

AN INSIGHT INTO POTENTIAL FISCAL IMPLICATIONS OF THE GREAT LOCKDOWN FROM THE PERSPECTIVE OF SMALL STATES

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ABSTRACT

The Great Lockdown has caused severe economic distractions to the majority of world countries, and de-globalization trends have started to increase. Globalization was to an extent beneficial for smaller economies, and it was one of the factors contributing to the rise in the number of countries around the world during the last few decades. According to the perceived larger openness and vulnerability of smaller states, it is thus expected that those countries are hit much harder by the economic contraction, as their outputs are much more volatile in relation to the economic cycles. In this context, the paper intends to investigate the exposure of European states to the current lockdown, where the focus is particularly on assessing the fiscal impacts of the lockdown. The main research question is whether there are any differences regarding the fiscal functions of government between smaller and larger states. This is addressed through the cross-national comparative investigation based on data for 44 European countries; and we specifically assess how fiscal activities of government differentiate among smaller and larger states. The results of the study suggest that the effect of the size of the state does not affect the consumption spending of government, but the size variable matters for the transfer expenditures. This piece of research would like to add to the development of the discipline of small state studies, in particular to the issue of their vulnerability and changing global economic environment.

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1. INTRODUCTION

The current coronavirus (COVID-19) pandemic has caused one of the largest global health crises, and the situation of the Great Lockdown, the term describing the current crisis, as coined by the IMF. From the global perspective, a significant contraction in the foreign direct investments and international trade has occurred, to some extent accompanied by the rising pressures for economic nationalism. This actually contributes to the de-globalization trends. Besides major global economic disruptions leading to the expected recession, almost all states have introduced, or are planning to introduce, some measures to soften the negative economic impacts of the lockdown, also including induced fiscal spending to counteract the sharp drop-off in economic activity. This spending can be in the range up to 20% of GDP for some states (see [IMF, 2020](#)).

In the context of small state studies, it can be argued that they are the ones that should be hit harder. Namely, the current lockdown has caused also an enormous reduction in the foreign direct investments in the range up to 40 percent ([UNIDO, 2020](#)), and the reduction in global exports, where EU is particularly under attack ([UNCTAD, 2020](#)). Namely, small states tend to be relatively much more open and integrated into the global trade, thus the economic consequences of lockdown and associated return of (economic) nationalism are particularly evident for them. The data provided by the [World Economic Outlook \(2020\)](#) project a very harsh fall of GDP for some smaller European countries (e.g. Iceland, Latvia, Estonia, Lithuania, Slovenia, Croatia, San Marino, etc.), particularly if we compare those projections with other larger countries. This should be evident also in the rising social security and transfer spending, in order to provide the necessary safety net for the residents.

Moreover, as [Rachman \(2020\)](#) argued this extraordinary crisis is not expected to lead to the full restoration of the globalized world after it ends, as evidence indicates the return of the nation states. They have more financial and organizational strengths than global institutions, global supply chains have shown their fragility, and political pressures for localization of production and protectionism have reinforced. Furthermore, the era of small government will be highly challenged per se after the current crisis ([Traub, 2020](#)).

[Oxford Analytica \(2020\)](#) provided the assessments on the preparedness and export exposure to COVID-19 pandemic for specific countries. It is evident that for the majority of small European countries relatively high export exposure is assessed. This exposure tends to be, on average, larger for smaller states, in comparison to larger ones. The effect is perceived to be stronger because supply chains will be slower to recover. Supply chains are more likely to encounter bot-

tlenecks as different countries remove travel and business restrictions at different rates. Thus, countries reliant on trade are particularly vulnerable to disruption also after the virus passes, and those countries include numerous small states.

Namely, small states' characteristics is that their economy is driven by only few sectors, a notion sometimes described with characteristics of “plantation economies”, although this notion should not be taken literally. Thus, these economies are dependent, and include the history of key industry ownerships by multinational corporations, the repatriation of profits, and the limited to non-existent domestic linkages. Trade balance is mostly in favor of larger and more developed countries, resulting in features of income distribution that effectively discriminate against economic transformation. In essence, this indicates that small economies tend to be rather disproportionately affected by the shifts in global economic patterns due to demand- and supply-side shocks; they are at higher risk to be deprioritized in global supply chains, and they are at a major risk of disruption if they tide towards achieving truly globalized economy changes ([Hackshaw, 2020](#)). Similar findings were already observed during the Great Recession period, roughly a decade ago.

Yet, when the lockdown ends, it is expected that international economic environment will change, and this will be challenging for small states in particular, as larger states are bound to become economically inward oriented. Moreover, all states will become more protectionist, and competition for attracting new businesses will increase ([Shimmin, 2020](#)). Thus, the trade transmission mechanism of external shocks is amplified within small states because of limited domestic markets, which increase the importance of international trade as a driver of growth. Furthermore, economic vulnerability is high in view of limited export diversification, and relative importance of tourism in production structure of the majority of small states. These factors suggest the arrival of challenging economic times in particular for small states, and this will reflect in the increasing fiscal stress ([Keane, 2020](#); [Coke-Hamilton, 2020](#)).

In this context, this paper intends to investigate the exposure of European states to the current lockdown, where the focus is particularly on assessing the fiscal impacts of the lockdown. The main research question is whether there are any differences regarding the fiscal functions of government between smaller and larger states, measured by the share of government consumption and transfer expenditures in GDP. Specifically, since the crisis situation is perceived to have impact, we select two time periods, the crisis period of 2009-10 and the period of economic prosperity of 2017-18, in order to investigate any potential differences

in the aggregate fiscal activities of governments, in order to portray expectations for the ongoing Great Lockdown crisis.

2. MATERIALS AND METHODS

When addressing the subject related to small state studies, we should bear in mind that state size, which is either micro, small, medium or large, is actually an endogenous variable as states are formed and able to survive given the appropriate economic, political and social conditions. [Alesina \(2003\)](#) promoted the elaboration on the state size as an endogenous variable, since the evidence indicates that the size of the countries is very diverse, that their numbers varied very much throughout the history as well as the meaning, functioning and role of the state. In this context, what we can observe is that after the World War II, in particular, the number of states has increased substantially. In fact, this number has tripled. It can be argued that we are currently living in the era of small states, as more than one third of the existing 215 states around the globe are actually small (see, e.g., [Brito, 2015](#)), if we assess the multiple criteria combination. It might be argued that we are experiencing the area of small states.

Consequently, small state studies have emerged as a discipline, and this discipline has been initially dominated mainly by the issues of vulnerability and a lack of capacities of small states, although these issues have been gradually replaced by the discussions on the potential opportunities of small states, not just their challenges ([Thorhallson, 2019](#)). The current theorizing thus focuses also on the specifics of the small economy modeling that has been viable due to the globalization trends ([Skilling, 2018](#); [Farrell, 2020](#)), but these trends have been reinforced additionally with the onset of the COVID-19 pandemic, or alternatively labeled the Great Lockdown crisis.

Small versus large states classification uses the size of the country as the main criterion, although this criterion can have several inputs, e.g. number of population, surface, GDP, etc., which can be applied also simultaneously. In practice, the number of population usually serves as the main input for classification of states. If the number of population is taken as the main criterion for categorizing states according to the size, the World Bank stipulates that 1.5 million residents is officially threshold for small states, but this threshold is heavily challenged due to the population and globalization shifts, where 10 million threshold is taken as more appropriate.

The economics of the state size thus treats it basically as the trade-off between the benefits of the size versus the costs of heterogeneity of population prefer-

ences ([Alesina et al., 2005](#)). Namely, the clear benefits of the larger state size are related to larger available domestic market size and thus implicitly less reliance on foreign trade, more diverse industry structure, larger availability of human potential, both in numbers and in their diverse capabilities, also, very importantly, per capita costs of several public goods and services are lower, either because more taxpayers can pay for them, or they have important scale economies or simply because the indivisibility is not implicitly increasing them. Notwithstanding, the aforementioned benefits are mostly economic in their nature, but there are also political and social benefits to the size, like larger military security, larger bargaining power in comparison to other states, larger international role of the state, larger possibility for internal redistribution etc. Since the focus of the paper stands on economic issues, only those are addressed. In contrast, larger countries might experience also some costs that come from the heterogeneity of population, which means that different preferences should be followed, and this increases costs, like distributional ones, and also ties that connect people might be looser, which generates difficulties in creating uniform and sustainable policies. Consequently, there is a trade off, and like in any organization, you might also have in the context of the state size the diseconomies of scale, arising mostly through administrative and congestion costs. We might argue that there is also some ground for the theory on the optimal size of state. Nonetheless, we will focus only on the economics of small states.

Economic literature has stressed the relations among the size of the country and governmental interventionism. For example, [Alesina and Wacziarg \(1998\)](#) argue that the size of government correlates negatively with country size and positively with trade openness. They have shown that smaller countries have a larger share of government consumption in GDP, and are more open to trade. Moreover, they argue that these empirical observations are consistent with recent theoretical models explaining country formation and break up. Namely, larger countries can afford to be closed, while small countries face stronger incentives to remain open; conversely, as trade liberalizes, regional and cultural minorities can afford to split because political borders do not identify the size of the market.

Similarly, [Rodrik \(1998\)](#) found a strong positive association between openness and government size. He explains this paradox by arguing that government expenditures are used to provide social insurance against the risk of terms of trade shocks that open economies face. This indicates that government consumption and expenditures play a risk-reducing role in economies exposed to a significant amount of external risk. [Goldsmith \(1999\)](#) justified the observation on the activist government in small states as being a buffer to vulnerability. Some recent studies have tried to put additional evidence on the relations between state size

and government size. For instance, [Jetter and Parmeter \(2015\)](#) pointed out that economies that are more open do not necessarily have bigger governments, but country size may be related to government size, as smaller states should have bigger government, although they admit using different datasets, timeframes, and sample country changes conclusions.

This theoretical insight suggest that relationship between state size and governmental interventionism is rather complex issue, and empirical investigations are warranted. If we followed assumptions stated above, smaller states should have larger governmental spending, on average at least, in comparison to larger states. Given the context, this study would like add to the existing research by providing some additional data-based experimental evidence on the relations among state size and government size. The cross-national comparative investigation based on the data for 44 European countries is utilized to assess the relationships among state size and government size. Specifically, we focus on the two categories of governmental spending, i.e. consumption spending and spending on transfers and subsidies, which are the two main categories of governmental spending.

Since this is explorative study, 44 European countries are split into two main clusters. The first cluster consists of smaller states, which are those that have less than 10 million residents; the second cluster consists of states that have more than 10 million residents, and we consider them larger states. Thus, we avoid speaking directly of small states due to the issues related to the problematic spectrum of medium-sized states, but rather split, given the European context, states into two clusters, those below and those above 10 million residents.

Given the focus of the paper, we analyze the available data for 2009-10 and 2017-18 time periods, in order to inspect the potential variations related to the different global economic conditions, as the first period corresponds to the period of the Great Recession, and the second for the period of the global economic prosperity. Since data on the fiscal records for the Great Lockdown period are still not available, we test the assumptions taken from data for the last global economic downturn in order to enable projections on the fiscal impacts of the current crisis in smaller and larger states.

3. RESULTS

The main research question addressed is whether there are any differences regarding the fiscal functions of government between smaller and larger states. Table 1 presents the outputs for the groups of states of two size clusters. Although the states analyzed are all very diverse, it is evident that the size vari-

able obviously does not play a role in influencing the extent of governmental expenditures, which is not in line with theoretical predictions, in particular for the governmental consumption spending.

Table 1. Evidence on the extent of budgetary part of government for selected European countries

State/ Indicator	2017-18		2009-10		State/ Indicator	2017-18		2009-10	
	Consumption spending (% GDP)	Transfer spending (% GDP)	Consumption spending (% GDP)	Transfer spending (% GDP)		Consumption spending (% GDP)	Transfer spending (% GDP)	Consumption spending (% GDP)	Transfer spending (% GDP)
Iceland	32.02	7.99	33.60	9.95	Switzerland	18.24	14.07	17.72	15.47
Malta	25.97	13.19	25.45	15.47	Austria	27.27	25.82	26.16	29.78
Luxembourg	35.56	22.99	34.50	24.39	Sweden	37.14	20.17	35.69	20.32
Montenegro	20.35	18.70	22.20	n.a.	Serbia	18.09	23.66	20.50	22.96
Cyprus	17.83	14.32	22.39	14.71	Hungary	28.88	17.78	29.07	20.52
Estonia	28.19	14.95	28.09	12.45	Average – smaller	24.82	16.61	25.16	17.65
Slovenia	25.99	18.90	27.06	23.08	Czech Republic	29.03	24.89	30.04	18.80
Macedonia	19.40	20.49	19.49	19.74	Belarus	22.71	20.83	n.a.	n.a.
Latvia	22.68	11.44	22.40	16.66	Belgium	31.53	29.82	31.39	28.29
Armenia	15.30	8.76	13.75	7.67	Portugal	21.57	19.88	24.62	22.91
Albania	12.01	9.64	12.50	10.09	Greece	22.45	23.05	23.60	22.33
Lithuania	21.07	13.84	23.57	17.58	Netherlands	35.86	24.30	38.56	26.12
Ireland	27.30	11.46	28.40	17.87	Romania	18.55	11.42	20.03	15.33
Moldova	17.99	13.26	19.10	14.91	Poland	23.38	16.61	23.53	18.67
Croatia	24.91	21.43	25.30	19.63	Spain	24.64	20.46	26.24	20.46
Bosnia- Herzegovina	21.02	17.56	20.82	15.19	Ukraine	23.09	19.33	23.31	21.48
Norway	34.81	19.02	33.83	19.30	Italy	23.56	24.52	25.10	24.15
Georgia	22.14	11.94	21.46	11.85	United Kingdom	22.28	17.21	24.57	16.10
Finland	30.28	25.29	30.77	23.54	France	29.93	28.32	29.92	27.41
Slovakia	26.23	19.55	25.11	21.46	Turkey	19.87	13.77	19.19	14.59
Denmark	34.88	20.57	36.50	24.76	Germany	26.88	25.95	25.57	27.71
Israel	28.86	12.49	28.40	10.55	Russia	25.99	18.01	26.30	18.61
Bulgaria	20.46	15.74	20.53	16.63	Average - larger	25.08	21.15	26.13	21.53

Sources: EFW (2010 and 2018), author's calculations.

Moreover, it is also evident that actually smaller states have, on average, lower share of governmental transfer spending in GDP, and this holds irrespectively of the time-periods under consideration. This is further reinforced, if the statistical analysis is performed, i.e., two-sample t-test assuming unequal variances, where the later empirical finding has been supported further (see Table 2 below).

Table 2. Testing the sample means of budgetary categories for smaller and larger states

	2017-18				2009-10			
	Consumption spending		Transfer spending		Consumption spending		Transfer spending	
	Smaller states N=28	Larger states N=16	Smaller states N=28	Larger states N=16	Smaller states N=28	Larger states N=15	Smaller states N=27	Larger states N=15
Mean	24.817	25.082	16.608	21.148	25.156	26.131	17.649	21.530
Variance	42.898	20.856	24.663	25.942	39.671	23.174	28.345	20.740
t Stat	-0.1578		-2.87026		-0.5669		-2.48889	
P(T<=t) one-tail	0.437706		0.003663		0.287151		0.009017	
t Critical one-tail	1.683851		1.695519		1.688298		1.69236	
P(T<=t) two-tail	0.875411		0.007326		0.574302		0.018033	
t Critical two-tail	2.021075		2.039513		2.028094		2.034515	

Sources: author's calculations based on data from Table 1.

4. DISCUSSIONS

This piece of research intended to investigate the exposure of European states to the current lockdown, where the focus is particularly on assessing the potential fiscal impacts of the lockdown, and where the observation differentiates between smaller and larger states. We can argue that the size of the state does not affect the consumption spending of government, but size variable matters for the transfer expenditures. It is evident that during the economic downturn period, governmental spending relatively increases, which is something that is expected due to the role of the so-called automatic fiscal stabilizers that majority of countries tend to have built into their fiscal policies. However, we cannot make statement that economic conditions change the structure of spending when smaller and larger states are compared, although variability of transfer expenditures is a little bit more explicit in smaller states, which partially corresponds to the assumptions derived from the existing literature. Namely, this tends to suggest that during the economic boom, smaller states are better off, and they consequently have

fewer social problems on average, but this problem relatively enlarges during the economic downturn.

The results of the study suggest that the effect of the size of the country does not necessary favor larger countries in respect to the smaller size of government due to the potential scale economies, but variations in transfer spending suggest a little larger vulnerability and exposure of smaller states to external economic shocks. In this context, it becomes of interest to study further the role of innovations in public services that enable the reductions in costs. Furthermore, it is evident that vulnerability does not play a major role, but diversity in preferences might be more important for the volume of transfer spending, and this might justify relatively larger transfer spending observed in larger states, if we seek the explanations in the existing literature.

5. CONCLUSIONS

The Great Lockdown, caused by the recent declaration of COVID-19 pandemic, has caused severe economic distractions to the majority of world countries. From the global perspective, a significant contraction in the foreign direct investments and international trade has occurred, to some extent accompanied by the rising pressures for economic nationalism. According to the perceived larger openness and vulnerability of smaller states, it is thus expected that those countries ought to be hit much harder by the economic contraction, as their outputs are much more volatile in relation to the economic cycles. In this context, this paper intends to investigate the exposure of European states to the current lockdown, where the focus is particularly on assessing the potential fiscal impacts of the lockdown, deriving from the existing evidence that stems from similar situations in the past.

The results of the study suggest that the effect of the size of the state does not affect the consumption spending of government, as the diseconomies of scale might be offset by larger innovations in public services that increase the efficiency of their delivery. In contrast, size variable matters for the transfer expenditure, but the major impact does not stem from the external exposure and shocks, but from the advantage of smaller states, that, at least on average, originates from the ability to utilize the benefits of more uniform population preferences. This is reflected in relatively lower levels of transfer spending of government in GDP, but the effect of volatility related to economic conditions can still be observed. Consequently, this research adds to the development of the discipline of small state studies, in particular to the issue of their vulnerability and changing global economic environment.

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УВИД У ПОТЕНЦИЈАЛНЕ ФИСКАЛНЕ ИМПЛИКАЦИЈЕ ВЕЛИКОГ ЗАТВАРАЊА ИЗ ПЕРСПЕКТИВЕ МАЛИХ ЗЕМАЉА

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САЖЕТАК

Велико затварање изазвало је озбиљне економске сметње већини свјетских земаља, а трендови деглобализације почели су да се повећавају. Глобализација је у одређеној мјери била корисна за мање економије и била је један од фактора који је допринио расту броја земаља широм свијета током последњих неколико деценија. Према ученој већој отворености и рањивости мањих држава, очекује се да су те земље много теже погођене економском рецесијом, јер су њихови производи много нестабилнији у односу на економске циклусе. У том контексту, овај рад намјерава да истражи изложеност европских држава тренутном затварању, при чему је фокус посебно на процјени фискалних утицаја затварања. Главно истраживачко питање јесте да ли постоје разлике у погледу фискалних функција владе између мањих и већих држава. Ово се рјешава кроз међународно компаративно истраживање, засновано на подацима за 44 европске земље; и посебно процењујемо како се фискалне активности владе разликују између мањих и већих држава. Резултати студије сугеришу на то да ефекат величине државе не утиче

на потрошњу владе, али је важан за варијабилну величину расхода трансфера. Ово истраживање треба да допринесе развоју дисциплине малих државних студија, посебно питању њихове рањивости и промјена глобалног економског окружења.

Кључне речи:

мале државе, владини издаци, глобализација, велико затварање, економска рањивост.