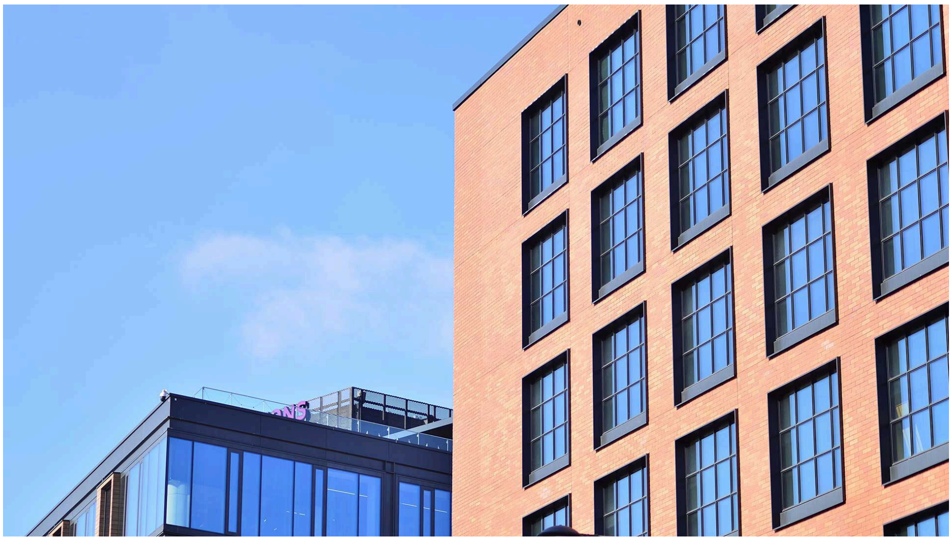
ASSESSMENT OF PUBLIC FINANCES 2024

Sustained efforts needed to turn Finland's public debt ratio around

4 Feb 2025 – Assessment of Public Finances – Finnish economy

The state of the public finances in Finland remains challenging. The economy's persistently weak productivity growth and the repeated economic shocks have together eroded the tax base, and expenditure growth has exceeded growth in revenue. Public debt relative to gross domestic product (GDP) has grown over the past decade to reach record highs. Turning the debt ratio onto a declining path will require sustained fiscal consolidation measures for some time to come. The EU's new fiscal rules provide a framework for reducing government debt ratios.



Current state of Finland's public finances and the outlook

Finland's general government deficit continued to grow in 2023 and 2024 and now clearly exceeds the 3% reference value defined in the EU's fiscal rules. Finland's general government debt-to-GDP ratio for 2024 will exceed the 80% mark, having more than doubled in just over 15 years. The Government has taken measures to rebalance public revenue and expenditure, but one parliamentary term is too short a time for correcting a structural deficit that has accrued over a longer period, particularly as the measures are hampered by cyclical fluctuations and the growing demand for services caused by population ageing.

Since the great financial crisis, shocks to the economy and industrial restructuring have slowed the rebalancing of general government finances. The shrinking of the deficit in 2021–2022, following the COVID-19 pandemic, was short-lived as the economy sank into recession again in 2023 (Chart 1). This was attributable particularly to the growth in public spending as a result of inflation and higher public sector wages. Interest payments on public debt increased as well, due to the rise in interest rates, but this was counterbalanced by higher interest income on general government assets. In taxation, the Government introduced index adjustments to tax scales corresponding to changes in the index of wage and salary earnings and also a reduction in central government earned income taxation, to ensure there was no tax tightening when elements of taxation were transferred from the municipalities to central government in connection with the funding of the health and social services reform. The deficit was further worsened by the temporary taxation and support measures for curbing the impact of the rise in energy prices and other consumer prices (Chart 2).

Chart 1.

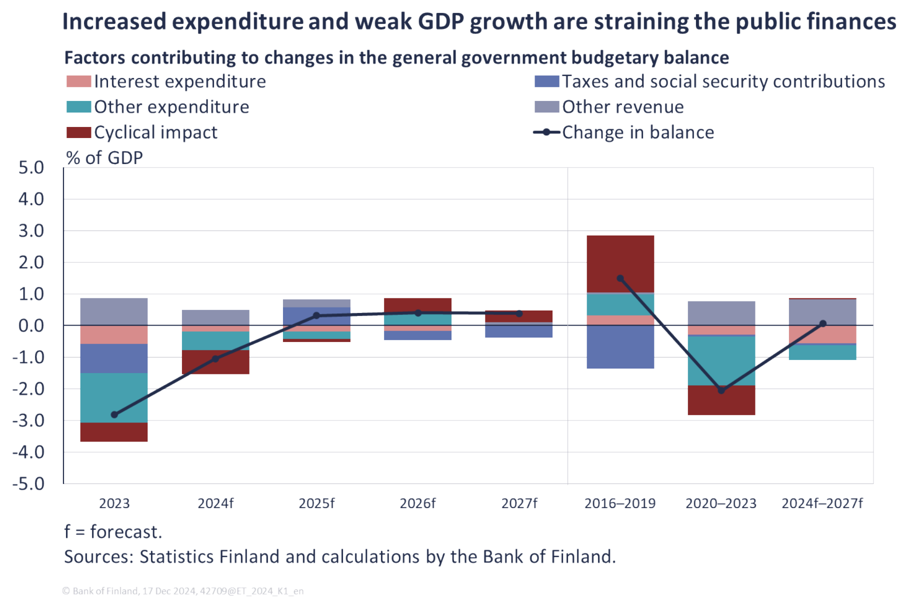
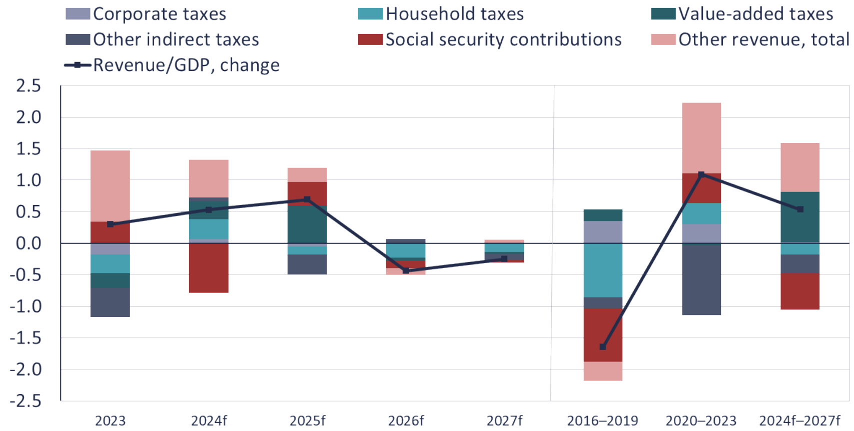


Chart 2.

Revenue growth will be supported by property income and an increase in indirect taxes

Change in public revenue, % of GDP



f = forecast.

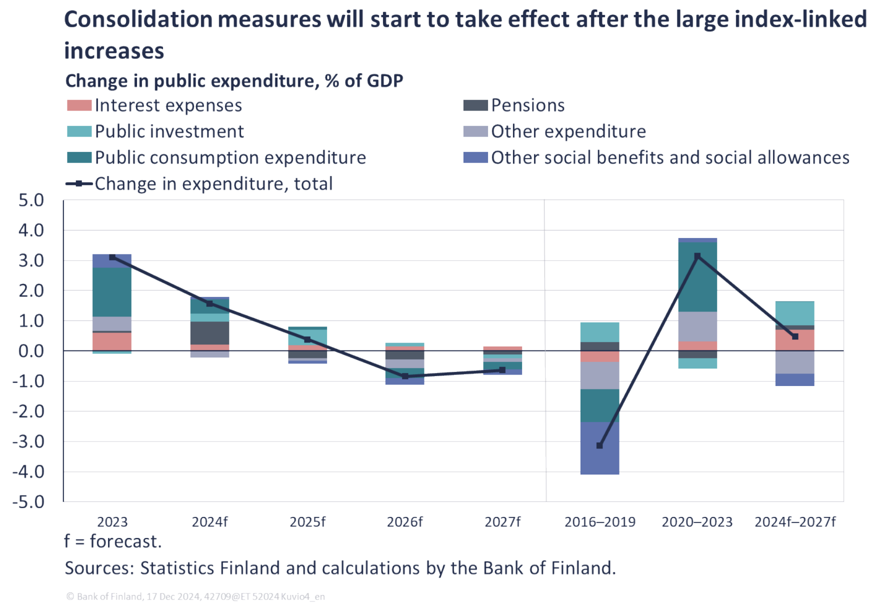
Sources: Statistics Finland and calculations by the Bank of Finland.

The general government deficit has continued to grow in 2024, due in equal measure to the weak cyclical conditions and the increase in public expenditure. Although the spending cuts listed in the Government Programme will curb expenditure growth, there will also be an increase in expenditure due in particular to index adjustments to pensions (Chart 3). The cut in unemployment insurance contributions will reduce public revenue, but revenue will also be boosted as a result of tighter taxation, for example the increase in the standard value added tax (VAT) rate to 25.5% on 1 September 2024. The tax-to-GDP ratio will remain at the level of 2023, at 42.5%. The higher level of interest rates means an increase in central government's net interest expenditure and also an increase in earnings-related pension providers' interest income on investments.

The additional consolidation measures of some EUR 3 billion decided by the Government in spring 2024 are divided evenly between the revenue and expenditure sides of the budget. In addition to the increase in the standard VAT rate, the Government will, at the start of 2025, increase some of the reduced VAT rates and increase social security contributions as a counterbalance to the cut in unemployment insurance contributions. On the expenditure side, the additional consolidation measures concern, for example, the funding of the wellbeing services counties and central government spending. Public investment will increase in 2025 with the start of the fighter aircraft deliveries to the Finnish Air Force. Public investment will also be supported by the Government's fixed-term investment programme.

With the large index-linked increases in pensions already made, the impact of the consolidation measures will then start to be felt in 2025. In the second half of the parliamentary term, the public expenditure-to-GDP ratio will decrease by 1.5 percentage points, i.e. public spending will grow at a slower rate than GDP. The revenue-to-GDP ratio will decrease too, albeit less than the expenditure-to-GDP ratio, and as a result, the fiscal balance will improve only slightly.

Chart 3.



Government's consolidation measures tighten fiscal policy

While the fiscal stance is neutral[1] in 2024, it will tighten significantly in 2025 due to the Government's fiscal consolidation measures (Chart 4). Economic growth will not start to gather pace after the cyclical trough until 2025, and the recovery will be slowed somewhat by the tightening of fiscal policy.

A similar or slightly larger fiscal policy tightening took place in 2015 at the lowest point of the cyclical trough, and this contractionary fiscal stance continued in 2016. Despite this, the economy recovered swiftly and the general government budgetary position improved rapidly, moving closer to balance. During that period, budget cuts affected spending on economic affairs (employment services and other services related to economic activity; expenditure on transportation, research and development; and agriculture and forestry), general public services, education and public order and safety, including defence. Index-linked increases to various social security benefits were also frozen.

In 2026, fiscal consolidation will continue and the ratio of public expenditure (less interest payments) to GDP will decrease. However, the ratio of public revenue to GDP will also decrease, despite the improvement in cyclical conditions, and fiscal policy will thus be fairly neutral. In 2027, the fiscal stance will be mildly contractionary again.

It should be noted that in 2027, despite a significant improvement in the general government structural primary balance compared to 2024, this will still be negative (-0.5%). The strengthening of the structural primary balance will be slowed significantly by growth in compensation of employees and in public investment (partly due to

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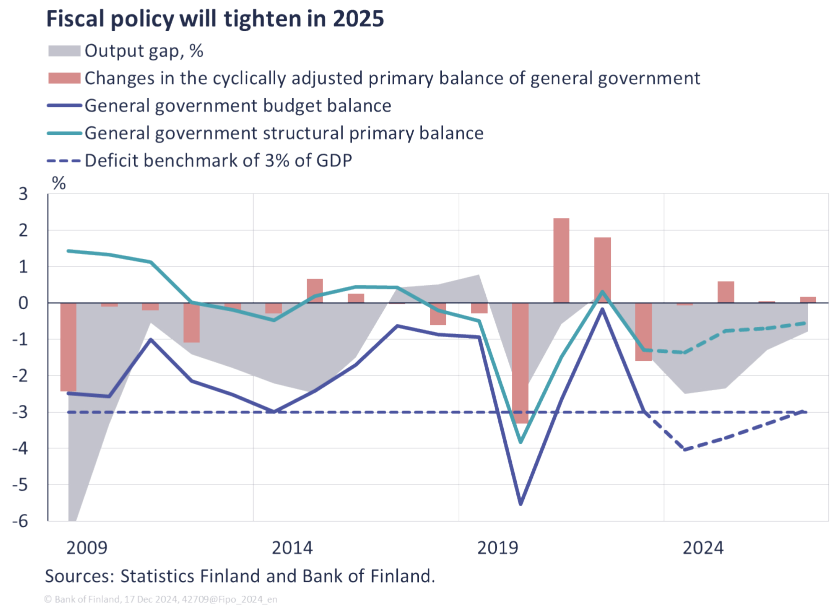
1. Measured in terms of the change in the cyclically adjusted primary balance.

investment in defence). Since 2012, the structural primary balance has averaged -0.6%, indicating that fiscal policy has been mildly expansionary in the past decade.

Chart 4.



Wellbeing services counties: current state and outlook

In their first year of operation in 2023, the wellbeing services counties posted a deficit of EUR 1.7 billion according to the National Accounts, which is 0.6% relative to GDP. The deficit is estimated to be of a similar magnitude in 2024. In 2025, funding will be adjusted to correspond with actual costs in 2023. However, under the Act on the Funding of Wellbeing Services Counties (617/2021), from 2025 onwards only 80% of the imputed growth in the service needs of the wellbeing services counties will be covered by central government funding. In accordance with the Act, counties should seek to cover, by the end of 2026, the deficits accumulated in their balance sheets.

The starting point for the wellbeing services counties to launch their healthcare, social welfare and rescue services was insufficient. The responsibility for organising the services was transferred to the counties in a situation in which inflation and public sector wage growth were exceptionally high. Under the Act, the appropriations allocated to the counties will be raised annually based on an index – the price index of the wellbeing services counties – which is the weighted sum of the increase in the earnings level in the economy as a whole (weight 0.6), the rise in prices (weight 0.3) and the change in employers' social security contributions (weight 0.1). The price index of the wellbeing services counties is calculated on the basis of a forecast of costs. The annual change in the index in 2023 was 3.5% even though in the same year the general level of earnings rose by 4.2% and consumer prices (CPI) by 6.3%. The rise in earnings in the local government sector (municipalities, joint municipal authorities and wellbeing services counties), at 5.6%, was higher than the general growth in earnings, due to the public sector wage programme negotiated in spring 2022. In local government, the compensation of employees increased by 7.5%, and intermediate consumption by as much as 16.7%, between 2022 and 2023. The growth in wage expenditure has also been affected by the harmonisation of wages within the counties.

There are also several other reasons for the large deficit. The use of purchased services increased and prices rose substantially as the counties suffering from a labour shortage strove to carry out their statutory tasks. Moreover, municipalities may have felt an incentive to limit health and social services costs prior to the transfer of these to the counties, because the proportion of municipal revenue corresponding to the health and social services costs was transferred to central government. The reductions in central government transfers to municipalities turned out to be problematic, however, and the Government decided to reduce the cuts in transfers for now. Furthermore, the administrative costs of health and social services may not have been fully taken into account in the transfer calculations, as it may have been impossible to differentiate the administrative costs from the municipality's general administration costs. Temporary costs will also arise in the transition period if systems and services need to be harmonised. In addition, wellbeing services counties are renting properties transferred from the municipalities which they can cease renting only in 2026. Overall, considering the size and timing of the reform, it is no wonder that problems have arisen.

The Government has taken several decisions on scaling back the tasks and obligations of the wellbeing services counties. The corresponding imputed savings will be deducted from the central government funding. The impact of the cost savings on the financial balance of the counties may turn out to be smaller than estimated. For example, the situation may not necessarily be improved by increasing the upper limits on client fees if the wellbeing services county has already raised client fees to the upper limit and central government then cuts funding by an amount corresponding to the income from the higher fee.

The counties have drawn up fiscal adjustment plans and measures are being implemented, but it looks unlikely that they will be able to cover the deficit accumulated in their balance sheets by the deadline of the end of 2026. If a wellbeing services county has not covered its deficit within the statutory deadline, the Ministry of Finance may initiate an evaluation procedure, in which the State and the county assess the financial capacity of the county to perform its tasks. However, most of the wellbeing services counties seem to be unable to cover their deficits within the statutory period, and the threat of an evaluation procedure may not be a sufficient incentive for speeding up the adjustment measures because the counties in any case have an obligation to produce the statutory services.

A soft budget constraint of this kind is problematic for central government funding.[2] If the budget allocated to a county is not sufficient for it to perform its statutory tasks, the central government is obliged to cover the actual costs (a national level calculation). At the same time, the counties have no incentive to leave any funding unused. If the counties were to collect supplementary funding via a county income tax, the democratically elected county council would have real budgetary power and responsibility. A marginal tax levied by the counties would also be an incentive for increasing the efficiency of operations to ensure that this tax supplementing central government funding remains small and that the benefits of more efficient operations would have an impact on the tax rate. The introduction of a county income tax under the current county structure could require some kind of revenue equalisation mechanisms. Nevertheless, some of the differences between the counties are already taken into account in the basic central government funding. In addition, if, following the evaluation procedure, the Government decided to merge certain wellbeing services counties, a significantly smaller number of counties could make the county income tax viable without separate revenue equalisation.

The health and social services reform was an exceptionally large structural reform of public administration and services, and its unfortunate timing has hampered its implementation. The rebalancing of the wellbeing services counties' finances is of utmost importance, but due to the tight timetable it may be difficult to achieve sustainable savings in costs through attempts to genuinely improve the operating practices. This kind of work requires a solid knowledge and research base, and this is something that periodic trials and experiments should also be producing within the framework of the services produced.

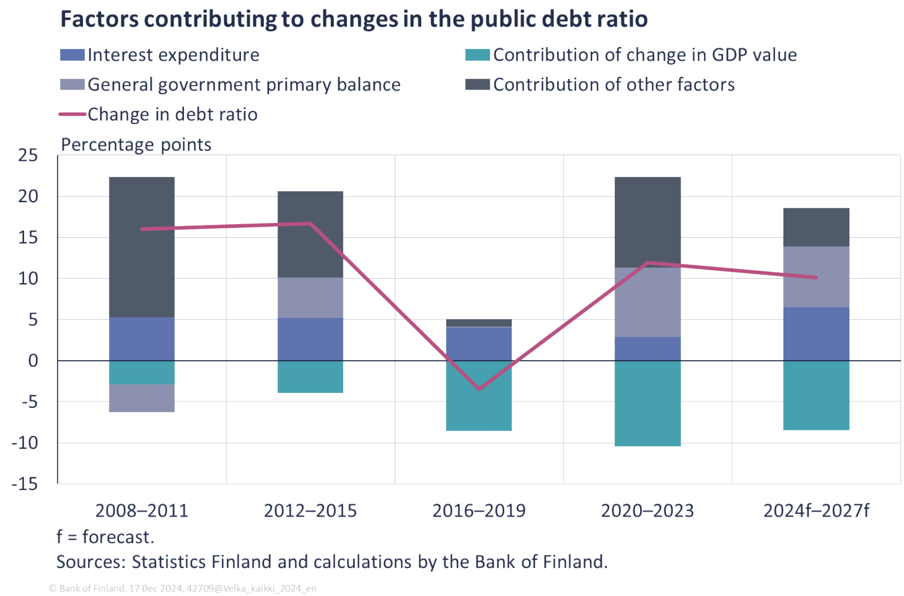
General government debt and contributing factors

The public debt-to-GDP ratio will grow further in the years ahead. The large budget deficits of central and local government must continue to be financed with new debt. With fairly low nominal GDP growth, the increase in the debt ratio in 2024–2027 will be slowed, but this will be less marked than in previous years (Chart 5).

As earnings-related pension providers are included in the general government sector, their surpluses reduce the total deficit of general government. However, public debt is necessary for financing the deficits of central and local government, and so other factors have played a relatively large role in the growth of the debt ratio. These other factors (so-called stock-flow adjustments) include the building up of public pension funds with the surplus of earnings-related pension funds and other financial transactions that increase or decrease debt. Due to the importance of the other factors contributing to the debt ratio, it is essential that they are also taken into account in assessments of the trajectory of public debt.

2. Kortelainen, M., Kotakorpi, K. and Lyytikäinen, T. (2021) 'Incentive effects of the wellbeing services counties' financing model' (in Finnish), *Kansantaloudellinen aikakauskirja/The Finnish Economic Journal*, 2/2021, pp. 203–211.

Chart 5.



New fiscal rules for the governance of country-specific debt risks

The objective of the EU's new fiscal policy framework[3] is to curb country-specific debt accumulation risks and to issue related fiscal policy recommendations for the medium term. The revised preventive arm of the Stability and Growth Pact (SGP) requires Member States to ensure that by the end of the adjustment period of four or seven years, and during the 10 subsequent years, a debt ratio that exceeds 60% is put on a plausibly downward path, even under adverse scenarios. At the same time, the general government deficit must be maintained below the reference value of 3% of GDP. The calculations must take into consideration the expected growth in expenditure related to population ageing.

The European Commission assesses debt sustainability in a conventional debt dynamics framework, in which the trajectory of public debt is based on the primary balance, interest expenditure and other factors determining the level of public debt over the 10 years following the adjustment period. The baseline scenario is based on the assumption of no change in fiscal policy, i.e. the structural primary balance is assumed to remain unchanged from the reference year. The trajectory of the debt-to-GDP ratio also naturally depends on expected GDP growth.

The trajectory of the debt ratio is also assessed on the basis of various more adverse assumptions, for example a weaker primary balance or higher interest rates. The

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3. As a result of the reform of the Stability and Growth Pact which entered into force at the end of April 2024, the preventive arm of the original Pact was replaced with Regulation (EU) 2024/1263 of the European Parliament and of the Council. Amendments were made to the corrective arm of the SGP, i.e. to Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and to Directive 2011/85/EU on requirements for budgetary frameworks of the Member States.

trajectory of the debt ratio is, in addition, projected using a statistical analysis in which, with a probability of at least 70%, the debt ratio should be on a declining path in the five years following the adjustment period.

In addition to being based on debt sustainability, the adjustment need is regulated by so-called safeguards. The debt sustainability safeguard requires that a debt ratio between 60% and 90% of GDP should decline by an average of at least 0.5 percentage points per year during the adjustment period. If debt exceeds 90% of GDP, the safeguard requires the debt ratio to decline by an average of at least 1 percentage point per year. The purpose of the deficit resilience safeguard is to ensure a sufficient buffer against the 3% deficit benchmark, and this requires a continuation of the adjustment until the (structural) deficit is no more than 1.5% of GDP.

Based on this, the European Commission computes for Member States whose debt ratio exceeds 60% or whose deficit exceeds 3% of GDP, a reference trajectory for annual net expenditure growth. Net expenditure refers to the aggregate of government expenditure net of the following: interest expenditure, financing of EU programmes (national expenditure and EU-financed share), cyclical elements of unemployment benefit expenditure, discretionary revenue measures, and one-offs and other temporary revenue measures (e.g. sale of assets).

The structural primary balance adjustment need required by the debt sustainability analysis and the safeguard conditions is converted to a rule that restricts net expenditure growth.[4] This also requires an assessment of the volume and growth rate of potential output. In addition, fiscal consolidation is expected to slow GDP growth.[5]

Based on the reference trajectory, Member States prepare a medium-term fiscal-structural plan for the parliamentary term, i.e. for four or five years. A Member State may request an extension of the adjustment period to seven years if its plan includes reforms and investments that correspond to the country-specific recommendations issued by the European Commission or otherwise promote the EU's priorities, such as the green transition or digitalisation. Reforms and investments under the Member State's Recovery and Resilience Plan may fulfil these criteria. The adjustment path put forward in the plan may deviate from the Commission's reference trajectory, but Member States may not backload the adjustment to the final years of the fiscal-structural plan.

After the Council of the EU has endorsed the fiscal-structural plan, compliance with the plan will be monitored. The Member States report annually, in the spring, on progress with the implementation of the plans. The Commission assesses adherence to the net expenditure path on the basis of actual expenditure. Therefore, the first assessment will not be made until 2026 and will cover the rate of expenditure growth between 2024 and 2025. Deviations from the agreed net expenditure path are recorded in the control account. The observed net expenditure growth in one year may be no more than 0.3% larger relative to GDP or cumulatively no more than 0.6% of GDP. If the deviation is larger, it will trigger a process that leads to the excessive deficit procedure (EDP).

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4. For more detail, see Henriksson, M., Kekäläinen, A. and Lehtimäki, J. (2024) 'Reform of EU fiscal rules' (in Finnish), *Kansantaloudellinen aikakauskirja/The Finnish Economic Journal*, 2/2024, pp. 209–221.

5. The European Commission applies a fiscal multiplier of 0.75.

The Commission will also monitor implementation of the reforms and investments constituting the criteria for extending the adjustment period. If a Member State does not present objective reasons for deviations from the plan, the Council may shorten the extended adjustment period or tighten the adjustment requirement.

Member States may draw up a new medium-term fiscal-structural plan whenever there is a new government or there are objective circumstances preventing the implementation of the plan within the original period. In case of a change of government, the control account is reset. For the new plan, the Commission issues a reference trajectory for net expenditure, which takes into account the Member State's earlier fiscal adjustments or their absence. However, the reference trajectory of the new plan may not backload the fiscal adjustment measures nor, as a rule, reduce them.

The regulatory framework contains two escape clauses. The general escape clause allows Member States to deviate from the net expenditure path in the event of a severe downturn in the euro area or the EU as a whole. At the request of an individual Member State, the Council of the EU may also allow that Member State to deviate from its net expenditure path as set by the Council where exceptional circumstances outside of the Member State's control have a major impact on its public finances. Such deviation may not, however, endanger fiscal sustainability over the medium term.

New fiscal rules set challenging adjustment targets for Finland

As Finland's debt-to-GDP ratio currently exceeds 60%, the Commission calculates for Finland's primary balance and consequently for its net expenditure growth, the necessary adjustment path to bring the debt ratio closer to 60%. Under the no-fiscal-policy-change scenario of the Commission's debt sustainability analysis, where the structural primary balance is assumed to remain constant at its base year level (Finland: -0.5), Finland's debt ratio will increase to over 98% by 2038 (Chart 6). The Bank of Finland's medium-term calculations point towards a similar outcome.

An annual adjustment just large enough to turn the debt ratio onto a downward path according to the debt sustainability analysis will not, however, be sufficient to satisfy the debt sustainability safeguard. The safeguard requires an average annual decrease in the debt ratio of 0.5 percentage points during the adjustment period in comparison with the previous year's (2024) debt ratio. The debt sustainability safeguard and its adjustment requirement are binding on Finland. The new rules necessitate greater fiscal adjustment from Finland than from most other EU countries, as the safeguards are not binding on countries that are subject to a deficit-based excessive deficit procedure (EDP).

Consequently, in its medium-term plan[6], Finland requested an extension of the adjustment period to seven years, which eased the annual fiscal adjustment requirement. The grounds given for the extension were the labour market reforms included in Finland's Recovery and Resilience Plan, the investment underpinning the health and social services reform, and the investment in the green transition and in research, development and innovation. The forthcoming social security reforms constituted a

6. Finland's Medium-Term Plan 2025–2028: National Medium-Term Fiscal-Structural Plan, publications of the Ministry of Finance 2024:59.

further justification.

Finland's medium-term fiscal-structural plan presents two deviations from the Commission's assumptions. First, Finland's plan assumes that potential GDP will grow at an annual rate of 0.9%. As the net expenditure path depends on the growth rate of potential GDP, this allows a little more room for manoeuvre in the initial years of the net expenditure path than with the Commission's reference trajectory. This deviation is only permitted in the first medium-term fiscal structural plan.

The second deviation concerns the so-called stock-flow adjustments. For Finland and Luxembourg, the Commission's debt sustainability calculations take account of the impact of the earnings-related pension funds on general government net lending.[7] The pension funds build up fund assets, so their surpluses do not reduce borrowing needs but instead increase the level of stock-flow adjustments. This was not taken into account in the Commission's previous debt sustainability analysis calculations, which means the debt projections were, in general, not fully realistic.

Although this change improves the Commission's debt sustainability analysis, there is a minor inconsistency. Namely, the Commission's assessment of the growth rate for net expenditure is not adjusted correspondingly for the earnings-related pension providers' expenditure on pensions. This means that if pension expenditure grows faster than the overall net expenditure path, it would be more difficult to comply with the expenditure rule.

Forecasts nevertheless suggest that pension expenditure growth will slow markedly in Finland in the coming years, and, for example, the Commission's Ageing Working Group expects pension expenditure relative to GDP to be smaller in 2040 than in 2022. Hence, the minor inconsistency in the debt sustainability analysis methodology is of no practical significance. Furthermore, if pension expenditure growth were to result in Finland failing to comply with the expenditure rule, Finland could, in the follow-up process, refer if necessary to earnings-related pension expenditure as a relevant factor explaining the deviation.[8]

Finland's medium-term plan assumes a stock-flow adjustment trajectory that has a debt ratio impact 1 percentage point smaller by 2028, and 2 percentage points smaller by 2031, than the impact according to the Commission's baseline. The grounds given for this are that Finland is procuring fighter aircraft, for which the payments began in 2022. The payments made so far have increased the borrowing needs but have not affected the deficit. When the aircraft deliveries begin in 2025, they will be recorded as public investment and the deficit will increase as a result. In the delivery phase, the previous payment instalments will reduce borrowing needs in relation to the investment items, and stock-flow adjustments will therefore turn negative in this respect.

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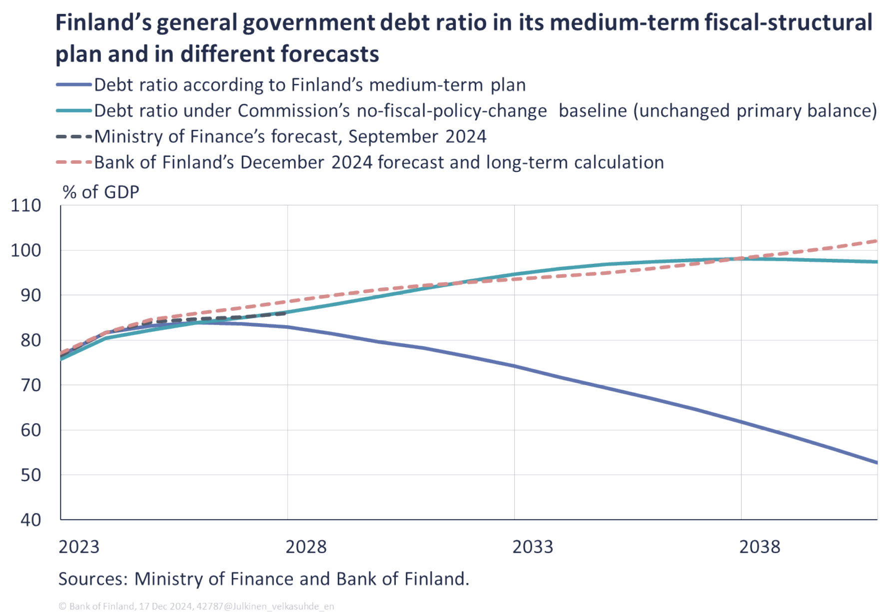
7. Debt Sustainability Monitor 2023.

8. See 'Adjustment of the Commission's method of forecasting Finland's public debt was necessary' (in Finnish).

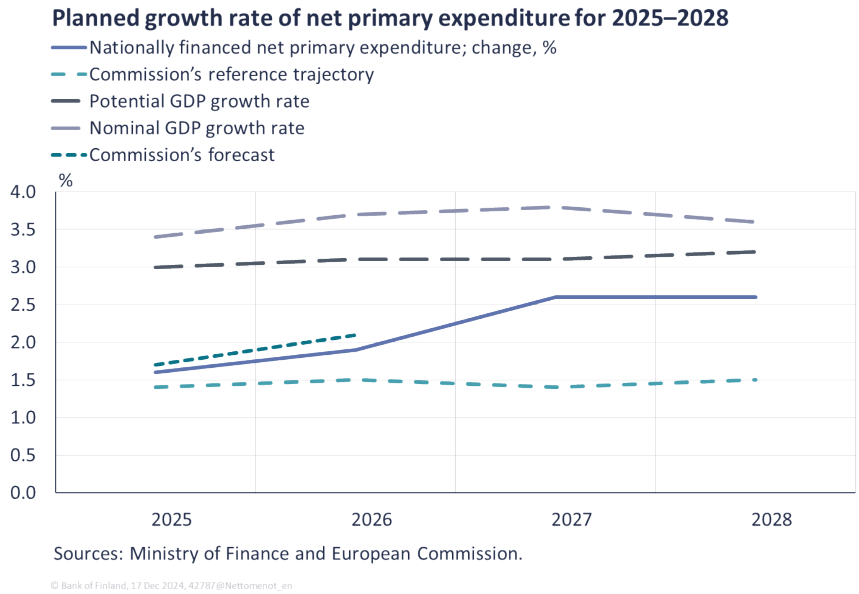
Chart 6.



In Finland's medium-term fiscal-structural plan, net expenditure in 2025–2028 will grow at an annual average rate of 2.2%, compared to an average of only 1.5% based on the Commission's reference trajectory. The medium-term plan envisages an annual net expenditure growth of 1.6% in 2025, 1.9% in 2026 and 2.6% in each of 2027 and 2028. In its opinion on Finland's Draft Budgetary Plan, the Commission states that according to its forecast, net expenditure growth might be exceeded by 0.1 percentage points in 2025.[9] Such a breach of the expenditure rule would not yet trigger an EDP, but the Commission nevertheless invites Finland to take the necessary measures to avoid breaching the rule.

9. Commission opinion of 26.11.2024 on the Draft Budgetary Plan of Finland, C(2024) 9054 final, European Commission.

Chart 7.

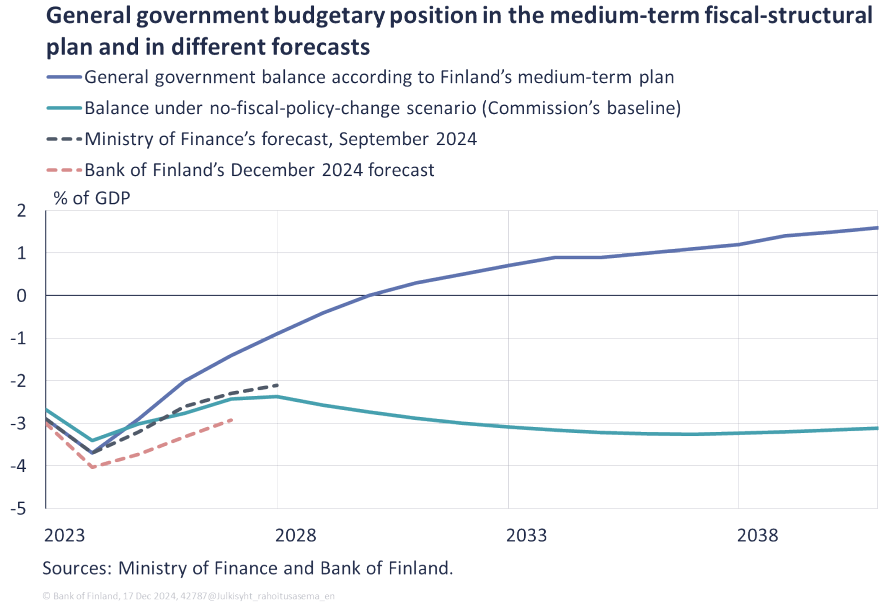


The expenditure growth rate may nevertheless be too high relative to the growth in revenue. The Bank of Finland's forecasts for the deficit (Chart 8) and debt (Chart 6) suggest so far that Finland cannot adhere to the medium-term fiscal-structural plan without the full implementation of the EUR 9 billion adjustment package sought by the Government. For 2027, the deficit projected by the Bank of Finland differs from that envisaged in the medium-term plan by 1.5 percentage points, or approximately EUR 4.5 billion. In the Bank of Finland's forecast, the number of people employed will hardly increase at all from 2023, and there is no certainty that the targeted savings of EUR 0.9 billion from changes in the wellbeing services counties' operating practices will be achieved.

According to a debt dynamics calculation performed on the basis of the Bank of Finland's forecast, an additional fiscal consolidation of EUR 4.5 billion over the next seven years would be sufficient to halt the rise in the debt ratio over the medium term. Consolidation measures curb economic growth to some extent, and so success with the employment measures already taken would help support achievement of the objectives and reduce the need for further consolidation measures. A sustainable rebalancing of the wellbeing services counties' finances is also necessary for turning the debt ratio around.

After parliamentary elections in 2027, the next government can draw up a new medium-term plan on the basis of a fresh analysis produced by the Commission. In this plan, too, expenditure growth must be set much lower than economic growth in order to keep the debt ratio on the envisaged downward path.

Chart 8.



Still too early to assess effectiveness of new regulatory framework

Most EU Member States submitted their first national medium-term fiscal-structural plans under the EU's new fiscal policy framework to the Commission by the end of October 2024. According to the Commission, only five countries (Finland, France, Italy, Romania and Spain) have requested an extension of the adjustment period to seven years. On the other hand, seven countries (Belgium, France, Hungary, Italy, Malta, Poland and Slovakia) are placed under an EDP, which determines the annual fiscal adjustment requirement for these countries until their deficits fall below the 3% of GDP reference value.

Placing Finland under an EDP was also considered, as Finland's deficit is projected to be significantly above the 3% reference value in 2024. However, Finland has requested activation of a national escape clause on the grounds that the security situation has economic implications. The Commission, in its report[10], assessed that initiating an EDP for Finland in autumn 2024 would not serve a useful purpose, as the Commission's forecast indicates that the Government's measures will be sufficient to reduce the deficit to 3.0% in 2025. The situation will be reviewed in spring 2025. The EDP requirements for fiscal consolidation would not be any tighter than the requirements for Finland under the preventive arm of the Stability and Growth Pact. Moreover, initiating an EDP would hardly provide the market with any new information that would affect the risk premium paid by Finland on its debt.

In the new regulatory framework, fiscal policy is guided by net expenditure growth, which makes it more straightforward and predictable to comply with the rules. In spite of

10. Report from the Commission: Austria, Finland. Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union, COM(2024) 959 final, European Commission.

this, it is already clear that there is considerable discretion and complexity in the new regulatory framework. The purpose was also to create space for necessary public investment without compromising debt sustainability. However, the most indebted Member States have little more room for manoeuvre even in the new regulatory framework.

The EU's new regulatory framework also requires a reform of the domestic fiscal rules in 2025. Finland's fiscal policy is currently governed by Act 869/2012 (known as the Fiscal Policy Act) and the Decree on the General Government Fiscal Plan (120/2014). The focus of the Fiscal Policy Act is on the medium-term objective (MTO) for the structural budgetary position, and this is no longer included in the new EU-level legislation. The Act has required the Government to take measures if, in the Government's assessment, the general government structural budgetary position deviates significantly from the MTO in a manner that jeopardises its achievement or if the Council of the EU has drawn attention to the matter. The Government is also required to submit a report or a statement to Parliament if the Council issues related warnings or recommendations to Finland. In practice, deviations from the MTO have so far not exceeded the threshold for taking measures required by the Act.

There is reason for new domestic legislation to replace the MTO for the structural budgetary position with a rule that restricts net expenditure growth. Application of the expenditure rule beyond the central government's on-budget entities may also require legislative changes. In addition, legislation should strengthen the importance of the domestic monitoring process and institutions, as even in the future, processes within the EU will not necessarily be effective enough to bring public indebtedness under control. The revised SGP and the Budgetary Frameworks Directive provide an opportunity for domestic fiscal supervisory authorities to become more closely engaged with the fiscal planning and monitoring processes. This opportunity should be grasped in Finland as elsewhere.

Long-term sustainability of public debt

Economics does not provide an unequivocal answer as to when the general government debt ratio is appropriate or too high. However, a higher debt ratio signifies higher interest expenditure, which means a larger share of public expenditure is spent on servicing debt. In addition, a larger amount of debt increases the debt refinancing risks, especially if there are disruptions in the financial markets. Debt-related risks are further reflected in the interest paid on debt in comparison with assets regarded as more secure. The risk premia on public debt may further affect the price of private debt. The financing of public debt may also crowd out funding for private investment.

Market confidence in the State's ability to service its debt is of key importance. If rising debt is not cyclical but instead follows an upward trend, market sentiment may change, even abruptly. As a small, peripheral economy, Finland has historically taken good care of its debt servicing capacity and reputation.

Finland's general government EDP debt for the full year 2024 is estimated at 82%. The definition of EDP debt has been harmonised in EU legislation. It refers to consolidated general government debt, meaning that liabilities between and within general government subsectors are eliminated. Thus, for example, government bonds held by earnings-related pension providers reduce the level of recorded EDP debt. In order to closely follow the harmonised definition, a decision was taken in 2022 to also include ARA interest subsidy loans (for rental and right-of-occupancy housing) in Finland's EDP debt and correspondingly in general government assets. As a result, the debt ratio rose by 5.9 percentage points, and changes in the amount of these loans will continue to affect changes in the level of debt. On the other hand, EDP debt excludes other contingent liabilities, which are fairly considerable in Finland by European comparison.[11] Looking only at central government on-budget entities and unincorporated state enterprises, the gross debt-to-GDP ratio exceeds 61% in 2024, compared with a peak of almost 65% recorded after the recession, in 1996.

Since the global financial crisis, Finland has been challenged by low economic growth, recurring international crises and population ageing. The demographic change alone has long been seen as a challenge for fiscal sustainability, and the declining birth rate has intensified the concerns. The working-age population shrank in 2010–2021, but higher net immigration has since brought the number of people aged 20 to 64 onto an upward trajectory.

In Statistics Finland's population projection published in 2024, the assumption about Finland's annual net immigration was revised from 15,000 to 40,000. The implications are that growth in the working-age population and in employment would be sustained far into the future, and, consequently, the outlook for the dependency ratio would also be considerably more favourable. The update of the Bank of Finland's long-term growth forecast relies on a more moderate assumption about net immigration (25,000), which is based on an average over the past five years (excl. Ukrainian refugees). In this forecast, too, higher employment would lead to somewhat stronger economic growth than previously estimated.

The new demographic assumptions have a clear positive impact on the outlook for Finland's long-term debt sustainability. With the new assumptions, the estimate for the sustainability gap has decreased to approximately 2%. The sustainability gap does not serve as a practical policy guideline but instead indicates the scale of the challenges related to long-term debt sustainability. The sustainability gap indicator is a measure of the size of a one-off fiscal adjustment that would stabilise the debt ratio over the long term. It does not, however, take a stand on whether the ratio will stabilise at a sustainable level. Medium-term assessments of debt sustainability demonstrate that the challenges concerning Finland's public debt accumulation will already be felt in the immediate years ahead and in the next decade – they are no longer problems to be tackled solely over the longer term.

Towards more balanced public finances

Rebalancing the public finances and turning the debt ratio onto a declining path require significant fiscal adjustment in Finland's current situation, and Prime Minister Orpo's

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11. Overview of central government risks and liabilities: Autumn 2023, publications of the Ministry of Finance 2024:20.

Government has started working towards this aim. The spring decisions on the additional consolidation measures were more balanced between revenue and expenditure than the measures in the Government Programme. Moreover, the purpose is to generate significant savings through structural reforms. Even in the best case, however, these savings will materialise only after a time lag.

Maintaining the current service structure requires more robust growth in the economy. Efforts should therefore be taken to strengthen GDP growth, although the extent to which economic policy can help in this respect are limited. Work-based immigration will support sectors affected by labour shortages and improve Finland's human capital, though it is otherwise difficult to influence the population structure.

Currently, there are more demands to increase spending than ideas for reducing it. A parliamentary agreement on a target for R&D expenditure is one of the measures to strengthen economic growth which can also be justified by research findings. Strengthening Finland's defence capabilities is also justified in the current security environment. However, since the balance of central government finances also has to be considered, finding the funding even for justified expenditure increases is not easy.

The Ministry of Finance has announced it will establish a regular process of reviewing spending and the structure of the public finances[12], which will hopefully provide decision-makers with better information on the effectiveness of public spending in the future. In order to maintain and increase public revenue, taxation as a whole should be assessed with the aim of ensuring tax revenues, while at the same time effectively promoting Finland's ambitious climate objectives. Rebalancing the public finances and controlling debt accumulation call for long-term and sustainable fiscal policies across parliamentary terms. The common European fiscal rules and objectives provide a good framework for this work.

Tags

public finances, sustainability of public finances, public debt, fiscal policy

12. See 'Ministry of Finance to establish a regular process of reviewing spending and the structure of public finances' (in Finnish).