MINISTRY OF FINANCE

Outlook and challenges for Finland's public finances

Ministry of Finance publications – 7b/2017

Economic Policy

Ministry of Finance publication 7b/2017

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Ministry of Finance, Helsinki 2017

Ministry of Finance

ISBN: 978-952-251-841-5

Layout: Government Administration Department/
Information Support and Publications Unit/Anitta Türkkan

Helsinki 2017

Description sheet

Published by	Ministry of Finance		February 2017
Authors	Economics Department of the Ministry of Finance		
Title of publication	Outlook and challenges for Finland's public finances		
Series and publication number	Ministry of Finance publications 7b/2017		
Subject	Economic Policy		
ISBN PDF	978-952-251-841-5	**ISSN (PDF)**	1797-9714
Website address (URN)	http://urn.fi/URN:ISBN:978-952-251-841-5		
Pages	52	**Language**	Finnish

Abstract

The government term is at its halfway point so this is a good time to examine the development of public finances and the labour markets in relation to the targets set for them. This report evaluates the situation in public finances and the labour market, and finds that the government is falling short of some of its key targets. Although there has been some positive economic news during the past few months, the problems in public finances and the labour market have not disappeared.

On the basis of this review we can state that the scale of the government programme and the planned timing of actions to be taken still seem to be correct. However, not all actions have been executed to the extent intended or their impact has been delayed.

It seems that the measures already taken in respect of employment and growth are not sufficient to strengthen public finances by the EUR 2 billion that was set as the target in the government programme. Achieving the employment targets is unlikely without effective policy measures that would strengthen the demand and supply of labour.

Savings of EUR 1 billion by eliminating tasks and obligations of public finances have not yet been reached even in half. In order to achieve the targeted savings, a significant number of decisions that will definitely result in further savings are needed.

The government could achieve its key targets by determined implementation of the actions contained in the government programme or by implementing alternative measures to strengthen public finances and increase employment rate. Measures to strengthen public finances should be focussed primarily on central government finances because the central government is not expected to meet the deficit target. This would also support meeting EU obligations.

Publisher	Ministry of Finance
Publication sales/ Distributed by	Online version: julkaisut.valtioneuvosto.fi Publication sales: julkaisutilaukset.valtioneuvosto.fi

FOREWORD

The Government has set as targets halting growth of public debt, increasing the employment rate to 72% and making the decisions necessary to bridge the sustainability gap. The government term is at its halfway point, so this is a good time to examine the development of public finances and the labour market in relation to the targets set for them. The report has been prepared for this purpose. The report does not, as a rule, examine possible individual measures to achieve the set targets, because employment and corporate taxation are being reviewed in working groups that will complete their work in January-February 2017. Assessments are based on the December 2016 forecast of the Economics Department of the Ministry of Finance as well as, to some extent, the September 2016 forecast.

Chapter 1 presents a snapshot of the current state of public finances, and examines the achievement of the Government's fiscal policy targets in the medium term. Chapter 2 reviews the sustainability of public finances in the long term as well as the progress of Government measures aimed at bridging the sustainability gap. Chapter 3 provides an overview of the labour market as well as an assessment of which employment measures, targeted at specific groups, would be most effective in the light of research knowledge. Chapter 4 sets out two different scenarios for the development of public finances, when either employment or adjustment measures are implemented.

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Summary and conclusions

Government targets on improving the state of public finances and raising the employment rate are not being fulfilled

The state of Finland's public finances has been weak for nearly a decade. Public finances have been weakened by industrial restructuring and population ageing. Normalisation of economic conditions will not be sufficient to improve the state of public finances substantially, since population ageing continues and structural unemployment is high. Finland must also be prepared for modest economic growth in the next decade.

The key targets set by the Government will not be fulfilled. The target by which additional debt will not be taken after 2021 is still far from being achieved. Public debt in ratio to GDP may start to fall slightly at the end of the decade, but the debt ratio threatens to rise again in the 2020s. The employment rate is likely to fall two percentage points short of the 72% target in 2019.

The target by which the total tax rate will not rise during the current parliamentary term is being fulfilled. Due to tax concessions associated with the Competitiveness Pact, the total tax rate is expected to fall significantly. One possibility to improve public finances would be to take advantage of the breathing space granted by the fall in the total tax rate by modestly increasing indirect taxation, if other measures aimed at improving public finances prove to be insufficient. In Finland's case, it would be economically justified to increase indirect taxation by raising the reduced value-added tax rates.

The overall state of public finances is likely to be weaker than targeted at the end of the parliamentary term due to the central government fiscal deficit. The other general government subsectors would appear, on average, to be achieving the targets set for them. Measures to improve general government finances should therefore be directed primarily at central government finances.

With respect to EU obligations, the deficit remains below 3%, but the debt ratio has exceeded the 60% reference level. In addition, convergence towards the medium-term objective set for the general government structural deficit will, according to the forecast, be slower than required. There is therefore a risk that Finland's obligations under the Stability and Growth Pact will not be met in the next few years. In autumn 2016, the Government committed to decide in spring 2017 on possible new measures necessary to ensure compliance with the EU's fiscal policy rules.

Achieving the target of the long-term sustainability of public finances requires determined implementation of planned measures

In the long term, the imbalance between general government revenue and expenditure, i.e. the sustainability gap, is just over 3% in ratio to GDP, i.e. approximately EUR 7 billion. The imbalance is due to the weak starting situation of public finances as well as future expenditure pressures arising from population ageing. Faster-than-expected economic growth will not solve the sustainability gap; action is needed to raise the employment rate and improve the efficiency of public service provision. In addition, the replacement of the fighter fleet and other required investments will create significant pressures for public finances in the 2020s.

Compared with spring 2015, the overall picture of the economy has remained unchanged to the extent that there is no reason to revise the scale or implementation of the EUR 10 billion package of measures included in the Government Programme. Immediate consolidation measures will strengthen public finances as planned by EUR 4 billion. The impact of employment and growth measures on public finances by 2021 is likely to fall short of the intended EUR 2 billion, so additional measures to raise the employment rate are required. Many risks, which should be taken into account in further preparation, are associated with achieving the EUR 3 billion savings target sought through the social welfare and health care reform. Achieving the EUR 1 billion savings sought by cutting public finance duties and obligations will still require a significant number of new decisions to ensure the savings are delivered.

The state of the earnings-related pension system is stable, but not risk-free. If the longer term economic forecasts deteriorate significantly from at present, pressures to increase pension contributions in the 2020s and 2030s will start to become unsustainably high. The impact of the 2017 pension reform should be carefully monitored for any unanticipated behavioural effects. The various early exit pathways from working life should be critically examined in future. One way to curb growth of earnings-related pension expenditure could also be to limit indexed increases of earnings-related pensions.

Raising the employment rate will require additional effective measures to increase labour supply and demand

Finland's employment rate is low and the unemployment rate high compared with the other Nordic countries. The problem is that both labour demand and supply are insufficient. High unemployment is a burden on public finances. In 2015, direct expenditure arising from unemployment (unemployment benefit, housing allowance paid to unemployed households, and part of social assistance) totalled approximately EUR 6 billion.

The number of long-term unemployed is at the highest level since the 1990s' recession. Particularly in 25–54 year-old age group, additional measures are required for cutting short the long periods of unemployment. In Finland, the employment rate of 55–64 year-old men is 60%, whereas in Sweden it is 77%. The early exit from working life of this age group should not be encouraged, rather early exit routes should be blocked.

The employment rate of 25–34 year-old women is 10 percentage points lower than in Sweden. There is evidence that home care support contributes to encouraging women to remain outside the labour market.

Particularly in the Helsinki Metropolitan Area, high housing costs and high housing allowances together reduce incentives to work. Measures to curb the rise in housing costs and remove the incentive problems caused by housing allowances are needed.

Unemployment and long-term unemployment among young people have increased in recent years at the same rate as unemployment in other age groups. Based on recent European research, youth employment could be improved by enhanced job-seeking counselling, sanctions when job offers are refused and wage subsidies in private sector employment.

As the period of unemployment lengthens, the probability of employment declines. Preventing the prolongation of unemployment is vital, because after unemployment becomes structural it will not necessarily fall when economic conditions improve. Measures must be targeted effectively, as the same measures will not work for everyone. Some of the unemployed need strengthening of their basic skills, some have education and skills that have become obsolete. Others, on the other hand, have suitable skills; the only problem is lack of a job.

Conclusions

The analyses in this report evaluating the state of public finances and the labour market finances find that the Government is falling short of some of its key targets. Although there has been some favourable economic news in the past few months, the problems in the public sector and the labour market have not disappeared.

On the basis of this review, it can be stated that the scale of the Government Programme and the planned timing of measures to be undertaken still appear to be appropriate. Not all measures, however, are being implemented to the extent planned or they will not have sufficient impact within the set timescale.

As matters stand, the employment and growth measures already implemented are not sufficient to strengthen public finances by the EUR 2 billion set as a target in the Government Programme. Achieving the employment target is unlikely without effective policy measures to strengthen labour demand and supply.

Half of the saving of EUR 1 billion sought by cutting public finance duties and obligations has still not been achieved. Achieving the desired saving therefore requires a significant number of new decisions to ensure the savings are delivered.

The Government may achieve its key targets through the determined implementation of the measures outlined in the Government Programme or by implementing alternative measures to strengthen public finances and raise the employment rate. Measures to strengthen public finances should be directed primarily at central government finances, because central government is significantly falling short of the deficit target set for it. This would also support compliance with EU obligations.

1 Snapshot of current state of public finances, and fiscal policy objectives

1.1 Current state of public finances

- The state of Finland's public finances has been weak for nearly a decade.
- Public finances have been weakened by industrial restructuring and population ageing.

Since 2009, Finland's general government finances have been deeply in deficit. The general government deficit is primarily due to a long period of weak development for the economy and employment (see Figure 1). International, and particularly European, economic development has been weak, which has been evident in a decline in demand for investment goods important for Finnish exports. In addition, the collapse of the Finnish mobile phone business and a decline in demand for printing paper have reduced Finland's export income and thereby significantly the financial foundation of the welfare society. This is illustrated by Figure 2, which shows that the reason for GDP being nearly 6% lower in 2015 than in 2008 is the contraction of the value-added of manufacturing industry (particularly the electronics industry).

Moreover, the change in the population age structure and the retirement of the baby-boom generation have particularly increased pension expenditure in recent years. Due to growth in pension expenditure, among other things, the general government deficit has remained large, even though efforts have been made in recent years to reduce the deficit through spending cuts and tax increases. This can be seen in Figure 3, which shows that the general government deficit has simply not decreased since 2009, yet the deficit excluding earnings-related pension funds has decreased significantly compared with 2009.

Figure 1.

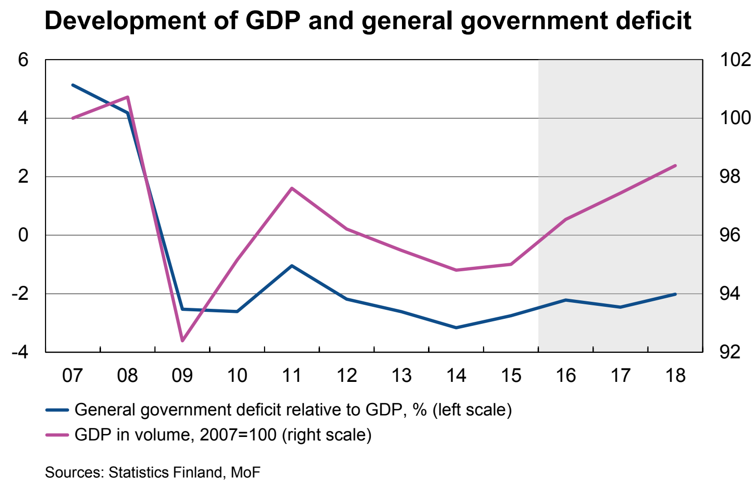


Figure 2.

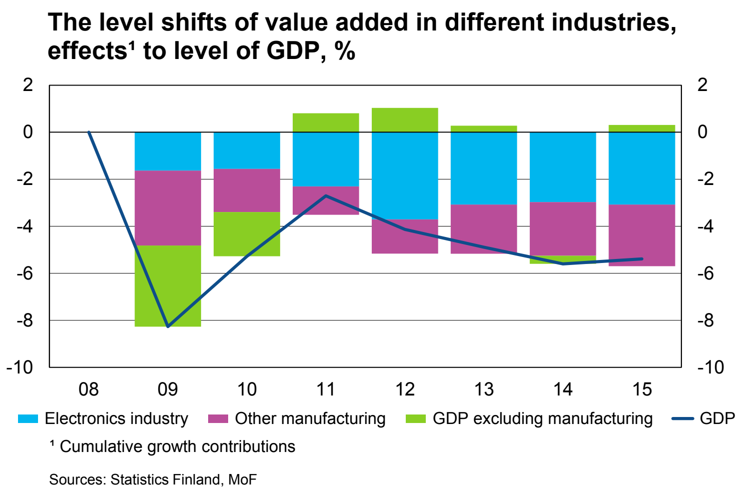
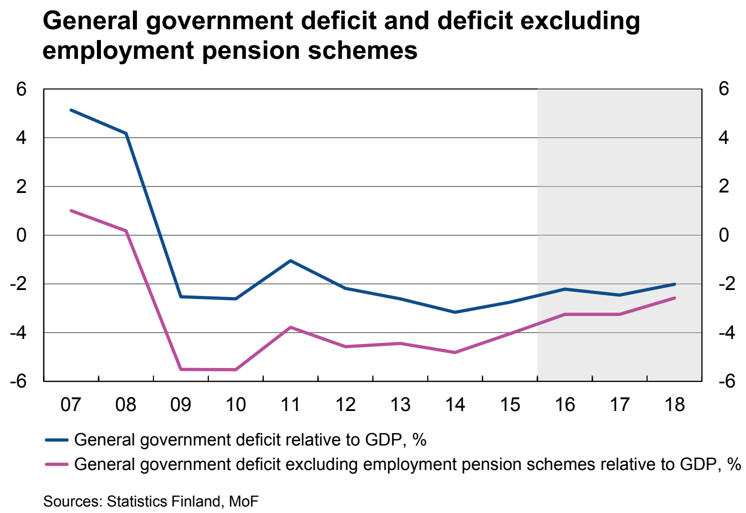


Figure 3.



1.2 Outlook for public finances in the next few years

- Normalisation of economic conditions will not be sufficient to improve the state of public finances substantially.
- Finland must also be prepared for modest economic growth in the next decade.

The budding recovery of Finland's economy has been based on domestic demand. The prospects of exports are not improving significantly. The Competitiveness Pact will support exports, but this will not be sufficient alone to stimulate significant growth in exports. As the economic recession recedes, the general government deficit will begin to shrink gradually, supported by Government measures. Tax concessions associated with the Competitiveness Pact will increase the general government deficit before the positive effects of the pact begin to be seen. The general government deficit is not likely to eliminated completely, however, because the improvement effect on general government finances of the normalisation of economic conditions will remain small.

Table 1. GDP growth and key forecast figures for general government finances*, % relative to GDP

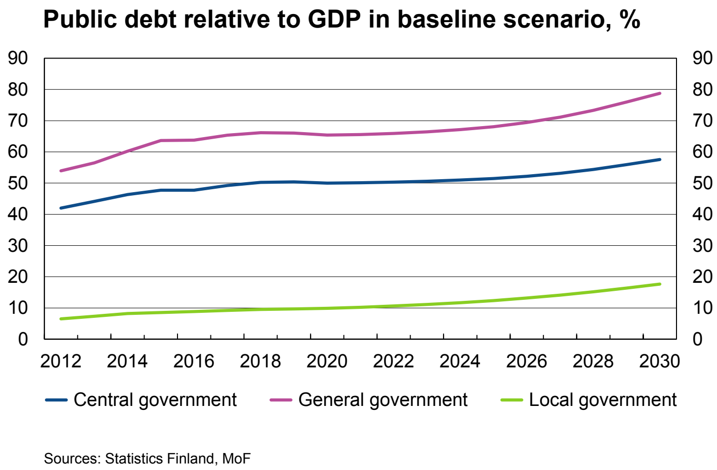
	2015*	2016**	2017**	2018**	2019**	2020**
GDP at market prices, change in volume, %	0.2	1.6	0.9	1.0	1.2	1.2
General government deficit	-2.8	-2.2	-2.5	-2.0	-1.5	-1.2
Central government	-3.0	-2.6	-2.6	-2.1	-1.7	-1.3
Local government	-0.6	-0.5	-0.5	-0.5	-0.5	-0.5
Social security funds	0.9	0.9	0.7	0.6	0.7	0.7
General government debt	63.6	63.7	65.3	66.1	66.0	65.4
Central government debt	47.7	47.7	49.2	50.2	50.4	50.0

*Forecast figures are based on the baseline scenario for 2016–2018 of the December 2016 macroeconomic forecast and the roughly estimated technical long-term scenario for 2019–2020 calculated on the basis of it. This is not a new forecast. A new forecast will be prepared for the Government's mid-term review and it will be published in April 2017.

In the coming decades, Finland must be prepared for the fact that its economic growth will not return to the rates of the years and decades that preceded the financial crisis. Opportunities for future economic growth will be limited by high structural unemployment and a reduction in the size of the working-age population. It also appears that productivity will develop more modestly than has been the case. In addition, the change in the population structure means that automatic growth of public expenditure will also continue in the 2020s. General government revenue will therefore be insufficient to maintain all the public sector structures and functions created on the foundations of stronger economic growth.

Figure 4 shows the development of the central government, local government and general government debt ratios in the coming decades. This is a pressure projection from 2020 forward, in which age-related expenditure increases the central government and local government deficits and thereby indebtedness[1]. In the analysis, the revenue and expenditure criteria for general government finances remain unchanged from 2021. The projection does not take into account the intended effects of the social welfare and health care reform.

Figure 4.



BOX 1. IMPACT OF LOW INTEREST RATES ON GENERAL GOVERNMENT BUDGETARY POSITION

The low level of interest rates in recent years has favoured borrowing. In Finland's central government budget, interest expenditure has declined from EUR 2.2 billion in 2008 to EUR 1.5 billion in 2016. At the same time, interest expenditure as a proportion of GDP has halved. In the same period, total central and local government debt has nearly doubled.

Interest rates will not, however, stay low forever: there have been signs of a pick-up in euro area inflation, and the ECB will in time withdraw from its purchase programme. Rising interest rates will be passed on into interest expenditure just as the need arises for central and local government to issue new debt.

On the other hand, Finland's general government net financial assets are positive, due to the investment assets accumulated from the surpluses of the earnings-related pension funds. The low level of interest rates has weakened the general government budgetary position, because the interest income received by the earnings-related pension funds has declined more than the interest expenditure paid by central government. Even though a rise in interest rates would, in time, improve the budgetary position of earnings-related pension funds, their surpluses can't be used to cover the deficits of the other sectors.

1 In the projection, average GDP growth is 1.3% in 2020–2030, inflation (GDP deflator) is, on average, 2% and development of age-related expenditure has been estimated using the social expenditure analysis (SOME) model.

1.3 Government targets relative to forecast development

- Public debt in ratio to GDP may start to fall slightly at the end of the decade.
- Additional debt will still be taken after 2021 and the debt ratio will start to rise again in the 2020s.
- The employment rate is likely to fall two percentage points short of the 72% target level in 2019.
- The total tax rate will fall significantly in the parliamentary term, due to the Competitiveness Pact and the tax concessions associated with it.

In its Government Programme, Prime Minister Sipilä's Government has set as a target that the general government debt-to-GDP ratio will level off by the end of the parliamentary term, and that additional debt will no longer be taken after 2021. A further target is that the total tax rate will not rise during the current parliamentary term.

According to the Ministry of Finance's latest estimates, it seems possible that the rise in the debt ratio would stop in 2019 and fall slightly in 2020. Additional borrowing is likely not to stop in 2021, because central and local government will still be significantly in deficit in 2020. The total tax rate will fall significantly in the parliamentary term, due to the Competitiveness Pact and the tax concessions associated with it. With respect to the total tax rate, the structure of taxation is examined in more detail in Box 2 in Chapter 2.

In addition to fiscal policy objectives, the Government has set as targets in its Government Programme that the employment rate will rise to 72% and the number of people in employment will increase by 110,000 during the government term. It seems that, without further measures, the targets set for the employment rate and the number of people in employment are unlikely to be achieved. The Ministry of Finance's latest estimate indicates that the employment rate would rise to nearly 70% in 2019 and the number of people in employment would increase from 2015 to 2019 by just over 40,000. The development of employment is examined in more detail in Chapter 3. In addition, Chapter 4 examines how large the impact on public finances would be if the 72% target employment rate were to be achieved in 2019 (scenario 1).

1.3.1 Balance targets of general government subsectors

- Due to the central government fiscal deficit, the overall state of public finances is likely to be weaker than targeted at the end of the parliamentary term.
- The other general government subsectors would appear, on average, to be achieving the targets set for them.
- Measures to improve general government finances should therefore be directed primarily at central government.

Alongside, and to concretise, the debt target, the Government has set deficit and surplus targets for the general government subsectors. If the targets are achieved, general government finances should be nearly in balance by the end of the parliamentary term.

The central government deficit target has been set at approximately 0.5% in ratio to GDP. Of the general government subsectors, central government is most strongly in deficit, nearly 3% in ratio to GDP. The deficit is projected to fall to just over 1.5% in ratio to GDP by 2019. Thus, with respect to central government, the deficit target set by the Government will still be far from being achieved. Chapter 4 examines a scenario in which an effort is made to reach the central government deficit target set for 2019 solely by adjusting general government finances.

The deficit target set for the budgetary position of local government is approximately 0.5% in ratio to GDP. In recent years, the local government deficit has been approximately 0.5% in ratio to GDP and it is projected to remain unchanged in the next few years. Thus, with respect to local government, the deficit target set by the Government would be achievable, provided that the consolidation measures prescribed by the Government are implemented in local government finances.

The target set for the budgetary position of the earnings-related pension funds is approximately 1% in ratio to GDP. In recent years, the surplus of the earnings-related pension funds has declined to just over 1% as pension expenditure has grown rapidly and the low level of interest rates has cut property income. The earnings-related pension funds' deficit is expected to decline to 0.5% in ratio to GDP by 2019. Thus, with respect to the earnings-related pension funds, the budgetary position would slightly fall short of the surplus target set by the Government.

With respect to other social security funds, the Government has set a target that their finances will be approximately in balance in 2019. In recent years, other social security funds have been slightly in deficit due to growth in unemployment expenditure. The finances of other social security funds will return to balance and even be slightly in surplus by 2019 as the employment situation slowly improves. Thus, with respect to the finances of other social security funds, they would very likely achieve the target set by the Government.

In summary, it appears that the other general government subsectors would, on average, achieve the set target, but the central government deficit will remain significantly larger than the target level. At the same time, due to the central government fiscal deficit, the overall state of public finances is likely to be weaker than expected. Measures to improve general government finances should therefore be directed primarily at central government.

1.4 Obligations jointly agreed in the EU

- The deficit remains below 3%, but the debt ratio has exceeded the 60% reference level.
- Convergence towards the medium-term objective set for the general government structural deficit will, according to the forecast, be slower than required.
- There is a risk that Stability and Growth Pact obligations will not be met in the next few years.
- In autumn 2016, the Government committed to take in spring 2017 possible additional measures, if necessary, to ensure compliance with the EU's fiscal policy rules.

In addition to the Government's own fiscal policy targets, it is natural to examine the implementation of obligations jointly agreed in the EU for the management of general government finances. Finland's general government deficit is, and is projected to remain, below 3% in ratio to GDP. On the other hand, public debt has grown above 60% in ratio to GDP. However, Finland has not to date entered the excessive deficit procedure[2].

There is a risk that the Stability and Growth Pact obligations will not be met in the next few years. Convergence towards the medium-term objective set for the general government structural deficit will, according to the forecast, be slower than required. According to the Ministry of Finance's forecast, the structural balance adjustment in 2017 and 2018 will be significantly smaller than required. There will also be a deviation from the expenditure benchmark this year and next.

In autumn 2016, the Government committed[3] to take in spring 2017 possible additional measures, if necessary, to ensure compliance with the EU fiscal policy rules[4]. The Stability and Growth Pact obligations and calculations concerning them have been described in more detail in Appendix 1 and in the 2017 Draft Budgetary Plan.

2 In assessing the fulfilment of the debt criterion, the Commission takes into account the so-called other relevant factors, of which for Finland the most relevant at the moment is that it complies with, at least broadly, the adjustment path towards the MTO.

3 http://vm.fi/artikkeli/-/asset_publisher/suomi-vastasi-komissiolle-alustavasta-talousarviosuunnitelmasta?_101_INSTANCE_C91M3tdJeutx_languageId=en_US

4 The Commission emphasised in its assessment of Finland's 2017 budget that the spring 2017 assessment will focus particular attention on credible plans for a return to the adjustment path towards the MTO, which means that efforts should be made in 2018 to achieve the required adjustment.

2 Long-term sustainability of public finances

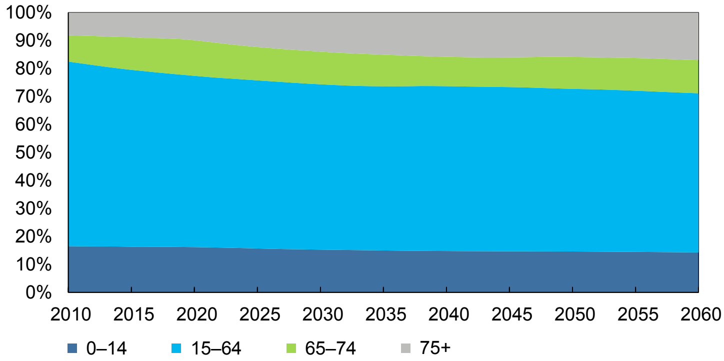
2.1 Sustainability gap

- In the long term, the imbalance between general government revenue and expenditure, i.e. the sustainability gap, is just over 3% in ratio to GDP, i.e. approximately EUR 7 billion.
- The imbalance is due to the weak starting situation of public finances as well as future expenditure pressures arising from population ageing.
- Faster-than-expected economic growth will not solve the sustainability gap; action is needed to raise the employment rate and improve the efficiency of public service provision.

A challenge for public finances even bigger than the current deficit is the change in population structure permanently in an unfavourable direction in the coming decades. In public finances, there is still a substantial sustainability gap, i.e. in the long term general government revenue will be insufficient to cover expenditure. A permanent imbalance between revenue and expenditure threatens to result in an unmanageable increase in debt. The future change in population structure will increase pension, health care and long term care expenditure, and the current already rather high tax rate will be insufficient to fund it. In addition, the change in population structure will reduce the working age population, which funds welfare services and benefits with taxes. In Finland, the change in population age structure will be evident more quickly than in other EU countries.

Figure 5.

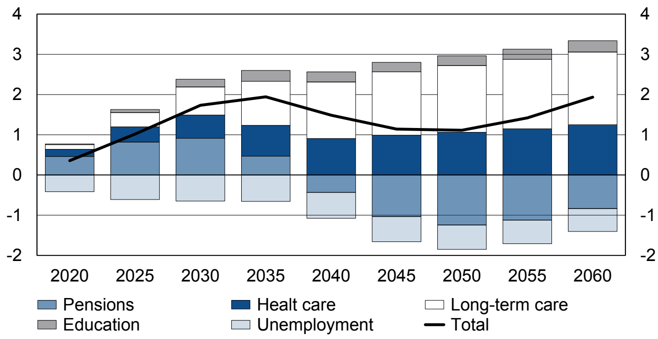
Share of population by age group



Source: Statistics Finland

Figure 6.

Change in age-related expenditure
from year 2015, relative to GDP, %



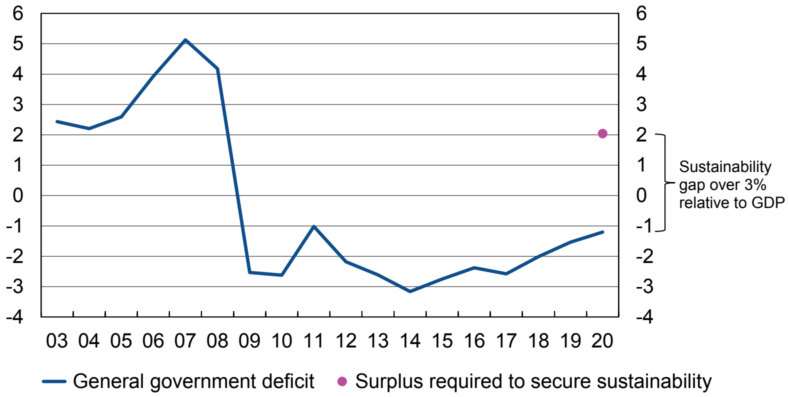
The figure is compiled using the model developed by the Ministry of Social Affairs and Health for social expenditure analysis

Source: MoF

According to the most recent, autumn 2016, estimate[1] of the Ministry of Finance, the sustainability gap is just over 3% in ratio to GDP, i.e. approximately EUR 7 billion. The sustainability gap can be technically expressed as the difference between the surplus safeguarding the sustainability of public finances and the public finances deficit on the starting year of the calculation (currently 2020) (see Figure 7). The surplus safeguarding sustainability means that the general government budgetary position should be approximately 2% in surplus in ratio to GDP at the beginning of the next decade for general government finances to manage the expenditure pressures arising from population ageing in the coming decades without additional measures. Instead of a 2% surplus, general government finances are projected to be just over 1% in deficit in 2020.

1 The sustainability gap estimate takes into account the 2017 pension reform. The calculation does not take into account the long-term measures outlined in the Government Programme to improve general government finances, such as the social welfare and health care reform.

Figure 7. **MoF's sustainability gap estimate in autumn 2016 relative to GDP, %**



Sources: Statistics Finland, MoF

To bridge the sustainability gap, structural measures implemented in good time will be important to ensure that drastic and hasty cuts are not necessary. A good example of a major structural reform is the 2017 pension reform, by which the retirement age will gradually begin to rise. There is naturally uncertainty associated within the sustainability gap estimate, because the calculation is sensitive to the assumptions used about future development. The calculation offers, however, a coherent way of examining the challenges facing public finances and solutions to overcome them.

Table 2 summarises the impact of various factors on the sustainability gap. The table shows, on the one hand, the scale of measures necessary to bridge the sustainability gap and, on the other hand, the sensitivity of the calculation to the assumptions used. From the calculation, one can infer that increases in the employment rate and the productivity of public services are the most effective means of bridging the sustainability gap. Nevertheless, it is very difficult to permanently improve general productivity development with policy measures, nor would this reduce the sustainability gap very much. This is due to the fact that an improvement in general productivity will increase, in the long term, real earnings in all sectors by the same amount, which will also be reflected in an increase in public sector labour costs.

Table 2. Impact of various factors on the sustainability gap

	Baseline scenario (autumn 2016)	Change, pp.	Impact on sustainability gap, pp.
Growth in general productivity (and real earnings)	1.4%	+ 1.0	-0.6
Employment rate	rises to 71.7% by 2060	+ 1.0	-0.4
Growth of productivity of public health and social services	0%	+ 0.5	-1.2
General government primary balance* / GDP in 2020	-0.2%	+ 1.0	-1.0
* deficit excl. interest expenditure			
Sensitivity of calculation to interest rate assumption			
Real rate of interest on debt and real return on assets	3% and 3.5%	-1.0	0.7

2.2 Sustainable expenditure growth in the long term

- In the long term, public expenditure should not grow faster than GDP because, on average, general government revenue will grow at the same rate as GDP.
- Due to population ageing, expenditure growth pressures will be greater than the growth potential of the economy in the 2020s, so measures such as the social welfare and health care reform and raising the employment rate are needed to curb expenditure growth.

Examined in more detail in Appendix 1, the expenditure benchmark of the EU Stability and Growth Pact will serve as a good guide for economic policy not only in the next few years, but also in the longer term. In the long term, it makes sense to tune growth of general government expenditure to correspond at most to growth in potential output, because in the long term growth of general government revenue will correspond, on average, to growth of potential output. This kind of analysis is consistent with the information produced by sustainability gap calculations, even if the approach is slightly different.

The 10-year average of Finland's potential growth will still remain low for a number of years, even if the estimate of potential growth in the coming years were also to be updated upwards in the future. At most, the 10-year average of potential output growth will, in the light of current knowledge, be approximately 1%. If inflation is assumed to be 2% per year, general government expenditure can in the longer term grow by no more than 3% per year. At the same time, growth pressure on pension, health care and long term care expenditure resulting from population ageing will, based on the sustainability gap calculation, be on average up to approximately 4% per year in the 2020s.

For general government expenditure growth to correspond, on average, to revenue growth, purposeful measures should be undertaken to curb expenditure growth. For this reason, in the social welfare and health care reform under way, efforts should be made to ensure that the reform really curbs growth in costs as intended. Raising the employment rate is also of prime importance for achieving the goal of curbing expenditure and safeguarding the financial foundation of public finances. Raising the employment rate will reduce unemployment and associated benefits, and will boost economic growth, thereby increasing tax revenue.

2.3 Implementation of the Government's EUR 10 billion target – the situation by subfactor

- Compared with spring 2015, the overall picture of the economy has remained unchanged to the extent that there is no reason to revise the scale or implementation of the EUR 10 billion package of measures included in the Government Programme.
- Immediate consolidation measures will strengthen public finances as planned by EUR 4 billion.
- The impact of employment and growth measures on public finances by 2021 is likely to fall short of the EUR 2 billion target, so additional measures to raise the employment rate are required.
- Many risks, which should be taken into account in further preparation, are associated with achieving the EUR 3 billion savings target sought through the social welfare and health care reform.
- Achieving the EUR 1 billion savings sought by cutting public finance duties and obligations will still require a significant number of new decisions to ensure the savings are delivered.

The fiscal policy targets outlined in Section 1.3 above are only stepping stones on the path towards the sustainable funding of public finances. It is for this reason that Prime Minister Sipilä's Government set as an objective in its Government Programme the bridging of the sustainability gap, which was estimated at that time to be approximately EUR 10 billion. The means to achieve the objective are immediate savings, efficiency improvements in public administration and service provision, and measures to strengthen conditions for economic growth.

The overall picture of the economy has remained unchanged since spring 2015. There is therefore no reason to revise the scale, content or implementation of the package of measures decided in the Government Programme to strengthen public finances.

2.3.1 Immediate consolidation measures

Of the EUR 10 billion package of measures, the immediate consolidation measures outlined in the Government Programme are currently estimated to amount to approximately EUR 4 billion; the savings have mostly been recorded in the central government spending limits and any deficiency may be covered with additional measures.

2.3.2 Employment and growth measures

Employment and growth measures (or consolidation measures replacing them) as well as structural reforms to take effect by 2021 are aimed at strengthening public finances by EUR 2 billion by 2021.

Of the employment and growth measures, the Competitiveness Pact ought to strengthen the general government balance by an amount that is at least 0.5% (just over EUR 1 billion) in ratio to GDP at the 2019 level, taking into account associated tax concessions. The Ministry of Finance estimates that the impact of the Competitiveness Pact on public finances will be broadly neutral in the longer term. Therefore the agreement is unlikely to achieve the intended strengthening of public finances.

Significant uncertainty, linked to international economic development, for example, is associated with the scale of the employment impact of the Competitiveness Pact. Thus, there is also a risk that the overall impact of the pact will weaken public finances. Without the positive effects of improving employment, the tax concessions associated with the pact will weaken the general government budgetary position in 2017–2019 by slightly over EUR 1 billion and from 2020 on by just over EUR 800 million. Despite this, the pact can be considered to be very important in terms of labour market stability, export competitiveness and confidence of companies and consumers.

Alongside the Competitiveness Pact, other measures supporting employment and economic growth (including wage settlements agreed) should strengthen public finances by nearly EUR 1 billion by 2021. The Government has decided on measures to support employment and growth, and possible new measures are currently being explored in various working groups. To date, the impact of the reforms already decided has been fairly weak. Thus, there is a need for further reforms.

Wage settlements in recent years have been extremely moderate, but the level of wage settlements in future years remains to be seen. It is highly probably, however, that wage settlements in the next few years will also be moderate. Assessing the impact of moderate wage settlements on public finances is not straightforward, because it is not clear with what kind of alternative wage development the realised increases should be compared.

BOX 2. FISCAL DEVALUATION AND TAXATION STRUCTURE

- One possibility to improve public finances would be to take advantage of the breathing space granted by the fall in the total tax rate by modestly increasing indirect taxation, if other measures aimed at improving public finances prove to be insufficient.
- In Finland's case, it would be economically justified to increase indirect taxation by raising the reduced value-added tax rates.

The Competitiveness Pact agreed last year resembles in spirit, to some extent, so-called fiscal devaluation. In fiscal devaluation, employers' indirect costs are reduced, and this is funded by increasing indirect taxation (for example value-added tax). In the Competitiveness Pact, the funding of employers' indirect costs is based, however, on savings arising in the public sector and initially borrowing, before the improvement of employment is expected to strengthen public finances. Such a procedure may to some extent be justified, because Finland's total tax rate is relatively high and taxation of providing and doing work is particularly severe.

The Government on committed to a policy of not increasing the total tax rate in the current parliamentary term. When the Government took office in 2015, the tax rate was 44.1%, whereas according to the most recent Ministry of Finance forecast it will fall as a consequence of the Competitiveness Pact to under 43% in 2018. Therefore, one possibility to improve public finances would be to take advantage of the breathing space granted by the fall in the total tax rate by modestly increasing indirect taxation, if other measures aimed at improving public finances prove to be insufficient.

Any increases in indirect taxation should be implemented taking the need to develop the structure of taxation into account. Taxation experts[1] and the European Commission have repeatedly recommended that the emphasis of taxation should be shifted away from taxation of labour towards taxation of consumption. In Finland's case, taxation of consumption is already severe, but the tax subsidy given to certain goods via reduced value-added tax rates distorts consumption and production (weakens economic efficiency).

In economics, the recommendation is to apply a single tax rate to all goods.[2] Research literature stresses that a single VAT rate increases the efficiency of both the economy and taxation. A single tax rate enables a lower level of the general tax rate than in a system in which reduced tax rates are applied in addition to the standard rate. Income distribution, for example, cannot be effectively influenced with reduced tax rates. Reduced rates also increase the complexity of the value-added tax system, the administrative burden of businesses and public authorities, and the cost of complying with the law. An increase in VAT would not weaken domestic export companies' competitiveness much, because VAT is not levied on export products.

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1 For example, Mirrlees et al. (2011): Tax by Design: the Mirrlees Review. Oxford: Oxford University Press and Ministry of Finance (2010): Final Report of the Working Group for Developing the Finnish Tax System, Ministry of Finance 51/2010

2 One possible model is to standardise all value-added tax rates at 22%, for more detail, see: Sustainability of public finances and structural reforms - Economic policy strategy 2013, Ministry of Finance 5/2013 (in Finnish).

2.3.3 Risks associated with the social welfare and health care reform

In addition to the measures to take effect by 2021, the Government is preparing measures that will take effect in the longer term. The measures are intended to strengthen public finances by EUR 4 billion on an annual basis up to the end of the 2020s. The most significant of these reforms is the social welfare and health care reform, which aims to curb growth in costs by EUR 3 billion[2].

Preparation of the social welfare and health care reform is already well under way, but significant details remain to be decided. At the moment, it seems that there are significant risks associated with achieving the reform's EUR 3 billion target, namely:

1. **Transition costs**
   Significant transition costs, resulting, for example, from harmonisation of salaries as well as information system investments, are inevitably associated with a reform of this scale. There is no provision for transition costs in the Government Programme or in the Government's first General Government Fiscal Plan. Achieving a EUR 3 billion net saving will therefore require a greater saving of health and social services expenditure.

2. **Freedom of choice legislation**
   Freedom of choice legislation may, at worst, lead to a significant growth in costs, if it enables private providers to select healthy clients or to send patients on barely adequate grounds to follow-up treatment at the cost of the county. The opportunity to closely coordinate patients' care chains might also be lost.

3. **Adherence to budget set by central government**
   In the selected, fully central government funded model, the counties have no incentive to spend less money than they receive from the central government, rather the opposite. Therefore, the only effective means of curbing growth in costs is setting a mechanical limit for central government funding. Health and social services are largely essential basic public services, and the central government is ultimately responsible for ensuring that statutory services can be provided in all counties.

   There is therefore a risk that the mechanical limit for central government funding will not be adhered to; the central government will be compelled to grant discretionary additional funding to counties whose money is running out. The existence of such a possibility may reduce the counties' interest in improving the efficiency of their activities and remaining within budget. In addition, it is possible that the criteria for the imputed funds allocation underestimate the actual funding needs of some of the counties.

2 Without the reform, growth of health and social services expenditure is projected to be 4.5% per year in nominal terms during the 2020s. Achieving the savings target would require growth of health and social services expenditure to be kept below 3% per year in 2020–2029.

In terms of achieving the savings target of the reform, the success of the reform in the biggest counties is important, because the expenditure of the four largest counties is more than half of the whole country's health and social services expenditure. Therefore, the fact that some of the counties will be very small in terms of population and weak in terms of capacity constitutes a lower risk than the above-mentioned risks with respect to achieving the savings target.

2.3.4 Cutting public finances duties and obligations

The Government Programme has set a target of achieving, by 2029, EUR 1 billion in savings in public finances by cutting municipalities' duties and obligations. Of this target, later extended from the municipalities to the whole of public finances, only less than half, i.e. just over EUR 400 million, has been identified to date as possible.

Only a fraction of these measures (some tens of millions of euros) are savings directly achievable through legislative changes. Realisation of savings generated by other measures will depend on how, for example, the municipalities change their activities as a result of decisions. There is some evidence that municipalities have not always implemented all of the changes, and for this reason savings have not been realised.

Achieving the intended EUR 1 billion savings will still require a significant number of new decisions to ensure the savings are delivered.

BOX 3. STATE OF EARNINGS-RELATED PENSION SYSTEM STABLE, BUT NOT RISK-FREE

- If the longer term economic forecasts deteriorate significantly from at present, pressures to increase pension contributions in the 2020s and 2030s will start to become unsustainably high.
- The impact of the 2017 pension reform should be carefully monitored for any unanticipated behavioural effects.
- The various early exit pathways from working life should be critically examined in future.
- One way to curb growth of earnings-related pension expenditure could also be to limit indexed increases of earnings-related pensions.

Finland's earnings-related pension system is designed so that, in principle, it ensures its own sustainability by adjusting the level of pension contributions. The pension benefits paid are not flexible, even if the economy performs poorly. Index adjustments (linked 80% to consumer prices and 20% to earnings) made to earnings-related pensions safeguard and, as a rule, even improve slightly the purchasing power of pensions, irrespective of economic conditions.

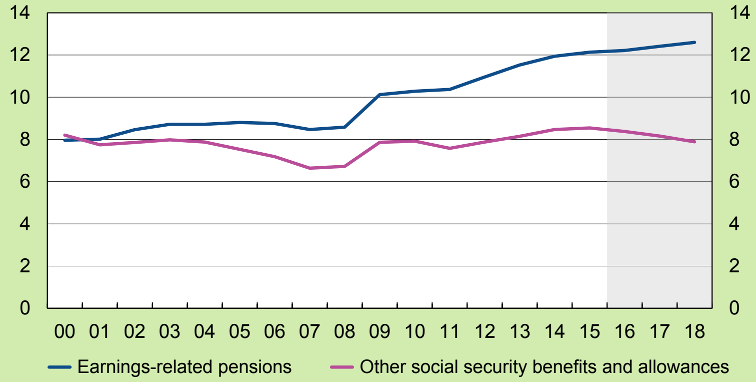
The sustainability of the pension system should therefore be assessed from the standpoint of whether the level of pension contributions collected is sustainable relative to taxation overall. The private sector's earnings-related pension contribution has increased over the last ten years by more than three percentage points. At the same time, other taxation of labour has eased to keep taxation at a reasonable level. The pressure to increase pension contributions has resulted from the fact that earnings-related pension expenditure in ratio to GDP has approximately increased by 50% since 2000. In contrast, all other social income transfers in ratio to GDP have simultaneously remained relatively constant (see Figure 8). Pension expenditure has been increased not only by growth in the number of pensioners, but also by the fact that the pensions of new pensioners are significantly better than before.

With respect to the earnings-related pension system, only the approval of legislation related to the 2017 pension reform was agreed in the Government Programme. The pension reform is expected to reduce the sustainability gap by around percentage point in ratio to GDP. There are risks associated with the impact assessments made, because the impact of the reform on lengthening working careers cannot be known precisely in advance. For example, use of the unemployment path to retirement or the opportunity to combine the partial early old-age pension with unemployment security might be more attractive than expected. Therefore, the impact of the reform must be monitored carefully in the coming years, even though the reform may be considered, in general, to be very successful.

When preparing the 2017 pension reform, the Finnish Centre for Pensions (ETK) estimated that in the private sector the current 24.4% earnings-related pension contribution would be sufficient to ensure the funding of pensions far into the future. In a new calculation by ETK in autumn 2016, the real rate of return on pension assets was reduced from 3.5% to 3.0% for the next 10 years. This would result in pressure to increase pension contributions by approximately 0.3 percentage points, on average, in the period 2022–2035. In an alternative pessimistic economic scenario produced by ETK, the pressure to increase pension contributions would be much greater than the baseline scenario, even 2–4 percentage points from the beginning of the 2020s.

In ETK's pension calculations, the pressure to increase earnings-related pension contributions is still relatively low. If, however, the longer term economic forecasts deteriorate significantly from at present, pressures to increase pension contributions in the 2020s and 2030s will start to become unsustainably high. Based on this, no conclusions can yet be made as to whether it is necessary to re-open the 2017 pension reform. To raise the employment rate and strengthen public finances, the various early exit routes from working life should, however, be examined critically also in the future. Another means of curbing growth in earnings-related pension expenditure could be to limit index adjustments to earnings-related pensions to the level of wage agreement increases, if they are below the change in the earnings-related pension index, as was done with index increases in 2015.

Figure 8. **Earnings-related pensions and other social security benefits and allowances relative to GDP, %**



Sources: Statistics Finland, MoF

BOX 4. DEFENCE PROCUREMENT WILL EXERT SIGNIFICANT PRESSURE ON PUBLIC FINANCES IN THE 2020S

The Defence Forces' strategic performance capability projects in the 2020s will contribute to increasing the need for measures to adjustment public finances. The projects are the replacement of the fighter fleet (HX project: EUR 7-10 billion) and the Finnish Navy's fleet acquisitions (Squadron 2020 project: EUR 1.2 billion). In addition to population ageing and defence force purchases, expenditure pressures in the 2020s will be increased by the "repair debt" emerging in transport infrastructure and public utility services.[1]

If the Defence Forces' strategic performance capability projects are funded completely by borrowing, they will permanently raise the debt ratio by three to four percentage points. The acquisitions are, however, more non-recurring expenditure than permanent expenditure increases, so their contribution to increasing the sustainability gap in public finances will be relatively small. In the present EU rules relating to public finances, the expenditure required by defence procurement is, however, taken into account just like other expenditure.

1 In the development estimate for public finances based on the sustainability gap calculation, the change in population structure will influence the development of pension, health care and long term care expenditure as well as public debt interest expenditure, but the GDP share of other expenditure will remain stable.

3 Employment and its impact on public finances

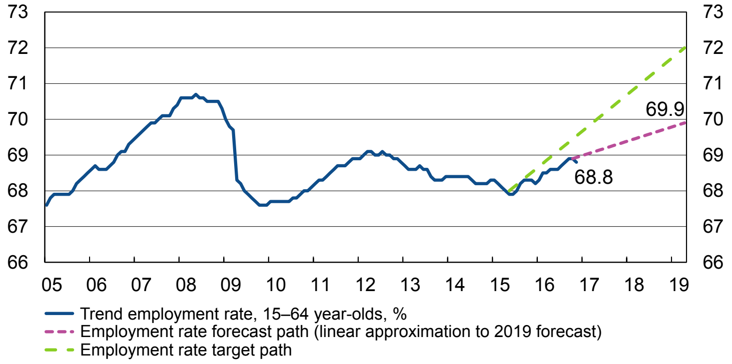
3.1 Development of employment rates in recent years

- Finland's employment rate is low and the unemployment rate high compared with the other Nordic countries. The problem is that both labour demand and supply are insufficient.
- High unemployment is a burden on public finances. In 2015, direct expenditure arising from unemployment (unemployment benefit, housing allowance paid to unemployed households, and part of social assistance) totalled approximately EUR 6 billion.
- The number of long-term unemployed is at the highest level since the 1990s' recession. Particularly in 25–54 year-old age group, additional measures are required for cutting short the long periods of unemployment.
- In Finland, the employment rate of 55–64 year-old men is 60%, whereas in Sweden it is 77%. The early exit from working life of this age group should not be encouraged, rather early exit routes should be blocked.
- The employment rate of 25–34 year-old women is 10 percentage points lower than in Sweden. There is evidence that home care support contributes to encouraging women to remain outside the labour market.
- Particularly in the Helsinki Metropolitan Area, high housing costs and high housing allowances together reduce incentives to work. Measures to curb the rise in housing costs and remove the incentive problems caused by housing allowances are needed.

The number of people in employment declined in 2013–2015 by nearly 2%. In 2016, the employment situation started to improve again due to economic growth, with increases in both the number of people in employment and the amount of hours worked. The employment rate also started to rise in 2016, but the Government Programme target of a 72% employment is far from being achieved.

Figure 9.

Trend employment rate, forecast path and Government Programme target, %



Employment rate target path starts 5/2015 and ends 4/2019.
Forecast path starts from starting situation 10/2016 of MoF's forecast.

Sources: Statistics Finland, MoF

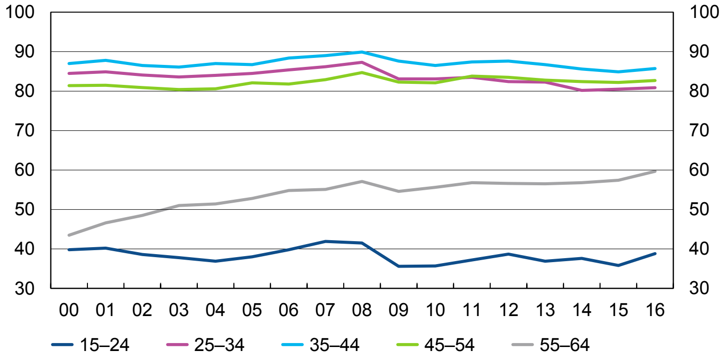
Raising the employment rate to 72% would require a significant increase in both the demand for labour and the supply of labour. Demand for labour started to increase in 2016, with the number of job vacancies rising above 40,000, which is about the same as at the 2007 cyclical peak. Even so, demand for labour demand is not considered to be sufficient in relation to the total number of unemployed. Broad unemployment, i.e. covering all unemployed job seekers and those in activation services, totalled 450,000 at the end of 2016. Even if all job vacancies were matched with unemployed people, there would still be over 400,000 people without work.

Demand for labour can be increased by ensuring that the growth rate of real labour costs does not exceed the growth rate of labour productivity. The Competitiveness Pact will reduce labour costs in 2017, but large increases in contractual wages, such as in 2008, should be avoided in coming years in order to increase the demand for labour.

As productivity develops at different rates in different sectors, it would also be appropriate to take sector- and company-specific productivity differences into account in wage agreements. For companies struggling with profitability problems, high collectively bargained wage increases are harmful and may lead to lay-offs or redundancies, and in the worst case even insolvency. An increase in local agreements could help companies adjust their operations in crisis situations without redundancies.

The supply of labour can be increased by improving incentives to accept work and by activating the unemployed to seek work more effectively or to accept the available work more readily. When reforming unemployment security and social assistance, it is possible to increase incentives to work. This chapter focuses specifically on factors influencing the supply of labour, as the Government has better opportunities to influence the supply of labour than demand for labour.

Figure 10. **Men's employment rates by age group, %**



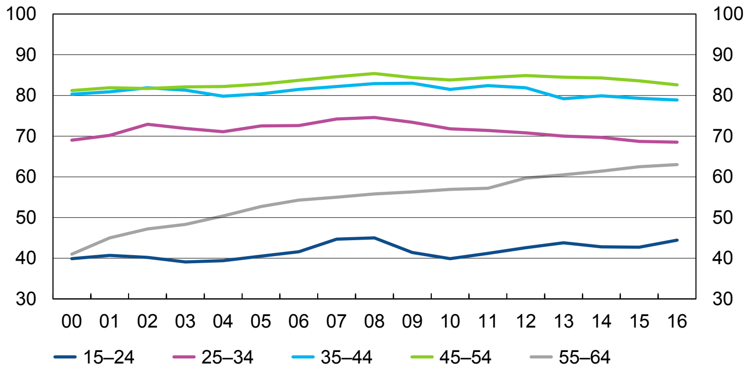
The 2016 data is average of January–September
Source: Statistics Finland

In recent years, employment rates of men have remained at the same level or have fallen in nearly all age groups. Only the employment rate of 55–64 year-old men has risen. Of particular concern is the fall in the employment rate of 25–34 year-old men to a level lower than at any time since the turn of the millennium.

The employment rate of 55–64 year-old men has improved in recent years, but despite this the present level of around 60% is low by international comparisons. In Sweden, the employment rate of men in the same age group is 77%, which indicates that the growth potential of the employment rate is highest of all in this age group.

In Sweden, the "last in, first out" principle, which protects more experienced workers from redundancies, has been enshrined in law. In Finland, on the contrary, people who have reached 59 years of age can receive earnings-related unemployment compensation until retirement, which does not exactly encourage employers to hold on to older workers. Additional days of unemployment security do not only lengthen the duration of unemployment, they increase the unemployment risk in the age group entitled to additional days. The early exit from working life of this age group should not be encouraged, rather early exit routes should be blocked.

Figure 11. Women's employment rates by age group, %



The 2016 data is average of January–September
Source: Statistics Finland

In recent years, employment rates of women have fallen most in the 25–34 and 35–44 year-old age groups. Compared with Sweden, the biggest difference is in the 25–34 year-old age group, in which Finland's employment rate is 10 percentage points lower.

Home care support directed at families with children under 3 years of age is a Finnish speciality, which may contribute to encouraging 25–34 year-old women to remain outside the labour market. In the other Nordic countries, parental leave lasts 12–16 months after the birth of a child, and no support for home care is paid thereafter.

Home care support has the effect of reducing the supply of labour. According to research[1], a EUR 100 increase in the municipal supplement for home care reduces the labour supply of mothers entitled to support by around 3%.

The OECD recommended in 2016[2] that Finland should shorten the combined duration of parental leave and home care support. This could encourage women to participate in the labour market.

Social security benefits may reduce incentives to accept or look for work. This means that even if gross income would increase significantly when a person is employed, the remaining net income would increase significantly less, as benefits are reduced or lost when income increases. In addition, taxation progression increases the proportion of taxes collected from earned income. In extreme cases, employment does not increase disposable income at all or even reduces it.

1 Kosonen Tuomas: "To work or not to work? The effect of child-care subsidies on the labour supply of parents", The B.E. Journal of Economic Analysis and Policy, 14(3), 2014.

2 OECD 2016. Economic Survey: Finland.

One key result of Finnish studies examining incentive problems is that, in Finland, a significant factor reducing incentives to accept work is related to high housing allowances. The housing allowance decreases rapidly as incomes rise and social assistance is fully means tested, which means that an increase in income reduces the allowance by up to 100%. According to the Social Insurance Institution of Finland, social assistance is paid most on the basis of housing costs and various kinds of healthcare expenditure.

Even though housing allowance and social assistance are intended to support their recipients not landlords, part of the monetary support may flow via higher rents to the benefit of landlords. According to Finnish research, of a one euro increase in housing allowance 60–70 cents is translated into rent increases in non-subsidised rental apartments.

The incentive problems caused by housing allowances are greatest in the Helsinki Metropolitan Area, where, for example, the City of Helsinki Department of Social Services and Health Care compensates with social assistance housing costs up to EUR 675 for one person. When housing costs are fully compensated from the housing allowance and social assistance, the incentives for a single person to accept low-paid work are very low. The impact of housing allowances on incentives to accept work was examined more extensively in a Ministry of Finance official outlook, published in spring 2015.[3]

In 2015[4], the IMF drew attention to the availability problems of affordable housing as one factor limiting mobility of labour. As solutions, the IMF proposed streamlining the zoning and planning process and increasing the supply of land as well as public investment, particularly in transport infrastructure.

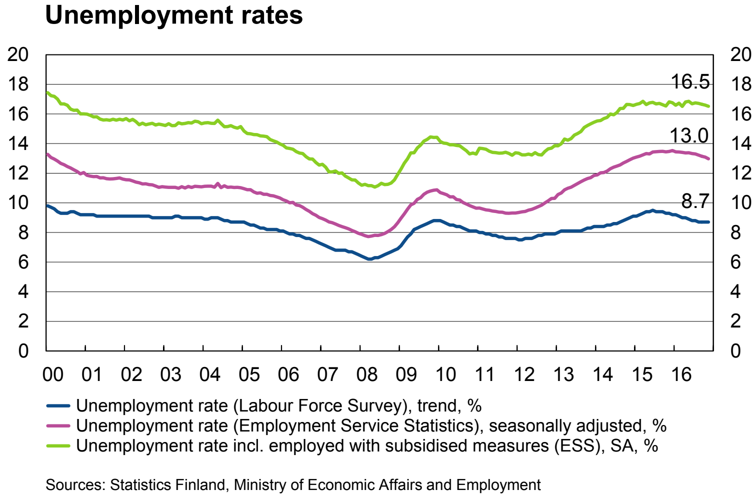
3 Starting positions for economic policy 2015-2019. Ministry of Finance publications - 13/2015 (pp. 52-57) (in Finnish).

4 IMF 2015. Finland - Concluding statement for the 2015 Article IV Consultation. https://www.imf.org/en/News/Articles/2015/09/28/04/52/mcs091515

3.2 Unemployment and long-term unemployment

- The changes in unemployment benefits and the obligations of unemployed that came into effect in 2017 include interviews with the unemployed four times per year as well as shortening the duration, extending the waiting period and lowering the higher components of earnings-related unemployment benefit.
- As the period of unemployment lengthens, the probability of employment declines.
- Preventing the prolongation of unemployment is vital, because after unemployment becomes structural it will not necessarily fall when economic conditions improve.
- Measures must be targeted effectively, as the same measures will not work for everyone. Some of the unemployed need strengthening of their basic skills, some have education and skills that have become obsolete. Others, on the other hand, have suitable skills; the only problem is lack of a job.

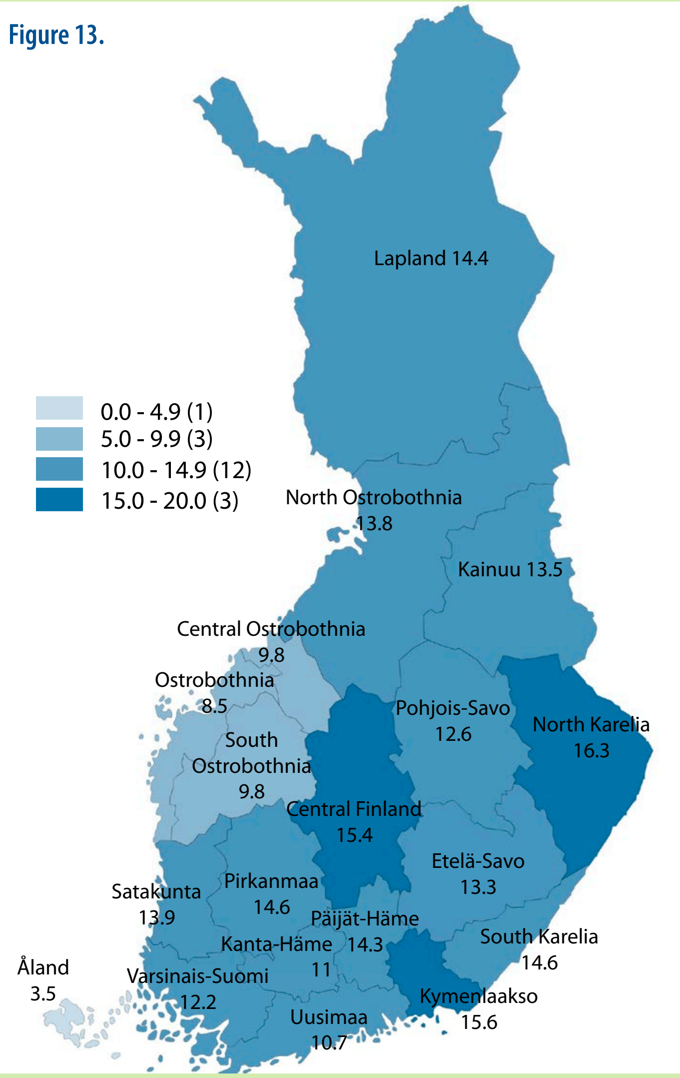
Figure 12.



Unemployment has started to fall in 2016, but at the same time the number of hidden and long-term unemployed has continued to grow. Broad unemployment, which also includes those in activation services, has remained unchanged at approximately 450,000. The unemployment rate corresponding to the definition of broad unemployment was over 16% in 2016.

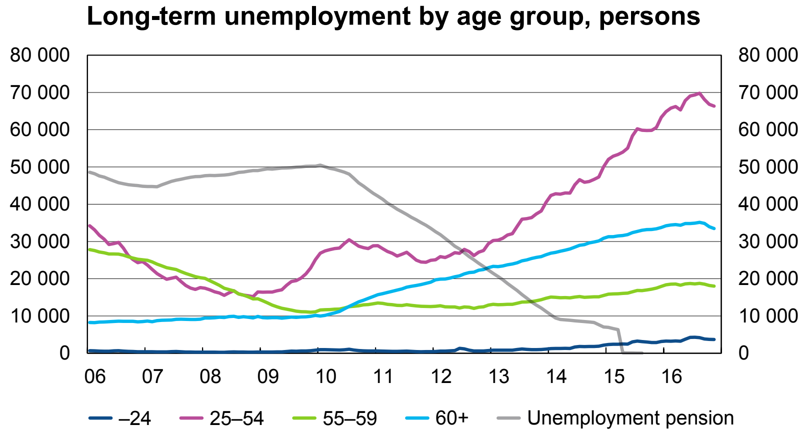
BOX 5. UNEMPLOYED JOB SEEKERS' PROPORTION OF LABOUR FORCE BY REGION

Figure 13.



In November 2016, the unemployment rate was highest in North Karelia and lowest in the Åland. Regional differences in unemployment rates have decreased over the last couple of years, particularly as the unemployment rate of Uusimaa has risen faster than the average for the country as a whole. In this light, problems relating to regional mismatching of labour supply and demand do not appear to have grown in 2015–2016. On the other hand, unemployment has more uniformly became a problem affecting the whole country.

Figure 14.

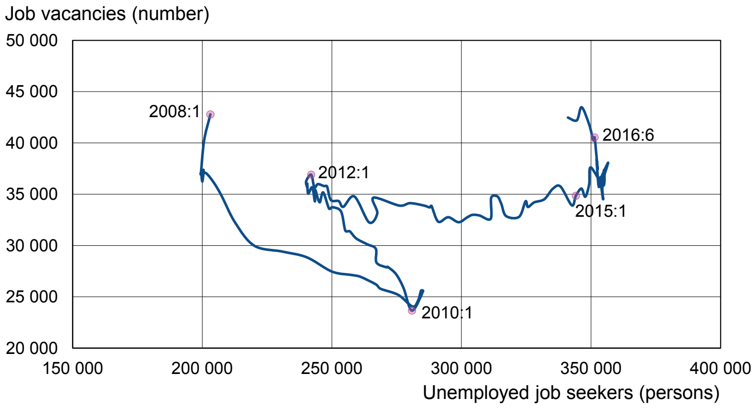


Source: Ministry of Economic Affairs and Employment

Unemployment has started to fall, but the number of long-term unemployed continues to grow, albeit more slowly than before. The flow into unemployment has declined, but the flow out of unemployment has declined even more. For those who become unemployed, unemployment is therefore often prolonged. In recent years, long-term unemployment has increased significantly in all age groups, but most of all among 25–54 year-olds. Long-term unemployment is caused by, among other things, the matching problems that arise when economic restructuring takes place. In the 2000s, the Finnish economy has become increasingly service-oriented as the share of primary production and manufacturing industry has declined.

The number of periods of unemployment completed is based to a large extent on unemployed job seekers own statements and studies made by TE Offices (public employment and business services). Payers of unemployment benefits are not obliged to inform TE Offices that the payment of an individual's unemployment benefit has ended. Thus, in Ministry of Economic affairs and Employment statistics, the number of periods of unemployment completed is probably slightly lower than the actual figure.

Figure 15. Labour market matching



Source: Ministry of Economic Affairs and Employment

Labour market matching problems have increased since 2012, because unemployment has grown, even though the number of job vacancies has remain unchanged. In 2016, the number of job vacancies rose to the peak level of 2007–2008, but there are now 150,000 more people unemployed than there were then.[5]

As the period of unemployment lengthens, the probability of finding employment declines and the risk of social exclusion increases. High long-term unemployment may therefore change into structural unemployment, which will prove difficult to reduce even as economic conditions improve. Employment measures should accordingly be increased, at least for those unemployed people with appropriate education and skills whose only problem is lack of a job. It is important to cut short a period of unemployment before it changes into long-term unemployment.

In 2011, the OECD[6] recommended the compulsory participation of the unemployed in activation measures at an early stage of unemployment. Furthermore, in 2016 the OECD[7] recommended stricter obligations for recipients of unemployment benefits to seek work as well as closer monitoring of job-seeking by increasing personal meetings with employment counsellors. The IMF also noted in 2015[8] that Finland spent less on active labour pol-

5 It is unclear whether all of the over 40,000 employment service statistics' vacancies are actually jobs waiting to the filled. Most vacancies are in the sales sector but, according to a survey (http://www.smkj.fi/liitto/mika-mattaa-myynnin-avoimissa-paikoissa [in Finnish]) commissioned by the Union of Marketing and Sales Professionals MMA, some of these vacancies are 100%-commission or pilot-entrepreneur positions, where the workers themselves are responsible for the costs and risks of working. Some of the vacancies may also overlap, but there is no evidence that this would be an extensive problem for the statistics. There may also be vacancies for jobs in which the actual wage proves to be too low due to limited working hours (so-called zero contracts).

6 OECD 2011. Economic policy reforms 2011: Going for growth. Country notes: Finland, https://www.oecd.org/finland/47469529.pdf

7 OECD 2016. Back to Work: Finland. Improving the Re-employment Prospects of Displaced Workers http://www.oecd-ilibrary.org/employment/back-to-work-finland_9789264264717-en

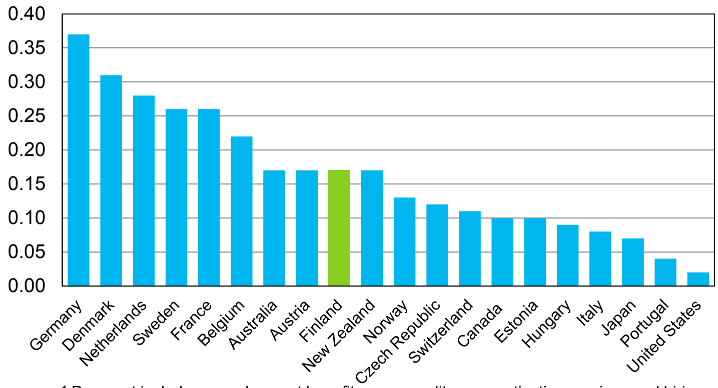
8 IMF 2015. Country Report No. 15/312, Finland Selected Issues, November 2015. https://www.imf.org/external/pubs/ft/scr/2015/crl 5312.pdf

icy than the other Nordic countries. The IMF, moreover, recommended in 2016[9] that labour policy activation measures be strengthened.

The IMF observed in 2015[10] that long-term unemployment benefit replacement rates are high for the long-term unemployed. The OECD also recommended in 2011 the phased reduction of unemployment benefit replacement rates as the duration of unemployment grows. In 2016 the IMF[11] stated that shortening the unemployment benefit period from 500 days to 400 days might increase the supply of labour. In 2017, replacement rates have been reduced whereby the waiting period has been lengthened and the higher earnings-related components reduced. Allowances other than the earnings-related allowance have not been changed.

Activation of the long-term unemployed is supported by a decision on the holding of regular interviews with the unemployed at three-month intervals from 2017. In the same context, it should be ensured that the resources of employment services are allocated correctly[12]. Well implemented, the interviews with the unemployed four times a year may improve the activity of the unemployed and help cut short periods of unemployment. This largely depends on whether the TE Offices have the capacity to offer services correctly targeted at those who need them. Some of the unemployed require counselling in job seeking, some need training in new tasks. For the unemployed who have the appropriate skills, regular interviews might act as an incentive to active job seeking.

Figure 16. **Public employment services and administration resources¹ relative to GDP in 2014, %**



¹ Does not include unemployment benefits or expenditure on activation services and hiring subsidies
Source: OECD

9 IMF 2016. Finland: Staff Concluding Statement of the 2016 Article IV Mission. https://www.imf.org/en/News/Articles/2016/10/03/MS100416-Finland-Staff-Concluding-Statement-of-the-2016-Article-IV-Mission

10 IMF 2015. Country Report No. 15/312, Finland Selected Issues, November 2015. https://www.imf.org/external/pubs/ft/scr/2015/crl 5312.pdf

11 IMF 2016. Finland: Staff Concluding Statement of the 2016 Article IV Mission. https://www.imf.org/en/News/Articles/2016/10/03/MS100416-Finland-Staff-Concluding-Statement-of-the-2016-Article-IV-Mission

12 In Finland, the number of public employment services personnel relative to the number of unemployed is many times lower than in Sweden. Sweden's Arbetsförmedlingen has 14,000 employees serving 370,000 unemployed, whereas Finland's TE Oiffces has 2,200 employees serving 450,000 unemployed. In Finland, significantly less is spent on public employment services in ratio to GDP than in Sweden, Denmark and Germany.

In 2014, three months after the completion of employment measures, 24% of those who participated in the measures were in employment in the open labour market and 42% were unemployed. The employment measures include wage subsidies, on-the-job training with labour market support, apprenticeship training at the workplace and entrepreneurship start-up grants. On average, women, highly educated people and 25–54 year-olds have been employed best on the open labour market after labour policy services (including, in addition to employment measures, independent studying and job alternation leave, for example).[13]

Employment services are not merely significant in direct employment, but also in maintaining occupational and functional capacity. It is important to prevent prolongation of unemployment and to stop unemployment from becoming structural to ensure that people's employment preparedness is appropriate when labour market demand improves.

The general level of education in Finland has risen, but many people are lacking the appropriate basic skills and education. This dichotomy is apparent in the fact that among the unemployed there are those whose skill and education do not meet the demands of the labour market and those who are highly educated.

At the same time as the proportion of highly educated people among the whole population grew by 39%, the proportion of them among unemployed job seekers grew by 58% and among long-term unemployed by 87%[14]. Although education still offers partial protection from unemployment, one should not think that unemployment or long-term unemployment is merely a problem for the poorly educated part of the population.

According to data from Statistics Finland's 2012 Adult Education Survey,[15] 32% of Finnish wage earners are, on their own assessment, under-educated, i.e. they work in jobs that require more than the individual's basic education provides. Both weak basic skills and under-education reduce opportunities for re-employment should a person become unemployed. Strengthening basic skills and qualification-based education are therefore still important in Finland, even though the average education and skills level is high.

13 Tuomaala 2016. Placement from services in 2013 and 2014. (in Finnish) Ministry of Economic Affairs and Employment analyses 74/2016.

14 In 2006, 9.1% of unemployed job seekers, on average, were highly educated (education: lower tertiary, higher tertiary or researcher degrees). In 2015, 14.4% of job seekers were highly educated. At the same time, the proportion of highly educated people in the Finland's total population (15 years of age and older) rose from 14.5% to 20.3%. Among the long-term unemployed, the increase in the proportion of highly educated people was stronger: whereas in 2006 7.3% of the long-term unemployed were highly educated, in 2015 the figure was 13.7%.

15 Lindberg 2014. Matching of education and jobs, and participation in work or vocational adult education. (in Finnish) Yhteiskuntapolitiikka 79:6.

3.3 Youth unemployment

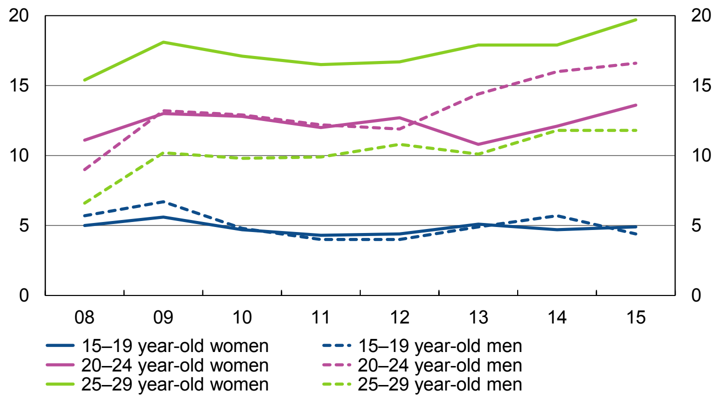
- Unemployment and long-term unemployment among young people have increased in recent years at the same rate as unemployment in other age groups.
- Based on recent European research, youth employment can be improved by enhanced job-seeking counselling, sanctions when job offers are refused and wage subsidies in private sector employment.

Until a few years ago, Finland did not have any long-term unemployed young people at all. Now, the number of long-term unemployed people under 25 years of age has reached around 4,000. The rapid growth of long-term unemployment among young people gives cause for concern (see Figure 14).

Although youth unemployment and particularly long-term unemployment are worrying phenomena, the official unemployment rate, based on the Labour Force Survey, might be providing an incomplete picture of the labour market position of young people. One key weakness of the indicator relates to the fact that it also defines full-time students as unemployed. For Finland, this is particularly problematic, because in Finland some 60% of unemployed people under 25 years old are students. The corresponding figure in EU countries is, on average, 25%.

Another notable aspect when using the official unemployment rate to examine young people's labour market problems is the fact that the unemployment rate is calculated as the proportion of unemployed in the labour force, not in the size of the age group. Only part of young people belong to the labour force. When these factors are taken into account, the picture of the difficulties facing young Finns in the labour market is not as gloomy as the official unemployment rates suggest.

Figure 17. NEET rates by age group, %



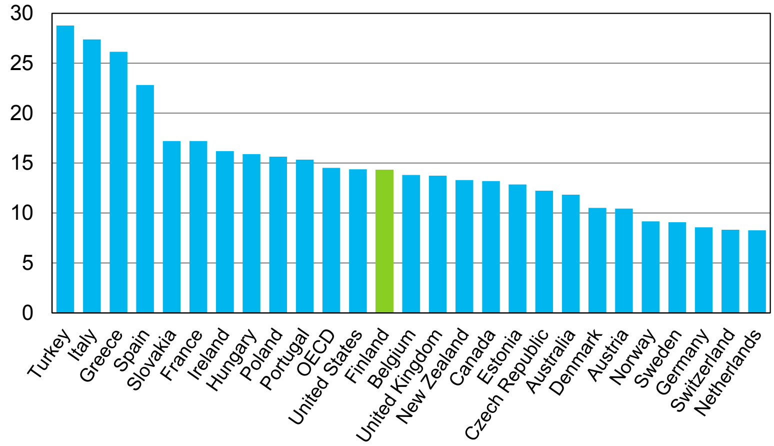
Source: Statistics Finland

NEET is an acronym for "Not in Employment, Education or Training". NEET rates tell how large a proportion of the individuals in an age group are not in work or education. They give a better picture of the employment opportunities of age groups at studying age than the (youth) unemployment rate.

The NEET rates of 20–29 year-old men in particular have risen significantly since 2008. Of 20–24 year-old men, nearly 17% were without work or a study place in 2015. The NEET rate of 25–29 year-old women is also high, but with this group comparisons are difficult due to changes that have taken place in the prevalence of child home care.

The youth guarantee[16] that entered into force from the beginning of 2013 does not appear to have had a significant positive impact on the NEET rates examined here. Based on research, the positive effects of the social guarantee for young people, which preceded the youth guarantee, were very modest and were directed at young people who had already performed vocational education[17]. The activation of educated young people with labour policy measures increased and accelerated slightly as a result of the social guarantee for young people. Overall, the increase in activation may be considered modest relative to the stated promise of the guarantee.

Figure 18. **NEET rates of 15–29 year-olds in 2015, %**



Source: OECD

16 The youth guarantee obliges employment services to end the period of unemployment of young people under 25 years of age or new graduates under 30 years of age within three months of the start of unemployment by offering a place in training, trial work placement, workshop or employment. The youth guarantee also includes an education guarantee, which guarantees to everyone who has completed basic education the opportunity for further education in an upper secondary school, vocational education, apprenticeship training, workshop, rehabilitation or in some other way.

17 Hämäläinen K., Hämäläinen U., Tuomala J.: "The labour market impacts of a youth guarantee: lessons for Europe?" VATT working papers 60, 2014.

In international comparisons, Finland's NEET rate is around the average level, particularly in relation to Finland's high 9% unemployment rate. In the other Nordic countries, NEET rates are, however, clearly lower than in Finland.

According to research, lowering the employer's social security contributions is an expensive and ineffective way of improving young people's employment opportunities[18]. On the other hand, the research indicates that sanctions that reduce unemployment benefit for refusing a job offer or activation service increase the probability of employment[19]. Labour policy activation services seem to work less well if they are targeted only at young age groups. Positive employment effects from activation measures directed at young people are most often produced by enhanced job-seeking counselling as well as wage subsidies in private sector employment.[20] It must be remembered, however, that employing young people by means of wage subsidies may at the same time reduce the employment opportunities of other unemployed people.

18 Skedinger Per: "Effects of payroll tax cuts for young workers", Nordic Economic Policy Review, 1/2014. Egebark, J. and Kaunitz, N.: "Do payroll tax cuts raise youth employment?", IFAU working paper, 2013.

19 Gerard J. van den Berg, Arne Uhlendorff and Joachim Wolff: "Sanctions for young welfare recipients", Nordic Economic Policy Review, 1/2014.

20 Jonas Maibom, Michael Rosholm and Michael Svarer: "Can active labour market policies combat youth unemployment?" Nordic Economic Policy Review, 1/2014.

4 Alternative scenarios for public finances

This chapter examined the development of public finances in different scenarios. Two of the Government's most difficult targets to achieve, in the light of current knowledge, have been selected as the scenarios. These are raising the employment rate to 72% in 2019 and achieving the central government deficit target in 2019.

In the first scenario, the improvement in public finances is based on boosting employment and thereby growth in GDP. Two different versions of the scenario, varying the link between employment and growth, have been prepared. In the second scenario, the effects of immediate consolidation measures on economic and public finances are estimated. The scenarios present "extreme examples" of how public finances could be improved by different means. In each scenario, public finances improve significantly.

4.1 Scenario 1: Employment rate rises to 72% in 2019.

This scenario examines how large the impact on public finances would be if the intended 72% employment rate were to be achieved in 2019. The calculations are based on supply-oriented approach, which assumes that the labour resources of the economy would be put to better use as a result of structural reforms. To what extent and how quickly the measures would lead to a rise in the employment rate, also partly depends on factors influencing overall demand. Overall demand, in turn, is influenced by international economic development, for example. The more positive the development, the better conditions will be for achieving the intended effects of structural reforms in the next few years.

This scenario describes the impact of structural policy measures on public finances mechanically, in very general terms. The impact of the reforms may be assessed in more detail when the content of the reforms is known more precisely.

In order to achieve the 72% employment rate, the employment rate would have to be slightly more than two percentage points higher than the baseline scenario. In this case, there would be approximately 70,000 more people in employment in 2019, and at the same time economic growth would be faster. The faster economic growth would strengthen public finances by increasing tax revenue and reducing the unemployment-related expenditure.

Scenario 1a assumes that the improvement in employment is transmitted fully into GDP. In addition, it assumes that of the additional people in employment approximately one third will come from outside the labour force and two-thirds from people who are unemployed. The analysis also assumes that the structural unemployment rate will not constrain growth.

Table 3. General government balance and debt ratio with a 72% employment rate, when improvement of employment is transmitted fully into GDP.

	Baseline			Scenario 1a		
	Growth	Balance	Debt	Growth	Balance	Debt
2012	-1.4	-2.2	53.9	-1.4	-2.2	53.9
2013	-0.8	-2.6	56.5	-0.8	-2.6	56.5
2014	-0.7	-3.2	60.2	-0.7	-3.2	60.2
2015	0.2	-2.8	63.6	0.2	-2.8	63.6
2016	1.6	-2.2	63.7	1.6	-2.2	63.7
2017	0.9	-2.5	65.3	1.9	-1.9	64.4
2018	1.0	-2.0	66.1	1.9	-0.9	63.8
2019	1.2	-1.5	66.0	2.2	0.1	62.0
2020	1.2	-1.2	65.4	1.2	0.5	60.3

If the alternative according to scenario 1a were fulfilled, the GDP growth would be around one percentage point faster than the baseline scenario in 2017–2019. As stated above, faster growth would also require stronger than expected growth in demand. The general government balance would improve significantly, and would be in surplus at the end of the period. General government debt would also begin to fall rapidly.

Scenario 1a examined what the impact of the employment rate rising to 72% by 2019 would be if GDP would react commensurately with employment. The change in GDP may be more modest, however. **Scenario 1a describes the maximum impact of the rise in the employment rate, which cannot as such be considered realistic.**

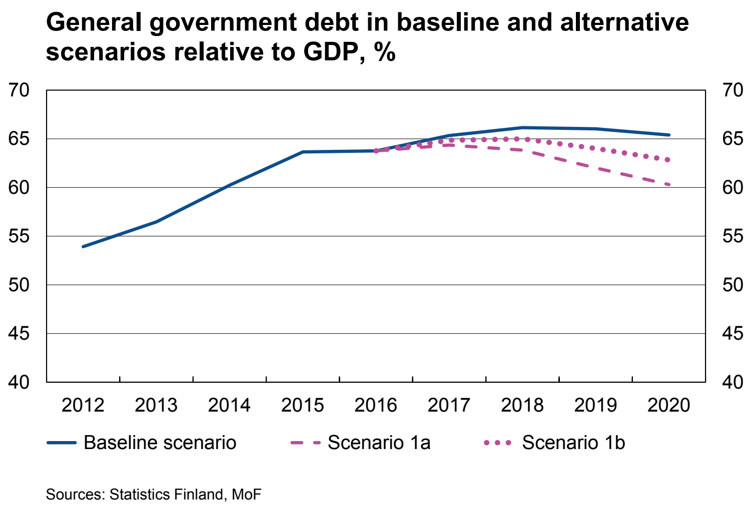
Scenario 1b assumes that around half of the improvement in employment will be reflected in an increase in GDP. This means that the development of productivity will be slower in this scenario than in the baseline scenario. This assumption can be justified by the fact that as unemployment falls and employment rises the productivity of the additional employed people will be lower, on average, than the existing workers. In other respects, the scenario makes the same assumptions as above. The analysis assumes that the structural unemployment rate will not constrain growth.

Table 4. General government balance and debt ratio with a 72% employment rate, when half of the improvement of employment is transmitted into GDP.

	Baseline			Scenario 1b		
	Growth	Balance	Debt	Growth	Balance	Debt
2012	-1.4	-2.2	53.9	-1.4	-2.2	53.9
2013	-0.8	-2.6	56.5	-0.8	-2.6	56.5
2014	-0.7	-3.2	60.2	-0.7	-3.2	60.2
2015	0.2	-2.8	63.6	0.2	-2.8	63.6
2016	1.6	-2.2	63.7	1.6	-2.2	63.7
2017	0.9	-2.5	65.3	1.4	-2.2	64.8
2018	1.0	-2.0	66.1	1.4	-1.5	65.0
2019	1.2	-1.5	66.0	1.7	-0.7	64.0
2020	1.2	-1.2	65.4	1.2	-0.4	62.8

Scenarios 1a and 1b give a range within which general government balance and debt could develop should the employment rate rise to 72% by 2019.

Figure 19.



4.2 Scenario 2: Immediate consolidation measures in 2018–2019

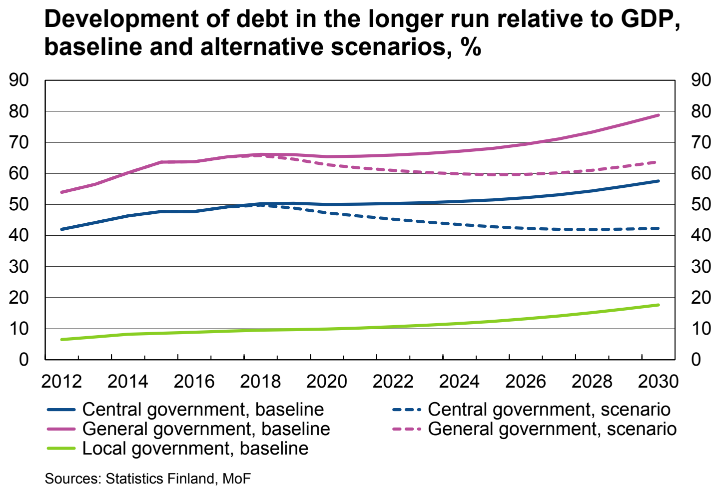
For central government finances to achieve the 0.5% deficit target set for them in 2019, the adjustment requirement would be approximately 1.2% of GDP, which is approximately EUR 2.7 billion. In the scenario, the adjustment has been divided in half for 2018–2019. In the scenario, the fiscal multiplier is assumed to 0.50, i.e. the adjustment will cut GDP by half of its amount. If the central government deficit target is achieved, central government and general government debt to GDP ratio will start to fall significantly, and this trend will continue until the next decade.

The given scenario for immediate consolidation measures is an extreme example. **It is not appropriate to achieve the target solely with large consolidation measures, because such a large adjustment should not take place over only two years**. It is worth keeping to the target, however, and to improve the central government deficit primarily with other measures.

Table 5. General government balance and debt ratio in an adjustment scenario

	Baseline			Scenario 2		
	Growth	Balance	Debt	Growth	Balance	Debt
2012	-1.4	-2.2	53.9	-1.4	-2.2	53.9
2013	-0.8	-2.6	56.5	-0.8	-2.6	56.5
2014	-0.7	-3.2	60.2	-0.7	-3.2	60.2
2015	0.2	-2.8	63.6	0.2	-2.8	63.6
2016	1.6	-2.2	63.7	1.6	-2.2	63.7
2017	0.9	-2.5	65.3	0.9	-2.5	65.3
2018	1.0	-2.0	66.1	0.7	-1.4	65.7
2019	1.2	-1.5	66.0	0.9	-0.3	64.6
2020	1.2	-1.2	65.4	1.2	0.0	62.8

Figure 20.



In the scenario, local government debt accumulation will continue in the 2020s, because the consolidation measures are focused only at central government finances. Growth of age-related expenditure will increase local government debt, and therefore the general government debt ratio will also grow.

4.3 Summary of the effects of the different scenarios on public finances

Table 6 brings together the effects of the scenarios presented above on the fulfilment of fiscal policy targets and rules. Particularly with respect to compliance with EU rules, much detailed interpretation as well as uncertainty arising from calculation is involved, and in borderline cases no straightforward answer on compliance or non-compliance with the rules can be given.

Table 6. Summary of fulfilment of fiscal policy targets and rules in the different scenarios

Fiscal policy Target/Rule	Baseline	Scenario 1a	Scenario 1b	Scenario 2
Public debt ratio levels off in 2019				
Public debt 60% reference level				
General government deficit at most -3% of GDP				
General government structural deficit -0.5% of GDP in 2019				
Central government deficit at most ½ of GDP in 2019				
Local government deficit at most ½ of GDP in 2019				
Social security funds close to balance in 2019				

= target not fulfilled

= target on borderline of fulfilment/fulfilled passably

= target fulfilled

The public debt ratio levels off very slightly in the baseline scenario. In the baseline scenario, the levelling off of the debt ratio can be considered to be within the margin of error of the forecast. In all of the other scenarios, the debt ratio can be seen to start more clearly on a downward path, and in scenario 1a the decline would already begin in 2017.

The general government deficit remains below 3% in the baseline scenario and the other scenarios. The general government debt ratio does not fall below the 60% reference level in either the baseline scenario or the other scenarios. Interpreting the EU debt rule is not quite so simple, however, because it assesses, among other things, the rate of reduction of debt (historically and in the future). In all the scenarios, Finland might already fulfil the EU's proactive debt reduction rule in 2018, and most surely so in scenario 1a.

Very great uncertainty is associated with estimating the structural deficit, because it was not possible to calculate it completely afresh in every scenario. Based on the nominal balance, one can assume, however, that in both the faster growth scenario (1) and also in the consolidation measures scenario (2) the target set for the structural deficit would be fulfilled, or very close to being fulfilled, in 2019.

Central government achieves the deficit target set for it only in scenario 2. Local government maintains its target in the baseline scenario and in the other scenarios. The social security funds fall slightly short of their target in the baseline scenario. In scenario 1, improving employment reduces unemployment expenditure and increases contribution income. Thus the target set for the social security funds will most probably be achieved. Scenario 2 does not assume changes to the budgetary position of the social security funds relative to the baseline scenario, as the adjustment is directed at central government finances.

APPENDIX 1: Stability and Growth Pact obligations

The Treaty on the Functioning of the EU contains reference values of 3% and 60% in ratio to GDP for the general government deficit and debt respectively. The Stability and Growth Pact prescribes rules according to which a Member State exceeding the reference values may enter an excessive deficit procedure. In the past few years, Finland has avoided an excessive deficit procedure, even though Finland's debt ratio has exceeded the 60% reference value. Among the explanatory factors for exceeding the debt reference value is currently the fact that Finland is, at least broadly, complying with the required adjustment towards the medium-term objective set for the general government structural deficit.

Medium-term objective

The Stability and Growth Pact obliges EU Member States to set a medium-term objective (MTO) for the general government structural deficit[1]. Finland's MTO has been set at a 0.5% deficit in ratio to GDP. The Government aims to achieve the medium-term objective in 2019. If a Member State has not achieved its MTO, the country's structural deficit should make sufficiently rapid progress towards the objective. The Council decides in its annual country-specific recommendations on the required adjustment for the current and following year, taking into account, for example, the financial situation of each country. Progress towards the MTO is assessed on the basis of two pillars, the reduction of the structural deficit and the so-called expenditure benchmark.

Change in the structural deficit

Finland is required to reduce its structural deficit by 0.6% in ratio to GDP in 2017. It is assumed that the required adjustment to the structural deficit in 2018 will also be 0.6% in ratio to GDP.

Finland's structural deficit will increase in 2017 as a result of the Competitiveness Pact and the tax concessions associated with it. Therefore, in 2017, there is a risk that a significant deviation will arise in the required adjustment towards the MTO[2]. In addition, according to the forecast there is a risk that the reduction in the structural deficit will also be smaller than required in 2018.

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1 The structural deficit is calculated by removing from the general government net lending the effect of the cycle (and one-off and other temporary measures). The remaining part describes the effect on the general government deficit of practised policy and factors other than those of a cyclical nature.

2 In an analysis of the structural balance and the expenditure benchmark, a significant deviation, 0.5% of GDP, may be formed in two different ways. Firstly, a significant deviation may be formed if in one period there is a deviation from the required change in the structural balance of 0.5 percentage points (in ratio to GDP). Secondly, a significant deviation may be formed if the average of deviations in two consecutive periods is more than 0.25 percentage points. The identification of a significant deviation may result in the opening of a so-called significant deviation procedure.

Table 7. General government deficit and structural deficit*, Ministry of Finance September 2016

	2014	2015	2016	2017	2018	2019	2020
General government nominal deficit	-3.2	-2.8	-2.4	-2.6	-2.0	-1.5	-1.2
Structural deficit	-1.6	-1.2	-1.2	-1.6	-1.3	-1.1	-1.2
Change in the structural deficit		0.3	0.0	-0.4	0.3	0.1	-0.1

*The most recent estimates of the structural deficit are from September 2016 and it will be estimated next in April 2017. The general government nominal deficit in the table is also according to the September 2016 forecast.

In the Draft Budgetary Plan published in the autumn 2016, Finland applied for the utilization of the so-called flexibility clauses[3] in 2017. The Commission has indicated that conditions for granting their use could be met, but a final decision will be made in spring 2017 in connection with the assessment of the Stability Programme. If the use of both the structural reform and investment clauses is approved for Finland, the 2017 adjustment requirement might fall to 0% of GDP. Central to the assessment will be a return to the adjustment path towards the MTO, i.e. whether Finland will comply with the required adjustment in 2018.

If use of the flexibility clauses in 2017 is not granted to Finland and a significant deviation is identified, Finland will probably enter an excessive deficit procedure, because at the same time the basis for compliance with the debt criterion would be undermined. Although there is currently a lot of uncertainty associated with the interpretation of the EU's rules, it would appear that compliance with the EU's rules will require additional measures in relation to the forecasted path.

3 Under the flexibility clauses, structural reforms and the short-term costs associated with them can under certain conditions be taken into account when assessing the progress towards the medium-term objective. Finland has applied to use the flexibility clauses when the 2017 adjustment is assessed.

Expenditure benchmark

The expenditure benchmark sets the upper limit for the real growth of general government expenditure. Simply expressed, one interpretation of the expenditure benchmark is that total general government expenditure should not be permitted to grow faster than revenue. The expenditure benchmark is calculated using the 10-year average of potential GDP growth, the size of the public sector, and required adjustment of the country.[4] The required adjustment is taken into account in the expenditure benchmark, as in order to fulfil the required adjustment expenditure must grow more slowly than revenue. In calculating the expenditure benchmark, changes to discretionary revenue are also taken into account. Therefore, compliance with the expenditure benchmark does not necessarily require an expenditure adjustment.

Compliance with the expenditure benchmark in the current year would require an expenditure adjustment or revenue increase of approximately 0.3% of GDP. To comply with the benchmark also in 2018, the adjustment effect should reach a total of 0.6% of GDP in 2017–2018. The adjustment figures given by the expenditure benchmark are somewhat more moderate for this year than the above-mentioned required adjustment to the structural deficit.

Table 8. Information required for calculating the expenditure benchmark, Ministry of Finance estimate*, %

	2016	2017	2018
10-year average of potential growth	0.3	0.3	0.3
Required adjustment	0.5	0.6	0.6
Expenditure benchmark (real)	-0.1	-0.8	-0.8
GDP deflator	1.3	0.9	1.6
Expenditure benchmark (nominal)	1.2	0.1	0.8

* The table's figures are based on the September and December 2016 forecasts of the Ministry of Finance. The nominal value of the 2016 and 2017 expenditure benchmarks is already known, but the 2018 value is an estimate based on the December 2016 forecast of the Ministry of Finance.

4 A more detailed description for method of calculating the expenditure benchmark is given in the Stability and Growth Pact manual, the so-called Vade mecum: http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip021_en.pdf

Based on the expenditure benchmark, general government expenditure should be significantly reduced in real terms in 2016–2018 and grow only slightly in nominal terms (see Table 8). The expenditure benchmark will also remain tight in later years, even if the MTO were also to be achieved[5]. Finland's potential GDP growth rate has slowed dramatically since 2008, dragging down the 10-year average for a long time.

5 If the medium-term objective is met, the required adjustment will no longer tighten the expenditure benchmark.

MINISTRY OF FINANCE
Snellmaninkatu 1 A
PO BOX 28, 00023 Government
Tel. +358 295 160 01
Fax 09 160 33123
www.financeministry.fi

ISSN 1797-9714 (pdf)
ISBN 978-952-251-841-5 (pdf)

February 2017