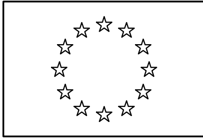

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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CONVERGENCE PROGRAMME OF ESTONIA
(2004-2008)
AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The Estonian convergence programme was submitted to the European Commission on 13 May 2004. It covers the period 2004-2008. The first Estonian convergence programme incorporates the measures taken in the budget for 2004, and is consistent with the State Budget Strategy 2004-2008. It was formally adopted by the Council of Ministers and thus represents the country's official medium-term macro-economic framework. The policy measures are consistent with the medium-term economic outlook as presented in the 2003 pre-accession economic programme (PEP). The programme spells out Estonia's intention to join ERM II and adopt the euro 'as soon as possible'. It claims that Estonia will be able to meet the criteria for euro zone membership throughout the programme period, but cautiously raises a caveat on future inflation developments (at present, inflation is below that of the euro zone) .

The programme largely complies with the "Code of Conduct on the content and format of stability and convergence programmes"[2]. Following a revision of the National Accounts which was published shortly after submission of the programme, GDP figures for the 1993-2003 period were revised upwards. Consequently, some of the figures and tables of the programme are by now outdated. Nonetheless, the overall picture and the assessment of the scenarios as they stand are not affected, given that the underlying trends of the projections do not change substantially.

A balanced government budget and the currency board arrangement are set to remain the anchors of macroeconomic stability in Estonia. The programme envisages steady real GDP growth between 5 and 6% p.a., driven by continued strong domestic demand and exports set to accelerate with the projected pick-up in external activity. Nonetheless, the net external contribution is expected to remain negative over the entire programme period. Both private consumption and investment are set to continue growing, albeit at a slowing pace. Unemployment would slowly abate to around 9.5% of the labour force. The envisaged recovery in the world economy and the resulting pick-up in export demand are expected to lead to a narrowing of the high current account deficit, which nonetheless is forecast to remain above 8% of GDP by 2008.

The macro-economic scenario appears broadly plausible. For the years 2004 and 2005, expected GDP growth is marginally below the Commission Spring forecast, while inflation is projected slightly higher. As compared with the 2003 PEP, the macro-economic scenario is somewhat lower with regard to GDP growth, accommodating the delay to the international economic recovery that has since set in, while the inflation and the unemployment outlook have improved on the basis of a better-than-expected turnout in 2003. The upcoming upward adjustment of growth figures in the Estonian forecast, following the National Accounts revision of 20 May 2004, adds to the plausibility of the scenarios as presented in the programme. A high external account deficit will continue to

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[1] This assessment has been carried out on the basis of information available as of 16 June 2004.

[2] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 - REV 1 of 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

The programme uses ESA95 data. It contains the tables required in Annexes 1 and 3 of the "Code of Conduct", and broadly complies with the model structure in its Annex 2.

be the major macro-economic imbalance in Estonia over the foreseeable future, given the strong investment needs in the economy. The programme deals with this issue in detail. With the general government budget forecast to remain in small surplus or balance throughout the programme period, the stance of budgetary policy is basically set to underpin the improvement in the current account, but to a considerably more limited extent than was the case in 2002 and 2003. Strict budgetary discipline, including the setting aside of possible 'surprise surpluses' will thus continue to be a crucial element to a sustainable correction of the external imbalance.

The currency board system in place since the country's independence – with the kroon pegged first to the DM and, since 1999, to the euro -, has served the country well and provides for high credibility among market participants. The monetary targeting through a hard peg to a strengthening euro helped to disinflate the Estonian economy quite rapidly, to an annual CPI increase of just 1.3% in 2003, but that rate is set to rise to around 3% over the medium term. Estonian interest rates are at a historical low, mirroring developments in the euro area and favourable international country ratings. Estonia aims at joining ERM II at an early stage, with a standard fluctuation band, while maintaining a unilateral commitment to the present currency board system. Also adoption of the euro is envisaged 'as soon as possible'.

The budgetary strategy as outlined in the programme is for the general government accounts to remain in surplus of 0.7% of GDP in 2004, and arrive at balanced budgets from 2005 onwards. This is slightly more optimistic than the 2003 PEP scenario which indicated no more surpluses already from 2004, and in line with the Commission forecast until 2005. On the whole, this implies a considerable fiscal easing as compared with the surprisingly high 2003 surplus. The programme contains a firm commitment to adhere to the rules of the Stability and Growth Pact, and to maintain the government accounts in balance or surplus over the entire programme period. An ongoing reform of the tax system aims at a stepwise reduction of the flat tax rates for both the corporate and personal income tax, which will be combined with higher social transfers and increased tax allowances. Strong growth, savings on the expenditure side, increased VAT and excise duty revenues, along with changes to the spending structure and improved tax collection are expected to finance these reforms. Overall, while nominal spending is expected to increase, the expenditure ratio would decline. While the central government and the social security funds are projected to remain in surplus over the programme period (despite considerable transfer payments to a private second pension pillar of up to 1% of GDP), local governments are expected to remain in deficit, even if the latter should narrow. Public debt corresponded to 5.8% of GDP in 2003 and is projected to further decline to just 3.2% of GDP by 2008. It is entirely covered by public sector reserves and represents a negligible risk to the Estonian economy.

The fiscal projections of the programme appear on the whole plausible, although the actual budgetary outcome may prove better than projected. This view is based in particular on a strong track record of prudent forecasting (and repeated overshooting of fiscal targets) in the past few years, a realistic growth forecast underpinning the programme's budget projections, possible further carry-over effects from the high 2003 surplus, slower-than-expected implementation of public investment spending based on EU transfers, but also the downward correction of deficit and debt ratios following the recent National Accounts revision. Downside risks, while not deemed acute from today's perspective, may nevertheless occur from a revenue shortfall due to the planned tax cuts, or adverse growth developments stemming from exogenous shocks. The swift melting of budgetary surpluses in 2004 and 2005 which would coincide with a projected

acceleration of economic activity is likely to lead to a distinct pro-cyclical stance of the fiscal path envisaged in the programme. Furthermore, should an orderly and sequenced reduction of the external imbalance not materialise through a recovery of private domestic savings (as the programme suggests), a fiscal policy aiming at balanced budgets might not be sufficient to support the planned correction of the current account deficit.

The programme clearly spells out the country's intention to comply with the goals of the Lisbon strategy by 2010. Employment ratios should be increased both by reforms to vocational training and a reduction of income taxes on labour. The need for a broadening of the supply base of the economy (and of the tax base at the same time) will be addressed through infrastructure improvements as well as measures in education in order to decrease the present skills mismatch on the labour market. The low level of productivity will be addressed through stimulating R&D both in the private and public sphere, in order to further enhance the economy's growth development. With regard to public finances, the programme aims at implementing structural reforms both to the expenditure and revenue side. The reforms on the expenditure side aim in particular at a better targeting of social transfers towards the needy and a strengthening of incentives to work. On the revenue side, the comprehensive tax reform that has started in 2004 will gradually lead to a further shift from direct to indirect taxation, while maintaining a simple tax system. The reforms, most of which are already underway, can reasonably be expected to strengthen incentives to work, to create new jobs and to discourage tax evasion.

Estonia is well placed to meet the projected budgetary costs of an ageing population. The considerable cost of implementing a fully funded private second pillar in the pension system is accounted for in the budgetary projections of the programme. A low government debt level, considerable government financial reserves and a medium-term budgetary strategy that is fully consistent with the objective of a close-to-balance or in surplus budgetary position, together with the reforms of the pension and health care systems which are meant to stem budgetary pressures in the longer term, should ensure that public finances remain on a sustainable footing.

Table 1: *Comparison of key macroeconomic and budgetary projections*

		2003	2004	2005	2006	2007	2008
Real GDP (% change)	**CP**	**4.7**	**5.3**	**5.8**	**5.6**	**5,9**	**5.8**
	COM	4.8	5.4	5.9	n.a.	n.a.	n.a.
	PEP	*4.5*	*5.6*	*6.0*	*6.0*	*6.0*	*n.a.*
HICP inflation (%)	**CP**	**1.3**	**3.1**	**3.0**	**2.8**	**2.8**	**2.8**
	COM	1.4	2.8	2.9	n.a.	n.a.	n.a.
	PEP	*1.7*	*3.8*	*3.4*	*3.2*	*2.8*	*n.a.*
General government balance (% of GDP)	**CP**	**2.6**	**0.7**	**0.0**	**0.0**	**0.0**	**0.0**
	COM	2.6	0.7	0.0	n.a.	n.a.	n.a.
	PEP	*0.4*	*0.0*	*0.0*	*0.0*	*0.0*	*n.a.*
Primary balance (% of GDP)	**CP**	**2.9**	**1.0**	**0.3**	**0.3**	**0.3**	**0.3**
	COM	2.9	1.0	0.3	n.a.	n.a.	n.a.
	PEP	*0.7*	*0.3*	*0.3*	*0.3*	*0.3*	*n.a.*
Government gross debt (% of GDP)	**CP**	**5.8**	**5.4**	**5.1**	**4.7**	**3.4**	**3.2**
	COM	5.8	5.4	5.3	n.a.	n.a.	n.a.
	PEP	*5.5*	*5.2*	*4.9*	*4.6*	*3.1.*	*n.a.*
Sources: *Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)*							

1. INTRODUCTION

The Estonian convergence programme was submitted on 13 May 2004. It covers the period 2003-2008. The programme was approved by the Council of Ministers, and thus constitutes a firm political commitment as the official medium-term macro-economic framework programme of the Estonian government. The Estonian convergence programme largely complies with the "Code of Conduct on the content and format of stability and convergence programmes"[3]. The data are generally in line with the ESA95 standards.

The programme contains a firm commitment to adhere to the rules of the Stability and Growth Pact, and to maintain the fiscal accounts in balance or surplus over the entire programme period. The budgetary strategy as outlined in the programme projects the general government accounts to remain in surplus in 2004, and to arrive at a balanced budget position from 2005 onwards. This deviates slightly from the 2003 PEP scenario which indicated no more surpluses already from 2004. The programme incorporates an ongoing reform of the tax system, with a stepwise reduction of the flat tax rates for both the corporate and personal income tax, combined with increased transfer payments and tax allowances. Primarily strong growth, but also savings on some public expenditure items along with changes to the spending structure, and improved tax collection are expected to accommodate these reforms. Within the framework of balanced budgets, public debt is projected to further decline from its already very low ratio of 5.8% in 2003 to just 3.2% of GDP in 2008. The programme spells out Estonia's intention to join ERM II and adopt the euro 'as soon as possible'.

Following a revision of the National Accounts[4] which was published on 20 May 2004, i.e. one week after submission of the programme, GDP figures for the 1993-2003 period were revised upwards. Consequently, some of the figures and tables of the programme are already outdated. Nonetheless, the overall picture and the judgement of the plausibility of the scenario are not affected, given that the underlying trends of the projections do not change substantially.[5]

2. MACROECONOMIC DEVELOPMENTS

2.1 Macroeconomic scenario

Balanced budgets and the currency board arrangement will continue to be the foundations of macroeconomic stability in Estonia. The programme envisages steady

3 The code-of-conduct tables annexed to the programme provide most of the required data, with minor exceptions, and also some optional information as indicated in the code. The only compulsory item which has not been provided is in the table on 'external assumptions' (annex 3 / table 7 of the technical assessment / table 12 of the convergence programme) 'World import volumes, excluding EU'. Inflation is still reported on the basis on the national definition of the consumer price index (CPI) although table 1 of the annex would require projections for the harmonised index of consumer prices (HIPC). And participation rates in table 6 are calculated in the age group 15-64, instead of the required 20-64 years old.

4 The major reason for the revision was methodological changes in the calculation of real estate services (including imputed rent) and the consumption of fixed capital.

5 In order to preserve comparability with the Commission forecast and Estonia's 2003 pre-accession economic programme, as well as the recently adopted Broad Economic Policy Guidelines for Estonia, this assessment deals with the figures of the programme as it stands. Wherever appropriate, the revised figures or ratios are added in parentheses or footnotes.

GDP growth between 5 and 6% p.a. over the programme period, driven by private consumption and investment, as well as accelerating export growth. The programme's external assumptions on exchange rates and interest rates are similar to those of the Commission's Spring forecast. They differ only slightly with regard to world and US growth (where Estonia is less optimistic than the Commission) and oil prices (Estonia sets them even lower). Inflation is set to increase distinctly in 2004 to an annual rate of 3.1%, following the surprising drop of the CPI to 1.3% in 2003. This increase is primarily due to EU accession effects (increases to VAT, some administered prices, some food items), and also a strong base effect. Thereafter, the CPI would stabilise at rates below 3%, in the medium term. This assumption reflects on the one hand the programme's external assumption on euro zone inflation, which, with basic disinflation achieved since 2003, is expected in future to directly influence inflation developments in Estonia through the kroon's hard peg to the euro. On the other hand, it provides for a differential to euro zone inflation of 1-2 percentage points due to the Balassa-Samuelson effect over the remaining catch-up period. This assumption corresponds to similar inflation differentials experienced by catch-up economies within the euro zone. The unemployment rate would in the medium term remain at levels around 9.5%, with employment growing in line with the labour force at 0.2 to 0.3% annually. While real wages grew stronger than projected in 2003 due to lower-than-expected inflation, they are projected to fall in line with productivity gains again starting from 2004 (first quarter 2004 wage figures confirm this trend). The current account deficit which in 2003 stood at 13.7% (12.6% according to revised figures) of GDP is forecast to decrease, but remain high at some 8.7% of GDP in 2008. An improvement in the trade balance for goods and services thanks to strengthened external demand and an increase in domestic savings—stemming from rising disposable incomes, buoyant company profits, and more subdued investment growth as compared with recent years—should contribute to the narrowing of the external imbalance, underpinned also by the general government budget that is forecast to remain in surplus or balance throughout the programme period.

On the whole, the macro-economic scenario appears plausible. For the years 2004 and 2005, expected GDP growth is slightly below the Commission Spring forecast, while inflation is projected slightly higher. As compared with the 2003 PEP, the macro-economic scenario is more cautious with regard to GDP growth, while the inflation and the unemployment outlook have improved, on the basis of more-favourable-than-projected results in 2003. However, a number of other risks to the macroeconomic scenario are not elaborated on in the form of fully fledged risk scenarios. The possibility of a slowdown in economic activity – triggered by a monetary tightening in the euro area, or an unanticipated demand shock – could put at risk the plans of the authorities. Although the probability of such an event should not be exaggerated, the experience from the Russian crisis shows that Estonian growth rates can be rather volatile in the face of unexpected exogenous shocks. Under these circumstances, the projected gradual narrowing of the external imbalances could be delayed, due to e.g. a slower-than-projected improvement of the trade balance or an unanticipated deterioration of the domestic savings-investment balance due to 'irrational exuberance'. In this context, rapid credit growth needs to be carefully monitored. Low interest rates and a pro-active drive by the financial sector to promote financial deepening have in recent years substantially eased access to credit. While it is true that the recent real estate boom in Estonia may have peaked before EU accession as the programme suggests, it cannot be outright excluded that household debt, which is still at a low level but growing fast, may continue to grow more strongly than in the programme's projection to finance higher-than-projected household consumption and investment. Such a development would put a

question mark on the projected slow recovery of private domestic savings which in return is assumed to make up for declining public savings in the medium term.

Table 2: ***Comparison of macroeconomic developments and forecasts***

	2003		**2004**		**2005**		**2006**		**2007**		**2008**	
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**
Real GDP (% change)	4.8	4.7	5.4	5.3	5.9	5.8	n.a.	5.6	n.a.	5.9	n.a.	5.8
Contributions:												
- Final domestic demand	8.7	8.0	7.5	6.5	6.9	6.9	n.a.	7.1	n.a.	6.8	n.a.	6.4
- Change in inventories	0.3	0.0	-1.1	-0.3	-0.3	-0.5	n.a.	-0.2	n.a.	-0.1	n.a.	0.0
- External balance on g&s	-4.2	-3.4	-1.0	-0.9	-0.6	-0.6	n.a.	-1.2	n.a.	-0.8	n.a.	-0.5
Employment (% change)	1.0	1.5	0.6	0.9	0.4	0.7	n.a.	0.3	n.a.	0.2	n.a.	0.2
Unemployment (% change	10.0	10.0	9.7	10.0	9.6	9.4	n.a.	9.5	n.a.	9.4	n.a.	9.4
HICP inflation (%)	1.4	1.3	2.8	3.1	2.9	3.0	n.a.	2.8	n.a.	2.8	n.a.	2.8
GDP deflator (% change)	2.7	3.0	3.7	3.8	3.7	3.6	n.a.	3.2	n.a.	3.0	n.a.	2.9
Current account (% of GDP)	-13.7	-13.7	-11.5	-13.0	-9.1	-11.4	n.a.	-10.8	n.a.	-9.6	n.a.	-8.7

Sources:
Convergence programme (CP); Commission services spring 2004 forecasts (COM)

Box: Output gap estimates for a small and open catch-up economy

The programme's annex 3 deals with issues related to the country's output potential and cyclically-adjusted budget calculations. The relevant Code of Conduct tables were partly filled (although this was not compulsory for this first convergence programme). The programme spells out Estonia's intention to apply a production function approach to future output gap calculations in the framework of the Stability and Growth Pact's multilateral surveillance procedures. The Estonian authorities recognise that there are huge uncertainties surrounding estimates for potential GDP or output gaps in a catch-up economy, notably in a very small and open one. Apart from the well-known statistical problems of economies that quite recently underwent transition from planned to market economies (lack of long time series, no availability of reliable capital stock statistics before 1995, and a labour market which can only partly fulfil its role as automatic stabiliser), the entire concept of output gap for an economy the size of Estonia's needs to be approached with some element of caution. Large swings in growth rates (and budget developments) can happen in connection with one-off events, be it a large-scale investment item (private as well as public) or an exogenous shock. In addition, the ongoing rapid structural transformation of the economy renders estimates of potential output over a medium-term perspective even more difficult. At the same time, the attempt to adapt standard methods derived from more mature economies would most probably lead to an underrating of the growth potential of the Estonian economy. Historical growth rates around 6%, peaking at 7.1% in 2000 indeed seem to support this assumption. On the one hand, in the present economic situation the very high current account deficit could be seen as an indicator for a moderately overheating economy, with excess demand fuelling imports rather than inflation. This argument would support the assumption of potential output growth around 4.5-5% p.a. On the other hand, abstracting from the deep recession following the 1998 Russia crisis, average growth of 6.6% over 2000-2003 (derived from revised GDP figures) would suggest potential growth at significantly higher rates.

2.2 External account

In 2003, the current account deficit widened to 13.7% of GDP (12.6% by revised figures). The current account deficit mirrored a decline in private savings by 5% in 2002, followed by an equally low level around 15% of GDP in 2003, while an increase of public net savings in both years provided a stabilising effect. The high current account deficit is the most important imbalance in the Estonian economy. Annex 2 of the programme discusses its causes and effects in some detail. The main driver of the current account deficit is buoyant investment growth with a high import content, a reflection of Estonia's rapid catch-up process. On the other hand, recent adverse developments in the goods and services balance were mainly driven by domestic consumption growth. The negative income balance, another key element of the deficit, results primarily from substantial profit outflows of foreign-owned firms whereby three-quarters of outgoing profits are re-invested in Estonia, registered as FDI inflows in the capital account and thus reducing the country's external net lending requirement.

Over the programme period, current account developments will continue to be driven by a gradually narrowing private savings-investment gap, while public savings – aiming at balanced budgets following previous surpluses – fall. The programme's scenario predicts a gradual narrowing of the external imbalance over the coming years, as domestic demand moderates and export growth picks up. The acceleration of export growth is

expected to set in from 2004 onwards, although the contribution from net exports to GDP growth is expected to remain negative over the entire programme period. Credit conditions are expected to tighten gradually against the background of a turn in the global interest rate cycle. Also, the second pillar pension scheme introduced in 2002 which is compulsory for new labour market entrants, with more than half of the labour force already participating, may lead to an increase in household savings, although quantitative estimates are difficult at this point of time. Increasing profit ability of domestic firms due to recovering exports is also expected to boost the domestic savings ratio.

The overall evidence suggests that Estonia's high current account deficit may have reached its peak in 2003. The deficit last year was for some part transitory[6], and an orderly correction may have already begun, as is suggested by the programme, and supported by data for the first quarter of 2004. Given the planned development toward balanced budgets, the programme's projections for the current account balance would require positive private net savings throughout the programme period. Some factors indeed point to a moderation in consumption growth that would allow the private savings ratio to recover somewhat. The observed tendency towards pre-emptive household consumption prior to EU accession (triggered by expectations of VAT and excise duty changes, price hikes in administered prices and some food items) and construction (triggered by expectations of future real estate price hikes) in 2003 and early 2004 can be assumed to have started subsiding. On the other hand, these projections are subject to considerable uncertainties, judging from the experience of many catch-up economies, not least Estonia, which in the recent past witnessed sharp negative swings of private net savings as economic expansion accelerated and private investment and consumption took off. Such a development might, via higher imports, result in a renewed widening of the current account deficit. The ongoing rapid deepening of the financial sector, in itself a positive sign of maturing of the Estonian economy as long as it proceeds without 'irrational exuberance', combined with a real estate boom also warrant close attention. If credit continues to expand rapidly, prudential vigilance will remain important to ensure that imbalances in the private sector reflect sound resource allocation. Whereas the widening of the current account deficit in 2003 does not originate from fiscal imbalances (indeed, public savings have increased considerably over the past years), a firm commitment to continued fiscal discipline is key to maintaining an adequate level of national savings. Whatever its origins, an external imbalance of that size certainly increases the Estonian economy's vulnerability to exogenous shocks. Thus, while from today's perspective the current account situation does not appear to call for fundamental policy corrections, continued fiscal discipline will be an essential element to ensure a smooth adjustment.

The financing of the current account is supported by sizeable FDI inflows (8.3% of GDP in 2003) though volatility has been considerable in recent years. The willingness of foreign creditors to finance Estonia's current account deficit is certainly supported by Estonia's sound public finances. Estonia's relatively high and rising international credit ratings (see eg. the recent Fitch upgrading to A+) constitute another stabilising factor, facilitating the country's access to international financing. Nevertheless, the external

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6 In 2003, in particular two transactions had a strong adverse effect on the current account: an important one-off public investment into the renewal of state-owned power stations worth roughly 1.5% of GDP, and one private sector buy-and-lease-out transaction with oil wagons for Russia that hardly affected the real economy in Estonia but accounted for another 3.6% of GDP on the current account deficit.

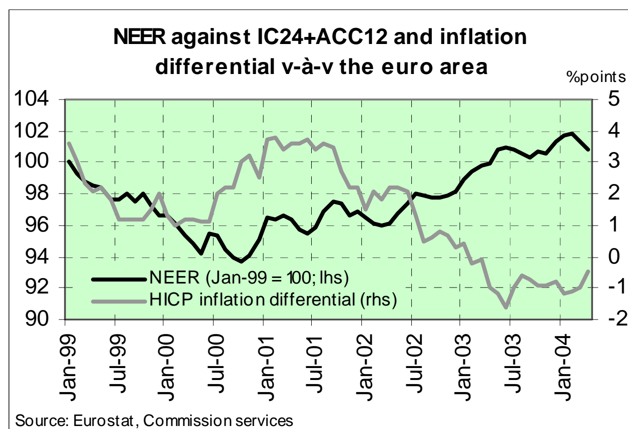
imbalance points to the need for Estonia to raise its 'structural' competitiveness over the medium term. In addition, its financing may increasingly depend on short-term and more volatile capital inflows instead of FDI, although at present much of the registered short-term capital flows into Estonia can be considered 'hidden FDI', as they take the form of inter-bank financing between large Scandinavian banks and their Estonian subsidiaries. Although these count as short-term capital inflows on the capital account, they are in fact more akin to equity capital rather than to credit.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Estonia's monetary regime is centred on a strict nominal exchange rate anchor. The country has been successfully operating a currency board system since 1992, with the kroon pegged first to the D-Mark and, since 1999, to the euro. Backed up by a track record of prudent economic policies, the currency board enjoys high credibility with markets and citizens.

The kroon's euro peg and its close trade ties with the euro area shape effective exchange rate developments, limiting nominal fluctuations. In real effective terms, the kroon has remained relatively stable since 1999, following a period of strong real appreciation during the initial phase of transition. On a year-on-year basis, the kroon registered a slight appreciation in both nominal and real effective terms in 2003.

Nominal exchange rate stability has contributed to rapid disinflation in the Estonian economy, from double-digit levels before 1998 to an annual CPI increase of just 1.3% in 2003. Year-on-year inflation during the first quarter of 2004 further dropped to 0.4%, but started to rebound in April. The programme assumes that inflation over the medium term is unlikely to stay at these very low levels. Starting from 2004, inflation is expected to rise to stable annual rates around 3%, with EU accession effects (VAT and excise duty increases, along with increases in some administered energy prices), higher oil prices and continued strong consumer demand triggering price increases later in the year, and a strong base effect adding to the picture in 2004. Such an outcome would be in line with the Commission's spring forecast. From 2005 on, the Balassa-Samuelson effect, reflecting productivity-related price level convergence during the catching up period, is projected by the programme to keep Estonian CPI rates 1-2 percentage points above euro area inflation.



Source: Eurostat, Commission services

The credibility of Estonia's monetary regime has been reflected in low interest rate spreads, with money market rates closely following euro area rates. Bank lending rates, which can serve as proxies for credit conditions at the long end, have fallen substantially during the last years. While the average interest rate on new kroon loans had stood at

more than 10 % in 2001, it has remained below 5 % since mid-2003.[7] Low interest rates have been a supporting factor for strong domestic credit growth.

The Estonian authorities have declared that Estonia will aim for euro adoption as soon as possible. In line with this position, Estonia's convergence programme reiterates the authorities' intention to apply for participation in ERM II "immediately after accession". Estonia would intend to join ERM II with the standard fluctuation band of +/-15 percent, while maintaining its present currency board regime as a unilateral commitment. The programme points in particular to fiscal discipline and a flexible labour market as underpinning factors for sustainable exchange rate stability, and to the virtual absence of "policy convergence costs" given the country's history of a fixed exchange rate regime.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1 Budgetary developments until 2003

Estonian fiscal policy has been tight throughout the entire stabilisation and early transition periods. The authorities have systematically kept public finances under control, on the basis of annual balancing of budgets. When GDP declined in 1999 due to the exogenous shock of the 1998 Russia crisis, the general government deficit in 1999 reached a high of 4% of GDP, which was rapidly brought down to 0.3% of GDP in 2000. Already in 2001, a small surplus of 0.3% of GDP was reached. Since then, solid surpluses have marked the fiscal picture. Similar to the strategy as outlined in the programme for financing the ongoing tax reform, fiscal consolidation in the late nineties comprised a falling expenditure/GDP ratio and a more or less constant revenue/GDP ratio, as a result of the economic upturn in combination with a lowering of the tax burden. In 2003, the general government account posted a surprise surplus of 2.6%[8] of GDP, despite the adoption of a supplementary budget to the tune of 1% of GDP in the first half of the year providing for an increase in pensions as well as of the reserves of the health care fund. This outcome compares favourably with a targeted surplus of 0.4% of GDP in the August 2003 PEP update. The positive result was achieved not only through somewhat stronger-than-projected GDP growth of 4.7% (5.1% according to revised figures), but also through improved tax collection (see box 'e-tax board' below), despite additional election-induced spending in 2003, and considerable deficits of some local governments, notably the city of Tallinn.

Table 3: ***General government balance and debt, 1998-2003 (% of GDP)***

	1998	1999	2000	2001	2002	2003
General government balance	-0.4	-4.0	-0.3	0.3	1.8	2.6
General government gross debt	6.0	6.5	5.0	4.7	5.7	5.8

Source:
Commission services, Fiscal notifications of Estonia 2000-2004

7 Note that this indicator is influenced by a range of factors, such as increased banking competition in the context of financial deepening.

8 2.4% of GDP in relation to revised GDP figures.

4.2 Programme overview

The budgetary strategy as outlined in the programme is for the general government accounts to remain in surplus in 2004, and to arrive at balanced annual budgets from 2005 onwards. This is slightly more optimistic than the 2003 PEP scenario which indicated no more surpluses already from 2004. The scenario is broadly in line with the Commission Spring 2004 forecast.

Following the path of the ongoing tax reform through to 2007, both expenditure and revenue are projected to peak in 2004 at 43.3 and 44% of GDP respectively, and thereafter to decline to 39.7% of GDP.

The assumption of strong GDP growth throughout the programme period is crucial for the fiscal plans to materialize in terms of balancing revenues and expenditures, whereby the revenue side represents the larger uncertainty. The Estonian authorities, however, have a track record of forecasting GDP growth and government revenue with some degree of caution, which is likely to be reinforced by the statistical effects of the recent National Accounts corrections on the projections of the programme.

Table 4: ***Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)***

	2003	2004	2005	2006	2007	2008
			General government balance			
CP	**2.6**	**0.7**	**0.0**	**0.0**	**0.0**	**0.0**
COM	2.6	0.7	0.0	n.a.	n.a.	n.a.
PEP	*0.4*	*0.0*	*0.0*	*0.0*	*0.0*	*n.a.*
			General government expenditure			
CP	**39,3**	**43,3**	**42,7**	**41,9**	**40,3**	**39,7**
COM	38.6	42.8	42.2	n.a.	n.a.	n.a.
PEP	*40.6*	*42.1*	*41.0*	*40.7*	*40.3*	*n.a.*
			General government revenues			
CP	**41,9**	**44,0**	**42,7**	**41,9**	**40,3**	**39,7**
COM	41.2	43.4	42.2	n.a.	n.a.	n.a.
PEP	*41.0*	*42.1*	*41.0*	*40.7*	*40.3*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

Estonia plans to continue with the implementation of a far-reaching tax reform that will lead to a further shift from direct to indirect taxation. These plans are quite ambitious, but are to be cautiously implemented in a sequenced way. At the same time, a pension reform implemented in 2002 foresees transfer payments from the social security budget to the private second pillar (rising from 0.7% of GDP in 2003 to around 1% of GDP in 2008), thus putting additional pressure on the general government accounts over the medium term. The programme contains a comprehensive discussion of the financing of these changes to the tax system and its effects on the general government balance. A gradual reduction of the flat tax rates for both the corporate and personal income tax from 26% in 2003 to 20% by 2007 and beyond will be combined with increased transfer

payments and tax allowances. Strong growth, savings on public expenditure, changes to the spending structure including administrative reform, improved tax collection, the introduction of new taxes and excise duties as well as VAT increases implied by EU accession are expected to provide for the financing of these reforms. While the central government and the social security budgets are projected to remain in surplus over the entire programme period, local governments are expected run minor deficits.

The most problematic aspect of the programme's fiscal scenario is that, while expressing no firm views on the country's present position in the business cycle, it assumes strong growth with little cyclical variation over the entire programme period. To arrive at a balanced budget as early as 2005 from a considerable budget surplus in 2003 implies distinct fiscal easing that may (and indeed is quite likely to) create a pro-cyclical stance. Arguably, considerations of cyclical stabilisation would have called for continued surpluses in the short term, also with a view to the large current account deficit. The programme takes the view, so far borne out by the fact, that the financing of a current account deficit caused by the high investment needs of a rapidly growing economy should pose no major problems. Nonetheless, strict budgetary discipline, including the setting aside of 'surprise surpluses' will continue to be a crucial element for the credibility of the fiscal framework, including its contribution to avoiding destabilising developments on the external balance.

Table 5: ***Composition of the budgetary adjustment (% of GDP)***

	2003	2004	2005	2006	2007	2008	Change: 2008-2003
Revenues	**41.9**	**44.0**	**42.7**	**41.9**	**40.3**	**39.7**	**-2.2**
of which:	23.3	23.7	23.5	22.5	21.8	21.7	**-1.6**
- Taxes & social security contributions	12.3	12.0	11.4	11.2	11.1	11.1	**-1.2**
- Other (residual)	6.3	8.2	7.9	8.2	7.4	6.9	**+0.6**
Expenditure	**39.3**	**43.3**	**42.7**	**41.9**	**40.3**	**39.7**	**+0.4**
of which:							
- Primary expenditure	39.0	43.0	42.4	41.6	40.0	39.4	**+0.4**
of which:							
Gross fixed capital formation							
Consumption	4.1	5.0	4.7	4.6	4.2	4.2	**+0.1**
Transfers & subsidies	18.6	19.6	19.3	18.9	18.1	17.8	**+0.8**
Other (residual)	15.0	16.0	16.2	16.1	16.0	16.0	**-1.0**
- Interest payments	1.3	2.3	2.2	2.0	1.7	1.4	**+0.1**
	0.3	0.3	0.3	0.3	0.3	0.3	**0.0**
Budget balance	**2.6**	**0.7**	**0.0**	**0.0**	**0.0**	**0.0**	**-2.6**
Primary balance	**2.9**	**1.0**	**0.3**	**0.3**	**0.3**	**0.3**	**-2.6**

Sources:
Convergence programme; ECFIN calculations

4.3 Targets and adjustment in 2004

The programme target of a 0.7% of GDP budgetary surplus is more ambitious than that of a balanced budget set both in the 2004 budget and the 2003 PEP, but still appears on the cautious side. The original target had been set on the assumption that domestic demand would subside towards its trend rate already from 2003 on. The programme suggests that the unexpectedly high level of revenues in 2003 will have a strong carry-over effect on the 2004 budget. Indeed, budget execution figures for the first few months of 2004 suggest once again strong revenue performance.

Cuts in direct taxes, along with increased social benefits, the cost of pension reform and the EU accession expenditure requirements related to a sharp increase in capital expenditure and public consumption are expected to weigh on public finances from 2004. EU related expenditure accounts for roughly 4% of GDP, and thus accounting for the main part of the sharp rise in the expenditure ratio in 2004 as compared with 2003. On the other hand, projected higher revenues stemming from the introduction or increase of VAT rates and excise duties upon EU accession, but also from improved tax collection (see also box on e-tax board) and strict expenditure control are expected to stem the weakening of the budgetary position..

Following the positive budget outturns in 2002 and 2003, together with a cautious forecasting strategy, Estonia should for the foreseeable future be in a position to continue running budgets close to balance or in surplus. Therefore there appears no risk for Estonia to breach the 3% of GDP reference value for the deficit in 2004, given that the likely result will be a general government surplus around or above 0.7% of GDP. Revenues both in 2004 and 2005 might well be closer to the ‘high-growth’ scenario of the programme’s general budget revenue sensitivity analysis (which would lead to additional revenues to the tune of 0.5% of GDP) than to the baseline scenario. The low-growth scenario in the sensitivity analysis, on the other hand, appears extremely prudent from today’s perspective. First quarter 2004 developments, with industrial production recording strong growth and tax collection once again buoyant, support this assumption.

However, the considerable fiscal easing implied by the 2004 budget, from a surplus of 2.6% of GDP[9] in 2003 to a surplus of just 0.7%, coupled with the positive outlook for growth, points to the non-negligible risk of a pro-cyclical stance this year.

4.4 Targets and adjustment in 2005 and beyond

The fiscal targets for 2005 and beyond are marked by the completion of the current tax reform which is implemented in various steps. By 2007, flat tax rates for both private income and corporate profits will be reduced to 20%, from the original 26%. This will bring the revenue-to-GDP ratio down to below 40% by 2008. EU related expenditure is expected to remain stable at around 4% of GDP (Estonia assumes that it will be able to absorb the maximum of EU funds over the entire programme period). R+D expenditure, on the other hand, is expected to grow by 0.7% of GDP over the programme period to a total of 1.5% of GDP, in order to narrow the gap with the Lisbon goal (1.8% of GDP) in this area. Also, public expenditure on the pension reform in the form of transfer payments from the social security budget to the private second pension pillar is expected to slowly rise to 1% of GDP over the programme period. On the revenue side, a continuation of the same effects as in 2004 and a flexible annual budgeting in combination with strict expenditure control is planned to secure that overall expenditure

9 2.4% of GDP with revised GDP figures

does not overshoot declining revenues. From 2005 onwards, in particular local governments will start to tighten spending on the basis of stricter regulations which are in the pipeline, but also because most of them will soon reach their legal spending ceilings. These ceilings consist of an overall threshold of 60% of own revenues, combined with a restriction that annual debt service must not exceed a ratio of 20% of annual revenues. The programme's fiscal projections for 2005 are broadly in line with the Commission forecast.

The programme's budgetary targets for 2005 and beyond appear on the whole plausible, and appear to be rather on the cautious side. This assessment is based in particular on a strong track record of prudent forecasting (and repeated overshooting of fiscal targets in the past few years), a conservative growth forecast underpinning the programme's budget projection, possible carry-over effects from a higher-than-projected 2004 surplus and the possibility of lower-than-projected run-up of public investment spending of EU transfers and related co-financing during the early period of EU membership. Downside risks could mainly occur from a revenue shortfall from the tax cuts, or exogenous shocks, whereby the Estonian economy is particularly sensitive to the business cycle in its neighbouring countries Finland and Sweden. Considerably slower growth than projected (although unlikely to materialise) would evidently have a negative impact on the balanced budget scenario under a no-policy-change assumption. The programme contains a comprehensive risk scenario for general government revenues that allows for a 1 percentage point growth deviation into both directions from the baseline scenario. According to this sensitivity analysis, the elasticity of tax revenues to GDP growth is 0.5, which implies that a 1 percentage point decline in GDP growth would lead to a 0.5% of GDP shortfall in general government revenues as compared with the baseline growth scenario. Due to the very low (5%) ratio of automatic stabiliser components in public expenditure, and the strict expenditure controls applied at central government level, the GDP elasticity of expenditures is considered to be zero.

There appears little risk for Estonia to breach the 3% of GDP reference value for the deficit in 2005 and beyond, and the close-to-balance requirement is likely to be respected over the programme period, given the country's strong track record of budget surpluses, combined with a prudent approach to fiscal policy, and a firm commitment to respect the rules of the Stability and Growth Pact.

Bearing in mind the aforementioned difficulties in estimating Estonia's cyclical position, the envisaged fiscal easing from a surplus of just 0.7% of GDP in 2004 to a balanced budget in 2005, and the further positive outlook for growth in the country's main EU trading partners Finland and Sweden, there is a continued risk of pro-cyclical developments also for 2005 and beyond, though to a lower degree than in 2004.

4.5 Debt ratio

Estonia's public debt, at 5.8% of GDP (5.3 % with revised data), is among the lowest in the EU-25. With balanced annual budgets or surpluses projected, debt is plausibly expected to come down to levels around 3% of GDP by 2008, broadly in line with the Commission forecast up to 2005. Despite the general government surplus, general government debt has increased slightly by 0.1% of GDP in 2003, due to financial operations in the local government sector, and the central government's strategy not to repay debt early, but to put surpluses into reserves. Privatisation receipts do no longer play a significant role for debt dynamics in Estonia. Because of its limited size, public

debt - which is entirely covered by public sector reserves - is a negligible risk to the Estonian economy.

Table 6: ***Debt dynamics***

	2003		2004		2005		2006	2007	2008
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Government gross debt ratio	5,8	5,8	5,4	5,4	5,3	5,1	4,7	3,4	3,2
Change in debt ratio (1 = -2+3+6)	0,1	0,1	-0,4	-0,4	0,1	-0,3	-0,4	-1,3	-0,2
Contributions:									
- primary balance (2)	-2,9	-2,9	-0,9	-1	-0,3	-0,3	-0,3	-0,3	-0,3
- snow-ball effect (3 = 4+5)	-0,1	-0,2	-0,2	-0,2	-0,2	-0,2	-0,1	0	0
- interest expenditure (4)	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,3	0,3
- nominal GDP growth (5)	-0,4	-0,5	-0,5	-0,5	-0,5	-0,5	-0,4	-0,3*	-0,3
- stock-flow adjustment (6)	3,1	3,2	0,7	0,8	0,6	0,2	0	-1,0	0,1

Sources:
Convergence programme (CP); Commission services spring 2004 forecast (COM); ECFIN calculations
Note:
The decomposition of the change in the gross debt ratio is based on the following equation for the budget constraint:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth

** Rounding difference*

5. THE QUALITY OF THE PUBLIC FINANCES

Estonia has a strong track record of fiscal discipline based upon cautious assumptions which yielded to considerable budgetary surpluses in recent years, and kept debt at very low levels. The programme aims at preserving budgetary discipline, while implementing structural reforms both to the expenditure and revenue side. These reforms have a potential to substantially further improve the quality of public finances in the foreseeable future. The programme presents a comprehensive overview of these reforms.

The reforms on the expenditure side aim in particular at better targeting social transfers towards the needy and strengthening incentives to work. They affect notably social assistance, disability and unemployment benefits. The implementation in 2002 of a comprehensive pension reform is putting pressure on the budget in the short term, through transfer payments from the general government to the new fully funded second pension pillar. This fiscal effect is projected to be reversed in the longer-term, while helping achieve the goal of a decent living standard for the retired. As for the pay-as-you-go system, an increase of the statutory pension age to 63 years for both genders is gradually implemented until 2016. A subdued indexation of first-pillar pensions also puts a brake on pension expenditure growth.

On the revenue side, the comprehensive tax reforms that have started in 2004 will lead to a further shift from direct to indirect taxation. The reforms are expected to strengthen

incentives to work, to create new jobs and to discourage tax evasion. The main features are: the introduction of a flat tax rate of 20% for both corporate and individual income taxation; a gradual increase in the level of the tax-exempt basic income; a tax exemption from corporate tax for re-invested earnings; and the wider application of the unified VAT rate of 18%. Before the start of the reform, the corporate and personal income tax rate stood at 26%. Overall, the ratio of general government revenues to GDP jumps to 44% in 2004, largely reflecting the expansionary effect of EU funds and its co-financing, but is set to decline along with the progressing tax reform towards the end of the programme period, to a level of below 40%.

The tendency for continued deficits at local government level (notably accounted for by the city of Tallinn) is expected to come to an end in the medium term, since the legal borrowing limits for local governments will be exhausted in the foreseeable future. In addition, legal measures to keep tighter control over local government spending have been initiated by the government.

A high level of fiscal reserves at different levels of government is another feature of Estonia's prudent fiscal policy. Central government reserves reached an overall level of 9.6% of GDP at the end of 2003. Surpluses and privatisation receipts at central government level are channelled into a 'Stabilisation Reserve' which has reached 4.4% of GDP at the end of 2003. This reserve can only be tapped with the approval of Parliament, for 'projects beneficial to the whole nation, including structural reform'. Also the Health Fund and the Unemployment Insurance Fund have to keep healthy reserves, whereby the latter constitutes a mechanism to protect the budget against unfavourable macroeconomic developments.

Altogether, the implementation of the structural public finance reform measures will bring Estonia further in compliance with the general guidelines of the BEPGs 2003-2005.

Having already achieved considerable progress over recent years, the government is continuing its efforts to improve the management of public finances in all phases of the budget cycle. The successful introduction of tax collection over the internet is producing impressive results. Both the process of budget planning and internal audit are being considerably strengthened through the introduction of performance-based budgeting in all ministries as of 2004, and a systematic improvement of co-ordination and modernisation of all public audit and evaluation functions.

Box: Tax collection in Estonia – the e-tax board

Tax collection in Estonia is probably the most advanced e-government feature in place in the EU. In 2000, the so-called 'e-tax board' was established by the government, allowing for the entire tax declaration and collection cycle to be processed over the internet, via email, and through internet banking. Both the income and corporate flat tax, and VAT are collected through simple and partly pre-filled forms which are available both in electronic and paper versions. The electronic version can be simply downloaded from the government's websites or via the internet portals of the country's five leading banks. The forms for income tax are identical for employees and self-employed, thus companies are not burdened with the income tax administration of their employees. After just four years following its introduction, the e-tax system enjoys wide popularity among taxpayers. According to information provided by the Estonian tax authorities, in 2004 already 60% of total personal income tax returns for the year 2003 were collected over the internet. Companies embraced the new system even more rapidly. In early 2004, 63.1% of Income and Social Tax declarations and 71.8% of VAT declarations were submitted electronically to the tax authorities. In order to counteract tax evasion, a statistical risk analysis of the average tax duties per industry and company size is carried out each year by the tax authorities. Companies or individuals that deviate strongly from these benchmarks or fail to declare at all receive a warning letter from the competent tax authority, and get into focus for on-site inspections. Sanctions are, however, not applied immediately, so the tax subject has a grace period for filing a new tax return after the expiry date. The system has not only simplified the burden of tax administration for both sides, it also greatly speeded up the process. Repayments of tax to individuals are processed within a maximum of 5 working days following reception of the electronic declaration, although in reality this is often done within just 1-2 days. There are no reliable estimates available on the impact of this taxpayer-friendly system on tax returns. However, the unexpectedly high tax revenues of 2003 (which accounted for the higher-than-forecast budget surplus) is likely due to these improvements in tax collection. This means at the same time that parts of the country's grey economy (which is still estimated at 12-15% of GDP) are being successfully "whitened".

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The programme contains a section on the long-term sustainability of public finances. It includes demographic and macroeconomic assumptions as well as projections for public expenditures on pensions and health care.

The demographic situation in Estonia is projected to deteriorate in the future. The ratio of employed to retired persons, which was 2 in 1992 and is currently 1.8, is projected to decrease to 1.27 by 2050. In order to curtail demographic pressure resulting from an ageing population, the Estonian authorities have increased the retirement age. This should be beneficial for the total participation rate, which is planned to increase until 2016 (the final point of a sequenced increase in retirement age for both genders), after which, however, the rate is projected to fall again.

This will also have positive budgetary implications as it will lead to a decrease in the number of retired, and consequently reduce the pressure of overall pension expenditure on the budget until 2016. Apart from parametric changes to the pay-as-you-go pillar (e.g. increase in the retirement age, pension indexation), the pension reform continued in 2002 with the introduction of a fully funded mandatory second pension pillar. With regard to

health care, the ongoing reform of the entire system is projected to result in a reduction in health care expenditures until 2030, by when they are expected to stabilise.

According to the long-term projections, overall age-related expenditures are projected to fall by 5.4% of GDP over the period 2000-2050. Savings to the tune of 4.2% of GDP are projected to materialize due to a combination of decreasing pension expenditures (with the private second pillar starting to pay out) and lower health care expenditures. Low public debt, substantial financial reserves of the public sector and a sustained position of budget balance throughout the programme period all contribute to the long-term sustainability of public finances. According to the long-term projections of pension and health care expenditure as presented in the programme, Estonia should therefore be able to meet the projected budgetary costs of an ageing population.

The comprehensive reforms to both the pension and health care sector will require careful monitoring and sequenced implementation. The payment of a three-year lump-sum increase in pensions aiming at compensating pensioners for previous losses in purchasing power creates a deficit in the first pillar of the pension system over the medium term. The pension insurance reserves which are devised for such cases are expected to turn into deficit in the years 2006-2007. While subsequently, the subdued pension indexation - which is in place since 2002 - will contribute to a rebuilding of the reserves, additional expenditure will be required to cover the financing gap in the meantime. On the other hand, the revenue loss to the first pillar which since 2003 results from a re-direction of a part of social insurance contributions to the private second pension pillar is fully covered by the budgetary scenario over the programme period. These transfer payments made up 0.7% of GDP in 2003, and are set to increase to a level around 1% of GDP by 2008. Finally, while there are some contingent liabilities, such as education loans, state guarantees and debt of local governments, these do not represent any immediate concern. Besides the institutional framework that sets strict borrowing limits for public institutions, the government has accumulated substantial financial reserves for these purposes.

Summing up, Estonia is well placed to meet the projected budgetary costs of an ageing population. A low government debt level, considerable government financial reserves and a medium-term budgetary strategy that is fully consistent with the objective of a close-to-balance or in surplus budgetary position together with the reforms of the pension and health care systems which are meant to stem budgetary pressures in the longer term should ensure that public finances remain on a sustainable footing. The considerable cost of implementing a fully funded private second pillar in the pension system is accounted for in the budgetary projections of the programme.

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME

Table 1. Growth and associated factors

		2003	2004	2005	2006	2007	2008
GDP *growth* at *constant* market prices (7+8+9)		4.7	5.3	5.8	5.6	5.9	5.8
GDP *level* at *current* market prices		116.2	126.9	139.2	151.7	165.4	180.1
GDP deflator		3.0	3.8	3.6	3.2	3.0	2.9
HICP change *		1.3	3.1	3.0	2.8	2.8	2.8
Employment growth		1.5	0.9	0.7	0.3	0.2	0.2
Labour productivity growth		3.2	4.3	5.1	5.4	5.7	5.6
Sources of growth: percentage changes at constant prices							
1. Private consumption expenditure		6.2	6.2	6.0	6.3	5.4	5.3
2. Government consumption expenditure		5.6	6.5	3.9	3.6	3.3	3.1
3. Gross fixed capital formation		11.5	6.7	9.1	7.8	7.7	7.7
4. Changes in inventories and net acquisition of valuables as a % of GDP		-1.4	2.5	1.9	1.6	1.4	1.3
5. Exports of goods and services		6.0	7.4	8.5	9.9	9.3	9.3
6. Imports of goods and services		9.0	7.2	7.9	8.9	8.7	8.5
Contribution to GDP growth							
7. Final domestic demand (1+2+3)		8.0	6.5	6.9	7.1	6.8	6.4
8. Change in inventories and net acquisition of valuables (=4)		0.0	-0.3	-0.5	-0.2	-0.1	0.0
9. External balance of goods and services (5-6)		-3.4	-0.9	-0.6	-1.2	-0.8	-0.5

*programme discusses only domestic CPI definition

Table 2. General government budgetary developments

% of GDP		2003	2004	2005	2006	2007	2008
Net lending (B9) by sub-sectors							
1. General government[1]		2.6	0.7	0.0	0.0	0.0	0.0
1. General government[2]		2.4	0.6	0.1	0.1	0.1	0.1
2. Central government		*0.2*	*-0.3*	*-0.5*	*-0.7*	*-0.7*	*-0.6*
3. State government		-	-	-	-	-	-
4. Local government		-0.5	-0.3	-0.2	-0.2	-0.2	-0.2
5. Social security funds		0.7	0.4	0.1	0.1	0.1	0.1
General government (S13)							
6. Total receipts		41.9	44.0	42.7	41.9	40.3	39.7
7. Total expenditures		39.3	43.3	42.7	41.9	40.3	39.7
8. Budget balance		2.6	0.7	0.0	0.0	0.0	0.0
9. Net interest payments		0.3	0.3	0.3	0.3	0.3	0.3
10. Primary balance		2.9	1.0	0.3	0.3	0.3	0.3
Components of revenues							
11. Taxes		23.3	23.7	23.5	22.5	21.8	21.7
12. Social contributions		12.3	12.0	11.4	11.2	11.1	11.1
13. Interest income		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
14. Other		6.3	8.2	7.9	8.2	7.4	6.9
15. Total receipts		**41.9**	**44.0**	**42.7**	**41.9**	**40.3**	**39.7**
Components of expenditures							
16. Public consumption		8.8	9.4	9.3	9.0	8.2	8.0
17. Social transfers in kind		9.8	10.2	10.0	9.9	9.9	9.8
18. Social transfers others than in kind		13.8	14.6	14.6	14.5	14.4	14.4
19. Interest payments		0.3	0.3	0.3	0.3	0.3	0.3
20. Subsidies		1.2	1.4	1.6	1.6	1.6	1.6
21. Gross fixed capital formation		4.1	5.0	4.7	4.6	4.2	4.2
22. Other		1.3	2.3	2.2	2.0	1.7	1.4
23. Total expenditures		**39.3**	**43.3**	**42.7**	**41.9**	**40.3**	**39.7**

Table 3. General government debt developments

% of GDP		2003	2004	2005	2006	2007	2008
Gross debt level		5.8	5.4	5.1	4.7	3.4	3.2
Change in gross debt		0.1	-0.4	-0.3	-0.4	-1.3	-0.2
Contributions to change in gross debt							
Primary balance		-2.9	-1.0	-0.3	-0.3	-0.3	-0.3
Interest payments		0.3	0.3	0.3	0.3	0.3	0.3
Nominal GDP growth		-0.5	-0.5	-0.5	-0.4	-0.3	-0.3
Other factors influencing the debt ratio [1]		3.2	0.5	0.2	0.0	-1.0	0.1
Of which: Privatisation receipts		*0.4*	*0.2*	*0.1*	*0.1*	*0.0*	*0.0*
p.m. implicit interest rate on debt		4.8	4.9	5.1	5.2	5.2	5.2

[1] Stock-flow adjustment

Table 4. Cyclical developments

% of GDP		2003	2004	2005	2006	2007	2008
1. GDP growth at constant prices		4,7	5,3	5,8	5,6	5,9	5.8
2. Actual balance		2.6	0.7	0.0	0.0	0.0	0.0
3. Net Interest payments		0.3	0.3	0.3	0.3	0.3	0.3
4. Potential GDP growth		4.5	5.2	5.8	5.6	6.3	6.2
5. Output gap		1.5	0.5	0.0	-0.6	-0.4	-0.3
6. Cyclical budgetary component		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
-of which cyclical contributions		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
-contributions from special items		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
7. Cyclically-adjusted balance (2-6)		2.3	0.6	0.0	0.1	0.1	0.1
8. Cyclically-adjusted primary balance (7-3)		2.0	0.3	-0.3	-0.2	-0.2	-0.2

Table 5. Divergence from previous update

% of GDP		2003	2004	2005	2006	2007	2008
GDP growth							
PEP [1]		4.5	5.6	6.0	6.0	6.0	–
CP [2]		4.7	5.3	5.8	5.6	5.9	5.8
Difference		0.2	-0.3	-0.2	-0.4	-0.1	...
Price Inflation (CPI)							
PEP [1]		1.7	3.8	3.4	3.2	2.8	n.a.
CP [2]		1.3	3.1	3.0	2.8	2.8	2.8
Difference		-0.4	-0.7	-0.4	-0.4	0.0.	
Actual budget balance							
PEP [1]		0.4	0.0	0.0	0.0	0.0	–
CP [2]		2.6	0.7	0.0	0.0	0.0	0.0
Difference		2.2	0.7	0.0	0.0	0.0	...
Gross debt levels							
PEP [1]		5.5	5.2	4.9	4.6	3.1	–
CP [2]		5.8	5.4	5.1	4.7	3.4	3.2
Difference		0.3	0.2	0.2	0.1	0.3	...
Tax burden							
PEP [1]		35.3	35.8	36.3	36.2	36.3	n.a.
CP [2]		36.0	36.5	35.7	34.5	33.5	33.4
Difference		0.7	0.7	-0.6	-1.2	-2.8	n.a.

[1] PEP, August 2003
[2] CP, May 2004

Table 6. Long-term sustainability of public finances [1]

% of GDP	2000	2005	2010	2020	2030	2040	2050
Total expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old age pensions	7.41	7.19	6.18	4.37	3.64	3.28	3.04
Health care (including care for the elderly)	4.81	4.45	3.95	3.32	3.12	3.19	3.17
Transfers payments [2]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenues	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: Tax on net pension payments	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
National pension fund assets [3]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions							
Nominal GDP per person employed	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate males (aged 20-64)*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rates females (aged 20-64)*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total participation rates (aged 20-64)*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate	13.6	9.4	8.6	8.1	7.6	7.0	6.5

* *The programme discusses participation rates of the age group 15-64 years*

Table 7. Basic assumptions

	2003	2004	2005	2006	2007	2008
Short-term interest rate (annual average)	2.3	2.2	2.7	3.3	3.7	3.7
Long-term interest rate (annual average)	4.1	4.3	4.5	4.6	4.9	4.9
United States: short-term (three-month money market)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
United States: long term (10-year government bonds)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
USD/€exchange rate (annual average)	1.13	1.28	1.22	1.10	1.00	1.00
Nominal effective exchange rate (euro area)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal effective exchange rate (EU)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
EEK/€exchange rate (annual average)	15.6466	15.6466	15.6466	15.6466	15.6466	15.6466
World GDP growth, excluding EU	3.5	4.1	4.0	4.0	4.0	4.0
United States, GDP growth	2.5	2.8	3.8	3.3	3.0	3.0
Japan, GDP growth	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
EU-15 GDP growth	0.8	2.0	2.4	2.5	2.5	2.5
Growth of relevant foreign markets	2.8	3.8	3.3	3.0	3.0	3.0
World import volumes, excluding EU	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World import prices (goods, in USD)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Oil prices (Brent, USD/barrel)	28.3	25.5	25.0	25.0	25.0	25.0
Non-oil commodity prices (in USD)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.