FUTURE OF ESTONIA: ECONOMIC THEORY ISSUES

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Let Us Be Realistic

People from different fields of life talk about **the future of Estonia**. Issues significant for them vary greatly and are at times even controversial. However, different views have, as a rule, also some common foundation. The larger the common foundation, the better the chance to develop a clearer and wider comprehension of where **Estonia** has reached **by today** and where it would like to be. Representing the economic community, I would like to add that we have to consider also **the price of the implementation of one or another vision**. The next Estonia cannot and should not be opposed to the current one. However, as a matter of fact, we are reaching a new quality phase in our development.

Various scenarios developed from different approaches **should have a common foundation based on facts, not dreams.** It is not enough to merely announce the state of affairs and say that we would like it to be different. In this case we would indulge in (citing the former President Lennart Meri) word shamanism and not in shaping the vision on the future of our state. We should answer to the question **WHY** things are the way they are. And we should also say **HOW, WITH WHAT INSTRUMENTS** we could achieve the desirable changes. Otherwise it is plain talk.

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Also, **there is not much sense in changes *per se.*** Even more so, as despite spreading whining, we have done many things well in Estonia. Furthermore, stability is a value in itself in our transition economy. The ten-year-old Estonian kroon and Estonian monetary system are excellent examples of stability, not *copied from Europe*, but **chosen** considering local circumstances. The Estonian economy has only gained from our wisdom to adhere to established principles and not to give in to the temptation *to try out something better*.

So we should

- think what kind of world is surrounding Estonia today and what would it look like tomorrow; what is permanent and what is changing in our broader environment;
- draw conclusions for ourselves of what kind of current opportunities Estonia has had and how they have been used, ie where we have reached by today;
- analyse rationally and without emotions what are Estonia's realistic opportunities in future and where we would like to get to.

A new and significant stage will open up for Estonia soon – Estonia will become a member of the European Union and we should know how to make use of the new opportunities. But we can do it only if we can take into consideration laws of economy and general developments in the world economy. Below there is a more detailed overview of the situation.

Market Economy has no Alternative

The concepts of *market economy* and *socialism* have acquired slightly different content than fifty years ago. However, the underlying question has remained the same. The market economy could be handled as **a global trend, which values maximum personal freedom and personal liability of economic agents.** Whereas **the need to subordinate individual needs to some extent to those of a collective, community, state** has not disappeared.

The evaluation of these two trends depends largely on the point of view. On the one hand, there is a distinctive opposition – *fight between a free society and its enemies.* On the other hand, we can speak also of a fight between *spontaneous damaging market forces* and *general human values*. Is the confrontation worth overly high importance? Economic theory provides a simple explanation both to the main trend and to the interrupting trend.

There is no arguing that **the market economy is the best for utilising reserves efficiently.** At least the mankind has not invented anything better, instead. However, the market economy is really effective only in the ideal world. Whereas the real world is far from the ideal, as:

- information and knowledge are unevenly spread. Not only within a country but also by geographic regions and cultures. Some people just are more informed of the world affairs than others;
- men are mortal – this is why they focus more on short-term objectives, want maximum welfare and are ready to overlook future generations;
- not everybody is willing to make a contribution (the so-called free riders) – while a part of the people also considers long-term objectives and makes future-oriented costs in their activities, the other part enjoys the outcome free of charge, so to say.

This leads to economic crises, large social inequality and inadequate provision of certain services (eg security).

Throughout the history, orientation to market economy has been prevailing as this has improved welfare both for our and previous generations. Nevertheless, from time to time problems in market economy swell to the extent that an *interrupting trend* could even become dominant. It is highly essential to contain this trend from destroying civilisation and state. Unfortunately, there are plenty of examples of such trends from the twentieth century – both seventy years of communist regime in Russia and its satellite countries and Hitler's power in Germany should serve as a warning for everybody. Ultimately, common sense wins but the price is far too high.

Now **the state** becomes involved, as it can regulate the 'imperfectness' of the daily life.

The Role of the State has Changed in the Economy

A change in the role of the state can be considered the most significant development during the recent a hundred and fifty years. The trend has been irrefutable – the active role of the state has decreased and has been replaced by the state as a provider of agreed services. Privatisation of public companies in all possible fields all over the world is an example of the trend. We can say that the countries that have readily followed the trend have done better.

The main function of the state is to develop policies and set conditions, not to decide and act for its citizens.

As a rule, the state as a producer of goods is inefficient. Public ownership has often led to economic and political corruption, price manipulation and higher production costs.

Does it mean that the role of the state has decreased in the economy? Not really. Merely the role of the state as an active guide (if not *a disturbing factor*) for people and private companies is shrinking. The aim of the state is to provide conditions for the more efficient performance of the market economy, set rules and framework for the economy, create conditions for a real market to emerge in the fields where it has been absent due to state or private monopoly.

Today a developed state should therefore provide the following services in the field of economy:

- **to secure both macroeconomic stability and financial stability** – stable currency, stable financial system, balanced and predictable budget. General wealth cannot grow without stable currency and stable prices; there would not be even social stability. The entire society, both the middle class and also the poorer people would suffer, only the richest could remain untouched from high inflation rate, bank failures and other crashes accompanying instability. At the current level of knowledge, only the state can bear general responsibility for the stability of the economy and financial environment – no one has seriously attempted to challenge this axiom in today's world and there are no visible signs of anyone attempting to do it within the next century;
- **to secure stable and comprehensible legal system** – the market requires agreed-upon rules for operation, high-quality legislation is a basis for every strong economy. It will be difficult to challenge also the functioning of the legal system as a function of the state in near future;
- **to facilitate market performance** – who else if not the state should take care of market surveillance and implementation of the best practices;
- **to establish markets** – to abolish monopolies, to involve the private sector to a greater extent in fields under state monopoly;
- **to secure access to information** – both figures and objectives of national policies should be accessible to everybody but the sate should ensure also wider public awareness of *world affairs.* Here we could definitely discuss whether – how and for what price – the national education system should be involved with this function.

However, it is most important to understand that the main function of the state is to develop policies and set conditions, not to decide and act for its citizens. But meeting this requirement sets requirements for citizens as well.

Trends and Relationships Directly Impacting Economic Development

The most essential prerequisite for improving the living standard in Estonia is a sustained rapid and sufficiently stable economic growth. The economic growth depends on three main factors:

- the volume of investments;
- the amount of labour;
- the labour productivity, in other words – how efficiently the workforce uses investments.

Trends Sustaining Capital Accumulation and Investments

The free movement of capital and FDI has become a global sustainable trend of the last decade. Even the 'machine breakers' of the 21st century – the anti-globalisation movement cannot undermine this. For Estonia this is excellent. A rapid development requires an inflow of capital, both foreign and domestic. In Estonia the marginal productivity of capital is higher than in developed neighbouring countries and the inflow of capital is considerably larger. Contemporaneously, it is necessary to sustain that inflow, as purely domestic capital could not secure rapid economic growth. **A stable investment climate** is, in its turn, a prerequisite for a sustained FDI inflow.

However, not only the volume of investments but also the purpose of investments is important.

The further development of the financial system will also facilitate investments. For sure, the share of the financial system in financing the economy will be increasing, even if the role of banking will not remain as prevalent as today in Estonia. Estonia would continue integration into international markets and at least some of our companies will be financed cheaper both by share capital and borrowing.

Hence, also **corporate governance should have more stringent standards:**

- executive management and supervisory board should have clearly distinguishable functions;
- executive management should unconditionally subordinate itself to shareholder oversight;
- a company should disclose reliable performance indicators;
- a company should be audited by a really independent auditor.

This would be the only way to involve low-cost capital from financial markets.

However, not only the volume of investments but also the purpose of investments is important. If the investments are carried by the hope to utilise a price increase (of real estate, etc) after the accession to the European Union, no real convergence will take place in economy, it would rather be a consumption based on convergence expectations. Should such *consumption of expectations* spread, the wealth-creating sectors will have fewer resources and there will be a threat to the macroeconomic stability.

What Influences Supply of Labour?

Clearly, the most significant trend influencing the supply of labour is the **aging of population in all developed countries.** This raises three important questions:

- how to ensure the needs of the aging population, ie how to raise money to meet rapidly growing pension, public health and social expenditure;
- how to increase the share of the working population;
- how to increase the elasticity of labour supply, ie how to ensure that the labour market would rapidly respond to changing economic conditions.

Costs of population aging can be covered in two different ways. Firstly, **the currently working-age generations should save more** for pensions and for medical costs. Secondly, **we should increase the efficiency of social security and public health systems.** For the state this means that budgeting for two years is not enough any more; a longer period of time should be considered. It is also important to **increase the share of private initiative** – in social policy more and more individual preferences and choices have to be considered, simultaneously involving the private sector to a larger extent to provision of services.

One of the options to increase the share of workforce is **to rise the retirement age.** All developed states are facing this task. Contemporaneously, it is essential **to motivate people who could work but for one or another reason do not want to (there are certainly also people who would like to but for different reasons cannot)**. Evidently one of the options could be **to curb social benefits.** But as important is **to pay a dignified salary for a dignified job**, ie CEOs should realise that if more people participate in the distribution of the economic growth, the society would only gain.

Although **active labour market policies** have a role to play, it is clear that **they can support the general framework reform, not to replace it. Immigration** is an issue in itself – would it even be possible that without immigration the European Union and Estonia could maintain the current level of development? If not, then the earlier we start to handle the problem in a reasonable way, the better.

What should a textile businessman do who admitted at a meeting in Eesti Pank that his largest problem is scarcity of seamstresses? No one wants to have this job. Should he:

- reorient into another field of activity;
- replace human capital with machines or
- bring the necessary labour in from other countries?

What would the outcome of one or another option mean for the economy as a whole?

The third issue is **making the labour market more flexible.** In essence this would mean higher labour mobility both between specialities and between regions and companies. It is difficult to say it out loud but in the interests of flexibility **termination of labour relations should be made as easy as possible for both the employee and the employer.** It is extremely important to ensure labour market flexibility in view of our upcoming accession to the European Union. In harmonising labour market regulation there is an inevitable pressure to approximate them to EU average indicators and for Estonian labour market it would mean shrinking flexibility.

However, this is not the only recipe. The labour market is flexible and of high quality if people do not depend only on the income from the sale of their labour – wages – but get a part of their income from the capital. The pension reform has again a positive role to play. In principle, we could ask what to do to have more owners in Estonia, not just wage earners. Definitely, labour flexibility is linked to general education – to substantial, not formal general education. The concern of Estonian businessmen for the scarcity of educated labour is justified. In the interests of our further development, we should deal with this issue most seriously. However, it is not possible to ensure real economic convergence with more developed EU regions without reducing the current **imbalance of demand and supply at the labour market** – without abolishing the situation that high unemployment rate and extensive shortage of labour exist side by side.

Increase in Productivity

Today it is not yet quite clear what forces determine changes in productivity in the society. However, it is possible to list **prerequisites** without which a rise in productivity is not possible. Firstly, **macroeconomic stability**, as investment is a prerequisite for growth and is made only if there is security vis-à-vis not only the inflation rate and economic growth of the next year but also of upcoming years. Secondly, **competition at the domestic and, even more importantly, at external markets**, as only competition will stimulate implementation of efficient projects and reorganisation of production to meet changing market conditions. Increase of competition is sometimes handled mistakenly – merely from the aspect of saving. Cutting of production costs can have only short-term success whereas long-term economic success arises from innovative value-added orientation in the economic development. The third prerequisite is **a sound and diversified financial system**, as the profit-oriented private investor will ultimately guarantee efficient oversight of innovative ideas. And last but not least – **physical and intellectual openness of the economy** to the external world, external competition and foreign capital.

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Creating these prerequisites is a *sine qua non* for successful innovation. **If these conditions are not satisfied, any additional steps taken by the state to support innovative projects is just wasting of taxpayer's money.** Comparing the level of contribution to research in developed countries and Estonia, we see that Estonia is about twice below the level – however, this is equally in the hands of the private sector and the state. Inevitably, besides solving fundamental issues, the state has to assume an additional role – to finance a part of basic research, provide or ensure together with the private sector to a limited extent necessary start-up capital, etc. It is better for a small state to participate in international cooperation. We cannot imagine each small EU Member State having its own large innovation centre, its own start-up capital fund. The more regional cooperation is done in this field in the Baltic Sea region, the better. The upcoming EU membership creates for Estonia cooperation preconditions like never before.

Estonia and European Union

Estonia has reached a remarkable threshold – already in 2004 we will be likely to become an EU Member State. This would increase our international exposure and entitle Estonia to participate as an equal partner in guiding pan-European processes. This would also empower us to direct our own development, as processes and trends in the European economy will affect Estonia anyway. The EU membership will mean enhanced responsibility – from now one it would depend on us to what extent Estonia's voice is heard among others.

Participation in European processes requires knowledge and experience. Hopefully, all our state institutions will be sufficiently ready by the accession to operate under new circumstances. But also private undertakings should be ready, as they have to adjust to new environment and make use of new opportunities. I believe CEOs have what to think about. In order to use all opportunities opening up with the EU membership, it is not enough to learn to write projects and apply for financing. We have to be active and offer our European partners Estonian experience, to share what we may have done better than they. Hopefully there is what to learn from Estonia.

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By 2010 the European Union should become one of the leading regions in the world with the most efficient economy and dynamic development. If we take the recent trends in the EU for a slight satisfaction with the achievements, it is probably difficult to implement this ambitious goal, although it could guarantee an ample lifestyle at least for the current generation. With such an attitude, the EU could not catch up with the USA and would probably lag behind other global trends as well. For Estonia this would mean several years of peaceful life at 3–4% annual growth of GDP. Both the European Union and Estonia can achieve more. We believe that both old and new Member States are going to contribute together into our common future. Talking about the labour market, we see that the guidelines and trends of the European Employment Strategy adopted in Luxembourg in 1997 are overlapping with the topics discussed in Estonia – labour market flexibility, reduction of labour taxation, active employment policy.

As a small state, Estonia can hopefully be more flexible, have more efficient economy and social system, in brief, secure more rapid economic growth and welfare growth. A major asset in the European Union lies in its currently centralised reasonable market-oriented policies (macroeconomic stability, free movement of goods, capital and also labour, common market surveillance rules). Simultaneously, factors affecting the supply side of the economic development are currently and probably also in the mid-term firmly under control of Member States, ie also of Estonia.

Will Estonia be wise enough to follow principles stimulating growth and increasing marginal productivity of capital? The Irish example confirms the possibility. Should Estonia succeed, we would have a minimum of 6% economic growth, be a model for other Member States and definitely can have our say in shaping the future of the European Union. Let us think about it!