EELARVENÕUKOGU
FISCAL COUNCIL

OPINION OF THE FISCAL COUNCIL ON THE ACHIEVEMENT OF THE GENERAL GOVERNMENT STRUCTURAL BUDGET POSITION TARGET IN 2016

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Contents

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Opinion

Under the State Budget Act, the Fiscal Council must issue its opinion on the achievement of the target for the structural budget position after the government's consolidated report on the financial year has been published. According to fiscal rules, the general government budget has to be at least in structural balance.

When the state budget strategy for 2016–2019 was prepared, the structural budget position target was set at a surplus of 0.6% of GDP. The target remained the same when the 2016 state budget was passed. In the state budget, it was also assumed that the budgets of both central and local governments, and the budget for the whole general government would be in a small nominal deficit.

Under the European system of accounts (ESA 2010), which is the basis for the fiscal rules in Estonia and the European Union, the revenues of the general government exceeded spending by an amount that was equal to 0.3% of GDP. The nominal surplus was mostly due to tax revenues being stronger and investment expenditure being smaller than expected. Despite GDP growth being relatively slow, labour taxes caused the tax income of the general government to rise nearly 6% in a year, which allowed increasing the general government current expenditure at the same rate.

Calculations by the Ministry of Finance put the general government structural budget surplus at 0.7% of GDP in 2016, which exceeds the target for 2016. Assessments by other institutions also indicate a fiscal position that is in structural balance or in surplus. Only the disaggregated method used by the Fiscal Council indicates that a structural deficit is also possible.

The Fiscal Council finds that based on the current estimate, the general government structural budget position for 2016 is in line with the State Budget Act. However, experience has shown that the estimates of output gap and the structural balance can later change significantly. This means that when planning fiscal policies, the estimate concerning the size of the structural surplus given in the consolidated report on the state financial year cannot be considered final.

Chairman of Fiscal Council
Raul Eamets
Tallinn, 25 July 2017

Explanatory Report

Under the State Budget Act, the Fiscal Council must issue its opinion on the achievement of the target for the structural budget position after the government's consolidated report on the financial year has been published. The state budget for 2016 was the second budget to be drawn up under the new State Budget Act passed in 2014, according to which the budget for the whole general government has to be at least in structural balance. The changes in law passed this summer regarding the structural balance rule will start to apply from the 2018 state budget (see Box 1).[1]

General government budget position target for 2016

After the exit from the crisis, the government set out a vision for fiscal policy with the goal of recovering its depleted reserves. The year 2014 marked a turning point: the target for a nominal surplus and nominal indicators more generally were essentially abandoned for the next four years and the government focused more on countercyclical fiscal policy, or the role of fiscal policy in smoothing the economic cycle.

The State Budget Strategy (SBS) 2016–2019 prepared in spring 2015 declared both that the government's medium-term fiscal policy objective is at least a structural *balance* of the general government, and that the government will continue its strict fiscal policy with a medium-term objective of a structural *surplus*. A structural surplus of 0.6% of GDP was planned specifically for 2016 (SBS 2016−2019, pp 58−60). This was based on the assumption that in 2016, the Estonian economy would be operating below its potential, and the output gap was estimated to be at –0.8% of GDP.

Over the next six months, estimates on the outlook for economic growth did not change much, and the summer 2015 forecast by the Ministry of Finance did not entail significant changes to the general government budget position compared to the spring forecast. The 2016 state budget was prepared knowing that even though economic growth was expected to pick up, the Estonian economy would stay 0.7% below its potential, which justifies the fact that expenditure increases slightly faster than tax revenues. As in the spring, the general government budget position was forecast to be in a minimal nominal deficit (around 20 million euros, or 0.1% of GDP) and in a larger than average structural surplus (around 130 million euros, or 0.6% of GDP). At the same time, the forecast for the tax revenues in the 2016 state budget had improved somewhat compared to the spring forecast.

In its 2015 autumn opinion, the Fiscal Council considered the new VAT and corporate income tax revenue forecast to be overestimated and added that the forecast additional revenues should not be treated as a source of funds for increasing spending. Regarding the cyclical position of the economy, the Fiscal Council considered it possible that the Ministry of Finance would have to decrease the negative output gap estimate even more later on, and did not rule out the possibility that the 2016 output gap would be either closed or positive. Given this, the Fiscal Council recommended preparing the budget for 2016 and the following years at a small structural surplus.

[1] The updated State Budget Act also foresees that in the future, the assessment of the structural budget position of the past fiscal year will be published in spring, together with the opinion on the targets for the structural budget position in the upcoming years.

Achievement of the budget position target

Nominal balance

The consolidated report for the state financial year found that there was a fiscal outcome of –133.1 million euros in 2016. Under the European system of accounts (ESA 2010), which is the basis for the fiscal rules in Estonia and the European Union, this means a nominal surplus of the general government budget in the amount of 56.7 million euros, or 0.3% of GDP.[2]

As in 2014 and 2015, the nominal budget position of the general government was better in 2016 than had been forecast when the state budget was prepared (see Figure 1). The nominal position was better than budgeted by around 80 million euros, or 0.4% of GDP. Around 40% of this improvement came from stronger tax revenues and 60% from smaller expenditure than was expected (mainly due to the smaller investment expenditure of the central and local governments).

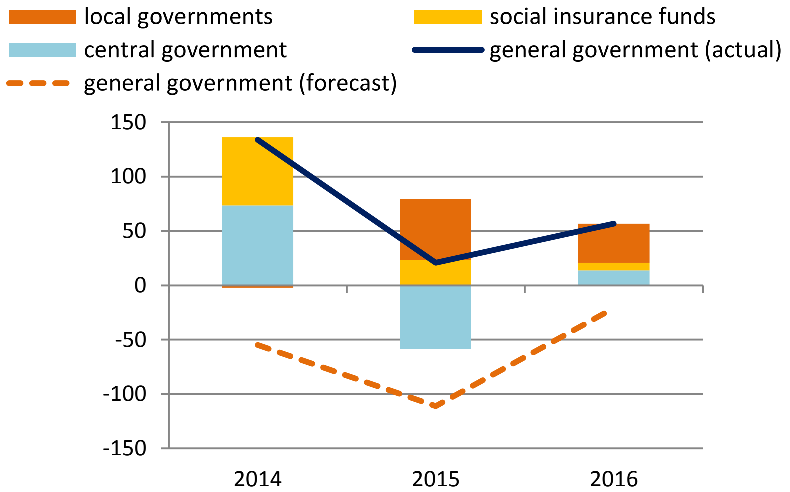

Figure 1. Formation of the general government nominal balance in 2014–2016 (million euros)

Source: Ministry of Finance

Across the main general government levels, expenditure was larger than planned only for the Health Insurance Fund, where a small deficit was seen despite the fact that social tax grew 6.5% in a year, and thus the contribution of social insurance funds to the general government budget surplus was lower than expected. However, the budget positions of the central and local governments were in a small surplus, contrary to expectations.

In particular labour tax, meaning social tax and personal income tax revenues were better than what was foreseen in the budget. Their share in government revenues was large enough to compensate for the 2.5% lower VAT revenue and the 5% lower corporate income tax (the possibility of lower tax revenues from VAT and corporate income tax had been indicated by the Fiscal Council in autumn 2015). Tax revenues increased by 5.7% in a year, which was less than in 2014 and 2015, but given the 3.3% nominal growth in GDP, the tax revenues were nevertheless very good. The rapid growth in tax revenues allowed increasing the general government current expenditure by nearly 6%.

[2] Surplus or deficit in terms of the fiscal rules is not comparable to the annual fiscal outcome that is presented in the consolidated report. The consolidated report considers the outcome to be the difference between revenue and expenditure, which is adjusted with the acquisition of fixed assets and which is also impacted by various financing transactions and asset revaluations. Specifically for 2016, the difference was mainly caused by financing transactions and revaluations (see also p 9 of the consolidated report for the state financial year).

Good tax revenues in 2016 were not surprising. After the exit from the crisis, both average wages and private consumption and the related taxes have grown faster than GDP. More dividends than before have been taken out in recent years, and the corporate income tax on dividends has also supported the very good tax revenues. Therefore, general government spending has also had the chance to grow faster than could have been expected, given the overall state of the economy. Compared to 2008, current expenditure had thus increased 38% by 2016. This is significantly faster than the growth of GDP in current prices (27%) and private consumption (24%). Only general government investment was 10% smaller than back in 2008.

Structural balance

The Ministry of Finance estimates that in the last three years, the general government structural budget position has been in surplus of 0.2–0.7% of GDP, and the budget position has strengthened each year. Leaving technical details aside, the structural deficit for 2016 as a whole was in line with the target set at preparing the budget, which was 0.6% of GDP (see Table 1).

Table 1. Formation of the 2016 general government structural balance

	SBS 2016−2019	State budget draft 2016	Actual
Nominal balance (million euros)	−22	−26	57
Nominal balance (% of GDP)	−0.1	−0.1	0.3
Output gap (% of GDP)	−0.8	−0.7	−0.4
Cyclical component (% of GDP)	−0.4	−0.3	−0.2
One-off measures (% of GDP)	−0.3	−0.3	−0.3
Structural balance (% of GDP)	0.6	0.6	0.7

Source: Ministry of Finance[3]

For the second consecutive year, the structural surplus planned in the draft state budget and the actual outcome according to the consolidated report for the state financial year are similar, but the position has formed differently from the forecast – the negative impact of the economic cycle has later been estimated to be smaller, and the nominal position was better than expected on the back of strong tax revenues. Not only is the impact of the economic cycle, but one-off revenue and expenditure measures are also left out when the structural budget position is calculated. The Ministry of Finance classifies additional state contributions to the second pension pillar as one-off expenditures for 2016; these contributions improve the general government budget position by 0.3 percentage points in the structural balance calculations.

Although the estimate for the 2016 output gap has later been lowered by half compared to the budgetary plans prepared in 2015, the Ministry of Finance's estimate on structural surplus is still based on the assumption that the output gap for 2016 was negative (0.4% of GDP). A similarly sized output gap is indicated in the latest economic forecast published by Eesti Pank as well as in the Fiscal Council's calculations.[4] According to estimates by IMF and OECD, the output of Estonian economy was even more below its potential. Only the European Commission estimated that last year, the Estonian economy was already operating at full capacity (see Figure 2).

[3] The figures used for calculating the structural budget position in the table may be affected by rounding.

[4] This estimate of the Fiscal Council is based on data from the Ministry of Finance's spring forecast 2017 and the Hodrick-Prescott filter.

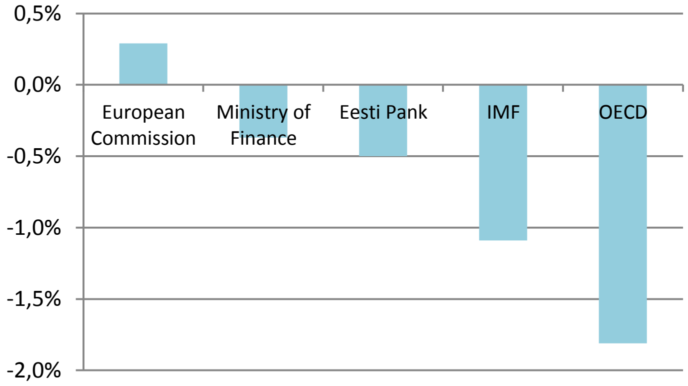

Figure 2. Estimates of the 2016 Estonian output gap (% of GDP)

Sources: Eesti Pank, European Commission, IMF, OECD, Ministry of Finance

Uncertainty at measuring the output gap – even when measured ex post, the estimates of various institutions differ up to 2 percentage points – is also transferred into estimates on the general government structural budget position. In addition to the Ministry of Finance, the latest estimates by the European Commission, OECD and IMF also refer to structural surpluses, albeit of different sizes (see Figure 3). At the same time, the estimates by these institutions, whose method of calculating the structural budget position is based on the sustainable development of tax bases and not only the size of the output gap, refer to a slightly weaker fiscal position. This arises mainly from the contradiction between the economic cycle and the labour market.

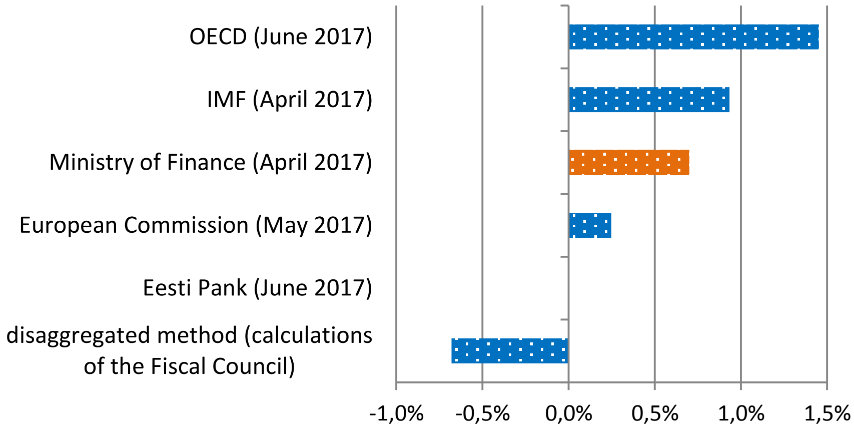

Figure 3. Estimates of the 2016 Estonian general government structural balance (% of GDP)

Sources: Eesti Pank, European Commission, IMF, OECD, Ministry of Finance, calculations of the Fiscal Council

For example, in 2016 GDP growth was 3.6% at current prices and 1.6% at constant prices. Both indicators however remain below the growth rate believed to be sustainable in the long term. Labour market indicators on the other hand show a reversed situation. In the last three years, the unemployment rate has hovered around 7% and on average, real wages have increased 6.5% a year. Both of these indicators exceed their long-term averages. Strong labour market indicators were also reflected by the rapid growth of tax revenues, with both labour and consumption taxes showing better revenues. That is why the disaggregated method based on tax bases refers to the positive impact of the economic cycle on tax revenues, and a structural budget position that is weaker than the nominal one.

The contradiction between labour and output indicators is not unique to Estonia. Even though the output gap of Central and Eastern European countries was estimated to be negative in 2015 and 2016, their employment rate was generally higher and unemployment lower than the average of the last ten years. It is not impossible that potential growth in those countries has slowed and so the results of the statistical methods of estimating the output gap that do not take the labour market figures sufficiently into consideration may send out the wrong signal when fiscal policy is planned.

The estimates on the structural budget position are not dependent on the institution and the methodology alone, but also the moment when the estimate is made. This is caused by the constant revisions of the output gap data in each new economic forecast, which specifies both the actual GDP growth of the previous years but also the cyclical position of the economy looking both back and forward. In case of Estonia, a change of one percentage point in the output gap estimate changes the structural budget position by around half a percentage point. On the example of the last three years, the structural budget position according to the latest estimate by the Ministry of Finance has become substantially weaker compared to the estimate prepared in the spring following the fiscal year (see Figure 4), which is also the basis for the Fiscal Council's opinion on achieving the structural balance target.

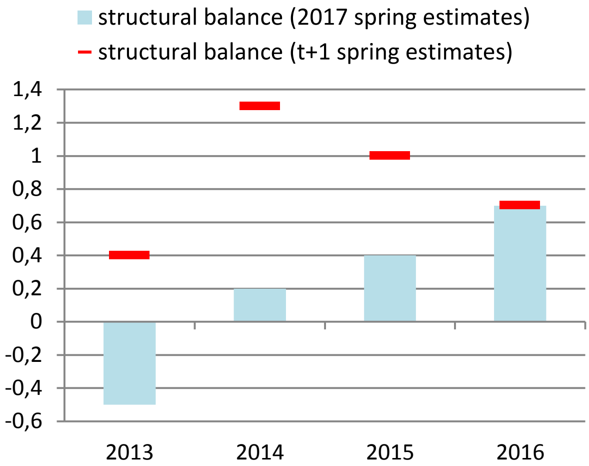

Figure 4. Estimates of the general government structural balance for 2013−2016 as presented in the spring forecast following the budget year compared to the latest forecast (% of GDP)

Source: Ministry of Finance

Under the State Budget Act, the general government budget position has to be in structural balance or surplus according to the forecasts and estimates of the Ministry of Finance in particular. The national consolidated report for 2016 showed that the general government structural surplus in 2016 was 0.7% of GDP. Estimates by several other institutions, prepared in spring and summer 2017, also refer to a budget position that is in structural balance or surplus. Even if the Ministry of Finance's estimate about the negative output gap in 2016 was replaced with the assumption that the output gap was zero or slightly positive, the government's structural budget position pursuant to the data of the state's consolidated report for 2016 would still remain in balance.

The Fiscal Council thus finds that based on the current estimate, the general government structural budget position for 2016 is in line with the State Budget Act. However, experience has shown that the estimates of output gap and the structural balance can later change significantly. This means that when planning fiscal policies, the estimate concerning the size of the structural surplus given in the consolidated report on the state financial year cannot be considered final.

Box 1. *Amendments to the structural balance rule*

Several amendments were made in summer 2017 to the State Budget Act, which was last updated in 2014, when national fiscal rules were introduced along with the Fiscal Council to monitor compliance with these rules. The main fiscal rule in Estonia, i.e. the structural balance requirement was also amended. Earlier, the rule was to ensure that the general government budget would be at least in structural balance each year. Starting from the next year's budget, however, the state budget can be prepared so that the general government budget position is in structural deficit.

Under the new fiscal rule, structural deficit is allowed, but only on certain conditions and to a certain extent. First, structural deficit can only be planned for if the *cumulative structural budget position* is in surplus. A cumulative fiscal position means that since 2014, the monetary values of the structural surpluses or deficits of each year are added up. Each spring, the cumulative structural budget position changes according to the structural surplus or deficit of the previous year. Although the structural balance estimates can change with each new economic forecast whenever the output gap estimates are revised, the estimate of the previous year's structural budget position will be fixed each spring and not changed later on when calculating the cumulative fiscal position.

Second, when planning for structural deficit, it cannot exceed the size of the cumulative surplus, or 0.5% of GDP in the year under review. When there is no cumulative surplus, the target for the fiscal position has to be at least structural balance, as required by the previous fiscal rule.

The Ministry of Finance estimates that in the last three years, the general government budget position has been in structural surplus (see Figure 5). This means that the cumulative fiscal position is also in surplus (around 270 million euros in monetary terms) and planning for structural deficit would be allowed. Under the State Budget Strategy 2018–2021, in the next two years the general government structural deficit will be 0.5% of GDP and in 2020, when the cumulative surplus is exhausted, 0.3% of GDP. This will use up the entire cumulative surplus built up from 2014 to 2017. After 2020, an equivalent amount of structural surplus should be built up before planning for subsequent deficits.

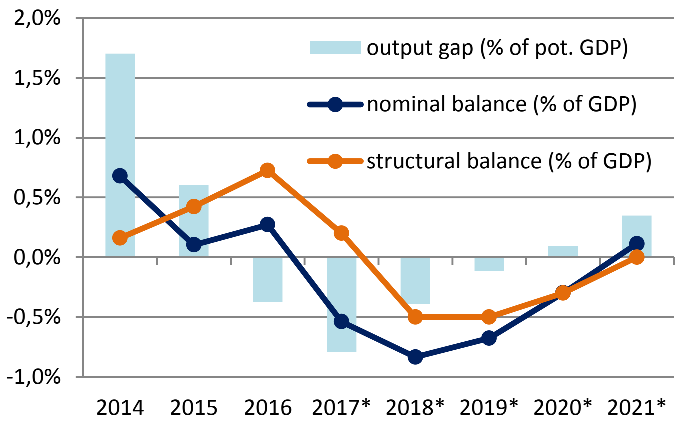

Figure 5. General government structural balance, nominal balance and output gap in 2014–2021

Source: Ministry of Finance

The structural budget position is a non-observable budgetary indicator that illustrates the gap between revenue and expenditure in a theoretical situation where the economy operates at its potential capacity each year. The general government structural budget position could show a surplus even at times when the nominal position is close to balance or even in deficit. Therefore, the existence of a structural surplus and adding up the surpluses of several years may not lead to actual fiscal reserves in an equivalent amount. All additional expenditure made on account of the cumulative surplus has to be financed either from reserves or with loans. For example, under the State Budget Strategy 2018–2021, the government's reserves will be decreased to finance the fiscal deficits of the coming years – from 9.8% as at the end of 2016 to around 7% of GDP by 2020.

The explanations around the new structural balance rule have included the claim that the balanced budget requirement will not be observed for every single year, but as the average of several years. But how many years is the average of several years? Figure 5 shows that the average fiscal position can be in structural deficit even during a five-year period (e.g. 2017–2021). Thus, we might rather say that the new fiscal rule will help to ensure that the budget is in structural balance at least over a period that equals the length of a typical economic cycle, i.e. the budget is balanced over the cycle. The fiscal rule however does not contain a mechanism to ensure structural balance over each period of a few years.