# OPINION OF THE FISCAL COUNCIL ON THE ANALYSIS OF THE MACROECONOMIC IMPACT OF ESTONIA'S DRAFT RECOVERY AND RESILIENCE PLAN

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**Contents**



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**Explanatory Report**

The Estonian draft Recovery and Resilience Plan describes the goals and actions that will be funded by the European Union's Recovery and Resilience Facility (RRF). A mandatory part of this is an analysis of the forecast impact of the RRF on the main macroeconomic indicators for Estonia. The impact analysis for the recovery plan was carried out by the Ministry of Finance jointly with an independent think tank.

At the request of the Ministry of Finance, the Fiscal Council has drawn up an independent assessment of the macroeconomic impact analysis for the recovery plan, following the call from the European Commission for the independent fiscal institutions and productivity boards of member states to be involved in preparing the recovery plans. The Fiscal Council analysed the draft Recovery and Resilience Plan that was submitted for public consultation from 20 May to 4 June 2021. The assessment it produced is publicly available and can be accessed on the website of the Fiscal Council.

**The goal, size and distribution of the RRF**

The RRF is a central part of the Next Generation EU (NGEU) initiative. The facility is aimed at supporting investment and reform, which are needed for the long-term recovery of the economy, increasing economic and social resilience, and supporting the green and digital transitions. The funding is accessible to all, but the main focus of it is on the member states that have been affected most by Covid-19.

The initial estimate suggests that Estonia will be able to access some 0.9-1.1 billion euros as a grant through the RRF, and it will be able to borrow up to 1.9 billion euros as a loan on top of that. The exact size of the grant will become clear in summer 2022, when the GDP figures for the member states for 2020-2021 are known. As the contraction of the Estonian economy was relatively moderate in 2020 and rapid recovery is forecast for 2021, it may be assumed that the grant received by Estonia is more likely to be smaller than larger within that range. The draft recovery plan for Estonia assumes that the grants will total 977 million euros, and that Estonia is not currently considering using the RRF loans.

The total size of the Recovery and Resilience Facility foresees up to 312.5 billion euros in grants and up to 360 billion euros in loans. The estimated maximum grant allocations of the member states show the Estonian recovery plan to be one of the smallest in the European Union. Around half of the RRF grants are intended for Spain, Italy and France (see Figure 1).

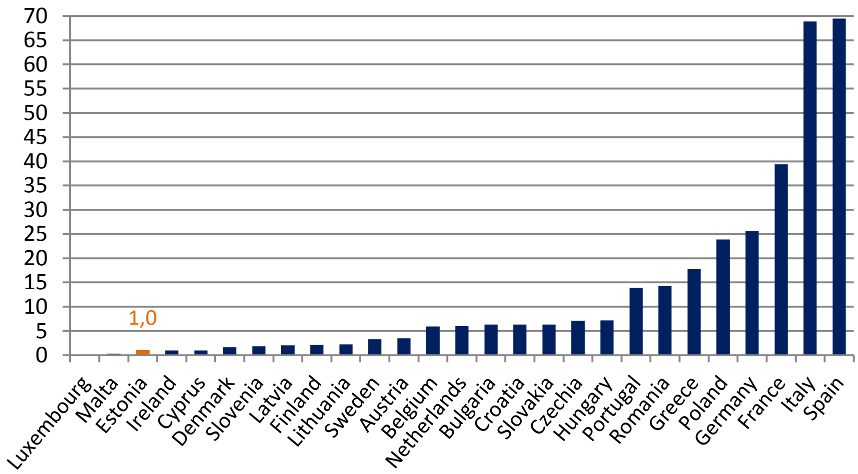


*Figure 1.* Estimated grant allocations (billion euros)

*Source:* European Commission (based on the Autumn 2020 Economic Forecast)

If the size of the RRF grants are compared to the size of the economy though, Estonia is close to the average of the member states. The planned grant of 977 million euros in the draft Estonian recovery plan is about 3.6% of the GDP of 2020. Relative to the size of the economies of the member states, the largest RRF grants are intended for Croatia, Greece and Bulgaria (see Figure 2). Member states can also use the RRF lending facility on top of the grants, but that is not considered here[1].

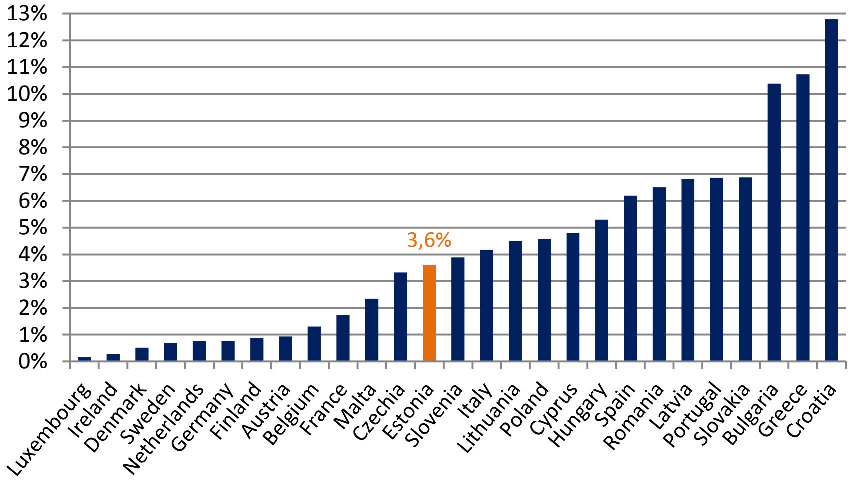


*Figure 2.* Estimated grant allocations as a share of the GDP of 2020 (% of GDP)

*Sources:* European Commission (based on the Autumn 2020 Economic Forecast), calculations of the Fiscal Council

The RRF grants can be used from the middle of 2021 until the end of 2026. The draft Estonian recovery plan envisages using around 25% of the grant in the first two years, and using it more intensively in 2024-2025 when around half of the total grant will be used (see Figure 3). The European Commission estimates that member states plan to use on average 40% of the recovery grants in the first two years, with Germany, France and Spain using more than 50%. The European Commission has also noted that member states are planning to direct on average around 30% of the grant to general government investment, almost 50% to capital transfers that will mainly go to private sector investment, and the rest to current and other spending[2].

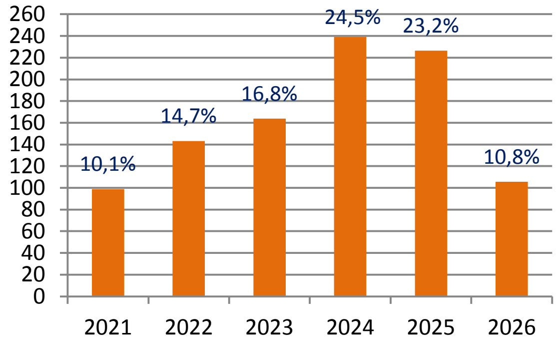


*Figure 3.* Size of the Estonian grant allocation (million euros) and annual share (% of total) in 2021-2026

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

[1] Member states are able to apply for RRF loans until autumn 2023.

[2] For more see the box on the RRF in the spring economic forecast 2021 of the European Commission.

**The importance of the RRF in Estonia's fiscal transfers and public sector investment**

The spring forecast 2021 of the Ministry of Finance shows fiscal transfers from abroad reaching record levels in the coming years as funds from both the previous and the new budget periods of the European Union will be used, with the Next Generation EU funds decided on during the pandemic available on top, including the Recovery and Resilience Facility. Fiscal transfers in 2024 will be almost double what it was in 2020 (see Figure 4 left panel). In different years, the RRF grant can provide around 8-15% of all Estonia's fiscal transfers and around 0.3-0.7% of Estonian GDP (see Figure 4 right panel).

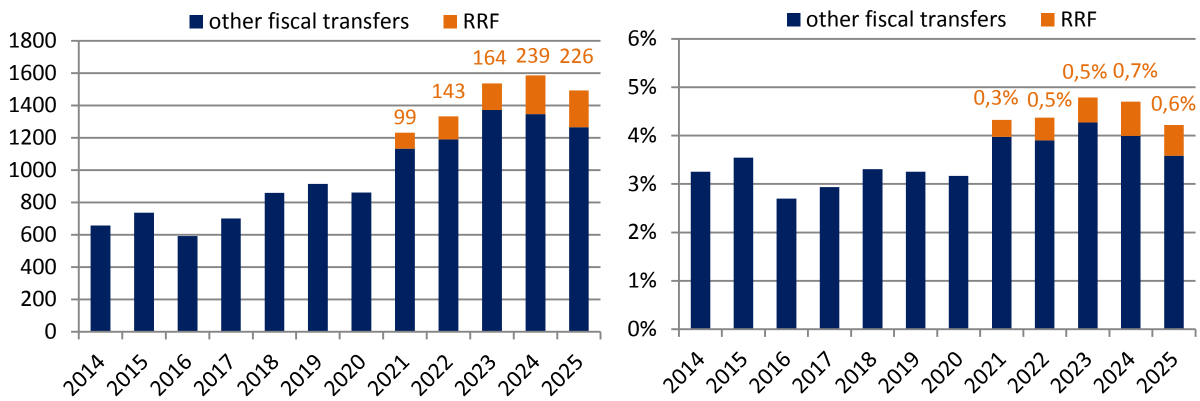


*Figure 4.* Amount of fiscal transfers (million euros, left panel) and share of GDP (% of GDP, right panel)[3]
*Source:* Ministry of Finance

The analysis of the macroeconomic impact of the recovery plan assumes that around 80% of the grant, or 780 million euros, will be directed to public and private sector investment, and around 20%, or 197 million euros, will go to public and private sector consumption. On average 66% of the investment will be classified as public sector investment and 34% as private sector investment. This means that the recovery plan will add 550 million euros of public sector investment in 2021-2026, and 265 million euros of private sector investment. Following from the forecast for Estonian general government investment in the state budget strategy 2022-2025, the contribution of the recovery plan to total public sector investment will be between 1.5% and 7% a year (see Figure 5).

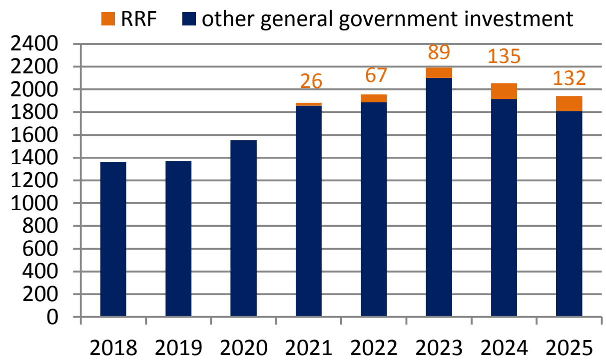


*Figure 5.* Estonian general government investment and the contribution assumed from RRF (million euros)
*Sources:* Ministry of Finance, calculations of the Fiscal Council[4]

[3] Figures 4 and 5 do not show data for 2026 as the spring forecast 2021 of the Ministry of Finance only goes out to 2025.

[4] The Fiscal Council has made a simplifying assumption in Figure 5 that the division of the RRF-funded investments between the private sector and the public sector will remain constant from year to year.

**The opinion on the analysis of the macroeconomic impact of the RRF**

The impact analysis for the recovery plan was carried out by the Ministry of Finance working jointly with an independent think tank and using the general equilibrium model of the Estonian economy[5]. The starting point for analysis of the economic environment was the spring economic forecast 2021 of the Ministry of Finance and the long-term economic projections of the Ministry of Finance[6]. According to the Ministry of Finance, the model simulates the *direct* impact of the growth in investment and consumption financed by the RRF on the key Estonian macroeconomic indicators. The results of the impact analysis are presented in a 10-year perspective. Longer-term positive impacts that may be expected from reforms, more efficient state governance, and growth in productivity are harder to measure and so are not included in the analysis.

The draft plan shows that Estonia is not currently considering using the RRF loans, and so the macroeconomic impact analysis considers only the possible effects of the grant. As the amount of the grant will only finally become known in summer 2022, the scale of the macroeconomic impact may differ from the results of the model-based simulation presented in the draft of the recovery plan even if other assumptions remain the same. The draft recovery plan for Estonia assumes that the RRF grant will total 977 million euros and the funds will be made available in 2021-2026.

The impact analysis finds that the RRF gives a temporary boost to growth in the Estonian economy and to other economic indicators, and that the effect fades with a longer or shorter delay after the funds have been used. The recovery plan leaves the total output of the Estonian economy on average 0.8 percentage point larger at constant prices during 2021-2026. The impact is biggest during the peak years of the grant in 2024-2025, at one percentage point of GDP or around 275-285 million euros a year. This means that the direct impact of the RRF will increase Estonian GDP by more than the amount of the grant paid, meaning that the assumed fiscal multiplier is greater than one.

The impact of the recovery plan could theoretically differ depending on the stage of the economic cycle at which the funds are used. The possible positive impact of additional investment and consumption by the public sector could prove larger at a time when there is a lot of available capacity in the economy and less at a time when the economy is already growing close to its capacity potential. In this case an additional stimulus could put upwards pressure on wages and prices that is not sustainable over the long term, and so could push the economy to overheat.

The Ministry of Finance states that the impact of the recovery plan will be countercyclical and will help to avoid the output gap becoming deeply negative. After strong cyclical conditions in 2017-2019, the Covid-19 pandemic in 2020 brought a recession and a negative output gap. Analysts estimate in forecasts this spring that the Estonian output gap will be largest in 2021, and will then start to narrow. Although analysts disagree about the speed at which the output gap will close and economic forecasts can change rapidly under the current circumstances, the Ministry of Finance estimates that the Estonian economy will be close to its potential level in 2024. In its opinion on the economic forecast of the Ministry of Finance in spring 2021, the Fiscal Council found that the economy may recover faster than predicted, and this opinion is supported by economic indicators that have been published more recently. For this reason the Fiscal Council would like to highlight that some of the payments under the RRF could arrive at a time

[5] The analysis of the macroeconomic impact uses EMMA, the macro model of the Estonian economy developed by Eesti Pank and used for the economic analyses and forecasts of the central bank.

[6] The spring forecast 2021 of the Ministry of Finance already contains the RRF and the increase in investment and consumption supported by it.

when the Estonian output gap has already turned positive, and so the plan could at least partly become pro-cyclical and encourage the Estonian economy, or sectors within it, to overheat.

Considering the recovery plan together with the other fiscal transfers available for Estonia to use (see Figure 4 on page 5) shows that the RRF in itself does not make the dynamics of Estonia's fiscal transfers pro-cyclical, but it accelerates the possible pro-cyclicality that is already there. The Ministry of Finance forecast that the fiscal transfers from abroad in 2024-2025 would in any case reach its highest level even without the contribution of the RRF. The Fiscal Council consequently recommends that the planning for the distribution of the RRF between years should also consider the forecasts for use of other fiscal transfers to ensure if possible that additional investment and consumption spending is distributed more evenly across the economic cycle. Estonia is planning to use a smaller share of the total amount of the RRF in the initial years of the payment period than other countries are.

The macroeconomic impact analysis in the recovery plan does not consider the risk that the additional growth in public sector investment could crowd out private sector investment. This assumes in other words that competing for the same resources will not cause the private sector to abandon its own investment. The recovery plan will directly inject 265 million euros of additional private sector investment over six years. Funding conditions in the market are generally favourable, and it is assumed that this will ease the risk of crowding out. The Fiscal Council finds though that there is still a substantial risk in the coming years of public and private sector investment projects starting to compete for the same limited amount of production resources like labour, mineral resources and construction materials. This could cause additional wage pressures and shortages of (domestic) skilled labour and production inputs, higher prices for construction projects, and delays in completion.

This could then mean that there is a different impact on the Estonian labour market, price level and private sector investment to what is assumed in the draft recovery plan. Average wages and prices in Estonia rise according to the impact analysis, but as the RRF has a similar effect in other European Union countries then the Ministry of Finance finds that Estonian competitiveness will not necessarily decline overall. The Fiscal Council considers though that there is a risk that average wages and the price level may rise faster than forecast, and so the positive impact of the RRF on Estonian competitiveness may prove smaller than expected.

In conclusion the Fiscal Council finds that the macroeconomic impact analysis in the Estonian draft recovery plan is compiled using an appropriate methodology and the results of the model-based impact analysis are interpreted adequately given the assumptions chosen. The Fiscal Council considers it possible though that some of the assumptions in the analysis may prove inaccurate, especially if the Estonian economy should recover faster than expected from the pandemic. The concerns of the Fiscal Council are then mainly connected to the economic forecast risks, not to the technical quality of the impact analysis. It should be admitted though that there is currently greater uncertainty around economic forecasting than usual and economic conditions can change rapidly both for the better and for the worse.

The Fiscal Council approves of the plan to use as much as 80% of the RRF for investment and only 20% for consumption spending, and considers that this high ratio of investment should be maintained when the amount of the grant is confirmed later. The rapid growth in fiscal transfers and public sector investment make it important that the quality of the investments is not overlooked. The Fiscal Council finds that the RRF could have a larger positive impact on the Estonian economy if the timing of the use of the grant can be managed more carefully given the position of the Estonian economic cycle and the scheduled use of other fiscal transfers. For this reason the Fiscal Council recommends considering using the RRF more quickly than planned to reduce the risk of excessive stimulation of the economy in the medium term.