Eesti Pank
Bank of Estonia

Flash report

SUSTAINABILITY OF PUBLIC FINANCES - EESTI PANK ESTIMATE

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The global financial crisis and the subsequent recession have turned out to be very severe. According to different forecasts, this markedly complicates also Estonia's economic adjustment and the country's economic volume is expected to contract sharply compared to 2008. In this difficult situation an adequate and timely reaction on the fiscal front is urgently needed.

According to Eesti Pank's forecast, it will take 4 to 5 years before the economy recovers to pre-crisis levels. Declining economic volume causes a considerable shrinkage of state revenues, making it impossible to finance expenditures at the level it has been done so far. The financing of the fiscal deficit while not revising the country's future plans and budget could prove to be a very difficult task and capital shortage could hit also the private sector.

Thus the fiscal policy has three objectives:

- to follow in both 2009 and 2010 the 3% of GDP reference value established by the Maastricht criteria;
- to restore fiscal surpluses and reserves once the crisis is over;
- to ensure long-term sustainability of public finances, i.e., the financing of costs arising from ageing population, chiefly pensions and health expenditure.

Achieving a fiscal balance will take time, but preparations have to start immediately

Both global and the Estonian economy are going through an exceptionally sharp recession. Even if the situation takes a turn for the better at the end of this or at the beginning of the next year, bouncing back to pre-crisis levels will take 4 to 5 years. From the point of view of public finances this means that tax revenues will be remarkably smaller in the next couple of years compared to, for example, 2008. Therefore it is necessary to bring recent years' soaring expenditures in line with decreasing revenues (expenditures financed from the EU budget are an exception).

If the current expenditure level is maintained, Eesti Pank's forecast does not expect fiscal balance to recur before 2014 once the economy recovers. Estonia's post-crisis debt burden would be around 30 billion kroons, exceeding the current liabilities by nearly 3 times.

Considering this, meeting the Maastricht budget criterion necessary for the accession to the euro area is just one part of the overall consolidation target, which simply says that already the first measures to improve the fiscal balance must be vigorous enough to keep the deficit below 3% of GDP both in 2009 and in the next years.

From the point of view of monetary policy it is also beneficial if the cost structure continues to support growth

Estonia has for a long time followed economical fiscal policies and experts are of the opinion the cost structure has also contributed to growth. Namely, compared to the EU average, the funds spent on investment and education are larger in Estonia, whereas the share of running costs is smaller. On the other hand, this means we have no such one-off expenditures that could be easily cancelled or postponed. Nevertheless, the primary measure among the corrective steps should be cutting costs. Otherwise we would probably have to abandon the policy of relatively low taxes.

Data on recent years show that nearly 5% of GDP of the general government expenditure is spent on investment. This has been somewhat reduced in the first supplementary budget compared to initial plans. Further cuts in investment are not impossible, but at this point it should be carefully considered how these would impact future economic growth outlooks and whether such cuts would not deprive us of the funds allocated from the EU budget to improve infrastructure. Further cost reductions should therefore focus more on various current expenditures.

Current expenditures, i.e., those recurring from year to year, constitute up to 80% of the consolidated budget. Two-thirds thereof are so-called operational expenditure and one-third so-called social expenditure. As expected, the government's efforts are focused on the current expenditure and the goal of reducing it occupies the central position in the first and in the second supplementary budget. However, running costs need to be reduced even more. Otherwise we are forced to make more and more difficult decisions in the next years. At this point it needs to be borne in mind that the postponement of costs related to the maintenance of roads and large-scale military purchases is a one-off measure, which would increase expenditure again in the next years and thus does not contribute to achieving long-term fiscal sustainability.

Since the value of GDP, i.e., the tax base, will be approximately 5% smaller in 2010 compared to this year, the operating expenditure of the next year should decrease in the same magnitude. In this case the general government expenditures would be smaller than in 2008, but still larger than in 2007 and the budget deficit would be slightly below the threshold.

Fiscal policy must be sustainable in long term

Fiscal balance requires that changes in the volume of expenditure are in line with the revenue base. Otherwise, fiscal policy is not sustainable in long term. Recent years' decisions have practically erased this connection in the field of social transfers. Both parental benefits and pensions have been increased and, irrespective of the recession, it is intended to raise them also this year.

Transfers to households (family and child allowance, pensions, sickness benefits, etc.) made up 26% of the consolidated budget expenditure in 2008. The share of these expenditures can be forecasted to increase to one-third this year and to 35-36% in 2010, depending on the quantity of the unemployed and those in need of subsistence benefits. More money will be needed for pensions as well – these account for about two-thirds of the transfers to households. If pensions stay at the current level, the ratio of the respective costs to GDP will increase from slightly over 7% in 2008 to almost 10%.

If social benefits are left at the same level or even increased (e.g., parental benefits), this requires, other things being equal, a more extensive cut in government consumption. In other words, the current social benefits financing system is unsustainable in a crisis situation and in years of relatively slow growth. Financing shortages are the most obvious in the case of old-age pensions.

The supplementary budget that came into effect in February included also suggestions to adjust the size of old-age pensions by means of indexation. Though this was a step in the right direction, such changes are suited to a normal business cycle, not to a crisis situation. The new adjustment principles do presume that in the case of an economic contraction or if the deficit of the first pension pillar exceeds 1% of GDP, the obligation to increase pensions due to indexation will be distributed over several years. But the principle that has prevailed is that old age pensions must not be reduced (i.e., the index must not be below 1). In the case of a steep or protracted recession this means a large deficit will persist for several years. Even if we implement the pension index cumulatively, i.e., if the years of recession postpone a new pension growth cycle, the need for financing will still be high, exceeding 1% of GDP also after 5 years. The deficit will start to decline along with a pick-up in economic growth, but it will never disappear if the current system is not changed. Therefore, the system of old-age pensions has to be reviewed promptly from the point of view of long-term sustainability.

No best options on the taxation front

The possibilities of cutting costs are more limited in the case of the second half of this year compared to next years. Therefore, it cannot be ruled out that in 2009-2010 also measures to increase revenues must be taken. Considering the time limit and the low of the global economy, such measures can mostly be tax policy related steps, since one-off measures to increase non-tax revenues may bring along even tougher choices in the next years.

Raising the tax burden is, of course, not at all recommended during an economic recession. But if the crisis is exceptionally steep and the situation so requires, one has to proceed from the previously established strategic goals and try to continue to carry the tax burden over from labour force to consumption. Whether and to what extent it is possible to follow the line, depends on the degree of curbing expenditures.

Estonia has always operated a policy of low taxes. The country's rapid economic expansion shows it has been the right choice. Unfortunately, it is almost impossible to say whether and how much it would be possible to raise the current tax burden (about 33% to GDP) without weakening Estonia's long-term growth potential. Numerous research papers only show that in light of Estonia's income level the tax burden should be within the range of 30-40% of GDP.

But in addition to theoretical considerations, we should also look at the actual situation in the competing countries. In Latvia and Lithuania, the tax burden accounted for 29-30% and in Poland 34% of GDP in 2008. It is possible these countries will also have to increase taxes during the crisis, but certainly not as drastically.

In conclusion, there is no basis to claim for sure that raising the general tax burden by a couple of percentage points would have catastrophic consequences. At the same time, liabilities received by the Unemployment Insurance Fund have already been multiplied, which conflicts with both long-term strategic goals and the principles of taxation during a crisis. Consequently, only taxes related to consumption or pollution are the next possible options.

A moderate increase in excise duties is the most in line with the endorsed tax strategy. With demand being very low, this would not pose a threat to meeting the Maastricht inflation criterion, either. If the curtailment of running costs to the desired extent fails, it cannot be excluded that consumption taxes will be raised more (and maybe temporarily).

As to increasing non-tax revenue, including the sale of assets, such steps would definitely strengthen the financial standing of the state and augment reserves. The question is whether and how much the revenues from sales would improve this year's fiscal balance and to which extent these are in line with the development plans of different sectors.

Although any measure represents a compromise between long-term and short-term objectives, there is the threat that problems related to long-term sustainability receive currently too little attention. When measures related to the expenditures side are planned, decisions that increase liabilities in the future should definitely be avoided.

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