Backgrounder

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The Estonian Economic Miracle

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Estonia is a small country in Northern Europe on the Baltic Sea, at the crossroads of East and West, South and North. Samuel Huntington states that the Estonian border is a border of Western civilization, a border where civilizations clash.[1] This has made Estonia interesting to historians but hard for people who live there.

Throughout history, Estonians have had to fight for their freedom. In 1918, Estonia declared independence. It was occupied by the Soviet Union in 1940 during the Second World War. We fought the communist terror during the war but were defeated. As a result of the occupation, Estonia lost nearly 20 percent of its population.

But we never gave up. When the 1980s offered us a new chance, we took advantage of it. Estonia became one of the first countries to pry open the cracks in the Soviet Empire. Finally, in 1991, after 50 years of occupation, Estonia became free again.

We had freedom but little else. Estonia was destroyed during the period of communist rule. In 1939, Estonia's living standards and way of life were more or less the same as neighboring Finland's. Then Estonia lost its independence, but Finland, despite losing territory and population, succeeded in keeping its independence. Life under two different political systems created a huge disparity in the development of Finland and Estonia. People learned and worked hard on both sides of the Finnish Bay, but only the Finns seemed to prosper. After starting from the same point, Finland's gross domestic product (GDP)

Talking Points

- Fifty years of communist rule devastated Estonia. In 1939, Estonia and Finland had similar standards of living. In 1987, Finland's GDP per capita was $14,370, compared to Estonia's GDP per capita of about $2,000.
- After the collapse of the Soviet Union, Estonia took advantage of a narrow window of opportunity to radically reform its economy.
- Key reforms included establishing a sound currency, balancing the budget, cutting subsidies to state-owned companies, opening the economy through property reform and privatization and by eliminating trade barriers, replacing the tax system with a simple flat tax, and establishing the rule of law.
- Estonia's reforms have yielded stunning results. Poverty and inequality are decreasing. Estonia has low unemployment and low inflation, and living standards are improving rapidly. The government's budget is not only balanced, but also running a strong surplus.

This paper, in its entirety, can be found at:
www.heritage.org/Research/WorldwideFreedom/bg2060.cfm

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reached $14,370 per capita by 1987, while optimistic calculations put Estonia's GDP at only about $2,000 per capita.

At the same time, even opponents of communism often failed to see the real economic problems stemming from the socialist way of thinking. People overwhelmingly hoped that removing the communists from power and liberalizing the economy would be enough to enable their country to quickly reach the same living standards as in Western Europe. Nobody actually understood how backward and underdeveloped the communist economies really were. As a result, the return to the free world was harder and more painful than anybody could have predicted.

The Window of Opportunity

It was cold in Estonia in January 1992. The end of communism had created real chaos in the country. Shops were completely empty, and the Russian ruble no longer had any value. Industrial production declined in 1992 by more than 30 percent—more than during the Great Depression of the 1930s. Real wages fell by 45 percent, while overall price inflation was running at more than 1,000 percent and fuel prices had risen by more than 10,000 percent.

People stood in lines for hours to buy food. Bread and milk products were rationed. Because there was no gas for heat, the government planned to evacuate much of the capital of Tallinn to the countryside. The only "institution" in Estonia that seemed to work was the informal market.

Estonia was absolutely dependent on Russia, which accounted for 92 percent of Estonian international trade. Estonia had little that it could sell on world markets. The Soviet command economy had ruined Estonia's environment, and the infrastructure was in catastrophic shape. For most foreign experts, Estonia was just another "former Soviet republic" with not much hope for a better future.

Nor did many Estonians themselves believe in Estonia's future. Seeing the chasm between reality in Estonia and what Estonians understood as a more normal life, people realized that small steps were not enough. Estonia needed to make a decisive, giant leap across the abyss. At the same time, there was no time to lose. Acting quickly was essential to reforming a country from its roots. This was the main reason why in September 1992, in the first democratic elections since World War II, the Estonian people elected those offering the most radical break from the Soviet past and the most decisive reform program.

Reform-minded governments are not given much time to take the necessary steps. There are limits to the trust that people place in their politicians and the level of pain that they are prepared to endure. Exceeding these limits can set off a serious backlash against the reformers and their new proposals. Lescek Balcerowicz, one of the architects of Polish economic reform, stressed the importance of "extraordinary politics," meaning that a radical economic program launched as quickly as possible after the breakthrough has a much greater chance of being accepted than either a delayed radical program or a non-radical alternative that introduces difficult measures gradually. In his own words, "Bitter medicine is easier to take in one dose than in a prolonged series of doses."[2]

Balcerowicz's theory is based on the assumption that liberalization from foreign domination produces in a country a special state of mind and corresponding political opportunities. Hence, the government has the possibility to make decisions that would not be made under normal political and economic circumstances.

In this sense, a crisis is not so much a crisis as an opportunity. Even a short examination of Central and Eastern European experiences shows no link between the intensity of social discontent (e.g., demonstrations and strikes) and the type of economic program pursued. In fact, delaying some necessary decisions can cause serious backlashes that would not have occurred if they were made at the right time. In reform, timing is everything.

The right decisions made at the right time can provide countries with advantages and guarantee greater satisfaction of the electorate through more

1. Samuel P. Huntington, *The Clash of Civilizations and the Remaking of the World Order* (New York: Touchstone, 1996), p. 158.
2. Leszek Balcerowicz, "Understanding Postcommunist Transitions," *Journal of Democracy*, Vol. 5, No. 4 (October 1994).

rapid development. The right decisions made too late are usually still the right decisions, but the results are often not as successful.

However, that window of opportunity does not last long. It quickly gives way to the more mundane politics of contending parties and interest groups, which is normal in established democracies. Parties always search for an agenda, an ideological profile to take more care of the practical interests of their voters. Radical decisions become harder to push through, and the speed of reforms naturally slows down.

Transition countries that do not take advantage of the period of "extraordinary politics" to launch a radical economic program still face the challenge of making the transition to a market economy, but under more difficult economic conditions. The countries that miss this opportunity risk macroeconomic instability, excessive and chaotic state regulation, and massive corruption.

These countries are usually given a second opportunity after the parties in power have totally failed, but if they miss the second opportunity, it becomes extremely difficult to convince the people, who have suffered twice the pain with no benefits, to go through it all once more.

If essential reforms must be accomplished in a relatively short time, preparation time is also brief. Laws that are passed must therefore be as simple as possible, and the resources to implement any particular decision are inevitably limited. This limitation also argues for simplicity, a fact repeatedly mentioned by Anders Åslund in his studies of transition economies.[3]

Estonia tried to learn from all such experiences. Two main lessons emerged from our own reform process. One is to take care of politics first and then to proceed with economic reform. The other is summed up by the well-known advertising slogan: "Just do it." In other words, it is essential to be decisive about adopting reforms and stick with them despite the short-term pain that they cause.

We had to deal with politics first because to initiate and sustain radical reforms, we needed to form a legitimate consensus for change. A consensus is possible only through democracy, using regular, accountable institutional structures and free and fair elections. To be successful from that point forward required a clear break with the totalitarian past and with the structures and people representing it.

The First Steps: Monetary Reform and Macro Stabilization

The beginning of economic reforms in Estonia was similar to the experience of other Central and Eastern European states (also known as "transition economies"), but in some areas it was perhaps worse. The Central European nations were able to start reforms earlier, in 1989–1990, while Estonian reforms began in 1991–1992. This loss of time was crucial and allowed the Estonian economy to deteriorate further.

The first real reform in Estonia was monetary reform in the summer of 1992. Introducing our own currency was an important challenge for Estonia. In the beginning, it seemed like a faraway dream. Supporters of monetary reform suggested different paths of reform, but all identified three objectives: eliminating inflationary impacts from the east, guaranteeing an equilibrium exchange rate based on supply and demand, and conquering the cash crisis.

Estonia launched its monetary reform in June 1992 by becoming the first country in the former Soviet Union to introduce its own currency. Using a currency board system, the Estonian kroon was made fully convertible from the first day by pegging it to the German mark. Fixing the exchange rate to a strong currency like the Deutsche mark created trust in the Estonian economy. However, to reap the benefits of having a currency board, Estonia also had to balance the budget. As a political slogan, balancing the budget was quite popular, but in practice it was highly unpopular.

Whereas in many other Central and Eastern European countries the initial "shock therapy" was

3. Anders Åslund, "Possible Future Directions for Economies in Transition," in Joan M. Nelson, Charles Tilly, and Lee Walker, eds., *Transforming Post-Communist Political Economies* (Washington D.C.: National Academy Press, 1998), pp. 455–470, at *http://books.nap.edu/openbook.php?record_id=5852&page=453* (July 31, 2007).

freeing prices to fluctuate, in Estonia it was balancing the budget in 1992. The priority placed on eliminating budget deficits was thus not only well grounded in economic thought, but also, more practically, the only way out of a desperate situation. The developments in several other Central and Eastern European countries indicated that monetary reform cannot succeed unless the budget is strictly controlled.

This became the task of the new government elected in September 1992. The government led by Pro Patria Union was built from groups and parties that had been part of the resistance movement against Soviet occupation and were therefore decisive in breaking with the communist past. Members of the government were very young. As the newly elected Prime Minister of Estonia, I was 32 year old, and many ministers were even younger. Like other young people, we did not know what was possible and what was not—so we did impossible things.

The buildup of a government action plan started with the creation of a government coalition. Launching a radical reform program would have been impossible without a firm and stable majority in the Riigikogu, the parliament of Estonia. The size of the majority was not important—the Pro Patria government had a majority of one vote. What is important is that it works. For that to happen, all members of the coalition must know their tasks and the government's agenda.

To achieve this, our major focus was the coalition agreement, which not only assigned cabinet seats among parties in the coalition, but also clearly presented the government's action plan. Every member of our coalition signed the agreement, which was crucial to enacting the economic reforms in Estonia. Even when the government's decisions were furiously attacked by the opposition, the government had the necessary majority in the Riigikogu to pass the necessary legislation.

Developing such a comprehensive program took some weeks. In Estonia, this was done with the help of several think tanks from abroad: The Heritage Foundation, the International Republican Institute, the Adam Smith Institute, and Timbro in Sweden. Also vital were the first Estonian think tanks, created years earlier by the same parties that had just come to power. Most of the reform agenda was presented and discussed at events organized by these think tanks, making the public familiar with the details. Without these think tanks, the fast and effective buildup of a government action plan would probably not have been possible.

Being prepared, we had the opportunity to act quickly and decisively. Balancing the budget required radical cuts in all kinds of subsidies and reducing the size of government. Each of these cuts was unpopular. We pushed through these cuts thanks to the coalition agreement, which established balancing the budget as the most important goal.

We tried to include the opposition in the budget discussions, but as in any other democratic country, the opposition was not willing to cooperate and instead actively fought the budget cuts, using both parliamentary obstruction and street demonstrations. In this situation, the government needed to ensure that all its majority voted and did not waste time on too many discussions. (Once, we had to transport a member of parliament who had just given birth from the hospital to parliament so that she could vote on an important piece of legislation.)

Reforms must be pushed through, not piece by piece, but in the biggest chunks possible. Political resistance to both small and big reforms is the same. We passed huge amounts of necessary laws within some months and balanced the budget. Afterward, we passed a law that only a balanced budget could be presented to the Estonian parliament. This requirement enabled the government to pass subsequent balanced budgets more easily and has made a balanced budget one of the trademarks of Estonia.

Estonia set achieving macroeconomic stability as its first primary objective. Monetary reform, the strict restraint of a pegged currency, and the balanced budget were all aimed at achieving that goal. The stringent financial restraints made it easier for the government to decide what to do. Without the ability to print money or any other way to raise money, the government could only balance the budget by cutting expenses. The International Monetary Fund (IMF) offered a loan to balance the budget, but the government decided to build the future of Estonia on the momentum for radical reforms, not loans.

As part of this momentum, subsidies for state-owned companies were identified as a poor policy, and they were cut. This was important for the development of new private companies because subsidies preserve old and often outdated production structures and hamper structural change in the economy. Cutting subsidies sent the Soviet industrial dinosaurs a simple and clear message: Start working or die out. As was shown by subsequent developments, the majority chose to start working.

It was important, therefore, that we were honest with our partners and the public during the negotiations on the coalition agreement. We said that the first years of reform would be extremely difficult, so the members of parliament who had to vote for such measures knew what would happen. This approach kept the government coalition together, at least for a year and half.

Our government coalition understood that the only way out was to continue along the path that we had charted. Otherwise, the people would have endured the suffering which inevitably accompanies stabilization of the economy but would have failed to see the results.

Estonia was confronted with an unavoidable decline in living standards, industrial and agricultural output, and GDP. Any movement toward prosperity therefore demanded the elimination of old, inefficient, artificially supported economic activities and the establishment of the "invisible hand" of the market economy.

By 1993, we started to see the first real results of these measures. The macroeconomic situation had stabilized. The inflation rate had dropped significantly, from 1,000 percent in 1992 to 89.8 percent in 1993 and then to 29 percent in 1995. The economy was reoriented from the East to the West, and exports had started growing rapidly. All of these good signs gave us a great chance to move to the second stage of reforms and put Estonia on the path to real long-term growth.

Openness

The transition from the first stage of reform to the second stage was one of the most decisive moments for the reform process. In the first stage, many of the government's tasks were relatively easy and largely determined by the realities of the existing difficult situation. In the second stage, both the freedom to choose and the consequences of those choices increased. In the first stage, a small team could achieve macroeconomic stabilization by implementing the reforms from the top down, but success in the second stage required involving a much broader group of people in the process, touching their hearts and changing their attitudes.

The shock therapy of macroeconomic stabilization gave the people a rude awakening. In the second stage, it was necessary to give them new hope, new prospects, and new opportunities. Without a major readjustment of attitudes, the post-communist predicament would have become a trap, and the nation would never have moved forward to become a "normal" country with a free government and free markets under the rule of law.

Under Soviet-imposed socialism, people were not used to thinking for themselves, taking the initiative, or assuming risks. Many had to be shaken free of the illusion—common in post-communist countries—that somehow somebody else would solve their problems for them. It was necessary to energize people, to get them moving, and to force them to make decisions and take responsibility for themselves. The government declared that it could only help those who were prepared to do something for themselves. This principle proved unpopular, but it helped to change attitudes.

To accomplish these goals, Estonia had to find a way to give people different opportunities to do business. To create that opportunity, we felt that we had to open the economy to world markets. We needed to foster competition and attract foreign investment. Lots of people were afraid of such openness, so the government had to show the way.

As a small, open economy, Estonia historically had relied on trade. Openness provides many advantages for a smooth and rapid transition to a market economy. It provides a rational set of market-determined processes for resource allocation, introduces more competition, allows countries to specialize according to their comparative advantages, and lets the market rather than the government pick the winners. A policy of openness also establishes an environment of transparency, with clear market-based signals for producers. This is also favorable to the development of subcontracting activities that take advantage of the transition country's skilled but low-cost labor.

Accordingly, Estonia reduced trade tariffs and non-tariff barriers and abolished all export restrictions, making the nation a free-trade zone. One reason for creating a free-trade zone is that we found that tariff protections primarily favored sectors that are politically organized rather than those that are in the most need.

This open trade policy proved to be highly successful, boosting competition, reconstruction, and growth. Openness brought to Estonia many new companies, which opened new, export-orientated factories. Of course, this policy provoked furious opposition, demonstrations, and petitions "to protect strategic parts of economy" or "defend local producers."

We did not pay much attention to such protests and pushed reforms through as fast as we could. Once the first results of openness were seen, reversing the reforms became much more difficult. Openness will always be politically unpopular, but nobody wants to change a system that works.

For a transition economy like Estonia's, attracting foreign investment was a superior alternative to borrowing from international institutions, such as the World Bank and the IMF. First, by accepting development aid, we would have run the risk of maintaining the relative backwardness of our country. Development aid may consist of obsolete technology and obsolete advice, which no longer assists modern countries. By using this assistance, countries in transition lose the opportunity to use their backwardness as a springboard for development.

To put it bluntly, give us no aid, but more trade. The opposition heavily criticized this decision, but we paid little attention to this because the decision was supported by the parliamentary majority. When presenting such a decision to the people, stressing their national pride, they understand it quite well.

Although interest in foreign investment is relatively similar in all transition countries, the results achieved differ enormously. Some countries try to encourage foreign investors by offering all sorts of enticements, such as tax exemptions, privileges, and special rights. The alternative is to build a business environment that favors both local domestic investment and foreign investment without making any distinction between them.

Estonia chose the latter path. At the beginning, there was a lot of discussion about this approach, but because we had written it into the coalition agreement, it was done quickly. When the positive results of this policy were seen within a few years, nobody wanted to change it.

Passage of the law on the sale of land ensured that all foreign investors could feel a greater sense of security, and it also signaled that their property rights would be protected. At the same time, all special privileges for a few foreign investors were abolished, encouraging all kinds of investment. Soon after, during 1993–1994, Estonia went from an almost unknown spot in the world for foreign investors to a mecca for them. The government's systematic work to build a good reputation for Estonia in the world also helped to boost foreign investment.

As a result, Estonia received more foreign investment per capita in the second half of the 1990s than any other country in Central and Eastern Europe. This large inflow of investment created new working places, reconstructed old factories, brought new knowledge and technology, and made Estonia more modern and competitive.

Yet to be truly successful in transition, a country must open its markets not only to the world, but also to its own people. Democracy and the buildup of civil society must be supported. An important step in this regard was the introduction of a social dialogue or partnership. In practice, this meant initiating trilateral negotiations among the state, employers, and employees. During 1992 and 1993, the government supported the transformation of the Soviet-type trade unions into free trade unions. This created a dialogue between the government and the trade unions that averted larger protests and demonstrations, particularly during the first painful period of reform.

During trilateral negotiations, the government explained the Estonian situation to the other two sides. It was important to concentrate the negotiations on the most difficult problems, creating clear priorities. For example, when we agreed that our biggest common goal was fighting unemployment, explaining what steps were needed became significantly easier.

Trade unions understood that even though a lot of working places would be lost during privatization, privatization was the only way to escape from the current situation. If the enterprises were not privatized and reconstructed, all of the workers in the enterprises would lose their jobs. As a trade-off, the trade unions were given the possibility of presenting their proposals to the Privatization Agency on how many jobs must be guaranteed in privatized enterprises as a condition for a privatization agreement. Most important was to make clear to the trade unions that they really had access to the government and to establish a regular dialogue between the government and the trade unions.

All of these steps gave a firm boost to the development of a civil society in Estonia by helping to bring on fundamental changes in mentality and attitudes. The people became used to expressing individual opinions and actively influencing decisions. They understood that their future depended on their own activity. It is important to support the development of free media, even when they often become critical of the reform government. Freedom of the press is an essential part of modern society, without which society cannot function. Establishing democracy at all levels of society is crucial for successful transition. Only then can one be sure that the results of transition will not be turned back at any moment.

The Rule of Law

Radical economic reforms cannot be implemented without laws regulating the economic space. Although the rule of law has been and still is one of the pillars of modern Western civilization, its importance was not readily understood in several transition economies. Some believed that decisive reforms could be implemented without supporting laws by using only government decrees or simply letting the old structures collapse without creating new legislation and institutions.

In some transition countries, politicians regrettably believed that a free-market economy could magically create wealth without clear laws or government to enforce those laws. Often, they paid insufficient attention to renewing and strengthening—not enlarging—the government.

However, good laws by themselves are not enough. All developing economies need to build effective institutions that move their new laws from paper to practice. Formal legal systems place judges, prosecutors, arbitrators, court functionaries, and the private legal profession in the role of primary interpreters and enforcers of laws. Developing and securing all of these systems is vitally important for the reforms' success, as is creating an effective civil service.

The rule of law is especially important in fighting corruption, one of the worst diseases of transition economies. Corruption thrives when public officials and private agents have much to gain and little to lose from taking a bribe, which is precisely the situation that exists in most transition countries. Uncertain or non-transparent rules, heavy regulation, and pervasive controls give officials exceptional power, many opportunities to seek bribes, and a wide scope for appropriating public wealth.

The Estonian experience illustrates that the most effective method of dealing with corruption and organized crime is decisive implementation of market economy reforms and the development of a civil society and the rule of law.

Any reform that increases the competitiveness of the economy will reduce incentives for corrupt behavior. Reducing controls on foreign trade, removing entry barriers to private industry, and privatizing state companies in a way that ensures competition supports the fight. If the rules are transparent and clear, and if the state has no authority to license businesses or restrict exports and imports, there will be no opportunities to pay bribes in those areas. Eliminating subsidies, "soft" loans, and all other such privileges removes another inducement for bribes.

Using such methods and policies, Estonia fought and successfully reduced corruption and organized crime. Opening the national economy to competition and introducing real reforms is the best way to avoid crony capitalism. It is important to give enough attention and resources to judicial reform, reform legislation, police forces, and building an effective and transparent administration, even though these areas may not look so necessary in the first years of reform. Estonia put these areas on the priority list of reforms and became the least corrupt country among all transition countries, achieving a better score in the international corruption index than some long-standing member states of the European Union.

Finally, special attention must be given to bank reform. Banks are a most important part of the economy. If organized crime takes control of them, it can quickly take over the entire country. Money laundering, dirty money, and all other nefarious operations must be separated from the banking system as soon as possible. Government must be extremely vigilant and tough on this issue because dirty money is always followed by dirty people.

Estonia eliminated all state banks and made very clear demands of private banks. Banks were to compete, and we did not hesitate to let them go bankrupt when necessary. As a result of this clear attitude, Estonia has the most effective banks in the Baltics and is less corrupt than other new EU member states.

Property Reform

At the heart of economic transition is a shift to private ownership. Without private ownership, the transition to markets is destined to fail. There are different ways to achieve a secure, free economy with strong property rights: restitution of property to former owners, privatization of existing state assets, and the re-emergence of private businesses. For reformers, the question is not how much to privatize, but how and when to privatize.

Privatization is never actually popular. It does not win votes. This means that privatization must be implemented as quickly as possible. There is no time for negotiations with the opposition, and they will fight it anyway.

Property reform and privatization are especially important because clearly defined property rights are essential to all truly reforming economies. These two reforms are a necessary precondition for a functioning market and the only way to change the behavior of people and businesses and encourage them to begin making the most important structural changes. Getting the economy on this road to change, not maximization of revenues, is actually the most important goal of privatization.

At the same time, it is important to clearly guarantee property rights and to create the necessary legal conditions and institutions to make this happen. Property laws must leave no room for interpretation. Accomplishing this goal, however, is not easy because property relations are always one of the most complicated parts of legislation. The situation is even more difficult because such laws must be passed quickly to prevent old property relations from contradicting new ones.

In Estonia, we passed the first laws on property reform in early 1992, concentrating first on returning property that had been confiscated or nationalized by the communist rulers to the original, legal owners. In cases in which directly returning property was not possible, people received compensation, not in money but in the form of privatization vouchers. With these vouchers, they could buy minority shares of privatized companies or land. When it was clear which property would to be given back to the legal owners, all other property was privatized. Land and housing were privatized using vouchers that people had received previously, quickly making as many people as possible owners of private property.

This was a complicated process. Left-wing parties protested furiously against such measures and organized rallies against them, but we stayed firm and accelerated the process. Once people have become property owners, the process can be reversed only by brute force. As in all other reforms, speed is important in property reforms. At the same time, it is necessary to pass the laws that guarantee real protection of property rights, not only in theory but in reality.

Larger objects were privatized by the Estonian Privatisation Agency, Estonia's Treuhand, in open bids. In most cases, a majority share of each company was sold to one core owner, and minority shares were sold to individuals for vouchers. This guaranteed legitimate owners for companies while ensuring that everybody could participate in the privatization. The goal of privatization was to guarantee necessary investments and a minimum number of workers in privatized factories for a certain time, not just to generate revenue for the government. As a result of these policies, the privatization process was smooth and fast, making Estonia a country of property owners.

The Flat Tax

To achieve a lasting breakthrough in Estonia's development, it was essential to make the most of the people's energy. Accomplishing this goal required both creating a favorable economic environment for private enterprise and inspiring people to assume responsibility for their own future.

While the second goal was attained largely through shock therapy, achieving the first objective was much more complicated. It was partly accomplished through adopting legislation based on liberal or limited regulation of the economy, thus depriving the bureaucracy of opportunities to intervene or easily undermine the foundation of new companies.

However, limiting regulation was not enough. When people who had started their own companies realized that the tax system punished success, their enthusiasm to persevere and determine their own future declined considerably. In this situation, they were more ready to move from the traditional tax system to a new and radical system.

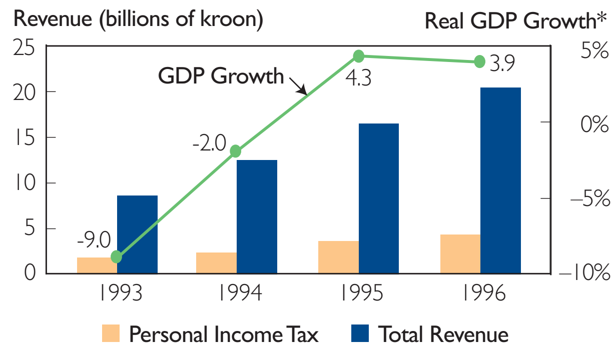
Radical tax reforms are popular only while they are part of theoretical discussion. When politicians try to implement them, the reforms immediately become highly unpopular. Winning elections on a platform of tax reform is difficult, but once a government is in power and must give the economy a boost, cutting tax rates is a good idea.

This step demands great political courage. Governments that cut tax rates or move to the flat tax are inevitably accused of supporting the rich, even though nearly all such tax reforms result in the rich paying a larger share of tax revenue than before. This fear of being labeled a supporter of the rich is a main reason why governments hesitate to introduce tax reforms, even when they know that such tax reforms are necessary. They are afraid of being badly defeated in next election.

Making the right decision and enacting the right policy are more important. I was certain that we must not punish people who are good at what they do. On the contrary, we decided to give them the opportunity to work more and to take control of their future. We decided that the entire tax system should favor savings and investments and encourage people to create new wealth. The tax system in Estonia had to be simple, inexpensive to apply, and transparent and understandable to the taxpayers. The tax base should be as broad as possible with a minimum number of exemptions, minimizing incentives for tax avoidance such as the underground economy. The tax rates had to be low, encouraging the activity of people and creating more growth.

Chart 1 B 2060

Estonian State Revenues



* Estonian statistics for 1993–1994 are more optimistic, listing GDP growth at –2.0% in 1993 and 0.1% in 1994.

Source: UNICEF, "A Decade of Transition," *Regional Monitoring Report* No. 8, 2001.

The best solution to all these goals was a flat-rate personal income tax, and Estonia introduced such a system on January 1, 1994.

The tax system became simpler and easier to understand for both taxpayers and tax collectors. Taxpayers could easily fill out their tax forms and avoid overly complex calculations and bureaucracy. Tax collectors could avoid a lot of unnecessary work and concentrate on those who were not paying their taxes at all.

As a result of these simplifications, the tax administration started to work more effectively, and tax compliance increased. The grey sector was badly hit, and state tax revenues started to increase rapidly. (See Chart 1.)

The flat tax reform also supported a rapid increase in economic activity. The Estonian people saw that if they worked more, they could earn more without the government punishing their success through higher tax rates.

Attitudes changed surprisingly fast. Thousands and thousands of new small and medium-size enterprises, restaurants, hotels, and shops were established. In 1992, Estonia had about 2,000 enterprises. By the end of 1994, the figure had ballooned to 70,000. Estonia had changed from the country of the working class to a country of entrepreneurs. The incentives to take charge of their own future helped Estonians to avoid massive unemployment.

Even after the Pro Patria government was voted out the year after tax reform, the flat taxed stayed. It turned out to be so effective that nobody seriously wanted to change it. Since 1994, Estonia has seen all possible government coalitions, often of parties that won elections by promising to abolish the flat-rate tax. Yet the flat-rate income tax persists.

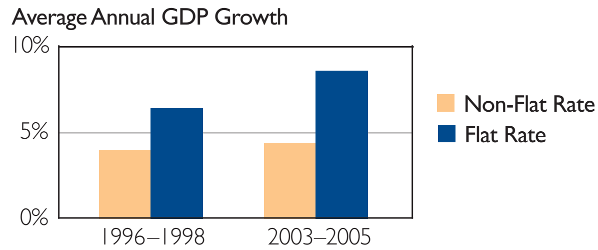
The Estonian experience with the flat-rate tax was so successful that other countries—first Lithuania and Latvia and then Russia in 2001—have copied it. Ukraine and Georgia have also introduced a flat tax, as did Slovakia in 2004 and Romania in 2005.

The flat-rate income tax has increased economic activity everywhere, created new workplaces, and suppressed the gray economy. Comparing the economic growth rates in Central and Eastern European countries with flat-rate personal income taxes to the growth rates of economies in the same region with progressive income taxation, we can see that countries with flat-rate taxes grew faster on average.

Comparing Central and Eastern European countries with flat rates (Estonia, Latvia, and Lithuania) to the most similar countries (Slovenia, Poland, Hungary, Slovakia, and the Czech Republic), we can see that the flat-tax countries grew significantly faster both in the first years after introduction of the flat tax and during the past three years. (See Chart 2.)

Chart 2 B 2060

Central and Eastern European Economic Growth, by National Tax System



Source: European Commission, Eurostat, updated July 14, 2007, at *epp.eurostat.ec.europa.eu/pls/portal/url/page/SHARED/PER_ECOFIN* (July 18, 2007).

The countries with flat-rate tax systems have reduced the relative income gap (in GDP per capita) with "Old Europe" much faster than other countries. Eurostat figures show that Estonian GDP per capita was 34.8 percent of the European average in 1996. Hungary was 48.5 percent, and Poland was 42.1 percent. In 2007, per capita GDP is roughly 65 percent in Estonia, 64 percent in Hungary, and 52 percent in Poland. The average catch-up of the three flat-tax countries is 25 percentage points, compared to Central and Eastern European countries with progressive taxes that experienced only a 14 percentage point catch-up.

The other clear difference between the flat-rate and progressive-rate countries is that the flat-rate countries' revenues and budgets are in better shape. Opponents often argue that the flat-rate personal income tax is socially unjust because it creates bigger inequalities in society than progressive taxation creates. This assertion is untrue, as the Gini coefficient[4] of income distribution has often decreased in flat-rate countries and is often lower than in progressive-rate countries. (See Table 1.)

In Estonia, the main increase in the Gini coefficient took place in 1989–1993, reaching its peak in 1995 with 0.398. It decreased in subsequent years.

4. The Gini coefficient is a measure of income distribution on a scale from 0 to 1, with 0 corresponding to perfect income equality and 1 corresponding to perfect income inequality.

Table 1 B 2060

Central and Eastern Europe: Change in Income Distribution, 1989–1997

	Change in Gini Coefficient
*Lithuania	0.036
*Estonia	0.081
Poland	0.059
Czech Republic	0.041
Russia	0.123
Bulgaria	0.133

* Countries with a flat tax system at the time.

Sources: European Bank for Reconstruction and Development, "Transition Report, Update 1995," April 1995, and "Transition Report, Update 1997," April 1997.

The flat-rate tax increased budget revenues, reduced incentives for the gray sector of the economy, and supported growth and economic activity. With such positive results, the Estonian example is now followed by more and more countries, pushing all Europe nearer to a real tax revolution.

The Estonian Miracle

Radical reforms in the 15 years since 1992 have changed Estonia beyond recognition from its communist days.

It is sometimes hard for us to remember how this country looked under the old system. Estonia became the first former communist country to rise to the status of a "free" economy in the annual *Index of Economic Freedom*, published by The Heritage Foundation and *The Wall Street Journal*. Even more remarkable, it is not just a "free economy," but one of the freest in the world, ranking 12th in the *2007 Index of Economic Freedom*.[5]

As a result of this amazing transformation, Estonia has experienced the fastest economic growth in Europe during the past few years. Since the start of Estonia's reforms, economic growth has averaged 6 percent per year. Growth was nearly 11 percent in 2005 and nearly 12 percent in the first half of 2006. As a result of this formidable growth, Estonia is catching up to the average European living standard faster than anybody expected.

Poverty and inequality are decreasing in Estonia. According to the United Nations Human Development Index, Estonia has moved from the group of not-so-developed countries to the group of developed countries. Estonia has low unemployment and low inflation, and living standards are improving rapidly. The budget is not only balanced, but also running a strong surplus. Estonia has passed several social reforms, such as health care and pension reform, and has become a full member of both NATO and the European Union.

By nearly any standard, Estonia is the most competitive economy among new EU member states. Only 10 years ago, Estonia clearly lagged behind most Central and Eastern European countries, but it has since passed them and is fast approaching the living standards of Old Europe.

All of these changes have allowed Estonia to prepare for the new challenges of the 21st century. The nation made a real jump in modern technology and is a frontrunner in e-government. During cabinet meetings, members of the government use only computers—no paper at all. Estonia is now ahead of many EU countries in Internet use. Estonians transact a large part of their bank transfers through the Internet. Tax declarations can be sent to the Tax Department electronically—more then 70 of Estonians did this in 2006. Best of all, completing the tax form takes about five minutes.

E-government can be a very effective tool in creating a lean and open government. The government's use of the Internet has in turn created favorable opportunities for new high-tech enterprises. Estonia has become the birthplace of many such enterprises. The most famous Estonian invention is the Skype electronic communication system, which was voted third most influential new trademark in the world in 2006. Of course, there is still a lot work to do. Estonia must face new challenges, but that really depends on Estonians themselves: The most difficult years are behind us.

5. Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index*.

Looking back on Estonia's transition from misery to prosperity, I can say from personal experience that the prime minister's task is not to be popular, but to build a working coalition, have a clear program of what to do, and then have the courage to make the decisions.

In a democracy, no prime minister stays in power forever, but a prime minister probably has a better chance of returning to power or staying in power when people can see that he really achieved something. I am a living example of this. I am the only prime minister in the transition countries who was voted back into power after being ousted, and I am the longest-serving prime minister in Estonian history.

Of course, implementing reforms can make a government unpopular. Thus, governments that implement such policies run the risk of being ousted from power sooner rather than later, but this is not important. Changing the country for the positive beyond recognition is far more important. Looking back, one can say: This was a dirty job, but someone had to do it. Once set in motion, the train cannot be easily stopped, and this is actually the only thing that matters.

—The Honorable Mart Laar served as Prime Minister of Estonia from 1992 to 1994 and from 1999 to 2002.

This is the third in a series of first-hand accounts of how countries achieved notable economic success by following the principles of economic freedom. Previous papers are: "How Ireland Became the Celtic Tiger" (Backgrounder *No. 1945) and "How Chile Successfully Transformed Its Economy"* (Backgrounder *No. 1958).*