OPINION OF THE FISCAL COUNCIL ON THE ACHIEVEMENT OF THE GENERAL GOVERNMENT STRUCTURAL BUDGET POSITION TARGET IN 2020

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Contents

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Opinion

Besides assessing the official economic forecasts of the state, it is also the task of the Fiscal Council to monitor compliance with the national fiscal rules. To do this the Fiscal Council assesses in the spring whether the structural budget position of the general government for the past year met the targets set for it, and the fiscal rules more broadly. For the first time in the history of the Fiscal Council and the State Budget Act, the general escape clause was activated in 2020 because of the outbreak of the Covid-19 crisis, and the requirement to meet numerical limits in setting fiscal policy was temporarily suspended. The escape clause will remain in place until at least 2021.

Unfortunately the budget position of the Estonian general government was not in structural balance before the pandemic, and so larger fiscal buffers were not built up against the crisis. The larger structural deficit than permitted in 2018 caused the correction mechanism contained in the fiscal rules to be engaged, which required the structural fiscal deficit to be steadily reduced, and the government wanted in consequence to return to close to structural balance in 2021.

This was at least the government's plan in autumn 2019 when the state budget for the next year was first drafted. The state budget for 2020 was drafted so that the nominal budget position of the general government would be in balance, and the structural budget deficit would narrow to 0.7% of GDP.

It became apparent though in spring 2020 that the goal of reducing the structural deficit was not achieved in 2019, and that the coronavirus crisis meant it would not be achieved in 2020 either. The escape clause in the fiscal rules was engaged when the Covid-19 crisis erupted and the Estonian government no longer set a numerical target for the size of the budget deficit in 2020, as budgetary forecasts made in spring and summer were surrounded by great uncertainty. The more pessimistic spring forecast of the Ministry of Finance suggested that the nominal budget deficit of the general government in 2020 could reach 10% of GDP, and the structural deficit could be 5% of GDP.

The Fiscal Council finds that it was reasonable in 2020 to apply the escape clause and to abandon the earlier numerical budgetary targets in order to ease the economic impact of the coronavirus pandemic.

The recession and the budget deficit in 2020 turned out smaller than forecast during the year by the Ministry of Finance. Statistics Estonia put the nominal budget deficit of the general government for 2020 at 1.3 billion euros, or 4.8% of GDP. The assessment by the Ministry of Finance finds that this gives a structural budget deficit of 3.6% of GDP.

The budget for 2020 was knocked out of balance by the reduction in revenues and increase in expenditures. The state budget for 2020 expected that general government revenues and expenses would be 11.5 billion euros, but revenues proved some 600 million euros smaller than this and expenses 700 million euros larger. The Ministry of Finance estimates that the cost to the budget of the state support measures to help the economy in 2020 were 2.8% of GDP. The support measures have continued in 2021.

The state took on both short-term and long-term debt liabilities to fund this unprecedentedly large budget deficit, and by the end of 2020 the general government debt was at its highest ever level at 18.2% of GDP.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 22 April 2021

Explanatory Report

Besides assessing the official economic forecasts of the state, it is also the task of the Fiscal Council to monitor compliance with the national fiscal rules. To do this the Fiscal Council assesses in the spring whether the structural budget position for the past year met the targets set for it and the fiscal rules more broadly. For the first time in the history of the Fiscal Council, the escape clause was activated in 2020 because of the outbreak of the Covid-19 crisis, and the requirement to meet numerical limits in setting fiscal policy was temporarily suspended.

The general government budgetary target for 2020

When the state budget for 2020 was first drafted in autumn 2019, the Estonian government set its numerical budget targets by starting from the requirements of the correction mechanism in the state budget act, which came into force after the structural budget deficit was larger than permitted in 2018. This required the structural budget deficit to be reduced each year by at least 0.5 percentage point until structural balance had again been achieved.

As the estimate of the structural budget deficit by the Ministry of Finance in autumn 2019 put it at 1.7% of GDP in 2018, the government set the budget target of a deficit of 1.2% of GDP in 2019 and of 0.7% of GDP in 2020 (see Figure 1). The government hoped that this would ensure that the budget position improved by 0.5 percentage point a year, and that it would come close to structural balance in 2021.

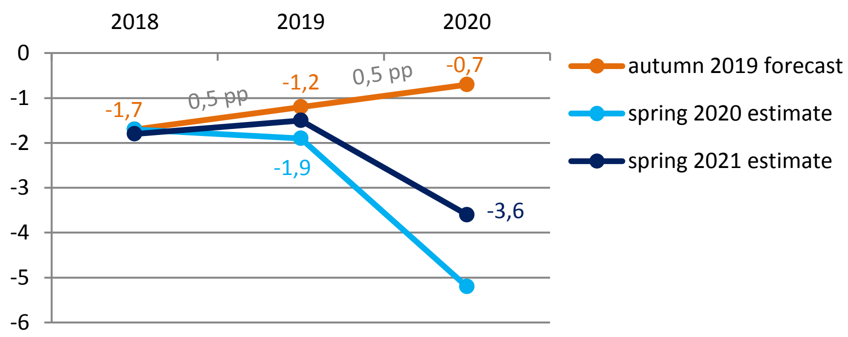

Figure 1. Setting the target for the general government structural budget position for 2020 (% of GDP)

Source: Ministry of Finance

The government plan to restore structural balance suffered two setbacks in spring 2020. The first is that it became apparent that the structural deficit in the previous year had again been larger than expected (see more in Background 2 pp11-12). The Ministry of Finance estimated in spring 2020 that the structural deficit in 2019 was 1.9% of GDP, meaning the budget position had not improved from 2018. The Fiscal Council found that the government did not meet its numerical budget targets for 2019 or the requirements of the correction mechanism that are necessary if structural balance is to be regained.

The second and more serious setback was delivered by the wide spread of the coronavirus pandemic from spring 2020. An escape clause in the European Union and Estonian fiscal rules was activated to ease the economic impact of the Covid-19 pandemic, and it exempted member states temporarily from the numerical limits on fiscal policy. This meant that Estonia had no obligation to continue its move towards structural balance in 2020 having failed to do so in 2019. The Estonian government passed a supplementary budget for 2020 in April 2020 that no longer stuck to the budget targets set earlier, but reflected the sudden deterioration in the economic environment and contained large-scale measures of economic assistance, which were expected to leave a structural budget deficit of more than 5% for 2020.

As the government no longer set numerical targets for the size of the structural deficit in 2020 after this, the analysis of the Fiscal Council focuses on the description of the general government budget position in 2020 and on the explanation of the changes to the forecast, but does not give the usual assessment of the achievement of numerical budget targets under the State Budget Act. The Fiscal Council finds that it was reasonable in 2020 to apply the escape clause and to abandon the numerical budget targets set earlier.

Achieving the general government budgetary target

Nominal budget position

A budget for 2020 with nominal balance was drawn up in autumn 2019 (see Figure 2), which was supposed to ensure that the structural deficit met its target of 0.7% of GDP. This assumed economic growth of a couple of per cent, a positive output gap, and growth of 5% in tax revenues. The large-scale spread of the coronavirus in spring 2020 and the restrictions introduced to stop it caused the economy to contract and tax revenues to be lower than expected. On the spending side the government deliberately decided not to reduce the spending planned in the budget, but rather expanded it as additional funds were needed for healthcare and social protection and to support the economy.

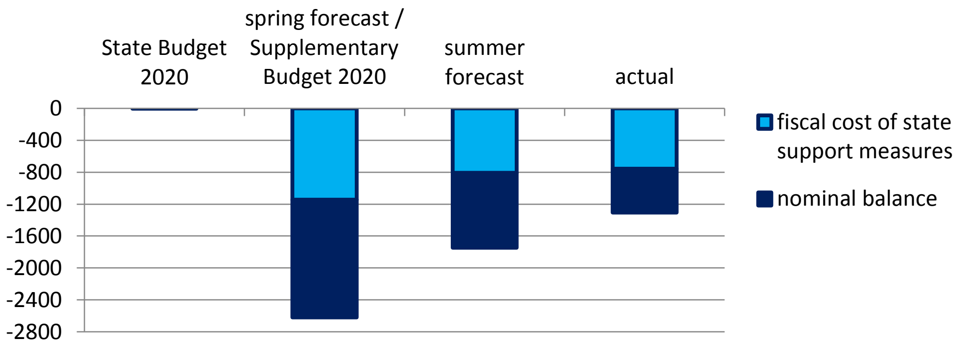

Figure 2. General government nominal balance and the cost of support measures in 2020 (million euros)
Source: Ministry of Finance

This means that the budget deficit in 2020 was caused both by falling revenues provoked by the economic crisis and the increased spending by the government. The spring forecast 2020 of the Ministry of Finance expected that the nominal deficit of the general government would total 2.6 billion euros, or 10.1% of GDP, of which a little over 1.1 billion euros was projected as the fiscal cost of the measures passed in the supplementary budget to support the economy[1]. The summer forecast 2020 found that the crisis would not affect the state finances by as much, and the nominal deficit was forecast at 1.75 billion euros or 6.6% of GDP. The cost of the measures was estimated to be lower because they were used less than expected and because they had cost less, and it was put at 810 million euros, or 3.1% of the expected GDP of 2020.

The actual contraction in the economy and the budget deficit have however proven smaller than was forecast during the year. The flash estimate of the Ministry of Finance put the budget deficit in 2020 at 5.5% of GDP, but preliminary data from Statistics Estonia show the nominal budget deficit of the general government in 2020 was 1.3 billion euros, or 4.8% of GDP (see Table 1). This is around half as much as was estimated when the supplementary budget was drafted in spring 2020. The Ministry of Finance estimates that the budgetary cost of the package of measures announced in the supplementary budget in 2020 was around 760 million euros, or 2.8% of GDP.

[1] The list of support measures and the Ministry of Finance forecast for their budgetary cost can be found in the opinion of the Fiscal Council published in spring 2020.

Table 1. The general government budget position for 2020 (% of GDP)

	spring 2019	*autumn 2019*	*spring 2020*	*autumn 2020*	*spring 2021*
	State Budget Strategy 2020–2023	State Budget 2020	spring forecast/ Supplementary Budget 2020	summer forecast/ State Budget Strategy 2021–2024	actual
Nominal balance (euros)	32 million	−6 million	−2620 million	−1749 million	−1305 million
Nominal balance	0.1	0.0	−10.1	−6.6	−4.8
Real GDP growth (%)	2.7	2.2	−8.0	−5.5	−2.9
Output gap	1.1	1.5	−10.2	−2.9	−2.5
Cyclical component	0.5	0.7	−5.0	−1.4	−1.2
One-off measures	0.0	0.0	0.0	0.5	0.0
Structural balance	−0.4	−0.7	−5.2	−5.7	−3.6

Source: Ministry of Finance

The smaller contraction than expected in the economy was accompanied by positive developments in private consumption and the labour market, which meant that the state budget received more in tax revenues than was forecast during the year. The state budget received 530 million euros less in tax revenue than was expected in autumn 2019, but 760 million euros more than was estimated when the supplementary budget was drafted in spring 2020 (see Figure 3). The spring forecast expected that tax revenues would be as much as 12% lower than in 2019 and the summer forecast found that tax revenues would be down by around 6%, but the actual decline in the tax receipts in the state budget in 2020 was only 2.4%. Total general government revenues from both tax revenues and non-tax income were at about the same level in 2020 as in 2019, as revenues were down only 0.3% on the previous year.

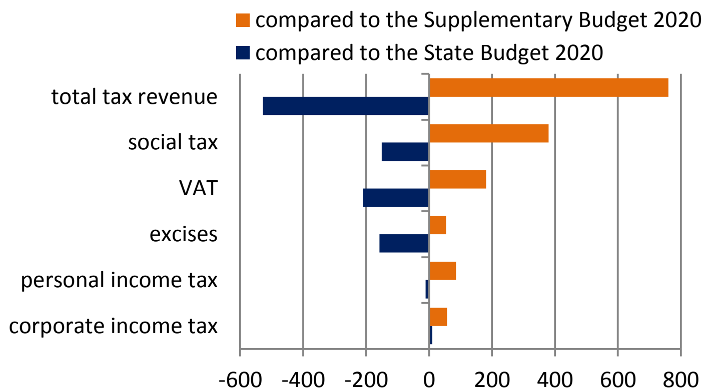

Figure 3. Tax revenues received in 2020 compared to the forecast in the State Budget 2020 and the forecast in the Supplementary Budget 2020 (million euros)

Source: Ministry of Finance

General government spending increased by 11.8% in 2020 (see Figure 4). Government spending was around 680 million euros higher than was forecast in autumn 2019 when the state budget was planned. The increase of around half a billion euros over the forecast came mainly from subsidies and social transfers, which reflects the support measures given by the state to ease the impact of the coronavirus pandemic and the increased spending on unemployment benefit. It was also raised above the forecast level to a lesser extent by compensation to workers, for healthcare for example, and by capital transfers. Despite the recession, general government investment was almost at the level planned in the state budget and reached around 1.6 billion euros, having been 1.4 billion a year in the previous three years. If government spending is divided into current expenses and capital expenses, or investment, then it was mainly current expenses that raised the spending level higher than expected in 2020.

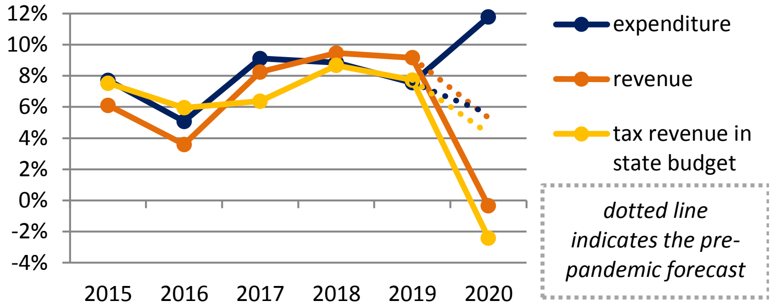

Figure 4. Growth in general government revenue and expenditure in 2015-2020 (%)

Source: Ministry of Finance

As the budget for 2020 was planned with nominal balance but expenditure exceeded revenue by 1.3 billion euros by the end of the year, the state treasury had to increase the state debt to cover spending. As the forecast produced during the year expected the economic contraction to be larger, more funds were borrowed than were actually needed in 2020. Debt liabilities of over 2.8 billion euros were taken on in 2020, as 575 million euros of short-term bonds were issued, of which 150 million matured before the end of the year, 1.5 billion euros of long-term bonds were issued, and 750 million euros was taken as a long-term loan from the Nordic Investment Bank (NIB). The state debt in 2019 was 8.4% of GDP, but by the end of 2020 the debt of the Estonian general government was 4.95 billion euros, or 18.2% of GDP.

Structural budget position

To calculate the structural budget position of the general government, the budget is corrected for the impact of the economic cycle and the effect of one-off and temporary budget measures. Although the size of the recession in 2020 and the nominal budget deficit are now known, it is still hard to estimate what impact the Covid-19 pandemic has had on the potential for growth in the Estonian economy, and how wide the output gap was in 2020. The output gap is especially difficult to measure at turning points in the economy, and furthermore the economic impact of the pandemic has been softened by the state support measures. This means it is also harder to identify the cyclical and structural components in the revenues and expenses in the state budget.

Forecasts made in the second half of 2020 expected that the Estonian output gap in 2020 would be negative and in the range of 1.1-4.6% of GDP (see Figure 5). The estimate by the Ministry of Finance in spring 2021 put the negative output gap in 2020 at 2.5% of GDP, meaning it was smaller than in most of the forecasts by other institutions. This estimate is supported by the heatmap of the Estonian economy produced by the Fiscal Council (see Background 1 p10).

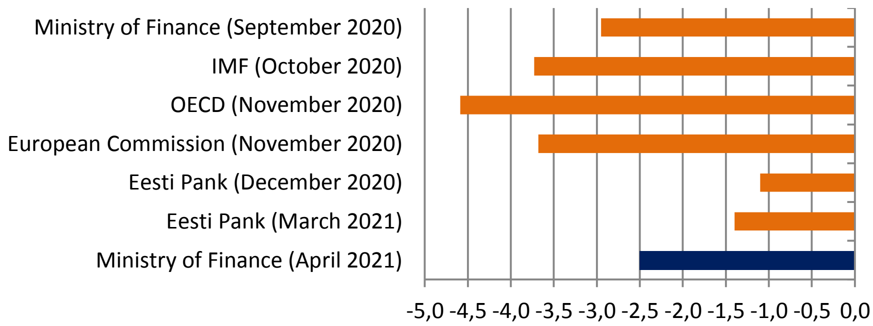

Figure 5. Estimates of the output gap in Estonia in 2020 (% of potential GDP)

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

In autumn 2020 the Ministry of Finance assumed that the calculation of the structural budget position for 2020 needed to exclude the funds released from the temporary halt in state contributions to the second pension pillar worth 0.5% of GDP. The ministry abandoned this approach in spring 2021 in line with the guidelines of the European Commission, and the temporary halt in state contributions is no longer counted as a one-off budget measure in the calculation of the structural budget position (see Table 1 p6). Equally the state support measures are not classed as one-off budget measures, although many of them are by nature temporary and one-off. This means that the size of the structural budget deficit in 2020 includes the budgetary costs of the state support measures, though they may not be permanent in nature, and so the structural deficit may narrow substantially once the support measures are ended.

The spring forecast 2021 by the Ministry of Finance put the structural budget deficit of the general government at 3.6% of GDP for 2020 (see Figure 6). The structural budget deficit is smaller than was forecast during the year, but notably larger than was planned for 2020 before the pandemic. Calculations by the Fiscal Council using the disaggregated method found that the structural deficit in 2020 could even be larger at 4.5% of GDP, as both private consumption and the payroll in the economy were less affected by the recession in 2020.

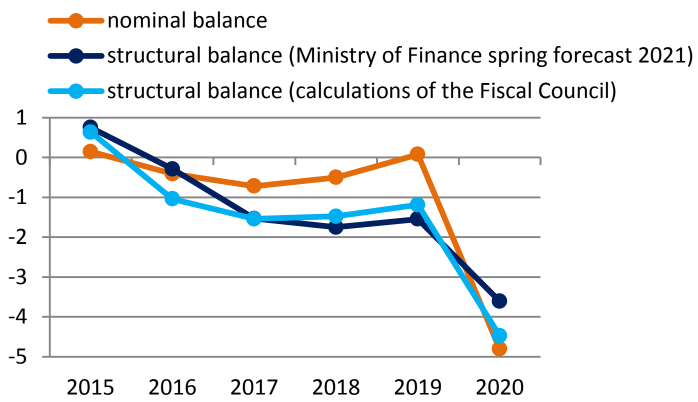

Figure 6. The nominal and structural budget positions of the general government (% of GDP)

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

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. Overall the fiscal position of the Estonian general government has been in notable structural deficit for four years in a row now, and the government plan of 2019 to restore structural balance by 2021 in accordance with the correction mechanism has by now lost its relevance because of the coronavirus crisis. As the crisis passes, the Fiscal Council finds it important that the government return to a rules-based fiscal policy and set the target of a return to structural budget balance.

Cumulative structural budget position

The Estonian fiscal rules contain not only the correction mechanism, but also the compensation mechanism, which requires the structural deficit that was larger than permitted to be compensated for in subsequent years by a structural surplus of the same size, and that the structural surplus should be at least 0.5% of GDP a year. The larger deficit than permitted is calculated from a measure of the cumulative structural budget position that adds together the results for the surpluses and deficits over the years (see Table 2). The State Budget Act does not permit a deficit in the cumulative position, and so once the general government has returned to structural balance, the cumulative structural budget position will also have to be returned to balance.

Table 2. The cumulative structural budget position as at the end of the year (million euros)

	2014	*2015*	*2016*	*2017*	*2018*	*2019*	*2020*
Fixed estimate from the spring	32	118	270	192	−164	−703	−703

Sources: Ministry of Finance, calculations of the Fiscal Council

The cumulative structural budget position of the general government was already in deficit in 2018, and calculations of the Fiscal Council show that it exceeded 700 million euros by 2019. The current fiscal rules require this deficit to be compensated in later years after structural balance has been achieved by a surplus of at least the same size. The cumulative deficit will deepen and the need to compensate for it will increase with each year for as long as the structural budget position remains in deficit. Adding the structural deficit of 2020 to it means that the cumulative structural deficit in the estimate of the Ministry of Finance was around 1.7 billion euros by the end of 2020.

The State Budget Act does not however state whether the cumulative deficit continues to be calculated while the escape clause applies. The Fiscal Council considers that the logic of the escape clause would suggest that the budget deficits built up while the escape clause applies should not be added to the calculation of the cumulative structural position, as the escape clause released all numerical limits. In this interpretation the cumulative structural deficit did not deepen in 2020, and it has remained at its level of the end of 2019.

Unfortunately there has been general uncertainty since spring 2019 about which national fiscal rules the Estonian government plans to uphold in the longer term. The previous government announced in spring 2019 its intention not to comply with some of the requirements of the fiscal rules and to amend the State Budget Act, but this change had not yet been made by spring 2021. The aim of the amendment to the act was to abandon the calculation of the cumulative structural budget position and the compensation mechanism that requires the government to plan a fiscal surplus once structural balance has been achieved. Unfortunately the achievement of structural balance has now been postponed because of the Covid-19 pandemic, as has the urgent need to make changes to the State Budget Act.

If the current government still wants to amend the State Budget Act, then the Fiscal Council considers it better that the amendments be made sooner rather than later in the interests of the transparency, credibility and clarity of the national fiscal rules. As one aim of the fiscal rules is to give clear signals about the government's planned fiscal policy for the longer term, then they should not contain components that the government does not intend to comply with.

Estonia's experience so far with the structural balance rule shows that alongside the more careful development of the compensation mechanism, attention should be focused on measuring the structural budget position more accurately (see Background 2). As it is harder to estimate the structural position for a small and volatile economy like Estonia's, possible measurement error should at least be taken into account and the budgetary targets should not be set only to meet the minimum requirements of the State Budget Act, as with the government's plan from 2019 for recovering structural balance, but with some additional leeway.

Background 1. *A macroeconomic heatmap for Estonia*

To assess 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 7), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating[2].

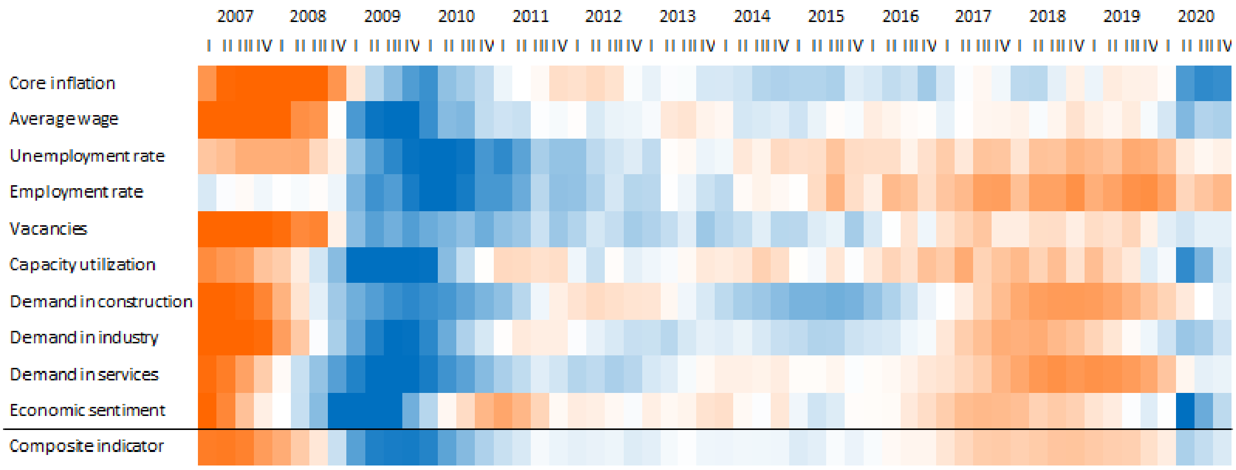

Figure 7. Macroeconomic heatmap for Estonia (Q1 2007 – Q4 2020)

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

After peaking in 2017-2019, the economic cycle turned in 2020 as the spread of Covid-19 and the restrictions introduced to stop it caused a recession in Estonia. The heatmap shows that the peak impact of the crisis was in the second quarter of 2020, when short-term movements in the economic sentiment, the capacity utilization, wages and prices deteriorated sharply. The economy improved gradually in the second half of the year, but still unevenly. Statistics Estonia estimates that the Estonian GDP was down 7% in the second quarter, and 2.9% for the year as a whole. The state support measures have helped to ease the impact of the restrictions. This is particularly evident in the labour market figures for 2020, where wage support measures helped to prevent a faster rise in unemployment and a faster fall in employment.

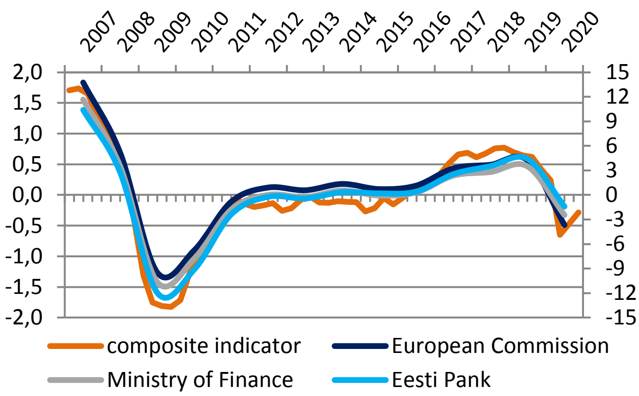

Figure 8. The composite indicator for the heatmap (left scale) and the output gap in % of GDP (right scale)

Sources: Eesti Pank, European Commission, Ministry of Finance, calc. of the Fiscal Council

[2] For more on the design of the heatmap, see the opinion of the Fiscal Council published in spring 2018.

Background 2. *Forecast errors in the structural budget position of the general government*

The Estonian government violated the structural budget balance rule contained in the State Budget Act in both 2018 and 2019, before the escape clause temporarily suspended the fiscal rules in spring 2020. In both cases the structural deficit was larger than was forecast when the state budget was compiled. Measuring the *structural* budget position needs the nominal budget position, the size of one-off and temporary budget measures, and the impact of the economic cycle to be assessed. The following analysis considers more closely which of these components have led to forecast errors in the structural budget position of the general government.

The forecast of the Ministry of Finance used in the state budget, which is drafted in the autumn before the budget year, is compared with estimates produced immediately after the budget year (see Figure 9). The Fiscal Council considers this an important time dimension, as whether the structural budget position met the targets set for it and the fiscal rules is assessed in the spring. Several components of the structural budget position may be revised in later years, but this is not the focus of the current analysis.

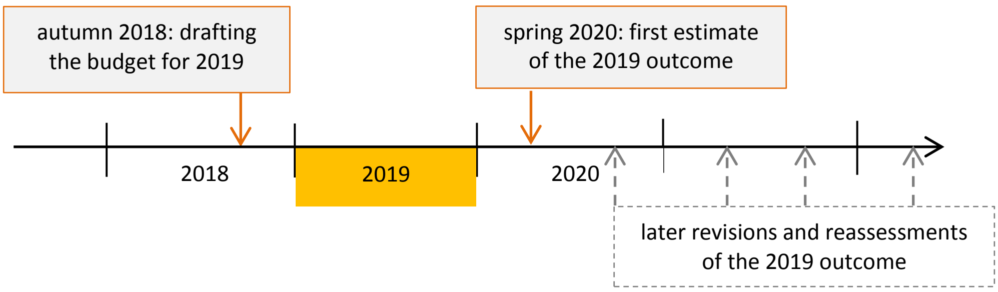

Figure 9. Defining the budget position using the example of 2019

Source: Fiscal Council

The structural budget position forecast in the state budgets in 2012-2019 differed by an absolute value of 0.7 percentage point on average from the estimate the following spring (see Figure 10). The fiscal position in 2012-2016 was stronger than expected by an average of 0.4 percentage point and the budgetary targets were met with a margin, but in 2017-2019 the structural budget position was notably worse than expected by an average of 1.2 percentage points, causing the fiscal rules to be broken. On average around half of the revision of the structural budget position in 2012-2019 can be seen to have come from the nominal budget position (shown in orange in the figure), a third from the economic cycle (shown in dark blue), and a tenth from one-off budget measures (shown in yellow).

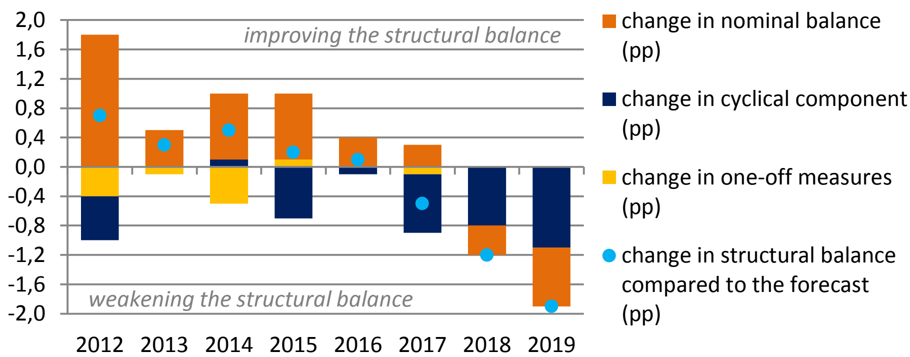

Figure 10. Changes in the structural budget position: spring ex-post estimate of the Ministry of Finance compared to the forecast in the state budget (percentage points of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

The main factor in the past couple of years has been the change in the cyclical component of the budget, to which has been added a weaker nominal budget position than expected. The impact of the economic cycle on the state budget is found from the size of the output gap and the sensitivity of the budget. Figure 11 illustrates how the forecasts of the Ministry of Finance tend to underestimate the cyclical position of the economy. The estimates by the ministry in the spring for the previous year are generally more positive than the estimates when the state budget is drafted, and in the autumn those estimates are corrected to be even more positive. On two occasions this has caused a change in sign, as the state budget in both 2015 and 2017 was drafted in the expectation of a negative output gap, but the output gap proved in retrospect to be positive. An accurate estimate of the output gap is an important input for the government though, as it wants to run a fiscal policy that does not increase imbalances in the economy.

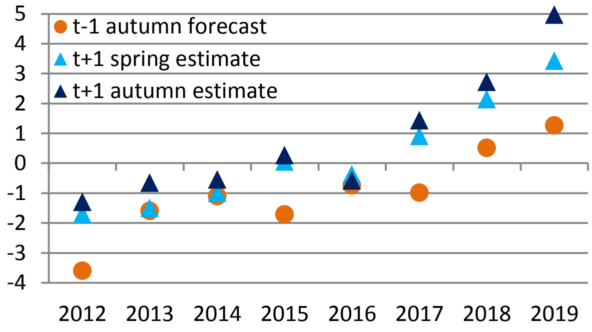

Figure 11. Forecast by the Ministry of Finance of the output gap when the state budget is drafted (t-1 autumn) and the initial estimates after the year (% of potential GDP)

Source: Ministry of Finance

Comparing the forecast of the Ministry of Finance with those of other forecasters shows that in 2012-2019 the ministry tended to change its estimates of the output gap for the previous year more than other forecasting institutions did (see Table 3). Comparing the estimates of the output gap in t+1 spring with the forecasts from t-1 autumn shows the ministry to be in second place behind the OECD for revising its estimates. The revisions of the ministry in the t+1 autumn estimates of the output gap are however the largest. The results shown in Table 3 can be interpreted for the Ministry of Finance to mean that the difference between the orange and dark blue points in Figure 11 is 1.78 percentage points on average.

Table 3. Change in the estimates of the output gap 2012-2019: difference between the initial estimates after the year and the forecast in the autumn before the year (percentage points)

	Ministry of Finance	European Commission	OECD	IMF
Change in the output gap: t+1 spring and t-1 autumn forecast	1.24	1.03	1.35*	0.93*
Change in the output gap: t+1 autumn and t-1 autumn forecast	1.78	1.41	1.65	0.99

Note: Changes are measured in absolute values and given as averages for 2012-2019.
** The OECD and the IMF did not publish estimates of the Estonian output gap in spring 2020.*

Sources: European Commission, IMF, OECD, Ministry of Finance, calculations of the Fiscal Council

In summary the differences between the structural budget position forecast in the state budget and the estimates given immediately after the year can be said to be large, as the absolute value is on average 0.7 percentage point. When the fiscal rules were breached in the years before the Covid-19 pandemic, the difference was even larger, and came mainly from the position of the economic cycle being underestimated. The revisions of the output gap by the Ministry of Finance immediately after the year have mainly been only in one direction, and have been a little larger than those of other institutions.