ASSESSMENT OF PUBLIC FIANANCES

Assessment of public finances 2019

Finnish economy | 17.01.2020 | Arto Kokkinen

AUTHOR

Arto Kokkinen

Sound fiscal policy should be conducted keeping in mind the economy's long-term challenges. Finland's population structure is becoming increasingly unfavourable on account of its declining working-age population and growing share of the elderly. This imbalance, together with rising age-related expenditure, will create a situation for the public finances where long-term general government expenditure is expected to exceed its revenue. In addition to the aforementioned sustainability gap, sound fiscal policy will prepare for future recessions and negative surprises.

Countercyclical fiscal policy in good and bad times?

Economic theory says that fiscal policy can in its part be used to smooth out the economic cycle. By

saving in prosperous times, the general government can increase its fiscal room for manoeuvre for the bad times. Therefore, countercyclical fiscal policy does not mean that the business cycle is only smoothed when the economy is in the doldrums, by raising public expenditure.

Countercyclical fiscal policy can be implemented via automatic stabilisers, discretionary (i.e. deliberate) policy measures or a combination thereof. Tax revenue and other general government revenue components, such as property income, automatically increase in good times and strengthen the general government's primary balance[1]. In bad times, conversely, tax revenue declines and general government expenditure, related to, for instance, unemployment, increases and helps stabilise growth. Because of automatic stabilisers, the very same fiscal buffers that are accrued in the good times provide the public finances with room for manoeuvre during the bad. By acting in this manner, the general government would automatically do its part in smoothing out the cyclical ups and downs of the economy. In addition to automatic stabilisers, countercyclical fiscal policy can be implemented by taking deliberate policy measures, for example by introducing fiscal consolidation when cyclical conditions are favourable.

Finland's economy needs a fiscal buffer which could be replenished through discretionary policy measures as well as through automatic stabilisers. Fiscal buffers are needed for mitigating future recessions but also for confronting longer-term challenges related to the public finances. Unfortunately, building up these buffers in the good times has not proven easy. Such has been the case, even in spite of advance knowledge of the strain put on the long-term sustainability of the public finances by population ageing and rising age-related expenditure.

The stance of discretionary fiscal measures can be examined by looking at changes in the general government structural primary balance. The structural primary balance is the general government balance adjusted for cyclical effects and one-off fiscal revenue and expenditure transactions and net of interest payments. Change in the structural primary balance thus serves as a proxy for the impact of discretionary fiscal policy on the general government balance.

If the change in the structural primary balance is negative, discretionary fiscal spending must have increased (or taxation eased by discretionary policy). Similarly, a positive change in the structural primary balance signifies a reduction in discretionary spending (or a discretionary tax hike). When the change in the structural primary balance is subtracted from the change in the nominal fiscal balance, the difference can be used to determine whether automatic stabilisers have been allowed to operate with countercyclical effect.

How to define good and bad times in the economy is a question in itself. One approach is to define bad times as periods of negative GDP growth and periods of positive growth as good. For example, a technical recession is defined as two consecutive quarters of negative GDP growth in the

analysis of business cycles.

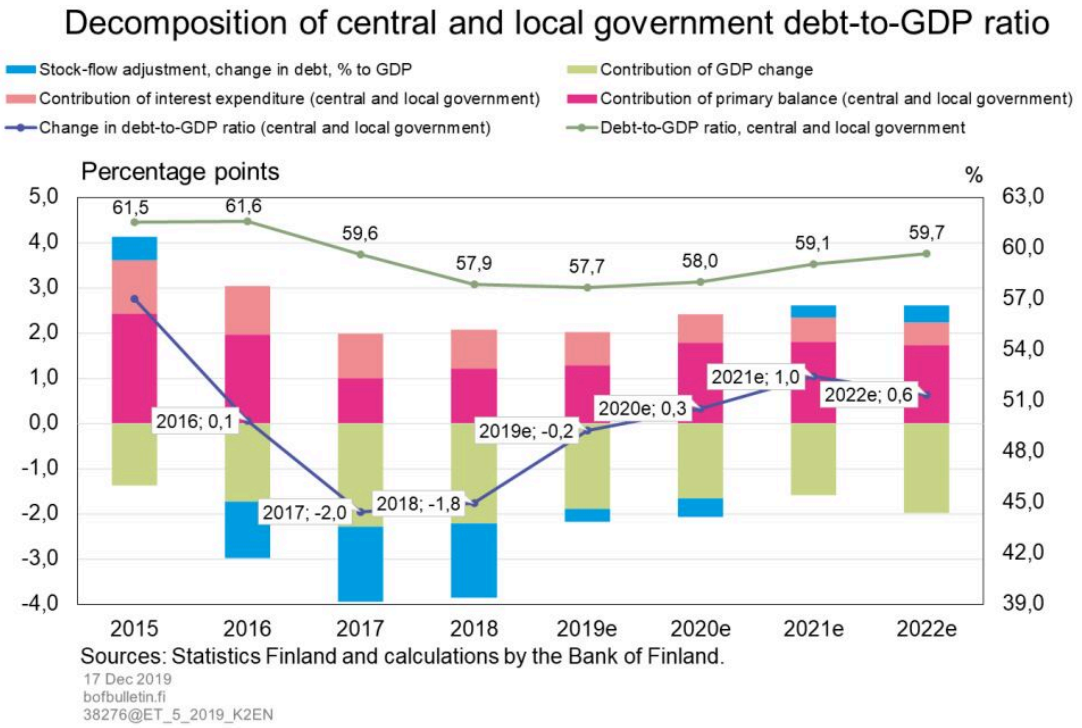
On the other hand, phases of the economic cycle are defined in terms of the difference between actual GDP and its long-term potential (trend), i.e. by estimating the so-called output gap. Using this approach, bad times are defined as periods when GDP is growing at a rate below its long-term potential (downturn). Conversely, good times are defined as periods when GDP is growing above its long-term potential rate (upswing). Using a third approach, bad times can be defined as periods when GDP falls below its potential level (recession), and good times when GDP is above its potential (boom).

Discretionary fiscal policy has been countercyclical when the change in the structural primary balance has been negative during bad times and positive in good times. The difference between change in the nominal fiscal balance and change in the structural primary balance, in turn, reveals the effect of automatic stabilisers. If the change in the fiscal balance has in bad (good) times been even more deeply negative (positive) than the change in the structural balance, then automatic stabilisers have stimulated (restricted) the economy, in addition to discretionary fiscal stimulus (contraction).

Chart 1 reveals that in every recessionary period (areas in grey) since 2002, the economy has been stimulated by discretionary measures as well as automatic stabilisers.[2] The nominal fiscal balance and structural primary balance have both seen negative change. In at least some of the years during the recessionary periods, the change in the fiscal balance has been greater than the change in the structural primary balance.

In prosperous times, by contrast, fiscal policy has been less systematic in smoothing economic activity downwards and accumulating savings. Expansionary fiscal policy has also been practised procyclically, during years of already positive growth, such as in 2018. The general government fiscal balance was still positive in the early 2000s, but fell into deficit at the onset of the financial crisis.[3] The general government has not rebalanced since, and will remain in deficit until the end of the forecast period. When the entire inspection period beginning from 2002 is looked at as a whole, discretionary efforts to build fiscal buffers in times of positive economic growth are revealed to have been less substantial than the discretionary stimulus spending practised during recessions.

Chart 1.



Following the financial- and euro area sovereign debt crises, the Finnish economy expanded in 2015–2018. Growth is also projected to continue, albeit at a diminishing rate, in 2019–2020. In 2015–2016, fiscal buffers were accumulated as a result of discretionary policy measures. By contrast, the general government fiscal balance weakened in 2017–2018, during years of positive growth and a booming economy, on account of tax cuts and reductions to social security contributions, among other factors.[4]

In 2017 the general government fiscal deficit shrunk in spite of discretionary fiscal stimulus, as the positive growth phase of the economic cycle meant that automatic stabilisers brought in extra revenue. In 2018, however, although remaining a year of robust growth, discretionary measures lowered the fiscal balance so much that little revenue was left over for rebuilding fiscal buffers. Similarly, in 2019, another year of continued positive growth, fiscal stimulus in the form of tax cuts seems to have prevented fiscal buffers from expanding.

This picture remains largely unchanged when using the output gap as an indicator for good and bad times. Only 2015–2017 are seen as poor years for the economy using this approach, as although GDP growth was positive during these years, the output gap still remained negative. On the other hand, the output gap did begin narrowing during this period, which might be viewed as

the start of an upswing. Estimating the output gap is, however, subject to a considerable degree of uncertainty, especially when done in real time. Quarterly national accounts statistics, which are revised ex post, introduce their own problems to discretionary fiscal policy. Nevertheless, the main observation still stands, which is that fiscal stimulus in bad times has superseded the accumulation of fiscal buffers during good times, regardless of which interpretation of the economic cycle is applied.

Between 2015 and 2018 the general government successfully reduced its fiscal deficit and lowered its debt-to-GDP ratio. Given the unfavourable trend of the population structure, these should be seen as welcome developments. However, efforts to fully rebalance the public finances during the economy's upswing and subsequent boom have remained unsuccessful. Fiscal buffers, which are important for maintaining sound public finances over the long term, have been not been rebuilt either, even in spite of advance knowledge of the imminent rise of age-related expenditure and the substantial long-term sustainability gap.

The policy decisions for Finland’s public finances taken in autumn 2019 have been made at juncture where economic growth, although diminishing, is not seen to be headed into recession and the output gap is not estimated to be negative, at least yet. Nevertheless, discretionary fiscal policy looks to remain expansionary in 2019–2020. This, for its part, only illustrates how difficult it is to rebuild fiscal buffers during high phases of the economic cycle.

Public debt-to-GDP ratio on the rise again

Public debt is accumulated not only through general government deficits but other factors as well. In the short term, annual deficits increase the accumulation of debt. However, when looking at the crisis years in Finland in the early 1990s, it becomes apparent that the expansion of the debt-to-GDP ratio during this period, from about 14% in 1990 to 56% in 1994, cannot be explained as the cumulative result of annual deficits alone. During the time, Finland was undergoing a banking crisis. Consequently, the central government was forced to take on substantial amounts of debt with its balance sheet assets and future tax revenues as collateral, not only to finance its budget deficit but also to capitalise banks which had fallen into crisis. This prevented the outright failure of banks and the loss of depositors’ savings.

Similarly, the public debt ratio, which was some 30% relative to GDP in 2008, increased during the financial- and euro area debt crises as well as during the protracted recession in Finland that followed, to 63% relative to GDP in 2015. As before, the rise in the debt ratio is not completely explained by cumulative annual fiscal deficits, although they are an important factor. Because of the aforementioned, projections which are solely based on fiscal deficits can underestimate the development of general government debt in the future. Unpredictable crises and severe

recessions impel the general government (and especially the central government) to take on debt, even in return for assets, to mitigate harmful effects on the aggregate economy.

Thus, over the long term, the accumulation of net general government debt is significantly influenced by the cumulative effects of fiscal deficits being larger than surpluses. In addition, the central government (and other general government entities) may borrow funds from the financial markets against assets and future tax revenue as collateral.[5]

In the following, the general government debt ratio will be examined in greater detail, with its 2015–2018 developments outlined as well as looking at the 2019–2022 forecast period. Finland's public debt-to-GDP ratio increased from just over 30% before the financial crisis to clearly over 60% in 2015. The debt ratio was successfully lowered afterwards and settled in 2018 at about one percentage point below the 60% reference value stipulated in the Treaty on European Union. In light of the long-term challenges ahead, the lower debt ratio is most certainly welcome. Progress on this front can be attributed to favourable growth, low interest rates and discretionary policy measures taken by the previous government. Some of this progress, however, was achieved by selling state-owned assets.

In the coming years, however, rising age-related expenditure, weakening growth, and the discretionary measures of the new government will once again put the debt ratio on an upward path. Despite the sales of state-owned assets, the general government debt ratio will exceed the 60% reference value already in 2021. The debt ratio's rise is partly explained by a coinciding procurement programme for fighter aircrafts beginning in 2021 and 2020; however, it appears that reference value would be exceeded even without this. Although the overrun is not projected to be large, it will contribute to pressures for lowering the debt ratio in the future.

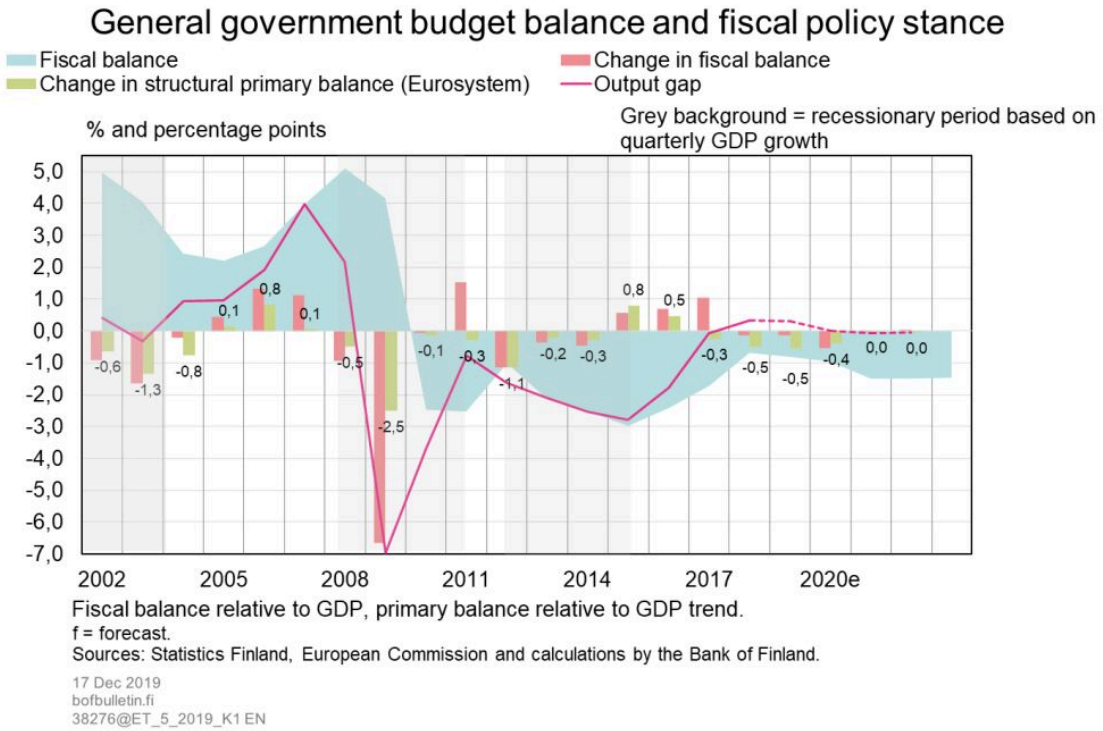
The debt ratio looks at general government debt relative to nominal GDP. Growth of the debt ratio decreases when the quotient's denominator goes up—that is, when nominal GDP expands. Lower levels of interest rates, in turn, mitigate the debt ratio's growth pressures when annual fiscal deficits are accumulated. Taken together, this means that the public debt-to-GDP ratio will fall as long as nominal GDP increases at a rate that is higher than the level of interest rates, if the primary balance change is not too negative and all other factors remain constant. The rise of Finland's public debt-to-GDP ratio has also been mitigated by the growth of property income received by employee pension providers as well as sales of government financial assets (shares and minority stakes).

Decomposing the general government debt-to-GDP ratio reveals that most of its change in Finland is attributable to the development of central and local government debt relative to GDP (Chart 2). In addition to the primary balance, the debt ratio has been affected by the factors

outlined above.

In 2018, the ratio of debt held by central and local government contracted. Nominal GDP growth outweighed interest expenditure. In addition, debt principal was paid off with revenues received from sales of financial assets ('stock-flow adjustment' in Chart 2). In this specific year, the revenues received from the sales of state-owned financial assets were larger than the central and local government primary balances.

Chart 2.



In 2019–2020, the debt-to-GDP ratio will expand as central and local government expenditure increases more than revenue, primarily on account of the discretionary measures pursued by the new government. This is illustrated in Chart 2 as the effect of the primary balance. However, the effect of nominal GDP growth, net of relatively low interest expenditure, will curb growth of the debt ratio. In addition, sales of state-owned assets will also be used to curtail the debt ratio during the forecast period.

Yet reducing public debt by selling general government assets is not Finland's best long-term solution at the moment. Because of the long-term challenges that lie ahead, the general government should strive to run fiscal surpluses during years of favourable growth. The general government's net financial assets would thus increase, providing Finland with fiscal buffers to

address its long-term challenges.

Fiscal rules assist in managing public finances over the long term

The rules governing the public finances and fiscal policies of the European Union Member States were already agreed in the early drafting of the euro area. The premise for this framework was that each Member State would manage its own fiscal expenditure, obligations and debt by itself. To prevent excessively high levels of public debt from building up, Member States agreed on rules limiting the general government deficit increasing the debt and the stock of general government debt itself. Accordingly, the Treaty on European Union stipulates that general government fiscal deficits should not exceed 3% relative to GDP, and that general government debt ratio should not exceed 60% to GDP. The framework for compliance and supervision is outlined in the Stability and Growth Pact.

In the 2019–2022 forecast period, Finland's general government deficit will remain below 3% to GDP. In contrast, the general government debt-to-GDP ratio will exceed the 60% reference value in 2021–2022, although this overstep is not projected to be particularly large, remaining under one percentage point. The debt ratio does risk growing later on, however, so decisive measures should be taken to prevent general government debt from 'getting out of hand' or limiting the fiscal space available in the long-term.

In the preventative arm of the Stability and Growth Pact, Finland also has the medium-term objective of achieving a cyclically-adjusted structural balance of about -0.5% to GDP. In 2019, a -0.5 percentage point 'significant deviation' looks likely to be avoided, although the structural balance will weaken in the range of -1.2 to -1.3 percentage points, relative to GDP. This is because of the allowance in public finances (0.5% relative to GDP) granted to Finland for 2017–2019, as per the structural reform clause.

In the European Commission's country-specific recommendations for 2020, Finland was urged to ensure that the nominal growth rate of net primary government expenditure not exceed 1.9% in 2020, corresponding to an annual structural balance improvement of 0.5% to GDP. Instead of this improvement, however, the structural balance will weaken to about -1.5%, as a result of factors which also include the Government's discretionary fiscal measures. Finland risks seeing a significant deviation from its medium-term objective in 2020, but will nevertheless remain in compliance with the Treaty's nominal fiscal balance and debt-to-GDP ratio criteria in the same year. Thus, by and large, Finland can be seen as being in compliance with the EU's fiscal rules.

Reforming the EU fiscal framework has been part of the discussion surrounding the further

development of Economic and Monetary Union.[6] The EU's fiscal rules have worked in the sense that the total fiscal deficit of the euro area contracted from slightly over 6% to GDP in 2010 to 0.5% in 2018. It is clear that the existence of the fiscal framework has contributed to this development. However, at the same time, about a third of the countries in the euro area have a public debt ratio in excess of 85% to GDP, nor has there been much success in lowering the overall level of debt. The existing fiscal framework is thought to be rather complex, and there have been calls for greater transparency in the supervision of compliance.

In addition to the EU rules, Finland has long implemented central government spending limits with reasonable success. Accordingly, the Government has again allocated around 80% of its budgetary appropriations to a binding four-year framework. The spending limits are set in real terms and are thus subject to annual price and cost level adjustments as well as potential structural adjustments. The spending limits system is based on ex ante review, so the expenditure in the central government's budget proposal is restricted beforehand.

The sustainability gap may be closed through several different means

Finland's general government remains in structural (cyclically adjusted) deficit. In addition, the continuing decline of the population structure will add growing pressure on the long-term sustainability of the public finances. As the population ages, general government expenditure on care services and pensions will rise, since the Finnish general government includes statutory pension schemes. Meanwhile, the working-age population will continue to decline.

In the long term, general government expenditure will exceed its revenue. According to the latest sustainability gap calculation, this difference currently stands at about 4.7% in proportion to current GDP. If nothing is done to address the sustainability gap, it will before long lead to uncontrolled growth of general government debt. Thus, the general government must not only discover new sources of revenue but at the same time identify areas for savings.

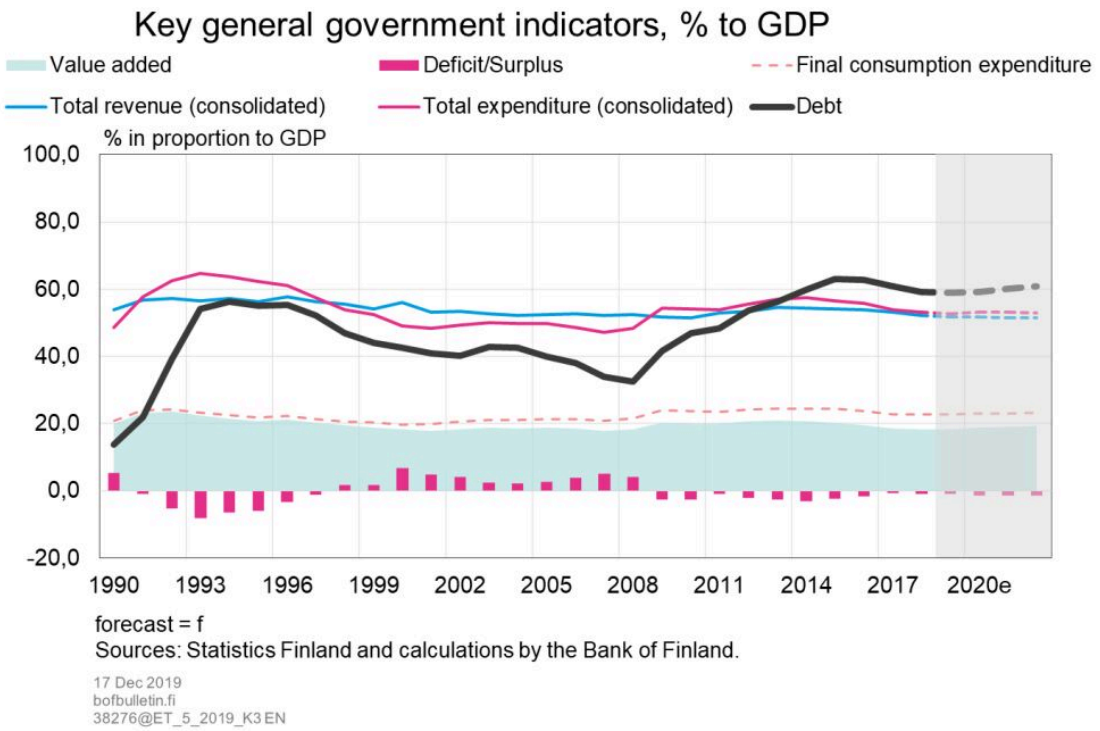
The existing general government revenue base could be strengthened by implementing structural reforms conducive to productivity and growth, as well as by raising employment and realigning the tax structure to be more conducive to growth. The structure of expenditure, in turn, should be closely monitored in future, due to the expenditure burden associated with population ageing. The public expenditure surveys published by the Ministry of Finance since 2015 are a particularly welcome addition for this reason. The most rapid phase of pension expenditure growth has already played out over the past decade. Health care and long-term care expenditure should be expected to rise over the coming years, and less has been done to prepare against this compared

with the pension system.

One key question is which areas of general government expenditure might yield savings to be put towards closing the sustainability gap. Often the first answer is the provision of public services and improving its labour productivity.

The savings potential in public services can be estimated by comparing the size of different expenditure items. The value added of public services production, which includes employee compensation and wear and tear of machinery and equipment (fixed capital depreciation), comprised slightly over 18% of GDP in 2018. When purchases of intermediate materials and services used in the production of public services are added to this value added, the resulting sum is public final consumption[7], comprising 23.2% of GDP (Chart 3).

Chart 3.



Public service production expenditure, including wages and intermediate purchases, therefore comes to about one-fifth of GDP (in 2018). As such, saving on public services is unlikely to be a panacea for closing the entire sustainability gap.

In 2018, tax revenue (and tax equivalents) stood at 42% in proportion to GDP. In addition, the general government received property income, such as dividend and interest income, as well as

entrepreneurial income from public enterprises, so that total general government revenue amounted to 52% in proportion to GDP. Together, tax revenue net of public service production expenditure (42% - 23% = 19%) and non-tax revenue (52% - 42% = 10%) comprise 29% in proportion to GDP, most of which is returned to the private sector. If calculated more precisely, public investment (4% including capital transfers), property expenditure (1%) and EU membership fees as well as fees for other international organisations (1%) should all be subtracted from the 29%. The final figure is roughly about 23% in proportion to GDP (over EUR 55 bn in 2018) and includes all transfers, welfare payments and benefits to households (including farmers), all subsidies paid to non-financial corporations, financial and insurance corporations as well as all central and local government grants paid to non-profit institutions serving households (foundations, associations, political parties etc.). In addition, the growing pension expenditure that is part of the statutory pension system belongs to this expenditure.

These figures suggest that it may not be straightforward to identify savings from public services large enough to cover the entire sustainability gap, while at the same time meeting an ageing population's demands for healthcare- and social services—even if productivity and economic growth could be boosted. In addition to services production, other savings might be discovered from the aforementioned areas of general government expenditure.

In order to reduce the consolidation pressures alluded to above, the general government will need to be able to build fiscal buffers—both in the short term and in the long term. Fiscal buffers would also allow for stimulus spending in bad times and assist in preparing for future crises. Excessive general government debt, in contrast, may jeopardise the economy's ability to overcome its long-term challenges, while also limiting important fiscal space when the economy is strained.

Notes

1. The primary balance is the difference between general government revenue and expenditure, excluding interest payments on general government liabilities. The primary balance reveals whether or not general government revenue and expenditure are in balance at a given period. Interest payments are excluded from the primary balance, as they are costs associated with public debt accumulated in the past. The fiscal (or budget) balance, in contrast, looks at the difference between revenue and expenditure and also includes interest payments. ↑
2. In at least some of the years during the recessionary periods, the change in the fiscal balance has been greater than the change in the structural primary balance. In these instances automatic stabilisers have taken effect to stabilise growth, alongside discretionary fiscal measures. ↑

3. This is partly explained by demographics, as Finland's working-age population (15- to 64-year-olds) began to decline soon after the onset of the financial crisis. ↑
4. Taxes and social security contributions were lowered to offset the Competitiveness Pact's negative effects on purchasing power. Employers' social security contributions were eased in conjunction with the Competitiveness Pact, while some of the incidence of these payments was shifted on wage-earners. ↑
5. In this sense, if the impact of future crises could be incorporated into the Finnish sustainability gap calculation ex ante, it might even be larger than the estimated 4.7% to GDP. Granted, general government revenues could just as well be affected by new success stories in the future, similar to Nokia's rise in the mobile phone industry. ↑
6. See e.g. Bénassy-Quéré et al. (2018), Reconciling risk sharing with market discipline: A constructive approach to euro area reform. CEPR Policy Insight no. 91, January 2018; Suvanto, A. et al. (2015). Improving the resilience of Europe´s Economic and Monetary Union, Ministry of Finance publications 37b/2015, 53 ↑
7. Being more precise the sales revenues and output for own use have to be deducted from the sum of production costs. In addition, current transfers provided to the households in the form of non-market goods and services must be added. ↑

Key words

countercyclical fiscal policy, debt, deficit, public finances