Assessment of Public Fianances

Correcting the course of the public finances even more challenging than expected

Finnish economy | 09 January 2024

The outlook for Finland's public finances is weaker than before. Finnish economic growth will remain muted in the coming years, and the fiscal consolidation measures planned by the Government will not be enough to reverse the trend in indebtedness. Bringing the public finances closer to balance requires, on a long term basis, concrete measures that affect both revenue and expenditure as well as structural reforms that support economic growth. Stronger fiscal rules would support decision-makers in fiscal consolidation.



State of the public finances difficult and outlook remains gloomy

During the Economic and Monetary Union from 1999 to date, Finland's central government has posted a surplus in only seven years, according to national accounts. The seven good years have been offset by 14 years of deficit since 2008. Public debt relative to GDP has more than doubled since 2008. In 2024–2026, economic growth will remain sluggish for cyclical reasons, and even the longer-term outlook for growth will not provide relief for fiscal problems.

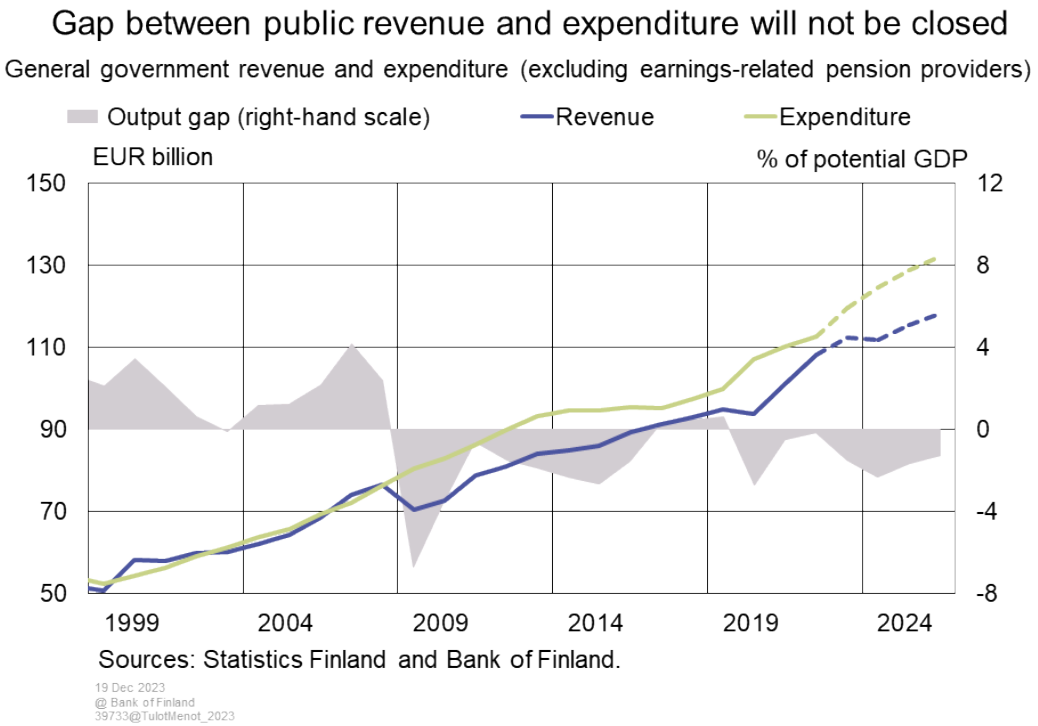
The rise in interest rates will have a rapid impact on debt servicing costs as the amount of debt has increased. Finland's credit rating has remained at the second highest level. The spread between the yield on Finnish and German sovereign bonds has so far remained relatively narrow, even though it has widened slightly due to Russia's war in Ukraine.

Finland's public debt-to-GDP ratio is still below the euro area average, and although the European Commission has already drawn attention to the development of the debt ratio, Finland's general government deficit has – supported by the surplus of earnings-related pension providers – remained below the 3% deficit reference value. Therefore, there has not yet been any external pressure to change the direction of fiscal policy.

Cyclical conditions are undermining the fiscal balance

Finland's fiscal problems derive from a long period of weak economic growth. Before the global financial crisis, the balance of central and local government[1] finances was built on strong economic growth. Industrial restructuring that took place during the financial crisis, weak external demand combined with competitiveness problems, and the deterioration of productivity growth have burdened the Finnish economy for a much longer period than expected. At the same time, public expenditure continued to grow rapidly even though the revenue base had crumbled (Chart 1). Even a gradual tightening of taxation did not restore the fiscal balance, as expenditure continued to grow at a rapid pace until 2014.

Chart 1.



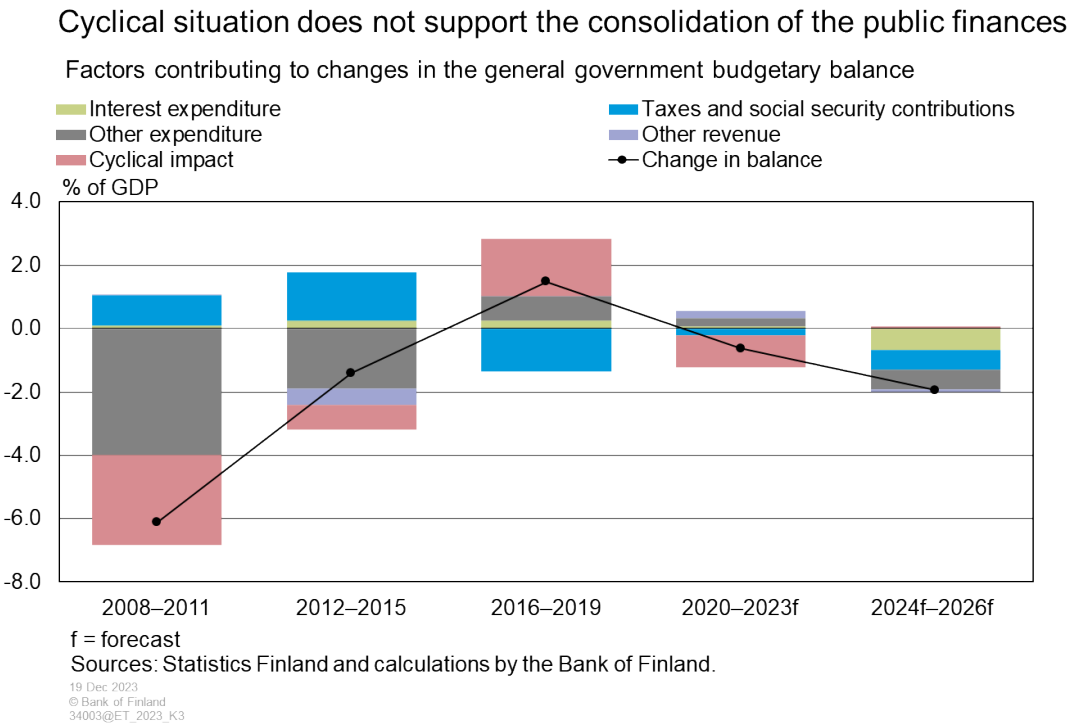
In the period 2015–2019, efforts were made to adjust public expenditure, and economic growth strengthened slightly. At the same time, however, taxation was reduced and the balance of central and local government finances was not restored; the structural deficit remained at around 2%. In 2019, cyclical conditions were favourable and the new Government's projection for the development of public finances was positive. The Government outlined both permanent expenditure increases and fixed-term (so-called future-oriented) investments, which were estimated to strengthen the foundation for economic growth in the longer term.

The COVID-19 pandemic that hit in 2020 was an event of exceptional scale, to which the public authorities responded strongly. As a result of the rapid recovery of the economy and the lifting of pandemic measures, the general government budgetary position improved rapidly between 2021 and 2022, and reached the level of 2019.

Russia's war in Ukraine, and the rise in inflation partly due to the war, nevertheless had an impact on public expenditure both via expenditures in support to Ukraine and for national security and via energy subsidies, index-linked increases in benefits, and higher public sector wages and other input prices. As this was accompanied by a rise in interest rates due to monetary policy tightening, general government interest payments started to grow and costs related to the start of the reform of health and social services increased public expenditure, the general government deficit started to increase again in 2023.

During the current parliamentary term, the outlook for Finland's economy is weak and the rise in interest rates and the growth in age-related expenditure will undermine the balance of public finances (Chart 2). Despite the planned spending cuts, public expenditure will grow rapidly, which will further undermine the balance. The reduction in taxes and social security contributions will adversely impact the achievement of fiscal balance at least in the short term.

Chart 2.



Tax-to-GDP ratio will decrease, growth in revenue base will remain weak

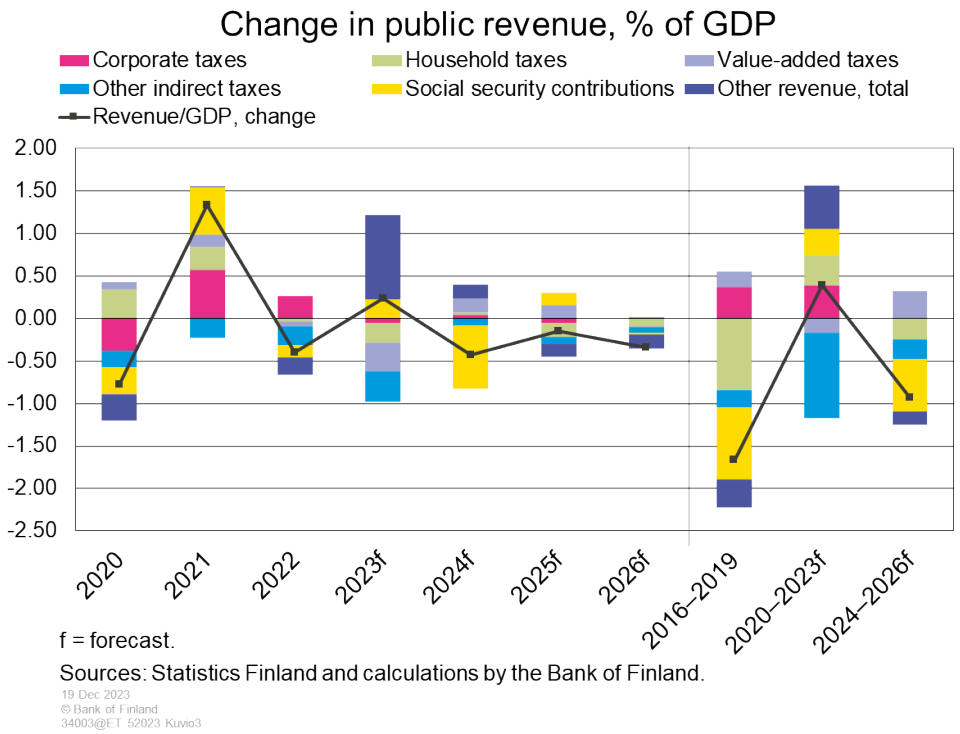
The level of general government debt has risen due to the persistent imbalance of revenue and expenditure. The ratio of public expenditure to GDP has increased by 5.4 percentage points from 2008 to 2022, while revenue has increased by only 0.5 percentage points. Moreover, in 2023, the ratio of public expenditure to GDP will grow by one percentage point, but revenue will increase by only 0.2 percentage points (Chart 3).

Revenue growth as a percentage of GDP was supported by tax tightening decisions in 2011–2015, the impact of which on revenue-to-GDP ratio was 1.8 percentage points. Thereafter, the ratio of public revenue to GDP fell, due to the discretionary reductions[2] in direct and indirect taxation of 1.8 percentage points of GDP between 2016 and 2023.

Revenues from excise duties and taxes, which are based on the volume consumed, typically decrease relative to the value of the products as prices rise or consumption shifts to less harmful products. Revenues from the duty on tobacco have remained more or less unchanged due to constant tax hikes. Revenues from car and vehicle taxes have decreased year by year, as emissions from new cars are lower than those of old cars. Fuel tax receipts relative to the value of consumption have decreased, which is due to the rise in crude oil prices and the increase in the volume of the less-taxed biofuel component. With the exception of value-added tax, other indirect taxes have indeed been tightened since 2008 by some 1.6% of GDP. Nevertheless, revenues from these taxes decreased by 2022 by 0.1% of GDP due to the other factors mentioned above.

The tax policy stance of Government is slightly expansionary. Government will reduce taxation in 2024–2026 by approximately EUR 300 million, based on the Government Programme and the General Government Fiscal Plan. Moreover, as a result of the reductions in social security contributions due to the cut in unemployment insurance contributions in 2024, public revenues will decrease by EUR 1.4 billion. The tax-to-GDP ratio will decrease by 0.8 percentage points by 2026.

Chart 3.



Despite spending cuts, public expenditure continues to grow

The public expenditure-to-GDP ratio increased by 5.4 percentage points in the period

2008–2022. Of the expenditure growth, 70% was due to pension expenditure. Slowing the growth rate of public expenditure in 2015–2017 was an efficient way to reduce the fiscal deficit.

In 2020, spending increased strongly due to the COVID-19 pandemic (Chart 4). COVID-19-related expenditure totalled approximately EUR 11.5 billion. In 2021–2022, expenditure related to the COVID-19 pandemic was reduced and the ratio of public expenditure to GDP returned to the level in 2019. Russia's war in Ukraine increased the need for not only direct support to Ukraine but also for strengthening Finland's defence capability and preparedness of society (EUR 4.5 billion).

The surge in energy prices and other consumer prices quickly weakened the purchasing power of households. Many countries conducted extensive support measures and Finland was no exception. The measures totalled approximately EUR 1.4 billion, i.e. 0.5% of GDP, which was relatively moderate in comparison to many other European countries. The permanent and fixed-term additional expenditure increases included in the Government Programme were executed almost as planned, despite the exceptional circumstances, and they totalled approximately EUR 8 billion. The impact of permanent expenditure increases on the legacy of expenditure was approximately EUR 1.4 billion. Half of the one-off investments (so-called future-oriented investments) of little over EUR 3 billion was financed by selling central government financial assets[3].

Expenditure has, however, continued to grow at a rapid pace in 2023, and expenditure in ratio to GDP will grow by 1 percentage point. The index increases to pensions will raise benefit expenditure, interest payments on public debt will grow and investments in both national security and the start of operations of the wellbeing services counties will increase expenditure.

Interest payments and pension expenditure will continue to increase in 2024–2026. General government interest payments will increase to an estimated 1.5% of GDP in 2026, compared to their lowest level of only 0.5% in 2021[4]. Due to high inflation, the index increases to pensions were exceptionally large in 2023, and the increase will also be significant in 2024. The large index increases have also boosted the popularity of part-time pensions.

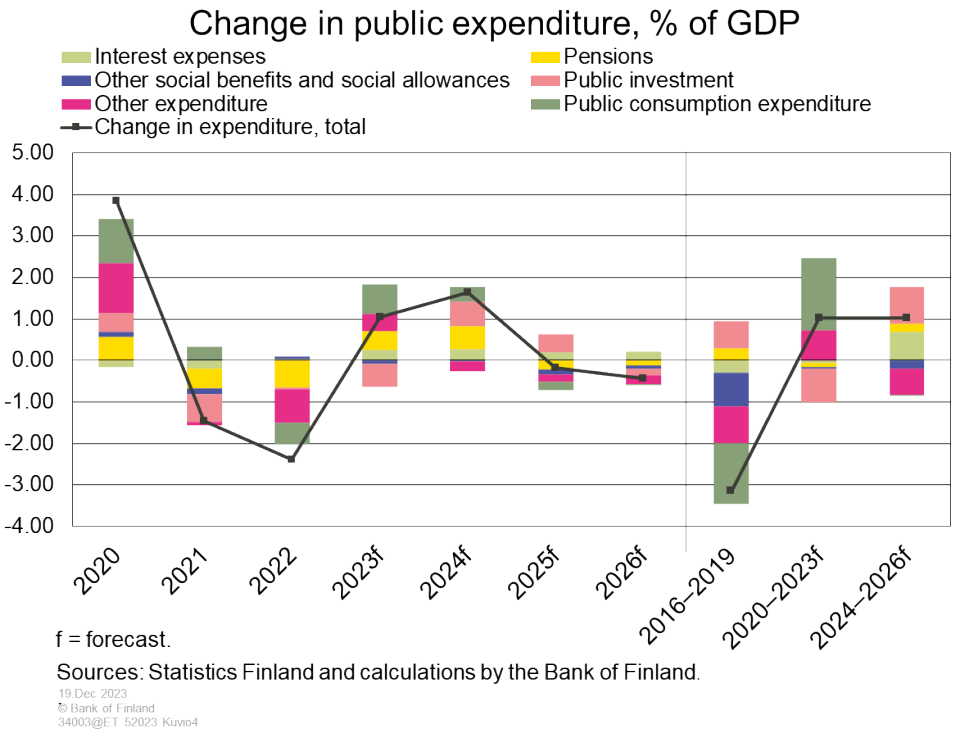
Social benefits will grow by 1.1 percentage points relative to GDP in the period 2022–2024. The index increases to many social security benefits and social allowances will be frozen for the next few years, which will generate budgetary savings of approximately EUR 0.5 billion. The level of pensions and income support will not be frozen, however.

The increasing need for health and social services as well as public sector pay rises are sustaining growth in the sum of public sector wages and salaries. The increasing demand for age-related services will also increase the use of purchased services. Public investment will also increase,

partly due to the fact that fighter aircraft purchases will be recognised under public investment as the fighters are delivered. Additional resources will also be allocated to defence and preparedness due to the deteriorating security situation.

The concrete spending cuts planned by the Government will not be enough to compensate for the increase in expenditure. Expenditure adjustment[5] will reduce general government expenditure by EUR 1.8 billion by 2026 and by EUR 2.5 billion by 2027.

Chart 4.



Public expenditure is therefore now growing at a higher rate than the economy. The European Commission also issued an opinion on Finland in November 2023 concerning the significantly faster growth of expenditure than budgeted. Based on the Commission's calculations, expenditure[6] is projected to increase by 4.4% between 2023 and 2024 whereas, according to the Commission's recommendation issued in spring 2023, an increase of 2.2% would be a sustainable level of growth. Moreover, as Finland's general government deficit will be above the budget deficit threshold of 3% in 2024 and the debt-to-GDP ratio already clearly exceeds the 60% threshold, the fiscal policy conducted in Finland will be the focus of increasing attention in the multilateral EU economic policy coordination process.

Finland has long enjoyed a reputation of a country with sound and responsible management of public finances, which is probably largely based on the fiscal consolidation in the late 1990s, the

strong fiscal position in the early 2000s, and the large size of pension assets and the investment returns on these assets. The persistent downward trend in fiscal indicators and ineffective efforts to remedy the situation are putting Finland's reputation to the test.

Fiscal policy has been mainly expansionary

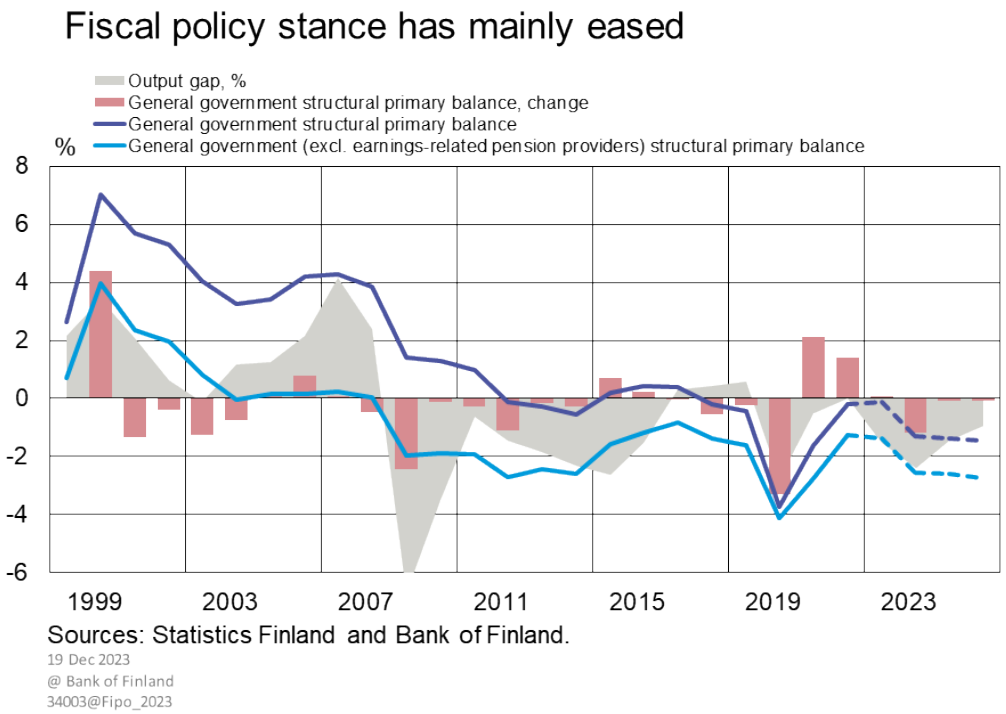
Since the financial crisis, the fiscal policy stance in Finland has been relatively expansionary. The general government structural budgetary balance adjusted for cyclical effects and one-off factors has remained in deficit, and the deficit has been less than 1% of GDP in only four out of 14 years.

The surplus of earnings-related pension providers is improving the overall picture of public finances. If earnings-related pension providers are excluded from the examination of public finances, the deficit is deeper, and since 2008 it has varied between 2% and 4%. The general government (excluding earnings-related pension providers) structural deficit is projected to weaken from 2% to over 4% by 2026.

Cumulatively, fiscal policy has been eased more than tightened since 2008. If the fiscal stance is measured by the change in the structural primary balance, then fiscal policy tightened significantly only in 2015, and in 2021–2022 following the strong fiscal stimulus measures taken due to the COVID-19 pandemic (Chart 5). The number of pensioners and growth in the sum of pensions paid have contributed to the outcome.

The structural primary deficit of the general government will deepen to 1.5% in 2024–2026. The fiscal policy stance will not change after 2024. The fiscal policy stance will ease also as a result of the EUR 1.8 billion in investments made with the assets of the EU's Recovery and Resilience Facility (RRF) in, for example, green transition, digitalisation as well as employment and social services in 2021–2026. As this expenditure is funded by non-repayable grants from the EU, they are not reflected in the fiscal balance and are thus not visible in the examination of the changes in the cyclically adjusted general government budget balance. The emphasis of RFF spending is on the period 2023–2024.

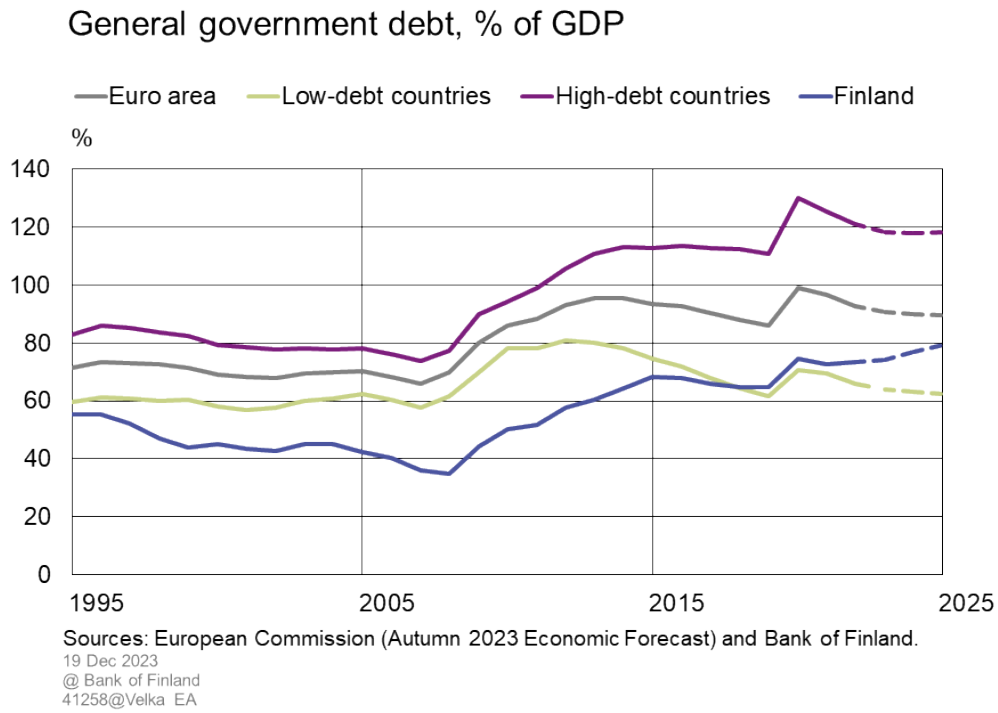
Chart 5.



Debt sustainability in the medium and long term

The chronic deficit in central and local government finances has led to a rapid increase in public debt over the last ten years or so. Although Finland's general government debt-to-GDP ratio has so far remained below the euro area aggregate debt ratio, it already corresponds to the euro area median and is also well above the average of countries with lower-than-average public debt (Chart 6).

Chart 6.



The projected increase in the debt-to-GDP ratio is causing concern, as public spending is under additional pressure not only from the rise in age-related health and social services expenditure but also from expenditure on climate, defence and contingency measures. In addition, a parliamentary commitment has been made to increase R&D expenditure in order to strengthen the conditions for economic growth. Against this background, stabilising the debt ratio, let alone reducing it, is a very challenging task, especially as economic growth is forecast to remain very slow in the coming years.

Over the past four years, public debt has increased due to the permanent and temporary expenditure increases set out in Prime Minister Marin's Government Programme, and also because of very exceptional events. Overall, exceptional times and related policy responses account for approximately two-fifths, or EUR 17 billion, of the EUR 45 billion increase in public debt during the parliamentary term. The Government Programme's 'future-oriented investments' and permanent additional expenditure added about EUR 6.5 billion to the debt during the parliamentary term. The debt was also swelled by growth in other central government expenditure (Chart 7).

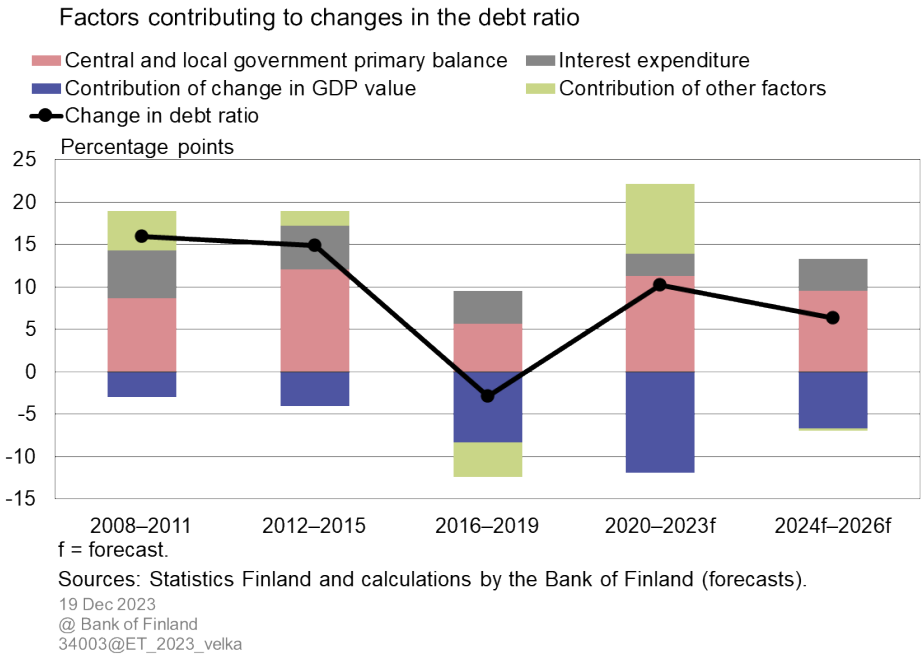
Looking at the outcome of the parliamentary term up to the end of 2023, the debt-to-GDP ratio will rise by approximately 10 percentage points. Due to inflation, nominal GDP has grown rapidly in 2022–2023, which has slowed the rise in the debt ratio. Nevertheless, the debt ratio has

increased as the deficits of general government (excl. earnings-related pension providers) have also been exceptionally large.

In the period 2024–2026, the rise in interest rates will fuel expenditure and debt more than before, as both interest rates and the amount of debt have increased. The planned expenditure cuts will not be sufficient to reduce the relatively large primary deficit, so public debt will continue to grow at a rapid pace.

Chart 7.

The contractionary effect of GDP on debt-to-GDP ratio is diminishing



f = forecast.

Sources: Statistics Finland and calculations by the Bank of Finland (forecasts).

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Risks surrounding long-term debt sustainability

Long-term debt sustainability can be assessed by assuming that the composition of general government revenues and expenditure remains unchanged, with the exception that account is taken of the estimated impact of demographic change on age-related expenditure[7]. If the debt-to-GDP ratio does not stabilise in the long term but grows unrestrictedly, there is a need for fiscal consolidation, i.e. there is a sustainability gap in the public finances.

The sustainability gap is measured by the 'S2' indicator, which indicates the immediate one-off fiscal adjustment needed to ensure that the debt ratio would stabilise over the long term. The value of the indicator is affected by the level of the debt ratio and of the structural balance at the base year of the sustainability calculation and by the expected change in age-related expenditure.

The calculation also builds on a population projection and an estimate of long-term economic growth and its composition.

The Bank of Finland's estimate for the sustainability cap has increased to approximately 4 ½ % of GDP. The Bank's estimate last year was 4% of GDP. The higher estimate is attributable to a weaker starting point – a higher debt ratio and structural deficit – in 2027, the calculation's base year. The level of interest rates and assumptions about their evolution in the coming decades have changed from the previous year, although longer-term assumptions on interest rates and returns have remained unchanged. Interest rates have risen rapidly and are now markedly closer to their assumed long-term level (4%).

The sustainability gap indicator is based on a simple technical quantification of the long-term pressures on the public finances. The assumptions underlying this calculation are subject to high uncertainty. The level of the indicator is also affected by estimates for the structural deficit and debt in the calculation's base year. For example, in 2007 the sustainability gap was estimated to be only 1% of GDP and the debt-to-GDP ratio was not expected to exceed 60% until 2046[8]. Thus, as such, the sustainability gap indicator does not provide a comprehensive picture of the risks related to the growth of public debt already in the medium term. Furthermore, it does not serve as a straightforward policy guideline, but offers one perspective on the sustainability of fiscal policy in light of future expenditure pressures.

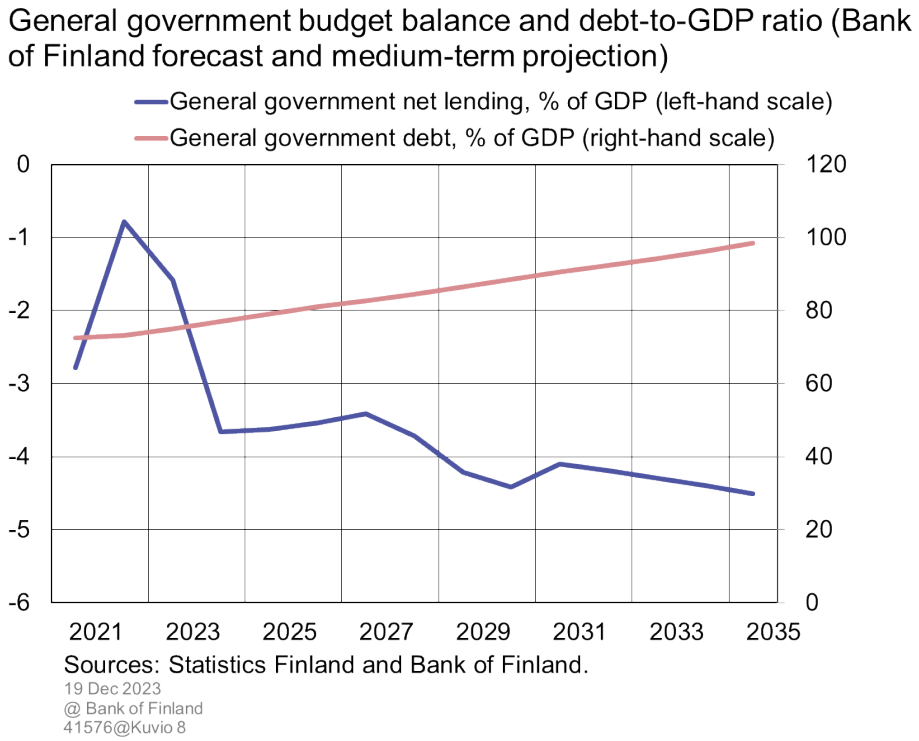
The Bank of Finland's sustainability gap estimate is based on the Bank's updated long-term forecast[9]. The baseline scenario of the long-term forecasts is founded on the assumption that it is possible to anticipate the slowdown in economic growth and respond to it through economic policy measures. Thus, investment in education will be increased, and net labour immigration – more specifically, the number of immigrants with education corresponding the level of domestic graduated workers – can be increased significantly. The sustainability gap estimate is also affected by the updated projection for the labour force participation rate, which has been revised slightly upwards due to recent years' actual trend in the participation rate. The scenario of lower-than-baseline growth is a scenario with no changes in economic policy. This scenario would result in a sustainability gap that is approximately 0.5 percentage points wider than the one suggested by the baseline scenario.

Growth in debt already a challenge in the medium term

According to the Bank of Finland's calculations, the general government deficit and debt-to-GDP ratios will be 3.4 % and 83%, respectively, in 2027. Thereafter, the deficit ratio will increase to 4.5% of GDP by 2035. The debt ratio will exceed 100% of GDP in the mid-2030s, and there are no

signs that it would start to decline thereafter (Chart 8). These calculations are based on the Bank of Finland's December 2023 forecast for the public finances, the Bank's long-term forecast, and its debt sustainability calculation.

Chart 8.

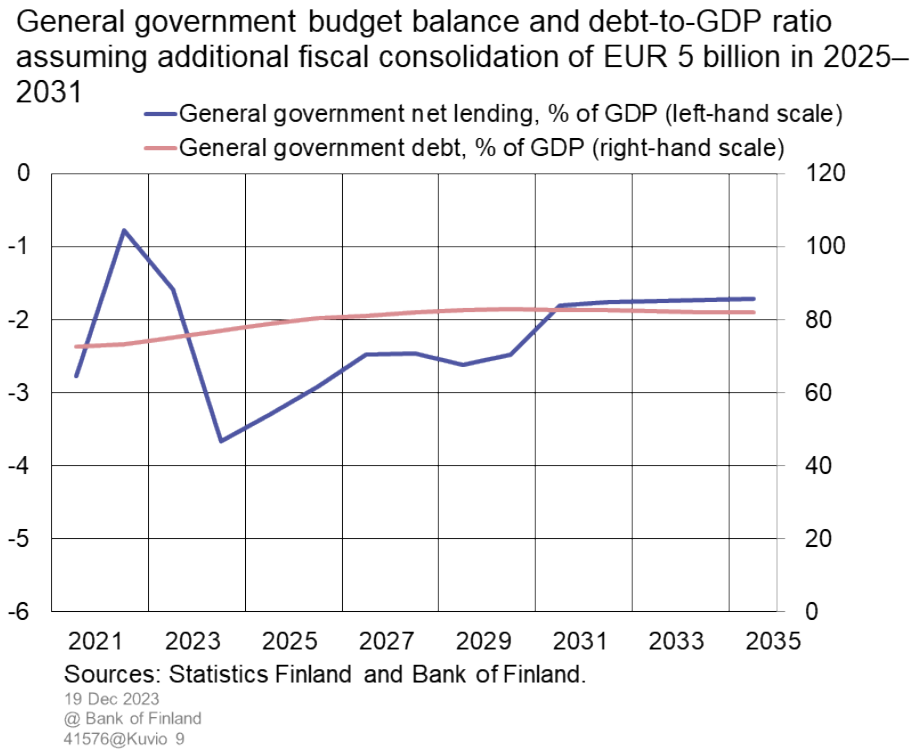


The Bank of Finland's December 2023 forecast takes into account government measures affecting public revenues and expenditure for which sufficiently detailed information has been available in the Government Programme, the General Government Fiscal Plan for 2024–2027, the budget proposal for 2024 or the Government's draft legislation. The net effect on the budgetary position of the government expenditure measures taken into account in the Bank of Finland's forecast totals EUR 700 million (0.2% of GDP) in 2024, after which the net effect will gradually increase to EUR 2.2 billion (0.7% of GDP) by 2027[10]. The net effect also includes the temporary additional expenditure related to the Government's investment programme insofar as the expenditures have been specified in allocation and funding decisions.

Stabilising the debt ratio so that it would no longer rise in the early 2030s would require an additional fiscal adjustment totalling EUR 5 billion in 2025–2031 (Chart 9). This additional fiscal consolidation, required in addition to the expenditure measures contained in the Bank of Finland's actual forecast for the public finances, is expected to start in the calculation in 2025 and be evenly distributed over the current and subsequent parliamentary term.

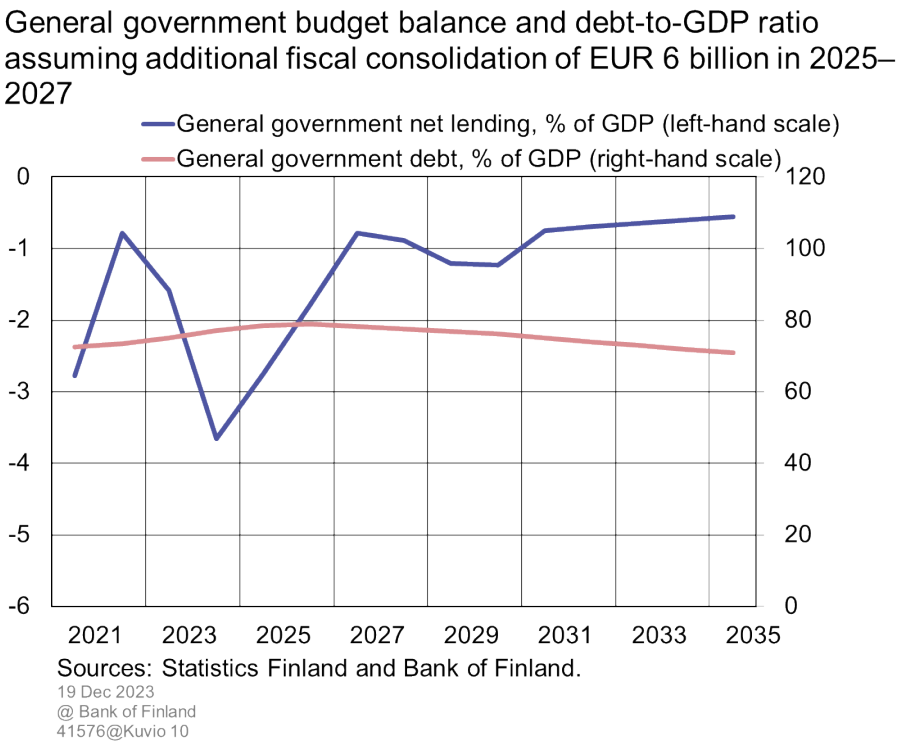
More than two-thirds of the additional fiscal adjustment is assumed to focus on monetary social benefits, subsidies and transfers paid by general government to other sectors. A little less than one-third is assumed to be targeted at public demand, i.e. public consumption expenditure and investment. This technical assumption is based on the estimate of the average distribution of government expenditure savings in 2024–2027 made in the Bank of Finland's actual forecast. The calculations take into account the impact of the additional fiscal adjustment on economic growth.

Chart 9.



The Government's deficit target of 1% for 2027 could, in turn, be reached with an additional fiscal consolidation totalling EUR 6 billion, distributed evenly in 2025–2027 (Chart 10). In this case, the deficit-to-GDP ratio would also remain close to 1% until 2035 and the debt-to-GDP ratio would fall to 71% by 2035.

Chart 10.

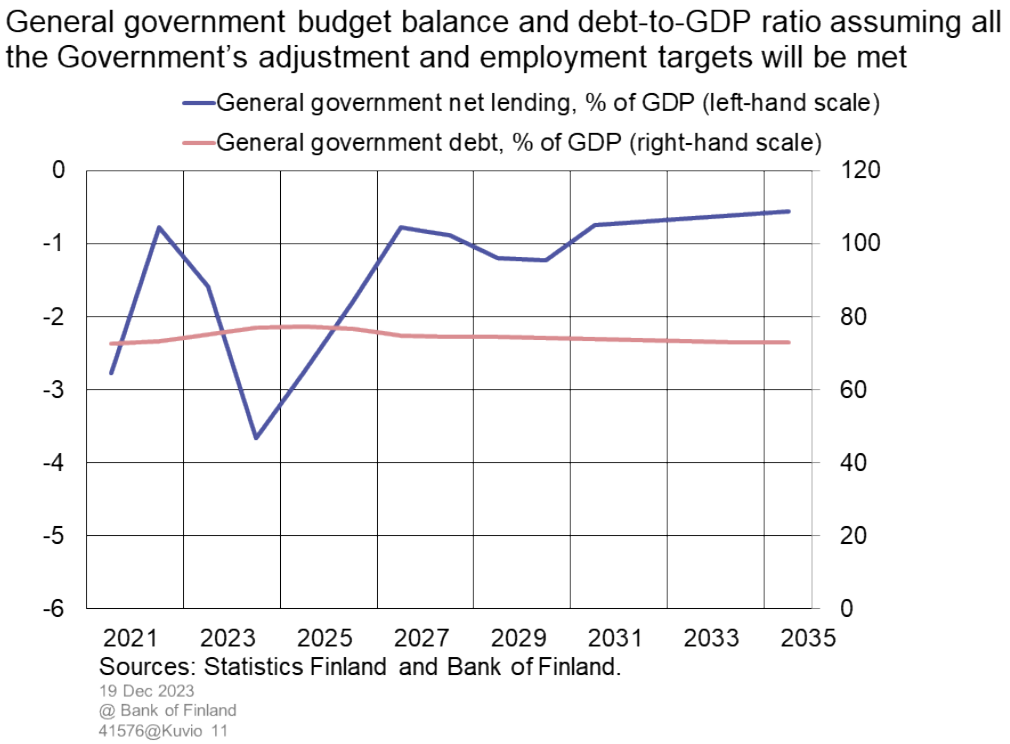


The levels of general government deficit and debt can be affected both by consolidation measures targeted directly at public revenues and expenditure and by structural reforms strengthening the conditions for economic growth. However, the current Government does not seek to adjust the public finances through revenue measures[11]. Instead, in addition to expenditure savings, the Government has outlined structural policy measures targeting 100,000 new persons in employment by 2027. The Bank of Finland's actual forecast does not take into account the impact of these measures on employment due to the uncertainty associated with the measures.

However, the forecasting framework for the public finances allows for a very rough estimate of the budgetary impact of the Government's targets for expenditure adjustments and employment if the targets were fully achieved. This rough estimate takes into account not only the measures already considered in the Bank of Finland's actual forecast but also the remaining government expenditure measures. According to the Government's estimate, the net effect of all these measures will total cumulatively EUR 4 billion by 2027.

Employment growth is expected to be evenly distributed over three years, i.e. in 2025–2027. Half of the new persons in employment is expected to come from the unemployed workforce and half from people outside the labour force. In this scenario, the general government debt-to-GDP ratio would stabilise over the medium term to approximately 73% (Chart 11).

Chart 11.



Public finances after crisis-hit parliamentary term

The past parliamentary term demonstrated the need for maintaining fiscal space in the public finances to address unexpected events. The COVID-19 pandemic as well as Russia's war in Ukraine and the ensuing sharp rise in energy prices and cost of living were exceptionally severe shocks affecting demand and supply in the economy. With active fiscal policy, the Government was able to soften the economic and social effects of the shocks.

The shocks were so exceptional that there were hardly any ready-made fiscal tools to tackle them. Measures to mitigate the effects of the shocks had to be created from scratch, or the Government applied existing policy instruments which failed to meet the needs. Thus, support measures were not necessarily always targeted correctly or accurately at households or businesses most in need.

The crises were very detrimental to the Government's fiscal targets and target dates. The Government initially sought to balance the general government finances by 2023, although forecasts already indicated in 2019 that the target would not be met but that the public deficit would increase.

The Government judged that its employment measures would spur economic growth and strengthen the public finances. It first sought to increase the number of persons in employment by

60,000 by the end of 2023, and the employment rate target was set at 75%. Later, the target was raised to 80,000 and the target dates were postponed to the period following the parliamentary term.

Over the past two decades, government programmes have placed a lot of weight on employment targets. Most governments have set an employment target number and some governments have also set a target employment rate, or only the latter. In general, the targets have ranged from 80,000 to 100,000 new employed persons. Few governments have achieved their targets, and those that have owe it to cyclical upturn of the economy.

While the number of employed persons has increased by almost 50,000 between 2008 and 2023, the revenue base of public finances remains unable to support public expenditure at the current tax-to-GDP ratio. The beneficial effects of the improved employment on public finances have been diluted by the fact that the increase in hours worked has grown at a slower rate than the number of employed. Moreover, the demand for labour is also high in the public sector, especially in health and social services, and the public sector is using purchased services more than before.

The reforms to EU fiscal rules after the financial crisis also emphasised the importance of setting targets for fiscal indicators in medium-term fiscal plans. In Finland, these targets have tended to be set so ambitiously that, at least according to the forecasts made early in the parliamentary terms, they could not be achieved solely through the concrete, measurable adjustments to revenue and expenditure listed in the government programmes. Instead, governments have considered the targets to be achieved through structural reforms that support employment and economic growth.

Looking back, governments have generally failed to achieve the objectives they have set for public finances. It should not be overlooked, however, that three out of four government periods since 2007 have been marked by economic downturns where the average output gap has been negative. Then again, no government since has managed to turn around the weak performance of the economy through fiscal or structural policies, although it is difficult to assess how the economy would have performed had fiscal policy been tighter on average.

The crises of recent years have put the steering of general government finances and fiscal rules to the test. The crown jewel of Finland's fiscal policy toolkit, the spending limits procedure for central government finances, showed both its flexibility and vulnerability. The Government Programme for the 2019–2023 parliamentary term provided flexibility in an exceptional economic situation by raising the expenditure ceiling with an additional EUR 1 billion, but nonetheless each year the Government failed to comply with the spending limits it had set[12]. Although in most cases the deviations were justified, the spending limits were also relaxed on lighter grounds under the

pretext of the crises. It is clear that the spending limits procedure system must be further strengthened, possibly also through legislation.

Difficult starting point for the new Government – the adjustment measures are threatening to prove inadequate

Since the turn of the century, government programmes have addressed the sustainability gap caused by the ageing population and the deterioration of the dependency ratio. Since 2009, public finances have deteriorated, the estimated sustainability gap has widened and the need to reverse the trend in public finances has grown increasingly apparent[13]. Petteri Orpo's Government, appointed in June 2023, also aims to turn around the direction of public finances by following an adjustment path of EUR 6 + 3 billion over two parliamentary terms as proposed by the Ministry of Finance[14].

The Government plans to stabilise the debt ratio and then bring it onto a permanent downward trajectory "viewed over more than one parliamentary term". At the same time, the Government has set an objective for the budgetary position of general government finances to improve so that the general government deficit will be no more than 1% of GDP by 2027. In the stability programme published in autumn 2023, the Government set a medium-term structural deficit target of -0.5%. However, as the forecasts indicate that the economy will normalise by 2027, these two objectives are incompatible. In any case, the structural deficit must be gradually reduced as soon as possible, since neither objective appears feasible in the light of current forecasts.

According to the Government, general government expenditure will be adjusted during the parliamentary term by an estimated net EUR 4 billion at the 2027 level. This is meant to be achieved through a large number of measures that will bring permanent savings, as listed in the appendix to the Government Programme. According to the General Government Fiscal Plan, expenditure within the scope of the central government spending limits will decrease by EUR 1.5 billion by 2027 compared with the technical plan adopted in spring 2023.

Central government finances will be cut the most (EUR 2.6 billion). Other substantial adjustment measures will be aimed at the wellbeing services counties (EUR 0.9 billion) and the social security funds (EUR 0.8 billion). The most sizeable savings will be directed at health and social services (EUR 1.3 billion at the 2027 level) and social security and benefits (EUR 1.2 billion).

In health and social services, the savings are mainly imputed, as the decisions regarding them are aimed at curbing the inexorably rising costs. Savings measures also include postponing some previously decided improvements to the level of services, pushing back their entry into force until

the next parliamentary term. Furthermore, the Government Programme mentions development measures aimed at the activities of the wellbeing services counties through which the Government aims to save up to EUR 0.9 billion over the parliamentary term. Each wellbeing services county will decide independently on these measures and the savings they may potentially bring will not be measurable afterwards.

In the early stages of the wellbeing services counties, there have also been signs that the provision of health and social services as required by the need for services will require more funding than estimated. It looks unlikely that the wellbeing services counties will manage to cover their deficits within the required three-year time limit. It would be important to outline a financing model for the wellbeing services counties that encourages them to curb the rising costs, especially with regard to the Government's decision to exclude the preparation of a county income tax from the toolkit.

The Government Programme states that the Government is committed to avoiding discretionary measures that increase the tax burden, as the Government seeks to improve incentives for working and self-employment. Both the tax measures presented so far and the reduction of the unemployment insurance contributions in 2024 will lower the tax-to-GDP ratio. However, if the Government's tax policies are in fact already firmly locked in, the fiscal adjustment built on mere expenditure cuts may prove to be too demanding.

To make up for this, the Government expects its reforms aimed at strengthening employment to complement the adjustment package by improving the fiscal balance by up to EUR 2 billion, given that the goal of increasing the number of employed people by 100,000 is met[15]. In this respect, the policies align with those of previous governments, having often proven to be unrealistic. If the working-age population continues to decline in line with the forecasts, the employment targets will become increasingly difficult to achieve.

Over time, the focus of taxation has moved slightly from direct to indirect taxation. Indirect taxation refers to, for example, consumption taxes and excise duties. As mentioned above, the revenue from excise duties in relation to the size of the economy tends to decrease over time unless the level of excise duties is increased as prices rise. Therefore the level of the taxes should be revised from time to time, so as to achieve the desired fiscal effect or restrict consumption. In this respect, the Government should also be prepared to raise taxes.

The Government Programme includes an investment programme of EUR 4 billion. The investment programme continues previous governments' practices to make temporary expenditure increases (such as 'key government projects' and 'future-oriented investments') during the parliamentary term, with the exception of the last year of the term. The programme will ultimately not increase

public expenditure by its full amount as, at the same time, budget cuts will be made to basic transport infrastructure management and transport projects. One-quarter of the package will be allocated to non-investment expenditure, such as financing reimbursements from Kela for the use of private healthcare services.

The package is financed by selling central government assets and making a total of EUR 800 million in revenue recognitions from the National Housing Fund, so these expenditure increases will not immediately increase public debt. However, the sale of assets will permanently reduce annual property income and weaken the central government's net investment position. Reducing the capital of the National Housing Fund will later threaten to cause a situation where expenditure of the Fund will have to be financed from the central government budget.

From the standpoint of the balance of public finances or the net investment position, asset sales do not differ from increasing public debt, unless the return on the assets is lower than the interest rate on the debt. It is therefore unclear why specifically earmarked asset sales would be the best way to finance these projects. The Government should be able to justify all investments and other expenditure included in the package equally, regardless of the method of financing, and hold them to the same standard as other items in the budget. Asset sales or the use of financial assets as such can, of course, be justified as part of a broader strategic vision for the balance between public assets and debt.

Turning around the public finances will require additional measures unless economic growth strengthens

Balancing general government finances is proving to be even more difficult than expected. According to forecasts, the tax-to-GDP ratio is decreasing and growth in the revenue base remains weak. The impact of the expenditure cuts is offset by the increasing interest expenditure, index adjustments to benefits and growth in public investments. At the same time, the economic situation is weakening the fiscal balance.

Costs for public services amount to less than half (44%) of all public expenditure. The share of public sector current transfers payable to households, businesses and organisations is almost equally large, 39% of public expenditure. In recent years, investments have averaged around 7.5% of public expenditure, while interest expenditure has amounted to less than 2%.

If public expenditure is adjusted only by cutting the production costs of public services, the consolidation measures will be very demanding, unless there is a willingness to make significant compromises regarding the level of service. Pensions alone make up a good one-fifth of public expenditure, which leaves the share of other current transfers at a good 15%. It is likely that

broader and thus more effective adjustment measures will become necessary.

In the earnings-related pension system, provision has been made for expenditure growth by raising assets financed by tax-like pension contributions. In health and social services, however, a corresponding provision for the changing age structure has not been made, which means that the growing need for services must be financed through taxes. The Government has set an objective to strengthen the sustainability of the pension system in a way that reduces the upward pressure on pension contributions. If this objective is achieved, however, the Government must be prepared to shift the focus of taxation to other types of taxes in order to successfully balance general government finances in a situation where the need for services increases due to the changing age structure of the population.

In Finland, relying on the desired positive effects of structural reforms has long been used as an excuse to avoid adequate fiscal consolidation measures with direct effects on revenue and expenditure. Despite good employment growth, general government finances remain imbalanced and debt growth has continued for a long time. For political decision-makers, the situation is difficult, as significant expenditure cuts or tax increases tend to make it difficult to maintain voter support.

Decision-makers would benefit from a stronger fiscal framework, one that would consistently steer fiscal management in a more sustainable direction. The Government intends to develop the national fiscal framework, which is essential, considering the upcoming reform of the EU fiscal policy framework. There are plans to establish a regular process for expenditure and structural surveys of general government finances, which will support decision-making over the longer term.

The debt ratio will continue to climb in the years ahead, and the outlook for the longer-term is bleak. Trends in the population structure, educational attainment, fixed investment and labour productivity do not suggest any significant increase in economic growth any time soon. Efforts must be made to influence these trends, while simultaneously ensuring the sustainability of general government finances. Finland's economy and general government finances are not untouched by the significant uncertainty caused by climate change and geopolitical confrontation. It is therefore important to ensure fiscal space in all circumstances.

Notes

1. Local government includes municipalities, joint municipal authorities and, starting from 2023, wellbeing services counties. ↑
2. Taxation-related decisions include index adjustments to tax scales. ↑
3. Source: Changes in central government ownership in 2007–2022, 18 January 2023. ↑

4. According to national accounts. ↑
5. Situation of savings decisions included in the Government Programme, Ministry of Finance Memorandum, 9 October 2023. ↑
6. The Commission's expenditure aggregate relates to public expenditure less interest payments, cyclical changes in unemployment expenditure, and measures to increase or reduce public revenue. The recommended ceiling on the growth rate of public expenditure is based on the Commission's estimate of the fiscal adjustment need of 0.3% of GDP in 2024. ↑
7. Age-related expenditure comprises pensions and spending on healthcare, long-term care and education. Sustainability calculations also take into account changes in unemployment expenditure in accordance with the demographic trend. ↑
8. Fiscal space. Publications of the Ministry of Finance 4/2007 (published in Finnish). In addition to the sustainability gap indicator, a 'budget balance ensuring sustainable general government finances' (the sum of structural balance and the sustainability gap) is often published. This measure is less sensitive to the estimate of the structural balance in the calculation's base year. ↑
9. Mäki-Fränti, Kokkinen, Obstbaum and Jalasjoki (2023), 'Finland's economic growth threatens to dwindle without investment in human and fixed capital: The Bank of Finland's long-term forecast' (in Finnish), The Finnish Economic Journal, Vol. 119, No. 3/2023 (pp. 265–272) (https://journal.fi/kak/issue/view/10516). See also Kokkinen, Obstbaum and Mäki-Fränti (2021), Bank of Finland's Long-Run Forest Framework with Human Capital, BoF Economics Review 10/2021 (https://urn.fi/URN:NBN:fi:bof-202112162154) and Mäki-Fränti, Kokkinen and Obstbaum, 'Finland's new long-term forecast suggests GDP growth will be more subdued', Bank of Finland Bulletin 2 February 2022 (https://www.bofbulletin.fi/en/2021/5/finland-s-new-long-term-forecast-suggests-gdp-growth-will-be-more-subdued/). ↑
10. According to the Government Programme, the Government ultimately targets net expenditure savings of EUR 4 billion by 2027, but the total amount could not be taken into account in the Bank of Finland's forecast due to the uncertainty of some of these measures. ↑
11. The Government Programme includes tax cuts and increases alike. In net terms, these measures will ease taxation. ↑
12. Separate report of the National Audit Office to Parliament: Fiscal Policy Monitoring and Audit Report on the 2019–2022 Parliamentary Term. National Audit Office's Report to Parliament, R 25/2022 vp. ↑
13. See e.g. Finland's Public Finances at a Crossroads. Approach to fiscal policy in the 2010s. Economic outlook and economic policy 8/2010. Ministry of Finance. (In Finnish) ↑
14. An innovative and sustainable Finland. Outlook review by officials at the Ministry of Finance 2022. Publications of the Ministry of Finance 2022:77. (In Finnish) ↑
15. The employment objective is linked to the imputed effect of the decisions, not to actual employment growth. ↑

Keywords

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