Practical Sovereignty Under Dependence

Exit Costs, Adjustable Relationships, and Political Choice in Small States

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Abstract

Small states routinely rely on larger states and international institutions for markets, monetary stability, administrative capacity, security, and regulatory access. Dependence is therefore often treated as a constraint on sovereignty. Yet formal independence and external dependence can coexist for long periods, while a legal right to withdraw from an arrangement may provide little practical freedom when alternatives are prohibitively costly. This paper develops an adjustability-centered framework for analyzing sovereignty under dependence. It distinguishes formal authority from practical sovereignty and argues that the relevant question is not whether a state is dependent, but whether consequential external relationships remain politically adjustable through negotiation, redesign, substitution, or, at the limit, exit. Liechtenstein provides a structured case. Its postwar and European integration history shows repeated dependence on larger systems alongside episodes of reorientation, treaty modification, differentiated integration, and externally induced policy adaptation. The paper introduces the concepts of relationship adjustability and practical choice, and proposes a qualitative Adjustability Test focused on authorization, voice, redesign, substitution, and transition costs. The contribution is diagnostic rather than classificatory: dependence becomes sovereignty-thinning when formal choice persists but feasible alternatives and credible adjustment mechanisms collapse.

Keywords: small states; sovereignty; dependence; exit costs; interdependence; external shelter; Liechtenstein; EEA; differentiated integration; political choice

Author note: This working paper develops and formalizes the practical-sovereignty and relationship-adjustability concepts introduced in Kao (2026a). It is analytically downstream from the provision-authority framework developed in Kao (2026b).

1. Introduction

Small states rarely exercise sovereignty from a position of self-sufficiency. They trade more intensively, rely on external markets, participate in regional legal orders, and often obtain important public or quasi-public capabilities through larger partners. The small-state literature has long treated openness and dependence as structural conditions rather than anomalies. Katzenstein (1985) emphasized the exposure of small European economies to world markets; shelter theory later described how small states seek political, economic, and societal support from larger states and international organizations (Thorhallsson & Steinsson, 2023).

The conceptual difficulty is that dependence can describe several different conditions. A state may rely on an external arrangement because it is efficient, because alternatives are unattractive, because switching costs are high, or because no feasible alternative remains. These conditions are not equivalent. Nor does a legal right to terminate a treaty establish that changing course is practically realistic. A relationship can be formally voluntary while becoming economically or institutionally difficult to replace.

This paper develops an adjustability-centered framework for distinguishing dependence from practical loss of political choice. It builds on the book-length analysis in Kao (2026a) and is intentionally distinct from the companion provision-authority framework in Kao (2026b). The companion paper asks a static architectural question: who supplies a capability, and where does political authority sit? The present paper asks the

dynamic question that follows when preferences diverge or conditions change: can a critical external relationship still be adjusted in politically meaningful ways? The framework makes three claims. First, sovereignty under dependence is better evaluated through adjustment mechanisms than through dependence intensity alone. Second, legal exit is only one adjustment mechanism and should be evaluated together with voice, redesign, substitution, and transition costs. Third, small states can preserve meaningful political agency when critical external relationships remain adjustable even if those relationships are deep and asymmetric.

Liechtenstein is a useful structured case because its statehood combines unusually dense external integration with repeated episodes in which the terms of integration changed. Its shift from an Austrian-centered economic orientation to Switzerland, its decision to join the European Economic Area while Switzerland remained outside it, its special arrangements on residence, and the transformation of its financial sector under international pressure all expose the difference between formal independence, dependence, and practical maneuvering room.

2. Dependence, Shelter, and Interdependence

Small-state scholarship gives strong reasons to expect dependence. Small populations and narrow domestic markets make it costly to reproduce every public function or economic input internally. Shelter theory makes the point explicitly: small states seek external political, economic, and societal shelter to compensate for structural vulnerabilities, but such shelter also entails costs and can require the surrender of policy room (Thorhallsson, Steinsson, & Kristinsson, 2018; Thorhallsson & Steinsson, 2023). In this literature, the central trade-off is not independence versus dependence in a binary sense; it is the type of protection obtained, the terms on which it is obtained, and the costs attached to it.

The broader interdependence literature likewise distinguishes mutual connection from equal bargaining power. Keohane and Nye (2012) treat asymmetry in interdependence as a potential source of power because actors differ in their sensitivity and vulnerability to disruption. Hirschman's earlier analysis of foreign trade made a related point: a relationship creates political leverage when one side can replace it more easily than the other (Hirschman, 1945/2024). Crescenzi (2003) formalizes this intuition in terms of exit opportunity costs: bargaining power depends not simply on the volume of interdependence but on how costly withdrawal would be relative to the costs actors are willing to bear.

These literatures identify the central ingredients of the problem, but they are not always organized around the institutional question faced by a small state inside a durable arrangement: what forms of political adjustment remain available before full exit? Hirschman's exit-and-voice framework is useful here because dissatisfaction can be managed through attempts to change an organization from within rather than through immediate withdrawal (Hirschman, 1970). For small states, the same logic extends beyond organizations to bilateral and regional arrangements. Renegotiation, carve-outs, interface redesign, substitution, and phased transition can preserve practical choice even when abrupt exit would be costly.

The framework developed below therefore does not treat dependence as proof of diminished sovereignty. It asks whether dependence has become rigid. A highly dependent relationship may still preserve substantial political choice if its terms can be renegotiated, adapted, or substituted. Conversely, a formally sovereign state may retain a legal exit right while possessing little practical capacity to exercise it.

3. From Formal Sovereignty to Practical Sovereignty

International legal sovereignty answers an important but limited question: does the state possess recognized authority to enter, modify, or leave international arrangements? Practical sovereignty asks a second question:

can those political choices be made effective at tolerable cost? The phrase practical sovereignty is used descriptively rather than claimed as a novel term. The contribution here is its operationalization through relationship adjustability: authorization, voice, redesign, substitution, and transition cost. Formal authority remains a necessary baseline; the concern is what happens when legal authority is paired with severe dependence and high switching costs.

Definition 1 (Practical Sovereignty). Practical sovereignty is the capacity of a political community to make consequential choices in its own name and to translate those choices into workable institutional arrangements despite external dependence.

Definition 2 (Relationship Adjustability). Relationship adjustability is the extent to which a state can alter the terms, architecture, provider, or continuation of a critical external relationship through politically and institutionally available mechanisms.

Adjustability is broader than exit. A relationship may be highly adjustable even when complete withdrawal is unattractive, because the state can exercise voice, negotiate exceptions, redesign interfaces, diversify providers, or sequence changes. Conversely, an explicit withdrawal clause may coexist with low adjustability if alternatives have atrophied and rebuilding them would impose prohibitive transition costs.

This suggests a distinction between formal choice and practical choice. Formal choice exists when law leaves an option open. Practical choice exists when at least one politically meaningful route to implementation remains feasible. The two often coincide, but they need not.

Table 1. Dimensions of relationship adjustability

Dimension	**Operational question**	**Why it matters**
Authorization	Can the state legally approve, reject, or terminate the arrangement?	Establishes the formal baseline of political authority.
Voice / negotiation	Can the state influence terms or implementation without leaving?	Makes adaptation possible inside durable dependence.
Redesign	Can interfaces, exceptions, or institutional boundaries be modified?	Allows policy divergence without full withdrawal.
Substitution	Are alternative providers or arrangements plausibly available?	Limits lock-in and strengthens bargaining capacity.
Transition cost	What economic, administrative, and temporal costs attach to change?	Determines whether a formal option is practically usable.

4. Liechtenstein as a Structured Case

Liechtenstein's history is especially useful because its external relationships are deep but not static. The country has repeatedly reorganized the interfaces through which it accesses monetary, customs, European, and financial systems. These episodes do not prove that all dependencies are benign. They show that the relevant analytical variable is whether critical relationships can be adjusted when domestic preferences or external conditions change.

4.1 Reorientation from Austria to Switzerland

Liechtenstein's modern economic integration did not begin with Switzerland. Frommelt (2016) notes that the principality was linked to the Austrian monarchy through customs and currency arrangements from the nineteenth century until the aftermath of the First World War. The collapse of that environment produced a strategic reorientation toward Switzerland, eventually institutionalized through the 1923 Customs Treaty and later monetary arrangements.

The significance of the episode is not that switching partners was easy. It was not. The point is that the external relationship supplying economic infrastructure was replaceable when the surrounding order changed. That historical transition is an extreme form of adjustability: substitution of one external orientation with another. It also demonstrates why dependence should not be measured only at a single point in time. A state can be deeply embedded in one system yet retain, or later reconstruct, the capacity to reconfigure the relationship.

4.2 EEA accession and interface redesign

A clearer modern test came after Switzerland rejected participation in the European Economic Area while Liechtenstein chose to proceed. Liechtenstein's participation could not simply be layered on top of the existing customs union without institutional changes. The EEA Council's 1995 decision records that the 1923 Customs Treaty had been amended in November 1994 specifically to allow Liechtenstein's participation in the EEA (EEA Council, 1995). More recent analysis of Liechtenstein's external relations continues to treat the simultaneous Swiss and EEA linkages as central to the country's sovereignty strategy, precisely because they combine deep integration with domain-specific constraints and negotiated differentiation (Frommelt & Rochat, 2024).

The resulting legal architecture required parallel origin arrangements so that EEA participation could coexist with the customs relationship with Switzerland. Frommelt (2016) treats these tailor-made solutions and opt-outs as central to the feasibility of EEA membership for a microstate.

The episode illustrates redesign rather than exit. Liechtenstein pursued a policy preference that diverged from its principal partner, but the practical implementation of that preference required cooperation and legal adaptation on both sides. Political agency therefore rested neither in unilateral self-sufficiency nor in frictionless freedom. It rested in the capacity to renegotiate an interface.

4.3 Scale-sensitive residence arrangements

Free movement creates a second type of adjustability problem because uniform rules can have unusually large effects at microstate scale. The EEA's Protocol 15 allowed Liechtenstein transitional quantitative limitations on new residents, seasonal workers, and frontier workers, reflecting the country's special situation. Current national guidance continues to describe quota-based residence rights for EEA citizens (European Free Trade Association, 1994; Liechtenstein National Administration, n.d.).

This matters conceptually because the accommodation was neither unilateral exemption nor complete insulation from the wider regime. Liechtenstein remained inside the EEA framework while obtaining differentiated arrangements that made participation compatible with its demographic and territorial scale. The wider system had to recognize the problem and accept the adaptation. Practical sovereignty here appears as negotiated differentiation: the ability to remain integrated while altering the local application of a general rule.

4.4 Financial-sector adjustment under external pressure

The financial-sector transformation after the late 2000s shows the other side of the framework. Liechtenstein could change its own laws, but it could not determine the external standards under which larger markets, tax authorities, and financial counterparties were willing to interact. OECD materials from 2009 document the movement toward information exchange and the Liechtenstein Declaration of 12 March 2009 (OECD, 2009).

This was an episode of constrained adaptation rather than self-directed redesign. External pressure narrowed the set of viable policies, and the costs of refusing the emerging standards rose. Yet the policy response still involved domestic legislation, international agreements, and repositioning of the financial center. The case is useful because it prevents the framework from equating adjustment with autonomy. A state can retain practical sovereignty while facing an unattractive choice set. What matters is whether political choice remains consequential, not whether external constraints disappear.

5. An Adjustability Test

The framework can be operationalized qualitatively. For any critical external relationship, five questions reveal more than a simple measure of dependence intensity.

First, authorization: does the state retain recognized political and legal authority to approve, reject, or terminate the arrangement? Second, voice: can it negotiate terms, request exceptions, or influence implementation? Third, redesign: can the institutional interface be modified when domestic preferences diverge? Fourth, substitution: are alternative providers, arrangements, or internal capabilities plausibly available? Fifth, transition cost: how costly and time-consuming would it be to move from the current arrangement to an alternative?

Adjustability Test. Relationship adjustability should be evaluated as a profile rather than a binary pass-fail threshold. Evidence of practical choice is stronger when formal authorization is paired with usable voice, redesign, substitution, or exit mechanisms, and weaker when transition costs make every alternative merely nominal.

The test is deliberately non-numeric. The dimensions are not commensurable, and a single index would obscure domain differences. Monetary substitution may be technically possible but economically costly. Residence differentiation may require partner consent but be institutionally routine. Financial standards may leave legal discretion while sharply narrowing commercially viable choices. The purpose is to identify where political choice remains actionable and where it has become nominal.

Table 2. Liechtenstein episodes through the adjustability framework

Episode	**Primary adjustment mechanism**	**What the episode reveals**
Post-WWI reorientation	Substitution	External economic orientation can be replaced, although at significant transition cost.
EEA accession while Switzerland stayed outside	Redesign	Deep bilateral integration can be reconfigured to permit policy divergence.

Episode	Primary adjustment mechanism	What the episode reveals
Residence arrangements under EEA rules	Voice + differentiated design	Uniform integration rules can be adjusted to microstate scale through negotiated accommodation.
Financial-sector reform after 2008	Constrained adaptation	External pressure can narrow options without eliminating domestic political choice.

6. Why Legal Exit Is Not Enough

The strongest implication of the framework is that legal exit should not be treated as a complete proxy for sovereignty. Exit rights matter because they establish an ultimate boundary to delegated or shared arrangements. But their practical value depends on the existence of alternatives and on the cost of reaching them.

This point follows directly from interdependence theory. If one party can replace a relationship easily while the other would face major disruption, the legal symmetry of the agreement coexists with asymmetric bargaining power (Keohane & Nye, 2012; Crescenzi, 2003). For a microstate, this asymmetry can be pronounced because rebuilding a currency system, customs apparatus, market-access regime, or specialized regulatory capability may involve high fixed costs relative to national scale.

Yet high exit costs do not automatically erase sovereignty. Many durable institutions are valuable precisely because leaving them is costly. The critical question is whether costly exit is accompanied by usable voice and redesign mechanisms, or whether the relationship has become institutionally rigid. In that sense, practical sovereignty is better understood as a portfolio of adjustment mechanisms than as a binary exit option.

This also clarifies the relationship between shelter and sovereignty. Shelter theory explains why small states seek larger structures and why those structures can demand concessions. The adjustability framework asks a narrower downstream question: once shelter is in place, what preserves political choice over time? The answer is not independence from the provider. It is the continued ability to renegotiate, differentiate, substitute, or, if necessary, transition away.

7. Limits and Failure Conditions

The framework has several limits. First, it does not provide a threshold at which dependence becomes subordination. Such a threshold is likely domain-specific and partly political. A state may tolerate very high monetary dependence while treating control over taxation, residence, or constitutional authority as non-negotiable.

Second, apparent adjustability may be misleading. A treaty can be renegotiable in law but politically frozen in practice. Alternative providers may exist but refuse equivalent terms. Domestic administrative capability may atrophy during long periods of external provision, raising future transition costs. Adjustment capacity therefore has to be evaluated empirically rather than inferred from formal clauses.

Third, Liechtenstein is a favorable environment for negotiated adjustment. It is surrounded by stable wealthy neighbors, embedded in dense European institutions, and has unusually high administrative and fiscal

resources for its size. The same mechanisms may be weaker for geographically isolated or lower-income small states.

Finally, adjustability is not costlessness. Political sovereignty has never implied freedom from consequences. A choice can remain sovereign even when it produces economic losses. The framework therefore asks whether alternatives are feasible, not whether they are painless.

8. Research Agenda

Comparative work could extend the framework in three directions. The first is domain comparison within states: currency, customs, defense, migration, energy, and digital infrastructure may display different combinations of voice, redesign, substitution, and exit. The second is cross-state comparison among microstates and small states, including Luxembourg, Monaco, Andorra, Iceland, Malta, and selected island states. The third is longitudinal analysis of switching costs. Long-lived integration may lower operating costs while increasing the cost of rebuilding abandoned domestic capabilities.

A particularly useful empirical design would compare episodes of policy divergence rather than periods of routine cooperation. When preferences remain aligned, dependence and authority are difficult to distinguish. Divergence reveals whether the weaker party can obtain differentiated treatment, redesign the interface, credibly threaten substitution, or only accept the provider's preferred outcome.

Future research could also connect adjustability to measurable indicators: diversity of substitute partners, legal renegotiation provisions, domestic fallback capability, transition time, market concentration, and the fiscal cost of rebuilding. Such measures would be most useful as domain-specific diagnostics rather than as a universal sovereignty score.

9. Conclusion

Small states make the relationship between sovereignty and dependence unusually visible. They often cannot reproduce every capability internally and therefore rely on external shelter, integration, and larger partners. That reliance is real, and it can create asymmetric bargaining power. But dependence does not by itself determine whether political sovereignty has become hollow.

The adjustability framework separates formal authority from practical sovereignty. Practical sovereignty is strongest when consequential political choices can still be translated into workable arrangements. Relationship adjustability identifies the mechanisms that make this possible: voice, redesign, substitution, and exit, evaluated against transition costs.

Liechtenstein's experience illustrates several forms of adjustment. It has substituted external orientations, redesigned the interface between Swiss integration and EEA membership, negotiated scale-sensitive residence arrangements, and adapted domestic policy under external financial pressure. These episodes do not show unlimited autonomy. They show something narrower and more useful: the terms of dependence have repeatedly remained politically negotiable.

For small states, the critical question is therefore not whether they depend on larger systems. Almost all do. The harder question is whether dependence leaves enough room to choose again when the existing relationship stops working.

AI Use Disclosure

OpenAI's ChatGPT was used only for literature discovery and bibliographic verification. The practical-sovereignty and relationship-adjustability framework and underlying concepts originate in the author's prior published work (Kao, 2026a). The author independently reviewed all cited sources and remains solely responsible for the final manuscript, its arguments, source selection, and citations.

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