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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

{C(2014) 8802 final}

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1. INTRODUCTION

Estonia has submitted its Draft Budgetary Plan for 2015 on 15 October 2014 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Estonia is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective (MTO).

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 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 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 2014-2015 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council on 8 July 2014, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The national macroeconomic forecast, which is incorporated in the 2015 Draft Budgetary Plan, was published on 1 September 2014. After an impressive rebound from the crisis, Estonia's real GDP growth moderated to 1.6% in 2013 and is forecast to remain sluggish at 1.5% in 2014 despite robust domestic demand (Table 1). Supported by a progressive recovery of Estonia's main trading partners, economic growth is projected to rise to 2.5% in 2015 and to 3.5% in 2016.

The forecast for 2014 and 2015 has been revised downwards compared to the Stability Programme presented in spring 2014. The main reason for the revision is a lower-than-expected outcome in the first half of this year and a worsened external demand outlook. According to the forecast, domestic demand remains the main growth driver in 2015 while export growth projections have been revised downwards to 3.5% from 6% in spring.

The unemployment rate has continued to fall substantially since 2011 and is projected in the Draft Budgetary Plan to be around 7% in 2014 and 2015. Wage pressures remain strong due to a persistent skills mismatch and a contracting working age population. Annual HICP inflation is forecast to recede from 3.2% in 2013 to 0.8% in 2014, before increasing to 2.3% in 2015. The inflation slowdown is mainly driven by external factors, while wage growth pushes core inflation up.

Table 1. Comparison of macroeconomic developments and forecasts

	2013	2014			2015		
	COM	**SP**	**DBP**	**COM**	**SP**	**DBP**	**COM**
Real GDP (% change)	1.6	2.0	1.5	1.9	3.5	2.5	2.0
Private consumption (% change)	3.8	3.9	3.6	3.6	3.8	3.8	3.4
Gross fixed capital formation (% change)	2.5	0.7	5.2	2.0	3.7	5.5	2.1
Exports of goods and services (% change)	2.6	2.4	2.0	1.5	6.0	3.5	3.4
Imports of goods and services (% change)	3.1	3.3	3.9	2.3	6.3	4.3	4.1
Contributions to real GDP growth:							
- Final domestic demand	3.2	2.4	2.0	2.6	3.1	3.5	2.6
- Change in inventories	-2.2	0.3	0.1	0.0	0.5	-0.3	-0.1
- Net exports	-0.5	-0.7	-1.7	-0.7	-0.2	-0.7	-0.6
Output gap[1]	1.9	0.3	1.1	1.4	0.4	0.7	0.6
Employment (% change)	1.2	0.2	0.1	-0.2	0.3	0.0	-0.3
Unemployment rate (%)	8.6	7.9	7.5	7.8	6.9	6.8	7.1
Labour productivity (% change)	0.4	4.7	0.9	2.2	6.5	2.5	2.3
HICP inflation (%)	3.2	1.7	0.8	0.7	2.9	2.3	1.6
GDP deflator (% change)	4.5	2.8	1.6	1.6	3.2	3.1	2.4
Comp. of employees (per head, % change)	7.2	6.2	6.0	5.2	6.3	6.1	5.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.8	1.3	0.4	-0.4	1.2	0.3	-0.7

Note:

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

Source :

Stability programme 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

The economic projections for 2015 are more optimistic in the Draft Budgetary Plan than in the Commission 2014 autumn forecast (the GDP growth rate for 2015 is 2.5% versus 2.0%). The Commission is less optimistic about domestic demand growth, investment in particular. This is due to the worsening of the external environment, resulting in lower corporate investment growth. Risks to the macroeconomic scenario could stem from external factors, but also the relatively high wage growth, which could start affecting competitiveness.

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 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 how well the budget rules are followed, in accordance with the requirements of the State Budget Act and the European Union law. Bank of Estonia covers the reasonable operating costs of the Fiscal Council and provides it with the background information, rooms and technical equipment needed for its work, and any necessary administrative services.

On 15 September on its website, the Fiscal Council published an opinion on the macroeconomic and fiscal forecasts of the Ministry of Finance. The Fiscal Council considered that the forecast of the Ministry of Finance constitutes a suitable base in terms of both economic growth and tax revenue for preparing the draft state budget for 2015. However, the Council highlighted a serious measurement risk to the estimates of the structural budget position, in particular that the structural position may be overestimated for the years 2014–2015. Moreover, the revision of the GDP data after the finalisation of the forecast will inevitably have an impact on the assessment of the structural fiscal position, but has not yet been taken into account by the Ministry. For this reason the Fiscal Council recommends that the government build its budget for 2015 with a structural surplus in the general government budget not lower than the 0.8% of GDP mentioned in the summer forecast.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

Estonia's Draft Budgetary Plan projects the general government deficit to narrow to 0.3% of GDP in 2014 (Table 2). This is somewhat better than the 0.7% of GDP target set in the Stability Programme in spring 2014, mainly due to better-than-expected revenue collection. The main source of deficit is central government, followed by local government. Social security funds are expected to be in a surplus of 0.2% of GDP. Tax revenue collection, VAT and fuel excise in particular, have been positively affected by the closure of tax fraud schemes in the first half of this year, which more than offsets the postponement of the VAT enhancing measures by a couple of months to end-2014. Furthermore, pension expenditure was lower than projected.

The 2015 nominal deficit target in the Draft Budgetary Plan is set at 0.5% of GDP. As a combination of a positive base effect from 2014 and a worsened growth outlook, the 2015 target remained unchanged compared to the target set in the Stability Programme. A worsening of the deficit is caused by strong expenditure growth, including increasing family benefits and pensions combined with across the board tax relief for labour and capital. These changes are partially offset by excise and VAT increases, rescheduling of dividend distribution from state owned enterprises from 2014 to 2015 and expenditure cuts.

The Commission forecasts a larger headline deficit than the Draft Budgetary Plan, i.e. 0.6% of GDP in 2015, mainly owing to more pessimistic GDP growth and labour market developments. Risks to the fiscal target for 2015 seem to be on the downside as growth expectations have been revised further down compared to the macroeconomic scenario presented in the Draft Budgetary Plan. However, as a large share of the GDP growth differential between national forecast and the Commission forecast is due to lower investment growth projections, the difference in fiscal outcomes is less pronounced in 2015. Implementation risks in view of upcoming general elections in spring 2015 are low, although the tax-enhancing measures entering into force in end-2014 depend on close monitoring in order to fully deliver the intended yields.

In 2013 Estonia had deviated from its medium-term budgetary objective (MTO) of a structural surplus. According to the Draft Budgetary Plan, the (recalculated) structural balance[1] is expected to improve by 0.9 pp. in 2014 to -0.4% of GDP and further by 0.1 pp. to -0.3% of GDP in 2015. The Commission 2014 autumn forecast projects a higher structural deficit for 2014 at 0.8% of GDP, which is expected to improve by 0.1 pp. in 2015. The structural position is weaker than in the Stability Programme, in particular in 2015.

[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. There is a discrepancy with the calculations of the structural balance presented in the Draft Budgetary Plan, mainly due to a difference in the assessment of the cyclical position of the economy between the commonly agreed methodology and the approach taken in the Draft Budgetary Plan. Moreover, not all measures identified by the authorities as one-offs meet the criteria used by the Commission (see Section 3.3 for details).

Table 2. Composition of the budgetary adjustment

(% of GDP)	2013	2014			2015			Change: 2013-2015
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**38.4**	**37.5**	***38.5***	**38.4**	**37.8**	***39.3***	**38.9**	**0.9**
of which:								
- Taxes on production and imports	13.4	13.5	13.9	13.8	13.9	14.4	14.4	1.0
- Current taxes on income, wealth, etc.	7.2	7.5	7.5	7.4	7.0	7.1	7.1	-0.1
- Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Social contributions	11.3	11.4	11.4	11.3	11.3	11.3	11.3	0.0
- Other (residual)	6.6	5.1	5.7	5.9	5.6	6.5	6.1	-0.1
Expenditure	**38.9**	**38.2**	**38.9**	**38.9**	**38.4**	**39.9**	**39.5**	**1.0**
of which:								
- Primary expenditure	38.8	38.1	38.8	38.7	38.3	39.7	39.4	0.9
of which:								
Compensation of employees	10.7	10.7	10.9	10.9	10.5	10.8	11.0	0.1
Intermediate consumption	6.6	7.2	6.8	6.8	7.1	6.9	6.9	0.3
Social payments	12.5	12.7	12.6	12.7	12.9	13.0	13.2	0.5
Subsidies	0.7	1.0	0.7	0.7	1.0	0.8	0.7	0.1
Gross fixed capital formation	5.5	4.3	5.5	5.1	4.1	5.2	4.9	-0.3
Other (residual)	2.8	2.2	2.3	2.5	2.7	3.0	2.6	0.2
- Interest expenditure	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1
General government balance (GGB)	**-0.5**	**-0.7**	**-0.3**	**-0.4**	**-0.5**	**-0.5**	**-0.6**	**0.0**
Primary balance	**-0.3**	**-0.6**	**-0.2**	**-0.3**	**-0.4**	**-0.4**	**-0.5**	**-0.1**
One-off and other temporary	-0.2	-0.3	-0.4	-0.3	-0.5	-0.5	-0.2	-0.3
GGB excl. one-offs	**-0.3**	**-0.4**	**0.1**	**-0.2**	**0.0**	**0.0**	**-0.4**	**0.3**
Output gap[1]	1.9	0.3	1.1	1.4	0.4	0.7	0.6	-1.4
Cyclically-adjusted balance[1]	-1.3	-0.8	-0.8	-1.0	-0.6	-0.8	-0.9	0.6
Structural balance (SB)[2]	**-1.1**	**-0.5**	**-0.4**	**-0.8**	**-0.1**	**-0.3**	**-0.7**	**0.9**
Structural primary balance[2]	-1.0	-0.4	-0.3	-0.6	0.0	-0.1	-0.5	1.0

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 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

3.2. Debt developments

The government debt-to-GDP ratio is forecast to remain below 10% in 2014-2015 (see table 3). According to the Draft Budgetary Plan, general government debt, which is the lowest in EU, is projected to decrease to 9.8% of GDP in 2014 and further to 9.3% of GDP in 2015. These forecasts are fully in line with the ones presented in the Stability Programme. The slightly higher debt projection in the Commission 2014 autumn forecast is linked to higher deficit expectations for the years concerned. The central government is using its previously accumulated financial assets for financing its deficits. The deficit of local governments and additional contribution to the EFSF are the main reasons behind the small increase in nominal debt in 2014 and 2015.

Risks related to the debt projections are low with small nominal general government deficits. Contingent liabilities are low in Estonia (below 2% of GDP in 2014-2015) and mainly consist of state guarantees to the private sector. At 0.2% of GDP in 2013, Estonia's net debt level was considerably lower than gross debt. According to the authorities, the net debt level is projected to increase to 1.7% of GDP by 2015 as the central government's financial assets will be used for covering its negative cash flows.

Table 3. Debt developments

(% of GDP)	2013	2014			2015		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**10.1**	**9.8**	**9.8**	**9.9**	**9.3**	**9.3**	**9.6**
Change in the ratio	0.4	-0.2	-0.3	-0.2	-0.5	-0.5	-0.3
Contributions[2]:							
1. Primary balance	**0.3**	**0.6**	**0.2**	**0.3**	**0.4**	**0.4**	**0.5**
2. "Snow-ball" effect	**-0.4**	**-0.4**	**-0.2**	**-0.2**	**-0.5**	**-0.4**	**-0.3**
Of which:							
Interest expenditure	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Growth effect	-0.1	-0.2	-0.1	-0.2	-0.3	-0.2	-0.2
Inflation effect	-0.4	-0.3	-0.1	-0.2	-0.3	-0.3	-0.2
3. Stock-flow adjustment	**0.5**	**-0.4**	**-0.3**	**-0.3**	**-0.4**	**-0.5**	**-0.5**
Of which:							
Cash/accruals difference		n.a.	n.a.		n.a.	n.a.	
Net accumulation of financial		n.a.	n.a.		n.a.	n.a.	
of which privatisation proceeds		n.a.	n.a.		n.a	n.a.	
Valuation effect & residual		n.a.	n.a.		n.a.	n.a.	

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 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

3.3. Measures underpinning the draft budgetary plan

The Draft Budgetary Plan 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 0.1% of GDP in 2014 and a net deficit-decreasing effect of 0.1% of GDP in 2015. In total 14 measures were reported with an individual effect of at least EUR 1 mln (*ca* 0.005% of GDP), mostly focussing on the expenditure side. All these measures have been included in the Commission forecast.

On the revenue side the total incremental effect of discretionary measures decided in the context of the Draft Budgetary Plan is -0.1% of GDP in 2014 and +0.3% of GDP in 2015. The government decided to reschedule dividend distribution from state-owned enterprises from 2014 to 2015 and to raise state fees in 2015.

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)		
	2014	**2015**	**2016**
Taxes on production and imports	0.0	0.0	0.0
Current taxes on income, wealth,	0.0	0.1	0.0
Capital taxes	n.a.	n.a.	n.a.
Social contributions	n.a.	n.a.	n.a.
Property Income	-0.1	0.2	0.0
Other	n.a.	n.a.	n.a.
Total	-0.1	0.3	0.0

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 revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan 2015

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2014	**2015**	**2016**
Compensation of employees	n.a.	n.a.	n.a.
Intermediate consumption	0.0	0.2	0.0
Social payments	n.a.	n.a.	n.a.
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	0.0	0.0	0.0
Gross fixed capital formation	0.0	0.0	0.0
Capital transfers	n.a.	n.a.	n.a.
Other	n.a.	n.a.	n.a.
Total	0.0	0.2	0.0

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 2015

On the expenditure side the total incremental deficit-increasing effect of discretionary measures decided in the context of the Draft Budgetary Plan is 0.2% of GDP in 2015. These measures mostly consist of non-recurrent investment projects, covering preparation costs for the work-capacity reform and other priority expenditure items, including defense.

Despite the positive short-term budgetary effect in 2015, the dividend distributions from state-owned enterprises entail a high degree of uncertainty for the medium-term planning as decisions are made on an ad-hoc basis, and in this particular case have a negative effect on the 2014 outcome.

The Draft Budgetary Plan reports one-off measures amounting to -0.4% of GDP in 2014 and to -0.5% of GDP in 2015. However, not all of these measures meet the criteria used by the Commission for one-offs. This concerns namely dividend distribution from state-owned enterprises and a temporary increase in the second pillar pension contributions in 2014-17. After excluding these measures, the overall impact of one-off measures amounts to -0.3% of GDP in 2014 and -0.2% of GDP in 2015.

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

Box 2. Council recommendations addressed to Estonia

On 8 July 2014, 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 reinforce the budgetary measures for 2014 in the light of the emerging gap of 0.3 % of GDP based on the Commission services 2014 spring forecast, pointing to a risk of significant deviation relative to the preventive arm of the Stability and Growth Pact requirements. In 2015, Estonia was recommended to significantly strengthen the budgetary strategy to ensure that the medium-term objective is reached and, thereafter, maintained. Estonia was also recommended to complement the budget rule with more binding multi-annual expenditure rules within the medium-term budgetary framework and continue to enhance the efficiency of public spending.

With a structural deficit estimated at 1.1% of GDP, Estonia has significantly deviated from the MTO in 2013, which was reached in 2011. However, according to the structural balance estimations in spring 2014, Estonia did not appear to deviate from the MTO in 2013 and, therefore, was expected to maintain its fiscal position in 2014. Nevertheless, a risk of a significant deviation from the MTO was identified for 2014 in spring 2014, calling for the need to significantly strengthen the budgetary strategy to ensure that the medium-term objective is reached in 2015. The MTO, a structural surplus, more than adequately reflects the objectives of the Pact.[2]

The (recalculated) structural balance is expected to improve in 2014 by 0.9% of GDP according to the Draft Budgetary Plan and by 0.4% of GDP according to the Commission 2014 autumn forecast, above the requirements, in what the structural balance pillar is concerned (see Table 5). The improvement is mainly caused by a decreasing nominal deficit and gradual closure of a positive output gap. The larger improvement of the (recalculated) structural balance in the DBP scenario can be partially attributed to the differences in one-off measures. Based on the average over 2013-2014, the change in the structural balance points to a non-significant deviation from the required adjustment according to the Commission forecast.

The growth rate of government expenditure, net of discretionary revenue measures, is projected to exceed the reference medium-term rate of potential GDP growth of 2.1%, pointing to a significant deviation from the MTO over the period 2013-2014 according to both the Draft Budgetary Plan and the Commission forecast. The divergence of the two indicators can be explained by changed economic growth composition where consumption and wage bill growth exceed GDP growth and by the closure of large scale tax fraud schemes in the first half of 2014 that has a permanent positive effect on revenue, not taken into account in the expenditure benchmark calculations. Furthermore, the volatility of public investment creates a negative contribution from the investment component on the expenditure benchmark. Finally, the 10-year average potential growth rate estimations, which are used in the expenditure benchmark calculations, are dominated by the negative growth estimates from the crisis period and therefore create unreasonable constraints for expenditure growth during normal times. The potential output growth in 2014 is roughly 0.4 pp. higher than the 10 year average potential growth rate. Therefore, the structural balance is considered to be a more relevant indicator for Estonia's fiscal effort in 2014. Overall, the adjustment path towards the MTO seems to be compliant with the requirement of the preventive arm of the Pact in 2014, but there is a risk of some deviation over 2013 and 2014 taken together.

In 2015, the (recalculated) structural deficit is projected to improve by 0.1 pp. of GDP according to both the Draft Budgetary Plan and the Commission forecast (see table 5). The change in the structural balance falls short of the required adjustment towards the MTO by 0.4% of GDP over one year, pointing to some deviation from the required adjustment.

[2] For the assessment purposes it has been assumed that the MTO is a balanced structural position (0% of GDP in structural terms).

According to the information provided in the Draft Budgetary Plan, the growth rate of government expenditure, net of discretionary revenue measures, in 2015 is not expected to contribute to an annual structural adjustment towards the MTO by 0.5% of GDP. This is because the growth rate of this expenditure is above 0.9%, the lower rate under the expenditure benchmark, pointing to a significant deviation. This is also confirmed by the Commission forecast. The divergence of the two indicators, as in the case for 2014, can be explained by closure of tax fraud schemes in 2014 with a positive carry over effect in 2015 and the fact that consumption and wage bill growth exceed GDP growth. These factors are not taken into account in the expenditure benchmark calculations. Furthermore, the 10-year average potential growth rate estimations, which are used in the expenditure benchmark calculations, are dominated by the negative growth estimates from the crisis period and therefore create unreasonable constraints for expenditure growth during normal times. Estonia's potential growth in 2015 is roughly 0.6 pp. higher than the 10-year average used in the expenditure benchmark calculations. Therefore, the structural balance is considered to be a more relevant indicator for Estonia's fiscal effort in 2015.

Finally, as Estonia's MTO (a structural surplus) is significantly above the minimum requirement (deficit of 1% of GDP), the deviation from the adjustment path towards the MTO identified above does not threaten the sustainability of Estonia's public finances, notably also given the very low level of debt and small nominal deficits (9.5% and 0.6% of GDP in 2015, respectively, according to the Commission forecast). Overall, the fiscal effort reflected by the structural balance points to some deviation from the adjustment path towards the MTO in 2015.

Following an overall assessment of Estonia's Draft Budgetary Plan, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, the adjustment path towards the MTO seems to be appropriate in 2014, but there is a risk of some deviation over 2013 and 2014 taken together. Some deviation from the adjustment path towards the MTO is also to be expected in 2015..

On the basis of this assessment, it also appears that Estonia is expected to comply only partially with the recommendation addressed to it by the Council on 8 July 2014.

Table 5: Compliance with the requirements of the preventive arm of the Stability and Growth Pact

(% of GDP)	2013	2014		2015	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance[2] (COM)	-1.1	-0.8		-0.7	
Structural balance based on freezing (COM)	-0.2	-0.5		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		Not at MTO	
(% of GDP)	**2013**	**2014**		**2015**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.5	
Change in structural balance[5]	-0.3	0.9	0.4	0.1	0.1
One-year deviation from the required adjustment after considering the relevant factors[6]	-0.4	0.7	0.2	-0.4	-0.4
Two-year average change in structural balance[5]	0.1	0.3	0.0	0.5	0.2
Two-year average deviation from the required adjustment after considering the relevant factors[6]	0.0	0.2	-0.1	0.1	-0.1
Expenditure benchmark pillar					
Applicable reference rate[7]	2.3	2.1		0.9	
One-year deviation[8]	-0.7	-0.1	-0.2	-1.4	-1.2
Two-year average deviation[8]	-0.1	-0.4	-0.5	-0.8	-0.7
Conclusion					
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	Overall assessment	Overall assessment	Overall assessment	Overall assessment	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 28.).

[5] Change in the structural balance compared to year t-1. Ex post assessment (for 2013) is carried out on the basis of Commission 2014 spring forecast.

[6] The difference of the change in the structural balance and the required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[7] 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 lower rate applies as long as the country is adjusting towards its MTO, including in year t. The reference rates applicable to 2014 onwards have been updated in 2013.

[8] 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 2015 (DBP), Commission 2014 autumn forecast (COM), Commission calculations

5. IMPLEMENTATION OF FISCAL-STRUCTURAL REFORMS

Estonia is recommended to further improve the setup of the fiscal framework. However, the binding nature of the expenditure ceilings in its medium-term budgetary framework has not yet been strengthened and/or multi-annual expenditure rules have not been introduced. Although the State Budget Act stipulates that expenditure ceilings will be put in place in the medium-term state budget strategy for the next four years, it contains no provisions on making them binding. Expenditure ceilings are the starting point for the following year's state budget, but they can be revised during the state budget preparation process. Moreover, the expenditure limits can also be revised in the following year's update of the budget strategy.

A specific section of the Draft Budgetary Plan makes an explicit reference to every structural country-specific recommendation issued by the Council in the context of the 2014 European Semester, giving details on a number of measures of direct relevance that will be financed in the 2015 budget. A number of measures aim at strengthening labour supply by lowering the labour tax burden, reforming the incapacity for work system and strengthening policy measures adressed to families aiming to reduce child poverty; other measures aim to improve the currently low energy efficiency of the economy and to foster an easy access to quality local services.

Box 3. Addressing the tax wedge

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 its commitment to effectively reduce the tax burden on labour. It will take stock of the Member States' plans for reductions in the tax burden when discussing the draft budgetary plans.

In the context of the European Semester, Estonia was issued a recommendation to "improve incentives to work through measures targeted at low income earners".

The tax wedge in Estonia is above the EU average for low income earners. Revenues from the employers' social security contributions are the second highest in the EU. The tax wedge for a single person without children earning 50% of the average wage was 37.6% compared to an EU average of 34% in 2013, for 67% of the average wage it was 38.7% (EU average: 37.7%). For the average wage, the tax wedge was 39.9% (EU average: 42.0%). Revenues from employers' social security contributions amounted to 10.6% of GDP in 2012. While the overall employment rate is above the EU average, structural unemployment is estimated to be high at around 10% of the total labour force.

Estonia's Draft Budgetary Plan contains the objective to reduce the tax wedge on labour as of 1 January 2015. This entails across the board cuts in tax rates: the personal (and corporate) income tax rate will be lowered by 1 pp. to 20%, the unemployment insurance contribution will be reduced to 2.4% from the current 3% and the tax-exempted income or basic allowance will be increased by 7%. These income tax cuts will be financed by increases in other taxes, VAT and excises in particular. The change is fully in line with Estonia's general tax policy objective to shift the tax burden away from labour to consumption and environment.

The measures reduce the tax wedge for all income categories by 1 pp. and are not targeted at low-wage earners, the group for which the current tax structure is most distortive. The planned increase in the monthly basic allowance to EUR 154 from EUR 144 compensates for the general wage growth, but it remains very low at 14% of average wage and at 40% of the minimum wage.

6. OVERALL CONCLUSION

Following an overall analysis of the Draft Budgetary Plan, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, the adjustment path towards the MTO seems to be appropriate in 2014, but there is a risk of some deviation over 2013 and 2014 taken together. Some deviation from the adjustment path towards the MTO is to be expected in 2015. Risks to the fiscal target for 2015 seem to be on the downside as the macroeconomic scenario presented in the Draft Budgetary Plan is on the optimistic side and the tax-enhancing measures entering into force in end-2014 depend on close monitoring in order to fully deliver the intended yields.

Regarding the fiscal framework, the strengthening of the binding nature of expenditure ceilings in the medium-term budgetary framework and/or the introduction of multi-annual expenditure rules has not yet been achieved.