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Developing the steering of general government finances: Summary of the final report and proposal for the Government Programme's policy text

The steering of general government finances needs to be enhanced and clarified

The framework for the steering of general government finances in Finland is established by EU regulations and national regulations as well as rules and objectives based on political commitments. Finland's fiscal policy rules and objectives have become highly multifaceted over the past parliamentary terms. During the current parliamentary term, the key objectives of the Government's economic policy were outlined in the Government Programme, as was the spending limits rule to be observed during the parliamentary term. Rules and objectives related to national and EU regulation also influence the steering of general government finances.

The credibility of the steering framework of general government finances has been put to the test during the current parliamentary term. Partly due to being forced by the circumstances, the current Government has applied flexibility with regard to its economic policy objectives, and the limits and objectives set out by the steering framework have not always been complied with. The credibility of sustainable fiscal policy has been eroded by, for example, the breaching of expenditure ceilings, abandoning the Government Programme objective concerning the balance of general government finances, low regard for the EU-related rules guiding fiscal policy, and difficulties associated with the clear communication of fiscal policy objectives.

Fiscal policy rules and objectives are not set merely for the sake of setting rules and objectives. The set of rules and objectives should provide decision-makers with functional and manageable practical tools for implementing fiscal policy in such a way as to support the sustainability of general government finances, the efficient use of public funds and decision-making that takes the economic cycle into account. As stated above, the steering framework has come under heavy pressure in recent times. The erosion of rules must be halted to prevent a trend that leads to the implementation of uncontrolled economic policy. The steering framework must be developed particularly based on the national conditions to ensure that it supports the Government in decision-making on economic policy and is supported by broad political – and even parliamentary – commitment. At the same time, the steering framework must be compatible with the EU's fiscal policy legislation. The situation is further complicated by the fact that the EU's fiscal policy framework is currently being reformed.

Due to the weak outlook of Finland's general government finances, it is increasingly important to have a consistent steering framework for general government finances that supports longer-term sustainability and the efficient use of public funds and has strong political support. Finland's debt has been growing for a long time. General government debt will continue to grow due to the ageing of the population, which automatically increases public expenditure. General government finances also come under pressure due to the new approaches and practices required for the mitigation of climate change, for example. The swelling of public debt may also complicate the implementation of demand-stimulating fiscal policy in future crises. Interest rates have been low in recent years, which has created the opportunity to fund increased expenditures with inexpensive debt. However, interest rates have now begun to rise, which will significantly increase debt servicing costs. Higher interest rates combined with substantial deficits at the central government, municipal and wellbeing services county levels constitute a major risk with regard to the rate of growth of general government debt.

The structure of Finland's general government will change in 2023 when the responsibility for the organisation of health, social and rescue services is transferred from the municipalities to the wellbeing services counties. This will increase central government on-budget expenditure and revenue, while municipal finances will contract. In that context, it is important to carry out an overall assessment of the steering of general government finances in order to fit the new sub-sector into the steering framework.

An effective framework of rules and objectives is ultimately in the interest of society as a whole. It gives political decision-makers the opportunity to implement appropriate economic policy while protecting taxpayers by reducing the tax burden. It also promotes intergenerational equity by curbing the growth of debt and thereby keeping general government finances on a sustainable foundation.

The views of the working group

The working group has assessed needs concerning the development of the steering of general government finances and makes the following proposals:

On the framework of rules

Rules-based fiscal policy is crucial for ensuring responsible and sustainable fiscal policy. Rules also introduce predictability and a long-term approach to fiscal policy.

The set of rules must be free of internal conflict and it must leave sufficient room for manoeuvre for fiscal policy to respond to practical decision-making situations. The rules must be in harmony with regulations issued by the EU.

The simplicity of the rules is key. The rules must be clear for the decision-makers themselves and also understandable to the general public.

The central government spending limits system is an important tool that will continue to be necessary in the future. The existing research literature suggests that expenditure benchmarks (such as the spending limits system) are more closely adhered to than other rules particularly if they are under the direct control of political decision-makers and if they are codified in law or mutual agreements.

It is necessary to assess to what extent the national legal basis of fiscal policy rules should be reformed, also taking into account potential needs for amendments arising from reforms to EU rules). Should the regulations more specifically recognise the key structures related to the drafting of fiscal policy (including the spending limits system and the General Government Fiscal Plan) and the principle of maintaining the sustainability of general government finances across generations?

In the view of the working group, the combination of an expenditure benchmark and a balance benchmark, anchored to a period corresponding to a parliamentary term, would be a good solution. This combination would also support the implementation of sustainable tax policy.

In the next parliamentary term, the starting point of economic policy should be long-term debt sustainability, as measured by the long-term development of the general government debt ratio. To support this objective, the Government Programme should include a nominal target for the general government budgetary position for the parliamentary term in question. This target would be aligned with the long-term debt sustainability objective, and it would be expressed as a ratio of GDP in 2027.

The set of actions necessary for achieving the budgetary position target would be expressed in terms of a euro amount in the Government Programme, and the Government would make a strong commitment to its implementation. The target expressed in terms of a euro amount would be maintained irrespective of economic cycles.

The Government should actively monitor the implementation of the set of actions and respond by introducing new actions if it appears that the scale of the actions is at risk of falling short of the target, or the achievement of the general government budgetary position objective is under threat. The mid-term review would be an important checkpoint.

The budgetary position targets of central government, municipal finances, wellbeing services counties and social security funds would be set based on the target established for the general government budgetary position. The central government spending limits system is an important operational tool. The central government expenditure ceiling and the Government Programme’s tax policy guidelines are to be aligned with the budgetary position target.

When it comes to the steering of municipal finances in particular, but also the steering of wellbeing services county finances, the Government has only indirect opportunities to exercise influence. The key is for the Government, in all of its discretionary measures, to consider general government finances as a whole so that the general government budgetary position target is achieved and the related actions are effectively implemented. Partial optimisation between different sectors must be avoided. The central government must give municipalities and wellbeing services counties the time and space they need to implement reforms that enable them to adapt to the available funding limits, taking into account the existing regulations that are binding on the individual municipality of wellbeing services county in question.

Target setting must take into account the limits established by EU legislation and national legislation.

On the central government spending limits system

Continue to set the spending limits for each parliamentary term in real terms, i.e. at fixed prices. Simplify discretionary price adjustments so that they are only made once a year (the price adjustment for year t should be made in January t-1, based on the December t-2 forecast). In addition, simplify the price adjustment procedure by only using the consumer price index going forward. Legislative and agreement-based index adjustments would be made in the same manner as they are now, as the existing procedures involved are effective with respect to the spending limits system.

Adequate appropriations must be reserved for politically significant projects or areas of spending at the beginning of each parliamentary term. Projects mentioned in the Government Programme can also be left unimplemented if they do not fit into the spending limits.

Maintaining adequate and realistic room for manoeuvre within the spending limits is key. The unallocated reserve should increase towards the end of each parliamentary term (for example, EUR 100/175/250/325 or 0.2/0.3/0.4/0.5 per cent of the expenditure ceiling), as unexpected spending needs typically emerge increasingly as the parliamentary term progresses. Where necessary, the Government can use separate, clearly defined spending limits provisions.

Investments should continue to fall under the normal spending limits, which should be as comprehensive as possible. Key investments (transport, R&D, defence, green transition, etc.) should be addressed when the spending limits are set at the beginning of the parliamentary term. A separate investment framework is not necessary and could complicate the overall picture.

The definition of an investment is problematic, and it is by no means clear that their longer-term profitability is always higher than that of consumption expenditure. A further risk is the possibility that attempts would be made to structure expenditure as investments, which would weaken fiscal policy regulation.

Good preparation of public investments makes it possible to set the limits at the necessary level. Where necessary, a separate spending limits provision could be made for unspecified investments or investments of uncertain scope, for example, as long as the content is carefully defined in advance.

In previous parliamentary terms, efforts have been made to use property income to finance the Government’s fixed-term spearhead projects/investments in the future. In those arrangements, both the realisation of the property income and the impact of fixed-term funded spending targets have both proved to be problematic, and similar arrangements should not be implemented in the upcoming parliamentary terms.

The Government Programme should state that the Government will not use disposals of central government assets (such as the disposal of shares) to circumvent the spending limits.

It is appropriate that the expenditure items that have been treated as cyclical expenditure outside the spending limits in previous parliamentary terms (unemployment security, housing allowance, basic social assistance and wage subsidies) remain outside the spending limits (except for changes in criteria that are within the spending limits). However, if the purpose of a discretionary decision is to strengthen general government finances, the level of spending limits should not be raised.

Keeping genuine financial investments as expenditure outside the spending limits is justified. However, a financial investment should be classified as an expenditure within the spending limits if, at the time of making the decision, it is considered to be a final expenditure. This could mean, for example, that the capitalisation is used for a purpose resembling ordinary budgetary spending, without the central government having any expected income in the form of profit distribution or capital repayment.

Going forward, the expenditures of the National Housing Fund (VAR) and the Development Fund for Agriculture and Forestry (Makera) should be included within the spending limits system to the extent that they are decided on in the Budget. Correspondingly, transfers from the Budget to these funds would be outside the spending limits.

On the escape clause

In the view of working group, it is justified to continue to maintain a defined escape clause as part of the spending limits system. The mechanism should serve as an extreme “emergency brake” for major crises. The criteria for triggering the mechanism should be set high in the Government Programme (see the proposal on the Government Programme item).

The amount in euros enabled by the mechanism and the content of the derogation from the spending limits would not be specified in detail in the Government Programme. The content would be specified in connection with the activation of the escape clause to suit the crisis at hand in terms of the timing, amount and content, while also applying suitable terms with regard to the self-financing contribution. In significant crisis conditions, it is important to recognise that not all of the Government’s planned projects, spending areas and existing expenditures are priorities in a crisis, which makes it necessary to adjust priorities and focus areas in times of crisis. The steps for deactivating the mechanism also need to be outlined in connection with its activation.

The Economics Department of the Ministry of Finance (an independent party) would be responsible for preparing a draft decision concerning the deployment and content of the escape clause for the Ministerial Committee on Economic Policy. During the drafting process, the Economics Department would consult experts relevant to the crisis at hand. The Ministerial Committee on Economic Policy would outline the deployment of the escape clause and the content of the derogation related to the spending limits system, as well as any conditional clauses related to the matter, and issue a recommendation to the Government regarding the use of the escape clause.

On tax policy

The spending policy and tax policy measures to be used should always be selected based on which instrument is better for achieving the ultimate objective. The Government Programme should state that the spending limits will not be circumvented by means of taxation, and the systematic assessment of this issue should be incorporated into tax policy decision-making.

It would not be appropriate to implement a separate revenue rule for changes in taxation or to incorporate changes in taxation into the spending limits system.

Nevertheless, the Government’s approach to tax policy should be clearly specified in the Government Programme and the first General Government Fiscal Plan so that tax policy is aligned with the budgetary position targets of general government finances and central government finances.

The Government Programme should also specify the conditions for any derogations from the stated tax policy. The revenue effects of tax measures specified in the Government Programme should be based on a careful impact assessment conducted by the Ministry of Finance.

On the steering of wellbeing services counties and municipalities

The funding model for the wellbeing services counties includes solutions for ensuring that funding is sufficient. In the Government’s sphere of action, the key objective of steering should be to curb cost increases and adhere to budget constraints. Clear steering supports the reform of the structures and operating practices of the wellbeing services counties, which also ensures effective basic services.

The availability and sufficiency of personnel has emerged as a major challenge in the public sector's basic services and in the national economy in a broader sense. In the upcoming parliamentary term, the central government should refrain from giving the wellbeing services counties significant new duties in order to give them time and space to work. This need is underscored by the fact that the increases in duties and obligations implemented by Prime Minister Sanna Marin's Government will still increase costs and personnel needs in the upcoming parliamentary term. The wellbeing services counties should be given sufficient space to organise service provision within the constraints of their autonomy.

The wellbeing services counties may involve unexpected and potentially large spending needs that could arise from mid-year requests for additional funding as well as the retrospective cost level adjustments included in the funding model. The funding of the wellbeing services counties should fall within the spending limits in its entirety, but the room for manoeuvre within the spending limits should provide the opportunity to prepare for potential unexpected factors. If necessary, this could be achieved by means of a separate provision that could not be used for other expenditure, for example. It is also proposed that the annual supplementary budget provision be increased in line with the growth of spending limits expenditure.

Municipal finances can be steered particularly by developing the provisions of the Local Government Act pertaining to municipal finances and the audit of administration and finances. It is important to ensure that the planning and management of municipal finances and activities better takes into account longer-term sustainability and maintaining an accurate picture of the municipality's activities. The need to amend the Local Government Act should be assessed at least with regard to the sustainability of investments, auditing and the effectiveness of the evaluation procedure.

It is advisable to refrain from giving municipalities new duties or expanding their current duties to give municipalities time and space to work, as their operating environment is changed by the reform of health and social services and the upcoming reform of employment and economic development services. The availability of labour varies between municipalities and constitutes a constraint to the implementation of new duties and obligations at the country level. Instead of detailed normative steering concerning the duties of municipalities, the focus should be on assessing alternative solutions to achieving the objectives, also taking into consideration the diversity and differentiation in the municipal field.

If new duties are nevertheless assigned, the Government Programme should include an item stating that municipalities will be fully compensated for the new or expanded duties or their other duties would be proportionately reduced. The method of compensation for expenditure increases or revenue losses arising from the central government's actions should always be selected based on determining the most appropriate and best-targeted instrument. Cuts to central government transfers to local government should be refrained from if they do not involve reductions in duties and obligations.

On social security funds

The budgetary position target set for social security funds cannot easily have a significant steering role in itself. For this reason, as part of the overall steering of general government finances, targets should also be set for the long-term level of contributions collected by social security funds.

In order to maintain unemployment insurance contributions at a stable level, the size of the Employment Fund's cyclical buffer should be doubled at a minimum, or other solutions for ensuring a stable level of contributions should be developed.

The drafting of regulatory amendments and related decisions on spending limits and budgets should include a more systematic assessment of impacts on general government finances as a whole, including social security funds.

On contingent liabilities

The risks, expected losses and income associated with contingent liabilities should be more systematically assessed and taken into account in the steering of general government finances. For example, the risk review included in the General Government Fiscal Plan should be developed by increasing information on the realised amounts of credit losses and guarantee losses as well as income streams associated with guarantee fees, and by presenting projections of their future development.

The process of assessing and granting central government guarantees should be harmonised by, among other things, specifying minimum information requirements concerning the risks involved with contingent liabilities and their broader significance to the central government's risk position.

An appropriate guarantee fee needs to be collected for central government guarantees. The fees collected for guarantees should cover the estimated risks involved. Guarantee fees should also be comprehensively introduced in the financing of housing.

Policy text proposal for the Government Programme of the next Government

Economic and fiscal policy

The starting point for the Government's economic and fiscal policy is long-term debt sustainability. To ensure this, the debt ratio of general government finances needs to be more permanently brought to a downward trend when assessed across parliamentary terms. This requires determined measures to strengthen general government finances over multiple parliamentary terms. It is a matter of protecting intergenerational equity.

The Government's target is for the general government budgetary position to improve to X per cent of GDP during the parliamentary term, that is, by 2027. This target is aligned with the objective of long-term debt sustainability.

To achieve this target, the Government commits to permanently strengthening general government finances during the parliamentary term through a set of actions that will strengthen general government finances by a net amount of EUR X billion at the level of 2027. General government finances are considered as a whole to avoid partial optimisation between sub-sectors (central government, municipalities, wellbeing services counties, social security funds).

The Government will actively monitor the implementation of the set of actions and respond by introducing new actions if it appears that the scale of the actions falls short of the target, or the achievement of the general government budgetary position objective is under threat.

The spending limits system of general government finances is a central instrument of the Government's fiscal policy steering, and the Government commits to a spending limits procedure concerning central government expenditure. The spending limits rule is described in Annex A. The Government commits to a target whereby, in 2027, spending limits expenditure will be EUR X billion lower (higher) than in the central government spending limits set on 23 March 2023 (at the 2024 price level).

Government Programme items and other actions will be implemented within the constraints established by the spending limits for the parliamentary term. In addition, the Government commits to re-examining the actions outlined in the Government Programme in the event of a significant change in the impact assessments of the actions compared to the assessments made in connection with the Government Programme, or if their implementation would jeopardise the achievement of the budgetary position target set for general government finances. The Government commits to prioritising the implementation of the projects as necessary.

General government expenditure will be adjusted by decisions of the Government by a net amount of EUR X billion at the level of 2027. To achieve this target, the Government commits to the actions, specified in Annex B, to accomplish permanent savings or increases in fees or other revenue.

The Government's tax policy is described in Annex C, and it aims to strengthen general government finances by a net amount of EUR X billion at the level of 2027.

The Government has further outlined structural policy measures that will strengthen general government finances by an estimated EUR X billion at the level of 20XX. These actions are described in Annex D.

The Government also takes a serious view towards the risks to general government finances associated with guarantee liabilities. The assessment and granting process of central government guarantees will be developed to take risks into account more comprehensively, and an appropriate guarantee fee will, as a rule, be collected for all guarantees. The collection of guarantee fees will also be introduced comprehensively in the financing of housing.

Annex A. Spending limits rule

The Government commits to observing the spending limits rule it sets, and adhering to the central government spending limits decision included in the first General Government Fiscal Plan of the parliamentary term. Government Programme items and other measures will be implemented insofar as this is possible within the spending limits.

In the spending limits for the parliamentary term, EUR 400 million will be reserved for supplementary budgets each year. In addition, the spending limits will include unallocated reserves in the following amounts: EUR X million in 2024, EUR X million in 2025, EUR X million in 2026, and EUR X million in 2027.

The purpose of the spending limits is to limit the total amount of expenditure to be met by taxpayers. When changes are made in the Budget that are neutral from this perspective, corresponding adjustments may be made in the spending limits of the parliamentary term.

The Government will not use tax concessions or tax subsidies to circumvent the spending limits. The Government will also not use the disposal of shares or receivables, funds or other methods to circumvent the spending limits in a manner that negates the purpose of the spending limits. The systematic assessment of this will be incorporated into the Government's decision-making.

Adjustments to the spending limits will be used as necessary to ensure that the spending limits system does not restrict the re-budgeting of expenditure, changes to the timing of expenditure items or refunds or compensation of revenue collected during the parliamentary term that has turned out to be unjustifiably high. Adjustments to the spending limits will also be used to ensure, where necessary, that matching changes between tax subsidies and expenditure items of equal size are treated equally by the spending limits.

Adjustments required by changes in the price level will be made annually to the spending limits for the parliamentary term. Price level adjustments will be simplified with regard to spending limits expenditure that is not within the sphere of legal or agreement-based price adjustments. Price adjustments to the expenditure items in question will be made once a year in accordance with the consumer price index forecast. No other upward adjustments will be made to the overall level of the spending limits for the parliamentary term except for price level and structural adjustments.

If the level of expenditure falls below the spending limits even after supplementary budgets, the difference – not exceeding EUR 200/300 million – can be used the following year for one-off expenditure items without reference to the spending limits.

The expenditure items that are outside the spending limits are listed below.

- Unemployment security expenditure, basic social assistance expenditure and housing allowance expenditure. However, expenditure effects resulting from changes to the criteria for these items and other discretionary decisions affecting their level are included within the spending limits. If the purpose of a discretionary decision is to strengthen general government finances, the level of spending limits should not be raised.
- Interest expenses on central government debt.
- Potential compensation to other tax recipients for changes in tax criteria decided by the central government (including social security contributions).
- Expenditure items corresponding in amounts to technical pass-through items and contributions from external parties.
- Transfers to the State Television and Radio Fund.
- Appropriations allocated to value added tax expenses.
- Financial investments. However, a financial investment should be classified as an expenditure within the spending limits if, at the time of making the decision, it is considered to be a final expenditure.

The finances of the National Housing Fund and the Development Fund for Agriculture and Forestry are included within the spending limits to the extent that the amounts of the expenditures are addressed in the strategy and outlook section of the Budget. Correspondingly, transfers from the Budget to these funds would be outside the spending limits.

The funding of the wellbeing services counties falls within the spending limits system. As the funding model is new, a precautionary allocation of EUR x million is made for unexpected factors, and this allocation cannot be used for other expenditure items. If part of this allocation remains unused, the spending limits will be lowered correspondingly.

The Government’s goal is to curb cost increases of the wellbeing services counties and ensure adherence to budget constraints. To this end, the Government will refrain from assigning significant new duties to the wellbeing services counties or municipalities to enable their controlled implementation of reforms that allow them to adapt to the funding framework available after the reform of health and social services. Measures that reduce, increase or expand duties or obligations will be compensated in net amounts by making 100 per cent adjustments to central government transfers to local government and/or the corresponding appropriations, or by eliminating other duties or obligations.

The spending limits rule includes an escape clause that aims to support

the capacity of economic policy to respond to highly exceptional and significant crises emerging from outside the Government's sphere of influence in the manner required by the circumstances.

The use of the escape clause can be triggered by exceptional circumstances with regard to the economy and employment. Such circumstances could emerge from: 1. The global economy and especially the euro area experiencing an economic downturn that is substantially more serious than normal economic cycles and pushes Finland's economy into the same situation, or 2. Finland's economy experiencing a serious economic downturn due to a temporary disturbance that is independent of the Government's actions. The consideration of the activation of the escape clause would, in such a situation, be based on an overall assessment of the state of the economy. The assessment would focus particularly on the development of GDP and the unemployment rate, as well as other relevant factors[1]. The analysis would focus not only on the scale of the disturbances but also on their projected duration and source in particular.

The activation of the escape clause can also be triggered by some other unusual event that is beyond Finland's control and has a significant impact on the general government budgetary position (for example, a pandemic or circumstances requiring preparation for war or extensive terrorism). Such factors that trigger the activation of the mechanism can be related to the declaration of emergency conditions and the adoption of the Emergency Powers Act, and exceptional circumstances as defined in the EU's Stability and Growth Pact.

The Ministerial Committee on Economic Policy determines whether the criteria for the activation of the escape clause are met and decides on the content of the derogation from the spending limits and the recommendation to the Government on the activation of the escape clause, based on a proposal by the Economics Department of the Ministry of Finance. In the preparation of the proposal, the Economics Department of the Ministry of Finance consults experts it deems relevant considering the nature of the crisis.

In specifying the content of the derogation from the spending limits, the following issues will be addressed, amongst others: 1) the duration of the derogation, 2) specifying the actions to be funded, taking the nature of the crisis and the appropriateness of the actions into consideration, 3) the size of the derogation in euros, 4) reallocations within the spending limits and other funding solutions that do not increase public debt, 5) the one-off nature of the actions to be funded, and corrective measures after the crisis has ended, and 6) the steps necessary for monitoring the situation.

[1] An indication of a serious disturbance in the euro area would be, for example, the euro area's GDP declining by a minimum of 0.5% over two consecutive quarters and a cumulative increase by a minimum of 0.5 percentage points in the euro area's seasonally adjusted unemployment rate within three months. An indication of a serious disturbance in the Finnish economy would be, for example, Finland's GDP declining by a minimum of 1.0% over two consecutive quarters and a cumulative increase by a minimum of 0.5 percentage points in Finland's unemployment rate trend within three months.