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COMMISSION OPINION

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on the Draft Budgetary Plan of ESTONIA

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GENERAL CONSIDERATIONS

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

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

CONSIDERATIONS CONCERNING ESTONIA

3. On the basis of the Draft Budgetary Plan for 2015 submitted on 15 October by Estonia, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

4. Estonia is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its medium-term budgetary objective (MTO, a structural surplus). On 8 July 2014, the Council recommended Estonia to reinforce the budgetary measures for 2014 in light of an emerging gap of 0.3% of GDP compared to the required adjustment towards its MTO and to significantly strengthen the budgetary strategy to ensure that the MTO is reached in 2015.

5. The macroeconomic projections for 2015 are more optimistic in the Draft Budgetary Plan than in the Commission 2014 autumn forecast (growth rates are 2.5% versus 2.0%). The projections underpinning the Draft Budgetary Plan have been revised downwards compared with the Stability Programme presented in spring 2014, reflecting a lower-than-expected outcome in the first half of 2014 and a worsened external demand outlook.

6. Regulation (EU) No 473/2013 requires the draft budget to be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic and tax revenue forecasts underlying the Draft Budgetary Plan have been endorsed by the Estonian Fiscal Council. In its endorsement of the forecasts, the Fiscal Council nevertheless flagged a possible overestimation of the structural balance for the years 2014-2015 by the Ministry of Finance. The Fiscal Council is an advisory body attached to the Bank of Estonia and consists of members with high reputation and experience. It assesses the macroeconomic and fiscal forecasts of the State and how well the budget rules are followed, in accordance with the requirements of the State Budget Act and the European Union law.

7. The Draft Budgetary Plan projects the general government deficit to decrease to 0.3% of GDP in 2014. This would be somewhat better than the 0.7% of GDP deficit targeted in the Stability Programme. The smaller-than-expected deficit would result mainly from the closure of tax fraud schemes in the first half of 2014 and lower

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

8. The Commission forecasts a slightly larger headline deficit for 2014 and 2015 (0.4% and 0.6% of GDP, respectively) compared with the targets set in the Draft Budgetary Plan. Risks to the fiscal projection 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. The tax-enhancing measures entering into force in end-2014 depend on close monitoring in order to fully deliver the intended yields.

9. The debt-to-GDP ratio will remain below 10% in 2014-2015. Differences in the Draft Budgetary Plan, the Stability Programme and the Commission forecast are minor. Risks related to the debt projections are low with small nominal general government deficits.

10. The measures presented in the Draft Budgetary Plan 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. Most of the measures are focused on expenditure, while the largest effect comes from the rescheduling of dividend distributions from state-owned enterprises from 2014 to 2015. Despite their positive short-term budgetary effect in 2015, the expected 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.

11. 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, which implies that the adjustment towards the medium-term objective is above what is required. 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% according to both the Draft Budgetary Plan and the Commission 2014 autumn forecast, pointing to a deviation from the MTO over the period 2013-2014 in excess of 0.25 % of GDP. The divergence of the two indicators can be, inter alia, explained by changed economic growth composition and closure of large scale tax fraud schemes in the first half of 2014 that has a permanent positive effect on revenue, but are not taken into account in the expenditure benchmark calculations. Therefore, the structural balance is considered to be a more relevant indicator for Estonia's fiscal effort in 2014. Based on an overall assessment, the adjustment towards the MTO seems 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 structural deficit is projected to improve by 0.1% of GDP according to both the (recalculated) Draft Budgetary Plan and the Commission 2014 autumn forecast. 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. In turn, the expenditure benchmark points to a significant deviation from the MTO in 2015. As in 2014, 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 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). An overall assessment, based on the Commission forecast, points to some deviation from the required adjustment path towards the MTO in 2015.

12. The 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, resulting in a reduction of the tax wedge for all income categories by 1%. These measures, however, are not targeted at low-wage earners, the group for which the current tax structure is most distortive. Regarding other fiscal-structural reforms, no progress has been made with the strengthening of the binding nature of expenditure ceilings in the medium-term budgetary framework and/or the introduction of multi-annual expenditure rules.

13. Overall, the Commission is of the opinion that the Draft Budgetary Plan of Estonia, which is currently under the preventive arm, is broadly compliant with the provisions of the Stability and Growth Pact. In particular, based on the 2014 autumn forecast, some deviation from the adjustment path towards the MTO is to be expected in 2015. The Commission invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2015 budget will be compliant with the Stability and Growth Pact.

    The Commission is also of the opinion that Estonia has made no progress with regard to the structural part of the fiscal recommendations issued by the Council in the context of the 2014 European Semester and thus invites the authorities to accelerate implementation.

Done at Brussels, 28.11.2014

For the Commission
Pierre MOSCOVICI
Member of the Commission