EELARVENÕUKOGU
FISCAL COUNCIL

OPINION OF THE FISCAL COUNCIL ON THE ACHIEVEMENT OF THE GENERAL GOVERNMENT STRUCTURAL BUDGET POSITION TARGET IN 2023 AND ON TARGETS SET FOR 2025-2028

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Opinion

The Fiscal Council finds that the fiscal targets set in the stability programme for 2025–2028 are in line with the national fiscal rules. The Fiscal Council applauds the goal of the government that started work a year ago of putting the state finances in order. Part of the government's plan was carried out in summer 2023 and part of it, which was presented in the state budget strategy in autumn 2023, still lies ahead. How the future outlook for the Estonian state finances appears depends though on that part of the plan.

The Fiscal Council finds that it is not currently certain that the fiscal targets will be achieved. The planned improvement to the budget is built on measures with a very large fiscal impact that have not yet been legislated or that have not even started the process yet. It will not be possible to pass some of the measures by the start of 2025 given the usual standards and timetables, but almost all of them need to be in place if the fiscal targets are to be met, and those targets have already been set as low as the rules allow.

Both national and the European Union fiscal rules have started to apply again from 2024, and medium-term fiscal targets need again to be based on their requirements. The fiscal rules were suspended for four years when the pandemic erupted, and the Estonian public debt has increased by 5 billion euros during that time, as the spending by the government substantially exceeded its revenues. The resulting budget deficit is mainly permanent or structural in nature, which means that improving the fiscal position will require the government to take deliberate revenue and expenditure policy decisions, and not just wait for a recovery in economic growth and consequently better tax receipts.

Estonia may face an excessive deficit procedure (EDP) from the European Union, because the budget deficit in 2023 was larger than 3% of GDP. Data from Statistics Estonia show that the general government budget was 3.4% of GDP, or around 1.3 billion euros. The spring forecast of the Ministry of Finance projects that the deficit will again exceed 3% of GDP in 2024. The Fiscal Council consequently considers it important that the budget deficit be reduced this year. The spring forecast finds that the shortfall from the 3% target will be around 170 million euros, which is 1% of the total spending of the general government in 2024.

The government has set the target in the stability programme of keeping the general government structural budget deficit to 1% of GDP in 2025–2028. This also means that the nominal budget deficit will no longer exceed 3% of GDP from next year. Achieving these targets needs a large amount of improvement to the budget, as the fiscal position for 2025 needs to be improved by around a billion euros from what was in the spring forecast. The stability programme considers that the total package of fiscal measures presented in the autumn should continue to be sufficient, and those measures coming into force in 2025 should ensure that the fiscal rules are followed over the longer term.

The supportive fiscal stance during the pandemic and the additional cost pressures afterwards have put the Estonian public finances in a difficult position. Opening the EDP may cause reputational damage to the economic environment, as Estonia has been known for its sound public finances and fiscal discipline. If the budget deficit remains consistently larger than permitted though, long-term budget plans and fiscal targets would in that case need to be coordinated with the European Commission, and a fixed trajectory for spending would need to be followed. Therefore, fiscal consolidation cannot be postponed any longer.

The Fiscal Council also notes that the Estonian general government budget was last in surplus in 2019. The forecasts this spring do not see budget balance being restored even by 2028, which would mean that the budget will have been in deficit and debt will have been growing for a decade. The Fiscal Council consequently advises that fiscal targets that are more demanding than just the minimum requirements of the fiscal rules should be set in future as growth returns to the economy.

Chairman of the Fiscal Council
Peter Lõhmus
Tallinn, 30 April 2024

Explanatory Report

Since 2022, when the state budget strategy started to be produced in autumn together with the state budget for the next year, the Estonian government has set medium-term budgetary targets twice a year: in the stability programme submitted to the European Commission in the spring, and in the state budget strategy in autumn, which is especially important in domestic politics. The Fiscal Council consequently assesses the medium-term budgetary targets of the government twice a year, and it also assesses in the spring whether the budgetary position for the past year met the targets set for it and followed the national fiscal rules.

This report from the Fiscal Council presents its opinion on the budgetary position of the general government in 2023 and on the budgetary targets set in the stability programme for 2025-2028.

Assessment of achieving the target for the structural budget position for 2023

It was known in summer 2022, when the government started to write the state budget strategy for 2023-2026, that the escape clause of the fiscal rules would continue to apply in the EU in 2023. This meant that the size of the planned structural deficit was not limited by the national fiscal rules, as it equally had not been in the preceding couple of years. The government set its budgetary targets in the state budget strategy 2023-2026 so that the structural deficit would neither improve nor deteriorate compared to 2022. The summer forecast 2022 of the Ministry of Finance put the structural deficit in 2022 at 2.6% of GDP, and so the government decided to maintain the deficit at the level of 2.6% of GDP in 2023 (see Figure 1) and afterwards as well.

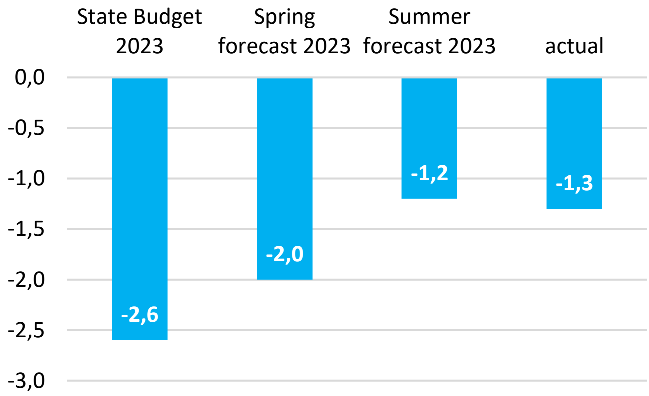

Figure 1. General government structural balance in 2023 (% of GDP)

Sources: Ministry of Finance, Statistics Estonia

Setting such a target allowed additional spending decisions to be taken in the state budget strategy on top of the summer forecast. The summer forecast 2022 of the Ministry of Finance expected the structural deficit in 2023 not to exceed 0.8% of GDP, and so this meant that the budgetary position could be weakened by 1.8 percentage points of GDP, or about 700 million euros. The fiscal measures that had the most impact on the budget were the rise and indexation of family benefits, wage rises for teachers and people working in internal security, culture and social affairs, increased spending on national defence, a rise in the income tax-free threshold, and additional spending on higher education. It had already been agreed earlier to exempt the average pension from income tax. Setting such a modest budgetary target and introducing additional cost-increasing fiscal measures brought a very fast rise in spending in 2023 and a deeper lasting budget deficit.

A target set like this for the structural fiscal position meant that the general government nominal budget deficit would amount to 1.5 billion euros, or 3.9% of GDP, when the state budget for 2023 was written (see Figure 2). The forecast for the nominal budget deficit deteriorated in spring 2023 as the outlook for growth worsened, but it improved again in summer 2023 as the labour market indicators proved better than expected.

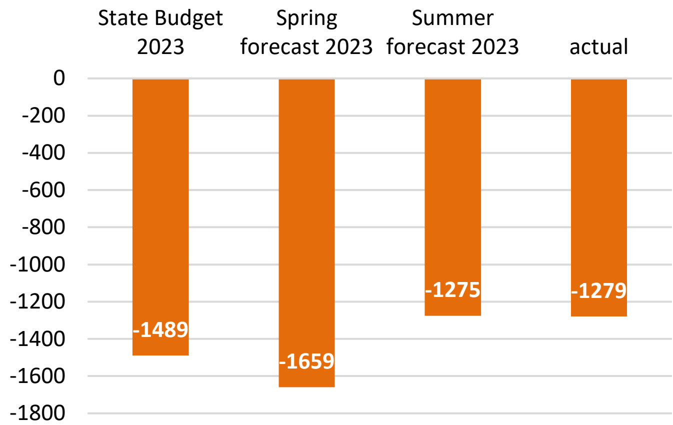

Figure 2. General government nominal balance in 2023 (million euros)

Sources: Ministry of Finance, Statistics Estonia

Halfway into the year the budget deficit in 2023 was only 1% of GDP, which prompted the question of whether the deficit would be much smaller than forecast, as it had been in the previous three years, but the Ministry of Finance estimated that the fiscal position would deteriorate sharply in the second half of the year. The fiscal position in the final quarter of the year was the weakest ever, and the actual budget deficit in 2023 proved very similar to what the Ministry of Finance had forecast in the summer. Data from Statistics Estonia show that the nominal budget deficit of the general government for 2023 was 3.4% of GDP, or around 1.3 billion euros.

This was a larger deficit than in 2022, when strong tax revenues resulting from high inflation meant that the budget deficit was only around 350 million euros, or 1.0% of GDP. The deficit grew because of the rapid rise in general government expenditures, which increased by 14.5% in total in 2023. General government revenues grew at the same time by 8.2%. General government expenditure is almost 2.1 billion euros more than in 2022, and public sector wages, social transfers and government investment were the biggest contributors to this (see Figure 3).

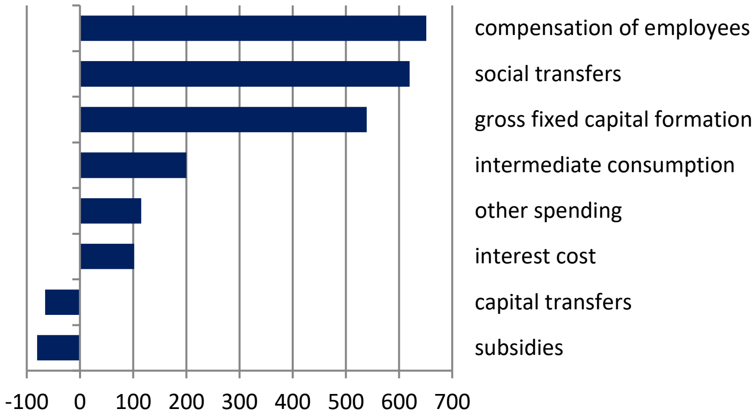

Figure 3. Growth in general government expenditure from 2022 to 2023 (million euros)

Source: Statistics Estonia

Taking the estimate of the output gap in the spring forecast 2024 from the Ministry of Finance puts the structural budget deficit last year at 1.3% of GDP. The structural deficit in 2023 was half of its target, as the nominal budget deficit was smaller than forecast and the estimate by the Ministry of Finance of the negative output gap was larger than forecast. This means that if the estimate by the Ministry of Finance of the size of the structural deficit is used, the government achieved its budgetary target in 2023.

The Fiscal Council considers that it is possible though that the cyclical position of the Estonian economy was not as bad last year as is indicated by the estimate of the output gap this spring by the Ministry of Finance of -4.3% of GDP[1]. Calculations by the Fiscal Council show that the cyclical component of the budget in 2023 was much smaller, and the structural deficit may have been as much as 3% of GDP. It consequently estimates that the structural deficit may have been larger last year than the target set for it of 2.6% of GDP, though there is more uncertainty than usual around the estimates of the size of the structural deficit.

Although the Ministry of Finance estimates that the structural budget deficit of the general government met the target set for it, the fiscal outcome last year may still cause the Excessive Deficit Procedure (EDP) of the EU fiscal rules to be engaged. The European Commission announced in spring 2023 that from 2024 it would again start to assess whether the state finances of member states comply with the criterion of 3% of GDP for the nominal budget deficit[2]. The nominal budget deficit of the Estonian general government exceeded 3% of GDP in 2023, and the spring forecast of the Ministry of Finance expects it to do so again this year, and then again in future unless additional fiscal measures are taken. Therefore, Estonia may face the EDP already this spring.

The state budget 2024 was written with a nominal general government budget deficit of 2.9% of GDP, but the spring forecast of the Ministry of Finance expects the deficit this year may reach 3.5% of GDP. A larger budget deficit is forecast than was expected in the autumn because the recovery in growth in the economy has been delayed, and so the Ministry of Finance has reduced its forecast for tax revenues. The Fiscal Council considers that stopping the deficit from exceeding 3% of GDP needs the fiscal position to be improved substantially starting from this year. The spring forecast of the Ministry of Finance indicates that the fiscal position for 2024 would need to be improved by about 170 million euros, which is 1% of the total forecast spending by the general government in 2024.

The main consequence of the excessive deficit procedure is that a member state that is subject to it must show how it plans to improve its fiscal position so that the nominal budget deficit no longer exceeds 3% of GDP. The Estonian government has already planned large-scale improvements to the budget from 2025, and so the decision to start the procedure would not particularly change the direction of Estonian fiscal policy moving forwards. The procedure may however hurt the reputation of the Estonian economic environment, as the country has long been known for its orderly and disciplined state finances.

It is also important to recognise that the new economic governance framework of the European Union gives more freedom in organising their state finances to countries that have low levels of debt and small budget deficits. Estonia is unfortunately not one of those countries at present, as the forecast this spring expects the budget deficit to be above 3% of GDP in future as well. Countries with a large deficit or a high level of debt must coordinate their future budget targets with the European Commission, basing them on the trajectory for further growth in expenditures described by the Commission. The Estonian government consequently needs to take account of both the national structural balance rule and the expenditure rule of the European Union when planning further improvement to the budget in the autumn.

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[1] For more see the Fiscal Council opinion on the spring forecast 2024 of the Ministry of Finance.

[2] Data from Eurostat show that Estonia was one of 11 countries in the European Union where the nominal deficit exceeded 3% of GDP in 2023. The deficit was smaller than 3% of GDP in 12 countries, and the budgets of four countries were in surplus.

The Fiscal Council finds that the budget deficit in 2023-2024 is mainly permanent or structural in nature, which means that improving the fiscal position will require the government to take deliberate revenue and expenditure policy decisions, and not just wait for a recovery in economic growth and consequently better tax receipts. If the economic climate were to improve unexpectedly, it would also make the achievement of the target for the structural budget position more demanding.

Assessments of the targets for the structural budget position for 2025–2028

It was known in spring 2023 that the fiscal rules would start to apply again from 2024, but it was not yet known what the new EU fiscal rules would be when the stability programme was written last spring (or when the budget strategy was written in the autumn). The economic governance framework of the European Union was being reformed at the same time that the escape clause applied to the fiscal rules. Agreement on the fiscal rules was only reached between member states in December 2023, and they were finally passed by the European Parliament in April 2024.

The uncertainty around the updated European Union fiscal rules and the requirements in them for countries like Estonia with low debt levels made it hard to set multi-year budget targets. Long-term planning for the state finances was also made harder by the worrying security situation and the uncertainty around economic forecasts. The newly elected government only set the target in the stability programme in 2023 that the nominal budget deficit should no longer exceed 3% of GDP in 2024, but the state budget strategy written in autumn 2023 set specific targets for the structural fiscal position for the next four years. At the same time that the budget strategy was being discussed, the national fiscal rules were eased (see Background).

The government set a medium-term target last autumn of reducing the structural budget deficit to 1% of GDP and of maintaining that level of deficit thereafter. The cyclical position of the economy was forecast to be too weak in 2024 for the fiscal position to be improved, and so it was planned that the target for the structural budget deficit would be achieved in 2025. A lot of new revenue and expenditure measures for this were announced in the budget strategy that would ensure meeting the budgetary targets according to the forecast of the Ministry of Finance. The planned improvement in the budget for 2025-2027 was designed so that it would meet the minimum requirements of the national rules.

The stability programme written in spring 2024 does not change the budgetary target for the government, and the target remains for the structural budget deficit to stay at 1% of GDP in 2025 onwards. This is the largest structural deficit that is currently permitted under the national fiscal rules. Developments since the autumn have made that target both harder and easier to meet.

The first development is that the outlook for growth in the Estonian economy has deteriorated from the autumn, and so the Ministry of Finance has reduced its forecast for tax revenues for the years ahead. This is the second time that the recovery in growth in the economy has been delayed since the government set the target in spring 2023 of starting to repair the state finances. This means that the measures planned by the government will come into force in a weaker economic climate than was originally thought. The need for fiscal improvement has however become more urgent. The Ministry of Finance forecast in the autumn that the nominal budget deficit would be 4% of GDP in the coming years if there was no change to fiscal policy, but the spring forecast raised this to 5% of GDP (see Figure 4). This would mean the Estonian government debt growing to 36% of GDP by 2028, with interest expenses exceeding 400 million euros.

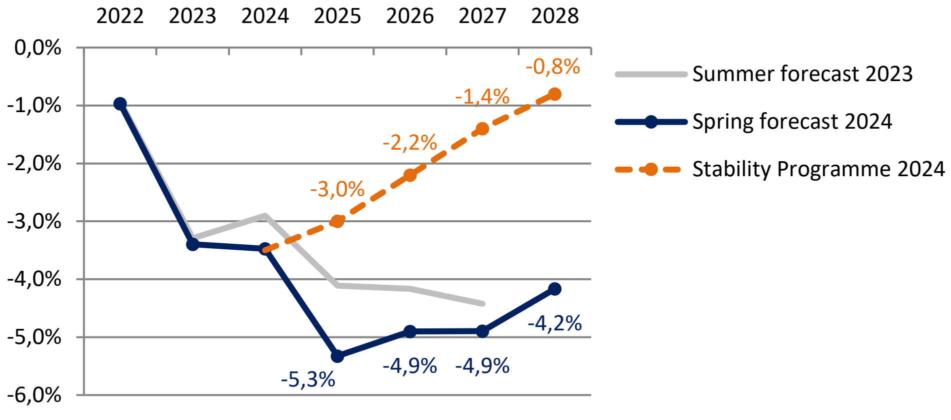

Figure 4. General government nominal balance in 2022–2028 (% of GDP)[3]

Source: Ministry of Finance

The second development is that the delay in the return of growth to the economy has made the estimate by the Ministry of Finance of the cyclical position of the Estonian economy worse (see Figure 5). The Ministry of Finance forecast that if all the fiscal measures in the budget strategy came into force, the negative output gap would become even wider in the coming years. The technical implication of this negative output gap would be though that the structural budget deficit would be smaller, which would then make it easier to achieve the numerical budget targets set earlier.

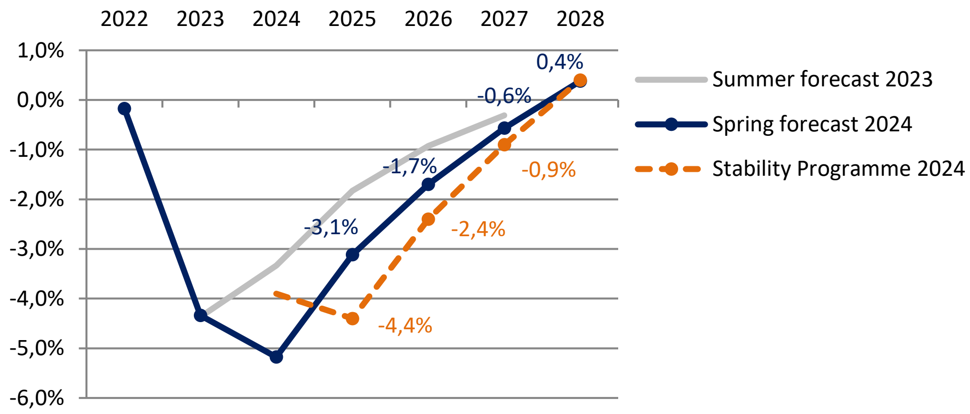

Figure 5. Output gap in 2022–2028 (% of GDP)

Source: Ministry of Finance

There has been no great change from the autumn in the list of revenue and expenditure measures planned for improving the budget in the years ahead, and the important assumption was made when the stability programme was written that all of the measures would come into force as planned. The stability programme 2024 shows the Ministry of Finance considers the fiscal measures announced in the autumn will still be sufficient for the government to meet its budgetary target of a structural deficit of 1% of GDP (see Figure 6).

[3] Figures 4-6 show three forecast scenarios. The summer forecast 2023 and the spring forecast 2024 of the Ministry of Finance did not contain the fiscal measures announced in the state budget strategy in the autumn for improving the budgetary position. The stability programme 2024 does take account of those measures however, and of its expected impact on the key macroeconomic indicators in the spring forecast, including the output gap.

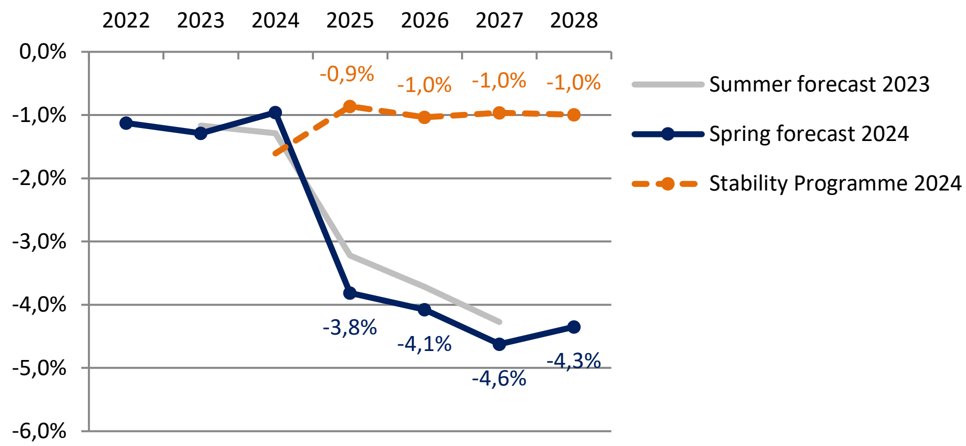

Figure 6. General government structural balance in 2022–2028 (% of GDP)

Source: Ministry of Finance

Taking the estimate by the Ministry of Finance for the cyclical position of the Estonian economy and the size of the structural budget deficit, and assuming that all of the new fiscal measures in the stability programme (see Table 1) come into force consequently means that in the opinion of the Fiscal Council the budgetary targets set in the stability programme 2024 comply with the national fiscal rules. The Fiscal Council finds however that it is currently not possible to say whether those targets will actually be achieved.

Table 1. The budgetary impact in 2025–2028 of the measures in the Stability Programme 2024 (% of GDP)

	2025	2026	2027	2028
Broad-base security tax	1.04	1.03	1.06	1.08
Motor vehicle tax	0.48	0.51	0.53	0.55
Reform of social tax special cases	0.28	0.30	0.30	0.30
Environmental fees	0.18	0.19	0.18	0.17
Reform of renewable energy fees	0.15	0.14	0.13	0.13
Fixing the tax-free threshold for old-age pensions	0.05	0.11	0.15	0.19
Tax on sweetened beverages	0.06	0.06	0.06	0.05
Higher rates for fines	0.04	0.04	0.04	0.03
Higher rates for state fees	0.03	0.03	0.02	0.02
More efficient tax collection	0.02	0.02	0.02	0.02
Other revenue measures	0.05	0.06	0.07	0.08
Revenue measures in total	2.18	2.30	2.60	2.54
Expenditure cuts	0.31	0.40	0.53	0.50
Lower interest expenditure on public debt	0.10	0.20	0.30	0.40
Changes to unemployment allowance and unemployment insurance benefit system	−0.03	0.04	0.04	0.04
Expenditure measures in total	0.19	0.48	0.91	0.85
Measures in total	2.36	2.78	3.50	3.39

Source: Ministry of Finance

The Fiscal Council already emphasised last autumn that meeting the budget targets set in the budget strategy would depend greatly on the planned revenue and expenditure measures actually being passed and then having the effect forecast. It was evident this spring that there had been no major progress in half a year in setting the content of many of those measures, and so the Ministry of Finance was not able to take account of them in spring forecast 2024.

This means it would be an even bolder assumption this spring to expect the fiscal measures presented in the state budget strategy to come into force in the planned form, as the large-scale improvement to the fiscal position was already planned for 2025. The improvement of the budget in all of the future years depends on whether the measures that should come into force in 2025 are applied. As the budgetary targets have already been set right on the limit of what is permitted under the national fiscal rules, the targets would be missed if even the smallest change were made to the planned fiscal measures, such as cancelling a planned revenue measure or making smaller expenditure savings than expected.

The Fiscal Council would consequently like to have seen the government clarify in its stability programme this spring which of the fiscal measures announced in the state budget strategy in the autumn are still expected to come into force in their planned form, and which are not. This would have reduced the uncertainty around the forecast for the state finances arising from political decisions. The European Commission is also considering this spring whether to start an excessive deficit procedure following the results for 2023, and that decision will also depend on the trajectory for the deficit in 2024 and onwards, meaning it might have been beneficial for the plan for improving the budget in the stability programme to have been more specific than what was announced in the autumn.

The spring forecast 2024 of the Ministry of Finance puts the general government nominal budget deficit in 2025 at 2.2 billion euros, or 5.3% of GDP, under the 'no-policy-change' assumption. The fiscal position would need to be improved by almost a billion euros next year for the budget deficit not to exceed 3% of GDP. Managing this would achieve compliance with the limit set by the EU of 3% of GDP for the nominal budget deficit, and also in the opinion of the Ministry of Finance ensure that the target for the structural budget deficit was met. This makes the improvement of around a billion euros in 2025 in the fiscal position vitally important for compliance with the minimum requirements of the fiscal rules. If the measures planned for 2025 come into force, the Ministry of Finance finds that they would ensure that the rules are followed in the years ahead as well.

Unfortunately, the government has told the media this spring that the security tax and the reform of renewable energy fees would not be implemented as initially planned[4]. Those two measures alone accounted for around half of the fiscal improvement for 2025, which is now under threat unless they are replaced by other revenue or expenditure measures of similar size. It is also known that the final form of the car tax has not yet been agreed, and that the tax on sweetened drinks will come into force a year later[5]. If the budget deficit cannot be reduced to the extent forecast, it will become less possible to hold down the interest expenses on the state debt. This makes the situation time-critical in the opinion of the Fiscal Council.

The Fiscal Council finds it important that the national fiscal rules be followed and that the targets for the structural budget deficit be met. The national fiscal rules have been eased once again recently and the government plans to meet only the minimum requirements, and so the planned improvement to the budget cannot be relaxed any further. Meeting the targets in the stability programme would mean that the nominal budget deficit of the general government, which the Ministry of Finance forecast in the spring will be 1.36 billion euros in 2024, would start to decrease gradually moving forwards, but would not reach balance even by 2028. This trajectory for the adjustment can consequently not be considered excessively steep over the years. The Fiscal Council accepts though that the improvement planned to the budget in 2025 is very ambitious if the forecasts by the Ministry of Finance for the general government budget deficit are compared with and without the fiscal measures.

[4] See more on the security tax and the reform of renewable energy fees.

[5] See more on the motor vehicle tax and the tax on sweetened beverages.

The forecasters expect growth to recover in the Estonian economy in 2025 despite the economic circumstances worsening this year, and this is when the next substantial fiscal measures should come into force. The long-term budget support that the state started providing during the pandemic and the additional cost pressures from it have put the Estonian state finances in a difficult position by now. This, combined with the fiscal rules starting to apply again from 2024, means that the improvement to the budget may not be postponed any longer.

The Fiscal Council finds that the looser fiscal rules leave sufficient room for new, justified cost pressures, such as spending on national defence, without threatening the long-term sustainability of the state finances. This though assumes that there will be the political will to abide by the rules. The national fiscal rules initially required structural balance to be achieved each year as a minimum, but a structural deficit of up to 1% of GDP is now permitted. The Fiscal Council is not in favour of easing the domestic fiscal rules any further, and recommends rather that the Estonian state finances be returned to the principle that has served well that when new permanent expenditures are taken on, they should be accompanied by new sources of permanent revenue of the same amount.

The Fiscal Council also notes that the Estonian general government budget was last in surplus in 2019. The forecasts this spring do not see budget balance being restored even by 2028, which would mean that the budget will have been in deficit and debt will have been growing for a decade. A key requirement for reducing the state debt and building up the fiscal buffers against the next crisis is that the budget should be in surplus. The Fiscal Council consequently advises that budget targets that are more demanding than just the minimum requirements of the fiscal rules should be set in future as growth returns to the economy.

Background. *The Estonian fiscal rules from 2024*

Estonian fiscal policy has had to be designed since 2014 following the rule of structural budget balance. The Fiscal Council assesses compliance with this rule retrospectively once the budgetary position for the previous year has become clear, and looking forwards when the government sets its budgetary targets for the coming years. When the state budget strategy 2024-2027 was written in autumn 2023, the government decided to change the rule for structural budget balance. The change to the rule was made in the State Budget Act in 2024.

The rule change allows the government to plan a structural budget deficit that is larger than previously (before the rule was suspended in 2020-2023). The budget rule that applied from 2014 required structural balance at least to be achieved every year, then it was changed in 2017 to allow a structural deficit of up to 0.5% of GDP if there had previously been a surplus of the same amount, but from 2024 the structural deficit may reach 1% of GDP. A budget deficit of this size may only be planned until 2030, or for as long as the Estonian general government debt does not exceed 30% of GDP, otherwise the largest permitted structural deficit is 0.5% of GDP. This is also the largest structural deficit that would have been permitted in Estonia under the European Union fiscal rules before the pandemic.

Changes were also made in 2024 to the correction mechanism of the fiscal rules, which is the requirement for how a budget deficit that is larger than permitted should be reduced. The correction mechanism previously required that the structural budget position be improved by at least 0.5 percentage point a year, while the new rule makes the amount of improvement depend on the cyclical position of the Estonian economy. If the economy is in a weak position, the improvement to the budget may be smaller than 0.5 percentage point, while if the economy is performing strongly an improvement of more than 0.5 percentage point is required (see Table 2)[6].

Table 2. The annual improvement to the structural budgetary position in the correction mechanism

Output gap	negative by more than −3% of GDP	−3% to −1.5% of GDP	−1.5% to 1.5% of GDP	positive by more than 1.5% of GDP
Size of annual adjustment	0	0 if economic growth is below potential, 0.25 if economic growth is above potential	0.5	at least 0.5 if economic growth is below potential, at least 0.75 if economic growth is above potential

Source: European Commission

On top of that, the calculation of the cumulative structural budget position and the compensation mechanism were removed from the State Budget Act. The cumulative position allowed a structural budget deficit to be planned only if there had previously been a structural surplus built up of the same amount. The compensation mechanism required a structural deficit that is larger than permitted to be compensated for later by a structural surplus of the same amount. This means that from 2024 it is no longer important to observe when planning a structural deficit whether the budgetary position was previously in structural surplus. The budgetary position only needs to be improved in future if the deficit is larger than permitted until the medium-term budget target of a structural deficit of 1% of GDP has been achieved, meaning it is no longer required to plan a structural surplus.

[6] This requirement applies as long as the Estonian general government debt does not exceed 60% of GDP and there is no danger to the long-term sustainability of the debt, otherwise the improvements required become much more demanding under all circumstances.

The State Budget Act still contains an escape clause that can suspend the fiscal rules under extraordinary circumstances. The escape clause can be applied and lifted following a decision taken within the economic governance framework of the European Union.