# Baltic Sea Region Report

## Heart-warming growth is a poor excuse to postpone reforms

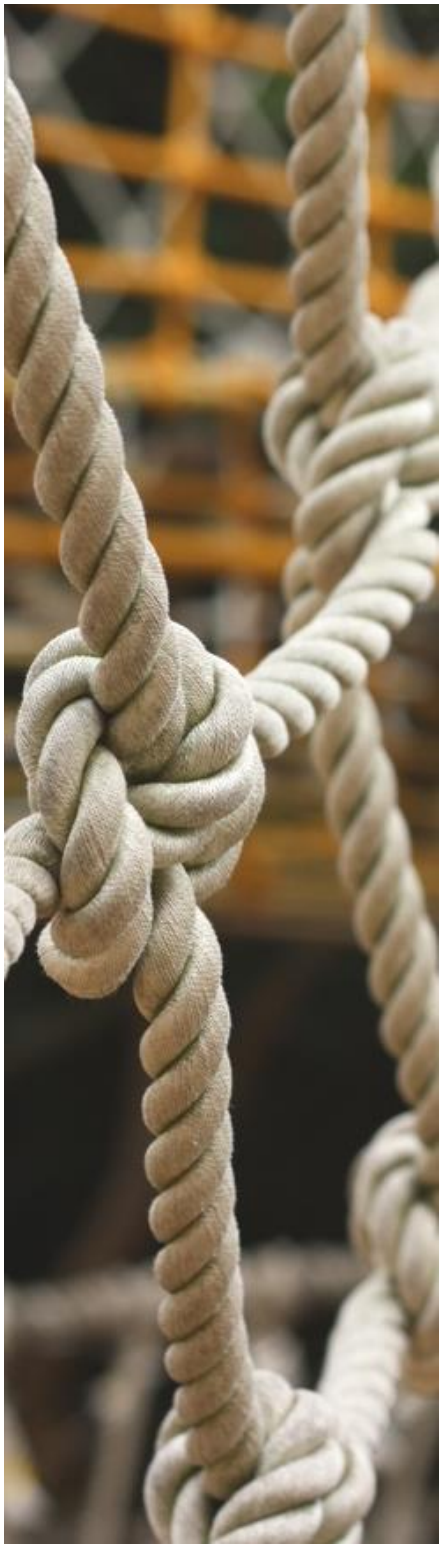
- Growth at its cyclical peak
- Productivity is the key to income convergence in the Baltics
- Sustainable development – where do we stand?
- Universal basic income – utopia or an urgent necessity?

**Growth at its cyclical peak**
The upswing in global growth has lifted the Baltic See region's economies to their cyclical peaks. Growth will slow, but there are at least a few good years of strong growth down the road. Geopolitics and a resurgence of populism are the key risks. Strong growth is the time to reform, correct for imbalances, and invest in boosting long-term growth potential. In Sweden, housing market adjustment is in focus, while labour market tightening remains the hotspot in the Baltics.

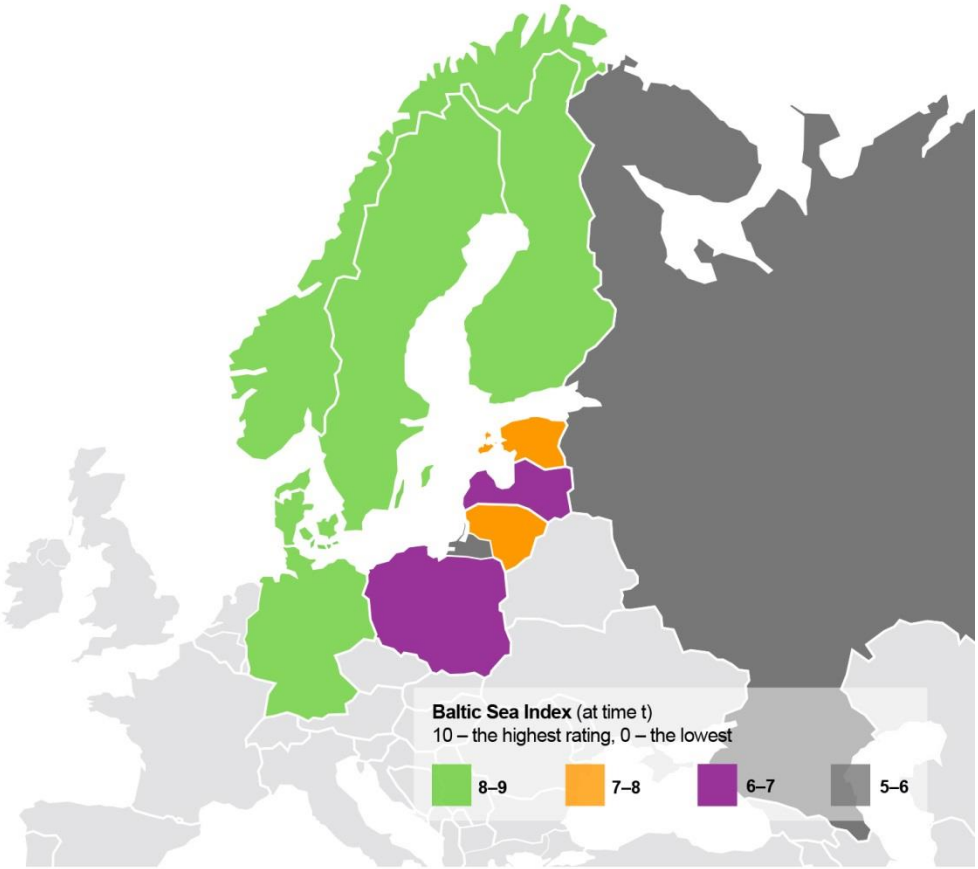
**The Baltic economies – productivity is the key to income convergence**
All the Baltic countries have recovered from the recession and narrowed the relative income per capita gaps with the EU. Lithuania has been the front-runner and surpassed Estonia, benefitting from slower price convergence and a more pronounced population decline since the bottom of the recession. However, the effect from these factors is likely transitory. In the medium term, in addition to brain drain, the population decline will trigger employment reduction, negatively affecting economic activity. The relative price levels, adjusted for purchasing power, will start growing faster (already happening in 2017), slowing the pace of real income per capita convergence. The key to successful income convergence is productivity growth and structural improvements to the economy.

**Sustainable development in the Baltics and Sweden – where do we stand?**
There is an increased focus globally on sustainable development and the UN 2030 Agenda. Sweden scores better than the Baltic countries with regard to sustainability principles (i.e., environmental, social, and governance indicators); however, policy makers and companies in both Sweden and the Baltics have to do their homework to promote robust, socially inclusive, and environmentally friendly growth in the medium term and to contribute better to the UN Sustainable Development Goals.

**Universal basic income – utopia or an urgent necessity?**
The idea of universal basic income, or unconditional cash payments for all citizens or residents of a specific country was first expressed by Thomas More and almost implemented by Richard Nixon in the US in 1968. This idea has recently grown in popularity worldwide. In an EU-wide survey from 2016, 64% of respondents supported the idea, while Finland started experimenting with its implementation this year. The discussions on universal basic income are picking up steam also in the Baltics. We shed light on the pros and cons of UBI and conclude that full implementation of it in the Baltics is unaffordable, but elements of it can improve social inclusion and the efficiency of existing social security systems.



# The Baltic Sea region and Swedbank Baltic Sea index 2017




The aim of the *Baltic Sea Report* is to assess the structural quality and strength of the Baltic Sea region economies from the point of the legal and business environment, and to provide analysis and suggest possible interventions by policymakers to support the swift and sustainable growth of their economies. The region includes 10 countries around the Baltic Sea: Germany, Denmark, Norway, Sweden, Finland, Russia, Estonia, Latvia, Lithuania, and Poland. Detailed analysis is provided for Swedbank's four home markets: Sweden, Estonia, Latvia, and Lithuania.

## Contents

# Introduction: growth at its cyclical peak

**The upswing in global growth has lifted the Baltic See region's economies to their cyclical peaks. Growth will slow, but there are at least a few good years of strong growth down the road. Geopolitics and a resurgence of populism are the key risks. Strong growth is the time to reform, correct for imbalances, and invest in boosting long-term growth potential. Productivity growth and the sustainable nature of growth are important. Full implementation of universal basic income in the Baltics is unaffordable, but elements of it can improve social inclusion and the efficiency of existing social security systems.**

**Strong growth momentum, global economy at mid-cycle**

**Global environment: strong growth momentum**

Global economic growth in 2017 has been much stronger than we had forecast a year ago. The upswing in growth is broad, spreading across advanced economies and emerging markets, with the euro area experiencing a particularly strong pickup. Global growth is mid-cycle, which means that the current business cycle still has a few good years to run and mature. The unemployment rate is falling, and labour shortages are inching up, which should start pushing up the so-far subdued wage growth; particularly in those economies where the business cycle is more mature, such as Germany and the US. For now, inflation expectations remain weak. While a cautious removal of stimulus has begun (most so in the US), monetary policy remains accommodative and supportive to growth, especially when measured in terms of real interest rates. The outlook for global growth is good. We expect strong growth in the US and euro area to continue in 2018, with real GDP growth at 2.2% and 2.1%, respectively. With the cycle maturing, growth in 2019 will slide a tad below 2%. Sturdy growth is expected also across emerging markets, and, although Chinese growth will continue to slow, over the next two years it will still remain above 6%. Benefiting from the commodity price recovery, growth has returned to Russia and Brazil. The global economy should expand (in PPP terms) by 3.8% in 2018 and 3.7% in 2019, up from 3.6% this year. The growth momentum is strong, confidence is up, and so are investments.[1] This helps the Baltic Sea region, whose economies are heavily export driven.

**Fast, sustainable, and inclusive growth is key to reduce the risks of populism and geopolitics**

Populism and geopolitical instability continue to pose challenges for medium-term and long-term growth, both globally and for the Baltic Sea region. During the past year, populism in Europe has retreated (particularly after the French elections) and is likely to stay at bay with the current upswing in growth, as the labour market improves and the gains from growth are felt across wider groups of the population. Financial markets are pricing in less risk of policy uncertainty. But it is far from plain sailing – the elections in Italy next spring could stir up another wave of uncertainty, with the economy still weak and the political scene unable to drive decisive structural improvements. If European policymakers fail to make growth more inclusive or if growth were to tail off sharply, populism will resurge. The rapid spread of new technologies (leading to job loss), along with inadequate active labour market policies (failing to support re-skilling), would widen the gap between the haves and have nots, and make the populists' case more appealing.

As to geopolitics, in the Baltic Sea region Russia remains the key source of uncertainty. With its patchy economic growth, outsized geopolitical ambitions, agile and opportunistic external policies, and approaching presidential elections, as well as the general rebalancing in global politics (e.g., morphing into a multipolar world), Russia's behaviour is unlikely to change. The three elements of the growth-populism-geopolitics triangle feed on each other, with a potentially amplifying negative impact. The only way to break these linkages is to make growth fast, sustainable, and inclusive.

**All the Baltic Sea region economies are growing again**

**The Baltic Sea region: growth peaking this year**

Improved external demand and stronger confidence has boosted growth in the Baltic Sea region, which we forecast to expand by 2.4% this year. All economies are expanding, all are growing faster than we had expected a year ago, and all (except for Sweden, whose growth in 2016 already was way above its historic averages) this year are set to grow faster than the year before. A clear across-the-board cyclical pickup. In terms of speed, the region's growth is peaking this year and will slow going forward as the upswing in the global economy fades; over the next few years, though, growth will remain solid and broad based.

Russia is back to growth, and foreign trade with Russia is on the rise again, but structurally it remains an outlier – its political regime and mutual sanctions with the rest of the region, dependence on commodities, and weaker institutions will keep its growth potential low and the risks for economic cooperation with it heightened. In Germany – the region's largest economy – the signs of the business cycle's maturing are increasingly visible. Unemployment is at its lowest in over 30 years, and labour shortages are inching up, which should soon find their way into stronger wage growth and inflation. German growth is past its

[1] See our *Swedbank Economic Outlook*, November 2017, for detailed forecasts here.

peak, but its growth will remain sturdy. Bogged down in institutional quarrels with the EU, the Polish economy has sped up as well, with some help from the EU funds inflow and its expansionary fiscal policy.

**Economic growth in the Baltic Sea region, %**

| | Average of 2005-2015 | 2016 | 2017f | | 2018f | | 2019f |
|---|---|---|---|---|---|---|---|
| Denmark | 0.8 | 2.0 | 2.4 | (1.7) | 2.2 | (1.9) | 2.0 |
| Estonia | 2.5 | 2.1 | 4.2 | (2.4) | 3.5 | (2.5) | 3.0 |
| Finland | 0.7 | 1.9 | 2.8 | (0.8) | 2.2 | (1.1) | 1.8 |
| Germany | 1.4 | 1.9 | 2.3 | (1.4) | 2.2 | (1.1) | 1.8 |
| Latvia | 2.6 | 2.1 | 4.7 | (2.6) | 4.2 | (2.9) | 3.2 |
| Lithuania | 3.1 | 2.3 | 3.8 | (2.8) | 3.5 | (2.5) | 2.5 |
| Norway | 1.5 | 1.1 | 1.8 | (1.5) | 1.8 | (2.0) | 1.4 |
| Poland | 3.9 | 2.9 | 3.8 | (3.4) | 3.3 | (3.3) | 3.0 |
| Russia | 3.0 | -0.2 | 2.0 | (1.5) | 2.3 | (2.0) | 2.0 |
| Sweden | 2.0 | 3.3 | 2.7 | (2.2) | 2.7 | (1.9) | 2.0 |
| Baltic Sea region (PPP weights) | 2.2 | 1.3 | 2.4 | (0.6) | 2.3 | (1.9) | 2.0 |
| Baltic Sea region, excluding Russia | 1.8 | 2.1 | 2.6 | (2.1) | 2.4 | (2.1) | 2.0 |

Source: Eurostat, WB, IMF, Swedbank Economic Outlook forecast November 2017 (November 2016 forecasts in parenthesis)

**Housing markets in focus in Norway and Sweden; good timing for rebalancing**

GDP growth in the Nordic 4 has largely picked up as well. High household indebtedness and a frothy housing market have been long identified as vulnerabilities for Norway and Sweden. In Norway, the impact of the recent oil crash has been overcome, and early this year growth approached 2%, but then the housing market correction started. Prices have fallen by 10% in Oslo, and this downturn has spread broadly across the country. Residential investment will take a step back and deduct from growth. Late this summer, some adjustment started also in Sweden, with prices inching down in the most expensive segments of Stockholm, Gothenburg, and Malmo. Fundamentals in both economies remain good, and we forecast only a slowdown in growth, with still-decent GDP growth rates going forward. The way that regulators intervene and households form their expectations about price developments will be crucial. However, the timing to correct for this structural vulnerability is good – both are small, open economies that benefit from a strong upswing in the global business cycle, i.e., exports can balance domestic weakness.

**The Baltics: upswing in growth should be used to reform and boost productivity growth**

The three Baltic economies have sped up most sharply, with real GDP growth rates about twice as fast as in 2016. The upswing is broad, with a recovery in investments and continued strong exports. With labour markets continuing to tighten, income growth is strong, boosting confidence, as well as the ability and willingness to consume. Labour markets are warming up, due to both cyclical (i.e., growth generates labour demand) and structural (i.e., ageing and emigration shrink labour supply) reasons; this problem is here to stay. Recently, average labour productivity has picked up by about 4% YoY, but such a speed cannot be sustained given the current business environment and institutional quality. The current upswing in global growth would be a good time to implement such reforms – the high tide covers the cost of implementation and is more forgiving for correcting reform design and enactment errors. Despite some improvements, progress has been insufficient. Meanwhile, domestic demand is taking over as a key driver of growth. But it is closely linked to the global economy – if global confidence and growth were to fizzle out, very soon the same would happen with domestic demand growth in the Baltics.

**No improvement in the Baltic Sea region's business environment quality against the rest of the world**

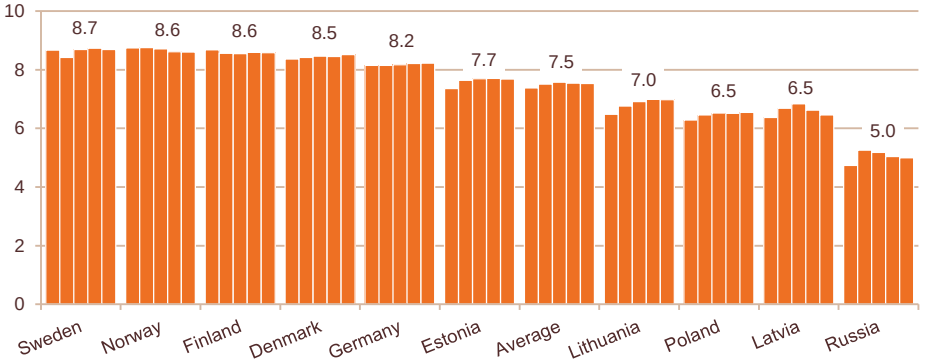
**Baltic Sea index: lack of ambition and massive cross-country differences**

To assess the Baltic Sea region's structural competitiveness and institutional development, we continue calculating the Baltic Sea index (BSI). The region's countries are ranked in relation to each other and the rest of the world. Ten areas with underlying components are used as a basis for the overall index, which should serve as a good indicator of the quality of the business environment in relation to other countries. Countries are ranked from 0 to 10, where a rank of between 9 and 10 implies that in the selected area the country belongs in the top 10% of all countries in the world. A country index is an average of all 10 areas. A regional index is an average of country sub-indices. If every country in the world were to improve at the same rate, our index and the country ranking would not change, because they measure comparative progress. The index is slow to react to policy change as (i) reforms often are slow to take effect, and (ii) collecting internationally comparable data generates a measurement lag.

The region's structural qualities, as gauged by the BSI, have remained unchanged from last year's reading (7.5). This means that the region has moved in line with the rest of the world. Only Denmark has seen its ranking improve, while Latvia's has fallen marginally. The region ranks above the EU (7.2), largely due to five areas: entrepreneurship, labour markets, tax

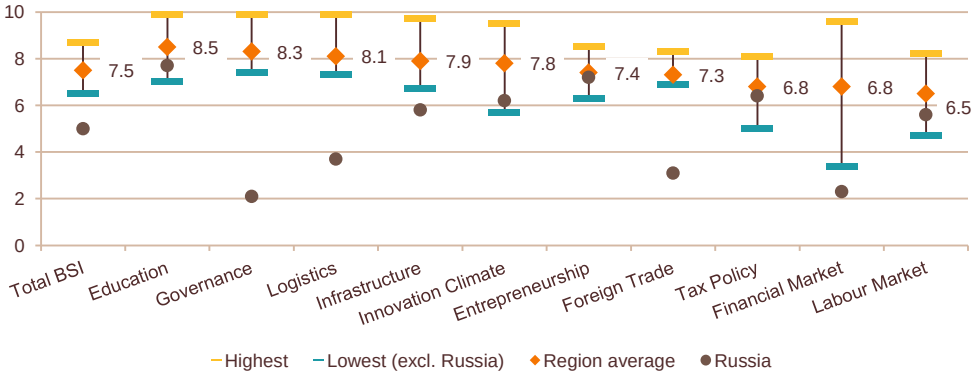
policy, financial markets, and education. At the same time, the region ranks below the US (8.5), especially in financial markets, innovations, infrastructure, and labour market.

**Swedbank Baltic Sea index 2017 - ranking compared with the rest of the world** (10 - highest ranking, 0 lowest)




Source: Swedbank Research

**Swedbank Baltic Sea Index 2017**




Source: Swedbank Research

**Improved structural qualities could unlock more growth**

The region's strength remains in education, governance, and logistics, where it ranks in the top 20% in the world. The key areas to improve are labour market, financial market diversity, and tax policy. The key weakness comes from the region's uneven structural quality. Russia is the major outlier, with massive spreads for the sub-indices of governance, foreign trade, and logistics (see the chart above). But the key gap for Russia, which our index fails to capture, is (geo)political risks. Unless these issues are resolved (which does not seem likely anytime soon), Russia and the rest of the Baltic Sea region will drift apart. At the same time, the large disparities in business environment quality hide large potential – bringing up these weak areas in each country, at least to the region average, could open avenues for closer cooperation and stronger growth.

If we look back 10 years, we see some convergence in structural qualities within the region (as measured by the BSI) has actually taken place, although the BSI for the region improved only marginally. The largest improvements during the 10 years were observed in Poland, Russia, and Lithuania (1.1, 0.7, and 0.6 points, respectively). Estonia and Latvia experienced 0.2-0.3-point increases. At the same time, Germany's score remained flat, while the Nordics experienced declines. The resulting reductions in regional disparities are thus bitter fruits for the Nordics, who have lost competitiveness vis-à-vis the rest of the world. And, while Poland's achievements are impressive, it managed only to catch up with Latvia, and its business environment remains well below the region average.

**Ten years from the global financial crisis: what can we learn from the Baltics?**

**Post-recession income growth has been spectacular in Lithuania…**

All the Baltic Sea region's economies are back to or above their levels before the global financial crisis, except for Latvia, which should reach its 2007 real GDP volume this year; Finland should do it next year. The best track record has been posted by Poland, which did not slide into recession and is now more than 35% above its 2007 level. The three Baltic economies were hit hardest, with GDP contractions of 17-23% as their domestic-imbalance-caused recessions overlapped with a global crisis. The Baltics have been fast to recover from such deep contractions. The first of our three in-depth studies in report (see p.15) takes a brief look at the key factors driving these recoveries. The Lithuanian track record is especially interesting as it has delivered the fastest income convergence of the three, catching up with the previously undisputed leader, Estonia, and scoring at 75% of EU-average GDP per capita in PPS terms in 2016 (up from 60% in 2007). Latvia stands at 65%.

**… but some success factors have been transitory; productivity growth is crucial for income convergence to continue**

We conclude that the recoveries in all three economies were primarily export driven, with export shares in GDP up by a massive 20-30 percentage points. The economies are now more open than ever. Post-recession real GDP growth was almost identical across the three countries, roughly at 3.3% per annum. Per capita income growth differences were more marked, with massive population loss through emigration (in Lithuania and Latvia; much less so in Estonia) and strong productivity growth (in Lithuania and Latvia; much less so in Estonia). The superb per capita income convergence in PPS posted by Lithuania, however, is likely to be transitory and may slow going forward. The key reason is that nominal price convergence with the rest of EU in Lithuania has been much slower than in Estonia or Latvia. For instance, the Lithuanian services price level in 2016 stood at only 45% of the EU average, in contrast to 54% and 62% for Latvia and Estonia, respectively. With price level convergence expected to pick up, real income convergence will slow. With a shrinking labour force, policies to raise investment and total factor productivity are key for income convergence in all three Baltic economies.

**Focus on sustainable development: how to boost socially inclusive and environmentally-friendly growth?**

**Sustainable development: how to grow wisely?**

Growth per se may not solve structural problems. For instance, growth that is not inclusive and widens inequality of incomes and opportunities, feeds populism generating risks to political stability and future economic growth. Similarly, climate change brings along costly economic and financial challenges. Generating environmentally friendly growth is vital. While the BSI is a good tool to assess quality of business environment from the companies' perspective, it does not take into account a wider spectrum of how growth is generated. We take the UN Sustainable Development Goals (2030 Agenda) as a departure point to assess sustainable development in Swedbank's four home markets and look at our economies' structural strength from another angle. As our in-depth shows (see p.18), Sweden scores better than the Baltics, similarly to the BSI. Yet, there is homework for all countries – both for policymakers and companies. As the focus on sustainable development globally increases, global companies no longer have the option to stand aside. In many cases, sustainability aspect has become an industry standard affecting major global companies, as well as small companies that supply global ones. Sustainability assessment is here to stay and affect daily business life; we take the first step to assess how our home markets are doing.

**Can universal basic income solve income inequality problems?**

Rising fears of job losses due to automation and globalisation, increased income inequality, and populism have fuelled interest in universal basic income (UBI) as a possible answer to social inclusion challenges. However, as our third in-depth study shows (see p.23 for details), replacing entirely the current social security systems in the Baltics with a flat basic income would be unaffordable – even to finance UBI at the current risk-of-poverty threshold requires an impossible 30-40% increase in tax revenues. Yet, some parts of the basic income model could be used in simplifying and improving the efficiency of the existing social security systems. Be ready for more policy discussions and trials in small target groups!

*Mārtiņš Kazāks*
*Lija Strašuna*

# Sweden: strong growth but lack of structural reforms

**The Swedish economy is benefitting from solid global growth, low interest rates, and an expansionary fiscal policy. According to Swedbank's index, the overall business environment in Sweden stayed at last year's level – with the highest score in the Baltic Sea region. The downward trend in education is an alarm bell and could have a negative impact on competiveness and long-term growth.**

**GDP per capita, PPP (2016):**
124% of EU 28
**Next parliamentary election:**
September, 2018
**Next municipalities election:**
September, 2018

| Economic indicator | 2005-2015 | 2016 | 2017f | 2018f | 2019f |
|---|---|---|---|---|---|
| Real GDP growth, % (calendar adjusted) | 2.0 | 3.1 | 3.0 | 2.8 | 1.9 |
| Consumer price growth, % | 1.1 | 1.0 | 1.8 | 2.1 | 2.8 |
| Unemployment rate, % | 7.6 | 6.9 | 6.7 | 6.4 | 6.3 |
| Nominal hourly wage growth, % | 3.0 | 2.4 | 2.7 | 3.1 | 3.4 |
| Current account balance, % of GDP | 6.4 | 5.1 | 5.3 | 5.3 | 5.2 |
| General government budget balance, % of GDP | 0.4 | 1.1 | 1.2 | 0.7 | 1.0 |

Source: Eurostat, Statistics Sweden and Swedbank Research

**Robust growth in the economy**

The growth rate in the Swedish economy will slow from today's high levels of around 3% to more sustainable growth of about 2% in 2019. A competitive and diversified business sector, strong government finances, and population growth are creating the potential for continued positive development. The political parties have now begun to aim for the 2018 general elections, and we are not counting on any upheavals in connection with the parliament's budget management. The opposition will criticise the government for an irresponsible fiscal policy, in view of the strong economic climate. The government may, for its part, argue that the fiscal framework is broadly in line and that in the end the Riksbank bears the main responsibility for a balanced economic policy. We will see a continued expansionary policy for 2018 and 2019.

**Solid global growth, strong labour market, and expansionary fiscal policy compensate for a slowdown in the housing market**

The driving force in the Swedish economy is shifting from domestic demand to export-driven industrial production. Sweden is benefiting from improving growth in its neighbouring region and recovery in global investments. In 2018, a strong labour market, coupled with a higher child allowance and lower tax on retirees, will contribute to nearly a 4% increase in disposable income. Consumer spending growth will level off as we near 2019, however, as savings rise (partly due to increased amortisation in housing) and employment grows at a more modest pace; meanwhile, inflation will bite into real wage growth. Swedish growth will also slow because housing investment will not continue to rise at the same high pace. At the same time, public sector investment is increasing, especially in municipalities and county councils. This is a result of the big population increase and the many young and older people, who are creating a greater need, for example, for preschools, schools, senior care, hospital renovations and expanded infrastructure. In the private sector, a higher utilisation rate in industry and a favourable global export outlook will drive investments. Overall, investment as a share of GDP is expected to be at 25 per of GDP-- significantly higher levels than average for mature industrial economies and also given Swedish conditions.

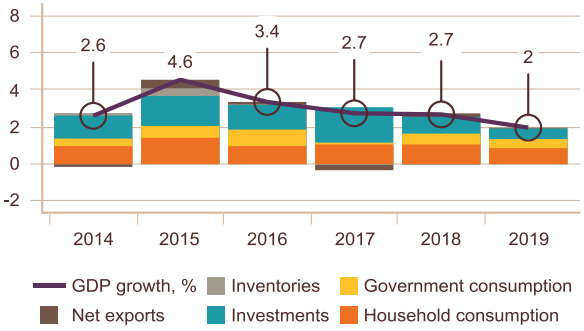
Inflation approached 2% in the third quarter of 2017. Inflation expectations from the money market show a similar trend, though expectations in November declined. The Riksbank's measures of underlying inflation are around or just below 2%. Temporary effects, such as the change in the way Statistics Sweden measures package travel and several administrative price increases, mean, however, that the higher third-quarter inflation rate rests on shaky ground. We expect inflation to fall going forward, when the base effects gradually subside. We do not expect a repo rate hike until next summer when the Riksbank is pressured by a fairly dovish ECB and fragile inflation rate. Nonetheless, we believe that underlying inflation will get support in 2018-2019 from the strong economy. The QE program's net asset purchases are likely to stop next year.

The labour market continues to improve, and the unemployment rate is expected to decline in 2018-2019. A widespread shortage of labour, both in the private and public sector, will support higher wage increases and higher domestic price pressure. We foresee nominal wage increases of 3% next year and 3.4% in 2019. Structural reforms to reduce long-term unemployment and to raise the employment ratio among foreign-born could have a dampening impact on wage increases.

The housing market is vulnerable. Two things have caused the slowdown in this market. The amortization requirement introduced in 2016 has had a moderating effect on price increases, mainly in metropolitan areas. At the same time, construction has increased substantially and

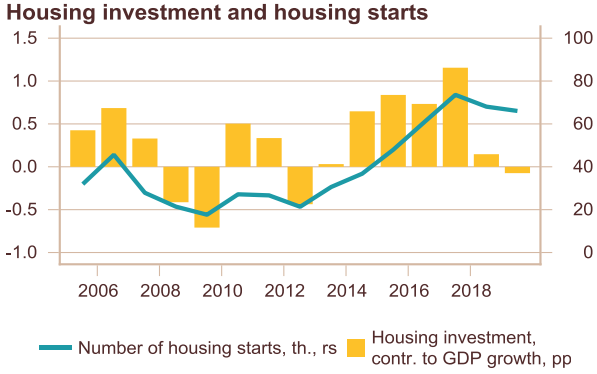
the supply of new housing is large. But new construction is dominated by relatively expensive condominiums and expensive rentals. When it comes to less expensive rentals, the shortage is large. We expect the current stabilisation of housing prices to continue. For the country as a whole, we anticipate largely unchanged prices, +/- 5%, depending on the market and type of property. A fairly significant correction can be seen for certain types of properties in downtown Stockholm, but this reflects an oversupply in the more expensive segment rather than conditions for the overall housing market. A strong labour market, rising disposable incomes, and robust population growth are neutralising any major decline in prices for the country in general.

**Contribution to GDP growth, pp**
Swedbank forecast 2017-2019




Source: Swedbank Research & Macrobond

**Housing investment and housing starts**




Source: Swedbank Research & Macrobond

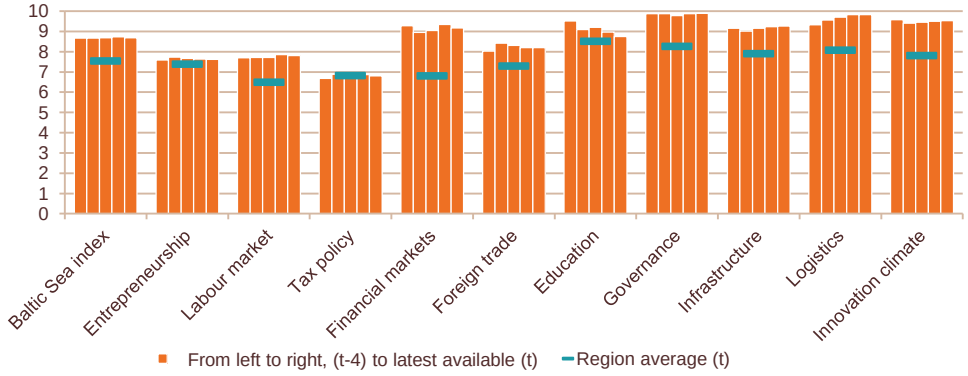
Given the strong economic fundamentals, the Swedish economy can withstand a 5-15% correction in housing prices. A larger price drop would have a noticeable negative impact on the Swedish economy, resulting in lower growth and rising unemployment. It is important, therefore, that politicians be careful in enacting any new measures, such as tighter amortisation requirements and scaled-down interest deductions. At this point, there is a risk that further measures, instead of stabilising the housing market, would cause it to decline.

**Sweden maintains a strong position in business environment**

**Sweden's business environment still ranked highest in the Baltic Sea region**

In Swedbank's Baltic Sea index (BSI), Sweden maintains a strong position in comparison with regional peers. Sweden's business environment has stayed as business friendly as last year, receiving 8.7 points on a 10-point scale. Governance has the highest score, followed by logistics, innovation, financial market, and infrastructure. Tax policy continues to show the lowest score, 6.8, and is a decline from last year. Sweden's tax policy ranks sixth among the Baltic Sea countries. The downward trend in education continues—the score of 8.7 in 2017 is a large drop from 9.9 in 2011 and is an alarm bell for future competiveness and the labour supply. Sweden's trend in this area differs significantly from Finland's, which still has the highest score, 9.9, for education, but also from Denmark's and Norway's. The servicification of the economy increases the need for skilled labour – the lack of labour has reached the highest level since the beginning of 2000, which could dampen creation of jobs and firms.

**Sweden: Swedbank Baltic Sea index 2017**




Source: Swedbank Research

Sweden's sub-index for entrepreneurship scored 7.6 in 2017, unchanged from last year and fourth among the Baltic Sea countries. At the same time, the catching-up process in entrepreneurship in the region is obvious, with an average score of 7.4, compared with 7.1 six years ago. However, the innovation climate in Sweden is still scoring high—along with the robust financial markets, a positive indicator for creation of new firms.

*Jörgen Kennemar*

# Estonia: good times to be used wisely

**The Estonian economy is doing rather well at the moment: GDP growth is rapid, the unemployment rate is low, the current account is in surplus. The current good times should be used to prepare for more difficult times. According to Swedbank's index, however, for the third straight year, the overall business environment in Estonia did not improve in 2017, compared with other countries. The government should focus on long-term structural issues rather than short-term political gains.**

**GDP per capita, PPP (2016):**
74% of EU 28
**Next parliamentary election:**
2019
**Next municipalities election:**
2021

| Economic indicator | 2005-2015 | 2016 | 2017f | 2018f | 2019f |
|---|---|---|---|---|---|
| Real GDP growth, % | 2.5 | 2.1 | 4.2 | 3.5 | 3.0 |
| Consumer price growth, % | 3.6 | 0.1 | 3.4 | 3.0 | 2.5 |
| Unemployment rate, % | 9.0 | 6.8 | 7.0 | 7.5 | 7.3 |
| Gross nominal wage growth, % | 8.0 | 7.6 | 6.5 | 5.3 | 5.0 |
| Current account balance, % of GDP | -3.7 | 1.9 | 2.2 | 2.0 | 1.6 |
| General government budget balance, % of GDP | 0.3 | -0.3 | 0.0 | -0.1 | -0.3 |

Source: Eurostat, Statistics Estonia, Bank of Estonia and Swedbank Research

One year ago, the economy was sending mixed signals: the labour market was overheating but economic growth remained modest. This year's data show clearly that, besides the labour market's tightening, economic activity has entered a fast-growth phase. The economy is expected to grow well above its potential in 2017-2018 as stronger external demand lifts exports and investments. The latter are also supported by the EU structural funds. Higher inflation eats into consumption this year, but in 2018 consumption is expected to strengthen again, mostly because remarkably higher tax-free income will push up the net wages of most employees.

## Overheating risks have increased

The main risks to growth are external – political uncertainty in Europe and/or possible corrections in the Scandinavian real estate market could have an impact on the Baltics through financial links, lower export demand, or the incomes of the workers employed there. Domestically, the scarcity of labour is driving up labour costs and could pose a threat to competitiveness. This scarcity of a suitable workforce is the most important factor restricting business for one-third of the manufacturing and service companies and for one-half of the construction companies. Construction volumes have increased significantly this year. The good news is that, currently, construction prices are still growing modestly despite vigorous demand.

Diverging developments in wages and productivity were less of a concern during the first half of this year. Labour productivity improved and companies' finances, previously suppressed by surging labour costs, recovered, due to vigorous demand and higher output prices on the back of a globally synchronised upturn. However, enterprises' finances took a negative turn again in the third quarter of 2017 as profits decreased in the whole economy as well as in most sectors because companies' costs rose faster than their turnovers, over the year.

In the current phase of economic development, the government should plan its expenditures carefully. Although the nominal fiscal deficit is small, as nominal GDP growth has accelerated, the structural fiscal deficit is more noticeable and will widen in 2018, given the large positive output gap. Government spending should be planned in a conservative manner; the state's tax income in 2018 is hard to predict due to substantial changes in tax policy in effect from next year (lower corporate income tax rates on "regular" dividends, different taxing of banks, an increase in the monthly tax exemption of individuals, and excise tax rate hikes).

According to the draft state budget for next year, currently being discussed in the parliament, public expenditure is expected to grow by 1 percentage point as a share in GDP in 2018 (to 44% of GDP). The general government's investment volumes are expected to grow by 10% in 2018 as the realisation of the EU structural funds' projects intensifies. Injecting additional public funds into the economy could accelerate the already-high growth of wages, prices, and construction volumes. This, in turn, could lead to a deterioration of the competitiveness of the exporting sector, as production inputs get too expensive. Currently, producer prices in the manufacturing sector of Estonia are growing moderately, and the enterprises' own assessment of their competitiveness has improved (mostly due to a surge in demand).

Although the current level of Estonia's general government debt is low, the ageing society, shrinking labour force, and decline in the inflow of EU funds (currently at around 10% of the state's budget) will increasingly pressure public finances; therefore, conservative fiscal planning would help avoiding an onerous debt burden in the future, when the number of taxpayers is expected to be substantially smaller than now.

**No improvement in business environment compared with other countries, according to Swedbank's index**

**Estonia's business environment still at the Baltic Sea region's average**

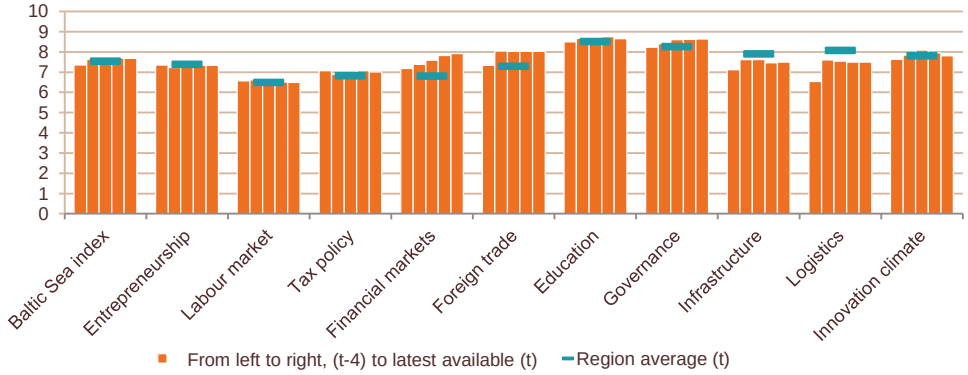
According to Swedbank's Baltic Sea structural index, Estonia's business environment's ranking among other countries remained the same in 2017 as during the previous two years. In 2017, Estonia's index was slightly above the Baltic Sea region's 10-country average. Estonia ranked below Sweden (which had the highest score), Norway, Finland, Denmark, and Germany, but above the EU28 average, Lithuania, Poland, Latvia, and Russia (which had the lowest score).

Estonia's business environment received 7.7 points on a 10-point scale, just like in 2015 and 2016. Out of the 10 areas we consider most important for business, one domain, financial markets, improved compared with the 2016 index, while the scores for two other areas, innovation climate and education, slightly worsened. In the financial markets' sub-category, raising money by issuing shares and/or bonds in the capital market and obtaining a loan from a bank have both become easier in Estonia.[2] In the innovation climate's sub-category, labour productivity as a proxy for innovation output deteriorated in 2015, the latest data this index takes into account. Also, the government's purchasing decisions to foster innovation were assessed less favourably by local executives surveyed in 2016-2017. In the education sub-category, tertiary education's enrolment rate[3] was on a small downward trend in 2014-2015 (latest years available), although still at a very high level by international comparison.

Estonia continues to be ranked high globally in the areas of education, governance, and innovation climate. At the same time, Estonia's performance in two other related areas, logistics and infrastructure, lags behind its peers in the region (of which some are the best in the world – e.g., Germany was the world's top performer in the World Bank's most recent (2016) logistics performance index). Estonia received lower scores not only in the field of arranging competitively priced shipments, but also in the quality of trade and transport-related infrastructure, as well as in the competence and quality of logistics services.[4] Lithuania seems to be doing much better in the logistics field, according to the international survey of logistics professionals, whose assessments constitute the ratings in this area. In 2015-2016, air transport in Estonia was temporarily hampered by the change of national carriers, but Estonia has been receiving low scores in this field for several years.

Two big national projects, the administrative reform (merging municipalities into bigger units with higher administrative capacity) and the EU presidency are ending soon. Now it's time for the government to focus on long-standing issues hampering productivity growth. In addition to improvements in infrastructure (that Swedbank's business environment index refers to), skilled immigration should be facilitated (otherwise production could move abroad due to the shortage of labour) and labour market, health, and education policies should be improved to fully utilise the human capital already in the country.

**Estonia: Swedbank Baltic Sea index 2017**




Source: Swedbank Research

*Liis Elmik*

[2] According to a survey of 166 executives in Estonia, surveyed by the Estonian Institute of Economic Research as part of the global World Economic Forum's Executive Opinion Survey in 2016-2017.

[3] Total enrolment in tertiary education, regardless of age, expressed as a percentage of the total population of the five-year age group following on from secondary school leaving. 72.9% in 2013, 69.5% in 2015.

[4] Based on an online survey of 1,051 logistics professionals at multinational freight forwarders and at the main express carriers in 132 countries, conducted in 2015-2016.

# Latvia: use growth to pay for reforms!

**The rising tide of global growth and domestic demand recovery has finally pushed the economy into positive output gap territory. The cyclical upswing will continue through 2018-2019, alas, fading as the business cycle runs out of steam. With a shrinking labour force, policies to raise investment and total factor productivity are key for income convergence going forward. Despite some improvements, progress has been insufficient, and the Baltic Sea index shows Latvia falling behind its peers.**

**GDP per capita, PPP (2016):**
66% of EU 28
**Next parliamentary election:**
October 6, 2018
**Next municipalities election:**
June 5, 2021

| Economic indicator | 2005-2015 | 2016 | 2017f | 2018f | 2019f |
|---|---|---|---|---|---|
| Real GDP growth, % | 2.6 | 2.1 | 4.7 | 4.2 | 3.2 |
| Consumer price growth, % | 4.4 | 0.1 | 2.9 | 3.5 | 2.5 |
| Unemployment rate, % | 12.0 | 9.6 | 8.5 | 7.5 | 7.2 |
| Gross nominal wage growh, % | 10.1 | 5.0 | 7.5 | 9.0 | 7.0 |
| Current account balance, % of GDP | -6.2 | 1.4 | -0.7 | -2.6 | -4.4 |
| General government budget balance, % of GDP | -2.9 | 0.0 | -0.8 | -0.8 | -0.8 |

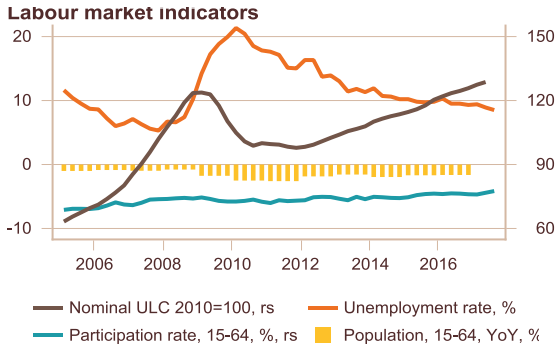
Source: Eurostat, Central Statistical Bureau of Latvia and Swedbank Research

**Strong and broad cyclical upswing...**

Following a few mediocre years, in 2017 growth has surprised on the upside. A positive output gap has finally opened up, with the labour market taking on most of the heat: labour demand is inching up, but negative demographic trends, and regional and skills mismatches shrink its supply. For its speed, real GDP growth of 5.8% YoY in the third quarter of 2017 has been the high note of this business cycle. Growth will go downhill but over the next two years will still remain above its medium-term potential of 2.5-3% per annum.

**Upswing is broad; domestic demand takes over as key driver of growth**

This cyclical upswing is driven by rising global demand, which is improving overall domestic confidence and supporting long-overdue pickup in domestic demand. Growth is seen across all sectors. Over the past decade, exports of goods and services have contributed most to real GDP growth, boosting its share from 42% of GDP to the current 62%. In 2017, we forecast export volumes to expand by a sturdy 5%. With strong global growth continuing, export volumes will surely keep expanding, but their rate of growth is already past its peak. With manufacturing output up 8.0% in ten months this year – by far its fastest rate over the past five years – recent goods exports growth is unlikely to be rivalled any-time soon, given the underinvestment of past years, current record-high capacity utilisation, and mounting labour shortages. As to services exports, it is set to struggle, with weak railway transit flows as Russia aims to redirect its foreign trade via its own ports, but China flows are still minor. Fast-growing IT services exports are held down by the lack of skilled labour supply.




Source: Swedbank Research & Macrobond

With the business cycle maturing, domestic demand becomes the key driver of growth. Gross fixed capital formation, with its current annual growth rate above 20%, is peaking in terms of speed. Tamer double-digit growth will continue into 2019 as the public sector works through the delayed inflow of EU funds, but the private sector compensates for past years' underinvestment and boosts productivity to counteract fast wage growth as the labour market continues to heat up. Household consumption, however, is only to see its peak growth of close to 6% next year as the minimum-wage raise (from EUR 380 to EUR 430), labour tax cut, and labour shortages drive up incomes, optimism, and willingness to consume.[5]

**No imbalances built up yet; still a couple of years of sturdy growth down the road**

The business cycle is young and no major imballances have been built up yet. The current account has just tapped into a small deficit. Credit growth remains subdued, and the stock of bank loans has just posted small positive annual growth following seven years of creditless recovery. Residential investment and prices are just picking up. It is a standard business cycle. The boom-bust story will not be repeated this time – due to new regulations and still-recent harsh memories. If anything, credit demand and supply are still way too cautious.

**… can pay the cost of growth-enhancing reforms, but only for a couple of years**

With sturdy real GDP growth and inflation at 3% (kept up by income growth, the excise tax raise, and global goods prices), over the next two years the nominal economy will expand by 6-8% per annum. With this reflected in government revenues, it is time for reforms – the high tide covers the cost of implementation and temporary revenue shortfalls while the economy realligns, and is more forgiving to correct reform design and enactment errors.

[5] See our *Swedbank Economic Outlook* (November 2017) for detailed short-term forecast here.

**Business cycle upswing is the time to reform to raise long-term potential growth**

With this in mind, fiscal policy is expansionary (but formally in line with the Fiscal Discipline Law), with some of the outlays directed towards reforms. A comprehensive tax code overhaul will come into force in 2018, with the most promiment change the tax cuts for low-to-medium wages and a common tax base rate of 20% for all types of incomes. This is aimed at reducing income inequality and narrowing labour tax wedge gap with Estonia and Lithuania. Corporate profits will be taxed only when the profits are distributed – it is hoped this will improve transparency of financial flows (i.e., less motivation to hide true profitability), and improve risk assessment, investment activity, and long-term growth potential. Advance corporate income tax payments based on past profits, which unduly worsen the corporate financial situation during downturns, will be cancelled. This, alas, comes at a cost of more red tape. To clamp down on tax evasion, the reverse value-added tax regime will be extended to more business sectors. A massive 0.5% of GDP expenditure raise for the health sector is causing efficiency concerns. All this has been enacted into law.

**Various reform plans discussed, but 2018 general elections to hinder their enactment**

A wide range of other reforms are at various stages of completion. For instance, in 2017 start-up legislation has been inacted to foster innovation. Public service employment cuts of 2% per year till 2020 are expected to kick in to raise efficiency. School network optimisation is being discussed and regulations prepared to raise education quality and cut costs. Stakes of major state-owned companies are likely to be floated on the stock exchange to support financial sector diversification. In short, Prime Minister Kucinskis (in office since February 2016) has been more busy on structural issues than his predecessor.

The general election of October 2018, however, is turning against his reform agenda. We do not foresee economic policy taking a U-turn post election, but initiatives that are not yet enacted stand a slim chance in a pre-election year. With a new parliament and government in office only in late 2018, it will be too late to include major reforms in the 2019 budget. In 2019, the business cycle will have become cooler, making financing reforms more difficult.

While there is some slack in the labour market and active labour market policies would help, with current demographic trends and migration policy (e.g., immigration is largely still taboo) labour force is projected to continue declining. The labour market heatup is both cyclical and structural, and wage pressures will ensue, putting competitiveness at risk. Medium-to-long term growth will be set by productivity, which requires policies and an environment supportive of investment (i.e., capital deepening) and total factor productivity.

**Latvia's structural strength indicator falls farther behind those of key competitors**

**Business environment disappoints: quality gap againsts peers widens**

According to Swedbank's Baltic Sea index, which measures an economy's structural and institutional strength, Latvia's score has worsened. The gap with principal competitors – Estonia and Lithuania – has widened. Now, the standing is on par with Poland and above that only of Russia. Of the ten subindices that we monitor, only one has improved (governance, perhaps driven by the 2016 OECD accession), seven have worsened, and two remain unchanged (as data for these subindices are reported only every other year). Only the tax policy subindex evaluation stands above the region's average; the enterpreneurship subindex has slid down to the region's average. Poor, indeed, and the need for improvement is glaring across the board. More-detailed analysis shows that the key reason for the poor performance is not that Latvia has become worse, but that others have performed better, i.e., to climb up the ranks, improvements must be faster than those of others.

**Latvia: Swedbank Baltic Sea index 2017**


Source: Swedbank Research

Sure, the regained zeal of Kucinskis' cabinet to reform is not seen in the index yet due to the measurement lag, but other countries have not been sitting idle, either. So, politicians, hurry up! IMF estimates[6] suggest that better property rights and an upgraded legal system could improve Latvia's potential growth rate by 1 percentage point a year for four years. Certainly worth to give it a push! And this is only one area of possible improvement.

*Mārtiņš Kazāks*

[6] See IMF (2017), Republic of Latvia Selected Issues Country Report No.17/195.

# Lithuania: fading potential growth

**Lithuania enjoyed a year of strong economic growth due to the cyclical upswing in the global economy. Growth of consumer spending was strong in the beginning of the year but is starting to fade. Exports have been the primary driver of growth, showing double-digit expansion. Alas, this will not last – cost competitiveness is slowly eroding, while productive investments are still insufficient. Reforms need to accelerate.**

**GDP per capita, PPP (2016):**
76% of EU 28
**Next parliamentary election:**
October 11, 2020
**Next municipalities election:**
February, 2019

| Economic indicator | 2005-2015 | 2016 | 2017f | 2018f | 2019f |
|---|---|---|---|---|---|
| Real GDP growth, % | 3.1 | 2.3 | 3.8 | 3.5 | 2.5 |
| Consumer price growth, % | 3.3 | 0.9 | 3.7 | 3.3 | 2.5 |
| Unemployment rate, % | 10.6 | 7.9 | 7.2 | 6.8 | 6.5 |
| Gross nominal wage growh, % | 7.0 | 7.9 | 8.2 | 7.0 | 6.0 |
| Current account balance, % of GDP | -4.7 | -1.1 | -0.8 | -1.7 | -2.0 |
| General government budget balance, % of GDP | -3.3 | 0.3 | 0.1 | 0.5 | 0.2 |

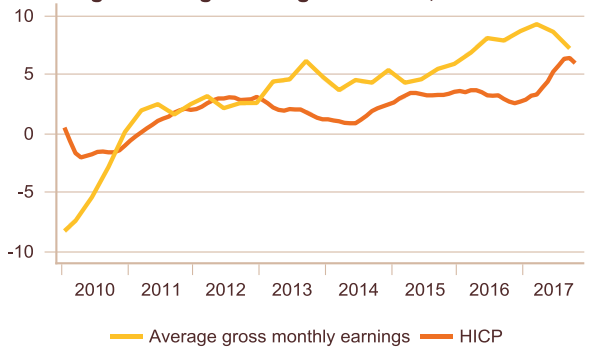
Source: Eurostat, Statistics Lithuania and Swedbank Research

**Very solid GDP and real wage growth despite high inflation**

### Economic growth in full swing

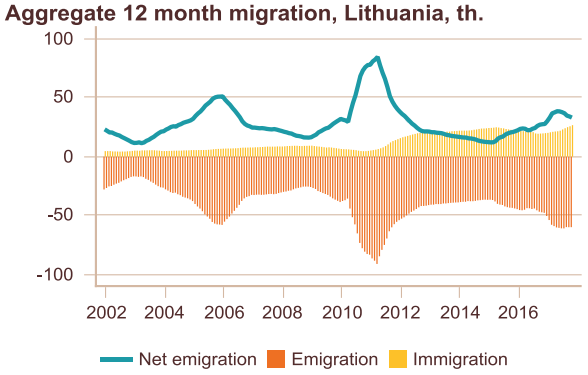
2017 has been a year of rapid growth, marked by very strong wage growth and high inflation. The minimum wage was increased multiple times in recent years and is now close to 50% of the mean wage; meanwhile, unemployment keeps falling, and participation and employment rates are at record highs. Couple this with a shrinking labour force and still-rather-restrictive immigration policies, and no one should be surprised with 9% wage growth. Naturally, some of the increased labour costs have translated into higher prices, especially in the services sector. Inflation is higher in Lithuania than in the rest of the euro area; average annual inflation will be close to 3.7% this year. Hikes in excise duties and the recovery of oil prices were the other main contributors to inflation. While inflation has eroded real wage growth, it still remained close to 6%. Some of the temporary factors will fade and inflation will ease next year, but labour shortages are likely to become more acute and wage growth will remain elevated, well above productivity growth.

**Annual growth of gross wage and HICP, %**




Source: Swedbank Research & Macrobond

**Aggregate 12 month migration, Lithuania, th.**




Source: Swedbank Research & Macrobond

**The results of labour and migration reforms are unclear**

### Structural reforms – some good ideas are in the air, but little progress yet

After long deliberation, the new labour code finally came into effect this summer. It is meant to align labour regulation better to the realities of the 21st century and allow for a more flexible and dynamic labour market. However, the impact of this new legislation is not observable yet as both businesses and institutions are attempting to grasp the new rules. We welcome most of the changes but do not think that they will be a game changer. Immigration reform, which promised to help solve the shortage of qualified labour is hanging in the air, at least for now. The government adopted the new rules in spring, but the number of people that received labour visas is even lower than last year; it is difficult to say if this is due to poor legislation or limited capacity and competence of the relevant institutions. Interestingly, immigration flows are increasing quite formidably this year, but most of these are repatriates or EU citizens who were not the target of the reform. Even with more relaxed rules and friendly policies of immigration, we are unlikely to see a surge of qualified immigrants, who usually can opt for richer EU countries with higher wages.

### BSI – progress stalled

In general, Lithuania's score and ranking did not change this year. The score remains 7.0, as does the ranking of seventh place in the region, Lithuania is still below the EU and region average and is hardly making any gains. There were gains in some areas, some red tape

was cut, and a few minor reforms were implemented that helped improve certain areas- entrepreneurship and tax policy, in particular - while in others the status quo was maintained and other countries overtook Lithuania, resulting in a marginally worse score.

To start off positively, the entrepreneurship score inched up in Lithuania. Most of the areas either stayed stable or saw a minor improvement. The reduction in the time to get a building permit and increased minor investor protection had the most positive impact on the sub-index, while the score for starting a business decreased somewhat. The final score for entrepreneurship is 7.8, 0.1 higher than last year.

The total score of the labour sub-index saw no change. Employment increased, riding the wave of the cyclical upswing, while productivity and labour market efficiency slightly deteriorated. It will be interesting to observe how this score develops in the future as the market adapts to the new labour code - the magnum opus of the last government.

**Significant improvement in tax collection due to adoption of electronic tax filing**

Probably the largest improvement was observed in the administration of taxes; the new system for electronical tax filing has greatly improved efficiency. The average time to pay taxes has dropped by 36% and now takes 109 days, compared with171 days before the reform. This resulted in a 10% increase in the score for tax policy to 6.6.

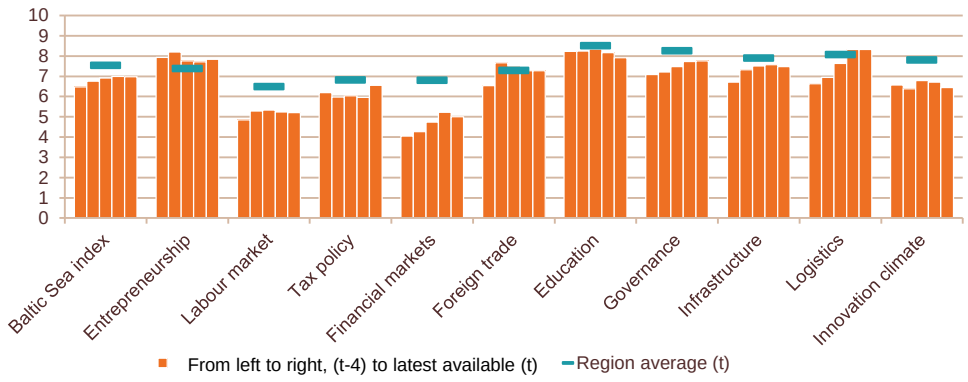
There were not any notable changes in either financial markets or governance. One dropped by 0.2, while the latter picked up by 0.1. Oddly enough, corruption perception deteriorated, while control of corruption increased, providing contrary insights. Maybe there is a chicken-and-egg problem present – more corruption scandals create an illusion that corruption is widespread, while in truth it is being rooted out. One indicator measures corruption by surveying the public, while the other attempts to capture the performance of control institutions by surveying experts and NGOs.

**Education & innovation scores keep worsening while government struggles to reform tertiary education**

Education and innovation are two other groups that saw a decline in the score. A relatively large share of population has tertiary education, but its quality is declining, according to the *Global Competitiveness Report*. The Ministry of Education is initiating a consolidation of universities and study programmes that, in theory, should allow the creation of higher-quality, more specialised, and better-financed universities. Currently, the future of the reform looks hazy, the progress of negotiations has been slow, and the final vision has not been decided. Unfortunately, the reform has elicited little enthusiasm from either the academic community or the parliament. Some incremental progress was recently made in reaching an agreement that provides a glimpse of optimism, but the finish line is not yet in sight. A common understanding exists that education is in bad shape, and there is pressure from society to take action, but difficulties have been encountered in consolidating different visions on the future of education. The problems with innovation largely stem from education. The lack of strong research institutions affects the innovation output. Institutional support to researchers in obtaining capital, research facilities, and know-how to ensure EU funds could provide a much-needed boost.

The government has plenty of reasonable ideas for structural reforms – from consolidation of higher education institutions, leaner governance, and a more efficient public sector in general, to tax reform and more flexible immigration policies. Unfortunately, the government's ideas are not always supported in the parliament, where the ruling coalition has a slim majority and conflicting views. Economic growth remains healthy, public finances will be in surplus next year (three years in a row), and foreign trade is balanced. But due to the rapidly shrinking and ageing society, potential growth now is below 3.0% and future convergence towards EU average will be very slow. Like last year, and the year before last year, and the year before that – reforms cannot wait.

**Lithuania: Swedbank Baltic Sea index 2017**




Source: Swedbank Research

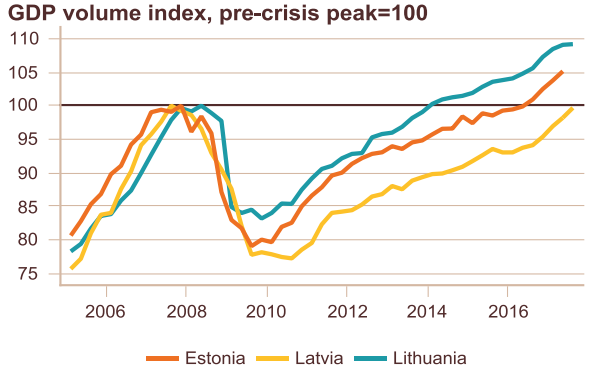
*Nerijus Mačiulis*
*Vytenis Šimkus*

# The Baltic economies: productivity is the key to further income convergence

**Real income per capita convergence continues…**

**Ten years after the start of the crisis, all the Baltic economies have reached or surpassed their pre-crisis peak size.** Given the deepness of the recession – the peak-to-trough decline in the GDP volume varied between 17% in Lithuania and 23% in Latvia – it took many years for the countries to return to the peak GDP levels seen in 2007-2008. The recession in Lithuania and Estonia ended in late 2009, and the countries managed to surpass their boom-time GDP volumes in 2014 and 2016, respectively. Latvia is lagging behind its peers as the recession there was the longest, lasting three years, with the economy returning to growth only in late 2010. Seven years later the losses have been pared, and the size of the economy is going to exceed the peak level at the end of 2017.

**GDP volume index, pre-crisis peak=100**




Source: Swedbank Research & Macrobond

**Export of goods & services, % of GDP**

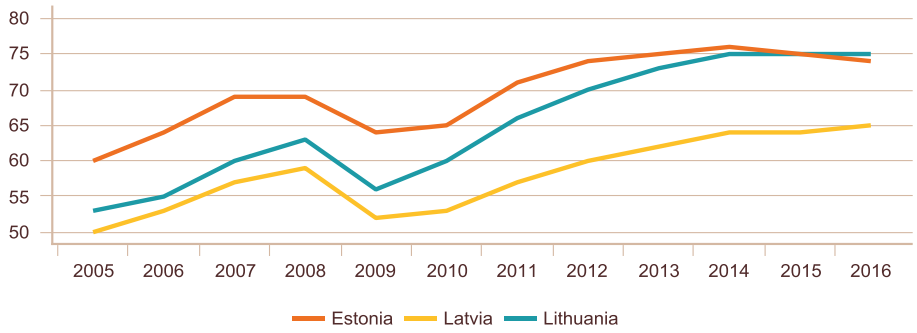

Source: Swedbank Research & Macrobond

**…but it has slowed post-crisis raising concerns about middle-income trap**

**Exports of goods and services were the main driver of recovery, increasing economic openness.** The painful price-and-wage correction improved competitiveness, allowing the economies to take full advantage of the opportunities offered by increasing external demand in the aftermath of the global recession. The recovery was facilitated by the increased trade openness of the economies – crucial to medium-term growth in the Baltics, provided that depopulation trends continue. The ratio of exports to GDP has increased sharply (17-25 percentage points since 2009), pulling along the manufacturing sector and business services; i.e., in Estonia, the share of the ICT sector, in Latvia, that of professional and scientific services, and in Lithuania, the ratio of transport services to GDP have, respectively, increased the most (in percentage points) since the trough. The rebound in consumption has somewhat raised the importance of the retail and wholesale trade in the economy.

**The income gap with the wealthier part of the EU is narrowing too slowly, raising concerns about getting stuck in the middle-income trap.** The speed of convergence has slowed in the aftermath of the recession. Although the pace most likely picks up in 2017-2018 as the Baltic economies ride the cyclical upswing wave, growth will moderate towards 2019, and convergence will slow going forward unless significant structural improvements to the economy are made. Considerable productive investments, improved efficiency, and structural improvements (e.g., to the education, health care, and judicial system; regional reform) are necessary to avoid the middle-income trap.

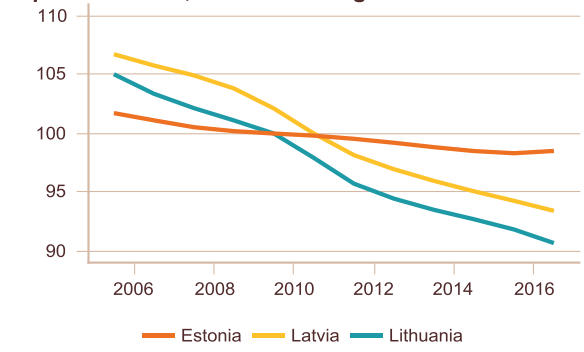
**Real GDP per capita in PPS (EU28=100)**




Source: Swedbank Research & Macrobond

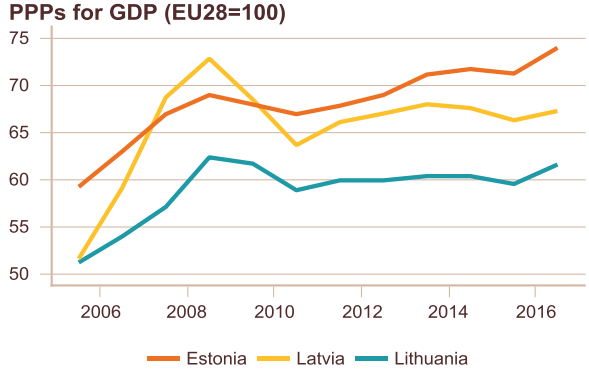
**In the post-crisis period, Lithuania appears to have done the best job in increasing its comparable material welfare, catching up with Estonia.** Real GDP per capita, adjusted for purchasing power, has increased to 74-75% of the EU28 average in Estonia and Lithuania, and 65% in Latvia. Latvia's per capita income difference with Estonia has narrowed, while it has widened with Lithuania, compared with the bottom of the previous business cycle.

**Population index, recession trough=100**




Source: Swedbank Research & Macrobond

**PPPs for GDP (EU28=100)**




Source: Swedbank Research & Macrobond

**Lithuania has delivered the fastest income convergence, catching up with Estonia…**

**Lithuania's progress can be explained by depopulation, coupled with greater productivity gains and stagnant price convergence.** The underlying factors are too controversial for us to confidently call it a success story. On the one hand, the outcome may be largely technical (i.e., diminishing population) and might come at the expense of medium-term growth. On the other hand, Lithuania has seen faster productivity growth since the trough than the other Baltic countries, especially Estonia.

**Depopulation has largely been a technical, short-term convergence trigger at a long-term cost.** All three Baltic economies have been growing at the same rate on average – about 3.3% (real GDP growth) per annum since the bottom of the crisis. However, the real GDP per capita growth has been considerably faster in Latvia and Lithuania (4.5-4.7%), as their population has been falling at an annual rate of about 1.1-1.4% compared with a mere 0.2% in Estonia. The difference is largely explained by emigration flows – these have been smaller in Estonia due to proximity of Finland (within a commuting distance, providing opportunity for pendulum migration). The depopulation has been mostly driven by an economically inactive population, especially the youth cohort. Hence, these trends have not significantly hindered overall economic activity in the short term and, in fact, have technically improved per capita income. However, the brain drain dents economic potential and lowers future growth.

**Average annual growth rate, recession trough-2016**

(EE, LT: 2009, LV: 2010)

| | Estonia | Latvia | Lithuania |
|---|---|---|---|
| Real GDP | 3.3% | 3.3% | 3.3% |
| Real GDP per capita | 3.5% | 4.5% | 4.7% |
| Real GDP (PPP)* | 4.5% | 4.8% | 5.4% |
| Real GDP per capita (PPP)* | 4.8% | 6.0% | 6.9% |
| Real labour productivity | 1.8% | 2.3% | 2.6% |
| Population | -0.2% | -1.1% | -1.4% |

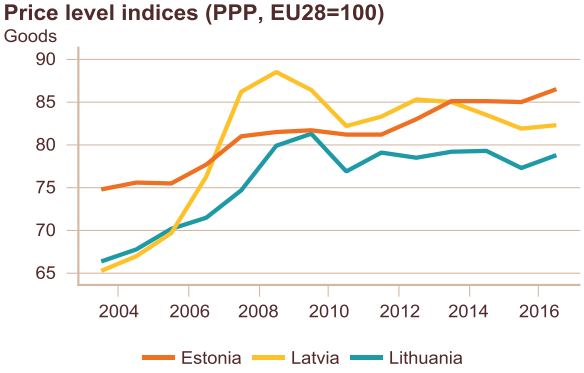
* relative to the EU28

Source: Swedbank Research & Eurostat

**…but some factors are transitory**

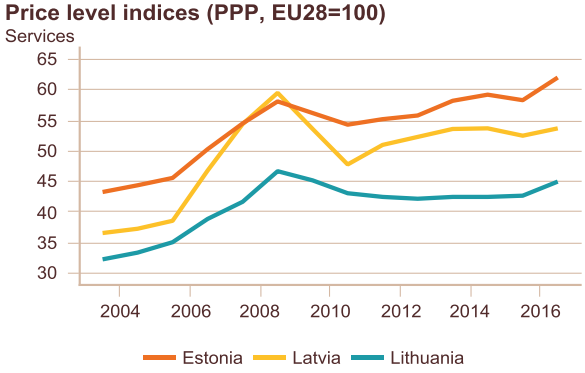
**Stagnant price convergence has boosted Lithuania's relative purchasing power, but the trend is likely to change in the medium term.** Lithuania's relative GDP deflator, adjusted for purchasing power (PPP for GDP), was at 62% of the EU average in 2016, unchanged from 2009. The relative goods price index in Lithuania has actually decreased, while the service price index has not changed much from the trough to 2016. Latvia has seen weak price convergence (67% of the EU average in 2016 vs. 64% in 2010), with converging relative service prices and unchanged goods prices. Estonia has come a longer way since the trough with respect to narrowing the relative price gap to the EU average, standing at 74% in 2016 (68% in 2009). Provided the economic integration continues and market efficiency improves further in the EU, the price equalisation of the Baltics relative to the EU will continue. In the medium term, the relative price level will likely be growing faster in Lithuania and, to a lesser extent, also in Latvia, slowing the real income convergence to the EU average in these countries compared with Estonia.

**Price level indices (PPP, EU28=100)**




Source: Swedbank Research & Macrobond

**Price level indices (PPP, EU28=100)**

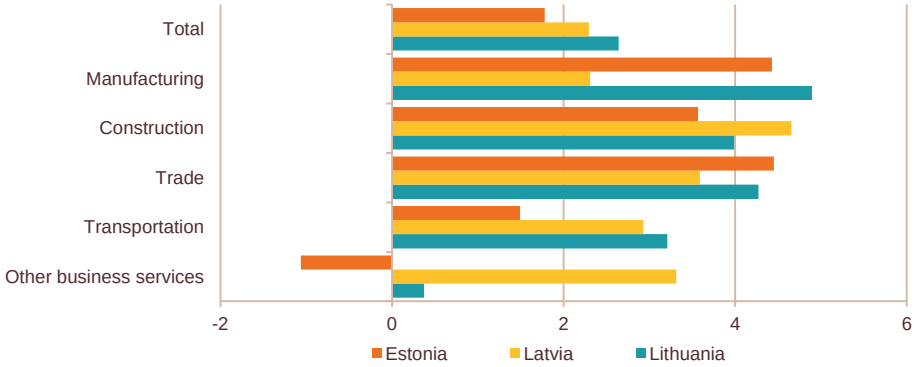



Source: Swedbank Research & Macrobond

**Key to sustainable convergence is productivity and structural reforms**

**Lithuania has been the leader in labour productivity gains within the Baltics since the trough.** Productivity (measured as the value added to total hours worked) growth has been the fastest in Lithuania, i.e., 2.6% per annum since the trough, while in Latvia and Estonia it was 2.3% and 1.8%, respectively. Despite falling population, the number of employed and the hours worked were, in fact, increasing in all the Baltics. The productivity gains in Estonia and Lithuania were largely driven by producing industries, while Latvia saw also a decent increase in business services sector productivity. (Note to the graph: Labour productivity growth in manufacturing appears slower in Latvia because this rebounded strongly on increasing external demand in all the Baltics in 2010, before the recession trough in Latvia.)

**Annual average labour productivity growth since the trough, %**




Source: Swedbank Research & Eurostat

**Only productivity growth and structural improvements to the economy can foster a steady catching-up of real per capita income.** All the Baltic countries have recovered from the recession and narrowed the relative income per capita gaps with the EU. Lithuania has been the front-runner and surpassed Estonia, benefitting from slower price convergence and a more pronounced population decline since the bottom of the recession. However, the effect from these factors is likely transitory. In the medium term, in addition to brain drain, the population decline will trigger employment reduction, negatively affecting economic activity. The relative price levels, adjusted for purchasing power, will start growing faster (already happening in 2017), slowing the pace of real income per capita convergence. The key to successful income convergence and insurance against the middle-income trap is productivity growth and structural improvements to the economy.

*Agnese Buceniece*

# Sustainable development in the Baltics and Sweden: where do we stand?

**There is an increased focus globally on sustainable development and the UN 2030 Agenda. Sweden scores better than the Baltic countries with regard to sustainability principles; however, both Sweden and the Baltics have to do their homework to promote robust, socially inclusive, and environmentally friendly growth in the medium term and to contribute better to the UN Sustainable Development Goals.**

**Increasing focus on sustainable development globally**

Both Sweden and the Baltic countries are experiencing a cyclical upswing and growth rates are very strong. But how inclusive is this growth? What are the structural preconditions for higher and sustainable economic growth in the medium term? What does increased focus on sustainable development globally mean for companies in Swedbank's home markets? In this report, we look into these questions through the prism of the UN Sustainable Development Goals (SDGs). The results presented here are preliminary and are to be developed and analysed further, given the increasing importance of the topic. These results are complementary to our Baltic Sea index (BSI), giving another perspective to structural qualities of the economies.

**Increasing focus on sustainability issues both on micro and macro levels…**

Sustainability and sustainable development is a hot topic worldwide. Investors increasingly look at ESG (environmental, social, governance) criteria and integrate them into their investment decisions. There is a push from new regulations, such as mandatory ESG disclosure for large companies in the EU[7] and global agreements, like the Paris climate agreement. An increasing number of ESG ratings/indices for companies and funds are being introduced and developed, and sustainability criteria are being integrated into business decisions, products, and processes. About 26% of all professionally managed assets globally are considered to be managed under responsible investment strategies. In the US, about 22% of managed assets use responsible investment strategies; in Europe, this share is 53%.[8] New financial instruments, like green bonds to finance environmentally friendly projects, are being developed, and their use is accelerating, while major rating agencies are developing frameworks to rate them.

Neither sustainability reporting nor general awareness of these issues is as yet developed in the Baltics as in Sweden (which, in many instances, is among the leaders in the EU). However, large exporting companies (especially those with foreign ownership) have already established ESG disclosure in some way, feeling the pressure either from the owners/parent companies or the clients. The Baltic countries must also comply with relevant EU directives on issues like renewable energy, emission reduction, etc. Green bonds are increasingly issued both in Sweden and the Baltics, more so from the private sector, but also from the municipalities in Sweden.

**… partly driven by new regulations and agreements**

A new push and a framework to tackle climate change and social challenges globally are coming from the UN 2030 Agenda for Sustainable Development that was adopted by the world leaders in September 2015 and came into force on January 2016. The framework consists of 17 SDGs, comprising a total of 169 targets and 232 indicators to be monitored at the country level. The goals focus primarily on three core elements: economic growth, social inclusion, and environmental protection. The SDGs are not legally binding; however, countries are expected to take ownership and establish a national framework for achieving the 17 goals. Countries are also primarily responsible for follow-up and review. The UN 2030 Agenda is also promoted on the EU level, building on the EU 2020 Agenda.

Authorities in all four countries have already started to translate the SDGs into their respective national contexts and are developing monitoring and reporting frameworks. Estonia already published its first assessment and review of the implementation process in 2016, Sweden has done so this year, and Latvia's and Lithuania's are due next year. Statistics are also being compiled and developed on the European level; however, data availability is still limited for some SDGs, especially for environmental indicators.

[7] Directive 2014/95/EU. Large public interest companies with more than 500 employees are required to include nonfinancial statements in their annual reports as of 2018 on the policies they implement in relation to environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery, and diversity on company boards. This directive will affect approximately 6,000 large companies and groups across the EU, including, e.g., listed companies, banks, and insurance companies. It is estimated that currently only about 2,500 large companies in the EU (out of about 42,000) formally disclose nonfinancial information on a yearly basis.

[8] Global Sustainable Investment Alliance (2016), Global Sustainable Investment Review, available here.

**The 17 Sustainable Development Goals**


Source: UN.

**SDGs as a point of departure to assess sustainable development**

**Still many areas to work on in Sweden and the Baltic countries**

Some research has been already conducted in this area, e.g., by the OECD, focussing closely on the indicators suggested by the UN and/or available proxy indicators to assess how far countries are from the 2030 goals; however, it is not yet available for all our four countries. Since our aim is a broader assessment of sustainable development in Sweden and the Baltics, we choose a somewhat more flexible approach, but still take the 17 goals as a point of departure. We interpret the goals based on our countries' national strategies and priorities, selecting indicators that, we believe, are the most relevant.[9] The range of indicators is limited, though, by insufficient data availability for some of the goals. Also, national monitoring frameworks (including particular indicators) are still being developed.

We selected 40 indicators covering 15 out of 17 SDGs[10] and grouped these into four sustainability pillars:

- **Growth** or, rather, structural preconditions for sustainable medium-term growth (14 indicators), such as education, innovation, labour force participation, and sustainable cities (contributing to SDGs # 4, 8, 9, and 11);
- **Social inclusion** (11 indicators), such as inequality and poverty, and health (SDGs # 1, 2, 3, 5, and 10);
- **Environmental protection** (7 indicators), such as energy intensity, emissions, renewable energy, and waste generation (SDGs # 6, 7, 12, and 13); and
- **Governance** (8 indicators), such as government effectiveness, rule of law, corruption perception, regulatory quality, and official development assistance (SDGs # 16 and 17).

To assess and compare progress in these areas we use EU28 90th or 10th percentiles,[11] depending on whether a maximum on minimum is relevant, for 2015 (the year when the UN 2030 Agenda was set) as a benchmark and calculate how far our countries have come towards the benchmark. We should keep in mind, though, that, due to income level differences, these benchmarks are more ambitious for the Baltics than for Sweden, at least in some areas. For certain indicators, country-specific numerical targets for 2020 or 2030 have already been assigned (either on a UN, EU, or national level). In most cases, these targets are less ambitious than those imputed by the percentile-benchmark approach; however, for six indicators national-level/UN-level targets are actually more ambitious than the percentile benchmark.[12] For comparability reasons, we stick to the percentile benchmark even when numerical targets are available, since otherwise less ambitious targets would improve the results for some countries, while others would be "punished" by using the more ambitious percentile benchmark.

**Sweden at 100% of the benchmark in 17 indicators out of 40; worst scores in environment**

Sweden scores better than the Baltics on most indicators and reaches nearly 90% of the benchmark for the social inclusion and growth pillars, almost 100% for the governance pillar (very similar to our BSI results), and about 80% for the environmental protection pillar. Overall, in 17 indicators out of 40, Sweden is already at 100% of the benchmark. Despite high scores for social inclusion, the situation with respect to income inequality and poverty

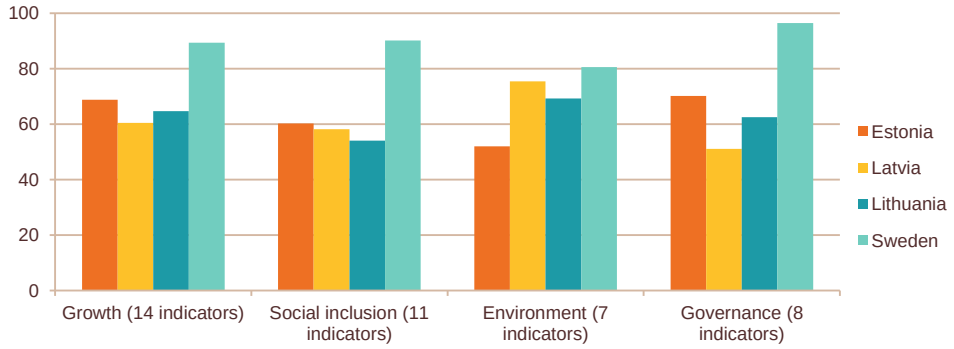
[9] Many of these are also included in the Social Scoreboard of the European Commission, available here.
[10] We could not find reliable or sufficiently recent data for Goals 14 and 15. The full list of the indicators are available at the end.
[11] OECD uses a similar approach in its analysis.
[12] These are area under organic farming, share of women in parliaments and large companies' boards, share of renewable energy for Sweden and Latvia, employment rate for Sweden, and R&D expenditure.

has been worsening in the last few years. As for the growth pillar, for some education indicators, such as early leavers, low achievers, and tertiary education attainment, Sweden actually lags some of the Baltic countries. In the environmental protection pillar, the largest improvements are necessary in the areas of resource productivity and waste generation, which pull down otherwise good results. In the governance pillar, scores have actually diminished somewhat in recent years, although remaining very high.

**Estonia scores worst in environment protection; Latvia, in governance; Lithuania, in social inclusion**

Among the Baltic countries, the largest differences are for the governance pillar, with Latvia scoring worst on most of the indicators, reaching only about 50% of the benchmark. Estonia leads with 70%. The smallest differences are for the social inclusion pillar, with all Baltic countries reaching about 60% (with a small decrease for Lithuania in 2015). Gender inequality seems to be a larger challenge for Estonia than the other Baltic countries, while Latvia and Lithuania struggle most with severe material deprivation rates. The latter is actually a bit puzzling, given that their risk-at-poverty rates are similar to Estonia's and might be subjective (this is a self-evaluation by households). Latvia scores rather badly on maternal mortality as well. As for the growth pillar, Latvia scores worst once again, with 60%, while Estonia reaches nearly 70%. Within this pillar, innovations (patents per capita and R&D expenditure) and lifelong learning for adults constitute the most pressing problems for both Latvia and Lithuania. While Estonia invests more in R&D, the number of patents per capita is actually the smallest there. The Swedbank BSI, which takes more factors into consideration, shows better results for Estonia than Lithuania or Latvia in innovation climate. Due to limited data availability, the environmental protection pillar is the trickiest to draw conclusions from, but the Baltics appear to reach 60-70% of the benchmark. Estonia scores worse on many indicators due to its polluting shale oil industry.

**Four sustainability pillars, % of benchmark***




* Benchmark for each indicator is fixed ar 90/10th percentile of EU28 in 2015 (depending on whether max or min is relevant)

Source: Swedbank Research and Macrobond

**Ambitious but feasible targets?**

If we make the 90/10th EU28 percentiles in 2015 the targets for 2030 for the countries, a 60-70% score implies a necessary improvement of 2-3% per year in order to achieve these targets by 2030. During 2007-2015, the average improvement for the Baltics was 3% per year for the growth pillar, 0-1% for the social inclusion pillar, and 1-4% for the environment protection pillar. During the last four years, the average improvement for the governance pillar was about 2-3%. This shows that attaining the benchmarks is feasible in some areas and very challenging in others. Some of the low-hanging fruit have been already picked, and maintaining the pace might be difficult and quite costly. For Sweden, already at 80-97% of the benchmark, the target is much less challenging; however, complacency would be a mistake. Note that, for the governance pillar, Sweden has experienced an average annual decline of 1% during the last four years. Moreover, some of Sweden's national targets (e.g., with respect to gender equality or reduction in emissions) are actually more ambitious than the percentile benchmark, implying that much work remains to be done.

**Think about micro impact when achieving macro goals**

**Implications for policy makers**

Many of the bottlenecks and/or existing structural problems that this analysis points to are nothing new; we have been talking and writing about them for years. There have also been policy actions aimed at dealing with these issues (we can see improvements in institutional quality, higher participation rates, reduced emissions, and increased recycling, etc.), although these have maybe sometimes been patchy or inconsistent over time. However, progress in some areas is still lagging (e.g., innovations in the Baltics), or the trend has changed recently (e.g., the increase in income inequality in Sweden). It is clear that all countries should promote sustainable development and contribute to the SDGs. Ambitious goals are good, but they should also be feasible. For instance, promoting renewable energy or increasing social protection to reduce income inequality can be costly. In some cases, sustainability and competiveness can constitute a trade-off for policymakers. It is thus crucial to think about market structures, micro impact, and incentives, while taking on and implementing macro goals, to avoid the risk of ineffective investments and reduced competitiveness – e.g., due to poorly designed support schemes for green energy or to investment made in excessive infrastructure only to utilise available EU funds.

**Increased pressure for sustainability analysis on corporate level**

**Implications for companies**

The ESG framework has become mainstream globally (even more so in Europe), and large companies no longer have the option to stand aside. Sustainability reporting and disclosure will increase and develop; this has already become an industry standard for large companies (especially international ones). Integrating sustainability practices into business operations can help create value for companies, e.g., via cost savings (energy), potential increase in revenues (on account of sustainable product innovation, access to new markets, and productivity growth), the building of intangible value (brand image and improving employee satisfaction), and improved risk management (legal claims and reputational risks). There is some evidence of a positive impact of sustainability practices on competiveness and the financial performance of companies,[13] although the research has been mixed so far. Sometimes, sustainable standards, such as an Forest Stewardship Council (FSC) certificate for wood products, are even a basic necessity, without which producers cannot sell their product to many companies. Large companies developing their sustainability frameworks will increasingly ask for sustainability analysis from their smaller suppliers.

While it means a somewhat heavier regulatory/disclosure burden, it should lead to larger transparency and to new business and investment opportunities. For instance, new financing opportunities like green bonds are increasingly available, the renewable energy and recycling industries are growing, demand for eco- and environmentally-friendly products and services is increasing.

*Lija Strašuna*

**Research used**

UN Sustainable Development Knowledge platform, https://sustainabledevelopment.un.org/

OECD (Jun 2017), Measuring Distance to the SDG Targets: an assessment of where OECD countries stand), available here

European Commission (Nov 2016), Commission communication on the next steps for a sustainable European future, available here

Eurostat (2017), Smarter, greener, more inclusive? Indicators to support Europe 2020 strategy, available here

Eurostat (Nov 2016), Sustainable development in the EU, available here

[13] A nice review by Arabesque (a global asset management firm that uses self-learning quant models and big data to assess the performance and sustainability of companies) here

| List of indicators | % of benchmark (2015 or latest available) EE | LV | LT | SE | Benchmark | SDG |
|---|---|---|---|---|---|---|
| **Growth** | 69 | 61 | 65 | 89 | | |
| Adult participation rate in learning (25-64 yrs, education or training in the last 4 weeks)* | 75 | 35 | 29 | 100 | 20.9 | 4 |
| Early leavers from education and training (% of 18-24 population)* | 48 | 53 | 100 | 71 | 5.3 | 4 |
| Employment rate (20-64 yrs), %* | 100 | 96 | 98 | 100 | 76.6 | 8 |
| Low achievers in basic skills | 100 | 77 | 58 | 71 | 14.4 | 4 |
| Material recycling, % of municipal generated waste | 53 | 53 | 62 | 89 | 53.8 | 9 |
| NEET rate, 15-24 yrs* | 68 | 55 | 66 | 95 | 6.2 | 8 |
| R&D expenditure, % of GDP* | 44 | 15 | 25 | 100 | 2.9 | 9 |
| Tertiary educational attainment (% of 30-34 population)* | 87 | 82 | 100 | 98 | 52.3 | 4 |
| Share of high-tech exports in total exports, % | 75 | 48 | 37 | 66 | 20.5 | 9 |
| Patent applications, residents (per capita) | 9 | 28 | 14 | 84 | 0.0002 | 9 |
| Rooms per person* | 79 | 59 | 74 | 84 | 2.0 | 11 |
| Households - level of internet access, %* | 94 | 84 | 79 | 100 | 91.3 | 11 |
| Participation rate for older persons, 50-64 yrs* | 100 | 97 | 100 | 100 | 75.4 | 8 |
| Air pollution, nitrogen oxides (kg per capita) | 54 | 68 | 66 | 95 | 12.5 | 11 |
| **Social** | 60 | 58 | 54 | 90 | | |
| Area under organic farming, %* | 100 | 94 | 53 | 100 | 14.3 | 2 |
| Gini index* | 77 | 73 | 68 | 91 | 25.1 | 10 |
| Severe material deprivation rate, %* | 53 | 19 | 18 | 100 | 2.5 | 1 |
| Risk-at-poverty rate, % (after social transfers)* | 57 | 56 | 56 | 76 | 12.3 | 1 |
| Maternal mortality ratio, % | 41 | 21 | 37 | 93 | 0.004 | 3 |
| Healthy life years at birth /women | 83 | 80 | 87 | 100 | 67.6 | 3 |
| Healthy life years at birth/ men | 82 | 79 | 82 | 100 | 65.7 | 3 |
| Income quintile ratio S80/S20* | 64 | 58 | 51 | 84 | 3.6 | 10 |
| Share of women in national parliaments* | 65 | 40 | 54 | 100 | 39.5 | 5 |
| Share of women in the boards etc* | 30 | 96 | 48 | 100 | 29.6 | 5 |
| Gender pay gap (unadjusted) | 22 | 35 | 42 | 43 | 6.0 | 5 |
| **Environment** | 52 | 75 | 69 | 81 | | |
| Energy intensity (energy consumption, % of GDP) | 26 | 44 | 44 | 82 | 90.6 | 7 |
| GHG emissions intensity of consumption (GHG emissions per consumption unit) | 93 | 91 | 75 | 94 | 78.5 | 12 |
| Resource productivity (GDP per domestic material consumption) | 25 | 24 | 44 | 44 | 3.4 | 12 |
| Share of renewable energy in gross final energy consumption, % | 83 | 100 | 75 | 100 | 34.4 | 7 |
| Share of the population connected to at least secondary urban wastewater treatment, 2005-15 (%)** | 86 | 69 | 75 | 90 | 96.9 | 6 |
| GHG emissions per capita | 43 | 100 | 85 | 100 | 5.9 | 13 |
| Generation of waste*** | 10 | 99 | 88 | 52 | 989.3 | 12 |
| **Governance** | 70 | 51 | 62 | 97 | | |
| Official development assistance as share of gross national income*** | 24 | 13 | 18 | 100 | 0.8 | 17 |
| Transparency International corruption perceptions index*** | 81 | 66 | 68 | 100 | 86.2 | 16 |
| Worldwide governance indicators (Voice and Accountability)*** | 78 | 56 | 64 | 97 | 1.5 | 16 |
| Worldwide governance indicators (Political Stability and Absence of Violence)*** | 66 | 37 | 76 | 94 | 1.0 | 16 |
| Worldwide governance indicators (Government Effectiveness)*** | 61 | 55 | 60 | 99 | 1.8 | 16 |
| Worldwide governance indicators (Regulatory Quality)*** | 93 | 59 | 63 | 100 | 1.8 | 16 |
| Worldwide governance indicators (Rule of Law)*** | 63 | 48 | 52 | 100 | 2.0 | 16 |
| Basel AML index**** | 94 | 81 | 98 | 85 | 3.6 | 16 |

* latest available 2016

** latest available 2013 for Latvia, 2014 for Sweden and Estonia

*** latest available 2014 (bechmark is also fixed at 2014)

**** latest available 2017 (published, data from earlier years)

Note: Relative colour scaling visualizes results from lowest (dark red) to highest (dark green)

# UBI – utopia or an urgent necessity?

**What is common to the 16th century writer, Thomas More, a Republican President, Richard Nixon, and an entrepreneur, Mark Zuckerberg? Not much, at first glance. Dig deeper and you will find that they were all (or still are) proponents of basic income, or unconditional cash payments for all citizens or residents of a specific country. This idea, first expressed by Thomas More and almost implemented by Richard Nixon in the US in 1968, has recently grown in popularity worldwide. The idea resonates well also among EU voters – in an EU-wide survey from 2016, 64% of respondents supported the idea,[14] while Finland started experimenting with its implementation this year. The discussions on this concept, universal basic income (UBI), are picking up steam also in the Baltics. Here, we shed light on the pros and cons of UBI and try to estimate whether the Baltic countries could afford it.**

**Revival fuelled by fear and discontent**

**Fears of automation and globalisation behind the revival of UBI**

The recent growing interest in UBI has been fuelled by rising fears of job losses due to automation and globalisation, as well as the growing inequality of income and opportunity across some advanced economies. The increasing discontent among citizens who have lost out to automation and globalisation and the rise of the precariat, the so-called new deprived social class facing insecurity and underemployment,[15] pose a considerable threat to political stability and democratic values, as indicated by the recent election outcomes in the US, the UK, and some other EU countries. The proponents of UBI argue that greater income security via this measure could be a possible solution to these problems and could help tame voter discontent and prevent them from supporting populists.

**Current social support systems disrupt motivation to work and are out of date**

However, there are additional arguments in favour of UBI related to the inefficiencies of the existing social support systems. There is a growing concern that the existing means-tested social support schemes disrupt people's motivation to seek employment and, thus, have a negative effect on the labour markets, economic development, and public finances. The disincentives to work emerge because people lose most of the benefits as they enter employment. For example, in 2015, in Latvia and Lithuania, over 80% - and, in Estonia, around 63% - of the gross earnings of a person moving into low-wage employment was taxed away by the combined effects of the withdrawal of benefits and higher tax and social security contributions. [16] Moreover, enrolment into social support schemes is often burdensome and time-consuming, and the conditions attached to the support are often viewed as degrading. The existing social protection systems also seem to be outdated and no longer meet the demands of the modern labour market, as evidenced by the growing popularity of "gig jobs" and self-employment, and thus may not be effective at reaching those in need of support.

**Current systems have created armies of bureaucrats and are costly to sustain**

Some also argue that the current complicated social protection systems have created armies of bureaucrats and the wasting of taxpayer money on non-productive activities, while simple UBI payments to all would eliminate the need for bureaucrats in the distribution process. This argument rings a bell also in the Baltic countries. However, data show that the administration costs of social spending in the Baltics are relatively small – in Latvia and Estonia, they account for 1.2-1.4%, and, in Lithuania, for 2.1%, of total expenditure on social protection--and are below the EU average. However, Lithuania is less efficient in managing and administering social support than the other two Baltic countries – in 2015, Lithuania spent EUR 46.7 per capita on administration of social support schemes, compared with EUR 26 in Latvia and EUR 27.6 in Estonia.[17] This could also be related to the fact that Lithuania has a somewhat larger share of social benefits that are means tested, which possibly complicates the administration of the system.

**UBI would make the system simpler, more reliable and accessible**

A UBI-based system would most likely be simpler, more reliable, and more accessible than the existing social protection systems. The proponents of UBI argue that it would also have a positive effect on the labour market by reducing the unemployment trap and the low-income trap, since, as support would not be phased out when incomes rise above a certain threshold, more people would thus be brought into employment. UBI would provide greater income security and thus people could more actively engage in activities that do not yield instant monetary gains, such as starting a business, retraining, and engaging in education – a very important positive aspect in an age when digitisation and automation are rapidly changing the requirements for workers' skill sets.

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[14] http://basicincome.org/news/2016/05/europe-eu-poll-basic-income-support/
[15] Guy Standing (2014), "The Precariat: The New Dangerous Class."
[16] Recently, steps have been taken in all three Baltic countries to lower taxation of low-income earners; thus, the unemployment traps should be smaller in 2016-2018.
[17] For Estonia, latest available data on administration costs are for 2014.

**Utopia that would not work in practice?**

**Still little knowledge of possible side-effects of UBI**

However, the expected positive effects of UBI on the labour market and the economy are by and large based on wishful thinking rather than hard facts. As there have been very few cases where UBI (or something similar) has actually been introduced, there is little knowledge of how it would change recipients' employment behaviour. The opponents of this idea argue that guaranteed income would reduce work incentives and thus have adverse effects on the labour market and the economy, and ultimately undermine the funding of UBI. This possible effect cannot be ruled out – research by Calnitsky and Latner (2017)[18] found that a basic income introduced as an experiment in Dauphin, Canada in 1975-1977 generated a reduction in labour market participation of 11.3 percentage points.

**UBI may reduce participation – not necessarily bad for the economy over long run**

However, the same study found that the incentives behind the participants leaving the labour force were largely related to other factors than simple leisure maximisation, such as limited employment opportunities, involvement in care work, disability, old age, illness, or educational investment. Thus, it is likely that, with basic needs secured outside the market, people would become more picky about jobs and work conditions, and would possibly choose to spend more time with family, or engage in non-paid care work or charitable activities. This outcome would not necessarily be bad for the economy over the long run. According to Calnitsky and Latner (2017, p. 20), "these alternate activities may be highly socially productive and may improve our collective well-being, even though, as sources of wealth, they are not tracked well by conventional income statistics."

**Equal UBI for all could contribute to rising income inequality**

Another argument often expressed by those opposing UBI is that equal transfers to all would make the system highly regressive, as those in greater need, e.g., the poor, the disabled, or the unemployed, would receive the same level of support as those in lesser or no need of support, which would contribute to rising inequality. Taxation of UBI alongside other incomes could alleviate some of these concerns; however, taxation of UBI could undermine the simplicity aspect of the idea. Guy Standing, an economist and a leading advocate of UBI, argues that, as UBI should be the right of every person, only income above UBI should be taxed. Moreover, he argues that this sum should be free of creditor or tax authorities' claims or of any fines.[19]

**UBI could reduce incentives to pay taxes and undermine the funding of the system**

The opponents also worry that uncoupling the social benefits and pensions from contributions may have adverse effects on incentives for paying taxes and could thus expand the shadow economy and encourage tax avoidance. The Baltic countries do not have to search long for evidence in favour of this argument – the Soviet slogan "from each according to his ability, to each according to his needs" did not work very well in practice. Thus, the risk of reduced incentives for paying taxes could be a serious drawback of such a system and could eventually undermine its funding.

**No best practices to follow in implementing UBI**

Some also worry that the idea looks good on paper but would be very difficult to implement in practice. Designing UBI would require making crucial decisions, which would be costly to reverse, and there are almost no best practices that could be followed in this process. First of all, who would be eligible for UBI – the citizens or the residents of a specific country? In the latter case, concerns may arise about how social migration would be controlled and whether this would be compatible with the free movement of people in the EU.

**No easy answers for designing UBI system**

Second, should UBI be distributed evenly to all, or should it be age dependent (e.g., less for children, more for the old)? How high should it be set? Some even question the very concept of "basic needs" that UBI should cover. This concept may evolve considerably over time, with pressures on financing the ever-larger basic needs mounting.[20] Should UBI be taxed or not? Should all social assistance programmes be replaced fully with UBI, or should there be additional benefits available to those with limited work capacity, e.g., the disabled or the old? The latter option would go against the arguments in favour of smaller government and cost saving.

Moreover, how would UBI payments evolve over time? Should UBI be automatically linked to some official indicators, e.g., inflation, median disposable income, or average wage developments? Or should the size of it be left to politicians to adjust regularly? The latter option would put a tool into politicians' hands that could be wielded in a populist manner and used to implement fiscally unsustainable decisions. These questions may seem technical, but the success of this measure would depend on these details, and reaching a political agreement on them would not be easy.

**UBI would be low with current spending levels**

**Affordability of this measure is the most problematic aspect**

But even if agreement is reached, affordability of this measure may still be problematic, especially in the Baltic countries, which tend to have relatively small social security budgets.

[18] C. Calnitsky and J.P. Latner, (2017), „Basic Income in a Small Town: Understanding the Ellusive Effects on Work."
[19] Guy Standing (2017), „Basic Income: And How Can We Make It Happen."
[20] https://www.bloomberg.com/view/articles/2017-06-04/universal-basic-income-is-neither-universal-nor-basic

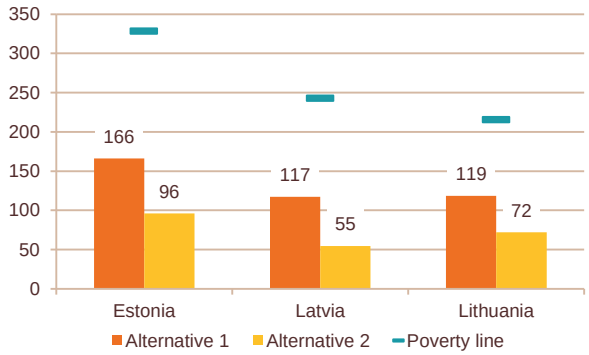
Thus, using 2015 data[21] on general government social protection spending, we conduct a simple thought experiment and try to evaluate how large the budget- neutral UBI could be in the three Baltic countries.

We do the calculations for the following two alternatives:

1. All government spending on social protection (spending on old age, survivors, family and children, unemployment, housing, social exclusion, and others) is replaced with UBI paid to all inhabitants.
2. All non-elderly government spending on social protection (excluding old-age-related spending) is replaced with UBI paid to all inhabitants below the age of 63 years (the approximate average statutory pension age in the Baltic countries). The elderly remain entitled to their old-age pensions.

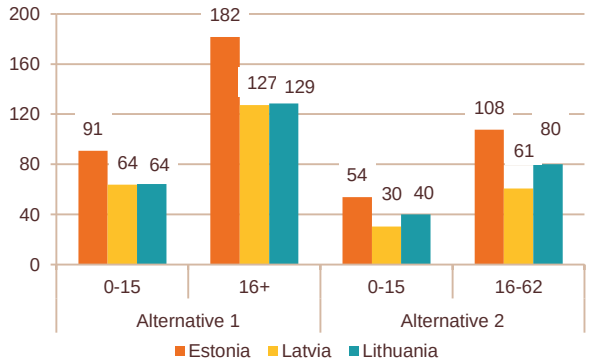
For each of these alternatives, we calculate the size of UBI for two scenarios: 1) UBI is paid to all inhabitants in equal amounts, and 2) children up to 16 years old receive 50% of UBI, and the remaining eligible recipients (16+ -year-olds in alternative No.1 and 16-62-year-olds in alternative No. 2) receive 100% of UBI. The at-risk-of-poverty threshold is set at 50% of the median equalised income for a single person. We assume that the introduction of UBI does not alter the tax revenue side.

**Monthly UBI paid to all eligible recipients in equal amounts, EUR/ person, 2015**




Source: Eurostat & Swedbank Research

**Monthly UBI by age groups: children paid 50%, the rest 100%, EUR/ person, 2015**




Source: Eurostat & Swedbank Research

**With current budgets, monthly UBI payments would be considerably below poverty line**

We find that, if all government social protection spending were distributed equally across the population, this would yield monthly UBI payments of only EUR 117-166, around 48-55% of the at-risk-of-poverty threshold. It is unlikely that the elderly would approve this kind of redistribution because their UBI would be less than half their old-age pensions. If only non-elderly spending were to be distributed in equal amounts to those below the retirement age, then the monthly UBI payments would be below EUR 100. In Latvia, this amount would be only EUR 55 – around one-fifth of the poverty line (see graph above).

Paying only half of UBI to children increases the UBI paid to those older than 16 only marginally--in the range of 9-12% for both alternatives – but UBI still remains significantly below the poverty line. This indicates that, with current social security budgets, UBI at socially and politically meaningful levels would be impossible.

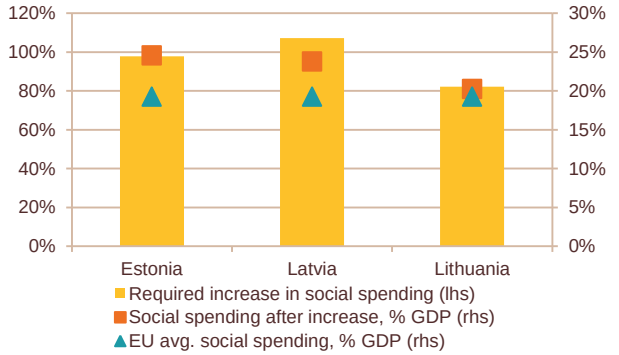
**UBI at poverty line would require much higher budgets and additional tax revenues**

Setting UBI at the poverty line and paying it to all inhabitants in equal amounts would require doubling the existing social protection budget in Latvia and Estonia and increasing it by 82% in Lithuania.[22] As a result, increased social spending in all three countries would amount to 20-25% of GDP and would be above the EU average, which stood at 19.2% in 2015.

This increase in UBI budget would open up a funding gap. If we assume that this funding gap would be financed solely by tax revenue, this would have to rise by around 30-40%, depending on the country. In such a case, tax revenues as a share of GDP would come close to the EU average in Lithuania and rise above it in Estonia and Latvia. The increases would most likely be even higher as the economies would probably be hit considerably by the tax hikes.

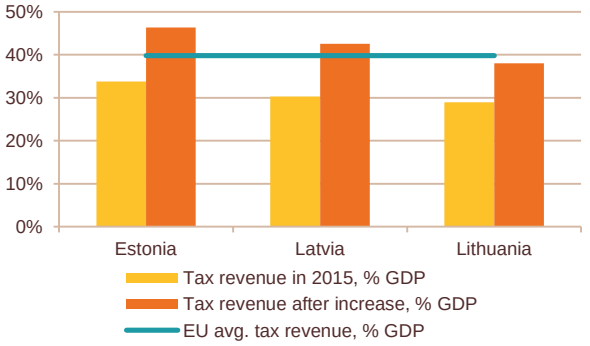
[21] The last year for which comparable data are available for all three Baltic countries.
[22] A smaller increase in Lithuania would be required because of the lower poverty threshold.

**Increase in social protection budget if UBI set at poverty threshold, 2015**




Source: Eurostat & Swedbank calculations

**Increase in tax collections to finance UBI set at poverty threshold, 2015**




Source: Eurostat & Swedbank Research

**Full implementation of UBI is largely unaffordable; some parts of UBI could be used to improve current schemes**

**Towards better-functioning social security system**

As the simplified calculations show, replacing the complicated social security system in the Baltics entirely with a flat basic income would be largely unaffordable. Not to mention that UBI is still uncharted territory, and more experiments are needed in order to see how it affects recipients' incentives and behaviour.

However, some parts of the basic income model could be used in simplifying and improving the efficiency of the existing social security systems. Governments could make the existing benefits more accessible by eliminating unnecessary conditions and means testing in order to reach those who fall outside the system. This could also help cut administrative costs. A more gradual phasing out of benefits would reduce the unemployment trap and increase the incentives for the unemployed to enter the labour market.

**Governments could aim for "partial" UBI applied to new cohorts**

In order to make the transition to basic income more gradual and limit the cost increases, governments, instead of implementing full-scale UBI, could consider a "partial" basic income that would apply only to new cohorts. Lithuania has taken a step in this direction by replacing the additional non-taxable income with lump-sum cash benefits paid to all children, without regard to family income.[23] Maybe, as a start, a similar basic income or, simply, a once- in- a-lifetime payout could be introduced to young adults, which would at least partly level the playing field for poorer youngsters. However, payments to young cohorts only may be met with resistance from the older ones.

**Negative income tax is another option**

Yet another alternative to UBI is a negative income tax, in which people earning below a certain amount receive supplemental pay from the government instead of paying taxes. This system would most likely be less fiscally demanding than UBI and would not exacerbate income inequality, but, at the same time, it would share some of UBI's benefits. Nevertheless, this measure, as well as others mentioned here, carry their own risks and potential side-effects; thus they require separate consideration, as well as separate estimations of their affordability.

*Laura Galdikienė*

[23] However, it is unlikely to reduce bureaucracy, since families will need to file an official request to receive these benefits. This change is expected to take effect as of January 1, 2018.

# Appendix: Swedbank Baltic Sea Index

The Swedbank Baltic Sea index assesses the Baltic Sea region's competitiveness and structural development. The region's countries are ranked in relation to each other and the rest of the world on the basis of ten areas that are considered relevant. Each area consists of several underlying components. The list is not complete, but it should serve as a good indicator of improvement in the business climate in relation to other countries. The samples vary, but in most cases cover most countries in the world. Countries are ranked from 0 to 10 where having a rank between 9 and 10 implies that in the selected area the country belongs to the top 10% "best" performing countries in the world. A country index is an average of all ten areas. A regional index is an average of country indices. The index allows to track a country's performance compared to others overall and also across ten selected areas against others and own past.

## Contents and sources of Swedbank Baltic Sea Region index 2017

**I Entrepreneurship**
- Starting a Business
- Dealing with construction permits
- Registering property
- Protecting investors
- Enforcing contracts
- Resolving insolvency

Source: Doing Business (World Bank)

**II Labour market**
- Labour market efficiency
- Labour productivity
- Labour force participation rate

Sources: World Bank, Conference Board TED and Global Competitiveness Report (World Economic Forum)

**III Tax policy**
- Ease of paying taxes

Sources: Doing Business (World Bank)

**IV Financial markets**
- Financing through local equity market
- Ease of access to loans
- Venture capital availability
- Soundness of banks
- Regulation of securities exchanges

Source: Global Competitiveness Report (World Economic Forum)

**V Foreign trade**
- Market access
- Border administration
- Business environment

Source: Enabling Trade Index (World Economic Forum)

**VI Education**
- Higher education and training

Source: Global Competitiveness Report (World Economic Forum)

**VII Governance**
- Corruption perception index
- Rule of law
- Control of Corruption

Source: Transparancy International and World Bank

**VIII Infrastructure**
- Infrastructure index (GCR)
- Trade and transport-related infrastructure

Sources: Global Competitiveness Report (World Economic Forum) and Logistics Performance Index (World Bank)

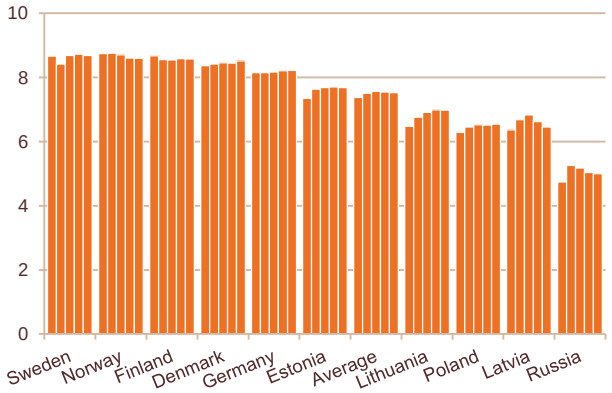
**IX Logistics**
- Customs
- International shipments
- Logistics competence
- Tracking&Tracing
- Timeliness

Source: Logistics Performance Index (World Bank)

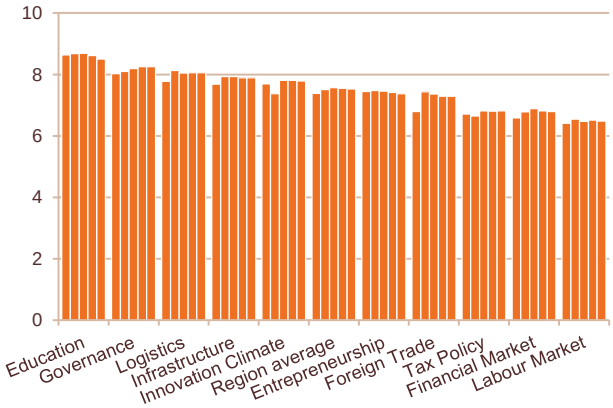
**X Innovation climate**
- Innovation Input
- Innovation Output
- Capacity of innovation
- Quality of scientific research institutions
- Company spending on R&D
- Gov't procurement of advanced tech products
- Availability of scientists and engineers

Source: Global Innovation Index (INSEAD (Institut Européen d'Administration des Affaires)) and Global Competitiveness Report (World Economic Forum)

**Swedbank Baltic Sea index 2017**

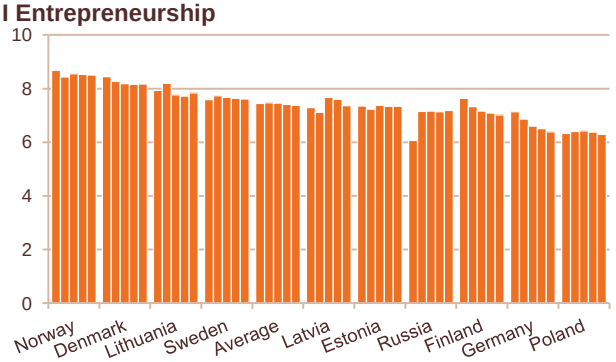



**Swedbank Baltic Sea index 2017**

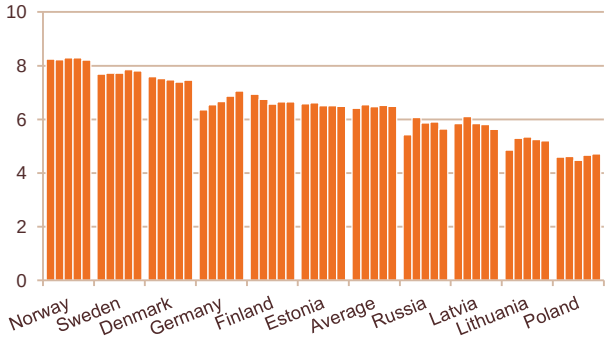



- From left to right, (t-4) to latest available (t)

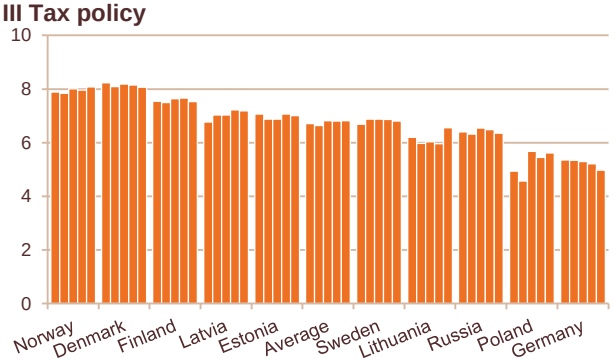
### I Entrepreneurship



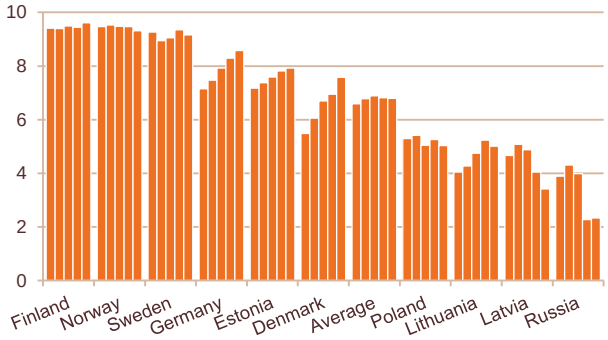

### II Labour market



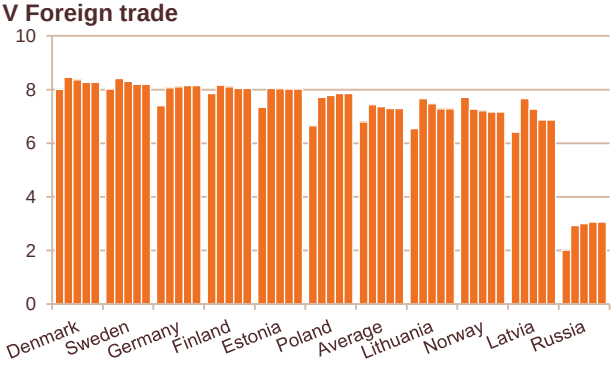

### III Tax policy



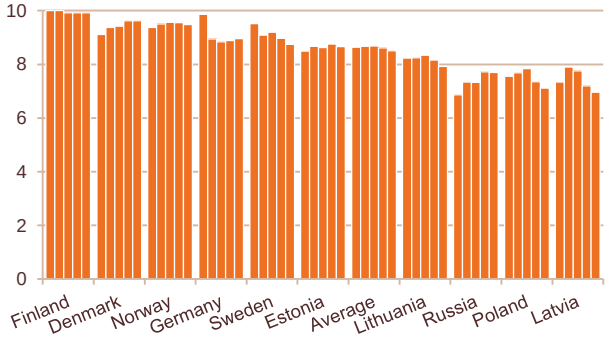

### IV Financial market



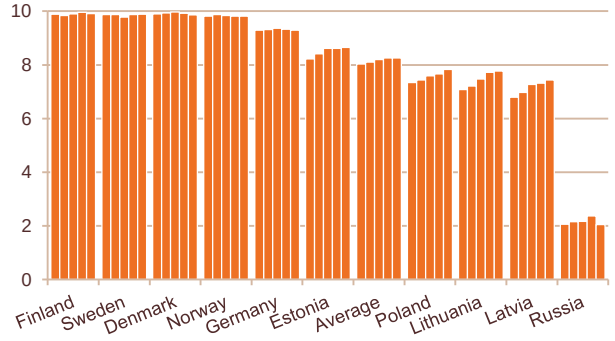

### V Foreign trade



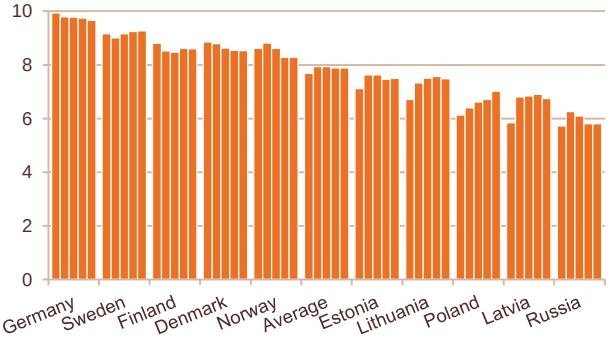

### VI Education



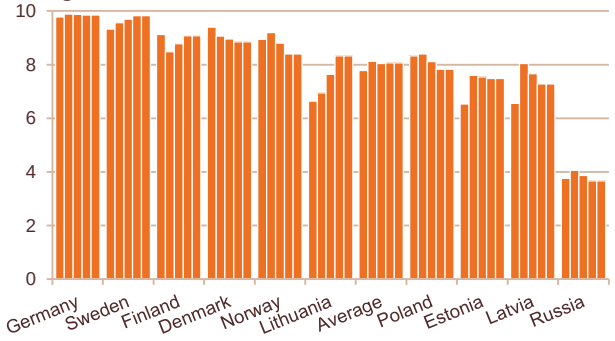

### VII Governance



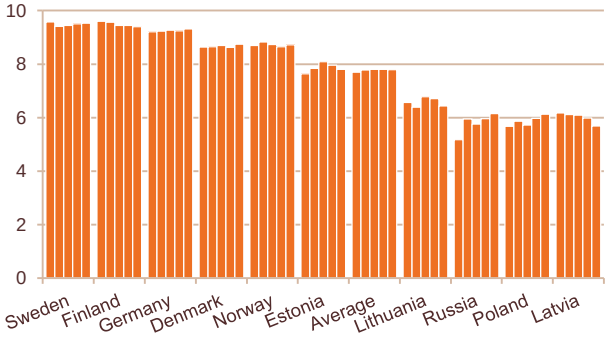

### VIII Infrastructure




### IX Logistics




### X Innovation climate




- From left to right, (t-4) to latest available (t)

| I Entrepreneurship | (t-4) | (t-3) | (t-2) | (t-1) | Latest available (t) |
|---|---|---|---|---|---|
| Norway | 8.7 | 8.4 | 8.6 | 8.5 | 8.5 |
| Denmark | 8.4 | 8.3 | 8.2 | 8.2 | 8.2 |
| Lithuania | 7.9 | 8.2 | 7.8 | 7.7 | 7.8 |
| Sweden | 7.6 | 7.7 | 7.7 | 7.6 | 7.6 |
| **Average** | **7.4** | **7.5** | **7.5** | **7.4** | **7.4** |
| Latvia | 7.3 | 7.1 | 7.7 | 7.6 | 7.4 |
| Estonia | 7.4 | 7.2 | 7.4 | 7.3 | 7.3 |
| Russia | 6.1 | 7.1 | 7.2 | 7.1 | 7.2 |
| Finland | 7.6 | 7.3 | 7.2 | 7.1 | 7.0 |
| Germany | 7.1 | 6.9 | 6.6 | 6.5 | 6.4 |
| Poland | 6.3 | 6.4 | 6.4 | 6.4 | 6.3 |

| II Labour Market | (t-4) | (t-3) | (t-2) | (t-1) | Latest available (t) |
|---|---|---|---|---|---|
| Norway | 8.3 | 8.2 | 8.3 | 8.3 | 8.2 |
| Sweden | 7.7 | 7.7 | 7.7 | 7.8 | 7.8 |
| Denmark | 7.6 | 7.5 | 7.5 | 7.4 | 7.5 |
| Germany | 6.4 | 6.5 | 6.7 | 6.9 | 7.1 |
| Finland | 6.9 | 6.7 | 6.6 | 6.7 | 6.7 |
| Estonia | 6.6 | 6.6 | 6.5 | 6.5 | 6.5 |
| **Average** | **6.4** | **6.5** | **6.5** | **6.5** | **6.5** |
| Russia | 5.4 | 6.1 | 5.9 | 5.9 | 5.6 |
| Latvia | 5.8 | 6.1 | 5.8 | 5.8 | 5.6 |
| Lithuania | 4.9 | 5.3 | 5.3 | 5.2 | 5.2 |
| Poland | 4.6 | 4.6 | 4.5 | 4.7 | 4.7 |

| III Tax Policy | (t-4) | (t-3) | (t-2) | (t-1) | (t) |
|---|---|---|---|---|---|
| Norway | 7.9 | 7.8 | 8.0 | 8.0 | 8.1 |
| Denmark | 8.2 | 8.1 | 8.2 | 8.1 | 8.1 |
| Finland | 7.5 | 7.5 | 7.6 | 7.7 | 7.5 |
| Latvia | 6.8 | 7.0 | 7.0 | 7.2 | 7.2 |
| Estonia | 7.1 | 6.9 | 6.9 | 7.1 | 7.0 |
| **Average** | **6.7** | **6.6** | **6.8** | **6.8** | **6.8** |
| Sweden | 6.7 | 6.9 | 6.9 | 6.9 | 6.8 |
| Lithuania | 6.2 | 6.0 | 6.0 | 6.0 | 6.6 |
| Russia | 6.4 | 6.3 | 6.5 | 6.5 | 6.4 |
| Poland | 4.9 | 4.6 | 5.7 | 5.5 | 5.6 |
| Germany | 5.4 | 5.3 | 5.3 | 5.2 | 5.0 |

| IV Financial Market | (t-4) | (t-3) | (t-2) | (t-1) | (t) |
|---|---|---|---|---|---|
| Finland | 9.4 | 9.4 | 9.5 | 9.5 | 9.6 |
| Norway | 9.5 | 9.5 | 9.5 | 9.5 | 9.3 |
| Sweden | 9.3 | 9.0 | 9.0 | 9.3 | 9.2 |
| Germany | 7.2 | 7.5 | 7.9 | 8.3 | 8.6 |
| Estonia | 7.2 | 7.4 | 7.6 | 7.8 | 7.9 |
| Denmark | 5.5 | 6.1 | 6.7 | 6.9 | 7.6 |
| **Average** | **6.6** | **6.8** | **6.9** | **6.8** | **6.8** |
| Poland | 5.3 | 5.4 | 5.0 | 5.3 | 5.0 |
| Lithuania | 4.1 | 4.3 | 4.7 | 5.2 | 5.0 |
| Latvia | 4.7 | 5.1 | 4.9 | 4.0 | 3.4 |
| Russia | 3.9 | 4.3 | 4.0 | 2.3 | 2.3 |

| V Foreign Trade | (t-4) | (t-3) | (t-2) | (t-1) | (t) |
|---|---|---|---|---|---|
| Denmark | 8.0 | 8.5 | 8.4 | 8.3 | 8.3 |
| Sweden | 8.0 | 8.4 | 8.3 | 8.2 | 8.2 |
| Germany | 7.4 | 8.1 | 8.1 | 8.1 | 8.1 |
| Finland | 7.8 | 8.2 | 8.1 | 8.0 | 8.0 |
| Estonia | 7.3 | 8.0 | 8.0 | 8.0 | 8.0 |
| Poland | 6.7 | 7.7 | 7.8 | 7.8 | 7.8 |
| **Average** | **6.8** | **7.4** | **7.4** | **7.3** | **7.3** |
| Lithuania | 6.5 | 7.7 | 7.5 | 7.3 | 7.3 |
| Norway | 7.7 | 7.3 | 7.2 | 7.2 | 7.2 |
| Latvia | 6.4 | 7.7 | 7.3 | 6.9 | 6.9 |
| Russia | 2.0 | 2.9 | 3.0 | 3.1 | 3.1 |

| VI Education | (t-4) | (t-3) | (t-2) | (t-1) | (t) |
|---|---|---|---|---|---|
| Finland | 10.0 | 10.0 | 9.9 | 9.9 | 9.9 |
| Denmark | 9.1 | 9.4 | 9.4 | 9.6 | 9.6 |
| Norway | 9.4 | 9.5 | 9.6 | 9.6 | 9.5 |
| Germany | 9.9 | 9.0 | 8.8 | 8.9 | 9.0 |
| Sweden | 9.5 | 9.1 | 9.2 | 9.0 | 8.7 |
| Estonia | 8.5 | 8.7 | 8.6 | 8.8 | 8.7 |
| **Average** | **8.6** | **8.7** | **8.7** | **8.6** | **8.5** |
| Lithuania | 8.2 | 8.3 | 8.3 | 8.2 | 7.9 |
| Russia | 6.9 | 7.3 | 7.3 | 7.7 | 7.7 |
| Poland | 7.6 | 7.7 | 7.8 | 7.4 | 7.1 |
| Latvia | 7.3 | 7.9 | 7.8 | 7.2 | 7.0 |

| VII Governance | (t-4) | (t-3) | (t-2) | (t-1) | (t) |
|---|---|---|---|---|---|
| Finland | 9.9 | 9.8 | 9.9 | 10.0 | 9.9 |
| Sweden | 9.9 | 9.9 | 9.8 | 9.9 | 9.9 |
| Denmark | 9.9 | 9.9 | 10.0 | 9.9 | 9.9 |
| Norway | 9.8 | 9.9 | 9.8 | 9.8 | 9.8 |
| Germany | 9.3 | 9.3 | 9.4 | 9.3 | 9.3 |
| Estonia | 8.2 | 8.4 | 8.6 | 8.6 | 8.6 |
| **Average** | **8.0** | **8.1** | **8.2** | **8.3** | **8.3** |
| Poland | 7.3 | 7.4 | 7.6 | 7.7 | 7.8 |
| Lithuania | 7.1 | 7.2 | 7.5 | 7.7 | 7.8 |
| Latvia | 6.8 | 7.0 | 7.3 | 7.3 | 7.4 |
| Russia | 2.1 | 2.2 | 2.2 | 2.4 | 2.1 |

| VIII Infrastructure | (t-4) | (t-3) | (t-2) | (t-1) | (t) |
|---|---|---|---|---|---|
| Germany | 9.9 | 9.8 | 9.8 | 9.7 | 9.7 |
| Sweden | 9.2 | 9.0 | 9.2 | 9.2 | 9.3 |
| Finland | 8.8 | 8.5 | 8.5 | 8.6 | 8.6 |
| Denmark | 8.8 | 8.8 | 8.6 | 8.5 | 8.5 |
| Norway | 8.6 | 8.8 | 8.6 | 8.3 | 8.3 |
| **Average** | **7.7** | **7.9** | **7.9** | **7.9** | **7.9** |
| Estonia | 7.1 | 7.6 | 7.6 | 7.5 | 7.5 |
| Lithuania | 6.7 | 7.3 | 7.5 | 7.6 | 7.5 |
| Poland | 6.1 | 6.4 | 6.6 | 6.7 | 7.0 |
| Latvia | 5.8 | 6.8 | 6.8 | 6.9 | 6.7 |
| Russia | 5.7 | 6.3 | 6.1 | 5.8 | 5.8 |

| IX Logistics | (t-4) | (t-3) | (t-2) | (t-1) | (t) |
|---|---|---|---|---|---|
| Germany | 9.8 | 9.9 | 9.9 | 9.9 | 9.9 |
| Sweden | 9.3 | 9.6 | 9.7 | 9.8 | 9.8 |
| Finland | 9.1 | 8.5 | 8.8 | 9.1 | 9.1 |
| Denmark | 9.4 | 9.1 | 9.0 | 8.9 | 8.9 |
| Norway | 8.9 | 9.2 | 8.8 | 8.4 | 8.4 |
| Lithuania | 6.6 | 6.9 | 7.6 | 8.3 | 8.3 |
| **Average** | **7.8** | **8.1** | **8.0** | **8.1** | **8.1** |
| Poland | 8.3 | 8.4 | 8.1 | 7.8 | 7.8 |
| Estonia | 6.5 | 7.6 | 7.5 | 7.5 | 7.5 |
| Latvia | 6.6 | 8.0 | 7.7 | 7.3 | 7.3 |
| Russia | 3.8 | 4.1 | 3.9 | 3.7 | 3.7 |

| X Innovation Climate | (t-4) | (t-3) | (t-2) | (t-1) | (t) |
|---|---|---|---|---|---|
| Sweden | 9.6 | 9.4 | 9.4 | 9.5 | 9.5 |
| Finland | 9.6 | 9.6 | 9.4 | 9.4 | 9.4 |
| Germany | 9.2 | 9.2 | 9.3 | 9.2 | 9.3 |
| Denmark | 8.6 | 8.6 | 8.7 | 8.6 | 8.7 |
| Norway | 8.7 | 8.8 | 8.7 | 8.6 | 8.7 |
| Estonia | 7.6 | 7.8 | 8.1 | 8.0 | 7.8 |
| **Average** | **7.7** | **7.8** | **7.8** | **7.8** | **7.8** |
| Lithuania | 6.6 | 6.4 | 6.8 | 6.7 | 6.4 |
| Russia | 5.2 | 5.9 | 5.8 | 6.0 | 6.2 |
| Poland | 5.7 | 5.9 | 5.7 | 6.0 | 6.1 |
| Latvia | 6.2 | 6.1 | 6.1 | 6.0 | 5.7 |

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