



Tallinn, Estonia

What the West Can Learn from Eastern Europe About Reform

By Johnny Munkhammar

A reason why Donald Rumsfeld's quip about certain parts of Western Europe being "old"—indirectly implying that other parts represented the new—created such a stir was probably that he just put words on the thoughts of many. During the turbulent years when the Berlin Wall came down and the Iron Curtain was lifted, there were many worries and fears for the future. A general belief was that the countries in the East would never be able to compete with the West and would most likely be dependent on foreign aid for decades. There was also a debate about whether they should choose stepwise reforms or "shock therapy" to get away from the disaster of the

centrally planned economy. Today, we can see the astonishing results. Most countries in Eastern and Central Europe have developed better than anyone dared to hope, due to free-market reforms, and the countries that have done so best were the ones that launched the most radical reforms. This has, in turn, enhanced competition and reform throughout Europe. In 2003, the year before the eastward enlargement, 36 reforms to facilitate doing business were carried out in European countries out of 89 globally, and eight of the top ten reformers were European.

Foreign direct investment in Eastern and Central Europe has boomed, with European



Union companies investing about \$150 billion in these countries since the early 1990s. Exports increased strongly following liberalization of foreign trade. Hungary's exports rose, for example, by 380 percent, and Czech exports rose by 280 percent in the 10 years before EU entry. Incomes have risen, and poverty rates have fallen. The high growth rates of Eastern and Central Europe have also contributed to higher growth rates in Western Europe. The 10 new EU countries from Eastern and Central Europe, with some 100 million inhabitants, still account for only about 7 percent of EU GDP—the EU had 492 million inhabitants in January 2007—but the share is growing.

It is sometimes claimed that most of this growth is just about catching up with the wealthiest countries and that when these countries do so, their growth will fade. It is probably partly true that they are catching up, helped to a great extent by the availability of imported technology and skills. But the evidence suggests that catching up is just a small part of the explanation. If catching up by poor countries was an automatic mechanism, why did it happen *now* in Eastern and Central Europe and not in the 1970s or 1980s? A country like Ireland was said to be just catching up, only for it to then surpass most other nations in the prosperity stakes. It is more a matter of growth-friendly institutions and policies, such as openness to trade, low and flat taxes, deregulated markets, improved macroeconomic frameworks, low inflation, and limited public expenditure.

The starting point for these countries in the early 1990s was very different from the situation in most other OECD countries today. They were poor, and the old system was obviously totally incapable of delivering anything but problems. Still, there are reasons to take a look at these countries in a reform perspective today. First, it is important to see which policies actually work and what direction reforms should

take. Second, there are strategic lessons: There were great problems 15 years ago, but there were also obstacles to reform and uncertainty about its direction and speed, and it was hard to know where to begin. Third, a main cause of economic problems, especially in Western Europe, has been excessive state intervention in the economy, and the problems in Eastern and Central Europe had a similar root, though different in extent. Ivan Miklos, former finance minister of Slovakia, thinks there is much for the West to learn. “The areas that need reform, such as social security systems, labour markets, welfare services, are largely the same and the reasons for the problems are similar.”

Every country in Eastern and Central Europe has an intriguing story to tell, and it has been told eloquently and extensively elsewhere. Two—Estonia and Slovakia—can illustrate the success and may be of particular use when analyzing reform strategies.

ESTONIA'S RADICAL REFORMS

Estonia today has a population of 1.3 million. I visited the Estonian capital of Tallinn in 2007, 14 years since my last visit, and found the difference dramatic. In 1993, two years after the liberation from the Soviet Union and Communism, the Hanseatic city of Tallinn was deeply depressing. Houses were falling apart, the streets were dirty, there were hardly any restaurants, and people seemed genuinely miserable. Army hats from the Soviet Union and vodka were two of only a few products sold on the street corners. Tallinn today is simply shining. There are many new office buildings, the old town has been renovated, restaurants abound, people communicate a sense of well being, technology seems to be present everywhere, and there is activity wherever you look. Of course, some parts of the city still retain traces of the old, but what has happened is nothing short of remarkable.

Tallinn shows what happens if a country



launches radical free-market reforms. In 2006, growth in Estonia exceeded 11 percent. Average income has risen by 120 percent in the last 10 years. Incomes for the 10 percent with the lowest incomes have risen by 160 percent. The Estonian Environment Information Centre shows that the environment has improved in many ways in Estonia, again stressing the need to grow economically to get greener. According to the World Database of Happiness, Estonians are also much happier today, which is also apparent in most other reformist countries for which there are sufficient time-series data. Estonia is now a member of the EU and NATO.

Under the leadership of Mart Laar, Estonia swiftly abandoned the collapsing centrally planned economy. Instead, the recipe was privatization, deregulation, tax cuts, and e-government. In 1994, Estonia introduced a flat tax of 26 percent for everyone regardless of income. Laar was warned that a flat tax would be impossible. It was not. Tax revenues have increased every year since 1994, despite reductions in the tax rate to 22 percent (soon to be 18 percent). The current government's state aim is a 12 percent flat tax. Estonia actually initiated the flat tax trend.

Many of Estonia's reformers were not politicians initially. Laar, for instance, was a history professor. But since the established politicians were part of the old system, there had to be new people coming in. A main question at the time was, of course, whether they should emulate the economic and social policies and systems of Western Europe, but they chose not to, because they wanted to achieve different results. However, they did get many of their ideas from Western think tanks and institutes. The political leaders were not experts in economic theory

or policy, but they knew the broad picture.

The reformers faced resistance from special interests, and in countries that had experienced a large amount of propaganda about the dangers of the market and the decadence of the West, there were fears and counter-reactions at first. But there was decisive political action, and the opponents were confronted. The abolition of all tariffs on foreign trade by Estonia—the first country to do so unilaterally after World War II—is also an interesting case of reform strategy. The Estonians believed they had to abolish all tariffs, without exception. Allowing some tariffs would have provided other industries with an argument to have tariffs for their protection, creating a slippery slope toward more trade restrictions.

SLOVAKIA'S "GOLD RUSH"

Going a bit further to the south, then, what are the reform lessons from Slovakia? In 1993, Czechoslovakia was peacefully dissolved (it had existed since World War I after the dissolution of the Austro-Hungarian Empire) and the Slovak Republic was founded, with a population of 5.5 million. For most of the 1990s, Slovakia did not reform like other countries in the region, and its political leadership under Vladimir Meciar was authoritarian and populist. Slovakia's prospects looked bleak, and it seemed unlikely that the country would be able to join the EU in the foreseeable future.

In 1998, a new government was elected. It proceeded to launch a series of reforms, including a flat income tax rate of 19 percent, privatization, deregulation, macroeconomic stabilization, and increased openness. The economic growth rate became one of the highest in Europe at 5 percent to 8 percent annually, and unemployment dropped from 19 percent in

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2000 to 13.6 percent in 2006 (still quite high). In 2004, Slovakia was among the 10 new European Union entrants, having enacted substantial reforms to meet the entry criteria. Following the economic reforms, Slovakia managed to attract considerable volumes of foreign direct investment. Indeed, the country has become the world's largest producer relative to its size. A visitor to the capital, Bratislava, these days will still find that the Communist regime's highway cuts brutally through the Old Town, but they will also see many signs of progress.

The reformist government was re-elected once, but in the election of 2006, the opposition formed a new coalition government. The government is led by Robert Fico of Smer, the party of Vladimir Meciar has returned, and there are a few xenophobic forces involved. In the election campaign, Fico promised to roll back reforms, especially the flat tax, in order to end the Slovakian "gold rush," which was odd, given how much Slovaks had benefited from the investments. This was widely reported as evidence that reform was unpopular and that reformers tend to lose elections. However, the main party of the previous government—and indeed the most reformist one—gained votes in the 2006 election. It was the lack of support for some smaller parties and their tactical moves that in the end paved the way for a new government. Contrary to some reports, therefore, democratic support for the Slovak reformers actually rose in 2006.

Since the 2006 elections, none of the main reforms, including the flat tax, has been rolled back as promised. True, the new government is not pressing ahead with further reform, but neither is it undoing what has been done. This is an important lesson, also confirmed by similar developments in many other reformist countries. Reforms are usually not repealed, simply because although they may be unpopular at first, nobody wants to go back afterwards. The next election outcome remains to

be seen, but it is a fact that it is the previous government's efforts that pulled Slovakia out of misery to success, and that is already part of the history books.

LESSONS

One lesson from Eastern and Central Europe has been that radical reforms do not always produce immediate positive results. There will be a period of transformation that also poses difficulties. The results will come—and will be more positive if the reforms are more radical—but it takes political persistence. Voters do not necessarily prefer far-reaching changes in these countries either, and the political situation in Eastern and Central Europe has been somewhat problematic in the last few years. Important further reforms have stalled. Still, the success of many countries in Eastern and Central Europe is enormous when their situation today is compared with the reality 15 years ago.

An international comparison with other wealthy countries is favorable for these countries in many respects, but it is also apparent that they need to do more. There have been a number of reforms of macroeconomic frameworks, product markets, state-owned companies, taxes, and trade. But as in Western Europe, a great deal remains to be done with regard to welfare services, social security, and (for countries like Poland) labor markets. Long-term trends such as globalization will, of course, have an impact, and demographics pose a bigger challenge for many countries in Eastern and Central Europe than for others.

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