RAHANDUS-
MINISTEERIUM
MINISTRY of FINANCE of the REPUBLIC of ESTONIA

Stability Programme 2014

Tallinn, 29.04.2014

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INTRODUCTION

According to EU rules on the coordination of budgetary policies, the member states of the European Union must annually submit updated stability and convergence programmes (members of the euro area and the member states who are not using the euro, respectively). Estonia has been a full member of the European Economic and Monetary Union (EMU) since 1 January 2011 and submits its Stability Programme to the European Commission and the Council of the European Union for the third time. This Stability Programme can therefore be regarded as the update of the programme submitted last year. The purpose of the Stability Programme is to illustrate the Government's policy in the performance of the Stability and Growth Pact (SGP). The current stability and convergence programmes submitted by the member states will be assessed by the European Commission and the Council of the European Union in May and June 2014.

The submission and assessment of stability and convergence programmes is an important part of the coordination and monitoring of the economic policy of the European Semester. The Commission and the Council assess the stability and convergence programmes within the scope of the European Semester before the most important decisions are made in the preparation of the budgets of member states in order to give policy recommendations on fiscal policy intentions if necessary.

Estonia's fiscal policy remains in line with the Stability and Growth Pact. The Stability Programme was prepared in parallel with the national State Budget Strategy in consideration of the Government's goals and policies, which are stipulated in the Coalition Programme and other strategic documents. The Stability Programme 2014 is based on the Ministry of Finance economic forecast of spring 2014.

Based on the new State Budget Act which entered into force in March 2014, an independent Fiscal Council will be established, having the task of providing assessments to economic forecasts which form the basis for Estonia's fiscal policy, and monitoring the respecting of the state's internal budget rules. In the course of preparing the State Budget Strategy 2015–2018 and the Stability Programme 2014, Eesti Pank was asked for an opinion concerning the economic forecast and the fiscal policy. At a discussion of the economic forecast in the Government Office, a representative of Eesti Pank found that the Ministry of Finance economic forecast being the basis for fiscal policy plans is largely realistic, considering the current knowledge. At the same time, the representative of Eesti Pank drew attention to additional risks present in the external environment and found that the forecast's risk scenario could have been more conservative. The Government must be ready to change the budget and expenditure plans in case of weaker than expected developments of the economic situation. On the subject of budgetary position objectives, Eesti Pank agreed with the Government's plan of setting the objective to be structural surplus and stressed that real-time assessment of structural positions is difficult and that nominal balance must also be achieved in the next few years. At the usual forecast seminary preceding the publishing of the Ministry of Finance economic forecast, economic experts of other general government and private sector institutions also drew attention to various risks, but considered the Ministry of Finance economic forecast realistic.

The time horizon of the Stability Programme 2014 is 2018 as required for the State Budget Strategy by the State Budget Act (for the following budgetary year and the subsequent three years). The document consists of seven parts providing an overview of the economic policy objectives, the economic situation and future prospects, the fiscal framework, a comparison with the previous Stability Programme, improvement of the quality of the public finances, the long-term sustainability of the fiscal policy and institutional functions.

1. ECONOMIC POLICY GOALS

The goal of the economic policy of the Government is to create conditions for sustainable economic growth, which will result in increased welfare and real convergence with developed countries. A pre-condition for stable economic development is to ensure macroeconomic stability, which supports internal and external balance. The speed of Estonia's real convergence has been fast and we are quickly approaching the EU average. The risks and imbalances that increased during the period of rapid credit-fuelled economic growth have decreased rapidly in the adjustment process that followed the crisis and reduced the further vulnerabilities of our economy. The sudden contraction in global economic activity and trade that was caused by the global credit crisis had a significant impact on Estonia's open economy, and our economy demonstrated remarkable flexibility in coping with this. The reliability of the fiscal policy was maintained in the changed economic conditions and the support it offered to economic development allowed the state to overcome the crisis without increasing its financial obligations considerably. Increasing economic flexibility, supporting the business environment and improving the efficiency of the labour market have become the key issues that help guarantee sustainable economic development.

One of the main goals of the fiscal policy is to support macroeconomic stability via the flexibility and efficiency of markets, to manage the risks that threaten the balanced development of economy, and to improve the economy's growth potential and employment. This is particularly important for securing the effective functioning of the economy in the single currency zone. The impact of the tax system and the expenditure side of the budget to the economy must be considered when they are planned, especially when changes are made. In addition, the long- term sustainability of public finances given an ageing population must be ensured. Ensuring a stable economic environment, channelling budget funds to foster of economic growth and employment, and ensuring long-term sustainability are the three areas which Estonia will focus on in its economic policy.

The Government's goal is to proceed with a sustainable fiscal policy. **The medium-term budgetary objective (MTO) of the Government is general government structural surplus.** A strict fiscal policy will ensure that a low level of government debt is maintained, which is a prerequisite for ensuring the long-term sustainability of public finances.

In order to assess its activities, the Government, which started its work 26 March 2014, has set itself goals in 23 policy areas as well as performance indicators that measure the achievement of these goals and their target levels, four of which are priorities for the Government.

The priorities of the Government for the year 2015 are: [1]

- **Reducing the poverty of children**
  Reducing the absolute poverty rate of children to 8.4%
- **Reducing the tax burden of labour**
  Reducing the implicit tax rate on labour to 33.2 percent
- **Securing Estonia's national security**
  Ensuring the state's readiness to cope with internal and external threats
  Defence expenditure remaining at the level of 2% of GDP
- **Sustainable public finance**
  General government's budgetary position being in 0.2% structural surplus

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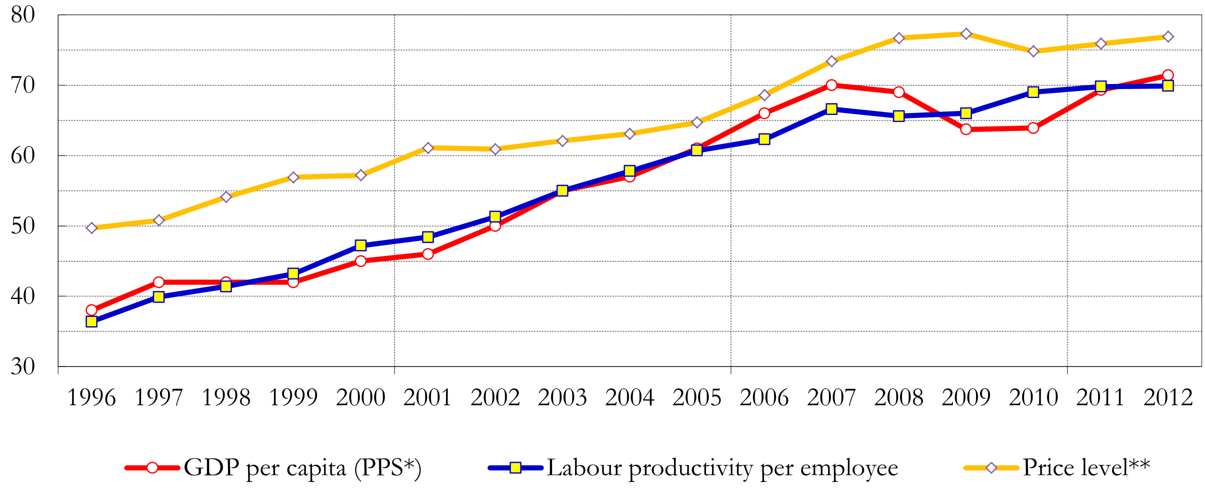
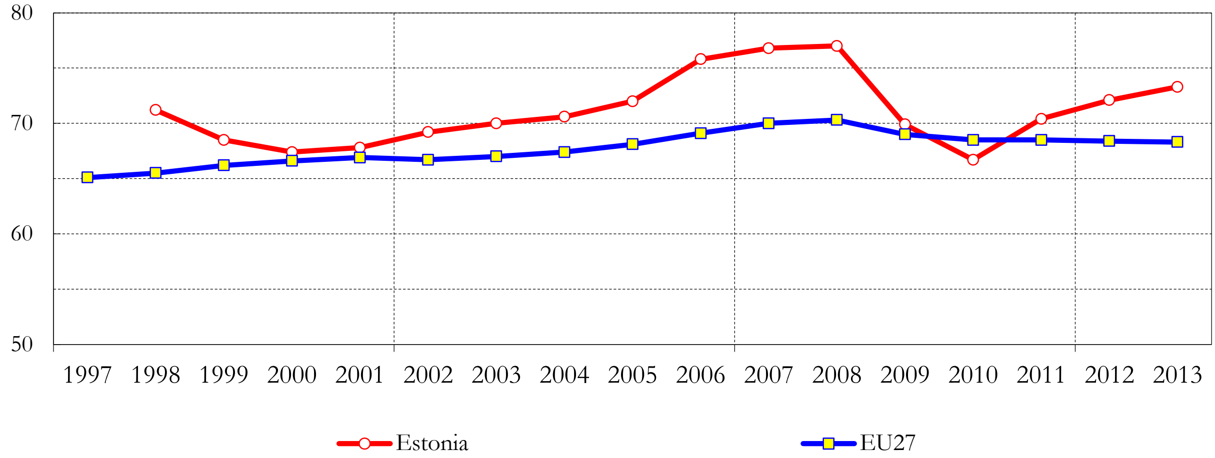
[1] Set in the State Budget Strategy 2015–2018.

Figure 1. Real Convergence with the EU (% of EU28)



**PPS – GDP calculated on the basis of purchasing power parity.*
*** Households' final consumption price level.*
Source: Eurostat.

Figure 2. Employment in the 20–64 age group (%)



Source: Eurostat.

2. ESTONIAN ECONOMIC DEVELOPMENT AND OUTLOOK

2.1. Developments of the external environment and assumptions

The **global economy's** growth in 2013 was the slowest for the past four years. In coming years, the growth is expected to accelerate in developed industrial countries and to less extent also in developing markets, which is conjointly expressed in increased growth of the global GDP. In the second half of the year before, the European Union economy came out from recession and its growth is expected to accelerate in 2014. Confidence indicators and PMI indices also refer to this, having been on a rising trend for the past six months. The growth expectations of some of Estonia's nearest neighbours and trade partners were reduced compared to the summer forecast, which means slower pick up of foreign demand for Estonia.

The European Union economy has become stronger over the recent quarters. In a quarter-on-quarter comparison, the EU economy has shown stable growth and in the 4th quarter the GDP growth accelerated to 1.1% in a year-on-year comparison. The economic activity indicators of the past few months show a pickup of growth in the 1st quarter of 2014. Our assumptions account for a 1.4% growth of the EU economy in 2014. The weighted average economic growth of Estonia's **main trading partners** started to become stronger in the second half of last year and this growth can be expected to accelerate to 1.7% in 2014. Estonia's export demand depends mostly on the developments of Sweden, Finland, Russia and other Baltic States.

Inflation was on a declining trend due to both internal and external factors in 2013. Decrease of import prices, the appreciation of euro together with the decrease of the effect of tax changes and modest demand reduced inflation to 1.4%. This year, inflation will decline to 1.1%, supported by decrease of energy prices and modest domestic price pressures. Inflation will also remain below the level of 2% in the coming years. Although the European economy has returned to a growth path, an increase of European Central Bank's interest rates is not expected in the near future. The reason is low inflation and the weakness of some euro area countries, therefore interest rates will remain low.

Crude oil prices decreased in 2013 due to lower demand caused by weak growth of the global economy. Futures indicate that oil price will decrease in the next few years. Accordingly, we assume that crude oil prices will decline to 104.1 USD in 2014 and 100.0 USD in 2015 and will remain on that level thereafter.

The exchange rate of **euro** to USD appreciated approximately 3% in 2013. The strengthening of the EUR/USD exchange rate also continued in the first months of the current year and external assumptions fix it to the mid-February's level. This means a strengthening of euro by a couple of percent compared to the year before and we assume that it will remain on that level in the coming years as well.

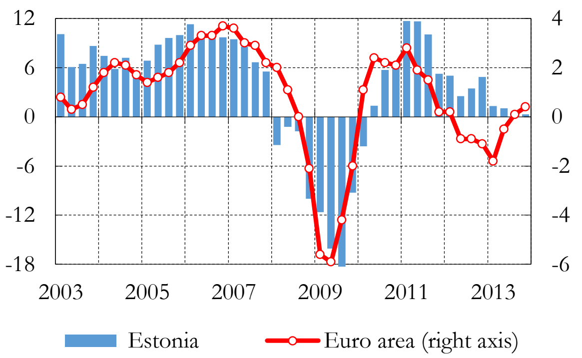
Table 1. External assumptions of the forecast (%)

	Assumptions in the Ministry of Finance spring forecast 2014						European Commission		
	2013	2014*	2015*	2016*	2017*	2018*	2013	2014*	2015*
1. 3-month Euribor (annual average)	0.2	0.3	0.4	0.8	1.2	1.6	0.2	0.3	0.4
2. Long-term interest rate in the euro area (annual average)	1.6	1.8	2.1	2.3	2.4	2.5	1.6	1.8	2.1
3. USD/EUR exchange rate (annual average)	1.33	1.36	1.36	1.36	1.36	1.36	1.33	1.36	1.36
4. Nominal effective exchange rate	1.4	1.4	0.0	0.0	0.0	0.0		-	
5. World GDP growth (excluding the EU)	3.6	4.1	4.4	4.5	4.6	4.6	3.6	4.1	4.4
6. EU27 GDP growth	0.1	1.4	1.7	1.9	2.0	2.0	0.1	1.5	2.0
7. GDP growth of Estonian export markets	0.9	1.7	2.1	2.3	2.4	2.4		-	
8. World import growth (excluding the EU)	3.5	5.4	6.1	6.3	6.6	6.6	3.5	5.4	6.1
9. Oil prices (Brent, USD/barrel)	108.5	104.1	100.0	100.0	100.0	100.0	108.5	104.1	99.6

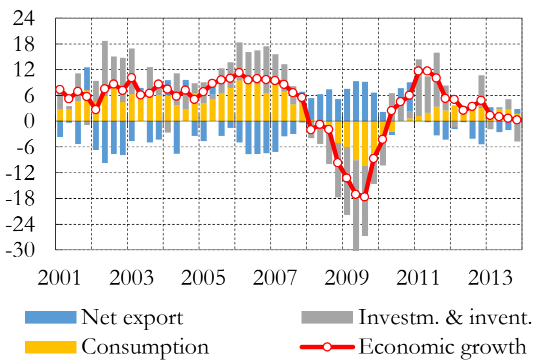
Sources: Historical data was obtained from Eurostat, Eesti Pank, the U.S. Energy Information Administration (EIA); forecasts are based on Consensus Economics (CF) and NYMEX Brent futures, if possible, which have been adjusted according to the most recent developments and the expert opinions of the Ministry of Finance.

Figure 3. Development of Estonia's main economic indicators (%)

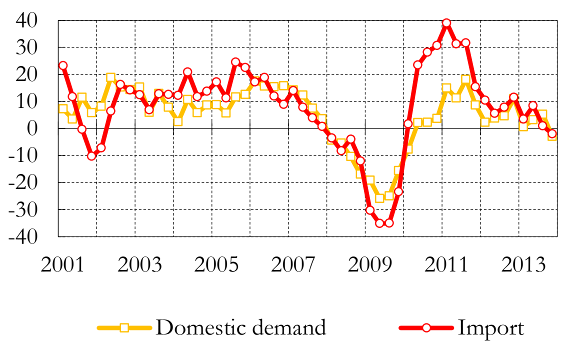
A. Economic growth in Estonia and in the euro area



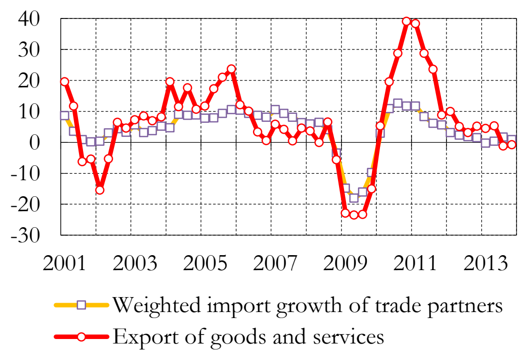
B. Contributions to economic growth



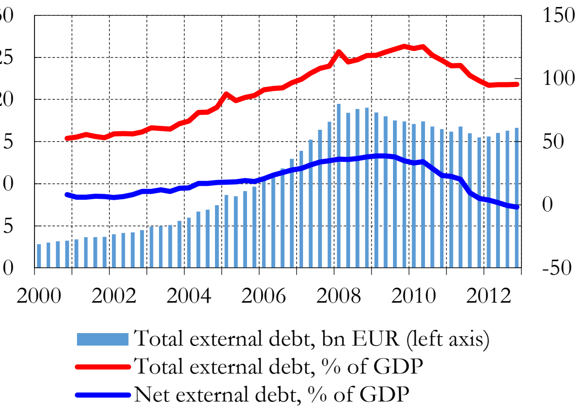
C. Real growth of domestic demand and imports



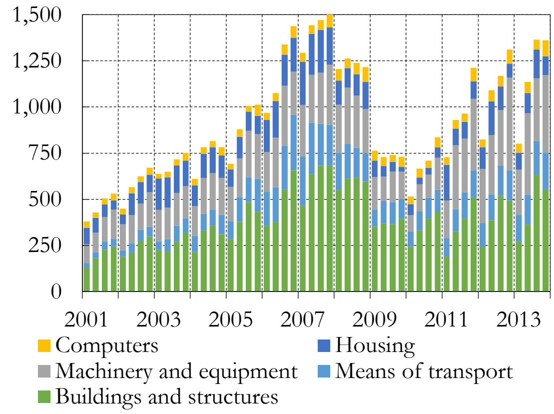
D. Real growth of exports



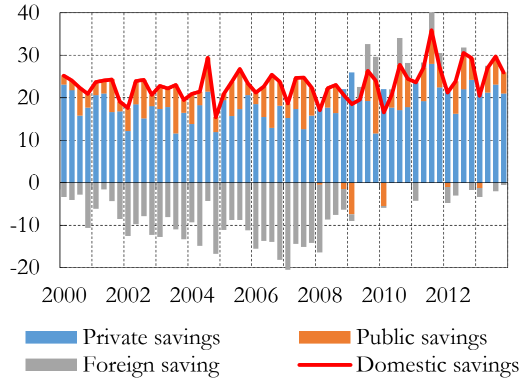
E. Total external debt and net external debt



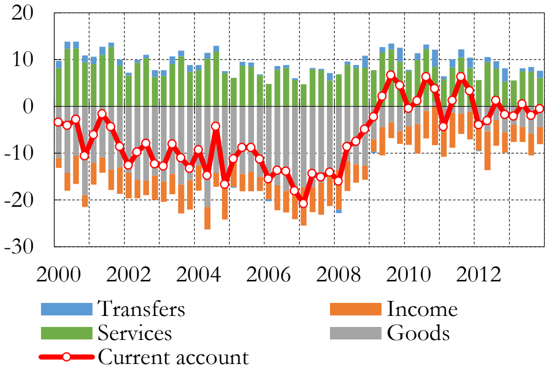
F. Structure of investments (million €)



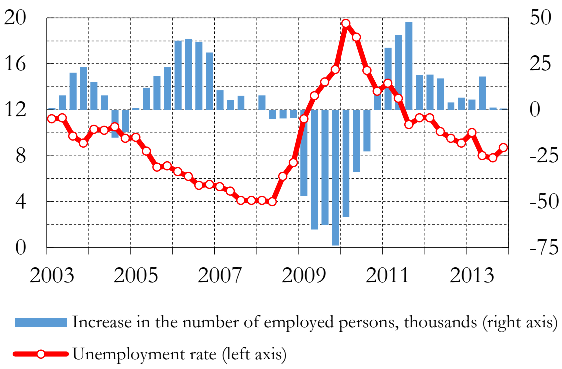
G. Savings (% of GDP)



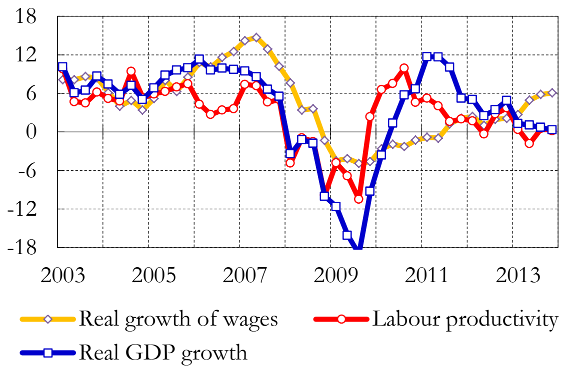
H. Current account structure (% of GDP)



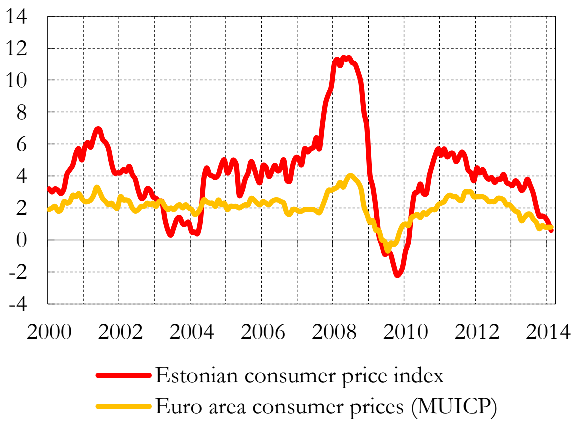
I. Employment and unemployment



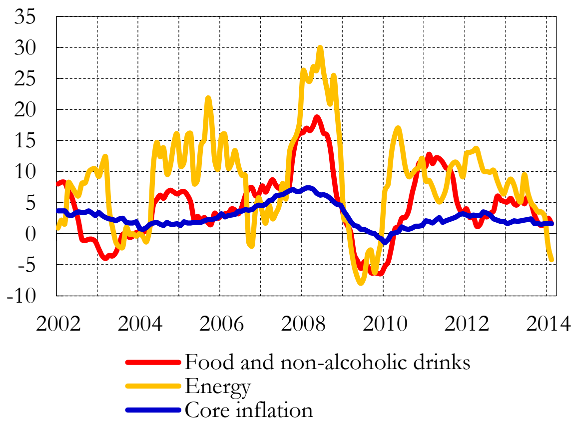
J. Labour productivity



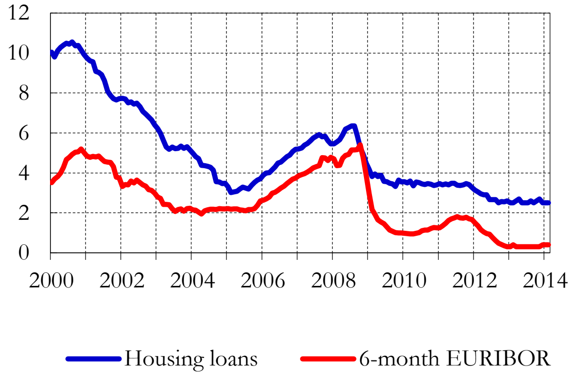
K. Consumer prices in Estonia and in the euro area



L. Change in main inflation components

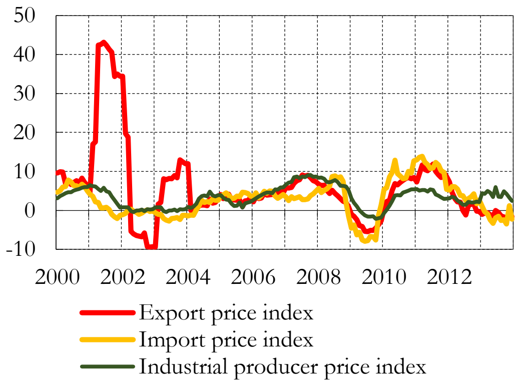


M. Interest rates



Source: Statistics Estonia, Eesti Pank, Eurostat.

N. Export, import and producer price index



2.2. Economic forecast

The assumptions of this forecast were fixed as of the end of February 2014 and therefore were not affected by the latest events in Ukraine. Since the Ministry of Finance's last, summer 2013 forecast, economic confidence in the EU has continued its fast and stable improvement. Confidence of industry, services and consumers show a clear improvement trend. Still, the construction sector is slow to recover in the euro area and also affects Estonian economy via Finland. As the economic recovery of several of Estonia's export partners has been relatively fast for a number of years already, the improvement of Europe's overall economy will not bring additional direct positive boost to Estonia's export demand. It will still indirectly increase confidence concerning the economic recovery of Estonia's nearest neighbours, as this confidence has systematically remained below the expectations of forecasters in recent years. Estonia's economic sentiment index has been on a slight trend of increase during the past six months, mainly supported by the trade and services sectors and consumers. The industrial situation is stable, waiting for the foreign demand to restore. But the confidence in construction sector has been in decline since autumn 2013, due to general government investments decreasing and private sector demand for buildings and residential premises being slow to restore.

As the foreign assumptions of this forecast were fixed before the escalation of events in Ukraine, the main scenario does not account for possible economic sanctions of the EU and possible counter-reactions by Russia. Nevertheless, the growth of Estonia's export demand in 2014 will remain below that forecasted in the previous summer (2% in the previous forecast and 1.7% herein in the current forecast), mainly due to reduction of growth expectations concerning Finland and Russia. The forecast's risk scenario is based on Russia's economic growth turning around this year (2% growth in the main scenario, 1% decline in the risk scenario) and on its estimated effect on economies in Estonia and in Latvia, Lithuania and Finland as well. Still, further development of the geopolitical crisis is as yet largely unknown and an assessment to possible economic effects of the past weeks' events should wait for stabilisation of the external political situation.

Estonia's **gross domestic product** will increase by 2.0% in 2014 and 3.5% in 2015 according to the forecast's main scenario. An increase by 3.6% is expected in 2016. The Ministry of Finance has adjusted this year's economic growth forecast downwards, mainly due to the growth outlook of Estonia's main trade partners worsening. The economic growth forecasts of 2015 and 2016 have not changed compared to the previous forecast. Economic growth is expected to accelerate in the second half of the year, due to restored growth of foreign demand. Economic growth will be driven by domestic demand in 2014, but the effect of export should increase in the future. A significant increase of economic growth and strengthening of foreign demand is expected in 2015–2016.

The growth in domestic **demand** will decelerate somewhat in 2014. The growth of private consumption will still remain fast (3.9%), regardless of the growth of wage income decelerating. The real growth of consumption is supported by slower increase of consumer prices and the next year's reduction of income tax rate. In coming years, the growth of real consumption will start to decelerate due to the price increase accelerating and due to the expected decline of the number of employed people in the forecast period's last years. Similarly to last year, the number of investments will remain modest. Corporate investments are held back by low demand for products and general government investments by decrease of projects funded from EU structural funds and from sales revenue of CO2 quota. The volume of investments into residential premises by the population is very low, but its growth that started in the second half of last year should continue.

Export of goods and services will increase by 2.4% in 2014. While enterprises were able to increase the market share in export markets in earlier years, this year's export growth will be less than the increase of foreign demand. This is due to the current shortage of foreign orders in countries outside the euro area and weakness in export of electronics. The external environment will start to recover faster in 2015 and the growth opportunities of Estonian enterprises will be improved by the gradual restoration of Finnish economy as well. The growth speed of export will be similar to that of foreign demand, stabilising at the level of 6.5–7% at the end of forecast period. The import growth of goods and services will accelerate to 3.3% in 2014, due to increasing domestic demand and growing import of inputs and components needed for export activities. The growth of import will remain somewhat faster than that of export in the forecast period because of high investment needs of enterprises. However the negative contribution of net export to GDP growth will decrease compared to previous years.

Regardless of weak export markets, external balance improved in 2013. **Current account** deficit decreased to 1% of GDP due to smaller deficit of income account. The current account deficit will increase somewhat in 2014 because of modest export outlook and due to domestic demand becoming stronger. At the end of the forecast period, current account deficit may reach the level of 2% of GDP.

The increase of **consumer prices** (CPI) will decelerate from 2.8% in 2013 to 1.4% in 2014 and will increase to 2.7% in 2015. Inflation will remain slow in the first half of the year and will start to accelerate in the autumn, due to food products becoming more expensive and higher core inflation, reflecting the price increases of services and industrial goods. While the increase of housing costs have been the main inflation factor in earlier years, this year the housing costs are slightly declining as a result of electricity, district heating and gas supply becoming cheaper. Partly due to this, the contribution of administrative price changes will remain negative this year. Based on crude oil futures, the fuel price will also continue to decline in 2014. In the coming years, the core inflation will accelerate somewhat and the price decline of external factors (fuel, district heating) will stop. If no large fluctuations will happen in commodity prices, the increase of consumer prices will stabilise on the level of 2.8% at the end on the forecast period.

The growth of **employment** decelerated in the second half of last year and remains modest on the annual scale, both in 2014 and in the year after (0.2–0.3%). Regardless of aggregated decrease of employment-age population (age group of 15–74 years), the rates of both employment and participation in labour force have increased while recovering from the crisis, allowing for an increase of the number of employed people. Still, the results of the latest census provide grounds for an assumption that the number of employed people will start declining in an accelerating pace beginning from 2016, inevitably restricting Estonia's opportunities for economic growth. In case of favourable economic developments, the unemployment rate will decrease to near 6% by the end of the forecast period.

The growth of **average wages** should decelerate during 2014 when compared to the previous year, although fast wage increase may be retained at the beginning of the year. Last year, wage income grew clearly faster than the profits of enterprises, but in longer perspective those growth speeds should become similar to each other. The wage growth of transportation and storage industry which drove the overall wage growth last year should decelerate because simultaneously with fast wage growth, a decrease of turnovers and profit took place in that sector. Shortage of labour force becoming worse in the coming years will force enterprises to invest, so the wage growth may still accelerate in medium term. We forecast the wage growth to be 6.2% in 2014 and to accelerate slightly in subsequent years. The growth of real wages in 2014 will remain on a comparable level to the last year (4.8%), due to sharp decelerating of the price increase.

Table 2. Forecast of gross domestic product in 2013–2018 (%)

	2013 level	2013	2014*	2015*	2016*	2017*	2018*
1. Real GDP growth	12,831	0.8	2.0	3.5	3.6	3.4	3.2
2. Nominal GDP growth	18,435	5.9	4.9	6.9	6.8	6.4	6.1
Sources of growth							
3. Private consumption expenditure (incl. NPOs)		4.2	3.9	3.8	3.3	3.2	3.1
4. General government's final consumption expenditure		1.3	1.0	1.0	1.0	1.0	1.0
5. Total capital investment in fixed assets		1.0	0.7	3.7	5.3	7.4	5.7
6. Change of inventories (% of GDP)		1.6	1.8	2.3	2.8	2.6	2.4
7. Export of goods and services		1.8	2.4	6.0	6.5	6.7	6.7
8. Import of goods and services		2.6	3.3	6.3	6.6	7.1	7.0
Contribution to GDP growth[1]							
9. Domestic demand (excluding inventories)		2.7	2.4	3.1	3.3	3.7	3.3
10. Change in inventories		-1.2	0.3	0.5	0.3	0.0	0.1
11. Balance of goods and services		-0.7	-0.7	-0.2	-0.1	-0.4	-0.2
Growth of value added							
12. Primary sector		-3.5	4.0	2.2	2.3	2.1	2.0
13. Manufacturing		4.5	5.2	5.6	5.0	4.8	4.2
14. Construction		-5.7	-5.1	3.9	4.7	4.3	4.0
15. Other services		2.0	1.4	2.8	3.0	2.9	2.8

1) Contribution to GDP growth indicates the shares of specific sectors in economic growth. This is calculated by multiplying growth in the area by its share in GDP. The sum of the contributions of different sectors amounts to economic growth (the slight difference can be attributed to a statistical error – the part of GDP that cannot be divided between the areas).
Source: Ministry of Finance, Statistics Estonia.

Table 3. Price forecast for 2013–2018 (%)

	2013	2013	2014*	2015*	2016*	2017*	2018*
	2005=100	*%*	*%*	*%*	*%*	*%*	*%*
1. GDP deflator	143.7	5.0	2.8	3.2	3.0	2.8	2.7
2. Private consumption deflator	140.5	3.4	2.3	2.9	2.9	2.8	2.8
3. Harmonised consumer price index	143.5	3.2	1.7	2.9	3.0	3.0	3.0
3a. Consumer price index	141.8	2.8	1.4	2.7	2.8	2.8	2.8
4. General government consumption expenditure deflator	155.2	6.1	4.5	5.0	4.5	4.5	4.5
5. Investment deflator	127.9	5.0	3.0	2.3	2.1	2.2	2.1
6. Export deflator	130.0	1.0	0.8	1.7	2.0	2.0	2.0
7. Import deflator	126.5	-0.4	0.8	1.6	2.0	1.9	1.9

Source: Ministry of Finance, Statistics Estonia.

Table 4. Labour market forecast for 2013–2018 (persons aged 15–74) (%)

	2013 level	2013*	2014*	2015*	2016*	2017*	2018*
		%	%	%	%	%	%
1. Employment, persons	621.4 1)	1.0	0.2	0.3	-0.1	-0.3	-0.5
3. Unemployment rate		8.6	7.9	6.9	6.4	6.0	6.0
4.Labour productivity, per employed persons	20.7 2)	4.8	4.7	6.5	6.9	6.7	6.6
6. Compensation of employees	8,748.9 3)	8.5	6.5	6.6	6.3	6.2	6.1
7. Compensation per employee (6./1.)	14.1 4)	7.8	6.2	6.3	6.4	6.5	6.6

1) Thousand persons.
2) Thousand EUR per employed person.
3) Million EUR.
4) Thousand EUR.
Source: Ministry of Finance, Statistics Estonia.

Table 5. Balance of payments forecast for 2013–2018 (%of GDP)

	2003–2012	2013	2014*	2015*	2016*	2017*	2018*
1. Net lending/borrowing vis-à-vis the rest of the world	-4.6	1.7	1.3	1.2	0.7	0.5	0.5
1a. Current account	-6.7	-1.0	-1.6	-1.7	-1.9	-2.1	-2.2
2. Balance of goods and services	-2.5	2.0	1.2	1.1	1.0	0.7	0.6
3. Balance of income and transfers	-4.3	-3.0	-2.8	-2.8	-2.9	-2.8	-2.8
4. Capital account	2.1	2.7	2.9	2.9	2.6	2.6	2.7
5. Errors and omissions	-0.1	1.2					

Source: Ministry of Finance, Eesti Pank, Statistics Estonia.

2.3. Comparison with the forecasts of other forecasters

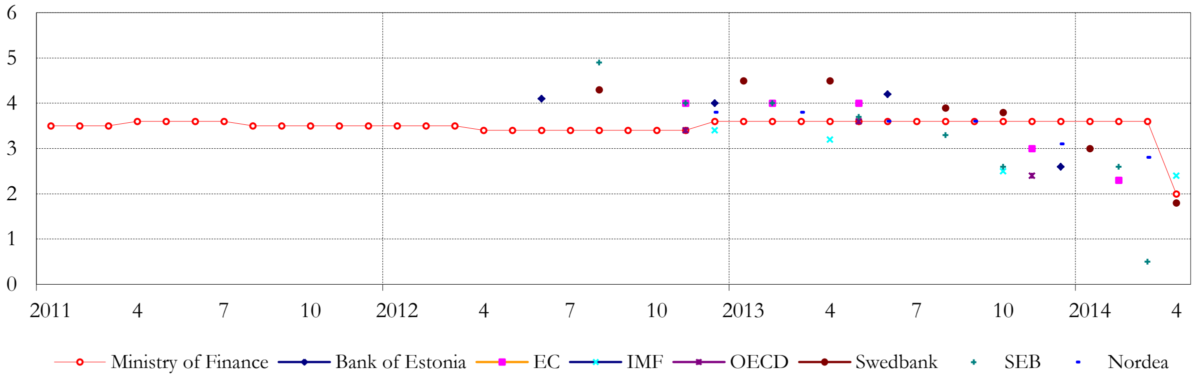
Highlighted below are the differences between the economic forecast of the Ministry of Finance for spring 2014 and the most recent known growth expectations of the other institutions that prepare macro-economic forecasts. As these forecasts are compared, it must be kept in mind that they were made at different times and thus on the basis of different information, which is the cause of the differences in the assumptions and results of the forecast. Earlier forecasts must be regarded in light of the assumptions that prevailed at the time they were prepared, as the external environment is uncertain and future prospects are not the same as they were some time ago.

While the assessments of various forecasters to economic growth of 2014, made in summer months of last year, fluctuated around 3.5%, the forecasts published towards the end of the year and in the first months of this year present significantly lowered assessments, guessing the economic growth of 2014 to be in the range of 2%–3%. This is primarily due to low GDP growth indicators of the 3rd and the 4th quarter and the combined effect of weak foreign demand. The Ministry of Finance's spring forecast is in the lower end of that range.

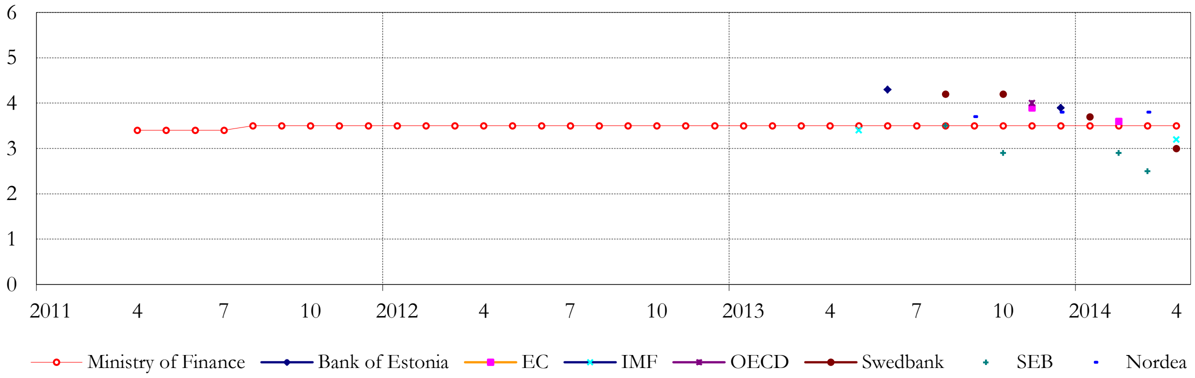
By 2015, institutions are expecting the economic growth to accelerate to 3-4%, based on the assumption of enlivening economy of Estonia's export partners and stronger domestic demand. The Ministry of Finance's expectations concerning the recovery of economic growth are similar to those of other forecasters.

Figure 4. Change in Estonia's economic growth forecasts (%)

A. Forecasts of Estonia's economic growth for 2014 according to forecast publication date



B. Forecasts of Estonia's economic growth for 2015 according to forecast publication date



Sources: Ministry of Finance, Eesti Pank, European Commission, IMF, OECD, Swedbank, SEB, Nordea.

Table 6. Comparison of economic forecasts

	Real GDP growth, %			Nominal GDP growth, %		
	2014*	**2015***	**2016***	**2014***	**2015***	**2016***
Ministry of Finance	**2.0**	**3.5**	**3.6**	**4.9**	**6.9**	**6.8**
European Commission	2.3	3.6	–	5.3	7.1	–
Eesti Pank	2.6	3.9	–	5.8	7.9	–
IMF	2.4	3.2	–	–	–	–
OECD	2.4	4.0	–	5.0	7.2	–
SEB	0.5	2.5	–	–	–	–
Swedbank	1.8	3.0	–	4.0**	6.0**	–
Nordea	2.8	3.8	–	5.0**	8.0**	–
Estonian Institute of Economic Research	2.7	–	–	–	–	–

	Consumer price index, %			General government position, % of GDP		
	2014*	**2015***	**2016***	**2014***	**2015***	**2016***
Ministry of Finance	**1.4 (1.7*)**	**2.7 (2.9*)**	**2.8 (3.0*)**	**-0.7**	**-0.8**	**-0.7**
European Commission	1.8*	2.8*	–	-0.4	-0.4	–
Eesti Pank	2.1 (2.3*)	2.9 (3.0*)	–	-0.3	-0.1	–
IMF	3.2*	2.8*	–	–	–	–
OECD	3.2*	3.3*	–	-0.1	0.0	–
SEB	0.6	2.6	–	-1.2	-1.2	–
Swedbank	1.3	2.5	–	-0.4	-0.3	–
Nordea	1.9	3.0	–	-0.5	-0.1	–
Estonian Institute of Economic Research	2.2	–	–	–	–	–

** Harmonised Consumer Price Index (HICP).*

Sources:

Ministry of Finance Economic Forecast. Spring 2014. 7.04.2014.
European Commission. European Economic Forecast Winter 2014. 25.02.2014.
IMF. World Economic Outlook. April 2014. 8.04.2014.
OECD. Economic Outlook No 94. November2013, 19.11.2013
Eesti Pank. Monetary policy and economy. Current state and outlook. 12.12.2013.
Estonian Institute of Economic Research. Konjunktuur No. 1(188) 2014. 7.04.2014.
SEB. Eastern European Outlook. March 2014. 26.03.2014.
Swedbank. Swedbank Economic Outlook. 8.04.2014.
Nordea Economic Outlook. March 2014. 12.03.2014.

2.4. Macroeconomic policy in coming years

2.4.1. Guaranteeing macroeconomic stability

The primary objective of the macroeconomic policy of the Government of the Republic is to ensure macroeconomic stability and internal and external balance. The imbalances and risks that appeared during the rapid potential-exceeding growth of the years prior to the economic crisis decreased quickly after the economic cycle turned. The focus of economic policy in the coming years should be on reducing the possibility of similar risks occurring in the new growth phase, whilst increasing competitiveness at the same time. However, the risks of a credit-based and excessively fast economic growth are minimal in the medium term.

Estonian economy showed remarkable flexibility in both the private and public sectors during the recession. The Government kept the budget deficit within the limits determined in the Treaty on European Union during the recession, giving the country a great starting position after the recovery of economic growth, as the general government debt did not increase significantly as a result of the crisis and most of the measures taken to improve the budget position have long-term impact.

Although the real economic growth remained below expectations in 2013, the general government position improved and the deficit for the year was 0.2% of GDP. The position is expected to weaken in 2014 but still remain in structural surplus. The general government position has been in structural surplus since 2009.

The changeover to the single European currency, the euro, and joining the euro area on 1 January 2011 has played an important role in helping us overcome the crisis successfully. Irrespective of the turbulence in global developments, the single currency has increased confidence in the Estonian economy and created good conditions for growth in the future. The continuing conservative stance in budgeting will provide a good basis on which to increase the confidence of economic agents also in the future. Its positive impact can be seen in economic developments after overcoming the crisis.

The economic policy of Estonia as a small and open economy is aimed at flexibility. The Government intends to maintain the relatively minimal extent to which it currently interferes with the economy also in the medium term, and its goals are to create conditions for the development of the private sector and to stabilise economic development by keeping the budget in a structural surplus.

2.4.2. External and internal imbalances of economy

The external and internal imbalances of the economy have decreased significantly in recent years. While in 2008–2009 five of the eleven indicators were above the macroeconomic imbalance thresholds, in 2010–2011 only two indicators did not meet the criteria - international investment position and unemployment rate. Since 2010 the current account deficit, the appreciation of the real effective exchange rate and the growth of nominal unit labour cost have not exceeded the threshold either. Since 2011, the private sector's consolidated debt burden also remains below the 133% threshold. A continually above-threshold negative international investment position is inevitable in the case of a young and rapidly developing economy because domestic savings have not been sufficient to grow the capital stock. At the same time, foreign investments are an important source of productivity growth. Therefore, this indicator will probably be beyond the recommended threshold for some time, although it can be said to have its positive sides as well. The other indicator exceeding the threshold – unemployment rate – already fell below the reference level of 10% in the second half of 2012, but as a three-year average used as an assessment criteria, it should remain below the reference value in 2014.

The current account deficit that reached 16% in the years of rapid economic growth decreased fast during the economic crisis and current account was in a surplus of 2.7% by 2009. This happened because imports decreased significantly faster than exports due to a sharp drop in consumption and investments. With investments growing fast and export markets remaining relatively weak, imports grew faster than exports in 2012, resulting in a current account deficit of 1.8%. The forecasted moderate deficit of the next few years will remain, according to Eesti Pank, within the limits of sustainable level.[2]

The debt burden of the private sector in Estonia at the start of the 2000s was almost twice below the EU average and according to unconsolidated data amounted to 67% of GDP, and loans taken from commercial banks comprised approximately one half of this. Households were the ones that were prepared to increase their loan burden as a result of the activation of the real estate sector and raising confidence created by the accession to the EU, and they used the money to improve their living conditions and to increase the level of private consumption. The increase in the loan burden was supported by the credit policy and low interest rates of commercial banks. This caused a sudden increase in the loan burden of households. The debt burden of the private sector in Estonia has been higher than the euro area average since 2006 (as % of GDP). Since 2009, the debt burden of the private sector started to decrease and the trend only reversed in 2012 when the loan stock of the business sector started to increase as compared to the previous month. As regards households, the loan stock turned to growth as compared to the previous month in the spring of 2013, supported by leasing that had been growing for some time and by an increase of housing loans. In the first months of 2014, the loan balance of households already increased in a year-by-year comparison as well, although the growth speed was marginal. The stock of consumption-type loans (consumer loans, student loans, other loans) is still decreasing, though. Demand for loans will probably remain low for the next couple of years and regardless of low interest rates, a new loan boom is not very likely due to modest demand.

Active supply of loans created conditions for the overheating of the property market in 2005-2007. Average transaction prices at the height of the property boom exceeded the price level of 2002 by more than three times. The trend on the property market changed in the middle of 2007: demand dwindled and pushed the market into a decline by the end of 2007. The global financial crisis that started in autumn 2008 deepened the decline even further. The average price of a square metre in apartment ownership transactions in Tallinn in March 2014 was still about a fifth lower compared with the previous peak[3]. The property purchase power of households was the lowest in 2007 (about 30 m^2 of apartment space on the basis of average wages[4]) and has doubled since then (about 60 m^2 at the beginning of 2014). Despite a modest loan growth, housing property transaction prices have shown a stable growth trend since the summer of 2009 and have increased by about 77% when compared to the bottom level (as per Pindi price index). The number of transactions is also having an upwards trend, although it is still at the level of 2004.

Nominal unit labour cost [5] increased consistently during the boom, when average wages increased rapidly and exceeded productivity. However, the nominal unit labour cost of 4-5% may be considered acceptable for the Estonian economy, as it does not suggest a decrease in competitiveness or emergence of macro imbalances. The change in the real until labour cost[6] was close to zero until 2006, which suggested that the ratio of wage expenses to GDP was stable and

[2] Estonian competitiveness report 2013, Eesti Pank. [http://www.eestipank.ee/publikatsioon/eesti-konkurentsivoime-ulevaade/2013/eesti-konkurentsivoime-ulevaade-2013].
[3] http://www.pindi.ee/link.php?id=31771&filename=2014.a+m%C3%A4rts.pdf.
[4] Purchase Power Index of Pindi Kinnisvara according to the lending capacity calculated on the basis of average wages [http://www.pindi.ee/link.php?id=31771&filename=2014.a+m%C3%A4rts.pdf].
[5] Ratio of labour costs to added value created per employee.
[6] Ratio of labour costs to added value.

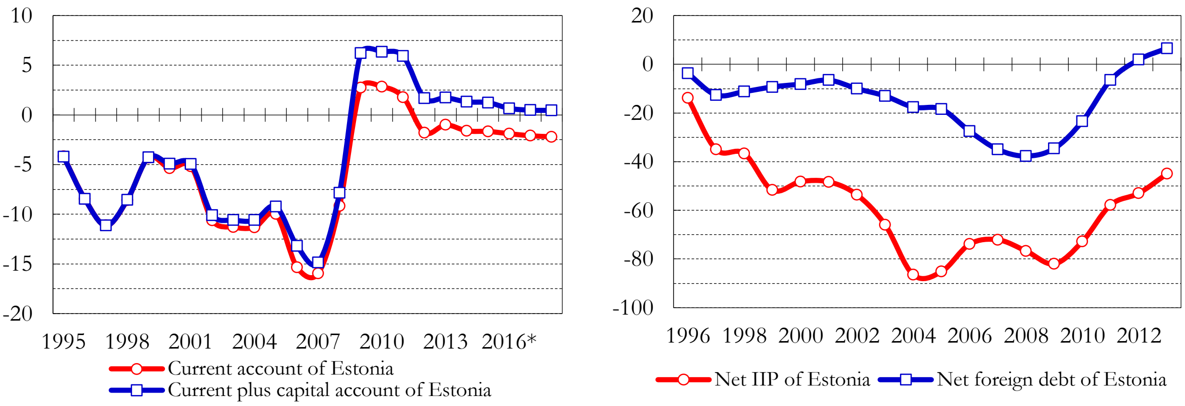
labour costs could be increased without damage to competitiveness. The labour market overheated in 2007 and 2008 as a result of excessive internal demand, which was followed by a strong correction whereby the wage increase turned to decline (-4.6% in 2009), unemployment increased and employment started to drop. The imbalances on the labour market created by the boom started decreasing fast during the crisis, which is also evidenced by the decrease in the nominal unit labour costs. The increase in nominal unit labour cost accelerated to 4.2% in 2012, but the three-year average used as a reference still remained at the level of -2.8%. But in 2013 the increase in nominal unit labour cost compared to that of three years ago was already 10.2%, although still remaining below the 12% threshold. This threshold will probably be exceeded in 2014 and 2015, because the base years will be 2011 and 2012 which had high unemployment rate and low unit cost and the wage growth is expected to be fast.

The economic policy of the Government is aimed at promoting economic growth via supply-side factors within the context of a generally liberal economic policy. Promoting free competition and efficiently functioning markets also makes it possible to reduce the probability of imbalances. The functioning of the labour market is supported by the Employment Contracts Act that has already been implemented and the expansion of the role of active labour market policy measures, which are aimed at reducing long-term unemployment by using in-service training and retraining for improving the qualification of the workforce and paying more attention to the needs of the labour market in designing the education policy.

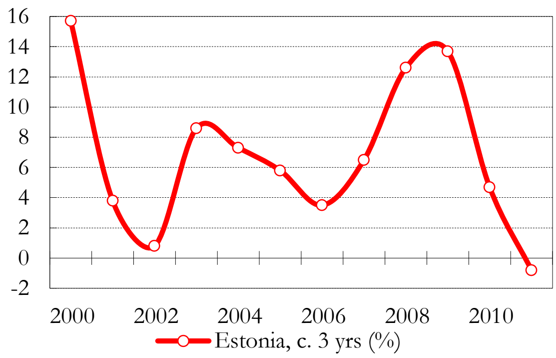
The Government and Eesti Pank are constantly monitoring the situation and taking care to ensure macroeconomic stability. Additional measures will be applied if necessary.

Figure 5. Selected indicators from economic developments

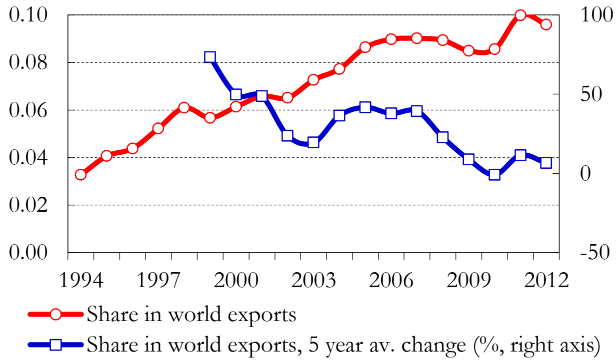
A. Current account balance (% of GDP) **B. Investment position (net IIP, % of GDP)**



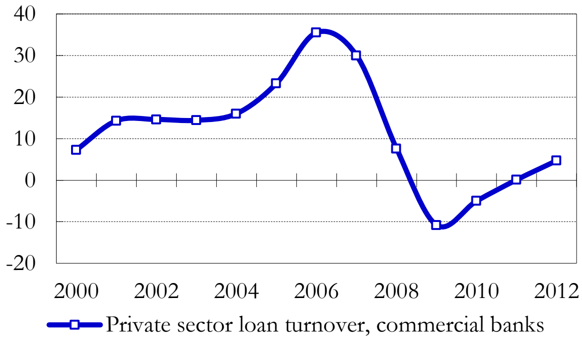
C. Real effective exchange rate[7]



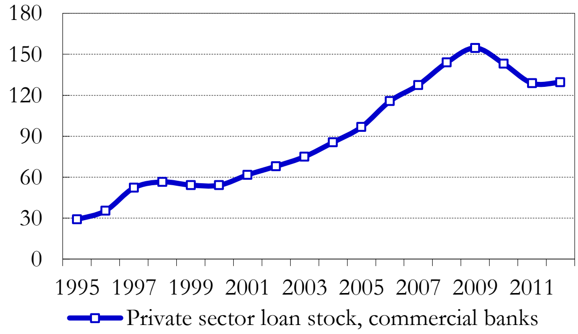
D. Share in world exports (%)



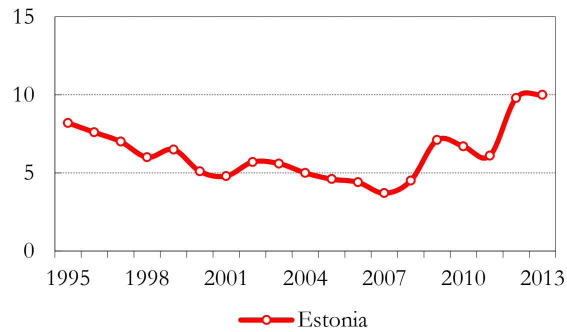
E. Private sector loan turnover (% of GDP)



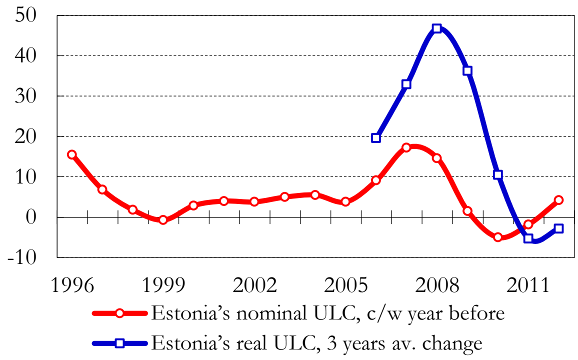
F. Private sector debt (% of GDP)



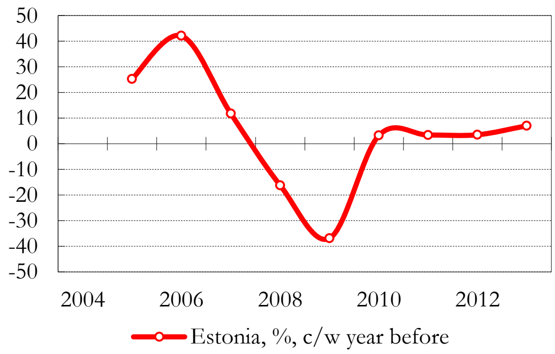
G. General government debt (% of GDP)



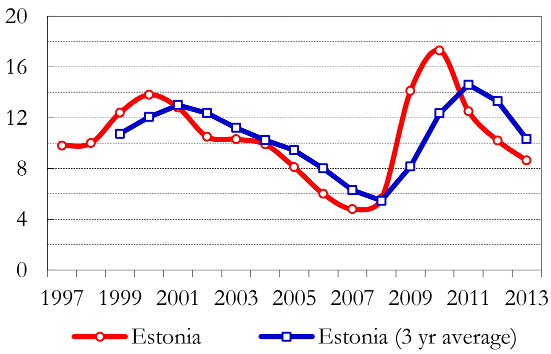
H. Change in unit labour costs (%)



I. Property prices



J. Unemployment rate (%)



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

[7] HCI of the euro area: *Harmonised competitiveness indicators based on consumer price indices, vis-à-vis EER-42 group of trading partners.*

3. FISCAL FRAMEWORK

The new State Budget Act entered into force in March 2014, with the aim to establish legal bases and basic requirements for guaranteeing Estonia's economic and budgetary sustainability in the long term. It also transposed the Council Directive 2011/85/EU on the requirements for budgetary frameworks of the member states into the national law. The Act establishes **budgetary position rules**, pursuant to which the state budget must be prepared so as to ensure that the general government's **structural budgetary position is at least in balance**. Requirements concerning operating results and net debt are established for central government's legal persons, with the objective to contribute in achieving general government's structural balance. Pursuant to the state budget strategy, conservative fiscal policy compliant with the provisions of the Base Act will be continued in the next four years, and the budget expenditure will be planned according to possibilities.

3.1. Fiscal Policy objectives of the Government of the Republic

The Government's objective is to guarantee a **sustainable fiscal policy that ensures macroeconomic balance.** The goal is to make fiscal policy decisions that support maximum macroeconomic stability, manage the risks that threaten the balanced development of the economy, and improve the economy's growth potential and increase employment. The **existence of adequate reserves** and **flexibility in the budget** for making changes in the structure of revenue and expenditure must be guaranteed in order to cope with future economic downturns.

Fiscal policy decisions are made **simultaneously** (i.e. only in the budget (strategy) process), decisions are **sustainable** (the long-term impact of decisions is considered) and take account of sector policies and the activities of the other levels of the general government; and all **funding sources** (European Union grants, proceeds from sales of greenhouse gas emission quotas, etc., in addition to tax revenue) are **uniformly regarded**.

3.1.1. Medium-term budget objective of the Government

The Government will continue with a strict fiscal policy and its **medium-term objective (MTO) is the general government structural surplus**.[8] This objective is in line with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. Planning the budget position with a surplus helps guarantee the long-term sustainability of the budget.

Estonia managed to achieve its MTO until the global economic crisis, but in 2008[9] the budgetary position of general government fell into a structural deficit. Since 2009, Estonian general government is in structural surplus again and the MTO is therefore met.

In 2014 the budgetary position will worsen, but it will still remain in structural surplus of 0.1% of GDP. The decrease of structural surplus compared with 2013 is caused by worsening of the positions of both social security funds and the central government. The objective for the coming years is set to 0.2% structural surplus, complying with the set MTO, except in 2016 where the structural budgetary position is expected to be in balance. The deviation from the objective in 2016

[8] The surplus target was set in Convergence Programme 2007. The Convergence Programmes of 2005 and 2006 set the objective to achieve a balanced budget.

[9] Due to later reassessments, structural deficit was also identified in 2006 and 2007.

will be minimal and one time only, mainly caused by the effects of the economic cycle and one-off measures (the nominal budgetary position will improve compared with 2015).

If the objectives are achieved, the general government's nominal budget surplus will be attained by 2017, which will make it possible to restore the reserves that had decreased during the recession. **No positive supplementary budgets will be prepared during the year and any extra tax revenue received in the budget will be placed into the reserves.**

3.1.2. Medium-term tax burden objective of the Government

The Government's objective is to retain the tax burden at the level it was at before the latest economic crisis (about 32% of GDP)**, by reducing labour-related taxes.**

The tax burden of 2014 will be 32.4% of GDP. In the period of 2014–2017, a reduction in the income tax rate and the unemployment insurance rate, an increase of the basic exemption, and also increased state contributions into the mandatory funded pension for those who continued their own contributions, will have an alleviating effect on the tax burden. The effect of increasing the tax burden will result primarily from increase of excise duties. In summary, the tax burden will remain at a level comparable to 2014, reaching 32.3% of GDP **by 2018**. The future developments are discussed in detail in the chapter on tax policy and tax burden.

The Government's objective is to reduce the implicit tax rate on labour to 33.2% by 2015.

The implicit tax rate on labour in 2014 is 33.8%. Compensation of the mandatory funded pension (2014–2017), a reduction in the income tax rate and the unemployment insurance rate (2015) and an increase of the basic exemption (2015–2018) will diminish this indicator to 33.2% by 2015. By 2018, the effect of compensating the mandatory funded pension will cease and the implicit tax rate on labour will increase to 34.2%.

3.2. Budgetary position of the general government

3.2.1. Nominal position of general government budget

In 2013, the general government's budgetary deficit decreased to 34 million EUR i.e. 0.2% of GDP. The central government and local governments ended the year with a deficit of 0.1% and 0.4% of GDP respectively; social security funds had a surplus of 0.3% of GDP. The deficit was reduced due to better than forecasted tax receipts, primarily in the part of corporate income tax. At the same time, the volume of investments remained low and e.g. payouts of parental benefit and other social benefits were modest. Local governments were in more than double the expected deficit, caused primarily by an increase of investments, related *inter alia* to last autumn's elections.

According to the forecast, the budgetary deficit of 2014 will be 0.7% of GDP, mainly caused by the central government, for the reason of state pension insurance expenditure exceeding the revenue by 2% of GDP. The negative ratio of revenue from sales of emission quotas and expenditure (investments) made from those funds will also increase the state budget's deficit. The budgetary position will improve in 2015, but will still remain at a deficit of 0.5% of GDP because the growth of revenue will be less than the growth of expenditure, *inter alia* due to reduction in labour tax burden. The general government's budgetary position is expected to improve continuously in the coming years and will attain a surplus of 0.5% of GDP by 2018.

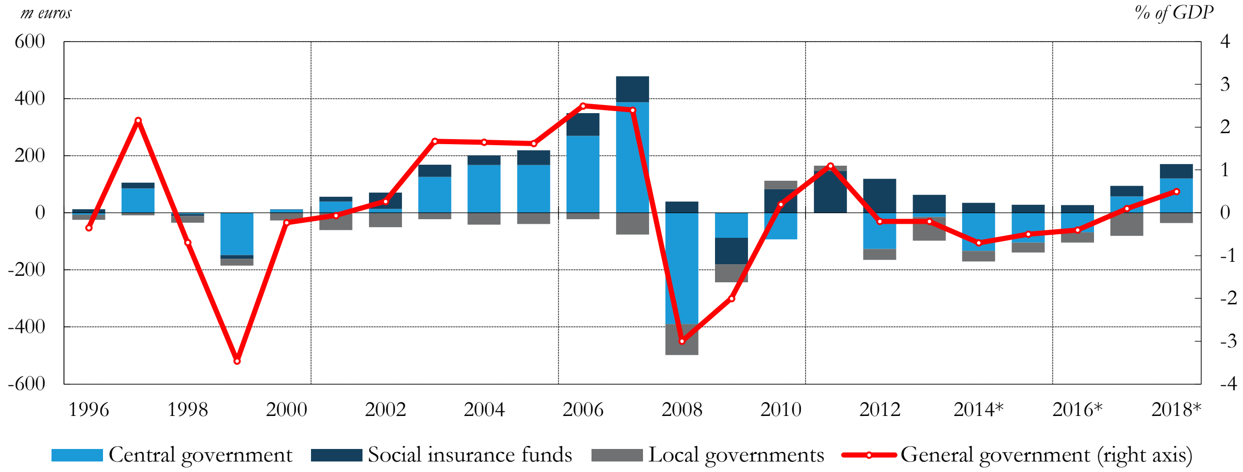
The Government's ambition is to maintain the structurally adjusted budget surplus achieved since 2009 throughout the forecast period (except in 2016 which is planned to have the balanced budget). In 2015, the Government is planning to achieve a structural surplus of 0.2% of GDP.

Table 7. Budgetary position objective of the general government for 2014–2018

	2014	2015	2016	2017	2018
Structurally adjusted budgetary position of general government (% of GDP)	**0.1**	**0.2**	**0.0**	**0.2**	**0.2**
Budgetary position of general government (% of GDP)	**-0.7**	**-0.5**	**-0.4**	**0.1**	**0.5**
State budget	-0.4	-0.2	-0.1	0.4	0.7
incl. state pension insurance	-2.0	-1.9	-1.8	-1.6	-1.3
Other central government	-0.3	-0.3	-0.2	-0.2	-0.2
Social security funds	0.2	0.1	0.1	0.2	0.2
Local governments	-0.2	-0.2	-0.2	-0.3	-0.1
Budgetary position of general government (m EUR)	**-135**	**-111**	**-78**	**13**	**136**
State budget	-82	-48	-30	95	169
incl. state pension insurance	-380	-397	-391	-375	-322
Other central government	-52	-56	-39	-38	-48
Social security funds	35	28	27	37	51
Local governments	-37	-35	-36	-81	-35

Source: Ministry of Finance.

Figure 6. Budgetary position of the general government



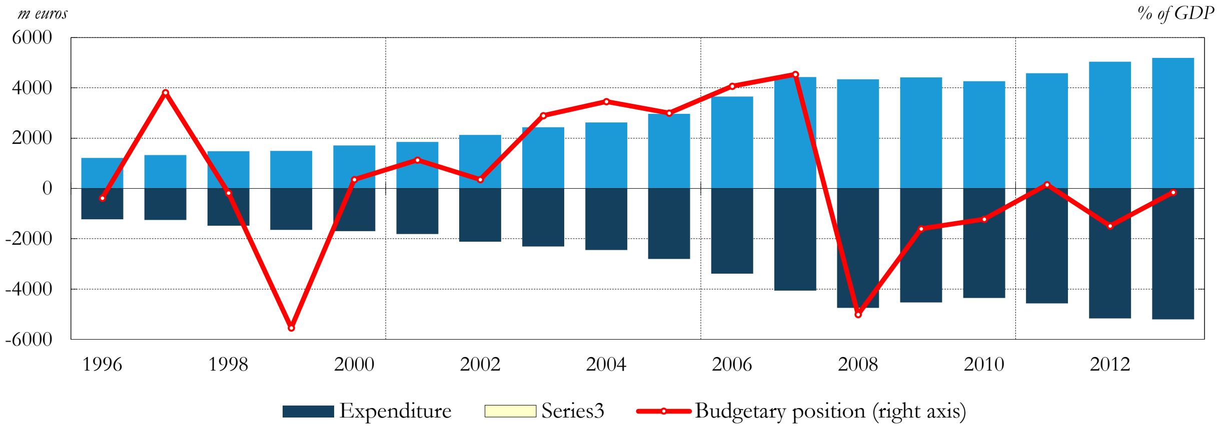
Source: Statistics Estonia, Ministry of Finance.

The general government covers public sector entities that are financed mainly via mandatory payments made by entities belonging to other sectors, and whose main activity is the redistribution of national income (so-called non-market producers). The general government in Estonia consists of three sectors: central government, local governments and social security funds.

Central government

The biggest part of central government, which comprises about three-fourths of general government, is agencies financed from the state budget (constitutional institutions and ministries with their areas of government). The central government also includes foundations established by the state (hospitals and the Environmental Investment Centre have the biggest impact), companies that mainly provide services to the state (e.g. AS Riigi Kinnisvara) and institutions governed by public law (e.g. universities, Estonian Public Broadcasting).

Figure 7. Revenue, expenditure and budgetary position of central government



Source: Statistics Estonia.

The tax revenue of the state budget, which is the most sensitive to economic development, comprises the biggest part of the central government's revenue. This is why the biggest part of the budget deficit is coming from the state budget when the economic cycle is in a phase of decline. Therefore, the state budget contributed the most to the budgetary surplus during the pre-crisis years. Non-tax revenue, which mainly consists of external support received from the European Union, also comprises a large part of the central government's revenue in addition to tax revenue.

The majority of the central government's expenditure consists of state budget expenditure, about one-third[10] of which are social security expenses (incl. state pension insurance). These expenses are followed by expenditure on economy (incl. agriculture and road construction) and health (allocation to the Estonian Health Insurance Fund).

The other central government budgetary position is the aggregate amount of foundations, commercial undertakings and agencies governed by public law. Large investments, which exceed the revenue of the current year, are one of the main factors that influence the budgetary position. The impact on the budgetary position is negative irrespective of whether they are financed from the reserves collected in previous years or with loans.

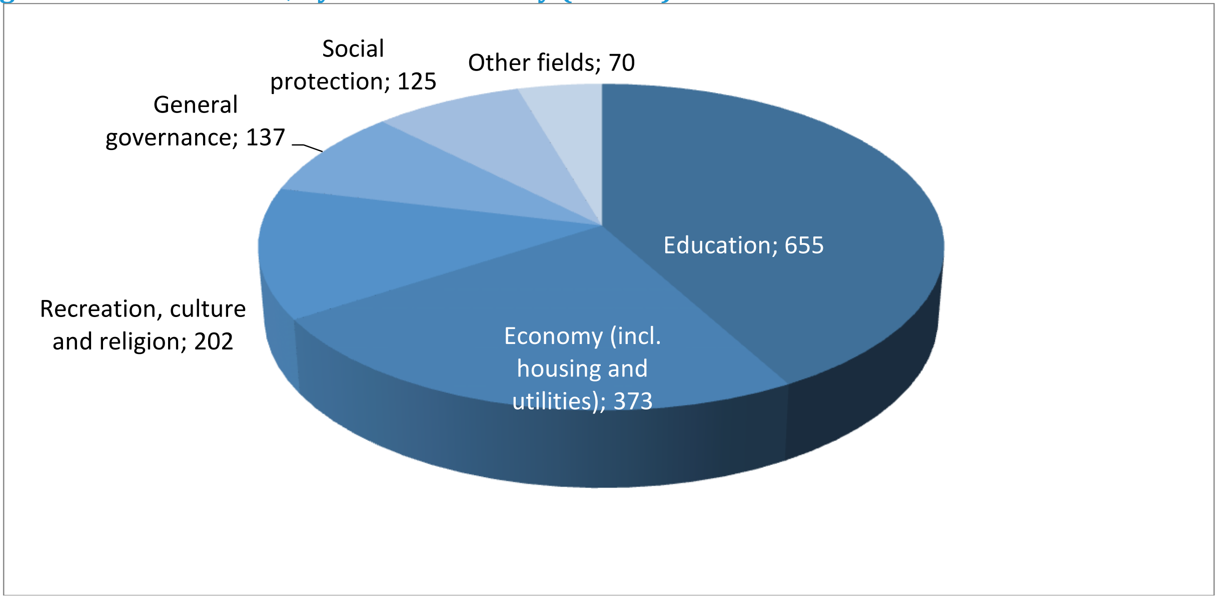
Local governments

Local governments (a total of 215) have an important role in the performance of public sector functions. They all perform the same functions irrespective of their size. General governance includes the upkeep costs of city governments and rural municipality governments and councils. Economic expenses (incl. housing and utilities) consist mainly of public transport within the rural

[10] Based on State Budget 2014.

municipality or city, road or street maintenance in the rural municipality or city, water supply organisation and street lighting. Social protection means upkeep of nursing homes, provision of social aid and welfare services and providing social protection for families. Upkeep of schools and kindergartens belongs to the area of education. Recreation, culture and religion include upkeep of hobby schools, cultural centres, libraries, museums and sports facilities and also youth work. Other areas make up a smaller part of a local government's expenditure which includes such activities as e.g. cleaning and organisation of waste management and effluent treatment. The total volume of those expenses on cash basis was 1,638 m EUR in 2013 (incl. 75 m EUR of liabilities). 63% of this was comprised of personnel and management expenditure.

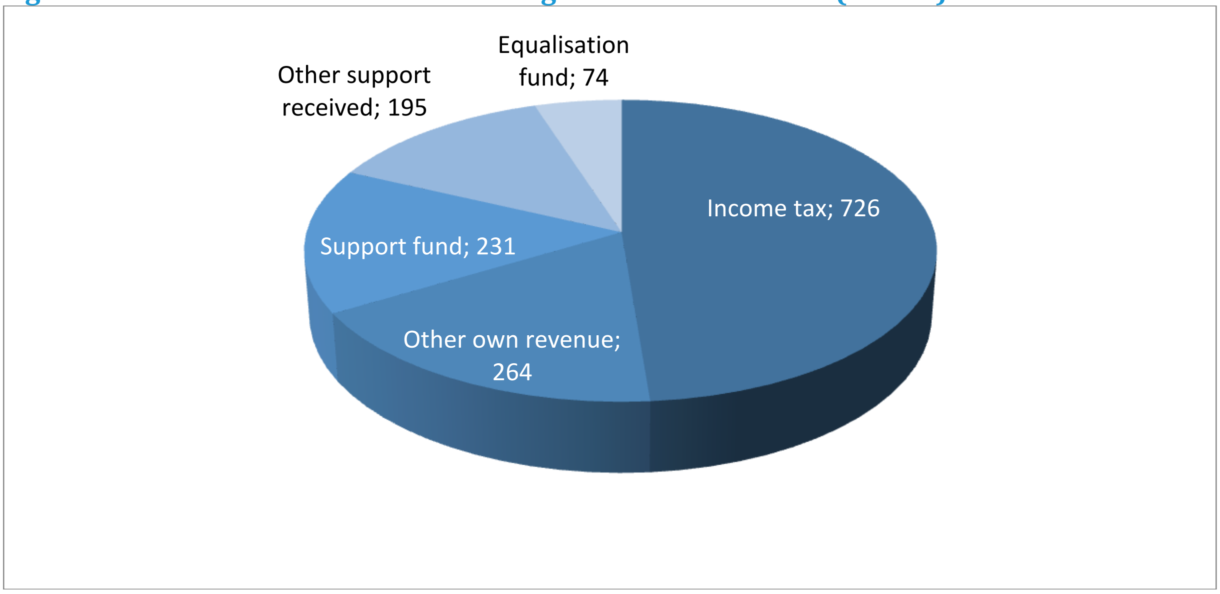
Figure 8. Division of expenses related to the main activities and investments of local governments in 2013, by areas of activity (m EUR)



Source: Ministry of Finance.

The budgets of local governments are independent, which means that they are responsible for preparing the budgets. A major part of the revenues of local authorities comes from personal income tax and support from the state budget.

Figure 9. Breakdown of revenue of local governments in 2013 (m EUR)



Source: Ministry of Finance.

The accrual deficit of local governments and their dependent units amounted to 82.7 million EUR in 2013. According to the forecast of the Ministry of Finance, local governments will be also in deficit in the period 2014–2018. To cover the deficit, liabilities will be increased.

The data from the budgets of local governments and their budget implementation are available in ongoing budget reports.[11]

Local governments undertook an obligation to prepare a budget strategy for 2014–2017 by November 2013. The strategy has remained conservative when planning revenue and expenditure. For example, the assumed income tax receipt for the period is 0.16 bn EUR less than the Ministry of Finance's forecast. Labour costs are planned to be increased by an average of 2.2% per annum, which is significantly below the forecasted growth of the country's average wage growth (an average of 6.4% per annum). The estimated increase of management expenditure is on average 2.0% per annum. It can be expected that these expenses will be continually adjusted upwards due to wage increase and inflation pressure. Careful approach has also been used when planning investments for 2015–2017. On average, 117 m EUR of own funds per year are planned to be used; this is roughly at the same level as in the period of 2010–2013. Surplus is planned to be attained starting with 2016, as a result of conservative planning. This provides a reserve for increasing their expenditure in the relevant budget year.

Table 8. Aggregate indicators of local governments, Ministry of Finance's forecast (m EUR)

Revenue and balance	2013	2014*	2015*	2016*	2017*	2018*
Revenue	1,332	1,396	1,458	1,515	1,575	1,641
- Income tax	726	779	834	884	937	995
- Equalisation fund	75	75	75	75	75	75
Budgetary balance	**-83**	**-37**	**-35**	**-36**	**-85**	**-35**

** forecast*
Source: Ministry of Finance.

Social security funds

The Estonian Health Insurance Fund and the Unemployment Insurance Fund form the sector of social security funds. In Estonia, the national pension insurance system is under the central government.

Table 9. Budgetary position of social security funds for 2013–2018

	2013	2014 budget	2014*	2015*	2016*	2017*	2018*
Social security funds (*m EUR*)	62	61	35	28	27	37	51
Social security funds (*% of GDP*)	0.3	0.3	0.2	0.1	0.1	0.2	0.2

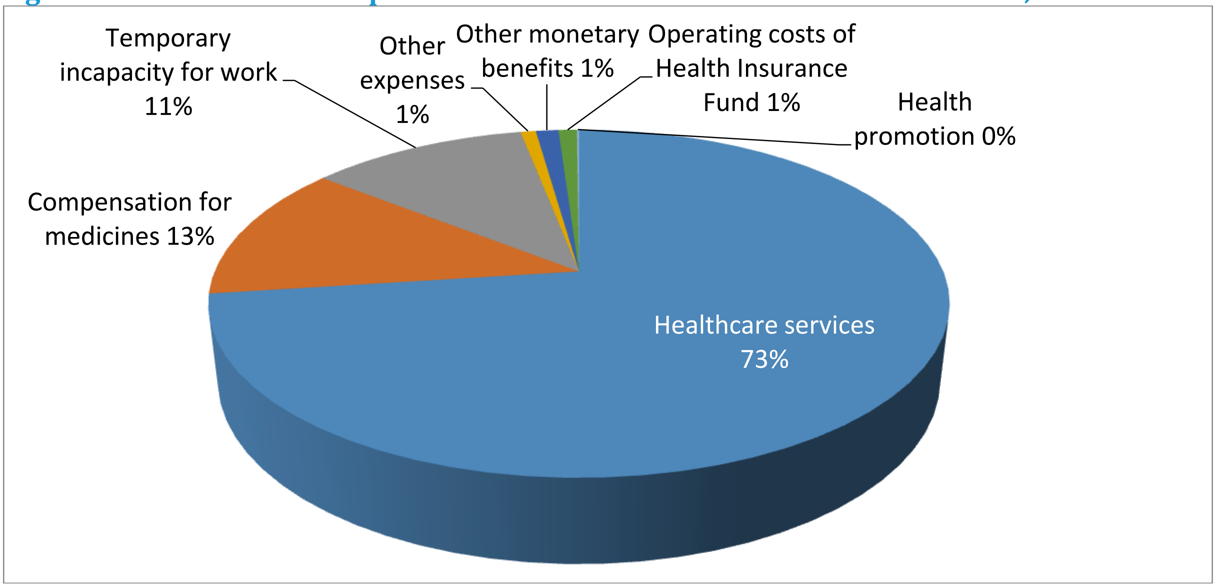
** forecast*

Source: Ministry of Finance.

The health insurance part of the social tax comprises about 99% of the revenue of the Estonian Health Insurance Fund. Health services (prevention of diseases, primary and specialised medical care, nursing care and dental treatment) constitute the biggest part of the benefits guaranteed to insured persons. These services are followed by compensation for medication and temporary sick leave.

[11] http://www.fin.ee/kov-eelarved-ulevaated#KOVK.

Figure 10. Breakdown of expenditure of the Estonian Health Insurance Fund, 2013



Source: Estonian Health Insurance Fund.

In 2013, the budgetary position of Estonian Health Insurance Fund fared better than expected, due to social tax receipts being larger and expenditure being less than forecasted (surplus of 1 m EUR). A deeper deficit of 13 m EUR is expected in 2014, primarily due to the medical personnel's wages growing faster than the social tax receipt, pursuant to the collective bargaining agreement signed in 2012. The highest increase, exceeding the growth speed of total expenditure, will happen in expenditure on specialised medical care which is also the largest type of expenditure. The cost of compensation for medicines, being the next largest, will increase somewhat slower than total expenditure in 2014. A small budgetary surplus is expected in 2015–2018.

Table 10. Aggregate indicators of Estonian Health Insurance Fund, 2010-2018 (m EUR)**

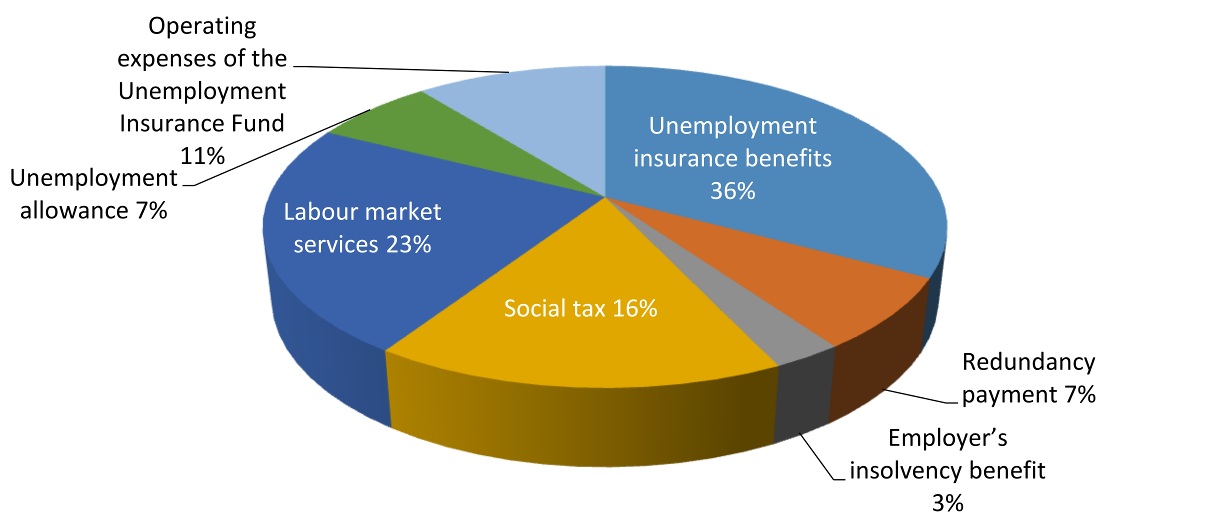
	2010	2011	2012	2013	2014*	2015*	2016*	2017*	2018*
Total revenue	694.4	735.1	781.9	836.9	893.5	961.7	1,026.7	1,094.1	1,168.1
incl. social tax	685.9	725.6	776.9	829.7	887.5	956.1	1,020.9	1,088.1	1,161.8
Total expenditure	700.3	725.5	780.9	838.4	906.4	959.2	1,024.3	1,088.2	1,156.1
Budgetary position	**-4.7**	**14.3**	**1.9**	**0.8**	**-12.9**	**2.5**	**2.4**	**5.9**	**12**

* *forecast*

** *Budgetary position in 2010–2013 according to data from the Ministry of Finance. Expenditure in 2014–2018 according to the specified forecast of the Ministry of Finance regarding the Health Insurance Fund. Forecast of revenues in 2014–2018 according to the Ministry of Finance's spring 2013 economic forecast.*

Unemployment insurance benefits comprise the biggest part of the expenditure of the Unemployment Insurance Fund. The length of the period in which these benefits are paid increased to 360 days in 2011. In 2013, the number of persons receiving the benefit decreased more than twofold compared with 2010 when the number of such persons was the highest. The declining trend is forecasted to continue throughout the budget strategy period both regarding the recipients of the benefits and the total number of unemployed persons. Still, the volume of expenditure is expected to stabilise because the payout amounts are related to wages which will increase during the forecast period.

Figure 11. Breakdown of expenditure of Estonian Unemployment Insurance Fund, 2013



Source: Unemployment Insurance Fund.

Similarly to 2012, the Unemployment Insurance Fund finished last year with a surplus (55 million EUR), but the surplus was significantly lower because the unemployment insurance rate was reduced at the beginning of 2013. This year's budgetary position of the Unemployment Insurance Fund is influenced negatively by an increase of expenditure (the expenditure on both benefits and services will increase). Also, the receipt of unemployment insurance premiums is not increasing at the same speed as other labour taxes because the premiums in January 2013 were still received at the prior higher rate. The expected surplus of 2014 is 48 million EUR. In 2015 the budgetary surplus of the Unemployment Insurance Fund will decrease to 25 million EUR as the unemployment insurance rate will drop to 2.4% and the operating expenditure of the Unemployment Insurance Fund will increase due to the work capacity reform being initiated. The budgetary position is expected to retain a similar surplus in the coming years, to be increased somewhat by 2018.

Table 11. Aggregate indicators of the Unemployment Insurance Fund, 2010-2018 (m EUR)***

	2010	2011	2012	2013	2014*	2015*	2016*	2017*	2018*
Total revenue	**238.4**	**249.7**	**249.3**	**184.8**	**193.5**	**169.2**	**181.7**	**193.8**	**207.4**
- unemployment insurance premiums	179.2	194.4	211.0	167.2	168.5	144.8	155.1	165.6	177.1
Total expenditure	**157.3**	**116.4**	**126.5**	**126.7**	**145.8**	**143.9**	**157.5**	**162.4**	**168.7**
- benefits**	76.2	44.6	48.7	54.4	60.5	56.9	56.2	55.6	56.8
Budgetary position	**78.1**	**129**	**118.6**	**63.2**	**47.7**	**25.3**	**24.2**	**31.4**	**38.7**

* *forecast.*

** *Unemployment insurance benefit, insurance benefit in case of redundancy and employer's insolvency benefit.*

*** *Budgetary position in 2010–2013 according to data from the Ministry of Finance; revenue and expenditure of the same years according to the annual accounts of the Unemployment Insurance Fund (except 2013 which is based on the initial budget implementation report); forecast for 2014–2018 according to the Unemployment Insurance Fund's forecast. As the Unemployment Insurance Fund's reports are prepared on cash basis and the Ministry of Finance's data are accrual-based, the difference between revenue and expenditure does not equal the budgetary position in 2010–2013.*

3.2.2. Cyclically adjusted position of general government budget

The method used by the Ministry of Finance to estimate the maximum possible gross domestic product (or the potential GDP[12]) is the production function method[13]. The use of this method indicates that from 2005 to 2007 the GDP of Estonia increased considerably faster than it should have, considering the resources existing in economy at the time, which created significant imbalances. The economic growth that could be considered manageable for the economy of Estonia before the crisis was about 6%, but it actually reached 10% at times. The growth was based on the rapid inflow of foreign funds as well as the overall optimism of local economic agents, which made domestic demand considerably bigger than total production and income. This excessive demand resulted in a scale of the economy that was up to 12% larger than usual (i.e. a GDP gap[14]) in 2007, which was accompanied by accelerating inflation, a strong deterioration of the trade balance and tension from the excessively intense and inefficient use of resources in the economy, which brought along an increase in their prices.

Demand for consumer and investment goods decreased sharply as the uncertainty that started to appear at the height of the boom continued to increase. The global financial crisis that started in autumn 2008 magnified the economic downturn caused by the cyclical behaviour of the economy even further. Global demand also decreased considerably as a result of the financial crisis and caused the scale of foreign trade to decrease by up to one third. The negative GDP gap of Estonia increased to almost 11% of GDP in 2009 as a result of this. When the economic cycle went into reverse and after rapid growth in 2011, the negative GDP gap has decreased quickly; according to the Ministry of Finance, it was about 1.5% of the potential GDP in 2013. According to the present forecast, the GDP gap will close completely in 2016.

As the recent financial crisis and its aftermaths have been considerably more serious than the usual cyclical volatility of the economy, it is likely that countries lost some of their production potential in the course of the crisis. The growth potential of the Estonian economy in the next few years will also be lower than before the crisis due to the same reasons.

The estimates[15] of the cyclically adjusted position of Estonia's general government budget found on the basis of the GDP gap indicate that the fiscal policy of Estonia became stricter in 2013 in the conditions of a negative GDP gap (the GDP level being lower than the potential level) and was thus procyclical. Estonia's fiscal policy of coming years will be countercyclical, except in 2016 when the GDP gap will become positive (the GDP level being higher than the potential level), but the fiscal policy will be more lenient i.e. procyclical. It should be kept in mind that the impact of a change in the use of external funds must also be assessed in addition to the change in the budgetary position when a final assessment is given to the fiscal policy. Since external funds are neutral with regard to the budgetary position – revenue always equals expenditure –, an increase in the use of funds, for example, is not reflected in the changes that occur in the budgetary position. It does, however, provide extra stimulation to economic activities during the economic recess and is countercyclical in its nature.

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[12] Potential GDP –maximum GDP using the existing production input (workforce, capital, productivity/skills) without causing excess pressure for price increase. Potential economic growth –change over time of potential GDP. Depends on changes in production inputs.

[13] Further information on GDP gap and cyclically adjusted budget position may be found in Appendix 3 to Estonian Convergence Programme of May 2004.

[14] Output gap –the difference between actual and potential GDP.

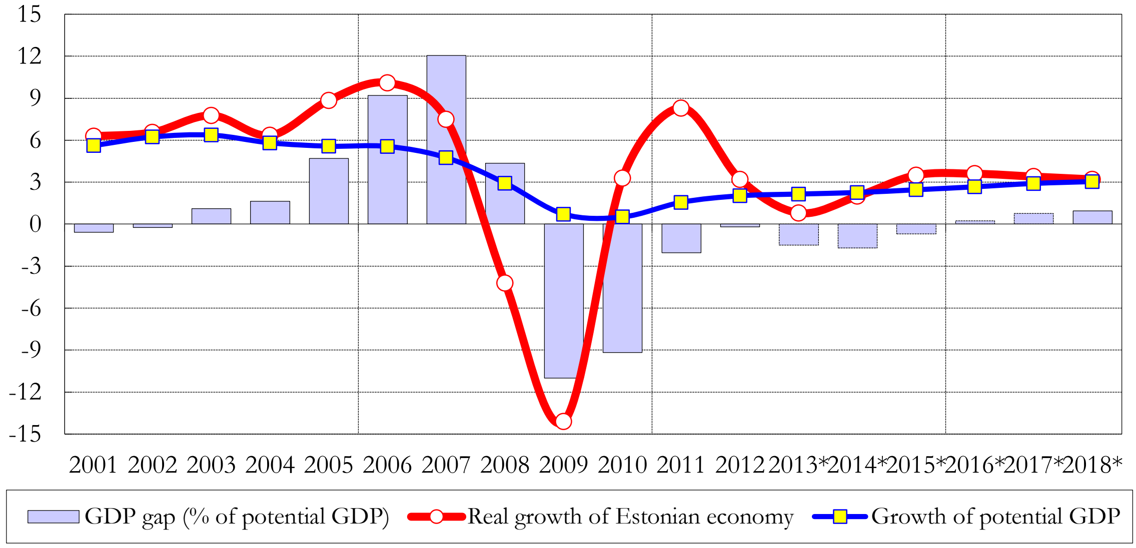
[15] According to the methodology renewed by the European Commission, the semi-elasticity applied to compute the cyclical component of the budget balance was 0.3 in the case of Estonia - the same as the previously used income elasticity (see also http://ec.europa.eu/economy_finance/publications/economic_paper/2013/pdf/ecp478_en.pdf).

Table 12. Cyclically adjusted budgetary position, 2013–2018 (% of GDP)

	2002–2012	2013	2014*	2015*	2016*	2017*	2018*
1. Real GDP growth (%)	4.1	0.8	2.0	3.5	3.6	3.4	3.2
2. Budgetary position of the general government	-	-0.2	-0.7	-0.5	-0.4	0.1	0.5
3. Interest payments	-	0.1	0.1	0.1	0.2	0.2	0.2
4. Potential real GDP growth (%)	3.8	2.3	2.5	2.7	2.9	3.0	3.2
4a. Contribution of capital (%)	2.7	1.5	1.4	1.4	1.4	1.5	1.6
4b. Contribution of labour (%)	0.2	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
4c. Contribution of productivity (%)	0.9	0.6	0.9	1.1	1.3	1.4	1.5
5. GDP gap (output gap)	0.9	-1.5	-1.7	-0.7	0.2	0.8	1.0
6. Cyclical budget component	-	-0.5	-0.5	-0.2	0.1	0.2	0.3
7. Cyclically adjusted budgetary position (7)=(2)-(6)	-	0.3	-0.2	-0.3	-0.4	-0.2	0.2
8. Cyclically adjusted primary position (8)=(7)+(3)	-	0.4	-0.1	-0.2	-0.2	0.0	0.5
9. Fiscal policy position	-	Pro-cyclical	Counter-cyclical	Counter-cyclical	Pro-cyclical	Counter-cyclical	Counter-cyclical

Source: Ministry of Finance, Statistics Estonia.

Figure 12. Development of potential GDP and GDP gap (%)



Source: Ministry of Finance, Statistics Estonia.

3.2.3. Structural position of general government budget

The structural budgetary position of general government is calculated by removing not only the impact of the economic cycle but also one-off and temporary measures, which may distort the budgetary position, from the nominal position. Measures that have a significant impact on the budget, but whose significant impact on the cyclically adjusted budgetary position is temporary and non-recurring (on the scale of at least 0.1% of GDP) are called one-off and temporary measures. Although the general principles on the basis of which the impact of a measure is classified as temporary have been defined, the consideration of each specific case is decided separately.

The Government's objective is to achieve a structural surplus of 0.2% of GDP in 2015, structural balance in 2016 and a structural surplus of 0.2% of GDP in 2017-2018.

The one-off measures that influence the budgetary position of general government are listed in Table 15. The total amount of one-off measures in 2013 was -0.2% of GDP. The investments associated with sales of AAUs will continue in 2014; added to this are the impact of the funded pension compensation mechanism and the higher than usual dividends of state-owned companies together with income tax. The effect of the measures in this year will be -0.3% of GDP. The investments associated with sales of AAUs will also continue in 2015–2016; the funded pension compensation will continue until 2017. There will be no impact of one-off measures starting with 2018.

Suspension of funded pension payments in 2009–2011 and compensation of funded pension in 2014–2017

From 1 June 2009 to 31 December 2010, the state contributions to funded pension were suspended. Those who wished could file a petition to continue with their own contributions in 2010. As an exception, people born in 1954 and earlier retained the possibility to continue the contributions from 2010 pursuant to the 2%+4% system in force until then. Starting with 1 January 2012, the contributions to funded pension were restored in full.

Those who **continued** with voluntary contributions in 2010 are automatically subject to the contribution rates of 2%+6% in 2014–2017, where the person pays 2% and the state adds 6%. Such persons are also entitled to file a petition to increase their own contribution from 2% to 3% (in that case the scheme used will be 3%+6%). Those who **did not continue** with voluntary contributions in 2010 had also an opportunity to file a petition to make contributions according to the 3%+6% system in 2014–2017. The expenditure related to restoration and compensation of funded pension contributions in comparison with the previous year are stated in Table 14.

Table 13. Percentages of funded pension payments, 2010–2018

	1942–1954	1942–1954	1955–...	1955–...
	continue	do not continue	continue	do not continue
2010	2+4	0	2+0	0
2011	2+4	1+2	2+2	1+2
2012–2013	2+4	2+4	2+4	2+4
2014–2017	2+4	2+4	2+6	2+4
2014–2017 if so wished	-	3+6	3+6	3+6
2018	2+4	2+4	2+4	2+4

Source: www.pensionikeskus.ee.

Table 14. Incremental pension expenditure, 2011–2018 (% of GDP)

	2011	2012	2013	2014*	2015*	2016*	2017*	2018*
Incremental pension expenditure	-0.4	-0.5	-0.1	-0.4	-0.1	-0.1	-0.1	0.0

Source: Ministry of Finance.

Revenue from sales of AAUs and investment expenditure related to the revenue

The AAUs are accounted only as those assigned under the Kyoto climate treaty, the trading period of which lasted until the end of 2012. Revenue from sales of those AAUs was received in the period of 2010–2013 and investments will be in the period of 2011–2016.

Dividends of state enterprises

Significantly larger than usual measures having a significant impact on the budgetary position are called one-off measures. Dividends of state enterprises are reflected among one-off measures only if the ratio of dividends to GDP exceeds the average level of previous 3 years and is at least 0.1% of GDP. In that case, the dividend amount exceeding the average level together with the income tax is considered to be a one-off measure.

Table 15. One-off measures and their impact, 2013–2018 (m EUR)

	2013	2014*	2015*	2016*	2017*	2018*
Revenue from sales of AAUs	18					
Expenditure of AAUs	-50	-53	-42	-10		
Dividends of state enterprises (share of GDP exceeding the average of previous 3 years and being at least 0.1% of GDP, together with income tax)		58				
II pension pillar contributions, 2+6 and 3+6		-58	-64	-72	-79	0
Total, m EUR	**-32**	**-52**	**-106**	**-81**	**-79**	**0**
Total, % of GDP	**-0.2**	**-0.3**	**-0.5**	**-0.4**	**-0.3**	**0.0**

Source: Ministry of Finance.

Table 16. Structurally adjusted budgetary position, 2013–2018 (% of GDP)

	2013	2014*	2015*	2016*	2017*	2018*
1. Cyclically adjusted budgetary position	0.3	-0.2	-0.3	-0.4	-0.2	0.2
2. One-off measures	-0.2	-0.3	-0.5	-0.4	-0.3	0.0
3. Structurally adjusted budgetary position (3)=(1)-(2)	0.4	0.1	0.2	0.0	0.2	0.2

Source: Ministry of Finance, Statistics Estonia.

3.3. General government revenue and expenditure

Table 17. General government revenue and expenditure, 2013–2018

	2013	2013	2014*	2015*	2016*	2017*	2018*
	m €	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Budgetary positions by general government levels							
1. General government	-33.6	-0.2	-0.7	-0.5	-0.4	0.1	0.5
2. Central government	-13.9	-0.1	-0.7	-0.5	-0.3	0.2	0.5
4. Local governments	-82.6	-0.4	-0.2	-0.2	-0.2	-0.3	-0.1
5. Social security funds	63.0	0.3	0.2	0.1	0.1	0.2	0.2
General government							
6. Total revenue	7,031.1	38.1	37.5	37.8	36.5	36.6	36.3
7. Total expenditure	7,064.7	38.3	38.2	38.4	36.8	36.6	35.8
8. Budgetary position	-33.6	-0.2	-0.7	-0.5	-0.4	0.1	0.5
9. Interest expenditure	25.3	0.1	0.1	0.1	0.2	0.2	0.2
10. Primary balance	-8.3	0.0	-0.6	-0.4	-0.2	0.2	0.8
11. One-off and temporary measures	-32.2	-0.2	-0.3	-0.5	-0.4	-0.3	0.0
Revenue by components							
12. Tax revenue (12=12a+12b+12c)	3,834.8	20.8	20.9	21.0	20.8	20.9	20.7
12a. Taxes on production and imports	2,477.6	13.4	13.5	13.9	13.8	13.8	13.7
12b. Taxes on income and wealth	1,357.2	7.4	7.5	7.0	7.0	7.0	7.0
12c. Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13. Social security contributions	2,109.0	11.4	11.4	11.3	11.3	11.3	11.5
14. Property income	197.1	1.1	1.3	1.1	0.9	1.1	1.0
15. Other revenue	890.2	4.8	3.9	4.5	3.4	3.4	3.1
16.=6. Total revenue	7,031.1	38.1	37.5	37.8	36.5	36.6	36.3
p.m.: Tax burden (D.2 (incl. taxes to the EU)+D.5+D.611+D.91-D.995)	5,956.9	32.3	32.4	32.3	32.1	32.2	32.3
Expenditure by components							
17. Compensation of employees + intermediate consumption	3,291.9	17.9	17.9	17.6	17.2	16.9	16.6
17a. Compensation of employees	1,972.8	10.7	10.7	10.5	10.2	9.9	9.7
17b. Intermediate consumption	1,319.1	7.2	7.2	7.1	7.1	7.0	7.0
18. Social transfers (18=18a+18b)	2,338.0	12.7	12.7	12.9	12.8	12.7	12.8
of this, unemployment benefits	69.3	0.4	0.4	0.3	0.3	0.3	0.3
18a. Social transfers in kind	328.9	1.8	1.8	1.8	1.7	1.7	1.7
18b. Social transfers other than in kind	2,009.1	10.9	10.9	11.2	11.1	11.0	11.1
19.=9. Interest expenditure	25.3	0.1	0.1	0.1	0.2	0.2	0.2
20. Subsidies	182.3	1.0	1.0	1.0	1.0	1.0	1.0
21. Gross fixed capital formation	797.0	4.3	4.3	4.1	3.5	3.6	3.1
22. Capital transfers	151.2	0.8	0.8	0.8	0.8	0.8	0.8
23. Other expenditure	279.0	1.5	1.4	1.8	1.3	1.3	1.2
24.=7. Total expenditure	7,064.7	38.3	38.2	38.4	36.8	36.6	35.8
p.m. Government consumption	3,594.3	19.5	19.6	19.4	19.2	19.1	19.0

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

Table 18. Impact of fiscal policy decisions on general government revenue and expenditure

	2013	2013	2014*	2015*	2016*	2017*	2018*
	m EUR	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*
General government revenue forecast	7,031.1	38.1	37.5	37.8	36.5	36.6	36.3
Revenue policy measures				1.1	1.3	1.4	1.1
General government expenditure forecast	7,064.7	38.3	38.2	38.4	36.8	36.6	35.8

Source: Ministry of Finance, Statistics Estonia.

Table 18 revenues and expenditures are based on the 2014 spring forecast by the Ministry of Finance (table 19). It includes the scope of the revenue measures required for the achievement of the objectives given in the Stability Programme.

Table 19. Revenues and expenditure according to the Ministry of Finance forecast of spring 2014, without budget policy decisions

	2013	2013	2014*	2015*	2016*	2017*	2018*
	m EUR	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*
General government revenue forecast	7,031.1	38.1	37.5	37.2	35.7	35.8	35.8
General government expenditure forecast	7,064.7	38.3	38.2	37.9	36.3	35.9	34.9

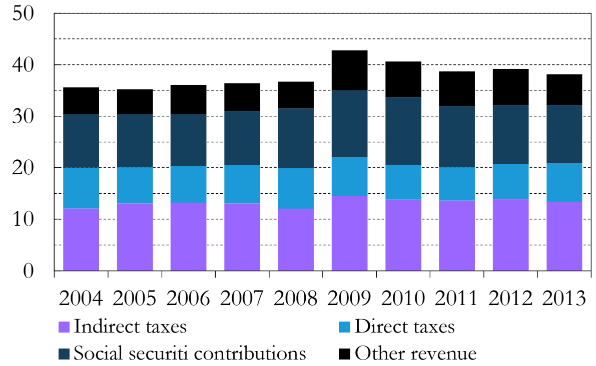
Source: Ministry of Finance, Statistics Estonia.

Structure of general government revenue

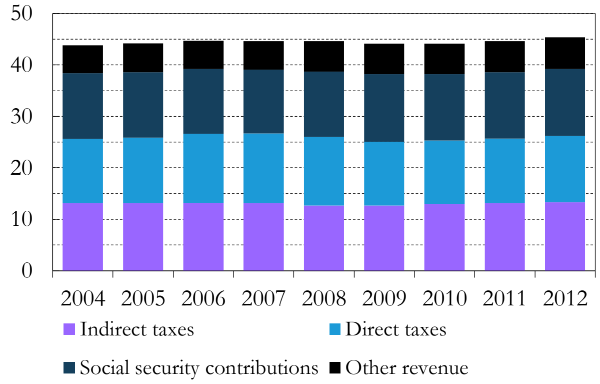
In 2013, general government revenue increased the most as a result of an increase in direct taxes, which occurred mainly due to an increase in the receipt of corporate income tax. The reason for the strong increase of private sector dividends (about 46%) was apparently *inter alia* the improved confidence of entrepreneurs and the retained profit gathered over the years, but a partial reason may also lie in a decrease of investment needs. Only a modest growth was exhibited by indirect taxes with higher share (receipt of fuel excise duty decreased due to more efficient vehicles being taken into use and the vehicle fleets being restructured to include more vehicles with diesel engine) and by social security payments (the unemployment insurance rate was reduced); in summary, the ratio of revenue to GDP decreased by 0.9%.

Figure 13. General government revenue and its structure (% of GDP)

A. General government revenue in Estonia



B. General government revenue in the EU



Source: Eurostat, Statistics Estonia.

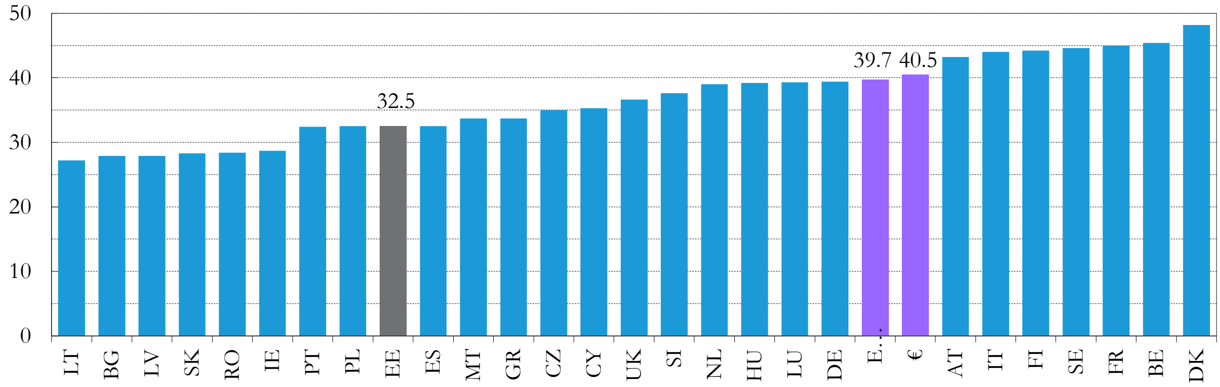
Future developments in tax policy and the tax burden

One of the tax policy goals of the Government is to shift the tax burden from the taxation of income to the taxation of consumption, use of natural resources and pollution of the environment, by partial reorientation of taxes. At the same time, the system will be kept **stable, simple and transparent** with as few exceptions and special cases as possible.

The Government's goal is to keep the tax burden near the level before last recession (about 32% of GDP) **by reducing labour-related taxes.**

According to Eurostat, the tax burden in Estonia in 2013 was 32.5% of GDP, which is significantly lower than the weighted average of both EU27 and the euro area (see Figure 13). Of Central and East European countries, only Slovenia, Hungary and Czech Republic have a higher tax burden than Estonia.

Figure 14. Tax burden in the European Union, 2012 (% of GDP)



Source: Eurostat.

The tax burden of 2014 will be 32.4% of GDP (see Figure 15A). This year's tax burden is reduced by an increase of the additional tax exemption of pensions and increased by raising the excise duties on tobacco and alcohol. In the period 2014–2017, the tax burden is reduced by a reduction in the income tax rate and the unemployment insurance rate and an increase of the basic tax-free allowance. Technically, higher contributions by the state to the mandatory funded pensions fund on behalf of those people who continued to make payments to the pension fund also have an effect of reducing the tax burden. The tax burden will be increased primarily by an increase of excise duties, but higher receipts will also result from the planned changes in taxation of company-owned passenger cars and from an additional electronic VAT declaration form containing transaction information. The planned measures are described in more detail below. In summary, the tax burden will remain at a level comparable to 2014, reaching 32.3% of GDP by **2018**.

Honest tax environment – equal competition and treatment

The Government has adopted two changes in VAT taxation, with a view to increase the fairness of the tax system. Restriction of VAT deductible on company-owned passenger cars is intended to tax private consumption done through a company. This measure restricts the VAT deductible on company-owned passenger cars and related expenditure to one half, unless the passenger car is used for business only.

An electronic addition to the VAT declaration will gather additional information about transactions between enterprises, reducing the number of VAT frauds and thus improving competition. The combined effect of those two measures on receipts of VAT in the next four years will be approximately 70–80 million EUR per year.

Fairer tax system – reducing differences in taxation

Tax incentives that have diverged from their original objective and have, therefore, become unjustified will be critically inspected and abandoned. Each tax incentive will be analysed to ascertain whether it is proportional to the goal to be achieved, whether it meets the expectations and needs of society, and whether trying to achieve this goal via the tax incentive is the most expedient approach. If necessary, the incentive will be implemented for a specific period of time, which makes it possible to analyse the effectiveness of the incentive in the achievement of the goal and to decide, on the basis of the analysis, whether the incentive should be extended.

Starting with 1 January 2015, the permission to use fuels with fiscal marking in ship traffic, railway carriage and heating will be abolished. This decision concerns on average 65% of current users of fuels with fiscal marking. The rate of the excise duty will increase from the current 110.95 EUR to the rate of ordinary diesel fuel i.e. 392.92 EUR.

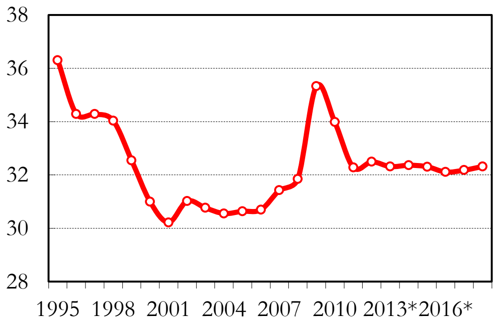
More growth-friendly tax structure – reducing the tax on labour, increasing the tax on consumption and environment exploitation

The tax burden on labour will be reduced by the following tax changes: gradual increase of the basic tax-free allowance to 184 € per month by 2018, decrease of the unemployment insurance payment rate from 3% to 2.4% in 2015 and raising the additional tax-free allowance of pensioners to 220 € per month in 2015.

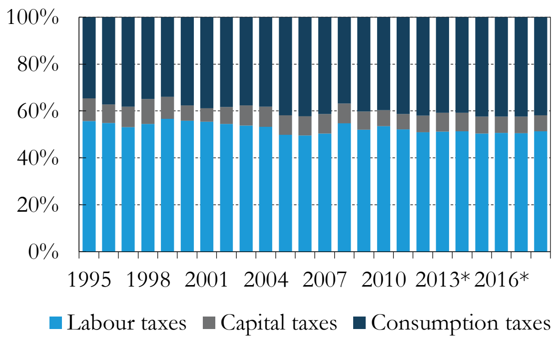
The tax burden on consumption will be raised by increasing the excise duty rates. The rates of alcohol excise duty will increase by 15% in the coming year and subsequently by 10% per annum until 2018. The alcohol excise duty will be increased in compliance with the price and tax policy measure of the Green Paper on alcohol policy which prescribes the development of a long-term framework for alcohol taxation. The rates of tobacco excise duty will be increased by 5% per annum, starting with 1 January 2016. Pursuant to the tax policy measure, the price of tobacco products must increase with at least the same speed as the consumer price index, in order to avoid the access to tobacco products becoming easier.

Figure 15. Development of tax burden in Estonia

A. Tax burden



B. Tax revenue ***(%)***



Sources: Ministry of Finance, Eurostat.

Environmental taxes will be raised by increasing the excise duty on natural gas. The natural gas excise duty will be increased from the current level of 23.45 EUR to 28.14 EUR, starting with 1 January 2015. The Government plans to continue increasing the tax rate on natural gas as a fossil fuel in the future.

By 2018 the share of **taxes on labour**[16] in the total tax revenue will remain at 51.4%, while the share of **taxes on capital**[17] will decrease from 7.8% to 6.8% and the share of **taxes on consumption**[18] will increase from 40.8% to 41.8% (see Figure 15B).

Environmental taxes,[19] being part of taxes on consumption, will make up 7.8% of all taxes in 2014, exceeding the European Union average (6.2% in 2011). The share of environmental taxes will decrease to 7.2% by **2018**, primarily due to decelerating growth of the fuel excise duty.

Table 20. Main changes in the tax policy in 2015[20]

Changes in taxes	Entry into force	Impact 2015	
		m €	*% of GDP*
1. Additional increase of excise duty on alcohol by 10% in 2015	1 Jan 2015	18	0.09
2. Abolishing the excise benefit of fuel with fiscal marking (except agriculture and fishing vessels)	1 Jan 2015	27.0	0.14
3. Taxing the support of Estonian Agricultural Registers and Information Board received from the state budget	1 Jan 2015	1.5	0.01
4. Increasing the rate of excise duty on natural gas to 20%	1 Jan 2015	3.1	0.02
5. Changes in VAT of company-owned passenger cars	1 Jan 2015	44.1	0.21
6. VAT additional electronic form	1 Jan 2015	27.5	0.13
7. Reducing the income tax rate from 21% to 20%	1 Jan 2015	-80.4	-0.39
8. Increasing the basic tax-free allowance from 144 € to 154 € per month	1 Jan 2015	-16.7	-0.08
9. Reducing the unemployment insurance payment rate from 3% to 2.4%	1 Jan 2015	-32.3	-0.16
10. Raising the additional tax-free allowance of pensioners to 220 € per month	1 Jan 2015	-4.3	-0.02

Source: Ministry of Finance.

Implicit tax rate on labour

In addition to the share of tax revenue in GDP, the level of tax burden is also characterised by the implicit[21] tax rate, being the ratio of received tax revenue to the tax base. Implicit tax rate on labour is calculated as the ratio of taxes on labour to labour costs. As the implicit tax rate includes factually received taxes, an international comparison must take into account the fact that the performance of tax administrators and the tax discipline of people varies across countries.

The Government's objective is to reduce the implicit tax rate on labour to 33.2% by 2015.

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[16] Pursuant to the ESA95 methodology, taxes on labour include: social insurance payments, natural person income tax on wage income, natural person income tax on social transfers and pensions, natural person income tax on business activities.

[17] Pursuant to the ESA95 methodology, taxes on capital include: corporate income tax, natural person income tax on capital income, tax on gambling, tax on advertising, tax on land, tax on heavy vehicles, state fees on activity permits and professional licenses, fee on special use of water, tax on closing of roads and streets, other taxes and fees.

[18] Pursuant to the ESA95 methodology, taxes on consumption include: value-added tax, customs duties, excise duties, motor vehicle registration fee, sales tax, pollution fees, fee for fishing right, boat tax.

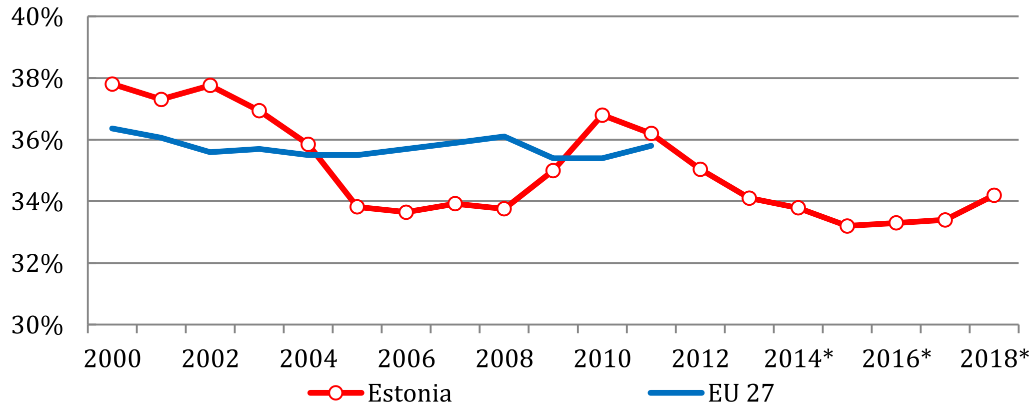
[19] Environmental taxes are those levied on energy (fuel and electricity excise duties), transport (heavy vehicle tax, vehicle registration fee, boat tax) and pollution (pollution charge, fee for the special use of water, package excise duty, fee for the right of fishery).

[20] Impact compared with the situation where the rates of 31 December 2014 still apply.

[21] Sometimes also translated into Estonian as actual or average tax rate. The preferred definition is still implicit tax rate, as its meaning is more precise compared with other variants.

The implicit tax rate on labour (see Figure 16) dropped sharply until 2005 and remained below 34% until 2008, due to reduction in personal income tax rate and increase of basic tax-free allowance. In the period of 2009–2010 the unemployment insurance payment rate was increased and the state's contributions into the mandatory funded pension were suspended, therefore the implicit tax rate increased. In 2011 the implicit tax rate on labour was 36.2%, placing us at the 11th place in the European Union. Resuming the state's contributions into funded pension (2012) and decreasing the unemployment insurance rate (2013) reduced this indicator to 34.1% by 2013. Compensations for funded pension (2014–2017), reduction of the income tax rate and the unemployment insurance payment rate (2015) and increase of the basic tax-free allowance (2015–2018) will reduce this indicator to 33.2% by 2015. The effect of compensation of funded pension will cease and the implicit tax rate on labour will increase to 34.2% by 2018.

Figure 16. Implicit tax rate on labour in Estonia and the European Union (% of tax base)



Source: Taxation Trends (2013), Ministry of Finance.

Tax expenditure

The tax expenditure contained in the state budget of Estonia for 2014–2015 are described below. The value of tax expenditure is calculated by using the revenue foregone method and cash basis accounting data and for each tax expenditure provision, the delay between the implementation of the provision and its actual application is taken into account. Only the so-called first round effects of the establishment of tax expenditure have been estimated. For example, in the event that an increased basic exemption is established, only the direct impact of the implementation of the provision has been assessed. However, the assessment does not include the fact that natural persons have more money in the case of increased basic exemption and more VAT is received if they use this money for consumption. The aggregate impact of the establishment of tax expenditure is regarded in the case of tax expenditure that is directly and clearly related to other taxes, e.g. the tax expenditure arising from the Alcohol, Tobacco, Fuel and Electricity Excise Duty Act influences the receipt of VAT to the extent of the final consumption rate. The different behavioural effects and budget restrictions have not been taken into account in the evaluation of tax expenditure due to the implementation of the method of revenue foregone.

In assessing the value of tax expenditure, it is important to understand that each individual provision of tax expenditure has been evaluated separately without considering the confluence of different provisions, which means that whilst finding the aggregate amount of tax expenditure by adding up different provisions is incorrect, it does make it possible to assess the level and trends of the established tax expenditure.

The tax expenditure that has a significant impact on the receipt of state budget revenue is regulated by three different legal acts –the Income Tax Act, the Value Added Tax Act and the Alcohol, Tobacco, Fuel and Electricity Excise Duty Act. In the case of the Value Added Tax Act[22] (VATA), the provisions through which the consumption of certain goods or services is promoted with the implementation of a lower tax rate can be regarded as tax expenditure or significant deviations from the pursued tax system. In the case of the Income Tax Act [23] (ITA), the provisions through which entrepreneurs operating in certain areas of activity, natural persons or families of certain type and natural persons that incur certain expenses or consume certain services are supported with increased basic exemptions can be regarded as tax expenditure or significant deviations from the pursued tax system be subtracted from a resident natural person's income earned in the Section 23, is a part of the pursued tax system (and not tax expenditure). In the case of the Alcohol, Tobacco, Fuel and Electricity Excise Duty Act[24] (ATFEEDA), the provisions through which entrepreneurs operating in certain areas of activity or the production of certain goods are supported with lower excise duty rates or excise duty exemptions can be regarded as tax expenditure or significant deviations from the pursued tax system.

The receipt of the state budgets for 2014 and 2015 is influenced by 20 different tax expenditure provisions in the VATA, the ITA and the ATFEEDA. The total scope of the main tax expenditure in 2014 comprises 352.8 million EUR or 1.8% of GDP. Additional basic exemption for pensions, more favourable rate of excise duty on diesel fuel for specific purposes and on light heating oil compared to lower the rate of excise duty on diesel fuel, and lower VAT rates for medicines and medical devices remain the largest types of tax expenditure. The volume of the three largest types of tax expenditure constitutes 70% of the total tax expenditure in 2014. In 2015, tax expenditure will decrease by 1.6% to 329.6 million EUR. This is due to abolishing the fiscal marking of fuel (except agriculture and fishing vessels).

In order to analyse the dynamics of tax expenditure by government functions, the government function with which each specific type of tax expenditure is associated is determined for each tax expenditure provision. Table 21 indicates that **six of the ten government functions** (economic affairs; housing and utilities; healthcare; recreation, culture and religion; education; social protection) **are supported via tax expenditure in 2014-2015**. The government functions that form the biggest share in 2014 are social protection (172.9 million EUR or about 49% of tax expenditure), economic affairs (71.5 million EUR or 20.3%) and healthcare health (49.4 million EUR or 14.0%). The tax expenditure that falls into the remaining government functions comprises 59.0 million EUR or 16.7% of total tax expenditure.

Tax expenditure may also be regarded as a share of the receipt of the relevant tax. In the case of value added tax, tax expenditure (items 1–3 in the table) comprises 77 million EUR in 2014, which is 5% of the total VAT received. The relevant tax expenditure (items 4–11 in the table) comprises 207 million EUR or 62% of the personal income tax received into the state budget and the amount of excise duties (lines 12–19 in the table) not received due to tax incentives is 57 million EUR or 8% of excise duties received.

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[22] The Value Added Tax Act, Estonian version https://www.riigiteataja.ee/akt/125102012017.
[23] The Income Tax Act, Estonian version, https://www.riigiteataja.ee/akt/129122012031.
[24] The Alcohol, Tobacco, Fuel and Electricity Excise Duty Act, Estonian version, https://www.riigiteataja.ee/akt/120122012004.

Table 21. Tax expenditure in state budget, 2014–2015[25] (m €)

Tax expenditure	Provision	Government function[26]	2014	2015
1. 9% VAT on books, workbooks and periodicals	VATA, § 15 (2) 1) and 3)	9	9.7	10.3
2. 9% VAT on medicines and medical devices	VATA, § 15 (2) 2)	7	49.4	52.1
3. 9% VAT on accommodation services	VATA, § 15 (2) 4)	8	17.5	18.5
4. Additional tax-free allowance from the second child	ITA, § 23^{1}	10	25.8	26.2
5. Additional tax-free allowance of pensioners	ITA, § 23^{2}	10	140.7	148.6
6. Additional tax-free allowance in case of benefit for accident at work or occupational disease	ITA, § 23^{3}	10	0.2	0.2
7. Deduction of mortgage interest payments	ITA, § 25	6	16.1	16.4
8. Deduction of training expenses	ITA, § 26	9	14.9	15.4
9. Deduction of gifts and donations	ITA, § 27 (1)	8	0.7	0.8
10. Deduction of insurance premiums and acquisition of pension fund units	ITA, § 28	10	6.2	6.6
11. Additional tax-free allowance of self-employed persons upon sale of agricultural produce or timber	ITA, § 32 (4)	4	2.6	2.6
12. 50% excise duty rate for independent small breweries	ATFEEDA, § 46 (1)	4	0.1	0.1
13. Lower excise duty rate on diesel fuel for specific purposes and on light fuel oil	ATFEEDA, § 66 (7)	4	55.5	22.4
14. Exemption of fishermen from fuel excise duty	ATFEEDA, § 27 (1) 22^{2})	4	1.1	0.8
15. Electricity used for chemical reduction and in electrolytic, metallurgic and mineralogical processes	ATFEEDA, § 27 (1) 24), 28^{4})	4	1.3	1.3
16. Electricity and fuel used to produce electricity and electricity used to maintain the ability to produce electricity	ATFEEDA, § 27 (1) 28^{2})	4	6.6	6.7
17. Electricity which forms on average more than 50% of the cost price of a product	ATFEEDA, § 27 (1) 28^{5})	4	0.1	0.1
18. Fuel used for mineralogical processes	ATFEEDA, § 27 (1) 28^{2})	4	4.1	4.2
19. Natural gas used for the purpose of operating the natural gas network	ATFEEDA, § 27 (1) 28^{6})	4	0.02	0.02
TOTAL			**352.8**	**329.6**

Source: Ministry of Finance.

Structure of general government expenditure[27]

While general government expenditure comprised 34.6% of GDP on average in the period 2000-2007, its share increased to 39.7% of GDP in 2008 and the growth continued, reaching 44.7% of GDP in 2009. The share of general government expenditure dropped to 38.3% of GDP in 2013.

The final consumption expenditure of general government comprised about 55% of general government expenditure in 2000-2005, and dropped to the level of 50% in the period of 2006–2009; its proportion in all expenditure has increased to 51.3% by 2013. The final consumption

[25] Tax expenditure assessments have only been calculated for the provisions that are included in tax regulations as of 1 January 2013.

[26] Government functions: 1. general public services; 2. defence; 3. public order and safety; 4. economic affairs; 5. environmental protection; 6. housing and utilities; 7. healthcare; 8. recreation, culture and religion; 9. education; 10. social protection.

[27] Does not include the money of the funds of the EU financial framework for 2014-2020 or the projected funds of the internal EU trading period with permitted AAUs from 2013 to 2020.

expenditure of general government includes public consumption and individual consumption expenditure. Individual and social goods and services are differentiated in the case of the goods and services offered by general government on the basis of the Classification of the Functions of Government (COFOG). Public consumption means services offered concurrently to all members of society or to the members of a part of society. They include, for instance, expenditure on environmental protection and on the organisation of the public sector's healthcare system. For example, expenditure on education and health care is considered individual expenditure. In case of general government, individual consumption expenditure equals social transfers in kind.

Social transfers comprise the second largest part of general government expenditure. The largest types of expenditure among social transfers are pension expenses and the disease treatment and prevention and health promotion expenses incurred by the Estonian Health Insurance Fund. The general government expenditure for the payment of social transfers in 2000-2007 comprised 9% of GDP on average. Its share increased to 13.9% of GDP by 2009, starting to decrease thereafter and reaching the level of 10.9% by 2013.

2.6% of general government expenditure, i.e. 1.0% of GDP, was used for the payment of subsidies in 2013. Subsidies are unilateral payments that manufacturers receive from general government or the institutions of the European Union. The purpose of the payments is to influence the level of production or prices, or to compensate the costs relating to production.

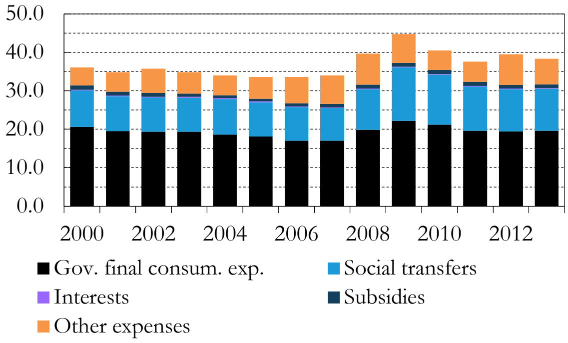
Interest expenditure account for the smallest share – in 2013, they amounted just to 0.4% of all general government expenditure, i.e. they comprised 0.1% of GDP. The low level of interest expenditure is the result of Estonia's light debt burden.

The share of other expenditures decreased in 2013 to 17.4%.

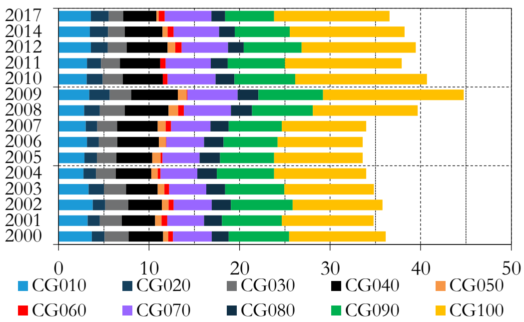
When considering the expenditure by economic activity, the share of expenditure on social protection is always the largest. These expenditures accounted for 9.9% of GDP on average in the period 2000-2007. Their share increased to 15.8% of GDP by 2009 when the unemployment insurance benefit and unemployment benefit expenses increased considerably as a result of the deterioration of the situation in the labour market, in which the pension increase also played a role. By 2012, the share of such expenditure dropped to 12.6% of GDP because the expenditure on unemployment insurance benefits and unemployment benefits decreased. Their share in total expenditure increased from 28.7% on average in 2000–2008 to 32.0% in 2012.

Figure 17. General government expenditure and its structure (% of GDP)

A. Expenditure by economic content in Estonia



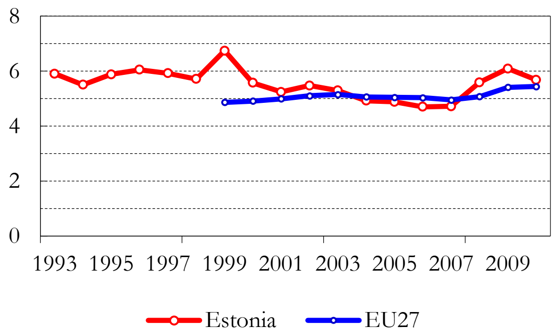
B. Expenditure by government function in Estonia[28]



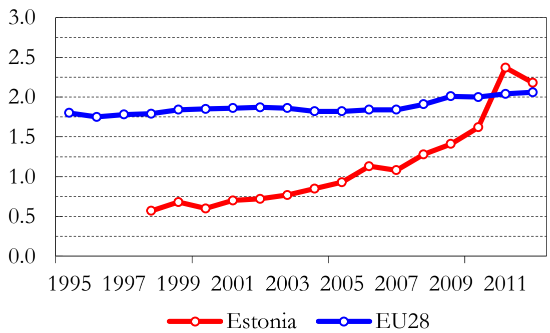
Sources: Statistics Estonia, Ministry of Finance.

Figure 18. Government investments into physical and human capital (% of GDP)

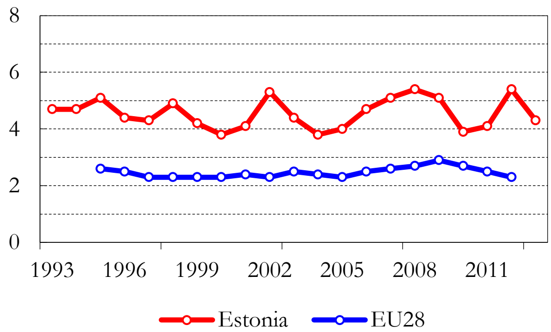
A. Public expenditure on education



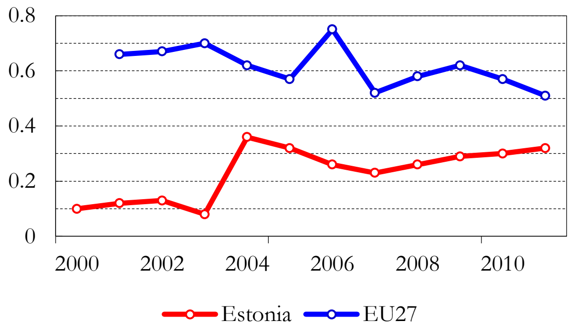
B. Research and development expenditure



C. General government gross fixed capital formation



D. State aid



Source: Eurostat.

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

Table 22. General government expenditure by government functions (COFOG) *(% of GDP)*

	COFOG code	2010	2011	2012	2014*	2017*
1. General public services	1	3.1	3.1	3.6	3.5	3.6
2. Defence	2	1.8	1.5	1.9	2.0	2.0
3. Public order and safety	3	2.2	2.1	2.1	1.8	1.6
4. Economic affairs	4	4.4	4.5	4.5	4.2	3.7
5. Environmental protection	5	-0.2	-0.3	0.9	0.6	0.3
6. Housing and community amenities	6	0.5	0.6	0.7	0.7	0.7
7. Health	7	5.3	5.0	5.1	5.0	5.1
8. Recreation, culture and religion	8	2.1	1.9	1.7	1.7	1.5
9. Education	9	6.7	6.3	6.4	6.1	5.4
10. Social protection	10	14.5	12.9	12.6	12.7	12.7
11. Total general government expenditure	**TE**	**40.5**	**37.5**	**39.5**	**38.2**	**36.6**

Sources: Ministry of Finance, Statistics Estonia.

The general government expenditure of 2014 will decrease by 0.1% to 38.2% of GDP. In the period of 2015–2017, the expenditure will increase on average 5.1% per annum i.e. slower that GDP and therefore, the general government expenditure will decrease to 36.6% of GDP. As a percentage of GDP, expenditure on education and economic affairs will decrease the most. One of the reasons for decreasing expenditures is the change of EU programming periods. The peak of using the funds of 2014-2020 will be after 2017.

Expenditure removed from cost target

Table 23. Amounts to be excluded from the expenditure benchmark

	2013	2013	2014*	2015*	2016*	2017*	2018*
	m EUR	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*
1. Expenditure on EU programmes fully matched by EU funds revenue	869.5	4.72	4.31	4.62	3.43	3.37	3.35
2. Cyclical unemployment insurance expenditure**	0.0	0.00	0.00	0.00	0.00	0.00	0.00
3. Effect of discretionary revenue measures***	-21.1	-0.11	-0.17	0.09	0.23	0.16	-0.01
4. Revenue increases mandated by law	0.0	0.00	0.00	0.00	0.00	0.00	0.00

** Forecast.*

*** Expert assessment assumes that the level of unemployment rate is normal.*

**** The measures that have been taken into account: decrease in income tax rate; increase of general basic exemption and basic exemption of pensions; increase in excise duties and abolishment of lower fuel excise duty; decrease in unemployment insurance rate; changes in the VAT system; increase in environmental fees; income tax on dividends; wage increase in state budget; effect of the work ability reform; revenue from CO_2 quota trading.*

Source: Ministry of Finance.

3.4. General government financing

The following forecast of debt burden and financial assets presumes that the objectives of the general government budgetary position contained in the Chapter "Objectives of the Fiscal Policy of the Government of the Republic" are achieved throughout the entire medium-term period.

3.4.1. General government debt

The main goal of Estonia's fiscal policy since the restoration of independence has been to keep the budgetary position of general government over the medium term in balance or, if possible, in a surplus, which has become expressed in the low debt burden of the state. The general government debt of Estonia at the end of 2013 amounted to 10% of GDP, which is 0.2% more than in 2012. The main reasons for the government debt increasing were an increase in loans issued by the European Financial Stability Fund (EFSF)[29] and the increase of debt of local governments. The central government debt (including the impact of EFSF) comprised 1,209 million EUR and the debt of local governments 636 million EUR of the total general government debt of 1,845 million EUR. Without the impact of EFSF, which amounted to 458 million EUR in 2013, the central government debt was 750 million EUR or 4.1% of GDP.

Table 24. Change in general government debt burden in 2013

	31 December 2012		31 December 2013		Change
	m EUR	*% of GDP*	*m EUR*	*% of GDP*	*% of GDP*
General government	**1,712.1**	**9.8**	**1,844.8**	**10.0**	**0.2**
Domestic debt	647.6	3.7	668.6	3.6	-0.1
External debt	1,064.5	6.1	1,176.2	6.4	0.3
Central government[30]	**1,228.2**	**7.1**	**1,310.5**	**7.1**	**0.1**
Domestic debt	253.3	1.5	236.3	1.3	-0.2
External debt	974.9	5.6	1,074.2	5.8	0.2
Local governments	**566.2**	**3.3**	**636.1**	**3.5**	**0.2**
Domestic debt	448.3	2.6	508.0	2.8	0.2
External debt	**117.9**	**0.7**	**128.1**	**0.7**	**0.0**
Social security funds	0.0	0.0	0.0	0.0	0.0
Domestic debt	0.0	0.0	0.0	0.0	0.0
External debt	0.0	0.0	0.0	0.0	0.0

The general government debt can be expected to decrease to 9.8% of GDP in 2014 as a result of reduction in the central government's share; the debt of local governments as percentage of GDP will remain at the level of 2013. According to the forecast, general government debt will keep decreasing in the coming years and will comprise 7.9% of GDP by the end of the forecast period (see Table 25). As the central government's negative cash flow will be funded from reserves, no new loans will be taken and at the same time, old loans will be repaid. Without the EFSF's impact, the share of central government in the debt burden will decrease both nominally and as a percentage of GDP. The EFSF's nominal contribution will increase at the same time, but as a percentage of GDP it will decrease. The deficit of local governments will be covered from external funds during the entire medium-term period and the nominal amount of their debt will increase, remaining near 3.5% as percentage of GDP.

[29] According to the methodology used to calculate the general government debt, the loans issued by the EFSF are partially reflected in the debt burden of Estonia since the state joined the EFSF.
[30] Consolidated figure on the level of the central government.

Table 25. General government debt developments, 2013–2018 (% of GDP)

	2013	2014*	2015*	2016*	2017*	2018*
1. Gross debt	**10.0**	**9.8**	**9.3**	**8.8**	**8.5**	**7.9**
2. Change in gross debt ratio	0.2	-0.2	-0.5	-0.5	-0.3	-0.6
Contributions to changes in gross debt ratio: (2=3-4+5+6)[31]						
3. Contribution of nominal GDP increase	-0.5	-0.5	-0.6	-0.6	-0.5	-0.5
4. Primary budget balance	0.0	-0.6	-0.4	-0.2	0.2	0.8
5. Interest expenditure	0.1	0.1	0.1	0.2	0.2	0.2
6. stock-flow adjustment, SFA	0.5	-0.5	-0.4	-0.2	0.3	0.5
Implicit interest rate on debt (%)	1.5	1.5	1.6	1.9	2.3	2.6
Other relevant variables						
7. Liquid financial assets	9.9	8.3	7.5	6.8	6.8	7.2
8. Debt amortisation since the end of the previous year	0.1	0.1	0.1	0.1	0.2	0.3
9. Net financial debt (9=1-7)	0.1	1.5	1.8	1.9	1.6	0.7
10. Share of debt nominated in foreign currency (%)	0.0	0.0	0.0	0.0	0.0	0.0
11. Average maturity[32] (in years)	6.8	6.0	5.2	4.5	3.8	3.2

Source: Ministry of Finance, Statistics Estonia.

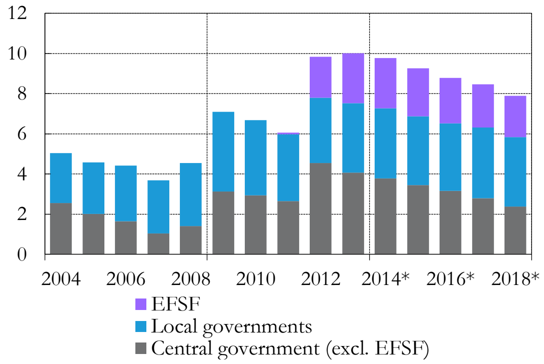
As the budgetary deficit increases, the general government debt could also be expected to increase in the extent of the deficit. In reality, the relationship between the debt burden and the deficit is more complex and there are other factors having a role in it. For example, debt burden can also increase if loan is taken for the purpose of providing funds for financing transactions instead of covering the deficit, but financing transactions are not reflected in the state's revenue or expenditure. The amount of such other factors is measured by stock-flow adjustment, SFA for short). In 2013, Estonia's SFA was 98.5 million EUR or 0.5% of GDP (see Figure 19B) which means that the debt burden increased more (132.7 million EUR) than by the amount of budgetary deficit (34.2 million EUR). The reason for the debt burden's increase exceeding the deficit was primarily an increase in the EFSF's impact. According to the forecast, the SFA will be negative in 2014–2016, meaning that the debt burden will increase less than by the amount of budgetary deficit, resulting from the fact that reserves will be used for covering the deficit. The SFA will be positive in 2017 and 2018. In 2017 it will be caused by the debt increasing more than by the amount of general government (due to increase of loan repayments which are not reflected in budget's expenditure) and in 2018 because the debt burden will decrease less than by the surplus (according to the forecast, the surplus will be used not for reducing debt, but for increasing reserves).

[31] In some years the equation does not work, due to rounding.

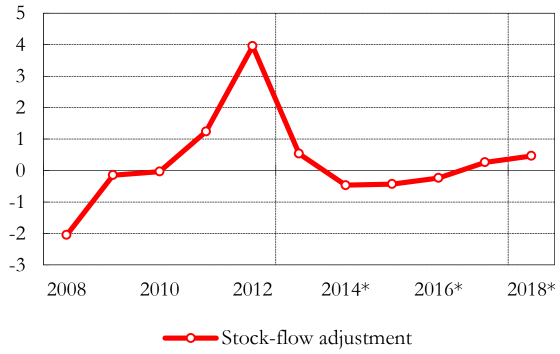
[32] Central government without foundations and legal persons governed by public law.

Figure 19. Development of debt burden, **2004–2018**

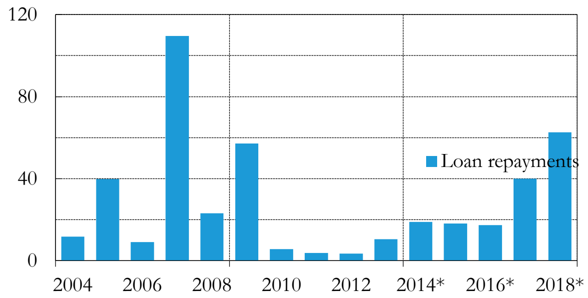
A. General government debt (% of GDP)



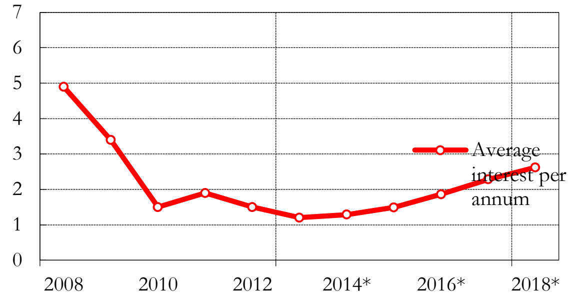
B. Stock-flow adjustment (% of GDP)



C. Repayment of central government[33] debt (m EUR)



D. Average interest rate of central government[34] debt (%)



Source: Ministry of Finance, Statistics Estonia, Eurostat.

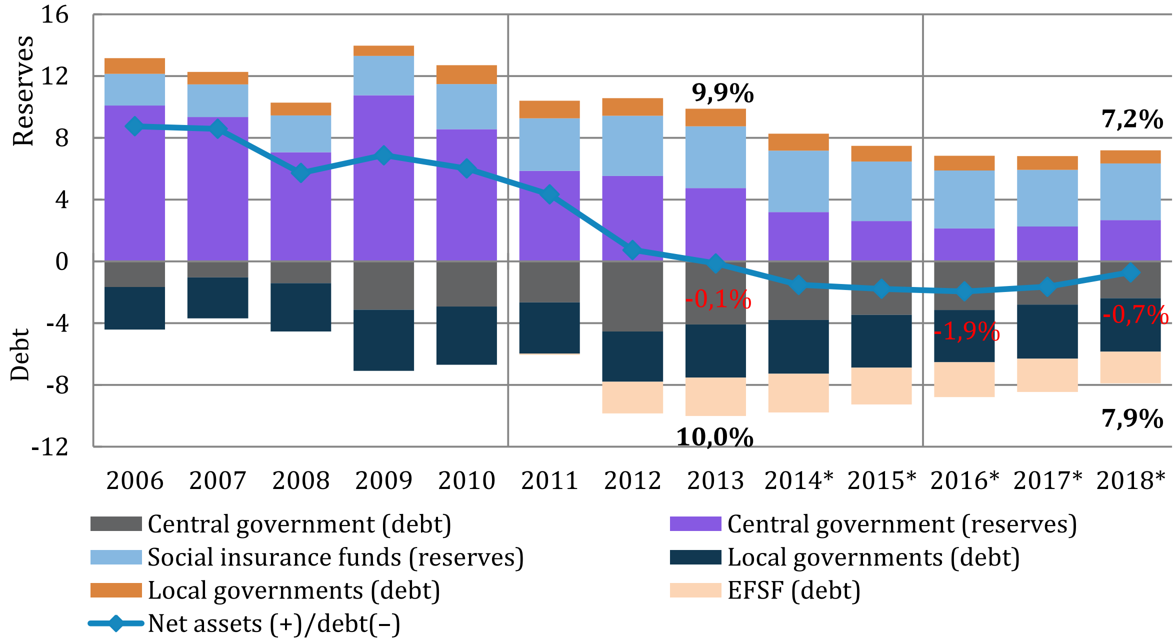
3.4.2. General government reserves and net position

The volume of general government's liquid financial assets[35] as of the end of 2013 was 1,821 million EUR or 9.9% of GDP. Compared to last year, the reserves of social security funds increased and the reserves of local governments and central government decreased. In the coming years, the need to fund the state budget's deficit and financing transactions will cause a gradual reduction of the reserves and by the end of 2017 the general government reserves will comprise 6.8% of GDP. In 2018 the reserves will increase to 7.2% of GDP.

The general government debt burden in 2013 exceeded somewhat the volume of reserves and the net debt amount was 0.1% of GDP (see Figure 20). According to the forecast, both the debt burden and the reserves will decrease in the coming years, but reserves will decrease more and by the end of 2016 the net debt will increase to 1.9% of GDP. Thereafter the net debt will start decreasing. The net debt is forecasted to amount to 0.7% of GDP at the end of 2018. Without the EFSF's impact, the reserves exceed the debt burden throughout the entire forecast period and net assets at the end of the forecast period will be 1.3% of GDP.

[33] Central government without foundations and legal persons governed by public law.
[34] Central government without foundations and legal persons governed by public law.
[35] Liquid financial assets are considered to be cash and deposits (ESA95 code AF.2), securities (except shares and financial derivatives) (AF.33), financial derivatives (AF.34), shares noted on stock exchange (AF.511) and investment fund shares (AF.52).

Figure 20. Liquid assets, debt burden and net position of general government, 2006–2018 (% of GDP)



Source: Ministry of Finance, Statistics Estonia.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS PROGRAMME

4.1. Possible negative developments

The future developments of the Estonian economy may be both positive and negative as compared with the main scenario. Since many various developments are possible, current risk scenario constitutes only technical calculations based on certain agreed assumptions and their purpose is to assess the impact of possible deviations on state budget. The negative risk depicted here includes possible negative impact of the events in Ukraine.

The forecast's risk scenario is based on Russia's economy turning around to a 1% decline this year and on its estimated effect on economies in Estonia and in Latvia, Lithuania and Finland as well. Still, forecasting further development of the crisis entails much uncertainty at this point and an assessment to possible economic effects of the past weeks' events should wait for stabilisation of the political situation.

Capital outflow from Russia, the country's trustworthiness declining in the eyes of foreign investors, and quick depreciation of the rouble would significantly deteriorate Russia's economic development. It would have a direct and an indirect negative impact on countries conducting trade with Russia because the rouble becoming cheaper and Russia's economy becoming stagnant would reduce the export revenue of enterprises exporting goods and services to Russia. This would cause a deceleration of the economic growth of Latvia, Lithuania and Finland by about 1 percentage point. Both transport and tourism services would be affected because imported goods would become relatively expensive in Russia and their demand would therefore decrease, reducing also the goods transit through Estonia.

In summary, the export growth would stop and the growth of wages and employment would decelerate due to lower demand; the savings rate would increase and the growth of investments would decelerate. As the situation would stabilise, the potential growth would be restored in the second half of 2015. In that case, Estonia's GDP growth would be 1% in 2014 and 2% in 2015. According to the risk scenario, the nominal GDP volume would be lower than that of the main scenario by 300 million EUR in 2014 and by 700 million EUR in 2015.

Table 26. Negative risk scenario (%)

	Negative risk scenario				Difference from baseline		
	2013	**2014***	**2015***	**2016***	**2014***	**2015***	**2016***
Nominal GDP (bn EUR)	18.4	19.0	20.0	21.3	-0.30	-0.70	-0.80
Real GDP growth	0.8	1.0	2.0	3.4	-1.0	-1.5	-0.2
Nominal GDP growth	5.9	3.3	4.9	6.5	-1.6	-2.0	-0.3
CPI	2.8	1.3	2.5	2.8	-0.1	-0.2	0.0
Real growth of domestic demand	1.5	2.1	2.6	3.7	-0.7	-1.1	-0.1
Real growth of export	1.8	0.5	4.0	6.0	-1.9	-2.0	-0.5
Employment growth	1.0	0.1	0.1	0.2	-0.1	-0.2	0.3
Nominal wage growth	8.6	7.9	7.2	6.4	0.1	0.3	0.0
Unemployment rate	2.8	1.3	2.5	2.8	-0.1	-0.2	0.0
External assumptions							
GDP increase of trade partners	0.9	1.0	1.6	2.2	-0.7	-0.5	-0.1
General government							
Tax burden (% of GDP)	32.3	32.6	32.4	32.2	0.3	0.0	-0.1
Budgetary position of general government (% of GDP)	-0.2	-0.9	-1.3	-1.1	-0.2	-0.5	-0.4
Debt burden of general government (% of GDP)	10.0	9.9	10.2	10.8	0.2	0.9	1.4

Source: Ministry of Finance, Statistics Estonia.

Next, we will describe the impact of the above risk scenario on the budgetary position of the general government according to the Ministry of Finance's spring forecast which accounts for the risk scenario of economic growth described above. The position's deterioration would come primarily from a reduction in tax revenue, affecting negatively all levels of general government. Mostly the risk scenario reduces the forecast of social tax receipt, in relation to both lower growth of employment and a reduced forecast of the average wage. At the same time, the deficit's deepening would be diminished by a decrease of the state budget expenses related to tax revenue (Estonian Health Insurance Fund's allotment, pension expenditure). Also, defence expenditure would decrease due to the lower nominal GDP.

Realisation of the negative risk scenario would increase the debt burden starting with 2014. In that year the negative cash flow can still be covered from liquid financial assets, but subsequently the loan market would need to be accessed to retain the state treasury's liquidity buffer.

Table 27. Budgetary position of general government according to risk scenario, 2014–2016

	Negative risk scenario			Difference from base forecast		
	2014	2015	2016	2014	2015	2016
General government balance (*m EUR*)	**-168**	**-259**	**-227**	**-33**	**-102**	**-78**
State budge	-104	-208	-187	-22	-59	-44
Other central government	-52	-39	-48	0	0	0
Social security funds	29	40	63	-6	-28	-20
Local governments	-41	-52	-54	-4	-15	-14
General government balance (*% of GDP*)	**-0.9**	**-1.3**	**-1.1**	**-0.2**	**-0.5**	**-0.4**
State budget	-0.5	-1.0	-0.9	-0.1	-0.3	-0.2
Other central government	-0.3	-0.2	-0.2	0.0	0.0	0.0
Social security funds	0.2	0.2	0.3	0.0	-0.1	-0.1
Local governments	-0.3	-0.3	-0.3	-0.1	-0.1	-0.1

Source: Ministry of Finance.

4.2. Comparison with the forecast of Stability Programme 2013

According to the spring 2013 forecast of the Ministry of Finance, the expected **economic growth** in 2013–2014 was 3.0% and 3.6%, respectively. We expected economic growth of 3.5% by 2015. The economic growth of Estonia in 2013 proved to be lower than forecasted in the previous Stability Programme, mainly because the export sector and domestic demand grew slower than expected. According to this forecast, the forecast of economic growth in 2014 is adjusted down to 2%, therefore the nominal growth of GDP will also be smaller than expected earlier. The forecast was adjusted because expectations of the development of export partners are more pessimistic than before, which also worsened the growth prospects of Estonian companies and led to the reduction of both exports and imports, and domestic demand forecasts. The economic growth forecast of 2015 and 2016 has not changed significantly when compared to the previous forecast, but the nominal growth is accelerated a little. This is caused by changes in the structure of real growth of GDP and by upwards adjustment of the expectations concerning price increase. The economic growth forecast for 2017 is more negative compared to the previous forecast, mainly resulting from the expected decline of employment.

Inflation was slower in 2013 than forecasted in the previous Stability Programme, mainly due to external factors – food prices were affected by a decrease in the prices of agricultural products in the second half of the year and the price of fuel decreased more than expected. The inflation forecast for 2014 has been adjusted downwards, primarily due to a decrease of energy prices and a more modest core inflation. Electricity has become significantly less expensive in the beginning of the year and this was not possible to foresee a year ago. The base inflation is kept low by some services becoming less expensive. The inflation forecast for 2015 has not changed.

The last year's **budgetary position of general government** proved to be somewhat better than expected due to the bigger amount of taxes received and lower social expenditure (incl. parental benefit) and investments. But expectations of the structural budgetary position of the next few years have become worse, primarily due to the deteriorated state of the economy. The nominal budgetary position has also deteriorated for all years when compared to the previous programme. Therefore, general government will achieve nominal surplus a year later than expected, which means that the objective of restoring the reserve will be achieved more slowly than predicted in the previous programme.

The **general government debt** in 2013 turned out to be lower by 0.2% of GDP than forecasted in Stability Programme 2013. The debt burden forecast for 2014 has been adjusted downwards as compared to the last year's forecast, due to the smaller impact of ESFS; the forecast for 2017 has been adjusted upwards due to worse outlooks for the general government budgetary position.

Table 28. Comparison with the forecast of the Stability Programme 2013

	2013	2014*	2015*	2016*	2017*	2018*
Real GDP growth (%)						
Previous version	3.0	3.6	3.5	3.5	3.5	-
Present update	0.8	2.0	3.5	3.6	3.4	3.2
Difference	-2.2	-1.6	0.0	0.1	-0.1	-
Nominal GDP growth (%)						
Previous version	6.6	6.8	6.6	6.5	6.4	-
Present update	5.9	4.9	6.9	6.8	6.4	6.1
Difference	-0.7	-1.9	0.2	0.2	-0.1	-
Harmonised Consumer Price Index (HICP) (%)						
Previous version	3.6	2.9	2.9	2.9	2.8	-
Present update	3.2	1.7	2.9	3.0	3.0	3.0
Difference	-0.4	-1.2	0.0	0.1	0.2	-
Structural budgetary position of general government (% of GDP)						
Previous version	0.3	0.7	0.7	1.0	1.0	
Present update	0.4	0.1	0.2	0.0	0.2	0.2
Difference	0.1	-0.6	-0.5	-1.0	-0.8	-
General government debt (% of GDP)						
Previous version	10.2	9.9	9.3	8.8	8.3	
Present update	10.0	9.8	9.3	8.8	8.5	7.9
Difference	-0.2	-0.1	0.0	0.0	0.2	-

Source: Ministry of Finance.

5. LONG-TERM SUSTAINABILITY OF FISCAL POLICY

The assumptions of the long-term budget projections given in this chapter were agreed on by the Economic Policy Committee of the European Union in 2011 and prepared on the same basis for the entire EU. In the long term, these trends coincide with the vision of the Ministry of Finance for future developments. The developments of initial years (and, as a result, some indicators, e.g. those of the labour market) have been adjusted according to the macroeconomic development scenario in this programme, in order to take into account the most recent developments. It is worth emphasising that the assumptions of the projections presented in this chapter are that the decisions made today remain valid for the entire forecast period and that the current policies will continue, which is why they do not reflect the most probable future scenario, but aspire to show the significance of the challenge associated with demographic trends, which can then be addressed with relevant policies.

The demographic trends have started to affect public finances – the proportion of people aged 65+ in the total population will increase from 25% in 2010 to 30% in 2020 and the costs of social security will increase accordingly. The economic crisis added to the challenges related to demographic changes. The crisis has a long-term impact, which is visible in a lower employment rate and lower output level. However, the effect of the crisis on long-term growth potential is expected to be minimal.

Several steps have been taken to guarantee the long-term budgetary sustainability, including:

- keeping the fiscal policy conservative and avoiding a significant increase in general government debt;
- reforming the pension system and encouraging contributions to pre-financed pension schemes;
- increasing the retirement age and making pension indices more flexible;
- ensuring a better fiscal situation via policies aimed at economic growth and employment.

The decision to suspend contributions into the second pension pillar from 1 July 2009 to 31 December 2010 was one of the measures taken during the crisis. The payments into the second pension pillar were restored to one-half of the original amount in 2011 and fully restored in 2012. The part of the social tax paid by the state is increased to 6% in 2014-2017 for those who voluntarily continued contributing to their second pension pillar and also for those who submitted the relevant application in 2013. In the latter case, the contribution made by the individuals themselves also increased to 3%.

Pursuant to the State Pension Act, the retirement age will be increased by 3 months a year from 2017 and will reach 65 by 2026 (the current retirement age is 63 years for men and 62 years for women; the latter will become equal with the retirement age of men by 2016). The forecasted life-expectancy of 63-year-old people by 2060 is also worth noting. The life-expectancy will increase by almost 6 years for 63-year-old women and 7 years for men as compared to 2010 (according to the Eurostat's forecast of 2011). The goal of the increase of retirement age is to ensure the adequacy (the decision makes it possible to pay about 5-10% higher pensions from 2026) and sustainability of the pension system. The amendment was driven by the desire to support the supply of workforce that is decreasing as a result of demographic developments.

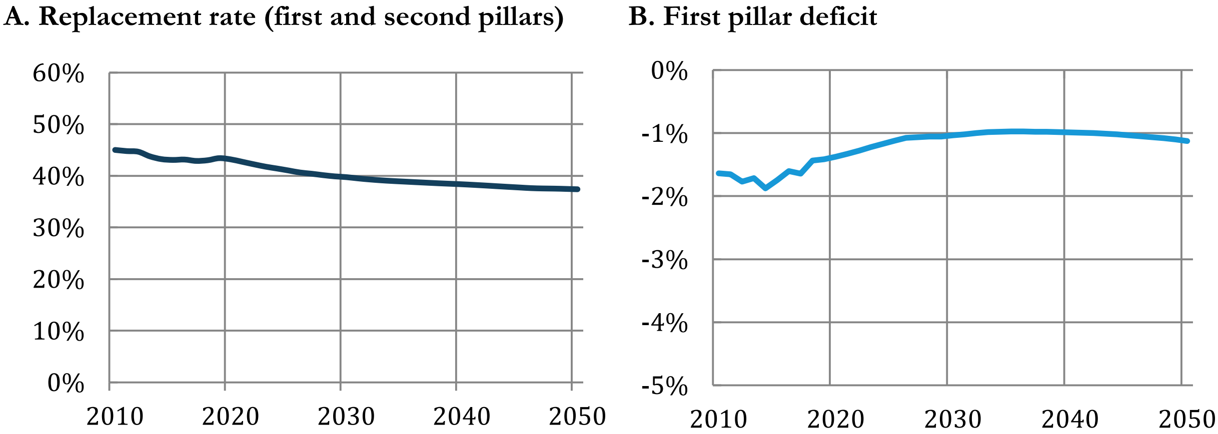
An analysis of the sustainability of the current policy indicates that thanks to the increasing retirement age and the contributions to the second pension pillar, the pressure on the public finances of Estonia caused by demographic changes is one of the lightest among the EU member states. The analyses made based on today's assumptions indicate, however, that the ratio of pensions (as a summary of the first and the second pillar) to average wages will deteriorate over time and additional decisions may be required in the future regarding the pension system.

Table 29. Long-term sustainability of public finance, 2010–2060 (% of GDP)

	2010	2020*	2030*	2040*	2050*	2060*
Total expenditure	**40.7**	**35.8**	**35.4**	**35.2**	**35.7**	**36.1**
Of which: ageing-related expenditures	20.0	19.1	18.7	18.5	19.0	19.4
Pensions	8.9	7.5	7.0	7.0	7.1	7.0
Social security pensions	8.9	7.5	7.0	7.0	7.1	7.0
Old-age pensions	7.5	6.1	5.6	5.7	5.9	6.0
other (survivor pension, disability pensions)	1.4	1.4	1.4	1.3	1.2	1.0
occupational pensions (if in general government budget)	-	-	-	-	-	-
Healthcare	5.2	5.4	5.6	5.9	6.0	6.2
Long-term care *(previously part of healthcare expenditure)*	0.5	0.6	0.6	0.7	0.7	0.8
Interest payments	0.2	0.2	0.2	0.2	0.2	0.2
Education expenses	4.8	5.1	5.1	4.5	4.8	5.1
Other expenditures related to ageing	0.6	0.5	0.4	0.4	0.4	0.3
Total revenue	**40.8**	**36.3**	**35.4**	**35.2**	**35.7**	**36.1**
of which: property income (incl. interest income)	0.0	0.0	0.0	0.0	0.0	0.0
of which: social security contributions (first pillar revenue)	7.0	6.2	6.0	5.9	6.0	6.0
Pension insurance assets (first pillar)	0.0	0.0	0.0	0.0	0.0	0.0
of which: consolidated public pension fund assets (assets other than government bonds)	0.0	0.0	0.0	0.0	0.0	0.0
Impact of pension reform						
Social contributions diverted to the second pillar (4% paid by the state)	0.0	1.13	1.20	1.24	1.28	1.28
Payment of second pillar pensions	0.0	0.2	0.8	1.3	3.3	2.1
Assumptions:						
Labour productivity growth	7.8	2.1	2.1	2.1	1.8	1.5
Real GDP growth	3.3	1.9	2.0	1.6	0.9	1.2
Employment rate, men (aged 20-64)	83.8	85.5	85.3	84.8	84.3	85.3
Employment rate, women (aged 20-64)	76.8	79.0	79.8	78.9	78.7	80.0
Total participation rates (aged 20-64)	80.2	82.4	82.5	81.8	81.5	82.7
Unemployment rate	16.9	7.0	6.8	6.6	6.5	6.5
Persons aged 65+ in total population	17.0	19.3	22.4	24.9	27.8	30.4

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

Figure 21. Financial indicators of state pension insurance (% of GDP)



Source: Ministry of Finance.

Measures to ensure long-term sustainability of pension insurance

The Government has also approved the concept of work ability insurance. As part of the plans for 2104, a Draft Work Ability Benefit Act and a Draft Act Amending the Social Welfare Act related to work ability will be submitted to a Government of the Republic sitting. The rapid increase in the number of persons receiving pension for incapacity for work needs addressing and the purpose of the concept is to establish a system that encourages employees to take care of their health and employers to create a healthy working environment. The implementation of the scheme is also a prerequisite for the plan to reform the payment of occupational pensions, old-age pensions under favourable conditions and superannuated pensions, which the Government has already approved in principle. The Government's coalition agreement also prescribes the initiation of discussions to develop the principles of a retirement system with a flexible age limit and to launch the system by 2019.

General government contingent liabilities

General government contingent liabilities are considered to be liabilities, the actual realisation of which depends on future circumstance. Potential liabilities are not added to the general government debt, but it is important to monitor their volume when assessing the long-term sustainability of public finances. In 2013, Statistics Estonia considered contingent liabilities to include state guarantees related to student loans and Kredex. The volume of guarantees related to student loans can be expected to decrease this year; guarantees related to Kredex will remain at the previous year's level as percentage of GDP.

Table 30. General government contingent liabilities, 2013–2014 (% of GDP)

	2013	2014
Total state guarantees	**1.8**	**1.7**
of this, student loans	0.9	0.8
of this, Kredex and Kredex credit insurance	0.9	0.9
of this, guarantees related to the financial sector	0.0	0.0

Source: Ministry of Finance.

6. QUALITY OF PUBLIC FINANCE

New State Budget Act

The new State Budget Act entered into force on 23 March 2014, transposing the Council Directive 2011/85/EU of 8 November 2011 on the requirements for budgetary frameworks of the member states and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union i.e. the so-called Fiscal Compact into the national law. Among the minimum requirements for budgetary frameworks prescribed by the Directive and the Compact, the most important for Estonia are the general government's balanced budget rule and the correction mechanism.

In addition to adopting the balanced structural budget rule, the Act clarifies the financial rules for the central government, local governments and social security funds, whereas the central government includes not only constitutional institutions and governmental agencies but also other legal persons of the central government: persons under public law, foundations established by the state and companies with state participation (pursuant to Regulation (EU) No 549/2013 of the European Parliament and of the Council).

The principle of independence of the Ministry of Finance's macroeconomic and financial forecast was also established. Additionally, a Fiscal Council will be assembled at Eesti Pank, with the task to express opinions on forecasts, budgetary position objectives and their fulfilment and possible adjustment needs. Pursuant to the correction mechanism, measures must be implemented where budgetary position differs significantly from the medium term budget objective or the adjustment plan i.e. by at least 0.5% of GDP per annum, until attainment of the medium term budget objective in compliance with the requirements prescribed in the Stability and Growth Pact.

A correction mechanism was added to the State Budget Act: if the actual data indicate that the general government budget is in a notable structural deficit, the general government budget for subsequent years after implementation of the correction mechanism must be planned with a structural surplus of at least 0.5% until achieving an equivalent surplus.

To achieve a stronger effect from the use of budget funds, the rules for preparing the state budget were updated. Four-year expenditure ceilings are now obligatory part of the State Budget Strategy. The strategic planning system was simplified and a legal framework for step-by-step transition to activity-based budgeting was established. The State Budget Strategy will continue to be based on the opportunities resulting from the public finance forecast. On the other hand, the State Budget Strategy's relationship to sectoral development plans and their implementation plans will become clearer. The new State Budget Act starts a gradual move towards a programme-based budget paying more attention to results.

The joint regulation of loans and guarantees was unified, to improve the clarity and flexibility of managing the state's cash flows. The cash flow management was connected more clearly to the need to ensure payouts at all times. The principles of management of general government liabilities were renewed. The Act provides for an extraordinary temporary loan limit for local governments in a situation where the general government's budgetary position exceeds the limits agreed in the EU. In that case all local governments must co-ordinate their loans with the Ministry of Finance.

Strategic management of the state

The Ministry of Finance and the Government Office continue close co-operation to ensure alignment of the state's strategic plans and funding. Starting with 2011, four main strategic documents of the Government of the Republic are updated simultaneously and in a co-ordinated manner: the action programme of the Government of the Republic of Estonia, the State Budget Strategy, the competitiveness programme "Estonia 2020" and the Stability Programme.

Estonia continues to plan the state budget's resources on the basis of a central principle that the state's funding sources and funding needs must be viewed as a whole. The funds of the EU programme period of 2014–2020 are also planned by analysing the state's needs as a whole. It means that in planning, the state's own funds, the EU funds and e.g. the funds of Norway, Switzerland and the European Economic Area are planned and monitored as comprehensively as possible.

Irrespective of the source of financing, all actions must be planned sustainably and effectively in cooperation with other sectors in order to mutually support the achievement of objectives. EU support is considered to be a once-off booster (e.g. to initiate and implement structural reforms and projects) and the use of it must result in a developmental leap forward, ensuring sustainable positive impact on the economy and society, while avoiding an additional burden on the state budget.

In the State Budget Strategy, the target levels of 2018 were added to all indicators; although these targets are ambitious, the resources are in line with the macroeconomic and public finance indicators in the economic forecast of spring 2014 and with the objectives and fiscal policy measures of the current State Budget Strategy.

In order to address the areas of government more comprehensively, the planned actions and financial plans of other members of general government were included into the preparations of the State Budget Strategy and the state budget more than in the previous year. Therefore, the financial plans i.e. state budget requests that were in line with the objectives and actions of organisation-based development plans were submitted together with the data from the non-budgetary general government institutions in the area of government of the respective ministry.

E-governance

The development of Estonia's e-governance, especially the development of public sector e-services and their usage by citizens and entrepreneurs has been notable. Estonia is a unique country in the world concerning the use of electronic ID, including e-voting practice and its popularity. Electronic authentication and digital signing make it possible to achieve nearly paperless document management, rendering many everyday activities more flexible and faster. Both citizens and entrepreneurs find that public e-services help them to save money and time, and they are generally satisfied with public services. In 2012, 76% of entrepreneurs and 67% of citizens said that they are satisfied with e-services.

The development of e-governance in Estonia is centrally co-ordinated by a dedicated agency –the Information Society Services Department of the Ministry of Economic Affairs and Communications. The development and administration of the state information system is also coordinated centrally - by the Estonian Information System's Authority. The objective is to improve the competitiveness of Estonian economy, the welfare of the people and the efficiency of governance.

The ID-card software has been updated so that documents can also be signed in BDOC format in addition to the traditional DDOC format. The software can also be used with Finnish ID-cards to sign .bdoc files. On 11.12.2013, Estonian Prime Minister Andrus Ansip and Finnish Prime Minister Jyrki Kataineni signed the world's first known digitally signed inter-governmental treaty, focussing on joint development of e-services.

The winner of the competition "Best Estonian e-service 2013" in the category of e-governance was declared the e-queue system for border crossing (www.eestipiir.ee).

Public service

Decrease of liquid funds due to increase of fixed expenditure and a deficit of labour force with necessary qualification in the labour market create a situation where ever more attention needs to be paid to more efficient use of resources. For more efficient management of human resource, the Ministry of Finance assesses in the White Paper on the state as an employer, how the changing and development of central co-ordination means helps achieve it. Additionally, more attention is paid to developing mid-level managers, improving their knowledge about human resource management. A competence model for mid-level managers of state institutions was developed in 2013; it will be implemented as a pilot project and developed further in 2014. More of central possibilities for more efficient management of the state's human resource are searched for, analysing e.g. the effect of central training on more efficient resource use, improving awareness in the area of personnel planning and conducting training and development activities in order to develop competencies which are important for resource management (e.g. strategic planning, impact assessment, etc.). Also, strengthening of joint values through the activity of the Ethics Committee and through implementation of anti-corruption strategy is important in public services. The Ethics Committee is developing a new ethics code and guide materials which would facilitate an increase of ethics of officials. An important change in anti-corruption activities since 2014 is the possibility to submit declarations of economic interests in electronic manner.

Starting with 2014, the Ministry of Finance will strengthen its activities in the area of co-ordinating the administrative organisation. The main development activities are directed towards strengthening the administrative organisation's analytic capacity and improving its management quality. A methodology will be developed for helping assess the procedures of the public sector administrative organisation and thereby towards improving the area's development activities. Additionally, various parties to the process are mapped, involving the main problems of the organisation's management quality which need to be focussed on in the next 3 years.

Structural sectoral reforms

In spring 2013, Estonia adopted nine reform plans[36], whereas several of the plans have a direct influence on public finance in addition to improving competitiveness. Among them, e.g. updating the development directions of the hospital network has been implemented by April 2014. Preparations for extending the funding of upper secondary school network's reform in general education with the support of structural funds, for developing support programmes for research, development and growth enterprises based on smart specialisation, and for support schemes of launching the work ability scheme's reform are planned to be completed in summer 2014.

The Government is planning to carry out several reforms throughout the next year, based on the country-specific recommendations and priorities agreed in the European Council, which have an important effect on the efficiency and effectiveness of public finance[37]:

- Based on the objective to reduce the tax burden on labour by redirecting it to taxation of consumption and environmental load, plans have been adopted for increases of excise duties on alcohol and tobacco, reduction in the unemployment insurance rate from 3.0% to 2.4%, and annual increase of the basic exemption by 10 EUR per month from 144 EUR to 184 EUR by 2018.
- In order to achieve more budget flexibility, plans have been adopted for disengaging the road maintenance expenditure from fuel excise receipts and for replacing the more

[36] Adopted with Government Decision dated 25 April 2013 in the national reform plan "Estonia 2020".
[37] Will be adopted by the Government at the end of April 2014 with an update to "Estonia 2020".

favourable excise duty on fiscal-marked fuel with a targeted compensation (except in agriculture and small fishing vessels).

- In order to ensure a fairer environment of competition and taxation and to improve tax receipts, an addition to the value added tax declaration will be established, detailing transaction-based information about both purchase and sales transactions, the value added tax deductions on company-owned passenger cars used for private purposes will be reduced, and the taxation of compensation for use of personal cars as a fringe benefit will be specified.

7. INSTITUTIONAL FUNCTIONS

Fiscal institutions

The fiscal institution[38] that may be pointed out in the Estonian context is the National Audit Office, which is independent in its activities and evaluates the legality and effectiveness of the use of public funds through economic inspections (audits). Various aspects of the audited agencies are assessed in the course of an audit e.g. the internal control system, financial management, economic activity, management, effectiveness of the organisation and activity, and reliability of the information technology systems.

Fiscal rules

Fiscal rules play an important role in the achievement of fiscal policy objectives. The objective set for the medium term in strategic development plans and the latest coalition agreements is a balanced budget (the "soft" rule that has so far been followed by all governments) although there were no provisions before March 2014 that require the general government or central government budget to be in balance (in a surplus).

The basis of the conservative fiscal policy of Estonia arises from the Constitution of the Republic of Estonia. The Constitution stipulates that if a proposed amendment to the state budget or to its draft has the effect of decreasing estimated revenue, or increasing expenditure or reallocating expenditure, the proponent of the amendment shall append financial calculations to the proposed amendment that demonstrate the sources of revenue necessary to cover the expenditure. Also, the Riigikogu may not eliminate or reduce expenditure that is prescribed by other laws in the state budget or in a draft budget.

The Constitution also regulates how expenses may be incurred in the event that the Riigikogu has not adopted the state budget by the start of the budgetary year – in such a situation, the expenses incurred in a month may not exceed one-twelfth of the previous year's expenditure. The Constitution stipulates that the President of the Republic must declare extraordinary elections of the Riigikogu if the Riigikogu has not adopted the state budget within two months after the start of the budgetary year.

The new State Budget Act entered into force in March 2014, with the aim to establish legal bases and basic requirements for guaranteeing Estonia's economic and budgetary sustainability in the long term. The Act establishes requirements and obligations for the area of budgeting and also definitions and principles of budgeting. In order to fulfil the requirements prescribed for preparing the state budget, conditions are established for planning funds and undertaking obligations by persons included in the general government. As one of its most important parts, the Act establishes unified budgeting rules for the general government. Council Directive 2011/85/EU on the requirements for budgetary frameworks of the member states sets an obligation to establish the implementation of unified rules for the general government, in order to ensure the general government's budgetary discipline and thereby balance. Article 5 of the Directive declares that member states shall establish budget rules expressed in numbers, which efficiently facilitate in the entire general government the fulfilment of relevant fiscal policy obligations resulting from the EU

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[38] According to the definition provided by the European Commission, fiscal institutions are institutions that (1) (regularly) analyse, assess or make recommendations regarding the fiscal policy of the state, (2) draw up independent forecasts of budget revenue or forecasts that are used upon comparison with the Government's forecasts. These institutions must also be financed from the public funds.

treaty. This is expressed primarily in respecting of the reference values set for deficit and debt in the EU treaty and in fulfilment of the medium term budgetary objectives.

The Act establishes budgetary position rules, pursuant to which the state budget must be prepared so that the government sector's structural budgetary position would be at least in balance. A budgetary balance rule is established for central government legal persons, i.e. that their operating expenditure must not normally exceed their operating revenue. The operating result does not reflect the unit's investment activity and this may result in its budgetary position being significantly different from its operating result. Investments are normally funded by own means gathered from previous periods (which means that the unit's operating activity has produced a surplus) or by loans. The balance rule is applied to persons belonging to the central government by way of adding the obligation to respect that rule to Acts regulating their activities or ensuring the respecting of that rule on the basis of the law (in the person's Articles of Association). Central government legal persons excessive investments are limited by the net debt rule, pursuant to which the upper limit of signing loan agreements is 40% of the net debt in relation to the operating revenue. This limit is not absolute and can be exceeded with permission from the Government of the Republic. In granting its permission, the Government of the Republic is guided by the need to respect the requirement for balance of the general government's budgetary position.

APPENDICES

Appendix 1. Main indicators of Estonian economy in 2003–2012

Table 31. Gross Domestic Product in 2003–2012

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	%	%	%	%	%	%	%	%	%	%
1. Real GDP	7.8	6.3	8.9	10.1	7.5	-4.2	-14.1	2.6	9.6	3.9
2. Nominal GDP	12.1	11.1	15.5	19.8	20.0	1.0	-14.0	2.9	12.8	7.4
Sources of growth										
3. Private consumption expenditure (incl. NPOs)	9.2	8.1	9.5	13.5	8.8	-5.2	-14.8	-2.6	3.8	4.9
4. General government final consumption expenditure	6.3	1.1	3.2	5.0	6.6	4.6	-2.6	-0.8	1.3	1.3
5. Total capital investment in fixed assets	16.7	6.0	15.3	22.9	9.3	-13.3	-39.0	-7.3	37.8	10.8
6. Change of inventories (% of GDP)	1.6	2.2	1.7	2.7	3.1	-0.4	-2.5	0.8	3.1	2.9
7. Export of goods and services	7.7	14.5	18.6	6.1	3.7	1.0	-21.3	23.7	23.4	5.6
8. Import of goods and services	11.2	14.7	18.9	13.9	6.3	-7.0	-31.1	21.1	28.4	8.8
Contribution to GDP growth 1)										
9. Domestic demand (excluding inventories)	11.3	6.6	10.6	15.7	9.3	-6.8	-20.4	-3.2	9.4	5.8
10. Change in inventories	-0.3	0.9	-0.2	1.4	0.8	-3.5	-1.9	3.2	2.7	-0.4
11. Balance of goods and services	-3.3	-1.2	-1.5	-7.0	-2.6	6.0	8.2	2.8	-2.0	-2.6
Value added growth										
12. Primary sector	8.1	-8.2	-0.5	-1.0	15.6	0.9	0.4	-12.5	15.7	12.4
13. Manufacturing	9.4	2.6	8.5	10.1	6.0	-5.3	-19.6	22.8	13.7	-1.1
14. Construction	9.7	8.0	25.0	8.3	11.4	3.6	-34.4	-4.4	31.8	12.5
15. Other services	6.9	7.0	7.7	10.2	6.3	-4.4	-11.2	1.3	6.3	4.1

1) Contribution to GDP growth indicates the shares of specific sectors in economic growth. This is calculated by multiplying growth in the area by its share in GDP. The sum of the contributions of different sectors amounts to economic growth (the slight difference can be attributed to a statistical error –the part of GDP that cannot be divided between the areas).
Source: Ministry of Finance, Statistics Estonia.

Table 32. Prices in 2003–2012 (%)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1. GDP deflator	4.5	6.1	8.8	11.6	5.4	0.2	0.3	3.0	3.3	5.0
2. Private consumption deflator	3.3	4.0	5.3	8.0	7.8	-0.4	2.4	4.9	3.7	3.4
3. Harmonised Consumer Price Index	3.0	4.1	4.4	6.7	10.6	0.2	2.7	5.1	4.2	3.2
3a. Consumer prices index	3.0	4.1	4.4	6.6	10.4	-0.1	3.0	5.0	3.9	2.8
4. General government consumption expenditure deflator	5.9	9.0	7.4	14.3	13.2	-0.3	-0.9	3.1	6.0	6.1
5. Investment deflator	2.5	4.1	9.2	8.4	-0.6	-1.4	-0.7	2.0	3.5	5.0
6. Export deflator	2.4	3.5	5.6	6.8	6.0	-1.8	3.2	4.5	1.7	1.0
7. Import deflator	1.2	2.1	3.5	3.8	6.9	-3.0	5.2	5.6	2.7	-0.4

Source: Ministry of Finance, Statistics Estonia.

Table 33. Labour market in 2003–2012

	2003	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
		%	%	%	%	%	%	%	%	%	%
1. Employment, persons	594.3 1)	1.5	0.2	2.0	6.4	1.4	0.2	-9.2	-4.2	6.7	2.5
3. Unemployment rate		10.0	9.7	7.9	5.9	4.7	5.5	13.8	16.9	12.5	8.6
4. Labour productivity, per person	16.0 2)	5.4	6.5	6.4	4.0	6.5.	-3.9	-5.1	7.2	3.2	2.0
6. Compensation of employees	3,859.9 2)	12.3	11.2	15.1	20.2	24.5	11.4	-13.2	-2.7	7.4	7.9
7. Compensation per employee (6./1.)	6.5 3)	10.6	11.0	12.8	13.0	22.8	11.2	-4.3	1.5	0.6	5.3
7a. Average gross monthly wage, EUR	429.7	9.4	8.4	10.8	16.5	20.5	13.9	-5.0	1.1	5.9	5.7

1) Thousand persons.
2) Million EUR.
3) Thousand EUR.
Source: Ministry of Finance, Statistics Estonia.

Table 34. Balance of payments in 2003–2012 (% of GDP)

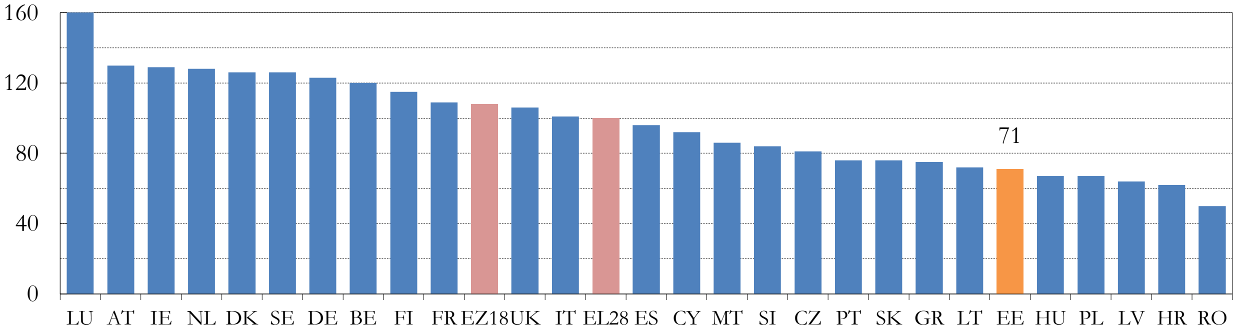
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-à-vis the rest of the world	-10.6	-10.6	-9.2	-13.2	-14.9	-7.8	6.2	6.4	5.9	1.7
incl.: - Balance of goods and services	-7.4	-7.0	-6.4	-10.6	-9.9	-4.5	5.1	7.4	6.1	2.5
- Balance of income and transfers	-3.9	-4.3	-3.6	-4.8	-6.0	-4.7	-2.4	-4.6	-4.3	-4.3
- Capital account	0.7	0.7	0.8	2.2	1.1	1.3	3.5	3.5	4.1	3.5
1a. Current account	-11.3	-11.3	-10.0	-15.3	-15.9	-9.2	2.7	2.8	1.8	-1.8
2. Errors and omissions	-0.6	-1.4	1.0	-1.1	0.2	0.3	0.5	-0.4	0.5	0.0

Source: Ministry of Finance, Eesti Pank, Statistics Estonia.

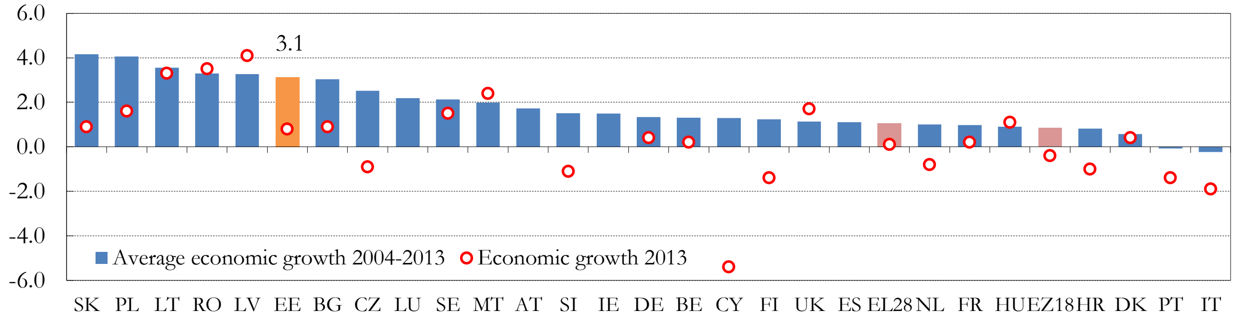
Appendix 2. Comparison of Estonia with other EU member states (figures)

Figure 22. Main macroeconomic indicators (%)

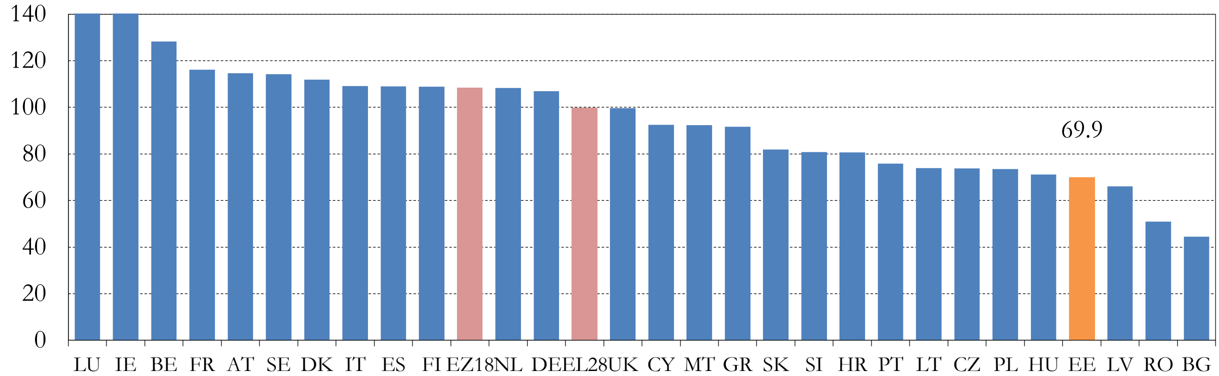
A. GDP per capita in purchasing power parities in 2012 (EU28=100)



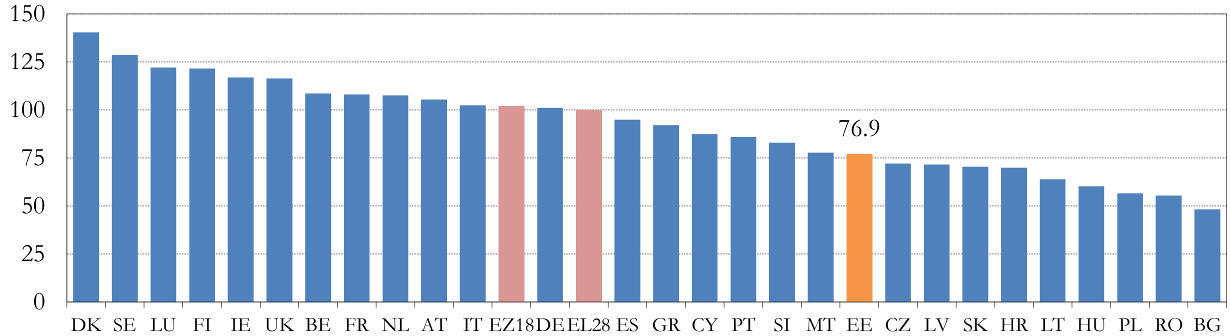
B. Economic growth in 2013 and 2004–2013



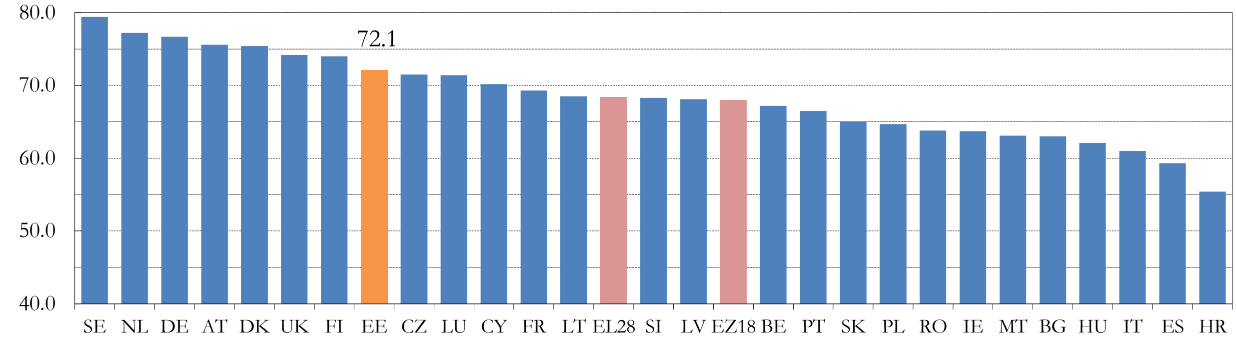
C. Labour productivity – GDP by working hours PPS 2012 (EU28=100)



D. Price level in comparison with the EU28 average in 2012 (EU28=100)



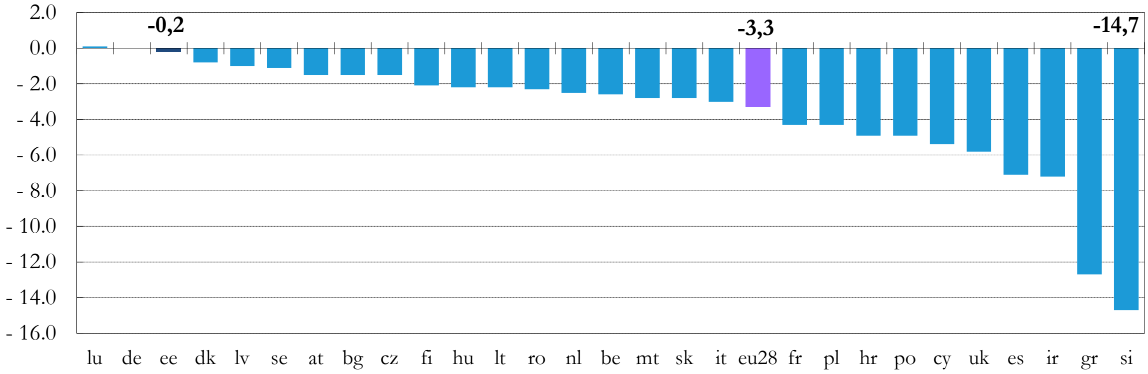
E. Employment rate (persons aged 15-64) in 2012



Sources: Eurostat, Statistics Estonia, Ministry of Finance.

Figure 23. Fiscal position of general government (% of GDP)

A. Budgetary position of general government in 2013



B. General government debt in 2013

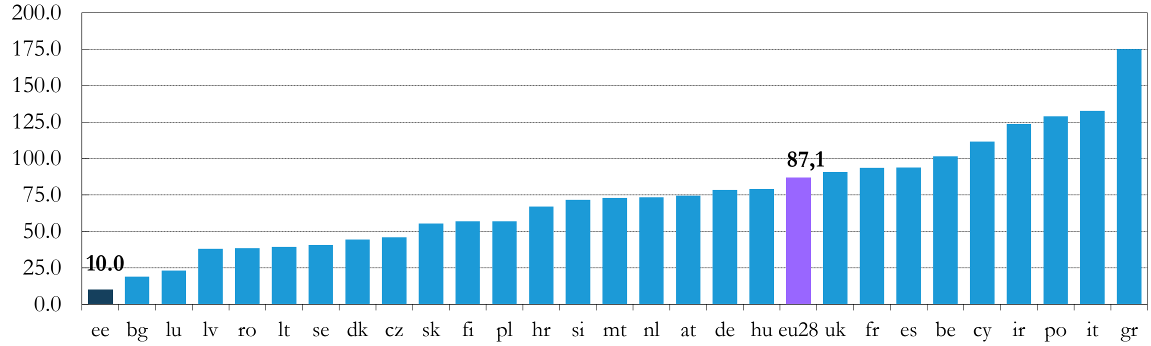
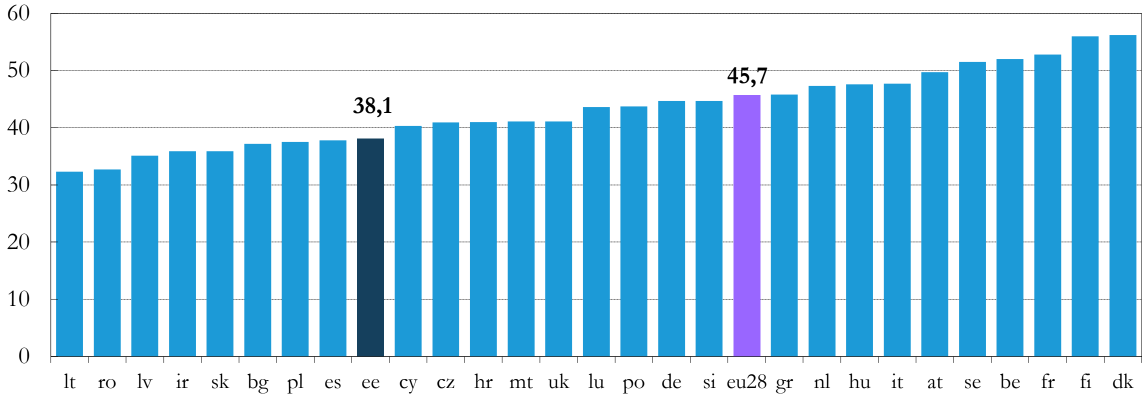
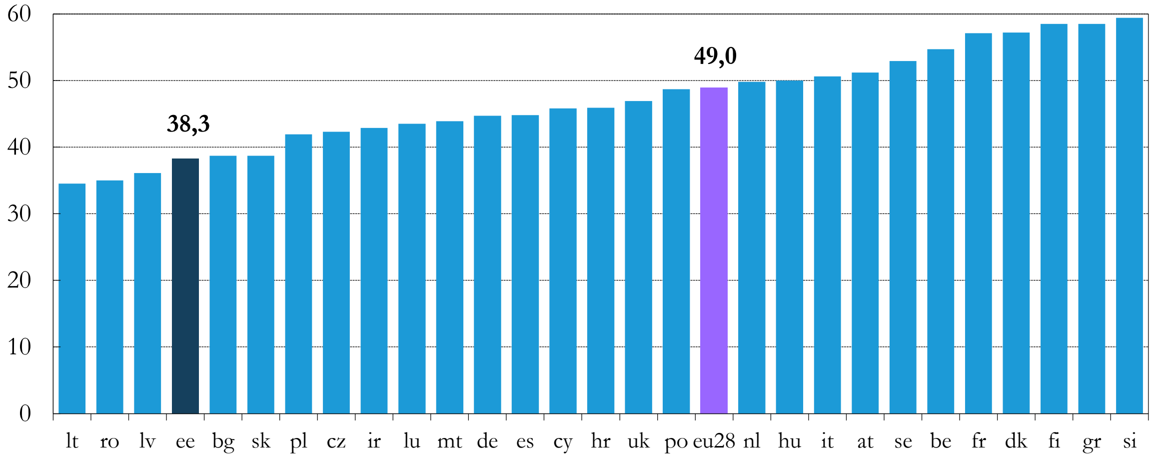


Figure 24. General government revenue and expenditure (% of GDP)

A. Estonian general government revenue compared to other EU member states in 2013



B. Estonian general government expenditure compared to other EU member states in 2013



Sources: Eurostat.

Appendix 3. Effect of administrative price increases on CPI

Table 35. Effect of administrative price increases on CPI in 2013–2018 (%)

Administrative measures	Entry into force	Price change (%)	Effect on CPI (percentage points)					
			2013	2014*	2015*	2016*	2017*	2018*
Changes in tax policy			**0.27**	**0.24**	**0.16**	**0.13**	**0.01**	**0.00**
Increase of tobacco excise duties (10%)	1.01.2012	6.5	0.02	-	-	-	-	-
Increase of tobacco excise duties (6%)	1.01.2013	4.8	0.08	0.03	-	-	-	-
Increase of tobacco excise duties (6%)	1.01.2014	4.8	-	0.08	0.03	-	-	-
Increase of alcohol excise duties (5%)	1.02.2012	2.1	0.02	-	-	-	-	-
Increase of alcohol excise duties (5%)	1.01.2013	2.2	0.12	0.01	-	-	-	-
Increase of alcohol excise duties (5%)	1.01.2014	2.2	-	0.12	0.01	-	-	-
Increase of alcohol excise duties (5%)	1.01.2015	2.2	-	-	0.12	0.01	-	-
Increase of alcohol excise duties (5%)	1.01.2016	2.2	-	-	-	0.12	0.01	-
Excise duty on oil shale for heat production	1.01.2013		0.03	-	-	-	-	-
Other administrative price changes			**0.94**	**-0.59**	**0.00**	**0.19**	**0.21**	**0.21**
Physician visit fee and in-patient fee	1.01.–1.03.2013		0.14	-	-	-	-	-
Refuse collection**	2013–2018		0.01	0.01	0.02	0.02	0.02	0.02
Public transport	1.01.2013		-0.30	-	-	-	-	-
Free higher education	1.09.2013		-0.09	-0.19	-	-	-	-
State fees (Motor Vehicle Registration Centre's activities)	1.01.2014		-	0.02	-	-	-	-
Electricity (incl. the electricity market's opening, network fees, renewable energy fee)**	2013–2018		1.12	-0.24	0.09	0.12	0.12	0.12
Water supply and sewage**	2013–2018		0.02	0.03	0.04	0.04	0.04	0.04
Natural gas	1.07.2012	10.0	0.03	-	-	-	-	-
Natural gas (network fees)	1.05.2013	-4.1	-0.02	-0.01	-	-	-	-
Natural gas**	2014–2018		-	-0.02	-0.02	-0.02	-	-
Price of heat energy in Tallinn and elsewhere**	1.01.–1.12.2013	0.5	0.03	-	-	-	-	-
Price of heat energy in Tallinn and elsewhere**	2014–2018		-	-0.19	-0.13	0.03	0.03	0.03
Total			**1.21**	**-0.35**	**0.16**	**0.32**	**0.22**	**0.21**
Government coalition's additional tax changes								
Increase of tobacco excise duties (5%)	1.01.2016	4.0	-	-	-	0.07	0.02	-
Increase of tobacco excise duties (5%)	1.01.2017	4.0	-	-	-	-	0.07	0.02
Increase of tobacco excise duties (5%)	1.01.2018	4.4	-	-	-	-	-	0.07
Increase of alcohol excise duties (15%)	1.01.2015	8.5	-	-	0.46	0.04	-	-
Increase of alcohol excise duties (10%)	1.01.2016	5.6	-	-	-	0.30	0.03	-
Increase of alcohol excise duties (10%)	1.01.2017	5.6	-	-	-	-	0.30	0.03
Increase of alcohol excise duties (10%)	1.01.2018	5.6	-	-	-	-	-	0.30
Increase of natural gas excise duties (20%)			-	-	0.02	0.02	0.02	-
Total additional effects			**-**	**-**	**0.48**	**0.43**	**0.44**	**0.42**

*** Assessment by the Ministry of Finance.*
Source: Ministry of Finance, Statistics Estonia, Eesti Energia, Tallinna Küte, Estonian Competition Authority.