Overview of risks associated with financial forecasting and monitoring in the state's fiscal policy

Dear readers,

The overview that you are reading is a story of how we missed the target multifold when estimating the budget deficit in calm circumstances. This despite the repeated recommendations of experts and accumulating statistics which showed that scenarios different from the forecasts are becoming a reality. It is also a story of how the state fails to notice overspending in its own wallet before it is excessive and it's too late to do anything about it.

Now, the world has irrevocably changed and missing the target of 2018 and the sudden increase in the budget deficit unexpected for the Ministry of Finance may seem insignificant in the midst of the current cataclysms. But these days help to assess the recently widespread attitude that "reserves burn fuel to no avail" or that Estonia has a lot of room to borrow funds and this room should be used up immediately. The 208 million euros that was accidentally used in excess of what was planned in 2018 is nearly six times the amount that the government is currently spending on support measures for tourism and small businesses. We could really use those euros now.

Today, we can be happy that the central government still had reserves at the beginning of the economic crisis caused by the spread of the coronavirus – despite the sharp decline in funds in recent years. It's the reserves and the low debt burden that allow us to head into a deeper budget deficit with a lighter heart and borrow funds without fear that it would overwhelm us in the future.

Excessive boldness in relaxing fiscal rules and borrowing funds would have quickly led Estonia with its small economy into a situation faced by struggling countries that already find it painful and difficult to cope with the short-term crisis.

In times of economic crisis, fiscal measures appropriate for a crisis are entirely acceptable, including running a deficit in the state budget to support domestic demand. However, the requirement and need to plan the state budget as accurately as possible and monitor its substantive use have not gone anywhere. It has become even more important because the costs associated with extensive support measures implemented by the state and loans to be taken to cover the costs create future liabilities and new additional tensions in future budgets.

For years, the fiscal council, the Bank of Estonia and many experts have reiterated as a mantra that in good times we need to accumulate funds for crisis years. Unfortunately, the Government of the Republic did not have a plan to replenish the reserves in the recent years and big forecasting errors and spending needs led to the reserves running out. In 2018 alone, the minus of the central government in the liquidity reserve increased by nearly 180 million euros, reaching a record of 642 million euros. Only the reserves of the Estonian

Unemployment Insurance Fund and the Estonian Health Insurance Fund kept the liquidity reserve afloat.

The minus is a problem, but the bigger problem is when the minus increases accidentally. At least that was the case in 2018 unfortunately.

The Riigikogu election campaign took place in the first months of 2019, during which big and expensive promises were made, but in just a few days after the elections, the Ministry of Finance announced a rapidly expanding budget deficit. The difference between the central government's total state budget revenues and expenditures, known as the budgetary position, had exceeded the plan eightfold in 2018 – the minus was 237 million euros instead of the planned 29 million euros. It was only thanks to the local governments, the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund whose revenues exceeded the expenditures that the deficit of the entire general government sector was limited to "only" 120 million euros.

How did it happen that the central government spent 208 million euros more compared to the revenues in the state budget than was planned when preparing the budget in 2018? Another important question is how was such a significant deviation not noticed when assessing the implementation of the budget in the middle of 2018? On the contrary. In the last months of 2018, the Government of the Republic, despite the warnings of the fiscal council, even made decisions that further deepened the deficit in order to simplify the process of preparing the state budget for 2019.

In the post-election period, many observed opinions in the public space that it was the government's conscious pre-election spending policy as well as opinions that the government was aware of the higher negative budgetary position of 2018 already in the final stages of the election campaign but didn't want to talk about bad news and potential cuts before the election day. These suspicions were fuelled by the knowledge that both in the previous year and the following year, the information concerning the budgetary position had been published as early as in February.

The National Audit Office cannot confirm or refute these suspicions. In the course of drawing up the overview, the Ministry of Finance explained that the initial figures were determined at the usual time in February and were shared in a wider circle, but due to large differences compared to what was planned, the Ministry of Finance wanted to clarify the situation and assess whether there were any errors in the accounting.

According to the explanations of the Ministry of Finance, they did not receive any information in 2018 that would have indicated a larger-than-expected deficit and the need to make decisions to improve the situation. Warning signs were present already when preparing the summer forecast in July-August of 2018. Foremost the shortfall in the accrual of excise duties and corporation tax and the underuse of foreign subsidies could have indicated the need to prepare a more conservative financial forecast. However, the Ministry of Finance instead adjusted the accrual of total state budget revenues and the indicators concerning the general government sector to be more positive in its summer forecast. They even predicted a decent budget surplus.

The Ministry of Finance indicated the inability to assess the effect of changes to the excise duty on alcohol in 2017 as one of the main reasons for the big forecast errors in 2018 because forecasting trade at the South border was a new factor. The magnitude of the risk arising from tax changes was not entirely unexpected and it was referred to by the fiscal council that gave their opinion on the draft state budget for 2018, deeming the forecast of state budget revenues to be too optimistic, precisely due to the uncertainty arising from tax changes.

Inaccurate forecasts and inadequate monitoring of state budget revenues and expenditures are risks that the government needs to take into account in order to make responsible budgetary choices that have a long-term effect on the well-being of the state, the residents, and companies. Over the years, the economic forecasts of the Ministry of Finance have tended to be conservative and accurate. However, it is a concern that large deviations in the implementation of the budget are noticed only after the financial year has come to an end.

What could be the reason for this? The data and responses submitted to the National Audit Office in the course of drawing up the overview reveal that the Ministry of Finance does not sufficiently analyse the making of expenditures from the state budget on an ongoing basis. There is also no practice implemented for the responsible authorities of the area of government to monitor and inform the Ministry of Finance of expenditures that significantly exceed those forecast in the state budget. While the officials of the Ministry of Finance draw up monthly reports on tax accruals to the management board, the Government Office and the Prime Minister, this does not concern the current expenditures from the state budget and the matter is not discussed. Although the Ministry draws up a general report on implementing the budget every month, its purpose is to inform the public by publishing an expenditure table on the Ministry’s website.

When the ongoing monitoring of expenditure is in the background, it is no wonder that nothing is done in the event of deviations. The deviation is simply not noticed or is detected too late to do anything about it. In an interview with the auditors, it was pointed out that the ongoing monitoring of state budget revenues and expenditures generally gets no attention in the country because the focus is on planning subsequent state budget strategies and state budgets. Unfortunately, that does seem to be the case.

It has been very clear in many audits carried out by the National Audit Office that the Ministries put a lot of energy into budget debates that focus on obtaining additional funds for subsequent state budgets when dealing with the money available to the state. There is much less energy left to assess the use of the allocated funds and the substantive implementation of the budget. What is already in hand stays in the background. The latest illustrative example was the audit on major investments where in many cases our auditors found it difficult to obtain accurate information about the cost of major investments. Because it apparently no longer mattered. It was the past. It is usually much easier to obtain information from the Ministry about how much money the Ministries estimate is lacking.

On the other hand, it is much more difficult to obtain structured information about how much money has been used for this or that project, activity or object and what has been achieved with the funds. However, money should be counted both when applying for funds as well as when using it. It is up to the Ministry of Finance to ensure this. The recipe is not complicated. There is no need for extensive development of information systems or the eventual implementation of the activity-based budgeting reform. There is enough information available now, too. It just needs to be used and conclusions must be drawn from this information.

Monitoring state budget expenditures during the financial year needs to be given more importance in the management of public finances. Counting money accurately is not important to those who have too much of it, those who don’t care, or those who just don’t know how to. I do not want to believe that we in Estonia are in the first, second or third situation.

But there’s room for improvement elsewhere, too. For example, in connection with collecting source data necessary for forecasting state budget revenues and monitoring the ongoing accrual of revenues. At the end of the overview we have put together 20 questions that we believe need to be answered in order to mitigate the risks in preparing the economic and financial forecast and monitoring the state budget revenues and expenditures. I am sure that once the questions are answered and the answers are addressed, the state’s finances will be even stronger than before, and this will help us be prepared for future crises which we certainly will have to face. The exchange of information with the Ministry of Finance shows that there is willingness to do so.

The crisis proves how important it is to keep the public finances in order and how rapidly buffers and reserves that might be enough to last for years in normal situations could decrease. We must be prepared for all this and continuously develop the backend of making state budgetary decisions – to maintain the ability to forecast and monitor the revenues and expenditures.

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