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COMMISSION STAFF WORKING DOCUMENT

Analysis of the 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 for 2017 on 16 October 2017 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Estonia is subject to the preventive arm of the Pact and should preserve a sound fiscal position which ensures compliance with the medium term budgetary objective (MTO of -0.5% of GDP.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2017 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2017 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis on the composition of public finances and on the fiscal-structural issues, including reducing the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The Ministry of Finance's macroeconomic forecast, which is incorporated in the Draft Budgetary Plan (DBP) for 2017, was published on 13 September 2017. Estonia's real GDP growth reached 2.1% in 2016 and is projected to accelerate to 4.3% in 2017, on the back of a surge in private and public investments and an improving external environment. In 2018, growth is forecast to abate to 3.3%, as investment growth is expected to return to more sustainable levels.

The forecast for 2017 has been revised significantly upwards (by 1.9 percentage points) compared to the Stability Programme presented in spring 2017, as actual GDP data for both 2016 and the first half of 2017 surprised on the upside. Growth for 2018 has been revised slightly upwards (by 0.2 percentage point), reflecting a stronger external outlook and higher business confidence, leading to higher investments.

According to the DBP, domestic demand is expected to remain the main growth driver in 2017 and 2018. The unemployment rate is projected to increase from about 7% in 2017 to above 8% in 2018, as the introduction of the 'work ability' reform bringing work-incapacity retirees back into the labour market more than offsets the underlying tightening of the labour market. Wage pressures remain substantial due to a tight labour market and decreasing

population at working age. HICP inflation is projected to peak at 3.6% in 2017, mainly driven by global energy and food prices and notably an increase in excise duties.

This scenario is broadly in line with the Commission 2017 autumn forecast, which expects real GDP growth for 2017 at 4.4% and 3.2% in 2018. Also the labour market is projected to develop in a similar way as the DBP. Overall, the differences in the macroeconomic scenario (and the resulting tax bases) should not lead to significant differences in the outlook for public finances. Therefore, 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 Draft Budgetary Plan was prepared by the Fiscal Policy Department in the Ministry of Finance of Estonia and was endorsed by the Fiscal Council, which is an independent advisory body attached to the Bank of Estonia. The Council assesses the macroeconomic and fiscal forecasts of the Ministry of Finance and the extent to which the budget rules are followed, in accordance with the requirements of the State Budget Act and European Union law.

On 27 September 2017, the Fiscal Council published an opinion[1] on its website on the macroeconomic and fiscal forecasts of the Ministry of Finance. The Fiscal Council considers that the Ministry's upward revision of GDP forecast for 2017 and 2018 is plausible. The Fiscal Council finds that the risks of growth being faster or slower than forecast are balanced. The Fiscal Council estimates the output gap to be positive at ½ % of potential GDP in 2018, which is similar to the estimate of the Ministry of Finance, despite using a somewhat different method.

The Fiscal Council noted that despite the very rapid expected growth in revenue, the Ministry of Finance forecasts a nominal and structural deficit in 2018. The Fiscal Council also finds that in particular the forecast for revenues from corporate income tax is based on overly optimistic assumptions, increasing the risk that the budget deficit will be larger than planned. Given the position in the economic cycle, the Fiscal Council recommends targeting a small surplus in the state budget to ensure that the structural budget position remains in compliance with the national and European budget rules.

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

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.1	2.4	4.3	4.4	3.1	3.3	3.2
Private consumption (% change)	4.4	2.2	1.8	2.2	4.0	4.4	3.6
Gross fixed capital formation (% change)	-1.2	9.3	13.7	16.6	0.0	4.1	4.4
Exports of goods and services (% change)	4.1	3.7	3.5	3.8	3.9	4.0	4.2
Imports of goods and services (% change)	5.3	5.4	3.8	4.4	3.0	4.4	4.4
Contributions to real GDP growth:							
- Final domestic demand	2.4	3.7	4.3	5.1	2.3	3.5	3.2
- Change in inventories	0.7	-0.2	-0.1	-0.4	0.0	0.0	0.0
- Net exports	-0.7	-1.2	0.0	-0.3	0.8	-0.2	0.0
Output gap[1]	0.5	-0.1	1.7	1.8	0.4	2.3	2.1
Employment (% change)	0.3	0.5	0.8	0.8	0.2	0.4	0.3
Unemployment rate (%)	6.8	7.8	6.9	6.9	8.9	8.3	7.7
Labour productivity (% change)	1.8	1.9	3.5	3.6	2.9	2.9	2.9
HICP inflation (%)	0.8	3.4	3.6	3.8	2.9	2.9	3.1
GDP deflator (% change)	1.6	3.2	4.2	4.3	3.2	3.4	3.7
Comp. of employees (per head, % change)	5.9	6.0	6.1	5.6	5.6	5.5	5.6
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	3.0	3.1	3.6	4.2	4.2	4.3	4.3

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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

According to Estonia's DBP, the general government deficit is expected to improve from 0.3% of GDP in 2016 to a balanced position in 2017 (Table 2). The projection for 2017 shows a significant improvement compared to the 2017 Stability Programme by 0.5 percentage point. The DBP explains that this improvement arises mainly from lower social expenditure, the postponement of some investments and somewhat higher tax revenues. The comparison of the DBP figures with the spring 2017 Stability Programme (Table 2) is significantly impacted by the large upward revision of the nominal GDP level, leading to a reduction in both revenue and expenditure ratios.

In 2018, the general government balance is projected to slide into a small deficit of 0.1% of GDP. This is 0.7 percentage point better than the target set in the Stability Programme, largely resulting from the carry-over of the improved position in 2017 (the main revisions relate to

higher income from labour taxes accompanied by lower expenditures in government consumption and social payments). Also, compared with the Stability Programme, the 2017 draft budget includes some measures that improve the fiscal outcome in 2018 by 0.1 percentage point (see Section 3.3)[2].

Reflecting the better-than-expected economic performance, the output gap estimate has been revised upwards considerably (from close to zero in the Stability Programme to about 2% of potential GDP in 2017 and 2018 in the DBP), impacting on the estimate of the structural position of the budget. As a consequence, the recalculated[3] structural balance is estimated to decline from 2017 to 2018 by 0.6 percentage point from a structural deficit of 0.4% of GDP in 2017 to a deficit of 1.0% of GDP in 2018[4].

The Commission 2017 autumn forecast projects a headline deficit of 0.2% of GDP in 2017 (see Table 2). This is a slightly larger deficit than in the Draft Budgetary Plan because of higher expenditure projections, mainly regarding wages, investments and subsidies. Due to the weaker starting point in 2017, the Commission also projects a higher deficit for 2018. The difference again mainly originates from the expenditure side, where the Commission projects higher investments, wages and intermediate consumption[5]. The worse nominal balance and a somewhat different assessment of one-off measures also result in lower structural balance projections for 2017 and 2018 in the Commission forecast.

Overall, there are negative risks associated with the DBP fiscal targets. Notably, the attainment of the DBP targets depends on the assumed yields of some large tax measures, i.e. the corporate income tax reform and excise increases. While the 2018 corporate income tax reform will incentivise distribution of profits[6] (dividends), the revenue impact from the corporate income tax reform is uncertain as it depends on the behavioural response of corporates to the tax reform. The Fiscal Council noted the same risk in its assessment and considered the assumptions used by the Ministry of Finance on corporate dividends to be overly optimistic. The revenue projection for excise duties is also subject to some uncertainty since the cross-border purchases of excise goods have risen sharply over the last year, but are assumed by the Ministry of Finance to abate in the coming years. These trends are difficult to predict as they depend on the behaviour of consumers. The above risks are somewhat mitigated by the good track record of Estonia in meeting and often even exceeding its budgetary targets.

Table 2. Composition of the budgetary adjustment

[2] In the case of Estonia, the low interest environment has no significant impact on the fiscal outcome, as the country's debt level is the lowest in the EU at about 10% of GDP and interest expenditure amounts to only 0.1% of GDP.

[3] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

[4] The targets of the DBP at face value, as published by the national authorities, indicate a structural deficit of 0.3% of GDP in 2018, which complies with the national fiscal rule of structural deficit of -0.5 % of GDP.

[5] On the revenue side in 2018, the Ministry of Finance forecasts somewhat higher yields than the Commission for the main tax categories, highlighting risks to the revenue projection.

[6] Currently, corporate income tax is paid in Estonia only upon distribution of profits.

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**40.3**	**40.8**	***40.0***	**40.2**	**41.2**	***39.9***	**40.3**	**-0.4**
of which:								
- Taxes on production and imports	15.0	15.2	*14.7*	14.6	16.0	*15.2*	15.1	0.2
- Current taxes on income, wealth, etc.	7.7	7.6	*7.3*	7.4	7.5	*7.4*	7.0	-0.3
- Capital taxes	0.0	0.0	*0.0*	0.0	0.0	*0.0*	0.0	0.0
- Social contributions	11.8	12.0	*11.5*	11.6	12.3	*11.9*	11.7	0.1
- Other (residual)	5.8	6.0	*6.5*	6.6	5.4	*5.4*	6.4	-0.4
Expenditure	**40.6**	**41.4**	**40.0**	**40.4**	**42.0**	**40.1**	**40.7**	**-0.5**
of which:								
- Primary expenditure	40.6	41.3	39.9	40.3	41.9	40.0	40.7	-0.6
of which:								
Compensation of employees	11.8	11.8	11.3	11.4	11.7	11.1	11.2	-0.7
Intermediate consumption	6.9	7.1	6.8	6.7	7.2	6.6	6.7	-0.3
Social payments	13.9	14.1	13.6	13.5	14.5	13.8	13.7	-0.1
Subsidies	0.5	0.4	0.4	0.5	0.4	0.5	0.5	0.0
Gross fixed capital formation	4.8	5.5	5.5	5.6	5.7	5.6	5.8	0.8
Other (residual)	2.7	2.4	2.3	2.7	2.4	2.4	2.7	-0.3
- Interest expenditure	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
General government balance (GGB)	**-0.3**	**-0.5**	**0.0**	**-0.2**	**-0.8**	**-0.1**	**-0.4**	**0.2**
Primary balance	**-0.2**	**-0.5**	**0.0**	**-0.2**	**-0.8**	**-0.1**	**-0.4**	**0.1**
One-off and other temporary measures	-0.1	-0.4	-0.4	0.0	-0.1	-0.1	0.0	0.0
GGB excl. one-offs	**-0.2**	**-0.1**	**0.4**	**-0.2**	**-0.7**	**0.0**	**-0.4**	**0.2**
Output gap[1]	0.5	-0.1	1.7	1.8	0.4	2.3	2.1	1.9
Cyclically-adjusted balance[1]	-0.5	-0.5	-0.8	-1.0	-1.0	-1.1	-1.4	-0.6
Structural balance (SB)[2]	**-0.4**	**-0.1**	**-0.4**	**-1.0**	**-0.9**	**-1.0**	**-1.4**	**-0.6**
Structural primary balance[2]	-0.4	0.0	-0.3	-1.0	-0.8	-0.9	-1.3	-0.6

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.2. Debt developments

According to the DBP, general government gross debt is projected to decrease from 9% of GDP in 2017 to 8.6% of GDP in 2018[7] (see Table 3). The 2018 figure is somewhat lower than in the Commission 2017 autumn forecast, largely reflecting the difference in the deficit projection.

[7] At the same time, the general government has over time accumulated sizeable reserves of liquid financial assets, projected at 8.6% of GDP in 2017.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**9.4**	**9.4**	**9.0**	**9.2**	**9.9**	**8.6**	**9.0**
Change in the ratio	-0.6	0.0	-0.4	-0.3	0.5	-0.4	-0.1
Contributions[2] *:*							
1. Primary balance	**0.2**	**0.5**	**0.0**	**0.2**	**0.8**	**0.1**	**0.4**
2. "Snow-ball" effect	**-0.3**	**-0.5**	**-0.7**	**-0.7**	**-0.5**	**-0.6**	**-0.5**
Of which:							
Interest expenditure	0.1	0.0	0.0	0.1	0.0	0.0	0.1
Growth effect	-0.2	-0.2	-0.4	-0.4	-0.3	-0.3	-0.3
Inflation effect	-0.2	-0.3	-0.4	-0.4	-0.3	-0.3	-0.3
3. Stock-flow adjustment	**-0.5**	**0.0**	**0.3**	**0.3**	**0.3**	**0.1**	**0.0**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation 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

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

According to the authorities, the measures presented in the DBP have a net deficit-increasing effect of 0.1% of GDP in 2017, and a deficit decreasing effect of 0.1% of GDP in 2018. Most of the measures concern specific relatively small revenue or expenditure items, with the bulk of the effect coming from postponing some investments from 2018 to the following years and planning to take out more dividends from state owned companies in 2018.

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 authorities)		
	2017	**2018**	**2019**
Taxes on production and			
Current taxes on income,	-0.03	0.03	0.00
Capital taxes			
Social contributions			
Property Income	-0.03	0.03	0.00
Other	0.00	0.02	0.00
Total	-0.06	0.08	0.00

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 this measure.

Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees	0	0.0	0
Intermediate consumption	0	-0.1	0
Social payments	0	-0.1	0
Interest Expenditure			
Subsidies			
Gross fixed capital formation	0	0.2	0
Capital transfers			
Other			
Total	0	0.02	0

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 of this measure.

Source: Draft Budgetary Plan for 2018

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

Estonia is subject to the preventive arm of the Stability and Growth Pact and should ensure maintaining its fiscal position at the MTO[8]. Box 2 reports the latest country-specific recommendations in the area of public finances.

Box 2. Council Recommendations[9] addressed to Estonia

On 11 July 2017, the Council addressed recommendations to Estonia in the context of the European Semester. In particular, in the area of public finances the Council recommended that Estonia pursue its fiscal policy in line with the requirements of the preventive arm of the Stability and Growth Pact, which implies to remain at its medium-term budgetary objective in 2018.

The Council noted that under unchanged policies, there is a risk of some deviation from the MTO in 2018.

In 2017, according to the DBP, the expenditure benchmark is projected to be adhered to. The recalculated structural balance is estimated to remain unchanged from the previous year at a deficit of 0.4% of GDP. Estonia is therefore slightly above its medium-term objective in 2017. However, according to the Commission 2017 autumn forecast, the structural balance is estimated to deteriorate by 0.6 percentage point of GDP (from -0.4% of GDP in 2016 to -1.1% of GDP in 2017). Nevertheless, this weakening is in line with the requirements of the preventive arm (Table 5), which allows for a maximum deterioration of the structural balance by 1.1% of GDP in 2017. This requirement was frozen based on the Commission 2017 spring forecast[10]. Estonia is therefore assessed to comply with the requirements of the preventive arm of the Stability and Growth Pact in 2017.

For 2018, according to the DBP, the growth of government expenditure net of discretionary revenue measures and one-offs will not exceed the applicable expenditure benchmark[11]. However, the recalculated structural balance is expected to fall short of the requirements of the Stability and Growth Pact in 2018. The structural balance is allowed to deteriorate by 0.2 percentage point of GDP (this requirement was frozen based on the Commission 2017 spring forecast). However, according to the DBP, the recalculated structural deficit is set to deteriorate by 0.6 percentage point of GDP (from -0.4% of GDP in 2017 to -1.0% of GDP in 2018 and thus moving away from the MTO), exceeding the allowed deterioration by 0.4 percentage point of GDP, implying a risk of some deviation from the adjustment path to the MTO. This calls for an overall assessment. The difference between the expenditure benchmark and the structural balance is in particular related to the way the nationally-financed government investment is treated[12]. This investment is smoothed over a four-year

[8] Estonia's MTO is a structural deficit of 0.5% of GDP.

[9] OJ C 261, 9.8.2017.

[10] While in level terms the structural balance deficit of 1% of GDP in 2017 does not meet the MTO, the assessment is based on the change of the structural balance from one year to the next. In order to avoid moving targets with each new forecast, the requirements are frozen in time.

[11] 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 EFC 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.

[12] Technically, the decomposition of differences between the change in the structural balance and expenditure benchmark also reveal a notable 'revenue shortfall' in 2018. However, this is explained by GDP composition

average in the expenditure benchmark indicator, while annual movements are fully captured by the structural balance. Thus, the expenditure benchmark does not fully capture the budgetary costs of the government's multi-year investment package over the period 2018-2020, which should not be seen as a temporary fluctuation in investment, but rather a medium-term level shift. Therefore, the structural balance is considered the better indicator of the current fiscal trends. Additionally, as highlighted in Section 3.1, there are downside risks related to the tax revenue estimates for 2018. Following an overall assessment, the Draft Budgetary Plan points to some deviation from the adjustment path towards the MTO is planned in 2018. The Commission 2017 autumn forecast provides a similar picture on the basis of which the conclusion of some deviation is confirmed[13].

effects, as nominal GDP growth (also boosted by investment) exceeds wage growth and private consumption, which are the main tax bases. Therefore, in the Estonian case, this indicator captures GDP composition effects in 2018, rather than signalling cautious revenue projections.

[13] The difference in expenditure benchmark figures between the DBP and Commission forecast is mostly stemming from 'government expenditure on EU programmes fully matched by EU funds revenue', which is significantly higher in the DBP forecast in 2017 and 2018. Correcting the DBP input data for this, the figures for the expenditure benchmark would be similar to the COM estimates.

Table 5. Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	0.0	-0.5		-0.5	
Structural balance[2] (COM)	-0.4	-1.1		-1.4	
Structural balance based on freezing (COM)	0.6	-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)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	Compliance			0.0	
Required adjustment corrected[5]				-0.2	
Change in structural balance[6]				-0.6	-0.4
One-year deviation from the required adjustment [7]				-0.4	-0.2
Two-year average deviation from the required adjustment [7]				0.3	0.2
Expenditure benchmark pillar				.	
Applicable reference rate[8]				6.1	
One-year deviation adjusted for one-offs [9]				1.0	0.1
Two-year average deviation adjusted for one-offs [9]				2.3	0.3
PER MEMORIAM: One-year deviation [10]				1.3	0.1
PER MEMORIAM: Two-year average deviation [10]				2.3	0.4
Conclusion					
Conclusion over one year	Compliance	Compliance	Compliance	Overall assessment	Overall assessment
Conclusion over two years	Compliance	Compliance	Compliance	Compliance	Compliance

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 38.).

[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 2016) was carried out on the basis of Commission 2017 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, 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.

[10] 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.

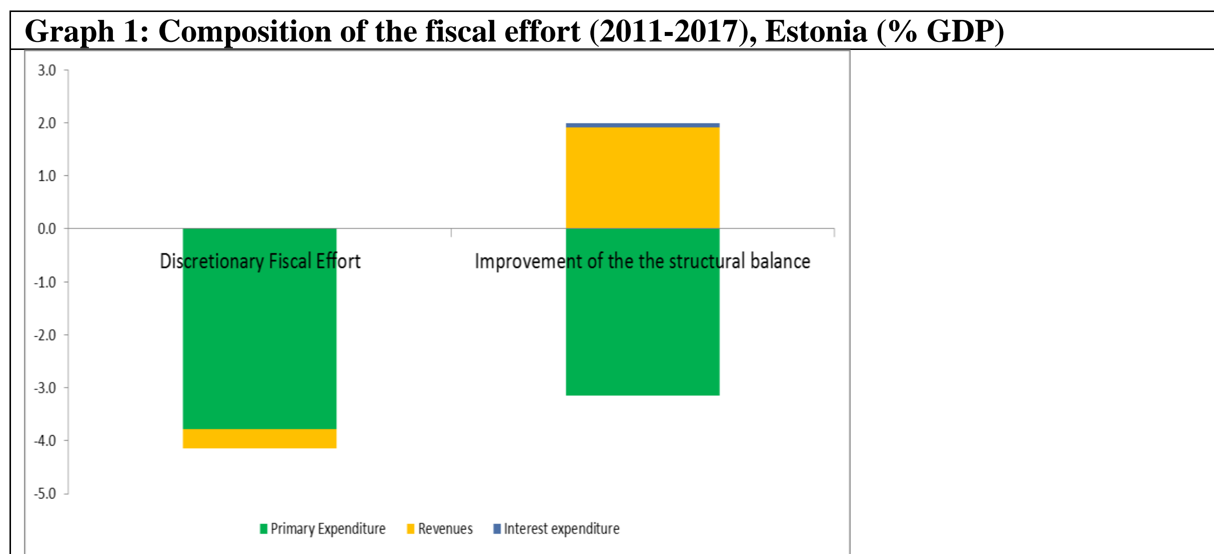
Source :

Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The DBP foresees that the revenue ratio to GDP will slightly fall by 0.1 percentage point of GDP from 2017 to 2018, while the expenditure ratio is set to rise by 0.1 percentage point of GDP. Expenditure increases are driven by investment and social spending. Over a longer-term perspective, the fiscal adjustment in 2011-2017 was characterised by a rising share of primary expenditure in GDP (notably due to rising social spending), while interest expenditure savings have played a negligible role (Graph 1).

Graph 1: Composition of the fiscal effort (2011-2017), Estonia (% GDP)



Notes: In Graph 1, the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3

http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

Source: Draft Budgetary Plans 2018, European Commission 2017 autumn forecast.

Estonia's tax system is relatively growth-friendly, with indirect taxes above the EU-28 average and labour taxes below the average. The upcoming tax reforms (see Box 3) will further increase indirect taxation while lowering labour taxation.

Estonia performs well in terms of tax administration efficiency. Over the recent years, Estonia has introduced a number of measures to increase tax compliance, such as an employment register and additional reporting obligations for VAT that proved to be effective.

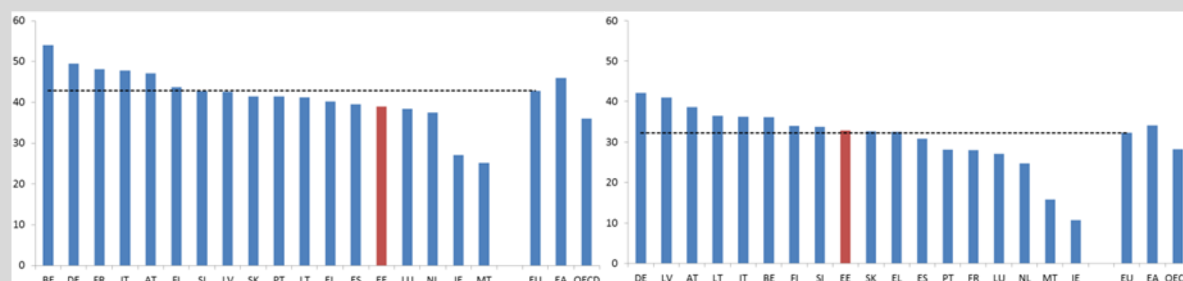
Box 3: Addressing the tax burden on labour in the euro area

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 benchmark 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.

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 burden on labour in Estonia at the average wage and at low wage (2016)



Notes: 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.

Benchmarking 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 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 2017 European Semester, Estonia did not receive Council Recommendations related to the tax burden on labour, but such a Council Recommendation existed in 2015. Since then, Estonia has taken several measures to shift the tax burden from labour to consumption and environmental taxes. The most notable and largest measure in terms of budgetary cost in this respect is the income tax reform, which will take effect in 2018. Its costs will be financed by increases in other taxes and excise duties. The reform will raise the tax free allowance from EUR 180 per month in 2017 to EUR 500 per month. The tax free allowance for people earning more than the average salary will decrease gradually and reach zero once a person's salary exceeds EUR 2,100 per month, adding an element of progressivity to Estonia's income tax system. This measure should reduce significantly the tax-wedge on low-income earners.

6. OVERALL CONCLUSION

Estonia is expected to comply with the requirements of the preventive arm of the Stability and Growth Pact in 2017 according to both the information provided in the DBP and the Commission 2017 autumn forecast.

In 2018, based on both the DBP and the Commission 2017 autumn forecast, the structural balance points to some deviation, while the expenditure benchmark points to compliance. Following an overall assessment, there is a risk of some deviation from the adjustment path towards the MTO in 2018.