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Analysis of the 2016 Draft Budgetary Plan of ESTONIA

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of ESTONIA

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1. INTRODUCTION

Estonia submitted its Draft Budgetary Plan (DBP) for 2016 on 15 October 2015 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Estonia is subject to the preventive arm of the Pact and should avoid deviating from the medium-term budgetary objective (MTO) in 2015 and 2016.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2015 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2015-2016 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact (SGP). Section 5 provides an analysis of implementation of reforms in the area of fiscal governance in response to the latest Country-specific Recommendations (CSRs) adopted by the Council on 14 July 2015, including those to reduce the tax wedge. Section 6 concludes.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The national macroeconomic forecast, which is incorporated in the 2016 DBP (DBP), was published on 17 September 2015. Estonia's real GDP growth reached 2.9% in 2014, but is projected by the Ministry of Finance to moderate to 1.7% in 2015 before accelerating to 2.6% in 2016. The forecast for both 2015 and 2016 has been revised downwards compared to the Stability Programme presented in spring 2015. The main reason is the lower-than-expected GDP outcome in the first half of 2015 and a weaker outlook for external demand. At the same time, the nominal GDP level is now higher compared to the spring forecast due to a statistical upward revision of past time series until 2014.

According to the DBP forecast, domestic demand remains the main growth driver in 2015 and 2016. For 2015, net exports also provide a positive contribution as exports are foreseen to decline stronger than imports. The unemployment rate is projected in the DBP to be around 6½ % in both 2015 and 2016. Wage pressures remain substantial due to a tight labour market and a contracting population at working age. HICP inflation is forecast to increase from about zero in 2015 to 2.3% in 2016. The current low inflation rate is mainly explained by decreasing energy and food prices. At the same time wage growth has been pushing core inflation up.

This scenario is broadly in line with the Commission's autumn forecast, which expects slightly higher real GDP growth for 2015 at 1.9%, but the same growth rate for 2016 as the DBP. Similarly, both forecasts expect domestic demand to drive growth, with relatively strong wage growth. The Commission also expects an acceleration of inflation in 2016, reaching 1.8% on average. Overall, the DBP’s outlook is based on plausible macroeconomic assumptions.

Box 1: The macro economic forecast underpinning the budget in Estonia

The macroeconomic forecast underlying the DBP was prepared by the Fiscal Policy Department in the Ministry of Finance of Estonia and was endorsed by an independent body, the Fiscal Council. The Fiscal Council is an advisory body charged with assessing Estonia's fiscal policy. It is attached to the Bank of Estonia and consists of six members with high reputation and experience. The Council assesses the macroeconomic and fiscal forecasts of the Ministry of Finance and to what extent the budget rules are followed, in accordance with the requirements of the State Budget Act and the European Union law.

On 29 September, the Fiscal Council published an opinion on its website on the macroeconomic and fiscal forecasts of the Ministry of Finance. The Fiscal Council considers that, while the GDP growth forecast is close to the 'consensus' forecast, risks relate to the expectation of external demand gathering strength in 2016. They also find that tax revenues, particularly VAT and corporate income tax revenues, may be somewhat overestimated for 2016. The Council highlighted measurement uncertainty of the estimates of the output gap and the structural budgetary position. They considered that the Estonian economy may already be operating above its potential, implying that the structural budget projections of the Ministry of Finance may be somewhat overestimated. Taking account of the above-mentioned uncertainties, the Fiscal Council recommends that the budgets for the years ahead should be planned with a small nominal surplus.

Table 1. Comparison of macroeconomic developments and forecasts

	2014	2015			2016		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.9	2.0	1.7	1.9	2.8	2.6	2.6
Private consumption (% change)	3.5	4.8	5.0	5.2	2.8	2.8	3.2
Gross fixed capital formation (% change)	-3.1	2.7	-2.0	-3.9	3.6	4.0	4.1
Exports of goods and services (% change)	1.8	2.8	-0.5	-0.4	4.0	3.5	3.5
Imports of goods and services (% change)	1.4	4.0	-1.5	-1.2	4.2	4.0	4.2
Contributions to real GDP growth:							
- Final domestic demand	1.5	3.4	2.4	1.9	2.7	2.8	3.0
- Change in inventories	2.5	-0.6	-1.5	-0.6	0.2	0.1	0.0
- Net exports	0.4	-0.9	0.7	0.6	-0.1	-0.2	-0.4
Output gap[1]	1.2	0.3	0.4	0.5	0.0	0.4	0.4
Employment (% change)	0.8	0.6	1.0	1.1	-0.3	-0.6	-0.6
Unemployment rate (%)	7.4	6.1	6.5	6.5	5.8	6.3	6.5
Labour productivity (% change)	2.1	1.3	0.6	0.8	3.1	3.2	3.2
HICP inflation (%)	0.5	0.8	0.2	0.1	2.6	2.3	1.8
GDP deflator (% change)	2.0	2.0	1.4	0.9	2.6	2.8	2.5
Comp. of employees (per head, % change)	5.9	4.8	4.5	4.9	5.2	5.0	5.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.3	1.7	5.0	2.9	1.0	3.7	2.5

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:
Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3. Recent and planned fiscal developments

3.1. Deficit developments

Estonia's DBP projects the general government surplus to fall from 0.7% of GDP in 2014 to 0.0% of GDP in 2015 (Table 2). The projection for 2015 shows a significant improvement compared to the 2015 Stability Programme due to better-than-expected revenue collection, extraordinary revenues from corporate income tax (0.5% of GDP) and also a 0.1% of GDP base effect from an upward revision of the 2014 outcome. At the same time, part of the government dividend revenues (0.35% of GDP) planned for 2015 is shifted to 2016 (see Section 3.3 below).

For 2016, the DBP projects a nominal deficit of 0.1% of GDP, which is unchanged compared to the target set in the Stability Programme. The (recalculated) structural balance[1] is estimated at 0.0% of GDP in 2016. While the Stability Programme foresaw a consolidation effort of 0.4 pp of GDP, the new fiscal path included in the DBP relies on a decline of 0.3% of GDP in structural effort compared to 2015. This change is largely explained by the effect from the extraordinary corporate income tax revenue (0.5% of GDP) in 2015, a temporary event expected to fall away in 2016. This revenue was not included in the Stability Programme. Also, the DBP explains that compared with the Stability Programme, the labour market outlook is assessed to be weaker and the pension expenditure growth is expected to be higher for 2016. The currently low interest rate environment has only a negligible positive impact on the aggregate fiscal position in Estonia, given the very low debt burden in the country. Based on the information provided in the DBP, interest expenditure is projected to stay at 0.1% of GDP in 2015 and 2016, and it has been at around this ratio over the past decade.

The Commission 2015 autumn forecast projects a slightly higher headline surplus than the DBP, i.e. 0.2% of GDP in 2015, mainly owing to more optimistic revenue assumptions against the background of a somewhat higher GDP growth projection. Due to the positive base effect from 2015, the Commission also projects a slightly higher surplus in 2016. The revenue and expenditure ratios to GDP are significantly different in 2016 between the Commission forecast and the DBP, which is explained by different assumptions on the EU funded investments (these differences have no major impact on the deficit projection, since both expenditure and revenue are broadly equally impacted).

Overall, the risks to the DBP fiscal targets can be considered as limited. Implementation risks for 2016 are low as most of the tax measures have already been legislated. Still, the tax measures require close monitoring in order to fully deliver their intended yields. As detailed in Box 1 above, the Estonian Fiscal Council drew attention to the risks stemming from external demand in 2016. The developments in the external environment can be considered as a general risk (not only related to Estonia) and concerns also the Commission macroeconomic scenario.

[1] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2014	2015			2016			Change: 2014-2016
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**38.7**	**41.1**	***39.9***	**40.1**	**40.1**	***39.1***	**40.0**	**0.4**
of which:								
- Taxes on production and imports	13.8	14.4	*14.3*	14.4	14.9	*14.9*	14.8	1.1
- Current taxes on income, wealth, etc.	7.4	7.3	*7.7*	7.7	7.1	*7.4*	7.3	0.0
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.1	11.4	*11.3*	11.3	11.3	*11.2*	11.3	0.1
- Other (residual)	6.4	8.0	*6.6*	6.7	6.8	*5.6*	6.7	-0.8
Expenditure	**38.0**	**41.7**	**39.9**	**39.9**	**40.2**	**39.2**	**39.7**	**1.2**
of which:								
- Primary expenditure	37.9	41.6	39.8	39.8	40.1	39.1	39.7	1.2
of which:								
Compensation of employees	10.8	11.2	10.9	11.0	11.0	10.8	10.8	0.0
Intermediate consumption	6.6	6.9	6.7	6.8	6.9	7.1	6.9	0.5
Social payments	12.4	13.1	12.9	13.0	13.1	13.0	13.1	0.6
Subsidies	0.5	0.4	0.4	0.5	0.4	0.4	0.5	-0.1
Gross fixed capital formation	5.0	6.1	5.5	5.6	5.7	4.8	5.5	-0.2
Other (residual)	2.5	3.9	3.4	2.9	3.0	3.0	2.9	0.5
- Interest expenditure	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
General government balance (GGB)	**0.7**	**-0.6**	**0.0**	**0.2**	**-0.1**	**-0.1**	**0.2**	**-0.8**
Primary balance	**0.8**	**-0.5**	**0.1**	**0.3**	**0.0**	**0.0**	**0.3**	**-0.8**
One-off and other temporary measures	-0.1	-0.6	-0.5	-0.3	-0.3	-0.3	-0.1	-0.2
GGB excl. one-offs	**0.9**	**0.0**	**0.5**	**0.5**	**0.2**	**0.2**	**0.3**	**-0.7**
Output gap[1]	1.2	0.3	0.4	0.5	0.0	0.4	0.4	-1.1
Cyclically-adjusted balance[1]	0.2	-0.8	-0.2	0.0	-0.1	-0.3	0.1	-0.4
Structural balance (SB)[2]	**0.3**	**-0.2**	**0.3**	**0.3**	**0.2**	**0.0**	**0.2**	**-0.2**
Structural primary balance[2]	0.4	-0.1	0.4	0.4	0.3	0.1	0.3	-0.2

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 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3.2. Debt developments

According to the DBP, general government gross debt is projected to decrease to 9.6% of GDP in 2016 (see table 3), which is the lowest in EU. This forecast is fully in line with the Commission 2015 autumn forecast. Risks related to the debt projections are low as the general government fiscal position is close to balance and the government has over time accumulated sizeable fiscal buffers.

Table 3. Debt developments

(% of GDP)	2014	2015			2016		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**10.4**	**10.3**	**10.0**	**10.0**	**9.9**	**9.6**	**9.6**
Change in the ratio	0.4	-0.1	-0.4	-0.4	-0.4	-0.4	-0.4
Contributions[2] :							
1. Primary balance	**-0.8**	**0.5**	**0.1**	**-0.3**	**0.0**	**0.0**	**-0.3**
2. "Snow-ball" effect	**-0.4**	**-0.3**	**-0.4**	**-0.2**	**-0.4**	**-0.4**	**-0.4**
Of which:							
Interest expenditure	0.1	0.1	-0.1	0.1	0.1	0.1	0.1
Growth effect	-0.3	-0.2	-0.2	-0.2	-0.3	-0.2	-0.2
Inflation effect	-0.2	-0.2	-0.1	-0.1	-0.3	-0.3	-0.2
3. Stock-flow adjustment	**1.7**	**-0.3**	**-0.1**	**0.2**	**0.0**	**0.0**	**0.3**

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

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the Draft Budgetary Plan

The DBP presents only those discretionary measures which were announced by the government in the draft budget (see Table 4), leaving out changes already legislated or decisions taken in the Stability Programme in spring. According to the authorities, the measures have a net deficit-increasing effect of over 0.3% of GDP in 2015 and almost 0.1% of GDP in 2016. In essence, the new measures entail lower dividend revenues from state owned enterprises in 2015, but higher dividend revenue in 2016, as well as various expenditure increasing items in 2016. All these measures have been included in the Commission forecast. However, the dividend distributions from state-owned enterprises constitute a high degree of uncertainty for the medium-term planning, since the government can at any time change its dividend policy, depending on fiscal needs.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the	
	2015	**2016**
Taxes on production and	0	0.0
Current taxes on income,	n.a.	n.a.
Capital taxes	n.a.	n.a.
Social contributions	n.a.	n.a.
Property Income	-0.3	0.4
Other	0	0.0
Total	-0.3	0.4

Note:

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

Source: Draft Budgetary Plan for 2016

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the	
	2015	**2016**
Compensation of employees	0	-0.1
Intermediate consumption	0	-0.4
Social payments	n.a.	n.a.
Interest Expenditure	n.a.	n.a.
Subsidies	n.a.	n.a.
Gross fixed capital formation	0	0.0
Capital transfers	n.a.	n.a.
Other	0	0.0
Total	0	-0.5

Note:

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

Source: Draft Budgetary Plan for 2016

The DBP reports deficit increasing one-off measures amounting to -0.5% of GDP in 2015 and to -0.3% of GDP in 2016. They include specific investment projects stemming from CO_2 emissions trading and a temporary increase in the second pillar pension contributions in 2014-17. However, the temporary increase in the second pillar pension contributions does not meet the criteria used by the Commission for one-offs. After excluding this measure, the overall impact of one-off measures as projected by the Commission amounts to -0.3% of GDP in 2015 and -0.1% of GDP in 2016.

4. Compliance with the provisions of the Stability and Growth Pact

Estonia is subject to the preventive arm of the Pact and should ensure maintaining its fiscal position at the MTO. Box 2 reports the latest country specific recommendations in the area of public finances.

Box 2: 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".

Estonia registered a structural surplus of 0.3% of GDP in 2014, compared with its MTO of a structural balance, thus above the MTO. According to the information provided in the DBP, with a structural surplus of 0.3% in 2015 and 0.0% of GDP in 2016, Estonia is expected to be above its MTO also in those years, which is confirmed by the Commission 2015 autumn forecast. As mentioned in Section 3.1, the risks to the attainment of the fiscal targets of the DBP can be considered as limited.

On the basis of this assessment, it appears that Estonia is expected to comply with the recommendation addressed to it by the Council on 14 July 2015 (Box 2).

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2014	2015		2016	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance[2] (COM)	0.3	0.3		0.2	
Structural balance based on freezing (COM)	0.3	0.3		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2014**	**2015**		**2016**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	0.2	-0.3		-0.3	
Change in structural balance[6]	0.9	0.1	0.0	-0.3	-0.1
One-year deviation from the required adjustment [7]	0.7	Compliant			
Two-year average deviation from the required adjustment [7]	0.2				
Expenditure benchmark pillar					
Applicable reference rate[8]	1.6	2.9		2.9	
One-year deviation [9]	-2.0	Compliant			
Two-year average deviation [9]	-1.4				
Conclusion					
Conclusion over one year	Overall assessment	Compliance			
Conclusion over two years	Overall assessment				

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 27.).

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

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

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

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures 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.

Source :

Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations.

5. IMPLEMENTATION OF REFORMS IN THE AREA OF FISCAL GOVERNANCE

The DBP makes an explicit reference to the structural CSRs issued by the Council in the context of the 2015 European Semester, giving details on a number of measures that are expected to be financed in the 2016 budget. A bulk of the measures aims at strengthening labour supply by lowering the labour tax burden, Work Ability Reform[2], strengthening active labour market policies, childcare policies and vocational training.

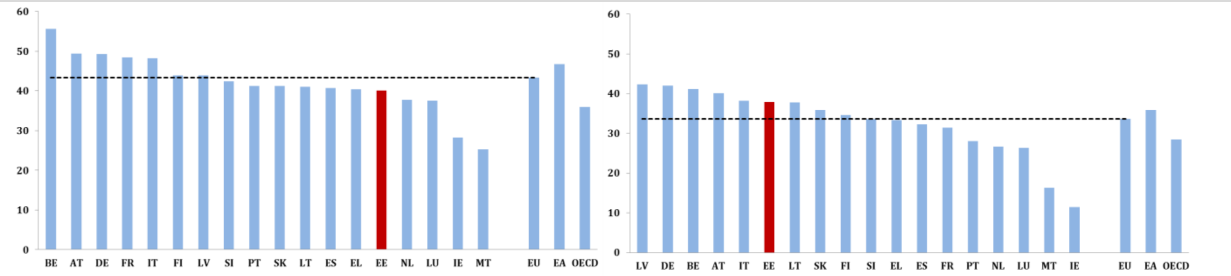
A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2016 Country Reports and in the context of the CSRs adopted by the Commission in May.

Box 3: Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to screen euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability. Furthermore, the Eurogroup expressed its intention to take stock of the state of play in the reduction of the tax burden on labour when discussing the DBPs of euro area Member States.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Estonia for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average. The tax wedge in Estonia is above the EU average for low income earners.

The tax burden on labour in Estonia at the average wage and a low wage (2014)



Notes: Data for Latvia, Lithuania and Malta is for 2013. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data..

This screening is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit

2 The reform seeks to increase the labour market participation of work incapacity pensioners.

system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2015 European Semester, Estonia was issued the recommendation to "(...) improve incentives to work through measures targeting low-income earners (...)." Estonia's DBP contains the following measures that affect the tax wedge on labour:

- increase the monthly income tax allowance by about 10% from EUR 154 to EUR 170 in 2016,

- introduce an income tax refund system for low-wage earners (effective in 2016, but fiscal costs will incur starting from 2017).

In addition to the measures contained in the DBP, which is focussed on 2016, the Stability Programme foresees measures also for the following years as part of an overall strategy to shift some of the tax burden from labour to consumption and environmental taxes. Notably, the increases in the monthly income tax allowance will continue on average by more than 6% each year (to reach EUR 204 by 2019) and social tax will be reduced by 0.5 pp. in 2018 and 2019. These tax cuts will be financed by increases in other taxes and excises. Overall, these measures would lower the tax wedge both for the average wage earners as well as the low wage earners.

6. Overall conclusion

Estonia was above its medium term objective in 2014 and according to both the information provided in the DBP and the Commission forecast, will continue to do so in 2015 and 2016.