EELARVENÕUKOGU
FISCAL COUNCIL

OPINION OF THE FISCAL COUNCIL ON THE TARGETS FOR THE STRUCTURAL BUDGET POSITION FOR 2022-2025

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Contents

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Opinion

The government has used the spring economic forecast 2021 of the Ministry of Finance as the basis for its state budget strategy for 2022-2025. It is the responsibility of the Fiscal Council to assess the budgetary targets set in the budget strategy, starting from the fiscal rules and the need to improve the budget position. The European Union introduced an escape clause for the fiscal rules in spring 2020, which still applies.

The Ministry of Finance estimates that the budget deficit of the general government will reach 1.7 billion euros, or 6% of GDP in 2021. The state budget strategy plans that the deficit will start to narrow from 2022, but balance will not yet have been reached by 2025 when the forecast horizon ends. Financing the budget deficit will increase the general government debt burden to 28% of GDP.

The government's aim in its budget strategy is to reduce the budget deficit of the coming years to below what was forecast in the spring. Additional revenues and expenditure cuts are planned in order to achieve this, together with a reduction in public sector investment. The state budget strategy puts the general government's nominal deficit at 3.8% of GDP in 2022 and 3.2% of GDP in 2023.

Under the fiscal rules of the European Union, the budget deficit may not exceed 3% of GDP under normal circumstances. As the spring forecast of the Ministry of Finance finds that the Estonian economy will have returned to its pre-crisis level from next year, the Fiscal Council finds that there is no longer any reason for the budget deficit to exceed the 3% limit from 2022.

In consequence the Fiscal Council recommends that when the state budget for 2022 is drafted in the autumn, the general government budget deficit should be reduced by at least 220-230 million euros from the current forecast. The budget deficit can be reduced by increasing revenues or reducing expenditures or both.

In its assessment of the spring forecast of the Ministry of Finance, the Fiscal Council found that growth in the economy in the years ahead could prove even faster than expected. This is because of the money paid out from the second pension pillar and the consequent increase in private consumption, and because of wages rising faster than forecast. This will mean that tax revenues may be higher than expected. If this positive growth scenario occurs, the Fiscal Council recommends that the additional tax revenues should be used not for additional expenditures, but for returning faster to budget balance.

Chairman of the Fiscal Council
Raul Eamets
Tallinn, 29 April 2021

Explanatory Report

It is the responsibility of the Fiscal Council to assess the budgetary targets set in the state budget strategy for the next four years, starting from the fiscal rules and the need to improve the budget position. An escape clause for the fiscal rules was activated in spring 2020 because of the coronavirus pandemic, and it still applies. The state budget strategy for 2022-2025 assumes that it is probable that the escape clause will still apply in 2022. The budget strategy is based on the spring 2021 economic forecast of the Ministry of Finance, which has been endorsed by the Fiscal Council.

Assessment of the targets for the structural budget position for 2022-2025

Budgetary position in 2021

The Ministry of Finance forecast in autumn 2020 that the nominal budget deficit of the general government in 2020 would be 1.75 billion euros, and that it would total 1.9 billion euros or 6.7% of GDP in 2021 (see Table 1). The state budget for 2021 assumed there would be no second wave of the coronavirus and that additional restrictions on economic activity would not be imposed. In consequence the expenditure forecast in the state budget did not include additional support measures for the economy in 2021. The Fiscal Council found last autumn that as it was forecast that the lowest point of the recession and the most expensive measures to support the economy would both occur in 2020, there was not any reason for the budget deficit to be deepened in 2021.

Table 1. The general government budget position for 2021

	State Budget 2021	spring forecast/ Supplementary Budget 2021	State Budget Strategy 2022–2025
Nominal balance (million euros)	−1898	−1723	−1706
Nominal balance (% of GDP)	−6.7	−6.0	−6.0
Real GDP growth (%)	4.5	2.5	2.5
Output gap (% of GDP)	−1.7	−2.9	−2.9
One-off measures (% of GDP)	0.7	0.8	0.8
Structural balance (% of GDP)	−6.6	−5.5	−5.4

Source: Ministry of Finance

Unfortunately the number of cases of infection started to rise again at the end of 2020, reaching a record level in March. This caused the government to pass a supplementary budget in spring 2021 to direct additional money to the healthcare system and to support the economy[1]. The supplementary budget was of 641 million euros in size and the Ministry of Finance estimates that the negative impact on the budget position for 2021 will be 385 million euros, or 1.35% of GDP.

Despite this the budget position in the spring forecast 2021 of the Ministry of Finance was better than it was in the autumn. As the economy contracted by less last year than expected and the production capacity in the economy will be larger in the coming years than was earlier forecast, the tax revenues in the state budget were increased in the spring forecast by 640 million euros for 2021. Tax revenues are increased by the general improvement in the economic environment as well as by the reform of the second pension pillar[2].

[1] For example, support measures included wage subsidies, an extension of compensation for sick days, and support for the tourism, culture and sport sectors.

[2] For more on the fiscal impact of the pension reform read the opinion on the spring forecast of the Ministry of Finance.

The state budget strategy 2022-2025 puts the nominal budget deficit of the general government for 2021 at 1.7 billion euros, or 6% of GDP. The deficit will be larger than it was in 2020, when data from Statistics Estonia put it at 1.3 billion euros or 4.8% of GDP (see Background 1).

The updated estimate of the Ministry of Finance of the economic cycle finds that the negative output gap will no longer peak in 2020, but in 2021, when the spring forecast finds that it will reach 2.9% of GDP. Although the one-off budget measures remain about the same size as was forecast in the state budget, the content of the measures has changed. In autumn 2020 the Ministry of Finance still calculated that the one-off measures would include a temporary halt in the second pension pillar contributions by the state, but by the spring the ministry had abandoned this approach. The additional income tax received by the state from the launch of the pension reform is considered a one-off measure in 2021, which it was not possible to do in earlier forecasts. The calculations of the ministry show a temporary boost to tax revenues of 240 million euros in 2021, or 0.8% of GDP, which has not been included in the calculation of the structural budget position.

Calculating from the spring forecast of the Ministry of Finance and the decisions added in the state budget strategy 2022-2025, the general government structural deficit in 2021 will be 5.4% of GDP. The structural deficit will be substantially larger than it was in 2020, when the Ministry of Finance put it at 3.6% of GDP. When the coronavirus crisis erupted, the Estonian government abandoned its earlier plan of reducing the structural budget deficit and did not set new numerical targets for the size of the structural deficit in 2020 and 2021. The Fiscal Council finds that this was justified. The fiscal rules were suspended in 2020 and still are in 2021, and so no sanction will be applied under the State Budget Act for the extraordinarily large budget deficit.

Budgetary targets for 2022-2025

The state budget strategy prepared this spring describes the development of the state finances in 2022-2025. Since the previous budget strategy was exceptionally passed in autumn 2020, the size of the economic contraction last year has become known and has proved smaller than was expected. Unfortunately it is not yet clear when the escape clause to the fiscal rules will be lifted[3]. This makes it harder to set and to assess the budgetary targets. The state budget strategy for 2022-2025 assumes that it is probable that the escape clause will still apply in 2022. The spring forecast shows that the Estonian economy will start growing again in 2021, and so the budget strategy drafted this spring should describe how the state finances are recovering from the recession and when the budget will return to balance.

The state budget strategy written last autumn for 2021-2024 forecast nominal budget deficits of 5.4% of GDP in 2022, 4.3% in 2023, and 2.5% in 2024. The accuracy of this forecast depended in the opinion of the Fiscal Council on whether the announced spending cuts were actually carried out. The size of the spending cuts foreseen in the budget strategy were 0.9% of GDP in 2022, 0.8% in 2023, and 1.4% in 2024. In addition, the Fiscal Council did not find that there was any reason for the budget deficit to exceed the 3% limit from 2022, given how the coronavirus crisis had affected the Estonian economy by then.

The state budget strategy for 2022-2025 this spring (see Table 2) puts the nominal budget deficit of the general government above 3% of GDP at 3.8% in 2022, and also in 2023 at 3.2% of GDP. The budget strategy proposes that the structural budget deficit will be reduced each year in future by at least 0.5 percentage point. Although the deficit will start shrinking from next year, budget balance will not yet have been achieved by the end of the forecast horizon and both the nominal and structural deficits will remain

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

around 1.6-1.7% of GDP. Financing the budget deficit will increase the general government debt burden to 28.2% of GDP by 2025. The government says that the focus after the Covid-19 pandemic is over will again be on long-term goals, and achieving and maintaining structural budget balance for the general government.

Table 2. The general government budget position in the state budget strategy 2022-2025 (% of GDP)

	2022	2023	2024	2025
Nominal balance (million euros)	−1148	−1030	−739	−585
Nominal balance	−3.8	−3.2	−2.2	−1.7
Output gap	−1.0	−0.5	−0.2	0.0
Cyclical component	−0.5	−0.3	−0.1	0.0
One-off measures	0.2	0.0	0.0	0.0
Structural balance	−3.4	−2.9	−2.1	−1.6
Government debt	24.6	27.4	28.0	28.2

Source: Ministry of Finance

This means the outlook for the state finances is better than it was in the budget strategy written in the autumn. The forecast is better even though the fiscal forecast no longer contains the spending cuts that had no actual content but was included in the previous budget strategy. A stronger economic environment and the impact of the pension reform mean the forecast for general government revenues has increased by more than the forecast for expenses.

On top of this the government set the goal when it was writing the state budget strategy of improving the fiscal position in the years ahead compared to the spring forecast of the Ministry of Finance. The package of revenue and spending measures has improved the general government budget position by around 0.3 percentage point for 2022 and 0.2 percentage point for 2024-2025 (see Table 3).

Table 3. General government revenue, expenditure, and the nominal balance in the state budget strategy 2022-2025 (% of GDP)

	2021	2022	2023	2024	2025
General government revenue	41.7	40.2	40.1	39.4	38.9
General government expenditure	47.6	43.9	43.3	41.6	40.5
Nominal balance	−6.0	−3.8	−3.2	−2.2	−1.7
change from the spring forecast (pp)	*0.06*	*0.27*	*−0.09*	*0.21*	*0.21*
change from the spring forecast (million euros)	*17*	*83*	*−27*	*70*	*74*

Source: Ministry of Finance

The general government revenues in the forecast are increased each year by 50-90 million euros by revenue measures such as dividends from state owned companies, sales of assets, tax revenues from Enterprise Estonia's measures, and the abolition of tax rebates for interest on housing loans. On the expenditures side there are both savings and increases in spending. The government hopes that savings on both the operating and labour costs of the general government will improve the fiscal position in 2022-2025 by 40-50 million euros a year. By shifting public sector investment, the state has reduced spending with its own resources, allowing it to save 85-95 million euros in 2024 and 2025. The forecast for spending is increased most by an extraordinary rise in pensions and an increase in the tax-free part of pensions, which will cost 140-190 million euros annually in 2023-2025.

Like last autumn, the Fiscal Council has recommended to the government that the nominal budget deficit should not exceed 3% of GDP starting from 2022. Although the state budget strategy has reduced the budget deficit in 2022 by 83 million euros from the spring forecast of the Ministry of Finance, achieving this goal needs the deficit to be reduced by a further 220-230 million euros (see Figure 1). In consequence the Fiscal Council recommends that when the state budget for 2022 is drafted in the autumn, the general government budget position should be improved further. The budget position can be improved by increasing revenues or reducing expenditures or both.

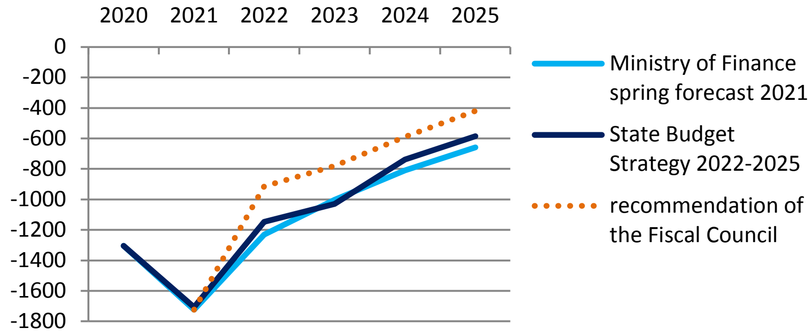

Figure 1. General government nominal balance for 2020-2025 (million euros)

Sources: Ministry of Finance, calculations of the Fiscal Council

Although the escape clause for the fiscal rules will probably be extended in the European Union in 2022 as well, the extent of the contraction in the Estonian economy and the outlook for growth mean that the Fiscal Council does not consider the escape clause to be justified under the Estonian circumstances. The Estonian economy contracted by less in 2020 than those in the European Union did on average, and the spring forecast of the Ministry of Finance finds that Estonian GDP will have passed its pre-crisis level in 2022 in both current and constant prices (see Figure 2). The spring forecast finds furthermore that the output gap will start to narrow rapidly in the years ahead and the negative impact of the economic cycle on the state finances will be modest after 2022 (see Table 2).

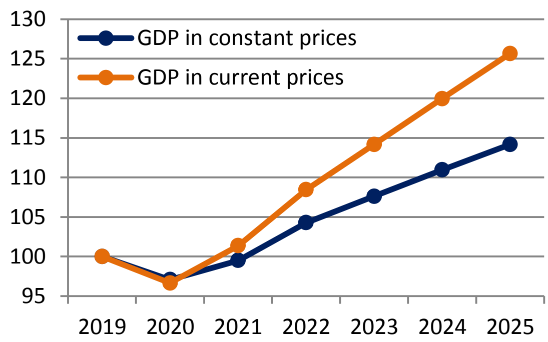

Figure 2. Forecast GDP at constant and current prices (GDP in 2019 = 100)

Sources: Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council believes it important that general government spending be brought into line with expected revenues and that large-scale budget deficits to support the economy remain a crisis measure only. General government spending increased sharply as a share of GDP in 2020 (see Figure 3). The state budget strategy 2022-2025 expects that general government spending will increase further as a share of GDP in 2021, and it will remain above its earlier level in future. Although general government revenues as a share of GDP will be increased by the pension reform and the growth in fiscal transfers from abroad, such an excess of expenditures will not be sustainable over the long term.

The state budget strategy for 2022-2025 puts the nominal budget deficit of the general government above 3% of GDP at 3.8% in 2022, and also in 2023 at 3.2% of GDP. Working from the outlook for growth in the Estonian economy in the spring forecast 2021 of the Ministry of Finance, the Fiscal Council finds that more demanding budgetary targets should be set in the coming years than those in the state budget strategy, and the fiscal rules should already be reapplied in 2022. This means that the nominal deficit should no longer exceed 3% of GDP from 2022 and the structural deficit must start to be reduced by at least 0.5 percentage point a year.

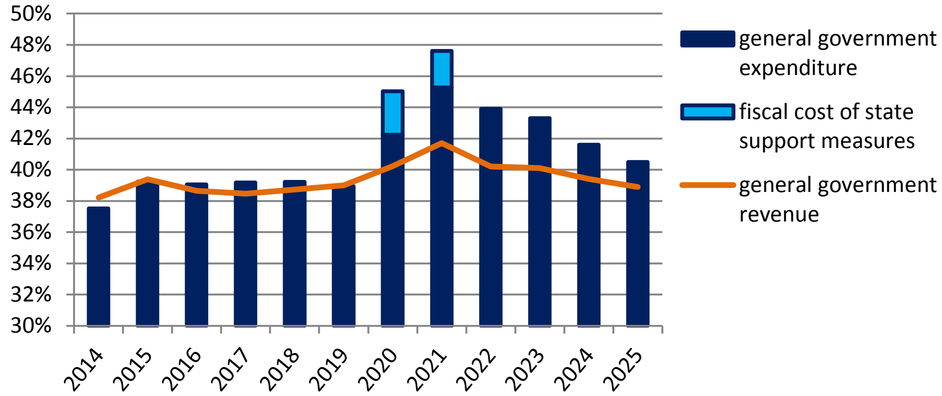

Figure 3. Revenue and expenditure of the general government (% of GDP)

Source: Ministry of Finance

In its assessment of the spring forecast of the Ministry of Finance, the Fiscal Council found that growth in the economy in the years ahead could prove even faster than expected. This is because of the money paid out from the second pension pillar and the consequent increase in private consumption, and because of wages rising faster than forecast. This will mean that tax revenues may be higher than expected. If this positive growth scenario occurs, the Fiscal Council recommends that the additional tax revenues should be used not for additional expenditures, but for returning faster to budget balance.

Background 1. *Developments in public finances in the European Union*

The spread of the Covid-19 pandemic in 2020 led to a recession, budget deficits and increasing debt in the European Union. The nominal deficit of the general government reached 3% of GDP in all the countries of the EU except Denmark (see Figure 4, left panel). Statistics Estonia put the deficit in Estonia in 2020 at 1.3 billion euros, or 4.8% of GDP. The Estonian government debt in 2019 was 8.4% of GDP, but by the end of 2020 this had increased by around 10 percentage points to 18.2% of GDP (see Figure 4, right panel).

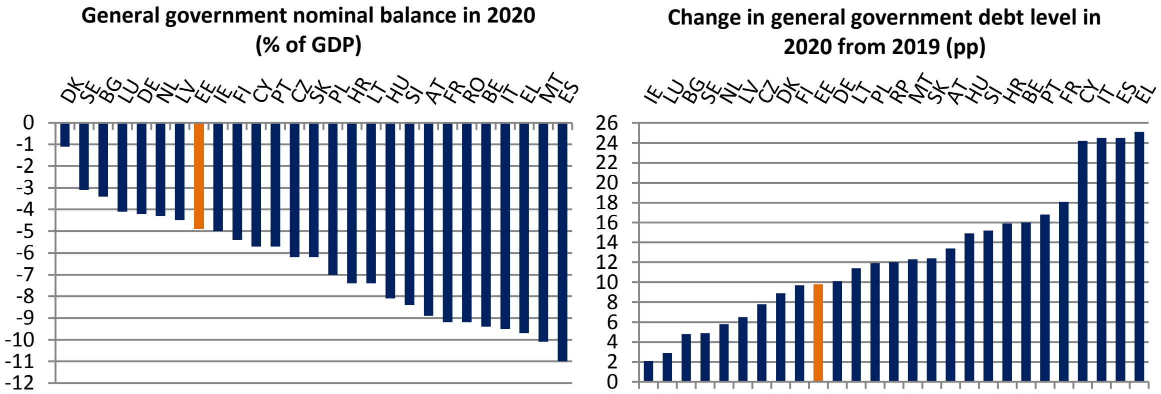

Figure 4. General government nominal balance and change in debt level in 2020

Source: Eurostat

As the recession and budget deficit in Estonia proved to be among the smallest in the EU in 2020, it may be assumed that this would allow Estonia to return faster than the average to budget balance, once the impact of the pandemic on the state finances and the temporary state support measures have ended. The spring forecast of the Ministry of Finance finds that the Estonian economy will start to grow again in 2021 and will exceed its pre-crisis level as early as 2022. The budget strategy expects the Estonian budget deficit to increase this year to 6% of GDP, but then to start declining to reach 3.8% of GDP in 2022. Comparing the deficits of EU countries in 2022 and in 2020 shows the improvement in the Estonian budget position over two years to be one of the smallest (see Figure 5)[4]. However, the improvement in the budget position is on average larger in countries where the deficit was larger in 2020.

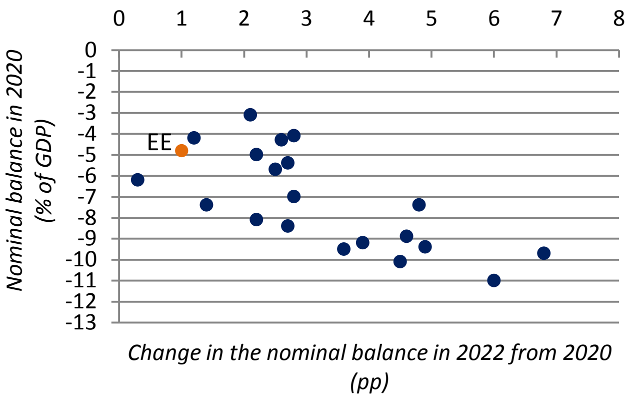

Figure 5. Change in the general government nominal balance in 2022 from 2020

Sources: European Commission, Eurostat, calculations of the Fiscal Council

[4] The figure uses data from Eurostat for the budget deficit in 2020 and forecasts for 2022 for the EU member states from the Stability and Convergence Programmes. Bulgaria, Cyprus, Denmark, Finland, Romania and Slovakia are not shown in figure as their programmes had not yet been submitted to the European Commission when this opinion was released.

Background 2. *The quality of public investment*

The ongoing coronavirus crisis has increased interest in public investment because large amounts of fiscal stimulus money are being directed into it. Furthermore, the urgent need to address climate change is making public investment one of the key elements in the strategy of mitigating climate change.

Some of the most important roles of *high-quality* public investment are promoting long-run economic growth, contributing to short-term growth, and supporting policies to mitigate climate change. Furthermore the criteria for quality include a high social rate of return or a high net present social value for public investment projects, and they suppose that projects are implemented without large delays and cost overruns, and without corruption. These facets of quality have recently been emphasised by various institutions, think-tanks, newspapers and opinion leaders such as the IMF and the European Commission[5].

In practice, the quality of public investments (QPI) is highly variable. This variation makes it crucial to carry out rigorous ex ante evaluation and selection of projects and to practice good management and control of project execution.

QPI is also connected to the fiscal governance objectives of sustainability and stability. Public investment can support macroeconomic stability if it is used as a countercyclical policy, promoting short-run economic growth during a recession or a recovery. Maintenance projects are particularly good for this purpose rather than large, new projects because they are more shovel-ready and job-intensive, leading to large short-term multipliers (IMF 2020b). QPI, by promoting growth in potential output, may contribute to the sustainability of public debt.

Quality also helps sustainability when it means there are no delays and no cost overruns, as lower costs have a direct effect on the public deficit. They reduce spending and at the same time they imply that less is needed in government revenues, reducing tax-induced economic distortions as well.

Various recommendations can be made for Estonia to achieve high quality in public investment.

It is important to remember that the EU economy is still weak, the Estonian economy is in the process of recovering, and economic uncertainty is elevated. Equally, the significant amounts of funding coming from the Recovery and Resilience Facility will have a positive impact on the economy, depending on how wisely they are used. The Estonian central and local governments should prioritise:

- maintaining existing structures rather than launching new projects, by improving the liveability and energy efficiency of housing for example, or by renovating and improving cultural and religious heritage sites;
- small projects over large ones, by completing existing railways for example;
- the simple over the complex, as engineering projects range greatly in their complexity, so building a bridge over a short distance is many orders of magnitude easier than creating an underwater tunnel.

Furthermore, central and local governments should give precedence to projects that:

- are clearly seen to be needed and have already been demanded by the public at the national or local level. It is important for this to create channels through which people can give their opinion on their needs;

[5] See IMF (2020a and 2020b) and A European Green Deal at https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en.

- are ready to start rather than those that require long planning, so projects that have been stopped or suspended for example;
- already have the necessary machinery and know-how available;
- promote or are at least consistent with the de-carbonisation of the economy and are energy efficient;
- are consistent with the natural characteristics of the country;
- bridge existing geographic interdependencies within the country, by improving the connections between towns and the countryside for example;
- use legal arrangements for which there is sufficient experience – it is wise to be very cautious about Public Private Partnerships, as recommended by the European Court of Auditors (2018);
- promote convergence between regions at least in their quality of living if not in their economic strength; and
- take account of existing infrastructure, by electrifying railways for example, which is reasonable as long as the electricity comes from a clean source.

The need to secure funding should not lead to projects being approved hastily without the proper consideration for legal constraints, environmental risks or public opinion.

Cost-benefit analysis should be done by independent experts and its results should be taken seriously by decision-makers. If the evaluation of a project is negative in most scenarios or in the most likely scenarios, then that project should not be carried out. Cost-benefit analysis cannot be cast aside arbitrarily or because of political opportunism.

Crowding-in effects should also be studied carefully. If the government plans a lot of large construction projects like motorways, fast trains, bridges and hospitals, one effect will be that the private sector has a strong incentive to invest relatively more in construction machinery and know-how rather than in other sectors like R&D.

If the government demand for a large number of large construction projects becomes relatively permanent, there is the risk of the composition of the stock of physical capital in the private sector being permanently tilted towards construction. The construction sector is non-tradable as its output cannot be exported, and it is not very innovative, unlike say the IT sector. As such, it does not promote increases in value-added for the same quantity of inputs, with roads and computers a case in point.

Promoting non-tradable and less innovative sectors at the expense of other sectors undermines the external balance of the economy and hurts its competitiveness. A public construction drive might also increase the cost of labour, which is detrimental to other sectors. This effect is exacerbated when it is coupled with restrictions on immigration.

This all makes it important to recognise that different public investments have different consequences for short-run and long-run growth, for the growth of the private sector, for competitiveness and the external balance of the country, and for the composition of the stock of physical capital.

There can be trade-offs between the different types of public investment. Although Estonia has had one of the largest public investment ratios to GDP in the EU[6] for example, the gross domestic expenditure by the corporate sector on research and development in euros per resident was only 40% of the EU average in 2019 according to Eurostat.

[6] The 2015-2019 average for Estonia was the second highest general government gross fixed capital formation as a percentage of GDP among all the EU countries (Ameco, see Eesti Pank, 2020).

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