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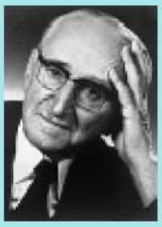



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Estonia in Transition under the Restrictions of European Institutional Competition

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Abstract

After the fundamental changes of the early 1990s and before Estonia joined the EU, many neo-liberal economists regarded Estonia as their model student – due to the country's economic principles. Economic growth has been positive from 1995 on (except in 1999) until 2007, and above the EU average. During this period, GDP per capita and productivity have grown from just under a third of the EU average to 70 per cent of it in 2007. Today the attitude towards Estonia has slightly changed, because Estonia has involved into global economic crises and in decline stage of local trade cycle simultaneously.

The transformation process in Estonia is an extreme case within a number of similar cases in Central and Eastern Europe. After regaining its political independence, Estonia established a liberal and democratic society. Since 1992 Estonia has pursued one of the most liberal trade policies in the world. The state budget is subject to the balanced-budget principle. In as early as 1998, 85% of companies were privatized. The currency board system tied the Estonian currency, the Eesti kroon (EEK), to the German mark (DEM) at a rate of about 8:1. To round the picture off: agricultural subsidies were abolished and a flat income tax rate was introduced.

This article seeks to analyze Estonia's transition under the restrictions of European institutional competition in more detail. The first and second part analyses some areas of transition macro- and micro-policies that have been suggested that Estonia applies in order to a) join EU and b) catch up within the EU. The third part deals with Estonia's position in international economic competition up to the present time. We define Estonia's strong and weak points in system competition today as result the transition policy. As can be shown, there is still a great need for convergence in economic performance compared to the EU average.

Keywords:

Institutional economics, transformation, economic integration, Estonia.

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Estonia in Transition under the Restrictions of European Institutional Competition

Introduction

After the fundamental changes of the early 1990s and before Estonia joined the EU, many neo-liberal economists regarded Estonia as their model student – due to the country's economic principles. Economic growth has been positive from 1995 on (except in 1999) until 2007, and above the EU average. During this period, GDP per capita and productivity have grown from just under a third of the EU average to 70 per cent of it in 2007. Today the attitude towards Estonia has slightly changed, because Estonia has involved into global economic crises and in decline stage of local trade cycle simultaneously. For year 2008 there was anticipated decrease in GDP at least 3.5 % and for year 2009 even more.

The transformation process in Estonia is an extreme case within a number of similar cases in Central and Eastern Europe. Estonia was the only country of the disintegrating Soviet Union that had been able to transform its economic structures so successfully that no transitional period had to be applied to the country's accession to the EU. After regaining its political independence, Estonia established a liberal and democratic society. The period between the declaration of independence in August 1991 and the adoption of a new constitution by referendum in June 1992 was less than a year. Estonia followed the example of Western democracies deciding for a pluralistic society with a strict separation of powers and the rule of law. The new Estonian government also immediately began the systematic reconstruction of the economic system. Since 1992 Estonia has pursued one of the most liberal trade policies in the world. The state budget is subject to the balanced-budget principle. In as early as 1998, 85% of companies were privatized. The currency board system tied the Estonian currency, the Eesti kroon (EEK), to the German mark (DEM) at a rate of about 8:1. To round the picture off: agricultural subsidies were abolished and a flat income tax rate was introduced[2].

Thus Estonia quickly managed to get over the bottom of the transition crisis it reached in 1993. At that time, production fell by 27% due to the loss of the Russian market. The country became the leader in economic growth among the transition countries in Central and Eastern

[2] A more detailed discussion for the period up to the year 2000 is offered by Wrobel (2000, 2001).

Europe. The economic progress is generally credited to the subsequent and decidedly liberal reform policies of all Estonian governments so far. Consequently, Estonia emphasized the need to transform its economy – i.e. the reconstruction of the economy's institutional framework (Wrobel 1999, p. 66). Estonia has assumed a favorable position in competition with different European and other economic models.

Average real economic growth in the last ten years has been approximately 7% per year. During the period 2000 – 2006, Estonian economic growth was the fastest among European Union countries – averaging around 8% per year. As a result, convergence with the average level of EU economic prosperity has also been significantly faster than expected. At the same time, GDP per person compared to EU15 is still low, the main reason for that has been the relatively low productivity (approximately half of the EU15 average). This low productivity level is related to both low TFP as well as capital intensity, which has grown quickly compared to other EU countries, but continues to be one of the most modest in the European Union. Basically, this means that companies have invested little, considerable human resources are being consumed, relatively inexpensive products are being produced and services with low added value are being offered.

This article seeks to analyze Estonia's transition under the restrictions of European institutional competition in more detail. The first and second part analyses some areas of transition macro- and micro-policies that have been suggested that Estonia applies in order to a) join EU and b) catch up within the EU. The third part deals with Estonia's position in international economic competition up to the present time. We define Estonia's strong and weak points in system competition today as result the transition policy.

1. Macroeconomic policy

1.1. General overview

Estonian economic model has had a very positive macroeconomic impact until the 2007:

- monetary and price stability has been preserved;
- foreign trade stability has improved;
- the state budget has shown a stable surplus;
- the labor market has sent positive signals.

The economy of Estonia has grown rapidly in recent years. At the end of 2007, Eurostat assessed the level of Estonian GDP as already over 70% of the EU average (Table 1). But since the middle of 2007, economic growth has slowed significantly. Real growth of GDP in 2007 dropped to its lowest level in 7 years. In 2008, the economic slow-down has further accelerated. The primary danger in the next years is the possibility that the economic standstill in Estonia will last several years.

Table 1. Estonian gross domestic product (accounting for purchasing power) for 2000-2007

	2000	2001	2002	2003	2004	2005	2006	2007
GDP annual growth (%)	9,6	7,7	7,8	7,1	7,5	9,2	10,4	6,3
GDP per person EU27 average (%)	44,7	46,2	50,0	54,5	57,4	62,2	67,6	70,8

Source: Eurostat

The inflation rate had already fallen to less than 5% in 1999 and continued to fall until 2004. In 2003 it was even lower than the EU average. Joining the EU has accelerated the general price increase somewhat. In addition, oil prices tended to raise inflation this year more than in the EU as a whole – in the Estonian price index, the share of fuel is 6.4% compared to 3.8% in the EU.

Foreign experts have always considered the foreign trade imbalance to be the largest problem of the Estonian economy. The trade record has shown a deficit for years that sometimes even exceeds 10%. Up to now, this has been an EU downside of massive foreign investments, which bring along imports of capital goods and in return cause a trade deficit. There is a statistical problem involved in this as well: the negative income in the trade records reflects the profits made by foreign investors that are generally not exported but reinvested. In the balance sheet they are therefore reflected on the positive side together with primary investments from abroad.

Estonia is one of the few countries in the EU that has earned a budget surplus. The surplus of all governmental budgets (central and local governments, social security insurance) was at its maximum in 2003 with 3% of GDP and in 2004 it was still 1.7% of GDP. The Government's 2006 budget surplus reached 6 billion Estonian kroons, which is 2.9% of GDP. That was the first time that all levels of the government sector had a surplus. About 80% of the budgetary surplus was from the central Government, which despite a deficit in the pension insurance fund, reached 4.6 billion Estonian kroons. The Government's 2007 budgetary surplus reached 6.5 billion Estonian kroons, which is 2.7% of GDP. Thus it becomes clear why Estonia has the lowest public debt within the EU – only 4.3% of GDP at the end of 2006 and felt to 3.5% at the end of 2007. Estonia's future is not unclouded, though. In particular, sustainable development of old age pension insurance is causing a headache.

Economic growth has also taken tension off the employment situation. Until 2000, Estonia's structural changes reduced employment, thus causing unemployment. Since then, positive aspects of growth have prevailed. Estonia has already achieved some of the goals the EU has set for employment. Only the overall objective of 70% is still to be attained. In future, one should rather be afraid of shortcomings on the supply side of the labor market. The qualification of the labor force does not always match the demands of the labor market. The high youth unemployment emphasizes this point as well. In the 15-24 age-group it was still 21% in 2004, after all.

Estonia has seen high economic growth in recent years. In the last more than ten years, only Ireland was more successful within the EU. The motors for economic growth were the export of goods and services and also domestic demand. Exports increased by 16% in 2004 (Eesti Pank 2005). Domestic growth had tended to stabilize. The main growth sectors were the processing industry, construction industry, hotel and catering, and finance. But growth in exports was modest in 2007 and problems with export competitiveness have broadened in 2008. In the medium term, the growth of exports appears to remain lower than the average from the last five years because of problems in economic correction. Also, the growth of foreign demand has slowed in recent years, which has had an impact on exports.

Estonia's demographic trend is similar to that of other EU countries. After the baby boom in the early 90s, the birth rate has fallen to a mere 1.39 (children per woman). It is forecasted that the population of Estonia will fall by 17-18% within the next 50 years. At the same time, life expectancy will rise, so that the population structure will become more unfavorable from the perspective of the old age pension system. In 1992 there were still 2 working people for each pensioner. At the moment this ratio is 1.8, but in 2050 it will probably be scarcely 1.3.

1.2. Macroeconomic stability

A stable macroeconomic framework for economic growth means above all maintaining medium-term budget stability. The balance between revenues and spending will be the basis for household planning in the coming years. Due to cyclical deviations, the actual outcome could definitely vary both ways. This planning principle corresponds to an anti-cyclical policy

– in times of crisis (e.g. in 1999) the budget will be in deficit, and in a period of boom, it will show a surplus. In the first case financial reserves are needed, whereas in the second they will accumulate. Until 2008 we have encountered the latter case – reserves are now almost 10% of GDP.

Monetary policy certainly also contributes to macroeconomic stability. In this respect, joining the euro zone (Economic and Monetary Union) is the most important economic measure on the agenda at the moment. Estonia has been a member of ERM II since June 2004 and is aiming at introducing the Euro as quickly as possible.

Until 2008 Estonia fulfilled three of the five so called Maastricht criteria. There was no problem with the state budget, public debt and long-term interests. The first two points have been discussed above. Estonia was far from the limits that are well-known – i.e. -3 and 60%. Long-term interests may not exceed more than 2% of the average of the best three countries (those with the lowest interest level). In July 2005, the target value was at 5.5% and the Estonian level even below that – i.e. 4.2%.

The only problem criterion was inflation, which may not differ by more than 1.5% from the average of the three best Euro zone member states. In July 2005, the numbers were 2.4% and 4.1% respectively. Since 2006, inflation has significantly increased in Estonia. In 2006, inflation reached 4.4% and accelerated to 6.7% in 2007. An increase in consumer prices in the first half of 2007 was caused by domestic factors, but in the second half, external factors emerged as food and oil prices rose suddenly in the world market. Average inflation in 2008 was 10.7% and it is expected that price increases will slow to 6.3% in 2009. It is not planned to use administrative or statistical tricks to manipulate this key figure.

There might also be legal problems for the Euro. In fact, the Estonian constitution determines that the only legal currency in Estonia is the Estonian kroon (EEK). According to EU opinion, Estonia should change that. Constitutional amendments are, however, difficult to accomplish – at least on short notice. Thus both the country’s present government and the Estonian Central Bank regard the referendum held prior to EU accession as sufficient, because the Treaty on European Union includes the compulsory introduction of a common currency. If Estonia’s Supreme Court shares this opinion, joining the Euro zone is expected to be legally safe.

Risk control is seen as a third measure in support of macroeconomic stability. Two risks are emphasized: the current account deficit and private debts. The current account has been discussed before – the only way government can contribute to minimize risks is by pursuing a conservative budget policy. Commercial bank loans were 2007-2008 growing by 40-50% (!) annually in Estonia, and so does the debt burden of the economy and population. The main reason can be found in inexpensive home mortgages and all in all positive expectations with regard to the economic situation. As commercial banks usually borrow their money from abroad, the country's (not the government's!) foreign indebtedness is growing all the time. If we look at this from the point of view of gross figures, the indebtedness is almost as high as GDP (the net figure is less than 20% though). In 2000, gross indebtedness amounted to just over 50%. To counteract arising risks and to keep the credit boom within a limit, the Bank of Estonia is holding commercial banks' minimum reserves at 13% (only 2% in the Euro zone, in contrast).

1.3. Sustainability in Fiscal Policy

The first problem was to set up an optimal pension scheme that is both sustainable in the long term and allows for an appropriate living standard for pensioners. In 2003, pensions reached 40.5% of average earnings, which is just above the European minimum standard.

Estonia has set up a three-column system, which consists of a state pension (based on the current disbursement method), a compulsory private scheme and an additional voluntary scheme. The first column is funded from social tax, which is altogether 33.5% of the employee's gross salary, which is paid for by the employer. 20% thereof – in terms of gross salaries – goes to the pension scheme. The second column is based on capital cover and is organized via private funds that are usually managed by commercial banks. The insurance premium rate is 2% of the gross salary and has to be paid by the insured person. In addition, the state puts 4% of the social insurance money on top of it. The second column is sustainable only under the condition that pensions gained from current disbursements are growing more slowly than wages and salaries and the resulting tax revenues.

The state pension (based on the current disbursement cost method) has been multiplied by a mixed index. That index is calculated using the average of both inflation and the growth of social tax revenues. In this way, Estonia succeeded in financing current disbursement and capital cover allowances from one source. The reserves originating from earlier years mainly lasted until 2006 as well – when a politically motivated increase in pensions was scheduled. After that, other sources had to be used. The government is primarily hoping for budget savings.

Health insurance is paid for from social taxes, and equals 13% of the gross salary. Up to now, this system has been functioning properly. In 2004, however, only 59% of the insured were happy with the quality of medical services. The unemployment insurance system was working well until crisis 2008.

1.4. Stimulation of economic growth and employment through fiscal policy

First of all, this objective raises the essential question of whether the state should play a larger or smaller role in the economy. In the first case, the tax ratio should be raised, and in the second lowered. After the changes of the early 1990s, from the very beginning Estonia focused mainly on the market rather than the state. The tax ratio has not fallen steadily but at least demonstrated a tendency to fall. With a tax ratio of more than 30%, Estonia is definitely no minimal state. As we have already seen, the state has to do a lot of work in the social area, and we will also analyze the state's economic role. All of these tasks require revenues for funding. They must not, however, endanger competitiveness. That means the structure of taxation, i.e. the income side of the budget, should be optimized.

Labor as a factor of production is highly taxed – more than the EU average. In 2002, taxes amounted to 37.4% of all personnel costs in the case of blue-collar workers. This number had to be reduced. There has been a political decision to achieve that objective through income taxation. The income tax rate has been decreased from 22% in 2007 to 21% in 2008. According to the amendment of 2007 in the Income Tax Act, there was planned to reduce the income tax rate to 20% in 2009, to 19% in 2010 and at least to 18% in 2011. But in September 2008, the tax reform was postponed by one year. The income tax ratio is presently 21%.

One must carefully consider where public money needs to be used in addition to the above-mentioned social services. Spending should definitely be focused on investments in infrastructure and human capital. That means, on the other hand, that other appropriations of funds must be cut back, e.g. state allowances as subsidies to the industry. Massive cutbacks took place in 2000. First of all, Estonia exempted all reinvested company profits from taxation. Previously, this rule had only applied to Tallinn and its surroundings. Until 1999, this was seen as a regional tax concession and therefore a subsidy. Secondly, the last preferential treatment rules for companies with foreign investments were abolished in 2000. Those rules came from a 1991 Act on Foreign Investments that is no longer in force.

1.5. Actual conjuncture problems in Estonia

Economy is subject to both continuous development factors and tendencies, which are under the observation in the current article primarily, as well as short-term factors or as economists like to say – to shocks. These can be supply-side (for example technological leaps) as well demand-side (for example unanticipated benefits) shocks. At that, the impact of these shocks may be temporary or permanent. At the first case, the supply/demand turns to the former level after some time, at the second case this does not happen – there will be shift in level. The technological changes are often just similar to the second type, but demand shocks are rather the first type. Exactly such positive temporary demand shock took place in Estonia in 2005-2007. The main reason for that was foreign loan money brought to Estonia by banks. The fact that this boom took place right after accession with European Union is evidently not contingency. As investors' as well creditors' trust in respect of future of the Estonian economy increased drastically.

If in the first years of decade the foreign loan money inflow was approximately 10 billion per year, then in 2005-2007 this amount was exceeded in six quarters. Maximum accrual was in the second quarter of year 2007 – approximately 19 billion. If take 10 billion provisionally as normal amount of additional money per year, then we receive estimated volume of the shock more than 100 billion kroons during the last three years. The Estonian economy had to absorb it all and certainly did – pleasant sides of this effect we may see practically everywhere in Estonia, but primarily in real estate market and construction sector. But this story has two ends. So has the demand shock or in other words, up shift of demand curve, both good as well as poor consequences. Demand curve upwards shift means primarily that, demand-side representatives, both enterprises as well as final consumers, are prepared to pay higher price for the same amount of products. Then the prices rise to higher level quickly. At the same time, are the supplies ready to offer bigger amount of products with higher price. During this process price starts to fall, still staying higher from preliminary price. But if the demand shock was really temporary and demand curve shifts back to the former level after some time, then firstly, follows rapid fall of prices to the initial level and then follows recession of supply and demand also to the initial level. Cycle is completed – we are back at the initial point.

2. Transition on the micro level

2.1. General remarks

Transition on the micro level primarily means the protection of individuals' economic freedom. This is guaranteed by the Constitution of Republic of Estonia from 1992. Hence, in economic theory and practice is well-known understanding, that it is not enough to have just a decision about having competition and economic freedom in order to get effectively functioning national economy and also to achieve distributional justice.

Therefore all the transition countries have been following the developed market economies as examples and have been built up the competition law with implementation mechanism (Fisher, 2000). Estonia has not been in the top of this list and not as active differently from other transition areas (Dutz/Vagliasindi 2000). In the literature we may find the doubt about rationality of competition policy in transition countries. Some authors do not consider it important in small economies, which are open to foreign competition (Godek 1998). Others again have doubts about administrative capacity in implementation of competition protection in transition countries and find the particular investments to be sub-optimal project (Singelton 1997). At the same time, there has not been done enough research about the real impact and effectiveness of competition policy in transition countries. Mostly the range of countries is limited to Central-European countries (for example Fingelton/Fox/Neven/Seabright 1996) and does not include Estonia. One exception here is OECD analysis from year 1999. From the other side, the analysis of the Estonian transition process does not treat competition policy problems radically enough (Hoag/Kasoff 1999, Wrobel 2000).

For the abovementioned reasons, it is obvious that a deeper analysis of Estonian competition policy would help to disclose its role in transition among other economic policy instruments. At the first sight, Estonia seems to confirm the supposition about the priority of liberalism in foreign economy in designing the competitive economic environment. From the other side, is interesting to compare the Estonian competition policy with European Union competition policy and its member states competition rules, find out differences and their objective and subjective reasons. Hopefully, there is still space for institutional system competition regardless of the high level centralization and harmonization in the EU competition policy. Only in that case, we may expect, that besides of mechanical imitation will appear also the creative learning and innovation process.

The current analysis is going to continue the previous ones done by authors in the same sphere (recently, Sepp 2000) and it is taking into account the developments mainly until Estonia's joining to the European Union.

The main changes in the Estonian competition policy have taken place just during the last decade.[3] It means that the main developments in the Estonian competition policy have taken place before year 2004, when Estonia joined to the EU. Also, the Community competition rules were modernized on May 2004, based on Council Regulation 1/2003. The main change compared to the old regulation is that member states now have the obligation, when proceeding cases that may affect the trade between them, to apply the EU competition rules in parallel to national legislation. Besides the changes in relation to accession to the European Union, one has to consider the changing relations between regulation and competition in general. As we may find in the literature, the regulatory toolbox has expanded and, most importantly, contains new techniques of 'regulation-for-competition' (Jordana/Levi-Faur 2004).

Furthermore, the EU competition policy provides a coherent framework for Estonian Government's more active interference in economy, including interference in industrial policy. Monitoring the state aid will safeguard control over possible political games in favor of certain economic groupings. Estonia should also take advantage of all the legal and monetary opportunities that are made available by the EU for the development of entrepreneurship. Among the issues awaiting attention are, for instance, those related to venture capital.

In the article, the abovementioned objectives are observed in five subparts. The first of them gives a short overview about the development of the entrepreneurship in the Estonian transformation process. In the second we look competition improvement through the market entry regulation. In the third sub-division, the enterprise activity is treated proceeding from blocking the private competition restrictions in Estonia, showing the formation of the policy and problems. The following, the fourth, analyzes competition creation in exceptional spheres from viewpoints of regulation and deregulation. The fifth deals with publicly originated competition restrictions, especially connected with state aid, which influences the competition.[4]

[3] After the third Competition Act came in force in 2001 it has been done already nine improvements in it by now.
[4] Here is need to stress that also in the blocking of private restrictions there is the possibility to over regulation, which itself is seen as public competition restriction.

2.2. Development of the entrepreneurship in the Estonian transformation process

Since Joseph Schumpeter, entrepreneurship has been regarded as one of the most important driving forces of the economy in economic theory. Societies differ greatly in terms of the actual spread of entrepreneurial initiative. Entrepreneurship presupposes foremost the individual freedom of economy. Other civilians or state may limit this freedom. In centrally planned economy, which dominated in Estonia till the end of the 1980s, the private freedom was limited by the state. On the one side private ownership of the industrial products was not acknowledged and the other side the economy managing was led from enterprises to national bureaucracy centers. It did not bring along the improvement for coordination of the economy as it was hoped earlier. Order rights were attenuated[5] and it gave a good opportunity for opportunistic behavior in enterprises and in bureaucracy centers as well. Consequences to that were big transaction costs and X-inefficiency and these were the main reasons for the system to collapse. In entrepreneurship there are certainly problems with transaction costs[6], but on the whole the competition finds out viable forms of economic activity.

Economic transition in micro level at the end of 1990s brought to an understanding that market economical enterprising cannot be established only on bases of liberalization (decentralization). The property reform, especially privatization appeared to be necessary.

Privatization for the real money in Estonia happened in two phases:

- Small privatization with the privatization of service enterprises (stores, shops, catering) foremost with the balance value less then 600 000 EEK and
- large privatization.

According to law the main privatization method was public offering to residents. Most of the state-owned enterprises were privatized in 1991-1994.

Large privatization followed the example of German *Treuhand* model. Privatization law stipulated three methods of privatization:

- Preliminary negotiation (differentially from other two methods, it is possible to estimate the business plan, investment and jobholding guarantees besides the price);
- Auction;
- Public sale of stocks.

[5] Kaulman, 1987, p.33.
[6] Coase 1937, Alchian/Demsetz 1972, Jensen/Meckling 1976

The main working method in Estonian privatization practice was the preliminary negotiation and participation was free for all investors. The main advantage for such a method was flexibility and among other things this method made possible to control the investors' background, their investment capacity and to consider the local circumstances. The third method – public sale of stock – was used in several purposes and it has been combined with the offering of preliminary negotiation. The main purpose of privatization with this method was also to achieve the enterprises competition capacity, which in the end must assure the functioning of markets and competition itself.

Estonian Privatization Agency stopped its' activity in 2001 and during the privatization process 12 billion of EEK came in. In a period of 1991 to 2001 Estonian Privatization Agency contracted 575 agreements in an amount of 8.3 billion of EEK. The value of property sold through auctions and preliminary negotiation offerings was 9 billions, additional 0.6 billions came from land selling. Agency's functions associated with continuing contracts were taken over by the Government and the Ministry of Finance.

Along with privatization there is another mechanism in creation of competitive economy – new enterprising. In 1992 the biggest number of enterprises (15 646) was registered into the Enterprising Register, by the year 1996 it had decreased almost three times (5386). The creation of new enterprises has stabilized for now to 10 000 new enterprises per year. Still it must be said that most of created enterprises do not turn out to be viable and only 40% of created enterprises will start activity. Most of the non-active firms stay so called shell companies.

In the middle of the 1990s the main reasons for starting enterprises were the opportunity to increase income, independent work, self-affirmation, to do something satisfying and to create jobs to themselves and co-workers. Most of the entrepreneurs (62%) had experiences in certain field of activity and half of them had worked as executives[7].

The attitude towards entrepreneurship is quite conservative, despite the widespread individualistic attitude among Estonians.[8] According to a 2004 survey, only 9% of the interviewees thought of themselves as potential entrepreneurs, and only 5% had been entrepreneurially active during the last three years. After the founding years of the 1990s, the number of active businesses is growing slowly – by about 6% annually.

[7] Aho, Piliste, Teder, 1998, p. 89-93
[8] Even very recognized academics sometimes consider entrepreneurial activity unproductive.

To improve the attitude towards entrepreneurial and innovative activities, the government planned a special PR program which included all target groups – from politicians to students. Business associations are seen as important dialogue partners. Economic and particularly entrepreneurial qualification should be integrated into every stage of education, including further training on the job, which should be extended.

Apart from informal factors, the law has an impact on the development of entrepreneurship. There is also some work to do in this field. Legal regulation should be efficient – the benefits from regulation should be higher than its costs. Unfortunately, there is very little competence for doing related analysis in Estonia. The government is planning to examine all bills ex ante, especially regarding their impact on small and medium-sized companies, which are particularly sensitive towards red tape obstacles. Several individual measures are planned to help reduce regulation costs for businesses.

Attempts are being made to facilitate both the analytical work and the Internet applications for the practical work in companies. To give an example, the majority of companies and individuals submit their tax declaration through the Internet. It is hoped that time spent on business set-up can also be reduced in this way. In 2005 this period was an estimated 45-60 days. It should not be longer than 25 days.

The regional distribution of businesses in Estonia is uneven and when taking into account only companies, the respective percentages are quite striking – companies located in Harju, Pärnu and Tartu county account for almost 75% of all companies. Concentration of businesses in urban areas is also apparent: 60% are located in the three larger cities, and almost a half of Estonian businesses are in Tallinn. Sole proprietors are regionally more evenly distributed, with roughly 50% in Harju county, Pärnu county and Tartu county. Only 32% of all sole proprietors are active in three major cities[9].

Along with the private capital, foreign direct investments have also played an important role in the development of the entrepreneurship in Estonia. At the end of the 2000 more than 44.5 billions of EEK of foreign direct investments head for Estonia and it exceeded several times the privatization benefit[10]. According to that indicator per inhabitant in CEE countries, Estonia was until 2001 on the second place after Hungary and Czech Republic, but is the leader since 2003 (table 2).

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[9] Enterprising Estonia, 2002, p.14.
[10] The annual of the Estonian Bank 2000. Tallinn, 2001, p. 124.

Foreign investments in particular have brought new know-how alongside capital to Estonia, thus enabling technological and product-related modernization. Nevertheless, Estonian companies' productivity is only half of the EU average, and only 3500 companies (i.e. 10% of active businesses) operate in foreign markets. At the same time, 30 leading companies account for 50% of all exports.

Estonian companies are presently more users of foreign technologies than strategic innovators. The latter group comprises only 5% of Estonian companies.

Table 2. FDI inward (US Dollars at current prices per capita).

YEAR		**1995**	**1997**	**1999**	**2001**	**2003**	**2005**	**2007**
ECONOMY	**MODE**							
Czech Republic	**Flow**	248	127	618	553	206	1144	896
	Stock	713	898	1715	2654	4441	5952	9923
Estonia	**Flow**	140	190	221	398	679	2141	1859
	Stock	469	819	1790	2319	5178	8398	12427
Hungary	**Flow**	494	405	323	386	211	764	556
	Stock	1094	1746	2271	2690	4768	6144	9711

Source: UNCTAD

The legal forms of the entrepreneurship have gone through a significant change (Table 3). When in the beginning of the transformation process the commercial undertakings dominated then since the liquidation of the Enterprise Register and re-registration of businesses in the Commercial Register the Estonian enterprises structure has become more transparent and effective. Especially remarkable was the requirement to raise the fixed capital from the former 300 EEK to internationally comparable 400 000 EEK. Most of the public limited companies were changed to private limited companies. The activity of the sole entrepreneurs was regulated as the sole proprietors.

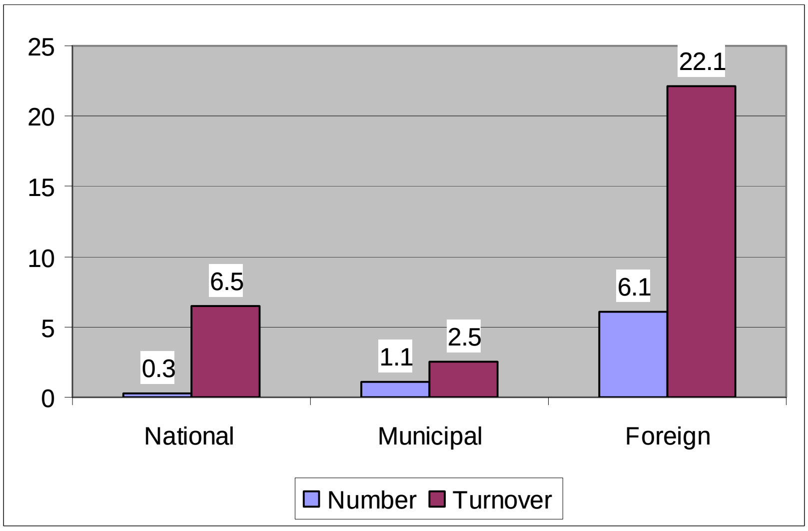
Table 3. Number of businesses and their distribution by the legal form[11]

FORM OF ENTREPRENEUR-SHIP	1.1.1995		1.1.2006	
	Number	%	Number	%
Self-employed entrepreneur	0	0	21671	22,6
Profit association	1902	2,8	695	0,7
Unlimited partnership	54	0,1	378	0,4
Trust company	51	0,1	708	0,7
Limited liability company	1276	1,9	66200	69,0
Joint-stock company	47627	70,2	5945	6,2
Other	16960	25,0	415	0.4
Total	67870	100	96012	100

Source: Estonian Statistic Board, Commercial Register.

Although, public enterprises are only an insignificant part (1.4%) of all the registered enterprises, they play an important role in some industries and in infrastructure (Figure 1). Public enterprises average proportion in turnover has decreased – from one third in 1994 to 16.2% in 1998 and to 9% in 2000. Still the turnover of the public enterprises is more than six times bigger than the average. Enterprises controlled by the foreign capital give one fifth of the turnover being more than four times bigger than average. It has acuminated the competition not only quantitatively, but also qualitatively and has affected conductively effectiveness and export.

Figure 1. Structure of companies based on ownership in Estonia in 2000 (%).



Source: Statistical Office of Estonia.

[11] In order to obtain a more adequate overview, changes in the number of economically active or operating businesses should be examined. According to the records of Estonian Tax Board, in 2001 there were 30 612 economically active companies in Estonia (the enterprises are considered to be economically active if they have submitted Income Tax Return and their yearly revenues are above zero). 75% of the operating companies were micro enterprises, 19% small, 3% medium-sized, 1% large enterprises and 2% with unknown status.

2.3. The Public Regulation of Market Entry — Competition Restriction or Creation of Effect Competition?

In case of market entry regulation the purpose of regulatory action is justified because the government screens new entrants in order to make sure that consumers get the high quality products from sellers. The regulation reduces the market failures such as low quality of products and services and negative externalities such as pollution as well at the first place. Also the problems connected with asymmetric information as the type of market failure has to be considered. It means that overall we can see here as economic or/and as well social goals for regulation.

By the OCED definition the differentiation is made between economic, social and administrative regulation. The two first mentioned are more concerned in market entry regulation process. It is because the economic regulation intervenes directly in enterprise and market decisions such as pricing, competition, market entry or exit; and social regulation protects values as health, safety, environment and social cohesion (The OECD …).

Economic regulation consists of two types of regulations: structural regulation and conduct regulation. Structural regulation is used for regulating market structure. Examples are restrictions on entry and exit, and rules against individuals supplying professional services in the absence of recognized qualifications. Conduct regulation is used for regulating behavior in the market. Examples are price control, rules against advertising and minimum quality standards. (Hertog 1999).

Economic regulation itself includes the arrangements of structure in different branches and its goal is to increase the social welfare, and reinforce the viability and competition of the firms. This aspect concerns the firms acting already in the market, but through the economic regulation on the market entry the creation of competition takes place as well. Government policy in screening the new entrants creates the competition in market entry. Here, in the first place one has to consider the procedures required for starting a business. Also, the entry is often controlled by licenses or certificates and a common policy approach is to license or certify providers, who meet standard of skills, training or experience.

Recently, quite a lot of attention has been paid to the issue, how the different countries regulate the market entry and, what type of regulations lead to improve economic and social outcomes. World Bank researches (Doing Business) include the data of 184 countries and have been created the indicators for ranking ease of doing business in those countries. For analyzing the market entry the set of indicators include number of procedures, time, cost and minimum capital to open a new business. Mentioned procedures and of course the requirement of different licenses are the main mechanisms in market entry regulation.

We may consider that regulating the market entry through the action permits and licenses will create the effect competition in entry to the certain market and is justified by existence of market failures, but on the other hand, those instruments are acting as state barriers for enterprises.

One of the most important market failures is limited and frequently asymmetric information of market participants. Just the asymmetric information problem makes essential to deal with unfair competition. In the Estonian Competition Act the VII Chapter treats the issues of unfair competition. There. §51 concerns misleading information and libeling of competitors. Hereby, it contributes to consumer and competition protection. The particular role has § 52, which forbids the abuse of confidential information and knowledge of the other company's employer or representative.

The principles of good faith and fair competition are certainly protected not only by the Competition Act[12]. This is also general principle of civil law. The competition prohibition has the same objective in the Estonian Business Code, where is stated that a person cannot be the associate in unlimited company, *commandité* in trust company nor self-employed entrepreneur at the same field of activity. Here the aim is to avoid unfair competition through elimination. In the first sight, there is the issue of individual protection (of other associates), but the broader objective is to increase the reliance and to guaranty more efficient organizational structure of economy.

Unfair competition would not be a problem in the situation of perfect information (in the world without transaction costs). For example, the prohibited misleading advertisement and libeling a competitor could not have any impact in the Estonian Competition Act, if consumers and other market participants could distinguish between true and false information. The mentioned improper devices are directly based on limited capacity (bounded rationality) of market participants in providing and processing information.

[12] Here is included the reference to the Advertising Act in connection with blocking improper advertisement.

There are three following solutions for particular problem:

- prohibit the abuse of bounded rationality of other market participants,
- demand activities from a potential abusers to increase the clearly arranged market,
- aid to them, who have less information — consultation for consumers, support for their organizations.
-

The first above mentioned task is solved in Estonia through the Competition Act and besides it also as well through the misrepresentation prohibitions in the Consumer Protection Act, in the Food Act (RT I, 1995, 21, 324) and in the Advertising Act (RT I 1997, 52, 835).

Nevertheless, the aim of consumer protection law and its normative acts is first of all to solve the second task mentioned. In those documents the obligations of sellers and rights of consumers are fixed mainly for the purpose to raise the consumers' information and herewith for the correction of really existing asymmetric information problems[13]. At the same time, in case of such normative documents, there the hazard may rise, that additionally to informing consumers also the choice and decision problems are solved on behalf of them. It may happen because certain commodities are treated as merit goods, which means that the individual demand is considered to be socially inaccurate. This kind of trusteeship is appropriate only in case of subjects with limited responsibility (for example children). There the justification for state regulatory intervention is the principle of paternalism. But sometimes it is technically impossible or economically costly to distinguish these persons with limited responsibilities (for examples alcoholics), therefore are applied general public restrictions for certain problematic fields of activity in Estonia as well in other countries. The third pillar of information policy is formed by governmental and public consumer protection organizations. The Estonian Consumer Protection Board is acting in the administrative area of the Ministry of Economic Affairs and Communication.[14] The Estonian Consumer Protection Board has its structural units in Tallinn and in all counties. Their main tasks are informing and consulting consumers and settlement of consumer complaints. Mainly are complaints concerning price setting by dominant enterprises in communal public services markets and one-sided changes of contracts. Beside of the Consumer Protection Board have the same directional tasks also boards which deal with health protection, standardization etc activities and have in principle the same rights for their action.

[13] Essentiality of the problem is stressed by given Nobel Prize in Economics in 2001 for works in this sphere, what indeed deal with a private or market solutions of the problem.
[14] http://www.consumer.ee/

A regulation, which is solving the asymmetric information problems, has two main tasks:

- guaranteeing the certain minimal standards for goods and services;
- avoiding social and ecological hazards**..**

In the both cases, there has to be discreet in applying a bureaucratic regulation and preferably try to apply, and in case of need, support the competition mechanisms. An example here is compilation of rates for enterpriser as is star-system in hotel-business. A performer of special requirements could use it as the positive advertisement in competition. The creation of system might be a task for professional and entrepreneurial associations. In Estonia, from year 2004, there is in force the law (RTI, 10.03.2004, 12, 79) of economic activity register (MTR) for activities with special requirements, which distinguishes simple registering requirement from requirement of applying action permit in administrative procedure. Last one as a stricter barrier to entry is limited to fewer branches of activity, specially in energy sector.

2.4. Blocking Private Competition Restrictions

Competition protection international experience is expressed in the most concentrated way in the Treaty of Establishing the European Economic Community (Articles 81-89), which are in force essentially unchanged form from 1958. At the same time, a lot has been guided by the German law of against the competition restrictions, which itself resounds experience of the USA competition policy, starting from Sherman anti-monopoly law. The latter, from 1890 has been base for modern competition policy. Nowadays, there is essentially dominant international consensus in rules of market behavior for enterprise, which expresses in cartel prohibition and control over the cases of abuse of dominant position by entrepreneurs. In treating the market structure (concentration) the main generally known instrument is merger control. Only states with the most strong competition policy (for example USA) can allow the distribution of already acting enterprises.

International experience has been an important factor in designing the Estonian competition law. The first draft law of Estonian Competition Act was in debate in Parliament (this time it was Supreme Council) in 1991. There were taken place also some essential discussion, but the draft was rejected because of near government crisis. By opponents the premature argument of competition law was put forward. It was argued that there is no need for competition protection law before the creation of competition. Authors of the draft (including one here-writer) stressed, that there is a mutual connection and competition law is necessary also to support the competition creation. At that time, the small privatization has been already started and during the time-period, new and in general small private enterprises (private shops) had to exist together with state monopolies. In those conditions the competition law ought to help in fighting against the abuse of dominant economic position and making easier to strike through in the market. The retained industrial and whole sale state monopolies had large opportunities for exploitative and exclusionary behavior when the state price control was abolished in 1991–1992. The competition law including the exploitation and exclusion prohibition could have been here in the right place.

The foreign experts were working on with the Competition law and the first Competition Act came into force in 1993 adopted by *Riigikogu*. In general the law followed international example, nevertheless there were observable also some other important peculiarities:

- Ethics of competition was regulated in the same law with competition freedom, while the same administrative law proceedings were used;
- The mergers control regulation was completely lacking;
- Government formed the state supervision competition agency in its own composition.

Differentiation between competition ethics and freedom as protection objectives is the European tradition. Nevertheless, competition law here before the Second World War was limited to unfair competition regulation only. For example, in Germany the respective act (UWG) was adopted in 1896. The same orientation of the unfair competition act was also in force in Estonia before the Second World War. In many countries (for example in France) the special laws of unfair competition do not exist and the regulation is processed by general norms of civil law. In transition countries (Hungary, Latvia, Lithuania) the unfair competition, similar to Estonia, is regulated with competition restrictions within the framework of one law. The USA law does not distinguish in that clear way, but uses the term unfair as for competition as an institution as both for unfair harmful action caused to individual competitors. In Estonia, the term unfair competition has acquired in mass media synonymous meaning of any kind of competition harm, which is not correct. The problems are connected, but still different in their essence, and using the same term makes analyses and policy turbid. Fortunately, makes the competition act here differentiation – dishonest business activity, which has contradiction with good customs and practices, is treated as unfair competition.

In principle, the most important is the legal base for restricting the unfair competition. At the beginning in Estonia, differently from most of other countries, was in use the administrative law approach to the debates which were in their contents civil. Complaints connected to unfair competition formed the major work of the Estonian Competition Board. This is for sure one reason why there was less attention paid to competition as an institution problems.

The establishment of the optimal merger control is the most complicated both as theoretically as politically. For its main objective it has to avoid the concentration of excess economic power to the hands of few groups, without blocking at the same time the objective using economies of scale as for cost savings as for innovations. The necessity of mergers control has been recognized step-by-step also in developed countries (in the EU as known not until year 1989, it means that more than 30 years later the establishment of other competition rules). The mergers control has been caused particular many disputes in small countries. Here under the rise of international competitiveness the policy has been very liberal. Nevertheless, even here the development is recognizably moving towards the harmonization with the EU policy. The EU policy itself is objective to continuing criticism.

Of course we cannot forget the peculiarities of small countries and connections with other branches of economic policy, in the first place with the foreign economic policy. It is clear that in open global markets is impossible to apply the same policy as in closed regional markets. There is necessity for differentiated approach to the mergers control. The control is required only there, where the Estonian internal market or some parts of it make up the independent relevant market. Some examples are following.

Already the language barrier may be the natural market obstacle. True, that in case of many goods this obstacle is relatively easy and cheaply to overcome (for example translating the consumer information), but not always. In journalism market it stays permanently very important. Big part of services markets is in its essence the local (retail trade, daily living services etc.), therefore geographically relevant market meaning has even every small town. In this case the market obstacle is essential specialty of the object of utility — it is impossible to produce services for stock neither to transport.

The argument of substitution the movement of goods by the movement of capital is not sufficient to completely abandon the mergers control. Movement of capital (establishment of new newspapers or services enterprise) does not happen instantly, and is related with additional costs of market entry and local monopolies may slow down the process. In case of small countries also have to be considered that political power is relatively easy to manipulate by economical power. Therefore is better here the additional attention paid to conglomerate mergers.

The own experience and attempt to harmonize with the EU rules has been led to the renewals of the complete competition act even twice — in 1998 and in 2001. The last version is in force from October 1, 2001. There has been renewed several treatments of the problems since 1998:

- The proceeding order of unfair competition has been changed;
- The exemptions for agreements and other coordinated action is regulated in more detail;
- There is added the treatment of special and private rights, natural monopolies (essential facility) and state aid regulation;
- Developed the merger control.

From the former act the treatment problem of the unfair competition has been formally solved, it is processed now in civil law order (§53). There we would expect, that Estonian courts will form the substantial case law soon and are enough eager to learn the usage of international experience. Here is still part of open law area in Continental Europe, which is grounded on undefined (soft) notions (for example, good practices and customs). Probably there is need for special training program for judges in this area.

The regulation of agreements and coordinated action[15] (new Competition Act Chapter II) meets the European model now. The Act prohibits agreements, concerted practices or decisions of alliances of undertakings, the purpose or result of which is restriction of free competition. Only in case of *de minimis* clause (§5 section 2) differentiation between vertical and horizontal cartels exist.[16] The only difference of the Estonian Competition Act compare to the EU competition rules[17] in this point is that the enterprises information exchange is directly equalized with coordinated action (§4 section 1 point 4). In agriculture non-price cartels are allowed, which are not making harm to the competition essentially (§4 section 2).

Exemptions' regulation (Chapter III) is also harmonized. For exemptions from cartel prohibition is not necessary only expected positive economic results from agreement, but also the consumer participation in them and justification of the competition restrictions for achieving those results. The block exemptions are possible, which may introduce by government in proposal of Minister of Economic Affairs and Communications.[18] There is

[15] With them are equalized also the decisions of entrepreneur associations.
[16] The less important are the horizontal cartels with market share up to 5% and vertical ones up to 10%.
[17] The Article 81 in Treaty establishing the European Economic Community (EEC).
[18] Four first group exemptions were established with Government act in March 23, 1999. Those were for agreements in franchising, sole selling and sole buying, and selective merchandising systems in

specially pointed out that exemptions do not widen to the enterprises of dominant position and non-competitive markets. (§7 section 3). Whole third chapter is dedicated to enacting the procedure of single exemptions in detail.

To define the dominant position there are used as quantitative as well qualitative criteria. The important complementing was made to the Competition Act with last change[19], which draws the quantitative criterion to the role of landmark. If before, that for fixing the dominant position was sufficient the fact of having 40% of market share, then now it gives only the base for this assumption. Decisive is the possibility of the autonomous activity. The dominant position is not treated as abuse in general, but the abuse of dominant position is what has restrictive effect on the competition. Differently from the first Competition Act, the seven given references do not mark separately the exploitative abuse (for example, too high prices). Those need to include under the unfair prices with too low and therefore exclusionary prices. Additionally to the cases of the EU competition rules[20] the concentration compulsion and unfounded refuse of delivery and purchase the goods is called directly an abuse (§16 point 5 and 6).

Differently from the second Competition Act (from 1998), where special- and private rights and natural monopolies were treated in separate chapters, the new Competition Act has been collected this topic under the general chapter about enterprise of dominant position. Essentially there is proceeded from the general acknowledge of essential facility doctrine. The new Act contains new provisions that establish limitations and obligations to the activities of an undertaking controlling essential facility.[21]

The merger control did not have any direct regulative contents in the Competition Act adopted in 1998.[22] Of course the information obligation is better than nothing, because the collected information was useful for abuse supervision in case of enterprises in dominant position. Still this policy was too narrow. Already, mentioned prohibition of the insisted mergers is not sufficient in the abuse supervision framework. Therefore is logical that mergers control part in Competition Act was renewed essentially (Chapter V).

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automobile market. In 2000 two more group exemptions were established for specializing and UA-agreements.

[19] This change in law talks first about collective dominant position in the market.

[20] The Article 82 in Treaty establishing the EEC.

[21] The application of doctrine is specified in exclusive laws about the special areas of the competition policy like in the Telecommunication Act, in the Electricity Market Act and the Railway Act. For example the new Railway Act foresees that the total carrier capacity has to be put to the public proceedings by the owner of railway.

[22] The only act enacting opportunity to block the mergers before the new Competition Act was the Act of Credit Organizations, which established the possibility to block banks merger or achieving the essential share. This was under the control of Banking Inspection.

The terminology was changed. Instead of using notion ‘mergers’ is used the notion ‘concentration’. In the context of business law the merger is only one form of the concentration. Here to be added acquiring dominant influence over the other enterprise or its part. Under the last mentioned there at the first place is understood the independent economic unit or enterprise, which has its own market turnover and therefore the market share. In the Estonian Competition Act a lot of attention has been paid to measuring the turnover, which still is not the most difficult problem of the mergers control. Of course it has to be stated clearly in one sense who should give the information about mergers. The present rule presumes partially the total turnover 500 million EEK in the world, among this at least two partial having the turnover over 100 million and at least one partial or part of its action in Estonia. Much more complicated is giving the appraisal of merger. Merger is prohibited, if it firstly, causes or strengthens a dominant position and secondly, harms the competition significantly.

The objective is to maintain and develop competition. There has to be considered as real as well potential competition, among this market structure and market barriers. The main criterion is choice options for buyers, suppliers and final consumers. Remarkable is that differently from European Council Act[23] Estonian law does not involve industrial policy reference to consider technological and economical effect, which is usually the main argument or covering shade for mergers. From other problems we may assert contradictions in notion system, which certainly have been decreased compare to the former versions. For example § 1 is connected only to law regulation area in protecting of competition and preventing its harming, and removing the damage. This does not cover the regulation of exemption areas. In case of last, there is more to do with substitution of competition, where free entrepreneurship is not possible or reasonable. Invisible hand of market is substituted by visible hand of state (official).[24] Of course there is attempt to minimize the substitution and keep the competition in place as much as possible. Nevertheless it does not change the essence of issue — competition does not solve all economic problems. Also the other institutional mechanisms are necessary.

Also the goods’ (commodity) market notion (§ 3) is not enough successfully defined. All alone the specification in definition “the area of circulating goods” is causing the problem for economists, because it is more connected with geographical boundaries. Internationally is in use the better (more abstract) notion – relevant market. Relevant market is appropriate from the point of some commodity market problem, geographically and commercially determined

[23] Here the new Act (139/2004) is in force from May 1, 2004.
[24] The § 17 defines for example *ex ante* price regulation opportunities for the enterprise with essential facility.

part, which covers all real competitors influencing one another. For determination could be the substitution consistency of goods from the point of view opposite side of the market. There the Estonian Competition Act places the buyers in front as opposite side of the market. At the same time, for example an activity of some milk manufacturer may harm the competition in buying up milk, but here the relevant market has to be defined from sellers (farmers) side considering first of all the geographical substitution of dairies as buyers. Potential competition is important as from commodity as well geographical aspects. In some cases it has to be possible to look at international market as relevant market, it means that structure of international market loses its essential meaning. Otherwise we ignore the statements of modern competition theory and imperil the development potential of a small state. Right step has been done here by the last change in the Act, allowing first time to see territory of Estonia (geographical) as a part of goods' market. In those cases the concentration of Estonian international market could not be the competition policy argument.

There is large variety in terms of competition policy organization in the international practice. At the same time, in theory has been stressed the partial similarity to monetary policy institution — necessity to protect the long-term economic interests from the daily political problems. Therefore has been often recommended that competition policy body should be relatively independent from executive power.

Looking at the experience of small countries we see the endeavor to separate the investigation of competition law violations from corresponding decision making. At that, the decision making body (Competition Council in Finland and Denmark, Cartel Court in Austria) is staffed by participation of parliament, king or president of the country. In Switzerland, the social cartel commission formed by parliament has important role. The competition policy bodies have an important role also in some transition countries. In Hungary, the President of Competition Board, who is appointed by the President of the country for six years, is participating in sessions of the Parliament and government. In Latvia, by the law from 1997, the Competition Council from legal person is the supervisory body. The members of the Council are appointed by the government for five years, but one government cannot recall the council member appointed by itself. This should help consolidate the independence of decision council. The status of council member is not connected with the parliament membership. Therefore the different methods are used in order to achieve one goal – to protect the independence of competition policy from government daily policy. In Estonia, the Competition Board has unusually weak position in the state structure. It is as a usual state board subordinated to the Ministry of Economic Affairs and Communications.[25]

[25] The last change in the Act enacts also the cooperation with European Commission according to the

Probably is that fact reflecting most clearly the understanding that competition policy has second-rate role in small open economy. In authors' opinion the stressing of foreign economic policy cannot lead to underestimation of processes in internal market. Separate problem is also the relation of the Competition Board with state regulators of independent branches of economy. In the international literature, there is discussion about the expediency to combine them. Here we can find the arguments from both side as in favor as against. Nevertheless, in small country (especially in transition period) the combining should strengthen the general status of competition policy and administrative capacity. Because all the regulators have at least one common task – control over the dominant enterprise, no matter *ex ante* or *ex post*. The Supervisory Inspection at the Bank of Estonia (*Eesti Pank*) could be set an example. From year 2008, the new institutional arrangement of the Estonian Competition Board is in place. Now there are integrated former single sector regulators (Postal Board, Energy Sector Inspection and Technical Supervisory Inspection) with the Competition Board.

The effectiveness of competition policy also depends on cooperation of executive body and court power. The new Estonian Competition Act foresees new solutions in work allocation between competition board and courts. The Competition Board is responsible for discovery the violation of law.[26] In case of impediment the proceeding the Competition Board may make precepts to natural or legal persons. In the failure to comply with a precept the Competition Board may impose a penalty payment (§ 62).[27] The violations of law in contents are looked by last changed law firstly as misdemeanor for which shall be sanctions: for physical person fine or arrest; for legal person fine up to 500 000 EEK. This last one is essentially modest compare to relatively usual rate, which was also in the former versions of Estonian law – up to 10% from previous year turnover. At the same time, there is complemented also criminal procedure, which gives first time the possibility to take criminal liability natural person, who are in fault in impairing the competition if there has been applied the punishment for the same misdemeanor before. The sanctions are in form of the fines or up to 3 years imprisonment. Though it is Estonian peculiarity at the first place and there is no hurry to cancel it as the competition board pursues, because the discussion continues at European level.

Act of EU Council 1/2003.

[26] In 2003 the Competition Board had enforcement activities concerning enterprises in total number of decisions 71. From which 21 cases were in abuse of dominant position/monopolistic power in the market, 2 cases of cartel agreements, 9 cases on other prohibited (horizontal and vertical) agreements, 39 cases of control of mergers, concentrations and acquisitions.

[27] For private person up to 50 000 and for legal person 100 000 EEK.

2.6. Competition Creation in Exceptional Spheres — Regulation and Deregulation

The competition replacement with public regulation is economically reasonable only in exceptional areas and even here, only in essence of natural monopolies, for example different supplying and distribution networks. Still, there is need to point out, that it concerns only managing the essence of monopoly – the networks, but it does not apply to their operating. Also the technological progress is capable to undermine the essence of natural monopolies as the mobile communication progress shows.

In Estonia, the corresponding law is in developing phase. The general framework here is designed by Competition Act Chapter IV. The §14 and 15 from the Chapter IV define the owner's essential facility accordingly the exclusive and sole rights, including the owner of the natural monopoly. There are also adopted the several exclusive rights as following: Energy Act regulating the fuel and energy sector (1997, reformed as Electricity Market Act in 2003), Railway Act (1999, renewed version from 2003 is in force from 31.03.2004), Cable Communication (1999) and also the general Telecommunication Act (2000) and recently Electronic Communication Act (2004, 2007).

In the Competition Act the natural monopoly is observed as the base for dominant position. The natural monopoly is connected with property rights concerning the particular network or infrastructure, which is impossible or unreasonable to duplicate, but without to the access to it there is no opportunity to operate in particular market. In such situation government and local governments have right to price control, it is "because the consumers of particular companies product or sellers to those companies cannot fall the essentially worse situation compare to the situation, when the free competition is in place in the particular sector" (§ 17). In theory, the described approach is known 'just-as-conception'. Therefore the invisible hand of market is replaced by visible hand of state. The Act formulates also the main obligations of the monopolists (§ 18):

- Guaranteeing the access to the networks and infrastructure in reasonable and non-discriminative conditions in order to supply or sell the products;
- Guaranteeing the transparency in accounting.
- Already the first Estonian Energy Act (RT I 1998, 71, 1201) met the principles of the European Union Internal Electricity Market first Directive (currently is in force the second Directive 2003/54/EU) and envisaged the obligations for network enterprises in terms of technical opportunities:
- Enable the direct connections between the producers and consumers;

- Offer the distribution services;
- Allow the accession with network.

Furthermore, the network enterprises we treated as been in dominant position in terms of the Competition Act, and there was envisaged the opportunity for price control and for that the necessary transparency in accounting. Practically the same principles are stated also by the new Electricity Market Act (RT I 2003, 25,153), but it is done by the regulation which is essentially detailed. Therefore, the Act is less transparent and carries more the sign of lobby work done by Estonian electricity monopoly - *Eesti Energia*.

For Estonia has given the exception in opening up the electricity market in the EU accession treaty until year 2012, because of the protection oil-shale energy interests. Nevertheless, the technical preparedness for the opening up the electricity market is lacking in the previous EU member states as well. At the same time, it will be clear, does it serve the electricity import or export interests, because the adjustment of oil-shale energy prices concerning the strict EU environmental rules is still in process. The current act in force, gives the right to choose the electricity deliverer for so-called free-consumers (consumption overcomes 40 GWh per year) until year 2009. From 2009, the free-consumer rights for major consumers will be guaranteed in a way, that their total consumption will make up at least 35% of the total amount of the market. Taking account the EU efforts for the opening up the electricity market in general, we may anticipate the pressure to Estonia for the acceleration of its electricity market opening process. The similar parallel has been shown through the hints to possible fines in case of delaying with regulation concerning the Estonian gas market.

In implementing the network charges Estonia follows the requirements of corresponding EU Directive (concerning the reconciliation and disclosure of prices ex ante). At the same time, the price regulation in general is stricter. New Estonian Energy Act (§ 75) requires besides the network charges to reconcile also the prices of electricity and its raw material and oil-shale prices with the Energy Market Inspection. It is probably inevitable until the real opening of the electricity market. In special literature, there has been opined, that state ex ante regulation of electricity prices will turn inessential even in case of small-scale consumers. This change assumes also progress in measurement technology in addition to opening the markets. Then analogically to telecommunication market, there is not any more in the first place the task of regulating the electricity prices by state, so far as the task of regulating charges of deliverer change.

The main problem still stays in network charges regulation or supervision in the future as well. Currently the EU Energy Act § 70 envisage not only three types of charges (accession charges, charges of using the network connection and charges of forwarding), but also the opportunities for their differentiation (essentially price discrimination). Taking into account information asymmetry in favor of network enterprise, it stands as an extremely difficult task for the Energy Market Inspection.

Herewith the preconditions for privatization of fuel- and energy sector are created – there is regulation mechanism replacing the competition. Unfortunately, the privatization process failed at the beginning of year 2000, because of poor (non-competitive) management of the process and political opposition. Those, who were against the privatization process, ignore opinions of political economy (especially capture theory). According to theory, the state agencies, which control monopolies tend to represent more the interests of enterprises compare to consumers' interests. This hazard is major particularly concerning the state monopolies by nowadays' concept. It is because here the enterprise leaders have more connections with politicians than in case of private enterprises. Of course, the additional saving motives and advantages for effective action from that are used better in private enterprises.

Differently from the Energy Act, tries the Competition Act to stress another neutralizing mechanism of natural monopolies: replace the 'competition in market' with the 'competition for market'. For that purpose, the monopoly has to give in open offering according to the public procurement law (RT I 1995, 54, 883: 1996, 49, 953). In principle, the idea is correct, but can not be the remedy in overall. The investments may give the advantage to those participants, who already are in the market longer time and who do not have to worry about cost-effectiveness of their investments and also get the better price offers in general.

When in energy sector the regulation has been functioning relatively steady (discontent is connected with the privatization), then much more criticized sector is telecommunication. The first object of criticism has been the cable communication law (RT I 1999, 25, 364). Here the local governments were allowed to divide their territories as the market shares for which the Communication Agency gave one or several permissions of cable TV. The one permission was issued in case, if the applicant engaged to offer the telephony service as well. Such opportunity for local monopoly provoked arguments against. There was the situation, where competition in one particular market (cable TV) was contributed because of another competition in telephony service market (even more important market).

The followed Telecommunication Act (RT I 2000, 18, 116) points out rather the supervision over the enterprises which have essential market power in telecommunication market. The attribute of the essential market power is 25% of market share. If the market share is more that 40%, then the corresponding articles of the Competition Act are applied. It is not obvious, why mobile communication market needs such special regulation, especially taking into account the highly concurrent oligopolistic market structure. In authors' opinion, there is enough implementing the regulation of enterprise in dominant position.

Also in the railway sector, the deregulation has been bringing up conflicts between the market participants. Especially, concerned is the former monopoly *Eesti Raudtee* who is the owner of the infrastructure, because it lost the control over the railway transport service market. The new Railway Act is more radical compare to the first one, which required that *Eesti Raudtee* has to give to other enterprises 25% of infrastructure capacity. Because of the vertical integration of *Eesti Raudtee* the transport service market is managed by Railway Inspection at current time, whereby the total amount of transportation is given to the open competition. There the *Eesti Raudtee* has to compete with others in the equal conditions.

2.7. State Aid

State support to enterprises is very common economic policy instrument. The issue is crucial topic also in Lisbon process started in 2000. At the same time, thereby it is easy to evoke competition distortions. This contradiction is reflected also in the State aid regulation in the EEC Treaty (Article 87). From one side, the State aid is declared to be in contrary with common market in general, from other side, there has been established a large number of exemptions. This regulation has been established as well in Estonian law though the EEC Treaty, the more after Estonia became the Member State of the EU.

European rules about State aid are included in new Estonian Competition Act (Ch VI). From 2004, Estonian law often indicates to the EEC Treaty. State aid is allowed only on the base of written permit from the European Commission, excluding area covered by block exemption. In this case, there has to be submitted required information to the European Commission, which improves appropriateness of State aid with group exemption. Under the State aid is recognized also the aid given by local municipalities and also by public and legal persons in private rights if they are public enterprises (§ 31) and have the following attributes:

- using the public resources or
- are under the public control.

In the EU practice, from 1990ties, is the ongoing process from sectoral subsidies of structural policy to horizontal State aid, which is supporting economic growth and competition. Also the Supreme Councils of Lisbon and Stockholm established the general task to reduce the State aid.[28]

On the base of this development we may evaluate the entrepreneurship support in Estonia. Most of the sectoral endowments were eliminated (for example for articles of food) already in the first years of transition. In some areas (housing economy) there has been shift from producer subsidies to consumer support. The subsidies have retained for public transport and agriculture. Recent fluctuations in years before joining the EU are mainly refer with compensation of natural disasters, subsidies of investment and tax allowance.

At the same time, in Estonia was established the support system for entrepreneurship orientated to economic growth and competition. This system consists of several state and private institutions.[29] In 1999, the Government started the reorganization of support system for entrepreneurship in order to increase its effectiveness. For nowadays most of former institutions are combined in two foundations in the jurisdiction of the Ministry of Economic Affairs and Communications:[30]

- Enterprise Estonia (*Ettevõtluse Arendamise Sihtasutus*) and
- Estonian Credit and Export Guarantee Fund, KredEx (*Krediidi ja Ekspordi Garanteerimise Sihtasutus*).

[28] The areas which are consider as perspective are :
- Support for SMEs;
- Regional aid for better use in development preconditions;
- Support for research and development activities.

Exemptions exist in agriculture and transport and temporarily in ship construction and mining industry (first of all in social reasons). Here the special conditions in use are also valid for Estonia. Accordingly to European Commission data the State aid in the EU has been reduced from 67 billion euro in 1997 to 49 billion in 2002. In 2002 73% of the aid was directed to horizontal objectives, in some states even 100%.

[29] The first support institution by state was the Estonian Innovation Fund, which was established already in 1991. The private institutions were established with foreign capital, for offering the venture capital, for example Baltic American Entrepreneurship Fund established in 1995 or Baltic Small Capital Fund established in 1997.

[30] In the counties the partners for the two institutions there are Entrepreneurship Centers, combination like this forms the support system for entrepreneurship. Separately is acting the Foundation for Rural Development.

There has been given up from loans on favorable terms because the commercial banking is developed enough and the activities are more focused on guarantees, which is the main problem for small entrepreneurship. Unfortunately, there still exist administrative barriers and because of that we cannot talk about integral and complete support system for entrepreneurship. Also, there is not still in place any state institution offering necessary venture capital.[31]

In the EU State aid regulation there is stated that the Member State has to inform the Commission about State aid given in every year. In Estonia, the Ministry of Finance is responsible for regularity of Sate aid. In the report the differentiation is made between horizontal, sectoral and regional aid and the following forms of aid are present: subsidies, tax allowances, loans on favorable terms, increasing of capital stock, tax shifting and guarantees.

Table 4. State aid in Estonia 2001 – 2006 (mln Euro).

	2003	**2004**	**2005**	**2006**	**Average 2001-2003**	**Average 2003-2006**
Agriculture	0.0	39.7	32.8	42.9	0.0	38.5
Fisheries	0.0	0.0	0.1	0.5	0.0	0.2
Horizontal objectives, of which	8.4	9.9	15.1	10.7	9.9	11.9
Export	0.8	2.0	1.6	0.9	0.5	1.5
Culture and heritage conservation	2.8	2.6	2.6	2.5	2.3	2.6
Employment	0.0	0.0	0.2	0.3		
Environment	0.1	0.1	1.0	0.4	1.0	0.5
Regional aid	1.4	3.0	2.6	2.0	3.3	2.5
Research and development	2.2	2.0	3.4	3.0	1.5	2.8
SME	1.1	0.3	3.5	0.8	1.2	1.5
Training	0.0	0.0	0.3	0.8	0.0	0.3
Particular sectors, of which	0.0	0.0	0.0	0.0	0.1	0.0
Total aid less agriculture, fisheries and transport	8.4	9.9	15.1	10.7	10.0	11.9
Total less railways	8.4	49.6	48.0	54.1	10.0	50.6

Source: State Aid Scoreboard.

In 1999, the main given forms of aid were regional aid and aid for trade. The first of them was connected first of all with income tax allowance for investments outside of Tallinn (the capital region) and Harju County (the neighbouring area to the capital city), the second of them was connected with income tax allowance for enterprises with foreign ownership. Both were in

[31] The European Commission indicates the Member States measures supporting the offer of the venture capital looking through the corresponding State aid rules ("The Action Plan: European Agenda of the Entrepreneurship Initiative", February 11, 2003).

force in 1999 as last year, because of that the statistical figure of the State aid is essentially lower from year 2000.

The share of the State aid in GDP is in Estonia stable 0.5 – 0.6 %, in the EU respectively approximately 1%. At the same time, the share of the State aid in the final consumption costs of governance sector is higher in Estonia. The main focus of the State aid has been the transport sector and agriculture (Table 4). The rest of the State aid from its direction may consider as out of danger from the point of view of competition policy.

3. Estonia's International Position in Institutional Competition

3.1 Institutional Competition

Institutional competition is characterized by competition between places, cities, municipalities or countries. These spatial units compete with each other for the mobile production factors in factor markets, i.e. for mobile capital, mobile technical know-how, and mobile highly qualified labor. Spatial units compete with their taxes, their infrastructure, and all of their institutional set-ups. Mobile capital can leave a country when conditions there become unfavorable, e.g. when taxes are increased. Taxation drives capital out of a jurisdiction, whereas infrastructure attracts capital. Obviously, there exists a trade-off between these two effects. In addition to tax competition and competition in providing public goods (so-called infrastructure competition), there is also competition among jurisdictions relative to institutional rules such as product standards, licensing procedures or other legal regulations. (Siebert, 2000: 1) The "exodus" of capital and the migration of people as well as the "voice"-processes of immobile factors living under unfavorable institutions as defined by Hirschman (Hirschman, 1970) restrict politicians in the maintenance or introduction of institutions, and form an incentive for institutional change. Politicians may react through institutional innovations or institutional imitations. Thereby institutional competition has one more effect. It's not only a possibility to restrict the actions of politicians working as a control procedure, but it is also a "discovery procedure" (Hayek, 1969) for new institutions. The important point here is that politicians and societies have the possibility of institutional learning in comparing problematic institutions with better-functioning institutions abroad. (Seliger 1999).

The success of the Estonian transition process can be illustrated through four examples that can be empirically operationalized to compare different countries. The criteria in question are:

1. human development – measured by the UN HDI (United Nations' Human Development Index),
2. economic competitiveness – which is operationalized through the WEF (World Economic Forum) indices on the base of Global Competitiveness Report,
3. economic freedom – measured by the Heritage Foundation economic freedom rankings and World Bank Group rankings on ease of doing business,
4. innovativeness – measured by the European Innovation Scoreboard.

3.2. Human Development

The Human Development Index (HDI) is compiled by the UN annually, and is based on three components. Two of them – health and education – reflect the most important aspects of human capital. Health is measured by the average life expectancy at birth, and the level of education is represented as a combination of literacy and enrolment in school. The third component of human development is economic prosperity, expressed by gross domestic product per capita (in USD, purchasing power parity).

In the Human Development Report for 2003, there is offered a qualitative model to understand the concrete connection between human capital and economic development. Precisely, mutual impact of these two phenomena may have seen through different filter or also catalyst. As drag or booster are acting in both directions formal and informal private and public institutions which guide human behavior. In some countries, therefore appears relatively concordant process between human development and economic growth, but in other countries, the one or another development pillar is going to be drag. Economic growth impact to human capital is also designed by private and public decisions (policy) in distribution of investments. Those also may be relatively promoting or retarding concerning human and social capital.

Estonia has in recent, year 2005, data engaged with 86 % of maximum level of human capital in the world 44th position, locating just between its Baltic neighbours, but lagging behind noticeably from the best transition country Slovenia.[32] At that, the Estonian human development index has been increasing, but the position has been dropped (it was 40th in year 2004).

[32] The leaders in the last years have still being Norway, Iceland and Australia. http://hdr.undp.org/en/statistics/

For the future, however, the difference in ranking for economic and human development is more interesting. Even if between those two phenomena have positive connection on the base of both as endogenous economic theory (Lucas) as well empirical analysis, it is not strictly functional (determinate) in any case. We cannot consider the positive impact of human capital as automatic. This is also confirmed by the UN report where is differentiated the gap between countries positions' in terms of human development and economic development.[33] Income level lags behind from quality of human capital in majority of transition countries, at that, mostly just in countries with reform suppression, where transition process has dragged on or practically has not started yet. In Cuba, what has the 51st position in terms of human development and the 94th in terms of income level, this gap is all together 43 positions, in Albania 30. In contrast to these countries are South-African Republic and Saudi Arabia, where income level exceeds significantly the human development (accordingly 65 and 19 positions). Concerning the last two, the reasons are evidently in natural resources primarily. Also, in the case of Russia the last factor dominates, guaranteeing for the country 9 positions better result in economic development compare to human development.

Table 5. The dynamics of human development index in Estonia and Germany in 1980-2005.

	1980	**1985**	**1990**	**1995**	**2000**	**2005**
Germany	0.86	0.87	0.89	0.91	0.93	0.94
Estonia	0.81	0.82	0.81	0.79	0.83	0.86

Source*:* Human Development Report 2007

Before said is affirmed by turning point in dynamics of human development in the middle of 1990ties, what did not appear in developed countries like Germany. This phenomenon is clearly caused by the institutional rearrangements. The particular dynamics in Estonia is characterized in table 5.

First of all has declined the income level. The quality of human capital, however, is more steady variable and it was not so much influenced by transition processes. Therefore was possible to be grounded on it as the certain reserve (capability) after the rearrangement of economic system and achieve relatively faster economic and as well human development general growth compare to other countries. Estonia's backwardness from the developed EU countries has diminished, because HDI increment has been 2-3 times quicker. Still in 2002, the human development estimation exceeded economic development indicator even by 10 position points in Estonia. By now, this reserve has been realized – both indicators have the

[33] http://hdrstats.undp.org/indicators/9.html

same position in 2005. Hereby, there has to aim towards balanced economic and human development in the Estonian future development process, what itself depends on suitable institutional environment primarily.

3.3. Competitiveness

The concept of competitiveness has been widely discussed in the literature. Although no real consensus has been found, a common understanding is being achieved (Trabold 1995). The concept of competitiveness denotes economic performance (ability to earn), which depends on two things: on the ability to assert oneself on the world market (ability to sell) and on the ability to attract mobile factors of production.

A second dimension of competitiveness is related to the subjects of that competition. Both companies and governments act as competitors. At a microeconomic level, individual companies compete – mainly as providers in goods markets. At a macroeconomic level, there is competition between governments and jurisdictions in mobile factors of production, in which two factors are of prime importance: institutions and infrastructure. In this context there is much talk of local competition between different industrial sites.

These general assumptions are also the basis for empirical research. For example, in its WCY (World Competitiveness Yearbook), the IMD subdivides competitiveness into four sections. Each of these sections includes four individual indicators: macroeconomic performance (83 indicators), government efficiency (77 indicators), infrastructure (94 indicators) and company efficiency (68 indicators). It can be said that Estonia gets – compared to other countries – distinctly higher rates for its competitiveness than for its human development. Estonia has maintained the best position among the new EU countries, which certainly offers good opportunities for mastering the convergence process and explains the astonishingly high growth rates – seen from the position of human capital. This might in particular be owed to the positive impact of the sound economic policy Estonian governments have pursued so far. One weak point is infrastructure, which undoubtedly has to be improved. The health system is considered to be especially critical.

The World Economic Forum (WEF) may consider as the leader in measurement of competitiveness, what issues *Global Competitiveness Report* (GCR) every year.[34] The last one includes two aggregated indexes. The first one is business index constructed by M.

[34] http://www.gcr.weforum.org/

Porter (*Business Competitiveness Index),* what estimates as complexity of company operations and strategy as well quality of business environment.

Estonia has the 35th position amongst 131 countries in terms of business development and the 26th position in terms of business environment in 2007-2008. Therefore the institutional potential is here higher than it has been realized in business so far. If the business environment is the best amongst the transition countries, then the quality of business administration comes off from Czech.

The second aggregated index was termed Growth Competitiveness Index until 2005. From year 2006, this index is substituted by Global Competitiveness Index (GCI) constructed by Xavier Sala-i-Martini. The GCI differentiates development factors on three development level:

- based on resources (basic factors) (indicators 1-4),
- based on effectiveness (indicators 5-10),
- based on innovation (indicators 11-12).

In case of every country the larger importance receive these factors in the general indicator, which correspond to the particular development level of the country. The truth is, that the development level is determined in relatively primitive way – accordingly to achieved income level. Estonia is placed between the second and the third development level in this context.
On the bases of GCI has Estonia the greatest development potential amongst transition countries.[35] The Estonia's position has been relatively stable (27th) during last years (2007-2008), whereby the shifts in the table have taken place because accrual of new countries. In terms of the basic factors of development has Estonia the 29th position, in terms of macro economic environment even the 14th. The best is estimation on effectiveness factors (altogether the 27th), especially technological maturity (the 19th). Evidently we have to reconcile with the poor estimate of market size (the 91st position). However, reason to be concerned is the especially critical estimation in terms of business development (complexity) (the 44th). First of all, there has been considered low development levels of business networks, cooperation connections and clusters in Estonia. Altogether get the Estonian innovation based development factors the 35th position, what does not show essential development potential. Rather vice versa. Therefore has to be paid special attention to the dynamic component of competitiveness, what is related with innovation first of all.

[35] USA, Switzerland and Denmark are leading.

3.4. Economic Freedom

In the literature, economic freedom is considered to be the best indicator for measuring the institutional quality of a national economy and that is in turn the second pillar of a modern growth theory, apart from human capital. Some institutional economists even claim that the traditional (production-theory based) growth theory could be deceptive for economic policy (Holcombe 2001, 629). Failure in development aid supports this point.

The core of economic freedom is that the right of disposition is guaranteed (this is mostly protected by the state). This hints at some of the problems in connection with the measuring of economic freedom. The role of the state must be examined in detail. A minimized state system should not be aimed at by any means. To guarantee the right of disposal, a strong state is necessary. But where the state tries to interfere with private initiative, individual freedom is often obstructed, and this is not acceptable (cf. also Voigt, 164-165).

A lot of empirical research has been done that proves the positive impact of economic freedom on economic development, both statistically, in terms of economic performance, and dynamically, in terms of economic growth – in spite of the short history of measuring economic freedom[36]. In as late as the 1980s, the Canadian Fraser Institute (FI) began doing such work, and published its first comparative analysis in 1996 (retrospectively, back to 1975). The Heritage Foundation (HF) has published its annual reports since 1995.

It must be emphasized that the freedom rankings almost exclusively examine institutions and policy, but not the ability to earn that which has already been achieved. In this respect they reflect a country’s developmental potential better than general data on competitiveness, which describes a mixture of potentials and achievements.

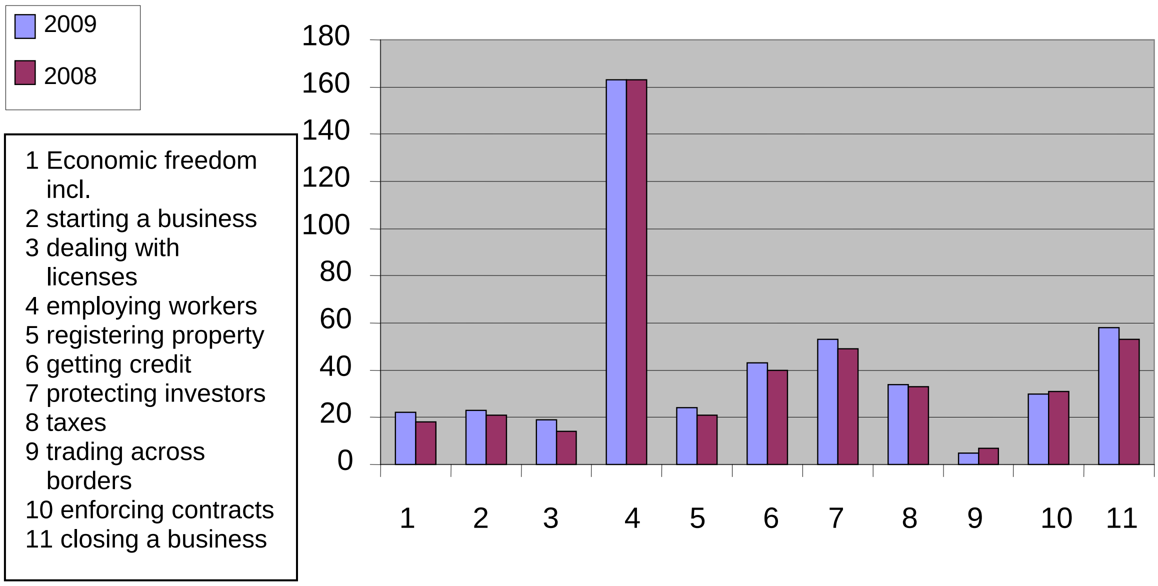
The Estonia's position is excellent in the HF estimation. In 2008, the Estonia's position in the world was the 12th and in Europe the 5th position. Leading countries in this respect were Singapore and Hong Kong in the world, and Ireland and Switzerland in Europe. For Estonia, openness in foreign trade has always been a motor for economic growth, in both the goods markets and the finance markets. This guaranteed the highest level of foreign direct investments among the transition countries. Fiscal policy is considered to have taken a very

[36] Previously, researchers had tried to operationalize the framework for economy indirectly through research on democracy. However, the results have shown that the connection between democracy and economic performance is not unambiguous. The reason may lie in the dilution of the rights of disposal of individual persons through democratic-populist majority decisions. The European welfare states (including Germany) are a good example of this. There are, however, some Asian countries that prove that an economy can prosper without having a lot of political freedom.

favorable development. There is a well-founded hope that this position will continue with the introduction of the Euro.

For Estonia somewhat problematic sphere has been and still is spread of shadow economy, what indicates weaknesses of the official economic environment. In 2007, there was added freedom of labor market to the analysis, what is also critical sphere for Estonia. Therefore we focus more detail on World Bank Group economic freedom analysis on the basis of doing business.[37]

Figure 2. Factors of economic freedom in Estonia (rankings).



Source: *Doing Business* 2008-2009.

In the data of year 2008, Estonia has the 18th place in terms of economic freedom, a year later the 22nd place. Leading countries here are Singapore, New-Zealand and USA before Hong Kong and Denmark. Figure 2 gives the overview about Estonia's ranking by the components. Expectedly receives Estonia's labor market regulation the poorest ranking (the 163rd place). In the international comparison the Estonian rules are less favorable in terms of business activity in all aspects of employment – as in hiring, determining working time, as well in firing. Also, additional costs in the form of social costs (33% of gross salary) and the firing costs (35 weeks of salary) are one of the highest in Estonia. Hopefully, the started labor market reform removes the obstacles in entrepreneurship and the drag from the whole economy. Excellent example here is Denmark, what has achieved a high 10th place.[38]

[37] http://www.doingbusiness.org/
[38] *Doing Business* 2008-2009.

3.5. Innovativeness in Estonia

Estonia has been a member of the EU since 1 May 2004, and is now continuing its development in a larger economic area.[39] In this context, the goals and framework set out by the EU have to be considered. The EU launched a comprehensive initiative (the so-called Lisbon process) in the year 2000 to improve its own position in competition with the USA and Japan. The basic idea was for the EU to assert itself through a knowledge-based and innovative economy. That applies to Estonia, whose potential to grow on the basis of capital and resources are slowly becoming exhausted. The analysis done up to now shows that an excellent business environment has been created in Estonia after the changes. This has led to the largest amount of private investments in the EU (25% of GDP in 2003), which went hand in hand with the spread of new ICTs (information and communication technologies). Nevertheless, the physical and social infrastructure has fallen somewhat behind (e.g. the health system). In such a situation, it cannot be easy to find new ways to develop the country, while at the same time maintaining success. Nevertheless, some thought should be given to this problem.

The European Innovation Scoreboard measures countries' innovativeness in five dimensions.[40] The first three – the innovation 'engines', knowledge creation and business innovativeness – are associated with inputs of the state innovation system. The first one estimates structural assumptions of innovation, primarily education system, the second one measures primarily the financing of science and development activity and the third one the compliance of business for innovations. The two last dimensions – the appliance and intellectual property – characterize outputs of innovation system. The first of them evaluates the structure of production and export, but the second one, through the creation of intellectual property (primarily patents). The results are presented in the all dimensions in the scale from 0 to 1. Besides the level of innovation, there is explained its dynamics, whereby appears general tendency of convergence – the countries with lower level of innovation, so far, have faster development.

The Estonia's position in 2007 scorecard indicates both as strengths as well weaknesses. Altogether, is Estonia in the 12th place in terms of innovation amongst the 27 EU countries, but on an average growth rate even the 10th in 2003-2007. Herewith belongs Estonia

[39] In some respects, however, this economic area has been narrowed. Euro-protectionism has replaced the complete openness of foreign trade that had prevailed until accession to the EU.
[40] For more detail see http://www.proinno-europe.eu/

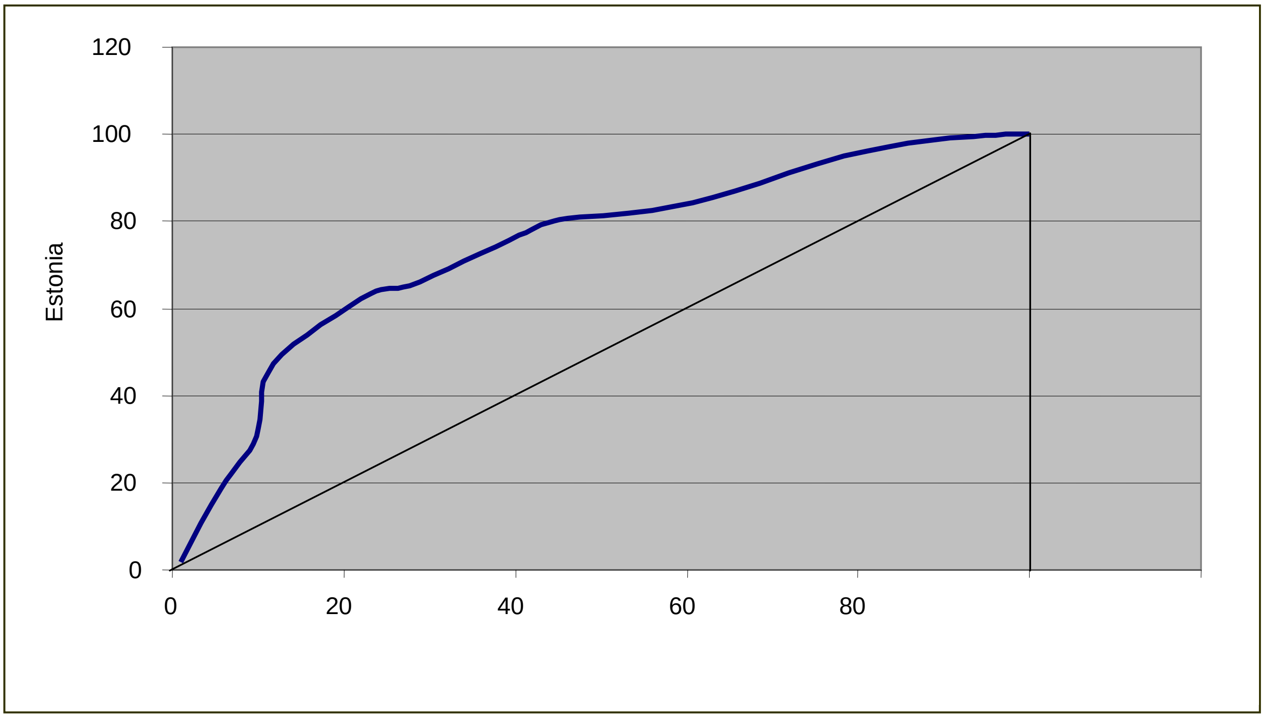
amongst moderately innovative countries, where else are only Czech Republic and Slovenia from the transition countries and Lithuania starting from year 2007.[41]

While the education system, internet distribution and small entrepreneurship innovativeness give to Estonia surprising result what exceeds the EU average (the last one even Finland), then as before there are shortcomings in the financing of science- and development activity in private sector. The most drastic is Estonian lag in terms of the share of enterprises which have received innovation support from state. While in Estonia it is 0.3 %, then on the EU average it is 9% and in Ireland even 28%. It is at least one of the drags on a way towards the efficient innovation system – there is not much high technological and in general new production, not talking about creation of new intellectual property. However, the policy analysis concerning Estonia does not stress as much lack of money, as insufficient and different understanding about the importance of innovation system as amongst the politicians as well in the public (Inno Policy, 2007).

During the last years' economic boom, in the conditions, where cost advantages have lost, this kind of trend may have seen as serious development drag. In the research done by the Faculty of Economics, University of Tartu to the Estonian Development Fund (Varblane *et al* 2008), has been stressed, that for reaching amongst world elite countries or reaching to post-industrial service economy, there has to achieve relevant structural changes just towards manufacturing industry with higher value added (see for more details Kaldaru, Sepp 2008). It seems that there is not enough large preconditions at the first place.

[41] European Innovation Scoreboard 2007.

Figure 3. Comparison of the Estonian structure of industry with the EU average (the cumulative shares of employment accordingly in 2003 and 2000).



Source: Compiled by authors.

In Figure 3, the horizontal axis characterizes the cumulative shares of industries in the EU employment averagely, whereby sectors are ordered by their productivity. On the vertical axis is the same for Estonia. There is seen obvious structural lag from the EU average, even not talking about countries with structural effectiveness. In Estonia form approximately half of employment the sectors with the lowest productivity, where in the EU works only one tenth of the employed. At the same time, sectors with higher productivity, where is captured a half of the EU employment, offer employment only for *ca* 20 per cent in Estonia. Hereby a industry and the industry makes a difference. Only strong economy with high added value industrial essence is able to uphold large sector of social services, which is characteristic for the welfare states.

Summary

After the fundamental changes in the early 1990s, and in particular after the currency reform in 1992, Estonia has pursued an economic policy that led to success in international institutional competition and rapid economic growth. In Europe, perhaps only Ireland has been more successful.

However, there is still a great need for convergence in economic performance compared to the EU average. The resource- and capital-based development Estonia has experienced until now has its limits. Estonia is not a low-tax country and will soon no longer be a low-wage country. To get to a new level of development, Estonia will need a new economic strategy. After joining the EU in 2004, this strategy had to be formulated within the European context. That means that Estonia has to assert itself within the Lisbon strategy and has to be competitive with its knowledge-based economy and society.

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