

Medium-Term Fiscal Policy Stance

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It appears that Finland's fiscal position will weather the current economic downturn better than other Euro Area countries. However, the economic slowdown will reduce the budget policy options available to the government. Labor taxes should be eased further in order to raise the employment rate. Our calculations show that in a scenario where annual economic growth averages only 2 percent over the medium term, the general government surplus would decline appreciably but would nevertheless remain at a sustainable level. Significant savings could be achieved by introducing reforms in the local government sector.

Export-Driven Cyclical Downturn Short-Lived

According to our recent global economic forecast, world economic activity is expected to begin picking up in the second half of next year. As such, the export-led economic downturn in Finland should remain relatively short-lived.

According to the Finnish Ministry of Finance, Finland's general government finances will continue to record a wide surplus next year, which will allow the government's fiscal policy stance of reducing labor taxes to be implemented.

Expansionary fiscal policy is warranted since the decline in output growth below its potential rate stems primarily from the weakening in external demand. At this juncture, it is difficult to justify fiscal tightening because there are still no indications that the economy has overheated. The price competitiveness of Finnish exporters has remained strong, and the private sector is not over-indebted.

The Ministry of Finance also believes that the decline in the general government fiscal balance is cyclical in nature, a development that will be reversed once the economy embarks on an upturn. Thanks to the fiscal surplus, the automatic stabilizers will be allowed to operate freely without having to tighten fiscal policy.

Economic Growth Could Remain Slow Due To the Wide U.S. Current-Account Deficit

The risk of a more prolonged world economic slowdown is still high because the world's major economies, the U.S., Japan and the EU, are experiencing synchronous recessions. Although monetary and fiscal policy has been loosened considerably in the U.S., it is not certain whether this will have a significant impact on the economy given the structural problems that exist and their required alleviation eventually. For example, reducing the large deficit in the current account would necessitate a period of subpar growth.

Based on the output projections for Finnish industry, GDP growth will average 3 percent during 2001-2005. In this baseline scenario, public consumption is assumed to increase at an average annual pace of one percent and taxes will continue to be reduced from 2003 onwards. The size of the tax and contribution cuts is estimated at 0.3 percent of GDP per annum.

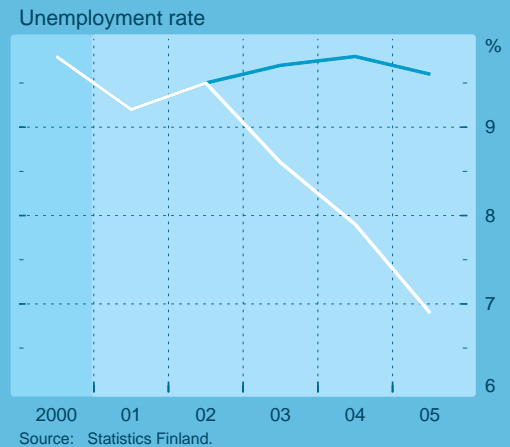
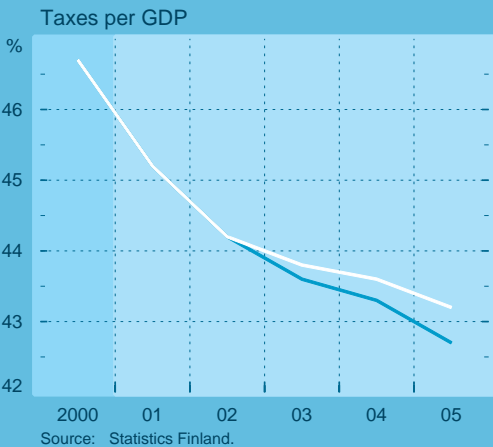
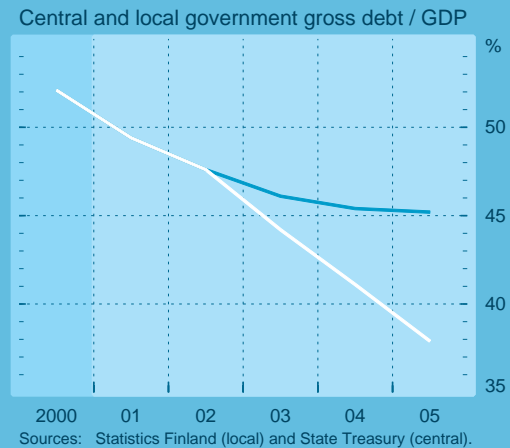
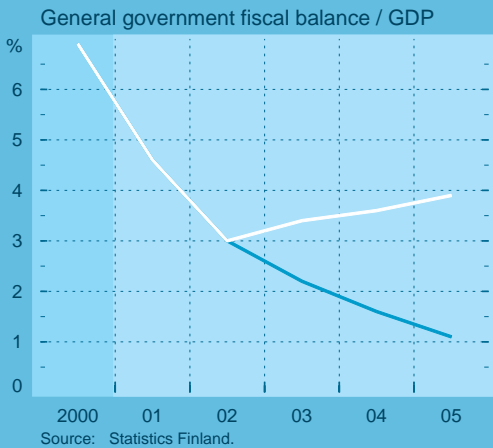
In the baseline forecast, the general government financial surplus as a percentage of GDP rises gradually starting in 2003 to a level of 4 percent in 2005. At the same time, the unemployment rate declines to 7 percent by the end of the projection period.

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In a scenario of slower GDP growth, averaging only 2 percent per annum, and given the same assumptions regarding public expenditure and tax cuts, the general government fiscal surplus would decline to one percent of GDP by the year 2005. The combined financial position of the central government and local government would show a deficit of approximately one percent of GDP by the year 2005. At the same time, the unemployment rate would not decline from its level of 9.4 percent forecast for next year.

It appears that Finland's fiscal position will weather the two-year long economic downturn better than other Euro Area countries. Even in a scenario of slower output growth in 2001-2005 than that forecast, the general government financial balance would weaken markedly but would nevertheless remain at a sustainable level. Hence, the government's tax-cutting stance can be continued, when implemented in combination with, for example, wage agreements aimed at dampening costs.

Key Economic Figures Given Different Growth Assumptions



— 2% GDP growth

— 3% GDP growth

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Fewer Options Available in Central Government Budget Policy

Finland's decade-long fiscal consolidation process has been successful on many counts. Measures aimed at restraining the growth of public expenditure and the government's active privatization policy have produced sizeable budget surpluses, which in turn have allowed the government to reduce its debt, lower labor taxes and also increase state expenditures in recent years.

The high tax and contribution burden has also been reduced at a faster pace than the government's program would suggest. By next year, the tax and contribution reductions will gross FIM 20 billion, with the household sector's share climbing to FIM 15 billion.

According to the budget proposal for next year, expenditures will exceed the government's targeted level, outlined in the Government Programme, by some FIM 6 billion in real terms during the government's period of office. According to ETLA's calculations, budgeted expenditures, in current prices, excluding interest payments will exceed their targeted level next year by almost FIM 10 billion.

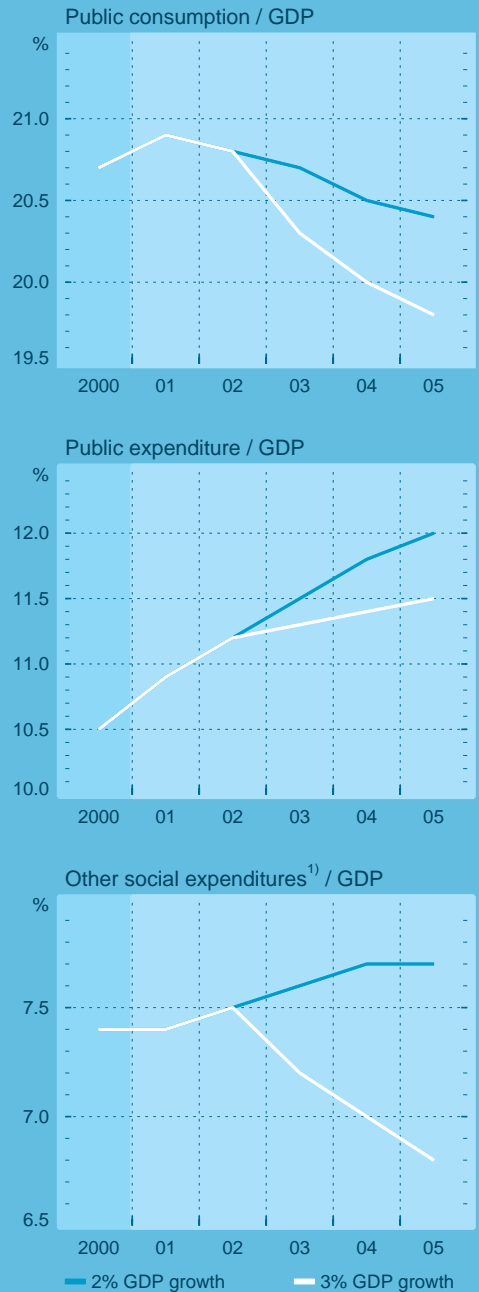
New choices will have to be made within budgetary policy, ones that bring employment considerations to the forefront. In this respect, ensuring wage policies that dampen cost pressures and strengthen corporate price competitiveness will be of utmost importance.

Reducing taxes in order to promote moderate wage agreements requires a strong fiscal position in general government finances. The surplus in the central government budget, forecast at just under one percent of GDP, places the central government in a good position from which to negotiate in the next round of wage bargaining.

Local Government Will Continue To Face Financial Difficulties, Unless Structural Reforms Introduced

The increases in state subsidies to municipalities will provide a little relief to the fiscal positions of small, sparsely populated municipalities. However, this additional stimulus will not suffice to stop the strong wave of migration currently taking place in Finland and the resultant

Key Public Expenditure Categories Given Different Growth Assumptions



1) Expenditures on unemployment benefits, health insurance, child allowances, student aid, housing allowances, home support and subsistence subsidies.

deterioration in the tax bases of those municipalities recording net outflows of residents. According to the Association of Finnish Local and Regional Authorities, smaller municipalities, in particular, will experience deteriorating financial positions.

Due to the European Union's eastern enlargement in 2005 onwards, Finland will receive less financial support from the EU's structural funds as well as fewer agricultural subsidies. Less support will be translated into much weaker economic activity and budgetary positions in many smaller municipalities undergoing structural change.

There will continue to be significant migration by younger, working-age segments of the Finnish population towards growing metropolitan areas in Finland. Without further stimulus from state subsidies, or municipal tax hikes, municipalities experiencing outward flows of residents will have to cut costs and boost the efficacy of their service provision activities.

Last year, there were around 250 municipalities in Finland, whose personnel costs exceeded their municipal tax revenues. In these municipalities, even moderate rises in the earnings of local government employees could lead to budget deficits, unless state subsidies increase or taxes are raised. Reducing municipal admin-

istrative costs and the salaries of high-level local government executives would offer significant room for lowering taxes.

Public and private service provision could be preserved in a more sustainable basis by eliminating superfluous administrative bureaucracy. Increasing the average size of a given service provider would reduce the average unit costs of services, thereby benefiting the clients.

Postponement of Pension Reform Will Prove Costly

Finland has one of the costliest population structures in the EU. One of the government's central aims has been to raise the retirement age by 2-3 years. In the tripartite negotiations between the government and labor market organizations this autumn, it was decided to postpone pension reform until the end of 2005.

Postponing pension reform will be translated into significant growth of pension expenditures already during the next few years. The growth of the population aged over 60, with the right to retire, will accelerate in 2003-2005 from its current pace of one percent to almost two percent. After 2005, this segment of the population will grow at an average annual rate of 3 percent.