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Estonia's New Government Faces Challenges in Stabilising Debt

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Fitch Ratings-Frankfurt/London-18 April 2023: The fiscal plans of Estonia's (AA-/Negative) incoming government seem insufficient to stabilise the debt burden, Fitch Ratings says. Several years of rising current spending have widened the deficit, while a worsening economic outlook, higher defence spending and rising interest rates point to a significantly looser fiscal stance than in the years before the pandemic, despite the introduction of some revenue-raising measures.

Following five weeks of negotiations, the centre-right Reform party, which secured 31% of the vote in March's general election, announced a coalition agreement on 7 April with two junior partners: the centrist Estonia 200, which won Parliamentary seats for the first time, and the centre-left Social Democrats. The new coalition has a comfortable majority, with 60 out of 101 seats. Reform, led by Prime Minister Kaja Kallas, and the Social Democrats were also part of the outgoing coalition, along with the conservative Isaama party.

The cornerstone of the coalition agreement is a substantial increase in military expenditure to 3% of GDP over the next five years from 2.2% of GDP in 2021. The agreement also confirmed a full transition to Estonian-language education by 2030, at an estimated cost of EUR300 million (0.8% of GDP) over the next four years. Both these

measures were included in the 2023 budget and should not lead to additional spending.

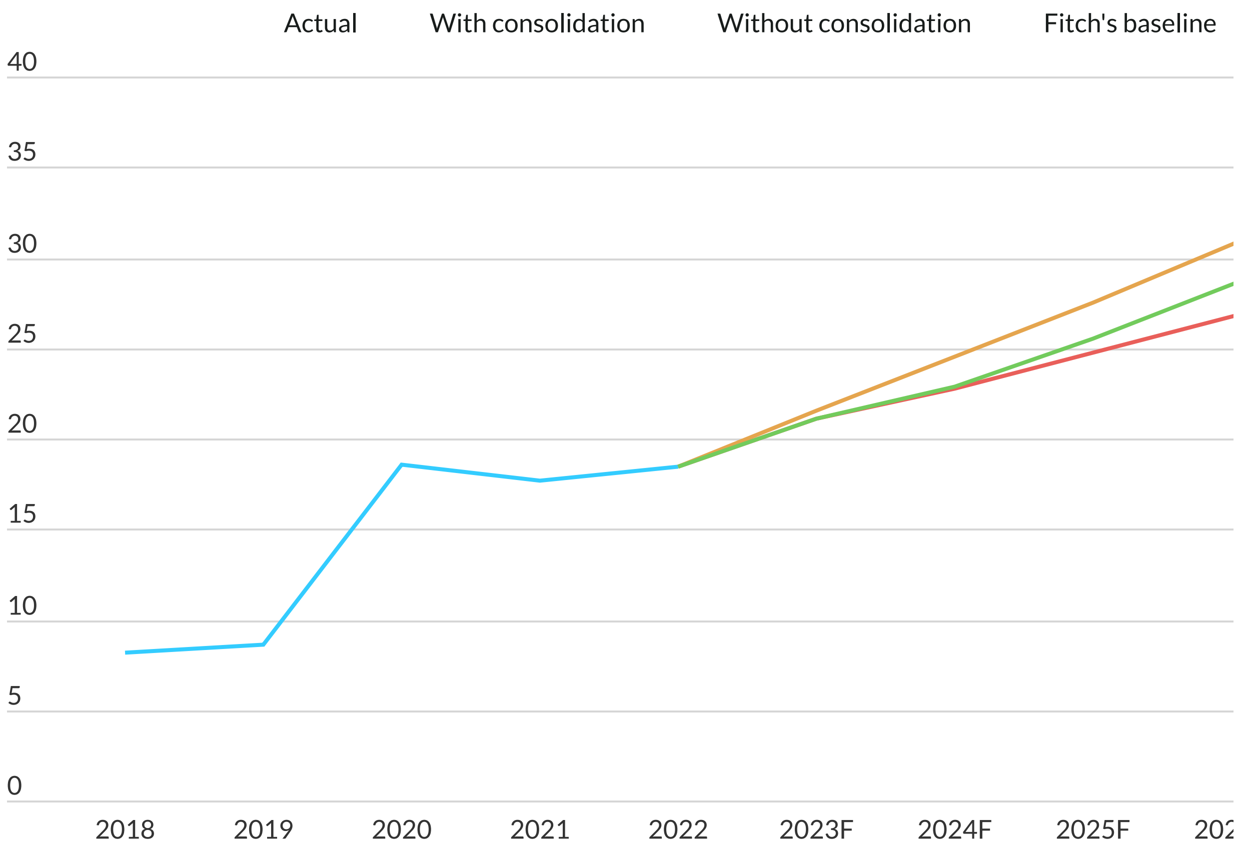
However, the most recent fiscal projections of the Ministry of Finance, released on 6 April, which incorporate the 2023 budget measures and updated macroeconomic forecasts, point to a substantial widening of fiscal deficits over the next five years, to an average of 4.2% of GDP. This contrasts with Estonia's broadly balanced fiscal position in the years leading up to the pandemic.

The wider deficits largely reflect the ongoing impact of a substantial increase in current spending over the past five years, including several rounds of extraordinary pension rises and an increase in publicly financed salaries in priority areas. Most recently, the outgoing government increased family allowances and spending on defence and education as well as raising the tax-free income threshold.

A less supportive economic backdrop will also weigh on Estonia's public finances. The Ministry of Finance now expects the economy to contract by 1.5% in 2023 after it shrunk 1.3% in 2022 with long-term annual growth of 2%-2.5%. This would be about half of the average in the five years before the pandemic. The rising cost of servicing a larger debt stock will also add to spending, with the Finance Ministry projecting interest payments at 1% of GDP by 2027 from 0.1% pre-pandemic.

The new coalition has announced plans to fund part of these spending increases. It has tabled a 2pp increase in VAT from 2024 to 22%. Some VAT exceptions will be removed and a new car tax introduced. The new Finance Minister, Mart Vorklaev, said the government aims to limit the 2024 budget deficit to 3% of GDP and keep it at that level in the coming years.

However, this would not stabilise the debt trajectory. Fitch's baseline projections, which assume slightly better economic and fiscal outturns than the Finance Ministry's updated forecasts, see debt/GDP increasing to 31.5% by 2027. In a scenario with stable fiscal deficits at 3% of GDP, debt/GDP still rises to 28.7%, up from only 8.5% before the pandemic.



Debt/GDP is still far below the ‘AA’ category median (48.4% of GDP in 2022), but low government debt provides important fiscal space to accommodate shocks for a small and open economy like Estonia.

The quality of fiscal policies and the debt dynamics will be important for the future direction of the sovereign rating. A significantly higher government debt/GDP reflecting persistently loose fiscal policy was among negative rating sensitivities identified at our most recent rating review in February.

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