EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 23 May 2018

Assessment of the 2018 Stability Programme for

Estonia

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION 3
2. MACROECONOMIC DEVELOPMENTS 3
3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS 5
3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018 5
3.2. MEDIUM-TERM STRATEGY AND TARGETS 6
3.3. MEASURES UNDERPINNING THE PROGRAMME 8
3.4. DEBT DEVELOPMENTS 8
3.5. RISK ASSESSMENT 10
4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT 11
5. FISCAL SUSTAINABILITY 13
6. FISCAL FRAMEWORK 16
7. SUMMARY 17
8. ANNEXES 18

1. INTRODUCTION

On 26 April 2018, Estonia submitted its 2018 Stability Programme, covering the period 2018-2022. The government approved the programme on 26 April at the same time as the national state budget strategy. It will be thereafter presented to some parliamentary committees for information.

Estonia is currently subject to the preventive arm of the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its medium-term budgetary objective (MTO). This document complements the Country Report published on 7 March 2018 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 2018 spring forecast. Section 3 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 17 April 2017 and prepared by the Ministry of Finance. It expects GDP to grow above potential in 2018 and slightly below thereafter. As such, growth is expected to come down from 4.9% in 2017 to 4% in 2018 and around 3% in 2019-2022 % (Table 1). Growth is supported by buoyant external demand, which is expected to result in strong export growth and a continued current account surplus. Private consumption growth is forecast to double in 2018 compared to 2017 mainly due to the personal income tax cut and to remain robust over the programme period. This GDP projection is higher compared to the 2018 Draft Budgetary Plan, presented in October 2017, which expected GDP to grow by 4.3% in 2017 and 3.3% in 2018[1]. In terms of composition, the latest forecast takes into account the better-than-expected outcomes for 2017 and is somewhat more optimistic about both foreign and domestic demand, as well as labour market developments. The forecast is broadly unchanged regarding inflation for 2018.

The Commission spring 2018 forecast expects slightly lower GDP growth in 2018 and 2019 than forecasted by the Ministry of Finance, at 3.7% and 2.8% respectively. The difference arises largely from the domestic side, as the Commission projects somewhat lower growth of private consumption, linked to a more conservative labour market outlook. The Commission forecast projects slightly lower employment and wage growth figures compared to the Ministry of finance. Still, overall both the macroeconomic scenario in the programme and in the Commission forecast expect the relatively strong employment growth to continue together with high participation in the labour market. Wage pressures remain strong due to a shrinking working age population and high demand for labour. Despite the tightening labour market,

[1] The 2017 Stability Programme expected GDP to grow by 2.4% in 2017 and 3.1% in 2018.

unemployment is still expected to increase somewhat as a result of the implementation of the Work Ability Reform, which brings previously inactive population into the labour force. Inflation projections do not differ much between the two forecasts, projecting inflation to abate to slightly below 3% in 2018, and to slow down further in 2019 taking into account announced slowdown of excise hikes.

The output gaps as recalculated by the Commission based on the information in the Programme, following the commonly agreed methodology, remain well in positive territory, 2.5% of GDP in 2018 and 2.2% in 2019, in line with the expectations of strong growth. This is higher compared to the output gaps presented at face value in the Stability Programme, which show a positive output gap of 1.6% and 1.3% in 2018 and 2019, respectively. The difference arises from potential growth estimates, as the Stability Programme projects a higher potential output compared to the Commission.

Overall, the macroeconomic assumptions underlying the Stability Programme are somewhat favourable for 2018, 2019 and for the outer years of the programme reflecting the higher potential growth estimates of the programme).

Table 1: Comparison of macroeconomic developments and forecasts

	2017		**2018**		**2019**		**2020**	**2021**	**2022**
	COM	**SP**	**COM**	**SP**	**COM**	**SP**	**SP**	**SP**	**SP**
Real GDP (% change)	4.9	4.9	3.7	4.0	2.8	3.2	3.0	2.9	2.9
Private consumption (% change)	2.2	2.0	3.8	4.7	2.7	3.3	3.0	2.7	2.7
Gross fixed capital formation (% change)	13.1	13.1	4.4	3.3	4.3	5.1	4.3	3.9	3.7
Exports of goods and services (% change)	2.9	2.9	4.2	4.5	4.0	4.2	4.0	3.8	3.8
Imports of goods and services (% change)	3.5	3.5	4.1	4.6	4.1	4.3	4.2	4.0	3.9
Contributions to real GDP growth:									
- Final domestic demand	4.2	4.2	3.3	3.4	2.6	3.1	2.7	2.5	2.5
- Change in inventories	-0.1	-0.2	0.2	0.3	0.0	-0.2	0.1	0.2	0.2
- Net exports	-0.4	-0.4	0.3	0.2	0.1	0.2	0.1	0.1	0.1
Output gap[1]	2.1	1.8	2.9	2.5	2.8	2.2	1.6	1.1	0.6
Employment (% change)	2.1	2.2	0.6	0.8	0.3	0.5	0.0	-0.3	-0.3
Unemployment rate (%)	5.8	5.8	6.0	5.8	6.3	6.2	6.3	6.5	6.8
Labour productivity (% change)	2.7	2.6	3.1	3.1	2.4	2.7	3.0	3.2	3.2
HICP inflation (%)	3.7	3.7	2.9	3.0	2.5	2.5	2.6	2.1	2.1
GDP deflator (% change)	4.0	4.0	3.5	3.5	3.0	3.0	2.7	2.5	2.5
Comp. of employees (per head, % change)	5.4	5.3	6.5	7.1	5.8	6.1	5.8	5.7	5.7
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	3.7	4.0	4.6	4.9	4.7	4.9	4.3	3.1	2.5

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 2018 spring forecast (COM); Stability Programme (SP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018

Estonia's general government recorded a deficit of 0.3% of GDP in 2017, which is worse than the balanced budget of 0.0% of GDP projected in the 2018 Draft Budgetary Plan. It is, however, better than the deficit target of 0.5% of GDP set in the 2017 Stability Programme (from April 2017). The difference with the previous Stability Programme arises mainly from better-than-expected labour tax income and lower social payments than planned due to better labour market outcomes. Partly offsetting this, excise taxes underperformed and investment expenditures were somewhat higher than expected.

For 2018, the Stability Programme plans a surplus of 0.2% of GDP. This is substantially better compared to the last Stability Programme of 2017 (which projected a deficit of 0.8% of GDP) and slightly above the 2018 Draft Budgetary Plan (which projected a deficit of 0.1% of GDP). As mentioned above, the Stability Programme is more optimistic regarding nominal GDP growth and wage growth (tax base) for 2018 than the Draft Budgetary Plan and the previous Stability Programme. In line with this, the better budgetary outlook for 2018 mainly results from higher revenues from labour taxes (social tax and personal income tax). On the negative side, the projection for excise tax revenues has been lowered substantially as consumers increasingly buy excise goods from abroad. Regarding expenditures, compared with the previous Stability Programme, social expenditure, intermediate consumption and investments have a slightly lower growth rate. The 2018 Stability Programme has significantly revised its assessment of the cyclical position of the economy, reflecting the upward revision of GDP for 2016 (from 1.6% to 2.1%), the better than expected economic outturn in 2017, and the more favourable economic outlook. While the 2017 Stability Programme, takent at a face value, estimated the output gap to be negative by 0.8% of GDP in 2017 and 0.4% of GDP in 2018, it now estimates a positive output gap of 0.9% of GDP in 2017, increasing to 1.6% of GDP in 2018. Overall, the more favourable cyclical position of the economy has markedly helped to improve the nominal budgetary position. The estimates of the structural position of the budget have also somewhat changed. The 2017 Stability Programme projected a structural surplus of 0.2% of GDP in 2017 turning to a deficit of 0.5% of GDP in 2018. The 2018 Stability Programme estimates that the structural position reached deficits of 0.3% of GDP in 2017 and 0.4% of GDP in 2018 (figures at face value).

The Commission spring 2018 forecast projects a slightly weaker near-term fiscal outlook, projecting a nominal budget balance of 0.0% of GDP in 2018 (see Table 2). The negative difference arises mainly from lower growth in income taxes (due to lower projected growth in tax bases and specifically lower revenue yield estimate from corporate income tax reform, as discussed in Section 3.3). Also, investment is projected to be higher in the Commission forecast.

Based on the Commission 2018 spring forecast, the structural balance is assessed to have declined to a deficit of 1.2% of GDP in 2017 and is set to further decline to 1.3% of GDP in 2018 (Table 2), below the MTO of a structural deficit of 0.5% of GDP. The difference with

the Stability Programme estimates arises from the estimates of the output gap and one-off measures[2].

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The main objective of the Estonian Stability Programme is to turn the nominal deficit of 0.3% of GDP in 2017 to a surplus of 0.5% of GDP in 2019, which according to the authorities would bring the structural position to balance over 2019-2022. This is considerably better than the structural deficit of 0.5% of GDP planned for 2018-2019 in the previous 2017 Stability Programme and the structural deficit of 0.3% of GDP planned for 2018 by the Draft Budgetary Plan in autumn 2017.

The programme maintains the MTO at a structural deficit of 0.5% of GDP, which reflects the objectives of the Pact. According to the programme figures at face value, the structural position is projected to stay at or above the MTO throughout the programme period. The recalculated structural balance is estimated to improve from a deficit of 0.8% of GDP in 2018 to a deficit of 0.4% of GDP in 2019, being in line with the MTO only in 2019 (see Table 2). The difference with the programme figures at face value largely arises from differing output gap estimates.

On the aggregate, no fiscal adjustment is planned on the expenditure side and the expenditure to GDP ratio is set to remain stable over 2018-2019 (see Table 2). The 2019 consolidation relies only on raising revenues. The programme's budgetary targets require the attainment of several non-tax revenue measures, some of which are still uncertain. Also, some of the measures have only an indirect budgetary impact and do not qualify as revenue measures in the sense of the EU fiscal surveillance rules (see Section 3.3. for details). Therefore, the Commissions 2018 spring forecast only included about half of the planned measures. As a result, the Commission forecasts a smaller headline surplus than the Stability Programme for 2019 (0.3% of GDP).

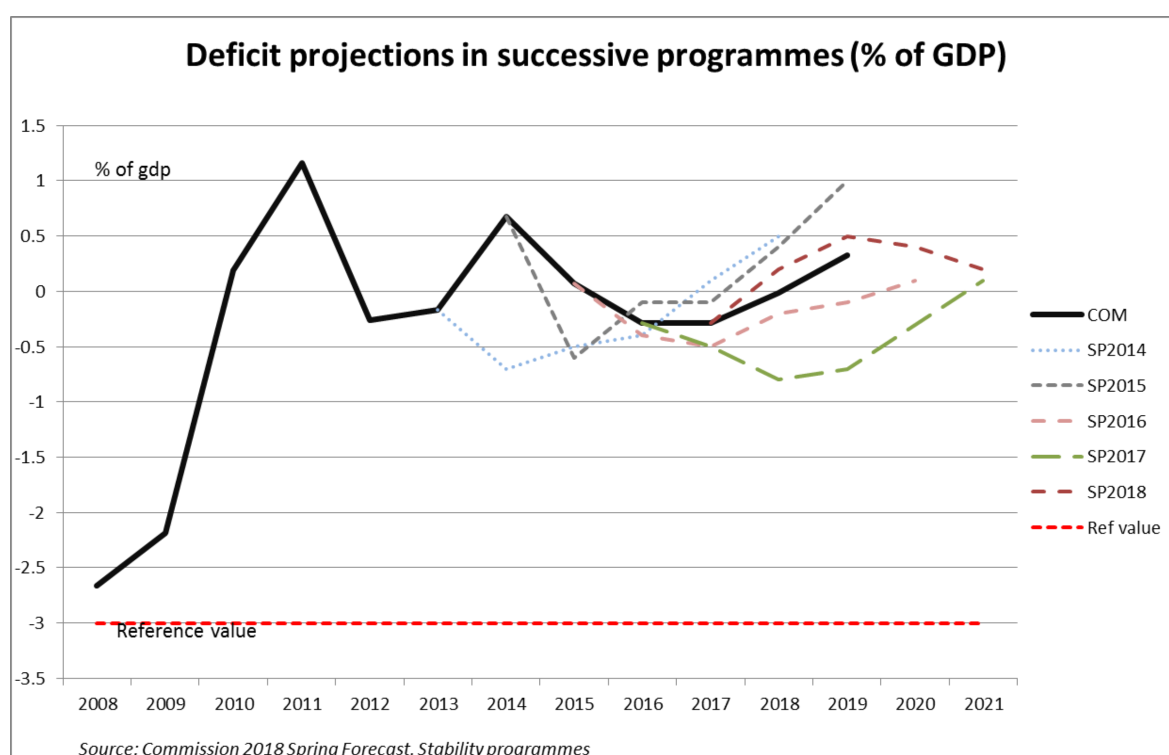
The Commission 2018 spring forecast expects a structural deficit of 0.9% of GDP in 2019. This is 0.5% of GDP lower than the recalculated Stability Programme figure, mainly reflecting differences in output gap estimates. Also, some of the one-off measures announced in the programme are not classified as one-offs according to the methodology used by the Commission.

[2] Some of the one-off measures announced in the programme are not classified as one-offs according to the methodology used by the Commission. This namely concerns a temporary increase in the second-pillar pension contributions in 2014-17 amounting to 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)	2017	2018		2019		2020	2021	2022	Change: 2017-2022
	COM	COM	SP	COM	SP	SP	SP	SP	SP
Revenue	**39.9**	**40.4**	**40.9**	**40.7**	**41.3**	**40.6**	**39.7**	**38.6**	**-1.3**
of which:									
									0.0
- Taxes on production and imports	14.6	14.7	14.5	14.9	14.8	14.5	14.4	14.1	-0.5
- Current taxes on income, wealth, etc.	7.4	7.4	7.7	7.3	7.5	7.5	7.7	7.8	0.4
- Social contributions	11.7	12.1	12.1	12.1	12.3	12.3	12.3	12.3	0.6
- Other (residual)	6.2	6.2	6.6	6.4	6.7	6.3	5.3	4.4	-1.8
Expenditure	**40.2**	**40.4**	**40.7**	**40.4**	**40.8**	**40.2**	**39.5**	**38.5**	**-1.7**
of which:									0.0
- Primary expenditure	40.2	40.4	40.7	40.3	40.8	40.2	39.5	38.5	-1.7
of which:									0.0
Compensation of employees	11.6	11.4	11.4	11.4	11.4	11.3	11.2	11.1	-0.5
Intermediate consumption	6.7	6.6	6.6	6.6	6.6	6.4	6.5	6.5	-0.2
Social payments	13.6	13.8	13.8	14.0	14.0	14.1	14.2	14.3	0.7
Subsidies	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.1
Gross fixed capital formation	5.6	5.9	5.7	5.7	5.5	5.4	5.4	5.2	-0.4
Other (residual)	2.1	2.2	2.7	2.2	2.1	1.7	1.1	0.6	-1.2
- Interest expenditure	0.0	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
General government balance (GGB)	**-0.3**	**0.0**	**0.2**	**0.3**	**0.5**	**0.4**	**0.2**	**0.1**	**0.4**
Primary balance	**-0.2**	**0.0**	**0.3**	**0.4**	**0.5**	**0.4**	**0.2**	**0.1**	**0.3**
One-off and other temporary measures	0.0	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0	0.3
GGB excl. one-offs	**-0.3**	**0.0**	**0.3**	**0.3**	**0.6**	**0.4**	**0.2**	**0.1**	**0.1**
Output gap1	2.1	2.9	2.5	2.8	2.2	1.6	1.1	0.6	-1.2
Cyclically-adjusted balance1	-1.2	-1.3	-0.9	-0.9	-0.5	-0.3	-0.3	-0.2	0.9
Structural balance (SB)2	**-1.2**	**-1.3**	**-0.8**	**-0.9**	**-0.4**	**-0.3**	**-0.3**	**-0.2**	**0.9**
Structural primary balance2	-1.2	-1.2	-0.8	-0.9	-0.4	-0.3	-0.3	-0.2	0.9

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 government in November 2016, when it took office. Most of those measures have already taken effect in 2018. Expenditure increasing programmes were largely in healthcare, education, social funding, in financing local governments and several investment programmes. The main revenue measures were a personal income tax cut for low- and medium-income earners. Its costs were planned to be covered by corporate income tax reform, excise rises for fuels, alcohol and tobacco, and a road usage fee. Some of the initially planned smaller revenue measures (like excise on packaging, tax on sweetened drinks, CO2 tax on personal cars) have currently been abandoned due to negative public perceptions of new taxes. The expected revenue yields of those past measures have been updated with the new Stability Programme for 2018 and beyond. Notably, the revenues expected from excise hikes have been lowered due to a significant increase in cross-border purchases of excise goods. Also, personal income tax reform costs are now expected to partly shift from 2018 to 2019[3].

The Stability Programme includes several revenue and expenditure side measures, largely taking effect from 2019 onwards. Expenditure-side measures are on aggregate deficit neutral, essentially composed of expenditure shifts, such as postponement of investments, offset by higher wage increases in priority areas. All of the consolidation in 2019 (0.65% of GDP) is planned to come from non-tax revenue increases. The largest measures are additional dividends from state owned enterprises (0.37% of GDP), revenues from the sale of 3.5 GHZ licences (0.06% of GDP), and some measures that only have an indirect budgetary impact, like increasing work permits for immigrants and programmes to renovate buildings (both together 0.13% of GDP). The latter do not qualify as revenue measures in the sense of the EU fiscal surveillance rules because they are taken with the primary aim of affecting another part of the economy and have only a very indirect impact on public finances. Also, given that the planned increase of dividends from SOEs is very large and subject to uncertainties, the Commission spring forecast included only a part of the planned revenues from this measure. On aggregate, the Commission's spring forecast includes about half of the new programmes revenue measures for 2019.

3.4. DEBT DEVELOPMENTS

Estonia's public debt declined to 9% of GDP in 2017, the lowest in the EU. It is forecast to decline further to 5.3% of GDP in the medium term according to the programme (Table 3). At the same time, liquid financial reserves of the general government sector amounted to 8.9% of GDP in 2017.

The Commissions projections also forecast a decline of public debt, abating to 8.3% of GDP by 2019. This is slightly less favourable than the projection of the programme, explained by a difference in the budget surplus forecast and technical assumptions about stock-flow trends linked to the interplay of reserves and debt obligations.

[3] The overall cost estimate has not changed, but appears now over 2 years due to higher expected tax returns in 2019. The new personal income tax system allows taxpayers effectively to choose their tax bracket beforehand. The actual income tax rate will be determined the next year based on annual income, leading to more adjustments with the tax returns than under the previous system. It is now assumed that more taxpayers have chosen conservatively to pay a higher income tax rate over 2018 and get a tax return next year, rather than pay less income tax over 2018 and face a potentially large tax claim.

Table 3: Debt developments

(% of GDP)	Average 2012-2016	2017	2018		2019		2020	2021	2022
			COM	SP	COM	SP	SP	SP	SP
Gross debt ratio[1]	**10.0**	**9.0**	**8.8**	**8.5**	**8.4**	**7.7**	**6.9**	**6.2**	**5.3**
Change in the ratio	0.7	-0.4	-0.2	-0.5	-0.4	-0.8	-0.8	-0.7	-0.9
Contributions [2] :									
1. Primary balance	**-0.1**	**0.2**	**0.0**	**-0.3**	**-0.4**	**-0.5**	**-0.4**	**-0.2**	**-0.1**
2. "Snow-ball" effect	**-0.3**	**-0.7**	**-0.6**	**-0.5**	**-0.4**	**-0.5**	**-0.4**	**-0.3**	**-0.3**
Of which:									
Interest expenditure	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Growth effect	-0.2	-0.4	-0.3	-0.3	-0.2	-0.3	-0.2	-0.2	-0.2
Inflation effect	-0.2	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.2	-0.1
3. Stock-flow adjustment	**1.1**	**0.1**	**0.4**	**0.4**	**0.4**	**0.2**	**0.0**	**-0.1**	**-0.5**
Of which:									
Cash/accruals diff.									
Acc. financial assets									
Privatisation									
Val. effect & residual									

Notes:

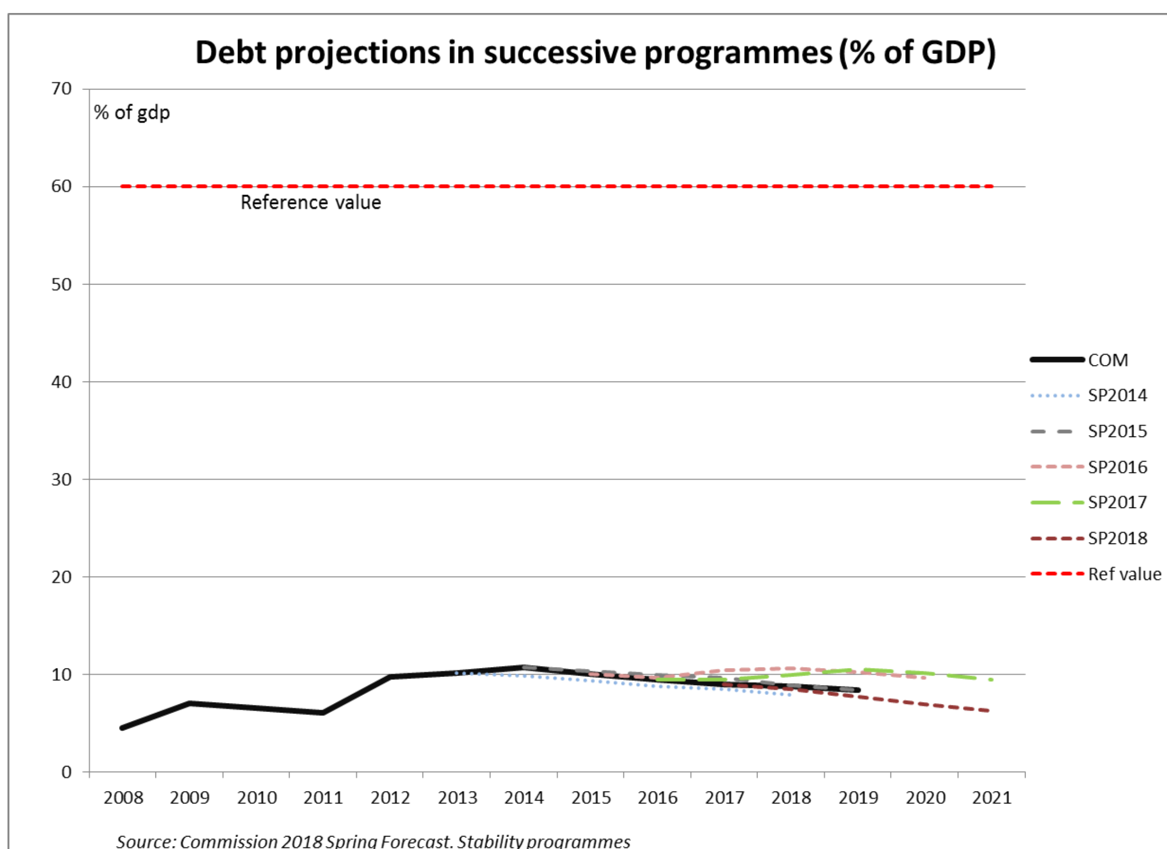
[1] End of period.

[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 2018 spring forecast (COM); Stability Programme (SP), Comission calculations.

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



3.5. RISK ASSESSMENT

Given that the Stability Programme is based on a somewhat favourable GDP growth scenario for the programme years, some risks relate to the expected evolution of tax bases. Mitigating this risk, the tax elasticities (revenue growth relative to tax base growth) appear to have been set relatively conservatively in the programme.

The revenue yield assumptions of some of the tax measures taking effect in 2018 are uncertain as well as the 2019 revenue measures of the most recent Stability Programme. Notably, substantial revenues are expected to accrue from a reform of the corporate tax system, which is designed to close some tax loopholes and motivate corporations 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 at this stage. Also, as mentioned in Section 3.3, some of the new programme's measures are not well specified. The Commission forecast has conservatively assumed somewhat smaller revenue increases from corporate income tax for 2018 and various other revenue measures.

Reflecting the lower yield estimates for some revenue measures, the Commission projects lower nominal budget surpluses than the Stability Programme. Also, the Commission expects a significantly larger positive output gap for 2018 and beyond than the programme, which suggest a weaker structural balance than presented in the programme.

In conclusion, there are some downside risks for 2018, 2019 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 the past years, nominal fiscal targets have often been outperformed (Figure 1).

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).

Box 1. Council Recommendations addressed to Estonia

On 11 July 2017, the Council addressed recommendations to Estonia in the context of the European Semester. In particular, in the area of public finances the Council recommended to Estonia to pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which entails remaining at its medium-term budgetary objective in 2018.

The Council noted that based on the Commission 2017 spring forecast, the structural balance is projected to register a deficit of 0,3 % of GDP in 2017, remaining above the medium-term budgetary objective. In 2018, Estonia is recommended to remain at the medium-term budgetary objective.

For 2017, the growth of government expenditure, net of discretionary revenue measures and one-offs, did not exceed the applicable expenditure benchmark. The structural deficit amounted to 1.2% of GDP in 2017, worse than previously expected and below the MTO. However, the worse than expected structural balance outturn was driven by the positive GDP growth surprise in 2017 and the subsequent reassessment of the output gap. This resulted in a downward level shift in structural balance figures for 2017 and the previous years. Nevertheless, the annual change in the structural balance in 2017 was appropriate compared to the required adjustment.[4] Therefore the ex-post assessment suggest that the adjustment path towards the MTO was appropriate.

For 2018, Estonia was recommended to remain at the medium-term budgetary objective. This is consistent with a maximum nominal growth rate of net primary government expenditure of 6.1%, corresponding to a structural adjustment of -0.2% of GDP[5]. 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

[4] The required change in structural balance for year t is "frozen" in Spring (based on the forecast availanble in Spring of year t-1) unless, based on a more recent forecast, the MS is considered to be in either exceptionally or very bad times, or is approaching the MTO such that delivery of the original requirement implies an over-achievement of the MTO.

[5] Following the Opinion of the Economic and Financial Committee of 29 November 2016 and the subsequent discussion and endorsement by the Committee, the "unfreezing" of the required adjustment for year t may only take place in two occasions: in autumn t-1, which in principle allows the change to be taken into account in the Member State’s budget for year t before it is finally adopted, and in spring t+1, at the time of the ex post assessment of compliance with the preventive arm.

benchmark[6] in 2018. Also, the recalculated structural deficit is set to improve by 0.3% of GDP, complying with the structural adjustment requirement for 2018 (see Table 6).

According to the Commission 2018 spring forecast, the growth of government expenditure, net of discretionary revenue measures and one-offs, in 2018 will exceed the applicable expenditure benchmark by 0.1% of GDP. The structural deficit moves further away from the MTO and is set to deteriorate by 0.1% of GDP, but it does not exceed the allowed deterioration (0.2% of GDP). The average deviation over 2017 and 2018 is within the requirements for both pillars. This calls for an overall assessment. The difference between the expenditure benchmark and structural balance indicators is largely explained by the different potential growth rates used in the two indicators. 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. Therefore, the expenditure benchmark provides an accurate assessment of Estonia's fiscal position. Following an overall assessment, some deviation from the adjustment path towards the MTO is to be expected in 2018.

In 2019, in view of Estonia's projected positive output gap of 2.8%, and with projected GDP growth below the estimated potential growth rate, the Stability and Growth Pact requires that the nominal growth rate of net primary government expenditure does not exceed 4.1%, corresponding to an annual structural adjustment of 0.6% of GDP. According to the information provided in the Stability Programme, the growth of government expenditure, net of discretionary revenue measures and one-offs, will significantly exceed the applicable expenditure benchmark in 2019 (gap of 0.8% of GDP). The recalculated structural deficit is set to improve by 0.4% of GDP, falling short of the required structural adjustment (gap of 0.2% of GDP). This calls for an overall assessment. Similarly to the assessment of 2018 (see above), the expenditure benchmark provides an accurate assessment of Estonia's fiscal position in 2019. At this point, the overall assessment of the Stability Programme suggests a risk of significant deviation from the requirements of the preventive arm in 2019.

In 2019, according to the Commission 2018 spring forecast, the growth of government expenditure, net of discretionary revenue measures and one-offs, will somewhat exceed the applicable expenditure benchmark (gap of 0.3% of GDP) [7]. This is confirmed by the deviation from the structural balance requirement by a similar gap. While the structural deficit is set to improve and move towards the MTO, it is not projected to improve sufficiently (gap of 0.2% of GDP). A gap also exists for both pillars when 2018 and 2019 are taken together. This calls for an overall assessment. All indicators point to some deviation from the adjustment path towards the MTO in 2019.

[6] As part of the agreement on the EFC Opinion on "*Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm*", which was adopted by the Economic and Financial Committee on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

[7] The programme projects a substantially higher deviation from the expenditure benchmark than the Commission, which is largely explained by the growth of 'other/residual expenditures' (visible in Table 2) well exceeding GDP growth, without offsetting EU funds or discretionary revenue measures.

Table 6: Compliance with the requirements under 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)	-1.2	-1.3		-0.9	
Structural balance based on freezing (COM)	-0.3	-1.3		-	
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	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Required adjustment[4]	Compliance	0.0		0.6	
Required adjustment corrected[5]		-0.2		0.6	
Change in structural balance[6]		0.3	-0.1	0.4	0.4
One-year deviation from the required adjustment [7]		0.5	0.1	-0.2	-0.2
Two-year average deviation from the required adjustment [7]		0.4	0.1	0.2	-0.1
Expenditure benchmark pillar					
Applicable reference rate[8]		6.1		4.1	
One-year deviation adjusted for one-offs[9]		0.5	-0.1	-0.8	-0.3
Two-year deviation adjusted for one-offs[9]		0.5	0.2	-0.2	-0.2
PER MEMORIAM: One-year deviation [10]		0.7	-0.1	-0.8	-0.3
PER MEMORIAM: Two-year average deviation [10]		0.7	0.2	-0.1	-0.2

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 2018 spring forecast (COM); Commission calculations.

5. FISCAL 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 2018 spring forecast and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 9% of GDP in 2017, is expected to decrease slightly to 7.7% by 2028, thus remaining well below the 60% of GDP Treaty threshold. Sensitivity analysis shows similar risks.[8] Overall, this highlights low risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would bring the debt ratio at about 5% of GDP in 2028.

The medium-term fiscal sustainability risk indicator S1 stands at -4.6 pps. of GDP, primarily thanks to the low level of government debt, which contributes -4 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 -6.6 pps. of GDP, leading to an even lower medium-term risk. Overall risks to fiscal sustainability over the medium-term are, therefore, 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) amounts to 0.6 pps. of GDP. In the long term, Estonia therefore appears to face low fiscal sustainability risks. This is mainly thanks to the projected decrease in ageing costs, in particular pension expenditure, which contributes -1.3 pps. of GDP. Full implementation of the Stability Programme would put the S2 indicator at 0.5 pps. of GDP, leading to similar long-term risk. However, 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. The risks to the pension system arising form the low adequacy are not reflected in the above figures.

Some further changes to the pension system are planned and are currently progressing in the legislative process: linking first pillar pension rights formula more to the length of career (rather than accumulated wage/taxes), link pension age to life expectancy, increase flexibility of pension age, and allow some categories of people to join the second pillar pension funds.

[8] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Debt Sustainability Monitor 2017 for more details).

Table 4: Sustainability indicators

Table 5 . Fiscal Sustainability Assessment
Estonia

Time horizon				Commission Scenario		Stability / Convergence Programme Scenario	
Short Term				**LOW risk**			
S0 indicator [1]				0.2			
	Fiscal subindex			0.1	LOW risk		
	Financial & competitiveness subindex			0.3	LOW risk		
Medium Term				**LOW risk**			
DSA [2]				LOW risk			
S1 indicator [3]				-4.6	LOW risk	-6.6	LOW risk
	of which						
		Initial Budgetary Position		0.0		-1.1	
		Debt Requirement		-4.0		-5.4	
		Cost of Ageing		-0.6		-0.1	
		of which					
			Pensions	-0.7		-0.3	
			Health-care	-0.1		0.0	
			Long-term care	0.1		0.0	
			Other	0.1		0.1	
Long Term				**LOW risk**		**LOW risk**	
S2 indicator [4]				0.6		0.5	
	of which						
		Initial Budgetary Position		1.0		0.3	
		Cost of Ageing		-0.4		0.2	
		of which					
			Pensions	-1.3		-0.8	
			Health-care	0.2		0.3	
			Long-term care	0.3		0.3	
			Other	0.3		0.3	

Source: Commission services; 2018 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2018 forecast covering until 2019 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 2018 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 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 for Commission 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 2017.

6. FISCAL FRAMEWORK

The government modified the domestic structural budget rule in 2017, allowing 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 modified structural balance rule was reflected in the lowering of the MTO in 2017 from 0.0% of GDP to -0.5% of GDP. The Estonian framework does not include a binding expenditure rule. 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.

Based on the information provided in the Stability Programme, the past, planned and forecast fiscal performance in Estonia appears to comply with the requirements of the applicable national numerical fiscal rule. However, compliance with the general government structural balance rule is not ensured 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, which is charged with assessing the macroeconomic and fiscal forecasts of the Ministry of Finance and the extent to which the national budget rules are followed. On 26 April 2018, the Fiscal Council published its opinion[9] on the macroeconomic and fiscal forecasts underlying the national budgetary strategy and the stability programme, as well as the opinion on the planned structural budget position. It endorsed the GDP and inflation forecast of Ministry of Finance, considering it plausible, with risks broadly balanced. However, the Council considered that in 2017 the general government budget position was in a larger structural deficit (0.7% of GDP) than estimated by the Ministry of Finance (0.3% of GDP) and in breach of the fiscal target set when the budget was drawn up in 2016 (which at the time required a balanced structural position). Looking ahead, the Fiscal Council finds that the targets presented in the programme for 2019 and beyond are in line with the domestic fiscal rules, at face value. The Council's own estimate of the output gap is similar to that of the Ministry of Finance for 2018 and 2019 and does not lead to major differences in the estimate of the cyclical component of the budget[10]. However, the Fiscal Council sees downside risks to the tax revenue outlook for 2018 and beyond, stemming from uncertainty due to various recent tax changes. It also finds that the measures underpinning the targets (largely from 2019 onwards) are not well specified. Overall, the Fiscal Council considers that the measures underpinning the targets are not sufficient to ensure that the national structural balance target is met from 2019 onwards.

The Stability Programme states that it also constitutes the national medium-term fiscal plan in the meaning of Article 4(1) of regulation 473/2013. It provides detailed information on planned investment projects over the programme horizon, but it does not specifically include indications on the expected economic returns on non-defence public investment projects that have a significant budgetary impact (as required by the abovementioned regulation).

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

[10] The Fiscal Council presents also alternative measures to estimate the output gap. Its 'heat map' estimate suggests a significantly higher positive output gap than the standard methodology.

7. SUMMARY

In 2017, Estonia's structural balance was is in line with the required adjustment towards the MTO. Also, the growth of government expenditure, net of discretionary revenue measures and one-offs, did not exceed the applicable expenditure benchmark. The ex-post assessment suggests that the adjustment path towards the MTO was appropriate.

In 2018, Estonia's Stability Programme plans a growth rate of government expenditure, net of discretionary revenue measures, which is in line with the applicable expenditure benchmark rate. The structural balance indicator also confirms that in 2018, the planned progress towards the MTO is appropriate. According to the Commission 2018 spring forecast, there is a risk of some deviation in 2018, based on the expenditure benchmark indicator, but not according to the structural balance indicator. An overall assessment concludes on the risk of some deviation in 2018.

In 2019, the Stability Programme plans a growth rate of government expenditure, net of discretionary revenue measures, which significantly exceeds the applicable expenditure benchmark. The structural balance indicator shows some deviation. Overall, the Stability Programme suggests a risk of significant deviation from the requirements of the preventive arm in 2019. According to the Commission 2018 spring forecast, both structural balance and expenditure benchmark indicated the risk of some deviation from the adjustment path towards the MTO. An overall assessment concludes on the risk of some deviation in 2019.

8. ANNEXES

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	7.3	1.4	3.8	1.7	2.1	4.9	3.7	2.8
Output gap [1]	1.6	5.4	-0.6	0.8	0.4	2.1	2.9	2.8
HICP (annual % change)	3.5	5.2	3.2	0.1	0.8	3.7	2.9	2.5
Domestic demand (annual % change) [2]	9.0	0.8	4.5	1.0	3.2	4.2	3.6	2.7
Unemployment rate (% of labour force) [3]	11.8	7.5	11.0	6.2	6.8	5.8	6.0	6.3
Gross fixed capital formation (% of GDP)	29.8	32.0	25.6	23.6	22.3	23.7	23.6	23.9
Gross national saving (% of GDP)	23.1	23.9	26.2	25.8	24.6	27.0	27.2	27.4
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**0.9**	**0.4**	**0.3**	**0.1**	**-0.3**	**-0.3**	**0.0**	**0.3**
Gross debt	**5.3**	**4.8**	**8.6**	**10.0**	**9.4**	**9.0**	**8.8**	**8.4**
Net financial assets	**29.8**	**29.2**	**32.5**	**41.7**	**40.3**	**n.a**	**n.a**	**n.a**
Total revenue	36.4	37.9	39.1	40.3	40.3	39.9	40.4	40.7
Total expenditure	35.4	37.5	38.8	40.2	40.6	40.2	40.4	40.4
of which: Interest	0.2	0.2	0.1	0.1	0.1	0.0	0.1	0.1
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-7.8**	**-4.1**	**1.5**	**0.5**	**-0.1**	**1.7**	**1.9**	**1.4**
Net financial assets; non-financial corporations	**-123.0**	**-155.7**	**-147.2**	**-154.9**	**-150.1**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-16.6**	**-2.2**	**4.8**	**3.2**	**2.8**	**n.a**	**n.a**	**n.a**
Gross capital formation	23.3	20.1	16.5	14.7	14.2	14.2	13.9	14.2
Gross operating surplus	31.0	30.4	31.5	28.2	26.6	27.9	27.8	27.6
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.0**	**-3.2**	**1.4**	**2.3**	**1.8**	**1.4**	**1.5**	**1.9**
Net financial assets	**49.5**	**51.6**	**55.2**	**70.2**	**70.2**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	34.0	36.3	35.3	37.1	37.8	37.3	37.1	37.2
Net property income	1.8	2.2	4.1	4.5	4.5	3.9	3.9	3.9
Current transfers received	17.1	15.4	17.0	17.2	17.5	17.0	17.1	17.2
Gross saving	0.7	1.8	5.5	6.9	6.7	6.6	6.8	7.3
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-9.3**	**-7.3**	**3.3**	**4.0**	**3.0**	**3.7**	**4.6**	**4.7**
Net financial assets	**60.3**	**77.2**	**54.7**	**39.8**	**36.9**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-6.2	-4.6	3.9	4.0	3.9	4.3	4.6	4.5
Net primary income from the rest of the world	-4.6	-4.7	-3.9	-2.1	-1.9	-2.0	-2.1	-2.0
Net capital transactions	0.5	1.8	2.9	2.1	1.1	0.8	1.6	1.8
Tradable sector	50.4	45.2	46.7	44.9	44.1	44.1	n.a	n.a
Non tradable sector	38.6	42.8	40.8	41.6	41.8	42.2	n.a	n.a
of which: Building and construction sector	5.7	8.1	5.9	5.4	5.2	5.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	69.4	93.2	100.9	108.7	112.5	115.4	119.6	121.5
Terms of trade goods and services (index, 2000=100)	91.6	100.3	100.6	102.5	103.4	104.8	105.1	105.1
Market performance of exports (index, 2000=100)	75.5	91.2	114.1	113.0	112.9	110.0	109.2	109.2

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 2018 spring forecast