EELARVENÕUKOGU
FISCAL COUNCIL

FISCAL COUNCIL OPINION ON THE SUMMER FORECAST 2019 OF THE MINISTRY OF FINANCE

September 2019

Contents

Fiscal Council
Estonia pst 13, 15095 Tallinn
+372 668 0661
info@eelarvenoukogu.ee
www.eelarvenoukogu.ee

Opinion

The summer economic forecast of the Ministry of Finance finds that growth in the Estonian economy will slow to 2.2% in 2020. Expectations for economic growth are lower than they were in spring, as the external environment has proved weaker than expected. Even so, the Estonian economy will be running at above its estimated potential in the years ahead.

The Fiscal Council finds that the summer forecast of the Ministry of Finance is in line with the changes in the Estonian economy and the assumptions used for the forecast. The Fiscal Council does consider though that there is a risk that geopolitical and foreign trade tensions may have more of an effect than assumed, and this could lead to economic growth being slower than forecast, and also slower than the risk scenario of the forecast of the ministry.

According to the summer forecast of the Ministry of Finance, the 2019 structural budget deficit will be 1.4% of GDP. The State Budget Act requires the structural fiscal position to be improved by at least 0.5 percentage point a year until structural balance has again been achieved. This means the fiscal position has to be further improved this year to comply with the fiscal rules. The Fiscal Council recommends that the steps to improve the fiscal position be planned with an excess, as revenues in 2019 could prove weaker than expected.

The general government fiscal position for the coming years will be weaker than it seemed in spring, and the structural deficit will remain throughout the whole forecast horizon, standing at -0.7% of GDP in 2020, and -0.6% of GDP in 2021. The structural deficit will remain despite the improved forecast for tax revenues, and the additional measures proposed in the state budget strategy this spring, including the faster use of EU structural funds.

The general government fiscal position was last in structural balance in 2016. This means that the structural deficit is forecast to remain throughout the peak of the economic cycle. The Fiscal Council finds that this is not a suitable fiscal policy given the state of the economy.

The State Budget Strategy for 2020-2023 that was passed in the spring set a structural deficit target for 2020 of 0.4% of GDP, and the target of structural balance for 2021. According to the summer forecast of the Ministry of Finance, these targets will not be met as things currently stand. The Fiscal Council recommends that the government stick to the budget targets set in the state budget strategy in spring, meaning that the fiscal position should be substantially improved in the years ahead and structural balance should already be attained in 2021.

The current State Budget Act requires that once structural balance has been achieved, a structural surplus should be planned to compensate for the earlier deficits that were larger than permitted. The government announced in spring 2019 that it was planning to abandon this requirement in the budget rules. If it is decided to change the fiscal rules once again, the proposed changes must be analysed thoroughly and not simply introduced at the last moment. To ensure that fiscal policy remains credible, it is important that the fiscal rules set out in the state budget act be those that the government plans to follow over the long term when planning and implementing its fiscal policy.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 23 September 2019

Explanatory Report

It is the job of the Fiscal Council to observe that the budgetary rules are complied with and to publish opinions on the state macroeconomic and fiscal forecasts, which are the basis for the preparation of state budgetary documents. The summer economic forecast 2019 of the Ministry of Finance was published before Statistics Estonia had released the revised estimate of the nominal position of the general government for 2018.

Opinion on the summer forecast 2019 of the Ministry of Finance

Assessment of the macroeconomic forecast

Comparison with the previous forecast

The new macroeconomic forecast of the Ministry of Finance confirms the opinion that was shared in the spring that growth in the Estonian economy has peaked and slower growth is to be expected. The outlook for the external environment has also changed.

The Fiscal Council agrees with the conclusion of the Ministry of Finance that uncertainty in global economic policy has deepened. Given this, it is to be expected that forecasts show slower growth in imports in Estonia's trading partners, and this will inevitably hinder Estonia's ability to export. Growth in Sweden and Finland, Estonia's main trading partners, will be even slower in the first years of the forecast horizon than the average growth in Estonia's export markets.

The imports of Estonia's export partners grew by more than 6% in 2017 and 3.5% in 2018, but while growth of 2.6% was expected in spring 2019, the new forecast puts growth in demand for imports this year at only 1.6%. The opinion remains the same as in the spring though that worsening trade conflicts and the continuing uncertainty around Brexit will primarily affect the forecast this year and next, after which growth in demand will stabilise at close to the level of 2020. Forecasts with similar assumptions, such as the IMF forecast of spring this year, have been made for the whole world and for the euro area.

Table 1. Key economic indicators for 2019-2023 in the macro forecast of the Ministry of Finance (%)

	Spring forecast 2019			Summer forecast 2019		
	2019	2020	Average for 2021-2023	2019	2020	Average for 2021-2023
Real GDP growth	3.1	2.7	2.6	3.3	2.2	2.5
Nominal GDP growth	6.0	5.5	5.1	6.8	5.1	4.9
Real growth in private consumption	4.7	2.9	2.7	3.6	2.8	2.4
Nominal growth in private consumption	7.0	5.2	4.8	5.9	5.1	4.6
Real investment growth	5.1	4.0	3.7	11.0	1.5	3.6
Real growth in exports of goods and services	3.2	3.0	3.3	3.4	2.4	3.3
Nominal wage growth	6.4	5.2	4.9	7.2	5.7	5.0
Employment growth	0.9	0.9	−0.2	1.0	0.1	−0.1
CPI	2.1	2.2	2.0	2.2	2.2	2.1
GDP deflator	2.8	2.7	2.4	3.4	2.8	2.4

Source: Ministry of Finance

Economic growth in the first half of 2019 was faster than expected, in both GDP volume and value, and prices rose faster than had been forecast. This affected the outlook for the whole year. Given the deterioration in the outlook for foreign trade, and the high reference base of 2019, it is to be expected that growth will be even slower in the years ahead than previously. The updated forecast of the Ministry of Finance expects that real GDP growth will stabilise in future at 2.5% and nominal growth will be close to 5% (see Table 1). This is a little below the average for 2010-2018.

Slower growth in the economy was also assumed in the spring forecast of the Ministry of Finance. The fall in economic growth in 2020-2023 is forecast to be sharper than it was in the spring, though starting from a higher base for 2019. For this reason the ability of the general government to finance its spending at the end of the forecast horizon is no worse than before, as the increase in GDP at current prices by the end of the forecast horizon will be about the same size as was forecast in the spring.

Although the current budget period of the European Union will end next year, a notable part of the agreed funds have not yet been used and transfers received from abroad will support growth in the economy throughout the forecast horizon. In this way it is assumed that general government investment will average 5.2% of GDP in 2020-2023, which is similar to the 5.3% recorded in 2017-2018.

Statistics Estonia this summer revised the time series for the national accounts from 1995 onwards. The revision of the data had only a small effect on the assessment of the potential level of the economy. The new forecast finds that the Estonian economy will be running at above its potential level throughout the years of the forecast.

Risks to the forecast

Assumptions about foreign demand have mainly been overly optimistic since the financial crisis. The risks of slower growth resulting from foreign demand may be worsened by domestic factors in Estonia, such as questions about the oil shale sector.

However, the average overestimation of future demand for imports in 2011-2018 has not necessarily led economic growth to be slower than expected, meaning the contribution of domestic demand to growth in the economy has usually been larger than forecast. Looking forward, there are also some risks to the forecast of domestic demand though.

The first is that economists have been arguing almost all the time since the crisis about sustainable growth in labour costs. The natural state of affairs in the Estonian labour market until the recession of 2009 was that labour costs increased at the same rate as corporate profit. While labour costs grew faster in some years, the earlier status quo was returned within a year or 18 months. Since the crisis, wages have often grown faster than forecast, and have exceeded the growth in profits, and not only in the forecasts of the Ministry of Finance. Nominal wages rose by 7.6% on average in 2018, which was faster than the 6.5% that was forecast in spring that year. Wages also rose faster in the first half of 2019, and the payroll was larger as a share of GDP than it was in 2018 or 2017.

The new forecast of the Ministry of Finance shows that wage growth will start to slow and will stabilise by the last year of the forecast at close to 5%, growing at the same rate as GDP. The ministry expects that employment will not increase any more in those years and unemployment will remain at close to 5.5%, which is only a little higher than in 2018-2019. This is close to the estimate of the Ministry of Finance for the natural rate of unemployment. The forecast does not explain what changes in the economy will lead to slower wage growth. Essentially the same question about rising labour costs arose in the discussions around the spring forecast 2016, when the Fiscal Council considered that the explanatory note to the forecast did not sufficiently explain how wage growth would slow while employment was extraordinarily high and unemployment low, and what investment and development strategies would be needed to achieve it. The forecast of the ministry from spring this year does not give any such explanation either.

In the past couple of years a large amount of temporary labour has come to work in Estonia. Understanding the assumptions of the ministry's forecast is made harder because the impact of foreign labour is not considered in detail. The explanatory note does indicate that the contribution of non-resident labour to receipts of labour taxes has increased, but it is not explained more precisely how the cross-border movement of labour affects employment, average wages or other labour market indicators.

Neither do economic analysts agree on what the correct level of investment should be for the business sector. The ministry indicates in its new forecast that given how far investment has fallen as a share of GDP, it could rise over the medium term with some support from the private sector. This however would require the economic environment to stabilise and confidence to return to companies and to households.

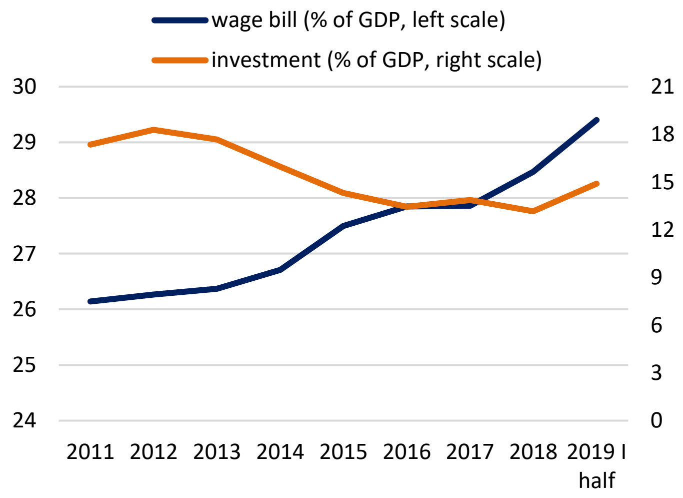

Figure 1. Private sector wage bill and investment in fixed assets 2011-2019

Source: Statistics Estonia

The widely shared opinion is that increasing wage pressures will push companies to invest more in raising productivity, including investment in development activities. This has not happened though. Wages paid by the private sector have increased steadily as a share of GDP, while the share of gross fixed capital formation has fallen at the same time (see Figure 1). Corporate investment increased in the first half of 2019 faster than usual, but this change will not necessarily last. The Fiscal Council cannot rule out a scenario where gross fixed capital formation by companies grows more slowly than has so far been forecast.

Overall the Fiscal Council believes that the macroeconomic indicators in the summer 2019 forecast of the Ministry of Finance are in line with the changes that have occurred in the Estonian economy since the spring, and with the assumptions about the external environment that were used in drawing up the forecast. The Fiscal Council finds though that there is a risk that the external environment will turn out to be even weaker than has been assumed in the baseline scenario of the summer forecast, and also than in the risk scenario of the forecast.

For this reason the Fiscal Council recommends that planning for spending policy in the years ahead should also consider a risk scenario where the changes in global trade turn out to be lasting ones, and the growth in trade stabilises over the medium term at a lower level than expected. Weaker foreign demand than expected will also reduce the tax receipts in the state budget.

Assessment of the fiscal forecast

In assessing the fiscal forecast the Fiscal Council focuses above all on 2019 and 2020, analysing how the general government fiscal position is set and the need to improve the structural fiscal position following the deficit of 2018.

Fiscal position for 2018-2019

It became apparent in spring 2019 that the structural deficit for the previous year had proved larger than planned and larger than was permitted under the fiscal rules in the Estonian State Budget Act. In its assessment in spring, which was based on the preliminary data from Statistics Estonia for the nominal deficit, the Ministry of Finance put the structural deficit in 2018 at 1.4% of GDP. The State Budget Act states that such a large deficit requires the fiscal policy goal of returning to structural balance to be set, improving the structural fiscal position by at least 0.5 percentage point a year. The state budget strategy for 2020-2023 set the government a target of returning to structural balance in 2021.

The size of the nominal deficit for 2018 has been revised this autumn, as has the assessment of the Ministry of Finance of the position in the economic cycle. Alongside changes in the economic environment the reassessment was affected this time by the revision of GDP data that led the figures for growth in the economy in 2017 and 2018 to be raised. In consequence the estimate of the ministry for the output gap of recent years has also increased, and it is now at 2.7% of GDP for 2018 and 2.6% for 2019, up from 2.1% for 2018 and 1.6% for 2019. The Fiscal Council finds these changes to be justified and that the estimates of the position of the Estonian economic cycle are now better aligned than the earlier estimates of the ministry and the Fiscal Council (see the heatmap of the Estonian economy on page 13).

When the government drew up the budget strategy for 2020-2023 in spring 2019, it announced several additional revenue and expenditure measures that were expected to leave the structural deficit for 2019 at 1.1% of GDP (see Table 2). In the spring estimate this meant that the structural deficit forecast for 2019 would be larger than permitted by 0.2 percentage point, or around 50 million euros. The government decided to re-evaluate the need for new additional measures after the appearance of the summer economic forecast this autumn.

Table 2. Fiscal position for 2018-2019 (% of GDP)

	2018	2019
Nominal balance (spring forecast incl. the measures in state budget strategy)	−0.5	−0.4
Nominal balance (summer forecast)	−0.5	−0.2
Output gap (spring forecast)	2.1	1.6
Output gap (summer forecast)	2.7	2.6
Structural balance (spring forecast incl. the measures in state budget strategy)	−1.4	−1.1
Structural balance (summer forecast)	−1.7	−1.4

Source: Ministry of Finance

The structural fiscal position is 0.3 percentage point weaker in the summer forecast 2019 than in the state budget strategy that was drawn up in the spring and the Ministry of Finance estimates it at 1.4% of GDP. As the updated forecast found that the structural deficit for 2018 also increased by 0.3 percentage point, the need to improve the fiscal position this autumn remained unchanged from to the assessment of the spring. The summer forecast of the Ministry of Finance finds that the structural fiscal position needs to be improved by a further 0.2 percentage point at least, or around 50 million euros.

The revised data from Statistics Estonia, which appeared after the summer forecast of the Ministry of Finance, put the general government nominal budget deficit for 2018 at 146 million euros, or 0.6% of GDP. Taking the estimate of the economic cycle in the summer forecast 2019 of the Ministry of Finance, this puts the structural deficit at 1.8% of GDP. As the structural fiscal position needs to be improved by at least 0.5 percentage point from 2019 at least, then the structural deficit this year must not exceed 1.3% of GDP.

The deterioration in the structural fiscal position in 2019 was caused by the change in the assessment of the position of the economic cycle. The nominal fiscal position has improved from the state budget strategy by around 30 million euros. The Ministry of Finance finds that the forecasts for both tax and non-tax revenues are better than in the spring.

The ministry has raised its forecast of tax receipts in the 2019 state budget from what it was in the state budget strategy by around 80 million euros. Better receipts than were forecast in spring are expected in all the main types of tax, with particular increases in receipts of 30 million euros in social tax and 32 million euros in excises. However, the actual tax receipts for the first seven months of the year (see Table 3) show that the growth in VAT and tax revenue as a whole has remained lower than was forecast for the whole year. Raising the forecast for labour taxes is justified given the better figures than expected for the labour market, but raising the forecast for receipts of consumption taxes may be premature in the opinion of the Fiscal Council.

Table 3. Forecast for growth in tax receipts in 2019 (%)

	State budget 2019	Spring forecast 2019	SBS 2020–2023	Summer forecast 2019	2019 7 months actual
Tax revenues total	6.3	6.0	5.8	6.9	5.4
Personal income tax	–6.7	1.6	1.6	2.9	–29.1
Corporate income tax	–2.6	–9.2	–9.2	–8.3	–11.6
Social tax	7.2	8.6	8.6	9.6	10.2
VAT	9.4	7.1	6.9	7.3	5.9
Excises total	5.7	4.2	3.3	6.5	7.4

Sources: Ministry of Finance, calculations of the Fiscal Council

The forecast for non-tax receipts in the state budget for 2019 has increased by 31 million euros over the spring forecast. The explanatory note to the forecast says that the main change comes from the upward correction of 41 million euros in sales revenues for CO2 quotas, and the main negative impact comes from the change in environmental fees of 12 million euros following the reduction in output at Eesti Energia. The forecast for subsidies, which is the main component in non-tax revenues, has not changed from the spring. Increasing the forecast for non-tax revenues through higher sales receipts from CO2 quotas does not however contribute to improving the fiscal position for this year, as the sales revenues available for use in 2019 were defined from the amount of quotas sold last year.

The Fiscal Council finds that the explanatory note to the forecast does not explain the changes in the forecast for general government spending clearly enough. This is also evident in the public communications of the Ministry of Finance, as the tax receipts in the state budget are commented on every calendar month, but assessment of spending is given less frequently. To avoid repeating the situation of last autumn when the growth in spending at the end of the year turned out to be faster than expected and the fiscal position was weaker than forecast, the Fiscal Council finds it important that growth in spending be monitored in real-time and analysis of this be published. The Ministry of Finance has a clear advantage over other institutions in accessing the data that would be needed for such an analysis. It can only be concluded from the summer forecast of the Ministry of Finance and the data released by Statistics Estonia for the first half of 2019 that a substantial slowing in the growth of current spending is expected in the second half of the year.

Overall the Fiscal Council finds it possible that the nominal fiscal position for 2019 will prove weaker than expected, and the need to improve the fiscal position this autumn will consequently prove larger. This would make it reasonable for the government to set a target of improving the fiscal position for 2019 by more than the minimum amount required by the State Budget Act.

Fiscal position for 2020-2023

The forecast for tax receipts in the state budget has been increased from the state budget strategy by around 70-90 million euros for each year of the forecast. Receipts of labour taxes have been increased for the future in the same way as for 2019. The forecast for social tax and personal income tax has been increased for each year by 100-120 million euros. Wage growth has been faster in 2019 than was expected in the spring forecast, and faster wage growth than was earlier forecast is also expected for 2020. The forecast for employment has also been adjusted slightly upwards, though by notably less.

The size of the payroll in the economy can be estimated from the statistics for average wages and employment, and this is a good indicator of receipts of labour taxes. Tax receipts should generally grow in line with the tax base, and the tax base should grow in line with the economy (see Figure 2). In recent years though the link between the payroll in the economy and receipts of social taxes has weakened, as the amount of foreign labour available in Estonia has sharply increased. Although some of the foreign labour is not reflected in the official employment statistics, it still contributes to receipts of labour taxes. So far this has meant faster growth in tax receipts than may be assumed from the developments in the tax base. These excess receipts could prove temporary though if the economic cycle turns, and they cannot be relied on for the state budget. The Fiscal Council recommends that future economic forecasts should treat the impact of temporary and imported labour on the Estonian labour market in greater depth, considering unemployment and employment rates as well as wage growth.

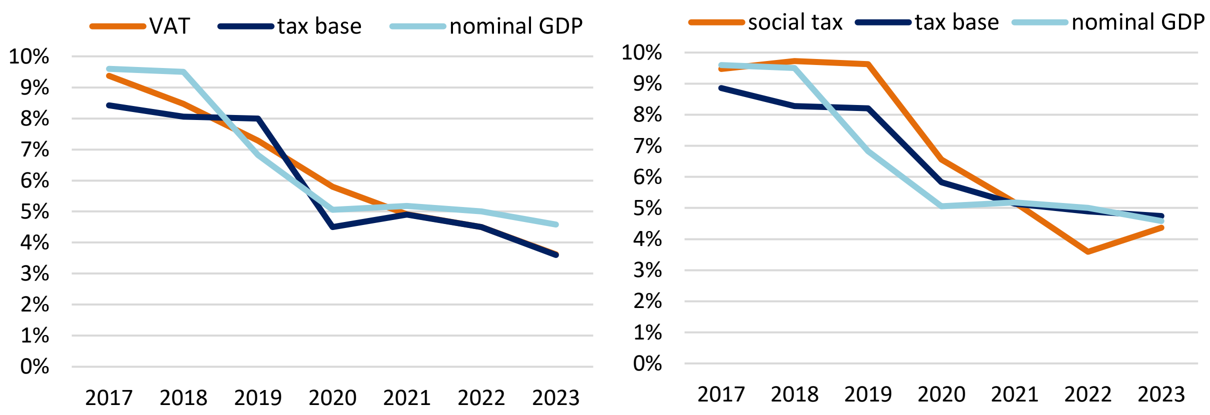

Figure 2. Growth in VAT and social tax receipts and in the tax base and the economy (%)

Sources: Ministry of Finance, calculations of the Fiscal Council[1]

There are no major changes in the forecast for consumption taxes in total for the year 2020-2023. Receipts of VAT have risen from the state budget strategy by a minor 2-9 million euros for the first years of the

[1] The VAT tax base in Figure 2 consists of forecasts for private consumption, general government intermediate consumption and investment by the general government and households. The tax base for social tax is calculated using the payroll in the economy based on the forecast for growth in average monthly wages and employment.

forecast. Although it is too early to assess the impact of the sharp cut in alcohol excise, the yearly receipts from it have been increased by 5-6 million euros in the summer forecast of the ministry. At the same time the expected receipts from fuel excise have been reduced by a slightly larger amount in the forecast period overall. The biggest reduction however has been in receipts of income tax from legal entities, which is 12-29 million euros a year lower than in the state budget strategy.

After the rapid growth in tax receipts in 2017-2019, the summer forecast of the Ministry of Finance expects that the growth in tax revenues in the state budget will slow, and will be around 5% in 2020-2021 and around 4% in 2022-2023. The Fiscal Council finds that the forecast of the Ministry for tax receipts is generally in line with the changes in the macroeconomic forecast.

It finds though that the probability of forecast errors for some particular tax types such as personal income tax, income tax for legal entities and excises is greater than usual because of the tax changes. Several of the tax changes that have come into force in recent years assume that taxpayers will change their behaviour. This is however unavoidably difficult to forecast, and so there is greater uncertainty around the forecast for the receipts of such taxes.

Following the revision of GDP data the opinion of the Ministry of Finance on the position of the Estonian economic cycle has changed. The opinion remains the same as in the spring that the output gap will remain positive in the coming years, but at a higher level than previously until it closes at the end of the forecast horizon. As a consequence of this the ministry has changed its assessment of the size of the cyclical component in the budget, which is used when the structural fiscal position is measured. The change in the estimate of the position of the economic cycle weakens the structural fiscal position in the forecast horizon by 0.1-0.2 percentage point (see Figure 3). A larger impact from the revision of GDP data on the structural fiscal position is noticeable in 2018-2020, as this is the main factor weakening the fiscal position in the opinion of the Ministry of Finance.

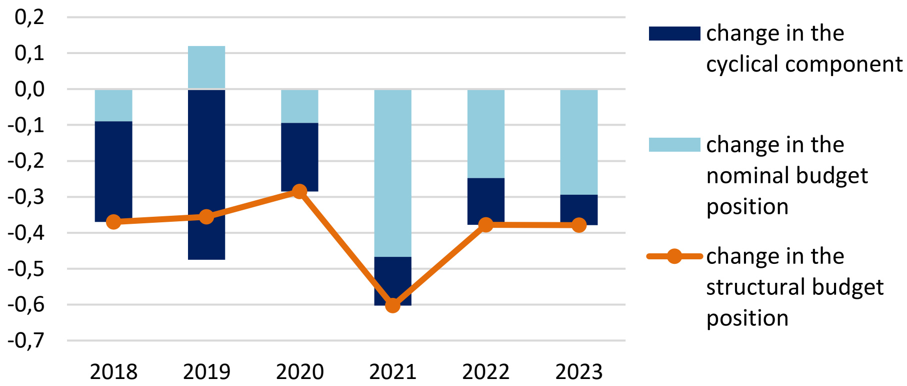

Figure 3. Change in the structural budget position from the state budget strategy (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

Together with changes in the estimate of the economic cycle, the outlook for the nominal fiscal position of general government has also changed. Although the forecast for tax revenues in the state budget has been raised, the nominal fiscal position of the general government overall has deteriorated. This means that the forecast for total government spending has been increased by more since the spring than the forecast for total revenue has. A small nominal surplus was planned for each year of the forecast in the state budget strategy 2020-2023, but the nominal fiscal position of the general government for 2020-2023 is close to balance in the summer forecast.

Changes in the estimate of the economic cycle and the nominal fiscal position have a negative impact on the structural position of the general government throughout the whole forecast horizon. The structural fiscal position is weaker than in the forecast of the state budget strategy 2020-2023 by 0.3-0.6 percentage point. The structural fiscal position of the general government will remain in deficit throughout the whole forecast horizon according to the summer forecast of the Ministry of Finance. The forecast has already taken account of revenue and expenditure measures that the government proposed to improve the fiscal position when it drew up the state budget strategy in the spring, including the faster use of EU structural funds in the new period[2]. This means that the fiscal position needs to be improved even further for structural balance to be achieved.

Given the latest assessment by the Ministry of Finance of the position of the economic cycle and assuming that it will be decided to reduce the structural deficit in 2019 to 1.2% of GDP, the structural deficit in 2020 cannot be larger than 0.7% of GDP under the fiscal rules. As improving the fiscal position will start from a larger structural deficit than was expected in the spring, the requirement to achieve structural balance has been pushed back by one year. Given this, and current assumptions, a structural deficit of 0.2% of GDP could be permitted in 2021 and then in 2022 the general government fiscal position should be in structural balance.

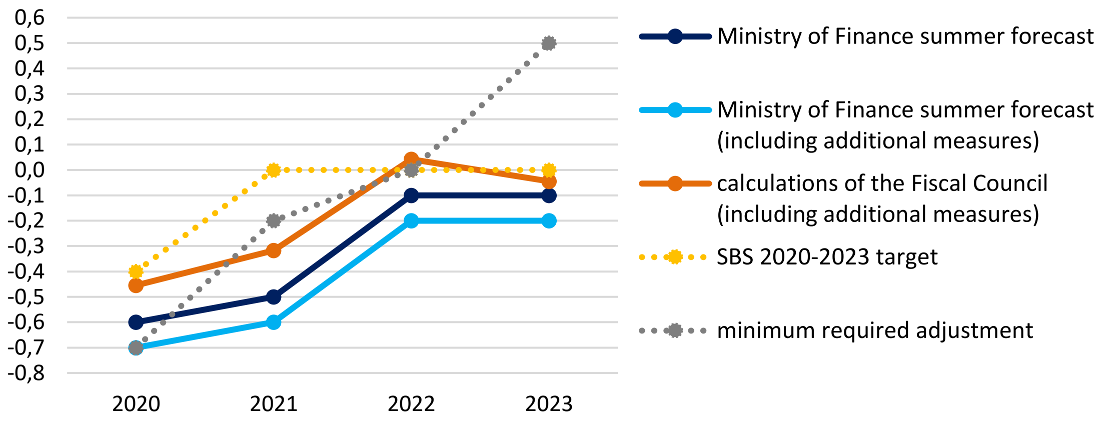

Figure 4. Estimates of the structural budget position for 2020-2023 (% of GDP)

Sources: Ministry of Finance, European Commission, calculations of the Fiscal Council

According to the summer forecast of the Ministry of Finance and given the additional budget measures on top of the forecast[3], the structural deficit for 2020 will reach 0.7% of GDP (see Figure 4). According to the budget rules this is the largest deficit that is permitted for 2020 under the assumption that a deficit of 1.2% of GDP will be recorded for 2019. Calculations by the Fiscal Council that base the estimate of the cyclical components of the budget on GDP and on more accurate development of the tax base show the dynamics for the general government structural fiscal position will be similar to those in assessment of the ministry.

The State Budget Strategy for 2020-2023 that was passed in the spring set a structural deficit target for 2020 of 0.4% of GDP, and the target of structural balance for 2021. According to the summer forecast of

[2] The assessment of the Ministry of Finance in spring assumed faster use of the European Union structural funds from the upcoming budget period, bringing in additional revenue of 0.3% of GDP in 2021, 0.9% of GDP in 2022, and 0.6% of GDP in 2023.

[3] The summer forecast of the Ministry does not include any measures that the government is planning to introduce but that have not yet been passed. The ministry lists such measures as additional income tax-free threshold for pensioners, a delay to the rise in excise on tobacco, and the write off of hopeless claims in connection with the transposition of the VAT directive, and the total impact of these would be around 30-40 million euros of additional spending in each year of the forecast.

the Ministry of Finance, these targets will not be met as things currently stand. The Fiscal Council recommends that the budget targets set in the state budget strategy in spring should be met, meaning that the fiscal position should be substantially improved in the years ahead and structural balance should already be attained in 2021.

The general government fiscal position was last in structural balance in 2016. As the summer forecast of the Ministry of Finance finds that structural balance will not be achieved in the years ahead, this means that the fiscal position has remained in structural deficit throughout the peak of the economic cycle. The Fiscal Council finds that this is not a suitable fiscal policy given the state of the economy.

The current State Budget Act requires that once structural balance has been achieved, a structural surplus should be planned to compensate for the earlier deficits that were larger than permitted. The government announced in spring 2019 that it was planning to abandon this requirement in the budget rules, so that a surplus need not be planned after structural balance has been achieved. The government wants to return to a requirement of structural balance each year rather than cumulative structural balance over the medium term.

When the State Budget Act and the fiscal rules in it was last changed in 2017, the Fiscal Council warned that the planned changes were prepared in a very short time. The Fiscal Council finds it important that if it is decided to change the fiscal rules once again, the proposed changes must be analysed thoroughly, the planned changes must be announced well in advance, and their introduction should not be left until the very last moment. To ensure that fiscal policy remains credible, it is important that the fiscal rules set out in the state budget act be those that the government plans to follow over the long term when planning and implementing its fiscal policy.

Background 1. *A macroeconomic heatmap for Estonia*

To assess the compliance with the rules on structural balance and the output gap in the macroeconomic forecast, the Fiscal Council needs to analyse the economic cycle in Estonia. Alongside the technical calculation of the output gap the Fiscal Council monitors several economic indicators that are simpler to measure and that give an indication of the cyclical position of the economy. The end result of this analysis can be presented in the form of a heatmap (see Figure 5), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating[4].

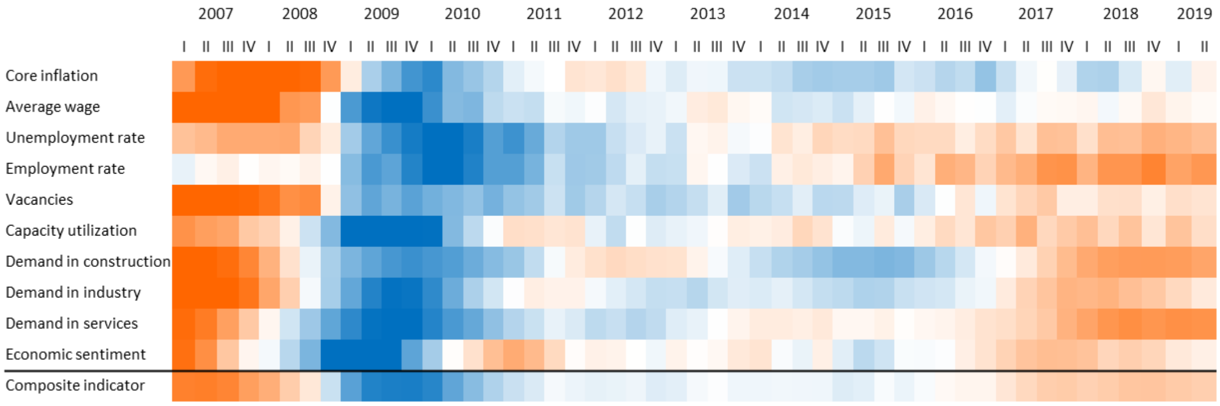

Figure 5. Macroeconomic heatmap for Estonia (Q1 2007 – Q2 2019)

Sources: Eurostat, Estonian Institute of Economic Research, Statistics Estonia, calc. of the Fiscal Council

The row under the line on the heatmap shows a composite indicator, made up as an average of all the economic indicators (see Figure 6). The composite indicator of the heat map using the most recent data from the first half of 2019 indicate some cooling, though this year the output gap will remain positive and will be 2.5%-4% of GDP according to the estimates of different institutions. As a result of the recalculation in the summer forecast of the Ministry of Finance, the estimates of the ministry and of the Fiscal Council for the cyclical position of the Estonian economy are better aligned than in the past couple of years.

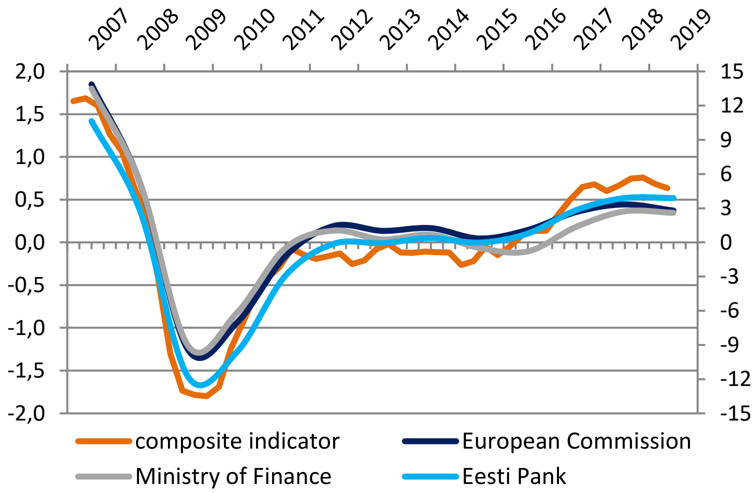

Figure 6. The composite indicator (left scale) and estimates of the output gap in % of GDP (right scale)

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

[4] For more on the design of the heatmap, see the opinion of the Fiscal Council published in spring 2018.

Background 2. *Public-private partnerships*

1. What is a PPP?

According to Eurostat, public-private partnerships are long-term contractual arrangements between a government entity, called the grantor, and a partner entity, usually a private business, that are mainly used for infrastructure development. The partner is responsible for building, operating and maintaining the infrastructure asset, which is designed to render some public services. In exchange for the services received, the government entity pays regular fees to the private partner after the asset has been built. Typical examples of PPPs are the construction and management of transport infrastructure and hospitals.

2. What is the motivation for engaging in a PPP?

In an ideal world, there are four main reasons for creating a PPP. These reasons can also be seen as advantages over other forms of public-private cooperation such as traditional public procurement and concessions.

Value for money (VfM): PPPs may encourage higher value for money, which means that the relation between benefits and costs will be superior with a PPP. Even though the cost of capital for firms might be higher than it is for governments, which is especially so when sovereign bond yields are historically low, it is believed that firms have superior know-how and stronger incentives to keep investment and operating costs low.

Affordability: a project is affordable if the flow of government spending related to the project respects the intertemporal budget constraint. PPPs may contribute to a project becoming affordable because private sector involvement makes the project cheaper or because the time profile of spending becomes more favourable to the government. Quite often, the government does not have any cash outflow during the initial phases of the project, such as design and construction, as the first payment is typically made only after construction is finished. Furthermore, payments are spread over a long period of time.

Distribution of risks: PPPs allow risk to be shared between the public and private sectors. They also allow different types of risk to be allocated optimally to the part that is better at managing each type of risk. For example, a government may assume demand risk while the private entity assumes construction risk.

Off-balance sheet nature: PPPs may be recorded outside the balance sheet of the government. According to Eurostat, this is the case when the private partner accepts most of the risks and gets most of the rewards from the project[5]. In this way, the government may pursue a policy of building infrastructure for example with no immediate impact on its accounts and without making it more difficult to respect the budget and fiscal rules.

It is important to note that future payments to the private partner do not enter any official measure of debt such as the Maastricht debt that is regularly published and monitored for the sake of compliance with national and European Union fiscal rules. When recorded off-balance sheet, the only impact that the PPP has on the government deficit results from the fees to be paid to the private partner every year.

[5] Eurostat (September 2016): *A Guide to the Statistical Treatment of PPPs*.

3. What are the political incentives for choosing PPPs over other forms of financing for large projects such as roads and what are the possible risks?

With off-balance sheet projects and deferred payments, PPPs make it possible for governments to promise and deliver large projects with no immediate costs for taxpayers, no immediate impact on the deficit, and all the future costs less visible than they would be with other forms of financing. While funding through taxes may directly affect the disposable income of families, PPPs do not have this effect. While funding through debt is visible from the regular publication and monitoring of debt statistics, PPP future payments do not enter such statistics.

4. What assessment can be made about the performance of PPPs?

PPP performance has been studied by academics in different fields and by institutions. A non-exhaustive survey of academic work can be found in Hodge et al (2018)[6]. For example, Soecipto and Verhoest (2018) have found that a large share of PPPs are subject to contract renegotiation[7].

The European Court of Auditors (ECA) analysed a sample of PPPs that were co-financed by EU funds. The overall conclusions were:

- PPPs increased the risk of a lack of competition during the procurement stage, diminishing the bargaining power of governments;
- PPP negotiation takes more time than traditional procurement;
- like with other forms of procurement, there were significant construction delays and cost overruns;
- forecasts of future demand were grossly overestimated[8];
- most of the PPPs were decided without comparative analysis of alternative forms of procurement;
- the distribution of risk between the public and the private sectors "was often inappropriate, incoherent and ineffective";
- at the same time, it was found that remuneration rates for the private partner were exaggerated in relation to the risks taken;
- ICT projects had the particular problem of incompatibility between the long-term duration of the contract and the current speed of technological change;
- the quality of the services provided was high.

The ECA warns that the success of PPPs depends on strong institutions and long experience with PPPs and that these conditions are only met in a small number of EU countries. Hence the ECA advises against disbursing a larger share of EU funds through PPPs in the future.

Both the Guide to the Statistical Treatment of PPPs (2016) and ECA (2018) point out the risk that a proper consideration of value for money might be overshadowed by the incentives that arise from the off-balance sheet nature of a PPP project, leading to the inappropriate use of PPPs.

---

[6] Hodge, G., Greve, C., Biygautane, M. (2018*): Do PPP's work? What and how have we been learning so far?*, Public Management Review 20:8.

[7] Soecipto, R.M., and Verhoest, K. (2018): *Contract stability in European road infrastructure PPPs: how does governmental PPP support contribute to preventing contract renegotiation?*, Public Management Review, 20:8.

[8] Evidence of the large overestimation of demand in transportation is provided by Flyvbjert et al (2005) who have found that forecast accuracy does not improve over time. The authors have found that political causes are relevant in explaining forecast inaccuracy. Cfr. Flyvbjerg, B., Holm, M.K.S., Buhl, S.L. (2005): *How (In)accurate Are Demand Forecasts in Public Works Projects?: The Case of Transportation*, Journal of the American Planning Association vol. 71:2.

The Guide also warns about the "affordability illusion", as the interaction between deferred and spread payments on one hand and the off-balance sheet nature of projects on the other may create the appearance that a project is affordable and may lead to fiscal sustainability problems. This is especially true when the liabilities arising from a PPP are contingent.

Evidence of cost overruns is provided by Monteiro (2007) among others, who assessed the Portuguese experience to conclude that while PPPs allowed for the rapid deployment of new infrastructure and the supply of high-quality services, there were significant cost overruns and PPPs created fiscal problems as their long-term impact on the budget was not sufficiently taken into account[9]. Some of the fiscal risks associated with PPPs may only become apparent years after a deal has been signed.

Furthermore, the experience in some countries is that PPPs may be associated with an increased perception of corruption. There is also a risk of increased political influence from foreign entities if a partner entity is to some degree controlled by a foreign government.

Given the warnings of the ECA and the existing experience in other EU countries, PPPs may be undertaken when a large project is in itself desirable in terms of the cost-benefit analysis and the PPP comes out as the best option after a comparative analysis of the other options such as traditional public procurement and concession. PPPs should not be undertaken as a way of evading fiscal rules but as a means for delivering high-quality projects with lower cost and less risk for the public sector.

[9] Monteiro, R. S. (2007): *PPP and Fiscal Risks: Experiences from Portugal*, IMF.