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Transforming an Economy while Building a Nation: The Case of Estonia

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TRANSFORMING AN ECONOMY WHILE BUILDING A NATION: THE CASE OF ESTONIA

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I. Introduction

Most Central and Eastern European countries are struggling with the daunting task of transforming their state-owned, centrally planned economies to a private, market-oriented basis. The newly or again independent states emerging from the collapse of the USSR and Yugoslavia and the dissolution of Czechoslovakia, face an even greater challenge. While also moving from plan to market, they must at the same time restructure their often provincial economies to ones befitting a sovereign state.

For a country in the early stages of nation- and state-building, the economics of transformation are changed in two ways. First, it will face some tasks, such as the introduction of a national currency, which are not faced by the 'older' nations. Second, the precise form of steps taken by all reforming CPEs, such as privatization, is often altered by the constraints and needs of nation-building.

This paper examines the specific issues faced by the 'new' states during this period of 'dual economic transformation', using the experience of Estonia as a case study.[1] This is done in several stages. First, the main social and political factors which impact on the Estonian transformation are described. This is followed by discussions of the impact of nation-building on fiscal and monetary policy, domestic liberalization, privatization, economic restructuring, and external economic relations. Finally, the paper concludes with a discussion of how the Estonian case can or cannot be generalized to other 'new' states.

II. The Socio-Political Setting

The environment in which Estonia is undertaking its economic transformation is shaped by three main socio-political factors; the collapse of Soviet power, the desire for a 'return to Europe', and the ethnic dimension of economic reform.

The collapse of Soviet power

In the former Soviet Union (FSU), the failure of the August 1991 coup led to a discrediting of most things Soviet. This was especially true in the Baltic States, where Soviet rule has been more recently imposed and viewed as particularly foreign. These perceptions both fuelled the drive to restore political independence and hastened the dismantling of the main pillars of the Soviet state (communism, central planning, the ruble, etc.).

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[1] I use 'new' and 'old' in inverted commas as several of these states have been at least nominally independent at previous times in history.

In fact, the strength of the antipathy in Estonia towards all things Soviet has been such, that even concepts like economic integration and cooperation, which are viewed positively or at least benignly in most countries, have been partially discredited simply by association with Soviet rule. The term 'socialist integration' is likely to conjure up images not of prosperity, but of an externally imposed inappropriate economic structure, of the forced consumption of shoddy goods, and of a barely functioning currency. For these reasons, ideas which many outsiders consider appealing, such as a common Baltic currency, a Baltic customs union, or continued close cooperation with the CIS countries, have so far found little real support in Estonia.

In the economic sphere, the Soviet collapse began long before the August coup. Since 1989, much of Estonian economic policy has been motivated by a desire to escape its negative effects. While the impact of real shocks, such as the rapid fall in trade volumes and the decline of certain industries, can scarcely be avoided, there are greater opportunities to escape the macroeconomic and financial chaos of the FSU.

Early Estonian attempts to counter the growing inflationary pressures in the ruble zone included the application of 'export controls' to stem the outflow of goods to neighboring regions which were also experiencing general shortage.[2] 'Protecting the internal market' was seen by much of the public as a general cure for many ills of the time. In a similar fashion, the subsequent emergence of high open inflation and a shortage of cash increased the pressure to introduce a national currency.

The net effect of the political and economic pressures arising from the Soviet collapse has been to encourage a cautious, if not autarkic, approach to economic relations with 'the East'. In spite of its much stronger trade links with the FSU, Estonia can at times appear to be less interested in maintaining these ties than are the countries of Central Europe.[3] This stance will likely be maintained until the neighboring economies are stabilized, and until Estonia feels that its is seen as equally independent to, say, Finland. As long as Russian officials continue to refer to the 'near abroad', there will be domestic political pressure to place enhancement of sovereignty

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[2] In some of the other republics, this put in motion a process of gaining greater economic independence, even when there was no political wish to leave the Union.

[3] This appears stronger the greater the geographic proximity of the two countries. For instance, Estonia now appears more interested in developing links with Ukraine, possibly as a counterweight to Russia's dominance of past trade.

above the development of economic ties.[4] In this environment, little positive cooperation is possible.

Once Estonia feels secure in its nationhood and clearly sees a common interest with other states of the FSU, active cooperation will surely be pursued. Until that time, Western calls for greater cooperation between the Baltic States, or between Estonia and Russia, are simply non-starters.[5] Western policy makers wishing to encourage longer-run cooperation among these states would do best to focus on *discouraging* the erection of major barriers, rather than *encouraging* active cooperation. This will ensure that when a real desire to cooperate emerges, it can be easily facilitated.

The new goal of a 'return to Europe'

In many former Soviet republics, particularly those in Central Asia, there was no obvious wish to leave the Union, nor is there now a clear goal of where to head as independent states.[6] In others such as Ukraine, while support for leaving the Union was strong, there is still little agreement on whether the future lies primarily with Russia or with Europe. In Estonia, there has been a clear consensus on both what to escape and where to head in the future. The latter is captured under the general heading of the 'return to Europe', a term which, while imprecise in meaning, reflects an often stated and nearly universal goal.

This goal is also expressed in the 'old' countries of Central and Eastern Europe, but the difference with Estonia is clearly a matter of degree. The simple fact that these states are already termed *European* makes any 'return' less significant than for a country where 95% of trade was conducted with ex-Soviet republics.

The desire for a 'return to Europe' has three sources. First, as in most ex-socialist economies, 'Europe' is seen as a proven model which has delivered prosperity. Second, if large countries such as Russia cannot easily 'return' to a Europe which is small by comparison, a nation of 1.5 million can surely be accommodated. Most importantly, while it is unclear whether Russia being also an

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[4] There is a clear historical analogy with the successor states of the Austro-Hungarian Empire. The obvious longing among some Hungarian officials for a return of lost territories, especially those populated by ethnic Hungarians, merely fuelled nationalist feelings and autarkic economic policies in these states. For more, see Pasvolsky (1928).

[5] The different results of parliamentary elections in Estonia and Lithuania also suggest that preferred reform paths may differ so greatly, that close coordination of economic policies is impossible. Estonia elected a distinctly right-of-center parliament on September 20, while the Lithuanian election was won by the renamed (pro-independence) Communist Party.

[6] For an excellent overview of the adjustment to independence in the new Central Asian states, see Olcott (1992).

Asian country can really 'return' to Europe, there is no such historical and cultural ambiguity in the case of Estonia.

The consensus about this long-run goal, at least among ethnic Estonians, and the strength with which it is pursued, has had two influences on the economic transformation. First, it has led Estonia to develop a highly liberal trade regime towards the West. After the restoration of independence, Estonia quickly reached bilateral free trade agreements with most EFTA nations, and signed an MFN agreement with the EC. The goal of reaching a more substantial association agreement with the EC is hardly questioned.[7] The convertible currency trade with other countries is largely free, with only a few import tariffs and export quotas and licenses.[8] Finally, foreign direct investments made in convertible currencies have so far been granted highly favorable tax treatment.

Second, consensus improves the political economy of sustaining economic reforms through the phase when most effects are negative. As deindustrialization and the reduction of links with 'the East' are seen as an integral parts of the 'return to Europe', the painful effects of restructuring can be presented as (and are often taken as) strong medicine which must be swallowed, rather than as a problem to be mitigated. Estonia has so far maintained social peace in the face of one of the most severe terms-of-trade shocks experienced by any former CPE, including a seventy-fold increase in the price of gasoline over of one year.[9] The ability of the Estonian authorities to implement and maintain balanced budgets and a tight monetary policy in the face of such a shock is also founded on this consensus and direction in society.

The ethnic dimension of economic reform

Problems of ethnic minorities are not confined to 'new' states, as the Bulgarian and Romanian examples show. Yet, most Western discussion about (and anxiety over) minority issues has been in the context of the Soviet, Yugoslav and Czechoslovak breakups. As Estonia's minorities together make up about 38% of its population, its ethnic relations have not surprisingly been widely discussed. As this analysis is often based on questionable analogies with other states having complex ethnic situations, e.g. Azerbaijan, Bosnia-Hercegovina and Croatia, it generally reaches pessimistic conclusions. Furthermore, it often focuses on issues which may have

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[7] There is less agreement on the desirability of full EC membership, as this is seen by some as giving up too much of recently won political sovereignty.

[8] From January to June 1992, tariff revenues represented only 1.2% of the income of the government (Statistical Office of Estonia, 1992b).

[9] The IMF (1992) estimates the size of the terms-of-trade shock in 1992 alone to equal a drop in GNP of about 20%.

less real influence on inter-ethnic relations, esp. the issue of citizenship rights, while ignoring the potentially more important links between ethnic tensions and the impact of economic restructuring.

In the case of Estonia, the current demographic situation creates both problems and opportunities. On the negative side, the dividing line between the initial winners and losers from economic reform will run close to divisions between the Estonian and non-Estonian populations. The benefits and costs of restructuring will be different across regions, sectors and enterprises, all of which are ethnically not well integrated. Non-Estonians are concentrated in Tallinn, the northeast, and towns with a strong military or railway presence (Paldiski, Tapa, Valga), and are relatively important in industry. Rural areas, and thus the agricultural sector, as well as most other cities and towns, are predominantly Estonian. Even within industry, individual enterprises are most often seen as being either 'Estonian' or 'Russian'.

This segregation of society may force economic reforms to be more cautious than otherwise desired. The experience of Eastern Europe shows that transformation brings deindustrialization.[10] In Estonia, where measured industrial production fell by 40% in the first 9 months of 1992 relative to the same period last year, this means that much of the initial brunt of reforms will fall on the non-Estonian population.[11] As the Soviet system created huge enterprises, a firm closure can lead to the laying off of thousands of workers. The fear of this outcome is one reason why the coming wave of bankruptcies creates intrepidation in official circles, even when the recorded unemployment rate is still below 1%. In the future, this could test the government's commitment to remove subsidies, as these are one way to postpone politically complicated firm closures.[12]

On the positive side, the Estonian minority situation differs from that in most countries in one important way. Namely, in most cases, minority populations have resided in their current locations for generations if not centuries. As these people could as well go back to their ethnic homelands as Americans of Irish descent could 'return' to Ireland, they truly have 'nowhere to go'.[13] This feeling, which can lead to fear and panic in the face of economic dislocation,

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[10] For an extensive recent overview of the transformation experience of the former centrally planned economies, see Åslund (1992).

[11] *Äripäev*, October 29, 1992.

[12] For example, the Estonian government recently froze the tax arrears of the Kreenholm textiles enterprise in Narva, which has over 7000 workers, almost all of them non-Estonians (Baltic Independent, 20 November, p. 4).

[13] The case of the Gypsies in Europe is the clearest case of the difficulties arising when a minority truly has nowhere to go.

largely explains why the Polish minority in Lithuania, while small in numbers, represents perhaps the most difficult case of minority relations in the Baltic region.[14]

In sharp contrast, most non-Estonians in Estonia are relatively recent immigrants. Rein Taagepera has estimated that in 1945 (after war, deportations, flight to the West, and the loss of terrirory are taken into account), the share of ethnic Estonians in the total population was about 94%.[15] By the 1989 census, this share had fallen to 61.5%. More important, as the ratio of net to gross immigration during the period 1946-90 (excluding most military personnel) was 0.284, i.e. roughly three in four immigrants have subsequently re-emigrated, the non-Estonian part of the population has a strong transient element.[16] Many immigrants were hired to build new megaprojects, such as the oil shale mines near Narva or the new harbor at Muuga near Tallinn. After these were completed, many returned home, to be 'replaced' by other workers as new projects were commenced.

The footloose nature of Estonia's minority populations is seen in the large increase in net emigration from Estonia in the last years. With the door to immigration almost closed, a net of 25,500 persons (around 5% of the entire non-Estonian population) have emigrated to former Soviet republics in the first 8 months of 1992.[17] If the tempo of the most recent months continues into 1993, around 50,000 persons will leave next year. Also, if economic dislocation is a motivating factor of emigration, the fact that major restructuring is only now beginning means that an even higher net figure for 1993 is not infeasible.

The very low volume of applications for Estonian citizenship is another possible indicator of transience among the non-Estonian population.

This aspect of its demographic composition gives Estonia a safety valve which more homogeneous states, or ones with more entrenched minorities, do not possess. Ignoring the negative effects of losing qualified specialists, if the pace of net emigration is linked to the pace at which employment positions are lost, the net effect could be a damping of the unemployment rate in Estonia.

A continued flow of net emigration could also improve the long-run basis for establishing a liberal open economy. As ethnic Estonians begin to feel that their national survival is no longer in

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[14] A related problem arises if the country of ethnic origin is small. For example, Russia could relatively easily absorb all ethnic Russians returning from Estonia, whereas Albania would have enormous difficulties in accommodating a substantial inflow from, say, Kosovo or Macedonia.

[15] Misiunas and Taagepera (1983, p. 272).

[16] Statistical Office of Estonia (1991), p. 43.

[17] *Baltic Independent*, October 30, 1992, p. 14.

danger, they will be more welcoming to new foreign influences and investments. If this also eases the relations with the remaining non-Estonian population, it could further contribute to political stability.

A much smaller group which could influence developments is the Estonian diaspora. Its real role will be rather minor. The net return from abroad is unlikely to exceed 1,000 persons. Unlike the overseas Chinese, for example, those remaining abroad will not be major investors in Estonia. The impact of the diaspora will be felt in some areas of technical assistance, but more importantly as a role model of relatives that did well in difficult conditions.

III. Fiscal and monetary aspects of restoring economic sovereignty

A 'new' state must undertake some of its most farreaching reforms in the areas of fiscal and monetary policy. The tax base must be both nationalized and restructured to the needs of a modern market economy. In most cases, a new currency must be introduced, if for no other reason than as a manifestation of state sovereignty. Finally, fiscal, monetary and exchange rate policies must be implemented by officials with little experience in doing so, at least in a market economy setting.

It is therefore surprising that perhaps the greatest successes in Estonian economic reform have so far come in these areas. The Soviet tax system has been fully nationalized and modernized. While far from perfect, it has functioned well enough to keep the budget in balance or mild surplus. The introduction of the new currency, the *kroon*, was more successful than had been expected.

Tax reform

After having won 'economic independence' within the Soviet Union in November 1989, Estonia (like the other Baltic States) moved quickly to nationalize and modernize its tax system. Until the beginning of 1990, its budget had been fully integrated into the All-Union budget, and was constructed using All-Union principles. The two main taxes were a turnover tax and a corporate tax, neither of which is appropriate in a market economy setting. The former was highly arbitrary, with the rate for a given good simply set to sustain the chosen difference between its wholesale and retail prices. This produced a proliferation of thousands of different rates specific to particular goods.

The corporate tax was designed to appropriate all of a pre-determined, industry- or firm-specific profit margin in a centrally

planned setting, rather than to create a neutral, stable environment in which private activity would develop.

Starting from this system, *nationalization* meant moving to a one-channel system where Estonia would collect all taxes and send a single, negotiated lump-sum payment to the Union government. While the removal of an assured tax base for Moscow was no way to run the Union, it was a good way for Estonia to enhance its economic independence.

Modernization meant introducing a tax system akin to those found in Western market economies. The differentiated turnover tax was replaced by VAT at a uniform rate. A progressive personal income tax based on unified income concept was introduced. A standard corporate income tax, which was first progressive but later changed to a flat rate of 35%, was also implemented. Most specific excise taxes were converted to an *ad valorem* basis and social security and medical taxes totalling 33% (to be paid by employers) were introduced. Finally, local governments were given their own tax base.[18]

As a result Estonia now has a desovietized tax system which, at least formally, is among the most modern in the the former socialist countries.[19] Its future tasks are more in the nature of calibrating and making rate adjustments than of major reform.

Practical implementation

Estonian and foreign tax specialists concur that many taxes remain unpaid and that tax administration could be improved. Still, the practical implementation of the new rules has been successful in that the Estonian government has maintained fiscal control. The 1991 budget outcome shows a consolidated surplus equal to 5.5% of GDP, while the 1992 budget is in rough balance.[20]

In the Soviet context, it is not only surprising that Estonia was able to maintain fiscal control, but that it chose to do so. As an unwilling member of a collapsing federation, Estonia's short-run interest would have been better served by fiscal profligacy. The

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[18] For example, the whole personal income tax goes to local authorities, while the corporate income tax is split 65/35 between the national and local governments. For an extensive discussion of Estonian tax reform, see van Arkadie and Karlsson (1992).

[19] For example, Czechoslovakia is moving to a VAT only in 1993 (Svitek, 1992), whereas Estonia's VAT has been in place since January 1991.

[20] IMF (1992) and Statistical Office of Estonia (1991). This has been helped by the fact that little privatization has so far taken place, since private firms are more adept at avoiding taxes than are the traditional state firms. Also, as personal income taxes are withheld at the source, while interest and dividend income are still small, much of the assessed personal income tax can now still be collected.

resulting costs of financial instability would have been spread over the whole ruble zone, while the benefits would have been reaped locally. Instead, Estonian fiscal responsibility released some savings which were transferred at negative real interest rates to other republics. This pursuit of sensible policies, even without clear incentives to do so, raises the probability that such policies will now be continued when the incentives to do so are greater.

Money and banking reform

A major difference between an 'old' and a 'new' state is that the former must introduce a new currency before being able to run a monetary and exchange rate policy. Estonia was the first Soviet republic to openly discuss introduction of a separate money. An influential September 1987 proposal for economic independence included a call to make a 'convertible ruble' the currency of Estonia.[21]

Estonia subsequently became the first ex-Soviet state to leave the ruble zone.[22] On June 17, 1992, its Monetary Reform Committee announced that as of June 20, the sole legal domestic means of payment would be the *kroon* (crown). The conversion from the ruble was completed over a 3 day period. The exchange was nearly proportional, with most monetary values (prices, wages, assets, etc.) simply reduced by a factor of ten.[23] This was preferred to a more confiscatory reform, as open inflation had eroded any 'monetary overhang' which may have existed in the past (the average resident would convert less than 12 USD of cash rubles).

The principle of near-proportionality has been used in all monetary reforms in the former USSR and Yugoslavia (Slovenia, Croatia, Macedonia) and will surely be used in Czechoslovakia.[24] In all cases, a monetary overhang had either been eliminated or never existed. Yet, while all ex-Yugoslav republics have used a one-step reform, Estonia has been the sole ex-Soviet republic to adopt this method. In the FSU, the preferred method appears to involve two

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[21] For an overview of the evolution of Estonian economic policy until 1991, see van Arkadie and Karlsson (1992).

[22] For an overview of monetary reform developments in the FSU, and the specifics of the Estonian reform, see Hansson and Sachs (1992) and Hansson (1993).

[23] The exceptions were small amounts of cash (sums above 1500 rubles per capita) which were converted at a confiscatory rate, and some large recent transfers to bank accounts, the source of which was controlled before conversion at the 10:1 rate.

[24] For descriptions of the Slovene reform, see Chetkovich and Chetkovich (1992) and Pleskovic and Sachs (1992).

steps, between which the local currency and the ruble circulate in parallel.[25]

The main impact of the Estonian reform came from the accompanying policy changes. In developing new macroeconomic policy rules, the authorities specifically bore in mind that Estonia is a small, 'new' state undergoing a deep economic transformation. In this setting, three criteria are particularly important. First, a small, open economy should undertake policies which lead to a *stable and convertible* currency. Second, a country with little experience in running a monetary policy, and where 'fine tuning' is premature, should implement *simple and failsafe* policies. Third, as there will be great pressures to reflate and retreat from reforms, *institutional guarantees* should be created such that responsible policies will be maintained.

The Estonian strategy rests on three pillars; a balanced budget, a credibly fixed exchange rate, and a currency board rule of monetary emission. Budget balance was first strengthened by a decree (which took effect at the time of currency reform) raising the VAT from 10 to 18%, the previously progressive corporate income tax (with an average rate of 27%) to a flat rate of 35%, and the top personal income tax rate from 33 to 50%. These rates were later incorporated into the balanced budget for the second half of 1992, approved by the Supreme Council on August 26.

The kroon was pegged to the deutschemark by a law which also forbids the Bank of Estonia from devaluing it.[26] This provides a legal guarantee of exchange rate stability. By setting the initial rate at an undervalued level, the Bank of Estonia was also able to secure the kroon's convertibility.[27]

The key policy decision was the enshrinement in law of a currency board rule of monetary emission. The Law on the Security of the Estonian Kroon, passed on May 20, 1992, required the central bank to introduce the kroon with all cash and bank deposits fully backed by gold and foreign currency reserves (these totalled around USD 120 million at the time of the reform). As a currency board, the Bank of Estonia is now restricted to issuing additional kroon cash and reserve deposits only in exchange for new foreign exchange receipts.

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25 Latvia, Lithuania and Ukraine all moved to national currencies via a parallel currency phase. As other republics which promise to introduce national monies have also introduced 'coupons' as ruble substitutes, they are also likely to remove the ruble by making 'coupons' the sole domestic means of payment.

26 For a compilation of the major laws and decrees of the currency reform, see Bank of Estonia (1992).

27 As the German mark was then worth 70-80 rubles, the 'proportionality' principle was used to set the kroon's external value at one-tenth of this rate, or 8.00 EEK/DEM.

As the kroon must always be fully backed, present and future convertibility is nearly guaranteed. As the Bank of Estonia could, in principle, redeem every kroon without running out of reserves, a speculative run leading to devaluation is unlikely. The currency board rule is extremely simple to implement. Finally, the enshrinement in law of a currency board creates a strong bulwark against pressures to run irresponsible monetary policies.

During its first months, the kroon has been more surprisingly successful. It quickly became convertible for current account purposes and for repatriating foreign direct investments, while most capital account transactions require only registration. Cash or account kroons are traded in Finland, Latvia, Lithuania and Sweden, and convertible currency payments operate relatively smoothly.

The kroon has also been stable. The Bank of Estonia has rigidly maintained the 8 EEK/DEM parity, even through the September exchange market crisis, while the Russian ruble has plummeted from 75 to 250 per DEM.

In response to its stability and convertibility, the kroon has become the actual sole means of payment within Estonia. Gone are both the ruble and the previously ubiquitous hard currency shops. The result has been greater competition in domestic trade and the wide availability of imported goods.

Contrary to initial fears, the Bank of Estonia has experienced an inflow of foreign exchange reserves, which by the end of August had grown by USD 20 million, or by about 40% of the initial base money emitted by the Bank of Estonia. Part of this reflects reverse capital flight in response to the favorable interest rates (up to a 36% annual rate for 3 month term deposits) now available in Estonia.

All of the news has not been good. In the first three months after monetary reform, measured inflation was 56%, which is still near Russian levels.[28] Part of this had been expected, especially as the VAT had been raised, and part reflects measurement problems, but much of it was not. The result has been a severe squeeze in living standards, which has created pressure for increases in nominal wages. While an earlier shortage of cash has been eliminated, the payments system within Estonia and with the ruble zone continues to function poorly. Still, the overall impact on the economy has been positive and farreaching.

In the area of banking reform, Estonia is following the same general plan as the other ex-socialist states. The central bank has

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[28] The difference with Russia is that its inflation is now accelerating, while Estonia's inflation rate has declined each month (24.3, 17.6 and 6.7%, respectively).

divested itself of commercial functions, creating a two-tier banking system. Its statutes grant it formal independence from the government. Finally, it is learning the difficult task of regulating the many new commercial banks, having intervened three major banks which had been experiencing severe payments problems in November.[29] Political independence has changed things only by allowing Estonia to choose the pace at which it undertakes these reforms.

IV. Domestic Liberalization

Post-monetary reform Estonia faces the same challenges as the 'old' former CPEs in liberalizing its domestic economy; removing most remaining price controls, reducing remaining subsidies, and passing and implementing a competition law. As in other smaller states, these steps must be coordinated with external liberalization, which will become a key influence on prices and the competitive environment.

Before currency reform, the situation was somewhat different. Lacking monetary and exchange rate policies, Estonia attempted to 'stabilize' its economy through the use of price policy. Until mid-1991, when inflationary pressures were still modest, price controls were maintained in an attempt to damp inflation.[30] Once these pressures became severe, and led to extreme repressed inflation (incl. shortages and black markets), Estonia changed to the other tack of freeing prices in an attempt to 'outrun' Soviet inflation. The goal of controlling inflation was subsumed to that of restoring balance between aggregate demand and supply.

Only with the introduction of the kroon was price reform again made a microeconomic issue, with the bulk of stabilization now undertaken via normal macroeconomic policies.

V. Privatization

Most issues which arise in privatizing Estonia's state-owned enterprises are the same as those in any ex-socialist economy. The actual development of privatization has also mirrored that in the 'old' countries, with sale of small enterprises proceeding relatively rapidly and quietly, while large-scale privatization has been slow and controversial.[31]

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[29] See *Baltic Independent*, 20 November, p. 1, and *Baltic Observer*, 26 November, p. 1.

[30] For an overview of the emergence of extreme inflationary pressures in the Soviet Union, see Hansson (1992).

[31] For an overview of recent privatization experience, see Åslund (1992).

One hindrance to privatization in the ex-Soviet and Yugoslav states, which is not directly related to being in a phase of nation-building, is the environment of extreme inflation and financial instability. In this milieu, accurate valuation of property is nearly impossible. Since valuation is a cornerstone of most privatization methods, this has slowed the sale of state assets.

Also, when financial assets have a highly negative expected rate of return, as has been the case in the ruble zone, there is a natural fear that real assets will not be purchased for use in production, but rather to be kept as idle stores of value. In an attempt to avoid this, privatization authorities have sometimes required new owners to make commitments about the use of these assets. For example, purchasers of farmland might have to promise to undertake active cultivation, while purchasers of shops might be required to continue in the current general activity for a specified time period. These restrictions require sale methods which are slower and less transparent than the auctions that could safely be used in a more stable macroeconomic environment. In this respect, the financial stabilization resulting from the monetary reform could reduce these barriers, and hence speed privatization.

Two influences on privatization which do stem from Estonia's being a 'new' state, and which complicate this process relative to the 'standard case', are political. First, both in formal international law and in the perception of ethnic Estonians, Estonia is not in fact a new state, but an existing state whose independence was restored *de facto*. Following the failure of the August coup, states which had recognized Estonia in 1940 stressed that they were not recognizing a new state, but simply restoring diplomatic relations. The first act of the new parliament elected on September 20, 1992, was also to declare that the current Republic of Estonia is legally the same state as that which existed in the inter-war period.

This fact, which is well-known to almost every Estonian, has had a psychological effect on the privatization process. Namely, the restoration of nationalized property to previous owners is in some sense viewed as the micro-level analogy to the restoration of the Estonian state.[32] Restitution and/or compensation of such property has found strong political support. The attempt of the first Popular

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[32] For example, the legal scholar Paul Varul, who has worked on drafting much of Estonia's commercial and privatization legislation, recently wrote: "If no one doubts that the events of 1940 were nothing other than occupation, then one cannot make different fundamental decisions concerning previous owners. It is impossible to link two things: we recognize the fact of occupation, but legalize all resulting developments in the area of ownership." (*Postimees*, 29 October 1992, p. 5).

Front-dominated government in 1990-91 to downplay restitution simply stalled the privatization process until this was reinstated.

Second, the debate over which methods to use in privatization is influenced by the legacy of the demographic changes which took place during Soviet rule. Different methods will differently distribute the initial privatized wealth between ethnic groups. At one extreme, extensive restitution and/or compensation of nationalized property would give relatively more property to pre-war residents and their descendants, i.e. largely to ethnic Estonians. At the other end, as post-war immigrants are less likely to own their apartments and more likely to work in industry, options such as free distribution of some enterprise shares to workers, or of rental apartments to existing tenants, would tend to favor non-Estonians.

As a result, the support for different privatization methods has been split along national lines. Estonians have favored restitution and voucher privatization, especially of housing, where the voucher allocation is based on years worked in Estonia.[33] Non-Estonians have favored schemes of free distribution to existing workers or tenants. As the choice of method is linked to emotional issues, such as the struggle for independence and the legacy of mass immigration during Soviet rule, debates on the choice of method have been impassioned and drawn out. This has markedly slowed the privatization process.

The actual model, while still fluid, is a hybrid which lies somewhat closer to the 'Estonian position'. Previous owners or their descendants can claim restitution for property existing before Soviet rule. Housing privatization will occur using vouchers, the size of which is based on years worked in Estonia (adjusted for military service and years spent in labor camps). Most small- and large-scale privatization will be undertaken as sales for cash, but with some privileges for existing workers and managers.

The choice of privatization method in Estonia, as in other 'new' countries, is also conditioned by a desire to ensure that most assets are initially purchased by local residents.[34] Very open, uncontrolled methods, which could lead to the dissipation of ownership over whole FSU, are frowned upon. The prospect of Latvians owning

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[33] Those who already own their lodgings could sell their vouchers or use these to acquire small firms or shares in large enterprises.

[34] This aversion to extensive foreign ownership is rather general. Nordic countries have long placed restrictions on foreign ownership of land, and have required some shares sold to foreigners to have negligible voting rights.

Estonian industries and vice versa, meets little favor in either country.

Again, these sentiments tend to favor voucher privatization based at the level of the 'new' nation. Many ex-Soviet republics, including all Baltic states, are now pursuing voucher privatization by along their own rules. Similarly, the CSFR voucher privatization scheme was quickly converted to a republican basis, i.e. vouchers could be used only in the republic in which they were issued, once the dissolution of the CSFR became certain.

VI. Economic Restructuring

As its economy is transformed to one which is appropriate for an independent country operating in a market environment, Estonia will go through the same qualitative changes as other ex-socialist countries. The share of national income generated by industry will decline while the long-neglected service sector begins to develop. Within agriculture and industry, the relative importance of sub-sectors will change. The extreme concentration of the communist economy will give way to a structure with fewer large units and more smaller enterprises and farms. Finally, firms will undergo internal management and organizational changes.

The difference between Estonia and most 'old' states is quantitative. The required changes in Estonia will be larger, simply because its economy is more distorted. Terms-of-trade within the Soviet Union were very different from those which prevailed on the world market, or even within the CMEA. Compared to Hungary and Poland, where some previous liberalization had taken place, Estonia's internal relative price structure must be more distorted. The existence of specialized plants designed to serve the whole Soviet market means that many enterprises are too large and too concentrated in their activities. While a gravity model of foreign trade would likely predict that less than one-half of trade should be with the FSU, the actual figure has been over 90%. Finally, with less prior reform than in most 'old' CPEs, the internal organization of enterprises will have to undergo larger changes.

The area in which required changes are most obvious is that of physical infrastructure. Estonia's previous integration into the Soviet system means that transportation links towards the East are relatively well developed. Similarly, the negligible trade volume between the Baltic States and with western Europe, means that North-South links and links with the West are weak.[35]

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[35] For an overview of the existing transporation infrastructure, see van Arkadie and Karlsson (1992).

As trade with Russia becomes less significant, while trade between the Baltic States will increase, the North-South links will need to be expanded and improved. As more East-West trade will not be Russian-Estonian trade, but Russian transit trade passing through Estonia, the current East-West infrastructure within Estonia will have to be complemented with expanded port facilities. Finally, as the economy adjusts to live within its new borders, some of the infrastructure will need to be adjusted to the new domestic needs.

VII. External relations

If most of the 'new' states share anything in common other than their 'socialist' heritage, it is that they are small (Russia and Ukraine being the two exceptions). Given that they arose from the breakup of other states, this is not surprising.

Among the 'new' states, Estonia has the smallest economy and population, which naturally makes it highly dependent on foreign trade. In 1991, the average of recorded exports and imports was 45.5% of net material product.[36]

In the area of external relations more than any other, the 'pure' impact of economic reform is hard to distinguish from the effects of nation-building. One way to do this is to consider how the Estonian economic transformation might have evolved, had the Baltic States remained part of a unitary Soviet Union that had undertaken a radical economic reform program including largely free prices, an open economy and an internally convertible currency. Judging from the experience of the 'old' Central and Eastern European countries which have chosen this path, and of Russia, the following four things would most likely have occured:

a) A change in the direction of trade. Trade with the West would have grown relative to trade with Soviet republics.[37]

b) A change in the sectoral composition of trade. Different sectors would have been differently affected by the net impact of economic restructuring on supply, and of opened borders and altered relative prices on demand.

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[36] Statistical Office of Estonia (1992a).

[37] Analogously, Russia's external trade is now faring much better than its economy as a whole, with export volumes to many western European countries rising.

c) A drop in volume of trade with Soviet republics. The temporary disruption arising from economic reforms would in any case have broken existing links.[38]

d) A collapse in the terms-of-trade. A move to largely free prices in an open economy would have eventually brought the same increase in the price of energy and other imports which Estonia is now facing.

These changes are also taking place in independent Estonia. Relative to this reference point, the achievement of state sovereignty changed three things:

a) The time sequence of the terms-of-trade shock. Estonia's foreign trade has moved to world prices faster than it would have without independence. Experience has shown that the greater the independence which a country has achieved from Russia, the faster it has been forced to trade at 'world market prices'. Even within the CIS, countries which leave the ruble zone are likely to face higher prices than those which do not.

b) The size of the trade volume decline. The fall in Estonia's trade volume has been increased by financial and border problems resulting from independence. Were the ruble as stable and convertible as the kroon, monetary independence need not have made much of a difference. As it turned out, payments by ruble zone enterprises are generally cumbersome (even within the same city), but particularly so when crossing state boundaries. One difference is that while Russian commercial banks clear payments between themselves at the Central Bank of Russia, inter-state payments also introduce the central bank of the other state. Other problems include the teething pains of learning a new payments system and the thinness of a new foreign exchange market in a small country, which reduces liquidity and increases buy-sell spreads.

Border-related trade barriers include time delays, licenses and other quantitative restrictions, and tariffs and export taxes. These new arrangements have also been introduced in a cumbersome way.

c) The magnitude of the direction of trade shift. As the financial constraints have primarily damped trade with former Soviet republics, and as Estonia has been more successful than the CIS

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[38] Analogously, there is surely now a drop in the volume of trade between St. Petersburg and the rest of Russia, i.e. within the same country, arising from the restructuring of the former's industry.

states in signing free trade agreements with the West, the direction of trade shift towards the West has been greater under independence.

The final dimension of external economic relations, which is by definition irrelevant in 'old' states but unavoidable in 'new' ones, is the eventual division of various assets, liabilities and claims. Where the divorce is by mutual consent, as in Czechoslovakia, this settlement can be clean and rather amicable. In the Soviet and Yugoslav cases, where the breakup has been bitter, and where the negative memories of (or the nostalgic longing for) empire are often strong, these issues are messy and still unresolved.

Even after several rounds of negotiations, very little can be said about the form of the final settlement. Power politics and international pressure will play major but as yet unclear roles. While the size of the net burden which one side or the other will bear is not clear, the form of some individual burdens is beginning to emerge. Estonia says it will not accept any of the external debt of the Soviet Union. As this claim is strengthened legally by the fact that most states which existed in 1940 merely restored diplomatic relations with Estonia, i.e. they implicitly view the period 1940-1992 as one of forced occupation, this is also a not unlikely outcome.

At the same time, the withdrawing Russian army is taking along or destroying most of its equipment and buildings. As most of this will be difficult to recover, Estonia will have the new burden of outfitting its armed forces. Even though these will be miniscule in comparison to the historic size of Soviet forces in Estonia, the financial burden will be be enormous relative to Estonia's economic potential. Building up even the smallest navy or air force is out of the question in the next few years.[39]

VIII. Conclusions

Estonia's 'dual economic transformation' exhibits unique elements as well as some general features common to all 'new' states undertaking economic reforms. If the analyst can commit one mistake, it is to generalize too much from the Estonian experience.

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[39] If one compares only Soviet debt and Soviet military hardware, the simple arithmetic of allowing Russia to keep both is strongly in Russia's favor. If the Soviet external debt is around 70 billion USD, a simple per capita division would make Estonia's share 400 million USD. If one also divided the value of all Soviet military assets on a per capita basis, the value of Estonia's share would surely exceed this sum. If one instead adopted a territorial principle, and remembered that several important airforce bases and a major nuclear submarine base are located in Estonia, the calculation would be dramatically in Russia's favor.

After all, the collapse of the previous states reflects a desire by the 'new' nations, exhausted from marching in step, to choose separate paths of development. The difference of views on economic reform strategy in the Czech Lands and Slovakia is only one example. Over time, these countries will begin to have less and less in common.

Also, the recent political histories of the ex-Soviet, Yugoslav and Czechoslovak states are quite different. The CIS members and the Czech and Slovak Republics are or will be true successor states, having gained independence simultaneously and through mutual recognition. The ex-Yugoslav republics other than Serbia and Montenegro are secessionist states, having gained recognition (weak in the case of Macedonia) *for the first time*, after issuing unilateral declarations of independence. In contrast, the Baltics are 'restored states' which did not secede, but simply regained their previous independence *de facto*.

Each type of country faces its own issues and problems. A restored state such as Estonia will more or less explicitly seek to rebuild much of what existed in the past. The desire to reduce trade links with Russia and increase them with the West (which speeds reforms), and to emphasize the restitution of nationalized property (which will slow reforms), all reflect this wish to partly restore what existed in the past.

The 'new' states also differ in the coherence of their future vision. The greater is the social consensus on where it should head in the future, the smoother its economic transformation will be.

Still, a summary comparison of the Estonian case with that of the other 'new' states reveals some trends which are rather general. First, the quest for independence is partly motivated by a desire to protect against economic shocks and/or the pace of reforms in other regions of the previously unified state. Estonia sought to escape the financial chaos of the ruble zone, and Slovenia the effects of a massive issuing of credits by other Yugoslav republics. Slovaks see independence as a way to slow 'overly fast' reforms, while Czechs may see it as a way to further speed these changes. This quest for insulation makes the 'new' states unenthusiastic about economic cooperation with other regions of the previous state. If cooperation does take place, it is more out of perceived necessity than innate desire.

Second, this protective stance is generally partial, as these states simultaneously and aggressively pursue new links with some neighboring regions outside the previous state. Estonia is actively building ties to Finland, Sweden and the EC; Slovenia to Austria and the EC; and the Muslim ex-Soviet republics to Turkey and Iran. In cases where the consensus about a 'return to Europe' is great (Czech

Republic, Estonia, Slovenia), this prusuit of new ties is particularly active.

Third, independence has exacerbated the short-run terms-of-trade shocks faced by most of these states. The reaction of the former metropolitan center is logically one of "You asked for independence, now live with it!"

Fourth, the 'new' states must undertake more restructuring than would have been required without independence. The new physical and financial boundaries impact on the environment in which economic activity takes place. The physical infrastructure will also need to be remade to suit the new boundaries and to link with newly important trading partners.

Finally, difficult ethnic relations can slow economic reforms. Slovenia and the Czech Republic, which are ethnically homogeneous, can most easily focus on economic issues. At the same time, ethnic conflict is not simply linked to the physical size of ethnic groups. A small but entrenched ethnic community, such as Poles in Lithuania or Serbs in Croatia, can be the source of much greater conflict than a large but footloose community, such as the Russians in Estonia.

If there is one quintessential step which the 'new' states will take, it is the introduction of a national currency, as it is the vehicle for achieving most of the goals noted above. Both for symbolic and real reasons, it is an important part of nation-building. As it allows autonomous monetary and financial policies, it is the vehicle for escaping the financial shocks in the previous state, be these from a too loose or overly tight monetary policy. If it is made stable and convertible like the Estonian kroon, it becomes a vehicle for the economic 'return to Europe'. Finally, as it gives the 'new' states an exchange rate instrument, it facilitates their absorption of the terms-of-trade shocks brought on by independence.

The ex-Yugoslav republics, the Baltic States and Ukraine have achieved monetary independence. In contrast, some CIS states and the Czech and Slovak republics are still discussing (possibly temporary) monetary unions. If monetary independence is really the main step in economic nation-building, these efforts will likely be more short-lived and problematic than their current supporters expect.

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