sup> Europe currently accounts for about 70% of Denmark's exports, and there is a sense that diversification into higher growth markets will improve both export growth as well as resilience.

## **Finland**

Finland's modern economic history began after the deep recession it encountered after the collapse of the Soviet Union, its biggest economic partner, in 1991. Finland then embarked on a rapid process of economic integration into the EU, and participation more globalisation more generally. Finland generated strong growth rates over the period until the global financial crisis.

Finland's economic policy approach is characterised by heavy investments (and good outcomes) in R&D and innovation, human capital, as well as strong macroeconomic policy (such as fiscal discipline). Finland also relied heavily on its large companies, most notably Nokia but also firms such as Kone. Finland performed strongly from the mid-late 1990s, tracking the small advanced economies average (Exhibit 35).

These high growth rates were driven off a strong performance in the international economy, growing exports and outward direct investment. Finland developed strong competitive positions in knowledge intensive sectors such as IT, on the back of a strong education system and heavy investment in R&D (at about 4% of GDP, Finland's spending on R&D is one of the highest in the developed world). Finland is regularly used as an example of economic transformation, moving from a fairly basic economy that was reliant on commodity exports to a high level of economic complexity.

Domestically, Finland ranks at the top of international measures of innovation and competitiveness (Exhibit 20), has a strong fiscal record, and has a flexible, efficient economy.

But since the global financial crisis, Finland's growth rates have been very sluggish. This performance reflects the underlying risk exposures facing small advanced economies. Over the past several years, Finland has been hit by a series of shocks. The most obvious was a firm-specific shock that caused a substantial reduction in size of Nokia. To give a sense of materiality, estimates suggest that Nokia accounted for a quarter of Finland's growth from 1998-2007, 20% of its exports, 30% of its R&D, and over 15% of its corporate tax revenue in 2007. The rapid decline of Nokia has had a pronounced effect:

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<sup>17</sup> <https://www.evm.dk/english/publications/2015/15-05-27-production-councils-summary>

<sup>18</sup> <http://um.dk/en/tradecouncil/about/strategy>

a drag of 1% of GDP on Finland's growth in 2009, and a reduction in corporate tax receipts from €1.3 billion in 2007 to about €100 million in 2009.

This was coincident with a major shock to the pulp and paper sector, as well as a market-specific shock to Russia (slow growth and sanctions) and slow growth in the EU. And, of course, relatively slow global growth post-crisis. These were independent shocks, but happened at roughly the same time.

The remaining networks business of Nokia (now Nokia Siemens) is doing well, and there are many examples of ex-Nokia engineers setting up new companies. However, this is clearly not a complete substitute. There is now a sense in Finland that Nokia was too big for the Finnish economy, and that Finland was too exposed to the behaviour and performance of a single company. Poor firm-level decision-making and intense competition (e.g. from Apple) had a major impact. This firm-level shock is a key reason why Finland's exports of IT and electronics reduced from a 24% share of exports in 2005 to 8% in 2013.

Finland's politicians are openly talking about a 'lost decade' as they struggle to regain competitiveness. They are actively reducing the cost structure of their economy, through tough negotiations with unions. And there is an active programme of fiscal consolidation.

In parallel, actions are being taken to improve the innovation system and enterprise policy – to build a stronger pipeline of growing Finnish firms. But the basic Finnish economic policy approach is not the problem. Finland provides a reminder of the acute vulnerability of small advanced economies to shocks, and the need to be very careful about economic risk and resilience. A key insight from Finland's experience is that even a high quality economic strategy can be derailed by a material economic shock.

## 6. Concluding remarks

Small advanced economies have performed strongly over the past few decades, as they have positioned themselves effectively to compete in an era of intense globalisation. There is no single 'best practice' policy template, and the specific design of small economy policy models differ significantly. However, there are some common broad themes that are consistently observed across successful small advanced economies: active international engagement; investing in innovation and human capital; and strong policy foundations.

However, the economic and political environment in which small economies are now operating has become more complex and challenging. In this post-crisis environment, it will be more demanding to generate strong economic outcomes. However, these broad policy themes remain relevant: small economies will need to have solid policy foundations that give them an edge; to be externally oriented with a clear strategy; and to invest heavily in knowledge and human capital.

## About the author

Dr David Skilling is the founding Director of Landfall Strategy Group, which was established in 2011. David advises governments, companies, and financial institutions in several small countries, and writes regularly on global economic and political trends from a small country perspective. Previously, David was an Associate Principal with McKinsey & Company in Singapore, as well as being a Senior Fellow with the McKinsey Global Institute. Before joining McKinsey, David was the founding Chief Executive of the New Zealand Institute, a privately-funded, non-partisan think-tank. Until 2003, David was a Principal Advisor at the New Zealand Treasury. David has a Ph.D. in Public Policy, and a Master in Public Policy degree, from Harvard University, as well as a Master of Commerce degree in Economics from the University of Auckland. David was named as a Young Global Leader by the World Economic Forum in 2008.

## About Landfall Strategy Group

Landfall Strategy Group is a Singapore-based research and advisory firm that provides advice on strategic issues to governments, firms, and financial institutions, particularly in small advanced economies. We provide distinctive perspectives on emerging global trends, working with decision-makers to understand key global changes and how governments, firms, and institutions should respond and position themselves in the emerging global economic and political environment.

[contact@landfallstrategy.com](mailto:contact@landfallstrategy.com)

[www.landfallstrategy.com](http://www.landfallstrategy.com)

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