OPINION OF THE FISCAL COUNCIL ON THE TARGETS FOR THE STRUCTURAL BUDGET POSITION FOR 2021-2024

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Contents

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Opinion

Under the state budget strategy 2021-2024, the Estonian general government fiscal deficit for this year should be 1.75 billion euros and that for 2021 should total 1.9 billion euros, or 6.6-6.7% of GDP. After this the deficit should start to narrow and the government target is that it should reach 2.5% of GDP by 2024.

The government has not set a numerical target for the size of the deficit for this year or next year, when the fiscal rules of the European Union have temporarily been suspended. As the lowest point of the recession and the most expensive measures to support the economy will both fall in 2020 according to the forecast of the Ministry of Finance, the Fiscal Council does not find any reason for the budget deficit to be deepened in 2021.

In 2022, when the economy is forecast to have returned to its level of before the crisis, the fiscal deficit will reach 1.6 billion euros or 5.4% of GDP. The Fiscal Council does not find that there is any reason for the budget deficit to exceed the 3% limit from 2022.

The Fiscal Council recommends that the government recover structural fiscal balance in 2023-2024. The structural fiscal deficit of the general government will start to narrow from 2022, but balance will not yet have been reached by 2024.

The government is planning to introduce a programme of savings worth one billion euros to improve the fiscal position after the crisis, of which half will be introduced in 2024. Unfortunately the budget strategy does not explain the measures that will be taken to achieve these cost savings, and for this reason the Fiscal Council doubts that the budget targets set for 2024 will be achieved.

The improvement in their fiscal position planned in the state budget strategy 2021-2024 is not consequently sufficient in the opinion of the Fiscal Council, and it is based partly on measures that are only starting to be decided.

The Fiscal Council believes it important that general government spending be brought in line with expected revenues in the near future, and that large-scale budget deficits to support the economy remain a crisis measure only. Using borrowed money to cover current expenses is not wise once the crisis is over nor sustainable in the long term.

Chairman of Fiscal Council
Raul Eamets
Tallinn, 29 September 2020

Explanatory Report

It is the responsibility of the Fiscal Council to assess the fiscal targets set in the state budget strategy for the next four years, starting from the fiscal rules and the need to improve the fiscal position. This year the budget strategy was exceptionally prepared in the autumn, as there was too much uncertainty in the spring for long-term budget plans to be produced. The basis for deciding both the state budget 2021 and the state budget strategy 2021–2024 is the summer 2020 economic forecast of the Ministry of Finance. The fiscal rules of the European Union have been temporarily suspended in 2020 and 2021 because of the coronavirus crisis.

Assessment of the targets for the structural fiscal position for 2021-2024

Budgetary position in 2020

When the government drew up the state budget for 2020 last autumn, it had to consider that the structural deficit had to be reduced by at least 0.5 percentage point in both 2019 and 2020. The larger deficit than permitted in 2018 had engaged the correction mechanism contained in the fiscal rules, which required a return to structural balance. The 2020 state budget was planned so that the general government fiscal position would be in nominal balance (see Figure 1), which would have left a structural deficit of 0.7% of GDP according to the forecast.

At the time the 2020 state budget was written, economic growth of a couple of per cent was assumed, together with growth of 5% in tax revenues. The coronavirus hit by surprise in the spring though, and the restrictions imposed to slow its spread delivered a major blow to the Estonian economy. The Ministry of Finance estimates that the economy will decline by 5.5% in 2020. This means the state treasury will receive notably less in tax revenues than was expected. Efforts have not been made to cut spending though, and indeed on the contrary, additional demands from healthcare and social care and a large package of measures to aid the economy have actually increased government spending.

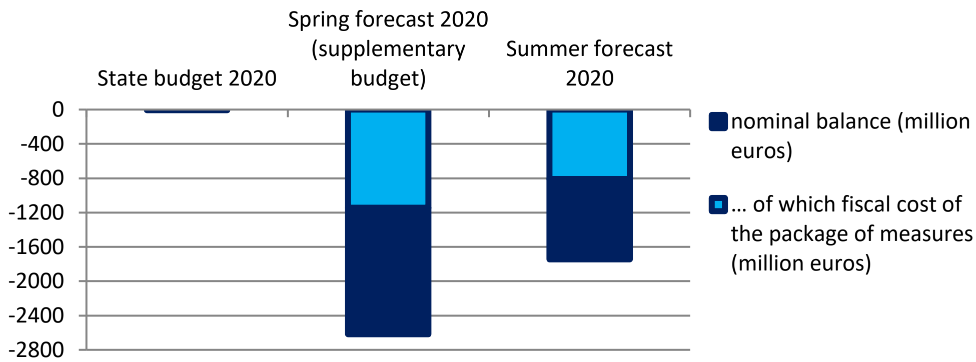

Figure 1. General government nominal balance for 2020 (million euros)

Source: Ministry of Finance

The spring forecast 2020 of the Ministry of Finance expected that the nominal deficit of the general government 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. The summer economic forecast found that the crisis would not affect state finances as much this year, and the nominal deficit would be 1.75 billion euros, or 6.6% of GDP. The cost to the budget of the fiscal measures 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.

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 1). 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.

Table 1. 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

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. This means that the structural deficit of the general government for 2020 will be 5.7% of GDP in the estimate of the ministry (see Figure 5). This evidently means that the fiscal position will be worse than in 2019, but the exemption from the fiscal rules granted in spring 2020 means that the government is not obliged this year or next to keep the budget in structural balance or to take the steps required under the budget rules to move towards balance.

Budgetary targets for 2021-2024

The state budget strategy and the fiscal targets for 2021-2024 are based on the summer 2020 economic forecast of the Ministry of Finance. The forecast found that the coronavirus crisis affected the economy by less in the spring than was expected, and that growth will return to the economy in 2021. 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 (see Figure 2).

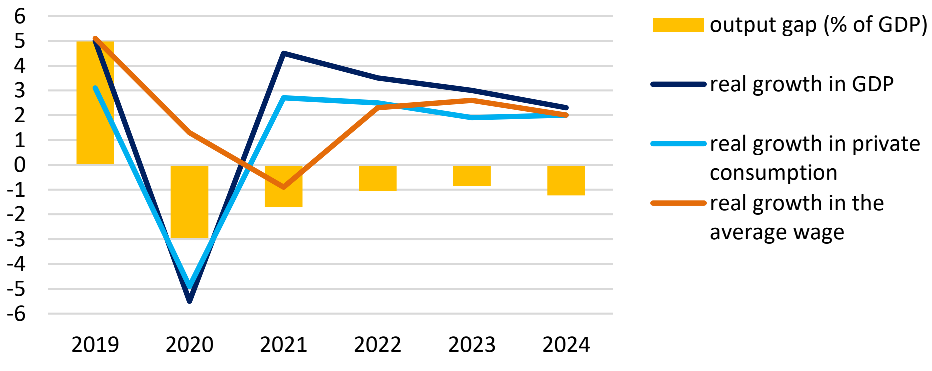

Figure 2. Key indicators in the summer forecast 2020 of the Ministry of Finance (%)

Source: Ministry of Finance

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. No major changes to the restrictions to limit the spread of the coronavirus have been made between the publication of the forecast and the passing of the budget strategy.

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 is forecast to remain above its earlier level in future (see Table 2). The ministry 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. This means that the general government budget will remain in large deficit throughout the forecast horizon, meaning the debt burden will grow rapidly.

Table 2. Revenue and expenditure of the general government in the state budget strategy (% of GDP)

	2020	2021	2022	2023	2024
general government expenditure	45.9	45.7	43.1	42.0	39.8
change from the summer forecast	0	1.9	0.8	0.1	−0.5
general government revenue	39.3	39.0	37.7	37.7	37.3
change from the summer forecast	0	1.3	0.8	0.1	0.1
nominal balance	−6.6	−6.7	−5.4	−4.3	−2.5
change from the summer forecast	0	−0.7	0	0	0.6

Source: Ministry of Finance

General government spending in the years ahead was put even higher in the state budget and the budget strategy than in the summer economic forecast, by 1.9% of GDP in 2021 and 0.8% of GDP in 2022. The budget strategy has added further large-scale investments to the spending side for road building, IT, fixed assets, and research and development activities, together with a rise in defence spending and a one-off increase in pensions. At the same time the government foresees a general cut in spending from 2022 of around one billion euros over three years.

The cost of the additional spending is covered by additional revenues that were not in the summer forecast 2020 (see Figure 3). The main assumption is that foreign funds from the European Union will be used more quickly than forecast, which will then give a boost to tax revenues. The differences between the revenues in the state budget strategy for 2023 and 2024 and in the summer forecast are more minor.

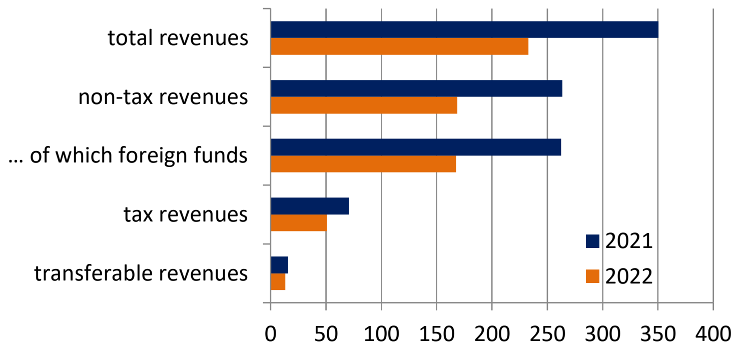

Figure 3. Changes in the forecast for state budget revenues from the summer forecast (million euros)
Source: Ministry of Finance

In total the 2021 fiscal position is 0.7 percentage point, or about 200 million euros, weaker than in the summer forecast. Revenues and spending have increased by similar amounts for 2022 and 2023, and so the forecast for the fiscal position is unchanged. The fiscal position for 2024 is 0.6 percentage point better than in the summer forecast. How accurate the forecast for 2022-2024 proves depends primarily on whether the planned cut in spending is actually carried out. The expected savings on expenditures in the budget strategy are of 0.9% of GDP in 2022, 0.8% in 2023, and 1.4% in 2024. Furthermore, faster use of the EU funds than forecast has also been used in the past as a way of increasing revenues in the state budget strategy. It assumes though a greater administrative capacity for using the foreign funds.

Under the state budget strategy 2021-2024, the Estonian general government fiscal deficit for this year should be 1.75 billion euros and that for 2021 should total 1.9 billion euros, or 6.6% of GDP this year and 6.7% next year. After this the deficit should start to narrow and the government target is that it should reach 2.5% of GDP by 2024 (see Table 3).

Table 3. The general government budget position 2020-2024 (% of GDP)

	2020	2021	2022	2023	2024
nominal balance (million euros)	–1749	–1898	–1622	–1357	–815
nominal balance	–6.6	–6.7	–5.4	–4.3	–2.5
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	–5.9	–4.9	–3.9	–1.9
one-off measures	0.5	0.7	0.0	–0.5	–0.5
structural balance	–5.7	–6.6	–4.9	–3.3	–1.3
general government debt	18.2	23.6	27.1	29.6	30.8

Source: Ministry of Finance

The government has not set a numerical target for the size of the deficit for this year or next year, when the fiscal rules of the European Union have temporarily been suspended. As stated in the state budget strategy, the requirement to avoid an excessive nominal budget deficit remains, with the limit set at 3% of GDP by the Stability and Growth Pact.

It is explained in the budget strategy that as the Estonian economy will not yet have fully exited the crisis in 2021, the government will have to take steps next year to revive the economy. The Fiscal Council considers that the fiscal deficit in 2021 may only exceed 3% of GDP if it does so because of the weakness in the economic cycle and the additional spending in response to the coronavirus crisis[1]. As the Ministry of Finance forecasts that the lowest point of the recession and the most expensive measures to support the economy will both occur in 2020, the Fiscal Council does not find any reason for the budget deficit to be deepened in 2021. The budget deficit does not necessarily have to be larger than in the previous year to be able to support the recovery of the economy from the crisis.

In 2022, when the economy is forecast to have returned to its level of before the crisis, the fiscal deficit will reach 1.6 billion euros or 5.4% of GDP (see Figure 4). Given how the coronavirus crisis has affected the Estonian economy so far, the Fiscal Council does not find that there is any reason for the budget deficit to exceed the 3% limit from 2022. The Fiscal Council believes it important that general government spending be brought in line with expected revenues in future and that large-scale budget deficits to support the economy remain a crisis measure only. Using borrowed money to cover current expenses is not wise once the crisis is over nor sustainable in the long term.

[1] For more see the explanations in the Fiscal Council opinion on the summer forecast 2020 of the Ministry of Finance.

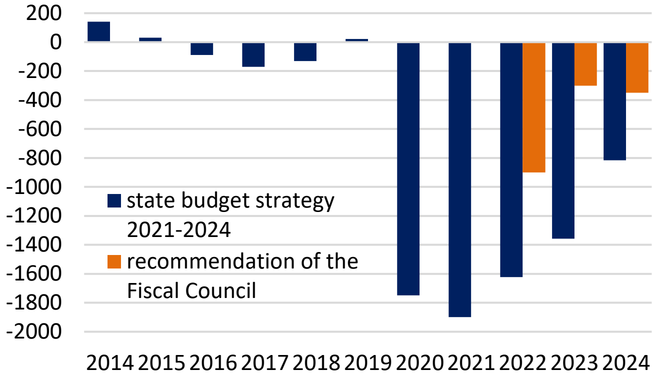

Figure 4. General government nominal fiscal position for 2014-2024 (million euros)

Sources: Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council recommends that the government recover structural fiscal balance in the economy in 2023-2024. The estimate of the ministry for the position of the economic cycle suggests that a nominal budget deficit of around 300-350 million euros could be maintained after the crisis so that the adjustment would not be too sharp. The state budget strategy plans that the structural fiscal deficit of the general government will start to narrow from 2022, but balance will not yet have been reached by 2024 (see Figure 5). Calculations by the Fiscal Council give a structural budget deficit going forwards of a similar size to that estimated by the ministry.

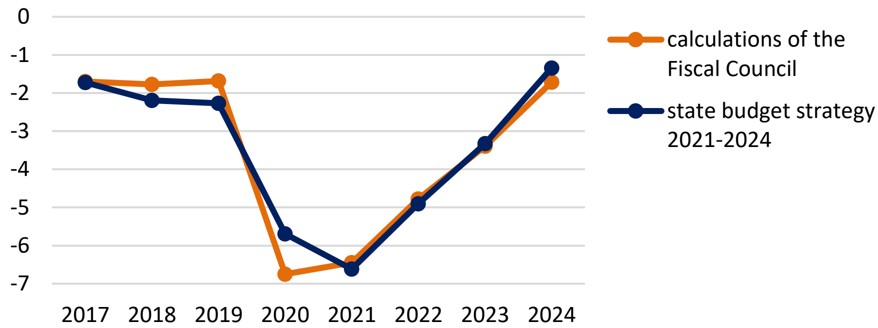

Figure 5. Estimated structural fiscal position 2017–2024 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

As it is currently harder than usual to estimate the position of the economic cycle, the Fiscal Council considers it reasonable that the government has not set numerical targets for the general government *structural* fiscal position for the years ahead. The target set for 2024 of reducing the *nominal* budget deficit is however not sufficiently stringent in the opinion of the Fiscal Council. The nominal budget deficit in the state budget strategy will exceed 3% of GDP each year until 2024. Achieving a smaller budget deficit in 2024 will depend on a large-scale cut in spending, but the measures needed to make this happen had not yet been agreed when the state budget strategy was written, and for this reason the Fiscal Council doubts that the budget targets set for 2024 will be reached.

The Fiscal Council considers it important to realise that the Estonian economy will be given an additional boost in the years ahead by increased investment funded by EU funds, which will be reflected in both the revenue and expenditures side of the fiscal position. This means the additional stimulus given to the economy will be bigger than may be understood from the size of the budget deficit, and so it will be possible to reduce the budget deficit more determinedly after the crisis without harming the potential for growth in the economy.