Republic of Estonia

STABILITY PROGRAMME 2011

Tallinn

April 2011

TABLE OF CONTENTS

INTRODUCTION **5**

1. OBJECTIVES OF THE ECONOMIC POLICY **6**

2. ESTONIAN ECONOMIC DEVELOPMENT AND PERSPECTIVES **8**

2.1. Recent economic developments 8

2.1.1. Macroeconomic situation 8

2.1.2. Estonian economy in the international context 12

2.2. Economic forecast 14

2.2.1. Macroeconomic forecast for 2011–2015 14

2.2.2. Forecast assumptions and comparison with economic forecasts of other institutions 18

2.3. Macroeconomic policy in the upcoming years 22

3. FISCAL FRAMEWORK **27**

3.1. Fiscal policy goals and budget priorities of the Government of the Republic 27

3.2. Budgetary position of the general government 29

3.2.1. Nominal budgetary position of the general government 29

3.2.2. Cyclically adjusted budgetary position of the general government 31

3.2.3. Structural position of the general government 33

3.3. Roles and budgetary positions of different levels of general government 34

3.4. Financing of the general government 39

3.4.1. General government debt 39

3.4.2. General government reserves 41

4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS PROGRAMME (CONVERGENCE PROGRAMME) **43**

4.1. Alternative scenarios and their effect on the budgetary position 43

4.1.1. Negative risk from the foreign environment 43

4.1.2. Positive risk – faster recovery of domestic demand 44

4.2. Comparison with the forecast of the Convergence Programme 46

5. IMPROVEMENT OF THE QUALITY OF PUBLIC FINANCES **49**

5.1. Forecast of expenditures and revenues of the general government until 2015 49

5.2. General government revenues 51

5.2.1. Structure of general government revenues 51

5.2.2. Future developments in tax policies 51

5.2.3. Tax expenditure 54

5.3. General government expenditures 57

5.3.1. Structure of general government expenditures 57

5.3.2. Main changes in expenditure policies influencing the budget for 2011 59

6. LONG-TERM SUSTAINABILITY OF THE PUBLIC FINANCES **61**

7. INSTITUTIONAL FUNCTIONS **65**

7.1. Development of the budgetary process 65

7.2. Fiscal rules and institutions 66

ANNEXES **69**
Annex 1. Main economic indicators of Estonia in 2001–2010 70
Annex 2. Comparison of Estonia with other EU Member States 73
Annex 3. Influence of administrative price growth on CPI 77

INTRODUCTION

According to the EU budgetary policy co-ordination rules the EU Member States shall present updated Stability and Convergence Programmes (correspondingly the members of the eurozone and the Member States that are not using euro) annually. Estonia as a full member of the Economic and Monetary Union (EMU) since 1 January 2011 presents its Stability Programme to the European Commission and the Council of the European Union for the first time. At the same time, the Stability Programme is essentially a continuation of the previously submitted Convergence Programme, the last update of which was approved by the Government of the Republic on 28 January, 2010. The purpose of the Stability Programme is to express the government policy in fulfilling the requirements of the Stability and Growth Pact. Assessment of the Stability and Convergence Programmes of the Member States by the European Commission and the Council of the European Union will take place in May and June of 2011.

Presentation and assessment of the Stability and Convergence Programmes is an important part of the European Semester of economic policy coordination and monitoring. In the framework of the European Semester, the Commission and the Council shall assess the Stability and Convergence Programmes before the Member States make the most important decisions in establishment of the next year's budget, in order to provide policy recommendations on fiscal policy intentions.

This year, four strategic documents of the Estonian government were prepared parallelly:

- State Budget Strategy 2012–2015;
- Stability Programme 2011;
- Government's Programme for 2011–2015 and its Implementation Plan; i.e. the Action Plan of the Government of the Republic;
- National Reform Programme "Estonia 2020".

Preparation of the documents is arranged uniformly and in substantive harmony.

Estonian fiscal policy is continually in concordance with the Stability and Growth Pact. The Stability Programme has been prepared based on the objectives of the Government and the policies for reaching these objectives stated in the Programme of the Coalition and other strategic documents. The Stability Programme 2011 is based on the 2011 Spring Economic Forecast of the Ministry of Finance.

The time horizon of the Stability Programme ends with 2015 as the Estonian State Budget Act requires from a budget strategy (the next financial year and the following three years). The document comprises of seven parts, presenting an overview of the objectives of the economic policy, economic developments of the previous years and the future outlooks, the fiscal framework, a comparison with the last Convergence Programme, improvement of the quality of the public finances, long-term sustainability of the public finances and the institutional functions.

1. OBJECTIVES OF THE ECONOMIC POLICY

The objective of the Government's economic policy is to create conditions for fast economic growth that brings about an increase in well-being and real convergence with the European Union. The precondition of stable economic development is ensuring macroeconomic stability and flexibility that supports internal and external balance. The pace of Estonia's real convergence has been rapid and we have steadily and quickly approached the European Union's average. The risks and imbalances increased during the period of rapid economic growth that was based on the inflow of credit have receded in the adjustment process during the crisis and thus decreased the further vulnerability of the economy. The steep recession in international economy and trade due to the global credit crisis had a significant impact on the open economy of Estonia which showed notable flexibility in handling these impacts. In this new economic situation, reliability of budgetary policy was maintained and its support to the economic development helped the country to emerge from the crisis. Increasing the flexibility of economy, supporting the business environment and enhancing functioning of the labour market has become the key for helping to ensure sustainable development of the economy.

One of the main objectives of fiscal policy is to support macroeconomic stability through flexibility and effectiveness of markets and to manage the risks endangering balanced development of the economy. This is especially important in ensuring effective functioning of the economy of the monetary union . In shaping the tax system and budgetary expenditure, their impact on the economic development needs to be taken into account in making changes. Also, long-term sustainability of public finances in the conditions of the ageing population has to be ensured. Ensuring stable economic environment, targeting budget funds to economic growth and improvement of employment, and ensuring long-term sustainability are the three fields that Estonia concentrates on in its economic policy of the upcoming years.

The objective of the Government is to continue with sustainable fiscal policy. The medium-term objective (MTO) is to maintain the budget surplus of the general government. Strict fiscal policy ensures the general government debt remains low, which is one of the preconditions for ensuring long-term stability of the state's economy.

Te priorities of the Government are:

- **Reaching the general government budgetary surplus**.
- **Positive growth of population** (Estonian nation should become a growing nation).
- **Increasing productivity to the level of 73% of the EU average** in 2015.
- **Achieving the pre-crisis employment level** in 2020. To achieve this it is planned to reach the employment level of 72% in the 20–64 age group in 2015.
- **Increase in healthy life expectancy** (57 years for men and 62 for women).
- Keeping the greenhouse gas emissions on the 2010 level (or below 20 million tons per year).

Figure 1

Real convergence with the EU (% of the EU27)

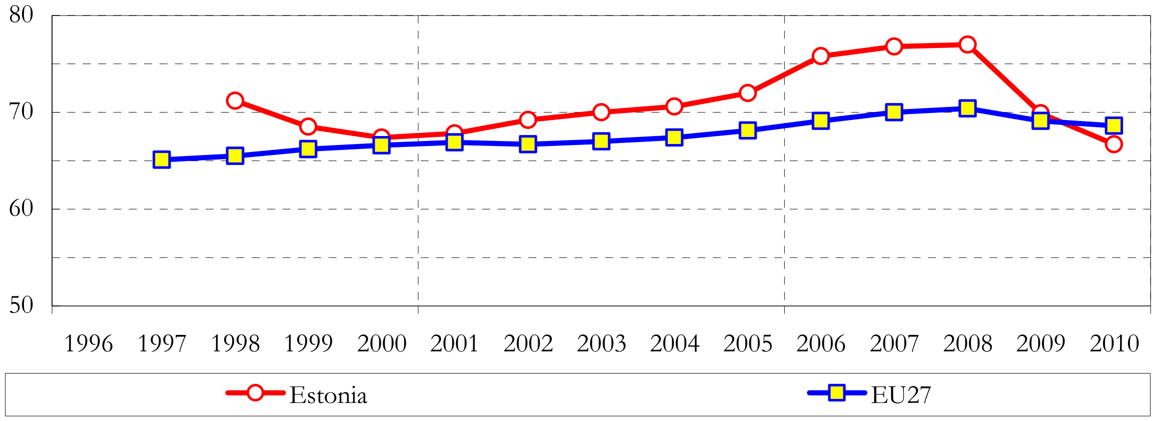
(per cent)

Source: Eurostat.

Figure 2

Employment in the age group of 20–64 years

(per cent)



Source: Eurostat.

2. ESTONIAN ECONOMIC DEVELOPMENT AND PERSPECTIVES

2.1. Recent economic developments

2.1.1. Macroeconomic situation

Estonian economy started to grow again in the second quarter of the last year and the GDP growth was 3.1% in 2010. The main growth engine was export that recovered quickly with the help of increasing foreign demand, contributing 14 percentage points to the growth of GDP. Domestic demand had a marginal growth (1%) and its ratio decreased to 90% of the GDP in current prices. Import grew together with export, but due to weak domestic demand the growth of import was slower than the one of export and the net export's contribution to the economic growth remained therefore positive although decreased to 1.7 percentage points compared to the previous year.

By economic sectors, the GDP growth of in 2010 was most influenced by the business sector, which value added increased by 5% compared to 2009. With the support of improving foreign demand, the work volumes increased in industry and in most of the servicing branches, bringing about an increase in sales revenues and restoration of profitability. Reduction of operational expenditures of businesses, most of all labour costs, had an important influence, increasing the efficiency and improving competitiveness. From the economic activities manufacturing contributed the most to the GDP growth – 2.6 percentage points. The value added increased due to increasing export in most fields of the manufacturing, but the growth was most influenced by the increase of value added in the manufacturing of computer, electronic and optical products (1.6 times). The GDP growth was also significantly influenced by the energy, real estate, renting and business activies, forestry, and transport and storage that improved its value added due to the concurrence of improvement in domestic and external demand. The value added of financial intermediation also grew quickly, being influenced mostly by the increase in revenues of banks from service charges and interest. The value added decreased the most in construction (10%) due to fall in construction volumes in the domestic construction market. Fall in the value added also continued in the activities with large proportion of the general government (public administration and defence, education, health and social work).

With the support of sizeable liquidity injections of major countries, the economic conditions started to improve rapidly and the trade volumes recovered quickly worldwide last year. It was a successful year also for Estonian exporting businesses. The growth in export increased in such an extent that the total export volumes of the year exceeded the pre-crisis level. Moreover, the growth was broad-based. First and foremost, strong demand by the most important trading partners was behind these developments, but also reorganisations made in the recession years that have increased productivity and improved profitability of businesses. The third important aspect was the effective use of the potential of Estonian electronics industry in the export chain through Sweden, being reflected well in the voluminous trade in communications equipment that started in the summer months of 2010 and reached its peak at the end of the year. From different product groups the export of electrical machinery and equipment, wood and articles of wood, metals, electronics and transport equipment can be highlighted. Export of textiles and chemical products showed more modest results. The export of goods and services at constant prices increased by 21.7% last year. When increase in the export of goods reached one third, then recovery of the export of services started in the second half of the year, wherefore the total growth indicator of the year was modest. Due to quick recovery of profitability of foreign investments, current account surplus decreased to 3.6% of GDP in 2010.

The keyword of 2010 was price increase of raw materials on international markets, increasing the level of prices in both Estonia and in the eurozone. Sizeable stimulus packeges by the major countries to support the economy, fast recovery of the developing countries after the crisis and the unfavourable weather conditions lead to significant rise in prices of raw materials last year. In addition, the consumer prices were influenced by the taxation measures to improve the budgetary position and the gradual recovering of the traders' marginal from the low level of the recession period. For these reasons, inflation accelerated throughout the year and the total annual rate was 3.0%. Due to increase in demand arising from the reasons mentioned above, the oil price increased by almost one third, whereas depreciation of euro had an additional effect on Estonia's consumer prices. Price increase pressures on services and industrial commodities that form more than half of the consumer basket remained modest last year.

Employment decreased by 4.2% or 25 thousand people last year. When the employment had decreased in the first half of 2010 rate in comparison with the previous year, it started to rise by 2.1% in the last quarter of the year, being the first rise since the second quarter of 2008. Fast recovery of the economy brought along a significant rise in labour demand. The largest contribution to this increase was by manufacturing in which the number of employees increased by 14.6 thousand people compared to the previous year. Since acceleration of the economic growth took place mainly because of increase of production volumes in the industry, the increase in employment was also mainly due to the increase in the number of employees in the industrial sector. Unemployment reached its peak in the first quarter of 2010, reaching 19.8%. This is the highest level of unemployment since restoration of Estonia's independence. In the second quarter of the year, downward trend began and by the fourth quarter, the number of the unemployed had decreased to 93.3 thousand people or to 13.6%. When in the first two quarters the unemployment decreased mostly due to fall in the number of people unemployed for less than a year, the fourth quarter saw a considerable decrease in the number of long-term unemployed (by 10.3 thousand people in comparison with the third quarter).

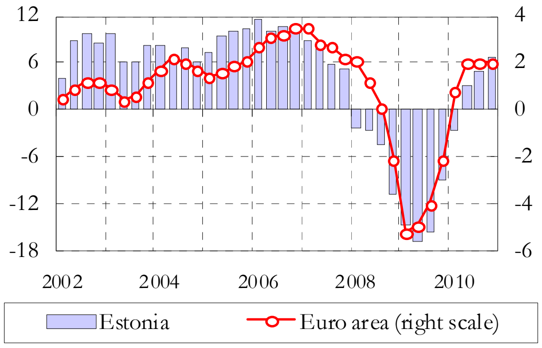
The average monthly gross wage fell by 5% during the crisis, but due to fast inflation, real wages will continue to decrease this year as well. The decrease in wages was caused by low demand and rapid growth of unemployment due to poor economic conditions. In the second quarter of 2010, decrease in wages was replaced by an increase and the average monthly gross wage grew by 1.2%. This was influenced by the improved economic conditions and significantly supported by an increase in remunerations in the exporting branches. The average wage continued to grow in the third quarter and accelerated to 3.9% in the fourth quarter. Acceleration in the wage growth was significantly influenced by recovery of irregular bonuses and additional remuneration that had considerably decreased during the crisis. Labour productivity started to grow again in the end of 2009. The real growth in the annual average labour productivity in 2010 was 7.6%. Many businesses had been forced to make its operations more effective during the crisis, wherefore the processes have been reorganised and less employees are used in production. As a result of this, the imbalances occurred during the domestic demand boom have decreased, and the growth in labour productivity exceeds the growth in the average wages and helps to reduce their dissonance. However, it needs to be noted that the growths in labour productivity and the average wages started to level in the last quarter of the year.

Figure 3

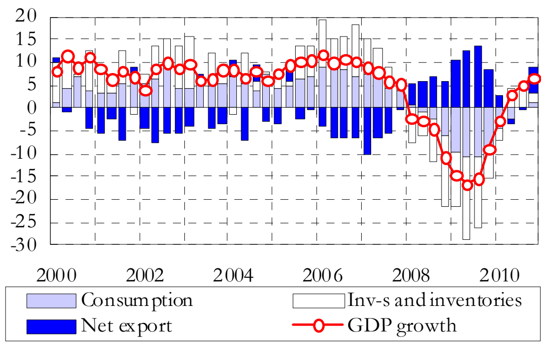
Developments in the main indicators of Estonian economy

(per cent)

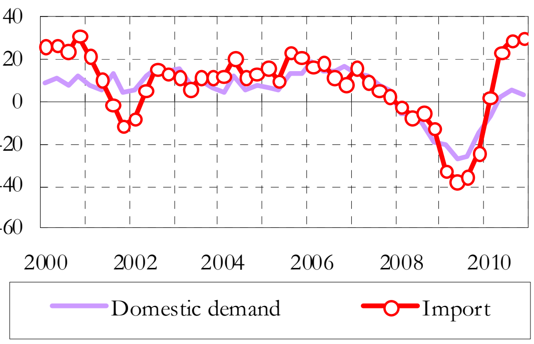
A. Economic growth in Estonia and the eurozone



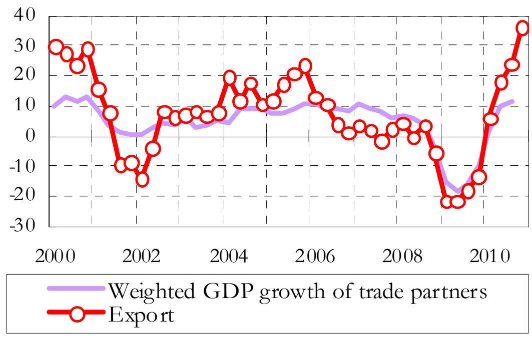
B. Contribution to the economic growth



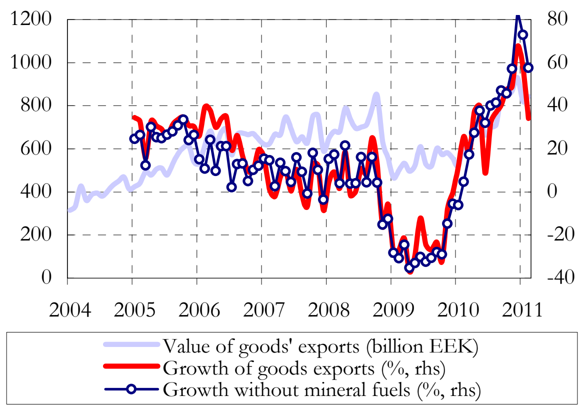
C. Real growth in domestic demand and import



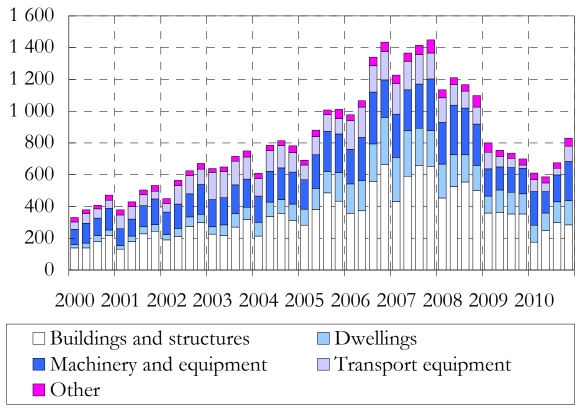
D. Real growth in export



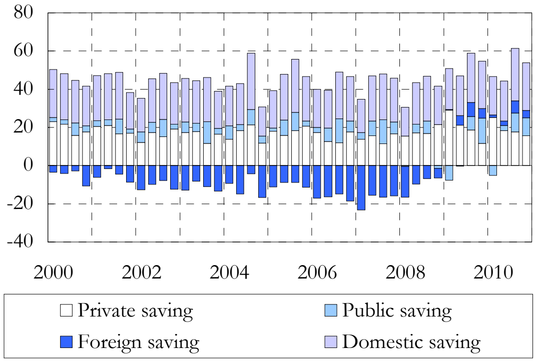
E. Volumes and growths of the export of goods



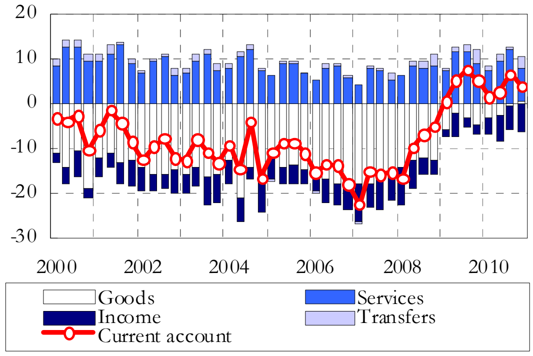
F. Investment structure (million EUR)



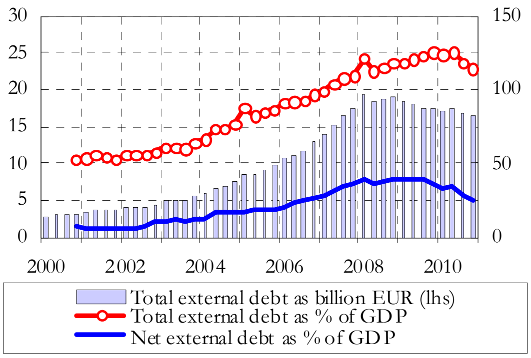
G. Savings rate (% of GDP)



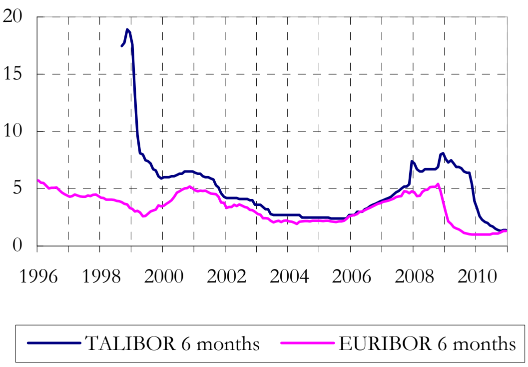
H. Current account structure (% of GDP)



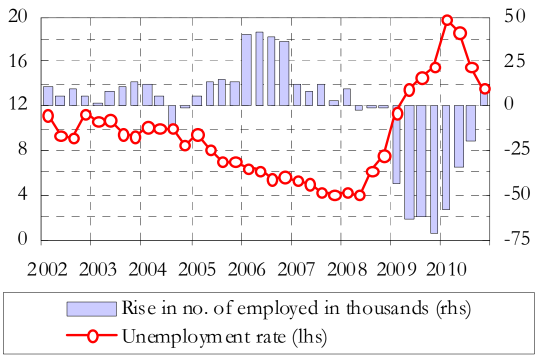
I. Gross and net external debt



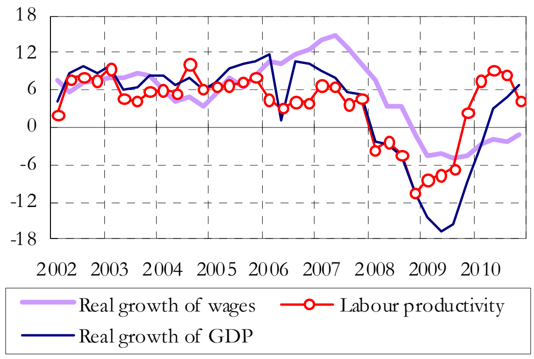
J. Interests



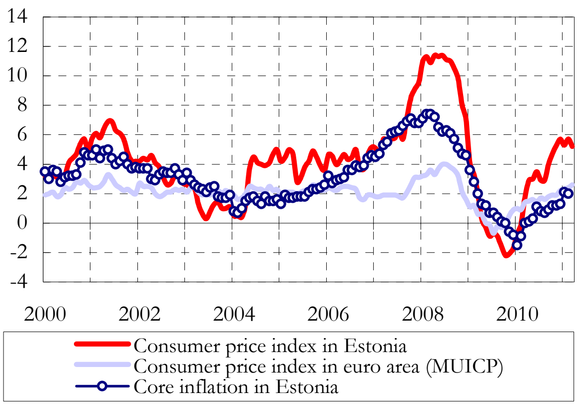
K. Employment and unemployment



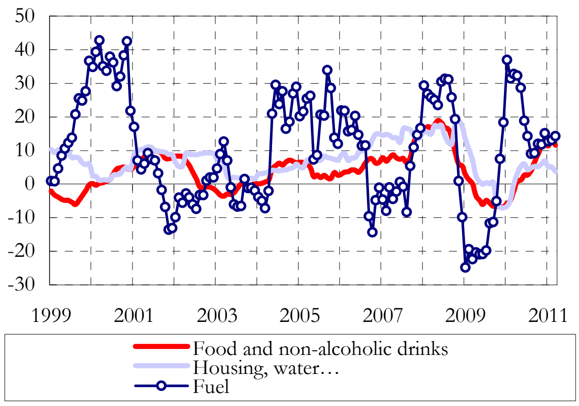
L. Labour productivity



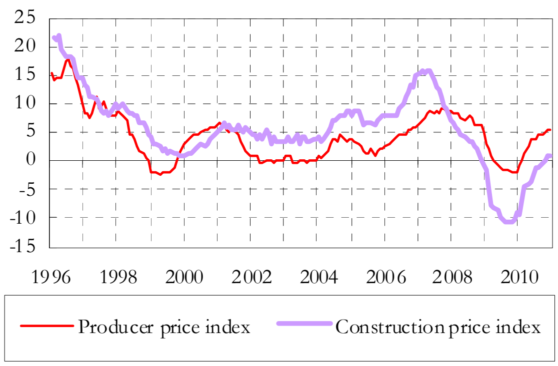
M. Consumer price index in Estonia and euro area



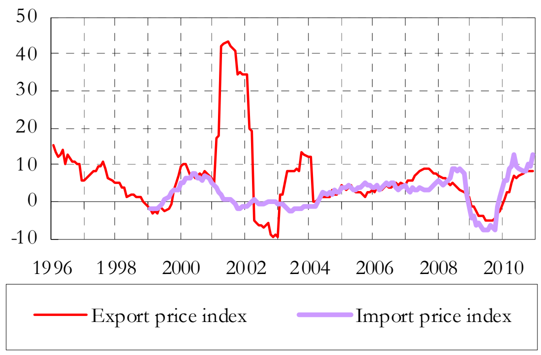
N. Change in the main inflation drivers



O. Production and construction price index



P. Export and import price index



Source: Statistics Estonia, Bank of Estonia, Eurostat.

2.1.2. Estonian economy in the international context

The rating agencies raised Estonia's ratings again to the highest level of all times in 2010. During the crisis, Moody's never lowered Estonia's rating A1 and restored the stable outlook in March 2010. Both Standard & Poor's and Fitch lowered their ratings in 2009, but in the summer of 2010 when adoption of euro in Estonia became final, they restored their pre-crisis ratings at the level A with a stable outlook. In addition to decreased risk of the exchange rate it was noted that Estonia has consistently demonstrated flexibility in economy, government public finances and labour market that is necessary for coping with the conditions of the monetary union.

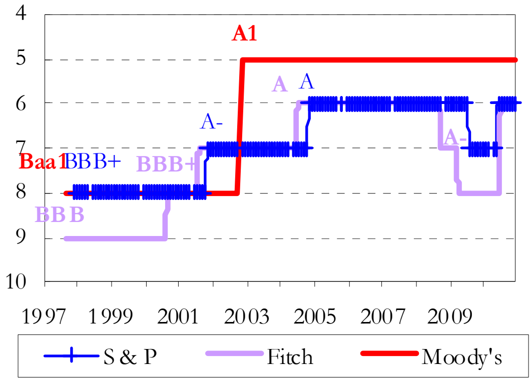
Estonia continually holds high places in the international economic freedom and competitiveness charts (see Figure 4B). The report of the Fraser Institute from April 2011 brings out flexibility and openness as the main principles of Estonian economic policy. Balanced fiscal policy and liberal trade and investment legislation has been implemented by different governments. Estonia is surpassed only by Ireland, Denmark and Luxembourg among the EU countries. According to the IMD's World Competitiveness Yearbook 2010, Estonia ranks as 34th among the world's countries in competitiveness. Among other things, this chart takes into account the wealth of the country which does not enable Estonia to obtain a better position. From the new EU Member States, Estonia is surpassed only by Czech Republic and Poland, while Portugal and Spain as the old Member States are left behind.

In the years 2001–2007, until the crisis began, the average annual growth of Estonia was 8.2%, being only surpassed by Latvia in the EU. Estonian GDP *per capita* (PPS) converged to 69% of the EU average by 2007. The EU's deepest economic recession next to Latvia took this indicator to 64% by 2009 (in Latvia, this was 52% and in Lithuania, 55%). The level of prices in the last five years has increased the most in Latvia, but the consumer prices grew the most in Estonia in 2010 (CPI 2.7%).

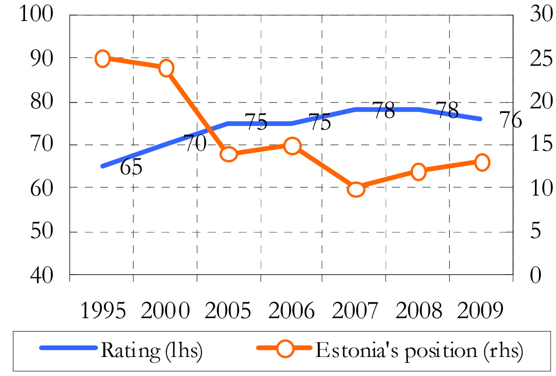
Figure 4

International evaluation to Estonian development and Estonian economy in international comparison

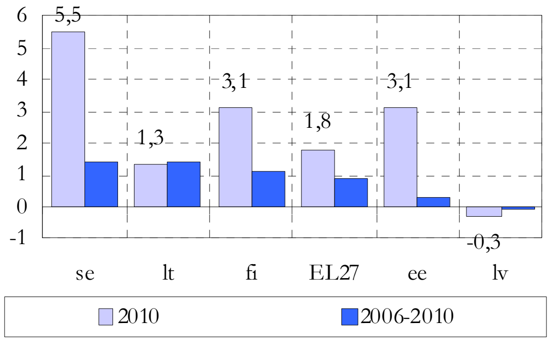
A. Dynamics of Estonian ratings



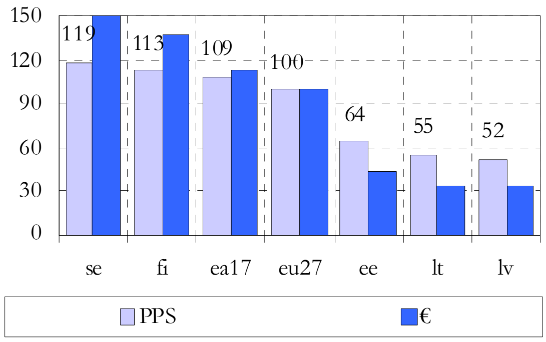
B. Index of Economic Freedom (Fraser Inst.)



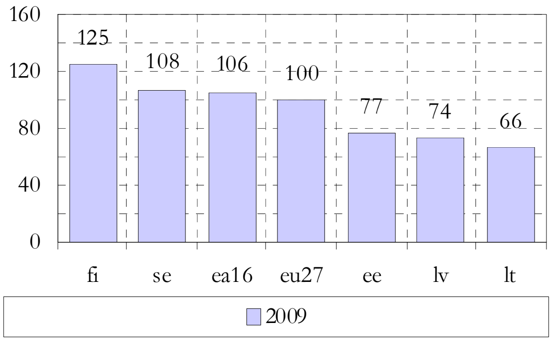
C. Economic growth (%)



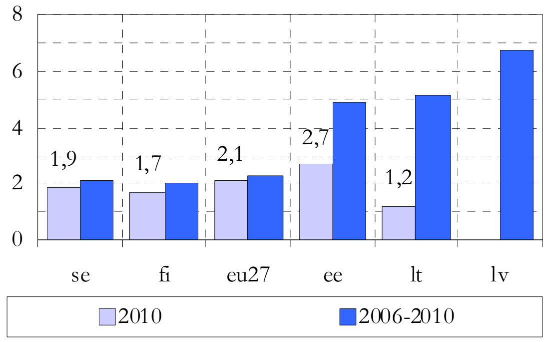
D. GDP *per capita* 2009 (PPS and €)



E. Price levels, 2009 (%), EU27=100



F. HICP in 2010 and 2006–2010 (%)



Source: Statistics Estonia, Eurostat, Standard & Poor's, Fitch Ratings, Moody's, Fraser Institute.

2.2. Economic forecast

2.2.1. Macroeconomic forecast for 2011–2015

Estonia's recovery from the crisis has been faster than expected. The export sector that leads the growth benefits from high external demand and improved competitiveness that derives from reorganisations and expenditure cuts in businesses to increase productivity. Increase in confidence of economic agents has benefitted from recovery of domestic demand, gradually increasing the ratio of consumption and investment volumes in economic growth.

Recovery of **global economy** from the crisis has turned out to be stronger than expected, but it takes place at different speeds in different regions. The Ministry of Finance expects the GDP growth of the European Union to be 1.8% this year, reflecting the improved outlook of foreign environment and stronger confidence. The rapid rise in the prices of raw material and energy in the last months has brought about acceleration of inflation in the eurozone. Both short- and long-term interest rates are continually on a lower level than in the years before the crisis. Considering the latest events in Northern-Africa and the Middle-East, the largest oil production region of the world, oil prices are expected to continue rising. With the increase in economic activity, acceleration of economic growth of Estonian trading partners is also to be expected. We expect the weighted average economic growth of our trading partners in 2011 to be 2.7% and in 2012, 2.5%.

The growth of **Estonian economy** reached 3.1% in 2010. According to this forecast, economy will grow 4% in both 2011 and 2012. The Ministry of Finance has revised this year's economic growth forecast upwards; the main reason for this is improvement of the growth outlooks of Estonia's main trading partners, bringing along upward revision of the export forecast. The main growth engine of economy is still export, bringing along improvement in economic confidence and gradual recovery of domestic demand. In 2012, there should be bigger contribution of domestic demand to economic growth, primarily due to significant acceleration of growth in private consumption and investments. The export and import growths will slow down and due to strong domestic demand; import will grow a bit faster than export. In 2013–2015, Estonian economy should grow on average of 3.5% a year. In addition to export, the growth in GDP will be supported by an increase in the stability of domestic demand.

Due to strong external demand and reorganisations taking place in businesses, the export volumes exceeded the pre-crisis level last year. In 2011, an increase of 15.9% may be expected in the **export of goods and services**; then the growth will slow down to 5.5% in 2012, and accelerate again in 2013 to 7.1%. Raised forecasts of the main trading partners, also the continuation of fast growth in the export of electrical machinery and equipment, mostly consisting of communication devices, are behind the strong export developments of 2011. In addition, larger growth may be expected in the export of wood and articles of wood, upholstered furniture, chemical and metal products and agricultural products. Slowing growth rate in 2012 is largely related to the impact of the rapid post-crisis recovery and the end of the impact of an increase in orders in subsection of communication devices. From 2013, the growth in export stabilises at 7%, being in line with the developments of the main export markets. Due to increasing import of the inputs and raw material for export products, rapid growth in **import** may also be expected this year (16.3%), whereas due to revival of domestic demand, the growth of import would surpass the growth of export.

Current account surplus reaches 2.5% of GDP in the current year and turns to deficit in 2013. In the upcoming years, the revenue account will be the main influencer of external balance. Due to good profitability of foreign investments the revenue balance will worsen, reducing the current account surplus. Growth in the inflow of external financing via capital account will be supported by an increase in external resources and the sales of greenhouse gas emission allowances this year.

Domestic demand grew 1% in 2010, somewhat exceeding the expectations of the MoF summer forecast. The drop in the largest component of domestic demand, private consumption, was less than expected (the actual drop was -1.9%, the summer forecast was -3.3%), but the drop in investments turned out to be deeper and the rate of public sector expenditure also remained a bit lower than expected. Although all three components of domestic demand were dropping in the annual comparison, powerful recovery of the assets of businesses turned the domestic demand to growth as a summary.

When in the years of rapid growth the savings rate of Estonian households was negative, then by 2009, the consumer behaviour of the population had changed radically and the savings rate increased to the average rate of the EU, contributing the rapid drop in private consumption. In 2010, private consumption was influenced positively by a turn in population's savings behaviour in the beginning of the year when the drop in consumption expenditure remained lower than the reduction of income. In addition, both wages and employment turned to growth in the end of the year. In the end of the year, increase in consumption expenditure clearly exceeded the raise in income from employment and social transfers, and this trend is expected to continue in the upcoming years. The real growth of private consumption is estimated to be 2.2% in 2011 due to high inflation, and 4.5% in the following years. The growth of consumption in the public sector remains lower than the economic growth throughout the forecast period.

The investment behaviour of both businesses and households is more sensitive to economic conjuncture than the consumer behaviour. Therefore, the level of investments had dropped approximately two times from its peak by the third quarter of 2010. Recovery of business investments presumes confidence in continuation of demand in the long run, recovery of profitability of businesses, improvement in the ratio between assets and obligations, exhaustion of the current production capacities and the support of the financial sector. By now, the new order indicators are at a relatively good state, business profits have considerably increased and the production capacities are about to exhaust in certain exporting fields. The risk margins of business loans are still relatively high.

We expect the growth of investment (gross fixed capital formation) in 2011 to be 8% which should initially mainly come from investments of the businesses to machinery and equipment. Recovery of housing investments will be slower. The investments will continue to grow faster than GDP and the investment structure should become broad-based. The rate of investments to GDP will start to grow, but still remains lower than the pre-boom level until the end of the forecast period.

Consumer prices will rise in 2011 by 4.5%, in 2012 by 2.8% and in 2013 by 3%. Due to external pressure for increase of prices, the inflation will start to accelerate this year. The world market prices of food and fuel are high and it has transferred quickly to the local retail prices. Food is estimated to account for half of the 4.5% inflation in 2011. However, the increase in the prices of services, which form most of the consumption basket, is modest since unemployment rate is high and private consumption still weak regardless of some recovery. The effect of the state's taxation measures to the prices will be significantly more modest from this year on, since the impact of tax changes implemented during the recession period for improving the budgetary position falls out of the calculation. Slowdown of inflation in 2012 could be expected mainly due to the expected stabilisation of the world market prices. Because of opening of the electric market in the beginning of 2013, the growth of consumer prices will temporarily accelerate. The growth in consumer prices will slow down somewhat in the last years of the forecast period, but remains still a bit higher in comparison with the eurozone due to the continuing convergence of the income and price levels.

Fast economic recovery has brought along considerable increase in demand for labour with businesses having the increasing need for new employees as the speed of economic growth accelerates and the work volumes increase. In total, the **number of employed persons** is expected to increase in 2011 in comparison with 2010 by approximately 12 thousand people or 2.2 per cent. The employment growth will slow down somewhat in 2012, reaching 1.9%. As the efficiency of labour increases, unemployment will decrease to 13.5% in 2011 and 11.4% in 2012. By the end of the forecast period the unemployment rate will decrease to 8%.

Moderate **increase in average wages** will continue this year as a result of the increased employment and improvement of the financial situation of businesses, reaching 3.5%. Economic recovery from the crisis has not yet ended and as long as the domestic demand stays low, no general rapid increase in wages can be expected. An important precondition for increasing the wages is that the businesses would have recovered from the crisis and the profitability that fell significantly during the crisis would be growing, since businesses alleviated the drop in labour market at the expense of profits. The average wages will grow by 4.2% in 2012 and it will accelerate to 5.2% by the end of the forecast period.

Table 1

Gross domestic product forecast for 2011–2015

(per cent)

	2010	2010	2011*	2012*	2013*	2014*	2015*
	mln EUR	*%*	*%*	*%*	*%*	*%*	*%*
1. Real GDP	8,988.9	3.1	4.0	4.0	3.6	3.6	3.4
2. Nominal GDP	14,500.9	4.6	8.0	7.1	6.9	6.4	6.3
Sources of growth							
3. Private consumption expenditure (incl. non-profit institutions)	7,197.0	-1.9	2.2	4.5	4.4	4.6	4.6
4. Government consumption expenditure	2,987.4	-2.1	0.0	1.0	1.0	2.7	3.3
5. Gross fixed capital formation	2,703.1	-9.1	7.9	8.2	7.7	7.1	6.6
6. Change in inventories (% of GDP)	193.4	1.3	2.0	2.1	2.2	2.1	2.0
7. Export of goods and services	11,349.4	21.7	15.9	5.5	7.1	6.8	6.8
8. Import of goods and services	10,380.6	21.0	16.3	6.0	8.0	7.9	8.0
Contribution to GDP growth [1)]							
9. Domestic demand (excl. inventories)		-3.5	2.6	4.0	4.0	4.3	4.4
10. Change in inventories		4.4	0.5	-0.1	-0.1	-0.3	-0.3
11. External balance of goods and services		1.6	0.9	0.0	-0.3	-0.5	-0.7
Growth of value added							
12. Primary sector	441.4	7.3	2.2	1.9	2.1	2.0	1.8
13. Industry	2,879.6	19.2	11.0	5.3	4.3	4.1	4.0
14. Construction	722.9	-10.1	5.0	8.6	5.2	4.3	3.8
15. Other services	8,647.9	1.6	1.6	3.4	3.3	3.3	3.3

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 slight difference is a statistical error – the part of GDP that could not be divided between the fields).
Source: Ministry of Finance, Statistics Estonia.

Table 2

Price forecast 2011–2015

(per cent)

	2010	2010	2011*	2012*	2013*	2014*	2015*
	2000= 100	*%*	*%*	*%*	*%*	*%*	*%*
1. GDP deflator	161.3	1.5	3.8	3.0	3.1	2.8	2.7
2. Private consumption deflator	146.2	2.1	3.7	2.4	2.5	2.3	2.3
3. Harmonised index of consumer prices		2.7	4.5	2.8	3.0	2.8	2.7
3a. Consumer price index	150.5	3.0	4.5	2.8	3.0	2.8	2.7
4. Government consumption expenditure deflator	207.3	0.1	2.1	2.2	3.7	3.5	2.9
5. Investment deflator	129.1	-0.5	8.5	4.3	2.8	3.0	2.8
6. Export deflator	139.8	4.1	3.6	2.1	2.1	2.0	2.0
7. Import deflator	127.1	5.7	4.2	2.0	2.0	2.1	2.0

Source: Ministry of Finance, Statistics Estonia.

Table 3

Labour market forecast for 2011–2015 (persons aged 15–74)

(per cent)

	2010	2010	2011*	2012*	2013*	2014*	2015*
		%	*%*	*%*	*%*	*%*	*%*
1. Employment, persons	570.9 [1)]	-4,2	2,2	1,9	1,1	0,9	0,8
3. Unemployment rate		16,9	13,5	11,4	10,0	8,8	8,0
4. Labour productivity, persons	15.7	7,6	1,8	2,1	2,5	2,6	2,6
6. Compensation of employees	6780.6 [2)]	-4,2	7,2	6,4	6,3	6,2	6,3
7. Compensation per employees (6./1.)	11.9 [3)]	-1,0	5,0	4,5	5,2	5,2	5,4

Source: Ministry of Finance, Statistics Estonia.

Table 4

Balance of payments forecast for 2011–2015

(% of GDP)

	2010	2011*	2012*	2013*	2014*	2015*
1. Net lending/borrowing vis-à-vis the rest of the world	6,8	6,4	4,8	2,2	0,0	-1,8
1a. Current account	3,6	2,5	1,3	-0,1	-1,7	-3,1
Of which: - Balance of goods and services	7,6	7,9	7,7	7,3	6,5	5,7
- Balance of primary incomes and transfers	-4,0	-5,3	-6,3	-7,4	-8,3	-8,9
- Capital account	3,3	3,9	3,5	2,3	1,7	1,4
4. Statistical discrepancy	-0,4					

Source: Ministry of Finance, Bank of Estonia, Statistics Estonia.

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

Recovery of global economy from the crisis has turned out to be stronger than expected, but it takes place at different speeds in different regions. Economy of the European Union will grow 1.8% this year, reflecting the improved outlook of the foreign environment and stronger confidence. Short-term interest rates remain at a lower level compared to the pre-crisis period. Nevertheless, beginning of the rising trend in the base interest rates aimed at controlling the accelerating inflation is expected soon. The common external assumptions of the Commission are higher than the ones of the Ministry of Finance for both short- and long-term interest rates. The exchange rate of the U.S. dollar against the euro strengthened last year due to faster recovery of the U.S. economy. The depreciation of the euro was caused by the problems occurred in relation to the debt crisis in the eurozone that rocked the stability and undermined the confidence that euro would hold out. Ministry of Finance expects the exchange rate of the U.S. dollar to fall against the euro a bit and remain on the same level in the upcoming year.

Considering the latest events in Northern-Africa and the Middle-East, the largest oil production region of the world, oil prices are expected to continue rising. The continuing growth of the world economy brings along an increase in demand and therefore influences the oil prices which are set for 2011 at the level of 105 USD/brl and for 2012, 108.2 USD/brl in the spring economic forecast of the Ministry of Finance. The common external assumptionson the oil price are higher for both 2011 and 2012, which means a marginally greater expectancy of inflation for 2011 compared to the forecast of the Ministry of Finance. With the increase in economic activity, acceleration of economic growth of Estonian trading partners is also to be expected. We expect the weighted average growth of our trading partners to be 2.7% in 2011 and 2.5% in 2012.

Table 5

The most important foreign preconditions of the forecast
(per cent)

	Preconditions in the Ministry of Finance's spring forecast of 2011							Commission spring 2011		
	2009	2010	2011	2012	2013	2014	2015	2010	2011	2012
1. Euribor, 3 months (annual average)	1.2	0.8	1.3	1.7	2.2	2.7	3.0	0.8	1.6	2.6
2. Long-term interest rate of the euro area (annual average)	2.7	2.7	3.2	3.4	3.6	3.8	3.8	2.7	3.4	3.7
3. EUR / USD exchange rate (annual average)	0.71	0.75	0.74	0.74	0.74	0.74	0.74	0.75	0.71	0.71
4. EEK / EUR exchange rate (annual average)	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6
5. Global economic growth (without EU27)	-0.8	5.6	4.5	4.6	4.7	4.8	4.8	5.6	4.6	4.7
6. EU27 GDP growth	-4.2	1.8	1.8	2.0	2.2	2.3	2.3	1.8	1.8	2.0
7. Growth of export markets of Estonia	-6.0	2.2	2.7	2.5	2.6	2.7	2.7		-	
8. Global import growth (without EU27)	-13.8	13.0	8.5	8.0	7.5	7.5	7.0	13.0	8.3	7.9
9. Oil price (Brent, USD/barrel)		79.6	105.0	108.2	111.4	114.7	118.2	80.2	112.8	112.0

Sources: the historic data comes from Eurostat, Bank of Estonia, the U.S. Energy Information Administration (EIA); the forecasts are based, when possible, on the futures of the ***Consensus Economics*** *(CF) and NYMEX Brent that have been corrected in correspondence with the latest developments and the expert opinions of the Ministry of Finance (MoF).*

Below, the most important differences between the Spring Economic Forecast of 2011 of the Ministry of Finance and the latest publicly known growth expectations of the other institutions preparing macro-economic forecasts have been brought out. In comparing these, it needs to be taken into consideration that the forecasts have been made at different times and therefore on the basis of different information that brings about differences in the forecasts assumptions and results.

The remarkable recovering ability of Estonian economy presents a challenge for the forecasters to keep the pace with upward revisions of their growth expectations, but the last year's experience demonstrated that economic development is able to show more positive results than expected. Therefore, by the time the Spring Economic Forecast of the Ministry of Finance is published, many institutions have still not been able to bring their forecasts in line with the actual developments at the end of the previous year.

The export and industrial production growth rates reaching tens of per cents are no surprise to anyone any more, but such growth cannot last long. Although there may be no consensus in the long-term export growth rates, the forecasters agree with lasting competitiveness and that export will be a more important growth factor now than before the crisis

Ministry of Finance's view on domestic demand developments retains a more conservative position in comparison with the other institutions. On one side, it is based on the conservative credit policy of commercial banks and cautiousness of consumers and businesses that hinders loan demand. On the other hand, it has to be stated that although the need for increase in production capacity is clearly existent, no great leap in the investment volumes have taken place and even the modest growth expectations of the Ministry of Finance have not taken place. Therefore, we have left more optimistic development possibilities of domestic demand to the risk scenarios.

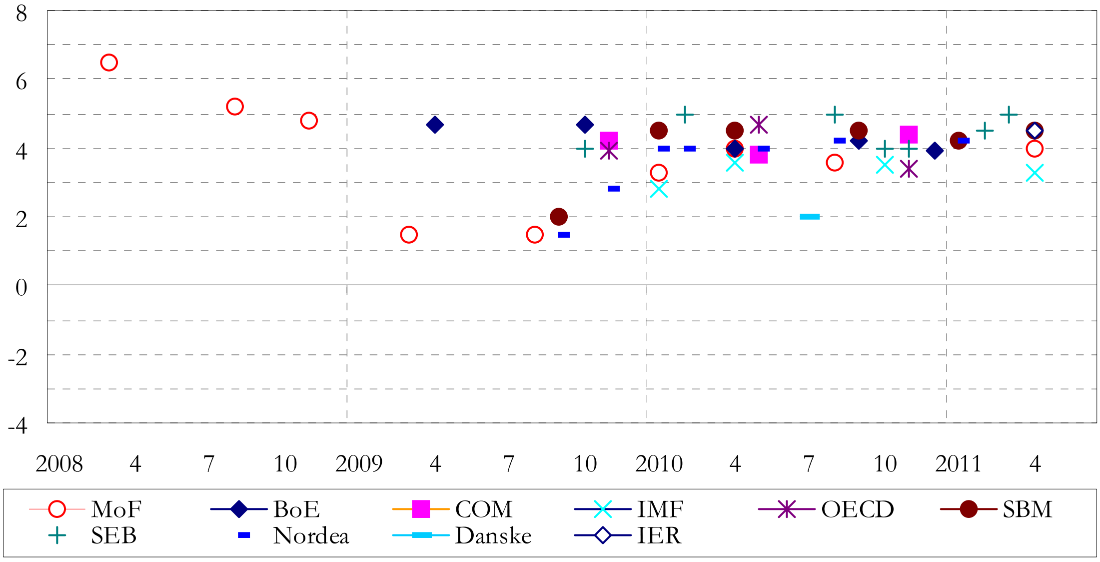
The accelerated speed of inflation is seen caused by mostly foreign factors (food, energy), the volatility of which makes production of valid forecasts harder. As to the food prices, at least stabilisation is expected, although the better weather conditions compared to the last year may also bring about a fall in the world market prices. At the same time, no change of prices means going back in the pace of inflation which is the main cause of slowdown of the consumer prices in 2012. As the only exception, SEB may be brought out with its forecasts of continuing acceleration of inflation in the next year, although the difference probably lies also in discrepancies in domestic demand and credit developments.

Figure 5

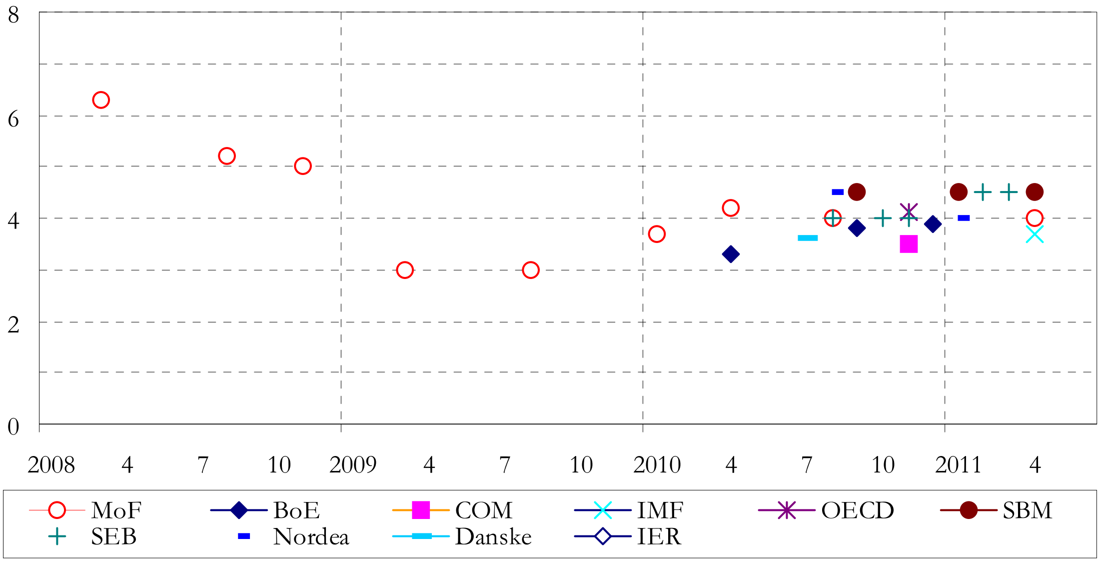
Change in Estonian economic forecasts

(per cent)

A. Estonian economic growth forecasts for 2011 by the time of publication of the forecast



B. Estonian economic growth forecasts for 2012 by the time of publication of the forecast



Sources: Ministry of Defence, Bank of Estonia, European Commission, IMF, OECD, Swedbank, SEB, Nordea, Danske Markets, Institute of Economic Research, Statistics Estonia.

Table 6

Comparison of economic forecasts

	Real GDP growth, %			Nominal GDP growth, %		
	2011	2012	2013	2011	2012	2013
Ministry of Finance	4.0	4.0	3.6	8.0	7.1	6.9
European Commission	4.4	3.5	–	7.2	5.8	–
IMF	3.3	3.7	–	–	–	–
OECD	3.4	4.1	–	5.3	6.2	–
Bank of Estonia	3.9	3.9	–	*6.0*	*6.7*	–
Estonian Institute of Economic Research	4.5	–	–	–	–	–
SEB	5.0	4.5	–	–	–	–
Swedbank	4.5	4.5	–	9.7	8.2	–
Danske	2.0	3.6	–	–	–	–
Nordea	4.2	4.0	–	7.6	6.5	–

	Consumer price index, %			Current account, % of GDP		
	2011	2012	2013	2011	2012	2013
Ministry of Finance	4.5 (4.5*)	2.8 (2.8*)	3.0 (3.0*)	2.5 (7.4**)	1.3 (4.9**)	-0.1 (2.9**)
European Commission	3.6*	2.3*	–	1.4 (5.4**)	0.9 (4.6**)	–
IMF	4.7	2.1	–	3.3	3.1	–
OECD	3.4	2.5	–	–	–	–
Bank of Estonia	3.5*	1.8*	–	*-2.6 (0.7**)*	*-2.8 (0.5**)*	–
Institute of Economic Research	4.0	–	–	–	–	–
SEB	4.0*	5.0*	–	2.0	1.0	–
Swedbank	3.8	3.2	–	5.7**	4.9**	–
Danske	3.3	2.7	–	-1.3	-5.2	–
Nordea	3.6	2.5	–	0.8	0.1	–

**Harmonised index of consumer prices.*
*** Current and capital account.*
Sources:
Spring Economic Forecast of the Ministry of Finance 2011. 11.04.2011.
European Commission. European Economic Forecast. Autumn 2010. 29.11.2010.
IMF. World Economic Outlook. April 2011. 11.04.2011.
OECD Economic Outlook No. 88, November 2010. 18.11.2010.
Bank of Estonia. Overview of the Estonian economy and financial sector. 20 December 2010.
Institute of Economic Research. Economic Situation No. 1 (176) 2011. 06.04.2011.
SEB. Eastern European Outlook. March 2011. 23.03.2011.
Swedbank. Estonian Economy. 07.04.2011.
Danske Markets. Macro monitor. Estonia. 21.07.2010.
Nordea Markets. Economic Outlook. January 2011. 19.01.2011.

2.3. Macroeconomic policy in the upcoming years

Ensuring macroeconomic stability

The main objective of the macroeconomic policy of the Government of the Republic is to ensure macroeconomic stability and domestic and external balance. The imbalances and risks emerging in the period of rapid economic growth exceeding the potential in the years of 2005–2007 have decreased quickly as the economic cycle turned. Future economic policy has to decrease the possibilities of such risks for emerge in the new growth phase and to use the current period to increase the economic competitiveness.

Estonian economy has shown significant flexibility in both the private and the public sector during the recession. During the recession the government has been able to keep the budget within the limits set by the Treaty on European Union, creating a good starting point for the state as the economic growth recovers, since as a result of the crisis the general government debt has not increased considerably and most of the measures for improving the budgetary position have a long-term effect.

Due to fall in economic activity, collection of tax revenues dropped drastically, putting the budget into tense situation and making it more difficult to meet the criteria set for the public finances in order to avoid excessive deficit. In 2009, the government adopted several measures for improving the budgetary position and thus the budget deficit was managed to be kept firmly below 3% of GDP. The budget of 2010 was also prepared in a way that the deficit limit of 3% of GDP not be exceeded, wherefore as a result of the faster economic recovery and one-off measures the nominally balanced general government budgetary position (+0.1% of GDP) was reached.

Adoption of the European single currency euro set as an objective in the Government Convergence Programme 2010 and joining the eurozone on 1 January 2011 was reached successfully, creating an advantage for recovering from the economic crisis as soon as possible. Drop in confidence and increase in the risk of devaluation under the conditions of recession was one of the most important problems in the uncertain situation of the crisis. Currently, Estonia clearly stands out from the other Middle- and Eastern-European countries with its well-functioning budgetary policy. The decision of not relaxing the budgetary policy in the conditions of the crisis may be considered correct since controlling of deficit in the budget and the level of debt, as well as adoption of the European single currency euro offers more certainty and stabilises the economic environment more than additional fiscal stimulus. The experience of Estonia and other countries showed that in general, increasing deficits in the budgets of the developing countries was taken more strictly than in the case of developed major countries and lowering of the ratings and increasing of the risk premiums rendered the economic situation more difficult. The messages of the government on preservation of the conservative fiscal policy and the positive euro decision has increased the confidence of economic agents that has had a positive impact on the rebound of economy after the crisis.

Estonian economic policy so far has been focussed on flexibility and a relatively low rate of intervention by the state, of which was also the basis of the private sector's conduct as the crisis began. In addition to relaxation of the budgetary position that had already taken place, the government offered support for flattening the economic cycle by changing the expenditure structure in a way that the government's operational and other running costs would be decreased in the conditions of limited means and the high level of investments preserved. More vigorous use of the EU structural funds and growth in volumes compared to the previous years also offered quantitative fiscal stimulus by bringing additional external financing to the economy.

External and internal imbalances of the economy

The challenges of the upcoming years in economic policy are related to strengthening of the institutional framework that would enable to manage the imbalances better and to avoid the possibilities of them occurring again. It is also important to ensure better functioning of the business environment and the labour market that helps to increase the long-term growth opportunities of economy.

Before the economic crisis in the years 2004–2007, the developments in Estonian economy were affected by a general positive sentiment after joining the European Union which, together with the inflow of foreign credit, caused both domestic and external imbalances in economy. The large current account deficit of the beginning years of the 2000's was brought about by the profits made on foreign investments on one hand and the large need for investments of a converging country in the other hand, characterised by the investment volume staying at 33–34% of GDP. Although in comparison with the other EU countries the current account deficit was relatively high, this was not caused by lack of competitiveness, which is also indicated by heavily increased export. The current account deficit was caused by the rapid real convergence and was largely in line with the normal level of current account deficit, which is between 6–8% of GDP according to the IMF[1]. Excessively fast increase in domestic demand was also accompanied by expansion of the current account to almost 17% of GDP by 2007. As the crisis began, the domestic demand and foreign trade shrank significantly, wherefore the current account turned to surplus. The fast reaction of businesses to the situation by reorganisation of processes, cutting expenditure and finding the new markets enabled to increase the competitiveness of production and to increase the market share on foreign markets. In the background of all of the above mentioned the current account will preserve its surplus during next few years, turning into deficit in 2014 due to recovery of domestic demand and an increase in foreign investment incomes; however, according to the Ministry of Finance, it will remain modest compared to its earlier extent.

Similarly to the current account deficit, the international investment position of Estonia is significantly influenced by the foreign investments to Estonia and the returns made on them. Since foreign investments are an important source of financing the convergence for a developing country without creating vulnerabilities in economy, it would be more purposeful in the context of imbalances to examine only the balance of foreign assets and liabilities of debt nature. From the level of 8% of GDP in 2000, the net foreign debt increased, as a result of fast credit inflow, to 39% of GDP by 2008. In the last two years, businesses and households have decreased their loan burden because of change in economic conjuncture and toughening of the credit conditions, positively influencing the level of foreign debt by reducing it by 14 percentage points to 24% of GDP. Taking into consideration the modest growth in credit presumed in the Spring Economic Forecast of the Ministry of Finance, the position of net foreign debt should not worsen considerably in the upcoming years.

In the beginning of the 2000s the debt burden of Estonian private sector was almost two times lower than the EU average, reaching 67% of GDP according to unconsolidated data; i.e. loans from commercial banks made up almost half of it. On the background of the more active real estate market and the steadily high level of confidence after joining the EU it were the households that were willing to increase their loan burden, using it for improving their living conditions and raising the level of current consumption. The increase in loan burden was also supported by the credit policy and low loan interests of the commercial banks. Therefore the loan burden of households increased more than fifteen times in comparison with year 2000. Since 2006, the debt burden of Estonian private sector exceeds the one of the eurozone. In 2010, the loan burden of the private sector decreased, also indicated by reduction in the balances of loans from commercial banks. Considering the credit policy of the banks and the modest demand of households for loan money, moderate growth in private sector loan burden can be expected in the upcoming years, but this will not lead to imbalances.

[1] Current Account Developments in New Member States of the European Union: Equilibrium, Excess, and EU-phoria. IMF working paper WP/08/92. [http://www.imf.org/external/pubs/ft/wp/2008/wp0892.pdf].

Existence of free money and the general attitude created possibilities for the real estate market to overheat in 2005 and 2006. At the peak of the real estate boom, the average prices of transactions exceeded the level of 2002 by more than three times. In 2007, a trend change took place at the real estate market, manifesting itself in growing insecurity and slowdown in the growth of demand that eventually turned the market into fall at the end of 2007. The global financial crisis that started in the autumn of 2008 further increased this fall. In comparison with the peak period, the average price of square meter price of real estate has fallen by 45–50% and returned to the level of 2005. The real estate purchasing power of households was the lowest in 2007 (approx. 30 m^2 of apartment space on the basis of the average wages[2]) and since that time, it has more than doubled. Regardless of that, the indications of the real estate market rebound are modest, the transaction prices have risen by 20% compared to the lowest point and the number of transactions by more than 80%, but the volume of transactions is still 2/3 lower than in the peak period.

Nominal unit labour cost[3] increased constantly during the years of boom when the average wages increased rapidly and surpassed the levels of productivity. However, in Estonian economy, nominal unit labour cost of 4–5% may be considered acceptable and it would not yet indicate to reduction of competitiveness and emerging imbalances. Until 2006, the change in real labour unit cost was almost zero[4], indicating unchanged employment expenses as a ratio to GDP and enabling to increase labour costs without damaging the competitiveness. In 2007–2008, overheating caused by excessive domestic demand took place in the labour market, followed by a strong correction during which the growth of wages slowed down drastically, unemployment increased and employment started to drop. The imbalances of the labour market started to reduce fast, also shown by the drop in nominal unit labour cost that decreased by almost one fifth in total. In the current year, the growth of the nominal unit labour cost will accelerate to 6.4%, but slow down after that and the growth of this indicator will remain stable and near 4% until the end of the forecast period. The relation of employment expenses to GDP will remain constant in the period of forecast. The unemployment rate above the normal rate of unemployment of the nearest years will keep the wage pressure low, enabling the businesses to hire additional workforce and to increase production without the fear of excessive wage pressure.

The impact of the aspects that caused overheating of economy in 2005–2007 has ran down by now and the economic growth is led by other factors (external demand and increasing competitiveness) wherefore it is unlikely that a similar domestic demand boom would occur in the upcoming years. At the same time, we still need to be prepared for reduction of economic imbalances, if necessary. In the context of general liberal economic policy, the government's economic policy is aimed at increasing the general well-being by promoting economic growth, and the most important instrument used for avoiding imbalances of economy is budgetary policy that has set sustainability and macroeconomic balance as its priorities. In addition, promoting free competition and the effective functioning of markets enables to reduce the possibility of imbalances. Functioning of the labour market is supported by the Employment Contracts Act that has already entered into force and an increase in the role of active labour market policy measures aimed at decreasing the long-term structural unemployment that will be the main problem in the upcoming years by using in-service and retraining for raising the workforce qualification, and turning more attention to the needs of the labour market when shaping the economic policy. In the upcoming years it will not be possible to support economic development by involving loan capital, or to increase investments in the former volume, wherefore increasing human capital through the contribution of the labour force and increase in labour productivity will be the main possibility for increasing the economic growth potential.

The Government and the Bank of Estonia are constantly monitoring the situation and supervising that the macroeconomic stability would be ensured. Additional measures are to be taken if necessary.

[2] The purchasing power index of Pindi Kinnisvara calculated according to loan capacity on the basis of the average wages [http://web.pindi.ee/index.php/6843/].

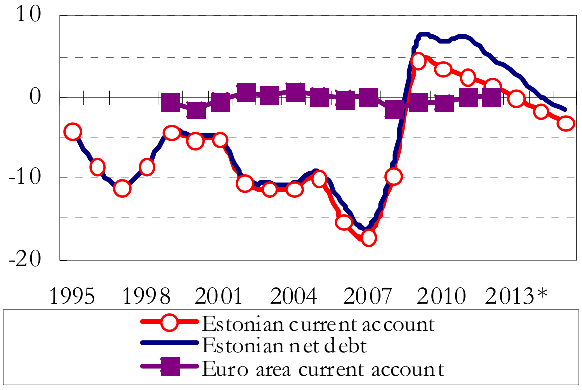
[3] Ratio of total labour costs to value added per employee.

[4] Ratio of total labour costs to value added.

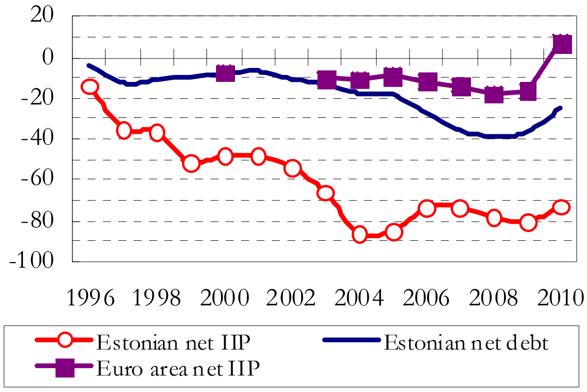
Figure 6

Selected indicators on economic developments
(% of GDP)

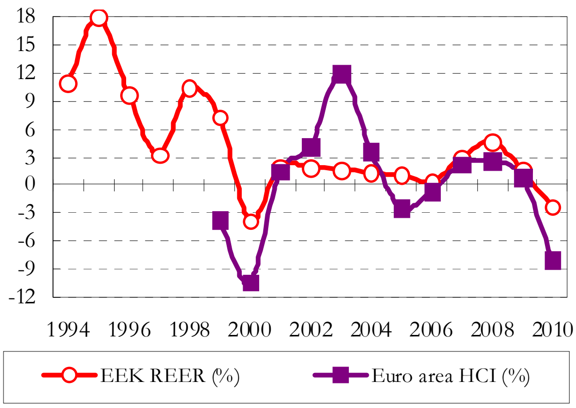
A.Current account balance (% of GDP)



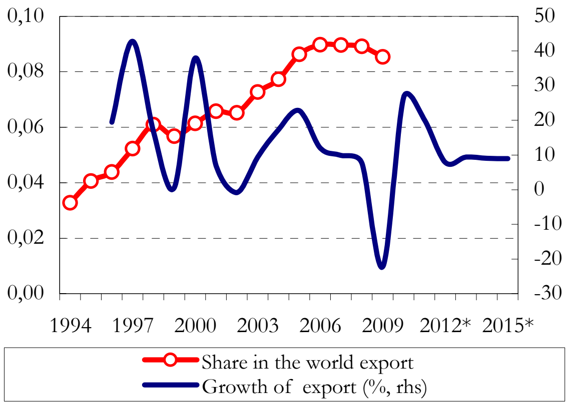
B. Investment position (net IIP, % of GDP)



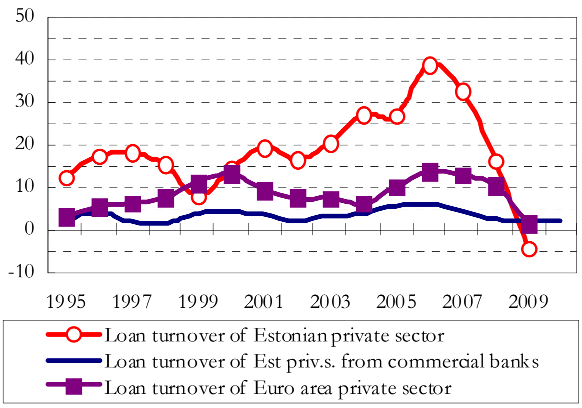
C. Real effective exchange rate[5]



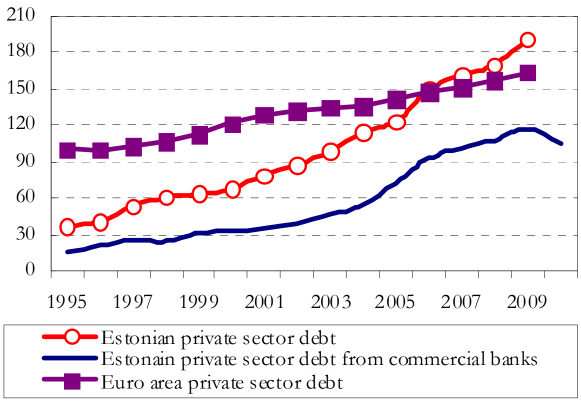
D. Share in world export (%)



E. Private sector loan turnover (% of GDP)

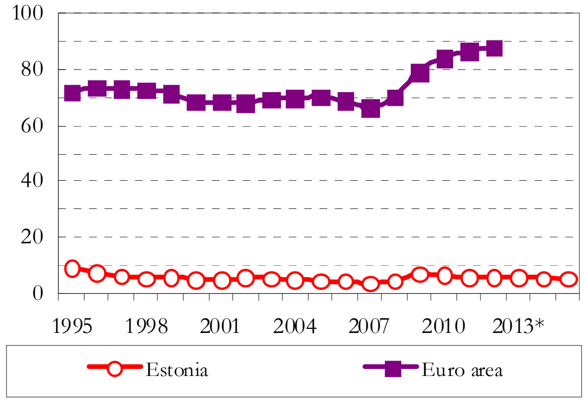


E. Private sector debt (% of GDP)

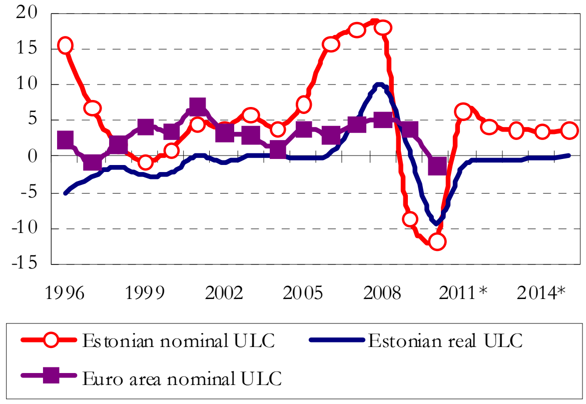


[5] Euro area HCI: Harmonised competitiveness indicators based on consumer price indices, vis-à-vis EER-40 group of trading partners.

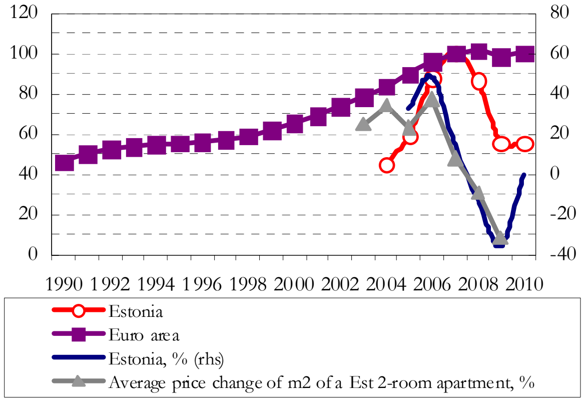
G. General government debt (% of GDP)



H. Change in labour unit costs (%)



H. Real estate prices[6], 2007=100



Source: Ministry of Finance, Statistics Estonia, Bank of Estonia, European Central Bank, Eurostat, European Commission.

[6] ECB Residential Property Prices, new and existing dwellings.

3. FISCAL FRAMEWORK

3.1. Fiscal policy goals and budget priorities of the Government of the Republic

The objective of the Government is to ensure **sustainable budgetary policy that balances macro-economic developments.** The aim is that budgetary decisions should maximally support macroeconomic stability, handle the risks that jeopardise the balanced economic development, and improve the growth potential and employment of economy. In order to manage future recessions, it is necessary to ensure a sufficient level of **reserves** and **budget flexibility** that allows to change the revenue and expenditure structure.

Budgetary decisions are made **simultaneously** (i.e. only during the budgetary (strategy) process), the decisions are sustainable (long-term impact of decisions is considered), taking maximally into account the field policies and operations of other levels of the general government, and **handling all sources of funding** (in addition to tax revenues, also the revenues from EU aids, sales of excessive pollution quotas, etc.) **jointly**.

Medium-term budgetary objective of the Government

The government will continue with strict budgetary policy. **The medium-term budgetary objective (MTO) is to maintain the structural budget surplus of the general government.** Objective set in such way is more ambitious than the minimum level set for the medium-term budgetary objective in the Stability and Growth Pact (for the eurozone and ERM II countries, -1% of GDP)[7] originating from the need to ensure long-term sustainability of the budget. Planning the surplus budgetary position helps to ensure long-term sustainability of the budget.

Estonia fulfilled its MTO until the global economic crisis, but in the years 2008 and 2009, the budgetary position was weaker than the objective. With the return to surplus of the nominal budgetary position of the general government, the MTO was met in 2010. Worsening of the actual budgetary position of 2011 and 2012 is mainly caused by one-off measures, wherefore the MTO will be met throughout the programme period according to the fiscal scenario of this Stability Programme.

The medium-term objective of the government regarding financial assets and liabilities

Throughout the programme period, the general government will maintain net assets, meaning liquid assets should exceed the debt, and starting in 2015 the level of net assets will be increased with the goal of restoring the reserves that were used during the recession.

The difference between liquid assets and debt of the general government was a positive amount at the end of 2010; in other words, the government of Estonia had net assets that amounted to 5.4% of GDP. Throughout the programme period the amount of reserves will remain higher than the debt, although the

[7] The range for the country-specific MTOs for euro area and ERM II Member States would thus be, in cyclically adjusted terms, net of one-off and temporary measures, between -1% of GDP for low debt/high potential growth countries and balance or surplus for high debt/low potential growth countries.

level of net assets will decline in the coming years. While the general government budgetary position is scheduled to be in surplus starting from 2013, the lowest level in net assets is expected in 2014, when it is 0.9% of GDP. This is largely explained by financial transactions (e.g. payments to the European Stability Mechanism), which can cause the general government to have a negative cash flow.

The medium-term objective of the government regarding the tax burden

To lower the tax burden to pre-recession levels by lowering taxes on labour. The tax burden will decline by 0.7% in 2011 to a level f 32.8% of GDP, and will continue to decline further to 31.1% by 2015. The tax burden will be reduced as payments into obligatory personal pension funds will resume in 2012 and compensation will be offered to those who continued payments during 2009 to 2011. The tax policy change with the biggest impact will be the lowering of the income tax rate to 20%, but also the reduction of the unemployment insurance payment rate, and starting from 2014 the ceiling on the social tax, which will make the portion of salaries that exceeds 4,000 euros per month exempt from the social tax (except the health insurance portion).

3.2. Budgetary position of the general government

3.2.1. Nominal budgetary position of the general government

In 2010, the general government budget was again in surplus by EUR 18.3 mln or 0.1% of GDP. The general government was last in surplus in 2007. Central government ended the year with deficit (0.6% of GDP). The social security funds and local governments were in surplus correspondingly by 0.6% of GDP and 0.2% of GDP. Due to one-off measures, the general government budgetary position will worsen next year to -2.8% of GDP and will then start to improve significantly, reaching a surplus of 0.5% of GDP by 2015.

The Government's objective is to maintain the structurally adjusted budget surplus throughout the period, increasing the surplus to 1.1% of GDP by 2015. In achieving this objective, nominal budget surplus of the general government will be reached in 2013, enabling to start with recovering of the reserves that have decreased during the crisis. Preparation of a positive supplementary budget is avoided during the financial year; the possible overreception of tax revenues will be directed to reserves.

Table 7

Objective of the general government budgetary position for 2011–2015

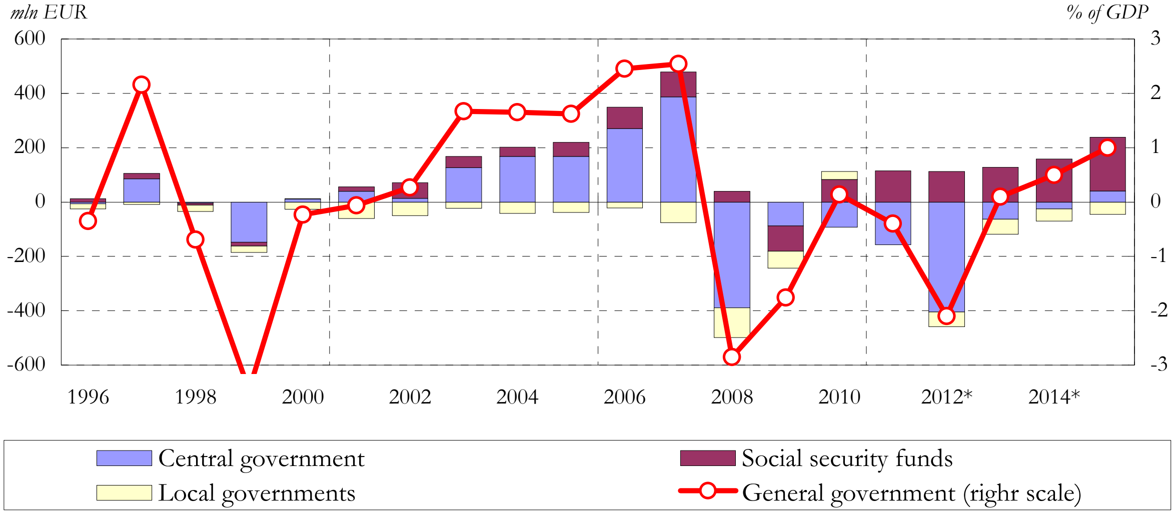
	2011	2012	2013	2014	2015
General government structural budgetary position (% of GDP)	**0,2**	**0,1**	**0,6**	**0,8**	**1,1**
General government budgetary position (% of GDP)	**-0,4**	**-2,1**	**0,1**	**0,5**	**1,0**
State budget	-1,0	-2,3	-0,3	-0,2	0,0
incl. state pension insurance	-1,8	-2,0	-2,0	-2,4	-2,3
Other central government	-0,1	-0,1	-0,1	0,0	0,2
Social security funds	0,7	0,7	0,7	0,8	1,0
Local governments	0,0	-0,3	-0,3	-0,2	-0,2
General government budgetary position (EUR mln)	**-66**	**-347**	**11**	**86**	**194**
State budget	-158	-392	-51	-36	-8
incl. state pension insurance	-280	-336	-362	-456	-475
Other central government	-23	-12	-12	9	49
Social security funds	115	112	128	158	197
Local governments	0	-55	-55	-45	-45

Source: Ministry of Finance, Statistics Estonia.

Figure 7

Budgetary position of the general government

(mln EUR)

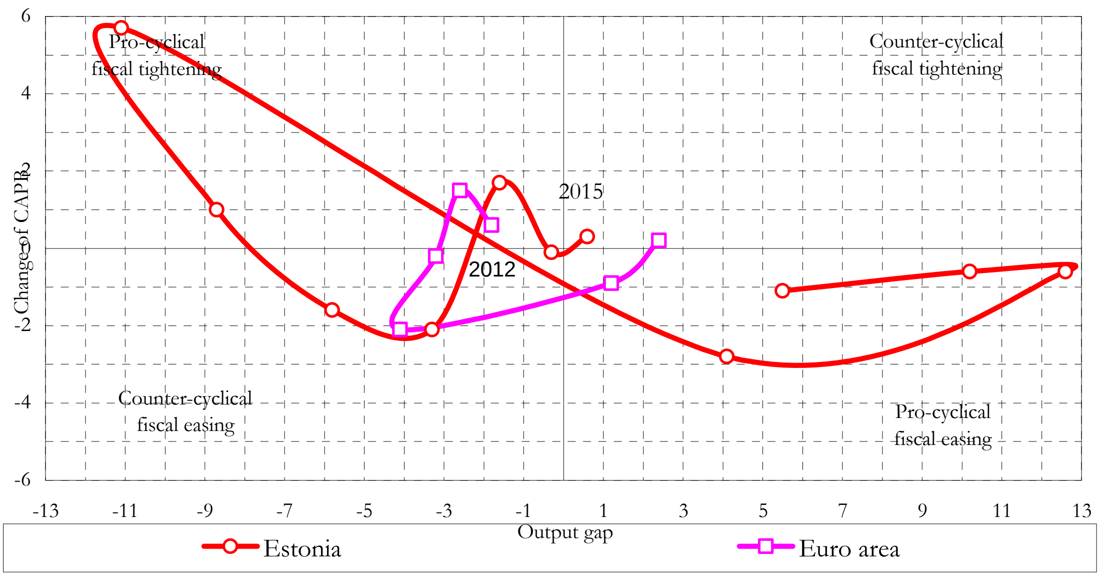


Source: Statistics Estonia, Ministry of Finance.

Figure 8

Fiscal stance and cyclical conditions of Estonian and euro area budgets in 2005–2015

(% of GDP)



Source: Ministry of Finance, Eurostat, European Economic Forecast of the European Commission, Autumn 2010.

3.2.2. Cyclically adjusted budgetary position of the general government

The Ministry of Finance uses the production function method[8] to evaluate the maximum level of total production (or the potential GDP[9]). According to this, Estonia's GDP increased considerably faster that would have been adequate considering the resources of economy in 2005–2006, thus creating significant imbalances. In the pre-crisis period, approx. 6% economic growth could have been considered suitable for Estonian economy, but in reality it sometimes exceeded as much as 10%. The growth was based on the rapid inflow of foreign finances and the general optimism prevalent in economy, channelling more money of the households and businesses to the economy than they were able to earn. The result of this excessive demand was economic volume (that is, an output gap[10]) that had grown to almost 12% higher than usual being accompanied by acceleration of inflation, short-term worsening of the trade balance and tensions in the economy from excessively intensive and inefficient use of the resources, bringing about the rise in their prices.

As the insecurity that had started to emerge at the peak of the boom increased, demand for ordinary consumer and investment products dropped drastically. The global financial crisis emerging in the autumn of 2008 intensified the economic recession originating from the cyclical behaviour of economy even further, creating more obstacles for availability of financial means than usual, and thus restricting the possibilities for financing investments. As a result of the financial crisis, global demand dropped drastically, creating up to one-third drop in the volume of foreign trade. As a result, the negative output gap of Estonia expanded to almost 11% of GDP in 2009. With the economic cycle turning, the negative output gap has also started to close rapidly; however, the position close to zero will not be reached until the end of the forecast period.

Since the crisis we recently went through is not merely a regular recession phase of economic cycle, the global demand structure has changed and accessibility of capital worsened significantly. Therefore, countries lost some of their production potential during the crisis. For the same reasons, the future growth potential of Estonian economy is lower than the growth potential before the crisis, still remaining a little depressed due to the aftereffects of the crisis.

The evaluations made on the basis of the output gap in the cyclically adjusted position of Estonian general government budget indicate that Estonian budgetary policy is counter-cyclical in the conditions of the negative output gap in 2011–2012. When in the counter-cyclical period of 2011–2012 the cyclically adjusted primary position worsens in the conditions of less-than-potential economic growth, in 2015, the output gap will be positive (the economic growth is higher than the potential) and the cyclically adjusted primary position will improve. However, it needs to be taken into consideration that in providing the final assessment of the budgetary policy, the impact of the change in the use of foreign instruments shall be assessed in addition to the change of the budgetary position. Since the former are neutral towards budgetary position – the proceeds are always equal to expenditure – the growth in the use of instruments, for example, is not reflected in the change of the budgetary position, but it stimulates economic activity during economic crisis and is counter-cyclic in nature.

[8] The methodology for evaluation of the output gap and cyclically adjusted budget position has been discussed in the Estonian Convergence Programme May 2004, Annex 3.

[9] Potential GDP – maximum level of gross domestic product (GDP), using the existing production inputs (workforce, capital, productivity / skills) that does not produce excessive price increase pressure.

Potential economic growth – change of the potential GDP in time. Depends on the changes taking place in production inputs.

[10] Output gap – difference between the actual GDP level and the potentisl GDP level.

Table 8

Cyclically adjusted budgetary position in 2009–2015

(% of GDP)

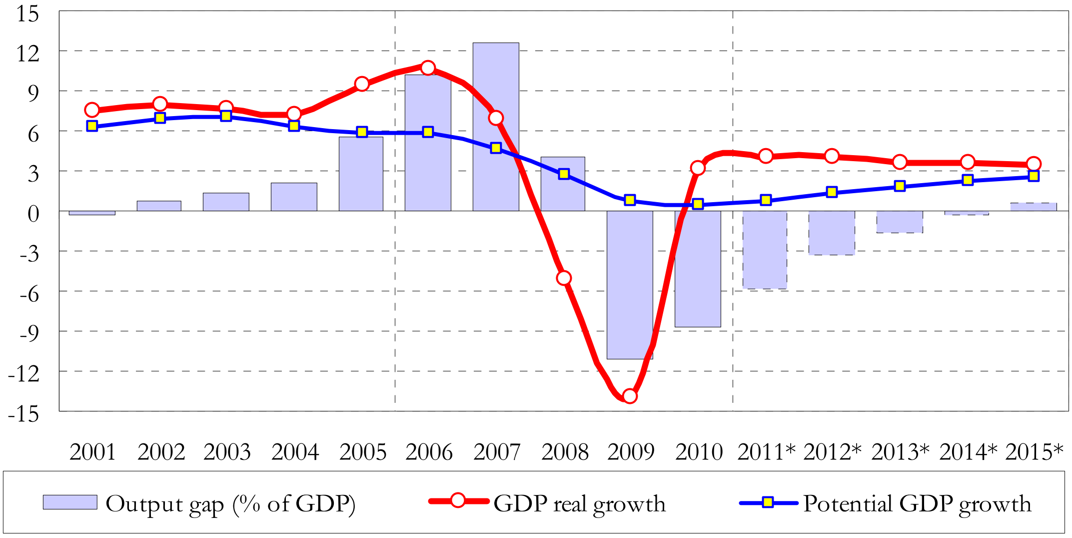
	2001–2008	2009	2010	2011*	2012*	2013*	2014*	2015*
1. GDP real growth (%)	6.5	-13.9	3.1	4.0	4.0	3.6	3.6	3.4
2. Net lending of general government	-	-1.8	0.1	-0.7	-2.1	0.1	0.5	1.0
3. Interest expenditure	-	0.3	0.1	0.2	0.2	0.3	0.4	0.4
4. Potential GDP growth (%)	5.7	0.7	0.4	0.8	1.3	1.8	2.2	2.5
4a. Contribution of capital to the potential growth (%)	3.5	1.1	0.7	0.9	1.0	1.1	1.2	1.3
4b. Contribution of workforce to the potential growth (%)	0.3	0.1	0.0	0.0	0.0	0.0	0.1	0.1
4c. Contribution of total factor productivity to the potential growth (%)	1.9	-0.1	-0.3	0.0	0.3	0.6	0.9	1.1
5. Output gap	4.5	-11.1	-8.7	-5.8	-3.3	-1.6	-0.3	0.6
6. Cyclical budgetary component	-	-3.3	-2.6	-1.7	-1.0	-0.5	-0.1	0.2
7. Cyclically adjusted balance (2-6)	-	1.6	2.7	1.1	-1.1	0.5	0.5	0.8
8. Cyclically adjusted primary balance (7-3)	-	1.9	2.9	1.3	-0.8	0.9	0.9	1.2
9. Budgetary policy position	-	Procycl.	Procycl.	Counter-cycl.	Counter-cycl.	Procycl.	Procycl.	Counter-cycl.

Source: Ministry of Finance, Statistics Estonia.

Figure 9

Potential GDPand output gap

(per cent)



Source: Statistics Estonia, Ministry of Finance.

3.2.3. Structural position of the general government

The structural position of the general government is found when one-off and temporary measures that may distort the budget position are removed from the nominal position in addition to the impact of the economic cycle. One-off and temporary measures having remarkable influence on the balance are the measures that have only temporary and non-frequent influence on the cyclically-adjusted budget balance (in the magnitude of at least approx. 0.1% of GDP). Although general principles have been defined based on which the influence of a measure is classified as temporary, each case is still observed separately.

The Government's objective is to maintain the structural budget surplus throughout the period, which was achieved in 2010 and increasing the surplus to 1.1% of GDP by 2015. Regardless of the significant worsening of the budgetary position in 2012, it has been caused by mostly one-off measures that do not influence the structural budgetary position.

One-off measures influencing the general government budgetary position are presented in Table 9. In 2010 the influence of such measures was 2.7% of GDP; the measures were suspension of the II pension pillar payments, positive balance of the sales of international assigned amount units (AAUs) and the additional dividends of AS Eesti Energia. The influence of 2011 is 1.1% of the GDP and the largest factors are similarly to the previous year the balance of the sales of international assigned amount units and 50% suspension of the II pension pillar payments. From 2012, measures worsening the budgetary position are to be expected and mainly due to investments related to the sales of EEUs, the impact of 2012 is as high as -1.2% of GDP.

Table 9

One-off measures and the influence of the above in 2010–2015
(EUR mln)

Measure	2010	2011	2012	2013	2014	2015
Eesti Energia dividends and income tax that exceed the regular level	82	14				
Suspension of the II pension pillar contributions	156	85				
Tallinna Sadam dividends and income tax that exceed the regular level		18				
Revenues from the sales of international assigned amount units (AAUs)	153	176	60			
Expenditure related to the sales of international assigned amount units (AAUs)		-124	-262	-4		
2+6 and 3+6 contributions to the II pension pillar					-52	-57
TOTAL	**390**	**170**	**-202**	**-4**	**-52**	**-57**
Total, % of GDP	**2.7%**	**1.1%**	**-1.2%**	**0.0%**	**-0.3%**	**-0.3%**

Source: Ministry of Finance.

3.3. Roles and budgetary positions of different levels of general government

By the end of 2011, it can be expected that the local governments' budget position reaches balance after the surplus of the last year. The social insurance funds will be in surplus for the whole period under consideration mostly thanks to the Unemployment Insurance Fund. At the same time, the budgetary position of the Health Insurance Fund is constantly improving and will reach a surplus in 2012.

Local governments

The local government units (226 units) have an important role in performing the public sector tasks. Regardless of the size, the same tasks are performed – maintenance of schools, pre-school child care institutions, hobby schools, community cultural centres, libraries, museums, sports facilities, care homes and health care facilities is organised, social assistance and services provided, welfare services for the elderly provided, youth work organised, housing and utilities, water and sewerage, maintenance, waste management, territorial planning, public transportation inside a rural municipality or a town organised, and the streets and roads of the rural municipality are maintained. In total, these expenditures exceeded 1249 mln EUR in 2010 (cash-based). 72% of these were operational costs.

The budgets of the local government units are more sovereign – they decide on its compilation themselves. The main sources of income are income tax and state budget supports.

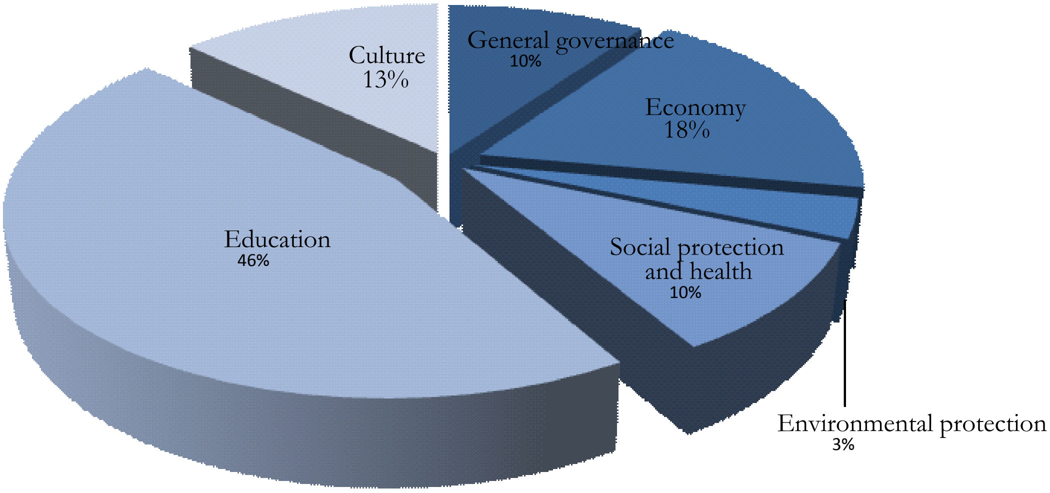
The expenditure of local government units have exceeded the revenues in all of the years, except in 2010 when the year was ended in surplus for the first time (+29 mln EUR). To cover the deficit, debt burden has been increased, reaching 50% of the local government units' revenues at the end of 2010, excl. the supports for specific purposes (total debt obligations of 569 mln EUR).

From 1 March 2009 to the end of 2011, the local government units may assume additional obligations only for co-financing of foreign investment projects and refinancing of the existing obligations, and have to obtain a prior approval from the Ministry of Finance. Due to the limitation they are expected to stay in balance in 2011, but as the limitation ends considerable deficit will be reached again (50 mln EUR per year on average).

The budgets of the local government units and data on execution of the budgets are presented in the monthly reports: http://www.fin.ee/index.php?id=11182.

Figure 10

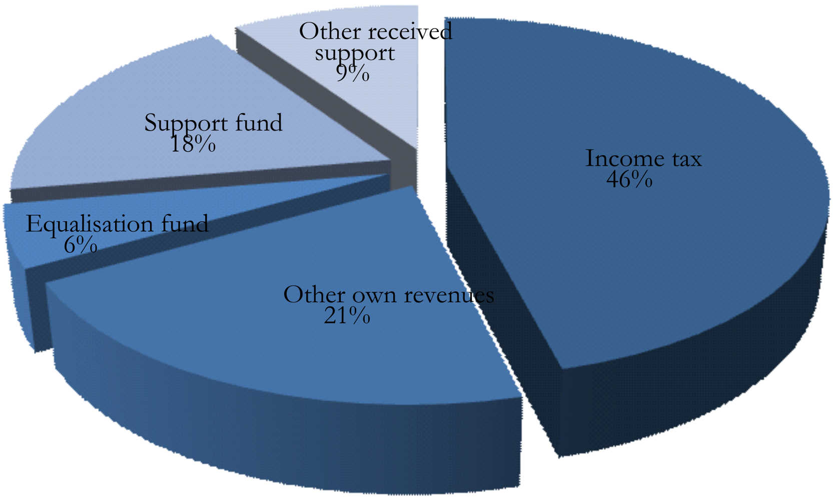
Division of the local governments expenditures by fields in 2010



Source: Ministry of Finance.

Figure 11

Division of the local governments revenues by fields in 2010



Source: Ministry of Finance.

Table 10

Aggregate indicators of the local governments

(EUR mln)

	2007	2008	2009	2010	2011*	2012*	2013*	2014*	2015*
Total revenues	1,288	1,454	1,292	1,270	1,355	1,380	1,400	1,415	1,445
- Income tax	627	734	634	585	615	652	696	737	782
- Equalisation fund	91	91	70	70	72	72	72	72	72
Total expenditure	1,305	1,518	1,358	1,249	1,355	1,435	1,455	1,460	1,490
Budgetary position	-19	-57	-76	27	0	-55	-55	-45	-45

Source: Ministry of Finance.

As the budgetary possibilities arise, the basis for formation of the local government unit revenue base is examined, taking into account their total deficit. Currently, no increase in the local government unit income tax and increase in the equalisation fund are planned.

In order to decrease the tax burden of home owners, land tax of the land under homes in densely populated areas of up to 1,500 m^2 and in low density areas for up to 2 ha will be abolished from 2013. In order to lower the land tax burden of homes in a neutral way to the budget, an analysis will be prepared which also considers the revenue bases of local governments. No real estate tax will be levied.

For increasing the youth participation in recreational activities and reduction of risk behaviour, a hobby payment of up to 130 EUR per year will be established from 2014 for every school-aged child (6–19).

Approximately 40 mln EUR from the funds received from sales of emission quotas have been directed to making 237 objects of the local governments more energy efficient (incl. schools, kindergartens, social welfare institutions, community cultural centres, etc.). The projects will be carried out in 2011–2012.

The share of funding for maintenance of the local roads in the general road maintenance funding will be increased. More precise distribution will be agreed during the process of preparing of the annual state budget.

Social security funds

Social security funds are the Health Insurance Fund and the Unemployment Insurance Fund.

99% of the **Health Insurance Fund** revenues are covered by the health insurance section of the social tax. Undoubtedly the largest form of compensation for the insured persons is the health services (prevention of illnesses, general and specialised medical care, nursing care and dental care). These are followed by compensating medications and benefits for temporary incapacity for work.

Due to good receipt of social tax, the Health Insurance Fund has ended earlier years in surplus, but in 2009 and 2010, the Health Insurance Fund's budget was correspondingly in a 41 and 6 million EUR deficit because of drop in the receipts of social tax. The impact of this drop to availability of health services was alleviated by structural changes in 2009 and the 6% price cut of services, enabling to save approximately 33 million EUR worth of health insurance funds in 2009; in 2010, this number was approximately 86 million EUR. As a result of these savings, availability of health services was kept relatively stable throughout the recession period. The satisfaction of the insured persons with the health care system, availability of medical care and its quality has not dropped, remaining on the level of 2008.

This year, a slight increase in deficit may be expected due to growth in expenditure levels. Among others, the expenditure will increase due to recovery of service price level in specialised medical care by 1% and in general medical care by 3% in the total sum of 7 million EUR, and increasing the number of cases to improve the availability of services by 12 million EUR. In the upcoming years, the Health Insurance Fund will probably reach surplus due to growth in the receipt of social tax; at that, recovery of the health service prices at the level of 2008 and improvement of availability of medical care by 1% annually has been taken into consideration.

Unlike the large deficit of 2009, the **Unemployment Insurance Fund** ended the last year with approximately 80 million EUR surplus originating from increase in the payment rates of unemployment insurance in the middle of 2009 and drop in the number of people receiving the benefit. The current year's budgetary position of the Unemployment Insurance Fund will be influenced positively by the continuing reduction of the volume of benefits and the growing receipt of unemployment insurance premiums, as a result of which the expected budgetary surplus will be approx. 125 million EUR or 0.8% of GDP. The unemployment insurance premium rate will be reduced in 2013. With an aim to increase flexibility of the labour market, the Employment Contracts Act will be analysed and at the proposal of the government, the plan to introduce compensations for the people leaving jobs at their own wish will not be enforced.

In order to ensure sustainability of the labour market services and flexible and beneficial reaction to the changes taking place in the labour market, the principles of funding the services were changed – since 2011 provision of services can be funded from revenues of the unemployment insurance premium.

Table 11

Forecast of social security funds' budgetary position in 2011–2015

	2011*	2011	2012	2013	2014	2015
Social security funds *(mln EUR)*	84	115	112	128	158	197
Social security funds *(% of GDP)*	0.6%	0.7%	0.7%	0.7%	0.8%	1.0%

**budget*

Figure 12

Division of health insurance expenditure of the Health Insurance Fund in 2010

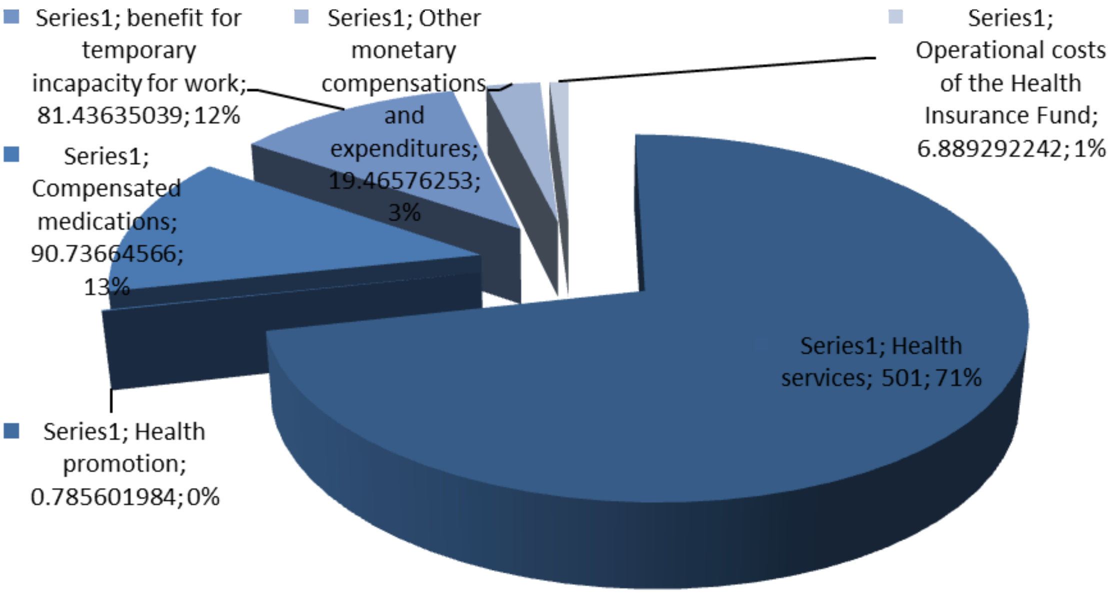


Table 12

Aggregate indicators of the Health Insurance Fund

(EUR mln)

	2007	2008	2009	2010	2011*	2012*	2013*	2014*	2015*
Total revenues	715	824	731	694	731	772	820	858	913
- Social tax	703	799	718	686	723	763	811	853	907
Total expenditure	655	789	771	700	744	770	809	834	868
- Health services	434	523	515	501	523	539	570	576	584
Budgetary position	**60**	**36**	**-41**	**-6**	**-12**	**2**	**11**	**24**	**45**

3.4. Financing of the general government

The following forecast of debt burden and financial assets presumes meeting the general government budgetary position objectives throughout the medium-term period.

3.4.1. General government debt

The main objective of Estonian budgetary policy throughout the years of independence has been to keep a balanced budget and, if possible, surplus of the general government in the medium-term period which has resulted in a low level of debt burden. In the end of 2010, Estonian general government debt amounted to 6.6% of GDP, which is 0.6 percentage points lower than in 2009. Of the 951 million EUR government debt, the debt of local governments amounted to 540 million EUR and the debt of the central government to 468 million EUR (the total number of debt is consolidated and does not equal precisely to the sum of the two levels).

In 2011–2015, the financing need of the central government can be covered mostly from reserves and the central government debt will not increase. A slow increase in the debt of local governments will be seen from 2012 when temporary restrictions to their borrowing will be lifted; however, as a percentage of GDP, the local government debt remains close to the current level, i.e. below 4% of GDP.

In total, the absolute sum of general government debt is expected to increase (from 0.95 mln EUR at the end of 2010 to 1.1 billion EUR by 2015) but since the nominal growth of GDP is faster than the growth of the debt, government debt will decrease as a share of GDP from 6.6 per cent to 5.4 per cent in the same period.

Table 13

Change in government debt in 2010

	Dec 31, 2009		Dec 31, 2010		Change
	million EUR	% of GDP	million EUR	% of GDP	%
General government	**991**	**7.2%**	**951**	**6.6%**	**-4.1%**
Domestic debt	533	3.8%	592	4.1%	**10.9%**
Foreign debt	458	3.3%	360	2.5%	**-21.5%**
Central government	**492**	**3.6%**	**468**	**3.2%**	**-4.9%**
Domestic debt	201	1.5%	259	1.8%	28.8%
Foreign debt	291	2.1%	209	1.4%	-28.2%
Local governments	**555**	**4.0%**	**540**	**3.7%**	**-2.7%**
Domestic debt	388	2.8%	389	2.7%	0.4%
Foreign debt	167	1.2%	151	1.0%	-9.8%
Social insurance funds	**0.3**	**0.0%**	**0.3**	**0.0%**	**-20.0%**
Domestic debt	0.3	0.0%	0.3	0.0%	-20.0%
Foreign debt	0.0	0.0%	0.0	0.0%	0.0%

Table 14

General government sector debt burden in 2010–2015

(% of GDP)

	2010	2011*	2012*	2013*	2014*	2015*
1. Gross debt	**6.6**	**6.0**	**6.0**	**5.8**	**5.6**	**5.4**
2. Change in gross debt	-0.6	-0.5	-0.1	-0.1	-0.2	-0.2
Contribution to changes in gross debt						
3. Primary balance	0.1	-0.7	-2.1	0.1	0.5	1.0
4. Interest expenditure	0.2	0.2	0.2	0.3	0.3	0.3
5. The effect of nominal GDP growth on debt	-0.3	-0.5	-0.4	-0.4	-0.4	-0.3
6. Stock-flow adjustments (SFA)	-0.1	-0.4	-1.8	0.3	0.6	1.1
Estimated interest rate of government debt (%)	2.5	3.0	3.9	4.4	4.8	5.1

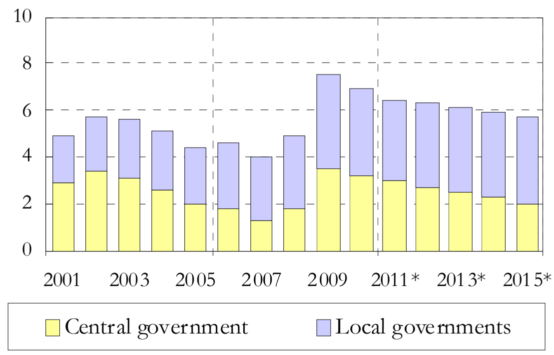
Source: Ministry of Finance, Statistics Estonia.

Figure 13

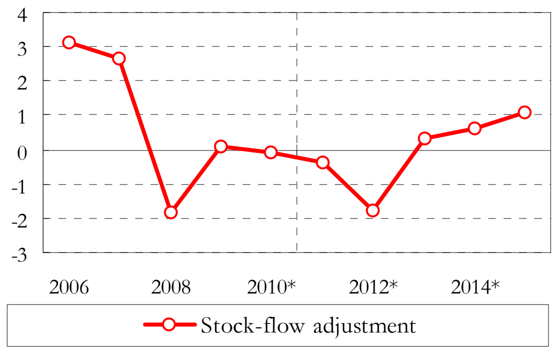
Debt burden development in 2002–2015

(% of GDP)

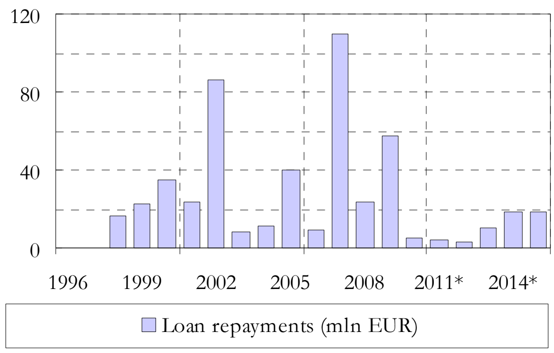
A. General government debt



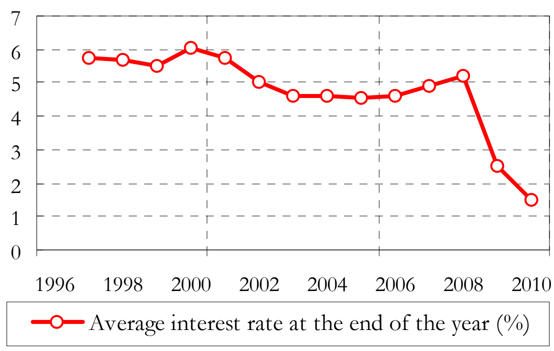
B. Stock-flow adjustment



C.Repayments of central government loans



D. Average interest of central government[11] debt



Source: Ministry of Finance, Statistics Estonia, Eurostat.

[11] Central government without foundations and public-legal entities.

Box 1. Other stock-flow adjustments (SFA)

Stock-flow adjustment (SFA) is the indicator indicating the difference between the current and previous year's debt positions (stock) and the current year's deficit (flow).

$$Debt(t) – Debt(t-1) = SFA(t) – Deficit(t)$$

The positive (negative) SFA indicates that in addition to deficit (surplus), debt is increased (decreased) by other changes as well (financial transactions, use of reserves, revaluations, difference between the cash-based and accruals-based reporting).

In theory, the change in debt should be similar to deficit/surplus during a longer period, thus the average SFA over the years should be as low as possible as an absolute value. If the SFA has been either positive or negative for several years in a row or has a cumulatively high value it may indirectly indicate that the state may have problems with its budget statistics. Estonian SFA indicators have been low and fluctuated on both positive and negative side. For Estonia, it can largely be explained by either increasing of the reserves (. e.g. positive SFAs in 2006–2007) or use of the reserves (negative SFA of 2008).

Estonian SFA will be negative in 2011–2012, indicating that mostly reserves are used for financing the budget deficit. In 2013–2015, positive SFA may be expected since the debt will continue to increase although the general government has reached budget surplus. Positive SFA can be explained by the fact that the budget surplus emerges mostly on the level of social security funds, while the budget of local governments is in deficit. The debt of local governments will increase, although the general government as a whole is in surplus.

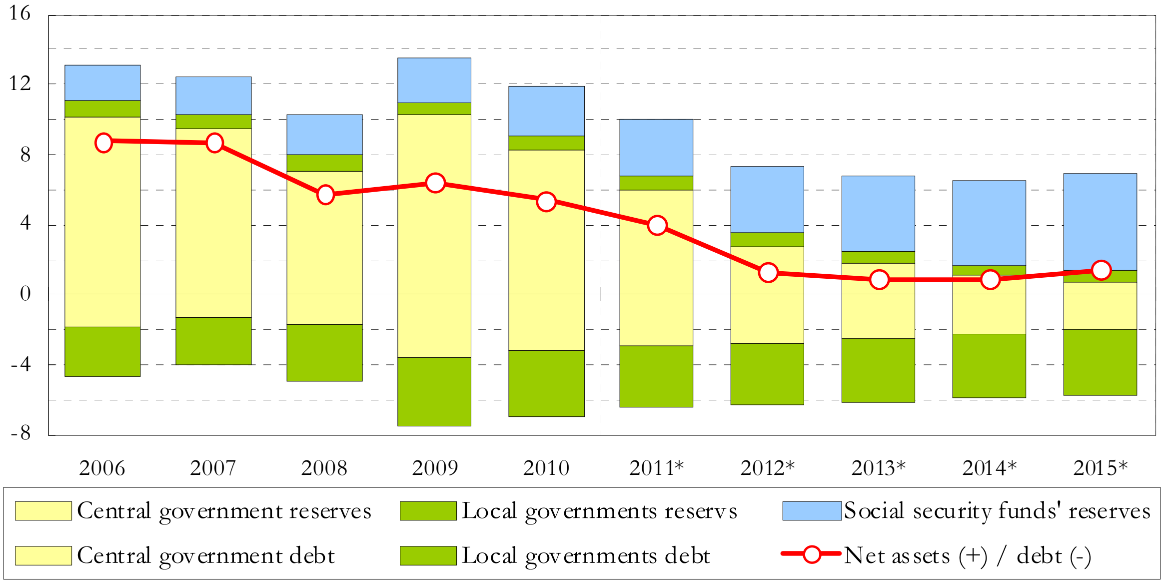
3.4.2. General government reserves

Throughout the entire period the level of net assets is preserved, i.e. liquid assets exceed the debt burden and from 2015, growing of net assets will be started with an aim to restore the reserves used during the recession.

The difference between the general government liquid assets and debt load at the end of 2010 was positive (Estonia had net assets) – 5.4% of GDP to be precise. Throughout the entire period, the level of reserves remains higher than the debt, although the level of net assets will drop in the upcoming years. Despite the fact that surplus has been planned to the budgetary position of the general government already from 2013, the lowest level of net assets is to be expected in 2014 when the corresponding indicator is 0.9% of GDP. This is mainly caused by financing transactions (e.g. payments to the European Stabilization Mechanism) that cause negative cash-flow on the level of the general government.

Figure 14

Liquid assets, debt burden and net assets of the general government in 2006–2015
(% of GDP)



Source: Ministry of Finance, Statistics Estonia

4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS PROGRAMME (CONVERGENCE PROGRAMME)

4.1. Alternative scenarios and their effect on the budgetary position

Below, two additional scenarios for the economic projection have been presented; their probability is lower than the one of the base forecast, but they help to explain uncertainty related to this forecast and the possible developments taking place upon realisation of the risks.

4.1.1. Negative risk from the foreign environment

2010 was characterised by fast recovery of the world economy, after which the market participants have started to raise the forecasts for the upcoming years. In light of this, the Ministry of Finance has also revised export forecast upwards in the base scenario. Despite of the positive growth expectations related to our closest neighbours, uncertainty in the world growth expectations is still high, resulting from continuation of the European debt crisis, tensions in North-Africa and the Middle East, and the natural disaster that hit Japan. These factors and the high world market prices of raw materials may start to negatively influence consumer confidence that would slow down the growth speeds of economies through cut of expenditures.

Due to Estonia sharing the same supply chain with the Nordic countries, more modest external demand would also mean weaker development outlooks for the local export and thus, due to smaller export profits, poorer opportunities for the growth of domestic demand. This would decrease the need for new employees and the wage pressures would become more moderate compared to the base scenarios. Due to growing uncertainties, investments to mainly exporting sector would be cut. Weaker developments on the external markets would bring along a decrease in the price pressure of raw materials, spreading gradually to retail prices and manifesting itself in the lack of inflation. In total, realisation of this risk would mainly influence the export sector, causing the contribution of export into economic growth to be more modest than in the base scenario and the economic growth would stabilise near 3% in the upcoming years.

The government revenue and expenditure forecast of the negative risk scenario is based on the macroeconomical forecast and foresees worsening of the state budgetary position in all the years. The position would worsen mainly due to decreasing tax revenues that exceed the drop in expenditures (mainly defence expenditures). Proceeds from social tax and unemployment insurance premium that are lower than in the base scenario would also worsen the position of social security funds for which the levels of expenditures are expected to preserve on the approximate level of the base forecast.

Table 15

Negative risk scenario

(per cent)

	Negative risk scenario				Difference with the base forecast		
	2010	2011*	2012*	2013*	2011*	2012*	2013*
GDP in current prices (mld EUR)	14.5	15.4	16.3	17.2	-0.22	-0.50	-0.67
GDP real growth	3.1	3.0	3.0	3.3	-1.0	-1.0	-0.3
GDP nominal growth	4.6	6.4	5.4	6.0	-1.5	-1.7	-0.8
CPI	3.0	4.2	2.2	2.5	-0.3	-0.6	-0.5
Real growth of domestic demand	1.0	3.2	4.0	4.0	-0.3	-0.5	-0.3
Real growth of export	21.7	12.5	2.1	5.5	-3.4	-3.4	-1.6
Real growth of import	21.0	13.7	3.0	6.4	-2.6	-3.0	-1.6
Employment growth	-4.2	1.8	1.1	0.9	-0.3	-0.7	-0.2
Nominal growth of wages	0,9	3.1	3.9	4.2	-0.4	-0.3	-0.4
Average wages (EUR)	791	816	848	883	-3.2	-5.3	-9.0
Current account (% of GDP)	3.6	1.8	0.1	-1.7	-0.7	-1.2	-1.6
External assumptions							
Economic growth of the main trading partners	2.3	2.2	2.1	2.2	-0.5	-0.4	-0.4
General government							
Tax burden (% of GDP)	33.5	33.1	32.3	32.2	0.2	0.4	0.5
General government budgetary position (% of GDP)	0.1	-0.7	-2.6	-0.5	-0.3	-0.5	-0.6
General government debt burden (% of GDP)	6.6	6.2	10.3	12.0	0.0	-0.8	-1.4

Source: Ministry of Finance, Statistics Estonia.

4.1.2. Positive risk – faster recovery of domestic demand

One of the factors that causes uncertainty in the forecast is the behaviour of economic agents. During the crisis, an important change took place in the saving behaviour of households – overconsumption that had characterised the boom period was replaced by saving at the average level of EU27 in a few years. It was imposed partly by the need to improve the balance between obligations and assets, but it also indicates a behavioural reaction to greater uncertainty. As the economic cycle turns, we have seen a growth of private consumption surpassing income growth due to increased confidence, but considering our level of development it may be assumed that the balanced savings rate may turn out to be significantly lower than the current one, giving an additional impulse for growth of domestic consumption.

Recovery of consumer confidence (and there is room for recovery) faster than the base scenario will also increase domestic demand or private consumption and investments in the sectors directed to internal market which will promote an increase in wages and employment, that is, income.

According to this scenario, mostly private consumption will contribute to faster growth in 2011 and investment in 2012. External demand and export will not change in comparison with the base scenario but the growth of import will be faster, making current account surplus smaller, and the current account balance will turn negative already in 2013.

According to the base scenario, both consumption and investment shares of GDP will be significantly lower than the pre-boom level, wherefore more optimistic developments in internal demand are not excluded. The level of private consumption remained at 55% in 2000–2005 and did not increase during the boom; according to the conservative main scenario, this will increase to 48% not until 2015. The level of investments in 2000–2005 was 30% of GDP, in 2006–2007, 35% of GDP and on the basis of the conservative main scenario, in 2011–2015, this will be 20–24%.

Looking at the pre-boom levels of consumption and investments it has to be noted that there is enough growth potential in domestic consumption, but realisation of the more optimistic developments depends largely on developments in confidence.

Similarly to negative risk scenarios, the general government budgetary position of a positive risk scenario is also influenced by better tax proceeds that improves the position in all years. A better result compared to the base scenario can also be expected from social security funds.

Table 16

Positive risk scenario

(per cent)

	Positive risk scenario				Difference with the base forecast		
	2010	2011*	2012*	2013*	2011*	2012*	2013*
GDP in current prices (mld EUR)	14.5	15.9	17.2	18.5	0.21	0.44	0.60
GDP real growth	3.1	5.0	5.0	4.0	1.0	1.0	0.4
GDP nominal growth	4.6	9.4	8.5	7.6	1.5	1.4	0.7
CPI	3.0	4.8	3.3	3.4	0.3	0.5	0.4
Real growth of domestic demand	1.0	5.0	5.8	4.6	1.5	1.3	0.3
Real growth of export	21.7	16.0	6.5	8.0	0.0	1.0	0.9
Real growth of import	21.0	16.9	7.4	9.0	0.6	1.4	1.0
Employment growth	-4.2	2.8	2.3	1.5	0.6	0.4	0.4
Nominal growth of wages	0.9	4.8	5.2	5.4	1.2	1.0	0.8
Average wages (EUR)	791	829	871	918	9.8	18.1	25.9
Current account (% of GDP)	3.6	2.1	0.4	-1.2	-0.4	-0.9	-1.1
External assumptions							
Economic growth of the main trading partners	2.2	2.7	2.5	2.6	00.0	0.0	0.0
General government							
Tax burden (% of GDP)	33.5	33.1	32.0	31.9	0.2	0.1	0.2
General government budgetary position (% of GDP)	0.1	0.1	-1.2	1.1	0.5	0.9	1.0
General government debt burden (% of GDP)	6.6	6.2	8.2	8.3	0.0	1.3	2.3

Source: Ministry of Finance, Statistics Estonia.

4.2. Comparison with the forecast of the Convergence Programme

Recovery of the **world economy** have turned out to be stronger than previously expected. The economic growth expectations of Estonian trading partners, incl. the European Union, are considerably more optimistic for the current year than in the forecast of the last Convergence Programme. The faster than forecasted recovery of economy brought along oil price increase last year, turning out to be somewhat faster than expected in the forecast. Considering the latest events and the geopolitical situation in Northern-Africa and the Middle East, increase in oil price will probably continue and the oil price assumptions are higher than in the Convergence Programme. Both short- and long-term interest rates remained on a lower level than presumed in the Convergence Programme forecast. The interest expectations are lower than in the Convergence Programme forecasted for this year as well, although the upwards trend of interests has started by now.

In its January 2010 forecast for 2010, the Ministry of Finance expected the pace of economic downturn to slow down to 0.1%. For 2011–2012, we expected an economic growth of 3.3% and 3.7% correspondingly.

Estonia's **economic growth** turned out to be more positive than forecasted in the beginning of 2010; the main cause for that was unexpectedly fast growth in the export sector. Recovery of domestic demand was also faster than expected due to unexpectedly high increase in stocks and smaller drop in private consumption costs than forecasted. According to this forecast, economy will grow 4% in both current and next year. The forecast is revised because of more optimistic economic growth expectancies of Estonia's main export partners and the significantly improved growth outlooks of Estonian businesses that brought along a raise in the forecasts on both export and some of the domestic demand components. The forecast of GDP nominal growth for 2011–2012 has been raised since the rise in prices is significantly higher than forecasted earlier.

The developments in employment and wages supporting **private consumption** were more negative in the first half of the year, but in the second half considerably more positive than expected in the Convergence Programme forecast. The consumer confidence indicators have been recovering at a stable pace and are currently exceeding the historic average. The developments in both labour market and the consumer behaviour have made a strong turn and the second half of 2010 indicated clear recovery in consumption growth. Therefore, in total, 2010 turned out to be more positive (change in consumption -1.9%) than forecasted in the Convergence Programme in the beginning of 2010 (-5.2%) and the real growth of approximately 4.5% may be expected in the upcoming years. The pace of private consumption real growth in 2011 (2.2%) is similar to the one presented in the Convergence Programme (2.5%), but hopefully this is caused by the temporarily increased inflation.

The development of **investments** turned out to be even more negative in 2010 (-9.1%) than forecasted earlier (-4.1%). Regardless of the deep recession that lasted for two years, the annual growth speeds of all sectors in the first three quarters were negative. The government sector's contribution to investments in 2010 proved negative instead of positive. In the last quarter of 2010, business and household investments still began to rise. The largest positive contribution was made by investments to machinery and equipment. Fast pace of growth was also demonstrated by investments into transport equipment, which is still, nevertheless, very low. Unfortunately, the positive decision of adopting the euro did not bring about a new wave of investments in 2010 yet. As to 2011, the investment growth pace has been raised a little (to 7.9%) and we are still expecting faster growth of investments towards GDP. However, investment deflator was revised upwards since clear signs of price pressures can be seen in the building sector.

The main export markets saw considerably faster recovery last year, enabling to raise the **export volumes** to the pre-crisis level. Faster than expected development of the trading partners may also be expected in 2011. In addition, raising the export forecast is also favoured by significant increase in contracts in the subsection of communication devices. Therefore, we revised the 2011 forecast for export of goods and services from 4.8% to 15.9%. Since the import contents of export is high in many industries, the import forecast is also raised. In 2012, post-crisis rapid recovery takes place, as well as temporary slowdown of export growth due to ending of the impact of an increase in orders for communication devices. The earlier years' developments also indicate that couple of years with rapid export growth is followed by temporary adjustment.

The **current account** surplus turned out to be smaller than expected in 2010 due to worsened balance of goods and revenues. Deterioration of the goods' balance has been affected by large import contents of export, as well as significant increase in the production input stocks; the income balance turned to unexpectedly large deficit due to fast recovery of profitability of foreign investments. These factors also have a negative influence on the external balance of 2011, but due to significantly improved export growth outlooks the current account will turn to deficit more slowly.

External price pressures were behind the acceleration in the growth of **consumer prices** in 2010. Rise in oil and food prices is also one of the main reasons for increasing the inflation forecast. Fast recovery of the world economy and the geopolitical situation brought along rising the assumptions of oil price. Food prices are largely influenced by the last year's reduced yield. Upward revision of food price forecast makes up most of the revision in this year's inflation forecast . Compared with the forecast in the Convergence Programme, the wage increase outlooks have improved in 2011, wherefore the increase in the prices of services is somewhat faster. The inflation forecast of 2011 has been raised from 1.9% to 4.5% and the one of 2012 from 2.3% to 2.8%. Behind the raised inflatsion forecast for 2013 is the impacts of opening of the electric market.

The **labour market** developments turned out to be more negative than expected in 2010. The drop in employment in last year (-4.2%) was noticeably steeper than forecasted in the Convergence Programme (-2.4%). The increase in unemployment also exceeded the previous expectations. The employment forecast for the current year is more positive than the one of the Convergence Programme. Estonia's recovery from the crisis has been faster than expected, which has brought along a noticeable increase in labour demand. This year, unemployment will remain somewhat higher than forecasted in the Convergence Programme. The developments in the **average wages** (growth of 0.9%) were more positive compared to the Convergence Programme forecast (drop of 3.4%). Compared with the correction in employment, drop in wages was relatively small during the crisis. Many businesses reorganised their work with a smaller number of employees, reduced the working hours and implemented partial working time. The expectations for 2011 are also more positive than in the Convergence Programme forecast. On the background of the economic recovery, the average wages has increased for three quarters already, indicating to faster recovery of businesses and an opportunity to raise remunerations together with the growth of sales revenues.

As to the **general government budgetary position**, the expectations for 2011 are more optimistic than in the Convergence Programme, also because of the improved economic situation. Due to one-off measures, the budget deficit of 2012 is lower in this programme. The objective of reaching nominal general government budget surplus still remains in 2013.

In the current forecast, the **general government debt** is lower than in the Convergence Programme for all the years. The planned usage of reserves is higher than in the former programme, helping to keep the general government debt burden low. The improved budgetary position outlooks also have influencing power.

Table 17

Comparison with the forecast of the Updated Convergence Programme 2010

	2010	2011*	2012*	2013*	2014*	2015*
Real growth of GDP (%)						
Previous update	-0.1	3.3	3.7	4.0	-	-
Current update	3.1	4.0	4.0	3.6	3.6	3.4
Difference	3.2	0.7	0.3	-0.4	-	-
Nominal growth of GDP (%)						
Previous update	-1.2	5.0	6.3	6.8	-	-
Current update	4.6	8.0	7.1	6.9	6.4	6.3
Difference	5.8	3.0	0.8	0.1	-	-
General government budgetary position (% of GDP)						
Previous update	-2.2	-2.0	-1.0	0.2	-	-
Current update	0.1	-0.4	-2.1	0.1	0.5	1.0
Difference	2.3	1.6	-1.1	-0.1	-	-
General government debt (% of GDP)						
Previous update	10.1	13.0	14.2	14.3	-	-
Current update	6.6	6.0	6.0	5.8	5.6	5.4
Difference	-3.5	-7.0	-8.2	8-.5	-	-
Harmonised index of consumer prices (HICP) (%)						
Previous update	0.4	1.9	2.3	2.7	-	-
Current update	2.7	4.5	2.8	3.0	2.8	2.7
Difference	2.3	2.6	0.5	0.3	-	-
Current account (% of GDP)						
Previous update	5.9	4.1	1.4	-2.4	-	-
Current update	3.6	2.5	1.3	-0.1	-1.7	-3.1
Difference	-2.3	-1.6	-0.1	2.3	-	-

Source: Ministry of Finance.

5. IMPROVEMENT OF THE QUALITY OF PUBLIC FINANCES

5.1. Forecast of expenditures and revenues of the general government until 2015

The **budget surplus of the general government** amounted to **19.7 million euro in 2010**, forming 0.1% of GDP. The position of the general government in 2010 was influenced by central government with a deficit (-0.6% of GDP); the local governments ended the year in surplus (0.2% of GDP), so did the social security funds (0.6% of GDP).

The budget deficit of the general government in 2011 amounts to 0.4% of GDP according to the forecast. The largest contribution to the general government deficit is made by the central government. The budget of social security funds is in surplus thanks to the Unemployment Insurance Fund and by presuming a slight drop in the unemployment insurance rates; this will support the budgetary position of the entire government sector also in the medium-term perspective. The total budget of the local governments is in balance in 2011; during the rest of the forecast period, this is in deficit.

The share of **general government's revenues** of GDP will drop throughout the period according to the forecast, reaching 34.3% of GDP in 2015.

The tax revenues will drop from 20.2% of GDP in 2010 to 19.7% of GDP in 2015. The production and import duties remain on the same level. The income and wealth taxes will drop from 6.7% of GDP in 2010 to 6.2% of GDP by 2015 due to decrease in the income tax rate of both legal and private persons (the tax rate will drop to 20% in 2015). Social security contributions will drop from 13.1% of GDP in 2010 to 11.1% of GDP in 2015. The reason is mainly restoration of the state's payments to the II pension pillar and compensations for the ones who continued with the payments. The unemployment insurance premium rates will also drop slightly. The tax burden will drop from 33.5% of GDP in 2010 to 31.1% of GDP in 2015.

The general government expenditures will drop from 40% of GDP in 2010 to 33.3% of GDP in 2015. During the forecast period, compensations for employees and intermediate consumption will drop from 19.2% of GDP to 15.9%, the social transfers from 15.6% of GDP to 13.3%. Gross capital formation will reduce largely in relation to decrease in external grants from 3.6% of GDP to 2.1%.

Table 18

Expenditures and revenues of the general government for 2010–2015

	2010	2010	2011*	2012*	2013*	2014*	2015*
	mln €	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Budgetary positions by general government levels							
1. General government	19.7	**0.1**	**-0.4**	**-2.1**	**0.1**	**0.5**	**1.0**
2. Central government	-92.9	-0.6	-1.0	-2.4	-0.4	-0.1	0.2
4. Local governments	29.1	0.2	0.0	-0.3	-0.3	-0.2	-0.2
5. Social insurance funds	83.5	0.6	0.7	0.7	0.7	0.8	1.0
General government							
6. Total revenues	5,814.0	40.1	39.9	38.3	36.8	35.3	34.3
7. Total expenditure	5,794.3	40.0	40.3	40.4	36.8	34.8	33.3
8. Budgetary position	19.7	**0.1**	**-0.4**	**-2.1**	**0.1**	**0.5**	**1.0**
9. Interest charges	20.8	0.1	0.2	0.2	0.3	0.3	0.3
10. Primary balance	40.5	0.3	-0.2	-1.8	0.3	0.7	1.2
11. One-off and temporary measures	390.4	2.7	1.1	-1.2	0.0	-0.3	-0.3
Revenues by components							
12. Tax revenues (12=12a+12b+12c)	2,934.0	20.2	20.3	20.4	20.1	20.1	19.7
12a. Production and import taxes	1,963.8	13.5	13.7	13.9	13.6	13.6	13.5
12b. Income and wealth taxes	970.2	6.7	6.7	6.5	6.5	6.5	6.2
12c. Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13. Social security contributions	1,903.2	13.1	12.3	11.7	11.5	11.1	11.1
14. Property incomes	196.0	1.4	1.2	1.1	1.2	1.2	1.2
15. Other revenues	780.8	5.4	6.1	5.1	4.1	2.9	2.3
16.=6. Total revenues	5,814.0	40.1	39.9	38.3	36.8	35.3	34.3
p.m.: tax burden (D.2 (incl. paid to the EU)+D.5+D.611+D.91-D.995)	4,857.0	33.5	32.8	32.4	31.9	31.5	31.1
Expenditure by components							
17. Compensations for employees + intermediate consumption	2,781.1	19.2	18.2	17.5	16.9	16.3	15.9
18. Social transfers (18=18a+18b)	2,255.5	15.6	14.6	13.9	13.7	13.5	13.3
18a. Non-monetary social transfers	383.4	2.6	2.6	2.5	2.5	2.5	2.5
18b. Monetary social transfers	1,872.1	12.9	12.0	11.4	11.2	11.0	10.8
19.=9. Interest charges	20.8	0.1	0.2	0.2	0.3	0.3	0.3
20. Subsidies	149.9	1.0	1.0	1.0	1.0	1.0	1.0
21. Gross capital formation	526.0	3.6	5.1	5.7	3.3	2.1	2.1
22. Other expenditure	61.0	0.4	1.3	2.0	1.6	1.7	0.8
23.=7. Total expenditure	5,794.3	40.0	40.3	40.4	36.8	34.8	33.3
p.m. General government consumption	2,987.4	20.6	19.5	18.8	18.1	17.5	17.1

** forecast.*
Source: Statistics Estonia, Ministry of Finance.

5.2. General government revenues

5.2.1. Structure of general government revenues

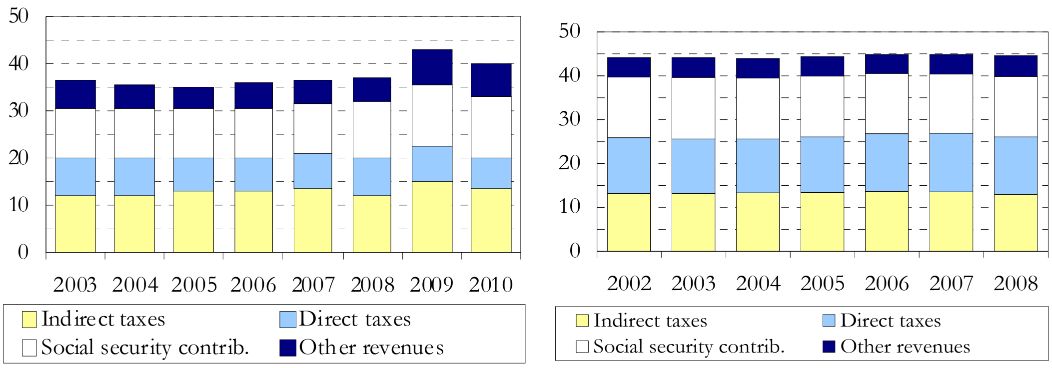
The general government revenues were increased one-off in 2009 by stocking up due to increase in the excise duty on tobacco. Due to suspension of the state's payments to II pension pillar, social security contributions have also increased, technically increasing the tax burden. Unemployment insurance premium rates were also increased.

Figure 15

General government revenues and their structure

(% of GDP)

A. General government revenues in Estonia **B. General government revenues in EU 27**



Sources: Eurostat.

5.2.2. Future developments in tax policies

One of the tax policy objectives of the government is to shift the tax burden from taxation of profit to taxation of consumption, use of natural resources and pollution of the environment by partially reorganising the taxes. At the same time, the aim is to keep the **system stable, simple and transparent** with as few exceptions and differences as possible.

Although the 35.9% of GDP tax burden in Estonia in 2009 was lower than the average 39.3% of the European Union 27 countries, when viewing the number of countries with higher and lower tax burden, Estonia is exactly in the middle. In 2010, the tax burden in Estonia started to decrease again due to lower proceeds from the income tax of legal persons (profit distributions of both public and private enterprises reduced) and the excise duty on tobacco (influenced by stocking up).

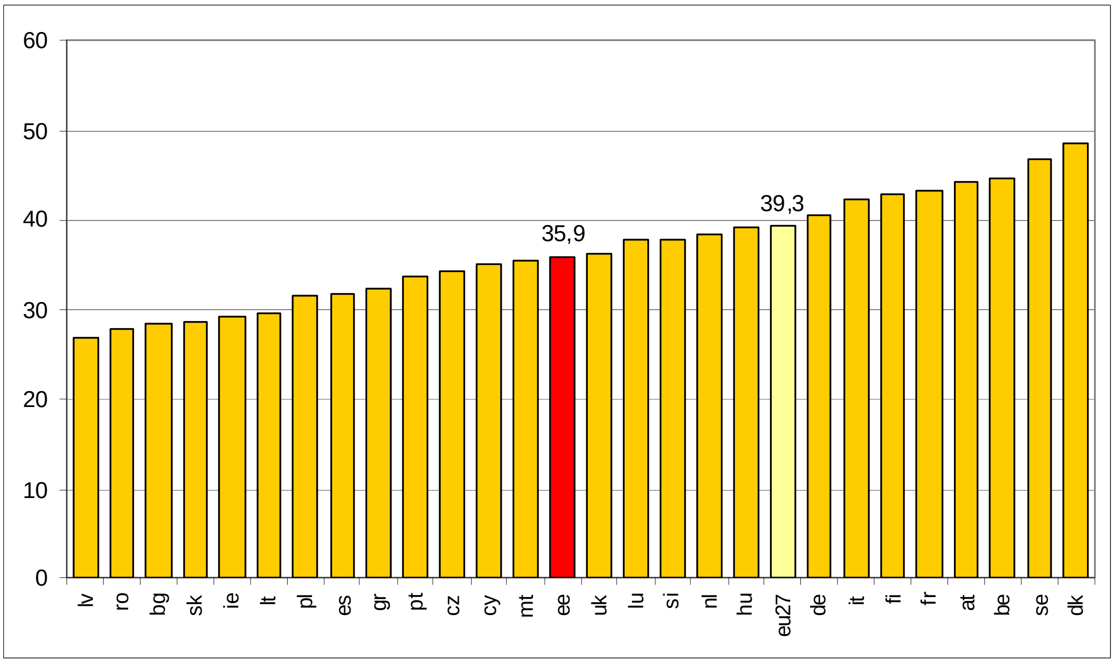
The objective is to take the tax burden to the pre-recession level by 2015 by reducing the workforce-related taxes.

The tax burden of 2011 will drop by 0.7% compared with the previous year, to 32.8% of GDP and by 2015, it will drop to 31.1% of GDP. The tax burden is reduced by both restoration of the state's payments of the mandatory funded pension by 2012 and higher state's payments to the ones who continued their payments. From tax political changes, the greatest impact on tax burden will be reduction of the income tax rate to 20%, but also reduction of the unemployment insurance premium rates and losing the obligation to pay social tax on remuneration exceeding 4000 EUR per month from 2014 (except health insurance).

Figure 16

Tax burden in 2009

(% of GDP)



Source: Eurostat.

Higher taxation of consumption and environment exploitation

Taxes that can be regarded as environment taxes in Estonia are fuel excise duty, excise duty on packaging, heavy goods vehicle tax, pollution charges and charges on the use of natural resources. Changing of the existing tax rates is not ruled out under the green tax reform.

Changes in taxation

The income tax rate will be reduced to 20% from 2015.

Laying down a maximum level to the pension insurance section of health insurance if remuneration exceeds 4,000 EUR from 2014.

Unemployment insurance premium rate will be reduced from 2013.

Rising of the tobacco excise duty. The tobacco excise duty rate was increased by 10% from January 2011 and it is planned to be additionally raised by 10% in the beginning of 2012 and 2013.

Taxing oil shale used for production of heat with an excise duty. Oil shale used for production of heat was taxed by an excise duty (0.15 EUR per GJ) from 1 January 2011.

Reducing differences in taxation

It is planned to critically overview and abolish the tax incentives that have withdrawn from their initial objective and turned out to be unjustified. For each tax incentive, it is viewed whether it is in proportion with the objective to be achieved, does it correspond to the society's expectations and needs and would this objective be best achieved through tax incentives. If necessary, the incentive will be provided for short term, giving an opportunity to analyse the effectiveness of the incentive in reaching the objective and to decide on the basis of an analysis whether it would be purposeful to continue with the incentive.

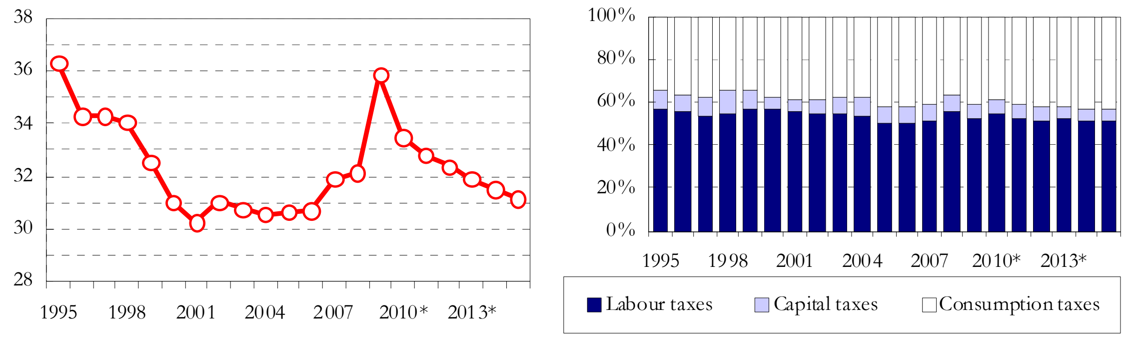
As a new initiative, income tax incentive maximum limit will be dropped to 1,920 EUR and reform for fuel marked with fiscal marker carried out.

Figure 17

Development of tax burden in Estonia

(% of GDP)

A.Tax burden **B. Tax revenues (%)**



Sources: Ministry of Finance, Eurostat.

Table 19

Main tax amendments in 2011 and 2012 influencing the state budget[12]

	Entry into force	Impact 2011		Impact 2012	
		mln EUR	*% of GDP*	*mln EUR*	*% of GDP*
Total tax revenues, incl.		**9.9**	**0.07**	**53.0**	**0.35**
1. Raising of the tobacco excise duty by 10%	1 January 2011	9.0	0.06	10.0	0.06
2. Taxation of oil shale used for production of heat with an excise duty (0.15 EUR per GJ)	1 January 2011	*0.9*	*0.01*	*1.0*	*0.01*
3. Raising of the tobacco excise duty by 10%	1 January 2012			*9.0*	*0.05*
4. Not taking expenses for formal education acquired within the adult education system as fringe benefit	1 January 2012			*5*	*0.03*
5. Reform of fuel marked with fiscal marker	1 January 2012			*28*	*0.2*

Source: Ministry of Finance.

[12] Influence compared to implementation of the rates/situation of 31.12.2010.

5.2.3. Tax expenditure

Below, tax expenditures in Estonian state budget on 2011–2015 have been described. In assessing the value of tax expenditure, the method of lost revenues will be used as well as cash-based data; for each tax expenditure, the delay time between implementation of the provision and its actual application has been taken into consideration. Only the so-called first round effects of implementation of tax expenditure have been assessed. For example, in implementation of additional basic exemption, its direct influence to receipt of income tax has been assessed, but not the fact that with additional basic exemption, more money is left for private persons and if they direct these additional means to consumption, more VAT will be received. As to the tax expenditure that is directly and unambiguously related to another taxes, the total impact of implementation of tax expenditure is viewed – for example, the tax expenditure from the Law of Excise Taxes of Alcohol, Tobacco and Fuel also influence receipt of VAT in the extent of the final consumption. Due to implementation of the lost revenues, no behavioural effects and budget limitations have been taken into consideration when assessing the value of tax expenditure – for example, it is presumed that consumption of goods and services is unit elastic (the relative change of amount is the same as the relative change of price).

In calculating the value of tax expenditure, it is important to understand that each tax expenditure provision has been assessed separately, regardless of the concurrences between the different provisions, and therefore finding the total amount of tax expenditure by adding up the different provisions is not correct, yet still enables to assess the level and trends of the implemented tax expenditure.

The important tax expenditures influencing state budget recovery of revenues are included in three legislations – the Income Tax Act, the Value Added Tax Act and the Law of Excise Taxes of Alcohol, Tobacco and Fuel. In the case of the Value Added Tax Act[13] (VATA), tax expenditures or important variations form the tax system taken as an objective are the provisions by which consumption of certain goods or services is supported by a lower tax rate. In the case of the Income Tax Act[14] (ITA), tax expenditure or important variations form the tax system taken as an objective are the provisions by which undertakers of certain fields, certain type of natural persons or families, natural persons making certain expenses or using certain services are supported by additional tax redemptions. It is presumed in the VATA that according to §23, the basic exemption deducted from the taxation period income of a certain natural person resident is a part of the tax system taken as an objective (and is not tax revenues itself). In the case of the Law of Excise Taxes of Alcohol, Tobacco and Fuel (LETATF), tax expenditures or important variations form the tax system taken as an objective are the provisions by which businesses in certain fields or production of certain goods is supported by more favourable excise duty rates or exemption form excise duty.

[13] Value Added Tax Act. (2008). – State Gazette (2003, 82, 554; 2007, 32, 259). [WWW] https://www.riigiteataja.ee/ert/act.jsp?id=12869417 (18.04.2008).

[14] Income Tax Act. (2008). – State Gazette (1999, 101, 903; 2007, 44, 318) – [WWW] https://www.riigiteataja.ee/ert/act.jsp?id=12851790 (18.04.2008).

Table 20

Tax expenditures in state budget for 2011–2015[15]

(mln EUR)

Tax expenditure	Provision	Governing function[16]	2011	2012	2013	2014	2015
1. 9% VAT rate on books and work exercise-books	VATA §15 (2) (1)	9	*3.1*	*3.2*	*3.3*	*3,5*	*3,6*
2. 9% VAT rate on medications and medicine equipment	VATA §15 (2) (2)	7	*10.2*	*10.8*	*11.3*	*12.0*	*12.6*
3. 9% VAT rate on periodical publications	VATA §15 (2) (3)	*8*	*3.0*	*3.1*	*3.3*	*3.5*	*3.6*
4. 9% VAT rate on accommodation services	VATA §15 (2) (4)	*8*	*11.4*	*11.9*	*12.4*	*13.0*	*13.5*
5. Additional basic exemption starting from second child	ITA §23¹	*10*	*25.7*	*26.6*	*27.4*	*28.3*	*29.1*
6. Additional basic exemption for pension	ITA §23²	*10*	*113.9*	*114.1*	*114.9*	*121.2*	*127.5*
7. Additional basic exemption for accident at work or occupational disease compensation	ITA §23³	*10*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*
8. Deduction of housing loan interests	ITA §25	*6*	*26.2*	*28.6*	*30.3*	*32.4*	*34.3*
9. Deduction of training expenses	ITA §26	*9*	*14.9*	*15.9*	*16.7*	*17.5*	*18.3*
10. Gifts and donations	ITA §27 (1)	*8*	*0.6*	*0.6*	*0.7*	*0.7*	*0.8*
11. Insurance payments and acquisition of pension fund shares	ITA §28	*10*	*6.5*	*6.9*	*7.3*	*7.8*	*8.2*
12. Additional basic exemption for a self-employed person in transfer of agricultural products or forest material	ITA §32 (4)	*4*	*2.8*	*2.8*	*2.8*	*2.8*	*2.8*
13. 50% excise duty rate on small brewers	LETATF §46 (1)	*4*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
14. Exemption of excise duty of biofuels	LETATF §27 (28) and (28¹); §66 (14⁸)	*4*	*1.0*	*1.0*	*1.1*	*1.1*	*1.1*
15. More favourable excise duty rate for special purpose diesel fuel and light heating oil	LETATF §66 (7)	*4*	*70.3*	*0.0**	*0.0*	*0.0*	*0.0*
16. Exemption from fuel excise duty of fishermen	LETATF §74²	*4*	*1.3*	*1.4*	*1.4*	*1.5*	*1.5*
TOTAL			***291.2***	***227.2***	***233.1***	***245.3***	***257.3***
% of GDP			***1.9%***	***1.4%***	***1.3%***	***1.3%***	***1.3%***
% of the state budget's taxable and non-taxable revenues			***4.9%***	***3.8%***	3.7%	3.9%	3.9%

**Transitional period may be implemented in 2012.*
Source: Ministry of Finance.

[15] The tax expenditure esitmates have been calculated for only the provisions that are included in the tax legislations as at 1.01.2011.

[16] Governing functions: 1. general government sector activities; 2. national defence; 3. law and order, safety; 4. economy; 5. environmental protection; 6. housing and utilities; 7. health; 8. leisure time, culture and religion; 9. education; 10. social protection.

The 2011–2015 state budget recovery of revenues are influenced by 16 provisions on different tax expenditures in the Income Tax Act, the Value Added Tax Act and the Law of Excise Taxes of Alcohol, Tobacco and Fuel. In total, the volume of the main tax expenditures in 2011 amounts to 291.2 million EUR or 1.9% of GDP. Tax expenditures make up 4.9% of the state budget's taxable and non-taxable revenues. From tax expenditures, additional exemption with the largest volume is for pensions, the lower excise duty rate than for diesel fuel is for special purpose diesel fuel and light heating oil, deduction of housing loan interests from the taxable revenues and additional exemption from the second child. The volume of the four largest tax expenditures in 2011 makes up 81% of the volume of all implemented tax expenditures. The largest tax change influencing tax expenditure is the reform of fuel marked with fiscal marker implemented from 2012, abolishing the more favourable excise duty rate of special purpose diesel fuel and light heating oil.

For analysing the tax expenditure by governing functions[17], a governing function with which the specific tax expenditure provision is related has been determined for each tax expenditure provision. The table below indicates that **six out of ten different governing functions is supported by tax expenditure in 2011–2015** (economic affairs; housing and community amenities; health; recreation, culture and religion; education; social protection). In 2011, the largest section is held by the governing functions „social protection“ (146.4 mln EUR or 50% of the volume of tax expenditures), "economic affairs“ (75.4 mln EUR or 26%) and „housing and community amenities" (26.2 mln EUR or 9%). The volumes of tax expenditure under the rest of the governing functions make up 43.2 mln EUR or 15% of the total volume of tax expenditure.

Tax expenditure may also be viewed as share of revenues of the corresponding tax. For value added tax, the tax expenditures (items 1–4 in the Table) in 2011 make up 27.7 mln EUR or 2.1% of the total VAT revenue. The corresponding tax expenditures (items 5–12 in the Table) formed on income tax received to state budget amount to 190.9 mln EUR or 87.2% and on the fuel excise duty (items 14–16 in the Table), 72.6 mln EUR or 19.8% of the revenues.

[17] Statistics Estonia. (2008d). Classifier of governing functions. – [WWW] http://metaweb.stat.ee/view_xml.htm?id=1129771&siteLanguage=ee (28.04.2008).

5.3. General government expenditures

5.3.1. Structure of general government expenditures

When in 2000–2007, the general government expenditures made up 35% of GDP on an average, then in 2008, they grew to 39.9% of GDP, in 2009, the growth continued to 45.2% of GDP and by 2010, this indicator had dropped to 40% of GDP.

The final consumption expenditure of the general government was on average 55% of the general government expenditure in 2000–2005; in the period of 2006–2010, it dropped to approximately 50% of the expenditure thanks to increase in social benefits. The general government's final consumption expenditure includes social consumption and individual consumption expenditure. For goods and services provided by the general government, individual and social goods and services are distinguished on the basis of the Classifications of the Functions of Government (COFOG). Under social consumption, goods and services offered simultaneously to all members of society or some part of society are regarded. For example, this involves expenditures for environmental protection and organisation of the public sector health system. Individual expenditure is expenditure on education and health, for example. In the case of general government, the individual consumption expenditure equals non-monetary social transfers.

Second largest section of the general government expenditure are social benefits. The largest expenditure sections among social benefits are pension expenditures and the expenditures of the health insurance fund for prevention of illnesses and promotion of health. The general government expenditures for payment of social benefits in the years 2000–2007 were 9% of GDP in average; by 2010, this increased to 12.9% of GDP.

2.6% of the general government expenditure, that is 1% of GDP was used for payment of subsidies in 2010. Subsidies are running autonomous payments that the producers receive from the general government or the institutions of the European Union. The purpose of these payments is to influence the level of production or prices or to compensate for the expenses related to production.

The smallest share is held by the expenditures on interests, forming only 0.4% of all general government expenditures or 0.1% of GDP in 2010. The small share of expenditures on interest payments is due to Estonia's low burden of debt.

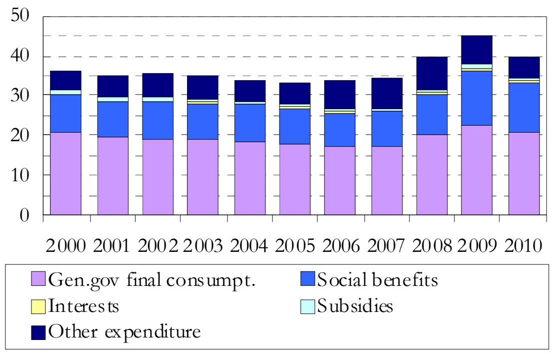
When to look at the expenditure by areas of activity, the share of expenditure on social protection is always the largest. These expenditures made up 10% of GDP on average in the period of 2001–2008 and increased to 15.6% of GDP by 2010. The share of all expenditures grew from the average 29% of 2001–2008 to 39% in 2010. Large part of the growth took place in 2009 when due to worsening of the labour market situation, expenditure on unemployment insurance benefits and unemployment benefits increased significantly; increase in pensions also played its part. In 2010, the expenditure on unemployment insurance benefits and unemployment benefits dropped, but the pension expenditures continued to rise. The share of all other expenditures remained near the average of 2001–2008 in 2010.

Figure 18

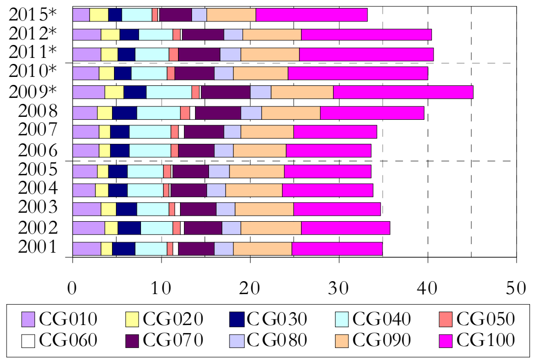
General government expenditures and their structure

(% of GDP)

A.Expenditure by economic content in Estonia



B. Expenditure by function in Estonia[18]



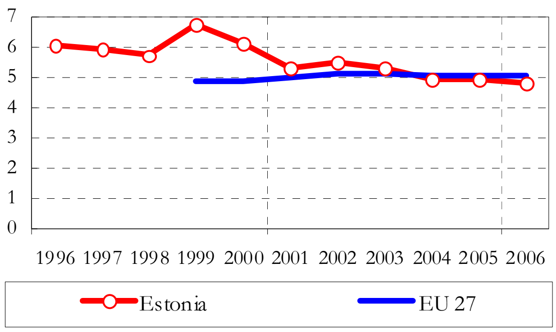
Sources: Eurostat, Statistics Estonia, Ministry of Finance.

Figure 19

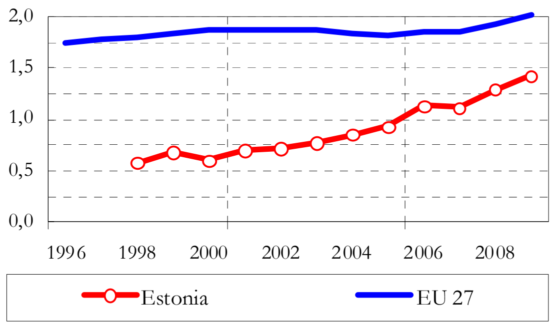
Government investments into physical and human capital

(% of GDP)

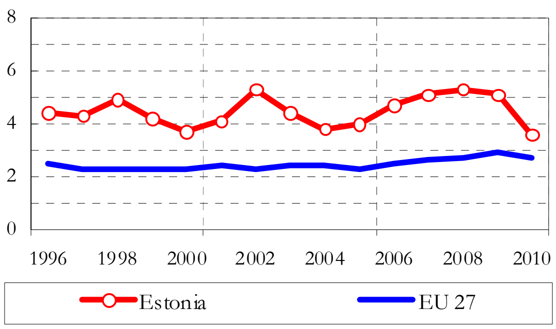
A.Public expenditure on education



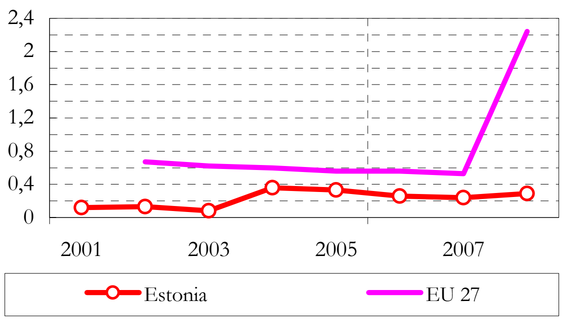
B.Research and development expenditure



C. Gross fixed capital formation of the gen. gov



D.State aid



Source: Eurostat.

---

18 CG010 – general public services; CG020 – national defence; CG030 – public order and safety; CG040 – economic affairs; CG050 – environmental protection; CG060 – housing and community amenitites; CG070 – health; CG080 – recreation, culture and religion; CG090 – education; CG100 – social protection.

5.3.2. Main changes in expenditure policies influencing the budget for 2011

The general government expenditure will decrease in the medium-term perspective from 40.0% of GDP in 2010 to 33.3% of GDP by 2015. This reduction is caused by smaller number of investments financed from foreign support in the conditions of a growing nominal GDP, and freezing of the operational costs of the state budget. There are also social transactions that are influenced (among others) by improvement in the labour market situation. The expenditures of the upcoming years are largely influenced by investments related to proceeds from international sales of emission quotas.

Table 21

General government expenditures by classification of the functions of the government (COFOG)

(% of GDP)

	COFOG code	2008	2009	2010*	2011*	2012*	2015*
1. General public services	1	2.9	3.7	3.0	3.0	3.0	1.9
2.National defence	2	1.7	2.2	1.8	1.9	2.0	2.0
3.Public order and safety	3	2.7	2.4	1.9	1.9	1.9	1.4
4.Econoic affairs	4	4.8	5.1	4.0	4.8	5.4	3.0
5.Environmental protection	5	1.1	1.0	0.8	0.8	0.9	0.5
6.Housing and community amenities	6	0.6	0.1	0.1	0.1	0.1	0.1
7.Health	7	5.2	5.6	4.5	4.6	4.6	4.0
8.Recreation, culture and religion	8	2.3	2.3	2.0	2.2	2.2	1.5
9.Education	9	6.7	7.0	6.3	6.4	6.4	5.6
10.Social protection	10	11.7	15.7	15.6	14.6	13.9	13.3
11.Total general government expenditures	**TE**	**39.9**	**45.2**	**40.0**	**40.3**	**40.4**	**33.3**

Sources: Eurostat, Statistics Estonia, Ministry of Finance.

General public services

General public services will increase in 2011, mainly due to growth of foreign instruments in projects related to regional development. By 2015, the expenditure will reduce to 1.9% of GDP.

National defence

The national defence expenditure will increase in 2011 compared to the 2010 in relation to the growth of defence expenditure share of GDP. By 2012, the expenditures will reach 2.0% of GDP and remain on that level until the end of the forecast period.

Public order and safety

The public order and safety expenditures will increase in 2011 and then drop to 1.4% of GDP by 2015, that is, to the expenditure level of 2010.

Economic affairs

The expenditures in the field of economy will increase significantly in 2011 in relation to the use of revenues from the sales of emission quota. The means will be directed to purchase of energy efficient means of transportation and development of wind energy. By 2015, the expenditure will reduce to 3.0% of GDP in relation to drop in foreign support.

Environmental protection

The expenditures in the field of environmental protection will increase in 2011 in relation to the larger usage of foreign support for water and waste management investments of the local governments. From the means received from sales of emission quota, it is planned to build combined power and heat plants using biomass, improvement of the district heating networks and establishing connections, as well as renovation of boiler plants, as a result of which the boiler plants will be taken to energy efficient heating management. In 2015, the expenditures will make up 0.5% of GDP.

Housing and community amenities

The housing and community amenities' expenditures will remain on the same level and make up 0.1% of GDP in 2015 as well. The means will mostly be directed to development of housing.

Health

The expenditures in the field of health will grow in 2011. Expenditures for national health insurance will also increase. The growth of expenditure in this field is significantly influenced by foreign-funded investments for the development of the hospital network. In 2015, the expenditure will make up 4.0% of GDP.

Recreation, culture and religion

The expenditures in this field will increase in 2011 in relation with several large-scale investments, the most important of which in 2011 are completion of the Estonian Maritime Museum and construction of the Estonian National Museum. In 2015, the expenditure will make up 1,5% of GDP.

Education

The expenditures in the field of education will grow in 2011. The largest of these expenditures are the ones in the field of higher education, vocational education, education support for local governments (expenditures of municipal schools) and the expenditures in the field of research and development. The volume of expenditures will increase in the upcoming years (although the share of GDP will decrease) and in 2015, the expenditure will form 5.6% of GDP.

Social protection

The social protection expenditure will increase slightly in 2011 in relation to the growth of pensions. At the same time, the Unemployment Insurance Fund's expenditures on unemployment insurance benefits and unemployment benefits will reduce. From the means from the sale of quotas, additional 13 social objects will be renovated in the field of social protection. The volume of expenditures will increase gradually (although the share of GDP will decrease) and by 2015, the expenditure will form 13.3% of GDP.

As an important new initiative, the expenditures are influenced by changing of the structure of state-commissioned education and contracting for additional student places, introduction of parent's pension, additional remuneration for Doctoral candidates and implementation of the principle of hobby payments, also making education allowances necessity-based.

6. LONG-TERM SUSTAINABILITY OF THE PUBLIC FINANCES

The assumptions of the long-term projections are in a general principle consistent with the commonly agreed assumptions for the entire EU agreed by the Economic Policy Committee of the EU, and coincide in broad terms with the vision of the long-term developments of the Ministry of Finance's. The time series has been adjusted in accordance with the macroeconomic development scenario presented in this programme and in the long term, a more conservative vision from, for example, labour market section has been taken assumed.

The impact of the receding economic crisis to the sustainability of the public finances is long-term and is expressed in the lower rates of employment and the level of output, while the impact on the long-term growth potential and growth rates is forecasted to stay minimal. The projections are based on no policy change scenario, wherefore these do not reflect the most likely future scenario but present the scale of the challenge accompanying the demographic trends that can be addressed by respective decisions.

There have been several steps taken to ensure long-term sustainability of the budget, including:

- keeping the fiscal policy conservative and avoiding considerable increase in the general government debt;
- reforming the pension system and promoting contributing to pre-financed pension schemes;
- increasing the retirement age and added flexibility to the pension index;
- ensuring better financial situation through policies aimed at economic growth and employment.

In 2008, new pension index was introduced for annual increasing of the pensions with an aim to ensure sufficient pension for the future, that is to at least maintain the relation between average wages and average pension in the long run. The new index is based on the growth in revenue from social tax more than before (80% of the growth in revenue from social tax + 20% of the annual inflation, instead of the former 50% + 50%) and according to the forecast it will increase pensions significantly more than the previous index. Also, in 2008, coefficients to the index for changing the shares of base pension and the length of employment score were applied in shaping a pension were also implemented, helping to increase the solidarity of the system. In adding the index to the legislation, also an obligation was added to analyse the sustainability of the public pensions once every five years and if necessary, change the pension index. The next analysis will be carried out in 2012.

Flexibility is also planned to the rule of indexation of pensions, manifested in a possibility to fix the pension index lower than the regular rate stipulated by law, if:

a) the real growth of GDP of the same year is negative, or
b) the difference between the state pension insurance expenditures and the estimated proceeds to the state pension insurance is more than 1% of the estimated GDP of the same year.

The difference between the regular rate of the index and the part of the index that is not increased/decreased will be settled in five years after the year of implementation of the changed index. The two-way flexibility of the system thus enables the latter compensation for lower increase in pension due to reduced index, and also one of the settlements reducing the regular rate of the index in the future if the regular index value is less than one (without nominally reducing pensions). In indexation of 2009, the Government of the Republic decided to limit the pension index with the level of 1.05 due to complicated financial situation. In 2010 and 2011, the lowest possible value 1.0 was taken as a value of the pension index and due to the actual dynamics of the index in the last years, it is estimated that the growth of the regular index should be reduced by 4.6 percentage points in the next five years.

As a crisis-time measure, it was decided to stop the II pension pillar payments in the period from 1 July 2009 to 31 December 2010. The main aim of this one-off and temporary measure was to direct the 4% of the joiners' social tax to the I pillar and to leave the additional 2% to be paid for people to use. Saving to the II pension pillar was resumed by halved rates for 2011 and the system will be restored completely in 2012. In the years 2014–2017, the state's part of the social tax directed to II pillar will be increased to 6% for those who voluntarily continued their payments in the interim period and for those who will submit a corresponding application in 2013. In the latter case, the individual payment rate will also rise to 3%.

In order to find additional means for financing the state pension insurance (and also health insurance), the initial idea of the pension reform was turned to, according to which the minimum social tax obligation was taken to the minimum monthly wage since 1 January 2009.

On 7 April 2010, the Riigikogu decided to approve the amendments to the national Pensions Act, according to which the retirement age will increase by three months from 2017, reaching 65 years of age by 2026 (the retirement age for men is currently 63 years and for women 61.5 years, increasing to 63 years by 2016). Here, the growth in life expectancy of the 63-year-olds by 2060 it is worth noting. Compared to 2010, the life expectancy is expected to grow by almost 6 years for 63-year-old women and 7 years for the men of the same age. The aim of the planned change is to ensure adequacy (the decision enables to pay approx. 5–10% higher pensions from 2026) and sustainability of the pension system, driven by the wish to support the decreasing labour supply as a result of demographic developments.

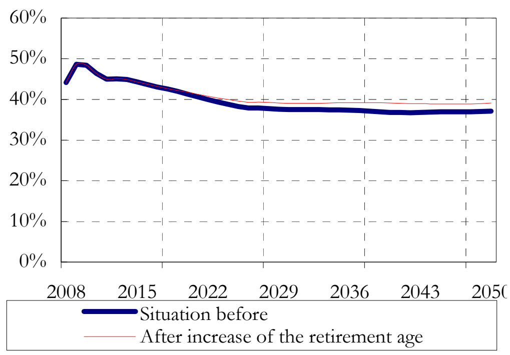
Increase in the retirement age also helped to improve the financial situation of the pension insurance in addition to the possibility of paying larger pensions in the future (see the graph below).

Figure 20

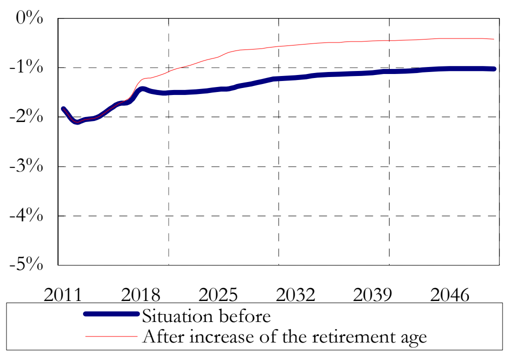
Impact of the increase in the retirement age to the financial indicators of the national pension insurance

(% of GDP)

A. Replacement rate (I+II pillar)



B. I pillar deficit



Source: Ministry of Finance

Table 22

Long-term sustainability of the public finances in 2010–2050

(% of GDP)

	2010	2015	2020	2030	2050
Total expenditure	**40.0%**	**33.3%**	**33.0%**	**32.5%**	**32.3%**
Pensions	8.6%	7.2%	6.8%	6.3%	6.1%
social security pensions	8.6%	7.2%	6.8%	6.3%	6.1%
old-age pension	7.4%	6.0%	5.6%	5.2%	5.3%
other (disability, survivors)	1.2%	1.2%	1.2%	1.1%	0.9%
occupational pensions (if in GG budget)	-	-	-	-	-
Health care	4.8%	4.4%	4.5%	4.5%	4.5%
Long-term care (previously part of health care expenditure)	0.1%	0.1%	0.1%	0.1%	0.1%
Interest expenditure	0.1%	0.4%	0.3%	0.3%	0.3%
Total revenue	**40.1%**	**34.3%**	**33.0%**	**32.5%**	**32.3%**
of which: interest revenues	1.1%	1.0%	0.9%	0.9%	0.9%
of which: social security contributions for pension	13.2%	10.5%	10.8	10.9	10.9
Pension reserve fund assets (I pillar)	0.0%	0.0%	0.0%	0.0%	0.0%
of which: consolidated public pension fund assets (assets other than government liabilities)	0.0%	0.0%	0.0%	0.0%	0.0%
Assumptions:					
Labour productivity growth	7.6%	2.6%	2.8%	2.6%	1.7%
Real GDP growth	3.1%	3.4%	3.3%	2.0%	0.5%
Participation rate, males (aged 20-64)	85.1%	85.4%	85.6%	86.2%	86.3%
Participation rate, females (aged 20-64)	77.0%	77.3%	77.4%	78.0%	78.1%
Total participation rate (aged 20-64)	81.1%	81.4%	81.6%	82.1%	82.2%
Unemployment rate	16.9%	8.0%	7.6%	7.3%	7.3%
Population aged 65+ over total population	17.1%	17.1%	18.8%	21.7%	27.4%

Source: Ministry of Finance, Statistics Estonia, EU Economic Policy Committee.

Activities for ensuring long-term sustainability of the pension insurance

In order to ensure sustainability of the public finances in the environment of an ageing population, Estonia has carried out the pension reform and established a three-pillar system (statutory national pension insurance, mandatory funded pension and additional supplementary private pension). During the reform, the decision was made to increase the retirement age and gradually equalise the retirement age of men and women. The women's' retirement age reaches the equal mark – 63 years – in 2016. According to the 2010 decision, the retirement age will continue to increase by 3 months each year after that deadline, reaching the age of 65 for both men and women by 2026. In the recent years, the average age of exiting the labour market has exceeded 62 years (reaching 62.6 years in 2009), being close to the nominal retirement age and exceeding the average of the European Union (61.4 years).

During last change of pension indexing, also a five-year cycle was prescribed after which the suitability of the pension indexes will be revised (from both the aspect of adequacy of pensions and the financial sustainability aspect). The next regular revision in 2012 is likely, since during the crisis the pension expenditure has increased in relation to the revenues (both general and in comparison with the ones received from social tax) and due to that, the long-term financial position of pension insurance has somewhat worsened.

Numerous special pensions (the Defence Forces, the police, etc.), early-retirement pension, old-age pensions under favourable conditions and superannuated pensions give an opportunity to retire before the retirement age. A plan for reforming payment of special pensions, old-age pensions under favourable conditions and superannuated pensions have received principal approval by the government.

7. INSTITUTIONAL FUNCTIONS

7.1. Development of the budgetary process

The latest developments of the budget process are related to the State Budget Strategy. One of the most important changes this year was combining the processes of preparing the Stability Programme and the State Budget Strategy. This was possible due to change of deadline of the Stability Programme.

The State Budget Strategy 2012–2015 approved in April 2011 stated the government priorities, objectives of field policies, indicators and their target levels. Fulfilling of the set objectives is monitored when preparing the budget strategy for the next period and reports on the execution of the budget. The State Budget Strategy 2012–2015 also includes an overview of fulfilling of the fiscal policy objectives set in the State Budget Strategy 2011–2014.

The methodologies for setting the objectives and measurers with an aim to synchronise the frameworks of strategical planning and budgeting will be developed further in the upcoming years. As a result of development activities, managers are given high-quality outcome information in a more systematic manner to increase the effectiveness and efficiency of the use of budget.

The State Budget Strategy 2012–2015 will be renewed in the spring of 2012, when medium-term budget frameworks will be set for policy areas.

7.2. Fiscal rules and institutions

Valid fiscal rules have had and still have an important role in achieving of the fiscal policy goals. In strategic development plans and all of the latest coalition agreements, the medium-term objective is a balanced budget (the „soft" rule so far adhered to by all governments), although no law stipulates the requirement of the budget balance (surplus) of the **general government or central government**. In 2011, it is planned to approve the amendments to the State Budget Act that also stipulate the requirement of a balanced budget at the legislative level.

Generally, however, the basis of Estonia's conservative fiscal policy comes from the Constitution of the Republic of Estonia. It stipulates that an initiator of a **state's budget** or its amendment proposal that prescribes reduction of revenues, increase in expenditures or reallocation of expenditure has to add financial calculations that indicate the sources of revenues needed for covering the expenditure. The Riigikogu may also not erase or reduce the expenditures accepted in the state's budget or its draft that has been stipulated by other laws.

The Constitution also limits expenditures if the Riigikogu has not accepted the state's budget by the beginning of the budgetary year – in this situation, expenditures may be made each month in the amount of up to one twelfth of the expenditures of the previous financial year. If the Riigikogu has not accepted the state's budget in two months after the beginning of the financial year, the President of the Republic has to announce extraordinary Riigikogu elections according to the Constitution.

On the basis of the Constitution, the State Budget Act has been enacted, setting down the procedure for preparation and accepting of the state's budget, at the same time significantly limiting the possibilities of increasing the debt burden and providing the procedure for making decisions as to the limit of reserves. The valid judicial area also states the rules for ensuring financial sustainability of other general government institutions in addition to the state.

Rules for maintaining the compulsory reserves

- The **State Budget Act designates the size of the cash reserve fund** annually**.**
- **Requirements** are set for the use of the health insurance fund's reserves (undivided profit, reserve capital and the risk reserve).
    - The legal reserve of the health insurance fund is the reserve formed of the budget funds of the health insurance fund for the reduction of the risk which macroeconomic changes may cause to health insurance system. The legal reserve amounts to 6% of the budget and each year, and at least one-fiftieth of the total budget of the health insurance fund and revenue from the social tax revenue prescribed for the payment of health insurance benefits is transferred to the legal reserve, until the amount of the legal reserve provided by the law is reached or restored. The legal reserve may only be used as an exception by an order of the Government of the republic on the proposal of the Minister of Social Affairs.
    - The risk reserve of the health insurance fund is the reserve formed of the budgetary funds of the health insurance fund in order to minimise the risks arising for the health insurance system from the obligations assumed. The size of the risk reserve is 2% of the health insurance budget of the health insurance fund and it may be used upon a decision of the supervisory board of the health insurance fund.
    - The undivided profit of the previous periods of the health insurance fund is allowed to be used in the extent of 30% during a financial year, but no more than 7% of the health services expenditure foreseen in the health insurance fund's budget the previous calendar year.
- The **legal reserve requirement** has also been **established for the unemployment insurance fund**, for the reduction of the risk which macroeconomic changes may cause to the unemployment

insurance system. The reserve must amount to at least 10% of the assets of the unemployment insurance fund. The legal reserve may only be used as an exception by a resolution of the supervisory board of the unemployment insurance fund if the assets of the trust fund of the unemployment insurance fund are insufficient. Before adopting the corresponding resolution, the supervisory board shall make a proposal to the Government of the Republic for increasing the rate of unemployment insurance payment to the level which ensures the receipt of funds which are sufficient in order to fulfil the objectives of the unemployment insurance fund.

Limitations for regulating the debt burden

- **State authorities are forbidden to take a loan**, use financial lease or take any other similar obligations. They are also not allowed to give securities and loans, make donations, buy shares, parts and any other holdings and acquire other financial assets, unless stated otherwise in the current Act or the state's budget.
- The **State Budget Act states the annual limits for the balance of budgetary loan and cash loan** (to be paid back within a year), **the balance of governmental loans given for performance of public duties and the volume of bridge financing**. In the State Budget Act of 2011, the volumes of limitations are as follows:
  - The maximum allowed budgetary loan balance is 1.47 mld EUR (approx. 10% of GDP) and maximum allowed cash loan balance 447 mln EUR (approximately 3% of GDP).
  - The maximum allowed balance of the loans granted by the Government of the Republic for performance of public duties is 447 mln EUR (approx. 3% of GDP).
  - The maximum allowed volume of foreign aid bridge financing is 383 mln EUR (approx. 2.5% of GDP).
  - The maximum allowed balance of the financing of expenditures exceeding state budget revenues received is 684 mln EUR (approx. 4.5% of GDP).
- The health insurance fund is only allowed to take a loan upon security on assets in its possession. **The health insurance fund is not allowed to give loans or secure a loan taken by other persons.**
- The unemployment insurance fund is only allowed to take a loan if the legal reserve assets are insufficient upon the security of its own assets or of the state. **The unemployment insurance fund is not allowed to give loans or secure a loan taken by other persons.**
- **The local governments have been established rules for assuming debt obligations.** In 2011, the local governments may assume long-term debt obligations in that extent of up to 60% of the net proceeds planned for the budgetary year (revenues from which the allocations from state budget intended for a specific purpose have been deducted) and only for co-financing and bridge financing of the investment projects funded solely on foreign support. Assuming these obligations shall be harmonised with the Ministry of Finance. Violations of the law is accompanied by sanctions, which is suspension of the income tax and equalisation funds allocated for the local government until the end of violation. Upon ending the violation, the suspended funds will be returned. In preparing the repayment schedules it needs to be taken into consideration that they may not exceed 20% of the net proceeds in any of the upcoming budgetary year.
- From 2012, the debt burden of a local government (difference between debt obligations and liquid assets) be 60% to 100% of the working income, depending on the level of the principal activity result. The similar limitation has also been extended to the registration unit of the local government (includes of the unit of the local government and the units depending on that unit).
- **There are rules imposed on the local governments for keeping the current expenditure and expenditures in balance.** The value of the main activity of the local government unit's and the registration unit of the local government unit's main activity has to be zero or positive.
- **There are loan limitations imposed to foundations established with state participation.** A foundation with state participation may take a loan and enter into financial lease contracts only upon the unitary decision of the members of the supervisory board.

In addition to limitations for taking loans, there are also limits for assuming obligations at the expense of the upcoming years. For example, state authorities may enter into contracts for purchasing items or ordering services, incl. construction works at the expense of the upcoming financial years only on the condition that the volume of contractual payments to be made in the upcoming financial years would not exceed 50% of the sum of the corresponding item of expenditure foreseen for the current financial year. The annual **State Budget Act also establishes the rates of all budgetary grants**, thus excluding the possibility of growing the rated of budgetary grants without the corresponding budgetary cover.

Fiscal institutions

- From Estonian **fiscal institutions**[19]the National Audit Office may be brought out, being independent in its activity and assessing the legality and efficiency of the use of public sector funds through economic control (audit). During the audit, the different aspects of the instructions are assessed, for example, internal audit, financial management, economic activity, productivity of management, organisation and activities, and reliability of information technology systems.

  The National Audit Office shall provide an assessment to the consolidated annual report of the state prepared by the Ministry of Finance and including all state accounting entities, as well as to the annual reports of constitutional institutions. In both cases, the conformity of the reports to the Accounting Act and the legality of the transactions in the report are analysed. The assessment of the consolidated annual report of the state will be sent to the Government of the republic for approval, after which it will be presented to the Riigikogu for ratification.

  The National Audit Office's audits and the proposals present a better overview for the Riigikogu and the Government of the Republic, as well as the taxpayer, of functioning of the public sector; on the other hand, the National Audit Office's suggestions should benefit improvement of efficiency in the public sector. In total, this should improve the quality of financing of the state.

[19] According to the European Commission definition, fiscal institutions are the institutions that (1) (regularly) analyse, assess or provide suggestions on the fiscal policy of a state, (2) prepare independent budget revenue forecasts or forecasts that are used as comparison material for the government forecasts. These instituions also have to be funded from the public sector funds.

ANNEXES

Annex 1. Main economic indicators of Estonia in 2001–2010

Table 23

Gross domestic product in 2001–2010

	2001 *mln EUR*	2001 *%*	2002 *%*	2003 *%*	2004 *%*	2005 *%*	2006 *%*	2007 *%*	2008 *%*	2009 *%*	2010 *%*
1. Real GDP	3 580.2	7.5	7.9	7.6	7.2	9.4	10.6	6.9	-5.1	-13.9	3.1
2. Nominal GDP	3 802.4	13.2	11.6	12.1	11.1	15.5	19.8	18.2	1.8	-13.9	4.6
Sources of growth											
3. Private consumption expenditure (incl. non-profit institutions)	3 660.2	7.1	10.3	8.7	9.5	9.8	13.7	8.6	-5.4	-18.4	-1.9
4. Government final consumption expenditure	1 248.0	2.6	2.6	0.8	2.0	-0.2	3.9	3.9	3.8	0.0	-2.1
5. Gross fixed capital formation	1 740.3	9.7	24.0	18.6	5.2	15.4	23.2	6.0	-15.0	-33.0	-9.1
6. Changes in inventories (% of the GDP)		1.5	2.6	1.6	2.2	1.7	2.7	5.2	0.8	-2.9	1.3
7. Export of goods and services	5 234.2	0.4	-1.0	7.4	14.6	18.6	6.7	1.5	0.4	-18.7	21.7
8. Import of goods and services	5 624.4	3.5	6.2	10.1	14.4	17.5	13.3	7.8	-7.0	-32.6	21.0
Contributions to GDP growth [1)]											
9. Domestic demand (excl. stocks)		7.0	12.6	10.6	7.3	10.2	15.7	7.5	-7.5	-19.6	-3.4
10. Changes in inventories		0.5	-0.2	-0.2	0.6	-0.2	1.5	3.0	-4.2	-3.4	4.2
11. Balance on goods and services		-2.7	-5.9	-2.6	-0.9	-0.5	-6.0	-5.4	5.7	11.3	1.7
Growth of value added											
12. Primary sector	251.7	-5.1	10.7	3.7	-9.3	-3.2	-3.3	1.6	3.4	5.5	7.3
13. Industry	1 335.8	10.4	6.9	10.2	8.7	10.3	11.5	4.5	-4.9	-22.7	19.2
14. Construction	312.3	2.2	11.2	0.6	9.8	22.0	19.6	14.0	-7.8	-29.7	-10.1
15. Other services	4 723.0	7.9	7.9	7.5	7.5	8.9	10.2	7.3	-5.2	-10.7	-0.3

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 slight difference is a statistical error – the part of GDP that could not be divided between the fields).

Source: Ministry of Finance, Statistics Estonia.

Table 24

Prices in 2001–2010

(per cent)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1. GDP deflator	5.3	3.3	4.2	3.6	5.5	8.3	10.5	7.2	-0.1	1.5
2. Private consumption deflator	6.2	2.7	2.1	2.0	3.6	5.0	7.5	8.6	-0.9	2.0
3. Harmonised consumer price index	5.6	3.6	1.4	3.0	4.1	4.4	6.7	10.6	0.2	2.7
3a. Consumer price index	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.4	-0.1	3.0
4. Public consumption deflator	5.0	6.5	10.6	5.0	12.7	8.6	17.3	14.2	-2.7	0.1
5. Investment deflator	6.0	1.0	0.5	3.3	4.0	9.0	6.8	-0.6	-3.3	-0.5
6. Export price deflator	6.3	0.2	1.8	2.3	3.6	5.0	8.3	7.3	-4.3	4.1
7. Import price deflator	2.0	-0.1	-0.2	1.5	3.3	4.1	3.3	5.9	-1.1	5.7

Source: Ministry of Finance, Statistics Estonia.

Table 25

Labour market in 2001-2010

	2001	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
		%	%	%	%	%	%	%	%	%	%
1. Employment, persons	577.7 [1)]	0.9	1.4	1.5	0.2	2.0	6.4	1.4	0.2	-9.2	-4.2
3. Unemployment rate	12.6	12.6	10.3	10.0	9.7	7.9	5.9	4.7	5.5	13.8	16.9
4. Labour productivity by the number of the employed	11.5 [2)]	6.5	6.5	6.0	7.0	7.3	3.9	5.4	-5.2	-5.1	7.6
6. Compensations for employees	3 106.1 [2)]	11.5	10.7	12.3	11.2	15.1	20.2	24.1	11.9	-13.3	-5.1
7. Compensation per employee (6./1.)	84.1 [3)]	10.5	9.2	10.6	11.0	12.8	13.0	22.4	11.7	-4.5	-1.0
7a. Average gross monthly wages, EEK	352.2	12.3	11.5	9.4	8.4	10.8	16.5	20.5	13.9	-5.0	0.9

Thousand people.
2) Mln EEK.
3) Thousand EEK.
Source: Ministry of Finance, Statistics Estonia.

Table 26

Balance of payments in 2001–2010

(% of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1. Net lending / borrowing *vis-à-vis* the rest of the world	-4.9	-10.1	-10.6	-10.6	-9.2	-13.2	-16.2	-8.7	7.3	6.8
incl. - Balance of goods and services	-2.1	-7.0	-7.4	-7.0	-6.4	-10.6	-11.3	-5.6	5.7	7.6
- Balance of incomes and transfers	-3.1	-3.6	-3.9	-4.3	-3.6	-4.8	-5.9	-4.1	-1.1	-4.0
- Capital account	0.2	0.5	0.7	0.7	0.8	2.2	1.0	1.0	2.8	3.3
1a. Current account	-5.2	-10.6	-11.3	-11.3	-10.0	-15.3	-17.2	-9.7	4.5	3.6
4. Errors and specifications	-0.1	0.6	-0.6	-1.4	1.0	-1.1	1.0	0.9	-0.7	-0.4

Source: Ministry of Finance, Bank of Estonia, Statistics Estonia.

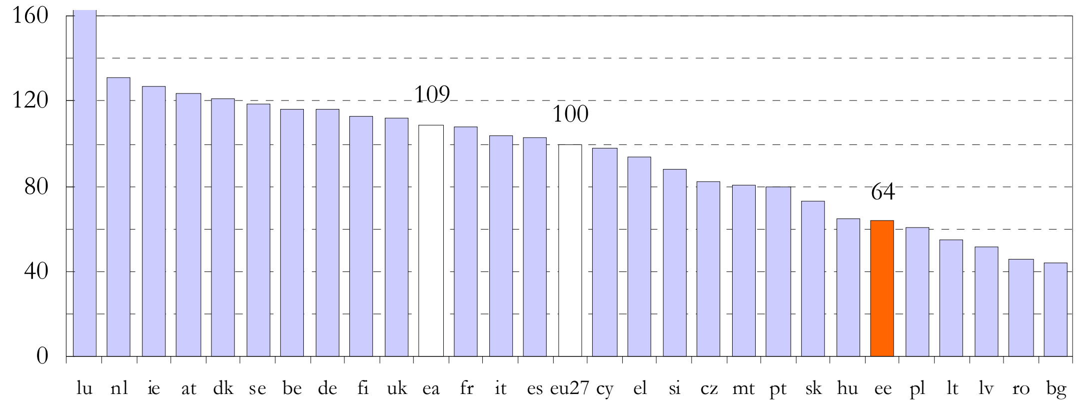
Annex 2. Comparison of Estonia with other EU Member States

Figure 21

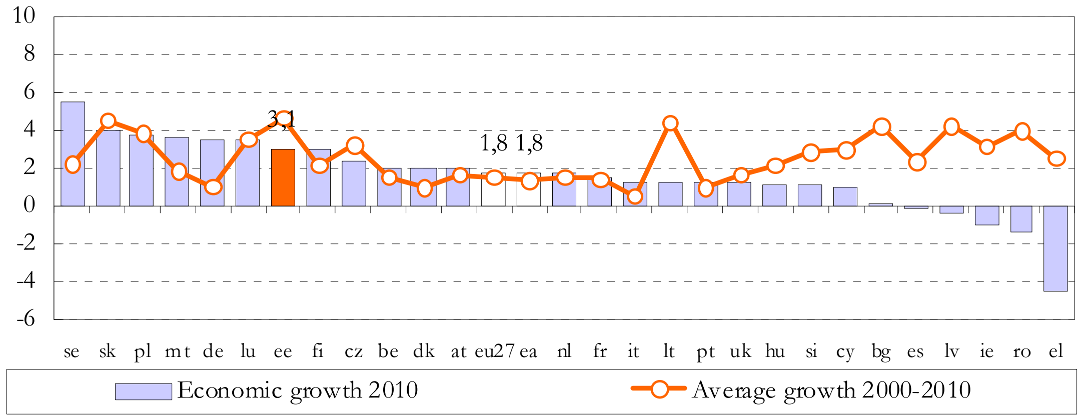
Main macroeconomic indicators

(per cent)

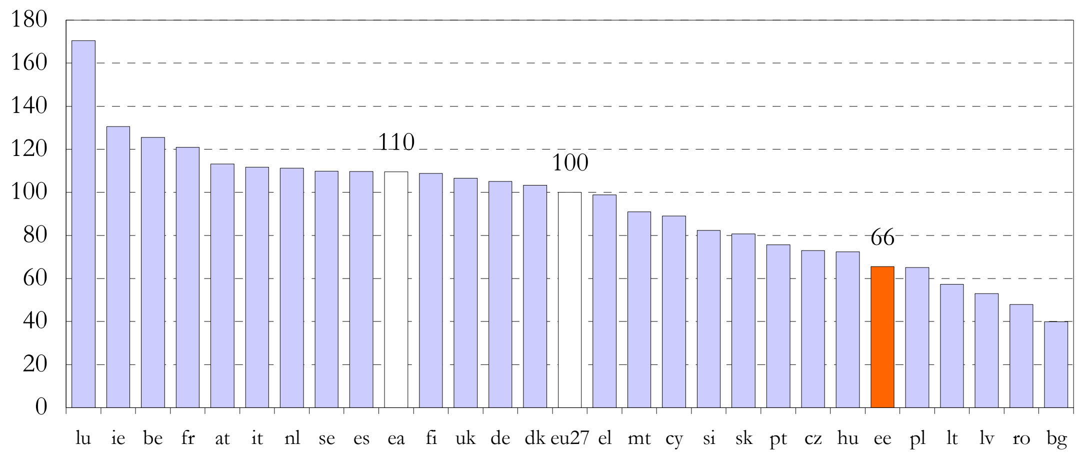
A. GDP *per capita* in purchasing power parities in 2009 (EU27=100)



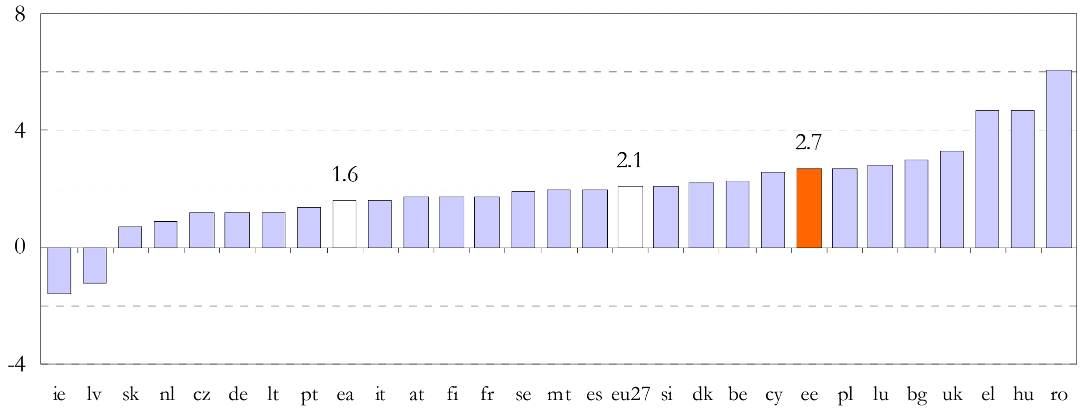
B. Economic growth in 2010 and 2000–2010



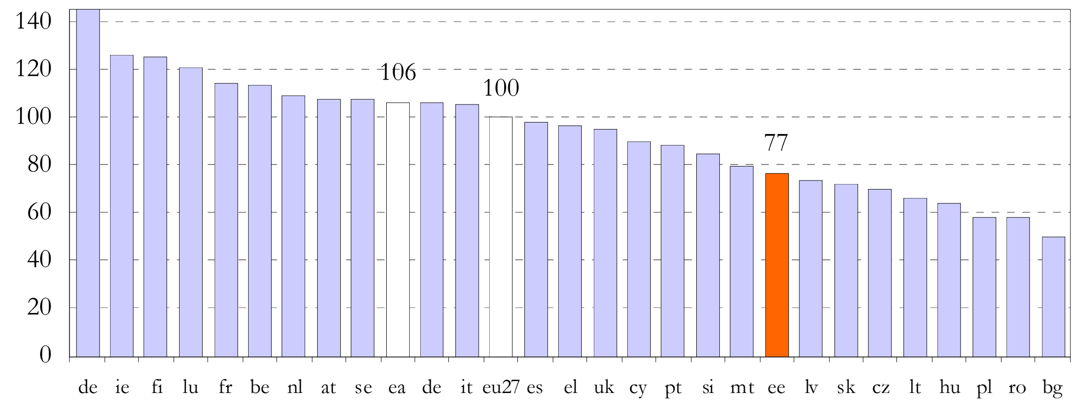
C. Labour productivity – GDP in purchasing power parities per person employed in 2009 (EU27=100)



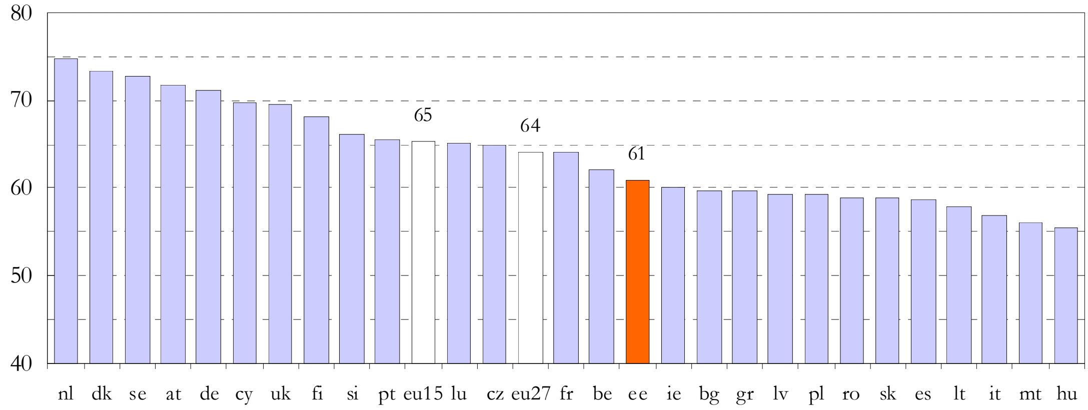
D. Harmonised index of consumer prices in 2010



E.Comparative price level to EU27 average in 2010 (EU27=100)



F. Employment rate (15–64 years old) in 2010



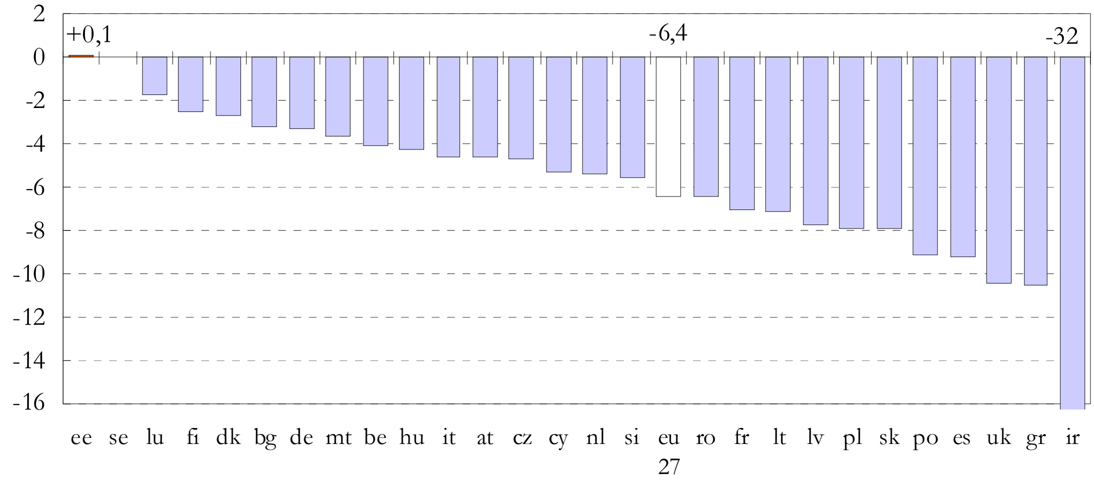
Sources: Eurostat, Statistics Estonia, Ministry of Finance.

Figure 22

Government fiscal position

(% of GDP)

A. General government budgetary position in 2010



B. General government debt in 2010

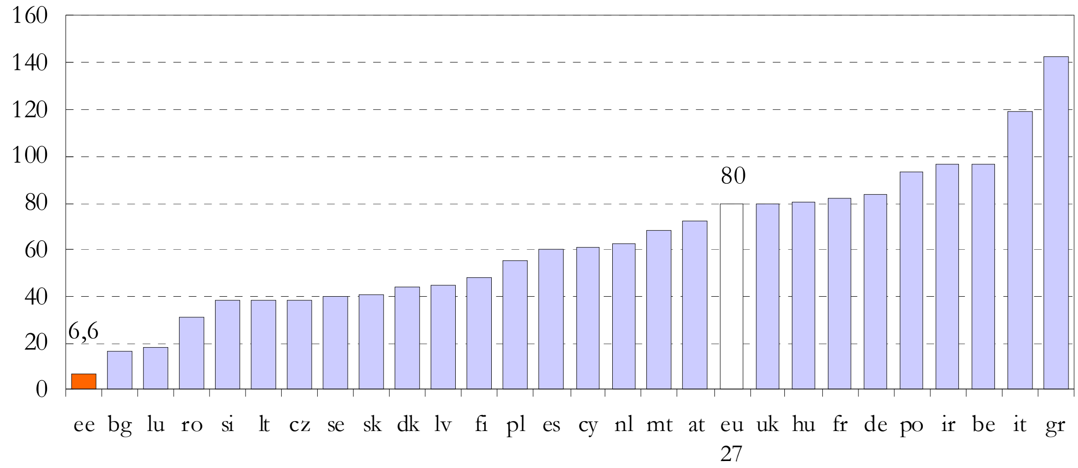
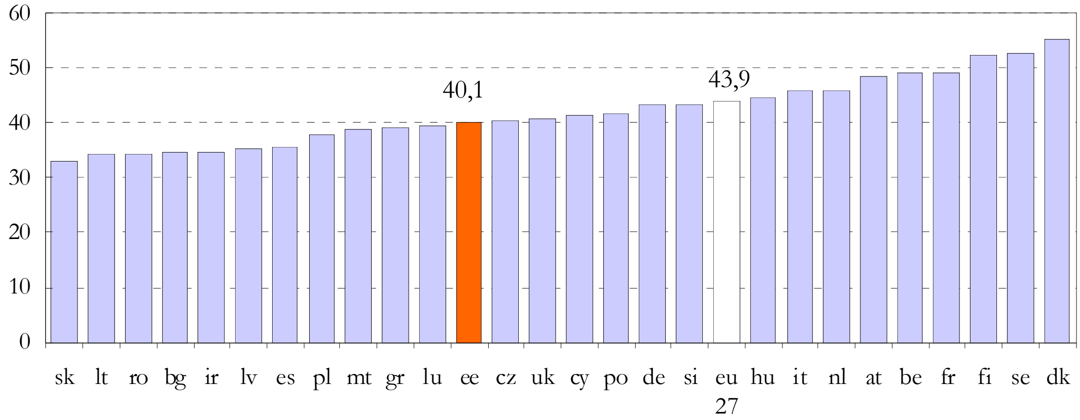


Figure 23

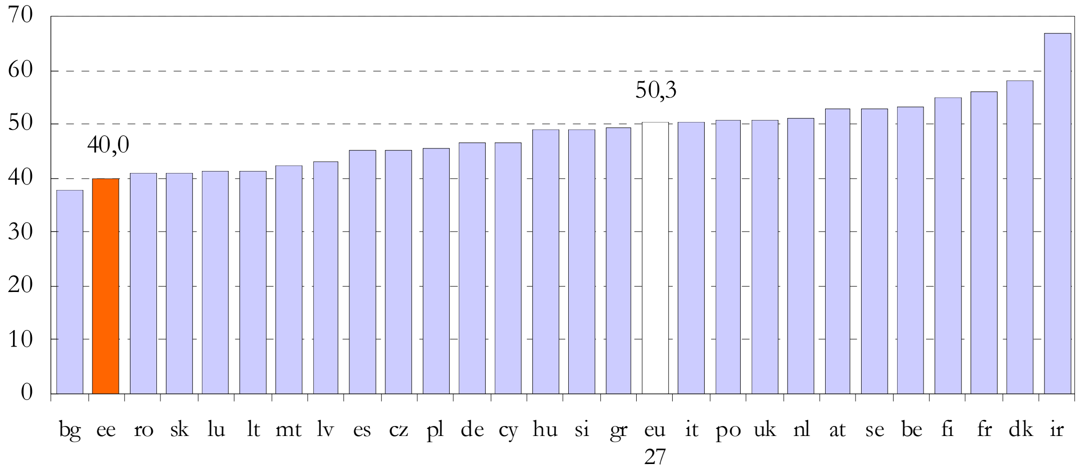
General government revenue and expenditure

(% of GDP)

A. General government revenues in 2010



B. General government expenditures in 2010



Sources: Eurostat

Annex 3. Influence of administrative price growth on CPI

Table 27

Influence of administrative price increases on CPI in 2010–2014

(per cent)

Administrative actions	Enforcement	Price increase (%)	Influence on CPI (% points)				
			2010	2011*	2012*	2013*	2014*
Change in tax policies			**1.16**	**0.32**	**0.07**	**0.07**	**0.00**
Notary fees	1.06.2009		0.03	-	-	-	-
VAT rate from 18% to 20%*	1.07.2009	1,7	0.50	-	-	-	-
Increase of excise duty on motor fuel	1.07.2009	4,9	0.12	-	-	-	-
Increase of excise duty on motor fuel	1.01.2010	3,2	0.16	-	-	-	-
Increase of excise duty on diesel oil for special purposes (64%)	1.01.2010		0.02	-	-	-	-
Increase of excise duty on tobacco (5%) + implementation of a minimum excise duty	1.01.2010	7.0	0.07	0.08	-	-	-
Increase of excise duty on alcohol (10%)	1.01.2010	3.0	0.17	-	-	-	-
VAT rate of hygiene products, diapers from 9% to 20%	1.04.2010	10.1	0.02	-	-	-	-
Sales tax in Tallinn **	1.06.2010	0.8	0.05	0.05	-	-	-
Increase of excise duty on metal cans	19.06.2010		0.02	0.01	-	-	-
Increase of excise duty on tobacco (10%)	1.01.2011	7.5	-	0.13	0.04	-	-
Increase of excise duty on tobacco (10%)	1.01.2012	7.5	-	-	0.13	0.04	-
Excise duty on oil shale for heating purposes	1.01.2011; 2013		-	0.02	-	0.03	-
Increase of state fee (ID-card)	1.01.2011		-	0.03	-	-	-
Abolition of Tallinn sales tax	1.01.2012		-	-	-0.10	-	-
Other administrative price changes			**0.47**	**0.34**	**0.53**	**0.78**	**0.29**
Collection of household waste**	2010–2014		-0.03	0.01	0.04	0.04	0.03
Electricity (incl. decrease of environmental fees)	1.08.2009	-3.0	-0.05	-	-	-	
Electricity (renewable energy fee, excise duty, increase of network fees)	1.01; 1.03.2010	7.7	0.23	0.01	-	-	
Electricity (decrease of electric energy prices)	1.04.2010	-1.2	-0.03	-0.01	-	-	
Electricity (increase of network fees)	1.06.2010	2.8	0.05	0.04	-	-	
Electricity (decrease of renewable energy fee)	1.01.2011	-2.0	-	-0.08	-	-	
Electricity**	2011–2014		-	0.04	0.12	0,60	0.12
Price increase of water and sewerage in Tallinn	1.01 (2010–14)		-0.01	0.00	0.01	0.02	0.02
Natural gas	1.10.2009	-6.0	-0.01	-	-	-	
Natural gas	1.05.2010	14.4	0.05	0.02	-	-	
Natural gas	1.09.2010	13.8	0.02	0.04	-	-	
Natural gas	1.01.2011	-10.0	-	-0.06	-	-	
Natural gas**	2011–2014		-	0.09	0.07	0.02	0.02
Heat price in Tallinn and elsewhere**	1.01.–1.12.2010	*5.5*	0.25	-	-	-	
Heat price in Tallinn and elsewhere**	1.01.–1.12.2011	*5.0*	-	0.24	-	-	
Heat price in Tallinn and elsewhere**	1.01.–1.12.2012	*6.0*	-	-	0.29	-	
Heat price in Tallinn and elsewhere**	1.01.–1.12.2013	*2.0*	-	-	-	0.10	
Heat price in Tallinn and elsewhere**	1.01.–1.12.2014	*2.0*	-	-	-	-	0.10
Total			**1.63**	**0.66**	**0.60**	**0.85**	**0.29**

** Actual effect from the rise of VAT on consumer prices.*
***Evaluation of the Ministry of Finance.*
Source: Ministry of Finance, Statistics Estonia, Eesti Energia, Estonian Competition Authority.