COUNCIL OF
THE EUROPEAN UNION

Brussels, 22 May 2012

9513/12

UEM 86

COVER NOTE

from:	Harri Tiido, Ambassador, Representative to the PSC, Charge d'Affaires a.i.
date of receipt:	4 May 2012
to:	Mr Carsten Pillath, Director-General, Council of the European Union
Subject:	Stability Programme 2012

Hereby please find enclosed "Stability Programme 2012".

(Complimentary close)

(s.) Harri Tiido

Encl.:

Republic of Estonia

STABILITY PROGRAMME

2012

Tallinn

April 2012

TABLE OF CONTENTS

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 (EMO) since 1 January 2012 and submits its Stability Programme to the European Commission and the Council of the European Union for the second time. This Stability Programme can therefore be regarded as the follow-up of the one submitted in the previous year. The purpose of the Stability Programme is to illustrate the government's policy in the performance of the requirements arising 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 2012.

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

Estonia's fiscal policy remains in line with the Stability and Growth Pact. The Stability Programme was prepared in parallel with the national State Budget Strategy in consideration of the government's goals and policies, which are stipulated in the Coalition Programme and other strategic documents. The Government approved the State Budget Strategy 2013-2016 and the Stability Programme 2012 on 26 April 2012. Before the approval the documents were discussed in the Committees of the Riigikogu. Stability Programme 2012 is based on the economic forecast of the Ministry of Finance from spring 2012.

The time horizon of Stability Programme 2012 reaches the year 2016, as required from the budget strategy by the State Budget Act (the next fiscal year and the three years following). The document consists of seven parts providing an overview of the economic policy objectives, the economic situation and future prospects, the fiscal framework, a comparison with the previous Stability Programme, improvement of the quality of the public finances, the long-term sustainability of the fiscal policy and institutional functions.

ECONOMIC POLICY GOALS

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

One of the main goals of the fiscal policy is to support macroeconomic stability via the flexibility and efficiency of markets, to manage the risks that threaten the balanced development of economy, and to improve the economy's growth potential and employment. This is particularly important for securing the effective functioning of the economy in the single currency zone. The impact of the tax system and the expenditure side of the budget to the economy must be considered when they are planned, especially when changes are made. In addition, the long-term sustainability of public finances given an ageing population must be ensured. Ensuring a stable economic environment, channelling budget funds to foster of economic growth and employment, and ensuring long-term sustainability are the three areas which Estonia will focus on in its economic policy 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 assess its activities the Government, which started its work 6 April 2011, has set itself goals in 18 policy areas as well performance indicators that measure the achievement of these goals and their target levels seven of which are priorities for the Government.

The priorities[1] of the Government are:

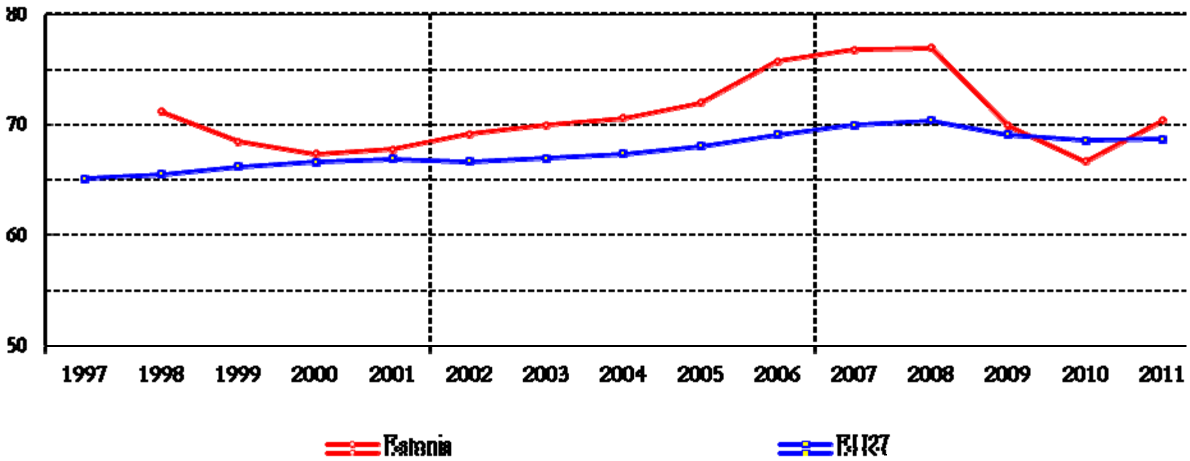
- achieving a general government surplus;
- positive population growth (the Estonian nation must become a growing nation);
- increasing the productivity to the level 73% of the EU average by 2015;
- achievement of the pre-crisis level of employment by 2020. This includes plans to achieve an employment rate of 72% in the 20-64 age group by 2015;
- reducing the share of young people with basic or lower education who are not studying to 11% in the 18-24 age group by 2015;
- increasing healthy life expectancy (57.1 years for men and 62 years for women); and
- keeping greenhouse gas emissions at the level of 2010 (or below 20 million tons per year).

[1] Set in the State Budget Strategy 2012-2015.

Figure 1. Real Convergence with the EU (% of EU27)

Source: Eurostat.

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



Source: Eurostat.

ESTONIAN ECONOMIC DEVELOPMENT AND OUTLOOK

Developments of the external environment and preconditions

Expectations of global economic growth decreased in the end of the last summer whilst the risks surrounding economic growth increased alongside the expansion of the debt crisis in the eurozone. The situation in global economy has started stabilising slowly in recent months, but there is still insecurity about the outlook of growth.

The economic growth of the **United States** slowed down to 1.7% last year, which corresponded to the summer forecast of the Ministry of Finance. The situation on the US employment market has improved, which has had a positive impact on private consumption. Economic growth in the last quarter of the year was 1.6%. The US economy is expected to increase by 1.9% in 2012 and accelerate to 2.2% in 2013.

The economic growth of the **European Union** slowed down in the second quarter of 2011, and economy grew by 1.5% over the year. The economy of the European Union decreased by 0.3% in the last quarter of the year when compared to the same period in the previous year, but it is a short-term decrease. The Ministry of Finance expects the economy of the European Union to remain on the same level as in the previous year and to grow by 1.2% in the next year. We expect the weighted average economic growth of Estonia’s trade partners to be 1.1% in 2012 and to accelerate to 1.8% in 2013 as a result of the increase in economic activity. Finland, Sweden, Russia and Latvia will make the biggest contribution to export demand.

The price increase of energy and commodities in the previous year led to a rapid increase in **consumer prices** in the eurozone, and inflation in the eurozone amounted to 2.7% in the year. We expect the increase in consumer prices to slow down in the coming quarters and inflation in the eurozone to reach 2.1% in 2012, as economic growth should be weaker and energy prices should stabilise. Inflation is expected to decrease to 1.9% in 2013. The European Central Bank reduced base interest rates to boost economy and this also has an impact on interest rates on the money market. Both short- and long-term interest rates will remain at a lower level this year than in the last with 0.8% and 2.0%, respectively.

The price of **oil** increased rapidly in the previous year and the average price for the year was USD 111 per barrel. The price of oil has increased considerably also in the first months of this year, and geopolitical tension and delivery problems have raised oil price expectations to USD 116 per barrel this year. The Ministry of Finance expects the price of oil to decrease to USD 110 in 2013 on the basis of oil futures.

The **US dollar**/euro exchange rate weakened by approximately 5% in the previous year. The euro remained strong against the dollar in the first half of the year, but started weakening in autumn. The weakening of the euro exchange rate resulted from the problems relating to the debt crisis in the eurozone, which created doubts about the future of the currency. The USD exchange rate against the euro will go up this year and we expect the exchange rate to remain at the same level in the next years.

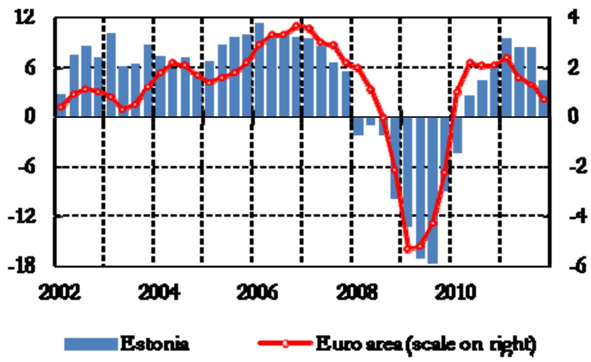
Table 1. Foreign assumptions of the forecast

	Assumptions in the Ministry's forecast for spring 2012							European Commission		
	2010	2011	2012*	2013*	2014*	2015*	2016*	2011	2012*	2013*
1. Short-term interest rate, (annual average)	0,8	1,4	0,8	0,9	1,4	1,7	2,0	**1,4**	**0,8**	**0,9**
2. Long-term interest rate (annual average)	2,7	2,6	1,9	2,2	2,4	2,6	2,8	**2,6**	**1,9**	2,2
3. USD/EUR exchange rate (annual average)	1,3	1,4	1,3	1,3	1,3	1,3	1,3	1,4	1,3	1,3
4. Nominal effective exchange rate	-3,2	**0,0**	**-1,0**	**0,0**	**0,0**	**0,0**	**0,0**		-	
5. World GDP growth (excluding EU)	**5,8**	**4,2**	**4,2**	**4,3**	**4,4**	**4,5**	**4,5**	**4,2**	**4,2**	**4,3**
6. EU27 GDP growth	**2,0**	**1,5**	**0,0**	**1,2**	**1,6**	**2,0**	**2,2**	**1,5**	**0,1**	**1,4**
7. Growth of Estonia's relevant foreign markets	2,5	2,6	1,1	1,8	2,1	2,4	2,5		**-**	
8. World import growth (excluding EU)	**16,3**	**7,5**	**5,6**	**6,2**	**6,5**	**6,8**	**6,8**	**7,5**	**5,6**	**6,2**
9. Oil prices (Brent, USD/barrel)	79,6	111,3	116,0	110,0	110,0	110,0	110,0	**111,5**	**119,9**	**113,5**

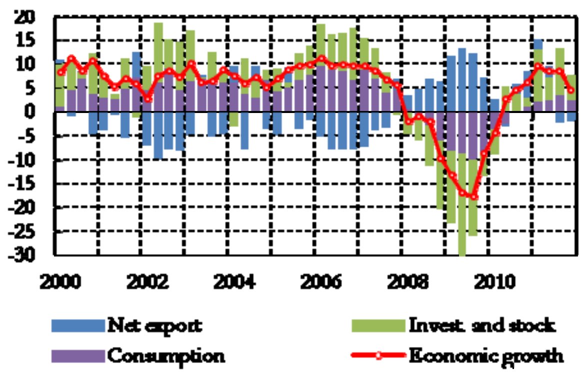
Sources: Historical data was obtained from Eurostat, the Bank of Estonia, the U.S. Energy Information Administration (EIA); forecasts are based on ***Consensus Economics*** *(CF) and NYMEX Brent futures, if possible, which have been adjusted according to the most recent developments and the expert opinions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

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

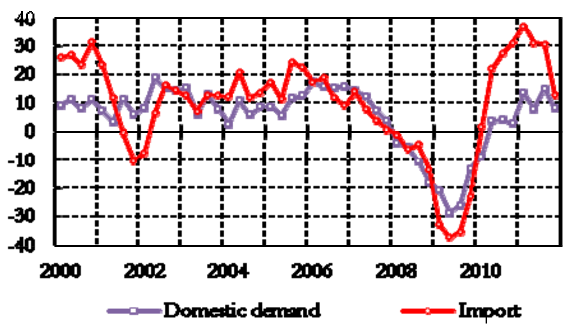
A. Economic growth in Estonia and the eurozone



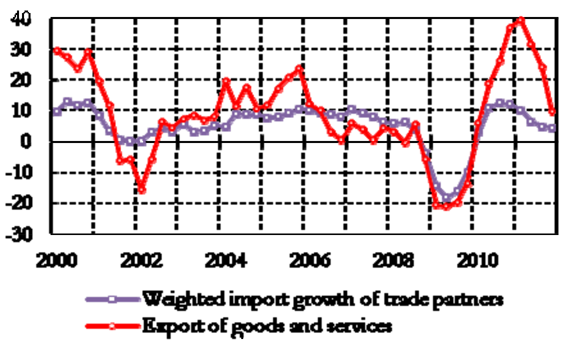
B. Contributions to economic growth



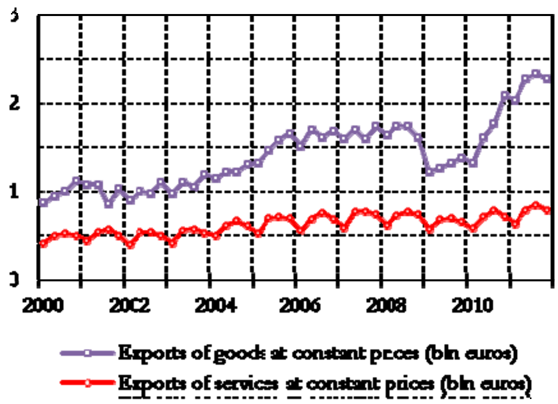
C. Real growth of domestic demand and imports



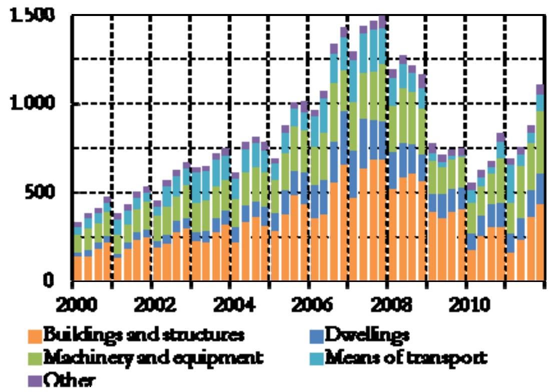
D. Real growth of exports



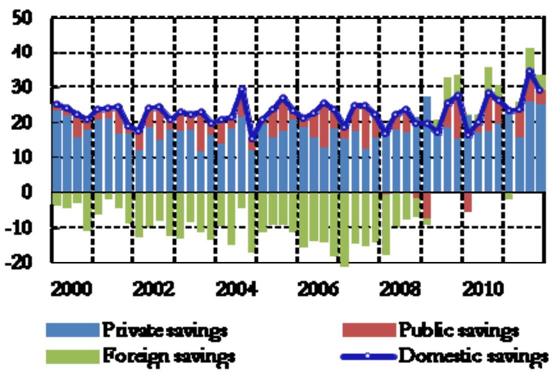
E. Exports of goods and services



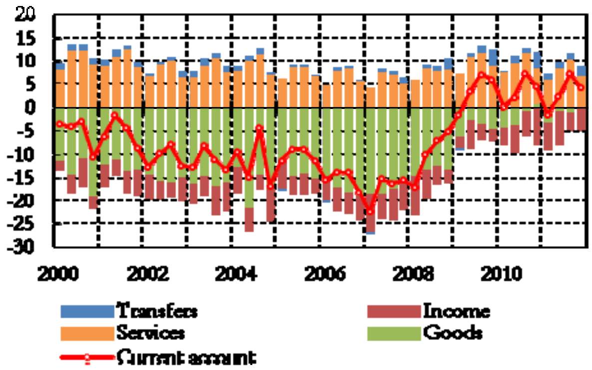
F. Structure of investments (€ million)



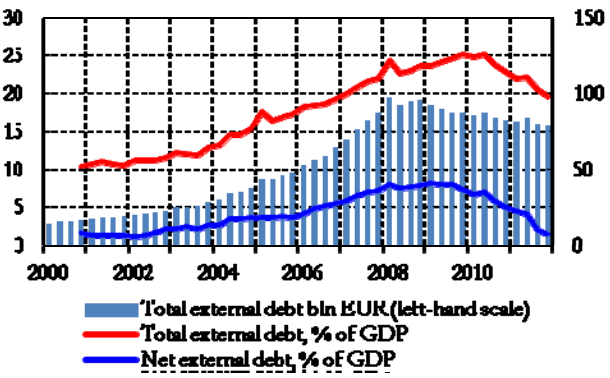
G. Savings (% of GDP)



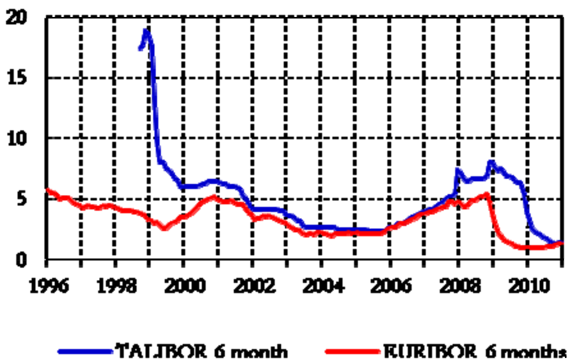
H. Current account structure (% of GDP)



I. Total external debt and net external debt



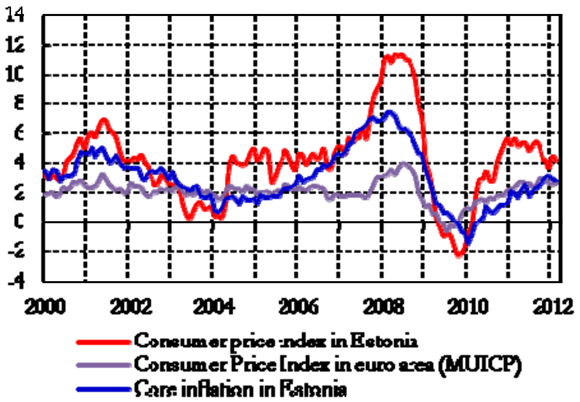
J. Interest rates



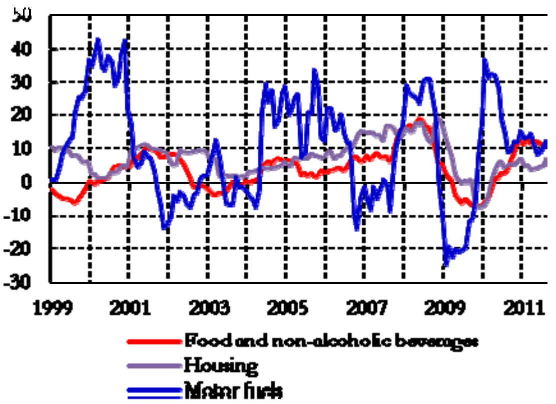
K. Employment and unemployment

L. Labour productivity

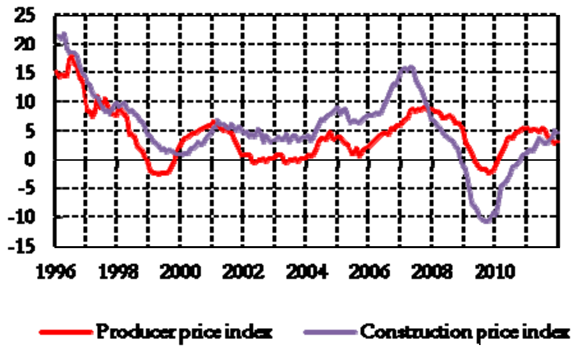
M. Consumer price index in Estonia and euro area



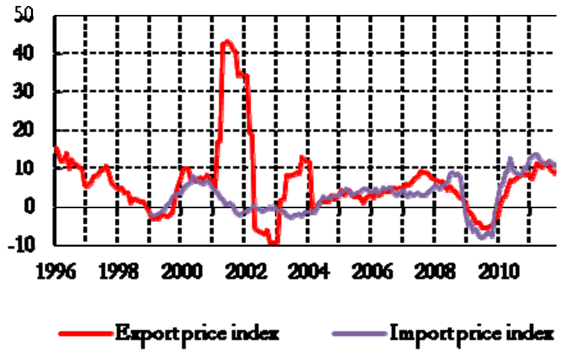
N. Change in main inflation components



O. Producer and construction price index



P. Export and import price index



Source: Statistics Estonia, Bank of Estonia, Eurostat.

Economic forecast

The prerequisites of this forecast were fixed as of the end of February 2012. The economic situation abroad as well as at home at the time when this forecast was prepared was considerably more stable than at the time of the previous forecast of the Ministry of Finance (published in August 2011). The risks surrounding economic growth increased suddenly at the time the previous forecast was prepared and this increase was the result of the expanding debt crisis in the euro area. Its impact on real economy was unknown by the time the forecast was completed, but insecurity about the future had grown considerably. Strong intervention by the European Central Bank and rules of macroeconomic supervision established for European Union Member States put a stop to the decrease in economic trust in the end of the previous year, and the trust has even grown somewhat in recent months. However, the external environment will offer the economic development of Estonia less support than expected, despite the stabilisation of future outlooks.

The Ministry of Finance expects the economy of the EU to remain on the same level as in the previous year and to grow by 1.2% in the next year. The increase in energy and commodity prices accelerated inflation in the previous year, but the speed of inflation is already expected to slow down in this year and the next. The European Central Bank is expected to keep interest rates on a historically low level both in this year and the next. We expect the weighted average economic growth of Estonia's trade partners to be 1.1% in 2012 (2% in the previous forecast) and 1.8% in 2013 (2.4% in the previous forecast). Expectations of the world market price of oil were increased somewhat for this year, but it has to be noted that the oil price has continued to grow after the prerequisites for the forecast were fixed. The risk scenario of the forecast expects the external environment to be even weaker and the oil price to remain high.

The economy of Estonia grew fast in the first quarters of 2011, but the last quarter of the year saw a slight decrease in economic activity, especially in the exporting sector. The slowdown in the growth of exports was balanced by strong domestic demand in the second half of the year. Economic growth in 2011 reached 7.6%, which exceeded the expectations of the forecast done last summer.

The **gross domestic product** of Estonia will increase by 1.7% in 2012 and 3.0% in 2013 according to the main scenario of the forecast. The Ministry of Finance has lowered the economic growth forecasts for this year and the next. The main reason for this is that the growth outlooks of Estonia's made trade partners have deteriorated. We expect the growth of exports to slow down considerably in 2012, mainly to the weak exports of industrial production. Economic growth is supported by domestic demand whose growth will slow down considerably in comparison to the previous year. Economic growth in 2013 should once again be supported by exports via the strengthening of the external environment. Economic growth will stabilise at around 3.5% from 204-2016 and the faster growth of internal demand will increase its share in GDP close to 100% in five years.

Export has been the engine of economic growth in the last two years. However, increase in the **exports** of goods and services will slow down in 2012 due to the weak growth outlook of trade partners as a result of the European debt crisis. The slowdown in the exports of goods is magnified by the weakness of the communication equipment sector, as we expect the exports of communication equipment, which had demonstrated a rapid increase in recent years, to decrease somewhat in this year. The weakened external environment also leads to a significant slowdown in the exports of transport services, but its impact on the exports of other services will be smaller. We can expect our main export markets to pick up gradually in the coming years, which will also accelerate the growth of our exports. Growth of exports will stabilise at around 7% in the last years of the forecast period. Increased investment activity and the growing consumption expenditure of households mean that imports will grow faster than exports. However, the larger import content of exports means that the growth of imports will also slow down considerably this year.

The **current account** surplus will decrease to 1% of GDP in 2012 and turn into deficit in the coming years. The reason behind the decrease in the surplus this year is the foreign trade balance, as the growth of imports exceeds the growth of exports due to the weakness of external demand and the continuing growth of the internal market. The increase in the services of imports, exceeding its exports, and the slight increase in the income balance deficit will also force the current account to run into a deficit in the next few years. The increasing receipts of EU funds aimed at investments will cause the capital account surplus to increase this year.

Domestic demand will grow somewhat faster than GDP also in 2012, and we expect the growth to reach 3.8%. Domestic demand started growing strongly (11%) in 2011. The growth of private consumption remained marginally weaker than forecast in summer, but the increase in total investments exceeded our expectations considerably in the second half of the year. Corporate investments were strong all throughout the year and public sector investments also made a strong contribution to the overall growth in the second half of the year. Households also supported the growth in the end of the year after four years, although the volume of new homes purchased is still almost two times smaller than before the crisis. In addition to investments growth was also supported by the increase in inventories, which was caused by a rapid increase in production and positive outlooks in trade.

The forecast of domestic demand has been adjusted downwards only to a small extent despite the weakening of the general economic outlooks. Trade statistics suggest that the rapid increase in private consumption has continued in the beginning of 2012 and the confidence of consumers is still growing slightly. The household saving rate, which increased rapidly during the crisis, can be expected to decrease further, which allows private consumption to increase somewhat faster than real income. We expect private consumption to increase by 2.2% in 2012 and 2.8% in 2013. The growth of investments should also continue strong in 2012 and in addition to the private sector, it is also well supported by the public sector. Irrespective of the generally low level of investments, the amount of investments made by the public sector in 2012 should be historically the largest. The reason for this is that investments from EU structural funds and the proceeds from sales of CO_2 emission quotas are all made in this year. We expect investments to grow by 15% this year and 4% in the next year.

Consumer prices (CPI) will increase by 3.3% in 2012, 3% in 2013 and stabilise at 2.7% in the subsequent years. We can expect inflation to slow down gradually this year, especially due to the decreasing impact of external factors. Inflation will fluctuate at around 4% in spring but in the second half of the year, it will drop to below 3% due to the slowdown of the increase in energy prices like motor fuels, heat and electricity. The continuing increase in salaries and private consumption expenditure, though at a somewhat slower rate than in 2011, favours the slight acceleration of core inflation in current year. Inflation in 2013 will be influenced by the full opening of the electricity market in the beginning of the year. However, it will not lead to acceleration of inflation, because oil prices will decrease in 2013 according to oil futures, resulting in lower fuel prices. The increase in consumer prices will be slower in the second half of the forecast period, but remain higher in comparison to the eurozone due to the continuing convergence of income and price levels.

The rapid economic growth in the previous year led to a significant increase in the demand for workforce, as increased workload allowed companies to hire extra staff and increase employment by 6.7%. The expected increase in the **number of employed persons** will be modest this year as economic activity is decreasing – 4 thousand people or 0.7% in comparison to the previous year. The employment will increase by 1% in 2013. Unemployment rate has decreased considerably since the heights it reached during the recession and it will continue to decrease to 11.5% in 2012 and 9.6% in 2013. The unemployment rate will reach 8.2% by the end of the forecast period.

The improvement of the economic situation of companies has allowed them to raise the salaries of their employees, which means that average salary increase by 5.4% in 2011. The increase in average salary will slow down to 3.8% this year as the economic growth is becoming slower. The increase in average salary will accelerate to 5% in the next year and reach 6% by the end of the forecast period. Real wages started growing in the third quarter of the previous year after a decrease of almost three years. Salary growth exceeded price increase in the year and real wages grew by 0.4%. Real wages will growth by 0.5% in this year and the growth will accelerate to 3.2% by 2016. The real growth in the annual average labour productivity will be 1% this year, but it will accelerate again in the coming years and reach 3.1% by the end of the forecast period.

Table 2. Gross Domestic Product forecast for 2012-2016 (%)

	2011 level	2011	2012*	2013*	2014*	2015*	2016*
1. Real GDP growth (2005 prices)	12 031	7,6	1,7	3,0	3,4	3,5	3,5
1a. GDP at constant prices (bln euros)		12,0	12,2	12,6	13,0	13,5	14,0
2. Nominal GDP growth	15 973	11,7	4,4	6,2	6,2	6,4	6,3
2a. Nominal GDP (bln euros)		16,0	16,7	17,7	18,8	20,0	21,2
2b. Nominal GNP (bln euros)		15,2	15,8	16,7	17,7	18,8	19,9
Sources of growth							
3. Private consumption expenditure (incl. NPOs)		4,4	2,2	3,5	3,8	4,7	4,2
4. Final consumption expenditure of the public sector		1,6	1,0	1,0	0,1	0,1	0,1
5. Total capital investment in fixed assets		26,8	14,8	4,0	8,0	8,2	8,3
6. Change in stock (% of GDP)		3,0	2,0	2,7	2,6	2,6	2,6
7. Export of goods and services		24,9	1,0	5,4	6,3	6,7	6,7
8. Import of goods and services		27,0	3,2	6,1	6,8	7,7	7,7
Contribution to GDP growth[1]							
9. Domestic demand (excluding stock)		7,6	4,5	2,9	3,9	4,5	4,4
10. Change in stock		2,6	-0,9	0,5	-0,3	-0,3	-0,1
11. Balance of goods and services		0,1	-1,9	-0,5	-0,3	-0,7	-0,9
Added value growth							
12. Primary sector		2,6	-0,8	3,1	2,0	1,7	1,9
13. Industry		18,2	3,8	5,4	5,3	4,8	4,6
14. Construction		17,7	6,3	4,8	4,6	4,7	4,5
15. Other services		2,9	0,8	2,1	2,7	3,1	3,0

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 which cannot be divided between the areas).
Source: Ministry of Finance, Statistics Estonia.

Table 3. Prices' forecast for 2012-2016 (%)

	2011	2011	2012*	2013*	2014*	2015*	2016*
	2000=100	*%*	*%*	*%*	*%*	*%*	*%*
1. GDP deflator	170,6	3,7	2,6	3,1	2,7	2,7	2,7
2. Private consumption deflator	157,4	4,8	3,1	2,9	2,6	2,6	2,6
3. Harmonised consumer price index	158,7	5,1	3,4	3,0	2,7	2,7	2,7
3a. Consumer price index	158,0	5,0	3,3	3,0	2,7	2,7	2,7
4. General government consumption expenditure deflator	187,1	2,4	6,1	2,0	2,0	2,0	2,0
5. Investment deflator	132,5	0,5	0,5	2,4	2,6	2,7	2,7
6. Export deflator	139,2	4,5	1,8	2,1	2,1	2,0	2,1
7. Import deflator	129,0	6,5	2,1	1,9	2,0	2,1	2,1

Source: Ministry of Finance, Statistics Estonia.

Table 4. Labour market forecast for 2012-2016 (persons aged 15-74) (%)

	2011	2011	2012*	2013*	2014*	2015*	2016*
		%	%	%	%	%	%
1. Employment, persons	609,1 [1)]	6,7	0,7	1,0	0,6	0,4	0,4
3. Unemployment rate		12,5	11,5	9,6	8,7	8,3	8,2
4. Labour productivity, persons	19,8	0,9	1,0	1,9	2,8	3,1	3,1
6. Compensation of employees	7453,8 [2)]	8,3	4,6	6,1	6,2	6,4	6,7
7. Compensation per employee (6./1.)	12,2 [3)]	1,5	3,9	5,0	5,6	5,9	6,2

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

Table 5. Balance of payments forecast for 2012-2016 (% of GDP)

	2001–2010	2011	2012*	2013*	2014*	2015*	2016*
1. Net lending/borrowing vis-à-vis the rest of the world	-6,8	7,0	5,6	3,1	0,9	-0,8	-2,5
1a. Current account	-8,2	3,2	1,0	0,0	-1,0	-2,3	-3,5
2. Balance of goods and services	-4,3	6,8	4,3	4,0	3,8	3,0	2,1
3. Balance of income and transfers	-4,0	-3,6	-3,4	-4,0	-4,7	-5,2	-5,6
4. Capital account	1,5	3,8	4,6	3,1	1,9	1,4	1,0
5. Errors and omissions	-0,2	-1,0					

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

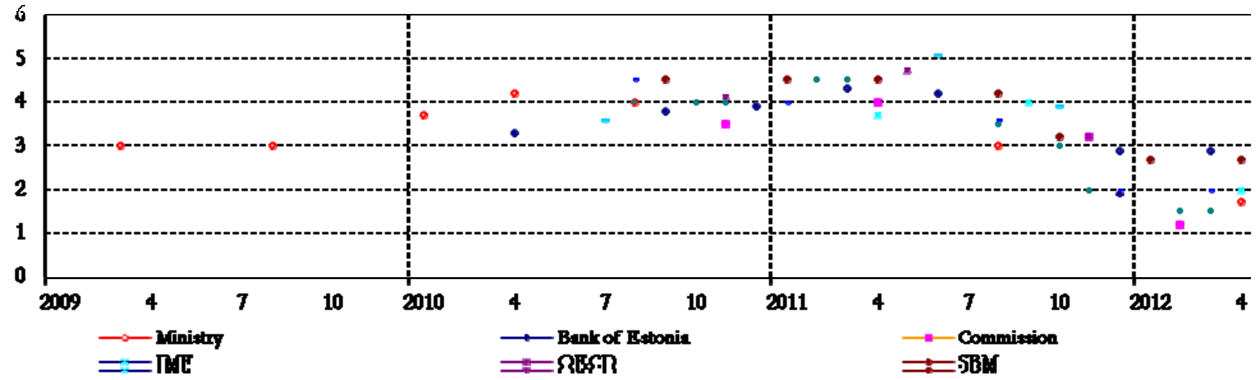
Comparison with the forecasts of other forecasters

The differences between the economic forecast of the Ministry of Finance for spring 2012 and the most recent known growth expectations of the other institutions that prepare economic forecasts are indicated below. As these forecasts are compared, it must be kept in mind that they were made at different times and thus on the basis of different information, which is the cause of the differences in the prerequisites and results of the forecast. Earlier forecasts must be regarded in light of the prerequisites that prevailed at the time they were prepared, as the external environment has changed in the last six months and future prospects are not the same that they were a couple of months ago.

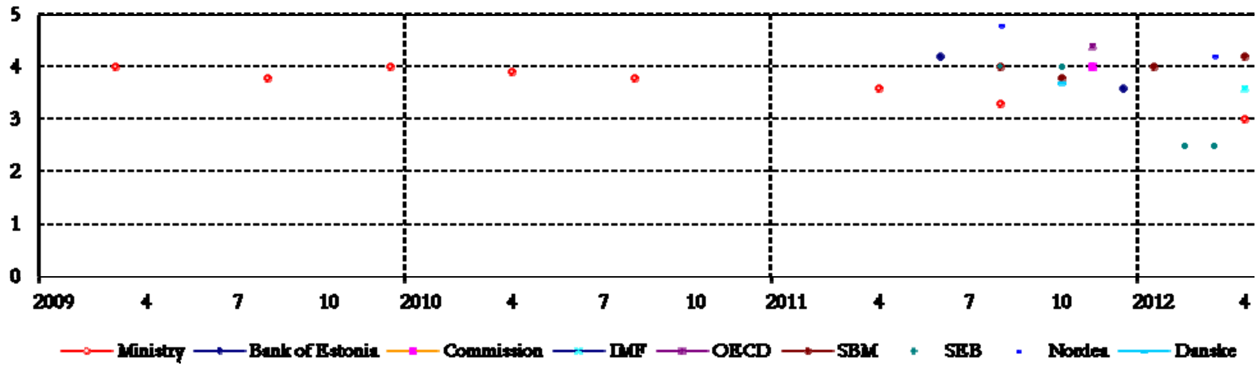
The forecasts prepared in the last six months are clearly pointing out that the economic growth of Estonia will slow down in the current year. This view is based on the growth forecasts of our trade partners, which have become more negative than anticipated. The Ministry of Finance's view of developments in the next year is rather conservative in comparison to other institutions.

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

A. Forecasts of Estonia's economic growth for 2012 according to forecast publication date



B. Forecasts of Estonia's economic growth for 2013 according to forecast publication date



Sources: Ministry of Finance, Bank of Estonia, European Commission, IMF, OECD, Swedbank, SEB, Nordea, Danske Markets, Estonian Institute of Economic Research

Table 6. Comparison of economic forecasts

	Real GDP growth, %			Nominal GDP growth, %		
	2011	**2012***	**2013***	**2011**	**2012***	**2013***
Ministry of Finance	7,6	1,7	3,0	11,7	4,4	6,2
European Commission	7,5	1,2	–	10,7	4,3	–
IMF	7,6	2,0	3,6	–	–	–
OECD	8,0	3,2	4,4	12,1	6,1	7,5
Bank of Estonia	7,9	1,9	3,6	11,9	4,4	6,6
Estonian Institute of Economic Research	7,6	2,9	–	–	–	–
SEB	7,6	1,5	2,5	–	–	–
Swedbank	7,6	2,7	4,2	11,6	5,7	7,1
Danske	7,5	2,2	3,7	–	–	–
Nordea	7,6	2,0	4,2	11,9	5,6	7,7

	Consumer price index, %			Current account, % of GDP		
	2011	2012*	2013*	2011	2012*	2013*
Ministry of Finance	5,0 (5,1*)	3,3 (3,4*)	3,0 (3,0*)	3,2	1,0	0,0
European Commission	5,1*	3,1*	–	–	–	–
IMF	5,1	3,9	2,6	3,2	0,9	-0,3
OECD	5,1*	3,2*	3,2*	–	–	–
Bank of Estonia	5,1*	2,8*	2,9*	2,7	2,0	0,9
Estonian Institute of Economic Research	5,0	3,1	–	3,2	2,0	–
SEB	5,1	4,0	5,0	3,2	1,0	0,5
Swedbank	5,0	3,8	3,2	6,7**	5,9**	5,5**
Danske	5,0	2,8	1,8	2,8	5,2	4,1
Nordea	5,0	3,5	3,7	3,2	-0,2	-0,8

*** Current and capital accounts.*

** Harmonised Consumer Price Index (HICP).*

Sources:

Ministry of Finance. Economic Forecast. Spring 2012. 3.04.2012.

European Commission. Interim Forecast. February 2012. 3.02.2012.

IMF. World Economic Outlook. April 2012. 17.04.2012.

OECD Economic Outlook No. 90, November 2011. 28.11.2011.

Bank of Estonia. Economic Forecast for 2011-2013. 14.12 2011.

Estonian Institute of Economic Research. Quarterly Review of Estonian Economy No. 1 (180) 2012. 4.04.2012.

SEB. Eastern European Outlook. March 2012. 29.03.2012.

Swedbank. Economic Outlook of Estonia. 24.04.2012.

Danske Markets. Emerging Markets Briefer. 16.03.2012.

Nordea Markets. Economic Outlook. March 2012. 27.03.2012.

Macroeconomic policy in coming years

Guaranteeing macroeconomic stability

The primary objective of the macroeconomic policy of the Government of the Republic is to ensure macroeconomic stability, and internal and external balance. The imbalances and risks that appeared during the rapid potential-exceeding growth from 2005-2007 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 economy of Estonia showed remarkable flexibility in both the private and public sectors during the recession. The Government kept the budget deficit within the limits determined in the Treaty on European Union during the recession, giving the 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 measures taken to improve the budget position have long-term impact.

The public sector ended up with its budget position in a surplus on the back of the macroeconomic developments of 2011 that were considerably better than expected and after 2012, which will be in a deficit due to one-off measures, there are plans to restore the structural surplus in 2013 and to keep the budget position in a surplus also in the medium term.

The changeover to the single European currency, the euro, and joining the eurozone on 1 January 2011 helped 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 and minimal interference by the state. The Government intends to maintain the extent to which it currently interferes with 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.

External and internal imbalances of economy

The challenges for economic policy in the coming years concern strengthening the institutional framework, which would make it easier to manage imbalances and prevent their reoccurrence. It is also important to guarantee better functioning of the business environment and labour market, which would improve the long-term growth prospects of economy.

During the period of 2004-2007, i.e. before the recession, the developments in Estonian economy were influenced by the general positivity created by the country joining the European Union, which alongside the inflow of foreign credit created both internal and external imbalances. The big current account deficit in the beginning of the 2000s was caused by the profits earned on foreign investments and the converging country's massive need for investments, which is characterised by the total amount of investments reaching 36% of GDP at the height of the economic boom. Although the current account deficit was relatively large in comparison to other EU countries, it was not caused by a lack of competitiveness, which is also confirmed by the strong growth of exports. The current account deficit was caused by the rapid real convergence and was largely in line with the normal current account deficit level, which according to the IMF was 6-8% of GDP[1]. The excessively fast increase in domestic demand also inflated the current account deficit to 16% of GDP by 2007. Internal demand and foreign trade shrunk considerably after the crisis broke, which is why the current account turned into a surplus. Companies reacted to the situation quickly by redesigning their production processes, cutting costs and looking for new markets, which allowed them to increase the competitiveness of their products and increase their share on foreign markets. The current account may be in balance in 2013 and in a moderate deficit in the subsequent years due to the increase in internal demand and especially in investments.

Similar to the current account deficit, the international investment position of Estonia is also significantly influenced by foreign investments made into Estonia and the revenue earned on these. As foreign investments are an important source of convergence financing for an emerging country without causing vulnerabilities in economy, then we should take a look only at the balance of foreign assets and liabilities, which are debts in their nature, within the context of external imbalances. Net foreign debt amounted to 8% of GDP in 2000, but ballooned to 38% of GDP by 2008 as a result of a rapid inflow of credit. Companies and households have reduced their loan burden in the last three years as a result of the changes in the economic situation and the implementation of stricter credit terms, which has also has a positive impact on the net external debt, which decreased to 7% of GDP by the end of 2011.

---

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

The debt burden of the private sector in Estonia at the start of the 2000s was almost twice below the EU average and according to unconsolidated data amounted to 67% of GDP, and loans taken from commercial banks comprised approximately one half of this. Households were the ones that were prepared to increase their loan burden as a result of the activation of the real estate sector and raising confidence created by the accession to the EU, and they used the money to improve their living conditions and to increase the level of general consumption. The increase in the loan burden was supported by the credit policy and low interest rates of commercial banks. This caused a sudden increase in the loan burden of households. The debt burden of the private sector in Estonia has been higher than the eurozone average since 2006 (as % of GDP). The loan burden of the private sector decreased in 2010 and 2011, which is also evidenced by the decrease in the balance of the loans taken from commercial banks. Demand for loans will probably remain very low for the next couple of years and the decrease in loan balance may stop, but the emergence of a new loan boom is unlikely despite the low interest rates.

The existence of available funds and the general mood caused the property market to overheat from 2005 to 2007. Average transaction prices at the height of the property boom exceeded the price level of 2002 by more than three times. The trend on the property market changed in the middle of 2007: demand dwindled and pushed the market into a decline by the end of 2007. The global financial crisis that started in autumn 2008 deepened the decline even further. The average price of a square metre of a dwelling is back at the level of 2005, which is still 40-50% lower than at the height of the boom. The property purchase power of households was the lowest in 2007 (*ca.* 30 m^2 of apartment space on the basis of average wages[1]), but has more than doubled since then. Despite this, any signs of the residential property market picking up again are modest. Transaction prices have increased by about 30% in comparison to the lowest point, but the number of transactions is still at the level of 2003.

Nominal unit labour costs[2] increased consistently during the boom, when the average wages increased extremely rapidly and exceeded productivity. However, nominal unit labour costs of 4-5% may be considered acceptable for Estonian economy, as it does not suggest a decrease in competitiveness or emergence of an imbalance. The change in the real until about costs[3] was close to zero until 2006, which suggested that the ratio of salary expenses to GDP was stable and labour costs could be increased without damage to competitiveness. The labour market overheated from 2007 and 2008 as a result of excessive internal demand, which was followed by a strong correction whereby the salary increase slowed down suddenly, unemployment increased and employment started to drop. The imbalance on the labour market created by the boom started decreasing fast during the crisis, which is also evidenced by the decrease in the nominal unit labour costs that fell by almost a fifth in total. The increase in nominal unit labour costs will accelerate to 4.2% in 2012, but it will then slow down again and the increase in the indicator will remain below 4% until the end of the forecast period. The ratio of labour costs to GDP will grow marginally in the forecast period. Unemployment will remain at a higher level than the natural unemployment rate, which keeps salary pressures low, allows companies to hire additional workforce and increase production without having to worry about the emergence of excessive pressure to increase wages.

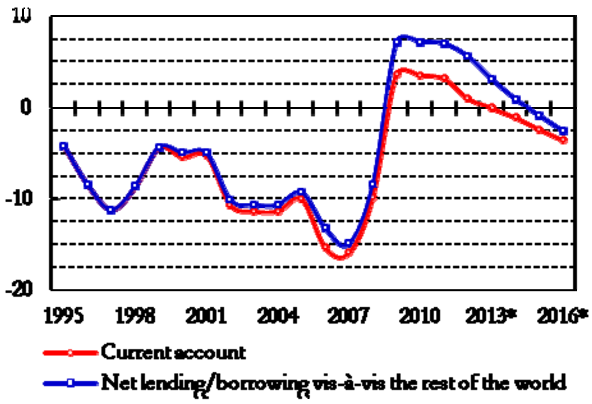
[1] Purchase Power Index of Pindi Kinnisvara according to the lending capacity calculated on the basis of average wages [http://web.pindi.ee/index.php/7347/].
[2] Ratio of labour costs to value added created per employee.
[3] Ratio of labour costs to value added.

The impact of the factors that caused the economy to overheat from 2005 to 2007 has disappeared by now and economic growth is driven by other factors (mainly external demand and improvement of competitiveness), which is why the emergence of a similar boom in internal demand is unlikely in the comings years. However, we still have to be prepared to reduce economic imbalances should they appear. The economy 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 markers also make it possible to reduce the probability of imbalances. The functioning of the labour market is supported by the Employment Contracts Act that has already been implemented and the expansion of the role of 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.

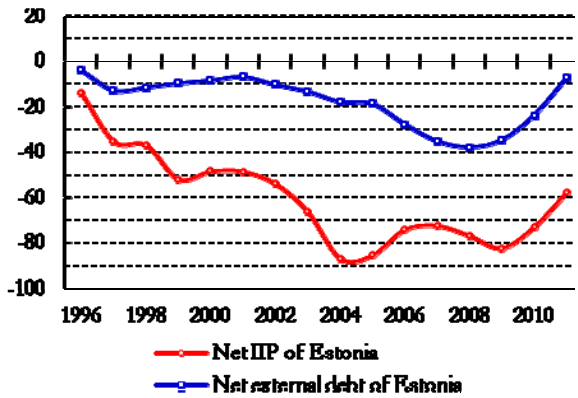
The Government and the Bank of Estonia are constantly monitoring the situation and taking care to ensure macroeconomic stability. Additional measures will be applied if necessary.

Figure 5. Selected indicators from economic developments

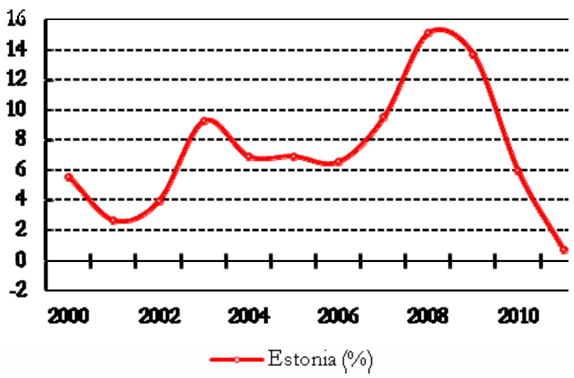
A. Current account balance (% of GDP)



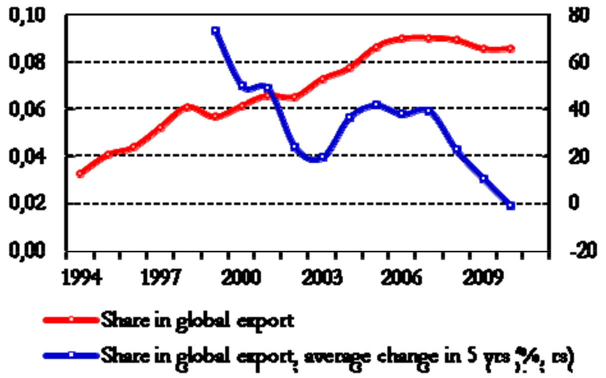
B. Investment position (net IIP, % of GDP)



C. Real effective exchange rate[1]

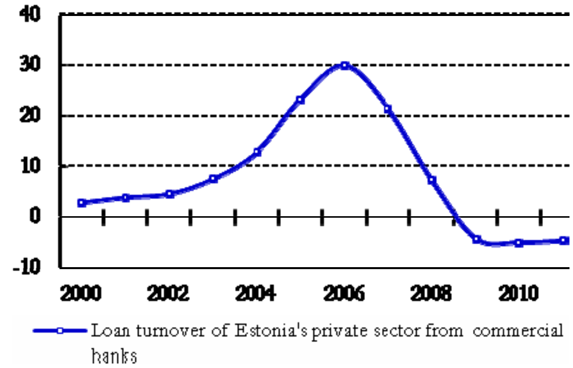


D. Share in world exports (%)

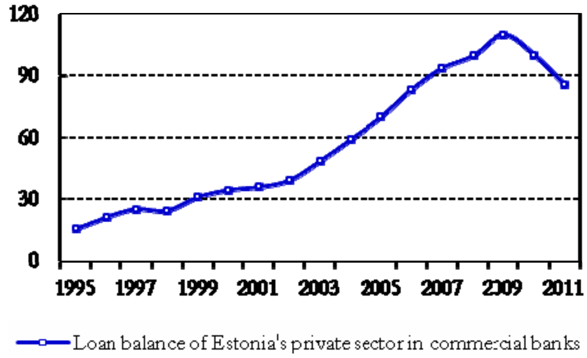


[1] HCI of the euro area: Harmonised competitiveness indicators based on consumer price indices, vis-à-vis EER-40 group of trading partners.

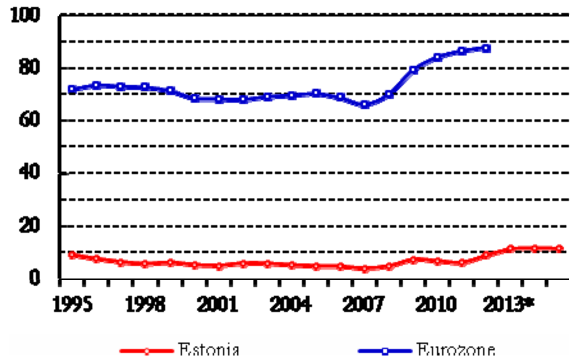
E. Loan turnover of private sector (% of GDP)



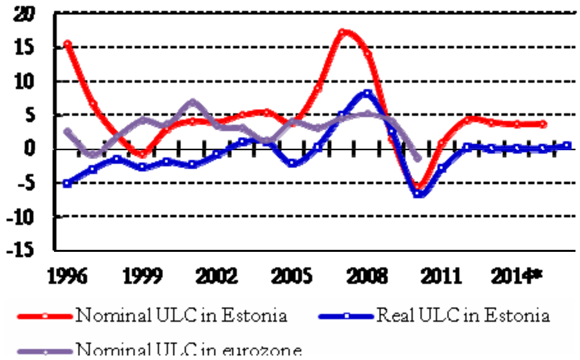
F. Private sector debt (% of GDP)



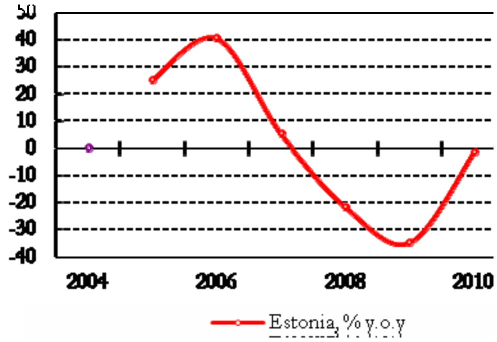
G. General government debt (% of GDP)



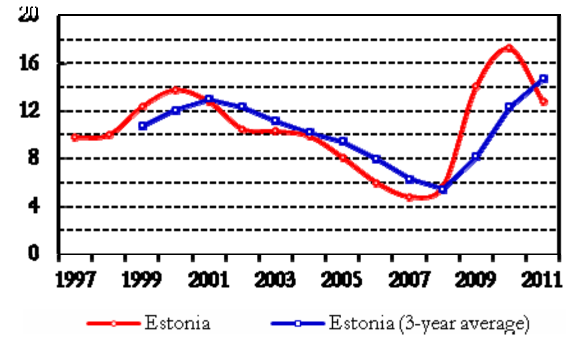
H. Change in unit labour costs (%)



I. Property prices



J. Unemployment rate (%)



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

FISCAL FRAMEWORK

Objectives of the fiscal policy of the Government of the Republic

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

Budget policy decisions are made **simultaneously** (i.e. only in the budget (strategy) process), decisions are **sustainable** (the long-term impact of the decisions is considered) and take account of area policies and the activities of the other levels of the government sector 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) can be **uniformly regarded.**

Medium-term budgetary objective of the Government

The Government continues with a strict fiscal policy and its **medium-term objective (MTO) is the general government structural surplus.**[1] This objective companies with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. Planning the budget position with a surplus helps guarantee the long-term sustainability of the budget. Estonia managed to achieve its MTO until the global economic crisis, but the budgetary position of general government fell into a structural deficit in 2008[2]. The general government of Estonia has been back in a structural surplus since 2009 and the MTO has therefore been achieves. The deterioration of the budgetary position in 2012 is caused mainly by one-off factors, but also the deterioration of the economic situation, which takes the structural budgetary position into a deficit for one year. The structurally adjusted budgetary position will once again be in a growing surplus from 2013 onwards.

Medium-term tax burden objective of the Government

Take the tax burden back to the level it was at before the recession by reducing taxes related to workforce.

The tax burden in 2012 will increase by 0.2% in comparison to the previous year, to 32.9% of GDP. Receipt of VAT and excise duties will increase this year (tobacco and alcohol excise will increase, and fiscal marking of fuel will be reformed); receipt of corporate income tax will increase due to the partial deferral of the profit distributions of state-owned companies until this year; and taxes related to workforce will also increase due to the positive developments on the labour market. However, restarting the payment of mandatory funded pension contributions in their full extent reduces the tax burden technically. All in all, tax revenue will grow slightly faster than economy, which will bring about an increase in the tax burden.

---

[1] The surplus objective was set in the Convergence Programme 2007. The objective in the Convergence Programmes for 2005 and 2006 was a balanced budget.

[2] According to the latest data, due to re-evaluations, there was a structural deficit also in 2006 and 2007.

The tax burden will decrease to 32.6% of GDP by 2016. Future developments are discussed in greater detail in chapter 3.3.2.

Budgetary position of the general government

3.2.1 Nominal position of general government budget

The budgetary position of the general government in 2011 was in surplus for the second year after the recession, which totalled 163.9 million euros or 1% of GDP. The central government ended the year in balance; social security funds and local authorities were in a surplus of 0.9% and 0.1% of GDP, respectively. Proceeds from sales of international emission quotas made a strong contribution to the achievement of a budget surplus, but the surplus would have been achieved without this support as well.

According to the spring forecast of the Ministry of Finance, the budget deficit in 2012 will amount to 2.6% of GDP. The main generator of the deficit is the central government, and the main reasons are the sudden increase in the investments resulting from the sales of quotas and restarting the payment of mandatory funded pension contributions in full. The budget deficit of general government will become smaller in 2013 due to the decrease in temporary impact factors to 1% of GDP, and the budgetary position will achieve a surplus of 0.5% of GDP by the end of the forecast period in 2016.

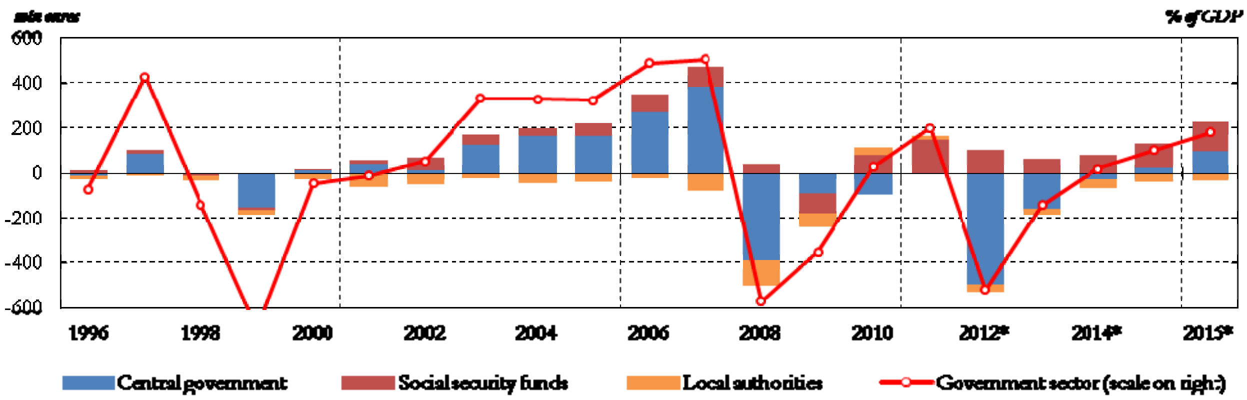
The **Government's objective** after the structurally adjusted budget surplus of 2010 and 2011 is to achieve another surplus in 2013 after the deficit of the current year and to increase it to 1% of GDP by 2016. The nominal budget surplus will be attained in 2014 if this objective is achieved, which will make it possible to replenish the reserves that decreased during the recession. No positive supplementary budgets will be prepared during the year and any extra tax revenue received into the budget will be placed into reserves.

Table 7. General government budgetary position objective from 2012-2016

	2012	2013	2014	2015	2016
Structurally adjusted budgetary position of general government (% of GDP)	**-0,5**	**0,1**	**0,5**	**0,7**	**1,0**
Budgetary position of general government (% of GDP)	**-2,6**	**-0,7**	**0,1**	**0,5**	**0,9**
State budget	-2,8	-0,8	0,0	0,3	0,5
incl. state pension insurance	-2,2	-2,2	-2,4	-2,6	-2,6
Other central government	-0,2	0,0	-0,1	-0,2	-0,1
Social security funds	0,6	0,4	0,4	0,5	0,6
Local authorities	-0,2	-0,2	-0,2	-0,2	-0,2
Budgetary position of general government (mln euros)	**-428**	**-123**	**14**	**94**	**193**
State budget	-463	-148	-3	68	111
incl. state pension insurance	-361	-384	-459	-515	-543
Other central government	-34	-7	-24	-41	-13
Social security funds	101	63	78	104	131
Local authorities	-33	-31	-37	-36	-35

Source: Ministry of Finance.

Figure 6. Budgetary position of the general government



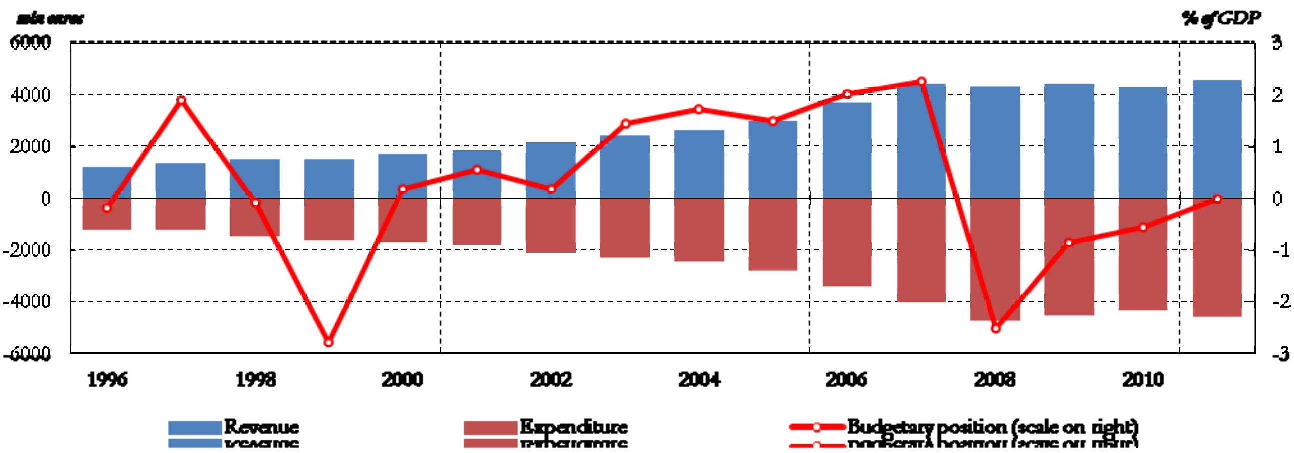
Source: Statistics Estonia, Ministry of Finance.

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

Central government

The biggest part of central government, which comprises *ca.* three-fourths of general government, are 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, Ministry of Finance.

The tax revenue of the state budget, which is the most sensitive to economic development, comprises the biggest part of the central government's revenue. This is why the biggest part of the budget deficit has come from the state budget when the economic cycle is in a phase of decline. However, the state budget also contributed the most to the budget surpluses before the crisis. Non-tax revenue, which mainly consists of external support received from the European Union, also comprises a large part of the central government's revenue in addition to tax revenue.

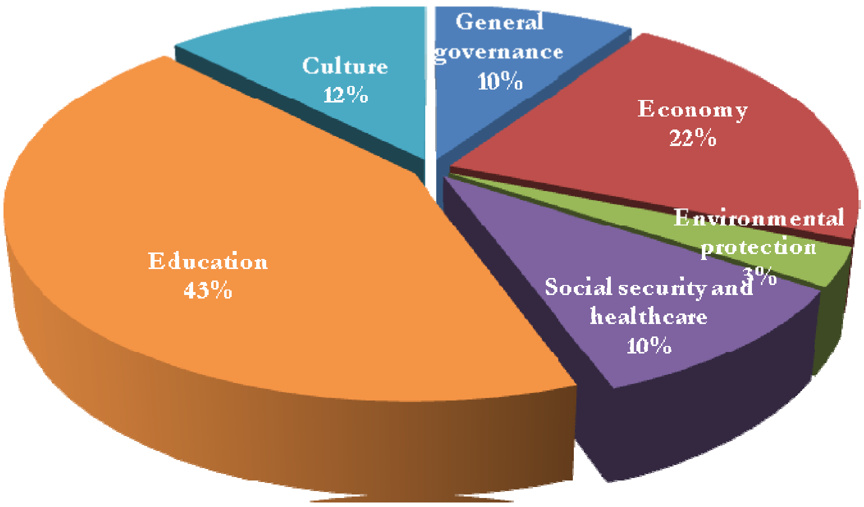
The majority of the central government's expenditure consists of state budget expenditure, ca. one-third[1] of which are social protection expenses (incl. state pension insurance). These expenses are followed by expenditure on economy (incl. agriculture and road construction) and health (allocation to the Estonian Health Insurance Fund).

The 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 authorities

There are 226 local authorities in Estonia that have an important role in the performance of public sector functions. They all perform the same functions irrespective of their size – organise the maintenance of schools, nursery schools, community cultural centres, museums, sports facilities, nursing homes and health authorities; provision of social welfare and social services; welfare of the elderly; youth work; housing and utility management; water supply and sewerage; waste management; territorial planning; public transport in municipalities, towns and cities; and maintenance of streets and roads in municipalities, towns and cities. The total amount of their expenses in 2011 on cash basis was 1,296 million euros. Operating expenses comprised 72% of this.

Figure 8. Division of the expenditure of local authorities by areas of activity in 2011

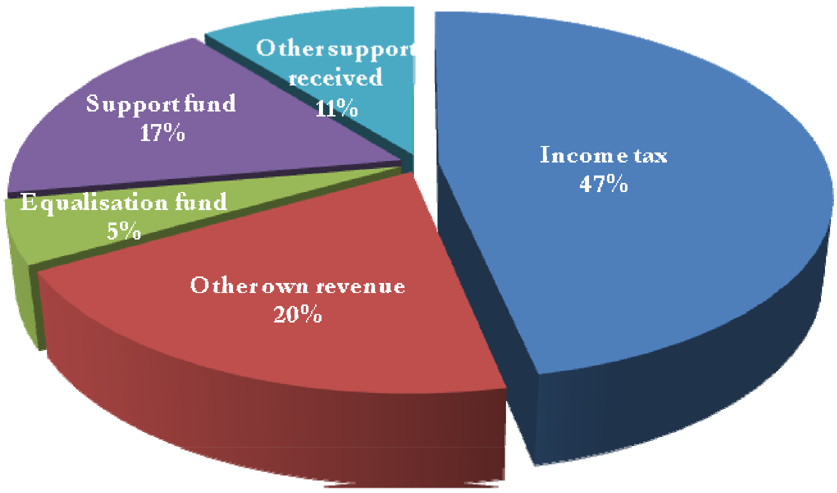


Source: Ministry of Finance.

The budgets of local authorities are independent, which means that they prepare them themselves. Their main types of revenue are income tax and support from the state budget.

[1] Based on the 2012 state budget.

Figure 9. Division of the revenue of local authorities in 2011



Source: Ministry of Finance.

The accrual-based surplus of local authorities from 2010 to 2011 was caused by the extraordinary restriction pursuant to which they were only allowed to assume additional obligations for the purpose of co-financing external support and refinancing existing obligations. They usually end up in a deficit without this restriction. The debt burden was increased to cover this, and it amounted to 565 million euros by the end of 2011. The data of the budgets of local authorities and their budget execution are available in monthly reports[1].

The activities of local authorities are regulated by the Financial Management of Local Authorities Act since 2012. The Act stipulates that local authorities must guarantee that the result of their main activities is positive every year and to keep their net debt burden (the difference between liabilities and liquid assets) within their individual limits (this applies to both the local authority itself and the entities that depend on the local authority). The individual limit depends on financial capacity and is 60-100% of operating revenue. The possibility to raise the net debt burden above 60% is postponed until the end of 2016, even if the individual limit would allow to do it earlier. This reduces the deficit.

Table 8. Cash-based aggregate indicators of local authorities (mln euros)

	2010	2011	2012*	2013*	2014*	2015*	2016*
TOTAL REVENUE	1 270	1 324	1 357	1 418	1 441	1 473	1 531
- Income tax	585	619	652	707	751	798	852
- Equalisation Fund	70	72	72	73	72	72	72
TOTAL EXPENDITURE	1 249	1 295	1 390	1 449	1 478	1 509	1 566
BALANCE	27	29	-33	-31	-37	-36	-35

** forecast*
Source: Ministry of Finance.

The basis on which the revenue base of local authorities is formed will be reviewed as soon as budgetary options appear, and their aggregate deficit will also be considered. There are no plans to increase the local authorities' income tax and equalisation fund in relation to their presumably high level of deficit and the limited state budgetary options.

[1] http://www.fin.ee/index.php?id=11182.

Land tax will abolished in 2013 in order to reduce the tax burden of homeowners. The abolishment will apply to land under homes to the extent of 1,500 m^2 in densely populated areas and 2 ha in low-density areas.

The share of financing the maintenance of local roads will be increased in the financing of overall road maintenance. The more specific division will be agreed on in the annual process of state budget preparation.

Social security funds

The Estonian Health Insurance Fund and the Unemployment Insurance Fund belong to the sector of social security funds. The national pension insurance system belongs to central government in Estonia.

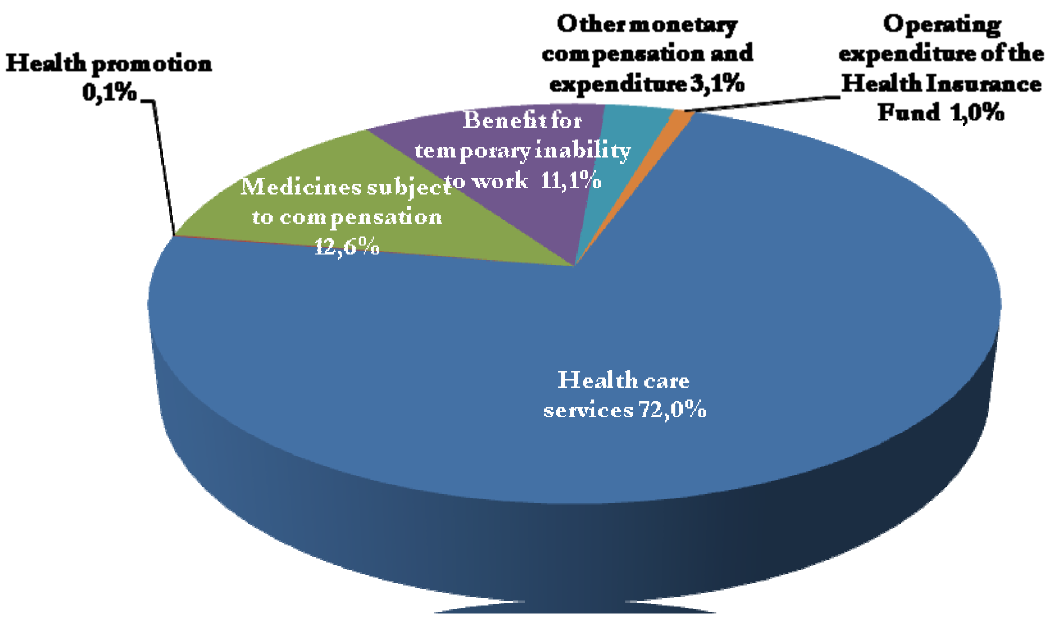
Table 9. Forecast of the budgetary position of social security funds, 2011-2016

	2011	Budget for 2012	2012*	2013*	2014*	2015*	2016*
Budgetary position of social security funds *(mln euros)*	148	106	101	63	78	104	131
Social security funds *(% of GDP)*	0,9	0,6	0,6	0,4	0,4	0,5	0,6

** forecast*

The health insurance part of social tax comprises *ca.* 99% of the revenue of the **Estonian Health Insurance Fund.** Health services (prevention of diseases, primary and specialised medical care, nursing care and dental treatment) comprise the biggest part of the compensation guaranteed to insured persons. These services are followed by compensated medicines and benefits for temporary inability to work.

Figure 10. Division of the expenditure of the Estonian Health Insurance Fund, 2011



The budget of the Estonian Health Insurance Fund ended up in a deficit due to the decrease in the social tax collected. In 2011 the budget of the Estonian Health Insurance Fund ended up in a surplus of *ca.* 13 million euros, mainly due to the collection of more social tax and the amount of expenditure (especially benefits for temporary inability to work) being smaller than forecast, but we expect a deficit in this and the two coming years. The deficit in 2012 is influenced by the increase in the levels of expenses (mainly the expenses of specialised medical care and medicines subject to compensation).

Table 10. Composite indicators of the Estonian Health Insurance Fund (mln euros)**

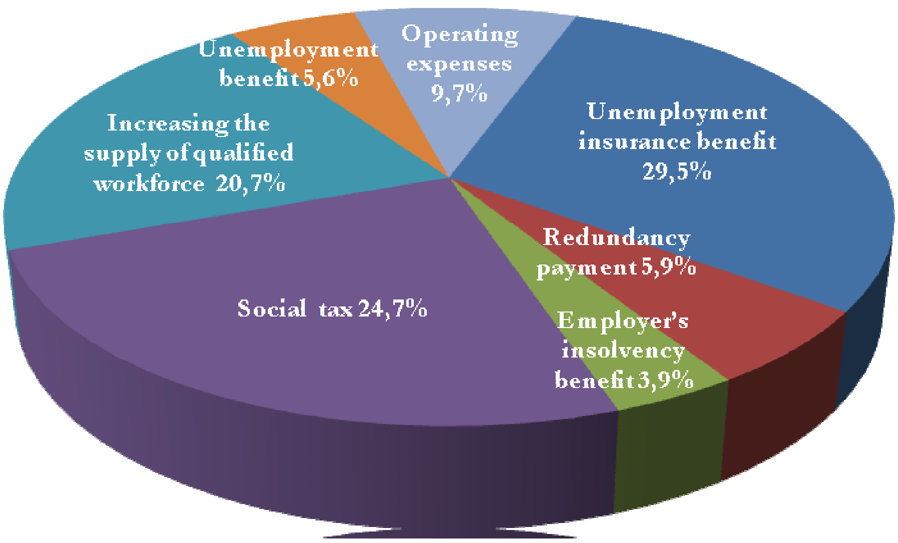
	2008	2009	2010	2011*	2012*	2013*	2014*	2015*	2016*
Total revenue	**824,5**	**730,5**	**694,4**	**735,1**	**772,4**	**822,0**	**860,6**	**911,9**	**969,7**
incl. social tax	799,0	718,0	685,9	725,6	763,7	812,7	850,5	901,1	958,1
Total expenditure	**788,6**	**771,2**	**700,3**	**725,5**	**787,2**	**829,3**	**865,7**	**904,3**	**944,4**
incl. health services	527,4	514,5	501,0	522,5	561,2	582,2	601,0	620,6	641,1
Budgetary position	**34,9**	**-40,6**	**-1,2**	**13,0**	**-14,8**	**-7,3**	**-5,1**	**7,6**	**25,3**

** forecast*

*** Budgetary position from 2008-2011 on the basis of the data of Statistics Estonia. Forecast of expenditure for 2012-2015 according to Resolution No. 13 of the Supervisory Board of the Estonian Health Insurance Fund "Approval of the Principles of Planning the Expenditure and Sources for Covering the Expenditure of the Estonian Health Insurance Fund in Four Years and the Requirements for Preparation of the Draft Budget of the Estonian Health Insurance Fund for 2012" dated 30 May 2011, and the expenditure forecast for 2016 is based on the principles given in the aforementioned resolution of the Supervisory Board of the Estonian Health Insurance Fund.*

Unemployment insurance benefits comprise the biggest part of the expenditure of the **Unemployment Insurance Fund.** The length of the period in which these benefits are paid increased to 360 days in 2011. The number of unemployment insurance benefit recipients increased *ca.* 3.5 times in 2009 and decreased by *ca.* 40% in 2010, and the decreasing trend should prevail during the entire programme period according to forecasts.

Figure 11. Division of the expenditure of the Unemployment Insurance Fund, 2011



Similar to 2010 the Unemployment Insurance Fund also ended the previous year in a surplus (*ca.* 135 million euros), which resulted from the increase in unemployment insurance premiums in the middle of 2009 and the decrease in the number of persons to whom this benefit was paid. The budgetary position of the Unemployment Insurance Fund this year is positively influenced by the continuing decrease in the volume of benefits and increasing collection of unemployment insurance premiums. The budget surplus expected as a result of this is *ca.* 115 million. The rate of unemployment insurance premiums is expected to decrease to 2% and 1% from 2013, which will reduce the budget surplus significantly.

Table 11. Composite indicators of the Unemployment Insurance Fund (mln euros)**

	2008	2009	2010	2011*	2012*	2013*	2014*	2015*	2016 *
Total revenue	**48,6**	**159,6**	**238,4**	**249,7**	**245,8**	**194,9**	**202,6**	**211,9**	**224,1**
- unemployment insurance premium	48,0	115,0	179,0	192,5	206,2	158,6	168,0	178,0	189,4
Total expenditure	**45,1**	**209,3**	**157,3**	**117,8**	**126,4**	**120,9**	**115,7**	**112,8**	**115,4**
- benefits**	37,0	139,0	76,0	45,8	41,9	38,5	34,6	33,7	34,8
Budgetary position	**1,9**	**-53,3**	**83,5**	**134,8**	**115,4**	**70,7**	**83,5**	**95,9**	**105,3**

** forecast*
*** Unemployment insurance benefit, insurance benefit in the case of redundancy and employer's insolvency benefit.*
**** Budgetary position from 2008-2011 on the basis of the data of Statistics Estonia.*

The principles of financing the services were changed in order to guarantee the sustainability of labour market services and the ability to react quickly and flexibly to changes on the labour market, which means that the provision of services is mainly financed from the collected unemployment insurance premiums since 2012.

3.2.2 Cyclically adjusted position of general government budget

The method used by the Ministry of Finance to estimate potential GDP[1] is the production function method[2]. The use of this method indicated that from 2005 to 2007 the GDP of Estonia increased considerably faster than it should have considering the resources existing in the economy at the time, which created significant imbalances. The economic growth that could be considered manageable for the economy of Estonia before the crisis was *ca.* 6%, but it actually reached 10% at times. The growth was based on the rapid inflow of foreign funds as well as the overall optimist of local economic agents, which made internal demand considerably bigger than total production and income. This excessive demand resulted in a GDP gap[3] of 12% in 2007, which was accompanied by accelerating inflation, a strong deterioration of the trade balance and tensions from the excessively intense and inefficient use of resources in economy.

[1] Potential GDP – the maximum level of output (GDP) that an economy can produce using the existing production inputs (workforce, capital, productivity/skills) whereby no excessive pressure to increase prices is created.
Potential economic growth – potential change in GDP over time. Depends on the changes in production inputs.
[2] See Annex 3 to the Estonian Convergence Programme of May 2004 for information about the GDP gap and cyclically adjusted budget position evaluation methodology.
[3] GDP gap – *(output gap)* divergence of the actual GDP level and potential GDP level.

Demand for consumer and investment goods decreased suddenly as the uncertainty that started to appear at the height of the boom continued to increase. The global financial crisis that started in autumn 2008 magnified the economic downturn caused by the cyclical behaviour of economy even further. Global demand also decreased considerably as a result of the financial crisis and caused the scale of foreign trade to decrease by up to a third. The negative GDP gap of Estonia increased to almost 11% of GDP in 2009 as a result of this. The negative GDP gap has started to narrow as the economic cycle is turning, but was still approximately 9% in 2010 and 3% in 2011. The GDP gap should close by the final years of the forecast period.

As the recent financial crisis and its aftermath have been considerably larger 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 Estonian economy in the next few years will also be lower than before the crisis due to the same reasons.

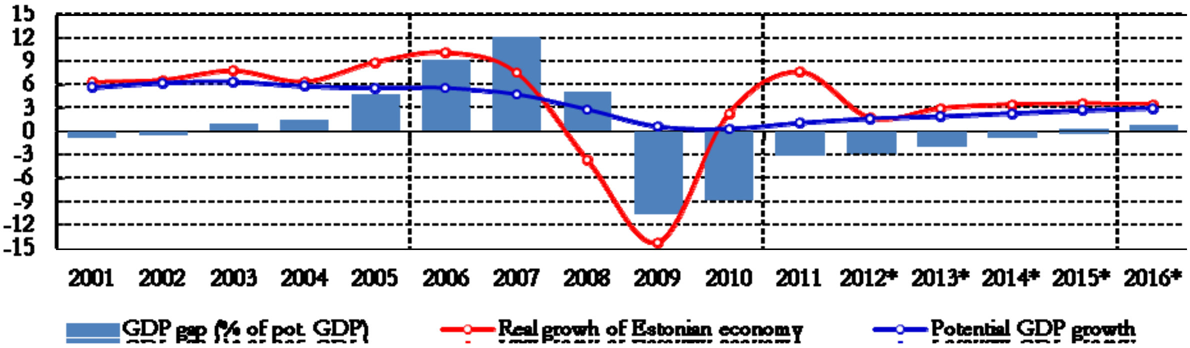
The estimates of the cyclically adjusted position of Estonia's general government budget found on the basis of the GDP gap indicate that the fiscal policy of Estonia is countercyclical from 2011 to 2012 in the conditions of a negative GDP gap (the GDP level is lower than the potential level). The GDP level will remain lower than the potential level from 2013 to 2014, but the fiscal policy will become stricter – the cyclically adjusted budgetary position will start improving – which is why the fiscal policy will become procyclical. The GDP gap will become positive in the period of 2015-2016 and the cyclically adjusted budgetary position will improve in both years. This is why the course of the fiscal policy in these years is countercyclical. However, it must be kept in mind that the impact of the change in the use of external funds must also be assessed in addition to the change in the budgetary position when a final assessment of the fiscal policy is given. Since these are neutral in regard to the budgetary position – revenue always equals expenditure – then an increase in the use of funds, for example, is not reflected in the changes that occur in the budgetary position. However, it does provide some extra stimulation to economic activities during the economic crisis and is cyclical in its nature.

Table 12. Cyclically adjusted budgetary position, 2011-2016 (% of GDP)

	2001–2010	**2011**	**2012***	**2013***	**2014***	**2015***	**2016***
1. Real GDP growth (%)	3,8	7,6	1,7	3,0	3,4	3,5	3,5
2. Budgetary position of the general government	-	1,0	-2,6	-0,7	0,1	0,5	0,9
3. Interest payments	-	0,1	0,1	0,2	0,2	0,2	0,3
4. Potential real GDP growth (%)	4,4	1,1	1,6	1,9	2,3	2,7	3,0
4.a Contribution of capital to potential growth (%)	2,9	1,2	1,5	1,5	1,6	1,7	1,8
4.b Contribution of labour to potential growth (%)	0,5	0,2	0,2	0,2	0,3	0,4	0,4
4.c Contribution of productivity to potential growth (%)	1,0	-0,2	0,0	0,3	0,5	0,7	0,9
5. GDP gap (output gap)	1,3	-2,8	-2,7	-1,7	-0,6	0,2	0,7
6. Cyclical budget component	-	-0,8	-0,8	-0,5	-0,2	0,1	0,2
7. Cyclically adjusted budgetary position	-	1,9	-1,8	-0,2	0,3	0,4	0,7
8. Cyclically adjusted primary position	-	2,0	-1,6	0,0	0,4	0,6	1,0
9. Fiscal policy position	-	Counter-cyclical	Counter-cyclical	Pro-cyclical	Pro-cyclical	Counter-cyclical	Counter-cyclical

Source: Ministry of Finance, Statistics Estonia.

Figure 1. Development of potential GDP and GDP gap (%)



Source: Ministry of Finance, Statistics Estonia.

3.2.3 Structural position of general government budget

The structural budgetary position of general government is found when one-off and temporary factors, which may distort the budgetary position, are removed from the nominal position in addition to the impact of the economic cycle. The measures that have a significant impact on the budget, but whose significant impact on the cyclically adjusted budgetary position is temporary and non-recurring (on the scale of at least *ca.* 0.1% of GDP) are called one-off and temporary measures. Although the general principles on the basis of which the impact of a measure is classified as temporary have been defined, the consideration of each specific case is decided separately.

The **Government's objective** after the structurally adjusted budget surplus of 2010 and 2011 is to achieve another surplus in 2013 after the deficit of the current year and to increase it to 1% of GDP by 2016. Even though the nominal budgetary position will deteriorate considerably in 2012, it is caused mainly by the impact of one-off factors, which have no influence on the structural budgetary position.

The one-off measures that influence the budgetary position of general government are listed in Table 13. The total amount of one-off measures in 2011 was 1.6% of GDP, which the temporary reduction of second pension pillar contributions by one half and the balance of sales of international emission quotas. The state starts paying its contributions to people's second pension pillars in full in 2012 and the influence will disappear. Divides of state-owned companies, which exceed the usual dividend and net profit ration, and income tax will be added. The balance of emission quotas will become negative, mainly due to the investments associated with the sales of AAUs[1] and its impact on the budgetary position will be as significant as -1.3% of GDP. The investments associated with sales of AAUs will continue until 2014 and the impact of the funded pension compensation mechanism will also appear in the same year. Impact on the budgetary position will decrease to -0.2 to 0.3% of GDP.

[1] Assigned Amount Unit.

Table 13. One-off measures and their impact, 2011-2016 (mln euros)

	2011	2012*	2013*	2014*	2015*	2016*
Suspension of second pension pillar contributions	84					
Revenue from sales of Assigned Amount Units (AAU)	191	47				
Expenses of Assigned Amount Units (AAU)	-24	-290	-52	-7		
Dividends that exceed the usual dividend and net profit ratio, and income tax that total at least 0.1% of GDP		26				
2+6 and 3+6 second pension pillar contributions				-39	-59	-65
Total, € million	**251**	**-217**	**-52**	**-46**	**-59**	**-65**
Total, % of GDP	**1,6**	**-1,3**	**-0,3**	**-0,2**	**-0,3**	**-0,3**

Source: Ministry of Finance.

Table 14. Structurally adjusted budgetary position, 2011-2016 (% of GDP)

	2011	2012*	2013*	2014*	2015*	2016*
1. Cyclically adjusted budgetary position	1,9	-1,8	-0,2	0,3	0,4	0,7
2. One-off measures	1,6	-1,3	-0,3	-0,2	-0,3	-0,3
3. Structurally adjusted budgetary position	0,3	-0,5	0,1	0,5	0,7	1,0

Source: Ministry of Finance, Statistics Estonia.

General government revenue and expenditure

Table 15. General government revenue and expenditure, 2011-2016

	2011 € mln	2011 % of GDP	2012* % of GDP	2013* % of GDP	2014* % of GDP	2015* % of GDP	2016* % of GDP
Budgetary positions by general government levels							
1. General government	164,7	1,0	-2,6	-0,7	0,1	0,5	0,9
2. Central government	-0,7	0,0	-3,0	-0,8	0,0	0,3	0,5
4. Local authorities	17,6	0,1	-0,2	-0,2	-0,2	-0,2	-0,2
5. Social security funds	147,7	0,9	0,6	0,4	0,4	0,5	0,6
General government							
6. Total revenue	6 264,2	39,2	40,1	38,4	36,9	35,7	35,2
7. Total expenditure	6 099,5	38,2	42,7	39,1	36,8	35,3	34,3
8. Budgetary position	164,7	1,0	-2,6	-0,7	0,1	0,5	0,9
9. Interest expenses	15,1	0,1	0,1	0,2	0,2	0,2	0,3
10. Primary balance	179,8	1,1	-2,4	-0,5	0,3	0,7	1,2
11. One-off and temporary measures	251,4	1,6	-1,3	-0,3	-0,2	-0,3	-0,3
Revenue by components							
12. Tax revenue (12=12a+12b+12c)	3 252,2	20,4	20,9	20,9	21	20,9	20,9
12a. Taxes on production and imports	2 205,3	13,8	14	14,1	14,1	14,2	14,1
12b. Taxes on income and wealth	1 046,9	6,6	6,8	6,8	6,9	6,7	6,8
12c. Capital taxes	0,0	0,0	0,0	0,0	0,0	0,0	0,0
13. Social security contributions	1 960,7	12,3	11,9	11,7	11,3	11,3	11,2
14. Property income	165,4	1,0	1,3	1,1	1,1	1,2	1,1
15. Other revenue	885,9	5,5	6,0	4,8	3,4	2,4	2
16.=6. Total revenue	6 264,2	39,2	40,1	38,4	36,9	35,7	35,2
p.m.: Tax burden (D.2 (incl. taxes to the EU)+D.5+D.611+D.91-D.995)	5 218,4	32,7	32,9	32,6	32,5	32,3	32,3
Expenditure by components							
17. Benefits to employees + intermediate consumption	2 909,3	18,2	18,2	17,7	17,0	16,4	15,8

	2011	2011	2012*	2013*	2014*	2015*	2016*
	€ mln	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
18. Social transfers (18=18a+18b)	2 141,2	13,4	13,4	13,2	13,0	12,8	12,6
18a. Social transfers in kind	279,9	1,8	1,7	1,7	1,7	1,6	1,6
18b. Monetary social transfers	1 861,3	11,7	11,6	11,5	11,3	11,2	11
19.=9. Interest expenses	15,1	0,1	0,1	0,2	0,2	0,2	0,3
20. Subsidies	166,7	1,0	1,1	1,1	1,0	1,0	1,0
21. Gross capital formation	670,5	4,2	6,8	4,7	3,6	3,5	3,4
22. Capital transfers	121,7	0,8	0,8	0,8	0,8	0,8	0,8
23. Other expenditure	75,5	0,5	2,4	1,5	1,1	0,5	0,3
24.=7. Total expenditure	6 099,5	38,2	42,7	39,1	36,8	35,3	34,3
p.m.: General government consumption	3 116,4	19,5	20,0	19,4	18,7	17,9	17,2

**Forecast.*

Source: Statistics Estonia, Ministry of Finance.

Table 16. Impact of fiscal policy decisions on general government revenue and expenditure

	2011	2011	2012	2013	2014	2015	2016
	€ mln	**% of GDP**	**% of GDP**	**% of GDP**	**% of GDP**	**% of GDP**	**% of GDP**
General government revenue forecast	6 264,2	39,2	40,1	38,1	36,3	34,9	34,4
Revenue policy measures				0,2	0,6	0,8	0,8
General government expenditure forecast	6 099,5	38,2	42,7	39,2	36,9	35,4	33,9
Expenditure policy measures				0,1	0,1	0,1	-0,4

Source: Statistics Estonia, Ministry of Finance

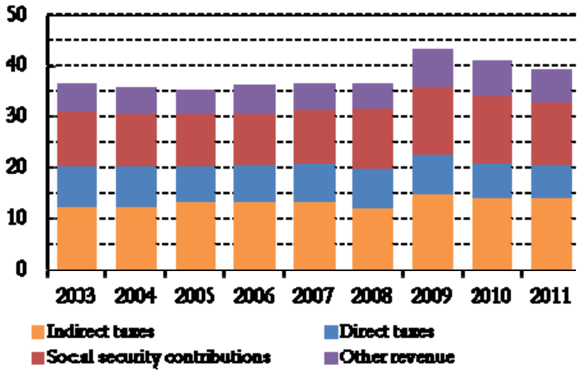
The revenue forecast by the Ministry of Finance for spring 2011 as well as the expenditure and the scope of the measures required for the achievement of the objectives given in the Stability Programme are given in Table 16. Increasing alcohol excise is one of the most important revenue policy measures that will be taken and the Tax and Customs Board will carry out several activities for the purpose of a more efficient collection of taxes (see also 3.3.2). Postponing the option to increase the net debt burden of local authorities (see also 3.2.1) and the decrease in interest expenses caused by the improvement of the State Treasury's cash flow as a result of measures are some of the factors that contribute to the decrease in general government expenditure.

3.3.1 Structure of general government revenue

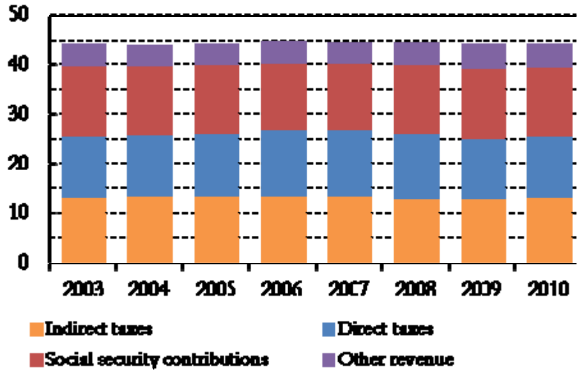
In 2011 general government revenue increased the most as a result of the increase in indirect taxes, which occurred due to the increase in the tobacco and alcohol excise collected. Personal income tax and social tax increased direct taxes and social security contributions, respectively, as the amounts collected increased due to the positive developments on the labour market. Partial restoration of the state's contributions into the second pension pillar had a technically decreasing impact on the collection of social security contributions. The ratio of revenue to GDP decreased on the whole because economic growth was faster than revenue growth, which shows that economic growth is focussed on export.

Figure 2. General government revenue and its structure (% of GDP)

A. General government revenue in Estonia



B. General government revenue in EU27



Sources: Eurostat.

3.3.2 Future developments in tax policy and the tax burden

One of the tax policy goals of the Government is to shift the tax burden from the taxation of income to the taxation of consumption, use of natural resources and pollution of the environment with the partial refocusing of taxes. At the same time the system should remain **stable, simple and transparent** with as few exceptions and differences as possible.

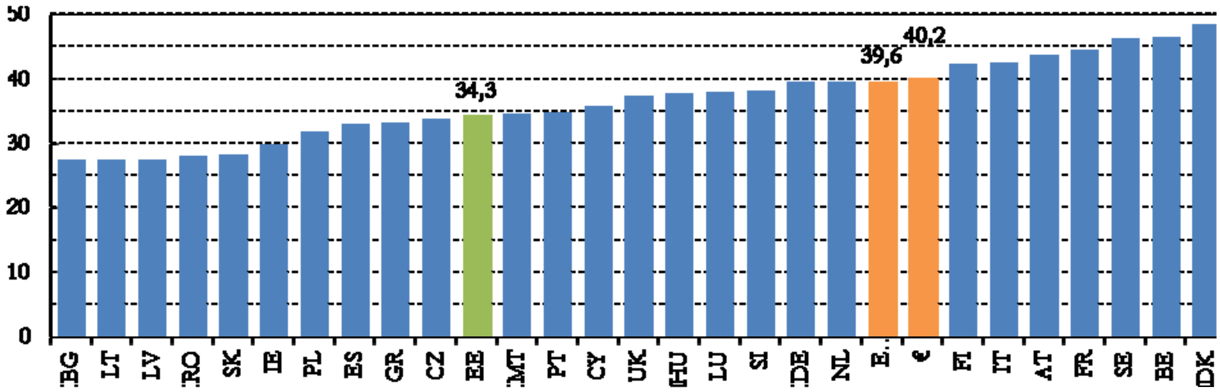
In 2010 the tax burden in Estonia decreased by 1.4% to 34.3% of GDP, which is considerably lower than the weighted average of the 27 countries of the European Union and the euro area. In 2011 the tax burden decreased by 1.5% to 32.7%. Nominal GDP increased faster than tax collection in both of these years, which shows that economic growth is focussed on export. The decrease in the tax burden in 2010 can also be explained with the fact that the amounts of several taxes that were collected were smaller than before – corporate income tax (the profit distributions of state-owned and private companies decreased), tobacco excise (the impact of people stocking up) and social tax (negative developments on the labour market). Partial restoration of mandatory funded pension contributions reduced the tax burden in 2011.

The goal is to take the tax burden back to the level it was at before the recession by reducing labour-related taxes.

The tax burden in 2012 will increase by 0.2% in comparison to the previous year, to 32.9% of GDP. Receipt of VAT and excise duties will increase this year (tobacco and alcohol excise will increase, and fiscal marking of fuel will be reformed); receipt of corporate income tax will increase due to the partial deferral of the profit distributions of state-owned companies until this year; and taxes related to workforce will also increase due to the positive developments on the labour market. However, restarting the payment of mandatory funded pension contributions in their full extent reduces the tax burden technically. All in all, tax revenue will grow slightly faster than economy, which will bring about an increase in the tax burden.

The tax burden will decrease to 32.6% of GDP by 2016. The higher contributions of the state into the mandatory funded pensions of persons who continued making their own contributions will reduce the tax burden from 2013 to 2016. The tax policy changes that reduce the tax burden are reduction of the rates of unemployment insurance premiums from 2013, abolishment of the obligation to pay the pension part of social tax on salaries that exceed €4,000 per month from 2014, and reduction of the income tax rate to 20% in 2015. The tax burden will be increased by the full implementation of the fiscally marked fuel reform in 2013, whereby excise incentives will be replaced with direct aid. The tax burden is also increased by the various measures taken to achieve the structural budgetary position objective (more efficient tax collection by the Tax and Customs Board, increasing the alcohol excise, reducing the limit of income tax deductions).

Figure 3. Tax burden in 2010 (% of GDP)



Source: Eurostat.

Higher taxation of consumption and environment exploitation

The taxes and charges that are regarded as environmental taxes in Estonia are fuel and energy excise, packaging excise, heavy goods vehicle tax, car registration fee, boat tax, pollution charges and charges for use of natural resources. Changes in the existing tax rate within the scope of the green tax reform are not precluded.

Reducing differences in taxation

Tax incentives that diverge 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.

Changes in taxes

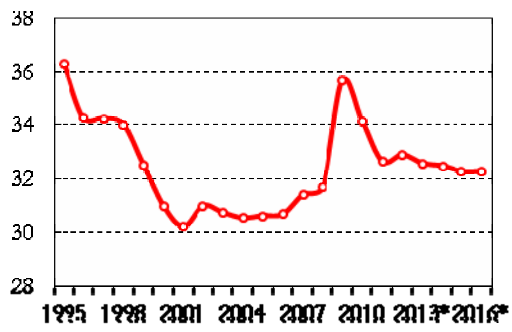
There are plans to increase alcohol excise by 5% every year (from 2013 to 2016) in order to reduce the accessibility of alcohol.

More efficient tax collection by the Tax and Customs Board

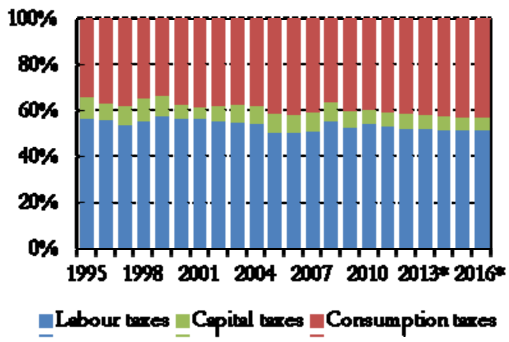
The Tax and Customs Board plans to apply three measures in order to improve tax collection: e-receipt, the obligation to register employees and taxation of persons who repeatedly bring goods subject to excise duty across the border.

Figure 15. Development of tax burden in Estonia

A. Tax burden



B. Tax revenue



Sources: Ministry of Finance, Eurostat.

Table 17. Main tax policy changes in 2012 and 2013[1]

	Entry into force	Impact 2012		Impact 2013	
		€ mln	*% of GDP*	*€ mln*	*% of GDP*
Changes in taxes					
1. Creation of an investment account	1 Jan 2011 (impact in 2012)	-4,3	-0,03	-4,6	-0,03
2. Increasing tobacco excise by 10%	1 Jan 2012	8,0	0,05	9,0	0,05
3. Fiscally marked fuel reform	1 Jan 2012	18,0*	0,11	68,5**	0,39
4. Not regarding the expenses of formal education within the adult education system as fringe benefits	1 Jan 2012	-5,4	-0,03	-5,4	-0,03
5. Increasing alcohol excise by 5%	1 Feb 2012	6,5	0,04	9,0	0,05
6. Reducing the upper limit of income tax incentive from €3,196 to €1,920	1 Jan 2011 (impact in 2013)			5,0	0,03
7. Increasing tobacco excise by 10%	1 Jan 2013			10,0	0,06
8. Increasing the excise duty payable on oil shale used for the production of heat (€0.3/GJ)	1 Jan 2013			0,6	0,00
9. Reducing the rate of unemployment insurance premium from 4.2% to 3.0% (2.0% and 1.0%)	1 Jan 2013			-52,4	-0,30
10. Increasing the personal income tax share of local governments by 0.17% in 2013 and 0.03% in 2014	1 Jan 2013, 1 Jan 2014			-10,5	-0,06
11. Increasing alcohol excise by 5%	1 Jan 2013			8,0	0,05

** The benefit of using fiscally market fuel in mining, construction and forestry works will be abolished.*
*** The benefit of using fiscally marked fuel will be abolished and replaced with a support scheme.*
Source: Ministry of Finance.

[1] Impact in comparison to the rates applied as of 31 December 2010.

3.3.3 Tax expenditure

The tax expenditure contained in the state budget of Estonia for 2012 and 2013 are described below. The method of revenue to be lost and cash-based data are used to estimate the value of tax expenditure, and the delay between the implementation of a provision and the actual application is considered for every tax expenditure provision. Only the so-called first round effects of the establishment of tax expenditure have been estimated. For example, the direct impact of the implementation of the provision on the receipt of income tax has been evaluated in the event of the establishment of tax exempt income. However, the aspect that has not been evaluated is that natural persons have more money in the case of additional tax-exempt income and more VAT is received if they use this money for consumption. The aggregate impact of the establishment of tax expenditure is regarded in the case of tax expenditure that is directly and clearly related to other taxes, e.g. the tax expenditure arising from the Alcohol, Tobacco, Fuel and Electricity Excise Duty Act influence the receipt of VAT to the extent of the final consumption rate. The different behavioural effects and budget restrictions have not been considered in the evaluation of tax expenditure due to the implementation of the method of revenue to be lost, e.g. it has been assumed that the consumption of goods and services is unit elastic (the relative change in quantity is the same as the relative change in price).

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

The tax expenditure that has a significant impact on the receipt of state budget revenue are contained in 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[1] (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 tax system that is the goal. In the case of the Income Tax Act[2] (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 consumer certain services are supported with extra tax exemptions can be regarded as tax expenditure or significant deviations from the tax system that is the goal. 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 tax system that is the objective (and it is not tax expenditure). In the case of the Alcohol, Tobacco, Fuel and Electricity Excise Duty Act[3] (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 tax system that is the objective.

[1] The Value Added Tax Act, https://www.riigiteataja.ee/ert/act.jsp?id=12869417.
[2] The Income Tax Act. (2009), https://www.riigiteataja.ee/ert/act.jsp?id=12851790.
[3] Alcohol, Tobacco, Fuel and Electricity Excise Duty Act, https://www.riigiteataja.ee/ert/act.jsp?id=12906565.

Table 18. Tax expenditure in state budget, 2012–2013[1] (€ mln)

	Provision	Government function[2]	2012	2013
1. 9% VAT on books and workbooks	VATA, cl. 15 (2) 1)	9	6,9	7,1
2. 9% VAT on medicines and medical equipment	VATA, cl. 15 (2) 2)	7	28,2	29,3
3. 9% VAT on periodic publications	VATA, cl. 15 (2) 3)	*8*	*1,9*	*2,0*
4. 9% VAT on accommodation services	VATA, cl. 15 (2) 4)	*8*	*17,9*	*18,6*
5. Increased basic exemption starting from the second child	ITA §23[1]	*10*	*24,8*	*25,6*
6. Increased basic exemption in the event of pension	ITA §23[2]	*10*	*114,2*	*119,2*
7. Increased basic exception in the case of compensation for accident at work or occupational disease	ITA §23[3]	*10*	*0,2*	*0,2*
8. Deduction of housing loan interest	ITA §25	*6*	*20,4*	*18,3*
9. Deduction of training expenses	ITA §26	*9*	*15,0*	*15,8*
10. Gifts and donations	ITA subsection 27(1)	*8*	*0,6*	*0,6*
11. Insurance premiums and acquisition of pension fund units	ITA §28	*10*	*7,1*	*7,4*
12. Increased basic exemption of sole traders upon sale of agricultural produce or timber	ITA subsection 32(4)	*4*	*3,0*	*3,0*
13. 50% excise duty rate for independent small breweries	ATFEEDA subsection 46(1)	*4*	*0,1*	*0,1*
14. Lower excise duty rate on diesel fuel for specific purposes and on light heating oil	ATFEEDA subsection 66(7)	*4*	*50,0*	*0,0*
15. Exemption of fishermen from fuel excise duty	ATFEEDA cl. 27(1) 22²)	*4*	*1,6*	*1,5*
16. Electricity used for chemical reduction and in electrolytic, metallurgic and mineralogical processes	ATKEAS cl. 27(1) 24), 28⁴)	*4*	*0,8*	*0,8*
17. Electricity and fuel used to produce electricity and electricity used to maintain the ability to produce electricity	ATFEEDA cl. 27(1) 28²)	*4*	*6,1*	*7,1*
18. Fuel used for mineralogical processes	ATFEEDA cl. 27(1) 28²)	*4*	*0,6*	*0,6*
19. Natural gas used for the purpose of operating the natural gas network	ATFEEDA cl. 27(1) 28⁶)	*4*	*0,01*	*0,01*
TOTAL			***299,4***	***257,2***

Source: Ministry of Finance.

The receipt of the state budgets for 2012 and 2013 is influenced by 19 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 2012 comprises 299.5 million euros or 1.8% of GDP. Increased basic exemption in the event of pension, lower excise duty rate on diesel fuel for specific purposes and on light heating oil, and increased basic exemption starting from the second child remain the biggest parts of tax expenditure. The scope of the three biggest parts if tax expenditure comprises 63.2% of the scope of the entire established tax expenditure in 2012. Tax expenditure will decrease by 14.1% in 2013 as a result of the fiscally marked fuel reform.

[1] Estimates of tax expenditure have been given in respect of the provisions contained in tax legislation as of 1 January 2012.
[2] Government functions: 1. general public services; 2. defence; 3. public order and safety; 4. economic affairs; 5. environmental protection; 6. housing and community amenities; 7. health; 8. recreation, culture and religion; 9. education; 10. social protection.

The government function with which each specific type of tax expenditure is associated is determined for each tax expenditure provision in order to analyse the dynamics of tax expenditure according to government functions[1]. Table 18 indicates that six of the ten government functions (economic affairs; housing and community amenities; health; recreation, culture and religion; education; social protection) are supported via tax expenditure in 2012 and 2013. The government functions that comprise the biggest share in 2012 are social protection (146.3 million euros or *ca.* 49.8% of tax expenditure), economic affairs (62.2 million euros or 20.8%) and health (28.2 million euros or 9.5%). The tax expenditure that falls into the remaining government functions comprises 62.7 million euros or 20.9% 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 1-4 in the table) comprise 54.9 million euros in 2012, which is 3.8% of the total VAT received. The relevant tax expenditure (items 5-12 in the table) comprise 185.3 million euros or 74.5% of the personal income tax received into the state budget and the same share in the case of fuel excise duty (items 13-19 in the table) is 59.2 million euros or 15.8%.

3.3.4 Structure of general government expenditure[2]

General government expenditure comprised 35% of GDP on average from 2000 to 2007, but their share increased to 39.5% of GDP in 2008, 45.2% of GDP in 2009, and then dropped to 40.6% of GDP in 2010. The decrease continued in 2011 and reached the level of 38.2% of GDP.

The final consumption expenditure of general government comprised *ca.* 55% of general government expenditure from 2000 to 2005, and dropped to the level of 50% for the period of 2006-2009. Its share increased to 52% of expenditure on average in 2010 and 2011. The final consumption expenditure of general government includes public consumption and individual consumption expenditure. Individual and social goods and services are differentiated in the case of the goods and services offered by general government on the basis of the Classification of the Functions of Government (COFOG). Public consumption means services offered concurrently to all members of society or to the members of a part of society. They include, for instance, expenditure on environmental protection and organisation of the public sector's healthcare system. For example, expenditure on education and health care is considered individual. In the case of general government the individual consumption expenditure equals social transfers in kind.

Social benefits comprise the second largest share of general government expenditure. The largest types of expenditure among social expenditure are pension expenses and the disease prevention and health promotion expenses incurred by the Estonian Health Insurance Fund. The general government expenditure for payment of social benefits from 2000 to 2007 comprised 9% of GDP on average. Their share increased to 14% of GDP by 2009, then started to decrease and reached the level of 11.7% by 2011.

2.7% of general government expenditure, i.e. 1% of GDP, was used for payment of subsidies in 2011. Subsidies are unilateral payments which manufacturers receive from general government or 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.

[1] Statistics Estonia, classification of government functions, http://metaweb.stat.ee/view_xml.htm?id=1129771&siteLanguage=ee.

[2] 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.

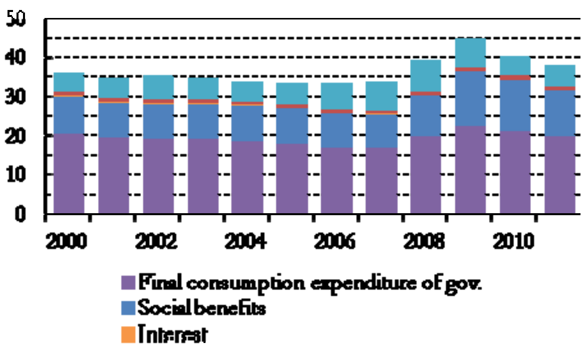
Interest expenses account for the smallest share – in 2011 they amounted to 0.2% of all general government expenditure, i.e. the comprised 0.1% of GDP. The smallness of interest expenses is the result of the small debt burden of Estonia.

Looking at expenditure by economic activity, we see that the share of expenditure on social protection is always the largest. This expenditure comprised 10% of GDP on average from 2000 to 2007, and increased to 14.6% of GDP by 2010. The increase continued in 2011 and reached 15.8% of GDP. The share in total expenditure increased from the 29% average in the years 2000-2008 to 41.5% in 2011. The biggest part of the increase occurred in 2009 when unemployment insurance benefit and unemployment benefit expenses increased considerably as a result of the deterioration of the situation on the labour market, and the pension increase also paid a role in this. Unemployment insurance benefit and unemployment benefit expenses decreased in 2010, but pension expenses continued to grow.

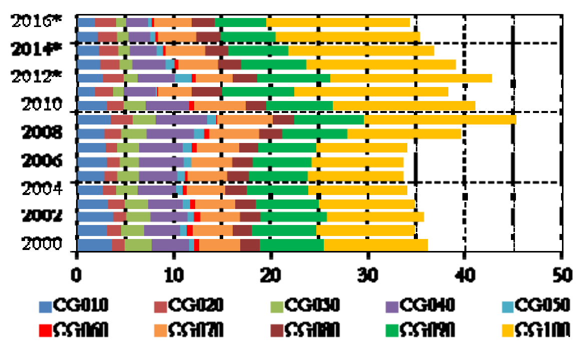
The share of other expenses in total expenditure in 2011 remained close to the average level of the period of 2000-2008.

Figure 16. General government expenditure and its structure (% of GDP)

A. Expenditure by economic content in Estonia



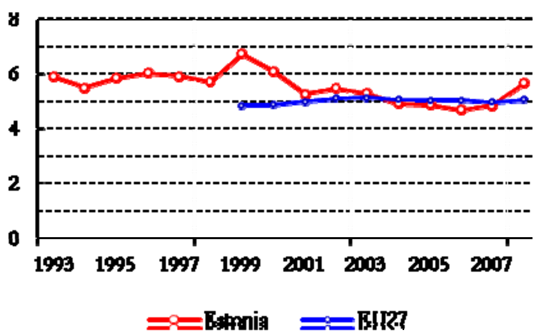
B. Expenditure by government function in Estonia[1]



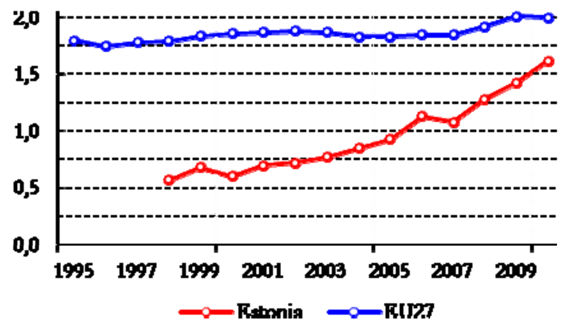
Sources: Statistics Estonia, Ministry of Finance.

Figure 17. Government investments into physical and human capital (% of GDP)

A. Public expenditure on education

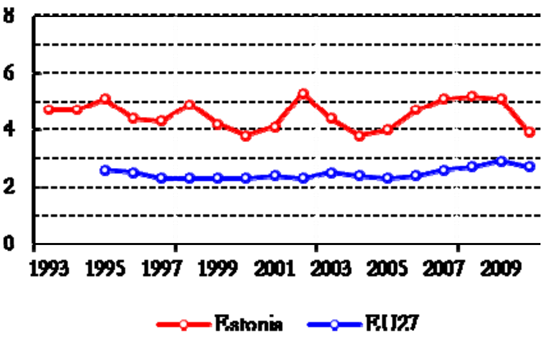


B. Research and development expenditure

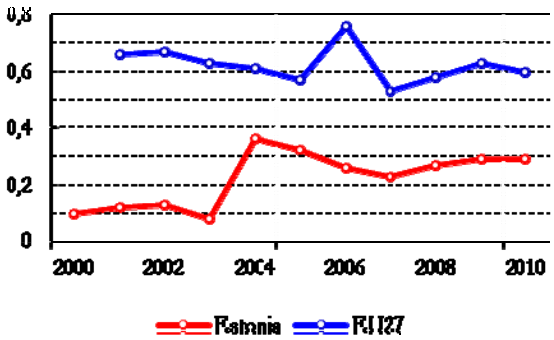


[1] CG010 – general public services; CG020 – defence; CG030 – public order and safety; CG040 – economic affairs; CG050 – environmental protection; CG060 – housing and community amenities; CG070 – healthcare; CG080 – recreation, culture and religion; CG090 – education; CG100 – social protection.

C. Gross fixed capital formation of general government



D. State aid



Source: Eurostat.

Table 19. General government expenditure by government functions (COFOG) (% of GDP)

	COFOG code	2009	2010	2011*	2012*	2013*	2015*
1. General public services	1	3,6	3,2	1,9	2,8	2,5	2,2
2. Defence	2	2,3	1,8	1,8	2,1	2,0	2,1
3. Public order and safety	3	2,4	2,2	1,1	1,4	1,2	1,1
4. Economic affairs	4	5,2	4,4	3,2	3,8	3,4	2,2
5. Environmental protection	5	1,0	-0,3	0,1	1,7	1,1	0,6
6. Housing and community amenities	6	0,1	0,6	0,2	0,3	0,3	0,3
7. Health	7	5,6	5,3	3,4	3,9	4,1	4,0
8. Recreation, culture and religion	8	2,3	2,1	3,2	2,5	2,4	2,4
9. Education	9	7,1	6,8	7,3	7,4	6,7	5,7
10. Social protection	10	15,7	14,6	15,8	16,6	15,3	14,7
11. Total general government expenditure	**TE**	**45,2**	**40,6**	**38,2**	**42,7**	**39,1**	**35,3**

Sources: Statistics Estonia, Ministry of Finance.

3.3.5 Expenditure removed from cost target

Table 20. Expenditure removed from cost target (% of GDP)

	2011	2011	2012	2013	2014	2015	2016
	€ mln	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Expenditure related to external funds that is covered with revenue	1 056,8	6,6	8,3	5,7	4,1	3,2	2,7
Expenditure fully covered with revenue	117,8	0,7	0,7	0,6	0,6	0,6	0,6
Change in expenditure related to unemployment benefits that does not arise from fiscal policy decisions	45,8	0,3	0,3	0,2	0,2	0,2	0,2

General government financing

The following forecast of debt burden and financial assets presumes that the objectives of the budgetary position of general government contained in Chapter 3.1 are achieved during the entire medium-term period.

3.4.1 Public sector debt

The main goal of Estonia's fiscal policy since the restoration of independence has been to keep the budgetary position of general government in balance or, if possible, in a surplus over the medium term, which has become expressed in the low debt burden of the state. The general government debt of Estonia in 2011 comprised 6% of GDP, which is 0.7% less than in 2010. The debt of local authorities comprised 539 million euros and the central government debt comprised 490 million euros in the total general government debt of 965 million euros. The impact of the European Financial Stability Facility (EFSF) on the debt of Estonia in 2011 was 14 million euros. 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 this facility.

The general government debt can be expected to increase in 2012 as a result of the EFSF's impact – the financial needs of central government will be covered on the account of financial reserves. It will be necessary to use loan options to balance cash flow on the level of central government in 2013, as financing transactions (incl. contributions into the European Stability Mechanism and the increase of the share capital of Eesti Energia) will also have a significant impact on cash flows from 2012-2013 in addition to the budget deficit. This is the main reason why general government debt will increase to 11% of GDP in 2013, but it will start decreasing again thereafter and reach 9.5% of GDP by 2016. According to the forecast the deficit of local authorities will be covered from external funds during the entire medium-term period and this will also be supported by the abolition of the loan restriction at the start of 2012. However, the loan burden of local authorities as a share of GDP will drop to 0.1% or 3.3% of GDP in 2016 when compared to 2011.

Table 21. Change in general government debt burden in 2011

	31 December 2010		31 December 2011		Change
	€ mln	% of GDP	€ mln	% of GDP	%
General government	**956,7**	**6,7%**	**965,2**	**6,0%**	**-0,7%**
Domestic debt	596,2	**4,2%**	621,1	**3,9%**	**-0,3%**
External debt	360,5	**2,5%**	344,1	**2,2%**	**-0,3%**
Central government	**472,7**	**3,3%**	**489,7**	**3,1%**	**-0,2%**
Domestic debt	264,0	**1,8%**	279,8	**1,8%**	**0,0%**
External debt	208,7	**1,5%**	209,9	**1,3%**	**-0,2%**
Local authorities	**540,7**	**3,8%**	**538,7**	**3,4%**	**-0,4%**
Domestic debt	389,2	**2,7%**	404,5	**2,5%**	**-0,2%**
External debt	151,5	**1,1%**	134,2	**0,8%**	**-0,3%**
Social security funds	**0,3**	**0,0%**	**0,1**	**0,0%**	**0,0%**
Domestic debt	0,1	**0,0%**	0,1	**0,0%**	**0,0%**
External debt	0,2	**0,0%**	0,0	**0,0%**	**0,0%**

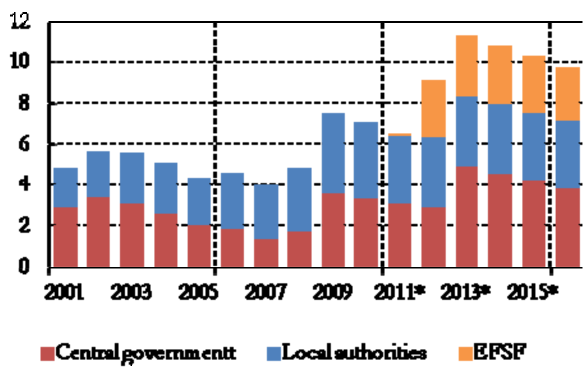
Table 22. General government debt burden, 2011-2016 (% of GDP)

	2011	2012*	2013*	2014*	2015*	2016*
1. Total debt	**6,0**	**8,8**	**11,0**	**10,6**	**10,0**	**9,5**
2. Change in debt burden	-0,7	2,8	2,2	-0,4	-0,6	-0,5
Contribution to change in debt burden:						
3. Impact of EFSF	0,1	2,7	0,4	0,1	0,0	0,0
4. Primary budgetary position	1,1	-2,4	-0,5	0,3	0,7	1,2
5. Interest payments	0,1	0,1	0,2	0,2	0,2	0,3
6. Other factors influencing the debt (SFA)	1,0	-2,3	1,7	0,2	0,6	1,0
Estimated interest rate of general government debt (%)	3,4	3,5	3,3	3,7	4,3	4,9

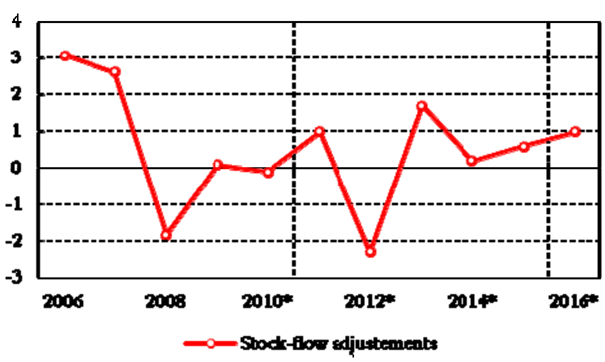
Source: Ministry of Finance, Statistics Estonia.

Figure 18. Development of debt burden, 2001-2016 (% of GDP)

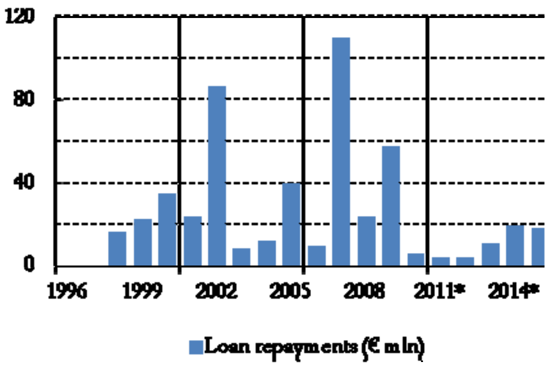
A. General government debt



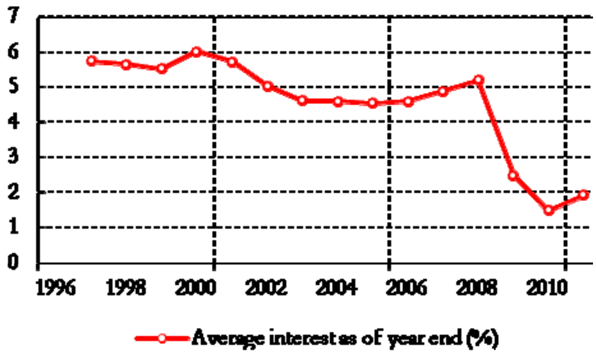
B. Stock-flow adjustments



C. Repayment of central government loan



D. Average interest rate of central government[1] debt

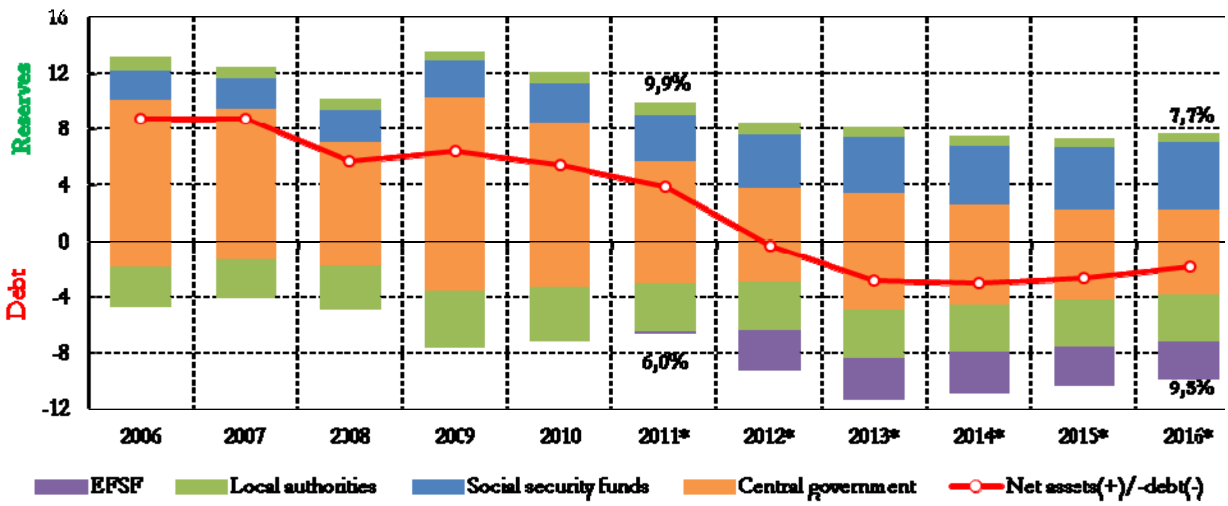


Source: Ministry of Finance, Statistics Estonia, Eurostat.

3.4.2 General government reserves and net position

The fact that the level of net assets will become negative in 2012 is the result of the EFSF's impact. Without consider the EFSF, the level of net assets will be maintained for almost the entire period, i.e. liquid assets will exceed the debt burden. Liquid financial assets will start growing at the general government level in 2016.

Figure 19. Liquid assets, debt burden and net position of general government, 2006-2015 (% of GDP)



Source: Ministry of Finance, Statistics Estonia.

[1] Central government exclusive of foundations and legal persons governed by public law.

SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS PROGRAMME

Alternative case scenarios and their impact on budgetary position

Below is the additional case scenario of the economic forecast, which is less likely to occur than the base forecast, but which helps to understand the uncertainty associated with the forecast.

4.1.1 Negative risk from the expansion of the eurozone debt crisis and high oil price

The situation in Estonian, European and global economy is considerably more stable when compared to the forecast made in the end of summer 2011. This is indicated by the confidence indicators of companies and consumers as well as the equity markets, where the price volatility that characterises uncertainty has been decreasing clearly since autumn. However, it is still possible that the different measures taken in the EU to balance state budgets will have a bigger backlash on the economy than expected, and the planned structural reforms introduced to support economic growth may not yet deliver desired results. The rapidly increasing oil prices also have a negative impact, as oil supplies are suffering from the adverse effect of the crisis in Iran.

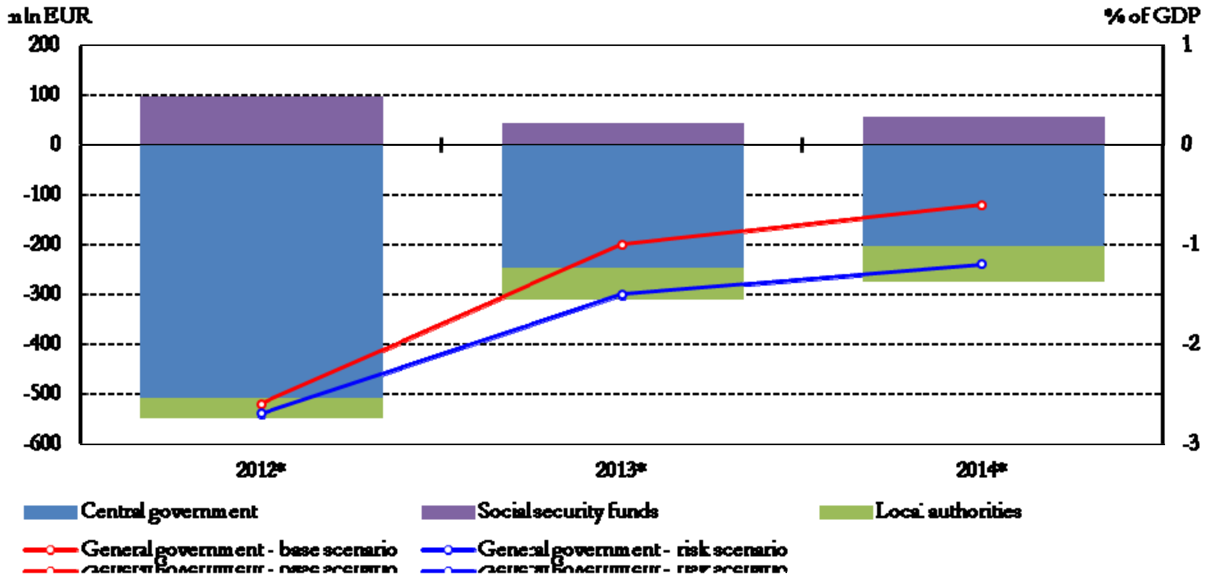
The overall improvement of the confidence of Estonian economic agents and the low base level of domestic demand shows that there is potential for growth in local consumption and investments. Also, the short-term deterioration of the economic situation will not have an impact on general government investments, whose contribution to demand in 2012 is significant. This means that the decrease in export opportunities is the main source of negative influence. The impact of the decrease in exports on labour income is small this year, but will grow in the next. The dynamics of private consumption are the same, but investments will decrease considerably in 2012. Increasing oil prices increase oil-related risks in the risk scenario, which is why inflation will be higher than the base scenario despite the weaker internal market developments. The weakness of the internal market will also be reflected in the noticeable slowdown of inflation in 2013. The growth rates of the base scenario will recover more or less by 2014, but the nominal volume of GDP will be 370 million euros less than in the base scenario. The GDP of Estonia will increase by 1% in 2012 and 2% in 2013 according to the risk scenario.

Table 23. Negative risk scenario (%)

	Negative risk scenario				Difference from base forecast		
	2011	2012*	2013*	2014*	2012*	2013*	2014*
Nominal GDP (bln euros)	16,0	16,5	17,3	18,4	-0,2	-0,4	-0,4
Real GDP growth	7,6	1,0	2,0	3,5	-0,7	-1,0	0,1
Nominal GDP growth	11,7	3,5	4,8	6,4	-0,9	-1,4	0,2
CPI	5,0	3,5	2,7	2,6	0,2	-0,3	-0,1
Real growth of domestic demand	11,1	3,4	2,7	3,9	-0,3	-0,8	0,1
Real growth of export	24,9	-1,9	3,1	6,3	-2,9	-2,3	-0,1
Employment growth	6,7	0,3	0,5	0,5	-0,4	-0,5	-0,1
Nominal wage increase	5,4	3,8	4,0	5,2	-0,1	-1,0	-0,1
Unemployment rate	12,5	11,9	10,4	9,6	0,4	0,8	0,9
External assumptions							
Economic growth of main trade partners	2,7	0,0	1,0	2,0	-1,1	-0,8	-0,1
Oil price	111,0	123,0	124,0	128,0	7,0	14,0	18,0
General government							
Tax burden (% of GDP)	32,7	32,8	32,1	31,5	-0,1	-0,4	0,4
Budgetary position of general government (% of GDP)	1,0	-2,7	-1,5	-1,2	-0,1	-0,5	-0,6
Debt burden of general government (% of GDP)	6,0	8,9	12,0	12,2	0,1	0,7	0,6

Source: Ministry of Finance, Statistics Estonia.

Figure 20. Budgetary position of general government and % of GDP, 2010-2013



Source: Ministry of Finance, Statistics Estonia.

The revenue and expenditure forecast of the risk scenario is based on the relevant macroeconomic forecast and predicts that the budgetary position of general government will deteriorate by 0.1 to 0.6% from 2012 to 2014. The budget deficit in the current year will amount to 2.6% of GDP according to the risk scenario. The deterioration of the position is mainly caused by the decrease in tax revenue, which has a negative impact on all levels of general government. The forecast of the receipt of social tax has been reduced the most in the risk scenario in relation to the decreases in the employment rate and the average salary forecast. However, the decrease in the state budget expenditure that is related to tax revenue slows down the growth of the deficit to some extent. The surplus of the Unemployment Insurance Fund reduces due to the decrease in unemployment insurance premiums and increase in benefits, and the position of the Estonian Health Insurance Fund is negatively influenced by the smaller health insurance revenue caused by the decreasing social tax. The budgetary position of local authorities will deteriorate by the decrease in the projected amount of personal income tax that will be allocated to them. Decreasing tax revenue will also have a negative impact on the state's debt burden. The budgetary position of other central government is not so closely associated with the economic environment, which is why no changes are expected here.

Table 24. Budgetary position of general government according to risk scenario, 2012-2014

	Risk scenario			Difference from base forecast		
	2012	2013	2014	2012	2013	2014
Budgetary position of general government (mln euros)	**-447**	**-265**	**-216**	**-19**	**-86**	**-103**
State budget	-476	-242	-198	-13	-53	-65
Other central government	-34	-5	-4	0	0	0
incl. social security funds	98	44	57	-3	-20	-22
local authorities	-36	-62	-71	-3	-13	-16
Budgetary position of general government (% of GDP)	**-2,7**	**-1,5**	**-1,2**	**-0,1**	**-0,5**	**-0,6**
State budget	-2,9	-1,4	-1,1	-0,1	-0,3	-0,4
Other central government	-0,2	0,0	0,0	0,0	0,0	0,0
incl. social security funds	0,6	0,3	0,3	0,0	-0,1	-0,1
local authorities	-0,4	-0,4	-0,4	-0,1	-0,1	-0,1

Source: Ministry of Finance.

Comparison with the forecast of Stability Programme 2011

The situation in **global economy** has started stabilising slowly in recent months, but there is still insecurity about the outlook of growth. The growth expectations of trade partners have decreased considerably in comparison to Stability Programme 2011 as a result of the slowdown of the partners' economic growth in the end of the previous year. The price of oil increased rapidly in the previous year. The price of oil has gone up significantly also in the first months of this year, which is why oil price assumptions for this year are noticeably higher when compared to the previous programme. The oil price assumption for the next year is slightly lower in this programme than in the previous year's one, and it is based on the expectations of markets. The European Central Bank reduced base interest rates to boost economy and this also has an impact on interest rates on the money market. Both short and long-term interest remains considerably lower than expected in Stability Programme 2011.

The Ministry of Finance expected economic growth to be 4% from 2011-2012 in its 2011 spring forecast. We expected the speed of economic growth to slow down to 3.6% by 2013. The **economic growth** of Estonia proved to be more positive than forecast in spring 2011, because the export sector grew faster than expected, and domestic demand recovered. According to this forecast, the economy will grow by 1.7% this year and 3% in the next year. The forecast was adjusted because expectations in the external environment are more pessimistic than before, which also worsened the growth prospects of Estonian companies and led to the reduction of exports and domestic demand forecasts. We also reduced the nominal economic growth forecast for 2012-2013, which is why the volume of GDP at current prices is 0.1 billion euros smaller in this year and 0.2 billion euros lower in the next year when compared to the previous forecast.

The increase in **private consumption** in 2011 proved to be two times faster than forecast in the previous programme. This was caused by the increase in the employment rate and average wages due to the economic growth that was faster than expected, and it was magnified further by the purchases of durable goods that had been postponed during the crisis. Cars and interior goods account for a significant part of consumption growth. As economy and internal demand livened up earlier than expected, then the increase in consumption in 2012 and 2013 will be smaller than previously forecast.

The **growth in investments** proved to be very strong in the second half of 2011 and it is likely to remain fast also in 2012. The machinery and equipment of companies and general government investments will both make a strong contribution into this. The level of investments has increased and their dynamics have changed when compared to the forecast made in the previous programme. The level was raised by the extremely rapid growth achieved in the previous year, whilst the options of financing the investments planned in the state budget were more strictly considered in regard to dynamics. The latter are associated with the fact that many investments made from EU funds and the CO_2 quota proceeds are lined up for 2012. The new structural funds period will start in 2013 and lead to an estimated 40% decrease in general government investments. Introducing this assumption increased growth in 2012 and reduced it in 2013.

The growth in **export** of goods and services in 2011 proved to be faster than expected. Although assumptions about the main export markets met expectations, the faster growth of export was largely caused by a considerable increase in foreign orders for communication equipment. We reduced the export forecast for 2012 and 2013, as the growth prospects of trade partners have deteriorated due to the debt crisis in Europe. Forecast of imports is also lowered due to the large import content of exports.

Current account surplus proved to be somewhat bigger in 2011 due to the smaller deficit in income balance and increased receipts of current transfers. In current Stability Programme we expect the current account surplus to decrease from 2012-2013 to a similar extent as in the previous forecast. As the trade deficit proves to be bigger in this forecast due to the weakness of the export of goods, it will be balanced out by the income balance, which we expect to deteriorate marginally.

The price pressures arising from internal and external factors in 2011 were stronger than expected in the previous Stability Programme. The price of oil increased faster and internal demand proved to be stronger, which is why headline **inflation** was 0.6% faster than expected. The inflation forecast for 2012 has also been raised by 0.6%, but mainly because of external factors: the price increase of motor fuels and heat energy will be faster than expected due to the high level of oil prices. Core inflation expectations for 2012 are similar to those in the previous forecast. Our forecast of headline inflation for 2013 is still 3%.

Developments in the **labour market** in the previous year proved to be more positive than expected. The rapid economic growth in the previous year led to a significant increase in the demand for workforce, as increased workload allowed companies to hire extra staff. The increase in the number of employed in the previous year (6.7%) was considerably bigger than forecast in Stability Programme 2011 (2.2%). Demand for workforce is expected to decrease this year as economic activity is slowing down. The number of employed will increase by 0.7% this year according to the forecast, which is 1.2 percentage points slower than expected in the previous forecast. **The improvement of the economic situation of companies has allowed them to increase the wages of their employees,** which means that the developments in the average wages (a 5.4% increase) in 2011 were more positive than expected in the previous programme (a 3.5% increase). **The increase in average wages will slow down (3.8%) this year alongside the slowdown of the economic growth, which means that expectations will be modest when compared to the previous year's programme (4.2%).**

The **budgetary position of general government** in the previous year proved to be better than expected due to the larger revenue earned from sales of AAUs and the bigger amount of taxes received. However, expectations for 2012 have become a bit more pessimistic and one of the reasons for this is the worsened economic situation. Modest expectations of economic growth have also reduced the budgetary position of the subsequent years, which is why the general government will achieve the next budget surplus later, in 2014.

The **general government debt** in this forecast is higher than in Stability Programme 2011 in all years. The increase in the debt burden is influenced by the worsened budgetary position outlooks and the increased financing transactions. The loans issued by the EFSF also increase the debt burden of Estonia.

Table 25. Comparison with the forecast of Stability Programme 2011

	2011	2012*	2013*	2014*	2015*	2016*
Real GDP growth (%)						
Previous version	4,0	4,0	3,6	3,6	3,4	-
Present update	7,6	1,7	3,0	3,4	3,5	3,5
Difference	3,6	-2,3	-0,6	-0,2	0,1	-
Nominal GDP growth (%)						
Previous version	8,0	7,1	6,9	6,4	6,3	-
Present update	11,7	4,4	6,2	6,2	6,4	6,3
Difference	3,7	-2,7	-0,7	-0,2	0,1	-
Budgetary position of general government (% of GDP)						
Previous version	-0,4	-2,1	0,1	0,5	1,0	-
Present update	1,0	-2,6	-0,7	0,1	0,5	0,9
Difference	1,6	-0,5	-0,8	-0,4	-0,5	-
General government debt (% of GDP)						
Previous version	6,0	6,0	5,8	5,6	5,4	-
Present update	6,0	8,8	11,0	10,6	10,0	9,5
Difference	0,0	2,8	5,2	5,0	4,6	-
Harmonised Consumer Price Index (HICP) (%)						
Previous version	4,5	2,8	3,0	2,8	2,7	-
Present update	5,1	3,4	3,0	2,7	2,7	2,7
Difference	0,6	0,6	0,0	-0,1	0,0	-
Current account (% of GDP)						
Previous version	2,5	1,3	-0,1	-1,7	-3,1	-
Present update	3,2	1,0	0,0	-1,0	-2,3	-3,5
Difference	0,7	-0,3	0,1	0,7	0,8	-

Source: Ministry of Finance.

LONG-TERM SUSTAINABILITY OF FISCAL POLICY

The assumptions of the long-term budget projections given in this chapter were agreed on by the Economic Policy Committee of the European Union and prepared on the same bases for the entire EU. In the long term, these trends coincide with the vision the Ministry of Finance has of future developments. The timelines have been partially adjusted with the macroeconomic development scenario of this programme with regard to the first years, because assumptions on the EU level were agreed on in the beginning of 2011 and therefore do not reflect the latest developments.

The impact of the recession on public finance is long-term and becomes evident in lower employment rates and output level whilst the impact on long-term growth potential and growth rates should remain minimal. It is worth emphasising that the assumptions of the projections given 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 size of the challenge associated with demographic trends to which we can react with policies.

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

- the fiscal policy has been kept conservative and increasing the general government debt significantly has been avoided;
- the pension system has been reformed and contributing into pre-financed pension schemes has been encouraged;
- the retirement age has been increased and flexibility has been introduced into pension indices; and
- a better fiscal situation has been guaranteed via policies aimed at economic growth and employment.

A pension index was introduced in 2008 in order to increase pensions every year, which is primarily based on an increase in the receipt of social tax (80% increase in social tax receipts + 20% annual inflation instead of the previous 50% + 50%), and which according to the forecast increases pensions considerably more than the previous index. Coefficients for changing the shares of base pension and the year of pensionable service indicator in pension formation were also implemented and they help make the pension system more solidary. The obligation to analyse the sustainability of state pension insurance every five years and to change the pension index if necessary was added to the legal act that governs pensions when the index was changed. The next analysis will be carried out in autumn 2012.

Flexibility is also included in the pension indexing rules, which is expressed in the option to approve a pension index that is lower than the ordinary rate prescribed by law if:

- the anticipated real GDP growth in the same year is negative; or
- the difference between state pension insurance expenditure and the estimated receipts to be transferred into state pension insurance is more than 1% of the anticipated GDP in the same year.

The ordinary index rate and the part of the index that was not increased/reduced will be offset within five years of the implementation of the changed index. **This two-sided flexibility in the system therefore allows the state to compensate for the lower pension increase resulting from the index on one hand, and on the other hand makes it possible to carry out a set-off that reduces the further ordinary rate of the index in case the value of the ordinary index is smaller than one (without reducing pensions nominally).** The flexibility of the law allowed the state to react to the complicated financial situation in the course of the crisis and to limit automatic indexing. Also, pensions were not reduced in the years were automatic indexing would have led to it, which is why the pension increase in the next few years is lower than the estimated index.

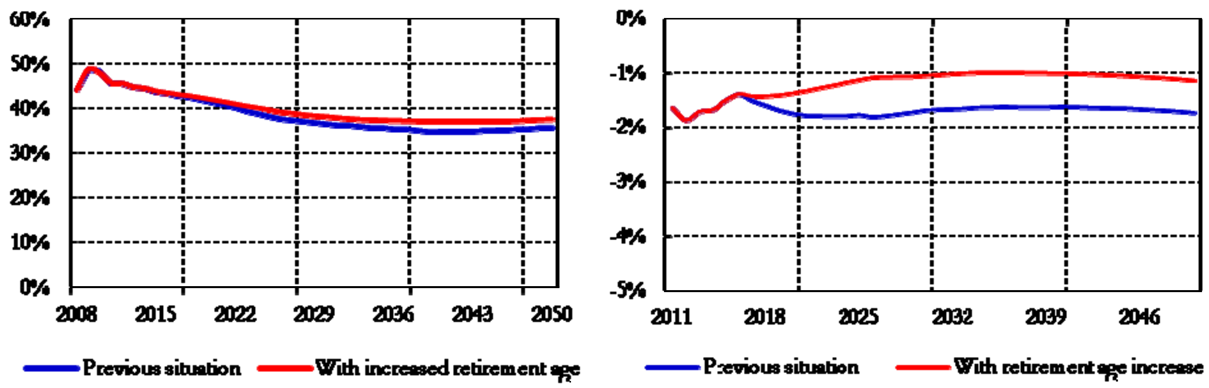
The decision to suspend contributions into the second pension pillar from 1 July 2009 to 31 December 2010 was one of the measures taken during the crisis. The payments made into the second pension pillar were raised to one-half of the original amount in 2011 and they will be back to the full original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

On 7 April 2010 the *Riigikogu* decided to approve the amendments made to the State Pension Act pursuant to which retirement age will increase by 3 months a year from 2017 and reach 65 by 2026 (the current retirement age is 63 years for men and 61.5 years for women; the latter will become equal with the retirement age of men by 2016). The projected increase in the life-expectancy of 63-year-olds by 2060 is worth a mention here. The life-expectancy will increase by almost 6 years for 63-year-old women and 7 years for men when compared to 2010. The goal of the planned amendments is to guarantee the adequacy (the decisions makes it possible to pay pensions that are 5-10% higher from 2026) and sustainability of the pension system. The amendment was driven by the desire to amend the supply of workforce that is decreasing as a result of demographic developments.

In addition to the option to pay bigger pensions, increasing the retirement age also helps improve the financial status of pension insurance in the future (see the figure below).

Figure 21. Impact of increasing retirement age on financial indicators of state pension insurance (% of GDP)

A. Replacement rate (first and second pillars) **B. First pillar deficit**



Source: Ministry of Finance

Table 26. Long-term sustainability of public finance, 2010-2060 (% of GDP)

	2010	2015	2020	2030	2040	2050	2060
Total expenditure	**40,9**	**35,2**	**35,4**	**35,0**	**34,7**	**35,2**	**35,6**
Pensions	8,9	7,4	7,2	6,7	6,6	6,7	6,6
Social security pensions	8,9	7,4	7,2	6,7	6,7	6,7	6,6
Old-age pensions	7,5	6,1	5,8	5,3	5,4	5,6	5,7
other (disability, survivors)	1,4	1,3	1,4	1,4	1,2	1,1	0,9
occupational pensions (if in gen. gov. budget)	-	-	-	-	-	-	-
Health care	5,2	5,3	5,4	5,6	5,9	6,0	6,2
Long-term care (previously part of healthcare expenditure)	0,5	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	0,2
Education expenses	5,2	4,8	5,1	5,1	4,5	4,8	5,1
Other age-related expenditures	**0,6**	**0,6**	**0,5**	**0,4**	0,4	**0,4**	**0,3**
Total revenue	**40,6**	**35,7**	**35,4**	**35,0**	**34,7**	**35,2**	**35,6**
of which: property income (incl. interest income)	0,0	0,0	0,0	0,0	0,6	0,0	0,0
of which: social security contributions (first pillar revenue)	7,0	5,9	5,8	5,6	5,6	5,6	5,6
Pension insurance assets (first pillar)	0,0	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	0,0
Systemic pension reforms							
Social contributions diverted to mandatory private scheme	0,0	1,0	1,1	1,1	1,2	1,2	1,2
Pension expenditure paid by mandatory private scheme	0,0	0,1	0,2	0,9	1,6	3,3	2,7
Assumptions:							
Labour productivity growth	6,7	3,1	1,4	1,4	2,1	1,2	1,0
Real GDP growth	2,3	3,5	1,9	2,0	1,6	1,6	0,9
Participation rate males (aged 20-64)	83,8	86,3	85,5	85,3	84,8	84,8	85,3
Participation rate females (aged 20-64)	76,8	78,1	79,0	79,8	78,9	78,9	80,0
Total participation rates (aged 20-64)	80,2	82,2	82,4	82,5	81,8	81,5	82,7
Unemployment rate	17,3	8,3	8,3	8,2	7,5	7,3	7,3
Population aged 65+ over total population	16,2	16,8	18,1	21,3	24,9	26,4	29,5

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

Measures of guaranteeing long-term sustainability of pension insurance

As pointed out above, a regular analysis will be carried out in autumn 2012 in order to ascertain whether the used pension index is suitable for guaranteeing the financial sustainability of pension insurance and the adequacy of pensions.

The Government has also approved the concept of insurance for inability to work. The rapid increase in the number of persons receiving pension for inability to work must be reacted to, and the goal of the concept is to create a system where workers are motivated to maintain their good health and create a healthy environment. 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, is also associated with the implementation of the scheme.

Table 27. Loans guaranteed by the Republic of Estonia, 2010-2011 (% of GDP)

	2010	2011
Total guarantees	**0,05**	**0,17**
North Estonia Medical Centre	-	0,03
Tallinn Airport	0,01	0,003
Kredex	0,035	0,14
Estonian Mail	0,005	-
Estonian Television	0,001	-

QUALITY OF PUBLIC FINANCE

The Ministry of Finance steers the design of fiscal policy and budget decisions, and the updating of organisation-based development plans in order to guarantee the high quality of public finance.

The keywords of the Budget Strategy 2013-2016 prepared in spring 2012 are the conservatism, sustainability and performance of the planned sector policies.

- Conservatism – the risks arising from the external environment are considered, funds and activities are planned sustainably, prudently and responsibly.
- Sustainability – decisions are made after considering their long-term justification and viability whilst long-term financing that corresponds to budget options is also guaranteed to avoid unjustified expenses in the future, to guarantee that actions are analysed and thought through before they are carried out, and that it is known which resources will be used and how this will be done.
- Performance – a critically weighed approach to activity planning in order to focus on the areas that have the biggest impact on the achievement of goals.

These principles can be followed in limited budget conditions by analysing area policies regularly and adjusting them to find the solutions and budgetary funds required for carrying out thoroughly analysed reforms, in the cooperation of the Ministry of Finance and other ministries.

The principle that is followed is that the only budgetary cover for new activities is the reassessment of priorities, i.e. making choices in various areas according to the changes in the situation. However, all important reforms in sector policies that improve quality, support sustainability and allow to save resources in the long term will still be carried out. An increase in revenue can only be planned for carrying out such structural reforms (reform plans), which allow to save resources later and create the opportunity to contribute to subsequent priorities and choices. This means that initiating new activities calls for reassessment of the financing of current policies and setting priorities within sectors. The efficiency of using resources is increased in the conditions of the existing means so the quality and accessibility of public services do not suffer.

Several reforms have been carried out to improve the functioning of state agencies, which meet the goals described above and help cope more efficiently in the future. The most important of these are the centralisation of support services and real estate management, and organising public procurements centrally.

A reform will be carried out in the financial management of the state in order to improve the quality of financial management and guarantee a more accurate and operational overview of the state's receivables, liabilities and investment needs. The terminology, principles and rules used in budgeting and accounting will be harmonised in order to streamline the financial management system. State agencies will start planning the budget on accrual-basis in addition to cash-basis after the implementation of the standardised financial accounting software during the centralisation of support services.

The biggest reforms planned in sector policies due to population aging are the structural reforms of education and social security.

The general education school network in Estonia, especially the network of upper secondary schools, will be streamlined to ensure that every upper secondary school student receives a quality education, and a higher education reform will be carried out with a comprehensive solution of education allowances and the implementation of new models in financing research.

Reforms in the area of social affairs will also be prepared – reform of the inability to work system and reform of old-age pensions under favourable conditions, superannuated pensions and occupational pensions. Streamlining the welfare network and reorganisation of national special social welfare institutions will also continue.

Improving the quality of finance on the side of taxes is supported by the critical review of tax incentives and the abolishment of incentives that no longer meet their initial goal and have become unjustified. 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.

INSTITUTIONAL FUNCTIONS

Valid 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 last coalition agreements is a balanced budget (the "soft" rule that has so far been followed by all governments) even though there are no laws that require the general government or central government budget to be in balance (in a surplus). Amendment of the State Budget Act is currently being prepared and the requirement to have a balanced budget will be stipulated at the level of law. The plan is to submit the amendment to the Riigikogu in the end of 2012.

The basis of the conservative fiscal policy of Estonia arises from the Constitution of the Republic of Estonia in general. 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 which demonstrate the sources of revenue necessary to cover the expenditure. Also, the Riigikogu may not eliminate or reduce expenditure in the state budget or in its draft which is prescribed by other laws.

The Constitution also regulates how expenses may be incurred in the event the Riigikogu have not adopted the state budget by the start of the budgetary year – in a situation like this, 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 Riigikogu elections if the Riigikogu has not adopted the state budget within two months after the start of the budgetary year.

The State Budget Act has been established pursuant to the Constitution and it stipulates the procedure for preparation and adoption of the state budget whilst limiting the options of increasing the loan budget and establishing the procedure for making decisions about the level of reserves. The present judicial area stipulates the rules for maintaining the financial sustainability of other general government institutions in addition to the state.

Rules for maintaining legal reserve levels

- The amount of the state's cash reserve is determined with the State Budget Act every year.
- Requirements have been set to the use of the reserves of the Estonian Health Insurance Fund (retained earnings, legal reserve and risk reserve).

  The legal reserve of the Health Insurance Fund comprises the budget funds of the Health Insurance Fund for the purpose of hedging the risks that arise from macroeconomic developments and threaten the health insurance system. The legal reserve amounts to 6 per cent of the budget and each year, at least one-fiftieth of the total budget of the health insurance fund and revenue from the social tax revenue prescribed for the payment of health insurance benefits which is higher than prescribed in the state budget is transferred to the legal reserve, until the amount of the legal reserve provided by law is reached or restored. The legal reserve may only be used as an exception by order of the Government of the Republic on the proposal of the Minister of Social Affairs.

  The risk reserve of the Health Insurance Fund is the reserve formed from the budgetary funds of the health insurance fund in order to minimise the risks arising for the health insurance system from the obligations assumed. The size of the risk reserve is 2% of the health insurance budget of the Health Insurance Fund and it may be used with a decision of the supervisory board of the health insurance fund.

The retained earnings of the Health Insurance Fund may be used in a financial year to the extent of 30%, but the amount used may not exceed 7% of the health service expenses set forth in the Health Insurance Fund's budget in the previous calendar year.

- The legal reserve requirement has also been established for the Unemployment Insurance Fund in order to reduce the risk which macroeconomic changes may cause to the unemployment insurance system. The legal reserve of the Unemployment Insurance Fund comprises at least 10% of the resources of the Unemployment Insurance Fund. The legal reserve may only be used as an exception by a resolution of the supervisory board of the unemployment insurance fund if the assets of the trust fund of the Unemployment Insurance Fund are insufficient. Before adopting the relevant resolution, the supervisory board makes a proposal to the Government of the Republic through the Minister of Social Affairs for increasing the rate of unemployment insurance premium to the level which ensures the receipt of funds which are sufficient in order to fulfil the objectives of the unemployment insurance fund.

Restrictions to regulate debt burden

- State authorities are prohibited from taking loans, using a financial lease and assuming other such liabilities. It is also prohibited for them to provide security, grant loans, make donations, purchase share or other holdings and acquire other financial assets unless otherwise prescribed by this Act or the state budget.
- The State Budget Act stipulates annual restrictions on the balance of the budgetary loan and cash loan (repaid within the year) in the budget act, the size of the cash reserve, the balance of the Government loans granted for performance of the public duties, the total bridge financing, etc.
- The Health Insurance Fund may only take loans secured with things in its ownership. The Health Insurance Fund is prohibited from giving loans and securing loan commitments of other persons.
- The Unemployment Insurance Fund has the right to take loans only if its capital reserves are insufficient and if the loan is secured with things in its ownership or guaranteed by the state. The Unemployment Insurance Fund is prohibited from giving loans and securing commitments of other persons.
  The activities of local authorities are regulated by the Financial Management of Local Authorities Act since 2012. The Act stipulates that local authorities must guarantee that the result of their main activities is positive every year and to keep their net debt burden (the difference between liabilities and liquid assets) within their individual limits (this applies to both the local authority itself and the entities that depend on the local authority). The individual limit depends on financial capacity and is 60-100% of operating revenue. Until the end of 2016, local authorities are temporarily prohibited from increasing their net debt burden to more than 60%, even if the individual limit would permit them to do so.
- The net debt of local authorities (the difference between debt obligations and liquid assets) may be 60-100% of operating revenue from 2012, depending on the level of their operating result. A similar restriction also covers local government financial management units (which consist of the local government and the entities dependent on them).
- Rules on keeping current revenue and expenditure in balance have been established for local authorities. The value of the operating result of the local government and the local government financial management unit must be zero or positive.
- Loan restrictions have been established on foundations established with the participation of the state. A foundation established by the state may take loans and enter into capital lease contracts only with the unanimous resolution of all members of the supervisory board.

In addition to the restriction on taking loans, limits have also been set on the assumption of obligations for the account of coming years. State authorities may enter into contract to purchase things or order services, including construction works, for the account of the coming years provided that the total amount of the contractual payments due in any coming budgetary year does not exceed 50% of the amount of the relevant item of expenditure prescribed for the authority in the current budgetary year. The rates of all state budget allowances are also stipulated with the annual State Budget Act, which means that allowance rates cannot be increased if there is no budget cover.

Fiscal institutions

The fiscal institutions[1] that may be pointer out in the Estonian context are 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, the financial management, the economic activity, the management, the effectiveness of the organisation and activity, and the reliability of the information technology systems.

The National Audit Office is obliged to assess the Consolidated Annual Report of the State, which is prepared by the Ministry of Finance and covers all state accounting entities, and the annual reports of the constitutional institutions. The compliance of the reports with the Accounting Act and the legality of the transactions contained in the report is analysed in both cases. The assessment of the Consolidated Annual Report of the State is sent to the Government of the Republic for approval and then submitted to the Riigikogu for approval.

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

[1] 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.

APPENDICES

Appendix 1. Main economic indicators of Estonia in 2001-2010

Table 28. GDP 2001-2010

	2001	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	mln EUR	*%*	*%*	*%*	*%*	*%*	*%*	*%*	*%*	*%*	*%*
1. Real GDP		6,3	6,6	7,8	6,3	8,9	10,1	7,5	-3,7	-14,3	2,3
2. Nominal GDP	6970,9	13,2	11,6	12,1	11,1	15,5	19,8	20,0	1,5	-15,1	3,4
Sources of growth											
3. Private consumption expenditure (incl. NPOs)	3 887,0	7,0	9,5	9,2	8,1	9,5	13,5	8,8	-6,1	-15,6	-1,7
4. Final consumption expenditure of the public sector	1 216,7	2,7	3,4	6,3	1,1	3,2	5,0	6,6	5,0	-1,6	-1,1
5. Total capital investment in fixed assets	1 843,9	12,9	24,2	16,7	6,0	15,3	22,9	9,3	-15,1	-38,0	-9,0
6. Change in stock (% of GDP)		1,5	2,6	1,6	2,2	1,7	2,7	3,1	0,6	-2,7	0,7
7. Export of goods and services	5 564,7	4,0	-2,7	7,7	14,5	18,6	6,1	3,7	0,6	-18,6	22,5
8. Import of goods and services	5 737,2	4,8	7,2	11,2	14,7	18,9	13,9	6,3	-6,3	-32,4	20,6
Contribution to GDP growth [1)]											
9. Domestic demand (excluding stock)		7,8	12,4	11,3	6,6	10,6	15,7	9,3	-7,9	-20,1	-3,1
10. Change in stock		-0,6	2,2	-0,3	0,9	-0,2	1,4	0,8	-2,5	-3,1	3,4
11. Balance of goods and services		-0,8	-8,0	-3,3	-1,2	-1,5	-7,0	-2,6	5,3	11,1	2,5
Added value growth											
12. Primary sector	288,2	-10,4	0,7	8,1	-8,2	-0,5	-1,0	15,6	10,0	12,4	-9,3
13. Industry	1 385,3	10,7	5,7	9,4	2,6	8,5	10,1	6,0	-8,6	-22,7	18,6
14. Construction	368,2	0,1	11,7	9,7	8,0	25,0	8,3	11,4	1,4	-36,1	-8,7
15. Other services	4 193,1	6,0	5,4	6,9	7,0	7,7	10,2	6,3	-2,6	-11,0	0,0

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 which cannot be divided between the areas).
Source: Ministry of Finance, Statistics Estonia.

Table 29. Prices from 2001-2010 (%)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1. GDP deflator	6,5	4,7	4,0	4,5	6,1	8,8	11,6	5,3	-1,0	1,1
2. Private consumption deflator	6,3	3,5	1,6	3,3	3,9	5,2	7,9	8,5	-0,9	2,3
3. Harmonised Consumer Price Index	5,6	3,6	1,4	3,0	4,1	4,4	6,7	10,6	0,2	2,7
3a. Consumer price index	5,8	3,6	1,3	3,0	4,1	4,4	6,6	10,4	-0,1	3,0
4. General government consumption expenditure deflator	4,9	5,7	4,9	5,9	9,0	7,4	14,3	12,9	-1,2	-0,8
5. Investment deflator	2,9	0,9	2,2	2,5	4,1	9,2	8,4	-0,1	-1,3	-0,3
6. Export deflator	2,7	1,8	15	2,4	3,5	5,6	6,8	6,5	-4,6	3,5
7. Import deflator	0,8	-1,0	-1,2	1,2	2,1	3,5	3,8	6,6	-1,5	6,4

Source: Ministry of Finance, Statistics Estonia.

Table 30. Labour market from 2002-2011

	2002	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
		%	%	%	%	%	%	%	%	%	%
1. Employment, persons	585,5 1)	1,4	1,5	0,2	2,0	6,4	1,4	0,2	-9,2	-4,2	6,7
3. Unemployment rate		10,3	10,0	9,7	7,9	5,9	4,7	5,5	13,8	16,9	12,5
4. Labour productivity, persons	15,3 2)	5,1	6,2	6,1	6,7	3,5	6,0	-3,8	-5,5	6,7	0,9
6. Compensation of employees	3 438,3 2)	10,7	12,3	11,2	15,1	20,2	24,5	11,5	-13,4	-3,6	8,3
7. Compensation per employee (6./1.)	5,9 3)	9,2	10,6	11,0	12,8	13,0	22,8	11,2	-4,6	0,6	1,5
7a. Average gross monthly salary, EUR	392,7	11,5	9,4	8,4	10,8	16,5	20,5	13,9	-5,0	1,1	5,4

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

Table 31. Balance of payments from 2001-2010 (% of GDP)

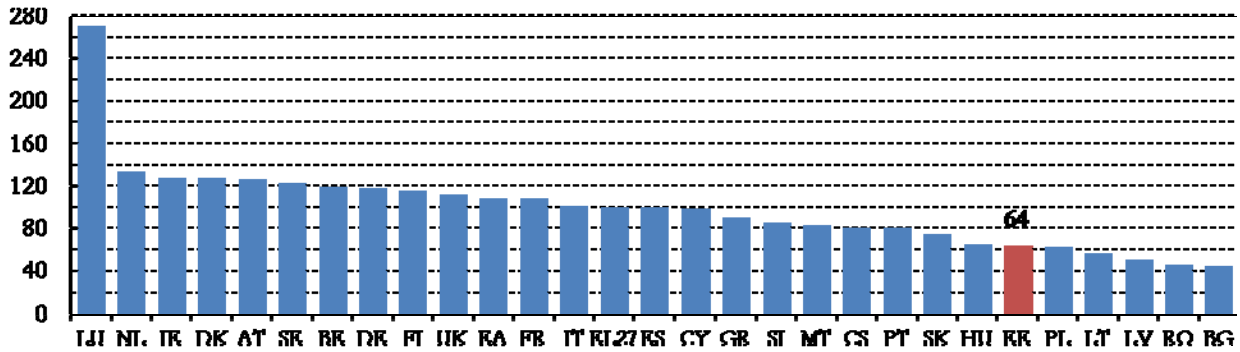
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	-4,9	-10,1	-10,6	-10,6	-9,2	-13,2	-14,9	-8,4	7,2	7,2
incl. - Balance of goods and services	-2,1	-7,0	-7,4	-7,0	-6,4	-10,6	-9,9	-5,4	5,8	7,4
- Balance of income and transfers	-3,1	-3,6	-3,9	-4,3	-3,6	-4,8	-6,0	-4,3	-2,1	-3,8
- Capital account	0,2	0,5	0,7	0,7	0,8	2,2	1,1	1,2	3,5	3,6
1a. Current account	-5,2	-10,6	-11,3	-11,3	-10,0	-15,3	-15,9	-9,7	3,7	3,6
2. Errors and omissions	-0,1	0,6	-0,6	-1,4	1,0	-1,1	0,2	0,9	-0,4	-1,5

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

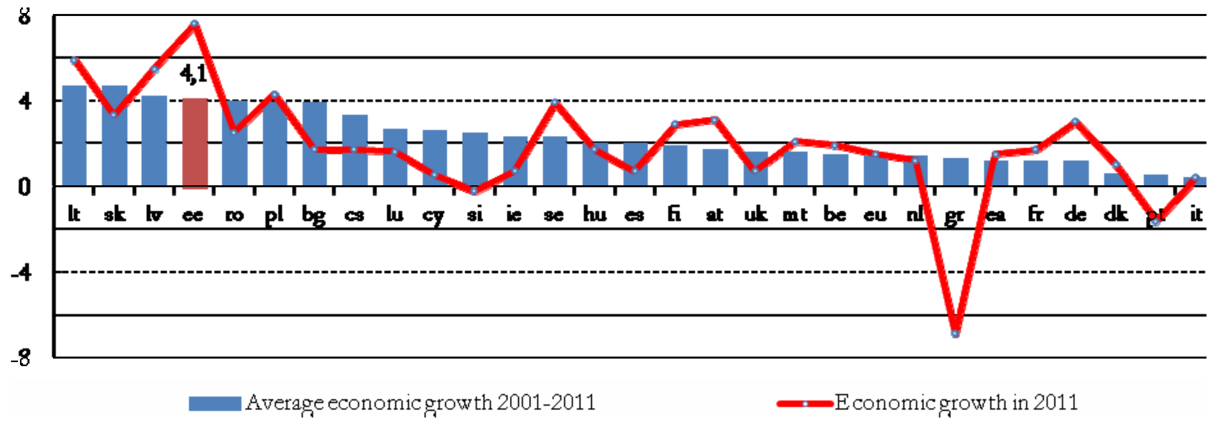
Appendix 2. Comparison of Estonia with other EU Member States (figures)

Figure 22. Main macroeconomic indicators (%)

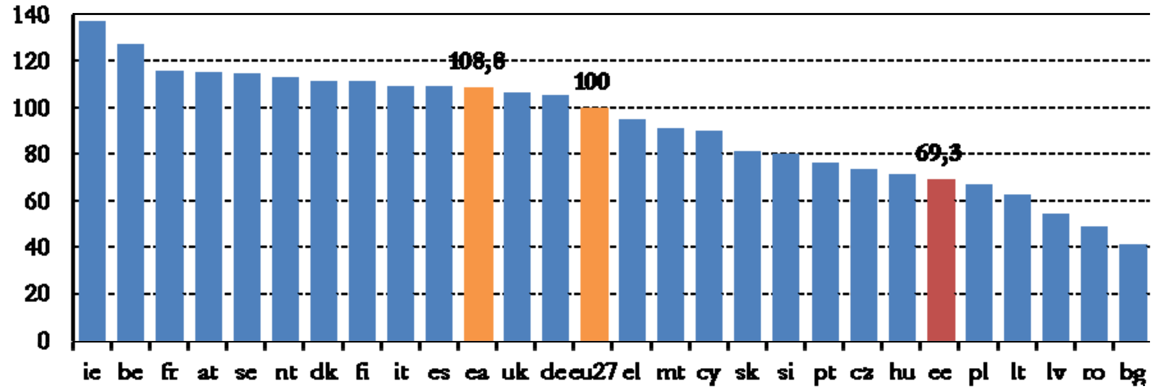
A. GDP per capita in purchasing power parities in 2010 (EU27=100)



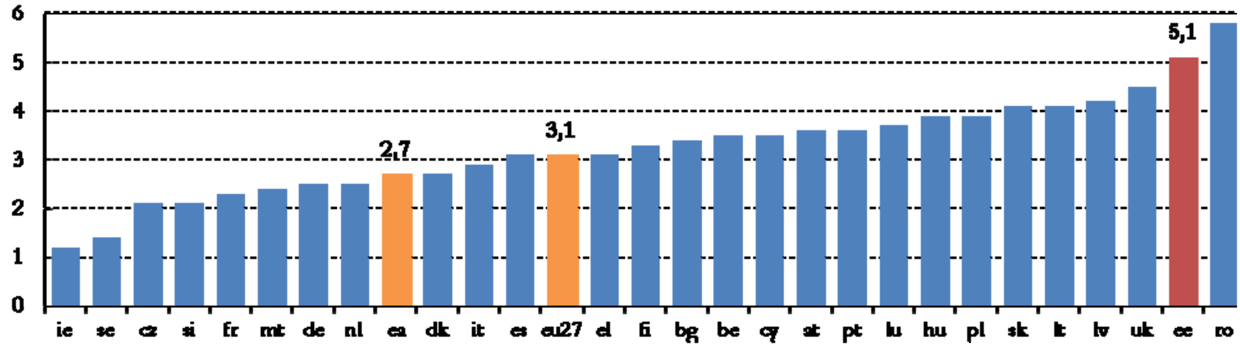
B. Economic growth in 2011 and in 2001-2011



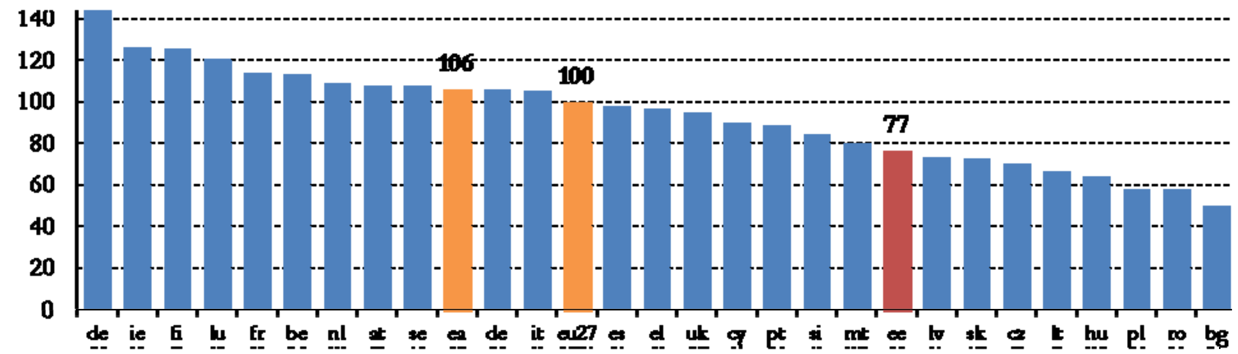
C. Labour productivity — GDP in purchasing power parities per person employed in 2010 (EU27=100)



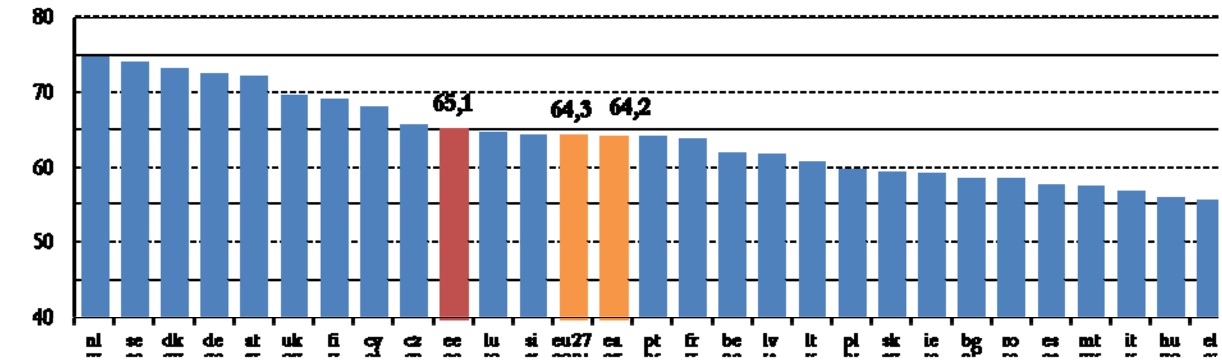
D. Harmonised consumer price index in 2011



E. Price level in comparison with the EU27 average 2010 (EU27=100)



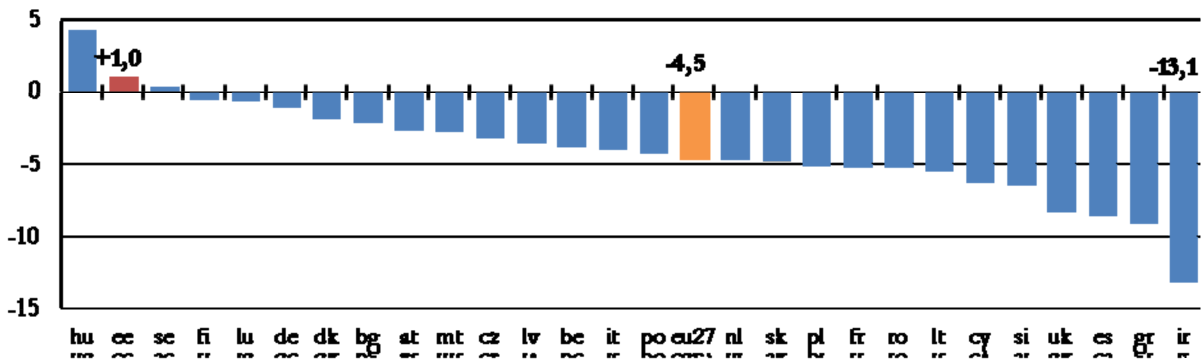
F. Employment rate (persons aged 15-64) in 2011



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

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

A. Budgetary position of general government in 2011



B. General government debt in 2011

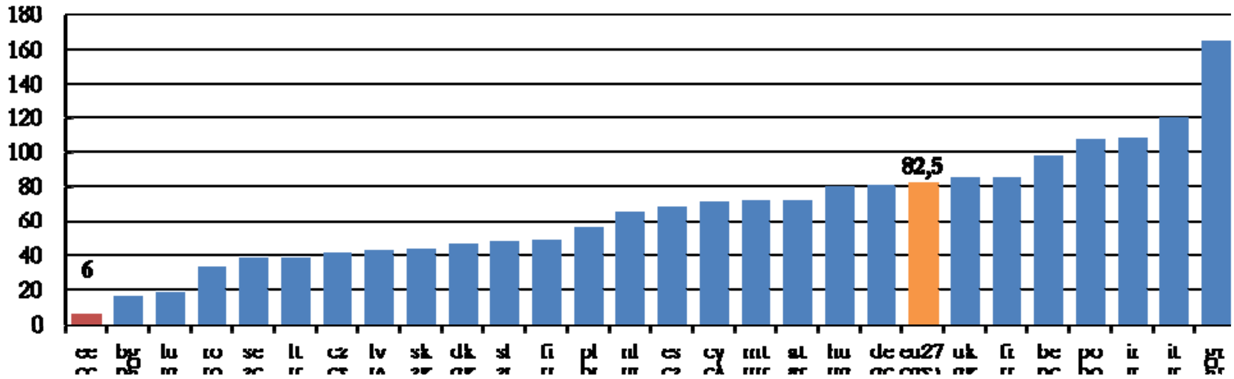
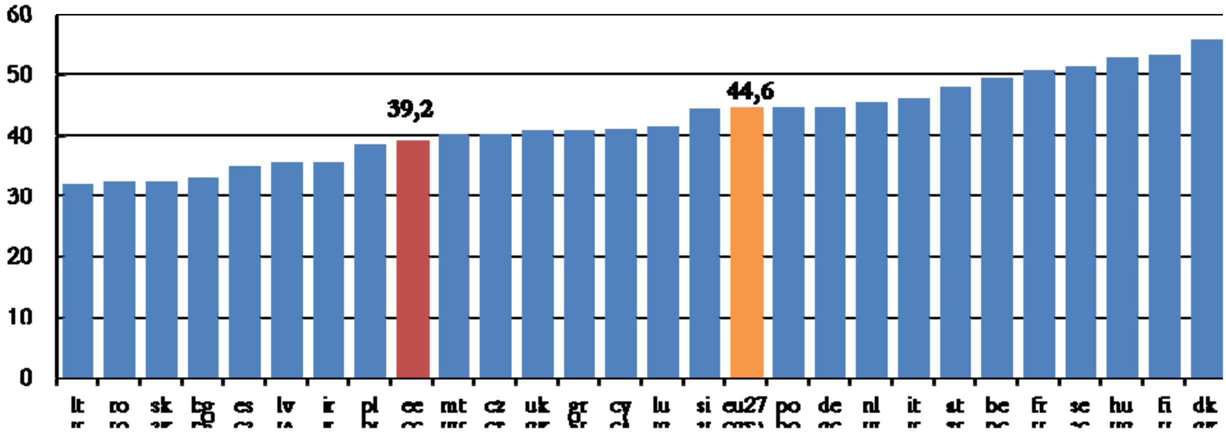
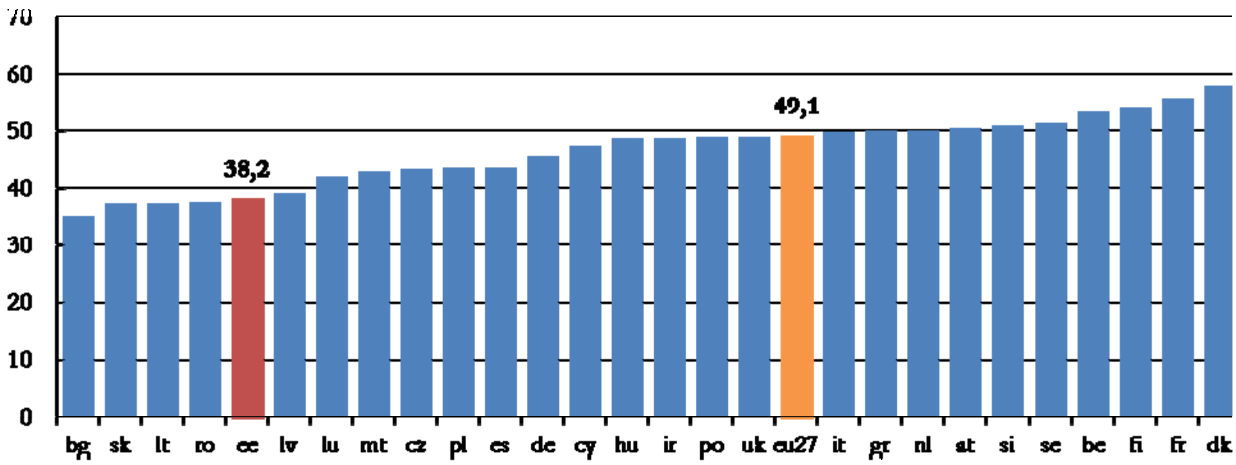


Figure 24. General government revenue and expenditure (% of GDP)

A. Estonian general government revenue compared to other EU Member States in 2011



B. Estonian general government expenditure compared to other EU Member States in 2011



Sources: Eurostat.

Appendix 3. Impact of administrative price increases on CPI

Table 32. Impact of administrative price increases on inflation, 2011-2006 (%)**

Administrative actions	Enforcement	Price increase (%)	Impact on CPI (%)				
			2011	2012*	2013*	2014*	2015*
Change in tax policies			**0,32**	**0,26**	**0,20**	**0,04**	**0,00**
Increase in tobacco excise rates (5%)	1.01.2010	7,0	0,08	-	-	-	-
Establishment of sales tax in Tallinn***	1.06.2010	0,8	0,06	-	-	-	-
Increase in state fees (ID card)	1.01.2011		0,03	-	-	-	-
Increase in tobacco excise rates (10%)	1.01.2011	9,0	0,15	0,05	-	-	-
Increase in tobacco excise rates (10%)	1.01.2012	6,5	-	0,11	0,02	-	-
Increase in tobacco excise rates (10%)	1.01.2013	8,0	-	-	0,13	0,04	-
Increase in alcohol excise rates (5%)	1.02.2012		-	0,10	0,02	-	-
Establishment of sales tax in Tallinn***	1.01.2012		-	0,00	-	-	-
Excise duty on oil shale for heating purposes	1.01.2013		-	-	0,03	-	-
Other administrative price changes			**0,40**	**0,94**	**0,80**	**0,26**	**0,23**
Public transport in Tallinn	1.07.2011		0,02	0,02	-	-	-
Refuse collection***	2011–2015		-0,04	-0,04	0,02	0,02	0,02
Electricity (increase in network fees)	1.06.2010	2,8	0,04	-	-	-	-
Electricity (decrease in renewable energy fee)	1.01.2011	-2,0	-0,08	-	-	-	-
Electricity (increase in network fees)	1.08.2011	7,9	0,13	0,18	-	-	-
Electricity (renewable energy, network fee)	1.01.2012	4,4	-	0,17	-	-	-
Electricity (incl. opening the electricity market in 2013)***	2013–2015		-	-	0,65	0,15	0,12
Water and sewerage***	2011–2015		0,05	0,03	0,04	0,05	0,05
Natural gas	1.05.2010	14,4	0,02	-	-	-	-
Natural gas	1.09.2010	13,8	0,04	-	-	-	-
Natural gas	1.01.2011	-10,0	-0,06	-	-	-	-
Natural gas	1.01.2012	12,3	-	0,06	-	-	-
Natural gas***	2013–2015		-	-	0,04	0,01	0,01
Heat price in Tallinn and elsewhere	1.01.–1.12.2011	5,9	0,28	-	-	-	-
Heat price in Tallinn and elsewhere***	1.01.–1.12.2012	10,0	-	0,52	-	-	-
Heat price in Tallinn and elsewhere***	1.01.–1.12.2013	1,0	-	-	0,05	-	-
Heat price in Tallinn and elsewhere***	2014–2015	0,5	-	-	-	0,03	0,03
Total			**0,72**	**1,20**	**1,00**	**0,30**	**0,23**

**Forecast.*
*** Considers the assumptions known at the time the spring forecast was prepared (incl. changes in taxes).*
**** Estimate of the Ministry of Finance.*
Source: Ministry of Finance, Statistics Estonia, Eesti Energia, Competition Board.