Republic of Estonia

UPDATED CONVERGENCE PROGRAMME 2004

Tallinn
November 2004

TABLE OF CONTENTS

INTRODUCTION

According to the procedures for co-ordination of EU budget policies, EU member states are required to submit updated stability programmes and convergence programmes (members of the euro area and member states that have not yet introduced euro, respectively) once a year. Estonia submitted its Convergence Programme to the European Commission and the council for evaluation in May 2004. This programme is the updated Convergence Programme.

The updated Convergence Programme 2004 was prepared by the Ministry of Finance of Estonia and it reflects the budget policy of Estonia proceeding from the draft state budget for the year 2005 submitted by the Government of the Republic to the Riigikogu. Estonia's budget policy remains in line with the Stability and Growth Pact. The Programme has been prepared based on the objectives of the Government of the Republic and its policies to achieve those, set by the coalition agreement and other strategic development plans.

As stipulated in the State Budget Act of Estonia, the time frame of the Updated Convergence Programme 2004 reaches to 2008 (the following budgetary year and the subsequent three years). The document consists of six chapters, providing an overview of: goals of economic policies, recent economic developments and future forecasts, fiscal framework, comparison with the previous programme and fiscal risks, improving the quality of public finance, and long-term sustainability of fiscal policy.

The main macroeconomic objective of the Government of the Republic of Estonia is to accelerate actual convergence with the European Union via fast economic growth. From the viewpoint of achieving this objective, implementation of an economic policy supporting macroeconomic stability and growth is important, which is directed to achieve the price stability and preserve a budget discipline. **The objective of the Government of the Republic is to become a full member of the European Economic and Monetary Union (EMU) as soon as possible, in order to increase the long-term economic development and enhance monetary stability**. For this purpose, Estonia has joined the exchange rate mechanism ERM II. We participate in ERM II with a standard fluctuation band while maintaining the achieved stability of exchange rate and present currency board system unilaterally.

Estonia's economic development has been positive – during the last five years, the economic growth rate has remained at 5–8%, unemployment is decreasing and the number of people employed increasing. We have also managed to successfully control inflation. Although the growth of consumer prices has somewhat accelerated this year, this was caused mainly by one-time measures in connection with accession to EU – e.g. increase in excise duty rates on fuel, alcohol and tobacco, and full implementation of the unified EU foreign trade policy with all the associated tariffs. Current account deficit has been specified as the main risk of Estonian economy – this, however, has specific reasons, and the most important of these is the negative income balance due to high profitability of foreign investors operating in Estonia. Nevertheless, this does not mean actual outflow of capital as the profit is mostly reinvested and shown in the payment balance as outflow of revenues on current account while being simultaneously recorded as foreign investment inflow on financial account. Therefore, the deficit is not related solely to impairment of the trade balance, which could be regarded as loss of competitiveness – vice versa, Estonia's position in international competitiveness rankings is constantly improving. In 2004, the current account deficit has not decreased as fast as predicted in the Convergence Programme submitted in May, due to unexpected significant increase in acquisition of reserves before accession to the European Union and introduction of new foreign trade statistics collection methods (a great deal of the goods that were handled under the supervision of the Customs in customs warehouses and were not included in statistics according to the main trade system rules are now in free circulation and included in the statistics, since in the case of trade within the EU the customs warehouses were replaced by intermediate warehouses).

The goal of the Government's fiscal policy is to ensure the conditions required for stable economic development through sustainable governing. For that purpose, the Government shall continue with balanced budget position, keeping in mind the main goals of the Stability and Growth Pact. In 2003, the total surplus of the general government amounted to all-time high 3.8 billion kroons, i.e. 3.1% of the year's gross domestic product. **Last year, the state budget surplus of Estonia was the highest among all EU member states, while our public debt was the lowest in the EU. In 2004, we expect the budget surplus to reach the level of 1% of the GDP, mainly owing to lower expenditure levels in comparison to those planned in the budget. This exceeds the predictions made in the Convergence Programme submitted in May**. According to the forecasts of the Ministry of Finance, Estonia's GDP gap will be negative in the medium forecast term, and the potential growth will be a little higher than the predicted growth, similarly to the European Commission's estimates. Evaluation of the structural balance of Estonian state budget based on the identified GDP gap indicates that Estonian budget policy has so far been significantly counter-cyclical. Over the last years, the considerable surplus of general government budget has also helped to balance the current account deficit. The objective established for the coming years, proceeding from the precondition of balanced economic development, is achievement of budget position balance. However, if the economic developments should differ from the projected outlook, the actual budget position can be different by the extent of the automatic stabilizers.

1. ECONOMIC POLICY GOALS

The main macroeconomic objective of the Government of the Republic is to accelerate real convergence with the European Union via fast economic growth. For achievement of this objective, it is necessary to implement an economic policy supporting macroeconomic stability and growth, which is directed towards achievement of price stability and maintaining of budget discipline.

It is the aim of the Government of the Republic **to become a full member of the European Economic and Monetary Union (EMU) as soon as possible to foster long-term growth potential and monetary stability**. For this purpose, Estonia has joined the exchange rate mechanism ERM II. We participate in ERM II with the standard fluctuation band and preserve achieved stability of exchange rate by maintaining unilaterally the present currency board arrangement.

For the adoption of euro Estonia must meet the convergence criteria established with the EU Maastricht Treaty regarding the budget deficit (not exceeding 3% of GDP), state debt (not exceeding 60% of GDP), inflation and interest rates (close to the respective average of the three best performing EU countries), and become the member of the exchange rate mechanism ERM II. If Estonian economy continues its current trend of development, there will be no problems with meeting the Maastricht convergence criteria and Estonia may easily be among the first new member states adopting the euro.

One of the most important preconditions to fluent functioning of the currency board system is budget discipline with flexible labour market. The debt of Estonian general government (in 2003, 5.8% of GDP) is the lowest among EU member states. Moreover, in addition to central bank reserves, general government's liquid (mostly foreign) assets accumulated from the privatization receipts and recent fiscal surpluses exceed 10% of GDP, thus exceeding the value of gross debt approximately three times. Availability of such reserves ensures the making of necessary budget expenditures even during less successful economic periods.

An objective for the coming years is **maintaining of general government budget balance**. Balanced budget policy provides an environment favouring economic development and contributing to the maintenance of economic growth while stabilising inflation and enhancing the confidence of consumers and investors. Such a fiscal policy will help to maintain low debt burden, being one of the pre-requisites for the long-term sustainability of public finances. Continuation of conservative budget policy is important in order to cope with demographic trends (i.e. ageing of the population). The implemented pension reform will also contribute to this cause.

Despite of the objective to achieve nominal budget balance, our budget policy has turned out to be counter-cyclical in practice and has thus been in conformity with the requirements set in the Stability and Growth Pact. Setting the goal of nominal balance has worked well for Estonia, as major structural changes have taken place in economy, disallowing to assess neither the economic cycle nor budget's cyclical position with sufficient confidence. In the next years, the Government intends to continue application of the state budget balance rule, but we will also continue to develop a methodology for evaluation of cyclically adapted budget positions.

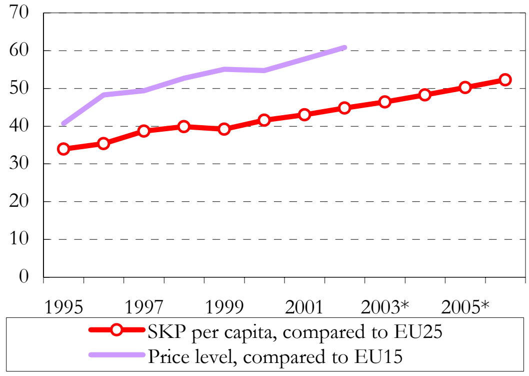
As for the taxes, there will be a shift from taxation of income and capital to taxation of consumption and pollution, while maintaining **the simplicity and uniformity of Estonian tax policy**. The income tax reform which is implemented during the next three years will help to reduce the tax burden of both the entrepreneurs and individuals; however, taxation of consumption will increase slightly as several excise duty rates will be increased and the differences in VAT abolished. Reduction of taxation of labour is substantiated by the intent to give a positive impulse to labour market development. In the coming years, the share of the government sector in economy will remain stable.

Figure 1

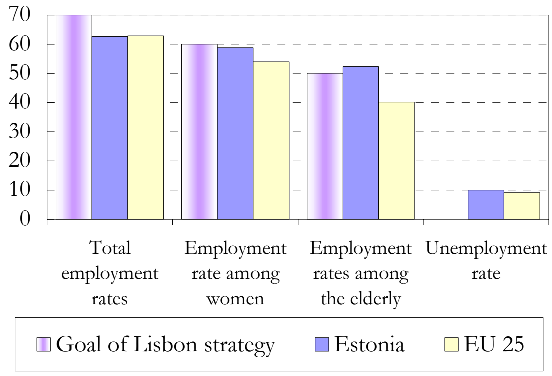
Real Convergence with the EU and Employment Goals of the Lisbon Strategy

(%)

A. Estonia's real convergence with the EU

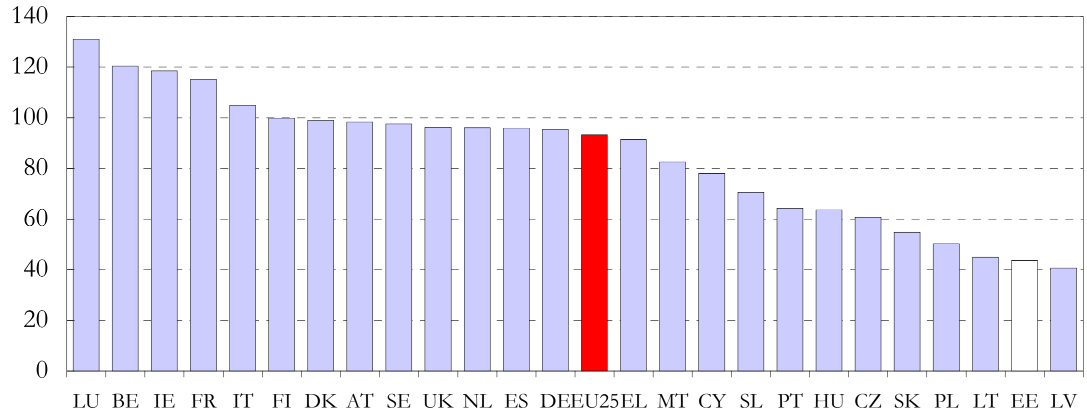


B. Employment



Source: Statistical Office of Estonia, Eurostat.

C. Productivity of labour per one employed inhabitant, with consideration of purchasing power parity, in 2003 (EU15 = 100)



2. ESTONIA'S ECONOMIC DEVELOPMENT AND PERSPECTIVES

2.1. Recent Economic Developments

During the first half of the year 2004, Estonia's economic growth amounted to 6.3%, this indicator being faster than the growth during the first half of the year 2003 (4.6%). The economic growth was supported by growth of domestic demand, the rate of which increased to 6.2% compared to the same period in 2003. The growth of domestic demand was driven by both the increase in growth of investments during the second quarter (20.2%) and stable growth of private consumption (6.1% during the first half of the year). The percentage of domestic demand in the gross domestic product increased to 107.3%.

On one hand, the increase in **private consumption expenditures** was supported by the increase of employment rate and rapid growth of personally usable income, and on the other by the high consumption tendencies resulting from low interest rates. The increase in the growth of private consumption expenditures, from 5.6% in the first quarter to 6.6% in the second quarter, was caused by the increase in demand due to price boost expectations in connection with accession to the European Union.

After commencement of the adjustment of **investments** during the second half of the year 2003, the growth of investments accelerated significantly in the second quarter of this year; such a surge was partly caused by loss of the high base influence. During the half year, the average growth of investments amounted to 6.1%. The growth was supported by increased capital investments of the government sector, active construction activities and increase in acquisition of means of production by enterprises. As concerns households, dwelling construction increased, as well as acquisition of dwellings, accompanied by significant increase in the percentage of real estate transactions.

The share of **export** in GDP increased to 78.1%, owing to growth in the export of both goods and services (21.3% and 16.3%, respectively) as a result of increased economic activity on foreign markets and improved terms of trade (association with the European single market and banishing of the so-called double custom tariffs, imposed by Russia, in May 2004). High investment activity, growth of industrial production and stably strong private consumption supported the growth of **import** of goods and services, which also accelerated during the first half of the year 2004, although less than the growth of exports (17.9% and 14.4%). The mutual influence of said factors reduced the negative influence of the exports sector on economic growth during the first half year.

Regardless of the acceleration in export growth, the trade balance deficit reached 19.5% of the expected GDP and the **current account deficit** during the first nine months of the year 2004 amounted to 15.2% of the GDP (according to initial data). In addition to trade balance growth, the current account was also influenced by increase in outflow of income to 7.8% of the expected GDP, of which 71.2% was reinvested during the first half of the year 2004.

When observing the growth of added value **by areas of activity**, it accelerated during the first half of the year 2004 in nearly all areas of activity. The growth of added value was the highest in construction (18%), supported by construction of infrastructure objects, industrial sector and tertiary sector buildings and dwelling construction. However, the processing industry's contribution to economic growth was the greatest, since it's share in the gross value added increased to 18%. The growth of processing industry (9.5%) was more or less equally supported by increased household consumption and export growth. The growth of added value in transport, warehousing and communications sectors continued at high rate (9.5%), mostly owing to increase in oil products transit operations. The growth of added value in wholesale and retail trade accelerated to 8.1% in comparison with the last year's average; it was mainly caused by significant increase in wholesale of fuel, metals and construction materials, as well as increase in retail sale of vehicles and foodstuffs. The contribution of the added value of real estate, leasing and business services to economic growth increased significantly during the first half year, caused mainly by increase in sales of real estate services.

The annual growth of the government sector's extensive areas of activity (public administration, national defence, social security, health and social care) in comparison with the previous year's same period accelerated as well, but was still slower than the average real growth of added value. Real growth of primary sector's added value during the first half year proved to be negative, due to decrease in forest management-related production and continuing decline of fishery.

During the first half of the year 2004, favourable developments continued in the **labour market** – this is revealed by growth of employment and decrease in number of the inactive. In the second quarter, the number of the employed amounted to 595.2 thousand people. Employment growth was influenced the most during the first half year by increase of the number of people involved in processing industry, construction, and state public service. Processing industry was influenced by strong domestic demand and growth of foreign demand, construction by active investment activities and state public service by increase in public service labour demand in connection with accession to the European Union. Unemployment decreased from 10.1% (1st quarter) to 10% (2nd quarter). As concerns distribution by age, the unemployment rate decreased during the first half year mainly among the age group of 50-74, which may be partly explained by gradual raising of women's retirement age.

The **average gross wage** during the second quarter of the year 2004 was 7,417 kroons, i.e. 7.3% more than during the last year's same period. Due to acceleration of inflation, the real growth of both gross wage and net wage decelerated. Owing to rapid increase in employment, the **productivity** (GDP per one employed inhabitant) remained low during the first half of the year 2004, increasing by 4.5% during the 1st quarter and by 4.8% during the 2nd quarter in comparison with the previous year's same period. In the 2nd quarter of the year 2004, the labour costs amounted to 47% of GDP, i.e. one percent more than in 2003 during the same period.

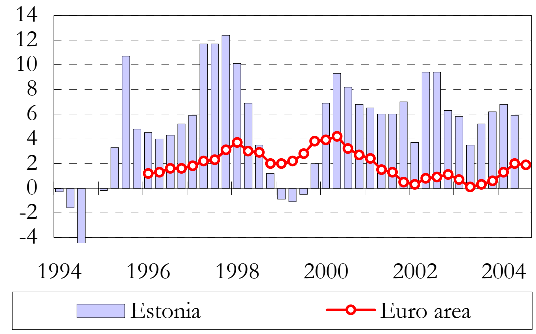
After the record low level of **inflation** experienced in 2003, slow increase in prices continued in the beginning of this year. In the 1st quarter, the prices of goods and services increased only by 0.4% compared to the same quarter of the previous year, due to cheapening of motor fuel and communication services. In the 2nd quarter, however, the increase in prices accelerated to 3.2%, being mainly driven by foodstuffs and motor fuel. Before accession to the EU, the demand for several foodstuffs (above all, sugar) increased, resulting in price elevation. The increase in motor fuel prices was caused by rise in oil prices on the global market and increase in fuel excise duty rates. The rapid inflation in June (4.5%) abated during the 3rd quarter and the annual increase in prices remained within 4%. The increase in prices was once again driven by motor fuel and foodstuffs. At the same time, communication service prices decreased, since the competition between communication service providers forced them to lower the prices.

Figure 2

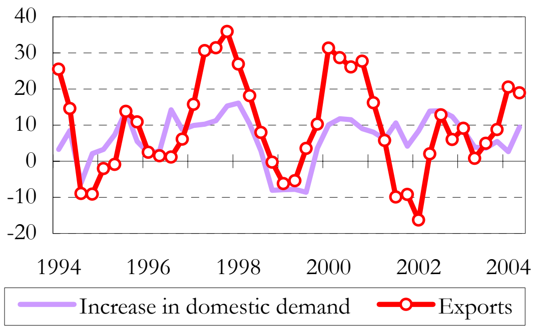
Development of Main Indicators of Estonian Economy

(%)

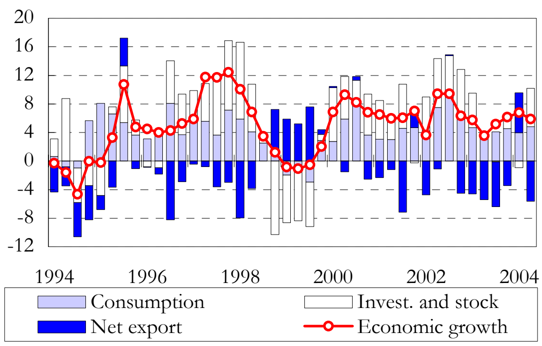
A. Economic growth of Estonia and the euro area



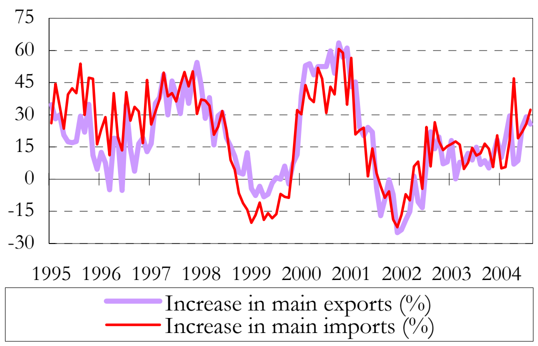
B. Increase in domestic demand and exports



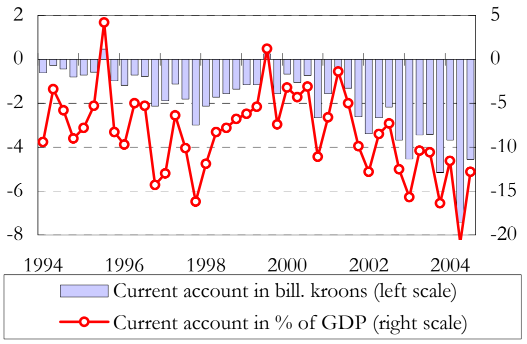
C. Contribution to economic growth



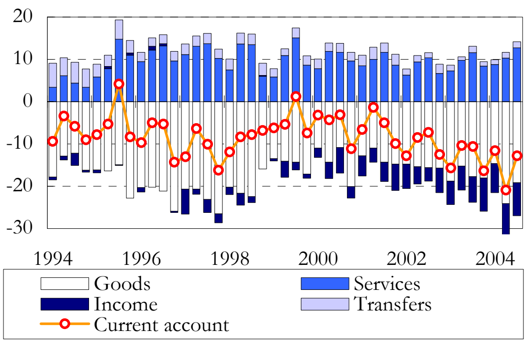
D. Export and import growth



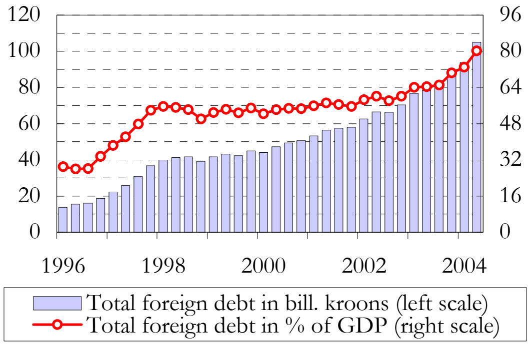
E. Current account



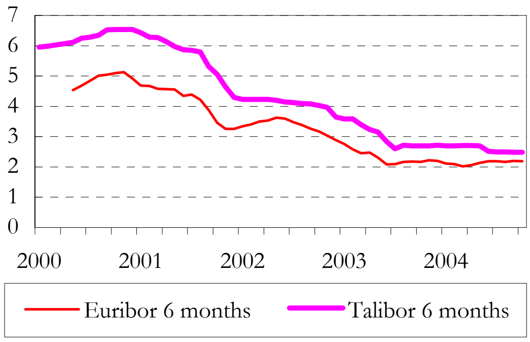
F. Structure of current account (% of GDP)



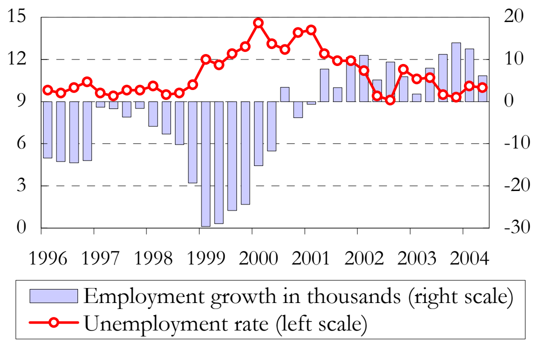
G. Total foreign debt



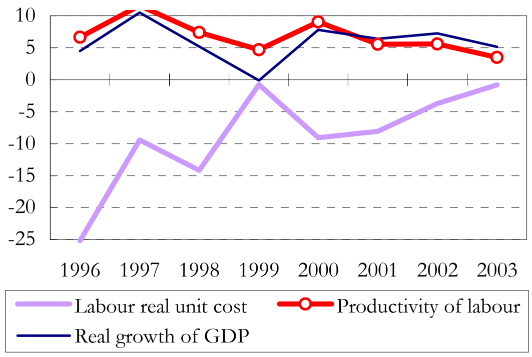
H. Interests



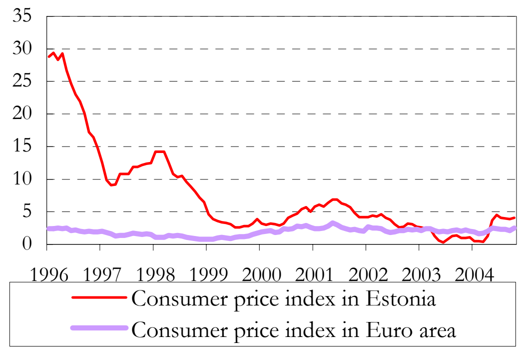
I. Employment and unemployment



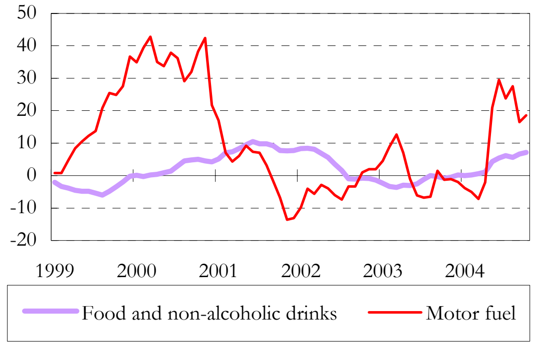
J. Productivity of labour



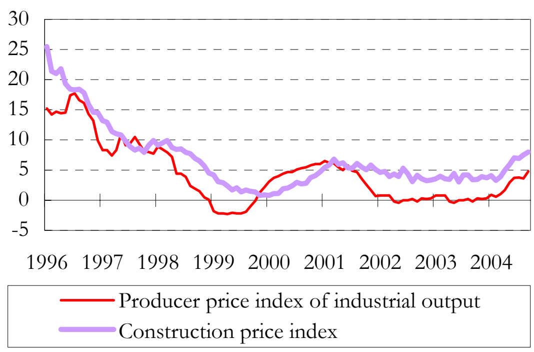
K. Consumer price index in Estonia and euro area



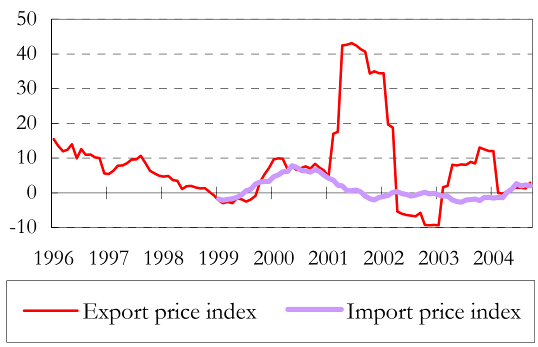
L. Changes in food and fuel prices in Estonia



M. Producer and construction price index



N. Foreign trade prices



Sources:: Statistical Office of Estonia, Bank of Estonia, Eurostat.

2.2. International Evaluation of Estonian Economy

In order to evaluate the development of Estonia, the credit ratings assigned to Estonia have to be analyzed along with references to Estonia in internationally accepted researches. Although in 2003 the rating agencies did not change Estonia's national long-term foreign currency denominated liabilities rating or national rating (Moody's: A1), the ratings were positively changed by Fitch (A-) and Standard & Poor's (A-), which allowed to expect further increase of the ratings. After joining the exchange rate mechanism ERM II in the beginning of July 2004, the rating agency Fitch indeed announced that it has decided to increase the national rating of new EU member states by one level (A), explaining this by accession of these states with the euro area in the near future. S&P followed this example and increased Estonia's national rating by one level (to A) in November. Fitch and S&P consider accession with the euro area an extremely positive factor from the viewpoint of a state's creditworthiness, since it will reduce the risks emanating from unbalanced state of the balance of payments and from external shocks. In addition to joining the EU and NATO, rating agencies named success in implementation of structural reforms, harmonization of legislation with the EU, conservative fiscal policy and the existence of a currency board system as strengths of Estonian economy, which have altogether strengthened the fundamentals of the economy and provided rapid economic growth. Record high current account deficit and low living standard are still considered the greatest problems.

Economic freedom is one of the distinct characteristics of Estonia. The Heritage Foundation's economic freedom index 2004 had Estonia on the 6th place among 161 other nations. A high place was given to Estonia due to liberal trade policy, open foreign investment policy, low control over prices and a well-developed banking sector. The evaluation given to Estonia deteriorated by 0.08 points in 2003, as the government increased the administratively regulated prices and the relative share of general government in economy increased (in 2002, the expenditures of the general government sector increased by 1.2 per cent, to 38.5% of GDP). The 2004 economic freedom index volume points at three problematic fields in Estonia: the big share of government expenditures, large share of shadow economy and protection of private property.

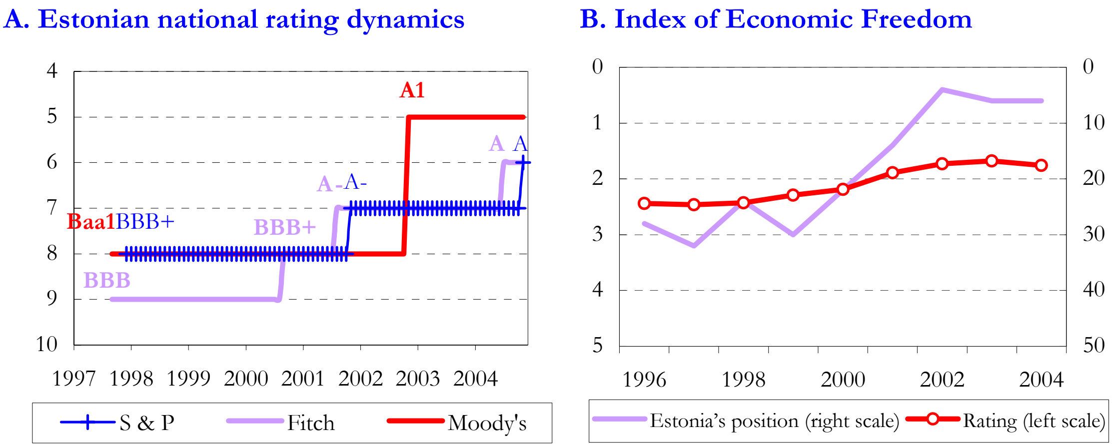
Competitiveness in Estonia also received high international grades. According to IMD World Competitiveness Yearbook 2004, Estonia's competitive ability among 60 nations decreased by 6 places, to the 28th place. In the summarized index, Estonia outpaces all other new EU member states included in the report (Latvia and Lithuania were not included). As concerns various components of this research, Estonia has somewhat given up or kept its positions. The given research named rapid economic growth and economic freedom among the country's strengths. High unemployment, price level and current account deficit, lack of skilled labour, low level of security and low living standard were marked as the main weaknesses of Estonia.

Another organization evaluating competition is the World Economic Forum, which gave the highest grade to Estonia in the 2004–2005 worldwide competition report on Central and Eastern Europe. Competition growth index (grades national economic growth potential per capita for the next 5-8 years) placed Estonia in the 20th place (among 104 nations), two places higher than a year before. According to this index, the main problems of Estonian economy include lack of skilled labour, non-efficient bureaucracy, access to financing, low professional ethics, and insufficient infrastructure. Less problematic are currency exchange, political instability, inflation, corruption and labour regulation. In the business climate index, which evaluates productivity of nations, i.e. their GDP per capita, Estonia ranked 27th among 103 nations; the rating improved by one place within one year.

Low level of corruption is also important from the viewpoint of national development. Transparency International's corruption perception index 2004 put Estonia, Slovenia and Botswana to the 31st place of 146 countries. In 2003, Estonia was on the 33rd place of 133 countries – higher than all other new EU member states, as well as Greece and Italy. Improvement of the index value was caused by implementation of the state's anti-corruption action plan and measures taken for regulation of the financing of political parties.

Figure 3

International Evaluation of Estonia's Development



Source: Standard & Poor's, Fitch Ratings, Moody's, Heritage Foundation.

2.3. Macro-Economic Forecast for Years 2004–2008

The economic forecast is based on the assumption that this year's favourable trends will continue in the near future as well, thus favouring more balanced economic development. Stronger EU economy will have positive impact on exports, while domestic demand will remain strong mainly owing to investments and continuously active private consumption. According to the forecast, economic growth is expected to reach 5.9% in 2005, followed by stabilisation in the mid-term period at potential growth levels.

Within the next few years, the current account deficit should gradually decrease due to increase in foreign demand and improvement in terms of trade (association with the European single market and banishing of the so-called double custom tariffs, imposed by Russia, in May 2004). In 2005, export of goods and services is expected to increase by 10.4%, and the average growth during the forecast period will be approx. 10%. Increasing foreign investments will support import growth, which is expected to reach 9.2% in 2005 and exceed 8% during the entire mid-term period. Reduction of the current account deficit will be hindered by the growth of income balance deficit as a result of increase in the volume of investments and improved profitability. Nevertheless, the current account deficit will be reduced to approx. 6% by the end of the forecast period.

Growth of private consumption will somewhat decelerate in 2005, due to increase in interest rates, but is still expected to exceed the 5% level during the entire forecast period. Growth of private consumption will be supported by tax reform and increase in employment. In the mid-term period, however, the growth of private consumption will be slowed down by increase in interest rates, which will increase loan servicing expenditures and support saving decisions.

Growth of investments will accelerate to 7.3% in 2005. The growth will be supported by the need for expansion of production in order to meet the demand, caused by recovery of foreign demand, and increase in the general government's percentage in overall investments. Support from structural funds will positively influence development of infrastructure and increase agricultural refunds, thereby making this field of activity more attractive. In the mid-term period, the volume of investments will stabilize at 29% of GDP.

In 2005, inflation will stabilize at 3.2%, influenced mainly by increase in prices for electricity, excise duty rates on alcohol and tobacco, and transport service costs (due to high oil prices). At the same time, we expect reduction of communication service prices, due to more intense competition and implementation of the free telephone number transfer system since 1 January 2005. In the mid-term period, inflation growth rate is expected to slow down and not exceed 3%; this is attributable to low inflation rates in the European Union Member States.

In 2005, the growth of average gross wages is expected to slow down to 4.1%. This is attributable to the desire to limit the growth of labour expenses due to increasing competition, the realisation of which desire will be possible owing to relatively high unemployment rate, and income tax reduction, which will increase real income of employees. In the mid-term period, the tax reform will decelerate the growth of real wages in Estonian decentralised labour market. In 2008, the growth of real wages is expected to accelerate to 6%.

Favourable developments are expected to continue in the labour market in the short term; this is revealed by the growth of employment and decrease in the number of the inactive. Employment growth is mostly attributable to favourable industrial conjuncture and increased investments. In 2005, unemployment rate is expected to decrease to 8.7%; in the mid-term period, unemployment rate shall decrease to 8.4% – this is attributable to relatively fast growth of employment and implementation of active labour market measures.

Table 1

Main Macroeconomic Indicators and Forecast for Years 2002–2008

(per cent)

	2002	2003	2004*	2005*	2006*	2007*	2008*
Main economic indicators							
1. GDP real growth	7.2	5.1	5.6	5.9	6.0	6.0	6.0
2. GDP (bill. EEK)	116.9	125.8	138.3	151.6	165.9	181.2	197.7
3. GDP deflator	4.4	2.4	4.0	3.5	3.3	3.0	2.9
4. Consumer price index	3.6	1.3	3.3	3.2	2.5	2.8	2.8
5. Employment (15-74 years old, thousands)	585.6	594.3	602.8	607.3	611.5	615.8	620.1
6. Employment growth	1.4	1.5	1.4	0.8	0.7	0.7	0.7
7. Productivity growth[1)]	5.8	3.6	4.2	5.2	5.3	5.3	5.3
8. Unemployment rate	10.3	10.0	9.7	8.7	8.4	8.4	8.4
9. Average wages (EEK)	6,110	6,702	7,213	7,749	8,309	8,930	9,727
10. Wage real growth	7.0	8.3	4.2	4.1	4.6	4.5	6.0
11. Investments and inventories (% of GDP)	31.8	31.1	30.4	29.9	29.6	29.3	29.1
12. Current account (% of GDP)	-10.2	-13.2	-10.8	-9.1	-7.7	-6.8	-5.6
Sources of growth							
13. Private consumption	9.9	5.4	5.9	5.4	5.3	5.2	5.2
14. General government consumption	5.9	5.8	5.7	4.3	3.9	3.6	3.3
15. Gross fixed capital formation	17.2	5.4	4.6	7.3	5.6	5.5	5.5
16. Change in inventories (% of GDP)	3.1	2.7	2.6	2.0	1.8	1.5	1.3
17. Export of goods and services	0.9	5.7	13.0	10.4	10.0	9.7	9.6
18. Import of goods and services	3.7	11.0	9.2	9.2	8.6	8.2	8.2
Contribution to GDP growth							
19. Domestic demand (excl. inventories)	8.6	10.2	3.7	6.2	5.6	5.5	5.3
20. Change in inventories	1.2	-0.2	0.1	-0.3	-0.1	-0.2	-0.1
21. External balance of goods and services	-2.6	-4.9	1.9	0.1	0.5	0.7	0.8

Growth of value added							
22. Agriculture	0.1	-1.5	2.7	2.2	2.5	2.8	2.8
23. Industry	14.1	8.2	9.0	10.0	9.4	9.6	9.4
24. Construction	20.6	7.7	12.6	8.0	7.3	6.6	7.0
25. Services	4.5	4.4	4.3	4.7	4.9	5.0	5.0

Sources: Ministry of Finance of Estonia, Statistical Office of Estonia, Bank of Estonia.
1) Real growth of GDP per one person employed.
2) Contribution to GDP growth indicates the share of the specific field in the overall economic growth. It is calculated by multiplying the growth of the field by its share in GDP. The sum of field contributions makes up the economic growth (slight difference is caused by statistical error – the share of GDP that could not have been divided between the fields).

Table 2

Comparison with Economic Forecasts of Other Institutions, for the Years 2004–2005

	GDP growth, %		Consumer price index, %		Current account, % of GDP	
	2004	2005	2004	2005	2004	2005
Ministry of Finance of Estonia	5.6	5.9	3.3	3.2	-10.8	-9.1
European Commission	5.9	6.0	3.4	3.5	-13.0	-11.6
IMF	5.8	5.4	3.0	2.5	-11.2	-9.5
Bank of Estonia	5.5	5.8	2.8	3.1	-10.2	-9.0
Estonian Institute of Economic Research	6.0	–	3.5	–	-12.4	–

Sources:
Ministry of Finance of Estonia.
European Commission. Economic Forecast. Autumn 2004.
IMF. World Economic Outlook. September 2004.
Bank of Estonia. Economic Forecast. June 2004.
Estonian Institute of Economic Research. Conjuncture, No.3, September 2004.

2.4. Fulfilment of Convergence Criteria

For the adoption of euro, EU member states that do not yet use the common currency are required to achieve a certain nominal convergence level, i.e. fulfil the convergence criteria established with the EU Maastricht Treaty. The criteria concern the budget deficit (not exceeding 3% of GDP), state debt (not exceeding 60% of GDP), and inflation and interest rates (close to the respective average of the three best performing EU countries). In addition to that, the member state must become a member of the exchange rate mechanism ERM II.

If the current Estonian economic policy continues, there will be no major problems with meeting the Maastricht criteria and Estonia will presumably be among the first new member states adopting the euro.

Estonia's **general government budget position** has been close-to-balance; in 2003, the surplus of our budget (3.1%) was even the greatest among EU member states. As a result of conservative budget policy, our state debt is also very small – in 2003, the smallest among EU member states. Nevertheless, it is by no means possible to exclude the possibility of various risks realisation, as happened in 1999, when economic recession and over-optimistic budget resulted in general government budget deficit, amounting to more than 3% of GDP. We will have no problems with meeting the debt criterion even in the case of economic recession. When specifying budget policy goals, it is also necessary to keep in mind that while the Maastricht criterion sets 3% of GDP as the limit for a budget deficit, the Stability and Growth Pact (SGP) establishes a much more stringent objective. SGP requires the EU Member States to devise their budget policy in such a way that the goal would be to have budget position close-to-balance or in surplus, which should ensure that the 3% limit is not exceeded even in case of economical problems. The existing current account deficit also requires more stringent policy. Therefore, it is important for Estonia to continue with the implementation of conservative budget policy and maintaining the balance of general government's budget. This requires substantial changes in budget policy implemented by local governments – budgets of local governments in total have up to today been in deficit consistently.

For Estonia, meeting the **price stability criterion**, which is a 'moving target' (changes every year), will probably be the most difficult task. According to economic forecasts issued by the European Commission in autumn 2004, the average price increase in the three EU countries with the lowest inflation rates will be around 1.1–1.4% over the evaluation period in 2006, consequently, the Maastricht price stability criterion is approx. 2.8%. According to the present forecast, Estonia will be able to meet the inflation criterion in 2006. The following risks may be identified in connection with meeting of the price stability criterion:

- More rapid growth of productivity and income is, as a rule, accompanied with a pressure for more rapid rise in prices. Therefore, Estonia's economic growth (which is more rapid than EU average) will be accompanied by more rapid inflation, and meeting the criterion may thus prove to be problematic.
- Open economy makes our inflation vulnerable to foreign price changes and thus also rather volatile. In 2001, for example, international price pressures generated inflation due to a rise in food prices, resulting in inflation rate of even more than 7% in some months. Another example is the decrease in food and fuel prices in 2003, as a result of which Estonian inflation was lower in 2003 than the respective EU average.
- It is important to keep administrative price growth influenced by the state under control, since in Estonia's case it is the main source of inflation.
- It is necessary to ensure that Estonian economic policy decisions do not amplify inflation, i.e. to avoid the implementation of expansive budget policy, accompanied with additional price pressures. For example, the major investments in road construction made by the general government over the last couple of years have triggered price increase in this sector. This is

why we have to observe the influence of sector-related expenditures on price levels in respective sectors, not only the total expenditures of general government and budget balance. Adoption of euro alone will not cause major inflation – this is evidenced by the present experience of the EU Member States: the estimated additional price increase associated with rounding after introduction of euro does not exceed 0.1–0.2%.

The **interest rate** criterion is linked to the inflation criterion – lower inflation shall be accompanied with lower interest rates. Estonia does not have the right instrument for evaluation of interest rate convergence (there are no 10-year government bonds in Estonian kroons), but considering the currently low interest rates on loans in kroons, Estonia is principally complying with the interest rate criterion as well.

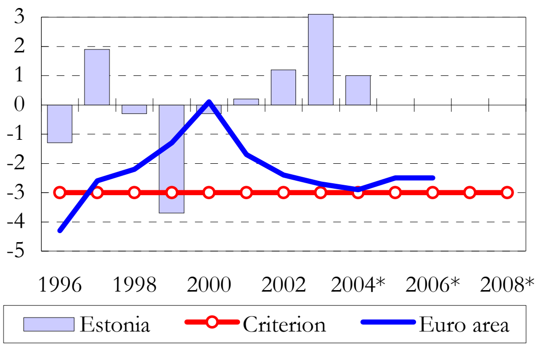
EEK/euro exchange rate has been fixed since 1999 – therefore, the stability of the currency exchange rate is not a problem either. Estonia has been a member of the exchange rate mechanism ERM II since 28 June 2004. Estonia participates in ERM II with a standard fluctuation band while maintaining the achieved stability of exchange rate and present currency board system unilaterally.

Figure 4

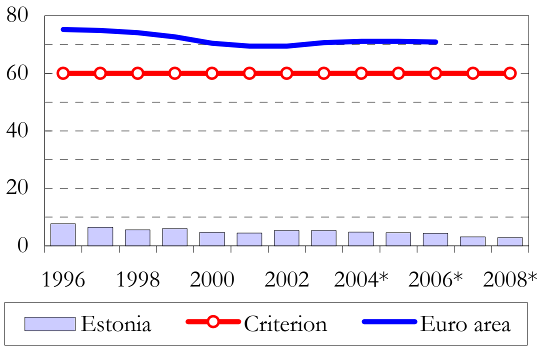
Real Convergence and Compliance with the Maastricht Criteria

(%)

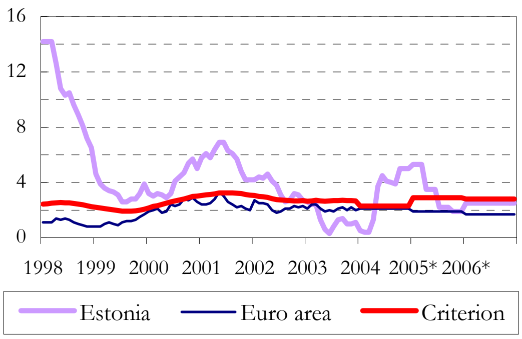
A. Balance of general government budget



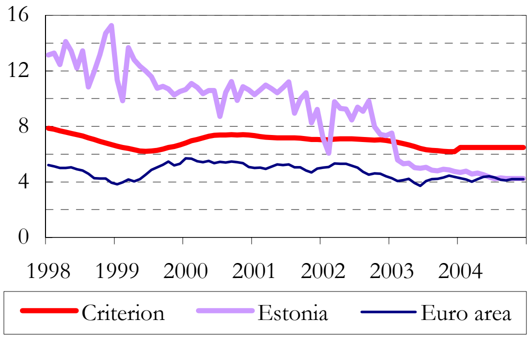
B. General government debt



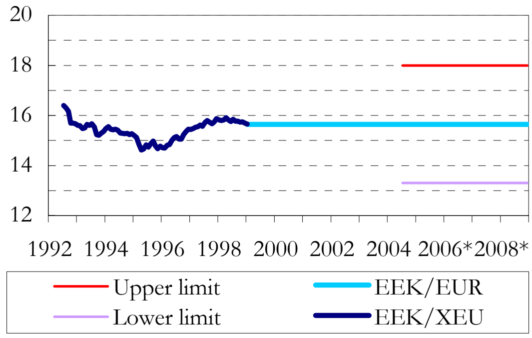
C. Inflation



D. Interest rates



E. EEK/EUR exchange rate



1) The graphs of inflation and interest rate criteria provided in Figures C and D do not represent established and certain rates, but indicate possible trends of the criteria and their possible values according to most recent forecasts.
Source: Ministry of Finance of Estonia, Statistical Office of Estonia, Eurostat, European Commission.

3. FISCAL FRAMEWORK

3.1. Fiscal Policy Goals of General Government

3.1.1. General Goals of Fiscal Policy

In its Convergence Programme of May 2004, the Government of the Republic established the following main goals of Estonian fiscal policy:

- maintaining of general government budget balance,
- no increase of tax burden,
- savings in state administration and directing the expenditures into economic development,
- ensurance of long-term sustainability of public finance.

3.1.2. Budget Priorities of the Government of the Republic for the Year 2005

The general objective of the Government of the Republic is achievement of sustainable, socially and regionally balanced economic development.

The priorities (fields) necessary for achievement of the general objective are described in the State Budget Strategy 2005-2008. Upon description of the Government's objectives for the next financial year, the contents of the coalition agreement, State Budget Strategy, and the 2005 State Budget Act have been taken into consideration.

There are different policies for achievement of the Government's general objective: education policy, subsistence policy, health policy, economic policy, etc. The aids ensuring best implementation of said policies include competent civil service staff. Therefore, it is necessary to pay constant attention to the public sector's administrative capacity. This capacity is of especially critical importance upon implementation of European Union's structural funds. In establishment of its objectives and performance of its daily work, the Government proceeds from the concept of citizen-centeredness – all that we do is directed towards the benefit of the population.

After successful accession to EU and NATO, one of the Government's outward-directed priorities is ensurance of the stability of state's foreign communication and well-considered nature of foreign policy. At the same time, besides foreign communication, the importance of Estonia's regionally balanced national development may not be forgotten. Therefore, among general priorities, it is necessary to point out supporting local development for reduction of regional differences, through strengthening of both local governments and civic initiative.

The state budget for 2005 concentrates on working people. The priorities of the budget include financing of active labour market policies and education, as well as reduction of the tax burden of labour.

Reduction of Tax Burden of Labour

In 2005, the tax-free threshold shall be increased from 1400 EEK to 1700 EEK per month, and the personal income tax decreased by 2%, i.e. to 24%.

Active Labour Market Policies

As a result of the implementation of the 220 million EEK active labour market policies package included in the draft state budget, at least 21 000 unemployed persons shall receive training, 14 000 unemployed persons shall be paid stipends, 920 unemployed persons provided with the possibility to engage in practical work, and 21 000 unemployed persons provided with access to training and practical work vacancies by allocation of transport allowances. 750 unemployed persons shall receive support for engagement in entrepreneurship.

High-quality education and science

A 660 million EEK education and science financing package includes measures for improvement of the quality of general, vocational, and higher education. In order to improve the level of general education, local governments and schools shall be granted more extensive decision-making rights and responsibility. Teachers' salary fund shall be increased by 220 million EEK, and 240 million EEK shall be added to the capitation fee for investments into education. The share of vocational education shall increase through acquisition of vocational school equipment and investments into infrastructure. In the case of higher education, the focus shall be on technical fields of study, information technology and biosciences. Approx. 200 million EEK shall be additionally allocated to scientific research and development.

3.2. General Government Budget Balance

In 2003, the overall surplus of the general government sector amounted to a record amount of 3.8 billion EEK, which totals to 3.1% of annual gross domestic product. Like last year, the surplus incurred at central government and social security funds' level (respectively, 2.9% and 0.7% of GDP) while the consolidated budget of local governments proceeded with a deficit, as usual – 0.5% of GDP. Local governments' deficit increased the debt of general government nominally, nevertheless remaining on the last year's level in comparison with GDP. The central government repaid the loans according to the repayment schedules set earlier and the surplus was used to form a reserve of financial assets.

The budget for 2004 was established in conformity with the main goals of economic policy, proceeding from the objective to keep the general government budget balanced. As in last year, the first months of the year indicated surplus that is attributable to higher revenue basis, but also to continuing of the favourable economic developments. After first six months, the general government sector's surplus amounted to 0.7% of GDP. Since the budget revenues received exceeded the expected level, the Government decided to establish a supplementary budget, which the Riigikogu passed on 10 November 2004. The supplementary budget increased this year's expenditures by 0.7% of GDP, and the main objective of the supplementary budget is financing of investments in order to reduce the pressure on the state budgets of the next few years. **In 2004, budget surplus is expected to reach 1% of GDP, mainly due to lower levels of expenditure in comparison to those planned in the budget.** On one hand, shifts in the schedules of some projects financed from European Union subsidies allow keeping of the sums intended in the budget for co-financing, while on the other greater possibilities have been created for ministries for transferring of budget allocations to the following years, if necessary.

The state budget for 2005, which was in the legal proceeding of the Riigikogu at the time of this Convergence Programme preparation, has been established with the objective to maintain general government budget balance.

Results of an analysis conducted by the Ministry of Finance using the production function method[1] indicate that Estonia's GDP gap during the mid-term forecast period shall be negative, and that the potential growth currently somewhat exceeds predicted growth. Calculations made by the European Commission have provided similar results (see Annex 3. Cyclically Adjusted Budget Balance), although the numeric values are different.

If the structural balance of Estonia's budget is evaluated based on the determined GDP gap, the results suggest that Estonian budget policy has so far been strongly counter-cyclical. Both actual and cyclically adjusted budget positions have been negative or equal to zero during the period of economic recession (1998–2000) and positive in the years of potential growth (2001–2003).

In the mid-term period, the Government of the Republic shall continue its conservative fiscal policy and keep the nominal general government budget in balance, as required by the Stability and Growth Pact. In the forecast period, GDP gap shall be slightly negative, which means that cyclical budget position shall be close to balance.

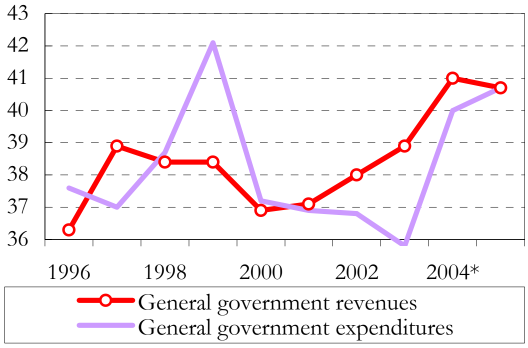
[1] The methodology for evaluation of GDP gap and cyclically adjusted budget position has been discussed in the Estonian Convergence Programme May 2004.

Figure 5

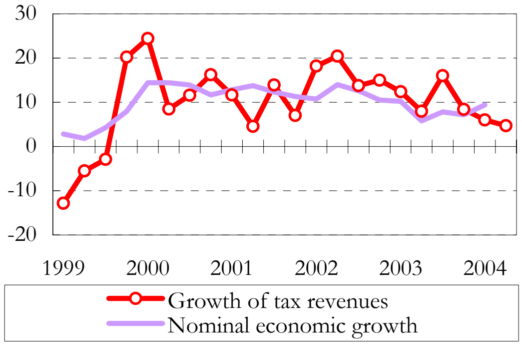
General Government Budget Balance (ESA 95)

(% of GDP)

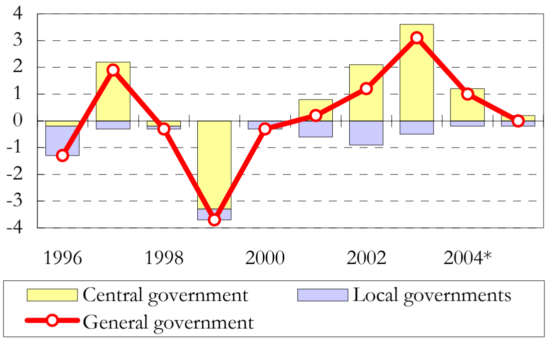
A. Revenues and expenditures



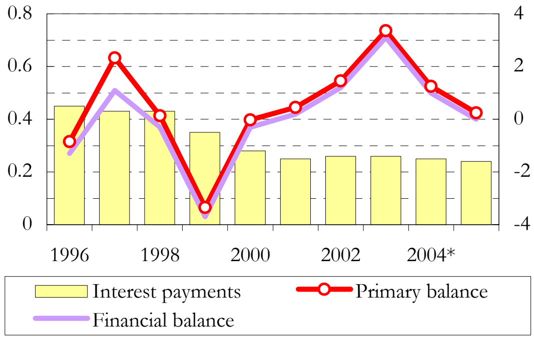
B. Growth of general government tax revenues *(%)*



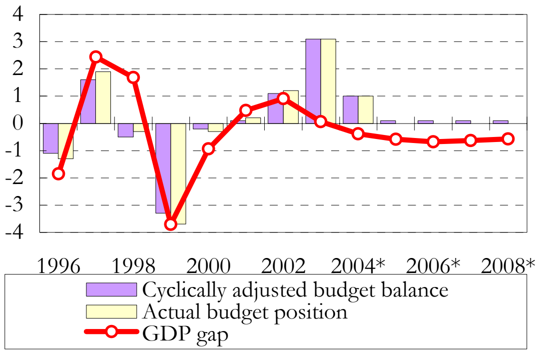
C. General government balance



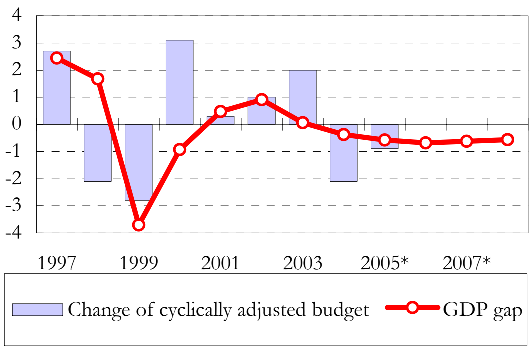
D. General government primary balance



D. Cyclically adjusted budget position



E. Change of cyclical budget position



Sources: Ministry of Finance of Estonia, Statistical Office of Estonia

3.3. Role of Different Levels of Government and Budget Balances

Estonian **central government** consists of ministries, constitutional institutions, state pension insurance, most public legal entities, and foundations controlled and financed by central government. The financial position of central government is most closely related to economic cycle, mostly due to financing – as major share of central government revenues consist of taxes more sensitive to economic development. Therefore, central government was the main cause for deficit during the economic recession (for example, in 1999) while recent years are characterised by surplus, due to better collection of taxes. The year 2004 will be the fourth surplus year for the central government, and the surplus is expected to reach the level of 0.8% of GDP. **In the mid-term, the central government shall continue close-to-balance position, ensuring it based on the objective of maintaining general government budget balance.**

Social security funds include the Health Insurance Fund and Unemployment Insurance Fund. Social security receipts are used to finance social security funds – Health Insurance Fund receives 13/33 of the collected social tax, while the Unemployment Insurance Fund is financed from compulsory unemployment insurance contributions which are divided between employer and employee and currently reach to 1.5% of an employee's gross income. From one hand, the level of expenditures of social security funds is determined by the volume of revenues collected, and from the other by legal reserve requirements of the funds. Based on the latter, the Health Insurance Fund has constantly been in surplus, while the surplus of the Unemployment Insurance Fund is attributable to a low cost level, characteristic of the fund's first years (Unemployment Insurance Fund was established in 2002) and the need to establish a sufficient reserve. According to the forecasts, social security funds will continue with a slight surplus (approx. 0.2–0.3% of GDP per annum).

The main tasks of **local governments** include co-ordination of local life and the primary education system, as well as promotion of human activities through social benefits. The number of functions delegated to local governments by the central government has increased over the last several years. The latest expenditure item transferred to the budgets of local governments was the payment of teachers' salaries (since 2000).

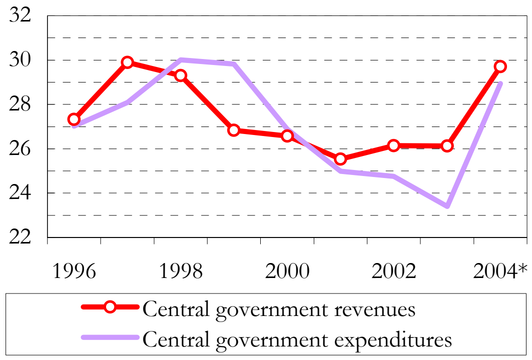
Local government units have a constitutional right for independent budgeting, which implies that they have relative freedom to form budget income and expenditures. Using the possibilities granted by the law, local governments have had a deficit in their budgets, starting since independence with high inflation during the first few years. The share of deficit has exceeded 5% of the local governments' aggregate income during the recent years. The surplus of other government levels is therefore a precondition to achievement of the main goal of fiscal policy – a balanced budget of the government sector.

In 2003, the deficit of local governments decreased by approximately 50% in comparison with the previous year, and the decrease continues in 2004. Besides that, the supplementary budget for 2004 contributed to improvement of the position, since local governments were thereby compensated the decrease in revenue base due to tax reform. In 2004, the predicted deficit of local governments will amount to 0.3% of GDP, and it will remain at the level of approx. 0.2% during the mid-term period. On one hand, the deficit decrease is caused by establishment of the goal of achieving balanced budgets in the medium term by local governments (mainly Tallinn), and on the other by reaching of the borrowing limits.

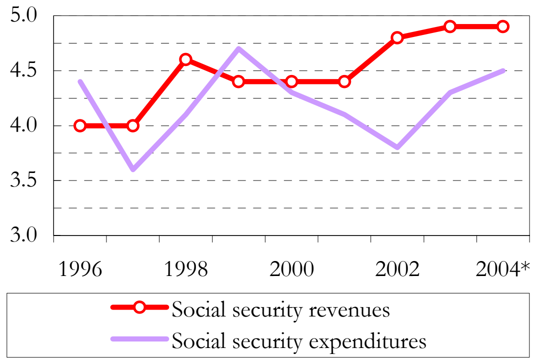
Figure 6

Government Sector Fiscal Indicators (ESA 95)
(% of GDP)

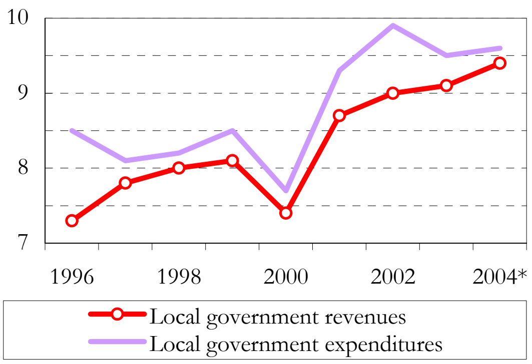
A. Central government revenues and expenditures



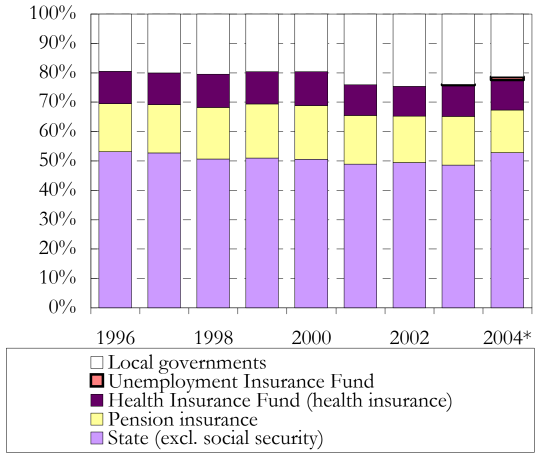
B. Social security funds' revenues and expenditures



C. Local government revenues and expenditures



D. Expenditures by general government sector levels



Sources: Ministry of Finance of Estonia, Statistical Office of Estonia

3.4. General Government Debt

The main goal of Estonian fiscal policy is to keep a balanced general government sector budget in the medium term, which results in a low level of debt burden relative to gross domestic product. General government debt reached 5.3% of GDP by the end of 2003, remaining on the previous year's level. Estonian general government sector's debt was 6.7 billion EEK at the end of 2003, out of which the central government debt amounted to 52% and the local governments' share to 48%. Foreign debt amount was 55%, or 3.7 billion EEK, 3.3 billion of which belong to the central government and 0.4 billion to local governments. Local governments have been actively borrowing in the recent years, thereby causing significant increase of domestic debt – by the end of 2003, the debt reached 3 billion EEK. During the first half of the year 2004, the debt level has not changed significantly – in fact, it has even somewhat (nominally) decreased due to local governments' surplus, amounting to 4.7% of GDP by the end of the half year.

Despite large budget surplus and principles of economic logic (according to which the debt is to be decreased in the case of surplus), the general government debt has increased over the last couple of years – the changing of this trend is to be expected in 2004. The reason can mainly be found in the fact that central government (and social security funds that have no debts) have not used the surplus for prior repayment and decreasing of debt (as, according to international standards, the debt burden is very low) and have instead used the money to increase deposits and establish reserves of liquid financial assets (above all, bonds with low risk level). The debt has increased mainly because of active borrowing by local governments to finance their deficit.

In the next few years, the debt burden of general government sector will decrease even more, reaching the level 2.9% of GDP by 2008. Here it is assumed that the repurchasing of euro(bonds) emitted by central government in the volume of 100 million euro will be financed from the available financial resources. The decrease will be mostly caused by preservation of a balanced general government budget policy, which means borrowing only the sums necessary for repayment of previous loans, leaving the reserves practically untouched. According to the forecast of the Ministry of Finance of Estonia, while the central government's debt burden is reduced due to budget planned with surplus, the local governments continue with a deficit according to the forecast, and will continue to finance their deficit by loans. However, the threat on the overall financial position of the general government to maintain a balanced budget will decrease, as several local governments approach the legally set borrowing limit, which prescribes a conservative budgeting policy, and thus a lower need for borrowing.

Table 3

General Government Debt Burden of 2003–2008

(% of GDP)

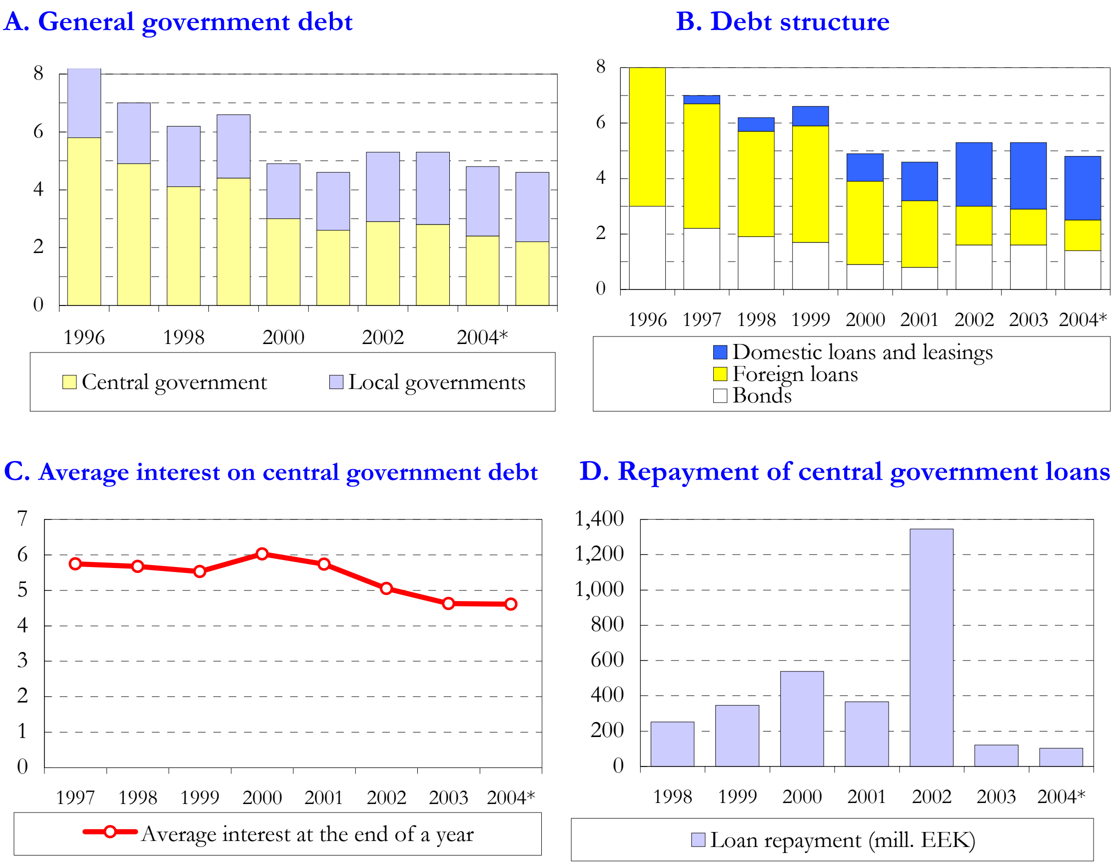
	2003	2004*	2005*	2006*	2007*	2008*
1. Gross debt level	**5.3**	**4.8**	**4.6**	**4.3**	**3.1**	**2.9**
2. *of which*: repayments due	0.3	0.3	0.3	0.3	1.3	0.2
3. Change in gross debt	0.0	-0.5	-0.2	-0.3	-1.2	-0.2
Contribution to change in gross debt	**0.0**	**-0.5**	**-0.2**	**-0.3**	**-1.2**	**-0.2**
4. Primary balance (-)	-3.4	-1.3	-0.2	-0.2	-0.2	-0.2
5. Interest	0.3	0.3	0.2	0.2	0.2	0.2
6. Nominal GDP growth	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3
7. Other factors influencing debt ratio	3.5	0.9	0.2	0.0	-0.9	0.1
8. *of which:* exchange rate change	0.0	0.0	0.0	0.0	0	0
9. *of which:* privatisation receipts	0.3	0.2	0.1	0.0	0.0	0.0
10. Implicit interest rate on general government debt (%)	**4.8**	**4.95**	**5.1**	**5.2**	**5.2**	**5.2**

Source: Ministry of Finance of Estonia

Figure 7

Debt Burden Development

(% of GDP)



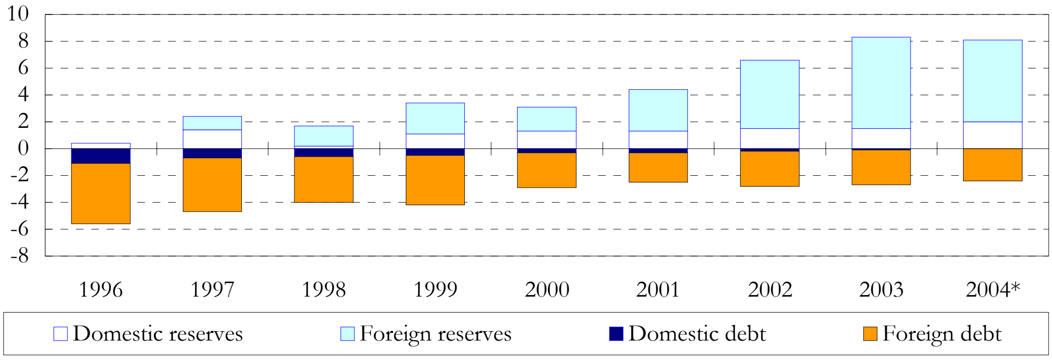
Sources: Ministry of Finance of Estonia, Statistical Office of Estonia, Eurostat.

3.5. Financial Reserves of the Government

Due to considerable surplus of general government budget in the recent years and, above all, in central government and social security funds' sector, the growth of general government reserves has been remarkable. At the end of 2003, central government's financial reserves exceeded the central government debt threefold and reached the amount of 10.6 billion EEK or 8.4% of GDP. By the end of the first half of the year 2004, the overall volume of savings and bonds had increased to 11.1 billion EEK. According to the forecast, since the budget surplus shall remain on the level reached by the end of the first half year until the end of the second half year, the central government's financial assets shall amount to 8.1% of GDP by the end of the year. As concerns 2005, according to the budget forecast, the financial reserves shall nominally remain on the previous year's level. A more detailed overview of the existing reserves and of their purpose and application regulations was provided in the previous Convergence Programme.

Figure 8

Central Government Debt and Reserves at the End of the Period
(% of GDP)



Sources: Ministry of Finance of Estonia, Statistical Office of Estonia.

4. COMPARISON WITH THE PREVIOUS PROGRAMME AND FISCAL RISKS

4.1. Comparison with the Previous Programme

Estonia's most recent macroeconomic developments have been rather similar to the forecasts given in the Convergence Programme May 2004, the main differences being caused by amendments in the GDP methodology of the Statistical Office of Estonia, introduced in June 2004 (imputed rentals were included in the GDP calculation), as a result of which the volume of GDP increased significantly. Inflation developments have been as expected and increase in prices is slowing down, but the increase in consumer price index in 2004 is somewhat higher than the forecasts given in spring. Unemployment rate was adjusted downwards in the most recent forecast of the Ministry of Finance of Estonia (summer 2004), due to fast growth of employment in the 1st quarter of the year 2004 and decrease in the number of the inactive.

Current account forecast was adjusted downwards in connection with the surprisingly good export results achieved in the 1st quarter of the year 2004 and specification of the data provided by the Statistical Office of Estonia, which included increasing of the foreign trade volumes of 2003. The forecast of current account deficit was also influenced by changes in the methodology applied by the Statistical Office of Estonia, which resulted in significant growth of GDP volume and lowering of the current account deficit's share in it.

Large current account deficit was balanced by general government surplus, reaching 3.1% of the GDP in 2003, which is the best indicator among the former and new EU Member States. Budget surplus is also expected this year. Based on the government's objective for balanced budget, the forecast budget positions for the coming years remain unchanged.

Although the general government budget surplus was larger than expected, debt burden still remained at the same level as a year before. This is mostly attributable to active borrowing activities of local governments. However, the central government did not use the budget surplus for loan repayment, as Estonia's debt burden is remarkably small in international context. The budget surplus was used to increase the liquid reserves. In comparison with the previous programme, the largest changes have taken place because of GDP recalculations.

Table 4

Change of Economic Programme in Comparison with Convergence Programme May 2004

(%)

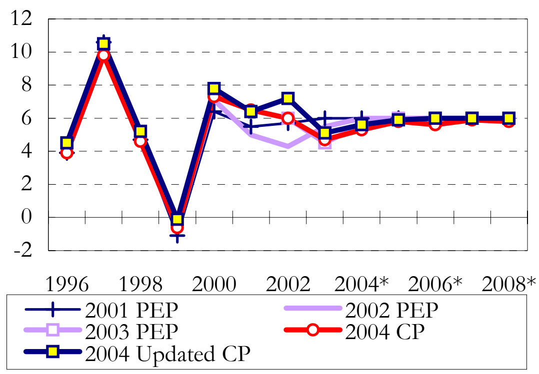
	2003	2004*	2005*	2006*	2007*	2008*
Economic growth, %						
Convergence Programme May 2004	4.7	5.3	5.8	5.6	5.9	5.8
Updated Convergence Programme Nov. 2004	5.1	5.6	5.9	6.0	6.0	6.0
Divergence	0.4	0.3	0.1	0.4	0.1	0.2
General government budget balance, % of GDP						
Convergence Programme May 2004	2.6	0.7	0.0	0.0	0.0	0.0
Updated Convergence Programme Nov. 2004	3.1	1.0	0.0	0.0	0.0	0.0
Divergence	0.5	0.3	0.0	0.0	0.0	0.0
General government debt, % of GDP						
Convergence Programme May 2004	5.8	5.4	5.1	4.7	3.4	3.2
Updated Convergence Programme Nov. 2004	5.3	4.8	4.6	4.3	3.1	2.9
Divergence	-0.5	-0.6	-0.5	-0.4	-0.3	-0.3

** Forecast.*
Source: Ministry of Finance of Estonia

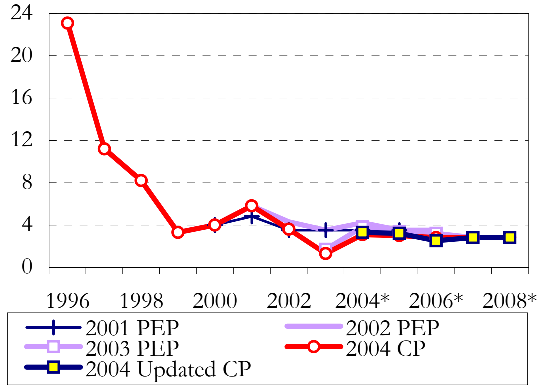
Figure 9

Divergence of Updated Convergence Programme 2004 in Comparison with Convergence Programme (CP) and Pre-accession Economic Programmes (PEP) 2001, 2002 and 2003

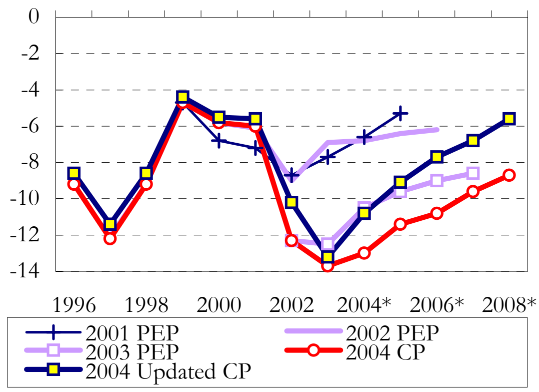
A. Economic growth (%)



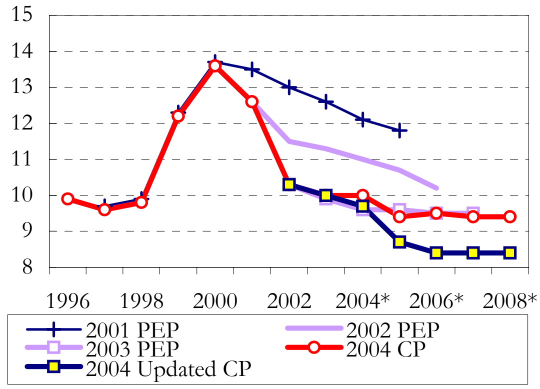
B. Inflation (%)



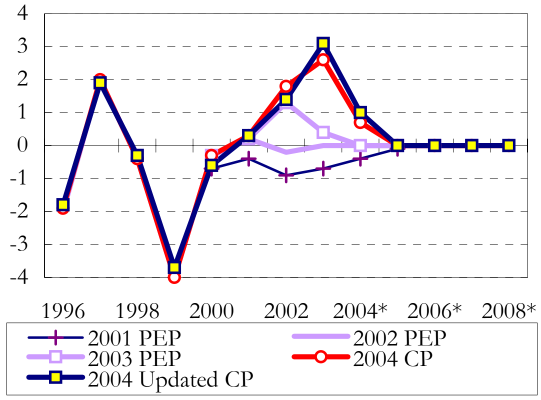
C. Current account balance (% of GDP) [2]



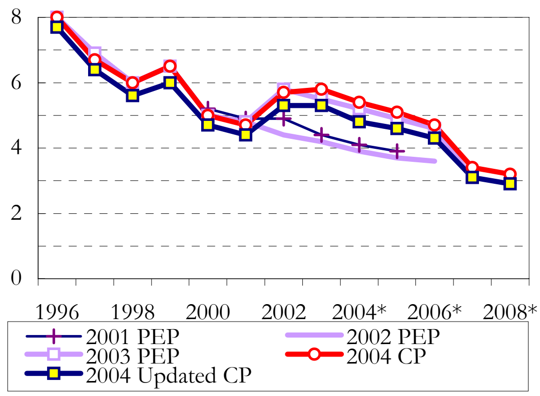
D. Unemployment (%)



E. Budget balance ESA 95 (% of GDP)



F. General government debt ESA 95 (% of GDP)



Sources: Ministry of Finance of Estonia, Statistical Office of Estonia, Bank of Estonia.

[2] Due to unexpected significant increase in acquisition of reserves before accession to the European Union and introduction of new foreign trade statistics collection methods (a great deal of the goods that were handled under the supervision of the Customs in customs warehouses and were not included in statistics according to the main trade system rules are now in free circulation and included in the statistics, since in the case of trade within the EU the customs warehouses were replaced by intermediate warehouses), the current account deficit in 2004 exceeds 15% of GDP.

4.2. Fiscal Risks

4.2.1. Central Government's Indirect Liabilities

From the viewpoint of ensuring the stability of the state's fiscal policy and increased transparency, specification of the state's potential liabilities and evaluation of the influence exerted by these liabilities on the fiscal position are to be considered very important. When dealing with potential liabilities, it is necessary to distinguish explicit contingent liabilities and implicit contingent liabilities. In the first case, the state's liabilities are specified by legislation or respective contracts. In the second case, it is presumed that the state will accept these liabilities should the respective event occur.

Explicit Contingent Liabilities

Study Loans

According to the Republic of Estonia Education Act, an Estonian citizen or a person staying in the Republic of Estonia on the basis of a permanent residence permit, the duration of whose studies according to the study programme is nine calendar months or more and who is enrolled in full-time study at an educational institution complying with the stipulations of the Act, has the right to obtain a study loan.

Upon the application of state security, the state shall perform the obligations of the recipient of the study loan arising from the loan agreement to the credit institution to the extent of the loan sum received by the recipient. If the state has performed the obligation of the recipient of a loan arising from the loan agreement, the state has the right of claim against the recipient of the loan and his or her sureties in the entire amount paid by the state to the credit institution.

According to banking statistics, the volume of potential obligations associated with study loans reached 2.6 billion EEK by the end of the year 2003, and this number is increasing continuously as the maximum amount of study loan increases. State security is realised from state budget; in 2003; the compensation amounted to 115.3 million EEK.

State Guarantees Granted by KredEx

State export guarantees. The grant of state export guarantees is regulated by the State Export Guarantees Act. The guarantees are granted by the Estonian Credit and Export Guarantee Foundation KredEx. Losses arising to a guarantee holder from an export transaction shall be compensated by Kredex to the extent of up to 100 per cent if political risk materialises and to the extent of up to 90 per cent if commercial risk materialises, the rest is the excess of the exporter. Average guarantee payments amount to approx. 0.5% of guaranteed short-term export turnover. As at the end of 2003, the guaranteed part amounted to 107.7 million EEK. According to plans made by KredEx, the volume of state export guarantees shall increase significantly during the next few years (to 104 million kroons by 2003). According to the Act, the guarantees may not exceed the limit sum of 300 million EEK. Nevertheless, due to forecasted increase in demand, proposals have been submitted for amendment of the Act by raising said limit sum to 1 billion EEK.

So far, materialisation of the guarantees has been relatively modest: by the end of the year 2003, losses in the sum of 305 thousand EEK had been compensated, which equalled to 0.16% of the export guarantees granted so far. A reserve fund intended for making of possible payments has been established based on the guarantee payments received; by the end of the year 2003, the reserve amounted to 4.4 million EEK. The Foundation must ensure that obligations arising from guarantee contracts are covered with own funds at all times, the established minimum size of the

Foundation's own funds is 12 per cent of the net asset value of the valid guarantees, but not less than 30 million kroons.

State loan guarantees. Grant of state loan guarantees is regulated by the Support of Enterprise and State Loan Guarantees Act. State guarantees are granted by KredEx, the foundation established by the state for guaranteeing of business and housing loans. State loan guarantees are granted for business loans and housing loans. 'Business loan' means an investment loan or a loan for working capital which is granted to undertakings in order to finance their enterprise-related expenses, or a leasing contract entered into for the same purpose. 'Housing loan' means a loan granted to persons which belong to a target group determined by the Government of the Republic or granted to apartment associations or housing associations in order to acquire housing or improve living conditions, including a loan granted in order to improve the economy, safety and maintenance of the residential building managed by the association, or a leasing contract entered into for the same purpose. Loan guarantees are being granted since 2001.

No state guarantee granted by a foundation may at any time exceed 75% of the balance of the loan commitment of the recipient of the loan. A state guarantee granted in an amount which exceeds 75% is valid only to the extent of 75%. When organising the grant of loan guarantees, the foundation must ensure that revenue and expenditure relating to the grant of the loan guarantees are balanced throughout a longer period, and that obligations arising from guarantee contracts are covered with assets at all times. Minimum limits of own funds have been established: 8% of the net asset value of the valid guarantees in the case of housing loans and 10% in the case of business loans, but not less than 30 million kroons. Today, the total amount of valid guarantee contracts entered into by the foundation may not at any time exceed 500 million kroons in the case of business loans and 700 million kroons in the case of housing loans. Since the indicated limit has already been achieved in the case of housing loans, and since in the case of business loans achievement of the respective limit is expected by the year 2007, proposals have been submitted for raising of the limits.

During the first three years of operation, no business loan guarantees were materialised, the first payments were made only this year. In the case of housing loans, two cases have been materialised, in the case of which losses were compensated in the amount of 85 thousand EEK. Reserve funds intended for making of possible payments have been established based on the guarantee payments received; by the end of the year 2003, the business loans reserve fund amounted to 15.4 million EEK and the housing loans reserve fund to 6.9 billion EEK. By the end of the year 2003, valid business loan and housing loan guarantees amounted to 268 million and 529 million EEK, respectively.

KredEx is an independent institution with its own assets and liabilities. The Government has only provided seed capital and additional finances are not being offered. Guarantees are offered by KredEx through commercial banks and the guarantee granting criteria are transparent. Possible payments made by the state shall be returned to the state on account of the income received by Kredex during the future periods. Therefore, possible risks of the state have been minimized.

Table 5

Volume of State Guarantees Granted by KredEx
(million EEK)

	2001	2002	2003	30.06.2004
Total valid guarantees	265.1	551.2	905.0	1121.2
Export guarantees	37.3	18.6	107.7	196.5
Business loan guarantees	82.4	214.9	268.3	290.8
Housing loan guarantees	145.4	317.7	529.0	633.9
Payments of KredEx guarantee losses	–	0.035	0.355	4.308
Export guarantees	–	0.035	0.270	1.681

Business loan guarantees	–	–	–	2.627
Housing loan guarantees	–	–	0.085	–

Source: KredEx.

Loan Contracts Guaranteed by State

According to the State Budget Act (until 1 January 2004, this field was regulated by the Foreign Borrowing by the Republic of Estonia and State Guarantees for Foreign Loan Agreements Act), a state guarantee may be applied for with respect to an obligation of a local government, a legal person in public law, a company in which all or most of the shares are or the only share is held by the state or a local government, or a foundation founded by the state if the applicant for the state guarantee is sufficiently creditworthy and assumption of the obligation is directly related to the performance of public functions or the requirement for a state guarantee is provided by law.

By the end of the year 2003, the remainder of guaranteed loans amounted to 618.2 million EEK, and this sum will decrease in the following years due to loan repayments (in 2003, the loan balance constituted 1.5% of state budget revenues). **There have been no cases of state guarantee materialisation, and the Government is of opinion that such materialisation is not likely to occur in the future as well.**

Table 6

Volume of State Guaranteed Loan Contracts

(million EEK)

	2002	2003	2004*	2005*	2006*	2007*	2008*
AS Tallinna Vesi	210.1	177.8	145.4	113.1	80.8	48.5	16.2
AS Eesti Veevärk	121.9	106.7	91.4	76.2	61.0	45.7	30.4
Eesti Post AS	84.0	84.0	73.5	63.0	52.5	42.0	31.5
AS Tallinna Lennujaam (EIB loan)	148.6	133.0	117.3	101.7	86.1	70.4	54.7
AS Tallinna Lennujaam (EBRD loan)	94.8	85.3	75.8	66.3	56.8	47.3	37.8
Eesti Televisioon	35.6	31.5	27.4	23.3	19.2	15.1	11.0
Guaranteed loan balance, sum total	**695.0**	**618.2**	**530.9**	**443.6**	**356.3**	**269.0**	**181.6**

** Forecast*
Source: Ministry of Finances of Estonia.

Obligations before Employees in Case of Company Bankruptcies

The state is obliged to compensate to employees for the wages, holiday pay and compulsory health insurance compensation unpaid to them before declaration of bankruptcy and the compensation which was not paid upon termination of employment contracts before or after declaration of bankruptcy. The total compensation paid to one employee may be up to equal to the amount of his or her two months' average wages, but it may not exceed Estonia's two average monthly wages at the time. In 2002, respective compensations paid by the state amounted to 21.6 million EEK. Since 2003, the means for covering of said expenditures are allocated by the Estonian Unemployment Insurance Fund. In 2003, the benefits upon the insolvency of an employer paid out by the Unemployment Insurance Fund amounted to 23.0 million EEK.

Summations

State compensations, both by court proceedings and extrajudicial resolutions. The necessary sums have been provided in the state budget; if the budgetary means should prove to be insufficient, the compensations shall be paid from the Government's reserve. In 2001, the sum amounted to 2.8 million kroons. Payments are made based on the Compensation for Damage Caused by State to Person by Unjust Deprivation of Liberty Act and other acts (mainly legal assistance).

Implicit Contingent Liabilities

Local Government Debt and Insolvency

Local governments with their active loan policies are under special attention of the Government, since the deficit of local governments forces the central government to establish state budgets with surplus; furthermore, as a member of the European Union, Estonia is obliged to follow the Maastricht criteria in the mid-term fiscal period. By the end of the year 2003, the debt of local governments amounted to 3.2 billion EEK. Due to Estonia's decentralised fiscal system, local governments are independent upon approval, implementation, and financing of their budgets, thereby exerting pressure in favour of growth of the Government's implicit contingent liabilities. However, involvement of external resources by local governments is limited by the Rural Municipality and City Budgets Act (debt obligations may not exceed 60 per cent of proposed budget revenue for that budgetary year; until July 2002, 75%), but the conditions stipulated by the act still allow local governments to borrow more than they are able to repay.

Local Governments Financial Management Act and Insolvency Act are currently being prepared. The Financial Management Act modernises and diversifies the methodology for accounting of debt obligations. At the same time, difficult financial situation regulation is established. The Insolvency Act establishes the conditions for settlement of claims in the case if a local government is declared insolvent. Implementation of this Act will thus help to decrease possible burdens of the general government through regulation of the activities of local governments

The state is not responsible for the obligations of local governments, and no help is generally provided by the state. Several local governments have managed to find solutions to their problems on their own and to reach an acceptable agreement with their creditors. In 2000, there were 4 cases, in connection with which some local governments were provided with loans, non-returnable support and returnable support in the sum of approx. 8.5 million kroons by the state. The means were allocated from the Special Situations Guarantee Fund of the Estonian Regional Development Foundation and of the non-budgetary reserve funds of ownership reform of the Government of the Republic. In 2002-2003, there have been two cases of allocating means from the Government's reserve to local governments.

In the end of 2002 and beginning of 2003, in all 5.2 million kroons were allocated from the reserve of the Government of the Republic for partial compensation of the central heating systems reconstruction loan taken by the city of Keila. The loan agreement was concluded at the time when the current territory of the city of Paldiski was legally the Paldiski district of the city of Keila, and the purpose of the loan agreement was financing of the reconstruction of Paldiski district's central heating system. Since the advantages arising from this loan are currently used by the city of Paldiski, which is now an independent local government unit, the Government of the Republic arrived at the conclusion that leaving of this obligation to the city of Keila would not have been reasonable, and transfer of the obligation to the city of Paldiski retroactively would not have been in accordance with the principle of legal expectations. In March 2003, 0.5 million kroons were allocated from the reserve of the Government of the Republic for payment of education-related debts of the city of Püssi, due to the very difficult economic situation in the city. By autumn 2004, the Ministry of Finance of Estonia and the Püssi City Government jointly prepared a rehabilitation plan for the city of Püssi and a financial plan for the years 2004-2007, based on which plans the solution of the difficult financial situation will be decided.

Financial Sector Obligations

In order to lessen the potential obligations of the financial sector, the state has founded the Guarantee Fund as a legal person governed by public law. The main objective of the Guarantee Fund Act (entered into force on 1 July 2002) is to establish the bases for functioning of deposit guarantee, investor protection and pension funds guarantee schemes in Estonia, as well as to develop a unified and efficient administration mechanism for the financial sector's guarantee schemes.

The Guarantee Fund replaced its predecessor, the Deposit Guarantee Fund founded in 1998, to which in addition to the Deposit Guarantee Sectoral Funds the Investor Protection Sectoral Fund and Pension Protection Sectoral Fund were added.

Here, attempts have been made to lessen the state's potential obligations through mandatory payment of contributions by those involved in the Guarantee Fund and participating in the scheme. In the case of the Deposit Guarantee Fund that existed for nearly four years, pre-financing was mainly applied, and for this reason the same financing method is also being used in the case of the respective new Sectoral Fund. By the end of the year 2003, 711 million EEK had been paid by credit institutions to the Deposit Guarantee Sectoral Fund. It is necessary to consider whether this sum is sufficient should a possible loss event occur. In the beginning of the year 2004, the overall volume of deposits in the credit institutions operating in Estonia amounted to approx. 54 billion EEK, of which the share of deposits belonging to private persons amounted to 18.5 billion EEK.

Although all Sectoral Funds are 'self-sufficient', limits have been established for collection of their quarterly contributions, in order to avoid excessive burdening of the financial market's development. In the case of each credit institution, the quarterly contribution may not exceed 0.125 per cent of the value of deposits guaranteed.

For this reason, the Guarantee Fund Act stipulates that if the assets of a sectoral fund are not sufficient to compensate for losses, it may take loans from credit institutions or other sectoral funds. If this possibility proves to be insufficient, the state's potential 'moral' obligation is engaged, i.e. the Guarantee Fund may request a loan from the state or a state guarantee for a loan taken. Therefore, long-term state assistance may prove to be extremely important, especially in the case of extensive loss events.

Post-financing is applied in the case of Investor Protection and Pension Protection Sectoral Funds, where service volumes are significantly lower and only the possible operation risk (not investment risk) is guaranteed. Nevertheless, if these sectoral funds should experience possible liquidity problems, the state is potentially obliged to interfere.

As concerns compensation for losses, separate limit values have been established for the Deposit Guarantee and Investor Protection Sectoral Funds, based on which the sufferer may apply for compensation. During the EU accession negotiations, a transition period was agreed: harmonization with the higher limit values established by the respective deposit guarantee and investor protection directives shall take place by 31 December 2007.

Therefore, the financial sector risks, especially as concerns small depositors and investors, have been established at a relatively low level and the need for state intervention is probably quite small. The only example of state intervention is the compensation of the deposits of Maapank's customers in 1998, to the extent of 366 million kroons – but the Deposit Guarantee Fund did not function at that time.

Obligations Associated with Privatisation Transactions

According to the Regulation "Procedure for Covering of Debts Associated with Privatised Property and Expenditures Associated with Privatisation" of the Government of the Republic, the finances received in connection with privatisation may be used for covering of the potential obligations of a privatised company, in the case if such obligations become evident after conclusion of the privatisation contract and provided that there is proof that the debt was not included in the budget of the privatised company and that parties to the contract were not aware of the debt.

The state has granted guarantees concerning possible compensation for losses to AS Eesti Raudtee, in connection with purchase of locomotives and submission of a possible claim by Valga KVD. The obligations assumed by the state in connection with these cases amount to max. 214 million kroons. Potential compensations shall be involved from the reserve of the Government of the Republic. In addition to this, obligations have been assumed concerning covering of losses arising from environmental damage liquidation. The only pending case is a 6.4 million EEK claim by AS Esoil.

Privatisation Vouchers

In accordance with the Act to Amend Acts Associated with Issue and Use of Privatisation Vouchers, the usage period of privatisation vouchers was selectively prolonged until 1 July 2006. If some privatisation vouchers remain unused after the expiry of said period, the Government may consider the possibility of compensating for such vouchers.

Obligations of Important Institutions

These include hospitals, various infrastructure undertakings, water economy enterprises, power stations, enterprises located in monofunctional settlements, etc.

Considerable tensions were caused by the bankruptcy of the Võhma meat processing plant (in 1996), which was the largest employer of the region. In order to relieve the difficult social and economic situation, in addition to compensating the employees for their unreceived wages, the Government allocated additional support in the sum of 0.4 million EEK from its reserve.

Natural Disasters and Environmental Damage

The state has remedied the consequences of such events quite willingly and reserves for such events will be available in the future as well. In 2003, 1.3 million EEK were allocated from the Government's reserve for that purpose.

Other Exceptional Compensations

There may be other situations and special events, in the case of which financing by the state is reasonable.

Table 7

Costs Associated with Realisation of Contingent Liabilities of the Estonian General Government

(million EEK)

	1997	1998	1999	2000	2001	2002	2003
Explicit contingent liabilities	***7.6***	***27.0***	***55.8***	***32.6***	***41.7***	***45.8***	***30.5***
Study loans	–	–	2.2	7.9	17.5	20.0	25.1
State guarantees	–	–	–	–	–	–	–
Company bankruptcies	7.6	26.5	50.7	22.9	21.4	21.6	–
Legal	–	0.5	2.9	1.8	2.8	4.2	5.4
Implicit contingent liabilities	***1.1***	***597.3***	***1.3***	***11.4***	***6.1***	**–**	**–**
Obligations of local governments	0.3	–	–	8.5	–	6.9	6.0
Banking-related obligations	–	366.0	–	–	–	1.0	4.7
Environmental and natural damage	0.8	231.3[3]	1.3	2.9	6.1	5.9	1.3
Sum total	**8.7**	**624.3**	**57.1**	**44.0**	**47.8**	**52.7**	**36.5**

Source: Ministry of Finance of Estonia.

[3] Of which 227 million EEK for partial compensation of natural disaster-relared damages to agricultural producers.

4.2.2. State Participation in Enterprises

Companies

Today, the state participates in 50 companies, in the following manner:
- 37 companies with 100% state participation,
- 3 companies with at least 51% state participation,
- 3 companies with 34 to 50% state participation, and
- 7 companies with less than 34% state participation.

On 1 January 2003, there were 53 companies with state participation. Administration over state participations is organised in a decentralised manner – in general, the ministry regulating the company's field of activity is appointed the administrator of the participation. State participations are currently being administered by ten ministries, of which the share of the Ministry of Economic Affairs and Communications is the largest (21 companies).

From 1 January 2003 to 1 October 2004, state participations have been sold in three companies for 16,754,829.7 EEK, in which companies the participations ranged from 75% to 0.003%. At the same time, the state has founded one new 100% state-owned company involved in assay marking, and in the near future a company involved in management of the state's liquid fuel reserves will be founded as well. During the period under consideration, state assets (monetary and non-monetary contributions to company share capital) with total value of 1.08 billion kroons (i.e. approx. 0.8% of GDP) were invested in the equity capital of companies with state participation – incl. the investment of the state participation in AS Eesti Põlevkivi (51%) into the share capital of AS Eesti Energia. Besides that, the shares of two 100% state-owned companies have been transferred to foundations established by the state.

As concerns participations in state-owned companies, four minor companies operating regional airports shall be merged with AS Tallinna Lennujaam, and the management of state participations not exceeding 34% shall be transferred to the Ministry of Finance of Estonia, since these can be considered as financial investments.

As concerns privatisation policy, the present coalition has agreed that companies with at least 50% state participation will not be privatised, but the possibility for their listing on the stock exchange in a manner allowing the state to exercise a dominant influence is not excluded.

By the end of the fiscal year 2003, the balance sheet total of assets of companies where the state owns more than 10% participation amounted to 36.6 billion EEK – in comparison with the respective figures in the year 2002, the increase is 3.1 billion EEK, i.e. 9.4%. The state's share in the assets amounts to 30.6 billion EEK (based on equity method analogy).

AS Eesti Energia continues to be the state-owned company with the greatest turnover. In the fiscal year 2003, the net turnover of AS Eesti Energia group amounted to 5.9 billion EEK, increasing by 3.1% in one year. In the fiscal year 2002, the net turnover of all companies with state participation amounted to 17.0 billion EEK, increasing by 0.5 billion (3.3%) in one year.

In the fiscal year 2003, companies with state participation over 10% made a total profit of 2.6 billion EEK, of which the state's share was 1.45 billion EEK. In the fiscal year 2002, the profit was 2.5 billion, and the state's share 1.6 billion. In 2003, AS Eesti Telekom earned the greatest profit, 1.0 billion EEK, followed by Eesti Energia (523 million EEK), Eesti Raudtee (347 million EEK) and Tallinna Sadam (231 million EEK). In the fiscal year 2002, net profit growth amounted to 48% (820 million EEK), of which the greatest part is attributable to the growth of the net profits of Eesti Energia and Eesti Telekom. In the fiscal year 2003, however, the net profit decreased by 1.57% (39 million EEK), which was mainly caused by the 46.8% decrease in the profit of Tallinna

Sadam in connection with increase in ice-breaking expenditures due to difficult ice conditions in winter 2003.

In the fiscal year 2003, total loss of companies with state participation over 10% amounted to 44.9 million EEK (in 2002, 37.9 million EEK). AS Werol Tehased suffered the greatest loss, 13.9 million EEK, which exceeded the previous year's loss by 29.0%. In all, 14 of the 46 companies in question operated at a loss in the fiscal year 2003.

By the end of the fiscal year 2003, the total equity capital of all companies with state participation over 10% amounted to 24.3 billion EEK (in 2002, 22.8 billion EEK), of which the state owned 20.2 billion (in 2002, 19.0 billion). Of the equity capital, the retained profits of the year 2003 and of the previous years total to 4.3 billion kroons, of which the state's share is 2.6 billion EEK (based on equity method analogy), thus amounting to 11.2% of the total equity capital. In the fiscal year 2003, the weighted average return on equity (ROE) of all companies with state participation over 10% amounted to 10.4%.

Foundations

By today, the state has established or commenced the establishment of 65 foundations, of which 37 have been established with the state being the sole founder. Exercise of the rights of the founder by the state has been divided between 24 ministries, county governments and constitutional institutions, of which the Ministry of Culture is the largest exerciser of the rights of the founder – in relation to 13 foundations.

In 2003, 7 new foundations were established; the respective figure by 1 October 2004 is 4. At the same time, 1 foundation terminated its activities in 2003, and 1 foundation merged with another foundation. During the said period, foundations established with state participation have been provided with state assets (monetary and non-monetary contributions to the foundations' capital), the total value of which amounts to 248.6 million EEK.

In 2003, assets of foundations established with state participation totalled to 4.3 billion EEK, which is 32.6% more than at the end of the year 2002, when the assets of foundations established by the state amounted to 3.2 billion EEK. The incomes of foundations established by the state totalled to 3.2 billion kroons, thus increasing by 41.5% compared to the year 2002.

5. IMPROVEMENT OF THE QUALITY OF PUBLIC FINANCE

5.1. Forecast of Public Finance up to 2008

Because of larger than expected collection of revenues in comparison to the budget, but mainly due to the fact that some expenditures are shifted into the next financial years, the general government surplus in 2004 is expected to reach the level of **1.0% of GDP**. For the general government, it is the fourth consecutive year of budget surplus. Among the most important factors behind improvement of the budget position (compared to the last years of the previous century) are the economic developments favourable from the viewpoint of revenue collection, as well as improved administration of revenue collection. The mid-term objective is continual ensurance of the compliance with the main goal of the Stability and Growth Pact – a balanced budget position or budget position with a surplus. Maintaining budget balance year after year also allows fulfilment of the balance goal over economic cycle. The budget forecast provided in this Programme takes into account the supplementary budget approved by Riigikogu on 10 November 2004, and the forecast concerning the year 2005 is based on the draft state budget for 2005, which was in the legal proceeding of the Riigikogu at the time of this Convergence Programme composition.

The price paid by the central government for achievement of fiscal policy goals is still rather high, since according to the forecast the local governments shall continue with deficit and the general government has to compensate the deficit of local governments for achievement of general balance by planning a larger surplus in the state budget. At the same time, it is necessary to point out that the deficit at municipal level is decreasing significantly compared to the recent years and shall amount to -280 million EEK in 2005, which is less than one third of the deficit in the year 2001. This decrease in deficit is caused by improvement of fiscal discipline at local government level, as well as by the fact that the limits for borrowing stipulated by law shall soon be taking effect, and this in turn requires adoption of a more conservative approach. In the forecast, the Ministry of Finance of Estonia also takes into account that amendments to the Rural Municipality and City Budgets Act are currently being prepared (estimated term of entry into force: 2006), and that the amendments should organise the budgeting principles of local governments. The planned amendments include mandatory preparation of a mid-term budget framework, establishment of limitations to annual deficit, and establishment of mandatory reserves.

Since the deficit of local governments is decreasing, the greatest challenge for the general government in the next few years will be covering of the pension insurance I Pillar deficit. Amendment to the Pension Insurance Act, endorsed by the Riigikogu in spring 2004, shall increase old-age pension by approx. 1,000 kroons over three years; however, such a decision contributes to pension insurance deficit. The deficit shall be the highest (0.7% of GDP) in 2006-2007; after that, the deficit will begin to decrease due to relatively conservative index.

In the near future, the budgets of social security funds will be planned with smaller surplus in comparison with the recent years. The Unemployment Insurance Fund and Health Insurance Fund are expected to replenish their reserves as required and in a volume equivalent to general economic growth. At the same time, the budget for 2005 of the Health Insurance Fund is planned with a minimum deficit (0.1% of GDP), while the contributions made to the Unemployment Insurance Fund (0.3% of GDP) exceed the benefits paid therefrom. Existence of reserves ensures payment of social security benefits even in the case of a possible negative scenario: reduction of social security fund incomes. As concerns the next few years, the budget position of the Health Insurance Fund is planned close-to-balance, while in the case of the Unemployment Insurance Fund it is presumed that the payments made from the Fund shall remain at the level of 2004.

Table 8

General government budget for 2003–2008 [1)]

(% of GDP)

	2003	2004*	2005*	2006*	2007*	2008*
Budget balance (B9) by sub-sectors						
1. General government	**3.1**	**1.0**	**0.0**	**0.0**	**0.0**	**0.0**
2. Central government	2.9	0.9	0.0	0.0	0	0
Of which: pension insurance contribution	*0.2*	*-0.3*	*-0.5*	*-0.7*	*-0.7*	*-0.5*
3. State government	-	-	-	-	0	0
4. Local government	-0.5	-0.3	-0.2	-0.2	-0.2	-0.2
5. Social security funds	0.7	0.4	0.2	0.2	0.2	0.2
General government (S13)						
6. Total receipts	38.9	41.0	40.7	39.0	37.6	37.5
7. Total expenditures	35.8	40.0	40.7	39.0	37.6	37.5
8. Budget balance	3.1	1.0	0.0	0.0	0.0	0.0
9. Interest payments	0.3	0.3	0.2	0.2	0.2	0.2
10. Primary balance	3.4	1.3	0.2	0.2	0.2	0.2
Components of revenues						
11. Taxes	21.9	21.3	21.4	20.4	19.5	19.6
12. Social contributions	11.5	11.1	10.9	10.7	10.5	10.5
13. Other revenues	5.5	8.6	8.3	8.0	7.5	7.4
14. Total receipts	**38.9**	**41.0**	**40.7**	**39.0**	**37.6**	**37.5**
Components of expenditures						
15. Collective consumption	8.8	9.3	9.1	8.7	7.7	7.6
16. Social benefits in kind	9.9	10.1	10.2	10.1	10.0	10.0
17. Social transfers other than in kind	9.6	10.1	10.2	10.2	10.1	10.1
18. Interests	0.3	0.3	0.2	0.2	0.2	0.2
19. Subsidies	0.9	1.4	1.4	1.3	1.3	1.3
20. Gross fixed capital formation	3.4	4.4	4.4	4.0	3.9	3.9
21. Other expenditures	2.9	4.5	5.1	4.5	4.4	4.4
22. Total expenditures	**35.8**	**40.0**	**40.7**	**39.0**	**37.6**	**37.5**

Sources: Ministry of Finance of Estonia, Statistical Office of Estonia.

1) The lowering of the revenue and expenditure levels in 2007-2008 in comparison with the previous years is caused by the fact that the new EU financial perspective was not available at the time of Programme preparation, for which reason the volumes of subsidies receivable in these years were forecasted in a conservative manner.

5.2. General Government Revenues

5.2.1. Structure of General Government Revenues

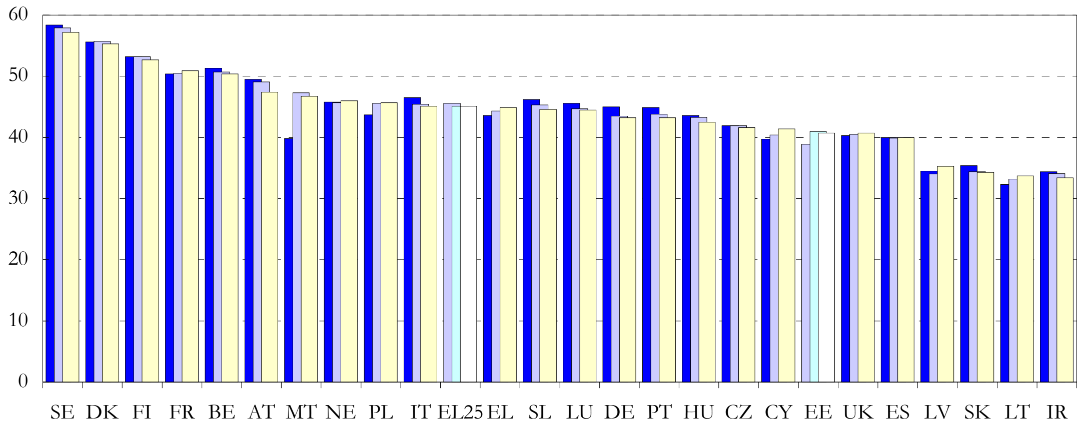
In years 1996-2003, the average ratio of general government revenues to GDP amounted to 37.9%. Single noticeable fluctuations before 2000 were mostly caused by single, so-called exceptional receipts, gained mainly from the sales of the shares of enterprises with state participation. Since 2000, the ratio of general government revenues to GDP has been steadily growing, exceeding the level of 41% of GDP in 2004. Increase in share of revenues is primarily attributable to good collection of tax revenues – while in 2001-2003 GDP in current prices increased 20.6%, the respective indicator for the collection of tax revenues in general government budget reached 30.7%. Strong growth of tax revenues was due to increase in VAT (domestic demand) and receipt of corporate income tax, related to active payment of dividends, supported by stably rapid growth in section of practically all the tax types. Improvement of tax administration is also an important aspect considering better collection of tax revenues.

Approximately 80% of general government revenues are contributed by three taxes: social security, income tax and VAT. As concerns tax revenues, a feature characteristic to the 1990-s is the shifting from direct taxation to indirect taxation (mainly through taxation of consumption), and this trend will continue in the future due to reduction of the income tax rate. In addition to tax revenues, several non-tax revenues are also paid to general government budget, for example: state fees, receipts from economic activities of enterprises with state participation, receipts from sales of state-owned assets, proprietary income, fines payable, loans taken, and supports and subsidies. In 2003, non-tax revenues contributed 14.6% of general government budget, being the next-important source of income after the three tax types mentioned above. Foreign assistance funds, allocated by the European Union, should increase the share of non-tax revenues in general government budget while reducing the share of tax revenues.

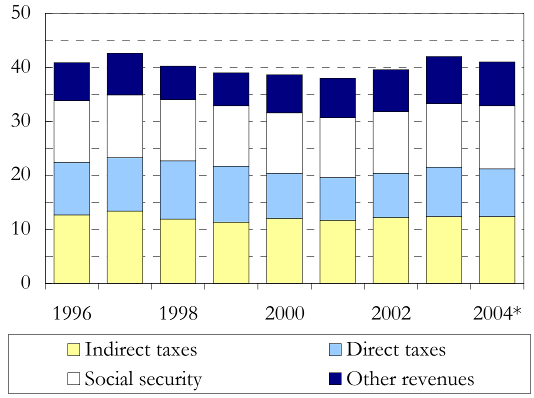
Figure 10

General Government Revenues and their Structure
(% of GDP)

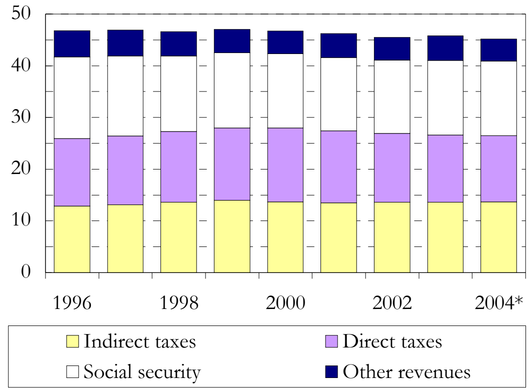
A. Estonian general government revenues compared with other EU Member States, 2004



B. Structure of Estonian general government revenues



C. Structure of general government revenues in EU 15



Sources: European Commission, Ministry of Finance of Estonia.

5.2.2. Most Important Developments in Revenue Policies Influencing the Budget for 2005

The purpose of Estonian tax system has been to motivate entrepreneurship and business while taxing consumption and pollution more than labour. At the same time, attempts have been made to keep the system simple, understandable and transparent, with as little exceptions and differences as possible. Our tax system has provided for economic growth and allowed functioning of the state during the last twelve years. In 2005, several amendments to legislation shall take effect, of which the most influential is the reduction of income tax rate.

The rate of **income tax** will be reduced from 26% to 24% in 2005, and the income tax-free threshold of natural persons will be increased by 300 EEK, to 1700 EEK. In comparison with 2004, these amendments will result in decrease of both natural and legal person income tax receipt to state budget by approx. 1.6 billion EEK. The income tax revenues included in the state budget for 2005 amount to 5.3 billion kroons – approx. 1 billion EEK less when compared to the budget for 2004.

Excise duties. In 2005, the excise duty rate imposed on strong alcoholic beverages and strong beer will be increased by 5%; the excise duty rate imposed on fuels marked with a fiscal marker will be adjusted upwards from 420 EEK to 690 EEK per 1000 litres, and the excise duty on cigarettes will be increased as well (as of 1 July 2005). In addition to the aforementioned legislation amendments, the collection of excise duties will increase in comparison with 2004 due to the fact that the effect of tax-free trade invalidation since 1 May 2004 and increase in fuel excise duty rates will become evident in the state budget for 2005 following the completion of a so-called full year. Due to existence of goods reserves, receipt of excise duty revenues will increase in the state budget for 2004 as a result of the aforementioned legislation amendments only during 6-7 months. Compared to the budget for 2004, the total increase in receipt of excise duties in 2005 will amount to 6.4 billion kroons, i.e. 24.3%.

The rate of **gambling tax** per one gambling table shall be increased from 15,000 EEK to 20,000 EEK, and per one gambling machine from 5,000 EEK to 7,000 EEK. In comparison with the budget for 2004, the gambling tax revenues will increase by 56.5 million EEK.

As concerns **value added tax**, no legislation amendments exerting significant influence on the budget enter into force in 2005, but the VAT base will increase due to after-effects of legislation amendments that entered into force on 1 May 2004. The greatest of these after-effects are associated with the invalidation of tax-free trade, obligation to pay VAT for the entire volume of transaction together with the first capital lease payment, and return of VAT to third country passengers. The planned VAT collection in 2005 amounts to 13.7 billion EEK, i.e. 18.0% more than in 2004.

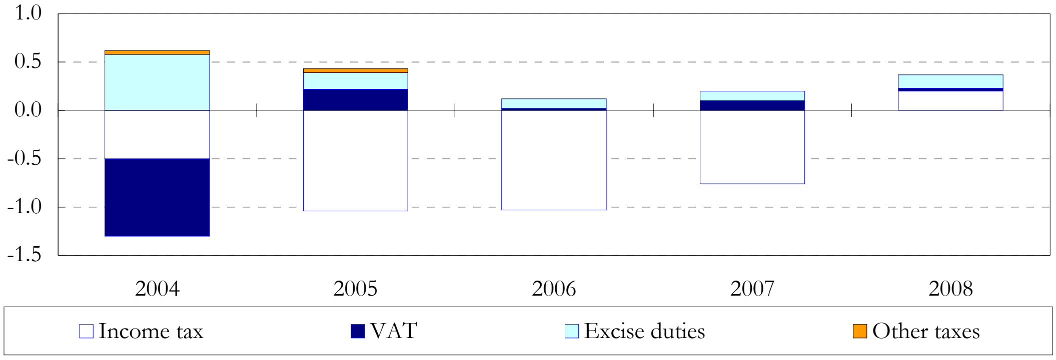
As concerns **non-tax revenues**, subsidies from the European Union and other institutions constitute the greatest item of income, totalling to 6.5 billion EEK. According to the budget for 2005, the expected gross yield of property shall amount to 1.6 billion EEK and revenues from sales of goods and services to 1.4 billion EEK. Revenues will be negatively influenced by state fees, since their receipt will remain below the level of 2004 as a result of several legislation amendments (state fees of the Communications Board, court fees, etc.). According to the budget for 2005, the planned receipts from other revenues amount to 573 million EEK and the receipts from sales of tangible and intangible property to 233 million EEK.

Figure 11

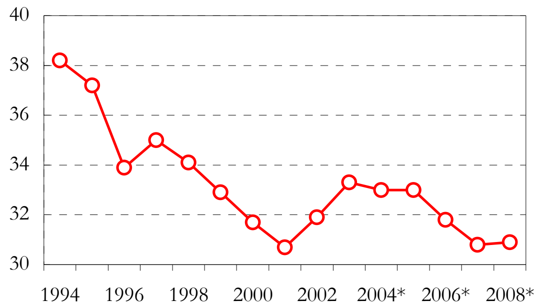
Development of Tax Burden in Estonia

(% of GDP)

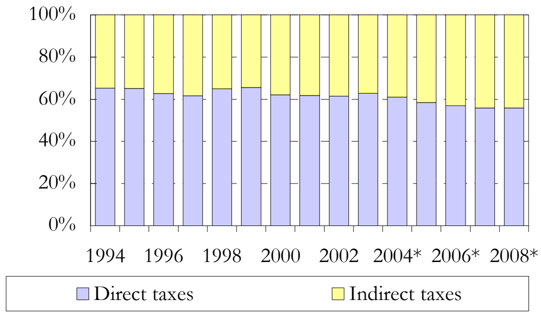
A. Influence of tax amendments in the next few years



B. Tax burden



C. Direct and indirect taxes ***(%)***



Sources: Ministry of Finance of Estonia, Statistical Office of Estonia

Table 9

Tax Amendments in 2005 and their Effects

Income tax of natural persons: • increase of tax-free threshold from 16,800 EEK to 20,400 EEK per year (-0.3% of GDP); • lowering of deduction limit from 100,000 EEK to 50,000 per year (effect in 2006: +0.05% of GDP).

Income tax:

- reduction of income tax rate from 26% to 24% (-0.8% of GDP).

Alcohol excise duties:

- increase of the rate of excise duty on beer from 55 EEK per one per cent of ethanol by volume per hectolitre to 58 EEK (+0.03% of GDP);
- increase of the rate of excise duty on fermented beverages or wine with an ethanol content of up to 6% (inclusive)by volume from 325 EEK per hectolitre to 341 EEK (+0.003 of GDP);
- increase of the rate of excise duty on intermediate products from 1,600 EEK per hectolitre to 1,680 EEK (+0.0001% of GDP);
- increase of the rate of excise duty on other alcohol from 145 EEK per one per cent of ethanol by volume per hectolitre to 152 EEK (+0.05% of GDP).

Excise duty on tobacco:

- increase of the rate of excise duty on tobacco from 240 EEK/1,000 pc. + 25% to 275 EEK/1,000 pc + 26%; (+0.02% of GDP)
- increase of the rate of excise duty on smoking tobacco and chewing tobacco from 240 EEK/kg to 280 EEK/kg (+0.001% of GDP).

Excise duty on fuel:

- increase of the rate of excise duty on kerosene from 3,840 EEK per 1,000 litres to 4,730 EEK (+0.001% of GDP);
- increase of the rate of excise duty on diesel fuel for special purposes and light heating oil from 420 EEK per 1,000 litres to 690 EEK (+0.05% of GDP);
- increase of the rate of excise duty on heavy heating oil from 200 EEK per 1,000 kg to 235 EEK (+0.001% of GDP);
- establishment of excise duty rate on shale-derived fuel oil (235 EEK per 1,000 kg) (+0.008% of GDP);
- establishment of excise duty rate on coal, brown coal and coke (4.7 EEK per gigajoule) (+0.002% of GDP);
- increase of the rates of excise duty on other, less important types of fuel (+0.004% of GDP).

Gambling tax:

- increase of gambling tax from 5,000 EEK to 7,000 EEK per gambling machine (+0.04% of GDP);
- increase of gambling tax from 15,000 EEK to 20,000 EEK per gambling table (+0.004% of GDP).

Source: Ministry of Finance of Estonia.

5.2.3. Simplification and Improvement of Tax Administration

In Estonia, the process of tax collection has been made as simple and transparent for taxpayers as possible. Since efforts are being made year by year in order to decrease the number of tax returns submitted in writing, one of the objectives of the tax authority is to make electronic submission of tax returns as simple as possible for the taxpayers. The entire process includes timely announcement of all amendments made in various tax return forms, which may be caused by legislation or rules in force in the European Union. Most significant of the amendments to be made are always covered by press releases, but the taxpayers also have the tax authority's support at their disposal during the entire process of tax return submission.

In Estonia, the e-Tax Board is functioning since the year 2000. Since that time, the possibilities offered by the e-Tax Board have become more extensive year by year: while in 2000 the e-Tax Board only allowed submission of natural persons' tax returns via the Internet, today it is also possible to e.g. submit, review and correct value added tax returns, income tax returns and social tax returns. During the first three quarters of the year 2004, 60% of natural persons' tax returns, 64% of income tax and social tax returns, and 74% of value added tax returns were submitted through the Internet.

The causes of the popularity of e-Tax Board and its utility are evident. Taxpayers need not waste their time and nerves running from office to office and standing in lines, since all the necessary actions may be performed at home or at work, using a computer. The more quickly and easily something can be accomplished, the larger is the likelihood that the respective possibilities will be used. The tax authority, on the other hand, needs not to waste its resources on entry of data into databases or receipt of tax returns.

In addition to simplification of tax liabilities declaration, understanding of tax-related legislation by the taxpayers has also been considered important. For this purpose, tax-specific customer training courses are being arranged several times a year, both for Estonian-speaking and Russian-speaking population. The arrangement of such training courses is beneficial for both taxpayers and the tax authority – on one hand, the transparency of the tax system is improved from the viewpoint of taxpayers, and on the other the tax authority needs to waste less time on tax returns containing errors.

5.3. General Government Expenditures

5.3.1. Structure of General Government Expenditures

From the very first years of independence, the ratio of general government expenditures to GDP has been close to 40% of GDP (except in 1999, in association with the economic crisis in Russia and Asia). In recent years, the level of expenditures has shown a slight increase, reaching the level of 40.0% of GDP in 2004. Despite the one-off financing items (including the possibility to use EU funds for financing of budget expenditures) having an expansionary effect on expenditures, increase in regular revenues has been even faster and budget surplus has increased year by year. However, main developments with respect to expenditures and GDP are attributable to changes in macro-economic situation. From the other hand, impact of political influences is clearly distinguishable in several years. During the periods of fast economic development, the share of expenditures to GDP has been lower, while at lesser growth rates the ratio of expenditures and GDP has started to increase, meaning that the policy has been counter-cyclical.

Transfers to households through different social benefits contribute the largest share (approximately 40%) of general government expenditures. Transfers with social background amount to approx. 15% of GDP. Pensions represent the largest group of expenditures, followed by medical treatment expenses, health care procedures, sickness benefits paid by Health Insurance Fund, and compensations for medicines. Subsistence benefits and subsidies to disabled people also make up a considerable share.

Expenditures on general government's employees (wages and taxes and fees paid on wages) contribute approx. one fifth of total expenditures; expenditures on goods and services purchased by general government are largely equivalent to this amount.

Expenditures made on investments and capital renovations and repairs contribute less than a tenth of general government expenditures. Compared to the respective European Union average, the share of capital expenditures is somewhat larger, but this is attributable to investment needs characterising a transition economy. Pre-accession funds of the EU have also played an important role here, since the co-financing expenditures have contributed notably to the volume of total expenditures.

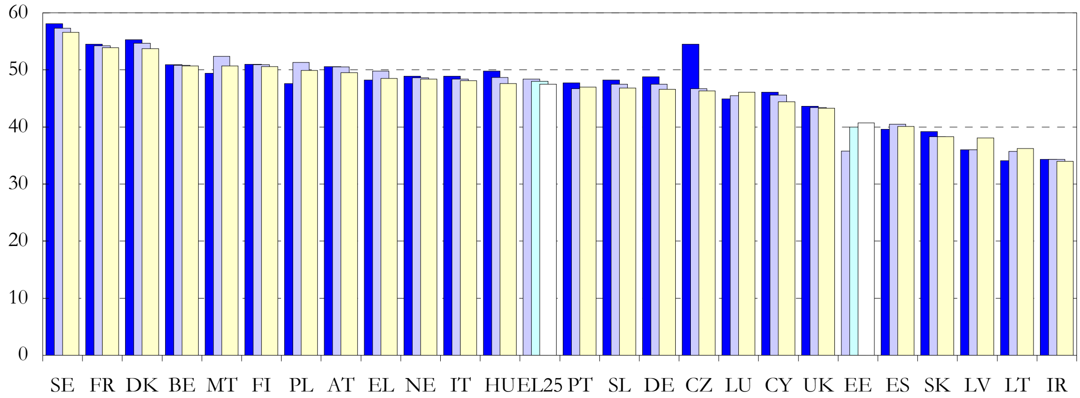
Other expenditures consist of interests due, subsidies to business enterprises and allocations to various non-profit organisations (public legal entities, foundations, non-profit associations, international organisations).

Figure 12

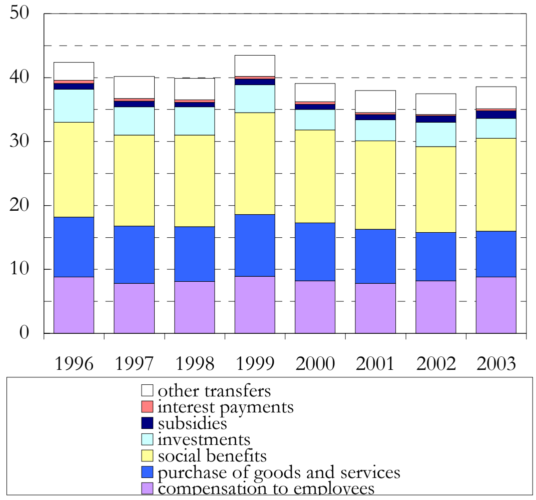
General Government Expenditures and their Structure

(% of GDP)

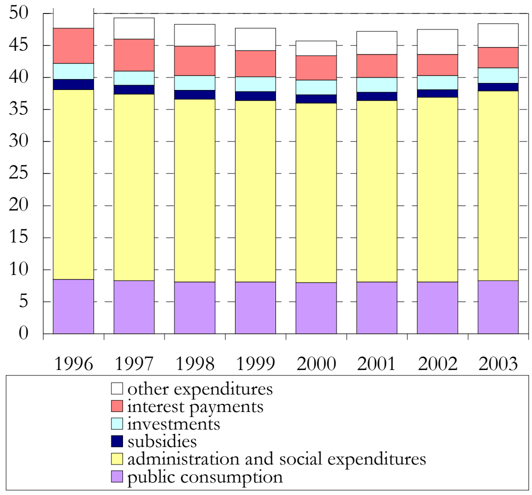
A. Estonian general government expenditures compared with other EU Member States, 2004



B. By economic meaning in Estonia[4]



C. By economic meaning in EU15



Sources: European Commission, Ministry of Finance of Estonia.

5.3.2. Most Important Changes in Expenditure Policies Influencing the Budget for 2005

Education (incl. teachers' wages and investments into schools). The wage fund of general education school teachers will be increased by 220 million EEK, which allows approx. 12% wage increase. In the case of vocational school teachers, the planned wage increase is approx. 13%. Means have also been provided for increasing of the wages of special education teachers and for provision of an extra year. Since 1 January 2005, investment resources will be transferred to general education schools as a single capitation fee allotment. 239.7 million EEK will be provided for repair of schools through capitation fees. Furthermore, in 2004, 600 million EEK were additionally allocated by supplementary budget for repair of schools via Riigi Kinnisvara AS. State-

[4] The expenditures of Estonian and EU general government have been classified differently. However, investments, subsidies, interest payments and overall volume of expenditures can be compared.

commissioned higher education focuses on technical fields of study, information technology and biosciences. In the budget for 2005, the growth in the higher education area amounts to 67.7 million EEK. Approx. 150 million EEK will be additionally input into research and development activities.

Active labour market policy. Of the budget for 2005, 258.9 million EEK (i.e. approx 26% more than in 2004) are allocated through various support mechanisms to the funding of active labour market policy. Additional training and retraining courses will be offered to at least 21,000 people (6,000 more than in 2004).

Health care. 7.3 billion EEK from the budget for 2005; approx. 8% (513 million EEK) increase in comparison with 2004. Planned expenditures include increasing of the minimum wages of medical staff (doctors and nurses, up to 33%) and a 520 million EEK increase of the budget of the Health Insurance Fund.

Social protection. The sum of various social security benefits exceeds 13 billion EEK, with growth of approx. 9%. The funding of parental benefits will be increased by 150 million EEK and the average old-age pensions and subsistence benefits will be raised as well.

Development of agriculture and rural life. In the budget for 2005, the possibilities for acquisition of additional direct aid for agricultural producers provided by EU accession conditions have been taken into consideration. The state's share amounts to 268 million EEK, which allows achievement of the maximum level allowed – 60% of the direct aid level of 'old' EU member states (in 2004, 216.6 million EEK). In all, 2.5 billion EEK (of which 1.9 billion EEK is foreign aid) will be allocated to funding of agriculture and rural development in 2005.

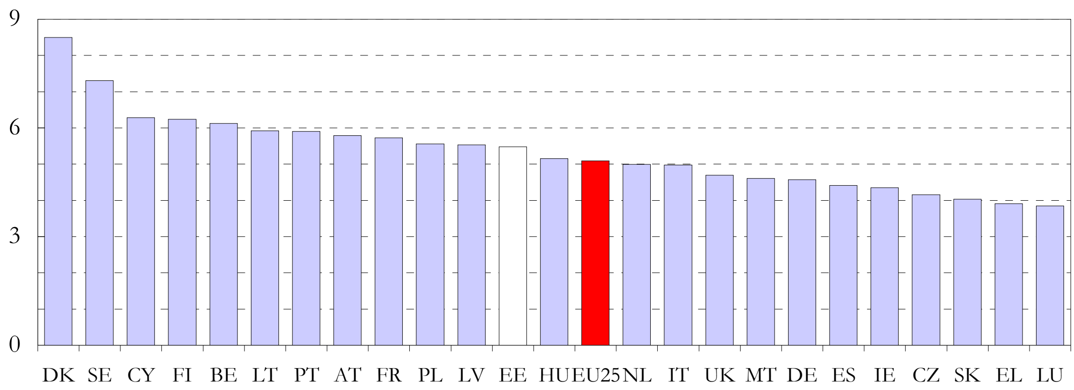
Development of environmental protection and management. From the budget for 2005, 1.17 billion EEK will be allocated to funding of the development of environmental protection and management (in 2004, 810 million EEK). The increase in comparison with 2004 is 31% (364 million EEK). The increase is mainly associated with provision of water economy and waste management investment supports to local governments on account of foreign aid.

Figure 13

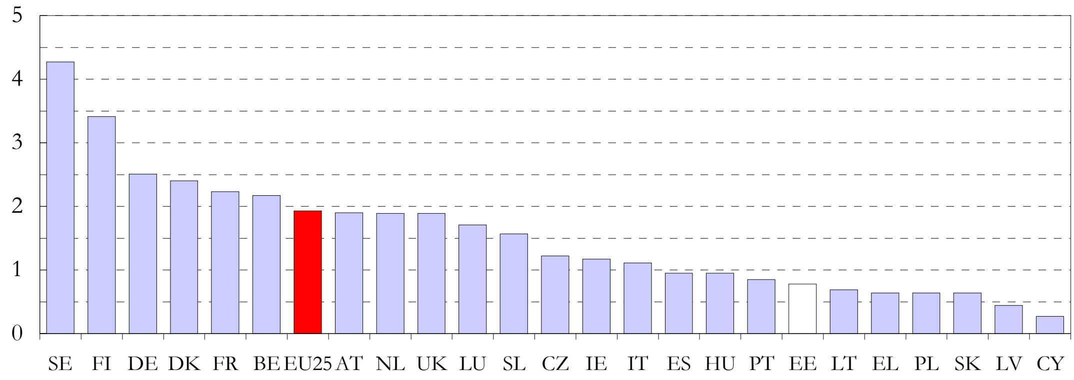
Education and R&D Expenditures Compared with Other EU Member States

(% of GDP)

A. Education expenditures in 2001



B. R&D expenditures in 2001



Source: Eurostat.

5.4. Development of Budgeting Process

In principle, the establishment process of the state budget for 2005 commenced in spring 2004, with devising of the State Budget Strategy. The State Budget Strategy for 2005–2008 was prepared by ministry-based performance areas. The institutions planned their activities, results, and resources required in 2005 based on performance areas, proceeding from the objectives identified in the State Budget Strategy and determining the measures required for achievement of the objectives.

Together with the State Budget Strategy, the Government of the Republic for the first time also approved a long-term financial perspective – the budget limits in the ministries' areas of government until the year 2008. Since the limits were approved for the first time with the Budget Strategy, this provided a direct input into establishment of the budget for 2005. The state budget for 2005 was established based on the State Budget Act, coalition agreement, State Budget Strategy 2005-2008 approved by Order No. 392-k of the Government of the Republic of 31 May 2004, and Regulation No. 116 of the Minister of Finance of 8 June 2004 "Preparation of Draft Budgets". The draft state budget for 2005 has been compiled on cash basis, similarly to the state budgets for previous years.

An important difference in comparison with the previous year was that the **ministries and the State Chancellery had to submit their budget applications without exceeding the limits established by the State Budget Strategy**. The action plan prepared on the basis of Budget Strategy 2005–2008 is a draft of the budget costs included in the budget for 2005, in which draft the measures' budgets of expenditure are reflected per source, by economic content of expenditures, without exceeding the aforementioned limits. The action plan specifies the measures required for achievement of objectives and the cost of said measures per each specific year. This is a big step on the road that leads to interconnection of activities and resources, but despite the fact that institutions were obliged to plan their next year's activities together with the resources necessary for performance of these activities, the connection between the objectives and the cost of their achievement still remains indirect. This is so due to the fact that a unified and comparable, activity-based cost budgeting methodology has not yet been established. Activity-based planning should also be supported by reporting, which is currently limited to only a routine control-based report concerning the compliance with expenditure limits provided for in the respective year's State Budget Act.

As was already mentioned above, the draft budgets for 2005 had to be submitted in the form of an action plan, by areas of activity, objectives and measures. **The objective was to show what will be done for the planned money**, also informing the general public about it through the explanatory memorandum to the draft budget. The state budget for 2005 was established based on the objectives and measures stipulated in the State Budget Strategy and the most important activities provided for in action plans, i.e. on the desired results to be achieved during the next budget year. Budget negotiations also focus on the results to be achieved through the use of finances received. In addition to economic content of expenditures, the Ministry of Finance of Estonia pays more and more attention to the results the institutions plan to achieve through the use of state budget resources. Information on achievement of the respective objectives must be provided in annual action plan fulfilment reports, the submission of which will be regulated by content-related instructions in the future.

6. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCE

Consequences of ageing of the population:

- Ageing of the population brings a decrease in the relationship between the employed and the retired (system dependence rate). The system dependence rate in Estonia, which was 2.00 in 1992, has now decreased to 1.80. According to projections it could decrease to 1.27 by 2050.
- Thus, the usual pay-as-you-go (PAYG; I Pillar in Estonia) pension insurance system cannot provide a normal quality of life to the retired and the ratio of the average pension to average salary (replacement rate) decreases.

Measures adopted so far for ensurance of the sustainability of Estonian pension insurance:

- Since 1999, pension rights in Estonia are tied to individually registered social tax, which ensures that I Pillar part of a person's pension also depends on his or her personal input.
- The Pension Act, which came into force in April 2000, enforced a rise of the pension age and gradual elimination of the pension age difference between the genders. A common pension age for men and women of 63 years will be achieved in 2016.
- Pension indexation applied since 2002 allows making the pension's growth dependent on the real situation in the country and its possibilities. Pensions will rise once a year based on an index composed of annual change in the consumer price index and arithmetic mean of growth in the pension's portion of the social tax. Indexation does not occur if the index value is less than 1, thus eliminating the possibility of a decrease in pensions.
- Pre-financed or obligatory savings pension system (II Pillar) started on July 1, 2002. The savings pension offers more stable solution for financing pension expenditures by transferring the I Pillar deficit, expected in the long run over the next few years.
- By implementation of conservative budget policy, Estonia has managed to keep its debt burden low and considerable reserves have been established by the central government over the years.

Long-term sustainability of the present budget policy. Analysis was conducted given continuing of the same policy, which means:

- preservation of the present social securities financing system, financed with the social tax;
- social tax is 33% of gross salary (20% pension insurance and 13% medical insurance);
- I Pillar pensions indexing continues using the same formula;
- no one-off pension increases in between 2005 and 2006 besides the approved pension rises of 100 kroons.

Developments expected during the next decades:

- I Pillar pension revenues decrease (as a percentage of GDP), since 4% of II Pillar participants' social tax payments is transferred to their personal pillar II account, which leaves 16% of their gross salary for the I Pillar (instead of the former 20%). Expected increase in II Pillar participants also has a negative impact on I Pillar income.
- The steps taken so far decrease pressure on the I Pillar expenditures. The rise in women's pension age will decrease the number of retired until 2016, and growth of expenditures will also be kept under control by the relatively conservative state pension index. The demographic situation also adds its pressure.
- At the same time, aggregate pension of the population increases, due to increase of II Pillar pension.

- Quicker growth of state pension insurance income compared to expenditures brings increase in reserves in the long-term. In 2000-2003, the reserve grew from 0% to 1.4% of GDP, but it is expected to decrease in the following years as a result of implementation of the II Pillar and additional one-off pension rises (e.g. raising of pensions by 100 kroons on 1 July 2003 and 1 April 2004). If such policies continue, it will result in I Pillar deficit and exhaustion of the reserves in 2006. After that, the state pension insurance should be in surplus again and the reserves will start to increase.

Possible further analysis in the future:

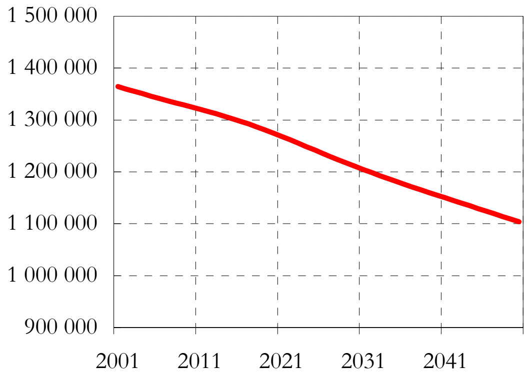
- In the long run, it is necessary to search for possibilities to review the pension index so that the decrease of the pension replacement rate acquired from I Pillar is reduced. In the next few years, this problem will be resolved by one-off pension rises in 2005 and 2006. In the more distant future, the restoration of I pillar balance and accumulation of reserves will provide a possibility for changing of the index.
- In the case of the present long-term sustainability forecast, health care expenditures are provided with consideration of the financing from social tax fixed at 13%. In the future, an alternative analysis must be conducted, proceeding from possible cost pressures.

Figure 14

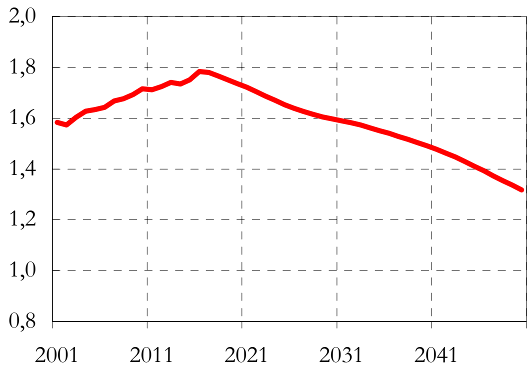
Long-term Developments of State Pension Insurance

(% of GDP)

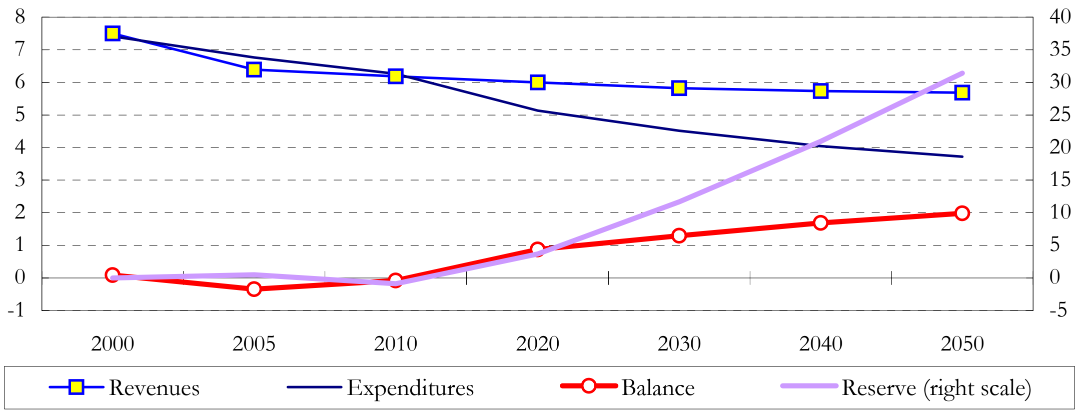
A. Population of Estonia



B. Employees/pensioners relation



C. Financial indicators of state pension insurance



Sources: Ministry of Finance of Estonia, Statistical Office of Estonia.

Table 10

Long-term Sustainability of Public Finances and State Pension Insurance

	2000	2005	2010	2020	2030	2040	2050
Basic indicators of public finance (% of GDP)							
1. Old age pensions, I Pillar (PAYG)	7.41	6.76	6.26	5.13	4.52	4.04	3.72
2. Health care	4.81	4.62	4.62	4.62	4.57	4.57	4.57
3. Revenues of I Pillar of pension system	7.5	6.39	6.18	6.00	5.82	5.73	5.68
4. of which social contribution	*7.21*	*6.11*	*5.90*	*5.73*	*5.57*	*5.45*	*5.43*
5. from state budget	*0.29*	*0.28*	*0.28*	*0.27*	*0.25*	*0.24*	*0.23*
6. Balance of I Pillar	0.09	-0.34	-0.08	0.87	1.30	1.69	1.98
7. I Pillar reserve	0.02	0.50	0 (-0.98)	3.68	11.68	20.96	31.42
Assumptions (%)							
8. Labour productivity growth	8.6	4.36	3.82	2.94	2.30	2.23	2.17
9. Real GDP growth	7.3	5.13	4.10	2.24	1.63	1.26	1.11
10. Participation rate males (aged 15-64)	70.2	68.2	71.0	73.3	72.3	72.1	71.0
11. Participation rate females (aged 15-64)	57.3	60.7	63.2	66.2	65.8	64.9	63.3
12. Total participation rates (aged 15-64)	63.3	64.3	67.0	69.7	69.0	68.5	67.2
13. Unemployment rate (ILO)	13.6	9.9	8.9	7.4	7.1	6.9	6.8
14. Population	1,369,515	1,346,241	1,324,914	1,274,599	1,210,419	1,155,012	1,103,950
Nominal pension and wage (in kroons)							
15. Average old age pension (switchers + non-switchers)	1,532	2,364	3,268	5,202	8,293	14,397	22,727
16. Average old age pension of the switchers to II Pillar	–	2,357	3,503	6,330	11,250	20,079	28,006
17. of which from I Pillar	–	*2,357*	3,162	4,688	6,359	8,466	10,873
18. from II Pillar	–	–	341	1,642	4,891	11,613	17,133
19. Average gross wage	4,907	7,784	10,892	19,757	33,227	53,202	84,632
20. Average replacement rate (%)	39.9	37.7	35.7	31.3	29.7	32.2	32.0
21. Replacement rate of switchers (%)	–	–	38.3	38.2	40.3	44.9	39.4

Source: Ministry of Finance of Estonia, Statistical Office of Estonia.

ANNEXES

Annex 1. Main Economic Indicators of Estonia in 1997–2003

Table 11

Main Macroeconomic Indicators of Estonia in 1997–2003

(per cent)

	1997	1998	1999	2000	2001	2002	2003
Main economic indicators							
1. GDP real growth	10.5	5.2	-0.1	7.8	6.4	7.2	5.1
2. GDP (billion EEK)	68.3	78.3	81.6	92.7	104.3	116.9	125.8
3. GDP deflator	10.5	9.0	4.3	5.3	5.8	4.4	2.4
4. Consumer price index	11.2	8.2	3.3	4.0	5.8	3.6	1.3
5. Employment (15-74 years old, th.)	617.2	606.5	579.3	572.5	577.7	585.5	594.3
6. Employment growth	-0.3	-1.8	-4.5	-1.2	0.9	1.4	1.5
7. Productivity growth	11.7	7.0	4.6	9.1	5.7	5.9	3.6
8. Unemployment rate	9.6	9.8	12.2	13.6	12.6	10.3	10.0
9. Average wages (EEK)	3,571	4,100	4,418	4,876	5,511	6,110	6,709
10. Wage real growth	7.6	6.0	4.3	6.1	6.9	7.0	8.3
11. Investments and inventories (% of GDP)	30.5	30.2	25.0	27.9	29.2	31.8	31.1
12. Current account (% of GDP)	-11.4	-8.6	-4.4	-5.5	-5.6	-11.3	-12.6
Sources of growth							
13. Private consumption	10.6	5.2	-2.7	8.5	5.9	9.9	5.4
14. General government consumption	-1.3	1.7	2.9	1.1	1.8	5.9	5.8
15. Gross fixed capital formation	19.9	14.0	-15.6	14.3	13.0	17.2	5.4
16. Change in inventories (% of GDP)	2.6	0.4	0.2	2.2	2.3	3.3	3.0
17. Export of goods and services	28.9	12.0	0.7	28.3	-0.2	0.6	6.0
18. Import of goods and services	29.3	12.3	-5.2	28.3	2.1	5.4	9.0
Contribution to GDP growth							
19. Domestic demand (excl. inventories)	10.6	7.0	-5.3	8.5	7.2	11.6	6.0
20. Change in inventories	2.0	-2.2	-0.2	2.2	0.2	1.2	-0.2
21. External balance of goods and services	-2.0	-1.1	4.8	-0.9	-2.1	-4.2	-3.2
Growth of value added							
22. Agriculture	5.9	0.1	-2.4	-0.8	-5.4	0.1	-1.5
23. Industry	14.5	5.4	-2.3	16.7	10.5	14.0	8.3
24. Construction	15.2	18.3	-8.2	13.8	4.3	20.6	7.7
25. Services	10.5	5.3	2.2	6.3	6.8	4.5	4.3

Sources: Ministry of Finance of Estonia, Statistical Office of Estonia, Bank of Estonia.

Annex 2. Assumptions of economic forecast

Table 12

Basic economic forecast assumptions for period 2002–2008

(per cent)

	2002	2003	2004	2005	2006	2007	2008
Short-term interest rate (annual average)	2.3	2.1	2.5	3.1	3.5	3.5	2.3
Long-term interest rate (annual average)	4.1	4.0	4.1	4.4	4.6	4.6	4.1
USD/EUR exchange rate (annual average)	1.13	1.21	1.19	1.19	1.19	1.19	1.13
EEK exchange rate vis-à-vis the EUR (annual average)	15.6466	15.6466	15.6466	15.6466	15.6466	15.6466	15.6466
World GDP growth	3.5	4.2	4.1	4.1	4.1	4.1	3.5
United States, GDP growth	3.1	4.3	3.1	3.0	3.0	3.0	3.1
EU-15 GDP growth	0.8	1.9	2.4	2.5	2.5	2.5	0.8
Oil prices (Brent, USD/barrel)	28.9	32.0	30.0	30.0	30.0	30.0	28.9

Source: Ministry of Finance of Estonia

Annex 3. Cyclically Adjusted Budget Position

Table 13

Cyclical developments
(% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004*	2005*	2006*	2007*	2008*
1. GDP growth (%)	4.5	10.5	5.2	-0.1	7.8	6.4	7.2	5.1	5.6	5.9	6.0	6.0	6.0
2. Budget balance	-1.3	1.9	-0.3	-3.7	-0.3	0.2	1.2	3.1	1.0	0.0	0.0	0.0	0.0
3. Interest payments	0.5	0.4	0.4	0.4	0.3	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.2
4. Potential GDP growth		5.9	5.7	5.7	4.8	4.9	6.5	6.0	6.2	6.2	6.1	6.0	6.0
5. GDP gap (*output gap*)	-1.9	2.4	1.7	-3.7	-0.9	0.5	0.9	0.1	-0.4	-0.6	-0.7	-0.6	-0.6
6. Cyclically adjusted budget balance	-0.9	1.4	-0.6	-2.9	-0.1	0.1	1.0	3.1	1.1	0.1	0.1	0.1	0.1
7. Cyclically adjusted primary balance	-0.5	1.9	-0.2	-2.6	0.2	0.4	1.3	3.3	1.3	0.3	0.3	0.3	0.3
GDP gap as estimated by the European Commission	-7.5	-1.0	0.2	-3.5	-0.7	0.2	1.1	-0.2	-0.8	-1.4	-1.9	-1.4	-0.9

Sources: Ministry of Finance of Estonia, Statistical Office of Estonia, DG Ecfin.