PUBLIC FINANCES

Pace of debt growth disquieting

18 Dec 2015 – Assessment of Public Finances – Finnish economy

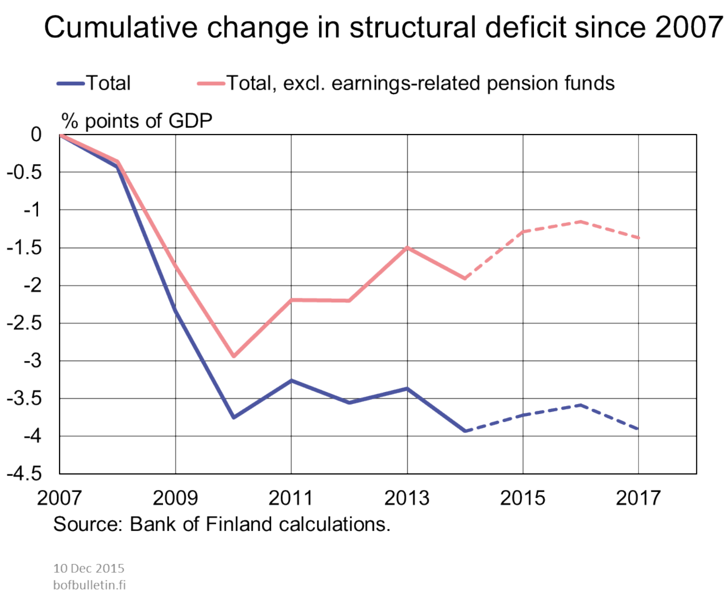
The prolonged recession in the Finnish economy has been directly reflected in the public finances, which have posted a deficit for 6 years already. In 2017, the public debt will rise to over 68% of GDP, which is more than double the level recorded in 2008. Given that the longer-term outlook for Finnish economic growth is poor due to the prolonged recession, a dwindling working-age population and industrial restructuring, the upward trend in public debt is disquieting.

Achievement of Government objective uncertain

The new Finnish Government's objective is to halt the upward trend in the debt ratio during the government term and put an end to growth in euro-denominated debt by 2021. To underpin these objectives, it was agreed in the Government Programme to consolidate the public finances by around EUR 4 billion during the government term. According to the Bank of Finland forecast, it is uncertain whether either of the objectives will be achieved.

Even though the previous Government already applied fiscal policy in an effort to consolidate the central government finances, Finland's public finances have deteriorated in tandem with the overall subdued condition of the economy. Despite higher taxation, tax revenue has grown more sluggishly than expenditures. Growth in social benefits and allowances has been fuelled not only by higher unemployment but also by the continued brisk pace of pension expenditure growth. Finland's fiscal stance has remained fairly neutral relative to the business cycle since 2013 (Chart 1). Measures to tighten central and local government finances will be offset in 2015, in particular, by a growth in earnings-related pension fund expenditures due to an increase in the number of pension recipients.

Chart 1



Comparisons show that the trend in Finland's public finances diverges from European developments. The general government deficit has remained within the limits of the Stability and Growth Pact, with the exception of the outcome for 2014. However, when earnings-related pension funds are excluded, Finland's public finances have deteriorated in recent years and are now among the weakest in the euro area. The large surpluses on the pension funds have masked the deep deficits in central and local government finances. In addition, the central and local government deficits have remained fairly unchanged in recent years, while general government finances elsewhere in Europe have improved on average.

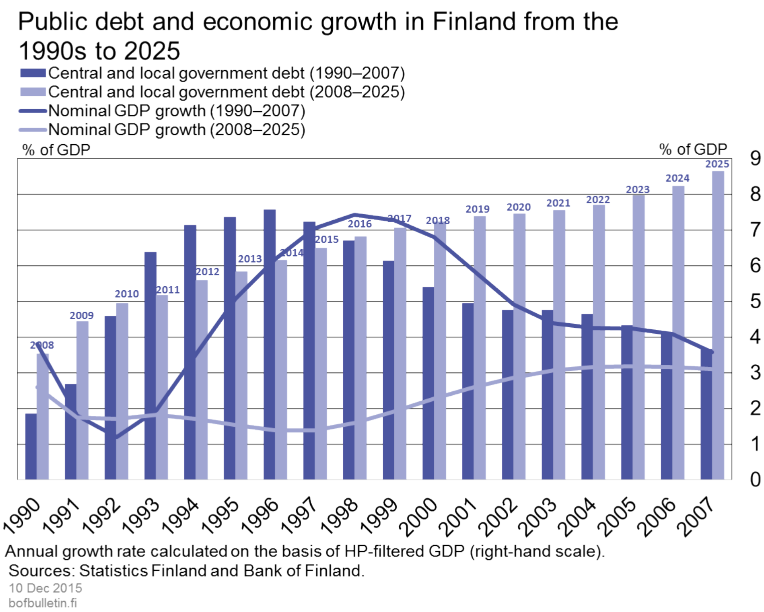
The General Government Fiscal Plan sets targets for nominal budget balances for the different general government subsectors. The deficit target for central and local government for 2019 is 0.5% of GDP, at maximum. The target for the earnings-related pension funds is a surplus of 1%, and for other social security funds a balanced budget. The targets for the earnings-related pension funds and other social security funds seem to be achievable. The local government target is also attainable, on condition that the planned revenue-increasing measures will be fully implemented and municipal expenditure growth can be slowed. The central government target, for its part, is ambitious and may necessitate further measures to consolidate expenditures if the tax rate is not increased as indicated in the Government Programme.

Slow economic growth hampers efforts to reign in pace of debt accumulation

The general government debt-to-GDP ratio in Finland will rise to over 60% in 2015. Even though the debt level is still moderate in European terms, the upward trend is disquieting. Debt growth has come to a standstill or has even begun trending downwards in several euro area countries. Finland's situation is difficult because of the challenges brought by the current economic recession and restructuring, but also because of the weaker longer-term growth outlook due to a dwindling working-age population and more muted productivity developments. Fiscal sustainability is also eroded by growing age-related expenditure and high structural unemployment.

A comparison with the situation during the recession of the 1990s sheds some light on the difficulties involved in debt management (Chart 2). Public debt[1] grew rapidly in the 1990s, peaking at over 75% of GDP in 1996. It took 12 years after that until the debt ratio had been reduced to 35% (in 2008). The adjustment phase was shorter in the local government sector, with municipal debt accumulation turning up again at the turn of the millennium. In the immediate post-millennium decade, debt grew by around 5% of GDP, and the share of local government in total public debt more than doubled. The rapid growth in municipal expenditure is also evidenced by the fact that the average municipal income tax rate rose by 2 percentage points in 1996–2008, even though the total tax ratio of the economy declined by almost 5 percentage points.

Chart 2



The decline in the debt ratio was supported by robust economic growth. In 1996–2008, nominal GDP grew at an average rate of 5.6% per annum. Given that GDP growth is

1. Non-consolidated EDP debt.

expected to remain at 1–1.5% in real terms in the next few decades and age-related expenditure continues to increase rapidly, stabilisation of the debt ratio will require substantially more sizeable consolidation measures than to date. At the same time, the room for manoeuvre in taxation has narrowed sharply.

Fiscal consolidation is more difficult than before also because inflation is slow. In an environment of subdued inflation, the freezing of index increases, for example, does not bring about a rapid correction in the expenditure structure, and revenue growth also remains sluggish. In addition, slower growth in nominal GDP makes it more challenging to correct debt relative to GDP.

The long-term outlook for the public finances is weak. According to the Bank of Finland's assessment, the long-term sustainability gap[2] in Finland's public finances is around 3½% of GDP, a good half of a percentage point less than a year earlier. The forecast for the sustainability gap edged down particularly due to more precise impact assessments of the pension reform. Compared with the current system, the pension reform will result in a rising number of persons employed and, correspondingly, in a lower number of pensioners. The sustainability gap assessment was also slightly lowered by a new population projection.

Despite the lower assessment of the sustainability gap, the consolidation measures for the immediate years ahead are substantial. It can be mechanically calculated that, to stabilise the debt ratio in the long term at around 60%, central and local government budget balances should be strengthened by as much as 6% of GDP in the 2030s. As a benchmark for the calculation, we can take a scenario that includes no consolidation, in which case public debt would exceed the value of GDP in 2029. (Chart 3). In practice, the consolidation efforts would need to be even more sizeable, since the negative growth effects from fiscal tightening have not been taken into account here.

The strong growth in immigration in 2015 will increase public expenditure in the short term but may, in the longer term, lead to higher employment, thereby strengthening the public finances (see the article on the impact of immigration). Funds allocated to immigration in the Budget will be tripled to 0.3% of GDP in 2016. In the budgetary planning period 2016–2019, the costs of social integration are estimated to grow further. The forecast assumes the increase in immigration resulting from the current refugee situation to be temporary, so that it will have no practical impact on fiscal sustainability in the long term.

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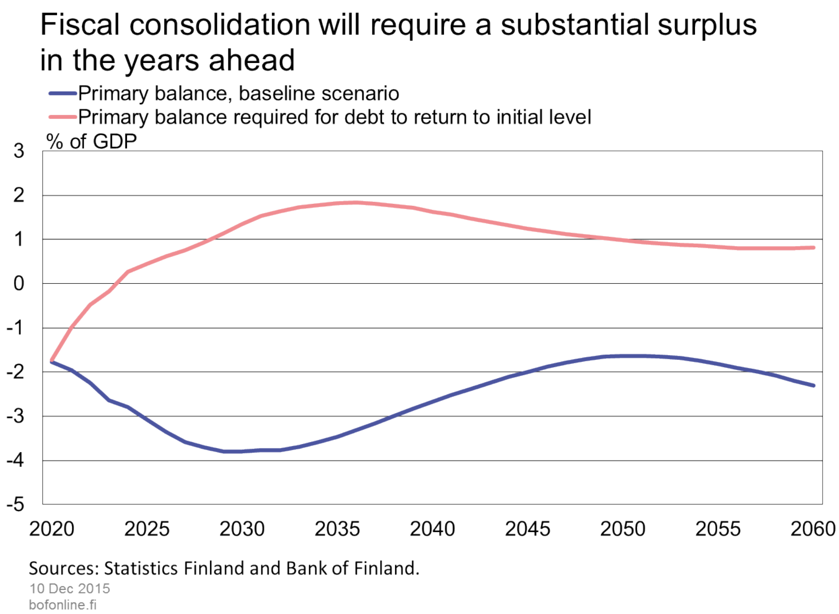
2. The sustainability gap forecast is based on Statistics Finland's newest population projection and the Finnish Centre for Pensions' assessment of the impact of the pension reform on the number of pension recipients and on employment.

Chart 3



In addition to the pension reform, the structural reform of social welfare and health care services occupies a key role in narrowing the sustainability gap. This is intended to generate savings of EUR 3 billion in the public finances by the end of the 2020s. As the reform pursues cost savings, particular attention in the planning phase should be paid to the mechanism by which the savings are to be generated. Concrete savings can be created primarily by defining the public service promise in accordance with the savings objective. Financial benefits achieved via improved productivity materialise gradually and are, in any case, difficult to quantify in advance. From a financial perspective, it is also important to ensure that the new system and its financial balance-related objectives fall within the fiscal governance framework.

Besides central government borrowing, other financial commitments of central government have also increased rapidly in recent years. Guarantees to Finnvera have increased, in particular, as have state-guaranteed housing loans. The increase in commitments does not automatically mean higher expenditure in the future, but such a risk has inevitably increased. Even though guarantees (for example) may be an efficient way to support corporate activities in an event of financial market disruptions, it is difficult to justify the state's involvement in risk-bearing by businesses in normal times. The focus of the EU fiscal governance framework on real-terms national accounts may otherwise encourage such conduct that budget expenditure is converted into financial transactions. An example of this is the partial capitalisation of budget-funded development aid. It would be advisable to pay attention to the selection of the most appropriate funding form for the activity being financed.

Tags

debt accumulation