ASSESSMENT OF PUBLIC FINANCES 2018

Now is an opportune time to strengthen fiscal buffers

10 Jan 2019 – Assessment of Public Finances – Finnish economy

Economic growth has supported the efforts to improve Finland's general government finances in recent years. However, changes in the composition of public revenue and expenditure are hampering the achievement of a balanced budget position. In the medium term, reaching the fiscal policy objectives will not become easier. Growth in age-related expenditure will make rebalancing of the public finances more difficult, and the fiscal sustainability gap is still considerable.

Achievement of general government structural balance will be postponed

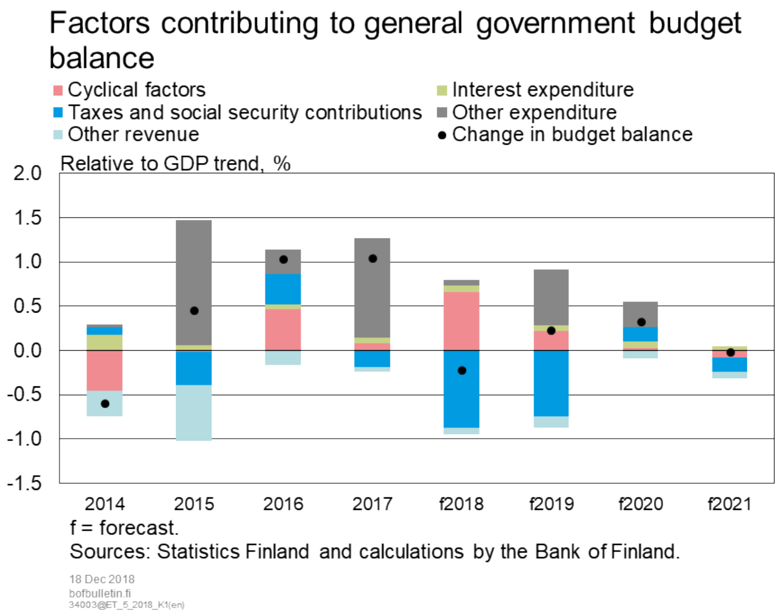
The double-dip recession of the past decade and economic restructuring have left a deep mark on Finland's public finances. In addition to the cyclical deterioration of the revenue base and increased expenditure needs, Finland's public finances are strained by demographic change. As baby boomers have reached retirement age, pension expenditure has grown rapidly and pensions paid relative to GDP have grown by almost

3 percentage points from the pre-recession years to 2017. Increases in social security contributions have been insufficient to maintain the level of the surplus on the social security funds, considering that property income received by the funds has also decreased.

With regard to the central government finances, transfers to social security funds – e.g. the state's share in certain pensions – have increased by 1.5 percentage points relative to GDP since 2005. The taxation of income has become less relevant in government taxation and, in recent years, the shift has been increasingly towards indirect taxes. As a whole, however, central government tax revenue relative to GDP will be about 1 percentage point lower than in 2005. Central government transfers to local government have increased, and municipal taxes have risen. Local government investment and consumption expenditure have grown especially in the social and health care services sectors. Interest expenditure on general government debt has contracted significantly in recent years, despite growth in the level of debt. This has provided cushioning for growth in other expenditure.

The upturn in Finland's economic growth has underpinned the public finances in recent years (Chart 1). In addition to positive cyclical effects, public finances have been bolstered in recent years especially by expenditure adjustments. The current Government will have implemented spending cuts of approximately EUR 4 billion by the end of the Government's term in office. The impact of this adjustment has been alleviated by the appropriations of EUR 1.6 billion for the Government's key projects in 2016–2018. The financing of the key projects will come to an end in 2018 as planned, and it appears that no permanent additional expenditures will be included to the budget relating to the projects. However, it would be advisable to assess the impact of key project funding ex post.

Chart 1

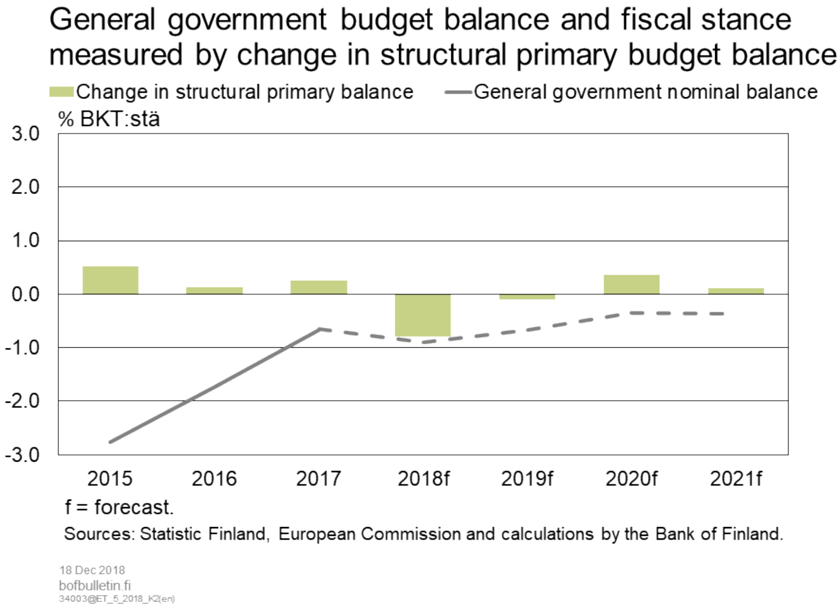


There are pressures to increase public expenditure coming from a number of sources.

Substantial defence material procurements are envisaged for the forthcoming years. There is also a parliamentary consensus on the need to increase funding for the development and maintenance of the transport infrastructure. Going forward, particular attention should be paid to the composition of public expenditure, especially due to the pressures arising from population ageing. A central government expenditure survey – last conducted in 2016 – could be a useful tool in examining public spending at the political level. The turn of the parliamentary term in 2019 would be a very opportune time to update and document the various expenditure items and assess the effectiveness of expenditure.

Fiscal policy will ease in 2018. The fiscal stance is not appropriate in view of the economic cycle, especially since the structural problems in the public finances have not been resolved nor fiscal buffers strengthened following the recession. In 2019, fiscal policy will be neutral, as measured by the change in the structural primary budget balance (Chart 2). Since the fiscal policy decisions for the latter forecast years 2020–2021 will be taken by the next Government, the current Bank of Finland forecast only assumes adjustments to the income tax scale in line with the increase in the earnings level.

Chart 2



Finland is compliant with EU fiscal rules

Fiscal policy rules have been shown to have a positive impact on the management of the public finances. Finland has long applied central government spending limits with fairly good success. The spending limits framework sets a binding ceiling for approximately 80% of budget expenditure for the following four years. The spending limits are set in real terms, meaning they are adjusted annually for changes in price and cost levels and possible structural corrections. The National Audit Office of Finland monitors compliance with the spending limits and submits a related report on an annual basis. The Office has noted that the spending limits framework has become non-transparent and difficult to monitor. In 2019, expenditure within the spending limits, including provisions, will be at the same level as expenditure budgeted for 2018.

Finland must also adhere to the EU's fiscal policy rules. The Treaty on the Functioning of the European Union (TFEU) limits general government deficit to 3% of GDP and general government debt to 60% of GDP. Compliance with these reference values is monitored under the Stability and Growth Pact (SGP). Since Finland's public debt will fall below the reference value of 60% already this year, the Bank of Finland forecast sees that Finland will meet both the deficit and the debt requirement in the next few years.

In the preventive arm of the SGP, Finland's medium-term objective (MTO) for the structural budget balance is –0.5% of GDP. In 2017, the MTO was met and even overachieved due partly to a windfall in tax revenue. In 2018, the structural deficit will be above what is allowed, but the distance to the MTO will not be critical, considering the temporary allowances granted to Finland relating to the implementation of structural reforms. According to the view of the European Commission, however, there is a risk of Finland not complying with the spending rule of the TFEU, which binds public expenditure growth to the growth rate of potential output.

The EU's fiscal policy rules have been criticised as being too restrictive on the one hand and too flexible and discretionary on the other. Discussions on the reform of the EU rules have been underway in recent years as part of the development of the EMU. Finland has emphasised each country's own responsibility for their own finances and adherence to the current rules. Increasing the clarity and ownership of fiscal rules via national legislation would be in the interest of the individual countries and the entire monetary union alike.

Strengthening of public finances necessary already in the medium term

The current Government set several fiscal targets at the beginning of its term if office. The target of putting the debt-to-GDP ratio on a downward path has been achieved. The objective of bringing an end to living on debt by 2021, in turn, does not appear plausible in light of forecasts. Sector-specific budgetary objectives will be missed by a close margin. With respect to the local government finances, the budgetary objective is achievable, but it appears that the central government nominal deficit will be higher than the targeted 0.5% in 2019. Achievement of a surplus of 1%, as targeted by the earnings-related pension funds, is not certain, either. According to the Bank of Finland forecast, the surplus on the earnings-related pension funds will erode further in the forthcoming years, as pensions will grow faster than property income and pension contribution revenue received by the funds. Achievement of the MTO of –0.5% for the structural budget balance does not seem plausible in 2019, but is possible for the next years. The objective of preventing a rise in the tax ratio has been clearly met, since the tax ratio has declined especially due to the Competitiveness Pact and the related compensations.

During the next parliamentary term commencing in 2019, management of the public finances will not be easing in light of the forecasts. Even though the slight downward trend in the debt-to-GDP ratio looks to continue over the next years, the debt ratio will still be over 53% in 2025. The estimate does not take into account the forthcoming defence material procurements, which will boost the debt ratio by 4–5 percentage points. Health care and long-term care expenditure related to population ageing will begin to grow in the next few years, as the baby boomers will exceed the threshold of 75 years. In addition to higher health care and long-term care expenditure, growth in the interest payments on public debt may also start to limit the fiscal space. In 2005, interest expenditure was 1.6% of GDP and the debt-to-GDP ratio was 40%. In 2017, interest expenditure was 1% of GDP, even though the debt ratio had risen to 61%. It the debt level increases in parallel with a rise in the interest rate level, public expenditure pressures will grow even further.

Strengthening of fiscal buffers now, in good economic times, is increasingly important. Bringing an end to debt accumulation and a steeper downward trend in the debt ratio would create more fiscal space to address forthcoming rising expenditure pressures or potential economic shocks. Strengthening central and local government structural balances would also act as a precautionary measure against the forthcoming challenges. This could be done in a balanced manner, by tightening the revenue base and reviewing the composition of expenditure. Measures to improve the productivity of the public sector are also necessary. The public finances can be also be strengthened in the area of social security, by increasing the EMU buffer of the Unemployment Insurance Fund, for example.

Long-term sustainability of public finances

The Bank of Finland's estimate for the sustainability gap in Finland's public finances is about 3% of GDP.[1] Even though the estimate is roughly unchanged on December 2017, the composition of the sustainability gap has changed slightly. The sustainability gap can be calculated based on three components, which have developed in opposing directions. The general government debt-to-GDP ratio is assessed to develop slightly more favourably in the medium term than estimated in December 2017, and therefore the estimate concerning interest expenditure on public debt, included in the sustainability calculation, is slightly lower than previously assessed. According to the new assessment, the general government structural primary balance is also slightly stronger at the beginning of the calculation, in 2025, than estimated in December 2017. The present value of future deficits, however, is now higher, which increases the sustainability gap.

The estimate for the sustainability gap has risen slightly on account of Statistics Finland's new population projection. A particular feature of the population projection was the assumption on the birth rate which was, due to recent years' developments, considerably lower than in the previous population projection of 2015. A reduction in the birth rate, if materialised, will have a negative impact on the number of working-age population. This, in turn, will weaken potential economic growth from the 2040s onwards. The impact on the sustainability gap, however, will not be as substantial, since imputed education

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1. Long-term sustainability gap calculations are subject to significant uncertainty. For this reason, the Bank of Finland estimates the sustainability gap with the accuracy of ½ percentage point. More detailed information about the sustainability gap is available in a separate article. The Bank of Finland's methodology for calculating the sustainability cap will be discussed in a forthcoming BoF Economics Review article.

expenditure will decline first and the other effects will not be visible until the latter years of the calculation.

Even though sustainability gap assessments are subject to significant uncertainty, they are indicative of future developments and their scale. Unlike in the framework of the pension system, preparations for the effects of population ageing are not yet sufficient in the social and health care services system. The social welfare and health care reform may, if successful, slow expenditure growth, but only if cost efficiency plays the key role in the reform. In general, it takes time to address structural challenges, and postponing of reform measures therefore increases future risks.

Central government liabilities exceed assets

General government assets relative to liabilities are exceptionally high in Finland, since the earnings-related pension funds are categorised as part of the public sector. However, the assets of the funds, which are about 80% relative to GDP, cannot be used to manage public debt, which mainly concentrates on the central and local government subsectors. Another problem in assessing the total public sector net debt is that pension liabilities are often excluded from the calculation. At present, pension liabilities are over 300% relative to GDP, for pensions already earned.

The central government's financial assets, however, are substantial. At the end of 2017, their value was approximately EUR 64 billion, which is more than 28% relative to GDP. 60% of the assets are shares and equities, the value of which has fluctuated even markedly. Central government property income has averaged about EUR 1.8 billion in recent years. In addition, shareholdings have been sold in various amounts in recent years. In spring 2018, the International Monetary Fund (IMF) analysed[2] the composition of Finland's public sector assets and the implications to the sustainability of the public finances. The analysis concludes that strengthening of the public finances is needed to address future age-related spending.

Central government guarantees have continued to grow substantially. At the end of 2017, the stock of government guarantees amounted already EUR 52 billion, representing a growth of EUR 6 billion on the previous year. Over the past 10 years, government guarantees have grown by more than 15 percentage points relative to GDP. The majority of the guarantees and their growth stems from export and funding guarantees to Finnvera. This means that government guarantees have been used for supporting the operating conditions for the export industries. A critical assessment and a plan for the future for government guarantees would be necessary now, when financing conditions have eased and there should be no constraints in obtaining market-based funding. Guarantees are a risk that may realise in a severe downturn – at a time when the public finances would already be strained.

Tags

economic growth, gross domestic product, public finances,

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2. Brede, M – Henn, C (2018) Finland's Public Sector Balance Sheet: A Novel Approach to Analysis of Public Finance. IMF Working Paper 18/78, April 2018.

sustainability of public finances