Assessment of Public Fianances

Overall positive sentiment will not resolve structural problems in public finances

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Finland's rapid economic growth in 2017 has notably improved the situation for the public finances. With the cuts in taxes related to the Competitiveness Pact, fiscal policy will ease in 2017 and 2018 and the structural deficit will deepen. Moreover, the projected acceleration of economic growth will not resolve the longer-term problems associated with Finland's public finances. Population ageing will push up public expenditure, while the contraction in the working-age population will rein in economic growth and thus weaken the funding base of the public finances. Growth in age-related expenditure will generate a sustainability gap that is still estimated at around 3% of GDP.

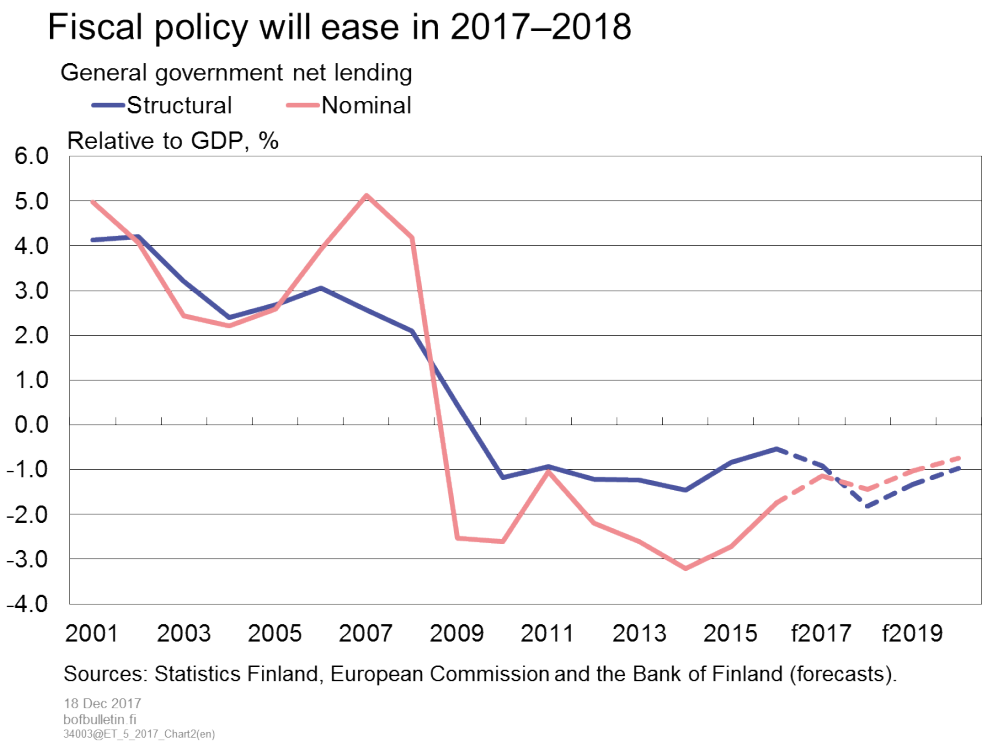


Fiscal policy to ease in 2017–2018

The strengthening of Finland's economic growth is favourably reflected in the public finances. Cyclical factors will have a positive impact on the general government budget balance in

2016–2018, in particular (Chart 1). There is, however, a structural imbalance between public revenue and expenditure, reflected in the fact that the rebalancing of public finances by 2020 does not appear plausible even in an environment of normalising economic growth.

Chart 1.



The composition of public expenditure has changed especially due to growth in pension expenditure. Compared with 2004, when central government finances were in balance and the social security funds posted robust surpluses, the pension expenditure-to-GDP ratio had risen by 3 percentage points by 2016.

Growth in social benefits and allowances has also been fuelled by a cyclical increase in unemployment expenditure. This increase, however, has already turned downward due to the improved employment situation. Nevertheless, it is still unclear how the prolonged recession has impacted the level of structural unemployment.

Other public expenditures have been adjusted since 2015. The current Government seeks to reduce public expenditure by EUR 4 billion by 2020. The public expenditure-to-GDP ratio will decrease to about 52% in 2020. The ratio was 49.3% in 2004 and 55.8% in 2016.

Over 80% of general government revenue consists of taxes and social security contributions. Increases in these items pushed up public revenue in 2011–2016. Employers' social security contributions were considerably reduced in 2017 in line with the Competitiveness Pact. At the

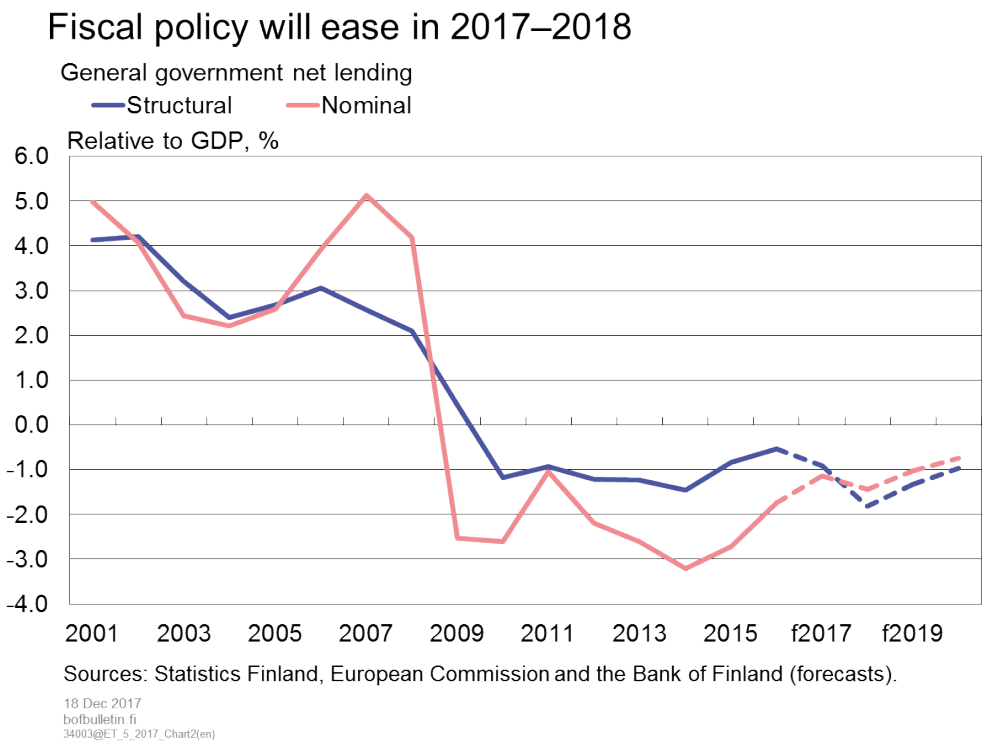
same time, labour taxation was eased, and the tax cuts will continue in 2018. On the other hand, tax revenue for 2017 will be boosted by one-off corporate tax receipts and more efficient processing of the inheritance and gift tax. In light of the Bank of Finland forecast, rebalancing of the public finances by 2020 does not appear plausible.

Finland's fiscal policy was accommodative in most of the years following the financial crisis. Fiscal policy was not tightened until 2015–2016, when the general government structural deficit – i.e. deficit adjusted for cyclical fluctuations – improved (Chart 2).

In 2017–2018, fiscal policy will ease markedly, with the economy already growing at a robust pace. Expenditure adjustments will be dampened by, on one hand, the Government's temporary allocation of EUR 1.6 billion to key government projects and, on the other hand, the Competitiveness Pact's cuts in income taxes and employers' social security contributions.

In 2019, fiscal policy will tighten again, as the financing of key government projects comes to an end and expenditure adjustments continue, assuming that the budget for the election year complies with the agreed spending limits.

Chart 2.



Structural balance target escaping again

On the basis of the European Commission's calculations, Finland achieved – perhaps somewhat surprisingly – the medium-term objective (MTO) for the general government structural balance in 2016. According to the Commission's calculations, Finland's structural balance was −0.4% of GDP, while the MTO is set at −0.5% of GDP.

In spring 2017, the Commission still assessed that the structural balance would only improve to −0.9% in 2016. However, the assessment changed not only due to a slight positive revision in the nominal deficit but also because of a higher output gap estimate used in calculating the structural balance. This is a good example of the problems associated with the measurement of the structural balance.

The structural balance will deteriorate again in 2017–2018. However, Finland has been granted temporary allowances linked to the structural reform and investment clauses, i.e. a temporary deviation of 0.6 of a percentage point from the required adjustment path towards the MTO for the structural balance. Therefore, the MTO will not significantly restrict fiscal policy in the latter part of the government term.

The General Government Fiscal Plan and Finland's Stability Programme drafted in spring 2017 included targets for the general government structural deficit and debt. Since the target paths deviated from the Ministry of Finance's forecast, the General Government Fiscal Plan stated that the targets would not be met without new measures. In that context, it would have been advisable to also discuss the means to achieve the targets. On the basis of the Bank of Finland forecast for the public finances, only the achievement of the target path for the debt ratio is plausible. Achievement of structural balance in 2010, meanwhile, is not plausible.

Finland's public debt (EDP debt) has grown significantly since the financial crisis. With the central and local government deficits contracting as forecast, debt growth will moderate. It does not appear that the Government's objective of bringing an end to living on debt – that is, the rebalancing of central and local government finances – will be achieved by 2021. However, the debt-to-GDP ratio will decline in the forecast period because the nominal growth rate of GDP has picked up.

Fiscal sustainability gap unchanged

The Bank of Finland assesses that the sustainability gap in Finland's public finances will remain at approximately 3%. The sustainability gap estimate is based on the Bank of Finland's medium-term forecast for 2017–2025 and pressure calculations for the subsequent years. In the calculation,

age-related expenditure will grow in line with the population structure, age cohort-specific social and health care expenditure and education expenditure. Long-term GDP growth is based on expected developments in the labour force and productivity. GDP growth is expected to average 1.2%. The real interest rate on the public debt is estimated to rise to 3% by the mid-2030s, and the return on pension funds to 3.5%.

Growth in social and health care expenditure will accelerate in the 2020s with the ageing of the baby boomers. According to the population projection, the number of persons aged over 80 in Finland will increase by about 200,000 in 2017–2030. The old age dependency ratio, i.e. the number of persons aged over 65 relative to the working-age population, will rise from 34% to 43% over the same period.

Population ageing will increase the demand for social and health care services and inevitably put a strain on the public finances. The social and health service reform seeks to restrain expenditure growth to below 1% per annum in real terms in the 2020s. Achieving this target is of key importance for the medium and long-term outlook for the public finances.

The defence materiel procurements envisaged for the 2020s are estimated to increase the public debt by 4–5% relative to GDP. Since no actual decisions have yet been taken, the procurements have not been taken into account in the medium-term forecast or the sustainability gap estimate. The defence materiel procurements will only have a marginal effect on the sustainability gap, via interest payments on the additional debt.

Risks to public finances high

Taking on more public debt was regarded as a necessary buffer when the Finnish economy drifted into recession in 2009. The debt-to-GDP ratio grew from 32.7% in 2008 to 63.6% in 2015. Despite this growth in public debt, the debt interest payments relative to GDP have decreased from 1.4% to 1.1% and are estimated to fall further, to 0.8% by 2020.

The decline in interest payments has supported management of public finances during the recession years. However, when the level of interest rates normalises, the interest payments on the public debt will also eventually start to rise. At the same time, growth in age-related expenditure will accelerate and the rebalancing of the public finances will become difficult. If the debt ratio cannot be placed on a clear downward path in the coming years, the fiscal policy buffer against future economic shocks will be considerably weaker.

Contingent government liabilities also pose a risk to the public finances. Over the past ten years, state guarantees have increased in Finland to reach the highest level in relative terms among EU

Member States. The majority of this increase has stemmed from export credit guarantees granted via Finnvera. Finnvera's importance has been apparent especially in funding exports of large ship deliveries. However, with the economic situation stabilising, it is time to assess whether state guarantees of similar magnitudes are still necessary to support exports, especially since growth in the stock of guarantees has inevitably led to higher associated risks.

Earnings-related pension funds play an essential role in the overall fiscal framework. At the end of June 2017, the investment assets of Finnish earnings-related pension insurers were record high, at about EUR 197 billion, which is over 90% relative to GDP. The proportion of equity and investment fund shares in pension assets has almost doubled in 2000–2016. As a result of the changes enforced in 2017 in connection with the pension reform, individual pension institutions' possibilities to increase equity risk have been enhanced. A higher weighting of equities increases fluctuations in investment returns and risks to earnings-related pension insurers.

Despite the positive economic sentiment, the structural problems in the public finances have not been resolved. Pension expenditure growth has changed the composition of public expenditure, and savings elsewhere in the public sector are insufficient to compensate for higher pension expenditure. With population ageing, growth in public social and health care expenditure will accelerate already in the mid-2020s. Therefore, measures to contain public expenditure growth will be necessary in the coming years, too. At the same time, growth in the funding base of the economy, and hence of the public finances, is in risk of falling below the rates recorded in previous decades. The funding base of the public finances can be bolstered, particularly by structural reforms to boost employment.

The fiscal policy stance over the forecast horizon will be expansionary in relation to the economic cycle. A relaxed fiscal policy is ill suited to a situation in which the composition of public expenditure is subject to pressures and the country seeks to restore the competitiveness of the economy.

Keywords

fiscal policy, public debt, public finances, structural deficit, sustainability gap