EELARVENÕUKOGU
FISCAL COUNCIL

FISCAL COUNCIL OPINION ON THE SUMMER FORECAST 2017 OF THE MINISTRY OF FINANCE

September 2017

Contents

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Opinion

It is the job of the Fiscal Council to observe that the budgetary rules are followed and to publish opinions on the state macroeconomic and fiscal forecasts, which the Ministry of Finance produces twice a year. Under the updated state budget act the spring economic forecast is used as the basis for drafting the state budget strategy and the state budget for the next year, which is then amended if necessary after the summer economic forecast is published. For this reason the Fiscal Council focuses primarily in its assessment on the outlook for 2018.

The summer economic forecast of the Ministry of Finance for 2017 expects that the Estonian economy will grow faster in 2018 than was previously forecast and with support from more branches of the economy. The economy will grow by 3.3% at constant prices and 6.9% at current prices. Although this is faster than the estimated long-term sustainable growth rate, the Fiscal Council considers that the risks to the forecast that could make growth faster or slower, stemming for example from slower growth in investment or faster growth in wages, are in balance in 2018.

In other words, the Estonian economy will grow at above its sustainable rate next year. The estimate of the Ministry of Finance puts the gap between actual GDP and the potential level, or the output gap, at 0.5% of GDP. The estimate of the Fiscal Council of the position in the economic cycle is almost the same. Other economic indicators that are easier to measure, such as rapid wage growth, rising employment, a rise in the vacancy rate, and an increase in reports from companies of labour shortages restricting growth, indicate that the Estonian economy is operating at above its sustainable level. Overall, the Fiscal Council finds that it is reasonable for the GDP growth forecast to be corrected upwards for the near term, and that the forecast of the Ministry of Finance is accurate enough in its description of the future development of the Estonian economy.

Like in the spring however, the Fiscal Council does not agree fully with the Ministry of Finance's forecast for tax revenues in 2018. Amendments to the corporate income tax system, which encourage regular distribution of dividends through a lower tax rate, will enter into force from next year, and the Ministry of Finance assumes that almost half as much will be taken out in dividends in 2018 as was taken in 2017. This assumption means that tax revenues will again grow by more than the economy as a whole, at a rate of 8%. The Fiscal Council considers this assumption to be too optimistic.

Despite the very rapid growth in revenues, the general government budget is expected by the summer forecast to be in nominal and structural deficit in 2018. The structural deficit is forecast to be 0.4% of GDP, which is above but close to the legally permitted limit. Given the possible errors in the forecasting of tax revenues and the difficulty of estimating the position in the economic cycle, the structural deficit may turn out to be bigger than this though.

For this reason, the Fiscal Council welcomes the government decision of 14 September to draft the state budget for 2018 with a smaller structural deficit than was expected in the summer forecast. Given the position of the economic cycle, the Fiscal Council recommends that the state budget should have a small surplus to ensure that the structural fiscal position remains within the legal limits.

Chairman of Fiscal Council
Raul Eamets
Tallinn, 27 September 2017

Explanatory Report

It is the job of the Fiscal Council to observe that the budgetary rules are followed and to publish opinions on the state macroeconomic and fiscal forecasts, which the Ministry of Finance produces twice a year. Under the updated state budget act the spring economic forecast is used as the basis for drafting the state budget strategy and the state budget for the next year, which is then amended if necessary after the summer economic forecast is published. For this reason the Fiscal Council focuses primarily in its assessment on the outlook for 2018.

Assessment of the macroeconomic forecast

Comparison with other forecasts

In producing its opinion on the summer forecast by the Ministry of Finance, the Fiscal Council made a comparison with other forecasts, as usual. It should be borne in mind for the comparison that the forecasts are produced at different times and so they use different assumptions about import demand from Estonia's main trading partners, commodities prices, the general direction of monetary policy and similar. How external impacts pass into the Estonian economy can also change over time, and of course the set of data describing the recent development of the Estonian economy also changes. The estimates for the outlook for growth both in the world and in the Estonian economy have improved since the start of this year. For this reason the figures in the Ministry of Finance forecast are closer to those of forecasts made in June or later (see Table 1).

Table 1. Estimates for GDP and CPI growth in Estonia in 2017-2018

	Real GDP growth (%)		CPI (%)	
	2017	2018	2017	2018
European Commission (May)*	2.3	2.8	3.3	2.9
Eesti Pank (June)	3.5	3.3	3.2	2.4
Nordea (June)	3.1	2.7	3.0	2.4
SEB (August)*	3.6	3.2	3.2	2.8
Consensus Forecasts (August)	3.1	2.9	3.1	2.6
Swedbank (August)	3.5	3.2	3.3	2.9
Nordea (September)	3.3	2.9	3.3	2.5
average of other forecasts	*3.2*	*3.0*	*3.2*	*2.6*
Ministry of Finance (September)	4.3	3.3	3.4	2.7

Note: The inflation forecasts of the institutions marked with an asterisk are based on the harmonised consumer price index. These estimates are not used in calculating the average of the forecasts.

Sources: Consensus Forecasts, Eesti Pank, European Commission, Nordea, Ministry of Finance, SEB, Swedbank[1].

[1] https://ec.europa.eu/info/files/spring-2017-economic-forecast-estonia_en
https://www.eestipank.ee/en/publication/estonian-economy-and-monetary-policy/2017/estonian-economy-and-monetary-policy-22017
http://www.nordea.ee/sitemod/upload/root/content/nordea_ee_uk/eeen_corporate/eeen_co_miksnordea_pr/EstoniaCountryOutlook_june2017.pdf
https://www.seb.ee/eng/news/2017-08-29/nordic-outlook-favourable-trends-global-economy-foster-faster-growth-estonia
http://www.consensuseconomics.com/Estonia_Economic_Forecasts.htm
http://swedbank-research.com/english/swedbank_economic_outlook/2017/q2/august_2017/index.csp
http://docs.nordeamarkets.com/EconomicOutlook/eo-en-03-2017/

Forecasts made in the past few months expect average real GDP growth to be a little above 3% in 2017, slowing to 3% in 2018. It is also forecast that consumer price inflation will slow from 3.2% in 2017 to 2.6% in 2018, mainly reflecting how forecasters see the impact of energy prices. The Ministry of Finance forecast differs from the others in that it forecasts faster GDP growth for 2017. It should be remembered here that the Ministry of Finance forecast is the first macro forecast to be published that is able to take account of the surprisingly fast growth in the Estonian economy in the second quarter of this year.

Comparison with the previous forecast

Unlike in previous years, economic growth in Estonia was faster in the first half of 2017 than had been forecast. For the first time in several years the assumptions of growth in the global economy that underlie domestic growth were met. Economic growth in the European Union and the euro area countries was faster in the second quarter of this year than it was last year and in the first months of this year.[2] The prospect of faster growth has increased in the opinion of experts from what it was when the spring forecasts were made. Faster growth than was expected in the spring may also be forecast for Estonia's main trading partners for the near future.

Given all this the Fiscal Council considers it reasonable that the GDP forecast for the short term should be adjusted upwards from what it was in the spring (see Figure 1). The Ministry of Finance forecast sees GDP growth of 3.3% at constant prices in 2018 and 6.9% at current prices. The explanatory note of the forecast says that growth is faster than usual in most branches of the economy. Exports, private sector investment and consumption have all been adjusted upwards since the spring and to a smaller extent so has general government investment, which will be at its highest in the forecast period in 2018.

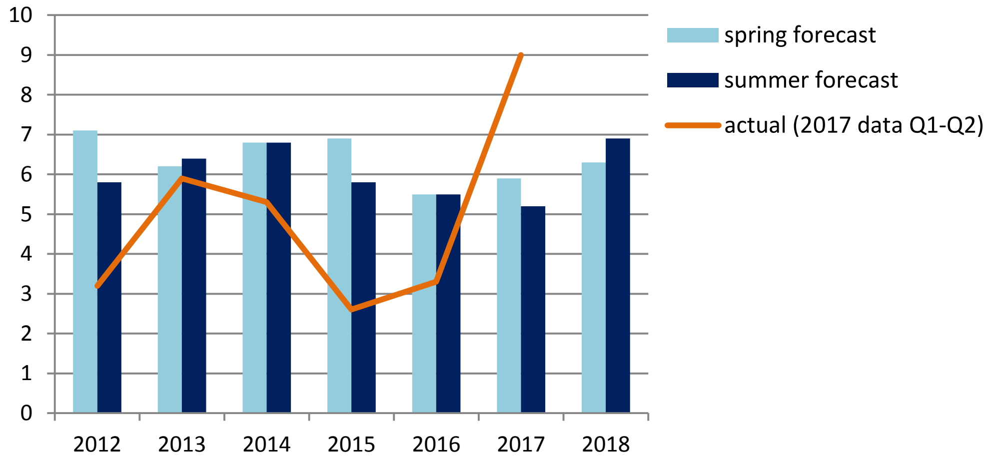

Figure 1. The forecasts of nominal GDP growth in the spring and summer forecasts of the previous year (%)

Source: Ministry of Finance.

The Fiscal Council finds that the risks of growth being faster or slower than forecast are balanced. Faster growth than had been expected in the first half of 2017 showed that the Estonian economy continues to be volatile and hard to predict. It is true that private sector investment increased faster than had been expected in the first half of 2017. This was affected substantially however by individual large transactions, which says little about whether this level of investment activity can be considered sustainable in the improved economic environment.

[2] For more see: http://ec.europa.eu/eurostat/documents/2995521/8213935/2-07092017-AP-EN.pdf.

At the same time the GDP forecast may contain components which will grow faster in 2018 than was forecast, such as the payroll. Since the end of the crisis, forecasts of the growth in the average wage have mostly been too low. Looking at the estimated sustainable growth capacity of the Estonian economy, it would be expected under normal circumstances that wage growth would slow to around 5%. In fact however, in 2012-2016 the average wage growth reached 6.5% (see Figure 2). Unfortunately it became no clearer in the first half of 2017 which channels might be used for a smooth adjustment in the labour market, and what investment and development strategies it would require from companies, and so it is possible that in 2018 the average wage growth will again be faster than forecast (see also Box 1). Whether the savings behaviour of households will also change and how this will affect economic growth through private consumption is very hard to forecast with certainty.

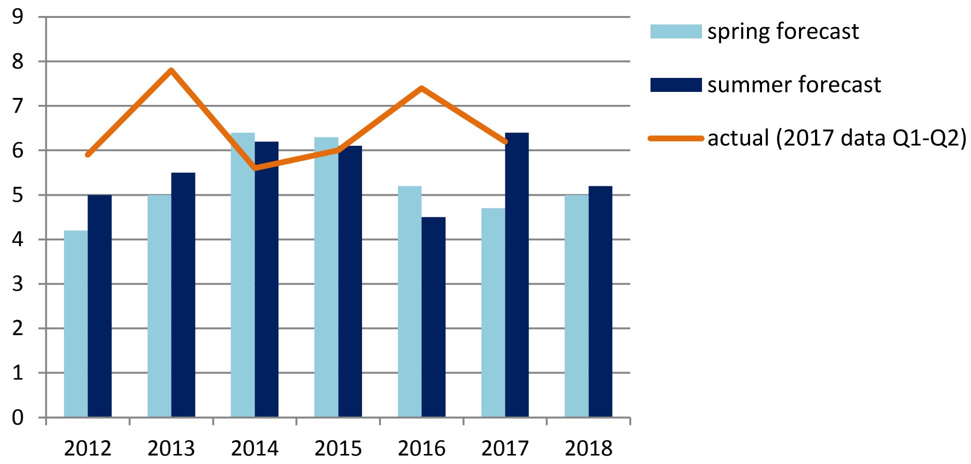

Figure 2. The forecasts of wage growth in the spring and summer forecasts of the previous year (%)

Source: Ministry of Finance.

The changes from the previous forecast mainly affect the years 2017-2018, and result from the development of the Estonian economy in the first half of this year. Looking forward further, the forecast by the experts from the Ministry of Finance for the impact of the Work Ability Reform on increasing employment and raising the labour market participation rate is a little more optimistic than earlier. The sustainable or potential level of GDP growth has equally been raised a little, as evidenced by the average real GDP growth in the later years of the forecast period (see Table 2).

The Ministry of Finance considers that the Estonian economy will run at above its estimated sustainable growth rate in both 2017 and 2018. Looking forward the main growth indicators for the economy, including growth in exports, domestic demand and labour costs, have become notably more in line than previously, meaning that estimates of the output gap arrived at with different methodologies have become closer to each other. The estimate by the Ministry of Finance based on the production function gives a positive output gap of 0.5% of GDP for 2018, and the technical analysis by the Fiscal Council, which is based on a Hodrick-Prescott filter, gives almost the same result (see also Figure 6 on page 11). Other economic indicators that are easier to measure, such as rapid wage growth, rising employment, a rise in the vacancy rate, and an increase in reports from companies of labour shortages restricting growth, indicate that the Estonian economy is operating at above its sustainable level.

Table 2. Key economic indicators for 2017-2021 in the macro forecast of the Ministry of Finance (%)

	Summer forecast 2017			Spring forecast 2017		
	2017	2018	2019-2021 average	2017	2018	2019-2021 average
Real GDP growth	4.3	3.3	3.0	2.4	3.1	2.7
Nominal GDP growth	8.7	6.9	5.6	5.6	6.3	5.6
Real private consumption growth	1.8	4.4	2.5	2.2	4.0	2.4
Nominal private consumption growth	5.7	7.5	5.1	5.7	7.0	4.9
Real investment growth (excl. inventories)	13.7	4.1	4.3	9.3	0.0	4.8
Nominal investment growth (excl. inventories)	17.5	7.4	7.1	11.2	2.7	7.3
Real growth in exports of goods & services	3.5	4.0	3.9	3.7	3.9	4.0
Nominal growth in exports of goods & services	7.3	6.1	5.9	5.8	5.8	6.0
Nominal wage growth	6.4	5.2	5.3	5.9	5.0	5.3
Change in the number of employed	0.8	0.4	0.4	0.5	0.2	0.1
CPI inflation	3.4	2.7	2.3	3.3	2.7	2.3
GDP deflator	4.2	3.4	2.6	3.2	3.0	2.8

Source: Ministry of Finance.

Overall the Fiscal Council finds that the summer forecast 2017 of the Ministry of Finance describes the outlook for the Estonian economy accurately enough. The Fiscal Council finds that the risks of growth being faster or slower than forecast are balanced for 2018.

Assessment of the fiscal forecast

General government nominal position

The Estonian tax system is relatively simple, is mainly proportional and has few exemptions. For this reason nominal GDP growth should be in line with rises in tax revenue. Since 2011 and the exit from the crisis however, growth in tax revenues has been significantly different from growth in the economy in several years. Equally, in those years the outlook for GDP growth has usually been overestimated, while the forecast for tax revenues has tended to be too pessimistic.

The Estonian economy is very open and so it is affected by changes in external demand. After the crisis though, trade around the world and in Europe has grown more slowly than forecast, and this has also been true of import demand in Estonia’s main trading partners. Exports of goods and services from Estonia grew by an average of only 3% in nominal terms in 2012-2016, which meant that nominal GDP growth was also lower than in earlier years (at 4.7%). Domestic demand, which is taxable unlike exports, increased in this period by an average of 5.7% a year though, and tax revenues rose by 6.7% a year. The situation began to change in the last months of last year, and in the first half of this year tax revenues rose more slowly than nominal GDP. The Ministry of Finance forecasts average yearly growth in tax revenues of 5.5% for 2017-2021, which is a little below the rate of GDP growth. The forecast finds though that 2018 will be an exception to this as tax revenues will temporarily grow faster again under the influence of tax policy measures (see Figure 3).

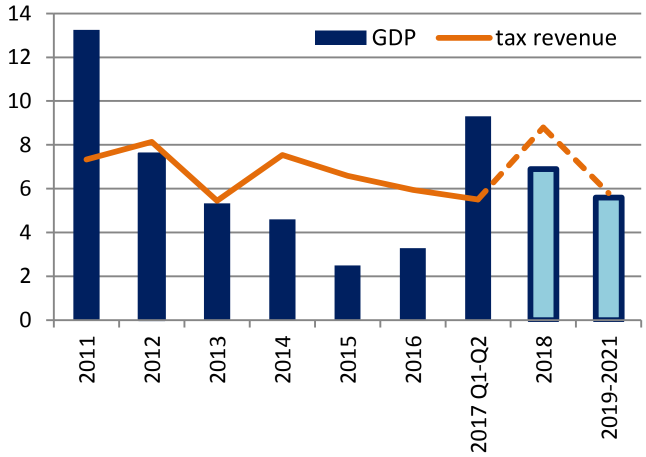

Figure 3. Growth in tax revenues and nominal GDP in 2011-2017 and forecasts for 2018-2021 (%)

Source: Ministry of Finance.

The link between rising tax revenues and overall economic growth has been weakened and will be weakened further in future by the absence of a traditional corporate income tax in Estonia, as the taxation of profits is postponed until dividends are paid out. Dividends and the tax paid on them have grown markedly more quickly since the crisis than increasing profits give reason to expect. From next year, a lower tax rate will be applied to companies who distribute dividends regularly, and in the short term this could make corporate income tax revenues more volatile and harder to forecast. The summer forecast expects that payouts of dividends in 2018 will be half as much as what they were in 2017, and if this happens, tax revenues will again grow by more than the economy as a whole. The Fiscal Council stands by its earlier opinion that the behaviour of investors has been hard to predict with income tax as it has been, and the change in the tax law increases the probability of forecast error further.[3]

Furthermore, the government has changed its tax policy relatively frequently in recent years and has maintained the aim that was set in the previous decade of shifting the tax burden from labour to consumption. Alongside a reduction in labour taxes, which are personal income tax and social security contributions, this has meant a rise in excises and more efficient collection of VAT. This trend will continue in 2018. Labour taxes will be cut substantially by the tax-free income reform, which raises the tax-free threshold for those on low and average wages to 500 euros a month. At the same time, excise rates on tobacco, strong alcohol, wine, beer, petrol and natural gas used for fuel will rise.

In total planned tax changes will increase revenues in the state budget for 2018 by 0.6% of forecast GDP. Not all of the tax changes that were assumed in spring when the state budget was being drafted have been passed, and so the effect of changes in tax policy is a little less than was forecast in the spring. At the same time the forecast in the new fiscal forecast for some taxes and non-tax revenues like financial revenues has been raised, and forecasts for some expenditures have been lowered. For this reason the summer forecast expects the nominal deficit in the general government budget to be 140 million euros smaller than was estimated when the budget strategy was drafted at −0.2% of GDP.

[3] For more on the Fiscal Council opinion on the Ministry of Finance spring forecast for 2017, see: http://eelarvenoukogu.ee/files/2017_Opinion_Spring.pdf.

The Fiscal Council must emphasise that account must be taken in assessing the nominal position of the planned general government budget of the very rapid rise in revenues. The Ministry of Finance forecast puts revenues in the state budget for 2018 at 8% more than they were this year even without transfers. More than one quarter of the growth in revenues comes from the forecast increase in corporate income tax revenues (see Figure 4). On top of this, transfers from the European Union budget will also increase and as a whole the state budget will increase next year by a little more than 10%.

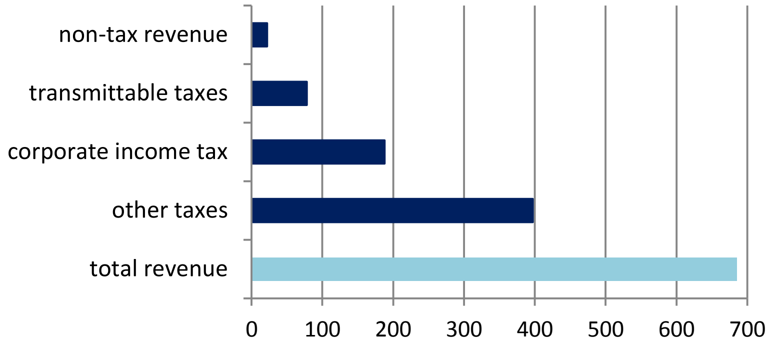

Figure 4. Forecast increase in revenues in the state budget for 2018 over 2017, excluding transfers (EUR million)

Source: Ministry of Finance.

The Estonian economy is very small and open and so forecast errors may be large. The numerous tax changes that are being introduced also increase the potential for forecasting errors and the risk that the forecast for revenues in the state budget will prove too optimistic. So that the structural deficit in the general government budget remains within the legally permitted limits, the Fiscal Council recommends that the 2018 state budget should have a small surplus.

General government structural position

The summer macroeconomic forecast of the Ministry of Finance takes account of the revisions by Statistics Estonia to the figures for growth in 2013-2016, which raised real GDP growth by 0.1-0.5 percentage point each year, and also of the faster economic growth in the second quarter of 2017 and the overall improvement in the economic environment, which other forecasters have not yet been able to take into account.[4] It matters for defining the structural position that the upwards revision of economic growth from the spring will lead to improved tax revenues according to the forecast, and also that the estimate of the gap between actual and potential GDP has changed.

In contrast to the spring forecast, the summer forecast finds that the Estonian economy will reach its sustainable level this year, and in the years ahead there will be a positive output gap rather than a negative one (see Table 3). As GDP growth has been corrected upwards, so has potential economic growth. In the spring the Ministry of Finance forecast the capacity for growth of the Estonian economy at 2.5-2.7% a year throughout the forecast period, but the summer forecast put it at 3.0-3.2%. The Fiscal Council finds that the reasons for such a re-evaluation should be explained in more detail in the explanatory note of the forecast.

[4] For this reason no comparison is included in this section with the estimates by other institutions of the Estonian output gap, the cyclical component of the budget or the structural budget position in 2018 or in the longer term. The calculations by the Fiscal Council are based on the summer forecast of the Ministry of Finance.

Table 3. General government structural position (% of GDP)

	SBS 2018-2021		Summer forecast 2017	
	2017	2018	2017	2018
Nominal position (million euros)	−119	−196	5	−61
Nominal position	−0.5	−0.8	0.0	−0.2
Output gap	−0.8	−0.4	0.4	0.5
Cyclical component	−0.3	−0.2	0.2	0.2
Cyclically adjusted position	−0.2	−0.7	−0.1	−0.5
One-off measures	−0.4	−0.1	−0.4	−0.1
Structural position	0.2	−0.5	0.2	−0.4

Source: Ministry of Finance.

The improved outlook for growth together with the refinement of the forecast for expenditures have markedly strengthened the nominal budget position for this year in the forecast by 124 million euros and for next year by 135 million euros. The summer forecast expects that the general government budget for 2017 will be in nominal balance, and that for 2018 it will have a nominal deficit of 0.2% of GDP. According to the methodology of the Ministry of Finance, a positive output gap leads to a positive cyclical component of the budget. In simple terms this means that a part of the good tax revenues for 2018 are temporary and should be discounted in estimates of the structural fiscal position. The list and size of one-off measures have not changed since the spring and the Ministry of Finance classifies as one-off measures in 2018 the support for the mergers of local governments, which in turn strengthens the structural fiscal position by 0.1 percentage point.

Overall the estimate of the Ministry of Finance for the structural fiscal position for 2017 of a surplus of 0.2% of GDP has not changed. There has been some improvement in the estimate of the structural fiscal deficit for next year, which will be 0.4% of GDP according to the updated estimate. The biggest changes from the spring are to be seen in the later years of the forecast period when the structural position will be strengthened even more so that it reaches balance in 2020 (see Figure 5).

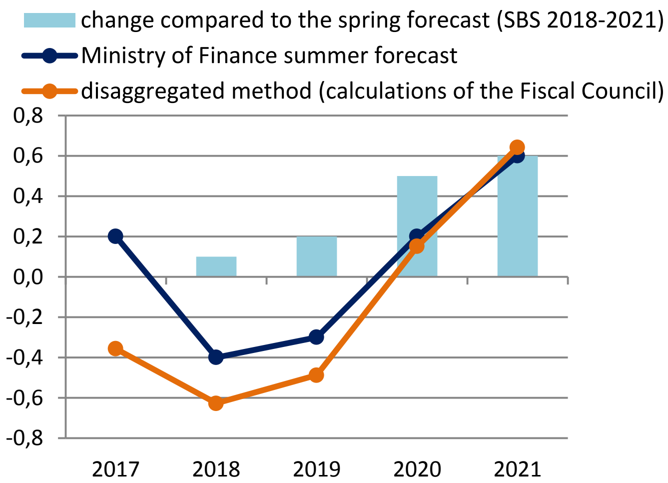

Figure 5. Estimates of the general government structural budget position (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council.

Unlike in previous years, the Ministry of Finance forecast for the dynamics of the structural budget position are similar to those arrived at using the Fiscal Council's disaggregated methodology, which uses economic indicators that are more closely related to tax revenues, such as private consumption and the payroll. Behind this is primarily the reassessment of the Ministry of Finance's figure for the output gap, which shows the gap now to be positive, and also the forecast changes in the structure of GDP, the result of which will be a reduction in the differences between the cyclical developments of GDP and the main tax bases.

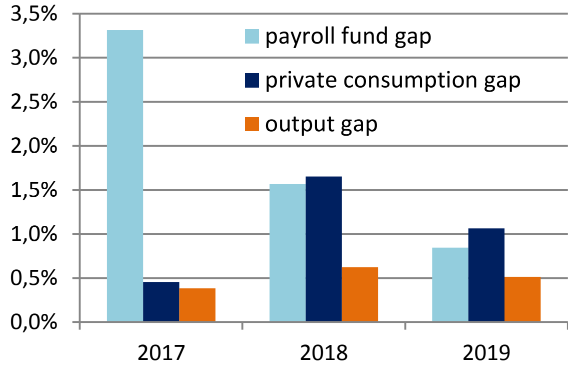

Figure 6. Gaps in the tax bases with the disaggregated method (Hodrick-Prescott filter, % of the trend)

Sources: Ministry of Finance, calculations of the Fiscal Council.

Overall the general government fiscal position in the summer economic forecast of the Ministry of Finance is much stronger than the targets set in the spring in the state budget strategy for 2018-2021, which expected a structural deficit of 0.5% of GDP in both 2018 and 2019 while exhausting the cumulative structural surplus by the end of 2020, especially for the later years of the forecast period. Despite the very rapid growth in revenues, the general government budget is forecast to be in nominal and structural deficit in 2018. The structural deficit is forecast to be 0.4% of GDP, which is above but close to the legally permitted limit.

Given the possible errors in the forecasting of tax revenues and the difficulty of estimating the position in the economic cycle, the structural deficit may turn out to be bigger than this though. For this reason, the Fiscal Council welcomes the government decision of 14 September to draft the state budget for 2018 with a smaller structural deficit than was expected in the summer forecast. Given the position of the economic cycle, the Fiscal Council recommends that the state budget should have a small surplus to ensure that the structural fiscal position remains within the legal limits.

Box 1. It will remain difficult to forecast wage costs in the near future

Since 2011 and the end of the crisis the growth in labour costs has consistently been underestimated in forecasts. This inaccuracy in forecasting is understandable, because wages rose faster in this period than productivity and corporate profits, which is in contradiction to earlier estimates of labour market flexibility in Estonia and assumptions of sustainable economic growth more broadly. Until the crisis the episodes of excess growth in labour costs were short, lasting only a couple of years, after which there was a readjustment. After the crisis and until this year the share of wages in value added had steadily increased (see Figure 7). Earlier experience would suggest that several modest readjustments or a single sharp one should have occurred during this period.

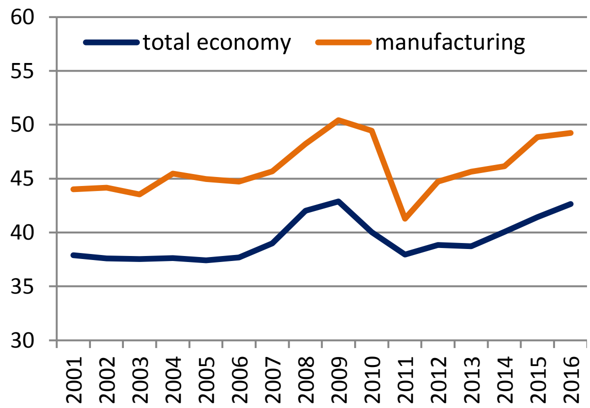

Figure 7. The relationship between wages and value-added in 2001–2016 (%)

Source: Statistics Estonia.

It is hard to find a justification for the excess growth in wage costs over such a long period. In strict terms, comparing growth rates in wages and profits is not sufficient to give an estimate of the sustainability of a company. Investors should not pay attention so much to the gap between profits and wage costs, or to the structure of GDP, as to the relationship of profit to investment. Unfortunately, information on stocks of capital comes only with a lag, and it is not currently possible to test whether the average return on investment has worsened in the past couple of years by as much as suggested by GDP figures.

Earlier experience indicates that it might be assumed that faster growth in wage costs than in profits means a reduction in the return on investment. The ratio of business profit to gross fixed capital formation for a sample of larger manufacturing companies for 2005-2007 for example was around 20%. From the end of the crisis until this year this indicator for profitability was showing a downwards trend and in 2016 it was probably close to 10%, though official data are not yet available. It is possible however that with interest rates being very much lower than usual, investors have accepted lower returns, as they can find no better way to use their money. Furthermore, more has been paid out in dividends per unit of fixed assets since the crisis than in 2000-2007. It is also possible that the growth in labour costs reflects unrealised hopes of a recovery in foreign demand for several years, as employers have overestimated future sales revenues in wage negotiations.

In the first half of 2016 for example nominal GDP was up 2.6% over the year, which was less than had been expected. In the first half of 2017 however, yearly growth in GDP was more than 9%. Forecasters have been expecting such a change since 2011. The growth in the average wage slowed last year though from 7.8% to 6.2%. Although the data for the first six months of 2017 show that growth in labour costs in the economy as a whole was in line with the improvement in productivity, average wage growth in excess of 6% cannot be seen as sustainable. The Ministry of Finance summer forecast assumes that the growth in the average wage will slow to 5.1% by 2021. It is evident that wage growth cannot exceed growth in productivity in the private sector for a long time. The forecast slowing of wage growth may be delayed for one or two years, as it is not yet clear what expectations investors have for profits in the near future.