EELARVENÕUKOGU
FISCAL COUNCIL

FISCAL COUNCIL OPINION ON THE SPRING FORECAST 2022 OF THE MINISTRY OF FINANCE

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Contents

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

Opinion

Russia's military invasion of Ukraine has made the economic environment very uncertain and forecasting extraordinarily difficult, which is also reflected in the outlook for Estonian public finances. Costs have increased unavoidably for defence and refugee-related spending. Spending is also affected by high inflation, which may lead to some investment being postponed or even cut.

Last year the Estonian economy grew rapidly as it recovered from the Covid-19 pandemic, but this year growth is forecast to stall. The Ministry of Finance is more cautious than other forecasters, projecting a decline of 1% in the economy in 2022 and growth of 1.2% in 2023. The Fiscal Council considers that the projection for growth in the spring forecast is justifiably conservative. The forecast figures for the outer years are even more uncertain than usual.

The outlook for growth in the Estonian economy in the near term is weaker than forecast last autumn because of the side-effects of the war and the high inflation. The Ministry of Finance forecasts that the consumer basket will rise by almost 13% in price in 2022, but the upwards pressure on prices may not stop there. The Fiscal Council sees that the biggest threat to economic growth comes from the uncertainty surrounding prices of commodities on global markets, and from supply-side restrictions and the general uncertainty about private and public sector investment. The Fiscal Council also doubts the assumption in the spring forecast that EU funds will be used most intensively in the next few years.

Given the existing risks and the general geopolitical uncertainty, the Fiscal Council considers that the spring 2022 economic forecast of the Ministry of Finance gives a sufficiently reliable picture of the near-term outlook for the Estonian economy.

The outlook for the public finances has deteriorated substantially in the spring forecast. Higher energy prices and a changed security climate have caused unexpected additional costs to the government's spending plans. At the same time, the forecast for state revenues is weaker, assuming a weaker labour market and lower private consumption. In total this points to larger budget deficits than were earlier forecast, an additional need to borrow, and a higher level of general government debt.

The Estonian government is also drawing up an extraordinary supplementary budget in spring 2022, and the spending in it could be 600-800 million euros. The supplementary budget had not yet been passed when the spring forecast was written, and so its impact is not covered in the macroeconomic or fiscal outlooks of the Ministry of Finance. It is also currently difficult to estimate the size of refugee-related spending or their possible contribution to state tax revenues.

The spring forecast is the basis for a stability programme in which the government sets the fiscal targets for the next four years. It is not yet clear in spring 2022 when and in what form the fiscal rules will be reapplied. The Fiscal Council considers it important that the state finances be managed responsibly even when fiscal rules are temporarily suspended. This means that temporary additional expenditures should be fully justified and permanent additional expenditure should be covered by permanent additional revenues. Otherwise there is a danger of a permanent shift in the structure of government revenues and expenditures and of that combining with high inflation to make the Estonian economy less competitive.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 20 April 2022

Explanatory Report

Russia's military invasion of Ukraine has made the economic environment very uncertain and forecasting extraordinarily difficult. The uncertainty that has been caused is notably greater than the impact that the pandemic had on international trade, which economies appear to have adapted well to. For this reason the Fiscal Council focuses primarily in its assessment on the outlook for this year and next. The forecast for 2024-2026 is considered inasmuch as it is necessary for understanding the fiscal forecast.

The spring economic forecast of the Ministry of Finance will from 2022 onwards no longer be used for planning the state budget strategy or the state budget for the next year. It will continue to be the basis for the stability programme intended for coordinating the economic policies of member states of the European Union, and for the extraordinary supplementary budget for 2022 this spring. The state budget strategy will be updated in the autumn based on the summer economic forecast of the Ministry of Finance.

Assessment of the macroeconomic forecast

Outlook for this year and next year

The Estonian economy recovered well from the pandemic in 2021. GDP grew by 8.3% at constant prices, and was more than 5% above where it was in 2019 before the pandemic. Exports of goods and services and domestic demand measured at constant prices were over 10% more than in 2019. Only the number of people in employment was lower than before that crisis. The rapid growth in the economy was mainly supported in the first half of 2021 by support measures that the government had passed for the economy and the change to make mandatory pension insurance optional, which shifted a large amount of savings into consumption in the fall[1]. An even faster recovery in the economy was prevented by faster rises than usual in energy prices in the final months of 2021.

Table 1. Key macroeconomic indicators in the spring economic forecast for 2022–2023 (%)

	2022		2023	
	Summer 2021	Spring 2022	Summer 2021	Spring 2022
GDP at current prices (billion euros)	32.4	32.7	33.9	33.9
Real GDP growth	4.0	−1.0	2.6	1.2
Real growth in private consumption	3.3	−4.6	2.4	0.1
Real growth in government consumption	−1.0	−1.4	0.0	0.0
Real growth in investment	−2.2	−7.2	5.9	3.9
Real growth in exports of goods and services	6.5	−2.0	4.0	2.3
Real growth in imports of goods and services	2.3	−6.6	4.4	2.1
CPI growth	3.7	12.7	2.1	2.1
Nominal growth in average wage	6.7	7.0	6.0	5.6
Growth in employment	1.4	−0.1	0.1	−1.2

Source: Ministry of Finance

Other than inflation being high, the outlook for growth in the Estonian economy at the start of 2022 was good. Russia's invasion of Ukraine changed this however, and made the economic climate extraordinarily

[1] GDP was also increased by one transaction where a large multinational company made intra-group changes to its ownership of intellectual property. These extraordinary changes meant a higher reference base for exports and private consumption, affecting the rate of growth forecast for 2023.

uncertain. The sanctions that the West and Russia imposed on each other mean serious restrictions on foreign trade and widespread interruptions to global supply chains. Both Ukraine and Russia were important export markets for several countries and producers. Even more important though was that those countries were an important part of the supply to the global economy of fuels, mainly gas, oil and coal, and various rare metals and foodstuffs, primarily grains. The outbreak of war means higher prices for commodities and reduced availabilities of them. It also caused greater uncertainty among investors and consumers when taking economic decisions. Under these circumstances it is to be expected that all the main economic indicators are forecast to deteriorate. The Ministry of Finance is forecasting a fall in GDP of 1% at constant prices in 2022, a rise in unemployment, and a sharp increase in inflation (see Table 1).

The indicator for real GDP leans heavily on the assumption that domestic demand and exports will become less import intensive, meaning the trade balance will improve in both constant and current prices (see Figure 1). This is despite the ratio of private consumption and investment to GDP remaining the same. The improvement in the external balance is a key assumption in the spring forecast, but unfortunately the Fiscal Council does not find that it is sufficiently clearly explained.

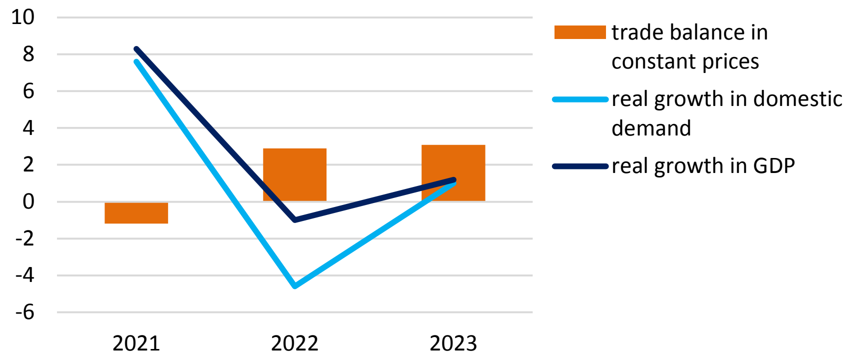


Figure 1. Forecast for growth in GDP and domestic demand, and trade balance for 2022-2023 (%)

Sources: Ministry of Finance, calculations of the Fiscal Council

Comparison with other forecasts

The Fiscal Council compares the forecast of the Ministry of Finance with those of other institutions, as usual (see Table 2). As forecast assumptions change quickly at the moment, there are fewer suitable forecasts available this time for the comparison. The growth forecasts for the Estonian economy for 2022 published in March and April 2022 range from a decline of 1% to growth of 1.5%. The outlook of the Ministry of Finance is the most cautious in the comparison with the other forecasters.

Table 2. Forecasts for GDP and HICP growth in Estonia in 2022-2023

	Real GDP growth (%)		HICP (%)	
	2022	2023	2022	2023
Eesti Pank (March)	−0.4	2.0	9.9	2.4
SEB (March)	0.6	2.0	11.5	2.8
Swedbank (April)*	1.5	2.0	10.0	4.5
IMF (April)	−0.2	2.2	11.9	4.6
average of the forecasts:	*0.4*	*2.1*	*10.7*	*2.6*
Ministry of Finance (April)	−1.0	1.2	12.4	2.1

* Inflation forecast not based on the *harmonized* index of consumer prices.

Sources: Eesti Pank, IMF, Ministry of Finance, SEB, Swedbank, calculations of the Fiscal Council

The forecasts for 2022-2023 assume that the war between Russia and Ukraine, or at least the active phase of it, will not last long, that dependence on raw materials from Russia and Belarus will be successfully reduced over the coming year, and that international supply chains will be reorganised. This outlook reflects the general assumptions about Europe and the whole global economy. The IMF and the OECD assume for example that growth in the euro area economy will the slower in 2022 than was earlier forecast by 1.1 or 1.4 percentage points respectively[2]. This means they assume that the euro area economy will grow this year by 2-3%.

The labour market and private consumption

The war is also causing a lot of discussion about how refugees from Ukraine will affect the Estonian labour market, as the refugees have the same social guarantees as permanent residents. At the time the forecast was written, the number of refugees had risen to almost 30,000, of whom more than half are of working age. At the same time there were 10,000 vacancies unfilled, and the Ministry of Finance estimated that weaker demand and breaks in the supply chain were threatening up to 20,000 jobs. The increased labour supply will increase the number of people unemployed, but should hopefully also raise employment, particularly in lower skilled jobs such as seasonal work in agriculture and services.

Overall the labour market indicators point to a change in the balance of supply and demand in favour of employers, which will be expressed in 2022 through a minimal reduction in employment of 0.1%, and a fall in real wages and labour productivity. A key explanatory indicator in this is the assumption of a temporary reduction in hours worked. Given these indicators, there is not sufficient justification for the statement on page 8 of the explanatory note to the forecast that wage pressures will remain high in the near term. It is true though that the labour market is very different across sectors and activities, and wage pressures may increase in some areas.

Inflation

Inflation is undoubtedly one of the key topics of the spring forecast. The main assumption underlying the forecast is the expected change in global market prices for commodities, food and energy. Like with the assumptions for growth in the economy, it is expected that inflation will remain at its highest level for a relatively short time. Forward transactions in the first half of March have led to the forecast that prices for key commodities like gas, oil and grain will start to fall from spring 2023. Nobody is able to say though how reliable the expectations of market participants in the new extraordinary circumstances are. There is no previous experience that can help in this. The forecast of the Ministry of Finance for consumer prices projects a faster rise in 2022 than other forecasters expect. The consumer basket was 12.8% higher in the first three months of the year than it was a year earlier, though only the data for January and February were known at the time the forecast was written.

Consumer prices are forecast to rise by 12-13% in 2022, which assumes that the month-to-month rise in prices will not exceed 0.55%. In other words a slow and gradual decline in inflation pressures is assumed. A fall in the inflation rate to a yearly average of 2% in 2023 assumes that prices will fall for a time at the start of next year. This assumption, and consequently the whole forecast of the year, could prove too optimistic, as price pressures will not necessarily fade that fast.

[2] For comparison, the Ministry of Finance estimates that the correction for Estonia will be up to 4 percentage points (see page 23 of the explanatory note).

Summary

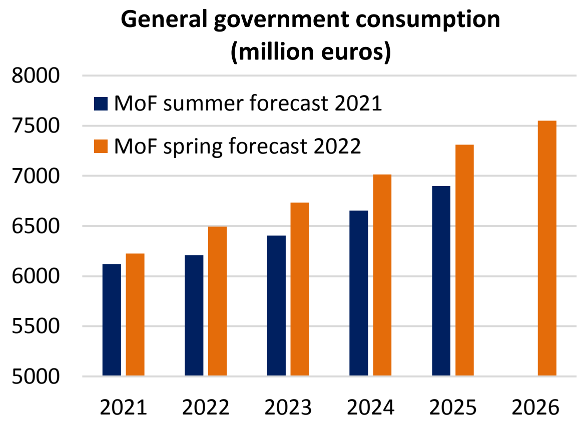
The Fiscal Council considers there are two reasons why the slowdown in 2022 may prove deeper than assumed in the spring economic forecast of the Ministry of Finance. The greatest danger to real growth in the economy comes from the uncertainty around commodities prices on global markets. Higher commodities prices could make production inputs too expensive for some producers in the current economic climate, and could lead them to stop production. Higher prices for commodities could also be passed on into the final prices for goods and services, and could make those too expensive for consumers. Equally the supply-side restrictions and general uncertainty among private investors could hinder investment projects, including those of the general government, as it is assumed that general government investment will increase as a share of GDP with support from the EU budget.

Risks to the growth are partially offset by the supplementary budget increasing spending by the assumed 1.8-2.4% of GDP, which was not included when the forecast was written, and may increase demand to some extent. As there were no reliable forecasts yet available for Estonia's main trading partners at the time the forecast was written, it is not possible to estimate how realistic the forecast for growth in exports is. It is also possible that the exporting sector will support economic activity more than expected.

Given the existing risks and the general geopolitical uncertainty, the spring economic forecast of the Ministry of Finance gives a sufficiently reliable picture of the near-term outlook for the Estonian economy. The forecast is based on assumptions about the performance of the global economy that are generally accepted internationally. The forecast of the Ministry of Finance for growth is more cautious than those of other forecasters, which the Fiscal Council considers to be reasonable.

Outlook for 2024-2026

The forecast for 2024-2026 works from the assumption that the sanctions imposed on Russia and Belarus will remain in place for a long time, but international supply chains will be successfully reorganised within around a year, and the final year of the spring forecast will be a time when the Estonian economy is already on a sustainable path of development. This means that the Estonian economy should by then have adapted to the existence of the Covid-19 virus, and to the economic and information war between the Western world and Russia. Unfortunately it is not yet possible to assess the accuracy of this assumption.



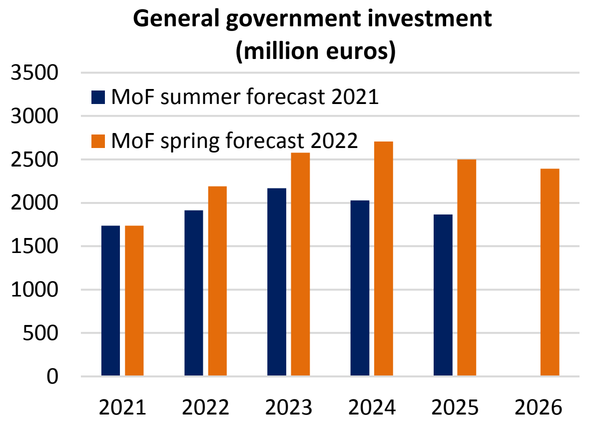


Figure 2. Forecasts for general government consumption and investment at current prices (million euros)

Source: Ministry of Finance

The growth figures in the economic forecast will be affected directly by the investment and final consumption of the general government. Larger figures for both of these are now expected than was the case in forecasts that were made last summer (see Figure 2). The increase in the forecast for investment is due to the updated view of the use of EU transfers, which suggests that general government investment will average 6.8% of GDP in 2024-2026. However, experience from earlier years does not unfortunately support the assumption that a rapid increase in the take-up of EU funds will actually happen. Absorption as a rule increases evenly until the end of the budget period (see Background). Changes in government consumption are technical in nature and will need to be reviewed after the new state budget strategy is prepared. It is possible that increasing the resilience of the economy, given both the pandemic and the danger of military attack, will need government revenues and spending to rise to a new level.

Assessment of the fiscal forecast

Uncertainty in the economic environment is also reflected in the outlook for public finances, which the Ministry of Finance considers has deteriorated substantially. It is important to remember that the forecast indicators in the spring forecast 2022 do not consider the supplementary budget for 2022, as it had not yet been passed when the forecast was released. For this reason the following tables and figures do not consider its impact either. The supplementary budget will raise spending considerably in 2022, though some of it will also contribute to increasing domestic demand. The spring forecast of the Ministry of Finance equally does not consider the possible tax revenues that refugees from the war could contribute through the Estonian labour market. This means that important factors on both the revenue and spending sides for the general government are missing, and it is hoped they will be explained in more detail in autumn when the state budget strategy and the state budget for next year are prepared. Neither is it yet clear in spring 2022 when and in what form the fiscal rules of the European Union will start to apply again.

Budgetary position in 2021

For the second year in a row, the nominal fiscal position of the general government was stronger at the end of the year than was assumed in earlier forecasts during the year (see Figure 3). The initial estimate of the Ministry of Finance was that the nominal deficit for 2021 would be 2.6-2.7% of GDP, but the preliminary estimate from Statistics Estonia put the budget deficit at 721 million euros, or 2.4% of GDP. The deficit was smaller than forecast because revenues were larger and expenditures were smaller.

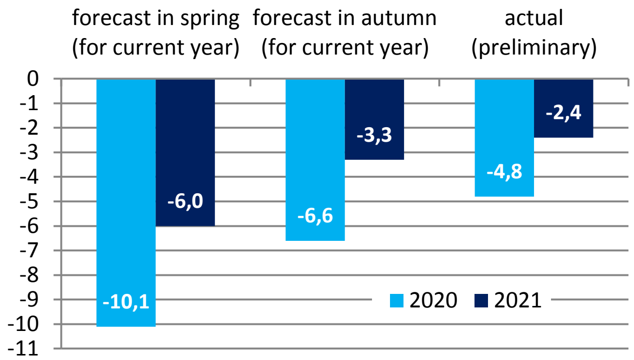


Figure 3. Forecasts of the general government nominal balance and the actual estimate for 2020-2021 (% of GDP)

Source: Ministry of Finance

The Ministry of Finance forecast a budget deficit last spring of 6% of GDP for 2021, which included the additional tax revenues from the changes to the second pension pillar. Faster then expected recovery from the pandemic meant that expectations for tax revenues were raised in the autumn. Tax revenues in the end proved better than even the most recent forecast, though one cause of the higher tax revenues in the final months of the year was unfortunately higher inflation. To alleviate rising energy prices, the government announced various support measures at the end of 2021 and in early 2022, which will mostly affect spending in 2022. A positive side to the energy crisis was that the state revenues from CO_2 quotas proved higher than expected, meaning that more spending could be planned in the current fiscal year[3]. The higher price level has allowed the Ministry of Finance to raise revenues from CO_2 quotas in the spring forecast 2022 to 265 million euros for this year and to 300 million euros for next year.

[3] The Fiscal Council discussed the emissions quota trading system of the European Union and its contribution to the Estonian state budget in its opinion of spring 2019.

Unfortunately a large amount of EU funds remained unused in 2021, meaning that general government spending was smaller than expected. When the state budget strategy for 2021-2024 was written in autumn 2020, it was forecast that transfers of 1.37 billion euros would be received in 2021. This estimate was raised to 1.45 billion euros in the state budget strategy for 2022-2025. However, the actual amount of EU transfers used last year was only 935 million euros. This has led to an increase in the forecast for EU support and investment for the upcoming years. In total, general government revenues increased by 13.4% in 2021 and expenditures by 5.8%, and the structural fiscal deficit was estimated by the Ministry of Finance at 3.8% of GDP (see Table 3).

Table 3. The general government budgetary position for 2021

	Autumn 2020	*Spring 2021*	*Autumn 2021*	*Spring 2022*
	State budget 2021 / State Budget Strategy 2021-2024	Spring forecast 2021 (including Supplementary Budget 2021 & State Budget Strategy 2022-2025)	Summer forecast 2021	Actual
Nominal balance (million euros)	−1898	−1706	−1006	−721
Nominal balance (% of GDP)	−6.7	−6.0	−3.3	−2.4
Real GDP growth (%)	4.5	2.5	9.5	8.3
Output gap (% of GDP)	−1.7	−2.9	0.2	1.0
One-off measures (% of GDP)	0.7	0.8	1.0	1.0
Structural balance (% of GDP)	−6.6	−5.4	−4.4	−3.8

Source: Ministry of Finance

Forecast of the budgetary position for 2022–2026

A significant increase in the general government fiscal deficit is expected in 2022 from the previous year (see Table 4), even while the size of the supplementary budget 2022 is unknown. The spring forecast 2022 of the Ministry of Finance expects the nominal budget deficit to be larger in each year of the forecast horizon than it was in 2021, when it was 721 million euros. This indicates an additional need to borrow, and a higher level of general government debt. The Estonian general government debt is forecast to grow from 5.5 billion euros in 2021 to 10.6 billion euros in 2026.

Table 4. The general government budgetary position in 2021 and the forecast for 2022-2026 (% of GDP)

	2021	2022	2023	2024	2025	2026
Nominal balance (million euros)	−721	−1248	−1268	−1254	−1049	−848
Nominal balance	−2.4	−3.8	−3.7	−3.5	−2.8	−2.2
Potential GDP growth (%)	3.0	2.1	2.0	2.1	1.9	2.1
Output gap	1.0	−2.0	−2.8	−1.7	−1.0	−0.4
Cyclical component	0.5	−1.0	−1.3	−0.8	−0.5	−0.2
Cyclical balance	−2.8	−2.8	−2.4	−2.7	−2.3	−2.0
One-off measures	1.0	0.2	0.0	0.0	0.0	0.0
Structural balance	−3.8	−3.1	−2.4	−2.7	−2.3	−2.0
General government debt	18.1	19.2	21.6	25.1	26.5	27.1

Source: Ministry of Finance

The fiscal outlook in the spring forecast 2022 is much weaker than it was in the autumn, considering also the decisions taken when the budget for 2022 was written that were not in the summer forecast, such as postponing the rise in excises, raising wages for teachers, and increasing spending on research and development and IT, and given also the methodological changes associated with the suspension of state contributions to the second pension pillar[4].

The nominal fiscal position has weakened in total by 1.7-2.4 percentage points depending on the year, and the structural fiscal position has weakened by 0.5-1.7 percentage points (see Figure 4). In autumn the forecasters still had grounds for raising their expectations for growth and it was not implausible that budget balance would be achieved by the end of the forecast horizon, but the energy crisis and high inflation and the war in Ukraine have again sharply changed the outlook for the Estonian public finances, this time for the worse. It should be remembered though that the long-term outlook for the fiscal position is much less certain than usual.

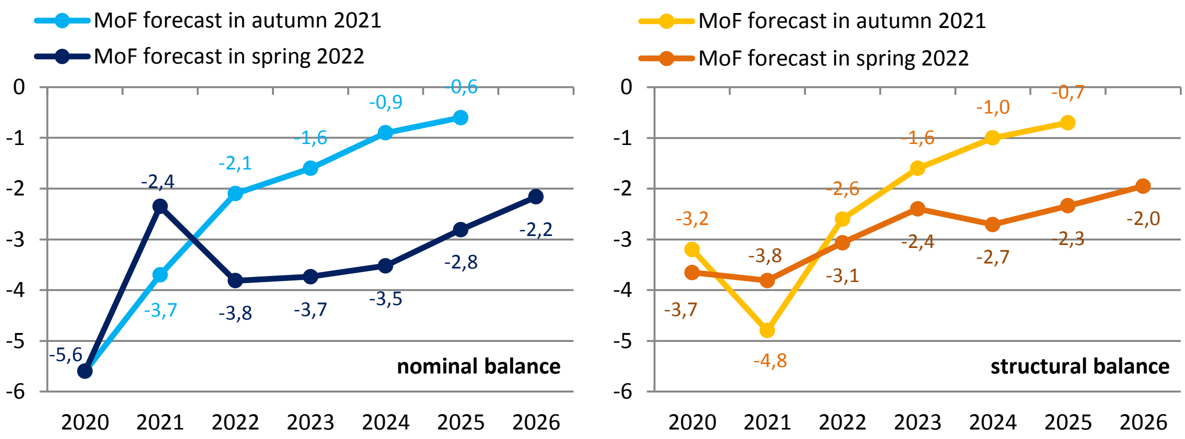


Figure 4. Forecast for general government budgetary position in comparison to autumn 2021 (% of GDP)
Sources: Ministry of Finance, calculations of the Fiscal Council

The forecast of the fiscal position of the general government is weaker than it was last autumn because of both higher spending and lower revenues (see Figure 5). The Ministry of Finance forecasts an increase in spending of around 550-750 million euros depending on the year, and a fall in revenues of 150-250 million euros. Spending will be affected by the support measures taken in late 2021 and early 2022 to handle the energy crisis, additional spending on national defence of more than 800 million euros, the costs of hosting refugees from the war of 140 million euros in 2022[5], increased social benefits because of the forecast rise in unemployment, and other state expenditures such as pensions that adjust automatically to rising prices. As the transfers from the European Union were not used in 2021 to the extent forecast, part of the rise in expenditures comes from investment being shifted to subsequent years.

[4] As the temporary suspension of state contributions to the second pillar of the pension system in 2020-2021 is now reported as a financing transaction under Eurostat guidelines, the fiscal position was weakened in the calculations by 0.55 percentage point in 2020 and 0.4 percentage point in 2021, and the position was strengthened for 2023-2024 by around 0.4 percentage point a year. The guidelines were issued in autumn 2021, but only after the summer economic forecast was issued and the state budget for 2022 was written.

[5] The Ministry of Finance assumes spending of 140 million euros in 2022 if there are 30,000 refugees from the war, and considering only costs that do not need separate decisions to be taken or legislative changes to be made. The costs for handling 50,000 refugees are estimated at over 200 million euros.

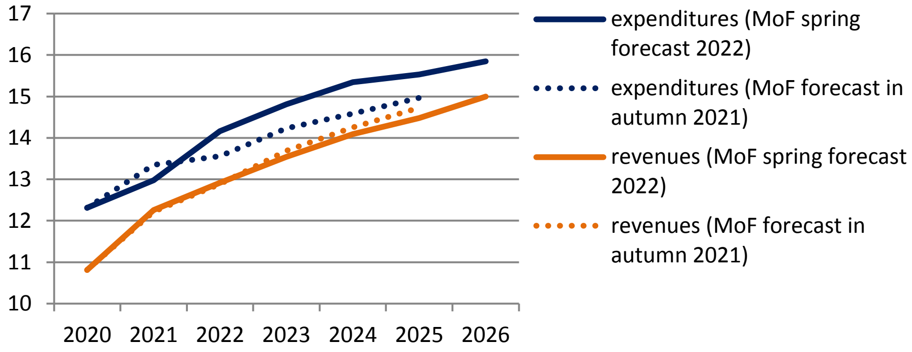


Figure 5. Forecast for general government revenues and expenditures in comparison to autumn 2021 (billion euros)

Source: Ministry of Finance

Growth in spending was slower than forecast in 2021 but the spring forecast 2022 of the Ministry of Finance expects general government spending to increase by 9.1% this year (see Figure 6). However, this forecast does not yet take account of the spending decisions in the supplementary budget for 2022. Initial indications are that the negative supplementary budget could be of 600-800 million euros, boosting the growth in expenditure in 2022, and so affecting the dynamics of growth also in subsequent years. The Fiscal Council considers that cost pressures will remain strong even after the supplementary budget is passed if the number of refugees or the negative impact of the war in Ukraine on the Estonian economy should prove larger than currently forecast or energy prices in the next heating period are high enough to require state subsidies.

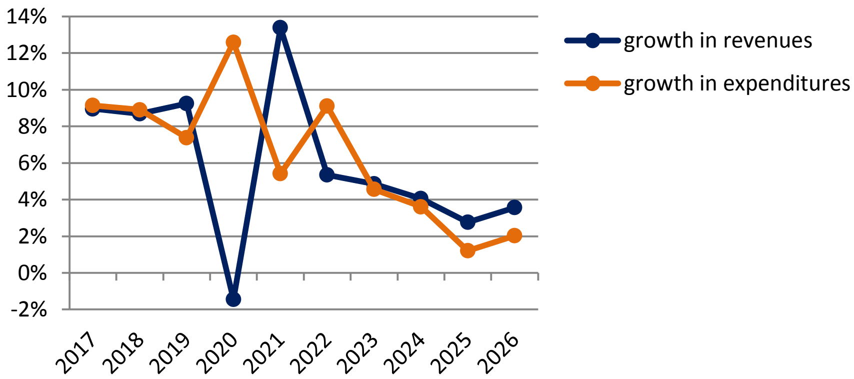


Figure 6. Growth in general government revenues and expenditures in 2017-2021 and forecast for 2022-2026 (%)

Source: Ministry of Finance

Although the Ministry of Finance is forecasting a small downturn in the economy in 2022 at constant prices, the total output of the economy at current prices will continue to grow, doing so by 6.7% in 2022, and the spring forecast find that this will help general government revenues grow by 5.3% this year. The forecast finds that the growth in general government revenues will slow in the longer term to 3-4% a year. The revenue forecast is lower than in the forecast written last autumn because the labour market and private consumption are weaker, and income tax revenues will fall from 2023 when the average pension is exempted from tax.

The largest part of general government revenues are tax revenues in the state budget, and the largest part of those are receipts of social tax and VAT. Tax receipts were very good in 2021 as economic activity recovered better than expected from the pandemic and also due to the fact that funds from the second pension pillar were used for consumption. The Ministry of Finance expects steady growth in tax revenues in 2022 as well, though partly due to higher inflation. To estimate whether the forecast of tax receipts is in line with the macroeconomic forecast, Figure 7 shows the expected development in social tax and VAT in comparison with the nominal growth in the tax base and the economy[6]. Under normal economic circumstances and with no major tax changes, it may be assumed that the rates of growth will remain similar over the years.

It is notable though for the past two years of crisis that the normal relations between tax receipts and the development of the tax base have not applied, which may be because of wage support measures, side effects of changes to the pension system, or unexpectedly high inflation. The spring forecast expects though that the growth in social tax in 2023-2026 will be in line with the development of the tax base and of the economy, averaging 5% a year. VAT receipts are forecast to grow by 7.3% in 2022, but on average by only 3.4% a year in 2023-2026. It is estimated that by the final year of the forecast, the growth in VAT will be a little lower than that in the economy.

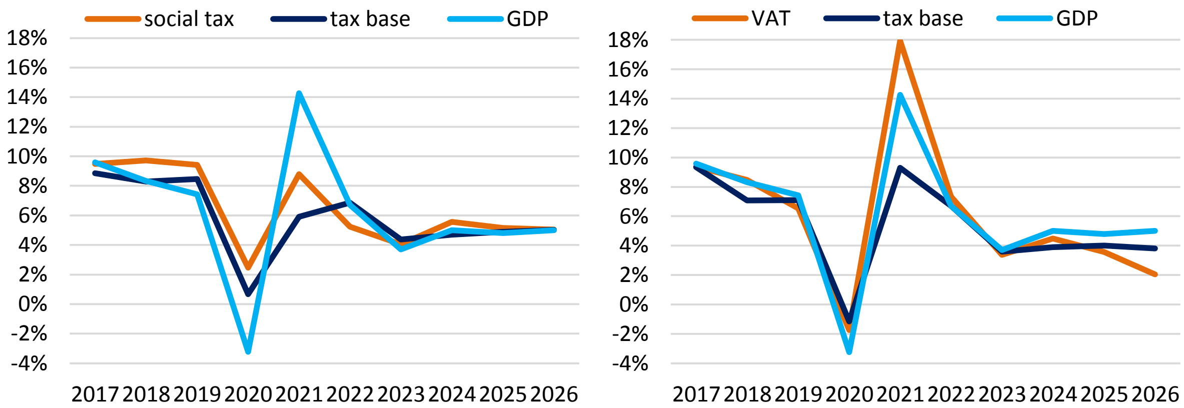


Figure 7. Growth in social tax and VAT in comparison to nominal growth in tax base and GDP (%)

Sources: Ministry of Finance, calculations of the Fiscal Council

Overall the Fiscal Council finds that the forecast for social tax and VAT receipts is generally in line with the macroeconomic developments described in the explanatory note to the spring forecast 2022. The Ministry of Finance has taken a more conservative stance in making its forecast for tax revenues in the long term. In addition, the spring forecast does not consider the possible tax revenue impact that refugees could have through the Estonian labour market. The Fiscal Council finds that the cautious approach to forecasting tax revenues adopted by the Ministry of Finance is reasonable given the volatility in commodities prices and the war in Ukraine.

[6] The VAT tax base in Figure 7 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. Both of these are macroeconomic approximations of the actual tax base, offering only a broad view of the development of the tax base.

The structural budgetary position and compliance with the fiscal rules

The Ministry of Finance estimates that the war in Ukraine has reduced the potential growth in the Estonian economy in the coming years by reducing the confidence to consume and invest, and the spring forecast puts the capacity for growth in the Estonian economy at an average of 2% a year moving forward, rather than the earlier estimate of 3%. The spring forecast did not attempt to estimate the possible impact on demand and supply in the Estonian economy from the refugees from the war. The forecast estimates that the actual economic development in Estonia will be below even this lower estimate of the potential trajectory of growth, as the Ministry of Finance considers that the output gap will remain negative throughout the forecast horizon (see also Table 4 page 10).

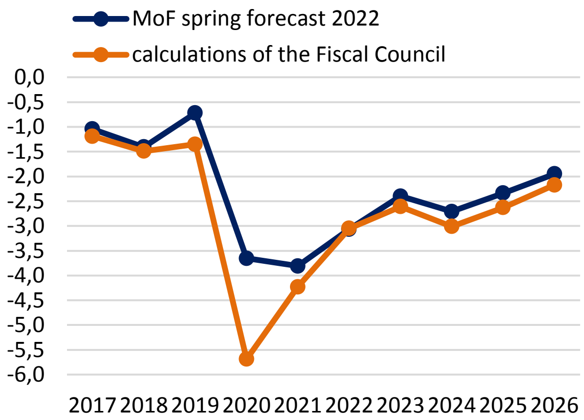


Figure 8. Estimates for general government structural balance in 2017-2026 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

Based on this estimate of the cyclical position of the Estonian economy and the outlook for the general government nominal deficit in the spring forecast, which did not yet include the spending in the supplementary budget, the structural budget deficit in 2022 will be 3.1% of GDP (see Figure 8). Calculations by the Fiscal Council using the figures from the spring forecast but a different methodology for estimating the cyclical component of the budget indicate a similar structural deficit in the upcoming years.

Estimating the general government *structural* deficit requires subtracting the effect of the economic cycle from the nominal fiscal position. The commonly used measure to express the cyclical position of the economy is the output gap, which compares the actual production volume of the economy and its estimated potential capacity. As it is difficult to measure the output gap accurately during a crisis, the estimates of the structural fiscal position in the recent past and for the near future are even more uncertain than usual[7]. As well as the impact of the economic cycle, all temporary and one-off budget measures that do not have a permanent impact on the structure of general government revenues and expenditures need to be subtracted when calculating the structural budget deficit. The Ministry of Finance considers that the additional receipts of income tax in 2021-2022 that resulted from the changes to the second pension pillar can be placed in this category.

[7] For more on the revisions of the Estonian output gap estimates and the structural fiscal position, see the Fiscal Council paper by Ricardo Vicente.

It could equally be argued that at least some of the support measures for the pandemic and the energy crisis are also temporary in nature and will not cause permanent changes to the structure of general government revenues and expenditures. As the general escape clause was applied at the start of the pandemic, the structural fiscal position became less important as a fiscal indicator, and so neither the Ministry of Finance nor other institutions like the European Commission have tried to exclude those support measures from the calculation of the structural deficit. The difficulty of identifying the exact cost of the support measures also makes the calculation more complicated. This could mean in essence that the estimates for the structural deficit for 2020-2021 and for 2022 exceed the actual deficits, meaning that careful analysis is needed to explain the change from year to year in the structural fiscal position in those years.

Even so, the general government fiscal position was in structural deficit during the pandemic years 2020-2021 and immediately before then, and the spring forecast 2022 of the Ministry of Finance expects the structural deficit to persist also in 2022-2026.

The escape clause of the fiscal rules that was initially applied in 2020 was later extended to 2021 and 2022. Before the outbreak of war in Ukraine, the economic forecasts for Estonia and for Europe indicated that the escape clause would no longer be warranted in 2023, but the question of extending the clause has now returned to the agenda. At the time that the spring forecast 2022 of the Ministry of Finance was written, it was not yet certain when and in what form the fiscal rules would start to apply again. This will probably still not be certain when the stability programme is written and the government starts to set its targets for the fiscal position for the next four years.

The Fiscal Council considers it important that even at times when the fiscal rules are temporarily suspended and cost pressures are severe, the state finances should be managed responsibly. When borrowing to cover temporary additional costs, it is important that the spending be clearly justified and targeted at specific and unexpected immediate needs. If permanent additional costs are created, permanent additional revenues must be found to cover them. Otherwise there is a danger of the structure of government revenues and expenditures being shifted out of place and of it combining with high inflation to make the Estonian economy less competitive.

Background. *Funds received from the European Union*

The new budget period 2021-2027 of the European Union started last year. The relative reduction in the level of transfers that results from the rise in living standards in Estonia will be smoother than was assumed a few years ago. The amount of funding available under the traditional cohesion policy will be smaller than in the previous budget period, but the direct agricultural subsidies will be around a third larger in the new budget period, the amount available for the Rail Baltica project will increase, various forms of targeted funding will grow, and a new Just Transition Fund will be added to support the new goals of climate policy. Estonia could receive 8-9% more support from the new European Union budget in total than it did in the previous period (see Table 5).

Table 5. The possible size and structure of EU funds in 2021-2027 (million euros)

	Budget 2014-2020	*Budget 2021-2027*	*NGEU*	*Total 2021-2027*	*Change from 2014-2020*
Cohesion Policy funds	3555	3073	207	3280	–8%
Direct agricultural subsidies, CAP	1007	1352		1352	34%
Rural development	726	636	63	699	–4%
Maritime and Fisheries Fund	101	96		96	–5%
Recovery and Resilience Facility (RRF)			862	862	
Just Transition Fund		154	199	353	
Internal Security Fund	62	82		82	32%
Horizon*	202	231		231	14%
Erasmus*	124	201		201	62%
Connecting Europe Facility (CEF)	477	950		950	99%
Total	6254	6775	1331	8106	30%

** The actual size of the support in 2021-2027 in the Horizon research and development programme and the Erasmus programme for education, training, youth and sport will be determined on a competitive basis.*

Source: Ministry of Finance

European heads of state decided in 2020 to create a temporary recovery fund supplementing the European Union budget called Next Generation EU (NGEU) to help countries get over the Covid-19 pandemic and to promote structural reforms. The main funding instrument in this is the Recovery and Resilience Facility (RRF), from which member states can receive support for carrying out reforms up until 2026. Estonia submitted its Recovery and Resilience Programme (RRP) last year, and this was approved by the European Commission and the Council. The cost of the Estonian programme in 2018 prices is around 860 million euros[8]. On top of the RRF as the main instrument, funding is also being temporarily increased through the cohesion policy, the rural development fund, and the Just Transition Fund. Estonia could access total support through the NGEU of up to 1.3 billion euros.

Making rapid use of EU funds will demand serious administrative efforts. Experience so far has shown that the amount of transfers used at the start of the new budget period is notably smaller than the average for the period even though the N+3 rule applies, by which amounts that have already been agreed can be

[8] For more on the goals of this instrument, see also: https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/country_overview.html

used in the three years after the budget period ends. For the two previous budget periods, it was also normal for the amount of funds used to increase during the period.

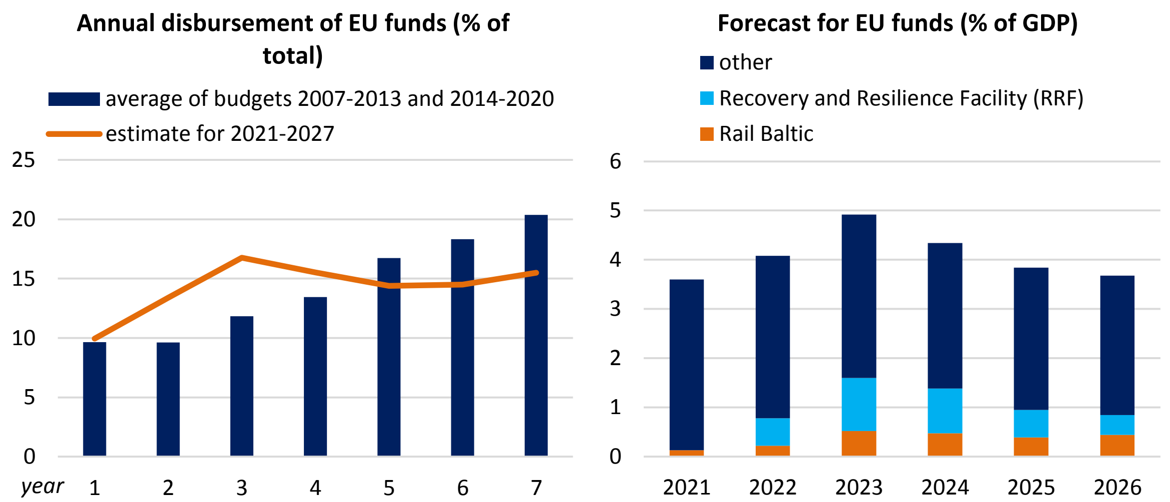


Figure 9. Use of EU funds in different budget periods over the years

Sources: Ministry of Finance, Statistics Estonia, calculations of the Fiscal Council

The new forecast suggests that the Ministry of Finance wants to use as much of the EU funds as possible in the middle of the budget period, in 2023-2025 (see Figure 9 left panel). This financing decision reflects partly the separate funding cycle of the major Rail Baltica project and the funding from the RRF (see Figure 9 right panel), and partly that one third of the possible funding available had not yet been used at the end of 2021.

Major uncertainty about the operation of supply chains and the prices of investment goods make it hard to forecast the use of EU transfers. It is understandable and reasonable given the position of the economic cycle that the government wants to use as much of the EU funds as possible in 2022-2024, but experience from previous periods suggests that this is unrealistic.

Estonia can receive total support from the European Union of 8.1 billion euros in the new budget period. It can also borrow up to 2 billion euros more from the NGEU temporary recovery funds. The Ministry of Finance forecasts that transfers from abroad in 2022-2026 will average 4.2% of GDP. That amount of support has only previously been received in 2009-2013.