EELARVENÕUKOGU
FISCAL COUNCIL

FISCAL COUNCIL OPINION ON THE SUMMER FORECAST 2020 OF THE MINISTRY OF FINANCE

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Contents

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Opinion

The summer 2020 forecast of the Ministry of Finance shows that the coronavirus has affected the economy less than was expected in spring, and it forecasts an economic decline of 5.5% for 2020. Growth in the economy will recover to 4.5% in 2021 and GDP at current prices will reach its level from before the crisis. Several economic indicators will recover more weakly than was earlier forecast though, as growth in wages and employment will not yet recover next year and growth in private consumption will be slower than that in the economy.

The Ministry of Finance finds that the output of the Estonian economy will this year be 3% below its capacity, and will not return to full capacity by the end of the forecast horizon. The Fiscal Council finds it may be assumed that the economy will have recovered by 2024, and the output gap will have closed.

The Fiscal Council finds that the summer forecast of the Ministry of Finance gives an adequate picture of the possible development of the Estonian economy, and so is a suitable basis for planning fiscal policy. The Fiscal Council sees a downside risk that unemployment may be higher in 2020 than forecast, and an upside risk that wage growth may be faster than expected in the coming years, which will contribute to growth in private consumption. It should also be remembered that the uncertainty around the economic forecast is greater than usual.

Expectations for tax revenues in 2020 have improved. The summer forecast finds that tax revenues in the state budget will be down around 6% this year, and general government revenues by around 4%. Growth in spending has however been faster than usual at more than 11%, and so the general government budget for 2020 will be in the nominal deficit by 6.6% of GDP. The ministry estimates that budget spending on measures to help the economy will amount to 3% of GDP this year.

This high level of spending is forecast to continue in the future. Tax revenues meanwhile will grow more slowly than earlier, and dependence on foreign funds will increase. The fiscal forecast shows a large deficit in the general government fiscal position throughout the forecast horizon, leading to rapid growth in the debt burden.

As the fiscal rules have been suspended temporarily, the Fiscal Council considers that any possible deviations from the rules should also be temporary. The summer forecast puts the budget deficit for 2021 at 1.7 billion euros, or 6% of GDP, even though the lowest point of the fall in the economy and the largest part of the spending on assistance packages will fall in 2020 in the estimate of the Ministry of Finance.

The Fiscal Council considers that the fiscal deficit in 2021 may only exceed 3% of GDP if this comes from the cyclical components of revenues and expenditures and the additional healthcare spending and direct economic assistance measures provoked by the coronavirus crisis. The current forecast indicators do not justify the fiscal deficit exceeding the 3% limit in 2022 in the opinion of the Fiscal Council, and structural balance should be restored in the later years of the forecast horizon.

The Fiscal Council believes it important that general government spending be brought in line with expected revenues and that large-scale budget deficits to support the economy remain a crisis measure only. If excessive fiscal stimulus is delivered when the production capacity of the economy is already nearing its potential and the labour market has stabilised, it could cause unnecessary pressure on wages and the price level, and this could then harm the competitiveness of the Estonian business sector.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 21 September 2020

Explanatory Report

The summer macroeconomic and fiscal forecast 2020 of the Ministry of Finance is used as the basis for the state budget for the next year and exceptionally this time also for setting the state budget strategy. Unlike the spring forecast, the summer economic forecast projects the outlook for the next four years. The greatest uncertainty this year and next is not around the traditional economic indicators, but about the spread of the coronavirus and the economic impact of it. Under the circumstances it has been extremely difficult to produce a reliable forecast and for the Fiscal Council to assess it.

Assessment of the macroeconomic forecast

Outlook for 2020 and 2021

The economic forecast published by the Ministry of Finance in spring together with the supplementary budget did not yet include the assistance measures planned to revive growth in the economy. For this reason alone the macroeconomic forecast of the Ministry of Finance could have been considered pessimistic. The main assumption that the forecast made about the pandemic is that both infections and the restrictions on economic activity would peak in the middle of May and and so some recovery in the economy may be expected from the end of the second quarter. This assumption generally held, though it is now expected that the economy will recover more slowly moving forwards.

Initial estimates put the Estonian economy 0.7% smaller in the first quarter of 2020 than a year earlier, and 6.9% smaller in the second quarter. The declines in the economies of EU member states around the Baltic Sea in the second quarter ranged from 4% in Lithuania to 11% in Germany. The decline in the Estonian economy is in the middle of this range. The fall was large in historical terms, but was still smaller than had been feared, and the drop in the second quarter was smaller than most forecasters expected[1].

The main cause of the fall in the second quarter in Estonia was weak foreign demand, which was even weaker than expected for sectors connected to tourism, but less weak than forecast for goods exports. The drop in foreign demand not only tightened cash flows, but also caused general uncertainty, which hurt both business investment and private consumption. The fall in investment was softened by increased investment by the general government in buildings and facilities, and increased investment by private consumers in residential property. Economic growth was also supported by increased consumption by the government.

The Ministry of Finance completed its summer forecast in the end of August, when the main economic indicators for the first half of the year were released. A rise in the number of infections recorded daily was already apparent by that time, but this did not yet imply that new restrictions would be introduced. This means that the main cause of the change in the earlier more pessimistic outlook was the economic indicators released for the first half of the year and the information received in early third quarter[2].

The forecast for economic growth in 2020 is more positive than the outlook in the spring, and GDP will shrink by 5.5% rather than the 8% previously predicted. Although the estimate of the ministry is that GDP at constant prices will be a little larger in the second half of the year than in the first half, the fall is still larger than the normal cyclical fluctuation and economic growth will only recover in yearly terms in 2021 (see Figure 1).

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[1] Media comment following the release of the GDP data for the second quarter can be read from Postimees.

[2] Retail volumes already started to recover in June, industrial output reached the level of last year in July, tax revenues in the state budget started to grow in July, and the Purchasing Managers Index (PMI) in the euro area indicated that economic activity had started to recover in the summer.

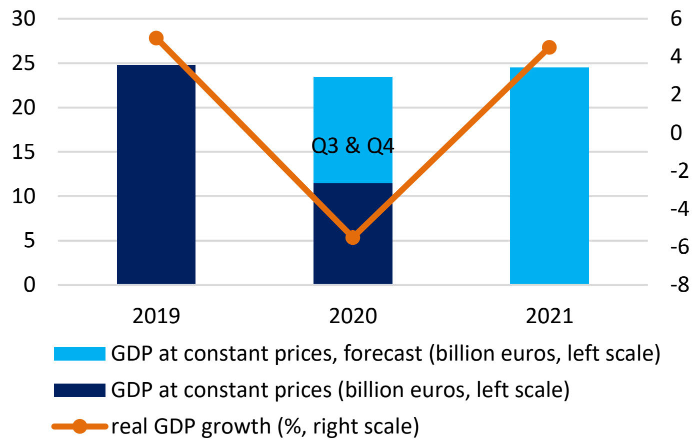

Figure 1. GDP volume and the change in it 2019-2021

Sources: Ministry of Finance, Statistics Estonia

It is forecast that a small improvement in the economy in the second half of 2020 will be led by domestic demand, while export volumes will remain at practically the same level as in the first half of the year. The improvement is possible primarily because general government consumption and investment spending remained smaller in the first half of the year than was suggested by the state budget passed for 2020. The funds set aside for local governments in the supplementary budget also suggests that general government spending will increase in the second half of the year.

There are three assumptions behind the forecast recovery in economic growth in 2021: a) the spread of the virus will be brought under control next year; b) European countries will manage to use broadly based support to avoid a substantial drop in demand in economic sectors not directly affected by the virus, meaning that the recession will not become widely spread; and c) the economy in the EU will return to its pre-crisis level in 2022. The growth forecast for 2021 is more pessimistic than it was in the spring (see Table 1). In other words, the fall in the economy in the first half of the year was smaller than was expected in the spring, but the recovery of growth will take longer. Several banks and analysts, including SEB, Swedbank, Luminor and Consensus Forecast, have essentially forecast the same.

Table 1. Key macroeconomic indicators in the spring and summer forecasts of the Ministry of Finance (%)

	2020		*2021*	
	Spring forecast	Summer forecast	Spring forecast	Summer forecast
GDP at current prices (billion euros)	25.9	26.5	28.6	28.2
real GDP growth	−8.0	−5.5	8.0	4.5
nominal GDP growth	−7.6	−5.6	10.6	6.4
real growth in exports of goods and services	−12.3	−8.5	12.0	5.8
real growth in government consumption	0.3	0.8	0.1	0.3
consumer price index	0.6	−0.2	2.1	1.4
real growth in private consumption	−11.8	−4.9	9.1	2.7
real growth in investment	−5.7	−10.1	5.7	5.1
real growth in domestic demand	−9.6	−6.6	7.9	4.5
real growth in the average wage	0.0	1.3	2.8	−0.9
nominal growth in the average wage	0.6	1.1	5.0	0.4
employment growth	−8.2	−2.9	2.8	−0.3

Source: Ministry of Finance

The Fiscal Council finds it hard to estimate whether the risks to the forecast for 2020-2021 are more on the downside or the upside for growth. The improvement in economic activity expected for the second half of 2020 for example assumes that consumers will spend less than their incomes would allow, because of the general uncertainty, and that their savings will then be spent in 2021. Savings and private consumption could turn out to be distributed quite differently across the years though, meaning private consumption may contribute more to GDP this year and less to it next year. It is also possible the general government investment will contribute less to economic activity than forecast this year and more next year, especially if foreign funding is used less this year than hoped, which happened repeatedly in the past budget period[3]. The Fiscal Council also finds there to be a risk that unemployment will be higher in 2020 than the 7.5% that is forecast. The unemployment rate had already reached 7.1% in the second quarter even while the restrictions on redundancies that came in with the wage subsidies were still in place.

In total there are various scenarios that could lead to the forecast level of GDP in 2020 and 2021. The Fiscal Council agrees with the forecast of the Ministry of Finance that achieving growth in the economy will need both exporting industry and the service sector to recover. The Fiscal Council considers it possible though that the GDP level of before the crisis at constant prices may be reached in 2022 given the assumptions used for the forecast.

The risk scenario

The economic forecast of the Ministry of Finance contains a risk scenario as usual. The negative risk scenario for 2020-2022 foresees major limits on economic activity in autumn this year, and assumes that the economy will not start to recover before summer 2021. In this case the economy would be more than 4% smaller than expected in the baseline forecast and the nominal deficit of the general government would be larger by 0.5-1.3% of GDP.

The great uncertainty in spring 2020 meant that the four-year budget strategy was delayed, which the Fiscal Council considers to have been a reasonable decision. In its opinion on the spring 2020 forecast, the Fiscal Council made known its concern that the general uncertainty may not have diminished by the time of the summer forecast. For that reason the Fiscal Council recommended that the fiscal forecast should consider producing several scenarios to support the government in choosing which principles to base the package of measures for exiting the crisis on.

The discussion in the media about the budget negotiations that started in September indicates that the government has decided for 2021 to fund first of all certain priority expenses and to support growth in economy. This assumes that the budget is not limited by the fiscal rules or by the need to find funds to cover the spending. This approach means that the risk scenario covering the years 2020-2022 only has value in providing some background. Under current circumstances there would be more value from a risk scenario that covers all of the state budget strategy period, so it would be easier to decide what level of tax revenues may be expected in three or four years and what taxes would need to be raised to cover spending.

Composition of growth and the economic outlook for 2022-2024

The summer economic forecast assumes that the recovery in the economy after 2020 both in Estonia and around the world will be slower than was thought in the spring. In consequence the experts from the Ministry of Finance have also reduced their assessment of the potential level of Estonia's economy. The Fiscal Council considers this change to be justified. The turning point in the forecast comes in 2022, when most economic indicators exceed their level of before the crisis in 2019 even while employment is lower than before and unemployment is higher (see Table 2).

[3] In 2015-2019 the summer forecasts for general government investment were out by an average of 7% in both directions. In some years they were out by more than 10%.

Table 2. Key macroeconomic indicators in the summer economic forecast for 2019-2024 (%)

	2019	*2020*	*2021*	*2022*	*2023*	*2024*
GDP at current prices (billion euros)	28.1	26.5	28.2	29.9	31.7	33.1
real GDP growth	5.0	−5.5	4.5	3.5	3.0	2.3
nominal GDP growth	8.4	−5.6	6.4	6.0	5.8	4.6
real growth in exports of goods and services	6.2	−8.5	5.8	4.5	3.2	3.0
nominal growth in exports of goods and services	6.6	−10.1	7.4	6.3	5.2	5.0
real growth in government consumption	3.0	0.8	0.3	0.3	0.3	0.3
nominal growth in government consumption	9.4	−0.5	2.3	4.0	3.7	3.3
consumer price index	2.3	−0.2	1.4	2.2	2.1	1.9
real growth in private consumption	3.1	−4.9	2.7	2.5	1.9	2.0
nominal growth in private consumption	5.7	−5.3	4.3	5.0	4.2	4.1
real growth in investment	11.0	−10.1	5.1	7.9	9.8	4.1
nominal growth in investment	15.6	−8.2	5.3	10.2	13.3	6.5
private sector investment to GDP ratio	21.3	20.0	20.0	20.6	21.1	21.5
public sector investment to GDP ratio	4.9	5.5	5.3	5.6	7.0	7.1
real growth in the average wage	5.1	1.3	−0.9	2.3	2.6	2.0
nominal growth in the average wage	7.5	1.1	0.4	4.5	4.8	3.9
employment growth	1.0	−2.9	−0.3	0.8	0.8	0.7
unemployment rate	4.4	7.5	8.0	7.3	6.6	5.9

Sources: Ministry of Finance, calculations of the Fiscal Council

The economic indicators for the final years of the forecast horizon can evidently not be taken to indicate sustainable development in the post-crisis economy. Both GDP and private consumption remain below their potential level. The Ministry of Finance estimates that the Estonian economy will still be running at around 1% below its potential level in 2022-2024. The explanatory note to the forecast unfortunately does not explain why the negative output gap will stop closing in those years and why GDP will grow more slowly in the final year of the forecast. The Fiscal Council finds that the explanatory note to the forecast should focus more attention on explaining the connections between the fiscal forecast and the macro indicators.

Annual growth in the Estonian exporting sector is forecast at 3-4.5%, which is practically the same as the expected increase in foreign demand. The assumptions around foreign demand are less certain than usual. This is firstly because no solution has been found to the circumstances in the global economy that were causing significant tensions in geopolitics and foreign trade before the crisis, and secondly because it is not clear how the pandemic and the consequent travel and logistical restrictions 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.

The Ministry of Finance assumes in its forecast that fiscal transfers will increase (see Figure 2), and that the share of the general government in investment will increase in consequence. Private sector investment will be practically unchanged from the past year as a ratio to GDP, but general government investment will increase by the end of the forecast horizon to 7%. It is assumed that growth will be strong in fiscal transfers, partly because there are still funds from the previous European Union budget period to be used by 2023, and partly because funds from the new budget period 2021-2027 will start to be used and they will be increased further by the European Union's recovery programme (see Background 1). It is important to note that the investment programme for 2022-2024 has not yet been fixed in place, and the procedures for applying for funding from the recovery programme from Europe have only just been started. For this reason the size of the general government investment and the consequent contribution of general government to economic growth may differ from the forecast.

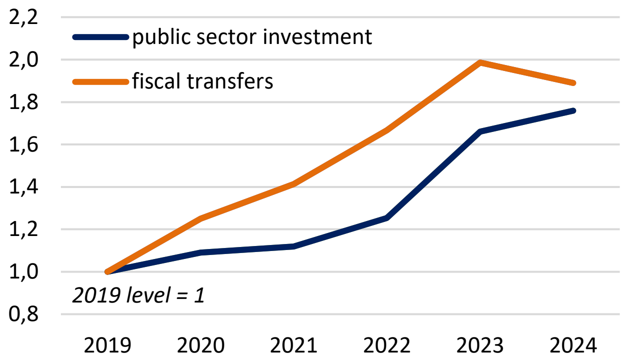

Figure 2. Public sector investment and fiscal transfers in 2019-2024 (nominal values, reference base 2019)

Source: Ministry of Finance

The Fiscal Council has noted in its earlier opinions that the forecasts of the Ministry of Finance tend to underestimate the growth in labour costs. It is assumed in the summer economic forecast that the payroll will remain the same as a ratio to GDP in 2022-2024 (see Figure 3). Wages have risen several times faster than expected since 2011 however, and have grown faster than productivity and corporate profits. It is possible that a new effective equilibrium is emerging, where the owners of capital have had to accept lower returns on their investments than earlier, and wage pressures will be stronger than expected during the exit from the virus crisis. The Fiscal Council considers that wage growth in the final years of the forecast horizon may also prove faster than expected, and this in turn may push the outlook for private consumption firmly towards growth.

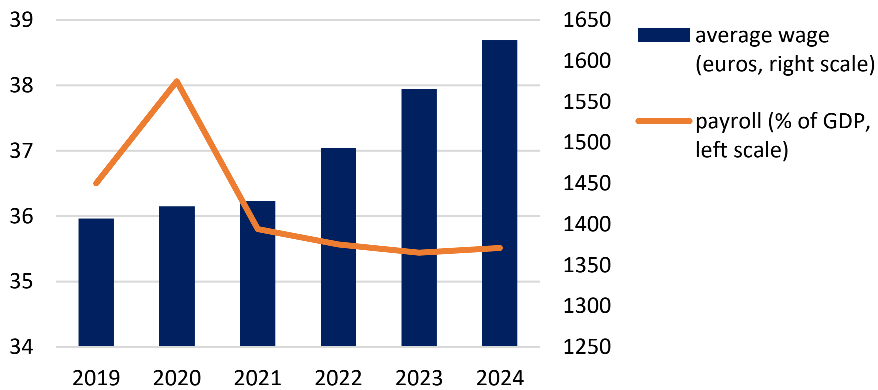

Figure 3. The average wage and the payroll as a share of GDP in 2019-2024

Source: Ministry of Finance

The Fiscal Council emphasises that it is extremely difficult under current circumstances to produce a reliable economic forecast looking forward several years. The uncertainty around the main assumptions is greater than usual and the Fiscal Council finds that it is not possible to say whether the risks to the Ministry of Finance forecast are more on the upside or the downside for growth. In its previous opinions on the economic forecasts of the Ministry of Finance, the Fiscal Council has generally found them to be as reliable as those by any other forecasters. In principle the same applies to the summer 2020 forecast, which gives an approximate picture of the possible developments in the Estonian economy in the years ahead and so supports the planning of the next wave of fiscal policy.

Assessment of the fiscal forecast

The outlook for Estonian state finances has changed a lot since last autumn when the previous four-year fiscal forecast was published. The summer economic forecast 2020 of the Ministry of Finance shows the nominal fiscal position of the general government to be in substantial deficit throughout the forecast horizon, by 4.7% of GDP on average in 2021-2024, because of increased expenses and reduced revenues. Although the forecast for 2020 is better than it was in the spring, the Fiscal Council finds future developments in state finances to be very worrying and that they require fiscal policy decisions to be taken to improve the fiscal position.

Budget position for 2020

The spring forecast of the ministry expected that the nominal deficit would total 2.6 billion euros this year, or 10.1% of GDP, of which over 1.1 billion euros would be the fiscal costs of the package of measures passed in the supplementary budget to help the economy (see Figure 4). The summer economic forecast finds that the crisis will not affect state finances as much this year, and the nominal deficit will be 1.7 billion euros, or 6.6% of GDP. The cost to the budget of the measures taken to help the economy will be smaller than forecast partly because they have not been rolled out as much as was expected and partly because they have cost less, and so the Ministry of Finance estimates they will cost 810 million euros this year. This means the package of assistance in 2020 will have been of 3% of GDP. The Ministry of Finance explains that the costs of the package of measures have partly been carried forward into future years[4].

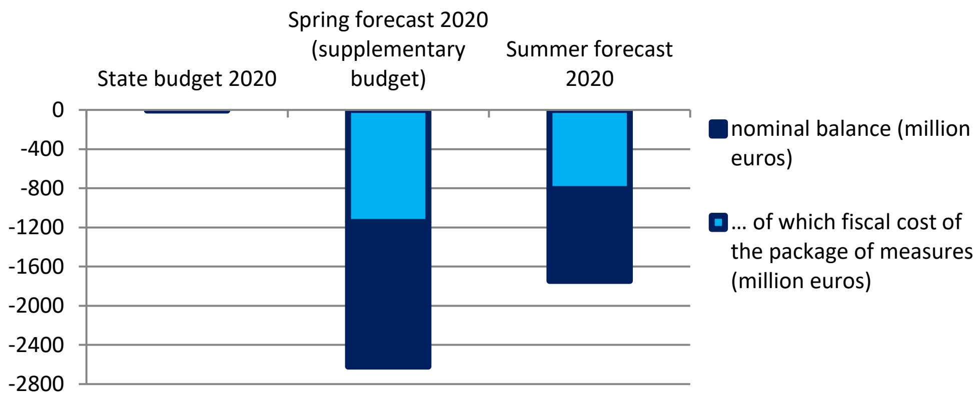

Figure 4. General government nominal fiscal position for 2020 (million euros)

Source: Ministry of Finance

As the coronavirus has affected the economy less than expected this year, the ministry has been able to improve its forecast of tax receipts for 2020 (see Table 3). The supplementary budget in the spring expected that tax revenues in the state budget would be as much as 12% lower than in 2019, but the summer forecast finds that tax revenues will be down by around 6%. The outlook for all the main types of tax revenues has improved since the spring, and it is forecast that VAT receipts will be 5.5% lower this year than last year, and that social tax receipts will only be down by 0.4%. Substantial changes in the forecast for excise have been caused by the drop in economic activity and by the cut in excise rates that was part of the package of assistance. The forecast of the ministry started from the tax receipts so far in 2020, which indicates that tax receipts are down 4% in the first seven months of the year. The Fiscal Council finds that the changes to the forecast for tax receipts in 2020 adequately reflect the fiscal impact of the coronavirus so far.

[4] Mainly the costs of loans and guarantees are carried forward, but some costs related to investments may also be shifted.

Table 3. Forecast for growth in tax receipts in 2020 (%)

	State Budget 2020	Supplementary Budget 2020	Summer forecast 2020	2020 7 months actual
total tax revenue	4.3	−12.1	−6.1	−4.1
personal income tax	26.8	−3.7	7.5	43.5
corporate income tax	−13.7	−23.0	−19.1	−16.4
social tax	7.0	−8.9	−0.4	2.2
VAT	6.7	−9.0	−5.5	−5.9
excises	−6.5	−25.3	−21.8	−19.9

Sources: Ministry of Finance, calculations of the Fiscal Council

Budget position for 2021 and the longer horizon

While the forecast for tax receipts and the general government fiscal position the 2020 are better than they were in the spring, the forecast for tax receipts for 2021 has been reduced further (see Table 4). Tax receipts in the state budget for 2021 are forecast to be more than a billion euros smaller than was expected a year ago. The nominal general government deficit, which it was estimated in the spring would not exceed 3% of GDP in 2021, will reach 6% of GDP according to the summer forecast.

Table 4. Forecast for tax revenues for 2021 (million euros)

	Spring forecast 2020	*change from previous forecast*	Summer forecast 2020	*change from previous forecast*
total tax revenue	7811.0	*−815.4*	7549.5	*−261.5*
personal income tax	370.0	*−94.0*	327.0	*−43.0*
corporate income tax	426.0	*−25.0*	349.0	*−77.0*
social tax	3370.0	*−390.0*	3365.0	*−5.0*
VAT	2505.0	*−270.0*	2485.0	*−20.0*
excises	1057.3	*−31.2*	943.6	*−113.7*

Source: Ministry of Finance

The deficit will be larger than expected because tax receipts will be smaller than in previous forecasts and expenditure will be higher, including some 130 million euros in costs for the assistance package carried forward from 2020. The forecast for general government expenditures for 2020-2021 is 1.1 billion euros larger than when the previous four-year fiscal forecast was written last autumn, and the forecast for revenues is 2.4 billion euros smaller (see Figure 5).

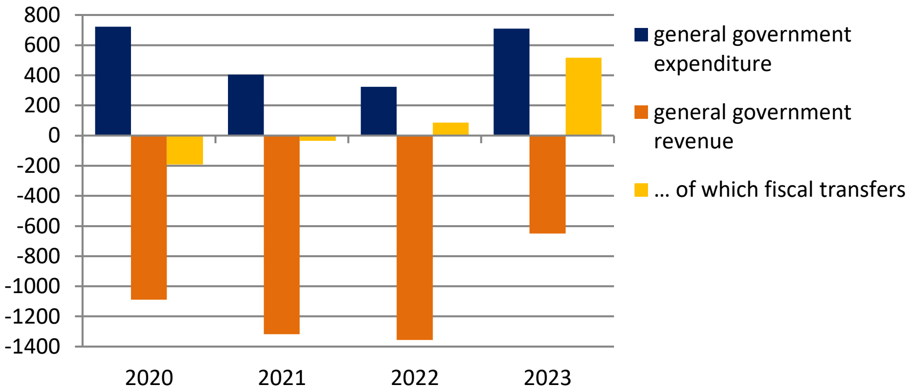

Figure 5. Changes in the revenue and expenditure forecast from the summer forecast 2019 (million euros)
Source: Ministry of Finance

The ministry estimates there will be a sharp increase in the use of EU funds (fiscal transfers) in the final years of the forecast, which will partly compensate for the slower growth in tax revenues. The Ministry of Finance estimates that the growth in tax revenues will be slower than the growth in the economy in the longer term, mainly because the labour market will recover more slowly. Once the economy starts growing again, it is expected that companies will be more cautious about hiring and about wage rises. Private consumption will also grow more slowly than the economy, as it will be held back by the uncertainty caused by the crisis and the lack of confidence to consume.

No large group of tax revenues will return to their rates of growth of before the crisis during the forecast horizon (see Figure 6). Receipts of the largest group, which is labour taxes, will increase on average by only 4.2% in 2021-2024, having previously averaged 8%. Receipts of consumption taxes will be a tenth lower this year than last, but will grow on average by 6% a year in the forecast horizon. The average growth in capital taxes will remain at only around a couple of per cent in the coming years. This means that receipts will not yet have reached their level of 2019 by the end of the forecast horizon.

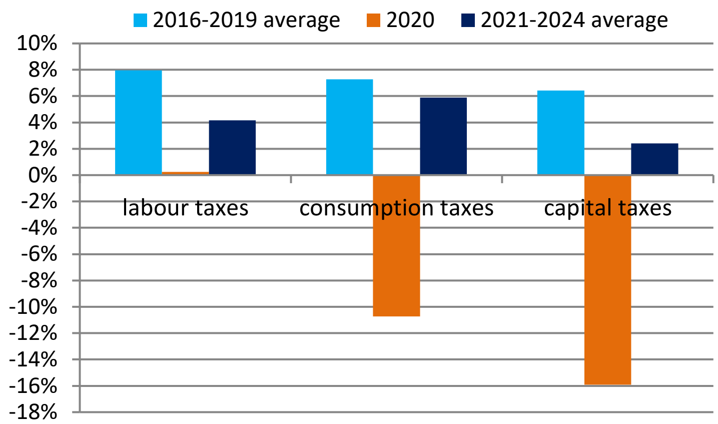

Figure 6. Growth in tax revenues before and after 2020 (%)

Sources: Ministry of Finance, calculations of the Fiscal Council[5]

To estimate whether the forecast 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[6]. The tax bases have in both cases come through the crisis better than economic growth as a whole, but growth in the tax bases is expected to be slower than growth in the economy in 2021. The Ministry of Finance estimates that the tax base for social tax, which is the nominal payroll, will not increase next year either, and so social tax receipts will remain modest for several years[7]. The growth dynamics of VAT is based more on the development of GDP than the corresponding tax base.

[5] 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 2019 were 5.2 billion euros of labour taxes, 3.6 billion euros of consumption taxes, and 0.6 billion euros of capital taxes.

[6] Figure 7 shows the tax base for VAT, which consists of the 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.

[7] 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%.

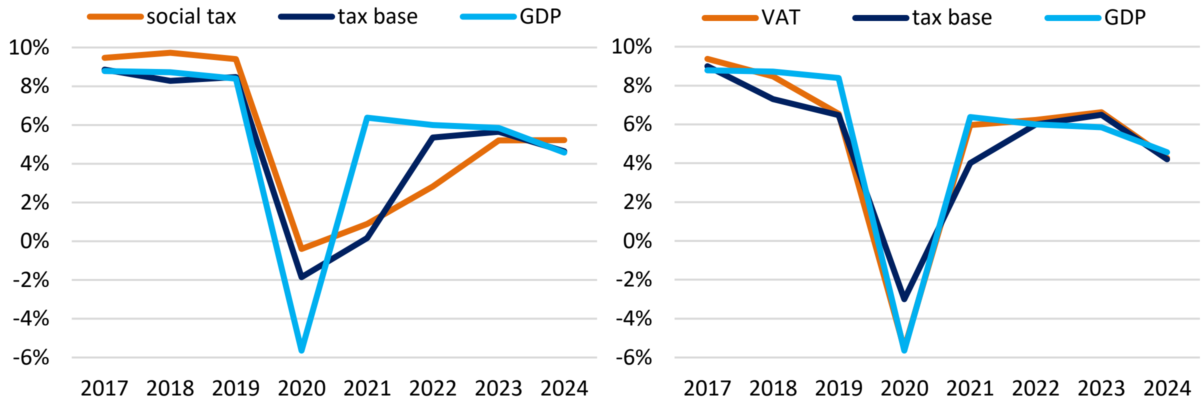

Figure 7. Growth in social tax and VAT receipts and in the tax base and the economy (%)

Sources: Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council finds that the forecast for tax revenues in the coming years is generally aligned with the macroeconomic developments described in the explanatory note to the forecast. The Fiscal Council considers it possible though that the payroll will recover faster in the coming years than is assumed in the summer economic forecast, leading to better receipts of labour taxes. The Fiscal Council sees risks in the forecast for non-tax revenues from the use of EU funds, which have previously generally been smaller than forecast. The uncertainty is greater in this case because of the change from the previous period for EU funds to the new and because of the new European Union support programmes, about which there is not yet any full picture.

The impact of the economic cycle and the structural budget position

The summer forecast of the Ministry of Finance assumes that the total output of the Estonian economy will remain at around 3% below its potential capacity this year (see Figure 8). As a result of the crisis, the estimates of the potential level of Estonia's economy have been reduced. The gap between actual and potential GDP will narrow over time, but the ministry estimates that it will not yet have closed by the end of the forecast horizon. The Fiscal Council finds it may be assumed that the economy will have recovered by 2024, and the output gap will have closed.

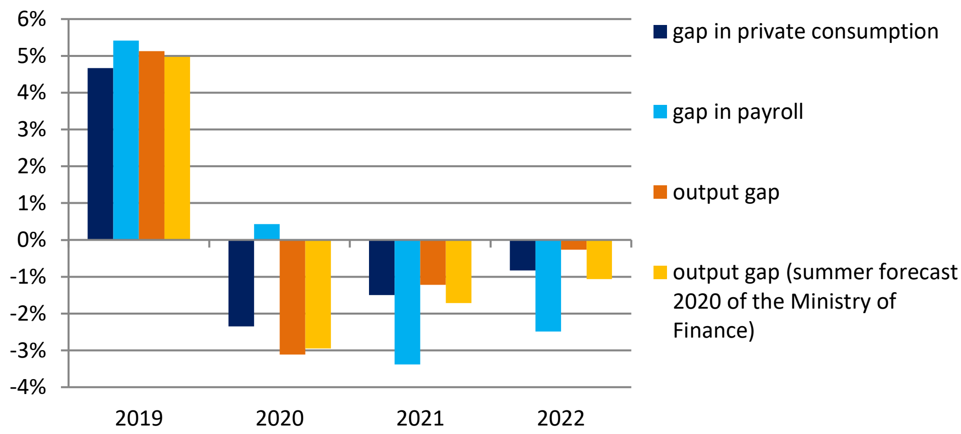

Figure 8. Gaps in the tax base (% of trend) with the disaggregated method

Sources: Ministry of Finance, calculations of the Fiscal Council

Calculations by the Fiscal Council from the key indicators in the summer economic forecast support the estimate that the negative gap may reach 3% of GDP this year, though the margins for error in the current estimate of the cyclical position of the economy are wider than usual[8]. For this reason the Fiscal Council has recommended that the estimate of the current state of the economy should observe a wider range of economic indicators (see the heatmap of the Estonian economy on page 18).

The summer forecast of the Ministry of Finance puts the structural deficit of the general government at 5.7% of GDP in 2020 and 5.9% in 2021 (see Table 5), and finds the deficit will remain throughout the forecast horizon. A one-off measure that will affect the estimated structural position is the suspension of state payments to the second pension pillar, which are treated as one-off revenue in 2020 and 2021, and one-off expenses in 2023 and 2024. Calculations by the Fiscal Council using the disaggregated method give a structural budget deficit going forwards of a similar size to that estimated by the ministry (see Figure 9).

Table 5. The general government budget position 2020-2024 (% of GDP)

	2020	2021	2022	2023	2024
nominal balance (million euros)	−1745	−1700	−1623	−1358	−1021
nominal balance	−6.6	−6.0	−5.4	−4.3	−3.1
output gap	−2.9	−1.7	−1.1	−0.9	−1.2
cyclical component	−1.4	−0.8	−0.5	−0.4	−0.6
cyclically-adjusted balance	−5.2	−5.2	−4.9	−3.9	−2.5
one-off measures	0.5	0.7	0.0	−0.5	−0.5
structural balance	−5.7	−5.9	−4.9	−3.3	−2.0
general government debt	18.2	24.0	27.4	29.7	31.3

Source: Ministry of Finance

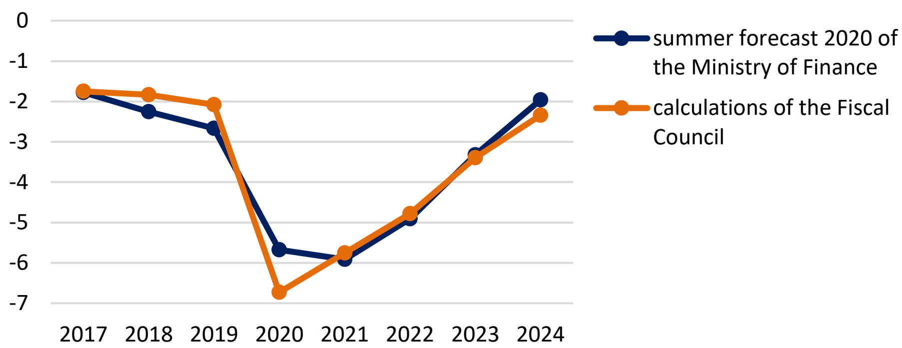

Figure 9. Estimated structural fiscal position 2017–2024 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

Compliance with the fiscal rules

General government expenditures grew rapidly in the years before the crisis. Economic growth averaging 5% and a positive output gap suggest buffers should have been built up against a crisis, but the general government fiscal position was actually in large structural deficit (see Figure 9). Although the correction mechanism for improving the fiscal position was launched in 2019, the cost savings required by the fiscal rules were not made successfully last year. With the economy now facing much more difficult times, it has become much harder to make the necessary adjustments.

[8] Several institutions providing analysis such as the IMF and the OECD have not presented their estimates of the output gap and the related structural fiscal position in their economic forecasts published this summer.

The summer forecast of the ministry expects that general government spending will increase sharply as a share of GDP in 2020 because of both the rapid growth of 11.3% in expenditures and the fall in GDP, and it will remain above its earlier level in future (see Figure 10). General government revenues in the coming years will be lower as a share of GDP than they were before the crisis, with a larger fall prevented by the increase in EU funds in the later years of the forecast horizon, and so such an excess of expenditures will not be sustainable over the long term. The Fiscal Council considers that if the changed economic circumstances have caused a major correction in the revenues of the state finances, it is important that the expenditures in the budget strategy be brought in line with this in the years following the crisis.

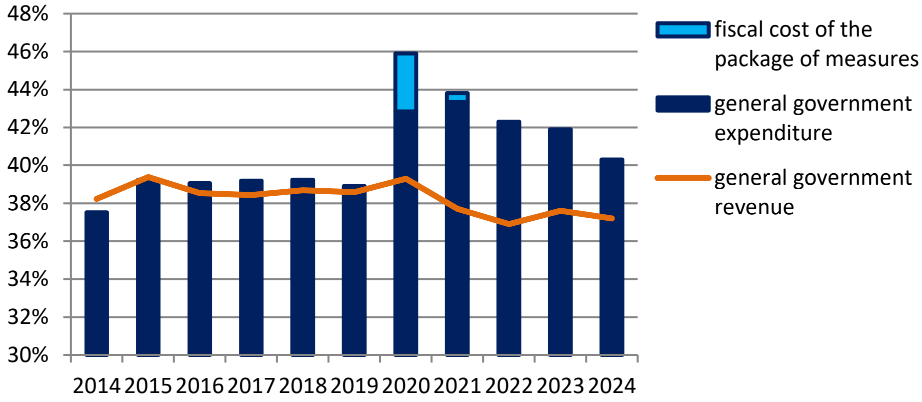

Figure 10. Revenue and expenditure of the general government (% of GDP)

Source: Ministry of Finance

The European Union's fiscal rules were suspended in spring 2020 so that member states could use fiscal policy measures to ease the economic impact of the coronavirus crisis. The domestic structural balance rule and the correction mechanism it contains were also suspended at the same time as the EU rules. As the fiscal rules have been suspended temporarily, any possible deviations from those rules should also only be temporary. The European Commission states that any budgetary measures taken during the crisis should not pose a threat to the long-term sustainability of state finances.

The suspension of the fiscal rules is only temporary, but it is not yet clear in autumn 2020 when the suspension will be ended. This means that as states draw up their budgets for 2021, they may assume that the suspension will remain for at least next year. When it announced the suspension, the Commission said that it would last as long as was needed for states to stop the spread of the coronavirus and use fiscal measures to ease its negative economic impact.

As stated in the explanatory note to the forecast of the Ministry of Finance, the requirement to avoid an excessive nominal budget deficit remains, with the limit set at 3% of GDP by the Stability and Growth Pact. The European Commission estimated in the spring that Estonia was forecast not to meet the budget deficit requirement in 2020, but decided not to initiate additional procedural steps against it[9]. The summer forecast of the ministry finds that the budget deficit will exceed 3% of GDP throughout the forecast horizon.

The 3% rule allows budget deficits to fluctuate according to the economic cycle. In difficult times, when the output gap is negative, the nominal budget position may remain in deficit in order to achieve structural balance. The state of the economy is reflected in the state finances through automatic stabilisers, which essentially means that tax revenue falls and spending on social benefits rises during harder times. The impact of the automatic stabilisers can be estimated from the size of the cyclical components in the budget.

[9] For more see the report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union.

The Fiscal Council recommends that the automatic stabilisers be allowed to operate freely in the coming years. In simple terms this means that the nominal budget deficit can be up to around half of the value of the output gap, not including one-off budget measures. The Ministry of Finance estimates that the output gap in 2021 will be -1.7% of GDP, and so the automatic stabilisers may drive the nominal deficit up to 0.8%. If the actual performance of the economy reveals the negative output gap to be larger, then a larger budget deficit is justified, and if the gap is smaller then the deficit should be smaller.

On top of the automatic stabilisers, the budget deficit in 2020 and 2021 will be widened by the package of measures passed to help the economy. The ministry estimates that budget spending on the measures to help the economy contained in the supplementary budget in the spring will reach 3% of GDP this year and will be 0.5% of GDP in 2021. It may be assumed that the package of measures in 2021 will not be limited only to those announced in the spring and considered in the forecast.

The summer forecast of the ministry puts the nominal budget deficit for this year at over 1.7 billion euros. The deficit will also reach 1.7 billion euros, or 6% of GDP, in 2021, though the Estonian economy is forecast to be recovering by then.

The Fiscal Council considers that the fiscal deficit in 2021 may only exceed 3% of GDP if this comes from the cyclical components of revenues and expenditures and the additional healthcare spending and direct fiscal measures provoked by the coronavirus crisis. It is important when the fiscal measures are defined that they be temporary and targeted directly at easing the impact of the crisis. The Fiscal Council considers in other words that any additional budget deficit on top of the deficit caused by the automatic stabilisers should be directly due to additional spending caused by the coronavirus crisis.

The current forecast indicators do not justify the fiscal deficit exceeding the 3% limit in 2022 in the opinion of the Fiscal Council, and structural balance should be restored in the later years of the forecast horizon (see Table 6). This means that the fiscal position needs to be improved in 2022-2024 by around 660 million to 1 billion euros compared to the summer forecast of the Ministry of Finance.

Table 6. The need to improve the fiscal position to achieve possible budget targets

	2020	*2021*	*2022*	*2023*	*2024*
numerical budget target	no target	no target	3% deficit limit	structural balance	structural balance
nominal deficit allowed to reach the target (euros):			−900 million	−300 million	−350 million
required improvement in the budgetary position compared to the summer forecast (euros):			725 million	1.07 billion	660 million
nominal balance (% of GDP)	−6.6	−6.0	−3.0	−0.9	−1.1
structural balance (% of GDP)	−5.7	−5.9	−2.5	0.0	0.0
output gap (% of GDP)	−2.9	−1.7	−1.1	−0.9	−1.2

Sources: Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council believes it important that general government spending be brought in line with expected revenues and that large-scale budget deficits to support the economy remain a crisis measure only. If excessive fiscal stimulus is delivered when the production capacity of the economy is already nearing its potential and the labour market has stabilised, it could cause unnecessary pressure on wages and the price level, and this could then harm the competitiveness of the Estonian business sector. Estonia's position as a member of the euro area makes this problem even more critical, as adjusting the levels of wages and prices is a long-term and painful process.

Background 1. *Additional funding from the European Union budget*

The European Council reached agreement at its meeting in July on a long-term budget for the European Union for 2021-2027 and on a temporary recovery programme for the economy. Given how hard the pandemic emergency had hit the European economy, it was decided to create a new temporary financing programme Next Generation EU (NGEU) to give member states subsidies and cheap loans. The overall financing package is planned at 750 billion euros and it is intended that this will be distributed to member states in subsidies and loans, with an almost equal split of 52% in subsidies and 48% in loans[10].

The main tool in the NGEU is the Recovery and Resilience Facility (RRF), of which 312.5 billion euros is intended for subsidies and 360 billion euros for loans. There are also several smaller programmes included in the NGEU, such as ReactEU, RescEU, rural development programmes, Horizon Europe, InvestEU, and the Just Transition Fund[11].

The subsidies from the RRF are intended primarily for the states that have been hit hardest by the crisis. The initial information is that up to 40% of the subsidies will go to helping Italy and Spain. Estonia's share of the RRF is around 0.35%, which is larger than its share of the GDP of the European Union. At first, 70% of the subsidies will be distributed, and how the remaining 30% is to be distributed will be decided by the end of 2023. This will allow the actual impact of the crisis on the economic indicators for 2020-2021 to be taken into account. The payments should be made over the next six years.

This is a temporary and emergency redistribution of money between member states for which the European semester procedure is being used. The plan is to fund several goals such as cohesion policy, rural development, and the objectives of the Green Agreement from both the normal European Union budget and the NGEU. The NGEU means that the transfers made to member states through the mechanisms of the European Union budget period will be some 30% larger than was planned for the new budget period in spring 2018. The difference between the NGEU and the usual budget framework lies in its shorter duration and the decision-making processes for financing.

The commission will fund the NGEU by issuing bonds backed by the future revenues of the European Union budget. In order to be able to borrow, the commission first wants member states to agree to raise the own resources ceiling, which would create a payment obligation for the member states and would give the commission the formal right to require member states to contribute more than the commission intends to spend in the next budget period. The difference of up to 0.6% of gross national income between these levels should ensure the commission can borrow on favourable terms[12]. It is planned that the debt will start to be paid down from European Union budget revenues in 2028, and that it may take until 2058. This means that the liabilities from larger subsidies, including increased payments to the European Union budget, may only be clearly apparent to member states from 2027.

The share of non-tax revenues in the income of the Estonian general government has reached 15% in the past couple of years, and up to a quarter of this has come from European Union fiscal transfers. As a large part of European Union funds is inversely related to the income level of the member state compared to the European Union average, these funds will decline gradually in the longer term.

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[10] For more see: https://www.consilium.europa.eu/media/45109/210720-euco-final-conclusions-en.pdf

[11] This will primarily support climate goals in regions where the costs of reorienting the economy are greatest, like Ida-Virumaa in Estonia.

[12] Which own resources should be used will remain a topic of negotiation for several years ahead. The first idea is to introduce a tax on non-recyclable plastic packaging from the start of next year.

The creation of the temporary facility means that the reduction in subsidies will be notably less sharp than was previously expected. If the transfers from the normal European Union budget and the NGEU are taken as a single cash flow, then the planned subsidies to Estonia in 2021-2027 will be 35% larger than in the budget period that is currently ending (see Figure 11). It is hard though to forecast how the planned subsidies will be distributed across the years of the budget period. It is normal for funds from the previous budget period to be used during the first couple of years of a new budget period, and a part of the support planned for the new budget period will be used after 2027.

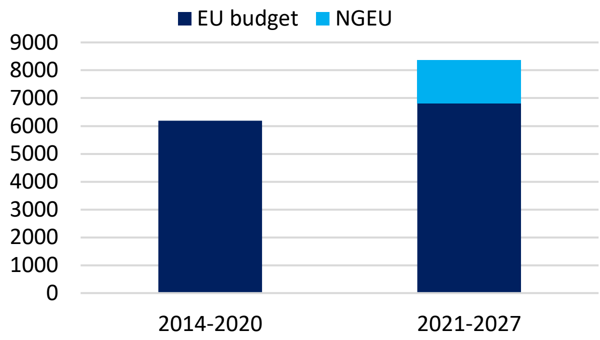

Figure 11. Transfers from the European Union budget and the NGEU (million euros)

Source: Ministry of Finance

The numerical fiscal rules and the calculation of the general government budget position are based on the methodology of the European Standard of Accounting (ESA2010). This considers a part of the transfers from the European Union budget, such as direct agricultural support, to be direct cash flows to the private sector and so they are not considered as general government revenues. This meant that around 60% of the funds received by Estonia from the European Union budget in 2014-2019 were considered as general government revenues.

If all of the funds received in Estonia from the NGEU are considered as general government revenues, it could be argued from initial estimates that European Union fiscal transfers will be around 50% larger in 2021-2027 than in the budget period that ends this year. This will mean that the funding constraints from EU funds are weaker than before.

Background 2. *A macroeconomic heatmap for Estonia*

To assess the compliance with the fiscal rules and the output gap in the economic forecast, the Fiscal Council needs to analyse 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 give an indication of the cyclical position of the economy. The end result of this analysis can be presented in the form of a heatmap (see Figure 12), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating[13].

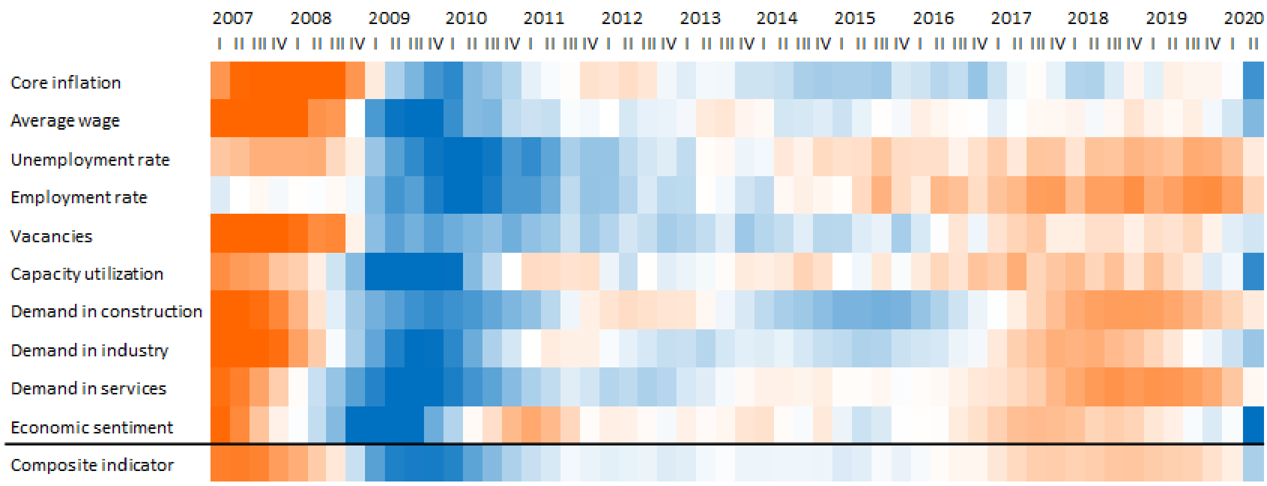

Figure 12. Macroeconomic heatmap for Estonia (Q1 2007 – Q2 2020)

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

Corrected data this autumn show that the Estonian economy grew by 5% both in 2019 and as an average in 2017-2019. This is in line with the composite indicator of the heatmap, which shows that the previous growth phase peaked in the second half of 2018. There have been some signs of cooling in the heatmap since the end of last year, but in the second quarter of 2020 more than half of the economic indicators were pointing to a recession. The wage support measure has temporarily eased the rise in the unemployment rate and the fall in the employment rate. The fall in the composite indicator of the heatmap is in line with the estimates of analysts for the Estonian output gap (see Figure 13).

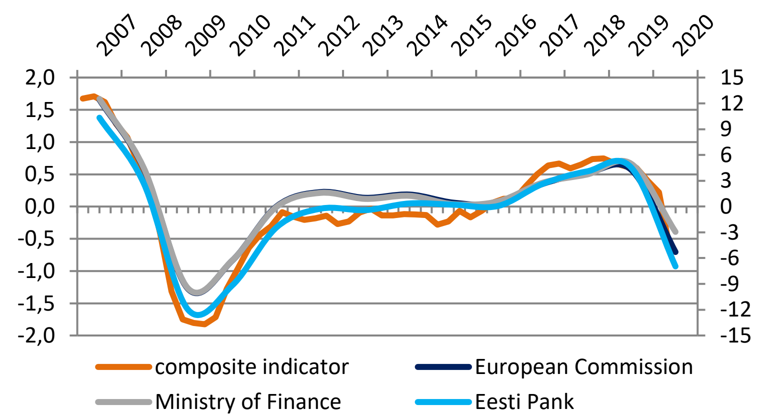

Figure 13. The composite indicator (left scale) and estimates of the output gap in % of GDP (right scale)

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

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