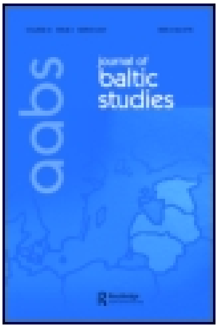

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NEO-LIBERAL SMALL STATES AND ECONOMIC CRISIS: LESSONS FOR DEMOCRATIC CORPORATISM

Baldur Thorhallsson and Rainer Kattel

This paper argues that the 2008 economic crisis was particularly deep in Estonia and Iceland because non-corporatist neo-liberal political features were essential endogenous factors deepening it. A lack of corporatist features also formed the basis for responses to the crisis and the political aftermath in both cases. Furthermore, the paper argues that adding new institutionalist aspects to the corporatist model – in particular the juxtaposition of compound and simple polities – helps deepen our understanding of political dynamics in societies that lack clear-cut corporatist features. It makes a big difference whether or not a country enters the neo-liberal era with an already corporatist set of structures.

Keywords: democratic corporatism; economic crisis; small states; Estonia; Iceland; neo-liberal policies; discursive institutionalism

Introduction

Estonia and Iceland were hailed as prime examples of the successful new globalized economy of the twenty-first century. The rapid economic boom was seen by many as proof that small states should adopt the neo-liberal agenda rather than follow the corporatist model that has been closely associated with the Scandinavian states, the Netherlands, Belgium, Austria, and Switzerland.

However, in the international financial turmoil of 2008, Iceland and Estonia experienced a deep economic recession. This called into question the sustainability of their economies. In fact, both countries went through a governmental crisis as well and, in the case of Iceland, also experienced strong social unrest. Their *laissez-faire* policies were increasingly questioned. This was also the case of the governments'

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limited consultation and consensus-building with other domestic actors in forming their economic policies. From the early 1990s, the Estonian and Icelandic governments implemented their neo-liberal policies and systematically sidelined those who stood in the way of their agendas. This was in sharp contrast to the small European corporatist states that made decisions in close cooperation with the most important actors in the labor-market and society in general.

According to Katzenstein's classic studies (1984, 1985), democratic corporatism is the key to the success of small European states. They have formed a comprehensive domestic decision-making framework built on consensus. This has created economic flexibility that allows them to respond to the fluctuations in the international economy. It has also led to political stability, even in times of deep economic recession. A balance has been created between the increased pressure for economic efficiency and concerns to maintain equality between different social groups. The state has deliberately restrained itself from exercising its unilateral power. Hence, the small European corporatist states tell an important story of how, despite considerable economic fluctuations due to their open economies, small societies have become economically and politically successful. Moreover, they are better equipped than large states to deal with the instability of the international economy. They are, in fact, economically and politically more successful than large states (Katzenstein 1984, 1985; Mjoset 2000). This is not to argue that small corporatist states studied by Katzenstein have not changed since the mid-1980s. On the contrary, Katzenstein described an economic world still dominated by the Fordist production system, and in which neo-liberal ideas were only beginning to take concrete shape. Certainly Nordic economies have also taken a lesson or two from neo-liberal policy textbooks, but their fundamental outlook has arguably not changed too much from Katzenstein's corporatist model (Mjoset 2002).

The sharp contrast between the hard-hit economies of Iceland and Estonia, on the one hand, and the smoother adjustment to the international recession of the small corporatist European states, on the other, is striking. Figure 1 shows real GDP growth rates in small European economies during the crisis; the countries shown are those from Katzenstein's study, with Estonia and Iceland added.

This leads us to question whether a lack of democratic corporatism based on consensus decision-making contributed to the scale of the economic crisis in these two small northern states. It also invites us to ask whether a lack of corporatism in dealing with the aftermath of the crisis created political instability in the two countries. Estonia and Iceland provide an ideal test case of the advantages and disadvantages of small European states that have not followed the corporatist trend. There are, however, important differences between them, such as Estonia's membership of the European Union (EU) and the Economic Monetary Union (EMU) versus Iceland's non-membership (though it is part of the European Economic Area (EEA)) and its national currency, the króna. In fact, Iceland is part of the Common Market, except for the sectors of fisheries and agriculture, and, for instance, implements EU regulations on finances. Accordingly, Iceland's EU accession process has been rather smooth since the country's EU membership application was approved by the Althingi – the Icelandic national parliament – in the summer of 2009. Upon closer examination there are key differences between these two small countries, and some

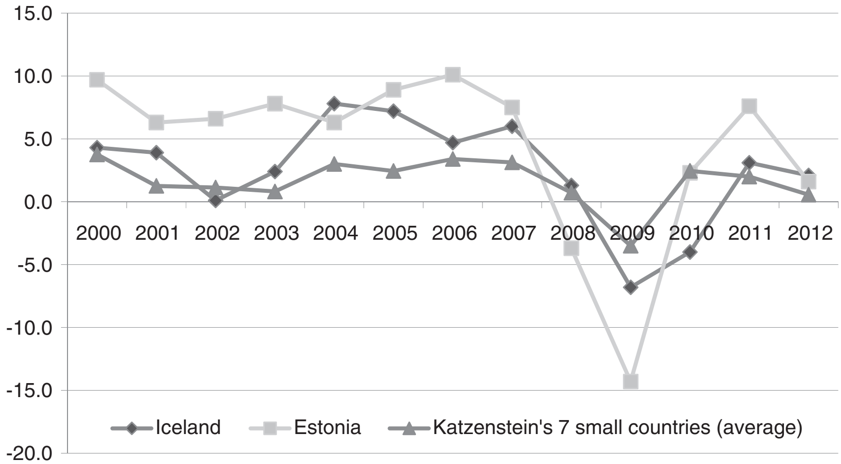

Figure 1. GDP growth rate (at market prices) in European small economies, 2000–2012.
Source: Eurostat 2012 (data for 2012 are forecasts); Katzenstein's seven small countries are Belgium, Denmark, the Netherlands, Austria, Sweden, Norway and Switzerland.

of the differences were in fact amplified by the crisis. Table 1 summarizes key economic indicators, giving both pre- and post-crisis levels. In fact, one can argue that the differences between Estonia and Iceland make the comparison particularly interesting.

Structurally, the economies of Iceland and Estonia are rather similar: in both cases, roughly 60% of the value added comes from services, one-third from industry, and the rest from agriculture (World Bank Development Indicators 2011). Before the crisis, the financial sector contributed roughly 6–10% of GDP to each economy. Counting the real estate sector this figure comes to 15–20% of GDP (Statistics Iceland 2011; Statistics Estonia 2011).

There are further similarities such as high pre-crisis growth rates and low unemployment numbers and also very low (Estonia) or relatively low (Iceland) levels of public debt. However, the cost of these strongly positive trends was in both cases a massive current account deficit showing the unsustainability of the very trends mentioned above. Indeed, especially in the case of Iceland, the pre-crisis levels of financial sector liabilities and household debt (and their rapid growth over a few years) was clearly untenable. Estonia showed similar tendencies, albeit at a much lower level.

A further key difference is the structure of financial sector ownership: by 2007, the Estonian banking sector was almost completely foreign (Swedish) owned, in contrast to the largely domestically owned Icelandic banks. Another key difference was the currency system: since 1992 Estonia has deployed a currency board with the kroon pegged, first to the German mark, and then to the euro; the Icelandic króna, on the other hand, was exchanged at daily market rates (or floating exchange rates).

These institutional differences played a crucial role in the unfolding of the crisis. With the global liquidity freeze in the autumn of 2008, the inflow of foreign financing – that essentially funded the current account deficit – stopped and quickly

TABLE 1. Key indicators for Estonia and Iceland in 2007 and 2010

	Estonia		Iceland	
	2007	2010	2007	2010
GDP per capita (euros)*	12,000	10,700	48,000	29,900
Real GPD growth rate %*	7.5	2.3	6	−4
Government consolidated gross debt as % of GDP*	3.7	6.7	28.5	92.9
Financial sector liabilities as % of GDP‡	198	197	967	1300
Household loans as % of GDP‡	45	52	124	123
Exports as % of GDP***	68.4	78.3	34.6	56
Current account balance %***	−16.3	3.6	−15.6	−9.8
Unemployment rate %	4.7*	16.9*	2.3**	7.6**
Public debt as % of GDP*	3.7	6.7	28.5	92.9
External debt as % of GDP‡	92	86	520	805
Currency	Euro peg with currency board	Euro	Floating exchange rate	Independent currency with capital controls
Capital controls	None	None	None	Controls
Ownership of financial sector	Largely foreign	Largely foreign	Domestic private	Domestic public

Sources: * Eurostat 2011; ** Statistics Iceland 2011; *** World Bank Development Indicators 2011; ‡ Central Bank of Estonia 2011, Central Bank of Iceland 2011; calculations by the authors.

bankrupted Icelandic banks; next, it brought domestic consumption to a halt. A government bailout of the banks in turn transferred private sector liabilities to public sector ones, thus increasing public debt threefold almost overnight. However, the Estonian banking sector was backed by the Swedish Central Bank (which took out a precautionary loan in the amount of €3 billion from the European Central Bank), and thus was spared this channel of liability transference. Furthermore, as Estonia had a high level of foreign-currency-denominated loans held by households, currency devaluation was vehemently opposed by all social actors and by the government. Consequently, it seemed that Estonia's sole option to deal with its massive drop in exports and foreign financing was to attempt to join the euro zone and regain stability. Euro zone entrance served as an economic, fiscal and political strategy for the coalition government to survive the crisis (Raudla & Kattel 2011). This was then helped along by weak social partners, especially institutionally and politically marginal labor unions. In contrast to Iceland, where union membership is high and tripartite bargaining processes have, at least in some sectors, a long history, Estonia has collective bargaining in only a few public sectors; most private-sector unions are company-based and not sector-wide organizations.

As a final difference, after the Icelandic krόna rapidly lost approximately 50% of its value, Iceland underwent structural economic change as domestic goods and exports became significantly more competitive. In Estonia no such change took place. Still, while Iceland's exports soared, its economy did not return to growth until late 2010 (Ólafsson & Kristjánsson 2012). Estonia, by contrast, saw a modest rise in exports, yet its economy grew solidly already in 2010. This is explained by yet another key difference between Iceland and Estonia: in contrast to Iceland, Estonia is heavily integrated into the Nordic economies. In addition to the banking sector, key exporting industries (electronics and forestry) have high rates of Scandinavian ownership, and exports to Scandinavia represent roughly half of all exports. Thus, as we saw in Figure 1, Scandinavia experienced a relatively smooth recession and its imports returned quickly and this saved Estonia's economy as well.

These structural and, above all, institutional differences set the stage for how the crisis unfolded in both economies, how it was handled, and what kind of changes resulted.

This paper is divided into five parts, including the introduction and conclusion. The second section will lay out our research framework by examining the origin of sectoral corporatism, corporatism, and Katzenstein's democratic corporatism. It will complement Katzenstein's framework with an institutionalist approach, which differentiates between compound and simple polities. The third section will analyze the Estonian and Icelandic domestic decision-making processes. Our aim is to find out how they differ from the Katzenstein framework found in other small European states. This paper examines whether these two states are clearly non-corporatist or whether they are characterized by sectoral corporatism, i.e. single-interest special access to policy processes. Its key questions are: why have Estonia and Iceland not followed the democratic corporatist model based on consensus decision-making? What were the consequences of implementing a neo-liberal agenda and of a lack of corporatism at the time of the 2008 financial crisis? Did this lack of corporatism lead to the economic crash or to an escalation of the crash? Section four will examine the political consequences of the economic crisis: did a lack of democratic corporatism (consensus decision-making) shape the political aftermath of the crisis? How capable was the neo-liberal domestic decision-making framework of dealing with the crisis after it hit? The paper also attempts to answer the question of whether the economic crisis changed domestic decision-making in our two test cases. It explores political developments since the crisis to see whether there has been a tendency to develop domestic consensus decision-making built on democratic corporatism. The conclusion returns to our core questions of whether Estonia and Iceland were worse hit by the crisis because of their lack of corporatism, and whether any political consequences can be attributed to this.

The Corporatist Framework

European sectoral corporatism emerged when agrarian interest groups gained privileged access to governments. Countries characterized by sectoral corporatism – where more note is taken of the interests of certain specific lobby groups than of others in governmental decisions – are more likely to adopt a societal corporatist decision-making structure (Lehmbruch 1984). Under this model, the government and the primary economic organizations engage in joint decision-making. Corporatism comes into the picture when labor-market organizations become crucial actors in the government's decision-making concerning public finances and the national economy. Its aim is to limit conflict in the society (Schmitter & Lehmbruch 1979; Douwes Dekker 1989). Scholars have made several attempts to define the scale of corporatism in different societies (e.g., Hemerijck 1992; Teulings & Hartog 1998). For instance, Lehmbruch distinguishes between pluralism (where lobby-group politics dominate the agenda without the involvement of organized labor, e.g., in the USA, Canada, and New Zealand), weak corporatism (where there is partial engagement of labor and capital, in the form of consultation or implementation in governmental decisions, e.g., in the UK and Italy), medium corporatism (where there is a closer engagement of labor-market organizations in government decision-making, e.g., in Belgium, Ireland, and Denmark), and strong corporatism (where labor and capital play a full and active part in governmental decisions, e.g., in Sweden, Norway, Austria, and the Netherlands) (Lehmbruch 1984). Recent developments within 'new institutionalism' (see Schmidt 2010 for an overview) have created a further potentially interesting dichotomy that somewhat overlaps with forms of corporatism. Schmidt (2005, 2008) created a continuum from compound to simple polities, based on the prevalence of discursive characteristics. In simple polities, 'the communicative discourse to the general public tends to be much more elaborate than the coordinative discourse among the policy makers' (2008, p. 312). These are usually countries with majoritarian institutions and unitary states. In compound polities, in turn, the coordinative discourse among policy makers, and different interest groups, tends to be more significant than communicative discourse towards the general public (2008, p. 313). These are often countries with proportional representative systems and corporatist policy actors, or federalist states.

Among his seven small European states, Katzenstein identifies three characteristics of strong corporatism that can be contrasted with the weak corporatism found among large states. First, an ideology of social partnership prevails in the small states. This emphasizes consensual decision-making between all key actors in the society. Accordingly, labor-market organizations and the government come to joint decisions regarding economic policy and finances. Second, the smallness of the society means there are fewer important economic sectors, fewer important organizations, and fewer policy-making sub-units as compared to larger states. Hence, decision-making in small states is characterized by centralization and concentrated interest groups, and it is easier to reach a compromise and consensus than in larger states. Third, a formal political bargaining framework is set up in which all important interest groups participate in policy formation and implementation of the government's policy.

According to Katzenstein, there are also historical reasons for the success of the small European states. Proportional representation and the fact that political parties on the right are divided have led to a distinctive party system and encouraged a system of coalition, or minority, governments. This has created a system of consensual decision-making and has given opposition political parties significant influence over policy formation. In essence, these are compound polities.

In sum, small states' democratic corporatism is the result of historical choices and the smallness of a society. The political elite has come to the conclusion that inclusive decision-making based on consensus is best suited to minimize conflicts and maximize economic gains. This decision-making framework is vital in order for small states to deal with economic and political vulnerability due to increased economic openness. This inclusive nature of the small European states' corporatism stands in sharp contrast to the American neo-liberal trend towards exclusion (Katzenstein 1984, 1985). In the American model, the role of labor-market organizations in forming government policies is restricted and the government plays a more limited role in shaping living standards. The market prevails (Ólafsson 1999).

Domestic Decision-making Processes: The Case of Estonia's Decision-making Culture

Since regaining independence in 1992, Estonia – as is to be expected in a proportional electoral system – has had coalition governments. These were initially relatively unstable, as coalitions and prime ministers tended to change between general elections. This has given way to stability, with the current prime minister having been in office since 2005, and in 2011 with his coalition having become the first one to survive the entire election period (although one party left the coalition in 2009). Politically, ever since the first free elections in 1992, Estonia has had governments that leaned more or less toward neo-liberal economic policies (Sikk 2006), and with relatively strong national-conservative features in other policy fields (see Pettai & Hallik 2002).

While post-Soviet countries are generally characterized by the weak involvement of civil society in political processes, Estonia might be seen as a somewhat extreme case, even in this context (Lagerspetz *et al.* 2002 *passim*). For most of the last two decades, Estonia has been characterized by weak to non-existent unions and industrial associations (Eamets & Kallaste 2004). Accordingly, political parties, electoral competition, and coalition agreements have become key features of the political decision-making process, with the latter gaining in importance and, in fact, relegating the Parliament to a less important position (for an overview of the literature on post-communist party systems in general, see Kreuzer and Pettai 2004; on Estonia specifically, see Sikk 2006). Accession to the European Union played a key role there, as it significantly enhanced the power and competencies of the central government and core executive (Drechsler *et al.* 2003; Suurna & Kattel 2010).

It can be argued that one of the key underlying themes for Estonian policy-making in general since the regaining of independence has been to avoid the emergence of visible corporatist structures. In part, this happened in order to avoid what was perceived as a typical Nordic corporatist society, with the instability of boom-and-bust cycles that both Sweden and Finland experienced during the financial and economic crises of the late 1980s and early 1990s respectively (Kattel 2009). The other important factor resulted in the early 1990s from the prevalence of the so-called Washington Consensus ideas about economic policies, with their distinct neo-liberal bend and flavor (Reinert 2007; Rodrik 2007). This is perhaps most pronounced in economic policy choices and structures. Estonia has shown remarkable stability in its economic and fiscal policy choices since 1992: after rapid liberalization and privatization, Estonia became an extremely open economy, essentially without tariffs, capital controls, or almost any other industrial (sectoral) policies to speak of; in public finances, Estonia stressed from the outset the importance of balanced budgets and pegged its national currency, the kroon, initially to the German mark, and then to the euro in the currency-board system that lasted until euro zone entrance in 2011 (Raudla 2010 *passim*).

Estonia's economic policy choices assumed the importance of foreign direct investments and their potential to restructure the economy and domestic technological, management, and other related organizational private sector capabilities. As unions and other civil society organizations remained weak, and as the core executive gained in importance through the EU accession, Estonia rapidly became a simple polity in the sense that coordinative discourse was almost non-existent, but communicative discourse, aimed at both the domestic electorate and European peers, came increasingly to dominate policy-making processes and structures. Accordingly, accession to the EU (and NATO) then to the euro zone became overarching political goals behind which the government could rally support without much actual discussion in the society at large. In fact, it can be argued that such large-scale goals were utilized to avoid deeper political conflicts. This has engendered a political culture of conflict avoidance; this, however, has not led to a wide-reaching consensus on smaller-scale issues.

Given the successful economic development of Estonia in the 1990s and early 2000s, certain policy choices came to be seen as important guarantors of success. For instance, it has been repeatedly argued by politicians that the currency board, the balanced budget, and the proportional income tax are the three 'holy pillars' of Estonian politics, which cannot be challenged since 'they are the bases for Estonian economic success' (Raudla & Kattel 2011). Indeed, it can be argued that the norm of balanced budget became a quasi-constitutional one in Estonia, which could not be challenged without significant political costs (Raudla 2010).

The Build-up to the Econimic Crash

As argued above, under the neo-liberal policy framework, Estonia followed a distinctly different path from Katzenstein's small European and, in particular, Scandinavian economies in its attempt to avoid instability and boom-bust cycles. Furious restructuring of the economy took place through massive inflow of foreign direct investment (Tiits *et al*. 2008). However, particularly during the early 2000s, large amounts of foreign investment, private lending, financed consumption, and a real estate boom drove wage-growth into double-digit territory. This forced Estonia (and the other two Baltic economies) to face a speculative position where its export competitiveness was threatened and its ability to meet all its liabilities (mostly in the private sector and households because public borrowing remained low) endangered. Economic policy concentrated almost solely on keeping the public budget balanced. Such a financial strategy, relying as it did on exchange-rate stabilization backed-up by currency pegging, the currency-board system, and fiscal balance, virtually ensured a foreign savings based growth strategy that often brings financial fragility. In addition, being a small open economy made Estonia vulnerable to experiencing economic cycles in a somewhat amplified form. Indeed, it can be argued that the currency-board system, with its heavy reliance on foreign direct investment and without any form of capital controls or investment management policies – as is the case in Estonia – is particularly prone to both debt-led growth during upswings and FDI reversals during downswings, as indeed is what happened in Estonia. The key pitfall of the foreign-savings-based growth strategy is financial fragility. In Estonia's case, this consisted both of a vulnerability to reverse foreign financial flows and of a rapid loss of competitiveness through currency appreciation. The result was a significant loss in external competitiveness.

Ironically, Estonia chose a monetary stability that eventually generated the very financial fragility that the economy lacked the means to deal with as the policy competencies to steer and manage the economy were underdeveloped. Hence, when faced with a major economic shock, the idea of actively steering the economy out of crisis appeared rather alien – there were no procedures and no analytical competencies for policy-makers to draw on (Raudla & Kattel 2011), nor were there any significant alternative competencies among the opposition, industry associations, or unions. The strongly neo-liberal and non-corporatist tendencies of the previous two decades had hollowed out the political and bureaucratic arena of both ideas and competencies.

It is also important to note that, with the deepening of the crisis, Estonia had the option to devalue its currency and thus attempt to regain some of the lost competitiveness. However, household credit rose very rapidly between 2000 and 2007 (from 7.1% to 43.3%, as percent of GDP; Kattel 2010) and gross debt of households as percentage of income reached nearly 90% by 2007 (Eurostat 2012); nearly 80% of the debt was denominated in euros (Haiss *et al*. 2009). This rendered the option of exchange-rate change potentially doubly painful (with soaring liabilities and falling income) and, as a consequence, devaluation was immediately discarded from policy discussions. By rejecting this option, and with next to no experience in heterodox/Keynesian economic policy, the government had relatively few remaining choices for how to deal with the crisis other than reverting to fiscal retrenchment (Raudla & Kattel 2011). Indeed, hanging on to the currency peg made sure that Estonia's kroon was all but doomed as an independent currency, and the euro became an almost mandatory exit strategy for both the kroon and the government. Ironically, as Estonia's banking sector is close to 100% foreign owned, this meant that during the crisis Estonia could effectively outsource the bailing out of its banking sector. While the Prime Minister argued, still in 2006, that he would not sacrifice economic growth in order to curb inflation (Estonia did not fulfill the Maastricht inflation criteria in 2006 and thus missed euro zone entrance in 2007; see Raun 2006), with the onset of the crisis and by rejecting devaluation, euro zone entrance almost inevitably became the panacea of Estonian discussions.

This led in 2008 and in particular in 2009 to very extensive fiscal adjustments. While in early 2009, the adjustment took the form of budgetary retrenchment – with extensive cuts to investments, transfers, and the government wage bill – then, in mid-2009, the cutbacks were complemented with tax increases (for details, see Raudla and Kattel 2011). In addition, the government massively increased use of European (structural) funding. While in 2007 European funding amounted to 3.75 billion kroons, in 2008 it grew to 5.45 billion, and in 2009 to 11 billion (Estonian Ministry of Finance 2009, 2010). In other words, the EU funds made up more than 12% of the entire 2009 budget.

The Case of Iceland: Traditional Decision-making Culture

Policy-making in Iceland has been characterized by centralization, the strong position of its political parties, the considerable political weight of its rural regions and primary economic sectors, and its substantial emphasis on political favoritism rather than general policy-making (Kristinsson *et al*. 1992). The state's centralized placement in the economy and society directed its control over the wage policy both at the public and private level (Guðmundsdóttir 2002). The tradition of majority governments and majority rule is partly the result of a lack of a comprehensive corporatist framework. The only viable path for the government was to forcefully implement its economic policies, since the culture of consensus did not prevail (Óskarsdóttir 2007). The view of the main actors on all sides was not composed of an ideology of co-operation and corporatism (Guðmundsdóttir 2002). The Icelandic labor-market has been characterized by conflict rather than consensus. Despite less tension in the labor-market in the last decades, Iceland continues to have the highest level of strikes among the OECD countries (Aðalsteinsson 2006).

Governments have had considerable influence over labor-market bargaining and their economic policies have often aimed at solving labor-market disputes (Óskarsdóttir 1997). Policy statements of governments often included means of co-operation and consultation with labor-market organizations. Until the 1970s and 1980s, they focused mainly on controlling inflation and dealing with current economic downturns. Later, the focus became much wider and, for instance, included employment policy and social and welfare policies (Kristinsson *et al*. 1992). On the other hand, governmental measures have been characterized by ad hoc responses rather than long-term economic policy-making and consensus-building on the labor-market. Governments often took measures without the consent of labor-market organizations in order to control inflation and wage increases, such as limiting or banning the price-indexing of salaries, devaluing the Icelandic króna, and forbidding strikes or stopping bargaining between trade unions and employers (Óskarsdóttir 1997). The relationship between the labor movement and the government was characterized by a deep distrust (Kristinsson 1993).

The government is in a weak position when it comes to its relations with particular policy sectors and the Icelandic way of decision-making is in line with sectoral corporatism, i.e. governmental policy processes have taken more note of specific single-interest lobby groups than others (Lehmbruch 1984). The primary sectors have led the way. The fisheries sector has obviously benefitted from its economic importance, and the over-representation of the rural regions in the Althingi (the national parliament) has given the farmers' lobby a strong political voice.

Moreover, the government relies on the expertise of the primary sectors (Kristinsson *et al*. 1992). For instance, in the present EU accession negotiations, the administration lacks expertise in the fields of fisheries, agriculture, and rural development. Governmental decisions have taken close account of the interests of the primary sectors, i.e. these sectors are core players in the policy-making process and, often, are responsible for implementing the policies (which they themselves have largely designed). This is one of the main criticisms of Iceland's agricultural policy in the Opinion Report of the European Commission on Iceland's application to the European Union (European Commission 2010).

Considerable changes have taken place in the labor-market since the mid-1980s. These are reflected in a change of attitude, i.e. labor-market organizations prioritize the improvement of living standards, in general, instead of focusing only on wage bargaining. Furthermore, organizational restructuring has taken place on the labor-market. The structure of the labor-market organizations has become more centralized both on the employers' side and on that of the trade unions. The resulting 'social pacts' were reached by the main labor federations, the employers' associations and the government in 1986 and 1990. Magnússon (2004) argues that labor-market organizations were active policy-makers regarding Iceland's economic policy in this period. The social pacts laid the foundation for economic stability in the country and closer cooperation and consultation between the labor movement and employers' organizations. Trust was finally established between these competing actors. One could say that labor was finally included in the governmental decision-making process and that Iceland developed towards being a compound polity. Coordinative discourse among policy makers (the government, the employers and labor) became more significant than communicative discourse addressing the public.

The Build-up to the Economic Crash: The Extension of Sectoral Corporatism and the Halt of Compound Polity

Sectoral corporatism created an ideal framework for the neo-liberal agenda. In 1991, the conservative Independence Party returned to office under a new leadership. Its coalition partners in government, the center-agrarian Progressive Party (1995–2007) and the Social Democrats (1991–1995 and 2007–2009), largely subscribed to its neo-liberal agenda. Majority rule, combined with a strong patronage system (Kristinsson 1996), facilitated the government's agenda and its favored economic sectors.

The government granted the aluminum and financial sectors (after privatization which was completed in 2003) the same status and influence within its policy-making processes as primary sectors (Thorhallsson 2010, 2011a). Thus, sectoral corporatism expanded into other economic sectors of importance. Other sectors and domestic actors were largely excluded from the process or kept on the sidelines, and allowed only partial engagement in the process. This, for instance, became the fate of the labor movement, the environmental movement, and the Organization of Disabled. Iceland took a gradual turn from the development of its compound polity (which had started to take a shape in the mid-1980s), where coordinative discourse and institutions played an important role, towards a more simple polity where communicative discourse from the government became more important. The corporatist focus on cooperation and consensus-building was seen as preventing the government from carrying out its policies.

Until 2003, a common vision was shared by the labor-market organizations and the government regarding the fundamentals. In the 2003 election campaign, the government started to promise and implement policies that went directly against economic stability. This included building a massive power plant and introducing tax decreases at a time of economic boom. These policies challenged social security and broke down the cooperation between the labor movement and the government. The relationship became characterized by the demands of the labor movement (Thorhallsson 2011b).

The aluminum and financial sectors expanded enormously. The financial sector outgrew the state's capacity to defend it. It had assets valued at over ten times Iceland's GDP when the international financial crisis hit the country in the autumn of 2008 (Central Bank of Iceland 2010). Earlier in the year, the market had lost faith in the state's capacity to defend the banks, and the Icelandic króna fell dramatically. In total, the króna depreciated by about 48% between 2007 and 2009 (Ólafsson & Pétursson 2010). Almost the entire financial sector collapsed overnight and the national economy with it.

Political Consequences of the Economic Crisis and Reassesment of Policy-making: The Case of Estonia

Hardening the neo-liberal paradigm

There are two main political consequences of the crisis in Estonia that are perhaps difficult to explain in a sense as one would have expected almost the opposite: first, the political crisis was relatively small and short-lived and public protest and unrest were non-existent despite unemployment reaching near 20% in 2009; second, the coalition that ruled Estonia into and throughout the crisis was elected back into the office in March 2011, post-crisis (the coalition gained 56 seats out of 101). These phenomena are two sides of the same coin that can be called hardening of the neo-liberal and non-corporatist political paradigm as the main consequence of the crisis.

The only significant sign of a political crisis in Estonia during 2008–2010 was the exit of the Social Democrats from the coalition government, thus leaving two right-wing parties in the government. While the budget cuts of 2008 went relatively smoothly, as the economic outlook worsened in spring 2009 the government commenced preparations for the next austerity package. As Raudla and Kattel (2011) show, this time the negotiations on the negative supplementary budget were lengthier and more conflict-ridden than in previous rounds. Whereas earlier, the ideologically dispersed coalition government – consisting of the rightist Reform Party, conservative and right-wing Pro Patria and Res Publica Union, and center-leftist Social Democrats – had managed to suppress their partisan differences, in this round ideological clashes came to dominate the austerity discourse, and, unable to resolve their disagreements, the Social Democrats left the coalition (Raudla & Kattel 2011). In June 2009, the minority government consisting of the two remaining parties submitted the draft negative supplementary budget to the parliament. As it did not have a parliamentary majority needed for passing the act (holding only 50 seats out of 101), the minority coalition resorted to procuring the support of the Green party (which then had six seats in the parliament) in order to get the austerity package adopted. In return for the Greens' support, the minority government agreed to increase environmental fees and taxes (Raudla & Kattel 2011).

There were no strikes, and only very minor public mass meetings or protests during the crisis. Any visitor to Estonia would have had virtually no idea during 2009 that this was a country going through the second-deepest economic decline in Europe, and was suffering from mass unemployment. There are four reasons for this and, in turn, two wider political consequences.

First, the government was extremely successful in depicting the crisis as exogenous in nature and thus was able to argue that Estonia's economic policy and political landscape essentially needed no changes. Second, the only substantial policy change foreseen by the government was to enforce the entrance into the euro zone which, in turn, made massive fiscal retrenchment necessary. Thus, the government was able to offer one overarching aim and direction for political discussions during the crisis, pre-empting and silencing any opposing voices in the process. Third, coalition politicians as well as members of the wider political elite, such as the president, stigmatized very early on any open political protest as unpatriotic and, in essence, as akin to violent street protest by Russian youth following the removal of the Bronze Soldier statue (commemorating World War II) from downtown Tallinn (the first violent protest since 1991) in April 2007. This effectively stigmatized any active public voicing of discontent. Fourth, as argued above, given the circumstances of Estonia's economic and fiscal policy choices during the past two decades, and (non-)evolution of policy skills accordingly, the government had effectively cornered itself into a situation where it had only one option; to enforce euro adoption by any means possible. This had become the coalition's guarantee of survival and, indeed, following the successful and widely lauded euro adoption in January 2011, the coalition won elections in March 2011.

The way the government handled the crisis has resulted in two wider political consequences. First, Estonia has become an even less corporatist and a simpler polity through the crisis. In fact, it is difficult to name even one policy area where the government is engaging in significant coalition-building, negotiations, or coordination with the opposition, unions, or civil society partners. At the same time, the government enjoys strong support both among the domestic electorate, and perhaps even stronger support among its European peers, as the EU sinks more deeply into a sovereign debt crisis in 2011. Estonia has the second-lowest public debt level in the EU, with less than 10% of the GDP, and was, in fact, the only country in Europe with a fiscal surplus in 2010. Ironically, the lack of corporatist structures was not only one of the factors that enabled rapid liberalization in 1990s and the boom in the first half of 2000s, but it also enabled a swift if socially painful handling of the crisis.

Second, the role of Parliament, and especially that of the opposition, diminished during the crisis. One of the key reasons for this was the inability of the opposition parties to voice serious criticism of the government, or to offer coherent alternatives.

Given Estonia's extremely one-sided economic policy experience and capacity, the opposition and the unions were not able to capitalize on the deep social crisis and thus effectively waned in significance.

In sum, the crisis strengthened non-corporatist and simple polity features in Estonia. Another interesting development also related to the crisis is the emergence of left-right divide in the Parliament after 2011 elections. The Parliament now consists of four parties, two center-leftist and two right-wing parties. The latter two form the government. While previous Parliaments had a variety of parties, and therefore coalition governments, the crisis seems to have crystallized politically rather different views on society and economy.

The Case of Iceland: Failed Attempts at Consensus-building and an Escalation of the Conflict-oriented Political Culture

The political aftermath of the Icelandic crash bears the clear hallmark of a missing democratic corporatist decision-making system based on consensus. As the crisis hit in early October 2008, the government and the Central Bank took decisive decisions without consulting one another or other relevant actors: 'a certain chaos seems to have ensued as regards contingency planning on behalf of the state' (Benediktsdóttir *et al*. 2010, p. 14). In the days leading to the crash, the government engaged in a pretence consultation process with the labor-market organizations while it was writing the Emergency Act, aimed at safeguarding the functioning of the banking system and transferring assets and liabilities from the collapsed banks to new banks. This led to a breakdown of the trust between the labor-market organizations and the government. On the other hand, in the days and weeks after the crisis hit, the government and labor-market organizations engaged in a common effort to ensure the functioning of the banks and of the business community at large (which was badly hit due to restrictions on foreign currency transfers). Also, the labor-market organizations called for assistance from the International Monetary Fund and worked with the government on the IMF's economic recovery plan (Thorhallsson 2011b). That said, the consultation process was more about information-sharing than decisive cooperation, though some division of labor took place in order to respond to the crisis (Thorhallsson 2011a).

Immediately after the economic crash, there were calls for a national government consisting of all political parties which were never seriously considered. Nor has the tradition of strict majority rule, largely excluding the minority in the Althingi, been modified in an attempt to create consensus although, on several occasions, the new left-of-center government (the first of its kind in Iceland's history), which took office early in 2009, has made several attempts to form a unified approach by involving the parliamentary opposition in its decision-making process. For instance, this was the case with the EU application, the 'Icesave' negotiations with Britain and the Netherlands, the restructuring of the fisheries management system and several measures intended to tackle the massive debts of households and companies, and to create economic stability and employment. The success of these measures has been very modest: the government has made more efforts than before to give the opposition a seat at the negotiating table, although the opposition decries these attempts as mere showmanship on behalf of the government.

Interestingly, the rapid economic downturn and the social unrest led to a common effort by the labor-market organizations and the government to deal with the crisis. A 'stability pact' was signed between these parties in mid-2009 and, for instance, included policies on taxes, the state budget, the building of power plants, employees' training and a wage agreement to the end of 2010. This was the first time that that such a pact had been formally signed by these three actors. However, the government did not deliver on its promises (Thorhallsson 2011b). Only nine months after the signing of the pact, the Confederation of Icelandic Employers broke away due to the government's failed promises and, in particular, its policy to change the fisheries management system. The Confederation claimed that the trust between it and the government had been broken (Confederation of Icelandic Employers 2010). Later, the employers made it a precondition for starting, and then later for completing, a collective agreement with the main labor movements that the government would not make any major changes to the fisheries management system (Vísir 2011). This clearly indicates the strong position of the fisheries sector within the Confederation and the temporary breakdown of the close working relationship between the sector and the new left-of-center government. Regardless, the government went ahead and proposed considerable changes to the fisheries management system. In spring 2011, a new collective agreement was finally reached according to the traditional working procedure, i.e. the labor-market organizations made an agreement, but before signing it they demanded that the government adopt particular measures such as tackling unemployment and easing the burden on businesses.

A corporatist decision-making framework based on consensus has not been the outcome of the crash in the autumn of 2008. There have been more conflicts between the largest labor movement and government since the crash than in the period 1995 to 2007. There are disputes about fundamentals. For instance, the government is driven by new public management ideas and wants to lay off the governing boards of governmental institutions where representatives of employers and employees have sat side by side and taken joint decisions with officials (Thorhallsson 2011b). Furthermore, the relationship between the government and the fisheries, agriculture and aluminum sectors has been characterized by conflict (i.e., over the application to join the EU, over environmental concerns regarding the building of new power plants, and over tax increases) ever since the government took office (Thorhallsson 2011a).

Although the Icelandic political culture is characterized by conflict rather than consensus, this has never been as clear as since the crash. The heated debates in the Althingi and in society at large indicate more tension than ever between competing interests on issues such as IMF assistance, the Icesave agreements, the EU application, the process of amending the constitution, rescue packages for households and companies, budget cuts, tax increases and broad economic policy, a decision by a parliamentary majority to press charges before a Court of Impeachment against the former Prime Minister for allegedly failing to prevent the financial crash, and finally, the Althingi's decision not to press charges against three of his ministers (two of them former ministers of the Social Democratic Alliance (SDA)). There is no official stable framework for bargaining on economic and societal issues to occur. There is no comprehensive framework where consensus can be reached between competing interests.

Accordingly, Iceland is characterized by simple polity features where politicians' priorities consist of competing for voters' attention, instead of bridge-building between competing interests. This is the case despite sectoral corporatism. In fact, sectoral corporatism, where particular interests are given greater privileges than others, seems to contribute to the conflict-oriented culture of Icelandic politics. The underdogs' communicative discourse to the general public becomes much more elaborate than the coordinative discourse with the government. Furthermore, when the privileged interests feel threatened, e.g., by the creation of the first left-of-center government, their initial reaction is publicly to berate the government's policies.

Moreover, political stability has been shaken by unexpected moves by the President to reject, on two occasions, the Icesave agreements approved by the Althingi (only once before in Iceland's history, in 2004, had a President refused to approve a law) and a decision by the Supreme Court to rule the election, by popular vote, of an advisory constitutional assembly invalid due to irregularities in the election process. Nevertheless, the parliamentary majority went ahead and appointed the 25 elected representatives to sit in a constitutional advisory committee and claimed that there had been no proof of misconduct in their election. These events add to the political instability following the collapse of the government, a parliamentary election in the spring of 2009 (two years earlier that anticipated according to the four-year parliamentary term) and the creation of an unstable government since the crash.

The present government is weakened by a bad split within the Left Green Movement on several sensitive issues such as IMF assistance, the EU application, the Icesave agreements, and economic policy in general. The Prime Minister and leader of the other coalition partner, the Social Democratic Alliance (SDA) has a hard time keeping the government together. Yet again, the concept of harmony is difficult to grasp when describing the Icelandic political culture and domestic decision-making.

Therefore, the conflict-oriented political culture has made it more difficult for the government to respond to and manage the crisis. Decisions on important economic measures are hardly ever taken by consensus or a qualified majority in the Althingi. Nearly all governmental measures are heavily disputed and often lead to vicious attacks by opposing interests. Any government would have a hard time cleaning up after an economic crash in such a decision-making framework.

Conclusion

We have argued that neither Estonia nor Iceland can be characterized as corporatist states in the sense of Katzenstein's framework, and that their lack of corporatism made each country particularly vulnerable to the economic crisis in 2008. In fact, we argue that the economic crisis was particularly deep in these countries because non-corporatist, neo-liberal political features were essential endogenous factors that deepened the economic crisis. In both cases, the neo-liberal agenda was a conscious political choice against corporatist developments in order to keep sectoral corporatist features (e.g., those of the financial sector) of the political and economic system, as in the case of Iceland, and in order to drive economic liberalization further and keep social partners, such as unions, weak, as in the case of Estonia.

A lack of corporatist features also formed the basis for responses to the crisis in both cases. Estonia was able to respond very quickly by adopting radical fiscal retrenchment policies in order to adopt the euro. In fact, Estonia hardened its neo-liberal stance and political relations, and thus further weakened coordinative and cooperative structures within government and with social partners. Iceland has witnessed historic political changes (first ever left-of-center government) without significant changes to its political culture of conflict and in fact with a weakening of social partners. This is particularly interesting, since in the 1980s Iceland had developed significant cooperative and coordinative structures that were then dismantled in the 1990s, and especially the 2000s, during the economic boom and the pursuit of neo-liberal policies.

We also show that adding new institutionalist aspects to the corporatist model – in particular the juxtaposition of compound and simple polities – helps deepen our understanding of political dynamics in societies that lack clear-cut corporatist features. Iceland's oscillation between a somewhat compound polity (in the 1980s) and simple polity (both prior to and after the 1980s) offers crucial insights into how corporatist features can be both developed and dismantled. In the aftermath of the crisis, both Estonia and Iceland show clear features of simple polities. This, we argue, helps further explain how a lack of corporatist characteristics makes small countries vulnerable to economic crises and fluctuations. We suggest that combining corporatist and institutionalist literature enables us to analyze both structural changes between and within institutions, their interactions and, crucially, changing ideas and ideologies and their impact on institutions. Katzenstein's two books were written at a time when the world was about to be transformed by the dissemination of neo-liberal ideas such as market efficiency, tax reform, capital market liberalization, the outsourcing of manufacturing, and the liberalization of financial services. Neo-liberal features have contributed to changing the scope and practice of politics inside his seven democratic corporatist countries. The aim of this paper was not to evaluate the changes of these seven countries' domestic decision-making and crisis responses, even though they fared economically better than our two cases during the 2008 crisis. Rather, our paper indicates that it makes a big difference whether a country enters the neo-liberal era with an already corporatist set of structures, or not.

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