Chapter 3

Economic stability and quality of institutions in Estonia

This chapter gives an overview of the performance of the overall economy, macroeconomic developments and challenges, and the governance and institutions.

3.1. Macro-economic policy environment

At the broadest level, stable and sound macroeconomic policies, leading to high growth and low and stable inflation rates, play an important role in setting a favourable environment for investment in farms or agri-food firms seeking to introduce new products, to adopt new production methods, or to undertake organisational changes that can lead to higher productivity growth and more sustainable use of natural resources. Assessment of the country's overall growth and growth potential in the short- to medium-term has implications for sector specific prospects as well. In some circumstances, macroeconomic policies and their impacts can contribute to implicit and perhaps unintended biases for or against the food and agriculture system.

Overall economic performance and medium term prospects for growth

Fast economic growth in Estonia during the last 25 years has caused significant structural changes. The competitiveness of Estonian goods and services both in domestic and international markets has changed, as well as the structure of foreign trade. Regaining independence in 1991 and the integration of the Estonian economy into the World economy, the accession to the European Union in 2004, and the recent financial crisis have been the main drivers behind the dynamics of competitiveness of the Estonian economy.

Estonia is a small country of only 1.3 million inhabitants, with open investment laws, and a balanced state budget. Since joining the European Union in 2004, it is part of the common market. Openness to international trade and investment started after regaining independence in 1991. According to the Wall Street Journal and the Heritage Foundation's Index of Economic Freedom, Estonia ranks as one of the freest economies in the world, being 9th among 178 countries in 2016 (Miller and Kim, 2016). In the Fraser Institute's "Economic Freedom of the World: 2015 Annual Report", the economic freedom scoreboard ranks Estonia 22nd among 157 countries **(**Gwartney et al., 2015**).**

According to the OECD better life index Estonia has made progress over the last decade in terms of improving the quality of life of its citizens, however, there are still only a few aspects of well-being where Estonia is performing well compared to industrialised countries. Estonia is performing above the OECD average in education and skills, environmental quality, and work-life balance, but below average in housing, jobs and earnings, subjective well-being, personal security, income and wealth, health status, and civic engagement.

Since the 1990s, growth in the Estonian economy has been considerable (Table 3.1). During the period 2001-07, the growth of GDP was very high making Estonia one of the fastest growing economies in Europe. Following the global financial crisis, the Estonian economy experienced a sharp contraction of output in 2008-09. The downturn of the economy was reinforced by the domestic credit boom in the construction sector and by pro-cyclical fiscal policy (OECD, 2011a, 2012, 2015a).

In recent years, economic growth has been disappointing, but it accelerated in 2017 (OECD, 2017a). According to the Bank of Estonia (2015), potential growth in 2015-16 has been below expectations for long-term growth for structural reasons, for example the decline in exports to traditional partners such as Finland and the Russian Federation, and the difficulty to find other export markets in the short term. In addition, a lower growth rate was also associated with a low investment rate compared to previous years. The OECD economic outlook from June 2017 projects higher GDP growth of 2.6% in 2017[1] and 3.1% 2018 (Table 3.1), helped by stronger investment in the public and private sectors. Higher public investment will partly reflect higher disbursement of EU structural funds in mid-programming period (OECD, 2017a). At the same time, consumption will remain strong, supported by accommodative tax measures (OECD, 2017b). In the longer term, the population decline and the slower productivity growth are the main factors behind a potential decrease in economic growth.

Table 3.1. Estonia's key indicators of macroeconomic policy, 1995 to 2018

	2000	2005	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017e	2018e
Real GDP growth, %	9.8	9.1	-5.0	-14.2	1.7	7.5	4.3	1.6	2.7	1.5	1.7	2.6	3.1
General government financial balance[1]	-0.1	1.1	-2.7	-2.2	0.2	1.2	-0.3	-0.2	0.7	0.1	0.3	-0.4	-0.7
Current account balance[1]	-5.4	-8.7	-8.7	2.5	1.8	1.3	-2.0	-0.4	0.9	2.2	2.7	1.8	1.3
Exchange rate, EUR per USD[2]	1.08	0.80	0.68	0.72	0.76	0.72	0.78	0.75	0.75	0.90	0.90	0.92	0.91
Consumer price index, harmonised, index 2010	0.7	0.8	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.2	1.2
Unemployment rate, %[3]	14.6	8.0	5.5	13.6	16.7	12.3	10.0	8.6	7.4	6.2	6.8	7.6	8.4
Labour productivity, index 2010	0.7	0.9	1.0	0.9	1.0	1.0	1.0	1.0	1.1	1.0	1.1	1.1	1.1

e: OECD Economic Outlook estimate.
1. As a percentage of Gross Domestic Product (GDP).
2. Period average.
3. End of year, as a percentage of total labour force.

Source: OECD (2017b), *OECD Economic Outlook, Volume 2017 Issue 1*, http://dx.doi.org/10.1787/eco_outlook-v2017-1-en.

Inflation has been low since 2000, but is projected to increase fast at around 3% according to the OECD economic outlook from June 2017, not least because excise tax rates and wage growth is expected to push it up (OECD, 2017b).

Statistically, the situation in the labour market also improved in the mid-2010s, but this is partially due to new regulations on the employees' registry since mid-2014, which have reduced undeclared work. The wage growth has exceeded productivity growth. Therefore, the profitability of companies has declined, which is one reason behind low investments by companies (MoF, 2015a). The labour market has tightened and shortages of skilled labour have started to appear in some sectors like agriculture. According to the OECD economic outlook from June 2017, growing tensions in the labour market will maintain wage growth above productivity growth. As a result, firms will hire less and unemployment will increase, reaching 8.4% of the labour force in 2018 (Table 3.1).

The general government financial balance was positive over 2014-16 due to increased tax receipts and dividends from the financial sector. It is projected to be slightly negative in 2017 and 2018, as public investment is expected to rise, notably in infrastructure, health care and education (Table 3.1). This increase is appropriate given Estonia's robust public finances and spending needs (OECD, 2017b). Estonia's general government gross debt — below 10% of GDP in recent years[2] — is the lowest in the OECD area. Current account surplus reached a height of 2.7% of GDP in 2016, but is expected to decrease in 2017 and 2018 (Table 3.1).

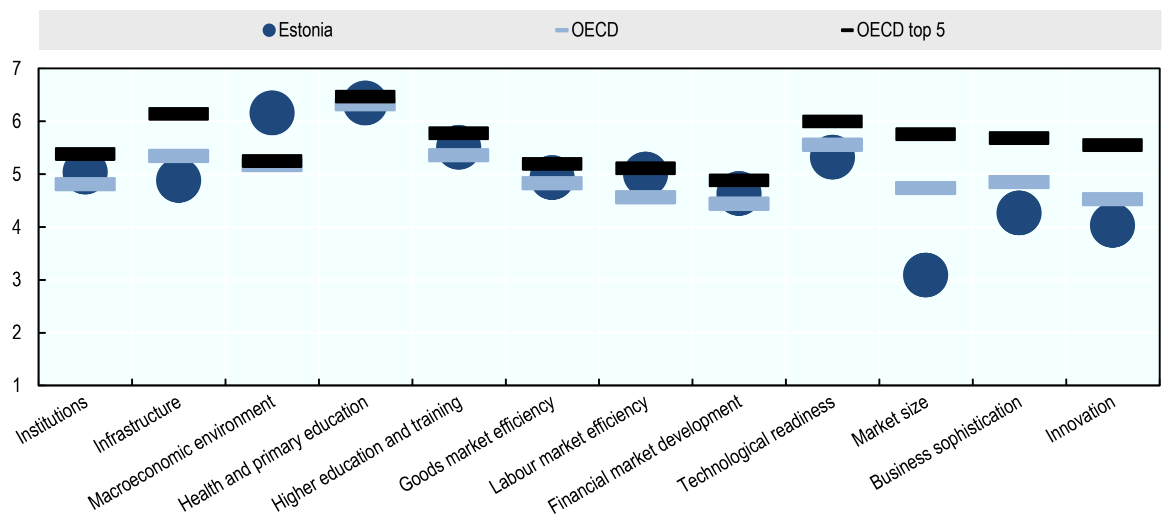
Estonia is a member of the Eurozone, as it adopted the euro in 2011. Comparing the trade structure of Estonia with exchange rate development, there are two groups of trading partners: countries from continental Europe who have floating currencies against the euro; and other countries using the US dollar. While the euro has weakened against the US dollar, it has strengthened against the currencies of non-EUR continental trading partners. As estimated by the Bank of Estonia (2016), the composition of the Estonian export markets implies that the depreciation of the euro against the dollar has little impact on trade while the nominal effective exchange rates have strengthened over all foreign partners combined.

Main components of global competitiveness

In terms of overall competitiveness, the World Economic Forum (WEF) Global Competitiveness Indicators (GCI) for 2016-17 ranks Estonia 30th among 140 countries. Figure 3.1 compares Estonia's score in the different components (pillars) of CGI with the OECD average, while the section below discusses rankings. Estonia is considered an innovation driven economy. The macroeconomic environment, rising to 12th rank in 2016/17 (3rd pillar), and labour market efficiency (7th pillar), for which it takes 15th place, contribute strongly to the overall good performance. However, Estonia lacks in market size and business sophistication (WEF, 2016).

Figure 3.1. Global Competiveness Index: All components, 2016-17

Scale 1 to 7 (best)



OECD top 5 refers to the average of the scores for the top 5 performers among OECD countries for the overall index (Switzerland, United States, Germany, Netherlands, and Japan).
Indices for EU28 and OECD are the simple average of member-country indices.

Source: World Economic Forum (2016), http://reports.weforum.org/global-competitiveness-index/.

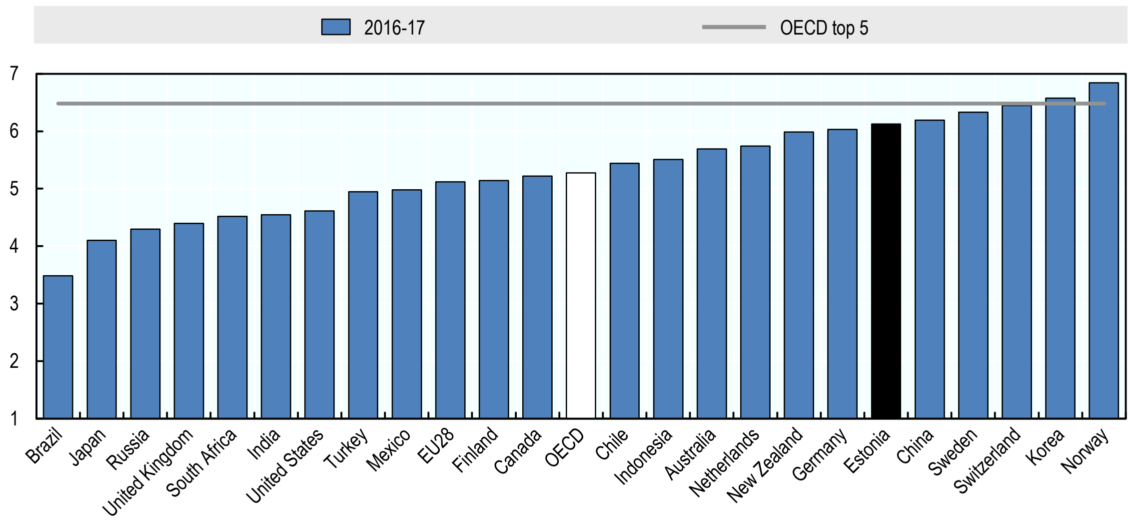
StatLink http://dx.doi.org/10.1787/888933654066

Estonian companies rank 44th in business sophistication and 28th in innovation. In business sophistication, companies are not successful in having a broad presence in the entire value chain; rather they are involved in individual steps of the value chain. Moreover, they are not very successful in using marketing to differentiate their products. The nature of competitive advantage in the Estonian economy is still in low-cost labour or natural resources (WEF, 2016). With regard to technological innovation, two issues stand out: the availability of scientists and engineers for companies (rank 45), and the level of government procurement for advanced technology products (rank 49).

The macroeconomic environment component of CGI consists of indicators, which are considered important for business and are significant for the overall competitiveness of a country. On a 7-point scale Estonia scores 6.2, only slightly behind the OECD top 5 (Figure 3.2). This good score reflects low inflation (though the reasons behind the low levels of inflation do not stem from competitiveness but more from continuing recession in the economy and imported inflation), low levels of government debt — Estonia ranks 5th in government debt as a % of GDP according to the 2016/17 CGI — and a positive account balance (WEF, 2016).

Figure 3.2. Global Competiveness Index: Macroeconomic environment, 2016-17

Scale 1 to 7 (best)



OECD top 5 refers to the average of the scores for the top 5 performers among OECD countries (Norway, Korea, Switzerland, Sweden and Luxembourg).

Indices for EU28 and OECD are the simple average of member-country indices.

Source: World Economic Forum (2016), http://reports.weforum.org/global-competitiveness-index/.

StatLink http://dx.doi.org/10.1787/888933654085

Both public and private institutions are considered very well developed and very reliable with combined ranking 23rd. The quality of infrastructure has a slightly weaker position (rank 33). The biggest disadvantage is in air transportation where both the quality of air transport infrastructure and the availability of airlines are very low. In addition, the quality of roads is low. Estonia ranks very high only in the maritime transport infrastructure (Chapter 5).

Estonia's educational system is considered to be of high quality (Chapter 5). Health and primary education (4th pillar), and higher education and training (5th pillar), support competitiveness and are ranked very high (12 and 18 respectively). Financial market development (8th pillar) is also considered very high (rank 22), especially the trustworthiness and confidence of the financial market. Both goods and labour markets (ranking 20th and 15th, respectively) are very efficient.

The Global Entrepreneurship and Development Institute (GEDI) with the Estonian Development Fund (EDF) carried out a survey in 2014, to analyse and identify the problems of entrepreneurial performance. Estonia was ranked 21st (among 120 countries) in the global ranking of entrepreneurship ecosystems, which is high compared to its GDP per capita. The most important obstacles to entrepreneurial performance were found to be innovation, finance, attitudes towards, and skills for, entrepreneurship (GEDI, 2014).

Government measures for promoting economic growth and jobs

In the National Reform Programme "Estonia 2020", approved in 2011, the two main objectives for 2015-20 to improve competitiveness were: 1) increasing the productivity, and 2) enhancing employment. In the programme, the main focus is on education and employment, with an emphasis on the integration of long-term and young unemployed people in the labour market, and on the development of their skills (Government Office, 2014).

Strategic planning in Estonia is governed by the State Budget Act and by Government Regulation No. 302 dated 13 December 2005, which states the types of strategic plans developed by the ministries. Development plans are divided into two broader categories: 1) sectoral plans, which are typically coordinated by the responsible ministry, and 2) organisation-based development plans that include the area of a ministry or government.

3.2. Governance and institutions

Good governance systems and high-quality institutions provide economic actors with the assurance that the government is accountable, transparent and predictable. They are a fundamental pre-condition both to encourage public and private investment in the economy and to enable those investments to achieve the intended benefits, both for investors and the host country. Moreover, governance systems play an important role in addressing market failure, influencing the behaviour of firms in terms of investment and compliance to regulations, as well as the efficient functioning of farm input and output markets. Finally, how the environment and natural resources are part of the institutional framework and public decision making is important in the capacity for designing efficient and acceptable policy tools (OECD, 2015b).

Transparency, clarity and predictability of governance rules, institutions and regulatory process

Since 1991, Estonia has transformed from a centrally-planned economy to a market economy. During the transformation process, the government followed a policy of openness to world markets and maintaining a balanced budget and a low level of government debt. As the 2011 OECD Public Government review recognises, Estonia has developed all the necessary functions and apparatus of a modern state. However, there are a number of challenges starting with continuing economic slowdown, worsening demographical situation and growing regional disparities. The policy of openness has improved competitiveness, but has also made the economy more vulnerable to external shocks. Nevertheless, the OECD review states that the Government of Estonia has been quite effective in state building and becoming a model for small open economies (OECD, 2011b).

An important conclusion from the OECD analysis is that in the post-crisis period, Estonia has shown good progress in developing further a single government approach with stronger administration from the Cabinet of ministers, constrained financial management and stronger governance and accountability frameworks. Nevertheless, there is strong evidence of the importance of informal networks and practices (OECD, 2011b).

The quality of public institutions is considered to be very good according to the World Bank's Worldwide Governance Indicators (WGI). The WGI define governance as the traditions and institutions by which authority in a country is exercised. WGI measures six broad aspects of governance: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption. Voice and accountability indicates how citizens are able to participate in selecting their government, freedom of expression and association, and a free media. This is an area where Estonia ranks very high, slightly below the OECD average. The lowest percentile rank is in political stability and the highest in regulatory quality (Table 3.2).

Table 3.2. World Bank's Worldwide Governance Indicators for Estonia, 2015

Percentile rank (0 to 100)

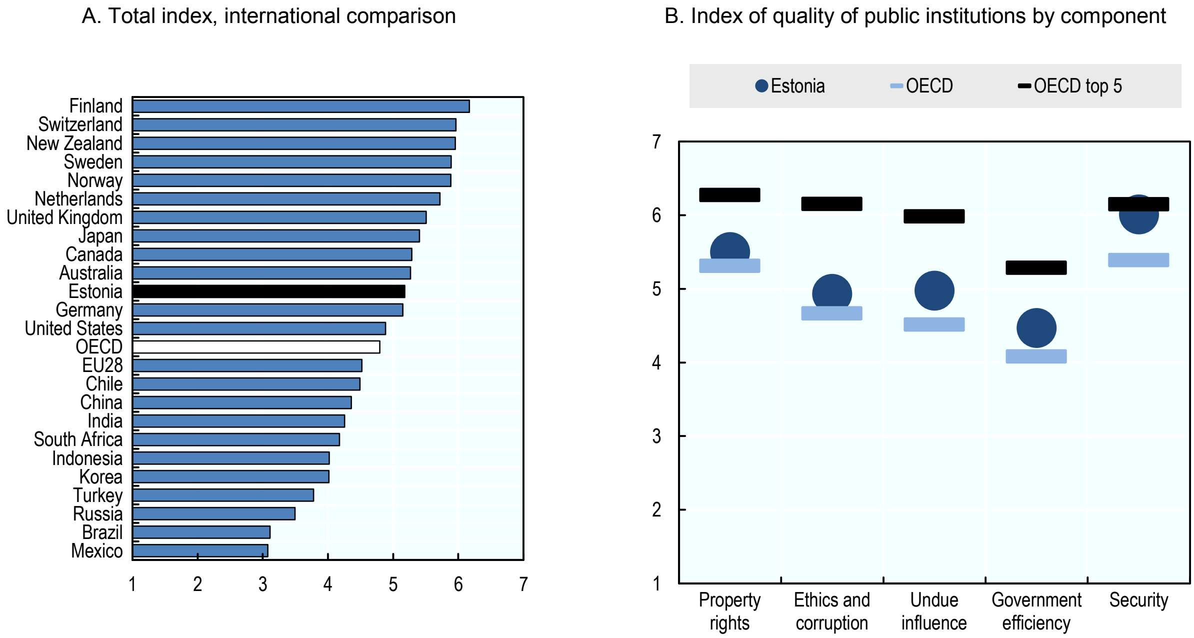
	Estonia	High income (OECD) countries
Voice and accountability	85	87
Political stability	66	74
Government effectiveness	83	88
Regulatory quality	93	87
Rule of law	87	88
Control of corruption	87	85

Source: World Bank (2016), World Bank's Worldwide Governance Indicators, http://info.worldbank.org/governance/wgi/.

According to WEF GCI, Estonia ranks very high in the quality of public institutions (Figure 3.3). Estonia scores above the OECD average in all categories of public sector quality, and performs very well in security, reflecting a very low level of organised crime (rank 10), business costs of terrorism (rank 12), crime and violence (rank 21). In ethics and corruption, the overall rank is 28, showing that illegal diversion of public funds, irregular payments and bribes are not common. However, Estonia is lagging somewhat behind in public opinion about ethical standards of politicians. Concerning undue influence, Estonia is also well considered (rank 18), meaning that the judicial system is independent from influences of the government, individuals, or companies, and that government officials show little favouritism when deciding upon policies and contracts. Government efficiency ranks 23 meaning a high efficiency of government spending and a low burden of government regulations, though Estonia is less efficient in the legal and judicial system for companies in settling disputes. The overall rank of Estonia in the quality of public institutions is 23 (WEF, 2016).

Figure 3.3. Global Competitiveness Index: Quality of public institutions, 2016-17

Scale 1 to 7 (best)



Indexes for EU-28 and OECD represent simple averages of member-country indexes.

OECD top 5 refers to the average of the scores for the top 5 performers among OECD countries (Finland, Switzerland, New Zealand, Sweden and Norway).

Property rights refers to the average of the indices Property rights and Intellectual property rights. Ethics and corruption refers to the average of the indices: Diversion of public funds, Public trust in politicians and Irregular payments. Undue influence refers to the average of the indices for: Judicial independence and Favouritism in decisions of governmental officials. Government efficiency refers to the average of the indices for Wastefulness of government spending, Burden of government regulation, Efficiency of legal framework in settling disputes, Efficiency of legal framework in challenging regulations and Transparency of government policymaking. Security refers to the average of the indices for: Business costs of terrorism, Business costs of crime and violence, Organized crime and Reliability of police services.

Source: World Economic Forum (2016), http://reports.weforum.org/global-competitiveness-index/.

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According to GCI scores, property rights, including financial assets and intellectual property rights are well protected. Based on business opinion surveys, Estonia ranks 25 in property rights protection, and has a higher score than the OECD average (WEF, 2016).

The 2011 OECD Public Governance review shows that national and sub-national administrative structures, problems in territorial management and relations between different levels of government hinder efficient delivery of public services of equal quality across the territory. However, the relatively even distribution of the working-age population across the territory is an advantage for the territorial balance of competitiveness (OECD, 2011b). The State reform subsequently abolished a layer of local government and merged some institutions in an effort to solve these problems. The government is carrying out a territorial reform aimed at significantly reducing the number of municipalities by 2018, which would help alleviate resource and capacity constraints (OECD, 2017c).

Environmental and natural resources concerns in institutions and the decision-making process

An example of natural concerns in institutions and the decision-making process is the project aiming to improve environmentally sound public procurements (MoE, 2014). In 2009, a four-year programme called "Better Use of Environmental Management in the Public Sector" was initiated by the Ministry of the Environment (MoE). The following programme covering 2014-20 was targeted on improving environmentally sound public procurements. It included training for government officials to enhance understanding and build new knowledge on environmental issues. These programmes originated from the EU initiative, Eco-Management and Auditing Scheme, developed by the European Commission and implemented by several countries, and used in public sector institutions. An environmental management plan for 2012-20 was developed in Estonia to improve measures for environmental management.

Mechanisms for ensuring policy coherence and transparency

According to the 2011 OECD Public Governance Review, the decision-making process in Estonia is very transparent, but there are still some drawbacks in taking account stakeholders opinions (OECD, 2011b). A survey conducted by Praxis (2010) shows that the main barriers to stakeholder participation with the state public administration are: insufficient preliminary information; too short timeframes for commenting; insufficient resources to divert to participating; and too time-consuming participation. OECD (2011b) concludes that Estonia has been successful in achieving stakeholder engagement goals in a relatively short period, but suggests that the engagement activities should be developed further, in order to make stakeholder engagement as effective as possible. Important suggestions for further improvement are made in embedding stakeholder engagement into the culture of the public administration so that its benefits are identified at all levels of public administration and politics.

3.3. Summary

- Estonia is a small country open to investment, with sound macroeconomic fundamentals, including a balanced state budget and low government debts following a sustainable fiscal strategy initiated in the 1990s.
- Due to a continuing economic slowdown of the main trade partners, especially in Finland and the Russian Federation, the demand for Estonia's goods and services has been low. Economic growth has been based on domestic consumption in recent years.
- The nature of competitive advantage is still in low-cost labour or natural resources. However, the wage growth has exceeded productivity growth in recent years. As a result, the profitability of companies has declined, partly explaining low investments.
- In terms of global competitiveness, Estonia ranks 30th among 140 countries. Estonia is considered by business leaders as an innovation driven economy, with a sound macroeconomic environment and high labour market efficiency. Even though the overall performance is very good, Estonia lacks in market size and business sophistication.
- In terms of business sophistication, Estonian companies do not have broad presence in the entire value chain; rather they are involved in individual steps of the value chain. Moreover, they are not using marketing to differentiate their products to a large extent, including in the agri-food sector.

- Estonia enjoys high quality public institutions and is considered as a secure country for business, with good ethical practices, an independent judicial system and transparent policies. Government efficiency is recognised for the high efficiency of spending and low burden of regulations, though Estonia is less efficient in the legal and judicial system for companies in settling disputes.

Notes

1. In revised OECD projections, growth will be expected to be above 3% in 2017.
2. General government gross debt according to the Maastricht definition is below 10%.

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