EELARVENÕUKOGU
FISCAL COUNCIL

# FISCAL COUNCIL OPINION ON THE SPRING FORECAST 2019 OF THE MINISTRY OF FINANCE

April 2019

**Contents**

Opinion ..... 3
Explanatory Report ..... 4
Opinion on the spring forecast 2019 of the Ministry of Finance ..... 4
  Assessment of the macroeconomic forecast ..... 4
  Assessment of the fiscal forecast ..... 7

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

**Opinion**

Giving an opinion on state macroeconomic and fiscal forecasts is one of the main tasks of the Fiscal Council. The spring economic forecast 2019 of the Ministry of Finance and the Fiscal Council opinion on it were written at a time when the economic policy programme of the new government coalition had not yet been finally agreed.

The spring forecast of the Ministry of Finance shows that the fiscal rules require the general government to take measures to improve the structural fiscal position. In its opinion on the outcome of the structural position of the general government for 2018, the Fiscal Council recommended that the general government should already return to structural balance this year.

The spring economic forecast 2019 of the Ministry of Finance gives a sufficiently credible basis for this. The new macroeconomic forecast for 2019-2023 is similar to other forecasts written this year and takes account of changes in the recent past in the global economy and in the Estonian economy.

Like they did earlier, the experts of the Ministry of Finance expect that growth in the economy will slow to its long-term sustainable level. The only change from the earlier forecast is in the trajectory of the slowdown in growth, as it will slow more sharply than previously expected at the beginning of the period, and more gently in the final years of the forecast horizon.

The structure of GDP and the outlook for future growth in the exporting sector have changed though. It is expected that foreign demand will already slow more sharply than previously expected this year, and so the growth in exports of goods and services from Estonia will slow. Even so, the Estonian economy will be running at above its estimated potential in the years ahead.

The outlook for state revenues is in line with the macroeconomic forecast. The Fiscal Council remains of the opinion that the simultaneous introduction of a large number of tax changes has made the probability of forecast error larger than usual. The fiscal forecast shows that the structural fiscal position of the general government is about to remain in deficit and therefore will require the earliest possible intervention.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 18 April 2019

**Explanatory Report**

It is the job of the Fiscal Council to observe that the budgetary rules are complied with and to publish opinions on the state macroeconomic and fiscal forecasts. The spring economic forecast 2019 of the Ministry of Finance and the Fiscal Council opinion on it were written at a time when the economic policy programme of the new government coalition had not yet been finally agreed. The spring forecast of the Ministry of Finance shows that the fiscal rules require the general government to improve the structural fiscal position of the general government in 2019 and in subsequent years.

## Opinion on the spring forecast 2019 of the Ministry of Finance

### *Assessment of the macroeconomic forecast*

*Comparison with other forecasts*

In producing its opinion on the spring forecast of the Ministry of Finance, the Fiscal Council made a comparison with other forecasts, as it usually does. Updated forecasts for the Estonian economy have been produced this year by the Ministry of Finance, and also by some commercial banks and Eesti Pank. The European Commission published its interim European Economic Forecast in February, and in April the IMF released its World Economic Outlook. The forecasts produced this year expect real GDP growth of up to 3% on average, slowing to 2.5% in 2020 (see Table 1).

*Table 1.* Estimates by various institutions for GDP and CPI growth in Estonia in 2019-2020

| | Real GDP growth (%) | | CPI (%) | |
|---|---|---|---|---|
| | 2019 | 2020 | 2019 | 2020 |
| SEB (January)* | 2.8 | 2.5 | 2.6 | 2.4 |
| European Commission (February)* | 2.7 | 2.4 | 2.8 | 2.3 |
| Consensus Forecasts (February) | 3.0 | 2.4 | 2.9 | 2.4 |
| Luminor (March) | 2.9 | 2.6 | 2.0 | 2.3 |
| Eesti Pank (March) | 3.0 | 2.3 | 2.2 | 2.2 |
| Swedbank (April) | 3.0 | 2.7 | 2.4 | 2.4 |
| IMF (April) | 3.0 | 2.9 | 3.0 | 2.8 |
| *average of other forecasts:* | 2.9 | 2.5 | 2.6 | 2.5 |
| Ministry of Finance (April) | 3.1 | 2.7 | 2.1 | 2.2 |

* Inflation forecasts based on the harmonised consumer price index. These estimates are not used in calculating the average of the forecasts.

*Sources:* Consensus Forecasts, Eesti Pank, European Commission, IMF, Luminor, Ministry of Finance, SEB, Swedbank

The growth forecasts of the Ministry of Finance assume faster growth by 0.2 percentage point than the average of the other forecasts. This is a normal difference, and it was even a little larger for the forecasts written in 2018. Forecasters all agree that consumer prices will rise more slowly in 2019-2020 than they did in 2018, when inflation was 3.4%. This is because the prices of food commodities and oil are expected to fall on global markets and because of the cancellation of excise rises. As the forecasts were not all written at the same time, the assumptions made about commodities prices may differ slightly. In summary the main indicators in the spring forecast of the Ministry of Finance for 2019-2020 are in line with other forecasts drawn up this year.

In its earlier opinions, the Fiscal Council has also analysed the size of forecast errors. The Estonian economy is very small and open, and so forecast errors are larger than they are on average in EU countries. The forecast of the Ministry of Finance is no different from those of other forecasters in this respect. The forecast error for GDP was last year smaller than the average for 2012-2018. Alongside forecast errors, it must be remembered that the initial estimate of economic growth can be revised retrospectively. Real GDP growth for 2013-2016 was on average higher than the initial estimates by more than one percentage point[1]. Producing high-quality economic statistics is the task of Statistics Estonia. The Fiscal Council considers it important that Statistics Estonia should have the resources it needs to be able to do its job.

*Comparison with the previous forecast*

GDP growth in 2018 was faster than forecast in both current and constant prices. Exports of goods and services grew by 4.3% last year at constant prices, which is about a percentage point more than in the previous forecast by the Ministry of Finance. Export prices also increased faster than expected in 2018, as did domestic demand. Growth was broadly based and all the main components of domestic demand grew faster than expected. In such cases, the forecast for economic growth is usually corrected upwards, but this time the outlooks for foreign demand and domestic demand have changed in different ways.

There are grounds to expect that foreign demand for the exporting sector will start to slow more sharply this year, which is earlier than expected. The danger sign for the exporting economy is that growth in global trade slowed by notably more than growth in domestic demand did last year. The IMF finds that global trade measured by imports grew by 4% last year, which is more than one percentage point less than in 2017. The growth rate for exports from euro area countries fell even more sharply as exports of goods and services grew by a little over 5% in 2017, but by 3% in 2018. Despite the strong domestic demand, GDP growth in the members of the monetary union slowed to below 2%. Experts do not agree on how much of this stemmed from problems in individual sectors or product markets.

Trade negotiations between the US and China have become complicated, and so both countries have introduced protectionist measures, while tensions in trade between the US and the European Union have also increased. On top of this, it is unclear what impact the exit of the United Kingdom from the European Union will have. All this means that forecasts for international trade are less certain than usual.

Estimates for the demand for imports in Estonia's main trading partners are also more pessimistic than earlier. It is forecast that demand for Estonian exports will grow by a little under 3.5%, which is a little below the IMF forecast for growth in global trade. The forecast of the Ministry of Finance assumes that Estonian exporters will manage to keep up with increasing foreign demand, but that unlike in most other years since the crisis they will not be able to increase their market share. The Fiscal Council finds that this is a reasonable assumption.

Like they did in earlier years, the experts of the Ministry of Finance expect that growth in the economy will slow to its long-term sustainable level. The only change from the earlier forecast is in the trajectory of the slowdown in growth, as it will slow more sharply than previously expected at the beginning of the period, and more gently in the final years of the forecast horizon. However, the structure of GDP has changed a little.

Looking back it can be seen that employment has increased by more than expected since the crisis, and the number of employees was around 1% higher last year than in 2017, which was more than most experts expected. The average wage level has again been higher than forecast as well, and this is expected to remain

[1] For more, see the opinion piece by Raul Eamets, Chair of the Fiscal Council.

the case this year, after which it is forecast that wages will rise more slowly, so that in 2021-2023 gross wages will increase by less than GDP (see Table 2 and Figure 1).

*Table 2.* Key economic indicators for 2019-2023 in the macro forecast of the Ministry of Finance (%)

| | Spring forecast 2019 | | | Summer forecast 2018 | | |
|---|---|---|---|---|---|---|
| | 2019 | 2020 | Average for 2021-2023 | 2019 | 2020 | Average for 2020-2022 |
| Real GDP growth | 3.1 | 2.7 | 2.6 | 3.0 | 2.9 | 2.8 |
| Nominal GDP growth | 6.0 | 5.5 | 5.1 | 6.3 | 5.8 | 5.6 |
| Real growth in private consumption | 4.7 | 2.9 | 2.7 | 3.9 | 3.0 | 2.9 |
| Nominal growth in private consumption | 7.0 | 5.2 | 4.8 | 6.8 | 5.6 | 5.2 |
| Real investment growth | 5.1 | 4.0 | 3.7 | 6.2 | 4.2 | 4.1 |
| Real growth in exports of goods and services | 3.2 | 3.0 | 3.3 | 3.8 | 3.8 | 3.7 |
| Nominal wage growth | 6.4 | 5.2 | 4.9 | 6.0 | 5.2 | 5.2 |
| Growth in employment | 0.9 | 0.0 | −0.2 | 0.8 | −0.1 | −0.1 |
| CPI | 2.1 | 2.2 | 2.0 | 2.8 | 2.0 | 2.1 |
| GDP deflator | 2.8 | 2.7 | 2.4 | 3.2 | 2.7 | 2.7 |

*Source:* Ministry of Finance

This assumption has proven faulty several times since the crisis years however, and the Fiscal Council has repeatedly highlighted the difficulty in forecasting wage growth in its earlier opinions[2]. The Fiscal Council considers that wages may rise even faster in the final years of the forecast horizon, and in most years covered by the forecast the Estonian economy will be running at above its calculated potential level, while it is expected that the number in employment will fall a little from 2021. The channels that will lead wage costs to grow more slowly are not sufficiently explained in the forecast.

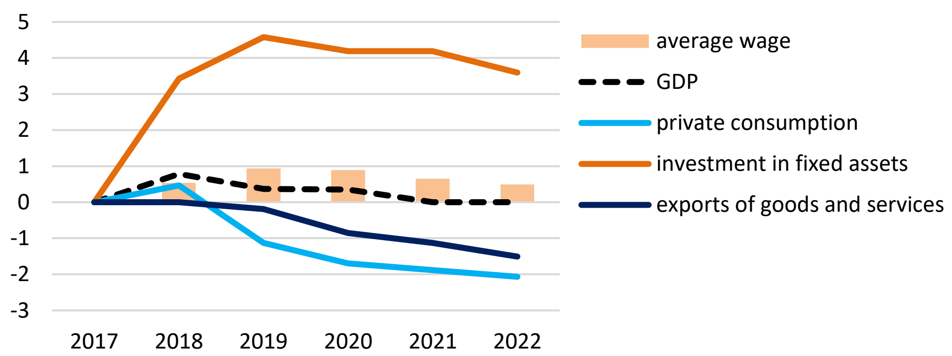


*Figure 1.* Change in GDP components and gross wages from the 2018 summer forecast (current prices, %)

*Sources:* Ministry of Finance, calculations of the Fiscal Council

The wage level will in future still be higher than was forecast last summer. The Ministry of Finance considers that the additional money will not go into consumption though but rather that people will prioritise savings. They will even consume less in the medium term than the previous forecast expected. The saving rate for households has risen surprisingly rapidly since the crisis, and the Fiscal Council believes that the growth in the saving rate may slow more quickly than forecast by the Ministry of Finance, and consumption may be higher than forecast. Private consumption is also made harder to forecast than earlier by the possible reform of the second pension pillar, about which exact details are not known.

[2] For more see the Fiscal Council opinion on the summer forecast 2017 of the Ministry of Finance.

Like with consumption, the real growth in investment in fixed assets is expected to be slower than in the previous forecast. The Fiscal Council finds that growth in investment may still be overestimated in the forecast. This is because the updated forecast assumes that general government investment will grow faster, which in turn assumes that transfers from the European Union budget will make a larger contribution than was earlier calculated. Experience has shown however that it is hard to forecast investment levels during the changeover of European Union budget periods.

Although the changes from the previous forecast are larger in nominal prices than in real terms, they are still quite small. The spring forecast of the Ministry of Finance describes the outlook for the Estonian economy accurately enough, and is appropriate for use in producing the state budget strategy. The Fiscal Council finds that under a scenario with no policy change the risks of growth being faster or slower than forecast are balanced. It should be noted though that the general government fiscal position last year was notably weaker than planned, and the fiscal rules require measures to be taken to improve the fiscal position. All else being equal, this means that the economy would grow more slowly than in the current forecast.

***Assessment of the fiscal forecast***

As the general government structural deficit was larger than planned in 2018, the fiscal position needs to be improved from 2019. The outlook for state finances included in the spring economic forecast 2019 of the Ministry of Finance, including the outlook for the fiscal position and the level of government reserves and debt, does not take account of the requirement to improve the budgetary position as required by the fiscal rules. For this reason the Fiscal Council focuses primarily in its analysis on the forecast for tax revenues for 2019-2020 and on the effect of the economic cycle on the fiscal position.

*Revenue forecast*

Tax receipts were very good last year and general government tax revenues were 10% higher than in 2017. The large number of tax changes meant that annual growth rates and the deviations from the forecast were very different for different taxes. In total the state budget received 0.4% more in tax revenues last year than was forecast when the state budget was drafted. Revenues from personal income tax were 66% higher than was assumed when the budget was produced and revenues from excise were 15% lower.

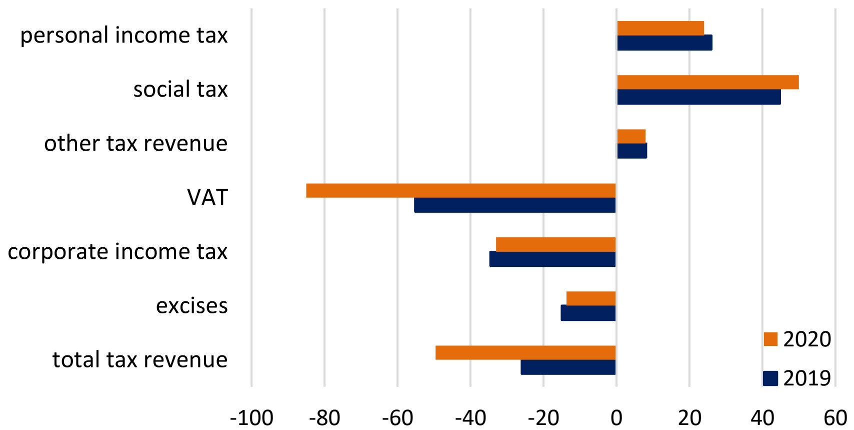


*Figure 2.* Changes in the forecasts for tax revenues in the state budget for 2019-2020 (million euros)[3]

*Source:* Ministry of Finance

[3] Tax receipts for 2019 are compared with the state budget for 2019, tax receipts for 2020 with the summer forecast 2018 of the Ministry of Finance.

Tax revenues were particularly good in the first half of last year as general government tax receipts were up 12% over the year and non-tax income was up 18%. This development fed overly optimistic expectations, and looking back the growth in revenue over the year as a whole was not as fast as was generally expected last autumn. Tax revenues in the state budget for 2019-2020 as a whole have been adjusted downwards a little in the spring forecast of the Ministry of Finance (see Figure 2). The Fiscal Council considers these changes to be reasonable.

A notable feature of the spring fiscal forecast 2019 of the Ministry of Finance is that the main tax types can be clearly divided into two groups. The first group are taxes where future receipts are mainly dictated by macro indicators in the economic forecast, such as social tax and VAT. The second group are taxes like personal income tax, corporate income tax and excises, where revenues are driven by how taxpayers react to the tax changes made last year.

Taxes in the first group are those like social tax and VAT, which provide between them 75% of the tax revenues in the state budget, and which have seen revenues receipts grow very fast in recent years, by an average of 9% in 2017-2018. Tax receipts should generally grow in line with the tax base, and the tax base should grow in line with the economy. The spring forecast of the Ministry of Finance shows growth in tax receipts slowing in 2019 in line with the expectations for a weaker economic climate (see Figure 3). Receipts of social tax and VAT will continue to grow in line with the growth in the tax base and the economy, but from 2020 they will do so at a clearly slower rate[4]. The Fiscal Council finds that the forecasts of the Ministry of Finance for receipts of social tax and VAT in the years ahead are appropriate. As already noted, growth in wages may prove faster in the final years of the forecast, and so social tax revenues would prove better.

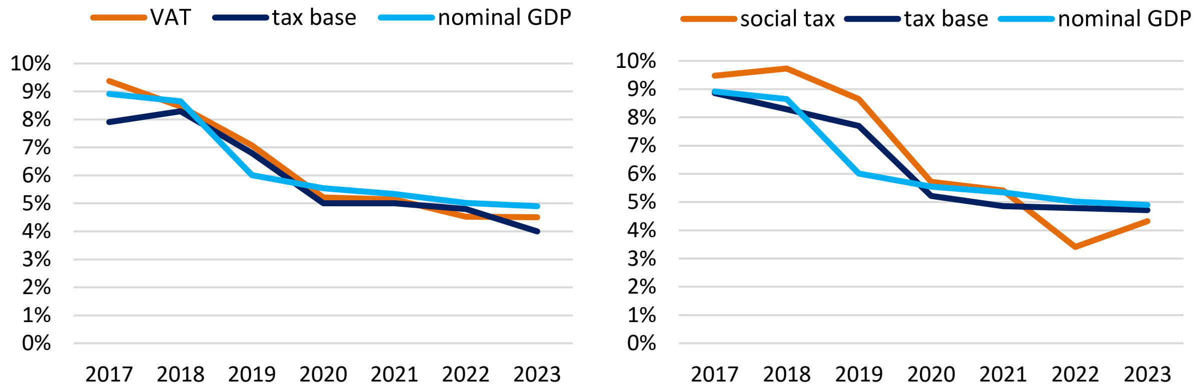


*Figure 3.* Growth in VAT and social tax receipts and in the tax base and the economy (%)

*Sources:* Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council finds that for the second group of taxes, those affected by tax changes, the risks are greater of a shortfall in receipts. The changeover to lower tax rates for companies that distribute profits to a regular schedule will start this year for example. The lower tax rate will only partly apply to dividends in the first year of the changeover, covering one third of the profit distributed last year. The dividends paid out by companies were 40% larger last year than they were in 2017, which suggests that companies made preparations to profit from the lower tax rate. However, decisions taken last year about the distribution of

[4] The VAT tax base in Figure 3 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.

profit do not necessarily mean that owners have set a clear schedule for distributing dividends for several years.

The behaviour of individual personal income taxpayers may also change. The majority of taxpayers earning less than the average preferred to avoid at all costs having to make retrospective additional payments to the Tax Board, and so they paid more in income tax than their actual income levels required. Although the data for the first months of this year indicate that this excess payment continued, taxpayers may adjust their behaviour.

The experience of 2018 shows that greater attention needs to be paid to the forecast of non-tax revenue, which provided 15% of general government income last year. A quarter of this was transfers from the European Union budget, which are more volatile than anything else but affect the fiscal position only a little. Unfortunately the receipts of other non-tax revenue have also been quite volatile. Income from ownership for example, which is mostly dividends taken from state-owned companies, has ranged between 0.7% and 1.4% of GDP since the crisis. The income received from sales of CO2 emissions allowances has also been very variable in recent years. The Fiscal Council considers that it is better to be cautious when forecasting these types of income rather than overly optimistic, to avoid raising expectations of revenue too high.

Overall the forecast of the Ministry of Finance for general government revenue is in line with the macroeconomic forecast. The Fiscal Council has noted in its earlier opinions however that the probability of forecast error is larger than usual when a lot of tax changes are introduced at the same time.

*General government budget position*

Statistics Estonia estimated that general government spending exceeded revenues in 2018 by some 120 million euros, and the nominal budget deficit of the general government was 0.5% of GDP (see Table 3). This is weaker than was expected when the state budget 2018 was written, and than in the forecast of the Ministry of Finance last autumn. The unexpected general government deficit arose because investment, social transfers and labour costs were larger than planned. At the same time the transfers from the European Union budget were smaller than forecast.

*Table 3*. The general government budget position 2018-2023 (% of GDP)

| | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|
| Nominal balance (million euros) | –120 | –67 | –75 | –152 | –222 | –60 |
| Nominal balance | –0.5 | –0.2 | –0.3 | –0.5 | –0.7 | –0.2 |
| Output gap | 2.1 | 1.6 | 1.1 | 0.7 | 0.3 | –0.1 |
| Cyclical component | 1.0 | 0.8 | 0.5 | 0.3 | 0.1 | 0.0 |
| One-off measures | –0.1 | –0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Structural balance | –1.4 | –1.0 | –0.8 | –0.8 | –0.8 | –0.1 |

*Source*: Ministry of Finance

It is also forecast that general government spending will grow faster this year than was assumed when the state budget for 2019 was written. At the same time the forecast for revenue has been revised downwards following the result for last year. The nominal fiscal position is on average 0.5 percentage point weaker than in the forecast last autumn, and will remain in deficit of up to 0.7% of GDP throughout the forecast horizon.

The fiscal position of the central government is affected by the results of the first pension pillar, public law institutions, state foundations, and businesses providing services to the state. The explanatory note to the spring forecast 2019 indicates for example that the contribution to the general government fiscal position made by foundations, public law institutions and business associations that come under the general government will be positive, varying between balance and a small surplus of 0.3% of GDP. This is quite an important assumption. Other central government income and forecasts for it, which includes the income and expenses for the first pension pillar, should be recorded separately in the tables, but the other central government position has not been published since the explanatory note to the spring forecast 2017. This information is needed for the public to understand fiscal policy and be better informed of the position.

To calculate the structural fiscal position of the general government, the nominal balance is corrected for the position of the economic cycle and the effect of one-off and temporary budgetary measures. The Ministry of Finance finds that the fiscal position will not be affected by one-off or temporary measures after 2019. The impact of the economic cycle is shown by the size of the output gap, which is the difference between the actual total output of the economy and its long-term sustainable capacity. The spring forecast 2019 of the Ministry of Finance found that the output gap in Estonia in 2018 was 2.1% of GDP and that it will narrow gradually in future. The main analysis institutions all agree that the Estonian economy was running at above its long-term sustainable level in 2018.

The deficit in 2018 means that the general government fiscal position is in nominal and structural deficit for the third year in a row. The general government's nominal fiscal position will remain in deficit throughout the whole forecast horizon, by 0.4% of GDP on average. A nominal fiscal deficit when the economy is performing well means that the structural position of the budget is in deficit too (see Figure 4). The Fiscal Council finds that the structural fiscal position of the general government for 2019-2023 will be similar to that in the spring forecast of the Ministry of Finance.

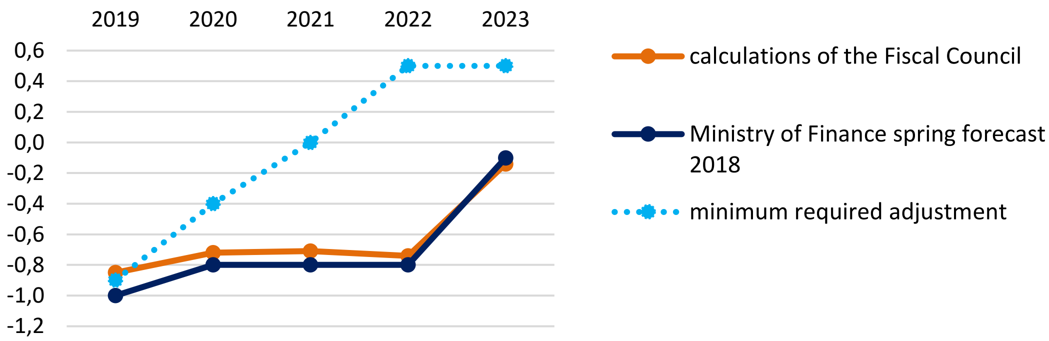


*Figure 4.* Estimates of the structural budget position for 2019-2023 (% of GDP)

*Sources:* Ministry of Finance, calculations of the Fiscal Council

This means that the revenue and expenditure forecast by the Ministry of Finance would lead to a persistent structural deficit in the coming years given the position of the economic cycle. For this reason measures that apply for only one year will not be enough to improve the path of public finances. Instead, changes of a more lasting nature will need to be made to the structure of state revenue and expenditure to put the general government fiscal position on a sustainable basis.

Fiscal policy in the coming years cannot be planned from the principle given in the State Budget Act that an earlier surplus allows a structural deficit of up to 0.5% of GDP to be planned, so that structural balance is maintained on average over several years. As the structural deficit was larger than planned in 2018 and the cumulative structural position also fell into deficit, plans for the fiscal position in the years ahead will have to comply with the requirements of the correction and compensation mechanism in the State Budget Act[5]. The requirements that this will place on the permitted size of the budget deficit and the dynamic between years are different from normal circumstances.

The State Budget Act requires that the structural fiscal position be improved immediately in 2019 by at least 0.5 percentage point from 2018. The structural fiscal position must be improved by at least 0.5 percentage point a year until structural balance has again been achieved (see Figure 4). Once the general government has returned to structural balance, a structural surplus must be planned so that balance can also be achieved in the cumulative structural position.

The spring forecast 2019 of the Ministry of Finance expects the structural deficit this year to be 1% of GDP, which is very close to the maximum deficit permitted for this year of 0.9% of GDP. The Fiscal Council finds that the improvement to the fiscal position in 2019 should not aim to be only the minimum required correction. Given the current state of the economy, it is not justified to have a structural deficit of around 1% that will have to be compensated for later regardless of the cyclical state of the economy. The fiscal framework of the European Union also has the principle that the fiscal position must be improved by larger amounts at times when the economy is doing well.

The Fiscal Council recommends that the target of structural balance set in the state budget for 2019 should still be met, if necessary by restricting the growth in spending. Given the good state of the economy, it would even be appropriate to set a target of a structural surplus for the fiscal position for 2019, so that the cumulative surplus can start to recover more quickly. A cumulative surplus is necessary so that fiscal policy can be used to boost the economy should the economic climate deteriorate. This buffer has now been used up even though the economic situation has been good.

In setting the budget targets in the state budget strategy for 2020-2023, it should be remembered that once structural balance has been achieved, the State Budget Act requires a structural surplus to be planned. The surplus should be of at least 0.5% of GDP a year, until balance has also been achieved in the cumulative structural position.

[5] More on the cumulative structural position and the correction and compensation mechanism in the fiscal rules can be found in the Fiscal Council opinion on the achievement of the general government structural budget position target in 2018.