EELARVENÕUKOGU
FISCAL COUNCIL

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

September 2023

Contents

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

Opinion

The summer 2023 forecast of the Ministry of Finance projects that the contraction in the Estonian economy this year will be larger than was thought in the spring. Weak foreign demand has pushed back the recovery in real GDP growth from the second half of 2023 to 2024. High inflation means though that there is a notable gap between the real values and nominal values for the indicators for economic growth. The nominal value of GDP in Estonia, which is closely connected to state tax revenues, has been increased for the forecast horizon since the spring.

The Fiscal Council endorses the summer forecast 2023 of the Ministry of Finance and finds that it is a suitable basis for drafting the state budget 2024 and the budget strategy for the next four years. While the spring forecast did not yet cover the coalition agreement for the new government and the goal of reducing the budget deficit, the summer forecast of the Ministry of Finance takes account of the tax changes and spending decisions that came into force in summer 2023.

The general government budgetary position in 2023 and 2024 is better than it was in the spring forecast by around 400-500 million euros. The 2023 budget deficit could consequently prove smaller than forecast if not all of the planned spending and investment is executed in the second half of the year. The summer forecast of the Ministry of Finance finds that the government will achieve the target it has set itself for 2024 of not letting the budget deficit exceed 3% of GDP.

It forecasts though that the budget deficit will exceed 4% of GDP from 2025 onwards. The outlook for the state finances remains difficult in the longer term because the government has accompanied its tax rises with decisions that will reduce revenues and increase spending. The changes in the macroeconomic outlook have increased both state revenues and expenditures at the same time. This means that moving forward the state budget will still not cover the extra increases decided on in recent years for spending on health, social protection and national defence.

The Fiscal Council considers that the budget deficit should be steadily reduced from 2024 onwards. As the escape clause of the European Union's fiscal rules expires in 2023, the fiscal targets set in the state budget strategy will again have to apply both the European Union's fiscal rules and the national ones. Keeping to the rules means that an additional substantial improvement in the budgetary position will be needed from 2025 on top of the measures already decided. The summer forecast did not yet include car tax, higher environmental fees or additional cuts to expenditures apart from a reduction in the increase in family benefits.

The budget strategy will need to take account of the uncertainty that surrounds the economic climate in Estonia and the forecast for real growth and inflation, since the Estonian economy could grow faster or more slowly than has been forecast. It is also more difficult than usual to estimate the cyclical position of the Estonian economy. It should also be noted that the large number of changes to the tax system in the coming years could cause forecast errors for tax revenues to be larger than usual, and that large changes to fiscal policy feed back into the macroeconomic forecast.

Vice-Chair of Fiscal Council
Andrus Alber
Tallinn, 7 September 2023

Explanatory Report

It is the task of the Fiscal Council to assess the state's official economic forecasts produced by the Ministry of Finance. The Fiscal Council finds that the summer economic forecast 2023 of the Ministry of Finance is a suitable basis for preparing the state budget and the budget strategy for 2024–2027. The government uses the state budget strategy to set its budgetary targets for the next four years.

Assessment of the macroeconomic forecast

The outlook for 2023–2024

Economic forecasters including the European Commission and Eesti Pank expected in the spring that growth in the Estonian economy would recover in the second half of 2023. The summer economic forecast issued by the Ministry of Finance postpones this improvement in circumstances to 2024.

Real growth in the economy in recent quarters has not kept pace with forecasts, while inflation has at the same time come down more slowly than forecast. Nominal GDP growth has consequently in total been faster than expected. This is all reflected in the summer economic forecast 2023 of the Ministry of Finance (see Table 1)[1].

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

	2023		2024	
	Spring 2023	Summer 2023	Spring 2023	Summer 2023
GDP at current prices (billion euros)	38.3	38.8	40.5	41.4
Real GDP growth	−1.5	−2.0	3.0	2.7
Real growth in private consumption	−1.1	0.0	2.4	1.5
Real growth in government consumption	4.5	2.3	−3.0	0.0
Real growth in investment	5.7	−2.1	3.8	3.1
Real growth in exports of goods and services	−1.0	−4.2	3.2	2.9
Real growth in imports of goods and services	−1.4	−4.7	1.9	1.4
CPI growth	9.2	9.6	3.0	4.6
Nominal growth in average wage	9.0	11.2	5.7	6.6
Growth in employment	0.3	1.0	0.6	0.4

Source: Ministry of Finance

The official data for the second quarter of 2023 were not yet known when the summer economic forecast was written. Data released by Statistics Estonia on 31 August show that the GDP price index, which primarily reflects domestic price pressures, fell to close to 8%, which is below the level forecast by the Ministry of Finance as the average for the year. There are unfortunately not yet enough data to see whether this indicates a faster recovery in the economy, or slower nominal growth.

Regarding developments in public finances, both GDP growth at current prices and growth in labour costs were faster in first half of the year than was forecast in the spring, and so tax revenues were better than expected. The Fiscal Council also noted in the spring that wage growth may prove faster than forecast.

[1] It should be noted with the rate of growth that Statistics Estonia revised its earlier time series for GDP in August. GDP at current prices in 2022 consequently turned out be 0.5% smaller than earlier estimated, while at constant prices it remained practically the same.

It is forecast that fiscal policy will support growth in the economy more in the second half of 2023 than it did in the first half. End consumption and investment by the general government at constant prices are expected by the summer forecast of the Ministry of Finance to be a fifth larger in the second half of the year than they were in the first half of the year. Growth in private sector spending will remain at around 2-3% though (see Figure 1, left panel). Ignoring the number of working days and seasonal factors, GDP will grow by 6-7% from the first half of the year, meaning that the downturn in the economy will start to come to an end. GDP will still be around 1% smaller than it was in the second half of last year, and growth over the year will only start to recover next year (see Figure 1, right panel).

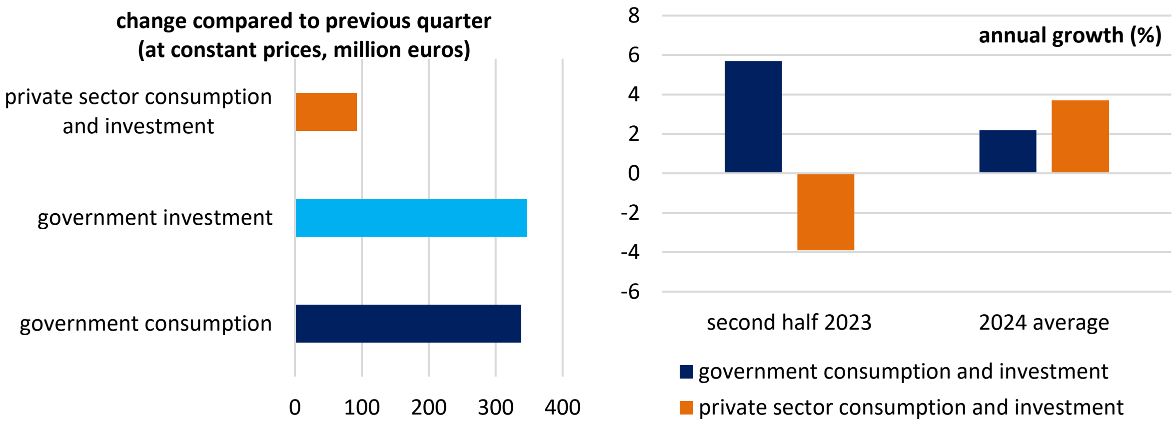

Figure 1. Growth in government and private sector consumption and investment expenditures

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

The Ministry of Finance expects that the general government budget deficit will be smaller in 2024 than in 2023. However, when estimating the impact of fiscal policy on the economy, the use of transfers from the European Union budget should also be taken into account. As some of the spending will be postponed, the transfers received from the EU will be larger in 2024 as a ratio to GDP than they are this year. This is a factor that supports growth in the economy, but does not substantially affect the government's budget deficit.

Only a few economic forecasts took account of the changes to tax and social policy that were approved in summer 2023 when the opinion of the Fiscal Council was written took. The forecast of the Ministry of Finance is close to the average of other forecasts (see Table 2). The differences between the forecasts of real GDP growth and inflation for 2023-2024 are smaller than the forecast errors that were usual before the crisis. All the forecasts expect that growth in the economy will recover in 2024 and inflation will be at least 3.5%, indicating that nominal growth in GDP will be relatively fast. The Fiscal Council considers that given the volatility in the economic environment, both faster and slower growth in the economy is possible.

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

	2023	2024	2023	2024	2023–2024 total	
	Real GDP growth (%)		CPI (%)		Real GDP growth (%)	CPI (%)
Swedbank	−2.0	2.0	9.8	4.3	0.0	14.5
Consensus Forecasts	−0.9	2.9	9.8	3.5	2.0	13.6
Eesti Pank	−1.0	2.5	9.1	3.9	1.5	13.4
IMF*	−1.6	2.9	9.7	3.7	1.3	13.8
Ministry of Finance	−2.0	2.7	9.6	4.6	0.6	14.6

**IMF forecasts HICP inflation*

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

Overall the Fiscal Council finds that the information available at the time the forecast was written was used as well as possible, and the summer economic forecast describes the near-term outlook for the Estonian economy with sufficient reliability. For this reason the Fiscal Council endorses the summer forecast 2023 of the Ministry of Finance and considers it a suitable basis for setting the state budget 2024.

The outlook for 2025–2027

The Fiscal Council noted in its opinion on the spring forecast 2023 of the Ministry of Finance that events in the past couple of years have increased the risks to economic forecasts over the medium term. By this it meant that it was not yet clear whether the recent pandemic caused lasting changes to supply chains or to the location of production and what those changes would be. It is equally hard to estimate how the war between Russia and Ukraine dragging on for a long time will affect international economic relations. It is so far clear only that those events have caused lasting increased expenditures for the government on strengthening national defence.

The risks to the medium-term outlook for the economy are the same size as they were in the spring and there have so far been few structural changes that may be considered lasting. It is consequently to be expected that the economic forecast made for 2025-2027 is relatively unchanged from the spring and mainly reflects inflation in 2023-2024 being higher than expected. GDP at current prices is consequently also larger in the later years of the forecast horizon than was forecast in the spring (see Table 3).

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

	2025	2026	2027	2025*	2026*	2027*
GDP at current prices (billion euros)	43.7	45.8	47.9	1.3	1.6	1.9
GDP at constant prices (billion euros)	26.6	27.3	27.9	–0.1	0.0	0.0
Real GDP growth	3.0	2.5	2.2	0.5	0.2	0.2
Nominal GDP growth	5.5	4.8	4.4	0.8	0.6	0.3
Real growth in private consumption	4.5	1.3	2.1	3.0	–1.1	0.3
Real growth in government consumption	0.5	0.0	0.2	0.0	0.0	0.0
Real growth in investment	3.9	6.4	1.4	0.5	4.9	0.0
Real growth in exports of goods and services	3.4	3.2	3.0	–0.2	0.0	0.0
Real growth in imports of goods and services	4.2	3.0	2.2	1.2	0.5	–0.2
CPI growth	2.5	1.7	1.9	0.4	0.4	0.0
Nominal growth in average wage	5.3	4.9	4.5	1.2	0.6	0.3
Growth in employment	0.1	0.0	0.0	–0.2	0.0	0.0
Employment (thousands)	687.6	688.0	688.0	2.2	2.3	2.3
Unemployment rate	6.4	6.2	6.1	–0.5	–0.4	–0.4

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

It was not yet known when the summer forecast of the Ministry of Finance was written what spending cuts or additional measures would be taken on top of those that had come into force in the summer to improve the budgetary position over the medium term. The general government budget deficit is forecast to exceed 4% of GDP in the later years of the forecast horizon. It is also forecast that transfers from the EU in 2025-2026 will be even larger as a share of GDP than in the best years of the past, and that they will reach 3% of

GDP. This is because growth in the economy in those years will receive additional support from transfers from the Recovery and Resilience Facility[2].

Overall the Ministry of Finance has followed generally accepted methodological approaches in writing the forecast and has used accepted assumptions about the performance of the global economy. Given the existing risks and the general geopolitical uncertainty, the summer forecast gives a sufficiently reliable picture of the near-term outlook for the Estonian economy that it can be used for drafting the state budget strategy. It should be noted though that large changes to fiscal policy feed back into the macroeconomic forecast.

Assessment of the fiscal forecast

The forecast for the state finances for 2023-2027 has been updated by the Ministry of Finance together with the summer macroeconomic forecast. While the spring forecast did not yet cover the new coalition agreement and the goal of reducing the budget deficit, the summer forecast of the Ministry of Finance takes account of the tax changes and spending decisions that came into force in summer 2023.

Budgetary position in 2023

The general government nominal budgetary position in 2023 will again be stronger than was estimated in spring, as the spring forecast from the Ministry of Finance expected the budget deficit to be 4.3% of GDP, but the summer forecast puts the deficit for 2023 at 3.3% of GDP[3]. The budget deficit for this year will be smaller than was forecast in the spring because of faster growth in wages and lower unemployment in the first half of the year, which have increased the forecast for tax revenues in 2023.

Whether this forecast for the budget deficit proves accurate depends greatly on whether the spending and investment planned for the second half of 2023 actually occurs. The nominal budget deficit for the general government in the first half of the year was estimated by the Ministry of Finance at only 346 million euros or 0.9% of total GDP for the year (see Figure 2).

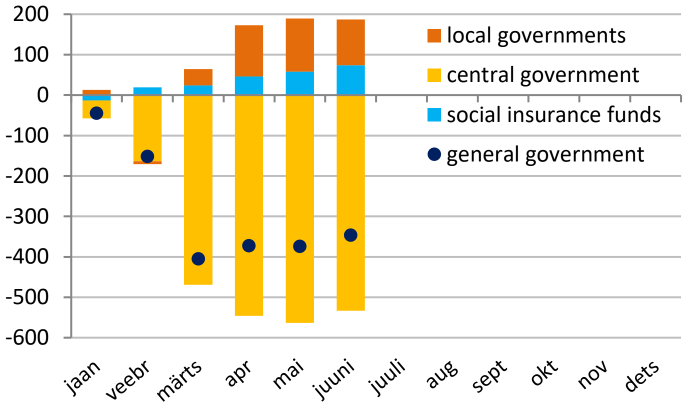

Figure 2. The nominal budgetary position for 2023 by subsectors (million euros)

Source: Ministry of Finance

[2] The European Union's Recovery and Resilience Facility (RRF) is a temporary source of crisis funding that member states can use to get financial support for structural reforms. Estonia's updated recovery plan is of 953.3 million euros, and it was approved in June 2023.

[3] The forecasts by the European Commission, the OECD and Eesti Pank that were published in May and June all indicate a similar budget deficit of 3.1-3.4% of GDP in 2023.

The ministry expects that the majority of the investment and the spending on defence by state and local governments will happen in the second half of the year. As the general government expenditures in 2023 were no different in the summer forecast to what they were in the spring, the forecast consequently points to a sharp deterioration in the budgetary position in the second half of the year.

If some of the spending and investment does not happen in 2023 however, the Fiscal Council considers that, similarly to previous years (see Background 1), the actual budgetary position of the general government may prove stronger than in either the spring or summer forecast. Shifting spending into 2024 could however increase the budget deficit next year if all else remains the same, and so threaten the government's target of keeping the deficit below 3% of GDP.

Budgetary forecast for 2024–2027

The summer forecast of the Ministry of Finance does not confirm the possible expectation that the budgetary position being stronger than expected in 2023 combined with the revenue and expenditure measures in the coalition agreement that are covered for the first time in the forecast could substantially improve the outlook for the state finances over the medium term, and that this could even give grounds for abandoning the tax plans and spending cuts that have not yet come into force.

The summer forecast expects the general government nominal budgetary position to improve only in the short term (see Figure 3) and predicts that the budget deficit in the longer term will be similar to what was expected in the spring forecast at more than 4% of GDP. Although several taxes will rise in 2024 and 2025 and the forecast of the Ministry expects this to increase general government tax revenues, there are other decisions in the coalition agreement that will reduce revenues and increase spending[4].

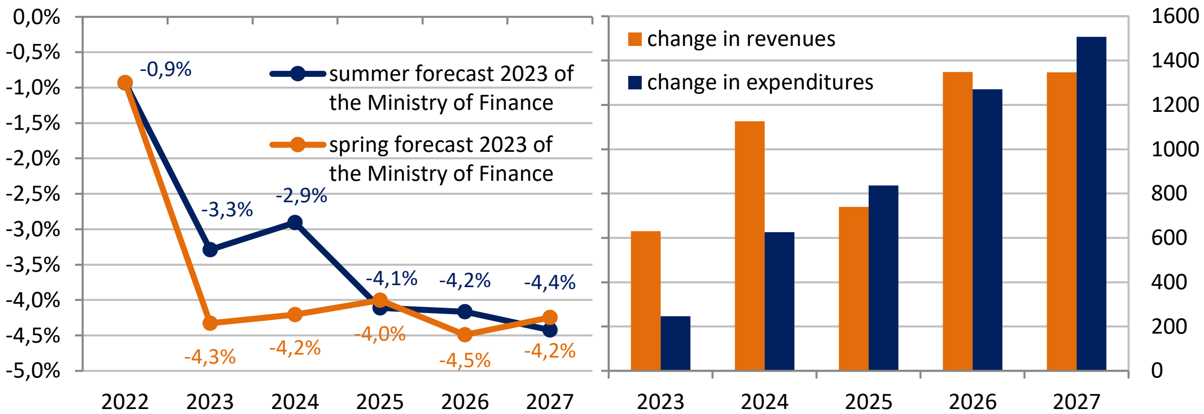

Figure 3. General government nominal budget deficit (% of GDP) and changes in the forecast for revenues and expenditures in comparison to the spring forecast 2023 (million euros)

Source: Ministry of Finance

The overall forecast for all the years of the forecast horizon is an increase in general government revenues and expenditures. General government revenues will be larger than they were in the spring forecast by 0.8-1.4 billion euros depending on the year, while expenditures will be 0.6-1.5 billion euros larger. Some of the increase in revenues and expenditures comes from the coalition agreement, and some comes from the change in the ministry's forecast for the outlook for the Estonian macroeconomy.

---

[4] Appendix 2 of the summer forecast of the Ministry of Finance presents the measures in the coalition agreement and an estimate of their fiscal impact. The forecast does not yet take account of all of the planned revenue measures such as car tax and higher environmental fees or the promised spending cuts that would further improve the budgetary position.

The summer forecast of the Ministry of Finance puts the general government revenues at around 4.6 billion euros more in 2024-2027 than was forecast in the spring. The Ministry of Finance estimates that only a fifth of this, or around 900 million euros, will come from the positive impact on tax revenues of the tax changes in the coalition agreement that were accounted for in the summer forecast (some of which will increase revenues and some of which will reduce them). The summer forecast puts the general government expenditures at around 4.2 billion euros more in 2024-2027 than was forecast in the spring. The coalition agreement to keep Estonian spending on national defence at 3% of GDP for the next four years again accounts for only a fifth of the additional spending, or around 800 million euros.

This means that the change in the ministry's outlook for the Estonian macroeconomy has an even larger impact than fiscal policy decisions, having allowed larger revenues than was forecast in spring, but also a larger cost base, which depends on the performance of the economy and tax receipts.

Analysing the changes to the forecast for expenditures by type of expenditure shows that around half of the additional spending, or 2.1 billion euros, can be classed as gross fixed capital formation and capital transfers, meaning that there is a large amount of investment in the forecast for additional spending. The explanation of the Ministry of Finance is that this comes from additional investment in defence, building Rail Baltica, and more intensive use of EU transfers from the new funding period. The other half of the additional spending comes from benefits to employees, intermediate consumption and social transfers, as the forecast expenditure on these has been increased by faster rises in wages and prices.

It was also agreed in the coalition agreement to reduce the rise in family benefits, which the Ministry of Finance estimates will help save the state a little over 500 million euros in the next four years. The summer forecast does not contain any additional measures for savings from general government spending.

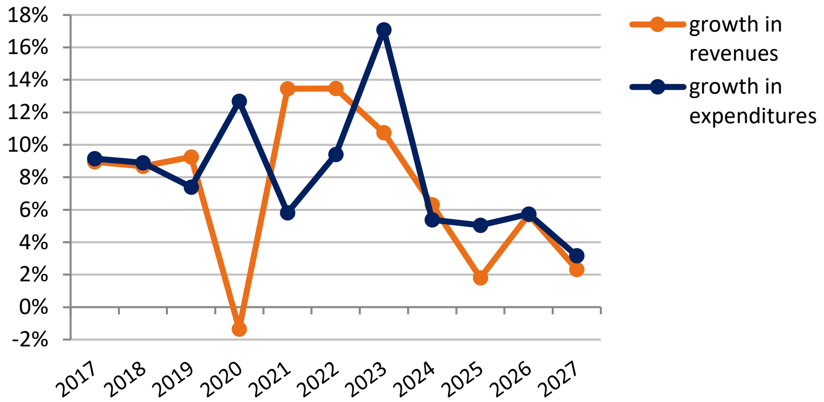

Figure 4. Growth in general government revenues and expenditures in 2017–2022 and forecast for 2023–2027 (%)

Source: Ministry of Finance

The forecast of the Ministry of Finance expects that general government expenditures will grow extremely rapidly this year by 17.1% (see Figure 4). This is mainly a consequence of high inflation in 2022, which affects the larger expenditures of the state with a lag. There was also an exceptional rise in pensions in 2023 and wage rises in several parts of the public sector. This means that although the Ministry of Finance expects the downturn in the economy in 2023 to be larger than it predicted in the spring, the spending policy of the government already had a supportive stance for the economy this year. The summer forecast expects the growth in general government spending to average 4.8% a year from here on, and public sector wages to rise by 4%.

The favourable changes in the forecast for the nominal size of the economy and for the labour market together with the tax rises that are coming in have allowed the Ministry of Finance to raise its forecast for tax revenues by 400-900 million euros depending on the year. 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 in comparison with the nominal growth in the tax base and the economy[5]. Under normal economic circumstances and with no major tax changes, it may be assumed that the rates of growth will remain similar over the years.

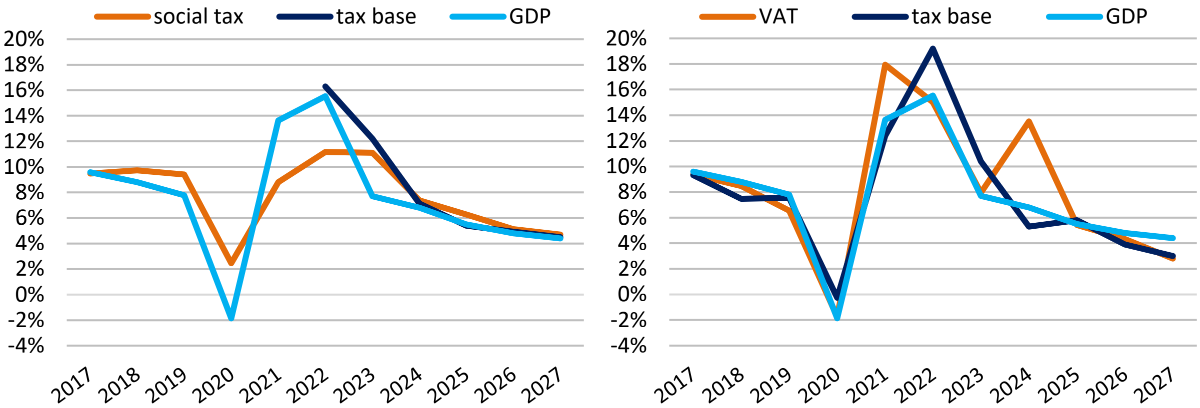

Figure 5. Growth in social tax and VAT in comparison to nominal growth in tax base and GDP (%)

Sources: Ministry of Finance, calculations of the Fiscal Council

The summer forecast expects in the longer term that the receipts of both social tax and VAT will be sufficiently in line with the developments of their tax bases. The Fiscal Council considers though in the shorter term that account must be taken of the possible disruption to the usual dynamics of tax revenues that will be caused by multiple changes to the Estonian tax system being applied within a short time. This particularly concerns changes to the income tax system and to consumption taxes. Earlier experience in Estonia has shown that when multiple tax changes introduced at the same time, the forecast errors for tax revenues can prove larger than they typically are.

The structural budgetary position and compliance with the fiscal rules

The government that was formed in spring 2023 set a target in the stability programme that the general government nominal budget deficit would not exceed 3% of GDP in 2024. The Ministry of Finance produced its spring forecast immediately before the coalition agreement was fixed, and it projected the budget deficit throughout the forecast horizon of 2023-2027 to be at least 4% of GDP. This meant that the budgetary position needed to be improved. The Fiscal Council considered that the target for 2024 was appropriate, but emphasised that the budget deficit should continue to be reduced gradually after 2024 as well.

The summer economic forecast of the Ministry of Finance for 2023 takes account of the tax changes and spending decisions that came into force this summer, and puts the nominal budget deficit for 2024 at 2.9% of GDP (see Table 4). If the forecast is correct, the government will meet its budget target for 2024, but the budget deficit is then forecast to be at least 4% of GDP again in the subsequent years.

[5] The VAT tax base in Figure 5 consists of forecasts for private consumption, government intermediate consumption and investment by the government and households. The tax base for social tax is calculated using the payroll in the economy based on the forecast for growth in average monthly wages and employment. VAT and social tax together bring in almost two thirds of all tax revenues.

The implication then from the macroeconomic outlook of the summer forecast of the Ministry of Finance and the estimated impact of the measures in the coalition agreement is that the decisions taken so far are not sufficient for the general government budget deficit to start narrowing consistently over the medium term.

Table 4. The general government structural balance in 2022 and forecast for 2023–2027 (% of GDP)

	2022	2023	2024	2025	2026	2027
Nominal balance	−0.9	−3.3	−2.9	−4.1	−4.2	−4.4
Nominal balance (million euros)	−335	−1275	−1204	−1797	−1908	−2115
Potential GDP growth (%)	2.6	1.6	1.6	1.4	1.6	1.6
Output gap	−0.8	−4.4	−3.3	−1.8	−0.9	−0.3
Cyclical balance	−0.5	−1.2	−1.3	−3.2	−3.7	−4.3
One-off measures	0.2	0.0	0.0	0.0	0.0	0.0
Structural balance	−0.8	−1.2	−1.3	−3.2	−3.7	−4.3

Source: Ministry of Finance

For the general government nominal deficit not to exceed 3% of GDP in future, the forecast of the Ministry of Finance suggests that an additional improvement of around 500-700 million euros a year to the budgetary position will be needed in 2025-2027 (see Figure 6). Complying with the national rules for structural budget balance would be even more demanding than this.

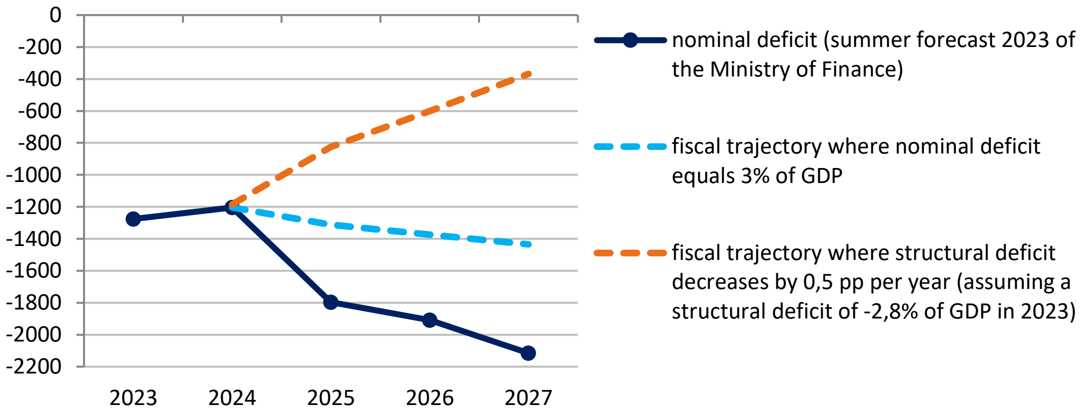

Figure 6. Forecast for the general government nominal budget deficit in 2023–2027 and the minimum requirements of the fiscal rules (million euros)

Sources: Ministry of Finance, calculations of the Fiscal Council

The escape clause of the fiscal rules that was introduced at the start of the pandemic will expire in 2023, meaning that fiscal policy will again have to start applying both the European Union fiscal rules and the national ones from 2024. This means that on top of the EU requirement that the nominal budget deficit may not exceed 3% of GDP under normal circumstances, the national fiscal rules will require the structural budget deficit to be reduced as well. The structural deficit must be reduced by at least 0.5 percentage point a year until structural balance has again been achieved.

According to the summer forecast of the Ministry of Finance, the structural budget deficit of the general government in 2023 will be 1.2% of GDP. This means that the structural deficit should not exceed 0.7% of GDP in 2024 and 0.2% of GDP in 2025, and that structural budget balance will need to be achieved in 2026. Given the summer forecast of the Ministry of Finance puts the structural deficit in 2026 at 3.7% of GDP, this would be an extremely demanding improvement in the fiscal position within a relatively short time.

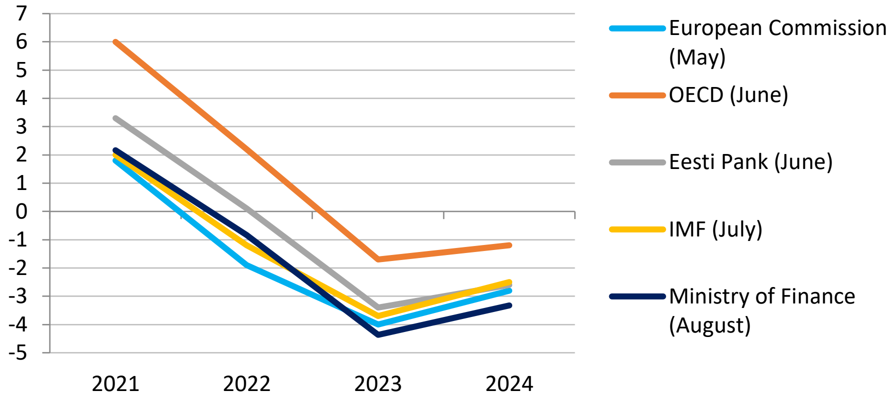

Figure 7. Estimates of the output gap in Estonia in 2021–2024 (% of potential GDP)

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

This estimate of the structural deficit and the trajectory of improvement are based on the forecast of the Ministry of Finance that the Estonian output gap will be negative in 2023 by as much as 4.4% of GDP. The explanatory note to the forecast of the Ministry of Finance admits that, like in spring, this figure may overestimate the cyclical weakness of the economy and so may put the structural budgetary position in too positive a light. Comparison with the most recent estimates by other institutions (see Figure 7) shows that the estimate of the Ministry of Finance for the cyclical position of the Estonian economy in 2023-2024 is indeed the most negative.

The Fiscal Council has usually submitted its own estimate of the size of the structural deficit using the forecast indicators from the Ministry of Finance but taking a different approach to estimating the fiscal impact of the economic cycle. The estimate by the Fiscal Council puts the general government structural deficit at 2.8% of GDP in 2023 and 2.4% in 2024 (see Figure 8). The weak position of the economic cycle described in the summer forecast of the Ministry of Finance is not indicated by the heatmap of the Fiscal Council (see Background 2), or by simple methodologies for identifying trend growth in the economy such as the HP filter. The Fiscal Council consequently supports the view of the Ministry of Finance that applying the common methodology used in the European Union leads to estimates in the summer forecast where the economic cycle may be too weak and the structural deficit too small.

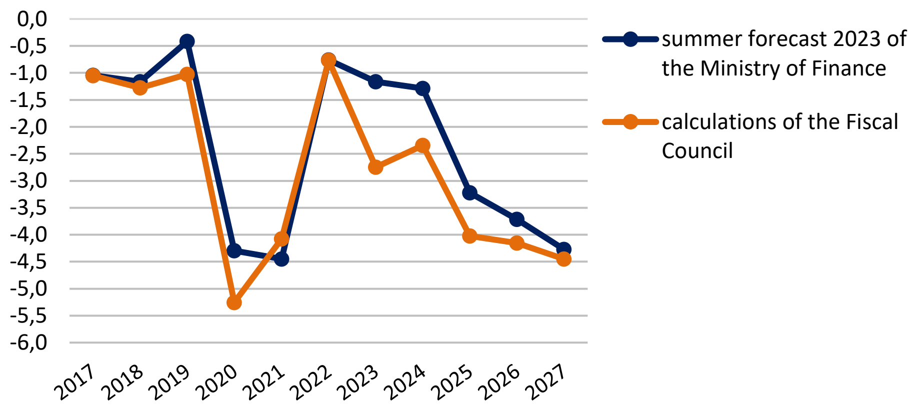

Figure 8. Estimates for the general government structural deficit in 2017–2027 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council considers that the budget deficit should be steadily reduced from 2024 onwards. The Fiscal Council consequently recommends that when the government sets its budgetary targets in the state budget strategy it should either apply the estimate of the Fiscal Council that the structural budget deficit will be 2.8% of GDP in 2023, reduce the *nominal* budget deficit of the general government by at least 0.5 percentage point a year starting from the budget deficit in 2024, or find some other short-term solution for defining the targeted improvement in the budgetary position while the difficulties in measuring the output gap persist.

Overall the summer forecast of the Ministry of Finance shows the outlook for public finances to be difficult, but the Fiscal Council considers that this is in line with the key indicators in the macroeconomic forecast and the assumptions used in writing it. Forecasts for tax revenues in this case may become more uncertain than usual because of the large number of changes in tax policy in 2024 and 2025. On the expenditure side, the forecast for public sector investment needs to be monitored carefully, as this has earlier been re-estimated repeatedly.

The summer forecast of the Ministry of Finance does not contain all of the revenue and expenditure measures planned by the governing coalition to improve the state finances, and so the state budget strategy to be written by the end of September may describe better the outlook for the state finances of Estonia in the next four years. The difficulties in estimating the cyclical position of the Estonian economy and the size of the structural deficit unfortunately makes setting the budgetary targets more challenging.

Background 1. *Forecast errors in the budgetary position for 2020–2022*

The forecast errors made by the Ministry of Finance in forecasting the general government nominal deficit have been larger than usual in the past three years (see Figure 9)[6]. The forecast errors have each time been in the same direction, as the actual outcome has proved better than was forecast by the Ministry of Finance during the year. This may also happen in 2023, as the budget deficit in the first half of the year was only 0.9% of the GDP forecast for the whole year, and the Ministry of Finance forecasts that by the end of the year, the deficit will prove smaller than was forecast in the spring. Nevertheless, the budget has not been in surplus in recent years, as the deficit has been smaller in size than expected, though still large.

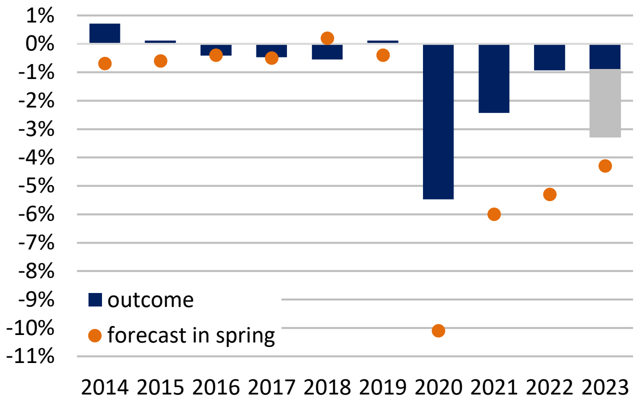

Figure 9. Spring forecasts of the general government nominal deficit and the actual outcome (% of GDP)

Sources: Ministry of Finance, Statistics Estonia

This raises the question of why the forecasts written in spring for the current year have had such large forecast errors. Taking the budget deficit as a share of GDP, the forecast errors have three components in general terms (see Figure 10). Firstly, general government expenditures have been smaller than forecast in all three years. Secondly, both general government revenues and the nominal size of GDP have been larger than forecast. All of this has helped improve the fiscal position from what was forecast in the spring.

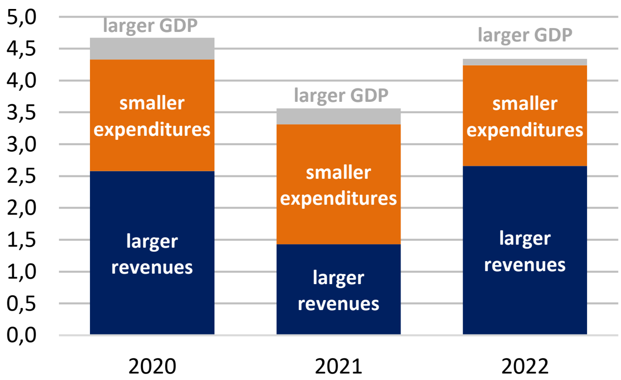

Figure 10. Components of the forecast errors for the general government nominal deficit (percentage points)

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

[6] Figure 9 compares the actual outcome with the forecast written by the Ministry of Finance in the spring, rather than with the forecast written in the previous autumn. This is because in 2020-2022 a supplementary budget increasing spending was passed each spring, causing substantial changes to the policy assumptions that lay behind the forecast.

Government spending has not been smaller than expected nor revenues larger because of inaccuracies in few individual budget items in the forecasts, which would have suggested that the forecast methodology might need changing. The reason for the errors is broader than this and is essentially that the economy has performed better than expected. The nominal size of the Estonian economy was larger than forecast in 2020-2022 but under very different circumstances, as the recession caused by the pandemic in 2020 was shallower than feared, the recovery after the pandemic in 2021 was faster than expected, and high inflation increased the nominal size of the economy in 2022 much faster than expected.

These macroeconomic developments meant that tax revenues were better than forecast and the costs of social transfers that depend on the labour market were smaller than expected. A supplementary budget was passed in the spring in all three of these years containing large additional state expenditures, including support measures, to ease the impact of various crises. The Ministry of Finance has had to produce estimates of the budgetary impact of such measures under a great deal of uncertainty. It has become apparent in retrospect that the two packages of support measures for the Covid-19 crisis, the two packages of support measures for the energy crisis, and the extraordinary expenditures on refugees from the war in Ukraine were not actually as large in 2020-2022 as was calculated in the spending forecasts for the supplementary budgets.

The Fiscal Council believes that the accuracy of the forecasts by Ministry of Finance will improve as the economic climate normalises, and they will again become comparable to what they were before 2020. Until then, it must be remembered when planning fiscal policy that the forecast errors in the budgetary position may prove larger than usual while there remains a lot of economic and geopolitical uncertainty. The Ministry of Finance showed in its analysis of forecast errors that was written when the spring economic forecast 2023 was published that the forecasts produced in the last few years by other institutions for the key macro and fiscal indicators have not been more accurate than those of the Ministry of Finance[7].

[7] The analysis by the Ministry of Finance of forecast errors appeared in the explanatory note (Appendix 3) to the spring economic forecast 2023.

Background 2. *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 11), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating.

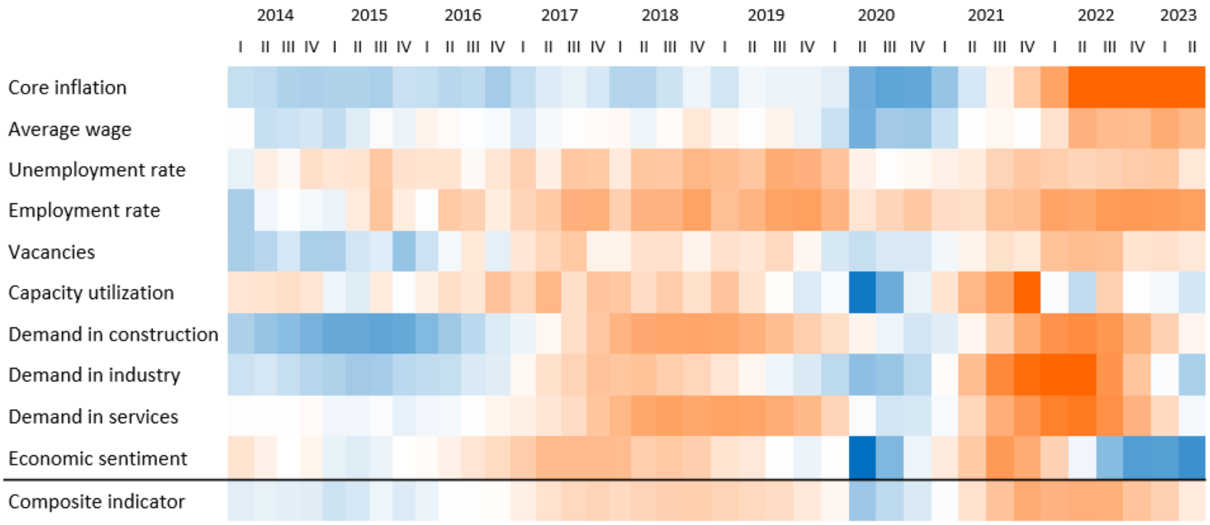

Figure 11. Macroeconomic heatmap for Estonia (Q1 2014 – Q2 2023)

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

The technical estimate of the Ministry of Finance found that the Estonian output gap in 2022 was negative at -0.8% of GDP, but the heatmap prepared by the Fiscal Council indicates that the economic cycle was in a stronger position. The only economic indicator in the heatmap that was notably down last year was the economic sentiment. The composite indicator of the map indicates that the cyclical position of the economy was stronger than the average in 2022 even if the indicator for core inflation, which currently reflects high price pressures, is excluded.

This year though the estimates by Estonian businesses of the demand environment have deteriorated alongside the economic sentiment, and the composite indicator suggests that the cyclical position of the economy has weakened. Whether the output gap is negative in 2023 depends on future developments in the labour market in the second half of the year. The summer economic forecast of the Ministry of Finance suggests that the improvement in the economic climate has currently been postponed until 2024.