

**Republic of Estonia**

**UPDATED  
CONVERGENCE PROGRAMME  
2006**

**Tallinn**

**November 2006**



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## INTRODUCTION

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According to the EU's rules on coordination of budgetary policies the Member States of the European Union must annually submit updated stability and convergence programmes (the members of the euro area and the Member States who are not using the euro, respectively). Estonia submitted its Convergence Programme to the European Commission and the Council of the European Union for assessment in May 2004. The present programme is the third update of the Programme. The purpose of the Convergence Programme is to express the government policy upon fulfilment of the convergence criteria and transition to the single currency, the euro. The present stability and convergence programmes submitted by the Member States will be assessed by the European Commission and the Council of the European Union at the end of 2006 and in the beginning of 2007.

The Updated Convergence Programme 2006 was drafted by the Ministry of Finance and it reflects Estonian budgetary policy based on the draft State Budget Act 2007 submitted to the Riigikogu by the Government of the Republic and the State Budget Strategy 2007–2010 approved by the Government on 31 May 2006. Estonian budgetary policy continues to be in compliance with the Stability and Growth Pact and the Broad Economic Policy Guidelines. The Programme has been drafted pursuant to the goals of the Government of the Republic and the policies of achieving them, as stipulated in the Governing Coalition Agreement and strategic development plans (incl. the Estonian National Action Plan for Growth and Jobs).

The Updated Convergence Programme 2006 is based on the current economic and budgetary policy situation and the economic forecast<sup>1</sup> that served as the basis for drawing up the state budget for 2007, which has been adjusted according to additional information received (incl. the adjusted time series of the DGP<sup>2</sup> and the budgetary position and public debt communication<sup>3</sup> of this autumn).

The time horizon of the Updated Convergence Programme 2006 reaches to 2010, as prescribed by the Estonian State Budget Act (the next budgetary year and three following years). The document comprises six parts, which give an overview of the economic policy goals, economic developments in recent years and future outlooks, the fiscal framework, a comparison with the previous programme, improvement of the quality of public finance and long-term sustainability of the budgetary policy.

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<sup>1</sup> The 2006 summer economic forecast of the Ministry of Finance was published on 22 August 2006.

<sup>2</sup> The Statistical Office published the adjusted GDP time series of 2000–2005 and Q1 2006 on 13 September 2006.

<sup>3</sup> The budgetary position and public debt figures for 2002–2005 as submitted to Eurostat by the Statistical Office on 29 September 2006.

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# 1. ECONOMIC POLICY GOALS

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The goal of the economic policy of the Government is to create conditions for strong economic growth, which will result in increased welfare and real convergence with the European Union. The precondition for stable economic development is ensuring macroeconomic stability as well as internal and external balance. Estonia's economic development has thus far been favourable and the same applies to the outlook for the near future. However, some imbalances and risks, which need to be attended to, have emerged. At present, our risks in the economic environment are related to a strong growth of the real estate market, loan growth and a high current account deficit. The reduction of the imbalances and maintenance of the pace of real convergence depends on the preservation of Estonia's competitiveness. It is important to maintain a favourable business environment and the flexibility of the economy.

In the environment of the currency board system the budgetary policy is the main tool for influencing the economy and controlling the risks threatening economic development. We need to adjust our tax system and shape the expenditure side of the budget in such a manner than it would further support economic development, i.e. we have to shift taxation from the labour force to consumption and pay more attention to investments in our expenditure. Furthermore, we have to ensure the long-term sustainability of the budgetary policy in the conditions of an aging population. Ensuring a stable economic environment, channelling budget funds to improvement of the economic growth and employment, and ensuring long-term sustainability are the three areas which Estonia will focus on in its economic policy in the coming years.

The goal 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 boost long-term economic development and increase monetary stability. Therefore Estonia has joined ERM II (Exchange Rate Mechanism), unilaterally preserving its currency board system along with the fixed exchange rate.

To introduce the euro, Estonia must fulfil the convergence criteria provided for in the Maastricht Treaty regarding public finance, price stability, interest rates and exchange rate stability. In order to fulfil the Maastricht criteria, the Government will continue to implement a conservative budgetary policy and avoid excessive administrative price increases.

The medium-term budgetary objective (MTO) of the Government is to keep the general government budget at least in balance. A conservative fiscal policy will ensure a low level of government debt, which is a prerequisite for ensuring the long-term sustainability of public finances.

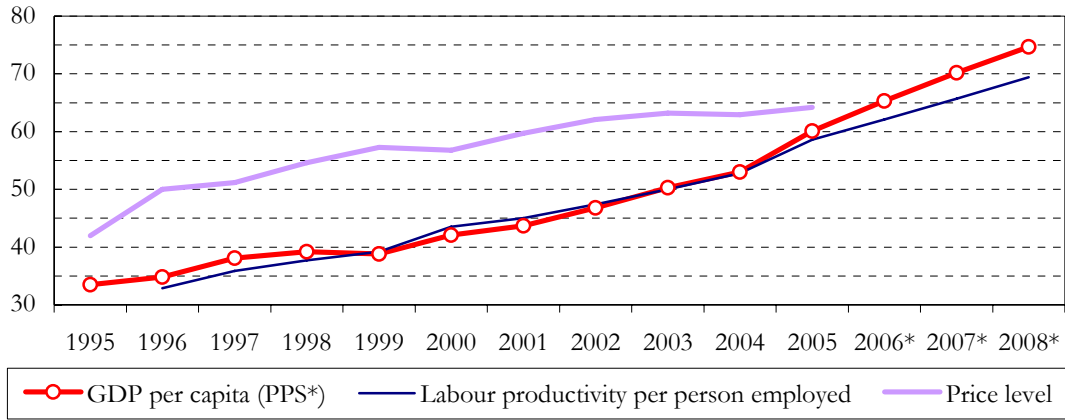
Drawing up a balanced budget each year may mean that in certain conditions the budgetary policy may become pro-cyclical, but setting a nominal balance objective has been right for Estonia, because the structural changes in the economy have been extensive and they have not allowed for evaluating the economic cycle or the cyclical position of the budget with sufficient reliability. In the coming years the Government will continue to follow the rule of at least a balanced annual budget.

**Figure 1**

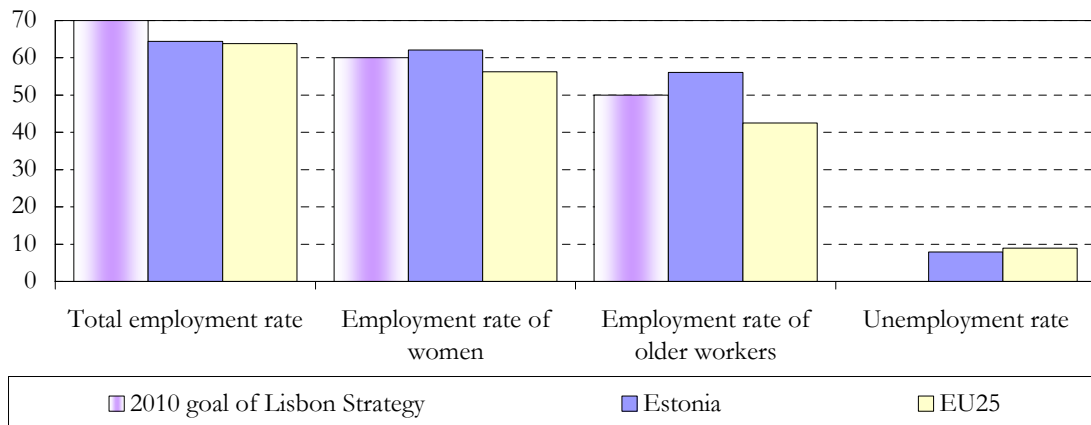
**Real convergence with the EU and employment goals of the Lisbon Strategy**

(per cent)

**A. Estonia's real convergence with the EU25**



**B. Employment rates in 2005 (people aged 15–64)**



Source: Estonian Statistical Office, Eurostat.

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## 2. ESTONIAN ECONOMIC DEVELOPMENT AND OUTLOOK

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### 2.1. Recent economic developments

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#### 2.1.1. Macroeconomic situation

Estonian **economic growth** strengthened in the first half 2006 to 11.7%, exceeding the previous year's growth (10.5%). The economic growth was supported by considerably stronger internal demand growth which speeded up to 12.4% compared to the same period last year, relying on the strong growth of private consumption as well as investments. As usually, export was the main contributor to the growth, but import rose faster than export, as a result of which the impact of net export on economic growth proved to be negative again.

In H1 the **real growth of private consumption expenses** rose to 15.3% in comparison with the same period last year. The growth was supported by a strong growth of net income and loan balance, which can be attributed to the growth of average wages and employment as well as higher consumer confidence regarding the future. Credit conditions remained favourable and the popularity of consumer credit is rising.

H1 2006 was characterised by persistently high **investment activity** and the growth of gross fixed capital formation reached 13.8%. Enterprises were the main contributors to investment growth. Booming real estate development, buoyant construction and inflow of external funds underpinned the strong growth figures. Owing to profitable real estate investments the share of acquisition of buildings and structures and investment in land has increased noticeably. The growth of the investments of the manufacturing sector was lower than the average of economic sectors and continuance of the same trend may start limiting further growth prospects of exports. The increased income receipts from the Structural Funds have increased general government investments, but due to the little share of the general government investments their impact on the growth of total investment is modest. After showing strong growth over the last two years the capital investments of households have somewhat moderated. Strong growth of income, longer loan maturities and an interest in improving the living conditions have supported households' investment decisions.

In H1 2006 the contribution of **export** to economic growth fell in spite of strong external demand. However, the share of export in the GDP rose to 80.6% in Q2 year on year over the same period. Growth of **imports** of goods and services (17.6%) slightly exceeded export growth, which was mainly supported by a rise in export of goods. Import growth remained high due to strong internal demand, which did not show any signs of moderation in Q3. The share of mineral products increased considerably in export and import of goods.

**External imbalance** increased noticeably in H1 2006. Current account deficit rose from 10.5% in 2005 to 13.0% of the GDP in H1 2006. The rise of the deficit in comparison with the previous year can be attributed to a decrease of the surplus of the services balance as well as an increase of the deficit of the goods balance. The decrease of the services balance can be attributed to a decrease in carriage and travel services in Q1 2006. The increase of the deficit of the goods balance was caused



by strong growth of import of goods arising from strong growth of internal demand. The deficit of the income balance rose by 0.1 percentage points, to 5.2% of the GDP compared to 2005. Thereby reinvested income accounted for 84.0% of the income balance.

Domestic **savings** increased noticeably in 2004 and 2005, reaching 24.8% of GDP in 2005. This is also the highest level in six years. In H1 2006 the increase of savings activity has stopped. Although in Q2 domestic savings were at the same level as a year ago, this has been achieved by a growth of the savings balance of the general government, i.e. the savings generation of the private sector has decreased. This is caused by considerable consumption growth as well as the increased investments of corporations at the account of credit. Faster growth of the revenues of the state budget in comparison with the expenditure and the increase of capital expenditure arising from the involvement of the Structural Funds of the EU caused significant increase of savings at the level of the general government.

**By economic activity**, value added growth strengthened in H1 2006 both in the industry as well as service sectors. Manufacturing had the strongest impact on economic growth. The share of manufacturing in the total value added rose to 20.2%, calculated in the prices of 2000. The 13.9% growth of manufacturing arises from increased internal demand and rapid export growth.

The growth of the valued added of the economic activities related to business services strengthened to 12.6% in H1 and its role in shaping the economic growth increased. The rise of value added in real estate, renting and business services (14.7%), internal trade (10.5%) and financial services (23.6%) affected the growth the most. The growth of the value added of real estate, renting and business services was supported by intensive real estate activities, rapid development of computer services and an increase of productivity. Financial services were affected by intensive loan and lease activities. Internal trade was affected by an increase in wholesale and retail trade volumes and an increase of the profit margins of chains and car dealerships. Transport, storage and communications made a significant contribution to economic growth. The growth of their value added (8.9%) is the improved efficiency of road transport corporations, strong development of storage and continued increase of income in telecommunications. The growth of the value added of hotels and restaurants moderated to 11.2% due to a slowdown of the growth of the sale of services as well as a decrease of the effectiveness of the activity.

An increase of the value added of construction (19.2% year on year) was supported by a strong growth of construction volumes, which brought about an increase of the income and profits of corporations. The pace of growth of the economic activities where the share of the general government is large (public administration, national defence, social insurance, health care, social care) rose to 4.0%, but its contribution to the economic growth remained marginal. In H1 the value added of the primary sector remained below that of the previous year (a decrease of 13.1%) due to a slowdown in the growth of livestock production, a decrease in the prescribed cut and the continuing price increase.

Owing to strong external and internal demand positive trends also continued in Q3. Therefore it can be expected that in 2006 the actual growth will be stronger than expected in both the manufacturing as well as service sectors, especially in terms of financial intermediation, construction and internal trade.

In 2005 the number of **the employed** rose 2%, i.e. by 11,900 persons, but in the first half of this year the number of the employed rose to 6.7%, which means that the number of employed persons exceeds that of H1 2005 by approx. 40,000. This development can be attributed to intensive economic activities in both the internal market and export sector. In terms of economic activities trade, construction and manufacturing were the most intensive. Expansion of the opportunities of finding work in connection with the opening of the neighbouring Finnish labour market has had its impact as well. Furthermore, the Labour Market Board has contributed to easing the labour market disruptions through retraining, in-service training, teaching Estonian to non-Estonians and attending to discouraged people.

The **unemployment rate** fell to 7.9% in 2005 and decreased further to 6.3% in H1 of this year. In H1 2005 the total number of the unemployed was approx. 58,000, but over the year the number of the unemployed has fallen by 15,000, to 43,000 persons. Thereby it is positive that the number of the unemployed has fallen mainly as a result of an increase in the employment of the non-Estonian unemployed and persons who have sought work for over a year. Again, the contribution of the Labour Market Board should be emphasised here. Moreover, a number of people of the retirement age and discouraged persons who had lost the hope of finding work have become active in the labour market. In the first half of this year the number of inactive persons decreased by up to 6.5%, i.e. by 25,000 persons year on year. Owing to the strong demand for labour most of them have found work and have thus not increased the number of the unemployed job-seekers.

In 2005 the **gross wages** rose 10.8% and the real wages rose 6.4%. This was followed by an even steeper growth in the first half of this year, i.e. 15.3% and 10.5%, respectively. This can be ascribed to favourable economic developments, which arise from a strong demand in the internal market and increased export. Competition with the labour markets of Finland, Sweden and other European countries and their pay levels has exercised pressure on the growth of wages.

Construction, trade and manufacturing exerted the strongest impact on the growth of the gross wages and salaries. Strong demand for residential construction as well as construction of infrastructure and industrial objects has, in turn, increased the need for building materials and timber products, and brought about a rise in prices and income. Rapid developments have allowed for increasing wages and salaries in these economic activities. Robust trade and expansion of chains to urban areas have also increased the demand for trade employees, which has created a more favourable pay negotiation position for employees. Since the employees of various economic activities have gone to work in foreign countries because of higher wages and salaries, local companies have to raise their level of wages and salaries in order to find any new employees or retain good skilled workers.

Against the background of rapid growth of the employed the growth of **productivity**, i.e. the value added generated per employed person moderated from 7.5% in H1 2005 to 4.7% in the first half of this year. In the first couple of years faster growth of wages and salaries moderated in comparison with the growth of productivity, but the developments in the first quarter of 2006 once again and to a greater degree show faster growth of real wages and salaries over productivity – 10.8% and 4.7%, respectively. At the same time it is surprising that, in spite of the strong growth of the number of employed, wages and salaries, the share of labour costs in value added did not increase in the first half of 2006, but even decreased by 1.5%. In connection with the labour markets of various countries opening up to the citizens of the new Member States of the EU the levels of wages and salaries are bound to become harmonised. Therefore the companies have to take quick steps to update their technology and increase the efficiency of work. In terms of labour productivity Estonia is currently among the last countries.

In the 9 months of 2006 headline **inflation** has remained strong, fluctuating between 4-5%. The factors on the supply side such as the rise in oil prices and the rise in food prices due to complicated weather conditions in summer, along with deepened factors on the demand side have not allowed inflation to slow down. The smaller administrative impact arising from the postponement of excise duty increases and a decrease of the contribution of motor fuel prices have been compensated by the rapid increase of the prices of food and housing components (primarily rent). A real estate boom has brought about a significant rise in rent prices and there are no signs of any slowdown in the price growth. Due to a significant increase in the prices of primary agricultural products caused by the summer draught the annual rise in food prices reached 7.5% in September. In September inflation moderated to 3.8% due to a decrease in the price of fuels for transport, but it was a temporary phenomenon, because in the coming months the prices of gas and heat are expected to rise. In terms of sharp income growth, strongly increasing credit volumes and optimistic future expectations of consumers it is easier to increase the prices of goods and services. Further, this is reflected in higher core inflation (a rise of approx. 1.5 percentage points year on

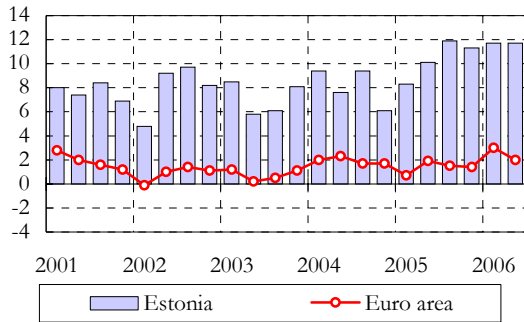
year). The increasing pressure exercised by wages – an important factor affecting pricing – exerts additional impact on prices.

**Figure 2**

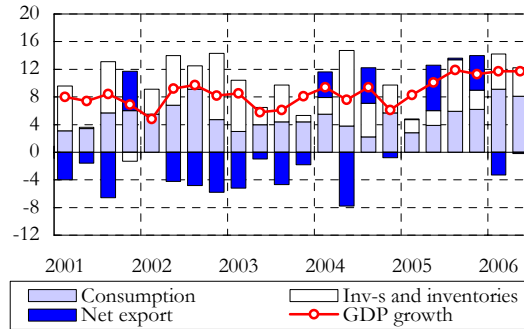
**Main Indicators of Estonian Economy**

(per cent)

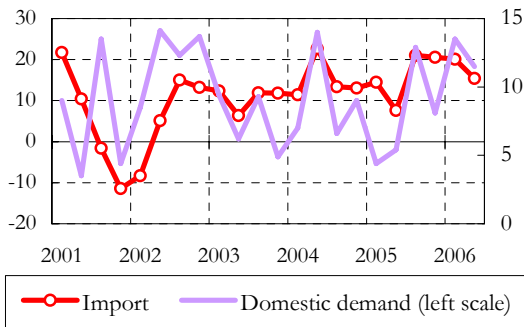
**A. Economic growth of Estonia and euro area**



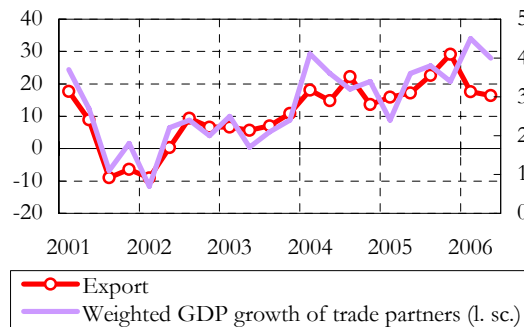
**B. Contribution to economic growth**



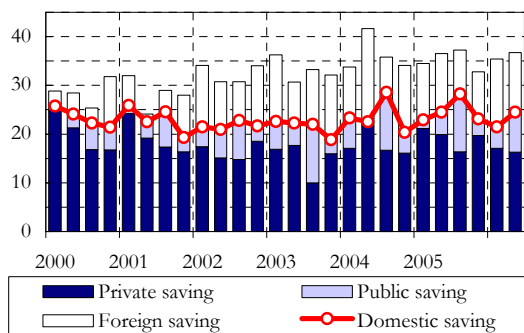
**C. Real growth of domestic demand and imports**



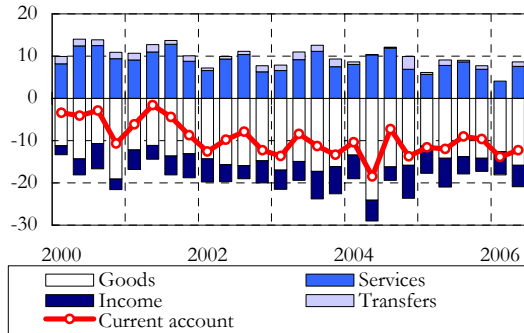
**D. Real growth of exports**



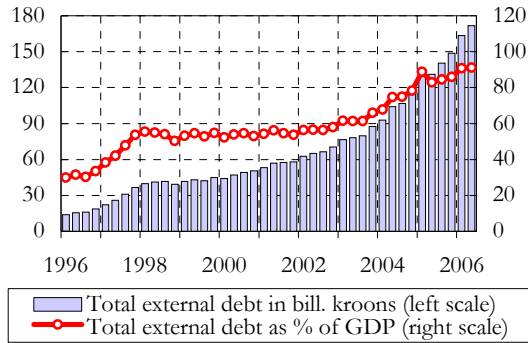
**E. Savings rate (% of GDP)**



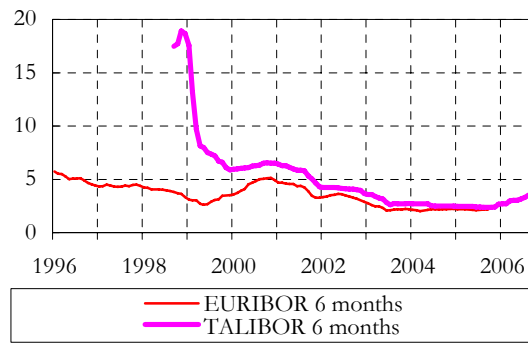
**F. Current account (% of GDP)**



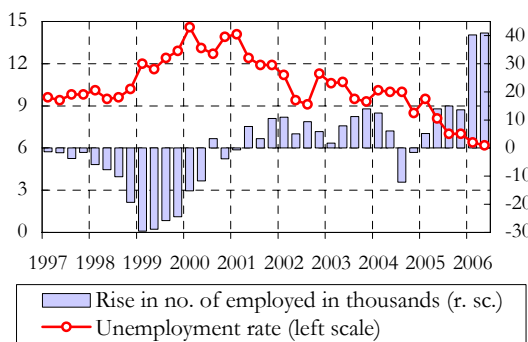
**G. Total external debt**



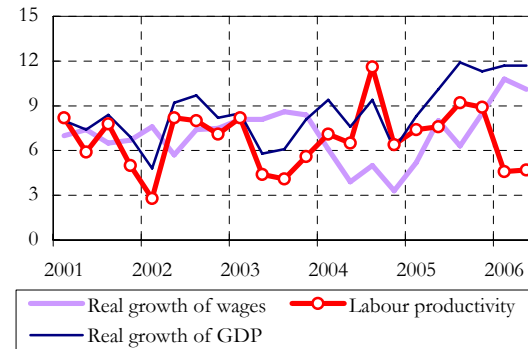
**H. Interest rates**



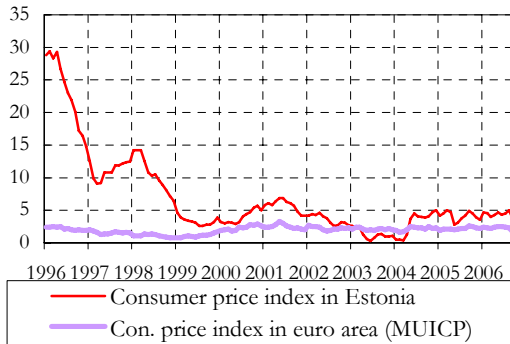
**I. Employment and unemployment**



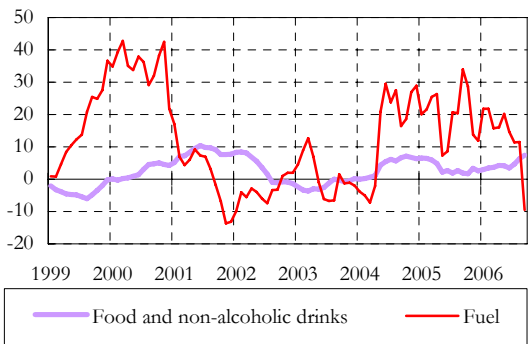
**J. Labour productivity**



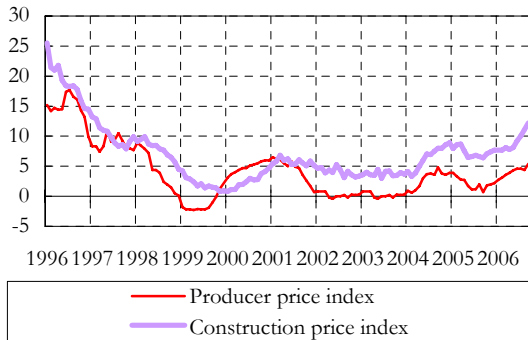
**K. Consumer price index in Estonia and euro area**



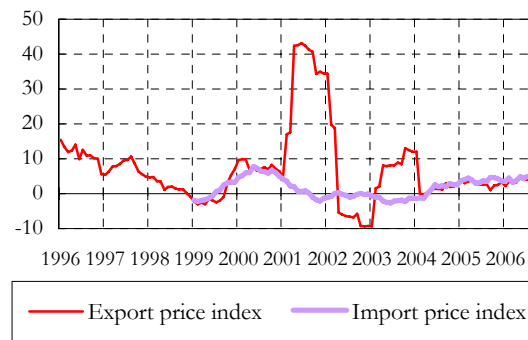
**L. Changes in food and fuel prices in Estonia**



**M. Producer and construction price index**



**N. Export and import price index**



Source: Statistical Office of Estonia, Estonian Bank, Eurostat.

**Box 1. Labour market developments, problems and possible solutions**

The Estonian labour market of 2006 is characterised by revolutionary developments. The number of the employed has risen to a level which at the beginning of the year could not be foreseen even for 2013 and the rate of unemployment has fallen steeply. Wages and salaries have increased rapidly, too. As for the unemployment, Estonia has already achieved two of its Lisbon goals set for 2010: the rate of unemployment of women in Estonia is slightly over 60% and the rate of employment of the elderly is 56% (the respective goals were 60% and 50%). The overall rate of employment is moving rapidly towards the goal of 70%. The developments are very positive for employees, but from the point of view of employers various new problems have emerged.

The number of the employed has risen the fastest owing to robust economic activity primarily in trade, construction and manufacturing. The demand for employees in hotels and restaurants, carriage and transport, and real estate, renting and business services has increased. The growth of the number of employees in trade arises primarily from expansion of retail trade chains throughout Estonia – in addition to Tallinn new shops have been opened in Tartu, Jõhvi, Narva, Pärnu and elsewhere. Housing development dominates in construction, but infrastructure and industrial objects – very labour-intensive endeavours – are being actively built as well. As for branches of manufacturing primarily the construction and timber industries, as well as corporations engaged in producing electrical devices, have needed additional labour force the most. The number of the employed has also increased owing to new hotels opening up, robust storage activity and higher demand for business services (security services, design services, notaries public, etc.).

At the same time many construction workers and specialists of other fields have gone to work in a foreign country, due to which local corporations have been forced to raise the level of wages and salaries in order to find any employees at all or retain the existing skilled workers. Rapid economic development allows for raising wages and salaries in fields of activity related to real estate and construction, but corporations whose activity is based on cheap labour will be under increasing pressure, because they will start losing their competitive advantage in foreign markets. The steeply increased demand for labour and very small number of the unemployed puts employees in a much stronger position upon determining the terms of remuneration and working conditions, and corporations can do nothing but raise the wages and salaries or lose the employee. However, finding a new employee takes time and effort and it may prove to be far more expensive than raising the pay of the existing employee. In connection with the labour markets of various countries opening up to the citizens of the new Member States of the EU, including Estonia, the levels of wages and salaries are bound to become harmonised. Therefore corporations have to take quick steps towards updating their technology and increasing labour productivity, which has not been paid sufficient attention in Estonia so far.

Upon improvement of terms of remuneration and working conditions, it is of primary importance that the Estonian people who have gone to work in a foreign country would return and start applying their knowledge and skills for the benefit of the Estonian economy. According to current data the people who have gone to work in a foreign country usually still prefer to live and work in Estonia. According to current estimates at least 20,000 people from Estonia work in a foreign country. These are available labour resources which we could use for the benefit of the Estonian economy in the case of provision of suitable working conditions.

Due to the extremely high demand for labour various risk groups also have the opportunity to participate in active labour. For example, over the last year many discouraged people who had lost any hope of finding work returned to the labour market. The number of long-term unemployed (over 12 months and over 2 years) has decreased rapidly and many elderly have given up their inactive status and returned to work. So far an important issue in the labour market was the high rate of unemployment among non-Estonians, but over the last 6 months many non-Estonian unemployed have found engagement in the labour market. The arrival of all the aforementioned

groups in the labour market has received considerable support from the Labour Market Board in the form of active labour market measures, e.g. retraining and in-service training for the unemployed, teaching Estonian to non-Estonians, and cooperating with local authorities who are more informed and have better access to the discouraged and long-term unemployed.

Since the number of registered unemployed has decreased considerably, it allows for a more thorough and personal approach in helping the long-term unemployed who need more attention and require first of all psychological encouragement and medical assistance in order to enter the labour market. Through projects of the European Social Fund women and mothers of small children have found work in Southern Estonia. The lack of motivation remains an obstacle to commencement of employment for mothers of small children, primarily due to a relatively low level of wages and salaries in comparison with possible social support and the costs of going to work (transport, childcare, etc.). The latest developments in the labour market have forced corporations to raise wages and salaries in order to find employees and look for flexible solutions for organising working time.

Flexible forms of work are not very widespread in Estonia. One of these forms is working under a flexible schedule, e.g. part-time work. In Europe 18-20% of employees work part-time on average, but in Estonia their share is only 8%. The possibility of part-time work is important primarily for mothers who have to take care of their children. Part-time work brings some variety to raising children and allows for engagement in the previously learnt specialty as well as additional income for the family, while leaving sufficient time for taking care of the children. Part-time work also brings some variety to the life of those pensioners who cannot take up full-time work due to health problems. Students who want to get their first work experiences and make a living also look for work opportunities. All these people are potential labour force who have not been sufficiently engaged in developing the economy.

There are other bottlenecks in the Estonian labour market. Going to work within the limits of a county where the distances may not be very long (approx. 30 km) is difficult, because the public transport connection is often weak and may not match with the working time. There is a huge deficit of kindergarten places and no reliable system of baby-sitters has been developed. This is a serious obstacle to mothers' participation in the labour market, not to mention the hesitations of employers upon hiring a young woman. The reputation of the Labour Market Board and vocational education schools has been low for a long time, although in the last couple of years the progress has been remarkable. The Labour Market Board has turned from a passive remitter of unemployment benefits into a provider of labour market services who is looking for opportunities of cooperation with schools, corporations and local authorities.

The current time of rapid economic growth is ideal for attending to the aforementioned shortcoming. This is the time when the Labour Market Board and local authorities attend to a smaller number of the unemployed and social support applicants – less money will be spent on allocating support and less time will be spent on formalising the required documents. This is the time where substantive issues can be attended to in order to make participants in economic activity stronger.

### **2.1.2. International Evaluation of Estonian economy**

Accession to the European Union and ERM II had a positive impact on the reliability of the Estonian economy in the eyes of rating agencies. Both Fitch Ratings and Standard & Poor's had raised Estonia's rating by one level – to level A – in the spring of 2005. Short-term postponement of the transition to the euro is not considered a high risk, but the positive outlook of the state rating was corrected to 'stable' by Fitch and Standard & Poor's. Given Estonia's high current account deficit and rapidly increasing external debt financing pegged to the euro the transition to the euro is considered very important. Fitch has promised to raise Estonia's credit rating after the respective

positive decision of the European Commission. Standard & Poor's finds that further rise of the state's rating is impeded by the relatively low income per capita. Estonia's conservative budgetary policy, rapid economic growth, flexible institutions, well-regulated banking sector and a high rank in the list of economic freedom are considered positive by the rating agencies. The current account deficit, strengthened inflation, rapidly increasing external debt and a low living standard are considered negative.

One of Estonia's characteristic features is **economic freedom**. Estonia ranks seventh among 157 countries in the Index of Economic Freedom 2006 of the Heritage Foundation. Estonia achieved its high rank owing to a relatively liberal trade policy, openness to foreign investments, modest control of prices and a well-developed banking sector. The estimate given to Estonia worsened slightly in comparison with the previous year, because upon accession to the European Union Estonia established all the foreign trade restrictions of the latter. Estonia's sore points indicated by the agencies include nepotism arising from the smallness of the country and a larger share of the shadow economy.

**Low corruption** is also important from the point of view of the development of the country. Transparency International's Corruption Perceptions Index 2006 placed Estonia to the 24<sup>th</sup> place among 163 countries. A year ago Estonia was ranked 27<sup>th</sup> among 159 countries. Estonia outperformed all the new Member States of the European Union. Foreign observers considered it positive that persistent attention is paid to fighting corruption in Estonia. However, the public procurement system and the scheme of financing political parties remain problematic.

Estonia's **competitiveness** is relatively highly valued in international terms. According to World Competitiveness Yearbook 2006 of the Institute for Management Development (IMD),<sup>4</sup> Estonia's competitiveness rose by 6 places to hold 20<sup>th</sup> place among 61 countries and regions. In terms of the aggregate index Estonia outperforms all other new Member States of the EU covered by the report (the Czech Republic, Slovakia, Hungary, Slovenia and Poland). The following Estonian indicators improved the most year on year: the inflow and outflow of foreign investments, the liabilities of portfolio investments, the turnover of the stock exchange, the number of computers per person and the capitalisation of the stock exchange increased considerably, while youth unemployment and the income tax rate decreased. Estonia's result was negatively affected by strengthening inflation, rising government subsidies, a decrease of the availability of IT skills, a rise of hourly wages in industry, an increase of the threat of transfer of R&D, insufficient emphasis on sciences in schools, a decrease of the share of foreign trade in GDP, a rise in the price of capital, a rise in long-term unemployment, rising cost of living, a decrease of the transparency of financial institutions, a decrease in understanding the economy among people, and a decrease in technological cooperation among corporations. According to the survey Estonia's strengths include the openness of the economy, low tax rates and strong economic growth. The improvement of Estonia's competitiveness is impeded by a high current account deficit, restrictions on importing labour force, paying little attention to social cohesion, lack of skilled labour, strong growth of labour costs, little investment in research and education, lack of computers, health problems (HIV/AIDS, alcohol, drugs) and great energy intensity of the economy.

The competitiveness of countries is also assessed by the World Economic Forum (WEF). Its Global Competitiveness Report 2006–2007 placed Estonia on the highest position among the new Member States of the European Union. In the Global Competitiveness Index, which estimates the prospects of the GDP growth per capital over the next 5-8 years Estonia moved up a place, to the 25<sup>th</sup> spot. According to the index, the main problems in the Estonian economy in order of importance are: lack of educated labour, inefficient work organisation in the public sector, insufficient work ethics, tax rates, inflation and insufficient infrastructure. Access to financing, labour regulations, tax policy, political instability and corruption are relatively less problematic. The Business Climate Index, which assesses countries' productivity or their GDP *per capita*, raised

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<sup>4</sup> *Institute for Management Development (IMD)*.

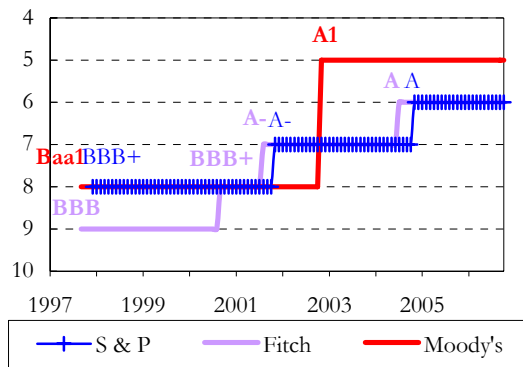
Estonia by three places to 24th place in comparison with the year before, whereby the business climate was given a better assessment than organisation and management of corporations.

The World Bank's survey of the ease of doing business, Doing Business 2007, shows Estonia, which holds 17<sup>th</sup> place, in a relatively good light. The Member States of the European Union ranked higher than Estonia in that respect are the United Kingdom, Denmark, Ireland, Sweden, Finland and Lithuania. The speed/low cost of business operations relating to foreign trade, the simplicity of obtaining activity licenses, the short term of entry into force of laws / low costs, low cost of real estate registration and the simplicity of payment of taxes are positive. The flexibility of the labour market received the worst estimate. In that respect Estonia held 151<sup>st</sup> place, with the flexibility of working time and the complicatedness of dismissal earning the most negative response. The complicatedness of establishment and dissolution of corporations and the complicatedness of getting a loan also received a relatively poor assessment.

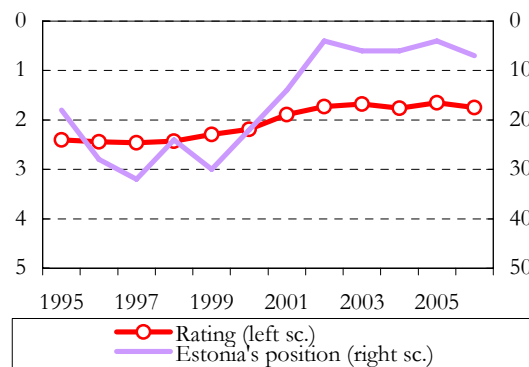
**Figure 3**

**International Evaluation of Estonia's Development**

**A. Dynamics of Estonia's national ratings**



**B. Economic freedom index**



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



**Table 1****Estonia's position in selected competitiveness indexes**

<b>Institution</b>	<b>Overall ranking</b>	<b>Among EU25</b>	<b>Among EU10</b>	<b>Total ranked</b>
Institute for Management Development 2006	20	8	1	61
Economic performance	12	4	1	61
Government efficiency	11	4	1	61
Business efficiency	22	8	1	61
Infrastructure	35	17	3	61
World Economic Forum 2006	25	11	1	125
Fraser Institute Economic Freedom of the World	12 <sup>1)</sup>	4 <sup>1)</sup>	1	132
Heritage Foundation 2006	7	4	1	164
Transparency International Corruption Perception	27	15	2	159
IBRD Doing Business 2007	17	7	2	175
Starting a business	51	11	3	175
Dealing with licenses	13	2	1	175
Employing workers	151	19	8	175
Registering property	23	7	3	175
Getting credit	48 <sup>2)</sup>	15	6	175
Protecting investors	33 <sup>3)</sup>	5	1	175
Paying taxes	29	4	1	175
Trading across borders	6	3	1	175
Enforcing contracts	20	9	4	175
Closing a business	47	16	4	175
IBRD Governance Indicators 2005				
Voice and accountability	31	17	4	208
Political stability	70	16	8	213
Government effectiveness	37	14	2	210
Regulatory quality	19	9	1	203
Rule of law	49	16	3	208
Control of corruption	41	13	2	204

1) *Tied with Austria, Finland and the Netherlands.*

2) *Tied with 16 other economies, including Belgium, Slovenia and France.*

3) *Tied with 12 other economies, including Portugal.*

*Source: IMD; WEF; Fraser Institute; Heritage Foundation; Transparency International; IBRD; Kaufman, Kraay and Mastruzzi; IMF.*

## 2.2. Economic forecast

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### 2.2.1. Macroeconomic forecast for 2006–2010

The growth of the **world economy** will strengthen in 2006 owing to increasing economic activity in the euro zone, Japan and Latin America. In 2007 global economic growth should start moderating again. The imbalance of the US economy and high oil prices continue to threaten global economic growth. In 2006 the economic growth in the EU will strengthen. Domestic demand will be the main contributor to economic growth – low interest rates will support investments and private consumption will pick up gradually. 2007–2008 economic growth in the European Union will moderate due to moderation of domestic demand and export growth, which are in turn affected by the tightening macroeconomic policy in Europe and a slowdown of the global economic growth compared to 2006.

In 2005 the **growth of the Estonian economy** strengthened to 10.5% owing to considerable growth of exports. Imports grew less than exports and therefore the impact of net exports on economic growth proved to be positive. Domestic demand made a significant contribution to the economic growth, although its annual pace of growth slowed down to 7.4% due to lower final expenditure of the general government and a decrease of inventory. The growth of domestic demand was supported equally by private consumption and gross fixed capital formation, which rose to 8.2% and 12.7%, respectively.

According to the forecast, **Estonian economic growth will reach 11% in 2006** with the support of domestic demand and growth of exports. The growth of domestic demand will accelerate to 12.6% and arise from stronger private consumption, which is supported by investment growth and the accelerated growth of the final consumption expenditure of the general government. The growth rates of exports and imports will decelerate and imports will grow faster than exports, as a result of which the contribution of net exports will be negative again. By 2007 the economic growth will moderate to 8.3%, primarily due to deceleration of the private consumption growth rate. The growth rates exports and imports will moderate as well, but the negative impact of net exports on economic growth will decrease.

In the medium term we expect an average economic growth of 7.6%, which is lower than the average growth in the last five years. Domestic demand will increase more slowly than economic growth and its role in the development of the economic growth should decrease. Deceleration of growth of exports and imports should continue, but exports will grow faster than imports, as a result of which the contribution of net exports to the economic growth will increase.

Manufacturing will grow through 2006–2010 faster than the economy in average, owing to both persistently strong domestic demand as well as growth of exports. As of 2007 we expect the growth of the service sector to decelerate in connection with stabilisation of the growth of the economic activities relating to real estate and a decrease in the consumer activeness of the population.

The growth of **private consumption** will increase to 15.2% in 2006. This is supported by the growth of the wage and salary fund, reduction of the income tax rate, an increase of the income exempt from income tax, and persistently strong growth of the loan balance flowing to consumption. However, as of 2006 the growth of the loan stock of households will start moderating and in connection with large and long-term housing loans interest payments will considerably reduce the impact of the rise of employment income on consumption in the second half of the forecast period. The rate of growth of average wages and salaries, which in 2006 is clearly exceeding productivity growth, will decrease. Thus, the rate of growth of private

consumption will fall below the GDP growth as from 2008 and the share of private consumption in the GDP will fall to 47.7% by the end of the period.

The forecast period is characterised by high **investment activity** where corporations will have a greater role. Initially, the growth of capital investments is based on real estate investments, but in the coming years the importance of investments aimed at increasing the production capacity is expected to rise. The investments of the government sector are boosted by an increase of the contributions of the EU funds in connection with the new financial perspective of the EU.

In the forecast period we expect the growth rates of **exports** and **imports** of goods and services to moderate gradually. The moderation of export growth in 2007 will arise from a considerable decrease in the GDP growth of the trade partners and 2008–2010 from a certain weakening of the competitiveness as a result of the strong growth of production costs. Owing to the deceleration of the growth rate of domestic demand 2007–2010 we expect the growth of imports to moderate in this period. The current account deficit will increase in 2007 owing to stronger growth of imports in comparison with exports. As of 2008 the current account deficit will be slightly falling primarily in connection with an improvement of the trade balance deficit, which is in turn affected by the faster growth of the exports of goods in comparison with imports 2008–2010.

**Inflation** will accelerate in 2006 to 4.4%, thereafter moderate to 4.3% in 2007 and accelerate again to 4.4% in 2008. The growth in consumer prices this year can be attributed to internal as well as external factors. Rising energy and food prices and housing expenses, which can be attributed to a strong rise in administrative prices (heat, gas) as well as non-regulated prices (rent, repair of dwellings) are the main factors influencing inflation. Inflationary pressures arising from strong domestic demand have begun emerging in the prices of very different goods and services. Higher input costs due to indirect effects arising from price rises of energy and the rising wage pressure will play its part as well. Food inflation will remain high this year and no considerable moderation of the rise in prices is expected next year either due to the price increases of the primary agricultural products caused by the summertime draught. Moderation of inflation in 2007 arises primarily from the assumed stabilisation of prices of fuels for transport. Among other things the contribution of price increases relating to housing will increase as a result of the abolition of the value added tax exception for heating. The acceleration of inflation in 2008 is caused by the rise of the excise duty rates on cigarettes, alcohol and fuel planned at the beginning of the year.

In 2006 **employment** will increase steeply (6.3%) and the annual rate of unemployment will fall to 5.6%. A larger portion of the growth of employment can be attributed to a decrease in non-activity, i.e. the return to the labour market of discouraged and other inactive persons, in the conditions of favourable economic growth. The number of the employed will grow robustly, primarily in construction and trade, but also in the hotel and restaurant business and manufacturing. The development of the labour market is impeded by the lack of skilled workers and top specialists. The real growth of the **average gross monthly wages and salaries** will rise to 10.3% due to already low unemployment and concurrent strong economic growth. Wage and salary pressures are primarily caused by accession to the EU and the opening-up of the labour markets of the Member States – many Estonians have gone to work abroad because of a higher pay and better working conditions. This year the growth of **productivity** will moderate due to a rapid increase of the number of the employed. This year and next year strong increase of wages and salaries and employment will bring about faster growth of the labour costs over the growth of value added, referring to the weakening of competitiveness of corporations based on cheap labour in the international market.

**Table 2****GDP Forecast for 2005–2010 <sup>5</sup>**

	2005	2005	2006*	2007*	2008*	2009*	2010*
	<i>mln EEK</i>	%	%	%	%	%	%
1. Real GDP	141,968.7	10.5	11.0	8.3	7.7	7.6	7.5
2. Nominal GDP	173,062.3	18.0	17.4	13.1	12.5	11.4	10.9
<b>Components of real GDP</b>							
3. Private consumption expenditure (incl. non-profit organisations)	77,662.8	8.2	15.1	9.6	6.0	5.5	4.4
4. Government final cons. expenditure	20,614.8	1.1	2.7	3.7	3.7	5.7	5.7
5. Gross fixed capital formation	46,242.5	12.7	13.1	11.0	9.4	7.9	7.8
6. Changes in inventories (% of GDP)		4.2	4.3	4.3	4.2	4.1	4.0
7. Exports of goods and services	129,320.5	21.5	13.3	11.4	9.9	9.8	9.8
8. Imports of goods and services	137,676.7	15.9	15.5	12.1	8.7	8.3	7.8
<b>Contributions to real GDP growth <sup>1)</sup></b>							
9. Domestic demand (excl. inventories)		8.8	12.9	9.6	7.1	6.5	5.8
10. Changes in inventories		-0.7	0.4	0.3	0.2	0.2	0.2
11. Ext. balance of goods and services		3.1	-2.9	-1.5	0.4	0.9	1.5
<b>Added value growth</b>							
12. Primary sector		2.3	-5.3	2.8	2.0	2.2	2.3
13. Industry		11.7	12.5	10.1	9.6	9.4	9.1
14. Construction		19.8	18.7	11.9	9.8	9.2	9.0
15. Other services		10.6	10.4	7.7	7.1	7.0	6.9

1) Contribution to GDP growth indicates the share of a specific field in the economic growth. It is calculated by multiplying the field's growth with its share in GDP. The sum of the fields' share makes up the economic growth (the reason for a little difference is a statistical error – the part of GDP that could not be divided between the fields).

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

**Table 3****Price Forecast for 2005–2010**

(percentage)

	2005	2006*	2007*	2008*	2009*	2010*
1. GDP deflator	6.8	5.7	4.4	4.5	3.5	3.2
2. Private consumption deflator	2.9	4.1	4.1	3.8	2.8	2.2
3. Harmonised index of consumer prices	4.1	4.4	4.3	4.4	3.5	3.2
3a. Consumer price index	4.1	4.4	4.3	4.4	3.5	3.2
4. Public consumption deflator	9.9	10.0	9.0	8.0	6.0	6.0
5. Investment deflator	3.3	6.3	5.4	4.6	4.2	4.1
6. Export price deflator	2.5	6.5	3.9	3.8	3.6	3.4
7. Import price deflator	4.3	6.8	3.9	3.7	3.6	3.4

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

<sup>5</sup> Autumn forecast of 2006 of the Ministry of Finance, completed after methodology changes of the GDP published in September, 13th, 2006 by the Statistical Office of Estonia.

**Table 4****Labour Market Forecast for 2005–2010 (15–74-year old persons)**

	2005	2005	2006*	2007*	2008*	2009*	2010*
		%	%	%	%	%	%
1. Employment, persons	607.4 <sup>1)</sup>	2.0	6.3	1.0	0.3	0.1	0.1
2. Unemployment rate		7.9	5.6	5.2	5.3	5.5	5.4
3. Labour productivity, persons		8.3	4.6	7.2	7.4	7.5	7.3
4. Compensation of employees	78,947.9 <sup>2)</sup>	15.5	21.3	13.7	11.9	11.1	10.8

1) *Thousand persons.*

2) *Million EEK.*

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

**Table 5****Balance of Payments Forecast for 2005–2010**

*(% of GDP)*

	2005	2006*	2007*	2008*	2009*	2010*
1. Net lending/borrowing <i>vis-à-vis</i> the rest of the world	-9.5	-10.2	-11.5	-9.9	-8.9	-7.2
1a. Current account	-10.5	-12.4	-13.4	-11.8	-10.7	-9.0
2. Balance on goods and services	-6.2	-8.3	-9.0	-8.0	-6.8	-5.1
3. Balance of primary incomes and transfers	-4.3	-4.1	-4.4	-3.8	-3.9	-3.9
4. Capital account	1.0	2.2	1.9	1.9	1.8	1.8
5. Errors and omissions	-0.1					

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

## 2.2.2. Forecast assumptions and comparison with the economic forecasts of other institutions

The external assumptions of the Ministry of Finance for 2006-2008 coincide with those used in the forecast of the European Commission regarding the key indicators. The average weighed economic growth of Estonia's trading partners and the economic growth of the European Union as the main trading partner of Estonia will moderate noticeably in 2007. The cycle of rise in short-term interest rates will also achieve its peak in 2007. Continued rises of the key interest rates will support a strong exchange rate of the euro against the US dollar. The price of crude oil will continue rising, albeit at a weaker rate than in 2006.

**Table 6**

### Comparison of external assumptions of the Ministry of Finance of Estonia and the European Commission

(percentage)

	Ministry of Finance autumn 2006							Commission autumn 2006		
	2004	2005	2006	2007	2008	2009	2010	2006	2007	2008
1. Euribor, 3-month (annual average)	2.1	2.2	3.1	3.7	3.6	3.2	3.2	3.1	3.7	3.6
2. Long-term interest rate of the euro area (annual average)	4.1	3.4	3.8	4.0	4.2	4.2	4.2	3.8	4.0	4.2
3. USD/EUR exchange rate (annual average)	1.24	1.24	1.25	1.27	1.27	1.28	1.28	1.25	1.27	1.27
4. EEK/EUR exchange rate (annual average)	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.7	15.7	15.7
5. World economic growth (excluding EU)	5.8	5.4	5.7	5.2	5.2	5.2	5.2	5.7	5.2	5.2
6. World growth of imports (excluding EU)	13.3	8.2	9.1	8.3	7.9	7.9	7.9	9.1	8.3	7.9
7. EU-25 GDP growth	2.4	1.6	2.8	2.4	2.4	2.1	2.1	2.8	2.4	2.4
8. Growth of export markets of Estonia	3.5	3.4	3.3	2.7	2.8	2.8	2.8	–		
9. Oil price (Brent, USD/barrel)	38.2	55.0	65.6	66.3	68.0	69.0	69.0	65.6	66.3	68.0

Source: Ministry of Finance of Estonia, the European Commission.

Upon comparison of the forecasts of the Ministry of Finance and other institutions it must be taken into account that the forecasts have been made at slightly different times and thus, based on different information, which brings about differences in the assumptions and results of the forecast. The forecast of the Ministry of Finance was made on 30.10.2006. The forecast of the Bank of Estonia was published on 8.11.2006, that of the European Commission was published on 6.11.2006, that of the IMF on 22.11.2006 and that of the Estonian Institute of Economic Research in September 2006. However, all the forecasts have been made after changes in the GDP methodology of the Statistical Office and adjustments of the annual reports on 13 September 2006.

Economic analysts are optimistic about Estonia's economic growth, although it is unanimously expected that in 2007 the economic growth will slow down due to moderation of internal demand and export growth. In terms of inflation the rise in prices is expected to slow down in 2007. Exceptionally, the Bank of Estonia forecasts the acceleration of inflation due to increasing internal demand and growth of expenditure. In terms of the current account the Ministry of Finance and the Bank of Estonia, unlike the European Commission and the IMF, expect the deficit to increase

in 2007. The weakening of the export competitiveness of Estonia is seen as the reason of expansion of the deficit. In spite of strong economic growth economic experts expect the risks related to overheating to deepen. High oil prices and large imbalance in the US/rest of the world still threaten the stable growth of the external environment as well.

**Table 7****Comparison of Economic Forecasts**

	GDP growth, %		Consumer price index, %		Current account, % of GDP	
	2006	2007	2006	2007	2006	2007
<b>Ministry of Finance</b>	11.0	8.3	4.4 (4.4 *)	4.3 (4.3 *)	-12.4	-13.4
European Commission	10.9	9.5	4.4*	4.2*	-11.5	-10.5
IMF	10.0	8.4	4.7	4.1	-12.5	-12.3
Bank of Estonia	11.8	8.3	4.4*	4.5*	-12.5	-13.5
Estonian Institute of Economic Research	11.0	–	4.4	–	-10.0	–

\* *Harmonised index of consumer prices.*

*Sources:*

*Ministry of Finance of Estonia.*

*European Commission. Economic Forecasts. Autumn 2006.*

*IMF. Republic of Estonia: 2006 Article IV Consultation – Staff Report. November 22, 2006.*

*Bank of Estonia Economic Forecast 2006–2008. November, 8th, 2006.*

## 2.3. Introduction of the euro

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### 2.3.1. Fulfilment of convergence criteria

As a Member State of the EU Estonia is obligated to introduce the euro once the required level of nominal convergence has been achieved. The EU's Maastricht Treaty stipulates the criteria regarding the public finances, price stability, interest rates and exchange rate stability. Furthermore, a Member State must have joined ERM II and spent at least two years there.

Given the currency board system Estonia has been *de facto* a member of the monetary union for over 14 years. Therefore joining the euro area is a logical step for the Estonian economy. During the entire period of circulation of the kroon the Estonian economy has proven its adaptability and has coped with problems. This shows that Estonia can successfully cope with problems as a member of the euro area and is thus virtually ready to join the euro area.

Estonia continues to fulfil all the nominal criteria except for the price stability criterion:

- o The budget of the general government of Estonia has been close to balance over the last ten years and the surplus in recent years has been one of the highest among the Member States of the EU. As a result of the conservative budgetary policy our general government debt is very small, the lowest among the Member States of the EU.
- o Primarily due to external price pressures – the rise in fuel and food prices – the 12 months' average **inflation** in Estonia is currently higher than the reference value of the price stability criterion (see Appendix 3 for further information).
- o Over the last three years Estonia's **long-term interest rates**<sup>6</sup> have been close to those of the euro area and below the reference value. Low interest rates show trust in Estonia's economic policy. Although the interest indicator based on the interest rate of long-term kroon loans cannot be directly compared with that of other countries the European Commission has, referring to low kroon interest rates, a small government debt and a good budgetary position, expressed the opinion that Estonia should have no problems in fulfilling the interest criterion and creation of a new instrument for evaluation of the fulfilment of the interest rate criterion is not required.
- o Estonia has been a member of ERM II for over 2 compulsory years and the **exchange rate** of the kroon has been stable during that period. Thus, Estonia fulfils the exchange rate stability criterion and the fixed exchange rate of the kroon against the euro also ensures fulfilment of the criterion in the future.

Due to inflation which exceeds the reference value the Estonian government was forced to postpone introduction of the euro which was initially planned for 1 January 2007. On 27 April 2006 the government set 1 January 2008 as the new target, but in the light of recent inflation developments achievement of this target is impossible as well.

A couple of percentage points higher inflation compared to the euro area is normal for a rapidly converging country and it cannot be considered as excessive. Low interest rates also show the absence of an inflationary problem. Considering our relatively low price level in comparison with the euro area inflation in Estonia will remain higher than in euro area for years and the fulfilment of the price stability criterion will be complicated. According to the recent forecasts of the Ministry of Finance and other institutions Estonia will not be able to fulfil the price stability criterion in the coming years.

Due to the volatility of price developments it is difficult to forecast inflation in a reliable manner for more than a few years. Therefore it is impossible to estimate when Estonia could fulfil the price

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<sup>6</sup> Due to a very small general government debt level Estonia does not have the proper instrument for evaluation of the convergence of interest rates – a 10-year government bond issued in Estonian kroons.



stability criterion and become a full member of the euro area. In spite of unfavourable inflationary developments Estonia would like to introduce the euro as soon as possible.

However, Estonia only has limited possibilities for reducing inflation below the reference value of the price stability criterion. The monetary policy based on the currency board system ensures long-term price stability, but does not allow for controlling the possible short-term price pressures. In the conditions of an open economy the budgetary policy is a relatively inefficient tool for limiting price pressures. The government has excluded one-off measures such as, for instance, reduction of indirect taxes, which would temporarily lower the rate of inflation. Such measures do not ensure a sustainably low rate of inflation and they may not ensure fulfilment of the inflation criterion. Moreover, such “tricks” may negatively impact the reliability of the economic policy. Reduction of indirect taxes is in conflict with the government’s objective of shifting taxation off from labour force and capital towards consumption and utilisation of natural resources.

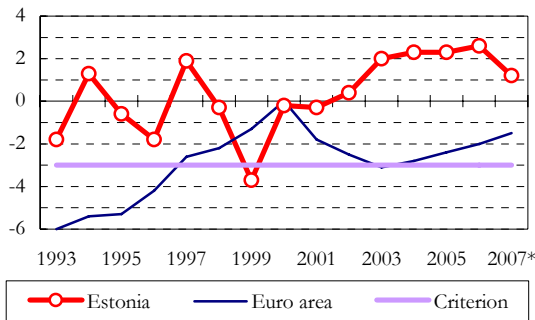
The markets have reacted calmly to the postponement of the instruction of the euro. This may be interpreted as a sign of the reliability of the Estonian economic policy. **The government will continue implementing the economic policy which has generated reliability towards Estonia and will join the euro area as soon as possible once the convergence criteria has been fulfilled.**

**Figure 4**

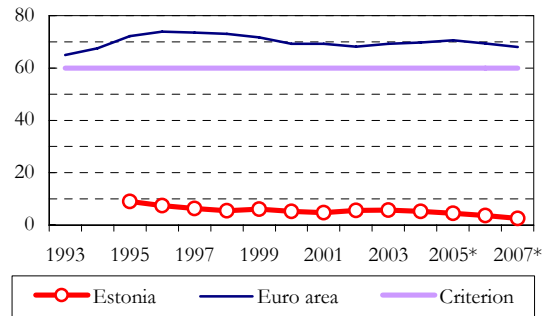
**Nominal Convergence and Fulfilment of Maastricht Criteria**

(% of GDP)

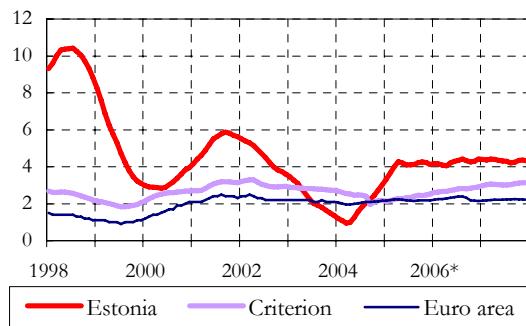
**A. General government budget balance**



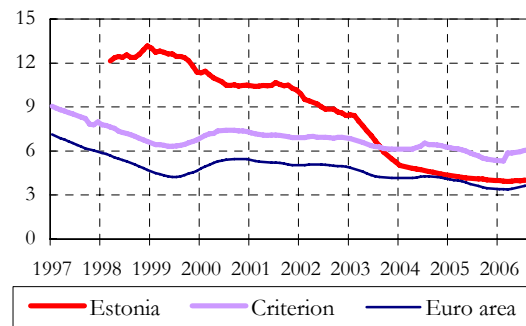
**B. General government debt**



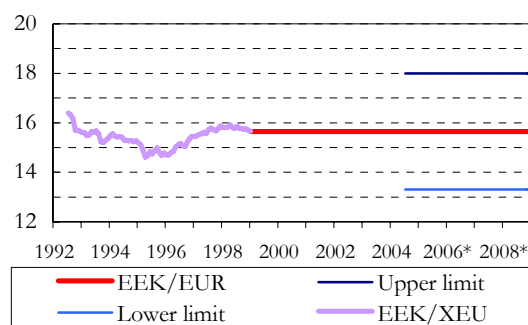
**C. Inflation (%)**



**D. Interest rates (%)**



### E. EEK/EUR exchange rate



Source: Ministry of Finance of Estonia, Statistical Office of Estonia, Eurostat, European Commission.

#### 2.3.2. Ensuring technical readiness

Until spring 2006 the technical preparation proceeded from the assumption that Estonia will introduce the euro on 1 January 2007. The Government postponed the deadline in April 2006 by one year, i.e. to 1 January 2008. Considering the inflationary developments, the Government is about to postpone that deadline as well. In the updated plan for transition to the euro no specific transition deadline has been set. In the current situation the goal of the Government is to take the technical preparations as far as possible without knowing the exact date of transition and most of these preparations have been finished by today.

The activities required for ensuring smooth transition to the euro are coordinated by a committee of experts formed at the end of 2004. It is supported by six work groups: a work group between the Bank of Estonia and credit institutions, a business environment work group, a work group for the technical readiness of government agencies, a consumer protection work group, a legislative drafting work group and a communication work group.

The work groups comprise representatives of the public and private sectors as well as non-profit sector. The representatives of different sectors have had the opportunity to present the points of view of their institutions at each stage of work. For instance, all the banks operating in Estonia are represented in the work group between the Bank of Estonia and credit institutions. Through their representatives the banks have been able to directly participate in the respective decision-making processes. The plan of transition to the euro has been drafted directly on the basis of the inputs from the work groups. The plan is a public document and it is available in Estonian, English and Russian on the websites of the Ministry of Finance and the Bank of Estonia.

## 2.4. Macroeconomic policy

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The main goal of the macroeconomic policy of the Government of the Republic is to ensure macroeconomic stability and internal and external balance. At present, the risks in the Estonian economic environment are related to a strong loan growth and a high current account deficit. Over the last five quarters the Estonian economy has grown clearly faster than its potential pace and in recent times signs of overheating in some sectors and possible reduction of the competitiveness due to rising wages and salaries in excess of the growth of productivity have appeared.

The rise in the standard of living has made people more creditworthy. In addition, falling interest rates and longer loan periods have contributed to loan growth. Robust increase of wages, salaries and loans and strong increase of the demand arising from people's optimism exceeds the supply in some sectors. The result is a rise in real estate prices and a persistently high current account deficit which can be attributed to a strong rise of import.

As for the current account deficit it should be noted that its reason does not lie in the weakening of the competitiveness of Estonian corporations in foreign markets<sup>7</sup>, but in import of capital goods and an increase of the deficit of the income balance. The increased deficit of the income balance does not show the actual outflow of capital, because it is mostly reinvested profit. Reinvested profit is indicated in the balance payments by way of concurrent double recording, i.e. as outflow of income in the current account and as inflow of foreign investments in the financial account, which means that even if no funds are moved in reality, there is a strong outflow of income in Estonia's current account deficit. The share of reinvested profit has increased in recent years owing to a strong inflow of foreign investments and the profitability thereof. The Government's goal is to reduce the current account deficit to a level<sup>8</sup> that is sustainable in the long term, but it is clear that it will take time and due to the developments of the income balance Estonia's current account deficit will remain relatively high in comparison with other countries for years.

Recently, there have been signs of the cooling of the real estate market and the rise in prices has moderated. Due to improvement of the credit conditions credit growth should moderate after a certain delay and the real estate market should calm down.

It is important to follow inflationary developments so the rise in prices does not become too strong. Currently, inflation is related primarily to high oil prices (for further information, see Appendix 3) and the current level of inflation does not threaten the Estonian economy.

Considering Estonia's specifics, i.e. the use of the currency board system, the fiscal policy is the primary tool to influence the economy and control the risks threatening balanced economic development. The Estonian general government budget has been in surplus since 2002. Since the budget has been prepared in balance, the stricter-than-planned budgetary position has inhibited the growth of domestic demand. This year the surplus will be *ca* 2.6% of the GDP. For the first time, the general government budget for the next year is planned in a considerable surplus (initially, 0.8% of the GDP), which may, based on economic developments, prove to be higher than planned – according to the latest forecast, 1.2% of the GDP. Estonia is one of the few EU Member States that fulfils the requirement of the Stability and Growth Pact to achieve a budgetary position close-to-balance or in surplus. The Government considers it important to implement a strict budgetary policy in the near future as well.

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<sup>7</sup> See also the concluding statement of the IMF's article IV consultations of 2005 – IMF, 22 July 2005 ([http://www.eestipank.info/pub/et/majandus/IMF/\\_20050722.pdf?objId=652670](http://www.eestipank.info/pub/et/majandus/IMF/_20050722.pdf?objId=652670)) and *Estonia's current account deficit: a sign of success or a problem?* – ECFIN Country Focus Volume 2, Issue 13, 7.07.2005 ([http://europa.eu.int/comm/economy\\_finance/publications/country\\_focus/2005/countryfocus13\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/country_focus/2005/countryfocus13_en.htm)).

<sup>8</sup> IMF has estimated that in the case of the Baltic States the sustainable level of the current account deficit is 7.5% of the GDP in the medium term and 5% of the GDP in the long term – see *IMF Country Report No 03/331. Republic of Estonia: Selected Issues and Statistical Appendix. October 2003.*

Furthermore, other measures aimed at controlling excessive demand have been taken:

- At the end of 2004 the circle of recipients of the housing loan collateral of the KredEx foundation was limited and the upper limit of the maximum loan collateral was reduced by a quarter, i.e. from EEK 400,000 to EEK 300,000.<sup>9</sup>
- As of 2005 the Government reduced by 50% the maximum amount of housing loan interest, training costs, gifts, donations and trade union entrance and membership fees deductible from income tax, i.e. to EEK 50,000 a year. The effect of this measure resembles that of interest rate rises and it should help limiting consumption and credit growth. At present, a legislative amendment reducing the limit of deductions to EEK 30,000 is being drafted.
- The Bank of Estonia did keep the minimum reserve requirement of commercial banks at the level of 13% for a long time, in order to ensure the availability of the required liquidity buffers in banks in the environment of robust credit growth. Compare: in the Eurosystem the minimum reserve requirement is 2%.
- At the end of 2005 the bank of Estonia decided to make stricter the housing loan regulations for commercial banks as of 1 March 2006:<sup>10</sup>
  - To increase the risk weighting of housing loans from 50% to 100% in the capital adequacy calculation, i.e. the banks will have to increase the share of their own funds as regards the funding of housing loans.
  - In order to ensure a level playing field, the supervisors/regulators of branches of foreign banks and parent banks of subsidiaries of foreign banks will be asked to implement, if possible, a 100% risk weighting on housing loans granted to Estonian residents when calculating the capital adequacy ratio.
  - To include 50% of the housing loans portfolio to the reserve requirement calculation base should a bank apply a lower risk weighting to the loans it issues rather than that established by Eesti Pank.
- In June this year the Bank of Estonia decided to increase the minimum reserve requirement of the commercial banks from 13% to 15% as of 1 September 2006.

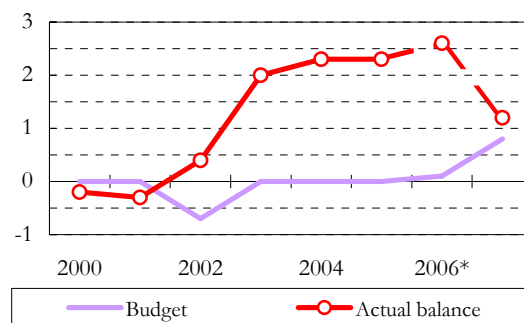
In addition to specific measures, promotion of overall savings (e.g. by implementation of the pension reform) and development of export (for further information see the Estonian National Action Plan for Growth and Jobs 2005–2007) also contribute to limiting the internal demand.

**The Government and the Bank of Estonia constantly monitor the situation and make certain that the economic stability is ensured. If necessary, further measures will be taken.**

**Figure 5**

### Planned and Actual General Government Budgetary Positions

(% of GDP)



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

<sup>9</sup> Through KredEx additional housing loan collateral is provided to certain target groups (forced tenants, young families, young specialists with higher education) so they can get a housing loan with a smaller self-financing portion (10% instead of the standard 1/3).

<sup>10</sup> Quarterly economic policy comments of the Bank of Estonia. 13 December 2005.

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## **3. FISCAL FRAMEWORK**

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### **3.1. General government's fiscal policy objectives**

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#### **3.1.1. Fiscal policy goals**

The primary fiscal policy goals of the Government given in the Convergence Programme<sup>11</sup> of May 2004 are as follows:

- o to keep the general government budget in balance;
- o to keep the tax burden stable;
- o cost-effectiveness in state administration and directing budgetary expenditure at economic development;
- o to ensure long-term sustainability of public finance.

#### ***The budget of the general government will be kept in balance over the medium term***

**The Government will continue to pursue a sustainable budgetary policy. The medium-term objective (MTO) of the Government is to keep the general government budget at least in balance. This objective complies with the Maastricht Treaty and the Stability and Growth Pact.**

A balanced budgetary policy ensures a favourable environment for economic development and contributes to maintaining economic growth, stabilising inflation and increasing the confidence of consumers and investors. Setting a nominal balance objective has been right for Estonia, because the structural changes in the economy have been extensive and they have not allowed for evaluating the economic cycle or the cyclical position of the budget with sufficient reliability.

In the coming years the goal is to keep the general government budget at least in balance. Such a fiscal policy will ensure a low level of government debt, which is a prerequisite for ensuring the long-term sustainability of public finances.

#### ***Tax burden will be kept stable***

The Government's plan was to keep the tax burden stable at the level of 2003, i.e. 31.9% of GDP. However, in the coming years it will be higher owing to improvement of tax collection due to effective work of the tax authority and improving tax discipline of taxpayers. As for taxation, there will be a partial shift from taxation of income to taxation of the use of natural resources and pollution of nature. However, the simplicity and uniformity of the Estonian tax policy will be preserved. Reduction of the income tax rate over the next four years will reduce the tax burden of corporations and private individuals. Furthermore, as of 1 January 2006 the Government will implement an additional income tax exemption minimum as of the second child of the family.

Labour force is taxed relatively high in Estonia. Too high taxation impedes the motivation of working. Therefore the Government plans reducing the taxation of labour force in order to boost the economy. Reduction of the tax burden of the labour force is led by the desire to give a positive

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<sup>11</sup> Similar objectives had already been provided in the Pre-accession Economic Programmes 2001-2003.

impulse for the development of the labour market and move towards the achievement of the Lisbon Strategy objectives. Estonia has already fulfilled the objective of the Lisbon Strategy for 2010 regarding the employment of the elderly and achievement of the objective regarding the employment of women is close at hand. The overall employment is, however, still lower. Considering the expansion of the tax base and improved administrative capacity (e.g. decreased share of envelope wages and salaries), the financing of the tax amendments is not a problem.

#### *Cost-effectiveness in state administration and directing budgetary expenditure at economic development*

The government would like to reduce the administrative expenses of the ministries. The budgetary control of state agencies will be improved and a uniform administrative expenditure policy will be developed.

An important step towards achieving this objective is the Government's activity upon developing and implementing the bases of a performance-based budgeting and reporting system. Performance-based budgeting places a greater emphasis on performance and brings greater flexibility upon using the budget. One of the prerequisites for implementation of the new system is formalisation of the principles of strategic planning, which should ensure that state agencies plan their activities keeping in mind the highest possible benefit for society in the conditions of limited resources and that the expenditure incurred on the basis of development plans is sustainable, targeted and as effective as possible. At the agency level the use of the principles of strategic planning usually contributes to better operation and improvement of the quality of public services. The use of the principles of strategic planning upon planning the development of the state and association thereof with the resources available to the state established the prerequisites for the financial management of the state, including increasing the quality of budgeting (see subsection 7.1).

To ensure cost-effectiveness in state administration the objectives and activities of agencies in the entire administrative organisation as well as the required resources should be reviewed. Thereby reduction of the administrative burden – one of the priorities of the EU – should be taken into account. This should, in addition to reducing the burden of the private sector, allow for saving public sector resources.

In addition, the structure of expenditure needs to be changed in order to direct expenditure more towards activities supporting economic development. It is planned to increase Estonian R&D expenditure (the main emphasis being on the private sector), which is low in comparison with other Member States of the European Union. More resources will also be spent on the implementation of active labour market policies. The Government is planning on finding more opportunities of involving the private sector in capital-intensive projects, e.g. R&D investments and the process of implementation of structural funds.

#### *To ensure long-term sustainability of public finances*

Estonia's fiscal policy has so far been conservative. The conservative policy must continue in order to cope with adverse demographic changes (ageing population) and ensure the sustainability of public finances in the long run. The public finances are also strengthened by a successfully implemented pension reform.

### **3.1.2. Budgetary priorities of the Government for 2007–2010**

In order to use state budget funds for achievement of long-term development as effectively as possible the **overall objective of the Government is to ensure socially and regionally balanced sustainable economic development of Estonia.**

By formulating such a goal consistency is established between past and future policy, because Estonia's economic policy has had this goal for years. Due to Estonia's current situation the goal of ensuring long-term growth, social and regional balance and sustainability of development is still relevant.

Long-term development and convergence depends primarily on the speed of economic growth. At the same time it is important to pay attention to the distribution of growing welfare in society – social and regional balance. Otherwise long-term development is under threat, because social problems exacerbate and the funds and development possibilities of the state are not applied in the optimum manner. It is important to create and maintain the prerequisites and possibilities for development and to ensure the conditions of growth (e.g. by increasing environmental and human friendliness).

Proceeding from the analysis of the current situation the goal is achieved and development opportunities are used with the help of activities aimed at solving the key problems. The activities of the State Budget Strategy for 2007-2010 were united and pooled into the following **objective-based** strategic areas, i.e. **priorities**.

- o **Educated and active population** – the development depends primarily on the people's ability to cope on their own, develop themselves and improve their standard of living. The prerequisites are good health, good education and the ability and possibility to successfully apply the education in the labour market.
- o **Growth of the research and development capacity and the innovativeness and productivity of corporations** – at present and even more so in the future the strength of economic development and long-term continuance thereof depends on R&D, innovativeness and productivity of corporations. Therefore Estonia must focus on knowledge-based economy, which brings about higher productivity and creation of value added.
- o **Better connections** – development of domestic and international connections and an increase of accessibility helps to create the prerequisites for continuance of strong economic growth, because it increases the effectiveness of operation of corporations, people's opportunities of work and movement, etc. It also allows for creating a basis for increasing the regional and social balance of economic growth.
- o **Smaller environmental burden** – ecological balance is the central prerequisite for the sustainability of society. It is especially important to pay attention to environmental protection at the time of strong economic and social development so the development does not worsen the status of the environment.
- o **Integral and balanced development of regions** – integral and balanced development of various regions in Estonia allows for increasing the regional balance of economic development as well as contributes to boosting the development and increasing the sustainability.
- o **Development of rural life and business in rural areas** - for the purpose of ensuring regional balance it is important to pay special attention to rural areas (including coastal areas), which have so far lagged behind in comparison with urban areas.
- o **Growth of security** – development is possible only in a stable environment where the residents and corporations have the feeling of security regarding protection and preservation of their health and property. Thus, it is important to create favourable background conditions for development, in addition to the direct key development activities, contributing to increasing the internal and external security of Estonia.
- o **Greater administrative capacity** – the administrative capacity of Estonia needs to be increased with regard to the public and third sectors for the purpose of increasing the effectiveness of the activities contained in the priorities, ensuring the desired impact and ensuring the daily functioning of the state.



## 3.2. General government budget balance

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### 3.2.1. Nominal balance of general government budget

In 2005 the **general government surplus** was EEK 4.1 billion, amounting to 2.3% of GDP. The trends of 2005 regarding the development of the position of the government sector were characterised by a strong decrease of the deficit of local authorities to a level of approx. EEK 50 million from the level of over EEK 300 million a year before and an increase of the surplus of social insurance funds and central government.

Central government surplus was largely based on lower costs in comparison with the budget, while the share of excess revenues was somewhat lower. The expenditure of the state budget was lower than planned in connection with amendment of the State Budget Act, according to which up to three percent of determined expenditure may be deemed transferable expenditure and used for the same purpose in the next budget year. This provision was adopted for the purpose of reducing the year-end expenditure of ministries and constitutional institutions aimed at exhausting all their budget funds. The balance of unused funds of the state budget at the end of 2005 was EEK 3.3 billion (1.9% of GDP) of which EEK 2.9 billion was transferred to 2006 (1.7% of GDP).

Due to higher-than-expected revenues the Government decided to draw up a **supplementary budget** on the basis of the summer forecast of the Ministry of Finance. The supplementary budget was adopted on November 22. The revenue of the supplementary budget amounted to EEK 5.5 billion and expenditure to EEK 3.2 billion. Supplementary budget was compiled with the principle that not all the additional revenue will be spent and the running costs will not be increased. The main objective of the supplementary budget was to increase reserves and investment. EEK 2.0 billion will be transferred to the pension insurance reserve and the expenditure will be directed to road construction, renovation of student dormitories, renovation and construction of embassy buildings, development of biometrical passports etc. By the supplementary budget the surplus of state budget 2005 in the amount of EEK 1.8 billion will also be transferred to the pension insurance reserve.

In 2006 the revenue is higher than forecasted due to more favourable economic developments than expected. On the basis of the first three quarters it is obvious that the expenditure of the Estonian Unemployment Insurance Fund and the central government will be considerably lower than budgeted in 2006. According to the forecast of the Ministry of Finance, general government surplus in **2006** will be EEK 5,371.9 million (2.6% of GDP). Central government will make the largest contribution to the general government surplus with its forecasted surplus of EEK 4,773.6 million, in spite of the EEK 499.5 million deficit of the pension insurance. The forecasted surplus of the Estonian Unemployment Insurance Fund is EEK 398.3 million. Usually, the budgetary position is worsened by the activities of local governments, but in 2006 the expected surplus of the aggregate budget of the local governments is EEK 200 million. The Estonian Health Insurance Fund is expected to maintain a budgetary balance.

According to a forecast, the general government surplus in **2007** will be EEK 2,833.7 million, i.e. 1.2% of GDP. The central government budget has been planned with a surplus in spite of a pension insurance deficit of approx. EEK 1 billion. The surplus of the Estonian Unemployment Insurance Fund will be at the level of recent years, i.e. 0.2% of GDP and the budget of local government will be in balance.

Through 2008-2010 the surplus will be at least around the level of 2007. Social insurance funds will have a slight surplus and local government will have a slight deficit, so the general government surplus results mainly from central government surplus (see also Table 21).



**Table 8****General Government Budget Balance 2004–2007**

	2004	2005	2006*	2007*
<b>General government (mln EEK)</b>	<b>3 423,5</b>	<b>4 060,8</b>	<b>5 371,9</b>	<b>2 833,7</b>
Central government	3 224,4	3 257,8	4 773,6	2 361,2
Social security funds	532,9	851,7	398,3	472,4
Local government	-333,8	-48,7	200,0	0,0
<b>General government (% of GDP)</b>	<b>2,3</b>	<b>2,3</b>	<b>2,6</b>	<b>1,2</b>
Central government	2,2	1,9	2,3	1,0
Social security funds	0,4	0,5	0,2	0,2
Local government	-0,2	0,0	0,1	0,0

\* *forecast.*

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

### 3.2.2. Cyclically adjusted balance of general government budget<sup>12</sup>

The analysis of the Ministry of Finance using the production function<sup>13</sup> method shows that in 2005 the GDP grew over the potential level and the positive output gap amounted to 1% of the GDP. In 2006 the positive output gap will reduce marginally. The potential and forecasted GDP will achieve the same level by the end of the forecast period. Structural changes in the economy and labour supply in 2006 brought about a rise of the potential output to a new level. After 2007 the estimate of the potential economic growth will be upheld by persistently high investment activity and growth of productivity.

By evaluating the cyclically adjusted position<sup>14</sup> of Estonia's budget on the basis of the calculated output gap the results show that the counter-cyclical position of Estonia's budgetary policy in 2006 will become pro-cyclical in 2007. The change of the position in 2007 is due to worsening of the cyclically adjusted primary balance, which arises from a considerable decrease of the nominal budget surplus of the general government, in times of economic growth that is continuously stronger than the potential level. In order to preserve the counter-cyclical policy the budget surplus of the general government should be over 2.7% of the GDP in 2007. In 2008 and 2010 the position will be counter-cyclical and in 2009 it will be pro-cyclical.

In the light of new data (i.e. revised GDP time series 2000-2005 and budgetary position time series 2002-2005) the budgetary policy was pro-cyclical through 2002-2005. Through 2002-2004 this could be attributed to an increase of the cyclically adjusted primary balance of the general government in the case of economic growth that was lower than the potential level. At the same time the stricter budgetary policy helped to reduce the risks of imbalance (e.g. an increase of the current account deficit). In 2005 the budgetary position weakened when the output gap turned positive.

<sup>12</sup> On the output gap and cyclically adjusted and structural budget position definitions and principles of calculation see Estonia's Convergence Programme of December 2005.

<sup>13</sup> On the GDP gap and cyclically adjusted and structural budget position evaluation methodology see Estonia's Convergence Programme of May 2004.

<sup>14</sup> Upon evaluation of the cyclical position, the elasticities of tax revenue and expenditure given by the European Commission were used.

**Table 9****Cyclically-adjusted Budget Balance 2005-2010***(% of GDP)*

	2005	2006*	2007*	2008*	2009*	2010*
1. Real GDP growth (%)	10,5	11,0	8,3	7,7	7,6	7,5
2. Net lending of general government	2,3	2,6	1,2	1,3	1,6	1,5
3. Interest expenditure	0,2	0,2	0,1	0,1	0,1	0,1
4. Potential GDP growth (%)	8,1	11,1	8,5	8,3	7,9	7,6
5. Output gap	1,0	0,9	0,7	0,2	-0,1	-0,2
6. Cyclical budgetary component	0,3	0,3	0,2	0,1	0,0	-0,1
7. Cyclically-adjusted balance	2,1	2,3	1,0	1,2	1,6	1,6
8. Cyclically adjusted primary balance	2,3	2,5	1,1	1,3	1,7	1,7

\* *forecast.**Sources:: Statistical Office of Estonia, Ministry of Finance of Estonia.***3.2.3. One-off measures and structural balance of general government budget**

Measures having considerable non-recurring impact on the budget are considered one-off and temporary measures. Although general principles by which measures are classified as temporary and one-off have been determined, it will be decided separately in each particular case, taking into account the impact of the measure. Since temporary and one-off measures distort the comparability of years, their impact will be removed from the cyclically adjusted budgetary balance and a structural budgetary balance which allows for better evaluation of the budgetary position will be calculated.

The measures that are one-off in the Estonian context have been given in the table below. In 2003 their impact was 0.1% of GDP, but in the following years it was much higher – in 2004 it was 0.6% of GDP, in 2006 it was 0.6% of GDP and in 2007 it will be 0.4% of GDP. Postponement of the VAT taxation moment and sale of the state assets in a greater volume than in the past are the main one-off measures that have a considerable impact in Estonia.

In connection with the accession to the EU in 2004 VAT is not paid on goods imported from EU Member States to Estonia upon their import, but the tax is declared in the VAT return of the respective period. As a result of the change the tax balance and the amount payable did not change. Only the moment of taxation was postponed, i.e. there was a one-month shift in the tax receipts. The amendment of the Value Added Tax Act in 2005 specifies the provisions regulating deduction of VAT paid on imported goods as input VAT, in order to bring them into compliance with EU directives.<sup>15</sup>

The regular receipts from the sale of the state assets is based on the average amounts received to the state budget from the sale of assets through 2000-2005. According to this, the regular revenue is approx. EEK 200 million a year. Upon removing the given amount from the amounts planned in the budget for 2006 and 2007, it becomes evident that the sale of the state assets exceeds prior volumes.

<sup>15</sup> According to the legislative amendment, a taxable person deducts the value added tax paid or payable on imported goods from the value added tax calculated on their taxable turnover as input value added tax in the value added tax return of the month of importing the goods, not in the value added tax return of the month of payment of value added tax for the imported goods.

**Table 10****Impact of One-off Measures 2003–2007**

Year	Measure	mln EEK*	% of GDP
2003	Sale of UMTS licences	150	0,1
2004	Joining the EU shifted VAT taxation moment	-1 200	-0,6
	Non-recurrent payment from the EU budget	274	
2006	Higher revenues from the sale of assets	1 200	0,6
	The time of deducting import VAT was shifted from the moment of payment to the moment of importation of goods	-215	
	Income tax from the revenues earned from the sale of shares of Hansapank	312	
2007	Higher revenues from the sale of assets	860	0,4

\* – *approximative*

Source: Ministry of Finance of Estonia.

By removing one-off and temporary measures from the cyclically adjusted budgetary balance, the structural budgetary balance will be obtained. The given indicator is used in the proceedings of the excessive budget deficit in order to assess the budgetary policy of the Member State and movement towards attaining the medium term objective. In addition it has been stipulated in the Stability and Growth Pact that the Member States that have not achieved their medium-term objectives must annually improve their structural budgetary balance to the extent of 0.5% of the GDP.

Due to a relatively high cyclically adjusted balance through 2006-2010 and the relatively smaller volume of the one-off measures, the structural balance will be positive in this period. Thus, the Estonian budgetary position is strong enough in order to prevent violation of the Maastricht budget deficit criterion, i.e. 3% of GDP.

**Table 11****Structural balance 2005–2010**

(% of GDP)

	2005	2006*	2007*	2008*	2009*	2010*
1. Cyclically-adjusted balance	2,1	2,3	1,0	1,2	1,6	1,6
2. One-off measures	0,0	0,6	0,4	0,0	0,0	0,0
3. Structural balance	2,1	1,7	0,6	1,2	1,6	1,6

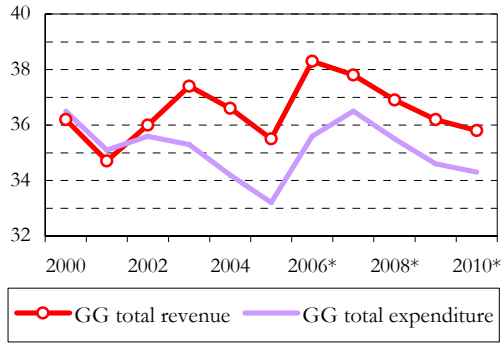
Sources: Statistical Office of Estonia, Ministry of Finance of Estonia.

**Figure 6**

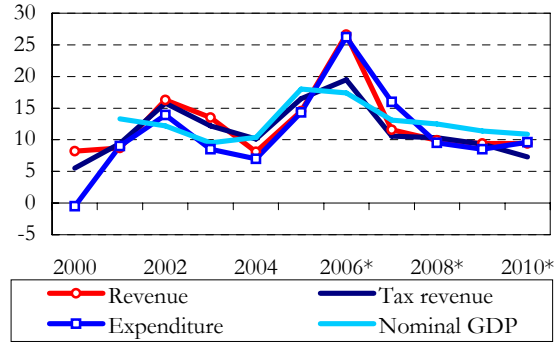
**General Government Budget Balance**

(% of GDP)

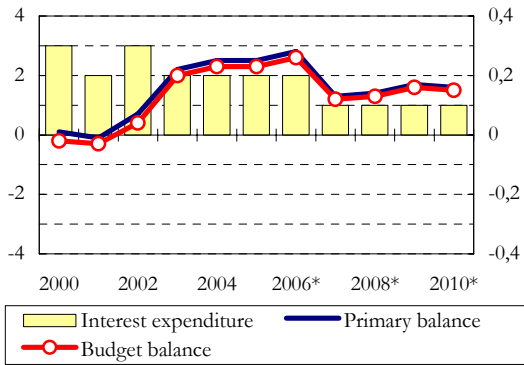
**A. Total revenue and expenditure**



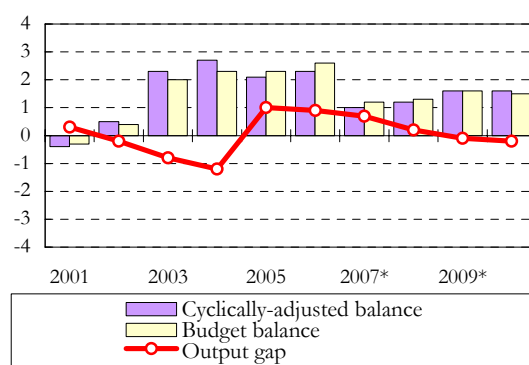
**B. Revenue and expenditure growth (%)**



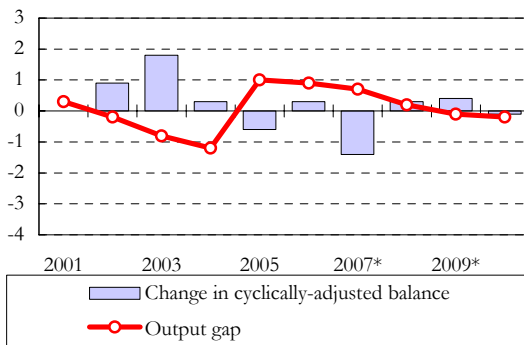
**C. Budget balance**



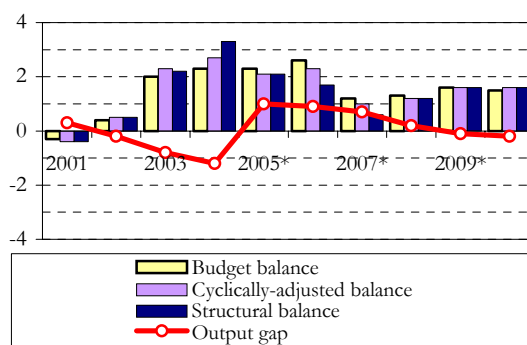
**D. Cyclically-adjusted balance**



**E. Change in cyclically-adjusted balance**



**F. Structural balance**

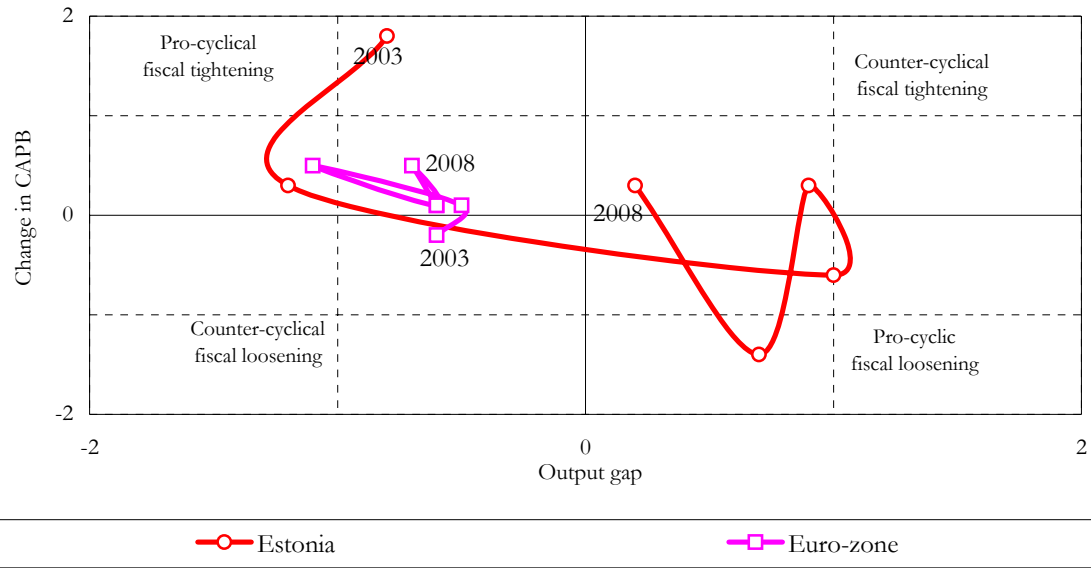


Sources: Ministry of Finance of Estonia, Estonian Statistical Office.

**Figure 7**

**Fiscal stance and cyclical conditions of Estonia and euro area in 2003–2008**

(% of GDP)



Sources: Ministry of Finance of Estonia, Eurostat, Public Finances in EMU 2005.

### **3.3. Roles and budgetary balances of levels of government**

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In Estonia the **central government** comprises ministries, constitutional institutions, state pension insurance, most of the legal persons in public law and foundations controlled and financed by the central government. The duties of the central government are related to state administration. It is also the duty of the central government to ensure security and public order. The duty of the central government is to organise agriculture, environmental protection, the infrastructure and culture through various agencies. Social care, health care and education are organised in cooperation with social insurance funds and local governments.

The financial position of the central government is connected primarily with the economic cycle as regards to financing – a large share of the central government revenue consists of taxes that are sensitive to economic growth. Therefore central government has been the main generator of the deficit in the decline phase of the economic cycle (e.g. in 1999), while in recent years it has been in surplus due to better-than-expected accrual of tax revenues. In 2005 the central government ended the year in surplus for the sixth year in a row – the surplus was 1.9% of GDP. According to the latest data, the surplus in 2006 will be 2.6% of GDP. In the medium term the central government will continue with a surplus, which will be ensured proceeding from the goal of keeping the general government budget at least in balance.

This year and, according to the forecast, in the next two years the state pension insurance belonging to the central government will be in deficit. In order to ensure the sustainability of the public finances in the environment of aging population Estonia has largely carried out pension reform and established a three-pillar pension system (state pension insurance, mandatory funded pension and supplementary private pension). The income of the state pension insurance comprises 20% of the social tax base of which 4% will be transferred to the funded pension system. To find additional funds for financing pension insurance (and health insurance) the government will return to the initial idea of the pension reform, according to which the minimum social tax obligation must be fulfilled on the basis of the minimum monthly salary. In 2006 the amount serving as the basis for the minimum obligation was raised to EEK 1,400 a month, in 2007 it will be raised to EEK 1,500 a month and by 2009 it will be raised to the minimum monthly salary of the previous year. It has been decided to transfer EEK 1.8 billion from the 2005 surplus and EEK 2.0 billion from the supplementary budget of 2006 to the pension insurance reserve for the purpose of strengthening the financial position of pension insurance.

The rise in pensions has been established by the State Pension Insurance Act, according to which state pension will be annually indexed by April 1 using an index the value of which is the arithmetical average of the annual growth of the CPI and annual growth of the pension insurance share of social tax revenues. In addition, there will be the extraordinary pension increases agreed on in the governing coalition agreement. As of 1 July 2005 the average pension rose to EEK 2,726 a month and as of 1 April 2006 the average pension rose to approx. EEK 3,136 a month.

National Health Insurance Fund and National Unemployment Insurance Fund belong to the sector of **social insurance funds**. The Health Insurance Fund is a social insurance fund operating pursuant to the principle of solidarity, which is funded out of the social tax (13% of the social tax base). According to the Estonian Health Insurance Fund Act, the Health Insurance Fund is obligated to have capital reserves and risk reserves. The size of the capital reserves is at least 6% and the size of the risk reserve is 2% of the budget total. The budgetary position of health insurance has so far been stable, but considering Estonia's demographic situation it is necessary to take further measures for ensuring long-term sustainability. The key principle is to preserve at least a balanced financial position of the health insurance.

The financing of the health care system can be improved by increasing the tax base through raising the amount serving as the basis for the minimum social tax obligation. In the conditions of aging population increasing the circle of persons on whom social tax is paid is considered for the purpose of ensuring the long-term sustainability of health insurance and it is tried to prevent a rise in the share of the persons who are equal to the insured persons. Reduction of the scope of the obligations of the National Health Insurance Fund is considered as a possible savings measure. Advocating and promoting a healthy lifestyle and improving the overall health of the population play an important role upon ensuring the long-term sustainability of health insurance, because they reduce the number of persons who need health services.

The duty of the National Unemployment Insurance Fund is the payment of unemployment insurance benefits, collective agreement termination insurance indemnities and employer insolvency insurance indemnities. The sums of the National Unemployment Insurance Fund are obtained from the mandatory unemployment insurance payments of the insured persons. According to the Unemployment Insurance Act, the rate of the payments may be 0.5-2% of the gross salary for the insured persons and 0.25-1% of the gross salary for the employer. In 2005 the employee paid the unemployment insurance payment at the rate of 1% and the employer at the rate of 0.5% of the gross salary. In connection with the increasing surplus the Government reduced the tax rate as of 2006 – the employee's tax rate fell to 0.6% and the employer's tax rate fell to 0.3%. The size of the capital reserves of the Health Insurance Fund is at least 10% of the volume of the assets of the Unemployment Insurance Fund.

The surplus of the National Unemployment Insurance Fund initially arose from the characteristic low level of the opening years of the system (the Unemployment Insurance Fund was established in 2002) and the need to create a sufficient reserve. The improving situation of the labour market has been the reason for the lower-than-planned costs. Owing to lower costs and improved tax collection the Unemployment Insurance Fund has been in annual surplus and the volume of the accrued reserves was EEK 1.9 billion as of the end of 2005.

The main duty of **local governments** is to organise the local life, general education system and to ensure the daily subsistence of people through social support. The number of functions transferred from the central government to local governments has increased over the years. One of the largest expenditure items in the budgets of local governments as of 2000 is the payment of teachers' salaries. As of 2005 the social care funds of disabled people were transferred to local governments and education investments allocated from the state budget were merged with the per capita fee of general education schools.

According to the Constitution, local governments have a separate budget and therefore local governments have relatively extensive discretion upon division of their revenue and expenditure. Using the opportunities given by the Constitution, the budgets of local governments have been in deficit since the restoration of independence. The average volume of the revenues of the budgets of Estonian local authorities has amounted to 8.7% of GDP in previous years, which is considerably lower than the average indicator of the Member States of the EU, while the share of the tax revenues of the local governments (4.3% of GDP) is equal to the EU average. The volume of the expenditure of the local authorities has been at the level of 9.1% of GDP in previous years.

The Rural Municipality and City Budgets Act establishes restrictions on assumption of debt obligations by local governments. The total amount of all outstanding loans, outstanding financial lease payments, issued bonds and other debt obligations must not exceed 60% of the budget revenue planned for the given budget year and in each single coming budget year the total amount of loan principals and interest payable, financial lease principals and interest payable, bond redemption costs and other debts must not exceed 20% of the budget revenue planned for the budget year.

The central government has decided to achieve a decrease of the deficit of the aggregate deficit of local government over the medium term by applying financial discipline measures. To strengthen

the financial position of local governments their share of revenues from natural person income tax has been increased in recent years. When the state started the process of reducing the income tax rate, the former bases of division of the natural person income tax were amended – instead of 56% of the total revenue it was established that local governments are entitled to 11.4% of the taxable income of a taxpayer, which means that if the income tax rate is reduced, the share accruing to local authorities will not decrease. By today this share has been raised to 11.8% and in 2007 it will rise to 11.9%. As of 2001 the deficit of local governments has decreased by approx. 1% of GDP and according to the forecast, in the medium term it will remain at the level of approx. 0.1% of GDP. On the one hand, the reason for reduction of the deficit lies in the objective established by local authorities to achieve a balance in the medium term (mainly Tallinn) and, on the other hand, in reaching the credit restrictions.

**Table 12**

**General Government Budget Balance 2003–2010**

(% of GDP)

	2005	2006*	2007*	2008*	2009*	2010*
<b>General government</b>	<b>2,3</b>	<b>2,6</b>	<b>1,2</b>	<b>1,3</b>	<b>1,6</b>	<b>1,5</b>
Central government	1,9	2,3	1,0	1,2	1,5	1,4
Social security funds	0,5	0,2	0,2	0,2	0,2	0,2
Local government	0,0	0,1	0,0	-0,1	-0,1	-0,1

\* *orecast.*

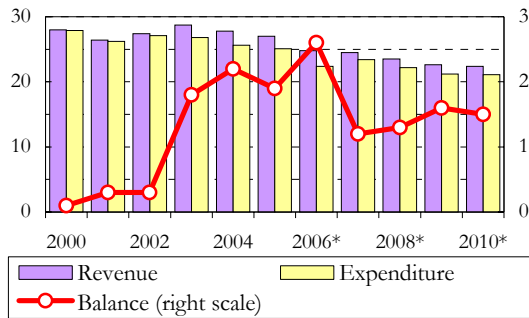
Sources:: *Statistical Office of Estonia, Ministry of Finance of Estonia.*

**Figure 8**

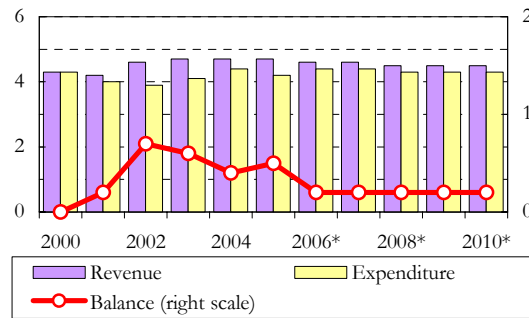
**Revenues and Expenditures of General Government Levels 2000–2010**

(% of GDP)

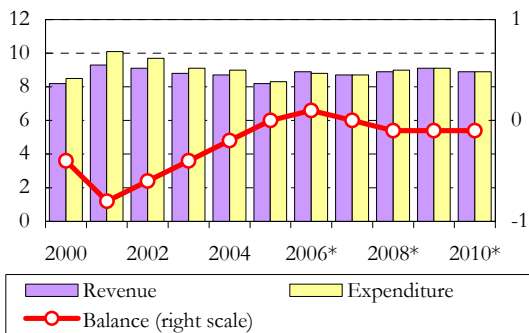
**A. Central government**



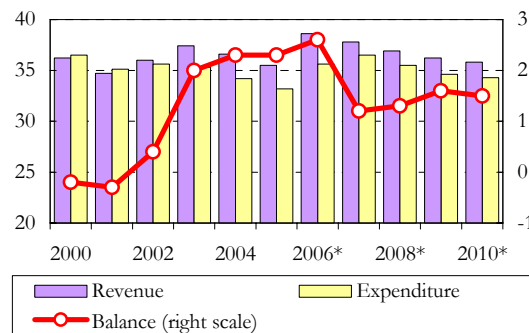
**B. Social security funds**



**C. Local government**



**D. General government**



Sources:: *Eurostat, Ministry of Finance of Estonia.*



## 3.4. General government financing

### 3.4.1. Government debt

The main goal of Estonia's budgetary policy ever since the restoration of independence has been to keep the general government budget in balance over the medium term, which is expressed in the low level of debt. At the end of 2005 the government debt of Estonia was 4.5% of GDP. From the general government debt of EEK 7.7 billion, the local government debt formed 54% in 2005 and that share has increased by 14.3 percentage points since 2001. The main reason here is the constant deficit of local authorities, because there are no more assets to sell to cover it and therefore the only option is borrowing. In 2005 the central government debt decreased, because in the conditions of a surplus there is no need for using external funds and loans were repaid on the basis of the prescribed repayment schedules.

The debt to external creditors amounted to 50.7% of the total debt, being EEK 3.9 billion as of the turn of the year, incl. the external debt of the central government amounted to EEK 2.6 million and the external debt of local authorities amounted to EEK 1.3 billion. The internal debt has slightly increased in comparison with the previous year due to more active borrowing by the central government in the domestic markets, amounting to EEK 3.8 billion as of the end of 2005. The debt of local authorities to domestic credit institutions is the largest among debt instruments, amounting to EEK 2.4 billion at the end of 2005.

**Table 13**

#### Change of General Government debt burden in 2005

	31. December 2004		31. December 2005		Change
	Mio EEK	% of GDP	Mio EEK	% of GDP	%
<b>General Government</b>	<b>7 630</b>	<b>5,2</b>	<b>7 708</b>	<b>4,5</b>	<b>1,0</b>
Domestic debt	3 646	2,5	3 802	2,2	4,3
Foreign debt	3 984	2,7	3 906	2,3	-2,0
<b>Central Government</b>	<b>4 082</b>	<b>2,8</b>	<b>3 620</b>	<b>2,1</b>	<b>-11,3</b>
Domestic debt	844	0,6	1010	0,6	19,7
Foreign debt	3 238	2,2	2 610	1,5	-19,4
<b>Local Government</b>	<b>3 686</b>	<b>2,7</b>	<b>4 177</b>	<b>2,4</b>	<b>4,8</b>
Domestic debt	2 940	2,0	2 881	1,7	-2,0
Foreign debt	746	0,5	1 296	0,7	73,7
<b>Social Security</b>	<b>2</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>-100</b>
Domestic debt	2	0	0	0	-100
Foreign debt	-	..	-	..	..

*Source: Ministry of Finance of Estonia.*

In spite of the surplus of the general government budget the government debt has nominally slightly increased over the recent years. One of the reasons is the fact that the central government has not used the surplus for early repayment or reduction of the debt, because the debt is very low by international standards and early repayment of the debt has not been beneficial for Estonia under the agreements made. The surplus has been used for increasing deposits and formation of reserves comprising of liquid financial assets, i.e. usually low-risk bonds. The share of privatisation income has been marginal in recent years.

**In the coming years the government debt will decrease to 1.9% of GDP by the end of 2010.** Thereby it has been presumed that the redemption of the (euro) bonds issued by the central

government in the amount of EUR 100 million will be financed out of the existing financial assets. The financial conditions of local authorities have improved and therefore the need for additional borrowing has decreased. According to the forecast, in 2006 and 2007 local authorities will end the year in a slight surplus and a balanced budget, but these years will be followed by years when there is a slight budget deficit. However, the threat to the fiscal stance of the general government and the fiscal policy of the central government while continuing to pursue the objective of a balanced budget will decrease, because several local authorities are approaching the loan limit established by law, which will result in conservative budgeting for them.

**Table 14****General Government debt developments in 2005–2010***(% of GDP)*

	2005	2006*	2007*	2008*	2009*	2010*
<b>1. Gross debt</b>	<b>4,5</b>	<b>3,7</b>	<b>2,6</b>	<b>2,3</b>	<b>2,1</b>	<b>1,9</b>
2. Change in gross debt ratio	-0,7	-0,8	-1,1	-0,3	-0,2	-0,2
<b>Contributions to change in gross debt</b>						
3. Primary balance (-)	-2,5	-2,8	-1,3	-1,4	-1,7	-1,6
4. Interest expenditure	0,2	0,2	0,1	0,1	0,1	0,1
5. Nominal GDP growth	-0,8	-0,7	-0,3	-0,4	-0,2	-0,2
6. Stock-flow adjustment	2,4	2,5	0,4	1,4	1,6	1,5
6.1 of which statistical discrepancies	0,2	0,1	0,0	0,0	0,0	0,0
6.2 of which net accumulation of financial assets	3,6	3,7	1,7	2,7	2,9	2,8
6.2.1 of which privatization proceeds	0,0	0,0	0,0	0,0	0,0	0,0
6.3 of which net incurrence of other liabilities	-1,4	-1,3	-1,3	-1,3	-1,3	-1,3
<b>7. Implicit interest rate on debt (%)</b>	<b>4,6</b>	<b>4,9</b>	<b>5,0</b>	<b>4,8</b>	<b>4,9</b>	<b>5,0</b>

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

**Box 2. Stock-flow adjustments (SFA)**

A stock-flow adjustment (SFA) is an indicator characterising the difference between the debt positions (stock) and deficit (flow) in the previous and this year.

$$\text{Debt}(t) - \text{Debt}(t-1) = \text{SFA}(t) - \text{Deficit}(t)$$

Positive (negative) SFA indicates that besides the deficit (surplus) the debt is also increased (decreased) by other changes (financial transactions, re-evaluations, and the difference been cash and accrual reporting).

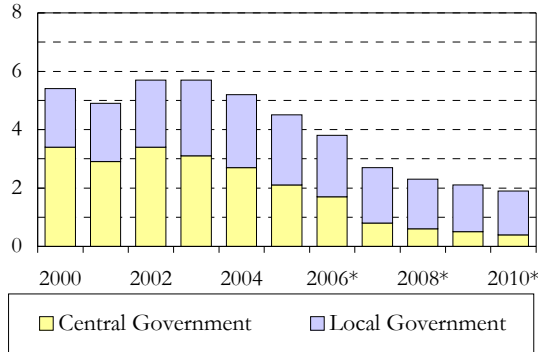
In theory the change in the debt should be relatively similar to the deficit/surplus at least in a longer period, but especially recent years have indicated that the correlation between the change in the debt and the deficit has weakened in the case of various countries. In the case of Estonia SFA has been high especially in the case of recent years, because the surplus has not been used for reduction of the debt, but for increasing reserves. The same tendency characterises the Nordic countries that create reserves in the social insurance sector in order to be better prepared for a rise in the costs arising from the aging of the population. SFA indirectly indicates that there may still be problems with the budget statistics in some countries.

**Figure 9**

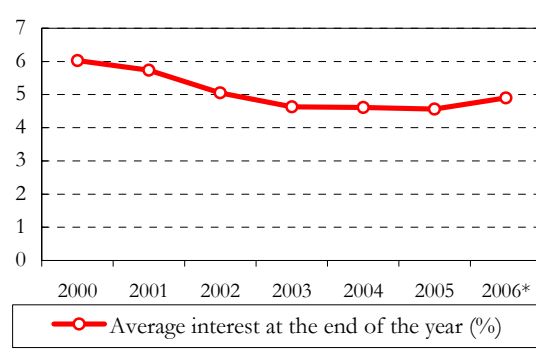
**Debt developments**

(% of GDP)

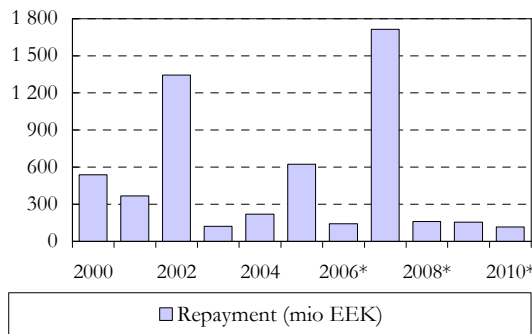
**A. General Government debt**



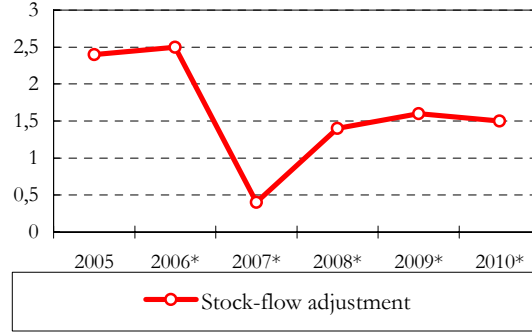
**B. Average interest of Central Government<sup>16</sup> loans**



**C. Repayment of Central Government loans**



**D. Stock-flow adjustment**



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

**3.4.2. General government reserves**

Owing to the remarkable surplus in the general government budget over the recent years, especially in the sector of the central government and social insurance funds, the reserves of the given levels of government have constantly grown. As of the end of 2005 the financial reserves of the central government exceeded the debt of the central government by over four times and amounted to EEK 14.7 billion, i.e. to 8.5% of GDP. The larger part of the financial reserves – EEK 10.2 billion – has been invested in low-risk bonds, but 4.5 billion is on various deposit and other accounts. As of the end of Q3 2006 the reserves of the central government amounted to EEK 19.7 billion, having grown by 22.2%.

Upon development of the strategy for administration of financial reserves it is proceeded from the objective of ensuring sufficient liquidity for the purpose of problem-free service of the state budget and timely performance of the state’s obligations. Upon creation of the stabilisation reserve investment strategy it is presumed that the reserve will be used in the conditions of economic growth and balanced budget only for alleviation of socio-economic crises.

The management of the reserves includes a combination of an optimum passive investment strategy drawn up for each set of assets and expressed as a standard portfolio and an active

<sup>16</sup> Central Government without foundations and public-legal entities.

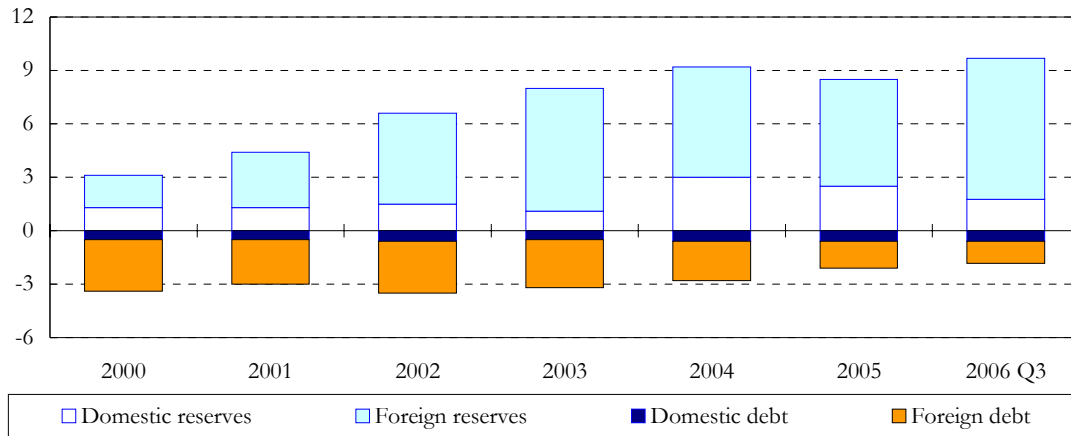
investment process which takes advantage of the actual opportunities offered by the market and during which it is consciously deviated from the standard portfolio. Thereby the standard portfolios express the investors' risk appetite and yield expectations and have to ensure achievement of the fundamental objectives of investment of the set of the assets – preservation of the value of the assets in the established investment horizon, sufficient liquidity and achievement of the maximum income to the extent of the established risk limits. Currency, interest, liquidity and credit risks will be managed upon administration of reserves.

The current investment strategy of the stabilisation reserve has been made based on the principle which would ensure non-negative yield of the reserve with 95% probability in a 6-month perspective in any market situation. It has also been presumed that the means of the reserve can be fully put to use after 3 months where necessary. Therefore the means of the reserve are invested only in high-liquidity and low-risk bonds. In the coming years the investment strategy will be updated in such a manner that a yield exceeding the inflation of the investments would be ensured in the medium term.

Upon investment of funds and reserves used for management of the daily liquidity of the state budget, high liquidity and a short investment horizon will be maintained in order to effectively manage the current non-compliance of the accrual of budget revenues and incurring costs. The seasonal nature arising from the difference between state budget revenue and expenditure has increased due to the extensive application of the support schemes of the European Union and the multitude of financing transactions. For instance, through 2007-2010 the support schemes of the European Union will be bridge financed out of the state budget funds before accrual of the money from the support to the extent of approximately EEK 3 billion in each calendar year.

**Figure 10**

**Central Government debt and reserves at the end of the period**  
(% of GDP)



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

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## **4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS PROGRAMME**

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### **4.1. Alternative scenarios and their impact on the budget**

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#### **4.1.1. Oil and overheating risk scenarios**

##### *Oil risk scenario*

This year the developments of the oil prices have been affected by the geopolitical instability of the Middle East crisis, which, along with limitations on the supply side and growing market demand, have influenced the global market prices more than in the past. Any negative news regarding regions relating to oil refinery and production have brought about a rise in prices.

In recent years the dynamics of oil prices has exceeded any expectations and broken new records. The average price in 2005 was \$55 /brl and in summer the oil prices reached their all-time high of \$78 /brl. Thereafter, emergence of various pieces of positive news brought about a strong correction. The price fell by almost a fourth in a short time and in autumn it has fluctuated at a level slightly lower than \$60 /brl.

Assuming that the crude oil prices will slightly rise in Q4 2006 (\$61-62 /brl), the average price of 2006 will be \$65.6 /brl, which equals the assumptions of the autumn forecast of the European Commission. In the following years we expect a slightly higher annual average price. A factor inhibiting a stronger growth of the crude oil prices will be the growing oil supply of non-OPEC countries, which should balance the reduced oil production in areas of crisis and be in compliance with the expected growth of the demand for oil products.

The importance of the oil risk for Estonia is characterised by the share of motor fuel in the consumption basket, which noticeably exceeds the average level of the EU25, amounting to 6.6% of the CPI<sup>17</sup> basket in 2006.

As for the oil risk and its impact two scenarios have been taken into account:

- a) the oil prices remain at the level presumed in the base scenario in Q4 2006 and 10% higher than expected 2007-2010, i.e. a higher than expected rise in prices will take place in 2007 and thereafter the dynamics will match the expectations, albeit at a higher level;
- b) if the oil prices remain at the average level of October in Q4 2006 (\$58 /brl) and 5% lower than expected in the base scenario 2007-2010.

The direct impact on motor fuels as well as on transportation services in general and on the prices of other goods and services has been taken into account. Since no second-round effects<sup>18</sup> have appeared from the rise in oil prices yet as indicated by the low inflation expectations of consumers,

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<sup>17</sup> In the basket of the Estonian Harmonised Index of Consumer Price (HICP) the share of motor fuel was 5.9%, but in the EU25 it was 4.2%.

<sup>18</sup> According to the second round effects, higher consumer prices bring about higher inflation expectations, which will increase the price level through wages and salaries.

we presume that the Estonian economy will remain sufficiently flexible and these effects will not appear in the future either.

According to the first scenario, inflation will rise by 0.5 percentage points in 2007 and by 0.1 percentage points in 2008. According to the second scenario in 2006 and 2007 inflation can be expected to fall by 0.1 percentage points. The given results refer to the sensitivity of Estonia's inflation to external shocks, but assuming that the economy is sufficiently flexible we can say that the impact of oil prices is not long-term, i.e. no second-round effects will appear.

**Table 15**

**Oil risk scenario of 2006–2010**

(per cent)

	2005	2006*	2007*	2008*	2009*	2010*
CPI forecast, november 2006	4,1	4,4	4,3	4,4	3,5	3,2
MoF crude oil assumption (\$/brl)	55,0	65,6	66,3	68,0	69,0	69,0
CPI, scenario I	4,1	4,4	4,8	4,5	3,5	3,2
Difference	-	0,0	0,5	0,1	0,0	0,0
Crude oil (\$/brl)		65,6	73,0	74,8	76,0	76,0
CPI, scenario II	4,1	4,3	4,2	4,4	3,5	3,2
Difference	-	-0,1	-0,1	0,0	0,0	0,0
Crude oil (\$/brl)		64,8	63,0	64,6	65,6	65,6

Source: Ministry of Finance.

**Overheating risk scenario**

This year the threats of overheating arising from strong economic growth which exceeds the potential increased further. The real estate market is still buoyant and the rise in prices continued. The rate of growth of borrowing, which is aimed largely at the real estate sector, strengthened with regard to corporations as well as private individuals. Construction volumes increased and the rise of prices in this sector strengthened considerably. Private consumption is also rising rapidly as expressed in strengthening retail sales and car sales.

The main risk is the continuance of the rapid growth of domestic demand, which takes place largely at the account of credit and brings about a rise of the imbalances. From the point of view of future developments the limited availability of labour force in certain fields of activity (industry, construction, retail trade, transport, information technology, hotel and restaurant management, etc.) is important as well, because it keeps up the pressure on wages and salaries and may enhance the consumption boom in the short term and bring about a decrease in the competitiveness of Estonian companies in domestic and foreign markets.

According to the risk scenario, the labour shortages and the persistence of a strong demand will strengthen the pressures on wages. In the basic scenario of the forecast it is assumed that in spite of the large share of real estate investments the investments in capital equipment will be sufficient as well, but in the case of the risk scenario this is not assumed, as a result of which a negative blow will come first of all from corporations. Prevailing pressures on wages and other costs will worsen the competitiveness in foreign markets. In the domestic market the demand may linger in the short term with the support of credit growth, but this source will be exhausted quickly. This will be followed by a decrease in product sales and production volumes. Corporations will be forced to focus more on product development and modernisation of production processes in order to

increase their productivity. The demand for more expensive labour will decrease and corporations will focus on increasing the effectiveness of employees. This will, in turn, exert pressure towards increasing unemployment. Low-productivity unskilled labour may become discouraged in the labour market. Subcontracting based on cheap labour may move away from Estonia and leave people without a job.

This means that the contribution of capital as a production input will increase, but in the environment of limited resources this will not be possible for everyone. The corporations who are already contributing to product development and whose production is not based on cheap labour are in a better position.

In the beginning of the risk scenario the strong optimism of consumer may continue, supported by a strong rise in wages and employment. On the basis thereof the use of credit will, due to a relatively unlimited inflow of external funds, be much more extensive than in the case of the base scenario. Increasing debt servicing payments due to rising interest rates will not have any significant impact, because optimism and a strong increase of households' income will dominate this effect.

It may be presumed that in this situation households will not be able to adequately evaluate the risks arising from the increasing debt burden, as a result of which the debt burden will reach a critical level. Realisation of the setback with regard to corporations will force them to considerably cut personnel costs, which will result in a decrease of households' income. As a result thereof the high loan burden will further amplify the moderation of the income growth. Private individuals are under the burden of performance of their existing obligations before banks, the banks are not interested in providing them with additional credit due to worsening financial situation as a result of which the amount of money flowing from private individuals to consumption will decrease noticeably. As a result of this private consumption, one of the most important drivers of economic growth will dry up. When consumer demand decreases, service and trade companies will be under threat and they will be forced to cut the number of employees depending on the changed situation. This is yet another factor contributing to a rise in unemployment.

All in all, in the case of the risk scenario the economic growth can be expected to moderate noticeably, resulting in an increase of the unemployment rate. If production is not quickly restructured in the changed competition environment and if the labour force is not reoriented to new economic activities, Estonia may get stuck in a development trajectory with considerably weaker growth. Assuming that corporations do restructure their production towards higher value added generation, we can expect continuance of reasonable growth in the longer term. However, in comparison with the base scenario, this will be at a lower level, because updating production processes is quite expensive and companies must virtually start penetrating new markets.

**Table 16****Overheating risk scenario 2005–2010***(percent)*

	Risk scenario						Difference from base line forecast					
	2005	2006*	2007*	2008*	2009*	2010*	2005	2006*	2007*	2008*	2009*	2010*
GDP real growth	10.5	12.1	9.0	5.4	6.5	6.8	0.0	1.0	0.7	-2.3	-1.1	-0.7
CPI	4.1	4.4	4.6	4.6	3.5	3.2	0.0	0.0	0.3	0.2	0.0	0.0
Domestic demand real growth (incl. inventories)	6.8	14.6	11.6	3.6	4.8	4.7	0.0	1.4	2.4	-3.1	-1.4	-1.0
Export real growth	21.5	13.3	10.4	6.3	6.2	6.5	0.0	0.0	-1.0	-3.6	-3.6	-3.3
Import real growth	15.9	16.0	13.0	4.3	4.4	4.3	0.0	0.5	0.9	-4.4	-3.8	-3.5
Employment rate growth	2.0	6.3	1.6	-0.9	-0.2	-0.2	0.0	0.0	0.6	-1.3	-0.3	-0.4
Wage real growth	6.4	11.1	10.4	5.2	6.3	6.6	0.0	0.8	2.5	-1.6	-0.9	-0.7
Current account (% of GDP)	-10.5	-12.8	-15.3	-12.9	-11.5	-9.6	0.0	-0.4	-1.9	-1.2	-0.8	-0.6
<b>Contribution to the growth of GDP</b>												
Domestic demand (incl. inventories)	7.4	15.5	12.5	4.0	5.2	5.0	0.0	1.5	2.6	-3.4	-1.5	-1.0
Balance of goods and services	3.1	-3.4	-3.5	1.5	1.3	1.8	0.0	-0.5	-1.9	1.0	0.4	0.3

*Source: Ministry of Finance.***4.1.2. Impact of fulfilment of risk scenarios on the budget****Oil risk scenario**

The impact of the higher-than-expected or lower-than-expected level of oil prices on accrual of tax revenues and thus, on the balance of the general government budget, cannot be estimated using a single method. Although by way of the sensitivity analysis it can be determined what effect a change in the percentage of the GDP has on tax revenues and it is possible to determine the impact mathematically, upon using the results it must also be proceeded from economic theory. In the case of these scenarios the microeconomic approach is more preferred.

**If the price of oil is higher than expected**, the following scenarios will be possible:

- o Fuel consumption will remain the same in terms of quantity and the expenses on fuel will increase, but if the budget limit remains the same, the expenditure on other benefits will decrease. In that case the increase of VAT accruing from fuel consumption and the decrease of VAT accruing from other benefits will be in balance and thus the **tax revenues of the state will not change** (scenario 1.1).
- o Fuel consumption will remain the same and the expenditure on fuel will increase, but the budget limit will be increased temporarily through savings or financing transactions. In that case the **accrual of VAT from fuel consumption will increase** (scenario 1.2).
- o The consumption of fuel will decrease and in the case of a constant budget restriction the costs on fuels and other benefits will remain the same. As a result of this the **revenue from excise duty will decrease** (scenario 1.3).

According to the first oil risk scenario the price of oil will remain at the level presumed in the basic scenario of Q4 2006 and through 2007-2010 the price of oil will be 10% higher than expected.



Relying on the average expected annual price of fuel (petrol) of EEK 12.50/litre, the impact on VAT and excise duty accruals will be found. Depending on the scenario, the tax revenues may rise or fall in 2007 by EEK 117.0 million or EEK 173.0 million, respectively.

**Table 17****Influence of first oil risk scenario on the general government tax revenues***(million EEK)*

	2006*		2007*		2008*	
	<i>base forecast</i>	<i>difference</i>	<i>base forecast</i>	<i>difference</i>	<i>base forecast</i>	<i>difference</i>
<b>Scenario 1.2</b>						
VAT	18 550,0	0,0	21 200,0	+117,0	23 485,0	+124,0
<b>Scenario 1.3</b>						
Fuel excise	3 725,0	0,0	3 962,0	-173,0	4 446,5	-189,0

*Source: Ministry of Finance.*

**If the price of oil is lower than expected**, the following scenarios will be possible:

- o Fuel consumption will remain the same in terms of quantity and the expenses on fuel will decrease. At the same time the expenditure on other benefits will be increased by the amount saved. In that case the decrease of VAT accruing from fuel consumption and the increase of VAT accruing from other benefits will be in balance and thus the **tax revenues of the state will not change** (scenario 2.1).
- o Fuel consumption will remain the same and the expenses on fuel will decrease. The resources saved on fuel expenditure will be spared. In that case **the accrual of VAT from fuel consumption will decrease** (scenario 2.2).
- o Upon increasing the consumption of fuel in the case of a constant budget limit the expenditure on fuel and other benefits will remain the same, as a result of which the **accrual excise duty from fuel will increase** (scenario 2.3).

According to the second oil risk scenario the price of oil will remain at the October level in Q4 2006 and through 2007-2010 the price of oil will be 5% lower than expected. Relying on the average expected annual price of fuel (petrol) of EEK 12.50/litre, the impact on VAT and excise duty accruals will be found. Depending on the scenario, the tax revenues may rise or fall in 2007 by EEK 58.0 million or EEK 85.0 million, respectively. In 2006 the impact will be considerably smaller, because the scenario only concerns the fourth quarter.

**Tabel 18****Influence of second oil risk scenario on the general government tax revenues***(million EEK)*

	2006*		2007*		2008*	
	<i>base forecast</i>	<i>difference</i>	<i>base forecast</i>	<i>difference</i>	<i>base forecast</i>	<i>difference</i>
<b>Scenario 2.2</b>						
VAT	18 550,0	-3,0	21 200,0	-58,0	23 485,0	-62,0
<b>Scenario 2.3</b>						
Fuel excise	3 725,0	+5,0	3 962,0	+85,0	4 446,5	+94,0

*Source: Ministry of Finance.*

**Overheating risk scenario**

Next, the impact of the overheating risk scenario on the taxes that account for the largest share in the budget, i.e. personal income tax, social tax and VAT, will be assessed. In the case of the first two the main factors are employment, wages and salaries, which, according to the scenario, will be higher than expected in 2006 and 2007 and lower than expected in the basic scenario in 2008. Owing to developments in the labour market that are more favourable than expected and bring about even higher consumption through an increase of the disposable income, the accrual of VAT in the opening years of the period under review will be higher than expected in the basic scenario. According to the risk scenario, as of 2008 consumption will be lower than expected in the basic scenario and this will reduce the growth of VAT accruals.

**Tabel 19****Influence of overheating risk scenario on the general government tax revenue***(million EEK)*

	2006	2007	2008	2009	2010
<b>Personal Income Tax</b>					
Base forecast	3 840,0	3 250,0	3 300,0	3 200,0	3 850,0
Risk scenario	3910,0	3520,0	3400,0	3220,0	3795,0
Difference	+70,0	+270,0	+100,0	+20,0	-55,0
<b>Social Tax</b>					
Base forecast	21 780,0	24 665,0	27 420,0	30 300,0	33 415,0
Risk scenario	21935,0	25650,0	27780,0	30345,0	33135,0
Difference	+155,0	+985,0	+360,0	+45,0	-280,0
<b>Value Added Tax</b>					
Base forecast	18 550,0	21 200,0	23 485,0	25 520,0	27 345,0
Risk scenario	18 880,0	22 105,0	23 890,0	25 650,0	27 305,0
Difference	+330,0	+905,0	+405,0	+130,0	-40,0

*Source: Ministry of Finance.*

Overheating also affects the expenditure side of the budget. This applies first and foremost to active labour market measures, unemployment benefits and subsistence benefits, which, according to the overheating scenario, should be lower than planned in 2007 and higher than planned through 2008-2010. This year employment has substantively increased as a result of the return to the labour market of the discouraged, so that the overall impact on the costs depends on whether the unemployed will remain among active participants in the labour market or join the ranks of the discouraged. The growth of unemployment by 0.8-1.4 percentage points or about a fifth through 2008-2010 in comparison with the basic scenario would probably increase the costs to the same extent. A growth of unemployment also affects the payments of the Unemployment Insurance Fund and thus reduces the surplus, but the financing of the increasing unemployment insurance costs will not be a problem, because the revenue exceeded the costs under the basic scenario and considerable reserves have been collected.

## 4.2. Comparison with the forecast of the previous convergence programme

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The economic growth expectations of Estonia's trading partners, incl. the European Union, are more optimistic in the autumn of 2006 than in the summer of 2005. Therefore the interest rate growth cycle has been stronger and the exchange rate of the euro with regard to the US dollar has been stronger than expected. After the interim developments the forecast of the oil prices has been lifted considerably and therefore the expected inflation of the euro zone has risen as well.

In September 2006 the Statistical Office published the data of the adjusted Gross Domestic Product as of 2000, which were amended in connection with the update of the methodology of national accounts pursuant to the system of the input-output tables. In addition, the Statistical Office revised the components and aggregate figures of the GDP of 2004 pursuant to the calculations made on the basis of annual reports. In connection with the specification of the basic data of the components of the GDP Estonia's economic growth proved to be stronger than before. According to the old methodology the average GDP growth in the last ten years was 6.6%, but now it is 7.2% and in the last five years the respective figures are 7.6% and 8.3%. As a result of the revision the real GDP rose to 8.1% in 2004 (during drawing up the forecast of the summer of 2005 the real growth of the economy in 2004 was 7.8%).

The growth of Estonia's GDP in 2005 proved to be much faster than expected last year, both due to stronger-than-expected growth of exports and domestic demand. After revision of the GDP time series this September it became evident that in 2005 the rate of growth of the domestic demand moderated due to the upward adjustment of the base of comparison by the Statistical Office. Nevertheless the growth rates of most of the components of the domestic demand proved to be stronger, while the growth of the final consumption expenditure of the general government remained slower than forecast.

In its summer 2005 forecast the Ministry of Finance expected real growth rates of 6.6% and 6.3% for 2006 and 2007, respectively. According to the autumn forecast of this year the Ministry of Finance expects economic growth of 11% in 2006, owing mainly to the strengthening of the domestic demand and private consumption. In 2007 we expect the economic growth to moderate to 8.3% due to moderation of the rate of growth of the components of domestic demand. In the medium term we expect an average economic growth of 7.6%, which is lower than the average growth in the last five years.

The forecast of the real growth of exports in Estonia for 2006–2007 is relatively similar to that of a year ago. The forecast of the growth of exports in the medium term is, however, more pessimistic than before in connection with the competitiveness problems and strong decrease of the price advantage, which emerged this year. The raise of the growth of **imports** forecasted for 2006–2007 arises from raising the domestic demand growth forecast. Over the medium term we expect a slower growth of imports in comparison with the summer 2005 forecast due to the lowering of the growth of exports forecast. The postponement of the slowdown of the growth of the domestic demand has increased the current account deficit more than expected. According to the latest estimates we expect the current account deficit to fall in 2008.

According to the summer 2005 forecast the Ministry of Finance expected **inflation** of 3.6% and 2.6% for 2005 and 2006, respectively. In reality the rise in prices in 2005 proved to be 0.5 percentage points higher and we raised the forecast for 2006 by 1.8 percentage points. The major adjustment of the consumer prices can be attributed to both supply and demand side factors. The developments of the oil prices in the world market did not meet the expectations and the price increases of various energy carriers were also underestimated. Signs of demand-side inflation started

emerging in Q4 2005 and strengthened over 2006. At the time of drawing up the previous forecast the expectations regarding the food prices were optimistic, but in reality the world market prices of food rose. Additional impact arose from the complicated weather conditions in the spring and summer of 2006, which contributed to the steep rise in food prices.

As for the number of **the employed** it was expected in the summer 2005 forecast that the number of the employed would grow 0.6% in 2005 and 2006. In reality, the growth in the number of the employed proved to be 2% in 2005, reaching the level of 607.4 thousand employed persons. The 2005 forecast was also too modest regarding the growth in the number of the employed in 2006. As of the first half of 2006 the number of the employed has grown 6.7%. For the entire year we expect growth of 6.3% in the number of the employed, i.e. an increase by 38,000 people.

The summer 2005 forecast was also pessimistic with regard to the speed of the decrease of the **rate of unemployment**. A year ago we expected unemployment to decrease to 9.3% in 2005, but in reality the rate of unemployment fell to 7.9%. In 2006 the rate of unemployment fell even more, reaching the level of 6.3% as of the first half of the year. According to the latest forecast we expect unemployment to fall to 5.7% by the end of 2006.

According to the summer 2005 forecast, the Ministry of Finance expected the **real gross wages and salaries** to rise despite of the growth of the inflation rate to 4.1% and the gross wages and salaries rose indeed. By 2006 the rate of inflation and the real growth of gross wages and salaries were expected to moderate. However, in reality the situation has been the opposite. According to the existing forecast, the rate of inflation will rise to 4.4% by 2006 and the real growth of wages and salaries will accelerate to 10.3%. We expect a relatively strong real growth in wages and salaries in 2007 as well (7.9%). The lack of qualified labour and the opening of the highly paid labour markets of European states after accession to the EU, has exerted pressure on the strong growth of wages and salaries in Estonia.

The difference between the **government debt** forecast in the Convergence Programme 2005 and the current forecast arises primarily from the much stronger growth of the GDP in comparison with the expected growth and from adjustment of the GDP time series by the Statistical Office this year as of the year 2000. Owing to the good financial status in 2006 the need of local authorities for the use of additional credit resources has decreased. Early repayment of the government debt has not been planned and the debt will be repaid pursuant to the agreed repayment schedule.

The **general government balance** forecast has increased in comparison with the Convergence Programme 2005 – a surplus, not balance is forecasted in the medium term. Owing to favourable economic developments revenues have increased in 2006 and on the basis of the data of three quarters it can be presumed that the Unemployment Insurance Fund and the central government will incur fewer costs. Therefore, the forecast of the surplus of 2006 has increased as well. The budget of 2007 was made with a surplus for the first time. It serves as the basis for the surplus of the general government. A thorough cost forecast was made in the framework of the State Budget Strategy 2007–2010 adopted in May 2006. According to the expenditure agreed in the strategy and the updated revenue forecast, a surplus has been forecasted for 2008–2010.

**Table 20****Comparison with the Forecast of the Previous Convergence Programme**

	2005	2006*	2007*	2008*	2009*	2010*
<b>Real GDP growth (%)</b>						
Previous update	6.5	6.6	6.3	6.3	6.3	-
Present update	10.5	11.0	8.3	7.7	7.6	7.5
Difference	4.0	4.4	2.0	1.4	1.3	-
<b>General government budget balance (% of GDP)</b>						
Previous update	2.6	0.1	0.0	0.0	0.0	-
Present update	2.3	2.6	1.2	1.3	1.6	1.5
Difference	0.3	2.5	1.2	1.3	1.6	-
<b>General government debt (% of GDP)</b>						
Previous update	4.6	4.4	3.3	3.0	2.8	-
Present update	4.5	3.7	2.6	2.3	2.1	1.9
Difference	0.1	0.7	0.7	0.7	0.7	-
<b>Consumer price index (%)</b>						
Previous update	3.6	2.6	2.6	2.8	2.8	-
Present update	4.1	4.4	4.3	4.4	3.5	3.2
Difference	0.5	1.8	1.7	1.6	0.7	-
<b>Current account (% of GDP)</b>						
Previous update	-10.4	-9.6	-8.6	-7.4	-6.0	-
Present update	-10.5	-12.4	-13.4	-11.8	-10.7	-9.0
Difference	-0.1	-2.9	-4.8	-4.3	-4.7	-

Source: Ministry of Finance of Estonia.

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## **5. IMPROVEMENT OF THE QUALITY OF PUBLIC FINANCES**

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### **5.1. General government budget forecast until 2010**

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In 2005 the general government ended the year in surplus for the fourth year in a row – the surplus was **2.3% of GDP**. The surplus can be attributed primarily to lower expenditure as well as higher-than-expected tax revenues. One of the key factors of the improvement of the fiscal stance is economic developments favouring accrual of revenues, while administration of revenue collection has improved as well. The goal in the medium term is to pursue fulfilment of the main aim of the Stability and Growth Pact – a general government budget which is in balance or in surplus.

Since the economic developments have been better than expected and thus the accrual of expenses has been better than planned and it is obvious that the expenditure of the National Unemployment Insurance Fund and the central government will be smaller than planned for the year, the **general government surplus in 2006 will amount to EEK 5.3 billion (2.6% of GDP)** according to the estimates of the Ministry of Finance. The surplus is in line with the recommendations of the IMF and the European Commission to save in the economic growth phase.

The surplus of local government in 2006 can be attributed to better-than-expected accrual of tax revenues and increased sale of assets. In the coming years the deficit of local authorities will be approx. 0.1% of the GDP.

According to forecasts the National Health Insurance Fund will be in balance in 2006 and over the medium term. The surplus of the National Unemployment Insurance Fund will be EEK 398.3 million. The reason for the surplus lies in good tax collection arising from a robust growth in wages and salaries as well as lower unemployment and the shorter average period of receipt of benefits.

**Table 21****General Government budget balance 2005–2010**

	2005	2005	2006*	2007*	2008*	2009*	2010*
	Level, mln EEK	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending by sub-sector</b>							
<b>1. General government</b>	<b>4 060,8</b>	<b>2,3</b>	<b>2,6</b>	<b>1,2</b>	<b>1,3</b>	<b>1,6</b>	<b>1,5</b>
2. Central government	3 257,8	1,9	2,3	1,0	1,2	1,5	1,4
4. Local government	-48,7	0,0	0,1	0,0	-0,1	-0,1	-0,1
5. Social security	851,7	0,5	0,2	0,2	0,2	0,2	0,2
<b>General government</b>							
6. Total revenue	61 442,7	35,5	38,3	37,8	36,9	36,2	35,8
7. Total expenditure	57 381,9	33,2	35,6	36,5	35,5	34,6	34,3
8. Net lending/borrowing	4 060,8	2,3	2,6	1,2	1,3	1,6	1,5
9. Interest expenditure (incl. FISIM)	314,1	0,2	0,2	0,1	0,1	0,1	0,1
10. Primary balance	4 374,9	2,5	2,8	1,4	1,4	1,7	1,6
<b>Selected components of revenue</b>							
11. Total taxes	35 033,6	20,2	21,0	20,3	19,8	19,3	18,4
11a. Taxes on production and imports	22 801,2	13,2	13,6	13,4	13,1	12,8	12,4
11b. Current taxes on income, wealth etc	12 232,4	7,1	7,4	6,9	6,7	6,5	6,0
11c. Capital taxes	0,0	0,0	0,0	0,0	0,0	0,0	0,0
12. Social contributions	18 114,1	10,5	10,3	10,2	10,1	10,0	9,9
13. Property income	1 734,9	1,0	1,1	1,1	0,9	0,8	0,7
14. Other	6 560,1	3,8	5,9	6,2	6,1	6,1	6,8
15. Total revenue	61 442,7	35,5	38,3	37,8	36,9	36,2	35,8
Tax burden	54 463,2	31,5	32,1	31,4	30,7	30,2	29,2
<b>Selected components of expenditure</b>							
16. Collective consumption	13 692,0	7,9	8,3	8,3	8,2	8,0	7,9
17. Total social transfers	32 247,9	18,6	19,1	19,3	18,1	17,3	16,7
17a. Social transfers in kind	16 406,3	9,5	9,7	9,8	9,2	8,8	8,5
17b. Social transfers other than in kind	15 841,6	9,2	9,4	9,5	8,9	8,5	8,2
18. Interest expenditure (incl. FISIM)	314,1	0,2	0,2	0,1	0,1	0,1	0,1
19. Subsidies	1 637,4	0,9	1,0	1,0	1,0	1,0	0,9
20. Gross fixed capital formation	5 523,0	3,2	2,8	3,8	4,0	3,8	3,6
21. Other	3 967,5	2,3	3,4	4,0	4,1	4,4	5,1
22. Total expenditure	57 381,9	33,2	35,6	36,5	35,5	34,6	34,3
Compensation of employees	16 224,9	9,4	9,2	9,2	9,1	9,0	9,0

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

## 5.2. General government revenue

### 5.2.1. General government revenue structure

Through 2000-2005 the general government revenue accounted for 36.1% of the GDP on average, while in 2005 the ratio was 35.5%. The division of revenue between tax and non-tax revenue through 2000-2005 has been on average as follows: 86.1% tax revenue and 13.9% non-tax revenue. Indirect taxes, including, according to ESA95, value added tax, excise duties, customs duties, gambling tax, land tax, heavy vehicle tax, most of local taxes and some fees account for the largest share (37.1% in 2005) of the general government revenue. The share of the indirect taxes increased in 2005 in comparison with 2004 by 1% of the GDP, to 13.2% of the GDP. In the coming years the share of the indirect taxes should increase further. Social insurance payments, which include social tax and unemployment insurance payments, accounted for 29.5% of the general government revenue (10.5% of the GDP) and direct taxes accounted for 19.9% of the general government revenue (7.1% of the GDP) in 2005. Accrual of personal income tax accounts for the largest share of the latter, followed by corporate tax. As for local taxes, this category comprises motor vehicle, boat and animal taxes. In addition to tax revenue various non-tax revenues also accrue to the general government budget: state fees, revenue from economic activities, state revenue from the sale of state assets, revenue from assets, grants and other revenue. In 2005 non-tax revenue accounted for 13.5% of the general government revenue (4.8% of the GDP).

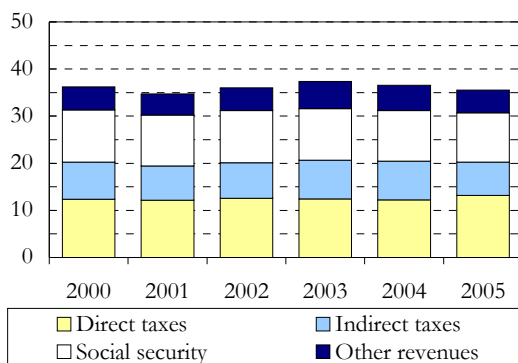
Through 2000-2004 the general government revenue accounted for 36.2% of the GDP on average in Estonia. The EU25 average in the same period exceeded the Estonian level by 8.8 percentage points, amounting to 44.9% of the GDP. No remarkable changes have taken place in the period under review with regard to the structure of the Estonian general government revenue – the share of direct taxes and other revenue has increased by 0.4 percentage points of the GDP, while the share of indirect taxes and social insurance payments has decreased by 0.2 percentage points and 0.3 percentage points of the GDP. The share of social insurance payments has remained unchanged in the structure of the revenue of the EU25, while the share of other revenue has decreased: direct taxes: -1.3 percentage points of the GDP; indirect taxes: -0.1 percentage points of the GDP; other revenue: -0.1 percentage points of the GDP.

**Figure 11**

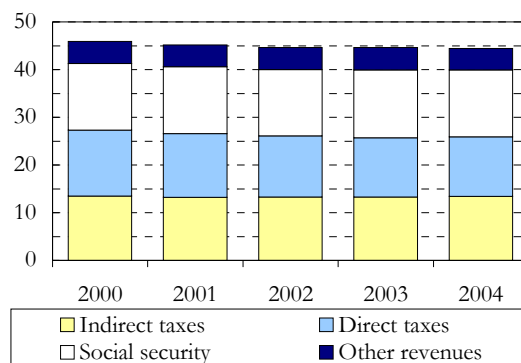
### General Government Revenues and their Structure

(% of GDP)

#### A. General government revenues in Estonia



#### B. General government revenues in EU25



Sources: Eurostat, Statistical Office of Estonia.



### **5.2.2. Future developments in tax policy and main changes in revenue policies affecting the budget for 2007**

Our current tax system has ensured economic growth and allowed the state to function successfully. Thus there is no direct need to reform it in principle. Nevertheless the Government has established the goal of shifting the tax burden partially from taxation of income to taxation of consumption, use of natural resources and pollution of the environment. At the same time it is tried to keep the system simple and transparent with as few exceptions and differences as possible.

In 2006 the total impact of tax amendments on the state budget amounts to -0.38% of GDP. Reduction of the income tax burden has an impact reducing the tax burden, while an increase of the minimum social tax obligation will increase the tax burden in 2006. In 2007 the impact of tax amendments on the state budget amounts to -0.36% of GDP, whereby similarly to this year the reduction of the tax burden has the strongest impact. However, it is partially balanced by an increase of value added tax on certain medical equipment and distant heating as well as further increase of the minimum social tax obligation.

#### **Reduction of taxation of labour force**

One of the goals of the Government is to promote job creation through reduction of the tax burden. To that end the share of income exempt from tax has been increased annually since 2004 and as from 2005 the income tax rate has been reduced annually. In 2003 the amount exempt from income tax was EEK 1,000 a month, but in 2006 it is already EEK 2,000 a month. In the long term the goal is to equalise the income exempt from tax with the minimum wages and salaries. Increasing the amount of income exempt from tax helps to reduce the tax burden of low-income people which has so far been higher in Estonia than the average of the European Union. The income tax rate has been reduced from 26% in 2004 to 22% in 2007. The income tax rate will be annually reduced until 2009 by 1%. By 2009 the income tax rate will be 20%. Considering global developments and the former positive experience, it is planned to continue taxing the income of natural as well as legal persons on the basis of a proportional income tax rate.

#### **Higher taxation of consumption and use of the environment**

On 7 July 2005 the Government approved the bases of the ecological tax reform. By reforming the tax system the Government wants to value natural resources and the environment. According to the bases of the green tax reform, specific measures for attainment of the objectives of the reform will be developed, whereby the overall tax burden will not be increased. In December 2005 the Environmental Fees Act was adopted as a part of the ecological tax reform.

The main taxes and fees which are considered environmental taxes exist in Estonia. These include fuel excise duty, packaging excise duty, heavy goods vehicle tax, pollution charges and fees for use of natural resources. In the framework of the green tax reform the existing taxes and fees will be increased and new taxes and fees will be imposed. As for possible objects of the environmental tax automobiles are not taxed in Estonia. Thus, in the longer term the importance of transportation taxes should increase.

The development of uniform bases for the excise duty policy belongs within the competence of the European Union, but certain choices have been left to the Member States. In addition to the fiscal goal, excise duties are used to influence people to act more economically, reduce excessive consumption of alcohol and limit smoking. Considering the rate of growth of average wages and salaries and the fact that in recent years the price of alcohol has risen less than the prices of other consumer goods, raising the rate of the alcohol excise duty is justified. The alcohol excise duty will be released under the current act by 10% as of 1 January 2008. In the longer term, in order to

ensure the desired impact of the alcohol price policy on the public health, the level of alcohol excise duty must be changed depending on the inflation and changes in the purchase power of the population.

Considering the expenses caused by smoking to society and human health and proceeding from the obligation assumed upon accession to the European Union to reach the minimum rate of the European Union not later than by 2010, the excise duty on cigarettes and smoking tobacco has been raised gradually on July 1 each year. According to the current act, the next rise of the excise duty on cigarettes and smoking tobacco will take place on January 1, 2008.

The goal of taxation of energy products is, in addition to receiving budget revenue, to influence people to consume more economically. Therefore energy products produced from non-renewable natural resources are subject to an excise duty in order to increase the effectiveness of energy use and to promote the development of renewable energy. Since the excise duty is bound to the quantitative goods, the share of the excise duty in fuel prices will be smaller each year given the overall growth of the economy and purchase power.

Upon taxation of energy products and electricity used for production of thermal energy, it must be proceeded primarily from the transitional periods for achievement of the minimum rates established in the Energy Taxation Directive and from the principles provided for in the long-term Fuel and Energy Sector Development Plan. The rise in the motor fuel excise duty to the level of EU's minimum rates has been planned for 2008-2010.

### *Reduction of tax exceptions*

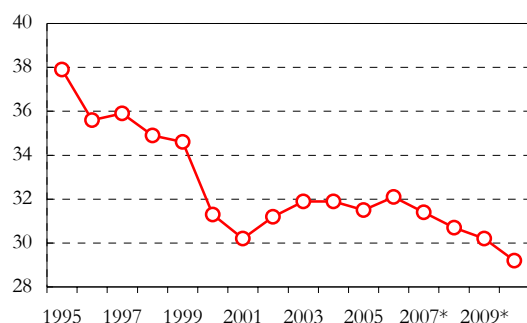
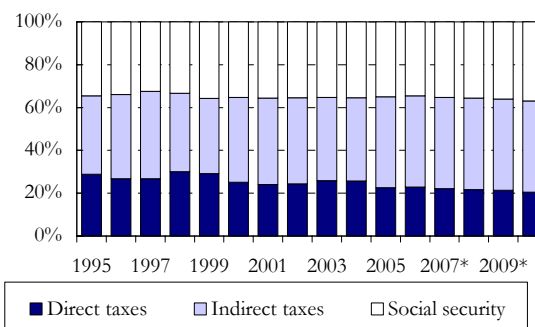
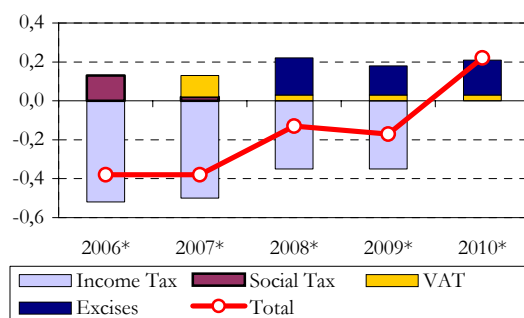
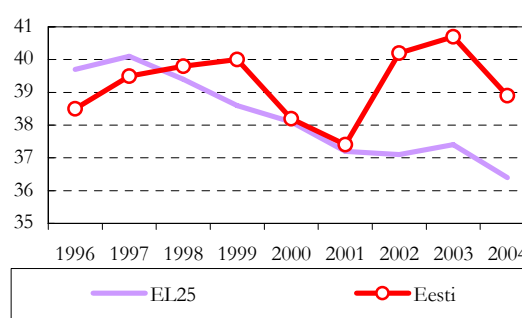
It is planned to critically review and abolish tax incentives which have been alienated from the initial goal and are unjustified. In the case of each tax incentives it will be analysed whether it is proportional to the achieved goal, whether it meets the expectations and needs of society and whether it is the most expedient to achieve this goal through the tax incentive. If necessary, the incentive will be made for a specific period of time, which allows for analysing the effectiveness of the incentive upon achievement of the goal and deciding on the basis of the analysis whether the incentive should be extended.

One option of reducing the tax incentives is, according to the plan, to reduce the limit of tax deductions stipulated in the Income Tax Act from the former EEK 50,000 to a lower level. This would mean expansion of the tax base and thus an additional source of revenue for covering the rise in income exempt from tax. At present, a legislative amendment reducing the limit of deductions to EEK 30,000 is being drafted.

Estonia's tax policy choices regarding value added tax are very closely related to developments in the European Union. The goal of the European Union is to move towards reduction of the administrative burden through harmonisation and simplification of the value added tax system. In comparison with other Member States there are few value added tax exceptions in Estonia, which allows for keeping the standard tax rate relatively low (18%). No reduced value added tax rate will be established for any additional goods or services through 2007-2010 and abolition of some existing exceptions will be considered.

**Figure 12**
**Development of Tax Burden in Estonia**

(% of GDP)

**A. Tax Burden**

**B. Tax Revenues (%)**

**C. Effect of tax amendments<sup>19</sup>**

**D. Tax burden of low-wage workers**


Sources: Ministry of Finance, Eurostat

**Table 22**
**Main Tax Amendments in 2007 and their Effects**

(% of GDP)

	Effect 2007	Enactment
<b>Reduction of labour taxation:</b>		
Reduction of income tax rate from 23% to 22%	-0,3	1 January 2007
Basic allowance starting from the second child (previously starting from the third child)	-0,2	1 January 2006
<b>Higher taxation of consumption and environment exploitation, reducing differences in taxation:</b>		
Some medical equipment is taxed at 18% instead of former 5%	+0,03	1 January 2007
Heat sold to individuals, housing associations, apartment associations, churches, congregations, and agencies or organizations financed from the state or local municipality budget, and peat, fuel briquettes, coal and firewood sold to individuals are taxed at 18% instead of former 5%	+0,07	1 July 2007
<b>Other:</b>		
Increase of the basic sum of minimal duty of social tax from 1,400 EEK to 1,500 EEK	+0,02	1 January 2007
Fuel excise exemption for fishermen (applies for diesel fuel for specific purposes and gas oil).	-0,002	1 January 2007

Source: Ministry of Finance.

<sup>19</sup> The figure shows the influence of tax amendment only on the year it comes into force (becomes effective).

### **5.2.3. Simplification and improvement of tax administration, effectiveness of tax collection**

In 2006 the growth of the tax revenue of the general government will exceed the economic growth similarly to 2002 and 2003. It should be stressed that accrual of value added tax has been very good. The growth of accrual of value added tax has been higher than the growth of final consumption in 2002, 2003 and 2005 and according to estimates the situation will be the same this year. The growth of tax revenue which cannot fully be explained by the effects of macroeconomics or legislative amendments can be associated with the good work of the tax authority upon tax collection.

#### **Improvement of tax behaviour through simplification of tax administration**

One of the goals of the Estonian tax policy is to make the tax collection process as simple and as transparent as possible. One of the priorities is development of the e-tax board which was launched in 2000. In 2004 58.3% of the tax returns of natural persons, 65.8% of social tax and income tax returns, and 74.8% of value added tax returns were submitted electronically, but in 2005 the respective figures were already 73.3%, 76.9% and 81.7% and in Q3 2006 80.6%, 82.2% and 86.4%, respectively. Electronic declaration allows for considerably saving costs for the state as well as entrepreneurs. It is also an operative instrument for analysing tax collection and quick detection of possible fraud.

As of 2005 the Tax and Customs Board carries out e-inspections in the course of which electronic data received from companies is analysed using the respective software. On the one hand, this reduces the time of carrying out tax audits. On the other hand, it allows for analysing a greater amount of data. This method is used mainly in larger corporations. In 2005 22 e-inspections were launched and in 2006 it is planned to carry out 50 e-inspections.

#### **Improvement of tax collection by way of reduction of the share of concealed pay**

Concealed pay (envelope salaries) can be associated with employers' desire to get a better competitive position by evading taxes, i.e. saving costs. According to the Estonian Institute for Economic Research 12% of salaried employees received envelope salary in 2005 on average. In comparison with 1999 the share of recipients of envelope salary has decreased by 7%.

The presumable reduction of envelope salaries has the following reasons:

- o Free movement of labour which forces Estonian entrepreneurs to pay wages and salaries to employees legally in order to prevent a situation where qualified labour moves abroad (especially in the construction sector).
- o The rules of private borrowing (housing loans) and establishment of the parental benefit, which motivate salaried employees to legally declare their full salary.
- o Coordinated activities of the Tax and Customs Board upon prevention of payment of envelope salaries. In 2005 a work group was established between different state agencies for the purpose of combating envelope salaries.
- o In the nine months of 2006 the tax authority has carried out 74 envelope salary raids and completed the audits of 96 instances of payment of envelope salary as a result of which corrected declarations were submitted and additional taxes were determined in the total amount of EEK 9.4 million. In 3/4 of the instances the envelope salary raids ended with correction of the tax amount. Usually, envelope tax raids have been carried out in companies operating in the service sector. In addition, companies engaged in construction, forestry, fishery and labour rental have been audited.
- o In 9 months of 2006 14 joint raids have been carried out. Cooperation between tax and customs centres and various departments/divisions upon carrying out joint raids has increased.

- In addition, there have been joint raids in cooperation with the police, Labour Inspectorate, Citizenship and Migration Board and the Border Guard.
- o In its efforts against envelope salaries the Tax and Customs Board started practicing a new approach in Q2 2006, namely pre-announced visits. The Board started to visit taxable persons to whom notices regarding their pay level had been sent in 2005. The goal is to receive feedback from the taxable persons who did not provide the tax authority with any feedback or change their tax figures to be more competitive. The goal of the visit is to talk to the taxable persons and identify whether the company has any objective reasons for operation in the business at such a level of wages and salaries. It is not simply an audit with a service approach to the taxable person. In 9 months of 2006 244 taxable persons have been visited. The feedback from taxpayers has been mostly positive and most of the companies have promised to raise or have already raised the level of the wages or salaries paid to their employees. In certain instances the payment of low wages and salaries by companies has been justified, which precludes further interest of the tax authority in these companies. A more detailed analysis of changes in tax behaviour in the given companies will be made in the fourth quarter.

**Improvement of tax collection owing to reduction of the share of the illicit market of goods subject to excise duty**

According to the Estonian Institute for Economic Research, the share of the illicit alcohol market decreased through 1999-2004 from 44% to 22.5%. In 2005 the share of the illicit alcohol market remained at the same level as in 2004 in spite of a rise of the alcohol excise duty in the beginning of 2005. The fact that in spite of the rise in prices the share of the illicit market has not increased shows that the work of the Tax and Customs Board and the police in combating the illicit alcohol market has been effective. In addition to continued joint raids of the Tax and Customs Board strong alcohol has been revenue-stamped since 1 July 2006 in order to reduce the share of illicit alcohol. The alcohol revenue stamp allows for easy differentiation between legal and illegal alcohol and the purpose of the revenue stamps is to prevent realisation of strong alcohol on which no excise duty has been paid in the legal sales network. In order to simplify the activities relating to alcohol revenue stamps an electronic database for management of revenue stamps will be launched as of June 1. From the point of view of entrepreneurs, this will simplify and speed up all operations relating to revenue stamps and, on the other hand, allow officials to monitor the movement of revenue stamps and payment of the excise duty on revenue-stamped alcohol.

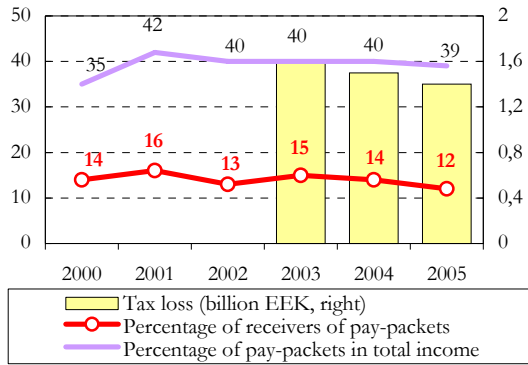
According to the Estonian Institute for Economic Research, the share of illegal cigarettes decreased through 1999-2004 in spite of various rises in the excise duty from 33% to 23.5%. However, in 2005 it increased to 27.5%. In a situation where the prices of cigarettes rise annually due to rises in the excise duty, the increase of the share of the illicit market is expected and in the coming years the reduction of the illicit market may prove to be more difficult in connection with the obligation to achieve by 2010 the minimum excise duty rate established by the European Union. To control the market of illicit cigarettes the Tax and Customs Board has acquired two mobile transparency devices in cooperation with the Border Guard, which allow for more effective border control owing to their mobile nature. Improvement of inspection is aimed first and foremost at the eastern border, but the devices are also used for operations on other borders. The method of operation-based mobile units has been used more effectively for combating and preventing violations crossing the southern border.

In the fuel market the problem is the fuel illicitly imported from Russia and the use of fiscally marked fuel for the wrong purpose. In connection therewith it is planned to reduce the difference between the ordinary fuel and fiscally marked fuel, in order to make the use of the fiscally marked fuel less attractive. The first major step towards that end has already been taken – as of 1 January 2005 the excise duty rate of fiscally marked fuel was raised and in comparison with 2004 its consumption decreased by 13% (the quantity released for free circulation) in 2005 and in the 9 months of 2006 by another 3.2%. The next rise in the excise duty on fiscally marked fuel will take place on 1 January 2007.

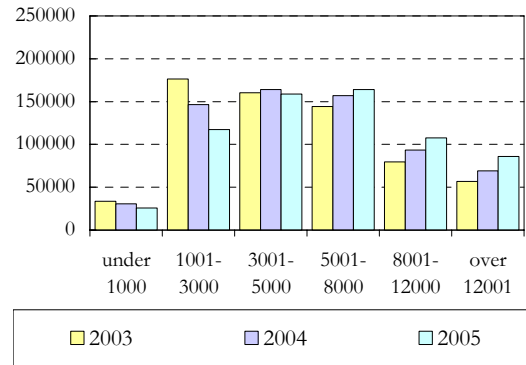
**Figure 13**

**Developments of Tax Administration in Estonia**

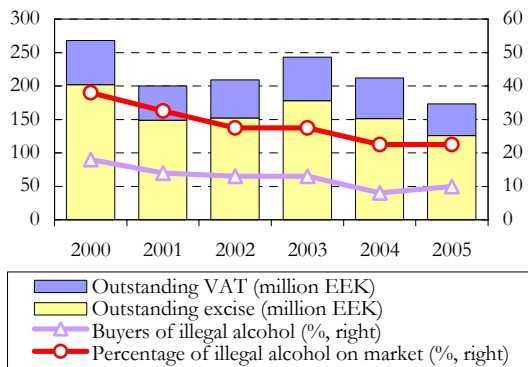
**A. Percentage of pay-packets in economy**



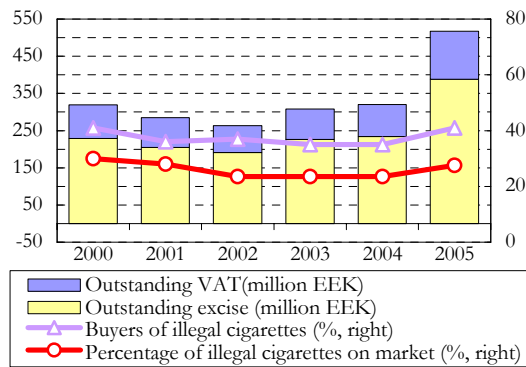
**B. Different wage ranges of labour force (EEK)**



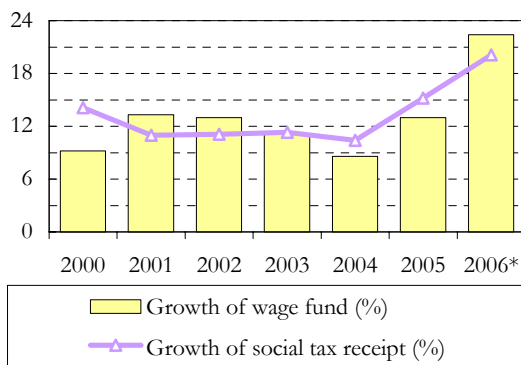
**C. Percentage of illegal alcohol**



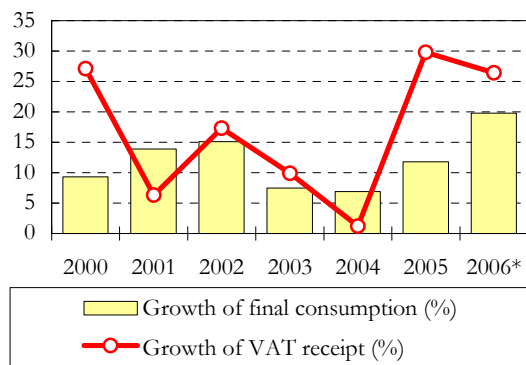
**D. Percentage of illegal cigarettes**



**E. Social tax receipt compared to wage fund**



**F. VAT receipt compared to final consumption**



Sources: Estonian Institute of Economic Research. Conjuncture, Tax and Customs Board, Ministry of Finance.



## 5.3. General government expenditure

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### 5.3.1. General government expenditure structure

Through 2000-2005 the expenses of the general government expenditure accounted for 35% of the GDP. In 2000 and 2001 the expenditure of the general government exceeded revenue, but as of 2002 the difference between the revenue and expenditure of the general government has been constantly positive, increasing year by year. As of 2004 the expenditure of the general government has decreased, amounting to 33.2% of the GDP in 2005.

As of 2000 the final consumption expenditure of the general government has constantly exceeded 50% of the expenditure of the general government, amounting to 18.7% of the GDP on average through 2000-2005. The final consumption expenditure of the general government includes public consumption and individual consumption expenditure. In the case of the goods and services offered by the general government it is differentiated between individual and social goods and services proceeding from the classifications of the functions of the Government (COFOG). Public consumption means services offered concurrently to all members of society or to the members of a part of society. They include, for instance, expenditure on environmental protection and maintenance of the health care system of the public sector. For example, expenditure on education and health care is considered individual. In the case of the general government the individual consumption expenditure equals social transfers in kind. Through 2000-2005 individual consumption expenses have constantly exceeded expenditure on public goods and services, amounting on average to 10% and 8.6% of the GDP, respectively.

Social benefits account for the second largest share of the expenditure of the general government. Among social expenses the largest expenditure classes are pension expenditure and treatment, medical procedures, sickness benefits and medicinal product compensation expenditure incurred by the Health Insurance Fund. The expenditure of the general government for payment of social benefits has been relatively stable through 2000-2005. The difference between the minimum and maximum levels is 0.7% of the GDP (8.9% of the GDP in 2002 and 9.6% of the GDP in 2000 and 2004). In 2005 social benefits accounted for 9.2% of the GDP.

2.9% of the general government expenditure, i.e. 0.9% of the GDP was allocated for payment of subsidies in 2005. Subsidies are unilateral payments which producers receive from the general government or institutions of the European Union. The goal of the payments is to influence the level of production, prices or compensate the costs relating to production.

The interest expenditure accounts for the smallest share – in 2005 these amounted to 0.5% of all the general government expenditure, i.e. 0.2% of the GDP. The smallness of the interest expenditure arises from the small debt of Estonia.

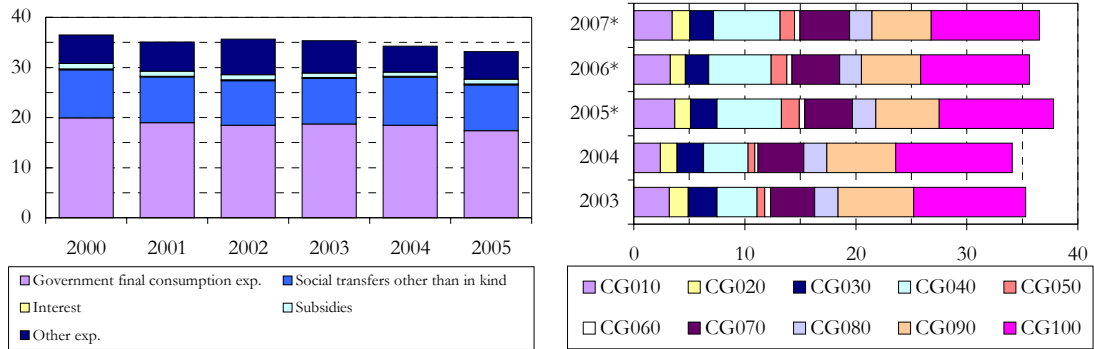
Looking at the expenses by economic activity, the share of expenditure on social protection is always the largest, amounting to 9.1% of the GDP in 2005 according to the Ministry of Finance. In most of the areas the percentage of expenditure of the GDP has been more or less at the same level. The expenditure in the field of the economy has grown considerably and reduction can be noticed regarding education.

**Figure 14**

**General Government Expenditure and its Structure**

(% of GDP)

**A. Expenditure by economic content in Estonia B. Expenditure by function in Estonia <sup>20</sup>**



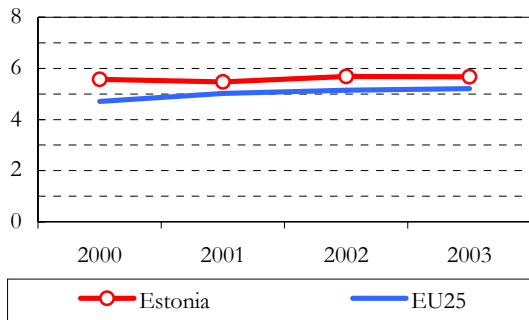
Sources: Eurostat, Ministry of Finance.

**Figure 15**

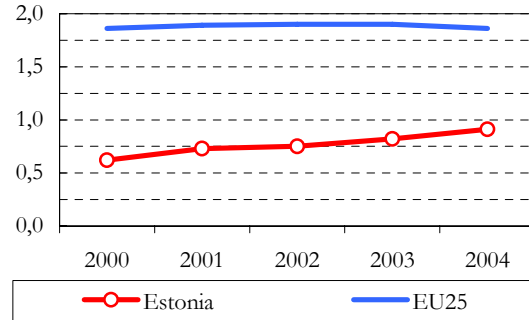
**Government investments into physical and human capital**

(% of GDP)

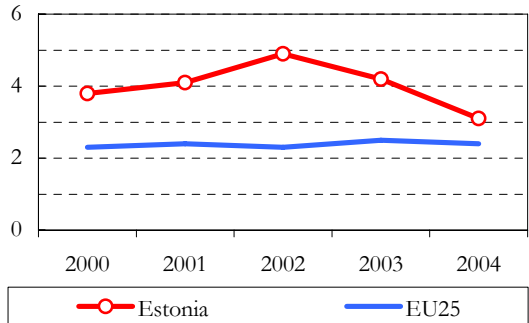
**A. Public expenditure on education**



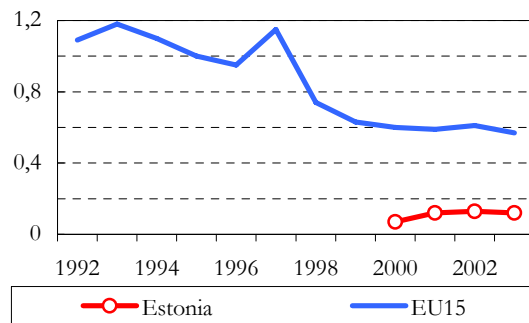
**B. R&D expenditure**



**C. General gov. gross fixed capital formation**



**D. Total state aid**



Source: Eurostat.

<sup>20</sup> CG010 – general public services; CG020 – defence; CG030 – public order and safety; CG040 – economic affairs; CG050 – environmental protection; CG060 – housing and community amenities; CG070 – health; CG080 – recreation, culture and religion; CG090 – education; CG100 – social protection.



**Table 23****General government expenditures by function (COFOG)***(% of GDP)*

	COFOG code	2003	2004	2005	2006*	2007*
1. General public services	1	3,2	2,4	3,2	3,3	3,5
2. Defence	2	1,7	1,5	1,2	1,4	1,6
3. Public order and safety	3	2,6	2,4	2,1	2,1	2,1
4. Economic affairs	4	3,6	4,0	5,1	5,6	6,0
5. Environmental protection	5	0,7	0,6	1,4	1,4	1,3
6. Housing and community amenities	6	0,5	0,3	0,4	0,5	0,5
7. Health	7	4,0	4,1	3,8	4,3	4,5
8. Recreation, culture and religion	8	2,1	2,1	1,9	2,0	2,0
9. Education	9	6,8	6,2	5,0	5,3	5,4
10. Social protection	10	10,1	10,5	9,1	9,8	9,7
<b>11. Total expenditure</b>	<b>TE</b>	<b>35,3</b>	<b>34,2</b>	<b>33,2</b>	<b>35,6</b>	<b>36,5</b>

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

### 5.3.2. Major changes in expenditure policies affecting the state budget of 2007

In 2007 the expenditure of the state budget will increase 21.4% in comparison with 2006, amounting to 32.4% of the GDP, whereby the growth rates of various economic activities vary from the 6.5% growth of environmental protection expenditure to 37.3% growth of national defence expenditure.

#### Social protection

The share in the budget amounts to 30.4% and the growth in 2007 is 17.4% (EEK 3.3 billion). The growth of the expenditure in this field arises primarily from the following activities:

- Pensions (growth of expenditure by EEK 2.11 billion, i.e. 17.9%). As of 1 April 2007 the average pension will rise to EEK 3,421.
- Parental benefits (growth of expenditure by EEK 61.4 million, i.e. 7.5%). The rise can be attributed to the growth of the rate of the parental benefit and average wages and salaries.
- Family benefits (growth of expenditure by EEK 87.2 million, i.e. 5.1%). Support to children growing in foster and guardianship families will increase by EEK 600 a month and the child allowance as of the second child will rise to EEK 900 a month and the circle of beneficiaries will increase by children who study in a general education school in the evening study or distance learning form and are not 18 years of age yet.
- Rehabilitation expenditure of children and adults with special needs (growth of expenditure by EEK 45.0 million or 96.5%). The growth has been planned pursuant to the insufficient financing of the service and service queues. The children rehabilitation service will grow the most (EEK 34 million), because it will give the best results, reducing the need for the service in the future.
- Care of children and people with special psychological needs (growth of EEK 73.9 million or 26.3%). The growth of expenditure is caused by the need to increase the wages and salaries of social care employees and hire new employees, because the respective figures are far short of the standards and the quality of social care will suffer.

#### Economic affairs

The share of the economic activity in the budget is 16.3%. The economic activity will grow 27.9% in 2007 (EEK 2.6 billion). The highest growth will be recorded in the following activities:

- Public transport (passenger travel) subsidies, growth of EEK 105.5 million in 2006 in comparison with 2006, i.e. 19.9%.
- Road maintenance, growth of EEK 213.8 in comparison with 2006, i.e. 8.1%;

- Allocations to Enterprise Estonia in the amount of EEK 123.6 million for supporting business, growth of 16.2%.

### **Health**

The share of the economic activity in the budget is some of the most average ones with its 14.3%. In 2007 the health care activities will grow 22.4% in comparison with the previous year (EEK 1.9% billion). The key activities are:

- the state health insurance by the Estonian Health Insurance Fund and the costs thereof were increased by 22% in comparison with the budget for 2006.
- Emergency medical care the growth of the costs of which is 26%.
- Allocations from ERDF for development of the hospital network (external assets) the expenditure of which will grow 99.2%.

### **Education**

The share of education in the state budget for 2007 is 11.3% and the growth in 2007 in comparison with 2006 is 17.9% (EEK 1.3 billion). Financing vocational education is still a priority, but each year the Government has increased the share of research and development. Proceeding from the draft budget for 2007 the growth of R&D expenditure in comparison with 2006 is 29%. A significant portion of the growth of education expenditure comprises the expenditure of the wages and salaries of teachers, which increase by no less than 15% in comparison with 2006. In 2007 all basic school students will receive workbooks free of charge. EEK 57.2 million has been allocated in the budget to that end.

### **Public order and safety**

The share of the public order and security expenditure is 6.8% and a falling trend of the importance thereof can be noticed: 6.8% in 2007. In 2007 the expenditure in the area will increase 18.4% in comparison with the previous year (EEK 787.0 million). The main growth in this area includes the following:

- wages and salaries of police officers – EEK 220 million;
- wages and salaries of rescue workers – EEK 78 million;
- wages and salaries of border guards – EEK 38 million;
- expenditure relating to issuing biometric travel documents – EEK 107 million;
- expenditure relating to development of the operative communications network – EEK 23.5 million;
- wages and salaries of prison officers – EEK 76 million;
- wages and salaries of judges and court officers – EEK 57.8 million;
- development of registers and information systems – EEK 71.5 million.

### **Defence**

The importance of the area in the budget for 2007 is 5.1%. The growth of national defence expenditure in 2007 in comparison with 2006 is 37.7% (EEK 1.0 billion). The following will increase the most among the national defence expenditure:

- costs of defence equipment and material – EEK 348.6 million;
- personnel expenditure of the Defence Forces – EEK 233.9 million.

### **Recreation, culture and religion**

The importance of leisure, culture and religion in the budget is 3.6% and the growth in 2007 is 24.4% (EEK 518.7 million). The growth of the expenditure in this field arises primarily from the following activities:

- Growth of the wages and salaries of culture employees, which aims at ensuring higher growth of the wages and salaries of culture employees than the average wages and salaries in Estonia. In 2007 the wages and salaries of culture employees will increase by approx. 15%, totalling EEK 722.7 million (growing EEK 93.9 million in 2007).
- Investments in modernising the technical equipment and working environment of Estonian Television and Estonian Radio amount to EEK 54.2 million in the next year (growing EEK 39.2 million in 2007).

## 6. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

The assumptions established on uniform bases by the Economic Policy Committee of the European Union with regard to the entire EU, which largely coincide with the long-term forecasts of the Ministry of Finance, have been used as the assumptions of the long term budget forecast. The macroeconomic forecast of this programme has been used with regard to years 2006-2010.

**Tabel 24**

### Long-term sustainability of public finances 2006–2050

(% of GDP)

	2006	2010	2020	2030	2050
<b>Total expenditure</b>	<b>35,6%</b>	<b>34,3%</b>	<b>32,9%</b>	<b>32,1%</b>	<b>31,6%</b>
Pensions	6,4%	5,8%	4,5%	3,9%	3,4%
social security pensions	6,4%	5,8%	4,5%	3,9%	3,4%
old-age pension	5,6%	5,0%	3,9%	3,4%	3,0%
other (disability, survivors)	0,8%	0,8%	0,6%	0,5%	0,4%
occupational pensions (if in GG budget)	-	-	-	-	-
Health care	4,6%	4,6%	4,5%	4,4%	4,4%
Long-term care (previously part of health care expenditure)	0,1%	0,1%	0,1%	0,1%	0,1%
Interest expenditure	0,2%	0,1%	0,1%	0,1%	0,1%
<b>Total revenue</b>	<b>38,3%</b>	<b>35,8%</b>	<b>32,9%</b>	<b>32,1%</b>	<b>31,6%</b>
of which: interest revenues	1,0%	1,0%	1,5%	2,2%	3,4%
of which: social security contributions for pension	10,3%	9,9%	9,6%	9,2%	9,1%
Pension reserve fund assets (I pillar)	1,8%	0,6%	8,4%	17,8%	39,8%
of which: consolidated public pension fund assets (assets other than government liabilities)	0,5%	0,0%	3,4%	14,2%	42,5%
<b>Assumptions:</b>					
Labour productivity growth	4,6%	7,3%	3,6%	2,8%	1,7%
Real GDP growth	11%	7,5%	2,7%	2,1%	0,7%
Participation rate, males (aged 20-64)	83,9%	85,3%	87,4%	87,6%	85,8%
Participation rate, females (aged 20-64)	73,9%	75,4%	79,5%	79,8%	77,6%
Total participation rate (aged 20-64)	78,7%	80,1%	83,3%	83,6%	81,7%
Unemployment rate	5,6%	5,4%	6,3%	5,9%	5,3%
Population aged 65+ over total population	17,1%	17,1%	18,7%	20,9%	25,4%

Source: Ministry of Finance, Estonian Statistical Office, EU Economic Policy Committee.

### Activities for ensuring long-term sustainability of pension insurance

In order to ensure the sustainability of the public finances in the environment of aging population Estonia has largely carried out a pension reform and established a three-pillar pension system (mandatory state pension insurance, mandatory funded pension and supplementary private pension). During the reform a rise of the pensionable age and gradual harmonisation of the

pensionable age of men and women were established. The pensionable age of women will reach the uniform pensionable age of 63 years in 2016. In 2004 the average age of leaving the labour market was 62.3 years. A number of special pensions (the Defence Forces, the police, etc.), early-retirement pension, old-age pensions under favourable conditions and superannuated pensions allow for retirement before the general pensionable age. In 2004 42.1% of retiring people retired before reaching the general pensionable age. It is planned to reform the payment of special pensions, old-age pensions under favourable conditions and superannuated pensions.

To find additional funds for financing the state pension insurance (and health insurance) the Government will return to the initial idea of the pension reform, according to which the minimum social tax obligation must be fulfilled on the basis of the minimum monthly salary. In 2006 the amount serving as the basis for the minimum obligation was increased to EEK 1,400 a month and the gradually continuing growth will raise the minimum obligation to the level of the minimum monthly salary. A problem also lies in the fact that the current level of the obligation does not provide people with sufficient length of service and results in a little pension in the future. Increasing employment also contributes to improving the sustainability – more taxpayers means a better relationship between taxpayers and dependants and better financial status of pension insurance.

In order to strengthen the pension insurance and ensure sustainability transfers to the pension reserve have been made out of the budget surpluses. EEK 1.8 billion was transferred from the surplus to the reserve in 2005 (1% of the GDP) and EEK 2 billion (1.0% of the GDP) was transferred to the reserve by the supplementary budget of 2006. Also, one-off payments have been made to the pension reserve out of the state budget in 2005 and 2006 (0.1% and 0.2% of the GDP, respectively).

#### *Possible developments of pension insurance*

Two scenarios regarding the developments of pension insurance have been given below (both take the second pillar of the pension insurance into account on the revenue and expenditure side):

- **The first scenario** shows a situation where the current policy continues, i.e. the revenue of the pension insurance comes from social tax, while the expenditure of pension insurance rises pursuant to the pension index (the average pension in 2006 being EEK 3,018). This development is financially sustainable in the perspective of 50 years (there will be a surplus again in the first pillar in 2009 and the present reserves are sufficient for covering the deficit), but it would not be a solution for the pensioners, because in the longer term it cannot ensure adequate income in the form of pension. The ratio of average wages and salaries and pensions will worsen from the level of 40.1% in 2006 to 26.8% in 2050.
- **The second scenario** presupposes that the ratio of the average pension and the average wages and salaries, which have been raised to EEK 3,018 by 2006 (approx. 40.1%), will be retained. In the case of this scenario the pension insurance will be in deficit for the entire period under review, with the annual deficit being between 0.5-1.5% of the GDP in most years. It virtually means that the revenue generated from social tax is not sufficient for payment of pensions in the environment of demographic developments in Estonia in such an extent as to keep the ratio of pensions and the average wages and salaries stable. Therefore this amount must be saved at the account of other expenditure in the conditions of a balanced budget. The scenario refers to the fact that merely by retaining the ratio of pension and the average wages and salaries at the level of 2006 (provided that other expenditure of the state are not cancelled for the purpose of paying pensions) will take the pension insurance reserve into a deficit of approx. 30% of the GDP in the 45-year perspective.

As such, the pension system with its current structure is financially sustainable, i.e. no additional funds need to be provided due to demographical changes. However, the framework does not ensure adequate pension for the present and future pensioners, i.e. the substitution rate (the ratio of the average pension and the average wages and salaries) will worsen in comparison with the present

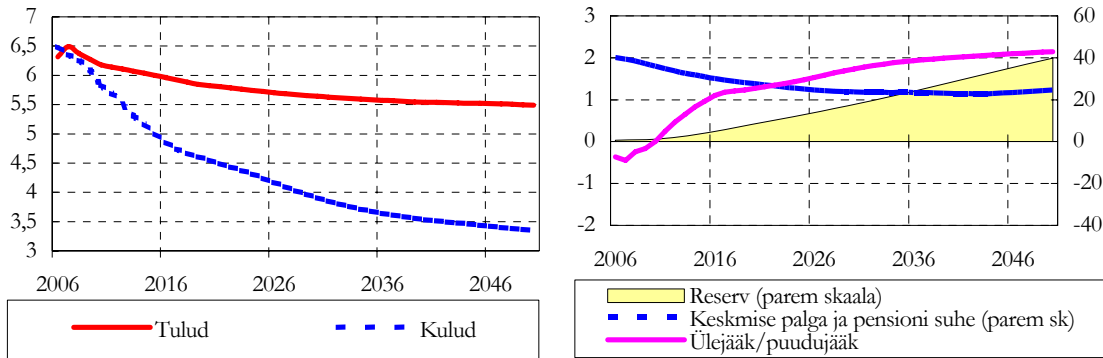
situation. On the other hand, the real impact and seriousness of the demographic changes lying ahead is shown by the fact that keeping the substitution rate of 2006 stable over the next 45 years requires provision of additional funds totalling approx. 40% of the GDP (total amount of annual deficits).

**Figure 16**

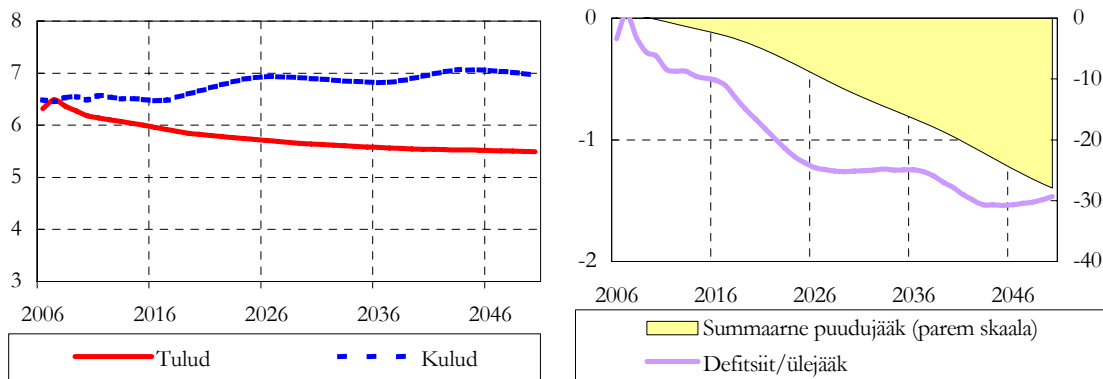
**Estimates of financial indicators of pension insurance**

(% of GDP)

**A. Scenario of continuance of the present policy (increase of pensions based on the index)**



**B. Ratio of pension and wages and salaries of 2006 is preserved**



Source: Ministry of Finance, Estonian Statistical Office.

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## 7. INSTITUTIONAL FUNCTIONS

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### 7.1. Development of budget process

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By the **State Budget Act** Amendment Act in 2002 the position of strategic development plans in Estonian public administration and their role in the state budget process was legalised. The purpose of the changes was to improve the quality of the state's financial management through giving substance to strategic development plans in the state budget process and to make strategic development plans the primary component of planning the activities of state agencies. **Regulation** No. 302 of the Government of the Republic of 13 December 2005 "Classes of Strategic Development Plans and Procedure for Drafting, Modification, Implementation, Evaluation and Reporting Thereof" regulated the classes of various development plans and their procedure in greater detail. For the first time in the history of Estonian public administration the regulation established clear requirements for activity-related development plans in order to bind them better to the processes of organisation-based development plans and budgeting. The regulation also defined the roles and responsibilities of various parties (Government, ministers, etc.) in the planning process. The regulation treats strategic planning systematically, in order to establish prerequisites for integration of policymaking, planning, budgeting and reporting. The purpose of such treatment is to achieve state budget financing of the objectives and priorities defined by the Government in the medium term and targeted and effective use of the state budget funds. Through application of a functioning strategic planning system, including through goal-setting and measurement of the effectiveness of the activities, preconditions for better operation of state agencies and improvement of the quality of public services are created. The regulation helps to better ensure the sustainability, purposefulness and impact of the expenditure incurred on the basis of development plans.

The **State Budget Strategy for 2007-2010** was for the first time made on the basis of the new requirements, i.e. the ministries drafted the development plans (incl. the financial plan) as the bases of the State Budget Strategy for their areas of government for 2007-2010 on the basis of the uniform requirements and before their approval by the minister of the respective area and submission to the Ministry of Finance the development plans of the area of government were discussed with the Prime Minister and other relevant ministers. For the first time, the **Financial Plan** for the next four years, i.e. **2007-2010** was drafted as a part of the State Budget Strategy. It contains the division of the funds required for achievement of the objectives set out in the State Budget Strategy by priorities, activities, areas of government as well as sources and it serves as the basis for drafting subsequent state budgets. In the framework of drafting the State Budget Strategy for 2007-2010 the **structural funds** received from the European Union through 2007-2013 was planned along with other funds, i.e. for the first time all the revenue and expenditure of the state budget for the next four years was planned collectively and at once. Integrated planning allowed for drafting the State Budget Strategy more flexibly, considerately, effectively and transparently, and improving the quality of budgeting. In order to increase the quality of budgeting and planning and make it more effective a new state budget information system was launched in 2006. Unlike its predecessor, it also contains integrated activity-based information in addition to the economic content.

The new **state financial management development concept**, which treats the state financial management as a whole (i.e. strategic planning, accounting, reporting and auditing in addition to

budgeting) has been developed over 2006. Such an approach proceeds from the fact that the system of financial management can effectively function only if all the stages of the cycle are in logical harmony and support each other. By the end of 2007 an analysis of the current situation of the state financial management will be finished, pointing out the strengths, weaknesses, opportunities and threats of the present state financial management system, and thus also the choices that have to be made as well as making proposals for improvement of the financial management system. At this stage of development of the financial management development concept the emphasis is on increasing the orientation towards effectiveness in financial management and on strengthening the bonds of planning and reporting. In 2006 development of the **information systems** of state financial management for improving the quality of financial management continued and, along with the development of the state budget analysis system, the integration of these information systems for the purpose of more effective processing and analysis of data was launched.



## 7.2. Budget rules and institutions

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### *Budget rules*

- The requirement of the budget balance of the **general government or central government** has not been provided by law. So far the budgetary balance has been a goal set out in coalition agreements and strategic development plans. Thus, it is a “soft” rule, but it has been observed by all governments.
- According to the Constitution, an amendment to the state budget or a draft state budget act, which brings about a decrease of the expenditure, an increase of the revenue or a redivision of the expenditure stipulated therein shall be accompanied by financial calculations, which indicate the sources of income required for covering the expenditure. Also, the Riigikogu cannot delete or reduce expenditure included in the state budget or a draft state budget act on the basis of other acts. According to the State Budget Act, the Government can submit at latest three months before the end of the budgetary year a **draft supplementary state budget act** increasing the expenditure to the Riigikogu. This deadline should prevent extensive implementation of a pro-cyclical budgetary policy.
- In the **Health Insurance Fund** Act it has been stipulated that the budget of the Health Insurance Fund comprises balanced revenue and expenditure of the Health Insurance Fund in one financial year. Requirements have been established regarding legal reserves and risk reserves. The legal reserves of the Health Insurance Fund are reserves comprising the budget funds of the Health Insurance Fund for the purpose of hedging risks arising from macroeconomic developments, which threaten the health insurance system. The size of the legal reserves is 6% of the total budget and annually at least 1/50 of the total budget of the Health Insurance Fund as well as excessive social tax revenues are transferred to the reserves until the amount of the legal reserves provided by law has been achieved or restored. The legal reserves can be put into use only exceptionally by an order of the Government of the Republic on the basis of a proposal of the Minister of Social Affairs. Before submission of a proposal to the Government of the Republic the Minister of Social Affairs hears the proposal of the Supervisory Board of the Health Insurance Fund.

The risk reserves of the Health Insurance Fund are reserves comprising the budget funds of the Health Insurance Fund for the purpose of hedging risks arising from obligations assumed for the health insurance system. The size of the risk reserves is 2% of the health insurance budget total of the Health Insurance Fund and it can be put into use by a resolution of the Supervisory Board of the Health Insurance Fund.

- The **Unemployment Insurance Fund** also has the legal reserves requirement in order to hedge the risks arising from macroeconomic developments, which threaten the unemployment insurance system. The size of the legal reserves is at least 10% of the total assets of the Unemployment Insurance Fund. The legal reserves may be put into use only exceptionally, in the case of insufficiency of the Unemployment Insurance Fund's fund for specific purposes, on the basis of a resolution of the Supervisory Board of the Unemployment Insurance Fund. Before making the respective resolution the Supervisory Board must, through the Minister of Social Affairs, make the Government of the Republic a proposal for increasing the unemployment insurance payment to the level which ensures receipts of funds sufficient for the achievement of the objectives of the Unemployment Insurance Fund.
- The State Budget Act stipulates annual restrictions on the balance of the budgetary loan and cash loan (repaid within the year) in the budget act, the size of the cash reserve, the balance of



the Government loans granted for performance of the public duties, the total bridge financing, etc. The total limits in the draft State Budget Act for 2007 are as follows:

- ✓ the size of the cash reserve is EEK 1,500 million (2% of the budget revenue; 0.7% of the GDP);
  - ✓ the highest permitted balance of financing the expenditure exceeding the state budget revenue is EEK 3,500 million (4.6% of the budget revenue; 1.5% of the GDP);
  - ✓ the highest permitted balance of bridge financing of foreign aid is EEK 3,000 million (4.0% of the budget revenue; 1.3% of the GDP);
  - ✓ the highest permitted balance of the budgetary loan is EEK 3,500 million (4.6% of the budget revenue; 1.5% of the GDP) and the highest permitted balance of the cash loan is EEK 3,500 million (4.6% of the budget revenue; 1.5% of the GDP);
  - ✓ the highest permitted balance of the loans given by the Government of the Republic for performance of the public duties is EEK 1,000 million (1.3% of the budget revenue; 0.4% of the GDP).
- The **Rural Municipality and City Budgets Act** establishes a debt limit and a debt service limit for local authorities. A rural municipality and a city may take a loan, use financial lease, issue debt securities and assume other debt obligations on the following conditions:
- ✓ the total amount of all outstanding loans, outstanding financial lease payments and issued bonds and the total amount of other debt obligations along with the loan taken, the financial lease used, the debt securities issued and the other debt obligations assumed must not exceed 60% of the budget revenue planned for the given budget year, less the allocations from the state budget intended for a specific purpose;
  - ✓ the total amount of outstanding loan principals and interest, financial lease payments and interest, costs of redemption of the bonds must not, in any coming budget year, exceed 20% of the budget revenue planned for taking loans, using financial lease or issuing bonds in the budget year, less the allocations from the state budget intended for a specific purpose;
  - ✓ the loan is taken, the financial lease is used and the bonds are issued for the purpose of the investments specified in the development plan of the rural municipality or city.

### Budget institutions

- As for **budget institutions**<sup>21</sup> in the Estonian context one can point out the State Audit Office, which is independent in its activities and evaluates the legality and effectiveness of the use of the public funds through economic inspections (audits). During the audit various aspects in the audited agencies are assessed, e.g. the internal audit system, the financial management, the economic activity, the management, the effectiveness of the organisation and activity, and the reliability of the information technology systems.

The State Audit Office is obliged to assess the Consolidated Annual Report of the State drawn up by the Ministry of Finance, covering all state accounting entities, and the annual reports of the constitutional institutions. In both events the compliance of the reports with the Accounting Act as well as the legality of the transactions contained in the reports are analysed. The assessment of the Consolidated Annual Report of the State is sent to the Government of the Republic for approval and thereafter it is submitted to the Riigikogu for approval. Thus, through approval or rejection of the assessment of the State Audit Office the Riigikogu assesses the work of the Government.

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<sup>21</sup> According to the definition, budget institutions are institutions that (1) (regularly) analyse, assess or make recommendations regarding the fiscal policy of the state, (2) draw up independent forecasts of budget revenue or forecasts that are used upon comparison with the Government's forecasts. These institutions must also be financed from the public funds.

The audits of the State Audit Office and the proposals contained in the audit reports give the Riigikogu and the Government of the Republic as well as the taxpayers a better overview of the functioning of the public sector, while the recommendations of the State Audit Office should contribute to increasing effectiveness in the public sector. On the whole, this should lead to improvement of the quality of public finances.

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# **APPENDICES**

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## Appendix 1. Key indicators of Estonian economy 2000–2005

**Table 25**

### Gross Domestic Product in 2001–2005

	2001	2001	2002	2003	2004	2005
	<i>mln EEK</i>	%	%	%	%	%
1. Real GDP	102 808,8	7,7	8,0	7,1	8,1	10,5
2. Nominal GDP	108 218,3	13,3	12,2	9,5	10,4	18,0
<b>Sources of growth</b>						
3. Private consumption expenditure (incl. non-profit institutions) <sup>1)</sup>	56 455,8	7,4	11,2	6,9	6,9	8,2
4. Government consumption expenditure	19 527,3	2,6	1,9	0,3	2,2	1,1
5. Gross fixed capital formation	24 817,4	9,7	24,1	7,0	13,5	13,6
6. Change in inventories (% of GDP)		1,5	2,6	3,7	4,7	4,2
7. Export of goods and services	81 532,4	2,0	1,7	7,6	17,1	21,5
8. Import of goods and services	85 008,2	3,5	6,0	10,6	15,2	15,9
<b>Contribution to GDP growth <sup>2)</sup></b>						
9. Domestic demand (excl. inventories)		7,5	13,1	7,8	10,4	8,0
10. Change in inventories		0,3	-0,3	2,7	2,2	-0,6
11. External balance of goods and services		-1,9	-6,3	-4,0	-0,1	1,9
<b>Growth of value added</b>						
12. Primary sector	4 540,2	-5,2	8,3	0,8	-7,2	2,3
13. Industry	21 985,4	10,4	7,3	8,0	9,3	11,7
14. Construction	5 440,2	2,2	11,6	2,7	7,1	19,8
15. Other services	64 735,3	8,0	7,6	7,7	8,3	10,6

1) Contribution to GDP growth indicates the shares of specific sectors in economic growth. For calculation of the indicators, the growth of a sector is multiplied by its share in GDP. The sum of sectoral contributions is the economic growth (the small differences are caused by statistical error – share of GDP that could not be divided between the sectors).

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

**Table 26**

### Prices in 2000–2005

(per cent)

	2000	2001	2002	2003	2004	2005
1. GDP deflator		6,3	2,9	1,0	1,8	2,9
2. Private consumption deflator		6,2	2,9	0,9	1,8	2,9
3. Harmonised index of consumer prices	3,9	5,6	3,6	1,4	3,0	4,1
3a. Consumer price index	4,0	5,8	3,6	1,3	3,0	4,1
4. Government consumption expenditure deflator		5,0	7,2	10,8	6,5	9,9
5. Investment deflator		6,0	0,9	0,7	4,5	2,5
6. Export deflator		4,7	-2,5	1,6	0,6	2,4
7. Import deflator		2,0	0,1	-0,6	2,1	4,4

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

**Table 27****Labour market in 2001–2005**

	2000	2001	2002	2003	2004	2005
		%	%	%	%	%
1. Employment, persons	572,5 <sup>1)</sup>	0,9	1,4	1,5	0,2	2,0
2. Unemployment rate <sup>22</sup>		12,6	10,3	10,0	9,7	7,9
3. Labour productivity, persons		6,7	6,6	5,5	7,9	8,3
4. Compensation of employees	44 553 <sup>2)</sup>	11,5	10,7	13,6	11,9	15,5

1) Thousand people.

2) Mln EEK.

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

**Table 28****Balance of payments in 2000–2005**

(% of GDP)

	2000	2001	2002	2003	2004	2005
1. Net lending/borrowing vis-à-vis the rest of the world	-5,0	-5,0	-10,1	-11,1	-11,7	-9,5
1a. Current account	-5,4	-5,2	-10,6	-11,6	-12,5	-10,5
2. Balance of goods and services	-3,3	-2,1	-7,1	-7,7	-8,1	-6,2
3. Balance of primary incomes and transfers	-2,1	-3,1	-3,6	-3,9	-4,4	-4,3
4. Capital account	0,5	0,2	0,5	0,5	0,8	1,0

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

<sup>22</sup> ILO definition, 15–74 years old.

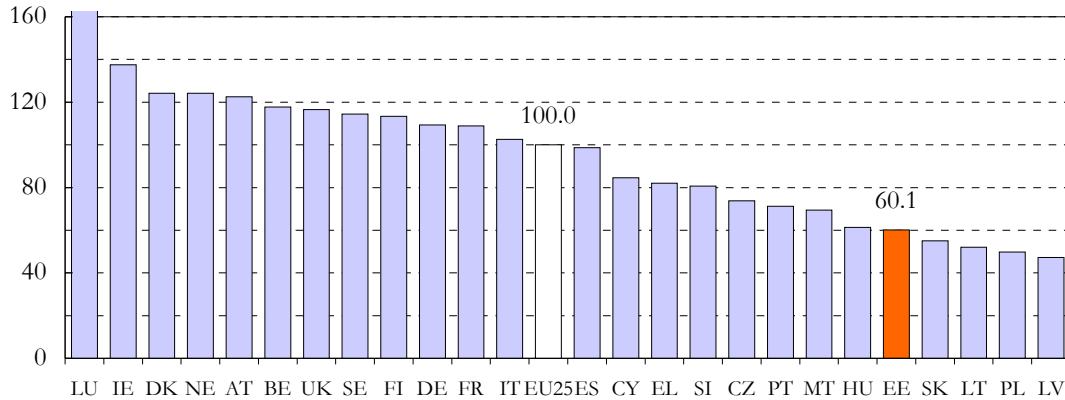
## Appendix 2. Comparison of Estonia with other EU Member States

**Figure 17**

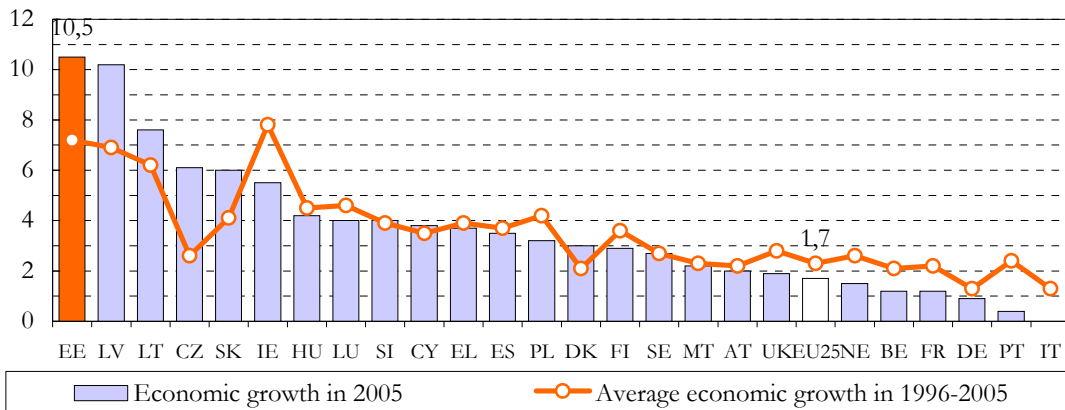
### Main macroeconomic indicators

(per cent)

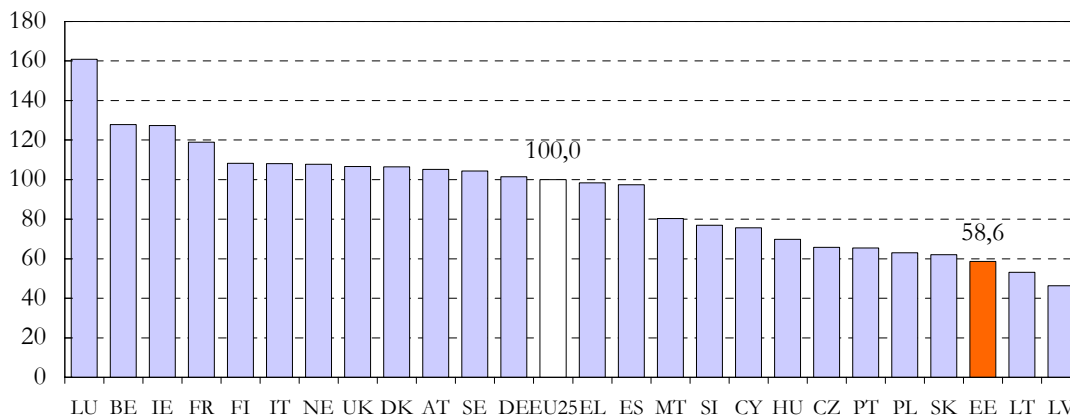
#### A. GDP per capita in purchasing power parities in 2005 (EU25=100)



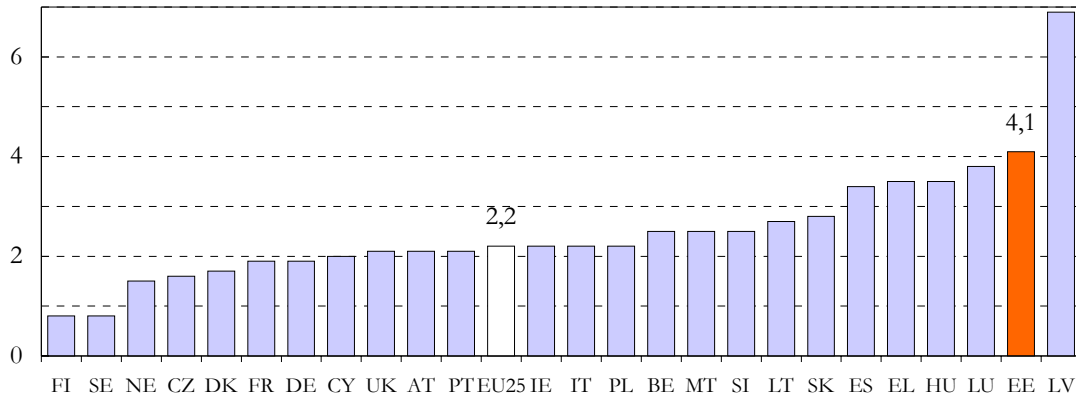
#### B. Economic growth in 2005



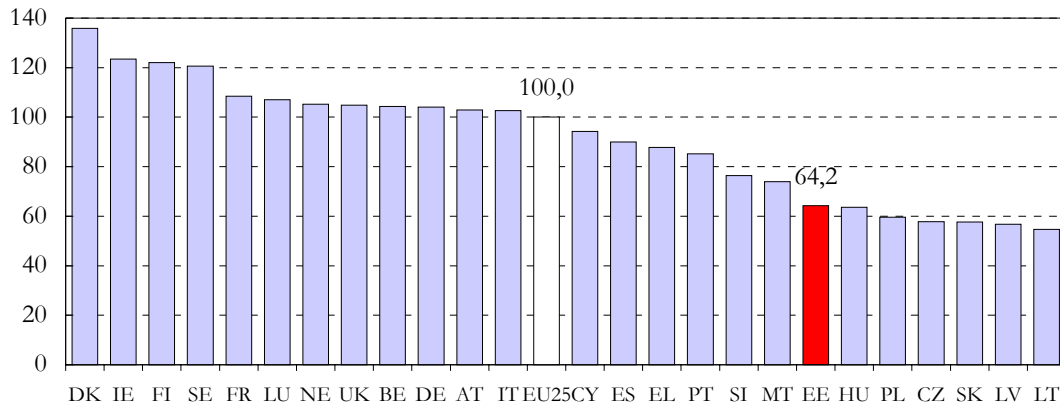
#### C. Labour productivity – GDP in purchasing power parities per person employed in 2005 (EU25=100)



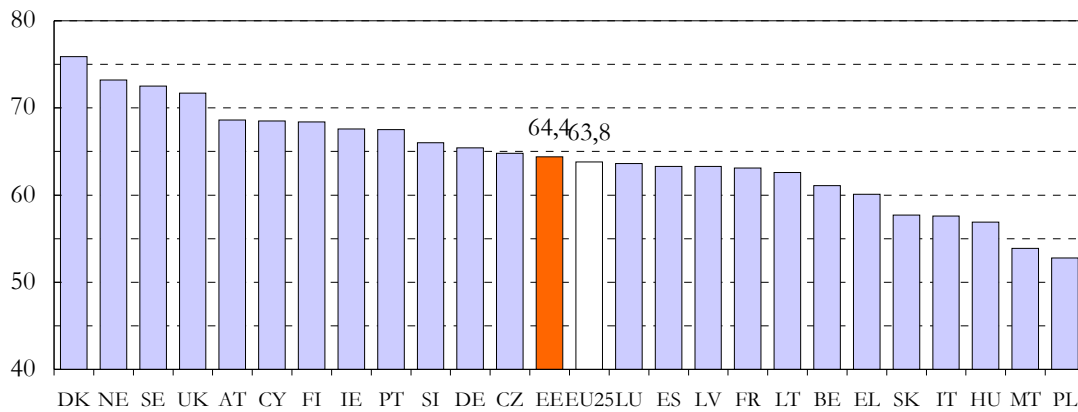
**D. Harmonised index of consumer prices in 2005**



**E. Comparative price level to EU25 average in 2005 (EU25=100)**



**F. Employment rate (15–64 years old) in 2005**



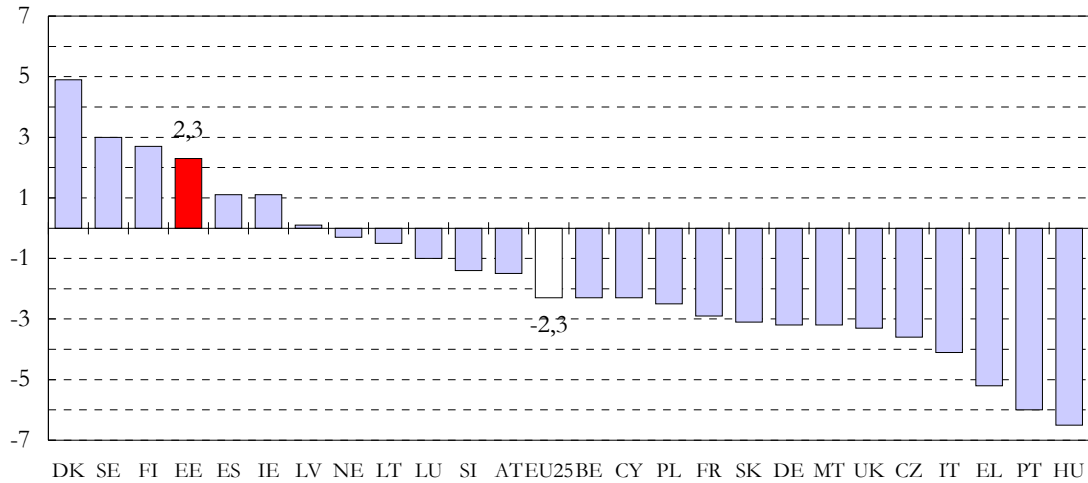
Sources: Eurostat, Statistical Office of Estonia, Ministry of Finance of Estonia.

**Figure 18**

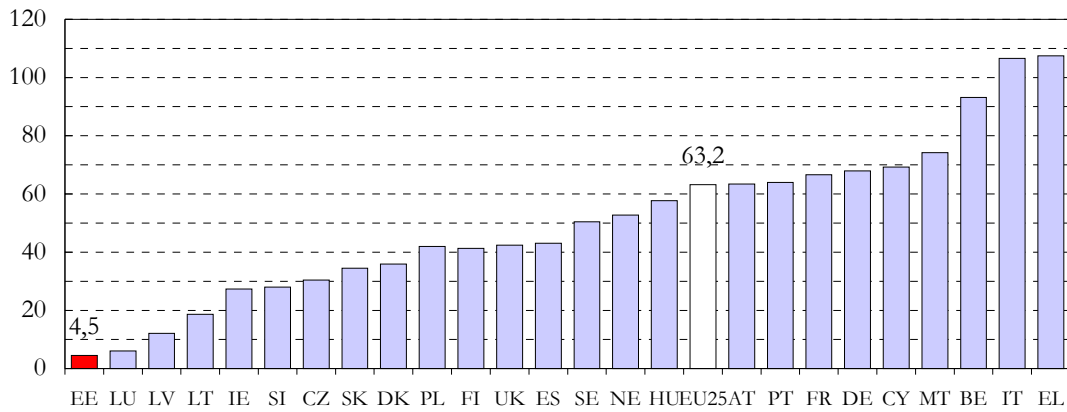
**General Government Fiscal Position**

(% of GDP)

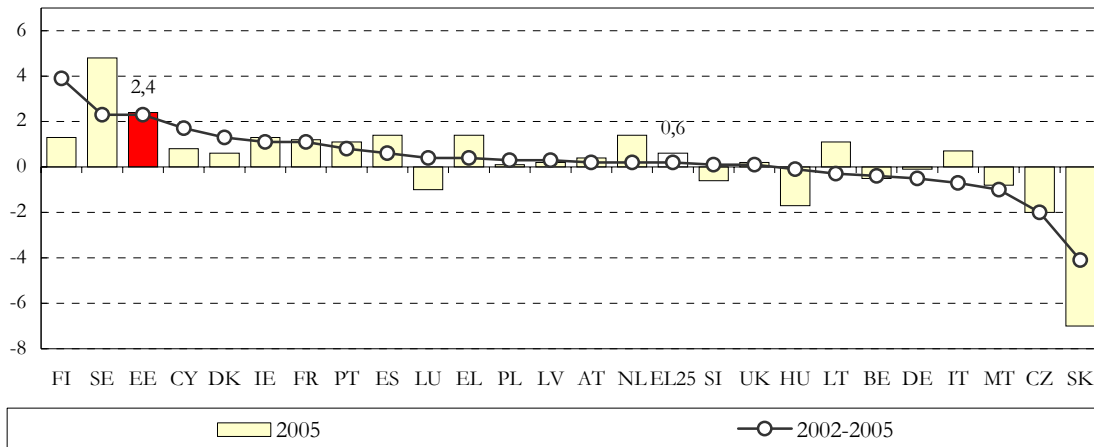
**A. EU-25 general government budget balance in 2005**



**B. EU-25 general government debt in 2005**



**C. EL-25 Stock-flow adjustments in 2005**



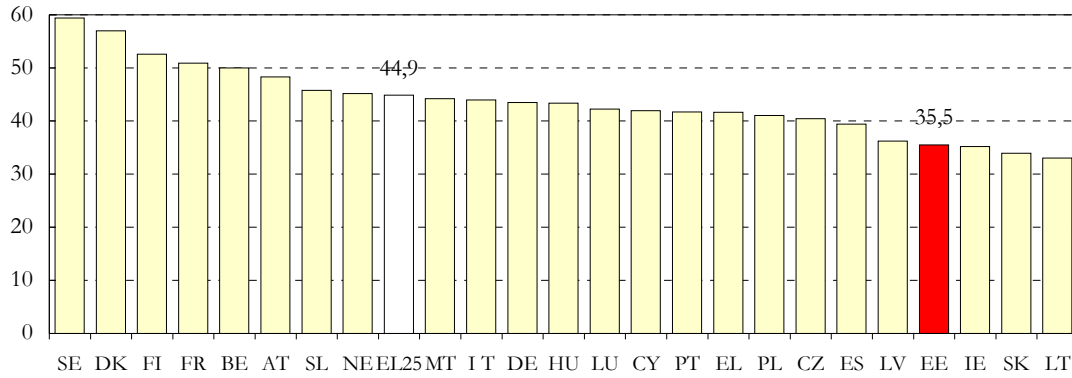
Sources: Eurostat, Statistical Office of Estonia, Ministry of Finance of Estonia.



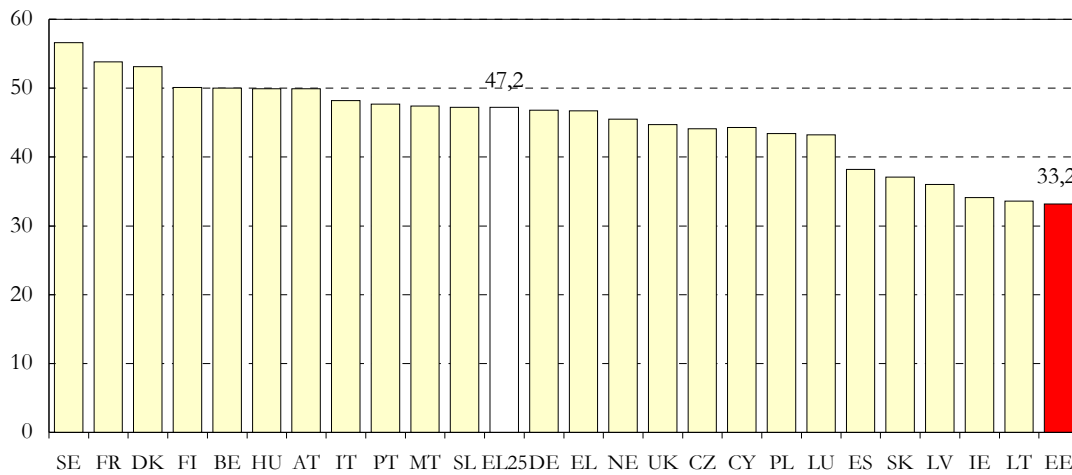
**Figure 19**

**General Government Revenue and Expenditure**  
(% of GDP)

**A. EU-25 general government revenue in 2005**



**B. EU-25 general government expenditure in 2005**

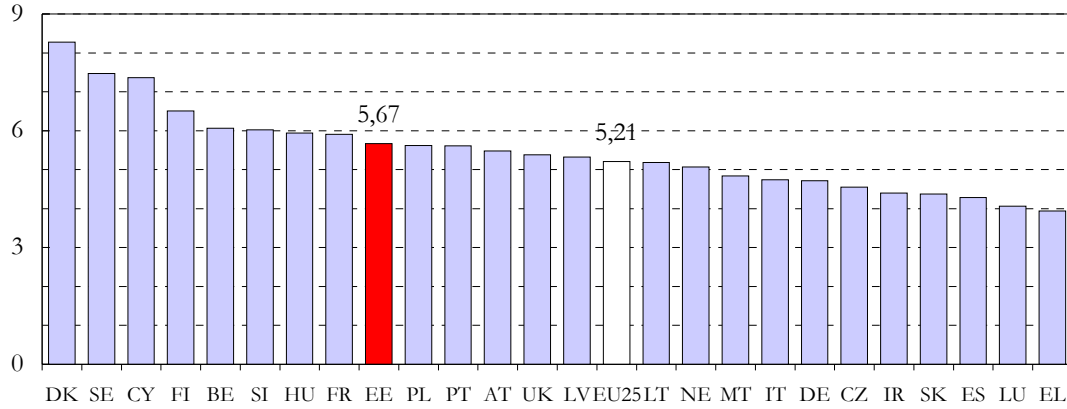


Sources: Eurostat, Ministry of Finance of Estonia.

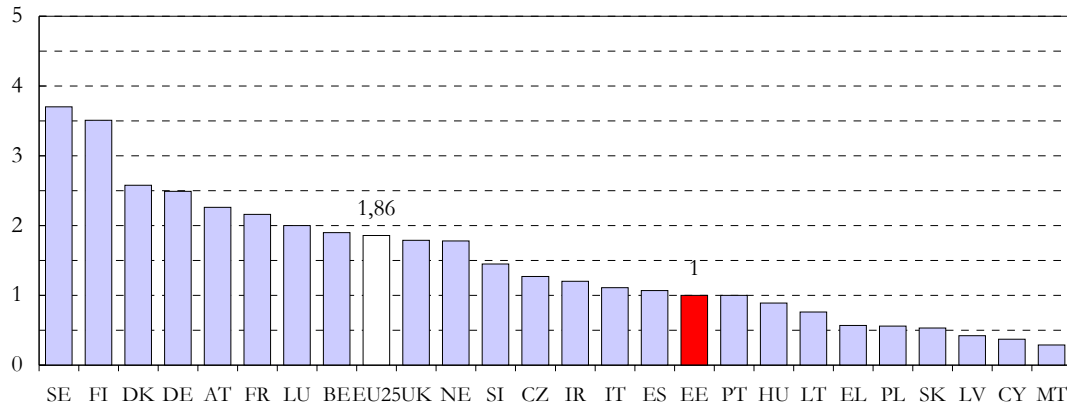
**Figure 20**

**Investment in physical and human capital**  
(% of GDP)

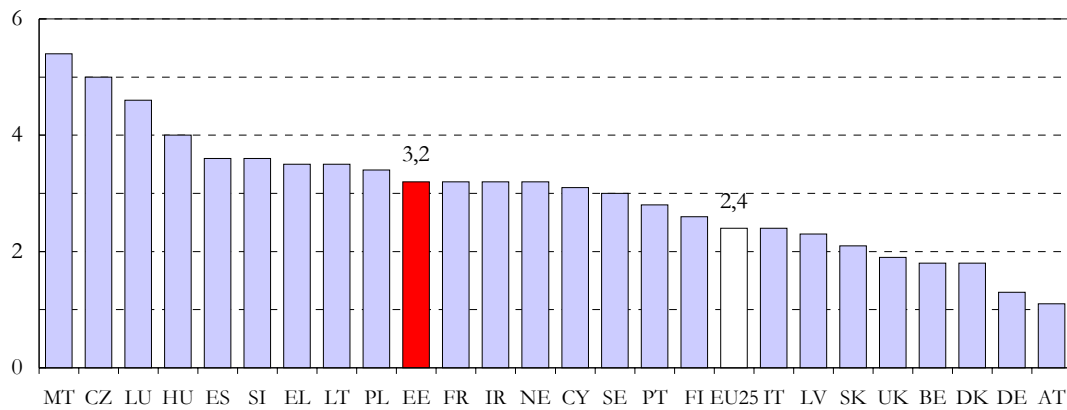
**A. Public sector education expenditure in 2003**



**B. Expenditure on research and development in 2004**



**C. General government gross fixed capital formation in 2005**



Sources: Eurostat, Ministry of Finance of Estonia.

## **Appendix 3. Inflation developments in Estonia**

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### **1. Recent inflation developments in Estonia**

The growth of Estonian consumer prices has been rapid since accession to the EU. Minding a few expectations the headline inflation has fluctuated between 4-5% until today. In May 2004 the rise in prices was caused by tax and foreign trade policy changes in connection with the accession to the European Union, but in the middle of 2005 price pressures arising from the robust growth of crude oil prices surfaced. Unlike in the case of the EU15, the changes in oil prices have a much stronger impact on inflation in Estonia (see Appendix 3 of the previous year's Convergence Programme). Contrary to the expectations, the geopolitical situation became tenser and in the summer of 2006 new record high levels of the world market prices of oil were observed, which did not allow for the growth of consumer prices to moderate. Furthermore, the inflationary pressures on the supply side deepened. Complicated weather conditions in spring and summer brought about a strong growth in food prices. Regardless of the fall in oil prices in autumn the administrative price rises in Q4 2006 do not allow for any moderation of inflation below 4% in the near future. It is positive that inflation expectations have been lower than in previous years and thus the deepening of the inflationary demand side pressure has not had any considerable impact on inflation expectations.

After 2004 when the core inflation was even lower than in the euro zone, the core inflation has picked up considerably. In the first half of 2005 the rise in prices was less than 2%, but as of the second half of the year the core inflation has accelerated, reaching 3.8% in Q3 2006 due to the demand-side factors and partially also due to the indirect effects of the rise in energy prices. In the initial phase the rise in prices could be attributed to price developments of clothing, footwear and also transport services, but later the impact of services related to recreation and culture as well as housing expenses increased. The main reason is the fact that in terms of the acceleration of income growth, strongly increasing credit volumes and optimistic future expectations of consumers it is easier to increase the prices of goods and services.

The stronger growth in food and non-alcoholic beverage prices (over 6% in Q3 2006) can be attributed primarily due to a considerable rise in the prices of the agricultural products caused by a drought. Secondly, one cannot rule out the pressures exerted by the demand side, which arise from increased income and also preferences for Estonian food, which is often more expensive than imported food.

Rising housing expenses, which can be attributed to a strong rise in administrative prices (heating, gas) as well as non-regulated prices (rentals, house repairs) are one of the main factors influencing inflation. In addition to the increases in gas and heating prices in the beginning of 2006 there were additional price corrections in autumn, whereby the price of gas rose by a half. The real estate boom has brought about a significant rise in rent prices and there are no signs of any slowdown of the rise in prices yet. Due to these factors the housing expenses will rise by a tenth in 2006.

Because of the record high levels of crude oil prices in 2006 the contribution of fuels for transport in consumer prices is still noticeable. Due to the fall in the oil prices in autumn 2006 the prices of fuel are lower than a year ago. In 2005 the rise in fuel prices (including a rise of the excise duty) accounted for approximately a third of the rise of the consumer price index, but in the 9 months of 2006 its contribution has fallen to a fifth.

The rise in energy prices (fuels for transport, heating) has, due to a rise in the prices of the inputs, brought about indirect inflationary pressures, which are characterised also by the development of the producer price index. Since the prices of energy carriers depend on the price trends of crude oil in the world market, it has brought about a significant rise in the price of heating oil and gas.

Administratively regulated heating energy and gas prices started rising in the beginning of 2006 and new significant price rises took place in autumn. This means that the indirect impact arising from the rise in energy prices should result in additional inflationary pressures in 2007.

Due to the postponement of raising the excise duties on tobacco and alcohol the impact of regulated price rises on the consumer price index in 2006 has decreased and the aforementioned rises in the prices of heating energy and gas account for the largest share.

## **2. Inflation trends in Estonia and the euro area – similarities and differences**

Over the last two years headline inflation in Estonia has exceeded that of the euro area by 2 percentage points on average. However, considering Estonia's remarkable economic growth and the rise in consumer prices arising from the continuing convergence, the respective inflationary difference is acceptable for a rapidly developing economy.

The inflation in the euro area has been above the target of 2% over the last years. Although the core inflation has been stable, various factors have brought about a rise of the headline inflation in euro area. In comparison with Estonia the reasons are similar: the prices of food have increased with regard to various components, whereby the rises in the prices of the primary agricultural products due to climatic reasons have had a stronger impact in recent months. Heating energy, gas and electricity are behind the stronger rise in housing prices. The contribution of the rise in the prices of motor fuel remains high. However, in Q4 2006 the impact of the component will remain marginal, being expressed in the considerable moderation of the inflation.

Comparing the inflation in Estonia and euro area based on main commodity groups, a number of differences and similarities can be observed. The trend of the HICP is similar in the case of food, housing expenditure, communication services, transport and health care. The greatest differences can be found in clothing, furnishings and household goods, recreation and culture related services and miscellaneous goods and services. The differing price developments of these product groups in Estonia and the euro area are related primarily to the demand-driven price pressures, as well as to the emergence of cost pressures.

The prices of food and non-alcoholic beverages show a growth trend in Estonia and the euro area as of the end of 2005. Thereby, like in other Baltic States, the rise in the prices has been more extensive in Estonia than in the euro area. In addition to the rise in the prices of agricultural products affected by the drought the prices of other key food products have also increased in Estonia and euro area.

The developments in the prices of alcoholic beverages and tobacco have been largely affected by changes in the rates of excise duties. Unlike in the euro area, the inflation of the given product group has increased in Estonia in recent months. The reason lies in the rise of the prices of alcoholic beverages, which can be attributed primarily to cost pressures.

The inflationary differences in the product groups of clothing, footwear and furnishings, household goods can be attributed to the demand-side factors. Rising margins and strong growth of sales in retail trade refer to it. Secondly, in the Estonian HICP no quality adjustments are realised regarding the given product group. With the rise of the living standard consumers have started to prefer more expensive products of higher quality, which has been expressed in the stronger increase of the price index. Since the prices of clothing and footwear have achieved the average European level, in the medium term the price dynamics of the product group should harmonise with that of the euro area.

In the euro zone the prices of recreation and culture services have been stable in recent years, but in Estonia there has been a strong rise. The reason lies in the price developments of holiday trips and entertainment services. Increased demand and the appearance of fuel price rises have brought about a considerable rise in the price of holiday trips.

The rise in housing prices has accelerated in Estonia as well as the euro area as of 2004. One of the reasons is a rise in energy prices. Although in the euro area the rise in the price of heating energy has been stronger than in Estonia, the impact on consumer prices is more moderate due to a smaller weight. Unlike in Estonia, rent prices have remained stable in the euro area. Since our energy resources are one of the least expensive in Europe, the price convergence is bound to continue in the medium term. A clear indication thereof is the strong rise in the prices of gas and heat this autumn. As a result thereof the purchase price of natural gas is close to the Finnish level.

The prices of communication services have been in clear deflation in recent years and the fall in prices has deepened. Thereby the prices in Estonia have fallen largely owing to the introduction of new discount packages in mobile communications.

The developments of the world market prices of crude oil have considerably affected the consumer prices throughout Europe. Thereby the impact on prices in Estonia has been stronger due to two reasons. First, since the share of excise duties is smaller in motor fuel prices and thus the share of the commodity is higher, the prices of motor fuel are more sensitive to oil price developments. Secondly, fuel accounts for a larger portion of the consumer basket than in the euro area. The rise in fuel prices brought about a rise in the prices of transport services in Estonia. The same trend took place in the euro area, albeit on a far smaller scale.

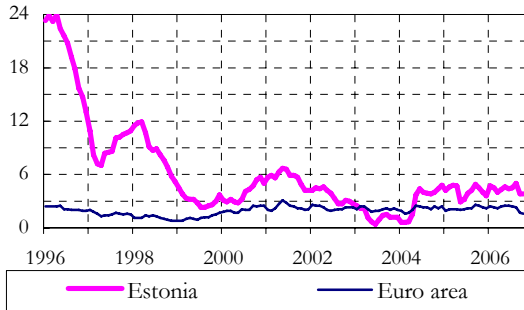
The inflation expectations of Estonian consumers for the next 12 months have been at a lower level in 2006 than in previous years. The rise in the index in summer reflected the rise in the price of fuels for transport due to achievement of a record high level of oil prices. Thereafter the index has fallen to the level observed before the summer. Thus, the appearances of demand-side inflation have not increased consumers' inflation expectations and it may be presumed that the strong rise in the prices have not been expressed in the acceleration of growth of wages. However, in the euro area the expectations regarding the rise in prices have increased and reached the highest level in recent years. The considerable slowdown of the inflation in autumn has not affected the inflation expectations either.

**Figure 21**

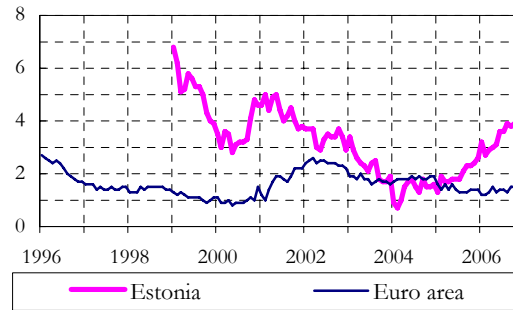
**Inflation Developments in Estonia**

(per cent)

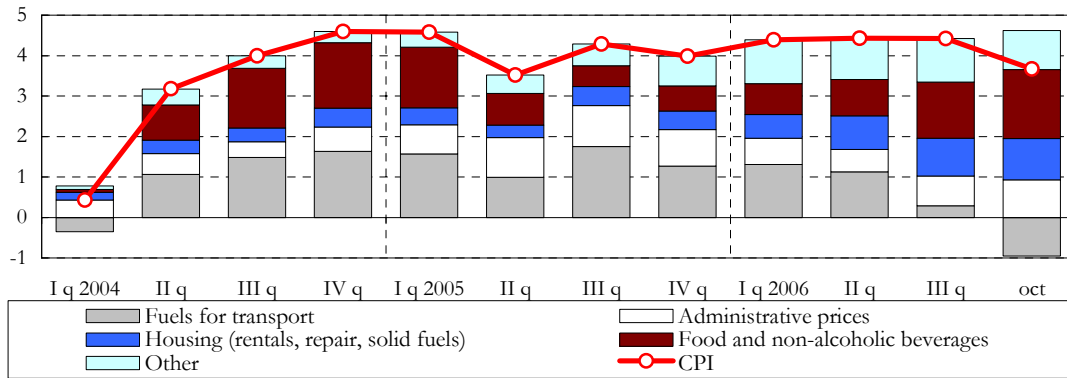
**A. Estonian and euro area HICP**



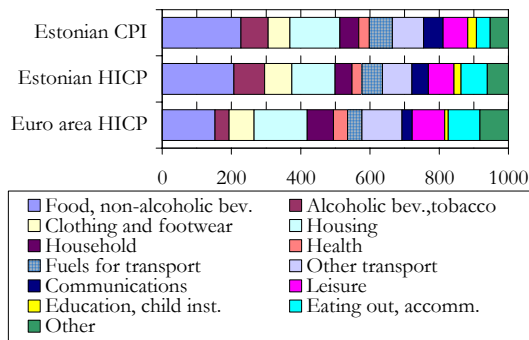
**B. Core inflation of Estonia and euro area**



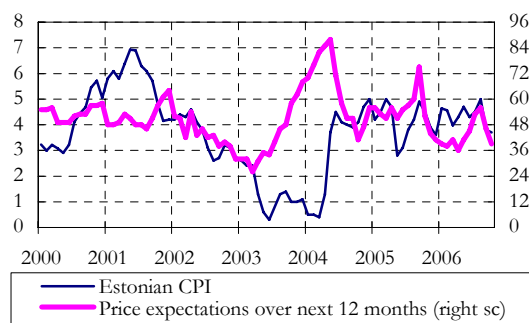
**B. Contribution of Estonian CPI**



**C. Consumer baskets in 2006**



**D. Inflation expectations in Estonia**



Sources: Statistical Office of Estonia, Eurostat.

**Table 29****Influence of Known Administrative Price Increases on Inflation 2006–2008***(per cent)*

Administrative actions	Enforcement	Price increase (%)	Effect on CPI		
			2006	2007	2008
<b>Changes in tax policy</b>					
Increase of excise duty on tobacco	01.07.2005	7,5	0,14	-	-
Increase of excise duty on tobacco	01.01.2008	16,5	-	-	0,22
Increase of excise duty on alcohol	01.01.2008	6,0	-	-	0,30
Some medical equipment is taxed at 18% instead of former 5%	01.01.2007	12,0	-	0,05	-
Replacement of 5% VAT tax rate by 18% rate for heating energy, peat, compressed peat, coal and firewood	01.07.2007	12,0	-	0,27	0,27
Increase of excise duty on motor fuels	01.01.2008	3,0	-	-	0,18
<b>Other administrative price changes</b>					
Refuse collection	01.11.05–30.03.06	17,0	0,05	-	-
Electricity	01.03.2005	13,3	0,07	-	-
Electricity*	ca 01.03.2008	ca 3,0	-	-	0,07
Price increase of water supply and sewerage in Tallinn	01.01 (2006–2008)	10,8	0,06	0,07	0,07
Natural gas	01.01.2006	11,4	0,04	-	-
Natural gas	01.10.2006	54,0	0,03	0,09	-
Price increase of distance heating due to the price increase of shale oil	01.01–01.04.2006	50	0,18	0,02	-
Price increase of heating energy based on natural gas in Tallinn	01.08.2006	7,5	0,06	0,07	-
Price increase of heating energy based on natural gas in Tallinn*	ca 01.08.2007	ca 20,0	-	0,13	0,18
Price increase of heating energy elsewhere	01.10–01.12.2006	ca 16,0	0,04	0,22	-
Price increase of heating energy elsewhere*	ca 01.09–01.10.2007	ca 8,0	-	0,04	0,09
<b>Total</b>			<b>0,67</b>	<b>0,96</b>	<b>1,38</b>
<b>Postponed</b>					
Increase of excise duty on alcohol	01.07.2006	6,0	0,15	0,15	-
Increase of excise duty on tobacco	01.07 (2006–2007)	7,5–16,5	0,14	0,30	0,13
<b>Total</b>			<b>0,29</b>	<b>0,45</b>	<b>0,13</b>

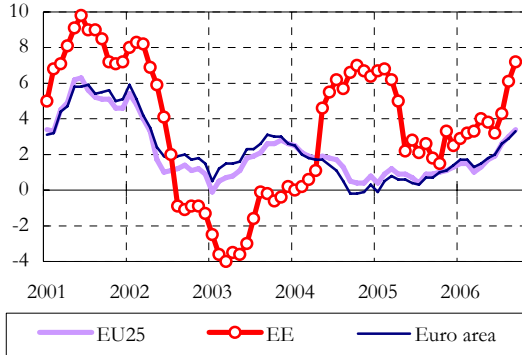
\* *expected.**Sources: Ministry of Finance, Statistical Office of Estonia, Energy Market Inspectorate.*

**Figure 22**

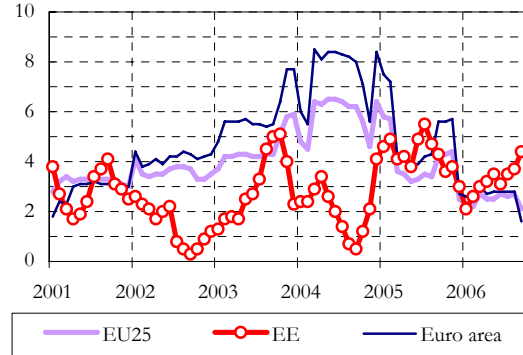
**Inflation developments by items in Estonia, EU25 and in the Euro area**

(per cent)

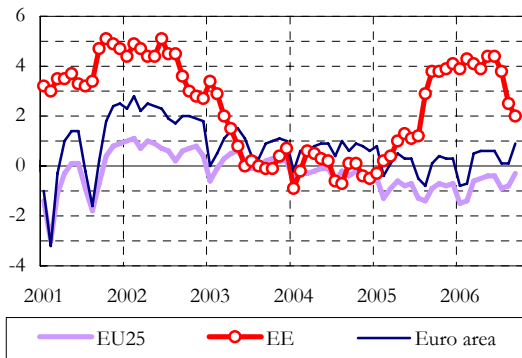
**A. Food and non-alcoholic beverages**



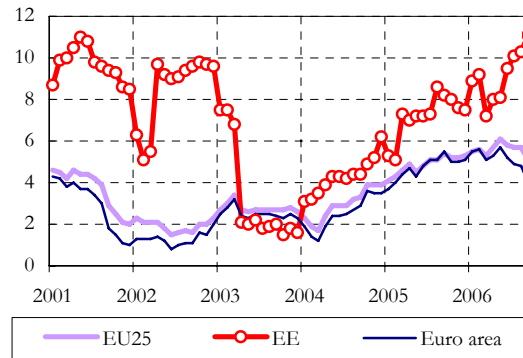
**B. Alcoholic beverages, tobacco etc**



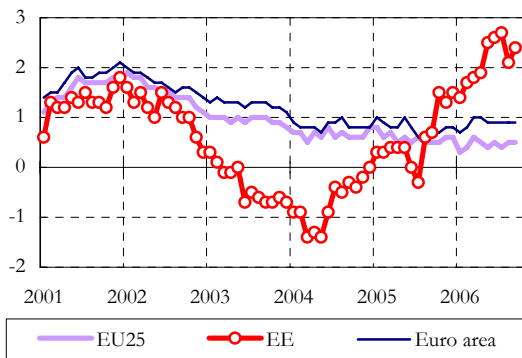
**C. Clothing and footwear**



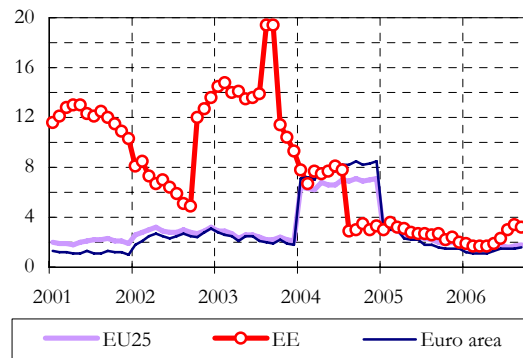
**D. Housing, water, electricity, gas etc**



**E. Furnishings, household equipment etc**

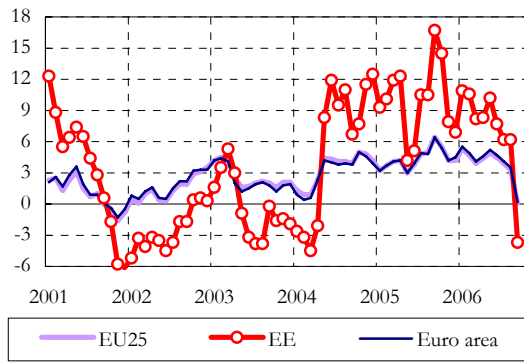


**F. Health**

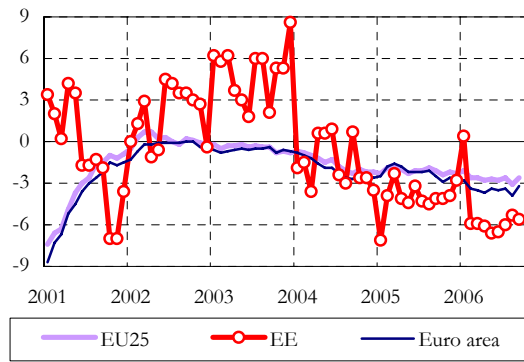




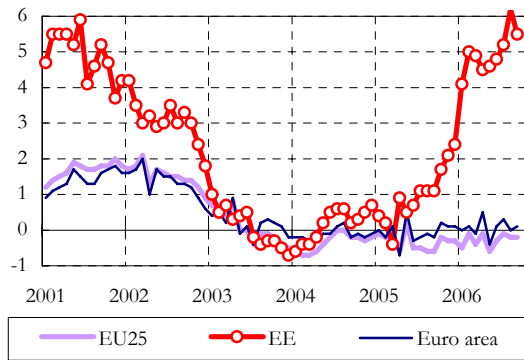
**G. Transport**



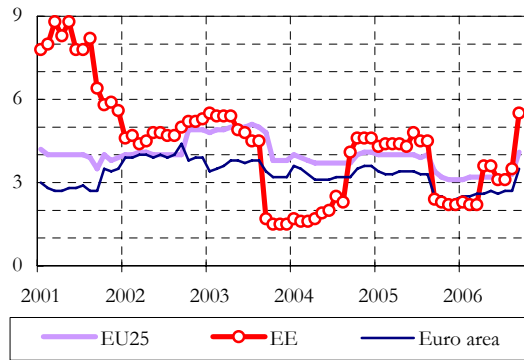
**H. Communications**



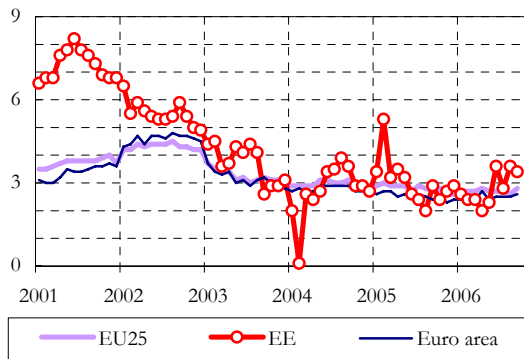
**I. Recreation and culture**



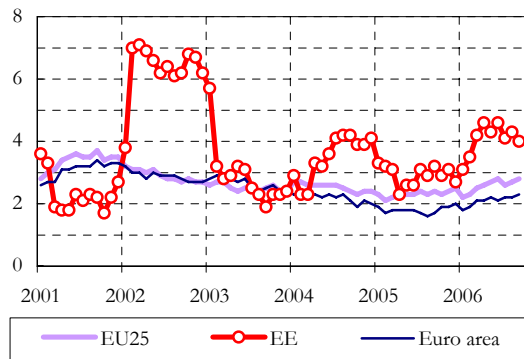
**J. Education**



**K. Restaurants and hotels**



**L. Miscellaneous goods and services**



Source: Eurostat.

**3. Impact of labour market developments on inflation**

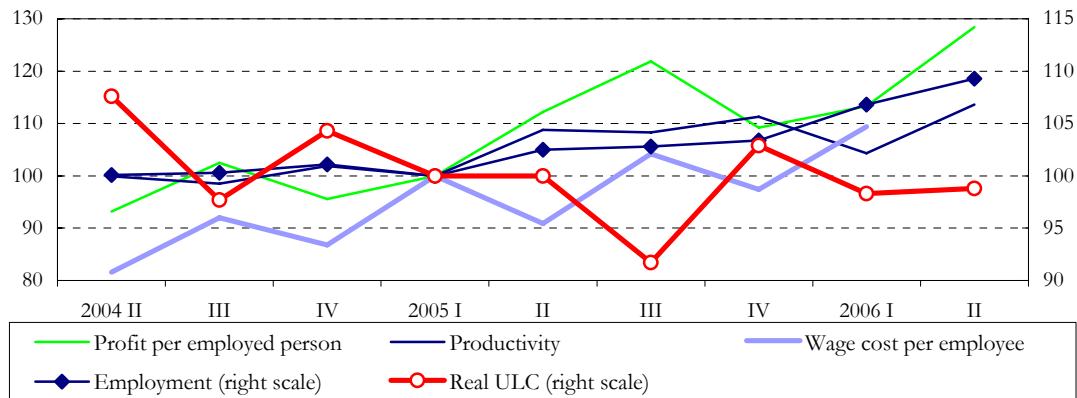
Strong growth of employment and wages has not had any direct impact on the inflation in H1 2006, because the profitability continues to rise and no signs of a slowdown can be observed yet. Looking at various economic sectors and their possible impact on the inflation, two activities need to be focused on in the first place: construction and tourism along with hotels and restaurants. The results of the analysis show that the strong rise of prices in construction can be attributed to a higher demand and therefore no pressure towards a rise in the prices is exerted by wages. The high demand in construction has arisen from favourable housing loan conditions. Also, in tourism the impact towards a rise in prices has been exerted by the increased demand and addition of hotel and restaurant services of a higher quality. In hotels and restaurants there has been no direct pressure

towards a rise in the prices by wages. There have also been no wage pressures in the industrial sector where the number of the employed is the highest.

**Figure 23**

**Employment and wage growth – influence on productivity and profitability**

(2005 I quarter = 100)



Sources: Statistical Office of Estonia, Eurostat.

#### 4. Risks

- The price of crude oil is very sensitive to negative news coming from oil refinery and production regions. In connection with the Iran crisis this spring and summer the price of oil hit new records. As a result of different positive news the price has fallen considerably by now. An increase in geopolitical pressures along with additional negative news would bring about a new rise in prices. Moreover, the rise in the oil supply may not keep up with the strong rise in oil demand. According to futures, the price of crude oil is expected to rise gradually to 65 USD/bbl by the middle of 2007. A further fall in the oil prices cannot be entirely precluded either.
- Housing prices like gas and heating. Gazprom's desire to harmonise gas prices with the Finnish level means a rise in prices in the coming years, although the strongest rise has already taken place. For companies this is expressed in a rise of input costs and it will eventually be reflected in consumer prices. The size of the price correction in the coming years and the possible timing are unknown. The prices of gas and shale oil are related to the price of oil, as a result of this oil price developments bring about corrections in gas and shale oil prices.
- Housing prices like rents and house repairs. The real estate boom has considerably increased rent prices and prices of house repairs, while the rise in the prices over this year has been accelerating. We expect the rise in housing prices to stabilise at a lower level over the next year and thus, a reduction of its impact on the CPI. However, there is a risk that the prices of rent and repairs may rise even more strongly than we expected. As of October 2006, their contribution to the CPI has already risen to 0.8 percentage points.
- The two-digit growth in private consumption due to a rise in income and a strong loan demand is increasingly reflecting in the growth of prices. The rising margins in trade refer to demand-side pressures and consumers easily accept the rise in prices. We expect the growth of consumption to moderate considerably in the coming years, but if the developments characteristic of 2006 continue, the demand-side pressures will remain stronger than expected.
- Rising labour costs. The labour deficit existing and increasing in different sectors and the outflow of labour force to foreign countries means rising wage pressures for corporations. Corporations are forced to raise wages in order to keep existing employees and attract new ones, which brings about a rise in the prices of the inputs and is thus expressed in higher

product and service prices. So far the impact has been modest, but according to the data of H1 2006 the risks have increased.

- Appearance of second-round effects. Owing to the flexibility of the Estonian economy no noticeable second-round effects have been observed, but they cannot be precluded in the future.
- As for the downside risks, the possible depreciation of the US dollar can be considered the most significant. This affects the prices of goods purchased in US dollars (e.g. industrial goods) and helps to alleviate the impact of high oil prices on the economy.

## **5. Summary**

- The factors on the supply side such as the rise in oil prices and the rise in food prices due to complicated weather conditions in summer, along with deepened factors on the demand side have not allowed headline inflation to slow down.
- The acceleration of the growth of income, robustly increasing loan volumes and optimistic future expectations of consumers have brought about demand-side inflation. The second factor is rising labour costs and cost pressures arising from the rise in energy prices, which will affect the price developments next year as well.
- Upside risks remain, because due to the unpredictable energy price developments on the one hand and the continuance of the consumption boom mainly on the account of the growth of debt burden on the other hand the inflation rate may increase more than expected.
- The developments of consumer prices in Estonia and the euro area by the components of the consumer basket have various common features, but the higher volatility of Estonian inflation is related to the aforementioned demand-side factors and continuance of the price convergence.
- Estonia's price level in comparison with the European average is low and continuance of rapid convergence means a higher increase in consumer prices over the medium term.