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COMMISSION STAFF WORKING DOCUMENT

Analysis of the Draft Budgetary Plan of Estonia

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of Estonia

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1. INTRODUCTION

Estonia submitted its Draft Budgetary Plan for 2019 on 15 October 2018 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Estonia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium term budgetary objective (MTO of -0.5% of GDP).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2018 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2018 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2018-2019 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2018. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

According to the macroeconomic scenario underlying the Draft Budgetary Plan, real GDP growth reached 4.9% in 2017 and is projected to decelerate to 3.6% in 2018 and 3.0% in 2019, as investment growth is returning to more sustainable levels, after a temorary surge in 2017.

The forecast for 2018 has been revised downwards (by 0.4 percentage points) compared to the Stability Programme presented in spring 2018, reflecting actual GDP data for the first half of 2018. Growth for 2019 has also been revised slightly downwards (by 0.2 percentage point), reflecting a weaker external outlook. Still, reflecting the extended period of good economic times, the output gap is estiamted to be positive and relatively large at around 3% of potential GDP.

According to the Draft Budgetary Plan, domestic demand is expected to remain the main growth driver in 2018 and 2019. The unemployment rate is projected to increase slightly in 2019, as the expected increase in labour supply from the introduction of the 'Work Ability' reform is set to bring work-incapacity retirees back into the labour market offseting the underlying tightening of the labour market. Wage pressures remain substantial due to a tight labour market and decreasing population at working age. HICP inflation is projected to slow

in 2018 and 2019, while remaining at elevated levels of 3.3% and 3.0% respectively, linked to upward pressures from global energy and food prices.

This scenario is broadly in line with the Commission 2018 autumn forecast, which expects slightly lower real GDP growth for 2018 and 2019 of 3.5% and 2.8% respectively. However, as the Commission forecasts higher GDP deflators for both 2018 and 2019, the projection for nominal GDP growth is slightly higher than in the Ministry of Finance forecast. The labour market is projected to develop in a similar way as in the Draft Budgetary Plan for 2018, but slightly weaker employment growth is foreseen for 2019. Overall, the Draft Budgetary Plan's outlook is based on plausible macroeconomic assumptions.

Box 1: The macroeconomic forecast underpinning the budget in Estonia

The macroeconomic forecast underlying the Draft Budgetary Plan was prepared by the Fiscal Policy Department in the Ministry of Finance of Estonia and was endorsed by the Fiscal Council (*Eelarvenõukogu*), which is an independent advisory body attached to the Bank of Estonia. The Council assesses the macroeconomic and fiscal forecasts of the Ministry of Finance and the extent to which the budget rules are followed, in accordance with the requirements of the State Budget Act and European Union law.

On 24 September 2018, the Fiscal Council published an opinion[1] on its website on the macroeconomic and fiscal forecasts of the Ministry of Finance. The Fiscal Council considers that the Ministry's GDP forecast for 2018 and 2019 is plausible. The Fiscal Council also sees balanced risks to the tax revenues. However, the Fiscal Council considers the cyclical position of the Estonian economy to be better than that estimated by the Ministry of Finance. Rapid wage growth, low unemployment, a large number of vacancies, and a rise in the employment rate, which is already high, all indicate peak cyclical conditions. The Fiscal Council therefore estimates the structural fiscal position to be slightly weaker than the Ministry of Finance calculations indicate. For this reason the Fiscal Council recommends that the 2019 budget targets a small surplus in the structural fiscal position of general government.

[1] http://eelarvenoukogu.ee/en

Table 1. Comparison of macroeconomic developments and forecasts

	2017	2018			2019		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	4.9	4.0	3.6	3.5	3.2	3.0	2.8
Private consumption (% change)	2.6	4.7	4.1	4.1	3.3	3.9	3.4
Gross fixed capital formation (% change)	12.5	3.3	-1.0	2.6	5.1	4.4	4.6
Exports of goods and services (% change)	3.5	4.5	3.4	4.6	4.2	3.8	3.9
Imports of goods and services (% change)	3.6	4.6	4.9	4.7	4.3	4.0	4.4
Contributions to real GDP growth:							
- Final domestic demand	4.3	3.4	1.8	2.7	3.1	3.1	3.0
- Change in inventories	-0.3	0.3	1.9	0.7	-0.2	-0.3	0.0
- Net exports	0.1	0.2	-0.9	0.1	0.2	0.0	-0.2
Output gap[1]	2.7	2.5	3.0	3.0	2.2	2.7	2.6
Employment (% change)	2.7	0.8	1.2	0.8	0.5	0.8	0.3
Unemployment rate (%)	5.8	5.8	5.7	5.7	6.2	6.0	6.0
Labour productivity (% change)	2.1	3.1	2.3	2.7	2.7	2.1	2.5
HICP inflation (%)	3.7	3.0	3.3	3.5	2.5	3.0	3.3
GDP deflator (% change)	3.9	3.5	3.9	4.2	3.0	3.2	3.6
Comp. of employees (per head, % change)	6.9	7.1	7.0	7.0	6.1	6.3	6.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	4.2	4.9	3.6	4.9	4.9	3.3	4.7

Note:

[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

According to Estonia's Draft Budgetary Plan, the general government deficit is expected to improve from 0.4% of GDP in 2017 to a surplus of 0.6% of GDP in 2018 (Table 2). The projection for 2018 shows a significant improvement compared to the 2018 Stability Programme by 0.4 percentage points. This improvement arises mainly from higher tax revenues. The comparison of the Draft Budgetary Plan figures with the spring 2018 Stability Programme (Table 2, expressed as a share of GDP) is also impacted by the recent large upward revision of the nominal GDP level (2.8% increase).

In 2019, the general government surplus is projected to decrease to 0.5% of GDP. This is in line with the Stability Programme target, implying that the better outcome in 2018 is not carried forward to the following year. This is linked to higher expected expenditure growth in 2019. The Draft Budgetary Plan projections include revenue and expenditure measures

negatively impacting the fiscal outcome in 2018 by 0.2 percentage point, but improving the budget balance by about the same amount in 2019 (see Section 3.3)[2].

In August 2018, following a regular annual revision of GDP data, Estonian Statistics Office revised significantly upwards Estonia's historic GDP data for 2014-2017. The upward revision suggests that the economic times were better than previously estimated over the past years and the output gap estimate has now also been revised upwards (from 2.5% and 2.2% of potential GDP in the Stability Programme for 2018 and 2019 respectively, to 3% and 2.7% in the Draft Budgetary Plan). This in turn impacts on the estimate of the structural position of the budget. The recalculated[3] structural balance is estimated to amount to a deficit of 0.6% of GDP in 2018 and 2019[4].

The Commission 2018 autumn forecast projects a headline surplus of 0.5% of GDP in both 2018 and in 2019 (see Table 2). This is marginally below the Draft Budgetary Plan projections[5]. The slightly worse nominal balance and a somewhat different assessment of one-off measures result in lower structural balance projections for 2018 and 2019 in the Commission forecast, of -0.8% and -0.7% of GDP respectively.

Overall, the risks associated with the Draft Budgetary Plan fiscal targets can be considered as balanced. The yield estimates of the major tax reforms that took effect in 2018 (the corporate and personal income tax reform and excise increases) have now been underpinned with actual tax receips data from the first half of 2018, reducing the risk of estimation error. The Fiscal Council also concluded that the risks to tax revenues are balanced, even if individual tax categories can surprise both on the upside and the downside.

The main negative risks to this fiscal projection pertain to the broader macroeconomic risks, which could erode the revenue base, while expenditure is predetermined to grow at a relatively rapid pace. In particular, social expenditures are set to grow relatively rapidly due to an indirect link to overall wage growth (with a lag of about 1 year), and various government expenditure measures. The above risk is somewhat mitigated by the good track record of Estonia in meeting or exceeding its budgetary targets and taking early corrective action in case of negative budgetary surprises.

[2] In the case of Estonia, the low interest environment has no significant impact on the fiscal outcome, as the country's debt level is the lowest in the EU at about 8% of GDP and interest expenditure amounts to only 0.1% of GDP.

[3] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

[4] The targets of the Draft Budgetary Plan at face value, as published by the national authorities, indicate a structural balance of 0.0% of GDP in 2018 and 2019, which complies with the national fiscal rule of structural deficit of -0.5 % of GDP.

[5]The revenue and expenditure ratios show significant differences between the two forecasts, mainly explained by the category 'other (residual)' showing large growth in the Ministry's fiscal projection on both the revenue and expenditure side. This is partly explained by assumptions about EU funds, which are broadly deficit neutral. The Commission forecast projects a more stable evolution of the revenue and expenditure ratio to GDP.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2017	2018			2019			Change: 2017-2019
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**38.9**	**40.9**	***40.9***	**39.9**	**41.3**	***41.4***	**39.8**	**2.5**
of which:								
- Taxes on production and imports	14.2	14.5	*14.1*	14.3	14.8	*14.4*	14.5	0.2
- Current taxes on income, wealth, etc.	7.2	7.7	*7.6*	7.4	7.5	*7.3*	7.0	0.1
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.4	12.1	*11.8*	11.8	12.3	*11.9*	11.8	0.5
- Other (residual)	6.0	6.6	*7.4*	6.4	6.7	*7.8*	6.5	1.8
Expenditure	**39.3**	**40.7**	**40.3**	**39.4**	**40.8**	**40.9**	**39.4**	**1.6**
of which:								
- Primary expenditure	39.2	40.7	40.3	39.3	40.8	40.9	39.3	1.7
of which:								
Compensation of employees	11.3	11.4	11.2	11.2	11.4	11.4	11.2	0.1
Intermediate consumption	6.6	6.6	6.6	6.5	6.6	6.7	6.5	0.1
Social payments	13.3	13.8	13.5	13.4	14.0	13.7	13.5	0.4
Subsidies	0.5	0.5	0.5	0.5	0.5	0.6	0.5	0.1
Gross fixed capital formation	5.4	5.7	5.8	5.6	5.5	5.8	5.4	0.4
Other (residual)	2.2	2.7	2.7	2.2	2.8	2.7	2.2	0.5
- Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General government balance (GGB)	**-0.4**	**0.2**	**0.6**	**0.5**	**0.5**	**0.5**	**0.5**	**0.9**
Primary balance	**-0.3**	**0.3**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**	**0.8**
One-off and other temporary measures	0.0	-0.1	-0.1	0.0	-0.1	-0.1	0.0	-0.1
GGB excl. one-offs	**-0.4**	**0.3**	**0.7**	**0.5**	**0.6**	**0.6**	**0.5**	**1.0**
Output gap[1]	2.7	2.5	3.0	3.0	2.2	2.7	2.6	0.1
Cyclically-adjusted balance[1]	-1.6	-0.9	-0.7	-0.8	-0.5	-0.7	-0.7	0.8
Structural balance (SB)[2]	**-1.6**	**-0.8**	**-0.6**	**-0.8**	**-0.4**	**-0.6**	**-0.7**	**0.9**
Structural primary balance[2]	-1.5	-0.8	-0.6	-0.8	-0.4	-0.6	-0.6	0.9

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

3.2. Debt developments

According to the Draft Budgetary Plan, general government gross debt is projected to decrease from 8.1% of GDP in 2018 to 7.4% of GDP in 2018 (see Table 3). The projection is similar to the Commission 2018 autumn forecast.

Table 3. Debt developments

(% of GDP)	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**8.7**	**8.5**	**8.1**	**8.0**	**7.7**	**7.4**	**7.6**
Change in the ratio	-0.4	-0.2	-0.6	-0.8	-0.8	-0.7	-0.4
Contributions[2] :							
1. Primary balance	**0.3**	**-0.3**	**-0.6**	**-0.6**	**-0.5**	**-0.5**	**-0.5**
2. "Snow-ball" effect	**-0.7**	**-0.5**	**-0.6**	**-0.6**	**-0.5**	**-0.5**	**-0.4**
Of which:							
Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Growth effect	-0.4	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2
Inflation effect	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2	-0.3
3. Stock-flow adjustment	**-0.1**	**0.6**	**0.6**	**0.4**	**0.2**	**0.3**	**0.6**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation effect & residual							

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2018 (SP); Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the Draft Budgetary Plan

According to the authorities, the measures presented in the Draft Budgetary Plan have a net deficit-increasing effect of 0.2% of GDP in 2018, and a deficit-decreasing effect of 0.2% of GDP in 2019. Most of the measures concern specific relatively small revenue or expenditure items, with the largest effect coming from cancelling the previously planned rise of alcohol excises from 2019 onwards (-0.1% of GDP in 2018 and 2019), sale of CO2 quotas in 2019 (0.1% of GDP), postponing some investments from 2019 to the following years (0.1% of GDP), planning to shift dividend revenue from state owned companies from 2018 to 2019 (0.05% of GDP), and shifting some expenditures forward from 2019 to 2018 (0.1% of GDP). The Commission 2018 autumn forecast takes account of these measures.

Table 4. Main discretionary measures reported in the Draft Budgetary Plan

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2018	**2019**	**2020**
Taxes on production and	-0.1	0.0	0.0
Current taxes on income,	0.0	0.0	0.0
Capital taxes			
Social contributions	0.0	0.0	0.0
Property Income	0.0	0.1	0.0
Other	0.0	0.2	0.0
Total	-0.2	0.3	0.0

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2019

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2018	**2019**	**2020**
Compensation of employees			
Intermediate consumption	-0.1	0.0	0.0
Social payments	0.1	0.1	0.0
Interest Expenditure			
Subsidies			
Gross fixed capital formation	0.0	0.0	0.0
Capital transfers			
Other			
Total	0.0	0.1	0.0

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2019

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Estonia is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its MTO[6].

Box 2. Council Recommendations[7] addressed to Estonia

On 13 July 2018, the Council addressed recommendations to Estonia in the context of the European Semester. In particular, in the area of public finances the Council recommended Estonia to ensure that the nominal growth rate of net primary government expenditure does not exceed 4.1 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP.

The Council noted that under unchanged policies, there is a risk of some deviation from the MTO in 2018 and 2019.

In view of the Commission autumn 2018 forecast projecting better fiscal performance in 2018, the gap to the MTO in 2019 now appears smaller. Adjusting the fiscal requirements that were set in spring 2018, the nominal growth rate of net primary government expenditure should not exceed 4.9%, corresponding to an improvement in the structural balance by 0.3% of GDP.

In 2018, according to the Draft Budgetary Plan, the growth of government expenditure, net of discretionary revenue measures and one-offs, will not exceed the applicable expenditure benchmark. Also, the recalculated structural deficit is set to improve by 0.9% of GDP, complying with the structural adjustment requirement for 2018 (see Table 6), thus indicating compliance with the SGP requirements in 2018 based on the Draft Budgetary Plan assumptions.

However, according to the Commission 2018 autumn forecast, in 2018 the growth of government expenditure net of discretionary revenue measures and one-offs is set to exceed the applicable expenditure benchmark by 0.1% of GDP. At the same time, the structural balance is estimated to improve by 0.8% of GDP, well above the structural adjustment requirement. The average deviation over 2017 and 2018 is within the requirements for both pillars. The deviation on the expenditure benchmark pillar calls for an overall assessment. The large difference between the expenditure benchmark and structural balance indicators is explained by four main factors that all add up to make the expenditure benchmark more restrictive than the structural balance indicator. Notably, smoothing of the potential growth[8], revenue windfalls[9], a role of GDP deflator[10] and smoothing of capital expenditure[11] all line up

[6] Estonia's MTO is a structural deficit of 0.5% of GDP.

[7] OJ C 261, 9.8.2017.

[8] The expenditure benchmark indicator uses a 10 year average potential growth rate, whereas the structural balance relies on an annual estimate of the potential growth rate. All in all, the 10 year average potential growth rate estimate covers currently a representative part of the economic cycle and can be considered as a relevant estimate of the potential growth.

[9] Revenue windfalls reflect tax growth above nominal GDP growth due to the strong growth of labour and consumption taxes.

[10] The expenditure benchmark uses a lower GDP deflator in its computation than the structural balance indicator (which does not fully reflect the current high inflation environment).

[11] Expenditure growth computation uses 4 year average capital expenditure growth (t-4), rather than current year capital expenditure.

in 2018 to explain the difference between the two pillars. Assessing the relevance of the above four factors separately, the first three can be considered to provide a more accurate assessment of Estonia's fiscal position and therefore suggest that the expenditure benchmark indicator provides a better assessment. Nevertheless, the smoothing of capital expenditure overstates the annual expenditure increase in 2018 arising from the government's medium-term investment package. The growth of government expenditure appears to be in line with the applicable expenditure benchmark once adjusted for the smoothing of capital expenditure. As an additional consideration for the overall assessment, the projected significant over-achievement of the structural balance pillar reduces the overall compliance risks for 2018. Following an overall assessment, the adjustment path towards the MTO seems to be in line with the requirement of the preventive arm of the Pact in 2018.

According to both the information provided in the Draft Budgetary Plan and the Commission forecast, in 2019 the (recalculated) structural balance is projected to be close to the medium-term budgetary objective of a structural deficit of 0.5% of GDP (gap of 0.1 and 0.2% of GDP respectively). Thus, the current assessment indicates a risk of some deviation in 2019. However, this assessment is dependent on the current projection that Estonia will be close to its medium-term budgetary objective. At the same time, Estonia has a requirement that the nominal growth rate of net primary government expenditure should not exceed 4.9% in 2019, corresponding an adjustment of 0.3% of GDP in 2019. Based on the Commission forecast, the expenditure benchmark would currently point to a risk of a significant deviation from that requirement in 2019. If the structural balance is no longer projected to be close to the medium-term budgetary objective in future assessments for 2019, the overall assessment of compliance will need to take into account a possible deviation from the above-mentioned requirement.

Table 5. Compliance with the requirements of the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	-1.6	-0.8		-0.7	
Structural balance based on freezing (COM)	-0.3	-0.8		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		Not at MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.3	
Required adjustment corrected[5]	-1.1	-0.2		0.3	
Change in structural balance[6]	-0.8	0.9	0.8	0.0	0.1
One-year deviation from the required adjustment [7]	0.3	1.1	1.0	-0.3	-0.2
Two-year average deviation from the required adjustment [7]	0.6	0.7	0.6	0.4	0.4
Expenditure benchmark pillar					
Applicable reference rate[8]	4.9	6.1		4.9	
One-year deviation adjusted for one-offs [9]	0.5	0.3	-0.1	-0.5	-0.5
Two-year average deviation adjusted for one-offs [9]	0.5	0.4	0.2	-0.1	-0.3

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 20XX-1) was carried out on the basis of Commission 20XX spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The Draft Budgetary Plan foresees that the revenue ratio to GDP will increase by 0.5 percentage points of GDP from 2018 to 2019, while the expenditure ratio is set to rise by 0.6 percentage point of GDP. Expenditure increases are mainly driven by social payments and the wage bill of government sector emplyees, while the investment ratio is set to remain stable at a high level.

Estonia's tax system is relatively growth-friendly, with indirect taxes above the EU-28 average and labour taxes below the average. The recent 2018 tax reforms (see Box 3) further increased indirect taxation while lowering labour taxation.

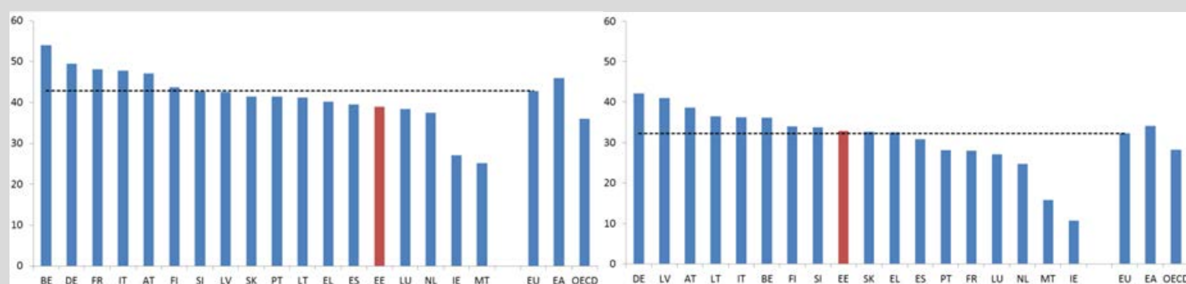
Estonia performs well in terms of tax administration efficiency. Over the recent years, Estonia has introduced a number of measures to increase tax compliance, such as an employment register and additional reporting obligations for VAT that proved to be effective.

Box 3: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker’s net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Estonia for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Estonia at the average wage and at low wage (2016)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts

should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2018 European Semester, Estonia did not receive Council Recommendations related to the tax burden on labour, but such a Council Recommendation existed in 2015. Since then, Estonia has taken several measures to shift the tax burden from labour to consumption and environmental taxes. The most recent and notable measure in this respect is the income tax reform, which took effect in 2018. Its costs were financed by a shift to other taxes (notably corporate income tax reform) and excise duties. The reform raised the tax free allowance from EUR 180 per month in 2017 to EUR 500 per month. The tax free allowance for people earning more than the average salary has been made income dependent, reaching zero once a person's salary exceeds EUR 2,100 per month, adding an element of progressivity to Estonia's income tax system. This measure reduces the tax-wedge on low- to medium-income earners. Estonias' 2019 Draft Budgetary Plan does not include any additional measures that affect the tax wedge on labour.

6. OVERALL CONCLUSION

In 2018, Estonia is expected to comply with the requirements of the preventive arm of the Stability and Growth Pact according to the information provided in the Draft Budgetary Plan and the Commission 2018 autumn forecast, following an overall assessment.

In 2019, based on both the information contained in the Draft Budgetary Plan and the Commission 2018 autumn forecast, the structural balance is expected to be close to the medium-term objective. If such projection is not confirmed in future assessments, the overall assessment of compliance will need to take into account the extent of the deviation from the requirement set by the Council.