EELARVENÕUKOGU
FISCAL COUNCIL

OPINION OF THE FISCAL COUNCIL ON THE ACHIEVEMENT OF THE GENERAL GOVERNMENT STRUCTURAL BUDGET POSITION TARGET IN 2019

April 2020

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Opinion

It became clear in spring 2019 that the general government structural deficit in 2018 was larger than permitted by the fiscal rules. This engaged the correction mechanism in the State Budget Act that requires the structural fiscal deficit to be reduced each year by at least 0.5 percentage point until structural balance has again been achieved.

The summer 2019 economic forecast of the Ministry of Finance put the structural budget deficit at 1.7% of GDP in 2018. For the fiscal deficit to be reduced by 0.5 percentage point, the government should have planned in autumn 2019 to improve its fiscal position for the current year by 50 million euros. The government set a target for the structural fiscal position of a deficit of 1.2% of GDP for 2019.

The spring 2020 assessment put the structural budget deficit for the general government at 1.9% of GDP for 2019. This deficit is 0.7 percentage point larger than the target set by the government, with 0.4 percentage point coming from the changed assessment of the economic cycle, and 0.3 percentage point coming because the nominal budget deficit was larger than expected.

This means the structural fiscal position has not improved from 2018. The Fiscal Council finds that the government did not meet its budget targets for 2019 or the requirements of the correction mechanism that are necessary if structural balance is to be regained.

There has been a structural deficit in the past three years and the fiscal rules have been broken for two years in a row. The emergency situation caused by the outbreak of the coronavirus activated the escape clauses in the European Union and Estonian fiscal rules in spring 2020. The escape clause allows the government to overlook the correction mechanism for this year.

Abiding by the fiscal rules and building up reserves when the economy is doing well is important if the economy is to be supported during difficult times. The Fiscal Council finds it important that by autumn 2020 at the latest the government submit a long-term outlook for the state finances together with the steps to be taken to return the budget to balance.

Chairman of the Fiscal Council
Raul Eamets
Tartu, 30 April 2020

Explanatory Report

Besides assessing the economic forecasts produced by the Ministry of Finance, it is also the task of the Fiscal Council to monitor compliance with the fiscal rules. It does this by assessing in the spring how the targets of the structural fiscal position in the previous year were achieved and giving its opinion on the budget targets set in the state budget strategy for the next four years. Although the government announced in spring that it would delay producing the state budget strategy for 2021-2024 until the autumn, the Fiscal Council is still able to assess the achievement of the structural fiscal position targets in 2019.

The recession caused by the restrictions introduced to stop the spread of the coronavirus did not affect the state finances in 2019. However, the emergency situation declared in spring 2020 and the application of the escape clause to the fiscal rules will affect the assessments and recommendations that the Fiscal Council can give about the results of last year.

The general government budget position target for 2019

The government normally sets its budget targets for four years in the state budget strategy and fine tunes them in the state budget for the year immediately ahead, but the numerical target for the structural fiscal position in 2019 changed repeatedly during the year. This was because the budget deficit in 2018 was larger than permitted.

The state budget strategy for 2019-2022 set a target for the general government structural fiscal position for 2019 of structural balance, or a deficit of 0% of GDP. This target was used when the state budget for 2019 was written. The assessments of the time assumed that achieving structural balance needed a nominal budget surplus of 0.5% of GDP. The Ministry of Finance forecast at the time the 2019 state budget was written in autumn 2018 that the fiscal position for 2018 would achieve structural balance.

It later became clear in spring 2019 that the general government fiscal position for 2018 was weaker than had been planned and the structural deficit would exceed the deficit permitted in the fiscal rules, so the correction mechanism in the State Budget Act was engaged, and its requirements applied immediately to setting the fiscal position for 2019. The government target was to make sure that the structural fiscal deficit in 2019 was at least 0.5 percentage point smaller than that in 2018.

The spring 2019 assessment put the structural budget deficit for 2018 at 1.4% of GDP (see Table 1). Although the state budget for 2019 was planned to be in structural balance, the expected fiscal position for 2019 had by this time deteriorated substantially. For the fiscal deficit to be reduced by 0.5 percentage point of GDP, the spring economic forecast found the fiscal position for 2019 would have to be strengthened by around 50 million euros. The government decided not to correct the fiscal position immediately and to consider the need for the correction again in the autumn after the summer forecast of the Ministry of Finance had appeared.

By autumn 2019, the assessments of the structural fiscal position had changed for 2018 and for 2019. The size of the nominal deficit in 2018 had become clearer and the Ministry of Finance had reassessed the position of the economic cycle, which was also affected by the revision of GDP data. As the fiscal positions for both years changed by a similar amount in consequence, the need to improve the fiscal position was no different from what it was in the spring assessment. The assessment produced in the autumn put the 2018 structural deficit even larger at 1.7% of GDP. This meant the government had to make sure that the structural deficit for 2019 did not exceed 1.2% of GDP.

Table 1. The need to improve the structural fiscal position in 2019 (% of GDP)

	Estimate of the structural position in 2018	Forecast for the structural position in 2019	Achieved improvement	Further improvement needed[1]
Spring forecast 2019	−1.4%	−1.0%	0.4 pp	0.1 pp
Summer forecast 2019	−1.7%	−1.4%	0.3 pp	0.2 pp
State Budget 2020	−1.7%	−1.2%	0.5 pp	0.0 pp

Source: Ministry of Finance

The summer economic forecast 2019 put the structural deficit for 2019 at 1.4% of GDP, meaning the fiscal position for the current year had to be improved by around 0.2% of GDP or 50 million euros to meet the requirements of the correction mechanism. When the government started to discuss the 2020 state budget in autumn 2019, necessary improvements were made in the fiscal position of the ongoing year. They found 15 million euros of additional revenues and spending cuts of 35 million euros in order to achieve that[2]. The updated forecast found the general government should be in structural deficit in 2019 of 1.2% of GDP.

Although the correction mechanism requires the fiscal position to be improved every year by a minimum of 0.5 percentage point, the government set a target of improving the fiscal position by exactly 0.5 percentage point in 2019 and in 2020 and 2021. The Fiscal Council recommended in autumn 2019 that the planned annual fiscal adjustment should be larger, as it was not justified to run such a large structural deficit given the state of the economy at that time. The fiscal framework of the European Union also has the principle that the fiscal position must be improved by larger amounts than usual at times when the economy is doing well.

Achieving the general government budget position target

Nominal position

So that the structural deficit in 2019 would not exceed 1.2% of GDP, the forecast nominal budget deficit was reduced in autumn 2019 to 18 million euros. This used the assumption that real growth in the economy would be 3.3% in 2019 and the output gap would be 2.6% of GDP (see Table 2). It became clear in spring 2020 though that the deficit was larger than expected, and the estimate by Statistics Estonia put the nominal deficit in 2019 at 90 million euros, or 0.3% of GDP.

Tax revenues continued to grow rapidly in 2019 because of the good position of the economic cycle (see the heatmap of the Estonian economy on page 11). The tax revenues in the state budget have been better (see Figure 1) than was assumed when the 2019 state budget was written or in autumn 2019 when the most recent measures to improve the fiscal position were planned. Taxes received by the state in 2019 were 101.3% of what was planned in the state budget. The methodology used in accounting for the national system of accounts put the yearly growth in tax revenues at almost 9%. European Union funds, which should have been at a peak level in 2019, were notably below expectations and not even at the level of 2018. General government revenues increased in total over the year by 8.1%.

[1] Rounding means that the need to improve the fiscal position further in the spring and summer economic forecasts is different at 0.1 and 0.2 percentage point, but in monetary terms that meant around 50 million euros in both cases.

[2] Additional revenues of 5 million euros were planned in dividends from state companies, and of 10 million euros from moving TS Laevad to the general government. Savings on expenditures were expected of 16 million euros from operating costs and 19 million euros from other smaller expenditure measures.

Table 2. The general government fiscal position for 2019 (% of GDP)

	spring 2018	*autumn 2018*	*spring 2019*	*autumn 2019*	*autumn 2019*	*spring 2020*
	SBS 2019-2022	State Budget 2019	spring forecast 2019	summer forecast 2019	State Budget 2020	actual
Nominal position (million)	133	130	−67	−68	−18	−90
Nominal position	0.5	0.5	−0.2	−0.2	−0.1	−0.3
Real GDP growth (%)	3.2	3.0	3.1	3.3	3.3	4.3
Output gap	1.3	1.3	1.6	2.6	2.6	3.4
Cyclical component	0.6	0.6	0.8	1.3	1.3	1.7
One-off measures	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1
Structural position	0.0	0.0	−1.0	−1.4	−1.2	−1.9

Source: Ministry of Finance

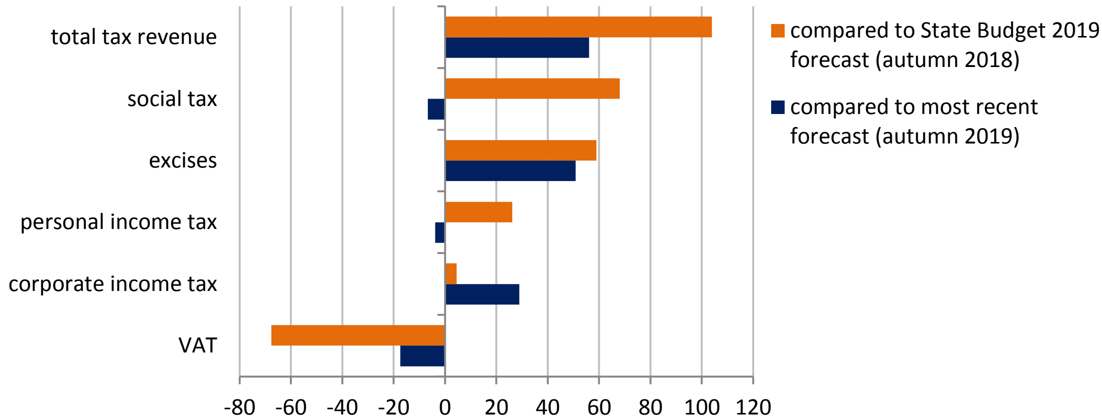

Figure 1. Tax revenues received in 2019 compared to the forecasts in autumn 2018 and 2019 (million euros)

Source: Ministry of Finance

General government spending increased by 7.5% in 2019. Overall this was not significantly different from the forecast, but neither the expenditures nor the funding structure of them was exactly what had been assumed in the state budget 2019. Unlike in previous years, local government investment grew notably faster than forecast. At the same time the central government did not execute several projects funded from the European Union budget, and investment in fixed assets was in fact less than in 2018. In consequence the funding structure of general government expenditures in the actual fiscal position was notably less favourable than was assumed when the state budget was written and the expenditures of both central government and local governments exceeded revenues.

In total the general government budget has been in nominal deficit since 2016 (see Figure 4 on page 8). The budget deficits have mainly been funded from reserves. The summer 2019 economic forecast of the Ministry of Finance put the total liquid financial assets of the general government at 8.5% of GDP in 2016, 7.8% of GDP in 2017, and 7.1% of GDP in 2018. In summer 2019 it became necessary to issue 200 million euros of short-term bonds to improve the liquidity of the state treasury. The state reserves cannot be topped up without a budget surplus. It is necessary to build up the reserves when the economy is performing well to give the government more options and flexibility for supporting the economy during difficult times. In other words, if a countercyclical fiscal policy is going to be run during a downturn without harming the sustainability of state finances, it must also be done during the upswing of the economy.

Structural position

To calculate the structural fiscal position of the general government, the budget is corrected for the economic cycle and the effect of one-off and temporary fiscal measures. The only one-off expense that affected the 2019 fiscal position was the support for merging local governments of 21 million euros or 0.1% of GDP. The government moved to improve the fiscal position in autumn 2019 following the assessment of the Ministry of Finance that the output gap in 2019 would be 2.6% of GDP. The estimate by the ministry of the position of the Estonian economic cycle was in the middle of the autumn and winter estimates from other institutions (see Figure 2).

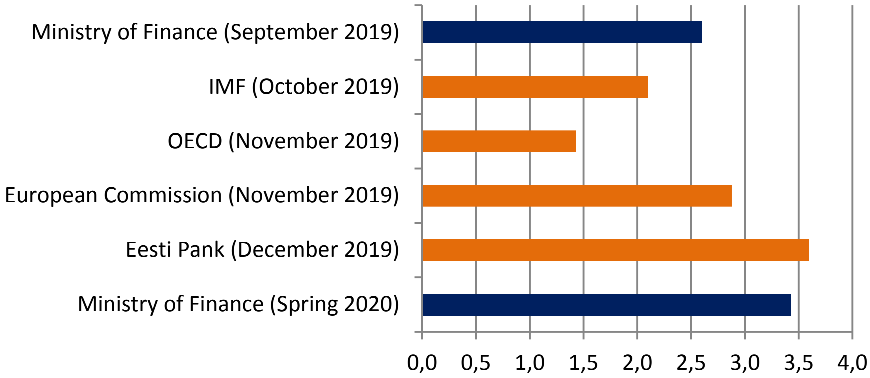

Figure 2. Estimates of the output gap in Estonia in 2019 (% of GDP)

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

As the actual growth in the Estonian economy in 2019 was faster than expected at 4.3% rather than 3.3%, the estimate of the Ministry of Finance in spring 2020 found a larger positive output gap as well. It should be noted though that the estimate by the Ministry of Finance of the output gap was made under more difficult circumstances this spring than usually. A better position of the economic cycle than forecast has an adverse impact on the structural fiscal position.

Taking the estimate that the Estonian output gap in 2019 was 3.4% of GDP, the structural fiscal deficit of the general government was 1.9% of GDP last year. This makes the structural fiscal position worse by 0.7 percentage point than the 1.2% of GDP that was the target for the structural deficit when the forecast was made last autumn, with 0.4 percentage point coming from changes to the estimate of the economic cycle, and around 0.3 percentage point coming because the nominal fiscal deficit was larger than expected (see Figure 3). In consequence the Fiscal Council finds that the targets set for the structural fiscal position in 2019 went unmet.

The structural position has proved notably weaker than was forecast in the autumn in the past two springs. The initial estimate of the structural fiscal deficit in 2018 was 1.4 percentage points larger than expected[3]. The nominal fiscal position contributed 1.1 percentage points to the deterioration of the structural position, and the economic cycle impacted it by 0.3 percentage point. This means the structural deficit has been larger than forecast over two years by a total of 2% of GDP. While it is understandably difficult to measure and forecast the position of the economic cycle, the gap between the revenues and expenses in the state budget is decided directly by the government. A larger part of the forecast errors in previous years have been caused precisely by the nominal deficit being larger than expected.

[3] The size of the structural deficit in 2018 was later clarified. This was affected by clarification of the nominal fiscal deficit, revision of GDP data, and a consequent re-estimate of the position of the economic cycle, and also a reassessment of the cyclical sensitivity of the Estonian fiscal position.

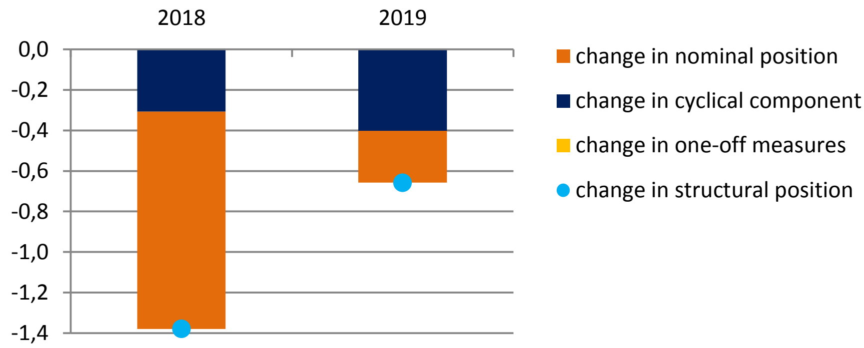

Figure 3. Change to estimates of the structural fiscal position in 2018 and 2019 (percentage points)[4]

Sources: Ministry of Finance, calculations of the Fiscal Council

The correction mechanism requires that the structural fiscal position be repaired by at least 0.5 percentage point a year until structural balance has again been achieved. The general government structural fiscal position in 2019 was not an improvement of the structural fiscal position of -1.7% of GDP in 2018, but was actually worse than it by 0.2 percentage point (see Figure 4). This means that the government did not make sure when setting the fiscal position for 2019 that the requirements of the correction mechanism were complied with and that the structural deficit was reduced by at least 0.5% of GDP. The spring forecast of the Ministry of Finance put the deviation from the target set in the fiscal position, which would have ensured that the correction mechanism requirements were met in 2019, at 0.7 percentage point[5].

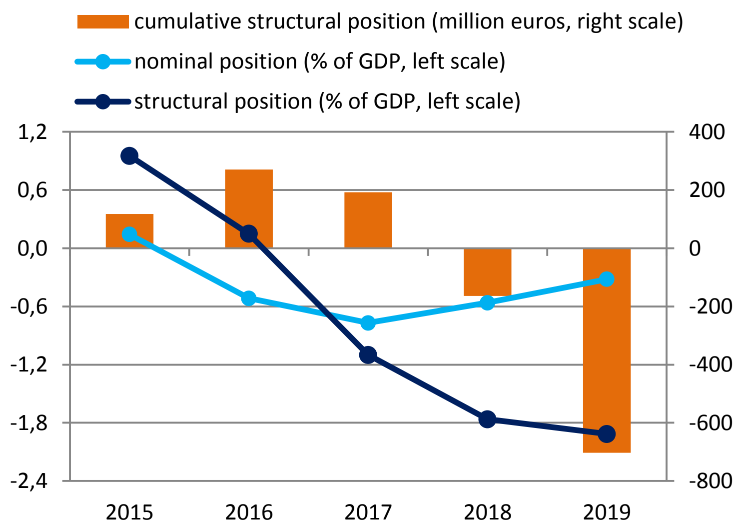

Figure 4. The nominal, structural and cumulative structural fiscal position of the general government

Sources: Ministry of Finance, calculations of the Fiscal Council

[4] The figure compares the latest forecast of the Ministry of Finance from the autumn and the first estimate from the next spring, when the Fiscal Council produces its opinion on the achievement of the budget targets for the previous year.

[5] The Estonian State Budget Act does not describe directly what happens if the steps taken to improve the deficit are not sufficient. If the European Commission were to identify such a deviation in its assessment though, it could spark a Significant Deviation Procedure. In this case the European Commission defines the need to improve the fiscal position each year, and monitors compliance with this closely. If the country concerned does not meet the requirements, the procedure may result in monetary sanctions.

The emergency situation caused by the outbreak of the coronavirus activated the escape clauses in the European Union and Estonian fiscal rules from spring 2020. Under normal circumstances the fiscal position would have needed to be improved in 2020, but the escape clause allows the Estonian government to overlook the correction mechanism when setting the fiscal position for 2020. The spring forecast of the Ministry of Finance finds that the structural fiscal deficit of the general government, including the economic assistance measures announced in the supplementary budget, will exceed 5% of GDP this year. This means that the structural fiscal deficit will continue to deepen further in 2020. The Fiscal Council finds it important that by autumn 2020 at the latest the government submit a long-term outlook for the state finances together with the steps to be taken to return the budget to balance.

Cumulative structural position

Alongside the correction mechanism, the Estonian fiscal rules have a compensation mechanism that is engaged once structural balance has been achieved again after the fiscal rules were broken. The compensation mechanism requires the structural deficit that was larger than permitted to be compensated for in subsequent years by a structural surplus of the same size. The larger deficit than permitted is calculated from a measure of the cumulative structural position that adds together the results for the surpluses and deficits over the years (see Table 3). The State Budget Act does not permit a deficit in the cumulative position, and so once the general government has returned to structural balance, the cumulative structural position will also have to be returned to balance[6].

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

	2014	*2015*	*2016*	*2017*	*2018*	*2019*
Fixed estimate from the spring	32	118	270	192	−164	−703

Sources: Ministry of Finance, calculations of the Fiscal Council

The cumulative structural position of the general government moved into deficit at the end of 2018 and the deficit has since deepened by the amount of the structural deficit of 2019. Working from the estimate that the structural deficit was 1.9% of GDP in 2019, the cumulative structural deficit was around 700 million euros by the end of 2019. The current fiscal rules require this deficit to be compensated for later by a structural surplus of at least 0.5% of GDP a year. The cumulative deficit will deepen and the need to compensate for it will increase with every subsequent year for as long as the structural fiscal position remains in structural deficit, except presumably while the escape clause applies.

Summary

In summary, both the nominal and structural fiscal positions of the general government were in deficit in 2019. The spring 2020 assessment put the structural deficit for the general government at 1.9% of GDP for 2019. The structural fiscal position was not an improvement on 2018. The cumulative structural deficit also increased by the amount of the 2019 structural deficit, and was 700 million euros at the end of 2019. The Fiscal Council finds that the government did not meet its budget targets for 2019 or the requirements of the correction mechanism that are necessary if structural balance is to be regained.

[6] After a larger deficit than planned had appeared in 2018 and the correction mechanism had been launched, the government announced in spring 2019 that it planned to change the domestic budget balance rules. The aim of the changes was to abandon the calculation of the cumulative structural fiscal position contained in the fiscal rules and the compensation mechanism that requires the government to plan a fiscal surplus once structural balance has been achieved. As of spring 2020 the fiscal rules contained in the State Budget Act have not yet been changed.

The larger deficit than permitted in 2018 allowed the government to plan a structural deficit for 2019 as well without breaking the fiscal rules, as the rules allow the deficit to be reduced gradually. It was still thought in autumn 2018 that the general government would be in structural balance in 2019. Although the government set a new target of improving the structural fiscal position in 2019 by 0.5 percentage point from the previous year and the forecast of the Ministry of Finance in autumn 2019 found this requirement to have been minimally met, the nominal fiscal position was weaker than expected and the changed assessment of the economic cycle meant the structural deficit was larger than planned at 1.9% of GDP instead of 1.2%. The structural fiscal position has now been weaker than planned in the past two years and to that extent it has caused the fiscal rules to be broken.

The Fiscal Council finds that the risk of the rules being broken is larger if the numerical budget targets are set at the limit of what is permitted by the rules. Although the Fiscal Council recommended that the improvement of the fiscal position should be planned in steps larger than 0.5 percentage point a year, the government target was to meet the minimum requirement of improving the fiscal position by exactly 0.5% of GDP, leaving no margin for forecast or measurement error. The changes to achieve even this improvement were only made towards the end of the year. The Fiscal Council has repeatedly recommended that the fiscal targets be set with a small margin to allow for uncertainty in the assessment of the position of the economic cycle and the structural fiscal position. The Fiscal Council does not consider the size of the final target for the structural deficit in 2019 of 1.2% of GDP was reasonable given the position of the economic cycle.

The Fiscal Council is concerned that there has been a large structural deficit in the Estonian general government fiscal position in the past three years and the fiscal rules have been broken for two years in a row. There is also continuing uncertainty about which domestic fiscal rules the government plans to uphold in the longer term. The government has already announced its intention not to comply in part with the current fiscal rules and its plans to change the State Budget Act.

As countries make efforts to ease the economic impact of the coronavirus crisis in spring 2020 and the fiscal rules are temporarily suspended, the non-compliance of the Estonian government with the requirements of the correction mechanism in 2019 will not have direct consequences this year. The escape clause allows the government to overlook the correction mechanism for this year. The Fiscal Council considers that the position of the state finances and the fiscal targets for the coming years should be analysed thoroughly immediately after the crisis is over, while also taking into account the application of the escape clause.

Backround. *A macroeconomic heatmap for Estonia*

To assess the compliance with the rules on structural balance and the output gap in the macroeconomic 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 5), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating[7].

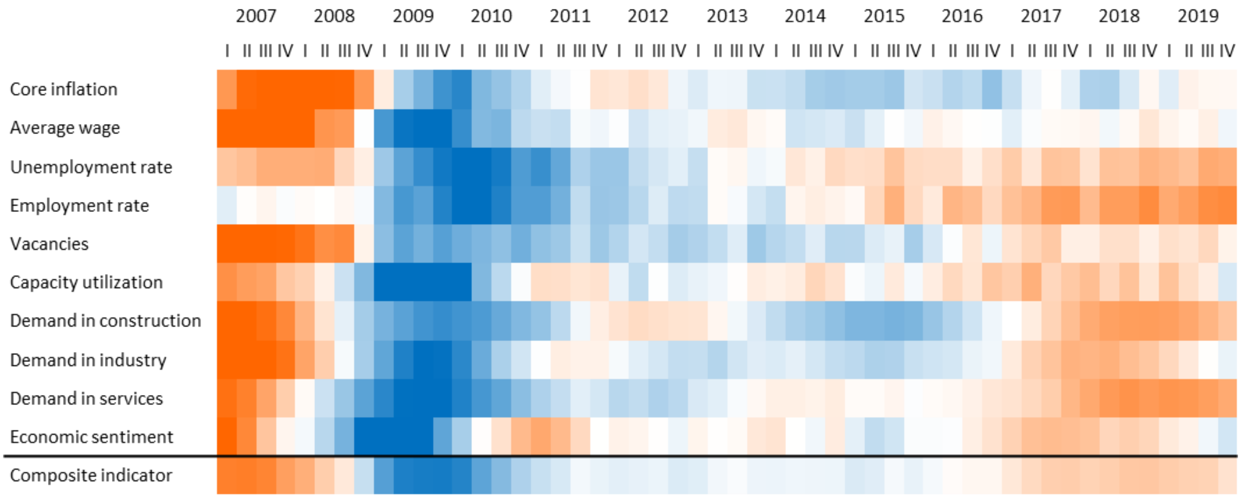

Figure 5. Macroeconomic heatmap for Estonia (Q1 2007 – Q4 2019)

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

Growth in the Estonian economy in 2019 was positively surprising and the initial data indicate that growth was a full percentage point faster than was forecast by the Ministry of Finance in autumn 2019, at 4.3% rather than 3.3%. The heatmap of the Estonian economy produced by the Fiscal Council shows some signs of cooling at the end of the year though. Estimates of demand and capacity utilisation in manufacturing industry fell clearly in the fourth quarter of 2019 as did the overall economic sentiment. These are more forward-looking economic indicators, and they generally affect the real economy with a lag. Although wages grew more slowly in the fourth quarter, labour market indicators for 2019 as a whole still indicated the economic cycle was in a strong position.

The composite indicator of the heatmap shows the Estonian economic cycle peaked in the second half of 2018 and there was a gradual descent from that peak in 2019. In spring this year the Ministry of Finance was forecasting that the economy would contract by 8% in 2020.

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