Assessment of public finances in December 2016

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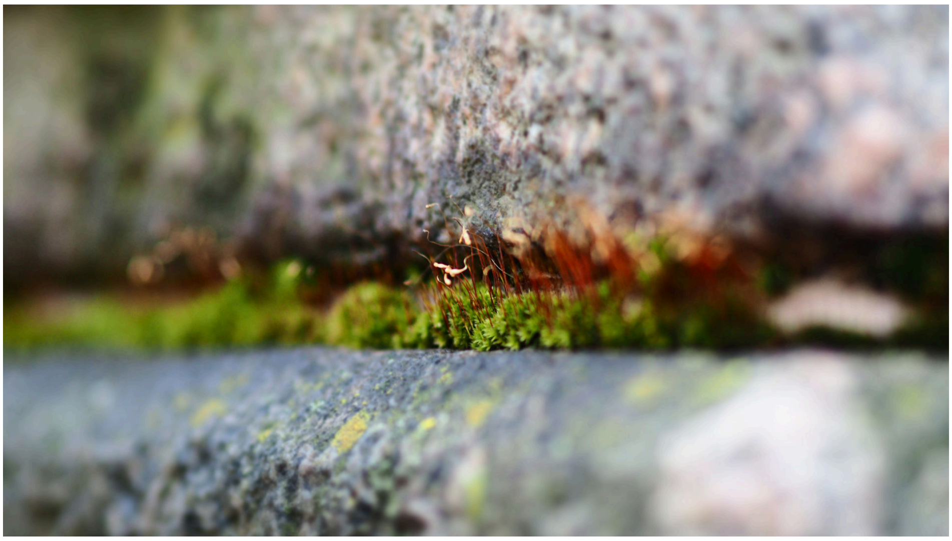
Finland's fiscal situation is challenging. The general government deficit is still high, and public debt is on an upward trend. Attainment of more balanced public finances is hampered not only by high unemployment-related and other social security expenditure but also by rapid growth in age-related spending and low economic growth. Therefore, the problems with public finances cannot be explained by cyclical factors alone. Rather, there is a significant and long-term structural problem with Finland's public finances. The public debt problem makes the Finnish economy more vulnerable to global economic disruptions.



The structural balance will not improve in the next few years

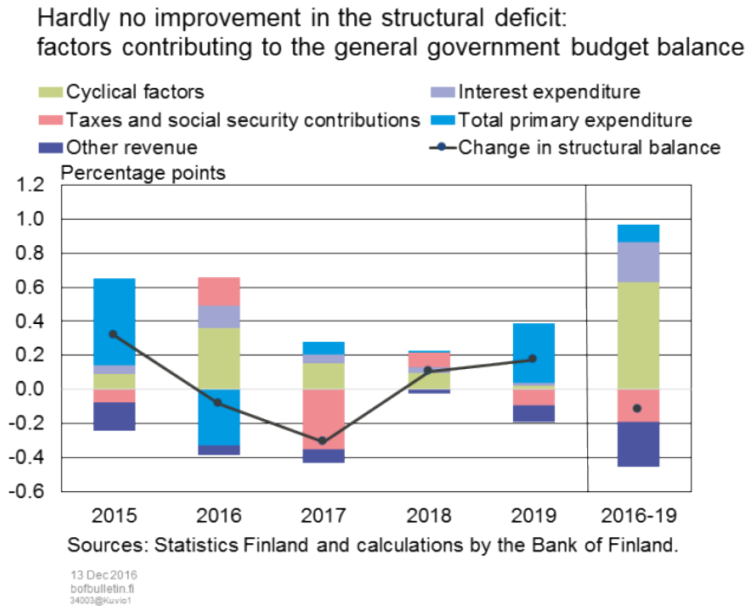
Finland's general government structural balance[1]deteriorated significantly in 2009, when fiscal policy was used to smooth the deep economic recession. As economic growth picked up in 2011, fiscal policy was tightened and the general government budget balance improved substantially. The following year, however, the Finnish economy drifted into a new three-year downturn. In the last year of the downturn, in 2014, Finland's general

1. The European System of Central Banks (ESCB) estimates structural budget balances adjusted for cyclical factors using a statistical methodology based on the Hodrick-Prescott (HP) filter. The European Commission estimates structural developments on the basis of the production function approach related to the modelling of economic activity. See Bouthevillain, C. – Cour-Thimann, P. – Van den Dool, G. – Hernández de Cos, P. – Langenus, G. – Mohr, M. – Momigliano, S. – Tujula, M. “Cyclically adjusted budget balances: an alternative approach”, ECB Working Paper Series No 77, September 2001. For a structural analysis of revenue and expenditure, see Kremer, J. – Rodrigues Braz, C. – Brosens, T. – Langenus, G. – Momigliano, S. – Spolander, M. “A disaggregated framework for the analysis of structural developments in public finances”, ECB Working Paper Series No 579, January 2006.

government deficit temporarily exceeded the 3% reference value set for deficit in the EU's Stability and Growth Pact.

In 2015, the deficit declined in response to expenditure adjustments (Chart 1). The number of public sector employees contracted and public investment was reduced. Growth in pensions and other social benefits slowed notably, as index increments were restricted to accord with the centralised wage agreement. In 2016, economic growth is already contributing more strongly to improving the nominal budget balance. Increases in social insurance contributions are also having a positive impact on public finances. In addition, interest payments on public debt are declining further. Growth in primary expenditure, however, is weakening the structural balance. The impact of expenditure adjustments is compensated by the Government's investment in its key projects and spending allocated to managing the refugee situation.

Chart 1.



In 2017, the general government structural balance will weaken due to lower taxes and social security contributions related to the Competitiveness Pact. The Competitiveness Pact will weaken the general government budget balance by around EUR 1.2 billion in 2017. In addition to income tax cuts of over EUR 500 million promised in the Pact, tax revenue will be affected by the tax-deductibility of social security contributions and structural changes to employees' health insurance contributions.

Ministry of Finance calculations show that over the longer term, however, the Competitiveness Pact will have a neutral impact on the general government budget balance if it results in an increase in the number of employees by 40,000. The employment effect is uncertain, however. A strong one-off tax reduction therefore poses a risk to public finances, even though the tax measures are justified from the perspective of lending support to household purchasing power and economic growth.

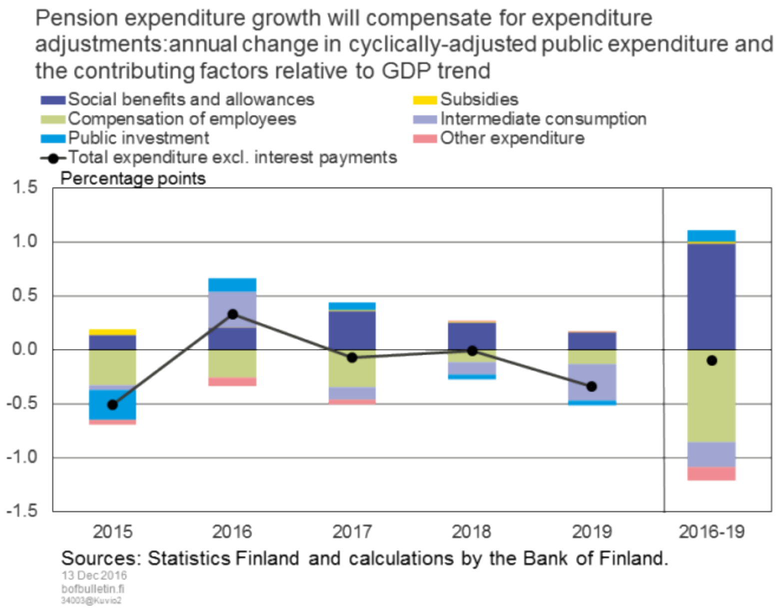
Since the forecast period extends to 2019, it is possible to make a preliminary analysis of fiscal policy for the whole parliamentary term (2016–2019 in Chart 1). According to the

Bank of Finland forecast, fiscal policy appears to be neutral or to ease slightly during the parliamentary term, because expenditure savings taken into the forecast to date are insufficient to reduce the structural deficit close to the level necessitated by longer-term sustainability.

Expenditure growth is particularly fuelled by continued brisk growth in social benefits – mainly pensions – during the forecast period on the back of an increase in the number of pension recipients (Chart 2). Population ageing in years of subdued economic growth has increased the challenges relating to the adjustment of Finland's public finances. The contribution of pension expenditure to the weakening of the budget balance in 2008–2015 totals 2.8 percentage points. In 2016–2019, the contribution is 1.1 percentage points in cumulative terms. This would require a corresponding increase in revenue or cuts in other expenditure to maintain the structural deficit at its current level. Growth in social benefits has partly been cyclical, due to increased reliance on unemployment benefits and social assistance following the economic downturn. Even though the forecast points to a decline in unemployment in the years ahead, it is again likely that some of the unemployed will be faced with long-term or permanent unemployment. This is also problematic for public finances.

Public expenditure cuts will focus in the coming years on public labour costs, in particular. The number of public sector employees has declined since 2014, and this trend is also projected to continue in future. In addition, the reduction in employers' social security contributions agreed in the Competitiveness Pact will be financed by a temporary reduction in public sector holiday bonuses in 2017–2019, and the impact on labour force requirements of the agreed extension of working time will be taken into account in budget appropriations. To contain public expenditure growth, it is important to improve public sector productivity. In this respect, the social and health services (SOTE) reform is subject to high expectations.

Chart 2.



The Bank of Finland forecast does not take into account the impact of the SOTE reform on the general government fiscal balance for 2019; the impact is assumed to be neutral. The SOTE reform seeks to permanently strengthen public finances by EUR 3 billion. The target is intended to be attained by reducing annual growth in public expenditure to below 1% in 2019–2029. The average annual real growth in health care expenditure was around 5% in 2000–2009, and since 2010 the annual growth rate has still been 2%. Over time, the target will become increasingly difficult to achieve, taking into consideration ageing baby-boomers and increasing demand for health care services.

In the shorter term, there is a risk that public expenditure will increase due to the fully new governmental level (counties) to be created in the SOTE reform on the basis of the existing division into regions. Centralising the organisation of services at a level above municipalities may improve governance and enable better control of funding. Stronger participation of the private sector in the provision of services and competition between private and public services provision could improve operational efficiency. Competition is intended to focus on the quality of services, and government would set the prices of services. This enables better cost control, although there are also problems relating to quality control. Expenditure growth could also be restricted by scrutinising the content of the service pledge.

The EU's model student at risk of failing

Except for 2014, Finland has been in compliance with the reference value of 3% set for nominal deficit in the corrective arm of the Stability and Growth Pact (SGP). According to the SGP's debt criterion, public debt should not exceed 60% of GDP. Even though the debt ratio exceeded the reference value in 2014, Finland was deemed not to be in breach of the criterion due to weak cyclical conditions. According to the European Commission, cyclically-adjusted, the debt criterion will, however, be breached in 2016. If the reference values are breached, then an overall assessment is made, after which an excessive deficit procedure (EDP) can be launched for the country in question. In an EDP launched due to a breach of the debt criterion, an annual target is set for returning the debt ratio to below 60% of GDP. The annual reduction target is 1/20 of the part of the debt exceeding the reference value.

The aim of the preventive arm of the SGP is to steer general government finances towards a sustainable balance by setting a medium-term budgetary objective (MTO), in structural terms, and an adjustment path towards that objective if it is has not yet been achieved. The MTO set for Finland's structural balance is −0.5% of GDP. As the Finnish economy has begun to grow, the required annual adjustment towards the MTO has been tightened.

The required progress towards the MTO can be postponed during an economic downturn, but in times of normal economic growth the structural balance should improve by at least 0.5 percentage point per annum. If the required improvement is not achieved or a country deviates from it by more than 0.5 percentage point[2], a Significant Deviation Procedure (SDP) may be launched. The adjustment targets set for Finland's

2. Or 0.25 percentage point on average in two years.

structural balance is 0.5 percentage point in 2016 and 0.6 percentage point in 2017. Considering the Government's budget proposal and the current economic situation, it is very likely that Finland will not meet the targets as such. This does not, however, automatically trigger the SDP.

In addition to the structural budget balance, the preventive arm of the SGP also examines public expenditure growth relative to potential output growth. Expenditure growth in Finland has remained below the reference value in the past few years, but for 2017 it is uncertain whether this criterion can be fulfilled, either.

On 16 November 2016, the Commission issued an opinion on Finland's draft budgetary plan. The Commission was of the opinion that the 2017 budget is at risk of non-compliance with regulations. Structural reforms implemented by the Government were not regarded as allowing flexibility as regards the adjustment path towards the MTO. Hence, the structural balance would need to be improved by at least 0.6 percentage point relative to GDP in 2017. The achievement of the target set for 2016 will be assessed in spring 2017. For 2016, the Commission will take into consideration the unexpected expenditure related to the refugee situation, which for Finland amount to 0.3% of GDP.

On the basis of forecasts, it would appear that the target for 2017 will not be reached without additional measures. The tax reduction related to the Competitiveness Pact and the other tax-reducing effects of the Pact will be focused on 2017. Even though allocation of tax reductions to the beginning of the Pact will support economic growth, the employment effects of the Pact will mainly materialise later.

The reduction of public sector holiday bonuses, which finances part of the fiscal losses arising from the Competitiveness Pact, will be temporary in 2017–2019. Savings in public finances stemming from the extension of employee working time will also be uncertain, even though they will already be taken into account notionally by cutting budget appropriations for 2017. Therefore, the Competitiveness Pact entails risks for public finances. However, the Government is committed to agreeing in the spring 2017 spending limits negotiations the measures required to return public finances to the adjustment path towards the MTO.

The General Government Fiscal Plan in light of the forecast

The Government's objective is to rebalance public finances and bring growth in the debt-to-GDP ratio to a halt during the parliamentary term. The Government has set sector-specific budgetary targets for rebalancing public finances, which are deficits of 0.5% for central and local government finances and a surplus of 1.0% for earnings-related pension funds. In addition, the Government Programme states that living on debt will be brought to an end by 2021, which can be interpreted to mean rebalancing of central and local government finances.

A fairly detailed adjustment programme was already drafted as an annex to the Government Programme. On the other hand, the Government will allocate additional funds to key government projects, which will increase public spending and investment in

2016–2018. Additional funds for public investment, particularly to reduce the infrastructure-related repair debt, are justified from the perspective of subdued economic growth, favourable cost level and efficiency. The temporary investment in key government projects will no longer affect public expenditure in 2019, which means automatic tightening of fiscal policy.

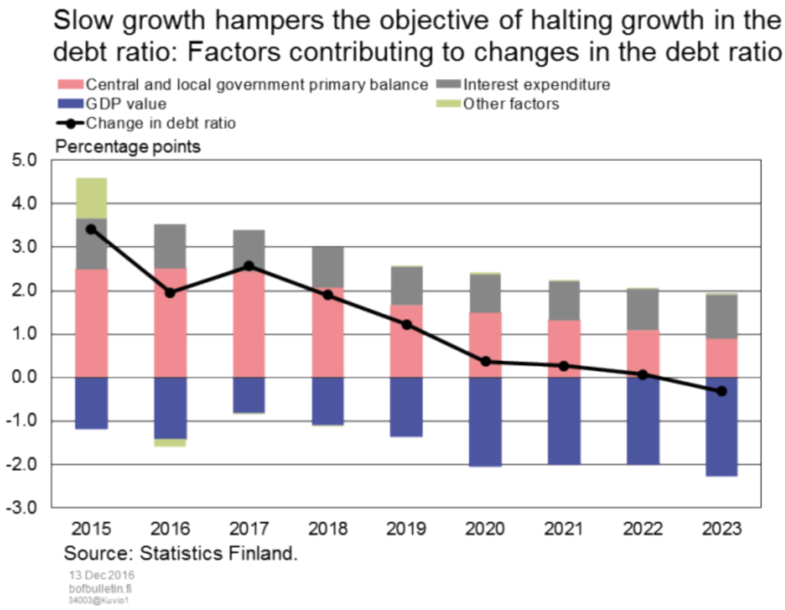
The General Government Fiscal Plan 2017–2020 is based on the Ministry of Finance's macroeconomic forecast for Finland. The spring Fiscal Plan states that Finland does not appear to be meeting the targets set for the general government budget balance. On the basis of the Bank of Finland's most recent forecast, too, it is unlikely that the targets will be met without additional savings measures. Even though it is possible to reach the target for local government finances, the central government budget balance does not appear to be improving sufficiently. In addition, the Bank of Finland forecast estimates that the surplus on the earnings-related pension funds will decline to 0.4% of GDP in 2019, which hampers the attainment of the structural deficit target, in particular. In practice, the Government has limited scope to influence the balance of earnings-related pension funds. The Government's measures to boost employment growth are therefore important.

Sustainability of public finances

Finland's public debt has increased by around EUR 90 billion from 2009 to 2015. According to the Bank of Finland forecast, public debt will continue to grow throughout the parliamentary term. Based on a medium-term forecast, growth in the debt-to-GDP ratio will not come to a halt until 2022–2023 (Chart 3). Debt will accumulate during the forecast years as a result of persistent deficits in central and local government finances.

Interest payments on public debt are so far estimated to remain relatively low, i.e. at around 1% of GDP. Other factors contributing to the debt are changes in the consolidation item and asset sales. The consolidation item consists largely of government bonds held by earnings-related pension funds. Pension funds sold a significant amount of bonds in 2015 in the context of the launch of the ECB’s public sector purchase programme, which was one of the factors increasing the consolidated general government debt by EUR 1.2 billion in debt statistics. The forecast assumes the consolidation item to remain unchanged relative to the stock of debt, but there is no estimate for asset sales except for 2016.

Chart 3.



Growth in the debt ratio will only come to a temporary halt. Public debt will already continue to grow in the 2030s if the pressures relating to public expenditure remain unchanged. Therefore, the problem with the sustainability gap in Finland's public finances has not yet been resolved. The Bank of Finland's new assessment for the sustainability gap is around 3% of GDP. The assessment has improved slightly on the previous year, due to a fall in the public deficit estimate in the first year of the projection in 2020 and a decline in the present value of interest expenditure on public debt.

The return on pension funds and the interest rate on public debt are assumed in the calculation to grow from the current level, to 5% in nominal terms by the mid-2030s. The demand for social and health care services is assumed to grow in response to the ageing population. As a result, public expenditure is assumed to grow to nearly 3% of GDP by 2060.

The SOTE reform seeks to create permanent savings of EUR 3 billion in public finances, which corresponds to around 1.5% of GDP. The aim is to slow real growth in social and health expenditure to 0.9% in 2019–29. For health care spending, this means halving real growth in costs, but for long-term care the target is more challenging. Expenditure on long-term care is assumed to grow in the baseline scenario by an average annual rate of nearly 4% in real terms in 2019–29. If the target is achieved, the sustainability gap would decline by nearly the targeted 1.5 percentage points.

There are no buffers against weaker developments

Finland's public debt has doubled relative to total output over the past seven years. On the basis of the Bank of Finland forecast and sustainability gap assessment, a mere stabilisation of the debt ratio necessitates significant fiscal consolidation.

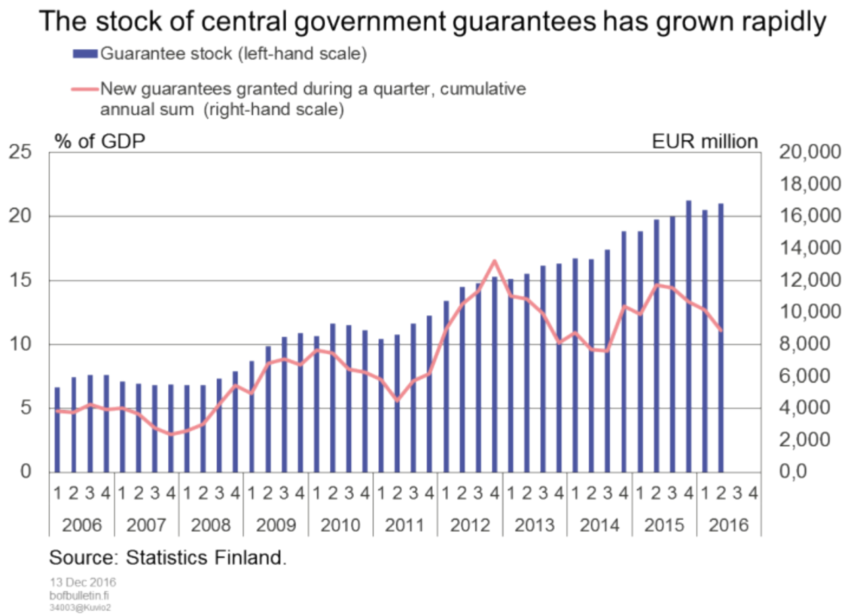
Long-term estimates about debt sustainability are based on the assumption that economic growth is stable on average and in line with productivity and employment growth. Both the recession of the 1990s and the downturn of the past years show that it cannot be ruled out that a similar downturn having a lasting effect on total output occurs during the next 50 years. In such a case, public debt would probably grow again to new and considerably higher figures.

Interest payments on public debt relative to GDP have declined over the past years, despite debt growth. The low level of interest rates cannot be considered to be a lasting phenomenon. With rising interest rates and debt, interest expenditure is estimated to grow to over 4% of GDP in the 2030s, meaning that debt would exceed the value of annual total output. In such a situation, fiscal balance would necessitate a primary surplus that is equal in size, and controlling the debt ratio would be considerably more challenging.

Central government liabilities are growing rapidly

In addition to debt, other general government liabilities have increased, too. The use of general government guarantees is relatively high in Finland. The majority of government guarantees are guarantees granted to Finnvera and housing loan guarantees. The stock of guarantees has doubled since the end of 2011 and amounts currently to around EUR 45 billion (Chart 4). The Government has decided to expand further the export guarantee powers granted to Finnvera and the Finnish Export Credit Ltd. Guarantees may be an inexpensive way to promote exports, but they also entail risks. Finland has begun to report the amount of guarantees and other general government liabilities in the General Government Fiscal Plan. In the same context, it would be advisable to also estimate future developments in the guarantee stock: how large the stock is intended to be increased and when it is planned to decline.

Chart 4.



Tags

debt accumulation, forecast, public debt, public finances, government debp