EELARVENÕUKOGU
FISCAL COUNCIL

FISCAL COUNCIL OPINION ON THE SPRING FORECAST 2024 OF THE MINISTRY OF FINANCE

April 2024

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Opinion

The uncertainty in the global economy and the security situation make it harder than usual to forecast the future performance of the Estonian economy. The recovery in growth in the Estonian economy has been delayed as foreign demand remains weak. Initial data show the recession in 2023 was deeper than expected, and the Ministry of Finance, like other forecasters, predicts that growth will only return to the economy in 2025.

The Fiscal Council endorses the spring economic forecast of the Ministry of Finance, which shows the Estonian public finances facing great difficulties. The Ministry of Finance considers that the budget deficit of the general government will reach as much as 5% of GDP, and public debt will continue to grow fast. Such fiscal policy course may hurt the stable development of the Estonian economy, and breaks the fiscal rules.

Estonian fiscal policy stance has been supportive since 2020, as state budgets have been planned with a large deficit. General government debt is now 5 billion euros larger than it was before the pandemic. The Fiscal Council considers that the cyclical position of the Estonian economy may be stronger than assumed by the Ministry of Finance, and so fiscal consolidation should not be postponed any longer.

Estonia may already face an Excessive Deficit Procedure (EDP) from the European Union this spring, because the deficit in 2023 was larger than 3% of GDP. The spring forecast projects that the deficit will exceed 3% of GDP again this year. Opening the EDP may lead to reputational costs for the Estonian economic environment, as the country has long been known for its sound public finances. The Fiscal Council considers it important that the budget deficit be reduced starting from this year.

The spring forecast does not take account of the revenue and expenditure measures that have not yet come into effect and that the government announced in autumn 2023. The Ministry of Finance estimates that if they are taken into account, the budget deficit in 2025 will not exceed 3% of GDP, and will continue to decline in later years. There unfortunately remains a lot of uncertainty about whether the measures in the budget strategy will actually come into effect. The Fiscal Council recommends that the government clarify how it will start to reduce the budget deficit, and which measures have by now been abandoned.

Overall the Fiscal Council considers that the spring forecast of the Ministry of Finance together with its various scenarios is a suitable base for building the government’s stability programme on, and for setting demanding fiscal targets for the next four years. The Fiscal Council recommends that when the targets are set, it should be remembered that the current budget deficit is of a lasting or structural nature. This means that achieving balance in the budget will require deliberate decisions about the state’s revenue and expenditure policies, and not just a return to growth in the economy.

Chairman of the Fiscal Council
Peter Lõhmus
Tallinn, 18 April 2024

Explanatory Report

It is the task of the Fiscal Council to assess the official economic forecasts, though Russia's military attack on Ukraine has meant that there remains a lot of uncertainty and so it is difficult to produce macro forecasts. Like it did last year, the Fiscal Council sees that the biggest threat to growth in the Estonian economy comes from the lack of clarity about growth in the global market, and from general uncertainty. It will take more time than was estimated a year or 18 months ago for demand for imports to recover in Estonia's main trading partners.

The spring forecast 2024 of the Ministry of Finance has been written using 'no-policy-change' assumption. The explanatory note to the spring forecast accompanies the baseline scenario with a risk scenario for a slower recovery in foreign demand, and an additional scenario that assumes that all of the fiscal measures presented in the state budget strategy last autumn come into force. The Fiscal Council considers that the general design of this forecast is reasonable and that the choice of scenarios is appropriate.

Assessment of the macroeconomic forecast

The outlook for 2024–2025

Forecasters have been expecting growth in the Estonian economy to recover throughout the past year and a half. The improvement in economic conditions has been repeatedly delayed though, and growth in the economy was weaker in the second half of last year than most forecasters expected, as for the year as a whole the economy declined by 3%. This has affected the outlook of the Ministry of Finance and the main macro indicators for 2024-2025 are weaker than was assumed in the previous round of forecasting (see Table 1). The rise in consumer prices has however slowed a little more sharply than expected.

Table 1. Key macroeconomic indicators in the spring forecast for 2024–2025 (%)

	2024		2025	
	Summer 2023	Spring 2024	Summer 2023	Spring 2024
GDP at current prices (billion euros)	41.4	39.2	43.7	41.6
Real GDP growth	2.7	0.0	3.0	3.3
Real growth in private consumption	1.5	0.7	4.5	3.7
Real growth in government consumption	0.0	1.3	0.5	1.5
Real growth in investment	3.1	−2.1	3.9	4.6
Real growth in exports of goods and services	2.9	−0.7	3.4	2.9
Real growth in imports of goods and services	1.4	−0.1	4.2	3.8
CPI growth	4.6	3.4	2.5	2.5
Nominal growth in average wage	6.6	6.0	5.3	5.1
Growth in employment	0.4	−0.3	0.1	0.5

Source: Ministry of Finance

The Estonian economy is small and open and so is largely dependent on the ability to export goods and services. The Estonian economy exited the crisis of 2009 largely because of the good performance of the exporting sector, but foreign trade has provided less support than expected for exiting the current downturn. Trade around the world grew notably more slowly in 2023 than demand did, which is a departure from the usual performance. The initial estimate from the IMF is that the rate of growth in global GDP was about two percentage points higher than the rate of growth in exports and imports. This difference was even wider in the EU and the euro area, and the average demand for imports was more than 1.5% smaller than a year earlier. This fall was notably larger than the average in the countries that are the main trading partners for Estonia.

A change like this in the proportions of domestic demand and foreign trade is generally considered to be a temporary distortion, and it is expected that annual growth in global trade will pick up in 2024 to 3.5%, which is about a percentage point faster than the growth in GDP. Unfortunately the assumptions for growth in foreign demand have proven too optimistic for Estonia in the past two or three rounds of forecasting[1]. It is consequently understandable that the forecasters of the Ministry of Finance have been cautious in their assessment of the outlook for the exporting sector, and the accelerating growth in the Estonian economy in 2024-2025 is based primarily on domestic demand (see Figure 1). Faster growth in general government spending than in private sector spending catches the eye in domestic demand, as it assumes that the general government budget deficit will remain wide.

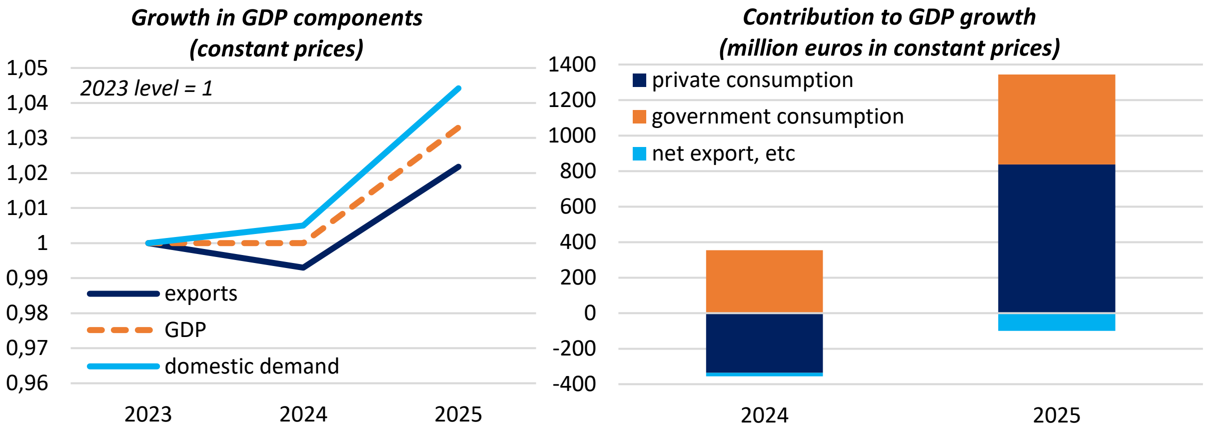

Figure 1. Forecast for growth in GDP and its components in 2024–2025

Source: Ministry of Finance

The Fiscal Council has usually compared the forecast of the Ministry of Finance with those of other forecasters. Only a few forecasts had been produced using the data for the end of 2023 at the time that the opinion of the Fiscal Council was written. Growth forecasts are not produced quarterly, and so it may only be assumed that the differences in the outlook for growth arise from the predictions for which quarter of 2024 the recovery in growth in the economy will start in. The average yearly indicators for 2024-2025 show the differences between the forecasts of real GDP growth and inflation to be smaller than the forecast errors that were usual before the crisis, and the projection of the Ministry of Finance is close to the average of other forecasts (see Table 2).

Table 2. Forecasts for real GDP and CPI growth in 2024–2025

	2024	2025	2024	2025	2024–2025 total	
	Real GDP growth (%)		CPI (%)		Real GDP growth (%)	CPI (%)
Luminor	–1.0	3.0	3.0	1.0	2.0	4.0
Consensus Forecasts	0.8	3.4	3.5	2.8	4.2	6.4
Eesti Pank	–0.6	3.2	3.2	2.4	2.6	5.7
average of the forecasts:	–0.3	3.2	3.2	2.1	2.9	5.4
Ministry of Finance	0.0	3.3	3.4	2.5	3.3	6.0

Sources: Consensus Forecasts, Eesti Pank, Luminor, Ministry of Finance

[1] The spring forecast of the Ministry of Finance contains a risk scenario for slower growth in the economy, primarily because of the risks around foreign demand. In this scenario, the continuing fall in income from exports causes growth in productivity and in wages to slow, and this means that the budget deficit is wider. The Fiscal Council considers that the risk scenario is not more probable than the baseline scenario, but it is based on the risks that the Fiscal Council considers to be the most probable in the current circumstances.

The relatively rapid growth in GDP after the downturn that started in 2022 can be seen as an expected rebound from the low reference base, and GDP measured at constant prices will be 6.5% larger in 2025 than it was in 2019. It does not follow from this that the potential for growth in the Estonian economy has increased even further in the past three or four years. The Fiscal Council finds that there are doubts about the estimate of the cyclical position of the economy, like there were last year, and more attention should be paid to it (see Background 1 and Background 3) as it is an important input in setting fiscal policy.

It should also be remembered with the forecast indicators for 2025 that the baseline scenario was written using 'no-policy-change' assumption and that it does not assume that the fiscal targets for 2024-2027 in the state budget strategy will be met. The economic impact of the additional fiscal measures in the budget strategy are considered in the additional scenario, which puts economic growth in 2025 at 1.3 percentage points lower at constant prices than in the baseline scenario, and 0.8 point lower at current prices. The Fiscal Council finds that the additional scenario gives an adequate description of the possible impact of the fiscal measures on the key economic indicators.

Overall the Fiscal Council finds that the information available at the time the Ministry of Finance forecast was written was used as well as possible, and the spring economic forecast describes the near-term outlook for the Estonian economy with sufficient reliability. For this reason the Fiscal Council endorses the spring forecast 2024 of the Ministry of Finance and considers it a suitable basis for writing the stability programme. Both the baseline scenario and the risk scenario show the need for substantial improvement in the fiscal position.

The outlook for 2026–2028

The key indicators for the final years of the forecast have changed little, unlike the outlook for the years immediately ahead. The main macro indicators for five years ahead are very similar in numerical terms to what they were in forecasts written before the pandemic. The key message of the medium-term outlook is that nominal GDP growth of 7%, which was typical in the decade of growth after the global financial crisis, can no longer be considered sustainable. Yearly growth of only up to 5% should also be expected for nominal wages (see Table 3).

Table 3. Key macroeconomic indicators in the spring forecast for 2026–2028 (%)

	2026	2027	2028	2026*	2027*
GDP at current prices (billion euros)	43.8	45.9	48.1	–2.0	–2.0
GDP at constant prices (billion euros)	26.5	27.1	27.8	–0.8	–0.8
Real GDP growth	2.8	2.5	2.5	0.3	0.3
Nominal GDP growth	5.1	4.8	4.8	0.3	0.4
Real growth in private consumption	1.9	2.2	2.2	0.6	0.1
Real growth in government consumption	0.0	1.5	1.0	0.0	1.3
Real growth in investment	5.9	–0.7	2.8	–0.5	–2.1
Real growth in exports of goods and services	3.2	3.0	2.9	0.0	0.0
Real growth in imports of goods and services	3.0	1.9	2.7	0.0	–0.3
CPI growth	2.1	2.0	2.0	0.4	0.1
Nominal growth in average wage	5.0	4.8	4.8	0.1	0.3
Growth in employment	0.0	0.0	0.0	0.0	0.0
Employment (thousands)	696.3	696.3	696.3	8.3	8.3
Unemployment rate	6.3	6.2	6.1	0.1	0.1

** change from the previous forecast*

Source: Ministry of Finance

The forecasting methodology for 2026-2028 uses similar assumptions to those from before the pandemic: a) labour costs will grow at the same rate as GDP; b) the exporting sector will be able to cope with increased foreign demand; c) corporate investment as a ratio to GDP will stabilise at close to its long-term average of the past; and d) the saving rates of households will increase together with their income levels. In retrospect these assumptions have held quite well over a long time.

The biggest difference between the medium-term outlook from before the crisis years and the forecast concerns the estimate of potential GDP growth. The spring forecast 2024 by the Ministry of Finance expects the Estonian economy to be performing at below its estimated potential level until 2028, though the yearly rate of GDP growth will remain at 2.5% at least. This means that the potential for growth in the Estonian economy is estimated at around one percentage point lower than in the forecast made by the Ministry of Finance in 2019 for example, and the potential growth in 2026-2028 is on average 0.7 percentage point lower than the estimates of growth made in 2020-2023. The Fiscal Council considers it debatable whether this difference is justified.

Assessment of the fiscal forecast

The fiscal measures presented in the state budget strategy last autumn for improving the budgetary position have not yet been legislated this spring, and so the baseline scenario of the spring forecast 2024 from the Ministry of Finance has not taken them into account. The ministry has consequently produced a separate additional scenario that assumes all the measures in the budget strategy are passed and that they affect the state finances, and consequently the economy. The additional fiscal measures would mainly come into force from 2025, and so will primarily affect the forecast indicators for 2025-2028. The Fiscal Council finds that the approach of producing multiple forecast scenarios gives an appropriate basis for writing the stability programme.

The Fiscal Council has used the baseline scenario from the spring forecast for assessing whether the fiscal forecast is in line with the macroeconomic outlook, but it has also considered the additional scenario containing the fiscal measures that have not yet come into force in analysing how fiscal policy complies with the fiscal rules.

Budgetary position in 2024

The spring forecast 2024 of the Ministry of Finance once again expects the recovery of growth in the Estonian economy to be delayed. A bigger decline than expected in 2023 and the expectation of zero growth in 2024 mean that the nominal size of the Estonian economy will be notably smaller in the coming years than was previously forecast, and so the forecast for tax receipts is also smaller.

The state budget 2024 was written with a nominal general government budget deficit of 2.9% of GDP, or 1.19 billion euros, but the spring forecast of the Ministry of Finance expects the deficit this year may reach 3.5% of GDP, or 1.36 billion euros. This means the forecast for the budgetary position has deteriorated by around 180 million euros. The forecast for total spending in 2024 has not changed from what the state budget expected, and so the deterioration in the position comes mainly from the revenue side for the general government. The deficit as a ratio to GDP will also be increased because the forecast for nominal GDP in 2024 has been reduced by around 2 billion euros.

The nominal budget deficit of the Estonian general government exceeded 3% of GDP in 2023, and the spring forecast of the Ministry of Finance expects it to do so again this year and next unless additional fiscal measures are taken, and so the Excessive Deficit Procedure (EDP) of the European Union may engage in spring 2024. The procedure may hurt the reputation of the Estonian economic environment, as the country has long been known for its orderly and disciplined state finances.

The baseline scenario of the spring forecast of the Ministry of Finance puts the structural fiscal deficit of the general government at 1% of GDP in 2024. This estimate comes from the assumption that the negative output gap will total 5.2% of GDP this year. The explanatory note to the ministry's forecast admits that their methodology may under current circumstances overestimate the cyclical weakness of the economy, and so underestimate the size of the structural deficit. This position is supported by the heatmap of the Estonian economy made by the Fiscal Council (see Background 3), which shows that the cyclical position of the economy has not weakened as much, and also by calculations of the structural budget deficit using other methodologies that show a much larger deficit in the short term (see Figure 5). This means that there is more uncertainty than usual around the estimates of the size of the structural deficit.

The Fiscal Council finds it hard to believe that only one third of the nominal budget deficit of 3.4-3.5% of GDP in 2023 and 2024 is of lasting or structural nature. Closer inspection of the spending decisions that have caused the budget deficit of late indicate that these are new permanent expenditures, and so the fiscal position will not be improved simply by a recovery in economic growth. This is also apparent in the longer outlook of the spring forecast of the Ministry of Finance that shows the structural deficit increasing sharply as the economic climate improves. The Fiscal Council considers that the majority of the current budget deficit is structural, and so achieving balance in the budget will require deliberate decisions about the state's revenue and expenditure policies, and not just a return to growth in the economy.

Fiscal forecast for 2025–2028 in the baseline scenario

The outlook for the Estonian state finances from 2025 will be affected very much by whether forecasts takes account of the fiscal measures in the state budget strategy for 2024-2027 that had not yet been enacted by spring this year. The fiscal measures to improve the budgetary position that were announced in the budget strategy in the autumn were very large in total, and so will substantially affect the future trajectory of the budget and whether the Estonian state finances comply with the domestic and European Union fiscal rules. Unfortunately it was still uncertain this spring whether the measures in the budget strategy would actually enter into force[2].

Table 4. Key fiscal indicators in the spring forecast baseline scenario

	2023	2024	2025	2026	2027	2028
Nominal balance (million euros)	−1279	−1363	−2219	−2146	−2247	−2002
Nominal balance (% of GDP)	−3.4%	−3.5%	−5.3%	−4.9%	−4.9%	−4.2%
Output gap (% of GDP)	−4.3%	−5.2%	−3.1%	−1.7%	−0.6%	0.4%
Structural balance (% of GDP)	−1.3%	−1.0%	−3.8%	−4.1%	−4.6%	−4.3%
Government debt (% of GDP)	19.6%	22.6%	27.1%	30.9%	33.9%	35.9%

Source: Ministry of Finance

Like it did for 2024, the Ministry of Finance has reduced the forecast tax revenues for the longer term by 180-270 million euros a year depending on the year, which will make it an even greater challenge to put the state finances in order. The summer forecast put the nominal budget deficit in 2025-2027 at around 4% of GDP, but the baseline scenario of the spring forecast has raised this to around 5% of GDP (see Table 4). The deficit remaining consistently so large would start to increase the debt burden of the Estonian general government rapidly so that it reached 35% of GDP by 2028. This forecast also means that the tax rises that have already come into force, with increases in VAT, income tax and excises, are not sufficient to start to reduce the state budget deficit in the coming years.

[2] Government statements to the media have cast doubt on the entry into force of the security tax and the reform of renewable energy fees for example, and the expected additional revenue from those two measures alone was about half a billion euros a year.

The spring forecast expects the budget deficit in 2024 to be similar to that of last year, as both the revenues and the expenses will increase this year by around 9%. The ministry then expects the deficit to widen sharply in 2025, because although the growth in expenses will slow to 4%, the general government revenues will be smaller than in 2024 (see Figure 2). Tax revenues will be smaller because of the economic environment cooling, but also because of the income tax reform that will apply from 2025 and will eliminate the tax hump, and which the Ministry of Finance calculates will reduce state revenues by more than half a billion euros. On top of tax revenues growing by less, it is forecast that non-tax revenues will decline in 2025, primarily those from economic activities and from interest and equity. The longer term forecast for 2026–2028 assumes that revenues and expenditures will grow roughly at the same rate.

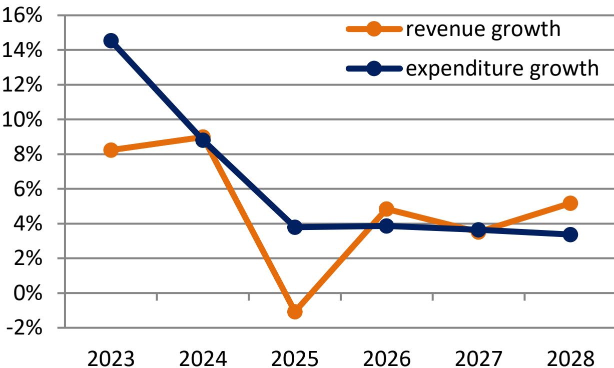

Figure 2. General government revenue and expenditure growth in 2023–2028 (%)

Source: Ministry of Finance

General government revenues are mainly tax revenues, and two thirds of those are receipts of social tax and VAT. To estimate whether the forecast by the Ministry of Finance for tax receipts is in line with the macroeconomic outlook, Figure 3 shows the expected growth in social tax and VAT in comparison with the nominal growth in the tax base and the economy[3]. Under normal economic circumstances and with no major tax changes, it may be assumed that the rates of growth will remain quite similar over the years. The Ministry of Finance is forecasting that VAT receipts will grow faster than usual in 2024 because of the rise in the standard rate of VAT to 22%, but in the longer term it is assumed that the receipts of the main taxes will be in line with the developments in the tax bases.

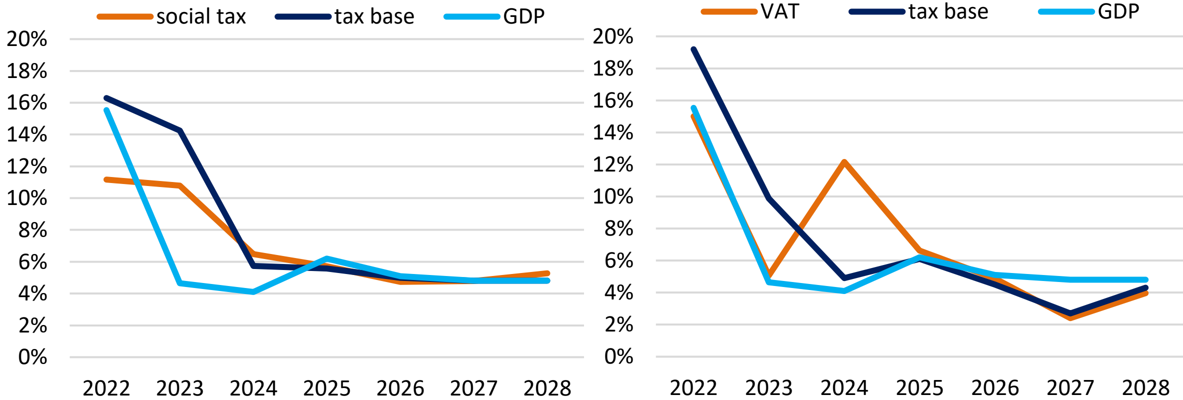

Figure 3. Growth in social tax and VAT in comparison to nominal growth in tax base and GDP (%)

Sources: Ministry of Finance, Statistics Estonia, calculations of the Fiscal Council

[3] The VAT tax base in Figure 3 consists of forecasts for private consumption, government intermediate consumption and investment by the government and households. The tax base for social tax is calculated using the payroll in the economy based on the forecast for growth in average monthly wages and employment.

Fiscal forecast for 2025–2028 in the additional scenario

The Ministry of Finance has produced an additional scenario to go alongside the baseline scenario in the spring forecast, basing it on the assumption that all of the fiscal measures in the budget strategy that were intended to improve the budgetary position (see Table 5) are enacted. The ministry estimates that increasing the tax burden and cutting government expenditures will primarily have a negative impact on the Estonian economic climate in 2025, when real growth in the economy may be 2% rather than 3.3%, and inflation may rise by 1.6 percentage points. Growth in the economy recovering more slowly would widen the negative output gap even further. The Fiscal Council finds that the additional scenario gives an adequate description of the possible impact of the fiscal measures on the key economic indicators.

The Ministry of Finance considers that the fiscal impact of the measures (see Figure 4) is large enough that the nominal budget deficit of the Estonian general government will not exceed 3% of GDP in 2025, and the state finances will move towards budget balance over the forecast horizon. The Fiscal Council considers that it was reasonable to produce the additional scenario and that a spring forecast with multiple scenarios is a good basis for writing the stability programme, since it allows the government to assess directly the impact of its policy decisions on the fiscal trajectory.

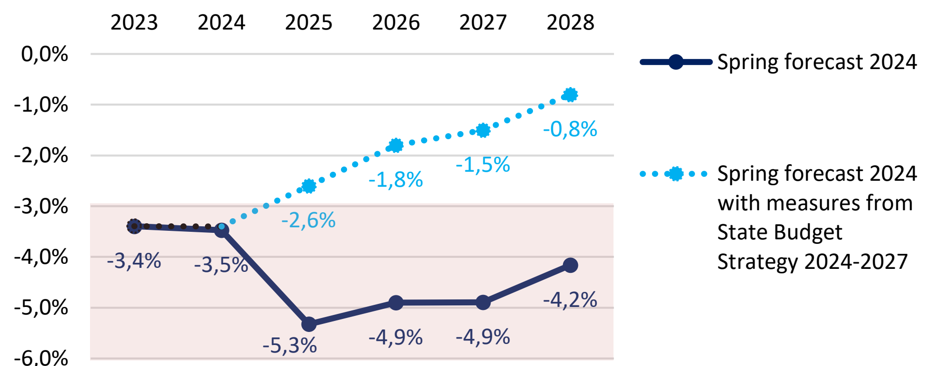

Figure 4. General government nominal balance in 2023–2028 (% of GDP)

Source: Ministry of Finance

The structural balance and compliance with the fiscal rules

The changes to the national fiscal rules that came into force in 2024 require the state budget to be written so that the general government structural budget deficit does not exceed 1% of GDP. The State Budget Act allows a structural deficit of that size to be planned only until 2030, or for as long as the general government debt ratio does not exceed 30% of GDP, otherwise the structural deficit may only be up to 0.5% of GDP. A correction mechanism is engaged when the deficit is larger than permitted and it requires the budgetary position to be improved depending on the position of the economic cycle: by less or even not at all during difficult times and by more during good times[4].

The ministry estimates that if all of the measures in the state budget strategy 2024-2027 for improving the budgetary position were to come into force, the debt ratio would stabilise and the fiscal trajectory would be in line with the requirements of both the national and the EU fiscal rules (see Figures 4 and 5). The nominal deficit would not exceed 3% of GDP after 2025 and it would fall to 0.8% of GDP by 2028, so complying with the key requirement of the EU rules that the nominal deficit may not exceed 3% of GDP. The structural deficit would be close to or less than 1% of GDP in 2025-2028, so that the key requirement of the national rules that the structural deficit may not exceed 1% of GDP would also be met.

[4] The Ministry of Finance considers that the cyclical position of the economy in 2024 and 2025 is sufficiently weak that the national fiscal rules would not require an improvement to the budget if the structural deficit were larger than permitted.

The estimate by the Fiscal Council of the structural budget deficit starts from the position that the cyclical state of the Estonian economy will not be as weak in the short term as is assumed by the spring forecast of the Ministry of Finance. The calculations of the Fiscal Council for 2023 and 2024 consequently indicate a substantially larger structural deficit. The estimates of the two institutions for the longer term are essentially similar and both show how difficult the situation facing the state finances will be if steps are not taken to improve the fiscal position.

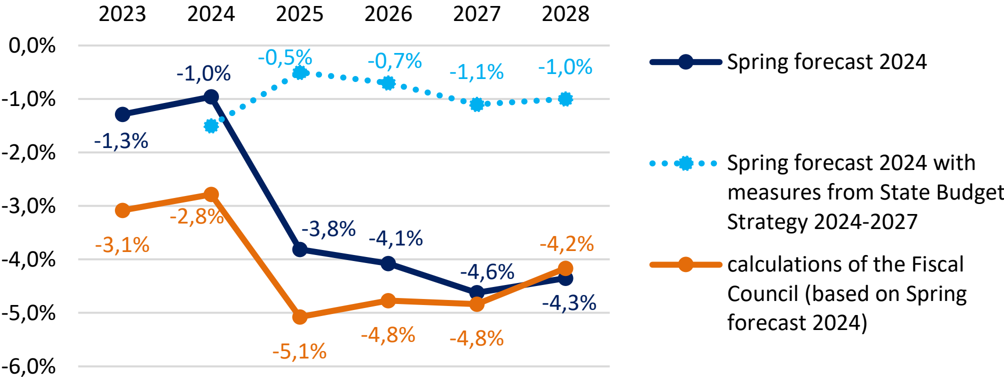

Figure 5. General government structural balance in 2023–2028 (% of GDP)

Sources: Ministry of Finance, calculations of the Fiscal Council

Estonian fiscal policy has been supportive of the economy since 2020, meaning it has planned large budget deficits. The debt of the Estonian general government is now 5 billion euros larger than it was before the pandemic[5]. Now that the escape clause of the fiscal rules has been lifted, Estonia may face an Excessive Deficit Procedure (EDP) already this spring.

The Fiscal Council consequently considers it important to make sure that the general government nominal budget deficit does not exceed 3% of GDP. The spring forecast expects this target to be missed by around 170 million euros this year, and by around a billion euros next year. The ministry estimates that the fiscal measures that were announced in the budget strategy in the autumn but that have not yet been enacted would improve the budgetary position in 2025 by around 1.1 billion euros, and so meeting the 3% limit for the nominal budget deficit would need practically all of those measures to be introduced as announced.

The Fiscal Council also finds it important that a nominal budget deficit of 3% of GDP should only be taken as a numerical benchmark for the Estonian state finances when the economy is facing difficult times, and not every year. All of the fiscal measures in the budget strategy coming into force would reduce the nominal budget deficit in future as well, down to 0.8% of GDP by 2028 in the estimate of the Ministry of Finance. The Fiscal Council considers that this trajectory of fiscal improvement could be demanding enough to comply with the national fiscal rules, but there remains a lot of uncertainty about the measures being enacted. The Fiscal Council recommends that the government clarify how it will start to reduce the budget deficit, and which measures have by now been abandoned.

In summary the Fiscal Council finds that the fiscal outlook depends largely on what steps the government takes next to put state finances in order. The spring forecast 2024 of the Ministry of Finance considers that the Estonian state finances will remain on an unsustainable path without additional fiscal measures to improve the budgetary position, and that compliance with both the EU and the national fiscal rules would need practically all of the measures in the state budget strategy to be enacted. Even though the recovery of growth in the economy has been delayed, the repairs to the state finances cannot be put off any longer.

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[5] Data from Statistics Estonia show that the general government debt in the fourth quarter of 2019 was 2.37 billion euros, but in the fourth quarter of 2023 it was 7.37 billion euros.

Background 1. *Potential growth in the Estonian economy*

The Fiscal Council noted in its opinions on the 2023 forecasts of the Ministry of Finance that events in the past couple of years have increased the risks to economic forecasts over the medium term. By this it meant that it was not yet clear whether and how much lasting change there will be to the potential for growth from the demanding targets of the green transition, assuming that the increase in productivity resulting from the investment will only be apparent after a delay, and from the impact on international supply chains of the recent pandemic and the Russian war in Ukraine. It only became evident at the start of last year that the events of the past couple of years had permanently increased general government spending on healthcare and national defence.

It was noted at the start of this year that at least some of the risks to the private sector had been realised. Using oil shale to produce electricity has become much less competitive as the cost of air pollution has been raised by the green transition. Renewable energy provided a little over 20% of electricity production last year, but the value added of the energy sector at comparative prices was still almost 60% smaller than before the pandemic. Eesti Energia announced that the value of the power plants running on oil shale had been written down by more than 0.6 billion euros.

The future value of the use of transport sector infrastructure has been reduced by the war, as is indicated by the reduced traffic volumes. Amounts transported by rail were less than half what they were in 2019, while transit trade was around a fifth. Larger volumes of goods heading southwards meant that the decline in traffic for ports was smaller at 40%. The Ministry of Finance estimates that the potential for growth in the economy continued growing at the same time at its usual rate (see Figure 6).

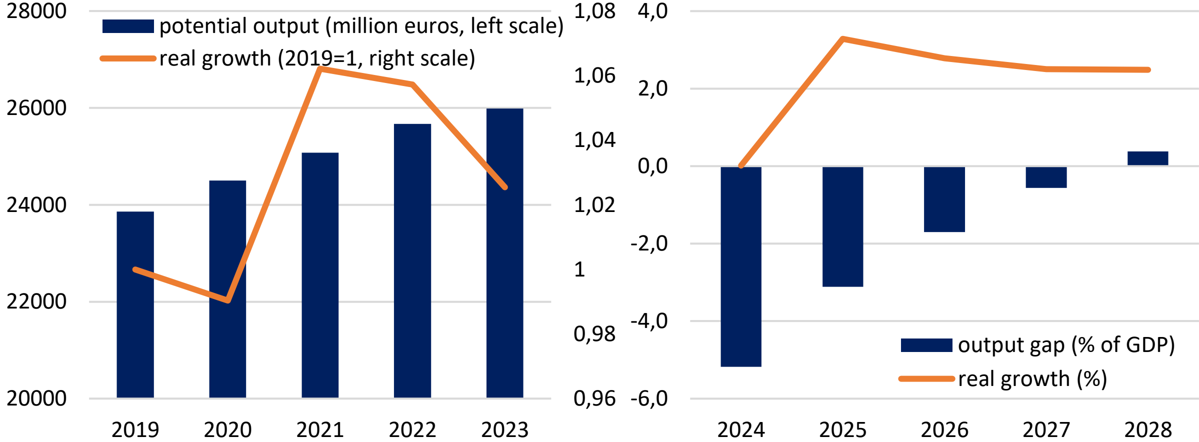

Figure 6. Indicators of actual and potential output in 2019–2028

Sources: Ministry of Finance, calculations of the Fiscal Council

In retrospect the level of potential GDP increased in 2020-2023 by about 9% from the year before the pandemic. Growth in potential GDP is expected to be much slower during the forecast horizon though, even though employment has been maintained and investment activity in the business sector is recovering. The explanatory note to the spring forecast from the Ministry of Finance could have given a more thorough explanation for the outlook for total factor productivity being notably more pessimistic than before.

The Fiscal Council finds in total that the potential output of the Estonian economy has generally been overestimated in the recent past, but the rate of growth moving forwards has been underestimated. This means that the negative output gap could under current circumstances be smaller than estimated by the Ministry of Finance and could close faster than expected during the forecast horizon.

Background 2. *Planned fiscal consolidation measures*

The government formed in spring 2023 set itself the goal of bringing the Estonian state finances into order, as the budget had moved into permanent deficit after several years of crisis. Some of the fiscal measures planned to improve the state finances were enacted in summer 2023, but some were only announced in the state budget strategy 2024-2027 that was written in autumn 2023. The measures presented in the state budget strategy last autumn had not yet been legislated by spring 2024, and so they are not included in the baseline scenario of the spring forecast 2024. Reducing the deficit from 2025 will depend on whether the measures in the budget strategy are actually passed as planned and with the expected fiscal impact.

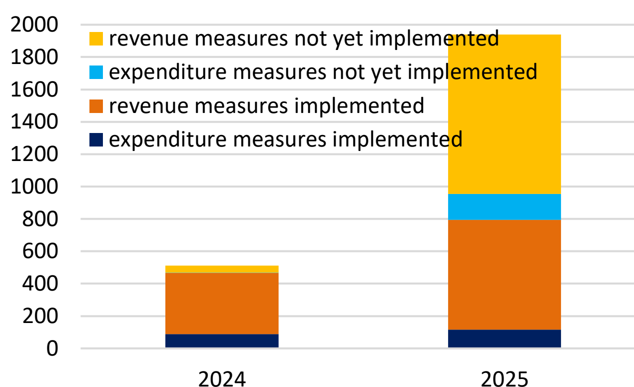

Figure 7. Budgetary impact of fiscal consolidation measures in 2024–2025 (million euros)

Source: Ministry of Finance

The measures with the biggest budgetary impact that have already entered into force are rises in VAT, income tax and excises. Additional tax revenue is also forecast for 2024-2025 from the profit distribution of the commercial banks in agreement with the government, in a revenue measure from the budget strategy that the Fiscal Council was critical of last autumn. The combined impact of these measures means that almost all of the planned improvement to the budget for 2024, totalling around half a billion euros, has occurred, and their impact is forecast to be even larger in 2025 (see Figure 7).

Table 5. Budgetary impact of consolidation measures in State Budget Strategy 2024–2027 (million euros)

	2024	2025	2026	2027
Broad-base security tax	0	430	446	480
Motor vehicle tax	0	200	220	242
Reform of social tax special cases	0	114	130	136
Environmental fees	34	74	81	81
Reform of renewable energy fees	0	60	60	60
Fixing the tax-free threshold for old-age pensions	0	22	46	68
Tax on sweetened beverages	0	25	25	25
Higher rates for fines	0	16	16	16
Higher rates for state fees	5	11	11	11
More efficient tax collection	5	8	8	8
Other revenue measures	0	23	27	32
Revenue measures in total	45	984	1071	1160
Expenditure cuts	0	120	189	256
Lower interest expenditure on public debt	2	42	88	136
Expenditure measures in total	2	161	277	392
Measures in total	47	1145	1348	1553

Source: Ministry of Finance

The measures presented in the budget strategy written in autumn 2023 should improve the budgetary position significantly from 2025 onwards (see Table 5). Together with the measures that have already come into force, the planned improvement to the budget for 2025 should total 2 billion euros. Unfortunately more than half of the amount of improvement planned for 2025 is incomplete, as the measures in the budget strategy have not yet been enacted in law by this spring. The biggest fiscal impact on the revenue side of the budget would come from the security tax, the car tax and the reform of social tax special cases, and on the expenditure side from the spending review. All of the measures planned in the budget strategy being passed would substantially improve government revenues and would also reduce its expenditures (see Figure 8), but not by enough for budget balance to be achieved by the end of the forecast horizon.

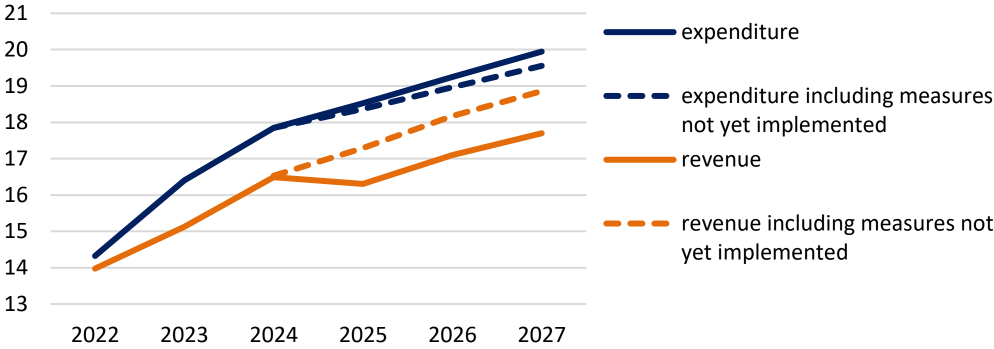

Figure 8. General government revenue and expenditure in 2022–2027 (billion euros)

Source: Ministry of Finance

The circumstances in which the state finances are to be repaired this time around is quite different from those after the economic crisis of 2008-2010. Figure 9 compares the general government revenues and expenditures in 2008 and 2020 and the next four years. General government expenditures were cut during the previous crisis and the expenditure level of 2008 was only attained again after four years, but this time round general government expenditures have continued to grow fast, and were boosted by three supplementary budgets in 2020-2022 that increased expenditures. This has partly been made possible by rapid growth in revenues, which was aided by the reform of the second pension pillar and the additional tax revenue that resulted from increased inflation, which did not happen during the previous crisis episode.

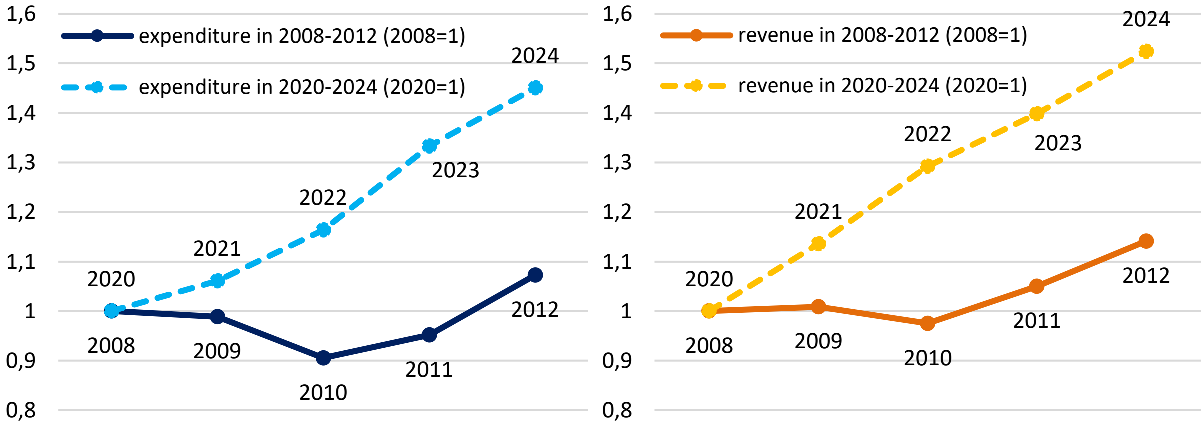

Figure 9. Comparison of general government revenue and expenditure trajectories in crisis episodes

Sources: Ministry of Finance, Statistics Estonia

The spending measures planned provide only about a fifth of the additional fiscal improvement in 2025, and the amount of government expenditure is not expected to decline from the previous year during any year of the forecast horizon. This means that improving the state finances this time rests mainly on revenue measures, and on raising the level of government revenues to match the new higher level of expenses.

Background 3. *A macroeconomic heatmap for Estonia*

To assess better the compliance with the fiscal rules and the output gap forecast by the Ministry of Finance, the Fiscal Council analyses 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 describe the cyclical position of the economy. The end result of this analysis can be presented in the form of a heatmap (see Figure 10), where the darker shade of blue indicates that the economy is cooling, while the darker orange indicates the economy is at risk of overheating.

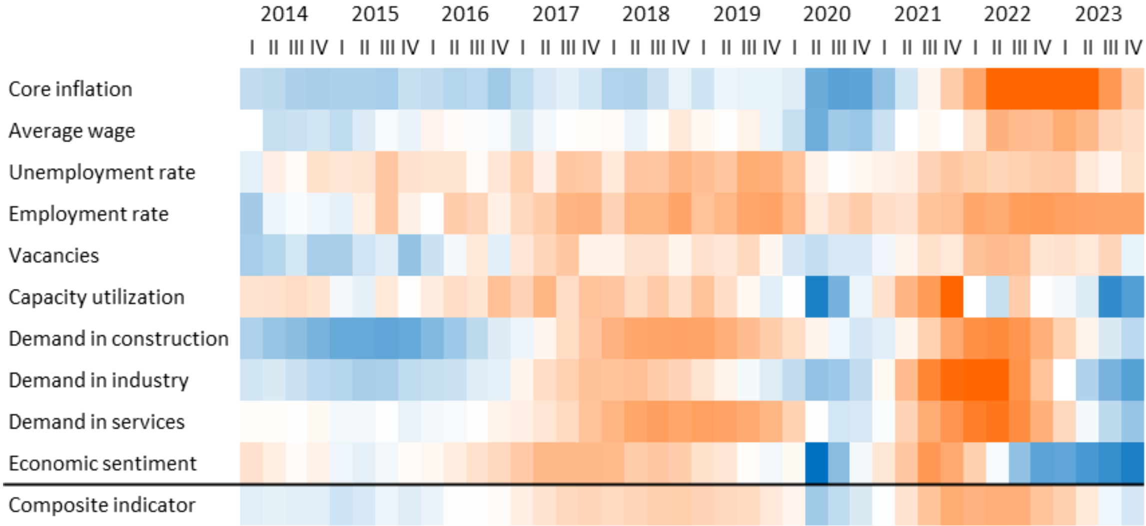

Figure 10. Macroeconomic heatmap for Estonia (Q1 2014 – Q4 2023)

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

Data from the Estonian Institute of Economic Research show that all the demand indicators that the Fiscal Council has chosen to describe the cyclical position of the Estonian economy on its heatmap weakened gradually during 2023. The composite indicator of the heatmap suggests cooling by the end of the year despite the continuing strength of the labour market. On average, the Estonian economy operated close to its potential level last year (see Figure 11), even when the composite indicator excludes core inflation (shown by the dotted line in the figure). This means that the heatmap does not show the cyclical position of the economy to be as weak as is suggested by the recent output gap estimates from other institutions.

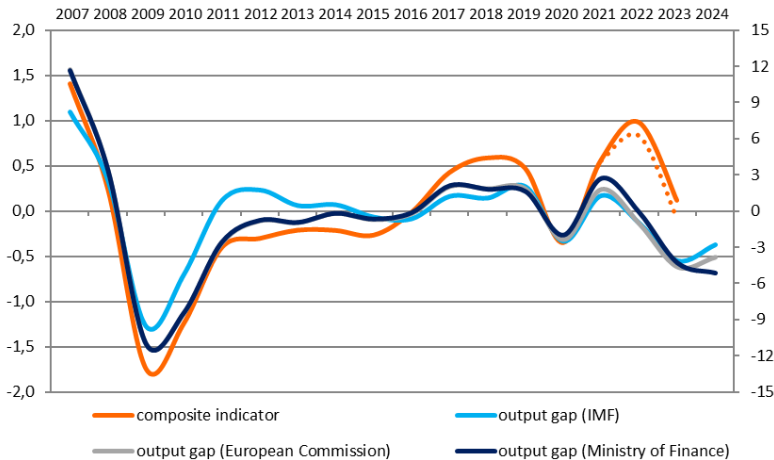

Figure 11. Composite indicator of the heatmap (left scale) and output gap estimates (% of GDP, right scale)

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