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The Finnish Economic
Policy Council

THE FINNISH ECONOMIC POLICY COUNCIL

Economic Policy Council Report 2023

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Economic Policy Council

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Preface

The Economic Policy Council was established in January 2014 to provide independent evaluation of economic policies in Finland. According to the government decree (61/2014) the council should evaluate:

1. the appropriateness of economic policy goals;
2. whether the goals have been achieved and whether the means to achieve the policy goals have been appropriate;
3. the quality of the forecasting and assessment methods used in policy planning;
4. coordination of different aspects of economic policy and how they relate to other social policies;
5. the success of economic policy, especially with respect to economic growth and stability, employment and the long-term sustainability of public finances;
6. the appropriateness of economic policy institutions.

The Council is appointed by the government based on a proposal by economics departments of Finnish universities and the Academy of Finland. The Council has adopted a rotating scheme, and the term of each member is four years. The Council members participate in the work of the Council in addition to their regular duties.

In the tenth report of the Economic Policy Council, we assess in particular Prime Minister Petteri Orpo's government programme (June 2023). The government's main economic policy objective is to stabilise the public debt

ratio by the end of the current parliamentary term. In our report, we focus mainly on the elements of the government programme that are important for this objective or that could have a major distributional impact. We also analyse other factors that could have a significant impact on public finances during the current parliamentary term and assess the government's first budget from the point of view of aggregate stabilisation.

We leave the assessment of some important policy issues to future reports. For example, we say very little about the government's R&D policy, investment programme or plans to increase the use of local bargaining in the labour market.

The Council does not make its own macroeconomic or fiscal projections but relies mainly on the Ministry of Finance's forecasts. The most recent information used in this report is the Ministry of Finance Winter 2023 Economic Survey and the November 2023 release of the Statistics Finland Labour Force Survey.

The Council has the resources to commission research in support of its work. These reports are published as appendices to the Council Report, but the authors of the reports are responsible for their content. The views expressed may or may not coincide with those of the Council.

A background paper has been published as a memorandum in connection with this year's Council report. Adam Rybarczyk of the University of Helsinki examines the properties of output gap estimates for Finland by comparing the European Commission's results with those of the IMF and OECD.

Several experts have shared their views and expertise with the Council. We thank Tuomo Suhonen and Veikko Uusitalo of the Labour Institute for Economic Research LABORE, Tomi Kyyrä, Hanna Pesola, Tuomas Matikka and Tuomas Kosonen of VATT Institute for Economic Research, Sampo Pihlainen and Sampo Soimakallio of the Finnish Environment Institute, Juha Mikola of the Natural Resources Institute LUKE, Tuomo Kalliokoski of the Ministry of the Environment, and Lassi Ahlvik of the University of Helsinki. We would also like to thank experts at the Ministry of Finance for patiently responding to several questions by the Council: Jukka Mattila, Simo Mentula, Jussi Kiviluoto, Filip Kjellberg, Janne Huovari, Annika Klimenko, Lauri Kajanoja, Leena Kerkelä, Atro Andersson, Marja Paavonen, Seppo Orjasniemi, Jenni Pääkkönen, Ulla Hämäläinen and Ilari Valjus. Adam Rybarczyk was a

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Helsinki, 24 January 2024

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1. Summary

Recent economic developments

The economic situation has suffered from the Covid-19 pandemic and Russia's invasion of Ukraine. Finland's GDP growth, while relatively resilient during the pandemic, lagged other Nordic countries in 2021 and 2022. Inflation in Finland peaked at 9.1% in 2022, influenced by global supply chain disruptions and the Russian invasion, but is projected to decline to around 2% in 2024.

In 2023, the economy has likely contracted a little. The economic outlook for 2024 has weakened recently, with the Finnish economy operating below its normal capacity and without internal inflationary pressure. On the other hand, the labour market remains relatively tight, and the employment rate is expected to decrease only slightly from its recent peak. Moreover, the decline in employment is largely concentrated in the construction sector. Therefore, the macroeconomic situation does not require broad-based fiscal stimulus measures.

Central banks across the globe responded to increased inflation by raising policy rates, leading to a rise in market interest rates. Long rates increased first, as market participants anticipated the need to increase policy rates. With inflation decreasing recently, the real interest rates have increased. In addition, real rates have also increased due to structural factors. They are also expected to remain at substantially higher levels than just a few years ago. This increases expected borrowing costs for governments, firms, and households alike.

Housing loan drawdowns have decreased sharply in response to higher interest rates, and residential property prices have declined. This has resulted in a sharp fall in housing construction. Higher real interest rates and declining house prices can be associated with risks to macroeconomic and financial

stability. However, Finland's household sector has a relatively low level of debt compared to other Nordic countries making these concerns less severe.

Arguably, the main problem with Finland's recent economic performance has been very low labour productivity growth, which has generally been weaker than comparable countries, in particular the recent years. At the same time, cost competitiveness has stayed relatively good because of moderate wage increases. However, low productivity is a structural challenge in Finland for which there are unlikely to be quick and easy solutions.

Employment policy

Following the practice of previous Finnish governments, the government of Prime Minister Petteri Orpo included employment policy targets in its programme. The government aims to achieve an employment rate of 80 % by 2031 and it also seeks to increase the number of hours worked. The core of the employment programme consists of several reforms aimed at reducing incentive traps by reducing the level of social security in relation to wages. All in all, the government aims at implementing reforms to increase employment by at least 100 000 persons. These employment-improving reforms are an important part of the government's fiscal consolidation plans. They are expected to boost annual public finances by EUR 2 billion via higher employment. In addition, the government will continue with the reforms of employment services decided in the previous parliamentary term.

Employment rate targets are well motivated for both social and fiscal reasons, but the choice of appropriate policies is challenging in practice. Employment rate is already relatively high by historical standards and further increases are more difficult to achieve than in the past.

Employment barriers are also of many types, and they can arise because of problems related to work capacity, work incentives or the functioning of the labour market (matching). Accordingly, employment policies are not one-size-fits-all policies and different employment obstacles need different cures. There is a need for targeting so that the interventions with the strongest employment effects can be used for specific groups of the unemployed. Since employment barriers are multifaceted, well-functioning co-operation between different ministries is important.

The focus of the government's employment programme is unbalanced because of its one-sided emphasis on tackling incentive barriers. Tackling only incentive problems is not enough considering the importance of adequate professional skills and health and also the scale of the labour market mismatch problem.

The ex-ante effects of these reforms are calculated by the Ministry of Finance using estimates of changes in work incentives and labour supply elasticities. The ex-ante estimates of employment effects are inherently uncertain. First, there is uncertainty about both labour supply elasticities and changes in work incentives. Second, the impact of a particular reform is also likely to depend on what other reforms are being implemented. Third, the labour market situation itself is likely to either hinder or assist the realisation of the potential employment effects.

All these uncertainties imply that one cannot give very definite "promises" of the effects of the reforms. This should also be kept in mind in the context of the role of employment reforms as a tool in balancing public finances. Overly optimistic estimates can give too much weight to employment policies in the consolidation.

Since 2015, Finland's population has grown only thanks to net immigration. With an ageing population and a lower birth rate, Finland will continue to need immigrants in the coming years. However, given the global competition for international labour and talent, it is not self-evident that they will end up in Finland. Some of the changes envisaged by the government, such as stricter requirements for citizenship, may make Finland less attractive in the international labour market.

Many ongoing reforms and the role of employment targets in economic policy emphasise the need for systematic ex post evaluations of reforms. It is good practice for ex post evaluations to be carried out by independent experts. Accordingly, a systematic commitment to ex post evaluations and adequate resources for this purpose are justified demands. In organising this, one must take into account that the capacity to carry out research in this area is scattered.

Housing policy

According to its programme, the objective of Prime Minister Orpo's Government's housing policy is to promote the functioning of the housing market so that everyone can live the best possible life in an affordable home of their choice. The council supports this objective and some of the policy reforms planned and already decided will promote this goal, while some will not.

The underlying reason for high housing costs is limited housing supply relative to demand. Government's tools to promote overall housing supply are limited because major land use decisions related to housing supply are made at the local level by municipalities. Local decision-making may not take into account all the benefits of additional housing supply, which may lead to insufficient supply of housing. This is why it is important that the government incentivises high-priced cities to zone land for housing through land use, housing, and transport (MAL) agreements.

Considering the government's own housing policy objectives, the cuts of the general housing allowance are somewhat questionable. The generosity of housing allowance is, of course, a value judgement. However, the government's housing allowance cuts will most likely worsen the housing market situation of most vulnerable groups. Furthermore, the housing allowance cuts, especially lowering the allowance's compensation percentage, will make lowest-income households more dependent on social assistance. This works against the government's goal of decreasing social assistance dependency.

The government is taking steps in the right direction with social housing policy. Targeting social housing more towards low-income and vulnerable households by instating income limits at the selection stage is justified, as is reducing the construction of social housing. Social housing is not the answer to overall supply shortages because it crowds-out private construction and does not increase overall housing supply. Moreover, the housing allowance is a better and more efficiently targeted way to reduce the housing costs of low-income households than social housing. The housing allowance is available to all that fulfil the criteria whereas this is not the case with affordable social housing. The goals of social housing should be made clearer, and the extent of social housing construction and tenant allocation rules should be evaluated based on these goals.

The government is also making positive strides with its housing taxation reforms. Lowering the housing transfer tax rate has the potential to improve the functioning of the housing market as it makes it easier for households to choose a housing unit that best suits their preferences and needs.

Fiscal policy

The current upward trend in public debt creates uncertainty about future taxes and the sustainability of public services and transfers, especially given that population ageing will continue to put pressure on public finances. An increasing debt ratio may also reduce the scope for counter-cyclical fiscal policy in the future. Against this background, the government's objective of stabilising the public debt ratio by the end of the current parliamentary term is well-justified, provided the economic environment remains relatively stable.

The consolidation programme outlined in the government programme will strengthen public finances relative to a baseline of no policy changes. However, it is unlikely to be sufficient to stabilise the debt ratio. One reason for this is the development of tax revenues. Tax revenues are projected to fall as a share of GDP in the coming years, largely due to the electrification of transport. Moreover, the Ministry of Finance now projects a substantially larger decline in tax revenues relative to GDP between 2023 and 2027 than at the time the government programme was prepared.

The fiscal impact of some of the measures in the government's consolidation programme is also very uncertain. As discussed above, there are many uncertainties related to the impact of the employment measures. And while it is important to constantly seek to improve public sector productivity, it is impossible to assess the government's chances of generating major savings by improving the operational efficiency of the wellbeing services counties.

The government is committed to taking additional action if it turns out that the measures outlined in the government programme are not sufficient to achieve its key fiscal objectives. However, according to the programme, the government will not raise the total tax rate "by Government decisions". This statement seems to rule out tax increases as a response to a decline in tax revenues that is unrelated to government decisions. On the other hand, strengthening public finances quickly through further spending cuts alone

may also be difficult in practice, at least without jeopardising some of the other objectives set out in the government programme.

The above statement on the total tax rate could also be interpreted to mean that the overall tax rate should remain below the level projected before the government programme was prepared. Such an interpretation would allow tax policy to respond to a faster than expected decline in tax revenues, thereby facilitating the achievement of the government's main fiscal objective.

However, the fact that the total tax rate is projected to fall does not make compensating tax increases harmless. The total tax rate in Finland remains quite high and the distortionary effects of tax increases tend to increase with the tax rate. To bolster public finances via taxation, it would be prudent to focus on broad, inelastic tax bases or reforms that render the tax system more neutral, minimising its undue influences on individuals' choices. This could involve increasing value-added taxation, particularly by increasing some of the reduced VAT rates, increasing property taxes (beyond current plans), and reducing the dividend tax exemption for non-listed companies.

The government's consolidation programme relies heavily on cuts to social benefits. The government's stated intention is to implement the cuts "in a way that acknowledges the situation of the most vulnerable groups". While some of the cuts are arguably compatible with this target, it is questionable whether the consolidation programme as a whole is in line with it. The main problem is that cuts in different social benefits partly affect the same people. Some people with very limited economic resources will see their disposable income shrink quite substantially.

This problem is linked to the fact that the government has sought savings mainly in benefits for people of working age, while a large part of social security spending is on benefits for pensioners. On the other hand, the government also wants to reform the pension system. This should provide an opportunity to look for savings in social security spending that do not jeopardise the livelihoods of the most vulnerable groups, or undermine incentives to work. It could be especially useful to reconsider some of the benefits in the earnings-related pension system that are not based on wage income.

Finland may not be able to meet its carbon reduction commitments under EU climate legislation. In particular, it will be difficult or even impossible to reach

the carbon sink target in the land-use sector in 2021-2025. This will create new fiscal risks as Finland may have to buy carbon sink units from other Member States.

The government should seek to create incentives to maintain and increase carbon sinks in order to reduce the need for the government to purchase offsetting sinks from abroad. From a public finance perspective, it would be desirable for these incentives to be based, at least in part, on landowners or the forest industry having to pay for the loss of carbon sinks they cause, rather than taxpayers subsidising the forest sector. Providing incentives to maintain carbon sinks would also be an important step towards making our overall climate policy cost efficient.

The government's first budget implements some of the expenditure cuts that are part of its consolidation programme. Despite these efforts, the increase in the public debt ratio is not slowing down. This is partly due to a weaker cyclical outlook and higher interest expenditure but also to the fact that the overall fiscal stance, which includes taxation, is not significantly tightened.

The current relatively loose fiscal stance may prove to be appropriate from the point of view of aggregate stabilisation. On the other hand, it increases the need to tighten fiscal policy in the coming years to stabilise the debt ratio.

2. Recent economic developments

Recent economic developments have been strongly influenced by crises such as the Covid pandemic and Russia's invasion of Ukraine. After the initial decline in economic output caused by the pandemic, many economies saw a period of recovery and GDP growth was for a while higher than before the pandemic hit. Now these strong growth figures seen in the last few years have abated, and forecasts of economic growth have been revised downwards.

The pandemic caused supply disruptions across the globe and Russia's invasion led to increased energy and food prices. Energy prices peaked in Europe in 2022, and inflation rose to levels not seen in decades. There was also a sudden shift in consumption patterns as the Covid pandemic restricted the consumption of services for a prolonged period of time and demand for certain material goods was higher than before. At the same time, both fiscal and monetary policy were relatively accommodative in most countries. There are therefore many factors behind the rise in inflation, and plausibly both demand and supply side factors contributed.

To combat the rise in inflation, central banks tightened their monetary policies. The European Central Bank increased its policy rate from -0.5% to 4.0% (as of December 2023) in just over a year and started to reverse its earlier balance sheet operations. Tighter monetary policy is reflected in market interest rates, which rose accordingly in 2023. The rise has caused households to decrease their borrowing and the tightening policy is starting to have a downward effect on real economic activity, with some sectors such as construction more heavily affected than others.

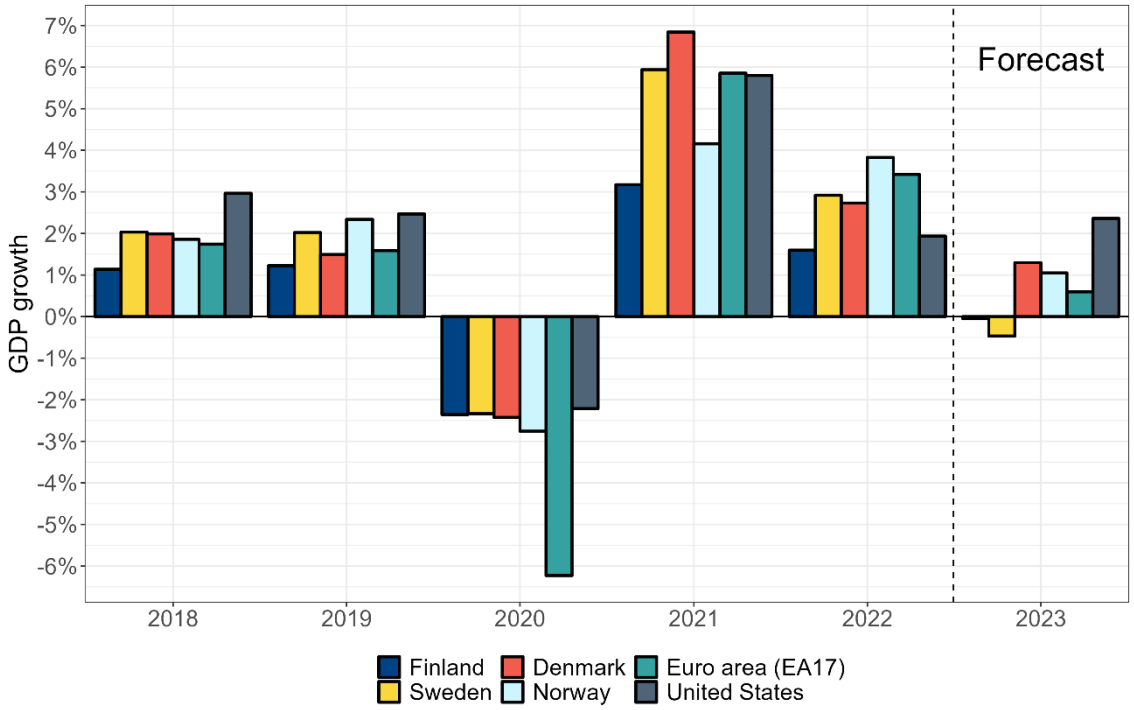
This chapter provides a brief overview of recent economic developments. 2.1. provides an overview of the international context and contrasts Finland to the other Nordic economies, the euro area and the United States. 2.2. focuses on the Finnish economic outlook, GDP growth and the output gap. 2.3. discusses

labour market developments. Finally, 2.4. considers the recent rise in interest rates and its effects on the economy, while 2.5. concludes.

2.1. Finland and the world economy

Figure 2.1.1. shows annual GDP growth in Finland and in selected countries over the years 2018-2022 as well as the projected growth for 2023. As in the other Nordic countries, the contraction in Finnish economic activity in 2020 was relatively modest when compared to the euro area average. However, Finnish GDP growth of 3% in 2021 lagged behind the other Nordic economies, which all grew closer to the euro area average of almost 6%. Still, this 3% growth was high compared to mean growth in Finland over 2015-2019, which was approximately 1.8% per year. In 2022, GDP growth in the euro area, Denmark, Norway, and Sweden was roughly between 2.5% and 4%, whereas growth in Finland was lower at below 2%. In 2023, both Finland and Sweden are forecast (by the OECD) to have a slight contraction in economic activity. Projected GDP growth rates are low in other countries too.

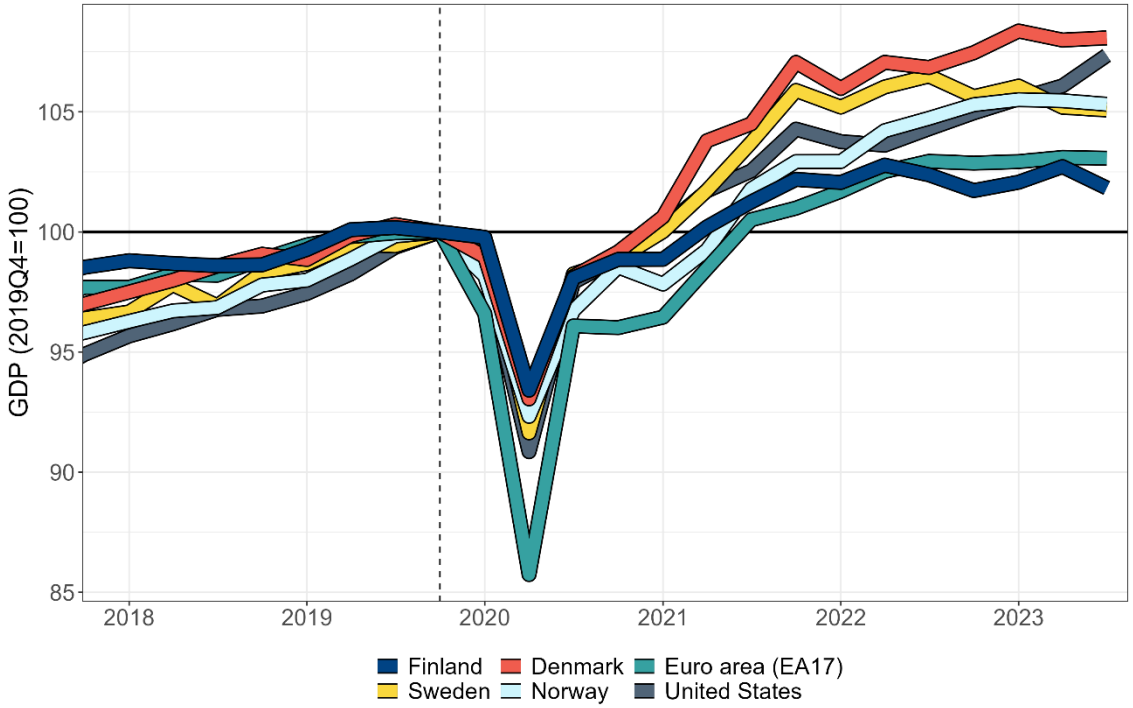
Figure 2.1.1. GDP growth 2018-2023*.



Source: OECD Economic Outlook (November 2023).

As noted, the Nordic economies weathered the pandemic relatively well. To provide a comparison in GDP trends over this period, Figure 2.1.2 plots quarterly GDP in selected reference countries (with values indexed such that the 4th quarter of 2019 is normalised to 100). In cumulative terms, Denmark has seen the highest growth since 2019Q4, followed by the US, Norway and Sweden.

Figure 2.1.2. Quarterly GDP (Quarter 4 2019=100).



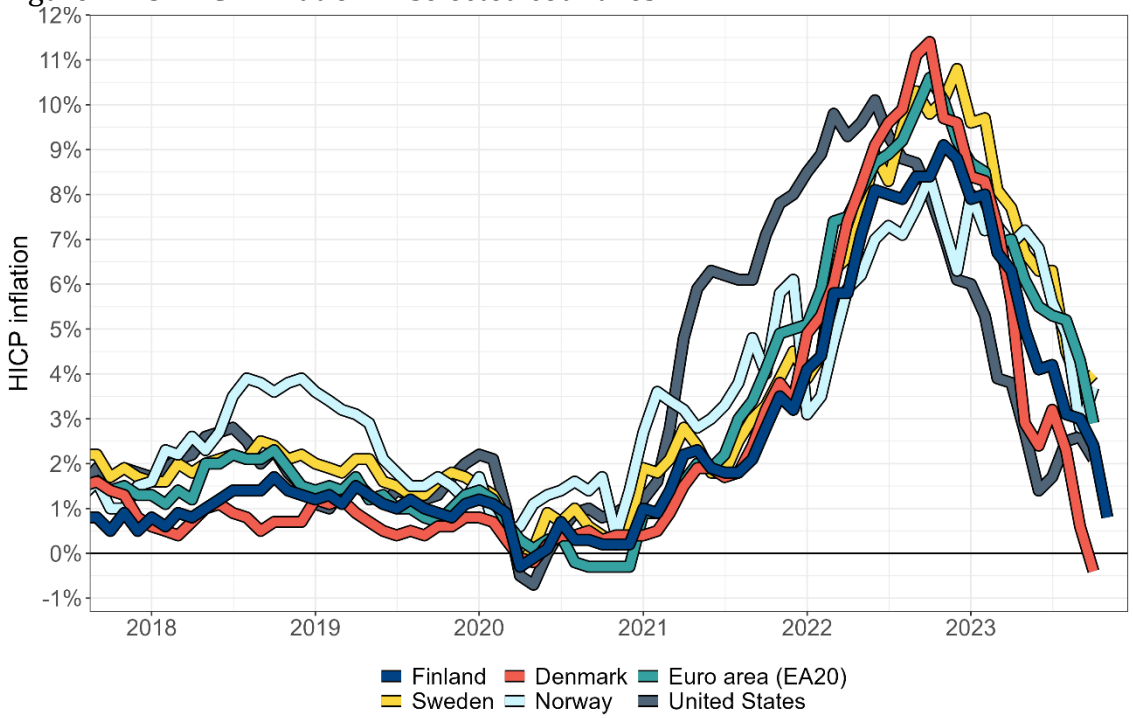
Source: OECD Economic Outlook (November 2023).

The slower growth figures in Finland mean that cumulatively Finland is falling behind its Nordic peers. Compared to the period before the pandemic (2019Q4), Finland's GDP was roughly 2% larger by the start of 2023, whereas Sweden's GDP had grown by 6%, Denmark's by over 8% and Norway's by 5.5%. During 2020-2022, Finland's working-age (15-64 year old) population declined by 0.2% cumulatively whereas Sweden's grew by 1.8% (Norway: +1.5%; Denmark: 1.0%) according to data from the World Bank. Therefore, roughly 2% points of the difference in Finnish and Swedish GDP growth between 2020-2022 can be explained by demographic trends. Since the onset of the pandemic, Finnish growth has also fallen behind the euro area average, which initially suffered a much larger decline in 2020. In contrast to most of the other economies in the figure, Finnish GDP decreased in late 2022 after the Russian invasion of Ukraine in early 2022.

Inflation started to rise in many advanced economies in early 2021, including Finland. The rise in consumer prices was partly due to supply chain and energy market disruptions related to the Covid-19 pandemic and the Russian invasion of Ukraine in February 2022. Government stimulus packages and expansionary monetary policies also contributed to inflationary pressures.

In 2022, inflation (as measured by the Harmonised Index of Consumer Prices, HICP) peaked at 9.1% in Finland, 10.6% in the euro area and 10.1% in the United States, where the initial upsurge as well as the later decline in inflation took place earlier (Figure 2.1.3). Inflation this high had not been seen in the developed economies for 40 years. In 2023 inflation has been declining, and in Finland inflation is expected to return to around 2% in 2024 according to most forecasts (see e.g. Table 2.2.1). Longer-term inflation expectations have also remained relatively close to 2%, which is the inflation target of many central banks.

Figure 2.1.3. HICP inflation in selected countries.

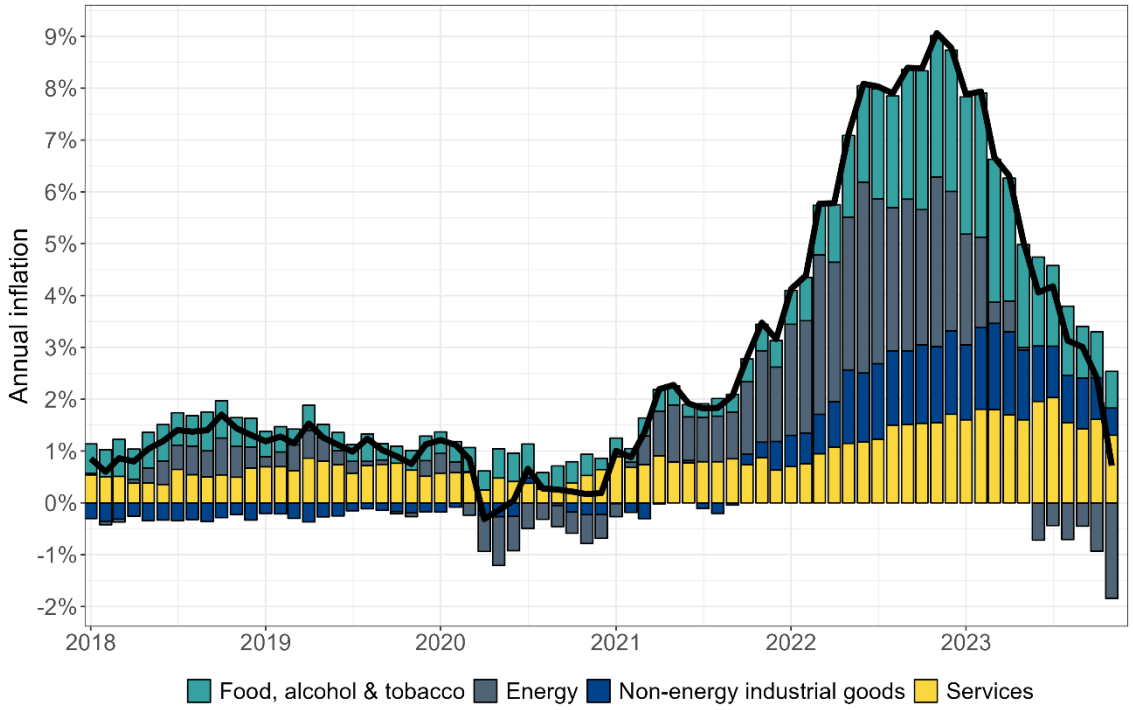


Source: Eurostat. Note: HICP is Harmonised Index of Consumer Prices.

Figure 2.1.4 presents a breakdown of HICP inflation in Finland into four components. The upward trend in inflation was at first explained by rising energy prices, but in 2022 all major components contributed positively to inflation. Notably, the initial rise in prices happened already in late 2021,

which precedes Russia's invasion of Ukraine in early 2022. At first, this rise was mostly due to energy but in 2022 the rising price level was evident in all components. More recently, prices in the more volatile items such as food, alcohol, tobacco, and energy have not been rising as fast as they did in 2022 and their share of total inflation has declined. In 2023, energy has started to contribute negatively as energy prices have fallen. The pace of price increases in non-energy industrial goods has also started to decline and more recently in late 2023 services are the largest contributor to overall inflation.[1]

Figure 2.1.4. Contributions to HICP inflation, Finland.



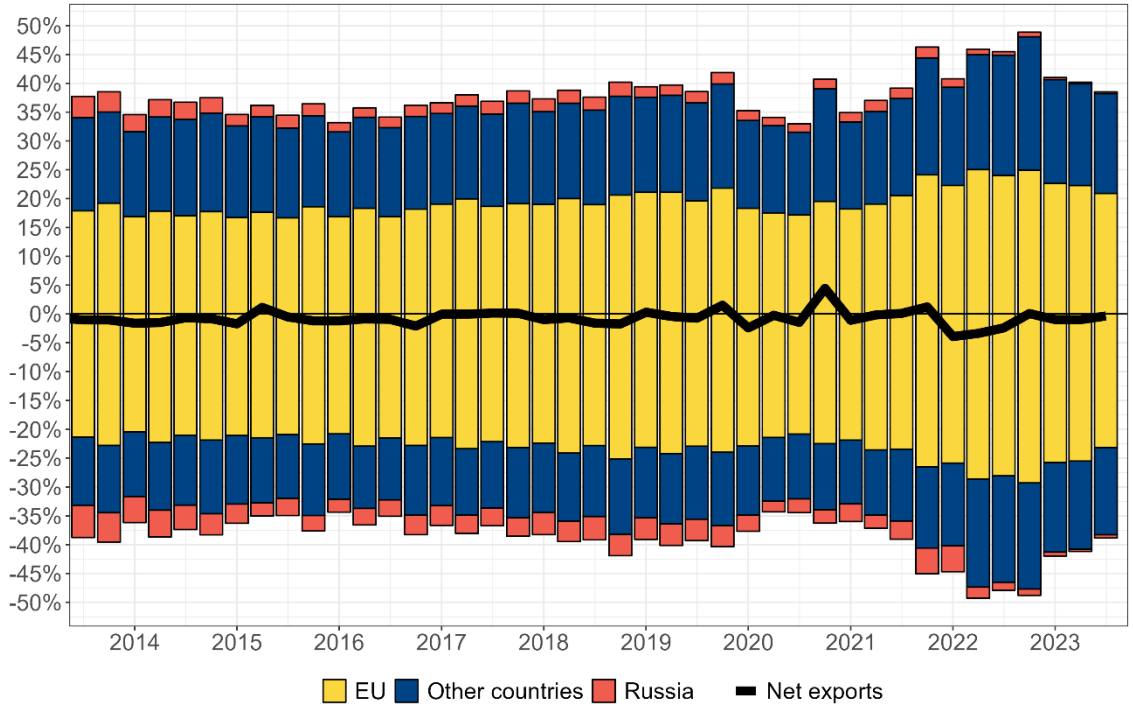
Source: Statistics Finland. Note: HICP is the harmonised index of consumer prices.

Amid slowing economic growth and high inflation, global trade has grown slowly in 2023 and the WTO has revised its trade forecasts downwards (WTO, 2023). As a small open economy, Finland is particularly exposed to cyclical variations in global trade. Figure 2.1.5. illustrates that Finland both exports and imports roughly 40% of its GDP in goods and services. Net exports have been slightly negative in recent years.

[1]Statistics Finland's inflation measures were erroneous from 2022M1 onwards due to double counting of electricity price increases. Official HICP numbers will not be revised afterwards, but the price index was adjusted in August 2023. The effect on total inflation was roughly -0.7% points (-18.7% points for electricity). The adjustment will affect annual inflation measures until August 2024.

Historically, Russia used to be an important trading partner for Finland and a source of imports in energy products. Since the onset of the invasion to Ukraine in 2022, Russia's role as a trade partner of Finland has declined dramatically. In the first quarter of 2023, both the value of exports and imports had decreased to less than EUR 500 million or less than 1% of quarterly GDP (Figure 2.1.5).

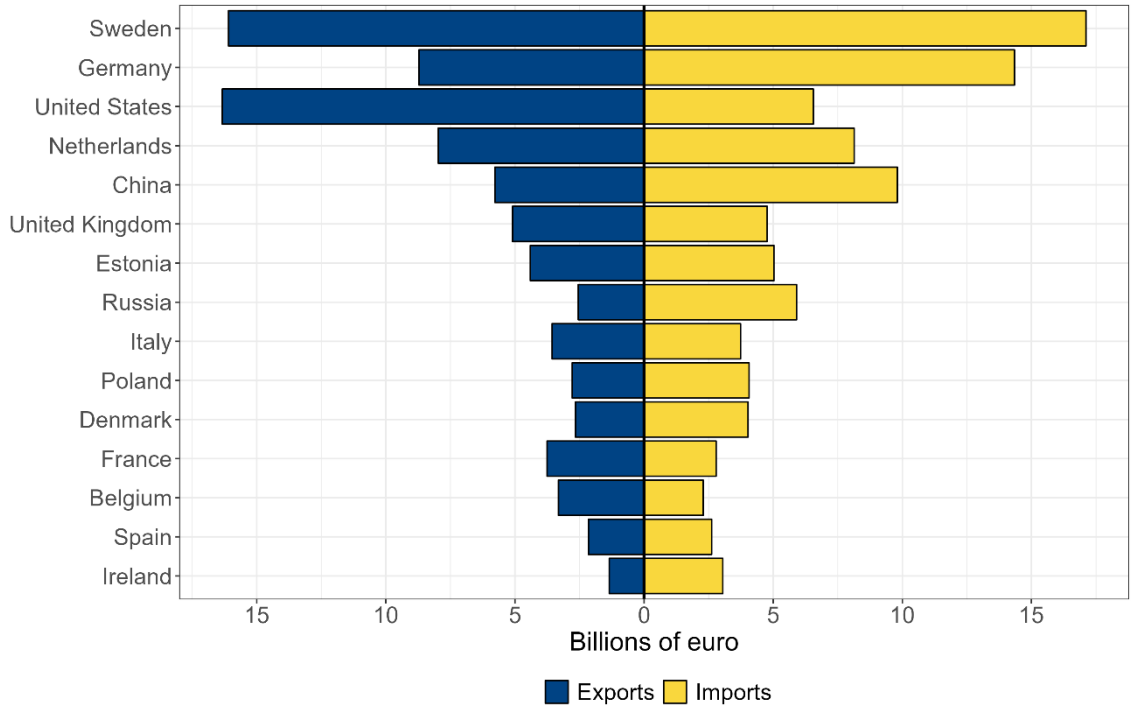
Figure 2.1.5. Quarterly exports (+) and imports (-) in goods and services as a percentage of GDP.



Source: Statistics Finland, International trade in goods and services.

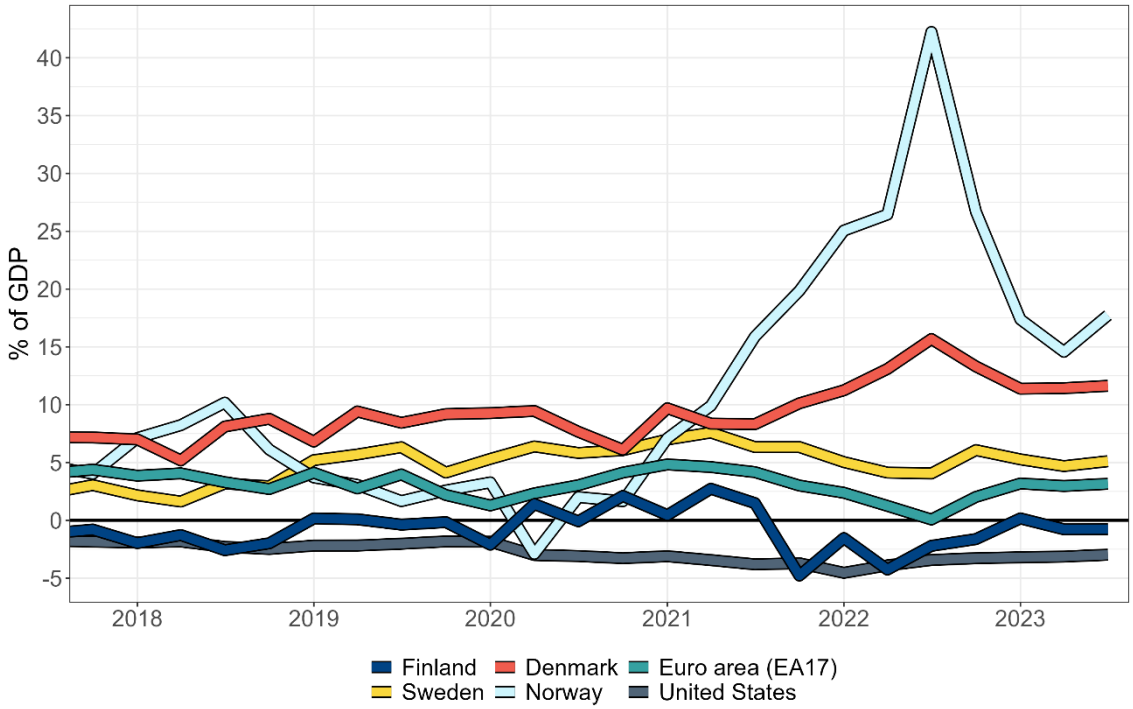
Most of Finland's foreign trade is with other EU countries. Figure 2.1.6 shows Finland's 15 largest trade partners in 2022 as measured by the sum of exports to and imports from that country. Finland's largest trading partner is Sweden, followed by Germany and the United States, to which Finland exports much more than it imports. In 2022, Russia was still ranked 8th in Finland's trade, with imports from Russia largely exceeding exports to Russia.

Figure 2.1.6. Finland's largest trading partners in 2022.



Source: Statistics Finland, International trade in goods and services.

Figure 2.1.7. Current account (% of GDP) in selected countries.



Source: OECD.

Finally, Finland differs from its reference countries in Europe with regards to its current account (see Figure 2.1.7). Over the past five years, the current account has been in surplus in Sweden and Denmark, and mostly in surplus in the euro area also, while in Finland it has been more often slightly in deficit. The current outlook is that global economic uncertainties may hamper Finland's foreign trade in the near future as well, which could put further pressure on the current account. Going forward, there could be a concern that the current account balance will continue to deteriorate in Finland. A sustained fiscal deficit, especially if it is financed by increased imports and borrowing from abroad, can contribute to a worsening of the current account deficit, see for instance Corsetti et al. (2006). Still, with fiscal policy being tightened going forward, as discussed in Chapter 5, we consider this to be a minor concern. Also, an ageing population may contribute to increasing savings, and could work to reduce the deficit.

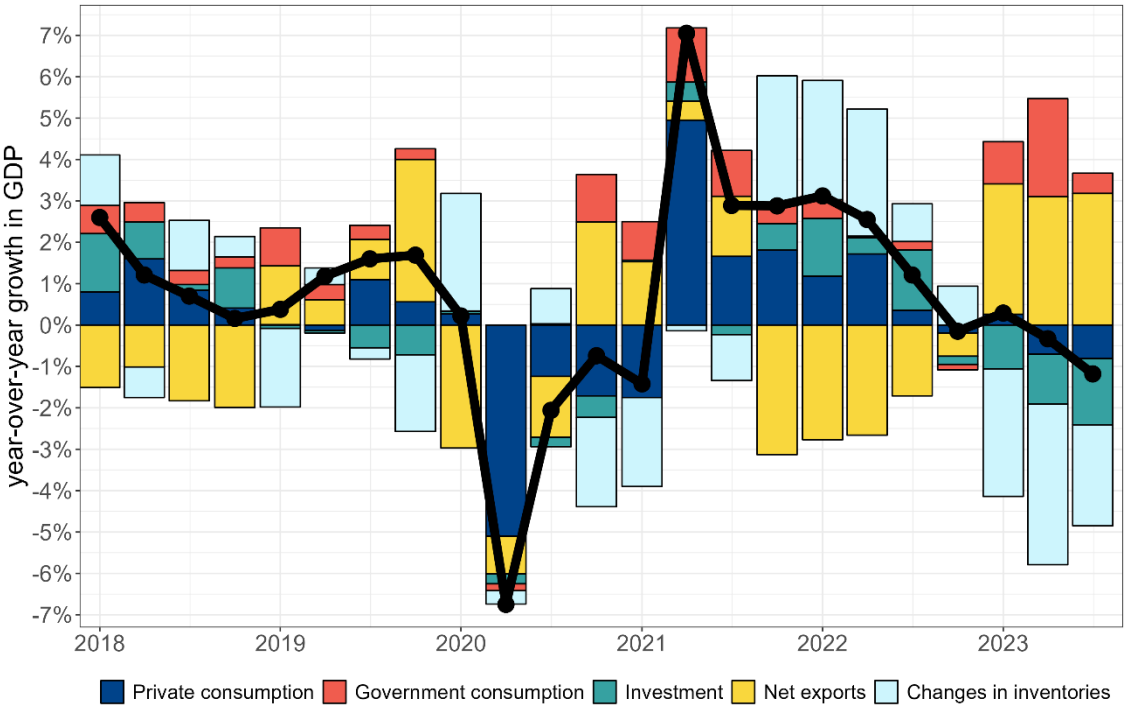
2.2. GDP developments and economic outlook

The robust growth following the Covid-19 pandemic has subsided, with Finnish GDP already declining in the last quarter of 2022. Economic forecasts for Finland indicate that GDP in 2023 will either decrease or not grow from 2022 levels.

Figure 2.2.1 decomposes year-over-year changes in aggregate output into their components: private and government consumption, investment, net exports, and changes in inventories. Much of the positive GDP growth after the pandemic can be explained by the rebound in private consumption and investment. Government consumption also contributed positively, while net exports had a negative contribution as imports grew faster than exports.

In late 2021 and continuing into 2022, there was a relatively large positive contribution from increasing inventories. Conceptually, increasing inventories indicate that more output has been produced than sold. However, inventories are an item in national accounts that is hard to estimate and contains a fair amount of uncertainty, meaning that the figures can see large revisions before they are final. In any case, as one would not expect inventories to increase continuously, a positive contribution often predates a negative contribution. This has been the case in 2023 as inventories have been decreasing following the earlier increase.

Figure 2.2.1. Contributions to GDP growth.



Source: Eurostat (quarterly national accounts).

Government consumption and net exports have been positive contributors to GDP in 2023. In the first half of the year, growth in government consumption was strong. Net exports increased, but mainly through a decline in imports. The largest component, private consumption, has fallen slightly in the last couple of quarters, as has aggregate output growth when compared to the same period a year earlier. It is particularly worrisome that the contribution of investment has been negative. The small amount of machinery, equipment, and intangible investments has been identified as one of main factors explaining the slow development of Finland's productivity (Finnish Productivity Board 2023).

Table 2.2.1 summarises forecasts for GDP growth, the unemployment rate and inflation by various institutions that make forecasts of the Finnish economy. The forecasts are from the autumn of 2023. Included are the Ministry of Finance, the Bank of Finland, three Finnish research institutes (Labore, Etla and PTT) and three international institutions (European Commission, IMF, and OECD).

Table 2.2.1. Economic forecasts of various institutions.

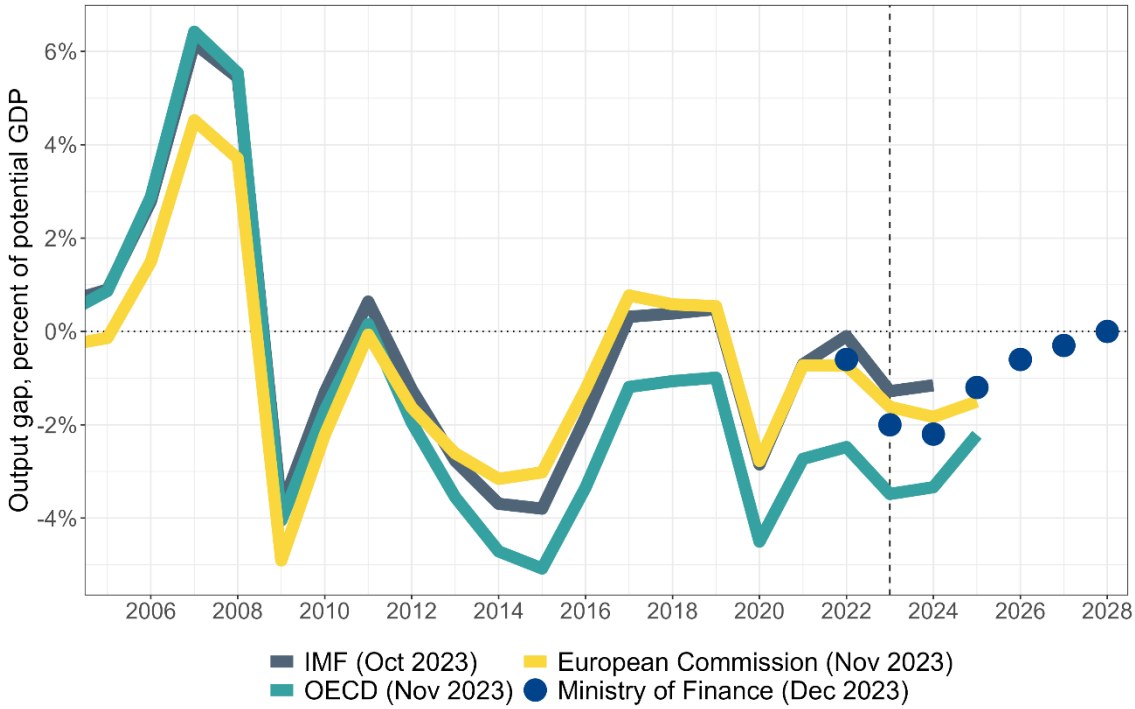
	GDP growth (%)			Unemployment rate (%)			Inflation (%) (*)		
	2023	**2024**	**2025**	**2023**	**2024**	**2025**	**2023**	**2024**	**2025**
Ministry of Finance (Dec 19th)	-0.5	0.7	2.0	7.2	7.5	7.1	4.4	1.2	1.7
Ministry of Finance (Oct 9th)	0.0	1.2	1.8	7.1	7.2	7.0	4.3	1.6	2.1
Bank of Finland (Dec 19th)	-0.5	-0.2	1.5	7.2	7.8	7.5	4.4	1.0	1.4
Labore (Sep 28th)	-0.3	0.8	1.7	6.9	6.7	6.7	6.1	2.4	1.8
Etla (Sep 14th)	-0.3	0.8	1.2	7.2	6.8	6.4	6.3	1.9	1.5
PTT (Sep 13th)	-0.5	0.5		7.3	8.5		5.7	2.8	
Eur. Commission (Nov. 15th)	0.1	0.8	1.5	7.2	7.3	7.0	4.4	1.9	2.0
OECD (Nov 29th)	0.0	0.9	1.8	7.2	7.4	7.1	4.5	2.2	2.3
IMF (Oct 10th)	-0.1	1.0	1.3	7.3	7.4	7.3	4.5	1.9	2.0

Notes: (*) Labore, Etla and PTT inflation forecasts are for national CPI, others forecast HICP.

For 2023 these organisations see on average a small contraction in Finnish GDP, with projections ranging from -0.5% to 0.1%. The outlook for 2024 worsened during the autumn, with forecasts made closer to the end of the year showing lower growth rates. For example, in October the Ministry of Finance forecast growth of 1,2%, but in December this was revised down to 0.7%. The Bank of Finland's forecast published on the same day put 2024 GDP growth at -0.2%. Forecasts from other institutions range from 0.5% to 1%. Overall, growth is forecast to accelerate towards more typical levels in 2025. Forecasts for the unemployment rate feature somewhat different trajectories. Some forecasters project an increase in unemployment in 2024, but Labore and Etla see the unemployment rate declining in the coming years. Inflation is forecast to decline in 2024.

Output is expected to be below its potential level in the coming years, i.e. the economy is not operating at normal capacity and the output gap is negative (Figure 2.2.2). Using the same methodology as the European Commission, the Ministry of Finance estimates the output gap to be -2% of potential output in 2023. This is between the estimates of -3.5% and -1.3% by the OECD and IMF respectively. Over 2024-2028, the Ministry of Finance projects the output gap to steadily close. Still, the projected economic downturn is reflected in an output gap of -2.2% in 2024. Box 2.1 considers past output gap estimates and their revisions based on the work of Rybarczyk (2023).

Figure 2.2.2. Output gap estimates.



Note: Vertical dashed line is for 2023.

Box 2.1. Revisions of output gap and potential output in Finland

To conduct appropriate and timely fiscal policy, policymakers need to have access to indicators of potential output, as well as the cyclical stance of the economy, i.e. the output gap. Potential output is usually defined as the maximum level of output that an economy can sustain without creating accelerating inflation. The output gap is then defined as the percentage deviation of actual output from potential output.

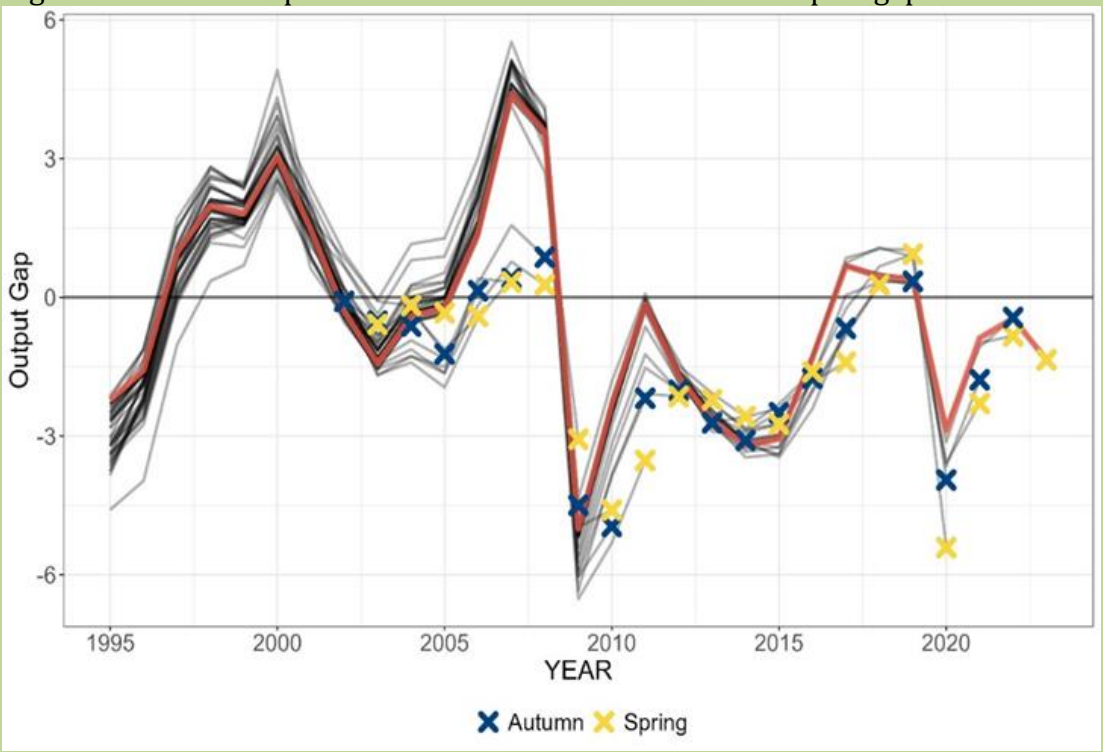
In practice, potential output and the output gap are used in the European Union's Stability and Growth Pact to calculate the structural variables used to define the medium-term objectives. The Member States can be sanctioned financially by the Commission for deviating from their objectives. In Finland, the Ministry of Finance uses the European Union's Commonly Agreed Methodology (EUCAM) to produce its estimates of potential output and the output gap.

As potential output cannot be observed directly, assumptions must be made on how to construct such a measure from observables. Most major

institutions, such as the EC and OECD, assume that potential output can be approximated using the production function methodology. In this approach the potential levels of labour, capital, and productivity are estimated, and then used as inputs in a Cobb-Douglas production function.

As these indicators of potential output and the output gap are important inputs in policy decisions, they should be available in real time, and their estimates should not exhibit large ex-post revisions. Unfortunately, much empirical evidence has shown that estimates of the output gap tend to suffer from large real-time biases and consequent revisions, which are often of the magnitude of the initial estimate.

Figure B2.1.1. European Commission's estimates of output gap for Finland.



Source: Rybarczyk (2023). Note: Each line corresponds to one vintage release. The thick red line is the latest vintage release (spring 2023). Crosses mark the real-time estimates. Yellow crosses indicae spring vintages, blue crosses autumn vintages.

Figure B2.1.1. presents the estimates of the output gap for Finland, as estimated by the EC. As can be seen, the real time estimates differ from the latest available values, especially around the financial crisis. This is arguably the time when accurate estimates were needed most. Furthermore, sign changes in the estimates can be noted before the

financial crisis, as well as in 2017. To give an example, there are multiple observations on either side of zero for 2005, with the spread being roughly three percentage points.

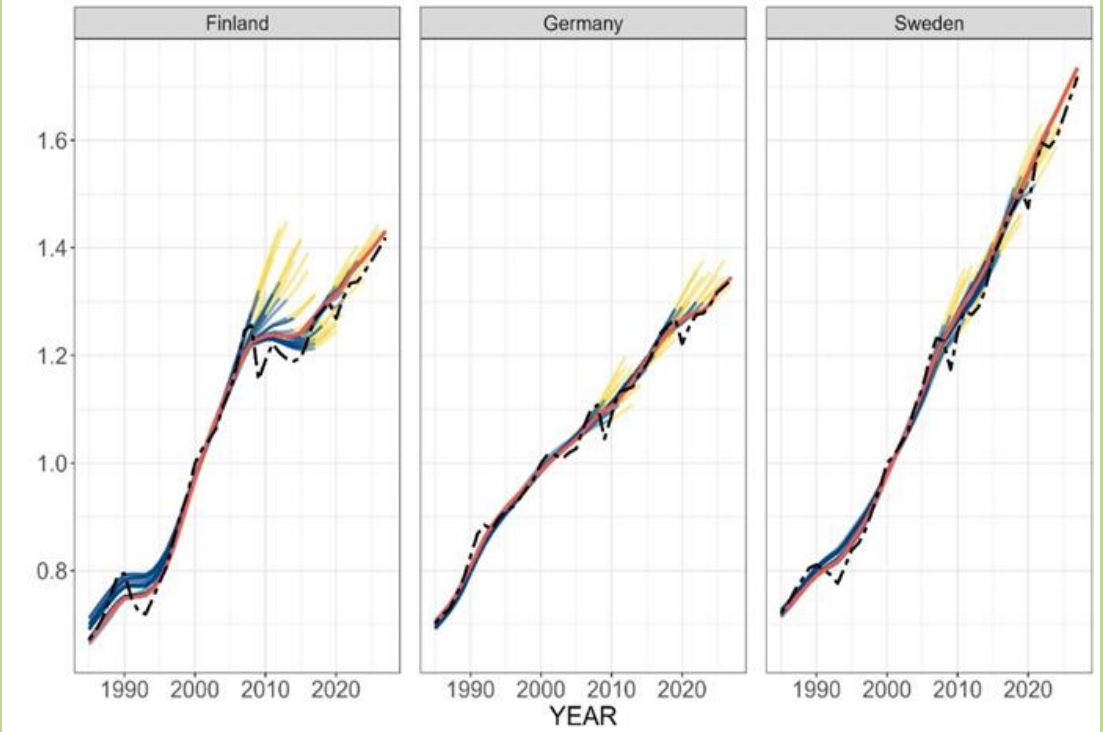
Estimation of the output gap tends to be especially difficult for small open economies, and in particular for Finland. This is reflected in the revisions of estimates of the output gap. The EC's median revision of the output gap estimate for Finland seven years after the initial estimate has been 0.66 percentage points over the period starting from 2002. For Sweden the value is 0.31, and for Germany 0.44. The standard deviation of the revisions is also larger for Finland: 1.68 against 1.25 and 0.94 in Sweden and Germany respectively.

As the output gap is a function of potential output, revisions of the former are directly related to revisions of the latter: a downward revision of potential output means an upward revision of the output gap. In Finland, revisions of the level of potential output were large around the financial crisis, compared to Germany and Sweden. These revisions in turn were driven mainly by revisions of total factor productivity, development of which stagnated in Finland.

These large revisions of potential output can be seen in figure B2.1.2. For instance, the latest estimates of potential output in 2006—2011 are lower than the real-time estimates, i.e. the real-time estimates of potential output were biased upwards. Additionally, Finland has still not returned to its pre-crisis growth rate, which is seen in the curve being flatter after 2015 than before 2008. On the other hand, potential output in Germany and Sweden was much less affected by the financial crisis, with both being able to maintain their pre-crisis growth rates.

Another area of interest beyond the real-time issues is forecasting the development of potential output, as this can be seen as a measure of growth beyond the short term. This kind of estimate is needed if one wants to build a projection for fiscal policy. The yellow parts of the lines in figure 2 denote the projected values of potential output. Although the over- and undershooting of the latest estimate follows a roughly similar pattern between the three countries, the magnitude of forecast errors is much greater for Finland than for either Germany or Sweden. This can of course be problematic if policy planning is based on these projections.

Figure B2.1.2. EPC's estimation results for Finland, Germany, and Sweden.

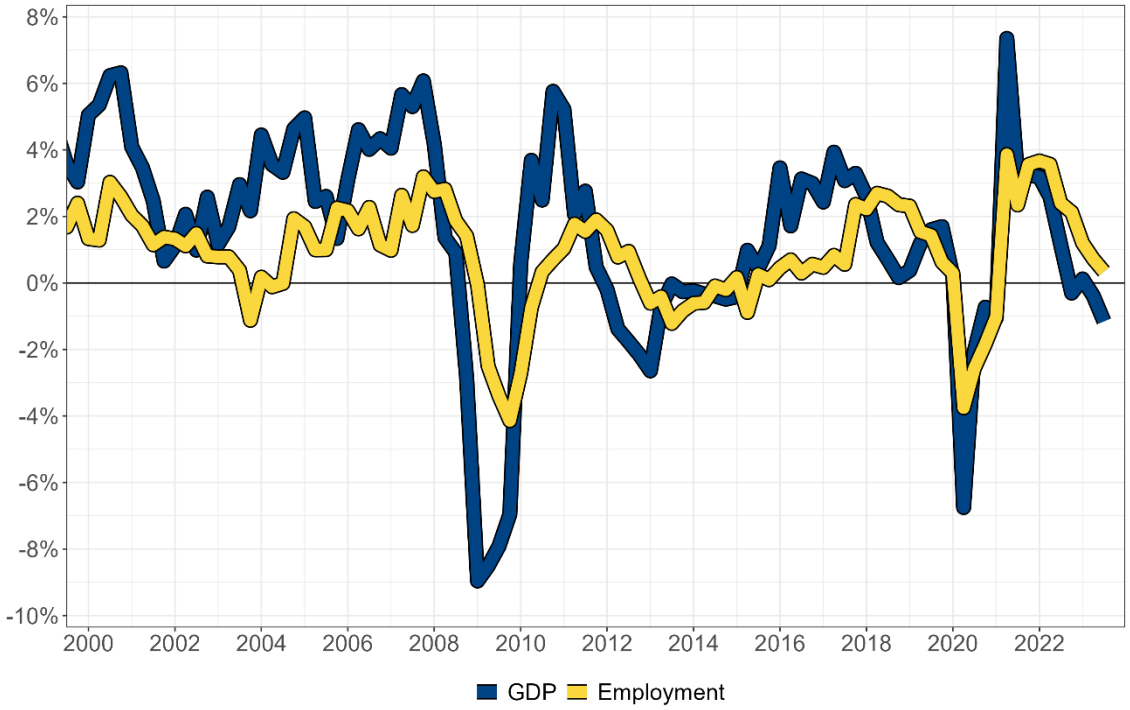


Source: Rybarczyk (2023). Note: Vintages of potential output (solid blue lines), latest vintage of estimated potential output (thick red line), latest vintage of real GDP (dashed line), and forecasts of potential GDP (yellow line). All values are normalised such that the 2000 value is equal to 1. The potential GDP series is shifted by the value of the output gap in 2000 so that the difference between the dashed and red lines can be interpreted as the output gap. The estimation is done using the spring 2023 version of the EUCAM software.

2.3. Labour market developments

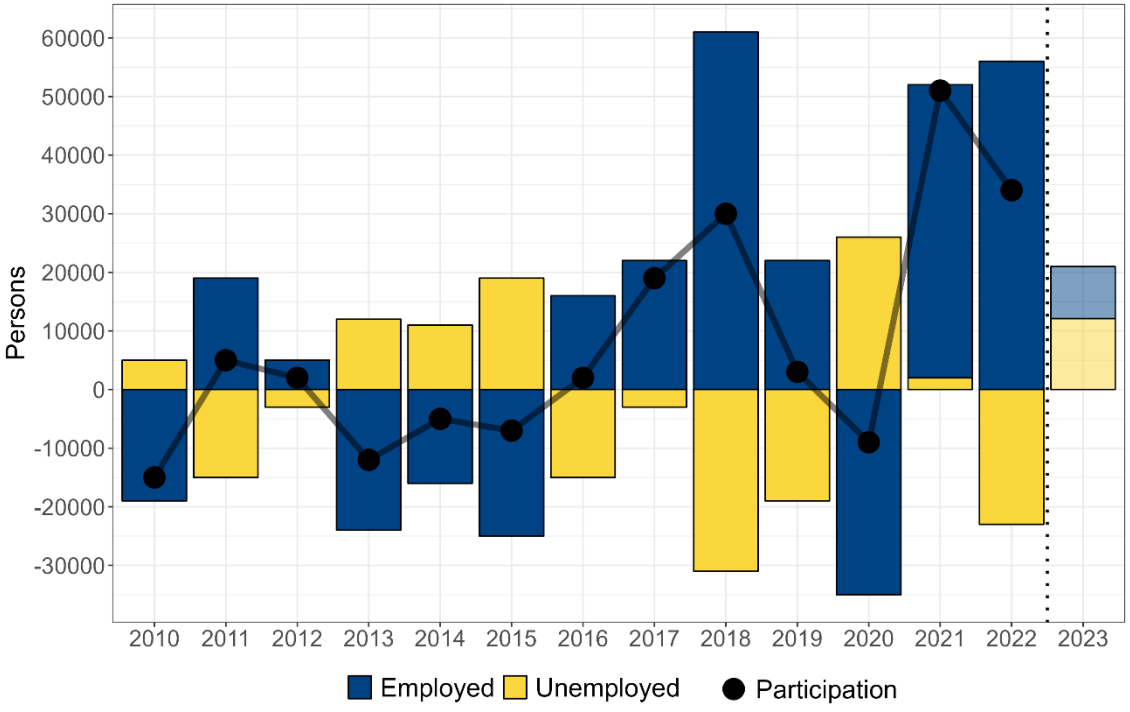
Notwithstanding the short-lived drop in employment due to the Covid-19 pandemic in 2020, the employment rate has been steadily increasing since 2015. In 2023, growth in the employment rate has stalled as the economy is facing a downturn, but the trend employment rate in the 20-64 year-old age group was still 78% in October 2023. Changes in total employment and economic activity as measured by changes in GDP are depicted in Figure 2.3.1.

Figure 2.3.1. Quarterly year-over-year changes in employment and GDP (%).



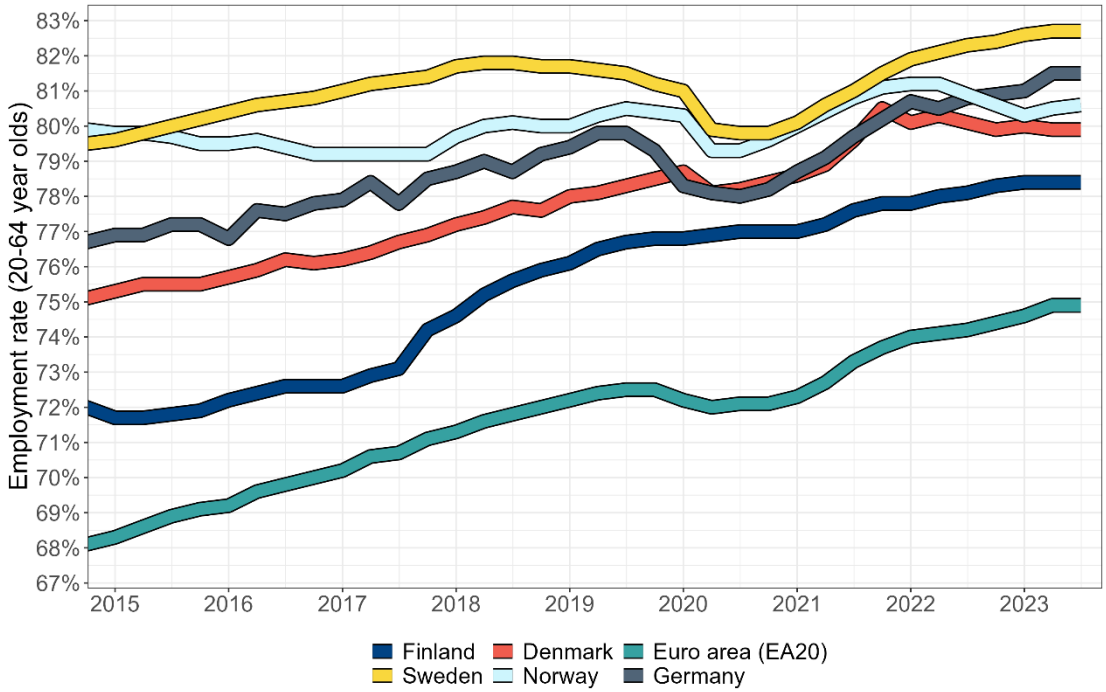
Source: Quarterly National Accounts (Statistics Finland).

Figure 2.3.2. Annual changes in employment, unemployment, and labour force participation 2010 – 2023*, 15-64 year-old population.



Source: Labour Force Survey (Statistics Finland). Note: 2023 based on first 10 months.

Figure 2.3.3. Employment rates in selected countries (20-64 years).



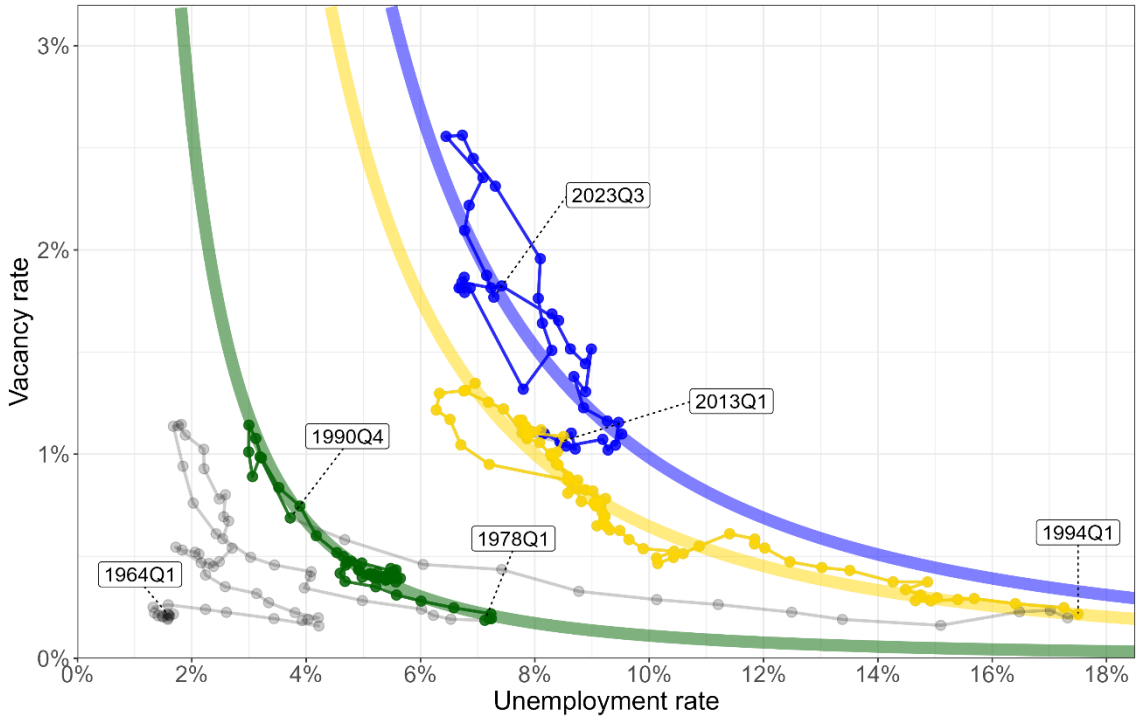
Source: Eurostat (LFS)

Even though the unemployment rate in Finland increased by less than the OECD average after the Covid-19 pandemic, it took 27 months to return to pre-pandemic levels, or six months longer than the OECD average (OECD 2023). This was despite a strong recovery in employment and participation rates. In Figure 2.3.2, there is a small increase in unemployment despite strong employment growth in 2021; unemployment has increased again in 2023. Figure 2.3.3 plots employment rates in a selected group of European countries. Finland is still lagging behind the other Nordics and Germany, but the employment rate is higher than the euro area average.

One measure for evaluating the efficiency of labour markets is the Beveridge curve. This curve features a negative relation between unemployment and vacancies: less unemployment requires more vacancies and fewer vacancies are associated with increased unemployment. Over the business cycle, unemployment and vacancy rates move *along* the Beveridge curve. Moreover, the Beveridge curve *may shift outwards or inwards* in the long run if there are changes in the process where jobseekers and employers find each other and make hiring decisions. The Beveridge curve for Finland is plotted in figure 2.3.4. It shows relatively high vacancy and unemployment *rates* in 2022, when

the job vacancy rate reached a historic peak.[2] However, even with record high vacancy levels, unemployment did not fall below 6%. More recently the labour market has become less tight as the number of vacancies has decreased and unemployment has increased slightly.

Figure 2.3.4. Beveridge curve for Finland (1964Q1-2023Q3).

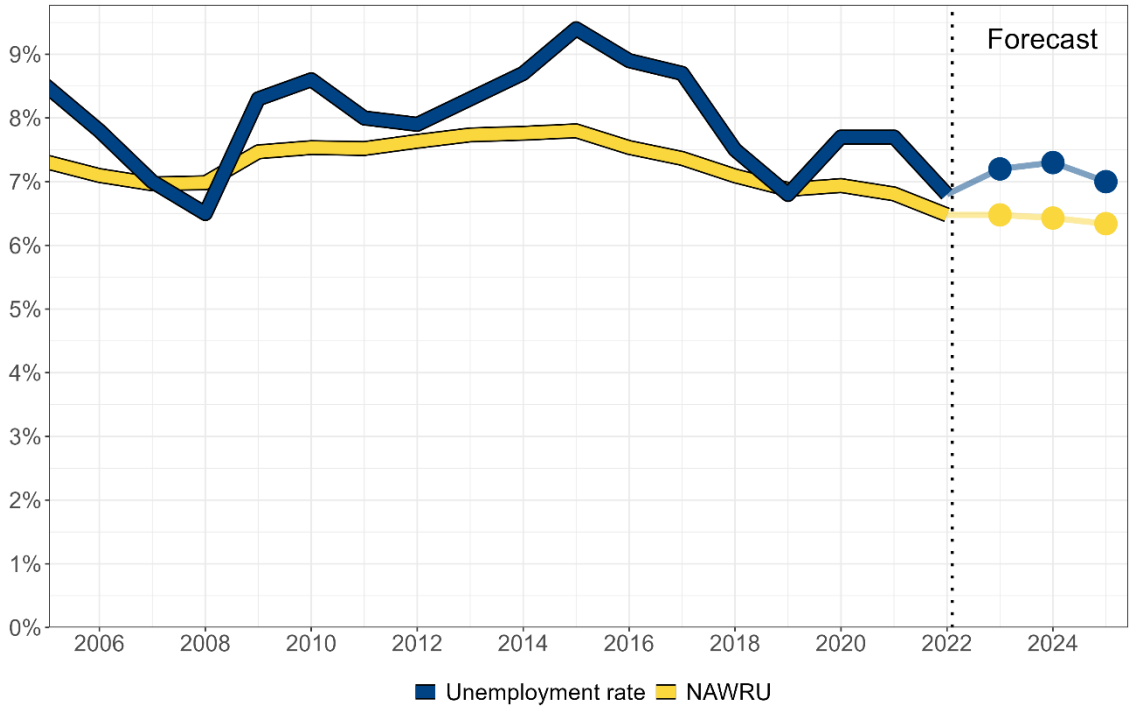


Source: Gäddnäs and Keränen (2023), updated with more recent data. Note: The blue curve is fitted with observations for 2013Q1-2023Q3 as the sample. The coloured Beveridge curves reflect the shifts in the average positions for 1978-1990 (green curve) and for 1994-2012 (yellow curve).

Another frequently used measure of labour market efficiency is NAWRU (Non-Accelerating Wage Rate of Unemployment), which represents the lowest level of unemployment that would not cause unsustainable inflationary pressures. Figure 2.3.5 plots the European Commission's estimates of NAWRU and the actual unemployment rate. The gap between the two is forecast to widen somewhat as unemployment is forecast to increase from 6.8% in 2022 to 7.2% and 7.3% in 2023-2024. The Commission estimates that NAWRU will be slightly below 6.5% in Finland in the same period.

[2] For a more thorough analysis of the Beveridgean unemployment gap in Finland, see Gäddnäs and Keränen (2023).

Figure 2.3.5. Unemployment rate compared to the non-accelerating wage rate of unemployment (NAWRU) in Finland.

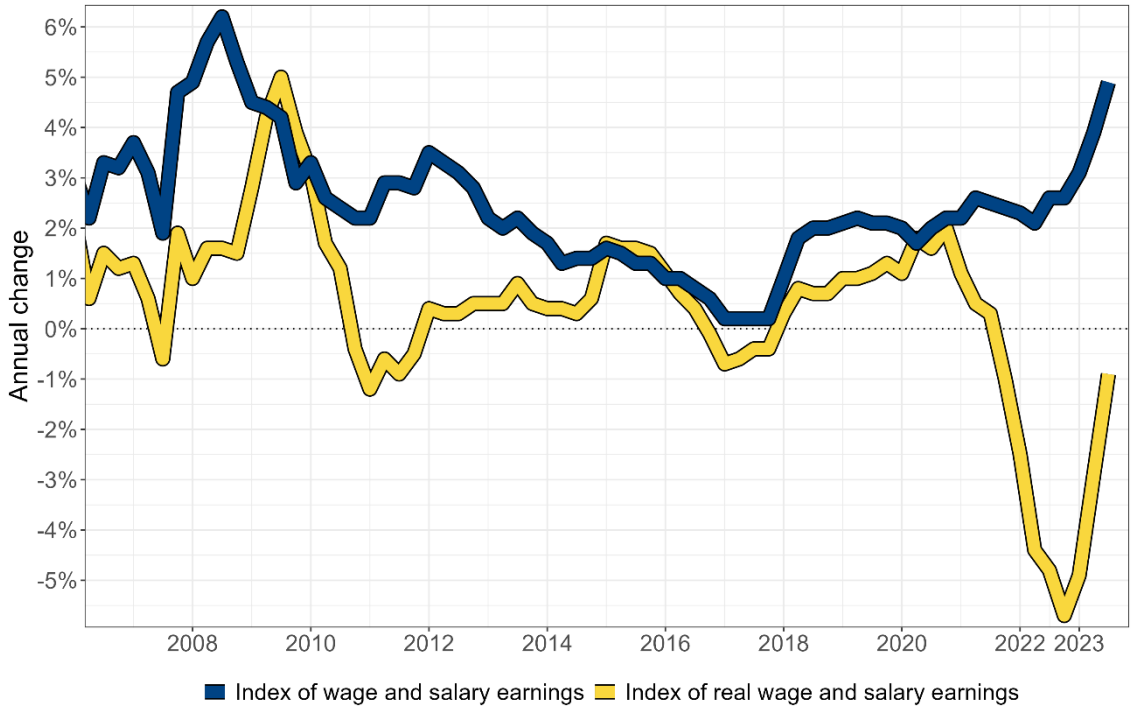


Source: European Commission (Ameco database).

Developments in the labour market are typically also reflected in changes in the price of labour. Despite the recent sharp increase in inflation, nominal wage increases (both contract wages and wage drift) have remained modest. This has led to a decrease in real wages both in 2022 and in 2023 (Figure 2.3.6). However, the earnings index is not the only indicator that can be used for measuring purchasing power. Obstbaum and Pönkä (2023) measure purchasing power by the combined income of all households, which includes not only wage income but also pensions and other social benefits and allowances received by households and capital income, all income net of taxes.[3] Their analysis points to a favourable trend in real purchasing power, partly due to an improvement in employment.

[3] In their analysis, purchasing power is deflated to real terms by the private consumption price index.

Figure 2.3.6. Nominal and real annual changes in earnings index (%).



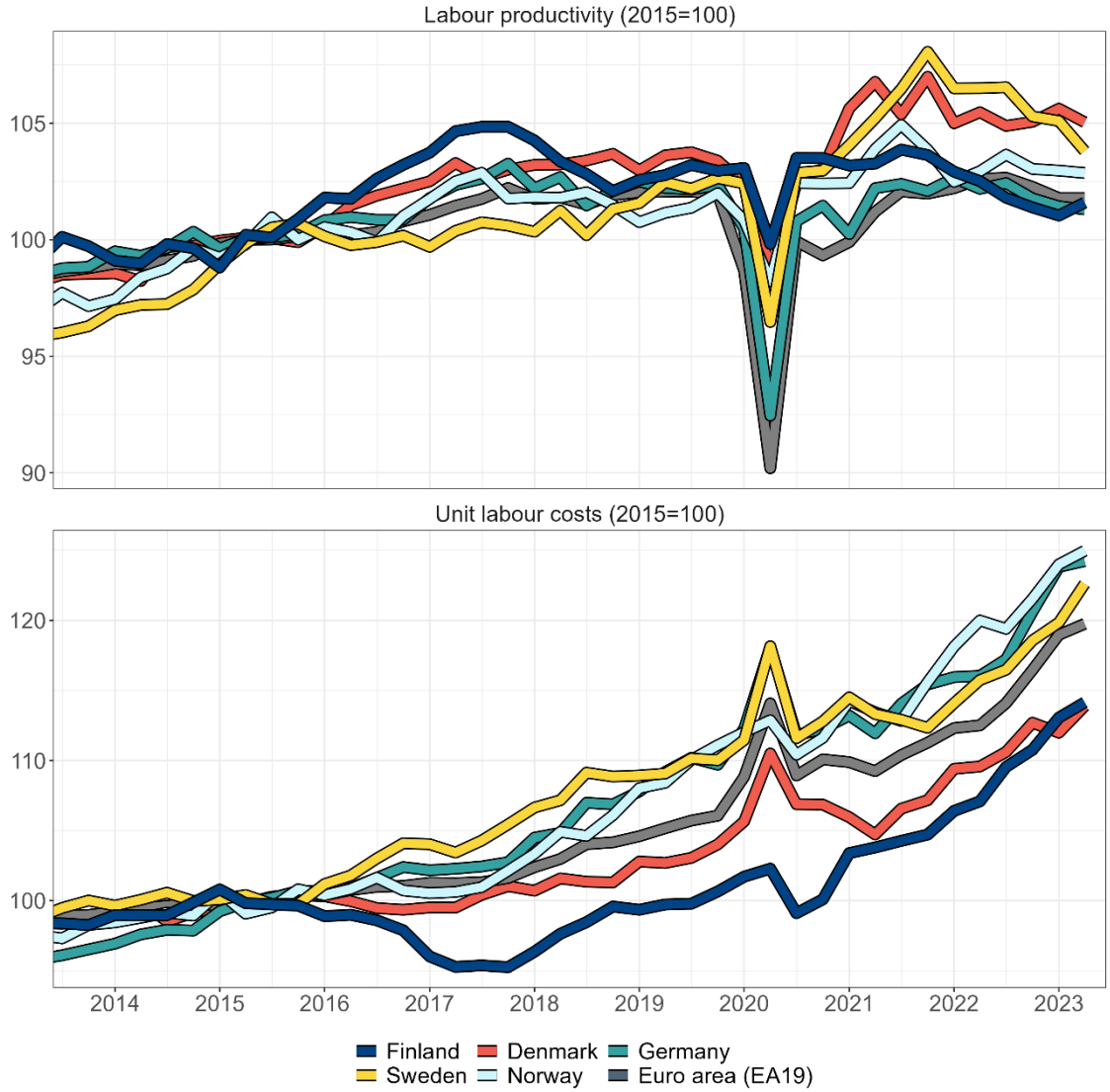
Source: Wages and salaries, Statistics Finland.

Finally, wages and unit labour cost developments play an important role in cost competitiveness for an export-driven small open economy such as Finland. Unit labour cost growth in Finland has been similar to competitor countries since 2017 and cost competitiveness has remained stable (see Figure 2.3.7).

Labour productivity growth in Finland and in other euro area countries on average has not been very strong (upper panel). However, Finland's labour productivity performance has generally been weaker than in its competitors. After 2015, Finland's labour productivity growth was briefly faster than in the reference countries, but has been slower in recent years, except for 2020.

Weak labour productivity growth has been offset by weak wage growth. In particular, Finland's cost competitiveness, as measured by unit labour costs, started improving against comparison countries in 2016 (lower panel), mainly because of the cost competitiveness pact of 2016. Since then, compensation per hour worked has underperformed peer countries in every year, which has kept Finland's cost competitiveness reasonably good. However, as the Finnish Productivity Board (2023) points out, it would of course have been better if competitiveness had remained good thanks to rapid productivity growth rather than slow wage growth.

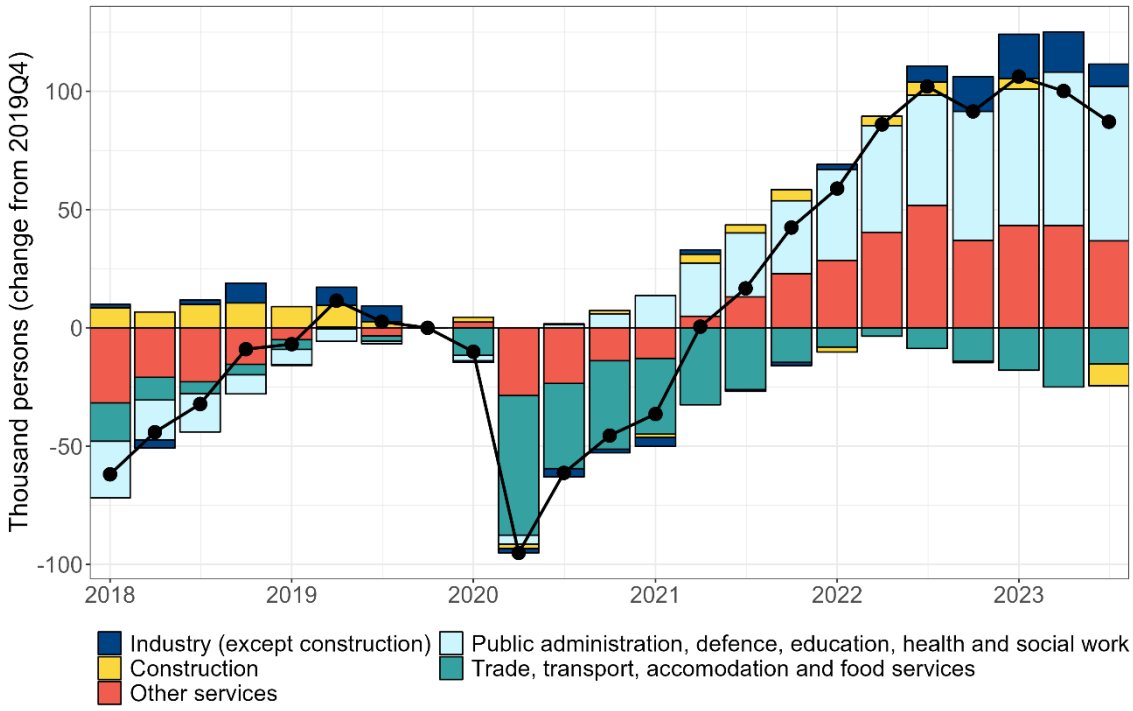
Figure 2.3.7. Labour productivity and unit labour costs in selected countries.



Source: OECD.

We finally look into sectoral developments to get a deeper understanding of the economic situation. The pandemic affected different sectors of the economy in different ways, as seen in Figure 2.3.8, which shows total employment in different sectors. We focus on changes in the number of employed persons since 2019Q4. Two findings stand out. First, employment in the public sector has increased since the onset of the pandemic, which is reflected as a positive contribution of the sector that includes public administration, defence, education, health and social work. This increase has to a large extent cushioned the economy during the crisis, but at the same time may provide challenges for the fiscal deficit going forward if the growth in the public sector is manifested in permanent increases in public employment.

Figure 2.3.8 Number of persons employed, thousand persons (change from 2019Q4)



Source: Quarterly national accounts.

Second, employment in other sectors declined during the pandemic, but to a varying degree. Services that relied on human-to-human interaction were more affected than services provided in a virtual environment or, for example, highly automated manufacturing that could operate with a smaller risk of the virus transmitting. Figure 2.3.8. shows that in 2020 employment dropped most significantly in the trade, transport, accommodation and food services sector. Employment has yet to recover to pre-pandemic levels in that sector. At the same time, the decline in industry and construction was much less severe than in other sectors, as they were able to remain operational. More recently, however, the construction sector is experiencing a decline as demand is falling amid the recent rise in interest rates.

2.4. Recent rise in interest rates and its effects

In response to increased inflation, central banks have increased their policy rates. Tighter monetary policy is also reflected in market interest rates, which

have been on the rise. A long period of low nominal interest rates seems to have come to an end for now.

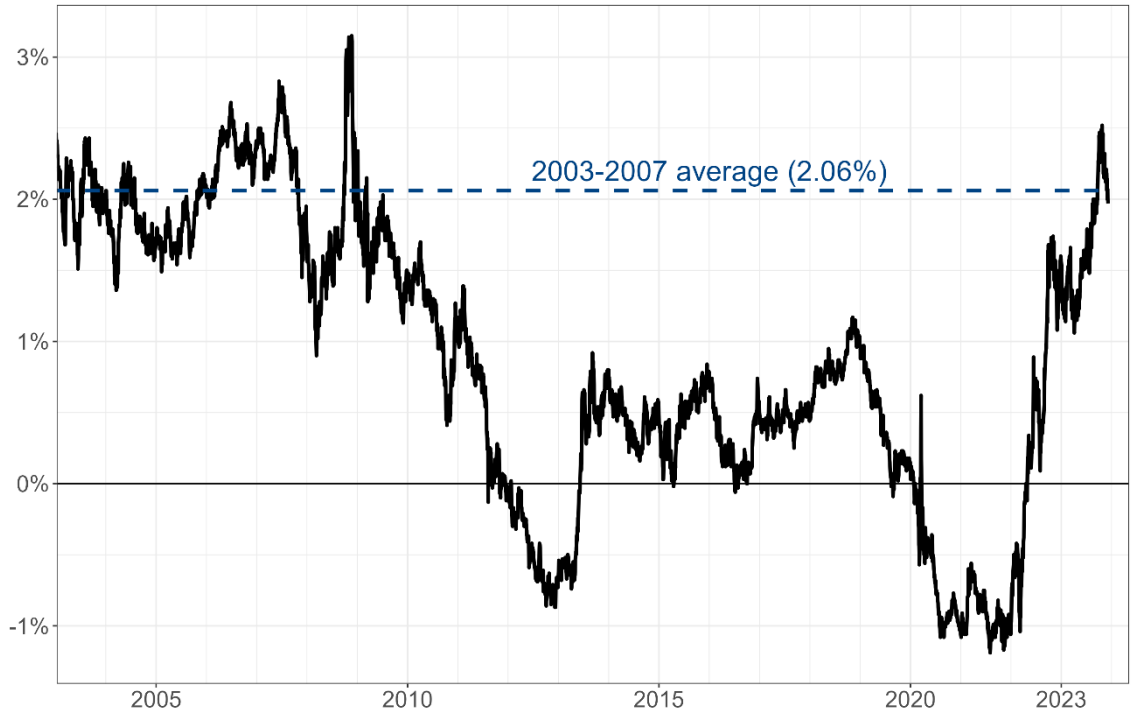
Even though interest rates have started to rise, actual real interest rates have been low in recent years due to high inflation. Real interest rates, which adjust nominal rates for inflation, reflect the true cost of borrowing and real earnings from investments. In doing so, they capture the cost of current and future consumption taking inflation into account. Central banks focus on these rates when shaping monetary policy, as they more accurately reflect the economic impact of policy changes. Recently, the real rates have also risen due to structural changes, such as demographic shifts and the advent of technology.

Perhaps the best indicator of the true increase in interest rates can be found in the market for inflation-indexed bonds, which promise a rate of real return. Changes in interest rates can be inferred from pricing on the secondary market where investors buy and sell these bonds. In contrast to bonds promising a nominal return, the real yield on inflation-indexed bonds does not depend on what happens to inflation from now on, which is uncertain.

The largest market for inflation-indexed bonds is in US treasuries. Market data on these bonds over time gives us a direct measure of the real interest rate that investors demand when lending to the US government. The yield on inflation-indexed 10-year US government bonds has risen from roughly -1% to around 2% since early 2022 (Figure 2.4.1.). This 3%-point increase indicates that investors believe that the rise in interest rates is not temporary in nature but a more permanent change in macroeconomic conditions. As the 10-year treasury bond can considered to be a safe asset, this change can be attributed to a rise in the expected safe rate of interest.

The new interest rate environment has broad implications. The cost of borrowing has gone up and previously accumulated debts, both public and private, will be more costly to manage in the future. High inflation has meant that real interest rates up to now (nominal interest rate minus inflation) have been low. However, market rates on inflation-indexed bonds indicate that interest rates will remain higher even after inflation has come down from its current levels.

Figure 2.4.1. Interest rate on inflation-indexed 10-year (constant maturity) US government bond.

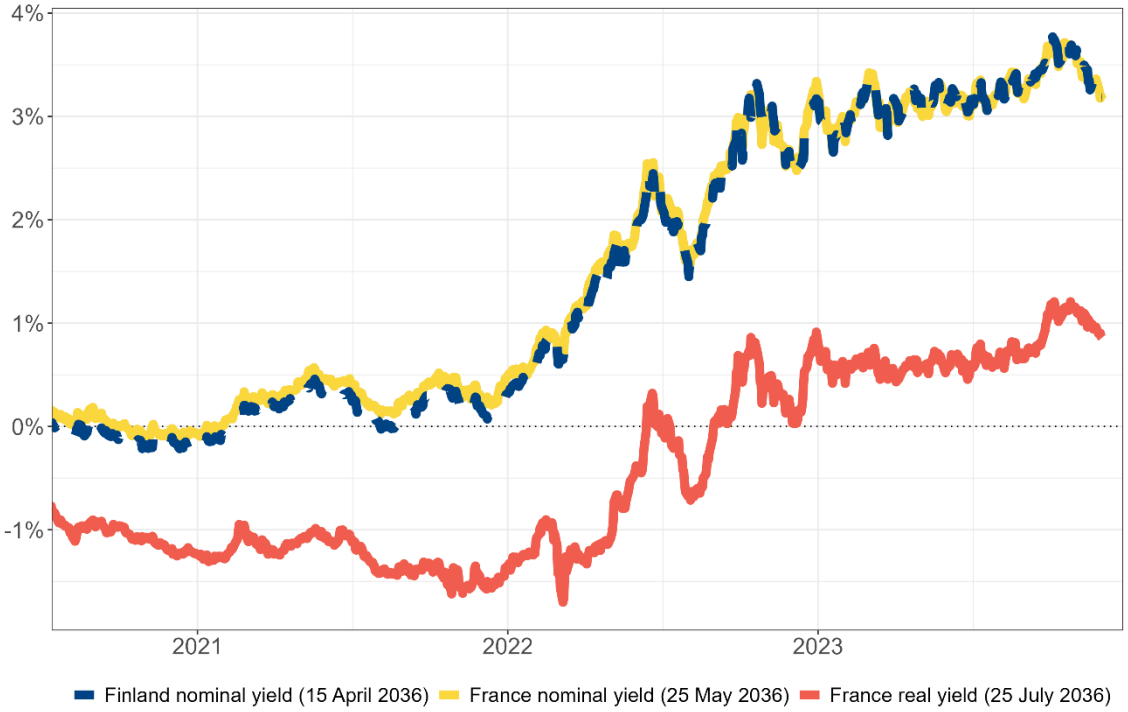


Source: FRED. Notes: Most recent observation is for December 7th 2023.

To get a sense of developments in Europe, Figure 2.4.2. depicts the yields of selected government bonds for Finland and France. All the bonds have a similar time to maturity, making the yields comparable. Since France issues both nominal and inflation-indexed bonds, we are also able to infer changes in inflation expectations. Here the real French yield is based on OAT€i, which is indexed to euro area HICP. Thus, the comparison between the French real and nominal yields provides an estimate of inflation expectations in the euro area.

The real yield on French government bonds has risen from roughly -1.5% in late 2021 to around 1% in 2023. This marks a 2.5%-point rise, which is comparable to the slightly larger rise in US real yields (Figure 2.4.1.). Based on market pricing, it thus seems that real interest rates have also turned positive in the euro area. Most of the rise in French nominal yields is explained by the change in real rates rather than changes in euro area inflation expectations, which have increased only slightly. At the same time nominal yields on French and Finnish bonds have continued to develop very similarly. It is therefore reasonable to think that the rise in Finnish government bond yields reflects the same rise in real interest rates (which are not readily observable for Finland) that is observable in both US and French real rates, rather than other factors.

Figure 2.4.2. Yields on selected Finnish and French government bonds maturing in 2036.

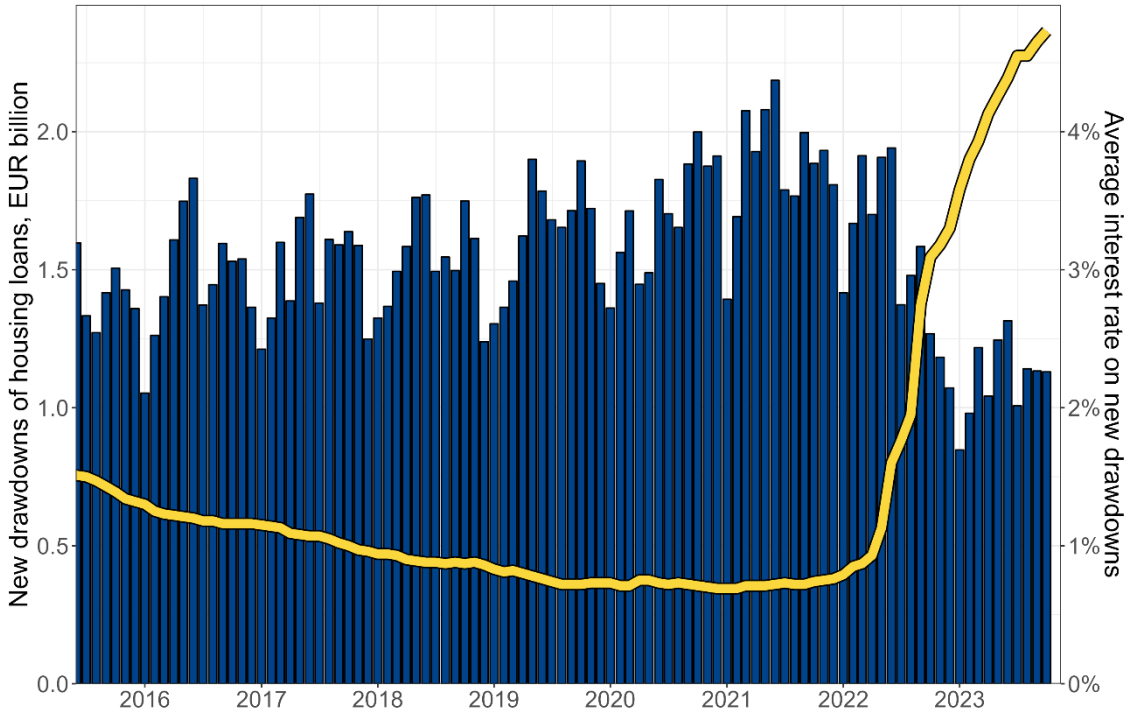


Source: Bank of Finland (Reuters), Agence France Trésor (Bloomberg). Note: Maturity date in parentheses. French real yield is for OAT€i, which is indexed to euro area HICP.

In response to higher interest rates, households have decreased their borrowing. Figure 2.4.3 plots monthly new drawdowns of housing loans in Finland and the average interest rates on them. New drawdowns have almost halved from 2 years ago when interest rates on new loans were still low at less than 1%. The interest rate on new housing loans averages roughly 4.5% currently.

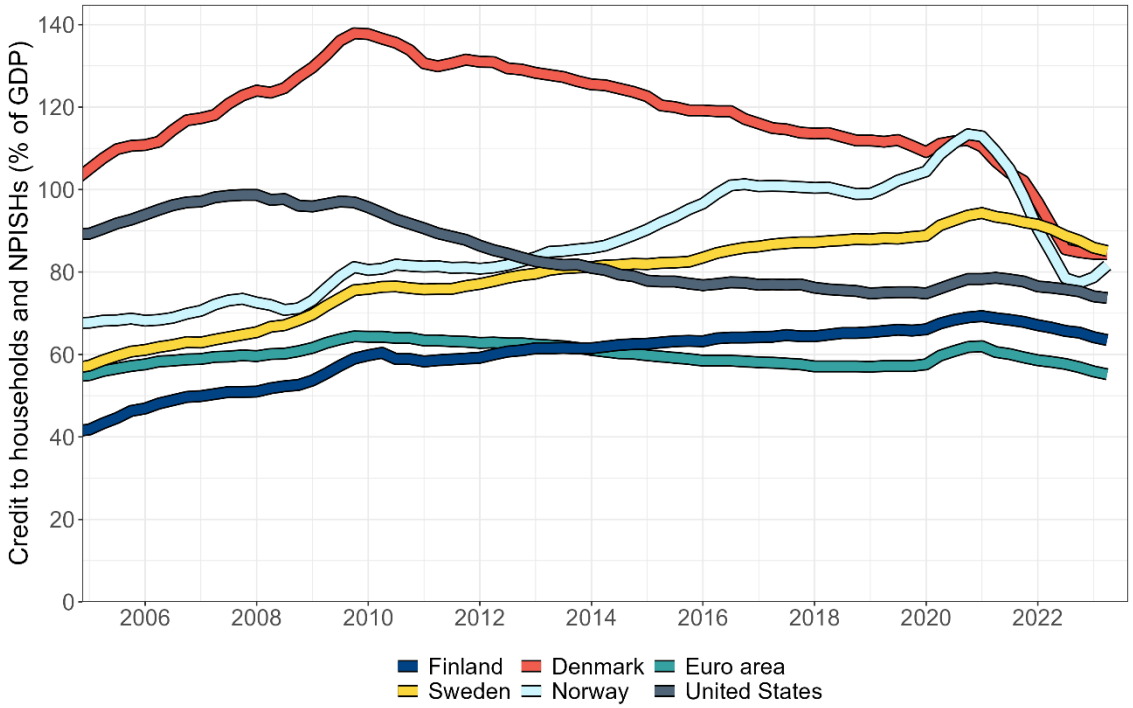
High levels of private or public debt imply a vulnerability to tightening of financing conditions. Persistently high inflation implies a need for tight monetary policy and may constitute a risk to financial stability. The Finnish household sector has less debt as a share of GDP than households in other Nordic countries (Figure 2.4.4). In Finland, the total credit to households and NPISHs (non-profit institutions serving households) in 2022 was less than 70 per cent of GDP, which is only slightly more than 10 years ago. Recently the share of debt to GDP has also decreased because nominal GDP growth has been high. If the nominal incomes of the household sector rise, this makes debt servicing easier.

Figure 2.4.3. New drawdowns of housing loans by households, monthly.



Source: Bank of Finland

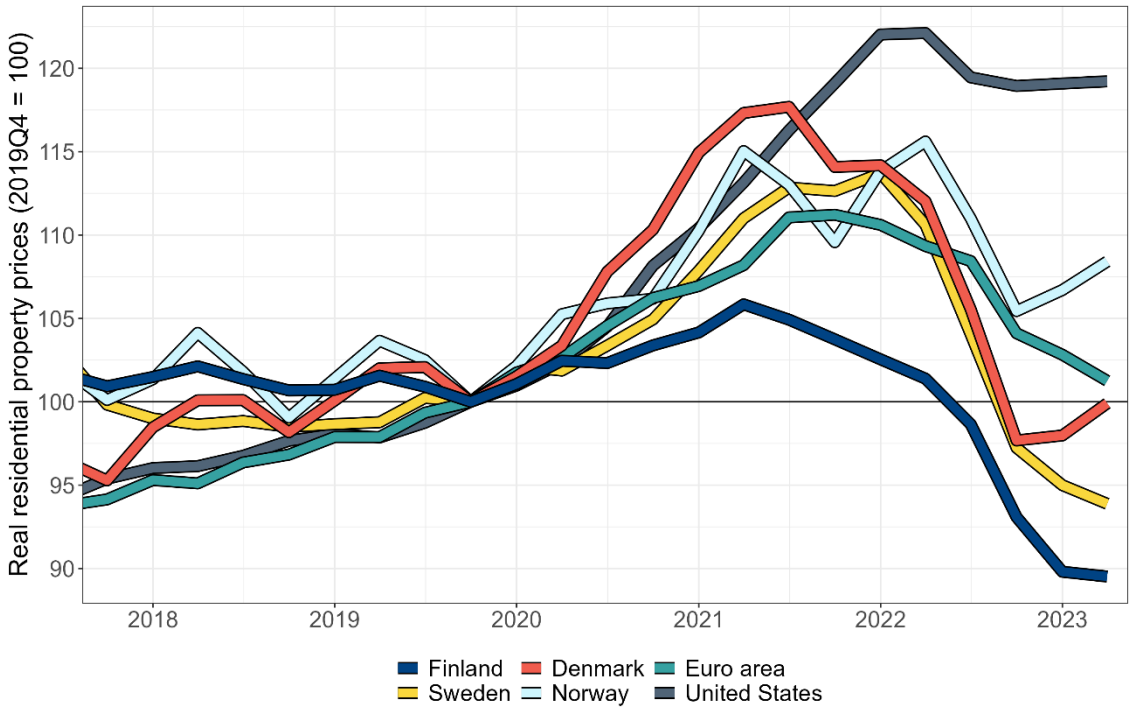
Figure 2.4.4. Household debt in selected countries.



Source: BIS. Note: Values for Norway have been scaled to represent % of mainland GDP.

Residential property prices increased in many countries in the aftermath of the outbreak of the pandemic as activity increased (Figure 2.4.5). The property price increase was relatively modest in Finland compared to the other Nordics, the euro area and the United States. Residential prices turned downwards in 2022. This is not surprising, as higher long-term real interest rates typically lead to lower real house prices because they increase the cost of borrowing. Despite that, in early 2023 nominal house prices were still higher than before the pandemic hit. This then gives less reason for immediate concern.

Figure 2.4.5. Real residential property prices, index (Quarter 4 2019=100).

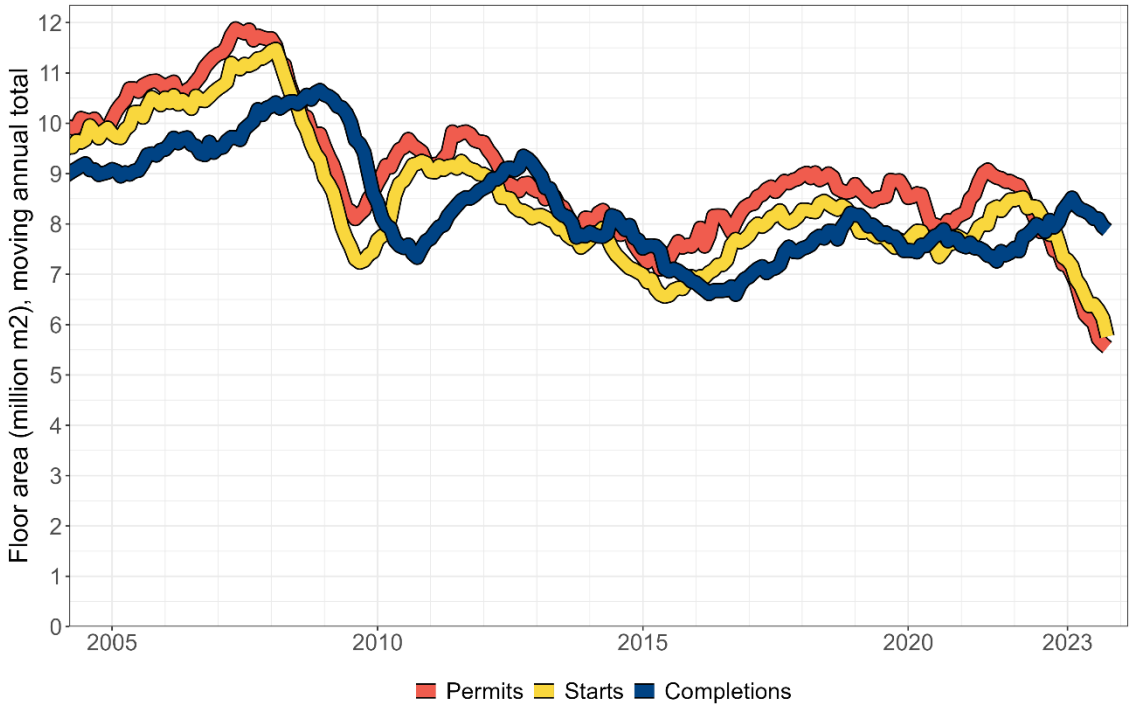


Source: BIS.

Changes in the demand for housing and commercial real estate have implications for the construction sector. This can be seen in Figure 2.4.6., which depicts building permits, starts and completions. New permits over the last 12 months have dropped sharply - by around a third from a year ago. Historically, changes in new permits lead building completions by around 18 months. Naturally, the effect on construction comes earlier than this and the volume index of newbuilding has already declined significantly from 2022 levels (source: Statistics Finland). In Figure 2.4.6, the pace of the drop in building permits is comparable to the drop in 2008. Back then, employment in the construction sector decreased by less than 20,000 persons (less than 10%). Thus far, while there are signs of increased unemployment in this

sector, a similarly large drop in construction sector employment is not yet visible in the data (see Figure 2.3.8).

Figure 2.4.6. Building permits, starts and completions.



Source: Statistics Finland.

2.5. Conclusions

Recent economic developments have been impacted by the Covid-19 pandemic and Russia's invasion of Ukraine. Finland's GDP growth, while relatively resilient during the pandemic, lagged behind the other Nordic countries in 2021 and 2022, with a slight contraction expected in 2023. Inflation in Finland peaked at 9.1% in 2022, influenced by global supply chain disruptions and the Russian invasion, but is projected to decline to around 2% in 2024.

In 2023, government consumption and net exports have contributed positively to growth, while the contribution from investment and inventories has been negative. For 2024, output is expected to be below its potential level. Hence the output gap will be negative, and the economy will not be operating at normal capacity. However, output gap estimates are often unreliable in real time (Box 2.1), and are subject to revisions, so care should be taken in basing policy on uncertain gap measures. Furthermore, compared to the past, the

level of vacancies is still relatively high, even though the labour market has become more slack than in 2022. The Council's view is therefore that the negative output gap does not justify additional broad-based stimulus measures on top of the current structural deficit.

Measures of labour market tightness have been increasing and reached historical peaks in 2022. Since then they have come down slightly. The Beveridge curve, which measures the efficiency of the labour market, shows relatively high vacancy and unemployment rates, with the unemployment rate close to the European Commission's estimates of equilibrium unemployment.

Finland's unit labour cost growth has remained stable since 2017, contributing to consistent cost competitiveness against comparable countries. Still, Finland's labour productivity has generally been weaker than comparable countries. The recent weak productivity growth has been offset by slow wage growth, contributing to some improvement in cost competitiveness.

Central banks responded to increased inflation by raising policy rates, leading to a rise in market interest rates. However, long rates increased before that due to structural changes. As inflation has gradually come down, the real interest rate has increased further, impacting borrowing costs. Housing loan drawdowns have also decreased sharply in response to higher interest rates, and residential property prices have recently started to decline. High levels of private or public debt imply a vulnerability to tightening of financing conditions. Still, Finland's household sector has a relatively low level of debt compared to the other Nordic countries, making this concern less severe in the Council's view.

The pandemic has affected sectors in Finland differently, with employment in services being more negatively affected. On the other hand, growth in employment in the public sector has increased sharply. Furthermore, the trend in labour productivity has been declining in Finland in recent years. This points to structural challenges for the Finnish economy going forward. For the near future, the Council also sees potential downside risks in the construction sector downturn in the current economic situation.

3. Employment policy

As discussed in the previous chapter, in the very recent past employment has responded quite rapidly to economic activity and the business cycle. Over the longer term, almost a decade, employment has increased. Nevertheless, Finland's employment rate lags behind its Nordic peers and many other advanced economies (Figure 2.3.3).

High employment has become an increasingly important policy objective for governments. Most people value the opportunity to earn their own living, and having a job means having a higher income. From a societal perspective, high employment helps to prevent poverty and increase social cohesion. It also helps to balance public finances, and the problems of rising public debt put increasing pressure on employment targets. Finland is an example of a country where numerical employment targets have come to play a central role in economic policy. However, labour market policies are also needed because of the rapidly evolving skills needs, driven by population ageing, digitalisation and the green transition.

The European Commission also makes recommendations on employment policy. In the context of the 2023 European Semester, one of the recommendations for Finland was to reform the social benefit system to increase its efficiency. The aim should be to improve work incentives and support the long-term sustainability of public finances. In addition, labour and skills shortages should be addressed by re-skilling and up-skilling the workforce and by increasing the supply of higher education in the fields most in demand in the labour market.[4]

Following the practice of previous Finnish governments, the government of Prime Minister Petteri Orpo included employment policy targets in its programme. The government aims to achieve an employment rate of 80 % by

[4] COM (2023) 626 final

2031 and it will also make efforts to increase the number of hours worked. The programme includes a number of reforms aimed at reducing incentive traps by reducing the level of social security in relation to achievable wages. In doing so, the government expects to increase employment by tens of thousands of new employees.[5] These employment-improving reforms are expected to boost public finances by EUR 2 billion. In addition, the government will continue with the reforms of employment services decided in the previous parliamentary term.

In this chapter, we first characterise the changes in (un)employment in the Finnish labour market to gain insight into the potential target groups of the structural reforms and employment policy measures. Against the background of labour market developments, we discuss the government's employment policy objectives and its reforms aimed at improving the incentives to work, and review some of the estimated employment effects of the proposed reforms. Finally, the proposals for reforming immigration policy are briefly reviewed.

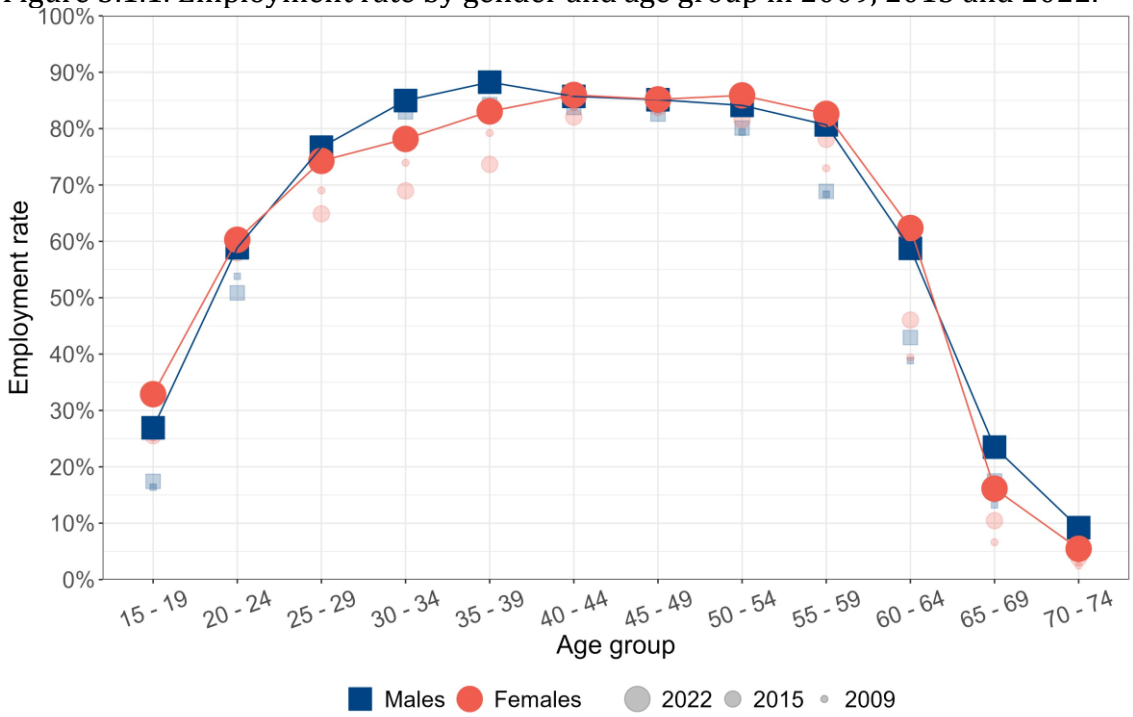
3.1. Employment developments and unemployment

For almost 10 years, Finland's labour market has been characterised by increasing employment following the rather stagnant period after the 2008 financial crisis. The increase in the *employment rate* has been strong, particularly in age groups near or above the old-age retirement age. Both male and female employment rates have increased significantly in older age groups, especially in the 60-64 age group. This trend was (and still is) reinforced by the 2017 structural reform of the pension system, which raises the lower age limit for old-age pensions by three months per year between 2018 and 2027. There has also been a significant increase in the employment rate of women aged 25-39. (Figure 3.1.1.)

Despite the considerable increase in the female employment rate, Figure 3.1.2 sheds light on why the employment rate for women is still lower than for men, especially in the age groups 30-34 and 30-39. If there are children in the family, the younger the youngest child the lower the female employment rate.

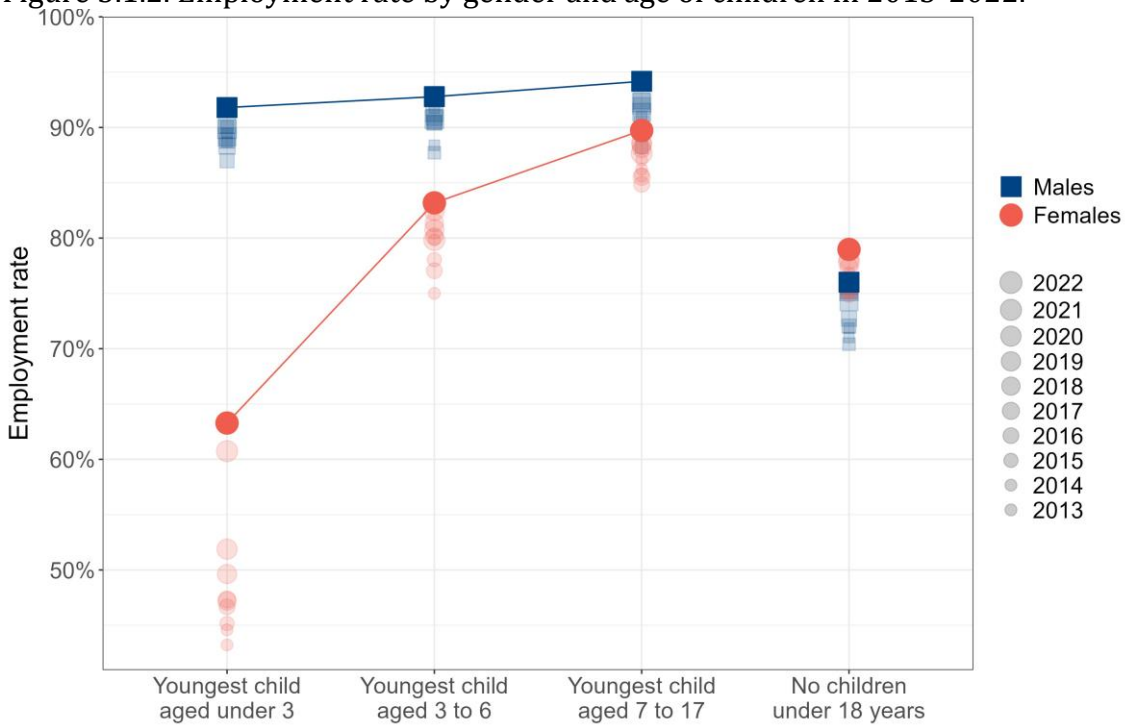
[5] Programme of the government of Prime Minister Petteri Orpo (p. 66). In the following, this programme will be referred to simply as the government programme.

Figure 3.1.1. Employment rate by gender and age group in 2009, 2015 and 2022.



Source: Labour Force Survey (Statistics Finland)

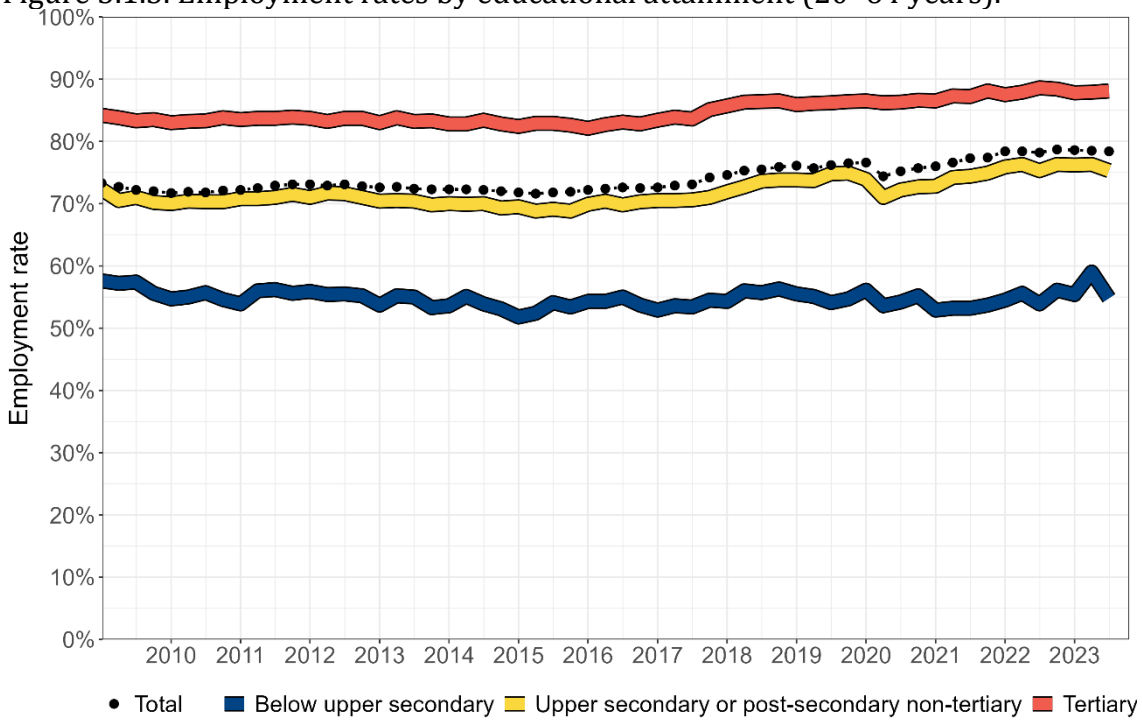
Figure 3.1.2. Employment rate by gender and age of children in 2013-2022.



Source: Labour Force Survey (Statistics Finland)

In any case, the gap between female and male employment rates has narrowed due to the increase in the employment rate of women with a youngest child under 3 (Figure 3.1.2).[6]

Figure 3.1.3. Employment rates by educational attainment (20–64 years).



Source: Eurostat

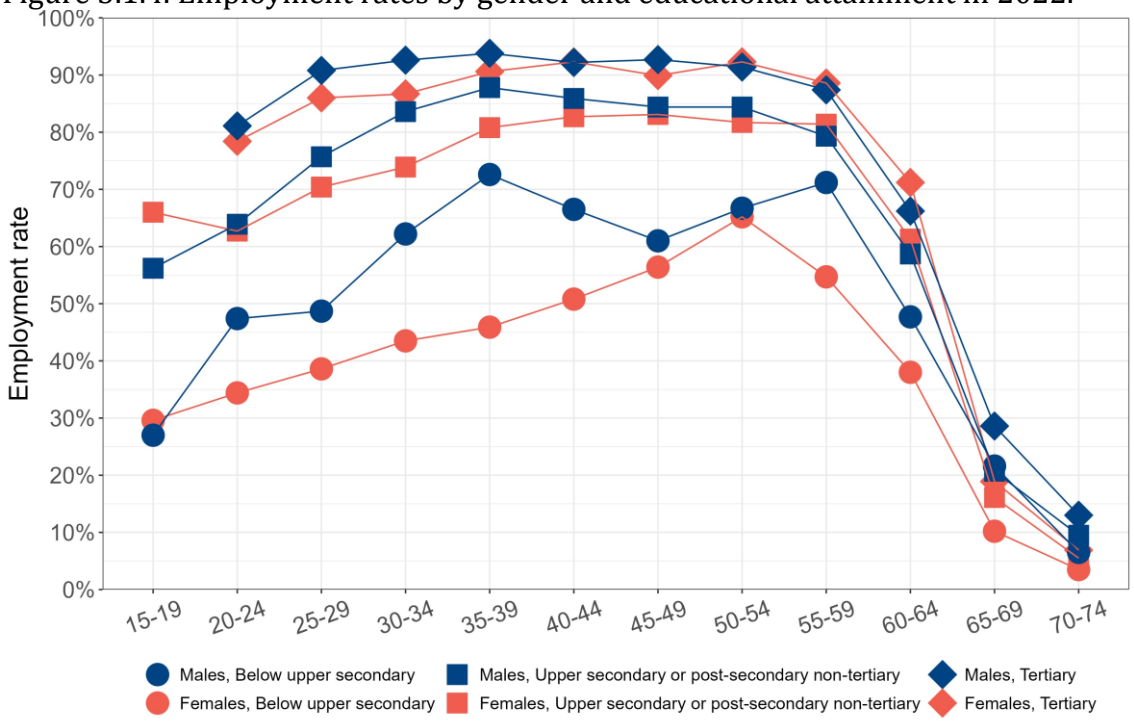
It is important to note that the employment rate also differs by level of education. The educational gap in employment rates is large and the difference between the lowest level of education ('less than upper secondary') and the highest level ('tertiary') is around 30 percentage points (Figure 3.1.3). This gap has also remained relatively stable over the years, posing a challenge to employment targets, even though the share of the population with the lowest level of education is decreasing. [7] This gap exists across all age groups and is even greater for younger age groups (Figure 3.1.4). Many people in these age groups are still studying and this clearly contributes to the size of the gap. There is also a gender gap, especially among those with less education, where the employment rate of women under 45 is much lower

[6] The measurement of employment rates also depends on the definition used. In 2021, the definition was changed to treat those on earnings-related parental leave as employed. The data in figure 3.1.2 use this new definition. However, according to Statistics Finland, the years before and after 2021 are not fully comparable.

[7] For example, in 2022 there were over 700,000 persons aged 15 – 64 with only basic education in spite of the past overall rise in the educational structure of the population.

than that of men. Unfinished studies and childcare responsibilities are among possible reasons explaining the difference.[8] For those with a higher level of education (upper secondary or higher) aged 45 and over, the difference in employment rates between men and women is less pronounced.

Figure 3.1.4. Employment rates by gender and educational attainment in 2022.

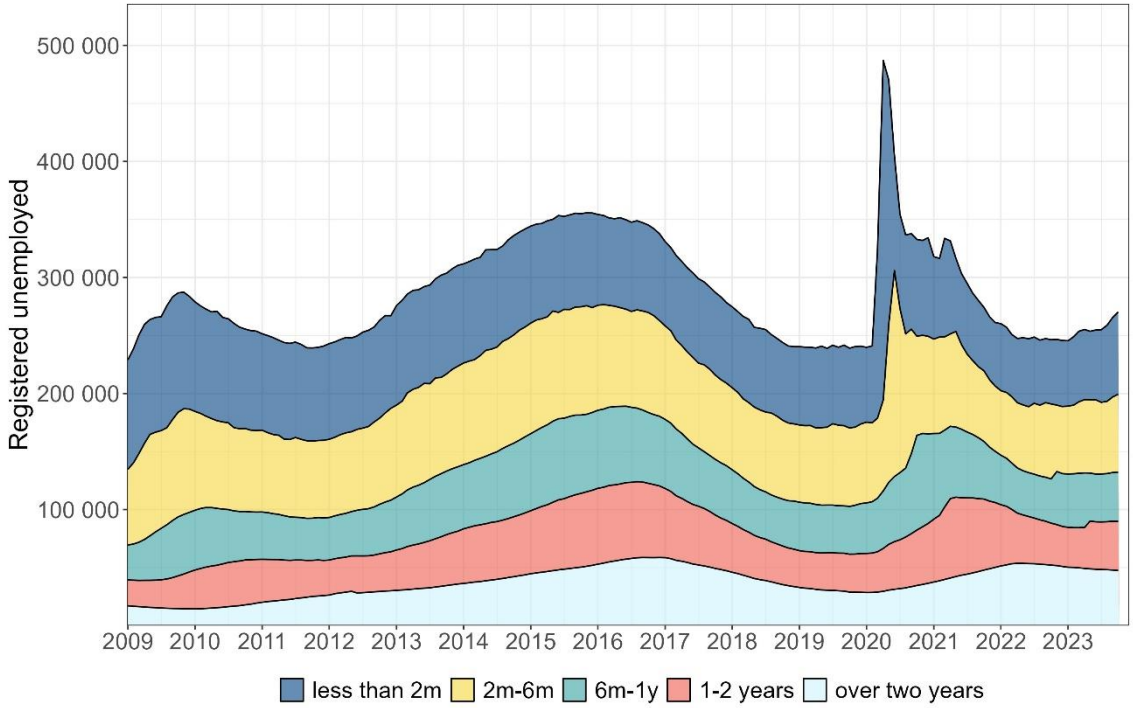


Source: Labour Force Survey (Statistics Finland). Note: age group on the horizontal axis.

Long-term unemployment in particular is a persistent challenge for the Finnish labour market. The number of long-term unemployed persons (more than one year of unemployment) peaked in the summer of 2021, when the average number of long-term unemployed persons exceeded 110,000. Since then, long-term unemployment has fluctuated around 90,000 and accounts for about one third of total unemployment (Figure 3.1.5). This relatively high share also underlines the need to pay attention to employment policies that could be successful with this group of labour market participants.

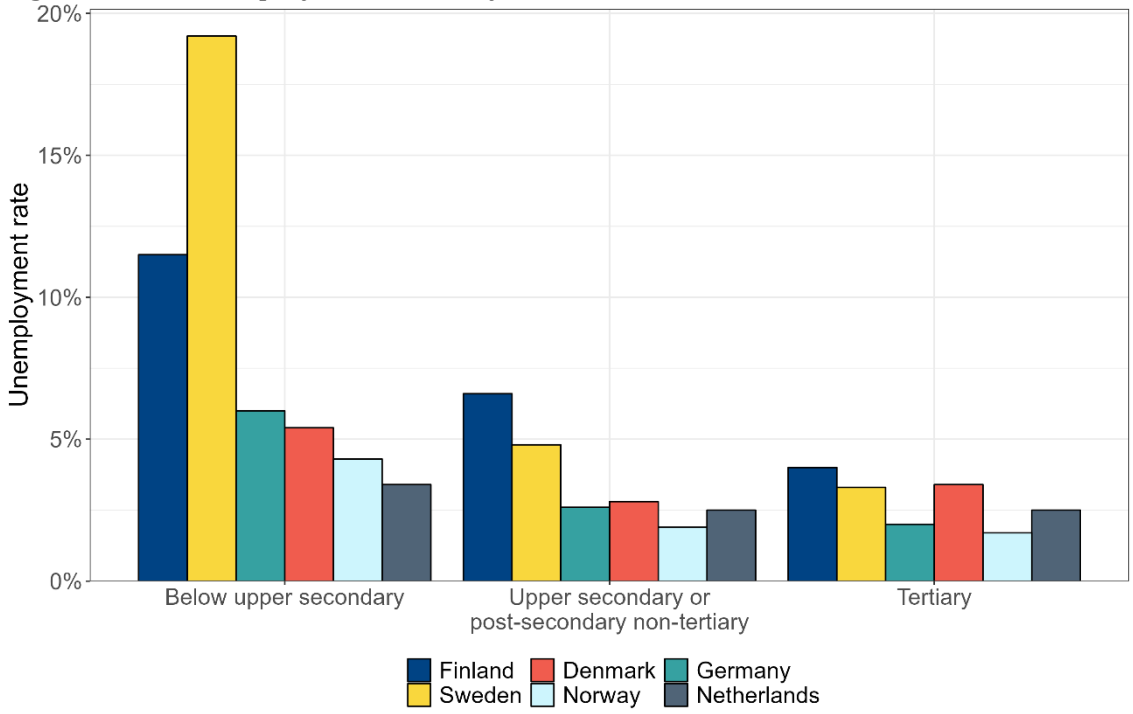
[8] The difference may be partly explained by the Finnish Home Care Allowance (HCA). However, while Gruber et al. (2023) find that HCA decreases maternal employment in both the short and long term, the effects are surprisingly similar regardless of women's education (two educational classes). Miettinen et al. (2023) find differences in home care spells by mothers' education. Mothers with lower education or low incomes stay at home longer than other groups.

Figure 3.1.5. Unemployment by duration (by month 2009M01-2023M10).



Source: Ministry of the Economic Affairs and Employment (seasonally adjusted by EPC).

Figure 3.1.6. Unemployment rates by level of education in selected countries, 2022.

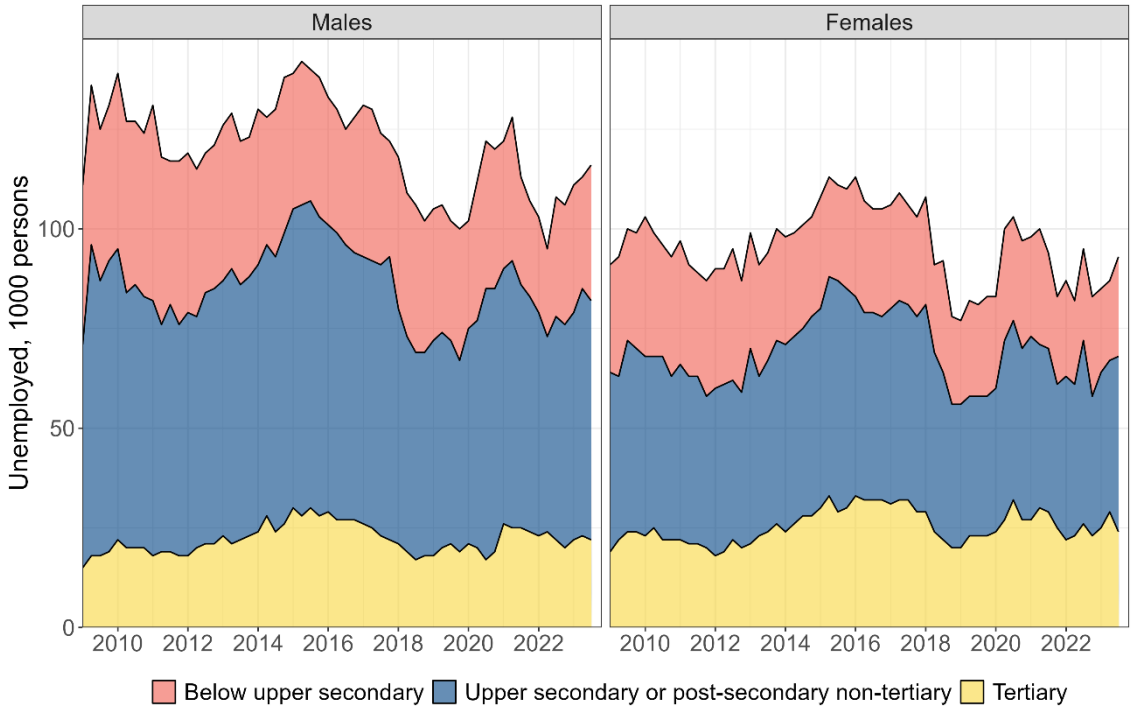


Source: Eurostat. Note: 25–74 years old.

Similarly to employment rates, unemployment rates differ markedly by educational attainment, and the differences are quite large by international standards (Figure 3.1.6). In 2021, Finland's unemployment rate for those with tertiary education was almost the same as the OECD average, but the unemployment rate for those with lower education (13.8 %) was 3 percentage points higher in Finland than the OECD average of 10.7 % (OECD 2023 p. 34).

In general, fewer women than men are unemployed, but among the highly educated unemployed there are slightly more women than men.[9] The opposite is true for the two other educational groups. However, both male and female unemployment appear to be cyclical (Figure 3.1.7). For example, in the aftermath of the 2008-2009 financial crisis and the Covid-19 pandemic, unemployment increased even among the highly educated.

Figure 3.1.7. Unemployment by gender and educational attainment (by quarter 2009Q1-2023Q3).



Source: Eurostat (LFS)

The previous descriptions may suggest that the typical problems faced by people with low education differ somewhat by gender. For women they are

[9] Similarly, women with tertiary education are no less unemployed than women with a low level of education.

related to lower labour market attachment and for men they are related to high unemployment and cyclical fluctuations. Accordingly, the required labour market policies may also be somewhat different.

The unemployed are a heterogeneous group with different backgrounds and reasons for being unemployed. Moreover, underemployment is not confined to this group. A large proportion of those currently inactive also represent a source of potential employment growth. Those with limited working hours or otherwise unstable labour market status are also potential targets for employment policies. This heterogeneity of employment problems is a factor that needs to be taken into account in policy making. Accordingly, this report also discusses the employment reforms of Prime Minister Petteri Orpo's government from this perspective.

The range of reasons for joblessness and underemployment calls for analysis to find well-motivated employment policies for these different groups. An OECD study by Farchy and Immervoll (2021) builds its analysis on the typology of employment barriers and the report uses it to quantify the extent and incidence of labour market difficulties in Finland. The typology follows the ideas first presented in Immervoll and Scarpetta (2012): employment barriers can arise because of problems related to (i) work capacity or capability, (ii) incentives to work or to look for work and (iii) job search success.

The target population in their study consists of the persistently unemployed (long-term unemployment or inactivity, 12 months) and those with weak labour market attachment (unstable jobs, limited hours, near-zero earnings). Employment barriers are measured at the individual level, using a wide range of socio-economic circumstances and self-reports of labour market status. This type of analysis necessarily involves many discretionary decisions regarding the definition of the target population and the criteria for employment barriers.[10] Accordingly, the results should be regarded as approximate rather than exact, but they can contribute to an understanding of employment problems.

[10] For example, one needs to define how to measure weak work incentives and the relevant cut-off points. The study uses the participation tax rate, and the cut-off point is 72% of potential earnings.

Table 3.1. Incidence of employment barriers in target population (%).

	Persistently out of work	**Weak labour market attachment**	**In total**
Insufficient work-related capabilities			
Low education	31	14	25
Low professional skills	28	15	23
No work experience	17	0	11
No recent work experience	79	0	52
Health limitations	52	31	45
Care responsibilities	15	15	15
Lack of financial work incentives			
High non-labour income	25	31	28
High earnings replacements	13	15	13
Scarce job opportunities	41	11	30

Source: Farchy and Immervoll (2021, p.44)

Key findings from the study by Farchy and Immervoll (2021) are presented in Table 3.1. They show, for example, that low education and low vocational skills affect 31% and 28% respectively of the permanently unemployed. All three types of barriers appear to be relevant, with health limitations having the highest prevalence.

Further analysis shows that 87% of the persistently unemployed group face two or more barriers to employment (70% of the target group as a whole). This multifaceted nature of employment problems in Finland implies that policies that address one specific barrier in isolation from other circumstances may be inadequate. In practice, however, feasible policies cannot address all barriers at the individual level, and targeting is needed so that interventions with the strongest employment effects are used for specific groups of the underemployed.[11]

[11] This study finds eight target groups with divergent policies: rural inactive, unstable work, skilled retirees, urban jobseekers, female carers, low-skilled youth, prime-age low-skilled individuals, individuals with limited financial incentives.

3.2. Employment policy targets and measures

Prime Minister Petteri Orpo's government programme sets numerical targets for employment policy. The government aims to implement reforms to increase employment by at least 100,000 persons during the 2023-2027 government term and to achieve an employment rate of 80% by 2031. In order to promote employment, the government is implementing measures mainly in the areas of social security and taxation.

Traditionally, the level and duration of earnings-related benefits in Finland, as in other Nordic countries, have been relatively generous by international standards (Kauhanen 2022). Increasing work incentives for low-income earners by reducing unemployment benefits and other social security benefits is not without costs, given the income distribution objectives of the Nordic welfare states. In general, when formulating social policies, it is necessary to choose the desired balance between social policy objectives (sufficient insurance) and appropriate work incentives. In practice, the ambitious employment targets are likely to increase the weight of work incentives in decision-making. The current government tends to focus its employment policy explicitly on work incentives.[12]

The government envisages to achieve considerable employment impacts through structural (or supply-side) measures related to its unemployment benefit package, and by other reforms in social security and taxation.[13] The common element in the strategy is to reduce income when unemployed or inactive. In this sense, the policy "makes work pay" compared to a situation where a person remains unemployed or outside the labour market.

Firstly, it is estimated that *the package of measures to eliminate incentive traps* will increase employment by a total of around 40,000 persons. Preliminary estimates of the employment effects of these measures were made by the Ministry of Finance for the government formation negotiations in May-June 2023.[14] In October 2023, the Ministry of Finance published some slightly

[12] Work incentives are also highlighted, for example, by the Ministry of Social Affairs and Health and in the European Commission's country-specific recommendations for Finland (see MoSAH (2021) and COM (2023) 626 final).

[13] See Annex D in Prime Minister Petteri Orpo's government programme.

[14] Various documents, e-mail exchanges and other material related to impact assessments have been made available on the Ministry's web page: https://vm.emmi.fi/l/ZxfX_kBZFdhG.

modified estimates.[15] The measures in this package are as follows (with the MoF's estimates of their employment impact *in italics in brackets* below):

- Grading of earnings-related unemployment benefit: the current level of earnings protection stays for the first eight weeks of benefit (40 benefit days). Thereafter, the benefit level is 80% up to 34 weeks of benefit (170 benefit days), after which the level is 75% of the full benefit level. *[MoF: Estimated employment impact of about 15,800 persons]*

- Child increases to unemployment benefits to be abolished. *[MoF: 10,000]*

- Increasing the employment condition for unemployment benefit to 12 months (in a 28-month period). *[MoF: 5,700]*

- Other measures under the label "Elimination of incentive traps": abolition of age-related exemptions in unemployment benefits *[MoF: 3,900]*, abolition of earnings disregards in unemployment benefits *[MoF: minimal]*, the waiting period for unemployment benefits will be increased from five to seven days *[MoF: 1,000]*, restoring the periodisation of holiday compensation in unemployment benefits *[MoF: 2,200]*, changing the employment condition to earnings-based instead of hours-based *[MoF: 1,500]*, closing down the possibility to accumulate work requirement in pay-subsidised work *[MoF: 1300]*.

Second, *the package of other social security and tax measures* aims to get an additional 37,000 persons into work.[16] The measures include:

- A freeze on all increases in national-pension index-based benefits for the government term (except for social assistance, pensions, front-veteran's supplements, disability benefits, child maintenance allowance, and the reimbursement cap for medicine expenses). *[MoF: 17,000 persons]*

- Abolition of adult education benefit *[MoF: 8,000]*

[15] See MoF expert opinion for the Committee on Social Affairs and Health of the Parliament https://www.eduskunta.fi/FI/vaski/JulkaisuMetatieto/Documents/EDK-2023-AK-40894.pdf and https://vm.fi/tyollisyystavoitteiden%20-seuranta

[16] ibid.

- Reductions in personal income taxation *[MoF: 8,700]*

- Other: reform of housing subsidies *[MoF: 1,900]*, language requirement for labour market support *[MoF: 1,300]*, abolition of job alternation leave *[MoF: minimal]*.

In addition to the above changes, the government programme includes a comprehensive additional package of reforms aimed at achieving the employment target. This part of the employment programme is presented without quantitative estimates for specific reforms. However, it is implied that the overall impact is about 20,000 persons or more, even if the content of the reforms is only approximate.

The various measures in this package range from those relating to industrial relations to initiatives to improve the quality of working life and to reform of social assistance. While this list includes many potentially influential reforms, further discussion will have to wait for later reports from the Council when more information on their content and estimates of their impact on employment are available. Of course, these reforms need to be considered from many angles. For example, the well-functioning wage model should be consistent with both micro and macro flexibility.[17] It should be flexible enough to allow the needed changes in relative wages and, at the same time, wage co-ordination is needed to maintain macro-level cost competitiveness and ability to react to crises. Achieving this is challenging and the way forward needs to be carefully implemented.

3.3. Employment impact assessment

As stated above, the calculation of the expected (ex-ante) employment effects was carried out by the Ministry of Finance and, according to the government programme, follow-up of the measures will also be based on an evaluation by the same ministry. We focus here on how the employment effects have been assessed so far.

[17] The government wants to strengthen the export-oriented labour market model. However, there seems to be no consensus among the social partners on the need and the model for coordinating wage increases in different sectors. In July 2023, the Ministry of Economic Affairs and Employment set up two working groups, one on industrial peace and the other on local bargaining and agreements. The tripartite working groups prepare the reforms set out in the government programme.

The basic idea behind the various measures is to improve monetary work incentives by lowering benefit levels for the unemployed. In other words, the reforms make it more advantageous financially to be employed rather than unemployed, as the gap in the level of disposable incomes in these two states will widen. The Ministry of Finance has basically used two different methods to construct the estimated impact on employment.

The first method is used when the unemployment benefit reforms are evaluated, and it utilises the results of previous studies focusing on whether and to what extent unemployment benefits prolong the time to the next job. The concept that is needed and obtained from earlier research is the elasticity of the time until re-employment with respect to the replacement rate (%-change in unemployment duration in relation to %-change in gross replacement rate, i.e. the benefit/wage ratio). In addition to this, one also needs to measure the magnitude of the incentive changes, i.e. the cuts in unemployment benefits are converted to the change in the replacement rate with the help of some simplifying assumptions. The employment effect is then obtained by multiplying the elasticity described above by the change in replacement rate.

In their calculations, the Ministry of Finance has made wide use of the elasticity estimates of Uusitalo and Verho (2010). They utilised the unemployment benefit reform that in 2003 raised the replacement rate for the first 150 days for a particular subgroup of the unemployed with at least 20 years of employment histories. Outside this group the rules were unchanged, which allowed for a "natural experiment". In their sample, the replacement rate increased by 15% and their estimates indicated that the benefit increase extended the time until re-employment by 33 days or 11.9%. Accordingly, the elasticity estimate in this study was 0.79 (≈11.9%/15%) and this is the estimate that is used in the calculations by the Ministry of Finance. For instance, in calculating the effect of the abolition of the child increase it is used for the unemployed who receive earnings-related benefits and also for those who receive basic unemployment allowance (see Box 3.1., which illustrates the calculations in more detail.)

Another group of the unemployed are those who have exhausted their UI benefits or who are new labour market entrants claiming a labour market subsidy instead of UI benefits. The level of this subsidy is lower than typical UI benefits. As the population receiving the labour market subsidy may differ in important respects from the population receiving UI benefits, the relevant

elasticity may also be of a different magnitude. Kyyrä (2023) studied a reform in 2012 that increased the level of the labour market subsidy. A 22% increase in the subsidy was found to reduce the unemployment exit rate by 9%. The elasticity of benefit duration with respect to benefit level is around 0.4 (≈9%/22%).[18] Based on this evidence, a 1% reduction in the labour market subsidy is expected to reduce unemployment by 0.4% in the group receiving the subsidy.

Box 3.1. Illustration of the assessment of the employment effects of removing the child increases from unemployment benefits

In its calculations, the Ministry of Finance (MoF) uses information on unemployment protection from Kela (2022). In 2021, 10.94 million days of earnings-related allowance, 3.88 million days of basic unemployment allowance and 14.82 million days of labour market subsidy, including child increases were paid. These days correspond respectively to 42411, 15023 and 57457 person-years of these transfers in total since the benefits are paid on average for 21.5 days per month. The abolition of child increases would reduce daily allowances by EUR 6-7, decreasing the level of benefits on average by 10% for those on earnings-related allowance who receive child increases. For those on basic unemployment allowance or labour market subsidy, the average decrease is reported to be 17%. Using these figures combined with the elasticities (0.8 and 0.4 from previous Finnish studies described above), the total employment effect is calculated as:

$$42{,}441 * 10\% * 0.8 + 15{,}023 * 17\% * 0.8 + 57{,}457 * 17\% * 0.4 \approx 9300$$

That is, for each group affected by the reform the size of the employment effect is calculated as the size of the population times the reduction in the benefit level times the relevant elasticity. This is roughly 9300 persons in total.

The Ministry of Finance (MoF 2023d) uses values from the year 2021. Using more recent numbers for 2022 would lead to a different employment effect as the size of the affected population and the average reduction in benefits

[18] Uusitalo and Verho (2010) estimated the elasticity with respect to the replacement rate, while Kyyrä (2023) estimated the elasticity with respect to the benefit level. In the calculations the change in the benefit level and the change in the replacement rate are the same, and in MoF (2023d) both concepts are used comprehensively.

are somewhat different. With 2022 values the employment effect would instead be:

$$29{,}375 * 10\% * 0.8 + 10{,}547 * 17\% * 0.8 + 55{,}360 * 17\% * 0.4 \approx 7600$$

If the affected population is smaller, as it would have been using 2022 rather than 2021 values (due to lower unemployment), then the estimated employment effect would also be lower. In this case, the estimates differ by almost 2000 persons. If the aim is to give an estimate of the long-term change in employment due to a reform, it seems that ideally one would want to use values that reflect some sort of long-term equilibrium in the labour market or some average values over a longer period.

It should be noted that the employment effect of removing the child increases from unemployment benefits was also calculated using a different method based on changes in the participation tax rate, with the employment effects ranging from about 9000 to about 23,000 persons (see MoF 2023d).

The total effect of the unemployment insurance reforms is estimated by the MoF to be around 40,000 persons. This is obtained by first calculating the effects for each individual reform using the same type of method described above and then summing the results. Some reforms directly affect the number of people influenced by other reforms. For example, lengthening the employment condition for earnings-related unemployment benefits reduces the number of people receiving those benefits. This leads to "cross effects", which make the employment effect of multiple reforms different from the sum of the employment effects of individual reforms. The issue was discussed at least in a memo in early June.[19] However, it would be good to be clearer about how exactly these have been taken into account.

Although the above method is basically simple, the calculations require various assumptions. For example, the choice of elasticity estimates is critical. Studies based on Finnish data are scarce, and the usefulness of results from other countries is limited because of differences in tax and welfare institutions between countries. Basing the calculations on high-quality research on the elasticity estimates is a good starting point. However, there

[19] Työttömyysturvan kokonaisuus (MoF 2023g).

remains the problem of the so-called external validity of previous results, i.e. whether results on incentive effects at one point in time and for one subgroup of the population are also valid for different periods and for different subgroups. For example, the critical question here is whether the current unemployed on earnings-related benefits (and basic unemployment benefits) are similar to the unemployed on earnings-related benefits and with long work histories in 2003. Clearly, uncertainty in the calculation of employment effects is unavoidable, and this should be reflected in the use of other defensible elasticity estimates. Treating the results as definitive in policy discussions gives a false impression of the nature of this type of calculation.[20]

The second method, used by the Ministry of Finance, is based on estimated changes in participation tax rates combined with an extensive margin labour supply elasticity, which indicates how much employment responds to changes in incentives. This method is more general in the sense that it can be applied to reforms other than unemployment insurance reforms that alter work incentives.

According to the calculations of the Ministry of Finance, the strongest employment impact comes from the index-linked benefit freeze (18,600-22,700 persons).[21] This is also a good example to illustrate the ex-ante calculation of employment effects with this method. These effects are based on the one hand on calculations of the participation tax rates (PTR) and on the other hand on the labour supply elasticity obtained from previous studies.

The participation tax rate is an indicator related to the financial gain of having a job: the lower the participation tax rate, the higher the reward from work. Having a job typically increases income, but part of the wage income obtained is "lost" due to heavier taxes and reductions in social security. The participation tax rate measures the size of this loss in relation to gross wages.[22]

[20] Furthermore, the application of earlier results necessitates the use of the same concepts and their empirical counterparts. The ability to replicate the calculations necessitates detailed reporting of the assumptions and choices made by MoF.

[21] See MoF (2023c).

[22] The participation tax rate can be calculated as PTR = 1 – [(income at work) - (income as non-participant)]/wage income.

The formula for the increase in employment (ΔF) can be presented as

$$\Delta F = \eta \frac{\Delta(1 - \overline{PTR})}{1 - \overline{PTR_0}} * F_0$$

where F_0 is the pre-reform number of the employed, $\overline{PTR}_0$ refers to the pre-reform and $\overline{PTR}$ to the post-reform participation tax rate and η is the labour supply elasticity (for more details see Ollonqvist et al 2021).[23] Here, the labour supply elasticity refers to the so-called total population elasticity, and the value used in practice comes from Jäntti et al. (2015).

Although the above formula is simple, the calculations require many steps and various assumptions. The cuts in social benefits have to be converted into changes in participation tax rates and this is done using the SISU microsimulation model. This type of model makes it possible to calculate taxes and benefits for each individual under different legislation (before and after the reform). In addition, it is necessary to estimate the potential wage that an unemployed (or inactive) person would be likely to earn if he/she were employed instead (calculation of the so-called imputed wage using wage regressions).

As a result, one can obtain the distribution of participation tax rates before and after the reform (see Figure 3.3.1). The measures included are those that will enter into force in 2024.[24] Accordingly, only the relevant part of the indexation freeze is considered and not the total contribution for the whole government term. Reductions in personal income tax are also included, but some reforms are not, for example because of difficulties in embedding them in the microsimulation framework.[25] Due to the changes in benefit levels and taxes, the distribution of participation tax rates shifts significantly to the left and the average PTR for the whole population changes from 67.5% to 64.2%.

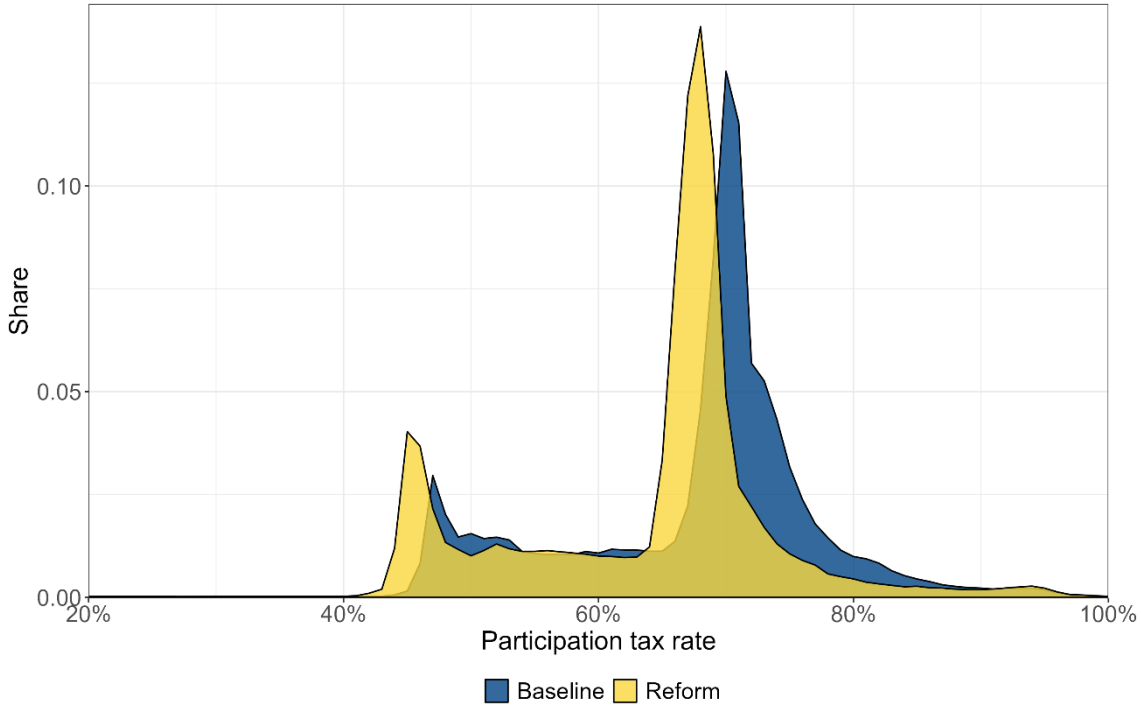
[23] E.g. the employment effect of 22,700 persons is obtained as 0.17*-5.6%*(0.766*3,312,000), where 0.17 is the labour supply elasticity η, -5.6% is Δ(1-PTR)/(1-PTR) and 0.766 is the employment rate for 20–64-year-olds and 3,132,000 is the size of the population in this age group. The calculation of the new participation rates assumes a maximum index freeze effect of -10.2%.

[24] See MoF (2023e).

[25] In these calculations the index adjustment in personal income tax is calculated as a tax reform. The reforms not included in the calculations are the abolition of the adult education allowance, the change of the employment condition to earnings rather than hours, the closing of the possibility to accumulate the work requirement in wage-subsidised work and the abolition of age-related exemptions in unemployment benefits.

Using the above formula for the change in employment gives an increase in employment of 43 500 persons.[26] This would be a relatively large change given that the reforms included in the calculations take effect in a single year. In this respect, they can be contrasted with the simultaneous changes in pension legislation, which increase pensionable age gradually year by year. The effect of the current reforms is also realised only over time and there are no clear estimates of the time profiles of the effects.

Figure 3.3.1. Simulated participation tax rates before and after the reforms.



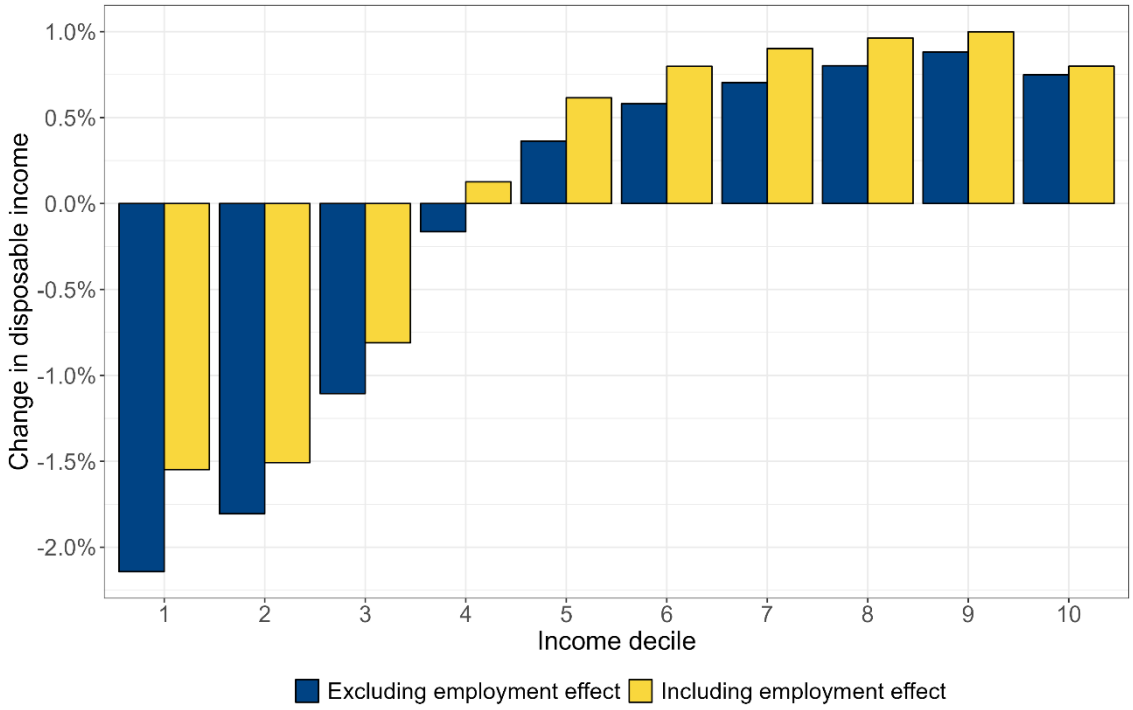
Source: Ministry of Finance (MoF 2023e). Note: blue distribution refers to the baseline state and yellow to the reform state.

The comprehensiveness of the reforms is also evident when considering their impact on disposable income and the income distribution (see also Chapter 5, Box 5.2). Figure 3.3.2. shows the changes in disposable income by income decile, both excluding the impact on employment and including the employment effect. The changes are clear. The three lowest deciles lose the most, while the majority (from decile 5 upwards) gain. When the expected employment effects are taken into account, the income losses in the lowest

[26] According to the above formula for the change in employment, the change in the average participation rate from 67.5 to 64.2 implies an increase of 43,500 persons, i.e.
0.17*10.1%*0.766* 3, 312,000.

deciles decrease, but they are still large. Similar (static) calculations have been made by the Finnish Institute for Health and Welfare (2023).

Figure 3.3.2. Change in disposable income by income decile.



Source: Ministry of Finance (MoF 2023e).

Assessing the employment effects of such a large reform package is naturally challenging. The labour supply elasticity used, for example, in calculating the impact of index freezes is from Jäntti et al. (2015). This study, based on cross-country micro data, is of good quality and provides, among other things, labour market participation elasticities (so-called extensive margin elasticities) for each of the 13 countries included in the analysis. It is probably the best available choice, but there are also caveats to consider.[27] One basic question is again related to the external validity of earlier results in these types of policy evaluations. For instance, Jäntti et al (2015) report that their participation elasticities also capture to some extent the retirement margin. The target group of the current reform package is overwhelmingly the lower end of income distribution with the weakest labour market attachment. There is a need for analyses that take a closer look at incentives within the target

[27] In some of the MoF's calculations, the effects are given with different elasticities. For example, the effects of removing child increases vary from 9,257 (0.1) to 15,738 (0.17) and 23,145 (0.25), with elasticities in brackets.

group and consider other employment obstacles in addition to the lack of incentives (see Section 3.1 above).

The uncertainties do not concern labour supply elasticities only. There is also uncertainty about changes in the participation tax rates. The social security cuts resulting from the indexation freeze depend on actual inflation in the coming years, and the changes in the PTR depend on this future, as yet unknown, development. Moreover, estimates of the reforms differ depending on whether they are calculated in isolation from the rest of the social security system or so that the interrelations are considered. For example, the cuts in unemployment and housing benefits will increase the use of social assistance with its disincentives.[28] Demand for labour fluctuates over the business cycle, and the overall state of the economy will either hinder or assist realisation of the potential employment effects. All these uncertainties mean that it is not possible, at least ex ante, to give very definite estimates about the effects of the reforms. This should also be borne in mind in the context of the role of employment reforms as a tool for balancing public finances.

The government plans to monitor the achievement of the employment targets over the parliamentary term on the basis of evaluations by the Ministry of Finance. It is prepared to take further decisions by the mid-term policy review if the objective of strengthening public finances is jeopardised. The Ministry of Finance has cooperated to some extent with the Ministry of Social Affairs and Health in the ex-ante evaluation, but the role of the Ministry of Economic Affairs and Employment is unclear. This unclear role of the Ministry of Economic Affairs and Employment is distracting given the natural role of division of labour between ministries. One reason for this situation can be related to the relatively low priority of analytical activities within the Ministry of Economic Affairs and Employment. This was one of the key findings of the recent external evaluation of the analysis activities of this ministry (Ruuskanen and Obstbaum 2022). However, the need to address the various barriers to employment together requires effective cooperation. Tackling incentive problems alone is not enough, given the role of problems related to skills and labour market mismatches.

[28] The increasing use of social assistance is also against the aims of the parliamentary Social Security Committee (2023). It is also against the policy targets of the current government since according to the government programme one should aim at reducing the number of persons who receive social assistance.

In addition, labour market reforms need to be systematically evaluated ex-post. It is good practice for ex-post evaluations to be carried out by independent experts using the working methods of the research community (see Box 3.2). Accordingly, a systematic plan and adequate resources are needed for these tasks.

Box 3.2. Relevant empirical studies on structural labour market reforms and their impacts

A large impact on employment is expected from a graded earnings-related unemployment benefit or a declining time profile of the benefit (included in *the package of measures to eliminate incentive traps*). According to Kyyrä (2022), most of the existing literature on the optimal time profile of unemployment benefits is theoretical, and the empirical evidence is scarce and mixed. Using Swedish data, Kolsrud et al. (2018) find that the unemployed respond most strongly to changes in unemployment benefits paid at the beginning of the unemployment spell. They also find that the consumption-smoothing value of unemployment insurance benefits is larger for the long-term unemployed. Therefore, a flat or even increasing benefit profile may be more desirable than a decreasing one. Lindner and Reizer (2020) come to the opposite conclusion in their study of an unemployment benefit reform in Hungary. They find that unemployment spells were shortened, and re-employment wages increased as a result of the reform, which increased benefits early in the unemployment spell and reduced them later in the spell. Therefore, a declining benefit profile would be optimal.

As part of the package to remove incentive traps, the government also proposes to remove the earnings disregards component of unemployment benefits. The earnings disregards have allowed individuals to earn up to EUR 300 per month without having their benefit reduced. Kalin et al (2023) provide recent evidence on the impact of the earnings disregard policy on part-time work during unemployment spells. Part-time or temporary work while receiving unemployment benefits is most common in the services and social and health sectors, and women are much more likely than men to be in part-time work. They show that the share of part-time workers among unemployment benefit recipients rose sharply from 10% to 18% within a few years after the introduction of earnings disregards in unemployment benefits and housing benefits in 2014-2015. However, there is no evidence

of economically significant positive or negative effects of increased participation in part-time work on transitions to full-time employment.

Kauhanen and Virtanen (2021) examined the effects of adult education on earnings and employment. The results show an increase in earnings and an improvement in employment as a result of adult education. However, there is considerable variation in these effects across different areas of education. The effects are largest for those who have completed primary education and for those who have completed upper secondary education. The effects are smallest for those who have already completed tertiary education at the start of their studies. Society's efforts in education and training should be targeted accordingly, for example at adults who want to raise their educational attainment. Expenditure could be better used for other training or upgrading the skills of the unemployed.

3.4. Active labour market policies underway

Spending on active labour market policies (ALMPs) in Finland can be considered generous compared to the OECD average, but less generous than in Sweden or Denmark. In 2020, Finland spent 0.86% of GDP on ALMPs. Finland is one of the leading OECD countries in terms of expenditure on training (labour market training and self-motivated training), with almost half of ALMP expenditure going on training. (OECD 2023)

Prime Minister Petteri Orpo's government has committed to continuing the reforms of ALMPs launched by the previous government. However, changes are already planned for the reforms that are still underway to transform the delivery of labour market support to jobseekers.

A new customer service model introduced by the previous government came into force in May 2022. The model was designed to provide more support to jobseekers in addition to job search obligations (the so-called Nordic labour service model). It aimed to support individual job searches earlier and more often than before. In practice, the idea was to replace quarterly meetings with employment counsellors with fortnightly meetings, and rules on the required number of job applications came into force (at least four applications per month). The National Audit Office of Finland (NAOF) has evaluated the new

model on the basis of initial experiences (NAOF 2023a). It notes that the system tends to result in over-serving self-directed jobseekers and under-serving people who need intensive support. As regards the quantitative job search obligation, the NAOF notes that it suffers from ambiguous instructions that make it difficult for public employment service professionals to apply it uniformly. As the barriers to employment are multifaceted, NAOF also emphasises cooperation between public employment services, the wellbeing services counties and the social insurance institution (Kela). The long waiting times in health services are a problem in the service process. According to the government programme (p. 71), the statutory service process of public employment services will be streamlined in order to use limited resources in a more appropriate and customer-oriented way.[29]

Another reform will transfer responsibilities from public employment services (PES) to the municipalities, which will be directly responsible for the provision of ALMPs. In order to ensure an effective provision of ALMPs, the financial incentives for municipalities will be changed by making them increasingly financially responsible for a part of jobseekers' social security as the duration of unemployment increases. In other words, getting people into work more quickly improves the financial position of municipalities. This responsibility will be transferred to the municipalities from the beginning of January 2025.

Each of these two reforms is expected to have a positive employment impact of about 7,000 - 10,000 persons. However, the Economic Policy Council (EPC 2023) has previously pointed out that there is considerable uncertainty about the employment effects, for example due to the evaluation methods used. The OECD (2023) points out that there are many different institutions involved in the delivery of ALMP services and that the transfer of responsibilities to municipalities will affect them all. Building the evidence base is now even more important in the context of ongoing reforms of the ALMP system.

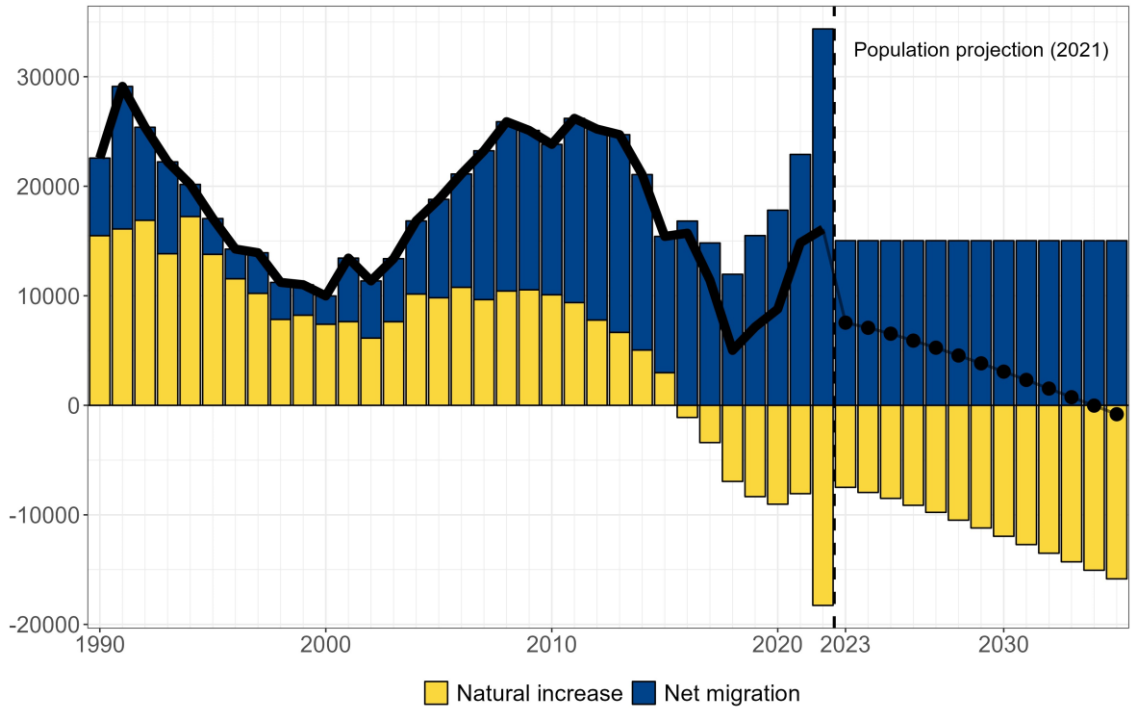
[29]There is a government proposal to amend the acts on the reorganisation of employment services and public employment services.
https://www.lausuntopalvelu.fi/FI/Proposal/Participation?proposalId=46d166fd-e46c-4c35-b7c7-0148757daf3f

3.5. Ageing population, immigration and integration policy

The economic consequences of a rapidly ageing population and a shrinking labour force call for specific measures and changes in Finland's immigration and integration policies. Accordingly, Prime Minister Petteri Orpo's government programme recognises labour migration as one of the measures to achieve the government's employment target, so that "immigration will complement other employment measures" (p.227).

Given the projected demographic changes, it seems necessary to attract migrants, otherwise the population will decline rapidly. Figure 3.5.1. illustrates the realised population change and the most recent population projection produced by Statistics Finland. In the past decade, net migration (the difference between the number of immigrants and the number of emigrants) has increasingly balanced the declining natural increase (the difference between the number of births and the number of deaths) in the population. Assuming that net migration stays at the level of 15,000 persons annually, according to the forecast the total population of Finland is expected to grow until 2035 and decline after that.

Figure 3.5.1. Realised and projected population growth in Finland (persons).



Source: Statistics Finland.

The declining natural increase and a substantial increase in average age may disrupt the labour market and may undermine the fiscal sustainability of pension systems. Moreover, there is a concern that population ageing reduces not only labour force growth, but also labour productivity. Ageing societies may become economically stagnant and less innovative.

In principle, net migration could help avoid population decline. Recently, Alho et al. (2023) calculated that with the current age and gender structure of net migration in Finland annual net migration of 44,000 persons would be needed to stabilise the size of birth cohorts and the labour force. This is a much higher number than that used in the projections of Statistics Finland (Figure 3.5.1). They concluded that their assumed high level of immigration would have large positive effects on economic growth and fiscal sustainability.

However, immigration will not automatically solve the demographic dilemma without the right policies, and migration has become one of the most controversial political issues in developed countries.[30] As Finland, among many other countries, seeks to attract highly qualified migrants, the international supply might not be sufficient for the high levels of skilled migrants needed. In the competition for labour, for example, the regulation of work is a key element of a residence permit system in the Aliens Act, which should be reformed in line with the needs of today's society.[31]

In reality, new immigrants' path to employment has often been difficult. Ansala et al. (2022) investigated immigrants' labor market entry in Finland and Sweden. Immigrants tend to enter low-wage establishments where coworkers and the manager are often from the same origin region, but there is notable variation in entry characteristics by immigrants' region of origin. The characteristics of entry jobs are strong predictors of immigrants' entry and future earnings and job stability in the host country.

[30] For international comparison, immigration accounted for 80% of the population growth between 2000 and 2018 in Europe (cf. 32% in North America); see Peri (2020). Marois et al. (2020) have investigated to what degree migration can mitigate the impacts of population ageing in Europe. There is also a growing literature and empirical evidence of ageing having a negative impact on productivity (e.g. Maestas et al. 2023).

[31] Lobodzinska (2011) and MoI (2023) review the *Aliens Act* (301/2004) and the Finnish immigration policy and regulation. For example, the current Aliens Act is based on the principle that a residence permit must be applied for abroad before entry. There are specific exceptions to the main rule and a general provision on derogation. Different residence permits are subject to different individual rules on whether there is a right to family reunification and whether a subsistence condition applies. Similarly, there are differentiated rules on the length of permits for different types of permits.

Regarding integration policies that promote employment, Sarvimäki and Hämäläinen (2016) examined a policy reform that introduced "integration plans" for unemployed immigrants in Finland. The tailored plans considerably improved the cost-efficiency of active labour market programmes. Even more importantly for integration, Pesola and Sarvimäki (2022) found that the same reform also improved children's educational attainment and hence their expected incomes.

Notably, a recent snapshot from Finnish register data shows that the employment of immigrants increases significantly in the years following immigration, even though the starting level of employment in Finland was quite low, especially in the early 2000s (Toikka et al. 2023). In particular, migrants who arrived in 2021 and 2022 have gained employment quickly after arrival compared to many migrants who arrived in the early 2000s. To gain a deeper insight into labour market integration, Pesola et al. (2024) investigate whether employment trends are due, for example, to the immigrants' integration profiles (taking into account business cycle variation, immigrants growing older etc). Their analysis is based on newly available data from the Finnish Immigration Service covering the residence permits granted in 2011-2021, which are linked to population-wide data on labour market and educational outcomes.

Pesola et al. (2024) find that there is heterogeneity in labour market performance across residence permit type in Finland (there are 108,369 immigrants in their sample). The public debate on immigration often focuses on asylum seekers, refugees, and family migrants, but the residence permit grouping can also distinguish between labour migrants, students and EU migrants[32]. Pesola et al. (2024) show that the labour market performances of different types of immigrants converge over time. During the first 10 years of residence in Finland, employment improves for those arriving on the basis of international protection, family reunification and from EU countries, while employment declines for those arriving on a work permit. Thus, after 10 years, the employment rate of EU arrivals is at the same level as that of work permit arrivals (80%), and the improvement is even more significant for the other groups. After 10 years of residence, the employment rate for those who arrived on the basis of international protection is 60% and for those who arrived on the basis of family reunification or study placement is 70%.

[32] However, a large proportion of EU migrants are apparently not registered; for example, all seasonal workers and others who live in Finland most of the time are not on the register.

However, the gaps in annual earnings remain much larger, with refugees earning, on average, just 48% of the level of labour migrants' earnings and other migrant groups falling in between.

The past employment performance of immigrants is not necessarily indicative of the future. Given the growing elderly population and the shrinking labour force, there is increasing demand for workers in health care and elderly care. Interestingly, Schotte and Winkler (2018) find that older individuals across most economies are more averse to immigration. However, this is driven by a generational (cohort) effect, with older birth cohorts showing higher levels of opposition towards immigration. The results may have implications for the political economy of immigration reforms in ageing societies. If individuals in ageing economies become less averse to immigration throughout the life cycle, overall attitudes towards immigrants may also improve as the elderly represent an increasingly larger fraction of the voting population. Moreover, individuals in countries that have less sustainable pension systems may become more pro-immigration with age.

In practice, increasing the influx of working-age immigrants means redesigning policy measures such as work permits, citizenship, eligibility for social assistance, equal opportunity in the labour market, and the integration of immigrants. However, the current government is planning changes to immigration and integration policy that will not necessarily make Finland more attractive in the competition for skilled labour.

The most controversial reform proposal concerns work-based residence permits.[33] A residence permit would be revoked if the holder is out of work for a period of three months. In other words, a holder of such a permit would have to leave Finland if the holder has not entered into a new employment relationship within three months. In addition, the legislation on permanent residence will be tightened as the government proposes an extension of the residence time required for Finnish citizenship from four years to eight years. The income limit will be increased as well.

Regarding integration policy, the government plans to use sanctions against an immigrant who fails to comply with their integration plan, participate in language training or pass the final test within the prescribed time limit; failure to do so may lead to a reduction in social assistance and labour market

[33] Ministry of Economic Affairs and Employment https://tem.fi/hanke?tunnus=TEM086:00/2023

support. Moreover, a specific integration support for immigrants will be implemented, which will include an incentive and an obligation to integrate.

It is difficult to assess what impact the planned policy reforms will have on immigration to Finland. Regarding integration and citizenship policies, Gathmann and Garbers (2023) review quasi-experimental evidence and field experiments from the social sciences on the link between eligibility rules, take-up and integration outcomes. Across countries and reforms, they find that faster access to citizenship increases take-up and improves the economic, educational, political and social integration of immigrants.

3.6. Council views

Year 2023 was marked by relatively positive employment performance despite the economic slowdown. However, the weakening economic situation was reflected in a falling number of vacancies and a moderately increasing unemployment rate.

The favourable employment development in recent years has not led to a decrease in unemployment to the same extent. The unemployment rate has remained relatively high and has not fallen below 6%. Long-term unemployment peaked in 2021 and since then has been around 90,000 persons. This hardcore unemployment is one of the challenges with respect to the employment targets.

Employment policies are targeted at a heterogenous group of persons that is not restricted to the unemployed. The target group also includes non-participants and those with otherwise weak labour market attachment (persons with unstable jobs, restricted hours and near zero-earnings).

Employment barriers are also of many types, and they can arise because of problems related to work capacity, work incentives or the functioning of the labour market (matching). Accordingly, employment policies are not one-size-fits-all policies and different employment obstacles need different cures. In practice, there is a need for targeting so that the interventions with the strongest employment effects can be used for specific groups of the unemployed.

Employment rate targets are well motivated for both social and fiscal reasons, but the choice of appropriate policies is challenging in practice. Employment

rates are already relatively high by historical standards and further increases are more difficult to achieve than in the past. In this respect, the current government's rather ambitious employment targets are challenging.

The focus of the employment programme is unbalanced because of its one-sided emphasis on incentive barriers in relation to other barriers. The aim is to "make work pay" by reducing income when unemployed or not participating.

The ex-ante effects of these reforms are calculated using estimates of changes in work incentives and labour supply elasticities. The ex-ante estimates of employment effects are inherently uncertain. First, there is uncertainty about both labour supply elasticities and changes in work incentives. Second, the impact of a particular reform is also likely to depend on what other reforms are being implemented. Third, the labour market situation itself is likely to either hinder or assist the realisation of the potential employment effects.

All these uncertainties imply that one cannot give very definite "promises" of the effects of the reforms. This should also be kept in mind in the context of the role of employment reforms as a tool in balancing public finances. Overly optimistic estimates can give too much weight to employment policies in the consolidation.

Since 2015, Finland's population has grown only thanks to net immigration. With an ageing population and a lower birth rate, Finland will continue to need immigrants in the coming years. However, given the global competition for international labour and talent, it is not self-evident that they will end up in Finland. Some of the changes envisaged by the government, such as stricter requirements for citizenship, may make Finland less attractive in the international labour market.

Since employment barriers are multifaceted, well-functioning co-operation between different ministries is important. Tackling only incentive problems is not enough considering the importance of adequate professional skills and health and also the scale of the labour market mismatch problem.

Many ongoing reforms and the role of employment targets in economic policy emphasise the need for systematic ex post evaluations of reforms. It is good practice for ex post evaluations to be carried out by independent experts. Accordingly, a systematic commitment to ex post evaluations and adequate

resources for this purpose are justified demands. In organising this, one must take into account that the capacity to carry out research in this area is scattered.

4. Housing policy

According to the programme of Prime Minister Petteri Orpo's Government: "The key objective of the Government's housing policy is to promote the functioning of the housing market. A well-functioning housing market enables everyone to live the best possible life in an affordable home of their choice."

In this chapter, we first provide a general overview of the reasons behind high housing costs in areas of high housing demand. We then comment on the government's plans to promote housing affordability. We focus on overall housing supply, the general housing allowance and social housing. This is followed by a discussion of the reforms of property taxation and the housing transfer tax.

4.1. Housing supply

Housing affordability is a major concern in most large cities around the world. Finland is no exception and housing costs consume a significant portion of household expenditures. This is especially the case for low-income households.

In housing markets, housing prices and rents, and thus housing costs, are determined by supply and demand. Housing prices and rents can be high only in areas with strong demand and where housing supply is inelastic, meaning that more homes are not being sufficiently built despite high prices. Thus, the underlying reason for high housing costs is limited housing supply relative to demand.

Economists tend to agree that regulatory constraints are the main reason for inelastic housing supply in many cities (*e.g.* Glaeser and Gyourko 2018). In Finland, municipalities oversee land use and zoning policies related to

housing supply, and central government has only limited policy options that can affect municipalities' decision-making.

There are two reasons why this may lead to suboptimal land use and housing supply decisions. First, policies related to increasing housing supply are decided by current residents of the municipality through local democracy, but those aspiring to move into the municipality have no democratic channel to influence these decisions. Therefore, it is unlikely that the welfare of these outsiders is fully internalised at the local level. Second, in so far as increasing city size leads to agglomeration benefits, some of these benefits accrue to the central government through higher tax revenue. Again, these benefits are not fully internalised by local decision-makers.

Central government encourages the largest cities to increase housing supply through land use, housing and transport agreements (so-called MAL agreements) between these cities and central government. These agreements specifically focus on ensuring the prerequisites for economic growth and accessibility in the regions through infrastructure and housing production investments. The main purpose is to encourage cities to boost housing supply by subsidising a portion of local infrastructure costs. The current government plans to continue this agreement procedure. While the aim of the agreements is commendable, there is a lack of scientific evaluations regarding their effectiveness.

Moreover, the government intends to streamline land use and building regulations and to enhance the transparency of how limitations on construction rights and other planning measures affect construction costs. It is important to gain insight into these costs. The government also aims to streamline the building and environmental permit process and to accelerate the appeal process. This may speed up construction but is not a panacea for increasing housing supply because land use policy will ultimately remain at the local level.

Finally, housing construction is highly cyclical. In the current stage of the business cycle, it would be desirable for large cities to release plots for construction at market prices, i.e. at the highest price that developers are willing to pay, and at the same time, require that construction begins soon. In other words, the goal should be that the price of plots and building rights is flexible through the business cycle so that construction activity does not collapse during an economic decline.

4.2. Subsidising housing for low-income groups

Even when there is adequate supply of housing to meet demand, housing expenses can remain excessively high for low-income households. Reducing housing costs for low-income individuals can be achieved either by providing targeted financial support for housing, such as the general housing allowance, or by offering social housing units at below-market rents (so-called ARA units).

Both forms of assistance decrease the recipients' housing costs and impose a financial burden on taxpayers. The costs of the housing allowance are incurred as direct payments or transfers made to eligible tenants. The costs associated with social housing arise from the government providing interest subsidies to facilitate the construction and maintenance of these housing units. Furthermore, social housing is often situated at lots owned by municipalities and municipalities charge below market lot rents. Rents of social housing units are cost-based so that both the interest subsidies and the lot rent discounts are passed on to tenants in the form of lower housing rents.[34]

In social housing, the assistance is linked to a particular housing unit. Tenants in social housing programmes are provided with rental apartments at below-market rents, but this support is contingent on them residing in designated social rental buildings. If social housing tenants move to a private market unit, they lose the subsidy. The housing allowance provides recipients with greater flexibility in choosing their housing as it can also be used for rental apartments in the private market. This gives individuals and families more freedom to select housing that suits their preferences and needs in terms of location, and dwelling size.

Support in the form of social housing may raise concerns about neighbourhood segregation, with low-income social housing tenants concentrated in specific residential areas and buildings (e.g. Eerola & Saarimaa 2018). The worry is that the clustering of disadvantaged individuals in particular regions may exacerbate poverty through mechanisms such as neighbourhood effects or the deterioration of local services (Chyn & Katz 2021). At the same time, social housing can be used as a tool for social mixing

[34] In some areas, cost-based rents may be higher than housing rents.

if it is allocated in neighbourhoods that are otherwise unattainable for low-income tenants at market prices.

It should be stressed that building social housing is not the answer to general supply shortages, as social housing crowds out private construction in areas with high housing prices (e.g. Baum-Snow & Marion 2009). Social housing should address other well-defined problems, such as homelessness and social mixing.

Housing allowance

In 2015, the general housing allowance was simplified, and an earnings deduction was introduced, which extended the housing allowance to the working population. Moreover, in 2017 the student housing supplement was abolished, and students became eligible for the more generous general housing allowance. Both reforms substantially increased housing allowance expenditures. To balance the public finances and curb the significant growth in housing allowance expenditures, the government aims to cut general allowance expenditure by some EUR 385 million.[35]

In the current system, the general housing allowance covers 80% of the difference between actual housing costs (or rents) and a basic deductible. The deductible is zero up to a threshold income level which depends on the number of adults and children in the household. Above the threshold, each additional euro of income reduces the monthly allowance by 0.42 euros. There is also an earnings disregard of EUR 300 per month so that allowance recipients can earn up to EUR 300 per month without these earnings affecting the amount of the allowance (see Kalin et al. 2023).

If the rent is above the maximum acceptable housing costs for the region and household size, the amount exceeding the maximum is not covered by the allowance. This is the case for a clear majority of allowance recipients (see Eerola et al. 2022). This has important implications for the incidence of the housing allowance because most allowance recipients pay their housing costs in full on the margin. That is, if they move to a more expensive home, they pay the rent increase in full. Similarly, if they move to a cheaper home, they fully benefit from the rent decrease if the rent stays above the acceptable housing cost ceiling. This means that the allowance does not distort the relative prices

[35] HE 74/2023 vp.

of housing and other consumption. In other words, it works more like an income subsidy than a price subsidy. Due to these details of the subsidy scheme, it is unlikely that changes in the allowance would have major effects on rents.

The government proposes to eliminate the earnings disregard (discussed in Chapter 3), raising the basic deductible from 42% to 50% and decreasing the compensation percentage from 80% to 70%. Furthermore, municipality categories 1 (Helsinki) and 2 (Espoo, Kauniainen and Vantaa) for maximum acceptable housing costs will be merged into the lower category 2. This reduces the allowance for recipients living in Helsinki. The general housing allowance will no longer be available for owner-occupied homes and an asset limit of EUR 10,000 will be introduced. To mitigate the effects on families with children, the basic deductible will be changed so that the income threshold is increased for children and decreased for adults.

How these proposed allowance cuts will affect the welfare of allowance recipients depends crucially on what happens to rents. A recent study by Eerola et al. (2022) analysed the rent effects of the 2015 reform, which substantially increased the allowance for particular types of dwellings and not others. They find that the reform had virtually no effects on the rents of dwellings that received a more generous subsidy. This is not surprising given that the allowance often works like an income subsidy, as explained above. Moreover, Eerola et al. (2022) find that allowance recipients' moving behaviour is quite unresponsive to changes in the allowance in different types of units. Thus, the government's proposed reforms are likely to increase the housing cost burden of low-income households as it is unlikely that rents would decrease substantially due to the cuts in the allowance. This is acknowledged in the government proposal.[36]

Housing allowance is tightly connected to social assistance, which is a discretionary last-resort form of financial assistance. The lowest-income households are at least partially shielded from the housing allowance cuts because they can apply for social assistance to cover their housing costs after the allowance is taken into account. Thus, when housing allowance expenditures decrease, social assistance expenditures in turn increase. This has been considered in the government proposal[37], but it should be

[36] HE 74/2023 vp.

[37] HE 74/2023 vp.

highlighted that the most vulnerable groups would be more reliant on social assistance, especially because the compensation percentage is lowered. This development would work against the government's goal of decreasing social assistance dependency.

The government also plans changes to social assistance in housing. The aim is to make eligible housing costs more binding and to encourage households to move to cheaper units if their housing costs exceed the eligible costs. There are exceptions to this rule for groups for whom moving costs would be particularly high. Currently, actual housing costs are often covered by social assistance if the recipient cannot find cheaper housing within their home municipality (see Eerola et al. 2019).

The reforms concern the general housing allowance. There is a separate and more generous scheme for pensioners. However, the government does not propose any changes to the pensioners' housing allowance apart from temporary index freezes. This choice is odd as sharing the allowance cuts allowance among a larger pool of people would have made the per-household cuts smaller. It might also be easier for pensioners to adjust their housing cost by moving because they do not need to commute to work.

Social housing

The government's plan is to moderately reduce the volume of social housing construction and to make construction more countercyclical. The government has already decided to eliminate subsidies for right-of-occupancy units, but there are no details about how much the government intends to reduce social rental housing construction.

The government also plans to allocate social housing units more towards low-income households and to those who find it difficult to obtain a housing unit on the private market.[38] To achieve this allocation goal, the government plans to reinstate income limits at the tenant selection phase. These limits would not, however, apply to special groups, such as student and elderly housing.

The proposed income limits are as follows: EUR 3540 per month for the first adult, EUR 2480 for each additional adult, EUR 650 per month for the first minor and EUR 600 for each additional minor. These limits are quite high, as

[38] According to earlier research, some social housing tenants in Helsinki are middle- and high-income earners (e.g. Eerola and Saarimaa 2018).

in August 2023 median monthly earnings were EUR 3114. Recent calculations by the Ministry of the Environment (MoE 2023b) reveal that in 2021 some 6.7% of new social housing tenants would not have been eligible for a social housing unit if these income limits had been in place at the time. This is a rather large number considering how high the limits are.

Targeting social housing at low-income households can be justified from a redistribution point of view. It may also limit housing allowance and social assistance expenditures, although this depends on whether social housing rents are below or above the eligible housing costs in these systems.

In addition to providing affordable housing, the social housing system aims to create socially mixed neighbourhoods and buildings. Instating income limits may counteract these goals, especially at the building level. However, the proposed limits are so high that major effects on the social mix, even at the building level, are unlikely.

The government programme also mentions the possibility of exploring ways of increasing rents for high-income social housing tenants above a certain income limit (regular rent review). This would, however, require major changes to the system because rents in social housing need to be cost-based.

The goals concerning social housing are justifiable. Social housing is not the answer to general supply shortages, and it should address other well-defined problems, such as homelessness and social mixing. The size and allocation of the social housing stock should be designed with these goals in mind. It is also important that social housing units are allocated to those in most need of affordable housing and income limits at the tenant selection phase are a step in this direction.

4.3. Taxation

Property tax rates are set by the municipalities within minimum and maximum limits set by central government. The government proposes to introduce a separate tax on land value and to increase the lower limit of the tax rate, effectively forcing municipalities to tax land value more stringently. Currently, the same tax rate applies to land value and the value of commercial buildings. It is not possible to increase the tax on land value without at the same time increasing the tax on the value of commercial buildings.

Increasing the land value tax (LVT) can be justified both on efficiency and equity grounds. The LVT is considered efficient because it does not discourage productive activities or development of land, and thus, does not lead to deadweight losses. Moreover, the incidence of LVT is on the landowner because the tax capitalises on the value of the land. When the tax rate is increased, land values drop by the discounted present value of the tax increase as housing rents are not affected by the tax increase.

Furthermore, since differences in the quality of local public goods are also capitalised into land values, the LVT in principle also works as a benefit tax, meaning that those who enjoy higher-quality local public services also pay more taxes. The LVT can thus be used to fund investments in local infrastructure in so far as they increase land values. For this mechanism to work properly, taxable land values need to be adjusted regularly and should closely follow market values. This is why the ongoing reform of the tax value assessment system, which aims to bring taxable values closer to market values, is important. Another important aspect related to property taxation is the central government grant equalisation scheme. If the property tax base (the value of land and buildings) is included in the equalisation scheme it may hinder the incentives of municipalities to make investments that increase land and property values.

In addition to changes in property tax, the government has decided to lower the housing transfer tax rate from 2% to 1.5% for apartments in multi-unit buildings and from 4% to 3% for single-family detached houses starting from October 2, 2023.[39] The government will also abolish the first-time buyer tax exemption from 2024 onwards.

The tax decrease should improve the functioning of the housing market. The tax imposed on housing transactions raises the expenses associated with moving, potentially causing households to reside in housing that does not align well with their needs. It may also impede households from transitioning between regional job markets. Finnish evidence from Eerola et al. (2021) shows that the transfer tax has an adverse impact on people's willingness to move. The tax exerts a stronger negative influence on short-distance moves, but it also has negative effects on long-distance relocations, suggesting that the transfer tax may hinder labour market mobility as well.

[39] HE 64/2023 vp.

Lowering housing transfer tax rates and abolishing the exemption for first-time buyers is a step in the right direction. A broader tax base with lower rates is preferable to higher rates and exemptions for some groups. The overall fiscal effect of the transfer reform is negative. However, combining the housing transfer tax reform with increases in the LVT shifts the overall tax burden from a highly distortive tax to a non-distortive tax. A potential challenge is that the transfer tax is collected by central government while the property tax is collected by the municipalities. The government should consider adjusting central government grants to municipalities in combination with these reforms.

4.4. Council views

According to its programme, the objective of Prime Minister Orpo's Government's housing policy is to promote the functioning of the housing market so that everyone can live the best possible life in an affordable home of their choice. The council supports this objective and some of the policy reforms planned and already decided will promote this goal, while some will not.

The underlying reason for high housing costs is limited housing supply relative to demand. Government's tools to promote overall housing supply are limited because major land use decisions related to housing supply are made at the local level by municipalities. Local decision-making may not take into account all the benefits of additional housing supply, which may lead to insufficient supply of housing. This is why it is important that the government incentives high-priced cities to zone land for housing through land use, housing and transport (MAL) agreements.

Considering the government's own housing policy objectives, the cuts of the general housing allowance are somewhat questionable. The generosity of housing allowance is, of course, a value judgement. However, the government's housing allowance cuts will most likely worsen the housing market situation of most vulnerable groups. Furthermore, the housing allowance cuts, especially lowering the allowance's compensation percentage, will make lowest-income households more dependent on social assistance. This works against the government's goal of decreasing social assistance dependency.

The government is taking steps in the right direction with social housing policy. Targeting social housing more towards low-income and vulnerable households by introducing income limits at the selection stage is justified, as is reducing the construction of social housing. Social housing is not a solution to overall supply shortages, as it crowds out private construction and does not increase overall housing supply in high-price areas. Moreover, the housing allowance is a better and more efficiently targeted way to reduce the housing costs of low-income households than social housing. The housing allowance is available to all that fulfil the criteria whereas this is not the case with affordable social housing. The goals of social housing should be made clearer, and the extent of social housing construction and tenant allocation rules should be evaluated based on these goals.

The government is also making positive strides with its housing taxation reforms. Lowering the housing transfer tax rate has the potential to improve the functioning of the housing market as it makes it easier for households to choose a housing unit that best suits their preferences and needs. Abolishing the housing transfer tax altogether should be set as a future target. The associated fiscal losses can be, at least partially, offset by further increasing the non-distortive land value tax.

5. Fiscal policy

A key objective of Prime Minister Petteri Orpo's government is to strengthen public finances. The previous chapters have discussed in some detail the government's employment and housing policies, which are also closely linked to this objective. In this chapter, we look at the outlook for public finances and the government's fiscal policy as a whole.

We first provide a brief overview and general discussion of the government's fiscal policy plan. We describe the main objectives and the broad structure of the consolidation programme outlined in the government programme and assess the credibility of the programme with respect to its objectives. We then describe the fiscal situation, including the fiscal implications of the recent rise in real interest rates as well as certain fiscal risks related to climate policy commitments and the green transition. Finally, we examine the government's first budget proposal from the perspective of aggregate demand management.

5.1. Overview of the government's fiscal policy plan for 2024-2027

According to its programme, Prime Minister Orpo's government aims to stabilise the public debt-to-GDP ratio and limit the general government deficit to no more than 1% of GDP by the end of its term. To this end, the government programme outlines a consolidation programme to strengthen annual general government finances by EUR 6 billion by 2027.

According to the government programme, "the total tax rate will not be increased by Government decisions" (p. 13). This approach emphasises the role of expenditure cuts as a way of improving public finances. On the other hand, the programme also states that the government aims to implement these cuts "in a way that acknowledges the situation of the most vulnerable groups" (p. 12). While this statement is open to interpretation, it suggests a

focus on protecting those most dependent on tax-funded services and transfers.

Structure of the consolidation programme

Close to EUR 2 billion of the EUR 6 billion consolidation target is to come from cuts in social benefits. As detailed in Chapters 3 and 4, this includes direct cuts in unemployment benefits and general housing allowance and allowing the real value of many other benefits to fall with inflation by keeping them fixed (or "frozen") in nominal terms.

A further EUR 2 billion is based on higher employment resulting from improved incentives to work, mainly due to cuts in various social benefits (see Chapter 3 for details). Higher employment would improve public finances both through lower expenditure (e.g. less spending on unemployment benefits) and higher tax revenues. Box 5.1 describes the assumptions behind the estimated link between higher employment and public finances.

Box 5.1. Fiscal effects of employment growth

In its programme, the government has outlined structural policy measures aimed at strengthening public finances by around EUR 2 billion by increasing employment by 100,000 persons. Most of the measures to increase employment are discussed in Chapter 3.

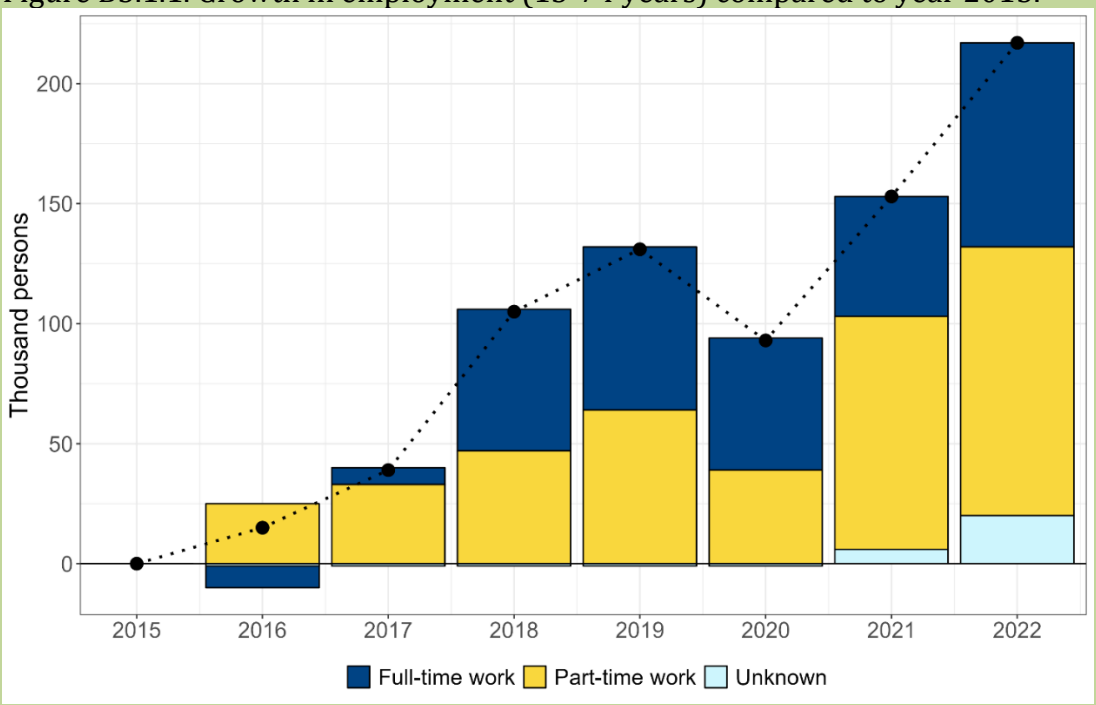
In a memo prepared by the Ministry of Finance prior to the government negotiations (MoF 2023f), it was estimated that increasing employment by one person in 2024 would improve public finances by EUR 26,200 per year. This rule of thumb is based on the following logic. Using the SISU microsimulation model and projected wages for the unemployed, one additional employed person would lead to a net change in transfers of around EUR -20,000 through increased direct tax revenues (from income tax) and reduced benefits paid. Increased employment would also be associated with an increase in corporate tax revenues. This effect is estimated at EUR 3,500 per person employed, assuming that the operating surplus of firms increases at a similar rate to the wage bill (taking into account the estimated wages of the newly employed).

Finally, employment also affects indirect tax revenues (consumption taxes), as higher employment is likely to increase consumption. Indirect tax revenues are assumed to increase by EUR 10,200 * 27% = EUR 2800, where

EUR 10,200 is the estimated change in disposable income and 27% is the implicit tax rate. The total figure of EUR 26,200 is slightly higher than previous MoF estimates because the sample used for this calculation is more recent and wages as a whole have increased over time. Different ways of calculating the fiscal impact of employment growth are also discussed in Seuri (2020).

If employment increased by 100,000 persons and each person had an annual impact on public finances of EUR 26,200, public finances would improve by EUR 2.62 billion. The rule-of-thumb measure takes into account the difference between full-time employment and no employment. In recent years, much of the growth in employment has been in part-time rather than full-time work (Figure B5.1.1.). If part of the employment growth relates to part-time work, this would reduce the overall benefit to public finances to some extent. However, some of the current government's policies, such as cutting the housing allowance and the removal of earnings disregards in unemployment benefits, make full-time work more financially beneficial than part-time work than before. Transitions from part-time to full-time work would also improve public finances but would not be counted as an increase in employment for the purposes of the Labour Force Survey figures.

Figure B5.1.1. Growth in employment (15-74 years) compared to year 2015.



Source: Statistics Finland (Labour force survey)

The rest of the expected consolidation is largely based on increasing the operational efficiency of public services. The government aims to save almost EUR 900 million by 2027 by developing the activities and existing practices of the wellbeing services counties and around EUR 250 million by improving the productivity of central government administration through digitalisation, reorganisation of tasks and other measures. The consolidation programme also includes a EUR 250 million reduction in funding for new transport infrastructure and some other direct spending cuts in various areas.

The government programme includes a EUR 4 billion investment programme, mainly focused on infrastructure projects, especially development of the railway network. In order to limit public borrowing, the government plans to finance these investments at least partly by reducing the capitalisation of state-owned unlisted companies and making revenue recognitions from the National Housing Fund. Such measures reduce the value of financial assets owned by the central government. The government is also committed to increasing public funding for research and development (R&D), in line with the national target of raising total (private and public) R&D expenditure to 4% of GDP by 2030.

The government programme (Annex C) does not envisage any major changes in the tax structure. However, the government proposes to slightly reduce the taxation of labour income and to increase the property tax on land values (see Chapter 4) and the VAT rate on certain goods that are taxed at a reduced rate. This can be seen as a small step towards a more efficient tax system, reducing the negative effects of the tax system on labour supply incentives and making the VAT system more neutral.

Credibility: goals vs. measures

Despite a relatively good employment situation, Finland's public finances have generally been in clear deficit and the debt ratio has been on an upward trend in recent years. At the same time, the population continues to age. It is therefore very likely that, in the absence of substantial consolidation efforts, the government debt ratio will continue to increase. (Section 5.2. discusses the projections for public finances.)

An ever-increasing debt ratio would undermine the fiscal sustainability of the welfare state by increasing uncertainty about future taxes and the tax-funded services and transfers that people can expect to receive. A rising debt ratio

may also reduce the scope for counter-cyclical fiscal policy in the future; further debt accumulation during a recession or crisis that requires increased public spending may rapidly raise the interest rate on newly issued public debt if the debt ratio is already high. Finally, EU fiscal rules are also likely to require Finland to limit its public debt in the coming years.[40]

Against this background, the government's main objective is well justified. Moreover, the required fiscal adjustment, around 0.5% of GDP per year, is not so large that it would necessarily cause major problems for short-term economic development. However, if the cyclical situation at the end of the government's term is very weak, adhering to the headline deficit target of -1% may lead to pro-cyclical policies. It is a reasonable target only in a relatively normal cyclical situation.

However, the government's programme is not entirely credible with regard to this main objective. One problem relates to tax revenues. As we describe in sections 5.2. and 5.4. below, the overall tax rate is expected to decline for reasons largely unrelated to the new government's decisions. Moreover, the expected decline in the total tax rate is larger in the latest fiscal plan, published in autumn 2023, than in the previous one, from spring 2023, which was available at the time the government programme was prepared.

The above quote from the government programme seems to rule out tax increases (which are not offset by reductions in other taxes) even in response to a fall in the total tax rate that is unrelated to decisions of the new government. On the other hand, strengthening public finances quickly enough through further spending cuts alone may be difficult in practice, at least without jeopardising some of the other objectives set out in the government programme. The decline in tax revenues relative to GDP therefore undermines the objective of stabilising the debt ratio.

Another problem concerns the fiscal impact of some of the measures. As discussed in Chapter 3, although the estimated employment effects are based on reasonable assumptions, there is a great deal of uncertainty about the

[40] The EU economic governance rules are being reformed. However, the new rules maintain the same debt limit of 60% as the old ones. The National Audit Office of Finland (NAOF 2023b) provides a useful discussion of the aims of the reform. See also the Economic Policy Council statement from September 2023: https://talouspolitiikanarviointineuvosto.fi/wp-content/uploads/2023/10/Edusk-talousvlk_Ukirje-komission-fiposaannot_TPAN-20230915.pdf

extent to which improved incentives to work will translate into higher employment and improved public finances.

It is particularly difficult to assess the government's chances of slowing down cost growth in the wellbeing services counties, even though its programme outlines several apparently sensible ways and milestones to achieve this. It is impossible to assess the exact financial situation of the counties at this stage. However, as they seem to be struggling to make ends meet now, it seems rather optimistic to think that they will have strong potential to generate savings in coming years without compromising the services provided to the population living in the area. In addition, central government has limited capacity to steer counties to improve their operational efficiency or improve coordination within counties.

It should also be noted that while reducing government assets to finance public investment indeed limits public borrowing, it makes little sense from the point of view of the long-term sustainability of public finances. Instead of increased interest expenditure, the cost of the investment will be in the form of reduced dividend or interest income.

This is not to say that reducing government financial assets is necessarily bad policy per se. For example, it could be argued that the fact that the government holds relatively risky financial assets and has a high level of debt makes its net wealth position (assets minus debt) overly sensitive to changes in asset valuations. However, there is no such discussion in the government programme.

Distributional implications

The government's proposed cuts in social benefits are designed to incentivise full-time work by reducing the relative financial attractiveness of part-time work, unemployment or non-participation in the labour market. After the cuts, some people on low incomes are likely to end up with higher incomes than before as a result of improved incentives to work. On the other hand, it is also clear that others will experience a reduction in their disposable income. For one thing, some unemployed people are unable to find work due to various frictions in the labour market.

Not all of the proposed cuts are necessarily incompatible with the objective of protecting the most vulnerable groups. For example, earnings-related

unemployment benefits are not targeted at those with the weakest labour market prospects. From the perspective of the most vulnerable groups, the main problem with the proposed social security cuts is probably that some people will be affected by multiple cuts.

Certainly, social assistance as a last resort benefit should cushion the fall in income for those with the least economic resources. On the other hand, the financial incentive to look for part-time work is often very weak for those receiving social assistance, as higher wage income often reduces social assistance one-for-one. As a result of the reforms, some people are also likely to be dependent on social assistance for longer than before, reducing their annual disposable income.

Box 5.2 discusses these distributional effects on the basis of a microsimulation analysis. The results suggest that many individuals with very limited economic resources are likely to see their disposable (real) income fall quite substantially as a result of the reforms. It is therefore questionable whether the government's consolidation programme is really in line with the stated objective of acknowledging the situation of the most vulnerable groups.

The government plans to implement a reform of social assistance and a broader reform of social security (a universal credit model) at a later stage. Without knowing the details of these reforms, it is currently not possible to assess their impact on income distribution.

Box 5.2. Distributional effects

By reducing social benefits, the government aims to consolidate public finances both by reducing social expenditure and by increasing employment through better work incentives (see Chapter 3). However, this policy is likely to have adverse distributional effects, as those who do not respond to it by working more will see their disposable income fall.

Figure B5.2.1 shows the average change in disposable income in the population aged 20-64, excluding students. It focuses on the change in income at the individual level, not at the household level. The change is further broken down into reductions in transfers paid (taxes and social contributions) and transfers received.

These calculations have been made with the SISU microsimulation model, using the same set of policy reforms that were considered in the memo from the Ministry of Social Affairs and Health (MoSAH 2023). These include cuts in social benefits to be implemented in 2024, as well as income tax changes, including both a 0.5%-point reduction in unemployment insurance contributions and the index adjustment of income tax brackets. (It is not clear whether these tax changes should be interpreted as 'reforms'. For example, it can be argued that since indexation of tax brackets to inflation is common practice, not indexing them would have been a tax increase.) Also included is the index freeze of many social benefits, although only as far as it concerns the year 2024. In these simulations, the baseline scenario assumes that the index governing the benefits would have risen by 5.3% without the freeze.

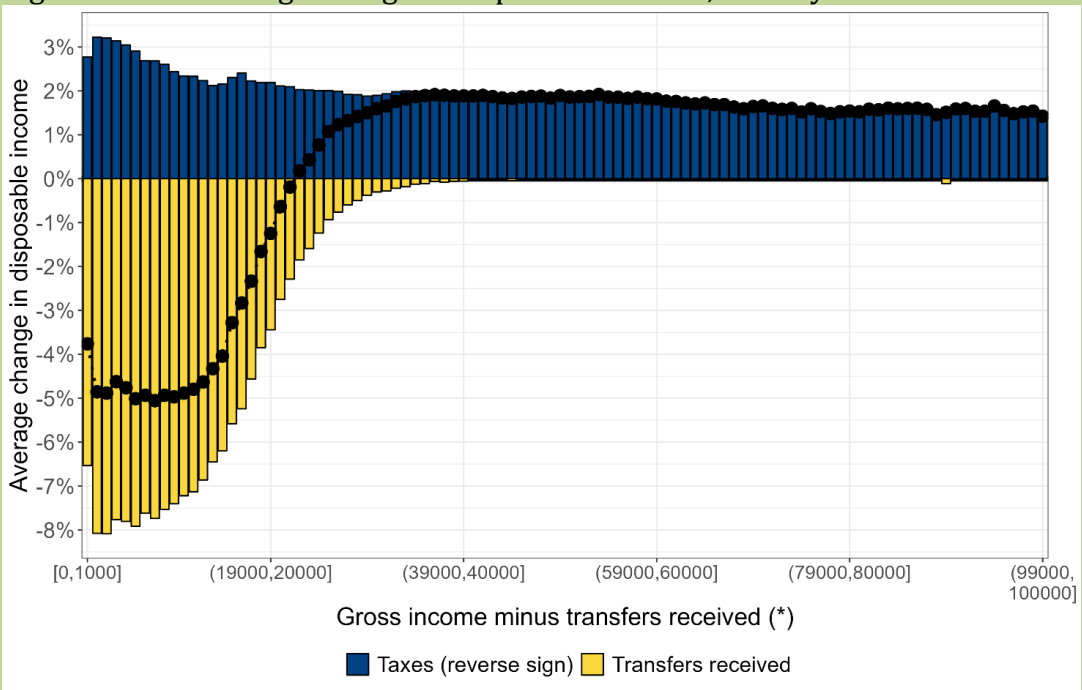
On the horizontal axis, this population is divided into relatively small (EUR 1,000) bins according to their gross income net of transfers received (in 2019, the sample year). The aim here is to see how the proposed reforms affect disposable income across individuals with different levels of market income, including those with very little income, in their main target group. (Figure 3.3.2 in Chapter 3 covers all types of households, including those outside the labour market, and shows the average effects in much larger groups.) The effects shown in Figure B5.2.1 do not include any labour supply responses. They show the effect of the reforms assuming gross market income remains the same.

The simulated outcomes are based on the annual situations of households. However, many individuals in the data may receive, for example, unemployment benefits only for some period of time and be fully employed the rest of the year. In these cases, comparing simulated outcomes at the annual level between different legislations does not fully reflect the effects of the reforms that the individual would face at a monthly frequency. Notwithstanding this, the average changes plotted in Figure B.5.2.1 are informative of the changes across different income levels.

The reforms seem, on average, to increase disposable incomes for those with incomes roughly above EUR 2,000 per month (calculated from annual incomes). At the same time, people who rely mainly on transfer payments see their incomes fall, unless they start earning more market income following the reforms. This also means that the reforms reduce the

disposable income of many individuals who work part-time unless they move full-time work.

Figure B5.2.1. Average change in disposable income, 20-64 years.



Sources: SISU microsimulation model and EPC calculations. Notes: (*) Persons are divided into brackets of EUR 1,000 of yearly income with underlying data from 2019. Those receiving either pensions or financial aid for students have been excluded.

For very low annual market incomes, the average effect on transfers is around -8% of disposable income. The total reduction in disposable income, however, is smaller, around -5%. This is because most transfers are taxable income and a reduction in transfers received therefore results in less taxes paid by the same individuals. This is reflected as a positive term in the figure. At the lower end of the income distribution this effect dominates the changes in tax policy, which are more relevant at higher income levels where the majority of income comes from wages.

Even though we are looking at relatively small groups, these average effects still hide substantial variation among individuals. We find that among those earning less than EUR 20,000 in market income annually, around 16% see their disposable income decrease by more than 10%, while the majority of that same group face much smaller changes.

In the current social security system, social assistance is a last-resort benefit. The results presented here account for social assistance as well,

albeit probably imperfectly. In 2024, social assistance is not affected by the freeze on index increases, unlike most other social benefits.

The proposed cuts in social benefits mainly affect people of working age. This is understandable from the point of view of work incentives. However, extending the cuts to pensioners to a greater extent would have allowed them to be spread more evenly across the population, protecting the most vulnerable groups.

On the other hand, the government programme mentions the need to develop the earnings-related pension system in order to strengthen public finances and stabilise the pension contribution rate. This could be an opportunity to find further savings in social security that do not endanger the livelihoods of the most vulnerable groups. The government has set up a working group to prepare the reform. It should come up with a proposal by early 2025.

5.2. State of public finances

Figure 5.2.1 shows the development of general government expenditure, revenue and taxes as a share of GDP in Finland since 2000, including their projected values in the last two general government fiscal plans. It shows that expenditure as a share of GDP increased markedly around the time of the financial crisis in the late 2000s. Since then, general government expenditure has been around 55% of GDP. Expenditure as a share of GDP is currently projected to decline slightly over the government term.

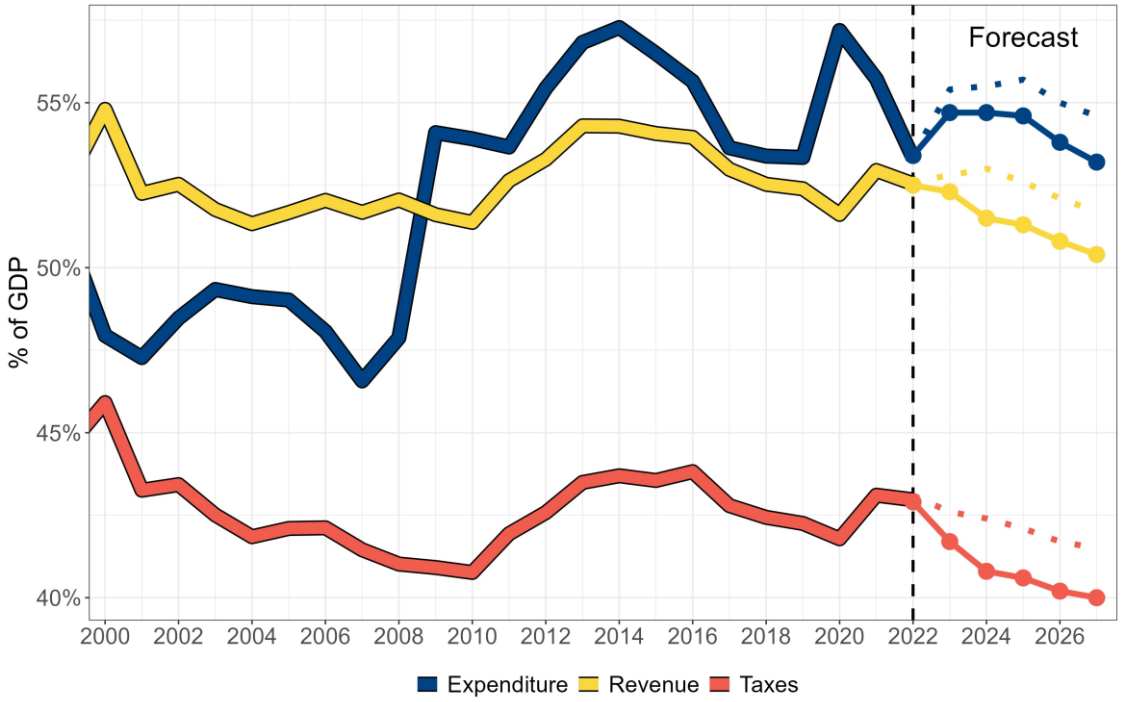
The projections in the fiscal plan of autumn 2023 do not take into account all the measures in the government programme or their intended effects. In particular, to the extent that government policies end up increasing employment or productivity in the wellbeing services counties, these effects will be reflected in later macroeconomic and fiscal forecasts.[41]

In contrast to expenditure, government revenue has not increased much relative to GDP. This has led to deficits. Taxes are the main source of

[41] See the Economic Survey of autumn 2023 for details (MoF 2023a, p. 79-81). However, the document could be clearer about the exact policy measures included in the forecast and their estimated impact. In particular, it is unclear which structural measures have been "partially taken into account".

government revenue. While the tax-to-GDP ratio (the total tax rate) increased somewhat in 2010-2016, it has since then declined slightly, and the decline is expected to continue during the forecast horizon until 2027. The tax-to-GDP ratio is forecast to fall to around 40% by 2027.

Figure 5.2.1. General government total expenditure, revenue, and taxes as share of GDP in 2000-2027*.



Sources: Statistics Finland and Ministry of Finance (General government fiscal plan).
Note: the forecasted values for 2023-2027 shown with solid lines are from the general government fiscal plan (autumn 2023); dotted lines are from the technical fiscal plan (spring 2023).

A declining path of revenue and tax shares was already projected in the technical government fiscal plan before the current government took office (dotted lines in Figure 5.2.1). Part of the decline is explained by the economy moving away from fossil fuels, which reduces carbon-based tax revenues. These developments are discussed in more detail in Section 5.3. below.

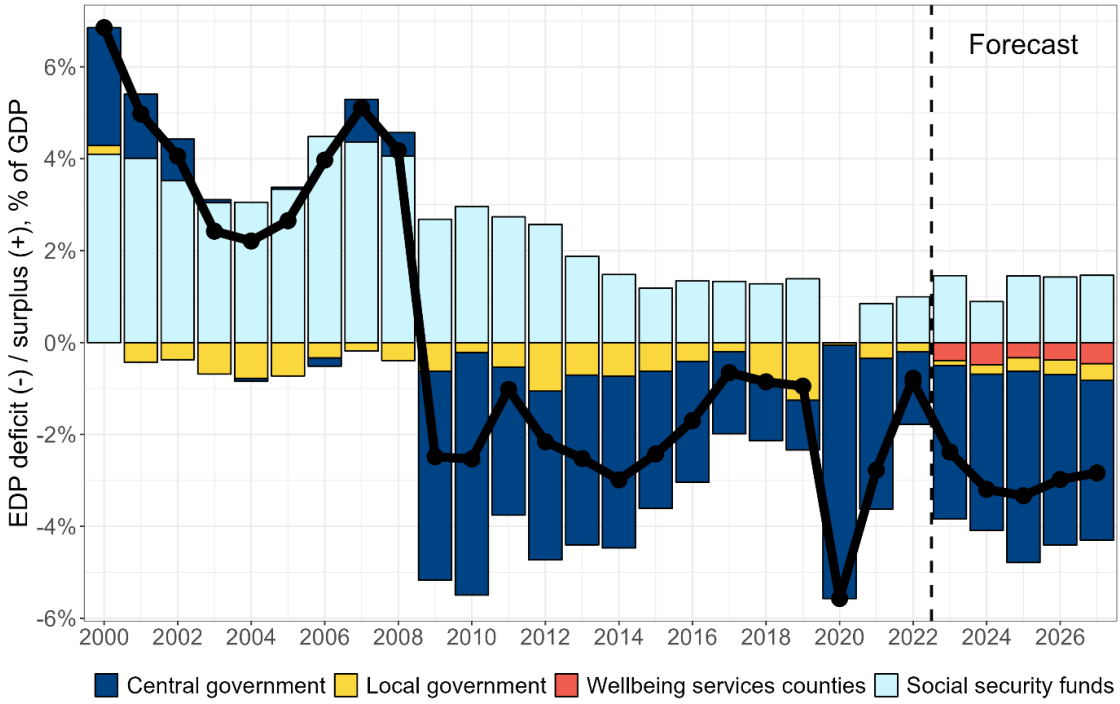
The more recent fiscal plan from autumn 2023 also takes into account some of the policy measures proposed by the current government. In this plan, the projected total tax rate for the years 2024-2027 is 1.5% points lower than in the spring 2023 technical plan. However, the government programme does not include major tax cuts that would not be offset by increases in some other taxes.

A major item behind the gap between what was projected before the government took office and now is a cut of EUR 1.4 billion in unemployment insurance contributions. This reduction is largely due to the increase of funds in the Employment Fund's buffer fund. The net impact on general government tax revenue is less than EUR 1.4 billion, as the reduction in contributions leads to a larger tax base for income taxation. On the other hand, cuts in social benefits also reduce total tax revenue to the extent that the benefits are taxable, although this effect is much smaller than the direct effect of these cuts on government expenditure. There are also other factors behind the faster-than-expected decline in tax revenues; the Ministry of Finance (MoF 2023a, p. 92) refers to lower accrued taxes and a weaker economic outlook.

Central government has been the largest contributor to deficits in recent years and this is expected to continue in the coming years (Figure 5.2.2). The wellbeing services counties, which receive their funding from central government, are also expected to run deficits. Only the social security funds are in surplus. The surplus mainly reflects the fact that the earnings-related pension system, which is included in the public sector, is partly funded. However, the reduction in unemployment insurance contributions will reduce this sector's surplus in 2024. Overall, general government deficits are projected to be around 3% of GDP in the coming years, although the economic cycle is expected to normalise towards the end of the forecast horizon.

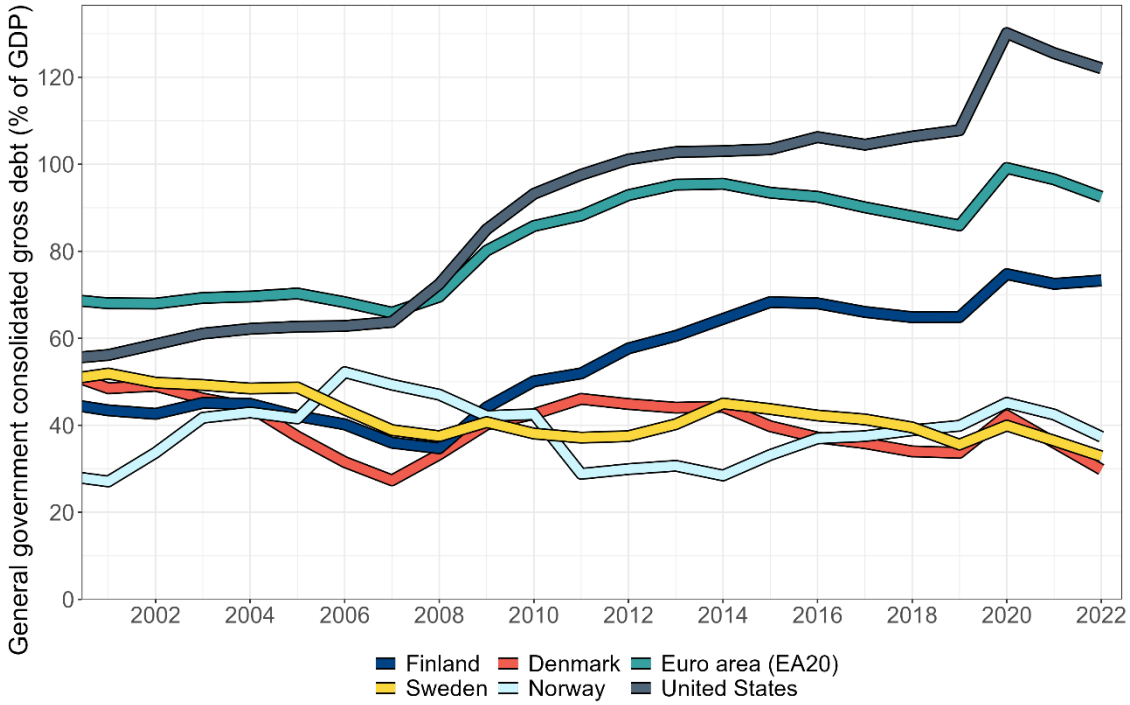
Deficits lead to the accumulation of public debt. Compared to its Nordic peers, Finland's general government debt-to-GDP ratio has increased considerably since the financial crisis, reaching more than 70% in 2022 (Figure 5.2.3). In Sweden, Norway and Denmark, the debt ratio has been fairly stable at around 40% of GDP and has been declining in the past few years. Finland's debt ratio is still below the euro area average, but the gap has been closing. The long-term debt target in the new EU fiscal framework will be 60 % of GDP.

Figure 5.2.2. General government budget balance in 2000-2027*.



Sources: Statistics Finland, Ministry of Finance (General government fiscal plan, autumn 2023). Note: EDP refers to excessive deficit procedure on the vertical axis.

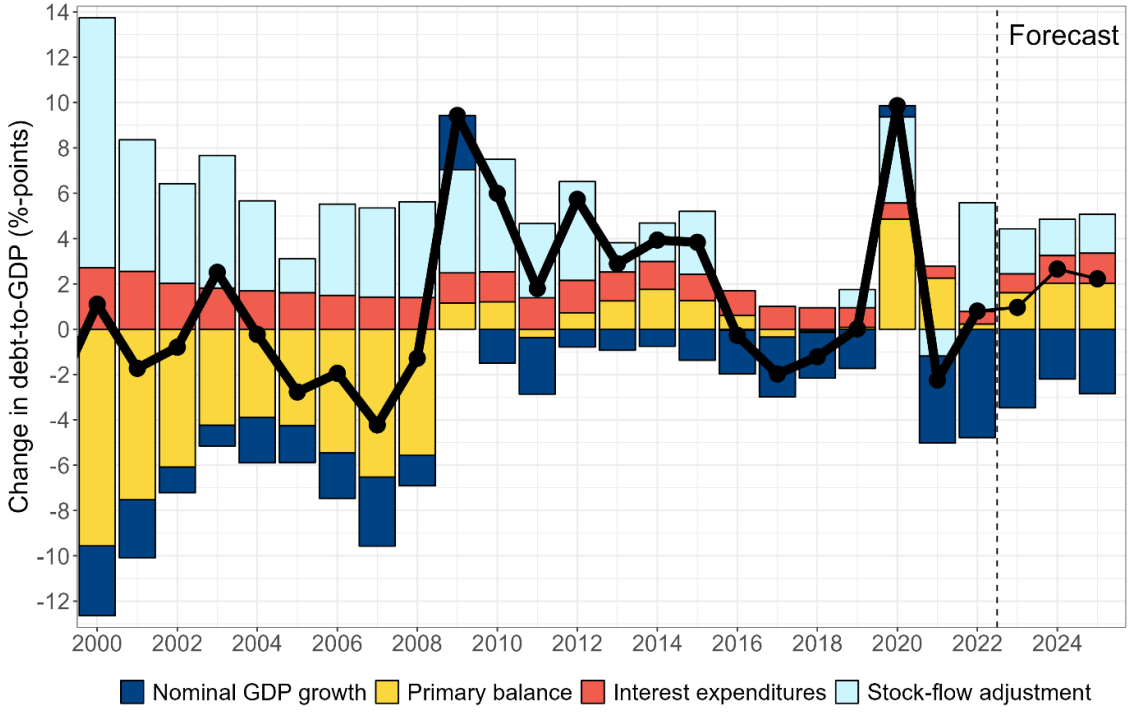
Figure 5.2.3. Debt-to-GDP ratio in selected countries 2000-2022.



Source: AMECO database.

The government budget balance is not the only determinant of changes in the debt ratio. Figure 5.2.4 decomposes the change in the debt ratio into nominal GDP growth, the primary balance, interest expenditure and the stock-flow adjustment, which is the change in the debt ratio not explained by the other three factors. The stock-flow adjustment mainly relates to the funds of the earnings-related pension system. The surpluses of these funds are not used to reduce the borrowing of other government sectors, but to help finance future pension obligations. Therefore, the stock-flow adjustment is typically positive. In other words, debt is accumulating faster than would be expected from the general government deficit.

Figure 5.2.4. Change in debt to GDP since 2000.



Source: AMECO database.

High inflation and higher-than-usual economic growth due to the recovery from the Covid-19 pandemic have meant that nominal GDP growth has contributed more to reducing the debt ratio in recent years than in previous years. In 2021, the debt ratio declined mainly due to strong nominal growth. On the other hand, interest rates have also risen. This increase is already affecting the government's interest payments, but as the government borrows at different maturities, the full effect of the rise in interest rates may still lie ahead. If interest rates remain high and the government needs to

refinance at higher rates, interest expenditure may contribute more to debt dynamics in the coming years.

In its fiscal plan, the current government has set multi-annual targets for general government finances.[42] These are summarised in Table 5.2.1 together with the forecasts by the Ministry of Finance and the gap between the two.

The government aims to reduce expenditure as a share of GDP, which would contribute to achieving its target of an overall budget balance of -1% by 2027. Achieving this deficit target would be at least broadly consistent with stabilising the debt ratio by the end of the government's term.

Table 5.2.1. Multiannual targets for general government finances (% of GDP).

		2023	2024	2025	2026	2027
Debt	Multiannual target	74.2	76.8	77.6	77.7	77.3
	Current forecast	74.2	76.8	78.9	80.4	81.6
	(Gap)	0	0	1.3	2.7	4.3
Budget balance	Multiannual target	-2.4	-3.2	-2.4	-1.6	-1
	Current forecast	-2.4	-3.2	-3.4	-3	-2.8
	(Gap)	0	0	-1	-1.4	-1.8
Expenditure	Multiannual target	54.7	54.7	53.9	52.7	51.8
	Current forecast	54.7	54.7	54.6	53.8	53.2
	(Gap)	0	0	0.7	1.1	1.4

Sources: General government fiscal plan 2024-2027 (autumn 2023); Ministry of Finance economic forecast (autumn 2023)

There is clearly a significant gap between these targets and the projections shown in the table. According to the Economic Survey of Autumn 2023 (MoF 2023a, p. 91), the government will not achieve its deficit target even if its consolidation programme improves public finances as estimated in the

[42] According to the Government degree on the General Fiscal Plan (120/2014), the General Government Fiscal Plan must establish multiyear budget goals for debt and expenditure relative to GDP. The targets should align with the Ministry of Finance forecasts, ensuring at least the attainment of the structural budgetary balance target to which Finland has committed in the Fiscal Compact.

government programme. The Ministry of Finance's latest economic survey (MoF 2023b) is even more pessimistic about public finances in the next two years.

5.3. Inflation, interest rates, and the cost of public debt

As described in Chapter 2, from 2021 onwards, inflation started to rise in many advanced economies, including Finland. A rise in inflation usually leads to an increase in nominal GDP and tax revenues, which reduces the value of public debt relative to GDP and makes it easier to service the debt. (For sure, inflation also increases nominal expenditures at least with a delay.) Without the recent rise in inflation, the debt-to-GDP ratio would probably be higher today.

On the other hand, along with rising inflation, interest rates on (newly issued) public debt have also risen. This is evident in the case of nominal interest rates on Finnish government debt, which have risen from close to zero between 2015 and 2020 to around 3% end of 2023 (Figure 2.4.2). For public debt sustainability and the cost of public debt, the relevant interest rate is the real interest rate, i.e. the nominal interest rate adjusted for inflation. Based on current (December 2023) market information described in Chapter 2, it seems reasonable to assume that the real interest rate on government debt has increased by 1-2 percentage points compared to the level prevailing for several years before the Covid-19 pandemic.

Unless the real interest rate on government borrowing soon falls back to its previous level, interest costs related to public debt will increase substantially relative to GDP and tax revenues, at least for some time. This will increase the cost of servicing public debt compared to the recent past.

A simple way to measure how much this cost will increase if the increase in the real interest rate turns out to be persistent is to consider the primary balance (government balance net of interest payments on the debt) relative to GDP that would be required to keep the debt-to-GDP ratio constant over time and see how it rises as the interest rate rises. Given the real interest rate, r, economic growth rate g, and public debt-to-GDP ratio d, the answer is approximately equal to $(r - g)d$ (see for instance Blanchard et al. 2021). The increase in this required primary balance following an increase in the interest

rate from r to r' is then given by $(r' - r)d$. (Technically speaking, this assumes that the change in the interest rate does not affect the stock-flow adjustment shown in Figure 5.2.4. We discuss the real interest rate and the return on social security funds below.)

The current debt ratio is around 75%. Therefore, a permanent 1.5%-point increase in the real interest rate increases the primary balance required to stabilise the debt ratio by $1.5\% * 75\% = 1.12\%$ of GDP, or about EUR 3 billion annually at the current level. This is a rough estimate of the impact of a 1.5% point higher real interest rate on the cost of servicing the current public debt.

Fortunately, the fiscal effort required to compensate for the rise in the real interest rate is likely to be smaller than this, at least in the long term. The main reason is that the Finnish public sector includes substantial funds related to the earnings-related pension system. A rise in interest rates increases the interest income of these funds. In addition, central government and the municipalities have some interest-bearing assets. And although it has permanently lowered the market value of assets with an infinite maturity such as shares and real estate in these funds, these lower prices can be expected to increase the expected return on future investments in similar assets. Consequently, the rise in real interest rates need not worsen the long-term sustainability of public finances as measured, for example, by the sustainability gap. It may well improve it.

However, the fact that a rise in real interest rates increases government revenues should not obscure the fact that it increases the cost of public debt. With less public debt, the impact of higher real interest rates on public finances would be less negative (or perhaps more positive). A higher real interest rate also increases the cost of servicing any additional public debt. Other things being equal, a higher real interest rate on public debt should therefore be a reason to limit net public borrowing.

Higher returns for pension funds also do not immediately or directly reduce the borrowing needs of central government and the municipalities. This is because the surpluses generated by the pension funds are not used to cover deficits in other sectors. Consequently, although a higher real interest rate may have a neutral or positive effect on long-term fiscal sustainability, it makes it more difficult to stabilise the debt ratio in the coming years. This is due to the direct impact of higher interest expenditure.

Higher returns for pension funds improve the fiscal position of central and local government indirectly by lowering the pension contribution rate (relative to a situation with lower returns). Lower pension contributions lead to higher tax revenues in two ways: first, because these contributions are deductible from income taxes, and second, by potentially increasing private consumption, which also generates tax revenue. A lower pension contribution rate also provides some scope for raising some tax rates without increasing the total tax rate.

5.4. Fiscal implications of climate policy targets and missing measures

The EPC (2023) dedicated a full chapter to climate policy and the fiscal risks associated with climate change. Here, we discuss the climate policy targets set out in Prime Minister Petteri Orpo's government programme, and their implications for costs in specific sectors of the economy and public spending.

The government is committed to the objectives of the Finnish Climate Change Act that entered into force already in 2022.[43] In addition, as an EU Member State, Finland complies with EU climate legislation, where emissions are divided into three separate sectoral regulations.[44] First, emissions trading covers energy production and large industrial plants. Carbon pricing has effectively reduced their emissions. Second, there is the so-called effort-sharing sector, i.e. construction, heating of buildings, housing, agriculture, transport, waste management and fluorinated gases from industrial processes. Finland's commitment is to reduce the effort-sharing sector's greenhouse gas emissions by 50% from 2005 levels by 2030. Achieving this reduction target will be challenging.[45]

In principle, emission credits could be borrowed from the third sector: land use, land use change, and forestry (LULUCF). However, Finland's carbon sinks under the LULUCF Regulation have collapsed. Moreover, the net sink target is included for the first time as a 2030 interim target for 2050 in the European

[43] The Act sets emission reduction targets as follows: -60% by 2030, -80% by 2040 and at least -90% but aiming at -95% by 2050, compared to 1990 levels. The carbon neutrality target by 2035 means that Finnish territorial emissions should be at least 70% lower in 2035 than in 1990, with the remaining carbon emissions offset by annual absorption from carbon sinks.

[44] Emissions Trading Directive (2003/87/EC), Effort Sharing Regulation (EU 2018/842), LULUCF (EU 2018/841)

[45] Annual Climate Report 2023 (MoE 2023a)

Climate Law, alongside emission reductions.[46] The Finnish target for carbon sinks in the land use sector is -17.8 million tonnes of CO_2 equivalent in 2030 (cf. Finland's total greenhouse gas emissions without the LULUCF sector in 2022 amounted to 45.8 million tonnes of CO_2 equivalent).

Finland may *not* meet the *interim* carbon reduction targets *or* the carbon neutrality target by 2035. The forest carbon sink has decreased considerably due to increased felling and reduced growth in the wood volume of trees (Luke 2022). Agri-environmental policies have not led to any carbon emissions reductions in agriculture, and reducing carbon emissions from industrial processes and energy production is heavily dependent on technological development, especially hydrogen-based solutions, and large-scale electrification.

There is a consensus among economists that carbon pricing is the most cost-efficient approach to providing incentives to reduce CO_2 emissions. However, the government's climate policy does not follow the market-based approach in some areas. For example, the government continues to promote energy efficiency mainly through voluntary agreements with companies and municipalities.[47] Promoting efficiency could rely more on price signals. The fact that the rapid rise in energy prices 2021 and 2022 led to significant energy savings (and reduced emissions) by companies and households in Finland and elsewhere in Europe illustrates the power of price signals in this area as well.

Here, we first focus on assessing the expected costs of climate policy with respect to carbon sinks under the LULUCF Regulation, and then discuss emissions from transport in the effort-sharing sector and their impact on public finances through tax revenues.

Carbon sinks

The carbon sink in the land use sector is currently below target. For the first five-year period (2021–2025), Finland will report a deficit of tens of millions of tons relative to the commitment. (Luke 2022)

[46] EU 2021/1119

[47] Energiatehokkuussopimukset 2017-2025 https://tem.fi/energiatehokkuussopimukset-ja-katselmukset A particular problem with voluntary energy efficiency agreements is whether they deliver real additional savings in energy consumption. Cornelis (2019) found that information on European voluntary agreements is very fragmented; only half of them have been thoroughly studied.

There are currently no policy instruments designed to ensure the adequacy of the carbon sink of managed forest land for the fulfilment of the EU obligation. A government programme priority (p. 145) is to "ensure growth in the Finnish forest sector", and the aim is to maintain or moderately increase logging in the state-owned forests managed by Metsähallitus. The regulation of forest harvests and the conservation of carbon sinks in forests is considered costly because of the expected increase in raw material costs and the negative impact on the forest industry.[48] There are no plans to implement restrictions on felling in state-owned forests, or to provide incentives for non-industrial private forest owners to increase carbon sinks in their managed forest areas.[49]

If the government intends to purchase emission reduction/carbon sink units from other Member States, it is important to know who will ultimately pay for the carbon sink units. Delivering carbon sink units for free might prove a substantial subsidy to landowners and industries using wood as a raw material. The subsidy would ultimately benefit citizens in the export countries who pay for Finnish forest products at a price that is below their social cost.

Regarding subsidies, it should also be noted that carbon emissions from energy-intensive industry are regulated under EU emissions trading (EU ETS), but industry receives allowances for free. The EU ETS raised about EUR 500 million for Finland in 2022.[50] The imputed revenue loss due to free allowances was about EUR 1,030 million in 2022, of which about a quarter

[48] The assessments were carried out by the Ministry of Finance using input-output modelling and specific assumptions on logging restrictions. For documentation and a memo on the economic impact assessment, see a working group report MoAgF (2023). The preliminary results of the working group were presented to the government programme negotiations in May 2023.

[49] Interestingly, the government will carry out an impact assessment on the introduction of a charge for changes to land use and develop a carbon sequestration market (p. 168). There is an extensive literature on policy instruments for increasing carbon sinks and the risks of design failures if the system is built on a voluntary basis (e.g. carbon leakage). For reviews on carbon sinks, EU obligations and policy instruments, see, e.g. Pihlainen et al (2014), Nurmi and Ollikainen (2019) and Soimakallio and Pihlainen (2023).

[50] Allowances are allocated free of charge to certain sectors that participate in emissions trading. The Energy Authority is Finland's national emissions trading authority responsible for permits, registers, and supervision. https://energiavirasto.fi/en/eu-emissions-trading-scheme

was allocated to the forest industry (approximated by the annual average allowance price of about EUR 80 per tonne of carbon dioxide).[51]

Purchasing emission reduction units or carbon sink units from other Member States would place an additional burden on public finances. However, a working group on the land use sector recommends buying sink units from other countries (MoAgF 2023). The purchase cost is highly uncertain, with estimates ranging from EUR 500 million to EUR 9,000 million. The wide range reflects alternative assumptions on the price of a sink unit (EUR 10-100 per CO_2 equivalent tonne) and the magnitude of the carbon deficit for 2021-2025 (50-80 million CO_2 equivalent tonnes). It should be noted that if the Finnish government decides to purchase carbon sink units, Finland will compensate those countries that have managed to increase their carbon sinks.

All in all, relying on purchases of carbon emission reduction units from other Member States may prove costly. Therefore, policy instruments that create incentives for increasing carbon sinks would be needed.

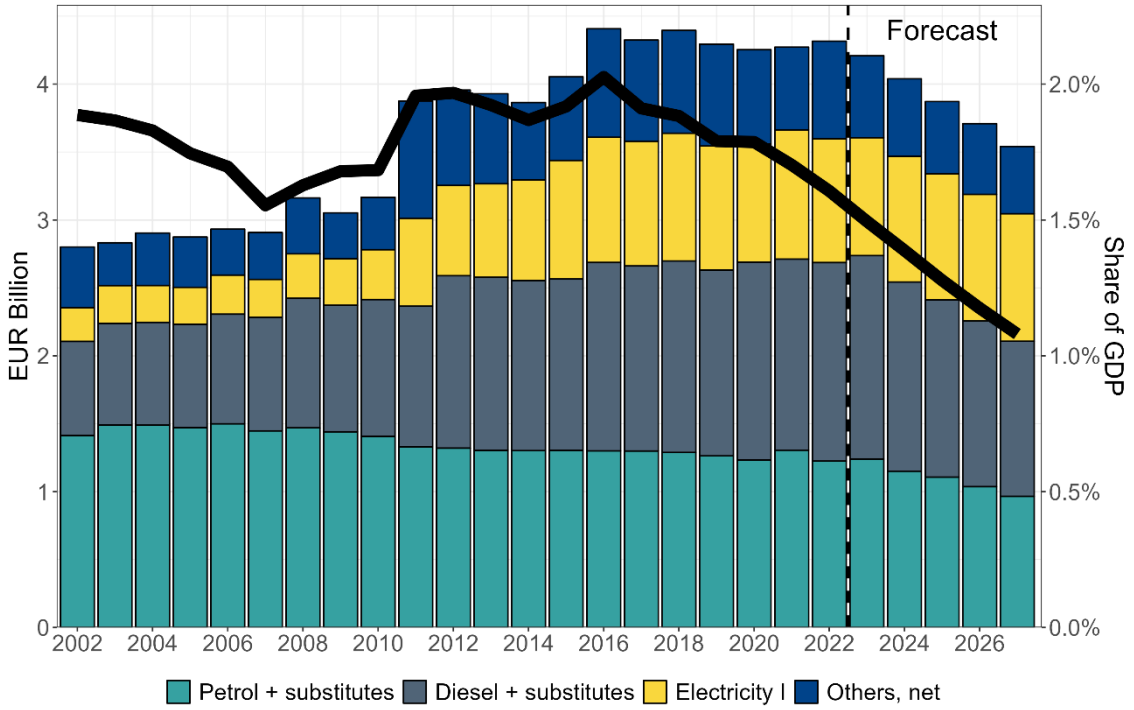
Climate policy instruments in the effort-sharing sector

The energy taxation framework is largely harmonised in the EU and includes heating fuels, light and heavy fuel oil, coal, and natural gas, as well as electricity. Revenues from energy taxes amounted to about EUR 4.3 billion in 2022. The Ministry of Finance forecasts that with current legislation and no new tax changes, revenues from energy taxes will decline (Figure 5.4.1).

Tax revenues from petrol, diesel, and their substitute biofuels and from heating fuels are projected to decrease by about EUR 0.7 billion by 2027. The decline in revenues as a share of GDP is particularly pronounced. Of course, the forecasts for tax revenues are uncertain as they depend on assumptions about the rate of electrification of the transport sector and the rate at which energy efficiency improves, among other things. It should also be noted that despite the increase in nominal excise duty levels on transport fuels, the real excise duty level on petrol has not increased in the 2010s, as consumer prices and household incomes have risen more than the average excise duty level.

[51] The Energy Authority https://energiavirasto.fi/paastooikeuksien-ilmaisjako. Energy-intense industry is additionally compensated for the increased costs caused by carbon pricing due to EU ETS. This support mechanism is currently called "aid for electrification of industry", and the total value of the subsidy for the forest industry was EUR 65 million in 2023 (cf. all industries in total EUR 118 million).

Figure 5.4.1. Realised and forecast development of energy tax revenues.



Source: Ministry of Finance 12.10.2023. Note: the y-axis on the left-hand side denotes revenues in billions and the y-axis on the right-hand side denotes share of GDP (black line).

Moreover, the MoF (2021) forecasts that other tax revenues from transport will decrease as well. The greatest decline will be in car tax revenues due to the increase in the share of electric vehicles and the increasing fuel-efficiency of other vehicles. Revenues from vehicle taxes will decline due to reductions in CO_2 emissions and the basic tax. In the long term, a carbon-based tax will no longer provide an opportunity to maintain the current fiscal role of transport taxation. This also concerns the design of the vehicle excise duty system.[52]

Furthermore, the current government is introducing changes in climate policy in the transport sector (which is part of the EU effort-sharing sector). The distribution obligation for the share of biofuels in road transport is to be reduced. As the distribution obligation will be lower than what was assumed in Finland's integrated National Energy and Climate Plan (NECP), it will be more difficult to achieve the carbon reduction target in the transport sector. In addition, the average price effect of the reduction in distribution obligation

[52] For the fiscal implications of the energy transition internationally, see e.g. OBR (2023), Raimi et al (2023).

levels in 2024-2027 compared to 2023 is offset by a permanent reduction in taxes on petrol and diesel from 2024.[53] Fuel taxes will also now be reduced in real terms due to inflation.

As the biofuel obligation will be less stringent than planned by the previous governments and fossil fuel tax rates will be lower, emission reduction measures will be needed in other sectors of the economy than transport. This is also likely to impose additional costs on taxpayers, as the government will have to buy emission reduction units from other EU countries with surpluses.

The shrinking energy tax base means that tax revenues will be permanently reduced and will have to be replaced by other means. Ideally, this would be based on a systematic review of the current tax system. A weight-based kilometre tax or road pricing may also be part of the solution.[54] However, there is no particular reason to try to keep public revenues from transport fixed.

5.5. Fiscal stance

Spending cuts and tax increases aimed at strengthening public finances tend to reduce aggregate demand. This reduction in demand often leads to a fall in output and employment, which in turn reduces the effectiveness of these measures in improving public finances. The impact of fiscal adjustment measures on output also depends on the cyclical situation of the economy. During a boom, output is mainly constrained by the availability of skilled labour rather than by insufficient demand. In such a situation, fiscal tightening tends to reduce inflation rather than output. Conversely, in a severe recession, when demand is already well below what the economy should be able to produce, fiscal tightening is likely to reduce output further.

The impact of fiscal consolidation measures on output, at least directly through a fall in aggregate demand, tends to diminish over time. It is therefore unlikely to render permanent fiscal consolidation measures useless from the

[53] Taxes are reduced by 4 cents/litre on diesel and 3.5 cents/litre on petrol. Furthermore, the current energy tax system includes tax expenditure ("tax subsidies") or lower tax rates on diesel fuel, fuel oil for machinery, electricity for industry and greenhouses etc.

[54] See e.g. Harrington et al (2007), Anderson and Auffhammer (2014).

point of view of the long-term sustainability of public finances.[55] Nevertheless, it makes sense to avoid tightening fiscal policy in a situation where output is constrained mainly by insufficient aggregate demand. Increased unemployment resulting from fiscal tightening in a recession would not only weaken public finances but also directly undermine the welfare of many people.

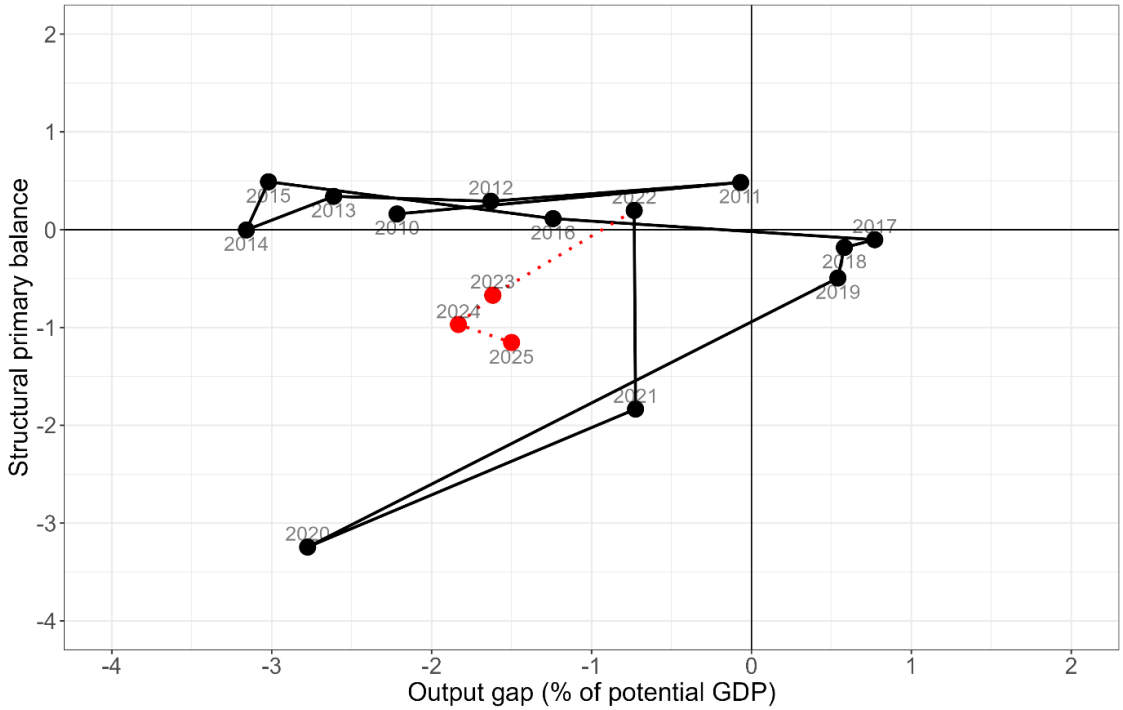
Figure 5.5.1 plots the structural primary balance and the output gap in Finland over the period 2010-2024 based on estimates and forecasts from the European Commission from November 2023. The output gap measures the difference between actual output and potential output. A negative output gap suggests that the economy should be able to produce more output without increasing inflationary pressures or other symptoms of an "overheating" economy. The structural primary balance measures the government surplus or deficit net of cyclical factors (such as higher unemployment insurance payments during a recession) and interest payments. With the output gap on the horizontal axis and the structural primary balance on the vertical axis, countercyclical fiscal policy should show up as points aligned around a line with a positive slope.

The output gap is forecast to be negative in 2024, suggesting that insufficient aggregate demand rather than production capacity will limit output this year. At the same time, the structural primary balance, which in principle should not reflect the economic slowdown, is also projected to be negative and the deficit to increase from 2023.

Based on these measures, the fiscal stance in 2024 thus appears to be countercyclical, or at least not clearly procyclical. Compared to 2023, the general government deficit, and probably also aggregate demand, is boosted in particular by a reduction in unemployment insurance contributions mentioned in Section 5.2. On the other hand, some of the social security cuts that are part of the consolidation programme outlined by the government will not be implemented from the beginning of 2024 but later.

[55] See the Economic Policy Council statement from April 2023 for a discussion on this issue and references to the related research: https://talouspolitiikanarviointineuvosto.fi/wp-content/uploads/2023/04/tpan-kannanotto-nykyinen-suhdannetilanne-ei-perustele-julkisen-talouden-sopeutustoimien-lykkaamista-1.pdf

Figure 5.5.1. Structural primary balance and the output gap 2010-2025.



Source: AMECO database. Note: Red dots are forecasts.

In the figure, there is no clear positive correlation between the output gap and the structural primary balance. In other words, fiscal policy has not been systematically countercyclical in the past. As discussed in Chapter 2, previous real-time estimates and forecasts of the output gap (the difference between actual and potential output) for Finland have been subject to large errors. This may explain, at least in part, why the figure does not show a clear positive relationship between the structural primary balance and the output gap. The problems related to measurement of the output gap (and the cyclical adjustment related to the structural balance) also underline the importance of considering the labour market situation in addition to output gap estimates when assessing the appropriate stance of fiscal policy.

As discussed in Chapter 2, while the labour market has weakened recently, the latest available data show that the unemployment rate has been relatively low and the vacancy rate relatively high. This also suggests that the government's first budget does not represent an excessively tight fiscal stance from the perspective of aggregate demand management and stabilisation. However, the latest forecasts for 2024 might justify a somewhat more expansionary fiscal policy than those behind Figure 5.5.1.

5.6. Council views

According to its programme, the main fiscal objective of Prime Minister Orpo's government is to strengthen public finances so that the public debt ratio can be stabilised by the end of the current parliamentary term.

We support this objective, provided the economic environment remains relatively stable in the coming years. The current upward trend in the public debt ratio reflects a long-term fiscal sustainability problem, which creates uncertainty about future taxes and the sustainability of public services and transfers. It may also reduce the scope for counter-cyclical fiscal policy in the future. Additionally, the recent increase in real interest rates has raised the cost of public debt compared to a few years ago.

The consolidation programme outlined in the government programme will undoubtedly strengthen public finances relative to a baseline of no policy changes. Unfortunately, it is unlikely to be sufficient to stabilise the debt ratio.

One reason for this is the development of tax revenues. Tax revenues are projected to fall as a share of GDP in the coming years, largely due to the electrification of transport, which will reduce carbon-based tax revenues from cars and fuels. In addition, for reasons largely independent of the current government, the Ministry of Finance now projects a substantially larger decline in the total tax rate between 2023 and 2027 than at the time the government programme was prepared.

The fiscal impact of some of the measures in the governments' consolidation programme is also very uncertain. For one thing, there is a great deal of uncertainty about the extent to which improved incentives to work will translate into improved public finances through higher employment. It is especially difficult to assess the government's chances of generating major savings by improving the operational efficiency of the wellbeing services counties.

The government is committed to taking additional action if it turns out that the measures outlined in the government programme are not sufficient to achieve its key fiscal objectives. However, according to the programme, the government will not raise the total tax rate "by government decisions". This statement seems to rule out tax increases as a response to a decline in tax revenues that is unrelated to government decisions. On the other hand,

strengthening public finances quickly enough through further spending cuts alone may be difficult in practice.

A more flexible approach to taxation would strengthen the government's credibility with regard to its goal of strengthening public finances. The above statement on the total tax rate could also be interpreted to mean that the overall tax rate should not exceed the level projected in the technical fiscal plan. Such an interpretation would allow tax policy to respond to a faster than expected decline in tax revenues, thereby facilitating the achievement of the government's main fiscal objective.

However, the fact that the total tax rate is projected to fall does not make compensating tax increases harmless. The distortionary effects of taxation tend to increase with the (effective) tax rate, and the total tax rate remains quite high in any case. For example, higher taxes on labour income are likely to reduce labour supply, leading to reduced taxable income.

To bolster public finances via taxation, it would be prudent to focus on broad, inelastic tax bases or reforms that render the tax system more neutral, minimising its undue influences on individuals' choices. This could involve increasing value-added taxation, particularly by increasing some of the reduced VAT rates, increasing property taxes (beyond current plans), and reducing the dividend tax exemption for non-listed companies.

The government's consolidation programme relies heavily on cuts to social benefits. The aim is to improve public finances both by reducing social spending and by improving incentives for job search and work.

The government's stated intention is to implement the cuts "in a way that acknowledges the situation of the most vulnerable groups". While some of the cuts are arguably compatible with this target, it is questionable whether the consolidation programme as a whole is in line with it. The main problem is that cuts in different social benefits partly affect the same people. Some people with very limited economic resources will see their disposable income shrink quite substantially.

This problem is linked to the fact that the government has sought savings mainly in benefits for people of working age, while a large part of social security spending is on benefits for pensioners. On the other hand, the government also wants to reform the pension system. The details are still

open, but this is an opportunity to look for savings in social security spending that do not jeopardise the livelihoods of the most vulnerable groups or undermine incentives to work. It could be especially useful to reconsider some of the benefits in the earnings-related pension system that are not based on (wage) earnings. For example, the current state-funded pension benefit based on studies leading to a vocational upper secondary qualification or a university degree seems like a transfer from all taxpayers to people who are unlikely to be poor, either in terms of lifetime income or annual income when they receive the transfer.

Finland may not be able to meet its carbon reduction commitments under EU climate legislation. In particular, it will be difficult or even impossible to reach the carbon sink target in the land use sector in 2021-2025. This will create new fiscal risks as Finland may have to buy carbon sinks units from other Member States.

In our view, the government should seek to create incentives to maintain and increase carbon sinks in order to reduce the need for the government to purchase offsetting sinks from abroad. From a public finance perspective, it would be desirable for these incentives to be based, at least in part, on landowners or the forest industry having to pay for the loss of carbon sinks they cause, rather than taxpayers subsidising the forest sector. Providing incentives to maintain carbon sinks would also be an important step towards making our climate policy more effective. In the current situation, we are probably missing out on relatively cheap ways to reduce net emissions.

The government's first budget implements some of the expenditure cuts that are part of its consolidation programme. Despite these efforts, the increase in the public debt ratio is not slowing down. This is partly due to a weaker cyclical outlook and higher interest expenditure but also to the fact that the overall fiscal stance, which includes taxation, is not significantly tightened. The current relatively loose fiscal stance may well prove to be appropriate from the point of view of aggregate stabilisation. On the other hand, it likely increases the need to tighten fiscal policy in the coming years to stabilise the debt ratio. This underlines the need for a fiscal consolidation programme that extends over several parliamentary terms.

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