EELARVENÕUKOGU
FISCAL COUNCIL

OPINION OF THE FISCAL COUNCIL ON THE ACHIEVEMENT OF THE GENERAL GOVERNMENT STRUCTURAL BUDGET POSITION TARGET IN 2021 AND ON THE TARGETS SET FOR 2023-2026

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Contents

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Opinion

Together with preparing the supplementary budget for 2022, the government has set its targets for the budgetary position for the next four years. Although the state budget strategy will be prepared in the autumn, the targets set now are important for coordinating the fiscal policies of the member states of the European Union. Any long-term projection made this spring is understandably very uncertain, making it harder to set fiscal targets.

Estimates by the Ministry of Finance put the structural budget deficit for the general government at 3.8% of GDP for 2021. As the restrictions on the size of the structural deficit have temporarily been suspended, the Fiscal Council cannot assess the fiscal position for last year under the national fiscal rules. The nominal fiscal deficit at 2.4% of GDP did however fall within the requirements of the stability and growth pact.

In 2021 the funds from the European Union were again not used in full to the extent forecast. Although the past year was an extraordinary one, where a new budget period was launched together with the use of the recovery instrument, the Fiscal Council finds that this is a repeating pattern in the planning of Estonia's state finances. To avoid forecast errors of this kind, the use of EU funds should be planned more conservatively, or the administrative capacity of the state for using the funds should be increased.

There have been new and unexpected challenges in the past half year that have stopped the government from improving the state finances as the pandemic subsides. The support measures introduced in the pandemic and the additional spending on healthcare have been superseded by the support measures for the energy crisis and the additional spending on defence and security. At the same time, economic growth is forecast to stall in 2022-2023.

The Ministry of Finance estimates that the state finances will deteriorate this year, and accounting for the 2022 supplementary budget puts the general government structural deficit at 4.5% of GDP, and the nominal deficit at 5.3% of GDP. The nominal deficit is forecast to remain above 3% in 2023-2024 as well.

The government set the target this spring of not letting the structural fiscal deficit exceed 3.5% of GDP in 2023. After that it wants to reduce the deficit by 0.5 percentage point each year until it achieves a structural budget deficit of 2% of GDP in 2026. Extending this plan onwards would see structural balance return by 2030. The general government debt is forecast to reach 11.6 billion euros by 2026, or almost 30% of GDP, meaning it will be double what it is today.

The government has set its targets on the assumption that the fiscal rules will start to apply again from 2023 in unchanged form. This makes the target of 3.5% for next year appropriate if the structural fiscal deficit in 2022 is not smaller than 4% of GDP, though if it is then the target for 2023 should be more demanding. The Fiscal Council finds that if these assumptions are met, the budgetary targets set under the stability programme are in line with the State Budget Act as it stands.

The Fiscal Council considers that fiscal policy must be planned responsibly even when fiscal rules are temporarily suspended and there are severe cost pressures. It is important that temporary additional spending is fully justified while permanent additional spending is covered by permanent additional revenues. Otherwise there is a danger of the structure of government revenues and expenditures being shifted out of place and of that combining with high inflation to make the Estonian economy less competitive.

Chairman of Fiscal Council
Raul Eamets
Tallinn, 28 April 2022

Explanatory Report

As well as assessing the official economic forecasts, the Fiscal Council also monitors compliance with the national fiscal rules. For this reason the Fiscal Council assesses each spring whether the structural fiscal position of the general government for the past year met the target set for it and whether the budgetary targets set for the next four years are in line with the fiscal rules. In this spring both of these opinions are presented in a single publication.

Because of the pandemic, the general escape clause that was initially applied in 2020 was extended to 2021 and 2022. The Fiscal Council consequently focuses the first part of its opinion only on describing the budgetary position of the general government in 2021, and does not give the usual assessment of compliance with the fiscal rules. The second part of the opinion of the Fiscal Council assesses the targets for the fiscal position for the next four years set in the stability programme written in spring 2022. The stability programme is written under the assumption that the escape clause will no longer apply in 2023.

Assessment of achieving the target for the structural budget position for 2021

Setting the target

The most recent numerical targets for the structural budget position of the general government were planned in autumn 2019, immediately before the pandemic and the consequent application of the general escape clause. The government then had to work from the correction mechanism contained in the fiscal rules when setting the fiscal targets, as the structural deficit in 2018 was larger than permitted at 1.7% of GDP. The State Budget Act required the structural fiscal deficit to be reduced each year by at least 0.5 percentage point until structural balance had again been achieved. The government plan expected structural balance to be approached in 2021 (see Figure 1).

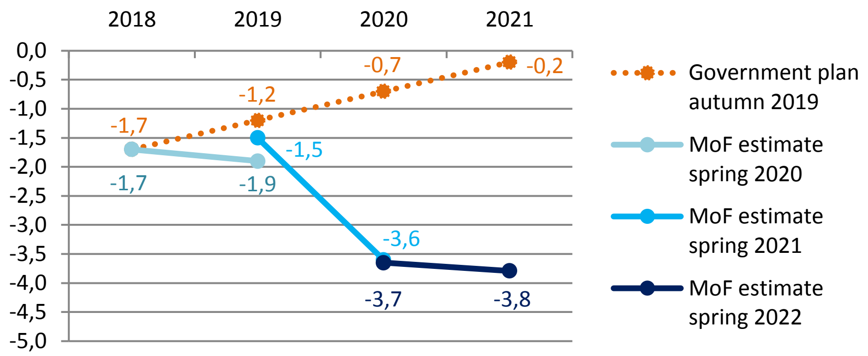

Figure 1. The general government structural balance in 2018-2021 (% of GDP)

Source: Ministry of Finance

There were several setbacks to this plan already in spring 2020. The first was that it became apparent that the structural deficit in 2019 had again been larger than permitted at 1.9% of GDP. The second was the spread of the Covid-19 coronavirus, which led to a temporary suspension of the European Union fiscal rules. This meant that the requirement in the Estonian State Budget Act to improve the fiscal position was also suspended automatically, and the government abandoned its earlier numerical fiscal targets. The Fiscal Council finds that it was reasonable in 2020 and 2021 to apply the escape clause of the fiscal rules and to abandon the numerical budget targets set before the pandemic. As there has been a great deal of uncertainty, the Estonian government has no longer set new targets for the structural fiscal deficit since the clause was applied. The actual developments in the public finances during the years of the pandemic (see also Background 2) have led further away from the target of structural balance.

Nominal budgetary position

Under the extraordinary circumstances, the writing of the state budget strategy for 2021-2024 was delayed until autumn in 2020 (see Table 1). The strategy and the state budget for 2021 were written in the knowledge that the escape clause would continue to apply in 2021. The actual scale of the recession in 2020 was not yet known, and the Ministry of Finance was forecasting in autumn 2020 that growth in the economy in the next year would be 4.5%, and the output gap would be -1.7% of GDP. It was also forecast at that time that the nominal budget deficit in 2020 would be 6.6% of GDP and an almost identical deficit of 6.7% of GDP was expected for 2021. The state budget for 2021 did not contain any additional Covid-19 support measures, but it assumed that some of the measures announced in the supplementary budget 2020 would continue.

Table 1. The general government budgetary position for 2021

	Autumn 2020	*Spring 2021*	*Autumn 2021*	*Spring 2022*
	State Budget 2021 / State Budget Strategy 2021-2024	Spring forecast 2021 (including Supplementary Budget 2021 & State Budget Strategy 2022-2025)	Summer forecast 2021	Actual
Nominal balance (million euros)	−1898	−1706	−1006	−721
Nominal balance (% of GDP)	−6.7	−6.0	−3.3	−2.4
Real GDP growth (%)	4.5	2.5	9.5	8.3
Output gap (% of GDP)	−1.7	−2.9	0.2	1.0
One-off measures (% of GDP)	0.7	0.8	1.0	1.0
Structural balance (% of GDP)	−6.6	−5.4	−4.4	−3.8

Source: Ministry of Finance

It had become clear by spring 2021 that state support measures would again be needed in 2021, and for the second year in a row a supplementary budget was written. Despite this, the Ministry of Finance was able to forecast a smaller deficit for 2021 than was assumed in the state budget, as it was possible for the first time in spring to include in the forecast the additional tax revenues arising from the changes to the second pension pillar. Another important new feature in the spring forecast was the resources from the EU recovery fund. The Ministry of Finance considered that the outlook for the Estonian economy and tax receipts by autumn was even better, and a nominal budget deficit of 3.3% of GDP, or around a billion euros, was forecast for 2021.

After the autumn there were several other important developments before the end of the year that affected the fiscal forecast for the current year as well. The first was that under guidelines from Eurostat the suspension of state contributions to the second pension pillar in 2020-2021 is reflected as a financing transaction, which led to a weakening of the fiscal position for 2021 of 0.4 percentage point. The second was that inflation in the final months of 2021 was higher than expected, which was also reflected in larger tax receipts. The third was that a rapid rise in energy prices led the government to decide to introduce new support measures. Several measures were announced to ease the rise in energy prices, and some of them were applied before the end of 2021[1].

[1] The budgetary costs of the measures taken to alleviate rising energy prices will mostly remain in 2022. The initial estimate was that the expenses from those support measures in 2021 would be around 40 million euros.

For the second year in a row, the budgetary position was stronger at the end of the year than was assumed in earlier forecasts during the year (see Figure 2). The initial estimate of the Ministry of Finance in early 2022 was that the budget deficit would be 2.6-2.7% of GDP, but the preliminary estimate from Statistics Estonia put the general government budget deficit for 2021 at 721 million euros, or 2.4% of GDP.

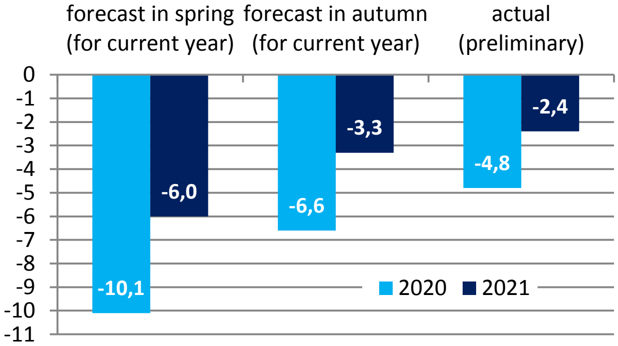

Figure 2. Forecasts of the general government nominal balance and the actual estimate for 2020-2021 (% of GDP)

Source: Ministry of Finance

The budget deficit was smaller than forecast because revenues were larger and expenditures were smaller. Tax revenues in the end proved better than even the most recent forecast (see Table 2), though one cause of the higher tax revenues in the final months of the year was higher inflation. A positive side to the rising energy prices was that the state revenues from CO_2 quotas were higher, meaning that more spending could be planned in the current fiscal year. The higher price level has allowed the Ministry of Finance to raise the forecast for revenues from CO_2 quotas to 265 million euros in 2022 and to 300 million euros in 2023.

Table 2. The general government revenues for 2021 (million euros)

	Autumn 2020	*Spring 2021*	*Autumn 2021*	*Spring 2022*
	State Budget 2021 / State Budget Strategy 2021-2024	Spring forecast 2021 (including Supplementary Budget 2021 & State Budget Strategy 2022-2025)	Summer forecast 2021	Actual
State tax revenue	7620.5	8244.9	8787.6	8963.5
.. social tax	3392.5	3595.8	3700.0	3732.3
.. VAT	2519.2	2598.2	2775.0	2877.1
.. excises	946.8	926.9	967.5	981.4
.. personal income tax	331.1	683.4	796.0	791.2
.. corporate income tax	351.0	359.0	462.0	481.2
EU transfers	1370.8	1454.8	1218.3	935.4

Source: Ministry of Finance

Unfortunately a large amount of EU funds remained unused in 2021, meaning that general government spending was smaller than expected. When the state budget strategy for 2021-2024 was written in autumn 2020, it was forecast that transfers of 1.37 billion euros would be received in 2021. This estimate was raised to 1.45 billion euros in the state budget strategy for 2022-2025. However, the actual amount of EU transfers used last year was only 935 million euros. In addition, the pandemic support measures turned out to be less costly in 2021 than was initially forecast. In total the general government revenues in 2021 increased by 13.4%, while expenses increased by 5.8% (see Figure 5).

The general government debt grew by around 440 million euros in 2021 to 5.5 billion euros by the end of the year. The debt burden did not increase though as a share of the total output of the economy, as general government debt was 19.0% of GDP at the end of 2020, and 18.1% of GDP at the end of 2021. Short-term state treasury bonds of 425 million euros matured in 2021, and 400 million euros of new short-term bonds was issued. A further 120 million euros was taken from the European Investment Bank (EIB) as an additional loan, and 230 million euros from the EU SURE instrument.

In total the general government fiscal position in 2021 was better than was expected when the state budget 2021 was written, or in the forecasts in the middle of the year. Unfortunately, the fiscal position was also improved partly because the funds from the European Union were not used in full to the extent forecast. Although the past year was an extraordinary one, where a new budget period was launched together with the use of the EU recovery instrument, the Fiscal Council finds that this is a repeating pattern in the planning of Estonia's state finances. To avoid forecast errors of this kind, the use of EU funds should be planned more conservatively, or the administrative capacity of the state for using the funds should be increased.

Structural budgetary position

To estimate the structural budgetary position from the nominal budgetary position of the general government, the effect of the economic cycle is removed together with the impacts of one-off and temporary fiscal measures. It may be assumed that it has been harder than usual for forecasters to identify these two components during the years of the pandemic. The output gap is harder to measure at turning points in the economy, as the downturn in Estonia in 2020 was eventually milder than forecast and the recovery in the economy in 2021 much faster than expected. Furthermore, the extent of the negative economic impact of the pandemic was reduced by the state support measures, at least some of which can by their nature also be defined as one-off measures.

Therefore it may be assumed that the forecasts by different institutions for the Estonian output gap have been more diverse in the past two years than usually, making it harder to interpret the structural budgetary position as well. Can the same be said about the *ex post* estimates of the Estonian output gap during the pandemic, as different institutions are able to apply the same economic indicators for the previous years?

Comparing the spring estimates of different institutions for the output gap of the year just ended (see Figure 3) shows no clear sign of this for 2020 though. The difference between the largest and smallest estimates is a little wider than the average for 2013-2019, but not unusually large. Equally, all institutions have agreed that the output gap was negative in 2020. As the figure shows this has not been always the case. It is also clear that the estimates of the Ministry of Finance have never been the most extreme, even as the ministry is the first to publish its spring assessment[2].

[2] The estimates of the output gap for the past year used in drawing Figure 3 were published by the Ministry of Finance and the IMF in April, by the European Commission and the OECD in May or June, and by Eesti Pank in June. As the IMF and the OECD did not publish their estimates of the output gap in spring 2020, the estimates of those institutions for 2019 date from autumn 2020.

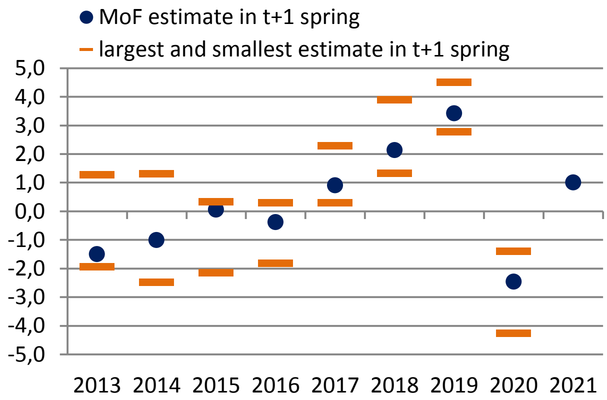

Figure 3. Spring estimate by the Ministry of Finance of the output gap in comparison with the largest and smallest estimates by other institutions (% of GDP)

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

The spring estimate 2022 of the Ministry of Finance found that the output gap in Estonia in 2021 was positive by 1.0% of GDP. At the time that the opinion of the Fiscal Council was written, the IMF was the only other institution to have published its spring estimate, which was 1.3% of GDP, and so the largest and smallest estimates for 2021 are not yet shown on the figure. The analysis from the heatmap of the Estonian economy (see Background 1) equally indicates that the cyclical position of the economy strengthened throughout 2021, and for the year overall this indicates a clearly positive output gap.

The spring assessment by the Ministry of Finance put the structural budget deficit for the general government at 3.7% of GDP for 2020 and 3.8% of GDP in 2021. This means that the deficit was notably larger in 2020 than in 2019, but then remained at about the same level in 2021 (see Figure 4 left panel). This assessment of the change in the structural deficit assumes that no effort is made to exclude the support measures for the pandemic and for the energy crisis in 2020-2021 from the calculation of the structural deficit[3].

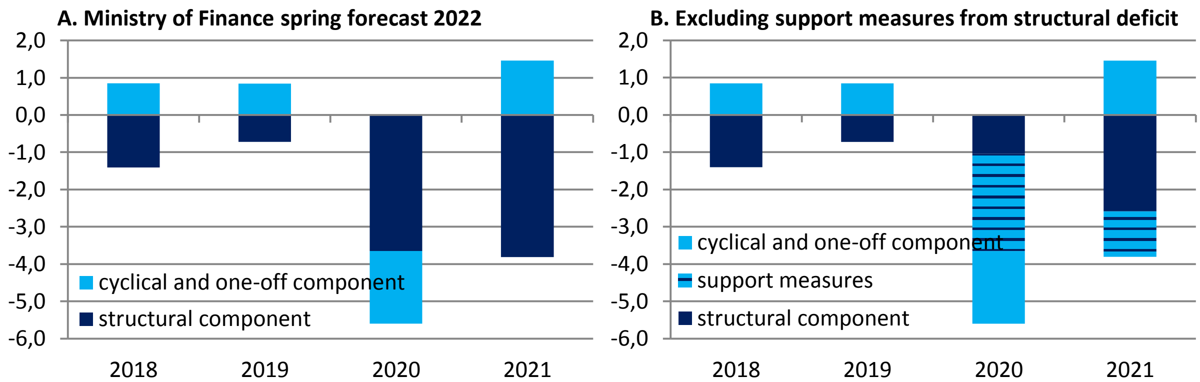

Figure 4. The cyclical and structural components of the budgetary position of the general government in 2018-2021 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

[3] The European Commission instructed member states not to classify pandemic support measures as one-off measures in the calculation of the structural fiscal position. The general escape clause reduced the need to do so, and it could also be argued that the exact classification of the measures and the country comparisons would have been complicated. Also, for the purposes of measuring the size of the fiscal impulse, it is better if the structural deficit includes the pandemic measures.

It is known though that at least some of those measures were also by nature one-off and temporary and so will not affect government spending over the long term. This means that the estimates by the Ministry of Finance for the structural deficit in 2020-2021 may be overestimated, and so the changes from year to year a little distorted.

Attempting to roughly extract the budgetary cost of the support measures from the structural fiscal deficit (see Figure 4 right panel) changes substantially the size of the structural deficit and its annual change[4]. The pandemic support measures were larger in 2020 than in 2021 and the cost of the support measures for the energy crisis that were announced at the end of 2021 will fall mainly in 2022, and so more changes are evident in the column for 2020. The analysis by the Fiscal Council indicates that the structural budget deficit in 2020 may not have been substantially larger than those in earlier years. The structural deficit clearly increased in 2021 though, when the state support measures were smaller and the cyclical position of the economy was more favourable. The Fiscal Council considers this analysis important, so that the permanent developments in the structure of government revenues and expenditures can be identified better.

Cumulative structural budgetary position

The Estonian fiscal rules contain not only the correction mechanism, which was activated in 2019 and lasted until the escape clause was applied, but also the compensation mechanism, which requires a structural deficit that was larger than permitted to be compensated for later by a structural surplus of the same size. The larger deficit than permitted is calculated from a measure of the cumulative structural position that adds together the results for the surpluses and deficits since 2014 (see Table 3). By law, a structural deficit can only be planned if the cumulative structural position is in surplus.

Table 3. The cumulative structural budgetary position as at the end of the year (million euros)

	2014	*2015*	*2016*	*2017*	*2018*	*2019*	*2020*	*2021*
Cumulative structural budgetary position	32	118	270	192	−164	−703	−703	−703

Sources: Ministry of Finance, calculations of the Fiscal Council

The deficit appeared in 2018 in the calculation of the cumulative structural position of the general government, and the calculations by the Fiscal Council show that it deepened by the end of 2019 to around 700 million euros. Although the State Budget Act does not specify so, the Fiscal Council considers that the cumulative deficit should not continue to be calculated in the years when the escape clause of the fiscal rules applies[5]. This means in the interpretation of the Fiscal Council that the deficit that needs to be compensated did not increase in 2020 and 2021. The cumulative deficit can increase though in those years when the escape clause does not apply but when the structural budgetary position has not yet reached balance.

Under the current State Budget Act, once the escape clause is lifted the structural budgetary deficit will need to be reduced by at least 0.5 percentage point a year until structural balance is again achieved. Once structural balance has been achieved, a structural surplus of at least 0.5% of GDP a year needs to be planned until the cumulative structural budgetary position has also been returned to balance.

[4] It was assumed when Figure 4 was drawn that the budgetary cost of the support measures that may be excluded from the calculation of the structural deficit was around 700 million euros in 2020, or 2.6% of GDP, and 375 million euros in 2021, or 1.2% of GDP. This should be considered as a rough estimate, but it should suffice for describing the trends in the changes.

[5] This was also noted by the Fiscal Council in its earlier opinion on the structural budgetary position for 2020.

Summary

The spring 2022 assessment by the Ministry of Finance put the structural budget deficit for the general government at 3.8% of GDP for 2021. This estimate works on the assumption that the general government nominal fiscal deficit was 2.4% of GDP last year, and the output gap was 1.0%, with the pandemic and energy crisis support measures not classified as one-off measures in the calculation of the structural deficit. The budgetary position of the general government in 2021 has proved stronger than was assumed in earlier forecasts made in the middle of the year, but understandably weaker than was assumed in the last forecast before the pandemic erupted, when the government set a target of approaching structural balance by the end of 2021.

The escape clause of the fiscal rules was applied when the pandemic started and extended for 2021, and the government abandoned its earlier numerical budget targets. The Fiscal Council considers this to have been reasonable. In consequence the extraordinarily large budget deficit in 2021 does not have any consequences in the context of the fiscal rules. It does mean though that the budgetary position of the Estonian general government has been in notable structural deficit for five years in a row now, and the general government debt burden has increased to 18.1% of GDP.

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

There have been new and unexpected challenges in the past half year that have stopped the government from improving the state finances as the pandemic subsides. The war in Ukraine and the high inflation caused by the energy crisis have meant that the outlook for the Estonian economy continues to be overshadowed by great uncertainty in spring 2022. This makes it harder to forecast the public finances and to draw up a long-term plan to strengthen the general government budgetary position. Neither is it clear yet when and in what form the European Union fiscal rules will be reapplied, and what changes they may demand of the Estonian State Budget Act[6].

The stability programme reflects the outlook for the next four years starting from the spring economic forecast of the Ministry of Finance and the decisions in the supplementary budget 2022[7]. The stability programme submitted to the European Commission and the domestically important state budget strategy have so far been one and the same document, but from 2022 the stability programme will continue to be written in the spring, while the state budget strategy will move to the autumn together with the state budget for the next year. The fiscal targets set in the stability programme work from the assumption that the fiscal rules will be reapplied in 2023 in unchanged form.

Unlike the spring forecast produced by the Ministry of Finance at the start of April, the forecast for 2022-2026 in the stability programme also includes the decisions in the supplementary budget 2022, which were not available when the spring forecast was written. The supplementary budget has a negative impact on the general government budgetary position from what it was in the spring forecast of 475 million euros for 2022 and 367 million euros for 2023 (see Table 4).

[6] A review of the European Union's fiscal rules was relaunched in autumn 2021 to make the rules simpler and more transparent. One change under consideration is replacing the structural balance rule based on the output gap measure with a spending rule that would make the growth in general government spending the most important measure for the yearly management of public finances rather than the size of the structural budget deficit.

[7] The supplementary budget in 2022 allocated 261 million euros for spending on the refugees from the war, 257 million euros for spending related to energy prices, 130 million euros for spending on defence and security, and 68 million euros for other spending. The Ministry of Finance also estimates a total impact of 8 million euros from the revenue-decreasing measures, which are a reduction in excise duty on specially marked diesel fuel and a lower VAT rate for press publications.

Table 4. Change in the general government nominal budgetary position in comparison to the spring forecast 2022

	2022	2023	2024	2025	2026
Spring forecast 2022	–1248	–1268	–1254	–1049	–848
Stability programme 2022	–1723	–1635	–1351	–1101	–859
change (million euros)	*–475*	*–367*	*–97*	*–52*	*–11*
change (percentage point)	*–1.5*	*–1.1*	*–0.3*	*–0.1*	*0.0*

Source: Ministry of Finance

The stability programme puts the general government's nominal deficit at 5.3% of GDP in 2022 and 4.8% of GDP in 2023. The forecast from the Ministry of Finance finds that the budget deficit will still exceed the limit of 3% of GDP permitted by the European Union Stability and Growth Pact in 2024 as well (see Table 5).

Table 5. The general government budgetary position in 2021 and the forecast for 2022-2026 (% of GDP)

	2021	2022	2023	2024	2025	2026
Nominal balance (million euros)	–721	–1723	–1635	–1351	–1101	–859
Nominal balance	–2.4	–5.3	–4.8	–3.8	–2.9	–2.2
Potential GDP growth (%)	3.0	2.1	2.0	2.1	1.9	2.1
Output gap	1.0	–2.0	–2.8	–1.7	–1.0	–0.4
Cyclical component	0.5	–1.0	–1.3	–0.8	–0.5	–0.2
Cyclical balance	–2.8	–2.8	–2.4	–2.7	–2.3	–2.0
One-off measures	1.0	0.2	0.0	0.0	0.0	0.0
Structural balance	–3.8	–4.5	–3.5	–3.0	–2.5	–2.0
General government debt	18.1	20.7	24.1	27.7	29.2	29.7

Source: Ministry of Finance

Additional borrowing will be used to finance the supplementary budget 2022, and the Ministry of Finance forecast that this will raise the debt burden of the Estonian general government to 29.7% of GDP by 2026. General government debt immediately before the pandemic was 2.4 billion euros, but by the end of 2021 it stood at 5.5 billion euros, and the stability programme forecasts it will be 11.6 billion euros by the end of 2026. This means that the Estonian general government debt is forecast to almost double in the next five years.

The decisions in the supplementary budget 2022 will have a notable impact on the rate of growth in spending over the coming years. The spring forecast found that growth of a little over 9% could be expected in general government expenditure in 2022, but the stability programme assumes growth in spending of almost 14% (see Figure 5). After peaking there, the growth in spending is forecast to be more subdued in future years. The forecast for spending in 2022-2026 as a whole is some 1.5 billion euros more than in the spring forecast of the Ministry of Finance, and revenues are forecast at almost 0.5 billion euros more. Although the supplementary budget mainly contains supplementary expenses, it also includes larger receipts from labour and consumption taxes.

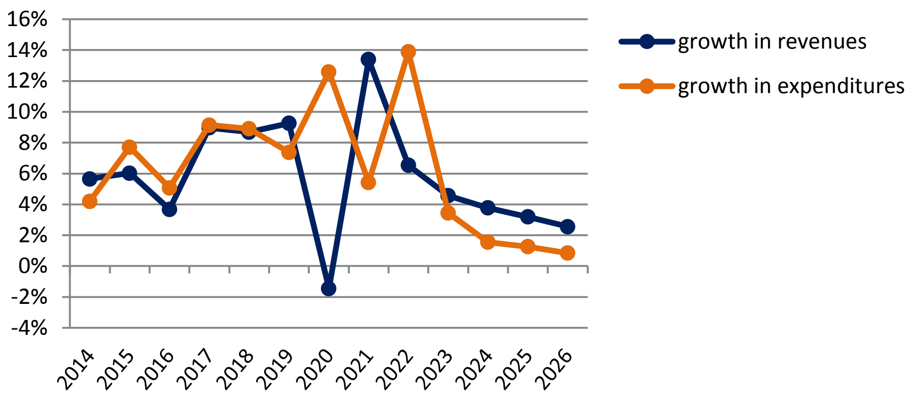

Figure 5. Growth in general government revenues and expenditures in 2014-2021 and forecast for 2022-2026 (%)

Source: Ministry of Finance

Combining the estimate of the cyclical position of the Estonian economy in the spring forecast and the updated forecast for general government revenues and expenditures in the stability programme suggests the general government structural deficit in 2022 will be 4.5% of GDP. This is more than the structural deficit during the years of the pandemic, which the most recent estimate from the Ministry of Finance put at 3.7-3.8%. Under normal circumstances for the economy, the State Budget Act allows the structural deficit to be up to 0.5% of GDP a year, but in 2020-2022 the fiscal rules of the European Union and of Estonia were temporarily suspended because of the pandemic.

Under the assumption that the fiscal rules will be reapplied from 2023, the Estonian government set the target in the stability programme that the general government structural deficit in 2023 will not exceed 3.5% of GDP, and that the deficit will narrow each subsequent year by 0.5 percentage point (see Figure 6). Achieving this target would mean that the structural deficit shrinks to 2% of GDP by 2026. Extending this plan onwards would see structural fiscal balance return by 2030. The general government budgetary position was last estimated to be in structural balance in 2016.

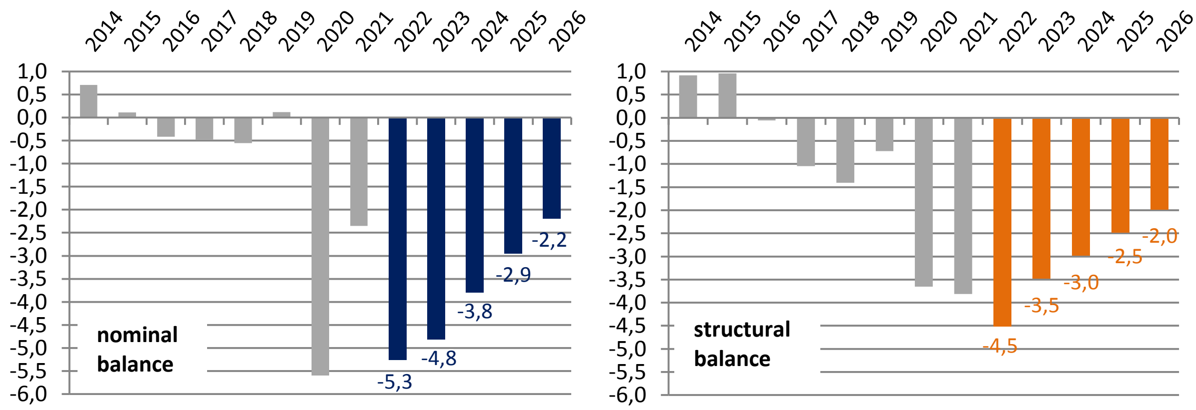

Figure 6. The nominal and structural budgetary position of the general government in 2014-2026 (% of GDP)

Source: Ministry of Finance

The government has set its budgetary targets on the assumption that the fiscal rules will start to apply again from 2023 in unchanged form. This makes the target of 3.5% for next year appropriate if the structural deficit in 2022 is not smaller than 4% of GDP, though if it is then the target for 2023 should be more demanding. The Fiscal Council finds that if these assumptions are met, the budgetary targets set under the stability programme are in line with the State Budget Act as it stands.

Before the outbreak of war in Ukraine, the economic forecasts for Estonia and for Europe indicated that the escape clause would no longer be warranted in 2023, but the question of extending the clause has now returned to the agenda. At the time that the stability programme 2022 was written, it was not yet certain when and in what form the fiscal rules would start to apply again.

Given the general uncertainty about the economic environment and the application of the fiscal rules, the fiscal policy planning rounds this autumn and subsequently could see major changes in the forecast assumptions and the outlook for the public finances. For this reason the Fiscal Council considers the trajectory of the structural budget deficit presented in the stability programme 2022 to be the best currently available forecast, rather than fixed budgetary targets for the coming years. The stability programme forecast shows that achieving structural balance under the current assumptions for economic growth and state revenues and expenditures will be difficult and will take time. The general government structural fiscal deficit will remain large even in years when no state support measures or unavoidable additional spending are yet planned.

The Fiscal Council considers it important that even at times when the fiscal rules are temporarily suspended and cost pressures are severe, the state finances should be managed responsibly. When borrowing to cover temporary additional costs, it is important that the spending be clearly justified and targeted at specific and unexpected immediate needs. 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.

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[8].

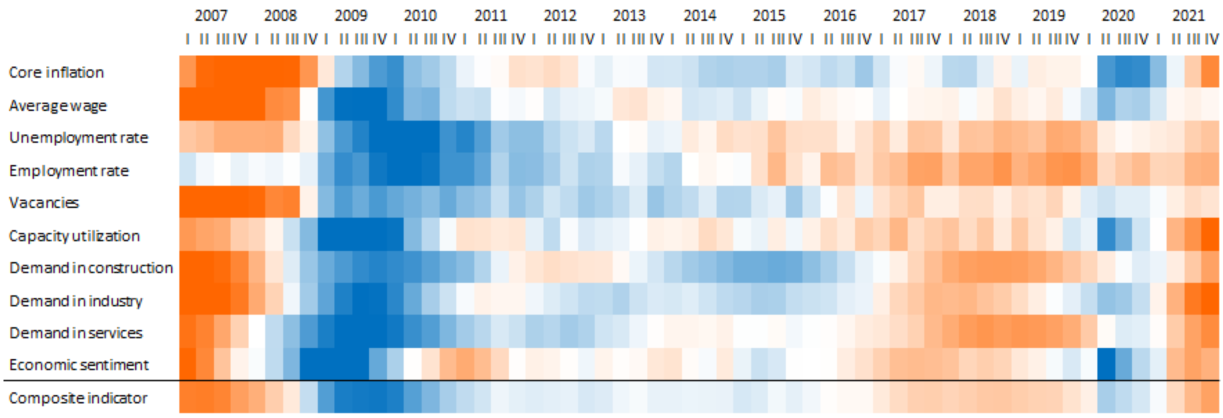

Figure 7. Macroeconomic heatmap for Estonia (Q1 2007 – Q4 2021)

Sources: Eurostat, Estonian Institute of Economic Research, Statistics Estonia, calc. 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 a recession in Estonia and elsewhere in the world. However, the heatmap shows that the Estonian economy has improved in each subsequent quarter and in the second half of 2021 the composite indicator was again clearly above its long-term average level (see Figure 8). This suggests that the Estonian output gap may have been positive on average in 2021, and that it may even have been larger than was estimated by the Ministry of Finance and the IMF for example in spring 2022. It can be expected that the next heatmap will show the Estonian economy cooling in early 2022, mainly because of the uncertainty caused by high inflation and the outbreak of war in Ukraine.

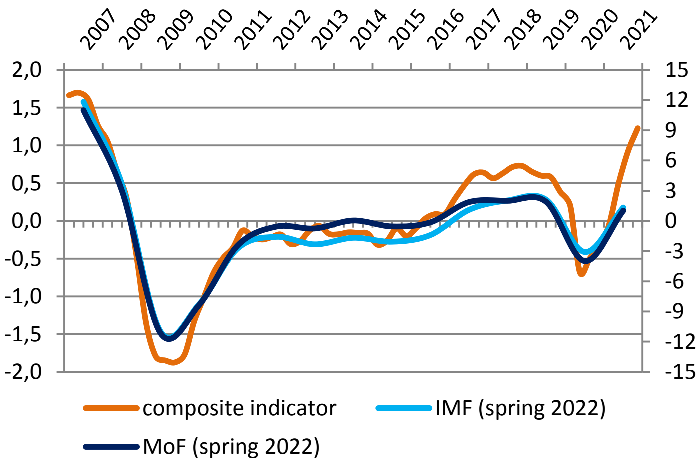

Figure 8. The composite indicator of the heatmap (left scale) and the output gap in % of GDP (right scale)

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

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

Background 2. *Changes in general government revenues and expenditures during the pandemic*

The government set the target in autumn 2019 that the general government budgetary position would be close to structural balance in 2021, but the outbreak of the pandemic in early 2020 threw all the earlier forecasts and targets into confusion. Before the pandemic it was assumed that revenues and expenditures would develop in line over the medium-term perspective, but the pandemic caused major changes in the development of both revenues and expenditures (see Figure 9). The following analysis uses the actual results for 2020 and 2021 to analyse which expenditure and revenue items have developed differently during the pandemic to what they would have done under the forecast from autumn 2019.

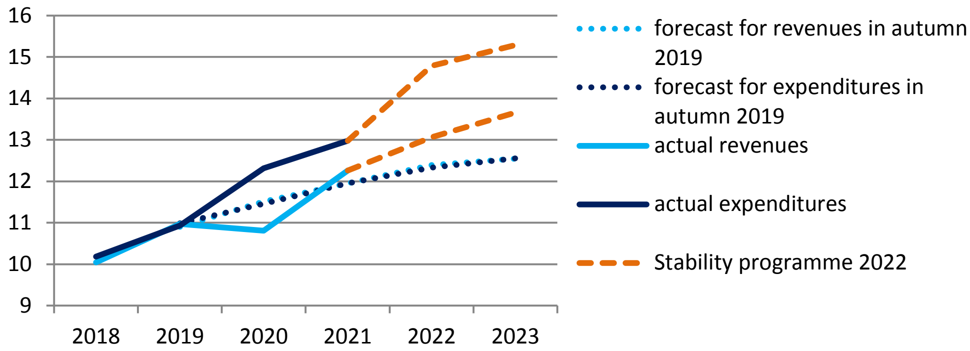

Figure 9. Government revenues and expenditures compared to the pre-pandemic forecast (billion euros)
Source: Ministry of Finance

Figure 9 shows that the actual expenditures of the general government were much larger in 2020 and 2021 than was forecast in autumn 2019. Total expenditures for the two years were around 1.9 billion euros larger. General government revenues in 2020 meanwhile were smaller than was forecast before the pandemic, causing a notable divergence between the actual developments of revenues and expenditures. Revenues in 2021 were actually slightly larger than was forecast in autumn 2019, when it was not yet possible to include the extraordinary tax receipts caused by the changes to the second pension pillar. Total revenues in 2020 and 2021 were smaller than was forecast before the pandemic, and without the extraordinary income tax receipts the difference would have been even wider.

Expenditures were larger than forecast mainly because of the support measures passed to alleviate the impact of the pandemic on the economy. Additional spending because of the support measures is evident in most subcategories of costs, depending on the type of measure, in both 2020 and 2021 (see Figure 10).

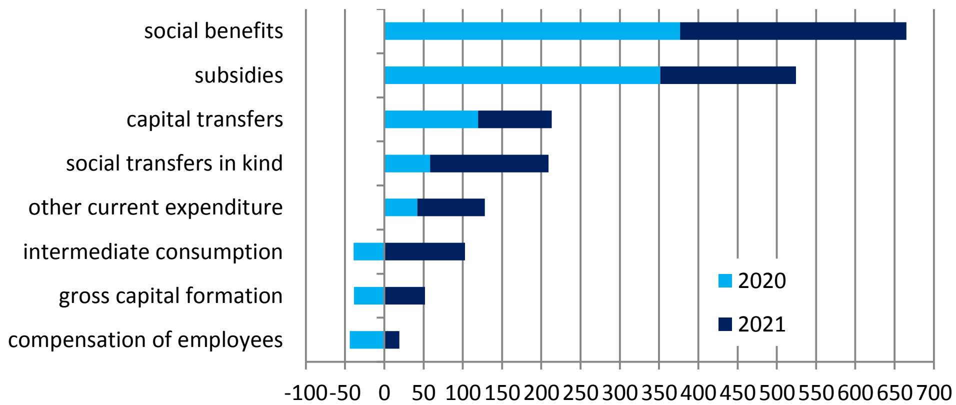

Figure 10. Government expenditures in 2020-2021 compared to the pre-pandemic forecast (million euros)
Source: Ministry of Finance

Social benefits and social transfers in kind were over 850 million euros more than was forecast, and subsidies were over 500 million euros more. These cost categories cover for example wage compensation and the various other pandemic support measures such as those for the tourism sector, ordinary labour market support measures that also increased during the crisis, state compensation to those leaving the second pension pillar and an extraordinary rise in pensions in 2021. Capital transfers, other current expenditures, and intermediate consumption by the government were also larger in 2020-2021 than was forecast before the pandemic. Gross capital formation (i.e. investment) and compensation of employees were about the same size in total over the two years as was assumed in the forecast before the pandemic. This indicates that there was no reduction in general government investment during the pandemic, though expectations for 2021 were even higher in the meantime because of the additional EU recovery funding available.

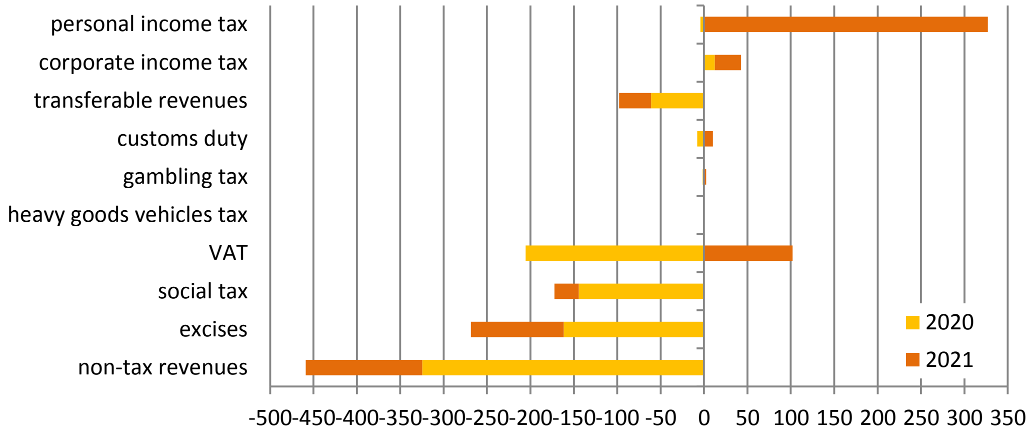

Figure 11. Government revenues in 2020-2021 compared to the pre-pandemic forecast (million euros)

Source: Ministry of Finance

Figure 11 shows the changes in general government revenues from the forecast made before the pandemic. If the extraordinary receipts of personal income tax in 2021 are excluded, as they could not have been foreseen in autumn 2019, then the pandemic has caused a drop in receipts in most of the main tax types and of non-tax revenues[9]. For the two years as a whole, receipts of excises, social tax and VAT were smaller than forecast by a total of more than half a billion euros. Non-tax revenues, mainly EU transfers, were smaller than forecast by almost the same amount. It was assumed in autumn 2019 that much larger transfers would be received than was actually the case in 2020 and 2021.

The gap that emerged between the general government revenues and expenditures when the pandemic erupted started to narrow in 2021 (see Figure 9), but the forecast in the stability programme written in spring 2022 and based on the changed security environment, found the gap would widen again in 2022 and remain large in 2023.

[9] Non-tax revenues cover general government revenues such as transfers from the European Union, dividends from state-owned companies, revenues from sales of CO_2 quotas, and state fees and charges.