

STATUS AND PROSPCTS OF THE ESTONIAN ECONOMY
Report of the Competitiveness Expert Council to the Riigikogu
Summary

June 2024

FOREWORD

At the initiative of the Riigikogu's Economic Affairs Committee, a council of experts was convened at the end of 2023. It was asked to analyse the competitiveness of the Estonian economy and offer ideas for improving it.

The expert council was made up of representatives from four institutions – Uku Varblane from the Foresight Centre, Ülo Kaasik from Eesti Pank, Kadri Männasoo from the Tallinn University of Technology and Priit Vahter from the University of Tartu.

Other experts were also involved in the tasks of the working group as much as possible. Thus, the expert council's report also included analyses and opinions from Alari Paulus, Kaspar Oja, Mari Pärnamäe, Mari Rell, Martti Randveer and Liina Kulu from Eesti Pank; Einari Kisel, Erkki Karo, Mari-Klara Stein and Helery Tasane from Tallinn University of Technology; Maaja Vadi, Krista Jaakson, Tiit Tammaru and Urmas Varblane from the University of Tartu; Erik Terk from Tallinn University; Tea Danilov from the Foresight Centre; Andres Kütt from Proud Engineers; Madis Raukas, Hendrik Pavel and Villem Vohu from the Estonian Business and Innovation Agency, the joint organisation of Kredex and Enterprise Estonia; Vaido Mikheim from Startup Estonia developing the local startup ecosystem; and Merle Raun and Tauno Õunapuu from LevelLab OÜ. In addition, representatives of professional associations provided input to the report in meetings with members of the expert council.

The members of the expert council thank everyone who contributed to the preparation of this report.

INTRODUCTION

The competitiveness of a country can be analysed in several ways. Most often, economic indicators of countries are compared. For example, the share of different types of investments in the gross domestic product (GDP), the volume of direct investments, the country's level of technological advancement and its position in supply chains may be considered. This is important information for assessing the country's growth potential and identifying bottlenecks.

However, in policy making, it is equally important to understand why the structure and economic indicators have developed the way they have. Therefore, it is necessary to look beyond economic indicators and assess the bigger picture. From a competitiveness perspective, several other factors are important as well, such as a stable economic environment, strong institutions, a well-developed financial system, dynamic businesses, good infrastructure, a flexible labour market and a workforce with the necessary skills, high innovation capacity, widespread use of information and communication technology (ICT), good public health and other indicators.

In addition, a country's competitiveness is influenced by societal values and norms, such as risk aversion, solidarity, ethics, etc. These are factors that are beyond the scope of immediate policy measures, but which can still be shaped over a longer period of time through institutional reforms.

Thus, many factors should be taken into account when studying competitiveness. Besides delving into assessments of Estonia's competitiveness, the expert council studied a limited number of bottlenecks in more depth:

- It is difficult for companies to find qualified workforce in Estonia.
- The gap between skills and actual work is quite large in Estonia compared to other countries. Labour turnover is also higher in Estonia compared to the European average.
- The level of digitalisation and automation is low in Estonian companies. Only a few are using artificial intelligence.
- The economy's resource productivity is low and companies lack knowledge on operating a technology-intensive business.
- There is too much bureaucracy and little clarity on government priorities and policies.
- The cost of capital is higher for Estonian companies than for those in most other EU countries.
- Implementing the green transition may result in more increase in costs.
- Estonia's small open economy is rather vulnerable to external shocks.

On the one hand, this choice of topics covers the bottlenecks that the expert council noticed both in international competitiveness rankings and during a meeting with Estonian entrepreneurs. On the other hand, it was affected by the tight timeframe given to prepare the report. Therefore, the expert council agreed not to set the goal of preparing a comprehensive analysis, but rather to assess the situation based on studies that have already been completed or are still in progress. If the expert council's work continues in the future, there will be an opportunity to also study other issues in depth.

The expert council worked on the principle of science-based assessment of the country's competitiveness, based on the results of both international and Estonian research and extending them to what is happening in the Estonian economy and society at large.

The report consists of seven chapters, which, taken separately, primarily reflect the personal views of their authors. Estonia's competitiveness and future prospects are a multifaceted topic that can be looked at through different perspectives, so it is understandable that the members of the expert council may disagree on the details of some topics or approaches. The summary and recommendations section of the report, on the other hand, is the joint work of the expert council, agreed upon and supported by all the members of the group.

SUMMARY AND RECOMMENDATIONS OF THE EXPERT COUNCIL REPORT

The long-term competitiveness of the Estonian economy is key to raising people's living standards and catching up with wealthier countries. A strong, innovative and responsible economy is also one of the central objectives of Estonia's long-term strategy "Estonia 2035". The issue of competitiveness is all the more acute as several factors that have brought us success in recent decades, such as cheap labour and energy, and access to affordable Russian and Belarusian raw materials, have been exhausted. Additionally, various unfavourable and unpredictable events have taken place in the economic environment in recent years. The COVID-19 crisis that began in 2020 and subsequent global supply issues forced many countries and companies to review their economic policies. Russia's full-scale war of aggression in Ukraine and deepening geopolitical polarisation have made the economic policies of developed countries much more interventionist, meaning that the state has started to intervene in the economy more and more – but such policies favour large countries. The surge in energy prices related to Russian aggression and the subsequent rapid general price increase caused central banks to quickly tighten monetary policy and raise interest rates. Looking ahead, the green transition, meaning the transition to a carbon-neutral economy with the aim of managing climate risks, will add more challenges.

Estonia, as a country with a small and open economy, has been greatly affected by these events. This economic recession is characterised by the accumulation of several unfavourable factors. The economy was able to recover very quickly after the COVID-19 crisis and certain sectors (e.g. real estate) even started to overheat. However, since the start of Russian aggression, the Estonian economy has been in constant decline. Only now, two years later, is the economy showing the first signs of ending its decline. Increasing energy and raw material prices, combined with rising labour costs, have often made production in Estonian companies more expensive compared to competitors. This would not be a problem if it was accompanied by growing productivity. Unfortunately, productivity has fallen in recent years due to declining demand. The latter has been amplified by our main trading partners' considerably weaker position compared to the European average. Also, disrupted supply chains and lost markets in Russia and Belarus need to be replaced.

Research conducted on the Estonian economy in recent years shows that the competitiveness of the manufacturing industry should be our greatest concern. The underutilisation of its production capacity gives hope that as markets recover or new ones are found, it would be possible to increase the production volume and productivity without major investments. On the other hand, there is a question of how competitive Estonian companies will still be once the markets recover.

The Estonian state and economy still have many strengths and competitive advantages that should be maintained and secured. Estonia has educated and intelligent people, a strong legal framework and an effective commercial code, as well as a flexible labour market. We are already world-famous for our digital state and ICT sector. On the other hand, comparing various

competitiveness rankings and the factors presented in them with the assessments of Estonian entrepreneurs and experts reveals a number of bottlenecks. Addressing them could improve the competitiveness of Estonian companies and the economy. Several of these factors have already been discussed in previous studies and analyses. Unfortunately, so far, the efforts have not alleviated the problems. In fact, some of them have worsened over time.

The expert council analysed the following bottlenecks in more detail:

- It is difficult for companies to find qualified workforce in Estonia.
- The gap between skills and actual work is quite large in Estonia compared to other countries. Labour turnover is also higher in Estonia compared to the European average.
- The level of digitalisation and automation is low in Estonian companies. Only a few are using artificial intelligence.
- The economy's resource productivity is low and companies lack knowledge on operating a technology-intensive business.
- There is too much bureaucracy and little clarity on government priorities and policies.
- The cost of capital is higher for Estonian companies than for those in most other EU countries.
- Implementing the green transition may result in more increase in costs.
- Estonia's small open economy is vulnerable to external shocks.

The following is a summary of the expert council.

IT IS DIFFICULT FOR COMPANIES TO FIND QUALIFIED WORKFORCE IN ESTONIA

The shortage of qualified labour is often cited as the main reason companies do not invest in technological development or expand production. Considering the ageing trend of the Estonian population and the low birth rate, this problem will only become more acute in the coming decades. Therefore, the expert council thinks it should be more clearly defined how this problem is intended to be solved. Broadly speaking, there are three ways to do this, which can also be combined: a) better use of the existing workforce on the labour market, b) increasing the productivity of the existing workforce, c) involving foreign labour.

Better use of the existing workforce may mean various measures to increase people's participation in the labour market (e.g. raising the retirement age or shortening parental leave would increase labour supply). In addition, the analysis showed that there is a quite large gap between skills and actual work in Estonia compared to other countries, which may give opportunities for better use of employees. Labour turnover is also higher in Estonia compared to other European countries – on average, people stay in one job for two years less than in Europe. This may mean that there is less advantage of work experience to increase employee productivity in Estonia and therefore promoting employee self-development in the workplace could be beneficial.

The most frequently cited shortage of qualified workforce in industry is that of engineers. Thus, it would be necessary to increase the training of engineers in particular, trying to integrate ICT specialties into training and supporting its application in industry. Introducing partial fees to higher education could be considered, thereby encouraging more informed career and study choices. Education provided in vocational education needs greater application. Closer cooperation between companies and vocational schools could offer this. More ways should be found to use artificial intelligence to assist in teaching and acquiring skills, both in schools and

in companies. Research has shown that artificial intelligence-based solutions can help less experienced and lower-skilled workers catch up with others.

When opting for greater involvement of foreign labour, increasing the company's productivity using additional workforce should be the goal. That is, the skills and knowledge of foreign labour should complement the knowledge and skills of local employees, not replace them. For example, the University of Tartu's RITA migration study (2021) recommends regulating immigration from third countries based on a points system, according to which immigrants are selected based on their skills (including language skills), level of education, work experience, or other criteria. When defining migration target groups, their previous experience with integration into Estonian society should be considered more, as well as the associated costs.

THE LEVEL OF DIGITALISATION AND AUTOMATION IS LOW IN ESTONIAN COMPANIES AND THE ECONOMY'S RESOURCE PRODUCTIVITY IS LOW

The level of digitalisation and automation is relatively low in Estonian companies. Various studies indicate that raising this level would significantly help increase the productivity of companies. Only a few companies use artificial intelligence. However, calculations made by the expert council indicate that the use of artificial intelligence has increased productivity among Estonian companies using it by more than 7%. Thus, greater attention should be paid to using the opportunities provided by artificial intelligence – e.g. enabling better collection and use of data.

Research also suggests that digitalisation and automation would have greater impact in companies if they also addressed management quality, organisational innovation, data analysis capabilities and business model refinement at the same time. Automation has increased productivity by an average of 22% among Estonian companies that have implemented it, but accompanied by organisational innovations, there was a 38% increase. Sometimes, companies have also lacked the ambition and ability to implement changes, which, with the arrival of various crises, has now left them in a difficult position. If the state wants to help companies in this situation, the effect would certainly be greater if all of these changes were addressed together.

TOO MUCH BUREAUCRACY AND LITTLE CLARITY IN GOVERNMENT PRIORITIES AND POLICIES

There are more and more complaints from companies about bureaucratic obstacles and uncertainty about economic policies. With the green transition, the regulatory burden increases further, as planning and managing the transition process requires more information and data. Given the systemic nature of this issue, it would be useful to strengthen incentives for responsible officials to speed up and simplify the state institutions' work and reduce reporting. Savings can come from eliminating morally outdated information obligations, as well as from automating data collection and processing. It would also be necessary to increase incentives for local governments so that they have a greater interest in promoting the development of local entrepreneurship.

Government actions have also increased the volatility and unpredictability of the economy at times. The government should make an effort to ensure that the use of EU structural funds is more even over time. For instance, in the current period, the implementation of structural funds is considerably slower than in earlier periods. A more even use of money from the structural funds would help reduce large fluctuations in orders. Government measures to improve the budget have also reduced the stability of the economic environment. Therefore, more predictable and sustainability-supporting budgetary rules that are reviewed with a certain regularity would be beneficial in the future.

BUSINESS FINANCING IS MORE EXPENSIVE THAN IN MOST OTHER EU COUNTRIES

The small scale effect resulting from the size of the market, high market concentration and relatively weak competition in Estonian banking have led to a situation where the cost of financing companies in Estonia is consistently higher than the European Union average. In recent years, the fact that a large portion of loans have floating interest rates and the impact of monetary policy is therefore more immediate has made Estonian companies' situations more difficult. In addition, entrepreneurs have difficulty finding suitable loan collateral. This market failure can be mitigated somewhat through state guarantees. Their wider use would contribute to the availability and affordability of financing for Estonian companies.

The Estonian capital market is small for structural reasons and offers little competition to the banking market as a source of financing. Institutional investors, including pension funds, play an important role in the development of the local capital market. Making the use of funded pensions more flexible reduced the volume of pension assets and shortened the investment time horizon. For instance, state liquidity guarantees could improve pension funds' weakened incentives to make long-term investments into Estonian companies.

IMPLEMENTING THE GREEN TRANSITION MAY RESULT IN EXTRA INCREASE IN COSTS

Economic policy measures aiming to achieve climate goals will entail both benefits and costs for the Estonian economy, which may change over time. Therefore, it is important to assess the associated benefits and costs before making any major climate policy decisions, as this makes it possible to identify and time subsequent steps better.

Analyses show that the average cost price of renewable energy will start to rise when the volume of renewable energy produced in our region (the Baltic countries) exceeds 60–80% of the volume of consumption. In the event of a higher share of renewable energy, production may exceed consumption at certain times, increasing the need to limit production. If each country optimises only its own system, this could lead to higher prices for the consumer. To optimise costs, it is therefore necessary to coordinate the development of renewable energy production volumes with neighbouring countries. To keep electricity prices lower, it is important to continue establishing external connections, including considering installing an electricity cable between Estonia and Sweden.

As climate concerns become more relevant, investors' interest in renewable energy, green economy raw materials and recyclable materials in the circular economy is growing. Estonia could better use its emerging competitive advantages in bioresources and the circular economy. In addition, we have potential in research and development in green technologies, where there are business opportunities in the development of new technologies or products that can be exported. A long-term vision of the state and reliance on state priorities would be helpful in this.