RAHANDUSMINISTEERIUM

Stability Programme 2015

Tallinn
14 May 2015

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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 eurozone and the Member States who are not using the euro, respectively). Estonia is 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 fifth time. This Stability Programme can therefore be regarded as a follow-up to the one submitted in the previous year. The purpose of the Stability Programme is to illustrate the Government's policy in fulfilling the requirements resulting from 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 2015.

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 being 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. Stability Programme 2015 is based on the economic forecast of the Ministry of Finance from spring 2015.

According to EU rules on the coordination of economic and budgetary policies of Member States, an independent Fiscal Council was formed under the Bank of Estonia in 2014, having the task of providing assessments to economic forecasts which form the basis for Estonia's fiscal policy, and monitoring the compliance of national budgetary rules. Regarding the economic forecast of the Ministry of Finance from spring 2015, the Fiscal Council states the following: "The Fiscal Council is of the opinion that the new economic forecast of the Ministry of Finance is realistic and informative, which makes it a suitable basis for the development of the coming year's State Budget Strategy." Additionally, the Fiscal Council recommended that the Government reach a nominal balance of the state budget: "The Fiscal Council recommends the Government to consider the aforementioned aspects when planning the fiscal policy, and to prepare a State Budget Strategy where the general government's budgetary position is at least in nominal balance already starting with the year 2016. According to the method used by the Ministry of Finance, this would mean planning a significant structural surplus. This would provide greater reassurance that the state budget will comply with the requirements of the State Budget Act in the coming years." At the usual forecast seminar preceding the publication of the economic forecast of the Ministry of Finance, economic experts of other general government and private sector agencies also considered the economic forecast of the Ministry of Finance to be realistic.

The time horizon of the 2015 Stability Programme reaches the year 2019 as required from the budgetary strategy by the State Budget Act (the next fiscal year and the following 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 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 and flexibility, which supports internal and external balance. The speed of Estonia's real convergence has been fast and we are 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 the fiscal policy given an ageing population must be ensured. Ensuring a stable economic environment, channelling budgetary 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 in the coming years.

The Government's goal is to proceed with a sustainable fiscal policy. **The medium-term budgetary objective (MTO) of the Government is a 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.

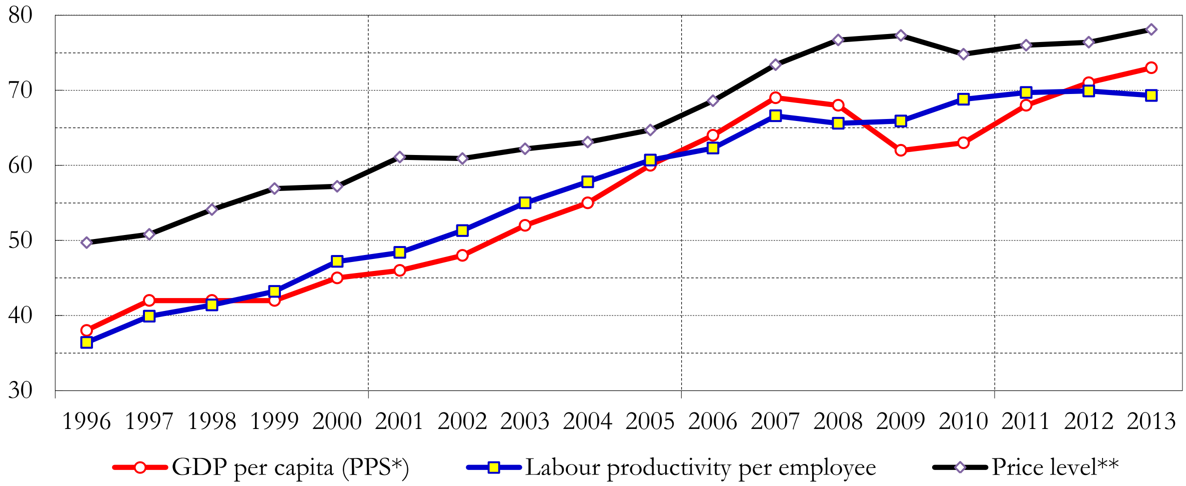
In order to focus its decisions and assess its activities, the Government has highlighted the priorities which it finds of utmost importance to implement. The priorities are based on the Coalition Programme and are one of the bases for setting the preferential order of actions planned and additional state budget applications filed.

The priorities of the Government and the policy initiatives and changes needed to implement them until the year 2019 are as follows:

1) Increasing the national security of Estonia.
    - Defence expenditure is retained at the level of 2% of GDP.
    - Membership of the Defence League and its specialised organisations increases to 30 thousand.
2) Promoting economic growth and reducing labour taxes.
    - Productivity per employed person as a ratio to the EU average increases to 79.1%.
    - Employment rate in the 20–64 age group increases to 75.7%.
    - Effective tax rate on labour decreases to 33.1%.

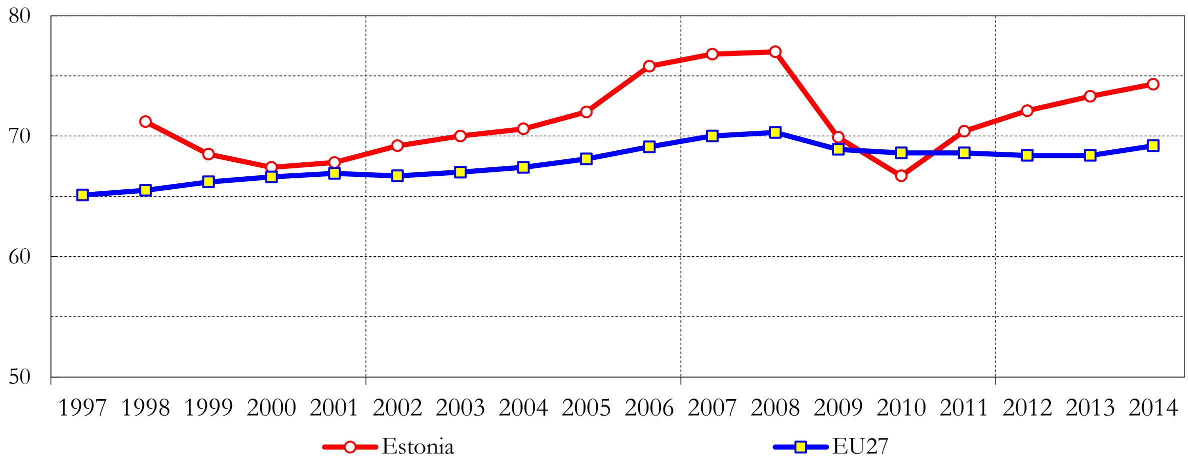
3) Increasing the coping of low wage people.
   - Absolute poverty rate decreases to 5.9%.
   - The proportion of adults (25–64 years) without specialised or vocational education decreases below 26%.
4) Improving the coping of families with children, developing an environment supporting childbirth.
   - Absolute poverty rate among children aged 0–17 years decreases to 7%.
   - Summary childbirth ratio i.e. the number of children per woman increases to 1.67.
5) Reforming public and local administration, alleviating peripheralisation.
   - The share of general government employees among working-age population does not increase.
   - Employment rate in rural areas (15–64 age group) does not decrease.
   - By the end of 2017, at least 95% of residents are living under local governments complying with the capability and sustainability criteria approved by the Government.

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



** PPS – GDP calculated on the basis of purchasing power parity.*
*** Price level of household final consumption expenditure.*

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

Global economy grew by 3.4% in 2014. This year, its growth is expected to pick up, primarily on account of advanced economies becoming stronger. The slowdown of the growth of developing markets is partly caused by Russia's weakening economy. After an economic decline of two years, the **eurozone's** economy resumed its growth again in 2014. In the coming years, the eurozone's economic growth is expected to speed up, supported by low oil prices and weakening exchange rate of the euro. Economic activity indicators (e.g. the industrial Purchasing Managers Index being at its highest for the past 10 months) also show an improved outlook of the eurozone.

The weighted average economic growth of Estonia's **main trading partners** and the import demand quickened last year. Regardless of the eurozone's economy becoming stronger, the growth expectations of the main trade partners were still corrected downwards, compared to the summer forecast. The reason for this is Russia's deteriorating economy and its indirect effect on our trade partners. For Estonia, this means a slower recovery of foreign demand and consequently, a modest 1% growth of export markets in 2015. Foreign demand will start improving in 2016 when the economic growth of main trade partners will pick up, supported by recuperating global demand and alleviation of Russia's economic decline. Estonia's export is mainly dependent on the developments of Sweden, Finland and other Baltic countries.

In 2014, the eurozone's **inflation** slowed down and turned to a negative territory at the end of the year, due to a deepening decline of energy prices. Because of low oil price, this years' price level will be the same as last year. In 2016, the negative effect of external environment will recede and the contribution from internal factors will gradually restore, making the inflation speed up to 1.3%. The expectations of market participants are that the eurozone's interest rates will remain at the current extremely low level. Moreover, European Central Bank employed an extensive asset purchase programme as an additional measure to avoid low economic growth and a period of low inflation.

In 2014, the exchange rate of euro to US dollar remained at the previous year's level. Last spring, the exchange rate of euro compared to US dollar started to depreciate and after a larger–than-expected asset purchase programme the depreciation became deeper. In March 2015, the EUR/USD exchange rate dropped to its 12 year low. The exchange rate was fixed at 0.890 at the end of February and we use this as a fixed rate for the entire forecast period.

Oil price turned to a decline in the middle of 2014 due to factors on both demand and supply sides, and the decline continued at the beginning of this year. In January 2015, the oil price dropped to 45 US dollars per barrel and has stabilised at a somewhat higher level thereafter. According to the futures fixed at the end of February, the oil price will remain low in the coming years but will have a slight increasing trend. Accordingly, we have fixed the oil price in our spring forecast at 62 and 70 USD in the years 2015–2016.

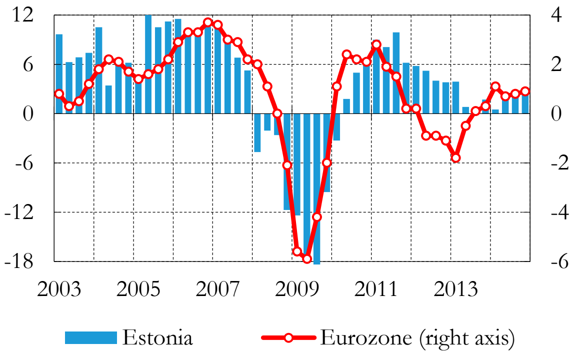
Table 1. Foreign assumptions of the forecast (%)

	Assumptions in the Ministry's 2015 spring forecast						European Commission		
	2014	2015*	2016*	2017*	2018*	2019*	2014*	2015*	2016*
1. Euribor, 3 months (annual average)	0.2	0.0	0.0	0.2	0.3	0.4	0.2	0.0	0.1
2. Eurozone's long-term interest rate (annual average)	1.2	0.4	0.5	0.8	1.0	1.2	1.2	0.5	0.7
3. USD/EUR exchange rate (annual average)	1.33	1.12	1.12	1.12	1.12	1.12	1.33	1.17	1.17
4. Nominal effective exchange rate	1.5	-1.2	0.0	0.0	0.0	0.0	1.4	0.2	0.0
5. World GDP growth (excluding EU)	3.7	4.0	4.4	4.5	4.6	4.6	3.7	4.0	4.4
6. EU28 GDP growth	1.3	1.7	2.0	2.0	2.0	2.0	1.3	1.7	2.1
7. GDP growth of Estonia's export markets	1.3	1.0	1.7	2.0	2.2	2.2		–	
8. World import growth (excluding EU)	2.1	4.0	5.2	5.7	6.2	6.2	2.1	4.2	5.3
9. Oil prices (Brent, USD/barrel)	99.0	62.0	70.0	73.0	75.0	77.0	99.0	53.0	61.5

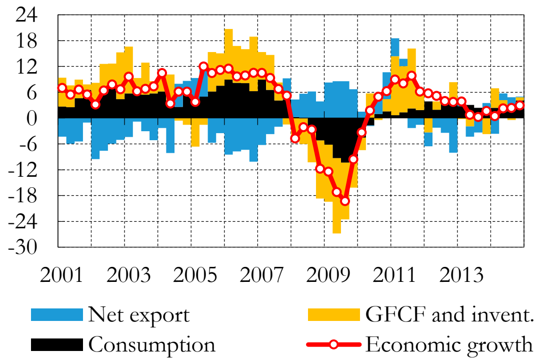
Sources: Historical data was obtained from Eurostat, Bank of Estonia, U.S. Energy Information Administration (EIA); forecasts are based on Consensus Economics (CF) and NYMEX Brent futures, if possible, which have been adjusted according to the most recent developments and the expert opinions of the Ministry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

Figure 3. Development of Main Indicators of Estonian Economy (%)

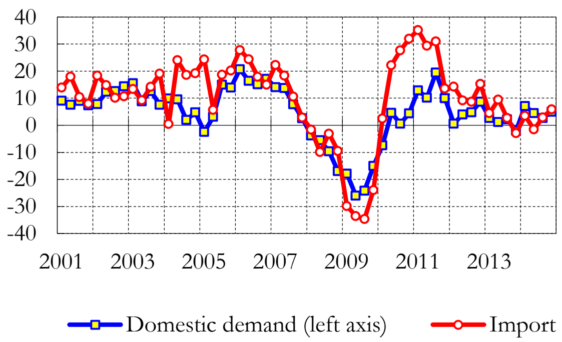
A. Economic growth in Estonia and the eurozone



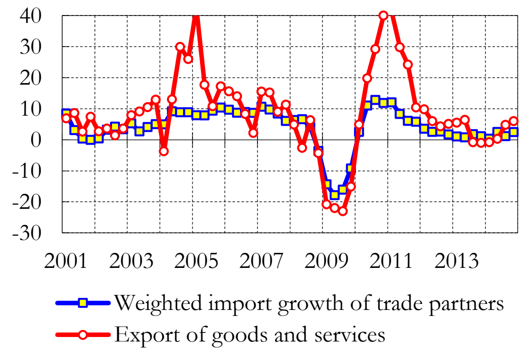
B. Contributions to economic growth



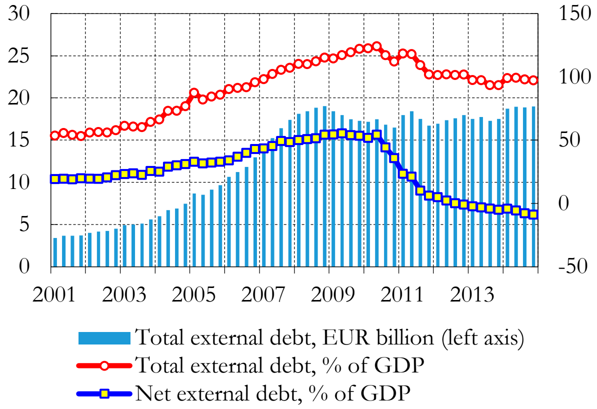
C. Real growth of domestic demand and imports



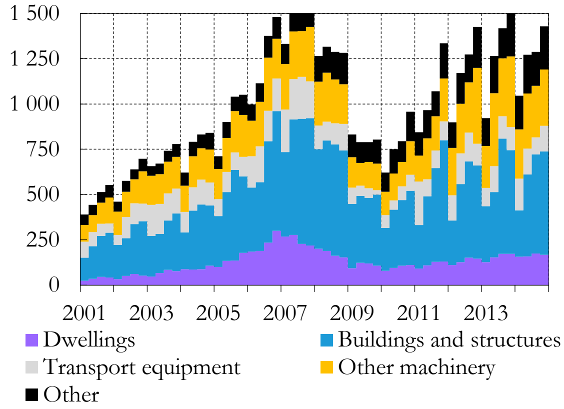
D. Real growth of exports



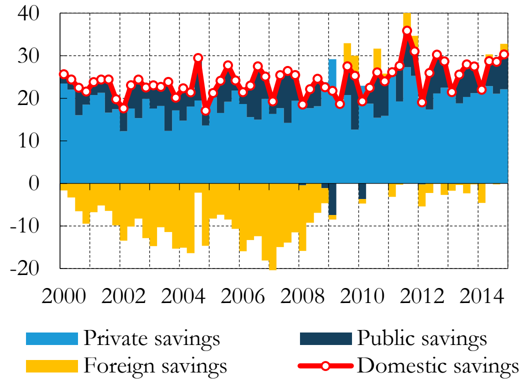
E. Total external debt and net external debt



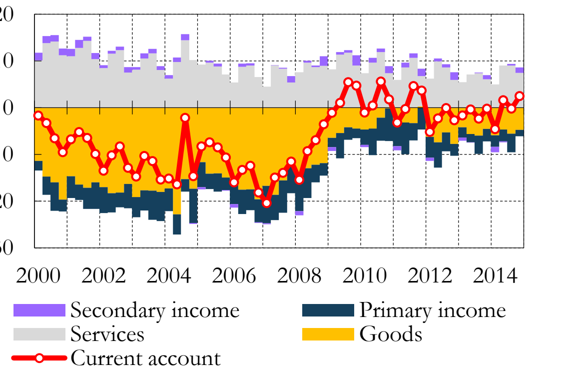
F. Structure of investments (million EUR)



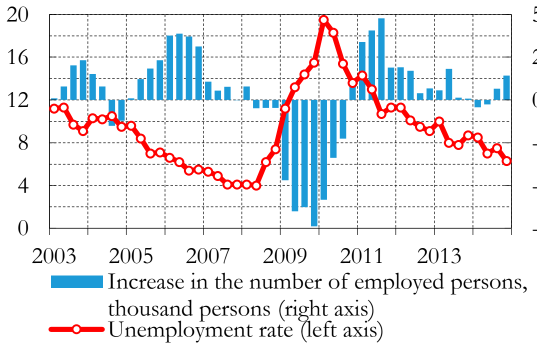
G. Savings (% of GDP)



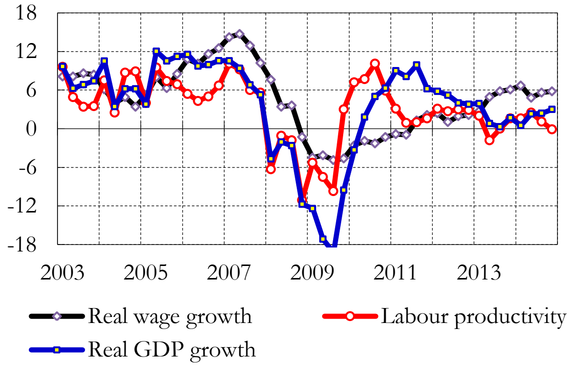
H. account structure (% of GDP)



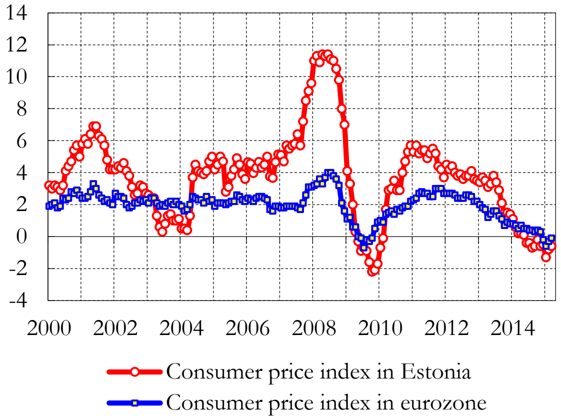
I. Employment and unemployment



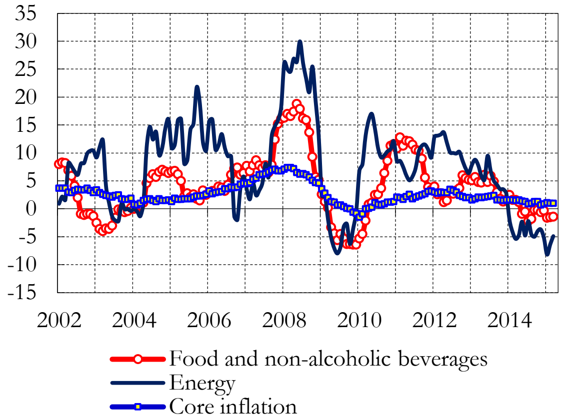
J. Labour productivity



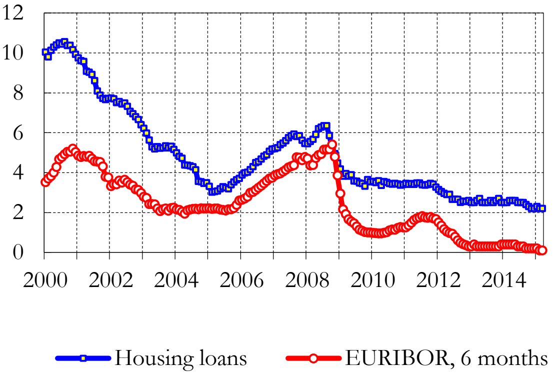
K. Consumer price index in Estonia and €-area



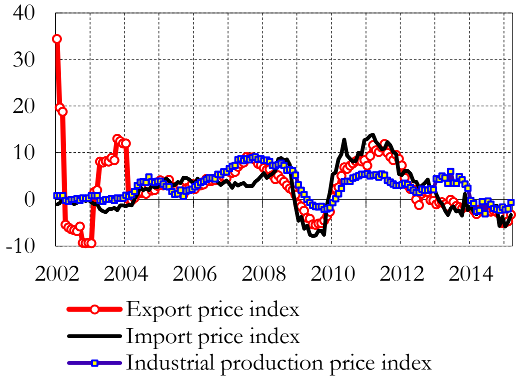
L. Change in main inflation components



M. Interest rates



N. Export, import and production price index



Source: Statistics Estonia, Bank of Estonia, Eurostat.

2.2. Economic forecast

At the time of preparing the previous forecast of the Ministry of Finance at the end of summer 2014, the economic sentiment in the EU was in a decline, but since the beginning of 2015 the sentiment indicators in Europe as a whole have started to rise again, driven by the European Central Bank's more specific promises regarding the achievement of its inflation goals as well as the remarkable price fall of oil products on the global market. Although the euro exchange rate against dollar has continued to decline, the price decrease of oil products increases the real income of the population of oil importing countries and reduces the costs for enterprises there, thus supporting economic growth. Regardless of the generally positive global development and several signs of a quickening growth in the EU, the growth outlooks of Estonia's export partners have still been adjusted downwards again for this year and the demand environment will also remain weaker than previously expected for the following years. Estonia's economic sentiment has been very stable over the past three years, but the latest months have seen a weakening of the sentiment indicators in several areas. Nevertheless, the price fall and the actively growing wage income continue to raise the consumption capacity of the population, and private consumption continues to drive the demand in this year as well. The price increase will be restored later on and with the hoped recuperation of the EU's economy, the growth of export and investments will also speed up. (The assumptions of this forecast are set as of the end of February 2015.)

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According to the forecast's base scenario, Estonia's gross domestic product will grow by 2% in 2015 and by 2.8% in 2016. We expect the economic growth to increase to 3.4% by 2017, whereafter the growth will start to slow down again due to the closure of the output gap and the decreasing number of employees. The Ministry of Finance has adjusted the economic growth forecasts downwards for this and the next year due to the deterioration of the growth outlook of Estonia's main trade partners. The economic growth forecasts for the following years have not changed when compared to the previous forecast. Export growth will speed up this year but domestic demand will remain the main growth driver and import will increase faster than export. We expect the export growth to become gradually faster starting with the year 2016, but the contribution of domestic demand will remain stable thanks to the restoration of investments. In 2018–2019, Estonia's economy should grow by 3% per year on average. The GDP growth in those years will be supported by not only export but also by domestic demand, as the growth rate of the latter picks up again.

The domestic demand growth in 2015 will be supported by both the increasing private consumption's growth and investments expected return to growth. The growth of private consumption will be kept high by a number of factors this year. The fast growth of wage income will continue with both an increase in the average salary and rising number of employees, and the increase of net salary this year will be further affected by a decrease in the labour tax burden. The cost of the consumption basket will not increase during the first half of the year and a moderate growth of consumer prices will restore only in the second half of the year. The favourable labour market sentiment will keep the consumers' sentiment high. Starting with the second half of 2015, several external factors recede that have been hindering a price increase, and the consumer basket's cost increase will start holding back the growth of real incomes. The expected 4.8% real growth of private consumption in 2015 will decelerate to 2.8% in 2016. Further on, the aggregated private consumption growth may drop even further due to the quickening of price increase and the reduction of the number of employees.

All sectors contributed to the decrease of investments in the past year, but there are reasons to believe that their growth will still be restored in 2015. In the business sector, the entire fall was caused by the energy industry, the negative impact of which should recede this year; the rest of economic areas in total provided a modest growth of investments in the past year as well. In the public sector, the use of the new period's EU structural funds was postponed from 2014 to 2015. Some of the housing investments made in the second half of the past year may be recorded as inventories in the statistics so far, and the growth is fast in that area. Overall, the growth of investments will still remain moderate (2.7%) in 2015, but as the external sentiment improves, it should increase to around 4–5% in the future.

The foreign trade forecast for the next few years has been adjusted downwards due to a weaker growth outlook of trade partners and a deterioration of Russia's economic situation. A 2.8% increase of the export of goods and services can be expected in 2015, whereas the increase will be stronger in the first half of the year due to a low base for goods export. Although the foreign demand is weaker than in previous years, export is supported by an increase of export volumes in some significant economic activities. The growth of service export will slow down due to the slowdown of transport services' export and the weakness of travel services export. The improvement of trade conditions will continue, primarily on the services side. Further on, the export growth will increase rate to the foreign demand growth rate, reaching 4.0% in 2016 and stabilising in the range of 5.5–6.0% at the end of the forecast period. Due to a significant increase of the public sector's investment activity, growing private consumption expenditure and increasing import of components and raw materials needed for export, the import growth of goods and services will increase to 4.0% in 2016. In the years 2016–2018, the import growth will pick up, remaining comparable to export.

In 2015, the current account deficit will increase to 0.8% of GDP due to the increasing investment activity of the public and corporate sectors; it will be expressed in a slight worsening of the foreign trade balance. In subsequent years, the foreign balance will continue to be affected primarily by a strengthening of investments. The growth of services export will continue to exceed the growth of import services. The profitability of foreign investors will start recovering as a result of the strengthening economic growth. The current account deficit will increase somewhat by the end of the forecast period, but will remain markedly lower when compared to the previous forecast.

Due to the low oil prices and the cheapening of food on foreign markets, consumer prices are decreasing in the first half of this year. At the end of the year, the negative contribution of external factors will gradually start decreasing. Inflation will also be raised by the state's measures, as a result of a start-of-the-year increase of alcohol excise duty. In 2015 as whole, consumer prices will grow by 0.2%. In 2016, inflation will increase to 2.2%, mainly due to a growing contribution of external factors as oil futures are on an upward trend and food prices will also start increasing due to growing demand. The price increase of services will speed up because the effect from free higher education recedes and wage growth increases gradually. This will be supplemented by an increase of tobacco excise. In 2018, the inflation is expected to speed up to 2.9% due to the faster salary growth causing a faster price growth of services, as well as due to the state's measures and the higher contribution of external factors. The slowdown to 2.6% in 2019 is related to the government-approved increases of excise duties coming to an end.

The situation in the labour market will become ever tighter and the rapid decline of unemployment has been driving wage pressures for some time already. As a result of a decreasing working age population and the assumption that the labour market participation rate and the employment rate are about to reach their historical highs, outlook for further employment growth is modest. Still, Employment will continue increasing in the statistics in 2015 as the adoption of the employers' obligation to register their employees has affected not only the Tax and Customs Board's registers but also various employment-related statistics.

According to the forecast, the number of employed people will increase by 0.6% in 2015 similarly to the previous year and will turn to a decline by up to a half percent starting with the next year. Simultaneously, the unemployment rate will drop below 6% starting with the next year. Despite labour shortages, the growth rate of average salary should decrease when compared to the last year, because the increase of price level in 2015 will be close to zero similarly to the last year, and the export prices are also in decline. The average wage can be expected to increase by 4.8% in 2015 and real wages will also increase at nearly the same rate. Presuming the foreign demand will recuperate, the nominal wage growth should pick up starting with the next year, but real wage increases will slow down to of 3% due to the quickening of price increase. The share of wage costs in value added has risen to a relatively high level and it should drop somewhat further on.

Table 2. Domestic Product forecast for 2014–2019 (%)

	2014 level	2014*	2015*	2016*	2017*	2018*	2019*
1. Real GDP growth	17 290	2.1	2.0	2.8	3.4	3.2	3.0
2. Nominal GDP growth	19 526	4.2	4.0	5.5	6.4	6.3	5.8
Sources of growth							
3. Private consumption expenditure (incl. NPISH)		4.5	4.8	2.8	2.4	2.6	2.8
4. Final consumption expenditure of general government		2.3	1.2	1.0	1.0	1.0	1.0
5. Gross fixed capital formation		-2.8	2.7	3.6	4.7	5.3	5.4
6. Changes in inventories (% of GDP)		2.3	1.2	1.0	1.0	1.0	1.0
7. Export of goods and services		2.6	2.8	4.0	5.2	5.7	5.7
8. Import of goods and services		2.7	4.0	4.2	4.7	5.7	6.1
Contribution to GDP growth[1]							
9. Domestic demand (excluding inventories)		2.1	3.4	2.7	2.7	3.0	3.1
10. Changes in inventories		2.5	-0.6	0.2	0.1	0.1	0.1
11. Balance of goods and services		0.0	-0.9	-0.1	0.5	0.1	-0.3
Value added growth							
12. Primary sector		8.1	-3.0	4.2	1.8	2.0	2.0
13. Manufacturing		3.3	3.5	5.0	5.0	4.8	4.2
14. Construction		-4.1	-1.3	2.0	4.7	4.2	3.8
15. Other services		0.7	1.5	2.1	2.8	2.7	2.7

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 discrepancy – a share of GDP which cannot be divided between the areas).
Source: Ministry of Finance, Statistics Estonia.

Table 3. Prices' forecast for 2014–2019 (%)

	2014	2014	2015*	2016*	2017*	2018*	2019*
	2010=100	*%*	*%*	*%*	*%*	*%*	*%*
1. GDP deflator	112.9	2.1	2	2.6	2.9	3	2.7
2. Private consumption deflator	113.0	0.7	0.5	2.2	2.8	3	2.7
3. Harmonised consumer price index	113.6	0.5	0.8	2.6	3	3.2	2.8
3a. Consumer price index	112.0	-0.1	0.2	2.2	2.7	2.9	2.6
4. General government consumption expenditure deflator	117.2	4.4	4.6	4.5	4.5	4.5	4.5
5. Investment deflator	110.1	1.2	2.2	2.4	2.3	2.3	2.3
6. Export deflator	107.4	-0.2	-1	1.3	1.6	1.8	1.8
7. Import deflator	105.8	-1.5	-1.4	1.3	1.8	1.8	1.9

Source: Ministry of Finance, Statistics Estonia.

Table 4. Labour market forecast for 2014–2019 (15–74 age group) (%)

	2014 level	2014*	2015*	2016*	2017*	2018*	2019*
		%	*%*	*%*	*%*	*%*	*%*
1. Employment, persons	624.8 1)	0.6	0.6	-0.3	-0.5	-0.5	-0.6
3. Unemployment rate		7.4	6.1	5.8	5.5	5.5	5.5
4. Labour productivity, persons	27.7 2)	1.5	1.3	3.1	3.9	3.7	3.7
6. Compensation of employees	9 468.5 3)	8.7	5.5	4.9	5.5	6.0	5.8
7. Compensation per employee (6./1.)	15.2 4)	5.6	4.8	5.2	6.0	6.5	6.4

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

Table 5. Balance of payments forecast for 2014–2019 (% of GDP)

	2005–2014	2014	2015*	2016*	2017*	2018*	2019*
1. Net lending/borrowing vis-à-vis the rest of the world	-2.2	0.6	1.7	1.0	1.5	1.2	0.6
1a. Current account	-4.5	-0.1	-0.8	-1.0	-0.8	-1.0	-1.4
2. Balance of goods and services	-0.6	2.5	1.8	1.6	1.8	1.7	1.3
3. Balance of primary and secondary income	-3.9	-2.5	-2.6	-2.6	-2.7	-2.7	-2.8
4. Capital account	2.3	0.7	2.5	2.0	2.4	2.1	2.1
5. Errors and omissions	0.2	1.3					

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

2.3. Comparison with the forecasts of other forecasters

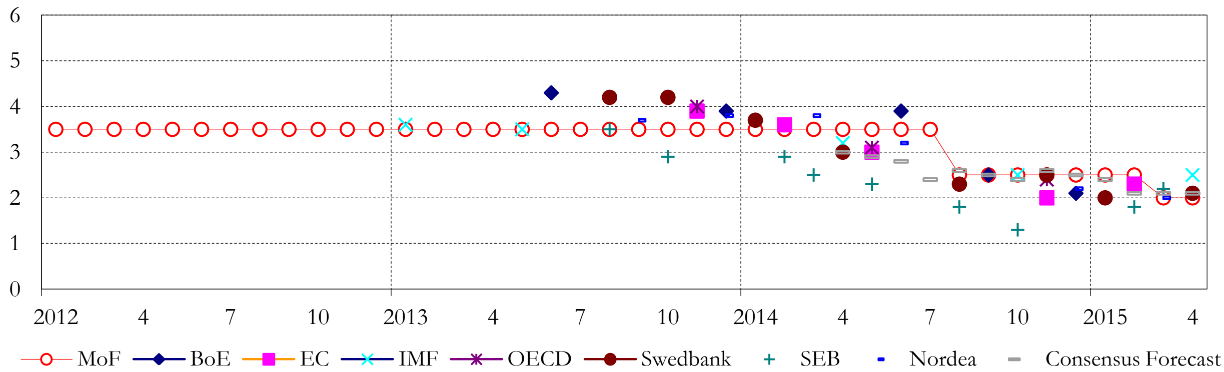
The differences between the spring 2015 economic forecast of the Ministry of Finance and the most recent known growth expectations by other institutions that prepare economic forecasts are indicated below. When comparing these forecasts, it must be kept in mind that they were made at different times and thus are based on different information, which causes differences in the assumptions and forecast results. Earlier forecasts must be assessed in light of the assumptions that prevailed at the time they were prepared, as the external environment (geopolitical risks, commodity prices, the exchange rate of euro) is volatile.

With some exceptions, the economic growth expectations of various forecasters in the past six months have remained in the range of 2–2.5% for 2015. A certain discrepancy has occurred that some institutions have adjusted their latest forecast slightly upwards, while others have adjusted theirs downwards. The spring forecast of the Ministry of Finance for this year is conservative, remaining at the lower end of the range of growth expectations.

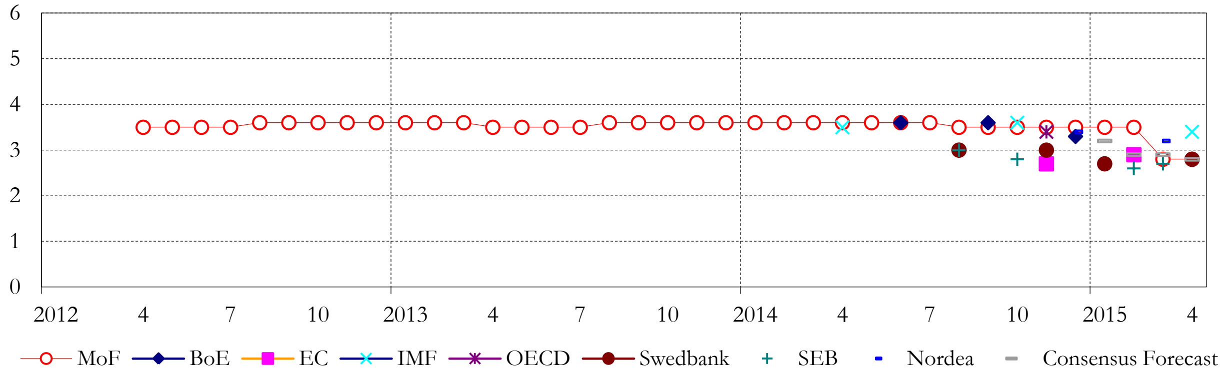
The institutions are expecting the economic growth to pick up in 2016. Forecasts vary around 3%, yet the trend is to lower the growth expectations a little. The reason for that is the geopolitical situation related to Russia and varying expectations towards its resolution. The Ministry of Finance expects the economic growth to speed up to 2.8%, which is comparable to the conservative forecasts of other institutions.

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

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



B. Forecasts of Estonia's economic growth for 2016 according to forecast publication date



Sources: Ministry of Finance, Bank of Estonia, European Commission, IMF, OECD, Swedbank, SEB, Nordea.

Table 6. Comparison of economic forecasts

	Real GDP growth, %			Nominal GDP growth, %		
	2015*	**2016***	**2017***	**2015***	**2016***	**2017***
Ministry of Finance	**2,0**	**2,8**	**3,4**	**4,0**	**5,5**	**6,4**
European Commission	2,3	2,9	–	4,0**	5,7**	–
Bank of Estonia	2,1	3,3	–	4,7**	5,9**	–
IMF	2,5	3,4	3,4	4,6	5,7	5,7
OECD	2,4	3,4	–	4,0	5,5	–
SEB	2,2	2,7	–	–	–	–
Swedbank	2,1	2,8	–	4,9	5,9	–
Nordea	2,0	3,2	–	–	–	–
Consensus Forecasts	2,1	2,8	–	–	–	–
Estonian Institute of Economic Research	2,0	–	–	–	–	–

	Consumer price index, %			General government position, % of GDP		
	2015*	**2016***	**2017***	**2015***	**2016***	**2017***
Ministry of Finance	**0,2 (0,8*)**	**2,2 (2,6*)**	**2,7 (3,0*)**	**-0,5**	**-0,6**	**-0,5**
European Commission	0,2*	1,9*	–	-0,2	-0,1	–
Bank of Estonia	0,8 (1,1*)	2,1 (2,4*)	–	-0,6	-0,4	–
IMF	0,4*	1,7*	2,0*	-0,5	-0,1	0,0
OECD	0,9*	1,7*	–	-0,3	-0,2	–
SEB	0,5*	2,3*	–	-0,7	-0,5	–
Swedbank	0,1	2,7	–	-0,5	-0,5	–
Nordea	-0,5	2,2	–	-0,4	-0,4	–
Consensus Forecasts	0,5*	2,1*	–	–	–	–
Estonian Institute of Economic Research	0,7	–	–	–	–	–

** Harmonised Consumer Price Index (HICP)*
*** Calculated on the basis of forecast nominal GDP volume or the sum of real GDP growth and GDP deflator.*

Sources:
Ministry of Finance. Economic Forecast. Spring 2015. 13.04.2015.
European Commission. European Economic Forecast. Spring 2015. 5.05.2015.
IMF. World Economic Outlook. April 2015. 15.04.2015.
OECD Economic Outlook. No 96. November 2014, 25.11.2014.
Bank of Estonia. Estonian Economy and Monetary Policy.. 2/2014. 10.12.2014.
Estonian Institute of Economic Research. Quarterly Review of Estonian Economy No. 1 (192) 2015. 6.04.2015.

SEB. Eastern European Outlook. March 2015. 25.03.2015.
Swedbank. Economic Outlook of Estonia. 21.04.2015.
Nordea. Economic Outlook. 11.03.2015.
Eastern Europe Consensus Forecasts. 20.04.2015.

2.4. Preparation and assessment of the economic forecast

The economic forecast of the Ministry of Finance is prepared by analysts of the Ministry's Fiscal Policy Department, belonging to the Ministry's staff. The objectivity and independence of the forecast is ensured by a transparent forecasting process, involvement of various external forecasters, and ongoing comparison of forecast results. The initial version of the Ministry of Finance's economic forecast is discussed with the forecast team of the Bank of Estonia. Before finalising the Ministry of Finance's forecast, its main assumptions and results are discussed at a joint seminar with all the most important Estonian forecasters working in the central bank, in commercial banks and in other organisations preparing economic analyses. In total there are roughly ten such organisations involved. Moreover, the explanatory memorandum of the Ministry of Finance's forecast includes comparison tables and figures detailing the forecast results of various independent forecasters, making it easy to notice a systematic bias of any forecaster.

At the usual forecast seminar preceding the publication of the economic forecast of the Ministry of Finance, economic experts of other general government and private sector agencies considered the economic forecast of the Ministry of Finance to be realistic.

According to amendments to EU framework for the coordination of economic and budgetary policies of Member States, an independent institution must be established in all Member States to monitor the compliance of the budgetary policy to the fiscal rules and, if necessary, to assess the need to apply corrective measures described in the framework. Estonia's independent Fiscal Council was established under the Bank of Estonia in 2014. Pursuant to its articles of association, the Fiscal Council's task is to provide assessments to the state's and fiscal forecasts, budgetary strategies, and the achievement of the structural budgetary position objective set for the general government.

The Fiscal Council's opinion dated 27 April 2015 about the spring 2015 economic forecast of the Ministry of Finance states the following:[1]

- **The Fiscal Council is of the opinion that the new economic forecast of the Ministry of Finance is realistic and informative, which makes it a suitable basis for the development of the coming year's State Budget Strategy.** However, it must be kept in mind that the part of the forecast that is dedicated to public finance does not contain the impact that the decisions of the new Government will have on the formation of the general government sector's budgetary position.
- The new fiscal forecast of the Ministry of Finance indicates that the deterioration of macroeconomic indicators in comparison to the ones forecast at the time the 2015 state budget was prepared may result in a situation where this year's budgetary position is weaker than the objective set. This must be taken into account when the state budgetary strategy is updated and the state budget for the next year is prepared. At the same time, nominal economic growth will be somewhat faster in the coming years according to the forecast than in 2014−2015 and the GDP structure will continue to support a relatively rapid increase in tax revenue. This is why the budgetary position planned for the coming years must not be weaker than the objective set in the State Budget Strategy for 2015−2018.
- Since the institutions that analyse the economic development of Estonia have different opinions on the status of the economic cycle, we still advise to assess the cyclical component of the budget using several alternative methods. The Fiscal Council is of the

[1] Read more on the Fiscal Council's website: http://eelarvenoukogu.ee/files/2015_kevadine_majprognoos_eelarvenoukogu_arvamus.pdf

opinion that the indicators of the general government's structural budgetary position may be overrated in the forecast, especially for 2015–2017.

- The Fiscal Council advises the Government to consider the aforementioned aspects when planning the fiscal policy, and to prepare a State Budget Strategy where the general government's budgetary position is at least in nominal balance from 2016 onwards. According to the methodology used in the Ministry of Finance, this means planning a significant structural surplus. This would provide greater reassurance that the state budget will comply with the requirements of the State Budget Act in the coming years.

2.4. Macroeconomic policy in coming years

2.4.1. Ensuring 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 years preceding the economic crisis with a rapid growth exceeding potential growth rates 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.

The Estonian economy showed a remarkable flexibility in both the private and public sectors during the recession. The Government kept the budgetary deficit within the limits determined in the Treaty on European Union during the recession, giving the state 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 deficit-decreasing measures taken have a long-term impact.

In 2014, the general government's budgetary position was in a surplus of 0.6% of GDP thanks to a better–than-expected tax revenue collection and lower expenditure. The position is expected to fall into a deficit in 2015, while still remaining structurally in a surplus. The structural position of the general government has been in a surplus since the year 2009.

The changeover to the single European currency, the euro, and joining the eurozone on 1 January 2011 had a significant role in helping us overcome the crisis successfully. Irrespective of the turbulence in global developments, the single currency has increased confidence in 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 low 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 thereby stabilise economic development by keeping the budget in a structural surplus.

2.4.2. External and internal imbalances of the economy

External and internal imbalances of the Estonian economy have decreased significantly in recent years. While five indicators out of eleven exceeded the macroeconomic imbalance thresholds in 2008–2009, only two indicators exceeded the thresholds in 2011–2012 – the international investment position and the new indicator of unemployment rate. The current account deficit, the strengthening of real effective exchange rate and the growth of nominal unit labour cost do not exceed thresholds anymore since 2010. The private sector's consolidated debt burden also remains below the 133% threshold since 2011. A persistently excessive negative international investment position cannot be avoided in a young, quickly developing country because domestic savings have not been sufficient to increase the level of local capital stock. Yet, foreign investment is an important source for a quick productivity growth. Thus, the indicator will probably remain outside the recommended limits for some time in the future, but it can also be considered to have positive effects. The other indicator exceeding the threshold – the unemployment rate – decreased below the reference level of 10% already in the second half of 2012 but its average over three years, which is used as an assessment criterion, should remain below the reference value in 2014.

The current account deficit, which deepened to 16% (of GDP) during the years of fast economic growth, decreased rapidly in the economic recession and the current account reached a surplus of 2.5% in 2009. This was due to a significantly faster decrease of import than export, resulting from a sharp fall of consumption and investment activity. Due to a robust growth of investment and a relative weakness of export markets, import grew faster than export in the years 2012–2013, bringing about a moderate deficit of the current account, although it was practically balanced already in 2014. As assessed by the Bank of Estonia, the moderate deficit forecast for the coming years remains within the sustainability limits for Estonia.[2]

The debt burden of Estonia's private sector 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. The households were the ones that were willing to increase their debt burden as a result of the activation of the real estate sector and increasing confidence created by the accession to the EU, and they used the money to improve their living conditions and to increase the level of consumption. The increase in the debt burden was supported by the credit policy of commercial banks and the low interest rates. This caused a sudden increase in the debt burden of households. The debt burden of the private sector in Estonia has been higher than the eurozone average since 2006 (as % of GDP). The debt burden of the private sector started to decrease in early 2009 and that trend was reversed only in the middle of 2012 when the business sector's loan stock started to increase again, compared to the month before. The household loan stock turned to an increase compared to the month before in spring 2013, supported by the already-growing lease balance and an increase of mortgage loans. In 2014, the growth rate of private sector loan stock reached 3% at times, but the growth slowed down somewhat at the end of the year (to 2.3%), which was clearly below the nominal economic growth rate. Nevertheless, the stock of consumption type loans (consumer loans, student loans, other loans) continues to decrease. Demand for loans will probably remain low for the next couple of years and so the emergence of a new credit boom is unlikely despite the low interest rates.

The active offering of loans created the conditions for the property market to overheat from 2005 to 2007. Average transaction prices at the peak 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 fell 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. In March 2015, the weighted average price for a square metre of apartment ownership transactions in the biggest cities of Estonia was about one tenth lower than the previous peak[3]. Over the same course of time, consumer prices have increased by 28% resulting in an even lower level of the real price of dwellings when compared to eight years ago. Despite of a modest loan growth, the deflated house price index which is used as an indicator of internal macroeconomic imbalances grew 7.3% in 2013, exceeding the reference value. Considering the historically relatively low real price of dwellings, as well as the very modest loan growth, the housing market cannot be said to have overheated again. The rapid price increase was probably caused by a low supply compared to the demand but the latest building permit data indicates an alleviation of supply problems.

[2] Estonian Competitiveness Report 2013, Bank of Estonia. [http://www.eestipank.ee/publikatsioon/eesti-konkurentsivoime-ulevaade/2013/eesti-konkurentsivoime-ulevaade-2013]

[3] http://www.pindi.ee/link.php?id=32064&filename=Turuylevaade_2015_03.pdf.

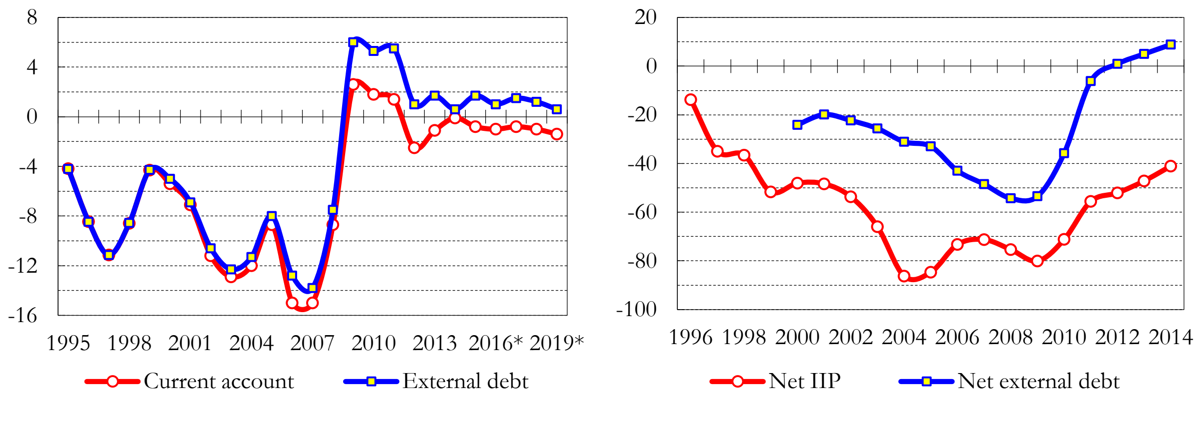
Nominal unit labour costs[4] increased consistently during the boom with the average wages increased extremely rapidly and exceeded productivity. However, a growth rate of nominal unit labour costs around 4-5% may be considered acceptable for the Estonian economy, as it does not suggest a decrease in competitiveness or emergence of an imbalance. The change in the real unit labour costs was close to zero until 2006, which suggested that the ratio of wage costs to GDP was stable and labour costs could be increased without damage to the 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 a decrease (-4.6% in 2009), unemployment increased and employment started to drop. The labour market imbalances created by the boom started unwinding rapidly during the crisis, which is also evidenced by the decrease in the nominal unit labour costs. In 2013, the growth of nominal unit labour costs increased to 6.8% and the rate of change over three years used as a reference was 9.6%. In 2014 however, the nominal unit labour cost growth was as much as 17.5% compared to three years ago, exceeding the threshold value of 12%. This results from a fast growth of wages and employment, which has already exceeded the growth rate of operating surplus (profits) for two years according to the national accounts data. However, this imbalance between the wage income and capital income is not confirmed by the business statistics, therefore the nominal unit labour cost determined on the basis of GDP statistics may not describe the situation accurately.

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 make it possible to reduce the probability of occurrence of imbalances. The functioning of the labour market is supported by the already implemented Employment Contracts Act 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 the Bank of Estonia 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

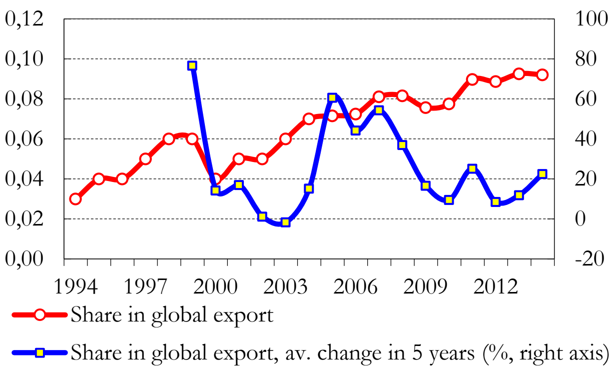
A. Current account balance (% of GDP) **B. Investment position (net IIP, % of GDP)**



[4] Ratio of labour costs to value added created per employee.

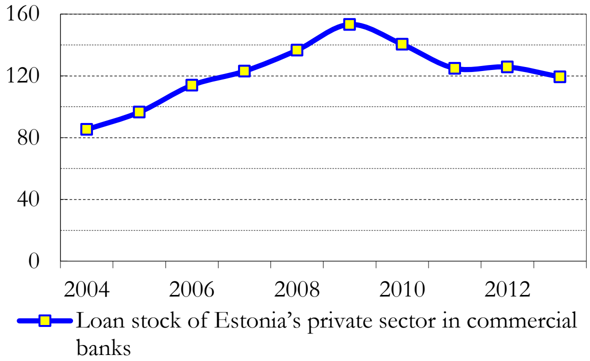
C. Real effective exchange rate [5]

D. Share in world exports (%)

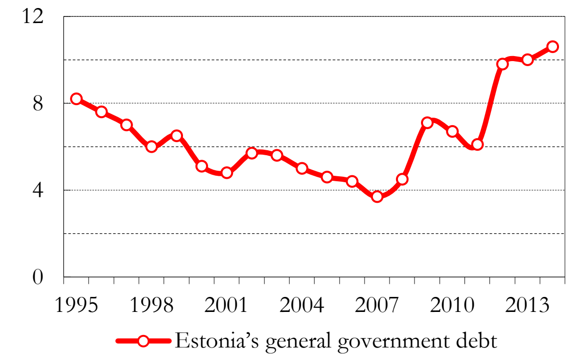


E. Loan turnover of private sector (% of GDP)

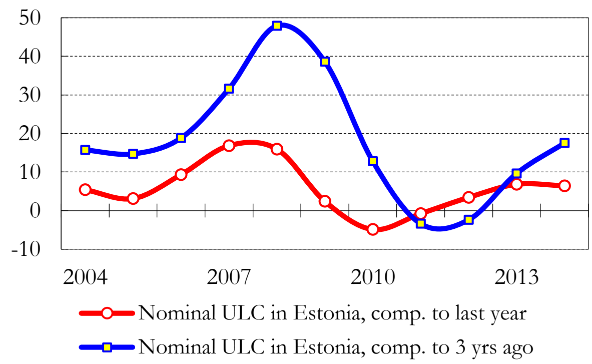
F. Private sector debt (% of GDP)



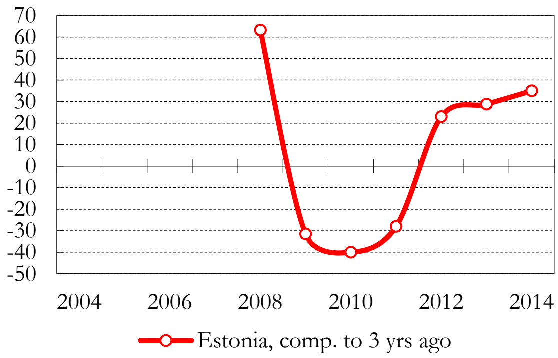
G. General government debt (% of GDP)



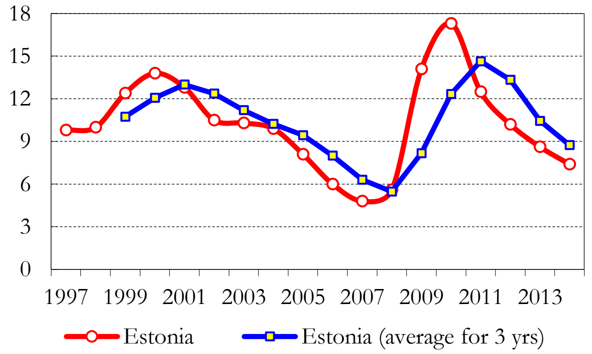
H. Change in unit labour costs (%)



I. Property prices



J. Unemployment rate (%)



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

[5] Eurozone HCI: Harmonised competitiveness indicators based on consumer price indices, vis-à-vis EER-42 group of trading partners.

3. FISCAL FRAMEWORK

In March 2014, the new State Budget Act entered into force, with the purpose of establishing legal bases and basic requirements to ensure long-term economic and fiscal sustainability of Estonia. Simultaneously, the Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States was transposed into the national law. The Act established **budgetary position rules**, pursuant to which the state budget must be prepared so that the general government's **structural budgetary position would be at least in balance**. Requirements were prescribed for central government legal entities concerning their net debt and operating results, in order to facilitate the achievement of structural balance of the general government[6]. In the next four years, the budgetary strategy is followed, continuing with a conservative fiscal policy compliant to the base act and planning the budgetary expenses according to possibilities

3.1. Objectives of the fiscal policy 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 revenue and expenditure structure must be guaranteed in order to cope with future economic downturns.

Budgetary policy decisions are made **simultaneously** (i.e. only in the budgetary (strategy) process), the decisions are **sustainable** (the long-term impact of the decisions is taken into account) and take account of sectoral policies and the activities of the other levels of the general government as much as possible; and all **sources of financing** (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 budgetary objective of the Government

The Government continues with a strict fiscal policy and its **medium-term objective (MTO) is a general government structural surplus.**[7] This objective complies with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and the new State Budget Act. Planning the budgetary position with a surplus helps guarantee the long-term sustainability of the budget.

The general government of Estonia has been in a structural surplus since 2009 and the MTO has therefore been achieved. In 2014, the surplus increased to 1.2% of GDP. In 2015 the structural surplus will decrease to 0.6% of GDP, as the growth of revenue will remain lower than the growth of expenditure due to reductions in the income tax rate and in the unemployment insurance rate. The objective for 2016 is set to maintain the 0.6% structural surplus and for 2017 and 2018 to achieve a 0.2% surplus, complying with the objective set in the previous State Budget Strategy.

If the objectives are achieved, the general government's nominal budgetary deficit will decrease to 0.1% of GDP in 2016 and 2017 and will reach a nominal budgetary surplus starting from 2018, which will make it possible to restore the reserves that had decreased during the recession. **No positive supplementary budgets will be prepared during the fiscal year and any extra tax revenue received in the budget will**

[6] The general government covers public sector entities considered non-market producers and financed mainly via mandatory payments made by entities belonging to other sectors. General government is divided into three subsectors:
1) central government – institutions on state budget, and foundations, legal persons under the public law and companies founded by the state;
2) local governments – institutions at the level of municipalities;
3) social security funds – the Health Insurance Fund and the Unemployment Insurance Fund.

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

be placed into the reserves. The Fiscal Council has also provided a recommendation to prepare the State Budget Strategy in a manner that the general government's nominal budgetary position would be at least in balance starting already from 2016.

3.1.2. Medium-term tax burden objective of the Government

The Government's objective is to retain the tax burden at the level of 2014 (about 33% of GDP)**, by reducing labour taxes.**

The tax burden of 2015 will be 33.0% of GDP. In the period of 2015–2019, a reduction of the income tax rate and the unemployment insurance rate, an increase of the basic tax-free allowance and a decrease of the social security contribution rate will have an alleviating effect on the tax burden. Technically, increased state contributions into the mandatory funded pension for those who continued their own contributions will also have an alleviating effect. The effect of increasing the tax burden will result primarily from increase of excise duties, but additional tax receipts will also come from the planned changes of package excise and from the establishment of road use tax for heavy vehicles. In summary, the tax burden will remain at a level comparable to 2014, reaching 33.4% of GDP **by 2019**. The future developments are discussed in detail in the chapter on tax policy and tax burden.

The Government's objective is to maintain the implicit tax rate on labour at the level of 2015 (about 33%).

The implicit tax rate on labour in 2015 is 33.0%. Higher contributions to the mandatory funded pension (2+6 and 3+6 contributions) will increase the indicator in 2014–2017. The implicit tax rate will lower in 2016–2019 due to an increase of the basic tax-free allowance and a decrease of the social security contribution rate. The implicit tax rate on labour will reach 33.1% **by 2019**.

3.2. Budgetary position of the general government

3.2.1. Nominal position of general government budget

In 2014, the general government's budget reached a surplus again, making up 0.6% of GDP i.e. 121 million EUR according to the initial data of Statistics Estonia. The central government and social security funds were in a surplus, both by 0.3% of GDP; local governments ended the year with a deficit of 5 million EUR (0.02% of GDP). The surplus was achieved due to better than forecast tax receipts, primarily in the part of corporate income tax, social security contributions and value added tax. Yet, the volume of investments remained lower than expected. Better tax receipts reduced the deficit of local governments as well. The result of social security funds was also better than expected, mainly due to less than forecast unemployment insurance benefit payouts.

According to the forecast, the budgetary deficit of 2015 will be 0.6% of GDP, mainly caused by the central government, but local governments will also remain in a deficit for the entire forecast period. The nominal deficit of the central government will be caused by a slower growth of tax receipts due to a reduction in the income tax rate and the unemployment tax rate, and also by investments related to the revenue from emission quota sales and by additional contributions to the second pension pillar, reaching a total of 0.6% of GDP in 2015. Social security funds continue to be in a surplus thanks to the Unemployment Insurance Fund (0.2% of GDP in 2015). In 2016, the general government's budgetary deficit will decrease to 0.1% of GDP due to the revenue and expenditure measures planned in the State Budget Strategy, and will reach a surplus of 1% in 2019.

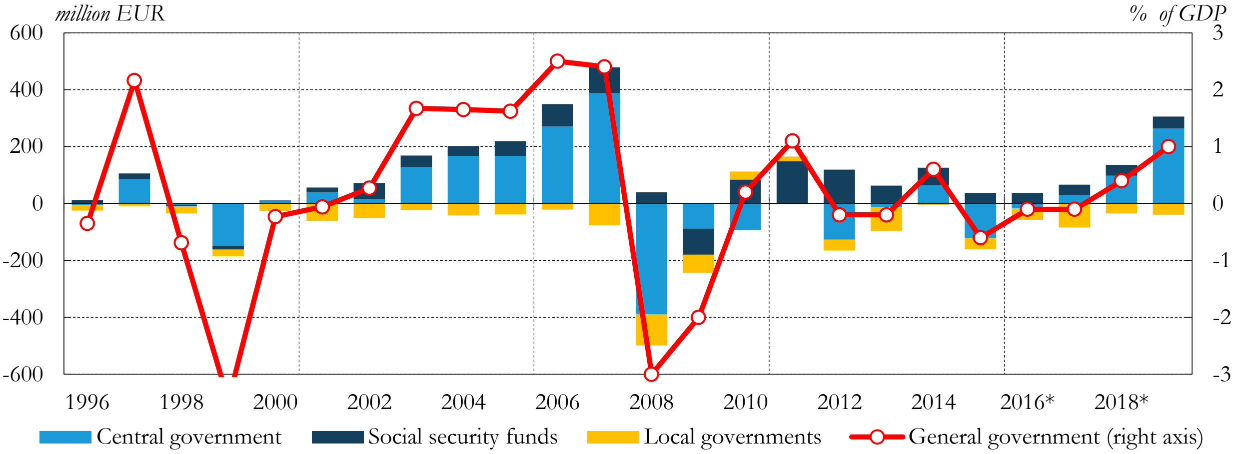
The Government's ambition is to maintain the structurally adjusted budgetary surplus achieved since 2009 throughout the forecast period. In 2016, the Government is planning to achieve a structural surplus of 0.6% of GDP.

Table 7. Budgetary position objective of the general government for 2014–2019

	2014	2015	2016	2017	2018	2019
Structurally adjusted budgetary position of general government (% of GDP)	**1.3**	**0.5**	**0.6**	**0.2**	**0.2**	**0.6**
Budgetary position of general government (% of GDP)	**0.6**	**-0.6**	**-0.1**	**-0.1**	**0.4**	**1.0**
State budget	0.3*	-0.6	0.0	0.1	0.4	0.5
Other central government		0.0	-0.1	0.0	0.0	0.6
Social security funds	0.3	0.2	0.2	0.2	0.2	0.2
Local governments	0.0	-0.2	-0.2	-0.4	-0.1	-0.2
Budgetary position of general government (m EUR)	**121**	**-123**	**-22**	**-18**	**101**	**266**
State budget	64*	-121	3	30	101	122
Other central government		-1	-20	-1	-4	142
Social security funds	62	37	37	37	39	42
Local governments	-5	-38	-41	-84	-35	-39

** Central government's position. Statistics Estonia publishes data by the central government's, social security funds' and local governments' level.*
Source: Statistics Estonia, Ministry of Finance.

Figure 6. Budgetary position of the general government



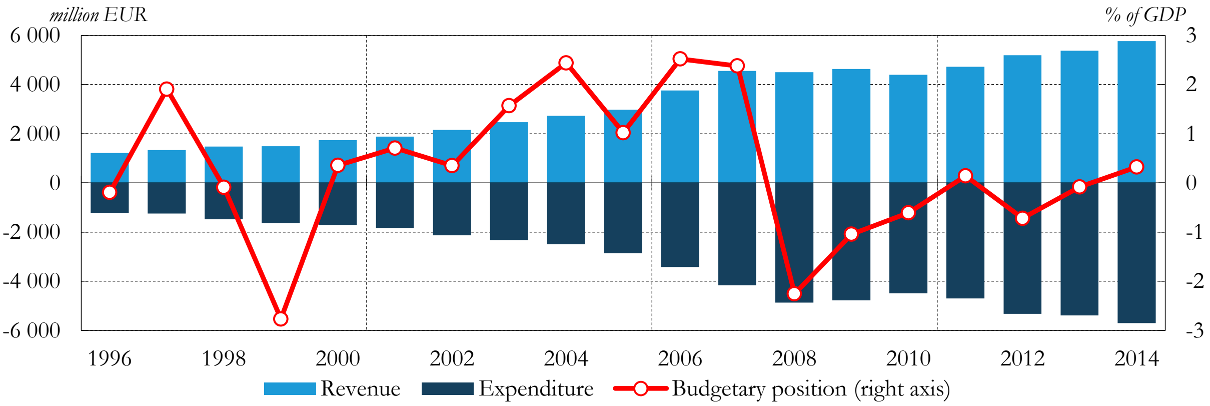
Source: Statistics Estonia, Ministry of Finance.

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 the 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 budgetary deficit is coming from the state budget when the economic cycle is in a declining phase. 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 the tax revenue.

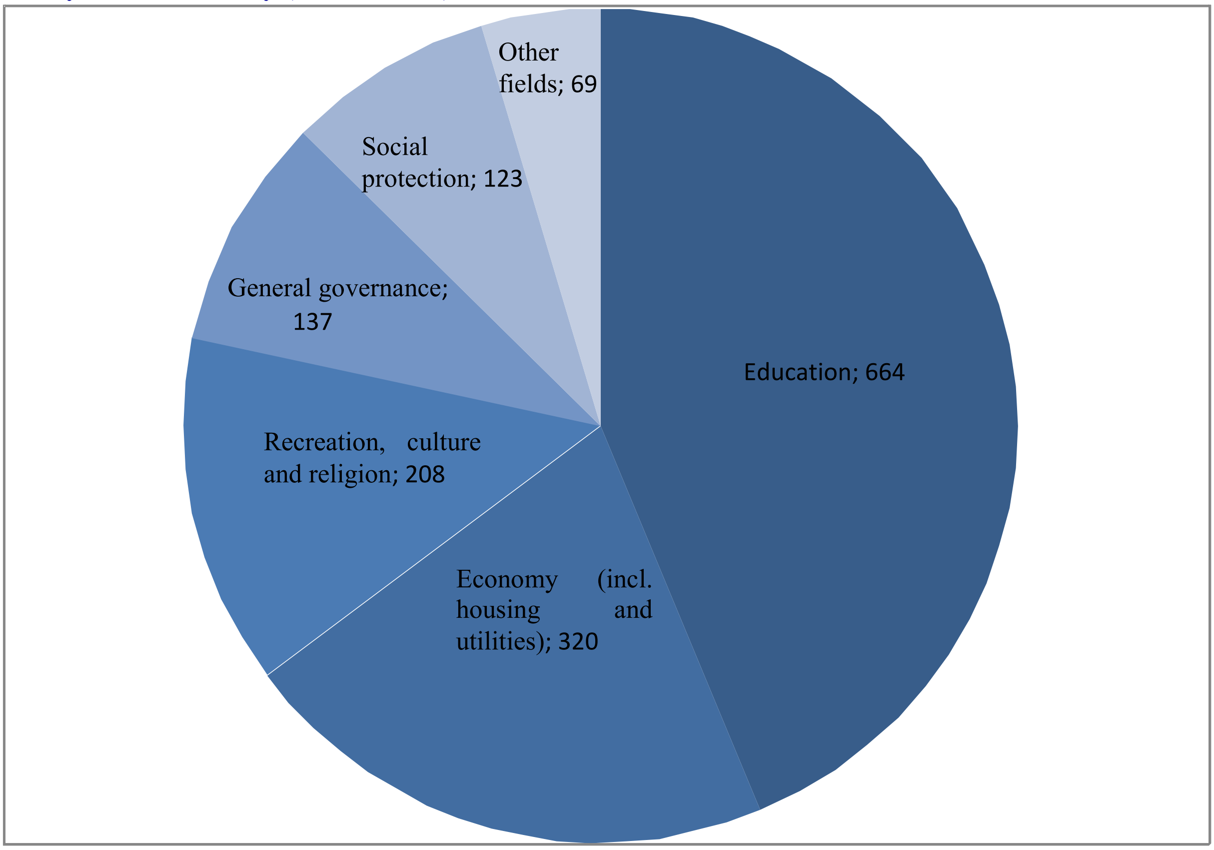
The majority of the central government's expenditure consists of state budget expenditure, about one-third[8] of which are social security expenditure (incl. state pension insurance). These expenditure are followed by expenditure on economy (incl. agriculture and road construction) and health (allocation to the Estonian Health Insurance Fund).

The remaining budgetary position of central government 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 213) 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 municipality or city, road or street maintenance in the rural municipality or city, water supply organisation and street lighting. Social protection means upkeep of care 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 1,616 m EUR in 2014 (incl. 95 m EUR of liabilities). 66% 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 2014, by areas of activity (million EUR)

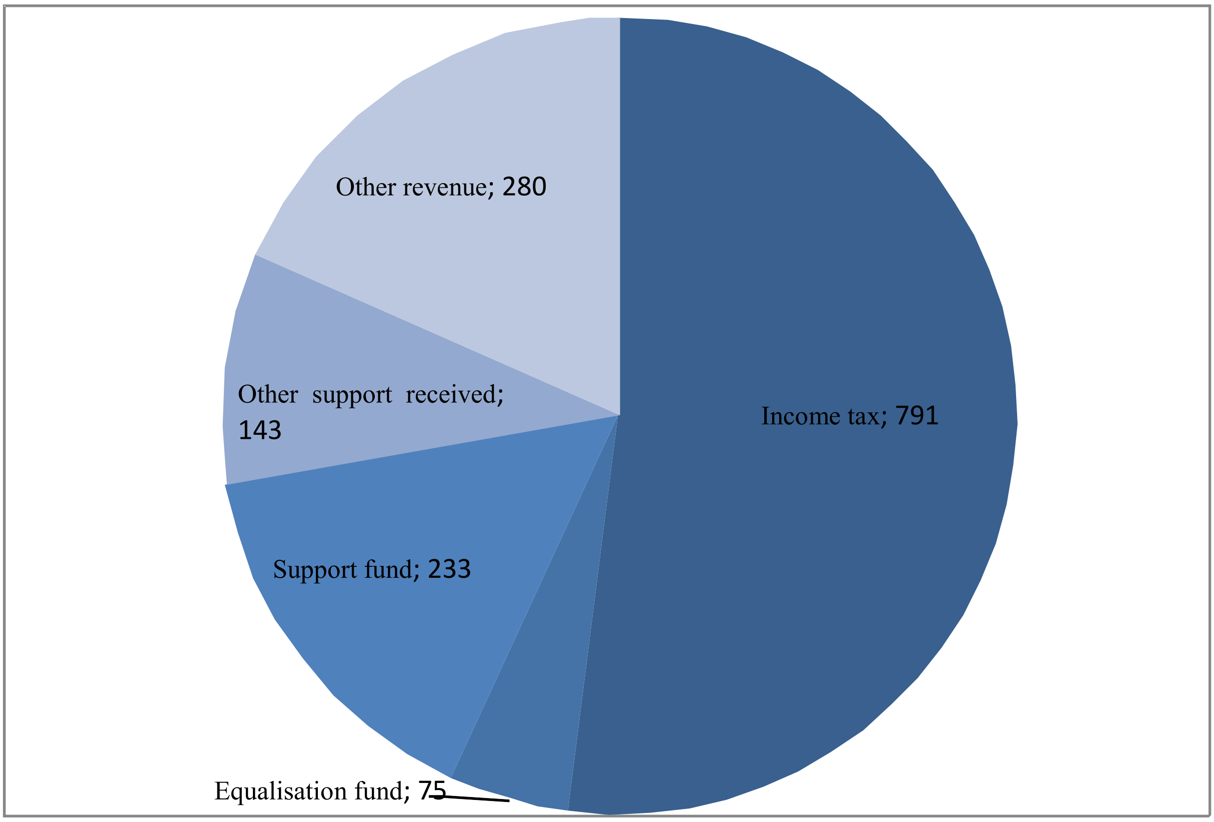


Source: Ministry of Finance.

[8] Based on State Budget 2014.

The budgets of local governments are independent, which means that they are responsible for preparing their budgets. The common purpose of the tax revenue transferred from the state budget (income tax and land tax) as well as the equalisation fund and the support fund is to ensure that local governments have sufficient funds to make independent decisions on local matters on the basis of laws. The equalisation fund is intended to equalise their budgetary possibilities. The support fund consists of various types of supports for different fields, making it possible to make labour expenses for teachers, ensure school lunches, pay subsistence allowances and needs-based family allowances, and maintain local roads. Local governments can also apply for a project based support from several measures. Other own revenue of local governments include mainly receipts of land tax and environmental fees or revenue sales of goods and services.

Figure 9. Breakdown of revenue of local governments in 2014 (million EUR)



Source: Ministry of Finance.

Local governments undertook an obligation to prepare a budgetary strategy for 2015–2018 by November 2014. The strategy has remained conservative when planning revenue and expenditure. For example, the assumed income tax revenue for the period is 82 m EUR less than the Ministry of Finance's forecast. Labour costs are planned to be increased by an average of 3% per annum, which is significantly below the forecast growth of the country's average wage growth (an average of 6% per annum). The estimated increase of management expenditure is on average 2% per annum. It can be expected that these expenditure will be adjusted upwards on-the-go, due to wage increase and inflation pressure. Careful approach has also been used when planning investments for 2015–2018. On average, 125 m EUR of own funds per year are planned to be used; this is less than in the period of 2011–2014. A surplus is planned to be attained starting from 2017 as a result of conservative planning. This provides a reserve for increasing their expenditure in the relevant budgetary year.

The breakdown of expenditure by areas of activity is mainly affected by changes in investments. Local governments refrain from investment decisions until the activities to be supported in the new period become clear.

Table 8. Breakdown of expenditure of local governments (except funding transactions), by areas of activity[9], according to the budgetary strategies of local governments (million EUR)

Area of activity	2013	2014*	2015*	2016*	2017*	2018*
01 General services of the general government	137	149	147	146	151	153
02 National defence	0	0	0	0	0	0
03 Public order and security	5	5	5	5	5	5
04 Economy	270	243	236	284	292	274
05 Environment protection	55	55	51	52	50	53
06 Housing and utilities	102	95	92	87	89	90
07 Health care	11	13	15	14	15	13
08 Recreation, culture and religion	203	211	193	201	218	211
09 Education	656	688	725	737	740	739
10 Social protection	125	132	132	139	149	149
TOTAL	1,562	1,591	1,595	1,666	1,709	1,686

Source: Ministry of Finance.

According to Statistics Estonia, the deficit of local governments and their dependant entities on accrual basis reached 5 million EUR in 2014. The Ministry of Finance forecasts that they will also remain in a deficit in the period of 2015–2019. Obligations are increased to cover this.

The budgets of local governments and their fulfilment of those budgets can be monitored from data presented in the budgetary reports.[10]

Table 9. Aggregate indicators of local governments, Ministry of Finance's forecast *(million EUR)*

Revenue and balance	**2014**	**2015***	**2016***	**2017***	**2018***	**2019***
Revenue	1,521	1,558	1,616	1,672	1,733	1,799
- Income tax	788	833	874	923	975	1033
- Land tax	59	59	59	59	59	59
- Equalisation fund	75	75	76	76	76	76
- Support fund	231	285	281	283	284	284
Budgetary position	**-5**	**-38**	**-41**	**-84**	**-35**	**-39**
Budgetary position (% of GDP)	**0.0**	**-0.2**	**-0.2**	**-0.4**	**-0.1**	**-0.2**

Source: Ministry of Finance.

Social security funds

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

Table 10. Budgetary position of social security funds for 2014–2019

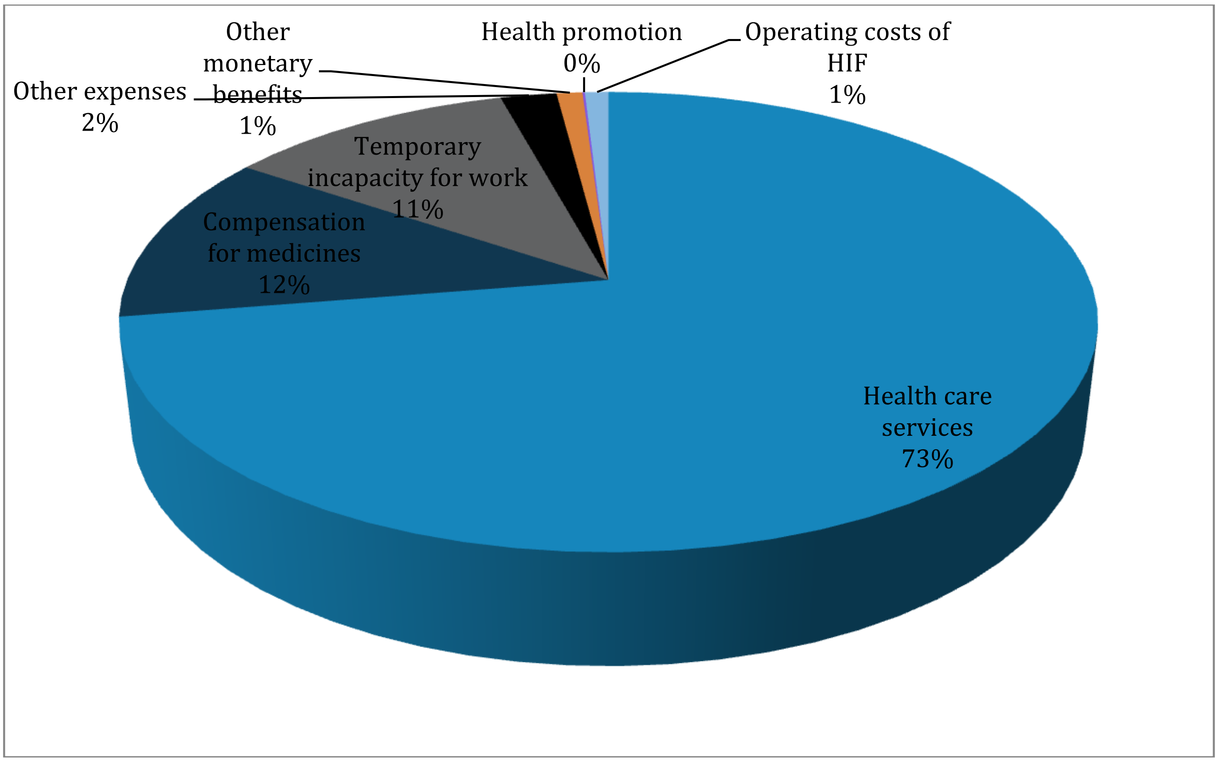
	2014	Budget for 2015	2015*	2016*	2017*	2018*	2019*
Social security funds (m EUR)	62	29	37	37	37	39	42
Social security funds (% of GDP)	0.3	0.1	0.2	0.2	0.2	0.2	0.2

** forecast*
Source: Ministry of Finance.

[9] Classification approved by general regulation of state accountancy, based on COFOG.
[10] http://www.fin.ee/kov-eelarved-ulevaated#KOVK

The health insurance part of social security contributions comprises about 99% of the revenue of **Estonian Health Insurance Fund** (HIF). Health services (prevention of diseases, primary and specialised medical care, nursing care and dental treatment) constitute the dominating part of the benefits guaranteed to insured persons. These services are followed by compensation for medicines and benefits for temporary incapacity for work.

Figure 10. Breakdown of expenditure of Estonian Health Insurance Fund in 2014



Source: Estonian Health Insurance Fund.

In 2014, the budgetary position of Estonian Health Insurance Fund fared poorer than expected, due to social security contribution receipts being lower and expenditure (mainly expenditure on temporary incapacity for work) being higher than forecast (deficit of 17 m EUR). A surplus of 2 m EUR is expected this year. The highest increase in 2015, yet still equal to the growth speed of total expenditure, will happen in expenditure on specialised medical care; this is also the largest type of expenditure. Expenses on general medical care, medicines and dental care will increase more than total expenditure. Expenditure on temporary incapacity for work will increase slower than other expenses. A budgetary position with larger deficit is expected in 2016–2019, reaching 11 m EUR by 2019. The forecast is based on the long-term cost budget and the health insurance part of the social security contributions forecast, both approved by the Council of Estonian Health Insurance Fund.

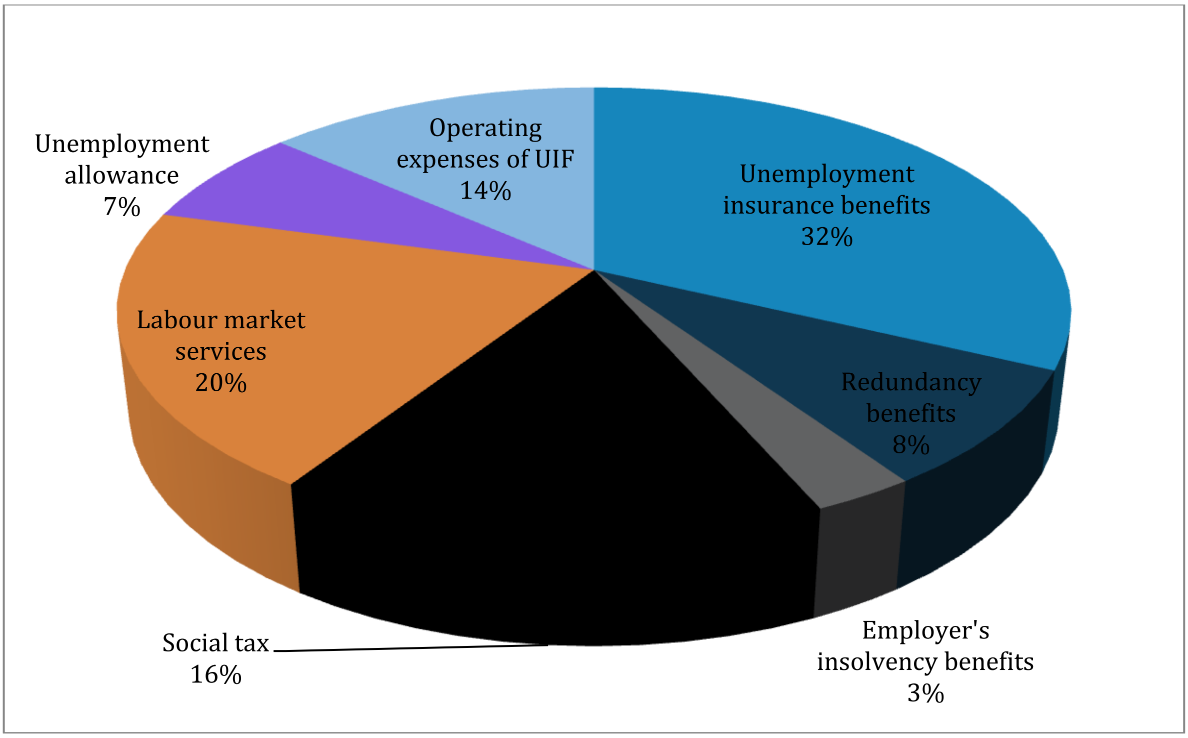
Table 11. Aggregate indicators of Estonian Health Insurance Fund, 2011–2019 (million EUR)**

	2011	2012	2013	2014	2015*	2016*	2017*	2018*	2019*
Total revenue	735.1	781.9	836.9	900.2	954.5	1,009.1	1,074.1	1,145.5	1,218.8
incl. social security contribution	725.6	776.9	829.7	893.8	947.2	1,002.0	1,066.0	1,136.3	1,208.2
Total expenditure	725.5	780.9	838.4	916.7	952.7	1,013.4	1,080.6	1,152.7	1,229.8
Budgetary position	**14.3**	**1.9**	**0.8**	**-16.5**	**1.8**	**-4.3**	**-6.5**	**-7.2**	**-11.0**
Budgetary position (% of GDP)	**0.1**	**0.0**	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

** forecast*
*** Budgetary position in 2011–2014 according to data from the Ministry of Finance. Expenditure in 2015–2019 according to the specified forecast of the Ministry of Finance regarding the Health Insurance Fund. Forecast of revenues in 2015–2019 according to the Ministry of Finance's spring 2015 economic forecast.*

Unemployment insurance benefits comprise the biggest part of the expenditure of the **Unemployment Insurance Fund** (UIF). In 2014, the number of persons receiving the benefit decreased almost threefold compared to 2009 when the number of such persons was the highest. A slight declining trend is forecast to continue throughout the budgetary strategy period both regarding the benefit recipients 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, 2014



Source: Unemployment Insurance Fund.

The surplus of the Unemployment Insurance Fund in 2014 was 78 m EUR, which is significantly larger than the surplus of 2013. The reason is the lower-than-expected costs on unemployment insurance benefits. This year's budgetary position of the Unemployment Insurance Fund is influenced by a reduction in the unemployment insurance premium rate (from 3% to 2.4%) and an increase of expenditure. The expected surplus of 2015 is 35 m EUR. Similar to the previous year, the expenditure on active labour market measures will also be covered from unemployment insurance premiums in this year and the coming years. Also, the work capacity reform is expected to entail additional costs. Still, the expected surplus of the Unemployment Insurance Fund will uniformly grow in the coming years due to an increase of revenue, reaching 52 m EUR in 2019.

Table 12. Aggregate indicators of the Unemployment Insurance Fund, 2011–2019 (million EUR)***

	2011	2012	2013	2014	2015*	2016*	2017*	2018*	2019*
Total revenue	249.7	249.3	184.8	197.2	173.1	183.6	193.3	205.3	219.0
- unemployment insurance premiums	194.4	211.0	167.2	174.6	150.1	158.4	167.9	178.0	189.4
Total expenditure	116.4	126.5	126.7	116.0	138.0	142.7	149.8	159.2	166.4
- benefits**	44.6	48.7	54.4	50.4	55.9	54.2	53.3	53.7	56.6
Budgetary position	**129.0**	**118.6**	**63.2**	**81.2**	**35.1**	**40.8**	**43.5**	**46.1**	**52.6**
Budgetary position (% of GDP)	**0.8**	**0.7**	**0.3**	**0.4**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**

** forecast*
*** Unemployment insurance benefit, insurance benefit in case of redundancy and employer's insolvency benefit.*
**** Budgetary position in 2011–2014 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; forecast for 2015–2019 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 2011–2014.*

3.2.2. Cyclically adjusted position of general government

The method used by the Ministry of Finance to estimate the potential output (or the potential GDP[11]) is the production function method[12]. According to this, in 2005-2007 Estonia's GDP 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 Estonia's economy 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 larger than total production and income. This excessive demand resulted in a volume of the economy that was up to 14% larger than usual (i.e. an output gap[13]) in 2007, which was accompanied by accelerating inflation, a strong worsening of the trade balance and tensions from the excessively intensive and inefficient use of resources in the economy, which brought along an increase in their prices.

Demand for consumer and investment goods decreased rapidly as the uncertainty that started to appear at the peak of the boom continued to increase. The global financial crisis that started in

[11] Potential GDP –maximum GDP level using existing production inputs (labour, capital, productivity/skills) without causing excessive price pressures. Potential economic growth –change in potential GDP level over time. Depends on changes in production inputs.

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

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

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 contract by up to one third. As a result of this, Estonia's negative output gap increased to 11% of GDP in 2009. When the economic cycle turned and after rapid growth in 2011, the negative output gap has been closing rapidly; according to the Ministry of Finance, it was about 1% of potential GDP in 2014. According to this forecast, a slightly negative output gap will remain for the next couple of years and will close in 2017.

As the global 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[14] of the cyclically adjusted position of Estonia's general government budget found on the basis of the output gap indicate that the fiscal policy of Estonia will be countercyclical in 2015 and in 2018–2019. The fiscal policy of Estonia became stricter in 2014 in the conditions of a GDP level below the potential level, and the same will occur in 2016 as well. The year 2017 will also be procylical as the fiscal policy will become more lenient when the GDP level being higher than the potential level. 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 an extra stimulation to economic activities during an economic recess and is countercyclical in its nature.

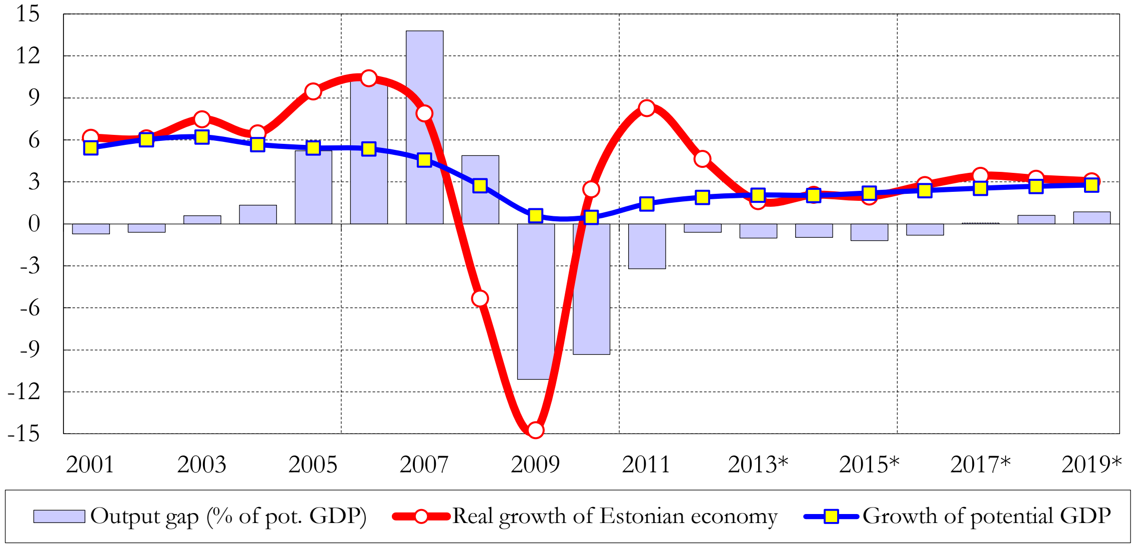
Table 13. Cyclically adjusted budgetary position, 2014–2019 (% of GDP)

	2003–2013	2014	2015*	2016*	2017*	2018*	2019*
1. Real GDP growth (%)	3.5	2.1	2.0	2.8	3.4	3.2	3.0
2. Budgetary position of the general government	-	0.6	-0.6	-0.1	-0.1	0.4	0.9
3. Interest payments	-	0.1	0.1	0.1	0.1	0.1	0.1
4. Potential real GDP growth (%)	3.3	2.0	2.2	2.4	2.5	2.7	2.8
4.a Contribution of capital to potential growth (%)	2.5	1.4	1.4	1.4	1.4	1.4	1.5
4.b Contribution of labour to potential growth (%)	0.4	0	0	-0.1	-0.2	-0.3	-0.4
4.c Contribution of productivity to potential growth (%)	0.6	0.6	0.9	1.1	1.3	1.4	1.5
5. Output gap	1.0	-1.0	-1.2	-0.8	0.1	0.6	0.9
6. Cyclical budget component	-	-0.4	-0.5	-0.4	0	0.3	0.4
7. Cyclically adjusted budgetary position (7)=(2)-(6)	-	1.0	-0.1	0.3	-0.1	0.2	0.6
8. Cyclically adjusted primary position (8)=(7)+(3)	-	1.2	0	0.4	0	0.3	0.8
9. Fiscal policy position	-	Pro-cyc.	Coun-tercyc.	Pro-cyc.	Pro-cyc.	Coun-tercyc.	Coun-tercyc.

Source: Ministry of Finance, Statistics Estonia.

[14] According to the methodology renewed by the European Commission in 2014, the semi-elasticity applied to compute the cyclical component of the budget balance was 0.44 in the case of Estonia (see also http://ec.europa.eu/economy_finance/publications/economic_paper/2014/ecp536_en.htm).

Figure 12. Development of potential GDP and output 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 factors, which may distort the budgetary position, from the nominal position. Measures that have a significant impact on the budget but only a temporary and non-recurring significant impact on the cyclically adjusted budgetary position (on the scale of at least 0.1% of GDP) are called one-off and temporary measures. Although general principles have been defined for classifying the impact of a measure as temporary, the consideration of each specific case is decided separately.

The Government's objective is to achieve a structural surplus of 0.6% of GDP in 2016, 0.2% of GDP in 2017-2018 and 0.6% of GDP in 2019.

Suspension of funded pension payments in 2009–2011 and a higher contribution rate 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 of funded pension contributions and a higher contribution rate in comparison with the previous year are stated in Table 15.

Table 14. Percentages of funded pension contributions, 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 15. Additional pension expenditure, 2011–2018 (% of GDP)

	2011	2012	2013	2014*	2015*	2016*	2017*	2018*
Added (incremental) pension expenditure	-0.4	-0.5	-0.1	-0.3	-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 the 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-owned 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 16. One-off measures and their impact, 2014–2019 (million EUR)

	2014	2015*	2016*	2017*	2018*	2019*
Revenue from sales of AAUs	-29	-58	-11			
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)	33					
Second pension pillar contributions, 2+6 and 3+6	-51	-56	-61	-66	0	0
Total, m EUR	**-46**	**-114**	**-72**	**-66**	**0**	**0**
Total, % of GDP	**-0.2**	**-0.6**	**-0.3**	**-0.3**	**0.0**	**0.0**

Source: Ministry of Finance.

Table 17. Structurally adjusted budgetary position, 2014–2019 (% of GDP)

	2014	2015*	2016*	2017*	2018*	2019*
1. Cyclically adjusted budgetary position	1.0	-0.1	0.3	-0.1	0.2	0.6
2. One-off measures	-0.2	-0.6	-0.3	-0.3	0.0	0.0
3. Structurally adjusted budgetary position (3)=(1)-(2)	1.3	0.5	0.6	0.2	0.2	0.6

Source: Ministry of Finance, Statistics Estonia.

3.3. General government revenue and expenditure

Table 18. government revenue and expenditure, 2014–2019

	2014	2014	2015*	2016*	2017*	2018*	2019*
	million EUR	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Budgetary positions by general government levels							
1. General government	121.3	0.6	-0.6	-0.1	-0.1	0.4	1.0
2. Central government	63.6	0.3	-0.6	-0.1	0.1	0.4	1.0
4. Local governments	-4.5	0.0	-0.2	-0.2	-0.4	-0.1	-0.2
5. Social security funds	62.2	0.3	0.2	0.2	0.2	0.2	0.2
General government							
6. Total revenue	7 665.7	39.3	41.1	40.1	40.4	39.6	39.2
7. Total expenditure	7 544.4	38.6	41.7	40.2	40.5	39.2	38.2
8. Budgetary position	121.3	0.6	-0.6	-0.1	-0.1	0.4	1.0
9. Interest	22.2	0.1	0.1	0.1	0.1	0.1	0.1
10. Primary balance	143.5	0.7	-0.5	0.0	0.0	0.5	1.1
11. One-off and temporary measures	-46.2	-0.2	-0.6	-0.3	-0.3	0.0	0.0
Revenue by components							
12. Tax revenue (12=12a+12b+12c)	4 209.3	21.6	21.7	22.0	22.1	22.1	22.2
12a. Taxes on production and imports	2 730.7	14.0	14.4	14.9	14.9	15.0	15.1
12b. Taxes on income and wealth	1 478.6	7.6	7.3	7.1	7.1	7.1	7.1
12c. Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13. Social security contributions	2 213.8	11.3	11.4	11.3	11.1	11.2	11.2
14. Property income	253.7	1.3	1.3	1.1	1.1	1.0	0.8
15. Other revenue	988.9	5.1	6.8	5.7	6.2	5.3	4.9
16.=6. Total revenue	7 665.7	39.3	41.1	40.1	40.4	39.6	39.2
p.m.: Tax burden (D.2 (incl. taxes to the EU)+D.5+D.611+D.91-D.995)	6 417.3	32.9	33.0	33.3	33.1	33.2	33.4
Expenditure by components							
17. Compensation of employees + intermediate consumption	3 472.8	17.8	18.1	17.9	17.4	17.0	16.7
17a. Compensation of employees	2 160.2	11.1	11.2	11.0	10.6	10.3	10.1
17b. Intermediate consumption	1 312.6	6.7	6.9	6.9	6.8	6.7	6.7
18. Social transfers (18=18a+18b)	2 465.7	12.6	13.1	13.1	13.5	13.7	13.6
of this, unemployment benefits	65.7	0.3	0.3	0.3	0.3	0.2	0.2
18a. Social transfers in kind	348.8	1.8	1.8	1.8	1.8	1.8	1.8
18b. Social transfers other than in kind	2 116.9	10.8	11.3	11.3	11.7	11.9	11.8
19.=9. Interest	22.2	0.1	0.1	0.1	0.1	0.1	0.1
20. Subsidies	86.5	0.4	0.4	0.4	0.4	0.4	0.4
21. Gross fixed capital formation	991.4	5.1	6.1	5.7	5.9	5.0	4.5
22. Capital transfers	152.0	0.8	0.8	0.8	0.8	0.8	0.8
23. Other expenditure	353.8	1.8	3.1	2.0	2.4	2.2	1.9
24.=7. Total expenditure	7 544.4	38.6	41.7	40.2	40.5	39.2	38.2
p.m. General government consumption	3 823.9	19.6	19.9	19.9	19.8	19.6	19.6

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

Table 19. Impact of fiscal policy decisions on general government revenue and expenditure

	2014	2014	2015*	2016*	2017*	2018*	2019*
	million EUR	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
General government revenue forecast	7 665.7	39.3	41.1	40.1	40.4	39.6	39.2
Revenue policy measures				0.6	0.6	0.6	0.5
General government expenditure forecast	7 544.7	38.6	41.6	40.2	40.5	39.2	38.2

Source: Ministry of Finance, Statistics Estonia.

Table 20 includes the revenue and expenditure forecast by the Ministry of Finance for spring 2015 and Table 19 includes the scope of the revenue policy measures required for the achievement of the objectives given in the Stability Programme.

Table 20. Revenue and expenditure according to the Ministry of Finance forecast of spring 2015, without budgetary policy decisions

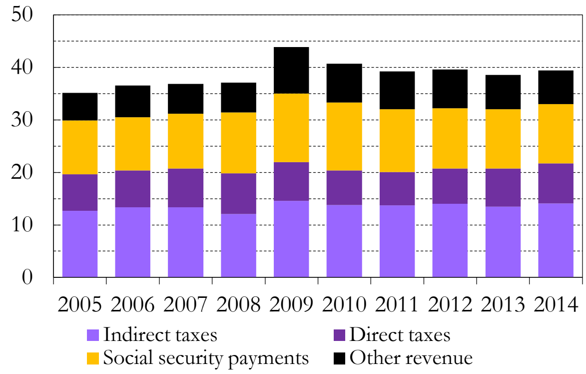
	2014	2014	2015*	2016*	2017*	2018*	2019*
	million EUR	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
General government revenue forecast	7 665.7	39.3	41.0	39.5	39.9	39.0	38.7
General government expenditure forecast	7 539.2	38.6	41.5	40.1	40.3	38.9	38.0

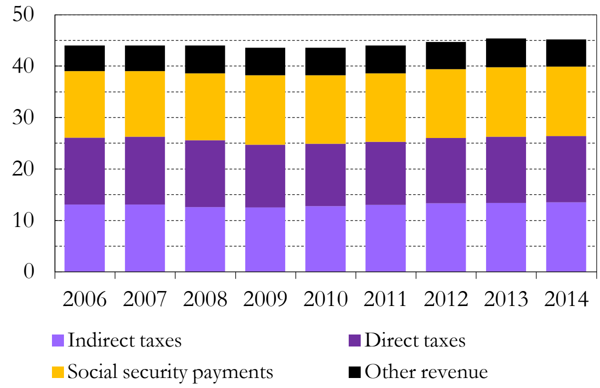
Source: Ministry of Finance, Statistics Estonia.

3.3.1. Structure of general government revenue

In 2014, general government revenue increased the most as a result of an increase in direct taxes, which occurred mainly due to an increase in the receipts of personal income tax – income tax returns on mortgage interest decreased. Indirect taxes also grew faster than average, primarily value added tax (frauds decreased as a result of implementing an addendum to the value added tax declaration) and alcohol excise (due to an increase in excise rates). The share of social security payments in GDP remained the same (technically, receipts decreased due to a higher rate of funded pension contributions (2+6 and 3+6 contributions)). Other revenue grew by a modest amount (external support decreased); in summary, the ratio of revenue to GDP increased by 0.8%.

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





Source: Eurostat, Statistics Estonia

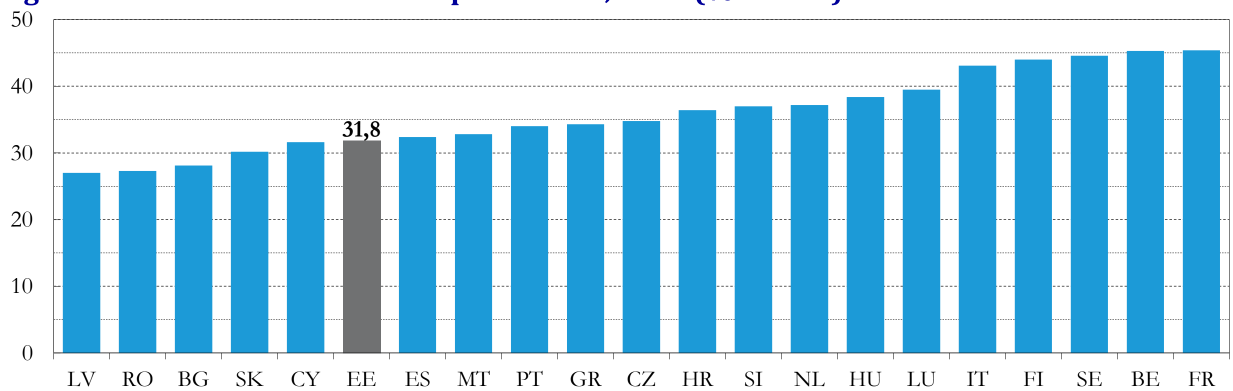
3.3.2. Future development in tax policy and the tax burden

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 maintain the tax burden at the 2014 level (about 33% of GDP**) by reducing labour taxes.**

According to Eurostat, the tax burden in Estonia in 2013 was 31.8% of GDP, which is one of the lowest among all EU Member States (see Figure 14). Compared with Central and East European countries, Czech Republic, Croatia, Slovenia and Hungary have a higher tax burden than Estonia.

Figure 14. Tax burden in the European Union, 2013 (% of GDP)



Source: Eurostat.

The tax burden of 2014 will be 32.9% of GDP (see Figure 15A). This year's tax burden is increased by administrative measures. The receipt of labour taxes was positively influenced by the implementation of employee's registry since 1 July. At the end of 2014, the obligation for companies to present the Tax and Customs Board with invoice data (KMD INF) and the 50%

limitation of input value added tax deduction on company-owned passenger cars entered into force. Due to transitioning to the ESA2010 accounting rules, the accounting of tax burden was supplemented by AAU sales revenue, which will have an impact starting with the year 2014.

In the period of 2015–2019, the tax burden will decrease due to a reduction of the income tax rate and the unemployment insurance contribution rate, an increase of the basic tax-free allowance and a reduction of the social security contribution rate. 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 packaging excise and from the establishment of a road use fee for heavy vehicles. The planned measures are described in more detail below. In summary, the tax burden will remain at a level comparable to the year 2014, reaching 33.4% of GDP by 2019.

Honest tax environment – equal competition and treatment

In the previous year, the Government adopted two changes in VAT , with a view to increase the fairness of the tax system. Restriction of VAT deductibility on company-owned passenger cars is intended to tax private consumption done through a company. This measure restricts the VAT deductibility on company-owned passenger cars and related expenditure to one half, unless the passenger car is used for business only. The relevant Act entered into force on 1 December 2014.

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 relevant Act entered into force on 1 November 2014. The combined effect of those two measures on receipts of VAT in the next four years will be approximately 100 m EUR per year.

Starting with the year 2016, the taxation of rental revenue will be tidied.

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 2016, the additional tax-free allowance from children of 1,848 EUR per year will be fixed at that level, deductible training expenses will be restricted and the upper limit of deduction will be reduced from 1,920 EUR to 1,200 EUR.

Starting with 1 January 2017, the VAT rate of accommodation services and of accommodation and breakfast services will be increased from 9% to 14%. The reduction of inefficient tax incentives is directed towards ensuring equal treatment of taxpayers and the neutrality of the tax system.

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

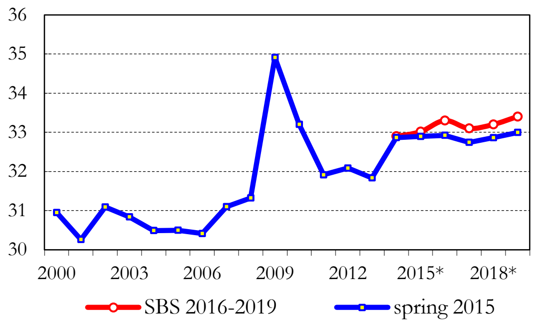
The tax burden on labour will be reduced by a reduction of the income tax rate and the unemployment insurance contribution rate starting with 1 January 2015, an increase of the basic tax-free allowance to 2,460 EUR (205 EUR per month) by 2019 and an increase of the pensioners additional tax-free allowance so as to make the average pension untaxed. The tax burden on labour will also be significantly reduced by lowering the social security contribution rate to 32.5% starting with 1 January 2017 and to 32% starting with 1 January 2018.

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 2020 (incl. wines over 6% by 20% in 2019 and 2020). 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 8% per annum starting with 1 June 2016 and going until 2018, and then by 10% per annum until 2020. 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 access to tobacco products becoming easier. The rates of both excise goods will increase more than the expected overall price growth, so as to increase tax revenue and restrict consumption.

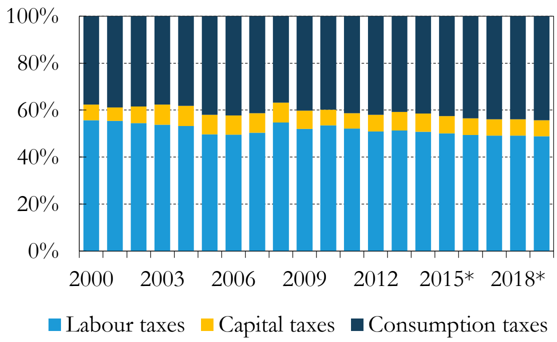
Environmental taxes will be raised by increasing the excise duty on natural gas. The Government plans to increase the excise duty on natural gas as a fossil fuel in 2018 and 2019, by 60% and 39% respectively. Also, the excise duty on diesel fuel will be increased by 14% and the excise duty on petrol fuel will be increased by 10% starting with 1 February 2016; both excise duties will also be increased by 10% in 2017–2018. Wishing to ensure equal taxation of the two most common motor fuels (diesel fuel and petrol fuel) and taking into account the energy content of those fuels, the excise duty on diesel fuel will be increased more in 2016.

Figure 15. Development of tax burden in Estonia

A. Tax burden



B. Tax revenue *(%)*



Sources: Ministry of Finance, Eurostat

Compared to 2015, the share of **labour taxes**[15] in total tax receipts will decrease from 50.2% to 48.9%, the share of **capital taxes**[16] will decrease from 7.3% to 6.8% and the share of **consumption taxes**[17] will increase from 42.6% to 44.3% **by 2019** (see Figure 31B).

[15] Pursuant to the ESA2010 methodology, labour taxes include: social security payments, natural person income tax on wage income, natural person income tax on social transfers and pensions, natural person income tax on business activities.

[16] Pursuant to the ESA2010 methodology, capital taxes 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.

Environmental taxes[18], being part of taxes on consumption, will make up 8.4% of all taxes in 2015, exceeding the European Union average (6.2% in 2011). The share of environmental taxes will increase to 9.6% **by 2019**, due to increased fuel excise duties, increased AAU sales revenue and the establishment of the road use fee.

Table 21. Main changes in the tax policy in 2016[19]

Changes in taxes	Entry into force	Impact 2016	
		million EUR	*% of GDP*
1. Additional increase of excise duty on alcohol by 5%	1. Feb 2016	22.0	0.10
2. Additional increase of excise duty on tobacco by 3%	1. Jun 2016	24.0	0.11
3. Increase of excise duty on diesel fuel by 14%	1. Feb 2016	43.0	0.20
4. Increase of excise duty on other motor fuels by 10%	1. Feb 2016	18.0	0.08
5. Equalising the excise duties on other fuels	1. Feb 2016	4.0	0.02
6. Increasing the basic tax-free allowance to EUR 2,040 per year	1. Jan 2016	26.0	0.12

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 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 maintain the implicit tax rate on labour at the level of 2015 (about 33%).

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 contribution rate was increased and the state's contributions into the mandatory funded pension were suspended, therefore the implicit tax rate increased. In 2012 the implicit tax rate on labour was 35.0%, placing us at the 13th place in the European Union. Resuming the state's contributions into funded pension (2012) and decreasing the unemployment insurance contribution rate (2013, 2015), reducing the income tax rate (2015) and raising the basic tax-free allowance (2015) will reduce this indicator to 33.0% by 2015. Higher contributions to funded pension (2+6 and 3+6 contributions) will influence the indicator in the period of 2014–2017. The implicit tax rate on labour will reach 33.1% by 2019. At the same time, the implicit tax rate on consumption will increase to 28.1% due to increasing excise duties.

[17] Pursuant to the ESA2010 methodology, consumption taxes include: value-added tax, customs duties, excise duties, motor vehicle registration fee, sales tax, pollution fees, fee for fishing right, boat tax, AAU sales revenue.

[18] Environmental taxes are those levied on energy (fuel and electricity excise duties, AAU sales revenue), 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).

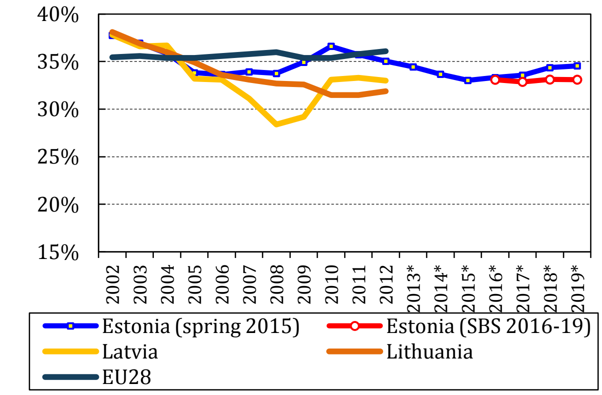
[19] Accrual-based impact compared with the situation where the rates/situation provided for in the law at the time of the Ministry of Finance's spring forecast of 2015 still apply.

Labour tax wedge is the difference between an employer's labour costs and an employee's net income, including monetary allowances (child allowance, needs-based family benefit, low-wage allowance). Different family types may have significantly different tax wedges – e.g. for a married couple with two children where one parent earns 100% of the average wage, the tax wedge is much more dependent on the basic tax-free allowance (additional for the stay-at-home spouse and the second child) than for someone living single. Pursuant to the OECD methodology, parental benefit is not accounted into this. An excessively high tax wedge may reduce incentives to work and thus have a negative impact on labour market developments.

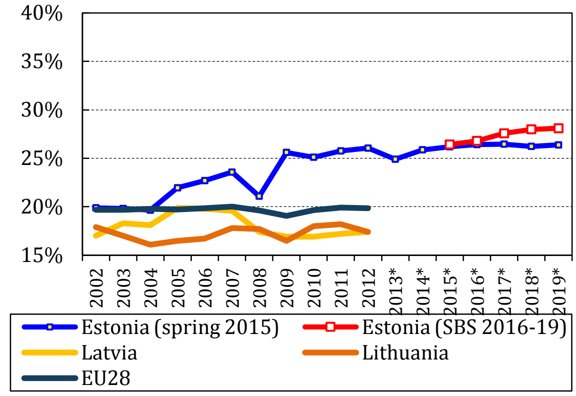
By 2019, the social security contribution rate will be reduced to 32%, the basic tax-free allowance will be increased to 205 EUR per month, the child allowance for the first and the second child will be increased to 60 EUR per month and the low-wage allowance will be implemented. These changes will reduce the tax wedge by an average of 1.0% for a single person (see Figure 32C) and by an average of 3.2% for families (see Figure 32D). For both family types, the tax wedge will decrease the more, the lower the income is. It has been found for Estonia that the positive effect of an increase of basic tax-free allowance on labour supply is higher than the effect of reducing the income tax rate[20]. International organisations (IMF and OECD) also recommend Estonia to reduce its low-income tax wedge.

Figure 16. Implicit tax rate (%of tax base) and tax wedge (% of labour expenditure)

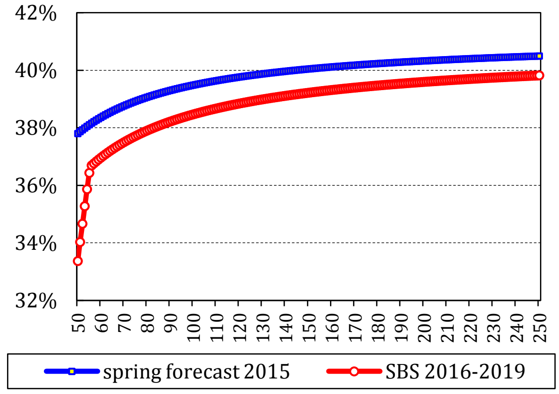
A. Implicit tax rate on labour



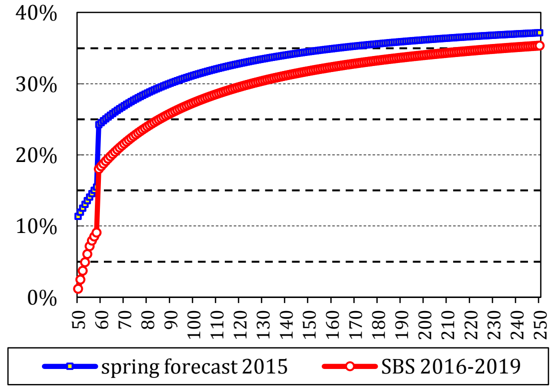
B. Implicit tax rate on consumption



C. Tax wedge, single person without children, earns 50–250% of average wage, 2019



D. Tax wedge, married couple, 2 children, one parent earns 50–250% of average wage. 2019



** According to the Ministry of Finance's spring forecast, the gross average worker wage in 2019 will be 16,404 EUR per year. The income threshold for needs-based family benefit in 2019 is considered as 9,575 EUR per year and the absolute poverty line as 3,180 EUR per year.*
Sources: Taxation trends in the European Union (2014), Ministry of Finance.

[20] K. Staehr (2008) Estimates of employment and welfare effects of labour income taxation in a flat-tax country: the case of Estonia, Bank of Estonia, Working Paper No 3/2008.

3.3.3. Tax expenditure

The tax expenditure contained in the state budget of Estonia for 2015–2016 are described below. The value of the 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 the 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 budgetary 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 amount 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 the tax expenditure by adding up different provisions is incorrect, but it enables 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[21] (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[22] (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. In the case of the ITA it is assumed that the tax-exempt income to be subtracted from a resident natural person's income earned in the taxation period that is established pursuant to 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[23] (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 2015 and 2016 is influenced by 20 different tax expenditure provisions in the Value Added Tax Act, the Income Tax Act and the Alcohol, Tobacco, Fuel and Electricity Excise Duty Act. The total scope of the main tax expenditure in 2015 comprises 346.0 million EUR or 1.7% of GDP. Additional basic exemption for pensions, lower VAT rates for medicines and medical devices, and more favourable rate of excise duty on diesel fuel for

[21] The Value Added Tax Act, Estonian version, https://www.riigiteataja.ee/akt/125102012017.

[22] The Income Tax Act, Estonian version, https://www.riigiteataja.ee/akt/129122012031.

[23] The Alcohol, Tobacco, Fuel and Electricity Excise Duty Act, Estonian version, https://www.riigiteataja.ee/akt/120122012004.

specific purposes 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 2015. In 2016, tax expenditure will decrease by 2.0% to 339.2 million EUR. This is due to abolishing the fiscal marking of fuel (except agriculture).

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 16 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 2015–2016**. The government functions that form the biggest share in 2015 are social protection (192.4 million EUR or about 56% of tax expenditure), economic affairs (46.0 million EUR or 13%) and healthcare (47.9 million EUR or 14%). The tax expenditure that falls into the remaining government functions comprises 59.7 million EUR or 17% 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 78 million EUR in 2015, which is 4% of the total VAT received. The relevant tax expenditure (items 4–12 in the table) comprises 222 million EUR or 71% 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 43 million EUR or 6% of excise duties received.

Table 22. Tax expenditure in state budget, 2015–2016[24] (million EUR)

Tax expenditure	Provision	Government function[25]	2015	2016
1. 9% VAT on books, workbooks and periodicals	VATA, § 15 (2) 1) and 3)	9	9.8	10.2
2. 9% VAT on medicines and medical devices	VATA, § 15 (2) 2)	7	47.9	50.2
3. 9% VAT on accommodation services	VATA, § 15 (2) 4)	8	20.2	21.2
4. Untaxed deposit interests	ITA, § 17 (2)	10	2.5	2.6
4. Additional tax-free allowance from the second child	ITA, § 23^1	10	25.8	26.3
6. Additoional tax-free allowance of pensioners	ITA, § 23^2	10	159.7	163.5
7. Additional tax-free allowance in case of benefit for accident at work or occupational disease	ITA, § 23^3	10	0.2	0.2
8. Deduction of housing loan interests	ITA, § 25	6	12.2	10.3
9. Deduction of educational expenses	ITA, § 26	9	14.2	12.0
10. Deduction of gifts and donations	ITA, § 27 (1)	8	0.8	0.8
11. Deduction of insurance premiums and acquisition of pension fund units	ITA, § 28	10	6.7	6.7
12. Additional tax-free allowanceof self-employed persons upon sale of agricultural produce or timber	ITA, § 32 (4)	4	2.6	2.4
13. 50% excise duty rate for independent small breweries	ATFEEDA, § 46 (1)	4	0.2	0.2
14. Lower excise duty rate on diesel fuel for specific purposes in agriculture	ATFEEDA, § 66 (7)	4	34.0	23.0
15. Exemption of fishermen from fuel excise duty	ATFEEDA, § 27 (1) 22^2)	4	1.2	1.3
16. Electricity used for chemical reduction and in electrolytic, metallurgic and mineralogical processes	ATFEEDA, § 27 (1) 24), 28^4)	4	0.7	0.7
17. Electricity and fuel used to produce electricity and electricity used to maintain the ability to produce electricity	ATFEEDA, § 27 (1) 28^2)	4	6.8	6.8
18. Fuel used for mineralogical processes	ATFEEDA, § 27 (1) 28^2)	4	0.6	0.6
19. Natural gas used for the purpose of operating the natural gas network	ATFEEDA, § 27 (1) 28^6)	4	0.05	0.05
TOTAL			346.0	339.2

Source: Ministry of Finance.

3.3.3. Structure of general government expenditure[26]

While general government expenditure comprised 34.9% of GDP on average in the period 2000-2007, its share increased to 39.8% of GDP of GDP in 2008 and the growth continued, reaching 45.7% of GDP in 2009. The share of general government expenditure dropped to 38.6% of GDP in 2014.

The final consumption expenditure of general government comprised about 54% of general government expenditure in 2000-2005, and dropped to the level of 48% 2006–2009 in the period of 2006–2009; its proportion in all expenditure has increased to 50.7% by 2014. The final

[24] Tax expenditure assessments have only been calculated for the provisions that are included in tax regulations as of January 1, 2015.

[25] 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.

[26] 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.

consumption expenditure of general government includes public consumption and individual consumption expenditure. Individual and social goods and services are differentiated in the case of goods and services offered by general government, based on 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 expenditures. In the case of general government, individual consumption expenditure equals non-monetary social transfers.

Social benefits comprise the second largest part of general government expenditure. The largest types of expenditure among social expenditure 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 benefits in 2000-2007 comprised 8.9% of GDP on average. Its share increased to 13.7% of GDP by 2009, starting to decrease thereafter and reaching the level of 10.8% by 2014.

1.1% of general government expenditure, i.e. 0.4% of GDP, was used for the payment of subsidies in 2014. 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.

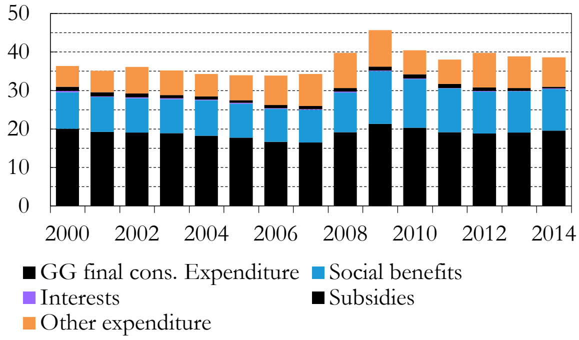
Interest expenses account for the smallest share – in 2014, they amounted to just 0.3% of all general government expenditure, i.e. they comprised 0.1% of GDP. The low level of interest expenses is the result of Estonia's light debt burden.

The share of other expenditures decreased to 19.8% in 2014.

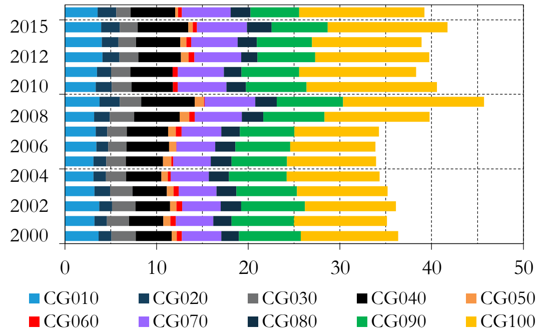
By economic activity the largest expenditure is on social protection. These expenditures accounted for 9.9% of GDP on average in the period 2000-2007. Their share increased to 15.4% of GDP by 2009 when the unemployment insurance benefit and unemployment benefit expenses increased considerably as a result of the deterioration of the situation in the labour market, in which the pension increase also played a role. By 2014, 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 28.3% on average in 2000–2008 to 32.7% in 2014.

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

A. Expenditure by economic content in Estonia



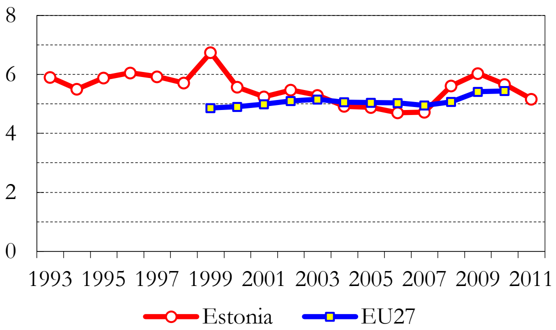
B. Expenditure by government function in EE[27]



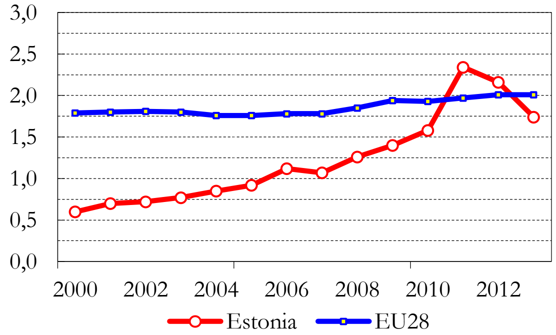
Sources: Statistics Estonia, Ministry of Finance.

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

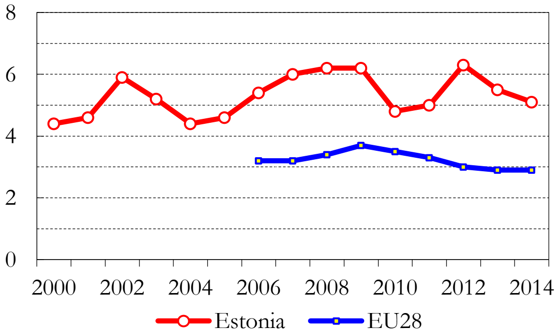
A. Public expenditure on education



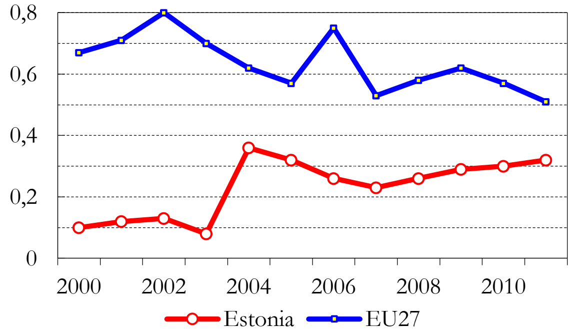
B. Research and development expenditure



C. General government investments in fixed assets



D. State aid



Source: Eurostat.

[27] 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 23. General government expenditure by government functions (COFOG) (% of GDP)

	COFOG code	2011	2012	2013	2015*	2018*
1. General public services	1	3.5	4.1	4.0	4.0	3.6
2. Defence	2	1.5	1.8	1.8	2.0	2.0
3. Public order and safety	3	2.1	2.1	1.9	2.0	1.6
4. Economic affairs	4	4.6	4.7	4.8	5.5	4.8
5. Environmental protection	5	-0.3	0.8	0.7	0.5	0.3
6. Housing and utilities	6	0.5	0.6	0.5	0.4	0.4
7. Healthcare	7	5.0	5.1	5.1	5.5	5.3
8. Recreation, culture and religion	8	1.9	1.8	2.1	2.7	2.2
9. Education	9	6.3	6.3	6.0	6.1	5.3
10. Social protection	10	12.7	12.4	12.0	13.1	13.7
11. Total general government expenditure	TE	38.0	39.7	38.9	41.7	39.2

Sources: Ministry of Finance, Statistics Estonia.

The general government expenditure of 2015 will increase by 3.1% to 41.7% of GDP, due to it being the last year of using previous EU programming period's funds. In the period of 2016–2018, the expenditure will increase on average 3.9% per annum and the general government expenditure will decrease to 39.2% of GDP. As a percentage of GDP, expenditure on general public services and economic affairs will decrease the most.

Amounts to be excluded from the expenditure benchmark

Table 24. Amounts to be excluded from the expenditure benchmark

	2014	2014	2015*	2016*	2017*	2018*	2019*
	Million EUR	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*
1. Expenditure on EU programmes fully matched by EU funds revenue	792.5	4.1	5.1	3.9	4.4	3.9	3.5
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***	20.1	0.1	0.0	0.6	0.3	0.1	-0.1
4. General government revenue increases mandated by law	0.0	0.0	0.0	0.0	0.0	0.0	0.0

** 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 additional basic exemption of pensions; increase in excise duties and abolishment of lower fuel excise duty; decrease in unemployment insurance payment rate; changes in the value added tax system; income tax on dividends; wage increase in state budget; revenue from CO2 quota sales; taxation of ARIB support; increase in state fees; reverse taxation of precious metals and precious stones; changes in gambling tax; taxation of e-cigarettes; changes in packaging excise duty; more precise taxation of rental revenue; increase in value added tax on accommodation services; increase in penalties; disengaging the additional basic exemption for the second; reduction in social security contribution rate; restriction of training expenditure deduction; reduction of the upper limit of income tax deduction.*
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's 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 2014 amounted to 10.6% of GDP, which is 0.5% more than in 2013. The main reasons for the government debt increasing were increases of the debt burden of other central government agencies (foundations and agencies governed by public law) and the debt burden of local governments. The volume of loans issued by the European Financial Stability Facility (EFSF)[28] increased a little. The central government debt (including the funds received from EFSF) comprised 1,316 million EUR[29] and the debt of local governments 757 million EUR of the total general government debt of 2,073 million EUR; the share of external debt in total debt was 66% (see Table 25). Without the funds of EFSF, which amounted to 485 million EUR in 2014, the central government debt was 831 million EUR or 4.3% of GDP.

Table 25. Change in general government debt burden in 2014

	31 December 2013		31 December 2014		Change
	m EUR	% of GDP	m EUR	m EUR	% of GDP
General government	1,887.5	10.1	2,072.5	10.6	0.5
Domestic debt	639.2	3.4	697.4	3.6	0.2
External debt	1,248.3	6.7	1,375.1	7.0	0.4
Central government[30]	1,311.0	7.0	1,420.0	7.3	0.3
Domestic debt	216.3	1.2	228.3	1.2	0.0
External debt	1,094.7	5.8	1,191.7	6.1	0.3
Local governments	678.5	3.6	756.8	3.9	0.3
Domestic debt	524.9	2.8	573.4	2.9	0.1
External debt	153.6	0.8	183.4	0.9	0.1
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

Source: Ministry of Finance, Statistics Estonia.

The general government debt can be expected to decrease to 10.3% of GDP in 2015 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 2014. According to the forecast, general government debt will keep decreasing in the coming years and will comprise 8.4% of GDP by the end of the forecast period (see Table 26). 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 3.9% as percentage of GDP.

28 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.

29 Consolidated figure on the level of the general government.

30 Consolidated figure on the level of the central government.

Table 26. General government debt burden, 2014–2019 (% of GDP)

	2014	2015*	2016*	2017*	2018*	2019*
1. Total debt	**10.6**	**10.3**	**9.9**	**9.6**	**8.9**	**8.4**
2. Change in debt burden	0.5	-0.3	-0.4	-0.4	-0.7	-0.6
Contribution to change in debt burden: (2=3-4+5+6)[31]						
3. Contribution of nominal GDP increase	-0.4	-0.4	-0.5	-0.6	-0.6	-0.5
4. Primary budgetary balance	0.7	-0.5	0.0	0.0	0.5	1.1
5. Interest payments	0.1	0.1	0.1	0.1	0.1	0.1
6. Difference between the change of debt burden and the budgetary position (stock-flow adjustment, SFA)	1.6	-0.5	0.0	0.1	0.3	1.0
Estimated interest rate of general government debt (%)	1.2	1.0	1.0	1.2	1.2	1.3
Other relevant indicators						
7. Liquid financial assets	10.4	9.3	8.9	8.6	8.1	8.0
8. Debt amortisation since the end of last year[32]	0.1	0.1	0.1	0.2	0.3	0.2
9. Net debt (9=1-7)	0.2	1.0	1.0	1.0	0.8	0.4
10. Share of debt nominated in foreign currency (%)	0	0	0	0	0	0
11. Average expiration limit[33] (in years)	6.0	5.2	4.3	3.6	3.1	2.7

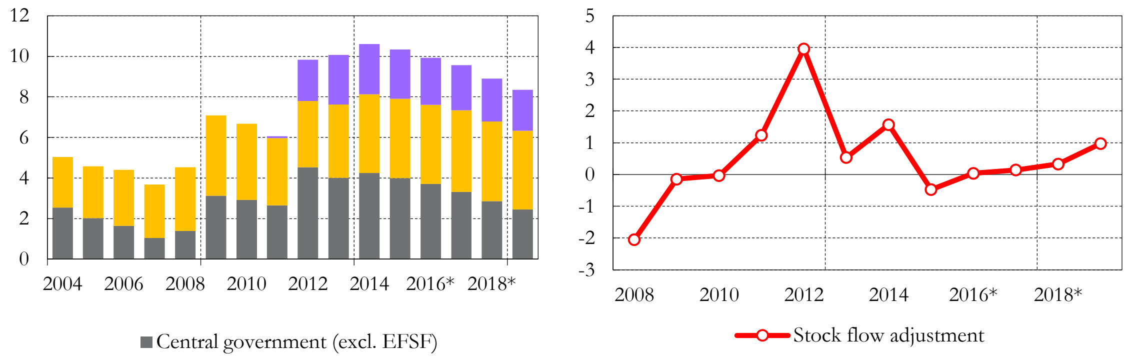
Source: Ministry of Finance, Statistics Estonia.

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 the difference between the change of debt burden and the budgetary position (in English also called "stock-flow adjustment", SFA for short). In 2014, Estonia's SFA was 306.4 m EUR or 1.6% of GDP (see Figure 19B), which means that the debt burden increased (185 m EUR) and the budgetary position was also in a surplus (121 m eur), meaning that the surplus was used not for debt reduction but for increase of reserves instead. According to the forecast, the SFA will be negative this year, 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 2016–2019. In 2016–2017 it will be caused by the debt increasing more than by the amount of general government deficit (due to increase of loan repayments which are not reflected in budget's expenditure), and in 2018–2019 by the debt burden decreasing less than by the surplus (according to the forecast, the surplus will be used not for reducing debt, but for increasing reserves).

Figure 19. Development of debt burden, 2004–2019

A. General government debt (% of GDP)

B. Difference between the change of debt burden and the budgetary position (% of GDP)

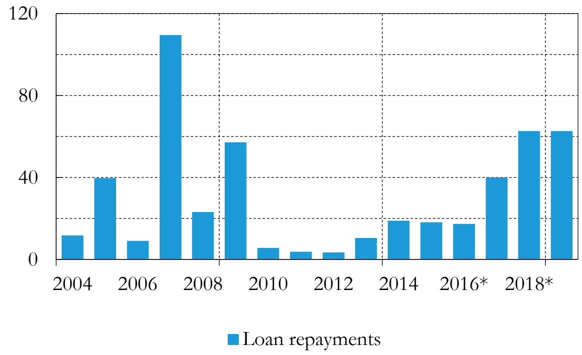


[31] In some years the equation does not work, due to rounding.

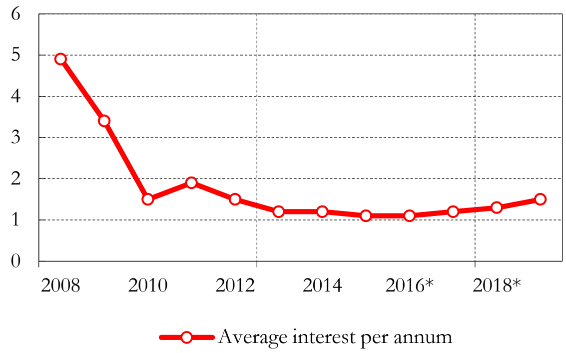
[32] Central government without foundations and legal persons governed by public law.

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

C. Repayment of central government[34] debt (m EUR)



D. Average interest rate of central government35 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[36] as of the end of 2014 was 2,039 million EUR or 10.4% of GDP. Compared to last year, the reserves of central government, social security funds and local governments all increased. This year, the need to fund the state budget's deficit and financing transactions will cause a gradual reduction of the reserves. Starting with the following year, the reserves are expected to gradually increase. Yet, the growth of reserves will remain below the nominal GDP growth, so the general government's liquid assets will decrease to 8% by the end of 2019.

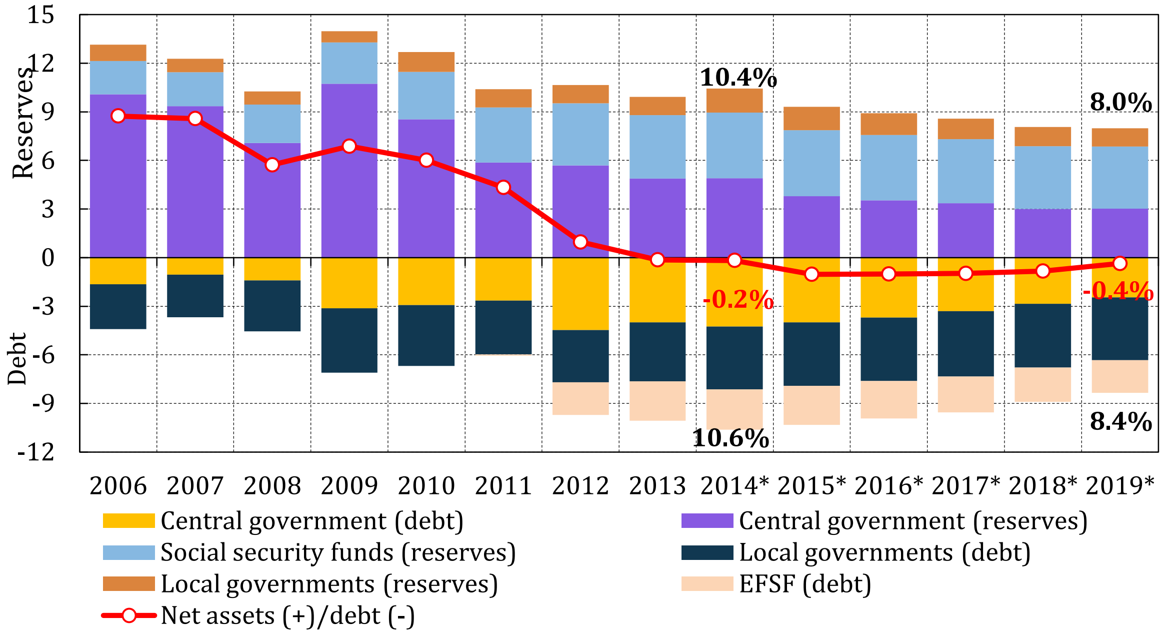
The general government debt burden in 2014 exceeded somewhat the volume of reserves and the net debt amount was 0.2% of GDP (see Figure 20). According to the forecast, both the debt burden and the reserves will decrease in the coming years, but reserves will decrease more and in 2015–2017 the net debt amount will remain at the level of 1.0% of GDP. Thereafter the net debt will start decreasing and is forecast to amount to 0.4% of GDP at the end of 2019. 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 1.6% of GDP.

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

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

[36] 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, 2006–2019 (% of GDP)



Source: Ministry of Finance, Statistics Estonia.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS PROGRAMME

4.1. Possible positive developments

Future developments of the Estonian economy may be more positive or negative compared to the baseline scenario. As the baseline scenario of the Ministry of Finance's forecast is relatively conservative compared to other forecasters, the additional scenario is more positive than the baseline scenario this time. Additional risk scenarios constitute only technical calculations based on agreed assumptions and their purpose is to assess the impact of possible deviations on the state budget.

Unlike previous forecasts, this time we base the additional risk scenario on a somewhat more positive external environment. Irrespective of the continued geopolitical risk, some institutions (e.g. European Central Bank) have revised their latest forecast upwards. Based on this, the decrease of energy prices and the weakening euro may support faster than expected recovery of economic growth in the eurozone. Assuming also that Estonian companies are flexible in finding new markets, the loss of Russian market has only a limited effect.

Thus, the forecast's risk scenario is based on a faster growth of export markets, supported by an increasing consumption activity by private consumers (resulting from the fall in energy prices). As a result, export growth will turn out quicker than in the baseline, entailing a positive effect on the investment courage of companies and on the labour market. Due to the somewhat lower oil price, consumer prices will not increase this year, that in turn favours the real growth of consumption expenditure. As a result of these factors, Estonia's GDP growth will increase to 2.5% in 2015 and 3.3% in 2016. According to the risk scenario, the nominal GDP volume will be 70 million EUR higher in 2015 and 180 million EUR higher in 2016 compared with the baseline.

Table 27. Positive risk scenario (%)

	Positive risk scenario				Difference from baseline		
	2014	**2015***	**2016***	**2017***	**2015***	**2016***	**2017***
Nominal GDP (billion EUR)	19.5	20.4	21.6	23.0	0.1	0.2	0.2
Real GDP growth	2.1	2.5	3.3	3.4	0.5	0.5	0.1
Nominal GDP growth	4.2	4.4	6.0	6.4	0.4	0.5	0.1
CPI	-0.1	0.0	2.1	2.8	-0.2	-0.1	0.1
Real growth of domestic demand	4.8	3.5	3.1	2.9	0.6	0.2	0.0
Real growth of export	2.6	3.5	4.8	5.3	0.7	0.8	0.1
Employment growth	0.6	1.0	-0.1	-0.3	0.3	0.2	0.2
Nominal wage growth	5.6	5.0	5.3	6.0	0.2	0.0	0.0
Unemployment rate	7.4	5.9	5.6	5.3	-0.1	-0.2	-0.2
External assumptions							
GDP increase of trade partners	1.3	1.2	1.9	2.1	0.2	0.2	0.1
General government							
Tax burden (% of GDP)	32.9	33.1	33.5	33.4	0.1	0.2	0.3
Budgetary position of general government (% of GDP)	0.6	-0.5	0.1	0.2	0.1	0.2	0.2
Debt burden of general government (% of GDP)	10.6	10.3	9.8	9.4	-0.1	-0.1	-0.2

Source: Ministry of Finance, Statistics Estonia.

The risk scenario's forecast of revenue and expenditure is based on the relevant macroeconomic forecast and foresees that the **general governments' budgetary position** will improve by up to 0.2% in 2015–2017. According to the risk scenario, this year's budgetary deficit will reach 0.5% of GDP. The position is improved first and foremost by an increase of tax revenue providing a positive impact at all levels of general government. The forecast increasing the most in the risk scenario is that of social security contribution receipts, which are related to both higher employment growth and an increase in forecast average wage. Yet, the reduction in deficit will be held back by an increase of state budget expenditure related to tax revenue (allocation to Estonian Health Insurance Fund, pension expenditure). Also, defence costs will grow as a result of an increased nominal GDP. The Unemployment Insurance Fund's surplus will be raised by growth of unemployment insurance payments and by decline in the amount of benefits, related to a lower unemployment rate when compared to the base scenario. The position of Estonian Health Insurance Fund will be influenced positively by increased health insurance revenue due to increasing revenue from social security contributions. The budgetary position of local governments will improve by the amount of increase of the forecast natural person income tax allocated to them. Increasing tax revenue will also increase the country's tax burden. The budgetary position of other central government is not so closely related to the economic environment, so no changes are expected there.

The budgetary position of local governments being more positive than in the base scenario will slow down the growth of debt burden of local governments in the risk scenario, causing the **general government's debt burden** to decrease by 0.2% of GDP. On the other hand, the improved forecast of the central government and the social security funds will increase their level of reserves to 0.2% and 0.1% of GDP, respectively. As a total effect of changes, the net debt burden will decrease by 0.1% to -0.9% of GDP this year, by 0.3% of GDP in the following year and by 0.5% of GDP in 2016.

4.2. Comparison with the forecast of Stability Programme 2014

In the spring 2014forecast, the Ministry of Finance expected the **economic growth** of 2014–2015 to be 2.0% and 3.5%, respectively. And a 3.6% economic growth was expected for 2015. In 2014, the GDP grew exactly by the forecast 2%, but the growth structure was somewhat different. Export growth (2.6%) was very similar to the forecast (2.4%), but an unexpected price fall in the second half of the year resulted in a 0.6 percentage points higher than expected growth of private consumption. The expected marginal growth of investments (0.7%) did not materialise (investments deceased by 2.8%), but it was technically compensated by a significant increase in inventories. As a result of a price decrease of energy products, the nominal GDP growth also remained 0.7 percentage points below the forecast of a year ago, but due to adjustments of statistical time series, the nominal GDP still turned out 200 million EUR higher. In the current forecast, the economic growth forecast for 2015 was reduced to 2% and nominal growth also remains significantly lower (4.0% vs. 6.9%). The adjustments are caused by more pessimistic development expectations of trade partners (in particular Russia and Finland) and the resulting deterioration of the growth outlook of Estonian companies, leading to downward corrections of the forecasts of export as well as import and domestic demand. Moreover, growth rates in the following years will remain lower because slow recovery from the financial crisis has probably had a permanent negative effect on economic growth potential in the medium term.

Inflation in 2014 turned out lower than in the previous Stability Programme, mainly due to external factors – the price decrease of commodities like oil and foodstuff prices on foreign markets turned out lower than expected. Moreover, the contribution of domestic factors turned out somewhat smaller as well. The inflation forecast for 2015 was cut as energy prices declined and the price increase of foodstuffs will be lower than expected. The oil price is at its lowest of the past several years; the price increase of foodstuffs is held back by low price level of foreign markets and by the effect of Russia's sanctions. Core inflation will be low due to the slowdown of price increase of services.

In the past year, **general government's budgetary position** turned out better than expected, thanks to improved tax receipts and lower investments. Expectations of the structural budgetary position of this year and the next year are higher as well, due to decisions approved by the Government of the Republic that improve the budgetary position. Nominal budgetary position of 2016 has also improved when compared to the previous Stability Programme, but general government will reach a nominal surplus one year later, i.e. in 2018, which means that the objective of restoring the reserve will be achieved more slowly than predicted in the previous programme.

In 2014, the **debt burden of general government** turned out higher by 0.8% of GDP than forecast in the Stability Programme 2014, mainly due to increase in debt burden of other central government (foundations, institutions governed by public law, state-owned companies) and local governments. Higher debt level will cause the debt burden to exceed the previous year's forecast in all subsequent years as well.

Table 28. Comparison with the forecast of the Stability Programme 2014

	2014	2015*	2016*	2017*	2018*	2019*
Real GDP growth (%)						
Previous version	2.0	3.5	3.6	3.4	3.2	-
Present update	2.1	2.0	2.8	3.4	3.2	3.0
Difference	0.1	-1.5	-0.8	0.0	0.0	-
Nominal GDP growth (%)						
Previous version	4.9	6.9	6.8	6.4	6.1	-
Present update	4.2	4.0	5.5	6.4	6.3	5.8
Difference	-0.7	-2.9	-1.3	0.0	0.2	-
Harmonised Consumer Price Index (HICP) (%)						
Previous version	1.7	2.9	3.0	3.0	3.0	-
Present update	0.5	0.8	2.6	3.0	3.2	2.8
Difference	-1.2	-2.1	-0.4	0.0	0.2	-
Structural budgetary position of general government (% of GDP)						
Previous version	0.1	0.2	0.0	0.2	0.2	-
Present update	1.3	0.5	0.6	0.2	0.2	0.6
Difference	1.2	0.3	0.6	0.0	0.0	-
General government debt (% of GDP)						
Previous version	9.8	9.3	8.8	8.5	7.9	-
Present update	10.6	10.3	9.9	9.6	8.9	8.4
Difference	0.8	1.0	1.1	1.1	1.0	-

Source: Ministry of Finance.

5. LONG-TERM SUSTAINABILITY OF FISCAL POLICY

The assumptions of the long-term budgetary projections given in this chapter were agreed on by the Economic Policy Committee of the European Union in 2014 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 – according to the latest population forecast of Eurostat, the ratio of dependants (here taken to mean people up to 18 years and above 65 years of age) to the employment-age population (18–65 age range) will increase from 60% in 2015 to 70% in 2024 and to 95% in 2060.

The following steps have been taken to guarantee long-term budgetary sustainability:

- 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 security contributions paid by the state increased to 6% for the period of 2014-2017 for those who voluntarily continued contributing to their second pension pillar and also for those who submit the relevant application in 2013. In the latter case, the contribution made by the individuals themselves also increases 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 62.5 years for women; the latter will become equal with the retirement age of men by 2016). The forecast increase of life-expectancy of 63-year-old people by 2060 is also worth noting. In the next 50 years, the life-expectancy will increase by almost 5 years for 63-year-old women and nearly 7 years for men as compared to 2014 (according to the Eurostat's forecast of 2014). 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. The increase of retirement age will compensate the demographic changes and the current assessments are that it will keep the number of pensioners stable until 2026.

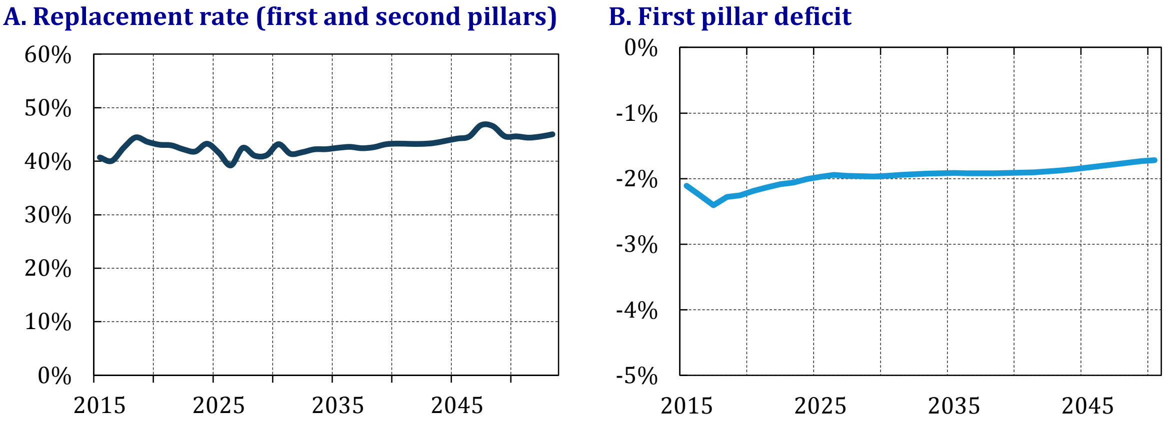
An analysis of the sustainability of the current policy indicates that thanks to the increasing retirement age and the contributions to the second pension pillar, the pressure on public finances of Estonia caused by demographic changes is one of the lightest among the EU member states. The analyses made 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 finances, 2010–2060 (% of GDP)

	2010	2020	2030	2040	2050	2060
Total expenditure	**38.2**	**37.3**	**36.9**	**36.7**	**37.2**	**37.6**
Of which: ageing-related expenditures	20.0	19.1	18.7	18.5	19.0	19.4
Pensions	8.9	7.8	7.2	7.0	6.8	6.4
Social security pensions	8.9	7.8	7.2	7.0	6.8	6.4
Old-age pensions	7.5	6.4	5.9	5.8	5.7	6.5
other (survivor pension, disability pensions)	1.4	1.4	1.3	1.2	1.1	0.9
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	**38.2**	**37.3**	**36.9**	**36.7**	**37.2**	**37.6**
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	5.6	5.2	5.1	5.1	5.1
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
Social contributions diverted to the second pillar (4% paid by the state)						
Payment of second pillar pensions	0.0	1.13	1.20	1.24	1.28	1.28
Assumptions:	**0.0**	**0.1**	**0.4**	**0.9**	**1.7**	**2.2**
Labour productivity growth						
Real GDP growth	7.8	2.7	2.0	1.9	1.8	1.5
Employment rate, men (aged 20-64)	3.3	2.0	1.5	1.2	0.9	1.4
Employment rate, women (aged 20-64)	83.8	84.9	85.3	85.5	85.7	86.6
Total participation rates (aged 20-64)	76.8	78.9	80.5	80.0	79.9	81.2
Unemployment rate	80.2	81.8	82.9	82.8	82.8	84.0
Persons aged 65+ in total population	16.9	7.8	8.0	7.5	7.5	7.5
Total expenditure	17.0	19.4	23.1	25.5	27.4	29.0

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 coalition has agreed to implement the work capacity reform and to ensure the sustainability of work capacity allowances. 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. Moreover, the Government's Coalition Programme prescribes the implementation of flexible pension age and the need to consider a faster increase of the base pension rate.

Potential general government liabilities

Potential general government liabilities are considered to be liabilities, the actual realisation of which depends on a 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 2014, Statistics Estonia considered potential 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. Potential general government liabilities, 2014–2015 (% of GDP)

	2014	2015
Total state guarantees	**1.6**	**1.6**
of this, student loans	0.7	0.7
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 FINANCES

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 business associations with state holding.

The principle of independence of the Ministry of Finance's macroeconomic and financing forecast was also established. Additionally, the Fiscal Council was established under the Bank of Estonia, 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 budgetary objective or the adjustment plan i.e. by at least 0.5% of GDP per annum, until attainment of the medium term budgetary objective in compliance with the requirements prescribed in the Stability and Growth Pact.

In addition to the mandatory correction mechanism, a compensation 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 budgetary funds, the rules for preparing the state budget were updated, the State Budget Strategy was made to include an obligation of four-year expenditure ceilings, the strategic planning system was tidied and a legal framework for step-by-step transitioning to activity-based budgeting was established. The State Budget Strategy will continue to be based on possibilities 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.

Transition to accrual-based and activity-based state budget

The challenge before Estonian Government is to adopt better decisions when directing limited resources to solve difficult challenges. Together with Estonia's success, the complexity of choices grows, less and less decisions can be based on experiences of countries that have already gone through similar situations and more political challenges occurring for the first time ever must be solved.[37] Successful resolution of challenges requires the ability to implement choices and to learn from consequences and use the practical experience gathered to make future decisions. The development of strategic and financial management is focused on improving co-operation and learning from experience, as well as on stronger control and sanctioning.

Problems of the strategic and financial management system are highlighted and solutions are proposed in the OECD 2011 Public Governance Review,[38] the relevant audit by the National Audit Office and in the 2014 joint report of Estonia, Finland and OECD titled "Fostering Strategic Capacity Across Governments and Digital Services Across Borders" and its action plan „Action Plan for building administrative capacity and implementing the recommendations of OECD Public Governance Reviews".[39]

The Coalition Programme sets out an important need to increase the transparency of the state budget, incl. transitioning to activity-based budget together with more effective substantive reporting on fulfilment of action programmes.

According to one of the most used budgetary classifications – the OECD Results-Based Budgetary Classification, Estonia uses a presentational results-based budget. A presentational results-based budget presents financial information together with information about results. In Estonia, this is expressed as area policy specific situation descriptions, objectives and list of policy changes given in the State Budget Strategy, as well as the composition of the budget's explanatory memorandum and the Action Plan approved by the Government of the Republic together with the state budget's sectioning and the report on fulfilment of the Action Plan presented within annual reports. A long-term challenge is a systematic transition from presentational results-based budget to budgeting using more information on results.

To increase results-based decisions in budgeting and to make the budget more transparent, activity-based budgeting is taken into use. The prerequisite for implementing activity-based budgeting is the use of an accrual-based budget. An accrual-based budget is also necessary for unification of the accounting principles used in accountancy and budgeting.

Estonia plans to transition to an accrual-based budget in 2017 and to activity-based state budget by 2020.

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

[37] See e.g. "Estonia's development needs for the next ten years", Ministry of Finance. 2012. (http://www.struktuurifondid.ee/public/arenguvajadused__final1.pdf). (as of 7 May 2015).

[38] OECD Public Governance Reviews. Estonia. Towards a Single Government Approach. OECD. 2011.

[39] Activity of the Government of the Republic upon assessing its work results and reporting the results. National Audit Office. 2012. (http://www.riigikontroll.ee/tabid/206/Audit/2265/Area/1/language/et-EE/Default.aspx). (as of 7 May 2015).

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. In 2015, Estonia's European Union Policy was added as the fifth base strategic document of the Government of the Republic.

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 one-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 and indicators were supplemented until 2019, based on priorities of the new composition of the government that entered the office after the parliamentary elections of 2015. The resources are in line with the macroeconomic and public finance indicators in the economic forecast of spring 2015 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.

Structural sectoral reforms

In spring 2014, Estonia adopted multiple reform plans,[40] whereas several of the plans have a direct influence on public finances in addition to improving competitiveness. Tax burden on labour was reduced, redirecting it to taxation of consumption and environmental load instead: excise duties on alcohol and tobacco were increased, the rate of unemployment insurance payment was reduced from 3.0% to 2.4% and the rate of basic exemption was increased to 154 euros.

In order to achieve greater budgetary flexibility, road maintenance expenditure was disengaged from fuel excise receipts and the more favourable excise duty on fiscal-marked fuel was replaced by better targeted compensations. In order to ensure a fairer environment of competition and taxation and to improve tax receipts, an addition to the value added tax declaration was 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 was reduced, and the taxation of compensation for use of personal cars as a fringe benefit was specified. Also, an employee register was established where starting with 1 July 2014 all

[40] Adopted with Government Decision dated 8 May 2014 in the national reform plan "Estonia 2020".

employees must be entered immediately before they start working; this register has notably improved the receipt of labour taxes.

The Government is planning to continue with the following 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 finances:[41]

- 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, increase of the basic exemption to 205 euros and gradual decrease of the social security contribution rate from 33% to 32%.
- In order to reduce tax differences, the value added tax rate of accommodation services will increase to 14% starting with 2017 and the upper limit of expenditure deductible from revenue will be reduced.
- In order to make public governance more efficient, works will be continued to centralise support services and reduce public sector's expenditure.

[41] Will be adopted by the Government at the end of May 2015 with an update to "Estonia 2020".

7. INSTITUTIONAL FUNCTIONS

Fiscal institutions

The fiscal institution[42] 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.

According to EU rules on the coordination of economic and budgetary policies of Member States, an independent Fiscal Council was formed under the Bank of Estonia in 2014, 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 budgetary rules. Pursuant to its articles of association, the Fiscal Council's task is to provide assessments to the Government's macroeconomic and financial forecasts, budgetary strategies, and the achievement of the objective set for the general government's structural budgetary position.

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 Programmes 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).

Generally, 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 Draft Act establishes requirements and obligations for the area of budgeting and

[42] 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.

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 numerical budgetary rules, which efficiently facilitate in the entire general government the fulfilment of relevant fiscal policy obligations resulting from the base treaty. This is expressed primarily in respecting of the reference values set for deficit and debt in the base 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 legal persons belonging to the central government, i.e. that their primary activity's expenditure must not normally exceed their primary activity's revenue. The results of primary activity do not reflect the unit's investment activity and this may result in its budgetary position being significantly different from its primary activity's result. Investments are normally funded by own means gathered from previous periods (which means that the unit's primary 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). Excessive investments by legal persons belonging to the central government are limited by the net debt burden rule, pursuant to which the upper limit of signing loan agreements is 40% of the net debt burden in relation to the principal activity's 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 2004–2013

Table 31. Gross Domestic Product in 2004–2013

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	%	%	%	%	%	%	%	%	%	%
1. Real GDP	6.5	9.5	10.4	7.9	-5.3	-14.7	2.5	8.3	4.7	1.6
2. Nominal GDP	11.6	16.0	20.1	20.1	1.7	-14.4	4.0	11.5	7.5	6.2
Sources of growth										
3. Private consumption expenditure (incl. NPISH)	7.8	9.3	12.7	9.0	-4.9	-15.3	-1.6	2.5	5.1	3.8
4. General government's final consumption expenditure	3.0	3.0	5.4	6.6	4.5	-3.2	-0.4	1.7	3.3	2.8
5. Gross fixed capital formation	5.5	15.3	22.8	10.3	-13.1	-36.7	-2.6	32.7	10.9	2.2
6. Changes in inventories (% of GDP)	2.7	0.2	2.6	2.7	-0.5	-2.0	0.0	3.2	1.7	-0.5
7. Export of goods and services	17.3	19.9	9.5	12.6	0.9	-20.3	24.0	24.9	6.2	2.4
8. Import of goods and services	16.1	16.7	20.7	13.0	-6.2	-30.6	21.2	26.5	11.8	3.3
Contribution to GDP growth[1)]										
9. Domestic demand (excluding inventories)	6.6	10.5	15.4	9.7	-6.7	-20.3	-1.5	8.6	6.1	3.1
10. Changes in inventories	0.4	-2.5	2.7	0.4	-3.2	-1.3	2.0	3.5	-1.4	-2.2
11. Balance of goods and services	-0.7	0.7	-8.4	-1.6	5.0	8.1	2.7	0.5	-4.3	-0.8
Value added growth										
12. Primary sector	-7.8	-0.9	-1.4	15.4	0.9	-0.2	10.2	16.4	16.6	-3.9
13. Manufacturing	2.5	7.6	9.3	6.1	-6.1	-17.9	15.4	12.0	1.9	3.5
14. Construction	7.4	25.3	8.3	11.1	3.4	-34.6	-3.7	31.3	7.5	-3.9
15. Other services	7.1	8.2	10.7	6.9	-4.1	-12.1	1.0	4.9	4.5	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 32. Prices in 2004–2013 (%)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1. GDP deflator	4.8	5.9	8.7	11.3	7.4	0.4	1.5	3.0	2.7	4.6
2. Private consumption deflator	4.2	4.4	6.1	7.7	8.3	-0.3	3.5	5.2	3.5	3.1
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	9.1	7.1	14.4	13.3	-0.1	-0.3	3.0	3.0	5.8
5. Investment deflator	2.7	4.2	9.2	8.4	-0.2	-1.4	-0.2	1.6	2.0	4.9
6. Export deflator	1.9	3.7	5.6	6.2	6.5	-2.2	3.6	4.6	1.8	1.0
7. Import deflator	1.1	1.7	3.1	4.1	6.4	-2.6	5.6	5.3	2.4	-0.4

Source: Ministry of Finance, Statistics Estonia.

Table 33. Labour market in 2004–2013

	2004	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
		%	%	%	%	%	%	%	%	%	%
1. Employment, persons	601.9 1)	-0.2	2.3	5.9	0.9	-0.2	-9.5	-4.4	6.2	1.9	1.0
3. Unemployment rate		10.3	8.1	5.9	4.6	5.8	13.6	17.5	13.6	10.0	8.6
4. Labour productivity, per employed person	22.6 2)	6.7	7.0	4.3	6.9	-5.1	-5.8	7.2	1.9	2.7	0.6
6. Compensation of employees	4292.3 2)	11.2	15.1	20.2	24.5	11.4	-13.2	-2.7	7.2	7.9	8.2
7. Compensation per employee (6./1.)	7.1 3)	11.4	12.6	13.5	23.4	11.7	-4.1	1.7	0.9	5.9	7.1
7a. Average gross monthly wage, EUR	466	8.4	10.8	16.5	20.5	13.9	-5.0	1.1	5.9	4.8	7.8

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

Table 34. Balance of payments in 2004–2013 (% of GDP)

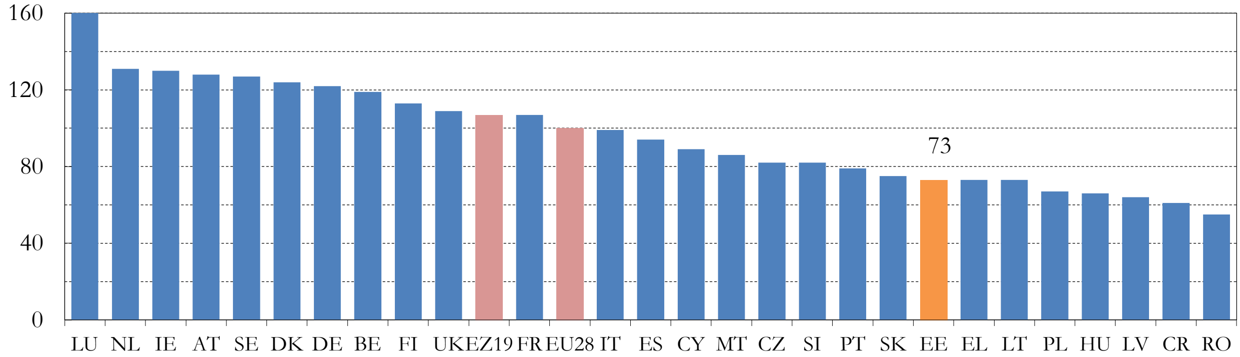
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1. Net lending/borrowing vis-à-vis the rest of the world	-11.3	-8.0	-12.8	-13.8	-7.5	6.0	5.3	5.5	1.0	1.7
incl.:	-7.9	-5.1	-10.1	-8.9	-3.9	5.0	6.4	5.8	1.0	1.4
- Balance of goods and services	-4.1	-3.6	-4.8	-6.1	-4.8	-2.4	-4.6	-4.5	-3.5	-2.6
- Balance of primary and secondary income	0.7	0.8	2.2	1.3	1.3	3.4	3.5	4.1	3.5	2.8
- Capital account	-12.0	-8.7	-15.0	-15.0	-8.7	2.5	1.8	1.4	-2.5	-1.1
1a. Current account	-0.7	-0.3	-1.4	-0.8	-0.1	0.1	0.4	0.7	1.7	0.4

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

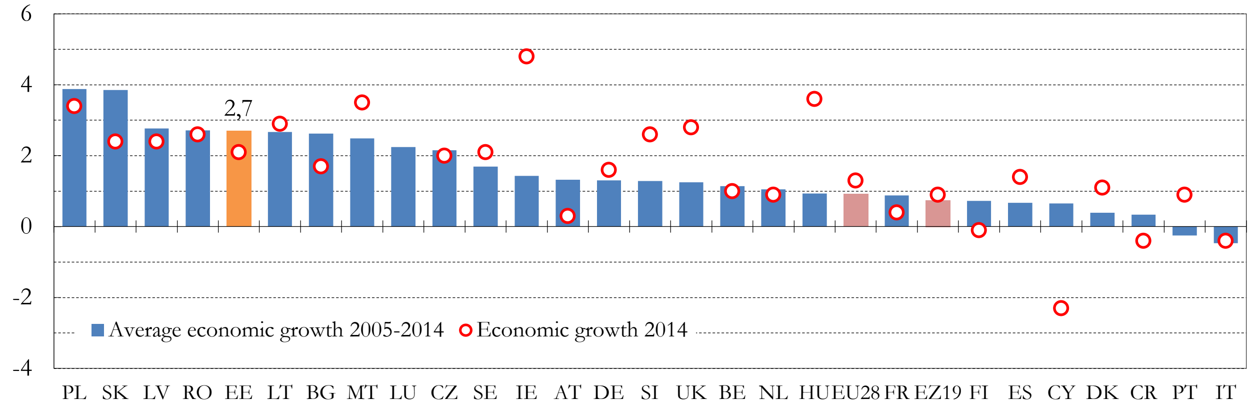
Appendix 2. Comparison of Estonia with other EU member states (figures)

Figure 22. Main macroeconomic indicators (%)

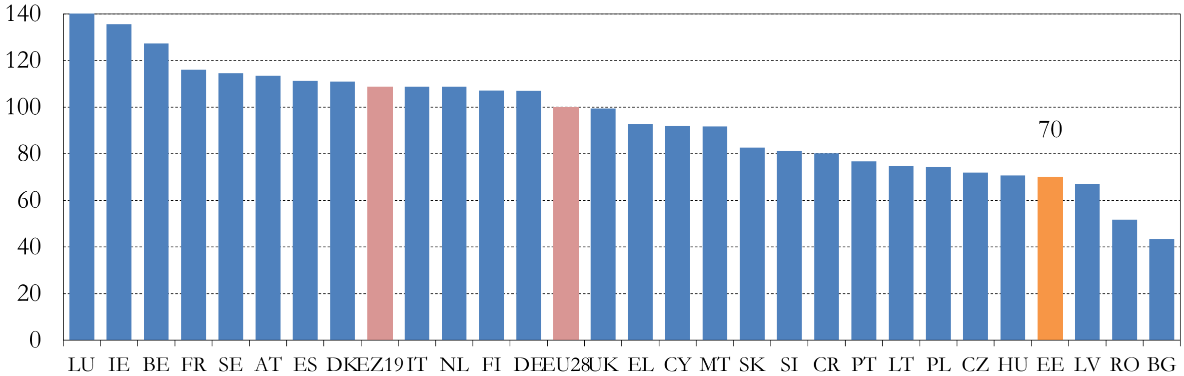
A. GDP per capita in purchasing power parities in 2013 (EU28=100)



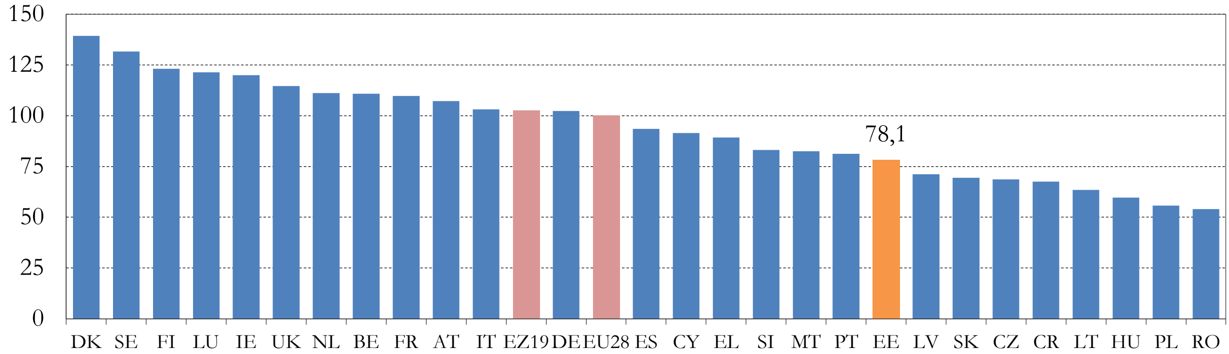
B. Economic growth in 2014 and 2005–2014



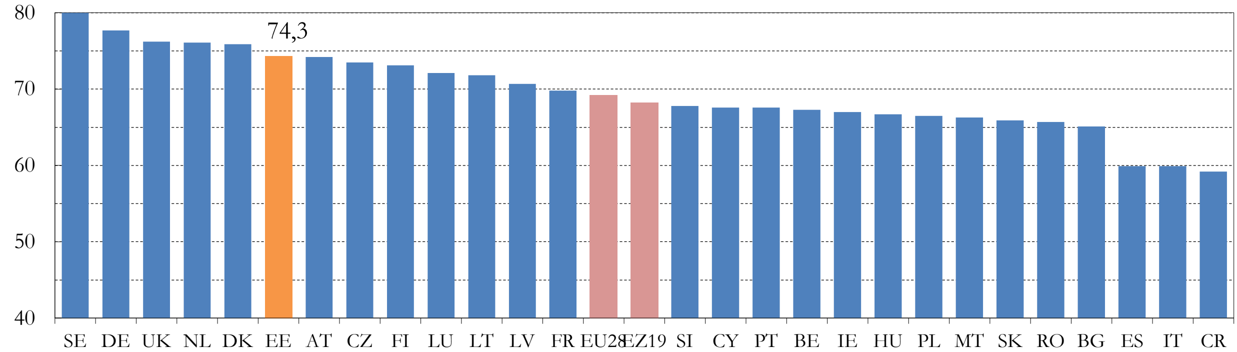
C. Labour productivity – GDP by working hours PPS 2013 (EU28=100)



D. Price level in comparison with the EU28 average in 2013 (EU28=100)

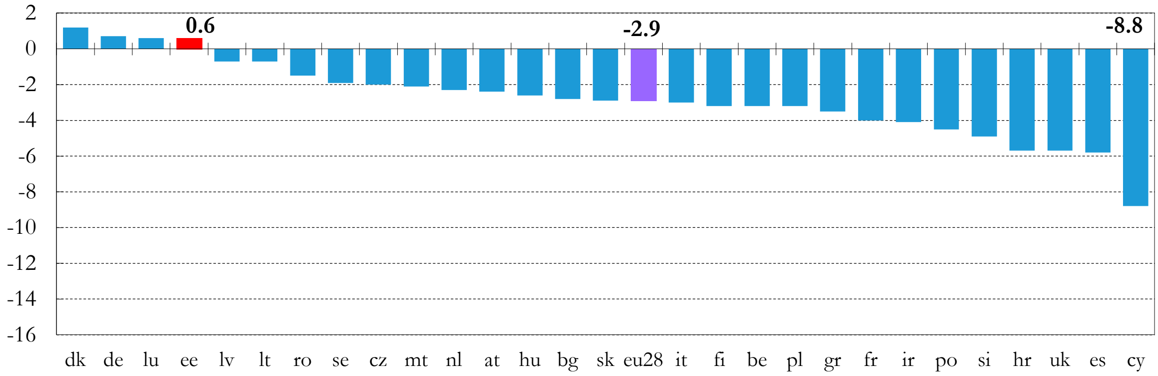


E. Employment rate (persons aged 15-64) in 2014

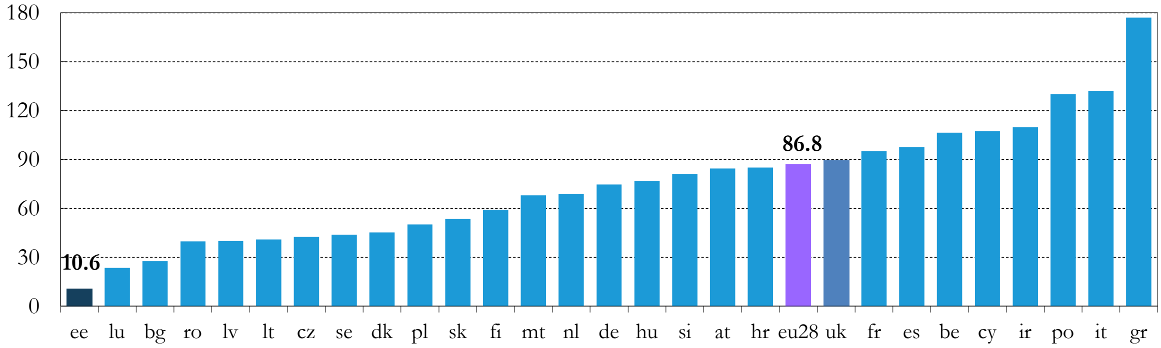


Sources: Eurostat, Statistics Estonia, Ministry of Finance.

Figure 23. Fiscal position of general government (% of GDP)
A. Budgetary position of general government in 2014

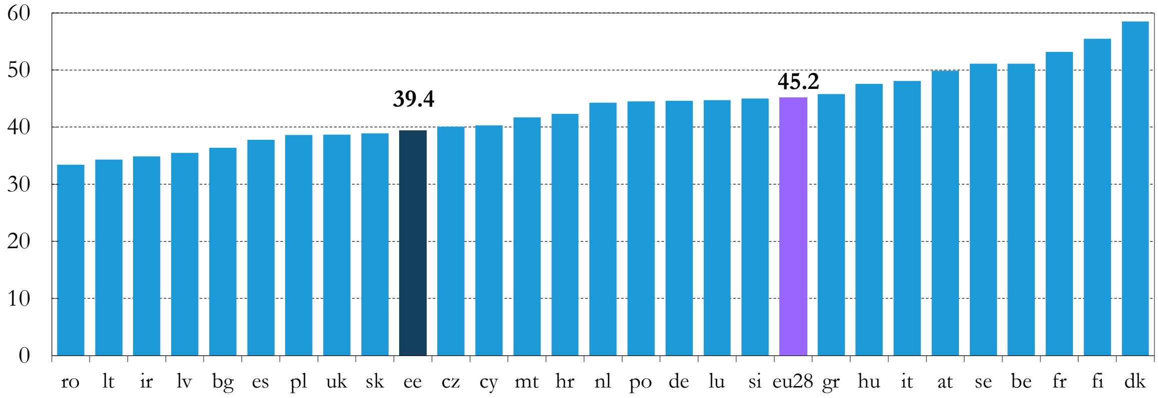


B. General government debt in 2014

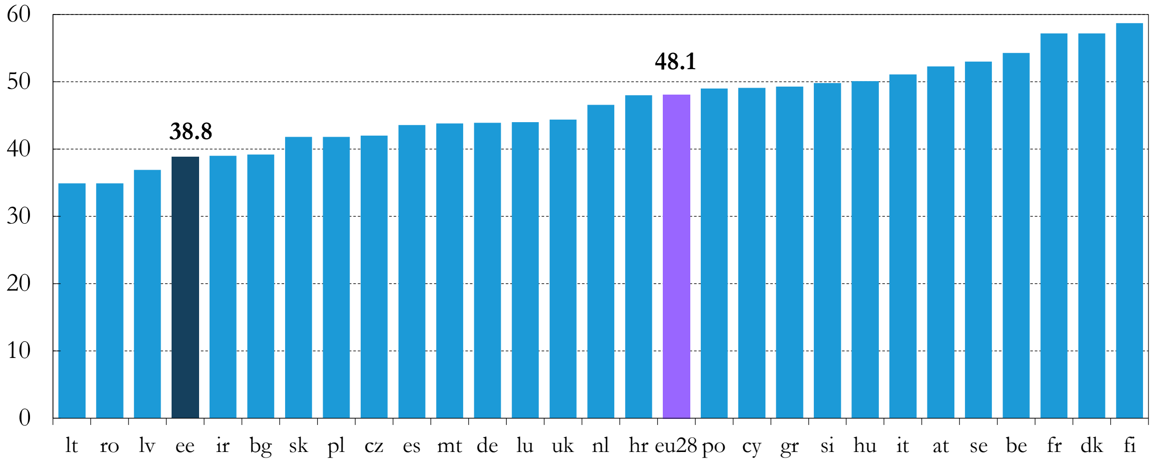


Sources: Eurostat.

Figure 24. General government revenue and expenditure (% of GDP)
A. Estonian general government revenue compared to other EU member states in 2014



B. Estonian general government expenditure compared to other EU member states in 2014



Sources: Eurostat.

Appendix 3. Effect of administrative price increases on CPI

Table 35. Effect of administrative price increases on CPI in 2014–2019 (%)

Administrative measures	Entry into force	Price increase (%)	Effect on CPI (percentage points)					
			2014	2015*	2016*	2017*	2018*	2019*
Changes in tax policy			**0.25**	**0.50**	**0.42**	**0.43**	**0.42**	**0.05**
Increase of tobacco excise duties (6%)	1.01.2013	4.8	0.03	-	-	-	-	-
Increase of tobacco excise duties (6%)	1.01.2014	4.8	0.08	0.03	-	-	-	-
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	4.3	-	-	-	-	0.08	0.02
Increase of alcohol excise duties (5%)	1.01.2014	2.6	0.14	0.01	-	-	-	-
Increase of alcohol excise duties (15%)	1.01.2015	8.5	-	0.44	0.04	-	-	-
Increase of alcohol excise duties (10%)	1.01.2016	5.5	-	-	0.29	0.03	-	-
Increase of alcohol excise duties (10%)	1.01.2017	5.5	-	-	-	0.29	0.03	-
Increase of alcohol excise duties (10%)	1.01.2018	5.5	-	-	-	-	0.29	0.03
Increase of gas excise duties (20%)	1.01.2015		-	0.02	-	-	-	-
Increase of gas excise duties (20%)	1.01.2016		-	-	0.02	-	-	-
Increase of gas excise duties (20%)	1.01.2017		-	-	-	0.02	-	-
Other administrative price changes			**-0.69**	**-0.60**	**-0.08**	**0.21**	**0.26**	**0.22**
Free higher education	1.09.2013-2016		-0.28	-0.26	-0.15	-	-	-
Electricity (incl. the electricity exchange price, network fees, renewable energy fee)**	2014–2019		-0.29	-0.06	0.11	0.09	0.09	0.09
Water supply and sewage**	2014–2019		0.04	0.05	0.05	0.05	0.05	0.05
Gas**	2014–2019		-0.02	-0.05	-0.05	-0.04	0.05	0.02
Price of heat energy in Tallinn and elsewhere**	2015–2019		-0.15	-0.28	-0.05	0.10	0.06	0.05
Refuse collection**	2014–2019		-0.01	0.00	0.01	0.01	0.01	0.01
State fees (Motor Vehicle Registration Centre's activities)	1.01.2014		0.02	-	-	-	-	-
Total			**-0.44**	**-0.10**	**0.34**	**0.63**	**0.68**	**0.27**
Government coalition's added tax changes***								
Increase of petrol fuel excise duties (10% per annum)								
Increase of diesel fuel excise duties (10-14% per annum)	1.01.2016 - 2019		-	-	0.15	0.16	0.17	-
Increase of excise duties on diesel fuel for specific purposes	1.01.2016 - 2019		-	-	0.11	0.08	0.09	-
Increase of shale oil (heating oil) excise duties	1.01.2016 - 2019		-	-	0.002	0.002	0.002	-
Increase of oil shale excise duties	1.01.2016		-	-	0.015	-	-	-
Additional increase of alcohol excise	1.01.2016		-	-	0.07	-	-	-

duties, wine and fermented beverages over 6% vol (20%)							
Additional increase of tobacco excise duties	1.01.2016. 2019-2020	-	-	0.17	-	-	0.33
Increase of VAT rate for accommodation services to 14%	1.06.2016 - 2020	-	-	0.01	0.14	0.05	0.19
Increase of gas excise duties (40-60%)	1.01.2017	-	-	-	0.03	-	-
Total additional effects	1.01.2018 - 2019	-	-	-	-	0.10	0.10
Changes in tax policy		**-**	**-**	**0.53**	**0.41**	**0.41**	**0.62**

*** Assessment by the Ministry of Finance, starting with 2015.*
**** These effects are not taken into account in the Ministry of Finance's spring economic forecast.*
Source: Ministry of Finance, Statistics Estonia, Eesti Energia, Tallinna Küte, Estonian Competition Authority.