EELARVENÕUKOGU
FISCAL COUNCIL

OPINION OF THE FISCAL COUNCIL ON THE ACHIEVEMENT OF THE GENERAL GOVERNMENT STRUCTURAL BUDGET POSITION TARGET IN 2018

April 2019

Contents

Fiscal Council
Estonia pst 13, 15095 Tallinn
+372 668 0661
info@eelarvenoukogu.ee
www.eelarvenoukogu.ee

Opinion

The state budget strategy for 2018-2021 set a target for the general government structural fiscal position for 2018 of a structural deficit of 0.5% of GDP. A structural deficit was planned for the whole of the next three years in order to stimulate growth in the economy. Expectations for the economic climate in the year ahead had improved when the 2018 state budget was drafted, and so the expected deficit was reduced by half, giving a target of a structural deficit of 0.25% of GDP. The Fiscal Council recommended that the 2018 budget should target a small surplus.

Rapid growth had already returned to the economy in 2017 with the support of foreign demand, and the economy continued to perform well in 2018 as nominal growth in it and growth in tax revenues in the state budget reached around 9%. The most recent expert opinions of the position of the economic cycle in Estonia indicate clearly that the economy is still experiencing good times. Even so the fiscal position of the general government was weaker than expected, and it was in nominal and structural deficit in 2018.

The Ministry of Finance finds that the Estonian general government had a structural deficit of 1.4% of GDP in 2018. The calculations of the Fiscal Council also find a structural deficit. Calculated from the spring economic forecast 2019 of the Ministry of Finance, the general government budget was in structural deficit in 2016 and 2017 as well. The Fiscal Council finds that the target set for the structural fiscal position in 2018 went unmet.

The State Budget Act allows a structural deficit to be planned of up to 0.5% of GDP a year. The actual structural deficit for 2018 was larger than this by more than 0.5 percentage point. The deficit in 2018 meant that the cumulative structural position, which accounts for the total results for 2014-2018, also fell into deficit. The State Budget Act requires that the structural fiscal position be improved immediately in 2019 by at least 0.5 percentage point from 2018. The structural fiscal position must be improved by at least 0.5 percentage point a year until structural balance has again been achieved.

The Fiscal Council finds that the improvement to the fiscal position in 2019 should not aim to be only the minimum required correction, achieving which would leave the fiscal position of the general government in structural deficit of 0.9% of GDP. Given the current state of the economy, it is not justified to have a structural deficit of around 1% that will have to be compensated for later regardless of the cyclical state of the economy. The fiscal framework of the European Union also has the principle that the fiscal position must be improved by larger amounts at times when the economy is doing well.

The Fiscal Council recommends that the target of structural balance set in the state budget for 2019 should still be met, if necessary by restricting the growth in spending. Given the good state of the economy, it would even be appropriate to set a target of a structural surplus for the fiscal position for 2019, so that the cumulative surplus can start to recover more quickly. This is necessary, so that fiscal policy can be used to boost the economy should the economic climate deteriorate. This buffer has now been used up even though the economic situation has been good.

In setting the budget targets in the state budget strategy for 2020-2023, it should be remembered that once structural balance has been achieved, the State Budget Act requires a structural surplus to be planned. The surplus should be of at least 0.5% of GDP a year, until balance has also been achieved in the cumulative structural position.

Chairman of Fiscal Council
Raul Eamets — Tallinn, 11 April 2019

Explanatory Report

Under the State Budget Act, the Fiscal Council must give its opinion in spring on the achievement of the target for the structural budget position in the previous year and on the targets set in the state budget strategy for the next four years, looking at the fiscal rules and the need to adjust the structural budget position. The state budget for 2018 was the first that was planned following the changes made to the State Budget Act in summer 2017. The main change was that the state budget could be planned in such a way that the general government structural position was in deficit. As the structural deficit was larger than planned in 2018 and the fiscal position needs to be improved this year, the Fiscal Council is extraordinarily publishing its opinion on the results of last year before the state budget strategy is compiled.

The general government budget position target for 2018

The new government coalition started to draft its first four-year fiscal documents in spring 2017. The state budget strategy 2018-2021 was drafted at a time when growth in the economy had been below the expectations of forecasters for several years, growth in investment had stopped, and the Ministry of Finance estimated the output gap to be negative. A programme of strategic investments was introduced by the government to revive growth in the economy, which was supposed to add 115 million euros in investment to the economy in 2018 and again in 2019.

Changes were proposed to the State Budget Act that would allow a budget to be passed with a structural deficit, so that the plans of the new governing coalition could be enacted. The changes that came into force in summer 2017 allow the state budget to be written so that the structural position of the general government is in deficit by up to 0.5% of GDP if a surplus of at least the same amount has previously been built up. The estimates at the time put the general government fiscal position for 2014-2016 in structural surplus. The state budget strategy 2018-2021 set targets for the fiscal position for the years ahead that would make full and immediate use of the flexibility that was introduced to the fiscal rules. Structural deficits were planned for 2018 and for 2019-2020. The target for the general government structural fiscal position for 2018 was a structural deficit of 0.5% of GDP.

Table 1. Key macroeconomic indicators for 2018

	Spring forecast 2017	Summer forecast 2017	Actual (spring 2019)
Nominal GDP growth (%)	6.3	6.9	8.6
Real GDP growth (%)	3.1	3.3	3.9
Output gap (% of GDP)	–0.4	0.5	2.1
Real private consumption growth (%)	4.0	4.4	4.6
Real investment growth (%)	0.0	4.1	3.3
Real export growth (%)	3.9	4.0	4.3
Growth in employment (%)	0.2	0.4	0.9
Nominal wage growth (%)	5.0	5.2	7.6

Sources: Ministry of Finance, Statistics Estonia

When drafting of the 2018 state budget started in autumn 2017, the estimate of the Ministry of Finance for the position of the economic cycle had changed, and a positive output gap was expected for 2018 (see Table 1). Forecasts for all the main economic indicators for 2018 had improved since the spring, and the actual position of the economy turned out to be even better still. This allowed the 2018 state budget to be passed with a nominal deficit of 0.1% of GDP and a structural deficit of 0.25% of GDP. The Fiscal Council recommended that the 2018 budget should be written with a small surplus.

Achieving the general government budget position target

Nominal balance

Statistics Estonia estimated that general government spending exceeded revenues in 2018 by some 120 million euros, and the nominal budget deficit of the general government was 0.5% of GDP (see Table 2). This is weaker than was expected when the state budget 2018 was written, and weaker than the latest forecast of the Ministry of Finance before the actual results became clear. The fiscal positions of local governments and social security funds had improved from what was planned in the state budget, but the fiscal position of the central government was weaker than expected by more than 200 million euros.

Table 2. The general government fiscal position 2018 by government sector (million euros)

	State budget 2018	Actual	*% of GDP*
Central government	−29	−237	*−0.9*
Local government	−14	44	*0.2*
Social security funds	8	73	*0.3*
General government total	−36	−120	*−0.5*

Sources: Ministry of Finance, Statistics Estonia

The deficit of the central government was not larger than planned because of tax revenues, which continued to grow fast. The Ministry of Finance estimated that 100.4% of the central government tax budget was met and that tax revenues were 8.7% larger than in 2017. Faster growth than forecast in employment and the average wage contributed to the excess revenues in social tax and personal income tax, while less was received than forecast in corporate income tax and excise (see Figure 1). Excise receipts were lower than forecast in the state budget partly because the planned rise in excise for 2019, which would have raised tax receipts at the end of 2018, was cancelled. The weaker receipts of corporate income tax were affected by the large changes in the income tax system in 2018, and the Fiscal Council had already drawn attention to the excess optimism in the forecast in autumn 2017[1].

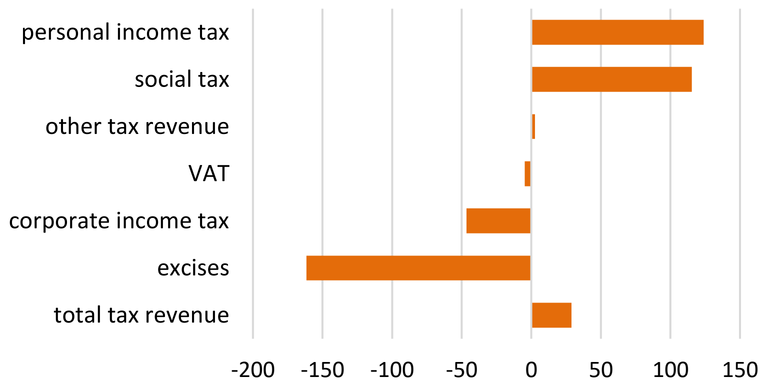

Figure 1. Tax revenues for 2018 compared to the state budget forecast (million euros)

Source: Ministry of Finance

The unexpected general government deficit arose because investment, social transfers and labour costs were larger than planned. At the same time the transfers from the European Union budget were smaller than forecast.

[1] For more see: https://eelarvenoukogu.ee/news/rapid-economic-growth-demands-a-budget-surplus

Structural balance

To calculate the structural fiscal position of the general government, the nominal balance is corrected for the position of the economic cycle and the effect of one-off and temporary budgetary measures. The only one-off measure that affected the 2018 fiscal position was the support for merging local governments of 0.1% of GDP (see Table 3). The effect of the economic cycle on the fiscal position was much more notable however, and was estimated by the Ministry of Finance at 1% of GDP.

Table 3. The general government structural fiscal position for 2018 (% of GDP)

	State budget strategy 2018–2021	State budget 2018	Summer forecast 2018 / State budget 2019	Actual (spring 2019)
Nominal balance (million euros)	−196	−36	154	−120
Nominal balance	−0.8	−0.1	0.6	−0.5
Output gap	−0.4	0.5	1.7	2.1
Cyclical component	−0.2	0.2	0.7	1.0
One-off measures	−0.1	−0.1	−0.1	−0.1
Structural balance	−0.5	−0.25	0.0	−1.4

Source: Ministry of Finance

The impact of the economic cycle is shown by the size of the output gap, which is the difference between the actual total output of the economy and its long-term sustainable capacity. The spring forecast 2019 of the Ministry of Finance found that the output gap in Estonia in 2018 was positive by 2.1% of GDP. This was the largest positive output gap of the past decade. This indicates a much better cyclical position than the state budget strategy or the estimates used for drafting the state budget do. This means that a larger part of the excess receipts of taxes in 2018 than was earlier calculated came from the good position of the economic cycle.

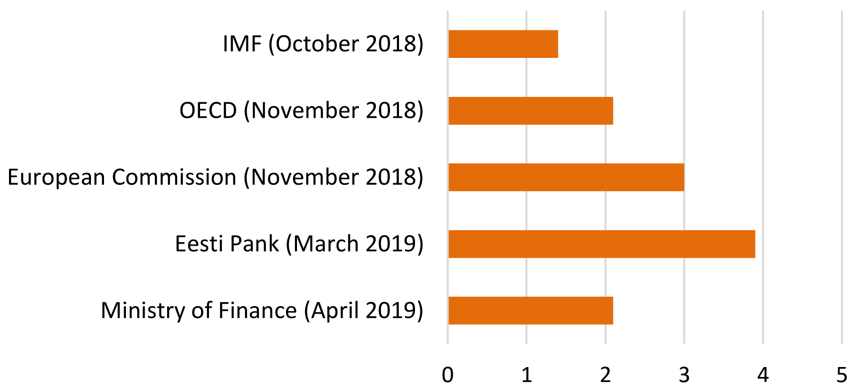

Figure 2. Estimates of the output gap in Estonia in 2018 (% of GDP)

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

The main analysis institutions all agree that the Estonian economy was running at above its long-term sustainable level in 2018 (see Figure 2). The opinions published this year (publication date shown in brackets in the figure) found the Estonian output gap in 2018 to have been between 2% and 4% of GDP. Analysis by the Fiscal Council, which looks at a broader set of economic indicators, supports this opinion (see Background 1). This shows that the good conditions achieved in the economy in 2017 were maintained in 2018 because of the strength of the labour market and demand.

A nominal fiscal deficit when the economy is performing well means that the structural position of the budget was in deficit (see Figure 3). The Ministry of Finance finds that the Estonian general government had a structural deficit of 1.4% of GDP in 2018, which is much more than the budget target set for 2018. Calculations by the Fiscal Council that draw on an estimate of the cyclical component of the budget from the development of the tax bases found a structural deficit of 0.9% of GDP. If the position of the economic cycle is estimated from a broader set of economic indicators though (see Background 1), the Fiscal Council finds the structural deficit to have been even bigger. The most recent estimate by the European Commission, which was published in November 2018 and so still expected the general government to be in nominal surplus, found a structural deficit of 0.8% of GDP.

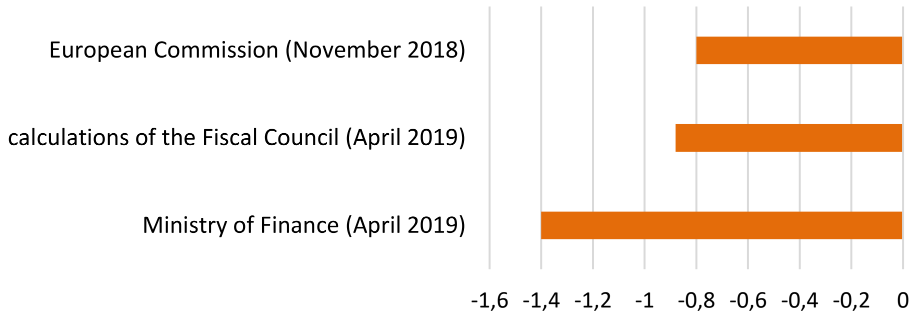

Figure 3. Estimates of the structural fiscal position of the Estonian general government in 2018 (% of GDP)
Sources: European Commission, Ministry of Finance, calculations of the Fiscal Council

Starting from the estimate for the development of the Estonian economic cycle in the spring 2019 forecast by the Ministry of Finance, the Fiscal Council calculates that the general government was in structural deficit in 2016 by 0.3% of GDP, and in 2017 by 0.9% of GDP. This means the general government fiscal position was in structural deficit for the third year, and structural balance has not been achieved even on average over a longer period. The average structural position for 2014-2018 was a deficit of 0.3% of GDP.

Cumulative structural balance

A structural deficit is allowed in Estonia under the State Budget Act if a structural surplus of at least the same amount has previously been built up. This is measured with the cumulative structural position, which is arrived at by adding up the results for the structural fiscal position from 2014 (see Table 4). The structural position for each year is fixed in the next spring and is not then changed.

Table 4. The cumulative structural position as at the end of the year (million euros)

	2014	*2015*	*2016*	*2017*	*2018*
Based on the fixed estimate	32	118	270	192	−164
Based on the latest estimate	*87*	*231*	*172*	*−41*	*−398*

Sources: Ministry of Finance, calculations of the Fiscal Council

The Fiscal Council estimate based on the data from the Ministry of Finance puts the general government cumulative structural surplus at around 200 million euros at the end of 2017, which would have allowed the government to plan a structural deficit for 2018. The structural deficit in 2018 was larger than expected though, and it also exceeded the surplus that had previously been built up, meaning that the cumulative structural position fell into deficit. Fiscal Council calculations put the cumulative structural deficit at around 160 million euros by the end of 2018.

If the cumulative structural position is calculated not with the estimates of the fiscal position fixed in the spring as required by the State Budget Act, but with the latest economic forecast of the Ministry of Finance, the cumulative structural deficit for 2018 comes in at around 400 million euros. In other words, the most recent information on the economic conditions of the past five years show the structural deficit built up by the general government over the years to be even bigger.

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 (for more see Background 2).

In summary, both the nominal and structural fiscal positions of the general government were in deficit in 2018. The Ministry of Finance finds that the Estonian general government had a structural deficit of 1.4% of GDP in 2018. The calculations of the Fiscal Council also find a structural deficit. The state budget strategy for 2018-2021 set a target for the general government structural fiscal position for 2018 of a structural deficit of 0.5% of GDP. Later, when the 2018 state budget was being passed, the deficit was reduced by half, giving a target of a structural deficit of 0.25% of GDP. The Fiscal Council finds that the target set for the structural fiscal position in 2018 went unmet.

The State Budget Act allows a structural deficit to be planned of up to 0.5% of GDP a year. The actual structural deficit for 2018 was larger than this by more than 0.5 percentage point. The State Budget Act requires in consequence that the structural fiscal position be improved immediately in 2019 by at least 0.5 percentage point from 2018. The structural fiscal position must be improved by at least 0.5 percentage point a year until structural balance has again been achieved. The structural deficit in 2018 meant that the cumulative structural position also fell into deficit. Once the general government has returned to structural balance, the State Budget Act requires that a structural surplus be planned so that balance can also be achieved in the cumulative structural position.

The Fiscal Council finds that the improvement to the fiscal position in 2019 should not aim to be only the minimum required correction of 0.5 percentage point, achieving which would leave the fiscal position of the general government in structural deficit of 0.9% of GDP for this year. Given the current state of the economy, it is not justified to have a structural deficit of around 1% that will have to be compensated for later regardless of the cyclical state of the economy. The fiscal framework of the European Union also has the principle that the fiscal position must be improved by larger amounts at times when the economy is doing well.

In consequence the Fiscal Council recommends that the target of structural balance set in the state budget for 2019 should still be met, if necessary by restricting the growth in spending. Given the good state of the economy, it would even be appropriate to set a target of a structural surplus for the fiscal position for 2019, so that the cumulative surplus can start to recover more quickly. A cumulative surplus is necessary so that fiscal policy can be used to boost the economy should the economic climate deteriorate. This buffer has now been used up even though the economic situation has been good.

In setting the budget targets in the state budget strategy for 2020-2023, it should be remembered that once structural balance has been achieved, the State Budget Act requires a structural surplus to be planned. The surplus should be of at least 0.5% of GDP a year, until balance has also been achieved in the cumulative structural position.

Background 1. *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 4), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating[2].

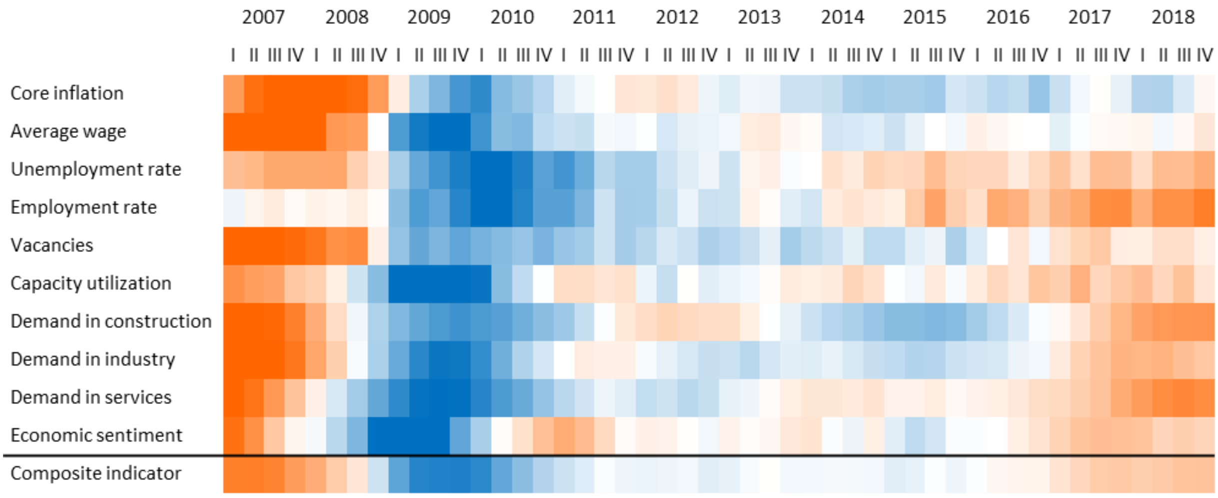

Figure 4. Macroeconomic heatmap for Estonia (Q1 2007 – Q4 2018)

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

The row under the line on the heatmap shows a composite indicator, made up as an average of all the economic indicators (see also Figure 5). The composite indicator of the heat map using data for the end of 2018, the most recent available, shows that the good conditions in the economy achieved in 2017 were maintained in 2018 because of the strength of the labour market and demand. Several institutions providing analysis have retrospectively raised their estimates of the size of the positive output gap in 2018. This means that both the technical estimates of the output gap and the broader collection of economic indicators in the heatmap indicate that the economy was in a very good cyclical position in 2018.

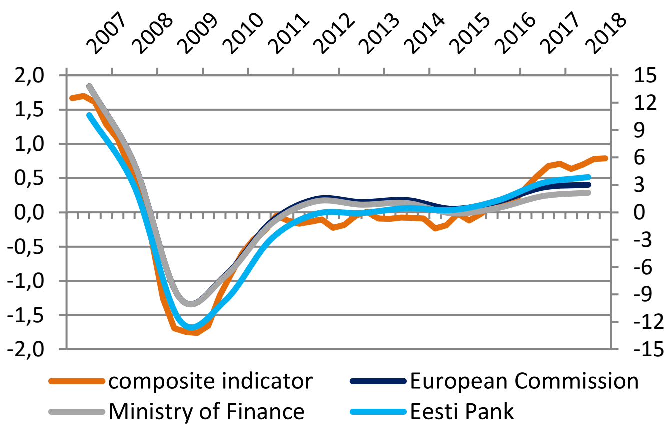

Figure 5. The composite indicator (left scale) and estimates of the output gap in % of GDP (right scale)

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

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

Background 2. *The correction and compensation mechanism in the Estonian structural balance rule*

A structural deficit is allowed in Estonia under the changes made to the State Budget Act in 2017 if a structural surplus of at least the same amount has previously been built up. This is measured with the cumulative structural position, which is arrived at by adding up the results for the structural fiscal position from 2014. Further to this, the structural deficit is not allowed to exceed 0.5% of GDP in one year under normal circumstances.

The law also provides a correction mechanism to be used if the deficit is larger than permitted. If it is apparent that the structural deficit is only a little larger than permitted, the Minister responsible sends an analysis of the situation to the government and if necessary makes proposals for how to improve matters. If the deviation is larger though, meaning that the deficit is more than 0.5 percentage point larger than permitted, the government must immediately start to take measures to improve the fiscal position in the year the deviation has appeared. In this, the structural position must be improved from what it was in the previous year by at least 0.5 percentage point, and this must be done every year until structural balance has again been achieved.

If the structural deficit is larger than the surplus built up in previous years, there will be a deficit in the cumulative structural position. Once the general government has returned to structural balance under the correction mechanism, balance must also be achieved in the cumulative structural position. The compensation mechanism in the fiscal rules requires the government to plan a structural surplus of at least 0.5% of GDP a year until cumulative structural balance has been restored.

The principles of operation of the correction and compensation mechanism are illustrated in Figure 6. The figure uses the information that the cumulative structural surplus at the end of 2017 was around 200 million euros, and the general government structural deficit in 2018 was 1.4% of GDP (left side of the figure). A deficit of this size means that by the end of 2018 the cumulative surplus had been replaced by cumulative deficit of around 160 million euros (right side of the figure).

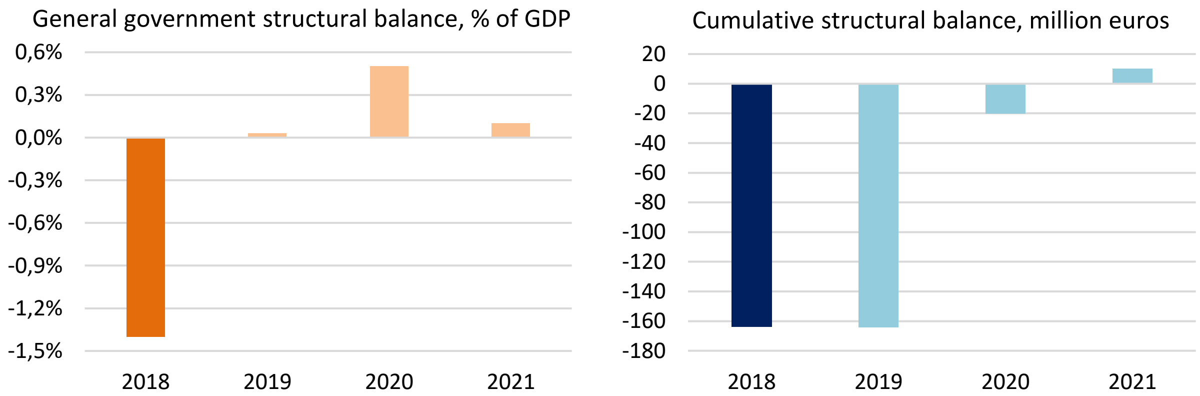

Figure 6. The scenario for correcting the general government structural position and returning to cumulative structural balance

Sources: Ministry of Finance, calculations of the Fiscal Council

By law, the structural position for 2019 must be improved from what it was in 2018 by at least 0.5 percentage point, which means that the structural deficit may not exceed 0.9% of GDP in 2019. The state budget for 2019 was written though with a target of structural balance for the general government. If this is kept to, as is assumed in Figure 6, the correction mechanism will be applied for only one year. Equally though, structural balance would not increase the cumulative deficit even further. In this case, the compensation mechanism would require a structural surplus of at least 0.5% of GDP to be planned for 2020. Assuming the minimum requirements for the surplus are followed, the cumulative structural deficit will be some 20 million euros by the end of 2020. This means a small structural surplus will need to be planned for 2021 too, so that the cumulative structural position will again be in balance by the end of 2021.

In this scenario the requirements of the correction mechanism and of the compensation mechanism will have been met by the end of 2021 and it will be possible to plan future fiscal policy on a clean sheet, always remembering that a surplus needs to be built up before a structural deficit can be planned.

If however the general government fiscal position is again in structural deficit in 2019, the requirements of the correction mechanism will have to be addressed at least in the planning of the state budget 2020. Furthermore, a structural deficit in 2019 would increase the cumulative structural deficit even further, and this would later have to be compensated.