

## What Causes Prosperity: The Estonian Example

1991 was an important year for Estonia. After 50 years of occupation by the Soviet Union, the small Baltic nation became free. Outside of this freedom, Estonians held claim to little else. Years of communist rule destroyed the nation's economy. The country's currency, the Russian ruble, held no value. Fuel costs rose 10,000 percent while inflation surpassed 1,000 percent. Real wages fell 45 percent and GDP fell below 2,000 dollars per capita. Ninety two percent of the country's international trade depended on Russia.<sup>1</sup> Chaos reigned. Lines for food were hours long and staples, including bread and milk, were rationed. The future of this devastated nation seemed bleak. Many experts viewed Estonia as "another former Soviet Republic" with little hope for prosperity.<sup>2</sup> However, this was not the case for Estonia.

Today's Estonia is nearly unrecognizable from its days of communist rule. In 2006, the nation boasted a per capita GDP of 20,300 dollars,<sup>3</sup> the highest in the former Soviet bloc.<sup>4</sup> With a real GDP growth rate of 11.4 percent in 2006,<sup>5</sup> the nation reported the fastest economic growth in Europe.<sup>6</sup> How, within a span of 15 years, did Estonia manage to prosper? The answer lies in economic freedom. In the *2007 Index of Economic Freedom* published by The Heritage Foundation and The Wall Street Journal, Estonia was the twelfth freest economy in the world. Its overall score was much higher than any other country in its region.<sup>7</sup> Jagdish Bhagwati explains, "Wherever governments used markets more and engaged in more open policies in

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<sup>1</sup> Whitney Stewart, "Former Communist Estonia, Georgia Leading in Economic Success," *Cybercast News Service*, 10 August 2007, 12 November 2007 <<http://www.cnsnews.com/ViewForeignBureaus.asp?Page=/ForeignBureaus/archive/200708/FOR20070810f.html>>.

<sup>2</sup> Mart Laar, "The Estonian Economic Miracle," *Backgrounder*, 7 August 2007, 12 November 2007 <[www.heritage.org/Research/WorldwideFreedom/bg2060.cfm](http://www.heritage.org/Research/WorldwideFreedom/bg2060.cfm)>.

<sup>3</sup> "Estonia," *CIA World Factbook*, 01 November 2007, 12 November 2007 <[www.cia.gov/library/publications/the-world-factbook/geos/en.html](http://www.cia.gov/library/publications/the-world-factbook/geos/en.html)>.

<sup>4</sup> David Storobin, "Estonian Economic Miracle: A Model for Developing Countries," *Global Politician*, 1 May 2004, 12 November 2007 <[www.globalpolitician.com/articleshow.asp?ID=614&cid=3](http://www.globalpolitician.com/articleshow.asp?ID=614&cid=3)>.

<sup>5</sup> *CIA World Factbook*

<sup>6</sup> Storobin

<sup>7</sup> "Estonia," *2007 Index of Economic Freedom*, 12 November 2007, <<http://www.heritage.org/research/features/index/country.cfm?id=Estonia>>.

foreign trade and investment, indeed in more economic freedom of different kinds, their countries have tended to prosper.”<sup>8</sup> Estonia did just this.

Upon gaining political freedom, Estonia pursued policies promoting economic freedom, allowing Adam Smith’s “invisible hand” to bring rise to order and prosperity. Policies instituted by the transitional government of the early 1990s included monetary reform, privatization of industries, protection of property rights, tax reforms, and the abolishment of trade barriers.

Monetary reform was the first step to the restoration of the Estonian economy. In June 1992, Estonia introduced the kroon, becoming the first former Soviet bloc country to introduce a currency of its own. The kroon was established using the currency board system. Under such a system, the kroon is pegged to the German mark. The board operates by linking the growth in the supply of the kroon to the board’s holdings of the German mark.<sup>9</sup> Therefore, the country cannot simply create more currency without first increasing its foreign reserves.<sup>10</sup> By fixing the kroon to a strong currency, Estonia built trust in its economy.<sup>11</sup>

Stabilization of the country’s macroeconomic chaos soon followed. The inflation rate fell from 1,000 percent in 1992 to a drastically lower 29 percent in 1995.<sup>12</sup> Today, the country reports a 4.4 percent inflation rate.<sup>13</sup> Without the ability to print more money, the Estonian government had to cut its spending. Subsidies to state-owned companies were identified as an inefficient and poor policy. Privatization soon followed.

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<sup>8</sup> Niclas Berggren, “The Benefits of Economic Freedom: A Survey,” The Independent Review, Fall 2003, 12 November 2007 <<http://www.independent.org/publications/tir/article.asp?issueID=5&articleID=48>>.

<sup>9</sup> Laar

<sup>10</sup> Robert Carbaugh, International Economics, Eleventh Edition, (Ohio: Thomson South-Western, 2007) 492.

<sup>11</sup> Laar

<sup>12</sup> Laar

<sup>13</sup> CIA World Factbook

Before transition into an open market, the government owned 95 percent of Estonian enterprises.<sup>14</sup> In an effort to reverse this, an ambitious privatization law was ratified in mid-1993. State-owned monopolies on public utilities, including the Narva Elektrivorgud power grid, Estonian Air and Eestil telecom network, were no longer permitted to dominate the economy. These companies were broken up and privatized through sales to new investors and managers as well as public flotations. Such actions eliminated the inefficient economic activities of the “Soviet Industrial Dinosaurs” and allowed for the establishment of a competitive market economy. Modernization of industries, transportation, and communication followed.<sup>15</sup>

Milton Friedman argued a centralized government cannot become a private enterprise society without extending protection of property rights. Privatization alone does not create a market economy. It is vital for privatization to be complimented with rule of law -- “What does it mean to privatize if you do not have security of property, if you can't use your property as you want to?”<sup>16</sup>

In early 1992, shortly after independence, Estonia passed its first laws on property reform. The first step to reform meant the return of confiscated and nationalized property to the original, legal owners. All other land and housing was privatized through a voucher program.<sup>17</sup> The Estonian constitution enforces the right to property: “The property rights of everyone are inviolable and enjoy equal protection...Everyone shall have the right to freely manage, use and command his or her property.”<sup>18</sup> The country’s judiciary, which enforces property rights and contracts, is independent and not subject to government influence. *The 2007 Index of Economic*

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<sup>14</sup> James D. Gwartney and Robert Lawson, “There’s Power in Economic Liberty,” *The Cato Institute*, 9 September 2005, 12 November 2007 <[www.cato.org/pub\\_display.php?pub\\_id=4655](http://www.cato.org/pub_display.php?pub_id=4655)>.

<sup>15</sup> “Small but Free: Estonia’s Economic Reforms,” *Adam Smith Institute*, 12 November 2007 <[www.adamsmith.org/80ideas/idea/76.htm](http://www.adamsmith.org/80ideas/idea/76.htm)>.

<sup>16</sup> Milton Friedman, “Economic Freedom behind the Scenes,” *The Cato Institute*, 12 November 2007, <<http://www.cato.org/special/friedman/friedman/friedman4.html>>.

<sup>17</sup> Laar

<sup>18</sup> “The Constitution of Estonia,” Chapter 1, Article 32, Section 1 and 2.

*Freedom* gives Estonia a 90 percent, ranking well above the world average in terms of property rights.<sup>19</sup> The reformation of property rights leads to greater efficiency. Friedman noted it is within human nature to be more diligent with one's own resources than with the resources of others. Because of this, efficiency and effectiveness are the natural offspring of private property.<sup>20</sup>

Progressive tax policies take a larger percentage from high-income groups than low income groups. Under such a policy, money that the wealthy would have reinvested into the economy must be paid out in taxes and used in the public sector rather than the private sector. Such policies stunt economic growth.<sup>21</sup> Rather than adopting a progressive tax policy, Estonia instituted a flat-rate personal income tax, promoting lower tax rates.<sup>22</sup> There is neither death tax nor wealth tax. The country also eliminated double taxation on savings and dividends.<sup>23</sup> Moreover, the system does not tax profit until it is removed from the company, meaning reinvested earnings are not subject to taxation.<sup>24</sup> The system avoids the distortions, loopholes, exemptions, and penalties common in many other systems.<sup>25</sup> Such a system avoids punishing productive behavior and encourages savings and investment, ultimately boosting economic performance.<sup>26</sup>

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<sup>19</sup> 2007 Index of Economic Freedom

<sup>20</sup> Milton Friedman, "On Freedom and Free Markets," Public Broadcasting Station, < [http://www.pbs.org/wgbh/commandingheights/shared/minitextlo/int\\_miltonfriedman.html](http://www.pbs.org/wgbh/commandingheights/shared/minitextlo/int_miltonfriedman.html)>.

<sup>21</sup> Ludwig Von Mises, Economic Policy: Thoughts for Today and Tomorrow, (New York: Free Market Books, 2000). 84.

<sup>22</sup> Daniel Mitchell, "Flat Tax is the Way of the Future," The Heritage Foundation, 20 March 2006, 12 November 2007 <[www.heritage.org/Press/Commentary/ed032006a.cfm?RenderforPrint=1](http://www.heritage.org/Press/Commentary/ed032006a.cfm?RenderforPrint=1)>.

<sup>23</sup> Daniel Mitchell, "Baltic Beacon," The Cato Institute, 20 June 2007, 12 November 2007 <[www.cato.org/pub\\_display.php?pub\\_id=8378](http://www.cato.org/pub_display.php?pub_id=8378)>.

<sup>24</sup> Signe Ratso, "Miracle of Estonia: Entrepreneurship and Competitiveness Policy in Estonia," United Nations Economic Commission for Europe, 12 November 2007 <<http://www.unece.org/ie/wp8/documents/mayfor/Signe%20Ratso.pdf>>.

<sup>25</sup> Baltic Beacon

<sup>26</sup> Laar

The flat-rate tax proved effective. The simplicity of the system decreased tax evasion and led to a rapid increase in state tax revenues. As Estonians realized increased earnings without punishment, attitudes changed and entrepreneurship grew. Thousand of new businesses were established. In 1992, there were 2,000 enterprises in Estonia. This number grew to 70,000 in 1994.<sup>27</sup>

After Estonia's successful implementation of the flat-rate income tax, many other countries soon followed. Lithuania, Latvia, Russia, Ukraine, Georgia, Slovakia, and Romania have all implemented the flat-rate tax. Comparing countries in Central and Eastern Europe, it becomes obvious flat-tax countries experienced significantly greater growth than those without the flat-tax. In 1997 alone, Central and Eastern Europe economies with a flat-rate system experienced 8 percent growth while those with a progressive system experienced 1.4 percent growth. Along with increased growth, countries implementing the flat-rate tax experienced increased revenues.<sup>28</sup>

Capital is vital to the prosperity of a developing country. Increased capital investment allows for industrialization. Protectionism, including tariffs and foreign exchange controls, prevent the inflow of capital into a country. Without this capital, it is impossible to build new factories and improve already existing ones. It follows that protectionism prevents the industrialization of a country, ultimately preventing prosperity.<sup>29</sup>

By 1992, the Estonian government abolished all tariff and non-tariff trade barriers. It ensured both foreign and domestic investors were given equal treatment under law, fully opening the door to foreign direct investment. Rather than relying on development aid from organizations including the World Bank and IMF, Estonia relied on attracting foreign direct

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<sup>27</sup> Laar

<sup>28</sup> Laar

<sup>29</sup> Economic Policy: Thoughts for Today and Tomorrow

investment and promoting trade. Mart Laar, the former Prime Minister of Estonia, asked “give us no aid, but more trade.”<sup>30</sup>

Estonia’s open trade policy proved successful. Many new, export-oriented factories were opened, boosting competition and leading to modernization and growth. Before 1993, Estonia was almost unknown to foreign investors. The following year, it became a “mecca” for them. In the late 1990s, Estonia received the highest per capita foreign investment in Central and Eastern Europe. Such investment brought new technology and knowledge and led to the construction of new workplaces and the modernization of old factories.<sup>31</sup> Trade thrived in Estonia. In 1990, Russia monopolized Estonia’s trade relations and Western Europe accounted for less than one percent of the nation’s total trade. Today, trade with Western Europe makes up two-thirds of trade in Estonia.<sup>32</sup>

Estonia provides an excellent example of how economic freedom transforms a country. After 50 years of communist rule, the Estonian economy lay in ruins. Inflation was rampant, per-capita income was dismally low, and the economy barely functioned. As Ludwig Von Mises noted, “All varieties of interference with the market phenomena not only fail to achieve the ends aimed at by their authors and supporters, but bring about a state of affairs which - from the point of view of their authors' and advocates valuations - is less desirable than the previous state of affairs which they were designed to alter.”<sup>33</sup> Although transition was not easy, by removing market interferences Estonia prospered through the natural order created by the free market. This small former Soviet republic shows that freedom works.

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<sup>30</sup> Laar

<sup>31</sup> Laar

<sup>32</sup> Razeen Sally, “Free Trade in Practice: Estonia in the 1990s,” Central Europe Review, 10 July 2000, 12 November 2007 <[www.ce-review.org/00/27/sally27.html](http://www.ce-review.org/00/27/sally27.html)>.

<sup>33</sup> Ludwig Von Mises, Human Action: A Treatise on Economics, (San Francisco: Fox & Wilkes, 1996) 878.

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