



EUROPEAN COMMISSION  
DIRECTORATE GENERAL  
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 26 May 2016

**Assessment of the 2016 Stability Programme for  
Estonia**

*(Note prepared by DG ECFIN staff)*

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## **1. INTRODUCTION**

This document assesses the Estonia's 2016 Stability Programme, which was submitted on 28 April 2016 and covers the period 2016-2020. The programme was approved by the government at the same time as the national state budget strategy.

Estonia is 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 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2016 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 risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a summary.

## **2. MACROECONOMIC DEVELOPMENTS**

The 2016 Stability Programme is based on the national macroeconomic forecast which was published on 5 April 2016. It expects a gradual acceleration of GDP growth from a lacklustre outcome of 1.1% in 2015 to 2.0% in 2016 and further to around 3% over the period 2017-2020 (Table 1). The acceleration is supported by improving export demand, while domestic demand is expected to remain the main growth driver.

The forecast for 2016 and 2017 has been revised downwards compared with the forecast underlying the Draft Budgetary Plan presented in autumn 2015, which at the time expected GDP to grow by 2.6% in 2016 and 3.4% in 2017. The main reason for the revision is weaker external demand outlook and more modest investment growth expected for 2016 and slightly weaker domestic demand expectation for 2017.

The unemployment rate is expected to have bottomed out in 2015 at 6.2% of the working age population and is forecast in the Stability Programme to gradually increase to 6.6% in 2016 and 7.6% in 2017. The rise in unemployment can in large part be explained by the statistical effect of the 'work ability reform', as it is expected to bring previously inactive population groups to the labour market. The weaker economic performance in 2015 is also expected to have a lagged impact. At the same time, wage pressures remain high due to a shrinking working age population and the historically high employment rate. Annual HICP inflation is forecast to increase from 0.1% in 2015 to 0.9% in 2016 and 2.9% in 2017, significantly impacted by wage pressures and hikes in excise taxes on fuels, alcohol and tobacco.

The output gaps as recalculated by Commission based on the information in the programme, following the commonly agreed methodology, turn negative to -0.7% of potential GDP in

2016, but move again to around zero by 2018, given the expected acceleration in GDP growth<sup>1</sup>.

The Stability Programme expects a gradual acceleration of GDP growth from 1.1% in 2015 to 2.0% in 2016 and further to around 3% over the period 2017-2020. Compared with the Commission, the programme forecasts a faster investment recovery in 2017, as it expects slightly stronger export growth. However, the main consumption tax base, i.e. private consumption, is similar between the two forecasts. Also, the tax base for labour taxes, predominantly wage growth, is projected even higher by the Commission forecast. Labour market and inflation projections are broadly similar between the forecasts. Therefore, the more optimistic GDP growth forecast for 2017 should not lead to major risks to the public finance projections, compared with the Commission forecast. Overall the macroeconomic assumptions underlying the Stability Programme are plausible for 2016, but optimistic for 2017.

**Table 1: Comparison of macroeconomic developments and forecasts**

	2015		2016		2017		2018	2019	2020	
	COM	SP	COM	SP	COM	SP	SP	SP	SP	
Real GDP (% change)	1.1	1.1	1.9	2.0	2.4	3.0	3.3	3.0	2.8	
Private consumption (% change)	5.0	4.8	3.3	3.4	2.6	2.5	2.8	3.2	3.0	
Gross fixed capital formation (% change)	-4.4	-4.5	2.3	2.4	3.5	4.4	4.7	5.0	5.0	
Exports of goods and services (% change)	-1.1	-1.1	1.8	1.6	3.6	3.8	4.5	4.8	4.7	
Imports of goods and services (% change)	-1.8	-1.8	2.8	3.7	3.9	3.8	4.3	5.0	5.0	
<i>Contributions to real GDP growth:</i>										
- Final domestic demand	1.8	1.8	2.6	2.7	2.5	2.7	2.9	3.2	3.1	
- Change in inventories	-2.5	-2.5	0.0	0.8	0.0	0.1	0.0	-0.1	-0.1	
- Net exports	0.5	0.5	-0.7	-1.6	-0.1	0.1	0.3	-0.1	-0.1	
Output gap <sup>1</sup>	0.3	0.1	-0.2	-0.7	0.2	-0.4	0.0	0.3	0.4	
Employment (% change)	2.9	2.6	-0.9	-0.9	-0.2	-0.1	-0.3	-0.2	0.0	
Unemployment rate (%)	6.2	6.2	6.5	6.6	7.7	7.6	8.8	9.7	9.8	
Labour productivity (% change)	-1.8	-1.5	2.9	2.9	2.6	3.1	3.5	3.2	2.9	
HICP inflation (%)	0.1	0.1	0.8	0.9	2.9	2.9	3.0	2.9	2.9	
GDP deflator (% change)	1.4	1.4	1.7	2.1	2.8	2.9	3.0	2.9	2.8	
Comp. of employees (per head, % change)	3.9	3.9	5.6	5.1	5.2	4.5	6.0	5.9	5.7	
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	4.0	3.9	2.1	3.1	3.1	3.2	3.0	2.5	2.0	
Note:										
<sup>1</sup> In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.										
<i>Source:</i>										
<i>Commission 2016 spring forecast (COM); Stability Programme (SP).</i>										

<sup>1</sup> The output gaps at face value as presented in the programme itself are slightly more negative by 0.2 p.ps. in all years over the programme period than the programme's recalculated output gaps.

### **3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS**

#### **3.1. Deficit developments in 2015**

Estonia's general government balance reached a surplus of 0.4% of GDP in 2015. This is substantially better than the 0.6% of GDP deficit target set in the 2015 Stability Programme and the balanced budget projected in the 2016 Draft Budgetary Plan. The over-performance was mainly due to a substantial revenue windfall of 0.5% of GDP from corporate income tax<sup>2</sup>, which is not expected to accrue again in the following years. At the same time, despite the lacklustre overall GDP growth, it was consumption-led and favourable for growth in tax bases. On the expenditure side, public investment came out lower than expected in the 2015 Stability Programme<sup>3</sup>.

Based on the Commission 2016 spring forecast, the structural balance is assessed to have improved by 0.5% of GDP from 0.1% of GDP 2014 to a surplus of 0.6% of GDP in 2015 (Table 2). Estonia thus exceeded its medium-term objective (MTO) of a structural balance<sup>4</sup>.

#### **3.2. Medium-term strategy and targets**

The main goal of the Estonian budgetary strategy as expressed in the Stability Programme is to remain at its medium-term objective (MTO). The MTO, unchanged compared with the previous programme, is a structural balance or surplus.<sup>5</sup> The MTO is more stringent than what the Stability and Growth Pact requires.

The Stability Programme foresees the headline balance to temporarily deteriorate to a deficit of 0.4% of GDP in 2016 and to 0.5% of GDP in 2017, before improving again to close to a balanced position over 2018-2020. The headline targets are less ambitious than the ones set in the 2015 Stability Programme for 2016-2017; at that time a deficit of 0.1% of GDP was targeted for 2016-17 and a surplus of 1% of GDP for 2019 (see Figure 1). The lowered targets reflect the expected weakening of GDP growth estimates over the programme horizon as well as lower dividends and resource taxes from the oil shale sector (see Section 3.3 for details). The programme's budgetary targets broadly represent projections under a no-policy-change assumption. However, the measures decided recently when the current budgetary strategy was adopted, will still have to be legislated in the 2017 budget.

Both according to the recalculated structural balance in the program and at face value, the structural position is projected to stay close to balance throughout the programme period, thus meeting the MTO (see Table 2).

The Commission forecasts a smaller headline deficit than the programme for both 2016 and 2017, namely 0.1 % of GDP in 2016 and 0.2% of GDP in 2017. This is explained by the

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<sup>2</sup> The corporate income tax windfall is due to a one-time tax payment from one large bank from previously cumulated profits.

<sup>3</sup> At that time, investment was expected to amount to 6.1% of GDP, but it turned out at 5.2 % of GDP. However, most of this is related to EU funds cycle and broadly revenue neutral.

<sup>4</sup> Estonia also over-performed the structural position planned in the previous Stability Programme, which at that time expected a structural deficit of 0.2 for 2015.

<sup>5</sup> For the assessment purposes it has been assumed that the MTO is a balanced structural position (0.0% of GDP in structural terms).

Commission projecting lower expenditure growth, including investment expenditure. Over the past years, actual expenditure has typically been somewhat lower than what was initially planned by the government. Regarding the structural position, the Commission 2016 spring forecast estimates it at balance in 2016 and deteriorating slightly to a deficit of 0.2% of GDP in 2017. This is 0.2 pps. lower than the respective figures of the recalculated Stability Programme. The difference mainly arises as some of the deficit-increasing one-off measures announced in the programme are not classified as one-offs according to the methodology used by the Commission<sup>6</sup>. Also, a more optimistic potential output growth estimate of the programme for 2016 and 2017 increases the output gap and results in a more positive structural balance<sup>7</sup> (see Table 2).

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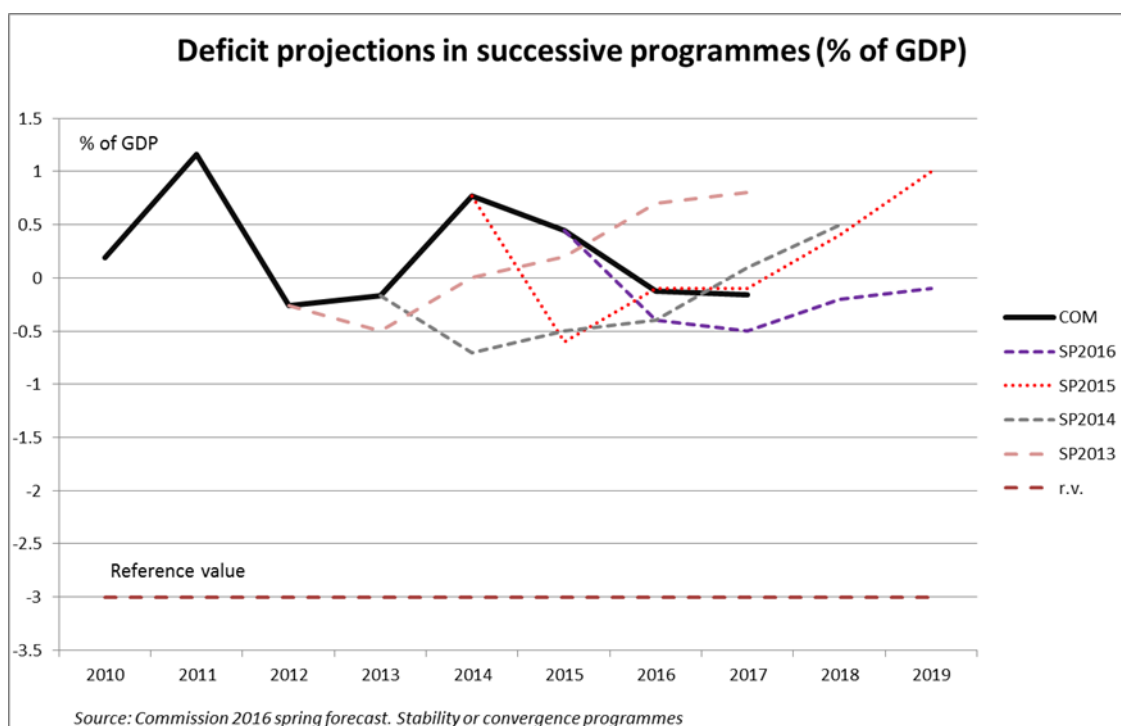
<sup>6</sup> See Section 3.3 for details.

<sup>7</sup> Unlike in the previous 2015 Stability Programme, the 2016 Programme has started to use the commonly agreed methodology as applied by the Commission for estimating the output gaps. However, since the Programme estimates a higher potential growth rate going forward and probably uses a longer time period in its calculations, significant differences still remain.

**Table 2: Composition of the budgetary adjustment**

(% of GDP)	2015	2016		2017		2018	2019	2020	Change: 2015-2020
	COM	COM	SP	COM	SP	SP	SP	SP	SP
<b>Revenue</b>	<b>40.0</b>	<b>40.1</b>	<b>40.4</b>	<b>40.0</b>	<b>40.2</b>	<b>39.5</b>	<b>39.5</b>	<b>39.0</b>	<b>-1.0</b>
<i>of which:</i>									
- Taxes on production and imports	14.3	14.8	15.1	14.9	15.0	14.9	15.1	14.8	0.5
- Current taxes on income, wealth, etc.	7.9	7.6	7.6	7.3	7.3	7.3	7.3	7.3	-0.6
- Social contributions	11.4	11.6	11.6	11.4	11.3	11.3	11.3	11.3	-0.1
- Other (residual)	6.4	6.2	6.1	6.4	6.6	6.0	5.8	5.6	-0.8
<b>Expenditure</b>	<b>39.5</b>	<b>40.3</b>	<b>40.8</b>	<b>40.2</b>	<b>40.7</b>	<b>39.7</b>	<b>39.6</b>	<b>38.9</b>	<b>-0.6</b>
<i>of which:</i>									
- Primary expenditure	39.4	40.2	40.7	40.1	40.6	39.6	39.5	38.8	-0.6
<i>of which:</i>									
Compensation of employees	11.3	11.5	11.3	11.4	11.2	11.0	10.9	10.9	-0.4
Intermediate consumption	6.8	6.8	6.8	6.8	7.0	6.7	7.0	7.0	0.2
Social payments	13.3	13.6	13.3	13.7	13.5	13.6	13.6	13.6	0.3
Subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.0
Gross fixed capital formation	5.3	5.2	5.2	5.2	5.8	6.2	5.7	4.2	-1.1
Other (residual)	2.3	2.7	3.6	2.5	2.7	1.8	2.0	2.8	-0.2
- Interest expenditure	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
<b>General government balance (GGB)</b>	<b>0.4</b>	<b>-0.1</b>	<b>-0.4</b>	<b>-0.2</b>	<b>-0.5</b>	<b>-0.2</b>	<b>-0.1</b>	<b>0.1</b>	<b>-0.3</b>
<b>Primary balance</b>	<b>0.5</b>	<b>0.0</b>	<b>-0.3</b>	<b>-0.1</b>	<b>-0.4</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.1</b>	<b>-0.4</b>
One-off and other temporary measures	-0.3	-0.1	-0.3	0.0	-0.3	-0.1	-0.1	0.0	0.3
<b>GGB excl. one-offs</b>	<b>0.7</b>	<b>0.0</b>	<b>-0.1</b>	<b>-0.2</b>	<b>-0.2</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.1</b>	<b>-0.6</b>
Output gap <sup>1</sup>	0.3	-0.2	-0.7	0.2	-0.4	0.0	0.3	0.4	0.0
Cyclically-adjusted balance <sup>1</sup>	0.3	-0.1	-0.1	-0.2	-0.3	-0.2	-0.2	-0.1	-0.4
<b>Structural balance<sup>2</sup></b>	<b>0.6</b>	<b>0.0</b>	<b>0.2</b>	<b>-0.2</b>	<b>0.0</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.6</b>
Structural primary balance <sup>2</sup>	0.7	0.1	0.3	-0.2	0.1	0.0	0.0	0.0	-0.6
<i>Notes:</i>									
<sup>1</sup> 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.									
<sup>2</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.									
<i>Source:</i>									
Stability Programme (SP); Commission 2016 spring forecasts (COM); Commission calculations.									

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



### 3.3. Measures underpinning the programme

Most of the discretionary revenue and expenditure measures affecting 2016 and beyond were decided and legislated already when the current government took office in 2015. On the expenditure side, these measures include increasing family benefits and investment priorities, but also savings in state administration. Among others, the administration savings contain a 1% reduction annually in public employment in 2016-17 each year, in line with the trends in working-age population. On the revenue side, it was decided to reduce the tax burden on labour with various tax changes spread over 2016-2018. The revenue loss has been compensated by significant increases in excise duties on motor fuels, alcohol and tobacco over 2016-2019 and an increase of preferential VAT on hotels from the current 9% to 14% in 2017. The 2016 Stability Programme reiterates the above-mentioned measures and also includes a recent measure to lower resource taxes for oil shale producers in order to support the oil shale sector and mentions the intention to take less dividends from the state owned energy company. These measures are also included into the Commission spring forecast<sup>8</sup>. However, the current programme does not provide a detailed and systematic update of the expected budgetary impact of these measures. Such an overview would strengthen the credibility and improve the transparency of the Stability Programme.

The programme also includes some new measures on the expenditure and revenue side from 2017 onwards, which were announced by the government at the time when the current

<sup>8</sup> According to the most recent information, the measure of lowering resource taxes might be somewhat redesigned compared with the initial plans which were made at the time of the Stability Programme preparation and the Commission spring forecast. Initially, the fiscal impact was assumed to be -0.1% of GDP in 2016 and -0.2% of GDP in 2017. The latest information is that the fiscal impact is expected to be stronger in 2016 and weaker in 2017, so that the annual impacts would be -0.2% of GDP in 2016 and -0.1% of GDP in 2017. The total cost of the measures is roughly the same, but the annual distribution has changed. This would, however, not change the conclusions of the current assessment.



Stability Programme was adopted. The measures are not specified in detail in the current programme and their budgetary impact is also not specified precisely, but it is implied that the net budgetary impact would be roughly neutral for 2017<sup>9</sup>. On the expenditure side, these new measures relate to additional infrastructure investments, supporting the mergers of municipalities and increased R&D funding. At the same time, the government aims to further limit administrative expenditure growth in 2017. On the revenue side, a tax for heavy vehicles is planned to be implemented, but the exact date of effect is not yet known. For 2017, some measures to further improve tax compliance are planned to be taken (reverse VAT on some specific sectors and tax compliance in fuel sales). Since these more recent measures were announced after the Commission spring forecast was finalised and were not specific enough to be taken into account, they are not reflected in these projections. However, given that they are assumed to be broadly budget-neutral, the comparisons between the Commission forecast and the Stability Programme remain valid.

The Stability Programme includes some 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 (deficit increasing 0.3% of GDP annually) and extra costs related to mergers of municipalities in 2017-2019 (deficit increasing 0.1% of GDP annually).

### **3.4. Debt developments**

Estonia's public debt declined to 9.7% of GDP in 2015. It is forecast to remain relatively stable at around 10% of GDP over 2016-2020 according to the programme (Figure 2). Since the Commission forecasts a slightly more favourable deficit outcome for 2016-2017, also the Commission's debt projections are more favourable, expecting the debt to GDP ratio to fall to 9.3% of GDP by 2017 (see Table 3).

Estonia's net debt level is considerably lower than the gross debt, at almost zero, since the country has accumulated sizeable reserves. In 2015, various reserves in the form of liquid financial assets amounted to 9.3% of GDP.

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<sup>9</sup> A neutral impact can be inferred, since the programme's budgetary projection did not change compared to the Ministry's spring forecast.

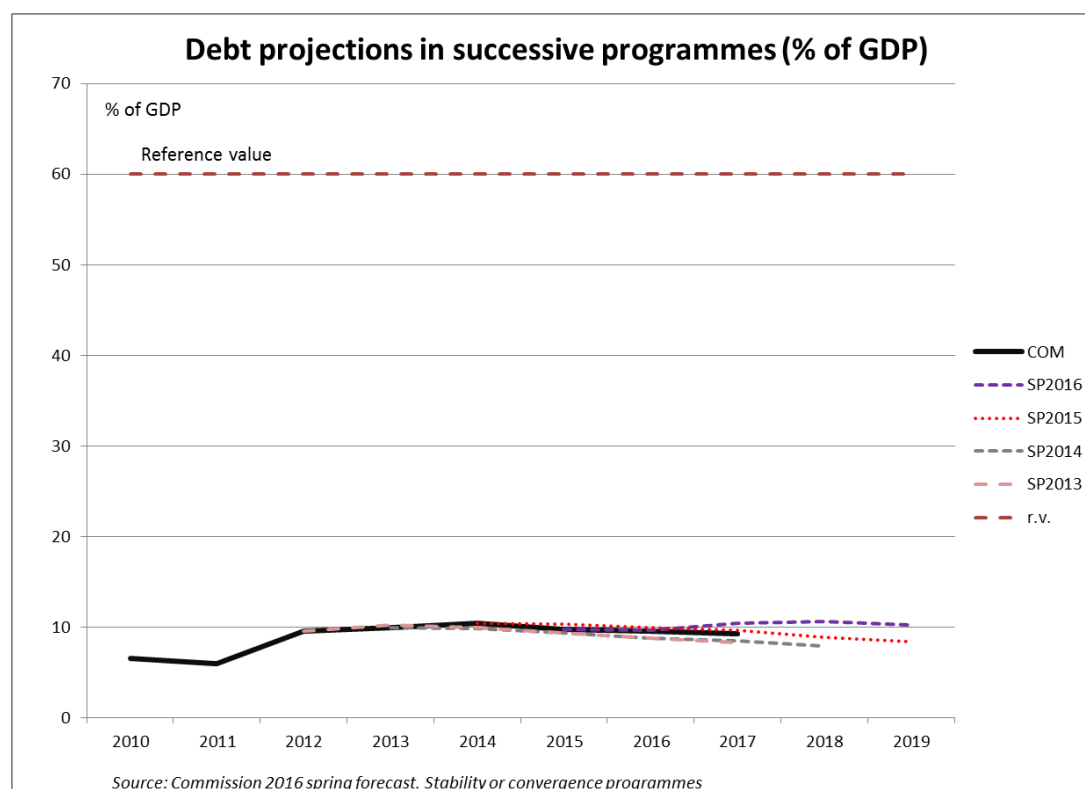
**Table 3: Debt developments**

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019	2020
			COM	SP	COM	SP	SP	SP	SP
<b>Gross debt ratio<sup>1</sup></b>	<b>8.5</b>	<b>9.7</b>	<b>9.6</b>	<b>9.6</b>	<b>9.3</b>	<b>10.4</b>	<b>10.6</b>	<b>10.2</b>	<b>9.6</b>
Change in the ratio	0.7	-0.6	-0.2	-0.1	-0.3	0.8	0.2	-0.4	-0.6
<i>Contributions<sup>2</sup> :</i>									
<b>1. Primary balance</b>	<b>-0.5</b>	<b>-0.5</b>	<b>0.0</b>	<b>0.3</b>	<b>0.1</b>	<b>0.4</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.1</b>
<b>2. “Snow-ball” effect</b>	<b>-0.4</b>	<b>-0.2</b>	<b>-0.3</b>	<b>-0.3</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.5</b>
<i>Of which:</i>									
Interest expenditure	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Growth effect	-0.3	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3
Inflation effect	-0.2	-0.1	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
<b>3. Stock-flow adjustment</b>	<b>1.5</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.2</b>	<b>0.0</b>	<b>0.8</b>	<b>0.6</b>	<b>0.1</b>	<b>0.1</b>
<i>Of which:</i>									
Cash/accruals diff.									
Acc. financial assets									
Privatisation									
Val. effect & residual									

**Notes:**  
<sup>1</sup> End of period.  
<sup>2</sup> 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 2016 spring forecast (COM); Stability Programme (SP), Commission calculations.*

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



### **3.5. Risk assessment**

Estonia's fiscal risks are overall low with a budget close to balance and a low debt level. In recent years, fiscal targets have been outperformed (Figure 1). However, as mentioned previously in Section 3.1, this was helped by a favourable GDP growth composition and some windfall revenues. At the same time, expenditure growth was rapid in recent years, which might have built up expenditure expectations for the future years as well.

The Programme is based on an optimistic GDP scenario for 2017, but the projection for the main tax bases is similar to the Commission forecast. This mitigates the risks to the public finance projections for 2017. However, since the programme assumes a higher potential growth rate for Estonia also for the outer years of the programme (influencing the medium term growth forecast), more pronounced risks might be related to the Programme's medium term fiscal projections.

As highlighted in the Commission spring forecast, the overall economic conditions for budget revenues have remained favourable in early 2016. However, some negative risks to the projections could arise from low energy prices, which might further impact domestic energy producers and related government revenues. Also, the significant increase in excise taxes could prompt a stronger-than-expected decline in retail sales. These specific risks would increase in the medium term as excise taxes are set to be raised in steps and a protracted low oil price economic environment might damage the business model of oil shale producers.

In conclusion, the fiscal risks concerning 2016 and 2017 appear balanced, but they are increasing for the medium term. Mitigating the abovementioned risks, Estonia has a strong track-record of meeting its fiscal targets and taking early corrective measures, as appropriate.

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

### **Box 1. Council recommendations addressed to Estonia**

On 14 July 2015, 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 avoid deviating from the medium-term budgetary objective in 2015 and 2016.

Based on outturn data, the structural surplus reached 0.6% of GDP in 2015, above the MTO of a structural balance. In its 2016 Stability Programme, the government plans for the (recalculated) structural position to soften to a surplus of 0.2% of GDP in 2016 and a balance of 0.0 % of GDP in 2017, meeting the MTO. In the remaining years of the time horizon, the programme also plans to stay at the MTO by a margin. For 2016 and 2017, the Programme's projections are confirmed by the Commission 2016 spring forecast, which projects a structural balance of 0.0% of GDP in 2016 and to a slight deficit of 0.2% of GDP in 2017. This can be considered as being at the MTO, albeit narrowly for 2017.

**Table 4: Compliance with the requirements under the preventive arm**

(% of GDP)	2015	2016		2017	
<b>Initial position<sup>1</sup></b>					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance <sup>2</sup> (COM)	0.6	0.0		-0.2	
Structural balance based on freezing (COM)	0.6	0.0		-	
<b>Position vis-a -vis the MTO<sup>3</sup></b>	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	<b>2015</b>	<b>2016</b>		<b>2017</b>	
	<b>COM</b>	<b>SP</b>	<b>COM</b>	<b>SP</b>	<b>COM</b>
<b>Structural balance pillar</b>					
Required adjustment <sup>4</sup>	0.0	0.0		0.0	
Required adjustment corrected <sup>5</sup>	-0.3	-0.6		0.0	
Change in structural balance <sup>6</sup>	0.5	-0.5	-0.5	-0.2	-0.3
<i>One-year deviation from the required adjustment<sup>7</sup></i>	0.8	0.1	0.0	-0.2	-0.2
<i>Two-year average deviation from the required adjustment<sup>7</sup></i>	0.8	0.5	0.4	0.0	-0.1
<b>Expenditure benchmark pillar</b>					
Applicable reference rate <sup>8</sup>	n.a. (structural balance at the MTO)				
<i>One-year deviation<sup>9</sup></i>					
<i>Two-year average deviation<sup>9</sup></i>					
<b>Conclusion</b>					
Conclusion over one year	Compliance	Compliance	Compliance	Compliance	Compliance
Conclusion over two years	Compliance	Compliance	Compliance	Compliance	Compliance
Notes					
<sup>1</sup> The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.					
<sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.					
<sup>3</sup> Based on the relevant structural balance at year t-1.					
<sup>4</sup> Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).					
<sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
<sup>6</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.					
<sup>7</sup> The difference of the change in the structural balance and the corrected required adjustment.					
<sup>8</sup> 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.					
<sup>9</sup> 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.					
<i>Source:</i>					
<i>Stability Programme (SP); Commission 2016 spring forecast (COM); Commission calculations.</i>					

## 5. FISCAL SUSTAINABILITY

Estonia appears to face low short-, medium- and long-term fiscal sustainability risks<sup>10</sup> with government debt at 9.7% of GDP in 2015, which is expected to slightly increase to 12.1 % in 2026, but still well below the 60% of GDP reference value. The full implementation of the programme would keep the debt ratio below 10% of GDP from 2020 on.

Based on Commission forecasts and a no-fiscal policy change scenario beyond forecasts, the medium-term fiscal sustainability risk indicator S1 is at -4.1 pps. of GDP, primarily related to the low level of government debt contributing with -3.9 pp. of GDP, thus indicating low risks in the medium term. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at -6.0 pps. of GDP, leading to even lower medium-term risk. Overall, Estonian risks to fiscal sustainability over the medium-term are, therefore, low.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 0.6% of GDP. In the long-term, Estonia therefore appears to face low fiscal sustainability risks. This is mainly due to the low pension expenditure growth, which contributes by -1.1 pps. of GDP. Full implementation of the Stability Programme would nonetheless put the S2 indicator at 0.3 pps. of GDP, leading to a lower long-term risk.

Estonia is implementing a Work Ability Reform, 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 is expected to 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.

Estonia has also previously taken some measures to improve long-term sustainability, notably increasing the pension age from the current 63 years of age to 65 by 2026 and favouring second pillar pension savings. However, as the Programme states, in the long term the ratio of pensions to average wage would likely decline, which might necessitate additional support to the pension system in the future.

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<sup>10</sup> This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 14 fiscal and 14 financial-competitiveness variables. The fiscal and financial-competitiveness sub-indexes (reported in table 5) are based on the two sub-groups of variables respectively. For sustainability risks arising from the individual variables, by country, see the Commission's Fiscal Sustainability Report 2015 (page 67).

**Table 5: Sustainability indicators**

<i>Time horizon</i>	<b>No-policy Change Scenario</b>		<b>Stability / Convergence Programme Scenario</b>	
<b>Short Term</b>	<b>LOW risk</b>			
<b>S0 indicator</b> <sup>[1]</sup>	0.2			
Fiscal subindex (2015)	0.2	LOW risk		
Financial & competitiveness subindex (2015)	0.2	LOW risk		
<b>Medium Term</b>	<b>LOW risk</b>			
<b>DSA</b> <sup>[2]</sup>	LOW risk			
<b>S1 indicator</b> <sup>[3]</sup>	-4.1	LOW risk	-6.0	LOW risk
<i>of which</i>				
IBP	-0.4		-1.2	
Debt Requirement	-3.9		-4.9	
CoA	0.2		0.0	
<b>Long Term</b>	<b>LOW risk</b>		<b>LOW risk</b>	
<b>S2 indicator</b> <sup>[4]</sup>	0.6		0.3	
<i>of which</i>				
IBP	0.4		0.2	
CoA	0.2		0.0	
<i>of which</i>				
Pensions	-1.1		-1.0	
HC	0.4		0.3	
LTC	0.4		0.4	
Other	0.5		0.4	

Source: Commission services; 2016 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2016 forecast until 2017. 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 2015 Ageing Report.

[1] 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.

[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. See Fiscal Sustainability Report 2015.

[3] 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 2017) 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.

[4] 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.

## 6. FISCAL FRAMEWORK

The 2015 budgetary outcome complied with the main national numerical fiscal rule, which is a structural budget balance directly referring to the MTO. The Estonian framework does not include a binding expenditure rule. The structural balance rule is planned to be met over the period covered by the Stability Programme, taking its calculations of the structural balance at face value. Only in 2018, the structural balance is projected to fall marginally by 0.1% of GDP below the MTO. Therefore, based on the information provided in the Stability Programme, the past, planned and forecast fiscal performance in Estonia appears to comply with the requirements of the national numerical fiscal rule.

The macroeconomic forecast underlying the 2016 Stability Programme was prepared by the Fiscal Policy Department in the Ministry of Finance of Estonia and was assessed by the Fiscal Council through its opinion published on its webpage. The Council was set up in 2014 on the basis of the State Budget Act, which stipulates that the Council is an independent 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. On 19 April 2016 the Fiscal Council published on its website its opinion on the macroeconomic and fiscal forecasts underlying the Stability Programme, as well as a recommendation for the possible fiscal targets to be set in it. It considered that the downward revision of the GDP growth forecast for 2016 by the Ministry of Finance is appropriate and in line with other forecasters. However, it considers the Ministry's macroeconomic forecast for 2017 and for the medium term as somewhat optimistic, which is influenced by a probably overly optimistic medium term potential growth projection. Therefore, the Fiscal Council highlights downside risks to tax collection. To counter the risks, the Fiscal Council recommends that the government sets the target of a small surplus in the structural fiscal position each year over the programme horizon.

Estonia's medium-term fiscal planning is subject to some uncertainties due to its exclusive focus on the structural balance target and under-use of expenditure targets. Given that the Ministry's estimates of the cyclical position of the Estonian economy often deviate from the Commission's assessment, compliance of the fiscal targets with the SGP requirements is difficult to assess and may not be ensured. However, 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 more stringent than the minimum requirement for the MTO set in the context of the SGP.

Estonia plans to implement accrual-based budgeting as of 2017 and increase the use of activity based budgeting principles by 2020, all of which is intended to improve the budgeting process.

There is no 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 national state budget strategy<sup>11</sup> is the document playing this role. There is no explicit information on expected economic returns on non-defence public investment projects with significant budgetary impact presented in the Stability Programme nor in the national state budget strategy (NMTFP) or the National Reform Programme.

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<sup>11</sup> The document is available at: <http://www.fin.ee/riigi-eelarvestrateegia>

## **7. CONCLUSIONS**

Based on outturn data, the structural surplus reached 0.6% of GDP in 2015, above the MTO of a structural balance, therefore in line with the requirement of the preventive arm of the Pact in 2015. In its 2016 Stability Programme, the government plans a headline deficit of 0.4% of GDP in 2016 and 0.5% of GDP in 2017, which corresponds to a recalculated structural surplus of 0.2% of GDP and a balance of 0.0% of GDP respectively. The structural position is projected to remain close to balance in the outer years of the programme. It therefore plans to continue to meet the medium-term budgetary objective - a structural balance - throughout the programme period. Based on the Commission 2016 spring forecast, the structural balance is forecast to move from a surplus of 0.6% of GDP in 2015 to a budget balance of 0.0% of GDP in 2016 and to a slight deficit of 0.2% of GDP in 2017. This can be considered as close to the MTO by a margin.



## 8. ANNEX

### Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
<b>Core indicators</b>								
GDP growth rate	5.2	8.2	-1.0	1.6	2.9	1.1	1.9	2.4
Output gap <sup>1</sup>	-1.1	7.9	-1.7	1.4	1.8	0.3	-0.2	0.2
HICP (annual % change)	5.0	3.9	4.6	3.2	0.5	0.1	0.8	2.9
Domestic demand (annual % change) <sup>2</sup>	5.9	10.3	-2.6	2.0	4.1	-0.7	2.7	2.6
Unemployment rate (% of labour force) <sup>3</sup>	11.9	7.8	11.6	8.6	7.4	6.2	6.5	7.7
Gross fixed capital formation (% of GDP)	28.4	34.1	25.6	27.1	25.2	24.2	24.4	24.5
Gross national saving (% of GDP)	22.5	23.3	24.6	28.0	27.6	25.9	24.9	25.8
<b>General Government (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-0.7</b>	<b>2.2</b>	<b>-0.8</b>	<b>-0.2</b>	<b>0.8</b>	<b>0.4</b>	<b>-0.1</b>	<b>-0.2</b>
<b>Gross debt</b>	<b>5.6</b>	<b>4.7</b>	<b>6.7</b>	<b>9.9</b>	<b>10.4</b>	<b>9.7</b>	<b>9.6</b>	<b>9.3</b>
<b>Net financial assets</b>	<b>33.5</b>	<b>30.5</b>	<b>31.3</b>	<b>31.2</b>	<b>30.5</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Total revenue	36.8	36.4	39.8	38.1	38.7	40.0	40.1	40.0
Total expenditure	37.5	34.2	40.6	38.3	38.0	39.5	40.3	40.2
<i>of which: Interest</i>	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.1
<b>Corporations (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-7.3</b>	<b>-7.9</b>	<b>1.4</b>	<b>2.1</b>	<b>-0.5</b>	<b>-0.3</b>	<b>-1.0</b>	<b>-0.4</b>
<b>Net financial assets; non-financial corporations</b>	<b>-115.6</b>	<b>-149.6</b>	<b>-152.3</b>	<b>-153.2</b>	<b>-150.8</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
<b>Net financial assets; financial corporations</b>	<b>-10.9</b>	<b>-10.7</b>	<b>2.7</b>	<b>7.5</b>	<b>4.9</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Gross capital formation	22.1	24.3	15.3	18.3	18.7	14.5	14.6	14.6
Gross operating surplus	29.0	32.6	29.8	32.3	30.9	27.3	26.2	26.1
<b>Households and NPISH (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>0.2</b>	<b>-6.1</b>	<b>1.9</b>	<b>1.4</b>	<b>0.7</b>	<b>2.9</b>	<b>3.2</b>	<b>3.6</b>
<b>Net financial assets</b>	<b>45.5</b>	<b>53.4</b>	<b>51.7</b>	<b>67.6</b>	<b>72.6</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Gross wages and salaries	34.6	34.7	36.3	35.2	35.6	37.7	37.8	37.7
Net property income	1.6	2.1	3.3	4.5	3.8	4.0	4.1	4.1
Current transfers received	18.5	14.6	17.3	15.7	15.6	16.4	16.7	16.8
Gross saving	2.8	-1.4	5.5	5.0	4.6	6.8	7.3	7.8
<b>Rest of the world (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-7.5</b>	<b>-12.1</b>	<b>2.0</b>	<b>2.9</b>	<b>2.1</b>	<b>4.0</b>	<b>2.1</b>	<b>3.1</b>
<b>Net financial assets</b>	<b>47.4</b>	<b>76.4</b>	<b>66.6</b>	<b>46.9</b>	<b>42.7</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Net exports of goods and services	-5.7	-8.1	2.8	2.2	3.4	4.0	3.4	3.4
Net primary income from the rest of the world	-3.2	-5.1	-4.5	-2.2	-2.5	-2.1	-2.7	-2.7
Net capital transactions	0.4	1.1	3.1	2.7	1.1	2.0	1.3	1.4
Tradable sector	50.2	47.9	45.4	47.1	46.2	44.8	n.a	n.a
Non tradable sector	39.1	40.5	42.3	40.6	40.9	41.7	n.a	n.a
<i>of which: Building and construction sector</i>	5.5	7.5	6.5	6.2	5.7	5.5	n.a	n.a
Real effective exchange rate (index, 2000=100)	65.6	80.7	101.5	101.9	105.6	108.8	110.8	111.6
Terms of trade goods and services (index, 2000=100)	87.0	97.6	100.8	101.0	102.2	102.5	102.8	103.0
Market performance of exports (index, 2000=100)	77.6	86.8	103.2	123.5	121.9	116.4	114.6	114.0
<b>Notes:</b>								
<sup>1</sup> The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
<sup>2</sup> The indicator on domestic demand includes stocks.								
<sup>3</sup> 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.								
<b>Source:</b>								
AMECO data, Commission 2016 spring forecast								