Editorial

Finland’s economic transition still incomplete

Finnish economy | 17 December 2019

The Finnish economy is still going through a period of transition in which it has to adjust to two large structural realignments. One of these concerns the ageing population. The other comprises the shocks to the economy suffered since 2007, from which we have not yet fully recovered.



Governments and social partners have in recent years agreed several important solutions to address the problems – such as the competitiveness of Finnish work and output – created by the above-mentioned major changes. However, there still remains a need for further significant adjustments. There is a substantial gap in the long-term sustainability of the public finances, which remain in deficit. The unemployment rate has declined significantly, but remains higher than in most other EU Member States. Moreover, labour productivity developments have been lacklustre.

The ageing population deepens the sustainability gap

One factor currently weighing on the long-term outlook for the public finances is the fact that the baby-boom generation has reached retirement age. This has increased public pension expenditure, and over the next few years it will also lead to a more rapid increase in expenditure

on health care and long-term care of the elderly. In the coming decades, the ratio of working-age population to total population will also decrease on account of lengthening life expectancies and a declining birth rate.

The Bank of Finland has revised its estimate of the long-term fiscal sustainability gap relative to the previous estimate, published in December 2018. The new estimate paints a gloomier picture than its predecessor, with the sustainability gap now estimated at 4.7% of GDP.

The estimate has been revised partly because the general government deficit forecast for the immediate years ahead has grown. This, in turn, is due both to decisions that weaken the general government balance and to a general weakening of the economic outlook.

The gloomier estimate of the sustainability gap is also partly due to the extension of the review period to 2070, the same time-frame employed by the Ministry of Finance. Towards the end of this period, the public finances will come under pressure from the effects of the recent drop in the birth rate, as the number of people of working age will decline further relative to the retired population.

Aim for employment to achieve a good Nordic level

The long-term outlook for the public finances would be eased if a higher proportion than now of the working-age population were in work. The aim of raising the employment rate to 75% over the next few years is well-justified. Beyond this, it would make sense to aim even higher, to reach a good Nordic level. For example, Sweden's employment rate currently stands at around 78%.

The prerequisites for higher employment should be improved by a variety of measures all pulling in the same direction. There is an important role for structural reforms to increase the supply of labour. These would enable a sustained increase in employment.

At the same time, it is important to seek to reduce mismatch problems on the labour market. Important factors here are the education system, housing policy and services for the unemployed.

A third key factor underlying the prerequisites for employment is labour demand. This can be sustainably supported by balanced development of labour costs and successful cyclical policy in both low and high phases of the economic cycle.

When selecting measures to improve the prerequisites for employment, it is important to draw on the knowledge provided by both research and international experience. With regard to measures to boost labour supply, these would suggest that employment can be improved by e.g. raising the lower threshold age for additional days of earnings-related unemployment benefit, and in general

increasing the incentives within the unemployment benefits system. One approach could be a gradation of the level of earnings-related unemployment benefit based on the duration of unemployment. Employment could also be boosted by reforms to the system of family leave and making it easier for targeted immigration for the purpose of employment. Processing of employment-related residence permits could be accelerated and the residence permits of foreign students who have studied in Finland extended.

When the aim is a significant rise in the employment rate, no stone should be left unturned. It is justified to seek benefits from measures for which there are as yet no clear research results. There are undoubtedly many such measures. It is also important to utilise those measures whose outcomes are better known, like those mentioned above.

There are several ways to strengthen the long-term outlook for the public finances. In addition to raising the employment rate and a critical review of public expenditure and taxation, it is also important to improve productivity in publicly funded services. This will enable the provision to the ageing population of the services they need without crippling the carrying capacity of the public finances. When planning such reforms, the perspective of general government sustainability should always be included in the analysis.

General government outlook weakened – buffers are required

The near-term outlook for the public finances has deteriorated. The general government situation is better than five years ago, but in recent years the public finances have nevertheless remained in deficit despite the favourable cyclical juncture. In 2018, the general government deficit relative to GDP deepened, and a similar outcome is forecast for 2019 and 2020.

The deepening of the deficit is due in part to fiscal policy, which has been eased and is forecast to be eased further in 2020. Automatic stabilisers should be allowed to take full effect, but there is also a strong case for deliberate policy measures to strengthen the public finances. This is justified above all by the long-term sustainability gap, but also because notwithstanding the slower pace of growth, the near-term forecast does not foresee a recession.

Despite the recent headwinds in the global economy, the cyclical situation in Finland has so far remained fairly robust, and the approximately 1% economic growth forecast for Finland in 2020 is only slightly below estimated average longer-term growth.

One central trend in the Finnish economy since 2007, and to an extent in recent years too, has been the sluggishness of labour productivity growth and business investment. From the

perspective of economic wellbeing and dynamism, it is also particularly important to improve the prerequisites for productivity growth.

Developments in labour productivity are affected by a large range of different factors, including many aspects of economic policy. When seeking to improve the prospects for productivity growth, key factors are innovation policy and the broader corporate operating environment from the perspective of the prospects for development and growth.

The education system is also relevant to facilitating labour productivity growth, particularly in the longer term. Various features of the education system have an influence in this area. One important feature is the general level of education.

In Finland, the general educational level of the population was on the rise for several decades, but this trend has been reversed during the past 10–15 years. Among young adult cohorts the level of educational attainment has turned downwards, which is exceptional in international comparison and concerning from a Finnish perspective. This trend can scarcely be considered positive, particularly when research data does not suggest any weakening in the returns to education.

Cost-competitiveness of Finnish output still requires further improvement

Raising the employment rate to 75% has been made feasible due to the increased employment of recent years. One contributing factor has been the improvement in cost-competitiveness.

When, in the next few months, negotiations are conducted over the coming round of collective agreements, it will be important to take into account the effects of cost developments on the prospects for production and employment growth in Finland. From that perspective it would be wise to facilitate a further slight improvement in cost-competitiveness. The possibility of a sustainable rise in costs and prices in Finland is limited by the fact that euro area developments in this area are still sluggish compared with previous decades and the objectives of the central bank.

Pay agreements supportive of employment are part of the series of adjustments that also include other measures to support employment and strengthen the foundations of productivity growth and the strengthening of general government finances. Taken together, these will make it possible to cope with continued demographic ageing, even in the difficult environment in which Finland now finds itself after a full 10 years of mainly sluggish economic developments.

In addition to the ageing population and the economic shocks of recent years, the economic transition and need for adjustment also relate to an even longer-term trend, climate change.

National and international efforts to slow this process have also been underway for a while already, but there remains much to do before we are on safe ground.

Helsinki, 16 December 2019

Olli Rehn
Governor of the Bank of Finland

Keywords

cost competitiveness, employment rate, fiscal policy, sustainability of public finances