

Fiscal Sustainability in Estonia

Introduction

Sustainability as the Measure of Current Policy and Future Trends

The purpose of analysing fiscal sustainability is usually to show the difference between the fiscal position resulting from current policies and the sustainable position in a certain moment in future. Thus the sustainable fiscal policy can be defined as a policy that can be continued indefinitely while unsustainable policies will ultimately have to be modified.

This paper briefly discusses the central demographic trends with the focus on developments in EU25 and Estonia, projected changes in economy and in public finances. Overview of the major spending policy areas is given and the fields mostly affected by ageing are explored in the Estonian context.

Current Situation as the Determinant for Future Developments

Past Demographic Trends

Re-gaining independence has influenced Estonian demographic developments (the number of population has decreased from approximately 1,5 to the current 1,3 million) and the fertility rate, which was on its highest level in 1988 (2.26), declined sharply to reach the level of 1.28 in just 10 years. Rapid economic development and an increased assurance about the future have somewhat changed this pattern and the fertility rate has increased to 1.5 in 2005 (see Annex 1). The increase in life expectancy, on the other hand, has not been as fast as elsewhere in EU25, which is mainly due to the low increase in male life expectancy (similarly to trends in Latvia and Lithuania) while in terms of females, the increase has been close to EU average.

Gray Future

Demographic trends already visible today are expected to continue. According to latest forecasts, migration will play a bigger role in the future but the share of the population living in developed countries will still decrease due to fertility rates

remaining low. Lower birth rates together with prolonged lives result in an increase of the share of dependent people compared to the number of people in labour force.

In case of Estonia, decrease in the number of people in labour force is faster than in EU25¹ (15%) but the old-age dependency is not increasing as rapidly as in EU (see Annex 1), thus delaying the major budgetary impact of ageing closer to the middle of the century and likely giving more time for policy response. However, “window of opportunity” for tough political choices is closing rapidly. Labour force in Estonia is expected to increase up to 2012 and start declining rapidly thereafter. Total population is already on the decrease, which makes it more difficult to undertake unpopular welfare sector reforms.

It should also be kept in mind that the past population projections from official sources have underestimated the gains in life expectancy and some commentators have argued that governments may be underestimating the potential budgetary impact of ageing populations (EC, 2006).

Economy

Rapid economic growth has resulted in general government surpluses in Estonia for many years now and in 2006 the surplus of revenues over expenditures (estimated to 3.3% of GDP) nearly covers the total stock of general government debt, which amounts to 3.7% of GDP (see Annex 2). Estonian government considers sound fiscal policy to be a necessary prerequisite for ensuring fiscal sustainability, giving the governments room to manoeuvre until the ageing of the population really begins (Ministry of Finance, 2006).

Economic growth, which was 11,4 % in real terms in 2006, was driven by domestic demand. Favourable climate in labour market, which contributes to sustainability, and borrowing by households have fuelled the domestic consumption – this has led to notable convergence with EU levels. Internal demand based growth has also increased inflation, and the increase of consumer prices reached the level of 4.5% in 2006,

¹ European Commission (2005) expects the number of people in labour force in EU25 to decrease by 4% and the number of old-aged (65+) dependent persons to increase by 30% in less than 20 years (by 2025).

exceeding the level needed to fulfil the Maastricht inflation criterion by 1.6 percentage points (see Annex 2). Euro adoption has therefore been postponed (all other criteria are met) and the government has set no specific deadline for the adoption.

2. Most Affected Areas

Pensions

Impact of ageing on pension spending is the biggest of all expenditure categories but on the other hand, also easiest to forecast. An increase in the number of dependent persons increases the need for financing. The extent of spending is also determined by macroeconomic determinants and labour market, which form the basis for the pension index.

To contribute into achieving the sustainable fiscal position in the future, many countries have abolished wage indexation and linked the size of the pension more to prices (OECD, 2006). Estonia introduced the indexation in 2000, thus presently, pensions are indexed annually by half of the sum of increase in social tax revenue and inflation. Because in recent years inflation rate has been much lower compared to the social tax increase (corresponding to increase of the wage bill), one-off increases of pensions have been used as a tool by the government not to let the rate of pensions fall compared to wages.

An increase in the number of dependent people and the decline of the ones working means that common pay-as-you-go pension systems are not sufficient to fill the needs of the retired in the future. Many countries have introduced new funded schemes mostly to ease the burden of future employees by increased saving today to guarantee high enough income for the retired. Voluntary private pension schemes (third pension pillar) were introduced in Estonia in 1998.

The pension reform has proved to be a success, with most of the labour force joining the second pillar funds voluntarily. The proportion of workers contributing to the scheme gives an indication on the future contribution of privately managed schemes

to incomes and high participation is the prerequisite of adequate total incomes in terms of lower replacement rates from the state pay-as-you-go systems.

The privately managed system in Estonia is simple, cheap to operate, straightforward, and attractive, although there are obviously no guaranteed investment returns.

Health care

Unlike pension spending, which is quite directly linked to ageing, health spending is proving to be especially dependent on different assumptions. As there is no experience of demographic change of that kind and magnitude – it can only be assumed what the longer life may look like and whether it will be spent in good health or not.

Estonian health-care system, which is quite effective, is based on solidarity principle and is currently solvent in terms of its financing side. Introduction of the system of family doctors has proven to be successful. Good collection of social tax (33 %, is divided between health insurance fund – 13% and pension insurance fund – 20%) and, on the other hand, somewhat limited capacity of the health care institutions to provide sufficient amount of services has resulted in the build-up of the financial assets also in the health insurance fund².

Education

A fall in the number of children and young people in Europe is expected over the next decades due to low birth rates. EC and EPC projections show that considering only the pure ageing effect, an average saving of 0.5-0.6% of GDP on education would be possible in Europe. Purely demographical approach suggests that the biggest decrease of spending will take place in the Baltic States (up to 1.5% of GDP compared to the current level) due to a sharp decrease of fertility rate in the 1990s.

² According to the projections by EC and EPC, which are based on the demographic forecasts of Eurostat and quite conservative assumptions, expenditures on health care in Estonia are going to increase by 0.7% of GDP in 20 years, which is somewhat lower than average increase in EU25, reaching 1.1% of GDP. The reasons behind the lower increase compared to the EU average are the lower starting level of spending and developments in the age-structure of the population.

But as in many other countries, also in Estonia the financial savings cannot be considered directly a future surplus as the educational system has its shortcomings. There are no long-term agreements in society in terms of educational goals and ways to achieve those. The goals are declarative and the graduates are not prepared with the needs of modern societies and labour market in mind. Educational disparities have somewhat diminished in recent decades and the number of people with higher education has increased. However, disparities between cities and rural areas remain significant and this might have a negative effect on future growth potential and sustainability.

Labour Market

Decreasing population and smaller labour force mean that the number of unemployed persons will also be lower, resulting in a decrease of spending on unemployed. EC (2005) projects the saving of EU25 on unemployment benefits to the amount of 0.3% of GDP by 2025 compared to current levels. Due to low unemployment rate and extremely low level of benefits, the saving for Estonia will be marginal (less than 0.1% of GDP).

Labour market will be more affected by immigration, which level is currently very low compared to the “Old Europe”. Wages are rapidly catching up with neighbouring countries and this might also put a stop to the current outward flow of Estonian workers. It is assumed (although the statistics about this are basically non-existent) that 3% of Estonian labour force is currently working abroad.

3. Fiscal Policy Perspective

Determinants of Current Fiscal Policy

Conservative fiscal policy is an important feature in terms of preparedness to cope with pressures of ageing population. In the framework of currency board arrangement, fiscal policy remains the only effective tool for the government to control the economic activity (MoF, 2006). Fiscal rules set by the Stability and Growth Pact, by which the EU Member States must have a medium-term objective of budgetary positions close to the balance or in surplus to avoid exceeding the 3% of GDP deficit

limit in terms of normal cyclical fluctuation should also be taken into account. All Estonian governments have more or less followed the conservative line in budgeting, with general government balance remaining the primary objective of the fiscal policy.

Main Characteristics of Estonian Fiscal Policy:

Balanced budget rule. During the 1990s, the legal commitment to keep the state budget in balance was introduced to the State Budget Act. Weakness of that concept was also apparent in the same law – revenues were defined as comprising all inflows (including borrowing and decreases of financial assets) and spending included all outflows (repayments of loans and an increase in financial assets). In 2002, the State Budget Act was changed and the new budget classifier was introduced together with clearly separating revenues, expenditures, and financial transactions but the requirement for balancing revenues and expenditures was abolished.

Commitment to balance general government budget. Although having no legal requirement to balance the budget, the government (in 1999) decided to set the target of balance in general government budget as the most important goal in fiscal policy. The goal has remained in agenda for all the following governments but the wording has even somewhat strengthened – before 2000, it was stated that the goal was to achieve the balance in general government budget over the medium term, but today the annual balance is targeted (MoF, 2006). Balancing the budget annually has served Estonia well – the budget position has rarely turned out to be pro-cyclical.

Small, open economy. Russian crises (1999) showed the vulnerability of economic openness and although it was also the year of elections – a sharp decline in economic growth due to lower foreign demand resulted instantly in general government deficit of over 3% of GDP. Although in 2007 the budget will end up in surplus for the sixth consecutive year, the accumulated financial reserves of 10% of GDP can cover only a couple of years of possible recession.

Future challenges in the field of fiscal policy

Based on risk assessments of the Estonian economy and demographic outlooks (by Ministry of Finance) there are 4 most important issues that need to be addressed in order to secure the sustainability of the government's fiscal policy.

Ensuring the solvency of pension system. Successful introduction of the three-pillar pension system and the increase of the retirement age will, according to calculations of the Ministry of Finance (2006), make the pension system financially, but not socially, sustainable. Conservative pension index means that pension spending will be lower than the collection of revenues and build-up of assets. But, on the other hand, it also means that the continuation of current policy will result in a rapid fall in the replacement rate (the level of average pension compared to average salary)³.

Increasing the retirement age is not currently in the political agenda, one reason being that the average length of life is just marginally higher than the official retirement age, so the decision would be highly unpopular. On the other hand, the effective exit age from labour force is already quite close to the official retirement age, so basically the good conditions in labour market are not pressuring the decision. Currently, the retirement age for men is 63 and for women it will reach 63 by 2016.

Additional funds are needed in health-care sector. As stated above, Estonian health care system works overall quite efficiently but considering growing demands due to ageing, fiscal sustainability of the scheme will certainly be undermined in the coming decades. Potential solutions are diverse: there is a possibility to increase the share of the patient in terms of financing the services provided. Another alternative is creating an insurance-based scheme similar to pension.

Future in Lisbon perspective

Economic growth in Estonia, which reached the level of 11,4% in 2006, is according to some experts on an unsustainable path. It is true that the growth is more than before based on domestic demand, which together with rapid credit growth and current account imbalances might undermine the strong position of the economy and make

³ For example, keeping the replacement rate at least on the current level (about 40%) requires a political decision and additional spending of about 1% of GDP annually (MOF, 2006). The pension reserve will be then spent by 2010 and, presuming the continuation of current balanced budget policy, will require an annual saving of 1% of GDP in terms of other spending categories. However, even that might be socially unsustainable as the level of pensions compared to wages is much higher in the neighbouring countries and pressures to increase the retirement benefits are stronger in societies with older voters. Another factor to be considered is that the fall in the replacement rate of the first pillar cannot directly be considered offset by the pensions from the II pillar because the defined contribution scheme will increase more the pensions of the higher contributors and that might create social tensions.

the challenge of ageing bigger due to worse starting position. On the other hand – export is currently growing almost by the rate of growth of the whole economy, showing no significant loss in competitiveness⁴. Risks in the financial sector are low due to foreign ownership of the major banks and the public finances are in a strong state.

The main uncertainty is about the way the economic development will settle into a sustainable growth path. Continuation of the conservative fiscal policy is really the only option for the government and this, together with interest rate hikes might be enough to ensure the realisation of “soft landing scenario”. The risks on sustainable development have increased but the fast growth period can currently be interpreted more as a time of catching up with developed world rather than as a period of unsustainability.

Despite catching up phenomena, the shrinking population will make it nearly impossible to achieve the current growth rates in the coming decades. Even more, to achieve a growth at all requires an increase in the productivity since the labour input has a negative effect on the output. Fiscal sustainability is a very important element in reaching the targets set by the Lisbon strategy. Deficits and build up of debt are moving the savings away from productive capital, therefore reducing the potential output and competitiveness. Long-term forecasts show significant pressure to increase spending in the future, which makes it then even more difficult to invest into growth-enhancing areas without having a healthy fiscal position and a reformed welfare sector.

EC (2005) has made an assumption in their baseline projections of converging labour productivity rates in EU during the next decades. Due to the unfavourable trends in population, Estonian nominal convergence with EU will continue up to 2040 (peaking at 91% of GDP per capita of the EU average) and start to diverge after that. This shows the importance of acting sooner rather than later. Because of the demographic structure, society might in the future be more willing to increase social spending

⁴ The headline figure of current account deficit is not showing the whole picture. Estonian corporate tax system is based on not taxing the profit, which is reinvested into company but the balance of payment is showing the outflow of the total earnings, thus resulting in deficit of revenue account even then there is no actual movement of funds.

rather than spending in growth-enhancing areas. The growth rate of R&D spending in Estonia is the fastest in EU but the level is still not sufficient to foster the long-term growth. Bringing the labour market issues, education and investments into the areas, such as R&D and human-capital, into the public agenda is the biggest benefit of the Lisbon strategy in terms of sustainable development.

Complexity of Fiscal Management and Decentralisation.

Fiscal sustainability can only be achieved when the government has control over the use of public funds and the decisions are based on the government accounts, which reflect the true state of public finances.

According to the Estonian constitution, local governments are independent in their management and in terms of budgeting. Only rules on local government budgeting apply to borrowing and are set by the Rural Municipality and City Budgets Act. According to this act, the total amount of repayments of financial obligations shall not exceed, in any coming budgetary year, 20% of the annual budget revenue, and the total amount of outstanding financial obligation shall not exceed 60% of the annual budget revenue of the municipality. Central government can reduce the support fund payments to the municipality concerned by the amount by which the limit has been exceeded.

Very fast economic growth has resulted in unexpectedly high collection of revenues, which has from its part decreased the need for local governments to use “creative” sources of financing. 2006 was the first year local governments finished with surplus on their combined budget since the early 1990s. Long period of deficits created a situation in which many local governments approached the deficit limit. While at the central government level, there are currently no PPP projects implemented in Estonia, there is one such a project being started in a local government.

To finance different projects, local governments use various schemes:

- a) Many local governments have created foundations. Foundation, by Estonian legislation, is a legal person in private law, which is created to manage assets and has a specific purpose of existence. Municipalities approaching the deficit limit

have used this format because a foundation (even when owned by a municipality) can borrow freely without being a subject to the debt limits.

- b) In the past, municipal companies have also been used – their share capital has been decreased and used as revenues for financing.
- c) Financial leasing/factorings/PPP. The act on local budgets was changed in 2002 to reflect the changing environment and add various debt instruments to the law. Previously, only loans and bonds were included in debt limits. The extensive use of leasing and factoring is no longer an issue. PPP, on the other hand, might become an issue for the future.

In order to establish the measures ensuring financial discipline and govern the local government insolvency, new legal acts have been prepared by the Ministry of Finance. It is important for a central government to have full information about all the actions of local governments and to have ready the rules, which ensure the provision of public services to the population and fulfilment of obligations taken by local governments. Having complete information is crucial for fiscal planning on the central government level as the state budget is planned with the target of general government balance in mind. Development of the government accounting system to which the municipalities are also subject to, benefits greatly the goal of having all necessary data available for fiscal planning purposes.

4. The role of the National Audit Office of Estonia

The purpose of the NAOE as the external auditor for the Government is to scrutinise the spending of public sector money. On the basis of audit results the NAOE advises the public sector institutions to perform their tasks in a more effective and efficient manner. The audit scope of the NAOE is the whole public sector, including local governments⁵.

When focusing at fiscal sustainability we can identify several ways how the NAOE could contribute to achieving the objectives of balanced budget, prudent policy making and implementation. **Firstly**, the provision of reliable information to the Parliament and general public. The NAOE is at the position to provide both the

⁵ Note that only financial audits by NAOE are mandated in local governments.

decision-makers and the public with information concerning the long term fiscal impacts of current policies, thus putting the pressure on the government to undertake policy reforms where necessary. Sustainability criteria need to be incorporated into the risk assessment of Government's policies. Those policies potentially having the greatest impact on sustainability could be favoured as objects of performance audit (e.g. pensions, healthcare and education or implementation of the Lisbon strategy). It is important not only to look at the policies at expenditure side, but also to find out whether the current policies support the productivity growth necessary to put the economy on a sustainable and ambitious growth track and thus generating sustainable budget revenues in the future.

Secondly, supporting the knowledge-based policy making and transparent budgetary process. Informed decision making can be achieved through the audits of budgetary system and the process of preparing legislative acts, paying more attention to regulatory impact assessment (and tools such as cost-benefit analysis and value for money tests) and better co-ordination of policies.

Thirdly, supporting the development of accounting procedures and financial management skills in the public sector (incl. local governments). This means that the NAOE will continue to provide high quality financial audits and suggesting the Government to develop prudent fiscal management regulations. Special attention should be given to the developments in the area of PPP's and in that relation, accounting of off-balance liabilities.

Fourthly, significant attention needs to be paid to help both the local governments themselves, as well as the government policies to deliver efficiency improvements at that level: economies of scale, better financing systems (e.g. the debt rules) and greater accountability.

Although fiscal sustainability is crucial for the stable development of a country, it would be exaggeration to suggest that the topic will be at the centre of the NAOE's work. Perhaps the most significant change for the NAOE in the context of emphasising fiscal sustainability issues is the need to broaden the scope of audits and not only look retrospectively at the compliance with regulations and provide assurance about efficiency and effectiveness in the scope of one policy area, but also undertake more ex ante analysis and increase the capability to evaluate more complex policy settings.

List of references

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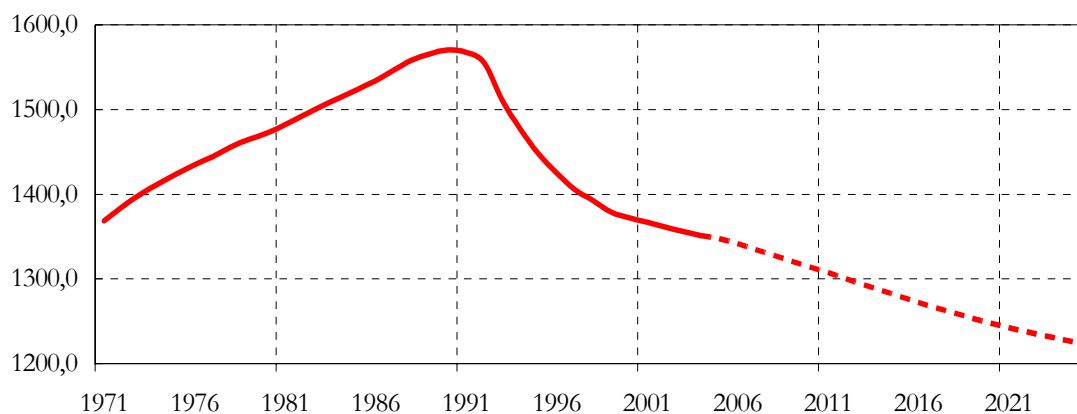
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ANNEXES

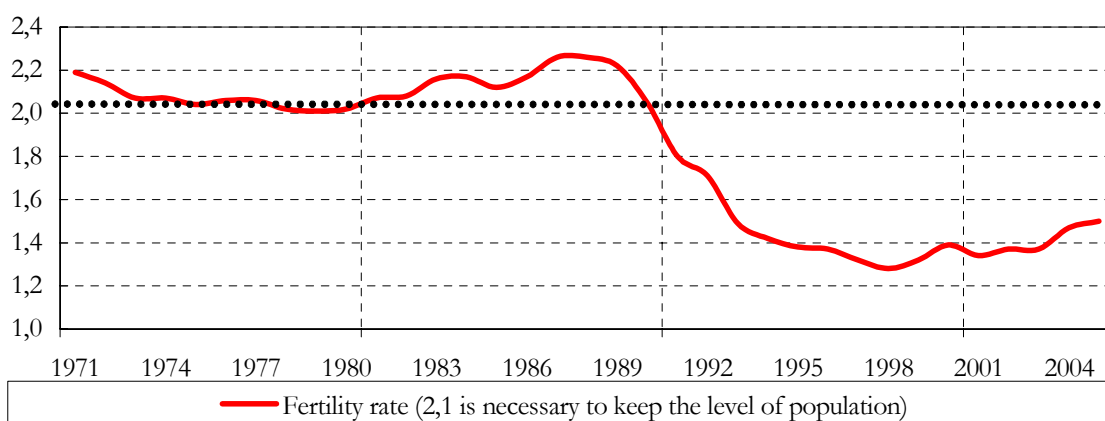
1. Main Demographic Indicators

Population in Estonia (1970-2025, in thousands)



Source: Statistics Estonia, Ministry of Finance

Fertility Rate in Estonia (1970-2005)



Source: Statistics Estonia

Demographic Dependency Ratios

	Old-age dependency ratio ⁶			Total economic dependency ratio ⁷		
	2005	2025	2050	2005	2025	2050
Estonia	23	31	43	135	118	137
Latvia	23	31	44	137	113	137
Lithuania	22	29	45	144	107	134
EU10	19	33	50	159	124	158
EU25	24	35	51	136	125	147

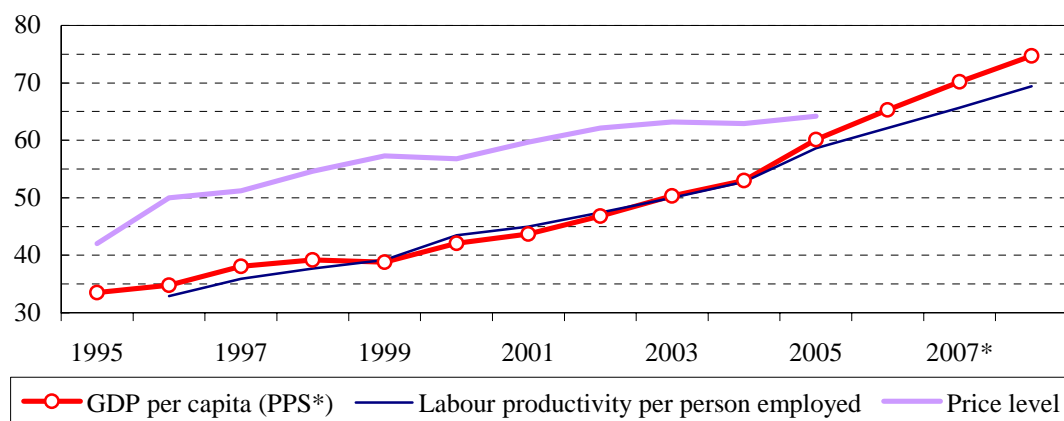
Source: Ministry of Finance of Estonia, EC (2006)

⁶ Population aged 65+ as a percentage of the population aged 15-64

⁷ Total population less employed as a percentage of employed population aged 15-64

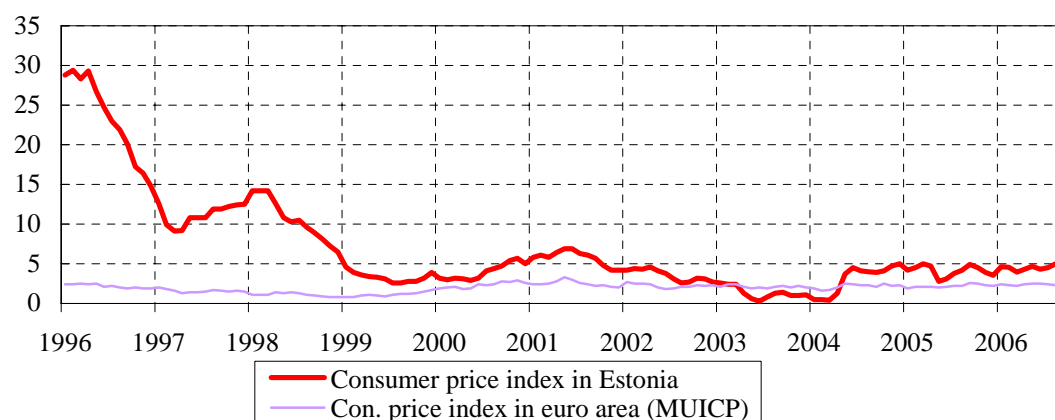
2. Main Economic Indicators

Real Convergence with EU



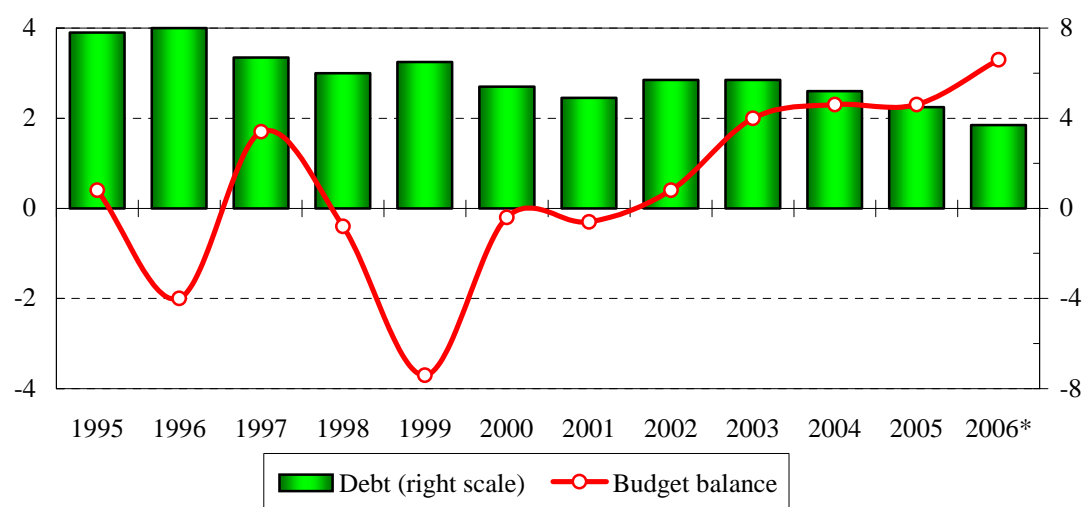
Source: Ministry of Finance

Consumer Prices in Estonia and in Euro Area



Source: Ministry of Finance

General Government Debt and Deficit (1995-2006)



Source: Ministry of Finance