FISCAL COUNCIL OPINION ON THE SPRING FORECAST 2023 OF THE MINISTRY OF FINANCE

April 2023

Contents

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Opinion

The state budget strategy for 2023–2026 written last autumn did not foresee a nominal budget deficit of less than 3% of GDP in any of the coming years. The estimate by the Ministry of Finance this spring for the outlook for the public finances is even worse, as the budget deficit in the spring forecast is not less than 4% of GDP in any year.

The fiscal forecast has deteriorated partly because the assessment by the Ministry of Finance of the outlook for the Estonian macro-economy has changed. The spring forecast of the Ministry of Finance expects slower economic growth and higher unemployment than was earlier forecast. This means lower revenues for the general government and higher spending.

Assessment of the spring forecast must consider that it takes no account of the new government coalition agreement or the plans to reduce the budget deficit, and those plans could have a substantial impact on the performance of the Estonian economy. The Fiscal Council finds that the goal of reducing the budget deficit is appropriate to slow the growth in Estonia's debt burden and price level. Furthermore, the fiscal rules of the European Union and Estonia will start to apply again from next year.

The Fiscal Council was critical in its evaluation of the economic forecast of the Ministry of Finance last autumn because the forecast did not take account of the policy measures announced beforehand by the government, but this spring the coalition agreement was only published after the spring forecast had been written. The forecast does however contain an additional scenario for spending growth, and the Fiscal Council considers this a good addition for describing long-term cost pressures.

Overall, the Fiscal Council finds that, given the chosen assumptions, the spring economic forecast of the Ministry of Finance gives a sufficiently reliable description of the outlook for the Estonian economy in the years ahead. For this reason the Fiscal Council has endorsed the spring forecast 2023 of the Ministry of Finance. It must still be emphasised that there remains a great deal of economic and geopolitical uncertainty. The Estonian economy may grow more slowly than forecast if commodities prices rise for example, or if there are interruptions to supply chains. Equally, wages may rise more quickly than forecast.

The Fiscal Council agrees with the opinion of the Ministry of Finance that the spring forecast may have painted too negative a picture of the cyclical position of the Estonian economy. An improvement in the economic cycle would not however reduce the need to improve the budgetary position.

The Fiscal Council finds that the spring forecast by the Ministry of Finance gives an appropriate basis for writing the stability programme. The government should describe the measures proposed for reducing the budget deficit and their estimated fiscal impact in the stability programme that is being prepared for release at the end of April. The Fiscal Council recommends that the government set the target for 2024 that the general government budget deficit not exceed 3% of GDP.

Vice-chair of the Fiscal Council
Andrus Alber
Tallinn, 20 April 2023

Explanatory Report

Assessment of the macroeconomic forecast

Russia's military invasion of Ukraine has made the economic environment very uncertain and forecasting difficult. Like it did last year, the Fiscal Council sees that the biggest threat to growth in the Estonian economy comes from the uncertainty surrounding prices of commodities on global markets, and from possible problems in supply chains and general uncertainty. More time will be needed for price pressures to ease than was thought at the end of last year. It is important to remember though that the assumptions for fiscal policy used in the spring forecast date back to the previous government and the contribution of general government spending to economic growth may now prove smaller than assumed.

The outlook for 2023–2024

Growth in the economy was weaker in the second half of last year than most forecasters expected, and this had some impact on the outlook. Both the real volume of GDP in 2023 and its size at current prices are smaller in the updated macro forecast, as the new view of how economic growth will develop in the private sector is more pessimistic than earlier.

Consumer price inflation was unusually high in 2022 because of the coincidence of several unexpected factors, and it reached almost 20%. Prices rose by almost the same amount for imported goods and services. Data for recent months show that it will take longer for external price pressures to fade than was assumed at the end of last year, and so the rate of inflation for 2023-2024 has been adjusted upwards (see Table 1). The Fiscal Council considers this to be a reasonable adjustment.

Table 1. Key macroeconomic indicators in the spring forecast for 2023–2024 (%)

	2023		2024	
	Spring 2023	Summer 2022	Spring 2023	Summer 2022
GDP at current prices (billion euros)	38.3	38.6	40.5	40.4
Real GDP growth	−1.5	0.5	3.0	3.0
Real growth in private consumption	−1.1	1.4	2.4	4.3
Real growth in government consumption	4.5	−1.2	−3.0	−1.5
Real growth in investment	5.7	3.7	3.8	3.8
Real growth in exports of goods and services	−1.0	1.6	3.2	3.5
Real growth in imports of goods and services	−1.4	0.3	1.9	3.4
CPI growth	9.2	6.7	3.0	1.0
Nominal growth in average wage	9.0	7.4	5.7	5.0
Growth in employment	0.3	0.5	0.6	0.2

Source: Ministry of Finance

The System of National Accounts shows compensation to employees last year increasing by around 14% over the year, which is only four percentage points faster than in 2021. Major uncertainty about the future made many companies try to maintain their profitability and create buffers against unexpected events further ahead.

Minimal growth in employment and a small rise in unemployment, probably around one percentage point, mean that the forecast for the average nominal wage in 2023 is practically unchanged from the previous forecast. With inflation higher than was previously expected, this means that the average real wage will continue to fall for longer than was thought. The assumption of real wages continuing to fall is in line with the changed outlook for growth in private consumption.

It is hard to estimate how accurate the assumption is that real wages will continue to fall. This is an unusual phenomenon for Estonia. Several extraordinary circumstances coincided in 2022, as there was general severe uncertainty among both employers and employees, Russia's invasion of Ukraine caused another reorganisation of foreign trade, the rate of inflation shot up and there was an unexpected large change in relative prices, and employment continued to increase while the unemployment rate remained below its historical average. How able businesses in different sectors were to pass the higher cost of production inputs on to consumers last year and in early 2023 varied widely[1].

What balanced growth in labour costs should look like under the circumstances is arguable. Earlier experience suggests that wages react to changes in the economy with some delay. The Fiscal Council considers that this delay could be shorter than assumed in the forecast, and that wage growth could start to accelerate this year by more than expected. This is particularly so if the overall confidence of employers and employees starts to improve.

The main components of domestic demand measured at current prices are even larger in 2023 than was earlier forecast. The Estonian economy is very open, and so the size of GDP depends very much on the external balance. The new forecast assumes that the trade surplus will be smaller than was expected last year, measured at both constant and current prices. This is an important factor holding economic growth back, and partly reflects the weakness of the exporting sector in 2023 (see Figure 1).

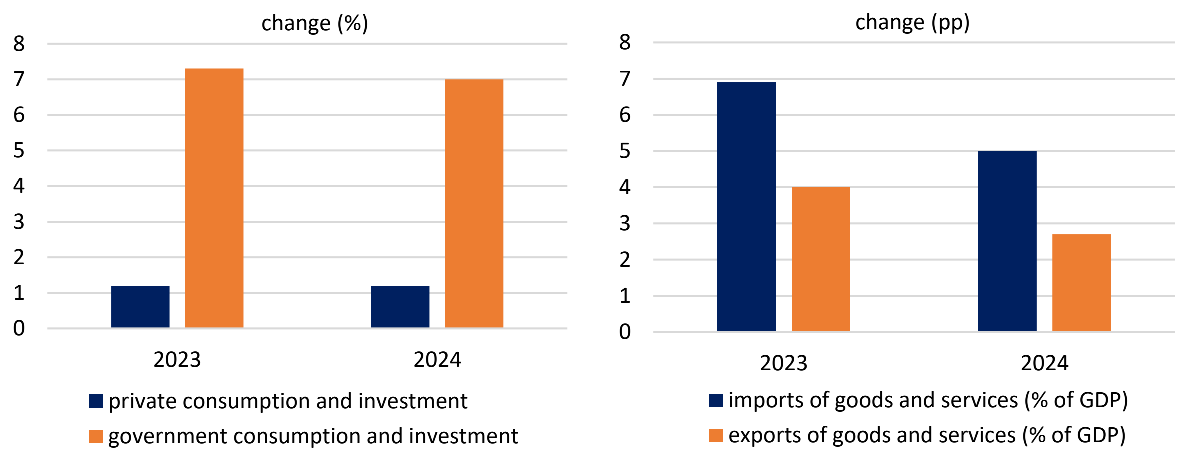

Figure 1. Change in domestic demand and forecast for the shares of imports and exports at current prices

Source: Ministry of Finance

Overall the economy is expected to revive only in the second half of 2023. The rate of growth for the main components of GDP in the forecast made for 2024 is close to that considered sustainable in the medium term at 2-3%, but the growth will start from a lower base than before, and so several indicators will remain lower than was forecast last summer. It is important to remember in this that the forecast was written before the new coalition agreement had been finalised. The rate at which inflation will come down is estimated more cautiously by the Ministry of Finance than by other macroeconomic forecasts produced at the end of last year, and the return to growth in 2023 is forecast to come a little later (see Table 2). The forecasts produced in the past three or four months have generally been very similar and the differences between the key economic indicators in them are smaller than the usual forecast errors.

[1] Compensation to employees increased on average in the economy by 14% last year, but this varied across sectors from 6% in agriculture and forestry to 45% in accommodation and food service. It was around 11-13% in sectors with higher value-added such as manufacturing, construction and retail. Enterprise data show that non-labour costs were on average 28% higher than in 2021.

Table 2. Forecasts for real GDP and CPI growth in Estonia in 2023–2024

	2023	2024	2023	2024	2023–2024 total	
	Real GDP growth (%)		CPI (%)		Real GDP growth (%)	CPI (%)
Swedbank	0.0	3.0	9.2	2.5	3.0	11.9
Consensus Forecasts	–0.1	3.3	8.8	3.1	3.2	12.2
Eesti Pank	–0.6	2.6	9.0	1.8	2.0	11.0
Luminor	0.0	4.0	9.0	0.0	4.0	9.0
Ministry of Finance	–1.5	3.0	9.2	3.0	1.5	12.5

Sources: Consensus Forecasts, Eesti Pank, Luminor, Ministry of Finance, Swedbank

The volatility in the economic environment means that both faster and slower growth is possible. The Fiscal Council recommends that the outlook for growth in the average wage should be considered carefully in the next forecasting round in the summer, as it may turn out to be too pessimistic in terms of growth.

The outlook for 2025–2027

Events in the past couple of years have increased the risks to the medium-term macro forecast. The first issue is that it is not yet clear whether the adjustments made during the pandemic have caused permanent changes in supply chains and the location of production or not. The second is that it did not become fully clear last year how the war between Russia and Ukraine will affect international economic relations and what will happen to energy prices in the shorter term. The third is that stricter climate targets will demand additional spending by both the private and public sectors, while their increasing impact on production may appear only after some delay.

It is very hard to estimate how all those factors will affect the potential growth in the Estonian economy in the short and medium terms. There have actually so far been very few apparently permanent changes to the structure of the economy, and so it is expected that the forecast for the medium term will essentially be similar to that produced half a year ago (see Table 3). As in the previous outlook, the Ministry of Finance estimates that the Estonian economy will be running at below its potential level throughout the forecast horizon. There are three important assumptions about the longer term.

Table 3. Key macroeconomic indicators in the spring forecast for 2025–2027 (%)

	2025	2026	2027	2025*	2026*
GDP at current prices (billion euros)	42.4	44.2	46.0	0.3	0.3
GDP at constant prices (billion euros)	26.7	27.3	27.9	−1.2	−1.2
Real GDP growth	2.5	2.3	2.0	0.0	0.3
Nominal GDP growth	4.7	4.2	4.1	0.3	0.0
Real growth in private consumption	1.5	2.4	1.8	−1.6	0.0
Real growth in government consumption	0.5	0.0	0.2	0.5	2.0
Real growth in investment	3.4	1.5	1.4	0.1	−0.8
Real growth in exports of goods and services	3.6	3.2	3.0	0.5	0.1
Real growth in imports of goods and services	3.0	2.5	2.4	0.0	−0.4
CPI growth	2.1	1.3	1.9	0.6	−0.6
Nominal growth in average wage	4.1	4.3	4.2	−0.5	−0.2
Growth in employment	0.3	0.0	0.0	0.2	0.0
Employment (thousands)	685.4	685.7	685.7	11.0	11.6
Unemployment rate	6.9	6.6	6.5	0.9	0.6

Source: Ministry of Finance **change from the previous forecast*

The first of these assumptions concerns the rate of growth in investment in the corporate sector. Many experts consider that investment has grown too slowly in recent years in both historical and international comparison. The new forecast for 2025-2027 predicts that investment in private sector fixed assets will grow faster than GDP by volume. This is put down to the corporate investment needed for the green transition. This assumption will need to be monitored in the future.

The second argument is about what may be considered sustainable long-term growth in labour costs. The general understanding for a long time has been that labour costs cannot grow constantly as a share of GDP without harming international competitiveness. This appeared to have been confirmed by the experience of other advanced economies. There were cases before the pandemic though where the additional growth in labour costs in Estonia lasted five or more years. There is no single, simple explanation for this. Many experts believe that this may be because of balanced development coming from structural changes in the economy. The spring forecast assumes that a constant share of value added created will be spent on wages in 2025-2027[2]. The Fiscal Council finds that this is a reasonable assumption.

The third assumption concerns the competitiveness of Estonia as a very open economy where the exporting sector is very important. The forecast assumes that growth in exports of goods and services in 2025-2027 will more or less be in line with changes in foreign demand. This principle has so far applied well and there is no reason to abandon it, and changes in some individual years should not be overemphasised[3].

Overall the Ministry of Finance has followed generally accepted methodological approaches in writing the spring forecast 2023 and internationally accepted assumptions about the performance of the global economy. 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 outlook for the Estonian economy and is a suitable basis for preparing the stability programme. It is important to remember with the spring forecast though that the assumptions for fiscal policy used in it date back to the previous government and the contribution of general government spending to economic growth may now prove smaller than assumed.

[2] This is then forecasting stability or zero growth in real unit labour costs (RULC).

[3] Estonia has mostly increased its market share in the past, but it must be remembered that it is a simplification to consider the gain or loss in market share as the change in the share of exports from Estonia within the costs of imports in target markets, and this assumption needs some other conditions to be met. One such condition is that the structure of exports and imports needs to be as constant as possible for example. The spring forecast refers to Estonia's loss of market share in 2022-2023. It is possible that this is simply noise generated by the large changes in relative prices.

Assessment of the fiscal forecast

An updated forecast for the state finances for 2023-2027 has been produced by the Ministry of Finance together with the spring macroeconomic forecast. The fiscal forecast considers the decisions and measures taken last autumn when the state budget strategy was written, but does not take account of the new coalition agreement that was only published after the spring forecast was written. The spring forecast is the basis for the stability programme that is submitted to the European Commission by the end of April.

Budgetary position in 2022

Preliminary data from Statistics Estonia show that the nominal budget deficit of the general government for 2022 stood at 335 million euros, or 0.9% of GDP (see Table 4). The fiscal position turned out to be much stronger than forecast, as a deficit of 1.7 billion euros or 5.3% of GDP was expected when the supplementary budget was written in 2022. The revenues of the general government were 872 million euros larger than was in the supplementary budget, and expenses were 516 million euros smaller. Revenues grew mainly because inflation being higher than expected led to larger tax revenues. On the expenses side, the state spent less than expected on investment and on the costs of refugees from Ukraine and energy subsidies. The cost pressures caused by higher inflation will mainly emerge in the state finances from 2023, when indexing and government policy measures widen the fiscal deficit sharply again. The spring forecast expects the fiscal deficit to remain large in future.

Table 4. The general government budgetary position in 2022 and the forecast for 2023–2027 (% of GDP)

	2022	2023	2024	2025	2026	2027
Nominal balance (million euros)	–335	–1659	–1704	–1700	–1985	–1955
Nominal balance	–0.9	–4.3	–4.2	–4.0	–4.5	–4.2
Potential GDP growth (%)	2.4	2.6	1.4	1.2	1.3	1.4
Output gap	–0.9	–4.9	–3.4	–2.1	–1.1	–0.5
One-off measures	0.2	0.0	0.0	0.0	0.0	0.0
Structural balance	–0.7	–2.0	–2.6	–3.0	–3.9	–4.0
General government debt	18.4	20.2	23.6	27.1	30.4	33.0

Source: Ministry of Finance

Budgetary forecast for 2023–2027

The spring forecast of the Ministry of Finance puts the budget deficit for 2023 at 1.6 billion euros, or 4.3% of GDP. When the state budget for 2023 was written, a deficit of 3.9% of GDP was forecast. The outlook for the state finances has deteriorated across the whole forecast horizon. The state budget strategy written last autumn expected the nominal budget to narrow to 3% of GDP in 2025, but the spring forecast expects the general government budget deficit to be at least 4% of GDP until the end of the forecast horizon. A larger budget deficit will cause faster growth in the debt burden and higher interest costs on the state debt.

The budget deficit is turning out to be larger because the forecast for revenues has been reduced and the forecast for costs increased for each year (see Figure 2). The explanation of the Ministry of Finance is that the weaker economic environment has reduced the expected tax revenues, and also the revenues from CO2 quotas. The change in the forecast for the main expenditure items has some reductions in costs and some increases, but as a whole the forecast for general government expenses is slightly increased. A substantial increase is forecast in government intermediate consumption, while wage costs and interest costs will increase by a smaller amount. At the same time there will be a major reduction in costs for capital formation and capital transfers, meaning public sector investments and investment grants.

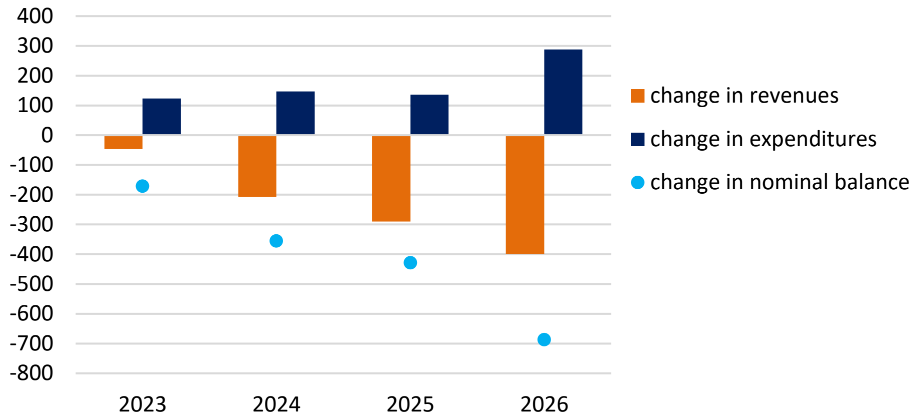

Figure 2. Change in the forecast for the general government revenues, expenditures and nominal balance from the state budget strategy for 2023–2026 drawn up in autumn 2022 (million euros)

Source: Ministry of Finance

The spring forecast of the Ministry of Finance expects that government expenditures will grow very rapidly this year by 15.3% (see Figure 3). This is partly a consequence of high inflation in 2022, which affects the larger expenditures of the state through indexing and through the additional decisions taken last autumn to raise public sector wages and family benefits[4]. There will also be several major tax changes coming into force in 2023, such as a rise in the general tax-free threshold and an exemption from income tax for the average pension, and an extraordinary additional rise in pensions. State investment will not contribute to the growth in expenditures in the way that was expected, as capital formation was expected in autumn to grow by 27% in 2023, but the spring forecast puts that growth at only 2.7%. The forecast for public sector investment and investment grants in 2023-2026 has been reduced by as much as 2.2 billion euros.

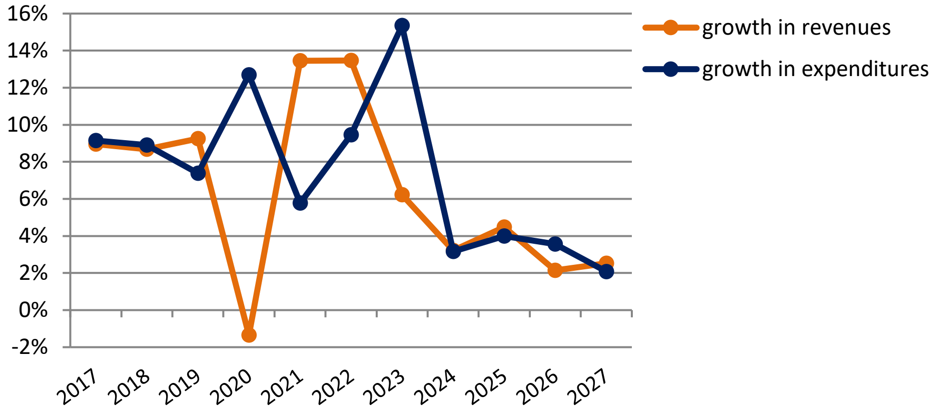

Figure 3. Growth in general government revenues and expenditures in 2017–2022 and forecast for 2023–2027 (%)

Source: Ministry of Finance

The growth in general government revenues has been very fast with support from the recovery in 2021 from the pandemic and the extraordinary income tax received following the pension reform, and also because tax receipts in 2022 were much larger than expected because inflation was high. The spring forecast expects growth in revenues to slow to 6.2% this year, with the growth in tax revenues at 6.5%.

[4] Pensions in Estonia and to a smaller extent the wages of civil servants are indexed, and they increased from 1 April 2023 by 13.9% in line with inflation and the growth in social tax receipts last year.

The longer term forecast assumes that government revenues and expenditures will grow by 2-4% each year. It should be noted here that the forecasts of the Ministry of Finance do not contain any changes that may be considered probable, but that have not yet been confirmed by decision of the government. This means there will be additional cost pressures in the final years of the forecast horizon, with accompanying tax revenues, but their size will only become clearer over time. The spring forecast assumes for example that public sector wages will grow on average by 3.0% in 2024-2027, and that spending on defence will fall back to 2% of GDP by 2027. The Fiscal Council considers useful the scenario that the Ministry of Finance has added to the spring forecast describing additional cost pressures, in which the growth in government expenditures continues its current trends in the longer term as well.

The spring forecast finds that tax revenues will grow by 3.8-4.4% a year from here on. To estimate whether the forecast of tax receipts is in line with the macroeconomic forecast, Figure 4 shows the expected development in social tax and VAT in comparison with the nominal growth in the tax base and the economy[5]. 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. Looking forward, the spring forecast expects that the receipts of both social tax and VAT will be in line with the developments of their tax bases. It may be noted for VAT however that the estimated tax base, which covers private consumption and investment, will grow more slowly than the economy as a whole during the forecast horizon. The Ministry of Finance assumes that the behaviour of consumers will be affected in the near term by the reduction in savings resulting from high inflation, and by higher interest rates. Also, less will be received in VAT following the downwards adjustment in government investment.

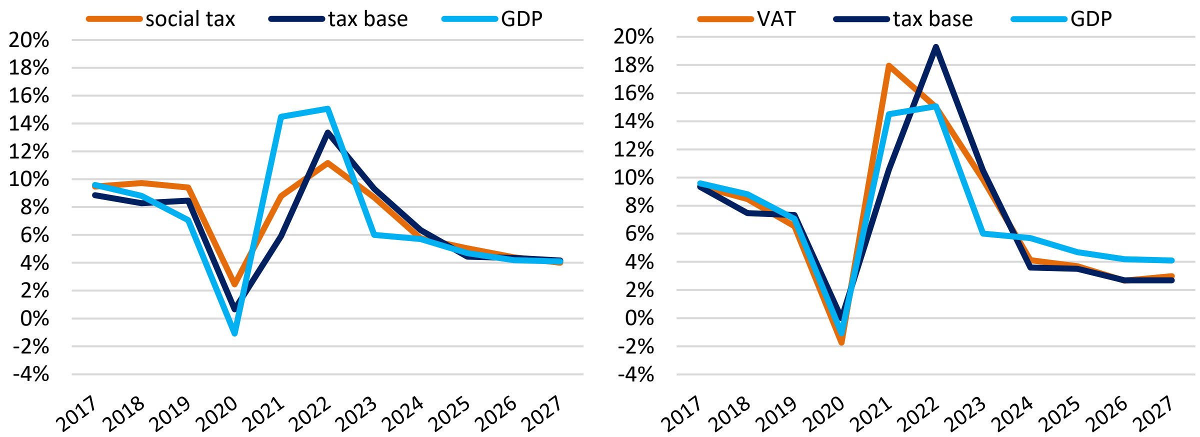

Figure 4. Growth in social tax and VAT in comparison to nominal growth in tax base and GDP (%)

Sources: Ministry of Finance, calculations of the Fiscal Council

Overall the outlook for state finances in the spring forecast of the Ministry of Finance is less favourable than that in the autumn, but the Fiscal Council considers that it is in line with the key indicators in the macroeconomic forecast and the assumptions used in writing it. It must be reminded, however, that the spring forecast has not yet taken account of the new government coalition agreement, or of its plans to reduce the fiscal deficit. Another key question in the spring fiscal forecast is the cyclical position of the Estonian economy, as the technical estimate of this is the basis for measuring the structural fiscal position.

[5] The VAT tax base in Figure 4 consists of forecasts for private consumption, government intermediate consumption and investment by the 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. VAT and social tax together bring in almost two thirds of all tax revenues.

The structural budgetary position and compliance with the fiscal rules

The spring forecast finds a negative output gap for 2023 of as much as 4.9% of GDP, and a structural fiscal deficit is estimated from that of 2% of GDP. This assumes that the potential growth of the Estonian economy will average only 1.3% in the forecast horizon (see Table 4), which is substantially below the earlier estimates. The Ministry of Finance admits that the output gap given in the spring forecast following the harmonised methodology of the EU may show the impact of the economic cycle inaccurately, as there is a risk that this method overestimates the cyclical weakness in the Estonian economy, and so the size of the structural deficit is underestimated. The ministry's spring estimate of the output gap in 2023 is much different to what it was in the autumn, and is larger than the estimates of other institutions (see Figure 5).

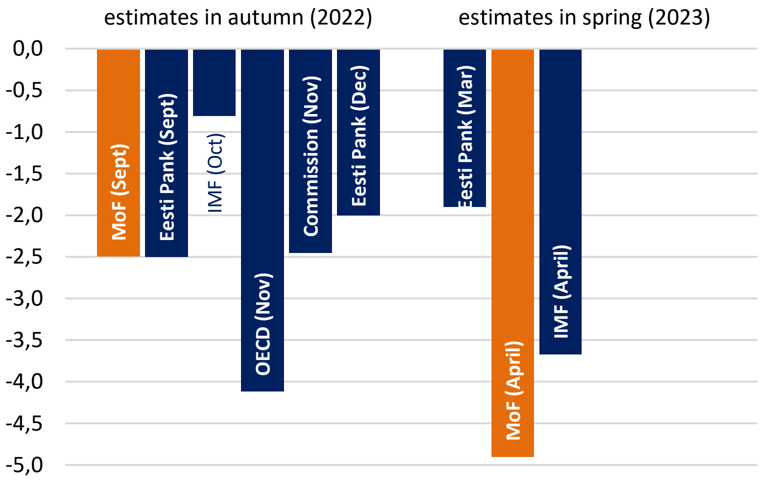

Figure 5. Estimates of the output gap in Estonia in 2023 (% of potential GDP)

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

The Fiscal Council has usually submitted its own estimate of the size of the structural deficit using the forecast indicators from the Ministry of Finance, but taking a different approach to estimating the impact of the economic cycle (see Figure 6). The calculations of the Fiscal Council support the view of the ministry that the cyclical position of the economy described in spring forecast is too negative and the structural deficit is too small. The Fiscal Council estimates that the structural deficit will be 3.4-3.7% of GDP in the years ahead, with no signs of improving in the medium term. The cyclical weakness described in the spring forecast of the Ministry of Finance is also not indicated by the heatmap of the Fiscal Council as at the end of 2022, or by simpler methods for identifying trend growth in the economy such as the HP filter.

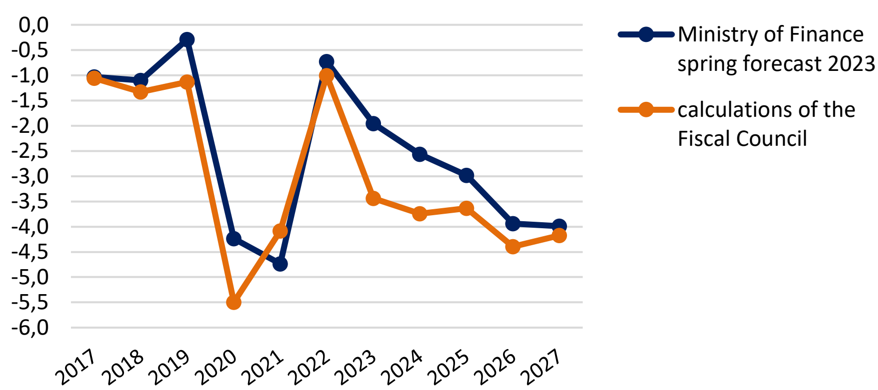

Figure 6. Estimates for the general government structural balance 2017–2027 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

The uncertainty about measuring the structural fiscal deficit makes it harder to set medium-term budgetary targets in the stability programme, and in the state budget strategy in the autumn. To make this problem worse, it is not yet fully clear in spring 2023 what the reform of the European Union economic governance framework will look like. The best indicator to follow for reducing the budget deficit would consequently at present appear to be the indicator for the general government *nominal* fiscal position, which is easier to measure and is more under the direct control of the government.

As the general escape clause will not be extended to 2024, the European Union's fiscal rules and the domestic ones will have to be applied again from next year. As the revision of the fiscal rules has not yet been completed, the Fiscal Council is basing its recommendations and assessments on the fiscal rules that applied before the escape clause was activated. The Fiscal Council recommends that the government set the target for 2024 that the general government nominal budget deficit not exceed 3% of GDP.

Following the spring forecast of the Ministry of Finance, this would mean that the fiscal position of the general government for 2024 would need to be improved by around half a billion euros, as the deficit could not be allowed to exceed 1.2 billion euros. Adhering to the forecast for the nominal fiscal position of -4.3% of GDP in 2023 and reducing the deficit in 2024 to 3% of GDP would probably meet the domestic requirement to reduce the structural fiscal deficit by at least 0.5 percentage point each year.

The government should describe the steps proposed for reducing the budget deficit and their estimated fiscal impact in the stability programme that is being prepared for release at the end of April, if the planned tax changes and spending decisions are by then known in sufficient detail. The European Commission also recommended that member states should show in their stability programmes being written in spring 2023 how they plan to reduce the nominal fiscal deficit to 3% of GDP as the escape clause ends[6].

The Fiscal Council recommends that once the main outlines of the European Union's reform of its economic governance framework are clear, the government should review the fiscal rules in the Estonian State Budget Act and decide whether the fiscal targets should be still be set using the measurement and goal of structural fiscal balance.

[6] See more on the European Commission guidance for fiscal policy in 2024 here.