EELARVENÕUKOGU
FISCAL COUNCIL

OPINION OF THE FISCAL COUNCIL ON THE ACHIEVEMENT OF THE GENERAL GOVERNMENT STRUCTURAL BUDGET POSITION TARGET IN 2022 AND ON TARGETS SET FOR 2024-2027

April 2023

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Opinion

The general government budget deficit in 2022 was much smaller than forecast, as higher inflation than expected brought with it strong tax receipts, while the additional expenditures planned in the supplementary budget proved smaller than forecast. General government expenditures exceeded revenues by only 355 million euros by the end of the year, or 0.9% of GDP. The Ministry of Finance estimates that this gives a structural budget deficit of 0.7% of GDP. Both the nominal and structural budget deficits were notably smaller than in 2021.

The improvement in the state finances in 2022 was only short lived and driven by factors that will not be repeated in subsequent years. The cost pressures caused by higher inflation will mainly emerge from 2023, when indexing and government policy measures widen the fiscal deficit sharply again.

The spring forecast of the Ministry of Finance puts the nominal budget deficit for 2024-2027 at 4% of GDP at least, without considering the new coalition agreement. Working from the spring forecast, the Fiscal Council found that the structural fiscal deficit in the same period will also average 4% of GDP. This means that general government revenues and expenditures are permanently out of balance.

The Fiscal Council finds that the budget deficit needs to be reduced as that will help slow the growth in Estonia's debt burden and restrain inflation. Furthermore, the fiscal rules of the European Union and Estonia will start to apply again from 2024, having been suspended since 2020 because of the pandemic and the war in Ukraine.

The government has set the target in the new coalition agreement of improving Estonia's public finances. The measures for doing this have not yet entered into force and they are not currently known with sufficient certainty, and so the spring forecast of the Ministry of Finance did not include them and nor does the stability programme written this spring. The stability programme consequently does not contain targets for the structural fiscal position in 2024-2027, and so the Fiscal Council cannot give any assessment on how appropriate they are.

It does however state in the stability programme 2023 that the government has set the target of reducing the nominal fiscal deficit to 3% of GDP in 2024. The Fiscal Council finds that setting a fiscal target like this is appropriate, and achieving it should help ensure compliance with the fiscal rules in 2024. The Fiscal Council considers that the budget deficit should continue to be reduced gradually after 2024 as well.

The Fiscal Council understands that setting medium-term budgetary targets has been difficult this spring for various reasons. The first is that the exact content of the revenue and expenditure measures planned by the new government is not yet known, and nor is their estimated fiscal impact. The second is that there remains a great deal of economic and geopolitical uncertainty, and so the forecast errors could prove larger than usual and fiscal policy needs to remain flexible. A third is that it is not yet known what form the European Union's fiscal rules will be reapplied in, and what requirements they may set for the Estonian state finances.

The Fiscal Council consequently recommends that the government present its numerical budgetary targets for the coming years together with the measures planned for achieving them in the autumn when the state budget strategy for 2024–2027 is written.

Vice-chair of Fiscal Council
Andrus Alber
Tallinn, 27 April 2023

Explanatory Report

As well as assessing the official economic forecasts, the Fiscal Council also monitors compliance with the national fiscal rules. For this reason the Fiscal Council assesses each spring whether the structural fiscal position of the general government for the past year met the targets set for it and whether the budget targets set for the next four years are in line with the fiscal rules. In the current case both of these opinions are presented in a single publication.

Because of the pandemic, the escape clause of the European Union fiscal rules that was initially applied in 2020 has been extended to the end of 2023. The Fiscal Council consequently focuses the first part of its opinion only on describing the fiscal position of the general government in 2022, and does not give the usual assessment of compliance with the fiscal rules. The second part of the opinion of the Fiscal Council assesses the targets for the fiscal position set in the stability programme written in spring 2023. The stability programme is written under the assumption that the escape clause will no longer apply in 2024, though without knowing the form in which the fiscal rules will be reapplied.

Assessment of achieving the target for the structural budget position for 2022

Like in 2020 and 2021, a supplementary budget was passed in spring 2022 that changed the forecast of the state finances for the current year quite substantially. When the supplementary budget 2022 was written, the Ministry of Finance forecast a nominal budget deficit for 2022 of 5.3% of GDP (see Table 1). The supplementary budget contained additional state spending of around 800 million euros on energy security and national security, and on refugees.

Table 1. The general government nominal balance for 2022

	Spring forecast 2022	Summer forecast 2022	Actual
CPI growth	12.7%	19.5%	19.4%
Real GDP growth	−1.0%	1.0%	−1.3%
Nominal GDP growth	6.7%	16.0%	15.1%
Growth in government tax revenues	4.8%	11.6%	10.8%
Growth in government expenditures	13.4%	11.6%	9.5%
Nominal balance (% of GDP)	−5.3%	−2.7%	−0.9%

Sources: Ministry of Finance, Statistics Estonia

It had become clear by the time that the summer economic forecast 2022 of the Ministry of Finance was written that the spring forecast had substantially underestimated the rate of inflation and the additional tax revenues that resulted. This meant that a much smaller budget deficit could be forecast for 2022 at the end of summer. The actual budget deficit in 2022 proved even smaller than that, as the additional expenditures planned in the supplementary budget proved smaller than expected in the second half of the year. In consequence government revenues were larger than expected in 2022, and its expenditures were smaller than expected. Preliminary data from Statistics Estonia show that general government expenditures exceeded revenues by only 355 million euros by the end of the year, or 0.9% of GDP.

Both the nominal and structural fiscal positions of the general government were substantially better than in 2021. The Ministry of Finance estimates that the structural budget deficit in 2022 was 0.7% of GDP (see Figure 1).

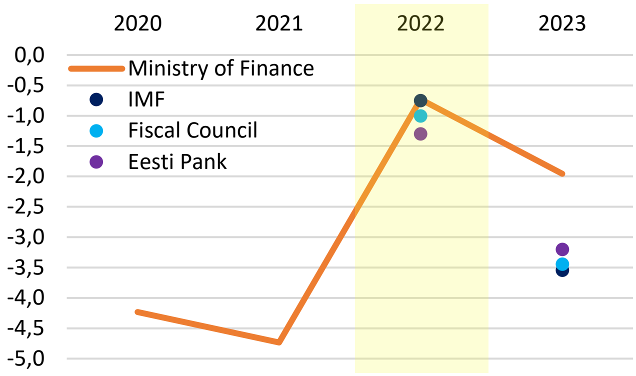

Figure 1. Estimates for general government structural deficit in 2020–2023

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

This estimate is based on the spring forecast of the Ministry of Finance, which finds the Estonian output gap in 2022 to have been negative at -0.9% of GDP, and assumes that the only one-off measure that affects the calculation of the structural budget deficit is the extraordinary tax receipts of 86 million euros that came from the changes to the second pension pillar[1].

The International Monetary Fund (IMF) has estimated a similar structural budget deficit for 2022. Calculations by Eesti Pank and the Fiscal Council (see Background 1) show the position of the Estonian economic cycle to be stronger than that estimated by the Ministry of Finance, and so the estimate of the structural deficit is that much larger. Both the Ministry of Finance and other institutions forecast that the general government structural fiscal position will weaken again in 2023.

The improvement in the public finances in 2022 was only short lived and driven by factors that will not be repeated in subsequent years. The cost pressures caused by higher inflation will mainly emerge from 2023, when indexing and government policy measures widen the fiscal deficit sharply again. The spring forecast of the Ministry of Finance puts the Estonian nominal budget deficit for this year at 1.66 billion euros, or 4.3% of GDP.

In summary, the Ministry of Finance estimated the structural budget deficit for the general government to have been 0.7% of GDP in 2022. As the restrictions on the size of the structural deficit have temporarily been suspended, the Fiscal Council cannot assess the fiscal position for last year under the domestic budget rules. The nominal fiscal deficit of the general government at 0.9% of GDP did however fall within the requirements of the European Union's stability and growth pact, which set a deficit limit of 3% of GDP.

Assessment of the targets for the structural budget position for 2024–2027

Last autumn, the government set the target in the state budget strategy for 2023-2026 that the structural fiscal position would neither improve nor deteriorate compared to where it was in 2022. At the time, the summer forecast of the Ministry of Finance expected the structural deficit to reach 2.6% of GDP in 2022. However, the summer forecast of the Ministry of Finance did not expect the structural deficit to be that large in any of the future years. This means that the government took decisions in the state budget strategy such as raising public sector wages, increasing family support and raising the tax-free threshold, that lifted the annual structural deficit to the target level.

[1] If the compensation for energy prices paid out to businesses and households in 2022 were to be classified as a one-off measure, then the structural budget deficit would be reduced by around 0.3-0.4 percentage point of GDP.

It is by now clear that the structural deficit in 2022 was substantially smaller than 2.6% of GDP and the new government has abandoned the targets that it set last autumn in the latest stability programme. The spring forecast 2023 of the Ministry of Finance finds the general government structural fiscal deficit will not in future remain at its level of 2022 and nor will it remain smaller than 2.6% of GDP (see Figure 2).

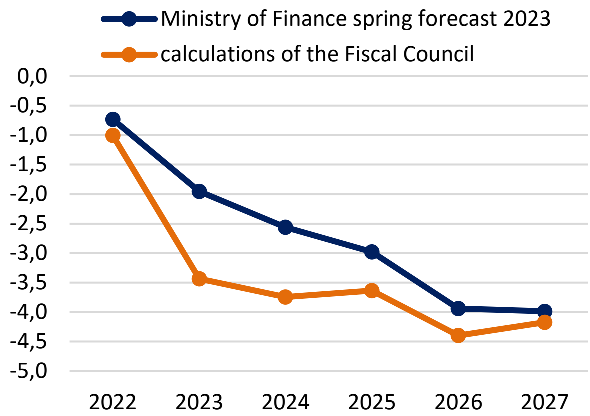

Figure 2. Estimates for general government structural balance 2022–2027 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

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. This then means that the structural deficit may prove larger than forecast. Working from the indicators in the spring forecast of the Ministry of Finance but using a different methodology for estimating the impact of the economic cycle leads the Fiscal Council to calculate that the structural fiscal deficit of the general government will be at least 3.5% of GDP in the coming years.

It is difficult for the government to set medium-term budgetary targets this spring and for the Fiscal Council to estimate how well aligned they are with the fiscal rules. It is known that the escape clause of the European Union fiscal rules that started to apply in 2020 will not be extended to 2024. This means that the requirements of the domestic structural balance rules will also start to apply again. The review of the EU fiscal rules has been restarted while they have been suspended, but this process has not yet been concluded. The current situation is consequently that the fiscal rules will start to apply again from next year, but at the time of writing the stability programme, it is not yet finally agreed what form they will take.

The European Commission recommended that member states show in their stability programmes being written this spring how they plan to reduce the nominal budget deficit to 3% of GDP and not exceed that limit subsequently[2]. The Fiscal Council consequently considers it reasonable that the new government has set the target of reducing the fiscal deficit to 3% of GDP in 2024 and that the appendixes to the stability programme describe the budget measures that are designed to help achieve that.

The European Commission also considers it possible that the excessive deficit procedures will be restarted in spring 2024 if the budget deficit in 2023 exceeds 3% of GDP without good reason. This means that if the Estonian nominal budget deficit exceeds 3% of GDP this year, and the spring forecast of the Ministry of Finance puts it at 4.3% of GDP, Estonia may escape such procedures if it has already set the target for 2024 of reducing the deficit to 3% of GDP.

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

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 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, and the reduction in steps of (at least) 0.5 percentage point a year if the deficit is larger than permitted.

In summary the Fiscal Council finds that the new government has set a suitable budgetary target for 2024 that the nominal budget deficit would not exceed 3% of GDP. The Fiscal Council considers that the budget deficit should continue to be reduced gradually after 2024 as well. It is important for this that the state budget strategy for 2024-2027 written in the autumn contain the government's medium-term outlook for the reduction in the budget deficit and a description of the measures that it has planned to help achieve those budgetary targets.

Background 1. *A macroeconomic heatmap for Estonia*

To assess better the compliance with the fiscal rules and the output gap forecast by the Ministry of Finance, the Fiscal Council analyses 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 describe the cyclical position of the economy. The end result of this analysis can be presented in the form of a heatmap (see Figure 3), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating.

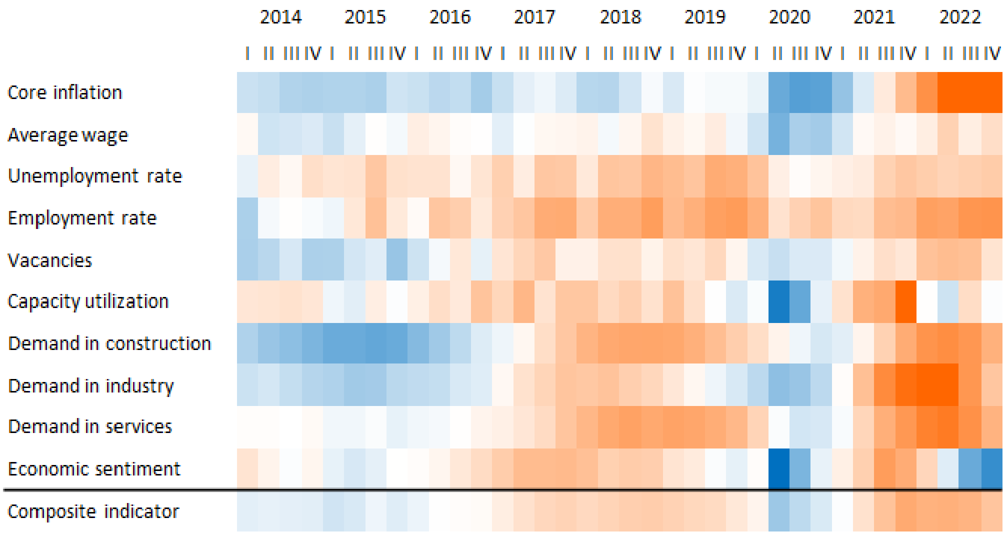

Figure 3. Macroeconomic heatmap for Estonia (Q1 2014 – Q4 2022)

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

The technical estimate of the Ministry of Finance found that the Estonian output gap in 2022 was negative at -0.9% of GDP, but the heatmap prepared by the Fiscal Council indicates that the economic cycle is in a stronger position. The only economic indicator in the heatmap that was notably down last year was the economic confidence index. The composite indicator of the heatmap indicates that the position of the economic cycle is stronger than the average in 2022 even if the indicator for core inflation, which currently suggests a risk of overheating, is excluded.

Background 2. *General government revenues and expenditures in 2023–2027*

The spending decisions made in the crisis years of 2020-2022 were not limited to short-term emergency measures. The decision to increase the crisis resilience of the healthcare system for example leads to a permanent increase in expenditures in the spring forecast (see Table 2), which will be made larger by the ageing of the population. Equally the decisions to increase social transfers in the past couple of years were not taken only to reduce the short-term risk of poverty, but also with longer-term goals in mind. The spring forecast consequently assumes that the share of social transfers in GDP will in future be larger than it was before the crisis started. Russia's full-scale invasion of Ukraine has also led to a review of spending on the national defence programme and the deadlines for executing it. The spring forecast assumes that the rise in defence spending will be temporary and that by the end of forecast horizon the same share of GDP will be spent on defence as before the pandemic.

One of the most important assumptions in the spring forecast is that wage costs will grow slowly in the public sector, and by less than those in the private sector in 2024-2027. The average growth of labour costs in those years is forecast at 3.0%, which is below the average nominal growth in GDP. Wage costs in the public sector have in the past grown at about the same rate as other current expenditures, as labour costs increased by an average of 7.3% a year in 2011-2019.

Table 2. General government expenditures and revenues (% of GDP)

	2011–2019	2019	2022	2023*	2027*
Expenditures by government function					
Social protection	12.3	12.9	12.5	13.4	14.4
Education	5.9	6.1	5.6	6.1	5.8
Health care	5.4	6.5	5.9	6.4	6.6
Economic affairs	4.4	3.9	4.6	5.3	3.4
General public services	3.8	3.5	3.6	4.0	3.5
Culture and religion	2.0	2.0	2.1	2.1	2.1
Defence	1.9	2.0	2.4	2.9	2.0
Internal security	1.9	1.8	1.8	1.8	1.8
Environmental protection, housing and utility	1.2	0.9	0.9	0.9	1.0
Expenditures by economic transaction					
Compensation to employees	10.5	10.9	10.4	11.4	10.6
Intermediate consumption	6.6	6.6	6.4	7.0	5.9
Social transfers	11.7	10.2	11.8	12.4	13.3
Investment	5.3	5.0	5.7	5.5	4.9
Other	4.7	6.7	5.1	6.6	5.9
Revenues					
Tax revenues	32.6	33.5	32.8	33.1	32.1
production and import taxes	13.8	14.2	13.2	13.4	12.7
income and asset taxes	7.3	7.4	7.9	7.7	7.4
social insurance payments	11.5	12.0	11.7	12.0	12.0
Non-tax revenues	6.3	5.9	5.7	5.5	4.2
Total expenditures	*38.8*	*39.4*	*39.4*	*42.9*	*40.5*
Total revenues	*38.9*	*39.5*	*38.5*	*38.6*	*36.3*
General government nominal balance	*0.1*	*0.1*	*−0.9*	*−4.3*	*−4.2*

Source: Ministry of Finance ** forecast*