EELARVENÕUKOGU
FISCAL COUNCIL

FISCAL COUNCIL OPINION ON THE SUMMER FORECAST 2021 OF THE MINISTRY OF FINANCE

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Contents

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Opinion

The Estonian economy has recovered better than expected from the Covid-19 pandemic, and the summer forecast 2021 of the Ministry of Finance expects the economy to grow by 9.5% this year and 4% next year. The slow decline in the spread of Covid-19 means it is still difficult to make a reliable economic forecast and forecast errors may be higher than usual.

The Fiscal Council finds that the economy may grow more slowly than forecast in 2021–2022. This is mainly because the expectations for a rapid recovery in the economy due to vaccination in Estonia and the rest of the world may not be realised, and the improvement in the supply chains of production inputs and consumer goods may take longer than expected. For this reason the Fiscal Council recommends that the preparation of the state budget for 2022 should also take into account the risk scenario in the macro forecast of the Ministry of Finance, which foresees a sharper slowdown in economic growth next year.

The summer forecast of the Ministry of Finance expects the nominal and structural budget position of the general government to be close to balance by the end of the forecast horizon in 2025. The budget deficit will start to narrow as the rapid growth in spending during the pandemic years slows next year, and it is assumed that in future the growth in general government revenues will be faster each year than the growth in spending. The Fiscal Council considers that the improvement in economic sentiment and expectations of wage rises in the public sector mean that the risk remains that the growth in expenditures will not be successfully kept so low when the next budgetary plans are prepared. In addition, the planning for expenditures has taken no account of accelerated inflation.

The Ministry of Finance estimates that the Estonian economy will already be running at above its pre-pandemic level this year in both current and constant prices, and that the output gap will close. While it is hard to estimate how the pandemic has affected the growth potential of the economy, the Estonian economy could soon show signs of overheating. The Ministry of Finance's spring forecast expected that the Estonian output gap would only close by 2025.

The improved outlook for the economy and the state finances means that the government should set more demanding budgetary targets than those that were in the State Budget Strategy in the spring. The Fiscal Council considers that it is no longer justified to apply the escape clause of the fiscal rules from next year given the Estonian circumstances, even though it continues to apply in the European Union. Even the earlier recommendation of the Fiscal Council to follow the fiscal deficit requirement of 3% of GDP in planning the state budget for 2022 is no longer ambitious enough.

As tax revenues recover and the state support measures end, the general government budget deficit will decrease in the years ahead, though fiscal policy will remain supportive. The summer forecast of the Ministry of Finance puts the general government nominal budget deficit for the next four years at a total of around one billion euros. The Fiscal Council considers that the Estonian economy does not need any additional fiscal support beyond this by increasing the deficit any further. An additional boost will be given to economic growth in the years ahead by increased fiscal transfers from abroad, which are considered neutral in terms of the budgetary position. Stimulating the economy further at a point where it is already operating at its capacity, or even temporarily beyond it, could in the short term reduce the purchasing power of consumers and in the long term hurt the competitiveness of Estonian companies.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 23 September 2021

Explanatory Report

The summer macroeconomic and fiscal forecast 2021 of the Ministry of Finance is used as the basis for setting the state budget for 2022. It remains difficult to produce reliable forecasts. It has been repeatedly shown for forecasts produced since the Covid-19 pandemic started that although the damaging impact of the pandemic on the economy has proved smaller than feared, overcoming the virus has proved harder than expected, and the outlook remains uncertain. The summer forecast 2021 of the Ministry of Finance was written at the time of a new wave of infections and had to consider that the restrictions put in place against the virus may endure, without knowing the exact nature or duration of those restrictions.

Assessment of the macroeconomic forecast

Outlook for 2021 and 2022

Cases of infection were on the rise when the economic forecast of the Ministry of Finance that was published in April was being prepared, and new restrictions were expected, while the main economic figures from the start of the year were not yet known. The good figures for growth in the final months of 2020 gave grounds to assume that GDP would continue to grow in the first quarter of this year, but experts could not agree about the second quarter and the economy was generally expected to make a clear turn towards recovery from the second half of the year.

Information received while the summer forecast was being prepared showed that the Estonian economy was up by 8.5% over the year in the first half of the year, which was faster than expected in the spring. It should be noted again that the economy has recovered faster than expected. The unexpected good news came from the private sector, where exports of goods and services were almost a fifth more than at the same time a year earlier, while the growth in final consumption by the government and in investment expenditures was at 5-6%.

Although the cases of infection started to increase while the summer forecast was being written, news arrived at the same time that the economy was continuing to grow in Estonia and elsewhere in Europe. A major difference from the spring was the higher number of people vaccinated. By the start of September, a little over half of the population had received at least two shots of vaccine, which suggests that the economy will be able to remain more open than during earlier waves of the virus despite new restrictions. This makes it reasonable to adjust the short-term growth forecasts upwards (see Table 1).

Table 1. Key indicators in the macroeconomic forecast for 2021-2022

	2021		2022	
	Summer 2021	Spring 2021	Summer 2021	Spring 2021
GDP at current prices (billion euros)	30.1	28.5	32.4	30.5
Real GDP growth	9.5	2.5	4.0	4.8
Real growth in private consumption	4.4	1.3	3.3	4.0
Real growth in government consumption	3.4	2.9	−1.0	−3.0
Real investment growth	6.8	−15.4	−2.2	8.8
Real growth in exports of goods and services	13.8	6.0	6.5	6.3
Real growth in imports of goods and services	12.5	−0.6	2.3	6.2
CPI growth	3.8	2.0	3.7	2.1
Nominal growth in average wage	7.0	3.9	6.7	5.6
Growth in employment	−0.3	−0.9	1.4	0.8

Source: Ministry of Finance

Faster growth than expected means that the Estonian economy will already be running above its potential level this year, meaning that the output gap will be positive. The Ministry of Finance estimates that the output gap will be small in 2021-2022 and will remain within 0.2-0.6%. The analysis by the Fiscal Council (see Background 1) indicates that a larger output gap could open this year. These differences in the estimates indicate differences of opinion on how the pandemic has affected the potential for growth in the Estonian economy.

Crises typically cause a clear drop in the potential growth of the economy, but the Ministry of Finance estimates that the Covid-19 pandemic has had a modest impact as the potential for growth in the economy is now higher than the estimates from before the pandemic (see Figure 1). The crisis may indeed have given a boost to growth in total productivity through certain sectors such as IT, and business services that use digital solutions, while the labour market measures of the government have helped keep people in the labour market. Equally, unemployment has still risen and employment has fallen, and those changes may be in part long-lasting ones. This suggests that potential GDP growth of 3.5-4% for the years after the pandemic may be an overestimate.

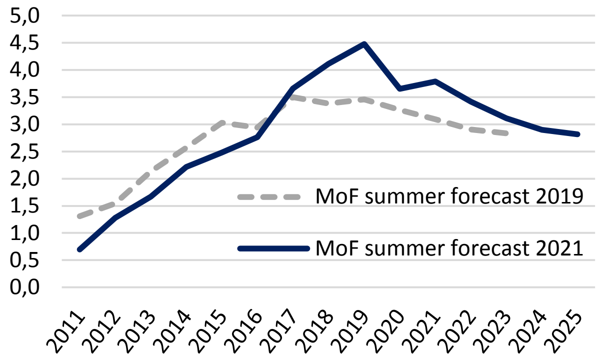

Figure 1. Potential GDP growth (%)

Source: Ministry of Finance

The updated forecast shows that growth in the economy will accelerate in the second half of 2021 to 10.5% over the same period of the previous year. This means that annual real GDP growth for 2021 will rise to 9.5%. This is largely because of the wide-scale fiscal stimulus and the temporary increase in consumption caused by the withdrawal of savings from the second pension pillar. For this year as a whole, GDP measured in both current and constant prices will be larger than it was in 2019 before the pandemic.

In its assessment of the economic environment more generally, the Fiscal Council finds there are two main reasons why growth in the economy may be slower in the second half of 2021 and in 2022 than is assumed in the summer forecast of the Ministry of Finance:

- the expectations of a rapid recovery in the economy due to vaccination in Estonia and the rest of the world may not be realised, and
- the improvement in the supply chains of production inputs and consumer goods may not arrive as expected.

The economic indicators for the first and second halves of 2021 must inevitably be compared with the period of the deep recession last year and the recovery that started in the autumn. The differences in the reference bases make the growth figures for the years hard to compare and interpret (see Figure 2). The volatility has been increased further by recent one-off software investments[1] and difficulties in compiling statistics that are indicated by the larger statistical errors than usual in the structure of the consumption side of GDP, which means the submission of costs over the past 18 months for private consumption, business investment, residential construction, and exports of goods and services is tentative.

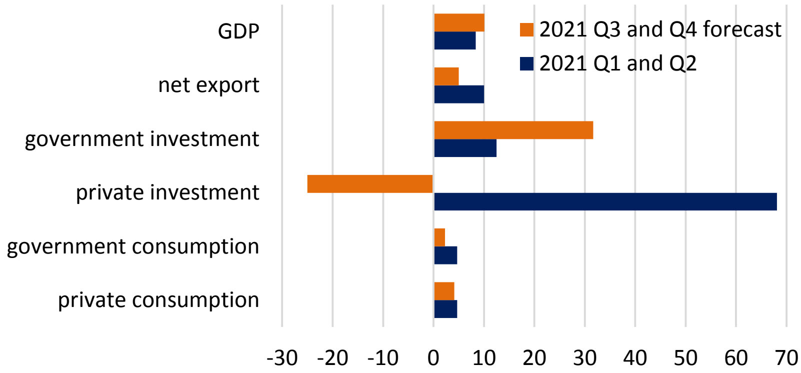

Figure 2. Annual growth in GDP and its main components in 2021 (%)

Source: Ministry of Finance

The forecast predicts growth in the economy over the coming 18 months to be driven by the exporting sector and an expected increase in market share. The shorter-term outlook for the second half of 2021 sees a major contribution to yearly economic growth from increased general government investment that accounts for almost 40% of the expected growth in GDP over the first half of the year. The Fiscal Council considers there is a serious risk that shortages of construction materials and higher prices for them could make it harder for new investment projects to be launched through public procurements and for those already started to be completed. The forecast also assumes the use of funding from the recovery and resilience facility that has not yet been approved by the European Commission and the Council (see Background 2).

The leap in general government investment is equally not in line with the slow growth in imports, which are forecast to provide substantial support for faster GDP growth in the second half of this year and to a lesser extent in 2022. The implications of these important assumptions for growth should be explained thoroughly in the explanatory note. So should the assumptions that bring the current account deficit of the balance of payments from a deficit of 6.5% of the GDP of the half year for the first six months of 2021 to a small surplus for the year as a whole.

While the factors noted above may slow the growth in private consumption and investment, it should equally be noted that more of the money withdrawn from the second pension pillar could be used for consumption than is assumed in the forecast of the Ministry of Finance.

The forecast assumes that price pressures coming from the outside world will weaken further in the coming half year. However, continuing supply difficulties and increased prices for electricity and fuels caused the consumer basket to rise in price by 0.7% in August. The consumer price index is forecast to rise by 3.8% in 2021. Whether the peak in price rises comes in the fourth quarter of this year or early next year will affect the average price indexes for both years substantially. The Fiscal Council considers that the impact of the recent rise in the prices of production inputs on consumer prices in the coming months is underestimated, and it may take longer than assumed for external price pressures to fade. Higher inflation than forecast may however support tax receipts.

[1] There was a large import of software by one multinational company, but GDP was not affected by this transaction.

Comparison with other forecasts

In assessing the forecast of the Ministry of Finance, the Fiscal Council usually also looks at the forecasts of other institutions (see Table 2). Short-term forecasts made during the pandemic depend more on data from the recent past and on current estimates of whether the virus is being contained in line with assumptions. Forecasts differ more widely from one another because of the information that was available when each forecast was prepared. The comparison is only made for those economic forecasts that were able to use data for at least the first quarter of 2021.

Table 2. Forecasts of growth in Estonian GDP and CPI for 2021-2022

	Real GDP growth (%)			CPI (%)	
	2021	2022	total 2021-2022	2021	2022
Luminor (September)	9.2	4.7	13.9	3.8	3.3
Fitch Ratings (September)	9.7	4.8	14.5	3.4	3.8
Eesti Pank (September)	9.5	3.5	13.0	3.6	3.6
SEB (August)*	6.6	4.5	11.1	3.2	2.7
Swedbank (August)	8.0	4.0	12.0	3.1	2.6
Consensus Forecasts (August)*	6.1	4.2	10.3	2.4	2.3
Standard and Poor's (August)	5.5	4.8	10.3	…	…
European Commission (July)*	4.9	3.8	8.7	2.2	2.4
IMF (July)*	3.4	4.5	7.9	1.7	2.5
Average of the forecasts:	*7.0*	*4.3*	*11.3*	*3.5*	*3.3*
Ministry of Finance (September)	9.5	4.0	13.5	3.8	3.7

** Harmonised Index of Consumer Prices. This forecast is not used in calculating the average growth of CPI.*

Sources: Consensus Forecasts, Eesti Pank, European Commission, Fitch Ratings, IMF, Luminor, SEB, Standard and Poor's, Swedbank, Ministry of Finance, calculations of the Fiscal Council

The nearer the forecast was made to autumn, the higher its forecast for growth this year in the economy and in the price level. The summer forecast of the Ministry of Finance is not particularly different from those of other institutions that were able to include the faster growth in the second quarter of 2021 when preparing their forecasts.

Forecasts for inflation reach up to 3.8% for 2021 and 2022. The price level is expected to rise faster than it was predicted to in the spring forecast, but inflation still remains moderate. The spread of the inflation forecasts is wider than usual, and this also applies when the deviations are compared with the spring round of forecasts.

Outlook for 2023-2025

The forecast for 2023-2025 describes an economy approaching a path of growth that is considered sustainable. Given that the Estonian economy got over its crisis faster than expected, it is no surprise that almost all the main macroeconomic indicators are estimated more positively than they were in the spring forecast of the ministry (see Table 3). The main economic indicators for 2023 covering GDP and private consumption and the average wage exceed not only where they were before the crisis, but also the levels forecast for them in summer 2019.

The assumptions for growth in the average nominal wage have changed since the spring. The forecast expects that wage growth will exceed productivity growth a little until 2025, and labour costs will generally increase as a share of GDP throughout the forecast horizon. The driver of wage growth will be the private sector. The Fiscal Council considers that additional explanations are needed for the outlook for changes in wage costs in the general government.

The Estonian government can expect greater fiscal transfers than was forecast before the pandemic because of the recovery and resilience facility, and it is forecast that transfers from abroad will cover the costs of three quarters of general government investment. It is good to note that the explanatory note to the forecast treats these transfers as a fiscal stimulus, even though those monetary flows do not affect the nominal or structural budget position under the rules agreed in the European Union. The large capital injections given to state-owned companies could also be treated as a stimulus, because although they are not classed under expenses under the principles of national accounts, they still add additional money into the economy.

Table 3. Key indicators in the macroeconomic forecast for 2023-2025 (%)

	2023	2024	2025	*change for 2023*	*change for 2024*	*change for 2025*
GDP at current prices (billion euros)	33.9	35.6	37.3	*1.8*	*1.9*	*2.0*
Real GDP growth	2.6	2.9	2.8	*−0.6*	*−0.2*	*−0.1*
Nominal GDP growth	4.9	5.0	4.8	*−0.4*	*−0.1*	*0.0*
Real growth in private consumption	2.4	2.5	2.7	*0.1*	*0.3*	*0.7*
Real growth in government consumption	0.0	0.0	0.0	*−1.0*	*−1.0*	*−1.0*
Real investment growth	5.9	2.0	2.2	*0.8*	*−3.2*	*−0.8*
Real growth in exports of goods and services	4.0	3.2	2.9	*0.2*	*0.0*	*−0.1*
Real growth in imports of goods and services	4.4	2.3	2.2	*0.8*	*−0.7*	*0.0*
CPI growth	2.1	1.9	1.9	*0.1*	*0.0*	*0.0*
Nominal growth in average wage	6.0	5.5	5.4	*0.9*	*0.6*	*0.7*
Growth in employment	0.1	−0.1	−0.2	*−0.5*	*−0.5*	*−0.4*
Employment (thousand people)	664.3	663.6	662.3	*4.5*	*1.1*	*−1.5*
Unemployment rate	5.7	5.6	5.6	*−0.9*	*−0.6*	*−0.4*

Source: Ministry of Finance

The other main assumptions for the medium-term outlook in the forecast are as follows:

- inflation will stabilise at 2%;
- growth in real wages will be the same as that in productivity;
- the unemployment rate will approach its estimated natural level of 6%;
- exports will grow a little faster than foreign demand does;
- the high import content of exports will mean that export prices rise at the same rate as import prices.

These assumptions suggest that the forecast presents an internally balanced view of economic development. These assumptions are more or less the same as they were before the pandemic and are generally accepted by forecasters, but they may not all prove to be correct. Inflation globally and in Estonia in 2023-2025 may not necessarily come down as quickly as forecast for example. Globalisation of the economy, the increased spread of digital solutions and the weak demand environment meant that inflation before the pandemic was for a long time lower than was expected and was considered sustainable. Fuel prices have also been at relatively low levels since 2014. Changes in supply chains, which have so far been only modest[2], and demanding climate policy goals may cause prices to rise faster. Nor has any solution been found for the circumstances in the global economy before the crisis that were caused by geopolitical and international trade tensions.

Overall, forecasting growth in the economy and inflation is currently harder than usual, and so the forecast errors may be larger. The Fiscal Council finds that the economy may grow more slowly than forecast in 2021-2022. Expectations in Estonia and elsewhere of faster growth in the economy because of the success of vaccination may not be realised, and supply chains may take longer than expected to improve. For this reason the Fiscal Council recommends that the preparation of the state budget for 2022 should also take into account the risk scenario in the economic forecast of the Ministry of Finance, which foresees a sharper slowdown in economic growth next year.

[2] See also: https://www.suerf.org/suer-policy-brief/22639/the-impact-of-covid-19-on-global-value-cha

Assessment of the fiscal forecast

The summer 2021 forecast by the Ministry of Finance for the state finances starts from the baseline scenario of the macroeconomic forecast. It is assumed in the fiscal forecast that the support measures introduced for the pandemic will not be extended for 2022 and the faster recovery in the economy than expected will already start to reduce the general government budget deficit strongly this year.

It should be remembered when comparing the summer fiscal forecast 2021 of the Ministry of Finance with the State Budget Strategy drawn up in the spring that the forecasts for 2023-2025 do not use the same assumptions for revenue and spending measures. If all the measures included in the budget strategy are used, the forecast for the budgetary position weakens and budget balance is not achieved by 2025. Additional budget measures beyond those in the summer forecast could also be passed this autumn because tax receipts are better than expected.

Budgetary position in 2021

For the second year in a row, the general government budget deficit is not as large as was initially feared in the forecasts written during the pandemic. The nominal deficit in 2022 was 1.3 billion euros rather than the 2.6 billion forecast, and the Ministry of Finance forecasts for this year that the budget deficit will be around 1 billion euros, or 3.3% of GDP, rather than 1.9 billion (see Table 4). The summer forecast assumes for this that the economy will grow by 9.5% this year and the negative output gap caused by the pandemic will close. The general government structural budget deficit, which excludes the additional income tax revenues received following the changes to the pension system[3], is estimated by the Ministry of Finance at 4.4% of GDP in 2021.

Table 4. The general government budget position for 2021

	State Budget 2021	Spring forecast 2021 / Supplementary Budget 2021	Spring forecast 2021 / State Budget Strategy 2022-2025	Summer forecast 2021
Nominal balance (million euros)	−1898	−1723	−1706	−1006
Nominal balance (% of GDP)	−6.7	−6.0	−6.0	−3.3
Real GDP growth (%)	4.5	2.5	2.5	9.5
Output gap (% of GDP)	−1.7	−2.9	−2.9	0.2
One-off measures (% of GDP)	0.7	0.8	0.8	1.0
Structural balance (% of GDP)	−6.6	−5.5	−5.4	−4.4

Source: Ministry of Finance

The fiscal position has improved with support from a stronger economic environment and tax receipts. The forecast for tax receipts for this year has been raised for a second time since the state budget for 2021 was prepared in autumn 2020 (see Table 5). The forecast for tax receipts was raised in the spring because the crisis had not proven as deep as feared and the tax revenues from changes to the second pension pillar could be taken into account. It is by now clear that the economy has recovered even more strongly than expected, and it is assumed in the summer 2021 forecast of the Ministry of Finance that receipts will be larger for all the main tax types than was predicted in the spring forecast. Tax revenues in the state budget for 2021 are now expected to be 543 million euros larger than in the spring forecast, and as much as 1.1 billion euros larger than was assumed when the state budget was written in autumn 2020.

[3] In spring the Ministry of Finance estimated that the income tax received from those exiting the second pension pillar would add one-off revenue of 240 million euros in 2021 and of 54 million euros in 2022, but these estimates have been changed in the summer forecast to 289 million euros and 54 million.

Table 5. Forecast for tax revenue growth in the state budget in 2021 (%)

	State Budget 2021	Spring forecast 2021 / State Budget Strategy 2022-2025	Summer forecast 2021	Actual growth in 2021 (7 months)
Total tax revenue	3.1	7.3	14.4	12.4
Social tax	1.7	4.8	7.9	8.0
VAT	7.4	6.5	13.8	17.6
Excises	7.3	3.3	7.8	12.6
Personal income tax	−2.6	75.2	104.1	35.3
Corporate income tax	−14.8	−20.1	2.8	8.2

Source: Ministry of Finance

The Fiscal Council finds that the rise in the forecast for tax revenues is justified and that the size of it is in line with actual tax receipts for the first seven months of the year. VAT revenues in the first half of the year grew by as much as 19.5%, and the summer forecast expects that growth will be 9.2% in the second half of the year. Growth in social tax receipts has been between 9% and 9.5% in recent months, and the ministry assumes that it will be around 8% for the year as a whole. Expectations for income tax revenues have been raised by re-estimating the tax revenues paid by those exiting the second pension pillar and by larger distributions of profit by businesses in the first half of the year than had been expected. Receipts of excise have been larger than forecast mainly because fuel consumption has been higher.

It is assumed for the year as a whole that general government revenues will increase by 13% in 2021, and general government spending by 8.9%. Growth in revenues was expected to be 8.7% in the spring, and growth in spending was expected at 10.9%. Spending has grown more slowly because the ministry estimates that the fiscal cost of pandemic support measures in 2021 will be smaller than expected. The ministry has also lowered its forecast for the use of fiscal transfers from abroad, which affects state spending through co-financing, while more public procurements than before are failing because of rising prices.

Budgetary forecast for 2022-2025

The improved economic environment has led the Ministry of Finance to raise its forecast for tax revenues in the longer term as well. The forecast made in the summer for tax revenues in the state budget for 2022-2025 is 620-960 million euros a year more than that made during the spring planning round for fiscal policy, creating good conditions for achieving budget balance faster.

Table 6. The general government budget position in 2020 and the forecast for 2021-2025 (% of GDP)

	2020	2021	2022	2023	2024	2025
Nominal balance (million euros)	−1332	−1006	−579	−361	−154	98
Nominal balance	−5.0	−3.3	−1.8	−1.1	−0.4	0.3
Potential GDP growth (%)	3.7	3.8	3.4	3.1	2.9	2.8
Output gap	−5.0	0.2	0.6	0.1	0.1	0.0
Cyclical component	−2.4	0.1	0.3	0.0	0.0	0.0
Cyclical balance	−2.6	−3.4	−2.1	−1.1	−0.5	0.2
One-off measures	0.0	1.0	0.2	0.0	0.0	0.0
Structural balance	-2.6	−4.4	−2.3	−1.1	−0.5	0.2
Government debt	18.5	17.7	19.3	20.0	19.2	17.9

Source: Ministry of Finance

The summer economic forecast 2021 of the ministry expects the general government nominal budget deficit next year to be 580 million euros or 1.8% of GDP (see Table 6), and to continue declining during the forecast horizon. The outlook for state finances in the years ahead is significantly better than it was in the spring, when the State Budget Strategy (SBS) 2022-2025 was drawn up (see Figure 3). It should be noted in this though, that the baseline scenario for the summer forecast does not take account of the budgetary measures that were in the State Budget Strategy in the spring but have not yet been enacted. The estimated budgetary impact of those measures in 2023-2025 is at least of 0.5-0.6% of GDP (dotted line)[4].

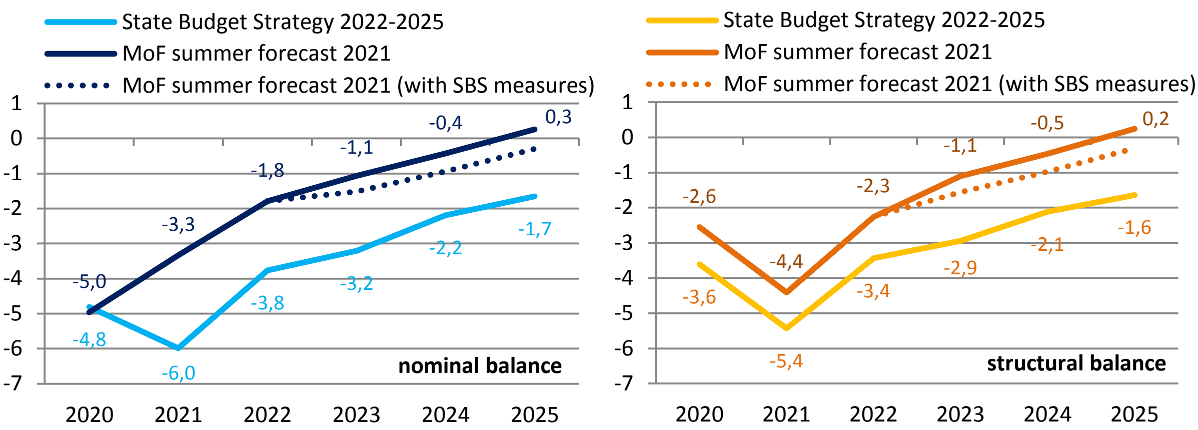

Figure 3. Forecast for the general government budget position 2021-2025 (% of GDP)

Source: Ministry of Finance

The summer forecast of the ministry expects the nominal and structural budget position of the general government to be close to balance by the end of the forecast horizon in 2025. The budget deficit will start to narrow because the rapid growth in spending during the pandemic years will slow next year, and it is assumed that in future the growth in revenues will be faster each year than the growth in spending (see Figure 4). The Fiscal Council considers that the improvement in economic sentiment and expectations of wage rises in the public sector for rescue workers and teachers for example mean that the risk remains that the growth in expenditures will not be successfully kept so low when the next budgetary plans are prepared. In addition, the planning for expenditures has taken no account of accelerated inflation.

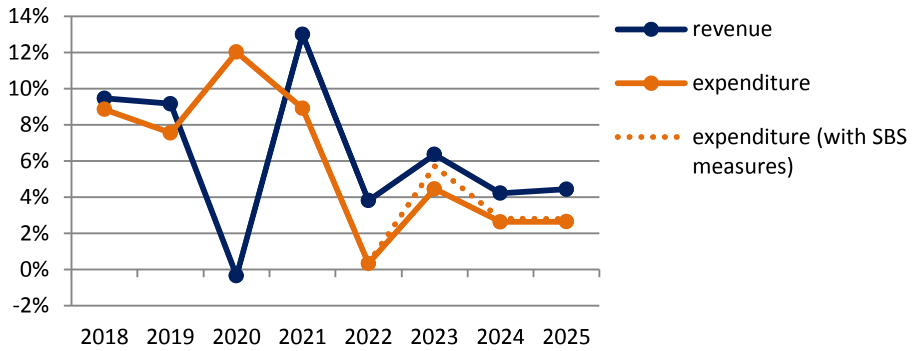

Figure 4. Growth in general government revenue and expenditure in 2018-2025 (%)

Source: Ministry of Finance

[4] This budgetary impact assessment includes a one-off pension increase in 2023 and an income tax exemption for the average pension, the abolition of housing loan interest deductions, electronic registration of employees in construction, a reform of plastic packaging collection, and a more efficient Competition Authority. It does not include the possible rise in funding for R&D due to an improved forecast for the level of GDP.

The growth in general government revenues comes largely from the development of tax revenues in the state budget. To estimate whether the forecast of tax receipts is in line with the macroeconomic forecast, Figure 5 shows the expected development in social tax and VAT as the main components of labour taxes and consumption taxes in comparison with the nominal growth in the tax base and the economy[5]. Assuming that there are no major tax changes, the growth in receipts of social tax and VAT should not generally be much different from the growth in their tax bases or in the economy over the long term.

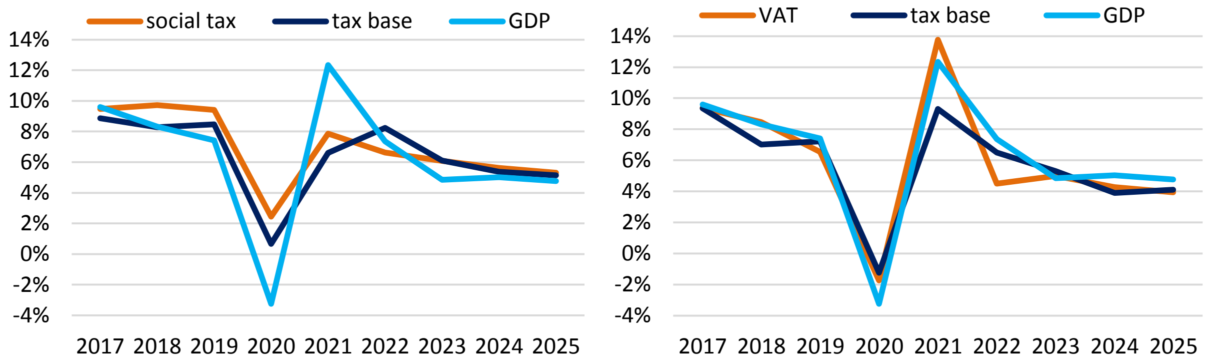

Figure 5. Growth in social tax and VAT receipts compared to nominal growth in the tax base and GDP (%)

Sources: Ministry of Finance, calculations of the Fiscal Council

Labour market support measures meant that social tax receipts continued to grow during the year of recession, although more slowly than previously. Receipts of social tax will improve as wage growth accelerates and employment recovers, and they are forecast to grow by 7.9% this year and 6.6% next year. The growth in social tax in 2023–2025 is in line with the forecast for the growth in the tax base at 5-6% a year.

Receipts of VAT this year are being supported by the general recovery in economic activity and private consumption, with additional domestic contributions coming from the money released from the second pension pillar and rising inflation. The low reference base from last year means that VAT receipts are up this year by almost 14%, but they will grow more slowly next year because the reference base will be higher. The growth in VAT in 2023–2025 is in line with the forecast for the growth in the tax base at 4-5% a year.

Overall the Fiscal Council finds that the forecast by the Ministry of Finance for social tax and VAT receipts is in line with the macroeconomic developments described in the explanatory note to the summer forecast. The forecast for tax receipts in the coming years has been raised substantially from the spring forecast, when the Fiscal Council noted that tax revenues for both consumption and labour taxes might turn out better than forecast. Even so, the Ministry of Finance still considers it possible that a larger part of the funds withdrawn from the second pension pillar and the voluntary savings built up during the pandemic may make it into consumption than has been forecast.

[5] The VAT tax base in Figure 5 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.

Compliance with the fiscal rules

The general government structural budget position is arrived at by subtracting the impact of the economic cycle and one-off or temporary budget measures from the nominal budget position. The commonly used measure for the cyclical position of the economy is the output gap, which compares the actual output of the economy with its estimated potential. There is currently more uncertainty than usual about the forecast for actual GDP and the estimates of economic potential, as it is hard to assess how the pandemic may affect the growth potential in both the short and long-term perspectives. The summer forecast 2021 of the Ministry of Finance assumes that the Estonian economy will reach its potential level this year and remain close to it throughout the forecast horizon (see Table 6 and Figure 6).

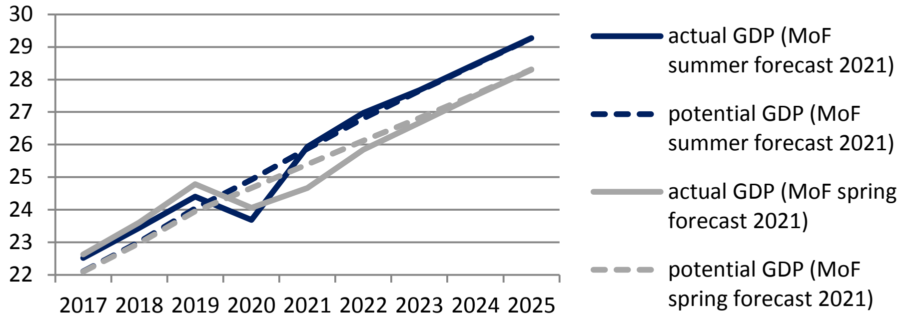

Figure 6. Actual and potential GDP volumes at constant prices (billion euros)

Source: Ministry of Finance

The potential GDP of the years before the pandemic is similar to what it was in the spring forecast, but the level of potential GDP for 2020 and that for the whole forecast horizon have been raised. It should also be noted that Statistics Estonia has recently updated the GDP data and has reduced its assessment of actual output volumes before the pandemic. Taken together this means that the positive output gap from before the crisis has been reduced in size in the summer forecast of the Ministry of Finance, while the negative output gap in 2020 has been widened to -5% of GDP, and the gap will close after the crisis much more rapidly than was earlier expected.

The summer forecast 2021 of the Ministry of Finance puts the structural budget deficit of the Estonian general government at 2.3% of GDP for 2022 (see Figure 7). The estimate of the structural budget deficit is in line with the assumption of a nominal budget deficit of 1.8% of GDP and an output gap of 0.6% of GDP. If the output gap proves larger than forecast, the structural deficit will deepen. Calculations by the Fiscal Council using the figures from the summer forecast but a different methodology for estimating the cyclical component of the budget indicate a similar structural budget deficit in the future.

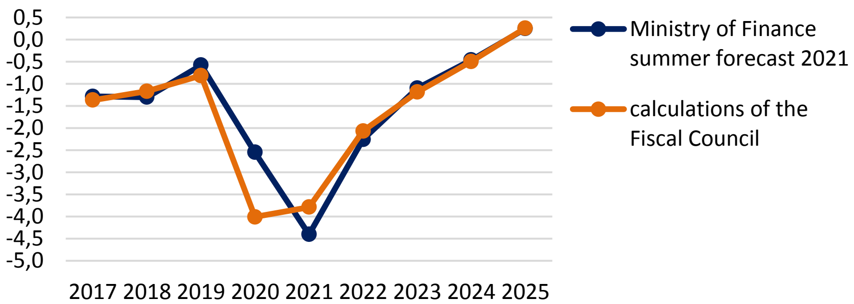

Figure 7. Estimates for general government structural balance 2017-2025 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

The Ministry of Finance estimates that the structural budget position of the general government will improve by more than two percentage points in 2022 and thereafter by at least 0.5 percentage point a year. It should be noted here though that the structural deficit for 2020-2021 contains the budgetary costs of the pandemic support measures that are mainly temporary in nature and that distort the comparison over years, and that the outlook in the summer forecast does not contain all of the budget measures that were planned in the spring or this autumn.

An escape clause of the fiscal rules in the European Union and Estonia was activated in spring 2020 to ease the negative economic impact of the Covid-19 pandemic, and it exempted member states temporarily from the previous numerical limits on fiscal policy. The exemption was originally intended for 2020 but it was extended to 2021 and then to 2022[6]. The most recent economic forecast from the European Commission suggests that the escape clause will probably no longer be justified in 2023.

As the Estonian economy was already showing signs of a rapid recovery from the pandemic in spring 2021, the Fiscal Council recommended that the government draw up its state budget for 2022 as if the escape clause did not apply in 2022 regardless of the decision of the European Commission. This meant that the nominal deficit should not exceed 3% of GDP and the structural deficit should start to be reduced by at least 0.5 percentage point a year. Developments in the Estonian economy in the meantime have shown that this recommendation was justified, and working from the summer forecast of the Ministry of Finance, the Fiscal Council considers that an even more ambitious target should be set in the state budget for 2022.

The pandemic that broke out in spring 2020 and the policy measures taken to ease its impact meant that Estonian general government revenues were smaller than expected and expenditures were higher. Negative supplementary budgets had to be passed in spring 2020 and spring 2021 and government debt was doubled from what it was before the crisis. The general government nominal budget deficit reached 1.3 billion euros in 2020 and it is forecast that this year general government expenditures will exceed revenues by around a billion euros.

Strong tax receipts have recovered by now and the outlook for state finances from next year no longer contains the state support measures taken to ease the economic impact of the pandemic. The general government budget position will start to improve in future in the summer forecast of the Ministry of Finance, but the nominal budget deficit of the next four years will still total around a billion euros, even without the budgetary expenses that could yet be added to the forecast. Working from the summer forecast of the Ministry of Finance for the general government budget position, the Fiscal Council does not see any need for additional fiscal stimulus in the Estonian economy in the years ahead.

The spring forecast of the Ministry of Finance expected the negative output gap in the Estonian economy to close only by the end of the forecast horizon in 2025, but the summer forecast finds that this will already happen this year and the gap will remain closed throughout the forecast horizon. Stimulating the economy further at a point where it is already operating at its capacity, or even temporarily beyond it, could in the short term reduce the purchasing power of consumers and in the long term hurt the competitiveness of Estonian companies.

The Fiscal Council considers that the improved outlook for the economy and the state finances allows the government to set more demanding targets for the budgetary position than those that were in the State Budget Strategy 2022-2025 in the spring.

[6] See also: https://ec.europa.eu/commission/presscorner/detail/en/ip_21_884

Background 1. *A macroeconomic heatmap for Estonia*

To assess 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 8), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating. The advantage of the heatmap is that the figures used in it (apart from the economic sentiment index) are not usually revised retrospectively.

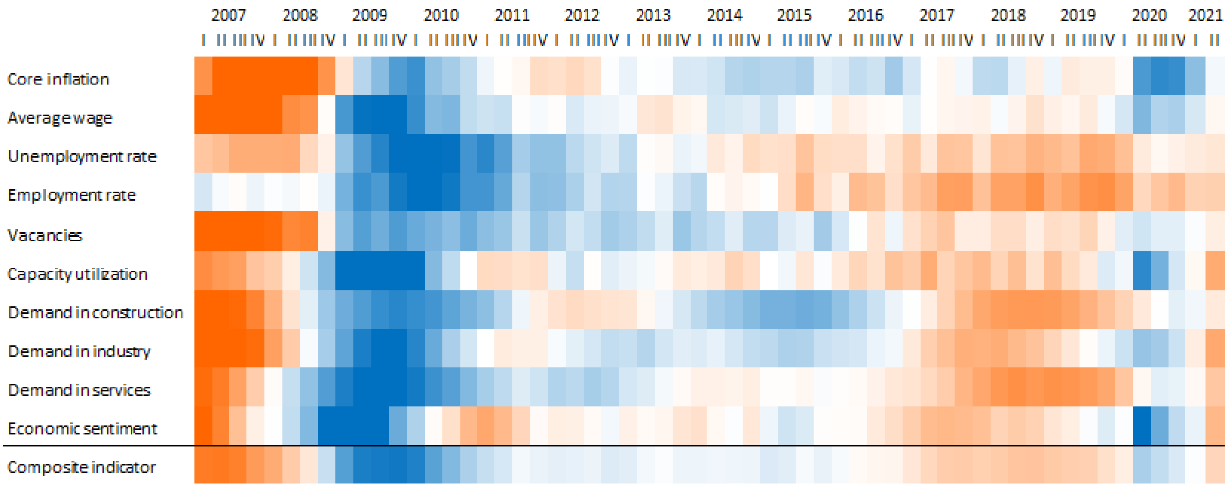

Figure 8. Macroeconomic heatmap for Estonia (Q1 2007 – Q2 2021)

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

After peaking in 2017-2019, the economic cycle turned in 2020 as the spread of Covid-19 and the restrictions introduced to stop it caused recessions in Estonia and elsewhere in the world. The impact of the crisis was most sharply felt in the second quarter of 2020. Subsequent quarters saw a gradual improvement in economic circumstances and by the second quarter of 2021 all of the economic indicators in the heatmap had again returned to their long-term average levels, or had exceeded them. The composite indicator of the heatmap indicates that a larger positive output gap could open this year than that expected in the summer economic forecast of the Ministry of Finance (see Figure 9).

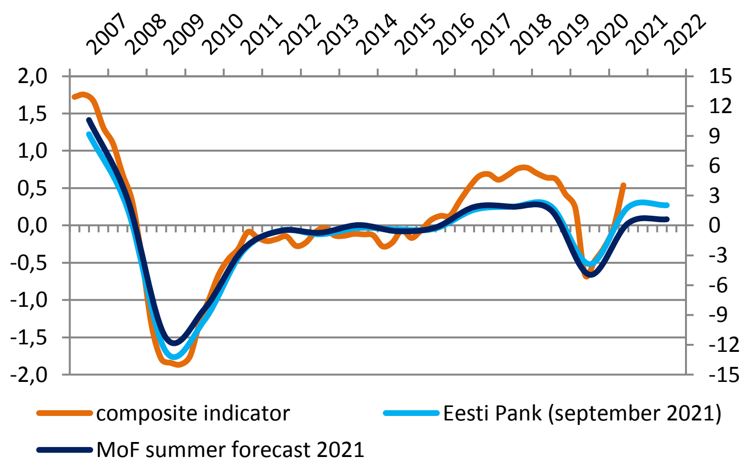

Figure 9. The composite indicator for the heatmap (left scale) and the output gap in % of GDP (right scale)

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

Background 2. *Estonian Recovery and Resilience Programme*

To help countries get over the Covid-19 pandemic and to promote structural reforms, it was decided at the meeting of the European Summit in July 2020 to create a temporary recovery fund called Next Generation EU to supplement the European Union budget. The main funding instrument in this is the Recovery and Resilience Facility (RRF), from which member states can receive support for carrying out reforms. The funding for this facility at the European Union level is around 724 billion euros at 2020 prices, of which 47% is intended as grants, and 53% as loans. The subsidies are intended for use in the years 2021-2026.

To fund the new instrument, the European Commission started issuing bonds in its own name in June 2021. To repay the debt, the member states have agreed to increase their contributions to the European Union budget from 2028. The repayment period for the debt is planned at up to 30 years.

To receive the grants, member states must submit a Recovery and Resilience Programme (RRP), which must be approved by the European Commission and by the council. The Estonian government approved the implementation programme drawn up for using the support in June this year and submitted it for approval to the European Commission. The Estonian Recovery and Resilience Programme is of 970 million euros in size. It has been agreed that each country receiving the support will spend at least 37% of the money received on the green agenda and at least 20% on promoting the digital economy. The Estonian application abides by this agreement (see Figure 10). An estimated 80% of the recovery programme is intended for investment. The European Commission and the council had not yet approved the Estonian programme when the opinion of the Fiscal Council was published.

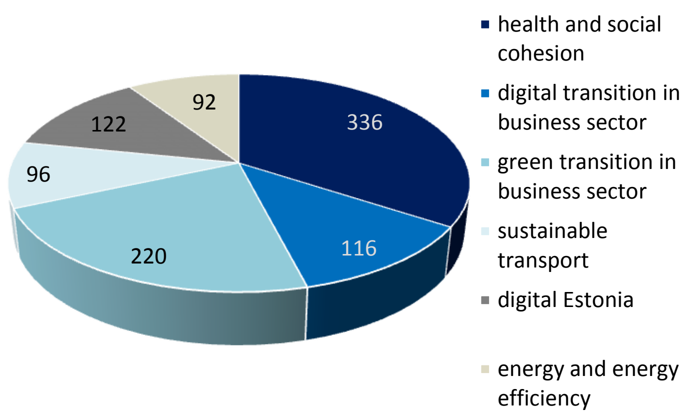

Figure 10. Use of the funds in the Estonian Recovery and Resilience Programme (million euros)

Source: Ministry of Finance

It has been agreed that the countries that suffered more in the crisis will receive relatively more support. Following this principle, new updated programmes for dividing the subsidies between countries will be drawn up by June 2022. If the Estonian economy is performing better than others, the amounts quoted above could be reduced by up to 150 million euros. Current assessments suggest it is probable that Estonia will receive foreign transfers of up to 8.4 billion euros in 2021-2027. The Estonian Recovery and Resilience Programme would make up a little over 10% of that under the current distribution.

Background 3. *Revisions to estimates of the output gap*

The output gap measures the difference between the output of an economy in a given year and the potential output of that economy. The gap is positive when the economy is running above its potential, which could be inefficient and can cause inflationary pressure, and it is negative when the economy is producing less than its potential, which is wasteful. Avoiding such inefficiencies by keeping the economy running close to its potential is one of the major macroeconomic objectives of governments, and this is done using stabilisation policies.

Setting the correct stabilisation policy needs precise and reliable signals about the position of the economy in the business cycle. One such signal is the estimate of the output gap for the current or the previous year.

Estimates of the output gap are also very important because they are one of the main variables used for calculating the structural budget position, which is the general government budget balance after the effect of the business cycle has been removed and one-off spending and revenue measures have been subtracted. The structural budget position is a central number in the set of those used for applying the European Union and national fiscal rules.

To assess whether those rules were respected in the previous year and whether the plans for the current year will respect them, and to determine whether any adjustments to fiscal policy are needed, it is essential that the previous and current structural balances be estimated correctly.

As the estimates of the output gap are so important for assessing and setting macroeconomic policies, it is equally important to establish how precise and reliable those estimates are. This box contributes statistical evidence that can help to answer this. An estimate that is precise is one where later revisions are not very large. It is reliable if later estimates for the same year agree with the initial estimate that the economy is above or below its potential.

Table 7 shows the estimates for the Estonian output gap published by the European Commission in successive spring economic reports.

Table 7. Gap between actual and potential gross domestic product (% of potential GDP)

Reports	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*2018*	*2019*	*2020*	*2021*	*2022*
S 2006	0.4	1.1	1.0															
S 2007	-0.1	1.7	0.7	-0.9														
S 2008	1.9	4.7	4.0	-0.5	-2.9													
S 2009	4.4	8.8	10.4	3.3	-8.6	-10.3												
S 2010	4.3	8.3	11.0	4.5	-10.1	-8.6	-4.8											
S 2011	7.4	10.7	11.8	3.2	-11.1	-7.7	-3.2	-0.3										
S 2012	7.0	10.7	12.9	5.5	-9.8	-7.7	-1.5	-1.9	-0.8									
S 2013	5.5	9.3	12.0	4.6	-9.4	-6.0	0.5	1.4	1.2	1.3								
S 2014	5.8	9.8	12.4	4.8	-9.6	-7.0	0.3	2.6	1.3	0.7	0.8							
S 2015	6.3	10.7	13.9	5.2	-9.6	-7.0	-0.7	2.2	1.6	1.3	1.0	1.3						
S 2016	6.8	11.4	14.8	6.0	-9.0	-6.7	-1.2	2.1	1.4	1.8	0.3	-0.2	0.2					
S 2017	6.4	11.0	14.4	5.7	-9.0	-6.6	-0.8	1.8	1.3	2.0	1.0	0.3	0.1	0.6				
S 2018	6.3	10.7	14.0	5.4	-9.3	-6.8	-1.0	1.6	1.4	1.9	0.8	0.4	2.1	2.9	2.8			
S 2019	6.2	10.6	13.9	5.2	-9.5	-7.0	-1.2	1.3	1.0	1.2	0.3	1.1	2.7	3.3	2.8	2.2		
S 2020	6.1	9.7	12.4	4.4	-9.6	-6.3	0.03	1.7	1.0	1.4	0.4	0.4	2.6	3.9	4.3	-5.3	-3.0	
S 2021	4.6	8.3	10.9	2.8	-11.2	-8.3	-2.3	-0.6	-0.8	-0.04	-0.7	-0.3	1.8	2.2	2.8	-4.3	-4.5	-2.8

Note: t corresponds to estimates for the current year, so it is for example the estimate of the 2005 output gap published in spring 2005; t + 1 corresponds to the estimate for the previous year, so the estimate of the 2005 output gap published in spring 2006; and so on for higher values of t. The units are percentage of potential GDP at constant prices.

Source: European Commission

In the period 2005-2019, running from Estonia's first full year in the EU until the year before the Covid-19 pandemic, there are eight years for which the output gap changed sign at least once in the subsequent spring estimates. In two of these eight cases the sign of the output gap changed twice, as the economy was first deemed to be below potential, then above potential, and then again below potential. In another case the output gap sign changes three times, starting above potential and finishing below potential, and in one case the estimate of the output gap changed its sign four times. Over the 15 years, the estimate for the output gap retains its sign and so is reliable in seven cases.

The estimates for the output gap are presented over time in Figure 11.

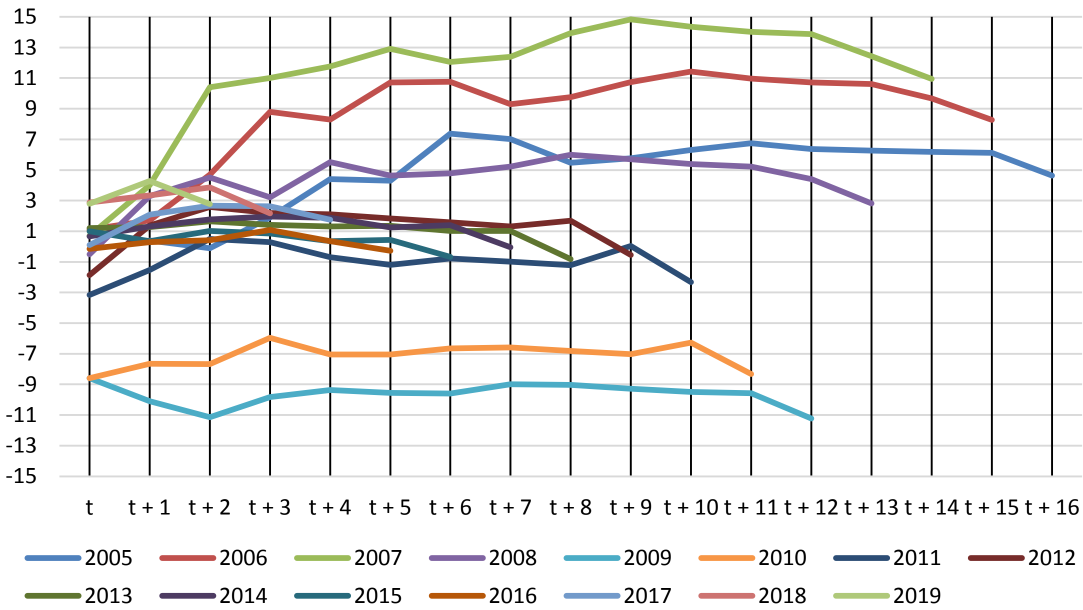

Figure 11. Estimates of the output gap (% of potential GDP)

Note: t corresponds to estimates for the current year, so it is for example the estimate of the 2005 output gap published in spring 2005; t + 1 corresponds to the estimate for the previous year, so the estimate of the 2005 output gap published in spring 2006; and so on for higher values of t. The units are percentage of potential GDP at constant prices.

Source: European Commission

The estimates for each year keep changing up and down over successive spring publications.

Table 8 presents descriptive statistics for the absolute value of the revisions of estimates for previous years some time later. An estimate is for example published in spring 2006 for the output gap of the previous year, 2005, then this estimate is revised a year later in spring 2007, two years later in spring 2008, and so on. A revision is simply the difference between two estimates. The statistics are calculated from the absolute value of the revisions to avoid any misleading cases of a zero average concealing two large revisions that cancel each other out because of their opposite signs even though they may be large in size.

Table 8. Output Gap - Revision from the estimate of the previous year to...

	2005 - 2019				2008 - 2019			
Time horizon	Average	S.D.	Max	N	Average	S.D.	Max	N
...1 year later	1.3	1.6	6.4	15	0.8	0.6	2.0	12
...2 years later	1.7	2.2	7.1	14	0.8	0.6	1.8	11
...3 years later	1.9	2.5	7.8	13	0.6	0.6	2.2	10
...5 years later	2.7	3.3	9.0	11	0.7	0.5	1.5	8
...spring 2021	2.1	2.1	6.9	15	1.1	0.5	2.1	12

Note: the descriptive statistics are calculated over the absolute value of the revisions. Units are the percentage of potential GDP at constant prices.

Sources: European Commission, author's calculations

The data used start in 2005, which was Estonia's first full year in the European Union. Two periods are shown, one of them using all the data, and one covering 2008-2019, which includes the financial crisis during which real GDP growth was negative in Estonia in 2008 and 2009, and the subsequent recovery running up to but not including the Covid-19 pandemic.

The average revisions for 2005-2019 and at all time horizons are always larger than 1.3 percentage points and the maximum for the revisions is always above 6.4 percentage points. The variation in the magnitude of the absolute value of the revisions is measured by the standard deviation (S.D.), which is always larger than 1.5 percentage points.

As the output gap estimates for 2005, 2006 and 2007 were very heavily revised (see Table 7), the averages, maximums and standard deviations using the shorter sample are lower at all time horizons than are those found using the longer sample. The averages for the shorter sample are all larger than 0.6 percentage point, the maximums are greater than 1.4 percentage points and the standard deviations are all above 0.5 percentage point.

Table 9 presents descriptive statistics for the absolute value of the revisions of current year estimates a year or more later. As an example, the current year estimate for 2006 is published in spring 2006, and its revision one year later corresponds to the difference between the estimates for 2006 published in spring 2006 and spring 2007.

Table 9. Output Gap - Revision from current year estimate to...

	2006 - 2019				2008 - 2019			
Time horizon	Average	S.D.	Max	N	Average	S.D.	Max	N
...1 year later	1.5	1.2	3.8	14	1.4	1.1	3.8	12
...2 years later	2.5	2.6	9.7	14	1.9	1.7	5.0	12
...3 years later	3.0	2.9	10.3	13	1.9	1.3	4.0	11
...5 years later	3.3	3.9	12.2	11	1.6	1.6	5.1	9
...spring 2021	2.3	2.8	10.2	14	1.3	1.0	3.3	12

Note: the descriptive statistics are calculated over the absolute value of the revisions. Units are the percentage of potential GDP at constant prices.

Sources: European Commission, author's calculations

The estimates for the current year are naturally highly likely to be revised as they are calculated using only information received up to late April, and so they cannot take account of later macroeconomic developments and changes in fiscal policy that may very well be made in response to the spring estimate. They are nevertheless essential as early indicators of the position of the economy in the business cycle and as ingredients for the current year estimate of the structural balance position.

From Tables 8 and 9, it is not surprising that all the averages and maximums for the revisions, with only one exception, are larger in Table 9, as that table considers current year estimates. The smallest of the averages is 1.5 percentage points for the longer sample and 1.3 for the shorter sample. The smallest of the maximums is the exception noted, which is 3.8 percentage points of potential GDP, which is also the smallest maximum in the shorter sample. With one exception, the standard deviations of the absolute value of revisions of the estimates for the current year are larger than those of previous year estimates. All the standard deviations in Table 9 are larger than 0.9 percentage point.