

**FISCAL COUNCIL OF ESTONIA
REPORT FOR 2018**

April 2019

CONTENTS

Chairman's foreword.....	3
1. Brief introduction to the Fiscal Council	4
2. Activity overview	5
3. Budget	9
Appendix 1. Opinion on the spring forecast 2018 of the Ministry of Finance and on the targets for the structural budget position for 2019-2022.....	10
Appendix 2. Opinion on the summer forecast 2018 of the Ministry of Finance.....	12

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CHAIRMAN'S FOREWORD

Estonian state finances have for a long time been managed under the principle of a balanced budget. At first this was an unwritten rule targeting nominal balance, and then a formal fiscal rule targeting structural balance. The state budget 2018 was the first to be written after changes to the State Budget Act in summer 2017 that allowed a structural deficit to be planned for the general government. The deficit can reach 0.5% of GDP if a surplus of the same size has previously been built up.

Although the state budget strategy at first foresaw a deficit of half a percentage point in 2018, when the state budget was passed for 2018 the structural deficit was 0.25% of GDP. Given the possible errors in the forecasting of tax revenues and the difficulty of estimating the position in the economic cycle, the Fiscal Council recommended that the 2018 budget should target a small surplus.

We now know that the actual result for 2018 was weaker than planned as the nominal deficit reached 0.6% of GDP and the structural deficit 1.5% of GDP, according to the spring forecast 2019 of the Ministry of Finance. The larger deficit than planned for 2018 sets limits on future fiscal policy.

The Fiscal Council is concerned that even though the economic growth has been good in recent years, the general government fiscal position was in deficit for the third year, and structural balance has not been achieved on average over a longer period. The Ministry of Finance spring forecast finds that if the fiscal position is not improved, the deficit will remain in the years ahead too.

However, the State Budget Act requires the fiscal position to be improved this year in order to return to structural balance. The structural fiscal position needs to be improved by at least 0.5 percentage point each year from the previous year until structural balance has again been achieved. This means that the general government may possibly also remain in structural deficit this year and next.

The Fiscal Council recommends that larger efforts should be made to improve the fiscal position while the economy is doing well, and that structural balance should already be regained in 2019. Every additional structural deficit will come with a high price as it will later have to be compensated by a surplus of the same amount. The longer it takes to repair the shortfall, the longer the hands of the government will be tied in planning fiscal policy.

The deficit in 2018 was a surprise to those who drafted the state budget as well, as they still thought in autumn 2018 that there would be a moderate surplus at the end of the year. The deficit arose because spending was larger than planned on investment and social transfers, while non-tax revenue was lower than expected. The Fiscal Council has so far focused mostly in its work on analysing the tax revenues in the state budget, as these are the main source of income for the government. The experience of 2018 shows though that greater attention needs to be paid to the developments in non-tax revenue too.

This spring marks five years since the Fiscal Council first started working. I would sincerely like to thank our colleagues from Eesti Pank for their high quality analysis and organisational support, and the Governor and Supervisory Board of Eesti Pank for their unstinting backing and for ensuring political independence for the Fiscal Council in its work. I am pleased that the Fiscal Council will be able to continue with the same membership for the next five years.

Chairman of Fiscal Council
Raul Eamets
Tallinn, 30 April 2019

1. BRIEF INTRODUCTION TO THE FISCAL COUNCIL

The Fiscal Council of Estonia is an independent advisory council established in 2014 under the State Budget Act, whose function is to give opinions on the macroeconomic and fiscal forecasts on which Estonia's fiscal policy is based and to observe compliance with national fiscal rules. European Union law makes mandatory for members of the euro area to establish a fiscal council that performs similar functions. In Estonia, the legal basis for the establishment of the Fiscal Council and its functions is the State Budget Act adopted on 19 February 2014¹. The statutes of the Fiscal Council were approved at the meeting of the Supervisory Board of Eesti Pank held on 9 April 2014². Information is exchanged between the Fiscal Council and the Ministry of Finance under a cooperation agreement signed in February 2018³.

Under the amendment to the State Budget Act of 2017, the Fiscal Council gives its opinion as follows:

- in April on the spring economic and fiscal forecast of the Ministry of Finance;
- in April on the achievement of the target for the structural budget position in the previous year and on the targets set out in the state budget strategy for subsequent years;
- in September on the summer economic and fiscal forecast of the Ministry of Finance.

Beyond the opinions required by law, the Fiscal Council is independent in planning its work and may at its own initiative publish opinions or research on the Estonian economy or fiscal policy. The opinions of the Fiscal Council and accompanying press releases, opinion pieces and background information papers are published in Estonian and English on the website of the Fiscal Council at www.eelarvenoukogu.ee.

The Fiscal Council has six members and is led by the Chair and the Vice Chair (see Table 1). The first members of the Fiscal Council were appointed to office on 14 May 2014. Members of the Fiscal Council are appointed at the proposal of the Governor of Eesti Pank and are confirmed in office for five years by the Eesti Pank Supervisory Board. On 26 March 2019 the current composition of the Fiscal Council was confirmed for a second five-year term of office.

Table 1. Members of Fiscal Council in 2018

Raul Eamets	Chairman	Dean of the Faculty of Social Sciences of the University of Tartu, Professor of Macroeconomics
Andrus Alber	Vice-Chairman	CEO of Finora Capital
Ülo Kaasik	Member	Deputy Governor of Eesti Pank
Martti Randveer	Member	Head of Economics and Research Department of Eesti Pank
Urmas Varblane	Member	Professor of International Business at the University of Tartu
Andres Võrk	Member	Analyst at the Johan Skytte Institute of Political Studies at the University of Tartu

Members of the Fiscal Council are expected to have an unblemished reputation, a Master's degree or equivalent in economics, and experience that will help the Fiscal Council in its work. Members of the Fiscal Council may not have a job or other position that could affect the independence of the Council in its work. Foreign experts may also be members of the Fiscal Council. The work of the Fiscal Council is funded by Eesti Pank. Three economists from Eesti Pank support the work of the Council, one of them in the role of secretary to the Council. The Fiscal Council gets help from Eesti Pank in editing and translating its publications, administering its website and other organisational issues.

¹ <https://www.riigiteataja.ee/en/eli/ee/504072014004/consolide/current>

² <https://eelarvenoukogu.ee/about-the-council/statutes>

³ <https://eelarvenoukogu.ee/news/the-fiscal-council-and-the-ministry-of-finance-have-signed-a-cooperation-agreement>

2. ACTIVITY OVERVIEW

Meetings and opinions of the Fiscal Council

The statutes of the Fiscal Council require it to meet whenever necessary, but at least five times a year. The Fiscal Council met five times in 2018. Four of the meetings were attended by all the members of the Council, and on one occasion five members attended⁴.

31 January 2018

At its first meeting of the year, the Fiscal Council discussed the fiscal rules and fiscal framework of the European Union. Fiscal Council analysts Lauri Punga and Andres Saarnit gave presentations on the preventive arm of the Stability and Growth Pact and on proposals to strengthen the fiscal framework of the European Union.

4 April 2018

At the second meeting of the Fiscal Council the Ministry of Finance presented its spring macroeconomic and fiscal forecast to the Fiscal Council.

23 April 2018

At its third meeting the Fiscal Council discussed its opinion on the spring forecast 2018 of the Ministry of Finance, the achievement of the structural fiscal position target in the previous year, and the targets set for the structural fiscal position in the state budget strategy.

The opinion of the Fiscal Council was published in a single document on 26 April (see the summary of the opinion in Appendix 1).

11 June 2018

The fourth meeting of the Fiscal Council was held on the side of the meeting of Baltic and Nordic independent fiscal institutions. The meeting discussed forecast errors in macroeconomic and fiscal forecasts, the long-term sustainability of state finances, the budgetary risks of projects undertaken jointly by the public and private sectors, and the opinion of the European Commission on the budget strategies of member states. Representatives of the Estonian Fiscal Council gave presentations on the macroeconomic heatmap of the Estonian economy and on the use of European Union structural funds in the Baltic states.

10 September 2018

At the fifth meeting of the Fiscal Council the Ministry of Finance presented its summer macroeconomic and fiscal forecast to the Fiscal Council.

The opinion of the Fiscal Council on the summer forecast of the Ministry of Finance published on 24 September was produced after electronic consultations were held (see the summary of the opinion in Appendix 2).

⁴ A meeting of the Fiscal Council has a quorum if at least four members are present.

Other meetings and presentations

1 February 2018

Chair of the Fiscal Council Raul Eamets attended the eighth meeting of the European Union Network of Independent Fiscal Institutions (EUNIFI) organised by the European Commission in Brussels. The meeting discussed the annual report of the European Fiscal Board for 2017, the action plan of the European Commission for deepening the Economic and Monetary Union in Europe, contingent liabilities of the general government, and the principle of 'comply or explain' in the work of fiscal councils.

14 February 2018

Chair of the Fiscal Council Raul Eamets and Minister of Finance Toomas Tõniste signed a cooperation agreement to organise the exchange of information between the Fiscal Council and the Ministry of Finance.

13 March 2018

Chair of the Fiscal Council Raul Eamets, Vice Chair Andrus Alber and analyst Lauri Punga met the IMF delegation in Eesti Pank to discuss the fiscal and tax policy measures of the government, the appropriate fiscal policy stance for the current state of the economy, and the government's strategic investment programme.

19 March 2018

Vice Chair of the Fiscal Council Andrus Alber and analyst Andres Saarniit attended a discussion at the State Budget Control Select Committee to discuss the position of the Estonian economy and state finances in 2017.

6 April 2018

Vice Chair of the Fiscal Council Andrus Alber met a European Commission delegation in Tallinn to discuss questions of the Estonian economy and fiscal policy.

26 April 2018

Vice Chair of the Fiscal Council Andrus Alber and analyst Andres Saarniit attended a meeting of the government to present the opinion of the Fiscal Council on the targets for the structural budget position in the state budget strategy.

4 May 2018

Vice Chair of the Fiscal Council Andrus Alber attended a meeting of the Network of EU Independent Fiscal Institutions in Rome. In the first half of the meeting, the analysis by the network on minimum requirements for fiscal councils and the process for endorsing economic forecasts were presented, together with the results of working groups looking at the output gap and the medium term fiscal framework. The second half of the meeting was a seminar on using microsimulation methods for analysing the impact of fiscal policy.

8 May 2018

Vice Chair of the Fiscal Council Andrus Alber gave a presentation to the Riigikogu in the discussion on the state budget strategy 2019-2022 as a matter of state importance, to present the opinion of the Fiscal Council on the targets for the structural fiscal position and respond to questions from Riigikogu members on Estonian fiscal policy.

5 June 2018

Member of the Fiscal Council Urmas Varblane presented the 2017 annual report of the Fiscal Council to the Eesti Pank Supervisory Board and the most recent opinion on the spring forecast of the Ministry of Finance and the structural fiscal position.

10-11 June 2018

Members and analysts of the Fiscal Council attended a meeting of the Baltic and Nordic independent fiscal institutions in Riga. Member of the Fiscal Council Urmas Varblane gave an introductory presentation on the use of the European Union structural funds in the Baltic states. Fiscal Council analyst Lauri Punga explained the design and use of the heatmap of the Estonian economy produced by the Fiscal Council.

19 September 2018

Chair of the Fiscal Council Raul Eamets and analyst Andres Saarniit attended a meeting of the governing cabinet to present the opinion of the Fiscal Council on the summer forecast 2018 of the Ministry of Finance and the recommendations of the Fiscal Council for the fiscal position for 2019.

25 September 2018

Chair of the Fiscal Council Raul Eamets attended the ninth meeting of the European Union Network of Independent Fiscal Institutions (EUNIFI) organised by the European Commission in Brussels. The meeting discussed challenges of the medium-term budgetary frameworks, policy costings, the appropriate fiscal policy stance for the euro area, and the flexibility contained in the Stability and Growth Pact.

18 October 2018

Chair of the Fiscal Council Raul Eamets and Vice Chair Andrus Alber met the IMF delegation in Eesti Pank. The meeting discussed the opinion of the Fiscal Council on the summer forecast of the Ministry of Finance and the Estonian economy and fiscal policy more broadly.

22 October 2018

Chair of the Fiscal Council Raul Eamets and analyst Andres Saarniit met the Estonian Free Party political party in the Riigikogu and then the Riigikogu Finance Committee to present the opinion of the Fiscal Council on the summer economic forecast of the Ministry of Finance and the recommendations of the Fiscal Council for the fiscal position for 2019.

30 October 2018

Chair of the Fiscal Council Raul Eamets presented the activities in the second half of 2018 to the Supervisory Board of Eesti Pank, which included the opinion of the Fiscal Council on the summer economic forecast of the Ministry of Finance and the recommendations of the Fiscal Council for the fiscal position for 2019.

5 November 2018

Fiscal Council member Ülo Kaasik gave a presentation to a meeting of the State Budget Control Select Committee of the Riigikogu, which was discussing the clarity and accuracy of the information in the explanatory note to the 2019 Draft Budgetary Plan.

23 November 2018

Vice Chair of the Fiscal Council Andrus Alber attended a meeting of the Network of EU Independent Fiscal Institutions in Bratislava. The first half of the meeting heard about the recent activities of the network, the work of the output gap working group, options for future funding for the network, and planned activities. The second half of the meeting was a seminar on macroeconomic nowcasting.

28 November 2018

Member of the Fiscal Council Urmas Varblane gave a presentation on the use of the European Union structural funds in the Baltic states at the Signals conference in Vilnius.

30 November 2018

Vice Chair of the Fiscal Council Andrus Alber gave a presentation on the opportunities and risks of the Estonian state budget to the European Commission representation in Estonia. The meeting heard the opinion of the European Commission on the Estonian Draft Budgetary Plan for 2019 and it also discussed the state finances of Estonia given the general economic background and in comparison to other countries.

4 December 2018

Vice Chair of the Fiscal Council Andrus Alber and analysts Andres Saarniit and Lauri Punga met the IMF's Public Investment Management Assessment (PIMA) delegation at Eesti Pank to discuss Estonia's fiscal rules, the budgeting process, and management of public sector investment.

3. BUDGET

The Fiscal Council of Estonia works with an annual budget approved by the Governor of Eesti Pank. The activities of the Fiscal Council are financed by Eesti Pank from its budget on the principle that the funds allocated must be sufficient for the Fiscal Council to be able to perform its functions independently⁵. An overview of the expenses of the Fiscal Council in 2018 is given in Table 2⁶.

Table 2. Fiscal Council expenditure in 2018 (euros)

Remuneration of members	57,989
Business trips	3,460
Seminars and events	255
IT expenditure	236
Total expenditure	61,940

Actual expenses for 2018 were 88% of the amount budgeted. Remuneration of members accounted for around 94% of the expenses of the Fiscal Council, business travel for 5% and other expenses for 1%.

The budget planned for the Fiscal Council for 2019 is 75,700 euros (see Figure 1). Planning of the budget takes account of the usual number of business trips to participate in the work of the networks of fiscal councils and the changes that came into force in 2018 in the Salaries of Higher State Servants Act, which affects the remuneration of members of the Fiscal Council.

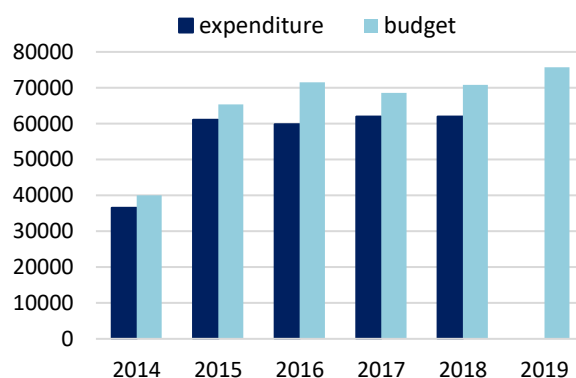


Figure 1. Fiscal Council budget and expenditure (euros)

⁵ The Government of the Republic compensates Eesti Pank for the direct expenses incurred due to the work of the Fiscal Council at the request of Eesti Pank. The central bank has not yet exercised this right.

⁶ Table 2 does not contain the costs of the pay of the Eesti Pank economists working to support the Fiscal Council.

APPENDIX 1. Opinion on the spring forecast 2018 of the Ministry of Finance and on the targets for the structural budget position for 2019-2022

Opinion

Under the State Budget Act, the Fiscal Council must give an assessment of the macroeconomic and fiscal forecasts of the Ministry of Finance, and of the structural budget position of the general government. This year there was a short gap between the releases of the economic forecast of the Ministry of Finance and the state budget strategy, and so the Fiscal Council has put its opinions together in one publication. The Fiscal Council bases its opinion on the targets for the structural budget position on the draft version of the budget strategy that was received on 20 April.

Opinion on the achievement of the general government structural budget position target in 2017

The economy grew notably faster than was forecast in 2017, and so tax revenues could have been expected to be higher than forecast. However, tax receipts were actually similar to the expectations in the state budget. This was mainly because revenues from excises and corporate income tax were lower. The Fiscal Council noted in its opinions published in 2017 that there was a risk of forecast error arising from the large number of tax changes and of tax receipts being lower than forecast.

The Fiscal Council finds that the structural budget position of the general government for 2017, which the Ministry of Finance estimates at -0.3% of GDP and the Fiscal Council at -0.7 of GDP, is in breach of the target that was set when the state budget for 2017 was drawn up. The ability of the government to use the cumulative structural surplus to set budget targets for 2019-2022 is reduced by the amount of the structural deficit in 2017.

Opinion on the economic forecast of the Ministry of Finance for spring 2018

The good state of the economy in the past year and the favourable external environment have raised the estimates of forecasters for the potential growth in the Estonian economy. The Ministry of Finance is forecasting economic growth of 4% for this year, and inflation of almost 3%. It is forecasting that growth will slow to 3.2% in 2019, but that it will remain close to 3% over the longer term.

The expected tax receipts in the fiscal forecast have been corrected for 2018-2019 in line with changes in the economic environment and more accurate assessments of the impact of tax changes. Receipts from consumer taxes, mainly excises, are lower than was forecast last autumn, but higher receipts from labour taxes more than made up for this. The reassessment of the tax forecast overall puts general government income higher by 0.3% of GDP both this year and next year. Despite the improved outlook for tax receipts, the general government budget in the spring economic forecast is in nominal and structural deficit in the years ahead. Both the Ministry of Finance and the Fiscal Council find the structural deficit under these assumptions could reach 0.7% of GDP in 2019-2020, which is more than is permitted by the State Budget Act.

Overall the Fiscal Council finds that the spring forecast 2018 of the Ministry of Finance describes the outlook for economic growth and inflation in Estonia accurately enough and is in line with the forecasts of other institutions. The Fiscal Council finds that the risks of faster or slower economic growth are broadly balanced. As it is not yet entirely clear what impact the tax decisions taken last year will have, the risks to the tax revenue outlook for 2018-2019 lean to the downside.

Opinion on the targets for the structural budget position set in the state budget strategy

The state budget strategy 2019-2022 sets a target for government fiscal policy of being at least in structural balance over the medium term. To achieve this, the government has decided during the discussions over budget strategy to introduce several revenue and spending measures that will improve the nominal budget position over the next four years by more than 500 million euros. As a result, the state budget strategy for 2019-2022 expects the general government budget to have a small nominal surplus and be in structural balance.

Measures to increase government income will be as much as 0.7% of GDP in the years 2019-2020. The Fiscal Council finds there is a danger that some of the planned measures presented in the state budget strategy will not bring in all of the additional revenues expected. Measures to create additional jobs for example, such as the renovation of apartment buildings or changes to the Aliens Act and the Weapons Act, may in the end not create jobs, but lead instead to existing workers and jobs being replaced. In this case there could be a fall in the tax revenues that the Ministry of Finance has already calculated in its recent spring forecast. It is also possible that the profits of state-owned companies will not grow at the expected rate and they will not be able to pay out as much in dividends as is hoped in the coming years.

The Fiscal Council is of the opinion that the targets for the structural budget position set in the state budget strategy 2019-2022 are in line with the State Budget Act, but achieving those targets assumes that the additional revenue and spending measures introduced in the budget strategy will materialise in their expected form. The materials received by the Fiscal Council do not explain these measures well enough, and their impact has been assessed only approximately. For this reason the Fiscal Council does not believe that the revenue and spending measures presented in the state budget strategy are sufficient for the target of structural balance to be achieved.

The spring forecast of the Ministry of Finance expects the general government budget to be in structural deficit in 2017 and 2018 even though the economy has grown rapidly. So that the flexibility built into the budget rules could be used in future should the economy take a turn for the worse, the Fiscal Council believes that a structural surplus should be planned at a time when the output gap is positive. In consequence the Fiscal Council recommends that the government draw up its state budget for 2019 so that the general government budget would be in structural surplus.

Chairman of Fiscal Council
Raul Eamets
Tallinn, 26 April 2018

APPENDIX 2. Opinion on the summer forecast 2018 of the Ministry of Finance

Opinion

The State Budget Act requires the Fiscal Council to give its opinion on the summer macroeconomic and fiscal forecast of the Ministry of Finance, which serves as the basis for planning the state budget for the next year.

Foreign demand grew faster than expected last year, which allowed the growth forecast for the Estonian economy to be raised. Several factors have now appeared though that could slow the growth in foreign demand. The first is the increasing restrictions on foreign trade around the world, and the second is that this year several large developing states have experienced economic difficulties. In consequence the Ministry of Finance is justified in reducing its forecast for real growth in the economy.

The Fiscal Council finds that the summer forecast of the Ministry of Finance describes the outlook for economic growth and inflation in Estonia accurately enough and is in line with the forecasts of several other institutions.

Tax revenues will continue to grow rapidly next year too. Receipts of labour taxes may grow even faster than expected, though the risk is greater on the downside for VAT receipts. Overall, the Fiscal Council finds that the risks of tax receipts being higher or lower than forecast are in balance and the fiscal forecast can be considered an appropriate basis for drafting the state budget for next year.

The Fiscal Council considers the cyclical position of the Estonian economy to be better than that estimated by the Ministry of Finance, and this means there are slightly different opinions on the structural fiscal position. Rapid wage growth, low unemployment, a large number of vacancies, and a rise in the employment rate, which is already high, all indicate peak cyclical conditions. Businesses also indicate that the economic environment is much better than usual.

The summer forecast of the Ministry of Finance puts the fiscal position of the general government in a structural deficit of 0.2% of GDP in 2019. The Fiscal Council recommends that when the state budget for 2019 is drafted, the structural fiscal position of the general government should be at least 0.4 percentage point of GDP, or some 100 million euros, better than in the summer forecast.

There are two reasons for the recommendation of the Fiscal Council. The first is that the fiscal position should be improved by 0.2 percentage point to ensure that the target of structural balance set in the state budget strategy is met. We recommend that the fiscal position should then be improved by at least 0.2 percentage point as the current state of the economy means it is not wise to loosen the fiscal policy stance. The Ministry of Finance expects a structural surplus of 0.2% of GDP for 2018.

For this reason the Fiscal Council recommends that a state budget be passed for 2019 that sets the target for the general government of a small surplus in the structural fiscal position.

Chairman of Fiscal Council
Raul Eamets
Tallinn, 24 September 2018

The full report can be found at: <https://eelarvenoukogu.ee/news/the-government-should-set-the-target-of-a-small-structural-surplus>