BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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ASSESSMENT OF PUBLIC FINANCES 2022

Finland's crisis-hit public finances need strengthening

Yesterday – Assessment of Public Finances – Finnish economy

In recent years, Finland's public finances have drifted from one crisis to the next. The pandemic, Russia's war in Ukraine, the energy crisis and high inflation, along with continued low economic growth, have caused radical changes in the economic environment. What stands out in particular is the change in Finland's debt trajectory since before the outbreak of the pandemic. In 2023, Finland's public finances will be running a deficit for the fifteenth consecutive year. The debt-to-GDP ratio does not yet differ from that of other euro area countries with lower-than-average public debt, but projections point towards a concerning trend. The debt trend is similar to that seen in the most indebted countries of the euro area, where the scars of the global financial crisis and the European sovereign debt crisis run deep. The pandemic persists while Russia's war in Ukraine and the energy crisis sow uncertainty in the economy and in fiscal policy as the parliamentary term draws to an end. The crises have demonstrated the continued need of sufficient fiscal space in the public finances.

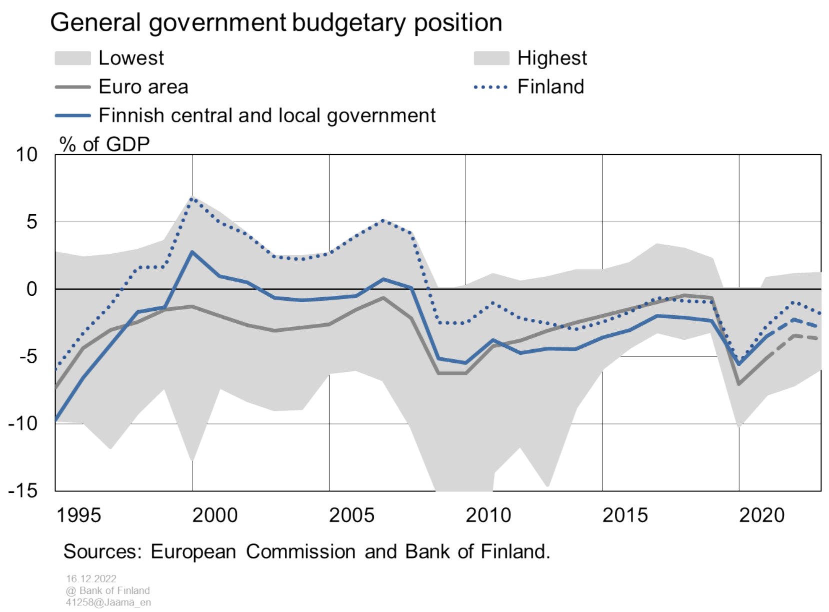
General government finances – Finnish public debt

is growing

Finland's general government finances deteriorated rapidly in 2009 and balance has not been re-established since. Economic growth has been low for a long time and Finland has been unable to rebalance public expenditure and revenues. The ratio of public debt to GDP has doubled during this period and the debt will continue to grow unless the direction of fiscal policy is corrected. In terms of general government deficit and public debt, Finland is still doing better than the euro area average, as the general government budgetary position is enhanced by the earnings-related pension funds' surplus and the fact that the level of public debt was initially low.

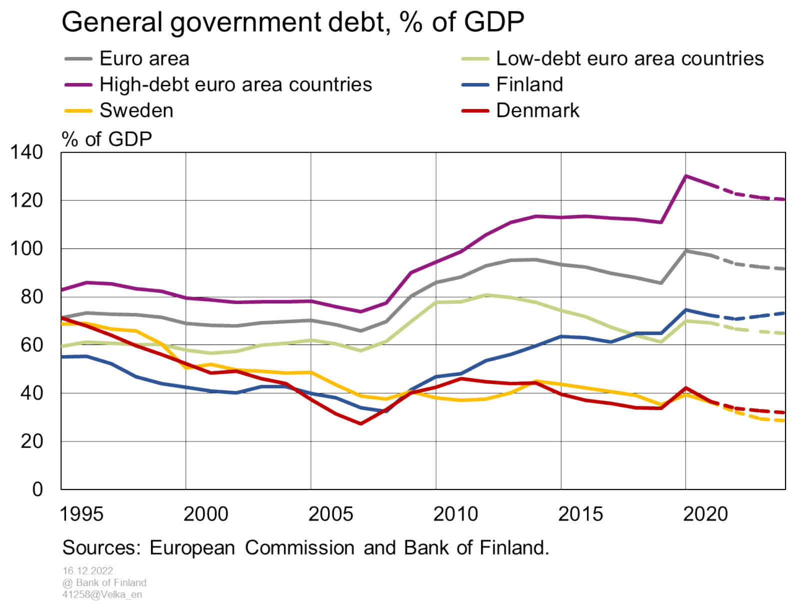
If the earnings-related pensions funds are excluded, Finland's general government deficit was weaker than the euro area average almost throughout the 2010s. During the pandemic, however, the combined deficit of central government, local government and other social security funds has been smaller than the euro area average (Chart 1). Thus, when measured by economic indicators, Finland has come through the pandemic relatively well so far.

Chart 1.



During the two pandemic years 2020–2021, Finland's debt-to-GDP ratio grew by a total of 7.5 percentage points, whereas the average increase in the euro area was a little over 11 percentage points (Chart 2). However, a look at Finland's closest peer countries reveals a less flattering difference. The debt-to-GDP ratio grew just fractionally less in Finland than in other euro area countries with lower-than-average public debt. Moreover, Finland's debt ratio grew by more than that of Sweden or Denmark. In Sweden, the debt ratio increased by only just over 1 percentage point and in Denmark by around 3 percentage points between 2019 and 2021.

Chart 2.

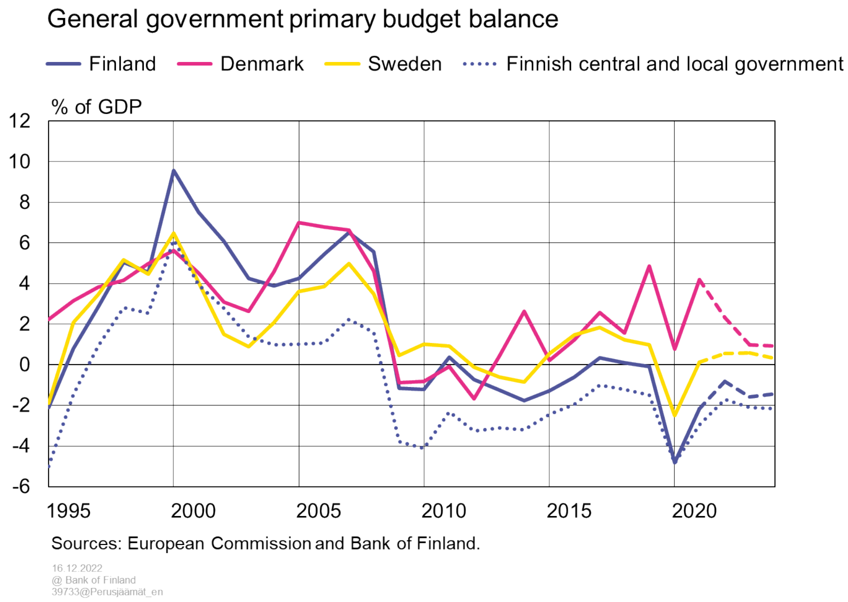


What is particularly striking is Finland's pre-pandemic debt trajectory. Since the global financial crisis, Finland's debt-to-GDP ratio has grown almost continuously. This is hardly in line with Finland's reference group of euro area countries with below average public debt, but is instead similar to the trend in the euro area's most indebted countries, where the scars of the financial crisis and the European sovereign debt crisis run deep. Although Finland's debt ratio does not yet differ from its euro area peer countries, the ratio's trajectory is divergent and concerning.

Chronic imbalance between revenues and expenditure

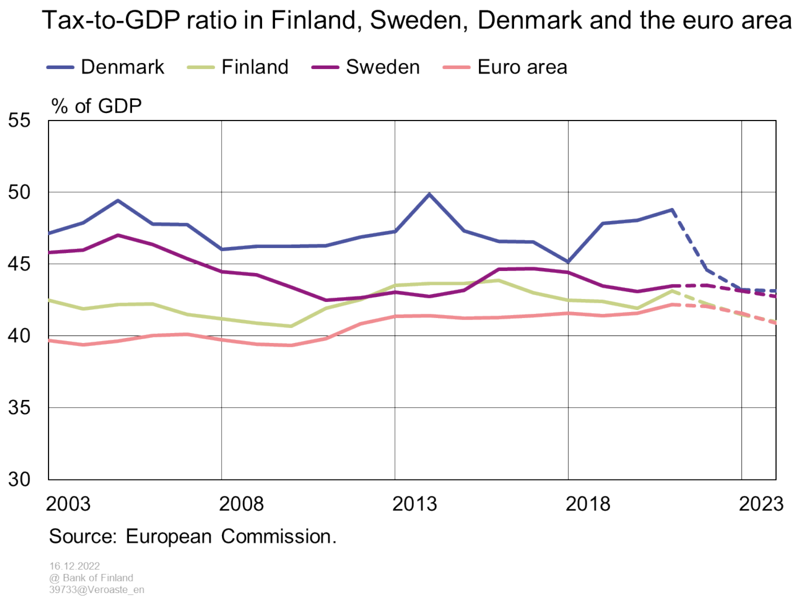
When compared against other Nordic countries, Finland's public finances have deteriorated over the last ten-plus years. In the 2010s and since, the general government primary budget balance (net lending excluding interest expenditure) has been clearly stronger in Sweden and Denmark (Chart 3). The difference is particularly evident in the growth of the debt ratio. While Finland's debt ratio has doubled since 2009, in Sweden and Denmark the debt-to-GDP ratio has varied between 30% and 40%.

Chart 3.



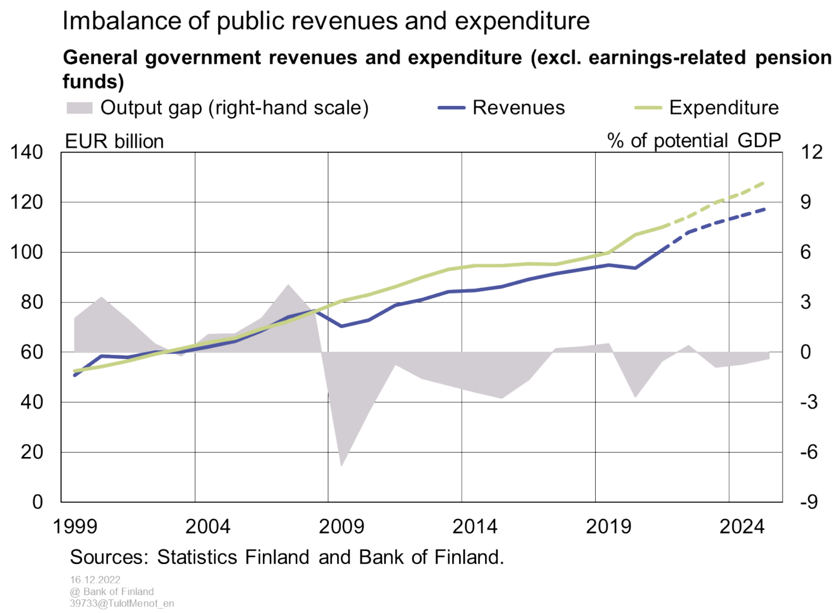
Sweden and Denmark have managed to balance public revenues and expenditure better than Finland. Both Sweden and Denmark have had a higher tax-to-GDP ratio than Finland, although the difference between Finland and Sweden is not large (Chart 4). By contrast, other public revenue, such as property income (especially income from earnings-related pension funds), has been somewhat higher in Finland. Then again, the ratio of public expenditure to GDP is 3–4 percentage points higher in Finland than in Sweden and Denmark.

Chart 4.



Finland has not managed to balance public revenues and expenditure since the financial crisis, and instead central and local government deficits have turned chronic and even the earnings-related pension funds' surplus has diminished as pension expenditure has increased. In Finland, the ratio of public revenue (excluding earnings-related pension providers) to GDP has averaged around 40% since 2009, while the average expenditure-to-GDP ratio has been close to 44%. The imbalance between revenues and expenditure is structural, i.e. the public finances have not been balanced since 2008 (Chart 5), even in normal economic conditions. In the pre-pandemic period 2010–2019, Finland's structural deficit averaged 1.0% of GDP, as estimated by the European Commission. Over the same period, Sweden had a structural surplus averaging 0.2% of GDP and Denmark a structural surplus averaging 0.5%.

Chart 5.



In the early 2010s, public expenditure continued to grow, despite the crumbling revenue base. Of all the general government consumption expenditure items, which currently amount to just over 24% of GDP, expenditure on social protection has increased the most[1]. Finland's average social protection expenditure in 2010–2019 as a percentage of GDP was 1.3 percentage points higher than the corresponding figure for 1999–2008. The same comparison for expenditure on healthcare provision reveals an increase of 0.8 percentage points.

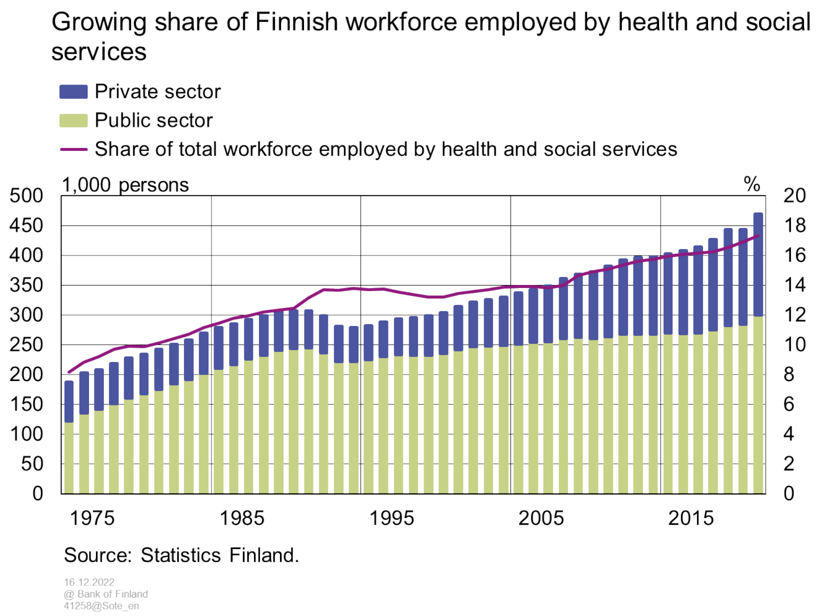
Employment in health and social services has been growing rapidly for a long time. Over the past two decades, this growth has increased further, especially in the private sector (Chart 6). From 2010 to 2021, the number of persons employed in health and social services increased by around 40,000 in the public sector and by over 57,000 in the private sector. This means that the public and private health and social services sectors

1. General government expenditure by function, Statistics Finland. Consumption expenditure is calculated by adding together output (including public sector labour compensation costs, intermediate consumption and consumption of fixed capital) and social transfers in kind through market producers, and by deducting the sales of goods and services. Social protection refers to all publicly funded measures provided by public or private organisations to ensure basic services and livelihoods for households and individuals when faced with risks (including services for older people).

accounted for nearly half (45%) of the overall growth of 216,000 in persons employed in Finland over the same period. The demand for health and social services provided by the private sector has been bolstered by publicly funded use of purchased services. The item in the national accounts comprising services purchased by general government[2] grew by just over 0.5 percentage points relative to GDP between 2010 and 2020. Correspondingly, the provision of services by the public sector also increased.

The employment needs in health and social services pose a major challenge for the Finnish economy. As Finland's working-age population is declining, a growing share of the labour force will be working in health and social services in the future. It is difficult to increase labour productivity in practical care work. While digitalisation can offer partial solutions, the quality of care work is still strongly linked to labour input. When a sector with low productivity growth expands in relation to other sectors, it weakens productivity growth in the economy as a whole and, consequently, the overall potential for growth.

Chart 6.



Health and social service expenditure will continue to grow in the future as the number of older people increases. Responsibility for organising health and social services will be transferred to the wellbeing services counties at the beginning of 2023. Cost-effectiveness in service production will be an important part of curbing expenditure growth in the wellbeing services counties in the future. Unfortunately, the financial incentives for the counties to operate more effectively are weak, while other incentive mechanisms, such as the threat of being merged with other counties, do not, in practice, apply to a significant number of the welfare services counties. A further concern is the so-called soft budget constraint, meaning that it is difficult for the State not to provide additional funding to counties if they are otherwise unable to provide public services to which people have a right. Giving the wellbeing services counties moderate rights to levy

2. Social transfers in kind provided by general government via market producers refers to expenditure arising from the public funding of goods and services provided to households by the private sector.

taxes would, on the one hand, likely increase their incentives to improve the cost-effectiveness of their service provision[3]. On the other hand, having an additional tier of government with tax-levying rights could potentially lead to higher taxes. However, the tax-to-GDP ratio will ultimately depend on the direction of public expenditure. To avoid a higher tax-to-GDP ratio, public sector resources must be used efficiently.

Public current transfers relative to GDP have increased by around 3 percentage points between the periods 1999–2008 and 2010–2019, to just over 18% of GDP as a result of increased pension expenditure. In other respects, the growth of monetary social benefits has been moderate, and in 2019 social benefits other than those paid by earnings-related pension funds were in fact about 1 percentage point of GDP lower than in 2010. In 2020, the pandemic caused a strong increase in social benefit expenditure (by 0.8% of GDP).

General government interest payments have been falling for a long time. In 1999, central and local government interest payments[4] amounted to 3.9% of GDP, but in 2021 to just 0.5% of GDP. Since 2010, interest payments relative to GDP have decreased by 0.8 percentage points. Now that interest rates have begun to increase significantly, general government interest payments will increase to an estimated 1% of GDP by 2025. Interest payments are now increasing in tandem with many other costs, and are at the same time limiting fiscal space.

Fiscal stance during high inflation

In the early stages of the COVID-19 pandemic in 2020, the economic recession weakened general government revenues while public support to households and companies increased public expenditure. The general government deficit increased by more than 4 percentage points. In 2021, the economy recovered and tax revenue grew strongly in relation to the cyclical circumstances.

Economic growth strengthened further and continued to support the public finances during the first half of 2022 (Chart 7), but as growth is projected to slow, it will no longer underpin the public finances. Over the forecast years 2022–2025, the fiscal balance will only improve in 2022. A mild recession will weaken the balance in 2023. The rising interest rates will also increase general government interest payments in the forecast years. High inflation will affect both public revenues and expenditure. Whether tax revenues increase depends on the growth of private consumption in the current conditions of high inflation and on how inflation passes through to wages. Tax revenue growth will be constrained both by measures aimed at mitigating the effects of rising energy prices and by index adjustments to the tax brackets for earned income tax. Public expenditure will increase due to the index increases made to social security benefits and social allowances and the increased costs of public sector wages, purchases and investments.

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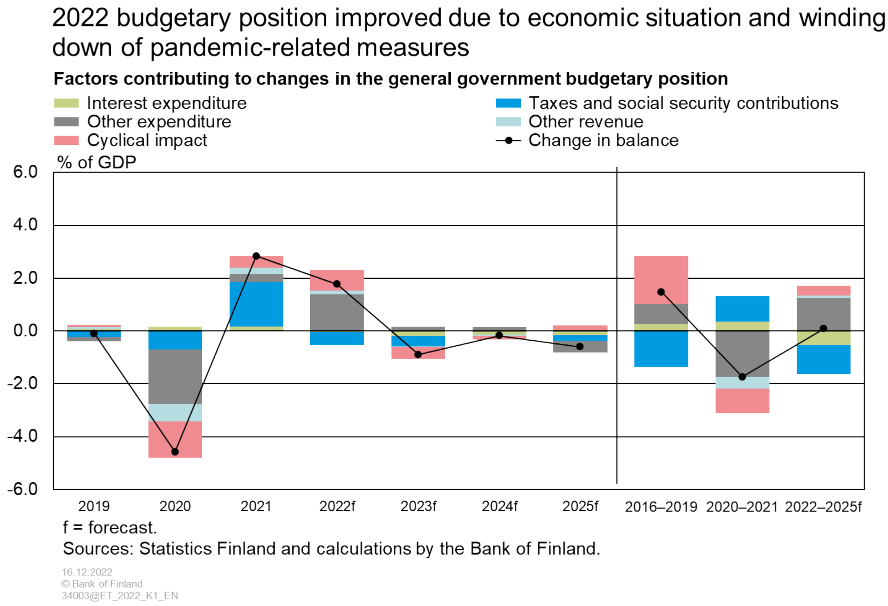
3. Mika Kortelainen, Kaisa Kotakorpi and Teemu Lyytikäinen (2021) 'Incentive effects of the wellbeing services counties' financing model' (in Finnish), Kansantaloudellinen aikakauskirja/The Finnish Economic Journal (pp. 203–211).
4. Unconsolidated interest payments by central and local government.

Chart 7.



As inflation has increased well beyond the European Central Bank's inflation target and there is a risk that above-target inflation may take root in the longer term, fiscal policy measures that boost aggregate demand and accelerate inflation should be avoided. As energy prices have risen exceptionally high, it is understandable that there is pressure to mitigate its impact on households and businesses. Both the European Commission[5] and the IMF[6] have recommended such measures, as long as they are temporary and carefully targeted at the most vulnerable. A neutral fiscal stance or one that curbs aggregate demand would support efforts to quickly tame inflation.

The measures to strengthen security and mitigate the effects of the energy crisis are mainly temporary. So far, the measures decided in Finland for compensating for the rise in energy prices have been relatively moderate (0.6% of GDP in 2022–2023) by European comparison[7]. The impact of tax subsidies and direct aid on the fiscal balance would be mitigated by revenue from a possible windfall tax, although no decision has been taken on this so far. However, support to compensate for high energy prices has not been targeted only at those most in need; for example, the reduced VAT on electricity applies to all households, regardless of the price agreed upon in the electricity contract. Moreover, the tax reduction may lead to increased demand for electricity and push up wholesale prices. This measure offers limited benefits to households and comes with a high cost for the public sector.

Different indicators paint slightly different pictures of the fiscal stance in 2022 and 2023. One way to examine the impact of fiscal policy on the economy is to look at the structural primary balance, i.e. the cyclically adjusted general government budget balance net of interest payments. The general government structural primary balance is estimated to be

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5. Recommendation for a Council Recommendation on the economic policy of the euro area 2023.

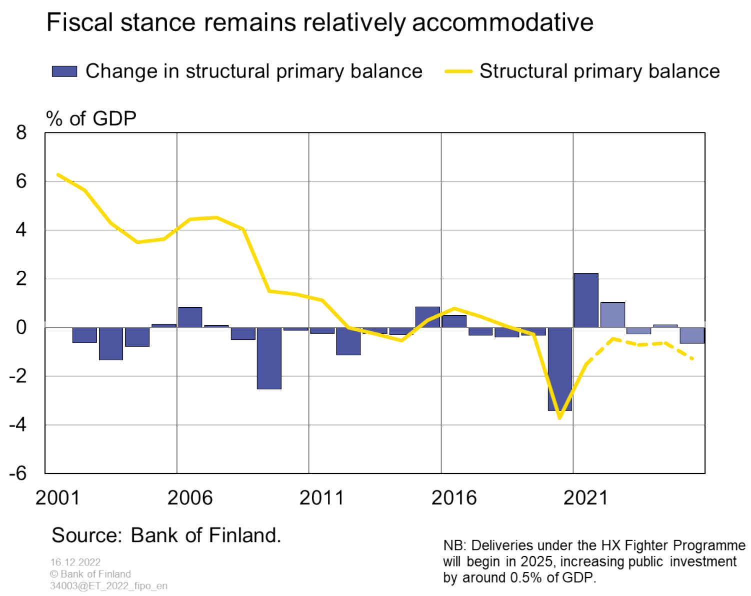
6. IMF: Staff Concluding Statement of the 2022 Article IV Mission.

7. See National fiscal policy responses to the energy crisis (bruegel.org), 21 October 2022.

-0.5% in 2022 and -0.7% in 2023, so in light of this indicator, the fiscal stance is slightly expansionary (Chart 8).

Another way to examine the effects of fiscal policy decisions is to observe the change in the structural primary balance, i.e. the fiscal impulse. According to this indicator, the fiscal policy tightened in 2022, mainly due to reduced investments in managing the COVID-19 pandemic. In 2023, the fiscal stance will be eased slightly due to investments in national security and energy subsidies.

Chart 8.



Based on the growth rate of public expenditure, the European Commission assessed Finland's fiscal stance to be broadly neutral[8] in both 2022 and 2023. The European Union's Recovery and Resilience Facility instrument will have a small supportive impact on economic growth, but since the expenditure increase is funded by non-repayable grants from the EU, the investments made through these instruments are not reflected in the fiscal stance.

In its statement on 17 November 2022, the IMF recommended that Finland should aim for a slightly tighter-than-planned fiscal stance in 2023. The IMF estimates that the measures to compensate for higher energy prices could be targeted better and without impeding the impact of price signals on energy demand. Over the medium term, the IMF recommends fiscal consolidation in order to reduce the debt ratio and make room for age-related spending.

Public debt ratio set to rise again

Finland's general government debt-to-GDP ratio for 2022 will show a further decrease,

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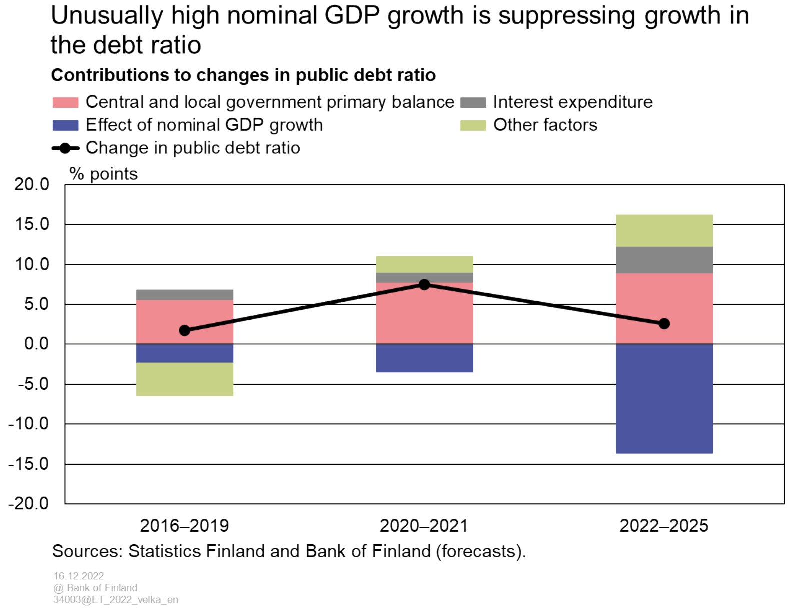
8. Commission Opinion of 22.11.2022 on the Draft Budgetary Plan of Finland, C(2022) 9508 final, European Commission 22 November 2022.

due to unusually fast growth in nominal GDP, the denominator of the ratio. The level of nominal public debt, however, continues to rise. During 2023–2025, borrowing will be driven by the budget deficits of central and local government (Chart 9). The period of favourable interest rates appears to have ended and interest expenditure will start to rise going forward, but nominal GDP growth will continue to have an offsetting effect on the debt ratio. The public debt will also be swelled by the procurement of defence equipment, such as fighter aircraft, with payment instalments beginning before delivery. Finland's public debt ratio will reach 75% in 2025 and is on course to rise further.

The general government debt position rose by about 6 percentage points because of a statistical revision made in June 2022[9]. The revision raised general government assets and liabilities by equal amounts, resulting in a revised gross debt stock of 72.4% of GDP in 2021. The statistical revision is a good reminder that in addition to the gross public debt it is worth paying attention to general government financial assets. On the other hand, some caution is needed when examining the latter. For instance, the investment portfolios of earnings-related pension funds are recorded as general government financial assets, and even though they are intended for financing future pension liabilities, they are not recorded as part of general government financial liabilities. Second, company shares make up a high proportion of the government's financial assets and their values can fluctuate sharply, as seen once again in 2022: the share value of state-owned listed companies at the end of November 2022 stood at about EUR 25.5 billion, a 27% decline compared with a year earlier. Such government shareholdings are often for strategic purposes, such as security of supply, which limits the extent to which these holdings can be sold. General government financial assets also generate property income for central government and municipalities, totalling about 1.3% of GDP per annum.

9. In June 2022 Statistics Finland revised the method by which interest subsidy loans for rental housing and right-of-occupancy housing are treated in the national and financial accounts. In the financial accounts, ARA interest subsidy loans will in future be presented in general government financial assets and liabilities. The revision significantly altered the general government consolidated EDP (excessive deficit procedure) debt and raised the public debt ratio by 5.9 percentage points in 2021. The revision was applied retroactively to the financial accounts data going back to the year 2000.

Chart 9.



Sustainability of public debt

Finland's public debt-to-GDP ratio has doubled over the past 14 years, and the level of debt will continue growing in the coming years according to the Bank of Finland's latest forecast with the assumption of unchanged fiscal policy. Finland's population is ageing, which means spending on health and social care can be expected to rise further in the coming years. Meanwhile, the working-age population is contracting, and a smaller labour force is weakening the revenue base for public expenditure. The population dependency ratio[10] will rise from 62.4% to 67.3% between 2019 and 2035, and further to 80.4% in 2070. With the public finances in deficit to begin with and the level of public debt markedly higher than before, the future burden of age-related expenditure relative to the revenue base risks swelling the public debt even further and widening the sustainability gap.

The long-term growth potential of the Finnish economy is weaker than before, because the working-age population is continuing to shrink and productivity growth has slowed. Productivity growth is being constrained by the availability of skilled labour, but also by the employment growth in health and social services, where raising labour productivity is difficult. In the services sector especially, it is likely that productivity gains will stem from improved management systems and organisational structures, and from the adoption of new technologies. Key to all these is an educated and skilled labour force. However, there is concern over the growth of human capital, as the average level of educational attainment in Finland has stopped rising, at least for the time being.

The long-term sustainability gap in Finland's public finances is estimated to be about 4% of GDP at the 2027 level (See Finland's public debt sustainability and fiscal consolidation

10. The number of people younger than 15 or older than 64 relative to the working-age (15–64) population. In 2009, the dependency ratio stood at 50.6%.

needs). This Bank of Finland estimate is about 0.5 percentage points higher than the estimate it made in 2021, as the forecast of the structural deficit in 2027 is slightly weaker than before, which means that future deficits are higher. In addition, the higher public debt and interest expenditure also affect the estimate. The estimate is based on the long-term forecast for the Finnish economy and a determination of the public finances in which fiscal policy is assumed to remain unchanged. The estimate is thus not a forecast but instead a stress projection of the pressures on the public finances. In spite of the calculation's inherent uncertainty, it illustrates the scale of the imbalance in the public finances over the long term.

Addressing the long-term challenges to the public finances should be done one step at a time. The sustainability gap indicator consists of three parts: future interest payments on the current debt stock, the general government structural balance in the base year of the calculation, and the present value of future primary balances. If our aim is to reduce the sustainability gap, then progress on this can best be made by focusing on the structural balance in the immediate years ahead. In addition, keeping the public debt stock at a moderate level would boost confidence in the management of the economy and help keep the risk premia associated with the debt interest rates in check. The long-term sustainability of the public finances can be improved by rebalancing them in the immediate years ahead and carrying out structural reforms that would strengthen the functioning of the economy in the future.

The general government (excluding earnings-related pension providers) structural deficit is estimated to come to just under EUR 6 billion in 2024. The deficit will further widen as interest payments and age-related expenditure increase on the back of a rising debt stock and growing share of older people in the population. Rebalancing the public finances will thus require a long period of fiscal consolidation that even upon completion will require an ongoing readiness to adjust spending in order to maintain the fiscal balance. Rebalancing the public finances over the coming parliamentary terms would entail a fiscal adjustment of about EUR 13 billion. Halting the rise in the public debt ratio would require an estimated adjustment of EUR 7 billion over the next eight years (See Finland's public debt sustainability and fiscal consolidation needs).

National fiscal framework put to the test

During the current parliamentary term, the Finnish and global economies have been buffeted by a major pandemic, Russia's invasion of Ukraine and an energy crisis. Fiscal rules and established practices have been set aside in favour of using the public finances to support the safety and wellbeing of society and to strengthen security in these exceptional circumstances. Nevertheless, the Government has made progress with implementing its Government Programme drawn up before the pandemic, adjusting the measures very little to the changed circumstances. It is repeatedly stated in the Programme and in the General Government Fiscal Plan that the Government is committed to reviewing its plans if their implementation should jeopardise achievement of the objectives set out for the public finances. However, such a review has not been carried out, and fiscal policy objectives have been pushed back.

In 2023, Finland's public finances will be running a deficit for the fifteenth consecutive year. Structural changes occurring in the economy following the 2008 financial crisis – changes in the production structure and the retirement of baby boomers – have created a gap between public expenditure and revenues, which threatens to widen in the near future. Governments have aimed to close the gap by boosting economic growth especially with structural policies, such as raising the employment rate, but also in part by implementing moderate spending cuts. The strategy does not appear to have been an unmitigated success, as the public debt in 2023 will be over 36 percentage points higher than in 2008, when the general government sector was last running a surplus.

With age-related expenditure rising each year, fiscal adjustments will have to be made to contain the expansion of total public expenditure. Put differently, it is likely that any resources freed by making spending cuts will in large part have to be put towards rising health and long-term care costs. The soundness of the Finnish spending limits system is of primary importance in controlling public spending. Exceptional circumstances cannot always be managed by exceeding the central government spending limits at will. Successfully controlling public expenditure and abiding by fiscal rules will foster trust in Finland's ability to service its public debt in the future.

EU fiscal rules at a turning point: Commission proposal to relax rules

The European Commission issued a Communication on 9 November 2022 outlining plans to reform the EU economic governance framework. The Commission's proposal would leave unchanged the Treaty reference values – a budget deficit threshold of 3% of GDP and a 60% debt-to-GDP ratio – but would nevertheless mark a significant departure from the existing framework. The framework would be based on a medium-term (10-year) debt sustainability analysis conducted by the Commission and would assume an unchanged fiscal policy. The Commission would set a reference fiscal adjustment path for net primary expenditure[11] where the public debt ratio would begin to shrink or remain at prudent levels. The fiscal adjustment path would be more stringent for countries with a substantial (> 90%) debt challenge. Countries moderately in excess of the 60% reference value would be granted more time to turn around their debt ratio. Each Member State breaching the debt limit would draft a four-year fiscal-structural plan compatible with the long-term sustainability of their debt and submit it to the Council for endorsement.

A Member State would be allowed to propose a longer adjustment period, extending the fiscal adjustment path by up to three years, if it commits to structural reforms and investments that support economic growth, debt sustainability and common EU priorities and targets. At the same time, the debt reduction targets could be relaxed as long the Member State's debt ratio is assessed to be on a sustainable path.

The advantage of the Commission's proposal is that, compared with structural budgetary

11. Given that the fiscal adjustment path would be based on growth forecasts and associated projections of public revenues, a Member State would be able to deviate from its designated adjustment path by simultaneously implementing measures that raise public revenues, such as tax increases. That is why the reformed framework would focus on net primary expenditure, where the effects of automatic stabilisers and discretionary measures on the revenue side are removed from changes in public expenditure.

positions and their relative changes, regulating the growth rate of primary expenditure is a much more feasible operational indicator. At the same time, it would, at least in principle, be more readily adoptable by local government and other general government subsectors outside central government. Monitoring the path of net primary expenditure without cyclical unemployment expenditure would allow automatic stabilisers to operate freely. In addition, limiting the growth of net expenditure would cause the public finances to strengthen during periods of economic expansion, as it would not be possible to offset higher revenue growth by immediately raising expenditure.

There have been weaknesses in the enforcement of the current EU fiscal rules. Because calculating the structural balance requires an estimate of potential output, a variable which cannot be directly measured, it is subject to uncertainty. This means that changes in the structural balance have been estimated conservatively, and failure to comply with the preventive arm of the Stability and Growth Pact (SGP) has not led to activation of the significant deviation procedure (SDP) for countries in the euro area. This procedure, along with structural balance monitoring and the associated medium-term objective (MTO), would now be discontinued. The Commission's proposal does not comment on the future of the Fiscal Compact between Member States. The Fiscal Compact prescribes a more stringent MTO for participants (applies to the euro area) and requires that the MTO be brought into national legislation.

In its Communication on reforming the economic governance framework, the Commission considers that enforcement would be improved by reducing the financial sanctions that constitute part of the enforcement mechanism. The Commission also proposes that a 'debt-based EDP' be activated by default when a Member State with substantial debt challenges deviates from its agreed fiscal adjustment path. For breaches of the 3% of GDP deficit reference value ('deficit-based EDP'), on the other hand, the (potential) activation of the EDP would remain unchanged. The Commission also proposes stronger accountability for Member States who fall short of meeting EDP objectives: they would be required to report to the European Parliament on corrective actions taken. In addition, macroeconomic conditionality could also be applied to other EU financing, meaning that funding could be suspended if a Member State neglected the effective action required by the EDP. The proposals for strengthening the enforcement mechanism seem useful, but their effectiveness in practice would depend on the specifics of their implementation, for example the amount of discretion available to the Commission and the Council of the European Union.

National ownership of the fiscal framework would also be strengthened by stepping up the role of national independent fiscal institutions in the assessment and monitoring of fiscal plans. The surveillance of macroeconomic imbalances in Member States would also focus on a more preventive approach, and greater attention would be paid to imbalances affecting the EU and the euro area.

New rules for the new parliamentary term: Ministry of Finance calls for more rigorous governance of the public finances

A Ministry of Finance working group tasked with developing the governance of the public finances proposed in its November 2022 report[12] that the central government spending limits system, tax policy, and the target levels for the general government budgetary position should all be coordinated so as to bring the public debt ratio onto a downward trajectory. First, the targets for the general government budgetary position would be derived from the targeted debt-to-GDP ratio, and then the extent of the necessary fiscal adjustments would be determined. The central government spending limits for the parliamentary term and the overall tax policy stance would then be established in the Government Programme in line with the budgetary position target. The fiscal adjustment target would be maintained irrespective of the economic situation, but an escape clause would exist for exceptional conditions.

The proposed model is a welcome and more ambitious step in the right direction compared with current practices. It also makes more concrete the fiscal adjustments needed to meet the budgetary objectives by expressing them in euro terms. Tax policy would still not be explicitly tied to central government spending limits, which means that, for example, preventing circumvention of the spending limits by increasing tax subsidies would have to be stated in the Government Programme, as is currently the case. However, tax policy could still play a substantial role together with expenditure policy in achieving the aim of rebalancing the public finances if the Government so desired.

The working group report compares the fiscal policy governance systems of Finland, Sweden, Denmark and the Netherlands. What all these have in common is an expenditure ceiling, although in contrast to the other countries, Finland's ceiling is not statutory. The expenditure ceiling in the other countries also covers a larger share of public expenditure: 55% in Sweden, 75% in Denmark and 80% in the Netherlands, compared with 45% in Finland. All of the countries have set a medium-term objective for their structural deficit. The only country with a debt ratio target more stringent than the EU's 60% reference value is Sweden, where deviating from 35% of GDP requires the government to issue a report to parliament outlining corrective measures.

When the financing of the wellbeing services counties is brought directly under central government control at the start of 2023, a higher proportion of public expenditure could fall within the scope of the spending limits. The funding for the counties should indeed be included under the spending limits, although it might be justified to create a separate supplementary budget provision for the funding that would not be available for other expenditure. At the same time, it is worth thinking about how the commitment of future governments to achieving the targets could be made more effective.

The Ministry of Finance working group did not directly take a view on which elements of Finnish law regarding fiscal rules should be reformed. The current statutory framework for fiscal policy governance is mostly related to EU regulation while the most effective governance instrument – the spending limits system – is based on established practices. It is conceivable that having a broader statutory base for the governance of the public finances might be more effective in influencing such matters. The downside would be some loss of flexibility. On the other hand, flexibility is also lost when fiscal space is

12. Developing the steering of general government finances (English summary). Publications of the Ministry of Finance 2022:71.

reduced by rising debt.

Working towards resilient public finances

Ensuring the sustainability of public finances even during future crises requires an active policy of creating fiscal space. Rebalancing the public finances not only requires direct adjustments to public revenues and expenditure in the near term but also structural reforms that will strengthen the public finances over the medium term. These measures can be taken by prioritising expenditures – cutting spending where it is less important and reallocating resources. Spending reviews which evaluate the effectiveness of different expenditure items can be used as an aid to this. In general, keeping the growth rate of total public expenditure below the long-term growth rate of nominal GDP can also be an effective way of balancing revenues and expenditure.

Public revenues can be strengthened by improving the efficiency of the tax system, for example by reducing tax subsidies and other exceptional measures. The Ministry of Finance has already announced that it will conduct a tax review with the aim of assembling information on potential tax changes that would improve the neutrality and efficiency of taxation and on how this might affect GDP growth and employment.

In the coming parliamentary terms, the boundaries set for the public finances must be seen as more binding if we wish to avoid accumulating a legacy of debt that would limit future choices. The domestic governance of fiscal policy must be enhanced. The targets for the general government budgetary position need to be consistently set with a long-term view spanning beyond parliamentary terms, and achieving the targets has to be supported with fiscal policy rules. The legislation on fiscal policy could be expanded to include the setting of public finance objectives and central government spending limits. Concrete targets as well as means for fiscal adjustment derived from rebalancing objectives would be found in Government Programmes.

The economy’s growth potential could be strengthened by investing in education and research and development. Efforts such as these would also support the green transition and its necessary investments. When the public finances are built on a solid foundation, they will also be able to withstand future crises.

Tags

economic policy, public finances, sustainability of public finances, public debt