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Democratic corporatism and small state resilience

An analysis of the explanatory power of democratic corporatism for the economic and political performance of seven small European states during the 2008 economic crisis.

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Introduction

The contemporary international economy is characterized by globalisation, economic integration, and increasing economic interdependence between states. The global financial crisis of 2008 caused major financial turmoil in the whole world, and it is a primary example of the strong interdependence between national economies. What started as a crisis in the subprime mortgage market in the United States, soon developed into an international banking crisis, followed by a global economic downturn and the European debt crisis. Consequently, none of the European states were spared in the economic crisis of 2008.

Small states are particularly vulnerable to changes in the international economy. Generally, they are dependent on international trade because of the limited size of their domestic markets. Because of their open economies, one would expect that small states were hit hard by the crisis. Iceland and Cyprus are the most evident examples of small state vulnerability during the crisis. The Cypriot economy was hit hard through the Greek debt crisis and eventually, Cyprus was among the five countries in the Eurozone that had to apply for a 10-billion-bailout agreement (Charalambous, 2014, p.14). Iceland was even more vulnerable, as it lacked external shelter from the European Union (Thorhallsson, 2011).

However, in his classic volume *Small States in World Markets* (1985), Peter Katzenstein suggests that small states can pursue domestic strategies to overcome their vulnerability in the international economy. According to Katzenstein, some small European states have developed domestic democratic corporatist structures that provide them with the ability of flexible economic adjustment. Democratic corporatism functions as a mechanism to successfully cope with sudden international economic changes and adversity. Though Katzenstein's theory has had major influence in the field of comparative politics and international relations, it has not remained unchallenged. The explanatory power of corporatism for macro-economic performance has been questioned in general, and one of the main critiques on Katzenstein has been that he avoids the issue of causal inference of the relationship between democratic corporatism and economic success. This raises the question whether the presence or absence of democratic corporatist structures actually influences the economic performance of some of Europe's smallest states.

As small states are vulnerable in the international economy, especially during an economic crisis, it is important for them to identify the domestic factors that can contribute to their ability to withstand economic shocks. Therefore, testing the applicability of Katzenstein's theory on the smallest states of Europe can be valuable for small states, as it provides them with information on whether domestic democratic corporatist structures are useful or not in improving their economic resilience. In order to clarify the causal claims made by Katzenstein, this thesis will analyse the relationship between democratic corporatism and economic performance for seven European small states: Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Malta and Slovenia – during and after the economic crisis of 2008.

<u>Small states in the international economy</u>

As a field of social science, political science seeks to provide general theories with wide application. Therefore, it should take all its cases seriously (Neumann & Gstöhl, 2006, p.28). However, under the realist premise that great power states have the capabilities to influence the international system, large states have traditionally received more attention in the discipline of international relations. Small states have largely been neglected because of their "supposedly insignificant role in international politics" (Veenendaal & Corbett, 2015, p.527). This is a shortcoming for the discipline. Small states can provide valuable information, as their political structures often deviate from those of larger states (Veenendaal & Corbett, 2015; Katzenstein, 1985). Studying small states therefore provides an opportunity to test and question existing knowledge about international relations.

The (neo-)realists who considered small states in their research – mainly scholars who were based in small countries – found that small states have to adjust to the rules of the game, which are primarily prescribed by big states (Neumann & Gstöhl, 2006, p.17-19). These assumptions resulted in the conventional wisdom that small states cannot independently influence international politics and that the foreign policy behaviour of small states is determined by the international system (Hey, 2003, p.6). However, various scholars have challenged this traditional understanding by asserting that domestic factors, rather than international factors, might in fact provide a better explanation for small state behaviour (East, 1973; Elman, 1995).

The (neo-)realist approach stresses power capabilities and state security issues, and therefore focuses on the balance of power in a system level-analysis (Hey, 2003, p.8). In the 1970s, neoliberal institutionalism made room for a new focus on economic interdependence and cooperation. This contributed to a higher level of attention for small states, as the global economy is an important policy area for these countries (Neumann & Gstöhl, 2006, p.11). Still, many economists stressed the weak economic position of small states. Given that many developing countries are small, the general view holds that smallness is a constraint on economic success and that small states have little influence on international organisations and decision-making in the international political economy (Neumann & Gstöhl, 2006, p.13).

Indeed, small states possess several characteristics that are presumably disadvantageous for their economic performance. Firstly, states with a small area often lack (a diverse) supply of raw materials and natural resources (Streeten, 1993, p.197). Consequently, they are primarily dependent on imports (Briguglio, 1995, p.1616). Furthermore, small states have a small domestic market. This causes them to depend on export markets, while policies of import-substitution are also limited (Briguglio, 1995, p.1616). Moreover, small states have limited possibilities to exploit economies of scale. Small states can overcome this deficit with export-oriented policies, but they still have to concentrate on just one or a few export products with comparative advantage (Streeten, 1993, p.198). Altogether, these characteristics often result in less diversified economic structures, making small states dependent on international trade and thus on economic conditions in the rest of the world (Kuznets, 1960). In turn, this means that small states are more vulnerable to unexpected shocks in international trade and other adverse economic changes. It follows that there is a dominant assumption that small states have a weak economic position.

Nevertheless, several studies have shown that empirically, a lot of small states do not meet the expectations of weak economic performance. Both in terms of growth rates and per capita incomes, small states perform equally well and sometimes even better than large states (Armstrong & Read, 1998; Easterly & Kraay, 2000). So apparently, some small states are able to cope with their vulnerable position in the international economic system quite well. In the classic study *Small States in World Markets* (1985), Peter Katzenstein has made a major contribution to the understanding of why this is the case, by analysing how seven small states in Europe (Switzerland, the Netherlands, Belgium, Sweden, Denmark, Norway and Austria) coped with the economic dislocations in the global economy of the 1980s, such as the oil crisis and increasing competition from Third World countries. He suggested that small state policy could even contain some important lessons for other states, including countries with big power capabilities.

According to Katzenstein (1985), small states are indeed more dependent on world markets because of their small size. Their economic openness makes them vulnerable to sudden changes in international economic conditions. Even though all states, including large ones, must find strategies to cope with global economic changes, small states lack the ability to adopt protectionist policies like large states often do in response to adverse economic change. Instead, small states adopt flexible policies of adjustment, by combining economic openness with domestic compensation for the victims of instabilities in investment and employment, such as investment reserves and subsidies, a national incomes policy, or social security expenditures (Katzenstein, 1985, p.48–56). These compensatory policies reduce the uncertainty stemming from market fluctuations.

In the seven small states analysed by Katzenstein, these policies proved to be successful – both in terms of economic performance and political legitimacy and stability. Katzenstein's yardstick for success or failure "measures the extent to which social coalitions, political institutions and public policies facilitate or impede shifts in the factors of production that increase economic efficiency with due regard to the requirements of political legitimacy" and Katzenstein suggests that small states successfully adjust to economic change "through a carefully calibrated balance of economic flexibility and political stability" (Katzenstein, 1985, p.29). This is made possible by domestic structures of democratic corporatism. Conversely, small states that adopt a liberal agenda and lack a framework of democratic corporatism, run the risk of being more vulnerable to economic changes and political disorder. In short, "for the small European states, economic change is a fact of life" and therefore "they live with change by compensating for it" (Katzenstein, 1985, p.24). The key to success is a framework of democratic corporatism. This concept will be elaborated on in the following paragraph.

<u>Conceptualization of democratic corporatism</u>

Democratic corporatism is an ambiguous concept, as there is no general agreement on the definition of it in the literature. Neither is there consensus on the central elements that constitute corporatism (Williamson, 1989). Generally, corporatist systems can be contrasted with pluralist systems, in which the influence of lobby groups and associations on a government's socio-economic policy is widely dispersed. Consequently, interest groups are constantly in competition with each other over the amount of public revenue that will be devoted to them (Williamson, 1989, p.53–54). In corporatist systems, on the other hand, labour organizations are highly involved in the decision-making of socio-economic policies. The goal of these structures is to limit (social) conflict in society (Thorhallsson & Kattel, 2013, p.88). As this thesis aims to test the applicability of Katzenstein's theory, his own definition of democratic corporatism will be used.

Katzenstein places democratic corporatism in between two other political forms of capitalism: liberalism and statism. Liberal countries, such as the United States and Great Britain, rely on macro-economic policies and market solutions, and respond to economic adversity with protectionist policies (Katzenstein, 1985, p.23). Democratic corporatist states also have liberal market economies, but substitute political mechanisms of compromise for dictates of the market (Katzenstein, 1985, p.133). In statist countries, like Japan and France, the government assists firms to become competitive and helps industry prepare for international competition (Katzenstein, 1985, p.26). In corporatist countries, state bureaucracies also have an important place in the market policy, but these state institutions are relatively neutral and have limited institutional autonomy and political interest of their own (Katzenstein, 1985, p.133).

Democratic corporatism is defined as "the voluntary, cooperative regulation of conflicts over economic and social issues through highly structured and interpenetrating political relationships between business, trade unions and the state, augmented by political parties" (Katzenstein, 1985, p.32). Katzenstein identified three main characteristics of corporatism, namely 1)an ideology of social partnership expressed at the national level, 2)a relatively centralized and concentrated system of interest groups and 3)a political bargaining framework in which important interest groups participate in policy formation. These characteristics enhance the ability of (small) states to reach compromise and consensus. According to Lijphart & Crepaz (1991), consensus democracy and corporatism are highly related. The need for coalition or minority governments – commonly caused by an electoral system of proportional representation – is an important condition facilitating corporatist compromise (Katzenstein, 1985, p.156-157). Coalition governments create a system of consensual decision-making as they encourage sharing of power among political opponents and provide opposition parties with influence over policy formation. Such a political culture of consensus enhances the prospects of corporatist compromise.

<u>Small states, democratic corporatism and economic performance</u>

Katzenstein's analysis of how small states cope with their vulnerability in the international economy has had a major influence on the fields of international political economy and comparative politics and it remains to be of great importance in small state studies (Ingebritsen, 2010). Generally, the scholarly literature on corporatism supports Katzenstein's argument that corporatism positively affects the macro-economic performance of (small) states. High growth, low unemployment and low inflation rates are found to be more common in states with corporatist structures and consensual democracies than in states with pluralist systems and majoritarian democracies (Lijphart & Crepaz, 1991, p.236; Wilensky, 2006). However, there is no uniform understanding of the consequences of corporatism, as "there is little evidence that corporatism matters as a determinant of economic outcomes" (Therborn, 1987). Some scholars claim that the efficacy of corporatist structures as a device for crisis management is in decline (Lijphart & Crepaz, 1991, p.237). According to Vis, Woldendorp & Keman (2012), corporatism accounts for policy formation and implementation, rather than economic performance.

In *Small States in World Markets* (1985), Katzenstein analysed seven states that were considered small at the time: Switzerland, the Netherlands, Belgium, Sweden, Denmark, Norway and Austria. Indeed, they were relatively small in comparison with the large countries that had – until then – dominated research on international relations and the international political economy. However, setting the bar at the population size of the biggest of these states at present day – The Netherlands with 17 million inhabitants – would mean that only ten states in Europe (Russia, Germany, Turkey, France, Great Britain, Italy, Ukraine, Spain, Poland and Romania) are not considered small (Neumann & Gstöhl, 2006, p.6). There is no generally agreed definition of small states in the literature of small state studies (Neumann & Gstöhl, 2006, p.9), but it can be argued that nowadays, the states analysed by Katzenstein would be identified as middle power states rather than small states. From this perspective, one could expect that even smaller countries might be more vulnerable to economic changes than the states analysed by Katzenstein, and, therefore, these smaller states are the most likely cases in which a framework of democratic corporatism is necessary to deal with economic change.

Recent studies have shown that some of these smaller European states have not adopted Katzenstein's framework. Kuokštis (2015) asserts that Estonia lacks corporatist structures and domestic compensation policies. Thorhallsson (2010) showed that corporatist structures in Iceland never fully developed and that Icelandic decision-making continues to be characterized by conflict rather than consensus. Thorhallsson & Kattel (2013) claim that the lack of corporatist structures in both Iceland and Estonia helps to explain why they were highly vulnerable to the economic crisis of 2008.

These studies have shown that some of Europe's smallest states lacking corporatist structures have not fared well during the crisis. However, it cannot easily be determined whether the lack of corporatist structures is the (main) explanation for this. For example, Thorhallsson (2011) has argued that – in addition to buffers from within – external shelter, such as membership of the European Union, is necessary for small states to be resilient in times of economic crisis. Furthermore, it has not yet become clear whether some of the smallest European states that fit the democratic corporatism framework have performed better. This raises the question whether non-corporatist small states are in fact less able to cope with changes in the international economy than corporatist small states.

King, Keohane & Verba (1995) have offered one of the main critiques on Katzenstein's work, namely that it avoids the issue of causal inference of the relationship between democratic corporatism and economic success: "Because of selection bias induced by his decision to study only successful cases, Katzenstein cannot rule out an important alternative causal hypothesis – that any of a variety of other factors accounts for this uniform pattern" (King, Keohane & Verba, 1995, p.478). So by selecting his cases on the dependent variable, some of Katzenstein's claims remain unsupported. Katzenstein's historical analysis is a valuable contribution for understanding the economic success of his seven cases, but by suggesting that democratic corporatism may contain lessons for large states, he seems to make the normative claim that democratic corporatism helps macro-economic performance in any case. When the issue of causal inference is not addressed, it is important to be careful with such implicit recommendations. Katzenstein has responded to this critique by admitting that "*Small States* would have been a better book had it pushed harder on an underdeveloped part of the analysis, either through further empirical work, by adding more cases, or through better developed counterfactual reasoning" (Katzenstein, 2003, p.13). This thesis aims to do both, by studying the explanatory power of the absence or presence of democratic corporatism in seven most likely cases that were not included in Katzenstein's research.

Research question

Katzenstein claims that the economic success of the seven small states he analysed could be explained by their domestic democratic corporatist structures. As there are much smaller states in Europe than his seven cases, this raises the question whether his theory is also applicable to those most likely cases – especially because not all of them have adopted a democratic corporatist framework. Furthermore, the theory of Katzenstein suggests that democratic corporatism might contain important lessons for (big) states, while he remains inexplicit about the causal inference of the relationship between corporatism and macro-economic performance. Therefore, this thesis puts Katzenstein's theory under scrutiny, by testing its applicability in the economic crisis of 2008. This particular crisis is suitable to analyse the different responses of small states, because all European states have (to a more or lesser extent) been impacted by this crisis. This thesis aims to answer the following research question: To what extent can democratic corporatism explain differences in the economic resilience of small European states during and after the 2008 crisis? The answer of this question might be valuable for small states, because it clarifies whether the lessons from *Small States in World Markets* are also applicable to them in the contemporary economy.

Expectations

On the basis of Katzenstein's theory, three general expectations can be formulated. First, Katzenstein suggests that structures of democratic corporatism contribute to the economic resilience of small states when they are faced with economic adversity. Therefore, it can be hypothesized that small European states without (strong) democratic corporatist structures have been hit harder in terms of macro-economic performance during the economic crisis of 2008, than small states with (strong) democratic corporatist structures. Alternatively, different compositions of their economies might also explain diverging economic performances.

Second, Katzenstein claims that the domestic structures of small states are an important explanation for their political strategies. Democratic corporatism enables small states to adopt policies of domestic compensation, which improves their ability to respond to and recover from economic shocks in a successful way. Hence, the second expectation is that small states with (strong) democratic corporatist structures adopted policies of domestic compensation in response to the economic crisis, while the governments of small states without (strong) democratic corporatist adopted policies that were less compensatory.

Third, Katzenstein's yardstick for success or failure also includes political stability and legitimacy. Democratic corporatism encourages concertation with the social partners, resulting in consensual policies. Therefore, the third expectation is that small states with (strong) democratic corporatist structures pursued policies based on consensus resulting in high political and social stability, whereas the governments of small states without (strong) democratic corporatist pursued their anti-crisis policies unilaterally, resulting in political and social instability.

Operationalization

Katzenstein (1985, p.34) stresses that characteristics of democratic corporatism can be found in all advanced industrial states, but that one can distinguish between "strong" and "weak" systems of democratic corporatism. This indicates that states can be ranked according to their scores of democratic corporatism. For the operationalization of democratic corporatism, several indicators will be selected from the database provided by Visser (2015). This is a comprehensive database on institutional characteristics of trade unions, wage setting, state intervention and social pacts in 51 countries between 1960 and 2014. However, only a few indicators in the database are relevant for the measurement of the features of democratic corporatism. The selected indicators and the ranking of the seven cases will be discussed later in the thesis.

The Economic Performance Index (EPI), developed by Khramov & Lee (2012) for the IMF, will be used to operationalize macro-economic performance. The EPI is a comprehensive index which gives an overall image of the economic stance of a state. Simply looking at GDP is not enough, as this does not always reflect the effects on e.g. the labour market (Tridico, 2013). The EPI is composed of 1)the inflation rate measuring the economy's monetary stance, 2)the unemployment rate measuring the economy's production stance, 3)the budget deficit as a percentage of total GDP measuring the economy's fiscal stance and 4)the change in real GDP measuring the aggregate performance of the entire economy. These indicators, except for the last one, were also used by Katzenstein to measure economic performance. Data provided by Eurostat (2016) on these four indicators will be used to calculate the EPI of the seven small states before, during and after the crisis, using the appropriate formula.[1]

Research design and methodology

This thesis provides a nested analysis in a mixed methods research design, following the guidelines provided by Lieberman (2005). This strategy combines case-study analysis with statistical analysis. The preliminary quantitative analysis both provides insights in the strength of the relationship between democratic corporatism and economic resilience, and guides the case selection for the qualitative analysis – in which specific explanations of individual cases can be explored (Lieberman, 2005, p.436). The nested analysis is particularly suitable for making causal inferences (Lieberman, 2005, p.437) and triangulation offers greater validity of the results (Bryman, 2012, p.633).

In the quantitative analysis, the first hypothesis will be tested by analyzing the correlation between the corporatist ranks of the seven cases and their decrease in economic performance during the crisis. The decrease in economic performance represents the impact of the crisis on the economies, and will be calculated by comparing the maximum EPI-score of the seven states before the 2008 crisis with their minimum EPI-scores during the crisis. A bivariate analysis, using Spearman's rank-order correlation coefficient, can be used to test the strength and direction of the assumed unidirectional relationship between the dependent variable (economic performance) and indicators of democratic corporatism as explanatory

[1] The formula developed by Khramov & Lee for calculating the EPI is: 100% - (Inf(%)-0.0%) - (Unem(%)-4.75%) - (Def/GDP(%)-0.0%) + (ΔGDP(%)-4.75%).

variables (Argyrous, 2011, p.245). The Spearman's rank-order correlation coefficient is calculated by ranking the sample for each variable and then comparing these ranks (Argyrous, 2011, p.246–247). As the theory of Katzenstein is explicit on the direction of the relationship (democratic corporatism explains economic performance), a one-tail sided test can be used. The correlation will be presented in a scatter plot and from this figure, cases will be selected for further qualitative analysis.

The qualitative analysis will be used to further explore the causal link between the two variables, and to test the second hypothesis on the link between democratic corporatism and anti-crisis policy responses and the third hypothesis on the link between democratic corporatism and political stability. The qualitative analysis will be executed through a content analysis of scientific studies on the selected cases and reports provided by national banks and trade unions, the OECD and several agencies of the European Union, such as the European Foundation for the Improvement of Living and Working Conditions (Eurofound) and the European Trade Union Institute (ETUI).

<u>Case selection</u>

The vulnerable position of small states in the international economy is caused by their economic openness – which is inherently linked to their small domestic markets. According to Katzenstein, domestic structures of democratic corporatism will help these small states to cope with their vulnerable position. As this thesis aims to study the effects of this domestic factor, the effect of external shelter on small state resilience is excluded by only selecting cases that are a member of the European Union.

Table 1: Smallness and economic openness of selected cases

	Population (2013)	Exports/GDP (2013)
Cyprus	865,878	58,7%
Estonia	1,320,174	84,5%
Latvia	2,023,825	61,3%
Lithuania	2,971,905	84%
Luxembourg	537,039	192,1%
Malta	421,364	158,2%
Slovenia	2,058,821	75,2%

Source: Eurostat (2016)

Therefore, seven EU-member states have been selected by their small size and open economies. Size can be measured on the basis of population size, and the bar for smallness is set at a population of 3 million inhabitants. Economic openness can be measured by the export of goods and services as a percentage of the GDP. This leaves the selection with seven states: Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Malta and Slovenia. Table 1 shows that the seven selected cases are both small and have very open economies, indicating their economic vulnerability. These are the most likely cases for the applicability of Katzenstein's framework, and they therefore constitute a good sample to test his theory.

Quantitative analysis

Operationalization and ranking of democratic corporatism

As noted above, democratic corporatism has three main characteristics. The first characteristic, an ideology of social partnership, indicates a political culture in which the social partners prefer consensus and compromise over competition. This feature can hardly be expressed in quantitative data. Moreover, an ideology of social partnership can also be regarded as a favourable condition for the development of the other corporatist characteristics, rather than being a main feature of democratic corporatism. After all, an ideology of social partnership and the third characteristic of "voluntary, informal and continuous" political bargaining are highly related. For these reasons, an ideology of social partnership will not be included in the quantitative analysis of corporatism, but it will be covered by the qualitative analysis on the selected cases.

From the database provided by Visser (2015), eight measurements have been selected to measure the remaining characteristics of democratic corporatism. The second characteristic of democratic corporatism can be split into two indicators of democratic corporatism, namely 1)the centralization of interest groups in peak organizations and 2)the concentration of these interest. A framework for collective (political) bargaining constitutes the third characteristic. The selected indicators are presented in the table 2 below.

The first measurement (I) is concerned with the formal hierarchical control of union confederations at peak and sectoral level. It is a summary measure of the authority of confederations over its affiliates and of the unions over their local or workplace branches. It is a continuous index and varies from 0 to 1. Unfortunately, Visser's database does not provide the same measure for employers' organizations. Therefore, the second measurement (II) concerns the number of employers' confederations. A small number employers' organizations indicates a relatively higher level of centralization than a large number of organizations. The third measurement (III) reflects the predominant level on which wage bargaining takes place. This indicator is selected because bargaining will take place on higher levels when the peak organizations have more hierarchical control. Visser (2015) has coded this measurement in the following way: 1 = bargaining predominately takes place at the local or company level; 2 = intermediate or alternating between sector and company bargaining; 3 = bargaining predominantly takes place at the sector or industry level; 4 = intermediate or alternating between central and industry bargaining; 5 = bargaining predominantly takes places at central or cross-industry level.

Table 2. Indicators measuring democratic corporatism

Characteristics of corporatism	Measurement
Centralization of interest groups	(I) Authority of Union Confederations
	(II) Number of Employers' Organizations
	(III) Level of Wage Bargaining
Concentration of interest groups	(IV) Employers' Organization Density
	(V) Union Density
	(VI) Collective (wage) bargaining coverage
Bargaining Framework	(VII) Tripartite Council
	(VIII) Routine Involvement

The concentration of interest groups is a measure of the degree of inclusiveness (Katzenstein, 1985, p.33). The employers' organization density rate (IV) expresses the percentage of employees in firms organised in employers' organizations. The union density rate (V) indicates net union membership as a proportion of all wage and salary earners in employment. However, non-member employees might still be covered by a collective wage agreement. Therefore, the sixth measurement (VI) shows the percentage of employees covered by collective wage bargaining agreements, as a proportion of all employees – irrespective of whether they are organized in a trade union or not.

The existence of a bargaining framework is measured by two indicators. Firstly, measurement VII expresses the existence of a standard (institutionalized) tripartite council concerning social and economic policy. The values of this indicator are coded by Visser (2015) in the following way: 0 = No permanent council; 1 = Council with various social interest representatives, including unions and employers; 2 = Tripartite Council with representation from the trade unions, employers' associations, and government(-appointed) representatives. The final measurement (VIII) expresses the routine involvement of unions and employers in government decisions on social and economic policy, regardless of the existence of a formal tripartite council: 0 = No concertation, involvement is rare or absent; 1 = Partial concertation, irregular and infrequent involvement; 2 = Full concertation, regular and frequent involvement.

In order to rank the seven cases on their scores of democratic corporatism, the average scores on the selected indicators over the time period of 2005 – 2014 have been calculated. These mean scores and their corresponding ranks are presented in tables 3, 4 and 5. Table 6 displays the sum of these ranks. The state with the lowest value, Luxembourg, has the strongest corporatist structures, followed by Slovenia, Cyprus and Malta. The Baltic states score lowest on the indicators of democratic corporatism. Following the first hypothesis, the states with (strong) corporatist structures are expected to have been hit less hard during the crisis, than the states without or with weaker corporatist structures. This correlation will be tested in the following paragraph.

Table 3. Centralization of interest groups

	Authority of union confederations (I)		Number of employers' organizations (II)		Level of wage bargaining (III)	
	Mean score	Rank	Mean number	Rank	Mean score	Rank
Cyprus	,30	3,5	2,00	3,0	1,83	3,0
Estonia	,25	5,0	3,00	5,0	1,00	5,5
Latvia	,20	6,5	2,00	3,0	1,00	5,5
Lithuania	,20	6,5	2,00	3,0	1,00	5,5
Luxembourg	,40	1,0	1,00	1,0	2,40	2,0
Malta	,30	3,5	3,30	6,0	1,00	5,5
Slovenia	35	2,0	4,90	7,0	3,50	1,0

Source: Visser (2015), calculations by author

Table 4. Concentration of interest groups

	Employers' organization density rate (IV)		Union density rate (V)		Collective (wage) bargaining agreements coverage (VI)	
	Mean %	Rank	Mean %	Rank	Mean %	Rank
Cyprus	62,50	3,0	52,72	2,0	50,04	4,0
Estonia	24,20	6,0	7,63	7,0	24,00	5,0
Latvia	33,68	5,0	15,05	5,0	17,44	6,0
Lithuania	16,13	7,0	9,84	6,0	10,82	7,0
Luxembourg	80,00	2,0	36,76	3,0	58,57	3,0
Malta	60,00	4,0	53,96	1,0	61,55	2,0
Slovenia	85,50	1,0	26,86	4,0	84,89	1,0

Source: Visser (2015), calculations by author

Table 5. Bargaining framework

	Tripartite Council (VII)		Routine Involvement (VIII)	
	Mean score	Rank	Mean score	Rank
Cyprus	,00	7,0	2,00	1,5
Estonia	,10	6,0	1,00	5,5
Latvia	2,00	2,5	1,00	5,5
Lithuania	2,00	2,5	1,00	5,5
Luxembourg	2,00	2,5	2,00	1,5
Malta	1,00	5,0	1,00	5,5
Slovenia	2,00	2,5	1,50	3,0

Source: Visser (2015), calculations by author

Table 6. Corporatism ranks

	Sum of ranks of columns (I) – (VIII) in tables 3, 4 and 5.	Corporatism rank
Cyprus	27,0	3
Estonia	45,0	7
Latvia	39,0	5
Lithuania	43,0	6
Luxembourg	16,0	1
Malta	32,5	4
Slovenia	21,5	2

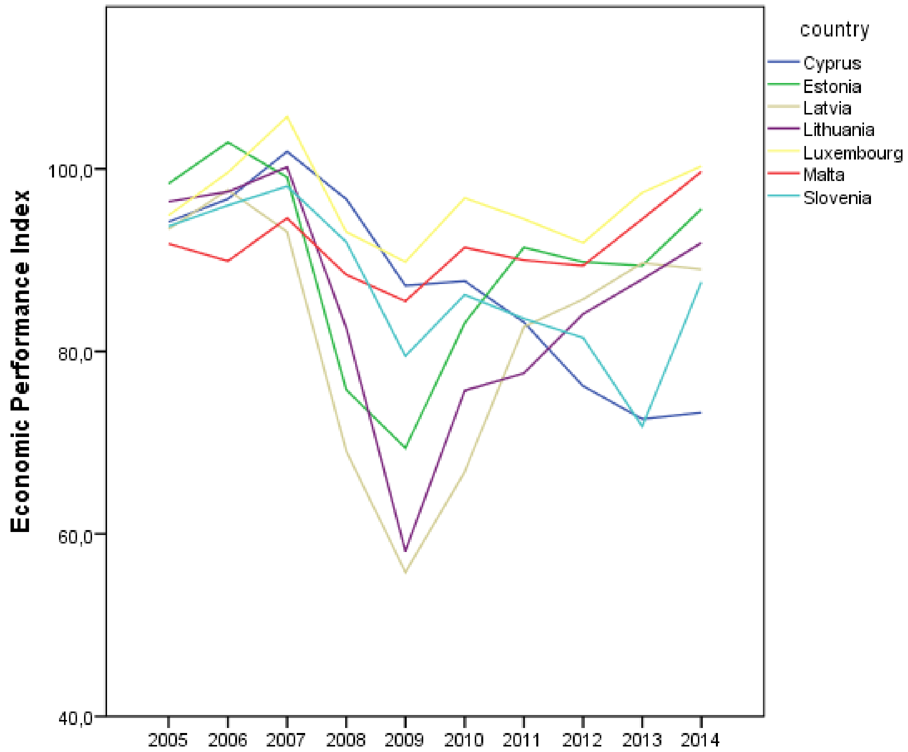
<u>Economic performance and corporatism</u>

Figure 1 shows the EPI of the seven cases from 2005 – 2014. After most states performed best in 2007 (except for Estonia and Latvia in 2006), the economies of all seven cases have been impacted by the economic crisis starting in 2008. The Baltic states have been hit hard in particular. And while most states hit their low-point in 2009, in Cyprus and Slovenia the crisis lingered and impacted their economies most in 2013. Figure 2 displays the relationship between corporatism and the decrease in economic performance during the crisis, for each of the seven cases.

This result generates a Spearman's rank-order correlation of 0,679 between the sum of corporatism ranks and the EPI decreases of the seven states. This means that there is a statistically significant relationship between democratic corporatism and the impact of the crisis on the economic performance of the small states ($p = 0.047$). Therefore, the first hypothesis can be confirmed: overall, the economies of the small European states with relatively weak democratic corporatist structures have been hit harder in terms of macro-economic performance during the crisis of 2008 than small European states with stronger democratic corporatist structures. The Baltic states have been hit hard in particular, while they also have the weakest corporatist structures. Furthermore, the states with strong corporatist structures, Slovenia and Luxembourg, performed relatively well.

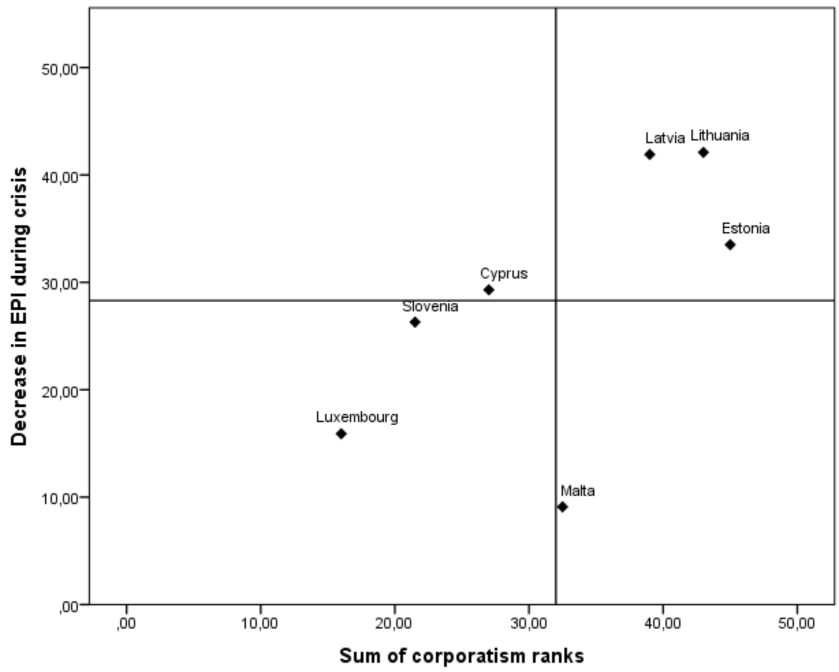
From these results, it is not yet possible to conclude that the statistically significant correlation between democratic corporatism and the impact of the crisis also represents a causal link between these variables. The differences in the composition of the economies constitutes a potential alternative explanation. According to the Central Bank of Malta (2016), the diversification of the Maltese economy in the years before the crisis has contributed to its resilience during the crisis, as it made the economy less vulnerable to industry-specific disturbances. Obviously, industry-specific disturbance was more severe in Cyprus and Luxembourg, as they have a large financial sector. The main difference was that domestic banks in Cyprus held much more banking assets than domestic banks in Luxembourg (Stephanou, 2011).

Figure 1: Economic performance of small states during the crisis



Source: Eurostat (2016), calculations by author

Figure 2: EPI decrease and degree of corporatism



Still, the presence or absence of democratic corporatism may have influenced the ability of the seven small states to recover from the economic crisis. As the statistically significant results are robust, the case study analysis should be focused on testing the model (Lieberman, 2005). Therefore, the case selection should be based on the widest degree of variation on the independent variable. So Luxembourg and Estonia, with respectively the strongest and the weakest democratic corporatist structures, are selected as two extreme cases, and can therefore be used as confirmatory case studies (Seawright & Gerring, 2008, p.300). They might contribute to our understanding on the extent to which the absence or presence of democratic corporatism makes small states more resilient or vulnerable. Furthermore, figure 2 displays Malta as an outlier: the Maltese economy has been hit least hard by the crisis, while its corporatist structures are relatively weak. An exploratory case study on this deviant case might give some insights into why Malta does not seem to fit Katzenstein's theory (Seawright & Gerring, 2008, p.302).

Qualitative analysis

Luxembourg: economy and corporatism in crisis

Luxembourg's strong democratic corporatist structures correspond with its political culture of consensus. The proportional electoral system has caused a need to form coalition governments. Consequently, political competition is limited and political parties have refrained from radical policy changes (Dumont, Kies & Portier, 2010a, p.126). This has fuelled an ideology of social partnership, which is clearly present in the so-called 'Luxembourg social model'. This model "combines continuous, institutionalized dialogue among industry, unions and the government to produce low inequality, an adequate redistribution of the fruits of economic growth and industrial peace" (Hirsch, 2010). Table 3 shows that the interest groups are highly centralized. The density rate of union membership is relatively low (36,76%) compared to the density rate of employers' organizations (80%), but the majority of the employees (58,57%) is covered by collective wage bargaining agreements (table 4). Furthermore, there are tripartite consultation bodies that constitute a formal political bargaining framework, guaranteeing permanent social dialogue between employers, employees and government (table 5). The most important corporatist institution is the National Tripartite Committee (NTC) in which government, employers and unions are engaged in policy-making on issues linked with labour market regulation, incomes and fiscal policies and social security (Dumont & Hirsch, 2003). In this institutionalised and permanent platform for social dialogue, decision-making is highly consensual (Dumont & Kies, 2013). It thereby fulfils its purpose of easing parliamentary approval for major policy changes. Based on the hypotheses of this thesis, it is expected that these strong democratic corporatist structures have helped Luxembourg to cope with the economic crisis.

Indeed, Luxembourg has weathered the crisis relatively well and the effects of the crisis have been less severe than in other small countries with large financial sectors, such as Cyprus (Clauwaert, Schömann, Buetten & Rasnača, 2016, p.1). According to the OECD (2012, p.12), the impact of the crisis on the economy of Luxembourg has been limited due to its "stable and well trusted institutions built on a culture of consensual decision-making". The main crisis management policies included monetary and financial measures, short working subsidies that dampened the rise in unemployment, and fiscal stimulus measures, such as public investments and higher social benefits (OECD, 2012). The corporatist institutions and mechanisms have been utilized to adopt these policies of domestic compensation. At the beginning of the crisis in 2009, the government consulted with the social partners to adopt a support plan intended to help companies in difficulty (Guyet, Tarren & Triomphe, 2012, p.76). Measures included state loan guarantees and subsidies for employers so that companies could maintain their personnel with a shorter work-time scheme, compensating for the employee's lost salaries (Clauwaert et al., 2016, p.2). Furthermore, government intervention in the two severely damaged banks Dexia and Fortis was based on consensus and received high domestic support (Dumont, Kies & Poirier, 2009).

However, the consensual democratic corporatism model was also challenged during the crisis. The pre-crisis growth of the financial sector – which accounts for one-third of the GDP – had led to an increasingly unequal distribution of labour income. The economic crisis exposed the dependence of the social transfer system on the volatile financial sector (OECD, 2012). In May 2009, trade unions organized a massive protest of 30.000 people in Luxembourg city against threats to dismantle the social security system (Guyet et al., 2012; Dumont, Kies & Poirier, 2010b). Furthermore, in April 2010, discussions on wage indexation in the NTC failed. This was the first serious breach in tripartite dialogue since 1982 (Broughton & Welz, 2013, p.16). The main problem was that the government submitted its Stability and Growth Pact for 2009 – 2014 to the European Commission before consulting these issues with the social partners first (Hirsch, 2010). Eventually the deadlock was solved through a bipartite agreement between the government and the national trade unions in September 2010. However, subsequent negotiations between the government and the employers' organisations failed again (Dumont, Kies & Poirier, 2011).

The Luxembourg social model turned out to be fragile during times of crisis. Slovenia, which also has relatively strong corporatist structures, experienced similar developments. When the crisis hit Slovenia, the government initially implemented some successful short-term anti-crisis measures aimed at job protection and burden-sharing – most of which were consulted with the social partners (Feldmann, 2017). However, tripartite consultations on long-term anti-crisis measures in November 2009 also failed, which lead to even higher social unrest in Slovenia, after which the government had to resign in 2011 (Guardiancich, 2010, p.110). So even though the corporatist structures initially helped Luxembourg and Slovenia to adopt some effective anti-crisis measures, the crisis also exposed the fragility of these structures. As a consequence, the political performance of these governments was not as resilient as one would expect based on their relatively strong corporatist structures and their policies of domestic compensation.

Estonia: the crisis as an opportunity for euro adoption

After the collapse of the Soviet Union, the Baltic states adopted liberal market economies, which – marked by their high GDP growth up until 2007 – initially proved to be successful for their economic development. Their neoliberal economies left little room for the development of democratic corporatism. Tables 3 and 4 show that the interest groups are decentralized and that few employers and employees are represented by organizations. The Estonian union confederations are splintered between rival organizations, and most companies play no part in employers' organizations (Woolfson & Kalleste, 2011, p.59). The involvement of the social partners in tripartite social dialogue is irregular and infrequent (table 5), and when it takes place, consultations have little substantive content (Woolfson & Kalleste, 2011, p.60). Ost (2011) used the label of 'illusionary corporatism' to describe the tripartite arrangements in the Eastern European countries, because, according to him, tripartite arrangements in these states were used as "a façade for introducing neoliberal policies undermining labour interests" (p.19).

Accordingly, tripartite consultations and former tripartite agreements were easily put aside by the Estonian government during the crisis. Figure 1 shows that the Estonian economy was hit severely by the crisis, and several case studies indicate that Estonia reacted to the crisis with a hardening of the neoliberal policy paradigm (Woolfson & Kalleste, 2011; Kattel & Raudla, 2013). According to Raudla & Kattel (2011), the neoliberal and non-interventionist tradition had given Estonia few possibilities to build bureaucratic and political capacities of macro-management. "Hence, when faced with major economic shock, the idea of actively steering the economy out of the crisis appeared rather alien" (Raudla & Kattel, 2011, p.182).

Instead, the Estonian response to the crisis was predominantly aimed at pursuing its desire to join the European monetary union (EMU). Therefore, Estonia pegged its currency to the euro and consequently, devaluation was no longer a policy option (Kallaste & Woolfson, 2013). In addition, Estonia implemented radical budgetary retrenchment measures, aimed at cutting expenditures in public sector wages, investments and social security, while increasing taxes (Raudla & Kattel, 2011). In comparison with the policies of domestic compensation in Luxembourg, which as a member of the EMU could also not opt for a devaluation, the Estonian response was much less egalitarian. The economic shock impacted the labour market in particular. In 2010, unemployment rates reached 16,7% in Estonia (compared to 5,1% in Luxembourg), while those still employed also faced difficulties because of the wage cuts. In all three Baltic states, the flexible labour market functioned as the primary adjustment mechanism during the crisis: "The public sector […] absorbed the crisis mainly through wage cuts, while the rest of the economy bore the brunt of job cuts" (Kalleste & Woolfson, 2013, p.258).

The social partners were basically ignored in the introduction of these austerity measures. In 2008, the Estonian government involved the social partners in the development of a new labour contract law. The government agreed to increase unemployment compensation in return for a new firing policy that made it easier for companies to fire employees. However, the eventual bill proposed by the government only included the new firing policy, while the promises on compensation policies were simply abandoned (Ost, 2011, p.43). One tripartite agreement was adopted in 2009, but it was mainly about vocational training, and it had nothing to do with the austerity measures (Kallaste & Woolfson, 2013).

Even though the Estonian government unilaterally pursued its austerity measures, they proved to be successful in terms of fiscal consolidation and restoration of investor's confidence (Vilpišauskas & Kuokštis, 2010). In 2009, Estonia was one of the five European countries that met the Maastricht debt and deficit criteria (Raudla & Kattel, 2011, p.164), and it became a member of the Eurozone in the aftermath of the crisis in 2011. The Estonian labour market had to take a blow, but in contrast to the protests in for example Greece, the austerity measures in Estonia did not result in significant political discontent or chaos. An important reason for this is that civil society, such as trade unions, are underdeveloped in Estonia and thus could not organize large protests. Furthermore, the crisis-exit strategy of Eurozone-entry provided a specific goal for the government, that could easily be communicated to the public and its success could easily be measured by the Maastricht criteria (Kattel & Raudla, 2013). The trust in the government remained high under the Estonian population and despite the heavy budget cuts and high levels of unemployment, the government was re-elected during the 2011 elections. The other two Baltic states seem to fit the third hypothesis better, as economic adjustment turned out to be much less successful and trust in the Latvian and Lithuanian government decreased (Vilpišauskas & Kuokštis, 2010). Nevertheless, the social unrest in all three Baltic states did not exceed the social unrest experienced in Luxembourg or Slovenia.

Malta: micro-economic adjustment in a micro-state

Malta deviates from the pattern displayed in figure 2, as it was hit least hard despite its relatively weak corporatist structures. Malta's lack of corporatist structures can be explained by its highly polarized politics, which is characterized by a two-party system in which the Nationalist Party and the Labour Party dominate the national elections and alternate in majoritarian governments (Baldacchino, 2002; Cini, 2002; Hirczy, 1995). These have been generally stable governments, but it also means that Maltese government can generally ignore opposition demands (Pace, 2002, p.34). The two principal unions, the GWU and UHM, have traditional affiliations with the two main political parties. Consequently, the influence of these groups on government policy has fluctuated with the alternation of the parties in government (Harwood, 2014, p.218-219). Even though most employees and employers are represented by a union (table 4), the ideological divide between the trade unions prevents them from uniting their efforts and collectively bargain with employers' organizations (Lafoucriere & Green, 2006).

Attempts to institutionalize social dialogue in Malta have not brought about a spirit of social partnership. For example, the Labour Party refused to take place in the Malta-EU Action Steering Committee, in which 130 interest groups could discuss and approve negotiation position papers during the Maltese bid for EU-membership before its accession (Pace, 2011). This reflects the polarized political environment. Furthermore, the Malta Council for Economic and Social Development (MCESD) acts as an advisory council that issues recommendations, but it is not involved in the implementation of policies. Its advisory function has also been challenged, as complaints have been voiced that the government fails to consult with the economic partners in the MCESD (Harwood, 2014, p.219) – which is also reflected in table 5, column VIII. Overall, high trust relationships between the social partners are absent (Rizzo, 2009, p.22). There seems to be "a general inability to prioritise the national interest, as negotiating parties take a narrow and partisan approach" and there is "a tendency of successive administrations to simply set up yet another institution every time a stalemate is reached, rather than addressing problems and making institutions work" (Rizzo, 2005, p.61).

Nevertheless, Malta proved to be resilient during the economic crisis. Several scholars note that the coinciding adoption of the euro with the economic crisis in 2008 has shielded Malta from the risks of a vulnerable national currency, such as exchange rate fluctuations (Caruana & Theuma, 2012; Azzopardi, 2009; Adonis, 2011). Furthermore, the Maltese financial sector is relatively small (Azzopardi, 2009) and its banking system is depicted as one of the soundest in the world (Adonis, 2011). However, Malta depends heavily on international trade, especially in the tourism and manufacturing sector, and these sectors were impacted quite severely because of a sharp decline in foreign demand for exports (Azzopardi, 2009; Debono

& Borg, 2009). The manufacturing industry's gross added value decreased with more than 18% in 2009 (Caruana & Theuma, 2012). Due to a timely and effective intervention, the Maltese government managed to mitigate the effects of these sectoral impacts on the economy. The government responded with a comprehensive fiscal stimulus package aimed at the micro-level rather than the macro-level.

The stimulus package contained public investment in infrastructure, environmental projects and incentives to sustain consumer expenditure, such as a decrease in the income tax (Caruana & Theuma, 2012). In addition, the most important measure concerned financial assistance to export-oriented firms. In March 2009, the Maltese government set up a taskforce to negotiate incentive schemes with companies experiencing difficulties because of the declining international demand, which resulted in a tailor-made solution per company. In return for direct budgetary assistance, the companies had to retain their workforce and increase investment and employment possibilities (Fenech, 2010). The measures were targeted at short-term recovery and long-term growth and competitiveness (Debono & Borg, 2009), while this strategy also secured many jobs (Rizzo, 2013). Therefore, it was possible to reach consensus with the trade unions on these schemes, even though many firms had to adopt a four day working week. The involvement and support of the trade unions contributed to the legitimacy of the schemes. According to Rizzo (2013), the consensus reached between the social partners can be considered social pacts at company level. So contrary to Luxembourg and Slovenia – where social concertation was troubled by the crisis – in Malta the crisis turned out to be an opportunity for close cooperation between the social partners, though it was expressed at company level rather than at the national level. Overall, the active stance of the government in seeking micro-economic solutions mitigated the effects of the crisis, while the impact of the crisis was relatively small in the first place due to the structure of the Maltese economy.

Discussion & conclusion

This thesis aimed to answer the following research question: To what extent can democratic corporatism explain differences in the economic resilience of small European states during and after the 2008 crisis? More specifically, the thesis has put Katzenstein's theory under scrutiny, by testing its applicability to some of the smallest member states of the European Union during the economic crisis of 2008. The quantitative analysis has shown that there was a statistically significant correlation between democratic corporatism and economic resilience during the crisis, which confirms the first hypothesis that the economic crisis impacted the economies of small states with democratic corporatist structures less than those states without democratic corporatist structures. Contrary to Katzenstein's *Small States in World Markets,* in this thesis the cases have not been selected on successful economic performance nor on strong democratic corporatist structures. Therefore, the fact that the small states with relatively weak democratic corporatist structures have been hit harder by the crisis and vice versa, seems to confirm Katzenstein's theory and makes his causal contention more plausible. This thesis thereby deals with the critique from King, Keohane & Verba (1995), who found that Katzenstein "would have been able to claim causal validity in some limited instances […] when he had variation in his explanatory and dependent variables" (p.478).

However, further qualitative analyses on the economic recovery of Luxembourg and Estonia after the economic crisis, do not seem to support the causal link per se. This can be further explained by discussing the remaining two hypotheses. First, the policy responses provided by Luxembourg and Estonia were indeed different and confirm the second hypothesis. Luxembourg opted for a more inclusive response with policies of domestic compensation, while the Estonian government unilaterally pursued radical austerity measures. These different responses and the subsequent different policy outcomes seem to be the results of the presence or absence of democratic corporatism. However, the relative success of these policies cannot really be compared, as the goals of the policies were different. Though the Estonian response to the crisis was much less egalitarian than the Luxembourg response, the EU applauded the Estonian fiscal discipline (Raudla & Kattel, 2011, p.164) and the Estonian population also seemed to be content with the anti-crisis measures, despite the resulting high levels of unemployment. After all, the Estonian government met its promised goal of EMU-membership in 2011. In Luxembourg, a lack of consensus in tripartite consultations created some social unrest, but it did not result in major political instability. Nevertheless, the third hypothesis cannot be confirmed, because the lack of democratic corporatism and the associated policies did not cause higher levels of political instability or social unrest in the Baltics, than in Luxembourg.

The deviant position of Malta indicates that relatively weak democratic corporatist structures cannot be a decisive factor for the economic vulnerability of a small state. The qualitative analysis has given some insights into how Malta managed to be resilient instead. The Maltese government managed to avoid the polarization in Maltese politics and the lack of social partnership on the national level, by actively seeking common ground with the social partners on the micro-level. This is a very unique response, which might only be feasible in very small states in which only a small number of relatively large companies employ a large portion of the population. Additionally, the traditional literature highlights 'less diversified economic structures' as one of the main vulnerabilities of small state economies (Kuznets, 1960) and Malta already curtailed its vulnerable economic position by the diversification of its economy in the years before the crisis.

Overall, the results of this thesis correspond with Katzenstein's contention that domestic political-economic structures matter for the policy responses and economic outcomes during a crisis. Democratic corporatism is likely to create an egalitarian response to economic adversity, but one needs to make a normative claim in order to decide whether this also constitutes a better response, resulting in a more successful economic outcome. Even though the very small states included in this thesis are expected to be more vulnerable than those analysed by Katzenstein, this thesis showed that these states can achieve economic resilience in many ways. Furthermore, social and political stability can also be maintained by keeping promises on policy outcomes, instead of consensual policies of domestic compensation. In conclusion, it is possible for very small states to domestically shield themselves from their vulnerable position in the international economy. Democratic corporatism can be helpful in doing so, but it is not decisive.

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