OPINION OF THE FISCAL COUNCIL ON THE TARGETS FOR THE STRUCTURAL BUDGET POSITION FOR 2023-2026

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Opinion

In writing the state budget strategy for 2023-2026, the government has decided not to improve the structural fiscal position or to worsen it from what it would be in 2022. The forecast of the Ministry of Finance puts the structural deficit of the general government for this year at 2.6% of GDP. This means the target of reducing the structural deficit, which was still considered a priority in the stability programme in spring, has been abandoned.

This decision has allowed the government to increase the general government nominal budget deficit by around 2.9 billion euros over the next four years from what was in the summer forecast of the Ministry of Finance. The additional deficit is being justified because of increased spending on defence and family support, and by the need to compensate for the rise in electricity prices.

For this amount of spending decisions to be added during the budget discussions is extraordinary, and so the Fiscal Council recommended that the Ministry of Finance produce an additional macroeconomic forecast scenario to accompany the state budget strategy. The Ministry of Finance has done this, and the Fiscal Council has endorsed it.

The budget strategy contains new spending that is permanent in nature, but no new permanent sources of revenue. The budget deficit for the next four years is forecast at 5.4 billion euros and the debt of the general government will double nominally from what it is today. The Fiscal Council understands that the additional extraordinary spending is necessary this year and next because of the war in Ukraine and high inflation. It is important though that public finances be managed responsibly even when fiscal rules are temporarily suspended and cost pressures are severe. This means that new revenue sources need to be found for the medium term that are not based only on borrowing.

In its assessment of the budgetary targets, the Fiscal Council has assumed that the fiscal rules will start to apply again in their earlier form from 2024. This means that the structural budget deficit will need to be reduced after 2023 by at least 0.5 percentage point each year. The forecast of the Ministry of Finance expects that the outlook for the Estonian economy will have improved sufficiently by that time.

The Fiscal Council consequently finds that only the target for 2023 in the budget strategy 2023-2026 complies with the fiscal rules, while the targets for the structural budgetary position for 2024-2026 do not. If the structural deficit in 2023 is 2.6% of GDP, then the targets for the following years should have been 2.1%, 1.6%, and 1.1% of GDP. This means that the total nominal budget deficit in 2024-2026 should have been 1.3 billion euros smaller.

While the Ministry of Finance forecasts that the *structural* budget deficit of the general government will not increase in 2023, the *nominal* budget deficit will be around half a billion euros larger than it is this year. Such a fiscal stance will not support the monetary policy fight against inflation.

Finally, the Fiscal Council does not find the current practice of setting long-term targets for fiscal policy twice a year, in the spring stability programme and the autumn budget strategy, to be appropriate, given that these plans are not binding on one another and the budgetary targets they set are not binding over the longer term. The Fiscal Council consequently finds that the earlier system where both of the medium-term budgetary documents were agreed together worked better.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 30 September 2022

Explanatory Report

This is the first year that the stability programme to be submitted to the European Commission and the domestically important state budget strategy are written at different times. The stability programme continues to be written in spring, while the state budget strategy is now written in the autumn together with the state budget for the coming year. The Fiscal Council continues to assess both documents and specifically whether the budgetary targets set for the next four years comply with the fiscal rules.

Assessment of the targets for the structural budget position for 2023-2026

Setting the targets

The Estonian government set the target in the stability programme in spring 2022 that the structural fiscal deficit in 2023 would not exceed 3.5% of GDP, and that the deficit would narrow each subsequent year by 0.5 percentage point. Achieving this target would mean the structural deficit shrinking to 2% of GDP by 2026. The spring budgetary targets followed the assumption that the fiscal rules would start to apply again from 2023 in unchanged form. The Fiscal Council found that if these assumptions were met and if the deficit in 2022 would not be smaller than 4% of GDP, the budget goals set under the stability programme would have been in line with the State Budget Act as it stood.

It became known in summer 2022 that the escape clause of the fiscal rules would continue to apply in 2023. It is still not yet clear though when and in what form the fiscal rules will start to apply again[1]. While the government set its targets for the fiscal position in the stability programme written in the spring in such a way that the structural budget deficit would be reduced as required following that expected return of the fiscal rules, the budgetary targets set in the state budget strategy in the autumn do not foresee any reduction in the structural deficit.

In writing the state budget strategy for 2023-2026, the government has decided not to improve the structural fiscal position or to worsen it from what it would be in 2022. The summer forecast from the Ministry of Finance put the structural deficit of the general government for this year at 2.6% of GDP. This means the government has decided to keep the structural deficit at 2.6% throughout the horizon of the budget strategy (see Figure 1).

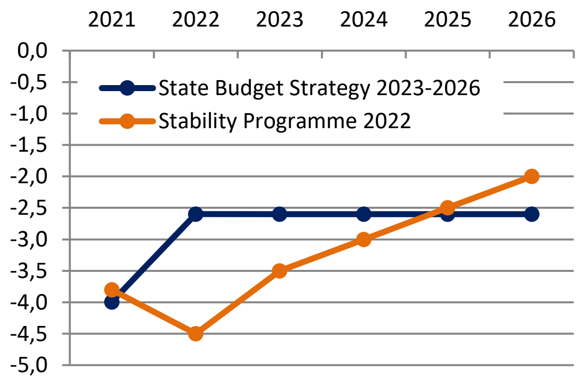

Figure 1. Targets for the general government structural budgetary position 2023-2026 (% of GDP)

Source: Ministry of Finance

[1] The European Commission will publish its proposals for the new fiscal rules for the European Union at the end of October. This will be followed by discussions between the member states and possible changes to the legislation, for which the timeline is hard to forecast at the present moment.

Changes from the summer 2022 economic forecast of the Ministry of Finance

As the general government structural deficit in the summer 2022 forecast by the Ministry of Finance did not exceed 1% of GDP in any of the coming years, setting the deficit target at 2.6% of GDP meant that when the state budget 2023 and the budget strategy were written, it was possible to increase the general government nominal budget deficit in the next four years by around 2.9 billion euros. This amount of spending decisions being added to the summer forecast is an extraordinary event. The decisions added to the summer forecast will have a fiscal impact in 2023 of 1.9 percentage points of GDP (see Figure 2), and an impact in the subsequent years of the forecast of 1.6-1.8 percentage points of GDP.

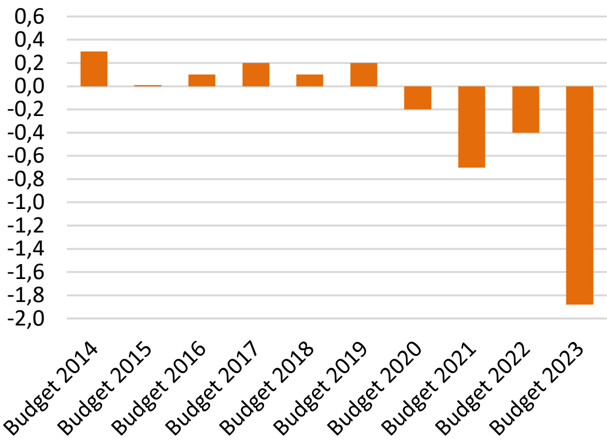

Figure 2. Impact on the budgetary position of the fiscal measures added to the summer forecast during the discussions over the state budget (percentage points)

Source: Ministry of Finance

The Fiscal Council recommended that the state budget strategy 2023-2026 should also include an updated macroeconomic forecast from the Ministry of Finance. As the Fiscal Council explained, the summer forecast of the Ministry of Finance underestimated substantially the amount of general government spending, the budget deficits and the debt levels for 2023-2026, and this then affected the other economic indicators that were forecast. Spending by the general government is around a billion euros a year higher in the state budget strategy than in the summer forecast, while the nominal fiscal deficit is on average 700 million euros larger and government debt will be 3 billion euros larger by 2026 (see Figure 3).

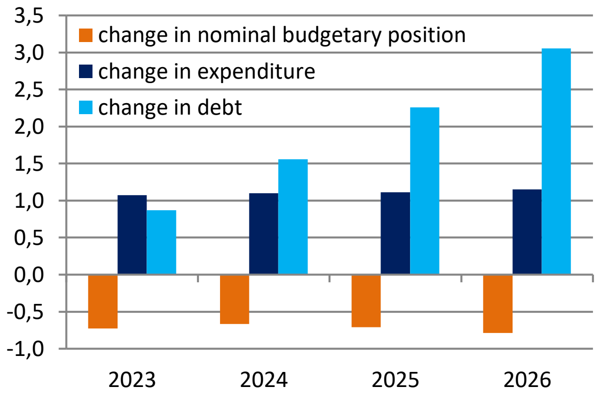

Figure 3. Changes in general government expenditure, the nominal budgetary position and the debt forecast from the summer economic forecast 2022 of the Ministry of Finance (billion euros)

Source: Ministry of Finance

The Ministry of Finance prepared a new macroeconomic forecast scenario to accompany the state budget strategy 2023-2026, and it based it on the most recent information on the budget measures planned by the new government coalition, and an updated estimate of the development of general government wage costs, consumption and investment. The Fiscal Council endorsed the new macro scenario of the Ministry of Finance, and considers it an important input for further discussions about the state budget and the budget strategy.

The budget strategy contains new spending that is permanent in nature, such as increased benefits for children and families, higher wages in the public sector, and a rise in the tax-free minimum threshold, but no new permanent sources of revenue. The summer forecast expected general government spending to increase by 5.2% in 2023, but now it puts it at 12.3% (see Figure 4). It puts growth in gross fixed capital formation, or investment, at 27.1%, growth in compensation to employees at 16.9%, that in intermediate consumption at 15.5%, and that in monetary social transfers at 10.9%. Looking forward, expenditures will exceed revenues each year by 1.3-1.5 billion euros. The Fiscal Council considers that keeping public finances sustainable means that new revenue sources need to be found for the medium term that are not based only on borrowing.

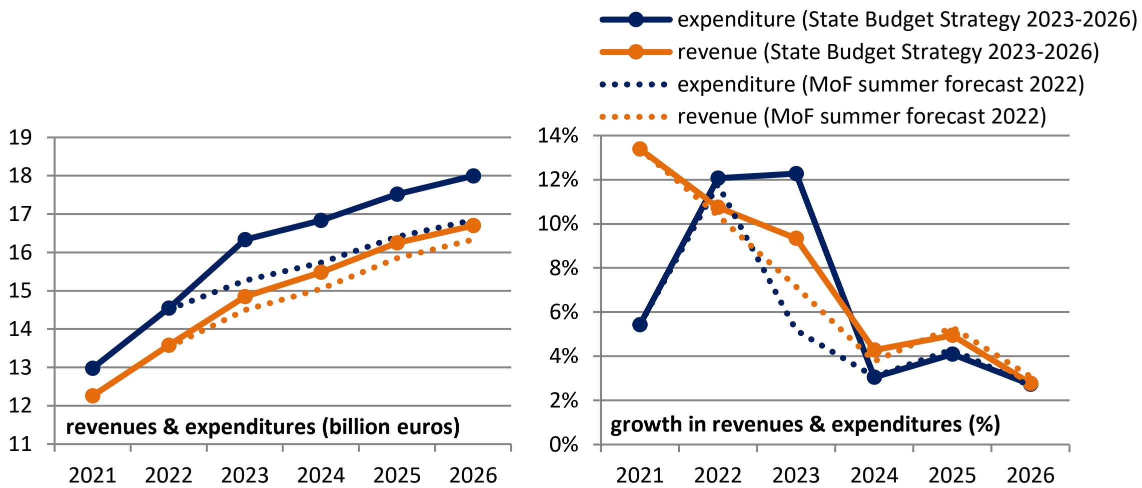

Figure 4. General government revenues and expenditures in the state budget strategy 2023-2026
Source: Ministry of Finance

Budgetary position in 2023-2026

The forecast of the Ministry of Finance for the structural fiscal deficit in 2022 assumes that the nominal deficit this year will be 971 million euros, or 2.7% of GDP, and that the output gap will be negative by 0.6% of GDP (see Table 1). The data available so far for 2022 indicate that in the first half of the year the general government nominal fiscal position was still close to balance. Data from Statistics Estonia show that general government expenditures exceeded revenues in the first of the year by only 30 million euros, while the Ministry of Finance estimates the difference at only 50 million euros over seven months. The ministry is also forecasting that tax revenues in the second half of the year will continue to exceed what was in the state budget for 2022 or the supplementary budget. The expected deterioration in the budgetary position is mainly explained by the expenditure measures in the supplementary budget 2022.

Table 1. The general government structural budgetary position 2022-2026

	2022	2023	2024	2025	2026
nominal budgetary position (million euros)	–971	–1489	–1350	–1272	–1299
nominal budgetary position (% of GDP)	–2.7	–3.9	–3.3	–3.0	–3.0
potential GDP growth (%)	3.2	2.5	1.9	1.8	1.9
output gap (% of potential GDP)	–0.6	–2.5	–1.4	–0.8	–0.6
cyclical component (% of GDP)	–0.3	–1.2	–0.7	–0.4	–0.3
one-off measures (% of GDP)	0.2	0.0	0.0	0.0	0.0
structural budgetary position (% of GDP)	–2.6	–2.6	–2.6	–2.6	–2.6

Source: Ministry of Finance

The Ministry of Finance estimates that the output gap will deepen sharply in 2023, but will then start to narrow until it returns to where it is today by 2026. It is understandably difficult to forecast at the moment what the potential production capacity of the Estonian economy will be and how far actual economic developments will diverge from this. The Fiscal Council finds that the data for the first half of 2022 did not show clear signs that the economic cycle has turned in Estonia (see Background), but forecasters are assuming that the economic climate will cool in the second half of the year. The most recent estimates from the main institutions providing analysis (see Figure 5) find that the output gap in Estonia will again be negative in 2022, and that it will deepen in 2023.

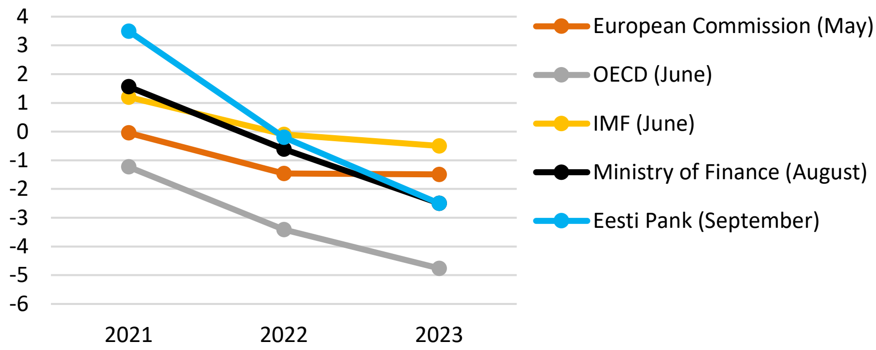

Figure 5. Estimates by different institutions of the output gap in Estonia 2021-2023 (% of GDP)

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

The forecast by the Ministry of Finance for the output gap falls in the middle of the others, but the spread of the estimates is notably wide, which unfortunately casts uncertainty over the measure of the general government structural fiscal position used in setting the targets for the state finances. Entering the estimates of the output gap from other institutions into the methodology used by the Ministry of Finance for calculating the structural fiscal position, with other assumptions taken from the forecast by the ministry, makes the estimates of the structural deficit for 2022 differ from one another by around 1.5 percentage points, and the estimates for 2023 differ by as much as 2 percentage points.

Compliance with the fiscal rules

Although the structural fiscal deficit would not increase in 2023 or later if the forecast holds, setting such a goal would still substantially increase the nominal fiscal deficit next year. This means that the nominal fiscal position of the general government in 2022 and 2023 will again move further away from balance, not closer to it (see Figure 6).

Several international institutions have recommended that governments setting their fiscal policies for 2023 opt for a restrictive fiscal stance to support the efforts of monetary policy to rein in inflation, but the nominal fiscal deficit of the Estonian general government will increase next year by around half a billion euros from what it is this year.

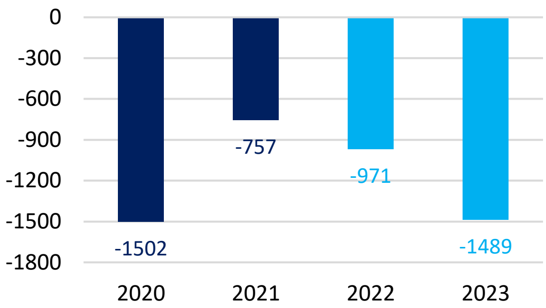

Figure 6. General government nominal budgetary position for 2020-2021 and forecast for 2022-2023 (million euros)

Sources: Ministry of Finance, Statistics Estonia

The European Union and Estonian fiscal rules, which set limits on the budget deficits and debt levels that are permitted, have been suspended since the pandemic erupted in spring 2020. The state budget strategy 2023-2026 was written in the knowledge that the fiscal rules will not be reapplied in 2023. It is not yet clear when and in what form they will start to apply again, and so the Fiscal Council has assumed in its assessment that the rules will come into force again from 2024 and in their current form. This means that the structural budget deficit will need to be reduced after 2023 by at least 0.5 percentage point each year. The forecast of the Ministry of Finance expects that the outlook for the Estonian economy will have improved sufficiently by that time.

This would mean the targets for the general government structural fiscal deficit would need to be 2.1% of GDP in 2024, 1.6% in 2025, and 1.1% in 2026 (see Figure 7). The nominal deficit in 2024 would then be smaller than 3% of GDP in accordance with the Maastricht requirements. When the state budget and the state budget strategy were written, government decisions were added to the summer forecast that have increased the budget deficit in 2023-2026 by a total of around 2.9 billion euros. This is around 1.3 billion euros more than in a scenario where the government sets its budgetary targets with the aim of complying with the minimum requirements of the fiscal rules that applied before the pandemic.

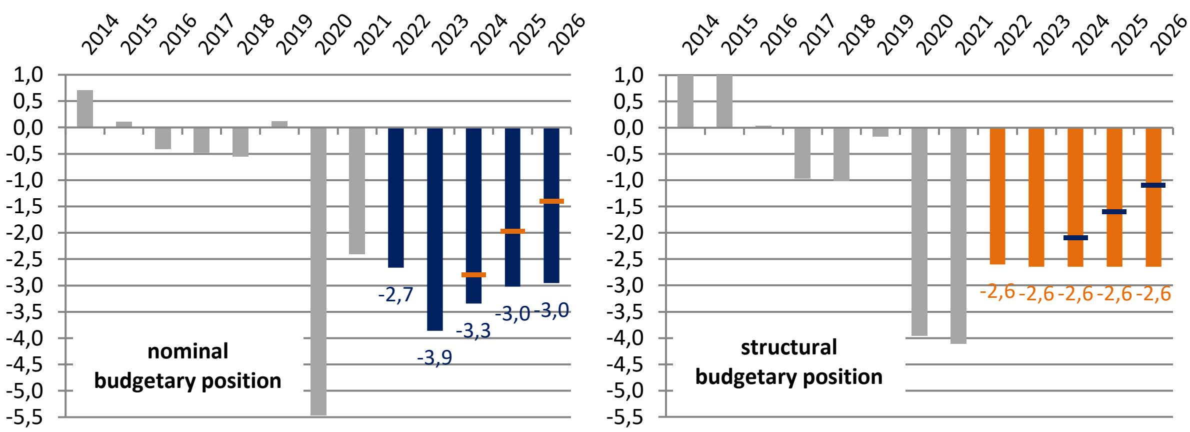

Figure 7. Forecast for the general government budgetary position 2022-2026 (% of GDP)

Source: Ministry of Finance

The Fiscal Council finds in summary that only the budgetary target for 2023 in the budget strategy 2023-2026 complies with the fiscal rules, while the targets for the structural fiscal position for 2024-2026 do not.

The total budget deficit for the next four years is forecast at 5.4 billion euros, which is almost the same amount as the current total debt of the Estonian general government, which was 5.7 billion euros in the second quarter of 2022. General government debt in the state budget strategy 2023–2026 will reach 26.2% of GDP by the end of 2026, or 11.5 billion euros, meaning it will have approximately doubled in nominal terms.

The Fiscal Council considers it important that even at times when the fiscal rules are temporarily suspended and cost pressures are severe, public finances should be managed under the principles of a responsible fiscal policy. When borrowing to cover temporary additional costs, it is important that the spending be clearly justified and well targeted. If permanent additional costs are created, permanent additional revenues must be found to cover them. Otherwise there is a danger of the structure of general government revenues and expenditures being shifted out of place and of this combining with high inflation to make the Estonian economy less competitive.

The procedure for setting the targets

Leaving aside the extraordinary circumstances in the Estonian public finances over the past few years (shorter forecast horizons in official economic forecasts and postponing the preparation of the state budget strategy in 2020, three supplementary budgets), a permanent system has now been introduced where the government sets the medium-term budgetary targets twice a year, in the stability programme in the spring and in the state budget strategy in the autumn. These two documents are not binding on one another though, and nor are the budget targets in them binding over the longer term, which essentially means that the four-year targets for the state finances can be rewritten every six months.

The example of 2022 also shows that the political negotiations that precede the stability programme may not be as thorough as those that surround the state budget strategy in the autumn.

As the budget targets set for a longer term should inform the public of the fiscal policy planned by the government, so providing security and stability for the future, the Fiscal Council considers that the current system is not the best possible approach. The Fiscal Council considers that the management of public finances should strive towards setting the targets for the fiscal position over the medium term in a carefully considered manner once a year, and should set targets that are of a more lasting nature.

The culture of political decision-making in Estonia ought to be of a standard where four-year plans for fiscal policy are not being rewritten twice a year. The Fiscal Council finds that the earlier system where the stability programme was agreed together with the state budget strategy for the next four years worked better.

How the tasks of the Fiscal Council are placed within the timetable for the management of the state finances should also be reviewed. The Fiscal Council has so far been invited to present its opinion on the targets for the structural fiscal position to the government on the same day that those targets are approved. This however effectively allows the government no time to consider the opinions of the Fiscal Council. The Fiscal Council generally only gets access to the materials it needs to produce its opinion a few working days before it has to produce that opinion. The fiscal targets set in the state budget strategy have never yet been changed in accordance with the recommendations of the Fiscal Council, even though the targets set have twice failed to comply in full with the State Budget Act as it stood at the time[2].

It is also known that after the economic forecast of the Ministry of Finance is finalised, the government immediately starts to use it to produce either the stability programme or the state budget and the budget strategy without waiting for the opinion of the Fiscal Council on the economic forecast, which is released within two weeks of the forecast being finalised. This arrangement can only work if the opinion of the Fiscal Council turns out to be positive. This autumn the Fiscal Council did not endorse the summer forecast of the Ministry of Finance, but the government had already started to use it in writing the state budget for 2023 and the state budget strategy for 2023-2026. The Fiscal Council considers that the current timetable has not taken sufficient account of the possibility that the opinion of the Fiscal Council may be negative. The government should ideally use an economic forecast that the Fiscal Council has endorsed when it is writing its budget documents.

[2] The budget strategy in spring 2017 planned a structural deficit for the years ahead even though the change to the law that would permit a deficit to be planned had not yet come into force. The targets set for 2021-2021 in the strategy written in spring 2019 complied with the fiscal rules, but the targets for 2022-2023 did not.

Background. *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 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.

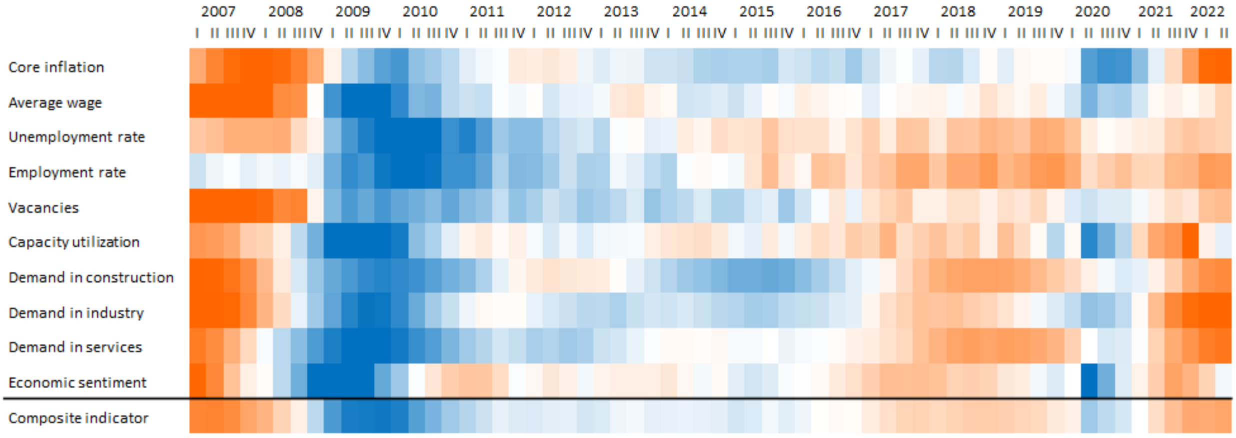

Figure 8. Macroeconomic heatmap for Estonia (Q1 2007 – Q2 2022)

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

After peaking in 2017-2019, the economic cycle turned in early 2020 as the spread of Covid-19 and the consequent restrictions caused recessions in Estonia and elsewhere in the world. However, recent data revisions from Statistics Estonia show that the decline in the economy in 2020 was smaller than it was initially measured at, as the real size of the Estonian economy shrank by only 0.6% rather than 3%. The composite indicator of the heatmap shows that the Estonian economy has improved in every subsequent quarter.

The position in the economic cycle was still strong in the first half of 2022, which is shown by the labour market indicators and survey data about demand. As high inflation is generally a sign of an economy overheating, the composite indicator from recent quarters has technically been boosted also by the rise in prices. Forecasters estimate that the Estonian economy could deteriorate in the second half of the year though. The heatmap shows the first signs of cooling in the data for the second quarter of 2022 in the capacity utilization in the industrial sector and the economic sentiment index.