ESTONIA

Highlights

- **GDP growth has decelerated.** Despite a marginal recovery in export demand, the GDP growth rate remained below expectations in the first half of 2016. Private consumption has continued to support growth, whereas investment is still to recover – along with the anticipated acceleration in disbursements of the EU structural funds from the new budget.
- **Red tape for businesses has been further reduced.** Following the introduction of policies to digitalise the public administration over the past years, the government has continued to reduce red tape in the past year, including through a substantial increase in the threshold for VAT taxation.
- **A work ability programme has come into force.** In order to enhance labour force participation, and amid the intensifying negative demographic trends, the government has launched a programme to bring as many people with reduced ability into the workforce as possible. This initiative is expected to bring rewards, as about one in eight working-age people claims to be incapable of work.

Key priorities for 2017

- **Energy efficiency should be strengthened.** Estonia has the second-highest energy intensity level in the European Union. Oil shale is an important source of energy in Estonia, and represents more than 60 per cent of the energy mix in the country. Additional investment in alternative fuel energy generation, including renewables, would balance the energy mix of the country.
- **A better environment for risk capital could underpin private sector investment.** New investment in high-value added sectors is needed to enhance production capacity and demonstrate to other businesses how upgraded capital and technologies will sustain growth. While there is an internationally known start-up sector, overall productivity growth has faltered recently, and innovation performance needs to be strengthened to sustain export market shares.
- **The public-private funding mechanisms established in the form of the EU financial instruments could extend the lifetime of the EU structural funds.** Estonia stands to surpass the 75 per cent threshold of national income relative to the EU average in the coming years. At that point it will become ineligible for large parts of EU structural and investment funds. Through the so-called financial instruments the funds can be reinvested again, also beyond the current EU budgetary perspective.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	4.3	1.4	2.8	1.4	1.6
Inflation (average)	4.2	3.2	0.5	0.1	0.5
Government balance/GDP	-0.3	-0.2	0.7	0.1	0.0
Current account balance/GDP	-1.9	-0.4	0.9	2.2	0.7
Net FDI/GDP [neg. sign = inflows]	-2.2	-1.0	-2.9	0.9	-1.3
External debt/GDP	102.4	95.3	94.5	93.8	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	72.9	69.7	68.8	70.4	n.a.

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Macroeconomic performance

Strong household consumption has supported positive growth. Following a growth rate of 1.4 per cent in 2015, GDP slowed to 1.1 per cent in the first half of 2016, markedly below expectations. The protracted recession in Russia continued to weigh on exports, while low commodity prices and an oversupply of oil on international markets negatively affected Estonia's shale oil production. Growth in 2015 was primarily supported by household consumption, underpinned by significant wage increases and income tax cuts. Weak investment demand resulted in lower imports and translated into a record-high current account surplus of 2.2 per cent of GDP, despite the overall drop in export volumes last year. However, new disbursements of EU funds for the 2014-2020 programming period should revive public investment gradually over the course of 2016. Private investment growth has also been weak, as geopolitical tensions dampened domestic sentiment.

A labour supply increase is expected to lead to a temporary rise in unemployment. Frail economic growth has resulted in the unemployment rate increasing slightly to 6.8 per cent in July 2016, which still represents a relatively low figure among the other EU countries. The launch in January 2016 of a work ability reform is expected to further raise the participation rate in the workforce, which is already impressively high at 71.9 per cent (for workers aged 15-64) in 2015. However, the expected rise in labour supply, induced partially by putting more disability pensioners to work and the recently softened net emigration, may result in a temporary growth in unemployment. This could help moderate nominal wage growth, at almost 6 per cent last year, and bring it closer to labour productivity growth.

High fiscal expenditures have been matched with solid revenue growth. In 2015, the fiscal budget surplus dropped to 0.1 per cent of GDP in 2015 from 0.7 per cent in the previous year. This results from a substantial increase in fiscal expenditures, which, at the same time, was to a large extent offset by strong revenue inflows. Anticipated changes in tax policies, including higher excise taxes on fuel, alcohol and tobacco, lower labour taxes and reduced resource taxes, and some cuts in public administration and higher social spending, are expected to cause a slight deterioration in the government fiscal position over the next two years. Public debt decreased to 10.1 per cent of GDP in 2015 and is expected to decline to below this level in 2016-17.

Growth will gradually gain momentum. Estonia's GDP is expected to grow at 1.6 per cent this year and 2.4 per cent in 2017, as the recovering neighbouring economies, such as Finland and Russia, will provide an additional boost to GDP growth, and the co-financing from the EU funds investment will likely accelerate.

Major structural reform developments

Risk funding for SMEs is being enhanced. EstFund, a new early-stage investment fund of funds was established by the Estonian authorities and the European Investment Fund in March 2016 and will start operating by the end of 2017. It will complement the existing Baltic Innovation Fund by providing small and medium-sized enterprises (SMEs) with risk capital in an even earlier phase and in smaller tranches. EstFund comprises three sub-funds: a venture capital fund, capital expansion fund and business angel co-investment fund, which are expected to raise private funds equalling at least 30 per cent of the total funds raised. It is the first fund of funds that the European Investment Fund has invested in, involving also resources from EU structural funds.

The business environment continues to be ranked among the most attractive in the central Europe and Baltic states region. In order to further cut red tape, in July 2016 the government decided to increase the annual VAT non-taxable threshold from €16,000 to €40,000, effective from January 2018. The change is expected to affect 15 per cent of all companies. The country remains the regional leader in the World Bank's *Doing Business 2017* report, which ranked the country 14th globally out of 190 countries. Estonia scores relatively highly in the registering property category (sixth place) as well as dealing with construction permits (ninth place). Around three days are necessary to open a new company, which is substantially below the OECD average of more than eight days. Costs relating to opening a business constitute only half of the OECD average.

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State ownership in domestic companies will be reduced. According to a report published by the Ministry of Economy in August 2015, several state-owned enterprises (SOEs) are expected to be sold partially or entirely in the next few years. Among the listed enterprises, the government could sell off the post company Omniva (Eesti Post) and the road service company Eesti Teed. For the post industry, listing the parcel business of Omniva would not affect delivery and services as these are regulated by the Postal Act. However, a strategic investor could strengthen the international expansion of the self-service parcel terminal networks, which expanded by nearly one third over the last year. In Estonia, more than 4 per cent of those employed work for SoEs, which constitutes one of the highest such rates among the OECD countries.

Further measures to raise employment have been introduced. A package of reforms effective since January 2016 aims to bring more workers with disabilities into the workforce. Each disabled person is approached individually, assessed on his or her ability to be active and consequently helped in finding opportunities in the labour market. People with disabilities are paid a working ability allowance, while employers are compensated for workplace adjustment costs. The reform also introduces a number of changes in the income and social tax laws, aimed at reducing the amount of paperwork by employees. Despite one of the highest employment rates in the European Union, this reform is expected to further boost employment in Estonia in the coming years, as about one in eight individuals of working-age claim to be incapable of work.

Shale oil-based energy is expected to be phased out. In June 2016, parliament passed the Organisation of Energy Sector Act, which provides the guidelines for achieving energy efficiency in production, consumption and distribution of energy. The Act transposes belatedly the EU directive, which supports the switch-over to low-carbon technologies and fuels. Estonia's energy intensity remains the second highest in the European Union, with the gross inland energy consumption to GDP ratio significantly above that of regional peers (Latvia, Lithuania and Poland).

Energy diversification has strengthened. The European Commission approved in June 2016 financial support of 75 per cent of the project's total cost of €250 million, for the construction of the BalticConnector gas pipeline between Estonia and Finland. The gas interconnection will lead to an open gas market for Estonia and is expected to be operational by 2019. The European Union will also co-finance the gas connection between Estonia and Latvia, which will enable better access to gas storage in Latvia. Ultimately, increased sources may lead to a higher share of gas consumption in Estonia's overall energy mix, which could help reduce the country's carbon intensity as it would displace more polluting fuels.