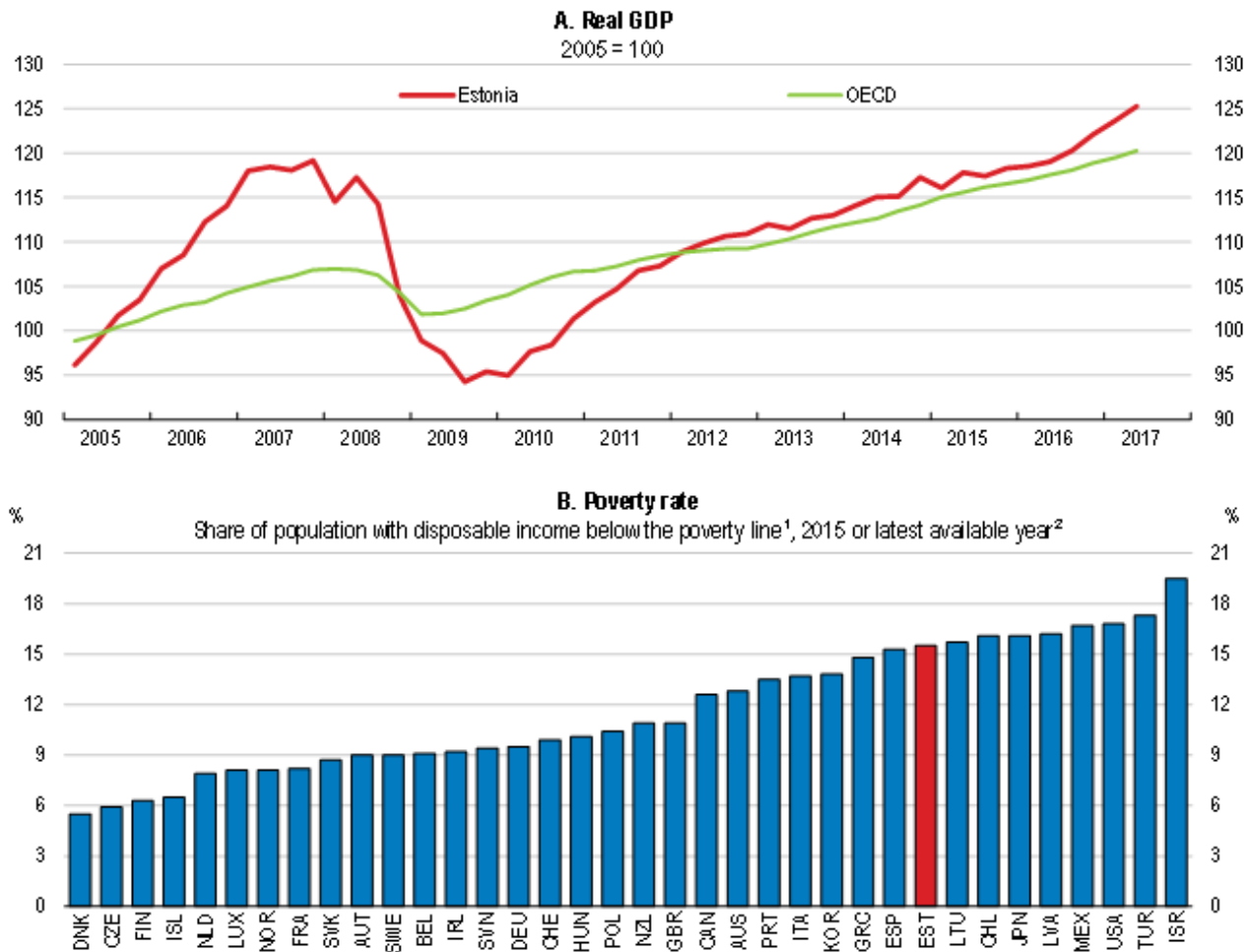# Estonia: Using fiscal space for a more inclusive growth

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Estonian growth is picking up again strongly in 2017 and the level of activity has finally surpassed its pre-crisis level, almost 10 years after the outset of the financial crisis (Figure 1, panel A). However, poverty remains among the highest in the OECD (Figure 1, Panel B).

To make growth more inclusive, the 2017 OECD economic survey argues that Estonia should make its tax and benefits policies more redistributive, but also use more actively its large fiscal space by allowing a small fiscal deficit in the longer term (OECD, 2017).

Figure 1. Activity is back to pre-crisis level but poverty remains high

A. Real GDP
2005 = 100

B. Poverty rate
Share of population with disposable income below the poverty line[1], 2015 or latest available year[2]
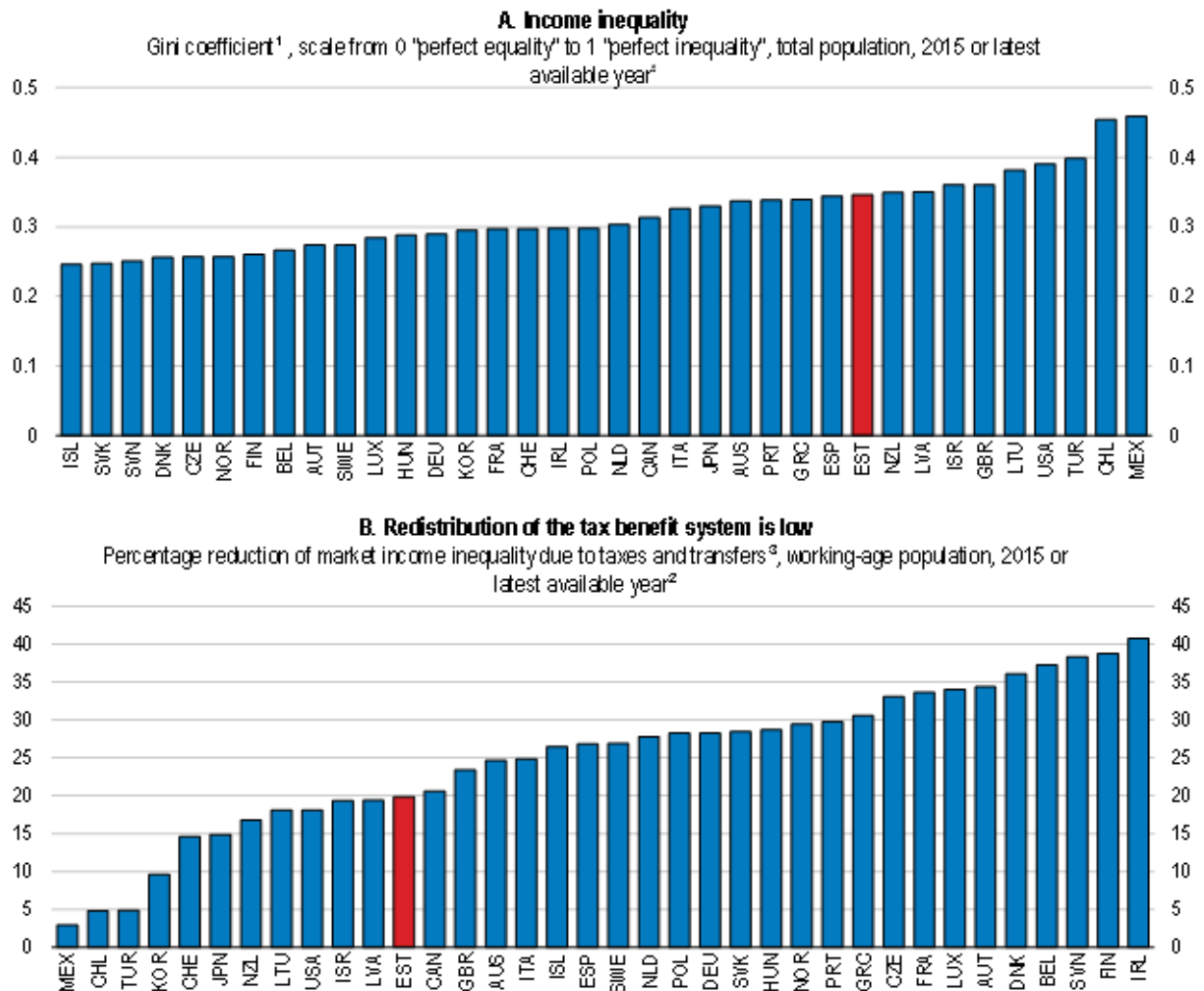

1. The poverty threshold is 50% of median disposable income.

2. Latest available data refer to 2015 for Chile, Finland, Israel, Korea, Mexico, the Netherlands, the United Kingdom, and the United States; to 2012 for Japan; and to 2014 for all other countries.

Source: OECD Economic Outlook 101 database (updated with information available on 1 September 2017); OECD Income Distribution database (IDD).

Market income inequality is high (Figure 2, Panels A), but the redistributive effects of the Estonian tax and benefit system is low (Figure 2, Panel B). It leaves a considerable proportion of the population at risk of poverty, notably the unemployed, disabled and low-educated. The old-aged are also more at risk of poverty, in particular because of the relatively low level of pensions.

Figure 2. The tax and benefit system does not reduce much inequality

A. Income inequality
Gini coefficient[1], scale from 0 "perfect equality" to 1 "perfect inequality", total population, 2015 or latest available year[2]

B. Redistribution of the tax benefit system is low
Percentage reduction of market income inequality due to taxes and transfers[3], working-age population, 2015 or latest available year[2]

1. Gini coefficient of disposable income.

2. Latest available data refer to 2015 for Chile, Finland, Israel, Korea, Mexico, the Netherlands, the United Kingdom, and the United States; to 2012 for Japan; and to 2014 for all other countries.

3. Redistribution is defined as the difference between market income and disposable income inequality (inequality measured using the Gini coefficient), expressed as a percentage of market income inequality. Market incomes are net of taxes in Hungary, Mexico and Turkey.

Source: OECD Income Distribution database (IDD).

The government is already working on important redistributive measures. For instance, the planned increase in the personal income tax allowance, which is steeper at lower wage levels, will improve the progressivity to the tax system from 2018. However, the lowest income earners will not benefit from this measure since they are exempt from the personal income tax. Besides, the level of spending allocated to protection of the most vulnerable is low: around 31% of total public spending in 2014 went on social spending, some 9 percentage points less than the EU average. The targeting of social programmes is

also poor, with means-tested measures accounting for a low share in total social spending.

Fiscal room is available for further measures to make growth more inclusive. Estonia has the lowest gross public debt relative to GDP in the OECD (Maastricht debt is at around 10%) and a structural budget surplus since 2009. Fiscal policy has been tight over past years, despite economic slack. The government plans a small structural deficit in 2018, 2019 and 2020, which is welcome, but the current fiscal rule imposes a return to a balanced budget in structural terms from 2021.

Beyond 2020, financing growth-enhancing measures could require revising the fiscal rule. Maintaining a small structural deficit for an extended period would not undermine the long-term sustainability of public finances. For instance, a persistent deficit of 0.5% of GDP would result in Maastricht debt reaching less than 11% of GDP in 2030 (Figure 3). In the same vein, increasing the deficit by 1% of GDP would still maintain a prudent debt level, even if coupled with 1 percentage point lower inflation and GDP growth (Figure 3).

Figure 3. A large fiscal space could be used to make growth more inclusive

Illustrative public debt paths, General government debt, Maastricht definition, as a percentage of GDP[1]
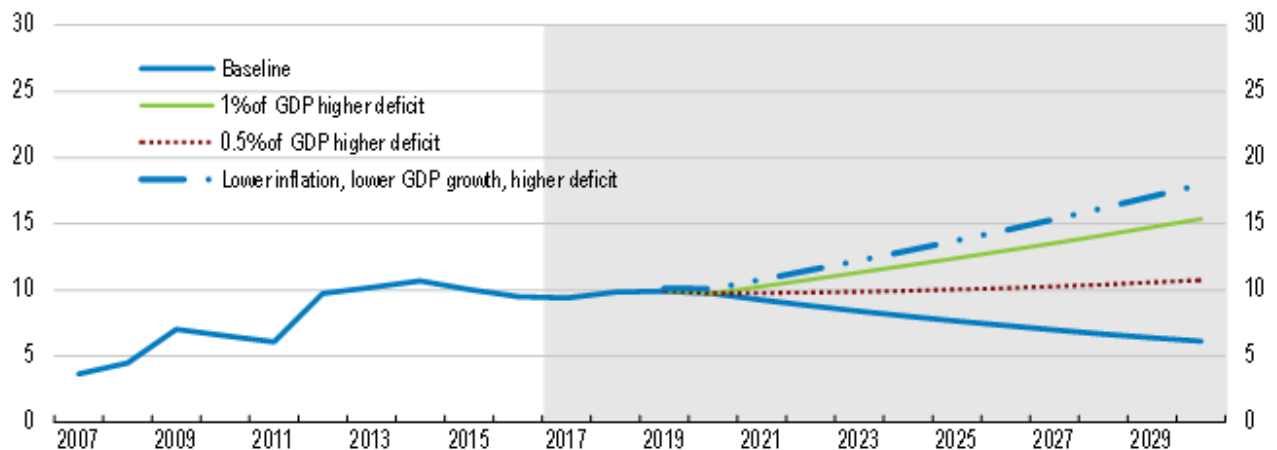
1. The baseline consists of projections for the Economic Outlook No. 101 until 2018. Thereafter, assumptions are: real GDP growth progressively closing the output gap and from 2020 growing by 2.5% in line with OECD estimates for long-term potential growth; a budget balanced in structural terms from 2021 as set out in the national reform programme; inflation declining progressively to 2% by 2030 and an average effective interest rate converging to 3% by 2030. The "0.5% of GDP higher deficit" scenario assumes a structural deficit maintained at 0.5% of GDP from 2021. The "1% of GDP higher deficit" scenario assumes a structural deficit increasing to 1% of GDP from 2021. The "lower inflation, lower GDP growth and higher deficit" scenario assumes lower inflation and real GDP growth by 1 percentage point per year, both from 2019 with structural deficit increased by 1% of GDP from 2021.

Source: OECD Economic Outlook 101 database; calculations based on OECD (2017), OECD Economic Outlook: Statistics and Projections (database), June.

References

OECD (2017), *OECD Economic Survey of Estonia*, OECD Publishing, Paris.