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THE INFLUENCE OF EU MEMBERSHIP ON COUNTRY'S COMPETITIVENESS – THE CASE OF ESTONIA

1. Introduction

The international country's competitiveness is one of the most interesting issues of modern economics. It can be defined and measured by many different ways and in modern literature we can find plenty of articles and books which try do describe this economic category. This article is dedicated to Estonia so it focuses mainly on macroeconomic level of international competitiveness. The main aim is to describe how the Estonia's membership in European Union has influenced its international competitive position. This position of Estonia in international economic-political space will be studied on the basis of well-known competitiveness measures, such as: Global Competitiveness Index made by WEF, World Competitiveness Index created by IMD and measures of Lisbon Strategy implementation.

Regaining independence, Estonia inherited a relatively large industrial sector from the period of central planning. Considerable structural distortions, inefficient production and underdevelopment of other sectors, especially services, were the main problems [Landesmann 2000]. Upon transition to market economy several factors, such as the loss of export market (especially Eastern markets), rapid trade liberalization, changes in macroeconomic policies and inadequate industrial restructuring caused an industrial decline. Additionally the Baltic States had to struggle with industrial crisis during mid-1990s. The radical steps were taken in the first half of 1990s. Estonia opened its economy and tried to achieve macroeconomic equilibrium. It caused the rapid development of Estonia into an investment-based economy [*The Estonian Economy...* 2003]. Privatization opened the door to the inflow of foreign investment necessary for economic growth and thereby helped to balance the deficit in the foreign trade balance.

Between 1991 and 2001 Estonia transformed itself from planned economy to market economy and its political system became democratic. During that period many important events, both economic and political, took place. The monetary reform conducted in June 1992 was a major turning point in economic reform.[1] At the same time, Estonia had suffered because of considerable level of inflation after monetary reform.[2] Then in 1992 first election to the Parliament (*Riigikogu*) and first President election took place. In 1994 Russian army retreated from Estonia. The most important reforms which improved Estonia's competitiveness were: the introduction of flat-rate personal income tax in 1994[3] and property reform which started in 1992.[4]

Free trade agreements between EU and Estonia were signed in July 1994 and came into force in 1995. On the basis of these agreements, the EU removed import duties from the beginning of 1995 and Estonia applied the tariff free regime. These agreements were later incorporated into the association agreements which were signed between the Baltic states and the EU in June 1995 and came into force in February 1998. Participation in organizations promoting trade cooperation (a free trade and association agreement with the EU, with other Baltic states, and the EFTA countries) accumulated for Estonia benefits and increased Estonia's competitive advantage. Finally in May 2004 Estonia became the member of the European Union.

In the 1990s the main sources of Estonia's competitiveness were: level of foreign investment and productivity growth [*The Estonian Economy...* 2003]. Estonian comparative advantages were related mainly to its cheap labor costs and low prices of other inputs such as electricity, wood, and metals. In part this cost-effect was achieved due to the import of these inputs from some other low-price areas (especially Russia). Undervaluation of the Estonian currency was one macroeconomic factor creating this phenomenon of cheap inputs. New investments and structural changes in the economy were the main factors leading to the competitiveness of the Estonian economy on the level of increased costs of inputs.

[1] Estonia was the first country in the former Soviet Union to introduce its own currency. Using a currency board system, the Estonian kroon was made fully convertible from the first day by pegging it to the German mark. Fixing the exchange rate to strong currency created trust in the Estonia's economy. More: ["The Estonian economic..." 2007].

[2] The inflation rate dropped from 1000% in 1992 to 89.8% in 1993 and then 29% in 1995. *Ibid.*, p. 5.

[3] There were many advantages connected with flat-tax. The tax system became simpler and easier to understand for taxpayers and tax collectors, the tax administration system worked more efficiently and tax compliance increased, state tax revenues started to increase rapidly as grey sector shrunk and the tax reform supported a rapid increase in economic activity – the number of Estonian small and medium-sized new enterprises increased from 2000 in 1992 to 70 000 in 1994. Estonia has flat 26% personal income tax and 18% VAT. In 2000 Estonian tax reform abolished corporate income tax.

[4] The reform focused on returning property that had been confiscated or nationalized by previous system to the original, legal owners. In cases in which directly returning was not possible, people received privatization vouchers.

When Estonia concluded the Europe Agreement, accession to the European Union became one of the most important goals for Estonian governments. The accession agreement between Estonia and EU fixed mutual obligations and rights. Also additional obligation were assumed in order to adopt EU supranational and directly applicable legislation and to harmonize other institutions. Then the Maastricht Treaty marked a new phase in the foundation of the union. One of the major achievements was the settlement of the objective of the Economic and Monetary Union (EMU), which was described as the continuous economic development with low inflation, low unemployment and social protection. Certain criteria and conditions for integration of state-members were proposed. Increasing economic growth and competitiveness of the European Union and its members were based on greater transparency of the economy, the improvement of the operation of the EU internal market and reduction of excessive regulation. For the effective functioning of the internal market, it was essential that the EU's four main freedoms, the free movement of people, goods, services and capital, operated without any exceptions. It was also necessary to obtain and hold a competitive position, especially for Estonia.[5]

2. WEF and IMD competitiveness indexes

The best known competitiveness overall ranking is published by World Economic Forum. The *Global Competitiveness Report* is a yearly report which has been published from 1979. The report "assesses the ability of countries to provide high levels of prosperity to their citizens. This in turn depends on how productively a country uses available resources. Therefore, the Global Competitiveness Index measures the set of institutions, policies, and factors that set the sustainable current and medium-term levels of economic prosperity" [Porter et al. 2008a].

Global Competitiveness Index (GCI) was developed for the World Economic Forum by X. Sala-i-Martin and originally was introduced in 2004. Current GCI is based on 12 pillars of competitiveness, providing a comprehensive picture of the

[5] The *acquis communautaire* is the basic literature to start research into cost and benefits of enlargement and to search for sources of international competitiveness. The chapters of *acquis* were 31 for 10 countries that entered EU in 2004. Chapters of *acquis* for Estonia were: free movement of goods, free movement of persons, freedom to provide services, free movement of capital, company law, competition policy, agriculture, fisheries, transport policy, taxation, Economic and Monetary Union, statistics, social policy and employment, energy, industrial policy, small and medium-sized enterprises, science and research, education and training, telecommunication and information technologies, culture and audio-visual policy, regional policy and coordination of structural instruments, environment, consumer and health protection, cooperation in the field of justice and home affairs, customs union, external relation, Common Foreign and Security Policy, financial control, financial and budgetary provisions, institutions and other issues [Bitzenis, Andronikidis A. 2006, pp. 18-21].

competitiveness landscape in countries around the world at all stages of development.[6] The WEF continues to expand geographic coverage in the report (134 global economies in 2008). The report contains a detailed economy profile for each economy featured in the study, providing a comprehensive summary of the overall position in the rankings as well as the most prominent competitive advantages and disadvantages.

In 2004 Estonia was placed 20th in the Global Competitiveness Index (Table 1). Best results gained traditionally in the technology (FDI flows), the worst in macroeconomic environment. But the macroeconomic situation improved much and Estonia climbed from 46th place in 2002 to 30th place in 2004. These changes were caused mainly by the necessity of fulfilment of EU obligations.

Table 1. The Global Competitive Index (by WEF, 2001-2008)

	GCI ranking (score)*	Technology index rank (score)*	Public institution index rank (score)*	Macroeconomic environment index rank (score)*
2001	29	8	29	43
2002	26	14	28	46
2003	22	10	28	34
2004	20 (5.08)	15 (5.01)	26 (5.59)	30 (4.65)
2005	20 (4.94)	18 (4.62)	25 (5.51)	30 (4.73)
	GCI Overall index	Basic requirements	Efficiency enhancers	Innovation and sophistication factors
2006-2007	26 (4.82)	32 (5.28)	26 (4.69)	34 (4.03)
2007-2008	27 (4.74)	29 (5.25)	27 (4.66)	35 (4.07)

* Data available since 2004.

Source: *The Global Competitiveness Report* 2001-2002, 2002-2003, 2003-2004, 2005-2006, 2006--2007, 2007-2008. IMD, Geneva 2002, 2003, 2004, 2005, 2006, 2007, 2008.

In 2006 Estonia was classified on 26th position (among 125 countries)[7] and was placed on 30th position in the 1st pillar: Institutions, on 30th place in the 2nd pillar: Infrastructure, on 16th place in Macroeconomy, on 43rd place in the 4th pillar: Health and primary education, on 23rd place in Higher education and training, on 25th place in Market efficiency, on 16th place in Technological readiness, on 35th place in Business sophistication and on 30th place in Innovation.

[6] The report shows data grouped in 12 pillars: Institutions, Infrastructure, Macroeconomic stability, Health and primary education, Higher education and training, Goods market efficiency, Labor market efficiency, Financial market sophistication, Technological readiness, Market size, Business sophistication and innovation [Lopez-Claros et al. 2007].

[7] All data come from: [Lopez-Claros et al., pp. 214-215].

The most notable competitive advantages Estonia gained in: burden of government compliance – 9th place (1st pillar: Institution), government debt – 3rd place, interest rate spread – 17th (3rd pillar: Macroeconomy), tertiary enrolment – 16th place and quality of math and science education – 18th place (5th pillar: Higher education and training), flexibility of wage determination – 2nd place, pay and productivity – 7th place, agricultural policy cost – 13th position and extend and effect of taxation – 13th place (6th pillar: Market efficiency), laws relating to ICT – 1st place, FDI and technology transfer – 8th place, mobile telephones – 15th place, and Internet users – 16th place (7th pillar: Technology readiness). The most notable competitive disadvantages Estonia reached in: ethical behaviour of firms – 44th place, protection of minority shareholders' interests – 41st place, and reliability of police service – 38th place (1st pillar: Institution), quality of air transport infrastructure – 44th place, and overall infrastructure quality – 35th place (2nd pillar: Infrastructure), real effective exchange rate – 99th place, and national savings rate (3rd pillar" Macroeconomy), time required to start a business – 54th place, hiring and firing practices – 48th place (6th pillar: Market efficiency), nature of competitive advantage – 61st place, and control of international distribution – 56th place (8th pillar: Business sophistication), availability of scientists and engineers – 50th place, and capacity of innovation – 39th place (9th pillar: Innovation).

In 2008 WEF classified Estonia on 27th position (the final score was lower than in the previous year). In the 1st pillar – Institution, Estonia took 34th place (out of 131)[8], in Infrastructure – 36th, in Macroeconomic stability – 14th, in Higher and primary education – 30th, in Higher education and training – 23rd, in Goods market efficiency – 27th, in Labour market efficiency – 26th, in Financial market sophistication – 31st, in Technological readiness – 19th, in Market size – 91st, in Business sophistication – 44th, and in Innovation – 31st. The most notable competitive advantages were: in 1st pillar: property rights – 26th place, burden of government regulation – 10th place, in 2nd pillar: quality of port infrastructure – 26th place, in 3rd pillar: government debt – 4th place, and interest rate spread – 12th place, in 5th pillar: internet access in schools – 6th place and tertiary enrolment – 18th place, in 6th pillar: business impact of rules on FDI – 7th place, extent and effect of taxation – 12th place, in 7th pillar: flexibility of wage determination – 2nd place, and pay and productivity – 8th place, in 8th pillar: restriction on capital flows – 17th place, and ease of access to loans – 18th place, in 9th pillar: laws referring to ICT – 2nd place, mobile telephone subscribers – 9th place, and FDI and technology transfer – 10th place. The most notably competitive disadvantages were: ethical behaviour of firms – 45th place, favouritism in decisions of government officials – 44th place, and reliability of police services – 44th place (1st pillar), available seat kilometers – 109th place and quality of roads – 55th place (2nd pillar), inflation – 65th place,

[8] All data come from: [Porter et al. 2008b, pp. 172-173].

and national savings rate – 58th rate (3rd pillar), quality of the educational system – 35th place (5th pillar), total tax rate – 77th place and time required to start a business – 70th place (6th pillar), non-wage labour cost – 115th place, rigidity of employment – 110th place, and firing cost – 60th place (7th pillar), legal rights index – 69th place (8th pillar), domestic market size – 96th place and foreign market size – 78th place (10th pillar), state of cluster development -72nd place, control of international distribution – 65th place (11th pillar), availability of scientists and engineers – 68th place (12th pillar).

The IMD *World Competitiveness Yearbook* (WCY) is another world's most renowned and comprehensive annual report on the competitiveness of nations, ranking and analyzing how a nation's environment creates and sustains the competitiveness of enterprises. It means that IMD assumes that wealth creation takes place primarily at enterprise level (whether private or state owned). However, enterprises operate in a national environment which enhances or hinders their ability to compete domestically or internationally. The methodology of the WCY thus divides the national environment into four main factors: Economic performance, Government efficiency, Business efficiency and Infrastructure. In turn, each of these factors is divided into 5 sub-factors which highlight every facet of the areas analyzed (altogether, the WCY features 20 such sub-factors). According to IMD the year 2006 was the best year for Estonia's competitiveness. It was classified on 19th position. Especially economic performance and business efficiency improved in comparison to the previous years (Table 2).

Table 2. Estonia – overall ranking and competitiveness factors (by IMD, 2003-2008)

Year	Overall ranking	Economic performance	Government efficiency	Business efficiency	Infrastructure
2003	22	19	11	23	30
2004	25	27	15	26	29
2005	24	15	13	26	33
2006	19	11	11	21	31
2007	22	9	13	24	31
2008	23	23	10	27	26

Source: [*World Competitiveness* ... 2006, 2008].

The biggest improvements of Estonian competitiveness, highlighted in 2006,[9] were: direct investment flows both inward and abroad, value traded on stock market, stock market capitalization, export of goods and commercial service and corporate tax rate on profit. Among strengths describing economic performance were: direct investment flow inward, real GDP growth *per capita*, real GDP growth, tourism receipts and terms of trade index. The biggest weaknesses were:

[9]All data come from: [*World Competitiveness*... 2006].

export of goods and commercial services, direct investment stock inward and abroad, and current account balance. Sub-factor Domestic economy was ranked on 6th position, International trade on 5th position, International investment on 7th position, Employment on 34th and Prices on 37th position. Sub-factors of Government efficiency obtained following positions: Public finance – 7th, Fiscal policy – 22nd, Institutional framework – 10th, Business legislation – 13th and Societal framework – 20th. The biggest strengths, according to this report, were: exchange rate policy, real short-term interest rate, investment incentives and real personal taxes. Among biggest weaknesses there were: immigration laws, social cohesion, employer's social security contribution rate, total reserves and country credit rating. Sub-factors of Business efficiency were placed as follows: Productivity and efficiency – 13th place, Labour market – 36th place, Finance – 30th place, Management practices – 32nd place, and attitudes and values – 23rd place. Among strengths were listed: female labour force, remuneration of management, banking regulation, entrepreneurship of managers and banking and financial services. The biggest weaknesses were: skilled labour, unit labour cost in the manufacturing sector, finance skills, banking sector assets and social responsibility of business leaders. In the last group of factors (Infrastructure) Basic infrastructure was listed on 30th place, Technological infrastructure on 28th place, Scientific infrastructure on 43rd place, Health and environment on 50th place, and Education on 21st place. Among strengths were: pupil-teacher ratio, water transportation, total public expenditure on education and communications technology. Among weaknesses were: qualified engineers, computers in use, health problems, energy intensity and high-tech exports.

3. Lisbon Strategy

In March 2000, Europe's heads of state and government met in Lisbon and declared their intention to make the European Union "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" [*The Lisbon Review*... 2004, p. 1]. To achieve this goal by 2010, they adopted the Lisbon Strategy of economic and structural reforms. The studies of implementation of Lisbon Strategy are carried out by the Global Competitiveness Programme of the World Economic Forum. The Lisbon Strategy can be usefully broken down into eight distinct dimensions, considered to be critical for national competitiveness: creating an information society for all, developing a European area for innovation research and development, liberalization (competing the single market and state aid and competition policy), building network industries (in telecommunications and in utilities and transformation), creating efficient and integrated financial services, improving the enterprise environment (for business starts-ups and in the regulatory framework), increasing social inclusion (returning people to the workforce, upgrading skills and modernizing social protection) and enhancing sustainable development. In 2004 Estonia was ranked first among accession countries by the Lisbon criteria. Among Estonia's specific strengths were the quality of its enterprise environment, and the level of sophistication of information society elements present in the economy (in both areas Estonia's scores were above the EU average). Estonia's financial services were treated as modern enough to allow a score close to the EU average. Estonia was the weakest in social inclusion (score 4.20 while EU average was 4.81) and sustainable development (Estonia scored 4.44, while EU average was 5.16).

Table 3. Lisbon Strategy – ranking and scores in 2004 and 2008

Item	2004		2008	
	rank*	score	rank	score
Final index	1	4.64	12	5.02
Information society	1	4.92	4	5.56
Innovation and R&D	3	3.82	12	4.06
Liberalization	2	4.40	12	4.99
Network industries	3	4.98	14	5.26
Financial services	1	5.43	12	5.69
Enterprise environment	1	4.90	–4	5.34
Social inclusion	5	4.20	13	4.83
Sustainable development	4	4.44	–8	4.44

* Ranking and scores of potential accession countries.

Source: [*The Lisbon Review*... 2004, 2008].

While Estonia was becoming a member of the European Union, the EU itself was preparing for implementation of the Lisbon goals. Estonia emphasized the central role of the member states in implementing the strategy and hoped that the EU enlargement would give the Lisbon process a new positive impulse. The Lisbon process has played an important part in the formation of Estonia's economic, social and environmental policy and evaluating of its scores describing the changes in Estonia competitive position among European countries. Again in 2008 Estonia was the highest-placed accession country, right behind Ireland at 12th place. It was the leader in such dimensions as information society and enterprise environment. The biggest progress was made in sustainable development, because in 2008 Estonia took 8th place within EU-27. Ensuring sustainable development is a long-term Lisbon goal. It takes account of the extent to which countries ensure that improvements in the quality of life for the present generation proceed steadily and do not come at the expense of future generations. Four priorities are: climate change, transport, public health and natural resources. Estonia understands that achieving the ambitious Lisbon economic goals cannot result in environmental degradation. A modern economic policy should include environmental considerations; environmentally friendly technologies should be further developed and more widely used.

4. Conclusions

Comparison of IMD and WEF results and competitiveness factors shows us similar strengths and weaknesses of Estonian economy. Also analysis of Lisbon process verifies these factors. The above analysis shows that Estonia offers one of the most liberated economies not only in Eastern Europe but in the whole Europe. Estonia's present "model of economic development is more close to the liberal free market model of capitalism than European social-democratic model of welfare state" [Raig 2007, p. 165]. Estonian economic policies such as trade policy, taxation policy and agriculture policy are very competitive. Therefore the deeper integration can eliminate such factors of Estonia's competitive advantages as: relatively cheap and in some fields highly professional labour force, free trade agreement with Ukraine and some other countries, low taxes, etc. In literature we can find many opinions emphasizing disadvantages connected with EU membership [Tupy 2003; Vahtra 2006]. Authors suggest that "the combined effects of market access and economic liberalization, not EU membership, optimize economic growth and increase international competitiveness" [Tupy 2003, p. 1]. But it has to be emphasized that Estonia after the collapse of communism has searched for a quick and certain way to prosperity and EU accession seemed like the only rational step forward. The quick improvement in carrying out political and economic reforms was the main reason for inviting Estonia to begin the accession negotiations with EU. The macroeconomic and political stability and reliability of future reforms, guaranteed by EU membership, increased international confidence and significance of Estonia as international partner. Good geopolitical situation, closeness to big markets, cost-effective labour and economic growth contributed to the promotion of Estonia as one of the business hubs in the region (Estonia has not got practically any import-export tariffs, its budget balance is guaranteed by law and carries small national debt, foreign direct investments *per capita* are very high, privatization is almost complete). The reforms which had been initiated in early 1990s were strengthened by the membership efforts. But it has to be emphasized that the backgrounds of present Estonian competitiveness were created in first years after gaining independence. Privatization, liberalization and realization of high-technology importance in the modern and competitive environment were crucial for current Estonian competitive position – an Estonia's miracle. Nowadays the economic crisis (which hit the world economy last year) verifies the durability and permanence of Estonian miracle. It touches backgrounds of economies and verifies confidence in market institutions. It is real test, especially for such young economies as Estonia.

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