Fiscal Council

Fiscal Outlook and Challenges in Estonia

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Introduction

Who we are?

- 6 members
- 3 staff (located at the central bank)

What we do?

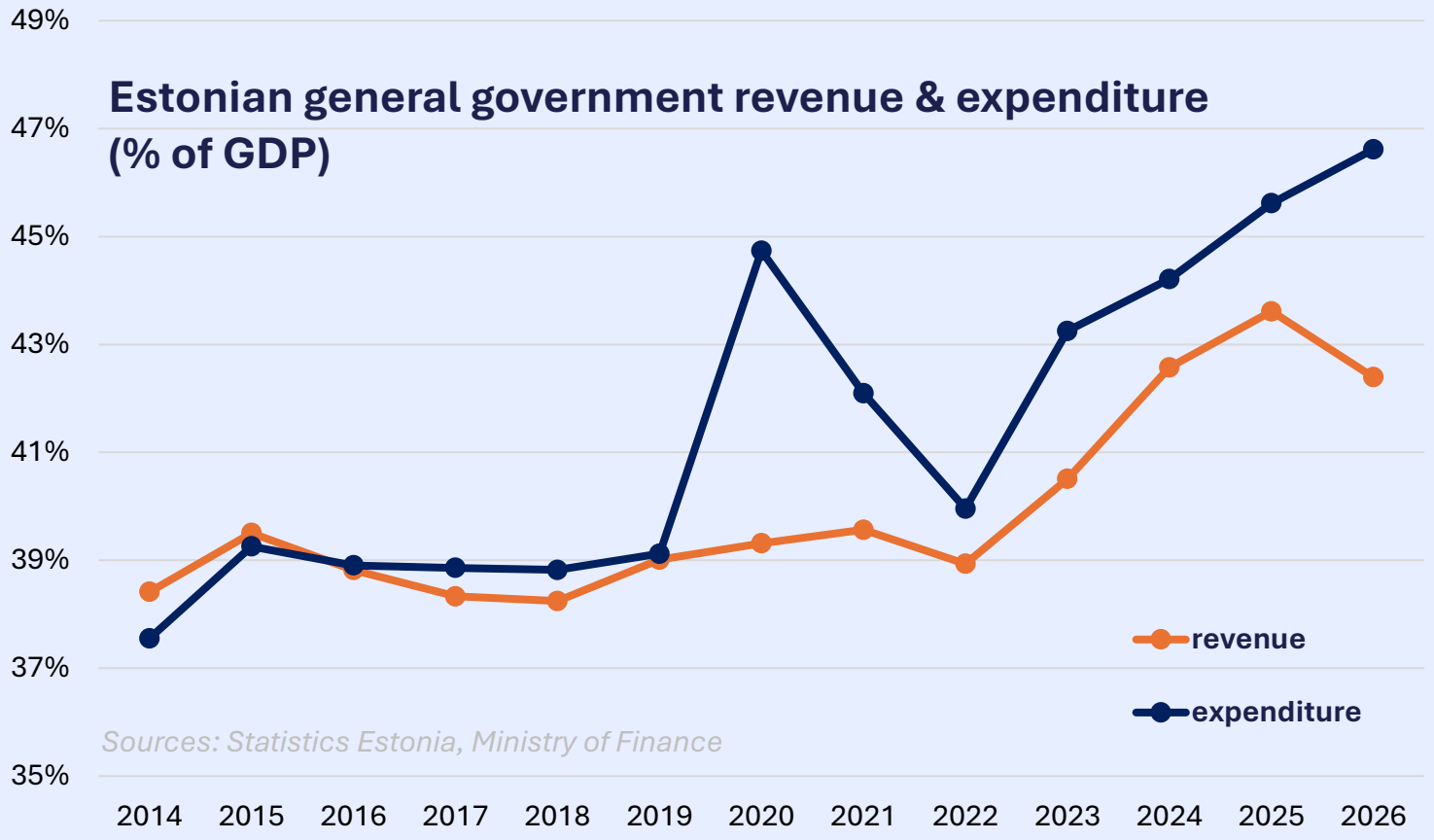
- Assessing official macro & fiscal forecasts
- Assessing compliance with national & EU fiscal rules
- Contributing to public discussions on fiscal policy

Main signposts

- Challenging external environment and many recently introduced tax changes complicate forecasting
- Overly flexible EU fiscal rules and suspended national fiscal rules have contributed to worsening fiscal outlook
- Still one of the lowest debt-to-GDP ratios in EU (as well as globally)

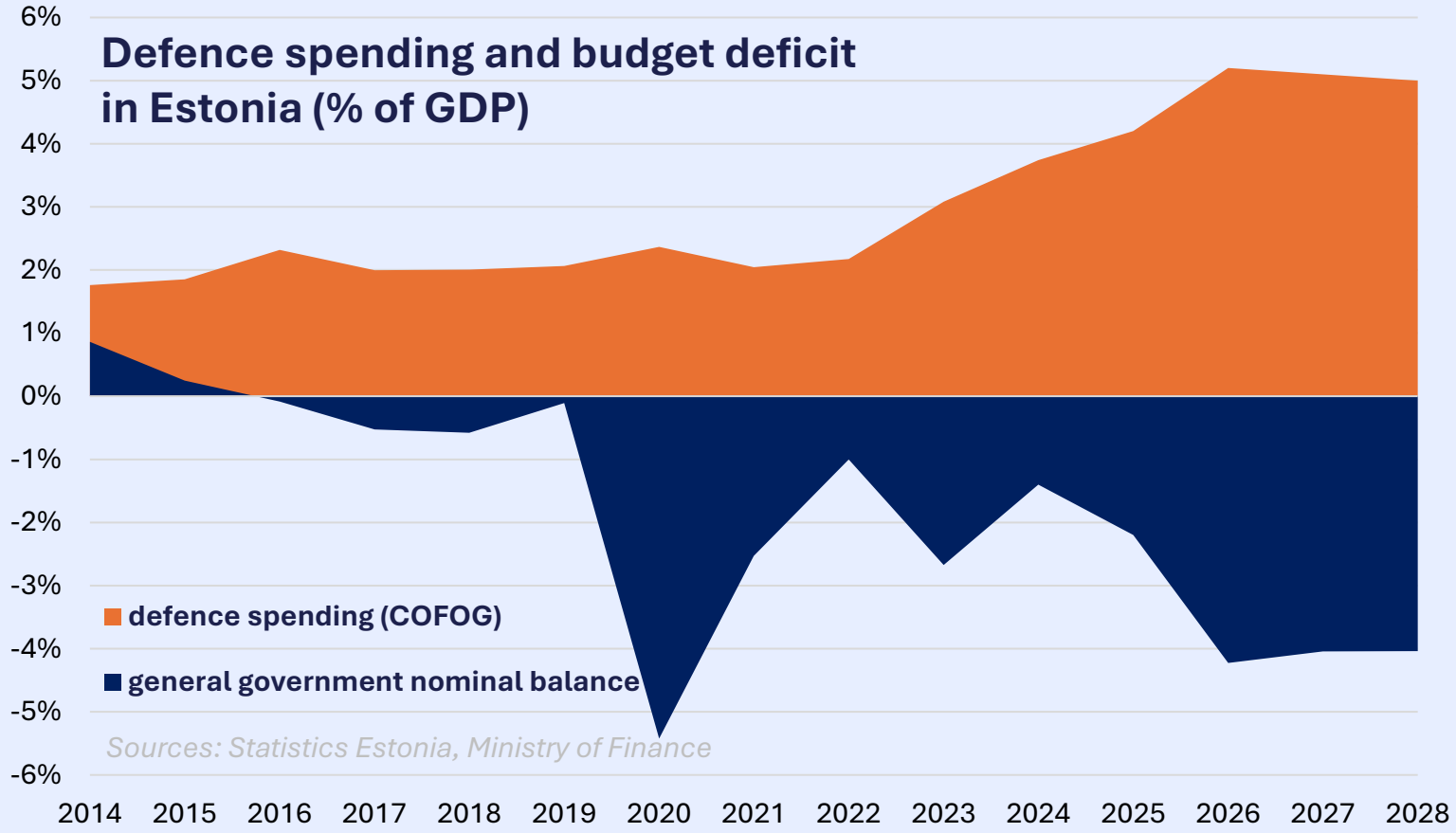
Large and permanent budget deficit opens up in 2026

- Continued increase in defence spending (& other cost pressures) leads to record-level government expenditure.



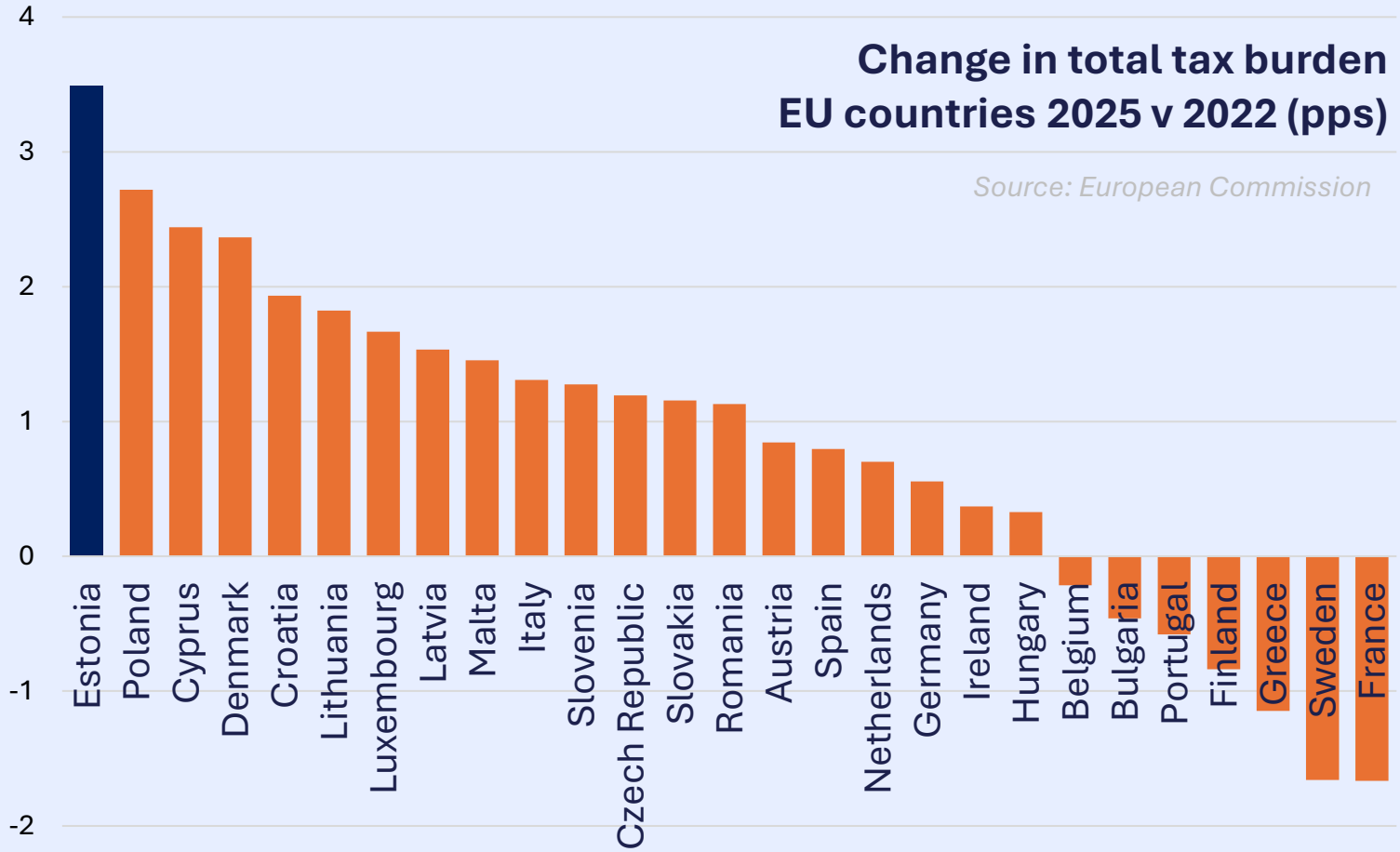
Budget deficit outlook mirrors the increase in defence spending

- Current near-term target for defence spending is 5% of GDP.
- Flashing warning signs: from close-to-balance budgets to crisis-induced deficits to a permanent deficit?



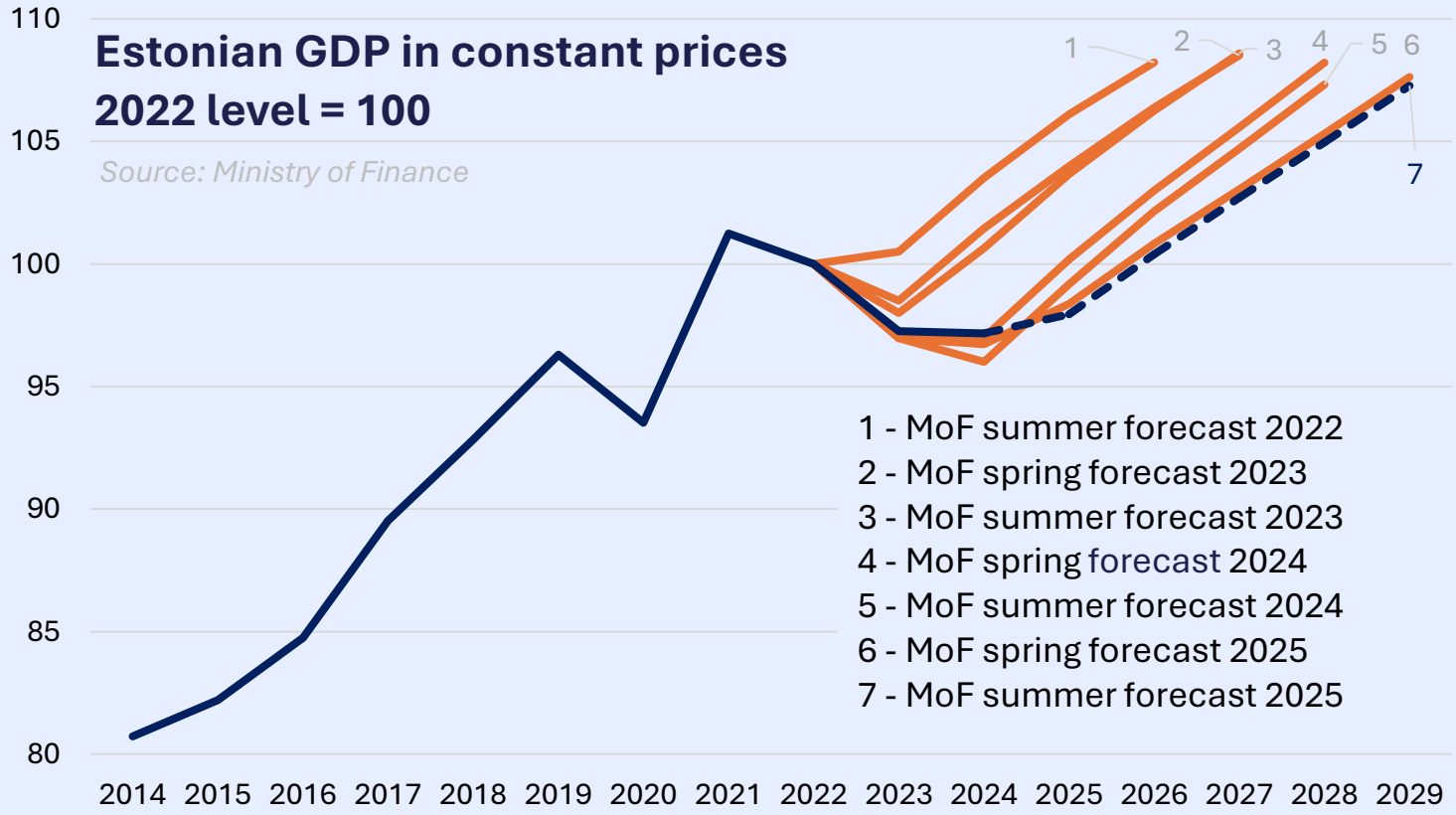
Initial increase in defence spending coincided with fiscal consolidation

- Several tax hikes and some cost-cutting introduced in 2024–2025 to meet 3% deficit target.
- The EU national escape clause for defence was a game-changer in Estonian fiscal policy.



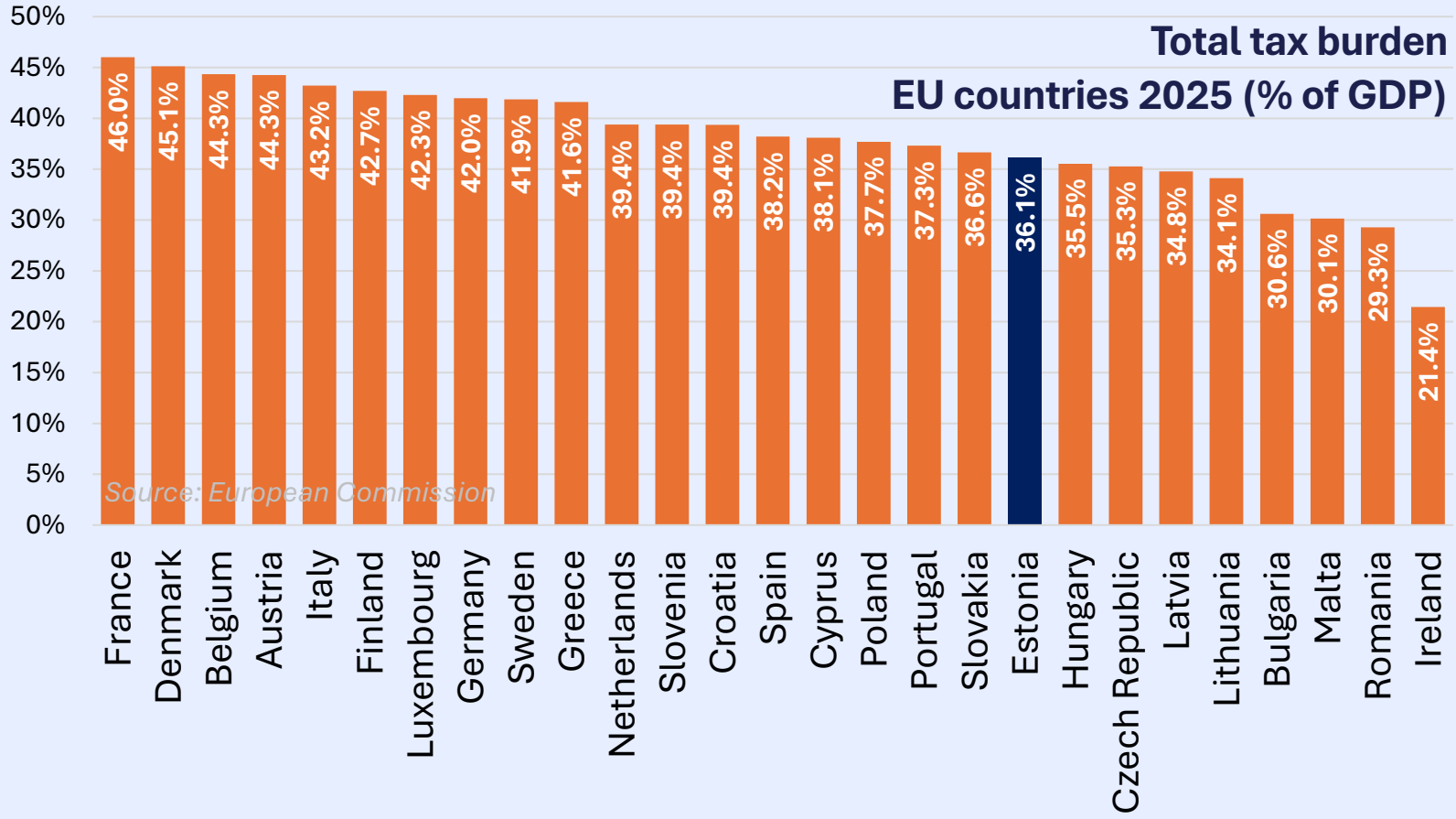
Fiscal consolidation in times of slow growth has been a challenge

- Consolidation measures relied heavily on the revenue side, with major tax hikes felt by all.
- At the same time, real economic growth did not pick up as expected & inflation remained higher for longer, proving those measures to be highly unpopular.



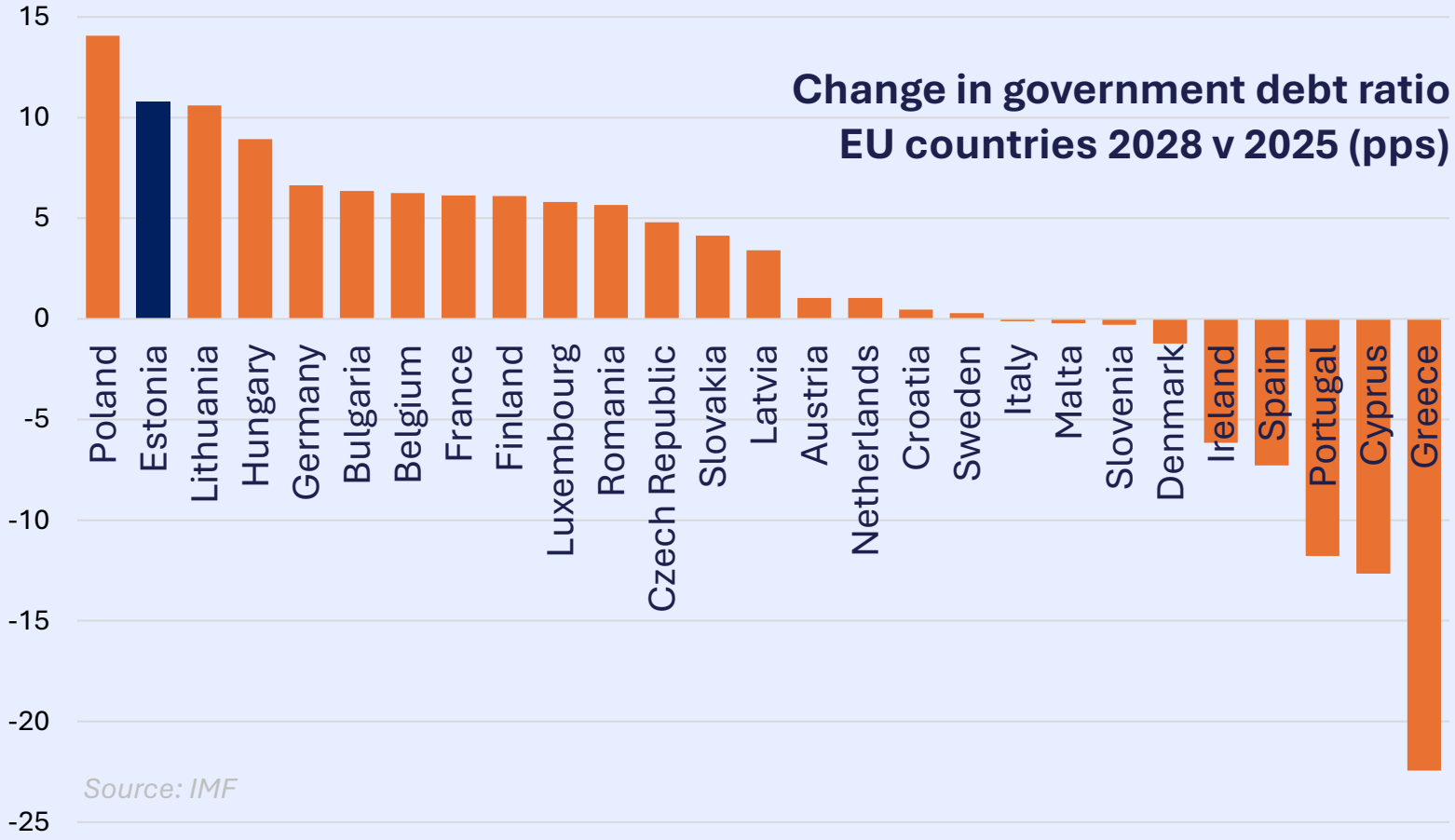
Tax burden remains relatively low even after fiscal consolidation

- Even after major tax hikes in 2024–2025, tax burden in Estonia has remained relatively low compared to EU countries.
- Several tax policy changes after 2025 have been revenue-decreasing.



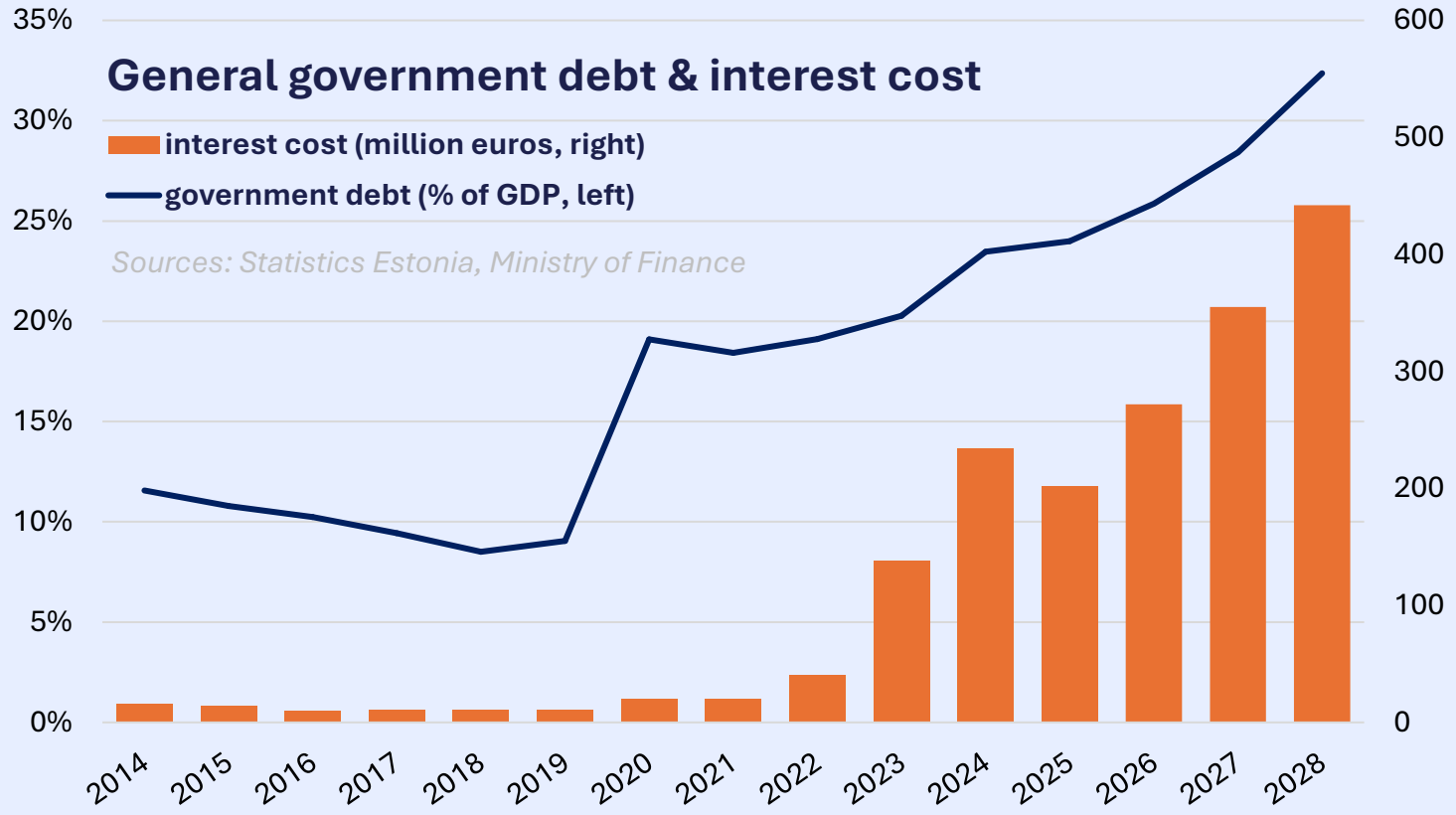
Financing defence spending has shifted from taxes to borrowing

- Estonia intends to use the maximum flexibility offered by the EU escape clause.
- Higher defence spending is now mainly debt-financed with no fiscal adjustment plan in sight.



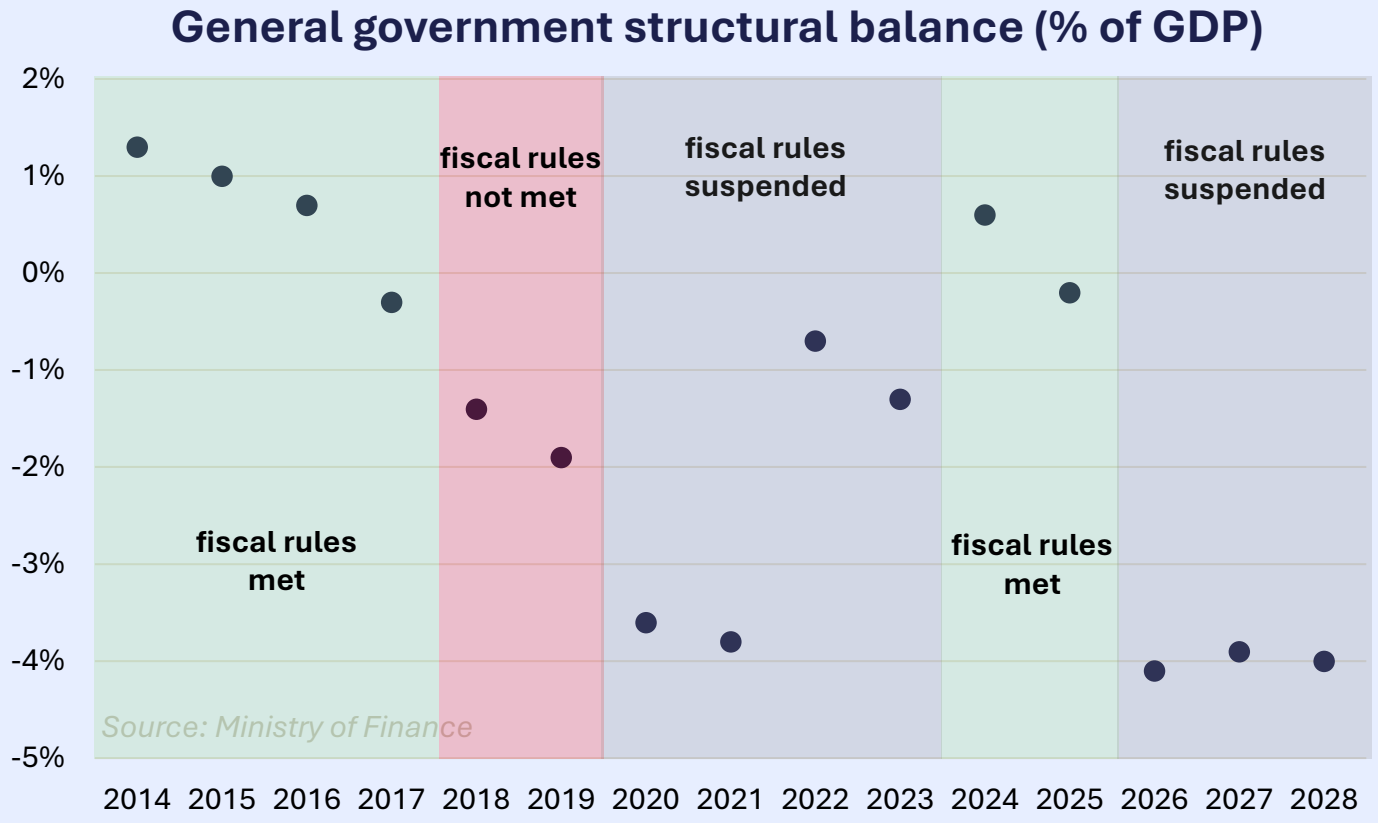
Luckily for Estonia, debt build-up has begun from very low levels

- Due to conservative fiscal policy in the past, debt-to-GDP ratio has only reached 26%.
- Low debt burden can provide breathing space to absorb shocks, but this advantage can disappear very fast.



National fiscal rules have not held up in the current decade

- National fiscal rules introduced in 2014 required an annual structural balance.
- Since then, rules have been either relaxed (2018, 2024) or suspended (2020–2023, 2026–2028…) several times.



Conclusion

- Financing a rapid increase in defence spending with a relatively low tax burden is very challenging.
- New permanent sources of funding are needed for a permanently higher defence spending.
- Flexibility offered by the EU escape clause has allowed to ramp up defence spending, but also to:
  - suspend ongoing fiscal consolidation;
  - suspend the requirements of national fiscal rules;
  - and to postpone the needed fiscal adjustment.
- Even after the escape clause, EU rules will not be enough to keep Estonian government debt under control. Fiscal Council has been arguing for the importance of stricter national fiscal rules and their early re-introduction.