Republic of Estonia

STATE BUDGET STRATEGY 2011-2014

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INTRODUCTION

Nature of state budget strategy

The purpose of the preparation of the state budget strategy is to ensure in the mid-term perspective the sustainability of the budgetary policy and make the government activities on the direction of the state and area developments more effective. The budget strategy presents the planned budgetary policy principles, Government's priorities, analysis of the economic situation and economic development forecast, including revenue forecast, and other information relevant to financial management, for the next four years.

The first state budget strategy-like document was prepared in 2000, and two years later, an obligation of annual strategy preparation was established by the State Budget Act[1]. The Government shall approve the annual strategy on the proposal of the Minister of Finance at least seven months before the beginning of next budget year.

The previous state budget strategy is updated every spring by specifying the plans for the next three years and setting plans for the fourth year. In this way, the mid-term term plans are adjusted to the constantly changing business, fiscal and activity environment.

Implementation and updating of state budgetary policy

State budgetary policy is implemented through development and activity plans of areas of government. Being guided by the state budget strategy approved by the Government and Minister of Finance's regulation on the drafting of state budget, the constitutional institutions, State Chancellery and ministries submit to the Ministry of Finance draft budgets for the next year or plans of action for the first year of development plans, and relevant financial plans. After submission of the draft budgets, they are analysed by the Ministry of Finance and after resolving eventual disagreements by way of negotiations, the Ministry of Finance shall prepare a draft State Budget Act, taking into consideration the summer economic forecast, and submits it together with an explanatory memorandum to the Government. The Riigikogu will start proceeding the draft state budget not later than three months before the beginning of the next financial year. After the Riigikogu adopts the state budget as an act and the State Budget Act has entered into force, the Government shall approve the action plan of the relevant year for implementation of the state budget, and an additional budget expenditure nomenclature resulting from it.

The state budget strategy is updated annually. In this purpose, the ministries and state agencies annually supplement the organisation-based development plan of their areas of government by one year to guarantee a continuous four-year perspective. As a basis for updating the development plan of the area of government serves the state budget strategy approved by the Government in the preceding year. Prior to the approval by the minister of the relevant area of government, the updated development plan is discussed with the Prime Minister and relevant ministers. The development plans are submitted to the Ministry of Finance by March 1 each year (on the year of regular Riigikogu elections – by April 30).

This state budget strategy serves as a basis for preparation of the development plans of areas of government and state budget strategy for 2012-2015.

[1] The State Budget Act, https://www.riigiteataja.ee/ert/act.jsp?id=13164364.

Monitoring of state budget strategy

At the end of financial year, every government agency shall prepare an annual report on its activities and submit to the Ministry of Finance a report on the execution of activity plan relating to the implementation of state budget. The Ministry of Finance prepares a report on the execution and implementation of state budget, which will be approved by the Government as a part of the state annual accounts belonging to the consolidated annual report of the state.

Regular reviews of the receipt of state budget revenue, use of state budget funds and economic and government situation are prepared and published during the entire financial year[2].

Based on this information, Chapter 1.2 sets out the implementation of targets established in the state budget strategy 2010-2013 and most important changes that have occurred in the state budgetary policy of the preceding years.

The implementation of former priorities indicated in the overview of current situation of sector policies in Chapter 1.1 will be monitored and described in the state budget strategy for the following period.

Preparation of the state budget strategy for 2011–2014

According to the Regulation of the Government "Types of strategic development plans and procedure for drafting, amending, evaluating and reporting on their implementation"[3], the ministries have prepared the development plans for their areas of government for 2011-2014 and have submitted these together with financial plans to the Ministry of Finance by March 1. The submitted development plans formed the basis for the spring economic forecast[4] of the Ministry of Finance and for the preparation of this strategy.

In April and May, the Cabinet deliberations took place, discussing the goals of the economic and fiscal policy and the budget priorities. The state budget strategy 2011-2014 was submitted to ministries for approval on May 13. The Government approved the strategy on May 20, 2010.

Structure of the state budget strategy for 2011–2014

This state budget strategy consists of two chapters. The first chapter features the analysis of the current situation and future prospects of Estonian economy and sector policies. The second part establishes the economic and fiscal strategy for the mid-term period.

The first chapter presents the analysis of the current situation and future prospects of economic, tax and fiscal policies and all sector policies which are based on the spring economic forecast of the Ministry of Finance. The second chapter discusses the goals and priorities of the Government's economic and fiscal policy and general government fiscal framework for the next four years. The annexes to the document include the Ministry of Finance's economic forecast of spring 2010 for 2009-2014 and the implementation of the strategy for use of structural funds 2007-2013 in 2011-2014.

[2] Ministry of Finances' monthly reviews of the monitoring of state budget, http://www.fin.ee/?id=81725.

[3] Types of strategic development plans and procedure for drafting, amending, evaluating and reporting on their implementation, https://www.riigiteataja.ee/ert/act.jsp?id=12790098.

[4] http://www.fin.ee/?id=263

1 ANALYSIS OF THE SITUATION AND PROSPECTS

1.1 ESTONIA'S (ECONOMIC) DEVELOPMENT AND CURRENT SITUATION

1.1.1 Economic, tax and fiscal policy

In 2000–2008, Estonia's economy saw an average growth of 7% per year, which placed Estonia among the three countries in the EU with the fastest growing real GDP. During that period, Estonia took a big jump in the improvement of average standard of living, increasing its GDP per capita from 45% in 2000 to 67% in 2008, compared to EU27. [5]

During the first half of the decade, the economic trends were balanced regardless of the fast growth: inflation stayed low, employment was growing, unemployment was decreasing and the growth of average wages was in accordance with the rise in labour productivity. The confidence of both consumers and companies was increasing and such optimism was further boosted by Estonia's accession to the EU in the spring of 2004.

All this also increased the confidence of foreign investors towards Estonia's economy and the real credit boom picked up steam in 2005. Private sector's loans to GDP grew from 42% in 2001 to 110% by the end of 2008, which is a very high indicator compared to the new EU Member States. Over 80% of the household loans constitute housing loans, whereas investments into buildings and constructions form more than a third of non-financial corporations' investments. Thus, a large part of debt finance has been used for acquisition of real estate or business activities relating to it, and not for raising the export potential. Construction boom has almost doubled the construction sector employment in 2004-2007, creating labour shortage and wage pressures in competitive sectors.

Estonia's favourable business environment has also attracted some large-volume foreign direct investments, which, however, have mostly been directed to financial sector, trade, real estate and business activities (total 73% in 1994-2008). Only 14% of foreign direct investments have been directed to manufacturing industry with export potential.

In 2006-2007, the unbalanced tendencies in the Estonian economy steepened. Large-scale inflow of foreign credit money and favourable credit terms impelled credit growth which caused an increase of both consumer prices and real estate prices. A strong increase of import capacities accompanied the boom of domestic demand, wherefore the current account deficit increased. Unemployment emerged in many branches of economy and contributed to the growth of wages which started to exceed the growth of labour efficiency (GDP in current prices/employment). Due to the fast development of domestic demand, the enterprises mainly focussed on servicing the domestic market; export contributions remained in the background.

Economic situation changed in spring 2007. The banks tightened the granting of credits, the consumers' confidence diminished and real estate market declined. Fast growth of income persisted, but from the beginning of 2008 insecurity increased, which was accompanied by a decrease of private consumption. Private sector investments also started to decrease, and the downward trend steepened.

In autumn 2008, the economic crisis culminated, causing a rapid collapse of export capacities, worsening the availability of credit money and increasing the insecurity of companies and households even more. In 2009, economic recession reached up to 14%.

The lack of balance and the risks which have formed in recent years as a result of changes occurring in economy have now receded or are currently receding. Due to decrease in receipt, the current

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[5] Eurostat, http://epp.eurostat.ec.europa.eu

account has a surplus, the lack of balance concerning the labour market and the pressure on the price increase caused by demand have been replaced by a diminishing decrease in employment and wages and by negative inflation. Due to fast adjustments which have taken place in enterprises and due to decrease in the cost level, the export sector has improved its competitiveness in foreign markets. The continued course of adoption of the euro and the signs of economic recovery are once again attracting foreign investors. Many foreign companies are establishing their production units in Estonia and expanding the operations here. Signs that the economy has stepped on a growth path started to manifest themselves in the 4th quarter of 2009, when, due to export, the economy saw a growth when compared to the preceding quarter, for the first time after a decline which had lasted for seven quarters.

Figure 1. Real convergence with the EU *(% compared to EU27)*

** PPS – GDP per capita in purchasing power.*
*** Price level of household final consumption.*
Source: Eurostat.

1.1.1.1 Current situation of the state's finances

<u>General government budgetary position</u>

The general government budgetary position has been in surplus from 2002 to 2007, primarily owing to a favourable business environment and to the economic growth exceeding the potential, thereby increasing the expected receipt of revenue. The biggest generator of the surplus was the state budget, but the budget surplus was also seen in social security funds. However, the consolidated position of local governments has traditionally been negative due to the expenditure increasing from year to year (even at the times of rapid growth in tax receipts).

Table 1. General government budgetary position 2006-2009

	2006	2007	2008	2009
General government budgetary position (mln EEK)	**5,181**	**6,414**	**-6,947**	**-3,685**
State budget	**4,271**	**6,101**	**-5,953**	**-1,257**
Other general government	**910**	**313**	**-994**	**-2,428**
Incl. local governments	-336	-1,128	-1,620	-955
Incl. social security funds	1,245	1,441	626	-1,473
General government budgetary position (% of GDP)	**2.5%**	**2.6%**	**-2.8%**	**-1.7%**
State budget	**2.1%**	**2.5%**	**-2.4%**	**-0.6%**
Other general government	**0.4%**	**0.1%**	**-0.4%**	**-1.1%**
Incl. local governments	-0.2%	-0.5%	-0.6%	-0.4%
Incl. social security funds	0.6%	0.6%	0.2%	-0.7%

Source: Statistics Estonia.

The sudden deterioration of the economic situation in 2008 pushed the public deficit to 2.8% of the GDP. According to Statistics Estonia, the general government budget deficit in 2009 was 1.7% of the GDP. Although in 2009 the general government budget deficit decreased when compared to 2008, all levels of the general government were in deficit. Thanks to the measures implemented, the budgetary position of central government improved the most. As a result of credit restrictions imposed on local governments, their budgetary position improved as well. Social security funds react to a changed economic situation with some delay and their budgets remained in a surplus in 2008. The rapid growth of unemployment last year caused an increased expenditure of the Estonian Unemployment Insurance Fund and a large deficit for social security funds. Last year, the budgetary position of the Estonian Health Insurance Fund was in deficit and exceeded the use of reserves allowed by the law.

General government debt burden and liquid financial assets

During the years of independence, the goal of Estonian budget policy has been to keep the general government budgetary position balanced and, if possible, in surplus during the mid-term period. This has allowed keeping the debt burden on a low level. In the end of 2009, the Estonian general government debt amounted to 7.2% of the GDP. The debt of local governments amounted to 55.9% of the general government debt of 15.5 billion EEK. The debt burden of central government increased due to the credit taken from the European Investment Bank for the co-financing of the EU projects, and also due to the public law institutions and foundations belonging to the general government.

Table 2. General government debt burden 2006–2009 *(mln EEK, % of GDP)*

	2006	2007	2008	2009
Total debt (mln EEK)	**9,242**	**9,268**	**11,600**	**15,501**
Incl. central government	3,845	3,267	4,439	7,706
local governments	5,787	6,646	8,048	8,667
Total debt (% of GDP)	**4.5%**	**3.8%**	**4.6%**	**7.2%**
Incl. central government	1.9%	1.3%	1.8%	3.6%
local governments	2.8%	2.7%	3.2%	4.0%

Source: Statistics Estonia

During 2009, the financial assets of the whole general government increased by 0.5 bln EEK, reaching 25 bln EEK which amounts to 11.6% of the GDP. Among general government levels, the central government reserves increased by 2.8 bln EEK. The volume of financial assets of both the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund has decreased – respectively down to 3.4 bln and 2 bln EEK. As of the end of 2009, the financial assets of the central government exceeded the central government debt approximately 2.4 times and amounted to 18.5 bln EEK, including the Stabilisation Reserve Fund with the market value of 4.7 bln EEK.

Table 3. General government financial assets 2006–2009 *(mln EEK, % of GDP)*

	2006	2007	2008	2009
Total financial assets (mln EEK)	**26,209**	**29,870**	**24,434**	**24,958**
Incl. central government	19,258	21,561	15,667	18,447
local governments	1,932	1,913	1,756	1,106
social security funds	5,019	6,396	7,011	5,405
Total financial assets (% of GDP)	**10.7%**	**12.2%**	**9.7%**	**11.6%**
Incl. central government	7.9%	8.8%	6.2%	8.6%
local governments	0.8%	0.8%	0.7%	0.5%
social security funds	2.1%	2.6%	2.8%	2.5%

Source: Ministry of Finance, Estonian Health Insurance Fund, Estonian Unemployment Insurance Fund.

1.1.1.2 Tax burden and future trends in the tax policy

The goal of the Government is to shift the tax burden from taxation of income to taxation of consumption, use of natural resources and pollution of the environment, with the help of partial reorientation. Efforts are being made to keep the tax system **stable, simple and transparent**, with as few exceptions and differences as possible.

In 2000-2006, the tax burden remained below 32%. During these seven years, the receipts of both direct tax receipts and social security contributions doubled, and the receipts of indirect taxes increased as much as 2.4 times. Corporate income tax receipt increased from 854.4 mln EEK to 3,123.4 mln EEK, i.e. by nearly 3.7 times. In 2002, the mandatory funded pension system (2^{nd} pillar) was implemented; the state payment (4%) of this system is not calculated as tax burden. Also, the unemployment insurance was implemented in the same year, and these payments increase the tax burden. As for indirect taxes, the VAT receipts increased by over 2.3 times and the total receipt of excise duty increased approximately 2.5 times, which was also influenced by the increase in excise duties during the period in question.

In 2007-2008, the tax burden remained near 32%. While in 2007 the tax revenues grew nearly by 5 bln EEK, in 2008 their growth decreased to 1.9 bln EEK.

One goal of the Government is to contribute to the creation of new jobs through the reduction of tax burden on labour. For that purpose, the tax-exempt part of income has been increased several times since 2004 and the income tax rate has been reduced since 2005. The long-term goal is to equalise the amount of tax-exempt income with the minimum wage. Increasing the amount of tax-exempt income helps to reduce the tax burden of people with low income, which was 38.2% in 2008 (corresponding EU15 indicator – 40.8%). The income tax rate has been reduced from 26% in 2004 to 21% in 2008. By now, the reduction of income tax rate has been suspended on the 2008 level due to the surrounding economic environment. In order to compensate for the increase of social costs, the rate of unemployment insurance payments has been increased.

In recent years, the structure of the general government revenues has been influenced by the increase of indirect tax rates. Still, their share in the GDP has not increased remarkably, as, for example, the influence of increased excise duties manifests itself with a delay and the reduction of VAT receipts due to decreased consumption was bigger than the decrease of the GDP. It is expected that an increase of the rates of indirect taxes will have a higher effect on the share of indirect taxes in the following years. The revenue structure is additionally influenced by e.g. the increase of the unemployment insurance payment rate that will increase the share of social security contributions and reduce the share of direct taxes (in 2009, the gross rate of unemployment insurance payments increased from 0.9% to 4.2%).

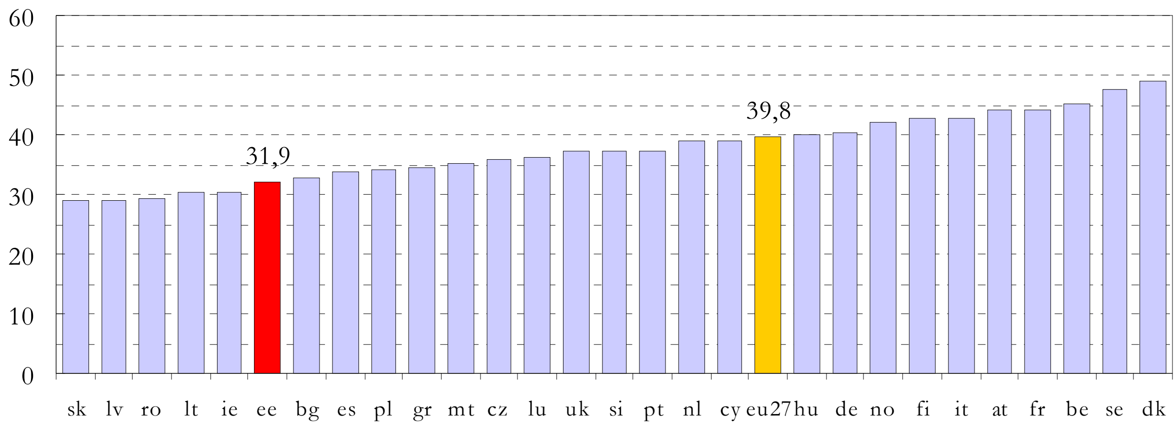
In 2009, the share of tax revenues increased in the whole economy by nearly four percentage points and reached the level of 1995. At the same time, by annual comparison the tax revenues decreased by nearly 3% and the total effect of tax policy changes amounted to just one fourth of the four percentage point increase of tax burden (1.1%). The remaining increase was divided between the estimated effect caused by the suspension of payments into the second pension pillar, the reserves of excise goods, and the changes in the GDP structure (See Figure 3A). The latter indicates that due to a significant reduction of export, GDP decreased faster than the tax receipts (which have not been influenced so much by changes in export) and this increased the share of tax receipts in GDP.

The tax burden is estimated to be 35.9% in 2010 and to decrease to 34.3% by 2011. In 2010-2011, the tax will be are lower than in 2009 due to a decreased receipt of social tax, excise duty on tobacco and corporate income tax.

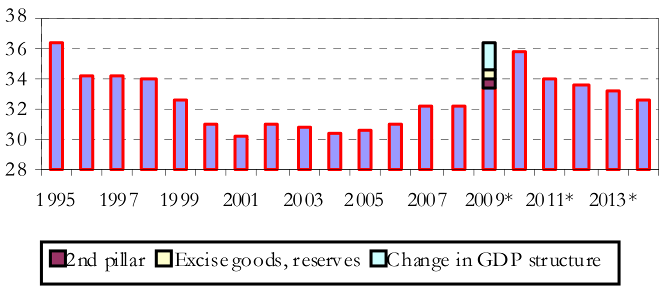
By 2014, the tax burden will decrease to 32.9%; this will be influenced by the resumption of payments into the 2^{nd} pension pillar by the state and the implementation of the 2+6 and 3+6 payment systems which will reduce the tax burden.

Figure 2. Tax burden

A. Tax burden in EU in 2008 ***(% of GDP)***



B. Tax burden in Estonia ***(% of GDP)***



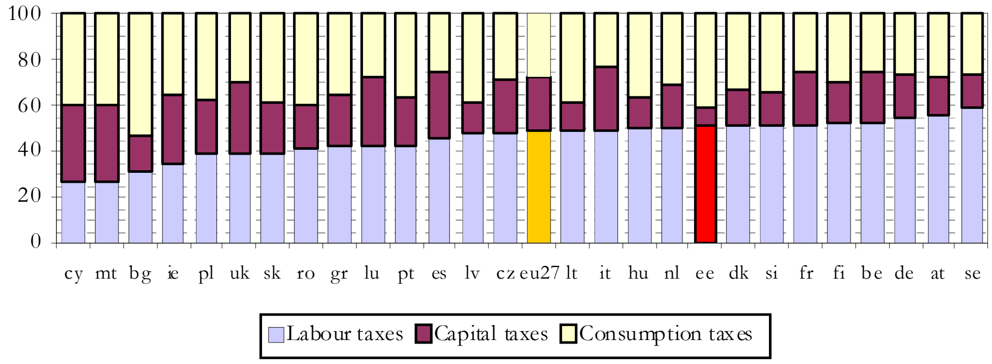
Source: Eurostat.

The share of labour taxes in Estonia has decreased since 1999, until last year (with the exception of 2007 and 2008). In 2009, they formed 51.7% of all taxes and, thanks to the increase in employment and average wages, the share of labour taxes will increase to 52.1% by 2014. Among other factors, the share of labour taxes is influenced by the implementation of the 2+6 and 3+6 systems of the 2nd pillar starting from 2014, which has the technical influence of reducing the tax burden. Similarly with labour taxes, the share of consumption taxes will also increase; in 2009 this was 40.5%. In the mid-term period, the growth of the share of consumption tax will be faster than the growth of the share of labour tax, amounting to 41.4% by 2014. The main source of growth will be the VAT receipt. The share of capital taxes will decrease from 7.9% in 2009 to 6.5% in 2014, primarily due to the reduction of the share of corporate income tax.

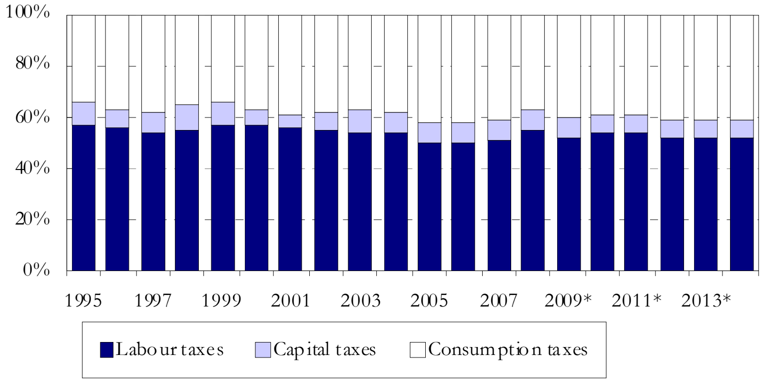
Labour taxes have the biggest share in the tax burden structure of most EU member states; the average figure in the EU was 46% of all taxes in 2007. The share of consumption taxes was 32.6% and the share of capital taxes was 21.6%. Since 1995, the share of labour taxes has decreased and the share of capital taxes has increased; the share of consumption taxes has remained the same (approximately one third of all taxes).

Figure 3. Structure of taxable revenues

A. Structure of taxable revenues in EU in 2007 *(%)*



B. Structure of taxable revenues in Estonia *(%)*



Sources: Ministry of Finance, Eurostat.

1.1.2 Current situation and goals in sector policies

1.1.2.1 Successful economy and active people

The main precondition for increasing the well-being of Estonian society and the economic growth is people with high level of education and good professional skills corresponding to the needs of economic development, who are motivated for life-long learning. Qualified people will allow ensuring a sustainable economic growth, relying on the combined effect of business environment, labour market and education and research policy. The state priority is to ensure an open and flexible life-long learning system and a favourable business environment (including close integration of economic environment with international markets).

One of the main problems in Estonia is the **low labour productivity** and **insufficient level of business and innovation awareness**. Labour productivity is 62.3% of the EU average (in 2009); it is likely that current trends will allow reaching 70% of the EU average by 2014. The development of new products, services and technologies with high added value requires considerable investments into equipment, employee qualification and innovation. Considerably closer co-operation between entrepreneurs on one hand and universities and research institutions on the other hand is also necessary for that.

The situation described above leads to another structural problem in Estonian economy, which is the **insufficient export capacity.** Due to low domestic demand and small domestic market, successful operation in foreign countries is an important factor of development for many enterprises. In 2009, the number of exporting enterprises was 8,531 and it is estimated that by 2014 this number will be 9,500. The factors that limit the export capacity of Estonian enterprises are e.g. low production capacities, little experience of operating in international markets, and heavy expenditures upon entering foreign markets.

It is important for the state that young people have an opportunity to acquire **high-quality education.** The general education system must be used for establishing opportunities for supporting the development of every learner; for the shaping of knowledge, skills, values and willingness necessary in personal occupational and in social life; for life-long learning. The problem is a high share of people aged 18-24 who abandon or do not complete their studies after finishing basic school. While in 2009 the share of young people with basic or lower lever education was 14.3%, now the goal has been set to lower the corresponding indicator below 12.5%[6] by 2014. The application of the new draft of the Basic Schools and Upper Secondary Schools Act requires significant changes in the organisation of schools; it will increase the obligations and responsibilities of different parties in order to support the development of all students and to reduce the number of young people abandoning school in the general education system.

The solution to key issues of economic problems lies in the conformity of education, primarily in the conformity of **vocational and higher education** to the development needs of the Estonian economy. The training of people and a general increase of average educational level are important in terms of raising the overall competitiveness of the state and in order to improve the position of people in the labour market. For example, the main concern of foreign investors is the availability and quality of labour. Still, the increase of the number of students in vocational education institutions and the improvement of vocational education quality is still encouraging. Although the number of students graduating from upper secondary schools is decreasing, the number of students accepted into vocational education institutions during academic years 2008/2009 and 2009/2010 has a trend of increasing.

The improvement of vocational education quality[7] shows that the levels of the Estonian qualification framework comply with the European qualification framework and that an integral model for the quality assurance system of vocational education has been developed. The availability of vocational education has improved, and vocational training opportunities have been created in basic schools and in upper secondary schools. The renovation of vocational education facilities and improvement of students' learning and living conditions there continues still.

Higher education in the national language and competitive research are of paramount importance in terms of competitiveness of the state and development of national culture and language. The intended goal on the EU level is to increase the share of people aged 30-34 with tertiary education in the society (the 2020 draft strategy of the EU states a goal of up to 40%; the 2009 level was 35.7%, the goal for 2014 is at least 37%).

The use of **research and development and innovation** achievements for the improvement of productivity and export capacity of enterprises has to be promoted. The total research and development costs of the general government have considerably increased with the help of structural funds, amounting to 1.44% of the GDP in the state budget for 2010. The continuation of a competitive system for stable funding is a precondition for ensuring that by 2014 the target level of co-financing of the research and development activity by the public and the private sector (3% of the GDP) will be reached[8].

Several measures have been launched in recent years, in order to promote the co-operation between enterprises and research institutions and to provide a practical output for research activity results:

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[6] Area of Government Development Plan 2011- 2014, Ministry of Education and Research

[7] In the end of 2008, a survey regarding satisfaction of social partners was carried out upon the order of MER; the purpose of the study was to determine how the social partners of the vocational education system evaluate the activities implemented in 2005-2008 for the development of vocational education. On the basis of the results of the survey it can be concluded that the progress made is valued highly by the partners from business sector as well. According to 41% of respondents, the quality of vocational training in Estonia has substantially improved.

[8] Strategy of knowledge-based Estonia

innovation vouchers, support scheme for research and development projects, support measure for clusters, the programme of technology development centres. Nearly 500 enterprises have received support and now contribute to further development of economy; however, it is too early to evaluate the long-term results of this.

The competitiveness and productivity of **agriculture** has increased. At the same time, not enough sustainable jobs have been created in alternative areas of activity to agriculture in rural areas. Urbanisation continues and the subsistence level is lower in rural areas. The drive for the growth of agriculture and food processing industry could be a better mutual co-operation than before and the implementation of new products and innovative technologies which would be competitive also in foreign markets.

For a quick launch of a new sustainable growth in the context of economic recession, a compromise between stimulating economic activity and developing human resources needs to be found. Measures have been launched for development of entrepreneurship, for creation of new jobs and for involvement of new investments. **Active labour market measures promote** the return of unemployed people to employment as quickly as possible, preventing the formation of long-term unemployment. For example, work practice and wage subsidies for enterprises have been implemented as measures supporting the employment of unemployed people; the start-up of businesses by unemployed people has been supported by granting relevant subsidies.

More than before, the focus is on continuing education and retraining of unemployed people with low qualification, in order to increase the competitiveness of these people in the labour market. Upon expanding the possibilities of life-long learning, the attention is paid to those goal groups who have so far participated less in the training (e.g. older people and people with lower level of education). While in 2009 the share of adults aged 26-64 participating in life-long learning was 10.6%, by 2014 this share should be 14%. Greater attention is paid to bringing back into the education system those people who have abandoned their education. People's will to work and working habits have to be preserved until and during the new period of economic growth. A goal has been set to increase the employment rate (the share of employed people aged 20-64 in the whole employment-age population) from 69.9% today to 71% in 2014 through these measures.

A structural problem of the Estonian labour market is **gender segregation**. This influences negatively the general situation of men and women in the society. Professional and vocational segregation, in turn, is one of the main reasons for the gender-based wage gap.

In addition to active labour market measures, an important measure for promoting the improvement of employment rates is the establishing of a suitable **work environment**. In order to support the promotion and shaping of safe flexibility principles in different areas of activity, it is necessary to raise the awareness of the parties of the labour market about various ways of using safe flexibility in employment relationships, including various labour market measures. For the purpose of increasing clarity with respect to **employment relationships,** the Employment Contracts Act was entered into force on July 1, 2009; this Act utilises the approach of safe flexibility. In the course of reforming the labour law, the circle of beneficiaries of unemployment insurance benefit was expanded, the unemployment allowance rate was increased to 50% of the minimum wage established by the Government for the preceding year, the child care leave pay was increased to the level of minimum wage, and the payment of average wage for paternity leave was prescribed. Due to the deterioration of the economic situation of the country and the increase of the unemployment rate, the amendments will enter into force only on January 1, 2013.

In order to reduce the employees' illnesses and extend people's working life, the occupation health and safety situation in enterprises and in the country on the whole has to be improved. Measures have to be developed in order to ensure that the victims of occupational accidents and people suffering from occupational diseases could return to work as quickly as possible. Enterprises can contribute to this by investing into the prevention of occupational accidents and occupational illnesses and into health promotion.

1.1.2.2 Viable and unified nation

The basis for the survival of Estonian society is the preservation of Estonian language and culture, long life expectancy of people, and educated children and young people. It is important to have a population that cares about its well-being and about the well-being of close friends and relatives; an effective and safe social support network is important as well. All people must have equal opportunities for successful coping, development and well-being in the future.

In order to strengthen the Estonian population, first of all an increase of population, **the growth of birth rate and longer life expectancy** have to be achieved. The extension of Health Adjusted Life Expectancy up to 55.9 years for men and up to 61.2 years for women has been set as a goal of 2014 (in 2008 this was 52.9 years for men and 57.3 years for women)[9]. As a precondition for this, the state is establishing better opportunities for people to lead a dignified and active life in old age, which on the whole extends the length of Health Adjusted Life Expectancy and increases social security in the society. Estonian people have an opportunity to acquire a competitive education based on equal opportunities. Preconditions for the integration of different ethnical groups into the Estonian society are established.

During the years of fast economic growth (2004-2007), **the social well-being** of the people considerably prospered. This was reflected by high subjective life satisfaction evaluations[10], as well as considerably improved material status which is indicated by the growth of family incomes. The number of people living below the subsistence minimum or under the absolute poverty line considerably decreased. At the same time, differences in the quality of life between older and younger generations and between different regions steepened and the difference between the social well-being of Estonian and Russian speaking population persisted. While in 2007 the rate of relative poverty was 19.5%, the goal for 2014 is to reduce it by 1% (18.5%). The economic crisis and the related unemployment and decrease in incomes bring along a bigger risk to end up in poverty. When a person ends up in poverty and is socially excluded, this does not influence just the person, but also his or her entire family needs help and support. Measures are implemented to prevent and alleviate the poverty and exclusion of children and to promote employment opportunities for young people. Special attention is paid to the availability of welfare services which support the activeness, coping and working of people, and to the sufficiency of social benefits for the alleviation of poverty.

Attention has to be paid to the integration of people who **have lost their capacity for work** and of disabled people into social life, by offering measures supporting their activeness. The year 2009 saw an increase of the number of applications both for determining the degree of disability and a permanent incapacity for work and for the receipt of social benefits of disabled persons and pensions for incapacity to work. In 2008, the social benefit for disabled persons of employment age was redesigned to be based on additional costs and to support activeness. Also, an activeness-based benefit system for children with disabilities has to be implemented in the future.

In 2007, the poverty gap between women and men in Estonia was one of the biggest in Europe. The reason to that was the income difference between women and men and, first of all, the gender-based wage gap. Women's poverty considerably influences children's poverty. The opportunity of parents to participate in the labour market is a decisive factor in prevention and alleviation of children's poverty, therefore the burden of care of families has to be decreased through the provision of pre-school education and the development of the childcare service. In order to notice and support the children and families in need of help, the state will increase the effectiveness of the child protection system and the services supporting parenting.

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[9] Development Plan 2011- 2014, Ministry of Social Affairs

[10] Eurobarometer 70: Public Opinion in the European Union. Autumn 2008. Emor

International experience and the Estonian data confirm the connection of unemployment and income levels to the **state of health**. In order to avoid health risks for the unemployed people, the state has established an opportunity for them to have health insurance cover. In order to prevent health problems and coping difficulties of the growing generation, it is important to aim the activities at the most sensitive periods of human development (pregnancy, babyhood and teenage years). By increasing the effectiveness of the support offered during these periods of life and by directing attention in the first order to poorer families with difficulties in coping, it is possible to substantially reduce the inequality which manifests itself in the population health. Unhealthy lifestyles of employment age population (insufficient physical activity, alcohol abuse, and smoking), bad state of health, and early mortality (primarily among men) affect negatively the quality of life of people, the labour supply and labour productivity, and the overall growth of well-being. The number of new registered HIV cases does show a declining trend but remains high nevertheless. During the next decade, HIV may become a substantial cause for the disease load of the country. Health risks are systematically evaluated in order to reduce health risks caused by the environment. People's awareness about risks concerning them is being increased, and the state is ready for emergency situations. High-quality health services are guaranteed for all people who need help.

Use of cultural services continues, but consumers have become more sensitive to prices. The number of people visiting libraries and museums shows a trend of growth. Active citizenship and participation in voluntary activities and donations has grown. Estonia has the eighth place among the EU member states regarding cultural indicators[11]. It is important for a small country to appreciate both its intangible and its tangible cultural heritage. Implementation of programmes supporting the richness of different cultural spaces (Kihnu, Setu, and Southern Estonia) will help to preserve and develop cultural diversity. Estonia was elected to be a member of the UNESCO World Heritage Committee and this opened an opportunity to have a say in matters concerning the world cultural heritage. In the future, culture and creativity have to be integrated more into other national policies as strategic elements. This will ensure the viability of Estonian cultural space, increase the sense of unity and cultural versatility, boost creative industries, and introduces Estonia in a positive way in the world, thereby enabling the formation of a social and economic benefit. Cultural involvement will help to make **the integration** of non-Estonian population more effective. The development of a national network for **organisation of sports** continues to be important, in order to ensure involvement in sports and regular exercise habits. The share of people who exercise on a regular basis in the entire population was 34.7% in 2009; the goal for 2014 is to reach the share of 40%[12]. As a positive development, the supporting of local initiatives has made the regional co-operation and co-operation between entrepreneurs considerably more active, contributing to the protection of local identity and cultural heritage and the development of sports opportunities. It is important to establish a health-supporting development environment for children, because the basis for attitudes and behavioural habits is formed in childhood and this will affect the state of health in adulthood. Opportunities for children and young people to participate in sports and exercising are increased.

1.1.2.3 Valuable living environment

One of the biggest values of Estonia is its rich natural environment and well-habitable artificial environment in the whole country. One precondition for Estonia's sustainability is the preservation of ecological richness and the balanced development of artificial environment as an important prerequisite for human and economic development. The development of living environment takes place in close co-operation with other Member States of the EU and the countries of the Baltic Sea region, taking into consideration the task of mitigating the climate change among other things, as this is becoming more and more important.

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[11] Dashboard of Sustainability. Statistics Estonia http://www.stat.ee/38256
[12] Development Plan 2011-2014, Ministry of Culture

Based on the global assessment of all indicators of ecological balance, the sustainability of Estonia ranks 23rd in the comparison of the European Union countries; this is primarily caused by inefficient use of oil-shale in the production of electricity.[13] Pressure on the environment is higher in bigger urban settlements; nearly 70% of Estonian population is living there.

One of the most important priorities of public health is the supply of sufficient amounts of high-quality **drinking water**, together with corresponding waste water treatment. Public water supply (87% in 2009) and sewerage (76% in 2009) is guaranteed to a large share of the population. While in 2009 the district water supply network supplied high-quality drinking water to 72% of consumers, by 2014 all consumers must have guaranteed access to high-quality drinking water. Problems with the quality of water mainly occur in industrial regions and in regions of intensive agriculture where the pollution load is high. Today, approximately 70% of Estonian surface water is in good or very good condition. Nearly 74% of Estonian rivers and 58% of lakes are in good condition. It is quite likely that it will not be possible to achieve a good condition of approximately 17% of surface water by 2015. Only 31% of Estonian coastal water is in good condition, but the deterioration of this condition is primarily caused by the Baltic Sea. Increasingly more attention is paid to water biota as well.

In nature conservation, importance is attributed to the protection of habitats and to the protection of valuable landscapes and ecosystems on the whole. The protection of natural values, the restoration and preservation of endangered species and habitats, the maintenance of semi-natural communities and organisation of alien and problem species control has to be ensured. There is a problem of fragmentation and destruction of populations and their habitats which are important for Estonia and on the international level. The goal for 2014 is to preserve and improve the achieved condition and to provide an overview of the condition of all species and types of habitat.

Due to the intensifying maritime transport resulting from economic activities, the danger of pollution of the Baltic Sea, including the maritime areas of Estonia, is increasing; it may reach the dimensions of an ecological catastrophe (in 2009, sea pollution was discovered on 59 occasions). The problem is the technically outdated pollution control. While in 2009 the available capacity for elimination of pollution accident consequences was 0.6 km^2 per 24-hour period, by 2014 the capacity for responding to pollution accidents is planned to be improved[14].

The issues of a consumer society are **waste generation prevention**, increase of recycling and reduction of disposal. Nearly 20 million tons of waste was generated in 2008, which approximately 80% was generated in industry, including over 73% of waste related to oil-shale and energy industry, which pollute both surface water and ground water. Solutions are still needed for ensuring the appropriate storage of oil-shale industry and energy industry waste by 2013. In 2009, the quantities of waste disposed into landfills decreased approximately by one fourth when compared to 2008. There is a problem of inadequate capability of local governments and insufficient co-operation between the private sector and the government regarding development of waste management. Although the rate of recycled materials to generated waste is increasing, the rate of development has not been sufficient so far. By 2014 the rate of waste recycling to total waste generation is planned to be 38% (32% in 2008).

The most important renewable natural resource is the **forest,** the use of which has fallen below the optimum volume in recent years. Wider use of timber instead of fossil energy sources would help to reduce the CO_2 emissions and conserve the environment. The use of forest provides employment and helps to make investments for the development of nature conservation and recreation and hunting services. Besides the forest, the agricultural land is also a renewable natural resource

[13]Dashboard of Sustainability. Statistics Estonia http://www.stat.ee/38256. 23rd place indicates that Estonia has not contributed sufficiently to the preservation of ecological balance.
[14] Development Plan 2011-2014, Ministry of Internal Affairs

(including the semi-natural communities), the opportunities of sustainable use and conservation of which are connected to the development of agriculture and food processing industry. In 2009 there were 457,456 ha of environmentally managed land, and it is considered important to increase the use of environmentally managed land in the future.

The demand for **mineral resources** has grown. The economic interests are still of primary importance in extraction of mineral resources, and an economical use of natural resources and the consideration of the environmental and socio-economical impacts is not guaranteed. In some areas, the building sector demand exceeds the extraction capacities of natural resources used in construction (limestone, gravel, and sand). The increase in oil price stirs interest in oil shale as a raw material for oil. During the last decade, the production of oil shale has grown nearly 46% and by the end of 2009 the oil shale extraction volume was 17 mln tons per year. Oil shale extraction and industry affect the whole Estonian environment, most of all the north-east part of Estonia. The main source of air pollution in Estonia is the energy industry utilising oil shale.

Energy industry utilising local oil shale ensures the necessary energy independence of Estonia, but it is increasingly more important to diversify the energy portfolio. As oil shale energy industry has a low efficiency factor and is located in concentrated space, it is necessary to update the technology and diversify the sources of energy in order to increase the efficiency of energy production and security of supply. The increased use of local sources of energy diminishes energy dependence. One sustainability indicator of energy industry is the share of energy produced from renewable sources, which has decreased in Estonia in recent years. In 2007 the share of energy produced from renewable sources of energy was approximately 10% of the end consumption (31% in Sweden, 30% in Latvia). In national energy balance, the share of renewable sources of energy was only 2.1% in 2008, but it is planned to reach 15% by 2014. The gradual opening of the Estonian electricity market (since 2010) will change the competition on electricity market and may bring along fluctuations of prices, including some price increase. At the same time, the opening of the electricity market and the constructing of additional electricity and gas supply connections between the Baltic region and the other EU Member States and the Scandinavia is the precondition for the optimisation of electricity market and thereby contributes to the improvement of Estonia's competitiveness.

Transport connections between Estonia and its main foreign trade partners (Nordic countries, Latvia, Lithuania, Russia and Western European countries) need to be improved. In order to achieve this, the volume of investments into the transport infrastructure has been increased (in 2001-209, approximately 18 bln EEK was spent on road management) in order to improve the situation of water, air, railway and road transport connections. There are problems with public transport: the domestic transport networks are irregular, and in rural areas the public transport connection with attraction centres has become worse in recent years; this has a negative influence on the location of settlements and provides an additional drive for the population concentration. The reduced provision of primary care services in thinly populated areas has the same effect. In 2005, the share of people commuting to work with public transport was 29.9%; the goal for 2014 is 30%[15].

1.1.2.4 Ongoing sense of security

A competitive society is characterised by ongoing sense of security which promotes the growth of population, reduces peoples' risks to suffer from accidents or crime, and prevents the deterioration of the living and economic environment. In addition to the developed infrastructure, a secure country is a precondition for the arrival of foreign investments to Estonia, and the latter forms a good basis for the economic growth. The purpose of establishing ongoing sense of security in Estonia is to ensure national peace and stability and to protect human lives, human health and property.

[15] Strategy 2011-2014, Ministry of Economic Affairs and Communication

The overall crime rate[16] decreased in 2009 when compared to 2008: violent crimes decreased, including aggravated criminal offences against persons; the crimes of driving while intoxicated, robberies and drug-related crimes also decreased. While 48,359 criminal offences were registered in Estonia in 2009, the goal for 2014 is to reduce the number of criminal offences below 48,000. Simultaneously with the reduction of the number of criminal offences, the goal is to reduce the number of people held in custody.

As an outcome of the implementation of the security policy[17], the criminal policy[18] and the traffic and fire safety programmes, the number of **deaths and injuries** in Estonia has decreased. Improvement of these indicators is also set as a goal for the coming years. In order to reduce the high **recidivism risk** (approximately 40% of people released from prison commit a new criminal offence within a year after the release, 26% of people released from prison are re-imprisoned within a year after the release)[19], different intervention programmes are implemented and their efficiency is increased, prisoners' motivation system for obtaining education is implemented, and drug abuse treatment of offenders and rehabilitation for imprisoned drug addicts is organised. A goal has been set to complete the prison reform by liquidating all camp-type prisons.

Among various types of criminal offences, the numbers of robberies committed by the use of a weapon, thefts from stores, computer-related frauds and acts registered as illicit traffic have increased. The **corruption cases** that have occurred in recent years (in local governments and the judicial system) damage the reputation of the country politically and economically; corruption also endangers the protection of state secret and boosts black economy and money laundering. In order to prevent the spreading of corruption, attention is paid to raising corruption awareness and to developing the detection and investigation capacity of offences in law enforcement agencies. In 2009, Estonia ranked 27th (6.6 points on a 10-point scale) according to the Corruption Perception Index of Transparency International; the goal for 2014 is 6.8 points[20].

Cybercrime was placed on the agenda as a critical item after the occurrence of cyber attacks in April 2007. Cybercrime is used to commit frauds and to paralyse the operation of enterprises and financial and government agencies and the overall virtual environment. In order to prevent and control cybercrimes, the co-operation of authorities on national and international level is strengthened, relevant legislation is developed, and the state-of-the-art technical level and the development of necessary know-how are ensured.

The approach in prevention, control and detection of criminal offences is primarily based on the priority of the offences and on their influence to the overall condition of the legal order. The following criminal offences are regarded as most important: drug-related crime, criminal offences committed by and against minors, corruption, aggravated offences against persons, organised and cross-border crime, and economic crime. In order to increase the sense of security, heightened attention is continually paid to preventive actions concerning fire safety and traffic supervision.

Military defence of Estonia forms a part of the integral national defence which is based on the primary self-defence capability and on the NATO collective defence.[21] The development of military defence is aimed towards prevention of military threats and, in case of need, towards countering such

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[16] http://www.just.ee/orb.aw/class=file/action=preview/id=48522/Kuritegevus+Eestis+2009.+Kokkuv%F5te.pdf
[17] http://www.siseministeerium.ee/public/Turvalisuspoliitika_2010.pdf
[18] Guidelines for Development of Criminal Policy
[19] http://www.just.ee/orb.aw/class=file/action=preview/id=48522/Kuritegevus+Eestis+2009.+Kokkuv%F5te.pdf
[20] http://www.transparency.org
[21] Pursuant to Article 5 the Parties agree that an armed attack against one or more of them in Europe or North America shall be considered an attack against them all and consequently they agree that, if such an armed attack occurs, each of them, in exercise of the right of individual or collective self-defence recognised by Article 51 of the Charter of the United Nations, will assist the Party or Parties so attacked by taking forthwith, individually and in concert with the other Parties, such action as it deems necessary, including the use of armed force, to restore and maintain the security of the North Atlantic area.

threats. For that purpose, the capabilities required for the military defence of Estonia and for the NATO collective defence are developed.

The development of the wartime and peacetime units of the Defence Forces has continued on the basis of compulsory military service in accordance with the preparation plan of operational structure units and the requirements arising from the NATO planning goals. The development activities concerning military defence are taking place, but due to economic reasons the achievement of several capabilities has been postponed into a more distant future than initially planned.

An important indicator characterising the Estonian military defence capability and the increased capacity of joining the NATO operations is the target level of usability of the army[22]. Here, the main goal is to increase this target level of usability. While in 2009 the share of deployable units was 31.1% and the share of sustainable units was 11.3% of the army composition, the goal for 2014 is to have the share of deployable units as 39.6% and the share of sustainable units as over 10% of the army composition.

During the last period, the participation of the Defence Forces and the Defence League in helping the civil authorities was specified further; this involves the activities in crisis situations, emergency situations, in rescue works and in ensuring security. The number of voluntary members of the Defence League continues to grow. In 2010, the formation of Cyber Defence Units (Cyber Defence League) was started.

In terms of international security co-operation, the importance of the **NATO Co-operative Cyber Defence Centre of Excellence** is increasing, as this organisation is contributing to the development of Estonian cyber security.

1.1.2.5 Civil state

Civil state, democracy and efficiency form a basis for the achievement of results in all areas of life. Public services are developed in order to facilitate the civil state. Improved availability of public services to citizens is ensured through structural reforms and centralisation of activities, and these services are made more cost-efficient for the state. The most important characteristic of the civil state is supervision over the legislative and executive power and the compliance of the local government legislation with the constitution and the laws. General government resources are used legally and efficiently, and financial and performance audits are carried out on a regular basis. The work of the Government has been arranged no the basis of the principles of effective governance. The goal for 2014 is for Estonia to achieve the 12th place among the Member States of the European Union by quality of governance[23] and to increase the reliability of public service from 43% (in 2009) to 60%[24].

The quality of **legislation** has improved and a European private law system has been developed[25]. The quality of legislation has been ensured by knowledge-based nature and comparative studies. At the same time, the availability of legal information needs to be improved, as this information is scattered between various information systems and is not easily found and systematised. The judicial system still has room for development regarding the ensuring of administering of justice in reasonable time. It is necessary to properly arrange the tasks and structure of the judicial system and to develop further the work processes of courts.

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[22] Target level for the usability of army characterises the preparedness of the army to participate in foreign operations and join in the NATO operations. The calculation methodology in case of both deployable and sustainable units is based on the principles agreed upon with the NATO and approved on the national level.

[23] World Bank's World Governance Indicators: participatory democracy and freedom of speech, political stability, government effectiveness, quality of legislation, state based on the rule of law, corruption level. In 2009, Estonia ranked 15th among the European Union member states.

[24] http://www.avalikteenistus.ee/uuringud

[25] http://www.just.ee/10687

The development of larger cities and county centres and the concentration of economy in the region of the capital have increasingly more influence on the **regional development** of Estonia. Outside the larger cities, the standard of living is lower and the activity opportunities are one-sided due to inactive business and visitor environment and a less favourable economic structure. Differences of counties by employment, unemployment and incomes of inhabitants have increased. While the opinion of residents about the availability and quality of public services was 3.64 on a five-point scale, the goal is to increase the level of satisfaction[26].

Estonia is relatively well covered by **Internet** connectivity: in 2008, 67.5% of the populations used the Internet, it is hoped to reach 75% by 2014. The number of users allows the assumption that access to Internet is satisfactory, yet there is a lack of infrastructure required for the development of Internet services which would be sufficiently open to competition – many areas are being used by only one operator. Along with the development of information society, increasingly more activities are transferred into the electronic environment and this inevitably causes an operating reliability risk. More versatile forms of crime grow increasingly in the electronic environment and thus it is important to guarantee a high security level for information systems of both private sector and general government.

The implications of international financial and economic crisis have revealed a more substantial international integration tendency[27]. Active foreign relations are important in **protecting the interests and international status of Estonia** and the results partially depend on the development of Estonia's foreign representation network.

In order to protect Estonian citizens abroad, the consular protection is developed in the hosting states of foreign representations; also, co-operation is developed with other EU Member States where Estonia does not have a consular representation (entering into visa representation agreements). Estonia also actively participates in the development of the EU visa policy and expands the visa-free travel opportunities for Estonian citizens.

In order to ensure the influentiality and good reputation of Estonia, active participation of Estonia in international organisations is expanded. Estonia is a donor country in the development co-operation, contributing to the growth of overall stability and well-being in the world regardless of economic recession, together with other democratic countries. By providing humanitarian assistance, Estonia shares the responsibility and is solidary with other countries. Upon the implementation of mutual development co-operation, Estonia focuses on countries where, relying on its experience, Estonia can offer added value for development.

1.1.3 Current funding and changes in resource-intensive sector policies

The volume of resource-intensive sector expenditures which are financed from the state budget has doubled during the last five years. The increase is caused by the addition of foreign aid into the state budget, but also by the continued increase of additional need for funding in sectors. In terms of volume, the highest increase has occurred with respect to pensions paid from the state budget which, when compared to 2003, have increased approximately 59%.

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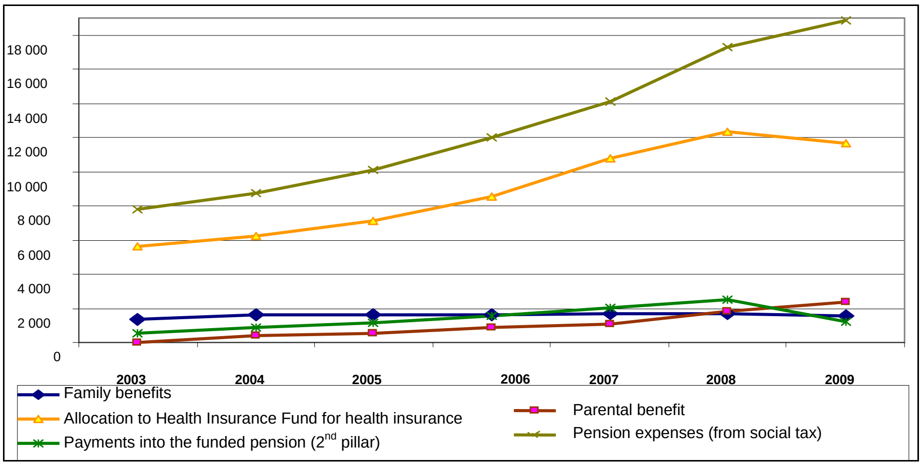
26 Survey carried out by Enterprise Estonia in cooperation with Turu-uuringute AS in 2008, the survey is carried out every other year.

27 http://www.vm.ee/?q=et/node/4476

Figure 4. Funding of higher expenditures in the social sector 2003-2009 *(mln EEK)*



**The presented data concerns budget implementation, including the expenditures from both the budget of the specific year and carried over from the preceding year*

Expenditures incurred in connection with pension insurance payments mainly depend on the number of retired people and the amount of pensions. Since 2004, the social tax that is paid from the income of employment age population has not covered the expenditures needed for the pensions. Thus, other state budget revenues have been used for the pension insurance payments as well, except in 2007 when the receipt of social tax exceeded the expenditure needed for pensions. Taking into consideration the demographic indicators, it is anticipated that the number of retired people will grow in the following years. Measures have been implemented to alleviate the shortage of funds (for example, increasing the retirement age), but this is not sufficient to ensure the sustainability of the current system.

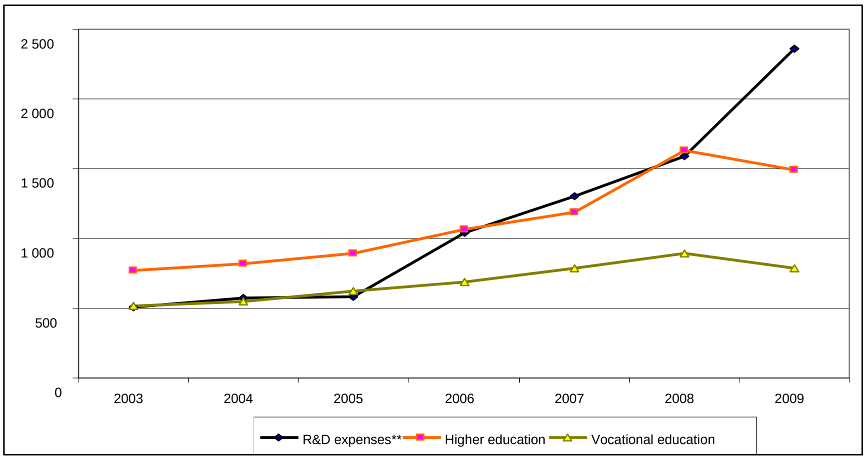
Another large budget expenditure which has grown during the last seven years is the allocations to the Estonian Health Insurance Fund, which have grown nearly two and a half times. The volume of expenditures in 2009 is lower by up to 1% than the level in 2008, but it is also important to consider the reduction of the duties of the Health Insurance Fund (for example, the benefits for incapacity for work being partially covered by employers and employees, among other things). During the coming years, the need for the development of health insurance system will become increasingly more critical, in order to find solutions for ensuring the sustainability of the health care system and the quality and availability of treatment.

Among the larger expenditures of the social sector, the funding of family benefits has been stable by years. The number of benefit recipients has grown but small fluctuations in the expenditure level are caused among other things by the amendment to law which entered into force in 2009, pursuant to which the recipients of parental benefits lost the right to receive child care allowance. The system in effect is not based on needs.

In 2009, the parental benefit expenditures increased 1.5 times when compared to the family benefit expenditures. Within five years, the actual expenditures have increased more than five times (0.42 billion in 2004 and 2.38 billion in 2009). One of the main reasons why the expenditures increased in 2008 was the extension of the period of payment of the benefit from one year to 1.5 years. In 2009, the increase in the parental benefit was affected most of all by wages which had increased during the preceding years of economic boom, and by the increased number of the recipients of benefit. In 2009 the maximum amount of benefit was 30,729 EEK (triple the average income per calendar month on which average Estonian social tax is imposed, i.e. 3 x 10,243 EEK), and in 2010 the amount will be 35,316 EEK (3 x 11,772 EEK). The number of recipients of the maximum amount of benefit has also increased.

Payments into the 2nd pillar of the funded pension are connected to the receipt of social tax, however, the payments directly depend on the number of people who have joined the 2nd pillar. Since the initiating of the mandatory funded pension in 2003, the payments increased up to 2008. In 2003-2008, the mandatory funded pension expenditures increased by over four times, i.e. by 1.95 bln EEK. In order to improve the budgetary position, the payments by the state into the mandatory funded pension fund were suspended for two years as of July 1, 2009. This change will affect the expenditures for the coming years, depending on the choices of people who have joined the funded pension system upon continuing the payments.

Figure 5. Funding of education and R&D 2003-2009 *(mln EEK)*



** The presented data concerns budget implementation, including the expenditures from both the budget of the specific year and carried over from the preceding year*
*** The R&D expenditures have been shown as the budget amount*

The funding of vocational and higher education takes place through state-commissioned education (SCE). In 2003-2009, the SCE funding of vocational education has increased 1.5 times (514 mln EEK in 2003, 747 mln EEK in 2009). The growth was caused by the increase of the basic cost of a student place, on average by 12% per year, and the number of students has remained the same. In 2009, the level achieved by the preceding year had to be reduced to the 2007 level. The goal of vocational education – to increase the average cost of a student place 1.5 times compared to the average cost of a student place in general education – has not been achieved (in 2007, the ratio with respect to study costs was 1.22 and together with investments the ratio was 1.42).

In 2003-2009, the SCE funding of higher education has increased be nearly 2 times (772 mln EEK in 2003, 1,494 mln EEK in 2009). During the same period, the number of students (including the student places covered by state budget and the student places not covered by state budget) has grown by more than three thousand students (65,659 students in 2003 and 68,985 in 2009). In 2008, the SCE funding was sharply increased (37%) and this allowed making the lecturers' wages more competitive. In 2009, the SCE funding of higher education decreased by 8%.

Research and development activity is one of the Government priorities and this manifested as the fast growth of investments regardless of a decreased budget. In 2003-2009, the corresponding expenditure in the budget has increased over four times. Investments have been made into human resources, studies and quality of infrastructure. While in 2008 the research and development expenditures amounted to 1.59 bln EEK (0.64% of the GDP), in 2009 the expenditures amounted to 2.36 bln EEK (1.12% of the GDP). 2.9 bln EEK (1.44% of the GDP) have been provided for research and development activities in the budget of 2010. During the last three years, approximately half of the funding for research and development expenditures came from foreign aid. In the changed economic situation, the contribution of general government into the research and development activity is of key importance for preserving the country's competitive position. In this regard it is important to plan the sector funding on the basis of strategic goals, so that the developments would support the activities having mutual effect in different sectors.

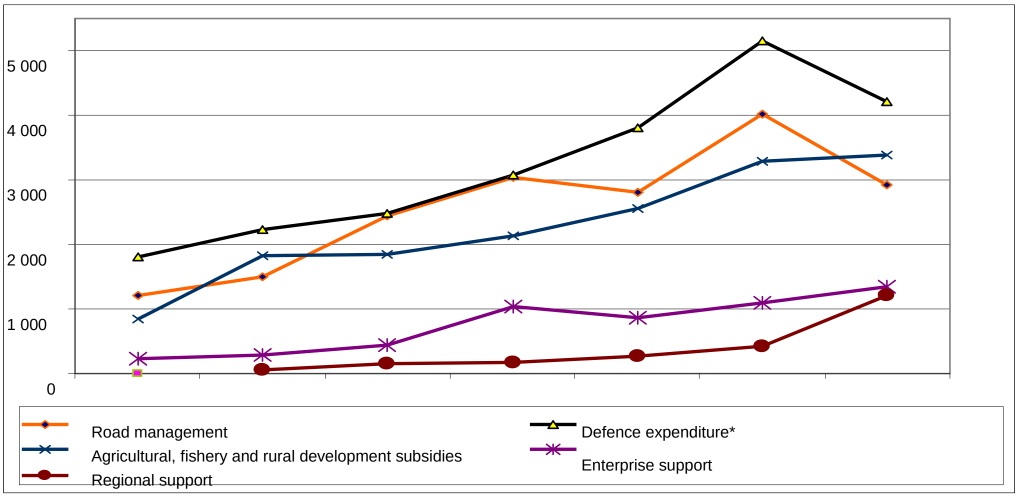
One of the more substantial measures implemented by the state for the recovery of economy is the enterprise support. In the past five years (2004-2009) the volume of this support has grown by more than ten times, thanks to the addition of foreign aid (131 mln EEK in 2004 and 1.35 bln EEK in 2009). Entrepreneurial applied research, product development, and technological innovation has been supported. Investments are not directly supported from the state budget; instead it is attempted to establish favourable conditions for investment. It is necessary to study the influence of implemented support schemes on the socio-economic development of the country for further development of enterprise support.

The influence of EU funds is also clearly visible in the constantly increased volumes of regional support in 2005-2009. In 2005, the planned volume of regional support in the state budget increased approximately twice; 87% of this was comprised of foreign aid. In 2009, foreign aid made up 84% of the volume of regional support planned in the state budget. In the nationwide implementation of regional support, the beneficiaries are most regions and local governments. As of 2009 there were only six local governments whose territories were not beneficiaries of any programme for ensuring regional development.

The funding of agricultural, rural and fishery development has also increased nearly four times within last seven years due to the EU support (from approximately 800 mln EEK to more than 3 bln EEK).

The problem in regional support and funding of rural development is the lack of strategic and purposeful planning, which should be in compliance with and provide support to the goals and shortcomings of different sectors.

Figure 6. Funding of road management, defence, regional and enterprise support and agricultural subsidies 2003-2009 *(mln EEK)*



The presented data concerns budget implementation, including the expenditures from both the budget of the specific year and carried over from the preceding year
** The defence expenditure has been shown as the expenditure of the Ministry of Defence, not including foreign aid*

In 2003-2009, the road management expenditures grew nearly two and a half times (1.2 bln EEK in 2003 and 2.93 bln EEK in 2009). The increase of expenditures was caused by the increase of the overall price level and the increase of the fuel price. In 2008, a reform of the road management organisation was carried out: five state companies were founded on the basis of the maintenance departments of road offices, and the Estonian Road Administration was granted the function of a contracting authority which reduced the number of employees by half. As a result of implemented savings, the road management expenditures for 2009 were on the level of 2007.

Defence expenditure formed 1.5% of the GDP in the year when Estonia joined the NATO alliance (2004). In the following years, the absolute volume of defence expenditure substantially increased (the budget of defence expenditures increased to 1.8% of GDP in 2008). The increase of Estonian defence expenditure to 2% was included as a goal in the Concept of Estonian Security Policy which was approved in 2001 and has been set as a goal also in the Estonian Defence Forces Development Plan 2009-2018 which was approved in 2009.

1.2 AMENDMENTS TO PREVIOUS BUDGETARY POLICY AND IMPLEMENTATION OF GOALS

One of the main goals set in the State Budget Strategy 2010-2013 is **to support macroeconomic stability through the flexibility and efficiency of markets and to control the risks threatening the balanced development of economy**. **The goal of the Government's mid-term budgetary policy is to keep the government budget in surplus;** this conforms to the requirements of the Maastricht Treaty and the Stability and Growth Pact. The goal is **to recover during the mid-term period the liquid assets of the country** which have been saved and are put into use in the present-day situation.

General government budget position

In 2009, the Government made a decision of improving the budget position to the extent of approximately 20 bln EEK, which is more than 9% of the GDP: According to the European Commission report[28], Estonia has implemented the most budget consolidation measures and has contributed the most into the stimulation of economy among all Member States of the European Union.

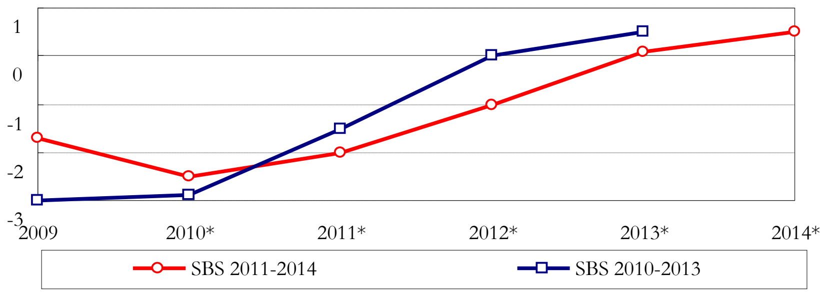
According to Statistics Estonia, the general government budget deficit in 2009 was 1.7% of the GDP. This is an important step closer to the goal set in the State Budgetary Strategy 2010-2013, i.e. to achieve budget surplus of the general government by 2013 and to recover within mid-term period the financial assets gathered during the growth phase of economic cycle to the pre-recession level.

A goal was set in the State Budgetary Strategy 2010-2013 to fulfil the Maastricht budget deficit criterion and to stay within the limits of 2.9% deficit. The adopted state budget 2010 fulfilled this goal, while 2.8% was planned as deficit. The Ministry of Finance's spring forecast also confirms the achievement of the goal, according to which the general government budget deficit will be 2.5% of the GDP.

The goals for general government budget position are less ambitious today when compared to the State Budgetary Strategy 2010-2013. At the same time a definite goal remains to reach surplus again, in order to recover and to increase the reserves after that. Compared to the previous budgetary strategy, an improvement of the budget position can be expected regarding both local governments and social security funds.

[28] *Progress report on the implementation of the European Economic Recovery Plan, 12/2009.*

Figure 7. Development of government budget position (*% of GDP*)



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

General government debt burden and liquid assets

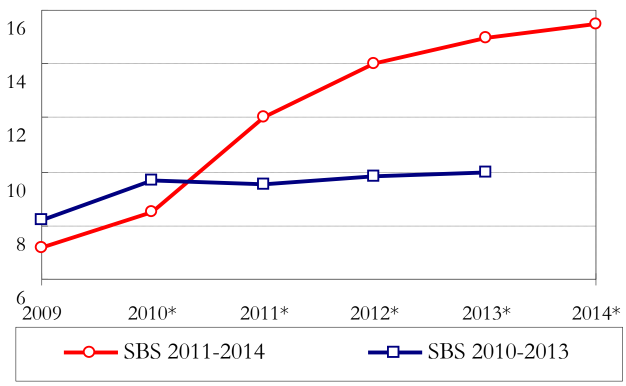
According to Eurostat, the level of debt of the Estonian general government as of the end of 2008 was the lowest among the European countries (4.6% of the GDP), followed by Luxembourg (13.5%) and Romania (13.6%).

The goal set in the State Budgetary Strategy 2010-2013 for the general government debt burden has been fulfilled – in 2010, the debt burden remains below 9.7% of the GDP (the level expected in the spring forecast is 8.5% of the GDP). The growth of debt burden is caused by the increased debt burden of the central government that is related to both the budget position goals of this budgetary strategy and the wish to avoid reducing the level of reserves. Compared to the forecast in the State Budgetary Strategy 2010-2013, the actual debt burden level of local governments is somewhat lower; this is due to decreased lending capacity.

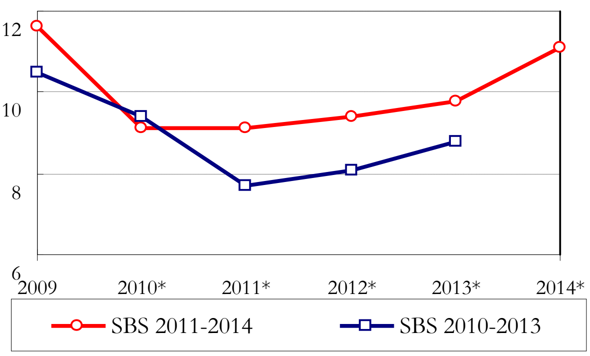
The expected balance of financial assets by the end of 2010 exceeds the level planned in the State Budgetary Strategy 2010-2013 by approximately 200 mln EEK. Due to the expected GDP growth, the volume of financial assets will be somewhat smaller as a percentage of the GDP than predicted the year before. In the next year, the volume of financial assets will start to grow, mainly due to the increased volume of the Estonian Unemployment Insurance Fund reserves. The goal has been set with the assumption that the state budget deficit will be covered by credits and thus the volume of the central government reserves will not decrease.

Figure 8. General government debt burden and liquid financial assets (*% of GDP*)

A. General government debt burden



B. General government financial assets government



Source: Ministry of Finance, Statistics Estonia.

Fiscal rules

Effective fiscal rules have played and are playing an important part in the achievement of budgetary goals. Strategic development plans and all recent coalition agreements have set the balanced budget as a mid-term goal (this is a "soft" rule which so far has been followed by all governments), although the requirement for the balanced budget of the general government or the central government (surplus) has not been prescribed in any law. In general, however, the basis for Estonian conservative budget policy comes from the Constitution of the Republic of Estonia. The Constitution prescribes that if a proposed amendment to the state budget or to its draft has the effect of decreasing the estimated revenues, increasing the expenditures or reallocating expenditures, then the proponent of the amendment shall append financial calculations to the proposed amendment which demonstrate the sources of revenue necessary to cover the expenditure. The Riigikogu shall also not eliminate or reduce expenditures in the state budget or in its draft which are prescribed by other laws.

The Constitution also limits the expenditures in cases where the Riigikogu has not passed the state budget by the beginning of the budget year – in this situation expenditure of up to one-twelfth of the expenditure of the preceding budget year may be made each month. If the Riigikogu has not passed the state budget within two months after the beginning of the budget year, the President of the Republic shall declare extraordinary elections to the Riigikogu.

On the basis of the Constitution, the State Budget Act was approved which provides the procedure for the drafting, passage and implementation of the state budget, thereby limiting substantially the opportunities for and increase of the credit load and establishing a procedure for adopting resolutions concerning the level of reserves. The current judicial area provides regulations for the state and also for ensuring the financial sustainability of other general government institutions.

Rules are prescribed for maintaining the legal reserve levels:

- The **size of the state Cash Reserve Fund** shall be **determined** annually by the State Budget Act.
- **Requirements** are set for the use of **the reserves of the Estonian Health Insurance Fund** (retained profits, reserve capital and risk reserve).
  - The legal reserve of the health insurance fund is a reserve formed from the budget funds of the Health Insurance Fund for reducing the risks resulting from reduction macroeconomic changes. The amount of the legal reserve is 6% of the budget; each year at least one-fiftieth of the total budget of the Health Insurance Fund and also the excess revenue from the social tax revenue prescribed for the payment of health insurance benefits shall be transferred to the legal reserve, until the amount of the legal reserve provided by the Act is reached or restored. The legal reserve may only be used as an exception by an order of the Government on the proposal of the Minister of Social Affairs. Prior to submitting a proposal to the Government, the Minister of Social Affairs shall hear the opinion of the supervisory board of the Health Insurance Fund.
  - The risk reserve of the health insurance fund is a reserve formed from the budget funds of the Health Insurance Fund in order to minimise the risks resulting from the obligations undertaken for the health insurance system. The amount of the risk reserve shall be 2% of the health insurance budget of the Health Insurance Fund and it may be used upon a decision of the supervisory board of the Health Insurance Fund.
  - The retained profits of the Health Insurance Fund may be used in the amount of up to 30% in any one financial year, but not more than in the amount of 7 per cent of the costs of health services prescribed in the budget of the Health Insurance Fund for the previous calendar year.
- **A legal reserve requirement has been established for the Unemployment Insurance Fund** for the reduction of risks to the unemployment insurance system resulting from macroeconomic changes. The legal reserve shall amount to at least 10% of the assets of the unemployment insurance fund. The legal reserve may only be used as an exception by a resolution of the

supervisory board of the Unemployment Insurance Fund in case the assets of the trust fund of the Unemployment Insurance Fund are insufficient. Before adopting the corresponding resolution, the supervisory board shall make a proposal to the Government through the Minister of Social Affairs for increasing the rate of unemployment insurance payments to the level which ensures a sufficient receipt of funds for fulfilling the goals of the Unemployment Insurance Fund.

<u>Restrictions for the regulation of credit burden have been established:</u>

- **State authorities are prohibited from taking loans**, using a financial lease and undertaking other such liabilities. It is also prohibited for them to provide security, grant loans, make donations, purchase shares or other holdings, or acquire other financial assets, unless prescribed otherwise by the State Budget Act or in the state budget.
- **The State Budget Act establishes annual restrictions on the balance of budget loans and cash loans** (which are repaid within a year), **on the balance of loans granted by the Government for the performance of public duties, and on the volume of bridge financing**. The volumes for 2010 are as follows:
  - The maximum permitted balance of budget loans is 15 bln EEK (approximately 7% of the GDP) and the maximum permitted balance of cash loans is 5.5 bln EEK (approximately 2.5% of the GDP);
  - The maximum permitted balance of loans granted by the Government for the performance of public duties is 6 bln EEK (approximately 3% of the GDP);
  - The maximum permitted volume of bridge financing is 6 bln EEK (approximately 3% of the GDP);
  - The maximum permitted balance of the funding of expenditure which exceeds the revenue of the state budget is 11 bln EEK (approximately 5% of the GDP).
- The Health Insurance Fund has the right to secure the loans undertaken by it with only such property that it owns. **The Health Insurance Fund is prohibited from granting loans and securing loan obligations of other persons**.
- The Unemployment Insurance Fund has the right to take a loan only if the assets of the trust fund are insufficient, and may secure the loan with property that the Unemployment Insurance Fund owns. The Unemployment Insurance Fund also has the right to take loans secured by the state. **The Unemployment Insurance Fund is prohibited from granting loans and securing obligations of other persons.**
- **Rules have been established for local governments regarding undertaking of debt obligations.** A rural municipality or a city may take loans or financial leases or issue securities which certify obligations (hereinafter debt instruments) and undertake other debt obligations on the following conditions:
  - The total amount of all standing loans, unpaid financial lease payments, issued debt instruments and other debt obligations together with the loan or financial lease to be taken, the debt instruments to be issued and other financial obligations shall not exceed 60 per cent of the proposed budget revenue for that budget year reduced by the targeted allocations from the state budget;
  - The total amount of repayable loans, loan interest, financial lease payments, financial lease interest payments and total expenditure for redemption of debt instruments in any coming budget year shall not exceed 20 per cent of the proposed budget revenue for the budget year during which the loans or financial leases are taken and debt instruments are issued, reduced by the targeted allocations from the state budget;
  - Loans and financial leases are taken and debt instruments are issued to carry out investments prescribed in the rural municipality or city development plan.
- **Loan restrictions have been established for local governments**. During the period of March 1, 2009 to December 31, 2001 the local governments may undertake long-term obligations or conclude financial lease agreements for bridge financing or for ensuring self-financing required for the granting thereof:

- The benefits received or to be received on the basis of the Structural Assistance Act 2004-2006 or the Structural Assistance Act 2007- 2013;
- The EU support received on the basis of other legislation;
- The support allocated to the Republic of Estonia under international agreements.

The undertaking of obligations shall be co-ordinated with the Ministry of Finance. Any violation of the law will result in sanctions, i.e. suspension of transfers of funds prescribed for the violating local government until the violation is terminated. Upon termination of violation, the suspended funds are transferred back.

- **Loan restrictions have been established for foundations with state participation.** A foundation with state participation may take loans or conclude financial lease agreements only with a prior unanimous decision of all founders.

In addition to restrictions established on the taking of loans, limits have also been set for the undertaking of obligations on account of future years. For example, a state authority may enter into contracts for purchasing goods or services, including construction work, on account of the budgets of future budget years, if the volume of contractual payments in any of the future budget years does not exceed 50 per cent of the amount of the corresponding item of expenditure prescribed for the authority for the current budget year. **The state budget support rates are also prescribed by annual state budget acts** and this excludes the increase of support rates due to lack of budget coverage.

Overview of activities in 2009 and 2010 for implementation of state budgetary strategy goals

The current state budgetary strategy planned to keep the tax system **stable, simple and transparent, with as few exceptions and differences as possible.** The following changes were implemented in 2009, in order to achieve this purpose:

- From January 1, the reduced rate of VAT was increased from 5% to 9%;
- From January 1, the reduced rate of VAT on funeral items and services, on tickets of performances and cultural events, and on handling of hazardous waste was abolished;
- From January 1, the right to deduct the entrance and membership fees paid to trade unions and the right to deduct the paid study loan interest from income was abolished;
- From January 1, additional exemption from income tax for the first child was abolished;
- From January 1, the maximum price of a fringe benefit for the use of an automobile was increased to 4,000 EEK;
- From April 1, the share of income tax allocated to local governments was reduced from 11.93% to 11.40%;
- From July 1, the VAT rate was increased from 18% to 20%;
- From July 1, the consumption taxes were increased: excise duty on natural gas increased from 157 EEK to 357 EEK per 1,000 m^3; excise duty on petrol increased from 5,620 EEK to 6,228 EEK per 1,000 l, and excise duty on diesel fuel increased from 5,165 EEK to 5,787 EEK per 1,000 l;
- On June 1, the rate of unemployment insurance payments was increased from 0.9% to 3%, and on August 1 it was increased from 3% to 4.2%.

- Changes which entered into force in 2010:
  - From January 1, the decrease of the income tax rate and the increase of basic exemption were suspended;
  - From January 1, the excise duty on alcohol was increased by 10% and on tobacco by 5%. The excise duty on tobacco is planned to be increased again from January 1, 2011;
  - From January 1, the excise duty on liquid fuel with fiscal marking was increased from 1,056 EEK to 1,736 EEK per 1,000 l. The excise duty on unleaded petrol was increased from 6,228 EEK to 6,615 EEK and the excise duty on diesel fuel was increased from 5,787 EEK to 6,148 EEK per 1,000 l;
  - From March 1, the excise duty on electricity was increased from 50 to 70 EEK per 1 MWh;

- From April 1, the value-added tax incentive on diapers and sanitary towels was abolished.

In order to ensure the long-term sustainability of fiscal policy and the ability to adjust in changing environment, the flexibility of the state budget must be increased:

- In environmental sector, the expenditures were disconnected from the receipt of the excise duty on electricity and partially from the receipt of environmental charges. Pursuant to the change, the part of the increase of environmental charges exceeding the level of receipts of 2009 will be allocated to public revenue, instead of the Environmental Investment Centre.
- In 2009 the Temporary Organisation of Payment of Wages Connected to Estonian Average Wages Act was amended, freezing the wages of officials appointed by the Riigikogu and the President of the Republic. This decision supplements the decision of not calculating the wages connected to average wages on the basis of the average wage indicators. The decision is effective from July 1, 2009 to December 31, 2010.

One of the budget priorities for the preceding period is **to reduce the obligations arising from various enforced legislation**. It was emphasised in the strategy that the system of social benefits must be primarily aimed at the improvement of life of those people who cannot cope without state aid, and that the support system must not hinder employment. As a result of this goal:

- In July 2009, a new Employment Contracts Act was passed (and the related Acts were amended), which postponed until 2013 the initially-planned payment of unemployment insurance benefit upon voluntary redundancy;
- In order to improve the long-term sustainability of the health insurance system, the deductible of employees and employers in the unemployment insurance benefit system was increased – the deductible of employees increased from one day to three days and the deductible of employers was implemented from the fourth day to the eighth day. From the ninth day the Health Insurance Fund undertakes the obligation to pay. Additionally, the sickness benefit rate was reduced from 80% to 70% of an employee's wage and the care allowance rate was reduced from 100% to 80%;
- In 2009, the Act was amended, reducing the pension index to the level of 1.05 upon indexation of pension on April 1, 2009. The amendment gave the Government an opportunity to approve a lower index, if the expected real GDP growth for that year is negative or if the difference between the pension insurance expenditures and the social tax receipt concerning the pension share is higher than 1% of the expected GDP for the same year. In addition, offsetting can be made within five years after the index change;
- In April 2010, the Riigikogu approved the amendments to the State Pension Insurance Act, pursuant to which the pensionable age will increase by three months per year starting from 2017, reaching the level of 65 years in 2026. These amendments will enter into force from January 1, 2011.

An important goal is **faster use of structural funds, including for increasing of economic growth and employment**.

- In spite of the fact that the Estonian economic recession was one of the biggest in the European Union and we have still been able to implement the most budget consolidation measures, the goal of economic stimulation has not remained in the background – taking into consideration the weakening of budget position and the increase in the EU support volume, we have contributed to economic stimulation more than the EU average.
- The Government approved amendments to the structural funds operational programmes and submitted these proposals to the European Commission for approval[29].
- 14% more funds were planned for investments in 2010 than in 2009.

[29] *Strategic Report for the Structural Funds Programming 2007–2013 (December 2009), Ministry of Finance*

- The volumes of labour market services and in-service training and retraining were increased, and the target group for active labour market measures was extended.
- The scholarships and transportation benefits for people participating in active labour market measures were increased and the procedure for their payment was simplified.
- A personified training card system was launched as an additional labour market training opportunity.
- In spring 2009, three new competence centres for technology (CCT) were funded in addition to the five already existing centres. With this, the total funding of CCTs was increased to one bln EEK.
- The target group of marketing support for companies starting with export activities was expanded.
- The limit for export guarantees was raised from 1 billion to 3 bln EEK, increasing the stability of guarantees and the risk-taking capacity of KredEx.
- The operation of the network of Estonian foreign representatives was reorganised, in order to provide suitable services for exporters and to involve foreign investors in targeted sectors.
- A programme of applications for participation if trade fairs and for development of joint marketing events and clusters was opened, including for branch associations and representative organisations promoting entrepreneurship.
- The implementation of the programme supporting technological investments was brought forward from 2010. The total programme volume was 550 mln EEK and the programme was started in July 2009.
- The maximum support rates which are granted to start-up companies were increased by more than two times, including the increase of start-up support to 100,000 EEK and growth support to 500,000 EEK per company.
- Surety limits for loans were raised from 800 mln EEK to 1.5 billion EEK, decreasing the minimum amounts and special audits.
- Provision of renovation loans and sureties to apartment buildings for improving energy efficiency was started.

The reorganisation of administrative structures and optimisation of functions in different sectors was planned, in order to both improve the quality of public services and save administrative expenditures.

- During the first half of 2009, the functions of former Labour Market Board were merged with the functions of the Estonian Unemployment Insurance Fund.
- In 2009, the Office of the Minister of Population and Ethnic Affairs was liquidated and its functions were divided between the areas of government of the Ministry of Social Affairs, the Ministry of Culture, the Ministry of Education and Research and the Ministry of Internal Affairs (Minister of Regional Affairs).
- Since January 1, 2010 the Plant Protection Inspectorate operating within the area of government of the Ministry of Agriculture was reorganised into the Agricultural Board which incorporates regional land improvement offices (13) operating as state agencies administrated by the Ministry of Agriculture and the Land Improvement Bureau of Supervision and Expertise.
- In the area of government of the Ministry of Environment, the Radiation Protection Centre, the county environmental services of the Ministry and the State Nature Conservation Centre were merged with the Environmental Board in 2009.
- In the area of government of the Ministry of Economic Affairs and Communications, the Estonian Motor Vehicle Registration Centre, the Road Administration, the local agencies of the Road Administration and the administrated state agencies were reorganised and merged into the Road Administration and regional offices of the Road Administration in 2009.
- In the area of government of the Ministry of Internal Affairs, the Police Board, the Border Guard Board and the Citizenship and Migration Board were merged into the Police and Border Guard Administration since January 1, 2010.

- Since January 1, 2010, the Health Care Board, the Health Protection Inspectorate and the Chemicals Notification Centre were reorganised and merged into the Health Board.
- In December 2009, the cabinet decided to start the transition of state agencies to the use of unified software for financial accounting and personnel and payroll accounting. This project will optimise payroll accounting within the area of government of each ministry, while making the areas of government comparable in the common information system. Optimisation will be performed one by one in each area of government, from July 1, 2010 to January 1, 2013.
- In February 2010, the cabinet decided to appoint the State Real Estate LTD. (RKAS) to be the provider of real estate services to the state from January 1, 2011, to transfer the general purpose immovables developed by administrators of state assets to the RKAS by June 30, 2011, and to transfer the special purpose immovables to the RKAS by December 31, 2012 on the basis of agreed lists. The duty of RKAS shall be to ensure that the assets which continue to be used by state agencies will be administrated to the extent of former budget funds, and to optimise the use of premises and the portfolio within two budget years after the asset takeover.

A goal was also set **to additionally limit the undertaking of various long-term obligations** (incl. the indirect loan burden of the state)**.**

- For that purpose, the State Assets Act was amended in the manner which enables the Government to have considerably more influence than before on the activities of foundations belonging to the general government, in order to ensure the sustainable budget policy and financial stability of foundations.
- With the Rural Municipality and City Budgets Act, the loan-taking opportunities of local governments and foundations under the influence of local governments became limited from March 1, 2009. Pursuant to the amendment, loans may be taken only for the co-financing of foreign funds.

It was also planned to assess the opportunities for the implementation of funding schemes based on liability and interests of private persons.

In connection with the achievement of the budget position goal, measures were implemented within the framework of budget consolidation in 2009 which do not directly lead to the achievement of goals set in budget priorities (for example, the suspension of funded pension payments or increasing the unemployment insurance payment rates at peak of unemployment) but were inevitable for keeping the government budget position under control in mid-term perspective.

1.3 MACROECONOMIC FORECAST AND GENERAL GOVERNMENT BUDGET DEVELOPMENTS

1.3.1 Macroeconomic forecast

The recovery of Estonian economy from crisis is happening faster than it was thought before. As a result of vigorous recovery of export, the economic growth forecast for this year was adjusted to 1%. At the same time, the labour market situation indicates continued decline in domestic demand.

During the 2nd half of 2009 the global economic activity proved to be higher than expected, but the revival takes place at different speed in different regions. Recovery from crisis is still uneven and it is surrounded by great insecurity. In the euro zone, the annual change of the Consumer Price Index reverted back to positive in last November after a temporary deflation. Among future developments, the acceleration of euro zone inflation can be expected. Although the pressure on price increase is returning, the short-term interest rates continue to be lower than the pre-crisis level. The improvement of the growth perspectives global economy will bring along the increased demand for petroleum products and this will influence the price level of oil. In 2010 a small recovery of the economic growth Estonian trading partners can be expected, due to the increased economic activity. We expect the weighted average economic growth of the trading partners to be 1.0% in 2010 and 2.0% in 2011.

In 2009, the Estonian economy decreased by 14.1%. According to the Ministry of Finance's spring forecast, the economic growth in 2010 will be 1%. The main reason for the upward adjustment of the economic growth expectation is faster-than-expected recovery of the foreign demand. During the second half of the year, the economy will start to recover slowly; this depends on the recovery of the demand of the main trading partners. The growth will be led by the export sector, but this positive effect is diminished by domestic demand which will continue to decrease. Economic growth rate will increase up to 4% in 2011, substantially exceeding the level predicted earlier. Export will remain to be the main drive for economic growth and will bring along gradual improvement of economic security and increased demand in the domestic market.

After the extensive decrease in export volumes last year, the recovery of export growth can be expected this year. On one hand, the improved expectation in external environment and the improved forecasts of trading partners mean higher demand for Estonian export. On the other hand, after the domestic demand boom ended, the companies have started to pay more attention to the export manufacture again, new markets are entered into, and the positive effect arising from the reduction of cost level also establishes good opportunities for increasing the export volumes faster than the external demand recovers. Therefore, a 6.3% growth of the export of goods and services can be expected in 2010. In 2011-2012 a quickening of export growth can be expected, in accordance with faster growth of the external demand. Although the domestic demand continues to be low, a 2.2% growth of import can be expected this year due to the increased import of inputs required for export. In accordance with the revival of domestic demand, the growth of import will be faster than the growth of export starting from 2011.

As a result of the massive changes in domestic demand and also the worldwide crisis, the current account turned into surplus in 2009. An increase of the current account surplus to 6.5% of the GDP can be expected in 2010, due to the recovering export and the continued weakness of domestic market. In future the surplus will start to decrease and will be replaced by deficit again due to the growth of import exceeding export and due to the improved profitability of foreign investors, being reflected in increase of the income account deficit. Increased receipt of EU support may be expected in the next few years, first of all on account of investments, increasing thereby the capital account surplus.

The annual rate of domestic demand started to decrease in the beginning of 2008, and in 2009 the speed of decline increased. Continued negative trends of the labour market bring along the continued decrease of private consumption until the end of 2010. However, annual speed of the decline of consumption will considerably slow down, being 5.6% for that year (19% in 2009). The uncertainty of the labour market also causes low willingness to consume in people who are still employed. The loan balance of people is rapidly decreasing and this shows that the population is reducing its financial obligations, reducing the ongoing consumption for that purpose. Slight increase of activity on the real estate market allows hope that the real estate investments of the population will no longer decrease and remain on the previous year's level in 2010. As for corporate investments, there is reason to believe that the decline will continue, because the utilisation level of production capacities is very low, it is difficult to earn profit and the financial sector is still very wary to grant loans. The final decision to adopt euro this summer may still bring a positive twist in corporate investments. Both the change in inventories and the investments of the general government will make a positive contribution to economy in 2010.

Consumer prices will rise by 1.1% in 2010 and by 2.0% in 2011. The recovery of inflation environment may be expected in March this year due to increased energy prices, the state tax measures and the cessation of decline in food prices. Increased energy prices are caused by high price level of petroleum products on the global market. Also, a slight recovery of price increase of food products can be expected when compared to the price level of last year's end, due to the effects of the external environment. State activities causing a price increase will include the increase of excise duties starting from January 1, 2010. The prices of services and industrial goods will decrease somewhat due to low domestic demand and the recession on the labour market, and this will help to alleviate the above-mentioned pressures on price increase. During the coming years, an acceleration of inflation may be expected, together with an increase of domestic consumption and recovered wage growth, but this will be lower than during the previous decade due to balanced economic developments. In the next few years, the influence of administrative price increases on inflation will decrease, as the EU minimum levels have been achieved.

Regardless of the slow recovery of the economy, it is expected that the number of employed people will continue to decline in 2010 when compared to 2009, decreasing by a total of 19,000 people, i.e. by 3.3%. The decline in employment is influenced by decreasing work volumes caused by reduced demand and by optimisation of costs by companies. With the acceleration of economic growth rate in 2011, the number of employed people will increase by 0.5%. In 2010, the unemployment will grow to 15.5% due to low demand for labour. In 2011, the unemployment rate will decrease again to 13.9% as the employment rate starts to increase. By the end of the forecast period, the unemployment rate will decrease to 7%.

In 2010, when the economy starts to grow, the decrease of the average wage will slow down to 2.8%. The reduction of price level in 2010 will be influenced by the decrease of work loads and performance pays, as well as changes in employment. In 2011, the average wage will start to increase again and the wage growth will reach 2.5%. By the end of the forecast period, the nominal wage growth will reach 4.2%, being in conformity with overall economic trends.

Table 4. Forecast of basic indicators of Estonian economy 2010–2014 ***(%)***

	2010 spring forecast					
	2009	**2010***	**2011***	**2012***	**2013***	**2014***
GDP at current prices (bln EEK)	214.8	213.4	226.3	241.5	257.4	274.2
Real GDP growth	-14.1	1.0	4.0	4.2	3.9	3.7
Nominal GDP growth	-14.6	-0.7	6.0	6.7	6.6	6.5
CPI	-0.1	1.1	2.0	2.4	2.7	2.7
GDP deflator	-0.6	-1.6	1.9	2.4	2.6	2.7
Real growth in domestic demand	-23.9	-2.2	4.5	4.8	4.6	4.6
Real growth in exports of goods and services	-11.2	6.3	8.0	8.8	8.5	7.8
Real growth in imports of goods and services	-26.8	2.1	9.1	10.0	9.7	9.2
Employment growth	-9.2	-3.3	0.5	1.6	2.2	2.2
Unemployment rate	13.8	15.5	13.9	11.9	9.5	7.0
Real growth of wages	-4.5	-3.8	0.4	1.0	1.5	1.5
Average wages (EEK)	12,317	11,972	12,265	12,682	13,215	13,770
Current account (% of GDP)	4.6	6.5	5.0	2.3	-1.0	-3.0
External assumptions						
Economic growth of main trading partners	-6.0	1.0	2.0	2.2	2.6	2.7

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

The table below presents the differences between the Ministry of Finance's forecast and other institutions' forecasts. When comparing the forecasts, it is necessary to take into account that the presented forecasts have been compiled at different times and thus based on different information, which causes differences in the assumptions and results of the forecast in the rapidly changing economic situation.

Table 5. Comparison of economic forecasts

	2009	Ministry of Finance		Bank of Estonia		European Commission	
		2010	2011	2010	2011	2010	2011
Growth in real GDP, %	-14.1	1.0	4.0	1.4	4.7	-0.1	4.2
GDP in real terms, bln EEK	214.8	213.4	226.3	211.8	224.2		
HICP, %	10.4	0.8, (1.1*)	2.0, (2.0*)	-0.4	1.7	0.5	2.1
Unemployment, %	13.8	15.5	13.9	16.6	14.3	15.2	14.2
Growth in average wages	-4.6	-2.8	2.5	-4.4	2.0	-2.7**	1.4**
Budgetary position, % of GDP	-1.7			-2.8	-1.5	-3.2	-3.0
Disclosure of forecast		13.04.2010		21.11.2009		3.11.2009	

** CPI*

*** Benefits to employees, growth per employee*

Source: Ministry of Finance, Bank of Estonia, European Commission.

The forecasts completed in the past few months indicate more and more an unanimous view of the relatively fast recovery of Estonia from the past crisis. This is based both on the growth forecasts of trading partners, which have become more positive than assumed earlier, and on the increased probability of the adoption of euro from January 1, 2011. The differences between the economic development forecasts of various institutions concerning 2010 lie precisely in the combinations of these two factors, and in different speeds of development. The Ministry of Finance's spring forecast differs from the forecasts of other institutions mainly by a more conservative outlook at the trends of domestic demand, which are more modest due to the impact that the loan policy of the banks and the continued decrease in incomes of people has on consumption and investments.

It is difficult to predict the turning points of an economic cycle, thus the growth speed of recovery after the bottom of Estonian economic cycle may prove to be different from expectations. The forecasts are made more uncertain by development expectations of the export partners and by the drastic improvement of overall security which may result from the adoption of euro in 2011, together with the increasing domestic demand.

1.3.2 Budget developments

Maintaining the general government deficit below 3% of GDP is necessary for meeting the Maastricht budgetary position criterion and also for maintaining the sustainability of budgetary policy in the conditions of recession. It is important for stabilization of the situation and maintaining the credibility of the fiscal policy, which has also been highlighted as positive factor by international institutions in their assessments of Estonia.

In 2010, the general government deficit will amount to 2.5% of the GDP according to the forecast. The main source of deficit will be the central government and within it primarily the state budget, due to its large share. Social security funds will reach surplus this year, mainly because of the unemployment insurance payment rate which increased last year due to the growth of the Estonian Unemployment Insurance Fund revenue. According to the forecast, the deficit of local governments will be 0.3% of the GDP this year.

Table 6. General government budgetary position forecast 2010-2014

	2010 EA	2010*	2011*	2012*	2013*	2014*
General government budgetary position (*mln EEK*)	**-5,790**	**-5,398**	**-5,001**	**-3,418**	**-1,389**	**284**
State budget	-4,853	-4,543	-5,414	-4,541	-2,646	-2,488
Other central government	-252	-424	-281	-195	-459	405
Social security funds	-85	169	1,194	1,918	2,315	2,968
Local governments	-600	-600	-500	-600	-600	-600
General government budgetary position (*% of GDP*)	**-2.8%**	**-2.5%**	**-2.2%**	**-1.4%**	**-0.5%**	**0.1%**
State budget	-2.3%	-2.1%	-2.4%	-1.9%	-1.0%	-0.9%
Other central government	-0.1%	-0.2%	-0.1%	-0.1%	-0.2%	0.1%

Social security funds	0.0%	0.1%	0.5%	0.8%	0.9%	1.1%
Local governments	-0.3%	-0.3%	-0.2%	-0.2%	-0.2%	-0.2%
Structurally adjusted budgetary position (% *of GDP*)		**-1.5%**	**-0.9%**	**-0.3%**	**-0.1%**	**0.6%**

According to the spring forecast, the structurally adjusted general government budget position will improve on the average by 0.5% per year, starting from 2011; this corresponds to the mid-term budget goal set by the Government concerning the improvement of position. Strict fiscal policy guarantees that the general government debt burden shall remain low, which in turn is one of the preconditions for ensuring the long-term sustainability of the state finance.

1.4 ADOPTION OF EURO AND RELEVANT CONSEQUENCES

Estonia's path of becoming a full member of the euro area

As a Member State of the EU, Estonia has an obligation to adopt the common currency of euro when the necessary nominal convergence level has been achieved. Estonia joined the European Union (EU) on May 1, 2004. The decision to join the EU was approved by referendum in autumn 2003 and this meant also that the people support the idea of Estonia joining the euro area.

The Government and the Bank of Estonia have set a **goal to adopt euro at the earliest opportunity** when Estonia can fulfil all required criteria. On June 28, 2004 Estonia joined the Exchange Rate Mechanism II (ERM II), which is a system preceding the accession to euro area in order to ensure stable exchange rates.

Practical preparations for the adoption of euro started already before joining the EU.

- At the cabinet meeting on January 15, 2004 the Government set a goal to be ready for the adoption of euro in terms of technical issues by mid-2006, which would have enabled the adoption of euro on January 1, 2008. Due to inflation being higher than the reference value, the Estonian Government was forced to postpone the goal to adopt euro.
- On April 27, 2006 the Government set the date of January 1, 2008 as the new goal, but in the light of further inflation trends, the fulfilment of this goal proved to be impossible. On November 30, 2006 the Government decided not to set any goals with specific dates, due to insecurity related to the forecasts of inflation trends.
- Based on the Ministry of Finance's spring 2009 forecast, the Government set a new goal on April 9, 2009 to adopt euro on January 1, 2011 at the latest.

The expansion of the euro area takes place based on the assessments performed by the European Commission and the European Central Bank (ECB). The most recent regular convergence reports were completed on May 12, 2010. After the Commission and the ECB have submitted their opinions, consultations will be held with the European Parliament and the recommendation will be received from the euro group, after which discussions will continue in the European Council. Thereupon, the Council (ECOFIN – the Economic and Financial Affairs Council) will give a final estimate whether Estonia is ready to join the euro area.

Fulfilment of the convergence criteria

After joining the ERM II, the European Commission and the European Central Bank have assessed Estonia's readiness level to join the euro area already on three occasions – in 2004, 2006 and 2008. The most recent convergence reports which were published in May 2008 evaluated the economic and legal integration of 10 Member States – Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden – with the euro area. According to the reports, Estonia fulfilled the criteria of exchange rate, government budget position, long-term interest rates and legal convergence. In the latter case, the prerequisite was to repeal the Currency Law and the Law on the Security of Estonian Kroon upon joining the euro zone. The only criterion which was not fulfilled was the price stability criterion, and the continued failure to fulfil this criterion has been the main obstacle on Estonia's path to becoming a member of the euro area.

In the new regular convergence report which was published on May 12, 2010, the European Commission found that Estonia complies with all Maastricht criteria and made a proposition to accept Estonia as a full member of the euro area.

- In 2001-2007, the Estonian government budget had a perceptible surplus; as a result of this, our government debt is very small, being the lowest among the Member States of the EU. However, economic recession has put a considerable strain on our public finance and has substantially decreased the budget revenues; still, the Government has been able to keep the government budget deficit below 3% of the GDP with additional budget policy measures. The deficit for 2009 was 1.7% of the GDP.
- Estonia has been a member of the ERM II for more than 5 years and the exchange rate of the Estonian kroon has been stable during that time. Thus, Estonia fulfils the exchange rate stability criterion.
- In the context of rapid economic growth, continued unification of price levels, and fast growth of factors arising from external environment, like e.g. fast increase in the costs of raw materials, it was more complicated for Estonia to fulfil the price stability criterion. By now, the 12-month average inflation (Harmonised Index of Consumer Prices, HICP) has quickly slowed down due to external and domestic factors and since November 2009 it has been lower than the reference value of the criterion. According to recent forecasts, our inflation continues to be low for years, meaning that we fulfil the criterion in a sustainable manner.
- Estonia does not have a proper instrument for the assessment of interest rate convergence (i.e. a government bond with the duration of at least 10-years, issued in Estonian EEK). At the same time, the European Commission has concluded in its convergence reports that on the basis of the interest level of loans granted to the private sector and the low debt level of the general government, Estonia has fulfilled the interest rate criterion.

Impacts of adoption of euro

- **No changes will occur in the economic policy**.
  No substantial changes will take place in the Estonian economic policy as a result of adoption of euro. As the Estonian kroon has been fixed to the D-Mark since 1992 and to euro since 1999 pursuant to the effective Monetary Committee system, Estonia has conditionally belonged to monetary union with the EU core countries for nearly 18 years now. A country does not conduct independent monetary policy within the framework of the Monetary Committee system, just like in the Monetary Union. Through a strictly fixed exchange rate the Estonian economy is already in the sphere of influence of the ECB monetary policy today. Consequently, the adoption of euro will not cause any significant changes for Estonia in terms of monetary policy. The transfer from kroon to euro shall take place with the current exchange rate of 1 EUR = 15.6466 EEK.
- **More opportunities to have a say in the economic policy of the EU**.
  Upon the adoption of euro, Estonia's role in the economic policy of the EU will increase as well. Previous trends have shown that the influence that countries not belonging to the euro zone can have on the economic policy of the EU is substantially smaller than that of the euro zone countries. After becoming a full member of the EMU and adopting euro, the representatives of the Ministry of Finance will participate in the work of the Eurogroup which includes the representatives of only those countries that use euro. The role of the Eurogroup in making decisions relating to the economic policy of the EU will increase in the future. The representatives of the Bank of Estonia will also participate in the drafting of the monetary policy for the euro area, taking part in the work of the most important decision-making body of the ECB – the Council.

- **Improved confidence**.
  The Monetary Committee system related to euro differs from the Monetary Union by the existence of exchange rates. After Estonia joins the euro area, the exchange rate risk will disappear, which will give the economic agents the security that there will be no theoretical devaluation risk in the future. Also, joining the euro area will bring along an obligation to comply with the balanced economic policy in the future. Along with the disappearance of the theoretical devaluation risk, the joining of a stable economic area and the continued economic policy will increase long-term monetary stability in Estonia, which will be reflected in stable and low interest rates. Consequently, the risk of steep increase in interest rates will decrease, as was apparent during the economic recession period in 2009 as well. A stable financial environment will contribute to the rise of economy and to the continued economic development.

- **Lower transaction costs**.
  The Estonian economy is closely connected to the economy of the EU – nearly 80% of Estonian foreign trade is conducted with the EU and two thirds of external trade transactions are made in euros. Thus, the adoption of euro will bring along smaller transaction costs, as the need for currency exchange will decrease. Based on the experience of other countries, these savings may reach the level of 0.2% of the GDP. The adoption of euro will also bring along a better comparability of prices.

- **Better potential for economic growth.**
  - Overall impacts: more secure financial environment, increased trustworthiness in the eyes of foreign investors, easier economic relations with many EU countries;
  - Higher inflow of foreign investments;
  - Increase in trade within the euro area: the ECB estimates an increase of turnover by 5–10%, the IMF even estimates the levels of 10–70%;
  - Faster economic growth: according to IMF, the adoption of euro may increase the GDP by 3-20% in 20 years; this is an average of 0.15-1% of additional economic growth per year.

- **Inflation will not accelerate, possible rounding up upon the recalculation of prices may cause a small temporary price increase.**
  The adoption of euro does not cause any substantial acceleration of inflation. This will be ensured by the continuation of balanced economic policy.

The possible rounding up of prices cannot be completely prevented. Based on previous experience, the impacts related to the adoption of euro have been short-lived and have caused a single price increase of only 0.1-0.3% on the average. In order to compensate this and to set an example, the amounts prescribed in EEK in the tax laws will generally be converted into euros in a direction that is more favourable for individuals. Benefits will also be rounded in a direction that is more favourable for the recipients of the benefits.

2 ECONOMIC AND FISCAL STRATEGY

2.1 GOALS AND PRIORITIES OF THE GOVERNMENT

2.1.1 Main goals of economic and fiscal policy

In the Estonian Monetary Committee system, **fiscal policy is the main means for influencing the economy and for managing the risks endangering a balanced economic development**. The most important goals of the fiscal policy are:

- To support macroeconomic stability through the flexibility and efficiency of markets,
- To control the risks threatening the balanced development of economy; and
- To improve employment and economic growth potential via the fiscal policy.

Long-term sustainability of the fiscal policy in the situation of demographic aging and adaptability in a changing environment must be ensured; this requires making the options of spending the budget funds less dependent on the revenues from consumption, and making the budget policy as a whole more flexible than before.

The goal is to **restore in the mid-term the liquid financial assets of the state** which have been collected thus far and are to be utilised during the economic crisis. In order to achieve this goal:

- A budget surplus must be achieved and retained in a favourable economic situation;
- It is important to respect the established annual budget expenditure levels in the situation of budget surplus, and not to increase them with additional supplementary budgets in the current year;
- Expenditure policy decisions must be made on the basis of conservative assumptions, ensuring sustainability also in longer term.

Objective of the general government budget position

The goal is to achieve a surplus of the structurally balanced budget position[30] **by year 2012.** This goal conforms to the mid-term budget goal (MTO) set by the Government, which is to improve the structurally adjusted general government budget position on average by at least 0.5% annually, starting from year 2011. **Upon achieving this task, a nominal budget surplus of the general government will be reached in year 2013**, which will allow starting to restore the reserves decreased during the economic crisis. In order to achieve a nominal surplus as soon as possible, the structurally adjusted budget position is planned to be improved faster in the beginning years of the period than in the end of the period.

Table 7. Objective of the general government budgetary position 2010-2014

	2009	2010*	2011*	2012*	2013*	2014*
Structurally adjusted budgetary position (% of GDP)		**-1.5%**	**-0.7%**	**0.1%**	**0.5%**	**1.0%**
General government budgetary position (mln EEK)	**-3,685**	**-5,398**	**-4,548**	**-2,452**	**155**	**1,381**
State budget	-1,257	-4,543	-4,962	-3,575	-1,101	-1,392
Incl. state pension insurance		-3,856	-4,641	-5,082	-4,546	-5,211
Other central government		-424	-281	-195	-459	405
Social security funds	-1,473	169	1,194	1,918	2,315	2,968
Local governments	-955	-600	-500	-600	-600	-600

[30] Upon calculating the structurally adjusted budgetary position, the effects of the economic cycle and also one-time and temporary factors are eliminated from the nominal position.

	2009	2010*	2011*	2012*	2013*	2014*
General government budgetary position (% of GDP)	**-1.7%**	**-2.5%**	**-2.0%**	**-1.0%**	**0.1%**	**0.5%**
State budget	-0.6%	-2.1%	-2.2%	-1.5%	-0.4%	-0.5%
Incl. state pension insurance		-1.8%	-2.1%	-2.1%	-1.8%	-1.9%
Other central government		-0.2%	-0.1%	-0.1%	-0.2%	0.1%
Social security funds	-0.7%	0.1%	0.5%	0.8%	0.9%	1.1%
Local government	-0.4%	-0.3%	-0.2%	-0.2%	-0.2%	-0.2%

** forecast.*
Source: Ministry of Finance, Statistical Office.

The budget position goals of the general government will be achieved via the fiscal policy measures described in the chapter below.

2.1.2 Budget priorities

General economic policy considerations dictate that the planned activities and **use of budget funds must be efficient and effective**. Planning of budget expenditures will prescribe the continuing of the domestic investments for supporting economic development and domestic demand, and will maximally utilise the opportunities provided by the EU funds. Opportunities will be searched for involving more private sector resources into capital-intensive projects, for example research and development investments. The government plans to implement maximum measures for making the providing of public service more efficient and thus to achieve savings and to improve the service quality.

Providing more efficient public service

In order to ensure the sustainability of the public finance and to retain adaptability in changing circumstances, **the flexibility of using the funds of the state budget** (*fiscal space*) **must be increased**.

For this, the share of expenditures related to receipt of revenues (for example, expenditures related to excise revenue and gambling tax) and liabilities directly resulting from various legislation will be decreased. Ending the purpose-orientation of tax-type revenues would allow:

- Paying more attention to the needs and goals of various sectors upon budget planning – funding of sector policies will be less dependent on receipt of specific type of revenue;
- Decreasing direct dependence of the funding of several sectors from the economic cycle and establishing more flexible opportunities for making expenditure policy decisions in both favourable and unfavourable economic periods.

Thus, additional reviewing of effective legislation is unavoidable in mid-term.

In order to **restructure the administrative structures and functions** and to **improve the quality of public service**:

- There are plans for optimising the use of premises of the state institutions and for improving the quality of property management. Savings can be achieved in administrative expenditures and in other operating expenditures via economy of scale;
- There are plans for consolidating support services, including across state institutions and state foundations. Options of state information technology administration and development consolidation will be assessed. Development of e-solutions facilitating additional savings and improving service quality will be set as goal in provision of public service;
- Opportunities will be analysed for merging institutions, foundations or small-scale business associations of the same type, in similar field of activity and with similar purpose, including e.g. institutions administrating project grants;

- In order to ensure the administration capacity and sustainability of local governments upon performing their tasks and upon providing services, the co-operation and merging of local governments, but also development of systems and consolidating of support services of local government will be facilitated;
- The tasks between state institutions and foundations, and functions between the state and the local governments will be reviewed.

More efficient use of budget funds would allow directing excess funds into improvement of the quality of public services and ensuring the competitiveness and coping of the general government without increasing the operating expenditures budget of the state institution. It is important to establish a motivating environment and to grant the managers sufficient freedom of decision (incl. in the field of personnel policy), at the same time ensuring sufficient transparency of decisions or actions and the existence of supervision measures and responsibility.

- In order to improve budgeting, the principles of distributing state resources must be reorganised. The resource distribution criteria will be reviewed according to the needs and specifics of the sector, e.g. in the education sector, the requests for training will be made more conformant to the needs of the labour market. In the cultural sector, the funding schemes for grants will be reviewed in order to increase the transparency of the funding schemes and to reduce the administration load. In the social sector, the system of providing the special care service will be reviewed in order to optimise the service prices.
- The planning of state personnel expenditures will be made to conform to unified principles: ensuring similar wage policy and reviewing the motivation systems in relation with performance assessment; increasing the transparency of activity supports in budget planning and budget use of foundations and legal persons in public law.
- A more homogeneous distribution of funds between local governments is planned to be ensured by further developing of the calculation formula of the adjustment fund for local governments, i.e. by amending the funding scheme.
- Necessity for amending the distribution of fees for special use of water and for mining rights of national importance between the state and the local governments will be assessed.
- The principles for making allocations from state budget for domestic measures and for structural measures will be harmonised (incl. making these principles take more account of financial capacities and financial activities of local governments).
- Regarding the use of structural funds, selection criteria for project grants will be reviewed and specified further and regional aspects of granted supports will be assessed.
- The principles of making allocations from the state budget will be reorganised and more intensive co-operation with local governments will be established, primarily regarding the planning of foreign grants.
- In order to monitor the use of state resources, more attention will be paid to increasing the transparency of activity supports in budget planning and budget use of foundations and legal persons in public law.
- Analysis will be performed about the necessity for increasing the share of budget funds intended for investments (incl. those facilitating export) and for establishing the so-called environment development opportunities, using the resources of (activity) supports.

Additional measures must be taken for **collecting state claims**.

- There are plans for reviewing the legal framework of execution proceedings, for centralising the administration of claims, incl. the function of collecting claims, for settling of state claims and for relating these to other activities of the state, for establishing co-operation between the relevant institutions in order to settle debts, and for implementing the database and the information exchange system supporting this.
- There are plans for increasing supervision over repayments of the free-of-charge legal aid provided by the state.

Public service according to capabilities

In order to take into account the negative demographic trends (demographic aging) and to ensure the long-term stability of public finance, the fiscal policy must be oriented towards sustainability. Attention will be paid to implementing the necessary changes in the social policy, the health policy, the education sector and the administrative-territorial matters.

In a situation of achieving budget sustainability, it is necessary to **find the balance between the capacity of providing public services and the availability thereof to the consumers**.

- Supports and services will be planned according to needs, and self-financing ratios of public services for consumers will be reviewed.
- Regional distribution of provision of various public services will be mapped and state networks of services will be reorganised in education, health and social sectors.
- In health insurance, the extent of the service package and the options for increasing private health insurance will be analysed.
- In the pension system, the systems of old-age pension under favourable conditions, superannuated pensions, special pensions and early-retirement pensions need to be reformed.

Additional opportunities will be established for implementing risk-based funding schemes based on responsibility and interests of employers and private persons, including e.g. by way of establishing opportunities for private insurance, but also by way of increasing the share of self-financing.

- There are plans for establishing the system of occupational health and safety insurance, which would allow the employer to insure the health risks of its family of employees; this, in turn, makes enterprises to establish as safe work environments as possible.
- There are also plans for gathering the field of funding risks of temporary absence from work into a single institution: unemployment insurance benefits, redundancy payments, employer's insolvency benefits (from the budget of the Unemployment Insurance Fund); unemployment benefits, active labour market measures (from the state budget); benefits for temporary incapacity for work (from the health insurance budget).
- Concepts will be developed for possible social security schemes involving the financial sector, in order to provide (insurance) solutions, to alleviate fairly the financial consequences of social risks (primarily the health risks of the population), and to facilitate preventive behaviour. For this, the social security schemes based on the financial sector will be analysed and possible alternatives will be developed, primarily in relation with health insurance and occupational health and safety insurance, by year 2012.

Regarding tax policy, the government will continue the implementation of established goals, which are explained in chapter 1.1.1.2.

Also, **additional limiting of the undertaking of various long-term obligations** (incl. indirect loan obligations of the state) **and controlling the summary budget deficit of the institutions influencing the general government** will be continued**.**

Additionally, it is important to **make budgeting more precise and to contribute into developments of financial management.** The more precisely the needs and opportunities can be forecasted upon preparing the budget and the more effectively the relevant activities are implemented, the less the need for additional expenditures will be and the better the opportunity for ensuring the stability of the economic environment will be. This requires further development of the systems, methods and processes for both the forecasting and the strategic planning and financial management of the state (including budgeting).

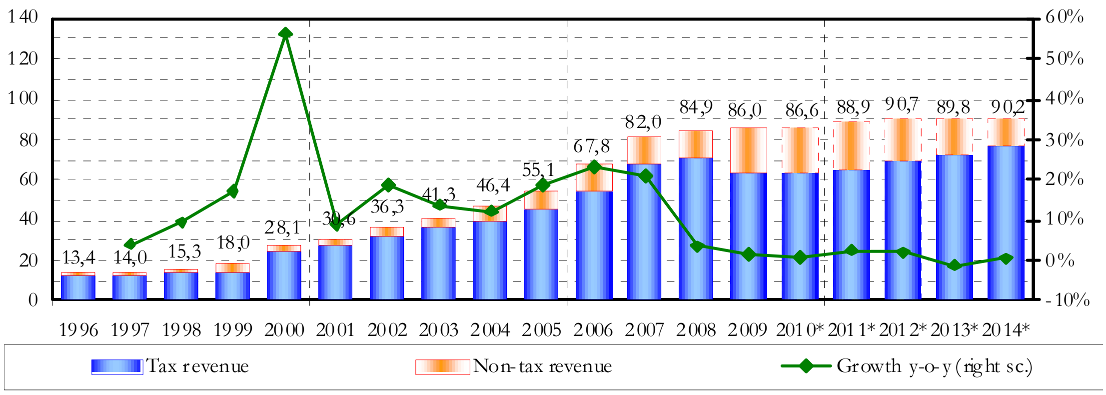
2.2 FISCAL FRAMEWORK OF THE GENERAL GOVERNMENT

In the next four years, the implementing of the conservative fiscal policy will be continued and the budget expenditures will be planned according to opportunities. Depending on the point of time when the budget priorities are implemented, the volume of budget revenues and expenditures and the budget positions of other levels of the general government may change somewhat upon preparing the annual state budget, compared to the figures presented in this strategy.

2.2.1 State budget revenue forecast

The state budget revenue forecast for years 2011-2014 is based on the Ministry of Finance's spring 2010 economic forecast[31]. The revenue will remain on a stable level throughout the period, whereas the share of tax revenue in the total revenue will increase due to the improving economic environment, and the share on non-tax revenue will decrease, mainly due to reduction of the volume of foreign funds.

Figure 9. Amount of state budget revenue (*bln EEK; %*)

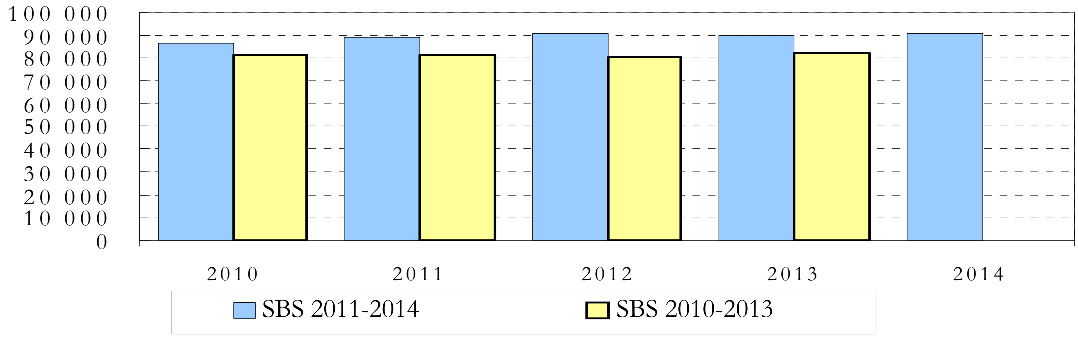


** forecast.*
Source: Ministry of Finance.

Tax revenue will grow on average by 5.1% annually in the period of budgetary strategy (2011-2014). The largest share of the tax revenue will be comprised of receipts social tax, value-added tax and excise duty. In years 2011-2014, the receipt of social tax will grow on average by 5.2% and the receipt in year 2014 is forecasted to be 32,600 mln EEK. The receipt will be influenced by change of the average wage and the employment. While a significant correction took place in the labour market in years 2009 and 2010, the period from year 2011 onwards is expected to bring a step-by-step improvement of the situation and thus a positive influence on the tax receipt. The receipt of value-added tax will increase in the period on average by 6.5% and the receipt in year 2014 is forecasted to be 23,800 mln EEK. The forecasted receipt of value-added tax will be influenced by changes in the confidence of consumers and also by the dynamics of value-added tax debts. In private consumption, more intensive growth can be expected starting from year 2012 when it will be 6.0%. The receipt of excise duty will grow in years 2011-2014 on average by 3.9% and the forecasted receipt for year 2014 is 11,885.5 mln EEK. The largest share of the excise duty receipt will be comprised of the receipt of fuel excise duty.

[31] http://www.fin.ee/?id=263

Figure 10. Comparison of the planned revenue in the state budgetary strategy 2011-2014 with the previous state budgetary strategy (*mln EEK*)



Source: Ministry of Finance.

The revenues of the state budget will increase each year when compared to the previous state budgetary strategy. The causes of this increase will be both the growth of tax receipts due to improved economic situation and the forecasted volume of foreign funds.

Table 8. State budget revenue forecast 2010–2014 *(mln EEK)*

	2010*	2011*	2012*	2013*	2014*
Taxes and social security contributions	**63,096.4**	**64,911.4**	**68,682.5**	**72,457.5**	**76,828.5**
Personal income tax	3,210.0	3,460.0	3,580.0	3,900.0	4,180.0
Corporate income tax	3,400.0	3,210.0	3,420.0	3,300.0	3,490.0
Social tax	26,600.0	27,400.0	28,800.0	30,600.0	32,600.0
Heavy goods vehicle tax	56.0	59.0	61.0	63.0	66.0
Value-added tax	19,000.0	19,700.0	20,900.0	22,300.0	23,800.0
Excise duties	10,205.4	10,425.4	11,220.5	11,540.5	11,885.5
Alcohol excise	*2,540.0*	*2,580.0*	*2,670.0*	*2,750.0*	*2,840.0*
Tobacco excise	*1,800.0*	*1,990.0*	*2,500.0*	*2,500.0*	*2,510.0*
Fuel excise	*5,420.0*	*5,370.0*	*5,560.0*	*5,800.0*	*6,040.0*
Package excise	*0.4*	*0.4*	*0.5*	*0.5*	*0.5*
Electricity excise	*445.0*	*485.0*	*490.0*	*490.0*	*495.0*
Gambling tax	320.0	317.0	321.0	324.0	327.0
Customs duty	305.0	340.0	380.0	430.0	480.0
Non-tax revenue	**23,552.3**	**24,015.0**	**22,062.0**	**17,297.0**	**13,343.4**
Total revenue	**86,648.7**	**88,926.4**	**90,744.5**	**89,754.5**	**90,171.9**

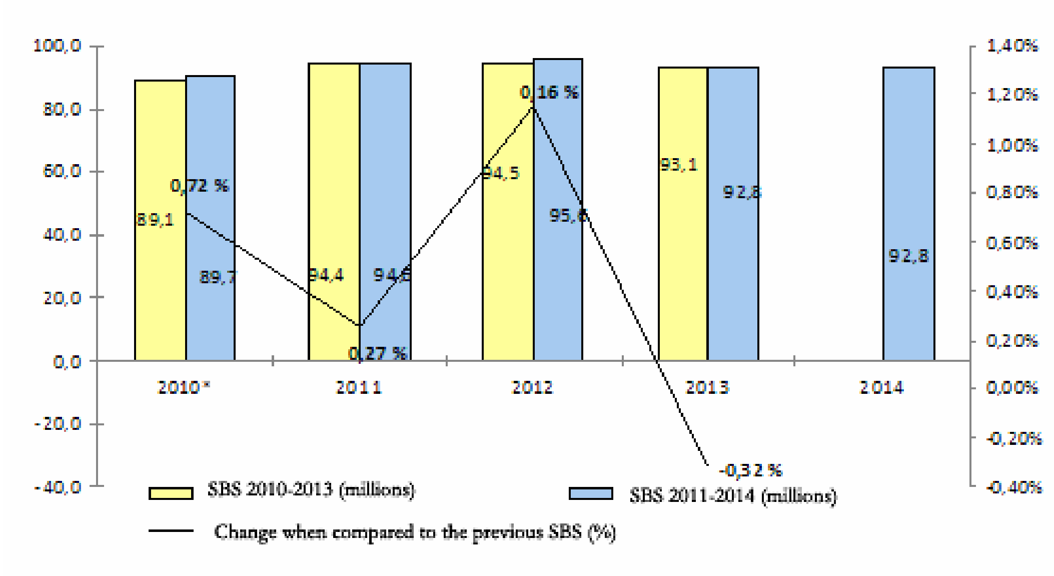
* *forecast.*
Source: Ministry of Finance.

The volume of non-tax revenue depends the most on foreign funds, which comprise approximately ¾ of all non-tax revenue. The volume of foreign funds will be the highest in the beginning years of the period and will then start to decrease due to the ending of the EU programme period of 2007-2013. The rest of the revenue types are expected to grow steadily, but the receipt from sales of assets and from privatisation will decrease.

2.2.2 State budget expenditure forecast

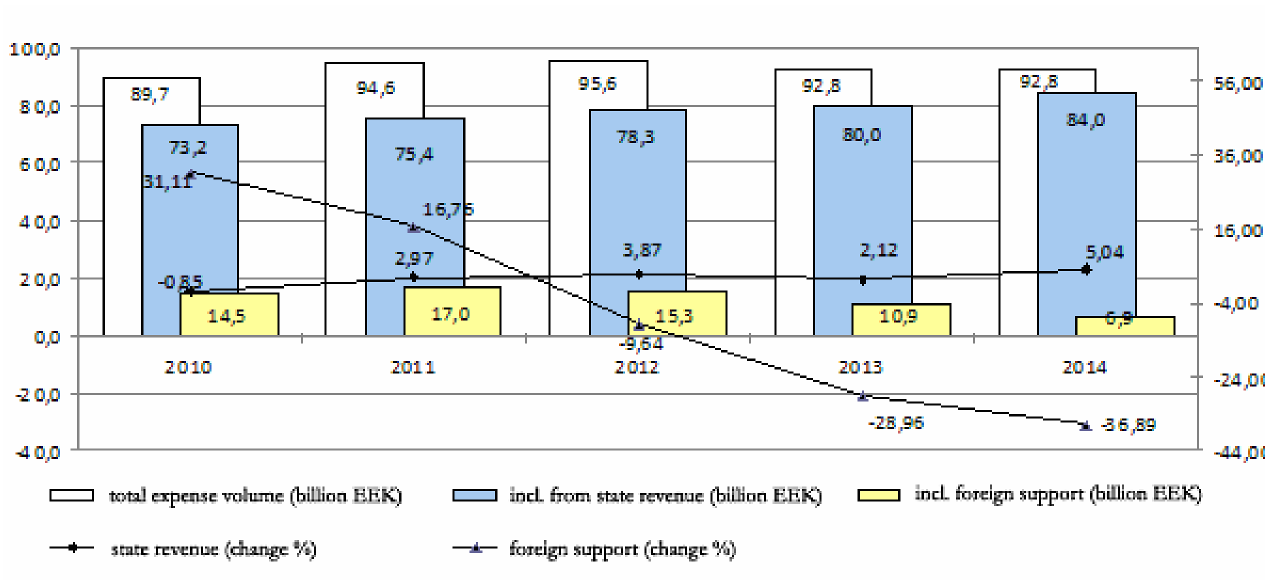
The total expenditure volume of the budget will not significantly change when compared to the previous state budget. The difference is mainly related to the specifying of the forecast of foreign funds. On the other hand, the structure of expenditures has been influenced by the measures for improving the budget position, implemented in year 2009, as these have an effect on the expenditures of the next years.

Figure 11. Comparison of the planned expenditures in the state budgetary strategy 2011-2014 with the previous state budgetary strategy (*bln EEK*)



When compared to the previous years, the share of foreign funds in the total expenditures of the budget will increase in years 2011 and 2012 due to the intensifying of the implementation of the structural funds of the EU programme period for years 2007-2013 and will comprise on average approximately 18% of the total expenditure volume. The total planned volume of foreign funds for years 2011-2014 is in excess of 50 bln EEK.

Figure 12. Comparison of expenditures by sources (*bln EEK*)



One of the government priorities is to use the foreign funds as fast as possible, in order to contribute to enlivening the economy and to creation of jobs. This is why there is a forecast of relatively sharp decline of the volume of supports for years 2013-2014, due to depletion of the funds of the programme period. The use of the EU support provides a significant contribution to preserving the high level of investments, primarily via the transport, environment, and research and development sectors. Also, investments into (vocational) education and into the infrastructure of health care and welfare and promotion of information society are supported. It is expected that support from the next EU programme period can be taken into use, starting from year 2014; the process of planning for this has already been started.

Figure 13. Fixed expenditures and other expenditures in budgets 2009 – 2014 (*bln EEK*)

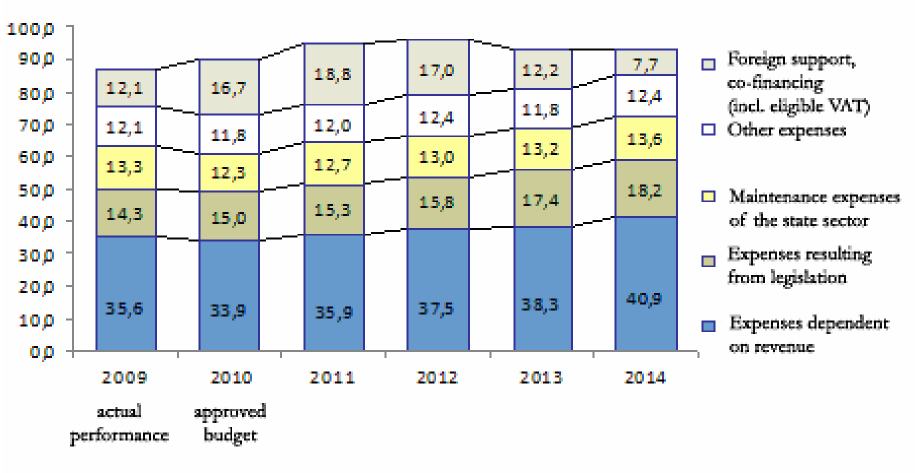


Figure 13 shows the structure of expenditures covered by state obligations, i.e. the fixed expenditures for the coming years, and also other expenditures. The figure indicates that the expenditures for both the current moment and for covering obligations undertaken earlier will increase more and more in the coming years and thus the volume of liquid funds will decrease. The graph of "Other expenditures" in the figure means funds from the state budget which are not covered by obligations resulting from legislation or international agreements, i.e. which can be used for implementing various sector policies. If the level of liquid funds remains constant, then there are no funds for new initiatives, incl. for new investments, and also for retaining a high-quality staff of officials.

Approximately 75% of the expenditure volume in the state budget is related to expenditures which are directly used for execution of effective legislation and which are necessary for maintenance of state institutions. The most increase in the obligations resulting from the legislation will happen to the expenditure of pension payments prescribed in the law. In year 2011, the above stated expenditures will increase by approximately 410 mln EEK, and by another 35 mln EEK in the next year.

Figure 14. State budget expenditures by economic content 2009-2014 (*bln EEK*)

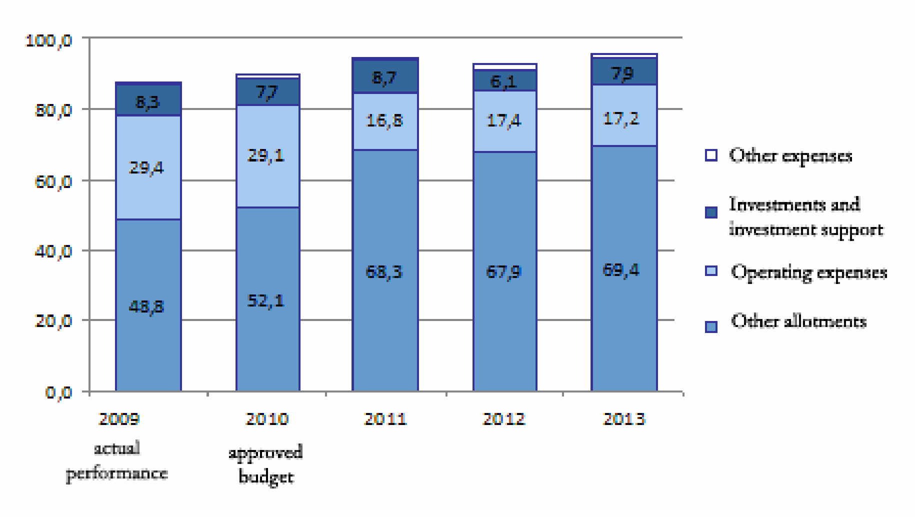


Figure 14 shows the distribution of the expenditure volume in the state budget by economic content. No significant changes in **operating expenditures** are forecasted for years 2011-2014, incl. no growth of the maintenance expenditures of the state institutions. Still, the structure of operating expenditures may change in the coming years due to the planned consolidation of support services and merging of institutions within an area of government.

For years 2011-2014 there is a forecast of an increase of **investment volumes** in all sectors of the state, incl. the public and the private sector, on average by 10-12% annually. Investments of state institutions, including investment support, will increase by 1,146 mln EEK, i.e. by 11.2% in year 2011 when compared to year 2010, but will decrease by 5,797 mln EEK, i.e. by 45% by year 2014 when compared to year 2010. The reduction in years 2013 and 2014 is related to reduction of the funds of the structural support period of 2007-2013. The planned investment volume of the general government for four years is 44,485 mln EEK, incl. 28,559 mln EEK from foreign funds.

Additionally, there are plans for general government investments via Riigi Kinnisvara AS for a total of 3,976 mln EEK. A large part of the total investment volume will be directed into road management (11.7 billion), into development of the health care and education infrastructure (4 billion), into research and development activities (2.3 billion) and into water economy projects (4.4 billion). Also, several cultural objects (incl. the Estonian National Museum for 676.6 million) and state special care or child care institutions (505.6 million) will be completed or renovated. Also, 924 mln EEK will be directed across the entire country into information technology development projects. A large part of the above stated projects will be implemented with foreign funds.

A significant part of the increase of government grants is related to restoring the state payments into the 2nd pillar of the funded pension. The state payments into the funded pension were suspended for 18 months since June 1, 2009 as an additional savings measure for improving the general government budget position. This change will affect the expenditures of the coming years as a result of the further choices of those who have joined the funded pension system regarding the continuing of the state payments. The change will increase the expenditures of years 2014-2017 (instead of 4%, the state will pay 6% into the 2nd pillar), depending on the number of people having applied for continuing their payments in years 2010 and 2011 and depending on the number of people who will apply for increasing their payments from 2% to 3% before year 2014.

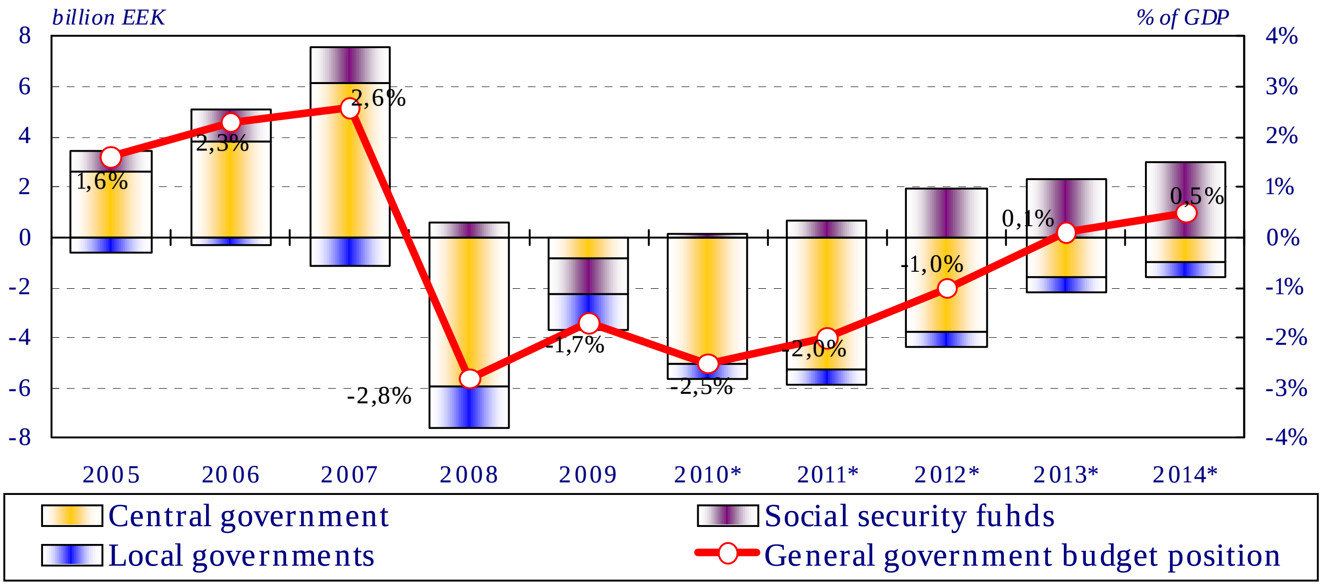
In addition to that, the increase of the volume of grants is related to the increase of foreign funds, a large part of which will be directed into development of agricultural production, into support for research and development projects and into various projects of regional development.

As a conclusion, it can be said on the basis of the above stated information that although there is no sudden increase of expenditures forecasted for the coming years, the continuing of the current practice will increase the pressure on expenditure planning of the state budget for the coming years. Additionally, the demographic changes of the population must be taken into account, which is why the current priorities in the tax, social and fiscal policy must be reviewed.

2.2.3 Expenditure and revenue forecast of other general government institutions

By the end of year 2010, the budget will have a deficit both regarding the central government and regarding the local governments and the Health Insurance Fund. The budget surplus of the Unemployment Insurance Fund is forecasted to reach approximately 0.7 bln EEK by the end of the year and will improve even more in the coming years, due to the expected preservation of the current level of the unemployment insurance payment rates and the decrease of the level of benefits.

Figure 15. General government budget position and its share in GDP, 2005-2014



Local governments

The general government budget position will be negatively influenced by the summary budget deficit of the local governments. The budget deficit of the local governments in the period of 2006-2009 has worsened the general government budget position by a total of 4 bln EEK. According to the data of the Statistical Office, the deficit of the local governments was equal to 0.4% of the GDP in year 2009. The annual deficit for the period of 2010-2014 is expected to be in the range of 0.5-0.6 bln EEK. A decrease of the deficit of is to be expected when compared to the previous years, because the loan-taking options of local governments are being limited until the end of year 2011 regarding anything but the purpose of co-financing foreign supports or refinancing earlier obligations. In addition to that, the decrease of revenue of the local governments has caused the debt burden of most of them to be near the maximum allowed limit of 60%, thus their option of undertaking additional obligations is becoming depleted.

Table 10. Forecast of the budget positions of local governments 2010-2014

	2010 EA	2010*	2011*	2012*	2013*	2014*
Local governments (*mln EEK*)	-600	-600	-500	-600	-600	-600
Local governments (*% of GDP*)	-0.3%	-0.3%	-0.2%	-0.2%	-0.2%	-0.2%

* *forecast*

From year 2011 onwards, the revenue of the local governments can be expected to start to increase, but the level of year 2008 will not be reached before year 2014.

The Riigikogu is currently discussing the draft of the Local Governments Financial Management Act which, if entering into force in year 2012, would set an individual net debt burden limit for each local government in the range of 60-100% of the revenue from the main activities. This would allow taking more loans when compared to the current situation, but it cannot be assumed that the option of taking more loans would be fully realised as budget deficit. The Rural Municipality and City Budgets

Act allowed the local governments to have 3.8 bln EEK more debt obligations in e.g. year 2008 than they had in reality.

In order to control the summary deficit, the draft Act prescribes a measure of the state as agreeing with the local governments about the maximum amount of deficit, granting them additional support from the state budget as recognition for not exceeding this maximum amount. Additionally, the draft Act sets limits for non-market players under the dominant influence of the local governments, the activities of which are also affecting the balance of the general government. This reduces the risks when shaping the balance of the general government.

The draft of the Local Governments Financial Management Act prescribes a compulsory budgetary strategy for four years which the local governments will have to prepare. This allows for supplementing the state budgetary strategy with more information about the local governments.

Social security funds

The sector of social security funds includes the Health Insurance Fund and the Unemployment Insurance Fund. The budget position of the Health Insurance Fund has been stable thus far, but considering the demographic situation of Estonia, the ensuring of long-term sustainability requires additional measures. The budget position of the Health Insurance Fund is expected to improve in the coming years and the budget deficit will be overcome, starting from year 2013.

Table 11. Forecast of budget positions of social security funds 2010-2014

	2010 EA	2010*	2011*	2012*	2013*	2014*
Social security funds (*mln EEK*)	-85	169	1,194	1,918	2,315	2,968
Social security funds (*% of GDP*)	0.0%	0.1%	0.5%	0.8%	0.9%	1.1%

* *forecast*

The Unemployment Insurance Fund has had annually surplus due to lower expenditures and better receipt of tax revenues than expected, and in the end of year 2008 the amount of the gathered financial assets was approximately 2.8 bln EEK. In the past year, the fast increase of unemployment caused the expenditures of the Unemployment Insurance Fund to exceed its revenue and the amount of financial assets of the Unemployment Insurance Fund decreased to the level of 2 bln EEK by the end of the year. Starting with this year, the Unemployment Insurance Fund has again a surplus due to the decrease of expenditures and the increase of revenue resulting from a higher tax rate. The assessment of the budget position of the Unemployment Insurance Fund is based on the assumption of a constant level of the rates of unemployment insurance payment at 4.2% for the entire period. Risks are hedged by way of establishing reserves, in order to avoid the need to increase the rate of unemployment insurance payments with the increase of unemployment. The necessity of retaining the tax rate levels is planned to be considered as a complex together with the labour market policy measures.

2.2.4 General government debt burden and liquid financial assets

The following forecast for debt burden and financial assets assumes the attainment of the goals of the general government budget position contained in Chapter 2.1.1 during the entire mid-term perspective.

The general government debt burden is expected to increase to the level of 14.1% of the GDP in years 2010–2014. In year 2010, the deficit of the state budget will be financed partly with the loan agreement signed with the European Investment Bank, under which it is planned to borrow approximately 8.6 bln EEK in the course of five years, primarily for the purpose of co-financing the foreign support projects. Approximately 2.3 bln EEK of the loan is planned to be utilised in year 2010. No other funds are planned to be involved in covering the budget deficit in year 2010. The rest of the deficit of the state budget for year 2010 will be covered by reserves. The deficit of the state budget for the next years is planned to be covered fully by loans. According to the Ministry of Finance's estimate, the local governments will continue to have a budget deficit for the entire forecasted period, which is why their debt burden will also increase. The debt burden of the local governments is forecasted to increase to the level of 11.1 bln EEK by year 2014, which is equal to 4% of the GDP.

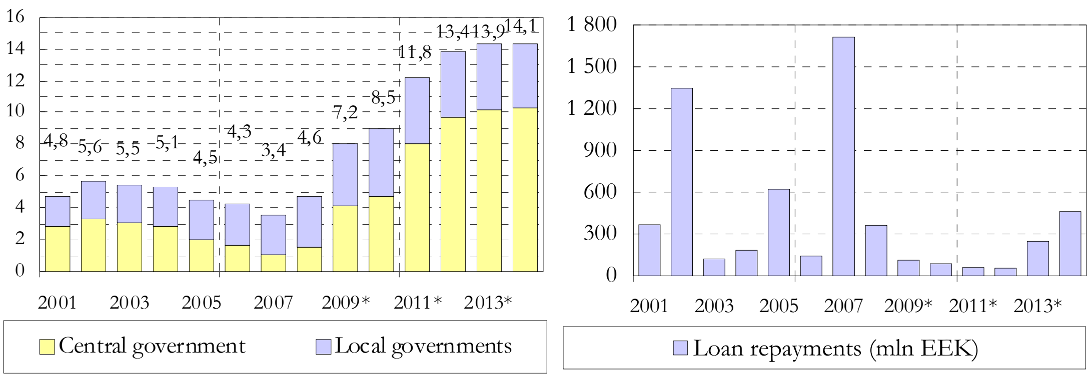
Table 12. General government debt burden 2009–2014 *(mln EEK, % of GDP)*

	2009	2010*	2011*	2012*	2013*	2014*
Total debt (mln EEK)	**15,501**	**18,240**	**26,740**	**32,370**	**35,740**	**38,550**
Central government	7,706	10,240	18,340	23,380	26,150	28,350
Local governments	8,667	8,870	9,270	9,870	10,470	11,070
Total debt (% of GDP)	**7.2%**	**8.5%**	**11.8%**	**13.4%**	**13.9%**	**14.1%**
Central government	3.6%	4.8%	8.1%	9.7%	10.2%	10.3%
Local governments	4.0%	4.2%	4.1%	4.1%	4.1%	4.0%

Source: Ministry of Finance, Statistical Office

Figure 16. Debt burden developments (*% of GDP*)

A. General government debt burden **B. Central government debt repayments**[32]



Source: Ministry of Finance, Statistical Office.

Developments of general government financial assets

On the basis of the forecast of the general government budget position, the amounts of funds of the central government and the local governments will decrease in year 2010. Regarding social security funds, the volume of reserves of the Health Insurance Fund will decrease by approximately 0.6 bln EEK, whereas the volume of reserves of the Unemployment Insurance Fund will increase in year 2010 by approximately 0.7 bln EEK thanks to the increasing of the rate of unemployment insurance payments in year 2009. The amount of financial assets of the entire general government for year 2010 is forecasted to be 19.5 bln EEK, which is equal to 9.1% of the GDP.

The goal for the next year is set for preserving the level of financial assets of the central government, thus the deficit of the state budget will be financed by loans. The level of financial assets of the central government is also influenced by the funding transactions of the state, including the additional increasing of the share capital of AS Eesti Energia in years 2011-2015 by up to 7 bln EEK, which is expected to have neutral effect on the budget position. Any possible negative effect on the budget position (via decrease of interest revenue and/or increase of interest expenditures) will be covered by way of implementing budget priorities in the annual budgeting process, where the annual volume of funding transactions will be specified as well.
The amounts of financial assets of both the local governments and the social security funds will increase in years 2011-2014.

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

Table 13. General government financial assets, 2009–2013 ***(mln EEK, % of GDP)***

	2009	2010*	2011*	2012*	2013*	2014*
Total financial assets (mln EEK)	**24,958**	**19,480**	**20,680**	**22,800**	**25,310**	**28,480**
Central government	18,447	13,100	13,100	13,100	13,100	13,100
Local governments	1,106	810	810	1,010	1,210	1,410
Social security funds	5,405	5,570	6,770	8,690	11,000	13,970
Total financial assets (% of GDP)	**11.6%**	**9.1%**	**9.1%**	**9.4%**	**9.8%**	**11.1%**
Central government	8.6%	6.1%	5.8%	5.4%	5.1%	5.1%
Local governments	0.5%	0.4%	0.4%	0.4%	0.5%	0.5%
Social security funds	2.5%	2.6%	3.0%	3.6%	4.3%	5.4%

Source: Ministry of Finance, Health Insurance Fund, Unemployment Insurance Fund.

SUMMARY

This state budgetary strategy has been prepared on the basis of the effective "State Budgetary Strategy 2010-2013". The grounds for updating the strategy are the Ministry of Finance's spring 2010 economic forecast, the renewed convergence programme 2010 and the development plans of the areas of administration and government. The purpose of the four-year strategy is to ensure in the mid-long perspective the sustainability of the budgetary policy and make the government's activities on the direction of the state and area developments more effective.

The first chapter of the budgetary strategy describes the current situation of the Estonian economy, tax and fiscal policy, and sector policies, and the future outlooks if changes are planned for the current policies. The second chapter of the document describes the economic and fiscal policy goals of the Government (incl. regarding the budget position) and its priorities via which the goals will be achieved in the process of preparing state budgets. In addition to this, the second chapter of the document also details the fiscal framework of the general government for the period of the strategy. In the course of updating this document, more attention has been paid to the achieving of the current strategic goals stated in chapter 1.2 when compared to the budgetary strategy for years 2010-2013. In relation with fulfilling the Maastricht criteria and the plan of adoption of euro in year 2011, chapter 1.4 describes the effects of the adoption of euro.

Upon updating the strategy, the fiscal policy goals of the government have been adjusted somewhat due to the economic trends and the analysis of the tax and fiscal policy and the current situation of all sector policies. The reviewing of the goals is also based on the results of monitoring the previous budgetary strategy for years 2010-2013, which indicated the following among other information:

- The general government budget deficit for year 2009 became 1.7% of the GDP, which is a significant step closer to the goal set in the "State Budgetary Strategy 2010-2013", i.e. to achieve a budget surplus of the general government by year 2013 and to restore during the mid-term period the amount of the pre-decline level of the financial assets gathered in the growth stage of the economic cycle.
- For this, measures improving the budget position were implemented in year 2009 on the basis of the priorities set in the budgetary strategy, in the amount of approximately 20 bln EEK which is equivalent to over 9% of the GDP.
- In year 2009, Estonia consolidated more budget than any of the Member States of the European Union and contributed more into stimulation of economy than the average level of the EU (according to the estimates of the European Commission).
- The "State Budgetary Strategy 2010-2013" set the goal of fulfilling the Maastricht budget deficit criterion in year 2010 and to remain within the 2.9% deficit limit. The approved state budget for year 2010 achieved this goal; the deficit was planned as 2.8% of the GDP. The achieving of this goal is also confirmed by Ministry of Finance's spring forecast, which states that the general government budget deficit will be 2.5% of the GDP.

When comparing with the "State Budgetary Strategy 2010-2013", the goals of the general government budget position are set less ambitiously in this strategy. At the same time, the definite goal of reaching surplus again is retained, in order to restore and then increase the reserves.

The main goals of economic and fiscal policy of the government continue to be:

- To support macroeconomic stability through the flexibility and efficiency of markets;
- To control the risks threatening the balanced development of economy;
- To improve employment and economic growth potential via the fiscal policy.

In order to restore within the mid-term period the liquid financial assets of the state thus far gathered and utilised in the economic crisis:

- A budget surplus must be achieved and retained in a favourable economic situation;
- The established annual budget expenditure levels must be respected and not increased with additional supplementary budgets in the current year;
- Expenditure policy decisions must be made on the basis of conservative assumptions, ensuring sustainability also in longer term.

The goals of the budget position of the general government are set as follows:

- To achieve a structural budget surplus by year 2012;
- To achieve a nominal budget surplus by year 2013 at the latest;
- To prepare the state budget for year 2011 with a nominal deficit not exceeding 2.0% of the GDP.

In order to achieve the goals of the budget position, this strategy stets budget priorities, which are oriented both towards increasing the efficiency of providing public services and towards reviewing the extent of the public services. The priorities thus set will be utilised as the basis for preparing the state budget for year 2011 and for the subsequent years, thus implementing the goals set in the strategy (incl. the budget position goal).

According to the strategy, no significant increase of the volume of revenue is expected for the coming years – the revenue volume of the state budget will remain on the level of 90 bln EEK throughout the period. The volume of expenditures in the budget will increase until year 2012 (to the level of approximately 96 bln EEK) due to the intensifying use of the EU supports, and will then decrease to the level of 93 bln EEK in the final years of the period. Both the general government debt burden (due to the budget with deficit) and the liquid financial assets of the general government will be increasing throughout the period. The level of liquid financial assets will be retained at 9-10% until year 2013 and will increase to 11.1% by year 2014, in accordance with the goal set.

ANNEXES

Annex 1. Ministry of Finance's economic forecast 2009-2014, spring 2010

	2009	2010*	2011*	2012*	2013*	2014*
Main economic indicators (%)						
1. Real GDP growth	-14.1	1.0	4.0	4.2	3.9	3.7
1a. GDP at constant prices (bln EEK)	137.9	139.2	144.8	150.9	156.9	162.6
2. Nominal GDP growth	-14.6	-0.7	6.0	6.7	6.6	6.5
2a. GDP at current prices (bln EEK)	214.8	213.4	226.3	241.5	257.4	274.2
2b. GNP at current prices (bln EEK)	208.6	206.7	217.3	228.1	237.5	250.4
3. GDP deflator	-0.6	-1.6	1.9	2.4	2.6	2.7
4. CPI	-0.1	1.1	2.0	2.4	2.7	2.7
5. Harmonised CPI	0.2	0.8	2.0	2.4	2.7	2.7
6. Employment (age 15–74, thousand)	595.8	576.4	579.3	588.6	601.5	614.7
7. Employment growth	-9.2	-3.3	0.5	1.6	2.2	2.2
8. Real growth in labour productivity	-5.3	4.4	3.5	2.6	1.7	1.4
9. Unemployment rate	13.8	15.5	13.9	11.9	9.5	7.0
10. Average wage (EEK)	12,317	11,972	12,265	12,682	13,215	13,770
11. Growth in real wage	-4.5	-3.8	0.4	1.0	1.5	1.5
11a. Growth in nominal wage	-4.6	-2.8	2.5	3.4	4.2	4.2
12. Investments and inventories (% of GDP)	19.4	20.5	23.0	24.6	25.9	27.2
13. Domestic saving (% of GDP)	24.0	27.0	28.0	26.9	24.9	24.2
14. Current account (% of GDP)	4.6	6.5	5.0	2.3	-1.0	-3.0
Sources of growth						
15. Private consumption expenditures	-18.9	-5.6	2.0	3.9	3.7	3.8
16. General government final cons. Expenditure	-0.5	-1.4	1.0	1.1	2.6	3.4
17. Gross fixed capital formation	-34.5	-3.7	7.6	9.0	8.3	7.7
18. Change in inventories (% of GDP)	-2.5	-0.3	1.6	1.9	2.0	2.2
19. Domestic demand	-23.9	-2.2	4.5	4.8	4.6	4.6
20. Exports of goods and services	-11.2	6.3	8.0	8.8	8.5	7.8
21. Imports of goods and services	-26.8	2.1	9.1	10.0	9.7	9.2
Contribution to GDP growth						
22. Domestic demand (excl. inventories)	-20.5	-4.0	2.8	4.1	4.2	4.4
23. Change in inventories	-4.6	1.9	1.3	0.2	0.0	-0.1
24. External balance of goods and services	12.9	3.1	-0.1	-0.2	-0.3	-0.6
Growth of value added						
25. Agriculture	-2.9	1.3	2.0	2.0	1.7	1.7
26. Industry	-23.8	3.7	6.5	6.5	5.6	4.8
27. Construction	-30.1	-2.6	4.3	4.6	4.3	4.0
28. Services	-13.7	0.0	3.4	3.7	3.5	3.4

** forecast*

Contribution to GDP growth shows the size of the share in economic growth of a particular area. It is calculated by multiplying the growth of the field by its share in GDP. The sum of the fields' contributions equals to economic growth (the reason for the minor difference is a statistical error – the part of GDP that could not be divided between the fields).

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

The forecast has been published by the Ministry of Finance on 13.04.2010.

Annex 2. Implementation of the national strategy for the use of structural funds 2007-2013 for 2011-2014

Within the framework of "State Budget Strategy 2007-2013" a sub-strategy "National Strategy for the Use of Structural Funds 2007-2013" was designed and approved in year 2006, which defined the main goals for the direction of the development of areas eligible for EU structural funds, corresponding indicators and priorities, or strategic areas of activity in 2007-2013.

The structural funds strategy forms a permanent part of the state budget strategies which are updated annually. It includes all potential areas with the same goals eligible for EU structural funding, thus, not only the activities funded particularly from EU structural funds but the areas related to the use thereof on the whole. This provides a more comprehensive approach to the planning of the development of the respective areas.

The purpose of this "State Budgetary Strategy 2011-2014" is to ensure, in the mid-long perspective, the sustainability of the budgetary policy and make the government activities on the direction of the state and area developments more effective. In order to achieve this, the essence of the structural funds strategy has been somewhat specified to adjust the implementation of the priorities to the dynamically changing situation.

For the use of structural funds, six priorities have been established for the longer term, which will be implemented by this budget strategy in 2011-2014 through the following areas and goals thereof:

Priority of the strategy for the use of structural funds 2007-2013	Implementation within the framework of the state budget strategy 2011-2014 (areas)
1) Educated and active nation	o Successful economy and active people o Viable and integral nation
2) Growth in capability of research and development activities and in innovativeness and productivity of enterprises	o Successful economy and active people
3) Better connectivity options	o Valuable living environment o Civil state
4) Sustainable environmental use	o Valuable living environment
5) Comprehensive and balanced development of areas	o Valuable living environment o Viable and integral nation
6) Greater administrative capability	o Civil state

Resulting from the changed economic situation and necessity to optimize the use of budget funds, including structural funds of the EU programme, an assessment of decisions taken during the planning process of EU structural funds has been initiated in 2009 in order to get a clear idea e.g. whether the set goals and activities are still relevant. The results of the assessment confirmed that the goals initially set in the implementation plans for EU structural means are still relevant, but it was also considered necessary to increase the volume of support directed from the EU structural funds to the goals of the sectors of primary importance in the coming years – labour market and promotion of entrepreneurship and innovation. In spring 2010, the relevant amendment proposals to the implementation plans were presented to the European Commission for approval. In addition to the above stated activities, new additional support measures were factually initiated, the support volumes of measures of higher priority were increased, and requirements for applying for and using of EU support were changed in years 2009-2010.