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Assessment of the 2019 Stability Programme for

Estonia

(Note prepared by DG ECFIN staff)

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EXECUTIVE SUMMARY

Estonia is subject to the preventive arm of the Stability and Growth Pact. Estonia's public debt is the lowest in the EU, at 8.4% of GDP in 2018.

The Estonian economy expanded by 3.9% in 2018 in real terms, but economic growth is expected to decline to 2.8% in 2019 and to 2.4% in 2020, according to the Commission 2019 spring forecast. Growth is expected to be mainly driven by robust domestic demand, while the external outlook has weakened. With short-term growth slightly below potential growth, the positive output gap is forecast to shrink from over 3% of potential GDP in 2018 to above 2% in 2020. Employment growth is expected to moderate from a historical peak level, while the unemployment rate is forecast to remain steady at slightly below 6%. Wage growth is expected to decelerate in 2019 due to slowing economic activity, while price increases are expected to moderate in line with lower commodity prices and in the absence of major consumption tax increases. The macro-economic scenario included in the Stability Programme is somewhat favourable.

The general government deficit rose to 0.6% of GDP in 2018, which was substantially worse than expected in the previous Stability Programme, Draft Budgetary Plan or the Commission autumn 2018 forecast. The negative surprise arose as a combination of lower-than-expected revenues and higher expenditures. The 2019 Stability Programme, which was submitted on a no-policy-change basis, projects the deficit to improve to -0.2% of GDP in 2019 but to worsen slightly to -0.3% of GDP in 2020. The recalculated structural balance[1] is set to amount to -1.5% of GDP in 2019 and -1.6% of GDP in 2020, far away from the MTO of -0.5% of GDP. Risks to the short-term fiscal outlook are tilted to the downside. Based on the Commission forecast, Estonia is at risk of a significant deviation from the adjustment path towards the MTO in 2019 and 2020.

1. INTRODUCTION

On 30 April 2019, Estonia submitted its 2019 Stability Programme (hereafter called Stability Programme), covering the period 2019-2023. The Stability Programme is based on a no-policy-change scenario, i.e. it does not yet reflect any measures of the new government that took office in end-April. Estonia also submitted an updated Stability Programme on 4 June 2019, while the Commission assessed the Stability Programme, that was submitted by the deadline of 30 April 2019.

Estonia is currently subject to the preventive arm of the 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 27 February 2019 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 2019 spring forecast. The following section presents the recent and projected budgetary developments, according to the Stability Programme. In particular, it includes an overview of the medium term budgetary plans, an assessment of the measures

[1] Recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology.

underpinning the Stability Programme and a risk analysis of the budgetary plans based on the 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 of long-term sustainability risks and Section 6 of recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Real GDP growth reached 3.9% in 2018 and, according to the macroeconomic scenario underlying the Stability Programme, is projected to decelerate to 3.1% in 2019 and 2.7% in 2020 due to cyclical factors and the slowdown in foreign demand. According to the Stability Programme, domestic demand is expected to remain the main growth driver in 2019 and 2020. The forecast for 2019 has been revised upwards (by 0.1 percentage points) compared to the Draft Budgetary Plan presented in autumn 2018, reflecting strong GDP data for the last quarter of 2018. Labour market participaton and the unemployment rates are projected to remain broadly stable. Wage growth is expected to slow down somewhat from 8.5% in 2018 to 7% in 2019, and to just over 5% in 2020. However, disposable income is set to increase strongly, since HICP inflation is to slow more than was projected in the Draft Budgetary Plan to just over 2% in 2019 and 2020.

The Commission spring 2019 forecast expects slightly lower real GDP growth in 2019 and 2020 than envisaged in the Stability Programme, at 2.8% and 2.4% respectively. The difference in real GDP growth projections arises from the domestic side for 2019 and net exports for 2020. The Commission projects somewhat lower growth of private consumption for 2019, linked to a more moderate labour market outlook. Still, overall both the macroeconomic scenario in the programme and in the Commission forecast expect the labour market to stay relatively strong. Wage pressures persist even with a slowing of economic activity due to a shrinking working age population. Inflation projections do not differ much between the two forecasts, expecting inflation at above 2% in 2019 and 2020.

The extended period of good economic times is reflected in a significantly positive output gap. The Stability Programme estimates the output gap to be positive at around 2% of potential GDP in 2018 and 1.6% in 2019, higher than an earlier estimate of 1.7% and 1.3% respectively presented in the Draft Budgetary Plan. 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, at 2.9% of GDP in 2019 and 2.6% in 2020. This is higher than the output gaps presented at face value in the Stability Programme. The difference arises because the Stability Programme projects a higher potential growth compared to the Commission calculations[2].

Overall, the macroeconomic assumptions underlying the Stability Programme are somewhat favourable for 2019 and 2020 reflecting the higher potential growth estimates of the programme.

[2] For example, the Stability Programme estimates potential growth to amount to 3.3% in 2020, while the commonly agreed methodology estimates 3%.

Table 1: Comparison of macroeconomic developments and forecasts

	2018		2019		2020		2021	2022	2023
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	3.9	3.9	2.8	3.1	2.4	2.7	2.7	2.6	2.5
Private consumption (% change)	4.7	4.6	4.0	4.7	2.9	2.9	2.9	2.7	2.6
Gross fixed capital formation (% change)	3.3	3.3	4.8	5.1	4.0	4.0	4.3	3.4	3.6
Exports of goods and services (% change)	4.3	4.3	3.4	3.2	3.4	3.0	3.2	3.3	3.3
Imports of goods and services (% change)	6.1	6.1	3.9	3.8	3.8	2.9	3.4	3.2	3.1
Contributions to real GDP growth:									
- Final domestic demand	3.2	3.2	3.4	3.6	2.6	2.5	2.6	2.3	2.2
- Change in inventories	2.1	1.9	-0.3	-0.3	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.1	-1.1	-0.3	-0.3	-0.2	0.2	-0.1	0.2	0.3
Output gap[1]	3.3	3.2	2.8	2.9	2.2	2.6	2.6	2.7	2.8
Employment (% change)	1.2	0.9	0.6	0.9	-0.1	0.0	-0.1	-0.2	-0.2
Unemployment rate (%)	5.7	5.4	5.7	5.6	5.7	5.7	5.7	5.7	5.7
Labour productivity (% change)	2.6	3.2	2.2	2.3	2.5	3.0	2.8	2.8	2.7
HICP inflation (%)	3.4	3.4	2.4	2.2	2.2	2.3	2.1	2.1	2.1
GDP deflator (% change)	4.6	4.6	3.3	2.8	2.7	2.7	2.6	2.4	2.3
Comp. of employees (per head, % change)	8.8	8.5	6.1	7.0	5.6	5.3	5.3	5.0	5.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.7	2.9	2.6	2.7	2.7	2.8	2.2	2.0	1.7

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 2019 spring forecast (COM); Stability Programme (SP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2018 AND 2019

The general government headline deficit increased from 0.4% of GDP in 2017 to 0.6% of GDP in 2018. The fiscal stance was expansionary in 2018, with a growing deficit also in structural terms. The 2018 outcome was substantially weaker than expected in the previous Stability Programme, which at the time projected a surplus of 0.2% of GDP, or the latest Draft Budgetary Plan, which projected a surplus of 0.6% of GDP. The negative surprise (compared to the budgetary plan) is explained by lower non-tax revenues, while some tax revenues also underperformed. Non-tax revenues were below expectations due to lower dividend revenues and a slow uptake of EU funds (the latter is broadly revenue neutral as it lowers expenditure). Excise taxes fell short of projections due to more cross-border purchases of excise goods (alcohol, fuels), which was partly compensated by stronger revenues from labour taxes. At the same time, expenditure grew more than expected on social spending programmes, domestically-funded investments and public sector wages. The errors in projections resulted from a large number of new revenue and expenditure measures that took effect in 2018 and whose budgetary impact was difficult to estimate beforehand. In particular, the budgetary impact of the largest revenue measures was uncertain as it involved behavioural changes of households and corporates, which were difficult to predict (hikes in excise taxes, major reform of personal income tax and corporate income tax).

For 2019, the Stability Programme foresees a deficit of 0.2% of GDP. This is substantially worse than planned in the last Stability Programme of 2018 and the 2018 Draft Budgetary Plan (which both projected a surplus of 0.5% of GDP). The weaker budgetary outlook for 2019 results from the weaker outcome in 2018 carrying forward. The small improvement in the budgetary outlook for 2019 compared to 2018 results mainly from higher revenue growth of labour taxes, dividends and higher revenues from the sales of CO2 quotas due to higher market prices. At the same time, the projection for excise tax revenues has been lowered. A higher EU funds absorption in 2019 leads to both higher investment and revenues growth rate and is thus broadly revenue neutral.

The Commission spring 2019 forecast projects a slightly weaker near-term fiscal outlook, with a deficit of 0.3% of GDP in 2019 (see Table 2). The difference reflects the more cautious GDP and labour market projection of the Commission. The Commission also expects the discretionary revenue measures to be smaller in 2019 than projected by the programme (see Section 3.3), but this is compensated by higher tax elasticities in the Commission projections. On the expenditure side, the Commission forecast expects higher spending on public wages than the Stability Programme.

The 2019 Stability Programme has revised its assessment of the cyclical position of the economy, moving closer to the Commission's common methodology for estimating the output gap. While the previous 2018 Stability Programme estimated the output gap to be positive by 1.6% of GDP in 2018 and 1.3% of GDP in 2019, it now estimates a positive output gap of 2.1% of GDP in 2018, decreasing to 1.6% of GDP in 2019. The estimates of the structural position of the budget have changed more substantially, largely due to the negative surprise for the nominal budget balance in 2018. The 2018 Stability Programme projected a structural deficit of 0.4% of GDP in 2018, turning to a balance of 0.0% of GDP in 2019. The 2019 Stability Programme estimates that the structural position was actually in deficit by 1.4% of GDP in 2018, improving to a deficit of 1% of GDP in 2019 (figures at face value). The recalculated programme figures show a higher structural deficit at 1.5% of GDP in 2019. Based on the Commission 2019 spring forecast, the structural balance is assessed to have declined to a deficit of 2.2% of GDP in 2018 and is set to improve to 1.7% of GDP in 2019 (Table 2), below the medium-term objective (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[3].

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The Stability Programme is based on a no-policy-change scenario, i.e. it does not yet reflect any measures of the new government. The programme foresees the nominal deficit of 0.2% of GDP in 2019 to slightly worsen to a deficit of 0.3% of GDP in 2020 and fluctuate around ½% of GDP thereafter. According to the authorities, this would correspond to a structural deficit of 1% of GDP in 2019 and 0.8% of GDP in 2020. Thereafter, the structural deficit is projected to remain unchanged at 0.8% of GDP until 2022 and improve to close to balance only in 2023. This is considerably worse than the structural balance of 0.0% of GDP planned for

[3] 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 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.

2019-2020 in the previous 2018 Stability Programme and the Draft Budgetary Plan in the autumn of 2018, due to the before-mentioned under-performance in 2018 (see Figure 1).

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 not to meet the MTO throughout the programme period. The recalculated structural balance[4] is estimated to slightly worsen from a deficit of 1.5% of GDP in 2018 to a deficit of 1.6% of GDP in 2020, also not meeting the MTO (see Table 2). The difference with the programme figures at face value largely arises from differing output gap estimates.

In terms of main revenue and expenditure trends in the coming years, the programme projects a decline in the revenue to GDP ratio (mainly reflecting lower consumption taxes and non-tax revenues), matched by relatively slower growth in public wage expenditure and investment. This is partly explained by the EU funds absorption cycle. At the same time, the tax projection can be considered as prudent. The Commission 2019 spring forecast expects a structural deficit of 1.7% of GDP in 2019 and 1.5% in 2020. This is broadly similar to the recalculated Stability Programme figures[5].

[4] Recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology".

[5] The differences in the structural balance arise from differences in nominal balance, output gap estimates and some of the one-off measures announced in the programme are not classified as one-offs according to the methodology used by the Commission.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2018	2019		2020		2021	2022	2023	Change: 2018-2023
	COM	**COM**	**SP**	**COM**	**SP**	**SP**	**SP**	**SP**	**SP**
Revenue	**39.0**	**39.5**	**40.0**	**39.4**	**39.5**	**38.8**	**37.8**	**37.1**	**-2.0**
of which:									
- Taxes on production and imports	13.9	14.2	14.3	14.1	14.0	13.7	13.4	13.2	-0.7
- Current taxes on income, wealth, etc.	7.5	7.3	7.3	7.2	7.3	7.4	7.5	7.6	0.1
- Social contributions	11.9	12.0	12.1	12.1	12.0	12.0	11.8	11.7	-0.2
- Other (residual)	5.7	6.0	6.3	5.9	6.2	5.7	5.1	4.6	-1.2
Expenditure	**39.5**	**39.9**	**40.2**	**39.9**	**39.7**	**39.3**	**38.5**	**37.3**	**-2.2**
of which:									
- Primary expenditure	39.5	39.8	40.2	39.8	39.7	39.2	38.4	37.2	-2.3
of which:									
Compensation of employees	11.3	11.5	11.2	11.5	11.0	10.8	10.6	10.5	-0.8
Intermediate consumption	6.4	6.4	6.4	6.3	6.3	6.2	6.1	6.0	-0.4
Social payments	13.5	13.6	13.6	13.8	13.8	13.7	13.4	13.3	-0.2
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.0
Gross fixed capital formation	5.5	5.5	5.9	5.4	5.7	5.5	5.3	4.5	-1.0
Other (residual)	2.3	2.4	2.3	2.4	2.3	2.5	2.0	2.1	-0.2
- Interest expenditure	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1
General government balance (GGB)	**-0.6**	**-0.3**	**-0.2**	**-0.5**	**-0.3**	**-0.5**	**-0.7**	**-0.2**	**0.4**
Primary balance	**-0.5**	**-0.3**	**-0.2**	**-0.4**	**-0.2**	**-0.4**	**-0.6**	**-0.1**	**0.4**
One-off and other temporary measures	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-0.6**	**-0.3**	**-0.1**	**-0.5**	**-0.3**	**-0.5**	**-0.7**	**-0.2**	**0.4**
Output gap[1]	3.3	2.8	2.9	2.2	2.6	2.6	2.7	2.8	-0.6
Cyclically-adjusted balance[1]	-2.2	-1.7	-1.6	-1.5	-1.6	-1.8	-2.0	-1.5	0.6
Structural balance[2]	**-2.2**	**-1.7**	**-1.5**	**-1.5**	**-1.6**	**-1.8**	**-2.0**	**-1.5**	**0.6**
Structural primary balance[2]	-2.1	-1.7	-1.5	-1.5	-1.6	-1.7	-1.9	-1.4	0.7

Notes:

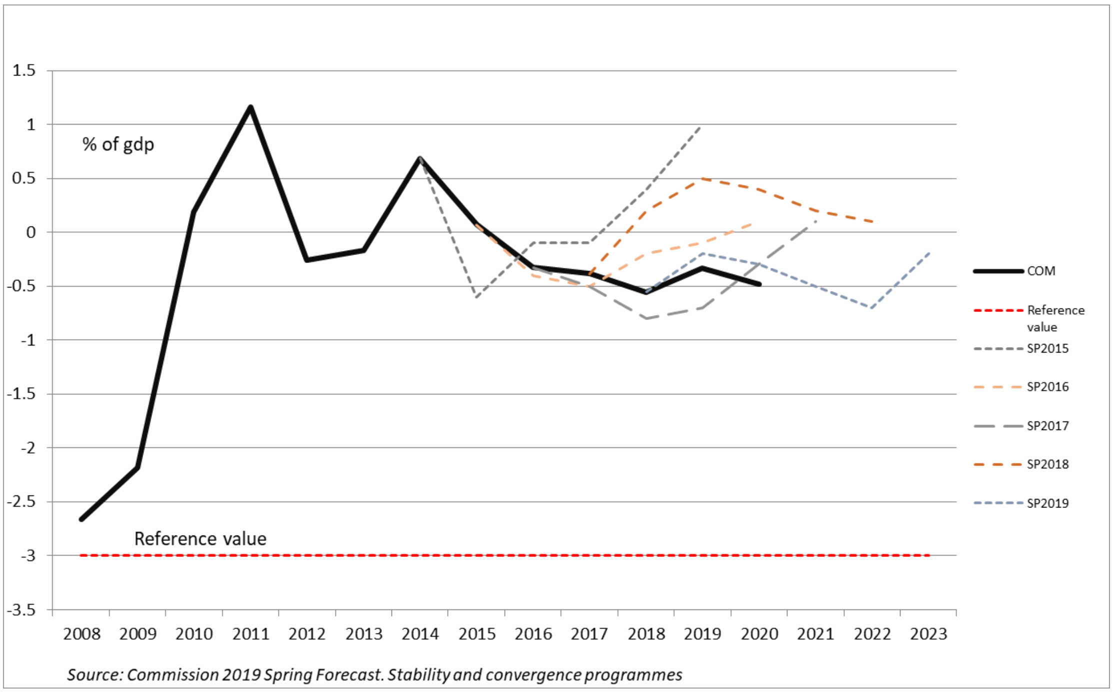
[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

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

Source :

Stability Programme (SP); Commission 2019 spring forecasts (COM); Commission calculations.

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



3.3. MEASURES UNDERPINNING THE PROGRAMME

The Stability Programme is based on a no-policy-change scenario and does not yet present any measures of the new government. However, the fiscal impact of some measures from the previous government carries over to 2019-2020. The Programme presents explicitly only those measures that take effect from 2019 onwards. These measures are all relatively small. The largest measures concern excise rises for tobacco, natural gas and tighter control of fuel sales, all together improving revenues by 0.1% of GDP in 2019 and 2020.

The 2019 Stability Programme does not report explicitly on those measures that took effect in 2018 and were announced with the previous Stability Programme or the 2019 Draft Budgetary Plan. Several of the larger measures of the previous government still have a significant budgetary impact for 2019 and to a smaller degree also for 2020. The main revenue measures in 2018 were a personal income tax cut for low- and medium-income earners, offset by corporate income tax reform, excise rises for fuels, alcohol and tobacco, and a road usage fee. On the expenditure side, spending was increased for healthcare, education, social funding, financing local governments and several specific investments. The Ministry of Finance 2019 spring forecast, on which the Stability Programme is based, uses updated revenue and expenditure projections, thus indirectly updating past revenue measures[6].

On the aggregate, the Stability Programme expects all the past measures to raise revenues by 0.8% of GDP in 2019 and to reduce revenues by 0.2% of GDP in 2020. Some of these measures do not qualify as revenue measures in the sense of the EU fiscal surveillance rules because they only have an indirect second-round impact on public finances or their impact is

[6] No detailed table with updated past revenue measures is presented in the Ministry of Finance 2019 spring forecast.

uncertain[7]. Therefore, the Commission spring forecast includes less than a half of the revenue impact for 2019 but is broadly similar for 2020.

3.4. DEBT DEVELOPMENTS

Estonia's public debt declined to 8.4% of GDP in 2018, the lowest in the EU. It is forecast to stay at this level in the medium term according to the programme (Table 3). At the same time, liquid financial reserves of the general government sector amounted to 7.1% of GDP in 2018. The Commissions projection for the debt ratio is slightly higher than the projection of the programme, explained by a difference in the budget surplus forecast.

Table 3: Debt developments

(% of GDP)	Average 2013-2017	2018	2019		2020		2021	2022	2023
			COM	SP	COM	SP	SP	SP	SP
Gross debt ratio[1]	**9.8**	**8.4**	**8.5**	**8.2**	**8.5**	**8.1**	**8.0**	**8.3**	**8.2**
Change in the ratio	-0.1	-0.8	0.1	-0.2	0.1	-0.1	-0.1	0.3	-0.1
Contributions[2]:									
1. Primary balance	**-0.1**	**0.5**	**0.3**	**0.2**	**0.4**	**0.2**	**0.4**	**0.6**	**0.1**
2. "Snow-ball" effect	**-0.4**	**-0.7**	**-0.4**	**-0.5**	**-0.4**	**-0.3**	**-0.3**	**-0.3**	**-0.3**
Of which:									
Interest expenditure	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Growth effect	-0.3	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Inflation effect	-0.2	-0.4	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
3. Stock-flow adjustment	**0.4**	**-0.7**	**0.2**	**0.1**	**0.0**	**0.0**	**-0.2**	**0.0**	**0.1**
Of which:									
Cash/accruals diff.									
Acc. financial assets									
Privatisation									
Val. effect & residual									

Notes:

[1] End of period.

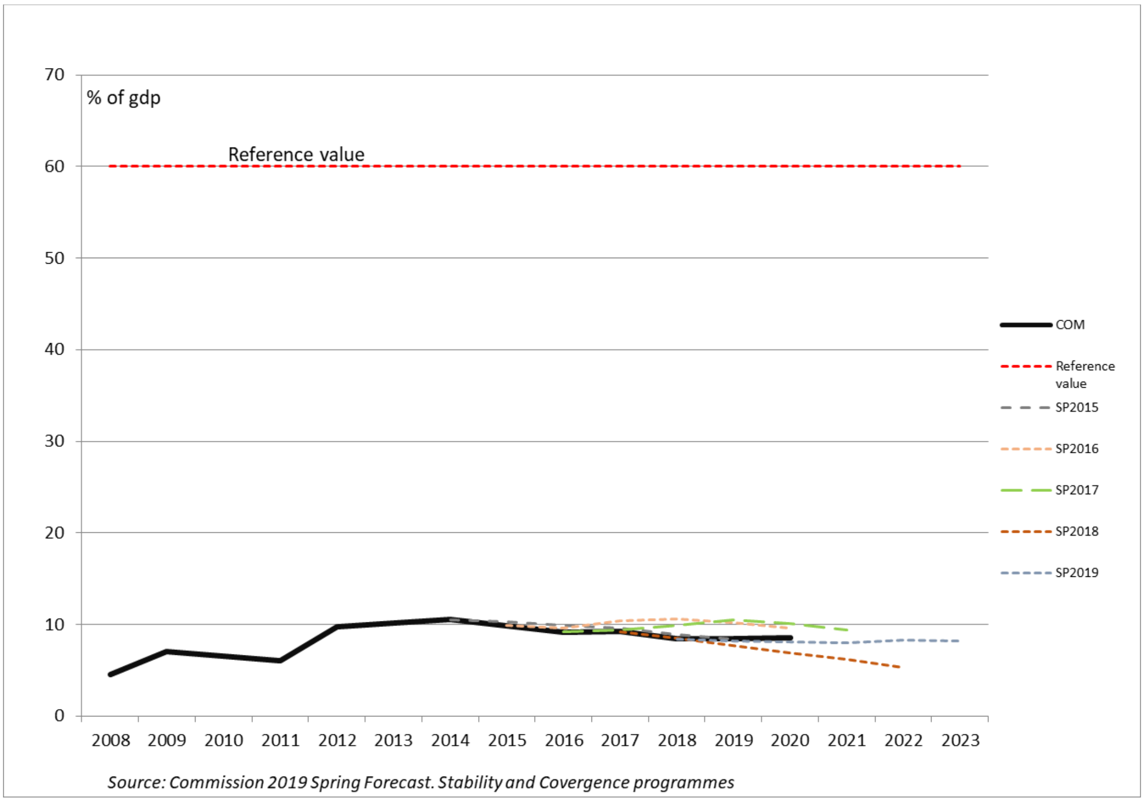
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets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

Source:

Commission 2019 spring forecast (COM); Stability Programme (SP), Comission calculations.

[7] See the Commission assessment of the 2018 Estonian Draft Budgetary Plan for details: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2018_en

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



3.5. RISK ASSESSMENT

Downside risks prevail for revenues. While the tax elasticities (revenue growth relative to tax base growth) appear to have been set relatively conservatively in the programme, some risks relate to the expected evolution of tax bases. As noted in Section 2, the Stability Programme is based on a somewhat favourable GDP growth scenario for the programme years. In addition, the programme also appears to overstate some discretionary revenue measures specifically for 2019 (but not for 2020), see Section 3.3. The major tax reforms that took effect in 2018 (the corporate and personal income tax reform and excise increases) have a notable fiscal effect also for 2019 and 2020. As also noted by the Fiscal Council, the risk of forecast errors concerning those taxes is still high and tilted on balance to the downside.

Exacerbating the downside risks for revenues, expenditure is predetermined to grow at a relatively rapid pace. In particular, social expenditures are set to grow relatively rapidly due to an indirect link to overall wage growth (with a lag of about 1 year). In an environment of slowing economic and wage growth, reducing expenditures in step with the slowing tax bases can be challenging.

Reflecting the above factors, the Commission projects lower nominal budget surpluses than the Stability Programme. In addition, the Commission expects a significantly larger positive output gap for 2019 and beyond than the programme, which suggest a weaker structural balance than presented in the programme. In conclusion, there are some downside risks for 2019, 2020 and for the medium term, regarding both the nominal and the structural fiscal targets.

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

Estonia is subject to the preventive arm of the Stability and Growth Pact (SGP). The Council addressed a SGP-related recommendation to Estonia last year 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'.

For 2018, Estonia was recommended to remain at the medium-term budgetary objective. This was consistent with a maximum nominal growth rate of net primary government expenditure of 6.1%, corresponding to a structural deterioration of -0.2% of GDP[8]. However, based on outturn data, the growth of government expenditure[9], net of discretionary revenue measures and one-offs, exceeded the applicable expenditure benchmark (deviation of 0.7% of GDP). The structural deficit amounted to 2.2% of GDP in 2018, substantially worse than previously expected and far away from the MTO. Nevertheless, the annual change in the structural balance in 2018 showed only some deviation (0.3% of GDP) from the required adjustment (deterioration of 0.5% of GDP compared to allowed deterioration of 0.2% of GDP). The average two-year deviation over 2017 and 2018 is within the requirements for the structural pillar, but indicates a small deviation for the expenditure pillar (0.1% of GDP). This calls for an overall assessment. The difference between the expenditure benchmark and structural balance indicators is largely explained by a significantly lower GDP deflator used for the expenditure benchmark indicator compared to the one underlying the structural balance. The GDP deflator underlying the expenditure benchmark was frozen based on the projection of the Commission 2017 spring forecast. At that time, the forecast expected much lower price and wage pressures than materialised in 2018[10]. The unexpectedly high price and wage increases benefitted tax revenues (and the budget balance) but also led to increased cost pressures for public expenditures. After adjusting for the GDP deflator effect, the expenditure benchmark points to some deviation in 2018, similarly to the structural balance pillar and the two year average expenditure deviation.

Overall, based on the outturn data and the Commission 2019 spring forecast, the ex-post assessment suggests that the adjustment path towards the MTO showed some deviation with the requirement of the preventive arm of the Pact in 2018.

Box 1. Council Recommendations addressed to Estonia

On 13 July, 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 “ensure that the nominal growth rate of net primary government expenditure

[8] Based on the 'freezing' of the requirement in spring 2017, Estonia appeared at that time to overachieve its MTO and was allowed to loosen its structural position accordingly.

[9] 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.

[10] GDP deflator was forecast to grow by 3.3% in 2018, outturn was 4.6%. Notably, government consumption deflator (one component of the GDP deflator) turned out significantly higher in 2018 than initially forecast (outturn 7.3%, forecast 5.7%).

does not exceed 4.1% in 2019, corresponding to an annual structural adjustment of 0.6% of GDP". These benchmarks were updated in the context of the Draft Budgetary Plan of Estonia. In view of the Commission autumn 2018 forecast, which projected a closer position to the medium term budgetary objective in 2019, the nominal growth rate of net primary government expenditure should not exceed 4.9%, corresponding to an annual structural adjustment of 0.3% in 2019.

For 2019, Estonia was recommended to reach its medium-term budgetary objective. This was consistent with a maximum nominal growth rate of net primary government expenditure of 4.9%, corresponding to a structural adjustment of 0.3% of GDP. Due to the negative fiscal surprise in 2018, the structural balance is now assessed to be far below the MTO in 2019. Still, the previous fiscal requirements are frozen at a less demanding level to ensure consistency of requirements.

According to the information provided in the Stability Programme, the growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is not expected to exceed the applicable expenditure benchmark of 4.9% in 2019. Also, the structural balance is expected to improve by 0.5 percentage points of GDP in 2019, thus also in line with the requirements. However, over the two year 2018-2019 average, the expenditure benchmark points to a significant deviation and the structural balance to some deviation. An overall assessment shows that there is a risk of significant deviation in 2019 due to the fiscal slippages that occurred in 2018 not being sufficiently compensated for in 2019.

According to the Commission 2019 spring forecast, the growth of government expenditure, net of discretionary revenue measures and one-offs, in 2019 will significantly exceed the applicable expenditure benchmark (gap of 0.5% of GDP)[11]. At the same time, the structural deficit improves by 0.5% of GDP, which is even slightly above the required adjustment of 0.3% of GDP. Over the two-year average, expenditure benchmark points again to a significant deviation and structural balance to some deviation. This calls for an overall assessment. Unlike in 2018, the GDP deflator used in the calculations makes only a marginal difference between the two indicators. The expenditure benchmark correctly reflects the risk of significant deviation from the adjustment path towards the MTO in 2019.

Following an overall assessment, a significant deviation from the adjustment path towards the MTO is currently expected in 2019.

In 2020, in view of Estonia's projected positive output gap of 2.2%, and with projected GDP growth below the estimated potential growth rate, the commonly agreed adjustment matrix under 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.

In 2020, according to the information provided in the Stability Programme, the growth of government expenditure, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark (gap of 0.5% of GDP). The recalculated structural deficit is set to deteriorate by 0.1% of GDP, falling significantly short of the required structural

[11] The difference between the Commission and Stability Programme figures for expenditure benchmark largely arise from the Stability Programme including more discretionary revenue measures (that do not qualify as revenue measures according to the Commission methodology, see Section 3.3). In addition, the Commission forecast expects higher growth of public wages.

adjustment (gap of 0.7% of GDP). Similarly, over the two-year average, expenditure benchmark points to some deviation and structural balance to significant deviation. An overall assessment, giving priority to the expenditure benchmark, suggests that the expenditure benchmark reflects adequately the fiscal stance of the country in 2020, implying the Stability Programme plans for some deviation.

According to the Commission 2019 spring forecast, the growth of government expenditure, net of discretionary revenue measures and one-offs, in 2020 will significantly exceed the applicable expenditure benchmark (gap of 0.7% of GDP)[12]. The structural deficit is set to improve only marginally by 0.1% of GDP and remain far from the MTO. The deviation from the structural balance requirement is slightly smaller (0.5% of GDP) than the expenditure benchmark deviation, pointing to some deviation from the requirement. Deviations over the two-year average confirm the above signals. An overall assessment shows only minor differences between the two pillars. Therefore, similarly to 2019, the expenditure benchmark correctly reflects the risk of a significant deviation from the adjustment path towards the MTO in 2020.

Following an overall assessment, a significant deviation from the adjustment path towards the MTO is currently expected in 2020.

[12] The programme projects a slightly lower deviation from the expenditure benchmark than the Commission, which is largely explained by the lower growth of public wages ('compensation of employees' in Table 2).

Table 6: Compliance with the requirements under the preventive arm

(% of GDP)	2018	2019		2020	
Background budgetary indicators[1]					
Medium-term budgetary objective (MTO)	-0.5	-0.5		-0.5	
Structural balance[2] (COM)	-2.2	-1.7		-1.5	
Setting the required adjustment to the MTO					
Structural balance based on freezing (COM)	-0.8	-1.7		-	
Position vis-à-vis the MTO[3]	At or above the MTO	Not at MTO		Not at MTO	
Required adjustment[4]	0.0	0.3		0.6	
Required adjustment corrected[5]	-0.2	0.3		0.6	
Corresponding expenditure benchmark[6]	6.1	4.9		4.1	
Compliance with the required adjustment to the MTO					
	COM	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Change in structural balance[7]	-0.5	0.4	0.5	-0.1	0.1
One-year deviation from the required adjustment[8]	-0.3	0.1	0.2	-0.7	-0.5
Two-year average deviation from the required adjustment[8]	0.0	-0.1	-0.1	-0.3	-0.1
Expenditure benchmark pillar					
Net public expenditure annual growth corrected for one-offs[9]	8.2	4.6	6.4	5.4	5.9
One-year deviation adjusted for one-offs[10]	-0.7	0.1	-0.5	-0.5	-0.7
Two-year deviation adjusted for one-offs[10]	-0.1	-0.3	-0.6	-0.2	-0.6
Finding of the overall assessment	some deviation	significant deviation	significant deviation	some deviation	significant deviation

Legend

'*Compliance*' - the recommended structural adjustment or a higher adjustment is being observed.

'*Some deviation*' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.

'*Significant deviation*' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).

Irrelevant for the Significant Deviation Procedure ' - a SDP would not be opened only based on the two-year deviation if the MTO has reached (at the time of the freezing or on the base of the last storage) in one of the two years.

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 point 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, 2018 edition, p.38.). In case of a SDP, the requirement corresponds to the Council recommendation when available; otherwise it refers to the Commission recommendation to the Council.

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

[6] 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.

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

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

[9] Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)

[10] 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:
Stability Programme (SP); Commission 2019 spring forecast (COM); Commission calculations.

5. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

Estonia does not appear to face fiscal sustainability risks in the short, medium or long run. However, as highlighted in the Commission 2019 Country Report for Estonia[13], the relatively low pension expenditure is mirrored by relatively low pension adequacy, leading to high relative poverty among the elderly. As the Stability Programme states, in the long term the benefit ratio would likely decline further (since wage growth is set to outpace pensions growth), which might lead to higher public spending.

Based on the Commission 2019 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 8.4% of GDP in 2018, is expected to rise to about 16% in 2029, thus remaining well below the 60% of GDP Treaty threshold. Sensitivity analysis gives similar results.[14] This points to low risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would also bring the debt ratio to about 16% of GDP in 2029.

The medium-term fiscal sustainability risk indicator S1[15] stands at -3.4 percentage points of GDP, primarily thanks to the low level of government debt, which contributes -4 percentage points 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 -4.7 percentage points of GDP, thus further reducing medium-term risks. Overall, with both the debt sustainability analysis and the S1 indicator pointing in the same direction, risks to fiscal sustainability over the medium term are low. Fully implementing the fiscal plans in the Stability Programme would further decrease those risks.

The long-term fiscal sustainability risk indicator S2 is at 1.6 percentage points of GDP. In the long term, Estonia therefore appears to face low fiscal sustainability risks. This is mainly thanks to the low projected ageing costs, in particular pension expenditure, which contributes -1 percentage point of GDP.[16] Full implementation of the Stability Programme would put the S2 indicator at 1.8 percentage points of GDP. Based on the debt sustainability analysis discussed higher and the S2 indicator, long-term fiscal sustainability risks are thus assessed as low for Estonia.

The above assessment does not yet include the impact of the recently adopted reform of the public pension scheme, nor the intention of the new government to reform the second pillar pension system. Broadly, the government plans to make the second pillar voluntary and allow people to withdraw their accumulated savings from the second pillar at any point in time.

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[13] https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-estonia_en.pdf

[14] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Fiscal Sustainability Report 2018 for more details).

[15] See the note to Table 7 for a definition of the indicator.

[16] The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report.

Table 7: Debt sustainability analysis and 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]			-3.4	LOW risk	-4.7	LOW risk
of which	Initial Budgetary Position		0.8		0.5	
	Debt Requirement		-4.0		-5.1	
	Cost of Ageing		-0.3		0.0	
	of which	Pensions	-0.5		-0.2	
		Health care	0.0		0.1	
		Long-term care	0.1		0.0	
		Other	0.1		0.1	
Long-term			**LOW risk**			
DSA [2]			LOW risk			
S2 indicator [4]			1.6	LOW risk	1.8	LOW risk
of which	Initial Budgetary Position		1.6		1.5	
	Cost of Ageing		0.0		0.3	
	of which	Pensions	-1.0		-0.8	
		Health care	0.3		0.4	
		Long-term care	0.3		0.3	
		Other	0.3		0.3	

Source: Commission services; 2019 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 2019 forecast until 2020. 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 2033. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2021 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 2018.

6. FISCAL FRAMEWORK

The current formulation of the national structural budget balance rule has been in place since 2017. It allows for a structural deficit of up to 0.5% of GDP against the earlier accumulated structural surpluses. Over a longer period, a balanced budget in structural terms is meant to be maintained on average. The Estonian framework does not include a binding expenditure rule.

Based on the no-policy-change scenario provided in the Stability Programme, the past and forecast fiscal performance in Estonia does not appear to comply with the requirements of the applicable national numerical fiscal rule, taking in particular into account the negative budgetary surprise in 2018. The presented path is even further away from the national budgetary requirements when using programme information recalculated by the Commission using the commonly agreed methodology.

The no-policy-change scenario of the Stability Programme is based on the macroeconomic and budgetary forecast prepared by the Fiscal Policy Department of the Ministry of Finance of Estonia. The Fiscal Council of Estonia (*Eelarvenõukogu*)[17] is an independent body charged with assessing the macroeconomic and fiscal forecasts of the Ministry of Finance and the extent to which the national budgetary rules are followed. On 18 April 2019, the Fiscal Council published its opinion on the macroeconomic and fiscal forecast of the Ministry of Finance. Since the forecast underlies also as the no-policy-change scenario of the 2019 Stability Programme, the Fiscal Council's opinion can be considered as applicable also with respect to this document.

The Fiscal Council endorsed the macroeconomic forecast of Ministry of Finance, considering it plausible with risks broadly balanced and a suitable basis for preparing the state budget strategy. The Fiscal Council found that the forecast for tax revenues in the state budget was in line with the macroeconomic projections. Still, the Council noted that the probability of forecast error was heightened, as had also been the case in the previous years, since the behavioural response to recent tax changes was difficult to predict (in particular with respect to corporate income tax, personal income tax and excises). The Fiscal Council's own estimates of the structural budget position are broadly similar to those of the Stability Programme, indicating a persistent structural deficit of around 0.8-1% of GDP over 2019-2022. The Council noted in its assessment that since the structural deficit was considerably larger than planned in 2018, the compensation mechanisms foreseen in the State Budget Act would kick in already for 2019. In line with the national fiscal framework, consolidation of at least 0.5% of GDP annually is required until the structural balance target is met, implying consolidation needs in 2019 and beyond. The Council argues that the current good economic times offer a suitable setting for budgetary consolidation and the government should take measures (curbing expenditure growth) to achieve the balanced structural position already in 2019.

The Stability Programme does not indicate that it would also constitute the national medium-term fiscal plan in the meaning of Article 4(1) of regulation 473/2013. It states that the national medium-term fiscal plan will be presented by end-May 2019.

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

7. SUMMARY

In 2018, Estonia did not achieve the MTO. A deviation of 0.3% of GDP from the required structural balance adjustment towards the MTO was recorded. The growth rate of government expenditure, net of discretionary revenue measures, exceeded the applicable expenditure benchmark rate by 0.7% of GDP. Following an overall assessment, this points to some deviation from the recommended adjustment path towards the MTO.

In 2019, the Stability Programme foresees a growth rate of government expenditure, net of discretionary revenue measures, which is in line with the applicable expenditure benchmark rate. The improvement of the structural balance of 0.4% of GDP in 2019 is also appropriate. However, over a two-year average, which captures the fiscal underperformance in 2018, the expenditure benchmark is significantly exceeded and the structural pillar shows some deviation. According to the Commission 2019 spring forecast, there is a risk of significant deviation in 2019, following an overall assessment.

In 2020, the Stability Programme projects a growth rate of government expenditure, which somewhat exceeds the applicable expenditure benchmark rate. A weakening of the structural balance of 0.1% of GDP in 2020 implies a significant deviation of 0.7% of GDP. The same signals are confirmed over a two-year average. According to the Commission 2019 spring forecast, there is a risk of significant deviation in 2020, following an overall assessment.

8. ANNEXES

Table I. Macroeconomic indicators

	2001-2005	2006-2010	2011-2015	2016	2017	2018	2019	2020
Core indicators								
GDP growth rate	7.1	0.0	3.7	3.5	4.9	3.9	2.8	2.4
Output gap [1]	2.9	2.6	0.5	1.1	2.7	3.3	2.8	2.2
HICP (annual % change)	3.6	4.9	2.6	0.8	3.7	3.4	2.4	2.2
Domestic demand (annual % change) [2]	9.0	-0.6	4.6	4.6	4.2	5.5	3.2	2.6
Unemployment rate (% of labour force) [3]	10.5	9.2	8.9	6.8	5.8	5.7	5.7	5.7
Gross fixed capital formation (% of GDP)	31.0	29.7	26.3	23.0	24.4	23.9	24.2	24.5
Gross national saving (% of GDP)	23.4	23.4	27.1	26.1	28.6	28.5	28.2	28.4
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**1.2**	**0.2**	**0.3**	**-0.3**	**-0.4**	**-0.6**	**-0.3**	**-0.5**
Gross debt	**5.1**	**5.2**	**9.3**	**9.2**	**9.2**	**8.4**	**8.5**	**8.5**
Net financial assets	**30.2**	**29.4**	**33.6**	**39.3**	**38.2**	**n.a**	**n.a**	**n.a**
Total revenue	36.1	39.0	38.8	39.1	38.9	39.0	39.5	39.4
Total expenditure	34.9	38.8	38.5	39.5	39.3	39.5	39.9	39.9
of which: Interest	0.2	0.2	0.1	0.1	0.0	0.0	0.0	0.0
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-7.1**	**-2.8**	**1.1**	**0.7**	**1.4**	**0.6**	**0.7**	**0.5**
Net financial assets; non-financial corporations	**-132.0**	**-154.5**	**-147.2**	**-153.5**	**-150.2**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-16.8**	**1.6**	**5.3**	**3.7**	**4.2**	**n.a**	**n.a**	**n.a**
Gross capital formation	23.5	18.3	16.9	15.8	15.9	16.8	16.6	16.9
Gross operating surplus	32.0	29.7	31.5	28.7	29.6	29.6	29.1	29.1
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.3**	**-2.0**	**1.8**	**1.7**	**2.6**	**2.3**	**2.1**	**2.6**
Net financial assets	**51.0**	**48.9**	**60.0**	**71.7**	**76.5**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	34.1	36.6	35.4	37.0	36.8	36.9	37.0	37.1
Net property income	1.9	2.5	4.3	4.1	4.3	4.0	4.0	4.3
Current transfers received	16.4	16.2	16.6	17.0	16.4	16.4	16.5	16.7
Gross saving	-0.4	3.2	5.7	6.0	6.6	6.3	6.2	6.6
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-9.7**	**-4.8**	**3.2**	**2.8**	**4.2**	**2.7**	**2.6**	**2.7**
Net financial assets	**67.7**	**74.5**	**48.4**	**38.9**	**31.4**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-6.6	-2.3	3.5	4.1	4.6	3.5	3.2	3.0
Net primary income from the rest of the world	-4.6	-5.0	-3.3	-2.3	-2.0	-2.2	-2.2	-2.1
Net capital transactions	0.5	2.3	2.6	1.0	1.0	1.2	1.2	1.3
Tradable sector	49.9	44.9	46.7	44.6	44.6	43.9	n.a	n.a
Non tradable sector	39.0	42.9	40.7	41.7	42.1	43.0	n.a	n.a
of which: Building and construction sector	6.1	7.6	5.8	5.6	6.1	6.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	72.0	97.7	102.7	111.3	116.3	122.7	124.1	125.0
Terms of trade goods and services (index, 2000=100)	93.9	100.9	101.3	103.3	104.1	104.5	104.7	104.8
Market performance of exports (index, 2000=100)	79.4	93.1	116.6	113.3	111.2	112.1	113.1	113.6

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2010 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 2019 spring forecast

Mandatory variables not included in the Stability Programme

The Stability Programme contains all mandatory variables.