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Assessment of the 2017 stability programme for

Estonia

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

On 27 April 2017, Estonia submitted its April 2017 stability programme, covering the period 2017-2021. The government approved the programme on 27 April at the same time as the national state budget strategy.

Estonia is currently subject to the preventive arm of the Stability and Growth Pact (SGP) and should preserve a sound fiscal position which ensures compliance with the medium-term objective.

This document complements the Country Report published on 22 February 2017 and updates it with the information included in the stability programme.

Section 2 presents the macroeconomic outlook underlying the stability programme and provides an assessment based on the Commission 2017 spring forecast. The following section presents the recent and planned budgetary developments, according to the stability programme. In particular, it includes an overview on the medium-term budgetary plans, an assessment of the measures underpinning the stability programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The stability programme is based on the national macroeconomic forecast which was published on 12 April 2017. It expects an acceleration of GDP growth from 1.6% in 2016 to 2.4% in 2017 and further to 3.1% in 2018 and stabilising thereafter at 2.7-2.8% over the period 2019-2021 (Table 1). The acceleration is supported by projected improvement of export demand, while domestic demand is expected to remain the main growth driver over the programme horizon. The GDP projection is broadly similar to the previous forecast underlying the Draft Budgetary Plan, presented in autumn 2016, which expected GDP to grow by 2.5% in 2017 and 3.0% in 2018. However, in terms of growth components, the latest forecast is somewhat more optimistic on domestic demand, inflation and labour market trends, which form the main tax basis. At the same time, import growth is projected to be significantly higher in 2017, which reduces the contribution of net exports to GDP growth.

The Commission spring 2017 forecast expects slightly lower GDP growth in 2017 and 2018, at 2.3% and 2.8% respectively. The difference arises from the external side, while domestic demand components are broadly similar. Also, wage growth, employment and inflation projections are comparable.

Both the macroeconomic scenario in the programme and in the Commission forecast expect unemployment to increase after 2016, which is explained by the statistical effect of the 'work ability reform' that brings previously inactive population groups back into the labour force. At the same time, wage pressures remain strong due to a shrinking working age population and the historically high employment rate. Both forecasts project inflation to peak at over 3% in 2017 and to abate to slightly below 3% in 2018. This is driven by global food and energy prices. Additionally, a staggered increase in excise duties is estimated to contribute to inflation by about 1 pp. in both 2017 and 2018.

The output gaps as recalculated by the Commission based on the information in the programme, following the commonly agreed methodology, remain close to zero in 2017, but turn positive to 0.4 % of GDP in 2018, in line with the expected acceleration of GDP growth. This is significantly different from the output gaps presented at face value in the stability programme, which estimates a negative output gap at 0.8% and 0.4% of GDP in 2017 and 2018, respectively. The difference largely arises from potential growth estimates, as the stability programme projects higher potential output compared to the Commission over the programme horizon. Also, the medium-term GDP growth projections contained in the programme exceed the Commission's potential growth estimates. This suggests that the programme's medium-term GDP growth projections are favourable.

Overall, the macroeconomic assumptions underlying the stability programme are plausible for 2017 and 2018, but they are favourable for the outer years of the programme.

Table 1: Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019	2020	2021
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	1.6	1.6	2.3	2.4	2.8	3.1	2.8	2.7	2.7
Private consumption (% change)	4.1	4.0	2.6	2.2	3.8	4.0	2.5	2.2	2.4
Gross fixed capital formation (% change)	-2.8	-2.8	9.3	9.3	0.1	0.0	4.8	4.7	4.7
Exports of goods and services (% change)	3.6	3.6	3.7	3.7	3.7	3.9	4.0	4.0	3.9
Imports of goods and services (% change)	4.9	4.9	5.4	5.4	3.5	3.0	4.2	4.2	4.0
Contributions to real GDP growth:									
- Final domestic demand	1.7	1.7	3.8	3.7	2.5	2.3	2.7	2.6	2.7
- Change in inventories	0.8	0.8	-0.6	-0.2	-0.1	0.0	0.0	0.1	0.0
- Net exports	-0.8	-0.8	-1.1	-1.2	0.3	0.8	0.0	0.0	0.0
Output gap[1]	0.3	0.1	0.1	-0.1	0.6	0.4	0.4	0.3	0.3
Employment (% change)	0.3	0.6	0.3	0.5	0.2	0.2	0.1	0.0	0.1
Unemployment rate (%)	6.8	6.8	7.7	7.8	8.6	8.9	9.5	9.6	9.6
Labour productivity (% change)	1.3	1.0	2.0	1.9	2.7	2.9	2.7	2.8	2.6
HICP inflation (%)	0.8	0.8	3.3	3.4	2.9	2.9	2.6	2.6	2.1
GDP deflator (% change)	1.7	1.7	3.6	3.2	3.3	3.2	2.8	2.8	2.7
Comp. of employees (per head, % change)	5.7	5.2	5.5	6.0	5.6	5.6	5.8	5.3	5.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.9	3.5	3.1	3.1	3.3	4.2	3.8	3.4	2.9

Note:

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

Source :

Commission 2017 spring forecast (COM); Stability Programme (SP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017

Estonia's general government balance reached a surplus of 0.3% of GDP in 2016, in line with the projection of the 2016 Draft Budgetary Plan (from October 2016). It is, however,

substantially better than the deficit target of 0.4% of GDP set in the 2016 stability programme (from April 2016). The difference with the previous stability programme arises mainly from better-than-expected labour tax income (reflecting stronger wage growth) and lower-than-expected investment expenditure due to delays in EU funded investment programmes. These developments have more than offset the higher -than- planned increase in public wage costs and social expenditure.

For 2017, the stability programme plans a deficit of 0.5% of GDP. This is in line with the last Stability Programme of 2016, but slightly better than the projected deficit of 0.6% of the 2016 Draft Budgetary Plan. The slightly better budgetary outlook for 2017 mainly results from higher revenues due to a shift in the increase of excise tax rate from 2016 to 2017. As mentioned above, the stability programme is slightly more optimistic regarding domestic demand (tax base) developments for 2017 than the Draft Budgetary Plan. Some deficit increasing measures (implementation costs in 2017 of tax changes taking effect in 2018; and postponing dividends from state owned enterprises from 2017 to 2018) were taken into account, which partly offset the better revenue outlook for 2017.

Based on the Commission 2017 spring forecast, the structural balance is assessed to have reached a surplus of 0.2% of GDP in 2016 (Table 2), above the medium-term objective (MTO) of a balanced budget.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The main purpose of the Estonian stability programme is not to exceed the medium-term objective (MTO) over the programme horizon. The MTO was lowered from a structural balance of zero to a deficit of 0.5% of GDP in 2017.

With respect to the medium-term strategy, the stability programme projects a headline deficit of 0.8% of GDP in 2018 and 0.7% of GDP in 2019, before improving again to a balanced position by 2021. While the headline target is 0.6% of GDP weaker for 2018 compared with the previous stability programme, both programmes project a return towards a balanced budgetary position by the end of the programme horizon (see Figure 2). The lowered budgetary targets largely reflect the authorities additional investment programme amounting to 0.5% of GDP in 2018 and an additional similar amount during 2019-2020.

The programme's budgetary targets broadly represent projections under a no-policy-change assumption. Some measures included in the programme (see Section 3.3 for details) are at an early stage of legislative process, but they are taken into account in the Commission 2017 spring forecast since they are sufficiently detailed in the programme and the legislative processes are currently on track.

According to the programme figures at face value, the structural position is projected to stay at or above the MTO throughout the programme period. However, according to the recalculated output gaps of the Commission, the structural balance is estimated to weaken from a deficit of 0.1% of GDP in 2017 to a deficit of 0.9% of GDP in 2018, clearly below the MTO (see Table 2). The difference with the programme figures at face value arises from differing output gap estimates.

The Commission forecasts a smaller headline deficit than the stability programme for both 2017 (0.3 % of GDP) and 2018 (0.5% of GDP) and lower investment expenditure in 2017 and 2018 than the stability programme. This can be mostly explained by the fact that the actual investment expenditure has been typically somewhat lower than what was initially planned by the government and fiscal targets have been outperformed (see Figure 1). While the

programme projects higher income and social taxes for 2018 than the Commission, this is offset by the programmes' conservative projection of 'other' revenues (non-tax revenue categories). The Commission 2017 spring forecast expects a structural deficit of 0.3% of GDP in 2017, deteriorating markedly to a deficit of 0.7% of GDP in 2018. This is 0.2% of GDP higher than the stability programme in 2017, but 0.2% of GDP lower than in 2018. As a notable discrepancy between the two projections, some of the one-off measures announced in the programme are not classified as one-offs according to the methodology used by the Commission[1].

[1] This namely concerns a temporary increase in the second-pillar pension contributions in 2014-17 in the amount of 0.3% of GDP annually and extra costs related to mergers of municipalities in 2017-2019 of about 0.1% of GDP annually. Since these one-offs relate to expenditure increases, they increase the calculated structural balance.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2016	2017		2018		2019	2020	2021	Change: 2016-2021
	COM	COM	SP	COM	SP	SP	SP	SP	SP
Revenue	**40.7**	**40.8**	**40.8**	**41.5**	**41.2**	**40.8**	**40.5**	**39.9**	**-0.8**
of which:									
- Taxes on production and imports	15.2	15.2	15.2	16.0	16.0	16.0	15.7	15.7	0.5
- Current taxes on income, wealth, etc.	7.8	7.7	7.6	7.3	7.5	7.5	7.5	7.8	0.0
- Social contributions	11.9	11.9	12.0	12.1	12.3	12.3	12.3	12.2	0.3
- Other (residual)	5.9	6.1	6.0	6.1	5.4	5.0	5.0	4.2	-1.7
Expenditure	**40.4**	**41.1**	**41.4**	**42.0**	**42.0**	**41.4**	**40.8**	**39.8**	**-0.6**
of which:									
- Primary expenditure	40.3	41.0	41.3	41.9	41.9	41.3	40.7	39.7	-0.6
of which:									
Compensation of employees	11.8	11.8	11.8	11.7	11.7	11.6	11.5	11.4	-0.4
Intermediate consumption	7.0	7.0	7.1	7.1	7.2	7.2	7.2	7.2	0.2
Social payments	14.0	14.2	14.1	14.6	14.5	14.4	14.3	14.2	0.2
Subsidies	0.4	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.0
Gross fixed capital formation	4.7	5.1	5.5	5.4	5.7	5.3	4.9	4.2	-0.5
Other (residual)	2.4	2.5	2.4	2.6	2.4	2.4	2.4	2.4	-0.5
- Interest expenditure	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
General government balance (GGB)	**0.3**	**-0.3**	**-0.5**	**-0.5**	**-0.8**	**-0.7**	**-0.3**	**0.1**	**-0.2**
Primary balance	**0.3**	**-0.2**	**-0.5**	**-0.4**	**-0.8**	**-0.6**	**-0.2**	**0.2**	**-0.1**
One-off and other temporary measures	-0.1	0.0	-0.4	0.0	-0.1	-0.1	0.0	0.0	0.1
GGB excl. one-offs	**0.4**	**-0.3**	**-0.1**	**-0.5**	**-0.7**	**-0.6**	**-0.3**	**0.1**	**-0.3**
Output gap[1]	0.3	0.1	-0.1	0.6	0.4	0.4	0.3	0.3	0.0
Cyclically-adjusted balance[1]	0.1	-0.3	-0.5	-0.7	-1.0	-0.9	-0.5	0.0	-0.2
Structural balance[2]	**0.2**	**-0.3**	**-0.1**	**-0.7**	**-0.9**	**-0.8**	**-0.5**	**0.0**	**-0.3**
Structural primary balance[2]	0.3	-0.2	0.0	-0.7	-0.8	-0.7	-0.4	0.1	**-0.3**

Notes:

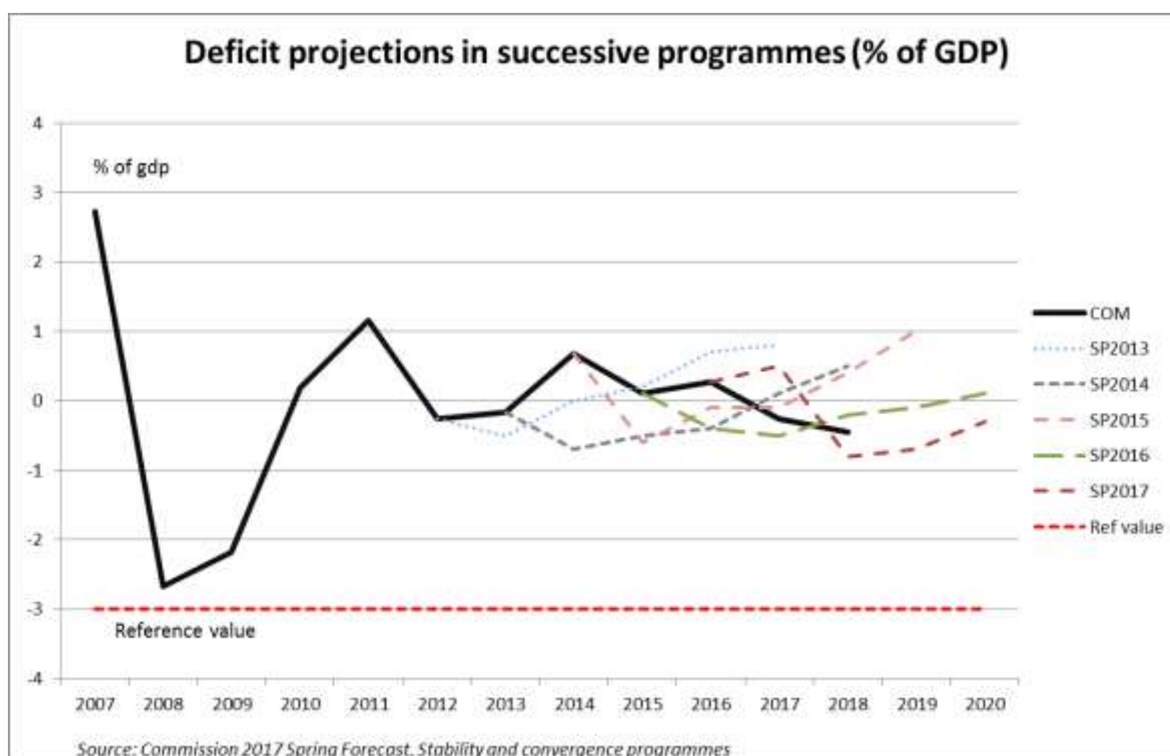
[1] Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

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

Source:

Stability Programme (SP); Commission 2017 spring forecasts (COM); Commission calculations.

Figure 1: Government balance projections in successive programmes (% of GDP)



3.3. MEASURES UNDERPINNING THE PROGRAMME

Several new revenue and expenditure measures were announced by the new coalition government in November 2016 and have presently progressed into legislation to a varying degree. The fiscal package is designed to be deficit neutral, so that expenditure increasing programmes (largely in healthcare, education, social funding and in financing local governments) amounting to about 1% of GDP are offset by commensurate revenue measures. In addition to this package, the government announced an investment package of 1.3% of GDP cumulative over 2018-2020, which is expected to raise investment expenditure by about EUR 100 million (0.5% of GDP) in 2018, therefore increasing the headline deficit by the same amount. The stability programme reflects both of these fiscal packages. Unlike the winter forecast, the Commission 2017 spring forecast now takes all the measures[2] from the two packages into account. The investment package explains to a large extent the downward revision of the Commission's fiscal projection for 2018.

The revenue increases largely relate to a substantial multi-year rise in excise duties for fuels, alcohol, tobacco, sweetened drinks, packaging (some of which were already legislated in 2015 by the previous government) and measures to boost corporate income tax revenues (closing some tax loopholes and motivating corporates to pay out more dividends.

At the same time, a large personal income tax cut for low- and medium-income earners is legislated as of 2018, which should substantially reduce the relatively high tax wedge for low-income earners. Some of the revenue measures were already legislated in late 2016; others are detailed in the stability programme but are yet to be fully legislated. According to the stability

[2] All the new fiscal measures are included in the Commission forecast, as the measures are sufficiently detailed in the stability programme.

programme, the unlegislated revenue measures amount to 0.8% of GDP in 2018. The largest of those are a corporate income tax reform, road use fee, excise on packaging, tax on sweetened drinks, additional dividends from SOEs, linking fines to personal income, changes to the parental leave system and online control of the fuel retail-wholesale market[3]. As these measures are sufficiently detailed in the stability programme and the legislative process is on track, all of the measures were taken account in the Commission 2017 spring forecast. The yield estimates of the revenue measures are overall plausible and are reflected in a similar manner in the Commission spring forecast, although some negative risks relate to the yield estimates (see Section 3.5).

3.4. DEBT DEVELOPMENTS

Estonia's public debt declined to 9.5% of GDP in 2016. It is forecast to remain relatively stable at around 10% of GDP in the medium term according to the programme (Table 3). The Commissions debt projections are slightly more favourable for 2018, expecting the debt-to-GDP ratio to remain at 9.5% of GDP.

Table 3: Debt developments

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020	2021
			COM	SP	COM	SP	SP	SP	SP
Gross debt ratio[1]	**9.3**	**9.5**	**9.5**	**9.4**	**9.6**	**9.9**	**10.5**	**10.1**	**9.4**
Change in the ratio	0.7	-0.6	0.0	-0.1	0.2	0.5	0.6	-0.4	-0.7
Contributions[2] :									
1. Primary balance	**-0.4**	**-0.3**	**0.2**	**0.5**	**0.4**	**0.8**	**0.6**	**0.2**	**-0.2**
2. "Snow-ball" effect	**-0.4**	**-0.2**	**-0.4**	**-0.5**	**-0.5**	**-0.5**	**-0.4**	**-0.4**	**-0.4**
Of which:									
Interest expenditure	0.1	0.1	0.1	0.0	0.1	0.0	0.1	0.1	0.1
Growth effect	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
Inflation effect	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
3. Stock-flow adjustment	**1.5**	**0.0**	**0.3**	**-0.1**	**0.3**	**0.3**	**0.4**	**-0.1**	**-0.1**
Of which:									
Cash/accruals diff.									
Acc. financial assets									
Privatisation									
Val. effect & residual									

Notes:

[1] End of period.

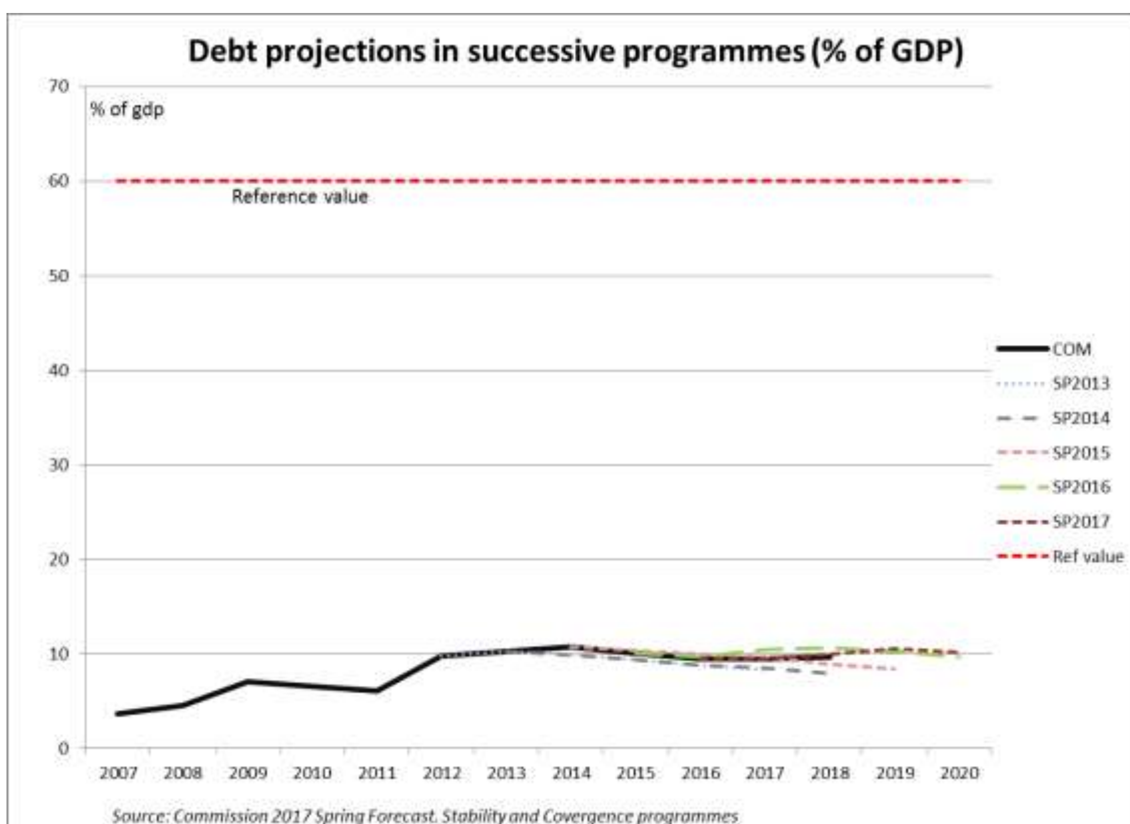
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets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

Source :

Commission 2017 spring forecast (COM); Stability Programme (SP), Comission calculations.

[3] The stability programme only presents the unlegislated measures. The already legislated measures are not separately mentioned but are included in detail in the Ministry of Finance 2017 spring forecast, which forms the base for the stability programme.

Figure 2: Government debt projections in successive programmes (% of GDP)



3.5. RISK ASSESSMENT

The revenue yield assumptions of the several new tax measures taking effect in 2018 are uncertain. Notably, substantial revenues are expected to accrue from a reform of the corporate tax system, which is designed to close some existing tax loopholes and motivate corporates to pay out dividends more regularly, as in Estonia corporate income tax is paid at the time of distributing dividends. However, the expected fiscal yield depends on the behaviour of corporations, which is difficult to predict. A specific risk relates to the already legislated beer and wine excise increase as of June 2017, as the legality of the increase is challenged in the Supreme Court of Estonia and the law might be revoked. The potential loss to the budget would amount to 0.1% of GDP in 2017 and 0.2% of GDP in 2018.

The stability programme projects nominal fiscal balances in a conservative fashion, expecting a higher fiscal deficit in 2018 than the Commission. However, the differing estimates of output gaps (see Section 3.2 above) lead to a risk of overestimating the structural position of the budget. The Commission expects a significantly larger positive output gap for 2018 than the stability programme, which suggest the structural balance might be weaker than presented in the programme. The Estonian Fiscal Council has also repeatedly drawn attention to the measurement uncertainty of the estimates of the output gap and has cautioned that the structural budgetary position might be weaker than projected by the authorities.

Given that the stability programme is based on a plausible GDP growth scenario for 2017 and 2018, risks to the public finance projections for 2017-18 arising from the short term

macroeconomic scenario appear to be mitigated. However, as mentioned in Section 2, the programme appears to overestimate medium term growth prospects.

In conclusion, there are some downside risks for 2018 and for the medium term, especially regarding the structural fiscal targets. At the same time, Estonia has a strong track-record in meeting its fiscal targets and in taking early corrective measures when needed, which somewhat mitigates the abovementioned risks. In recent years, nominal fiscal targets have been outperformed (Figure 2).

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

Estonia is subject to the preventive arm of the Stability and Growth Pact (SGP). The Council did not address a SGP-related recommendation to Estonia last year. Estonia should remain at the MTO. Based on outturn data, the structural surplus reached 0.2% of GDP in 2016, above the MTO. Therefore Estonia complied with the requirement of the preventive arm of the Stability and Growth Pact in 2016.

In its 2017 stability programme, the government plans to be above the revised lower MTO, reaching a deficit of 0.1% of GDP in 2017. The Commission forecasts a higher structural deficit of 0.3% of GDP in 2017, which is still above the MTO. Estonia is therefore assessed to be compliant with the requirements of the preventive arm of the Stability and Growth Pact in 2017.

For 2018, the structural balance is allowed to deteriorate by 0.2% of GDP, moving to the MTO.[4] According to the stability programme, the recalculated structural deficit is set to deteriorate by 0.8% of GDP (from 0.1% of GDP in 2017 to 0.9% of GDP in 2018), exceeding the allowed deterioration by 0.6% of GDP (see Table below). This implies a risk of significant deviation from the MTO. Still, according to the information provided in the stability programme, the growth of government expenditure, net of discretionary revenue measures and one-offs, will not exceed the applicable expenditure benchmark in 2018. This calls for an overall assessment. An analysis of the stability programme figures reveals that the significant deterioration in the structural balance (while the expenditure benchmark is met) largely arises from projected revenue shortfalls in 2018. This suggests that the programme's revenue projections are conservative. However, even after taking account of this, the deterioration of the structural balance still shows some deviation (-0.2). The remaining deviation is largely explained by the differences in the way the nationally financed investment expenditure is treated by the two indicators. It is smoothed out over a 4 year average in the expenditure benchmark indicator while it is fully captured in the structural balance. Thus, the expenditure benchmark indicator does not capture the budgetary costs of the government's multi-year investment package. Adopting a conservative approach, the structural balance is preferred as an indicator of the current fiscal trends. The overall assessment based on the stability programme suggests a risk of some deviation from the requirements of the preventive arm in 2018.

The Commission estimates a slightly lower structural deficit than the stability programme, at 0.7% of GDP for 2018. The deterioration of the structural deficit by 0.4% of GDP exceeds the allowed deterioration by 0.2 % of GDP. However, the growth rate of the expenditure aggregate is projected not to exceed the expenditure benchmark. This calls for an overall

[4] In 2018, Estonia is allowed to deteriorate its structural balance as this reflects the projected overachievement of the MTO in 2017 (structural balance at -0.3% of GDP against an MTO set at -0.5% of GDP).

assessment. The difference between the expenditure benchmark and the structural balance is mainly related to the smoothing of investment expenditure and as already explained above; the expenditure benchmark does not capture the government's multi-year investment programme. Therefore, the structural balance is a more relevant indicator. In addition, there are some downside risks to the 2018 revenue projections. Following an overall assessment, some deviation from the adjustment path towards the MTO is to be expected in 2018.

In the outer years of the projection, at face value the programme plans to stay at the MTO, with a structural deficit of 0.5% of GDP in 2019, improving to a balanced position by 2021. However, as highlighted in Section 3.5, there are some risks related to the medium-term projections as the programme relies on a somewhat optimistic GDP growth scenario and might overestimate the structural position of the budget. This highlights the need to mitigate the budgetary risks already in 2018, as otherwise the fiscal risks could cumulate over the medium term.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	0.0	-0.5		-0.5	
Structural balance[2] (COM)	0.2	-0.3		-0.7	
Structural balance based on freezing (COM)	0.6	-0.3		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	-0.6	-1.1		-0.2	
Change in structural balance[6]	0.3	-0.4	-0.6	-0.8	-0.4
One-year deviation from the required adjustment [7]	0.9	0.7	0.6	-0.6	-0.2
Two-year average deviation from the required adjustment [7]	0.8	0.9	0.7	0.1	0.2
Expenditure benchmark pillar					
Applicable reference rate[8]	3.6	4.9		6.1	
One-year deviation adjusted for one-offs[9]	0.5	0.5	0.6	1.1	0.0
Two-year deviation adjusted for one-offs[9]	0.1	0.5	0.5	0.8	0.3
PER MEMORIAM: One-year deviation [10]	0.7	0.6	0.7	0.8	0.0
PER MEMORIAM: Two-year average deviation [10]	0.1	2.2	0.7	0.7	0.3
Conclusion					
Conclusion over one year	Compliance	Compliance	Compliance	Overall	Overall
Conclusion over two years	Compliance	Compliance	Compliance	Compliance	Compliance

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 2014) is carried out on the basis of Commission 2015 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.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law 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 :

Stability Programme (SP); Commission 2017 spring forecast (COM); Commission calculations.

5. LONG-TERM SUSTAINABILITY

Estonia does not appear to face fiscal sustainability risks in the short run according to the S0 indicator, which captures short-term risks of fiscal stress stemming from the fiscal, as well as the macro-financial and competitiveness sides of the economy.

Based on the Commission forecast and a no-fiscal policy change scenario beyond the forecast, government debt, at 9.5% of GDP in 2016, is expected to increase slightly to 14.3% by 2027, thus remaining well below the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2027. This highlights low risks for the country from debt sustainability analysis in the medium term. The full implementation of the stability programme would nonetheless put debt on a decreasing path by 2027, keeping the debt ratio at below 10% of GDP from 2020 onwards and implicitly below the 60% of GDP reference value in 2027.

The medium-term fiscal sustainability risk indicator S1 stands at -3.7 pps. of GDP, primarily thanks to the low level of government debt contributing with -3.8 pp. of GDP, thus indicating low risks in the medium term. The full implementation of the stability programme would put the sustainability risk indicator S1 at -6.4 pps. of GDP, leading to even lower medium-term risk. Overall, risks to fiscal sustainability over the medium-term are low. Fully implementing the fiscal plans in the stability programme would further decrease those risks.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 0.9 pps. of GDP. In the long-term, Estonia therefore appears to face low fiscal sustainability risks. This is mainly thanks to the low projected ageing costs, in particular pension expenditure, which contributes -1.2 pps. of GDP. Full implementation of the stability programme would nonetheless put the S2 indicator at 0.1 pps. of GDP, leading to even lower long-term risk.

Estonia is implementing the Work Ability Reform, addressing the very high proportion of persons (10% of working age population) assessed as partially or fully incapable for work and receiving incapacity pensions. The reform will introduce a qualitative shift from evaluating incapacity for work to assessing the person's actual ability to work. Also, the provision of support and activation services is substantially improved. Although the reform is expected to bear costs, related to implementation costs in the short run and expanded services in the longer run, it is expected to further improve the long-term sustainability of public finances via a lower number of incapacity pension recipients and increased labour market participation.

Estonia has also previously taken some measures to improve the long-term sustainability of public finances, notably increasing the pension age from the current 63 to 65 years by 2026 and favouring second pillar pension savings. The adequacy of pensions (ratio of pensions to average wage) is currently relatively low compared to the EU average, leading to high relative poverty among the elderly. As the stability programme states, in the long term the benefit ratio would likely decline (since wage growth is set to outpace pensions growth), which might necessitate additional support to the pension system.

Table 5: Sustainability indicators

Time horizon			No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.2			
Fiscal subindex			0.0	LOW risk		
Financial & competitiveness subindex			0.4	LOW risk		
Medium Term			**LOW risk**			
DSA [2]			LOW risk			
S1 indicator [3]			-3.7	LOW risk	-6.4	LOW risk
of which						
	Initial Budgetary Position		0.0		-1.4	
	Debt Requirement		-3.8		-5.0	
	Cost of Ageing		0.0		0.0	
	of which					
		Pensions	-0.5		-0.3	
		Health-care	0.1		0.1	
		Long-term care	0.1		0.1	
		Other	0.3		0.1	
Long Term			**LOW risk**		**LOW risk**	
S2 indicator [4]			0.9		0.1	
of which						
	Initial Budgetary Position		0.8		0.1	
	Cost of Ageing		0.1		0.0	
	of which					
		Pensions	-1.2		-1.0	
		Health-care	0.4		0.3	
		Long-term care	0.4		0.4	
		Other	0.5		0.3	

Source: Commission services; 2017 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2017 forecast covering until 2018 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2016.

6. FISCAL FRAMEWORK

The 2016 budgetary outcome complied with the main national numerical fiscal rule, which requires that the structural budget position is in balance or in surplus, and which is directly referring to the MTO. The Estonian framework does not include a binding expenditure rule. The government has announced in its 2017 Stability Programme and in the national State Budget Strategy an intention to modify the current balanced budget rule and the corresponding legal proposal has been presented to Parliament on 4 May 2017. The proposed framework would allow for a structural deficit of up to 0.5% of GDP against the earlier build-up of structural surpluses. Over a longer period of time, a balanced budget in structural terms is meant to be maintained on average. The proposed modified structural balance rule is already reflected in the lower MTO, as described in the previous sections. Based on the information provided in the stability programme, the past fiscal performance in Estonia appears to comply with the requirements of the applicable national numerical fiscal rules, whereas the planned performance would comply with the modified numerical fiscal rule at face value. However, compliance with the modified rule is not ensured in 2018 and 2019 when using programme targets as recalculated by the Commission using the commonly agreed methodology.

The macroeconomic forecast underlying the stability programme was prepared by the Fiscal Policy Department in the Ministry of Finance of Estonia and was assessed by the Fiscal Council. The Council was set up in 2014 on the basis of the State Budget Act and is an independent advisory body charged with assessing the macroeconomic and fiscal forecasts of the Ministry of Finance and the extent to which the budget rules are followed. On 26 April 2017, the Fiscal Council published its opinion on the macroeconomic and fiscal forecasts underlying the stability programme, as well as the opinion on the planned structural budget position. It considered that the GDP and inflation forecast of Ministry of Finance are appropriate. However, it did not agree with the Ministry's assessment of the economic cycle, arguing the output gap is likely to be more positive than estimated by the Ministry, as illustrated by the strength of the labour market. Therefore, the Fiscal Council did not consider the additional fiscal stimulus as appropriate. In the opinion of the Fiscal Council, the structural deficit will be higher in 2018 than planned by the Ministry. The Fiscal Council also considered the tax revenue projection as overly optimistic in view of the large amount of new and sometimes complex tax changes, which added to the risk of some of the new tax measures underperforming relative to their expected yields.

Regarding the planned changes to the State Budget Law introducing the modified structural budget balance rule, the Fiscal Council drew attention that the law was modified only 3 years ago and that in order to maintain the credibility of fiscal rules they should not be changed so often. The Fiscal Council also noted in its assessment that the government's planned structural deficit of 0.5% of GDP was not in line with the State Budget Act currently in force. Similarly to the Commission assessment discussed above, the Fiscal Council's estimates that the structural budget deficit in 2018 could be larger than the -0.5% of GDP permitted by the proposed modified rule.

Estonia has implemented accrual-based budgeting as of 2017 and plans to increase the use of activity-based budgeting principles by 2020, all of which are aimed at improving the budgeting process. Estonia's medium-term fiscal planning is subject to some uncertainties due to its exclusive focus on the structural balance target and under-use of expenditure targets. Given that the Ministry's estimates of the cyclical position of the Estonian economy often deviate from the Commission's or Fiscal Council's assessment, compliance with the fiscal targets is difficult to assess and to ensure at the planning stage. As a technical issue, the

stability programme does not specify whether it also constitutes the national medium-term fiscal plan in the meaning of with Article 4(1) of regulation 473/2013.

7. SUMMARY

In 2016, Estonia achieved its MTO. The 2017 stability programme sets a new MTO, lowering it from a structural balance of zero to a deficit of 0.5% of GDP. Estonia plans to be above the new MTO in 2017 according to both the stability programme recalculated figures and figures at face value. This is also confirmed by the Commission forecast.

In 2018, Estonia plans a further weakening of the structural deficit to 0.5% of GDP (at the MTO) according to the stability programme figures at face value. The recalculated figures indicate a structural deficit of 0.9% of GDP, corresponding to a deterioration of 0.8% of GDP compared with the previous year. This implies a significant deviation of 0.6% of GDP from the adjustment path towards the MTO in 2018. Based on Commission 2017 spring forecast, the structural deficit is estimated to amount to 0.7% of GDP for 2018, deteriorating by 0.4% of GDP from the previous year and exceeding the allowed deterioration by 0.2% of GDP. Nevertheless, the expenditure benchmark is met in 2018 both according to the stability programme and the Commission forecast. Following an overall assessment, there a risk of some deviation from the adjustment path towards the MTO in 2018.

8. ANNEX

Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
Core indicators								
GDP growth rate	5.9	5.7	0.2	2.8	1.4	1.6	2.3	2.8
Output gap [1]	-0.4	8.1	-2.6	2.0	1.0	0.3	0.1	0.6
HICP (annual % change)	3.5	5.8	3.1	0.5	0.1	0.8	3.3	2.9
Domestic demand (annual % change) [2]	6.9	6.3	-0.4	2.5	0.7	2.6	3.3	2.4
Unemployment rate (% of labour force) [3]	12.1	6.8	12.2	7.4	6.2	6.8	7.7	8.6
Gross fixed capital formation (% of GDP)	28.6	33.8	25.3	24.4	23.7	22.0	23.2	22.4
Gross national saving (% of GDP)	22.6	23.9	25.5	26.9	25.3	24.2	24.2	23.6
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.2**	**1.3**	**-0.3**	**0.7**	**0.1**	**0.3**	**-0.3**	**-0.5**
Gross debt	**5.5**	**4.4**	**7.9**	**10.7**	**10.1**	**9.5**	**9.5**	**9.6**
Net financial assets	**31.3**	**29.8**	**32.2**	**30.7**	**42.1**	**n.a**	**n.a**	**n.a**
Total revenue	36.4	36.4	40.1	39.1	40.5	40.7	40.8	41.5
Total expenditure	36.6	35.1	40.4	38.5	40.4	40.4	41.1	42.0
of which: Interest	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-6.9**	**-6.4**	**2.6**	**-0.8**	**2.3**	**1.3**	**1.1**	**1.1**
Net financial assets; non-financial corporations	**-119.3**	**-152.0**	**-149.7**	**-150.9**	**-150.0**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-13.1**	**-7.9**	**4.0**	**2.6**	**1.3**	**n.a**	**n.a**	**n.a**
Gross capital formation	22.2	23.1	15.3	17.3	14.4	13.9	14.2	13.2
Gross operating surplus	30.2	31.9	30.6	31.5	28.2	26.1	25.9	25.4
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.8**	**-5.1**	**1.7**	**1.0**	**0.2**	**0.5**	**0.7**	**1.2**
Net financial assets	**47.6**	**51.9**	**52.2**	**70.9**	**66.0**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	34.1	35.6	35.6	34.7	36.9	38.0	37.9	37.6
Net property income	1.7	2.2	3.6	5.8	4.4	4.3	4.3	4.6
Current transfers received	17.9	14.6	17.5	16.1	16.5	16.9	17.1	17.3
Gross saving	1.8	0.0	5.5	5.3	5.0	5.6	5.8	6.3
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-8.1**	**-10.6**	**4.1**	**2.1**	**4.2**	**2.9**	**3.1**	**3.3**
Net financial assets	**53.4**	**78.3**	**61.4**	**46.6**	**40.8**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-5.5	-7.2	4.1	3.5	4.1	4.0	2.9	3.1
Net primary income from the rest of the world	-4.0	-5.1	-3.9	-2.7	-2.1	-2.0	-2.4	-2.2
Net capital transactions	0.4	1.2	3.4	1.1	2.0	0.9	2.0	2.1
Tradable sector	50.4	46.6	45.9	46.8	45.0	44.3	n.a	n.a
Non tradable sector	39.0	41.8	41.5	40.2	41.4	41.4	n.a	n.a
of which: Building and construction sector	5.4	8.1	6.0	5.5	5.4	5.1	n.a	n.a
Real effective exchange rate (index, 2000=100)	67.2	87.2	100.5	103.4	108.5	112.5	114.9	116.0
Terms of trade goods and services (index, 2000=100)	89.2	99.0	100.7	102.5	102.8	103.8	103.9	103.9
Market performance of exports (index, 2000=100)	75.8	89.9	108.1	119.0	113.4	113.7	113.8	113.6

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2017 spring forecast