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COMMISSION OPINION

of 22.11.2022

on the Draft Budgetary Plan of Estonia

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(Only the Estonian text is authentic)

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GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area, to ensure that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact and the European Semester for economic policy coordination.

2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan by 15 October, presenting the main aspects of the budgetary outlook of the general government and its subsectors for the forthcoming year.

3. The general escape clause of the Stability and Growth Pact has been active since March 2020.[1] On 23 May 2022, the Commission indicated, in its Communication on the European Semester,[2] that heightened uncertainty and strong downside risks to the economic outlook in the context of war in Europe, unprecedented energy price hikes and continued supply chain disturbances warrant the extension of the general escape clause of the Stability and Growth Pact through 2023 and it considered that the conditions to deactivate it as of 2024 were met. The continued activation of the general escape clause in 2023 will provide the space for national fiscal policy to react promptly when needed, while ensuring a smooth transition from the broad-based support to the economy during the pandemic times towards an increasing focus on temporary and targeted measures and fiscal prudence required to ensure medium-term sustainability.[3]

4. The Recovery and Resilience Facility, as established by Regulation (EU) 2021/241, provides financial support for the implementation of reforms and investment, notably to promote the green and digital transitions, thereby strengthening the economies' resilience and potential growth. Part of this support is in the form of non-repayable financial support ("grants"), entailing a fiscal impulse financed by the Union. Together with cohesion policy funds and the Just Transition Mechanism, the RRF is supporting a fair and inclusive recovery in the EU in line with the European Pillar of Social Rights. It also boosts growth and job creation in the medium and long term, and thereby strengthens sustainable public finances. According to the Commission

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1 Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact, COM(2020) 123 final of 20 March 2020.

2 COM(2022) 600 final.

3 On 17 June 2022, the Council agreed its recommendations on the 2022 National Reform Programmes and the opinions on the 2022 Stability and Convergence Programmes, which takes into account the continuation of the Stability and Growth Pact's general escape clause into 2023. (See: https://www.consilium.europa.eu/en/meetings/ecofin/2022/06/17/)

proposal of 18 May 2022,[4] the Facility should also aim at increasing the resilience of the Union energy system by reducing dependence on fossil fuels and diversifying energy supplies at Union level ('REPowerEU objectives').

5. On 12 July 2022, in the recommendations delivering Council opinions on the 2022 Stability Programmes,[5] the Council recalled that the overall fiscal stance is currently best measured as the change in primary expenditure (net of discretionary revenue measures and excluding temporary emergency measures related to the COVID-19 crisis), including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other Union funds, relative to medium-term potential growth.[6] Going beyond the overall fiscal stance, in order to assess whether national fiscal policy is prudent and its composition is consistent with the green and digital transitions, energy security and ensuring social and economic resilience, attention is also paid to the evolution of nationally-financed[7] primary current expenditure (net of discretionary revenue measures and excluding temporary emergency measures related to the COVID-19 crisis) and investment.

6. The shocks unleashed by the Russian invasion of Ukraine are impacting the EU economy both directly and indirectly, setting it on a path of lower growth and higher inflation. Intensifying and broadening inflationary pressures have been prompting faster normalisation of monetary policy in the euro area. Public spending on measures containing the social and economic impact of high energy costs, on security and defence and on humanitarian assistance to the displaced persons from Ukraine is weighing on public finances. The specific nature of the macroeconomic shock imparted by Russia's invasion of Ukraine, as well as its long-term implications for the EU's energy security needs, call for a careful design of fiscal policy in 2023. A broad-based fiscal impulse to the economy in 2023 does not appear warranted. The focus should instead be on protecting the vulnerable, allowing automatic stabilisers to operate and providing temporary and targeted measures to mitigate the impact of the energy crisis and to provide humanitarian assistance to people fleeing from Russia's invasion of Ukraine, while maintaining the agility to adjust, if needed. Fiscal policy should combine higher investment with controlling the growth in nationally-financed primary current expenditure. Full and timely implementation of the Recovery and Resilience Plans is key to achieving higher levels of investment. Fiscal policies should aim at preserving debt sustainability as well as raising the growth potential in a sustainable manner, thus also facilitating the task of monetary policy to ensure the timely return of inflation to the ECB's 2% medium-term target. Fiscal plans for 2023 should be anchored by prudent medium-term adjustment paths reflecting fiscal sustainability challenges associated with high debt-to GDP levels that have increased further due to the pandemic as well as the reforms and investment challenges associated with twin transition, energy security and social and economic resilience.

7. Russia's war of aggression against Ukraine has resulted in substantial additional increases in and volatility of the prices of energy. The price shock in imported energy

[4] COM(2022) 231 final.

[5] Council Recommendation of 12 July 2022 on the National Reform Programme of Estonia and delivering a Council opinion on the 2022 Stability Programme of Estonia, OJ C 334, 1.9.2022, p. 44

[6] The estimates on the fiscal stance and its components in this Opinion are Commission estimates based on the assumptions underlying the Commission 2022 autumn forecast. The Commission's estimates of medium-term potential growth do not include the full positive impact of reforms that are part of the Recovery and Resilience Plan and that can boost potential growth.

[7] Not financed by grants under the Recovery and Resilience Facility or other Union funds.

implies a substantial terms-of-trade loss to Member States' economies. In parallel, the exceptionally high temperatures in summer 2022 pushed up demand for electricity, while, at the same time, energy production from certain technologies has been significantly below historical levels due to technical and weather-dependant circumstances. All Member States have been negatively affected by the current energy crisis, albeit to a different extent, calling for a rapid and coordinated response.

8. Given that budgetary resources are limited and need to be used in the most efficient way, in order to manage a durable and equitable adjustment across society, the quality and design of the policy response is highly important. Therefore, also in line with the Council Regulation on an emergency intervention to address high energy prices adopted on 6 October 2022, measures should focus on providing temporary support, targeted to households and firms most vulnerable to energy price increases, while maintaining the right incentives to reduce energy demand and increase energy efficiency, in line with the European Green Deal.[8] Policies should also help reducing the energy consumption and develop the energy autonomy of the Union.

CONSIDERATIONS CONCERNING ESTONIA

9. On 14 October 2022, Estonia submitted the Draft Budgetary Plan for 2023. On that basis, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

10. On 12 July 2022, the Council recommended that Estonia[9] take action to ensure in 2023 that the growth of nationally financed primary current expenditure is in line with an overall neutral policy stance[10] taking into account continued temporary and targeted support to households and firms most vulnerable to energy price hikes and to people fleeing Ukraine. Estonia should stand ready to adjust current spending to the evolving situation. Estonia was also recommended to expand public investment for the green and digital transitions, and for energy security taking into account the REPowerEU initiative, including by making use of the Recovery and Resilience Facility and other Union funds. For the period beyond 2023, Estonia should pursue a fiscal policy aimed at achieving prudent medium-term fiscal positions.

11. On 23 May 2022, the Commission issued a report under Article 126(3) Treaty.[11] That report assessed the budgetary situation of Estonia, as its general government deficit in 2022 had been planned to exceed the Treaty reference value of 3 % of GDP. The report concluded that the deficit criterion was not fulfilled.

12. According to the Commission 2022 autumn forecast, the Estonian economy is expected to contract by 0.1% in 2022 and grow by 0.7% in 2023, while inflation is forecast at 19.3% in 2022 and 6.6% in 2023.

According to the Draft Budgetary Plan, the Estonian economy is expected to grow by 1.0% in 2022 and 0.5% in 2023, while inflation is projected at 19.5% in 2022 and

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[8] Communication from the Commission, the European Green Deal, COM(2019) 640 final.

[9] Council Recommendation of 12 July 2022 on the National Reform Programme of Estonia and delivering a Council opinion on the 2022 Stability Programme of Esonia, OJ C 334, 1.9.2022, p. 44.

[10] Based on the Commission autumn 2022 forecast, the medium-term (10-year average) potential output growth of Estonia, that is used to measure the fiscal stance, is estimated at 10.0% in nominal terms. The Commission's estimates of medium-term potential growth do not include the full positive impact of reforms that are part of the Recovery and Resilience Plan and that can boost potential growth.

[11] Report from the Commission prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union, COM(2022) 630 final of 23 May 2022.

6.7% in 2023. The higher GDP growth in 2022 is explained by stronger net exports, compared to the Commission forecast. The differences also reflect different cut-off dates across the two sets of projections. The labour market is expected to remain relatively strong in both forecasts. In both sets of projections investment is projected to drop sharply in 2022, mainly reflecting a base effect from the previous year (investment in intangibles), but also slowing construction activity. In spite of rapid inflation, both forecasts expect private consumption to continue growing slightly over 2022 and 2023, reflecting the strong labour market, accumulated savings and significant fiscal measures bolstering households' purchasing power.

Overall, the macroeconomic assumptions underpinning the Draft Budgetary Plan are markedly favourable in 2022 and plausible in 2023.

Estonia complies with the requirement of Regulation (EU) No 473/2013 since the draft budget is based on independently endorsed macroeconomic forecasts.[12]

13. The Draft Budgetary Plan assumes that expenditure amounting to 0.5% of GDP in 2022, 0.3% in 2023, 0.4% in 2024, 0.5% in 2025 and 0.4% in 2026 will be financed by non-repayable financial support (grants) from the Recovery and Resilience Facility. Expenditure financed by Recovery and Resilience Facility grants will enable high-quality investment and productivity-enhancing reforms without a direct impact on the general government deficit and debt of Estonia. The Commission 2022 autumn forecast includes a similar amount of expenditure financed by Recovery and Resilience Facility grants.

14. In its 2023 Draft Budgetary Plan, Estonia's general government deficit is planned to increase from 2.7% of GDP in 2022 to 3.9% of GDP in 2023, mainly due to substantial rises in expenditures on defence, education, research and development, as well as on child benefits, public wages and on displaced persons from Ukraine. Revenues are negatively impacted by an increase of the the tax free allowance of the personal income tax brackets, benefitting most the low income earners. The Commision projects a lower deficit of 2.3% of GDP in 2022, reflecting the most recent data, which is not taken account in the Draft Budgetary Plan due to an earlier cut-off date. The recent data shows continued strong revenue accrual (also reflecting inflation effects on VAT) and indicates somewhat smaller deficit than expected in the plan, in spite of the weakening economic activity. This lower deficit base carries over to 2023, when the Commission also projects a slightly lower deficit of 3.7% of GDP. The general government debt ratio is planned to increase from 18.8% of GDP in 2022 to 19.8% of GDP in 2023. These projections are broadly in line with the Commission 2022 autumn forecast.

The outlook for public finances continues to be subject to the high uncertainty that surrounds the macroeconomic projections, including macroeconomic risks related to the Russian invasion of Ukraine, energy price hikes and continued supply chain disturbances.

[12] The Estonian Fiscal Council opinion of 6 September 2022 did not endorse the 2022 Summer Economic Forecast of the Ministry of Finance as it was found to use out-of-date assumptions about the growth of government spending, not taking account of the upcoming significant fiscal measures under preparation. Thereafter, the Ministry of Finance prepared an additional macroeconomic scenario including the new fiscal measures on September 23 (published on 27 September as part of explanatory letter of 2023 State Budget and the 2023-2026 State Budget Strategy). On the basis of this additional scenario, the Fiscal Council endorsed the new macroeconomic scenario of the Ministry of Finance on 27 September 2022.

15. The Draft Budgetary Plan contains an extensive list of measures, some of which do not meet the definition of a discretionary fiscal measure as commonly agreed and used by the Commission, for example the secondary revenue impacts of expenditure measures, increased dividends from the state-owned enterprises or the postponement of previously foreseen excise tax increases. The revenue measure for 2023, which the Commission also counts as a discretionary fiscal measure, concerns raising the tax-free allowance of the personal income tax brackets. In the aggregate (including also those measures that the Commission does not count as discretionary fiscal measures), the draft budgetary plan projects the revenue measures to have a deficit-decreasing impact of 0.9% of GDP. On the expenditure side, the main Draft Budgetary Plan measures for 2023 are targeted salary increases (teachers, cultural workers, internal security, IT specialists), additional defence spending, expenditure on education programmes and R&D, child benefits and spending on displaced persons from Ukraine (total increase of expenditure by 2.8% of GDP). The Draft Budgetary Plan revenue and expenditure measures taken together increase the general government deficit by 1.9% of GDP. The Commission's forecast takes account of the same measures with similar amounts.[13]

    The government deficit is impacted by the measures adopted to counter the economic and social impact of the exceptional increases in energy prices, which aggravated over the course of the summer. The budgetary cost of these measures is projected in the Commission 2022 autumn forecast to amount to 0.9% of GDP in 2022 and 0.3% of GDP in 2023. The first batch of measures for the winter of 2021/2022 was temporary and has already expired in the spring of 2022. The measures included inter alia lower excise for agricultural fuel, a partial compensation of energy bills for households earning less than the median income, reduced network charges for electricity and gas for households and corporates, electricity and gas price caps for households, and a one-time 50-euro social transfer to pensioners and children. The second batch of measures for the winter of 2022/23 is also temporary. These measures include a compensation of a share of all households' heating, electricity and gas bills over the winter of 2022/2023, and a smaller measure supporting the transport sector and care institutions over 2023. In addition, the state-owned energy company was mandated by the government to sell electricity at a pre-determined fixed price[14] to households and small enterprises, starting from October 2022 for four years. All the other measures have been announced as temporary, having already expired or expiring after the first quarter of 2023. The measures do not appear targeted to vulnerable households or firms,[15] and most of them do not fully preserve the price signal to reduce energy demand and increase energy efficiency.[16] As a result, the amount of temporary and targeted support to households and firms most vulnerable to energy price hikes, that can be taken into account in the assessment of compliance with the fiscal country-specific recommendation for 2023, is estimated in the Commission 2022 autumn forecast at 0.1% of GDP in 2022 and 0% of GDP in 2023.

[13] Those measures which do not meet the definition of a fiscal measure as used by the Commission are still indirectly included in the forecast. For example, the second-round revenue impacts are not accounted as a separate measure but do enter the forecast via macroeconomic effects.

[14] The price was set by the Estonian Competition Authority and allows for reasonable profitability of the state-owned energy company.

[15] Targeted measures amount to 0.1% of GDP in 2022 and 0% of GDP in 2023, while untargeted measures amount to 0.8% of GDP in 2022 and 0.3% of GDP in 2023.

[16] Income measures amount to 0.4% of GDP in 2022 and 0% of GDP in 2023, while price measures amount to 0.4% of GDP in 2022 and 0.3% of GDP in 2023.

The government deficit is also impacted by the costs to offer temporary protection to displaced persons from Ukraine, which in the Commission 2022 autumn forecast are projected at 0.4% of GDP in 2022 and 0.5% in 2023.

16. Based on the Commission's 2022 autumn forecast and including the information incorporated in Estonia's 2023 Draft Budgetary Plan, gross fixed capital formation is expected to amount to 5.4% of GDP in 2022 and 6.0% of GDP in 2023, compared to 5.6% of GDP recorded in 2021. This includes investment for the green and digital transitions and for energy security, such as the strengthening of the electricity grid to also enable more renewable energy production, energy efficiency in housing, ICT projects, railway electrification, and investments on sustainable transport, which are partly funded by the Recovery and Resilience Facility and other EU funds.

17. In 2023, the fiscal stance is projected in the Commission 2022 autumn forecast to be expansionary (-1.0% of GDP[17]). This follows a contractionary fiscal stance in 2022 (0.9% of GDP).

The growth in nationally-financed primary current expenditure (net of new revenue measures) in 2023 is projected to provide an expansionary contribution of 0.9 percentage points to the fiscal stance[18]. This includes the reduced impact from the support measures adopted to counter the economic and social impact of the exceptional increases in energy prices by 0.6% of GDP[19], of which temporary and targeted support measures to households and firms most vulnerable to energy price hikes account for 0.1% of GDP. This also includes higher costs to offer temporary protection to displaced persons from Ukraine (by 0.1% of GDP). Therefore, the expansionary contribution of nationally-financed primary current expenditure is not due to the temporary and targeted support to households and firms most vulnerable to energy price hikes and to people fleeing Ukraine. The expansionary growth in nationally-financed primary current expenditure (net of new revenue measures) is driven by permanent increases in social spending, public wages, education and defence expenditure.

The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 0.2 percentage points of GDP. Nationally-financed investment is projected to provide an expansionary contribution to the fiscal stance of 0.3 percentage points in 2023.[20]

18. The Draft Budgetary Plan does not include budgetary projections beyond 2023, although it refers to the government's medium-term budgetary strategy to maintain the current structural deficit level of 2.6% of GDP up till 2026, given the challenges related to the energy and security crises.

19. In 2023, based on the Commission's forecast and including the information incorporated in the Draft Budgetary Plan, the overall fiscal policy stance is estimated to be expansionary. This includes an expansionary contribution to the overall fiscal stance from nationally-financed current expenditure. This expansionary contribution

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[17] A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy. The fiscal stance includes the fiscal impulse funded by the Union.

[18] This follows a contractionary contribution from this component of 0.9 percentage points in 2022.

[19] The budgetary impact of targeted price and income measures is projected to decrease by 0.1% of GDP and remain stable respectively, while the budgetary impact of untargeted price and income measures is projected to decrease by 0.1 and 0.4% of GDP respectively.

[20] Other nationally financed capital expenditure is projected to provide a contractionary contribution of 0.4 percentage points of GDP, reflecting a base effect from 2022.

is not the result of temporary and targeted support to households and firms most vulnerable to energy price hikes and the cost to assist people fleeing Ukraine. Overall, the growth of nationally-financed primary current expenditure is not in line with the recommendation of the Council. Estonia plans to finance additional investment through the RRF and other EU funds, and it also plans to preserve nationally-financed investment. It plans to finance public investment for the green and digital transitions, and for energy security.

Overall, the Commission is of the opinion that the Draft Budgetary Plan for Estonia is partly in line with the fiscal guidance contained in the Council recommendation of 12 July 2022. The Commission invites Estonia to take the necessary measures within the national budgetary process to ensure that the 2023 budget is consistent with the recommendation adopted by the Council on 12 July 2022.

While Estonia rapidly deployed energy measures as part of the emergency policy response to the exceptional energy price hikes, a prolongation of existing and/or an enactment of new support measures in response to high energy prices would contribute to higher growth in net nationally-financed current expenditure and to an increase in the projected government deficit and debt in 2023. Therefore, it is important that Member States better focus such measures to the most vulnerable households and exposed firms, to preserve incentives to reduce energy demand, and to be withdrawn as energy price pressures diminish.

A comprehensive description of progress made with the implementation of the country-specific recommendations will be made in the 2023 Country Report and assessed in the context of the country-specific recommendations to be proposed by the Commission in spring 2023.

Done at Brussels, 22.11.2022

For the Commission
Paolo GENTILONI
Member of the Commission