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New Europe's Boomtown

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Philippe Benoit du Rey is not one of those gloomy Frenchmen who frets about the threat to Gallic civilization from McDonald's and Microsoft. He thinks international competition is good for his countrymen. He's confident France will flourish in a global economy — eventually.

But for now, he has left the Loire Valley for Tallinn, the capital of Estonia and the economic model for New Europe. It's a boomtown with a beautifully preserved medieval quarter along with new skyscrapers, gleaming malls and sprawling housing developments: Prague meets Houston, except that Houston's economy is cool by comparison.

Economists call Estonia the Baltic Tiger, the sequel to the Celtic Tiger as Europe's success story, and its policies are more radical than Ireland's. On this year's State of World Liberty Index, a ranking of countries by their economic and political freedom, Estonia is in first place, just ahead of Ireland and seven places ahead of the U.S. (North Korea comes in last at 159th.)

It transformed itself from an isolated, impoverished part of the Soviet Union thanks to a former prime minister, Mart Laar, a history teacher who took office not long after Estonia was liberated. He was 32 years old and had read just one book on economics: "Free to Choose," by Milton Friedman, which he liked especially because he knew Friedman was despised by the Soviets.

Laar was politically naïve enough to put the theories into practice. Instead of worrying about winning trade wars, he unilaterally disarmed by abolishing almost all tariffs. He welcomed foreign investors and privatized most government functions (with the help of a privatization czar who had formerly been the manager of the Swedish pop group Abba). He drastically cut taxes on businesses and individuals, instituting a simple flat income tax of 26 percent.

These reforms were barely approved by the legislature amid warnings of disaster: huge budget deficits, legions of factory workers and farmers who would lose out to foreign competition. But today the chief concerns are what to do with the budget surplus and how to deal with a labor shortage.

Wages have soared thanks to jobs created by foreign companies like Elcoteq of Finland, which bought a failing electronics factory and now employs more than 3,000 people making phones for Nokia and Ericsson. Foreign investors worked with local software engineers to create Skype, the Internet telephone service, and the country has become so Web-savvy that it's known as E-stonia.

"The spirit is so different here," Benoit du Rey says. "If you come to the government here and want to start a company, they'll tell you, 'Good, do it right now.' Then you can work free without being bothered by stupid things. Here I talk to my accountant once a month. In France, for every seven or eight workers, you need one full-time worker just to fill out the forms for taxes and other rules.”

It took him less than two weeks last year to start his company, Aruzza. Now he has employees from five countries working on deals like importing Spanish ham, exporting Estonian sofas to France and finding programmers in Tallinn to write software for a California company.

He is not a free-market purist — he likes the health care and social services provided by countries like France. But to pay for their safety nets, he figures they need to cut regulations and taxes so they can have robust economies like Estonia’s, which grew about 10 percent last year.

The growth over the past decade has produced so much unanticipated revenue that the tax rate is being gradually reduced to 20 percent. Laar’s political rivals still complain that his flat tax unfairly helps the rich, but as he notes, the level of income inequality in Estonia actually declined during the past decade.

“People think a progressive tax system is fairer,” Laar says. “But in the real world rich people find a way to avoid high taxes. With a flat tax, they stop worrying about sheltering their income or working in the gray economy. There is less corruption because it’s easier to pay the tax.”

Since Laar started the revolution, the flat tax has been adopted by its Baltic neighbors and a half-dozen other countries, including Russia, Ukraine and Romania. Such radical reform is still taboo in Western European countries like France, but they can’t seal their borders against this threat. If they don’t go to Estonia for a lesson in economics, their enterprising citizens will make the trip on their own.