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But, as a Russian – oh, you're not a Russian? Well, as a German, you – oh, you're not a German either? Well what are you? An Eskimo? No? An Estonian*? Where is that?*
Jaan Kross, Professor Martens' Departure

Abstract

This paper examines the political economy of Estonian trade policy in the 1990s. Estonia is a unique case in the world economy, in that the country rapidly implemented unilateral free trade after regaining independence and sustained it right through the 1990s. We analyse the circumstances, interests, ideas and institutions that have shaped Estonian trade policy during the past decade. Our stress is on institutions, particularly the *national decision-making setting* for trade policy. Through this prism we try to understand how a free trade regime was implemented and sustained, and what this experience suggests for the feasibility of free trade elsewhere. We also look at the increasingly "multi-track" nature of Estonian trade policy through bilateral free trade agreements, WTO accession and, especially, the movement towards EU accession. Although the other trade policy tracks to some extent provide a lock-in for unilateral reforms, we argue that EU accession is undermining the simple, classical liberal trade policy regime that existed during the 1990s.

Keywords: trade policy, free trade, political economy, Estonia, FTAs, WTO, EU

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Introduction

Estonia, the smallest of the Baltic republics, was part of the Soviet Union just a decade ago; now, as a sovereign nation-state, it is in the first division of East European countries in transition negotiating terms of accession to the European Union. Since the restoration of independence in 1991[2] Estonia has undergone the swiftest, most comprehensive transformation of a national economy in modern times. Trade policy reforms have been critical to the overall reform effort, rapidly shifting the economy from high protection within the Soviet command economy to *almost complete free trade à la Hong Kong.* It is this that sets Estonia apart from other better-known, "headline" reforming countries, such as Poland, the Czech Republic and Hungary in East Central Europe, Chile in Latin America, and New Zealand in Asia-Pacific. However, since the mid-1990s, Estonian trade policy has become more complex; in particular, EU accession negotiations are bringing about fundamental and irrevocable changes to its trade policy regime.

Our focus is the *political economy* of Estonian trade policy reforms. Given broadly similar (and dire) initial conditions at the outset of transition in the ex-Soviet Union, why did Estonia race ahead of the pack to abolish protection wholesale? In the second phase of transition, Estonia is inexorably pulling away from unilateral free trade and towards the tariff and non-tariff protection of the EU's Common Commercial Policy. Our emphasis here is on the trade policy-related aspects of Estonia's quest for EU membership rather than on the accession package as a whole; and we try to assess to what extent EU accession is undermining Estonia's liberal trade policies of the 1990s.

We address these questions through the political economy looking glass of circumstances, interests, ideas and institutions. Our stress is on *institutions,* and especially the *decision-making setting* for trade policy. This approach stands out from other studies of trade policy reform in developing and transitional countries in that it points to national decision-making processes as one of the core components of the political economy explanation.

Estonia is a fascinating – perhaps unique — example of recent trade policy reform. However, the reader may well ask whether any wider, more general lessons can be gleaned from the Estonian experience. After all, this is a country of 1.45 million people nested in a region that, until just a decade ago, seemed to have disappeared from the global map.

We argue that the Estonian trade policy experience is of interest and relevance to other developing and transitional countries in three respects. First, Estonian free trade was part of a constitutional, "classical liberal" package of small government, stable exchanges and *laissez faire*, akin in some respects to the "Victorian social contract" of mid-to-late nineteenth century Britain. The Estonian case could well say something about the political and economic requisites for attempting and sustaining a classical liberal transformation of other national economies – especially small, open (or potentially open) economies.

Second, national trade policy-making is becoming more complex throughout the developing and transition worlds, and it is facing ever-greater external demands and challenges. In particular, countries are pursuing trade policy on numerous tracks at the same time. The "multi-track" management of Estonian trade policy may help to shed some light on the relationship between unilateral trade policy, bilateral and regional trade agreements, and the multilateral trading order. The Estonian experience illustrates both complementarities and tensions between these tracks, which may be of general relevance.

Third, since independence trade policy in Estonia has been one of the pillars of national political and economic institution building. The evolution of trade policy decision-making, within government and involving both non-governmental actors and international organisations, has been integral to such institutional build-up. Once again, there may well be Estonian lessons for other countries in not-too-dissimilar situations.

The following discussion begins with an overview of Estonian policy reforms and economic performance since 1991, concentrating on trade policy reforms. The argument proceeds to political economy explanations, zeroing in on the decision-making framework for trade policy. Then follows a consideration of "multi-track" trade policy (on unilateral, bilateral, EU and WTO tracks). The conclusion assesses the state-of-play in Estonian trade policy, and draws out lessons from the Estonian experience for the conduct of trade policy elsewhere in the less developed world.

Estonian policy reforms and economic performance post-independence: an overview

a) Initial conditions

Like its neighbours Latvia and Lithuania, Estonia was fully integrated into Soviet central planning. Moscow determined what was produced in Estonia; and economic relations with foreign countries were managed via all-Union foreign trade associations. Not surprisingly, Estonian exports outside the Soviet Union accounted for a paltry 2-3 per cent of its GDP in the second half of the 1980s, with two-thirds of that going to other COMECON countries.[3]

Political independence in 1991 took place in an atmosphere of escalating economic crisis. The break-up of the Soviet economic system left the small Baltic markets in an extremely weak and vulnerable position. At a stroke, their main export market, the rest of the ex-Soviet Union, collapsed; simultaneously, they suffered a huge adverse terms of trade shock as a result of massive and sudden price increases on energy imports. In the Baltic region as a whole, GDP declined by 40 per cent and industrial production by 60 per cent between 1990 and 1994, accompanied by hyperinflation in 1991/92.[4] Initial conditions, therefore, were worse for the Baltic states than for the East Central European states that were part of the Soviet sphere of influence without actually being part of the Soviet Union.

b) Economic policy reforms and economic performance

Estonian policy reforms started earlier, proceeded more quickly and were more comprehensive than anywhere else in the ex-Soviet Union, even compared with its Baltic neighbours.

Internal price liberalisation started early (in October 1990). Arguably, the centrepiece of the overall reform effort was the dramatic currency reform of June 20th 1992 (forty-four years to the day after Ludwig Erhard's landmark monetary reforms in West Germany). A currency board was introduced – the first in an ex-Soviet type economy – fixing the new Estonian kroon against the DMark at 8:1. The currency reform took Estonia out of the increasingly volatile rouble zone, introduced hard budget constraints, was crucial for the speedy restoration of macroeconomic stability, and, more generally, injected a strong dose of credibility into the wider reform programme.[5] The Estonian kroon became automatically fixed to the Euro when Germany entered the European Monetary Union in 1999.

Other reforms followed thick and fast. On the fiscal side, state subsidies were gradually eliminated, including subsidies to agriculture; balanced budgets were made a legal requirement; and a flat tax of 26 per cent on personal and corporate incomes was introduced (corporation tax on reinvested earnings was abolished in 2000). Large-scale enterprise privatisation was modelled on the East German Treuhand approach: direct sales to "core" investors were based on open bids followed by negotiations on restructuring and new investment. Also worthy of mention are progressively stronger financial regulation, strong bankruptcy laws and an amended commercial code that establishes basic principles for restructuring firms.

The final pillar of Estonian policy reform was the "big bang" move to external openness. Early on in transition Estonia established a liberal payments regime, abolished almost all tariff and non-tariff barriers to trade, and pulled the door wide open to foreign direct investment. The details of trade policy reform will be discussed below. (See Table I for milestones in Estonian economic policy reform during the 1990s).[6]

Table 1: Milestones in Estonian economic policy reform

1989	First private bank formed
1990	Price liberalisation started; abolition of state trading monopoly.
1991	Independence from the Soviet Union; small-scale privatisation started; first wave of trade liberalisation; law on foreign investment enacted.
1992	New DM-pegged currency board; new centre-right reformist government led by Mart Laar; large-scale privatisation started; bankruptcy law enacted.
1993	Establishment of Estonian Privatisation Agency on the Treuhand model; abolition of almost all remaining tariffs; Baltic free trade agreement signed.
1994	Completion of small-scale privatisation; full current account convertibility according to IMF Article VIII; full capital account convertibility; removal of remaining non-tariff trade barriers; introduction of flat income tax.
1995	Economy starts to grow after 36% contraction between 1990 and 1994; start of WTO accession negotiations; free trade agreement signed with EFTA and Ukraine; Association Agreement with the EU; application for EU membership; commercial code enacted; centrist government formed after the general election.
1996	Free trade agreements signed with Czech Republic, Slovakia and Slovenia.
1997	10.6% GDP growth – the highest in Europe; European Commission recommends Estonia as one of six candidates on fast-track to EU membership; free trade agreement with Turkey; last remaining (insignificant) tariffs abolished.
1998	Free trade agreements with Poland and Hungary; commencement of EU accession negotiations; Europe Agreement came into force; pension reform law adopted; EU-compatible competition law adopted.
1999	Three party centre-right government formed after general election; Estonia becomes 135th WTO member; law on introducing customs tariffs adopted.
2000	Customs tariffs on agriculture against third countries introduced. Tariffs due to go up to EU levels upon accession.

Sources: EBRD *Transition Report 1999;* authors' additions

The British "Victorian social contract" encompassed internal and external free trade, stable exchanges based on the gold standard, and "Gladstonian public finance" (light taxation and expenditure in the context of balanced budgets).[7] Hong Kong is the closest twentieth century equivalent. Estonia, with its light regulation, currency board, small budget deficits and unilateral free trade, came close to this classical liberal package in the 1990s on most counts.[8]

Estonian public policy post-independence has set the scene for the speedy structural transformation of the economy.[9] A previously closed, technically backward and uncompetitive economy is moving fast towards a developed economy structure. Prices are stable and the public finances have been in reasonably good order. Output stabilised and shifted into high growth gear in 1996, although it was hit hard by the Russian crisis in 1998/99. The clearest sign of rapid structural transformation is the almost total overhaul of Estonia's trade and foreign direct investment relationships as part of its reintegration into the world economy. This will be discussed below.

That said, there remain major fault-lines in Estonian economic performance, notably high unemployment (14.8% in 2000 according ILO labour force surveys).[10] (See Table II for the main indicators of Estonian economic performance in recent years).

Table II: Estonian economic indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP growth, %	-14.2	-8.5	-2.0	4.3	3.9	10.6	4.7	-1.1	6.4, H1
Inflation, %, end-year	1076	89.8	41.7	28.9	14.8	12.5	6.5	3.9	5.4, 10
General government budget balance, % of GDP	-0.3	-0.6	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-1.7, H1
Average gross wage, USD, period average	N/a	N/a	134	208	248	256	283	337	286, 1-9
Unemployment, end of period, registered	0.9	5.5	5.1	5.0	5.5	4.6	5.1	6.5	6.7, 10
Exports, USD million	430	766	1211	1660	1764	2275	2674	2437	2352, 1-9
Imports, USD million	397	854	1557	2398	2876	3516	3928	3430	2997, 1-9
Current account balance, % of GDP	N/a	1.3	-7.2	-4.4	-9.2	-12.1	-9.2	-5.8	-5.4, H1
Nominal GDP, in bn USD	1.04	1.64	2.28	3.54	4.37	4.63	5.19	4.84	N/a

Sources: Estonian Statistical Office, Bank of Estonia, Bank of Finland, IMF

c) Trade policy reforms and integration into the world economy

Substantial unilateral trade-and-investment liberalisation has taken place outside the OECD area since the 1980s. A number of Latin American, East Asian and East European countries have been in the vanguard of such unilateral liberalisation (one could add Australia and New Zealand from the OECD). Chile and New Zealand stand out as regional benchmarks, as does the Czech Republic from East Central Europe.[11]

However, none of the above has gone as far as Estonia. If the litmus test of free trade (broadly defined) is non-discrimination between own citizens and foreigners on international transactions,[12] then Estonia (until 2000) and Hong Kong come closer to it than any other country (with the possible exception of a handful of island micro-states serving as tax havens).[13] Estonia's substantial commitment to non-discriminatory unilateral free trade in the 1990s was the hallmark of its classical liberal package of policy reforms. We now turn to the details of its trade policy reforms.

To begin with, the currency reform was indispensable to trade-and-investment liberalisation. Full convertibility on current and capital account transactions (by March 1994) complemented the adoption of the currency board. These reforms, coupled with a substantial real devaluation of the new currency, enabled Estonian trade and FDI to switch quickly from ex-Soviet (mainly Russian) to West European markets.[14]

On the trade side, state trading monopolies and import quotas inherited from Soviet central planning were removed in 1991/92, *without converting quotas into tariffs.* Customs duties were applied on a few peripheral items,[15] but even these were repealed in 1997. The average weighted tariff was 1.4 per cent by the end of 1993 (down to zero by 1997). It should be noted that agricultural protection was abolished as part of the package.[16] In 1991, more than 200 items were covered by export quotas and licences; by the beginning of 1993, only five were still in force (all subsequently abolished by 1995).[17]

Table III: Estonia's trade liberalisation in comparative perspective

	Average weighted tariffs, in %, 1999	Trade to GDP ratio, 1999
Estonia	0	186.0
Bulgaria	15.1	87.7
Czech Republic	6.8	128.6
Hungary	13.3	137.6
Latvia	5.3	120.6
Lithuania	4.5	89.9
Poland	11.6	48.9
Romania	23.8	62.1
Slovakia	12.0	134.5
Slovenia	10.6	112.6
EU	5.0	74.5 (simple average)
Hong Kong	0	219
Singapore	0.26 (1995)	255
New Zealand	3.0 (2000)	56
Malaysia	8.1 (1997)	221
Mauritius	14.54 (1995)	132
Chile	9.0 (2000)	55

Sources: IMF *World Economic Outlook*; IMF Occasional Paper 180; WTO *Trade Policy Reviews*; World Bank Country Data.

Table III illustrates the extent of Estonian import liberalisation in comparative context. Its very liberal trade regime compares favourably not only with the ex-Soviet Union, but also with East Central European countries and radical liberalising countries in other regions. Within the Baltic region, while Estonia went practically all the way to free trade, Latvia and Lithuania maintained protection, especially on agricultural imports, with high tariff dispersion and recourse to quotas. Even comparatively liberal Latvia had 14 tiers of tariffs ranging from 0 to 75 per cent in 1999, with an average production-weighted tariff of 35 per cent on agricultural imports.[18] With foreign trade amounting to about 186 per cent of GDP, Estonia ranks amongst the most open economies in the world.[19] Growth is very much export-led and Estonia is becoming increasingly integrated into a Nordic/Baltic economic space.[20]

Estonia's liberalisation of foreign direct investment was also rapid, with the introduction of a legal framework for FDI in September 1991. National treatment applies and the full repatriation of profits is guaranteed. Licensing procedures are simple and impose few restrictions. Large-scale privatisation from late 1992, aimed at core (mainly foreign) investors, complemented the open door to FDI. The very liberal FDI regime has also guaranteed effective market access to foreign service providers.[21]

From the early 1990s, Estonia's FDI regime has largely eschewed selective incentives to attract foreign investors. Policy-makers have resisted tax holidays, free trade zones and the like in the belief that this would undermine the clarity and credibility of the *non-discriminatory* rule-framework[22]. This is another classical liberal feature of trade policy Estonia has shared with Hong Kong; most other countries, including nearly all countries in East Europe, offer selective (i.e. discriminatory) incentives to attract FDI.[23]

Radical trade-and-investment liberalisation, in combination with the collapse of the Soviet economic system and other policy reforms, has brought about a profound and rapid shift in Estonia's trade and FDI geography. Western markets accounted for 5 per cent of Estonia's exports in 1991; by 1999, the EU alone accounted for 63 per cent of Estonian exports and 58 per cent of its imports. Finland and Sweden are Estonia's main trading partners; Finland in particular has played a crucial, catalysing role in reintroducing Estonia to the world economy. Correspondingly, Russia's share of Estonian trade has declined dramatically since 1992. Trade with other Baltic countries remains modest. (See Table IV for Estonian exports and imports by country). Exports are still generally resource- and low-skill intensive, with somewhat higher value exports going to EU (rather than Russian) markets.[24]

Foreign direct investment has played an equally important and related part in Estonia's economic transformation. As Table V shows, Sweden and Finland are the main source countries, with investment largely flowing into manufacturing export sectors and services, especially telecommunications and banking. Much of the inward investment in manufacturing is in the form of subcontracting work for Finnish and Swedish-based companies. Estonian inward FDI stock per capita, at $1275 by 1999, is the third highest in Eastern Europe and the ex-Soviet Union after Hungary and the Czech Republic.[25]

Table IV: Main trading partners (January – October 2000)

	Exports	% of total	Imports	% of total
1	Finland	31.2	Finland	28.7
2	Sweden	20.4	Sweden	9.8
3	Germany	9.3	Germany	9.8
4	Latvia	7.1	Russia	8.7
5	United Kingdom	4.6	Japan	6.3
6	Denmark	3.5	Italy	2.9
7	Lithuania	2.9	Latvia	2.7
8	Netherlands	2.5	Denmark	2.5
9	Norway	2.4	United Kingdom	2.3
10	Russia	2.0	United States	2.2
11	France	1.5	Netherlands	2.2
12	United States	1.3	France	2.1

Source: Statistical Office of Estonia, www.stat.ee

Table V: FDI stock by source countries as of the end of September 2000

		Euros thousands	%
1	Sweden	1,051,553	39.2
2	Finland	834,591	31.1
3	USA	121,530	4.5
4	Norway	115,381	4.3
5	Denmark	108,644	4.1
6	Germany	72,471	2.7
7	United Kingdom	68,324	2.6
8	Netherlands	55,109	2.1
9	Russia	38,539	1.4
10	Singapore	33,697	1.3

Source: Eesti Pank/Central Bank of Estonia, www.ee/epbe

Political economy explanations

Now we turn to the political economy of Estonian trade policy reforms. A big question, or "puzzle," presents itself: Given roughly similar economic circumstances at the *point de départ* of transition in the ex-Soviet Union, why did Estonia go so much further than others, including its Baltic neighbours, in trade-and-investment liberalisation?[26] Why did it rush unilaterally, and exceptionally, to almost complete free trade? Our set of political economy explanations is framed within the well-known taxonomy of circumstances, interests, ideas and institutions.[27] As mentioned earlier, we stress institutions, and put the spotlight on trade policy decision-making.

Now, Estonia's quest to join the EU means it has to renounce free trade and adopt EU protection against third parties. This presents a second puzzle, which will be addressed head-on in the following section on "multi-track" trade policy. We also analyse Estonia's bilateral free trade agreements and WTO accession to identify complementarities and tensions between unilateral reforms and multi-track trade policy.

Phase One: The return to the world economy and unilateral free trade

a) Circumstances: crisis and other exogenous factors

The "crisis" explanation for radical economic policy reform is a popular one, following Dr. Johnson's maxim that "if a man knows he is going to be hanged in a fortnight, it concentrates the mind wonderfully."[28] And indeed all the real-world examples of radical trade policy reforms seem to have occurred in the aftermath of crises.[29] As a *partial* explanation, this fits the Estonian case. The extremely severe economic crisis in the early 1990s crippled the institutions and interests that held sway during Estonia's long subjection to Soviet central planning; and, by that time, the ideas and attitudes favouring "command and control" economics had been thoroughly discredited. Hence, economic crisis provided a rare "window of opportunity" for Estonian policy-makers to push through a critical mass of reforms.

Other "exogenous" factors should be taken into account. One is the very small size of the economy, which was conducive to the commonsensical appreciation that Estonia's future lay with integration into the world economy. Also, political-economic history and culture tie Estonia (and Latvia) more than any other part of the ex-Soviet Union to the West. Furthermore, Estonia's linguistic and cultural connection with Finland provided it with some contact to the West during the years of Soviet occupation.

Not least, the overriding imperative of Estonian public policy since 1991 has been to distance itself from Russian influence, safeguard national independence, and embed the nation firmly in Western Europe. Trade policy was and is viewed as a tool to achieve this primary national goal; along with other aspects of policy reform, it is part and parcel of an exercise in nation building.[30]

Crisis and other exogenous factors, while providing the appropriate backdrop, do not (pre)determine the extent, pace and sustainability of the reform programme. Russia and the rest of the CIS, after all, did not take advantage of economic crisis to launch wide and deep policy reforms. All three Baltic countries faced very similar economic conditions in the early 1990s, but only Estonia speeded ahead to unilateral free trade. This means that other factors, such as the role of institutions, interests and ideas, have to be brought into play. Our task is to see how initial conditions, particularly economic crisis, have *interacted* with other political economy factors to shape the form and content of Estonian trade policy in the 1990s.

b) Interest groups

Economic policy reform in Estonia did *not* occur at the behest of organised interests. As in many other developing and transitional countries, the reforms were carried out in an atmosphere of crisis — *against*, rather than in favour of, powerful established interests.[31] The big bang move to free trade, with the assistance of other reforms, especially the privatisation programme, pulverised the pre-independence *nomenklatura* coalition of state and party bureaucrats, and managers of state-owned enterprises and collective farms. This did not happen in Russia and the Ukraine, nor did it go as far in Latvia, Lithuania and other East European countries.[32]

Moreover, in the early days of external liberalisation, interest groups lacked experience of (relatively free) international trade, which meant that they did not fully grasp the long-term impact of liberalisation. The severe shortages of the final years of the Soviet Union made import quotas seem unattractive even to agricultural interests.[33] The undervalued kroon also helped to give industry and agriculture time to adjust, as the imported goods were simply not affordable for most domestic consumers. Generally speaking, the *bouleversement* of economic transition forced businesses, unions and other interests to concentrate their efforts on survival; this left little time and even fewer resources for collective action in the public policy-making process. However, the situation has been changing, albeit slowly, in recent years.

Over time the kroon has appreciated in real terms given relatively high inflation under the currency board (compared with Western Europe), and this has increased the competitive pressures faced by domestic producers. Domestic interest groups have also had time to organise and formulate their interests more effectively. The gradual strengthening of interest groups and growing resistance to liberal policies could be discerned already in 1995, when the centre-left and agricultural parties, who had a more protectionist agenda, were successful in the general elections and formed the government. Although this did not lead to any major policy shift at the time, this trend has continued ever since.[34] We return to the increasing role of interest groups later in the discussion.

c) Ideas

Another distinguishing feature of the Estonian experience is that a strong “home-grown” consensus in favour of reforms, including free trade, developed earlier and reached deeper than elsewhere in the transition world.

A number of pro-independence groups had been engaged in intensive discussions on economic policy reform in the five years preceding independence, and a plan for economic autonomy (known as IME) was launched as early as 1987.[35] This helped to build up a head of steam for later reforms. Other background factors, such as exposure to the West through Finnish television, may also have played a role. However, only with the election victory of radical free-market reformers in September 1992 was the paradigm shift in ideas secured and placed at the heart of public policy. The ideological free-trade zeal of governing politicians (most noticeably the then prime minister, Mart Laar) served to reinforce the general commitment to free trade that was already made by the first government shortly after Estonia had regained independence. The strength of the market-liberal parties in the 1992 election illustrates the strong popular support for such ideas at the time.[36]

Early ideological and political momentum in support of free trade influenced the *modality* of trade liberalisation. By 1991/92, key decision-makers had come to the conclusion that domestic barriers to trade were more costly than other countries' barriers to Estonian exports. The logical policy corollary was that there should be a unilateral opening to imports (and inward investment). Negotiating export market access was important, *but import liberalisation was not used as a bargaining chip to that end.* Unilateral free trade, therefore, was Estonia's equivalent of the Nike strategy: "Just do it"; and it quickly became Estonia's distinctive international trademark, its answer to the "Nokia effect" in Finland.

While Estonian trade policy made textbook economic sense, it was a truly exceptional political strategy. As is well known, policy-makers, contrary to economic logic, are *reciprotarians* in trade policy: they proceed from the assumption that "exports are good and imports are bad," and make import liberalisation contingent on the opening of foreign markets to own exports.[37] Latvian trade policy, for instance, was in the conventional, reciprotarian mould: import barriers were retained and then gradually reduced in conjunction with international agreements (IMF Letters of Intent, bilateral FTAs, the Association Agreement with the EU, WTO accession).[38] International negotiations were *sine qua non* in order to persuade otherwise recalcitrant domestic politicians and interest groups to support (or at least not block) trade liberalisation. Astoundingly, Estonia, rather than resorting to mercantilist haggling over export concessions, followed Mart Laar's maxim: "Liberalise, then negotiate; but don't negotiate and then liberalise."[39]

The way in which Estonian policy-makers tapped into foreign advice is also indicative of "home-grown" or "bottom up" reform. In most other transitional countries, particularly in the ex-Soviet Union, the lack of a domestic compass for reform translated into a reliance on outsiders to provide broad strategic policy direction. Estonia, in common with all other transition countries, called in external advice on the technical aspects of policy design and implementation,[40] but it did not need the IMF and the EU to give political shape and direction to its reform programme in the early phases of transition. Indeed, the very fact that Estonian officials went ahead with the DM-based currency board in 1992, *despite* IMF advice to stay in the rouble zone, was a clear indication that there was a sturdy home-made compass guiding the reform effort.[41] However, the influence of the EU in particular on various aspects of national policy has been growing as a result of the EU accession process. We return to this matter later.

d) Institutions and trade policy decision-making

For Estonia, the restoration of national independence hastened the destruction of old Soviet-type institutions, out of whose ashes new ones had to be created – literally from scratch. This was the Phoenix-like setting for the rules, organisations and procedures governing the making of trade policy in the first phase of transition.[42]

We now turn to the institutional set-up for managing trade policy to ascertain how it has affected policy outcomes. Parliament (the Riigikogu) has the final authority over trade policy. All domestic legislation and international agreements (such as free trade agreements and

WTO accession) have to be approved by the legislature.[43] The free trade regime has enjoyed the support of a majority in the Riigikogu right through the 1990s, despite many changes of government. This was at least partly due to the far-reaching consensus about liberal economic ideas that prevailed through most of the decade.

However, we also need to examine the role of the civil service, and in particular the Ministry of Foreign Affairs, to understand the emergence of free trade. It is hardly an exaggeration to call Estonian trade policy (including policy on FDI) from 1991 the creation of one institution: the External Economic Policy Department within the Ministry of Foreign Affairs (MFA). It takes the lead in drafting relevant legislation, carrying out relevant background research, co-ordinating between ministries, and liasing with business on trade policy matters. The MFA briefs ministers and is answerable to parliamentary commissions, and has had the main responsibility for negotiating bilateral free trade agreements and WTO accession. It is also one of the key ministries responsible for accession negotiations with the EU.

Under the exceptional circumstances of the early 1990s, when post-independence policies had to be developed *de novo*, and when politicians' experience of international trade was virtually non-existent, the role of the civil service was very significant. In 1991, the brand-new MFA under Foreign Minister (now President) Lennart Meri recruited mainly young Estonians untainted by the Soviet past. A handful of them, without any relevant previous experience, took charge of trade policy. Initially, there were turf battles with the Trade Ministry and Board of Foreign Economic Relations, both of which favoured continued government intervention in external trade and promoted trading links with Russia post-independence. The influence of the MFA in particular, and more generally of free trade ideas in the newly independent Estonia, was such that these organisations were quickly sidelined, before being abolished in 1992 and 1994 respectively.

Although the economics and finance ministries also have some responsibility for trade policy (the latter especially for customs policy), the MFA has been the undisputed lead ministry, especially in the early 1990s. It has been responsible for the broad direction of policy and has co-ordinated with other ministries, when their input has been required on specific issues.[44] Other ministries and regulatory agencies have therefore largely occupied backseat positions in trade policy-making. As mentioned earlier, interest groups outside government have been disorganised and quiescent. Hence, the MFA's quasi-monopoly of expertise and capacity on trade policy issues has been the source of its autonomy and power, within government and in dealings with interest groups.

Under hothouse conditions of economic crisis and extraordinary politics, the small group of newly-recruited young MFA bureaucrats, with the solid backing of the government of the day, pursued an extremely unconventional policy — the bold dash to unilateral free trade. It was hardly the result of theoretical grounding, calm reflection and painstaking analysis; on the contrary, it was a supreme *act of faith*, a pragmatic, calculated gamble that the future fruits of free trade would more than compensate for the present sacrifice of old, uncompetitive industries. Part of the calculation was that tiny Estonia was too desperate and destitute to afford a sophisticated trade-and-industrial policy geared to protecting and promoting "strategic" industries; rather it had to go for the simple and economical option: free trade.

At the outset, two priorities dominated trade policy thinking: access to key export markets; and the overhaul of the domestic economy so that it would quickly discover its niche in an international division of labour. The first consideration led to the negotiation of bilateral free trade agreements; the second to the unilateral opening to import competition, in the hope that this would unleash a (Schumpeterian) gale of creative destruction in the domestic economy.

Initiating trade policy reforms was one matter; *sustaining* them was quite another. By 1995, farmers' associations and their supporters in parliament and government (particularly the Ministry of Agriculture) had started to lobby more actively for a return to agricultural protection. At the end of 1997, a proposal to impose agricultural tariffs against the EU was only narrowly defeated in government. The MFA (and also the Finance Ministry) continued to support free trade, not least since Estonia's free trade agreements precluded the imposition of tariffs on the bulk of agricultural imports. Victory in this battle served to "lock in" the unilateral free trade regime.

Overall, the effective technocratic management of trade policy has helped to ensure policy continuity despite the vicissitudes of Estonian party politics. In the first period of escalating crisis (1991/92), the government, following MFA advice, made a commitment to free trade and removed most tariffs. The following period (1992-95) saw a deepening and consolidation of the free trade regime under a new free market-oriented coalition government. This enabled a national free trade consensus to take root; and flanking reforms buttressed the policy of external openness. The next period (1995-99) saw a succession of multi-party coalition governments, including representation of agricultural interests, but the free trade regime remained intact. This illustrates the far-reaching liberal-economic consensus of most parties in the Riigikogu at the time. MFA input and the effective lock-in mechanisms established in the previous phase, especially the bilateral free trade agreements, were also very important in this context.[45]

It may be useful at this juncture to shed some comparative light on Estonian trade policy-making. Lithuania and Latvia, for example, had equally extraordinary initial conditions, but the shakeout of the old guard in the key ministries (especially in Lithuania) was not nearly as sweeping as it was in Estonia. In Latvia, the foreign and economics ministries share trade policy competence: the former leads on EU and WTO tracks; the latter has responsibility for bilateral FTAs. Not surprisingly, this has complicated trade policy management. Finally, Latvian trade policy has seen its fair share of political and interest group interference, particularly in favour of agricultural protection. All these factors have contributed to a more complex policy regime.[46]

The Latvian case corresponds well to trade policy in East Central Europe, where substantial external liberalisation has co-existed with creeping sectoral protection, particularly in agriculture.[47] In contrast, Estonian trade policy was *sui generis* in Europe: the key role of the lead ministry in the policy-making process helped to underpin the commitment to unilateral free trade. Nowhere else in Europe has the lead ministry given such clear and strong technocratic direction to trade policy, with the benefit of broad political support. In terms of trade policy management, we believe the Estonian MFA-led operation compares not unfavourably to well-run trade policy-making operations in emerging markets further afield, notably in Chile, Hong Kong, Singapore, Australia and New Zealand.[48]

Estonian trade policy-making has become more complex since the mid 1990s. In particular, EU and WTO negotiations have broached tricky non-border issues that now figure prominently on trade policy agendas. This has inexorably drawn other Estonian governmental agencies, particularly the economics and agricultural ministries, into the heart of international trade negotiations, and the MFA's quasi-monopoly in this regard is not quite what it used to be.[49] This makes the MFA's task of co-ordinating trade policy within government gradually more complicated. At the same time, policy-makers have to pay greater attention to more vocal interest group preferences on trade policy issues. All this – a sign of more "normal" political-economic conditions in an economy that is becoming more complex and differentiated – widens the decision-making circle and adds to the complexity of what, only a few years ago, was a simple and straightforward trade policy operation. Other developing and transitional countries, one should add, face similar challenges in their trade policy-making operations. The following section on multi-track trade policy will go somewhat deeper into these challenges facing Estonian trade policy-making.

e) Conclusion: unilateral free trade and "liberalism from below"

A number of factors contributed to Estonia's classical liberal package of policy reforms, including unilateral free trade. Economic crisis and political independence furnished an exceptional window of opportunity for dramatic change. At the same time, rent-seeking interest groups were very weak, and home-grown ideological and political momentum for radical reform was accelerating. This allowed a small group within the Estonian MFA to propose and gain political support for a policy of unilateral free trade, rather than resort to mercantilist reciprocity. The key point to emphasise here is that Estonian trade policy reform resulted from a blend of extraordinary circumstances and *domestic* political economy forces – prominently including, one should stress, the role of key individuals in officialdom and politics. Reform was indeed the product of "liberalism from below" rather than external pressure ("from above," as it were). Elsewhere in the transition world, such forces "from below" were not strong enough to support a shift all the way to free trade.[50]

The "Estonian exception" in recent trade policy reform merits comparison with the British exception in the nineteenth century. Britain sustained unilateral free trade, through thick and thin, from the early 1840s to 1914 as part of a broader "Victorian social contract." Such extraordinary continuity of policy reposed on the domestic *terra firma* of a phalanx of political and interest group support; a solid ideological consensus; firm control of the levers of policy by a Bank of England-Board of Trade-Treasury nexus within government; and, not least, the vital contribution of towering personalities such as Peel, Gladstone, Cobden and Bright.[51] More recently, other notable examples of radical, sustained trade policy reform, such as in Chile from the 1970s and New Zealand from the 1980s, relied overwhelmingly on a confluence of initial crisis and domestic political economy factors.[52]

Phase Two: From unilateral free trade to multi-track trade policy: Estonia in the WTO and *en route* to the EU

Since the mid-1990s there has been a gradual shift in policy-making in Estonia. Some parties in power between 1995 and 1999 were elected on a somewhat less liberal agenda, although this did not lead to any changes in trade policy. This trend in the realm of ideas and personalities was partly reversed at the last elections in 1999, which returned to office a three-party centre-right coalition.

As mentioned earlier, interest groups are becoming more vocal, partly due to the real appreciation of the currency. Farmers' associations, bolstered by Estonia's drive to accede to the EU (which requires joining the Common Agricultural Policy), are campaigning more loudly for subsidies and protection against cheap imports. Similarly, unions under the new and stronger leadership of Kadi Pärnits are gaining influence. The business sector comprises many and varied interests, the most visible of whom are a bevy of relatively large foreignowned firms, and smaller local enterprises that have sprouted up in the wake of the reform programme. The latter constituencies are open market-oriented and influential with two of the three political parties that make up the present government. The top 50 Estonian companies are now grouped in the Estonian Business Association, which is becoming more vocal on a number of public policy issues. Nevertheless, all organised interests still lack the resources, expertise and experience to make a substantial input into public policy-making. On trade policy, the MFA still fills the gap.[53]

This second phase of Estonian trade policy reforms, starting in the mid 1990s, has witnessed a shift from unilateral free trade to trade policy pursued more vigorously on other tracks. On the *bilateral track*, Estonia negotiated free trade agreements with a widening range of trading partners; on the *multilateral track,* it was locked into a four year negotiation to accede to the WTO, and is now party to the rights and obligations of WTO membership; most importantly, on the *regional track,* it entered into negotiations to accede to the EU, following hard on the heels of its Association Agreement with the Union (signed in 1995). As indicated earlier, EU membership will require giving up autonomous competence in trade policy upon accession, and has already led to the abandonment of the cornerstone of Estonian trade policy in the 1990s: unilateral free trade.

These have been the Estonian trade policy *outcomes* during the second half of the 1990s. What are the *decision-making processes* driving this shift from unilateral free trade to multi-track trade policy? How has the paradigm shift in national trade policy on the road to EU accession been managed within government? The following discussion addresses these questions by examining developments on bilateral, multilateral and regional trade policy tracks in turn.

a) The bilateral track: FTAs for export market access and as a lock-in device

Negotiating bilateral FTAs was a priority for Estonian trade policy *ab initio*, and was pursued in tandem with unilateral free trade. The initial motivation was to secure export market access, especially given that the newly-independent Estonia was not a GATT contracting party and did not automatically enjoy Most Favoured Nation treatment from other countries.

The initial batch of FTAs was signed in 1992 with four EFTA countries (Sweden, Finland, Switzerland and Norway). A Baltic FTA followed in 1993, and then one between Estonia and Ukraine in 1995. The latter two FTAs are particularly far-reaching: they establish zero tariffs on all goods, including agriculture. Further agreements were concluded with Hungary, Poland, the Czech Republic, Slovakia, Slovenia and Turkey. In 1993, Estonia signed an Agreement on Trade, Business and Economic Co-operation with the EU, followed by a FTA on industrial goods, which came into effect in 1995. This was swiftly superseded by a fully-fledged Association Agreement with the EU. (Details of negotiations with the EU will be discussed later). By 1998, 73 per cent of Estonia's trade was subject to preferential trade agreements. In addition, Estonia had concluded bilateral investment treaties with 25 countries by 1999. One major lacuna in Estonian trade policy is the lack of an FTA with Russia, which continues to refuse Estonia MFN treatment.[54]

Apart from securing market access, the FTAs could also be seen as a lock-in device for the primary policy of unilateral free trade. This secondary objective was related to the realisation that, sooner or later, domestic interests, particularly on the agricultural front, would threaten free trade; this led Estonian policy-makers to use FTAs as an important tool to prevent reform reversal.

Furthermore, independence from the Soviet Union and the break with the command economy created a legal vacuum, which extended to external trade relations. The FTAs negotiated in the early years of transition were very useful in that they furnished a ready-made, albeit partial, legal framework until the Estonian parliament ratified relevant domestic legislation covering foreign trade.[55] In the later period FTAs have been concluded mainly to secure market access, but they have also contributed to harmonising Estonia's trade regime with the EU, as all the Central and Eastern European countries and Turkey have FTAs with the EU as well. Ukraine is the notable exception to this rule.

Of course, Estonia is not alone in spinning a web of FTAs around it. Other East European countries have done the same. Further afield, Chile is a useful comparator: the first phase of unilateral opening to imports and inward investment (1974-1989) was followed by much greater emphasis on bilateral FTAs in the 1990s.[56] In a major trade policy shift, Singapore, New Zealand, Japan, Korea and other Asia-Pacific countries are now targeting a series of bilateral, and possibly plurilateral, FTAs.[57] However, in one respect at least, Estonia stands apart from other small open economies with bilateral FTAs: it concluded FTAs having already gone all the way to free trade; haggling over export concessions, while important to others, was not on the Estonian radar screen.

b) The multilateral track: locking in trade policy reforms through WTO membership

Estonia obtained observer status in the GATT in 1992, applied for accession to the WTO in 1995, and finally became the WTO's 135th member in November 1999. This accomplished one of Estonia's foreign policy priorities after independence. It should be noted that Estonia joined the WTO *as a developed country*; it never sought developing country status with Special and Differential Treatment. In addition, it was a signatory to the Information Technology Agreement before formal WTO membership. Negotiations for membership of the Government Procurement Agreement are ongoing at the time of writing (early 2001).[58]

To an even greater extent than the bilateral FTAs, the Estonian MFA viewed WTO membership as a guarantor of export market access and as a lock-in device for unilateral liberalisation. This is why WTO membership remains somewhat controversial among protectionist opposition politicians, who resent the WTO agreement for imposing too stringent limitations, especially on agricultural tariffs. The Estonian negotiators thought that WTO accession negotiations would be short and simple, given that Estonia had already moved to free trade; little did they realise that the road to WTO membership would be long and complicated.[59]

Working Party negotiations on *tariff bindings* were the first major road-block. Estonia presented the WTO with a precedent and a problem: for the first time, an accession candidate started negotiations with near-zero tariffs, but wanted to bind tariff ceilings in the WTO at much higher (EU) levels (given Estonia's application for EU membership). However, the WTO's "standstill" procedure for accession negotiations normally requires binding tariffs at levels not above applied rates pre-accession (and is normally used to lower, and then bind, applied rates). A compromise was reached after much time-consuming haggling. On industrial products, average tariff bindings are just over 6 per cent; for agricultural products, just over 17 per cent (applied rates being zero on the former and, since January 2000, 3.3 per cent on average on the latter). In addition, domestic agricultural subsidies are bound at 5 per cent, with export subsidies prohibited. When Estonia accedes to the EU it will give up these WTO commitments and assume those of the EU; this will require the EU to compensate Estonia's trading partners, if requested, where Estonian bindings are lower than those of the EU at the time of accession.[60]

By contrast, Latvia and Lithuania were more conventional candidates for WTO accession: starting with protective tariffs, market access negotiations led to WTO bindings that were lower than previous applied rates. Both fitted into established and familiar mercantilist negotiating procedures.[61]

Crafting and ratifying *WTO-compatible domestic legislation* was the second issue that took time to sort out in Estonia's Working Party negotiations. This required new national legislation on customs tariffs, customs valuation, import licensing, technical barriers to trade, sanitary and phytosanitary measures, trade-related intellectual property rights, safeguards, anti-dumping and countervailing duties, and excise taxes.[62]

The third and last hurdle to overcome was an EU-US dispute on *audiovisual services*. The US objected, but finally gave way, to the EU's insistence that candidates for EU membership should adopt EU "domestic content" on audiovisual services in the WTO. Apart from that, Estonia agreed to open its local and international telecom service operations fully by 2003, and committed itself to full market access in financial, freight, education, environmental and tourism services.[63]

Joining the WTO gives Estonia the multilateral seal of approval for its remarkable trade policy reforms. Furthermore, the accession process has proved to be a very useful capacity-building exercise for the Estonian trade policy machinery. It has enabled officials to go beyond the relatively simple border issues that held centre-stage during the first phase of unilateral liberalisation, and get to grips with technically complicated non-border trade policy issues. The WTO review of Estonian legislation has deepened the knowledge and administrative capacity of officials, not only with respect to WTO agreements, but also concerning the wider workings of a market economy. This applies, in the first instance, to the lead MFA negotiators involved in the WTO accession process, but encompasses negotiators from other ministries as well, especially from the Ministry of Economics (which took the lead on the GATS) and the Ministry of Agriculture. Divisions from both the latter ministries have become more closely involved in Estonia's WTO-related work since accession. In effect, WTO accession negotiations and subsequent membership have helped spread trade policy capacity beyond the MFA to other parts of government.[64]

Being a model pupil in accepting and implementing the terms of WTO accession is one thing; becoming a self-conscious, proactive member of the club is quite another. In reality, Estonia's participation in the WTO is and will be heavily constrained by its pursuit of EU membership – the categorical imperative of present Estonian foreign policy. Other Eastern European candidates for EU membership are in a similar position in the WTO. All have very limited leeway for independent action given that they are disposed (or feel constrained) to fall into line with the EU's priorities in the WTO. They co-ordinate closely with the EU delegation in Geneva; and they are most unlikely to oppose the EU on politically sensitive issues, such as audiovisual services and agriculture. Accordingly, Hungary withdrew from the Cairns Group; and Estonia joined other Eastern European countries in becoming a member of "Friends of Multifunctionality" in the WTO (alongside the EU, Japan, Switzerland and Norway).[65] This is an interesting turn of events for a country that hitherto displayed impeccable free trade credentials in agriculture. Moreover, this is an early sign of the sea change that is about to take place in Estonian trade policy *en route* to EU membership. To this we now turn.

c) The regional track of EU accession: locking in or reversing trade policy reforms?

Estonia is now on the threshold of joining the EU. Inevitably, the adoption of the EU rule-book will bring about profound change in Estonia's legal and public policy framework. Already, regulation is increasing in quantity and complexity, presaging, in all probability, a departure from the simpler, more straightforward classical liberalism of the 1990s in the direction of something closer to the EU mainstream. The most visible sign of this trend is the end of free trade, which is the focus of this article. Estonia will have to align itself fully with the EU's Common Commercial Policy, including protection against third countries, upon accession. In readiness for this, it formally renounced its zero tariff policy in January 2000 and imposed (so far moderate) agricultural tariffs on countries with which it does not have free trade agreements. The average weighted tariff on agricultural imports is now 3.3 per cent, and Estonia is under pressure from the EU to extend this protection further.[66] This is but one element of the increasing complexity of Estonian trade policy *en route* to EU accession.

The journey towards the EU started in earnest with the free trade agreement, which was signed in July 1994. This was superseded by the comprehensive Association Agreement of 1995, which came into force without a transition period (unlike the EU's Association Agreements with Latvia and Lithuania). Estonia applied for EU membership in November 1995, and its Europe Agreement with the EU came into force in early 1998, when formal accession negotiations commenced. Estonia, Cyprus, the Czech Republic, Hungary, Poland and Slovenia are the so-called Luxembourg group of applicants, forming the first wave of transition countries with which the EU decided to start accession negotiations in 1997. Lithuania, Latvia, Bulgaria, Malta, Romania and Slovakia were given the green light to start accession negotiations in Helsinki in December 1999.[67]

EU accession has become the key priority of Estonia's foreign economic policy, and considerable efforts have been devoted to harmonising legislation and regulation to Western European models. Given the breadth and complexity of the EU *acquis,* all ministries have become heavily involved on the EU accession track, but the MFA (mainly through the Department for European Integration) and also the Ministry of Justice have particularly far-reaching responsibilities. The Economics Ministry also plays a considerable role in the adoption and implementation of the EU *acquis* within Estonia. Inter-ministerial co-ordination on EU-related matters takes place through the Council of Senior Civil Servants, whose secretariat, the Office of European Integration, reports directly to the prime minister.[68]

Estonia's efforts have borne fruit, in that 16 out of 31 chapters of the negotiations had been closed by December 2000, which is significantly more than virtually all the other candidate states have achieved.[69] EU accession could therefore be said to provide the overall compass for policy and further legal reforms.[70]

We now turn to the reasons why EU accession has become such a priority and focus of trade policy for the Estonian decision-makers involved.

Although potential economic benefits are mentioned, it seems clear that Estonian policy-makers have viewed EU membership, in addition to hoped-for NATO membership at some juncture, through the prism of foreign policy, i.e. security. The EU is seen as the strongest anchor for Estonia's return to the West, and in particular as a security guarantee against future instability and predation coming from Russia. Even Estonian economic liberals argue that the EU's protective cloak is worth the sacrifice of full-blooded liberal economic policies, if that is indeed what EU membership requires.[71]

In narrower economic terms, EU membership will inevitably result in some trade diversion, given Estonia's existing unilateral free trade regime. First, the adoption of the EU's Common External Tariff will lead to low-cost imports from third countries being replaced by high-cost imports from elsewhere in the EU. Just to give an indication of the changes involved, Estonia is in the process of moving from its zero tariff position at the end of 1999 to the application upon accession of 10,794 EU tariff lines. While the average EU tariff is low (about 4-5 per cent *ad valorem*), it hides many peak tariffs and tariff escalation (on processed goods) in product areas such as agriculture, textiles and clothing, and cars and trucks.

Second, Estonia will have to introduce the whole system of non-tariff measures applied by the EU in relation to third countries, such as quotas, anti-dumping and rules of origin regulations, export subsidies, technical standards, and sanitary and phytosanitary measures. Falling into line with EU quotas on iron, coal and steel, for example, could well reduce cheap imports from the CIS and increase prices substantially. Moreover, these non-tariff measures violate the principles of simplicity and transparency, which have been the hallmark of Estonian policies so far.

Third, Estonia will have to renounce its FTA with Ukraine upon acceding to the EU, and possibly the Baltic FTA too, should Estonia join prior to Latvia and Lithuania. Both FTAs were considered important since they provide for zero tariffs on trade in both industrial and agricultural goods. However, Estonia has renounced the use of transition periods for winding up its third-country FTAs when it adopts EU customs arrangements.[72]

Changes are going to be most dramatic on the agricultural front. Here Estonia is switching from the free trade of the 1990s to the high protection of the Common Agricultural Policy, with its arsenal of peak tariffs, price supports and other domestic subsidies, export subsidies and contingent protection. Urmas Varblane's calculations, based on existing producer subsidy equivalents, show that support to Estonian agriculture will increase by a factor of four-to-five when Estonia joins the CAP – presaging a massive increase in the cost of food.[73]

Joining the EU, therefore, clearly seems inconsistent with the fervent free trade policies pursued so far. In this respect Estonia is *sui generis*: other East European candidates for EU membership have higher average tariffs than the EU on industrial goods, in addition to a range of non-tariff barriers, which means that their net protection against non-EU countries will decline upon accession. However, the reverse case applies to agriculture, in which net protection against non-EU countries will increase.[74]

The potential welfare losses arising from trade diversion have to be set against the potential benefits of full integration into the EU's Single Market, which already accounts for two-thirds of Estonia's foreign trade. The Association Agreement allows the EU to impose quotas and contingent protection (such as special safeguards and anti-dumping duties) on "sensitive products" imported from Estonia, most notably in agriculture. These will be removed upon accession, as will other remaining non-tariff and regulatory barriers to trade (such as onerous testing and certification procedures, product quality standards, customs procedures and other administrative requirements). However, the Association Agreement already guarantees free trade in industrial goods; and the extent of extra market access that will come with accession is open to interpretation (besides being impossible to predict with any great precision at this stage).[75]

Votaries of EU membership also point to other potential economic benefits, which may have positive effects on Estonia's foreign trade. A more stable and secure political environment, they argue, most notably through the removal of the Russian threat, may spur more, and higher value-added, foreign investment.[76] This is likely to increase trade, as most foreign investors do not come to Estonia to serve the small home market, but rather to integrate new investments with their cross-border production networks, and to export to Western Europe. However, there is no evidence to indicate that EU membership *per se* will boost the quantity and quality of inward investment.[77] Finally, EU financial support, for example through Structural Funds, may help improve Estonia's infrastructure and trigger further investment and trade. That said, future Eastern European members of the Union are likely to receive substantially less in the way of financial transfers than did Portugal, Spain, Greece and Ireland in previous waves of enlargement.

In terms of *trade policy decision-making*, EU membership will change practically everything. Estonia will transfer trade policy competence to the Commission in Brussels. A relatively small, simple and reasonably well-managed bureaucratic operation, led and co-ordinated by the Estonian MFA, will be subsumed into a large and complex EU trade policy machinery. Some Estonian officials with trade policy experience will, no doubt, take up positions in the Commission; others will stay in the MFA and other ministries to deal with Estonian interests in the EU's Common Commercial Policy. Estonia will be able to influence the latter through its seat in the Council of Ministers and, at the level of officials, in the Article 133 Committee. Hence, Estonian policy-makers will have to define and pursue national interests in commercial relations with non-EU countries within this new policy and legal framework. This may in fact require a larger domestic trade administration, as some aspects of EU trade policy, such as dispute settlement cases of relevance to Estonia, may have to be monitored at national level.[78]

The MFA's lead role in trade policy will obviously disappear upon accession, but it remains to be seen what role it, other ministries and their political masters will play in Estonia's contribution to the EU's Common Commercial Policy. Indeed, one may well ask whether the accession of Estonia, the European country with the most liberal international trade regime, will help tilt EU trade policy in a more liberal direction – in terms of unilateral action, through bilateral and regional arrangements, and in the WTO. The Estonian officials we have interviewed talk about alliance-building with like-minded EU member states, such as Britain, Sweden, Finland, Ireland and the Netherlands, all with relatively more liberal (or less protectionist) trade policy preferences than other EU member-states. Whilst this is a distinct possibility — Finland's example of effective engagement in the EU on many issues provides a role model here — it is an open question whether this will really happen in practice.

Not only is Estonia's weight in the EU going to be very small, it is also possible that the country's preferences may change. What Jagdish Bhagwati calls the "Our Market Is Big Enough Syndrome" may set in.[79] Once Estonia is a full member of the club, its interest in laboriously lobbying for liberalisation of EU trade vis-à-vis third countries – the benefits of which are likely to accrue mainly to other member-states – may fade. Moreover, many interest groups will have a stake in a "Fortress Europe" – and not only in agriculture. Some Estonian firms, for example, may be happy if additional access to EU markets is denied to transitional countries outside the EU.

Most importantly, Estonian integration into the Common Agricultural Policy (or some reformed version of it) will yield benefits to agricultural interests and is likely to strengthen this lobby. Already, some opposition parties (especially the rural-based Rahvaliit) are arguing for extra national protection and subsidies to inflate the agricultural sector, in order to extract maximum subsidies from the EU.[80] Especially in agriculture, a creeping process can be discerned whereby domestic interest groups and EU requirements mutually reinforce each other in moving Estonia away from "pure" free trade.

In the realm of ideas a shift may also occur. In recent months a debate about the proper model of capitalism for Estonia has surfaced. Foreign Minister T.H. Ilves's suggestions that Estonia adopt a Northern European social democratic welfare state model, instead of the "neoliberal" American model, could be a sign of the increasing attractiveness of a main-stream European policy package, which would differ from the more classical liberal policies followed so far.[81]

Is EU accession providing an additional lock-in mechanism, or does it imply a wholesale reversal of trade policy? EU-style regionalism is clearly not compatible with Estonian-style unilateral free trade, unless the Union as a whole adopts the latter. Needless to say, the chances of that happening are, at best, microscopic. Seen in this light, EU membership will lock in elements of protection Estonia eschewed during the 1990s. It will also add to the complexity of trade policy and make it more opaque, especially due to the adoption of new non-tariff barriers.

On the other hand, it could be argued that EU accession will provide a lock-in mechanism against the wholesale reversal of *relatively* liberal trade policies, whereby free trade at least with other EU members is guaranteed, and EU trade policy with respect to third countries constitutes a benchmark of reasonably acceptable practice.[82] Whether such a lock-in – in addition to the ones provided by existing FTAs and WTO membership – is necessary, is another matter. The bottom line is that the main attraction of EU membership does not lie in trade policy, but is seen primarily in terms of security, and perhaps related to other aspects of economic policy.

Conclusion

This discussion has presented Estonia in the 1990s as a modern-day classical liberal equivalent of the "Victorian social contract" of nineteenth century Britain, especially in its exceptional attachment to unilateral free trade. The overarching lesson to be drawn from the first phase of Estonian trade policy reforms is that a unilateral dash to free trade, followed by external lock-ins, is feasible, if extraordinary, in late twentieth century/early twenty first century conditions. The Estonian experience compares well even with other benchmarks of recent liberal trade policy practice, such as Chile, New Zealand and Hong Kong.

Many factors – crisis, lack of powerful interest groups, ideas – contributed to Estonian trade policy reform. However, we have emphasised the institutional aspects of trade policy, and particularly the decision-making setting within government. Clear and simple decision-making procedures were critically important; this helped a handful of strategically placed freshman officials to capitalise on a once-in-a-lifetime window of opportunity early in political and economic transition. Having competent people in key positions at the right time, and with the appropriate political support, was particularly important given Estonia's Soviet legacy of weak and defective institutions.

The *process* involved a small bureaucracy with a powerful and efficient lead ministry and clearly allocated roles for other ministries; the *outcome* was the rapid establishment of a simple and transparent policy framework (almost complete free trade, full openness to FDI based on national treatment, no selective incentives, full capital and current account convertibility). The very simplicity and coherence of the trade policy framework gave Estonia excellent business-friendly credibility, with a brand name that was distinctive and difficult to beat.[83]

These "classical liberal" Estonian lessons – clear and simple decision-making procedures for a clear and simple policy framework – could be useful for other emerging markets, especially those with a history of weak institutions which find themselves in the midst or aftermath of political and economic crisis. This is precisely when a window of opportunity for radical reform – of policies *and* institutions — may present itself. These lessons are more likely to be applicable to small countries, where there are fewer obstacles to effective decision-making, and a more commonsensical appreciation of the benefits of integration with the world economy, than is the case with large countries.

Exploiting favourable initial conditions is usually not enough: a lock-in mechanism is required to ensure the sustainability of a liberal trade-and-investment regime. Estonia did this: first through bilateral agreements with important trading partners, and then with WTO accession. On both bilateral and multilateral tracks, "locking in" took place once unilateral reforms had been implemented. Other transitional countries, in contrast, needed the external prop of IMF pressure, and bilateral, WTO and EU agreements, in order to trigger further own liberalisation of imports and inward investment.

Two lessons follow from this account. First, a free trade regime is most likely to be achieved "from below," through unilateral reforms. Second, recourse to international agreements to provide a lock-in mechanism is most likely to be effective if far-reaching unilateral reforms have been implemented in advance.

The second phase of "multi-track" Estonian trade policy reforms has been much more complicated, and not without its contradictions. The external trade policy tracks have given Estonia improved market access and to some extent (with the exception of the EU track) helped to lock in reforms. However, both WTO and EU accession negotiations have proved difficult and prolonged, and added to the complexity of trade policy. Estonia's pursuit of EU membership – the highest priority of its foreign policy – prevents it from being a proactive and forward-looking new member of the WTO. Above all, the road to EU membership is *locking out* the free trade Estonia practised in the 1990s; and it is replacing what was a simple and transparent set of policies with creeping regulatory complexity. On the decision-making front, the national trade policy process is becoming more complex as ministries other than the MFA become more closely drawn into the regulatory details of trade policy, and as interest groups become more vocal.

Other small, open emerging markets face not totally dissimilar circumstances with their multi-track trade policies. For example, Chile's reasonably straightforward trade policies during the 1980s, based on a uniform tariff and GATT bindings, gave way in the 1990s to unilateral openness, GATT/WTO agreements *and* a patchwork of ever-increasing bilateral and regional agreements, especially in the Western Hemisphere. Similarly, Singapore and New Zealand, previously reliant on unilateral and GATT/WTO tracks to launch and sustain liberal trade policies, are now placing more emphasis on bilateral and regional tracks. This may or may not be a positive development, but it certainly adds to the complexity of trade policy-making.

For the countries mentioned above, bilateral and regional tracks represent a modification of existing trade policies. For Estonia, and to a less extreme extent the other East European countries on track for EU membership, the regional dimension involves sweeping changes to trade policies. Ultimately, it will lead to the dismantling of national trade policies in order to merge fully with the EU's Common Commercial Policy. Those of a classical liberal disposition will no doubt shed a Proustian tear in remembrance of things past – that interlude of Estonian free trade launched in the first flush of national independence and sustained through the 1990s.

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IMF, *World Economic Outlook 2000*, www.imf.org,

Estonian Ministry of Economics, www.mineco.ee

Estonian Ministry of Foreign Affairs, www.vm.ee

Statistical Office of Estonia, www.stat.ee

World Bank, Country Data, www.worldbank.org

WTO, Trade Policy Reviews, www.wto.org,

Notes

[1] We would like to thank Iikka Korhonen, Alari Purju, Laura Solanko and a number of Estonian civil servants for very helpful comments on a previous draft. The usual disclaimer applies.

[2] Estonia had a brief flowering of independence during the interwar period. Following the conclusion of the Molotov-Ribbentrop pact it was invaded by Soviet troops in 1939, then occupied by the Nazis in 1941, and finally reoccupied and annexed by the Soviet Union in 1944. Nearly half a century of Soviet rule came to an end with the declaration of Estonian independence on 20th August 1991. See von Rauch (1974), Misiunas and Taagepera (1983) and Taagepera (1993).

[3] Kukk (1997a), pp. 261-262.

[4] Ibid., pp. 262-264.

[5] Ibid., pp. 245, 248-253. Also see Kukk (1997b), Lainela and Sutela (1994), Korhonen (1999).

[6] For overviews of Estonian economic policy reforms, see Lainela and Sutela (1994), Kukk (1997a), WTO (1999), EBRD *Transition Report* (various years).

[7] Schumpeter (1954), pp. 397-406, Howe (1997). Also see Sally (1998) and Sally (2000), p.238.

[8] The 33 per cent tax on employers to fund social security, and the 35-40 per cent share of public spending in national income (albeit not very high by Western European standards) might not count as part of a classical liberal package. See Berengaut et al. (1998) and also Kallas (2000) on recent tax reductions.

[9] On Estonian economic performance, see EBRD (1999), p. 216, BOFIT (2000), p. 1, Estonian Investment Agency (2000), pp. 12, 14, PriceWaterhouseCoopers (2000), p. 3.

[10] See http://www.ilo.org/public/english/support/publ/wer/tables/tab4_bal.htm; Official unemployment figures are much lower, but they are not based on internationally comparable methodology. See also Lainela (2000), p. 6 f.

[11] On trends in external liberalisation as part of overall policy reforms, see Henderson (1998), pp. 45-46, 54-58.

[12] Henderson (1992), p. 635.

[13] Arguably, otherwise free-trading Singapore falls short due to its partially closed and discriminatory policies on access to its service sectors, although deregulation and external liberalisation are in train. See *Financial Times (*2000a).

[14] Purju (1996), p. 9.

[15] Import duties on furs, cars, yachts, motorcycles, sea- and snow-scooters; an export duty on vintage cars. Ibid., p. 21.

[16] Protection against Russian grain imports for three months in 1993 constitutes the only exception to agricultural protection before 2000. See Kala (1995), p. 283.

[17] Purju (1996), pp. 20-22, WTO (1999), pp. 14-15.

[18] Kukk (1997a), p. 268, IMF (1999).

[19] Ministry of Economics, http://www.mineco.ee/valiskaubandus/index.asp?id=21

[20] Estonian Investment Agency (2000), pp. 3-5, Purju (2000), p. 9.

[21] WTO (1999), pp. 4-5, 35.

[22] For a short period a system of selective incentives was in place, which were later abolished. See Shen (1994).

[23] WTO (1999), p.25, Leimann, Purju and Tartu (1998), p.10, interviews.

[24] Purju (2000), pp. 9-12, Kukk (1997a), p. 263.

[25] Leimann, Purju and Tartu (1998), pp. 23-24, Purju (1996), pp.36-38, Estonian Investment Agency (2000), p. 8.

[26] Feldmann (2000), p.5.

[27] See Bhagwati (1988), Bates and Krueger (1993), Williamson (1994), Henderson (1998).

[28] See, in particular, Williamson (1994) and Balcerowicz (1995).

[29] See Rodrik (1996).

[30] On these exogenous factors, see Feldmann (2000), pp. 13-15, interviews.

[31] This tallies with David Henderson's argument that interest groups have not played a major role in recent policy reform. Henderson (1998), pp. 72-74, 90 ff..

[32] Purju (1996), pp.13-15, Feldmann (2000), p. 15-16, 18-19, interviews.

[33] Interviews.

[34] For an analysis of the 1995 election, see Arter (1996), pp. 231-245. On the continuity of policy after the election, see Korhonen (1996).

[35] See Taagepera (1993) and Laar, Ott and Endre (2000).

[36] Interviews. Most of the following discussion in this section is based on interviews.

[37] Bhagwati and Irwin (1991), Krugman (1997). For an extended discussion of the intellectual history of unilateralism and reciprocity as modes of trade liberalisation, see Robbins (1958), pp. 182-231, Sally (1998), pp. 54-60, 191 ff., Irwin (1996), pp. 106-115.

[38] Poland, the biggest East European economy, resembles Latvia in this respect, despite dramatic and extensive unilateral trade liberalisation in 1990. Further liberalisation was only forthcoming as a result of outside pressure and international agreements – with the EU, other trading partners and the WTO. See Varblane (2000).

[39] Interview with Mart Laar, November 1998.

[40] Here the role of Ardo Hansson of the World Bank stands out. Dr. Hansson, a Canadian-Estonian Harvard economist, brought Estonian policy-makers into contact with circles of Western economists associated with Jeffrey Sachs and Anders Åslund.

[41] Lainela and Sutela (1994), p. 68.

[42] There is hardly any source material on trade policy *making* in Estonia. Purju (1996), pp. 14-16, describes the broad outlines of the trade policy decision-making process. Otherwise the following discussion relies on a wide range of interviews conducted with Estonian bureaucrats, politicians and businesspeople between 1998 and 2000. Some Latvian civil servants were also interviewed.

[43] Until recently the government had the right to impose tariffs without consulting Parliament, although the former is obviously dependent on the legislature's confidence. This section of the law on customs tariffs has been removed and tariffs can now only be imposed by Parliament. Interviews.

[44] Co-ordination has been facilitated by the fact that Estonia's civil service is rather small, and that it is in the main only specific individuals who deal with trade policy outside the MFA.

[45] The presence of a critical mass of non-party technocrats in key ministerial positions also ensured policy continuity. This was the case with two successive foreign ministers during the 1995-99 period.

[46] For a comparison of the political economy of trade liberalisation in Estonia and Latvia, see Feldmann (2000), especially pp. 17-21.

[47] Csaba (1995).

[48] Incidentally, the foreign ministry takes the lead on trade policy in Chile, Australia and New Zealand.

[49] In absolute terms, trade policy capacity within the MFA's Department of External Economic Policy has increased: it has 25-30 civil servants compared with (literally) a handful in the early 1990s. In relative terms, the gap with some other ministries is probably not as wide as it used to be.

[50] On the distinction between "liberalism from below" and "liberalism from above," see Sally (1998), p. 131 f..

[51] Howe (1997). Also see the discussion of nineteenth century British trade policy in Freytag and Sally (2000).

[52] See the chapters on Chile and New Zealand in Williamson (1994), Henderson (1997).

[53] Interviews, Purju (1996), p. 17, Purju (2000), p. 4.

[54] WTO (1999), pp. 4,37, Purju (1996), p. 18.

[55] Interviews.

[56] Herreros (1999), p. 3.

[57] *Financial Times* (2000b).

[58] Ministry of Foreign Affairs, *Estonia Today,* 10th November 1999, WTO (1999), pp. 3,45.

[59] Interviews.

[60] Purju (2000), interviews.

[61] Interviews.

[62] Purju (2000), WTO (1999), p. 27, interviews.

[63] EBRD (1999), p. 24, interviews.

[64] Purju (2000), interviews.

[65] Interviews.

[66] Ministry of Economics, http://www.mineco.ee/valiskaubandus/index.asp?id=21 and BOFIT (2000), p.1.

[67] Ministry of Foreign Affairs, *Eesti ja Euroopa Liit*, www.vm.ee/euro.

[68] Ibid.

[69] Ministry of Economics, http://www.mineco.ee/eurointegratsioon/index.asp?id=23 and Lainela (2000).

[70] Lainela (2000).

[71] Interviews.

[72] See the official Press Release by the MFA on the Estonian negotiation stance (available at www.vm.ee/euro), and the report by Varblane et al. (2000) on the economic costs of giving up the free trade agreements.

[73] On the trade diversion implications of EU accession, see Varblane (1999).

[74] Varblane (2000), Purju, Koidu and Kuldkepp (1999), p. 112.

[75] For a broadly positive assessment of the trade effects of EU membership, see Purju, Koidu and Kuldkepp (1999), Purju (2000). See Varblane (1999) for a more sceptical view.

[76] Purju, Koidu and Kuldkepp (1999), p. 109.

[77] Ziacik (2000) finds that future EU membership is a less significant determinant of FDI than, for example, labour force characteristics, expected market growth, currency convertibility, capital mobility, political stability and other factors she examines in her investor survey. Some of these other factors may be indirectly associated with EU accession, which complicates the analysis. A recent paper by Bevan and Estrin (2000) finds that announcements about EU accession have increased FDI in transition countries.

[78] This has been the Finnish experience after accession. Interviews.

[79] Bhagwati (1992).

[80] Interviews. See also Reiljan and Kulu (2000). Janno Reiljan, Professor of International Economics at the University of Tartu and a member of parliament for the Rahvaliit party, is one of the key economic spokesmen among the opposition parties.

[81] Ilves (2000). For an opposing view, see Kallas (2000).

[82] Free-traders would, of course, dispute the proposition that EU trade policy, on balance, is “reasonably acceptable.”

[83] Varblane et al. (2000), Section 3.5, argue that the loss of this brand name is indeed the main disadvantage of trade policy associated with EU accession.

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