Finland: Staff Concluding Statement of the 2019 Article IV Mission

November 18, 2019

The new coalition government has presented an ambitious policy agenda. The goals are admirable: more social inclusion, higher employment, a cleaner environment—and a balanced budget. Now the challenge is to make the government program work. Some goals might take some time to be met—along the way, priorities will have to be chosen, and some policy options that have been ruled out deserve serious reconsideration.

The government has set itself the task of making Finland a more inclusive and sustainable society. In particular, there are to be one-off increases in public expenditures on education, employment, infrastructure, and climate policies. This additional spending will cost up to 3 billion euros—1¼ percent of GDP—of which 1.4 billion euros has been committed and 1.7 billion euros is as yet unallocated. In the short run, the extra fiscal stimulus will provide useful support for demand in an otherwise slowing economy. Nonetheless, growth is likely to be only around 1¼ percent this year and 1½ percent in 2020, a sharp contrast to the past three years that have seen 2½ percent growth on average.

The medium-term perspective brings the challenges for fiscal policy into focus. The government has set a target to balance the public finances by 2023, with debt declining by then. This is an important goal: rising demands for healthcare and social services will stress the public finances, and fiscal buffers are essential to ensure the social support model can be sustained.

But balancing the budget seems unlikely. Assuming that potential growth hovers around 1¼ percent over the medium term, even just the committed spending would imply that the

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government would have to borrow about 1 percent of GDP in 2023. This would mean missing the government's own medium-term target. Further, there are significant risks to this outlook: the economy might not recover as well as assumed, and spending on "one-off" expenditures might be hard to switch off.

For its part, the government's target scenario shows balance by 2023. This is only partly achieved by new tax measures—crucially, the government assumes that it will boost employment still further than in our assessment. Our projections attempt to take the impact of these policies into account, but are necessarily uncertain because the measures have not yet been fully defined. If that higher employment were achieved, the budget *might* balance—but not if policies used to boost employment are themselves costly.

In our view, fiscal credibility would be enhanced if the government commits not to spend the extra 1.7bn euros until it is sure that it can balance revenues against the 1.4bn euros of one-off items. The planned mid-term budget review sets a criterion of employing 30 out of the targeted 60 thousand more people before *all* spending on one-off items takes place—a more prudent criterion would be for *half* of the spending to take place at that point.

More likely, the government will need to take corrective actions to meet its medium-term target, which would likely require about ½ percent of GDP in net savings. All options should be on the table. If spending is to be front loaded, bringing excise taxes forward would be safer. The government could significantly improve the public finances by eliminating environmentally-harmful subsidies that are *each year* worth 3½ billion euros—about one quarter of current education spending. Such an initiative would require political consensus, and some time for industries to adjust—but globally raising the price of carbon is the single most effective tool for countries to reduce fossil fuel emissions, and the government has set a goal for Finland to be carbon neutral by 2035. Otherwise, the government will have to find other savings. Crucially, cost control has to be part of the debate about health and social services reform.

The government rightly recognizes that the social model depends on high employment. Some areas look ripe for improvement, although here again political compromises would be required. Many Finnish women stay out of the workforce for long periods while raising children—not only lowering employment but earnings over their lifetimes—which warrants a careful examination of the incentives generated by leave and homecare benefits. Still more could be done to increase participation and employment of older workers, such as by further limiting early exit routes out of the labor force. Current tax and benefit schedules mean that some—especially low-wage and part-time earners—pay a financial penalty to work, rather than stay unemployed or out of the workforce completely.

Instead, the government program favors so-called active labor market policies to boost employment. More resources for case workers who assist those seeking jobs could help. But relying on job subsidies, which are expensive and have had mixed effects in other countries, seems likely to disappoint.

Household finances also deserve attention, as for public finances. Household debt has been increasing, but excessive leverage ultimately benefits no one. In this context, the recent recommendation from a government-appointed working group to limit the ratio of household debt to income is both sensible and in line with steps taken in many other countries. Its introduction will make lending safer overall. Crucially, the Debt-To-Income limit would cover all borrower's debts. The working group proposes that the DTI limit be 450 percent; anticipating cases in which higher leverage could be affordable for some borrowers, it proposes an exemption to allow banks a share of borrowers with higher debt ratios.

Much of the recent increase in household debt is driven by housing company loans. A concern is that financing the purchase of a house through shares in a housing company masks risks to home owners and can make higher prices appear more affordable than they truly are. The working group has therefore recommended restrictions targeted at these loans. But it is important to address the underlying causes that have led to the boom in such lending—in particular, the tax code creates a clear incentive for investors to favor housing company loans over conventional mortgages.

Better data would help borrowers, lenders, and policy makers. The planned electronic register of housing company shares will make it easier to assess risks of investing in housing companies. A comprehensive credit registry would facilitate other measures to address borrower risks, such as limits on debt servicing to income, should those be needed.

The government has embraced a wide range of worthy goals. Achieving them is not impossible, but will likely require compromise and caution, keeping fiscal sustainability and financial stability in mind.

The mission would like to thank the authorities and other counterparts for their warm hospitality and for candid and high-quality discussions.