

INTERNATIONAL MONETARY FUND

Finland—2003 Article IV Consultation

June 9-18, 2003

Preliminary Conclusions

1. ***The Finnish economy has made enormous strides since the problems of the early 1990s.*** The economic restructuring and expansion after the crisis reflects a combination of private sector initiative and solid macroeconomic management, including the shift from large deficits to significant surpluses of the general government. This, against the background of excellent physical and social infrastructure (including education) and a well-developed welfare state, allowed Finland to converge successfully to the euro, and to outperform euro-area partners in the recent past in terms of economic growth and the public finances. Even under the difficult circumstances of the last two years, the economy has performed reasonably well—though the pace of activity has slowed considerably and remains subject to volatility. Meanwhile, inflation is now subdued. It is recognized that the boom of the 1994-2000 period was exceptional and that, in order to keep the economy growing, create new jobs, and sustain the welfare system, Finland has to improve various incentives.
2. ***Notwithstanding the structural reforms of the past, the high rate of unemployment is one indication of the need for further reform efforts.*** High labor taxes and the lack of wage differentiation have made much of the unemployment structural. This is reflected in its persistence, as well as the high proportion of long-term unemployed and the lack of jobs for low-skilled labor. At the same time, a low effective retirement age has been one of the factors depressing the supply of labor. Taking into account individuals who left the labor force early and participants in active labor market programs, the unemployment rate is about 16½ percent, compared with the official rate somewhat above 9 percent.
3. ***The Finnish population is also aging rapidly.*** The old-age dependency ratio will rise to 40 percent in 2020 and 50 percent in 2030, almost double the ratio today and among the highest in the EU during that time. The demographic shock puts downward pressure on the labor force and thereby lowers potential economic growth, with consequences for Finland's ability to generate the resources to maintain the welfare state.
4. ***Real growth is likely to be moderate in 2003, but should gather pace in 2004.*** With the recent downward revisions to the euro-area forecast, the mission projects real GDP growth in Finland of 1.3 percent in 2003, driven by private consumption and some, albeit scaled-back, growth in exports. A pick up in exports and investment lies behind the mission's projection of growth of 2.6 percent in 2004. Downside risks stem mainly from the external environment—in which the upswing in the euro area still looks fragile and a further strengthening of the euro-U.S. dollar exchange rate could occur—but also from possible continued business investment weakness. A softening of strong consumer confidence would

also affect the downside. By the same token, while there are major uncertainties about the prospects for the ICT sector, upside surprises are not out of the question.

5. ***In the face of a rapidly aging population, the key challenge is to support medium-term growth and employment while securing long-run fiscal sustainability.*** Meeting this challenge involves a number of interrelated elements. These comprise the need to: (i) raise the employment rate, involving increasing work incentives for all age and skill groups; (ii) cut taxes, notably on labor, as an important component of raising employment, safeguarding competitiveness, and enhancing growth; (iii) establishing and maintaining a record of expenditure discipline, to make room for credible tax cuts without compromising the public finances; (iv) further pension reform to make a longer working life more attractive and thereby increase the effective retirement age; and (v) reform the product market to enhance the economy's efficiency and generate employment. Most of these elements are discussed in the government's economic program. How they come together has important implications for economic performance and the health of the public finances.

FISCAL POLICY

6. ***Tax cuts and expenditure ceilings are at the center of the policy debate.*** Tax cuts, especially on labor, are an essential ingredient for raising the employment rate. But to maximize their impact they need to be credible—that is, they need to be seen as immune to future reversals. This requires safeguarding the fiscal balance. Too much of a deterioration in the public finances can raise expectations that taxes will need to be increased later on, which would lessen the impact of the initial tax cuts. Expenditure ceilings, when set at a level that does not raise such expectations, can be a useful tool in maximizing the desired impact of tax cuts when the public believes fully that the ceilings will be adhered to.

7. ***Population aging also has important implications for the size of the fiscal balance.*** Recent studies by the Bank of Finland and the Ministry of Finance are revealing on this score. The scenarios in both studies are broadly compatible with a target level for the general government surplus of about 4 percent of GDP on average over the 2003-10 period. In the Ministry of Finance study, taking into account the effects of various recent reforms (including to pensions, agreed in 2002), gross public debt would double between 2020 and 2050, rising to almost 80 percent of GDP, because of population aging. The Bank of Finland study, which also takes into account the 2002 pension reform, suggests that the ratio of both pension contributions to wages and the tax-to-GDP ratio would have to be increased by about 4 percentage points over the next two decades to cover higher age-related spending while keeping the central government balance out of deficit and securing a surplus in the social security funds of around 2-3 percent of GDP. Thus, in formulating fiscal policy, the authorities face hard choices between accumulating substantial fiscal surpluses now or, in the absence of raising public debt or changing the parameters of the pension system, higher taxes and contribution rates in the future.

8. ***With these considerations in mind, a medium-term target for the general government surplus of at least 4 percent of GDP is a useful norm for keeping the public finances healthy after the demographic shock sets in.*** Achieving this norm, while leaving room for needed tax cuts on labor, puts expenditure restraint at center stage. In 2004, a neutral fiscal stance (i.e., no discretionary stimulus, based on the primary structural balance) would seem to represent a minimal fiscal effort. Based on the mission's estimates (including its GDP projections), this would imply a general government surplus of at least 2 percent of GDP (and a corresponding central government deficit of 0.4 percent of GDP). A stronger fiscal effort would be needed to make the suggested medium-term norm feasible. With the output gap not yet closed, a phased-in approach would be sensible, targeting an adjustment in the structural primary balance of ½ percent of GDP per year, while allowing the automatic stabilizers to play around the consolidation path. Given the mission's projection for output, this would imply raising the actual general government surplus in broadly equal increments from its estimated 2003 level (2 percent of GDP) to reach 4 percent of GDP by 2006.

9. ***While the authorities' fiscal program is still being fleshed out, the discussions revealed key details.***

- The budget for 2003 is already set. With tax cuts of a ½ percentage point of GDP and expenditures increasing by 4 percent in real terms, the Finance Ministry envisages that the surplus of the central government will swing into a deficit of 0.2 percent of GDP.
- Various factors affect the projections for spending and revenues during 2004-2007. First, expenditure ceilings have been proposed for the period. Among their main features, they exclude cyclical components and interest payments, and real expenditure growth in the items they cover averages 1.3 percent per year over the period. This growth is frontloaded so real spending growth in 2004 is 3.2 percent. Second, on revenues, Finance Ministry projections assume declining corporate tax receipts; incorporate significant tax cuts in 2004 (equivalent to almost 0.6 percent of GDP, presumably on labor to a significant degree, though the exact nature of the cuts are under discussion); and take into account lower indirect tax receipts, mainly as a result of Finnish adjustments to EU regulations.
- Overall, the Finance Ministry envisages that central government will be in balance by 2007, if 100,000 new jobs can be created. Absent substantial job creation, its projection foresees central government deficits of 1.1 to 1.3 percent of GDP in 2004-2007, corresponding to a surplus for the general government of only 1.7 percent in the latter year. However, the creation of 100,000 more jobs would add to revenues and lower spending, and leave a general government surplus of 3½ percent of GDP in 2007. The specific measures to meet this ambitious target for jobs are not explicitly costed out in terms of their impact on the fiscal accounts, but any additional expenditure measures are assumed to be met within the expenditure ceilings. While the government has adopted a limit of 2¾ percent of GDP for the central government deficit, the expenditure ceilings are expected to be the binding constraint and balance for the central government is expected to be achieved "under normal circumstances."

- Thus, the strategy, which rightly emphasizes that employment growth is crucial, seems to put tax cuts on labor ahead of increasing the fiscal surplus by aiming for greater restraint in spending. The cyclical outlook and low inflation serve to mitigate any near-term problems that might otherwise be associated with the resulting fiscal stimulus. However, the mixed record on expenditure discipline underscores the risks of further fiscal deterioration. In these circumstances, the government stresses the seriousness with which the expenditure ceilings will be pursued.

10. *Against this background, the mission would make several observations and recommendations:*

- First, it is extremely important to take structural measures (e.g., further reform of labor markets and pensions as discussed below) as quickly as possible. Frontloading measures would make the targeted increase in employment more realistic, thereby helping the sustainability of the public finances. Moreover, in light of the risks associated with the current approach, the importance of early structural measures cannot be emphasized enough to re-enforce confidence in the long-term viability of the public finances.

- Second, revenue estimates by the Ministry of Finance may be conservative. Higher-than-expected revenues (including because of higher-than-expected growth) should be used to lower debt and raise the general government surplus, up to the norm discussed above. Only then should the higher revenues be used to lower taxes. This brings to the fore other revenue considerations, raised during the previous consultation. In particular, in cases in which the fact that services are free creates overspending in the public domain, measures that raise revenues while potentially keeping public spending in check—such as user fees—deserve careful evaluation. Other sources of revenue could include raising property taxes (Finland ranks among the lowest in the OECD in terms of property taxes as a percent of GDP).

- Third, while the new government's emphasis on reducing the high tax burden is well placed, a more ambitious ceiling on public spending would raise the fiscal surplus and strengthen the likely impact of tax cuts. Indeed, in light of the overruns to past expenditure ceilings, there is a strong case for initially putting tax cuts on hold until expenditures are convincingly under control.

- Fourth, an alternative path for expenditures could be considered to move fiscal policy closer to the norm suggested above—for example, one in which there is no real increase in spending over the 2003 level. Such a move would be less stringent than it would appear on face value, in light of recent expenditure growth. The mission estimates that this action would raise the fiscal surplus by about 1 percent of GDP in 2004, and by 1.3 percent in 2007. Even greater spending restraint could have larger economic benefits.

- Fifth, while the mission welcomes several features of the government's ceilings, some modifications are worthy of consideration. On the plus side, the expenditure ceilings extend over the government's term in office, they exclude cyclical components so the

expenditures covered by the ceiling are controllable, they also exclude falling interest payments which makes the ceiling tighter, and they have been well publicized. However, in the mission's view, ways to strengthen their effectiveness include submitting them to parliament as part of the regular budgetary process along with a description of the underlying rationale and the strategy to achieve them. The idea is to garner broader political commitment to them, not only in the current year but also in subsequent years. Another way to strengthen their effectiveness is through improving the transparency of the framework by switching from real to nominal spending limits. This would avoid the complications that have arisen in monitoring ceilings because of difficulties in translating nominal into real spending.

- Sixth, various measures might be considered to restrain spending. While Finland's level of expenditure is not particularly out of line with the high level of other Nordic countries (indeed it is lower), a comparison with the EU average suggests room to adjust across spending categories, particularly on social protection (also with a view to making work more attractive) and education. Health is another area where savings may be possible. Moreover, a significant share of public employees at all levels of government will be retiring in the coming years. This should provide a catalyst for restructuring the public sector. And the evidence suggests, according to our discussions with the Ministry of Finance, that if all municipalities were to provide services as efficiently as the best one, cost savings of 20-30 percent appear possible. Better use of economies of scale through enhanced local cooperation (e.g., in health) is one way for local governments to achieve fiscal savings. Another way is by encouraging greater use of procurement and tenders for the private provision of public services, in addition to providing municipalities with greater know how to undertake such tasks. The mission welcomes the endeavors of the working group on how to improve the efficiency of the public sector, but recognizes that it will take time to put reforms in place and realize fiscal savings. Thus, in the short-run, general cuts across spending categories may be considered.

- Seventh, to the extent that the fiscal balance falls short of the suggested norm, it will be all the more imperative to pursue even greater pension reform. While there is a strong social consensus in Finland on guaranteeing a certain level of real income, without an adequate accumulation of fiscal surpluses now and corresponding reduction in debt, the inevitable age-related deterioration in the fiscal balance implies that benefits paid to pensioners will need to be reduced—if large increases in taxes and contributions are to be avoided. Alternatively, or possibly in addition, other parameters of the pension system may need to be adjusted, such as delaying further the time of retirement. In any event, with increasing the employment rate at the forefront, further pension reform is needed to further raise the low effective retirement age.

STRUCTURAL REFORMS

11. ***While a major reform of the pension system has improved the outlook, it has not resolved ongoing tensions.*** The 2002 pension reform significantly enhances sustainability, for example by increasing the effective retirement age, allowing an earlier start of earnings-related pension accrual, changing the indexing mechanism, and factoring in increasing life

expectancy. However, the “baby-boom” cohorts are largely shielded from the effects of the reform. To further raise the effective retirement age, the case is strong, in the mission’s view, to: (i) eliminate the subsidized component of the part-time pension scheme; (ii) tighten eligibility criteria for disability pensions; and (iii) reduce disincentives to hire older workers. The latter requires limiting the extent to which larger firms face both rising contributions and increasing payments for the direct cost of unemployment and disability as the age of their employees increases. Consideration could also be given to shortening the transition periods that shield large parts of the “baby-boomer” generation from the 2002 reform.

12. *With the slowdown in economic growth ending the gradual reduction in unemployment, the need for structural reform of the labor market is all the more apparent.*

While many of the problems are not new, tackling unemployment and raising the employment rate has become especially pressing against the background of slower potential growth. Indeed, the ICT sector made a large contribution to growth over the 1990s, but a repeat on that scale is unlikely. In addition to reducing the tax wedge and incentive traps at the lower end of the skill scale, the mission still considers several other reforms to be important. The first relates to the centralized wage bargaining system. While it has helped to deliver moderate average wage increases, more wage differentiation, so that wages would be more in line with the differences in the demand for labor across regions and in productivity developments across skills, is crucial. It would help to reduce regional and skill mismatches, improve the attractiveness of hiring lower-skilled workers, provide the opportunity to gain greater work experience to enhance future employability, and improve the chances for increasing living standards through own efforts. Greater wage flexibility, along with an opening up of the publicly-dominated market for social services, would also improve the prospects for developing the private market for personal services. With an aging population, the demand for these services will increase and, with the right reforms, could contribute to alleviating unemployment at lower skill levels. Other measures include encouraging job search by tapering off unemployment benefits, and stricter enforcement of job acceptance requirements, possibly to include part-time work. Finally, time spent before entering the labor market remains too long. Thus, the policy debate has appropriately focused on enhancing the efficiency of the education system and introducing incentives to lessen the duration of studies, with a view to students entering the labor market at an earlier age.

13. *The mission welcomes recent efforts to increase privatization, and supports efforts to enhance the functioning of product markets.* Competition policy was key in Finland’s successful drive to liberalize markets, and could now serve to improve the operation of market forces in some sectors, for example construction. More generally, strengthening the enforcement of existing laws and raising the prospect of higher sanctions would help to ensure an appropriately competitive market place. On privatization, the increased pace in 2002 is welcome. The mission encourages continued efforts in this direction.

THE FINANCIAL SECTOR

14. ***The Finnish financial system has weathered the slowdown in economic growth and decline in equity prices fairly well.*** Notwithstanding some decline in profitability in 2002 and the first quarter of 2003, bank balance sheets remained healthy. Looking ahead, though bank profitability would be affected by further declines in interest rates or a serious economic downturn, stress tests conducted recently by the Bank of Finland suggest that the banking sector could withstand further distress. While the decline in equity prices has had a stronger impact on the insurance sector than the banking sector, and the solvency ratios of some less-established companies are only at a satisfactory level, solvency ratios remain quite good in general. This limits the potential for systemic fallout, but it is still important to monitor the situation closely—as is currently the case—with a view to taking preemptive measures should they ever be needed. In this vein, the mission welcomes the cooperation between various institutions involved in the supervision and regulation of financial markets to undertake comprehensive stress testing.

15. ***The mission also welcomes key aspects of the new Act on the Financial Supervision Authority (FSA) and efforts to strengthen cooperation among Nordic supervisors.*** In particular, the FSA's independence and powers to take prompt corrective actions have been strengthened. As the latter would be strengthened further by the adoption of the EU's financial services directive and the Basel-2 accord, the mission hopes that the legal means of implementation can be found. With a view to comprehensive and coordinated oversight of financial markets, including banks, insurance companies, and securities markets, another important action worthy of serious consideration is unifying the supervisory authority. Recent progress made in Nordic supervisory cooperation, both by financial supervisory authorities and central banks, is welcome. Developing more fully a crisis management framework and further harmonization of regulatory and supervisory arrangements—not just across the Nordic countries but in the euro area too—are important items for the policy agenda. Finally, Finland's efforts to keep its framework on combating money laundering and the financing of terrorism up to date is to be commended.

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The mission would like to thank the authorities, and other participants in its meetings, for the open and stimulating discussions, timely provision of information, and overall hospitality. Also, it warmly welcomes the clear commitment to cooperation and transparency.

Helsinki
June 18, 2003