

BTI 2014 | Estonia Country Report

Status Index	1-10	9.42	# 3 of 129	
Political Transformation	1-10	9.70	# 2 of 129	➔
Economic Transformation	1-10	9.14	# 3 of 129	➔
Management Index	1-10	7.26	# 4 of 129	
	scale	score	rank	trend

This report is part of the Bertelsmann Stiftung's Transformation Index (BTI) 2014. It covers the period from 31 January 2011 to 31 January 2013. The BTI assesses the transformation toward democracy and a market economy as well as the quality of political management in 129 countries. More on the BTI at <http://www.bti-project.org>.

Please cite as follows: Bertelsmann Stiftung, BTI 2014 – Estonia Country Report. Gütersloh: Bertelsmann Stiftung, 2014.

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Key Indicators

Population	M	1.3	HDI	0.846	GDP p.c.	\$	23064.8
Pop. growth ¹	% p.a.	0.0	HDI rank of 187	33	Gini Index		36.0
Life expectancy	years	76.1	UN Education Index	0.919	Poverty ³	%	1.5
Urban population	%	69.6	Gender inequality ²	0.158	Aid per capita	\$	-

Sources: The World Bank, World Development Indicators 2013 | UNDP, Human Development Report 2013. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$2 a day.

Executive Summary

Estonia has made an overall impressive recovery from the sharp economic downturn in 2009/2010. The recovery has been aided by innovative and highly efficient public and private sectors. The country has retained its attractiveness to foreign investors thanks to its openness, streamlined government, strong rule of law and business-friendly economic environment. Economic output has increased since 2010 and government's financial position remains favorable thanks to the lowest public debt levels in the European Union. Yet the country also faces socio-economic challenges such as continuously high levels of unemployment and volatile inflation. There are further economic risks associated with the small size of the country as well as its openness. These factors make it highly dependent on export markets and inflow of foreign investment, and, in turn, on the vitality of the European and global economy. Prospective economic stagnation in the European Union crisis remains a key risk factor.

The country has recently enjoyed an unprecedented run of political stability, with the incumbent center-right government returned after the parliamentary elections of 6 March 2011, despite having implemented a radical austerity program during a recession. The Reform Party and the Union of Pro Patria and Res Publica form a coalition under the leadership of Andrus Ansip, who has been in office since 2005, making him the second longest serving prime minister in Europe. The party system consolidated further with only four political parties (the Centre Party and the Social Democrats, in addition to the two governing parties) represented in the parliament in 2011.

In 2012 there were ever clearer signs that civil society was becoming more active in the political sphere, with national strikes staged by trade unions and public intellectuals launching a highly popular drive for democratic reforms. However an increase in volume does not necessarily mean that civil society has become more influential or effective, especially as overall levels of civic participation remain low. Furthermore, the activation of civil society can be traced back to troubling developments – an increased perception of political corruption and party financing scandals on one hand, and the lack of government responsiveness to public opinion and popular

grievances on the other. Both have the potential to weaken the legitimacy of the political system unless the expectation of democratic reforms is fulfilled. There is also the issue of inter-ethnic relations which have not significantly improved over the last decade. The ethnic cleavage is not fully politicized as the multi-ethnic Centre Party functions as the political representative of the largest minority. It responded negatively to recent education reforms which substantially increase the use of the Estonian language in Russian-language schools.

History and Characteristics of Transformation

The beginning of the Estonian transition process can be traced back to reforms initiated by Soviet Union president Mikhail Gorbachev in mid-1980s. Increased openness led to some economic and political reforms and by 1988 the country enjoyed a reasonably free public sphere with a number of different political organizations competing for public support. These included the first anti-communist party, which was formally established in 1988. The main political divide at the time ran between the Estonian Communist Party and various pro-independence forces. However, early on in the independence process, a significant divide opened up between radical pro-independence forces and more moderate popular movements (such as the Popular Front). The moderates dominated the last Estonian Supreme Soviet, elected in free elections in 1990 and the radicals the Congress of Estonia, a representative body of inter-war citizens and their descendants. The divide between the two pro-independence political streams is still readily apparent in Estonian party politics, especially as the Communist Party has essentially disappeared from the political sphere. One area of contention was the status of the Russian-speaking population, most of whom had migrated to Estonia during the Soviet period and enjoyed a privileged status in comparison to ethnic Estonians. Although both moderates and radicals shared suspicions about the settlers' loyalty, the former were keener to reach out and integrate the Russian-speakers. However, it was the policies of the radicals which dominated in the wake of independence.

The establishment of independence in 1991 was firmly grounded in restorationist ideas and the principle of legal continuity with the inter-war republic was often invoked. Citizenship in the restored state was only granted automatically to citizens of the inter-war republic and their descendants. A significant portion of the population – primarily Russian-speakers who had moved to Estonia during the Soviet period – had to undergo a process of naturalization. Many chose to become citizens of the Russian Federation instead (which was open to all former citizens of the Soviet Union) or remained stateless (a special “alien” status was created by the Estonian parliament). Even though the proportion of Estonian citizens has increased over time, 8% of population were citizens of a foreign country (predominantly of the Russian Federation) and 6.5% stateless at the time of the 2011 census.

It was partly this limited franchise which prevented the ethnic divide from developing into a major political cleavage. With few supporters of the old regime among the population, governments managed to push through radical economic reforms and a completely re-orientate the country in

terms of both its foreign relations and trade patterns. From early 1990s on, Estonia steadfastly pursued the path to membership in NATO and the European Union (EU). The accession process had widespread support from the elite, which was intent on conforming to the membership criteria. However euroskepticism among the population at large was relatively high compared to most other new member states in Central and Eastern Europe – mostly among some hard-line nationalists who rejected the idea of shared sovereignty as well as many Russian-speakers uncomfortable with the idea of turning away from Russia. However, since the membership referendum in 2003, public opinion has become increasingly positive about the country's membership in the EU.

Estonia has always had liberal economic policies. By 1995, the country had already established a free trade regime and undergone a radical privatization program, which attracted foreign investors. After a sharp downturn in early 1990s, the Estonian economy grew continuously from 1995 until the 2008 recession, at an average of 7.1% per annum.

The 1990s and early 2000s saw instability in the government and party system as new parties enjoyed unprecedented success (the Reform Party in 1995; Res Publica in 2003) and the Coalition Party, a leading partner in several 1990s governments disbanded in 2000. However, government policies have been remarkably consistent and there has been recent consolidation within the party system – following the 2011 elections, only four parties remained in parliament.

The BTI combines text analysis and numerical assessments. The score for each question is provided below its respective title. The scale ranges from 1 (worst) to 10 (best).

Transformation Status

I. Political Transformation

1 | Stateness

The state has a clear monopoly on the use of force in Estonia. Currently, there are no extra-legal forces or threats to the country's territorial integrity. In the early 1990s there a modest and short-lived risk that Ida-Virumaa (the north-eastern region, mostly inhabited by Russian-speakers) could secede in favor of Russia.

Question
Score

Monopoly on the
use of force
10

The state enjoys a high degree of legitimacy among both majority and minority ethnic groups. It is very rarely questioned, even though legitimacy is generally stronger among ethnic Estonians than Russian-speakers (i.e. ethnic Russians, as well as most other ethnic groups originating in the former Soviet Union). A significant proportion of the Russian-speakers are citizens of the Russian Federation or have no citizenship (each group accounting for about 7% of the population). The latter group is predominantly composed of former citizens of the Soviet Union who did not automatically qualify for Estonian citizenship in early 1990s and have not yet undergone naturalization – mostly because they lack the necessary proficiency in Estonian.

State identity
8

Estonia is one of the most secular countries in the world, even though the Christian (Lutheran) traditions among the ethnic Estonian majority have a modest, conservative influence over culture and politics. However, its effects are at best indirect, potentially affecting some social attitudes, such as gender equality or rights of sexual minorities.

No interference of
religious dogmas
10

The state's administrative capacity has increased considerably since independence and the state fulfills all key functions, including the provision of infrastructure, education and health. The quality of services is generally good, even if some may lag behind more affluent neighboring northern European countries.

Basic
administration
10

2 | Political Participation

Elections in Estonia are generally free, fair and meaningful in the sense of determining public policies and filling political positions. The National Electoral Committee is independent and conducts elections in an impartial manner. Following the parliamentary elections of 6 March 2011, only four complaints were submitted to the Supreme Court (which resolves electoral complaints), all of which were rejected. Polling is highly accessible as periods of early voting are long and advance Internet voting has been in use since 2005, including two parliamentary elections. Internet voting is available for the vast majority of the population holding electronic ID cards (also used for other forms of online identification, such as internet banking) and in 2011 almost a quarter of votes were cast online. The electoral turnout was 63.5%. All registered political parties and independent candidates can contest national elections; ad hoc electoral lists are also allowed in local elections. All permanent residents are eligible to vote in local elections – including non-citizens. In parliamentary elections, suffrage is only granted to Estonian citizens, excluding people with foreign citizenship or none at all. During the early 1990s, Estonia's restrictive citizenship policy limited the number of eligible voters to roughly 60% of the voting-age population. However by 2011 this figure was up to 86.5% thanks to increased naturalization.

Free and fair elections

10

Access to mass media is free to all political parties, but minor parties have often complained of exclusion from main election debates on public television. Electoral campaigns have become increasingly expensive, giving an advantage to parties which benefit from state subsidies – mostly those already strongly represented in the parliament – and which are able to attract considerable private donations.

In Estonia, democratically elected power holders have a power to govern without any substantial interference from non-elected veto powers. Government policies have generally been business-friendly yet have not given obviously privileged any sector or individual business. Civil control over the military is strong and well-established. The Lutheran clergy is loyal to the government and weak in political terms, although it commands some influence over public opinion.

Effective power to govern

10

The Estonian Constitution guarantees civic groups full freedom of organization and participation. These rights are protected in practice and there have been no serious accusations of limitation of these freedoms. Registration rules for associations are non-discriminatory and clearly established in the Non-Profit Associations Act. However actual levels of civic activism are generally low and the influence of non-governmental organizations on public policy is limited.

Association / assembly rights

10

Freedom of expression is unrestricted and protected by the constitution. In 2010, government proposals for legislation which could force journalists to reveal their sources attracted substantial criticism from the media. Nonetheless the law was passed with some modifications and seems to have had little impact on the overall level of media freedom.

Freedom of
expression
10

The media – especially the popular public broadcaster – is generally unbiased and represents a wide spectrum of opinions. The Public Broadcasting Council is composed of eight members, four of whom are nominated by parliamentary political parties with another four independents selected by the parliament. Ownership of the private media is transparent. The two most popular private television channels are foreign-owned (by Sweden's Viasat and Norway's Schibsted, which also owns a major daily newspaper, Postimees). Internet-based news and entertainment portal Delfi (owned by the Estonian Ekspress Grupp, which also operates news portals in Latvia, Lithuania and Ukraine) is popular and has tested the limits of freedom of expression since its introduction of anonymous reader comments on its news stories in the early 2000s. Public trust in the press (with 53% tending to trust the press) is much higher than the European Union average (40%, according to Eurobarometer, December 2012).

3 | Rule of Law

There is a clear and effective separation of powers in Estonia with mutual checks and balances generally working well. The judicial system is independent of the executive and administration is largely free from unwarranted party political pressure. The parliamentary political system ensures that executive and legislative powers are fused, with the former dominating the latter. Of the 164 acts passed by the 2011/2012 parliament, only 27% were initiated by parliamentary committees or factions, with the majority of these concerning not substantive policy issues, but merely the creation or operation of special parliamentary committees or the nomination of political representatives to various bodies.

Separation of
powers
10

The Estonian courts are independent and free of both executive intervention and, largely, from corruption. Judges of the first and second instance are appointed for life by the president on the recommendation of the Supreme Court. Justices of the Supreme Court are appointed by the parliament based on the recommendation of the Chief Justice, who is appointed by the parliament following a recommendation from the president. The Supreme Court also fulfills the functions of a constitutional court. Requests for constitutional review can be initiated by the President or the Chancellor of Justice. The system of judicial review is well-established, and the Supreme Court regularly declares parliamentary acts unconstitutional. In 2011, the Constitutional Review Chamber ruled in favor of the defendant by declaring an act wholly or partially unconstitutional in 22 out of 41 cases. For several years judges have

Independent
judiciary
10

criticized the Ministry of Justice's financing of the courts as this practice has been seen as a potential source of executive pressure on the judiciary.

Estonia is widely considered the least corrupt country in Central and Eastern Europe. Political and administrative corruption is not widespread and effectively penalized when it occurs. Perceptions of corruption are more positive than elsewhere in Europe. According to the Eurobarometer study published in February 2011, 47% of Europeans believed that corruption had recently increased in their countries. Estonia bucked the trend with only 25% reporting an increase in perceived corruption levels in the previous three years and 24% reporting a decrease, making Estonia the most optimistic European country (the EU average was a mere 7%). Almost a third of Estonians believed that the government's efforts to combat corruption were effective, against just 22% as the EU level. Estonia was one of two EU countries where a roughly equal number of people believe that the rate of prosecution is sufficient to for deterrence of bribes, and those who believed there are too few (the other being Finland). In 2011/12, a number of high profile corruption cases were considered by the courts, particularly against local government officials, a number of whom were convicted. However in 2012, the Prosecutor General's office dropped a case against two prominent Centre Party members suspected of influence peddling in relation to 2011 European Capital of Culture contracts, following a Supreme Court decision which highlighted legal loopholes regarding influence peddling and lobbying.

Prosecution of
office abuse
9

Civil rights are guaranteed by the Estonian constitution, which bans discrimination based on nationality, race, sex, language, religion, political opinion or social status. Rights are respected by state institutions and there is effective protection of individuals. Apart from the court system, there are two national institutions whose key functions include the protection of civil rights. As well as its role in constitutional review, the Chancellor of Justice monitors the protection of fundamental rights and freedoms, performing the function of an Ombudsman. The Gender Equality and Equal Treatment Commissioner monitors compliance with regulations concerning gender equality (enshrined in the Gender Equality Act and Equal Treatment Act). Both of these institutions function well and have generally maintained independence from the government.

Civil rights
10

4 | Stability of Democratic Institutions

Estonia's democratic institutions are robust, largely adhering to procedures established by the constitution and other legislation. There is occasional friction between branches of government, but it has never resulted in substantial damage to democratic governance. Relationships between the central government and certain local governments can be tense. There is often antagonism between the government

Performance of
democratic
institutions
10

and the opposition Centre Party (led by the mayor of Tallinn), most recently prompted by the implementation of language reforms in Russian schools.

Democratic institutions are generally accepted as legitimate by all centers of political power and non-governmental associations. There have only been minor examples of significant political players questioning democratic procedures. After the 2011 parliamentary election, for example, the Centre Party filed a protest over internet voting with the Supreme Court. However, the party's opposition was short-lived and somewhat opportunistic, the party having encouraged online voting by setting up computers in campaign tents during the 2009 local elections.

Commitment to
democratic
institutions
10

5 | Political and Social Integration

Following considerable fragmentation and transformation around the 2003 parliamentary elections – when the new Res Publica party achieved unprecedented success and formed a government – the party system has been fairly stable. Following the 2011 parliamentary elections, which saw low levels of voter volatility (aggregate volatility 13%), only four political parties remained in the parliament. The party system is nonetheless relatively polarized, with the Centre Party's long-serving controversial and autocratic leader Edgar Savisaar (the Mayor of Tallinn) making it difficult for it to enter a coalition with any of the three other parties.

Party system
9

The main political parties have developed strong organizations, including efficient central offices and local branches. Party headquarters tend to dominate parliamentary groups – which are highly disciplined – and there is limited evidence of extensive intra-party democracy either in terms of policy instigation or candidate selection. Internal conflicts often have centrifugal consequences as recent examples show. In recent years the Pro Patria and Res Publica Union has suffered from persistent internal conflict among politicians from its constituent parts, which merged in 2006. The party has managed to stay together, but in 2011, prominent members of the Pro Patria faction established the non-governmental Free Patriotic Citizen organization which intends to contest 2013 local elections with its own lists. Furthermore, the Centre Party has consistently lost members over the years, frustrated with the incontestable dominance of the party leader. In 2012 five MPs and both of its MEPs (including the party leader's former wife) left the party after a former Minister of the Interior was expelled for his criticism of party leaders. Finally, the Silvergate scandal prompted by illegal party financing practices (see section Q15.3 Anti-corruption policy) exposed divisions within the Reform Party. While most of party leaders insisted there had been no wrongdoing, other prominent figures disagreed openly and called for more transparency and democracy in the party.

Even though freedom of organization is granted by the constitution, civil society has been weak. There are few active non-governmental organizations and they exert little

Interest groups
9

influence over the political process. The 2012 teachers' and doctors' strikes succeeded in securing pay and may represent a turnaround in this trend. Government has nonetheless paid little attention to trade unions and civil society groups, with cabinet ministers often stating that citizens ought to confine their participation in the democratic process to elections.

Approval of both democratic norms and democratic political institutions is generally fairly high, but still lags behind levels seen in countries with longer experience of democracy. Popular satisfaction with the workings of democracy remains below the EU average. According to a 2012 Eurobarometer survey, 38% of Estonians were satisfied with the workings of democracy in their country, against an EU average of 49%. Central and East European countries, however, only Poland and Latvia recorded higher levels of satisfaction. Trust in national institutions is similar to the EU average, or higher. Estonians tend to trust national and local governments (35% and 56% respectively), which is higher than the EU average (27% and 43%). Trust in political parties (16%) and parliament (29%) is close to the EU average. Levels of trust in political institutions are among the highest in central and eastern Europe. According to the European Social Survey (2010), trust in the legal system and police are significantly above the levels found in any other post-communist country. The military is one of the most trusted national institutions – 83% of the population tended to trust it according to a study commissioned by the Estonian Consumer Protection Board (June 2012).

Approval of
democracy
10

Public opinion surveys indicate high levels of interpersonal trust compared to other post-communist countries. According to European Social Survey (2010), 40% of Estonians reported that they trust others (7 or above on a scale from 0 to 10 where 0 stood for “You can't be too careful” and 10 for “Most people can be trusted”) that exceeded the figure for other post-communist states.

Social capital
9

According to a Eurobarometer survey on volunteering (2011), Estonians were more active in voluntary work than the EU average – 30% of Estonians (against just 24% of EU citizens) were engaged in voluntary activities on a regular or occasional basis. Estonia was among the most active countries in Central and East European countries (second only to Slovenia).

According to a study by the University of Tallinn's Centre for Civil Society Research and Development (2011/12), 31% of the Estonian population were members of civic organizations, slightly more than half of them active. However sports, recreational and cultural organizations dominate, while only 20% of all civic activities undertaken had a political character, such as contacting officials, signing petitions or campaigning for a political purpose.

While trade unions have generally not been particularly powerful, their activities increased in 2011 and 2012, when both teachers and doctors launched national strikes

demanding salary increases. Protesters also took to the streets in response to the Anti-Counterfeiting Trade Agreement (ACTA). In 2012, civil society also took to the Internet, as Charter 12 – an online movement demanding changes to party financing regulations and electoral rules – was launched on an online petition portal.

II. Economic Transformation

6 | Level of Socioeconomic Development

Estonia has reached a very high level of human development according to the United Nations' Human Development Index. It ranks 34th in the world, ahead of all other Central and East European countries except Slovenia and the Czech Republic. Income inequality as measured by the Gini index is slightly above the EU average (31.9 versus 30.7 in 2011), but has decreased in recent years. The level of absolute poverty is low but still among the highest in Central and Eastern Europe (1.5% of the population living on under \$2 a day PPP in 2004, more recent data not available). Relative poverty – measured as the proportion of the population whose income is below 60% of the national median – stood at 17.5%, close to the EU and Central East European average (2010/2011). Levels of poverty are higher among minorities than among ethnic Estonians (relative poverty is 7 percentage points higher) and in north-eastern Estonia, predominantly inhabited by Russian speakers.

Gender inequality as measured by the multi-dimensional UNDP Gender Inequality Index is similar to the of Central and East European average. While Estonia has the highest female labor force participation rate in the region, it is complemented by the widest gender pay gap in the EU (27.7% compared to the EU average of 16.2% in 2010 according to Eurostat). Enrolment levels of both girls and boys in primary and secondary education are healthy, and tertiary educational attainment is higher than the EU average (40.3% versus 34.6% amongst 30-34 year olds in 2011). Estonia has one of the highest proportions of female university students in the EU (60.9% in 2010).

Question
Score

Socioeconomic
barriers
8

Economic indicators		2009	2010	2011	2012
GDP	\$ M	19117.6	18845.7	22154.7	21854.2
GDP growth	%	-14.1	3.3	8.3	3.2
Inflation (CPI)	%	-0.1	3.0	5.0	3.9
Unemployment	%	13.8	16.9	12.5	-
Foreign direct investment	% of GDP	9.8	10.9	2.0	7.4
Export growth	%	-20.6	22.9	23.4	5.6
Import growth	%	-32.0	21.0	25.0	9.1
Current account balance	\$ M	558.7	535.0	410.6	-404.8
Public debt	% of GDP	7.2	6.7	6.1	8.5
External debt	\$ M	-	-	-	-
Total debt service	\$ M	-	-	-	-
Cash surplus or deficit	% of GDP	-1.5	-0.1	1.0	-
Tax revenue	% of GDP	17.3	16.1	16.0	-
Government consumption	% of GDP	22.1	20.9	19.5	19.6
Public expnd. on edu.	% of GDP	6.1	5.7	-	-
Public expnd. on health	% of GDP	5.3	5.0	4.7	-
R&D expenditure	% of GDP	1.43	1.62	-	-
Military expenditure	% of GDP	2.3	1.7	1.7	1.9

Sources: The World Bank, World Development Indicators 2013 | International Monetary Fund (IMF), World Economic Outlook 2013 | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database 2013.

7 | Organization of the Market and Competition

Since independence, Estonia has pursued liberal free market policies. Foreign investments are actively encouraged – first and foremost by an attractive tax regime, which exempts re-invested profits from corporate income tax. Tax revenues as a share of GDP have been below the EU average since 1997 (16% versus 19% in 2010). Market access is generally free and entry costs are low. The country has been firmly committed to the principle of balanced budgets and currency stability. The kroon, the national currency from 1992 until the adoption of the Euro in 2011, was firmly pegged to the German Mark from its inception, and later to the Euro.

Market-based
competition
10

As an EU member state, Estonia has developed a comprehensive legal framework to prevent monopolistic structures and conduct. It is one of the few European countries where agreements which restrict competition are subject to criminal proceedings. Regulations are enforced by the Estonian Competition Authority (which replaced the Competition Board in 2008). The authority has dedicated divisions working on communications (including railways and postal services), energy and water. In recent years it has carried out inspections on gas supply (in cooperation with the EU authorities), postal services, electronic communications, waste management and security services companies.

Anti-monopoly
policy
10

Estonia's foreign trade is highly liberalized and the country enjoys membership in the WTO (since 1999) and in the European Common Market (2004). The annual volume of exports and imports together represent around 90% of the country's GDP.

Liberalization of
foreign trade
10

Estonian banking laws and regulations are in line with EU directives. Estonia has implemented most EU banking and finance law regulations, including the Basel II Capital Requirements Directive. At 10%, the capital-to-assets ratio is somewhat higher than the Basel II minimum requirement (8%). The banking sector is competitive, with foreign-owned banks predominating. The market share of foreign banks has been in excess of 90% since 1998 and reached 94% in 2011 – among post-communist transition countries, only Bosnia and Herzegovina has a higher share of foreign-owned banks. The main banks are subsidiaries of Swedish (Swedbank with 46% market share and SEB 19%), Nordic regional (Nordea 14%) and Danish (Danske Bank 9%) banks.

Banking system
10

Global recession saw the previously very low rate of non-performing loans increase, although it remained the lowest in Central and Eastern Europe (5.2% in 2011). Total indebtedness of private households increased rapidly and doubled in five years between 2004 and 2009 to exceed 100% of gross disposable income in 2009, but it has since decreased (OECD).

8 | Currency and Price Stability

A small and open economy, Estonia has often faced the challenge of controlling inflation over the last two decades. Annual change in consumer prices has remained below 11% since 1997, but inflation levels have been volatile, influenced by economic cycles. Recently the country has moved from the galloping inflation of 2008 (10.4%) to deflation in 2009 (-0.1%), followed again by high levels of inflation as the economy started to recover (5.0% in 2011 and 3.9% in 2012). Since 2011, Estonia's exchange-rate policies and the role of the central bank have been determined by the country's membership of the European Monetary Union. With the adoption of the euro, the independent foreign exchange policy ceased to exist; however, even prior to this the kroon was fixed to the Euro. The 2012 appointment

Anti-inflation /
forex policy
9

of Ardo Hansson – a former World Bank economist – as the new governor of the Bank of Estonia brought renewed credibility to the institution.

Estonia stands out as a country with one of the most prudent public finance systems in the EU. It has accumulated the lowest level of public debt of all European countries, and by a considerable margin: 7.3% of GDP in November 2012, compared to 16.5% in Bulgaria (the second lowest) and an EU average of 84.9%. Estonian governments have pursued conservative fiscal policies – state budgets have usually been balanced and have often returned a surplus, (e.g. 2010 – 11 and 2006, with +2.5% of GDP). The state budget has been in deficit for some years, such as during the recession (-2.9% in 2008) and in 2012 (around -2.4%). The government has built up significant state reserves (approximately 10% of GDP), meaning it can usually cap a deficit without the need to increase public debt levels. Estonia's current account balance recently turned positive (+2.2% of GDP in 2011), but it has had a volatile history. It was well into negative territory before the recession (-15.9% of GDP in 2007) and is expected to go again into deficit in 2012/13.

Macrostability
10

9 | Private Property

Property rights are enshrined in the constitution, widely observed and effectively enforced by the courts. Expropriation follows clearly established rules and compensation is based on market values. Foreign and domestic capital is treated equally and there is no discrimination against foreign ownership.

Property rights
10

Private businesses are the backbone of the Estonian economy and the private sector dominates the economy (80% in 2010 according to estimates from the European Bank of Reconstruction and Development). A radical program of privatization was largely complete by the mid-1990s and currently only a handful of large companies are still owned by the state (the port of Tallinn, the power plants, railways, the postal system and national airlines). Private enterprise benefits from business-friendly regulations and a highly flexible labor market, with wages proving highly responsive to deteriorating economic conditions during the recession.

Private enterprise
10

10 | Welfare Regime

Health care and most pensions are funded through a 33% social tax on payroll (i.e. paid by employers). Health care is funded through a national Health Insurance Fund which also covers the cost of services to most non-working people. However, there are some issues with health service coverage as some groups are not insured (e.g., adults who neither work nor receive social benefits). Total public spending on health (4.7% of GDP) is among the lowest in the EU (ahead of Cyprus, Bulgaria, Latvia and Romania).

Social safety nets
9

The pensions system is based on three pillars: state pensions, mandatory funded pensions invested in private pension funds (voluntary for those born before 1983) and private supplementary pensions supported by tax incentives. The 2002 pension reform established the second pillar to ease the future budgetary burden of an aging population. Compulsory payments were suspended during the recession, but resumed partially in 2011 and fully in 2012.

Parental entitlements and unemployment benefits are relatively generous. The parental entitlement amounts to 100% of prior salary and is paid for up to 19 months (including pre-natal leave). Unemployment benefits are paid for up to one year with the initial replacement rate at 50% (dropping to 40% after the first 100 days). To finance the increase in payments caused by the recession, unemployment insurance tax increased to 4.2% in 2009, reduced again to 3% in 2013.

Other social benefits are significantly less generous as levels of taxation and income redistribution are low. For example, the average monthly old age pension stood at €16 in 2012, barely above the minimum wage of €90 and less than twice the official poverty threshold for single households. Unemployment benefits for those who do not (or no longer) qualify for insurance payments is around a third of the poverty threshold and paid for less than one year. The levels of family, disability and subsistence benefits are also generally low. However, the overall levels of absolute and relative poverty are average by Central and East European standards.

The Estonian Constitution guarantees equal opportunities for everyone regardless of their social status, religion or ethnicity. Male and female enrolment ratios are level in primary and secondary education while women greatly outnumber men among university students. Estonia also boasts the highest female employment levels in Central and Eastern Europe, albeit accompanied by the highest gender pay gap in the European Union.

Equal opportunity
9

The status and future of the Russian language in secondary education has been a contentious issue since independence. In 2010, the parliament ruled that all secondary schools must teach at least 60% of the curriculum in Estonian from 2011 (Russian-language primary education is still permitted). On one hand, this should increase Russian-speaking children's Estonian language proficiency and enhance their educational opportunities and career prospects. On the other, there are concerns about the right to education in the native language of a very sizable ethnic minority (according to the 2011 census, 30% of the population reported Russian as their first language).

According to the Language Act, a degree of Estonian language proficiency is required for certain public and private positions (e.g., doctors, nurses, lawyers, police officers and some transport workers). The requirements may reduce the opportunities for some Russian-speakers who lack a sufficient command of the state language, even

though the requirements can be justified from the perspective of service-provision and safety. National statistics also suggest that ethnic non-Estonians are at a greater risk of unemployment – during the recession, unemployment peaked at 23.4% among minorities and at 13.5% among ethnic Estonians.

11 | Economic Performance

In 2011/2012, the Estonian economy recovered from a deep recession that had hit the country in 2008/2009. The country recorded the fifth highest economic growth rate in the EU in 2010 (GDP growth of 3.3%) and the highest in 2011 (8.3%). More moderate GDP growth was expected in 2012 (2.5%, fourth highest in the EU) and subsequent years, but levels are still likely to be well above the sluggish average growth in the EU.

Output strength
9

Levels of inflation have been highly volatile. Since joining the EU in 2004, Estonia's level of inflation has often been among the highest in the Union. Only in response to recession did inflation drop below 4% (2009/10) while 2011/2012 saw a return to high inflation (5.1% and 4.2% respectively; second highest in the EU).

Unemployment levels increased considerably during the recession putting Estonia among the worst-affected countries in the EU (16.9% in 2009). The rate of long-term unemployment exceeded 6% in 2010 and it took longer for unemployment to subside than for the economy to resume growth. However, levels have gradually decreased and had dropped below 10% by September 2012 (less than the EU average).

12 | Sustainability

Estonia is classified as a modest performer in the Environmental Performance Index and is outperformed by all Central and East European EU member states except for Romania and Bulgaria. While it scores very highly for biodiversity and habitat protection and highly for air and water quality, its performance is less than exemplary in terms of fish stock overexploitation and, in particular, CO₂ and SO₂ emission levels per capita and kWh electricity produced. However, several recent developments indicate that the government is trying to improve the country's ecological credentials, which may lead to improved outcomes in the near future.

Environmental
policy
8

In 2011, the Ministry of Economic Affairs and Communications launched the Electric Mobility Program. The program provides electric cars for use by social workers, supports private individuals purchasing electric cars while also creating the first nationwide network of electric car-charging stations in the EU. The project was funded from the auctioning of Estonia's excess Kyoto CO₂ quota. The proceeds have also been used for the Green Investment Scheme which has recently funded the renovation of heating networks, combined generation plants and investments in wind

energy (the county aims at 25% of renewable energy sources by 2020). The government is also running a program which supports renovation of houses and public buildings to achieve energy savings between 10 and 30%. To increase environmental awareness, the Environmental Investment Centre runs a program supported by the European Regional Development Fund (“Development of Environmental Education Infrastructure” measure, which started in 2010) and the European Social Fund (“Development of environmental education” measure, still at draft stage at time of writing).

Enrolment levels and general quality of education are high. Estonia spends more on education than any other Central and Eastern European country (6.1% of GDP in 2010), exceeding the EU average of 6.1%. Even though expenditure on research and development doubled within a decade (from 0.7% in 1999 to 1.4% of GDP in 2009), it has lagged behind the EU average (2%) and some Central and East European countries (Slovenia and the Czech Republic). Estonia has a vibrant digital economy sector and is the most knowledge-intensive of the Central and East European countries. According to statistics published by the European Bank of Reconstruction and Development, around a third of total exports to other EU countries are hi-tech products and services. According to the OECD Economic Survey of Estonia 2012, however, the country also retains a comparative advantage in low and medium-low technology industries. The government has pioneered several digital initiatives in the public sector, such as electronic medical histories, internet voting and online tax returns. Estonian governments have been committed to supporting innovation and education, even though extra funding has not always been forthcoming, resulting, for example, in the teachers’ strike in 2012. The government is introducing higher education reform that would eliminate all fees for university students and aligning universities with particular academic fields. Universities will also be financed according to performance (e.g., graduation rates and research impact). It remains to be seen whether the shortfall resulting from the abolishment of fees will be fully compensated by the state, and whether students from less affluent socio-economic backgrounds will have greater access to higher education.

Education policy /
R&D
9

Transformation Management

I. Level of Difficulty

The Estonian government does not face acute structural constraints which limit governance capacity. Education levels among the population are high, extreme poverty is rare and disease levels are low. The country benefits from a fairly advantageous location – while it lies at some distance from populous West European countries, it has access to the sea and enjoys proximity to affluent Nordic countries, particularly Finland. However Estonia’s population is concentrated in a limited number of urban centers, distances between which are relatively high given the low overall population density. This presents challenges in terms of infrastructure and rural development. A radical territorial-administrative reform aimed at creating more financially viable municipalities has been debated for years but there has been very limited progress and the trend of regional decline has continued.

Structural
constraints

2

Financial problems experienced by national carrier Estonian Air have reduced the number of direct flight connections to European capitals from Tallinn; this may deter investors and so affect the country’s longer-term economic performance. Labor migration – particularly to Finland – since the country’s accession to the European Union in 2004 is also an issue. This has also created new social problems (where children are left behind by parents working abroad, for example) and may eventually lead to a decrease in human capital (“brain drain”) and an increase in the elderly dependence ratio.

While weak compared to neighboring Nordic countries, Estonian civil society is relatively strong compared to most other former communist countries and Estonia boasts the highest levels of inter-personal trust in the region. Various civil society organizations participate actively in public life. Such organizations have become more numerous and active since the mid-1990s due to the enabling effect of economic growth and policy initiatives. In 2002, the parliament approved the Estonian Civil Society Development Concept, followed by governmental action plans on civil society support. In 2008, the government established a National Foundation of Civil Society which funds a large number of projects and studies each year. The Estonian Cooperation Assembly was established in 2007 under the auspices of the president;

Civil society
traditions

2

in 2012 it initiated crowdsourcing of proposals for enhancing democracy in the aftermath of a political funding scandal.

While Estonian politics can often seem confrontational at both national and local levels, there have been very few instances where political conflict has turned violent. So too with ethnic minority protests, with the exception of the 2007 “Bronze Soldier” episode, a number of Russian-speakers rioted against government plans to relocate a controversial World War II monument from central Tallinn to a military cemetery. More recently, education reforms requiring all secondary schools to teach 60% of their curricula in Estonian from 2011 has created tension between the Centre Party and the governing coalition. The Centre Party governs Tallinn, the ethnically split capital, and represents the bulk of the country’s Russian-speaking minority, vocally defending the status quo in secondary schools. In 2012 the Estonian Security Agency accused two prominent municipal politicians of pressuring headmasters to supply Russian-only education; the politicians denied the accusations and sued the agency for defamation.

Conflict intensity

3

II. Management Performance

14 | Steering Capability

Governments have been able to set priorities and maintain them over time aided by relatively high levels of political stability. Andrus Ansip (Reform Party) is the second longest serving European prime minister, taking office in April 2005. His party has been a member of every governing coalition as a leading or minor partner since November 1995 (with the exception of the period 1997 – 99). The current government (also includes the Pro Patria and Res Publica Union) came to power in April 2009 and was re-elected in March 2011; the coalition is likely to continue until the next parliamentary election in 2015. National development strategies and plans are well-established, as are procedures for budgetary planning and impact assessment. However, some reforms have stalled for extended periods for want of political will or due to opposition. One example: the topic of administrative reform – significantly cutting the number of local authorities to make them more efficient – has been high on the political agenda for more than a decade, yet there has been very little progress beyond voluntary mergers of local authorities.

Question
Score

Prioritization

9

Governing coalitions have been stable in recent years, and since April 2011 they have commanded a clear majority in parliament; aided by a high degree of parliamentary discipline, this ensures that their effectiveness in policy implementation. While coalition partners generally abide by agreed policies, challenges are more common

Implementation

9

in times of crisis. The 2007 coalition agreement, for example, did not foresee the 2007 economic downturn, and when recession struck the Social Democrats clashed with their partners, leaving the coalition in 2009. Overall, governments have been able to balance the state budget, assisted by the center-right profile of most coalitions. Controlling inflation has proved a greater challenge – the OECD singles out the Estonian government’s poor counter-cyclical policies as a major point of weakness.

As a member state of the EU and OECD, Estonia is thoroughly integrated in international networks of policy exchange. Policymakers are therefore constantly and intensively exposed to new different ideas. The volatile economic conditions of recent years have demanded a high degree of policy flexibility. On the downside, Estonian policymakers often appear stubborn, seeing changes of opinion as a sign of weakness, a mindset which reduces the scope for policy learning. Experts from well-established policy studies institutions (e.g. PRAXIS) are often insufficiently engaged in designing and implementing policies; many decisions are taken within ministries with limited consultation.

Policy learning
8

15 | Resource Efficiency

Estonian public administration is generally efficient, especially in the wake of the austerity program implemented at the time of the economic recession. There is little political interference in administrative appointments, although some top positions have become politicized in the last decade – principally those of the county governors, nearly all of whom are now members of ruling political parties. Estonian governments have continuously adhered to the principle of balanced budgets. Estonia has the lowest level of government debt in Europe. Actual state budget expenditures rarely deviate from plan, except during times of extreme growth and recession.

Efficient use of
assets
9

The National Audit Office is an independent constitutional institution which audits the use of budgetary resources by state and local governments, addressing both financial and performance criteria. It often provides rigorous critique of administrative practices. Estonian governments have made efficiency savings by pioneering e-governance (including paperless communication using secure digital signatures) and introducing a wide variety of online services to both individuals and businesses. There is extensive use of electronic ID cards, which are held by nearly all adult Estonians and can be used to securely identify individuals online.

The governing coalition which was returned to office in the parliamentary election of 2011 has generally been united on policies contained in the coalition agreement. The highly compatible programmatic profiles of the two governing parties and the small size of the country, which encourages settlement of disagreements in private, mean there is little public friction concerning policies. The Government Office operates a Strategy Unit which supports the work of the government and coordinates

Policy
coordination
8

the drafting and implementation of the government's action plan, as well as strategic development plans.

The Estonian government conducts business with a high degree of transparency, readily granting citizens and the media access to information. The National Audit Office independently and effectively reviews spending by government ministries. Estonia is a founding member of the Council of Europe's GRECO (Group of States against Corruption) and its recommendations are usually implemented in full. The government adopted a detailed Anti-Corruption Strategy in 2008 and the Ministry of Justice website includes tools and guidelines for entrepreneurs, civil servants and individuals for avoiding and reporting corruption.

Nonetheless, challenges remain. The regulation of party financing has been a particularly controversial issue in recent years. In late 2010, Edgar Savisaar, the mayor of Tallinn and the leader of the opposition Centre Party, was accused of soliciting money from Russian Railways. In 2012, a former MP from the governing Reform Party accused the party's central office of accepting anonymous donations passed on by MPs and party members. These accusations led to the resignation of the Minister of Justice (former Secretary General of the party) even though public prosecutors did not raise formal charges. The party leadership dismisses accusations of irregularities, but the scandal sparked widespread public discussion on ways to improve the monitoring of party funding.

Before the 2011 parliamentary elections, a new Supervisory Committee on Party Financing was established, comprising representatives of parliamentary parties and members nominated by the Chancellor of Justice, the National Audit Office and National Electoral Committee. Political parties submit regular reports to the committee, documenting donations and campaign expenditure. This is a clear improvement on the previous system, whereby campaign expenditure reports were submitted to a parliamentary committee composed only of MPs. However, the effectiveness of the new committee has been called into question. Firstly, with a tiny budget and just two civil servants at its disposal, it cannot verify reports submitted by parties and candidates. Secondly, representatives of political parties constitute the majority of the committee, limiting its independence if political parties choose to collude.

16 | Consensus-Building

There is a widespread agreement among major political actors on the desirability of a (liberal) market economy and representative democracy. Center-right governments have dominated since independence in 1991 and have followed neo-liberal economic policies of balanced budgets, low public borrowing, low, flat tax, and currency stability. Even the two center-left parties which constitute the parliamentary

Anti-corruption
policy
9

Consensus on goals
9

opposition (the Centre Party and the Social Democrats) agree with these fundamental objectives in broad terms. However, they have long advocated progressive taxation to replace the flat tax regime as well as stronger welfare safety nets.

There are no anti-democratic political, military or economic actors with significant voice or power in Estonia.

Anti-democratic
actors

10

The main social cleavage in Estonia runs between the ethnic Estonian majority (68.7% of the population) and the Russian speaking minority. It is only partly politicized as ethnic Russian parties are generally weak and have not been represented in the national parliament since 2003. This void has been filled by the Centre Party which has successfully built up support among the Russian speaking community and is an outspoken advocate for its concerns, sometimes in conflicting with governing parties (which are almost entirely ethnic Estonian). This polarization is somewhat moderated by (occasional) attempts by the other three parliamentary parties to court Russian-speaking voters, especially in local elections, where they represent a higher proportion of eligible voters.

Cleavage /
conflict
management

7

While the government adopted a detailed Integration Action Plan in 2008 and funds a range of activities through the Integration and Migration Foundation Our People (MISA), the minority integration policy has languished since 2009, when the post of Minister of Population and Ethnic Affairs was abolished. According to the Integration Monitoring report (Praxis 2011), the ethnic divide has reduced slightly in some areas (interaction, language use and identification with Estonia among Russian-speakers) notwithstanding the economic crisis, which hit Russian-speakers harder.

Civil society actors have become increasingly active in politics. In 2012, teachers' and doctors' unions staged national strikes; prominent intellectuals launched a petition demanding democratic reforms, building up a significant following; protesters took to the streets in response to the Anti-Counterfeiting Trade Agreement (ACTA) and the prime minister's high-handed dismissal of their concerns. Although civil society organizations are generally vocal and constructive, politicians sometimes see their activities as an obstacle to effective governing. The government does respond to pressure, even though direct involvement of civil society organizations in the decision-making process remains limited. In late 2012, prominent public intellectuals signed Charter 12 which called for increased democracy in response to a party funding scandal within the Reform Party. "People's Assembly", an online platform initiated by the president, crowdsources proposal for amendments to laws covering political parties (to increase internal democracy and transparency of political financing), elections and other elements of democracy. Over 1,300 suggestions have been submitted, but the long-term impact of this innovative approach to democratic reform remains to be seen at the time of writing.

Civil society
participation

9

The political leadership recognizes the need to deal with historical acts of injustice, but Estonia has not implemented an extensive program of lustration. Interpretation of historical events and periods – including World War II, the Soviet occupation and collaboration with the Soviet power structures – is ongoing. World War II, in particular, is a frequent source of disagreement; many Russian-speakers still value the achievements of the Red Army, while the ethnic Estonian majority (especially the political elite) tends to view it as a foreign force which occupied Estonia for decades after the end of the war. Two presidential initiatives presidents have aimed at reconciling Estonia with its past: the Estonian International Commission for Investigation of Crimes Against Humanity established by Lennart Meri in 1998, and the Estonian Institute of Historical Memory (which focuses on human rights during the Soviet period) established by Toomas Hendrik Ilves in 2008.

Reconciliation
8

17 | International Cooperation

Estonia benefits from extensive assistance through the EU's Structural Funds, amounting to roughly 3% of GDP in the current 2007-2013 financial period. Priorities include lifelong learning, energy efficiency, administrative capacity building, labor market measures, information society development, water and waste management infrastructure, reduction of regional disparities, development of R&D and transport networks. The use of structural funds is linked to long-term strategic plans adopted by the parliament and government, which are generally well coordinated between ministries. However, the European Commission froze structural funding to Estonia for a short period in 2011 after an EU audit highlighted a lack of Ministry of Finance oversight of other ministries in distributing the funds.

Effective use of
support
10

The government is internationally seen as highly and increasingly trustworthy. International credit rating agencies rank Estonia among the most credible countries in Central and Eastern Europe. In 2011, Fitch raised Estonia's credit rating to A+, the second highest in the region after the Czech Republic. Estonia is generally perceived as a successful EU member which abides by EU norms. Government officials are often openly critical of countries which are less rigorous in their compliance (such as Greece).

Credibility
10

Estonia has been involved in various forms of international cooperation since independence. In the period immediately before and after independence, closest cooperation was with other Baltic countries, but the emphasis gradually shifted to cooperation with the Nordic countries and the Baltic Sea states at large. The EU accession process reinforced this tendency. Cooperation within the various European Union frameworks remains a priority, with narrowly regional links losing some of their earlier significance.

Regional
cooperation
9

Nonetheless, the Baltic states have made joint efforts to increase energy security. This issue gained additional urgency after in light of the closure of a Soviet-era nuclear power plant in Lithuania in 2009, the long-term infeasibility of oil-shale based electricity production in Estonia and the perception that reliance on Russia for energy resources is undesirable. A joint nuclear power plant in Lithuania is a key project, but little progress has been made. The prime ministers of the Baltic states signed a communiqué on the construction of the power plant as far back as 2006, but the project has since stalled. The project faced another setback in 2012 when the plan for building the power plant was turned down in a consultative referendum in Lithuania; Estonian president Toomas Hendrik Ilves publicly expressed frustration over this change of direction. Likewise, the proposed Rail Baltica, which would provide a high-speed rail link between all three Baltic states as well as Poland and possibly Finland, was in discussion for years before the project started moving forward in early 2013.

Relations with the Russian Federation have been more difficult, especially in the wake of the “Bronze Soldier” protests in 2007 and the lack of a border treaty some 20 years after Estonian independence. A border treaty was signed in 2005, but has remained in limbo after Russia withdrew its signature after the Estonian parliament added a preamble to the ratification. Consultations on the treaty resumed in 2012.

Strategic Outlook

The short and medium term political and economic prospects for Estonia are largely positive. Lack of popular support for anti-system parties and widespread approval of democratic principles will likely ensure political stability. New political parties may emerge, a prospect raised by influence-peddling scandals in 2011 and 2012. However any newcomers will face an uphill battle in gaining members and funds. Approval ratings for governing parties have been decreasing in advance of local and national elections (due in 2013 and 2015, respectively), but leading figures forestalled the threat of new contenders with greater responsiveness to criticism.

With support for the country's four parliamentary parties remaining fairly stable since 2011, the only (moderate) risk exists is of a political stalemate should the two opposition parties (the Centre Party and the Social Democrats) win a narrow majority in 2015. Even though their programmatic profiles are compatible in economic terms, Edgar Savisaar, the long-standing and dominant leader of the Centre Party, is a highly divisive figure, seen by many as a pariah in Estonian politics. The other parties are unlikely to join any coalition led by Savisaar, even if his party wins the largest number of votes (as happened in 2003). If the Social Democrats become the largest parliamentary party, it would have to choose between a coalition with (a) one of the center-right incumbents which would have major reservations about its economic policies, and (b) the Centre Party with its controversial democratic credentials. However Estonian political parties have managed to downplay ideological and personal animosities in the past, for example the 2002 coalition between the Reform Party and Centre Party, formed after the resignation of prime minister Mart Laar (Pro Patria).

Economic policy – such as the flat tax regime and the level of social expenditure – is the main dividing issue between the government and the opposition. However differences between the major parties are generally slight as none of them is advocating a radical departure from broadly liberal economic policies and balanced budgets. Indeed, membership in the European Union and European Monetary Union sets significant constraints on government policies, and every major political player is keen to abide by European norms. Even if the government debt were to increase, it would do so from a very low base. Increased redistribution might also raise domestic consumption and produce beneficial social effects. One of the country's main economic risks is extreme dependence on exports and foreign investments for economic growth. For a small and open economy such as Estonia's, external shocks and credit cycles pose far greater risks to economic growth than unfavorable domestic political developments. The country weathered the recession reasonably well by relying on a radical austerity program which met with little domestic opposition, aided by a widespread understanding that the crisis was not of the government's making. If economic conditions were to deteriorate once more, the population may be less accepting of further public sector cuts.

Finally, labor migration to more affluent EU member states may pose further challenges. On the one hand, migration has acted as a safety valve against unemployment and those working abroad have injected money into the Estonian economy. On the other hand, there is the danger of a permanent brain drain. However the favored destination for Estonian migrants has been neighboring Finland, close enough for maintaining close ties or even commuting. As a consequence levels of permanent migration are likely to be lower than in other CEE countries.