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Assessment of the 2015 Stability Programme for

ESTONIA

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

This document assesses Estonia's Stability Programme (hereafter called Stability Programme), which was submitted to the Commission on 14 May 2015 and covers the period 2014-2019. The incoming government did not submit a Stability Programme by the required deadline of 30 April. The programme was approved by the government and will be presented to the national parliament (Riigikogu) for a debate without a vote.

As the programme was submitted after the end of April deadline set by the Regulation because of intensive budgetary discussions within the incoming government after the March 2015 general elections, the fiscal measures and other information included in it could not be taken into account in the Commission 2015 spring forecast published on May 5, which is the basis for this assessment. The numerical tables in the current report reflect the original spring forecast figures, but the overall assessment of compliance with the MTO also takes into account the new fiscal measures.

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

This document complements the [Country Report](#) published on 26 February 2015 and updates it with the information included in the Stability Programme. Section 2 of this document presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2015 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 risks analysis of the budgetary plans based on Commission forecast. Section 4 assesses the compliance against the obligations stemming from the Stability and Growth Pact, including a risk analysis based on the Commission 2015 spring forecast. Section 5 gives an overview on long term sustainability and section 6 focuses on fiscal framework and quality of public finances issues. Finally, section 7 summarises the main conclusions of the present document.

2. MACROECONOMIC OUTLOOK

The national macroeconomic forecast, which is incorporated in the 2015 Stability Programme, was published on 13 April 2015¹. The macroeconomic scenario of the programme does not include the impact of fiscal measures presented in the programme. Economic growth is expected to remain moderate at around 2% in 2015 (Table 1). Supported by a progressive recovery of Estonia's main trading partners, economic growth is projected to rise to 2.8% in 2016 and to peak at 3.4% in 2017.

The forecast for 2015 and 2016 has been revised downwards compared with the 2015 Draft Budgetary Plan presented in autumn 2014. The main reason for the revision is a more negative external demand outlook. According to the forecast, domestic demand remains the

¹ The external assumptions underlying the macroeconomic scenario were fixed in end-February and are marginally less optimistic than in the Commission 2015 spring forecast. The macroeconomic forecast does not take into account the effect of the fiscal measures introduced by the 2015 Stability Programme.

main growth driver in 2015, private consumption in particular, while export developments are projected to outpace domestic demand growth as of 2016.

The unemployment rate has continued to fall substantially since 2011 and is projected in the Stability Programme to be around 6% in 2015 and 2016. Wage pressures remain strong due to a shrinking working age population, and the historically high employment rate. Annual HICP inflation is forecast to increase from 0.5% in 2014 to 0.8% in 2015 and 2.2% in 2016. The current low inflation is mainly driven by external factors, while wage pressures and excise rate hikes are foreseen to push inflation up in 2016-2017.

The output gaps as recalculated by Commission based on the information in the programme, following the commonly agreed methodology, are positive at over 1% of potential GDP in 2014, but decline to around zero over 2015-2016, given that GDP growth is expected to remain below potential. The output gaps at face value as presented in the programme itself are significantly more negative than to the programme's recalculated output gaps. The difference is caused by a more pronounced negative effect of the crisis according to the approach taken in the programme, resulting in a negative output gap at around 1% of potential GDP in 2014-2016 as mentioned in the programme.

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018	2019
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	2.1	2.1	2.3	2.0	2.9	2.8	3.4	3.2	3.0
Private consumption (% change)	4.6	4.5	4.8	4.8	4.3	2.8	2.4	2.6	2.8
Gross fixed capital formation (% change)	-2.8	-2.8	1.0	2.7	3.2	3.6	4.7	5.3	5.4
Exports of goods and services (% change)	2.6	2.6	2.2	2.8	4.5	4.0	5.2	5.7	5.7
Imports of goods and services (% change)	2.7	2.7	3.4	4.0	5.3	4.2	4.7	5.7	6.1
<i>Contributions to real GDP growth:</i>									
- Final domestic demand	2.1	2.1	3.2	3.4	3.5	2.7	2.7	3.0	3.1
- Change in inventories	2.6	2.5	0.0	-0.6	0.0	0.2	0.1	0.1	0.1
- Net exports	0.0	0.0	-0.9	-0.9	-0.5	-0.1	0.5	0.1	-0.3
Output gap ¹	1.3	1.4	1.0	0.3	1.3	0.0	0.4	0.7	0.7
Employment (% change)	0.8	0.6	0.6	0.6	-0.3	-0.3	-0.5	-0.5	-0.6
Unemployment rate (%)	7.4	7.4	6.2	6.1	5.8	5.8	5.5	5.5	5.5
Labour productivity (% change)	1.3	1.5	1.6	1.3	3.2	3.1	3.9	3.7	3.7
HICP inflation (%)	0.5	0.5	0.2	0.8	1.9	2.6	3.0	3.2	2.8
GDP deflator (% change)	2.1	2.1	1.7	2.0	2.8	2.6	2.9	3.0	2.7
Comp. of employees (per head, % change)	7.8	5.6	5.1	4.8	5.7	5.2	6.0	6.5	6.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.8	0.6	0.5	1.7	0.2	1.0	1.5	1.2	0.6
Note:									
¹ In percent of potential GDP, with potential GDP growth recalculated by the Commission on the basis of the programme scenario, using the commonly agreed methodology.									
Source :									
Commission 2015 spring forecast (COM); Stability Programme (SP).									

The macroeconomic assumptions underlying the Stability Programme are plausible. The programme is slightly less optimistic than the Commission 2015 spring forecast concerning real GDP growth both in 2015 and 2016. In 2015, the lower GDP growth in the programme is mainly due to a 0.6 pp of GDP fall in inventories while the Commission assumes no changes in this item. In 2016, the difference is caused by a lower expected growth of private consumption (2.8% vs. 4.3% in the Commission forecast) stemming from more conservative households' saving developments. The Commission macroeconomic forecast was not updated following the receipt of the programme.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014

Estonia's general government budget reached a surplus of 0.6% of GDP in 2014. This is substantially better than the 0.7% of GDP deficit target set in the Stability Programme in spring 2014 and the 0.3% of GDP deficit projected in the 2015 Draft Budgetary Plan (Table 2). The over-performance was mainly due to higher tax revenue as a result of the fight against fraudulent tax schemes and introduction of the tax-enhancing measures, as well as higher corporate income tax revenue². The budgetary outcome was also positively affected by lower-than-planned social transfers (mainly unemployment benefits), delayed public investment projects and by the postponement of one-off investment projects from 2014 to 2015, financed from CO₂ quota sales revenue. Roughly 50% of the over-performance was originating from the revenue side.

Based on the Commission 2015 spring forecast, the structural balance is assessed to have improved by 0.9% of GDP to a surplus of 0.2% of GDP in 2014. Estonia achieved its medium-term objective (a structural balance) in 2014 after deviating from it in 2012-2013.

3.2. Target for 2015 and medium-term strategy

The target for 2015

The 2015 headline deficit target is set in the Stability Programme at 0.6% of GDP, compared with a deficit of 0.5% of GDP targeted in the Draft Budgetary Plan and the 2014 Stability Programme. This slightly lower target results from a combination of revenue and expenditure effects. A positive base effect arises from the better-than-expected outcome in 2014. However, this is countered by a weaker GDP growth outlook and postponement of public investment from 2014 to 2015. The budgetary position is also weakened by strong expenditure growth, including increasing family benefits, combined with across-the-board tax relief for labour and capital. These expenditure increases are partially offset by tax-enhancing measures: excise and VAT increases and rescheduling of dividend distribution from state-owned enterprises from 2014 to 2015. No deficit-decreasing measures have been taken for 2015, even though it was recommended in November 2014 in the Commission opinion on the draft budgetary plan of Estonia that additional measures would be required in order to ensure compliance with the Stability and Growth Pact.

² In Estonia the corporate income tax is paid on dividend distributions; retained earnings are untaxed.

The Commission forecasts a smaller headline deficit than the Stability Programme, i.e. 0.2% of GDP in 2015, mainly owing to a different public investment scenario and a more positive carry-over from 2014 on the outcome of social security funds and local governments.

According to the Commission calculations on the basis of the information in the programme, using the commonly agreed methodology, Estonia reached a structural surplus of 0.1% of GDP in 2014. The recalculated structural surplus is expected to worsen by 0.3 pp. to -0.2% of GDP in 2015. The Commission calculations indicate a weaker structural fiscal position than estimated by the Estonian Stability Programme due to a difference in the assessment of the cyclical position of the economy between the commonly agreed methodology and the approach taken in the programme.³

The Commission 2015 spring forecast estimates the structural surplus of 0.2% of GDP reached in 2014 to turn into a deficit of 0.4% of GDP in 2015. The Commission projection for 2015 is thus somewhat worse than the recalculated structural balance of the programme.

The discrepancy stems from the fact that some of the one-off measures announced in the programme are not classified as one-offs according to the methodology used by the Commission.⁴

The medium-term strategy

The main goal of the Estonian budgetary strategy, as expressed in the Stability Programme, is to be at its medium-term objective (MTO) and to build sufficient fiscal buffers for a potential future economic downturn.⁵ The MTO, unchanged compared with the previous programme, is a structural surplus.⁶ The MTO is more stringent than what the Pact requires by more than one percentage point.

The Stability Programme foresees the headline deficit to improve to 0.1% of GDP in 2016-17, and return to a surplus in 2018-19. The headline target is somewhat more ambitious than the one set in the 2014 Stability Programme regarding 2016 but less ambitious from 2017 onwards. Next year's fiscal target includes a number of new measures reflecting priorities of the incoming coalition government after the March 2015 general elections. At face value, according to the programme, the MTO (a structural surplus) is adhered to throughout the programme period, with a projected structural surplus of 0.2%-0.6% of GDP in 2016-2019. The net positive effect of new budgetary measures announced in the Stability Programme

³ The programme estimates the structural fiscal surplus to worsen from 1.3% of GDP in 2014 to 0.5% of GDP in 2015. At face value, the programme foresees a gradual closure of a negative output gap by 2017, while according to the (recalculated) output gap estimations using the common methodology Estonia's GDP has already been slightly above potential since 2012.

⁴ See section on "Measures underpinning the programme" for details.

⁵ At face value, the structural position target set in the programme is compliant with the MTO (a structural surplus) and with the national numerical fiscal rule required by the State Budget Act; the latter stipulates that the state budget should be drafted in such a way that the structural budget position of the general government sector is at least in balance.

⁶ For the assessment purposes it has been assumed that the MTO is a balanced structural position (0.0% of GDP in structural terms).

amounts to 0.5% of GDP in 2016, while the cumulative impact decreases to around 0.3-0.4% of GDP in 2017-19.

The recalculated structural balance indicators confirm that the structural fiscal position is projected to remain in surplus over the medium term. However, the Commission 2015 spring forecast estimates the structural deficit to increase further by 0.3% of GDP to 0.7% of GDP in 2016 due to the widening of a positive output gap and a smaller impact of one-off measures. It should be noted that due to late submission the new fiscal measures announced in the Stability Programme are not included in the Commission 2015 spring forecast and the numerical tables in the current report reflect the original spring forecast figures.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	2019	Change: 2014-2019
	COM	COM	SP ³	COM ⁴	SP ³	SP ³	SP	SP	SP
Revenue	39.4	39.9	41.1	39.6	40.1	40.4	39.6	39.2	-0.2
<i>of which:</i>									
- Taxes on production and imports	14.1	14.4	14.4	14.4	14.9	14.9	15.0	15.1	1.0
- Current taxes on income, wealth, etc.	7.6	7.3	7.3	7.2	7.1	7.1	7.1	7.1	-0.5
- Social contributions	11.3	11.4	11.4	11.4	11.3	11.1	11.2	11.2	-0.1
- Other (residual)	6.4	6.9	8.0	6.7	6.8	7.3	6.3	5.8	-0.6
Expenditure	38.8	40.2	41.7	39.8	40.2	40.5	39.2	38.2	-0.6
<i>of which:</i>									
- Primary expenditure	38.6	40.1	41.6	39.7	40.1	40.4	39.1	38.1	-0.5
<i>of which:</i>									
Compensation of employees	11.1	11.2	11.2	11.1	11.0	10.6	10.3	10.1	-1.0
Intermediate consumption	6.7	7.0	6.9	7.3	6.9	6.8	6.7	6.7	0.0
Social payments	12.6	13.0	13.1	13.1	13.1	13.5	13.7	13.6	1.0
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.0
Gross fixed capital formation	5.1	5.3	6.1	5.0	5.7	5.9	5.0	4.5	-0.6
Other (residual)	2.7	3.1	3.9	2.8	2.8	3.2	3.0	2.7	-0.8
- Interest expenditure	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
General government balance (GGB)	0.6	-0.2	-0.6	-0.1	-0.1	-0.1	0.4	1.0	0.4
Primary balance	0.7	-0.1	-0.5	0.0	0.0	0.0	0.5	1.1	0.4
One-off and other temporary measures	-0.1	-0.3	-0.6	-0.1	-0.3	-0.3	0.0	0.0	0.1
GGB excl. one-offs	0.7	0.1	0.0	-0.1	0.2	0.2	0.4	1.0	0.3
Output gap ¹	1.3	1.0	0.3	1.3	0.0	0.4	0.7	0.7	-0.6
Cyclically-adjusted balance ¹	0.0	-0.7	-0.8	-0.7	-0.1	-0.3	0.1	0.7	0.6
Structural balance (SB)²	0.2	-0.4	-0.2	-0.7	0.2	0.0	0.1	0.7	0.5
Structural primary balance ²	0.3	-0.3	-0.1	-0.6	0.3	0.1	0.2	0.8	0.5

Notes:

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

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

³The one-off measures are reflected as they were announced in the Stability Programme, i.e. some of the measures that are not considered as one-offs according to the Commission methodology are not excluded from the calculations.

⁴The Commission spring forecast figures do not include the new fiscal measures presented in the Stability Programme.

Source:

Stability Programme (SP); Commission 2015 spring forecast (COM); Commission calculations.

Measures underpinning the programme

The overall net positive effect of the measures announced in the 2015 Stability Programme amounts to 0.5% of GDP in 2016, while the cumulative positive effect decreases to around 0.3-0.4% of GDP in 2017-19.

On the expenditure side, new measures include increasing family benefits and some investment priorities, but also savings in state administration. Among others, the administration savings include a 1% reduction annually in public employment in 2016-17, in line with the trends in working-age population. On the revenue side, the main focus is on reducing the tax burden on labour, including the gradual increase of the monthly basic personal income tax allowance from current EUR 154 to EUR 205 in 2019, introduction of a support measure targeted to low income earners in 2016 and lowering the social security contribution rate by 0.5 pp. in 2017 and 2018. The revenue loss is mostly compensated by increases in excise duties on motor fuels, alcohol and tobacco over 2016-2019, increase of preferential VAT on hotels from current 9% to 14% in 2017 and by additional dividend distributions from state-owned enterprises.

These measures were not taken into account in the Commission's 2015 spring forecast as they were announced after the forecast cut-off date. The Commission has evaluated the nature and possible yield of these measures in relation to the Commission spring forecast. A partial update of the Commission 2015 spring forecast, without secondary effects stemming from the fiscal measures, would leave the projected headline balance unchanged for 2015, but would improve the balance by about 0.4% of GDP in 2016. This is somewhat lower than the net impact of the measures of 0.5% of GDP presented in the programme, given that the Commission 2015 spring forecast under a no-policy-change assumption already included some of the dividend policy measures presented in the programme. The numerical tables in the current report reflect the original spring forecast figures, but the overall assessment of compliance with the MTO also takes account of the new fiscal measures.

The Stability Programme includes some of one-off measures that are not classified as one-offs according to the Commission's methodology. 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 dividends from state owned companies in 2014 in the amount of 0.1% of GDP.

Main budgetary measures

Revenue	Expenditure
2014	
<ul style="list-style-type: none">• Increasing excise duties on tobacco and alcohol (0.1% of GDP)• Compensation of second pillar pension contributions (-0.3% of GDP annually during 2014-17)	

Revenue	Expenditure
2015	
<ul style="list-style-type: none"> • Lowering the tax burden on labour and capital: cutting the income tax rate from 21% to 20%; raising basic allowance from personal income tax by 7% to EUR 154 per month; lowering unemployment insurance contribution rate from 3% to 2.4% (-0.6 of GDP) • Introduction of VAT information system with the digital invoice collection (0.2% of GDP) • Limiting VAT deductibility for company passenger cars used for private purposes to 50% (0.1% of GDP) • Increasing excise duties on alcohol, tobacco and heating fuels (0.1% of GDP) 	<ul style="list-style-type: none"> • Raising child benefits (0.4% of GDP)
2016	
<ul style="list-style-type: none"> • Increasing excise taxes on alcohol, tobacco and motor fuels (0.5% of GDP) • Additional dividend distribution (0.2% of GDP) • Lowering labour taxation (-0.1% of GDP) 	<ul style="list-style-type: none"> • Increasing family benefits (0.1% of GDP) • Reducing governance costs (-0.1% of GDP)
2017	
<ul style="list-style-type: none"> • Increasing excise taxes on alcohol, tobacco and motor fuels (0.2% of GDP) • lowering labour taxation (-0.5% of GDP) 	<ul style="list-style-type: none"> • Increasing family benefits (0.1% of GDP)
2018	
<ul style="list-style-type: none"> • Increasing excise taxes on alcohol, tobacco and motor fuels (0.2% of GDP) • lowering labour taxation (-0.3% of GDP) 	<ul style="list-style-type: none"> • Increasing family benefits (0.1% of GDP)

Revenue	Expenditure
2019	
<ul style="list-style-type: none"> • Increasing excise taxes on alcohol and tobacco (0.1% of GDP) • lowering labour taxation (-0.1% of GDP) 	
<p><u>Note:</u> The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

3.3. Debt developments

Estonia's public debt is forecast to fall from 10.6% of GDP in 2014 to below 10% of GDP in 2016 and further to around 8% by 2019 according to the programme (Table 3). These projections are in line with the Commission 2015 spring forecast. The central government is using its previously accumulated financial assets for financing its deficits. The nominal debt is foreseen to increase slightly over the period 2015-17 as a result of the deficit of the local governments and additional contributions to the European Financial Stability Facility (EFSF).

At 0.2% of GDP in 2014, Estonia's net debt level was considerably lower than the gross debt. According to the authorities, the net debt level is projected to increase to around 1% of GDP in 2015-16 as the central government's financial assets will be used for covering its negative cash flows. Along with the expected reserve accumulation from the central government budget surpluses in 2017-19 the net debt level is projected to fall to 0.4% of GDP by 2019.

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018	2019
			COM	SP	COM ³	SP	SP	SP	SP
Gross debt ratio¹	7.9	10.6	10.3	10.3	9.8	9.9	9.6	8.9	8.4
Change in the ratio	1.1	0.5	-0.3	-0.3	-0.5	-0.4	-0.3	-0.7	-0.5
<i>Contributions²:</i>									
1. Primary balance	0.1	-0.7	0.1	0.5	0.0	0.0	0.0	-0.5	-1.1
2. “Snow-ball” effect	-0.1	-0.3	-0.3	-0.3	-0.4	-0.4	-0.5	-0.5	-0.4
<i>Of which:</i>									
Interest expenditure	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Growth effect	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
Inflation effect	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.2
3. Stock-flow adjustment	1.1	1.6	-0.2	-0.5	0.0	0.0	0.2	0.3	1.0
<i>Of which:</i>									
Cash/accruals diff.									
Acc. financial assets									
<i>Privatisation</i>									
Val. effect & residual									

Notes:

¹ End of period.

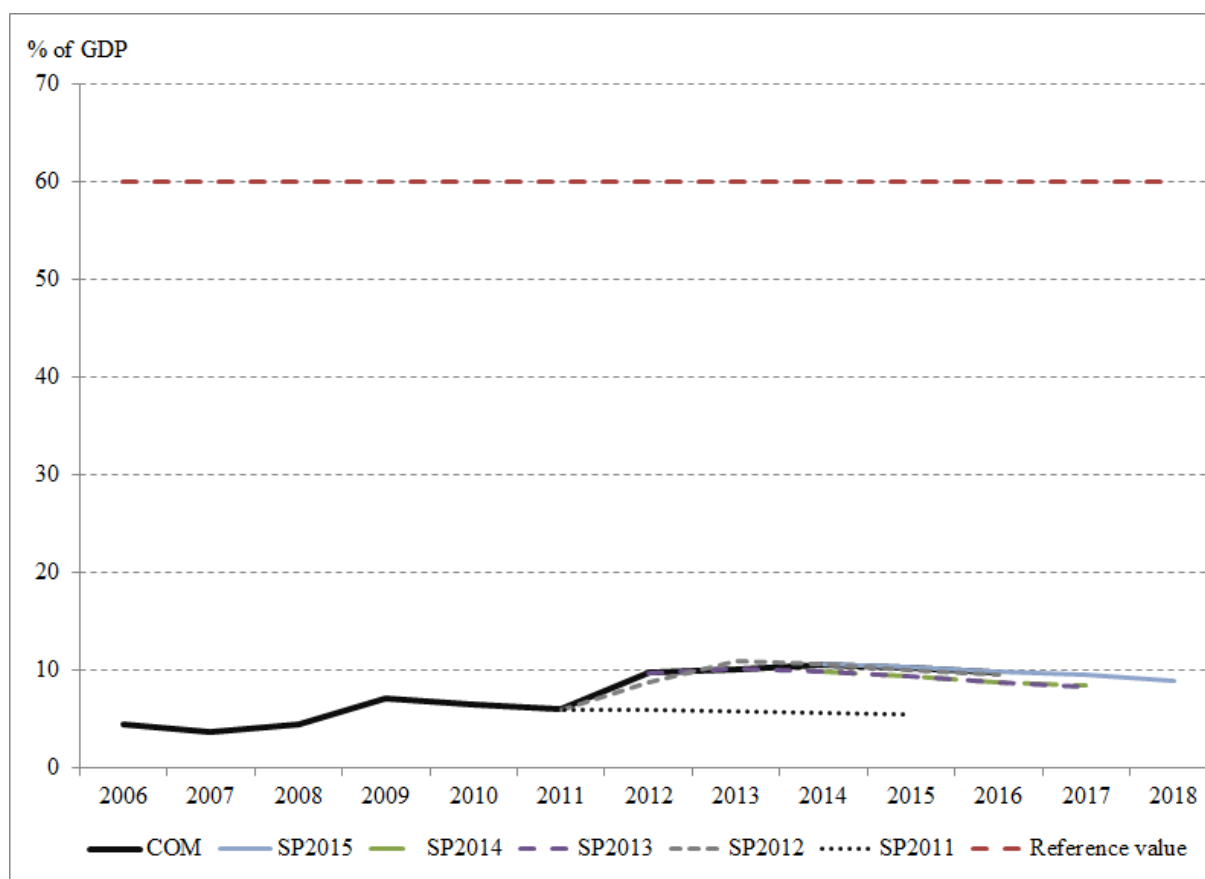
² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and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

³ The Commission spring forecast figures do not include the new fiscal measures presented in the Stability Programme.

Source:

Commission 2015 spring forecast (COM); Stability Programme (SP), Commission calculations.

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



Source: Commission 2015 spring forecast; Stability Programmes.

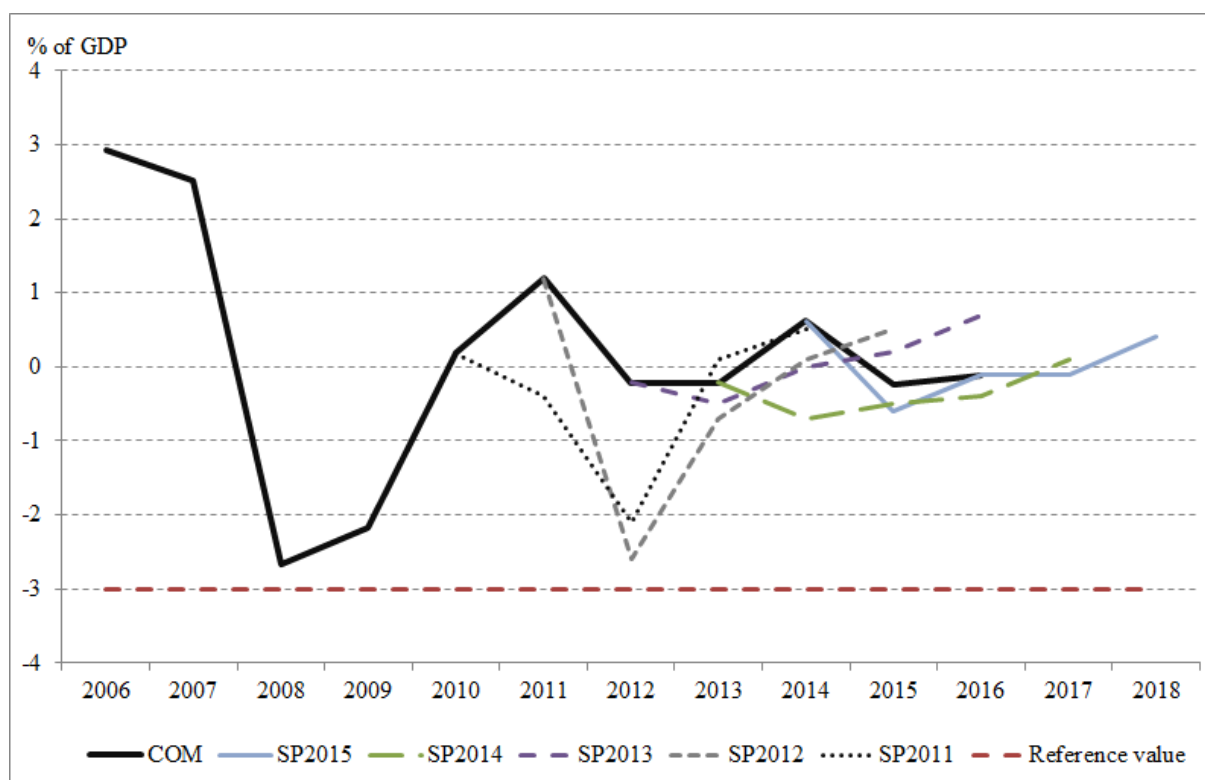
3.4. Risk assessment

Estonia's fiscal risks are low with a budget close to balance and a low debt level (10.6% of GDP in 2014). Nevertheless, some postponement of the fiscal targets has occurred in previous years (Figure 2). This was due to a worsened growth outlook, but also emerging expenditure pressures contributed to the phenomenon.

Risks related to the debt projections are low, with the general government deficit foreseen to return close to balance by 2016.

Estonia's medium-term fiscal planning is subject to uncertainties due to its exclusive focus on the structural balance target. Moreover, the authorities do not use the commonly agreed methodology for estimating the structural balance (see section 3.2. for details), implying that compliance of the fiscal targets with the SGP requirements is difficult to assess and may not be ensured. It should also be noted that compliance with the SGP requirements for Estonia is measured against the MTO chosen by the authorities, which is significantly above the minimum requirement.

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



Source: Commission 2015 spring forecast; Stability Programmes.

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

Box 1. Council recommendations addressed to Estonia

On 8 July 2014, 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 reinforce the budgetary measures for 2014 in the light of the emerging gap of 0.3 % of GDP based on the Commission services 2014 spring forecast, pointing to a risk of significant deviation relative to the preventive arm of the Stability and Growth Pact requirements. In 2015, significantly strengthen the budgetary strategy to ensure that the medium-term objective is reached and, thereafter, maintained. Complement the budget rule with more binding multi-annual expenditure rules within the medium-term budgetary framework and continue to enhance the efficiency of public spending.

The structural balance is assessed to have improved by 0.9% of GDP to a surplus of 0.2% of GDP in 2014. As Estonia returned to its MTO in 2014, the fiscal effort ensured compliance with the structural balance pillar. Nonetheless, Estonia is assessed to deviate significantly based on the expenditure benchmark pillar both according to the one year indicator (gap of 2.0% of GDP) and over 2013 and 2014 together (annual average gap of 1.4% of GDP), warranting an overall assessment. The divergence of the structural balance and the expenditure benchmark indicators can be explained by a change in the composition of economic growth and the closure of large scale tax fraud schemes in 2014 that have a

permanent positive effect on revenue, but are not taken into account in the expenditure benchmark calculations. Finally, Estonia's currently estimated potential growth is somewhat higher than the medium-term average used in the expenditure benchmark. The latter appears lower as it is impacted by the considerable downturn of 2009-2010, pointing to some overestimation of the signals sent by the expenditure benchmark. Therefore, the structural balance is considered to be a more relevant indicator for Estonia's fiscal effort in 2014. Based on the outturn data and the Commission 2015 spring forecast, and following an overall assessment, the adjustment path towards the MTO appears appropriate and compliant with the requirement of the preventive arm of the Pact in 2014.

Estonia should ensure that it continues to adhere to the MTO in 2015. At face value, the Stability Programme plans to maintain a structural fiscal position that complies with the MTO in 2015. The recalculated structural balance indicates some deterioration, but the balance is still projected to be in the vicinity of the MTO with a margin of 0.2% of GDP. Both the structural balance presented in the programme and the recalculated structural balance for 2015 include one-off measures in the amount of 0.3% of GDP that are not considered as one-offs according to the Commission methodology.

However, in the Commission 2015 spring forecast Estonia's structural balance is expected to deteriorate by 0.5% of GDP, pointing to some deviation (gap of 0.4% of GDP) from the MTO in 2015. The expenditure benchmark pillar both based on the programme data and the Commission forecast points to a significant deviation (gap of 0.9% and 1% of GDP, respectively), warranting an overall assessment. Similar to 2014, the divergence of the two indicators can be explained by the permanent effect on revenue from closure of large scale tax fraud schemes in 2014 and the difference between the currently estimated annual potential growth and the medium-term average potential growth, resulting in some overestimation the signals sent by the expenditure benchmark. An impact from one-off transactions (related to CO₂ quota) has a further negative effect on the expenditure benchmark. Therefore, the structural balance is considered to be a more relevant indicator for Estonia's fiscal effort in 2015. Following an overall assessment, some deviation from the MTO is to be expected in 2015 putting under risk the compliance with the requirements of the preventive arm of the Pact.

In 2016 Estonia is expected to correct the projected 0.4% of GDP deviation from the MTO that emerged in 2015. As in 2015, the Stability Programme projections taken at face value indicate compliance with the MTO, and this is confirmed by the recalculated structural balances. However, the Commission estimates point to a 0.3% of GDP deterioration in the structural balance for 2016, resulting in a significant deviation from the MTO in 2016 and over 2015-2016, taken together. Based on the Commission updated forecast (assuming the announced new measures would be fully and timely implemented but without including secondary effects), Estonia's structural deficit is expected to improve by 0.1% of GDP, still suggesting a significant deviation from the requirement (annual average gap of 0.3% of GDP) when assessed over two years.⁷ The risk of significant deviation is also confirmed by the expenditure benchmark calculations, as the growth rate of government expenditure, net of discretionary revenue measures, is in excess of 0.4 % of GDP on average over 2015 and 2016. Therefore, there is a risk of a significant deviation from the adjustment path towards the MTO in 2016.

⁷ The numerical tables in the current report reflect the original Commission 2015 spring forecast figures, i.e. without the new fiscal measures presented in the Stability Programme.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2014	2015		2016	
Initial position¹					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance ² (COM)	0.2	-0.4		-0.7	
Structural balance based on freezing (COM)	0.2	-0.4		-	
Position vis-a-vis the MTO³	At or above the MTO	At or above the MTO		Not at MTO	
(% of GDP)	2014	2015		2016	
	COM	SP¹⁰	COM	SP¹⁰	COM¹¹
Structural balance pillar					
Required adjustment ⁴	0.0	0.0		0.4	
Required adjustment corrected ⁵	0.2	-0.2		0.4	
Change in structural balance ⁶	0.9	-0.3	-0.5	0.4	-0.3
<i>One-year deviation from the required adjustment⁷</i>	0.7	-0.1	-0.4	0.0	-0.7
<i>Two-year average deviation from the required adjustment⁷</i>	0.2	0.3	0.2	-0.1	-0.5
Expenditure benchmark pillar					
Applicable reference rate ⁸	1.6	2.5		1.1	
<i>One-year deviation⁹</i>	-2.0	-0.9	-1.0	0.1	-0.2
<i>Two-year average deviation⁹</i>	-1.4	-1.5	-1.5	-0.4	-0.6
Conclusion					
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Compliance	Overall assessment
Conclusion over two years	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Significant deviation
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 = 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 28.).					
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.					
⁷ The difference of the change in the structural balance and the required adjustment corrected.					
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 not at its MTO.					
⁹ 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.					
¹⁰ The SP scenario includes one-off measures as they were announced in the Stability Programme, i.e. some of the measures that are not considered as one-offs according to the Commission methodology are not excluded from the calculations.					
¹¹ The Commission spring forecast figures do not include the new fiscal measures presented in the Stability Programme.					
<i>Source:</i>					
<i>Stability Programme (SP); Commission 2015 spring forecasts (COM); Commission calculations.</i>					

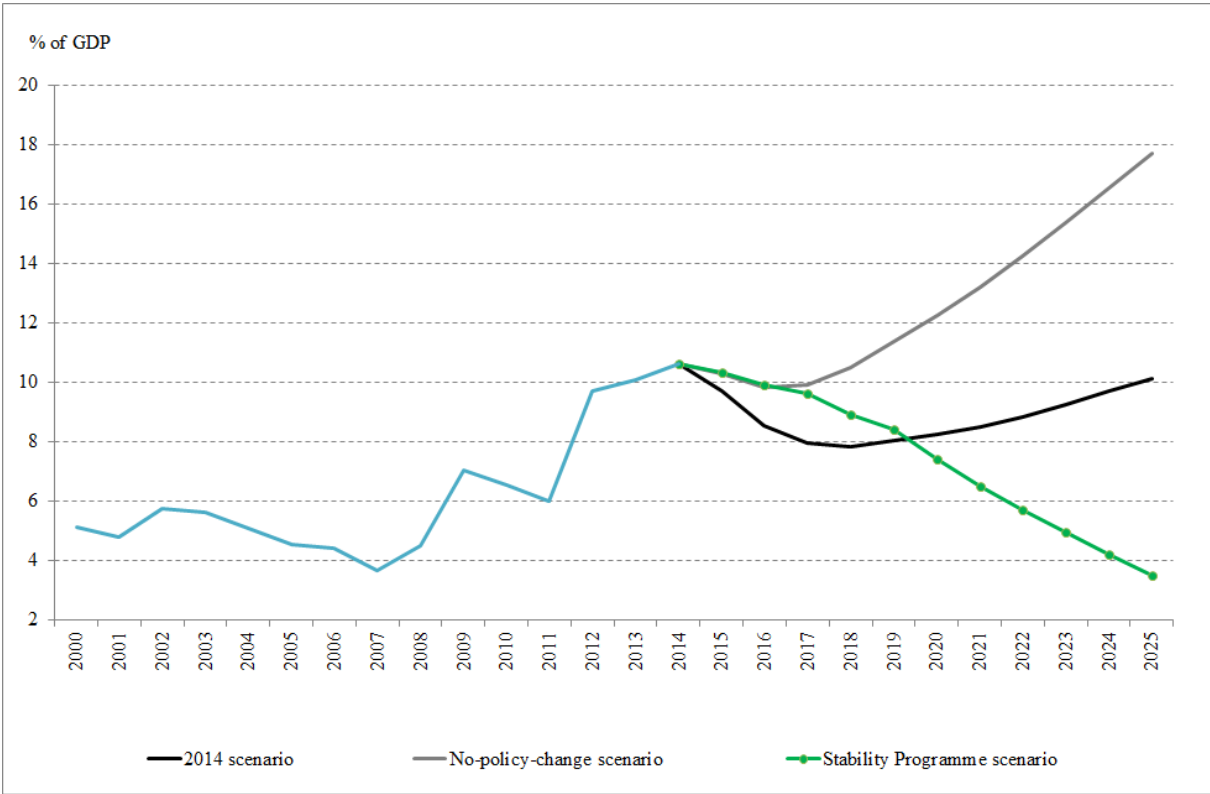
5. LONG-TERM SUSTAINABILITY

The assessment includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report⁸ published on 12 May.

Estonia appears to face low medium and long-term fiscal sustainability risks with government debt at 10.6% of GDP in 2014, i.e. well below the 60% of GDP reference value and low long-term costs of ageing. The full implementation of the programme would reduce the debt to 8.4 % of GDP by 2019, and to below 4 % of GDP by 2025 (Figure 3).

Estonia is implementing a Work Ability Reform in 2016, 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 and the provision of support and activation services is substantially improved. Although the reform will bear costs, related to both short-term implementation and expanded services, it will further improve the long-term sustainability of public finances via a lower number of pension recipients and increased labour market participation.

Figure 3: Gross debt projections (% of GDP)



Source: Commission 2015 spring forecast; Stability Programme; Commission calculations.

⁸ See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm.

Table 5: Sustainability indicators

	Estonia			European Union		
	2014 scenario	No-policy-change scenario	Stability Programme scenario	2014 scenario	No-policy-change scenario	Stability/Convergence Programme scenario
S2*	0.6	1.3	0.4	1.4	1.7	0.4
<i>of which:</i>						
Initial budgetary position (IBP)	0.1	0.9	0.0	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	0.5	0.4	0.5	1.0	1.1	1.1
<i>of which:</i>						
pensions	-1.0	-1.0	-1.3	0.0	0.1	0.1
healthcare	0.4	0.4	0.4	0.8	0.7	0.6
long-term care	0.5	0.4	0.6	0.7	0.7	0.6
others	0.6	0.6	0.7	-0.4	-0.3	-0.2
S1**	-3.5	-2.9	-6.4	1.4	1.8	0.5
<i>of which:</i>						
Initial budgetary position (IBP)	-0.9	0.2	-1.9	-0.4	-0.3	-1.6
Debt requirement (DR)	-3.0	-3.5	-4.5	1.7	1.9	1.8
Long-term cost of ageing (CoA)	0.4	0.4	0.0	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.12	:	:	:	:	:
Fiscal subindex	0.00	:	:	:	:	:
Financial-competitiveness subindex	0.17	:	:	:	:	:
Debt as % of GDP (2014)	10.6			88.6		
Age-related expenditure as % of GDP (2014)	17.2			25.6		
Source: Commission, 2015 Stability Programme						
Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability 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.						
* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.						
** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.						
*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indices, thresholds are respectively at 0.35 and 0.45.						

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES⁹

6.1. Fiscal framework

There is no clear statement that Estonia considers its Stability Programme to be its national medium-term fiscal plan (NMTFP) in the sense of Article 4(1) in the EU Regulation 473/2013; in fact, the role of the latter document is fulfilled by the national state budget strategy.

The macroeconomic forecast underlying the 2015 Stability Programme was prepared by the Fiscal Policy Department in the Ministry of Finance of Estonia and was endorsed by the Fiscal Council. The Council was set up in 2014 on the basis of the State Budget Act, which stipulates that the Council is an 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. According to the Act, the Council operates as an independent body which accepts no instructions from any private or public body. Among other tasks, the Council is designated to assess the compliance of the (structural) fiscal targets set in the state budget strategy and the Stability Programme before the government adoption.

On 27 April 2015 the Fiscal Council published on its website the opinions on the macroeconomic forecast underlying the Stability Programme and the state budget strategy, as well as a recommendation for the possible fiscal targets to be set in the programme. The Council considered that the spring forecast of the Ministry of Finance constitutes a suitable base for state budget strategy. However, the Council highlighted a serious measurement risk to the estimates of the structural budget position and recommended the government to take necessary measures and plan the nominal budget at least in balance in 2016.

6.2. Quality of public finances

With a view to improving the quality of public finances Estonia introduced a number of measures in 2014 to improve tax compliance. During the first four months after a Labour Registry was set up (in July 2014), the official declaration of employees has increased by approximately 1.7%, most of them in construction, retail and the restaurant sector and officially earning close to minimum wage.¹⁰ On 1 November, a digital invoice data collection system was introduced to improve VAT collection.¹¹ Although the system will only become fully operational in June 2015, VAT revenue collection already increased significantly after the first months of partial implementation. Finally, in order to reduce tax exemptions and tax loopholes, the VAT-deductibility of company cars also used for private purposes was reduced by 50% in December 2014.

For improving strategic fiscal management, the government is planning to shift from the current cash-based compilation of the state budget to the accrual accounting basis in 2017 and to introduce activity-based state budgeting in 2020. The efficiency of the state governance is expected to improve with centralisation of the support services and lowering of public expenditure.

⁹ This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Stability Programme.

¹⁰ About 9000 people, according to the tax office.

¹¹ Digital invoice data collection makes it possible to automatically compare data from buyers and sellers.

7. CONCLUSIONS

Estonia's 2015 Stability Programme was submitted after the end of April deadline set by the Regulation because of intensive budgetary discussions within the incoming government after the March 2015 general elections, the fiscal measures and other information included in it could not be taken into account in the Commission 2015 spring forecast published on May 5, which is the basis for this assessment. The numerical tables in the current report reflect the original spring forecast figures, but the overall assessment of compliance with the MTO also takes into account the new fiscal measures.

In 2014, Estonia achieved an improvement of the structural balance of 0.9% of GDP, which is in line with the required adjustment, and the MTO was achieved.

Estonia plans a deterioration of the structural balance by 0.3% of GDP in 2015 and is expected to deviate from the MTO by 0.2% of GDP¹². In 2016, an improvement of 0.4% of GDP is planned, correcting the deviation from the MTO when taken at face value.

However, according to the Commission 2015 spring forecast taking into account the announced new measures presented in the Stability Programme, there is a risk of some deviation from the MTO in 2015 and a risk of significant deviation from the MTO over the years 2015 and 2016 taken together. However, as Estonia's MTO (a structural surplus) is significantly above the minimum requirement (deficit of 1% of GDP), the deviation from the MTO identified above does not threaten the sustainability of Estonia's public finances, notably also given the very low level of debt and small nominal deficits (10.3% and 0.2% of GDP in 2015, respectively, according to the Commission forecast).

¹²In case *ex-post* data for 2015 confirms that the deviation from the MTO remains at 0.2% of GDP as currently planned, the conclusion would be that Estonia was at the MTO within a margin of 0.2% of GDP.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	6.8	8.0	-0.3	4.7	1.6	2.1	2.3	2.9
Output gap ¹	-1.4	5.1	0.4	2.2	1.6	1.3	1.0	1.3
HICP (annual % change)	6.1	3.3	5.1	4.2	3.2	0.5	0.2	1.9
Domestic demand (annual % change) ²	6.9	10.8	-1.5	4.8	0.9	4.8	3.2	3.5
Unemployment rate (% of labour force) ³	11.5	9.1	10.5	10.0	8.6	7.4	6.2	5.8
Gross fixed capital formation (% of GDP)	28.0	33.0	27.5	27.0	27.3	25.8	25.4	25.5
Gross national saving (% of GDP)	22.1	23.3	23.8	26.9	27.6	26.0	25.3	25.2
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	0.1	1.7	-0.2	-0.2	-0.2	0.6	-0.2	-0.1
Gross debt	5.0	5.1	5.5	9.7	10.1	10.6	10.3	9.8
Net financial assets	32.6	30.4	30.2	32.5	n.a	n.a	n.a	n.a
Total revenue	35.8	36.4	39.5	39.6	38.5	39.4	39.9	39.6
Total expenditure	35.7	34.6	39.7	39.8	38.8	38.8	40.2	39.8
<i>of which: Interest</i>	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-4.9	-6.7	-1.6	0.8	3.0	-3.9	-4.1	-3.9
Net financial assets; non-financial corporations	-113.0	-144.1	-156.9	-125.2	n.a	n.a	n.a	n.a
Net financial assets; financial corporations	-10.6	-14.2	3.1	2.3	n.a	n.a	n.a	n.a
Gross capital formation	21.3	24.1	17.4	18.6	17.3	18.3	17.7	17.9
Gross operating surplus	27.2	32.4	29.4	31.6	31.0	27.9	26.7	26.9
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	-1.5	-6.2	0.2	1.1	0.6	2.2	3.0	2.5
Net financial assets	47.1	55.0	52.6	35.8	n.a	n.a	n.a	n.a
Gross wages and salaries	35.5	34.5	36.8	35.4	36.1	37.5	38.2	38.1
Net property income	1.4	1.8	2.9	2.7	3.3	3.6	3.5	3.5
Current transfers received	16.2	14.8	16.4	16.8	16.3	16.2	16.6	16.5
Gross saving	1.3	-2.2	4.5	4.4	4.9	6.8	7.7	7.3
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-7.4	-11.5	-1.0	1.1	2.4	0.8	0.5	0.2
Net financial assets	44.0	72.9	71.4	55.1	n.a	n.a	n.a	n.a
Net exports of goods and services	-6.6	-7.8	0.9	1.0	1.4	2.5	2.0	1.5
Net primary income from the rest of the world	-2.7	-4.8	-5.1	-4.0	-2.5	-2.4	-2.4	-2.4
Net capital transactions	0.4	0.5	2.7	3.5	2.7	0.6	0.8	0.8
Tradable sector	50.5	49.0	45.0	46.7	46.6	n.a	n.a	n.a
Non tradable sector	38.4	39.6	42.7	40.5	41.0	n.a	n.a	n.a
<i>of which: Building and construction sector</i>	5.4	6.8	7.1	6.5	6.6	n.a	n.a	n.a
Real effective exchange rate (index, 2000=100)	64.5	75.7	100.9	96.2	102.3	108.8	108.9	109.9
Terms of trade goods and services (index, 2000=100)	85.3	95.9	100.9	98.7	100.2	101.5	102.0	102.2
Market performance of exports (index, 2000=100)	65.8	82.6	98.1	120.5	122.2	121.5	120.0	119.3
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.								
<i>Source :</i>								
AMECO data, Commission 2015 spring forecast								