Assessment of Public Fianances

Attention should already be turned to the post-crisis years

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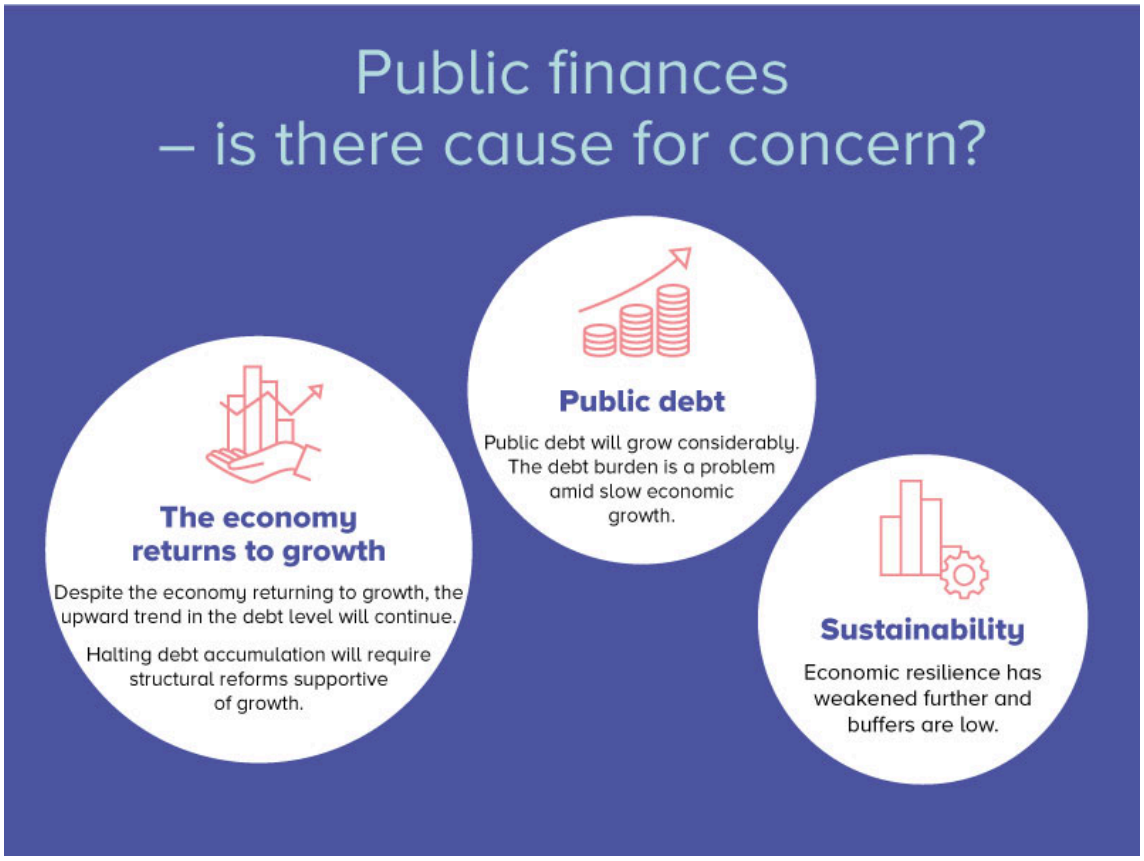
During the acute phase of the COVID-19 pandemic, fiscal policy has been deployed to support households and businesses hit by the crisis. At the same time, fiscal stimulus has been stepped up to bolster economic recovery. After the crisis, once the economy has returned to a sustainable growth path, the upward trend in the public debt-to-GDP ratio must be halted and fiscal space rebuilt. Changing the course of the public finances will require broad consensus on long-term objectives, clear short-term interim targets, and concrete measures over the coming years. With the coinciding rise in age-related expenditure, rebalancing the public finances will be difficult.



The medium-term fiscal outlook has deteriorated

The duration and economic impact of the COVID-19 pandemic are still surrounded by great uncertainty. Despite growth recorded for the third quarter, there will be no swift rebound from the recession of the early part of the year, as the second wave of the pandemic has also intensified in Finland. The necessary measures to combat the epidemic and to support firms and households have led to a strong increase in public expenditure. At the same time, policymakers have turned their attention to the future and have employed fiscal measures – for example increases in public

investment – to support economic recovery in the immediate years ahead. Even though Finland has weathered the pandemic relatively well compared with many other countries, there are a number of question marks about the forthcoming recovery phase. A particular concern is whether the recession will have long-term consequences for the labour market, economic growth and the public finances.

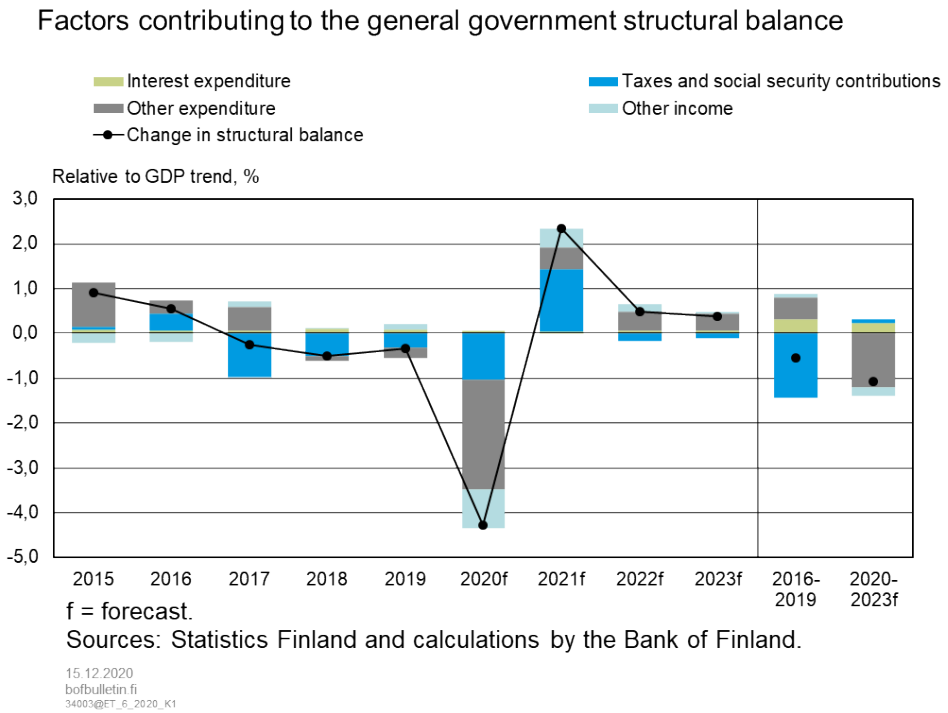


Finland's general government finances entered the pandemic in a notably weaker state than going into the global financial crisis in 2008. Finland already ran a structural deficit before the pandemic, which grew in 2017–2019 (Chart 1). Finland's fiscal balance was therefore weaker than in the other Nordic countries. In Sweden and Denmark, the public finances were structurally balanced or in surplus long before the pandemic, and the general government debt-to-GDP ratio was just over 30%.

Finland's structural deficit had persisted at around 1% already since the global financial crisis. In 2010–2015, the surplus on the social security funds (pension funds) contracted rapidly in response to the retirement of the baby boomers. After 2015, the surplus stabilised while the central and local government deficits declined by about half. Considering the cyclical situation, however, the aggregate general government deficit shrunk less than expected. Although the

previous government implemented fiscal austerity measures, the reductions in taxes and social security contributions to stimulate economic activity reined in public revenue growth. In consequence, by 2019, the general government structural deficit had grown to about 1½% relative to GDP.

Chart 1.



Despite the fiscal deficit, the public debt-to-GDP ratio began to decline in 2016, falling in total by over 4 percentage points to 59.3% in 2019. This was modest compared with the debt ratio's growth of over 30 percentage points in 2009–2015. The fall in the debt ratio mainly reflected the contribution of faster economic growth to the ratio, combined with a decline in interest payments on public debt.

Finland's fiscal balance will be notably weaker in the coming years than estimated just a year ago, before the pandemic. The current forecast suggests that the general government deficit will, after the sharp increase in 2020, only contract to about 2.5% in 2023–2025. The structural deficit, too, will grow in 2020 on account of the substantial fiscal stimulus in the acute phase of the crisis, but will shrink in the following years. Despite this, the structural deficit will continue at higher levels than prior to the pandemic.

Fiscal policy will remain supportive of growth

Setting the appropriate fiscal stance for the state of the economy will require careful consideration in the coming years. In times of an acute pandemic, fiscal policy must support firms and households in overcoming the crisis in order to minimise permanent damage from lockdowns and a temporary decline in aggregate demand. The Finnish Government, for its part, has implemented a number of support measures, and some of these will be continued in 2021. At the same time, the automatic fiscal stabilisers will operate, i.e. public expenditure will rise automatically on account of increasing unemployment and social security spending while tax revenues decrease.[1] Fiscal policy will therefore be highly supportive of growth in 2020.

Fiscal policy has already shifted to supporting aggregate demand through increased public investment. Measures to compensate for losses in total output – especially investments and other expenditure increases which also facilitate long-term economic growth – are now useful and timely. In this situation, there should be no new permanent expenditures in order to avoid hindrances to the fiscal consolidation phase ahead. Fiscal policy will tighten in technical terms in 2021 on the back of withdrawal from some support measures and a decrease in direct additional spending on health care. Nevertheless, the public finances will remain firmly in deficit. In the course of 2020, public expenditure has increased in total by about EUR 5 billion due to crisis management and support measures. On top of this comes the temporary reduction of over EUR 1 billion in earnings-related pension contributions, which has been implemented using the EMU buffer of the earnings-related pension system. In 2021, the costs from the measures will decrease to some EUR 2 billion. The EU's recovery instrument, in turn, can be utilised starting from 2021, and it will bring financial support to Finland in an estimated total amount of EUR 3 billion in 2021–2026.

The EU recovery instrument will channel EUR 750 billion to structural reform measures and related investments supporting recovery and growth in the EU economies. Of the total financial support, EUR 390 billion will be disbursed to Member States as grants and EUR 360 billion as loans. The recovery instrument will be financed via EU borrowing, and debt repayment will begin as late as 2028 and extend over a period of 30 years. The largest part of the funds will be allocated based on Member States' standard of living, population and unemployment rates, and later also based on the economic fallout from COVID-19. The Finnish Government has outlined the use of the funds in the Sustainable Growth Programme for Finland, which is to be finalised in spring 2021. The funds will be primarily directed at measures supporting green transition and digitalisation.

Because of the uncertainties related to the evolution of the pandemic, economic forecasts are also

subject to exceptional uncertainty at present, and it is therefore not yet possible to assess exactly when fiscal policy should shift from expansionary to strengthening the general government fiscal balance. According to the Bank of Finland's December 2020 forecast, Finnish economic growth will reach the level of potential output again in 2023, when fiscal policy, too, should already be geared towards rebalancing the public finances.

Debt is easy to come by but difficult to get rid of

Finland's general government debt-to-GDP ratio will grow rapidly in 2020–2021, by around 13 percentage points, and will continue to rise to about 76% in 2025. According to the European Commission's November 2020 forecast, the euro area average debt-to-GDP ratio will rise to over 102% by 2022. Although Finland's debt ratio will continue to persist at levels below the euro area average, it is alarming that public debt will also continue to grow in the medium term.

Interest rates on public debt have declined on a broad front in the euro area countries in recent years, reflecting a fall in the general level of interest rates and the ECB's monetary policy purchases. In Finland, for example, interest expenditure on the public debt was 1.4% relative to GDP in the pre-crisis year 2007. Even though the public debt ratio has doubled since then, interest expenditure relative to GPD was only 0.8% in 2019. As maturing debt is rolled over at lower interest rates, interest expenditure is expected to fall further to 0.6% by 2023.

As regards the evolution of the debt-to-GDP ratio, it is important, firstly, how much new debt is needed to cover interest payments on existing debt and the rest of the general government deficit, and, secondly, how fast GDP – the denominator of the debt ratio – grows. If the general government primary budget position is sufficiently close to balance, debt dynamics are mainly determined by the difference between these two factors, i.e. the interest rate-growth differential. If the interest paid on public debt is at a notably higher level than the growth rate of the economy, the debt ratio will rise. If it is lower, however, even a high debt ratio may, in the long term, converge to a sustainable level.

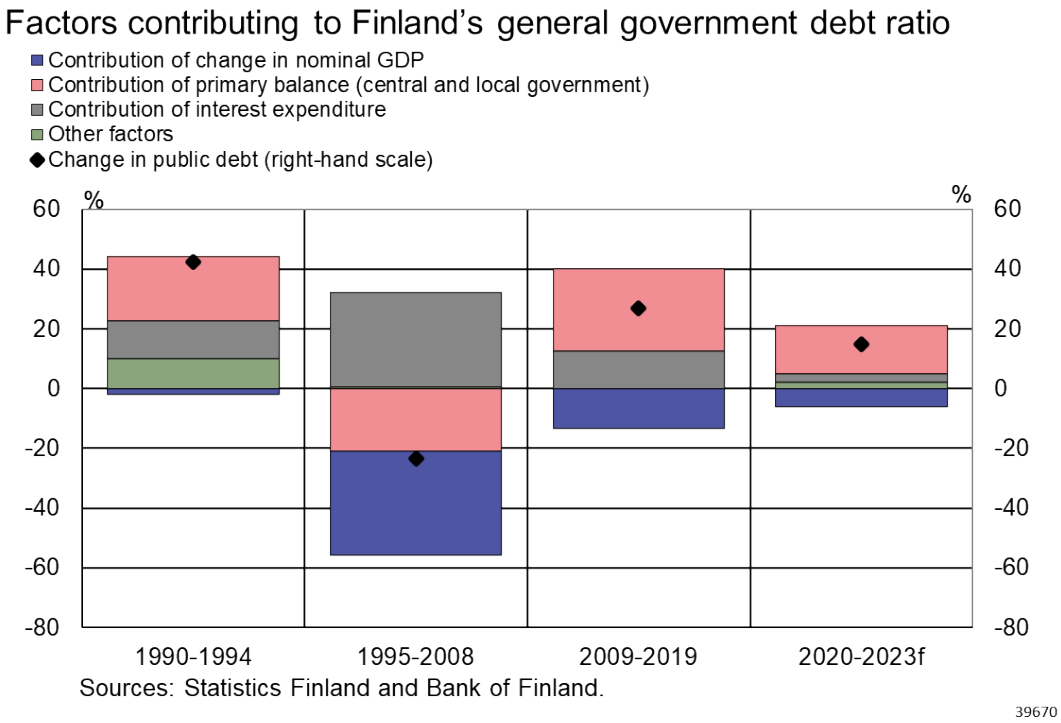
The European Commission's autumn 2020 forecast suggests that the interest rate-growth differential will be negative in all euro countries in 2021–2022. In two out of three euro area countries, the debt ratio will therefore begin to decline already in 2022. During these two forecast years, the aggregate euro area debt ratio will fall by 6.7 percentage points on account of the interest rate-growth differential. In Finland, the differential would contribute to reducing the debt ratio by 4.5 percentage points in 2021–2022. A favourable interest rate-growth differential is an exception by historical standards, however.[2] There are grounds to expect that the differential will return to adding to the public debt burden in the future.

The interest rate-growth differential has been found to depend on the level of public debt. A higher debt burden means higher investor return requirements. At the same time, a high level of public debt and concerns over its sustainability imply greater volatility in sovereign yields in the event of economic disturbances. The COVID-19 pandemic was encountered in a situation where non-standard monetary policy instruments were still in use and, on the other hand, euro area countries' sovereign debt levels were still high following the financial crisis. Therefore, one of the monetary policy measures taken in response to the pandemic crisis was to expand the sovereign bond purchase programme, which in turn contributed to narrowing the spread between euro area government bond yields. This has enabled the conduct of a more active fiscal policy. Once monetary policy returns towards normal times, government bond yields will be subject to upward pressure, especially if there are doubts about the sustainability of public debt.

Finland's general government debt-to-GDP ratio was almost halved after the 90s recession in 1995–2008 (Chart 2). During this consolidation phase, the contractionary effect that economic growth had on the debt ratio (GDP in the denominator) was equal in size to the expasionary effect from interest expenditure. Therefore, correcting the imbalance between central and local government revenue and expenditure played a major role in the reduction of public debt. Another perspective to the consolidation phase is that although the central and local government, including also interest expenditure, were still in deficit, the debt ratio's decline was the result of strong economic growth.

Finland's public debt-to-GDP ratio returned to growth after the financial crisis. The prolonged period of slow economic growth in the aftermath of the crisis led to an almost doubling of the debt ratio. The ratio began to fall only in 2016, albeit very slowly. In 2009–2019, interest expenditure declined despite the rising debt level on account of a general fall in interest rates. During the same period, the central and local government finances were chronically in deficit.

Chart 2.

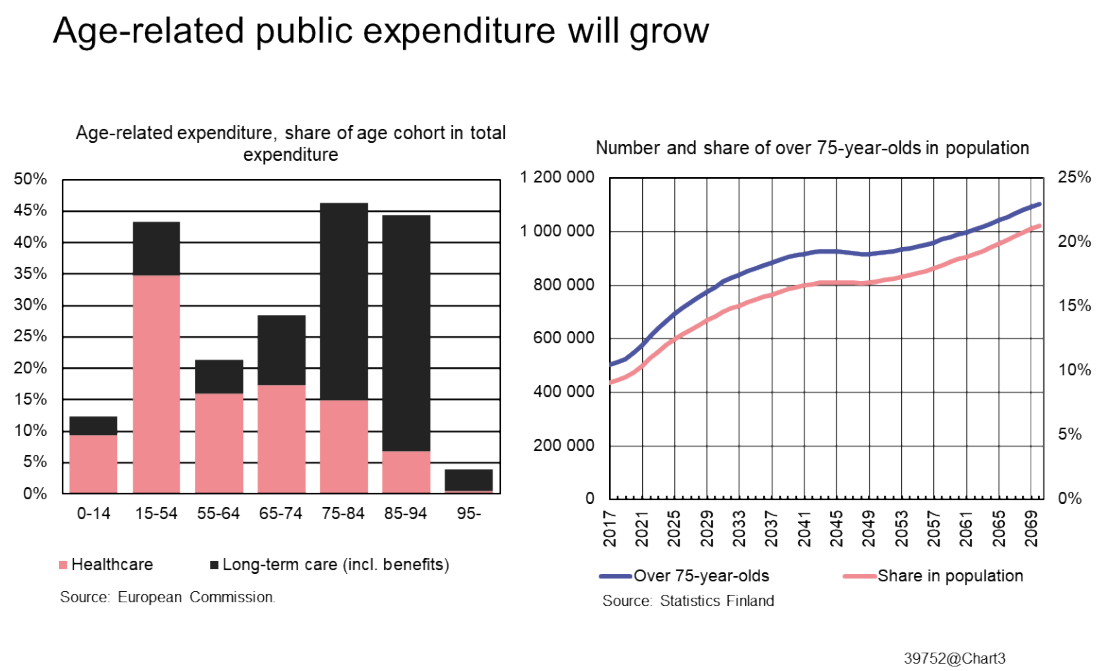


After the COVID-19 pandemic, public debt will rise to a new level also in Finland. Although the interest burden on public debt is expected to ease further in the coming years, economic growth is anticipated to remain slow over the longer term. Therefore, stabilising or reducing Finland's debt ratio will very likely require active measures to improve the balance of the public finances.

Fiscal sustainability gap larger than before

Finland's general government debt position is set to deteriorate further as a result of the the COVID-19 pandemic. With population ageing, the working-age population will decline and economic growth will moderate, while age-related public expenditure will increase. The number of persons aged over 75 will grow rapidly over the next decade (Chart 3). It is well known that there will be a great need for long-term care, especially for those over 75, and meeting these service needs will necessitate significant financial efforts. Without corrective measures to slow public expenditure growth, the general government debt will continue to expand and reach an unsustainable level over time.

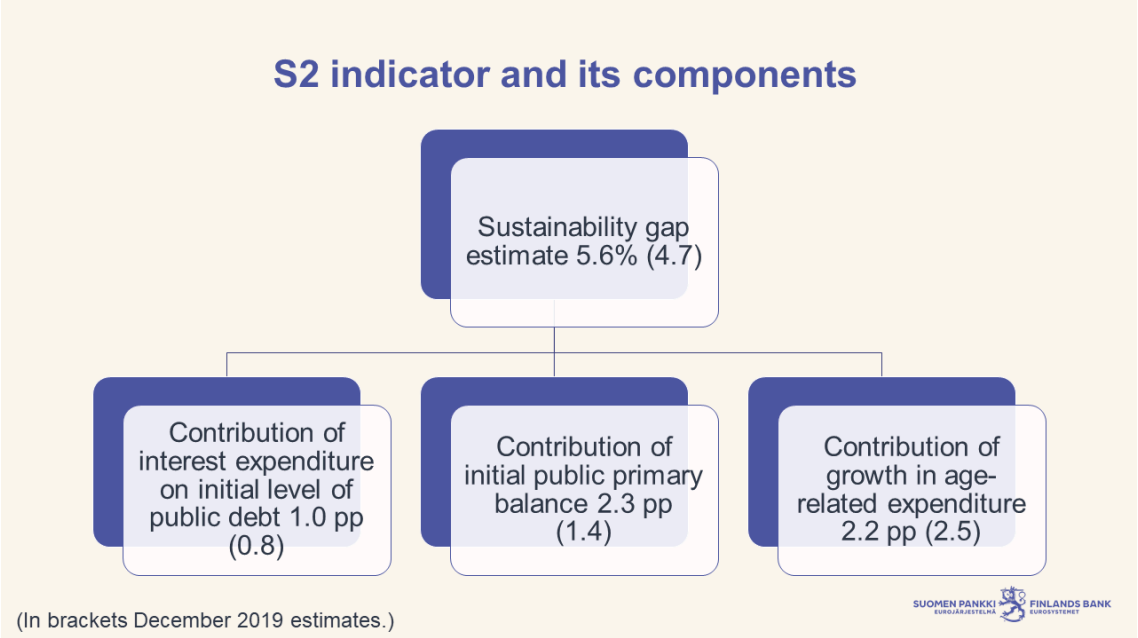
Chart 3.



The long-term sustainability of the public finances is measured by the S2 indicator, which summarises in a single figure the extent to which the fiscal balance should be improved in the base year of the calculation for public debt not to increase in an uncontrollable manner in the future. The S2 indicator is not a feasible policy guideline as such, as the correction it indicates could result even in a relatively steep and unnecessarily sizable debt reduction in the long term. Nevertheless, the indicator gives an indication of the scale of the fiscal sustainability challenge.

Because of the fiscal deterioration caused by the COVID-19 pandemic, Finland's sustainability gap is larger than previously assessed, at 5½% relative to GDP. The year-earlier figure was about one percentage point lower. The current higher estimate was most affected by the weaker general government primary balance for the calculation's base year 2025. The higher level of public debt also contributed to increasing the estimated sustainability gap via increased interest expenditure.

Chart 4.



The interest rate assumptions of the calculation have been revised from a year earlier. Accordingly, the nominal interest rate on public debt and the nominal return on assets held by pension funds are expected to reach their long-term levels of 5.0% and 5.5%,[3] respectively, only by 2040, while the previous assumption was by 2035. The revision increased the estimated sustainability gap by just under 0.2 percentage points, as pension fund returns provide a larger contribution to fiscal sustainability than the interest rate on public debt.

Fiscal policy objectives in the short and long term

Finnish governments have paid attention to safeguarding long-term fiscal sustainability since the early 2000s. During the most recent parliamentary terms, governments have also set shorter-term objectives for the budget balance and debt in government programmes and annual general government fiscal plans. In the latter and the Finnish stability programme, the objectives are set as required by the European Semester, and they apply to all general government sub-sectors, i.e. central government, local government and social security funds. The setting of objectives has also enabled closer monitoring of fiscal policy, carried out by the National Audit Office of Finland as an independent fiscal supervisor.

In the current Government's programme, the objectives for the parliamentary term were that, given normal global economic circumstances, Finland's general government finances would be in balance and the public debt-to-GDP ratio would decrease at the end of the parliamentary term. Reaching the 75% employment rate target was a key factor in achieving these objectives.

However, even before the COVID-19 pandemic, forecasts suggested that achieving the fiscal objectives seemed uncertain.

Due to the exceptional uncertainty caused by the pandemic, these objectives were no longer included in the spring 2020 General Government Fiscal Plan. It is already clear that the fiscal balance will deteriorate during the COVID-19 crisis to such an extent that the objectives will have to be set from a new starting point next spring. At that point, consideration should already be given to the concrete additional measures required to achieve the objectives and the timing of these measures.

In June 2020, the Government specified that the main objective in strengthening the public finances was to stabilise the general government debt-to-GDP ratio by the end of the decade. Achieving this target would require an adjustment of about EUR 5 billion in the budget balance.

In the same context, the Government published a 'sustainability roadmap'[4] outlining the measures to be taken to address the challenges to fiscal sustainability. The packages of measures presented in the sustainability roadmap seek to strengthen the public finances by a total of EUR 4.5 billion by the end of the decade. The health and social services reform targets cost savings of EUR 0.5 billion. Measures to improve employment aim to raise the number of persons employed by 80,000 and thereby strengthen the public finances by EUR 2 billion. Other measures supporting economic growth, such as wage moderation and measures related to competitiveness and R&D, aim at improving the public finances by EUR 1 billion. In addition, through higher productivity in public services provision, achieved by e.g. promoting digitalisation, the Government targets cost savings of EUR 1 billion.

Some of the proposed objectives are already well known from the previous governments' programmes. For example, a nominal employment-rate target has been in government programmes since the late 1990s. The employment target has been set somewhere between 70–75%, and the target horizon has been either the end of the parliamentary term or a longer period. The target (increase in the number of persons employed or the employment rate) has only been reached by two of the five governments in 2007 and 2019. After the financial crisis, the governments have also largely failed in reaching their fiscal targets.

The health and social services reform has long been under preparation, but has proven difficult to design in such a way that the reform would definitely curb cost growth. The reform also involves costs in the transition phase, and cost savings can be expected in the 2030s at the earliest.

Structural reforms promoting employment, competitiveness and the efficiency of public service provision are of utmost importance. However, structural measures sometimes take effect only

after a long lag, and the success of the measures cannot always be guaranteed during a single parliamentary term. Therefore, fiscal objectives for a single parliamentary term cannot depend on the results of structural reforms alone.

The structural reforms sought by Prime Minister Marin's Government require a number of additional financial injections that will at least temporarily raise public investment or other public expenditures. If the reforms fail or otherwise have a smaller impact than preliminary estimated, the fiscal balance will not ultimately strengthen as expected. Instead, after the additional injections, the net public debt will be even larger. Therefore, the uncertainty related to the achievement of structural objectives should be taken into account. Similarly, it should be ensured that the short-term objectives for the general government budget balance and debt will be met irrespective of the investments in structural reforms.

An approach such as the sustainability roadmap to the sustainability problem may be useful if future governments can also be committed to at least the targeted stabilisation of the debt-to-GDP ratio. As health care and long-term care already require an increasing amount of resources each year, attaining a balanced budget position will be more difficult every passing year. Therefore, going forward, greater emphasis should consistently be placed on short-term objectives and their attainment. Long-term challenges require short-term milestones.

Fiscal objectives supported by fiscal rules

Although it is not relevant at the moment to address the fiscal strain caused by the COVID-19 pandemic, preparations should be made for the upcoming consolidation phase. The post-financial crisis period already demonstrated how difficult it is to rebalance the public finances in an environment of slow economic growth and annually rising age-related expenditure. As Finland's long-term economic growth is projected to remain slow for structural reasons, the question arises whether the fiscal policy tools currently deployed are sufficient in the consolidation phase. Since rules-based fiscal policy has been found to best contribute to the sustainable management of the public finances, compliance with and possible strengthening of domestic fiscal rules would support future fiscal consolidation.

Finland's fiscal policy is guided by the EU's common fiscal rules as well as domestic legislation and practices. Of the domestic practices, the most important is the central government spending limits procedure. The system has been consistently refined, but its application naturally involves political discretion. The 2011 Budgetary Framework Directive and the Fiscal Compact agreed in 2012 were implemented in Finland through the Fiscal Policy Act (869/2012) and the Government Decree on the General Government Fiscal Plan (120/2014). With this package, Finland committed to setting a medium-term objective for the general government structural balance and compatible

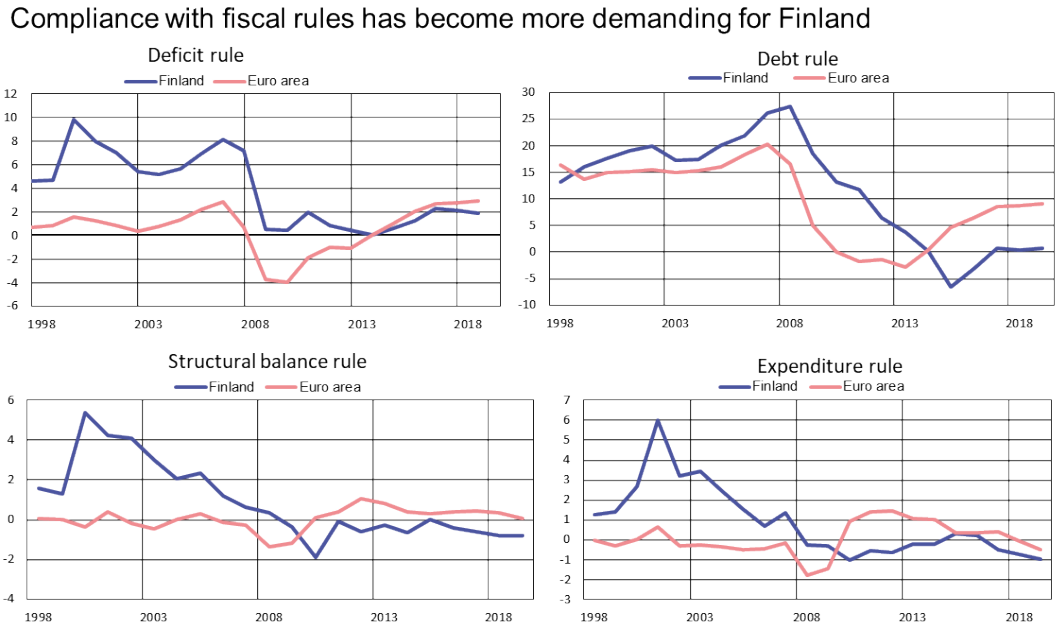
multiannual targets for nominal budget balances for the aggregate general government sector and its subsectors.

The EU fiscal rules are based on the EU Treaty and the Stability and Growth Pact (SGP). In the spring, the finance ministers of the EU Member States decided, on a proposal by the European Commission, to activate the general escape clause of the SGP, meaning that Member States were permitted to deviate from the adjustment requirements under the EU fiscal rules. However, the activation of the clause does not prevent the initiation of excessive deficit procedures. Departure from the requirements is temporary, but so far there has been no announcement of how long the general escape clause remains in effect.

The European Fiscal Board (EFB) has collected data on EU Member States' compliance with the EU fiscal rules before the COVID-19 pandemic.[5] The data examines compliance with the rules in a purely numerical manner: a positive value indicates achievement of the reference value set for a rule and therefore compliance with the rule; a negative value a shortfall and non-compliance. The data focuses on compliance with four fiscal rules: the deficit rule, debt rule, structural budget balance rule and the expenditure rule. Of these, the last two have only been introduced in 2005 and 2011, but here they are examined throughout the period 1998–2019. It should also be noted that in the end the rules are not specific, but that the European Commission has discretion when making its overall assessment of compliance with the rules.

Based on the EFB data, Finland has largely complied with the EU fiscal rules very well (Chart 5). Before the financial crisis, Finland's public finances operated best within the limits set by the rules.[6] Since the financial crisis, however, the situation has clearly changed, and compliance with the rules has become more demanding for Finland. Since 2008, Finland's compliance with the rules has been around 55%. Finland has not exactly achieved the structural budget balance target since 2009, even though the target has been enshrined in domestic legislation.

Chart 5.



The charts plot the deviation of the actual value of a target variable from the reference value set for a rule, i.e. a positive value indicates compliance with the rule; a negative value non-compliance. The figures are in percentage points.
Source: EFB Compliance Tracker.
5.12.2020 eurojatalous.fi 39754@Yhdistelmä

Expenditure rules have been identified as the most effective fiscal policy rules guiding the management of the public finances.[7] The Finnish central government spending limits system can be classified as one kind of an expenditure rule. The system has been found to have worked relatively well in Finland, and it has been fine-tuned over time. The COVID-19 crisis forced Finland to abandon the spending limits in 2020 and, in part, also in 2021. Appropriations into the management of the pandemic and, in part, support measures were made regardless of the limits. However, the Government has announced that it will return to adhering to the spending limits which were decided before the crisis.

As part of the spending limits system, the Government introduced an 'exceptional situation mechanism' in the Government Programme for serious economic disturbances. The mechanism was activated because of the COVID-19 pandemic in June 2020. The mechanism allows an increase of EUR 1 billion in government expenditure over a period of two years, i.e. EUR 500 million a year in 2021–2022.

Returning to the spending limits is an important element in the fiscal consolidation phase coming ahead. On the other hand, the problems encountered in achieving the fiscal targets following the financial crisis suggest that the system might warrant further development. It should be ensured that the expenditure ceiling is set to a level compatible with the medium-term fiscal objectives and domestic and EU fiscal policy rules. After all, expenditure within the spending limits cover only

about 80% of central government spending, meaning a large share of public expenditure is excluded.

Compliance with fiscal rules has been found to be more difficult if the general government sector is fragmented.[8] In Finland, expenditure by central government, local government, employment pension schemes and other social security funds accounted respectively for 26%, 40%, 20% and 14% of consolidated total general government expenditure in 2018. The Finnish spending limits system sets a ceiling for local government expenditure, but it only limits the impact on expenditure of the tasks given by the state to municipalities. In the context of the health and social services reform, in the General Government Fiscal Plan the financing of the 'wellbeing services counties' would be adjusted taking into account the long-term sustainability of the public finances.[9] When a larger proportion of public spending can be examined in a centralised manner, it is also possible to better manage public expenditure as a whole.

During the current and previous parliamentary term, governments have included key projects or future-oriented investments to the spending limits for the interim years of the parliamentary term. This has enabled temporary expenditure increases in targets that governments have considered important. The expenditure increases have been financed, or the intention has been to finance them, through revenue from the sale of state-owned assets. The spending limits have also been circumvented through various arrangements where assignment of shares has been used to cover expenditure increases deemed necessary.[10] From the perspective of the general government net asset position, asset sales are comparable to debt accumulation. There may well be grounds for asset sales, but it also means a reduction in the return on assets, thus weakening the state's net financial position. Any disposal of public assets should be based on a thorough consideration and a long-term plan.

Now that the fiscal balance is deteriorating, decisions on temporary expenditure increases, too, should be made with careful consideration. A step in this direction is that the Government has announced its intention to use the EU's recovery instrument to finance some of the future-oriented investments that are in line with Finland's recovery plan. The Government has also stated that some of the future-oriented investments will be reconsidered once the situation has changed. However, refraining from spending increases alone will hardly be enough to consolidate the public finances in the coming years.

Risks to the public finances will increase

Although Finland's public debt is still below the euro area average, Finland's contingent liabilities are the largest among the EU countries.[11] Contingent liabilities include central government loans

and guarantees, and the latter of these totalled about 25% relative to GDP in 2019. About half of the guarantees are associated with export financing granted through Finnvera. As a support measure related to the COVID-19 crisis, these guarantees have been significantly increased. At the same time, the Government has had to prepare the budget taking into consideration an increase in compensation to Finnvera arising from credit losses. Export financing has focused in particular on cruise ship deliveries. As the cruise industry is one of the industries severely affected by the pandemic, the probability of realisation of the risks inherent in these liabilities has increased.

The COVID-19 pandemic hit Finland before the public debt-to-GDP ratio could be significantly reduced after the financial crisis. The substantial fiscal stimulus in response to the pandemic will leave a long-lasting scar on the management of the public finances in many other countries, too. Although the interest rate on public debt is low and market confidence in Finland's debt servicing capacity is good, measures to stabilise debt are important to maintain that confidence. Recessions are a recurring phenomenon, and we must be prepared for them. There is a risk that the debt level will rise more during recessions than can be reduced during upswings, in which case debt accumulates and will become increasingly larger in size relative to the carrying capacity of the economy. Such a development will eventually raise doubts about Finland's debt sustainability.

Notes

1. On a European level, automatic stabilisers play an important role in Finland. See: Automatic fiscal stabilisers in the euro area and the COVID-19 crisis. ECB Economic Bulletin, Issue 6/2020. ↑
2. Checherita-Westphal, C. – Semeano, J. (2020) Interest rate-growth differentials on government debt: an empirical investigation for the euro area. ECB Working Paper Series No 2486 / November 2020. ↑
3. The assumption about the long-term level of return on pension fund assets is the same as that in the long-term projections of the Finnish Centre for Pensions. ↑
4. The Roadmap for strengthening the sustainability of public finances was further elaborated on 16 September 2020, see: https://valtioneuvosto.fi/documents/10616/37498572/Kest%C3%A4vyystiekartta.pdf (in Finnish). ↑
5. Larch, M. – Santacroce, S. (2020) Numerical compliance with EU fiscal rules: The compliance database of the Secretariat of the European Fiscal Board. ↑
6. It should be noted that in Finland, general government also includes private employee pension institutions whose relatively large surplus, especially before 2008, facilitated the achievement of the deficit rule, in particular. Since then, with the acceleration of pension expenditure growth, compliance with the expenditure rule has been more difficult. ↑
7. Belu Manescu, C. – Bova, E. (2020) National Expenditure Rules in the EU: An Analysis of Effectiveness and Compliance. European Economy Discussion Paper 124, April 2020. ↑

8. European Fiscal Board (2019) Assessment of EU fiscal rules with a focus on the six and two pack legislation. August 2019, p. 30. ↑
9. Government proposal on Acts related to the health and social services reform, 14 October 2020. ↑
10. Kehysjärjestelmän kehittäminen vaalikaudelle 2019–2023. Valtiovarainministeriön julkaisuja 2019:33 (in Finnish and Swedish only). ↑
11. Katsaus valtion taloudellisiin vastuisiin ja riskeihin, syksy 2020. Valtiovarainministeriön julkaisuja 2020:78 (in Finnish only). ↑

Keywords

COVID-19 crisis, fiscal policy, public debt, public finances, sustainability of public finances