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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 2020 on 15 October 2019 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 (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 2019 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 2019 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 2019-2020 (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 2019. 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 4.8% in 2018 and is projected to decelerate to 3.3% in 2019 and 2.3% in 2020, in line with the weakening external environment and lower electricity production from oil shale due to the increased CO2 quota price.

The growth forecast for 2019 has been revised upwards (by 0.2 percentage points) compared with the Stability Programme presented in spring 2019, reflecting stronger-than-expected GDP growth in the first half of 2019. In contrast, growth for 2020 has been revised downwards (by 0.5 percentage points), due to a weaker external and domestic outlook. Reflecting the extended period of economic good times, the output gap is estimated to be positive, but closing rapidly from 2.6% of potential GDP in 2019 to 1.5% in 2020[1].

According to the Draft Budgetary Plan, domestic demand is expected to remain the main growth driver in 2019 and 2020. The unemployment rate is projected to increase slightly in 2020. In spite of the slowing economy, wage pressures remain substantial due to a tight labour market, in a setting of a decreasing population at working age. Harmonised Index of

[1] Draft Budgetary Plan figures at face value

Consumer Prices inflation is projected to slow in 2019 and 2020 to slightly above 2%, assuming lower global energy prices.

This scenario is broadly in line with the Commission 2019 autumn forecast, which expects slightly lower real GDP growth for 2019 and 2020 of 3.2% and 2.1% respectively. Projections for price increases and for GDP deflator for both 2019 and 2020 are similar. The Commission forecast foresees slightly weaker employment and wage growth for 2019 and 2020. Overall, the Draft Budgetary Plan's outlook is based on plausible macroeconomic assumptions.

Box 1: The macro economic 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 26 September 2019, the Fiscal Council published an opinion on its website on the macroeconomic and fiscal forecasts of the Ministry of Finance. The Fiscal Council's opinion is also summarised in the Draft Budgetary Plan. The Fiscal Council considers that the Ministry's macroeconomic forecast for 2019 and 2020 is in line with the changes in the Estonian economy and with the assumptions used in the forecast. Nevetheless, the Fiscal Council highlights external global risks that may lead to Estonian economic growth being slower than projected.

The Fiscal Council also considers that tax revenue forecast is broadly in line with expected economic developments but notes that expenditure projections are not sufficiently explained. Coupled with the macroeconomic risks, this could lead, in the Council's opinion, to a weaker fiscal outcome. The Council moreover notes that the general government fiscal position has been in a structural deficit since 2016, throughout the peak of the economic cycle. The Fiscal Council finds that this is not a suitable fiscal policy and recommends that the government improves the fiscal balance substantially in the years ahead.

Table 1. Comparison of macroeconomic developments and forecasts

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	4.8	3.1	3.3	3.2	2.7	2.2	2.1
Private consumption (% change)	4.3	4.7	3.6	3.4	2.9	2.8	3.0
Gross fixed capital formation (% change)	1.7	5.1	11.0	9.0	4.0	1.5	2.1
Exports of goods and services (% change)	4.3	3.2	3.4	2.6	3.0	2.4	1.9
Imports of goods and services (% change)	5.7	3.8	4.4	3.4	2.9	2.1	2.1
Contributions to real GDP growth:							
- Final domestic demand	2.7	3.6		4.0	2.5		2.2
- Change in inventories	0.9	-0.3	4.7	-0.3	0.0	1.8	0.0
- Net exports	-0.8	-0.3	0.0	-0.5	0.2	0.0	0.0
Output gap[1]	3.4	2.9	2.8	2.9	2.6	1.4	1.5
Employment (% change)	1.2	0.9	1.0	0.7	0.0	0.1	0.0
Unemployment rate (%)	5.4	5.6	5.0	5.1	5.7	5.2	5.4
Labour productivity (% change)	3.5	2.3	2.3	2.5	3.0	2.0	2.1
HICP inflation (%)	3.4	2.2	2.2	2.4	2.3	2.3	2.1
GDP deflator (% change)	4.5	2.8	3.4	3.4	2.7	2.8	3.0
Comp. of employees (per head, % change)	10.2	7.0	8.3	7.3	5.3	5.8	5.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	3.4	2.7	2.4	2.7	2.8	2.9	2.9

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 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 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 0.6% of GDP in 2018 to 0.1% of GDP in 2019 (Table 2). The projection for 2019 shows a slight improvement compared to the 2019 Stability Programme by 0.1 percentage points. This improvement arises mainly from slightly lower expenditures. The comparison of the Draft Budgetary Plan figures with the spring 2019 Stability Programme (Table 2, expressed as a share of GDP) is significantly impacted by the recent large upward revision of the nominal GDP level (denominator effect) for 2018.

In 2020, the general government is projected to reach a balanced budget. This is an improvement compared to the Stability Programme target of -0.3% of GDP. The improvement is linked to lower expenditure growth in 2020 (in part investments).

In August 2019, following a methodological revision of GDP data, the Estonian Statistics Office revised Estonia's historic GDP data significantly upwards for 1995-2018. As a result, the output gap estimate has now also been revised upwards (from 1.6% and 1.1% of potential GDP in the Stability Programme for 2019 and 2020 respectively, to 2.6% and 1.5% in the Draft Budgetary Plan). This in turn results in more stringent estimate of the structural position

of the budget. The recalculated[2] structural balance is estimated to amount to a deficit of 1.3% of GDP in 2019 and of 0.6% of GDP in 2020[3]. Overall, the government targets a consolidation in 2019 and 2020, as is indicated by the change in the (recalculated) structural balance.

The Commission 2019 autumn forecast projects a headline deficit of 0.2% of GDP in both 2019 and in 2020 (see Table 2). The Commission deficit forecast is marginally below the Draft Budgetary Plan projections, because the Commission forecasts weaker macroeconomic and labour market developments[4]. The slightly worse nominal balance and a somewhat different assessment of one-off measures result in lower structural balance projections for 2019 and 2020 in the Commission forecast, of -1.6% and -0.9% of GDP respectively.

Overall, the risks associated with the Draft Budgetary Plan fiscal targets can be considered as tilting to 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.

Table 2. Composition of the budgetary adjustment

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

[3] The targets of the Draft Budgetary Plan at face value, as published by the national authorities, indicate a structural balance of -1.2% of GDP in 2019 and -0.7% of GDP in 2020.

[4] The difference in revenue and expenditure ratios is also explained by assumptions about absorption of EU funds and related investments, which are broadly deficit neutral (affecting both the revenue and expenditure side).

(% of GDP)	2018		2019			2020			Change: 2018-2020
	COM	DBP	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**38.5**	**38.5**	**40.0**	***39.3***	**39.0**	**39.5**	***39.5***	**39.1**	**1.0**
of which:									
- Taxes on production and imports	13.7	13.7	14.3	*14.0*	13.9	14.0	*13.9*	13.8	0.2
- Current taxes on income, wealth,	7.4	7.4	7.3	*7.3*	7.2	7.3	*7.3*	7.2	-0.1
- Capital taxes	0.0	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.7	11.7	12.1	*11.9*	11.9	12.0	*12.0*	12.0	0.3
- Other (residual)	5.7	5.7	6.3	*6.1*	5.9	6.2	*6.3*	6.1	0.6
Expenditure	**39.1**	**39.1**	**40.2**	**39.4**	**39.2**	**39.7**	**39.6**	**39.3**	**0.5**
of which:									
- Primary expenditure	39.1	39.1	40.2	39.4	39.2	39.7	39.6	39.3	0.5
of which:									
Compensation of employees	11.3	11.3	11.2	11.3	11.3	11.0	11.4	11.3	0.1
Intermediate consumption	6.4	6.4	6.4	6.3	6.3	6.3	6.2	6.2	-0.2
Social payments	13.4	13.4	13.6	13.4	13.4	13.8	13.8	13.8	0.4
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.0
Gross fixed capital formation	5.3	5.3	5.9	5.7	5.4	5.7	5.6	5.2	0.3
Other (residual)	2.4	2.4	2.7	2.3	2.4	2.5	2.2	2.4	-0.2
- Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
General government balance (GGB)	**-0.6**	**-0.6**	**-0.2**	**-0.1**	**-0.2**	**-0.3**	**0.0**	**-0.2**	**0.6**
Primary balance	**-0.5**	**-0.5**	**-0.2**	**0.0**	**-0.2**	**-0.2**	**0.0**	**-0.1**	**0.5**
One-off and other temporary measures	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-0.6**	**-0.6**	**-0.1**	**0.0**	**-0.2**	**-0.3**	**0.0**	**-0.2**	**0.6**
Output gap[1]	3.4	3.6	2.9	2.8	2.9	2.6	1.4	1.5	-2.2
Cyclically-adjusted balance[1]	-2.2	-2.3	-1.6	-1.5	-1.6	-1.6	-0.7	-0.9	1.5
Structural balance (SB)[2]	**-2.2**	**-2.3**	**-1.5**	**-1.4**	**-1.6**	**-1.6**	**-0.7**	**-0.9**	**1.5**
Structural primary balance[2]	-2.2	-2.3	-1.5	-1.4	-1.6	-1.6	-0.7	-0.9	1.4

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 corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.2. Debt developments

According to the Draft Budgetary Plan, general government gross debt is projected to decrease from 8.8% of GDP in 2019 to 8.0% of GDP in 2020. The Commission 2019 autumn forecast projects a slightly higher debt ratio for 2020, at 8.4% of GDP. The difference between the two projections is mainly explained by the different assumptions about the stock-flow adjustment (see Table 3).

Table 3. Debt developments

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**8.4**	**8.2**	**8.8**	**8.7**	**8.1**	**8.0**	**8.4**
Change in the ratio	-1.0	-0.2	0.4	0.3	-0.1	-0.8	-0.3
Contributions[2]:							
1. Primary balance	**0.5**	**0.2**	**0.0**	**0.2**	**0.2**	**0.0**	**0.1**
2. "Snow-ball" effect	**-0.8**	**-0.5**	**-0.4**	**-0.5**	**-0.3**	**-0.4**	**-0.4**
Of which:							
Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth effect	-0.4	-0.2	-0.3	-0.3	-0.2	-0.2	-0.2
Inflation effect	-0.4	-0.2	-0.3	-0.3	-0.2	-0.2	-0.2
3. Stock-flow adjustment	**-0.7**	**0.1**	**0.9**	**0.6**	**0.0**	**-0.4**	**0.0**
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 effects.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan details only those new measures that were taken after the 2019 Stability Programme. According to the authorities, these new measures have a net deficit-decreasing effect of 0.2% of GDP in 2019, and a deficit-increasing effect of 0.2% of GDP in 2020. Most of the measures for 2020 concern relatively small revenue or expenditure items and were taken specifically in the context of the 2020 budget negotiations. The largest positive fiscal effect comes from dividend revenue from State-owned companies and the negative fiscal effect from limited expenditure increases for wages in some public sector priority areas, operating expenses, some specific investments and a small rise of pensions in addition to indexation.

Some substantial measures took effect with the previous Stability Programme or the 2019 Draft Budgetary Plan and still have a significant budgetary impact for 2019 and to a smaller extent for 2020. The main measures affecting 2019-2020 are a personal income tax cut for low- and medium-income earners, corporate income tax reform, excise rate changes for fuels, alcohol and tobacco, sale of CO_2 quotas, shifting dividend revenue from state-owned companies from 2019 to 2020, and a number of other smaller measures. On aggregate, the Draft Budgetary Plan expects these measures to raise revenues by 0.7% of GDP in 2019 and by 0.4% of GDP in 2020. While the Commission forecast also includes the above measures into the revenue projection, some of the measures do not qualify as 'discretionary revenue

measures' in the sense of the EU fiscal surveillance rules because they either have only an indirect second-round impact on public finances or they cannot be factually considered as discretionary for the government (for example fluctuations in the CO_2 quota price). Therefore, the Commission assesses that the 'discretionary revenue measures' are smaller for 2019 and 2020, which impacts the calculation of the expenditure benchmark, discussed in the next Section.

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)	
	2019	**2020**
Taxes on production and imports	0.0	0.0
Current taxes on income, wealth, etc.	0.0	0.0
Capital taxes		
Social contributions		
Property Income	0.0	0.1
Other	0.0	0.0
Total	**0.1**	**0.1**

Note:

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

Source:

Draft Budgetary Plan (DRM) for 2020

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2019	**2020**
Compensation of employees	0.0	0.4
Intermediate consumption	-0.1	0.0
Social payments	0.0	0.1
Interest Expenditure		
Subsidies		
Gross fixed capital formation	0.0	0.1
Capital transfers	0.0	-0.2
Other		
Total	**-0.1**	**0.3**

Note:

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

Source:

Draft Budgetary Plan (DRM) for 2020

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 medium-term budgetary objective [5].

Box 2. Council Recommendations[6] addressed to Estonia

On 9 July 2019, 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 2020, corresponding to an annual structural adjustment of 0.6% of GDP.

The Council noted that under unchanged policies, there is a risk of significant deviation from the medium-term budgetary objective in 2019 and 2020.

In 2019, 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 over one year. Also, the recalculated structural deficit is set to improve by 0.9% of GDP, complying with the structural adjustment requirement for 2019 (see Table 6). The average deviation over 2018 and 2019 confirms compliance with the structural balance pillar, but indicates a risk some deviation from the expenditure benchmark (gap of 0.1% of GDP).

[5] Estonia's medium-term budgetary objective is a structural deficit of 0.5% of GDP.
[6] OJ C 301, 5.9.2019 p. 30
https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1572857755673&uri=CELEX:32019H0905(06)

The overall assessment, giving priority to the expenditure benchmark, indicates a risk of some deviation over 2018 and 2019 taken together.

According to the Commission 2019 autumn forecast, the growth of government expenditure net of discretionary revenue measures and one-offs shows some deviation from the applicable expenditure benchmark in 2019 (gap of 0.4% of GDP). At the same time, the structural balance is estimated to improve by 0.6% of GDP, above the structural adjustment requirement for 2019. The average deviation over 2018 and 2019 confirms compliance with the structural balance pillar, but indicates significant deviation from the expenditure benchmark (gap of 0.5% of GDP). The deviation in the expenditure benchmark pillar calls for an overall assessment. The large difference between the expenditure benchmark and structural balance indicators is notably explained by the GDP deflator[7] effect. The latest assessment of the Stability Programme of Estonia[8] discounted the effect of the GDP deflator on the expenditure benchmark for 2018. The GDP deflator underlying the expenditure benchmark was frozen based on the projection of the Commission's previous years' spring forecast. At that time, the forecast expected lower price and wage pressures than materialised in reality[9]. The higher than expected price and wage increases contributed to tax revenues, but also led to increased cost pressures for public expenditures. After adjusting for the GDP deflator effect for 2018 and 2019, the expenditure benchmark points to some deviation for both one year and the two year average.

Giving priority to the expenditure benchmark, the overall assessment indicates a risk of some deviation from the requirements of the preventive arm of the Pact in 2019.

In 2020, according to the Draft Budgetary Plan, 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). The recalculated structural deficit is set to improve by 0.7% of GDP, complying with the structural adjustment requirement for 2020. The average deviation over 2019 and 2020 confirms compliance with the structural balance pillar, and indicates compliance with the expenditure benchmark. An overall assessment, giving priority to the expenditure benchmark, indicates a risk of some deviation from the adjustment path towards the medium-term budgetary objective in 2020.

According to the Commission 2019 autumn forecast, the growth of government expenditure net of discretionary revenue measures and one-offs shows some deviation from the applicable expenditure benchmark in 2020 (gap of 0.4% of GDP). At the same time, the structural balance is estimated to improve by 0.6% of GDP, slightly above the structural adjustment requirement for 2020. The average deviation over 2019 and 2020 confirms compliance with the structural balance pillar, but indicates significant deviation from the expenditure benchmark (gap of 0.4% of GDP). The difference between the expenditure benchmark and structural balance indicators is notably explained by the smoothing of capital expenditure[10].

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[7] The expenditure benchmark uses a lower GDP deflator in its computation than the structural balance indicator. The GDP deflator underlying the expenditure benchmark was frozen based on the projection of the Commission previous years' spring forecast.

[8] https://ec.europa.eu/info/sites/info/files/economy-finance/06_ee_sp_assessment_0.pdf

[9] GDP deflator was forecast to grow by 3.3% in 2018, outturn was 4.5%. Notably, government consumption deflator (one component of the GDP deflator) turned out significantly higher in 2018 than initially forecast (outturn 7.2%, forecast 5.7%). For 2019, the GDP deflator forecast has also been revised upwards from 3% to 3.4%.

[10] Expenditure growth computation uses 4-year average capital expenditure growth (t-4), rather than current year capital expenditure. The investment programme of the previous government, which contributed to an investment

The smoothing of capital expenditure overstates the annual expenditure increase in 2020, given that it captures an extraordinary peak in state- funded investments over the previous years. Once adjusted for the smoothing of capital expenditure, the expenditure benchmark points to some deviation for both one year and the two year average.

An overall assessment, giving priority to the expenditure benchmark, indicates a risk of some deviation from the requirements of the preventive arm of the Pact 2020.

peak over the past years, therefore influences the average. Estonia's public sector investment to GDP ratio is one of the highest in the EU and is projected to remain so in 2020 after the return to levels observed prior to the national investment programme.

Table 5. Compliance with the requirements of the preventive arm

(% of GDP)	2018	2019		2020	
Initial position[1]					
Medium-term budgetary objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	-2.2	-1.6		-0.9	
Structural balance based on freezing (COM)	-0.8	-1.6		-	
Position vis-a -vis the MTO[3]	At or above the MTO	Not at MTO		Not at MTO	
	2018	**2019**		**2020**	
(% of GDP)	**COM**	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.3		0.6	
Required adjustment corrected[5]	-0.2	0.3		0.6	
Change in structural balance[6]	-0.5	0.9	0.6	0.7	0.7
One-year deviation from the required adjustment[7]	-0.3	0.6	0.3	0.1	0.1
adjustment[7]	0.0	0.2	0.0	0.4	0.2
Expenditure benchmark pillar					
Applicable reference rate[8]	6.1	4.9		4.1	
One-year deviation adjusted for one-offs[9]	-0.7	0.5	-0.4	-0.3	-0.4
Two-year average deviation adjusted for one-offs[9]	-0.1	-0.1	-0.5	0.1	-0.4

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 is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance corresponds to 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 ed. 2018, 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 2018 was carried out on the basis of Commission 2019 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 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.

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

The Draft Budgetary Plan foresees that the revenue and expenditure ratios to GDP will increase by 0.2 percentage points of GDP from 2019 to 2020. This revenue increase is explained by policy measures related to labour taxes and non-tax revenues. Expenditure increases are mainly driven by social payments, while the investment ratio is set to slightly decline from a relatively high level.

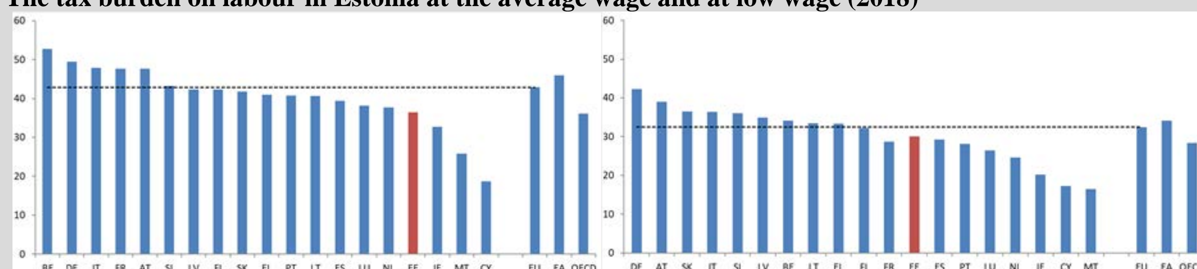
Estonia's tax system is relatively growth-friendly, with indirect taxes above the EU-28 average and labour taxes below the average. The recent 2018 tax reforms (see Box 3) further increased indirect taxation while lowering labour taxation. Estonia performs well in terms of tax administration efficiency.

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 (2018)



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 2019 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 noticeable 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 as of 2018. 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 has reduced the tax-wedge on low- to medium-income earners. Estonias' 2020 Draft Budgetary Plan does not include any additional measures that affect the tax wedge on labour.

6. Overall conclusion

In 2019 and 2020, Estonia is at risk of some deviation from the requirements of the preventive arm of the Stability and Growth Pact based on an overall assessment according to the information provided in the Draft Budgetary Plan and the Commission 2019 autumn forecast.