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Understanding the Baltic and Estonian Puzzles: the Political Economy of Rapid External Liberalization in Estonia and Latvia

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Abstract

External liberalisation is usually hard to implement politically. Therefore the speed and depth of liberalisation in Estonia and Latvia raises a 'Baltic puzzle'. Estonia is also unique in that it has implemented free trade – the 'Estonian puzzle'. This paper uses political economy analysis of exogenous factors, interests, institutions and ideas to understand these two puzzles. The impact of the crisis of the early 1990s on interests and institutions is shown to be a precondition of the Baltic puzzle, but ideas and exogenous factors are more important in explaining actual policy choices. The Estonian puzzle is seen as the result of a unique configuration of political economy variables.

Key words: political economy, external liberalisation, free trade, Estonia, Latvia

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Introduction

Despite the extensive literature on the political economy of external liberalisation in emerging markets, the remarkable progress of Estonia and Latvia over the last decade has only been marginally addressed.[1] This essay aims to make a modest contribution to fill this gap in the literature as there are lessons to be learnt from the experience of these two countries.[2]

My study has two areas of analysis. First, I want to examine the main features of external liberalisation in Estonia and Latvia by focusing on what I label the ‘Baltic and Estonian puzzles.’[3] It is widely recognised that the Baltic States have made greater progress in market-based reform than other former Soviet Union states, as well as numerous other ex-socialist countries.[4] Rapid external liberalisation has been an important part of these reforms. In this study I try to explain the rapid implementation of external liberalisation and the reorientation of their economic relations to the West – the ‘Baltic puzzle’ – through a political economy analysis of reform in two of the three Baltic states.

There are significant differences between Latvian and Estonian policies. Arguably, the most remarkable differences are Estonia’s very rapid reorientation of economic relations to the West and adoption of a unilateral free-trade regime. This approach constitutes a distinct ‘Estonian puzzle’. Indeed, free trade in the true sense is quite rare.

Second, I argue these results have broader relevance. Understanding successful reform and the contributing factors may help shed light on the political economy of reform in general. Although most observers agree that comprehensive reforms seem to occur in the aftermath of crises, the relative roles of interests, institutions and ideas remain controversial.[5]

The structure of my essay is as follows. The first section discusses a few theoretical preliminaries – external economic relations under the command system and liberalisation of this regime, the linkages between external liberalisation and transition and the political economy of policy reform. In the second section, I survey the progress in external liberalisation in Estonia and Latvia and provide an empirical overview of the Baltic and Estonian puzzles. The following two sections attempt to shed light on these two puzzles by using political economy analysis. A final section concludes with some general thoughts.

My argument is that the rapid liberalisation in Estonia and Latvia was made feasible by the initial crisis and its impact on institutions and interests. The substance of reform, however, requires examining the role of ideas, which are partly the function of exogenous factors. Differences between the two countries’ reform paths can probably be best understood as a result of specific configurations of political economy variables – interests, institutions and ideas.

I also want to mention methodology here. This essay primarily looks at domestic-level explanations of external liberalisation. Systemic factors are not ignored, but treated as exogenous. They are expected to affect policy through their impact on key domestic-level variables (interests, institutions and ideas). Moreover, this essay can be located within the tradition of ‘understanding’ in political economy. I do not attempt to ‘explain’ by developing formal models and testing them on specific data.[6] Instead I employ the technique of careful case studies, where I look at how political economy variables may have affected external liberalisation. I also consider the possible impact of exogenous factors such as initial conditions, the external environment and history/culture. If these variables can be regarded as *consistent* with the outcomes I examine, I conclude that they are likely to have contributed to those outcomes. Otherwise, I shall consider such variables as insignificant. I have used both written sources and interviews with policymakers and academics in this work. Where my conclusions rely primarily on interviews, I mention it explicitly.

1 External liberalisation and transition: some theoretical preliminaries

> *Now, 40 years after Baran wrote The Political Economy of Growth, the Leninist model is bust. It is clear that capitalism can lead to growth in countries which are willing to trade and that, far from monopoly capital stifling growth in countries, capital goes wherever it will make profits. As Marx said 150 years ago, capital has no country.* Lord Desai[7]

In this section, I first provide an overview of external economic relations in a command economy and the reforms a transition economy embarking on liberalisation needs to implement. Next, I examine the linkages between external liberalisation and transition and argue that some external liberalisation is essential during transition. As the degree of external liberalisation is largely a political decision, I discuss the political economy of reform in the final sub-section.

1.1 External economic relations of a command economy and external liberalisation

For the purposes of this discussion, the term *external economic relations* refers to three separate types of flows: *trade flows* (sales and purchases of goods and services), *investment flows* (foreign direct investment) and *financial flows* (current and capital account transactions).

In a classical command economy all external economic relations are regulated by the central plan and controlled by special monopolies, such as the 'mono-bank' and foreign trade organisations.[8] These monopolies arise from the underlying logic of a command economy, namely the idea that a central planning authority should set national production and consumption at the social optimum. Under this system, it is essential that the planners control external economic relations as independent actions taken by individual firms might undermine the central plan.

International economic relations in a command economy are subordinate to broader political objectives and aggregate welfare is not maximised in the general economic sense. In the hey-day of central planning, trade with the West was quite limited, mainly due to the fear that the dependence on trade with the enemy might make the countries vulnerable.[9] This provided the underlying rationale for CMEA, the organisation that regulated trade among most centrally planned economies. Although many of these economies were quite open when measured by the trade-to-national-output ratio, the trade flows were essentially politically motivated barter transactions within the CMEA and lacked a coherent economic rationale.[10] In terms of payments and FDI, links to the West were almost impossible to form due to non-convertibility (and different official exchange rates) and prohibitively restrictive investment legislation.

External liberalisation refers to removing the bureaucratic restrictions on trade, investment and financial flows. *Trade liberalisation* involves three components. First, the state monopoly on foreign trade has to be removed, i.e. firms should be granted the possibility to import and export goods without going via a foreign trade organisation. Second, quantitative restrictions and administrative rules exclusively regulate command economy trade flows. External liberalisation requires the replacement of these administrative and quantitative rules with tariffs to make the system flexible and efficient. Third, trade liberalisation involves reducing the effective rate of protection, which means that once quotas have been converted to tariffs, tariff rates need to be reduced.

Investment liberalisation requires removing the legal impediments to foreign investment and granting foreigners the right to conduct business and buy or lease land. In a classical liberal regime, the principle of non-discrimination between domestic and foreign-owned firms with respect to taxation, legislation, etc. applies, and foreigners have the right to repatriate profits.

The key aspects of payments liberalisation are the unification of the exchange rate and the establishment of current and capital account convertibility. To make convertibility possible, payments liberalisation also requires abolishing the mono-bank and introducing a flexible banking system.

1.2 Linkages between external liberalisation and transition

External liberalisation in the former socialist countries must be seen in the context of transition in general. The overarching goal in all these countries is the adoption of the market system. For our purposes, we take its desirability as given.[11] In a market system, regulated external relations of the kind prevailing in command economies are unsustainable.[12] For the market to operate efficiently, firms and individuals must have direct access to international markets both as consumers and producers, which is to say non-convertibility and fully regulated international trade are unsustainable. Although it is theoretically possible to construct a market economy without liberalising the investment regime, closure from international investment is scarcely desirable in practice, as this would mean forgoing investments needed for restructuring. In other words, *some* liberalisation is essential for the market system to work.

Moreover, external liberalisation is linked to the core components of transition to a market-based economy: *liberalisation* of prices, *stabilisation*, *privatisation*, *restructuring* and *institutional reform* and the introduction of *hard budget constraints*.

Trade liberalisation is related to price liberalisation, restructuring (by making foreign capital goods available), increasing competition and stabilisation (by preventing monopoly pricing). FDI and trade liberalisation are often complementary as a large proportion of trade is driven by foreign investments. FDI is also closely related to privatisation and restructuring.

A unified exchange rate and current account convertibility are essential prerequisites of a liberal trade regime. Capital account convertibility may promote FDI and the exchange rate may be used as a nominal anchor for stabilisation.

To conclude, fully regulated trade, non-convertibility and closure to FDI under the command system are ultimately unsustainable. Thus, a certain amount of liberalisation is needed in transition. Exactly how far a country will choose to liberalise is a political decision, so we now turn to the political constraints on this process.

1.3 The political economy of external liberalisation

Although conventional economic theory stresses the gains from external liberalisation, the experience of developing countries since World War II suggests that liberalisation is often quite difficult to achieve.[13]

Political economy analysis usually focuses on the role of three variables: interests, institutions and ideas.[14] In addition, the literature on policy reform emphasises the role of crises in bringing about external liberalisation. Indeed, there are apparently no cases of radical reform not preceded by crisis. In Eastern Europe, the crisis involved the collapse of the old political system and a deep economic recession accompanied by dramatic output falls. However, a crisis by itself cannot explain successful reform, as many half-hearted reform attempts in the aftermath of crises illustrate.[15] Rather we need to consider the impact of a crisis on core political economy variables.

A crisis fundamentally affects interests, institutions and ideas. Under normal circumstances *interest group lobbying* may make socially gainful reform extremely difficult due to collective action problems.[16] In times of crisis, however, interest groups are weakened and mainly concerned with their own survival. Lobbying temporarily ceases, creating a window of opportunity for policymakers to carry out reform.[17]

A crisis may also fundamentally affect *institutions*. In this essay I will assume that institutions can affect outcomes by defining the set of feasible options and in shaping actors' behaviour, especially because it may be costly to deviate from the rules entailed by them or to reform institutions and regimes themselves.[18] Institutions may thus lead to inertia, especially if they constitute organised collusions ('iron triangles') of business, bureaucrats and politicians.[19] In the case of the Soviet Union, the end of communism implied the collapse of a one-party state and regained independence for several countries, including the Baltic States. The crisis meant that new institutions had to be created and existing ones radically reformed. This created an opportunity to bypass the usual inertia.

In periods of dramatic change and crisis, society also questions the *ideas* underlying the previous policy consensus. Ideas may be defined as "shared beliefs about the world" (world views, principled and causal beliefs) and may affect policy outcomes by serving as principled or causal road maps, affecting strategies where there is no unique equilibrium or becoming embedded in institutions.[20] Henderson argues that a change in prevailing ideas is essential to successful reform.[21] Paradigm shifts are unlikely to be successful unless the 'idea' of a new paradigm (say capitalism or free trade) is widely accepted, although in practice this may often be reflected in interests or become embedded in institutions (e.g. as an independent central bank). Even if policy reform is the result of a changing balance of interests, ideas plan an important role in helping actors define their interests.

In specific cases, policies are affected by *exogenous factors* such as initial conditions, the external position of a country and its historical and cultural heritage. These factors may contribute to the way actors define their interests and determine which ideas become prominent. Thus, a careful analysis of their impact on the political economy variables is required. I assume here that such factors do not directly cause policy outcomes. In any case, such determinism cannot be empirically validated.[22]

Having identified the variables most relevant to analysis of policy reform, next I present a survey of the progress in external liberalisation in these two countries.

2 External liberalisation in Estonia and Latvia: the Baltic and Estonian puzzles

> *For many years the Baltic States were told that such small states could not survive on their own without the brotherly help and sacrifice of other Soviet republics, especially Russia. Since independence, however, these three countries have been able to achieve a faster, deeper and more successful transformation towards the market system than any of the former Soviet states.* Juris Dreifelds[23]

This section provides brief case studies of external liberalisation in Estonia and Latvia, and serves as a preparation for the analysis in sections 3 and 4. I begin by explaining my two stylised 'Baltic' and 'Estonian' puzzles. This is followed by a brief description of developments in payments liberalisation. We then consider FDI and trade in greater detail.

2.1 The Baltic and Estonian puzzles

Estonia and Latvia became independent of the Soviet Union in August 1991 after the failed coup in Moscow. At that point, they were fully integrated into the Soviet economy and effectively isolated from the world economy. The non-convertible Soviet rouble was the official means of payments and the non-Soviet share of trade was less than 3% in 1991.[24] There was little foreign investment, although a slight opening up had occurred during the Perestroika period.[25]

Since then a remarkable transformation in external economic relations has occurred – not just compared to the rest of the former USSR, but most Central and Eastern European countries. I refer to this phenomenon as the Baltic puzzle,[26] which is perhaps best symbolised by the successful introduction of national currencies along with achievement of stabilisation and full convertibility.

There are also some notable differences between the depth of external liberalisation *policies* in Estonia and Latvia. I call this arising result the 'Estonian puzzle.' Estonia's reforms have been more radical than Latvia's. A policy of unilateral free trade was adopted, which is an extremely rare feature in the world political economy. Latvia's trade policy is also quite liberal, but contains industrial-policy-motivated protection and, like in most OECD countries, special status for agriculture.[27] The creation of a level playing field between domestic citizens and foreigners in a classical liberal vein is also largely reflected in Estonia's FDI policies, where liberalisation has been somewhat more radical than in Latvia.[28] Estonia can thus be described as a country approximating the open economy of economics textbooks.

Moreover, in terms of outcomes, Estonia managed to reorient trade and investment flows to the West more quickly than Latvia. As will be discussed in section 4, this is closely related to the policy regime, although the proximity of Finland and Sweden may have played a part as well. Table 1 provides a brief summary of the two puzzles, which will be presented in greater detail in the following sections in the discussions of the specific issue areas.

Table 1. Policy areas in Baltic and Estonian puzzles

Policy area	**Baltic puzzle**	**Estonian puzzle**
Payments	Estonia and Latvia have full current and capital account convertibility	*
FDI	Estonia and Latvia have very liberal FDI regimes	Estonia's licensing procedures are simpler, with fewer exceptions for foreigners
Trade	Estonia and Latvia have very liberal trade regimes	Estonia has unilateral free trade; Latvia's trade regime resembles the standard OECD regimes more
Reorientation (trade and FDI)	Estonia and Latvia have successfully reoriented their economies to the West	Estonia achieved the reorientation of trade more quickly and has attracted more FDI per capita

* Both Estonia and Latvia have very liberal regimes. The differences cannot be said to constitute a puzzle.

2.2 Convertibility and liberalisation of payments

As regards the *liberalisation of payments*, both Estonia and Latvia have moved very fast. Estonia introduced its own currency, the *kroon*, in June 1992, whereas Latvia used an interim currency (the Latvian rouble) from May 1992 until the gradual introduction of the *lats* between March and October 1993 was completed. The currencies quickly established themselves as reliable means of payment, largely thanks to very successful stabilisation. After a period of managed floating, the *lats* was pegged to the SDR. The *kroon*, on the other hand, was pegged to the D-Mark at its inception (and later the euro) through a currency board arrangement. Latvia was the first of the two countries to establish full current and capital account convertibility and Estonia quickly followed suit.[29]

Both Estonia and Latvia have very liberal payments regimes and there are no substantive differences between them.[30] The rapid liberalisation has been successful and has not led to any capital flight. The success of stabilisation in both countries compares favourably with all other transition countries and is consistent with the Baltic puzzle.[31]

2.3 FDI

The liberalisation of the foreign direct investment regime was also rapid, and Estonia and Latvia introduced a legal framework for FDI a few months after regaining independence in 1991.[32] The general provisions are very similar in the two countries. National treatment applies and full repatriation of profits is guaranteed. With respect to licensing procedures, the Estonian system is simpler and contains fewer restrictions. In Latvia, foreign firms were granted the right to buy land somewhat later, and provisions remain slightly more restrictive in Latvia even now.[33]

Estonia has also been more successful in attracting foreign direct investment on a per capita basis than has Latvia. In the 1990s, Estonia has attracted approximately USD 1,600 per capita in FDI, whereas the corresponding figure for Latvia (since 1992) is USD 770.[34] As can be seen from Table 3, Estonia is one of leaders among the ex-socialist countries negotiating about EU accession in terms of attracting FDI per capita, whereas Latvia is roughly in the middle of this group.

Table 2. Foreign direct investment inflow

from balance of payments, USD million										
	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**Inflow as % of gross fixed capital formation**	**Inflow per capita, USD**
Czech Rep.	1004	654	869	2562	1428	1300	2720	5108	36.2	497
Estonia	82	162	215	202	151	267	581	306	.	212
Hungary	1471	2339	1147	4453	2275	2173	2036	1944	16.6	194
Poland	.	1715	1875	3659	4498	4908	6365	6500	16.3	168
Slovenia	111	113	128	176	186	321	165	83	1.6	42
Bulgaria	42	40	105	90	109	505	537	739	43.5	90
Latvia	29	44	213	178	382	522	356	300	.	124
Lithuania	10	31	31	73	152	355	926	486	.	132
Romania	77	94	341	419	263	1215	2031	961	20.0	43
Slovak Rep.	.	168	250	202	330	177	566	330	5.0	61

Source: Hunya (2000)

A big difference between the two countries is the source of FDI inflows. Investments from Sweden (41%) and Finland (30%) together constitute over 70% of all FDI in Estonia in the 1990s, whereas the geographical distribution of FDI has been more even in Latvia. The main investors in Latvia in the 1990s were Denmark (14%), the USA (10%), Germany (8%), Sweden (8%), Russia (7%) and Britain (7%).[35]

Finally, I note that the developments in the FDI regime are consistent both with the Baltic puzzle and the Estonian puzzle. Estonia and Latvia maintain liberal FDI regimes and have attracted significant amounts of foreign investments even compared to some of the most successful transition countries in Central Europe. However, the Estonian policy regime is more liberal. Estonia is also a regional leader in attracting FDI.

2.4 Trade liberalisation

Both Estonia and Latvia have proceeded briskly with trade liberalisation. The state monopoly on trade was abolished, and most quotas and administrative restrictions (e.g. licensing) were abandoned or replaced with tariffs in 1992. A few exceptions included trade in tobacco, alcohol, weapons and a few other goods.[36]

As Table 3 illustrates, both Latvia and Estonia established very liberal trade regimes very early in the transition process, which compare favourably not only with the rest of the former Soviet Union, but also with the Central and Eastern European countries (who started the transition process earlier) and the world at large.

Table 3. Average weighted tariff rates in 1993 (1994) in selected transition countries

Estonia	**1.4%**
Latvia	**3.4% (1994)**
Croatia	10%
Czech Republic	5.7%
Poland	11% (industry); 18% (agriculture)
Romania	11.7%
Russia	14% (1994) (also many other means of protection)
Slovak Republic	5.7%

Sources: EBRD (1994); Shteinbuka and Cīrule (1997) for Latvia

Moreover, Estonia's trade liberalisation has been more comprehensive and the regime is genuinely liberal. From late 1993 onwards, tariffs were maintained only for a handful of goods; in 1997, even these were abolished.[37]

The situation was different in Latvia where trade liberalisation has been less comprehensive and where there is significant tariff dispersion. In 1999, there were 14 tiers of tariffs ranging from 0 to 75%.[38] Many trade restrictions have been maintained for industrial policy purposes. From late 1994, raw materials, capital goods and certain other goods not produced domestically had minimum tariff rates of 0.5-1%, which were significantly lower than the standard rate for consumer goods of 20% and which favoured domestic producers. Tariffs became a tool of government industrial policy in Latvia, whereas Estonia applied a consistent policy of free trade.[39]

A big difference between the two countries' trade regimes concerns *agriculture*. Estonia is one of the few countries in the world to implement free trade in agriculture. The only exception from these free trade policies since 1993 was the implementation of 70% import tariffs on imports of flour and cereals from Russia between August and December 1993. This was generally interpreted as an anti-dumping measure.[40]

Latvia, in contrast, has consistently maintained agricultural tariffs. The standard rate was 53% in 1994 (peak rate 55%), and the average rate in 1999 was 19.5% (basic)[41] or 14.07% (MFN).[42] The Latvian case corresponds closely to the agricultural protection imposed by most industrialised countries. The Estonian experience is quite unique. One can anticipate signs of gradual convergence, as Estonia introduced agricultural tariffs against third countries at the beginning of 2000 as part of the harmonisation towards the Common External Tariff of the European Union. If both countries become members, the remaining differences are likely to disappear.

In terms of the bilateral and multilateral track both Estonia and Latvia have signed numerous free-trade agreements with the EU/EFTA and various other transition countries (including Ukraine) and both became members of the WTO in 1999.[43]

Both Estonia and Latvia have reoriented their trade flows to the West.[44] The reorientation of trade flows to the West happened more quickly in Estonia. Both countries traded almost exclusively with other Soviet republics before regaining independence. The non-Soviet share of Estonia's and Latvia's total trade was less than 3% in 1991.[45] By 1993, only 20% of Estonia's foreign trade was conducted with Russia. The corresponding figure for Latvia was 30% and for Lithuania as much as 60%.[46]

At present, both Estonia and Latvia conduct about two-thirds of their trade with the European Union and only about 10% with Russia.[47] Germany is Latvia's biggest trading partner, while Finland is the most important trading partner for Estonia. Gravity models suggest that the trade of Estonia and Latvia with Western Europe is close to expected levels. In some cases, actual trade exceeds expected trade, as in the case of trade with Finland and Sweden, which suggests that trade growth has been even greater than one might predict on the basis of standard models.[48]

Thus, the Baltic and Estonian puzzles emerge particularly clearly in the context of trade liberalisation. Both countries have liberalised to a great extent, but Estonia's unilateral free trade has been particularly remarkable.

3 Understanding the Baltic puzzle: the political economy of rapid external liberalisation

> *In small nations, the will is more obvious than it is in large ones. In a small country, will is manifested quite in the same way as it is manifested in a family that has decided against a holiday in the South to build a new roof for their home instead. Here too, two factors should be pointed out: first, you should be convinced that the old roof is no good, and second, you must be convinced that there is no one else to build your roof for you.*
> Lennart Meri[49]

We next discuss Estonia's and Latvia's rapid progress in external liberalisation, the 'Baltic puzzle.'

Starting with a description of exogenous factors (initial conditions and crisis, external position and history/culture), I argue that although they provide a backdrop to policy, they cannot fully *explain* the Baltic puzzle. This is consistent with my general rejection of determinism.[50] I then perform a political economy analysis of external liberalisation by looking at interests, institutions and ideas in the light of the exogenous factors. My argument is that the weakening of interests and the creation of new institutions created a good basis for reform, but that this cannot explain the uniqueness of the Estonian and Latvian experience. It seems that political and economic ideas – a widespread consensus that certain reforms were needed and a will to implement them (as President Meri notes above) – played a key role here.

3.1 Exogenous factors

We consider three sets of exogenous factors that have affected policy reform: *initial conditions and crisis, external position* and *history/culture*.

The *initial conditions* of reform were very difficult, and it is no overstatement to call this a crisis. Politically, the transition process coincided with the process of state building. The reform process took off after Estonia and Latvia regained independence in August 1991.[51]

Both countries had to create most of the political institutions of independent states – border controls, armed forces, state administration, foreign service, etc. – and this made the transformation task more complex than in most Central and East European states, which already had most normal state structures. Moreover, the citizenship question (i.e. whether to grant citizenship to members of ethnic minorities) proved to be controversial in both countries and required considerable attention from policymakers.

This was also a time of a severe economic crisis associated with steep output falls exacerbated by domestic and external demand shocks.[52] This "transformational recession" lasted until the basic components of the market system were in place, production recovered and new outlets for production could be found.[53] The Russian trade shock associated with the collapse of the USSR and the economic crisis was particularly severe for Estonia and Latvia given their dependence of Soviet markets.[54]

As pointed out before, all major reforms in trade policy have been preceded by crises, which profoundly affect interests, ideas and maybe even institutions within societies. In short, past failures provide a rationale for policy reform. Nevertheless, all of the ex-Soviet republics faced severe crises in the early 1990s, but the non-Baltic states did not succeed in implementing far-reaching reforms and external liberalisation.[55] This seems to confirm my comment in sub-section 1.3 that the existence of a crisis may be conducive to reform, but that it cannot by itself explain the Baltic puzzle.

Second, both Estonia and Latvia were severely constrained by their *external position*. Neorealists might argue that a country's foreign policy is largely a function of its position in the international system.[56] Although the starting point of my analysis is at the domestic level, it is important to note how the international context constrains domestic policy.

Two core factors are pertinent with respect to the external position of Estonia and Latvia: the *security dilemma* and the *size of the economies*. The security dilemma was viewed as a paramount constraint. Having lost their independence in 1939 and well aware that Russia still considered them within its sphere of influence – especially given the large proportion of Russian-speakers in the countries – safeguarding national sovereignty was bound to be a core objective of policy. Given this sense of insecurity, integrating economically and politically with the West was seen as an important way to reduce political risk.[57]

As regards the size of the economies, both Estonia and Latvia have small home markets (about 1.5 million and 2.5 million inhabitants, respectively) and they are also very dependent on imports of energy and a range of capital and consumer goods. Given the high opportunity costs of autarchy, one might expect external liberalisation to be more likely in Estonia and Latvia than in Poland, which can afford to be more protectionist with its large, growing home market.[58]

External factors have played a great role in promoting external liberalisation by affecting the core political economy variables (see below). However, the differences in external liberalisation between Estonia and Latvia on one hand and e.g. the small Caucasian republics probably are not explained by systemic factors alone. One needs to address domestic preconditions to understand why the reintegration into the world economy was prioritised in the Baltic states.[59]

History and culture tie Estonia and Latvia much more closely to the West than any of the other ex-Soviet republics. Both countries (or parts of them) have been under German and Swedish rule, which has left significant traces in their national cultures. Both Estonia and Latvia are predominantly Lutheran, and thus the only ex-Soviet republics that are protestant. These historical and cultural ties with Western Europe were further underpinned by the interwar independence. This period of independence, a market-based economy and relatively democratic societies existed as a Golden Age throughout the period of Soviet occupation in the nations' collective memory. Economic relations at that time were chiefly conducted with the West; Britain and Germany were Latvia's and Estonia's main trading partners.[60]

Independence was in many ways seen as synonymous with being a part of Western Europe. Contrary to e.g. Russia where the debate between Westerners and Slavophiles has never been resolved, there is thus a strong sense in Estonia and Latvia of being a part of Europe.[61] Thus, history, culture and geography – the relative proximity of Western Europe which facilitated integration – constitutes an important difference between Estonia and Latvia on one hand and the rest of the former USSR on the other. Still, this is only a partial explanation of the Baltic puzzle, as external liberalisation has been more radical than in many small Central and East European states, such as Slovenia, with cultural ties to the West.

I conclude that these three factors – crisis, external position and history/culture – *taken together* contributed to an environment where external liberalisation could be seen as a *likely* outcome. However, as my survey illustrates, determinism must be rejected, as none of these factors separately led to the Baltic puzzle – an outcome that few people would have predicted ten years ago. We therefore need to proceed with a political economy analysis to see how these factors have translated into actual policy.

3.2 Political economy analysis: interests, institutions and ideas

We now examine the role of the three political economy variables *interests, institutions* and *ideas* in contributing to the Baltic puzzle.

As pointed out in subsection 1.3, *interest groups* play a crucial role in the determination of foreign economic policy in most industrialised countries and, in particular, often act to prevent trade liberalisation. The initial phase after the collapse of communism differs fundamentally from this standard situation in that it constitutes a "period of extraordinary politics."[62] During this period interest group politics is temporarily suspended and policymakers enjoy a window of opportunity to carry out reforms independently, until new interest groups form. For the Baltic states, this meant that the previously powerful interest groups, e.g. industrial firms and collective farms, were dissolved or significantly weakened.[63] Given the deep crisis in the economy these groups became predominantly concerned about their own survival and had less of an impact at the outset than e.g. the big interests in Russia.

The 'period of extraordinary politics' may also have been longer in Estonia and Latvia than in the other transition countries, including Lithuania.[64] One reason for this may have been the greater perceived urgency of the issue of national survival and the reversal of Russification, which was linked to the sizeable Russian minorities and the debate about their citizenship rights. Taagepera has argued that there were only two electorally relevant interest groups in Estonia in the run-up to independence: the ones favouring independence (mainly ethnic Estonians) and the ones opposing it (mainly ethnic Russians and other nationalities).[65] During the period of extraordinary politics the ethnic Estonians and Latvians who constituted most of the electorate (given the restrictive citizenship laws) were very concerned with national survival. Thus, the political debate revolved around national survival instead of reverting to socio-economic issues as quickly as elsewhere (e.g. Lithuania or Poland), where national survival was not seen to be at stake.[66]

I conclude that the period of extraordinary politics was particularly conducive to radical economic reform in Estonia and Latvia as the usual inertia created by politicking, particularly by producer interests, was largely overruled. However, the absence of interest group pressure can only explain that reform was possible, but hardly its nature or the Baltic puzzle.

I now turn to the role of *institutions* in accounting for the Baltic puzzle. The collapse of the Soviet Union created an institutional vacuum much greater than in most Central and East European countries. Many institutions had to be created, not just reformed. This vacuum also created an opportunity for a *tabula rasa* and a way of bypassing the usual institutional inertia, in that new people took over.[67] In many cases Estonian and Latvian specialists who had lived in exile were brought in to create the new institutions, e.g. Ardo Hansson and Rudolf Jalakas in the case of the Bank of Estonia.

The relatively limited resources for creating big institutions also favoured a relatively open international regime, as successful external controls require more administration (notably customs officials).[68] The possibility to create new institutions was exploited more fully in the Baltic States (particularly in Estonia) than elsewhere in the CIS, where the old bureaucrats and politicians have often continued to work at their old positions.[69] Thus, the institution building in Estonia and Latvia, just as the weakening of interests, constituted a good environment for reform. Again, these two factors cannot fully account for the *content* of reform and the radical external liberalisation.[70]

To understand the Baltic puzzle, we also need to look at the third factor, namely the role of *ideas* that serve as principled or causal road maps.[71] Although the impact of ideas is often difficult to quantify and substantiate formally, it seems to be a very important contributor to the Baltic puzzle. Here, I focus on economic and political ideas, which were important to the key policymakers in both Estonia (e.g. *Pro Patria*) and Latvia (e.g. *Latvia's Way*) and also most certainly more popular with the population at large than in the other former Soviet republics.[72]

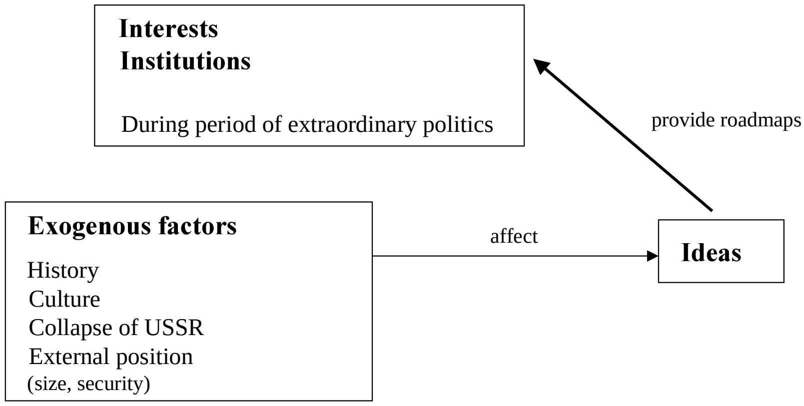
The economic ideas most prevalent in Estonia and Latvia were those of neoclassical economics.[73] The merits of free markets and competition seemed obvious to the policymakers at the time, especially given the blatant failures of the command system. An open economy can be seen as a part of this package. The Estonian and Latvian foreign service officials I spoke to referred to this as a "pendulum effect," i.e. the perceived necessity to try something completely different. This attitude was further promoted by the exogenous factors discussed above; in particular, the size of the economies and their resulting trade dependence, as well as the decline in trade with Russia.

The salient political idea related to foreign policy was that Estonia and Latvia needed to be reintegrated into Western Europe. This idea was greatly conditioned by exogenous factors – partly by historical and cultural factors, and partly by perceived security imperatives. Thus, opening up the economy and trading with Western Europe could be seen as a way of achieving this political objective.[74]

3.3 Conclusion

To conclude I would argue that the idea-based consensus of the key policymakers which was supported by the populations at large is at the core of the Baltic puzzle. Certain ideas acted as roadmaps to policymakers, who could implement them thanks to the special role of interests and institutions in early transition. These ideas gave a purpose where the *tabula rasa* of interests and institutions could be exploited at the outset of reform. The prominence of these ideas can largely be explained as a result of exogenous factors.

Figure 1. The Political Economy of the Baltic Puzzle



4 Accounting for the Estonian puzzle

> *Estonia is the leader among the Baltic countries in foreign trade liberalisation. It presently has one of the most liberal foreign trade systems in the world, and certainly the most liberal one in Europe*. Seija Lainela and Pekka Sutela[75]

I now would like to address some core differences between Estonia and Latvia, namely Estonia's more rapid reorientation to the West and the adoption of a unilateral free trade regime[76]. This is perhaps the most remarkable feature of Estonia's reforms, given how rarely free trade occurs in the world. I will try to analyse this outcome by comparing Estonia to Latvia, which has adopted varying tariff rates for industrial policy purposes and agricultural protection. My argument is that interests, institutions and ideas all seem to have contributed to this, and that Estonia's geographical position may also have helped to achieve the rapid reorientation.

4.1 Explaining the Estonian puzzle: policies

We begin the analysis with a discussion of exogenous factors (initial conditions, external factors and history/culture) and then turn to the differences in the role of interests, institutions and ideas, all of which seem to have had a bearing on policy.

4.1.1 Exogenous factors

In terms of *initial conditions*, Estonia may have been in a more favourable position to embark on rapid reforms than Latvia. An ambitious proposal for economic autonomy was made already in September 1987 when the IME programme (*Isemajandav Eesti*) was launched. This programme, which partly drew on the historical precedent of Finland's special position in

Czarist Russia, envisaged economic autonomy, including an Estonian currency.[77] Economic policy issues were actively debated for several years before independence, and a certain policy consensus existed which could then be implemented. Many of the people participating in the draft of this proposal assumed key positions in economic policymaking after independence, e.g. Siim Kallas, who became President of the Bank of Estonia. Latvia lacked such blueprints, partly because the Communist Party – the key political force in Soviet Latvia – was less supportive of autonomy than its Estonian counterpart, largely due to the high proportion of ethnic Russians among its members. Not surprisingly, the break with Moscow happened later in Latvia.[78]

With respect to *external factors* there are many similarities, especially the tenuous relationship to Russia.[79] However, the role of the Nordic countries, and Finland in particular, was different. People in Northern Estonia could watch Finnish TV during the Soviet era, and this exposure to capitalism may have increased the consensus among people to reform rapidly. The cultural and linguistic affinity has probably promoted trade and FDI, as it has been easy for Finnish business people to work in Estonia. Finland has also become the largest trading partner and alongside Sweden the largest foreign investor in Estonia. The geographical proximity and excellent communications between Tallinn and Stockholm and Helsinki have also contributed to contacts with the Nordic neighbours and a high level of integration. Finnish tourists make up the lion's share of total tourism in Estonia and have raised aggregate demand, especially in Tallinn. All of this may have made it more obvious for Swedes and Finns to trade and invest in Estonia rather than Latvia.[80]

Finally, it has been argued that there are also *cultural differences* that made Estonians more likely than Latvians to embark on radical external liberalisation. Some observers, for example Estonian foreign minister T.H. Ilves, went so far as to suggest that there is a "civilisational" border between the two countries, with Estonia belonging to a distinct "Huntingtonian sub-civilisation" together with Scandinavia and Britain.[81] Others have noted a greater sense of individualism and a more positive attitude towards foreigners in Estonia which may have generated more favourable preconditions for opening up.[82] Admittedly, this may be a partial explanation of the Estonians' greater willingness to liberalise quickly, but cultural criteria are inevitably subjective. They can also create an impression of determinism that may lead one to underplay the role of institutions.[83]

In sum, the exogenous factors – the preparations as part of IME, the Finnish connection and possibly also a culturally motivated favourable attitude towards the rest of the world – may have contributed to the policymakers' boldness in embarking on radical trade liberalisation in Estonia.

4.1.2 Political economy factors

With regard to the three political economy variables *interests, institutions* and *ideas* significant differences existed between Estonia and Latvia, and I shall now examine them in turn.

Most experts on the Baltic States agree that the role of interest groups is much greater in Latvia than in Estonia.[84] This may partly be related to different economic structures at the outset of reform, particularly the existence of larger industrial units with more political clout and the greater involvement of the ethnic Russian population in business activities. Given that the Russians do not participate (at least as actively) in the official political system as many of them are non-citizens, one might hypothesise that they are more likely to use lobbying activities instead.[85] I will now examine how interest group activity may have contributed to two core differences between Latvian and Estonian trade policy, namely protection for industrial policy purposes and agricultural protection.

First, Latvia had a greater share of heavy industry than Estonia, where there was more light industry.[86] Large factories and firms are generally much harder to restructure, and their liquidation is likely to be very painful. Due to both the welfare cost and also the larger political clout of these industrial structures resisting change, it may have been harder to proceed rapidly with external liberalisation in Latvia. The economic case for gradualism to shield firms from suddenly facing competitive pressures and to prevent the short-run welfare costs of an excessive fall in production may also have been stronger.

Interest-based explanations also seem relevant in accounting for the agricultural tariffs. Rural interests seem to be better organised and represented in Latvia than in Estonia. One reason for this is demographic. Latvia's seven biggest towns all have Russian-speaking majorities, whereas the countryside is overwhelmingly Latvian. The picture is mixed in Estonia, where the capital Tallinn has roughly an equal proportion of Estonians and non-Estonians and two of the other four largest cities have clear Estonian majorities.[87] Given that many non-Estonians and non-Latvians do not participate in political elections, it is clear that the rural constituency is a much larger part of the Latvian electorate. Consequently, all major political parties in Latvia seem to agree on the desirability of maintaining agricultural protection.[88]

This contrasts sharply with Estonia, where only a few parties have actively supported agricultural tariffs. The weakness of the Estonian agricultural lobby can be illustrated by the brief period of agricultural protection against Russian imports in August 1993. Although the establishment of the tariffs may be seen as a result of interest group pressures, they were only maintained until December, mainly because they were seen to be ineffective (Russian agricultural products were imported via Latvia instead). Had the agricultural lobby been sufficiently strong, one would expect it to have lobbied successfully for protection vis-à-vis other countries as well. Instead Estonia reverted to free trade.[89]

There are also significant *institutional differences* between Estonia and Latvia, which seem to have favoured the adoption of a coherent free trade policy in Estonia. One aspect of this is the more frequent occurrence of government crises in Latvia, which has partly been offset by the continuing presence of *Latvia's Way* in government.[90] Although this has not led to major policy reversals, it may well have contributed to slowing down the pace of reforms and to making it harder to devise an equally coherent and simple trade policy regime as in Estonia.

Moreover, technocrats have played a greater part in economic policy formulation in Estonia.[91] The Foreign Economic Policy Section of the Estonian Ministry of Foreign Affairs has played a key role in policy formulation and has overall responsibility for trade policy among the ministries, although other input is often used on specific issues. In Latvia, the responsibility for trade policy is divided between the MFA and the Economics Ministry, which is in charge of bilateral trade relations. Although the Estonian parliament has the overall responsibility for trade policy, the role of the bureaucracy in policy formulation can always be expected to be significant. Both the key role of technocrats – assuming that corruption is not pervasive – and clearly assigned responsibilities contribute to coherent policymaking like free trade across the board. Varying tariff rates suggest, *ceteris paribus*, political compromises to gain the support of powerful interest groups such as industry or agriculture.

Similar differences appear in the realm of *ideas.* The salience of neoliberal economic ideas seems much greater in Estonian politics. One needs only look at the parties' economic programmes: all the parties in government at the time of the dramatic trade liberalisation in

1992-3, including both the liberal-conservative Pro Patria (*Isamaa*) and the centre-left Moderates (*Mõõdukad*), supported free trade. Only the Agricultural Party (*Maarahva Erakond*) has consistently pushed for protection, whereas e.g. the *Koonderakond* supported agricultural tariffs in opposition, but did not push the issue while in government. By contrast, there has been a broad policy consensus in Latvia in favour of agricultural tariffs.

In terms of *political ideas* there is broad agreement among the main parties (but not necessarily the populations at large) in both countries about the ultimate aim, namely integration with Western Europe and EU membership. The adoption of agricultural tariffs against third countries by Estonia from the beginning of 2000 means that complete free trade no longer applies. This may signal the beginning of a process of convergence of Estonia's and Latvia's trade policies, which will culminate with the likely EU accession when both of them adopt the Common External Tariff.[92]

The different time paths may be attributed to differences between the *ideas* about appropriate short-term political means. The Estonian case has been labelled a classical liberal approach with its emphasis on *unilateralism*, whereas Latvia has favoured *reciprocity* in terms of trade policy making[93]. This may partly be linked to the prominent role of technocrats in policy formulation in Estonia, as stated above.

To conclude, the discussion above suggests that differences in interests, institutions and ideas are all consistent with the differences between the Estonian and Latvian trade regimes and may be viewed as factors explaining the Estonian puzzle.

4.2 Explaining the Estonian puzzle: outcomes

The Estonian puzzle in terms of outcomes refers to the more rapid reorientation of trade to the West and also to the greater success in attracting FDI on a per-capita basis.[94] These outcomes must, to a large extent, be seen as a function of the more liberal policy choices, but I will briefly consider two additional factors.

First, there are important linkages with the reform process in general. Most obviously, the role of privatisation by competitive tenders open to foreign bidders has been greater in Estonia.[95] As a large proportion of FDI is linked to privatisation, this goes some way in explaining the higher rates of FDI in Estonia. Moreover, a considerable amount of FDI to Estonia and Latvia is trade-creating, especially given the small size of their markets. Foreign firms thus make use of the high skills of the work force in relation to the low wage costs to establish production networks. In this way, privatisation policies may have contributed to the rapid trade growth.

More generally, it seems that Estonia has been more successful in legal reform. The level of corruption is lower in Estonia than in Latvia, as illustrated e.g. by Transparency International's surveys.[96] This may have consolidated the impression of Estonia as a better business environment among potential investors. Finally the impact of the external factors should not be understated. As pointed out in sub-section1.4, the role of Estonia's special relationship to Finland and to a lesser extent Sweden has been of great importance in attracting foreign investment, especially in the early phases of reform.

4.3 Conclusions

To conclude the analysis of the Estonian puzzle, I note that the three classical political economy variables all seem to have contributed. The more favourable exogenous factors may have facilitated rapid reform, especially the cultural and geographic closeness to Finland and Sweden.

5 Conclusion: the political economy of external liberalisation

The purpose of this essay has been to make a contribution to the literature about the political economy of external liberalisation in transition countries and policy reform in general by carrying out a case study of two successful reformers, Estonia and Latvia. I have tried to incorporate exogenous factors in a political economy analysis to explain two puzzles – the Baltic and Estonian puzzles.

There are some important lessons from this exercise. First, my discussion of the Baltic puzzle confirms the findings of earlier work on policy reform that a crisis may be a trigger for reform, in that it prevents the usual interest group activity from blocking reform.[97] It is also consistent with the findings of David Henderson that the role of ideas is significant in large paradigm shifts.[98] Crises, institutional change and absence of traditional lobbying can only explain the feasibility of reform, but not completely its substance. Exogenous factors (history, geography, security concerns, etc.) may help to explain the prevalence of certain ideas at a certain time.

Second, although free trade is widely advocated by economists, it rarely exists in practice. Understanding the Estonian puzzle is therefore very important, especially for free trade advocates. The difference with Latvia illustrates that fairly similar exogenous factors, such as history, security and the size of the economy, do not necessarily trigger the same idea-based consensus. Instead, it seems that a favourable configuration of interests, institutions and ideas, which it may not be possible to copy elsewhere, helped to make the Estonian puzzle a reality.

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Notes

[1] For a survey of the literature, see Rodrik (1996).

[2] One might argue that it is irrelevant to draw lessons from the experience of two small countries with about 1.5 (Estonia) and 2.5 million (Latvia) inhabitants. On the other hand, certain issues are generic and there are many small economies in the world where these lessons may be applicable.

[3] I refrain from comment on current policy or future developments.

[4] See EBRD (1994 & 2000).

[5] See Rodrik (1996).

[6] On these two approaches, see Hollis and Smith (1990).

[7] Desai (2000:3)

[8] Kornai (1992)

[9] On alliance trade, see Gowa (1989).

[10] On CMEA trade, see Kaser (1965). Trade outside the CMEA increased during the era of détente and import-led growth in the 1970s, since it was seen as a way of improving economic performance. For a survey of the import-led growth strategy, see Fallenbuchl (1981), Hanson (1982) and Gomulka (1978).

[11] On the problems of command economies, see Kornai (1992)

[12] For the sake of simplicity, I speak of a stylised free-market economy. Today, most economies are actually mixed with some state intervention.

[13] Rodrik (1996) and Henderson (1998).

[14] Hall (1997)

[15] See Rodrik (1996:27). Note that e.g. India has faced several balance of payments crises after independence, but liberalisation only started after the crisis in 1991. See Joshi and Little (1994).

[16] On the collective action problem see Olson (1965).

[17] On the window of opportunity in transition – the period of extraordinary politics, see Balcerowicz (1995).

[18] For debates about the role of institutions and regimes in IPE, see e.g. Krasner (1983), Keohane (1984) and Keohane and Nye (1977).

[19] Given the prominence of bureaucratic coordination in the command economies, this seems to fit the old regime well.

[20] Goldstein and Keohane (1993:3ff).

[21] On the importance of liberal ideas in policy reform over the last decades, see Henderson (1998).

[22] Countries with similar histories, positions in the international system or facing similar external shocks often choose very different policies (cf. Gourevitch's Second Image Reversed). Hall (1997).

[23] Dreifelds (1996:4)

[24] Shteinbuka and Cirule (1997) and Kukk (1997)

[25] Estonia had the USSR's first two joint ventures in 1987, and by July 1991 both had over 100 JVs. Shen (1996:159)

[26] Strictly speaking, an examination of the Baltic puzzle should involve Lithuania, but I here consider two out of three Baltic States as a representative sample. Much of what I say about Estonia and Latvia holds for Lithuania too, although reforms have been somewhat slower there (EBRD 1994, 2000; Lainela and Sutela:1994). Noting that in the past the term 'Baltic states' only denoted Latvia and Estonia. Perhaps this further pardons my omission of Lithuania. See von Rauch (1970:xi).

[27] Shteinbuka and Cirule (1997)

[28] On classical liberalism and its applicability to the Estonian case: Sally (1998) and Sally (2000).

[29] For surveys of the currency reforms in Estonia and Latvia: Lainela and Sutela (1994), Lainela (1995).

[30] Lainela and Sutela (1994) argue that the differences between the two countries with respect to currency reform, exchange rate policy and stabilisation merely illustrate different ways of achieving the same target.

[31] EBRD Transition Reports (various years) and Bank of Finland website www.bof.fi/bofit.

[32] Shen (1994)

[33] On all, see WTO (1998) and (1999) and Mygind (1998).

[34] Bank of Finland (2000b)

[35] Bank of Finland (2000b)

[36] Kala (1995), Purju (1997), Kukk (1997)

[37] Furs (16%), sea scooters, small vessels and snow scooters (10%) (WTO 1999)

[38] IMF (1999b)

[39] Shteinbuka and Cirule (1997)

[40] Grain received as humanitarian aid was exported to Estonia. The tariffs were ineffective, as the agricultural goods were imported via Latvia instead. Lainela and Sutela (1994:117), Kala (1995).

[41] Basic production-weighted average 34.9%

[42] IMF (2000)

[43] WTO (1998) and (1999)

[44] For an economic assessment: Korhonen (1996).

[45] Shteinbuka and Cirule (1997) and Kukk (1997)

[46] Lainela and Sutela (1994:118)

[47] See Ministry of Economics, Latvia (1999) and Bank of Finland (2000a).

[48] See Partanen (1998).

[49] Meri (2000)

[50] See 1.3

[51] Some reforms preceded independence. See Misiunas and Taagepera (1993) for details.

[52] Lainela and Sutela (1994)

[53] Kornai (1993)

[54] Poland conducted about 20% of its trade with Western Europe in the mid-80s. The corresponding figure for the Baltic States was negligible (Varblane 2000b:2).

[55] See e.g. EBRD (various years).

[56] Waltz (1979)

[57] See e.g. Taagepera (1993) and Shen (1994).

[58] Varblane (2000b)

[59] Different perceptions of the security dilemma or the opportunity cost of independence in economic terms may constitute a partial explanation. Baltic living standards were higher than in Russia, whereas the Caucasian living standards were lower than in Russia.

[60] von Rauch (1974:125f)

[61] See Meri (2000)

[62] Balcerowicz (1995)

[63] There are differences here between Estonia and Latvia, see section 4. Interest politics has consistently been more prominent in Latvia.

[64] The political backlash against reforms in Lithuania coincided with the election of the ex-communists to government in 1992. More moderate backlashes occurred in 1995 in Estonia and Latvia. For a discussion of this, see Mygind (1998).

[65] Taagepera (1993:176)

[66] See Mygind (1998)

[67] This is true both of Latvia and perhaps even more so of Estonia.

[68] For an elaboration of this argument with respect to Poland, see Sachs (1993).

[69] This is broadly true of Russia.

[70] A public choice-based account of bureaucratic decision-making would usually assume that administrators want to maximise their departments and budgets selfishly – this would not necessarily point towards external liberalisation, and quite possibly the opposite.

[71] See Goldstein and Keohane (1993:3ff.).

[72] These were the key parties in the reformist governments in 1992-3.

[73] In the realm of ideas there are significant differences between Estonia and Latvia, which I discuss in the next section.

[74] It may be hard to separate economic and political factors in practice, as a main motivation for the rapprochement with Western Europe probably was the idea that ‘being in Europe means being rich.’

[75] Lainela and Sutela 1994:117

[76] Much of what I say about trade also applies to FDI.

[77] Taagepera 1993:128ff.

[78] Arter (1996:55)

[79] A small difference later in transition may be that Latvia has a Most Favoured Nation trade agreement with Russia, whereas Estonia does not. This may have contributed slightly to Estonia's reorientation to the West.

[80] The Finns are sometimes also referred to as the Estonians' leading lobbyists in Brussels, which might be viewed as the political dimension of this relationship.

[81] Ilves (1999). See also Huntington (1996).

[82] Shen (1994:215) and Mygind (1998)

[83] They are virtually impossible to test empirically and can very easily become "catch-all" categories accounting for everything that we cannot explain otherwise. See also Olson (1996)

[84] Interviews; Mygind (1998).

[85] This is difficult to prove, but most interviewees considered this as a fair description.

[86] Shen (1994)

[87] See Arter (1996) and Taagepera (1993).

[88] Nissinen (1999: 174ff.)

[89] The introduction of agricultural tariffs against third countries from early 2000 only partly reflects interest group pressures. The main reason seems to be external pressure: my Estonian interviewees suggested i.e. the need to establish customs practices and gather experience from tariff collection before EU accession and the adoption of the Common External Tariff.

[90] Parallels have been drawn to the post-war Italian system, which experienced frequent government crises, but always with the Christian Democrats in the cabinet. See *The Economist* (2000).

[91] Mygind (1998)

[92] See Varblane (1999a, 1999b) for the implications of EU accession.

[93] Although both Estonia and Latvia view WTO membership as an important goal, there are differences in short-term policy emphasis. Both the Estonian and Latvian diplomats I spoke to stressed that WTO membership was prioritised much more by the Latvian MFA, whereas the Estonians maintained a focus on the unilateral track and viewed WTO membership largely as a way of locking in previous domestic reforms. See also Sally

(1998) on the theory behind this and Sally (2000) for the Estonian case.

[94] For a more comprehensive study of the Estonian investment climate, see Ziacik (2000).

[95] See EBRD (various years)

[96] According to this, Estonia has lower levels of corruption than several EU members. See Ilves (1999).

[97] Rodrik (1996)

[98] Henderson (1998)

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