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The Choice of Reforms and Economic System in the Baltic States

KARSTEN STAEHR

Tallinn University of Technology, Tallinn, Estonia.
E-mail: karsten.staehr@ttu.ee
Eesti Pank, Tallinn, Estonia.
Department of Economics and Finance, Tallinn University of Technology, Akadeemia tee 3-486, 12618 Tallinn, Estonia.

This paper discusses the reforms that introduced market-based economies in the three Baltic states and seeks to identify particularities defining the resulting economic system. The reforms were rapid and broadly based and involved particular measures such as currency boards, free international trade, flat taxes and funded pension systems. The result was liberal-market economic systems with more emphasis on private enterprise, high-powered incentives and small governments than in most other post-communist countries. The unique choice of reforms may be seen as paradoxical given the proximity of the Baltic states to the Nordic welfare states. The choice may partly be explained by the initial economic and structural conditions of the countries, but the democratic and political dynamics as well as the preferences and values of the public are arguably of greater importance.
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INTRODUCTION

The Baltic states regained their independence from the Soviet Union in August 1991 and new democratically elected governments set out to reform the

economies. An observer coming to Tallinn, Riga or Vilnius in the early transition phase might have wondered which direction the economic reforms would take and how the economies might end up being organised in the longer term. It would be natural to speculate that the Baltic states would seek inspiration from their former master Russia or from the Central European countries which started their reforms early or perhaps from the Nordic countries with which there are close economic and cultural ties. In the end, the Baltic states chose their own transition path and economic systems that in many ways are unique.[1]

This paper discusses the economic reforms and the resulting economic system of the Baltic states and seeks to explain the choices of the countries. The debate on the choice of economic systems in Central and Eastern Europe has been rekindled by the divergent performance of the countries during and after the global financial crisis (Atoyan, 2010; Becker *et al.*, 2010; Farkas, 2016; Kornai, 2016).

The post-communist transition has been labelled the dual transition as it implied fundamental reforms of both the economy and the political system. Along these lines, the transition in the Baltic states could be labelled the triple transition since it also implied the establishment of new national administrative and institutional structures. This is important because of the inherent paradox of the economic transition since the government is responsible for the transfer of economic decision-making from itself to the private sector (Islam, 1993; Kuzio, 2001).

Analysis of the economic reform process is particularly pertinent in the case of the Baltic states. The Baltic states managed to leave the Soviet Union and join the European Union in little more than a decade. The admission to the EU bore witness to the countries managing to establish democratic rule, functioning market economies and administrative and institutional structures to satisfy the *Acquis Communautaire*. The economic reform process in the Baltic states has had implications for developments in other post-communist countries, as they have adopted reform elements that were initially unique to the Baltic states (Åslund, 2010).

Many studies of the post-communist economic transition have focused on economic reforms, which are the *means* of attaining changes in the organisation of the economy, while the literature has dwelt less on the implicit choice of economic system and the institutional and structural *goals*. It has often been assumed that the objective of the transition would be a market-economic system, but the specifics of that system have received little

[1] The term *economic system* is used here to signify the organisation of production and distribution of resources in an economy; see the next section for further discussion.

attention. This approach overlooks the substantial differences to be found in the organisation and functioning of various market economies, differences that may be of great importance for the well-being of individuals and the performance of the economy in the short and long terms (Gregory and Stuart, 1995; Eichengreen, 2007).

Bohle and Greskovits (2007) categorise the economic systems that resulted from 15 years of reform in Central and Eastern Europe. The reforms in the Baltic states led to a liberal economic system with little government intervention, while the reforms in Slovenia led to a system with many corporatist or cooperative hallmarks. The rest of the post-communist countries in Central and Eastern Europe are seen to have intermediate systems in which the government retains an active but not corporatist role in the economy. The contributions in Lane and Myant (2007) discuss the varieties of capitalism that emerged in a broadly defined set of post-communist countries. Buchen (2007) compares Estonia and Slovenia and reaches the conclusion that the role of the government differs markedly in the two countries.

Only a few studies have detailed the reforms or the resulting economic system in the Baltic states. An early contribution is van Arkadie and Karlsson (1992), which provides a discussion of the challenges and early reforms in the three countries. OECD (2000) gives an account of the first decade of economic reforms and the economic results, but does not consider the specificities of the economic system that was established. Norkus (2011) combines a number of indices of institutional and organisational structures and concludes that there is a "neoliberal Baltic capitalism model" (p. 24) with Estonia standing out as the most clear-cut case. Hubner (2011) assesses the reforms and the economic performance in the Baltic states and argues that "unfettered liberalisation" led to an unwarranted dependence on capital inflows, with adverse consequences during the global financial crisis.

This paper sets out to address two main issues. First, the paper examines the hypothesis that the Baltic states followed a distinct reform path that led to an economic system which differs markedly from those in the neighbouring countries. Both quantitative and qualitative information is used to analyse the reform path and the resulting economic system. Second, given that the first question is answered affirmatively, the paper asks why the Baltic states made choices that differed so markedly from those of its neighbours. It may indeed be seen as paradoxical that the Baltic states had extensive economic and political contacts with the Nordic countries but nevertheless chose reforms that led to very different economic systems.

The paper finds that the economic reforms in the Baltic states broadly based and rapid and typically implied free markets, limited government intervention and high-powered incentives. Estonia was the most avid

reformer followed by Latvia and Lithuania. The reforms led to what can be categorised as a liberal-market economic system, unlike the systems in most other post-communist countries. The choice may seem surprising given that the Baltic states had extensive political and personal contacts with the Nordic countries and Germany, all of which have a different economic system. The choice is partly related to the initial economic and structural features of the Baltic states, their democratic and political dynamics, and the preferences and values of the public.

The rest of the paper is organised as follows. The next section contains a brief discussion on the classification of economic systems. The following sections provides an analysis of economic transition indicators for the Baltic states and other post-communist countries, a discussion of some qualitative aspects of the reforms in the Baltic states and a synthesis linking the economic reforms with the resulting economic system. The second-last section contains a discussion of a number of key factors that can have affected the choice of economic reforms in the Baltic states. The last section summarises the paper.

ECONOMIC SYSTEMS

This section provides a brief background to the literature on varieties of capitalism and the categorisation of economic systems. It aims to clarify the factors that are used to identify different economic systems and explain the categorisation used in the rest of the paper.

The term *economic system* is a collective label for the institutional and regulatory organisation of the production and distribution of resources within a political entity (Gregory and Stuart, 1995, ch. 2). The economic system is of importance for different measures of economic performance such as income, unemployment and inflation, which again affect economic welfare. A process of economic reforms changes the institutional and regulatory organisation of an economy and, as such, is a key determinant of the ensuing economic system.

Measuring and classifying economic systems is difficult as different systems are composed of numerous institutions, regulatory regimes and administration practices. It is customary to focus on four partly overlapping dimensions or attributes of economic systems, these being the organisation of decision-making, information exchange and coordination, property rights and economic incentives (Gregory and Stuart, 1995, ch. 2).

A government is able to affect the attributes of an economic system, and they generally do so. This makes the *role of the government* in the economy the main axis of characterisation. The command economy is characterised by

invasive government measures as decision-making is centralised, production is coordinated through plans, most means of production are state-owned and incentives may partly be provided through coercion. The capitalist economy is characterised by decentralised decision-making, market-based allocation, private ownership and high-powered economic incentives.

Among capitalist economies, it is useful to distinguish between different systems reflecting different *varieties of capitalism* (Hall and Soskice, 2001). First, a *liberal-market* system is one where the functioning of markets is relatively unconstrained by government intervention, private ownership and free enterprise dominate, and economic incentives are not affected much by redistribution. Second, the *activist* economic system is a system where the government has a pronounced role in the economy, and decision-making is centralised due to direct government intervention in the economy. Third, the *cooperative* or *corporate* system entails a coordinating and less direct role for the government, as decision-making and some control rights are determined through negotiations and mutual agreements between organisations in the economy (Hall and Soskice, 2001; Bohle and Greskovits, 2007).

The division into three capitalist systems provides a good starting point, though it brushes over many intermediate and partly overlapping cases. Eichengreen (2007, ch. 13) argues that all three capitalist economic systems can be identified on the map of Western Europe, with the liberal-market system in the UK and Ireland, the activist system in Latin Europe, and the coordinating system in countries like Germany, Austria, the Netherlands and the Nordic countries.

The literature on economic systems and varieties of capitalism typically stresses *path dependence*, which is unsurprising, given that institutions and organisational structures evolve gradually (Hall and Soskice, 2001). It is seldom the case that economic systems undergo wholesale changes that essentially break the path dependence. The transition process in the post-communist countries is thus a unique experience where the economic reforms implemented from around 1990 precipitously changed the economic system in most of the countries.

The categorisation of economic systems in this article follows Hall and Soskice (2001), but there are evidently other categorisations. Amable (2003) conceptually identifies five systems of capitalism, these being the market-based, social-democratic, Asian, Continental European and South European forms of capitalism. The global financial crisis appears to have affected the countries with different systems to varying degrees, though there is no one-to-one relationship. Farkas (2016) discusses the economic systems in the EU countries with particular reference to the developments after the global financial crisis. She favours a distinction between the systems of the Nordic, North-Western, Mediterranean and Central and Eastern countries, but stresses

that this categorisation is derived empirically and does not reflect geographical conditions *per se*.

ECONOMIC REFORM INDICATORS

There were various components in the economic reform package in the post-communist countries (Blanchard *et al.*, 1991). This section discusses quantitative indicators of the key reform components. This makes it possible to assess how fast and comprehensive the reforms were and to identify clusters or groups of countries with relatively similar reform components.

The European Bank for Reconstruction and Development (EBRD) produces six different transition indicators that are often used to assess the extent of reforms within the areas of liberalisation, privatisation and structural reform. Each of the indicators takes a value from 1 to 4.33, where 1 is the level in a tightly state-controlled economy and 4.33 the highest level in a well-functioning market economy. The individual transition indicators are: (1) trade and the foreign exchange system, (2) price liberalisation, (3) small-scale privatisation, (4) large-scale privatisation, (5) governance and enterprise restructuring and (6) competition policy. As a rule, a higher indicator would signal less government intervention in the area covered.

Figure 1 shows the overall EBRD transition indicator computed as a simple average of the six individual indicators. The overall EBRD transition indicator is computed for the three Baltic states separately and for the averages of five Central European countries as CE5 (Poland, the Czech Republic, Slovakia, Hungary and Slovenia); four CIS countries as CIS4 (Russia, Ukraine, Belarus and Moldova); and eight countries in southeast Europe as Balkan8 (Romania, Bulgaria, Serbia, Croatia, Serbia, Montenegro, Macedonia and Albania).

The overall EBRD transition indicator was already above 1 for Estonia and Lithuania in 1990, and it passed this for Latvia in 1991, reflecting how market-economic reforms were being introduced, while the countries were still part of the Soviet Union. The following years saw very rapid progress with reforms in all three Baltic states, but most pronouncedly in Estonia. The overall indicator for Estonia was higher than the indicators for the other two Baltic states from 1993 and passed the indicator for the CE5 group from 1999.

The Baltic states do not stand out for their overall level, but rather for the speed of their economic reforms in the early stages of the transition process in 1992–1994. Other post-communist countries implemented economic reforms more slowly. This is particularly true of the CIS4 and the Balkan8 countries, but even the CE5 countries were slower, though most of them began the

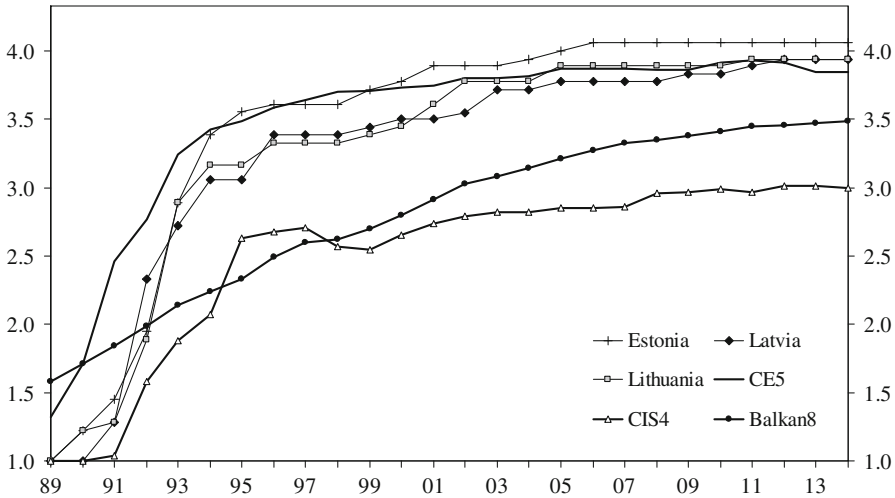

Figure 1: Overall EBRD transition indicator for the Baltic states and selected country groups, 1989–2014
Note: See the text for explanations of the overall EBRD transition indicator and the country groupings. The EBRD does not update the data series after 2014. No data are available for the Czech Republic after 2008 from which year CE5 consists of only four countries.
Source: EBRD (2016), author's calculations

reform process earlier and from a more reformed outset. If it was ever appropriate to use the label *big bang reforms*, then it would be about the economic transition in the Baltic states, spearheaded by Estonia.

Figure 1 offers information on the level and speed of the overall economic transition, but not on possible similarities in the reform pattern across the post-communist countries. To this end, cluster analysis using the six EBRD transition indicators for subsets of post-communist countries may be useful. The cluster analysis uses Ward's method where clusters are formed by agglomeratively adding countries to the existing clusters so that the squared Euclidian distance is minimised.[2] The clustering uses the average of the individual EBRD transition indicators over the 3 years 1996–1998 to avoid changes from 1 year to another affecting the results unduly. The results are shown in a dendrogram where the horizontal axis shows the similarity of the

[2] Ward's method is an agglomerative cluster method which starts with one cluster for each of the countries in the data set. The dissimilarity measure is the squared Euclidean distance between the transition indicators of a given country and an existing cluster; if there is more than one country in the cluster, the centroid of each of the transition indicators across the countries in the cluster is used. Clusters are formed agglomeratively or sequentially by finding the country and the existing cluster, among which the Euclidean distance between the transition indices is minimised (Mojena 2006).

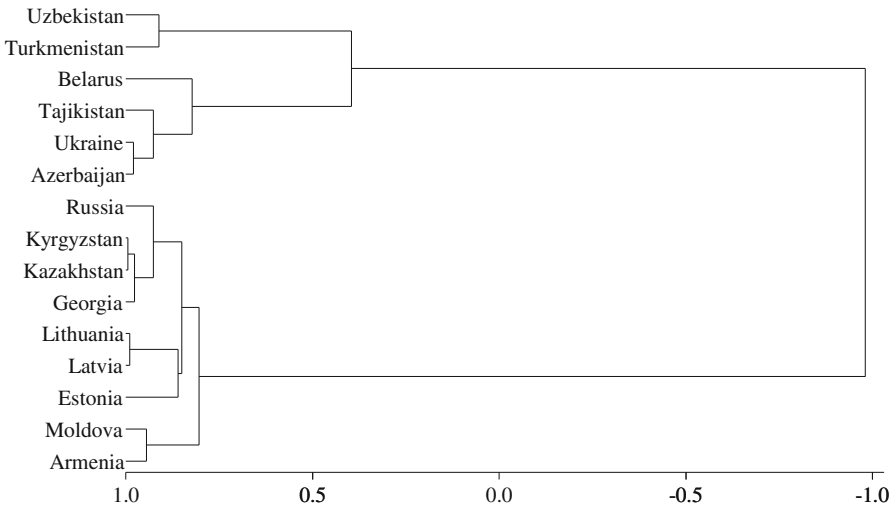

Figure 2: Dendrograms showing clusters of six EBRD transition indicators for 15 ex-Soviet countries, 1996–1998
Note: The horizontal axis depicts correlation similarity; movements to the right imply less similarity between the clusters. The clustering uses the average of the individual EBRD transition indicators over the years 1996–1998.
Source: EBRD (2016), author's calculations

clusters expressed as the correlation coefficient between the centroids of the transition indicators of the clusters. A correlation coefficient of 1 implies perfect similarity; movements to the right imply lower correlation coefficients and less similar clusters.

Figure 2 shows a dendrogram depicting the results of the cluster analysis for 1998 using the subset of the 15 countries that emerged from the breakup of the Soviet Union. Having been part of the Soviet Union, the 15 countries had reform indicators that were alike when the reform process started, but the picture was very different a decade later. The different transition paths of the ex-Soviet countries are indeed very visible in the dendogram with the main difference being between a cluster of countries with little reform progress and a cluster of countries with greater progress. Within the latter, the Baltic states constitute a separate cluster with very similar reform components. The Baltic states already stood out among the ex-Soviet countries in 1998.

It is informative to compare the Baltic states with the other eight countries from Central and Eastern Europe (CEE) that joined the EU in 2004, 2007 or 2011. Figure 3 shows dendograms for the 11 CEE countries for 1998. It is notable that the pattern of economic reforms was much more similar across

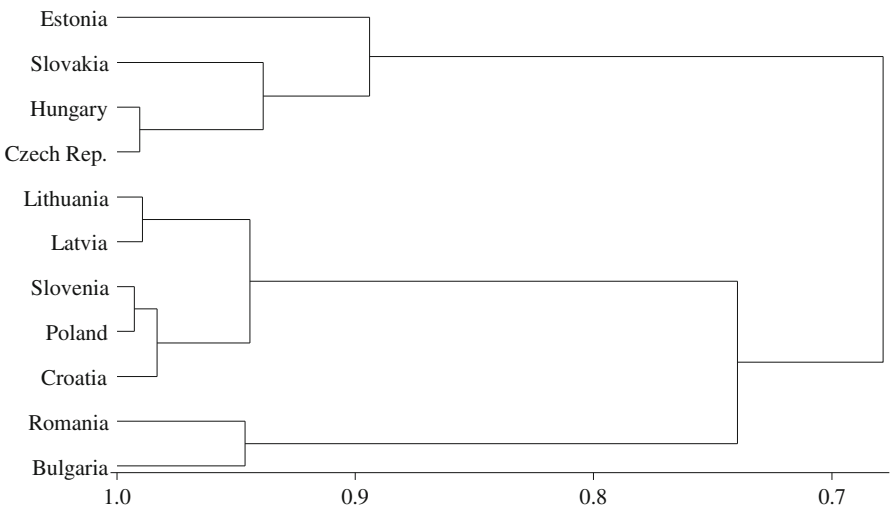

Figure 3: Dendrograms showing clusters of six EBRD transition indicators for 11 CEE countries, 1996–1998
Note: The horizontal axis depicts correlation similarity; movements to the right imply less similarity between the clusters. The clustering uses the average of the individual EBRD transition indicators over the years 1996–1998.
Source: EBRD (2016), author's calculations

the CEE countries than across the ex-Soviet countries, as can be seen from the correlation similarity index on the first axis. This may in part reflect how the prospect of EU membership became an external anchor for economic policymaking in the CEE countries from the mid-1990s (Staehr, 2011).

Estonia is in a cluster of countries with the Czech Republic, Slovakia and Hungary, three countries that started the reforms early. Lithuania and Latvia are in a separate joint cluster, but the reform pattern is not very different from that of Slovenia, Poland and Croatia. Romania and Bulgaria, which joined the EU in 2007, are in a separate cluster. Finally, Romania and Bulgaria are in a separate cluster, reflecting the gradual and piecemeal reform process in these countries in the 1990s. The upshot is that the reform patterns in the Baltic states did not stand out in 1998 from those of the other CEE countries.

Three conclusions emerge from the analyses of the EBRD transition indicators in this section. First, the Baltic states started the economic reform process later than the countries in Central Europe, but caught up in a short time due to *big bang reforms*. Second, Estonia has been the front runner, with a higher overall EBRD transition indicator than the other two Baltic states from as early as 1993. Third, cluster analysis shows that by 2004 the economic reforms in the Baltic states exhibited a pattern which differed markedly from those in most other countries that emerged from Soviet Union, while the

differences were smaller with the eight other CEE countries that had joined the EU by 2011.

FEATURES OF ECONOMIC REFORMS IN THE BALTIC STATES

The analysis of the EBRD indicators in the previous section provides information on the extent of government intervention in various areas but leaves out many aspects of the reforms. To distinguish between the different varieties of capitalism, detailed analyses of the reforms and the changing roles of government are needed. To this end, this section discusses some key reforms in the Baltic states. The reforms are typically important ones that directly helped delineate the role of government and form the economic system in the Baltic states.

Deregulation and the business environment

The Baltic states moved forward with reforms such as price liberalisation, privatisation and the streamlining of regulation at a faster pace than most other post-communist countries (EBRD, 2016). These measures facilitated the formation of private business and reduced the role of government in the economy. The Baltic states have a conducive business environment; the *Doing Business* indicators produced by the World Bank place the Baltic states in the top places among the post-communist countries, with Lithuania ranked 15th overall, Estonia 16th and Latvia 26th among the 155 countries surveyed in 2005 (World Bank, 2005).

External liberalisation

The Baltic states were among the post-communist countries with the most comprehensive and rapid liberalisation of production, trade and price setting. Particularly notable is that the Baltic states removed essentially all capital controls in the early 1990s, while the Central European countries typically delayed this move until the beginning of the 2000s when the upcoming membership of the EU dictated such a move. The early liberalisation increased international financial integration but also removed a key policy instrument (von Hagen and Siedschlag, 2008).

Privatisation through sale to foreigners

The privatisation process in the Baltic states was complex and controversial, like in other post-communist countries. Two features stand out. First, the countries started the privatisation process early, in some cases, while they were still part of the Soviet Union. Second, a large amount of the privatisation

of both small and large firms was done through direct or trade sales, including sales to foreign owners. This privatisation method simplified the often complex corporate governance issues associated with many other privatisation models and rapidly reduced the role of the government in the business sector. Estonia was the front runner, but the other Baltic states subsequently adopted the trade sale model (Berengaut *et al.*, 1998, ch. 6; Norkus, 2007). The Baltic states were also among the first post-communist countries to actively encourage foreign direct investment in greenfield projects.

Currency boards

Estonia introduced a currency board in 1992 and Lithuania followed suit in 1994, while Latvia introduced an exchange rate regime mimicking a currency board from 1995 (Korhonen, 2000). The very tight exchange rate pegs were the cornerstone of the inflation stabilisation programmes in the Baltic states. The institution of a currency board is in some respects the ultimate market-liberal or non-intervening monetary policy as almost all independent policymaking is ceased and the main task of the central bank is to apply the preset rules for managing the foreign exchange reserves.

Fiscal policy

The Baltic states have generally pursued prudent but very inactive fiscal policies without counter-cyclical properties (Staehr, 2016). This is most pronounced in the case of Estonia, which essentially balances its budget year by year and whose public debt as a percentage of GDP has for years been among the very lowest in Europe. Latvia encountered a fiscal crisis in 2008–2009, but this was largely the result of the government bailing out a private bank after the bank encountered solvency problems. Lithuania had very modest debt until the global financial crisis, after which some debt was accumulated.

Labour markets

Labour markets in the Baltic states have been notable for the modest role of trade unions and the very low coverage of collective agreements. This evidently precludes corporative measures, so the regulation of labour markets is largely a government matter, for instance through minimum wages and limits on working hours.[3] Formal employment protection in the Baltic states has arguably

[3] Põder and Kerem (2011) compute the principal components of a diverse range of indicators for health, family policy, education, labour markets and social protection. The Baltic states are closely clustered and exhibit comparatively weak social protection and a high degree of *commodification* of the labour market, reflecting how labour markets are lightly regulated and have few safeguards for workers.

been on par with the levels of protection in many Central European countries, but lax enforcement of the regulations has meant that the labour markets in the Baltic states can be seen as very flexible (Eamets and Masso, 2005).

Income taxes

Estonia introduced a flat income tax in 1994, followed by Lithuania the same year and Latvia the following year. The flat tax means that all income above the basic tax-free allowance is taxed at a fixed percentage. The systems vary somewhat across the Baltic states, particularly with respect to corporate income taxation. A flat income tax system typically implies less redistribution than a progressive system (Saavedra *et al.*, 2007). The flat tax has subsequently been adopted by a number of other post-communist countries.

Social protection

The social protection systems in the Baltic states have generally retained the broad coverage from Soviet times but typically exhibit modest compensation rates and reliance on self-insurance (Aidukaite, 2006). The systems rely on passive support and have put limited emphasis on active measures that seek to stimulate labour market participation and social inclusion (Masso and Paas, 2006). The costs of social protection have been lower in the Baltic states than in the Central Europe countries.[4]

Pension systems

The Baltic states were among the first in Central and Eastern Europe to introduce funded pensions along the lines of the three-pillar model of the World Bank. Some other CEE countries introduced such systems but several, including Poland and Hungary, have subsequently scaled back their systems. The three-pillar systems implemented in the Baltic states provide high-powered incentives as the eventual pension payouts depend to a large extent on the social security contributions paid by the individual (Raudla and Staehr, 2003; Casey, 2004).

This discussion of individual reforms suggests that the Baltic states carried out many reforms in the 1990s and early 2000s which changed the organisation of the economy and the incentives of individuals and companies in profound ways. The Baltic states were in many cases first-movers among both post-communist and Western European countries; this was the case with flat taxes, the currency boards and the deregulation of the three-pillar pension systems. The resulting economic system will be discussed in the next section.

[4] Slovara (2008) uses numerous criteria to produce social framework rankings for regions in the EU and finds that all three Baltic states (each constituting one region) are in the lower third of the ranking of EU regions. However, many EU regions, in particular in Central Europe, have rankings below those of the Baltic states.

THE ECONOMIC SYSTEM OF THE BALTIC STATES

The previous two sections discussed the reforms which shaped the economic system in the Baltic states.

The EBRD indicators showed that the countries introduced fast and comprehensive reforms from an early stage. By the mid-1990s, the pattern of reforms in the Baltic states differed markedly from the pattern in the ex-Soviet countries but less so from the pattern in the CEE countries. A closer look at specific reforms made it clear that they typically reduced the role of government, provided high-powered incentives and had little emphasis on redistribution. In other words, the reforms led to extensive decentralisation of decision-making, coordination, control rights and income claims within a short time. When these features are held up against the preferred categorisation of economic systems, it is reasonable to conclude that the reforms in the Baltic states led to the adoption of liberal-market economic systems.

The reform choices and the resulting economic system set the Baltic states apart from the other EU countries of Central and Eastern Europe, which in most cases have chosen a more interventionist or coordinating role for the government (Bohle and Greskovits, 2007, 2012). The economic reforms have resulted in liberal-market economic systems, while other post-communist countries have typically opted for reforms that gave government a more activist or coordinating position in society. This conclusion aligns well with the findings by Feldmann and Sally (2002), who argue that the main pillars of the economic reforms in Estonia—and by implication also in Latvia and Lithuania—led to an economic system akin to the "Victorian social contract" of the nineteenth century based on free trade, fixed exchange rates, small government and a *laissez faire* approach.

The presence of the liberal-market system is consistent with the size of the government in the Baltic states. Figure 4 shows a cross-plot of per capita GDP in purchasing power parity terms and total government spending other than interest payments as a share of GDP, both averaged over the period 2001–2003 for the EU countries.[5] The Baltic states exhibit smaller governments than would be expected given their income levels, and this is also noticeable in comparison with most of the CEE countries although Romania also has a relatively small government.[6]

[5] The intercept estimate of the trendline is 35.2 with standard error 2.7, and the slope estimate is 0.076 with standard error 0.034; the coefficient of determination is 0.172.

[6] Two non-CEE countries often attributed with the liberal-market model, the UK and Ireland, also have smaller governments than would be expected given their income level.

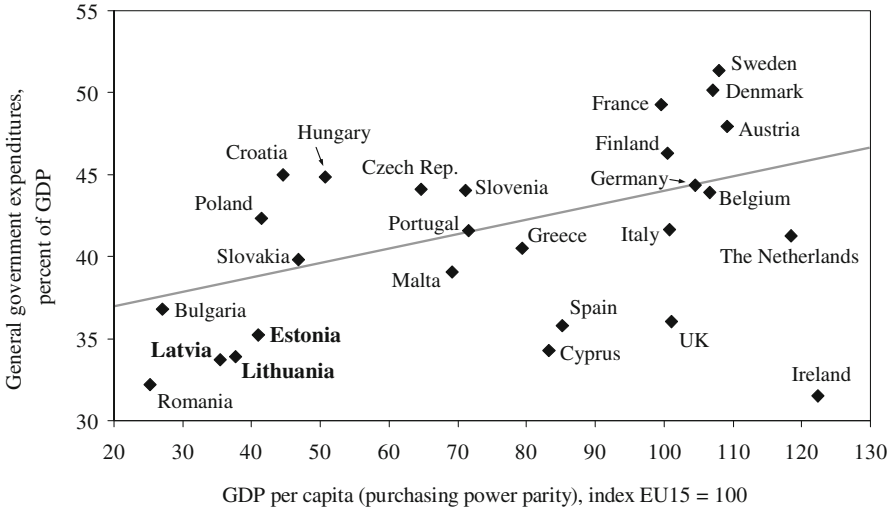

Figure 4: Relative per capita GDP and government expenditures in 27 EU countries, averages 2001–2003
Note: Luxembourg is not included.
Source: Ameco (2017, codes: *HVGDPR*, *UUTGI*), author's calculations

The comparatively small size of government in the Baltic states has persisted for extended periods. Figure 6 in "Appendix" shows the government spending in per cent of GDP for each of the Baltic states and the CE5 group of countries in Central Europe. Government spending in the Baltic states is generally substantially lower than it is in the CE5 group except during the global financial crisis, when the Baltic states saw exceedingly large declines in GDP, while the CE5 countries weathered the crisis much better.

The Baltic states stand out for their economic transition resulting in liberal-market economic systems, but there is evidently also some heterogeneity across the countries. Overall, Estonia appears as the country that implemented reforms faster and more extensively than Latvia or Lithuania. A number of novel policy initiatives such as the currency board, the comprehensive external liberalisation and the flat tax system were pioneered in Estonia and subsequently introduced in the other two Baltic states. Overall, Estonia stands out as the clearest exponent of the liberal-market economic system, but Latvia and Lithuania follow closely (Heritage Foundation, 2016).

A PARADOX

As discussed, the Baltic states implemented economic reforms that laid the foundation for liberal-market economic systems with high-powered economic incentives, free markets and small public sectors. This choice of economic system may be seen as surprising given the political context in which the transition took place. The Baltic states had limited contacts with the USA, the UK, Ireland or other countries where the liberal-market system dominates, but extensive contacts with the Nordic countries and Germany, where the cooperative system dominates and government plays important coordinating roles in the economy buttressed by extensive welfare states (Eichengreen, 2007).

The contacts with the Nordic countries and Germany have historical roots going back centuries. In the 1980s, the contacts came largely through cultural and scientific exchange but tourism and communication with the diaspora also played a part. The Nordic countries and Germany were among the Western European countries that supported the independence movement in the late 1980s most strongly both diplomatically and economically (Lane *et al.*, 1999). The Nordic countries and Germany became key donors to the Baltic states after they regained independence in 1991 (Bergman, 2006). The Baltic states similarly engaged in defence cooperation with the neighbouring Nordic countries at an early stage (Archer, 1999). The cooperation was mainly bilateral, but there were also numerous multilateral initiatives such as the establishment of the Council of the Baltic Sea States.

It may be seen as a paradox that the relatively deprived Baltic states that emerged from the Soviet Union in 1991 received economic and political support from the Nordic countries and Germany but then chose economic reforms and policies that eventually led to economic systems that differed substantially from those in these neighbouring countries. This paradox has not received much attention, though it might provide insights into the reform process in the post-communist countries and possibly also lessons for reform efforts in general. This section discusses possible factors that may help explain the paradox.

Democracy and economic reform

The starting point is that the Baltic states democratised very rapidly after regaining independence in 1991. The countries were functioning democracies within a year or two. Studies have shown that the extent of market-economic reforms is closely related to the extent of democratisation in the post-communist countries (Fidrmuc, 2003). Using co-integration methodology, Staehr (2006) finds that the causality goes from political reforms or democratisation to market-economic reforms, while there is no relationship

in the opposite direction. Governments may seek to retain control over the economy in less democratic countries, while this is not the case to the same extent in more democratic countries.

The early and rapid democratisation of the Baltic states set them apart from many other countries that emerged from the breakups of the Soviet Union and Yugoslavia. The early democratisation may thus be a key factor behind the Baltic states moving ahead with fast and comprehensive economic reforms in the early 1990s.

Public preferences

The early democratisation of the Baltic states suggests that the preferences and values of the public have delineated the space for economic reforms. This makes it expedient to consider studies of public values in the post-communist countries. Taagepera (2002) applies principal component analysis on data from the 2000 World Value Survey for 65 countries in order to map out societal values or preferences. The analysis suggests that the public in the Baltic states is survival-oriented, in line with the public in other post-communist countries, but more secular–rational than is typical in those countries.

The values in the Baltic states may help explain public support for economic reforms that promise modernisation and the opportunity to pursue individual economic advancement. The reforms and the resulting liberal-market system may thus be in accord with the values of a large part of the electorate in the Baltic states. The preference for modernity and individual advancement may also imply a willingness by the public to accept the higher degree of inequality and poverty that may be associated with the liberal-market economic system (Aidukaite, 2006).[7]

The public acceptance of reforms reducing the role of government in the economy may also stem from an unfavourable assessment of economic and societal developments during the Soviet period. Data from the World Value Survey from 1995 to 1999 suggest indeed that the public in the Baltic states had a more negative assessment of communism than the public in other post-communist countries (WVS, 2016). The public might may thus have seen fast and comprehensive economic reforms as a means of dismantling the communist legacy.

[7] As part of the tsarist empire and later the Soviet Union, the Baltics were occasionally used as a laboratory for reforms of the economic and administrative system (Raun, 2001, chs. 13–14). This was particularly the case during the Khrushchev era, where several reforms that decentralised economic decision-making were rolled out in the Baltics before being extended to the rest of the Union. The same applied to Gorbachev's economic reforms, which were implemented earlier and with greater impetus in the Baltics than in other parts of the Soviet Union. These experiences may have accustomed the public and policymakers to economic reforms and created acceptance of such measures.

The Soviet heritage may also have been important for its impact on civic society. The communist system meant the suppression of independent organisations and other pillars of civic society. The movements seeking independence for the Baltic states in the 1980s became the basis for the political parties after 1991 and ceased any role as independent organisations outside the political system. Moreover, whereas trade unions played a role in the anti-communist movements in some central European countries, this was not the case in the Soviet Union, where the trade unions were controlled by the communist party. The upshot is that the reforms in the Baltic states were decided with no or little input from civic society, trade unions or other actors outside the political system. The concentration of power may have facilitated fast and comprehensive reforms limiting the role of government (Kubicek, 2004).

Controversially, the choice of the liberal-market system may also be related to the ethnic composition of the Baltic states. Empirical research shows that capitalist countries with substantial ethno-linguistic fractionalisation tend to redistribute less than countries with little fractionalisation (Sturm and de Haan, 2015). Estonia and Latvia and to a lesser extent Lithuania have substantial ethnic minorities consisting mostly of Russians who migrated to the region during the period of Soviet occupation. After the Baltic states regained independence in 1991, the decision-making became dominated by politicians from the titular ethnic majorities, and they may have seen the liberal-market economic system as a means of avoiding redistribution in favour of the minorities (Anderson, 1999).[8]

Economic conditions

The reform choices are likely to have been influenced by the possibilities and constraints afforded by the economic situation in the countries, including the initial conditions. The post-communist countries began the transition process from very different economic and structural starting points. De Melo *et al.* (2001) consider numerical indicators for 13 different economic and structural measures collected around 1990. The measures include GDP per capita, number of years under central planning, industry structure and urbanisation. Figure 5 shows the first two principal components of the data series. The first principal component is largely associated with the degree of macroeconomic distortion, while the second principal component is associated with the degree of economic development.

The Baltic states were among the more economically developed post-communist countries. The countries, however, were plagued by macroeconomic

[8] The ethnic dimension may also help explain the choice of privatisation based on restitution, and also the choice of small governments and limited social safety nets if the minorities would be in a less favourable economic position.

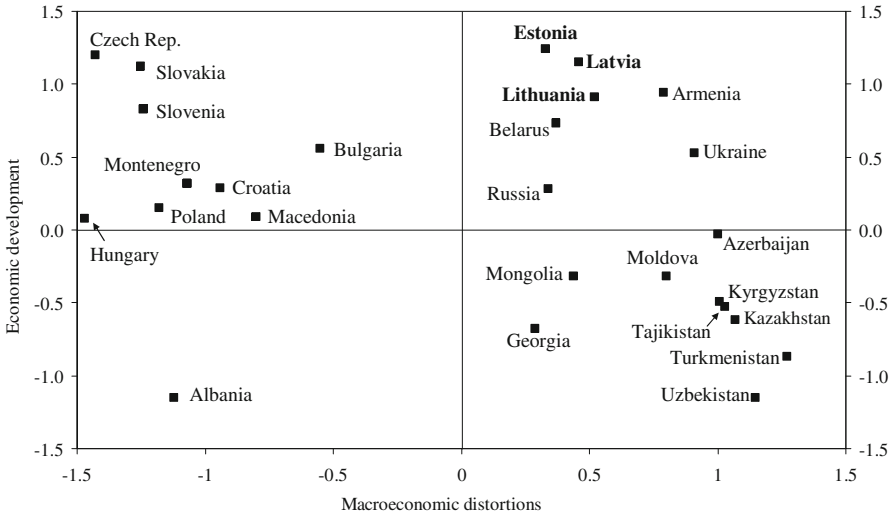

Figure 5: Economic and structural starting points of the post-communist countries
Note: The data used for the computations of the composite indices are from 1989 or 1990 and in some cases averages over the late 1980s.
Source: De Melo *et al.* (2001)

distortions such as high inflation, goods shortages and unfamiliarity with market processes, as were other countries emerging from the Soviet Union. The predominance of such distortions may be a factor behind the preference for rapid and comprehensive reforms seeking to address or alleviate the consequences. Laar (2002, ch. 6) argues that unfavourable initial conditions in combination with embryonic public administrations led policymakers to favour reforms that were simple to implement and made a clear break with the past through a swift and comprehensive reform policy.

At a more general level, the small open economies of the Baltic states restrained the possibilities for independent economic policymaking. The limited government intervention and the rules-based policies pursued to a larger extent in the Baltic states than in for instance the Central European countries may to an extent reflect the constraints afforded by the small size of the economies and the dependence on external conditions.

Finally, that two Nordic neighbours, Sweden and Finland, were experiencing deep economic crises in the beginning of the 1990s. Their economic and financial crises were aggravated by fiscal problems as declining production and rising unemployment led to large budget deficits. The crises in Sweden and Finland may have made large government and, specifically, the Nordic welfare model seem less attractive to the policymakers and the public in the Baltic states.

FINAL COMMENTS

The economic changes in the Baltic states have been remarkable since the countries regained independence in 1991. The starting points of the three countries were in many ways unfavourable as they faced severe economic distortions and disruptions of trade after the breakup of the Soviet Union. The new democratically elected governments also faced the challenges of having to establish national institutions and administrative structures.

The path of economic reform chosen in the Baltic states set the countries apart from other post-communist countries, both those emerging from the breakup of the Soviet Union and those from Central Europe. The reforms were extensive and speedy. Moreover, a number of distinct reforms were implemented during the first decade after independence, including extensive internal and external liberalisation, currency boards or corresponding systems, privatisation through foreign sales, flat income taxes, individualised pension saving and limited social protection. Estonia moved most rapidly and furthest in this direction, but Latvia and Lithuania followed closely.

The economic reforms led in short order to liberal-market economic systems in the Baltic states characterised by free enterprise, high-powered economic incentives and relatively small governments. In 2016, 25 years after the Baltic states regained independence, Estonia had arguably the most unswerving liberal-market system but Latvia and Lithuania were not far behind.

The economic transition in the Baltic states has been successful insofar as the countries have managed to establish market-based economies in which living standards and most indicators of economic well-being have increased substantially. The reforms meant that the European Union deemed that the countries already had functioning market economies and the capacity to cope with competitive pressures at the end of the 1990s when negotiations on EU membership were initiated (OECD, 2000). It is also notable that the Baltic states have exhibited flexibility and political determination through boom-bust periods, including in the aftermath of the global financial crisis (Åslund, 2010). These achievements are all the more remarkable when the disadvantageous starting point of the Baltic states and the developments in several other countries that emerged from the Soviet Union are considered.

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APPENDIX

See Figure 6.

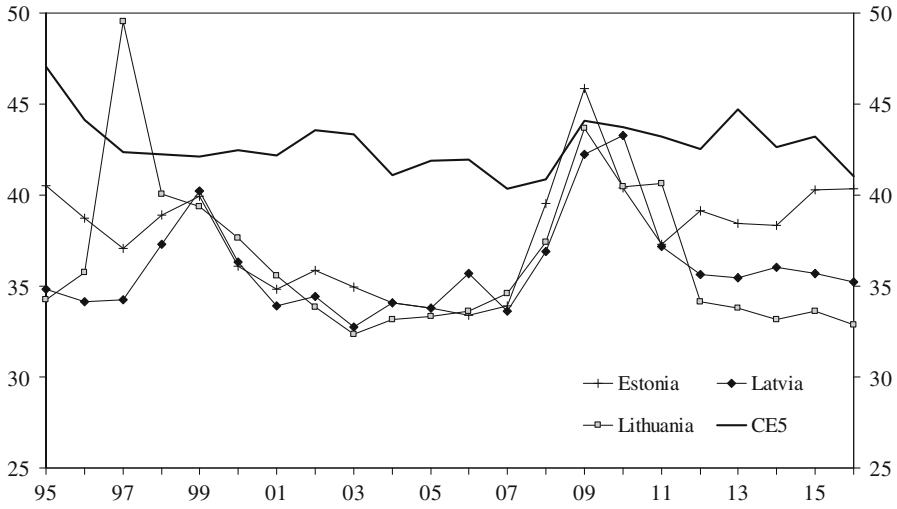

Figure 6: Government expenditures, per cent of GDP, 1995–2016 Note: CE5 is the unweighted average for the Czech Republic, Hungary, Poland, Slovenia and Slovakia. The large spending in Lithuania in 1997 was due to compensation for lost savings in the early 1990s.*Source*: Ameco (2017, codes: *UUTGI*), author's calculations