

# Time for fiscal policy to refocus on the future

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Managing the consequences of the COVID-19 pandemic still requires a lot of work, but in many sectors of Finland's economy the engines are already firing on all cylinders. The elevated structural deficit in the country's public finances will need to be remedied in the wake of the pandemic, when the longer term expenditure pressures related to an ageing population start to swell steadily, turning into today's issues and problems. At the same time, future challenges such as climate change mitigation call for political action, and this will also affect the fiscal balance and the level of debt. In fiscal policy there must be a return towards more balanced budgets, but new spending on matters that are always deemed indispensable makes this difficult.



## Improved economy will strengthen the general government budget balance

Although the impact of the COVID-19 pandemic on the economy has been less marked in Finland than in many other countries, the effects have fallen unevenly among households and between different industries and sectors. The sudden standstill in the economy had a negative impact on the public finances. Public expenditure was expanded by the costs of managing the health crisis and by the fiscal support given, which sought to ameliorate the economic effects of the crisis. The Finnish economy is recovering rapidly: growth has been brisk this year and is set to continue higher than normal in 2022. However, there is still uncertainty over the course the pandemic will take, and this uncertainty will affect

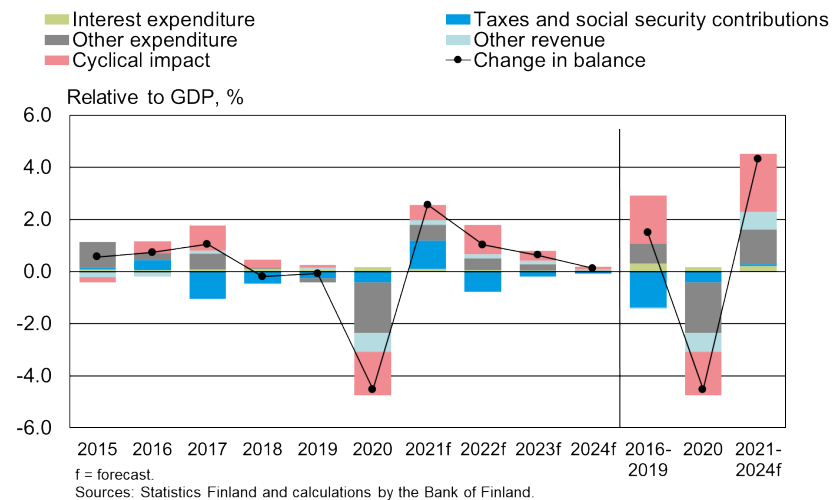
the economy for some time yet.

In the general government sector, action was taken particularly by central government concerning the impact of the acute downturn. The central government deficit grew to 5.5% of GDP in 2020. Exceptionally, there was an improvement in the budgetary balance of local government, as local COVID-19 measures were given strong financial support by central government. By contrast, the budgetary position of the social security funds weakened significantly, though it remains in balance, as unemployment expenditure climbed considerably and the economy and employment were supported through temporary relief concerning employment pension contributions. The general government deficit in relation to GDP will shrink by more than 4 percentage points in the forecast period 2021–2024, but at the end of the period it will be at a level of 1.2%.

The contraction in the general government deficit will to a significant extent be attributable to a vigorous recovery in the economy. The cyclical contribution to the contraction in the nominal deficit will be just short of 2.5 percentage points (Chart 1). The positive cyclical impact will be at its greatest in 2021 and 2022. Economic growth in 2023 will slow to a point near the estimated long-term potential growth rate. The deficit will also decline as the expenditure required for pandemic-related measures decreases. The expenditure impact of the permanent spending increases made during the parliamentary term will still be felt at the end of the forecast period.

Chart 1.

Factors contributing to changes in the general government budget balance



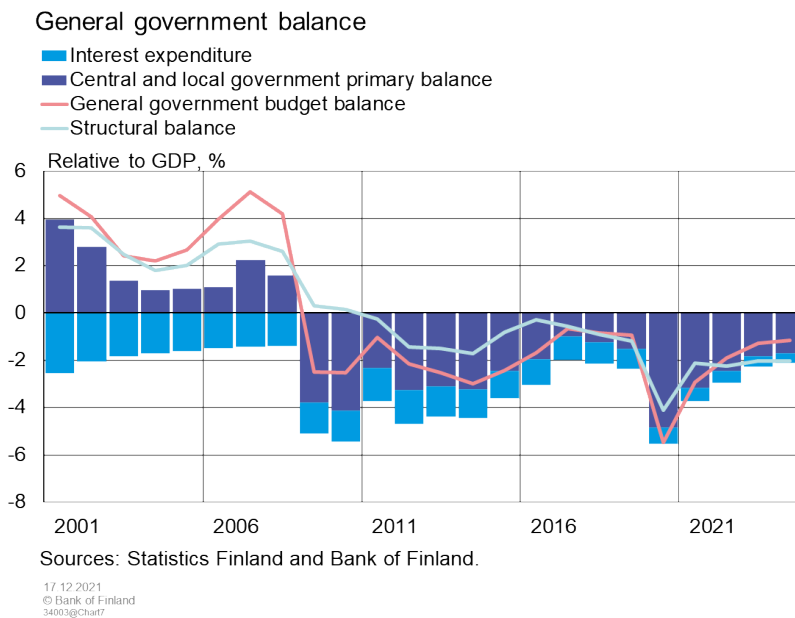
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## Structural balance weaker than before the pandemic

The structural balance is the nominal budget balance of general government net of the cyclical component and temporary factors. It depicts the balance in the public finances under normal, balanced cyclical conditions. The structural balance is calculated using an approximation of potential output, the estimation of which involves uncertainty,

particularly in the context of marked fluctuations in the economy. The structural deficit in the public finances in 2023–2024 is now expected to be about 2% of GDP (Chart 2), which is weaker than its pre-pandemic level. The 2019 structural deficit was an estimated 1.2% of GDP. This weakening of the structural deficit is attributable in part to the permanent expenditure increases of approximately EUR 1.4 billion associated with the Government Programme.

Chart 2.



The financing of the permanent expenditure increases is based on tax changes, spending reallocations and employment-promoting measures, though the impact of these on the public finances is still uncertain. In 2020–2021, tax increases concerning, for instance, energy and environmental taxes and alcohol and tobacco duties amounted to almost EUR 400 million, but at the same time taxes on low and middle incomes were reduced. In addition, tax changes proposed for 2022 will reduce tax revenues by about EUR 300 million in net terms. Employment is expected to increase in the forecast period, with the number of people in employment in 2024 being about 66,000 more than in 2019.

Alongside the permanent expenditure increases, the Government is allocating a total of around EUR 2 billion in 2020–2022 to its future-oriented investments. This expenditure is intended to be financed mainly through property income. Some of the future-oriented investments are such that there is a risk of them turning into permanent additional expenditure.

The European Union’s Next Generation EU recovery instrument was introduced in summer 2021, and most of its financial support is to be channelled via the Recovery and Resilience Facility (RRF). Finland’s allocation from the RRF is provisionally estimated to be about EUR 2.1 billion, to be used over the period 2021–2026. The receipt of RRF support is conditional upon having a plan for structural reform of the economy and related investments for this. Finland’s plan<sup>[1]</sup> was approved by the European Commission and the Council of the European Union in autumn 2021, and the advance payment to

Finland will amount to 13% of the full amount. The corresponding expenditure is budgeted in the Government's 2021 supplementary budget proposals. The remaining portion of the support will be paid during 2022–2026 in step with actual progress on the reforms and investments.

## Fiscal policy will continue to support growth in 2022

Fiscal stance portrays the impact of fiscal policy decisions on the economy. The stance is often examined using indicators of the general government balance, especially the cyclically adjusted balance (excludes the impact of the business cycle) or structural primary balance (cyclical budget balance net of interest payments that also takes temporary factors into account), or by looking at changes in these. Cyclically adjusted indicators eliminate from the nominal budget balance the impact of the change in tax revenues and social security expenditure (i.e. automatic fiscal stabilisers) associated with the business cycle. Another approach to pinpointing the fiscal stance is to estimate the effect on the general government balance of decisions concerning expenditure, taxes and payments.<sup>[2]</sup>

Whereas the European Central Bank (ECB) and the European Commission have normally used the change in the cyclically adjusted indicator or in the structural primary balance to illustrate the fiscal stance, the IMF, for its part, has used the level of the structural primary balance itself.<sup>[3]</sup> This was noted by the European Fiscal Board (EFB) in its annual report on the euro area's fiscal stance<sup>[4]</sup> in summer 2021. The EFB then started using the term 'fiscal stance' when referring to the *level* of the structural primary budget balance, and the term 'fiscal impulse' when referring to the *change* in the structural primary budget balance. During the COVID-19 pandemic in particular, with fiscal measures reaching an exceptional level, a more balanced understanding of the fiscal stance is possible by examining the position using different approaches.

It is also now appropriate to take into account the support being obtained via the EU's recovery package, which will enable public investments to be made and, for example, investment support to be given to bring forward private sector investments. As these expenditures are financed completely through the EU package, they do not affect the general government balance at this stage. Thus, in this respect the indicators referred to above do not capture the growth impact achieved with the recovery package. These

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1. Sustainable Growth Programme for Finland – Recovery and Resilience Plan. Publications of the Finnish Government 2021:69.

2. See e.g. Ahola, I., Pääkkönen, J. and Tamminen, V.: Assessing the discretionary fiscal effort – presenting alternative indicators. Publications of the Ministry of Finance 40/2017 (published in Finnish).

3. See the IMF's concluding statement on the Finnish economy (Finland: Staff Concluding Statement of the 2021 Article IV Mission) 19 November 2021: [https://www.suomenpankki.fi/globalassets/fi/media-ja-julkaisut/tiedotteet/documents/concluding\\_statement.pdf](https://www.suomenpankki.fi/globalassets/fi/media-ja-julkaisut/tiedotteet/documents/concluding_statement.pdf).

4. European Fiscal Board: Assessment of the fiscal stance appropriate for the euro area in 2022, 16 June 2021. Box 1. [https://ec.europa.eu/info/sites/default/files/2021\\_06\\_16\\_efb\\_assessment\\_of\\_euro\\_area\\_fiscal\\_stance\\_en.pdf](https://ec.europa.eu/info/sites/default/files/2021_06_16_efb_assessment_of_euro_area_fiscal_stance_en.pdf).

expenditures will fluctuate in the range 0.1% – 0.3% of GDP in the years 2021–2026.<sup>[5]</sup> It should also be noted that when repayment of part of the EU funding begins from 2028 onwards in the form of elevated membership contributions, the concomitant expenditure growth is not to be interpreted as expansionary fiscal policy. For these reasons, the European Commission’s assessment of the fiscal stance in this situation is with reference to the change in primary government expenditure (spending net of interest payments), such that expenditure is also net of pandemic-related direct and indirect expenditure (e.g. health security spending).<sup>[6]</sup>

In Finland, both the nominal and the structural budget balance weakened sharply in 2020, when public funds were used to support health security measures and businesses and households. This was well justified and continues to be so to the extent that the pandemic is still affecting various sectors. The general government deficit shrank significantly when, in 2021, the COVID-19 restrictions were lifted and the temporary measures to ease tax and payment arrangements were discontinued. If the fiscal stance is assessed by looking at the change in the structural primary balance, then fiscal policy appears to have tightened in 2021 (Chart 3). By contrast, the Commission’s expenditure indicator points to a further easing of fiscal policy in 2021. In the subsequent forecast years 2022–2024, fiscal policy will be fairly neutral if measured in terms of the change in the structural balance or using the Commission’s expenditure indicator. It is worth noting, however, that the level of the structural primary balance will still be noticeably weaker during the forecast years than in the pre-pandemic year of 2019.<sup>[7]</sup> Fiscal policy will therefore still be supporting GDP growth in 2022–2024.

There is good reason now to take into consideration in the fiscal stance the fact that Finland’s economy has been recovering rapidly from the standstill caused by the pandemic crisis, and that the upturn will be affected by growth constraints. When all production inputs are fully utilised in the economy, expansionary fiscal policy will lead to higher prices and is therefore less effective than in the downturn and trough of the cycle. If growth in the economy continues to be robust without pandemic-related setbacks, then a tighter than planned fiscal policy would underpin the balancing of the public finances in the medium term and create a buffer to cope with future challenges.

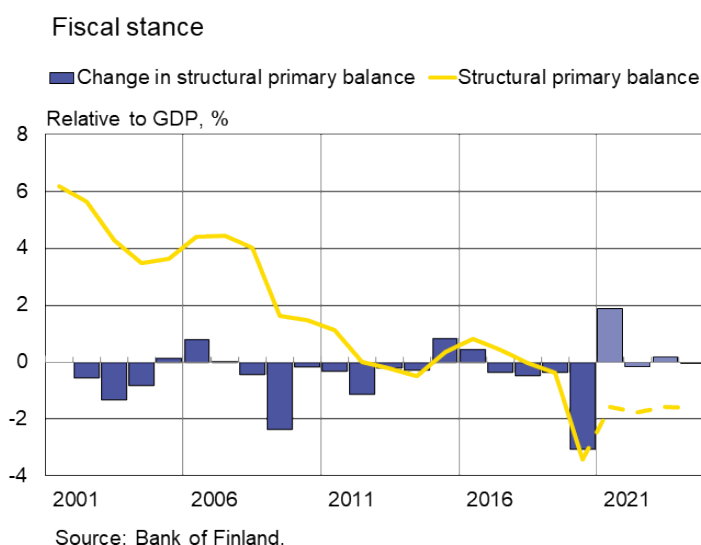
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5. Finland’s 2022 Draft Budgetary Plan. Publications of the Ministry of Finance 2021:62.

6. Commission Staff Working Document. Statistical Annex providing background data relevant for the assessment of the 2022 Draft Budgetary Plans. SWD(2021) 915 final.

7. This assessment is based on the methodology used within the European System of Central Banks, which differs from that used by the European Commission.

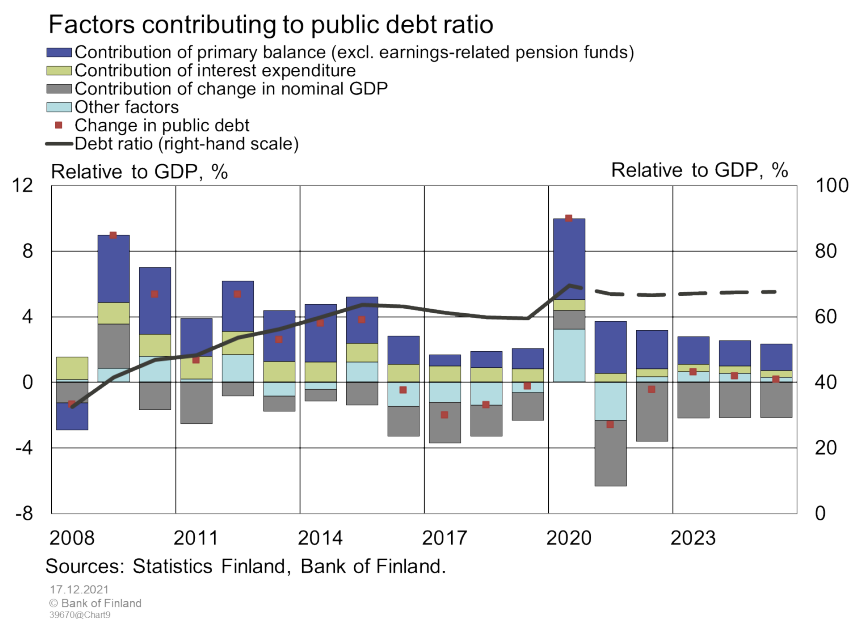
Chart 3.



## General government debt climbs

Finland's general government debt (consolidated Excessive Deficit Procedure (EDP) debt) grew by more than EUR 21 billion in 2020. Further debt in 2021 was considerably less than this, as it has been possible to make use of the Government's strong cash position and because planned expenditure has not taken place at the scale or to the timetable envisaged. The rise in the general government debt ratio will nevertheless continue during the forecast period due to the central and local government deficits, and will again exceed 67% in 2024 (Chart 4). Although GDP growth will help to curb the debt ratio, it will not be sufficient to reverse the upward trend in the ratio. Interest expenditure on general government debt continues to account for an ever smaller share of public spending, and so with interest expenditure being low, a smaller adjustment in the primary balance would be needed for the debt ratio to be turned around.

Chart 4.



## Risks surrounding long-term debt sustainability

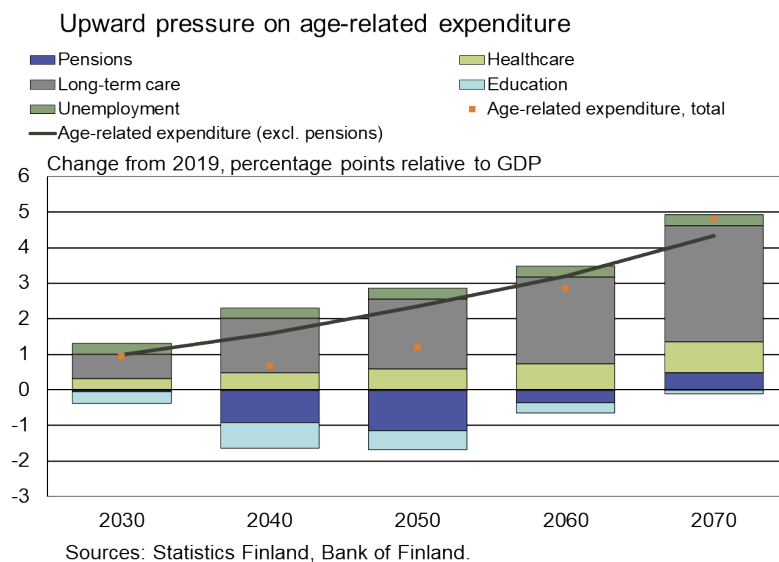
Long-term debt sustainability is measured by the S2 sustainability gap indicator, which condenses into a single figure the extent to which the general government budgetary position should be permanently adjusted so that public debt does not grow uncontrollably in the future. The sustainability gap estimate is not a forecast but a technical quantification of the pressure on the public finances. This involves estimating the path taken by Finland's public finances from 2025 onwards, using the assumption that the revenue and expenditure policies remain unchanged even if there is a rising level of public debt. The calculation also uses an approximation of long-term growth and makes assumptions about interest rates, among other things. An estimate of demographic changes is also made, based on the 2021 population projection produced by Statistics Finland. Demographic changes will affect the calculation's estimated expenditure on healthcare, long-term care, and education and training.

Using the S2 indicator, the Bank of Finland currently estimates that the sustainability gap will be about 3½% of GDP, or approximately EUR 10 billion, in 2025. This estimate has decreased from that calculated in December 2020 (about 5½% of GDP). The decrease is attributable to an improved short-term forecast for general government finances and an update to some of the background data and assumptions. These changes are described in a separate article (see [Long-term sustainability of the public finances](#)).

Although the sustainability gap has decreased, the sustainability challenge remains substantial. A structural adjustment to the fiscal balance at such a scale will be challenging, especially when the growth in age-related expenditure is already at hand and general government finances are structurally in deficit to begin with (Chart 5). The rise in pension expenditure has already been particularly steep in the years of slow economic growth following the global financial crisis. In addition, the increasing need for healthcare and long-term care services, and the effects of this, are already visible to an

extent. The treatment backlog due to the COVID-19 pandemic will also have to be dealt with in the years ahead. In the long term, sustainable fiscal policy would include striving to bring public finances closer to balance in spite of the pressure to increase spending. More balanced public finances would keep the debt ratio under control and would also allow the creation of necessary fiscal space for use in future economic downturns.

Chart 5.



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## General government debt over the medium term

Finland's general government debt is subject in the long term to significant upward pressure due to age-related expenditure and because the budgetary position is in deficit to start with. Since long-term calculations involve considerable uncertainty, it can also be worthwhile to examine the debt ratio over shorter intervals of 10–15 years under various assumptions. Many international organisations, such as the IMF, the European Commission and the ECB, draw up debt sustainability analyses on a regular basis, and these include assessments of the debt ratio in the near future under different scenarios.<sup>[8]</sup>

The debt path resulting from the sustainability calculations is based on a scenario in which fiscal policy does not change and age-related expenditure increases in accordance with the demographics. This indicates that the debt ratio would exceed 75% by 2035.

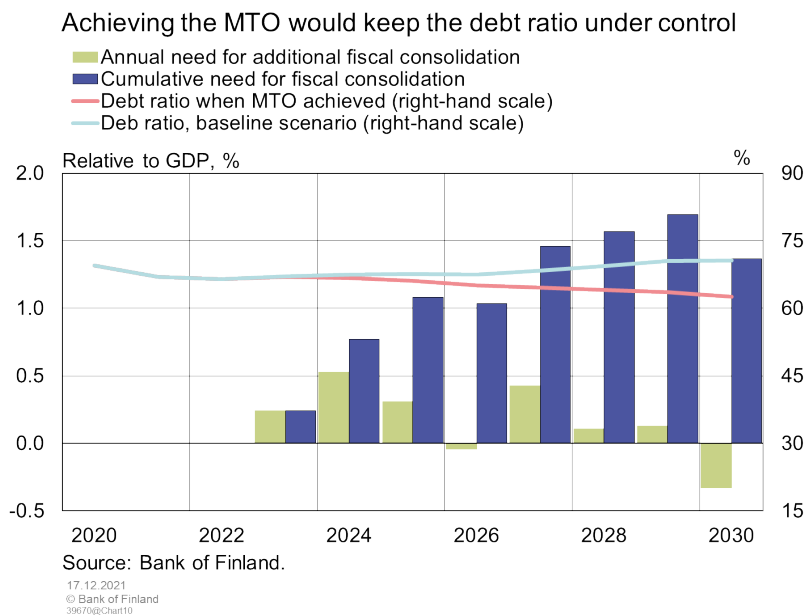
The debt ratio can also be examined in a scenario where the medium-term objective (MTO) for public finances is achieved in the manner called for in the current Stability and Growth Pact (SGP) in steps of 0.5 percentage points during 2023–2026, and subsequently the fiscal balance is kept at this level. The calculation demonstrates that achievement of the MTO would lead to a debt path that is clearly more favourable than the baseline forecast: the current MTO level would, in the long term, keep the debt ratio

8. See e.g. European Commission: Debt Sustainability Monitor 2020. European Economy Institutional Paper 143, February 2021.



at an average of just over 60%. After the pandemic, the setting of fiscal objectives should aim at getting close to fiscal balance and at implementing measures for achieving the MTO.

Chart 6.



## Fiscal policy objectives eased

In 2019, the Finnish Government set the MTO at  $-0.5\%$  of GDP. In practice, this is also the minimum level to which Finland is committed in the Fiscal Compact. The European Commission’s calculations show that since 2010 the structural balance reached its best level in 2015, at  $-0.7\%$ . Due to the uncertainty associated with making current estimates of the structural balance, the interpretation under the preventive arm of the EU’s Stability and Growth Pact (SGP) is that the MTO is considered to have been reached when the deviation from it is less than 0.5 percentage points.

The SGP’s General Escape Clause, activated because of the COVID-19 pandemic, provides an opportunity still in 2022 to deviate away from the adjustment path rooted in the SGP’s requirements and towards the MTO. According to a communication from the Commission,<sup>[9]</sup> the grounds for such an exceptional procedure will no longer apply in 2023, when the pre-pandemic level of total output will have been reached in the Member States. In Finland, the pre-pandemic output level was already reached in early 2021. The objectives currently set for Finland’s general government finances include the following: in 2022 the Finnish economy will be within the 3% limit imposed for the nominal deficit, and in 2023 the structural balance will be reduced by 0.5 percentage points in line with the requirements of the preventive arm of the SGP.

Multiannual objectives for general government finances as required by the Budgetary

9. Commission communication, 2 June 2021: Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy. COM(2021) 500 final.

Frameworks Directive were included in Finland's General Government Fiscal Plan and also in its Stability Programme submitted to the EU. In the parliamentary term's first General Government Fiscal Plan, the Government aimed for balanced public finances in 2023. Exceptionally, in spring 2020 no objectives were set, because of the great uncertainty associated with the prevailing pandemic. In spring 2021, the previous targets were no longer realistic, which is why the new multiannual objectives are significantly less ambitious than previously (Table 1). The objectives are very close to the Ministry of Finance's spring 2021 forecast for the public finances.

Table 1. Fiscal objectives, % relative to gross domestic product (GDP)

<b>Government's fiscal objectives for 2023</b>			
% of GDP	Autumn 2019	Spring 2021	Forecast (BoF)
General government nominal budget balance	0,0	-2,1	-1,3
- structural budget balance	-0,5	-1,8	-2,0
General government expenditure	50,7	53,1	52,9
General government gross debt	58,1	73,9	67,1

The 2023 objectives for the nominal budget balance of general government by sector were also eased. These are currently as follows: the central government deficit will equal approximately 2.25% of GDP; the local government deficit will equal approximately 0.5% of GDP; the budgetary position of the wellbeing services counties will be close to balance; the earnings-related pension funds' surplus will equal approximately 1% of GDP; and the budgetary position of the other social security funds will be close to balance.

Under the spring 2021 General Government Fiscal Plan, the Government is committed to reviewing the measures in its Government Programme if their implementation would jeopardize attainment of the fiscal objectives. Based on the Bank of Finland's public finances forecast, the nominal objectives are otherwise quite achievable, but the structural budgetary position is not improving sufficiently quickly. Since the multiannual objectives are in certain respects less ambitious than what might be expected on the basis of the latest forecasts, it would be justifiable in the spring 2022 General Government Fiscal Plan to tighten the objectives for the end of the parliamentary term. The fiscal policy assumptions in the public finances forecasts are rooted in the Government Programme and in decisions already taken. Through active fiscal policy measures, the post-pandemic recovery in the public finances could take place more quickly than is currently expected.

The Government's aim is to turn around the upward trend in the general government

debt-to-GDP ratio by the mid-2020s. Even though it currently seems very likely that this debt target can be achieved, the debt ratio nevertheless threatens to start climbing again in the latter half of the decade, which would place long-term debt sustainability at risk.

The Government has drawn up a sustainability roadmap in which the key packages of measures for strengthening the sustainability of the public finances consist of: boosting employment and reducing unemployment; improving the conditions for economic growth; strengthening the productivity and cost-effectiveness of public administration; and implementing the reform of healthcare and social welfare. The Government intends to prepare decisions on these packages of measures in advance of the spring 2022 government spending limits discussion. According to the Bank of Finland's new long-term assessment, economic growth in Finland will average 1.2% per annum over the period 2021–2040, after which it will slow.<sup>[10]</sup> If the current demographic and educational trends continue, the amount of human capital in Finland will begin to decline in the 2040s. GDP growth would then dwindle and the debt ratio would be at risk of reaching an unsustainable level. The extent of human capital can be boosted by investing in education and training, creating more incentives for getting trained and finding work, raising the birth rate, and increasing employment-based immigration.

The Government is aiming to raise the employment rate to 75% by the end of the decade. It has already taken decisions on measures designed to increase the number of people in employment by more than 70,000. These measures include the transfer of employment and economic development services (TE services) to the municipalities, the extension of compulsory education, the discontinuation of the unemployment pathway to retirement, the adoption of a Nordic labour market model, a reduction in the client fees for early childhood education and care, the introduction of local government pilots on employment, the reform of the pay subsidy scheme, and measures to promote employment among people with partial work ability. Through the employment measures taken during the parliamentary term, the Government aims to achieve an overall positive net fiscal impact of more than EUR 0.5 billion by the end of the decade. There is considerable uncertainty associated with this assessment, however. The employment promotion measures are vitally important for the future of Finland's economy, but in so far as the measures are based on an increase in public spending, they are also associated with risks from the point of view of the public finances.

Regarding structural reforms, the long-awaited reform of health and social services is now to be implemented. The costs of establishing the wellbeing services counties and associated systems will burden the public finances in the early phase of the reform. In addition, in certain respects not all the costs are yet known. Cost savings targeted by the reform are not expected until the 2030s. Savings are possible if the best practices are adopted efficiently and if the new counties have sufficient incentives to make their activities more cost-effective.

If the structural reforms being prepared are not enough to strengthen the public finances as intended, the Government is committed to introducing new measures or also pursuing measures that will have a more immediate impact on public revenues and expenditure.

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10. See Bank of Finland Bulletin, Kokkinen, A., Mäki-Fränti, P. and Obstbaum, M. [Finland's new long-term forecast suggests GDP growth will be more subdued](#).

However, with the objectives now having been reset, and because the horizon for these extends beyond the current parliamentary term to the midpoint of the decade or later, it remains unclear what the circumstances would have to be for it to be considered necessary to pursue, for instance, measures affecting public revenues and expenditure. Fiscal balance objectives will next be set in spring 2022.

## Fiscal policy rules at a turning point

Consideration of the need for reform of the EU's common fiscal rules was begun in 2019 in connection with the European Commission's regular review of the legislation. The general view was that the regulatory package has become excessively complex, that commitment to and compliance with the rules has weakened, and that the rules could lead to pro-cyclical fiscal policy and the ineffective use of public funds in regard to facilitating economic growth. The public consultation begun by the Commission was discontinued in spring 2020 because of the COVID-19 pandemic, but was resumed in autumn 2021. With the aid of this consultation and the discussions within the Council of the EU and its committees, the Commission aims to achieve a consensus that it could then use to propose changes to the fiscal rules during 2022.<sup>[11]</sup>

The Government, in its Report on EU Policy, has taken the view that a simplification of the regulatory framework should be examined but without re-opening the Treaties. Finland emphasises each Member State's responsibility for economic policy and for creating headroom in better times to allow them room to manoeuvre in less favourable periods. Finland also emphasises that the regulatory framework must enable fiscal policy to be conducted proportionately to the cyclical conditions. More detailed views on the rules reform will be formulated before the close of the consultation period at the turn of the year and also after the Commission presents any proposals for legislative amendments.

At the same time as the EU's fiscal rules framework is renewed, it would also be useful in Finland to examine the national fiscal guidance framework. The spending limits procedure for central government finances has evolved over the past two decades and can be considered the most important tool for guiding fiscal policy. The spending limits procedure is not based on legislation, however, but on established practices. The procedure is therefore flexible, but it is also vulnerable to changes that could weaken its effectiveness. In 2020, the decision was taken that the costs of health security for pandemic-related treatment and care would not be included within the spending limits framework. An 'exceptional situation mechanism' was added to the spending limits rule during the current parliamentary term, and this mechanism was activated in 2021–2022 because of the COVID-19 pandemic. The mechanism made it possible to increase the spending limits by EUR 500 million in both years. In its spring 2021 mid-term policy review session, the Government decided to further increase the parliamentary term

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11. The Eurosystem reply to the 19 October 2021 Communication from the European Commission was published on 1 December 2021: [https://www.ecb.europa.eu/pub/pdf/other/eurosystem\\_reply\\_commission\\_eu\\_economy\\_after\\_covid\\_implications\\_economic\\_governance211202~d2eeec68dc.en.pdf](https://www.ecb.europa.eu/pub/pdf/other/eurosystem_reply_commission_eu_economy_after_covid_implications_economic_governance211202~d2eeec68dc.en.pdf).

spending limits for 2022 and 2023. The spending limits were raised by EUR 900 million for 2022 and EUR 500 million for 2023, as the Government considered that the spending limits' room for manoeuvre did not allow unforeseen spending changes to be incorporated or implementation of all the reforms it deemed necessary. Within the 2023 spending limits, it is also intended that expenditure items totalling EUR 370 million will be financed by making certain spending reallocations.

The spending limits procedure did not limit the response to the pandemic or the scale of that response. In part, the necessary spending was treated as expenditure outside the spending limits, and there was also a new provision for emergency situations. This proved necessary immediately, although it was manifestly insufficient. In the future there should be a return to the established spending limits procedure, and there should also be reduced scope for raising the spending limits in the middle of a parliamentary term. The procedure should not be relaxed in any way, as it helps build trust in Finland's ability to formulate durable fiscal policy. Justified expenditure increases that extend over two or more parliamentary terms are possible even under the current system, as was the case with the recent major procurement projects for the Defence Forces. Spending limits must be adjusted in line with the level of structural revenue, so that the balance target that has been set can be achieved under normal economic conditions. A stable spending limits framework set in this way will best function counter-cyclically, curbing expenditure growth during periods of faster cyclical revenue growth, and in a downturn will maintain the expenditure level despite a revenue decrease.

In fiscal guidance, reinforcement could be given to the process of attaining the multiannual objectives and the structural balance target if the Government, when falling short of the objectives, were to have a clearer duty to explain the reasons for this and to set out how it will return to a path towards the objectives. Current legislation gives the Government fairly wide scope for considering the need to embark on measures to correct fiscal stability or issue a report to Parliament if Finland is to fall significantly short of the structural balance target. Only when the Council of the EU decides that Finland has not taken effective action is the Government obliged to provide a statement to Parliament on the deviation and necessary measures for correcting the situation. The threshold for providing such a statement to Parliament could be lowered significantly and could be based on an assessment by an independent fiscal institution.

Finland's public finances face long-familiar challenges but also various new ones requiring resources in the near term. These include ensuring the conditions for economic growth, meeting the service needs of an ageing population and mitigating climate change. The fiscal balance must be maintained in such a way that excessive growth in public debt does not restrict the choices of future generations. Structural reforms are necessary, but management of the public finances cannot rely on these alone. A more effective and diverse set of tools should be considered for managing the public finances and controlling expenditure.

In Sweden, the fiscal framework incorporates a range of tools and benchmarks. By law, the expenditure ceiling for central government finances must be established three years in advance. Alongside this, Sweden has set a debt anchor at 35% of GDP. If this is exceeded by more than 5 percentage points, the Swedish government has to provide a report to the country's parliament. The debt objective is supported by a target for the

general government nominal balance, which since 2018 has been 1/3% of GDP averaged over the business cycle. Local government is subject to a budget balance requirement. As a country outside the euro area, Sweden has set a structural balance MTO of -1%.

Fiscal challenges arise from the need to maintain a stable revenue base and to control expenditure as pressures increase from different directions. A spending review looking at public expenditure items could identify and weigh up items where savings can be made and would allow space to be created for more important expenditure.<sup>[12]</sup> In Finland, spending reviews have been conducted before, though they have largely focused on the most important targets of public spending.<sup>[13]</sup> By further developing spending reviews and linking them to the process of drawing up spending limits at the start of a parliamentary term, the necessary fiscal space can be found and the use of public funds made more effective.

## Elevated risks to public finances during pandemic

General government debt has grown rapidly during the pandemic, by around 10 percentage points relative to GDP. Although the debt-to-GDP ratio is still lower than the average for EU countries, the greater level of debt is associated with higher risk. Interest expenditure on Finland's central government debt has continued to fall. Whereas in 2000 the yield on 10-year government bonds was still more than 5% and the Government paid total interest amounting to 3.2% of GDP on an amount of debt smaller than at present, in 2021 the yield on the Government's new debt is at zero and total interest expenditure is only 0.5% of GDP. Despite this, Finland must be prepared for a rise in interest rates. When public spending is facing pressure from age-related and other necessary expenditure, a rise in interest expenditure would significantly hamper the achievement of balanced finances. The effect on the public finances of climate change and measures required to mitigate it is still uncertain, but in the short term this impact will probably be negative.

There is still great uncertainty about the path the pandemic will take, which means fiscal measures should be scaled to allow fiscal space in the event of developments taking a less favourable course than anticipated. The fiscal stance should now take into account the Finnish economy's rapid shift from crisis to upturn. A faster return to balanced public finances would represent successful counter-cyclical policy and would serve to prepare the public finances for the longer term challenges lying ahead. The fiscal framework should be developed in such a way that medium-term objectives would be set according to the scale of long-term challenges, and monitoring of and accountability for the attainment of objectives would be strengthened. The ecological sustainability gap creates significant additional pressure on management of the public finances and increases the challenge of balancing revenues and expenditure in the longer term.

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12. See e.g. European Commission: Quality of public finances: Spending reviews as a key tool to enhance public investment in the Euro Area. Technical note to the Eurogroup. 29 August 2019.

13. <https://vm.fi/menokartoitus>.

## Tags

fiscal sustainability, public finances, public debt, fiscal policy