

UNICE TASK FORCE ON ENLARGEMENT

**2002 REPORT ON CANDIDATE COUNTRIES' PROGRESS
TOWARDS EU ACCESSION**

ESTONIA

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Executive Summary

This UNICE Task Force on Enlargement (UTFE) report condenses the views of business on Estonia's progress towards accession to the EU. It reflects the views of the business on recent developments related to Estonian accession to the Union and its preparedness for EU membership.

General assessment of the situation

European business supports the accession of Estonia to the EU. There is a consensus among Estonian politicians to accede to the EU and NATO. The Estonian government is committed to complete EU accession negotiations in 2002, so that Estonia could join the Union in 2004.

According to a study commissioned by the State Chancellery at the beginning of 2002 some 42% believe that Estonians would vote for accession, whereas 21% think that the referendum outcome would be against entry into the EU. Most of the respondents, 57%, said that EU accession would be of benefit in the final analysis, even if it caused some problems for Estonia. Expectations are highest among farmers, civil servants, students and the business community.

Estonia fulfils the Copenhagen political criteria and it has a well-functioning and open market economy subject to competitive pressure. The share of foreign trade with EU member countries is close to 70%. A strong majority of the European and domestic companies operating in Estonia support EU accession.

Preparation for EU membership is proceeding well and Estonia should be able to complete all the remaining reforms and be ready for EU membership in 2004. From the business point of view this should not create any problems.

Actions recommended

- Information across the whole country is important to guarantee broad and sustainable support for EU membership and successful adaptation to the EU-harmonised legislative environment. Distribution of information about changes to legislation and the practical consequences for businesses and citizens should be enhanced.
- Though the time to apply for restitution of land and houses to their original owners has ended, new claims are appearing. Court rulings on these cases are quite slow and investment projects may be delayed, which should be prevented by expeditious processing of the cases.
- Privatisation is almost finished. The complicated privatisation of the energy sector should be completed in a transparent manner and in line with the decisions made at the Barcelona Summit.
- As a rule Estonian legislation ensures free movement of goods and promotes investments. Enforcement of the TRIPS agreement including the fight against piracy and counterfeit products has been strengthened and the situation has improved considerably, but there is still work to be done in this area.
- In the tourism business preparation for the time without the support of duty-free sales in Baltic Sea passenger traffic should be intensified.
- Closure of outdated industrial production has created high unemployment in the eastern part of Estonia, which should be addressed in a firm manner in industrial, regional and investment policies.

Introduction

This progress report gives an overview on the status in 2002 of Estonia's preparations for EU accession from the business viewpoint and primarily reflects the views of the companies operating in the Estonian market.

Relations between the European Union and Estonia

Estonia is one of the frontrunners in EU accession negotiations. The somewhat slower pace in the negotiations at the end of 2001 and beginning of 2002 is explained by the unwillingness on the Estonian side to agree with such commitments that Estonia is most probably not able to keep. Simultaneously implementation of the Europe Agreement has been smooth and efficient.

The new President Arnold Rüütel and the new government headed by Prime Minister Siim Kallas are strongly committed to completing accession negotiations by the end of 2002 so that Estonia could join the Union in 2004. The high priority put on European integration is underlined by simultaneous preparations for joining NATO. This goal-setting has no real opposition in Estonia.

Opinion polls show that support for EU membership has changed quite substantially during the accession process. Despite this, the will to join the EU and NATO has not been under real threat.

According to a study commissioned by the State Chancellery in the beginning of 2002 approximately 70% of Estonians would take part in a referendum to decide Estonia's entry into the EU. Nearly 80% are undecided on how to vote, but have a more positive rather than negative attitude towards the union. Some 18% are neutral, less than 4% negative rather than positive, and none totally negative.

Some 42% believe Estonians would vote for accession, whereas 21% think the referendum outcome would be against entry. Most of the respondents, 57%, said that accession would be of benefit in the final analysis, even if it caused some problems for Estonia. Expectations are highest among farmers, but also civil servants, students and businesspeople are looking forward to joining the EU. The government has promised a referendum in autumn 2003.

According to the Estonian Confederation of Employers and Industry more than 70% of the Estonian business community is in favour of EU membership, though there is uncertainty among small enterprises on the consequences of Union membership.

Role of business organisations in EU accession

Regular consultation with the interest groups is a practice in Estonia. The Consultative Committee counselling the Foreign Minister on EU accession headed by the chairman of the Estonian Chamber of Commerce and Industry, Mr Toomas Luman, plays a prominent role in the preparation of Estonian positions for the accession negotiations.

The organisations representing Estonian business have faced a very challenging task in giving their input to the accession process due to the wide scope of issues to be tackled. Consultation and information of the relevant interest groups and the general public are of great importance to guarantee broad support for EU membership and a successful adaptation to the EU legislative environment throughout the whole country.

The Estonian Chamber of Commerce and Industry and the Estonian Confederation of Employers and Industry are increasing and improving their information supply on

enlargement for companies. The Estonian social partners are also looking forward to the EU-Estonia Joint Consultative Committee, which was established in April 2002 and has its first meeting in July 2002.

Economic Development

Estonian economic policy is very liberal and in many areas more liberal than in the EU. Estonian industry as well as banking, insurance, transport and other services have been privatised to a degree which exceeds the average in the EU. Consequently EU harmonisation of economic policy has meant measures such as introduction of customs tariffs which Estonia abolished together with state subsidies in 1992. Estonia has started to provide modest agricultural subsidies as well.

Introduction of customs tariffs and their collection as well as establishment of all structures necessary for enforcement of the CAP and the EU's structural policy are a very demanding task for Estonia, but it should be able to put all the necessary structures in place well before 2004.

Macroeconomic development

EU is the most important partner for Estonia in trade and investment. In January 2002 the share of EU countries in Estonian exports was 68%. Simultaneously the share of Russia and other CIS countries was merely 4%. In part this is due to the double tariffs introduced by Russia in 1995 on imports from Estonia. The already initialled Agreement on Trade and Economic Cooperation is based on MFN treatment and would end the application of double customs tariffs for Russian imports from Estonia. The agreement is, however, still waiting to be signed and to come into force.

In 2001 the GDP increased by 5.4% and industrial sales by 6.9% compared with the previous year. Annual inflation was 4.2%. Estonian exports increased by 7%, while imports rose by 4%. The Estonian trade deficit equalled approximately 18% of GDP. The large surplus in the balance of services (mainly transport and tourism) continues to offset Estonia's trade deficit in goods. The inflow of foreign direct investment to Estonia was over € 600 million and the net inflow of FDI was over € 400 million. Consequently the current account was nearly balanced. Most of the FDI came from Finland and Sweden and was mainly directed to the financial sector, real estate, transport, communications and trade.

According to the Estonian Statistical Office the unemployment rate at the end of 2001 was 11.9%. Fairly high unemployment in a period of high growth reflects productivity gains and possible structural unemployment.

In the first quarter of 2002 industrial output fell by 0.1%, but economic growth is expected to continue this year. In spring 2002, the expected annual GDP growth rate for 2002 was according to the Bank of Estonia 4.2%, IMF 4.1%, Hansabank 4.7%, Nordea 3.9%, SEB 4% and EIU 3.1%.

Structural reforms

Privatisation has proceeded well and is nearly completed. There has been lack of transparency in the energy and transport sectors as well as privatisation of forests, but in general the privatisation has been a success.

The existence of a functioning market economy

Estonia has an open and well-functioning market economy. Estonia is member of WTO and its liberal trade regime allows fully-fledged competition between domestic and foreign companies.

According to a study published by the Finnish Central Chamber of Commerce in October 2001 representatives of 75 companies operating in Estonia considered the business environment fairly satisfactory. Business practises have reached European level, flexibility and openness have increased, quality and efficiency thinking have gained ground and the service sector is highly developed. The results of a survey conducted by the Swedish Trade Council in Tallinn in September-October 2001 are fairly similar to that of the Finnish survey.

The Economist Intelligence Unit (EIU) expects Estonia to retain the best business environment in the Eastern Europe over the next few years. The Heritage Foundation has ranked Estonia the 4th among the most free economies in the world by the Economic Freedom Ranking. The Global Competitiveness Report 2001-02 ranks Estonia 27th, the second most competitive CEE country after Hungary. The Institute for Management Development (IMD) ranks Estonia 21st on the competitiveness scoreboard.

The capacity to cope with competitive pressure and market forces within the EU

Estonian companies have operated in an open economy since 1992 when import tariffs were abolished. Operation without tariff protection has compelled Estonian companies cope with fierce competition and adapt their operations, products and production costs to the prevailing situation in the world market. Estonia's main export items are machinery and equipment, wood and wood products, textiles and clothing. Estonia is very competitive in contract manufacturing, transport and other services, and the agri-food complex is developing fast.

Progress in Adoption, Implementation and Enforcement of the Acquis

The four freedoms

Estonian legislation secures free movement of goods and promotes investment. Enforcement of the public procurement legislation has improved and the adoption of European standards and product safety acts is proceeding. Enforcement of the TRIPS agreement including the fight against piracy and counterfeit products has been strengthened, and the situation has improved considerably. The main problems are that: 1) offences against intangible rights are not considered serious and citizens do not condemn them; 2) the police is overworked; 3) training does not reach all the relevant persons; and 4) there is not enough statistical information. The share of counterfeit products is biggest in vodka, cigarettes, sportswear, CDs, computer software and games. According to the Business Software Alliance (BSA) their share in software is nearly 70%.

The land reform and restitution of land and houses to their original owners and their heirs has created cases of unclear ownership and delayed investment projects due to slow court rulings. Land reform and real estate registration should be completed as soon as possible.

Free movement of services including banking and insurance is well established. Majority ownership by solid foreign banks in the financial sector has abolished risks in capital transfers and payments. Likewise there are no problems in insurance.

There is no quota on immigration of nationals from EU countries. Integration of the Russian-speaking people is slow, but there is now more activity in this respect than in previous years.

Information society and telecommunications

The IT sector is an area of fast growth in Estonia. Every fourth Estonian has an internet connection and every second a mobile phone. Estonia has introduced the digital signature and aims at launching internet-voting in the next parliamentary elections scheduled for 2003. All members of the Estonian parliament, Riigikogu, operate on documentation which is mainly distributed by computers only. The decisions made by the parliament are available in internet and income tax declarations to the Tax Board by internet have been possible since 2000.

There are 470,000 internet banking clients, while the Estonian population is 1.4 million. All schools are equipped with internet connections. The biggest Estonian exporter Elcoteq operates in electronic contract manufacturing and the economic newspaper Äripäev ranks JOT (manufacturer of automatic production lines and robots for the electronics industry) is 4th among the TOP 100 Estonian companies.

Education, training and youth

The Estonian educational system has undergone a profound reform. Young specialists have gained key positions in public administration and business, which shows that the reforms have been successful. There is a lack of skilled IT professionals, lawyers and business managers, but the situation is improving. The vocational training system supplies adequate initial training for various professions.

Research and technological development

Research and technological development are given growing attention. The lack in funding should be covered by developing close links between research institutes and the industry. The spearheads of advanced research are material technology, applications in biomedicine and genetic technology.

Economic and Monetary Union

The cornerstones of Estonian economic policy are liberal trade policy and minimum state interference. In 1992 the Estonian currency (Kroon) was pegged to the German Mark and afterwards to the euro without any exchange rate corrections. Estonia is committed to secure smooth functioning of its currency board regime until it joins EMU. No changes are expected to the current exchange rate, but the inflation and unemployment rates require due attention.

Taxation

Estonian company and personal income taxation are moderate. VAT is 18% and the income tax rate is set at 26%. Re-invested earnings can be deducted from corporate tax.

EU membership means abolition of tax-free sales for EU citizens. Estonia has applied for a transition period to smooth the effects of the end of tax-free on ships sailing in the Baltic Sea. Tax-free sales are of significant importance for the tourism business. The share of the tourism cluster is approximately 13% of GDP. Estonia has to develop its tourism attractions or it may otherwise experience problems in adaptation to the time after tax-free. Harmonisation of cigarette taxation may increase the share of illegal trade in cigarettes (in the eastern part of Estonia approx. 40%), if measures against illegal trade are not intensified.

Because of the low taxes the role of shadow economy is as a rule relatively small, but there are demands for cash payment in the timber trade for instance. Estonia established a special tax police in 2001 to tackle the problems related to tax collection.

Industry

Estonian industry has developed without governmental interference and without subsidies. This has meant profound reform of the old industry and closure of non-competitive production. As a result of the liberal economic policy and competitive production costs the logistically well situated capital city Tallinn and its surroundings have received plenty of foreign investment.

Simultaneously the eastern part of Estonia has suffered from cuts in the outdated big industry, the closure of the old non-competitive plants and insufficient new investment. Uneven development requires special attention in Estonian industrial, regional and investment policies. EU membership and the closeness to St Petersburg should offer new business potential for the eastern part of Estonia as well.

Agriculture and food industry

Estonia has continued development of its agricultural and rural policy. Plenty of legislative work has been done in order to reach the obligations of EU membership. Thus implementation, but especially enforcement of the legislation, plays the main role in the near future. The government allocated from the state budget € 44 million to agriculture and rural development in 2001.

During the last two years agricultural production has remained fairly stable in Estonia. However, in 2001 milk production exceeded production in 1996 due to higher prices. In 2001 the average producer price of milk was € 200 per tonne, while in the EU the producer price varies between € 270-350 per tonne. Agri-food exports to EU increased in the first half of 2001 by 61% narrowing Estonia's agri-food trade deficit. The main reason for the high growth was a trade concession in the form of the double-zero agreement between Estonia and the EU.

The number of farms has continued to increase. In July 2001 there were 56,000 farms (over 1 hectare of arable land) in Estonia. However, agricultural production remains concentrated in large units. The share of farms with more than 50 hectares is only 3.6% but 56% of the land. Animal production is concentrated into large units as well. Dairy farms with more than 100 cows had 71% of the total cow herd (EU-15: 17% in 1997).

Despite progress in the field of veterinary and phytosanitary sector considerable efforts are continuously needed. Administrative structures have improved. Estonia has successfully established and accredited the agency needed to launch the SAPARD programme which helps Estonia to continue necessary investments in the food chain.

Energy

Privatisation of the energy sector has suffered from lack of transparency. In the case of the Narva power plants, which operate on environmentally problematic oil shale, privatisation has already taken six years. The power plants were initially sold to the US-based NRG Energy, which did not secure the required financing for the renovation, and the deal is now off. The Estonian president has proposed establishment of a company for running the Narva power stations and the main electricity lines. Two thirds of the share capital of the company should be state-owned. Distribution and sale of electricity should be privatised as well according to President Rütel.

In addition to the failure of the NRG Energy deal the present policy has been motivated by the high dependency of the poorly developed north-eastern part of Estonia in the oil shale industry and the required security of energy supply. Estonia is not connected to the European energy networks and electricity production is mainly based on the oil shale. Consequently integration into the European energy networks should be speeded up so that the high dependency on oil shale can be reduced. The first project under preparation is an electricity transmission cable from Estonia to Finland. Whatever decisions are made in the energy sector, they should be in line with the decisions of the Barcelona Summit.

Transport

Privatisation of the railways and the Tallinn local bus traffic suffered from lack of transparency which led to open accusations of unfair treatment, but the situation has calmed down.

Estonian companies are competitive in transport. The volume of transit cargo (mainly oil products from Russia) as well as passenger and cargo maritime traffic has increased tremendously in the last ten years. In the event of the abolition of tax-free on passenger ships sailing to Finland and Sweden, Estonian shipping companies require similar subsidies as those currently offered by EU countries.

Small and medium-sized enterprises

The liberal economic policy and minimal bureaucracy have generated numerous small companies, especially in trade and other services but also in construction and industrial production. This has been of great importance when the outdated industries had to downsize or close their operations.

The change continues. The number of wholesalers is going down and supermarkets belonging to international chains are increasing their share in retail. Foreign chains of stores have landed on the Estonian market and the role of open market and kiosk business has decreased rapidly. In industry there is a tendency towards bigger units as well.

Employment and social affairs

The present Estonian trade unions and employer organisations are relatively young and represent according to different sources 20-40% of the work force and employers. Tripartite relations have been institutionalised and the basic labour standards meet the requirements of the ILO Conventions. Terms of employment are mainly negotiated at company level. The situation is, however, changing and in addition to the minimum wage, issues such as safety at work and working hours are negotiated on tripartite basis. The pension and health care systems have been reformed.

The Estonian Government proposed, in accordance with the Europe Agreement, in March 2001 that a Joint Consultative Committee composed of economic and social actors from the EU and Estonia should be established. The committee was established in April and the first meeting should take place in July 2002.

Human rights and protection of minorities

Estonia has made amendments to the language law and it should be in accordance with international standards. The Estonian population minister has decided to launch an "Integrating Estonia 2002-2004" project to support teaching of the Estonian language and a broadening of contacts between Estonian- and Russian-speaking youth.

The OSCE representative office was closed at the beginning of 2002 and its duties have been taken over by the Population Ministry. This is regarded as a strong positive signal, and human rights and protection of minorities are now considered to be in order. EU business no longer experiences problems in obtaining residence and work permits as it did a few years ago.

Regional policy and cohesion

Estonian economic development is unevenly distributed. The eastern part of Estonia with the Russian-speaking majority is lagging behind due to an inadequate level of investment to compensate the loss of jobs due to downsizing of outdated production. The government has to strengthen facilitation of structural reforms and make the least developed areas attractive for new investment. This should be observed in the use of EU financing as well.

Environment

Closing of the old heavily polluting enterprises as well as investments in air protection and municipal waste water and waste management facilities have significantly decreased environmental pollution in Estonia. There is, however, big demand for environmental investments in Estonia. Special attention should be given to the oil shale-based industry and electricity production.

The Ministry of Finance has indicated that the environmental programme in 2001-2013 costs approximately € 1.7 billion. EU support plays a significant role in financing environmental projects. Customised information on EU standards and their implementation is needed for municipalities and enterprises.

Consumer protection

Consumer protection is considered important and further development of local control mechanisms is widely supported in Estonia.

Justice, home affairs and customs

The enforcement of new legislation has not caused major problems for business. This does not, however, undermine the need for continuous training in the judiciary. In cases like those related to land ownership, court rulings may be quite slow, and investment projects have been delayed.

Cooperation between the judiciary, prosecution, police and customs should be further developed, e.g. in protection of intangible rights, where training of all those involved in enforcement of the relevant legislation should be strengthened.

Organised crime is not considered a problem for business but the fight against corruption, crime and drug trafficking must be continued efficiently. In the capital city Tallinn crimes such as stealing and street violence have decreased, but car thefts and drug offences have increased.

Corruption

Corruption is not a big problem in Estonia. Transparency International has ranked Estonia 26th among the least corrupt countries. The ranking is the highest among the CEE countries.

A survey conducted in December 2001 by the Jaan Tonisson Institute and pollsters Emor shows that Estonian residents meet with corruption less frequently than three years ago. Among those asked 83.5% had not recently encountered corruption. In a similar survey in December 1998 the figure was 69.4%. Businessmen operating in Estonia find the trend similar to that of the survey.

Despite progress, the fight against corruption in the police, customs and other organisations and institutions of the central and local administration must be continued. All accusations on corruption as well as money-laundering should be studied carefully.

Trade and international economic relations

The EU is the most important trading partner and the Estonian trade policy is oriented on the EU framework. Estonian business sees Russia as an important growth potential if the already initialled Agreement on Trade and Economic Cooperation is signed and comes into force. The agreement is based on MFN treatment and would end the application of double customs tariffs for Russian imports from Estonia. Also, the agreement on state borders between Estonia and Russia has not been signed yet, though the negotiations were completed some time ago.

Abolition of the Estonian bilateral FTAs is understandably a prerequisite for EU membership. This should not cause major problems as the EU agreements with the countries in question do not bring high customs tariffs or other significant changes in business practices.

Administrative and judicial structures and their capacity

As a rule the required institutions are in place but they must be strengthened, with emphasis on the qualification of human resources and the existence of modern technical facilities. Training of personnel and investment in modern facilities in the central and local administration, judiciary, police, customs and other institutions should be a priority, without denying personnel an adequate salary level.

Conclusions and recommendations

The preparation for the EU membership is proceeding well. Estonia is determined to complete all the remaining reforms and be ready for EU membership in 2004 and from the business point of view this should not create any problems. The main issues to be tackled are:

- Information across the whole country is important to guarantee broad and sustainable support for EU membership and successful adaptation to the EU-harmonised legislative environment. Distribution of information about changes to legislation and the practical consequences for businesses and citizens should be enhanced.
- Though the time to apply for restitution of land and houses to their original owners has ended, new claims are appearing. Court rulings on these cases are quite slow and investment projects may be delayed, which should be prevented by expeditious processing of the cases.
- Privatisation is almost finished. The complicated privatisation of the energy sector should be completed in a transparent manner and in line with the decisions made at the Barcelona Summit.
- As a rule Estonian legislation ensures free movement of goods and promotes investments. Enforcement of the TRIPS agreement including the fight against piracy and counterfeit products has been strengthened and the situation has improved considerably, but there is still work to be done in this area.
- In the tourism business preparation for the time without the support of duty-free sales in Baltic Sea passenger traffic should be intensified.
- Closure of outdated industrial production has created high unemployment in the eastern part of Estonia, which should be addressed in a firm manner in industrial, regional and investment policies.

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