Forecast

# Consolidation measures strengthen public finances

Finnish economy | 30 June 2015

The effects of the Government's economic policy programme are assessed separately in this alternative scenario, as the programme is not included in the baseline forecast. The consolidation measures, if carried through, will markedly strengthen the public finances. On account of the measures, growth in the general government debt to GDP ratio will come to a halt in 2019. The effects on economic growth essentially depend on whether cost-competitiveness can also be improved. Despite the consolidation measures, the general government debt ratio resumes growth over the longer term.




## Effects of the Government's economic policy programme

The Bank of Finland's June 2015 baseline forecast does not account for the measures envisaged in the new Government's economic policy programme, but their effects are assessed separately in

this alternative scenario. In the Government programme, the decisions on public spending cuts and taxation are key to future economic activity and the situation regarding the public finances. As the effects are passed through to the economy via both the demand and the supply channel and are also fundamentally dependent on the choice of fiscal policy measures, a comprehensive impact assessment can best be made using a macroeconomic model.

The assumption in the model simulation is for the size of fiscal consolidation to be EUR 4 billion by 2019, as proposed by the Government, of which about EUR 0.7 billion is based on increased revenues and EUR 3.3 billion on spending cuts. Expenditure cuts focus mainly on social benefits and allowances, totalling nearly EUR 2 billion. Cuts in development aid, business subsidies and consumption expenditure cover the rest of the adjustment, a good EUR 1.3 billion. The scenario also accounts for an input of EUR 0.6 billion earmarked for reducing the renovation backlog in 2016–2018, to be financed from income on assets. Investment of about EUR 1 billion in the Government's spearhead projects, as envisaged in the programme, is excluded from the scenario, as there is not yet sufficient information available on allocation or funding.

Scenario 1, which assumes no conclusion of a 'social contract', takes account of the Government's planned conditional tax increases and spending cuts beyond 2018. This conditional package includes measures increasing tax revenues by just under EUR 0.5 billion and spending cuts of nearly EUR 1 billion. Via reduced index compensations, these conditional consolidation measures would affect pension benefits and other expenditures across a broad front.

Scenario 2 assumes conclusion of a social contract or a corresponding arrangement and, consequently, by 2019 unit labour costs are assumed to grow by nearly 5% less than in the baseline forecast. The Government is committed to supporting the social contract by cutting income tax if the contract brings the targeted cost effects and adequately strengthens the public finances. The assumption in this scenario is for total income tax reductions in 2018 and 2019 to be EUR 0.9 billion. In scenario 2, where wage developments are moderate, the public finances are reinforced, as the necessary public services can be provided by less staff.

## Temporary slowdown in growth

In **scenario** 1, GDP growth in 2016 slows substantially on the baseline forecast. Economic growth decelerates further in 2018 and 2019, as supplementary consolidation measures cut current transfers and public consumption expenditure.

Public demand declines and private consumption growth slows, as cuts in current transfers reduce disposable household income. This contraction in aggregate demand weakens employment relative to the baseline forecast. However, lower demand curbs to some extent increases in

average wages and unit labour costs. This, in turn, boosts growth in both exports and private investment. Public investment also speeds up, driven by the growth package.

Overall, GDP in 2021 is 0.5 percentage points, i.e. about EUR 1 billion, lower than in the baseline forecast (Table).

**Scenario** 2 foresees GDP growth slowing in 2016 as a result of savings in public expenditure, but reductions in unit labour costs begin gradually to improve competitiveness and increase exports. Private investment also picks up markedly, with the investment ratio returning to its level of 2010–2011. Wage moderation causes average wages to rise distinctly more slowly than in the baseline, which increases labour demand. Moreover, tax reductions and withdrawal from supplementary cuts in 2018 add to consumers' purchasing power. Accordingly, private consumption begins to gradually support growth.

Overall, real GDP in 2021 is about 4.3% up on the baseline forecast. However, domestic inflation well below the baseline reduces nominal GDP relative to the baseline. Nominal GDP in 2021 is almost EUR 3 billion smaller than in the baseline forecast.

Consolidation measures, accompanied by strengthening cost-competitiveness in response to sharp reductions in unit labour costs, accelerate economic growth substantially in scenario 2, while economic growth slows, on average, in scenario 1.

## Public finances strengthened

The consolidation measures strengthen the public finances discernibly compared with the baseline forecast. Both scenarios foresee growth in general government debt to GDP coming to a halt in 2019.

Despite the Government programme measures, the debt ratio resumes growth in the middle of the 2020s, driven by increases in health and long-term care expenditures.[1] Over the longer term, the debt ratio in scenario 2 remains lower than in scenario 1. The higher investment ratio in scenario 2 increases the economy's productivity and, by extension, potential output, as a result of which productivity is estimated to improve annually by ½ of a percentage point faster than in the baseline, i.e. at about 1½% (Chart 1).

Chart 1.

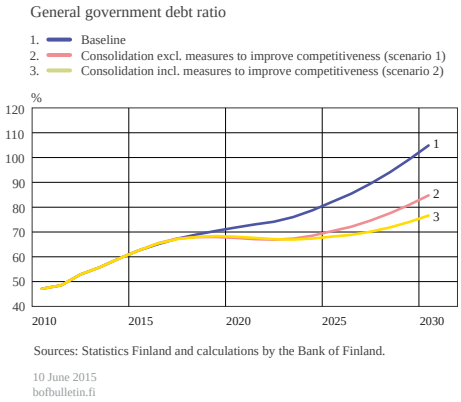



Table 1.

| **Fiscal consolidation commencing in 2016 – Alternative scenario 1** | | | | | | |
|---|---|---|---|---|---|---|
| % change on previous year | | | | | | |
| | | **2016** | **2017** | **2018** | **2019** | **2021 deviation, %** |
| GDP | Baseline forecast | 1.2 | 1.3 | 1.5 | 1.4 | |
| | Alternative scenario | 0.7 | 1.3 | 1.3 | 1.3 | |
| | Difference | −0.5 | 0.0 | −0.2 | −0.1 | −0.5 |
| Exports | Baseline forecast | 3.3 | 4.0 | 3.4 | 3.0 | |
| | Alternative scenario | 3.5 | 4.3 | 3.6 | 3.1 | |
| | Difference | 0.3 | 0.3 | 0.1 | 0.1 | 0.6 |
| Private consumption | Baseline forecast | 0.4 | 0.7 | 1.2 | 1.2 | |
| | Alternative scenario | −0.1 | 0.7 | 0.9 | 1.1 | |
| | Difference | −0.5 | 0.0 | −0.2 | −0.1 | −0.4 |
| Private consumption deflator | Baseline forecast | 1.2 | 1.4 | 1.6 | 1.7 | |

| Fiscal consolidation commencing in 2016 – Alternative scenario 1 | | | | | | |
|---|---|---|---|---|---|---|
| | Alternative scenario | 1.1 | 1.1 | 1.8 | 1.7 | |
| | Difference | −0.1 | −0.2 | 0.2 | 0.1 | 0.0 |
| Unit labour costs | Baseline forecast | 0.3 | 0.8 | 1.6 | 1.5 | |
| | Alternative scenario | 0.4 | 0.6 | 1.7 | 1.5 | |
| | Difference | 0.1 | −0.2 | 0.1 | 0.1 | 0.0 |
| Productivity per person employed | Baseline forecast | 1.0 | 0.7 | 1.0 | 1.2 | |
| | Alternative scenario | 0.6 | 0.6 | 0.6 | 1.1 | |
| | Difference | −0.4 | −0.1 | −0.4 | −0.1 | −0.9 |
| General government net lending | Baseline forecast | −3.1 | −3 | −2.9 | −2.9 | |
| | Alternative scenario | −3 | −2.5 | −1.5 | −1.2 | |
| | Difference | 0.1 | 0.5 | 1.3 | 1.7 | 1.9 |
| General government debt | Baseline forecast | 65.1 | 67.3 | 69.0 | 70.4 | |
| | Alternative scenario | 65.4 | 67.4 | 67.9 | 68.0 | |
| | Difference | 0.4 | 0.1 | −1 | −2.5 | −5.9 |
| Source: Bank of Finland calculations. | | | | | | |

Table 2.

| Fiscal consolidation commencing in 2016 – Alternative scenario 2 | | | | | | |
|---|---|---|---|---|---|---|
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| | | **2016** | **2017** | **2018** | **2019** | **2021 deviation, %** |
| GDP | Baseline forecast | 1.2 | 1.3 | 1.5 | 1.4 | |
| | Alternative scenario | 0.8 | 1.5 | 2.5 | 2.9 | |
| | Difference | −0.5 | 0.3 | 1.0 | 1.5 | 4.3 |
| Export | Baseline forecast | 3.3 | 4.0 | 3.4 | 3.0 | |
| | Alternative scenario | 3.9 | 4.9 | 4.9 | 4.7 | |
| | Difference | 0.6 | 1.0 | 1.5 | 1.7 | 5.8 |
| Private consumption | Baseline forecast | 0.4 | 0.7 | 1.2 | 1.2 | |
| | Alternative scenario | 0.4 | 0.9 | 1.8 | 2.3 | |
| | Difference | 0.0 | 0.2 | 0.7 | 1.1 | 4.1 |
| Private consumption deflator | Baseline forecast | 1.2 | 1.4 | 1.6 | 1.7 | |
| | Alternative scenario | 0.6 | 0.6 | 0.5 | 0.1 | |
| | Difference | −0.4 | −0.8 | −1.5 | −1.7 | −5.4 |
| Unit labour costs | Baseline forecast | 0.3 | 0.8 | 1.6 | 1.5 | |
| | Alternative scenario | 0.2 | 0.3 | −0.1 | −0.6 | |
| | Difference | −0.1 | −0.6 | −1.6 | −2 | −5.8 |
| Productivity per person employed | Baseline forecast | 1.0 | 0.7 | 1.0 | 1.2 | |
| | Alternative scenario | 0.6 | 1.1 | 2.1 | 2.5 | |

| Fiscal consolidation commencing in 2016 – Alternative scenario 2 | | | | | | |
|---|---|---|---|---|---|---|
| | Difference | −0.4 | 0.4 | 1.0 | 1.3 | 4.0 |
| General government net lending | Baseline forecast | −3.1 | −3 | −2.9 | −2.9 | |
| | Alternative scenario | −2.7 | −2.1 | −2 | −2 | |
| | Difference | 0.4 | 0.9 | 0.9 | 0.9 | 1.2 |
| General government debt | Baseline forecast | 65.1 | 67.3 | 69.0 | 70.4 | |
| | Alternative scenario | 65.4 | 67.1 | 68.0 | 68.4 | |
| | Difference | 0.3 | −0.2 | −1 | −2.1 | −5.4 |
| Source: Bank of Finland calculations. | | | | | | |

## Notes

1. The longer term was examined using general government sustainability analysis. ↑