EDITORIAL

Public finances need more room for manoeuvre

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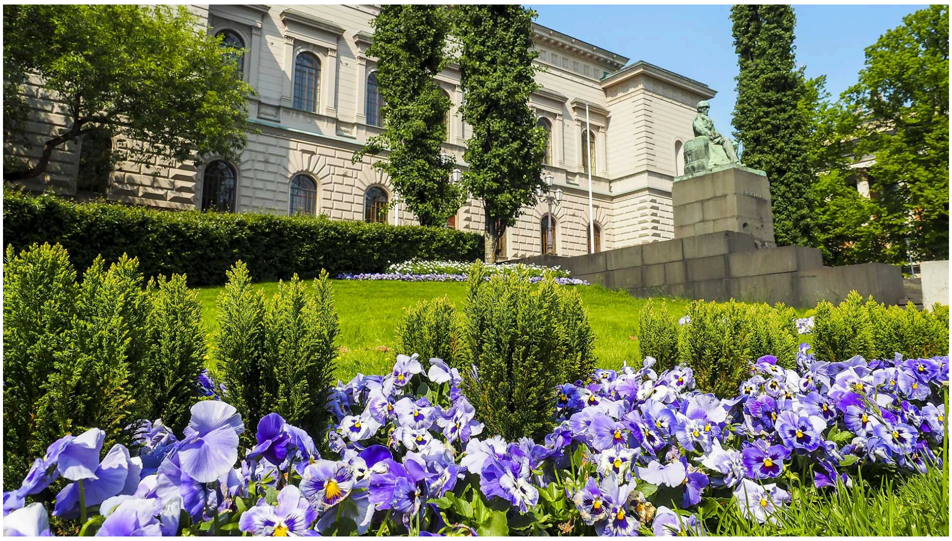
Finland's new parliamentary session begins with the country enjoying a brighter economic outlook than four years ago. Yet the past year has also seen the outlook deteriorate. Momentum in the global economy has slowed. World trade growth, as well as growth in the manufacturing output of the advanced economies, has been at a near standstill since late 2018, and the outlook remains clouded by risks related to trade policy, among other things.



Finland's economic growth has continued, but at a slower pace. In the immediate years ahead, growth is anticipated to continue at, or slightly below, the economy's long-term potential. This would be markedly slower than in recent years.

Finland's public finances are in better health than they were a few years ago. The deficit has shrunk, and the debt-to-GDP ratio has declined. Cyclical developments have contributed to this, but so have the fiscal consolidation measures agreed upon in the two previous parliamentary sessions. Nevertheless, the general government balance has remained in deficit.

In the coming years, the public finances will be strained by growing pension expenditure, and by the demands placed on health- and long-term care services by an ageing population. The long-term sustainability gap in the public finances is considerable. The Bank of Finland's December 2018 estimate puts the sustainability gap at about 3% relative to GDP. This is the amount of additional revenue needed for general government finances to break even, given the current outlook.

It is important that proactive measures are taken to strengthen the public finances when the economy is not in recession. The current situation might be compared with the period following the 1990s recession. At the time, the GDP ratio of general government debt was brought down by over 20 percentage points, after persistent efforts spanning several years. In 2008, the debt-to-GDP ratio stood at a mere 33%.

When the shock waves of the global financial crisis hit Finland in the latter half of 2008, the general government finances were able to strongly support domestic demand. The low level of public debt allowed for much-needed room for fiscal manoeuvre. Lenders' confidence in Finland's ability to service its swiftly growing debt burden was not significantly compromised. One might ask whether such support for domestic demand would have been possible if it had not been preceded by determined efforts to lower the debt ratio.

When the global economy again falls into recession, Finland may well find itself in a similar situation. The smaller the public debt burden is at the time, the more room there will be for fiscal manoeuvre.

In general, it makes sense to have a broad view of the economic situation in all decisions that materially involve government income and expenditure. For example, if fiscal policy is relaxed at a time when the economy is not in recession, gains in output and employment growth may prove marginal. On the other hand, the costs of public expenditure items may go up as prices rise.

Finland's employment situation has improved swiftly, especially since 2017. The employment rate has climbed to over 72%. While favourable cyclical developments have had a hand in this outcome, so have government measures and improvements in Finland's cost-competitiveness.

Looking at the first half of the current year, however, employment growth seems to have been unable to keep pace with previous years. The Bank of Finland's new forecast anticipates continued employment growth in the immediate years ahead, but at a slower pace. This forecast does not take into account the economic policy measures outlined for the new parliamentary session.

Finland's employment rate should be raised to a good Nordic standard. In Sweden, Norway and Denmark employment stands at about 75–78%.

Employment growth plays a key role in shaping the fiscal balance. The costs of maintaining a large welfare state may prove insurmountable if not backed by a high rate of employment that can be sustained over the long term. Because of the magnitude of the sustainability gap, it is unlikely that it will be bridged by simply raising the employment rate. Nevertheless, boosting employment is likely to be a necessary condition.

The impact of a higher employment rate on the fiscal balance is not entirely straightforward. Not all jobs contribute to the fiscal balance in equal measure. Positive effects may prove marginal if a job is created through copious public spending. This manner of job creation has a time and a place, but it is inefficient for strengthening the public finances.

The employment situation is unlikely to be remedied by any single measure, instead requiring a battery of reforms. In light of research data, meaningful results can be achieved by pursuing reforms in family-related leave, unemployment benefits and other forms of social protection. Success in developing the education system and active labour market policies are also needed. In addition to labour market institutions, employment is also affected by the housing market's ability to supply homes in the areas where they are in high demand.

The lion's share of collective labour market agreements currently in place are due for renegotiation in 2019 and 2020. The upcoming round of agreements will also play an important part in creating conditions conducive to employment. Finnish cost-competitiveness has recovered in recent years, owing to the Competitiveness Pact and moderate wage settlements. A further slight improvement is still needed, however, as competitiveness had been eroded so much in previous years.

In future, parties to collective bargaining should take into account that an agreement negotiated in one industry will affect the production costs of another. When Finland's cost-competitiveness initially began to decline, of particular significance were the collective agreements negotiated just over a decade ago. At the time, conditions of employment were agreed on for the two years ahead – regrettably just before the onset of the global financial crisis. Wages rose in the export industries, but their operating costs were also inflated by wage rises in other sectors.

Finland's export industries source a variety of their production inputs from other domestic industries such as wholesale, transportation, storage, professional services, information technology and marketing. Wage developments in domestic industries have an immediate impact on the prices of their goods and services. This can have a large impact on export industries.

To get a picture of the magnitude of these effects, one may look at the manufacturing industry, which accounts for about three quarters of all Finnish goods and services exports. According to fresh calculations published by the Bank of Finland, a 1% wage rise outside the manufacturing industry results in roughly the same increase in costs for manufacturing as if manufacturing wages had been raised by the very same margin.

Given that the different industries under collective bargaining are this co-dependent, it is clear that coordination must be front and centre in Finnish wage formation. It makes sense that the collective agreements negotiated for the export industries should serve as a reference for cost developments, and that other domestic industries should normally refrain from exceeding them.

In the last round of negotiations, much was made of the 'Swedish model', which came to serve as inspiration for a 'Finnish model'. It is not wrong to say that the Finnish model was eventually born in practice, although perhaps not before leaving the theoretical drawing board. A solid practice, once discovered, should not be lightly discarded.

It is to be hoped that Finland's cost-competitiveness will improve mainly on the basis of strong labour productivity growth. This would lessen the need for wage restraint. In general, labour productivity growth is foundational for economic prosperity.

Finland's productivity developments remained muted for a long time after 2008. As the Finnish economy began to recover in 2016, productivity growth regained its footing as well. In 2018, however, productivity growth began to stagnate once again. This reflects a much broader long-term trend of diminishing productivity growth shared throughout many of the advanced economies.

There is no silver bullet for improving the prerequisites of increased productivity growth. In the long term, productivity is largely the fruit of innovation – of its discovery and adoption. Instrumental to innovation are education, scientific research, product development, and a business environment hospitable to investment. Productivity growth can also be supported with measures that improve the allocation of the economy's resources. Here, promotion of competition and the functioning of labour markets play a central role.

Looking to the immediate years ahead, we find the economic outlook clouded by the recent slowdown in global growth. However, the future of the Finnish economy will not be determined by this alone. Setting the course for employment and productivity growth in Finland is very much the prerogative of domestic policy-making.

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Tags

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