EELARVENÕUKOGU
FISCAL COUNCIL

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

April 2021

Contents

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Opinion

The decline in the Estonian economy and the fiscal deficit in Estonia were both smaller than expected last year. Assuming there is no third wave of Covid-19 and consequent restrictions on economic activity, the spring economic forecast of the Ministry of Finance expects the economy to grow by 2.5% in 2021 and 4.8% in 2022.

The Fiscal Council finds that the economic environment in the years ahead may even be better than forecast. With support from the savings built up earlier and the money withdrawn from the second pension pillar, growth in private consumption could prove faster in the years ahead than is assumed in the spring forecast. Furthermore, the earlier forecasts of the Ministry of Finance have repeatedly underestimated the growth in wages. In consequence receipts of both consumption taxes and labour taxes could be better in future than is forecast. There may also be a bigger boost to economic growth than expected from investment driven by large-scale fiscal transfers.

The government will use the spring economic forecast of the Ministry of Finance as the basis for its draft budget for 2022 and the state budget strategy for 2022-2025. The Fiscal Council considers the forecast of the ministry to be a suitable basis for this.

The spring forecast expects the general government nominal budget deficit to be 6% of GDP in 2021 and then to start narrowing, but considers it will not yet have reached balance by the end of the forecast horizon in 2025. The outlook for the state finances is still better than it was in the autumn. The Covid-19 crisis has had less of an impact on the economy than was feared, and the forecast this time takes account of the pension reform, which will increase tax revenues in the state budget.

The Fiscal Council finds it reasonable that the spring forecast no longer takes account of the spending cuts of around one billion euros that were announced when the previous state budget strategy was drawn up last autumn. Corrections to the fiscal position that are not accompanied by actual measures should be avoided in future.

As it is forecast that the Estonian economy will return in 2022 to its level from before the pandemic, the Fiscal Council recommends that the fiscal rules should start to apply again from next year. This means that the nominal deficit should not exceed 3% of GDP in 2022 and the structural deficit should start to be reduced year by year.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 16 April 2021

Explanatory Report

The spring macroeconomic and fiscal forecast 2021 of the Ministry of Finance is used as the basis for the state budget strategy 2022-2025. In the near future there will remain a great deal of uncertainty about the spread of Covid-19 and its economic impact. The spring forecast of the ministry uses data that were available before 15 March. The forecast was made at a time when it was not clear in Estonia whether the increase in infection would continue and whether it was more likely that the restrictions restraining economic activity would last for a longer or a shorter time. Infection was starting to rise again in leading economies of Europe and there were reports of interruptions to the roll-out of public vaccination programmes. Under these circumstances it was much harder than usual to produce a reliable forecast.

Assessment of the macroeconomic forecast

Outlook for this year and next year

It has been increasingly shown in analysis and forecasts produced after the virus emerged that despite the continuing major uncertainty about the outlook, the harm caused by the virus to the economy has in retrospect been less serious than was feared. The Estonian economy was 2.9% smaller in size for 2020 as a whole than in the previous year, which is a smaller decline than most forecasters expected, and than the average in the euro area. The smaller decline in the Estonian economy reflects how demand held up in major trading partners during the crisis, and how the national measures limiting the movement of people and economic activity had less of an impact. The restrictions introduced because of the pandemic in 2020 in Estonia were among the least tight in the European Union[1].

The restrictions brought in to guard against the virus in the first months of 2020 in Estonia were also relatively supportive of economic growth, and tighter restrictions imposed in March are not assumed to last long in the view of the ministry. In consequence the forecast expects a rapid recovery in the economy from the second half of the year. The economy will have returned to its pre-crisis level by the end of 2021, and the output over the whole year will be only 0.5% smaller than in 2019. The macro forecast of the ministry contains a risk scenario as usual, which this time considers a postponement of the recovery of the economy by two quarters (see Figure 1). The subsequent recovery would be faster though, and by the end of 2022 there would be essentially no difference from the baseline scenario. In total there are various scenarios that could lead to the forecast GDP levels in 2021 and 2022, with the assumption that exporting industry and the service sector recover.

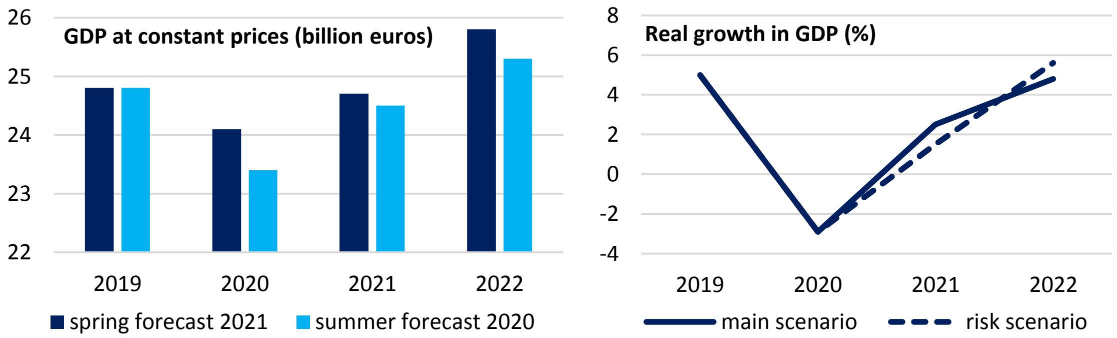

Figure 1. GDP volume and growth 2019-2022

Source: Ministry of Finance

[1] https://ourworldindata.org/grapher/covid-stringency-index

The economic forecast published by the Ministry of Finance last autumn expected that domestic demand would support a partial improvement in the economy in the second half of 2020. It was assumed that GDP would be slightly larger in the second half of the year than it was in the first half, which would mean that the result for the whole year was a fall of almost as much as in the first half of the year. As end consumption and investment spending by the general government were smaller in the first half of the year than was forecast in the state budget, the public sector was supposed to play a major role in driving the improvement. These assumptions turned out to be accurate.

However the private sector made a much larger contribution than expected to the recovery of the economy. Private consumption measured at constant prices was larger in the second half of 2020 than in the first, and it was 1.5% lower over the year. Exports of goods also started to grow, and the figure for the last six months of the year exceeded its equivalent for 2019 by more than 10%. The spring forecast expects the recovery in the economy to be relatively broadly based, and the key indicators for the economy in 2022 to be better than previously assumed (see Table 1). Although the forecast is a little more optimistic than earlier about the number of employees, this does not mean that employment will bounce back in the near future. The spring forecast finds that there will be 2.5% fewer jobs in 2022 than there were before the crisis.

Table 1. Key macroeconomic indicators in the spring economic forecast for 2021-2022 (%)

	2020	2021		2022	
	actual	spring 2021	summer 2020	spring 2021	summer 2020
GDP at current prices (billion euros)	27.2	28.5	28.2	30.5	29.9
Real GDP growth	−2.9	2.5	4.5	4.8	3.5
Nominal GDP growth	−3.4	4.9	6.4	7.0	6.0
Real growth in exports of goods and services	−5.5	6.0	5.8	6.3	4.5
Real growth in government consumption	3.6	2.9	0.3	−3.0	0.3
CPI growth	−0.4	2.0	1.4	2.1	2.2
Real growth in private consumption	−2.5	1.3	2.7	4.0	2.5
Real growth in investment	18.4*	−15.4	5.1	8.8	7.9
Real growth of domestic demand	2.4	−2.2	4.5	4.6	3.3
Real growth in average wage	3.4	1.8	−0.9	3.4	2.3
Nominal growth in average wage	2.9	3.9	0.4	5.6	4.5
Growth in employment	−2.2	−2.2	−0.3	−0.9	0.8

**One large investment was made in the private sector in 2020 that substantially impacts the reference base for 2021.*

Source: Ministry of Finance

The current high levels of uncertainty mean that there are both optimistic and pessimistic opinions about the outlook for the exporting sector. The reasons for this are that: a) although the import demand in Estonia's main trading partners is forecast to grow faster than at the time of the previous forecast, these expectations may underestimate the impact of the new wave of the virus and mainly reflect the smaller decline last year than was expected; b) it is not yet clear whether the strong growth in exports of a relatively narrow set of goods in the last months of last year indicates a temporary change in global supply chains or the beginning of a new trend; c) several major economies have already introduced very large support measures and will continue to apply them, which may also accelerate the expected economic recovery in Estonia and its main trading partners. The performance of the exporting sector also depends on how much cooperation there will be in restoring cross-border travel in different regions of the world.

In contrast, the Fiscal Council considers that the growth in private consumption may be faster than is forecast by the Ministry of Finance. This is partly because the savings of at least the wealthier part of the public have grown rapidly and opportunities for spending them have been limited. It is also because the impact on private consumption of the money being released from second pillar pension savings may be underestimated (for more see p10).

Comparison with other forecasts

In assessing the forecast of the Ministry of Finance, the Fiscal Council usually also looks at the forecasts of other institutions (see Table 2). The forecasts for real GDP growth for 2021 are between 2% and 3.4%, and for 2022 they are between 3.8% and 5.0%. Growth is forecast on average to be 1.4 percentage points faster in 2022 than this year. The inflation forecasts for 2021 range from 1.1% to 1.9%, and for 2022 they are from 1.5% to 2.5%, meaning that inflation is on average forecast to be slightly higher next year. The figures for growth in 2021 have been corrected downwards slightly from the earlier forecast, and those for 2022 have been shifted slightly upwards, as the escape from the virus is proving harder than previously thought, while the vaccination plans allow a better outlook for economic growth in 2022.

Table 2. Estimates for GDP and CPI growth in Estonia in 2021-2022

	Real GDP growth (%)		CPI (%)	
	2021	2022	2021	2022
Swedbank (January)	3.1	4.3	1.1	1.7
SEB (January)*	3.3	3.8	1.4	2.3
European Commission (February)*	2.6	3.8	1.2	2.1
Consensus Forecasts (March)	2.9	4.4	1.6	1.9
Luminor (March)	2.5	5.0	1.9	2.1
IMF (March)	3.4	4.2	1.8	2.5
Eesti Pank (March)	2.7	5.0	1.6	1.5
Estonian Institute of Economic Research (April)	3.0	–	1.8	–
Average of forecasts:	*2.9*	*4.4*	*1.6*	*1.9*
Ministry of Finance (April)	2.5	4.8	2.0	2.1

* Inflation forecasts based on the harmonised consumer price index. These estimates are not used in calculating the average of the forecast. The months indicate when the forecasts were published.

Sources: Consensus Forecasts, Eesti Pank, European Commission, IMF, Estonian Institute of Economic Research, Luminor, Ministry of Finance, SEB, Swedbank

The spring forecast of the Ministry of Finance for growth in 2021 is 0.4 percentage point lower than the average and is among the more cautious of the forecasts. The forecast of the ministry for growth in 2022 is 0.4 percentage point above the average, putting it among the more optimistic of the forecasts. The ministry's forecast for inflation for this year is the highest, and its forecast for inflation in 2022 is 0.2 percentage point above the average.

The difference in the forecast figures may come not only from the timing of the forecast but also from the assumptions made about the reform of the second pension pillar. The funds freed up by the reform may give a substantial boost to growth in the economy, raising inflation pressures and affecting various other macro indicators.

Economic outlook for 2023-2025

In the opinion of the Ministry of Finance the Estonian economy will reach its potential level in 2025, and economic growth will stabilise at 3%. Import demand in Estonia's main trading partners will grow by 3-3.5% a year, which is almost twice the average in the euro area. These assumptions suggest the environment for growth is good, and so the forecast for most of the key indicators for the economy has improved (see Table 3). Unfortunately the virus has not yet been finally defeated and the recovery in both the European and global economies could prove slower and more volatile in the medium term than is currently forecast. Equally, it is not clear how the pandemic will change the behaviour of producers and consumers. It is possible there will be some closing off of economies and some reorganisation of production and shortening of supply chains, which would change the relationship between global economic growth and global trade.

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

	2023	2024	2025	2023*	2024*
GDP at current prices (billion euros)	32.1	33.7	35.3	0.4	0.6
Real GDP growth	3.2	3.1	2.9	0.2	0.8
Real growth in private consumption	2.3	2.2	2.0	0.4	0.2
Real growth in government consumption	1.0	1.0	1.0	0.7	0.7
Real growth in investment	5.1	5.2	3.0	−4.7	1.1
Real growth in exports of goods and services	3.8	3.2	3.0	0.6	0.2
Consumer price index	2.0	1.9	1.9	−0.1	0.0
Employment growth	0.6	0.4	0.2	−0.2	−0.3
Unemployment rate	6.6	6.2	6.0	0.0	0.3

** Change from the previous forecast.*

Source: Ministry of Finance

It is important for the recovery in the economy that the government will receive relatively large amounts of fiscal transfers from abroad throughout the forecast horizon. At the start of the forecast period it will still be possible to use funds from the previous European Union budget period of 2014-2020. The programmes in the new European Union budget period will be enhanced by the programme to relaunch the economy across the European Union, and in Estonia by the subsidies for Rail Baltica. The forecast expects fiscal transfers in 2023-2025 to be 4-6% of GDP. This is a substantial stimulus. The Fiscal Council considers it is even possible that the amplification of economic growth by fiscal transfers could be even larger than initially estimated. This is especially so as additional stimulus is applied across the EU.

The funds received from the European Union budget has kept the investment level of the general government high for a long time, and public investment in the years ahead will be 6-7% of GDP (see Figure 2), which is well above the average for the European Union. The explanatory note to the forecast does not explain sufficiently clearly though how much excessive demand and competition in the construction sector or in parts of it could be caused by using these large amounts of money.

Analysts still argue a great deal over the level of investment that is needed to raise the production potential of the private sector, and there is no single agreed opinion on this. The relative size of corporate investment has for a long time been relatively modest compared to what it was earlier. Private sector investment in GDP is put a couple of percentage points lower than in the earlier forecasts of the Ministry of Finance, which is not necessarily justified. The Fiscal Council finds it possible, given Estonia's capacity so far to use fiscal transfers from abroad and the dynamics within the programming period, that general government investment will not necessarily fall as a share of GDP in the final years of the forecast.

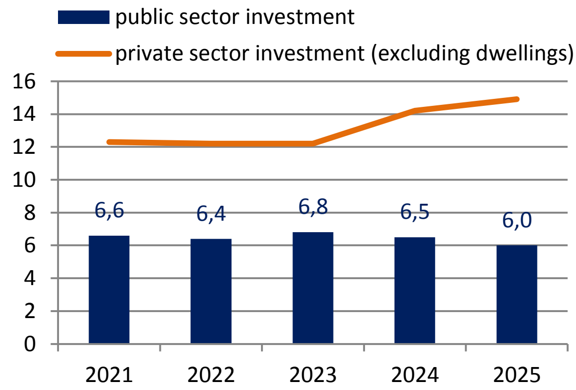

Figure 2. Forecast for public and private sector investment in 2021-2025 (% of GDP)

Source: Ministry of Finance

The other topic that needs to be looked at is balanced development in the labour market. The explanatory note to the forecast considers that labour costs found from the average nominal wage and employment will change at about the same rate of 5% a year in 2023-2025 as nominal GDP growth will. This means that no rise in real unit labour costs is forecast. The Fiscal Council has noted in several of its earlier opinions the tendency of the Ministry of Finance to underestimate the growth in labour costs. Wages have risen several times faster than expected since 2011 and have grown faster than productivity and corporate profits. The analysis of forecast errors contained in the explanatory note to the spring forecast confirms this argument, as growth in both the average wage and employment has been systematically underestimated. The interpretation of the Ministry of Finance is that structural shifts are happening in the economy towards more labour-intensive branches, and analysts cannot forecast these with sufficient confidence. It is equally possible though that a new effective equilibrium is emerging, where owners and investors have had to accept lower returns on their investments than earlier, while the gap between wage costs and profits does not reflect this change.

In its previous opinions on the economic forecasts of the Ministry of Finance, the Fiscal Council has found them to be as reliable as those by any other forecasters. In principle the same applies to the spring 2021 forecast, which gives a relatively conservative picture of the possible developments in the Estonian economy in the years ahead and so is a suitable basis for the round of fiscal policy planning in the spring.

It is extremely difficult under current circumstances to produce a reliable economic forecast looking forward several years. The Estonian economy reaching its estimated potential level in 2025 means many assumptions about Estonia and elsewhere need to be met. Both the baseline scenario in the spring economic forecast 2021 of the Ministry of Finance and the Fiscal Council's opinion on the realisation of the positive risks contained in it assume that vaccination against Covid-19 will roll out as planned and there will be no additional outbreak of the virus. It is understandable that no one can currently describe with sufficient accuracy the changes that may happen in the global economy after the pandemic.

The Fiscal Council considers it worth noting that the explanatory note to the economic forecast spring 2021 of the Ministry of Finance contains a thorough analysis of forecast errors and that the ministry has paid particular attention to monitoring and forecasting expenditures, which both the Fiscal Council and the National Audit Office had previously identified as a shortcoming.

Assessment of the fiscal forecast

The spring forecast 2021 of the Ministry of Finance uses quite different assumptions compared to autumn 2020, as the size of the recession and the budget deficit last year were known when the forecast was compiled, the supplementary budget for 2021 has been added, account has been taken of the impact of the second pension pillar reform, and the spending cuts of around one billion euros that were announced in the state budget strategy 2021-2024 have been removed from the expenditure side of the budget.

Budgetary position in 2020

A budget for 2020 with nominal balance was drawn up in autumn 2019 (see Table 4). The large-scale spread of the coronavirus in spring 2020 and the restrictions introduced because of it caused the economy to contract and tax revenues to be lower than expected. General government spending increased by 11.8% in 2020 meanwhile. Statistics Estonia estimates that the nominal budget deficit of the general government in 2020 was 1.3 billion euros, or 4.8% of GDP, which the Ministry of Finance estimates as a structural deficit of 3.6% of GDP. The fiscal rules were suspended in 2020, and so no sanction will be applied under the State Budget Act for the extraordinarily large budget deficit[2].

Table 4. The general government budget position for 2020

	State Budget 2020	spring forecast/ Supplementary Budget 2020	summer forecast/ State Budget Strategy 2021-2024	actual
Nominal balance (million euros)	−6 million	−2620 million	−1749 million	−1305 million
Nominal balance (% of GDP)	0.0	−10.1	−6.6	−4.8
Real GDP growth (%)	2.2	−8.0	−5.5	−2.9
Output gap (% of GDP)	1.5	−10.2	−2.9	−2.5
Structural balance (% of GDP)	−0.7	−5.2	−5.7	−3.6

Source: Ministry of Finance

Budgetary forecast for 2021-2025

The spring forecast 2021 of the Ministry of Finance finds that the general government budget deficit will deepen further in 2021 to give a nominal deficit of 6% of GDP and a 5.5% structural deficit (see Table 5). It was assumed when the state budget for 2021 was compiled that the nominal deficit this year would total 1.9 billion euros or 6.7% of GDP.

Table 5. The general government budget position for 2021-2025 (% of GDP)

	2020	2021	2022	2023	2024	2025
Nominal balance (million euros)	−1305	−1723	−1231	−1003	−809	−659
Nominal balance	−4.8	−6.0	−4.0	−3.1	−2.4	−1.9
Output gap	−2.5	−2.9	−1.0	−0.5	−0.2	0.0
Cyclical component	−1.2	−1.4	−0.5	−0.3	−0.1	0.0
Cyclical balance	−3.6	−4.6	−3.5	−2.9	−2.3	−1.8
One-off measures	0.0	0.8	0.2	0.0	0.0	0.0
Structural balance	−3.6	−5.5	−3.7	−2.9	−2.3	−1.8
Government debt	18.2	21.4	24.9	27.7	28.5	28.8

Source: Ministry of Finance

[2] For more see the opinion of the Fiscal Council on the structural budget position in 2020.

There have been major changes from the forecast published last autumn on both the revenue and expenditure sides of the budget, both for this year and in the longer term. The first is that the spring forecast takes account of the supplementary budget for 2021. The supplementary budget is of 641 million euros in size and the ministry estimates that the negative impact on the budget position for 2021 will be 385 million euros, or 1.35% of GDP. As the economy contracted by less last year than expected and the production capacity in the economy will be larger in the coming years than was earlier forecast, the tax revenues in the state budget have been increased in the spring forecast (see Table 6), which will have a positive impact on the fiscal position in 2021 and throughout the whole forecast horizon. Tax revenues have also been increased by the reform of the second pension pillar.

Table 6. Forecast for tax revenues in the state budget in 2021-2022 (million euros)

	2021	*change from previous forecast*	2022	*change from previous forecast*
Total tax revenue	8258.1	637.6	8509.0	498.9
Personal income tax	692.0	360.9	561.0	187.1
Corporate income tax	369.0	18.0	384.0	1.5
Social tax	3595.0	202.5	3730.0	255.8
VAT	2595.0	75.8	2725.0	56.7
Excises	925.5	–21.3	1022.7	–4.4

Source: Ministry of Finance

The impact of the second pension pillar reform on the state finances

The spring forecast 2021 of the Ministry of Finance takes account of the impact of the second pension pillar reform for the first time. The ministry has used a survey carried out in October 2020 by Kantar Emor to forecast the possible behaviour of people in the pillar.

The reform has a direct impact on state finances because the money withdrawn from the second pillar before retirement age will increase income tax revenues in the state budget and government expenditure will be reduced from the cancellation of contributory pensions, as the state will no longer have to make the 4% contribution from social tax. The budget will also receive more from consumption taxes if the funds released from the second pillar are used for consumption. The spring forecast of the Ministry of Finance assumes that some 1.2 billion euros will be withdrawn from the second pillar. This means that around 350 million euros more will be received in personal income tax in the state budget 2021-2022, and the state will need to allocate around 100-130 million euros a year less from social tax in future. The ministry's forecast of the amounts to be withdrawn from the second pillar is well aligned with the actual data from the end of March, which show that applications to withdraw 1.3 billion euros from the second pillar were received, though as these applications could still be withdrawn, the actual amount may yet be smaller.

As well as how much money is taken out of the second pillar, how those funds will then be used is important in the context of a forecast. The Ministry of Finance estimates that the funds will be split roughly equally between consumption and the real estate market, and that 600 million euros in additional demand will be added to the Estonian economy over the next 18 months. To put that in perspective, the Estonian economy is forecast to be 30.5 billion euros in size in 2022. As it is difficult to forecast how people in the second pillar will behave, especially as the decision to withdraw money was made during a recession, there remains great uncertainty about the impact of the pension reform. The Fiscal Council considers that the assumption in the spring forecast of the Ministry of Finance for how the money will be divided between consumption and real estate may not necessarily prove correct, and so the impact of the pension reform on private consumption may be underestimated in the forecast, and so may tax receipts also be.

The government is using the spring forecast of the Ministry of Finance as the basis for the state budget strategy for 2022-2025. This means that the government is using higher revenues than were forecast in the autumn, but also that general government expenses have increased (see Figure 3). Revenues are around 0.9-1 billion euros higher, but expenses have risen by less and unevenly across the years.

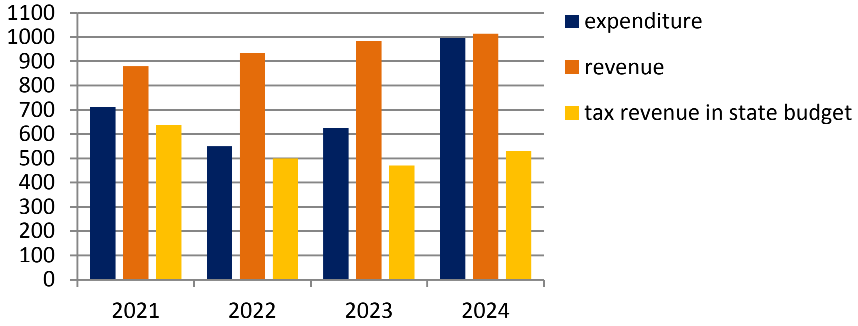

Figure 3. Changes in the general government revenue and expenditure forecast from autumn 2020 (million euros)

Source: Ministry of Finance

The main rise in the expenditure forecast for 2021 has come from the supplementary budget passed this spring, but the rise in the expenditure in 2022-2024 comes partly from a change in one important forecast assumption. The spring forecast does not contain spending cuts that were announced in the budget strategy last autumn, as that consolidation plan did not actually contain any specific measures. The spending forecasts for 2022 and 2023 are increased by around 260 million euros in consequence, and the forecast for 2024 by 460 million euros, which is almost half of the additional spending in 2022-2024. The forecast has also been raised by expenditure types such as old-age pensions that depend on the performance of the economy.

As the government has passed supplementary budgets in both 2020 and 2021 to fund healthcare costs and the support for the economy, the growth in spending has proven faster than usual for those years (see Figure 4). The spring forecast of the ministry finds that government spending will not grow further from this high level in 2022, and in the longer term the growth in expenditures will remain below the growth in revenues. Even so the additional growth in expenditures during the crisis was so fast that balance between revenue and expenditure volumes will not be recovered by the end of the forecast horizon. The growth in government revenues will already recover this year with support from the pension reform after its drop-off in 2020, but in the future it will remain below its average from before the crisis.

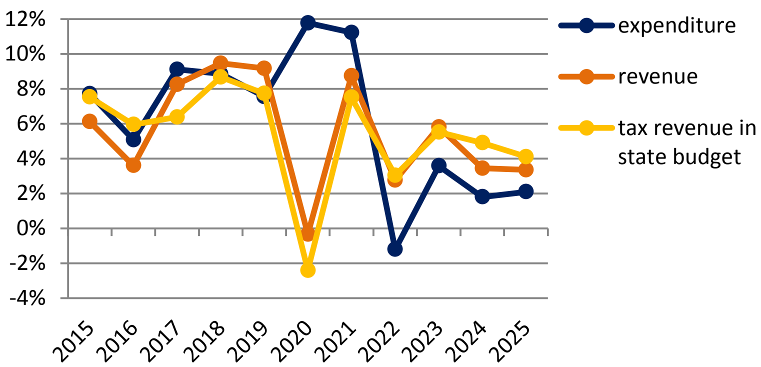

Figure 4. Growth in general government revenue and expenditure in 2015-2025 (%)

Source: Ministry of Finance

The changes made in the spring forecast to revenues and expenditures mean overall that the forecast for the general government budget position has improved since last autumn (see Figure 5)[3]. Although the deficit is forecast to start shrinking from next year, budget balance will not yet have been achieved by the end of the forecast horizon and both the nominal and structural deficits will remain close to 2% of GDP.

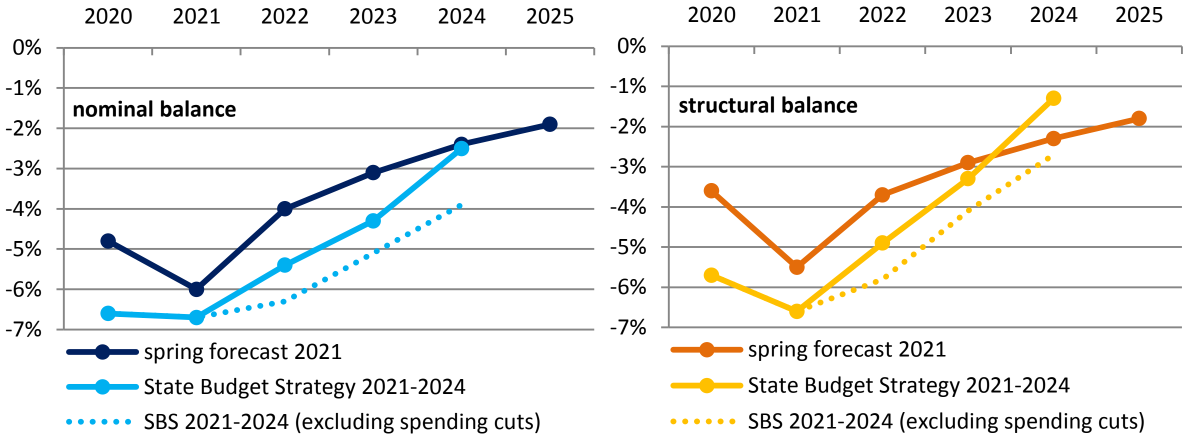

Figure 5. Forecast for the general government budget position 2021-2025 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

As noted earlier, general government revenues will grow more slowly during the forecast horizon than they did on average before the crisis. Closer analysis of tax revenues shows the growth in both labour taxes and consumption taxes in the spring forecast of the Ministry of Finance to average 4.5% in future, having earlier been 7-8% (see Figure 6). However, slower growth in tax revenues has been assumed in several earlier forecasts of the Ministry of Finance, and so it will no longer be the impact of the Covid-19 pandemic after 2020 and 2021 but a general trend in the development of the Estonian economy that needs to be accounted for by when fiscal policy is set.

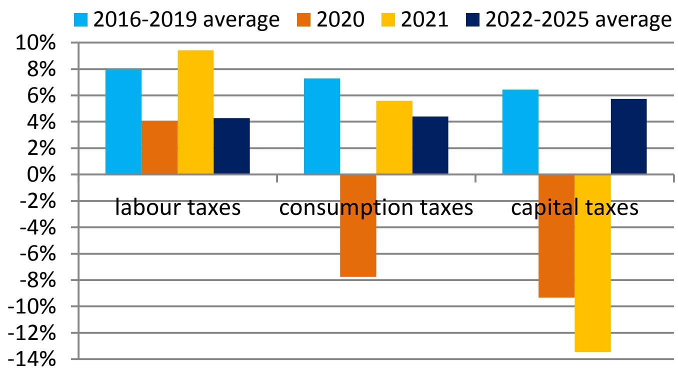

Figure 6. Growth in tax revenues in 2016-2020 and forecast for 2021-2025 (%)

Sources: Ministry of Finance, calculations of the Fiscal Council[4]

[3] The Fiscal Council finds that it would be more appropriate here to compare the spring forecast 2021 and the State Budget Strategy (SBS) 2021-2024 only once the announced spending cuts have been excluded from the budget position (dotted line in Figure 5).

[4] Figure 6 groups together social tax and personal income tax, including the part allocated to local governments, under labour taxes; VAT, excise and customs duties under consumption taxes; and corporate income tax, heavy vehicle tax, gambling tax and land tax under capital taxes. Receipts under this distribution in 2020 were 5.45 billion euros of labour taxes, 3.38 billion euros of consumption taxes, and 0.57 billion euros of capital taxes.

To estimate whether the forecast of the main types of tax receipts is in line with the macroeconomic forecast, Figure 7 shows the expected development in social tax and VAT as the main components of labour taxes and consumption taxes in comparison with the development of the tax base and the economy[5].

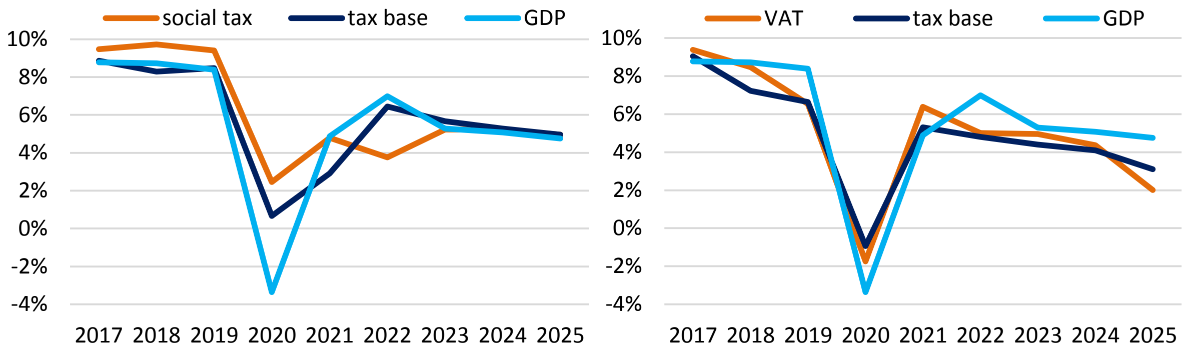

Figure 7. Growth in social tax and VAT receipts compared to nominal growth in the tax base and GDP (%)

Sources: Ministry of Finance, calculations of the Fiscal Council

The recession caused by the pandemic, the wage subsidies paid out and the changes to tax policy together mean that social tax receipts in 2020-2022 are not normally aligned with macro indicators[6]. They will become better aligned in the years ahead, but at a notably lower rate of growth than before the crisis. It is apparent with VAT that although tax revenues have mostly grown in line with the tax base, which is mainly private consumption, that tax base will in future grow more slowly than GDP. The spring forecast expects that VAT, like social tax, will grow more slowly in future.

Overall the Fiscal Council finds that the forecast by the Ministry of Finance for social tax and VAT receipts is generally conservative and that it is in line with the macroeconomic developments described in the spring forecast. The Fiscal Council considers it possible though that the savings built up earlier and the money withdrawn from the second pension pillar could mean that growth in private consumption proves faster in the years ahead than is assumed in the spring forecast. Furthermore, the earlier forecasts of the Ministry of Finance have repeatedly underestimated the growth in wages. In consequence receipts of both consumption taxes and labour taxes could be better in future than is forecast.

The growth in the Estonian economy may also get a bigger boost than expected in the coming years from fiscal transfers from abroad. Estonia is able to add to the funds from the previous and current European Union budget periods during the forecast horizon with the extraordinary EU funds dedicated for the recovery from the pandemic. The amount of fiscal transfers from abroad will be twice as much in 2023 as it was in 2020, and will remain at a high level until the end of the forecast horizon (see Figure 8). The spring forecast 2021 finds that around one third of the transfers will go into public investment, which will also grow faster in the coming years. It is forecast that the level of public investment at the end of the horizon will still be smaller than was assumed in the state budget strategy compiled in autumn 2020. The Fiscal Council finds that the spring forecast does not explain clearly enough why the forecast for public investment has been reduced while fiscal transfers are forecast to remain about the same.

[5] The VAT tax base in Figure 7 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.

[6] The Ministry of Finance explains that social tax receipts will also be affected in 2022 by changes in tax policy that will lower the tax rate under certain circumstances from 33% to 20%.

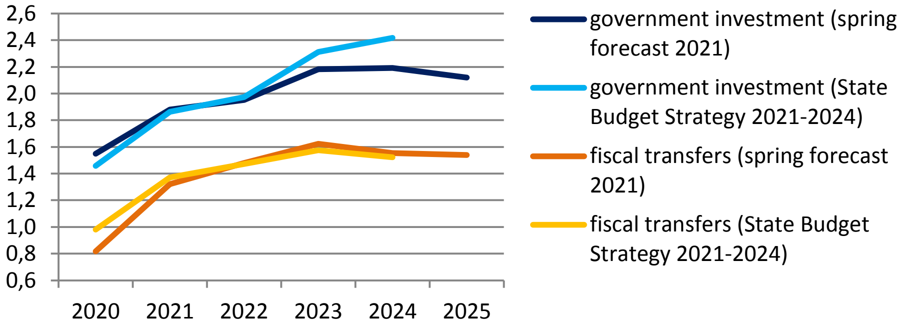

Figure 8. General government investment and fiscal transfers from abroad (billion euros)

Source: Ministry of Finance

The spring forecast 2021 of the Ministry of Finance assumes that the total output of the Estonian economy will remain at 2.9% below its potential capacity this year (see Figure 9). The ministry estimates that the gap between actual and potential GDP will narrow in 2022 and will close by the end of the forecast horizon. Calculations by the Fiscal Council using the disaggregated method and based on the figures in the spring forecast of the Ministry of Finance indicate a fairly similar dynamic in the economic cycle. This means that the calculations by the Fiscal Council give a general government structural budget deficit going forwards of a similar size to that estimated by the ministry (see Figure 10).

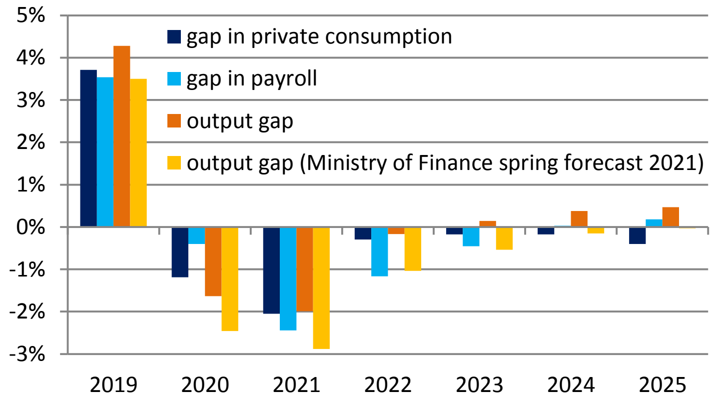

Figure 9. Gaps in the tax bases with the disaggregated method (% of the trend)

Sources: Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council uses similar assumptions to the Ministry of Finance for one-off and temporary budget measures. In autumn 2020 the Ministry of Finance still calculated that the one-off measures would include a halt in the second pension pillar contributions by the state and that these would later be compensated, as was done during the previous financial crisis, but in spring the ministry followed the guidelines of the European Commission and abandoned this approach. Only the additional income tax received by the state from the launch of the pension reform is considered a one-off measure during the forecast horizon, as it gives a temporary and one-off lift to state revenues in 2021-2022, and so need not be considered in the calculation of the structural position.

It should also be considered that the size of the structural deficit in both 2020 and 2021 contains the support measures taken by the state to ease the economic impact of the pandemic, but this spending is not permanent in nature. This means that the structural budget position will in future be improved at least partly because the measures taken by the state to support the economy will end.

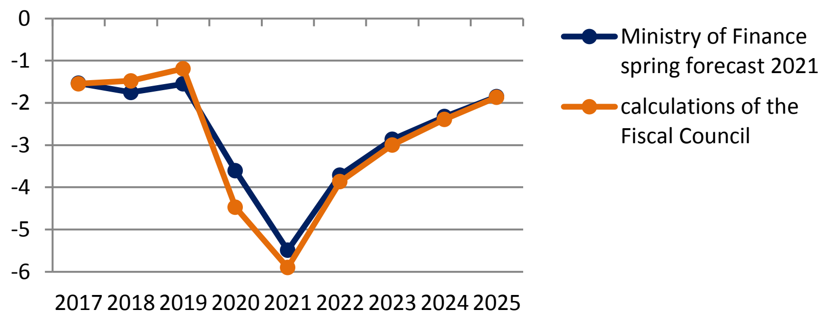

Figure 10. Estimated structural balance 2017-2025 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council believes it important that general government expenditures be brought in line with expected revenues and that large-scale budget deficits to support the economy remain a crisis measure only. General government spending increased sharply as a share of GDP in 2020 because of both the rapid growth in expenditures and the fall in GDP. The spring forecast of the Ministry of Finance expects that general government spending will increase further as a share of GDP in 2021, and it will remain above its earlier level in future (see Figure 11). Although general government revenues as a share of GDP will be increased by the pension reform and the growth in fiscal transfers from abroad, such an excess of expenditures will not be sustainable over the long term.

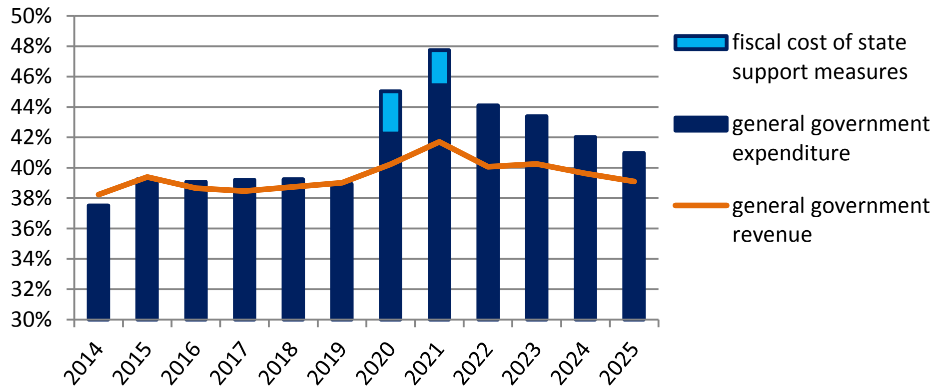

Figure 11. Revenue and expenditure of the general government (% of GDP)

Source: Ministry of Finance

Compliance with the fiscal rules

An escape clause to the fiscal rules in the European Union and Estonia was introduced in spring 2020 to ease the economic impact of the Covid-19 pandemic, and it exempted member states temporarily from the numerical limits on fiscal policy. The escape clause was originally intended for 2020 but it was extended to 2021 and this spring the European Commission will decide whether it is justified to extend it to 2022 as well. The European Commission will base its decision on how quickly the European Union and the euro area are recovering economically to where they were before the crisis. If it becomes clear from the spring forecast of the European Commission that GDP will not return next year to its level from before the crisis, then the escape clause may be extended to 2022[7]. The winter forecast of the European Commission shows that it would be justified on this criterion to extend the escape clause to the fiscal rules to 2022.

[7] For more on the escape clause see https://ec.europa.eu/info/files/one-year-outbreak-covid-19-fiscal-policy-response_en.

The Estonian government is this spring drawing up its state budget strategy for 2022-2025 and the draft state budget for 2022. The Estonian economy contracted by less in 2020 than those in the European Union did on average, and the spring forecast of the Ministry of Finance finds that Estonian GDP will have passed its pre-crisis level in 2022 in both current and constant prices. In consequence the Fiscal Council recommends that the government draw up its state budget for 2022 as if the escape clause does not apply in 2022 regardless of the decision of the European Commission. This means that the nominal deficit should no longer exceed 3% of GDP and the structural deficit should start to be reduced by at least 0.5 percentage point a year.

The spring forecast of the Ministry of Finance puts the nominal budget deficit in 2022 at 4% of GDP. This means that the budget position would need to be improved by a little over 300 million euros next year for the deficit not to exceed 3% of GDP (see Table 7). Other assumptions remaining the same, this would reduce the structural budget deficit in 2022 to 2.7% of GDP, which would be a substantial improvement from 2021. Starting from a structural deficit of this level, the budget position for 2023-2025 would also need to be improved in the state budget strategy to ensure that the structural deficit is reduced by 0.5 percentage point a year in future. The budget position would need to be improved by around 220-240 million euros a year in the years ahead. Over four years this would then improve the nominal budget position by around 1 billion euros from the spring forecast of the Ministry of Finance.

Table 7. The general government budget position for 2022-2025

Ministry of Finance spring forecast 2021:	*2021*	*2022*	*2023*	*2024*	*2025*
Nominal balance (million euros)	−1723	−1231	−1003	−809	−659
Nominal balance (% of GDP)	−6.0	−4.0	−3.1	−2.4	−1.9
Structural balance (% of GDP)	−5.5	−3.7	−2.9	−2.3	−1.8
Fiscal Council recommendation:	*2021*	*2022*	*2023*	*2024*	*2025*
Nominal balance (million euros)	−1723	−915	−780	−590	−420
Nominal balance (% of GDP)	−6.0	−3.0	−2.4	−1.8	−1.2
Structural balance (% of GDP)	−5.5	−2.7	−2.2	−1.7	−1.2
Change in the structural balance (pp)			*0.5*	*0.5*	*0.5*
Improvement in the nominal balance (million euros)		*316*	*223*	*219*	*239*

Sources: Ministry of Finance, calculations of the Fiscal Council

However, even in this scenario the general government budget position does not reach balance by the end of the forecast horizon, as both the nominal and structural budget deficits are of 1.2% of GDP. The government debt would not in this case reach 10.2 billion euros or 28.8% of GDP by the end of 2025, but would be around a billion euros smaller.

The Fiscal Council finds it important for the transparency and credibility of state finances that if the state budget strategy moves to improve the general government budget position from what is forecast, then the steps taken to improve it should not be free of actual revenue and cost measures in the way that the state budget strategy for 2021-2024 was.