# WHAT WE HAVE LEARNED IN ESTONIA ABOUT FREEDOM AND GROWTH

*Mart Laar*

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Similar to the people of Tolkien’s Middle-Earth we are living on the change of the times. World around us is changing faster and faster. We must meet new and new challenges and try to learn from the experiences from just finished changes. Changes of the past decade have really been enourmous. Between 1917 and 1950 a lot of countries seceded from democracy and market economy and launched an experiment in constructing an alternative economic and political system. A massive effort was made to centralise the control of production and allocate all resources through state planning. This huge experiment changed the political and the economic map of the world and set the course of much of the twentieth century. The failure of this experiment has set in move just as radical a transition, as these same countries are trying to change course again, seeking to restore democracy, rebuild markets and reintegrate themselves into the world economy.

This experiment had its impact on democratical countries too. Role of the governments and their intervention in the life of its citizen has grown significally during last century. Higher taxis, social spending and more regulation have been part of this process. As a result of this even the most developed countries are forced to look on new solutions, make choices and unpopular decisions. We are actually all standing on the crossroads and thinking what road we will choose.

Not all countries have been succesful in this road of changes. Some have succeeded, some have failed. Transition is never easy. Every moment of transition to each of us is offered enormous amount of different solutions and options, where to go or what to do. Again and again we are standing on a crossroad, where sometimes options as “good” or “bad” are not available and we must decide between “bad” and “worse”.

Nevertheless: looking on countries in transition we can find four main lessons emerged from those transitions. First of those is simple:

TO  HAVE SUCCESS YOU MUST BE FREE AND OPENED TO THE WORLD As it was said soon before - XX century was really not the best century for humankind. Devastating wars, rise of national-socialism and communism created huge losses and enormous sacrifice. Hundreds of millions were killed in the attempts to build paradise on the Earth. From my childhood I remember the joke about two man discussing is the communism scientific system or not. At the end one of the man says: no, it is not. Scientists had first tested communism on white mouses, but communists did it with people.

But dictatorships not only killed people and burned books, they closed their countries to the World. At the same time lasting development is not possible in closed society. You could not compare your achievements with others, make corrections, learn from their successes and mistakes. Without openess society dies.

To prove this we can compare developments in communist Central Europe with some of the poorer countries of Southern Europe, namely Greece, Portugal and Spain. These are an important comparison group as Central Europe differed little from these counarties before the World War II. Jeffrey Sachs has by example compared Poland starting from 1950s- Poland and Spain were then both largely agricultural, Catholic, peripheral regions of Europe. The two countries had about the same population in 1950 and tehy were also very close in per capita income terms. By 1988, however, Spain’s per capita income was four times that of Poland. Clear difference in income was also reflected in Spain’s greater ownership of consumer durables and much higher proportion of the population in tertiary education. Starting from the similar point in mid-1950s, Spain shot ahead of Poland in the next thirty-five years and started to catch up with the rest of Western Europe, while Poland fell farther behind. The central reason for Spain's success was its shift from being economically and politically isolated from the rest of Europe to being closely integrated with Europe.

In Northern Europe Estonia and Finland can offer similar example. It would be hard to find in the eve of XX century two more similar countries than Estonia and Finland. Heriting both from Finno-Ugric nations, Estonia and Finland are very similar by language and culture. Both countries were largely agricultural, but getting through industrialization in the beginning of the XX centuries. Both countries are Lutheran, peripheral regions of Europe on the border with East. Both declared their independence in the aftermath of World War I and went through fast development during the decades of independence. Finland and Estonia resembled each other a great deal in their socio-economic development between the World Wars in 1922-1938. By some measures Finland was slightly ahead in 1940 in economical development, by other analyses not. More or less, Estonia and Finland were just on the same level in 1940. They both had disastrous experiences just before mid-century. Estonia lost its independence and one third of the population, Finland succeeded to keep its independence, but suffered loss of territory and population. The subsequent period of fifty years under two different economic systems led to vastly different economic structures and behavioural patterns and opened up a huge gap between the development of Finland and Estonia. At the same time people learnt, worked and made an effort on both sides of the Finnish Bay. The advantages though seemed to be given mainly to the Finns.

Starting from the more all less similar point at the beginning of the 1950s Finland GDP started to grow clearly faster and in the 1970s when Estonian development totally stagnated difference between Estonian and Finnish growth-rate became very big. According to the estimations in 1988 household income per capita was in Finland 6 times higher than in Estonia. Very few people had by example private car yet 1950s both in Estonia and Finland. In 1987 there were nearly 400 cars per inhabitant in Finland. In Estonia the same ratio was 150.

The gap between the two countries according to international statistics on human development also increased. Before World War II Estonian and Finnish mortalities were alike. After the war they started to differ. The development of infant mortality in Finland and Estonia in the post-war period shows us again how well it reflects changes in economic and social processes. After World War II infant mortality declined rapidly in Finland. The change in infant mortality was relatively favourable in Finland in the 1970s. The infant mortality rate declined by more than 50 percent -from 13.2 per thousand births in 1970 to 6.4 in 1986 and it is among the lowest in the world. After the war infant mortality declined in Estonia in the same way as in Finland. Since 1970 there has been considerably less success in Estonia compared to Finland. Estonia reached the lowest level of infant mortality in 1988, but it was still two times higher than in Finland.

Comparisons between Estonia and Finland could be continued, but the result is anyway clear: The Finns level of development and standard of living exceeded in 1988 by far the Estonian, despite the fact that during the pre WWII period the level were more or less the same. The main reason for Finland's success was its shift to modern market export orientated economy and fast integration with Europe.
To say it again – FREE COUNTRIES GROW FASTER!

So at one moment captive nations became free, but what kind of freedom was this? Freedom and democracy usually came with collapse of economy and social security networks, which was often followed by hyperinflation, ethnical and political conflicts, sharp rise in criminality, corruption and chaos – and all other problems heritated actually from the former totalitarian regime. A change from totalitarism to working democracy is extremely demanding and a tough challenge. Everybody knows, how to make fish-soup from fish, but who knows how to get a fish back from the soup again?

One reason why lot of countries in transition have failed is their reluctance to relay not on their own strengths but on foreign aid. This was ofcourse not so much their failure but failure of leftwing thinking of world economist, seeing in the massive foreign aid medicine against all diseases.

The reason was the perceived failure of free markets and a presumption that incentives, institutions and markets played little, if any, role in fostering economic growth. It can be a dangerous trap. More and more examples have proved that foreign aid had not only not helped, but had positively harmed the developing countries. It encouraged inefficiency and waste and the adoption of perverse policies. It has destroyed local producers and created corruption and through this violence, wars and chaos. If the people are made dependend not from their work but from foreign aid question who distributes and controlles this aid can create big amount of conflicts. Because ruling foreign aid You will rule all country. Productive economic activity is replaced by political economic activity.

In reality the only key to reducing world poverty is more rapid economic growth in developing countries. And experience shows that the private market economy is the most reliable engine of growth. Countries who have undertood this have been succesful, who does not have failed. We in the Estonia did not want to fail. At the same time were were really down at the beginning of our reforms in 1992.

Even during the times of the Great Depression of the 1930s industrial production had not declined as in 1992 by more than 30 percent over two years, real wages fallen by some 45 percent, fuel prices risen by more than 10 000 per cent over the same period, while inflation was running more than 1000 percent per annum. People stood for hours in lines to buy food. Bread and milk-products were rationed. Shops were completely empty and money did not have real value any longer. There were not many who believed in a better future at this moment.

But we understood quickly that to get out of this mess we could relay only on ourselves and not on foreign aid. Because through foreig aid developed countries are often helping themselves not countries in need. We did not wanted to stay among developing countries, which are helped and where nobody wants to invest. So part of our strategy involved cutting Estonia free from all the various international aid and assistance programmes which are usually offered to developing countries. Estonia did not want to show itself as a developing country but as a country which could already stand on its own two feet. Estonia applied to leave the USAID aid programme and all the other programmes, stressing that it could manage on its own and that it wanted to trade with the rest of the world. Our policy was clear : GIVE US NO AID BUT TRADE and this brought us success. From the total chaos and destruction Estonia has fast raised among the fast developing nations. Ten years ago Estonia was among most “unfree” countries in the world. Two years ago Estonia for the first time, a former communist country has a free economy according to the Heritage Foundations’s annual Index of Economic Freedom. And even more remarkable – it is not only a “free economy”, but one of the freest in the world.

Soon in 1992 Estonia by example abolished all import tariffs and became one big “free trade zone”. This open economic policy has affected Estonia in an entirely positive manner. Firstly, some of the arguments for imposing tariffs to "protect the economy" go against the law of comparative advantage, and are thus based on false premises. In the long run, it is no more possible for the economy *as a whole* to be protected than for it to be *generally* uncompetitive. The main impact of tariff protection will be to favour some sectors of the domestic economy over others. Protection will often be given to the politically best organised sectors, rather than to those which are most needy. Such factors will also make a smooth phasing out of "temporary" tariffs unlikely, as pressure for their maintenance will be great.

Secondly, in countries with labour costs and skill endowments which are very different from those in their nearby neighbours, sub-contracting will play an important role in industrial trade. Products will be shipped back and forth between the countries at various stages of processing. A complex set of trade barriers would make such trade, which has been especially important in allowing existing enterprises to stay afloat and begin minor restructuring, much more problematic.

And thirdly, the state in former planned economies is simply too weak to undertake effective intervention. Tariff policy will tend to evolve in a myopic, haphazard fashion, influenced more by rent-seeking than by sound analysis. The case of Russia is an excellent example. The stated goal of export taxes and quotas on raw material exports was to ease the transition to a market economy. The actual effect was the generation of massive bribery, criminality and corruption, where a narrow group of well-connected persons became extremely rich at the expense of those whom the policy was meant to assist. The allocation of cheap credits from the Central Bank of Russia also appears to have been dictated more by corruption than by some "economically optimal policy". An open trade policy and the loss of tariffs have important positive aspects. They strengthen competition and force businesses to reorientate themselves. Tariffs can create a “demand barrier” which can be a major impetus to trade reorientation. Initially, enterprises complained about weak domestic demand under the new macroeconomic and exchange rate policies. When they realised that no reflation would be forthcoming and felt the pinch of tight financial policies, they started to produce products what they can sell in the world markets.

The open economic policy played an important role in the birth of the “Estonian economic miracle”. In the World Bank analysis “From plan to market”, the advantages of a liberal trade policy are set out against the backdrop of a comparison of Estonia and Ukraine. “There is powerful evidence from transition economies that the benefits of early external liberalisation far outweigh the potential costs. Establishing essentially free trade early on yields a particularly large return in these countries. Firm-level evidence shows that trade liberalisation has indeed spurred enterprise restructuring and helped make markets competitive.”

As a result of this and other reforms Estonia has achieved one of the fastest growth-rates among transition economies. Estonia has achieved stabile 5-6% growth, which in some years have reached 10%. Budget is balanced, foreign debt small, inflation low. Estonian living standards have grown fast. In the UN Human Development Index Estonia has raised more than 40 places and belongs now to the group of developed countries.

This is second lesson what we can learn from transitions: FREE TRADE AND ECONOMIC GROWTH ARE MAKING NATIONS PROSPERIOUS, NOT FOREIGN AID.

At the same time we must remember, that decision to go your own way could not guarantee success. To achieve real breakthrough Governments must give freedom not only to its people but to their economies aswell. For the past 10 years the Index of

Economic freedom published by The Heritage Foundation and The Wall Street Journal has measured economic freedom around the world in an effort to trace path to economic prosperity.

As more years of data has become available we can make some conclusions. The data demonstrates that (seven-year average) growth rates in countries are positively related to (seven-year) improvements in their Index scores. The 142 countries with available data were divided into fifths according to how much their Index scores had improved over the seven years. The countries with the most improvement are in the first quintile, and those with the least improvement or most deterioration are in the fifth quintile. Comparing the average growth rates of these two groups, the countries in the top quintile had almost twice as much growth as those in the bottom quintile. Even for the middle three quintiles growth rises and falls with changes in the Index score.

In other words, countries moving down the road map toward economic freedom have higher growth rates. As long as they keep progressing along the road map, their growth rate tends to be above the average for all countries. The faster they move, the higher is the growth rate. Once countries decide to stop or slow down the speed of economic reforms, growth plumments. So the important message to the countries of the world is that they can help themselves only by starting to adopt economic freedom. These reforms can be hard and unpopular, in the short term they can even create some amount of pain. But without pain there will be no gain. The more economic freedom countries adopt, the faster they grow or the longer they have superior growth. More growth in turn means that the average level of prosperity is increasing.

A lower growth usually calculates into lower GDP. Economically free countries have higher per capita income. Countries with higher level of economic freedom are clearly richer as countries with smaller level. The country’s Index score is positively related to United Nations Human Development Index aswell. Economically free countries are not making only some people rich, they guarantee balanced development all society, better education and healthcare. So we have reached the third lesson: FREE ECONOMIES GROW FASTER AND ARE RICHER

So we must make our economy free. Unfortunately this is easier to say as do. To free your economy it is not enough to cut taxes or privatize state owned enterprises. To achieve economic freedom you must do lot of more – you must reform and actually free all your society. In 1990s Milton Friedman answered question how to achieve economic freedom during transition with three words: privatize, privatize, privatize. After ten years experience he says that it is not enough. A stable economy requires transparency and effective public administration, defined property rights backed by an effective and independent legal system and free media, a robust and well-regulated financial sector and nott-corrupted public sector. Different studies have proved that the strength of the rule of law and the risk of expropriation are critical determinants of development. Without strong property rights, an investor cannot be sure of his ability to lay claim to a bussiness he builds, as a result, the level of risk involved in a bussiness venture increases, and investors are left unsure and likely to put their money elsewhere.

All this is actually part of the Economic Freedom Index. This is put together measuring and weighting 10 different factors:

- **TRADE POLICY**
- **FISCAL BURDEN OF GOVERNMENT**
- **GOVERNMENT INTERVENTION IN THE ECONOMY**
- **MONETARY POLICY**
- **CAPITAL FLOWS AND FOREIGN INVESTMENT**

- **BANKING AND FINANCE**
- **WAGES AND PRICES**
- **PROPERTY RIGHTS**
- **REGULATION**
- **INFORMAL MARKET ACITIVITY AND CORRUPTION**

We can refer to these 10 factors of the Index as “10 step plan to reach prosperity”. The 10 factors provide a road map and only by sticking to the highlighted route can a country achieve economic freedom and prosperity.

Achieving economic freedom is like building a car. It is not possible to say what is the most important component of the car: the engine, the transmission, the steering wheel, the brakes or the tires. Without any one of these components, the car is unlikely to reach the desired destination. In similar fashion, ignore any one of the 10 factors of economic freedom, and abundant prosperity is likely to remain elusive.

This helps us to understand difficulties Russia is meeting moving towards market economy. Russia has passed amount of reforms. It has privatized, cut taxes and introduced 13% flat rate personal income tax and balanced its budget. Nevertheless Russia is by the Index not even mostly free economy. Russia is situated in the index only on the 114. place, far behind of worst European country and is listed as “mostly unfree” country. And what is even more bad: Russia’s score has nearly not at all improved during ten year existence of the Index.

Russia has a large informal market, a high level of restrictions on banking and finance, high level of corruption and regulation and weak public administration, weak protection of property rights and absence of the rule of law. All of these issues translate into higher bussiness costs and barriers to a higher level of prosperity. According to the US Department os State, “High costs in complying with Russian tax authorities, incosistent government regulation, the inability of some investors to obtain redress through the legal system, and crime and corruption all dissuade investors".

These are the reasons why amount foreign investments to Russia are not even not nearing minimum level needed for Russia. And there the fourth lesson comes: TO MAKE YOUR ECONOMY FREE YOU MUST MAKE YOUR PEOPLE FREE!

If Russia wants to attract the amount of foreign investments needed for real reconstruction of its economy, he must understand that to reform its economy is not enough,  economic reforms must be balanced with political reforms, buildup of rule of law and democratic institutions. Russia can talk lot of about property rights but not many people are believing it, looking on jailed bussinessmen, surpressed media and institutions or war in Tschechenia. All this is not making Russia stronger, in opposite – they are making Russian situation significantly weaker.

To advance toward better future Russia need both low taxes and rule of law. Index of economic freedom shows that all its parts or factors are equally important. You can be very good in some of them but if you are not advancing in all of them your score will be poor. At the same time Russia is having all chances for success. All of us can fly, but we need two wings for this.