Estonia

Country note, July 2018

Key messages:

- **Economic growth is expected to slow from 4.9% in 2017 to 4% in 2018 but to stay above potential**
- **The general government recorded a deficit in 2017 and a structural deficit is also expected for 2018**
- **Achieving the goal of structural balance set for 2019-2021 will depend on planned revenue measures**

Macroeconomic outlook

Economic growth exceeded expectations in 2017 and reached 4.9% in real terms, driven by surging investment and a favourable external environment. Strong growth is expected to continue in 2018 and the Ministry of Finance forecasts real GDP growth of 4% (see Chart 1). Looking ahead, GDP growth is expected to converge with its long-term sustainable rate of close to 3% after 2018. The Ministry's macroeconomic forecast was endorsed by the Fiscal Council, which considered the risks to the growth outlook to be balanced.

Fiscal outlook

The general government recorded a deficit of 0.3% of GDP in 2017 in both nominal and structural terms, according to the estimate by the Ministry. While VAT and labour taxes rose rapidly, revenues from excises and corporate income tax were lower than expected. The Council cautioned against the risk of forecast error arising from the large number of tax changes in several publications, and this uncertainty in the tax revenue forecasts can be expected to continue in 2018.

The Ministry projects the structural deficit will reach 0.4% of GDP in 2018. The updated budget strategy sets the goal of structural balance being met in each year in 2019-2021. To achieve this goal several revenue-increasing measures were announced in the spring. The lack of detail and impact assessment available at the time draw the Council to the conclusion that these measures may not be sufficient to achieve structural balance. The Minister of Finance responded publicly to the concerns raised by the Council (*comply or explain*).

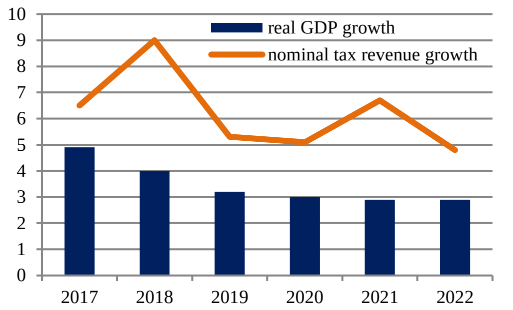
Unlike in some previous forecast rounds, the estimates of the Ministry and the Fiscal Council for the cyclical component of the budget are very similar for the years ahead, leading to similar estimates for the structural balance (see Charts 2 and 3), assuming that the nominal budgetary position improves by the amount envisioned in the budget strategy.

Fiscal framework and national fiscal rules

After the national structural balance rule was amended and the MTO lowered in 2017, the maximum structural deficit allowed is now 0.5% of GDP. The national fiscal framework permits structural deficits only if structural surpluses of the same amount have previously been accumulated. This ensures that structural balance is maintained on average over the medium term.

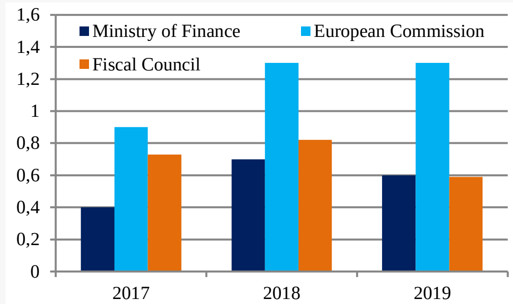
The Ministry forecasts structural deficits in both 2017 and 2018. The Council is concerned that structural deficits are being recorded in times of strong economic and tax revenue growth.

Chart 1: Growth in the economy and tax revenues (% y-o-y)



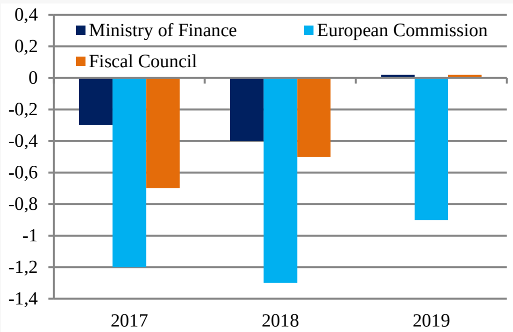
Source: Ministry of Finance

Chart 2: Estimates of the cyclical component (% of GDP)



Source: Ministry of Finance, European Commission, Fiscal Council

Chart 3: Estimates of the structural balance (% of GDP)



Source: Ministry of Finance, European Commission, Fiscal Council

Key indicator forecast

		2017	2018 f	2019 f	2020 f	2021 f	2022 f
Real GDP growth	[% y-o-y]	4.9	4.0	3.2	3.0	2.9	2.9
Output gap	[% of pot. GDP]	0.9	1.6	1.3	0.9	0.4	0.0
GG nominal balance	[% of GDP]	−0.3	0.2	0.5	0.4	0.2	0.1
GG structural balance	[% of GDP]	−0.3	−0.4	0.0	0.0	0.0	0.1
GG debt	[% of GDP]	9.0	8.5	7.7	6.9	6.2	5.3

Source: Ministry of Finance (Spring forecast 2018, State Budget Strategy 2019-2022)