Economic Policy Council Report
2014

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Economic Policy Council

VATT Institute for Economic Research

Arkadiankatu 7, 00100 Helsinki, Finland

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Preface

The Economic Policy Council was established in January 2014 to provide independent evaluation of economic policies in Finland. According to the government decree (61/2014), the Council's task is to evaluate

1. the appropriateness of economic policy objectives

2. whether the objectives have been achieved and whether the policies chosen were appropriate

3. the quality of the forecasting and assessment methods used in policy planning

4. the co-ordination of various aspects of economic policy and how they relate to other social policies

5. the success of economic policy, especially with respect to economic growth and stability, employment and the long-term sustainability of public finances

6. the appropriateness of economic policy institutions

The members of the Council are appointed by the government for a five-year term based on a proposal by the economics departments of Finnish universities and by the Academy of Finland. The members of the Council are university professors and contribute to the work of the Council in addition to their regular work. The Council has a part-time secretary general. The Council is hosted by the VATT Institute for Economic Research but works independently of the Institute.

This is the first report of the Council. This report analyses recent economic developments and fiscal policy. We also evaluate the appropriateness of existing fiscal policy rules and analyse the structure of taxation. We analyse the preparation of economic policy by looking at the work of the working group for the development of

the Finnish tax system and the working group preparing reform of the pension system. Two specific policy issues are discussed in detail: pension reform and regulation of local government financing. Both of these are key elements of the government structural reform programme. Other major elements of the programme are not discussed because details of the reforms planned are not available. In addition, evaluation of the reform of the social and health care system, for example, is performed by the National Institute for Health and Welfare.

The government has allocated EUR 100,000 to research projects that support the work of the Economic Policy Council. This funding comes from the programme for analysis, assessment and research activities in support of government decision-making. Three reports were commissioned with the support of this funding. A report on the pension reform proposal by Jukka Lassila, Niku Määttänen and Tarmo Valkonen, and a report on macroeconomic governance in local administration are being published at the same time as this report. A report on labour supply responses to tax policy by Jarkko Harju, Tuomas Kosonen and Tuomas Matikka will be published in 2015 and will be discussed in the Council's next report.

Several experts have attended Council meetings. We would like to thank Permanent Secretary Martti Hetemäki of the Ministry of Finance, Director of Fiscal Policy Audit Heidi Silvennoinen of the National Audit Office, researcher Olli Kärkkäinen of the Parliament Research Service, Research Director Antti Moisio of the VATT Institute for Economic Research, and research advisor Niku Määttänen of the Research Institute of the Finnish Economy for sharing their expertise and views with the Council.

This report is based on unclassified material and data, which are not always published in a detailed form. Also, interpreting published analyses is not always straightforward. We thank Kaarlo Reipas and Ismo Risku of the Finnish Centre for Pensions, Reijo Vanne of TELA, Veli Laine of the European Commision, Benjamin Strandberg of the Association of Finnish Local and Regional Authorities, Mikael Kirkko-Jaakkola of the Taxpayers Association of Finland, and Jonna Berghäll, Tuulia Hakola, Marketta Henriksson, Mauri Kotamäki, Mikko Spolander, Arvi Suvanto, Veliarvo Tammnen and Lauri Taro of the Ministry of Finance for answering numerous questions and helping with the acquisition of data.

All the members of the Council have participated in the writing process. We have benefited significantly from discussions and comments by other researchers. We thank Mika Maliranta, Jukka Pirttilä, Matti Tuomala, Juhana Vartiainen, Seija Ilmakunnas, Jukka Pekkarinen, Eugen Koev, Rauli Svento, Seppo Kari, Jari Vaniomäki, Jarkko Harju, Tuomas Matikka, Tuomas Kosonen, Timo Rauhanen and Vesa-Matti Heikkuri

for their contributions. We would also like to thank Raija-Liisa Aalto of the VATT Institute for Economic Research for her help in administrative issues related to establishing the Council and Maija-Liisa Järviö, Mikko Keinänen, Henri Lassander, Andrew Lightfoot, Anita Niskanen, Annika Nivala and Päivi Tainio for assistance in editing, proofreading and language checking, and setting up the Council's website. Naturally, we are solely responsible for the content of the report.

Helsinki 2 June 2015

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Summary

Economic outlook

The economic outlook in Finland is still weak. Output growth was negative in 2012 and 2013 and is forecasted to be around zero in 2014. Most forecasts expect a slow recovery in 2015 but growth rates are expected to be low up to 2018. Output is clearly below its potential level and Finland is still experiencing a prolonged recession.

Unemployment has increased from 2011 but relatively little given the slow growth in the economy. Most labour market indicators point to unemployment being largely cyclical, with very few signs of structural unemployment increasing in recent years.

Productivity growth ended after 2007. This development is partly related to a shift in industry structure from high-productivity manufacturing industries, in particular electronics and metal industries, towards service sectors where the average labour productivity is lower. However, a much larger share of the decline in productivity is due to a decline in manufacturing industries and within firms in those industries. The outlook for productivity growth and therefore also economic growth in future is bleak.

Public finances and fiscal policy

Public finances have suffered from a decrease in tax revenue related to a decrease in economic activity. Social security funds are still in surplus but other sectors of government are showing large deficits. Also, the surplus in social security funds has decreased in recent years due to increasing pension expenditure. Central government has been in deficit since 2009 and local government has been in deficit since 2001.

A large part of these deficits is structural. The structural deficit of the entire public sector is predicted to exceed one per cent in 2014 and to remain around one per cent up to 2018. This is a significant deviation from the medium-term policy objectives that Finland has committed to. According to the Stability and Growth Pact and domestic

fiscal policy legislation, such a deviation requires the government to take corrective actions.

The fiscal policy of the government for 2015 is contractionary, leading to adjustments to expenditure savings and revenue increases of about EUR 2.5 billion compared to 2014. Roughly half of these measures were decided already in 2012 and half in spring 2014. The new government appointed in June 2014 revised these decisions only slightly without altering the general fiscal policy stance.

Tightening fiscal policy at a stage when the output gap is still negative will depress domestic demand and have a negative effect on economic growth in 2015. Reaching the fiscal policy targets would require even larger adjustments in 2015 and 2016. However, the Council notes that the tightening of fiscal policy in 2015 is large given the state of the business cycle, and does not recommend further fiscal tightening until the economy has returned to a more robust growth path as such tightening could lead to higher unemployment. This implies that Finland will not achieve its medium-term fiscal policy objectives. However, three consecutive years of negative or zero growth should be interpreted as exceptional circumstances as defined by the Stability and Growth Pact.

Based on sustainability indicators, public finances are not balaced in the long term. The current deficit implies that larger adjustments will be needed in the future. Balancing public finances requires further adjustments of about three per cent of GDP, even after the pension reform.

As required in fiscal policy law, the government issued a statement in October 2014 noting a significant deviation from its medium-term fiscal policy objectives. In its statement, the government refers to measures in the structural policy programme of August 2013. The Council notes that even though these measures may have an effect on the long-term sustainability of public finances they will have little impact over the medium term. For example, the pension reform, if implemented according to a proposal by labour market organisations, will lower pension expenditure only from 2021 onwards. Reforms of the social and health care system and macro governance of municipal finances may have a more rapid effect, but the details of these reforms are still open. Achieving the fiscal policy objectives in the medium term will require new consolidation decisions that should be implemented already in 2017 and 2018.

Finland has committed to the fiscal policy rules of Stability and Growth Pact. These rules set limits for public debt and the structural deficit of the entire public sector. In addition, the government has set target levels for central government debt and is

revising the fiscal rules for local government. In practice, the most binding fiscal rule has been the central government spending limit decision.

The Council notes that spending limits have a strong political status and this should be maintained. However, spending limits should be set so that they are consistent with the deficit target. This also implies that revenue-side measures should be treated symmetrically with expenditure. In practice, this would imply adjusting spending limits when discretionary changes are made to tax parameters.

In Finland, pension funds are included in the public sector. As the pension system is preparing for an expected future increase in pension expenditure, these funds consistently show a surplus. This surplus masks large deficits in other government sectors. Local government showed a deficit even at the peak of the business cycle in 2008 whilst central government had a surplus that was small given the magnitude of the boom. The Council recommends that Finland adopts a separate structural deficit target for each sector of government even though current EU regulations do not strictly require this. These targets should be specified in terms of deficit and the targets should be cyclically adjusted instead of defining them as an unadjusted debt-to-GDP ratio as is currently the case. The targets should also be consistent with long-term sustainability.

Structural policy programme

The government has designed a structural policy programme that aims to remove the sustainability gap in the public sector. When it was published the programme was mainly a list of policy targets rather than a list of actual policies. Calculations on the effects of the policy programme are therefore misleading. For example, prevention of the shadow economy is a good objective, but the estimate of a revenue increase of EUR 300 million from combating the shadow economy has no basis. A better description of the structural policy programme would be that the aggregate target is divided into numerical sub-targets. This is useful in designing reforms as it sets goals for each element in the reform package. However, policy goals should not be confused with the expected effects of these policies.

Over time the design of the policy has also become more concrete and, for example, the likely effects of pension reform, which is one of the key parts of the programme, can now be assessed. In this report, the Council evaluates the reform of the pension system and the management of local government finances. It is not possible to assess the social and health care reform as the details of the reform are still open.

In the structural policy programme, the goal set for the pension reform is that the reform will extend working careers by 1.5 years by 2025 and reduce the sustainability gap by 1

percentage point. The Council has commissioned a background report from ETLA to evaluate the effects of the reform. According to ETLA's baseline scenario, the reform will increase employment by just six months, but will achieve the target in terms of the sustainability gap and will reduce the sustainability gap by more than 1 percentage point. The estimated impact of the reform, however, depends on other determinants of retirement decisions. A more pessimistic scenario predicts an extension of working careers by 3 months and a 0.6 percentage point reduction in the sustainability gap.

Increases in retirement age and changes in accrual rates imply cuts in pension benefits. According to calculations by ETK, average pensions decrease by 7- 12% when one compares persons retiring at the same age under current rules and under the proposed rules. Reporting an increase in average pensions is misleading as this is due to increases in the retirement age. While cutting pension benefits is necessary if the goal of the reform is to improve the sustainability of public finances, changes in the system should also be communicated in a transparent way.

Much of the increase in local government expenditure has been caused by an increase in the number of tasks allocated to municipalities. Investments have been the main cause of the increase in municipal debt. The new local government expenditure cap is an important new measure for ensuring spending discipline in the public sector, because it prevents circumventing central government spending limits by shifting tasks and expenditure to municipalities.

The local government expenditure cap constrains the actions of central government and the balance requirement is set at the level of the entire local government sector. Therefore these measures are not effective constraints on individual municipalities. The deficit rule applying to individual municipalities, on the other hand, will only be slightly modified and the sanctions associated with breaking the rule are not very strong. The structural programme aims at reducing the tasks of municipalities and increasing the productivity of public services. The details of the implementation of these measures are still unclear and it is uncertain whether they will be successful in curtailing expenditure growth. If these measures succeed they will contribute to closing the sustainability gap.

The ultimate goal of structural programmes, and of the public sector as a whole, should be to maximise the welfare of citizens. Reducing municipal tasks almost inevitably leads to a reduction in the level of services. There are very strong grounds for the public provision of many services, such as health care, due to the incompleteness of the private insurance market.

Tax policy

The most significant tax policy change during the parliamentary term was a reduction in corporate income tax from 26% to 20%. While this reduction was a justified reaction to tax competition pressures, its magnitude was rather large. Tax competition in general should be seen as negative tendency and Finland should not be proactive in this development.

Lowering income taxes on low wages has been justified both in terms of work incentives and equity. However, the employment effects of these tax reductions are likely to be rather small.

There is still scope for improving efficiency and simplicity in the tax system. Raising lower VAT rates and making value-added tax more uniform could increase tax revenue. Tax expenditures related to various tax deductions should be reduced to make the system more transparent. In particular, using tax breaks to circumvent spending limits should be prohibited.

Inheritance tax should not be abolished. Inheritance tax is an efficient way of raising revenue because it causes fewer distortions to economic activity than many other taxes.

Preparation of economic policy

The tasks of the Council include the evaluation of the preparation of economic policy. The Council has analysed, based on interviews, the work of the working group for the development of the Finnish tax system and the working group preparing reform of the pension system. The Council notes that both working groups have utilised research-based knowledge extensively.

The working group for the development of the Finnish tax system submitted its report towards the end of 2010. It aimed at a comprehensive reform, and some of its proposals have been implemented. Their impact was hampered by a lack of commitment by decision-makers. The exceptional transparency of the group's work created a basis for broader discussion and will support subsequent stages of the work.

Negotiations between the labour market organisations on the pension reform in 2014 took place behind closed doors. In the pensions case, the government gave precise guidelines for the preparatory work led by interest organisations. The government's guidance role was based on an agreement with the labour market organisations and on the active part played by the MoF in the analytical work preceding the negotiations.

The settlement was tied to the sustainability of public finances in line with the structural policy programme. Through this model, the tripartite framework proved its potential,

which may also reflect future trends in decision-making. The Economic Policy Council draws attention to the transparency in decision-making based on the tripartite framework and in the expert knowledge supporting it. The decision by ETK to publish impact assessments immediately after the settlement was concluded was useful, because it provided important information for broader discussion.

Contents

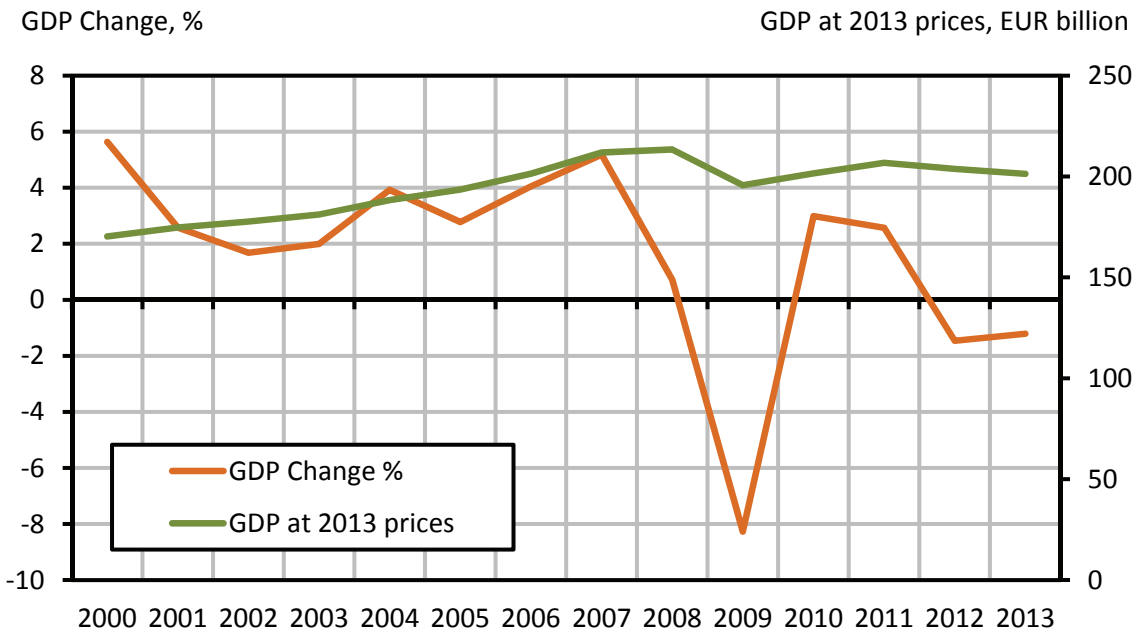
1 Recent economic developments

In this chapter, we describe recent economic developments in Finland. The main focus is on the parliamentary period 2011 – 2015.

1.1 The Finnish business cycle

Finland is experiencing a double-dip recession. At the beginning of the parliamentary period in 2011, the Finnish economy was recovering from the 8% drop in GDP in 2009. The financial crisis had caused a large shock in the global economy. Finnish exports had declined substantially due to the recession in its key export markets. In addition, Finnish firms lost market shares in key industries, in particular the electronics industry. By 2011 the worst part of the crisis seemed to be over. As illustrated in Figure 1.1.1, Finnish GDP grew by more than 2% in 2010 and 2011. However, this recovery soon turned into a prolonged recession starting in 2012. GDP growth rates were negative in 2012 and 2013 and GDP growth is expected to be close to zero in 2014. Five years after the collapse in 2009, Finland's GDP is still five per cent below the previous peak in 2008.

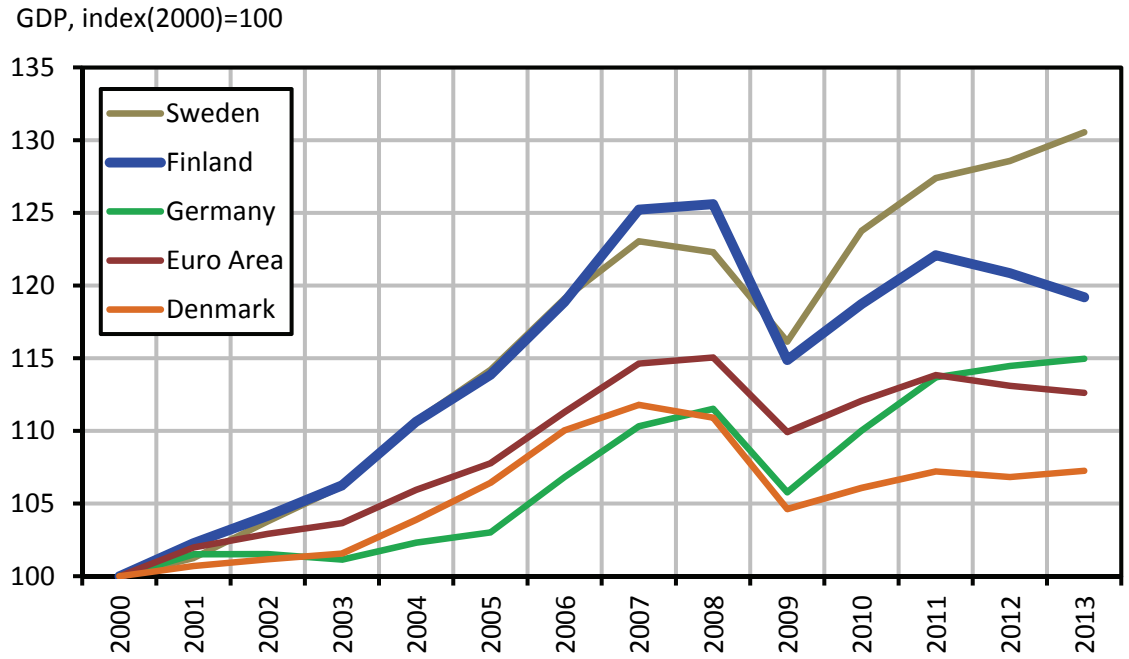
Figure 1.1.1. Development of GDP 2000 - 2013



Source: Statistics Finland, National accounts

Figure 1.1.2 puts Finland's economic performance in an international context. Compared with selected other countries and the Euro Area aggregate, GDP growth in Finland between 2000 and 2008 was exceptionally high and the drop in 2009 was deeper than in most other European countries or in other Nordic countries. The recovery has also been substantially slower than for example in Sweden. A double-dip pattern similar to that experienced in Finland is also visible in the Euro Area aggregate. Despite the prolonged recession, output in Finland is still 20% above the level of 2000, due to the rapid growth between 2000 and 2007. Over past 14 years, the Finnish economy has grown faster than euro countries on average or for example Germany. Sweden stands out as a country that, like Finland, experienced strong growth in the 2000s but has managed to return to a growth path after the 2009 financial crisis.

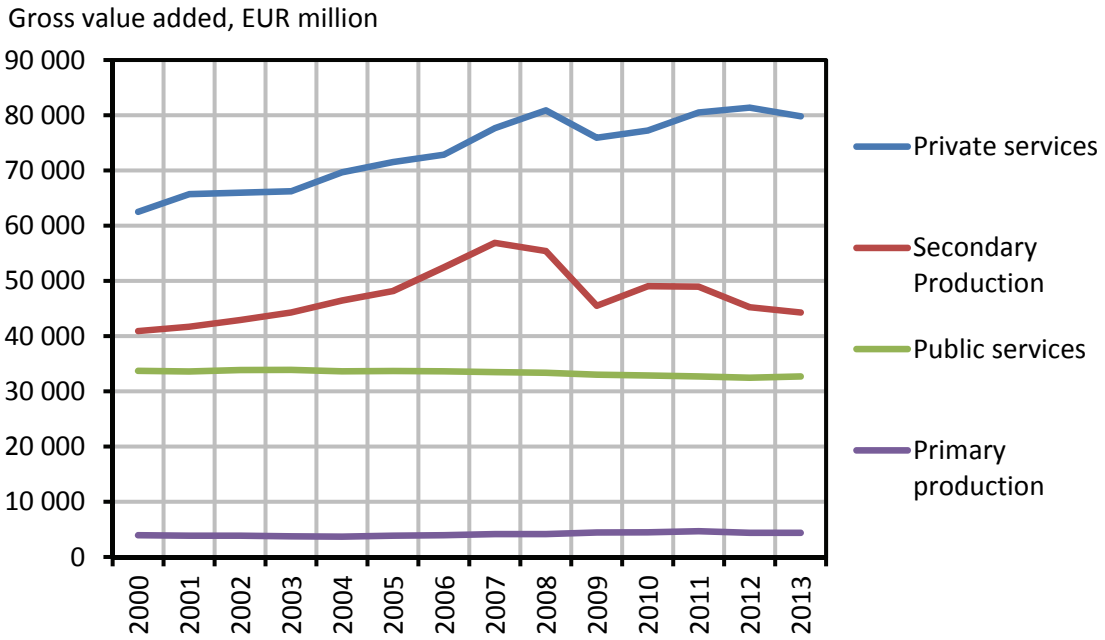
Figure 1.1.2. GDP at constant prices in selected countries 2000 – 2013 (index, 2000 = 100)



Source: European Commission, AMECO database

Figure 1.1.3 shows that Finland's weak economic performance is mainly explained by a fall in industrial output (secondary production). Industrial production started to fall in 2008 and fell by almost 20% in 2009. Industrial production increased in 2010 but has declined thereafter so that in real terms industrial output in 2013 was lower than in 2009. The private service sector experienced a smaller drop than industry. The production of services has also recovered more quickly and has reached the pre-crisis level. Public services are on a slowly declining trend that does not display any cyclical changes. Primary production is a relatively unimportant sector in the Finnish economy.

Figure 1.1.3. Gross value added by sector (2010 prices, EUR million)

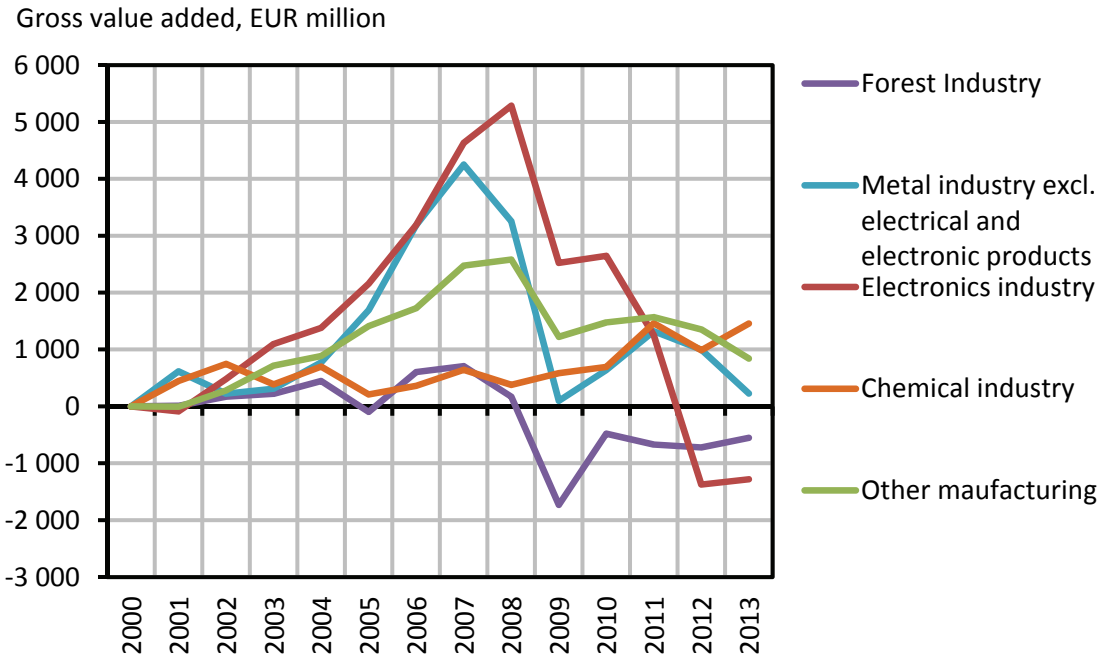


Source: Statistics Finland, National accounts

The drop in industrial output is to a large extent due to the decline of the electronics industry after the boom of the 2000s. As shown in Figure 1.1.4, the annual gross value added of the electronics industry increased by EUR 5 billion from 2000 to 2008 and fell by over EUR 6 billion in 2009 – 2013. The metal industry also experienced rapid growth in the 2000s which was followed by a drop after the beginning of the financial crisis. Production in the forest industries declined in 2009 and is still below the level achieved in 2000. The chemical industry is one of the few sectors that has grown in recent years despite the recession.

Figures 1.1.3 and 1.1.4 together show that in the past five years the Finnish economy has experienced rapid changes in industrial structure. The economy has become more service-oriented and the relative importance of various industry sectors has changed. Such a structural change could lead to mismatch problems in the labour market, which may reduce the effectiveness of expansive fiscal policy. Indicators of structural problems in the labour market are analysed in Section 1.3.

Figure 1.1.4. Gross value added in manufacturing 2000-2013, change from year 2000

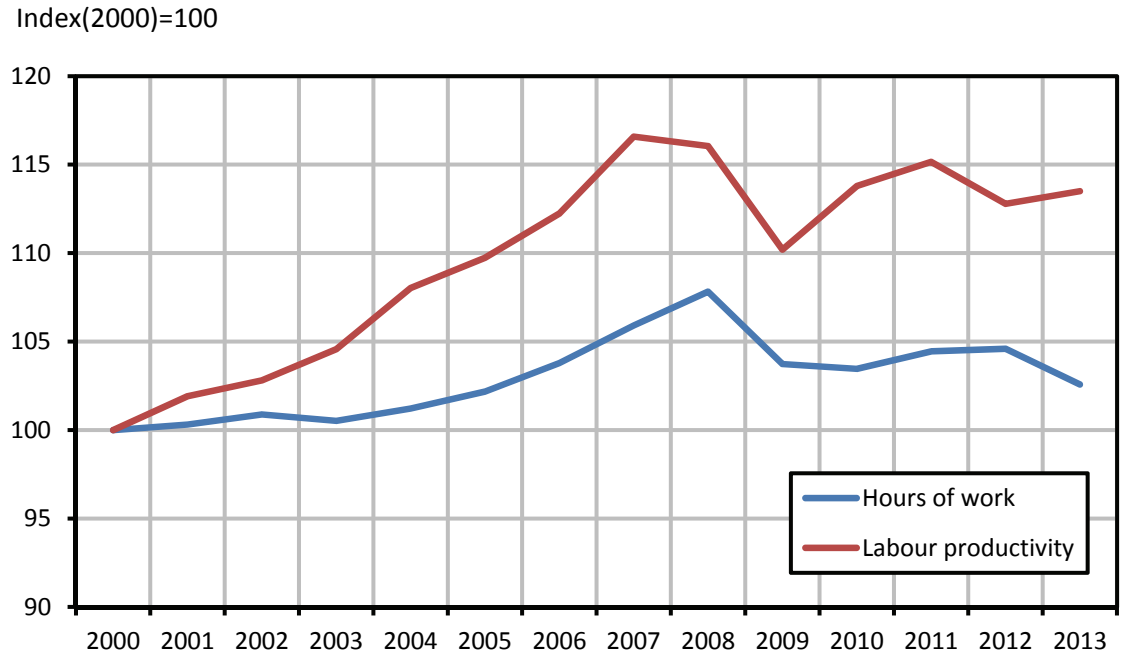


Source: Statistics Finland, National accounts

The dramatic drop in GDP after 2008 could have led to a substantial reduction in employment and increased unemployment. Employment and unemployment have, however, reacted notably slowly to the recession. These developments imply a drop in labour productivity. Figure 1.1.5 shows that the growth in GDP per hour of work stalled in 2007 and dropped by 5 per cent in 2009. Falling labour productivity is highly exceptional. Since 1975, labour productivity has fallen only in three years: 2008, 2009 and 2012. The average growth rate in labour productivity was 2.7 per cent between 1975 and 2008.

The decline in labour productivity is partly caused by the contraction of high-productivity industries and the reallocation of resources to the service sector, where labour productivity is lower on average. The main reason, however, is a decline in productivity within industries and within firms (Maliranta 2014).

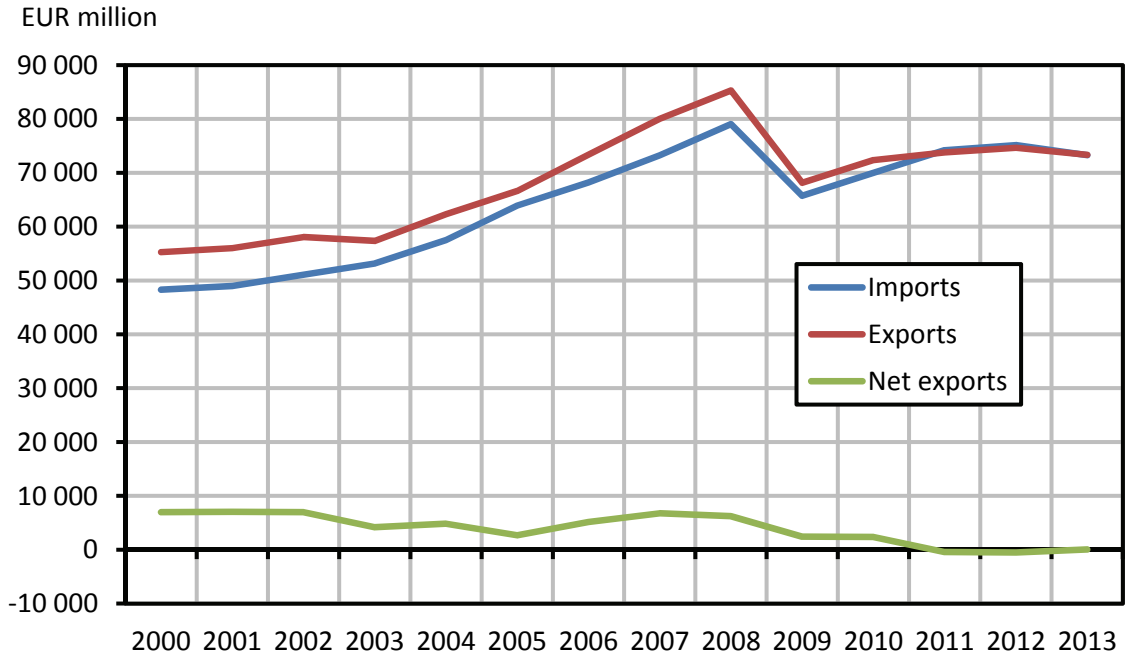
Figure 1.1.5. Hours of work and GDP per hour of work 2000-2013 (index, year 2000=100)



Source: Statistics Finland, productivity surveys

The fall in industrial output was largely due to a drop in export demand in 2009 and stagnant development thereafter (Figure 1.1.6). In addition to weak demand in export markets, Finnish firms have also lost market share so that exports have grown less rapidly than the volume of international trade. Imports have fallen slightly less than exports and imports and exports are roughly balanced after a long period of positive net exports.

Figure 1.1.6. Imports and exports 2000-2013 (2010 prices, EUR million).



Source: Statistics Finland, National accounts

1.2 Economic outlook

Table 1.2.1 shows the latest forecasts for the change in real GDP for 2014, 2015 and 2016 by the Ministry of Finance (MoF), The Bank of Finland (BoF), and three Finnish research institutes (the Research Institute of the Finnish Economy (ETLA), the Labour Institute for Economic Research (PT) and Pellervo Economic Research (PTT)). The forecasts of the European Commission, OECD and IMF are also reported.

The forecasts, which were updated in the autumn of 2014 (EC, MoF, BoF, ETLA, PT and PTT), show stagnant or negative growth for 2014. The outlook for 2015 is better, but there is unlikely to be any rapid return to robust growth rates. All forecasts for 2015 are between -0.1 (BoF) and 1.1 (IMF). The outlook of the Ministry of Finance is the most optimistic for 2015 among the forecasts updated in November or December. The gap between the forecasts of the BoF and MoF is one percentage point.

Forecasting economic growth for 2016 is difficult. All forecasters apparently expect a return to a growth trend. However, this trend is expected to be much weaker than

growth before the crisis. The forecast of the Ministry of Finance is in line with the views of other institutes.

Table 1.2.1. Forecast GDP, change in volume (per cent)

	2014	2015	2016
Ministry of Finance (17.12.2014)	0.1	0.9	1.3
Bank of Finland (11.12.2014)	-0.2	-0.1	1.0
European Commission EC (4.11.2014)	-0.4	0.6	1.1
International Monetary Fund IMF (March 2014)	0.4	1.1	1.5
Organisation for Economic Cooperation and Development OECD (May 2014)	0.2	1.1	
Research Institute of the Finnish Economy ETLA (25.9.2014)	-0.4	0.8	1.8
Labour Institute for Economic Research PT (17.9.2014)	-0.3	1.0	
Pellervo Economic Research PTT (23.9.2014)	-0.2	0.5	

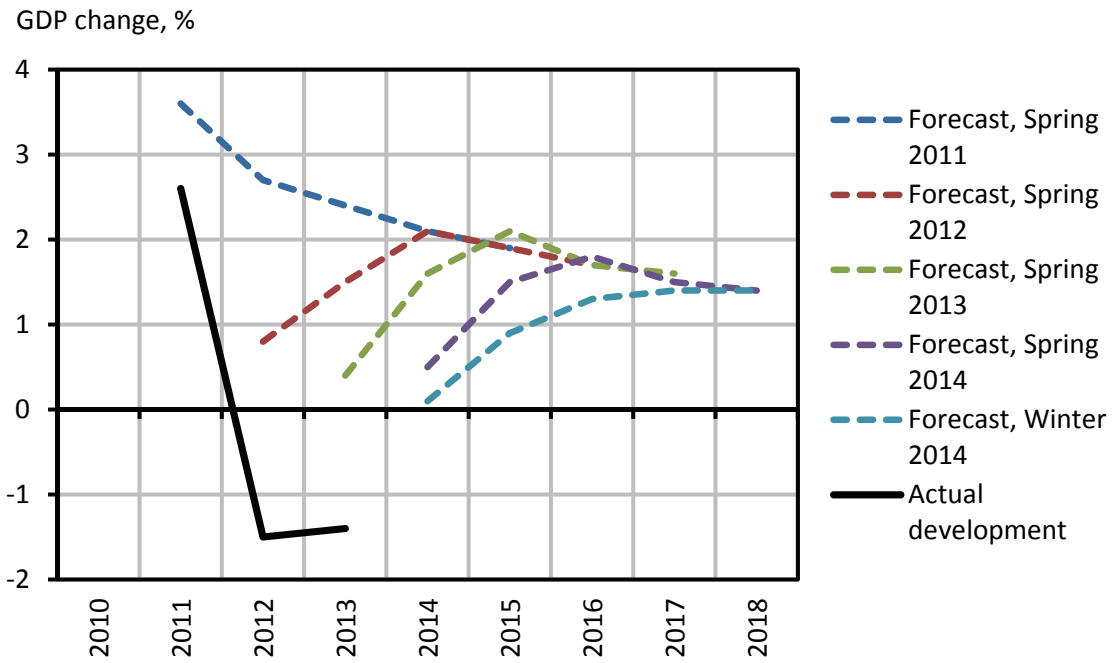
The forecast of the MoF is particularly important for economic policy as the government budget is based on it. The comparison of current forecasts in Table 1.2.1 shows no signs of the MoF forecast diverging systematically from other forecasters. In the past few years all forecasters have had trouble predicting economic growth rates and their forecasts have been revised downwards several times.

Figure 1.2.1 shows how the MoF has updated its forecasts during the parliamentary period and compares the forecasts with actual GDP growth. At the beginning of Prime Minister Jyrki Katainen's government in the spring of 2011, Finland was expected to continue to recover from the slump of 2009. Figure 1.2.1 shows that expected GDP growth in 2011 was over 3.5%, and for 2012 – 2015 the predicted growth rate was between 2% and 3%. The actual development of GDP has been in stark contrast with the growth predictions of spring 2011 (Figure 1.2.1). In 2012 and 2013, Finnish GDP fell by 2.6% in total and for 2014 the Ministry of Finance predicts zero growth.

Cumulatively, predicted GDP in 2014 based on the 2011 spring prediction by the MoF was 11% higher than the actual figure.

Figure 1.2.1 reports the updates by the MoF to its forecast over time. These figures are based on the Stability Programmes published each spring from 2011 to 2014. In addition, the figure presents the most recent forecast of winter 2014.[1] As shown in the figure, even the same-year forecasts published in the spring have been about two percentage points higher than the actual developments in 2012 and 2013. In both of these years, the MoF also expected a relatively rapid return to a growth path, which has not happened by 2014. In all fairness it should be noted that the slow growth surprised most other forecasters also.

Figure 1.2.1. MoF forecasts and actual development 2011-2014 (GDP volume change, per cent)



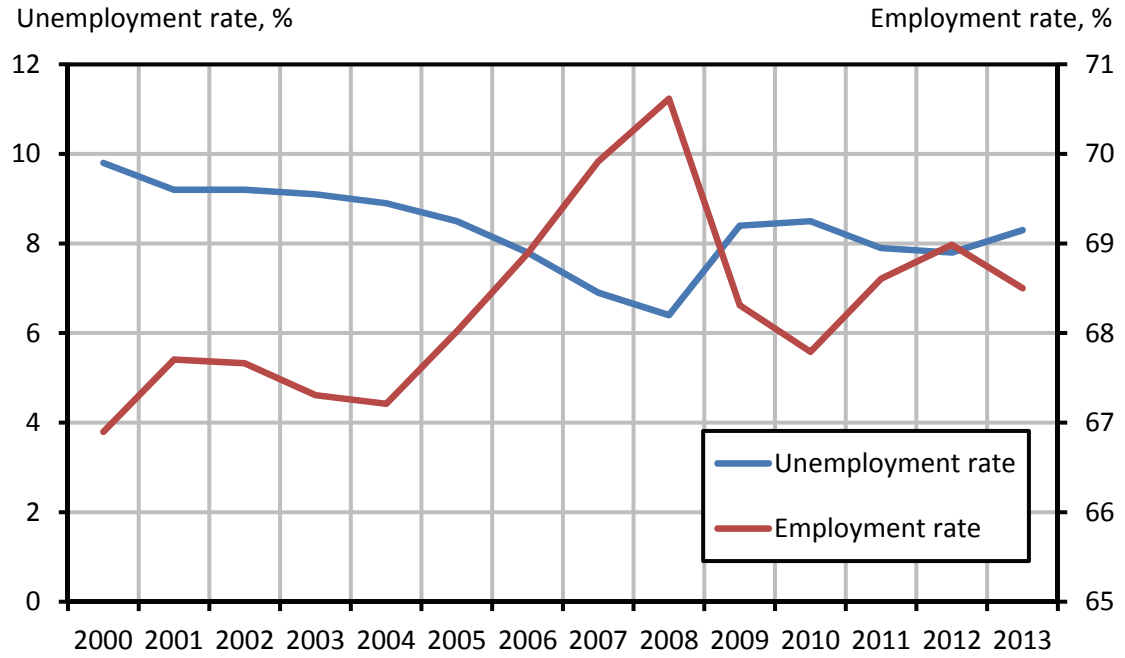
Source: Statistics Finland, National accounts; MoF, Stability Programme reports 2011 – 2014 and Economic Surveys (winter 2014 and autumn 2014).

[1] The winter 2014 Economic Survey by the MoF gives its forecast to 2016. The growth rates for 2017 and 2018 in Figure 1.2.1 come from the autumn 2014 Economic Survey.

1.3 The labour market

Figure 1.3.1 shows the unemployment rate and employment rate between 2000 and 2013. The unemployment rate increased from 6.4% in 2008 to 8.5% in 2009 and has remained quite stable at around 8%. At the same time, the employment rate decreased from over 70% to 68-69%. The reduction in the employment rate is not dramatic compared with the reduction in GDP, but employment is nevertheless well short of the target of 72% in the government programme.

Figure 1.3.1. Unemployment rate and employment rate according to Statistics Finland 2000–2014



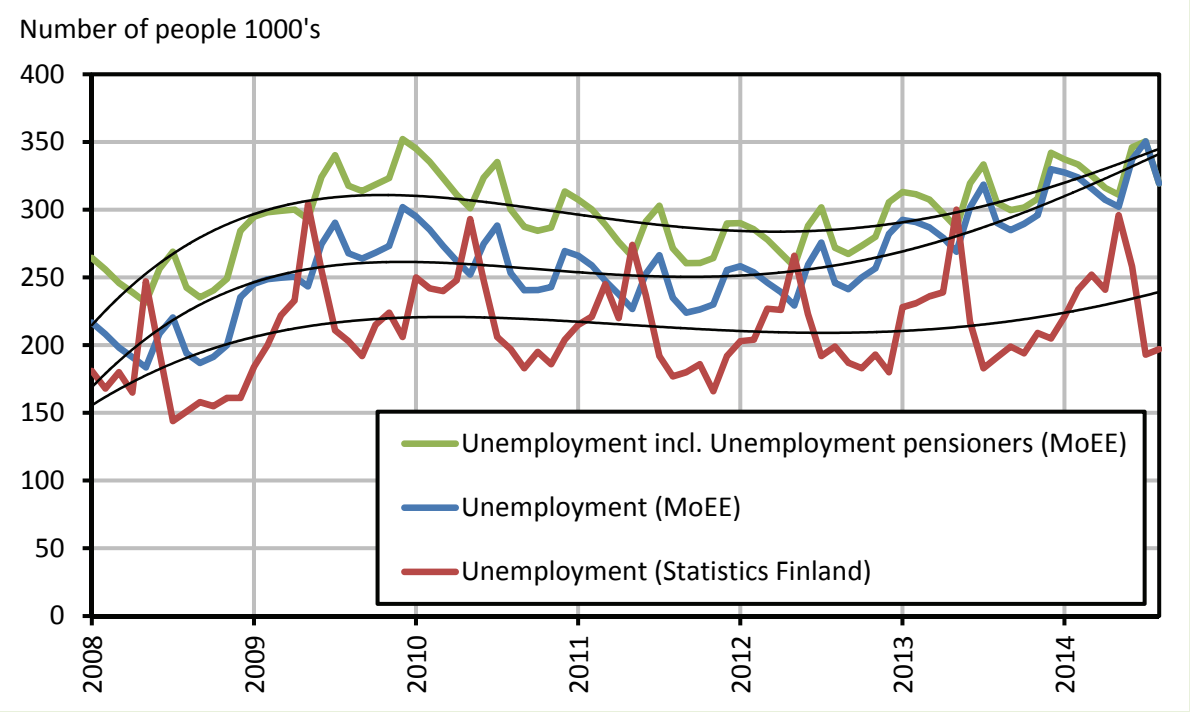
Source: Statistics Finland, Labour Force Survey

The unemployment rate in Figure 1.3.1 uses the Statistics Finland definition of unemployment, which is based on the Labour Force Survey. An often used alternative measure of unemployment is the number of registered jobseekers provided by the Ministry of Employment and the Economy (MoEE). The two time series have diverged in the past few years, which has created some confusion. In Box 1.3.1 we compare the development in unemployment based on these series and show that the divergence is largely explained by a reform of the unemployment pension system, which is not correctly taken into account in the MoEE data. The Labour Force Survey data is better suited for analysing the development of unemployment as it is consistent over time.

Box 1.3.1 Why do the unemployment rates of Statistics Finland and the MoEE diverge?

Figure 1.3.2 depicts the number of unemployed persons measured by Statictics Finland and the MoEE. The Statistics Finland figures are based on the Labour Force Survey. This is an ongoing survey that interviews 12,000 persons each month. The survey has been conducted in a consistent way since 1997 and it uses definitions that are internationally comparable. Respondents are classified as unemployed if they have not been working during the week when surveyed, have actively looked for work during the past four weeks and could start a job in two weeks, or if they have agreed to start in a job within two weeks. The MoEE unemployment figures are based on the number of registered job seekers registered at Employment and Economic Development Offices (TE Offices).

Figure 1.3.2. Number of unemployed according to Statistics Finland and MoEE 2008 – 2014



Source: Calculations by the Economic Policy Council; Statistics Finland, Labour Force Survey; MoEE, Työpoliittinen aikakauskirja (2014/3)

The two series seem to diverge from 2012 onwards. It has been argued that the widening of the gap between MoEE and Statistics Finland measures is due to discouraged unemployed persons who are registered as job seekers and claim benefits but are not actively looking for work because no jobs are available. These people would be classified as unemployed

according to the MoEE definition but not according to the Statistics Finland definition. We argue, however, that the apparent divergence of the two series is misleading, because the MoEE methodology is not conistent over time.

The widening of the gap between these two measures in recent years is to a large extent driven by the pension reform in 2005, which abolished unemployment pensions. Before 2005 unemployed persons who turned 60 before their earnings-related unemployment benefits (500 days) expired could receive unemployment pensions from age 60, or after having received unemployment benefits for 500 days, until old-age retirement. The unemployment pension system was abolished in 2005 and replaced with extended unemployment benefits. Currently, unemployed persons who turn 59 before receiving benefits for 500 days are eligible for extended benefits up to age 65. This age limit will increase to 60 for cohorts born in 1955 or 1956 and to 61 for cohorts born in 1957 or later.

In practice, replacing unemployment pensions with extended unemployment benefits implies that many long-term unemployed who would have been on unemployment pension under the old rules are now registered as unemployed job seekers. According to data provided by the Finnish Centre for Pensions (ETK), 50,770 persons received unemployment pensions in 2008. This number has gradually declined to 5,257 in 2013 and will be zero in 2015.

To make time series of unemployment based on MoEE statistics consistent, those receiving unemployment pensions should be added to the unemployed in all years (green line in Figure 1.3.2). The number of unemployment pensioners is based on the MoEE statistics and is added to the monthly unemployment figures. This largely removes the different trends in the MoEE time series and the Statistics Finland time series. The same procedure makes an even larger difference to the time series of the long-term unemployed. A large fraction of the long-term unemployed are in their sixties and would have received unemployment pensions if the system still existed.

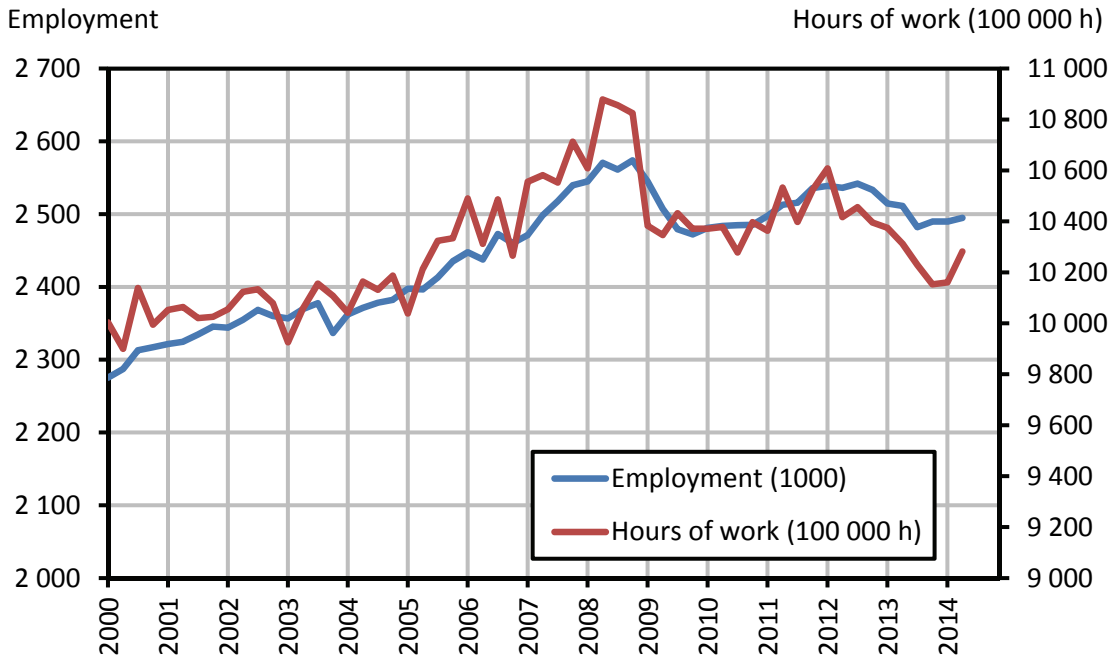
Another policy change affecting the comparability of the MoEE figures over time was that from July 2013 onwards all workers on temporary layoff were required to register at an employment office. It is hard to estimate the impact of this change on the MoEE unemployment figures because temporary layoffs vary substantially over time. In any case, this has a lesser impact on aggregate unemployment rates than the abolition of the unemployment pension system.

Reports with misleading data on long-term unemployment have been published recently. For example, the MoEE's short-term labour market forecast (TEM-analyyseja 60/2014), which discusses long-term unemployment at length and notes adverse developments in the

oldest age groups, does not even mention the change in the pension system – nor try to adjust its estimates. Similarly, the report of the Earnings and Cost Development Committee (Tulo- ja kustannuskehityksen selvitystoimikunnan raportti 27.6.2014) appears to use inconsistent time series on unemployment, which leads them to conclude that mismatch problems in the labour market have increased.

The growth in unemployment and fall in employment have been exceptionally low given the severity of the recession measured in terms of GDP. However, the labour market can also respond to the business cycle through changes in hours of work. Figure 1.3.3 shows that total hours worked have fallen more than employment during the recession. Labour input, measured in terms of hours worked, decreased by 4 per cent between the fourth quarter of 2008 and the first quarter of 2009, while the number of employed decreased by only 1 per cent. Conversely, when the recovery begins, there will be more room to increase labour input than suggested by the fall in the employment rate.

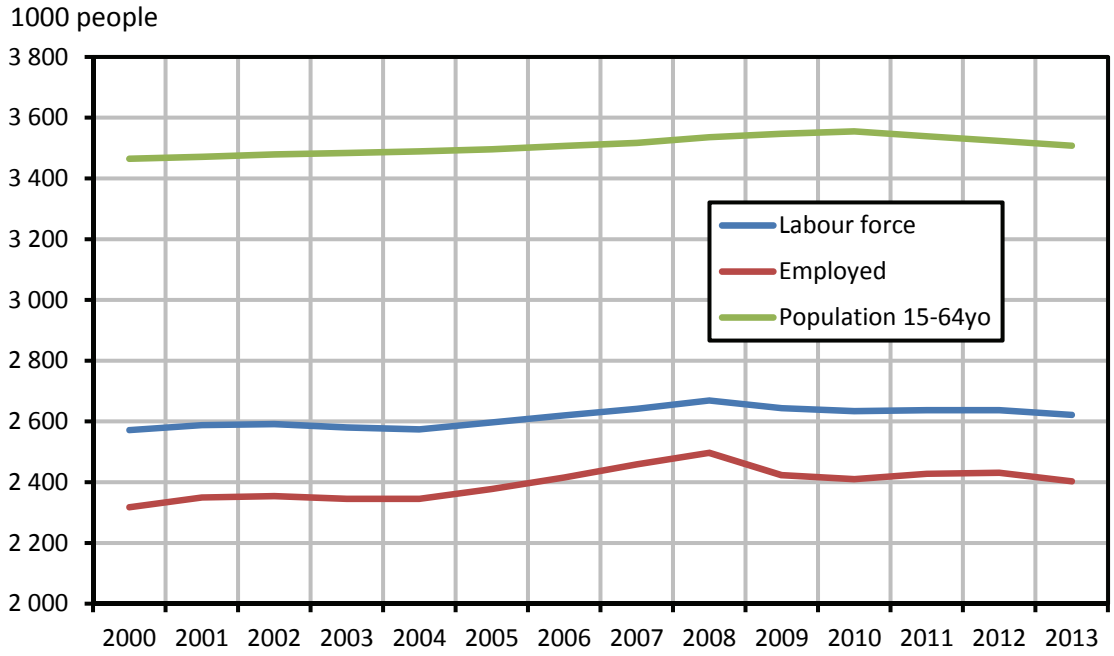
Figure 1.3.3. Employment and hours of work (quarterly) 2000-2014 Q2



Source: Statistics Finland, National accounts

The size of the labour force is important for the potential output of the economy. Figure 1.3.4 shows that the labour force started to decline slowly in 2009 as labour force participation decreased due to the recession. The working-age population reached its peak in 2010 and is declining, which contributes to the decline in the size of the labour force. Employment has decreased by roughly 5 per cent from the peak of 2008.

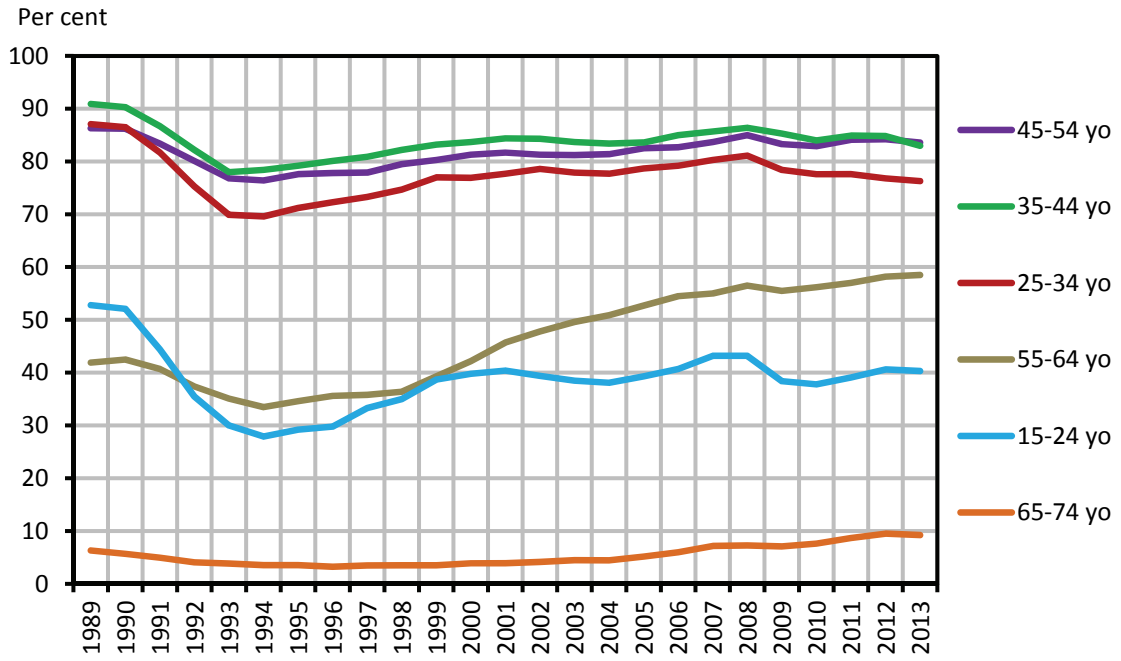
Figure 1.3.4. Working age population, labour force and employment 2000-2013



Source: Statistics Finland, Labour Force Survey

Employment growth in the 2000s has been largely due to growth in the age group 55-64 (Figure 1.3.5). The employment rate among over 55-64-year-olds (and among 64-74-year-olds) has continued to grow despite the recession. Employment rates in these age groups are strongly affected by the pension system, which we analyse in Section 4.1. Employment rates in the prime age groups (25-54), in particular in the age group between 25 and 34, have declined since 2009.

Figure 1.3.5. Employment rate by age group 1989-2013, per cent



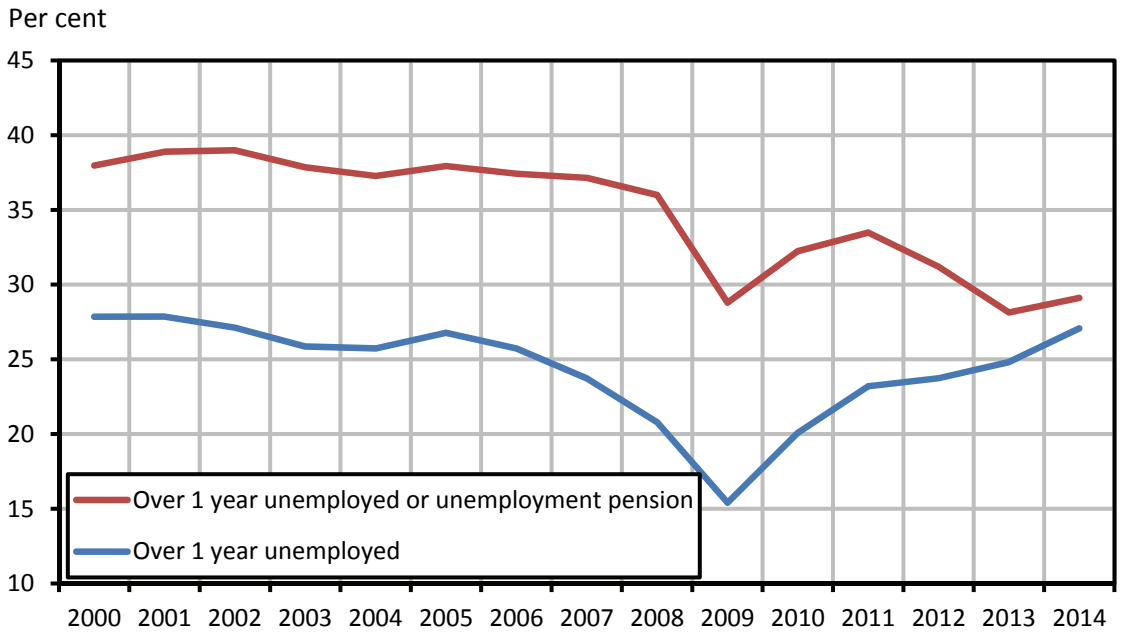
Source: Statistics Finland, Labour Force Survey

In order to evaluate recent fiscal policy decisions, it is important to understand to what extent the current recession is caused by demand shocks due to cyclical fluctuations in the international economy, and to what extent the growth potential of the Finnish economy has weakened due to structural factors. In principle, fiscal policy should aim to smooth out cyclical fluctuations by more expansionary fiscal policy during a recession and more restrictive policy in a boom. However, if the current economic situation reflects a permanent reduction in growth potential, and unemployment is due to structural problems, expansionary fiscal policy has little effect on output and will merely result in higher debt and a greater need for adjustments later on.

One indicator of potential mismatch problems in the labour market is long-term unemployment. If, for example, the skill composition of the unemployed is such that they become unsuitable for the vacant jobs, unemployment spells tend to become longer. Figure 1.3.6 describes the development in the number of long-term unemployed between 2000 and 2014, based on data from the MoEE. The red line in the figure shows the share of long-term unemployed when unemployment pensioners are included in the long-term unemployed in order to facilitate comparability over time (see Box 1.3.1). Without the inclusion of unemployment pensioners, one would erroneously conclude that the share of the long-term unemployed is rising rapidly (blue line). A more consistent calculation reveals that the fraction of unemployed who have been

unemployed for more than a year has decreased despite the recession. This suggests that the increase in unemployment in recent years is mainly cyclical.

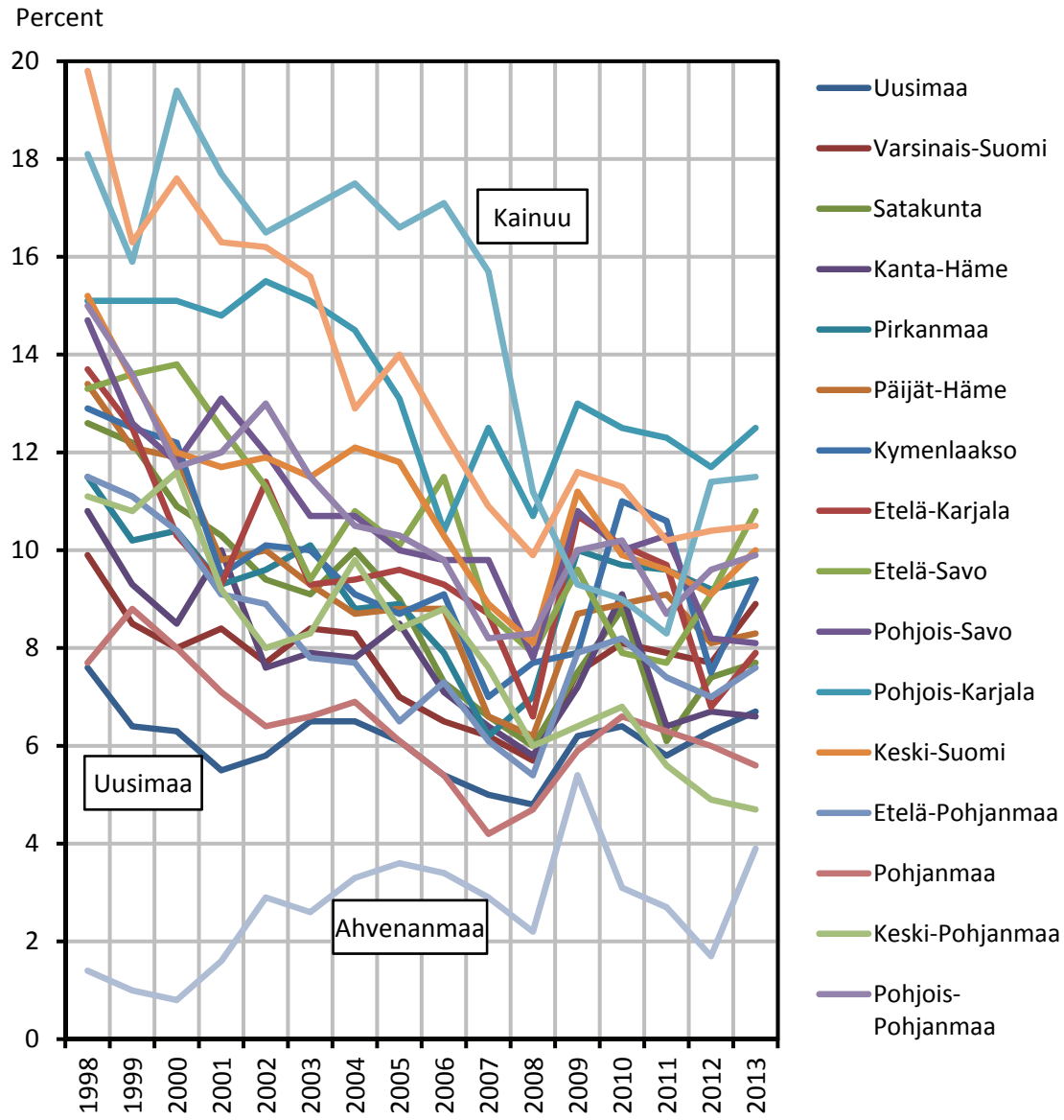
Figure 1.3.6. Long-term unemployment including and excluding unemployment pension 2000-2014, per cent



Source: Statistics Finland, Labour Force Survey; MoEE, Työpoliittinen aikakauskirja (2014/3)

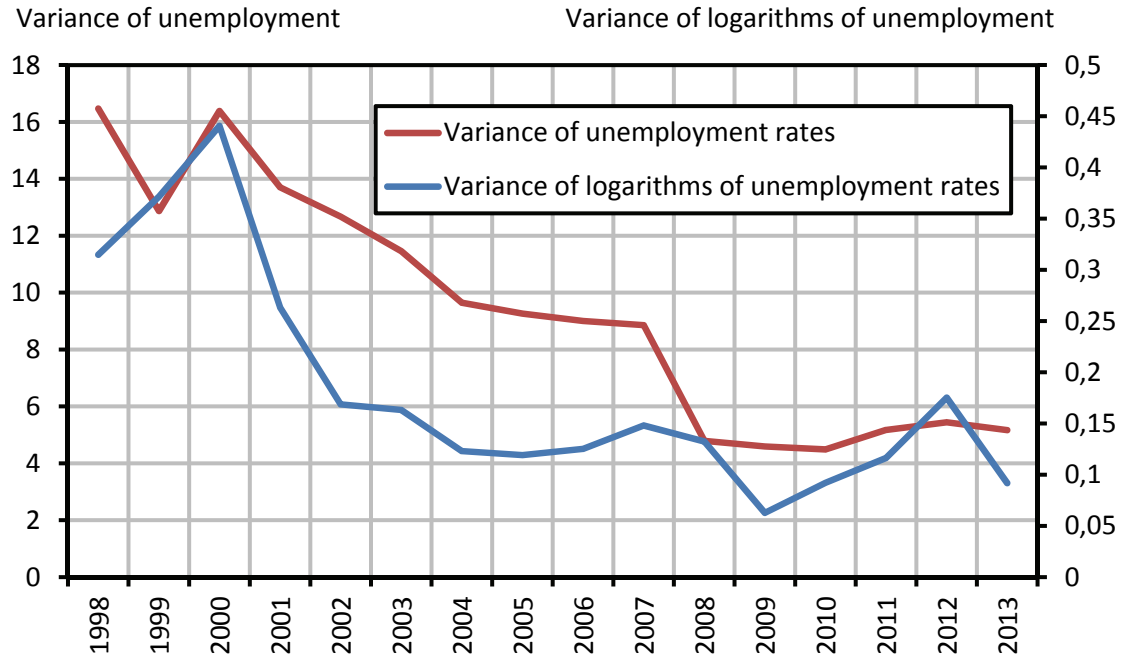
Another indicator of structural problems in the labour market is regional disparity in unemployment rates. The divergence of unemployment rates in different areas would suggest that the supply and demand for labour are spatially mismatched. Figure 1.3.7 depicts unemployment rates in Finland's TE regions between 1998 and 2013. The long-term trend seems to be a convergence in unemployment rates rather than divergence, and the recession has not reversed that trend. Rather, unemployment has increased in regions with traditionally low unemployment rates such as Uusimaa and decreased in traditionally high unemployment regions. This observation is confirmed by Figure 1.3.8, which shows the variance of regional unemployment rates and the variance of the logarithms of unemployment rates. Neither of the two measures points towards increased differences in unemployment rates across regions. Thus the spatial mis-match problems in the labour market do not seem to have increased during the recession.

Figure 1.3.7. Unemployment rate by region 1998 - 2013, per cent



Source: Statistics Finland, Labour Force Survey

Figure 1.3.8. Regional differences in unemployment rates 1998-2013



Source: Council's calculations of the based on data in Figure 1.3.7

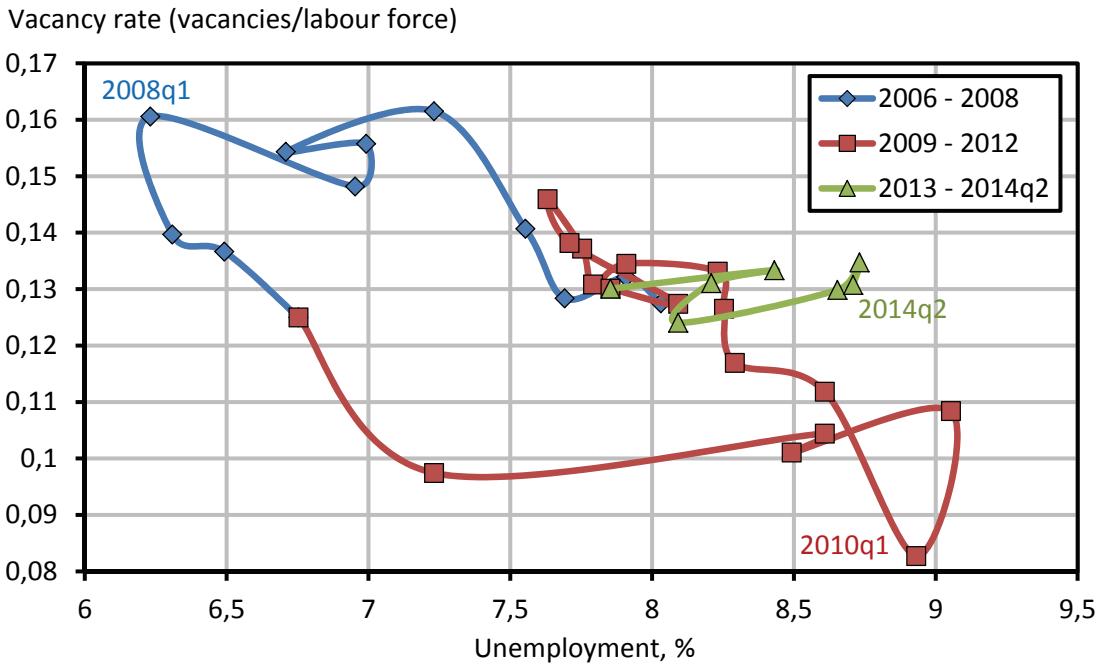
One of the most commonly used indicators of the mismatch problems in the labour market is the Beveridge curve, which plots the relationship between the vacancy rate (vacant jobs/labour force) and the unemployment rate. In a recession the number of vacancies decreases and the unemployment rate increases. In an expansion vacancies increase and unemployment decreases. This implies a downward-sloping relationship between unemployment and vacancies where movements along the curve indicate cyclical fluctuations. An outward shift in the unemployment–vacancy relationship, i.e. a simultaneous increase in vacancies and unemployment indicates increasing mismatch problems.

In Figure 1.3.9 we plot vacancy rates based on the number of open vacancies in job centres against unemployment rates from the Labour Force Survey. The data are quarterly and span from the first quarter of 2006 to the second quarter of 2014. Both vacancies and unemployment are scaled by dividing them by the size of the labour force

(employed + unemployed). We have removed seasonal variation and used a simple smoothing algorithm to retrieve trends in both series.[2]

Our interpretation is that the movements in the Beveridge curve indicate large business cycle fluctuations but little sign of changes in structural problems. Unemployment declined and vacancies increased between 2003 and 2008 and then in 2009 the pattern was quickly reversed. However, developments after 2009 also largely remain on the curve, with only slight indications of outward movement during 2014.

Figure 1.3.9. Unemployment and vacancy rate 2006 – 2014Q2 (seasonally adjusted)



Source: Statistics Finland, Labour Force Survey; MoEE, Finnish Labour Review (2014/3)

A potential problem with Figure 1.3.9 is that it may not adequately reflect changes in labour force participation. However, the figure is not sensitive to using (1-employment rate) instead of the unemployment rate on the horizontal axis. Using unemployment rates calculated from MoEE data would indicate large outward shifts in the curve after 2012. As noted in Box 1.3.1, this would be misleading as the MoEE unemployment series are not consistent. There are also issues related to the measurement of vacancies.

[2] The smoothing is done by calculating the difference between each quarterly observation and the average in the same quarter in the whole period, and adding the average of all quarters in the whole period.

According to the MoEE (Finnish Labour Review 3/2014), about 40-50% of open vacancies are notified to the employment services. Since 2003 Statistics Finland has collected data on open vacancies based on a survey of firms. In principle this would be a better way of capturing also vacancies that are not reported to the employment services. Unfortunately, Statistics Finland changed its survey procedure in 2013 so that earlier data are not consistent with more recent data.[3]

[3] Using vacancy statistics by Statistics Finland instead of the MoEE would lead to an inward shift in the Beveridge curve in 2013–2014, indicating less severe mismatch problems in the labour market.

2 Public finances and fiscal policy

This chapter describes and analyses the state of public finances and the government's fiscal policy. By way of a background to the analysis we summarize the central statements regarding public finances in the programmes of the governments of Jyrki Katainen and Alexander Stubb.

Programme of Jyrki Katainen's government (June 2011)

Consolidation of public finances was one of the top priorities of Jyrki Katainen's government. The aim of the programme was to lower the central government debt-to-GDP ratio by the end of the parliamentary term. This was to be achieved by adjustments in central government expenditure and revenues totaling EUR 2.5 billion annually up to 2015. The adjustments were to be equally divided between the revenue and expenditure sides. The government committed to undertaking further adjustment measures if the central government debt-to-GDP ratio did not shrink and if the central government deficit showed signs of settling at over 1% of GDP. The government programme also included the somewhat peculiar goal of maintaining the AAA credit rating of government bonds.

The government programme also aimed at closing the sustainability gap that was estimated to be around 4 percent of GDP at the time when the government programme was written. The goal was to increase the employment rate to 72% and to reduce the unemployment rate to 5% by the end of the parliamentary term. Measures for reducing the sustainability gap were described later in the government structural policy programme . We will discuss some elements of this programme in Chapter 4.

Programme of Alexander Stubb's government (June 2014)

The programme of the new government appointed in June 2014 was largely based on the previous government's programme. Sound public finances were still one of the key goals although the target for reducing the central government debt-to-GDP ratio was

postponed so that it now had to be reached by the end of the spending limit period, i.e. by 2018. Maintaining the AAA credit rating was still listed as a policy goal. The new government agreed to implement the structural policy programme of the previous government. The budget for 2015 was to be constructed in accordance with the spending limits adopted in the General Government Fiscal Plan. Unlike the previous government, the new government did not commit to not using tax subsidies to circumvent the spending limit decisions.

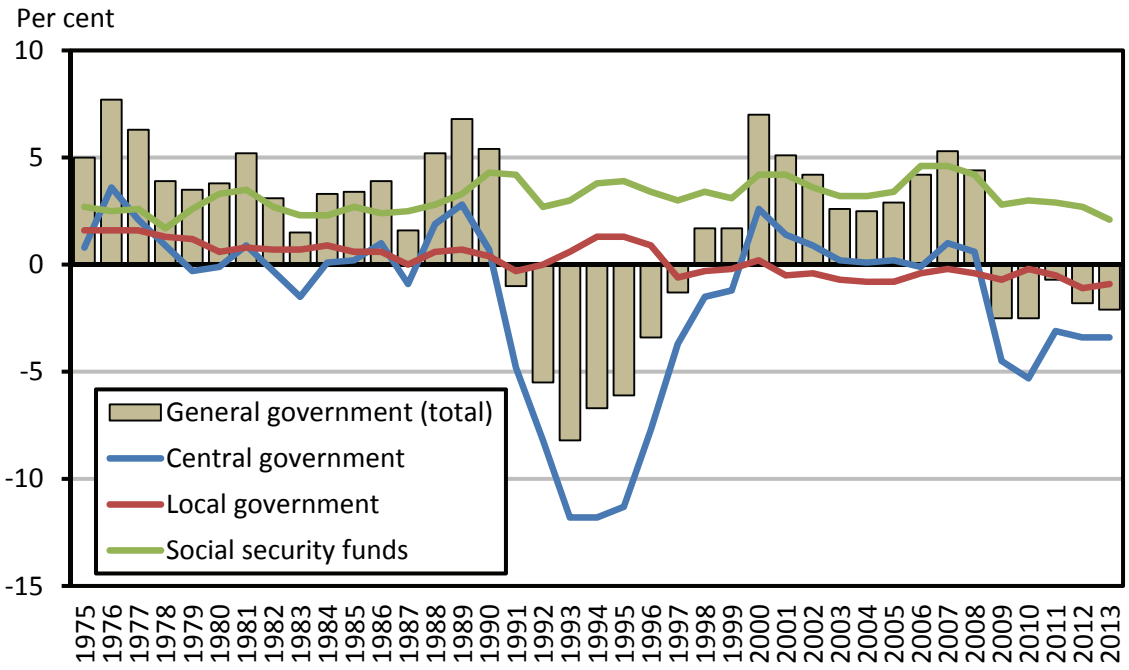
2.1 General government deficit and debt

In Finland general government consists of the central government, local government (municipalities) and social security funds (including private sector pension funds). Figure 2.1.1. describes the general government deficit and components between 1975 and 2013.

In the recession of the 1990s and its aftermath, general government spending exceeded government revenues for seven consecutive years. The deficit exceeded 5% of GDP in the four years 1992-1995. In the 1990s the general government deficit was mainly due to the sizeable central government deficit. Between 1998 and 2008 the general government had a surplus, which was mainly due to a surplus in pension funds preparing for the coming increases in pension expenditure. Central government ran a surplus between 2000 and 2008 (with the exception of 2006), but the surplus was small compared with the deficits in the 1990s. Cumulatively, the central government surplus in 2000–2008 was less than 10% of GDP. For comparison, the cumulative central government deficit in 1991-1999 was 62% of GDP. Local government ran a surplus in the early 1990s but has had a deficit since 1997.

From 2009 onwards, general government has had a deficit, again driven by large deficits in central government. In 2009 and 2010 the central government deficit was around 5% of GDP. Cumulative central government deficit in the four years 2009–2013 was about 20% of GDP. Since 2009 the central government deficit has remained well above the 1% target set in the programme of Katainen's government.

Figure 2.1.1. General government surplus/deficit in 1975-2013 (ratio to GDP, %)

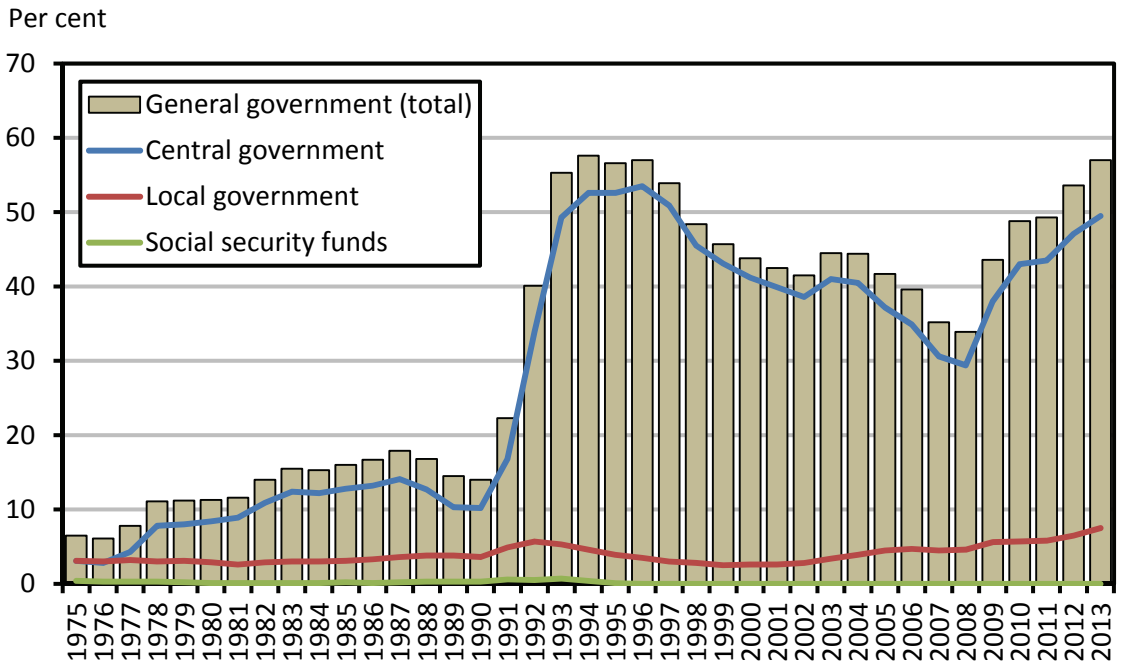


Source: Statistics Finland: General government deficit and debt

The general government debt-to-GDP ratio increased rapidly in the 1990s crisis and then declined from 56% in 1994 to 33% in 2008 (Figure 2.1.2.). The decline in relative indebtedness was driven by strong economic growth. In nominal terms public debt also increased over that period. Most of the public debt is central government debt. However, local government debt has also doubled in the past ten years and was 7.4% of GDP in 2013. Social security funds have no debt and instead have substantial assets.

According to current forecasts, public debt will continue to increase until 2018 and will exceed 60% in 2015. Central government debt is expected to increase until 2016 but should decline slightly in 2017 and 2018.

Figure 2.1.2. General government indebtedness in 1975-2013 (ratio to GDP, per cent)



Source: Statistics Finland: General government deficit and debt

2.2 Cyclically adjusted deficit

The government deficit and changes in government deficit depend, in addition to fiscal policy decisions, on the state of the economy. In order to measure the effects of discretionary fiscal policy, business cycle effects need to be removed from the headline deficit figures.

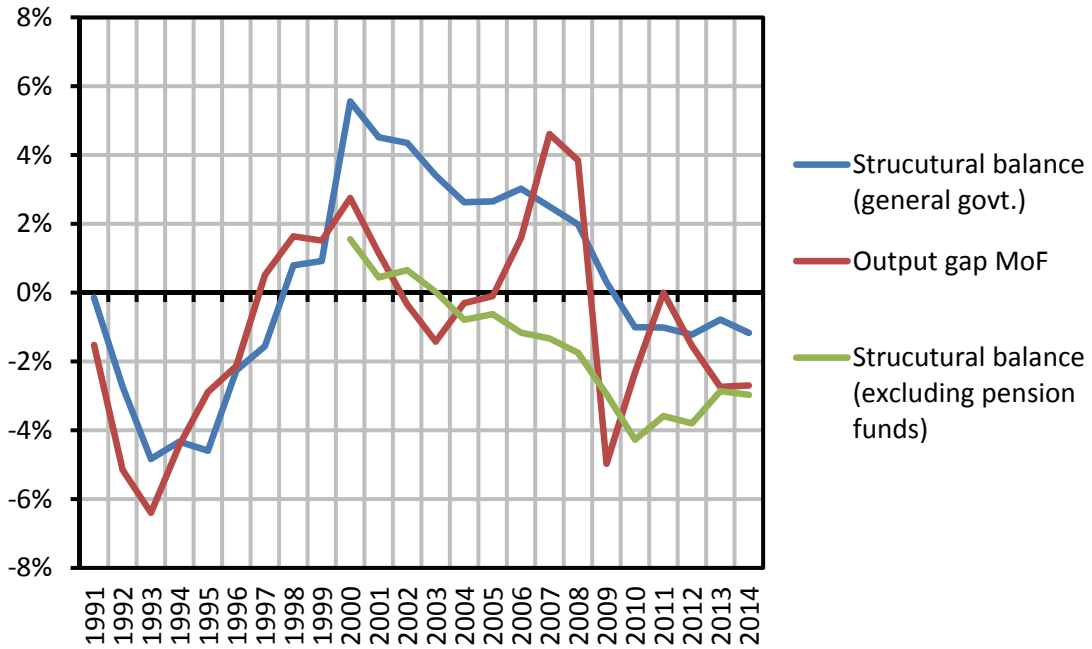
A widely used indicator for evaluating fiscal policy is the general government structural deficit. The structural deficit is calculated by subtracting the estimated cyclical component and one-off effects from the actual general government deficit. The cyclical component is calculated based on the output gap (i.e. deviation in output from its potential level) and an estimate for the semi-elasticity of net lending with respect to the output gap. In principle, an increase in the structural deficit should indicate expansionary fiscal policy and a decrease in the structural deficit contractionary policy.

The structural deficit is an important fiscal policy indicator, especially in the EU context, because the Stability and Growth Pact requires that all the Member States set

themselves a medium-term objective (MTO) defined in terms of the structural deficit. The current target for Finland is from 2013 and is -0.5% of GDP. We will discuss these rules in more detail in Chapter 3.

Figure 2.21. depicts the development of the structural deficit and the output gap in 1991–2014. The figures for 2014 are based on forecasts by the MoF. In addition to the structural deficit of general government, we present our own estimates of the structural deficit for central and local government excluding social security institutions from 2000 onwards. Box 2.2.1 describes the method.

Figure 2.2.1. Output gap and structural deficit incl./excl. pension funds 1991-2014 (Ratio to GDP, per cent)



Source: Calculations by the Economic Policy Council; National Audit Office (2013) data related to the audit of structural deficit calculations; data provided by the MoF

The public sector had a reasonably large structural surplus between 1999 and 2008. The general government structural balance weakened quickly in 2009 and has thereafter remained quite stable at around -1% of GDP. Taken at face value this would indicate that fiscal policy has been counter-cyclical. During the expansion, the structural balance was positive and it turned negative in 2009 at the start of the recession. However, the structural deficit is also affected by structural changes that do not involve discretionary policy changes. For example, population ageing increases pension expenditure and therefore increases the structural deficit even if no changes in fiscal policy are implemented. Thus, judging by the structural balance, fiscal policy may appear more

expansionary than if judging by discretionary fiscal policy measures when the population is ageing. Other potential problems related to the measurement of the structural balance are discussed in Section 3.

A serious concern, as regards Finland, is that the structural surplus before 2009 was mainly due to a surplus in pension funds. The local government sector showed deficits and central government had a small surplus even in times when the output gap was positive and large (Figure 2.1.1). The surplus in the pension funds will be needed to cover the expected increase in pension expenditure and cannot be used to cover deficits in other government sectors, with the exeption of the State Pension Fund. Calculating the structural deficit excluding the pension funds reveals that the rest of the public sector has had a structural deficit since 2004. The structural deficit (excluding pension funds) has grown rapidly since 2005 and exceeded 4% of GDP in 2010. Improvements in the central government fiscal balance in 2013 have reduced the structural deficit, but even in 2013 and 2014 it stood at around 3% of GDP.

Including the pension funds in the public sector therefore hides a large structural deficit in the rest of the public sector. This deficit will eventually have to be covered by balancing the financal situation in central and local government. Setting fiscal policy targets based on the entire public sector results in an overly optimistic view of the fiscal adjustment needed.

One could also note that while the structural deficit estimates of the public sector may provide a false impression of the adjustment needed, calculations related to the sustainability gap also account for expected increases in pension expenditure and therefore provide important additional information for setting fiscal policy goals. However, setting medium-term objectives in terms of the structural deficit would be a useful procedure but one would need to set separate targets for the subsectors of government and these targets should be consistent with long-term fiscal sustainability.

We should add that there is an element of wisdom after the fact in the calculations pertaining to the period before the recession. For example, according to current estimates the output gap in 2007 was about 5% of GDP. However, in its autumn 2007 Economic Outlook the Ministry of Finance estimated the output gap to be only 0.5% of GDP. Hence the surplus in government finances was seen as structural at the time but afterwards appeared to be due to a peak in the business cycle. Accordingly, using the pre-recession output gap estimate for 2007, the structural balance in 2007 would be +1 per cent instead of -1.3 per cent, as seen in Figure 2.2.1.

Box 2.2.1 Structural budget balance excluding pension funds

The sStructural balance (*SB*) is calculated by subtracting from the general government budget balance (*BB*) the estimated cyclical component (*CC*) of the budget balance. All variables are expressed as ratios to GDP.

SB = BB – CC

The cyclical component is calculated by multiplying the output gap estimate (*GAP*) by the semi-elasticity (ε) of the budget balance with repect to the output gap. The semi-elasticity is a measure of the sensitivity of the budget balance to the business cycle, and it gives the expected change in *BB* (in percentage points) when the output gap increases by one percentage point. In addition, the cyclical component includes one-off factors *X*, which are relatively unimportant in Finland.

$CC = \varepsilon GAP - X,$

The Economic Policy Council's estimates for the structural balance without pension funds are calculated by modifying the official method in two ways. Firstly, we subtract the budget balance of the pension funds from the general government budget balace. Secondly, we adjust the semi-elasticity so that it reflects the business cycle sensitivity of the budget balance of the public sector excluding pension funds.

The semi-elasticity can be written as follows (Mourre et al. 2014):

$$\varepsilon = \varepsilon_R - \varepsilon_G = (\varphi_R - 1)\frac{R}{Y} - (\varphi_G - 1)\frac{G}{Y}$$
$$= \left(\sum_{i=1}^{5} \varphi_{R,i}\frac{R_i}{R} - 1\right)\frac{R}{Y} - (\varphi_{G_U}\frac{G_U}{G} - 1)\frac{G}{Y}$$

where it is seen that the semi-elasticity consists of the semi-elasticity of the revenue side of the budget balance ε_R and the semi-elasticity of the spending side ε_G. The semi-elasticity of revenue is calculated based on the elasticity estimates φ_{Ri} of various revenue categories R_i (i=1,…5), revenue shares R_i/R and the ratio of total revenue to *GDP R/Y*. The semi-elasticity of spending is based on the elasticity of unemployment-related spending G_U, its expenditure share G_U/G and the ratio of spending to GDP *G/Y*. Other spending categories are assumed to be unrelated to the business cycle, and thus affect the estimates of the semi-elasticity only through their effect on total expenditure *G*.

The Economic Policy Council's estimate of the semi-elasticity and its components are shown in Table 2.2.1. The left panel replicates the calculation of the semi-elasticity for

the whole general government. The resulting semi-elasticity is 0.57, which corresponds to the estimates of the EC and the OECD. The right panel calculates the semi-elasticity excluding pension funds. The elasticities of the revenue and expenditure categories are the same as in the left panel but the shares of revenue and expenditure have been adjusted by excluding contributions to pension funds from the revenue side (on average 74% of the revenue of social security funds between 1999 and 2014) and by excuding pension expenditure from the expenditure side (on average 17% of general government expenditure between 1999 and 2014). In addition, the GDP ratios of government revenue and expenditure are adjusted accordingly. These adjustments reduce the semi-elasticity from 0.57 to 0.49.

Table 2.2.1. Semi-elasticity of budget balance with respect to output gap and its components (incl. and excl. pension funds)

	General government		General government (excluding pension funds)	
	Elasticity	Revenue and expenditure shares	Elasticity	Revenue and expenditure shares
Income taxes	1.41	26.13	1.41	31.61
Corporate income tax	2.03	6.71	2.03	8.12
Social security contributions	0.77	23.41	0.77	7.36
Indirect taxes	1	25.81	1	31.22
Non-tax revenue	0	17.93	0	21.69
Unemployment related expenditure	-3.6	4.98	-3.6	6.00
R/Y %		53.13		43.92
G/Y %		51.08		42.37
Semi-elasticity ε		**0.57**		**0.49**

Source: Mourre et al. (2014) and calculations by the Council.

2.3 Discretionary fiscal policy measures in 2011–2014

Another way of measuring the fiscal policy stance is a bottom-up approach. Aggregate fiscal policy is the sum of each policy decision and summing the fiscal impacts of these policies measures the aggregate policy stance. The effects of fiscal policy decisions are measured by comparing the estimates of the fiscal impacts of government decisions to a policy-off case where expenditures and revenues may change only due to the business cycle and structural effects. For example, an increase in unemployment-related expenditures due to a rising unemployment rate is not a discretionary fiscal policy measure but an increase in this expenditures due to a decision to increase benefit level is.

This section describes the impact of fiscal policy decisions in various years on the central government budget balance. The estimates for the impact of the decisions are based on data provided by the Ministry of Finance. The calculations by the MoF on the mangnitude of fiscal policy decisions reported in the autumn 2014 Economic Survey 2014 use the same data.

A natural way of examining the fiscal impact of policy decisions made in a given year is to describe their impact on the budget balance in a few subsequent years. Typically, discretionary fiscal policy measures involve decisions that affect revenues and spending with a lag. For example, the full impact of tax rate changes on revenue is often not seen until two years after becoming effective due to the lag in tax payments. Some policy changes are gradual in nature. For example, in 2011 the government decided to cut the deductibilty rate of mortgage interest from 100 per cent to 75 per cent between 2012 and 2014. Moreover, some policy measures are in force for a fixed period, after which they expire. The so-called solidarity tax on earned income exceeding EUR 100,000 in 2013 – 2015 is an example.

We illustrate the development of the fiscal policy line of the government using the bottom-up approach in Figures 2.3.1.–2.3.3. Figure 2.3.1 describes the effect of expenditure decisions on the budget balance of central government, Figure 2.3.2 shows the effect of tax changes and Figure 2.3.3 shows the combined effect of these decisions on the budget balance. In these figures a higher value on the vertical axis represents improvement in the budget balance.

In Figure 2.3.1, the lowest line shows the impact of the 2011 spending limit decision on the budget balance. The budget for 2012 was roughly neutral but, in accordance with the government programme, the government decided to implement spending cuts in later

years rising to EUR 1.2 billion annually in 2015. The single largest expenditure side adjustment was a EUR 600 million cut in transfers to local government.

In the spring of 2012 the economic outlook had deteriorated significantly, which implied that the fiscal adjustments agreed on in the government programme were not sufficient for meeting the deficit and indebtedness targets in the programme. Accordingly, in 2012, the government decided on further spending cuts. These measures had little effect on the 2013 and 2014 budgets but reduced the spending limits by almost EUR 1 billion in 2015. This was the first time when spending limits have been adjusted downwards during a parliamentary term in the history of the current spending limit system.

In the spring of 2013 the economic outlook had deteriorated further. This time, the government made only minor adjustments to the 2015 spending limits. In the spring of 2014 the government again decided on further cuts of EUR 750 million in 2015, rising to EUR 1.3 billion in 2018. The spending cuts decided on between 2011 and 2014 totalled roughly EUR 3 billion (or 1.5 per cent of GDP) annually in 2015.

Figure 2.3.2 describes the decisions affecting central government revenue in the same way as Figure 2.3.1 describes spending adjustments. Adjustments to the earned income tax schedule based on the wage-level index or inflation are not considered active tax policy measures because such adjustments keep the average tax rate on earned income roughly unchanged. Respectively, neglecting the wage-level index or inflation adjustments is interpreted as a tax change affecting revenue. Replacing the fee for the national broadcasting company (YLE) with the YLE tax is not included. Neither do we include the supposed EUR 200-300 million revenue increase from combating shadow economy.

In Figure 2.3.2, it is seen that the fiscal impact of tax policy decisions made in different years exhibits a zigzag pattern. The lowest line describes the effect of the tax policy measures in the government programme and the first budget of the government in 2011. Tax increases and decreases cancelled each other out in 2012 but in later years tax increases outweighted decreases, improving the central government budget balance by roughly EUR 1 billion in 2014.

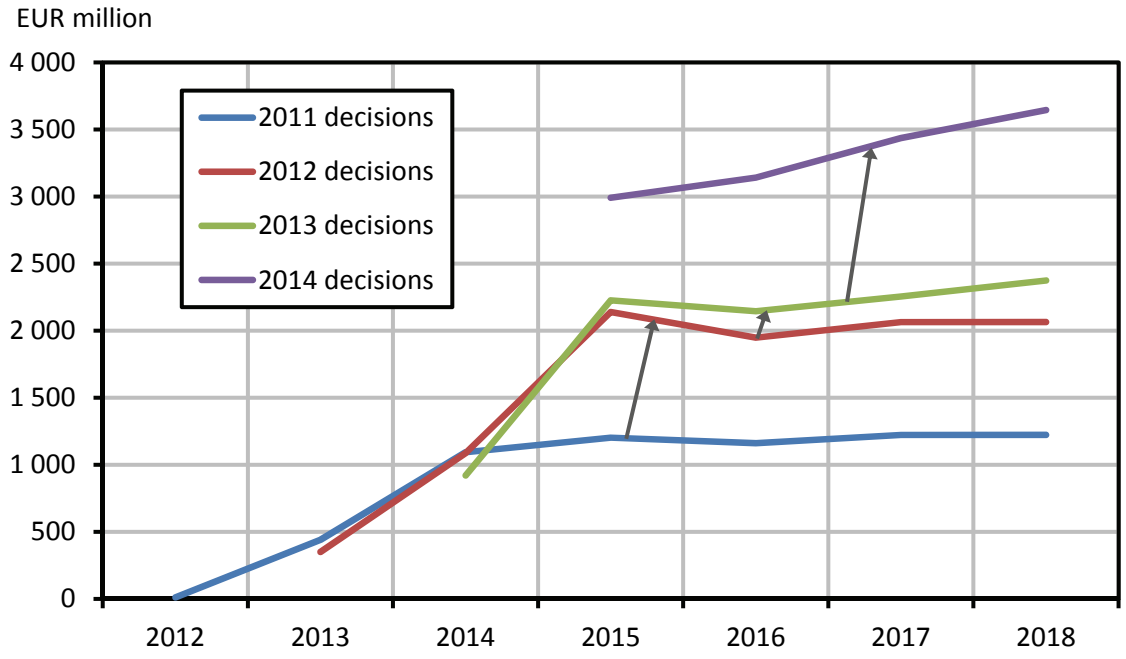
In 2012, the government decided to implement substantial tax increases. These new measures were expected to increase government revenues by EUR 1.2 billion in 2013, rising to EUR 1.5 billion by 2015. The most important measures in terms of revenue were the one percentage point increase in VAT and neglecting wage-level index or inflation adjustments to the income tax schedule. In 2013 tax policy was expansionary.

A substantial reduction in the corporate tax rate resulted in a loss of tax revenue of about 600 million. The decisions made in 2014 again reversed the direction.

Two lines illustrate the decisions made in 2014: the purple line describes the situtation in March 2014 after the spending limit decision and the light blue line relates to the situtation in the autumn after the government of Alexander Stubb had taken office. In the spring of 2014, before Stubb's government, the planned tax changes would have again increased tax revenue by roughly EUR 300 million in 2015 and EUR 700 million in 2018. The new government, however, reversed some of the decisions, reducing tax revenue compared with the decisions made in the spring. In 2015, tax revenue was even projected to decrease slightly compared with the decisions made in 2013.

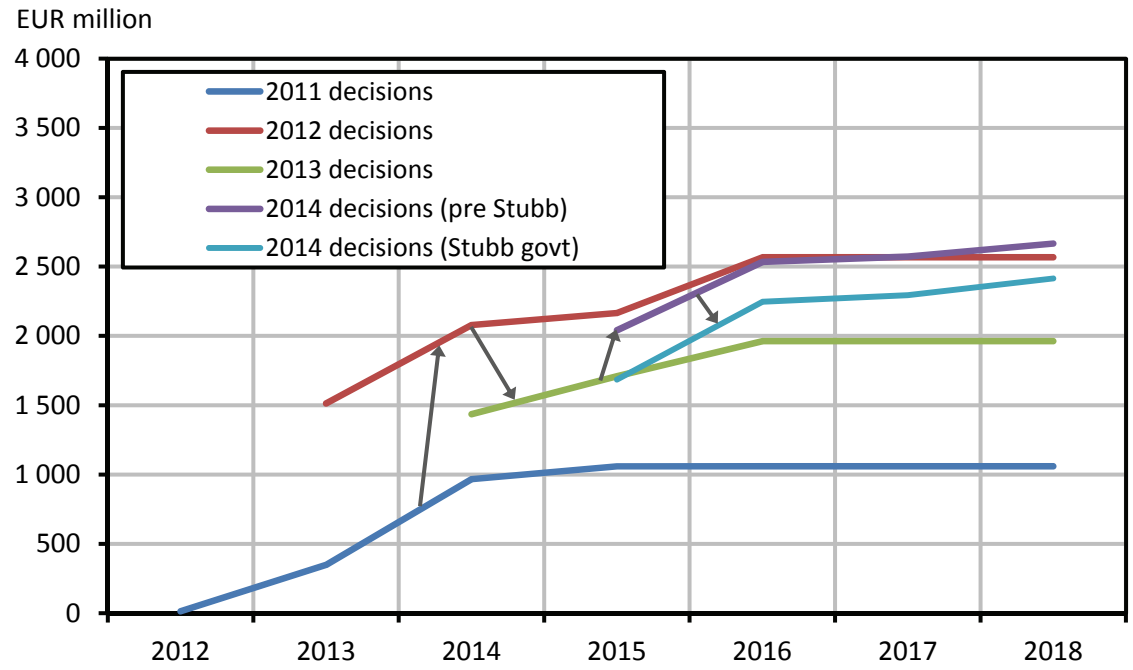
Figure 2.3.3 illustrates the combined effect of expenditure and revenue-side decisions on the central government budget balance. The figure exihibits a zigzag pattern similar to Figure 2.3.2 describing taxation decisions. The decisions made in 2012 led to tighter fiscal policy compared with 2011. The direction was reversed in 2013, when the decisions made were expansionary. In the beginning of 2014, the plan was again to tighten fiscal policy, but part of the tightening was reversed by the new government in the autumn. All in all, the expenditure and revenue side adjustments decided on in 2011 – 2014 have tightened fiscal policy significantly compared with the fiscal policy line laid out in the program of Jyrki Katainen's government in 2011. Moreover, spending cuts have accounted for a larger share of the adjustments than initially planned. Also, the time profile has become more backloaded so that the full impact of the adjustment measures will be felt in the next parliamentary period instead of 2014 and 2015.

Figure 2.3.1. The effect of expenditure adjustments on the central government budget balance in 2012 - 2018 (EUR million)



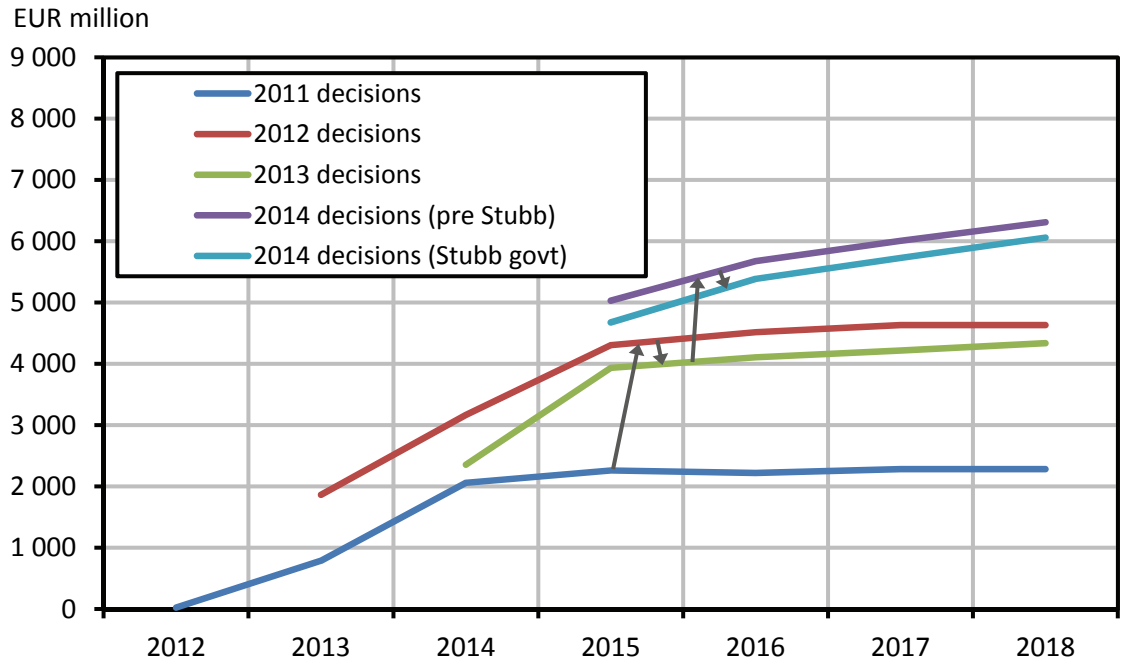
Lähde: Calculations by the Council based on data provided by the MoF.

Figure 2.3.2. The effect of tax changes on the central government budget balance in 2012 - 2018 (EUR million)



Lähde: Calculations by the Council based on data provided by the MoF.

Figure 2.3.3. Central government budget adjustments total 2012 - 2018 (EUR million)



Lähde: Calculations by the Council based on data provided by the MoF.

Figures 2.3.1–2.3.3 examine the impact of fiscal policy decisions made in different years on the time profile of the central government budget balance. Figure 2.3.4 and Table 2.3.1 show the combined effect of fiscal policy decisions between consecutive years irrespective of when the policy decisions were made. The focus is now on the effects of central government decisions on the budget balance of the entire general government.

Figure 2.3.4 shows that the total impact of central government adjustment measures on the general government budget balance is about EUR 6 billion annually in 2015, which is about 3 per cent of GDP. The baseline is the hypothetical situation where no fiscal policy decisions were made during the parliamentary period. The tightening of fiscal policy has been gradual. In 2012, the effect of adjustment measures was only EUR 300 million. The most significant tightening of fiscal policy took place in 2015 when the impact of the adjustment measures was EUR 2.5 billion compared with the previous year. In the beginning of the parliamentary period increases in taxes and social security contribuitions accounted for a large share of the tightening of fiscal policy. The impact of spending cuts was not significant until 2015, if cuts in grants to local government are not interpreted as true expenditure savings from the point of view of the entire public sector.

Figure 2.3.4. The effect of adjustment measures on the general government budget balance in 2012 - 2018 (EUR billion)

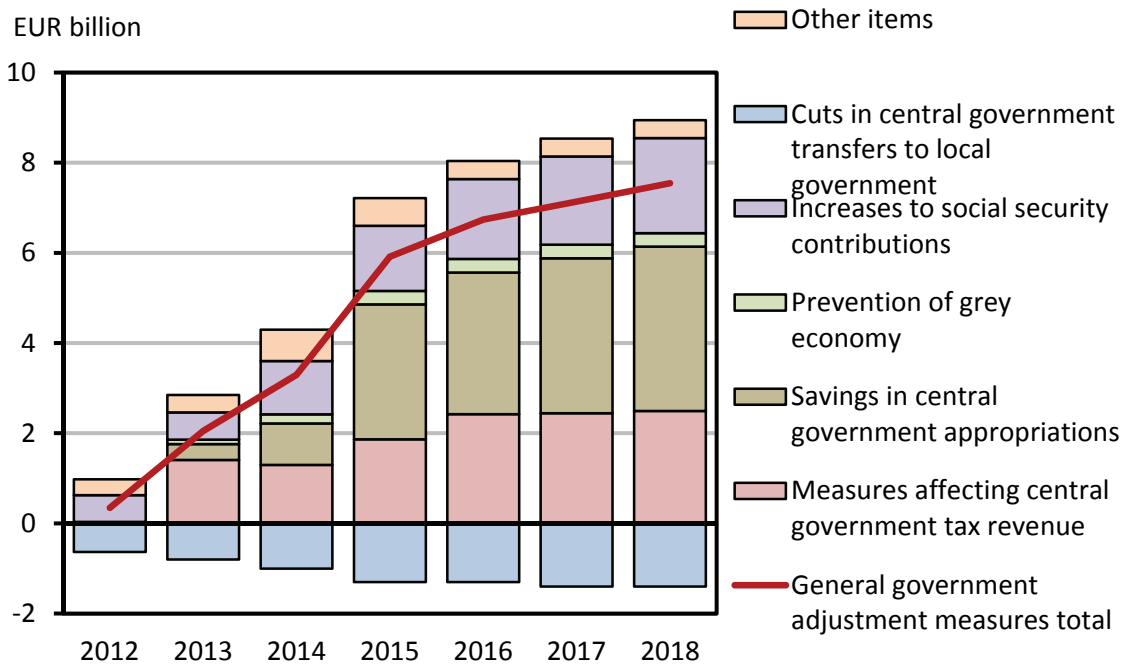


Table 2.3.1. The effect of adjustment measures on the general government budget balance in 2012 - 2018 (EUR billion)

	2012	2013	2014	2015	2016	2017	2018
Measures affecting central government tax revenue	0.0	1.4	1.3	1.9	2.4	2.4	2.5
Savings in central government appropriations	0.0	0.4	0.9	3.0	3.1	3.4	3.6
Prevention of grey economy	0	0.1	0.2	0.3	0.3	0.3	0.3
Central government adjustment measures total	**0.0**	**1.9**	**2.4**	**5.2**	**5.9**	**6.2**	**6.4**
Increases to social security contributions	0.6	0.6	1.2	1.4	1.8	2.0	2.1
Cuts in central government transfers to local government	-0.6	-0.8	-1.0	-1.3	-1.3	-1.4	-1.4
Other items	0.4	0.4	0.7	0.6	0.4	0.4	0.4
General government adjustment measures total	**0.3**	**2.0**	**3.3**	**5.9**	**6.7**	**7.1**	**7.5**

Source: MoF, Economic Survey, Autumn 2014

In Figure 2.3.4 and Table 2.3.1 cuts in grants to local government are included in central government expenditure savings, but excluded from the total impact of adjustment measures on the general government budget balance, because cuts in transfers to muncipalities do not directly reduce public spending but shift the burden from central government to the municipalities. For this reason, the line showing the impact of central government adjustment measures for the entire public sector is lower than the bars showing the total amount of central government adjustment measures. Table 2.3.2 shows that, without cuts to transfers to municipalities, central government expenditure would in fact have risen between 2012 and 2014. Central government spending cuts improve the budget balance of the entire public sector only from 2015 onwards.

Municipalities can respond to cuts in grants by raising local taxes, cutting spending or by borrowing more. Increases in local taxes between 2012 and 2014 are included in Table 2.3.1 under "other items". However, spending cuts by municipalities are not included because estimates of the impact of discretionary expenditure adjustments are not available for the municipality sector. Thus, Figure 2.3.4 may underestimate the magnitude of total general government adjustment measures. On the other hand, the debatable expected revenue from the prevention of the shadow economy is included. The government programme listed a number of measures assumed to increase revenue by EUR 300 – 400 million euros, which is a significant share of government revenue adjustments. However, it is not clear how the government came up with this revenue estimate.

Table 2.3.2. Central government expenditure cuts excluding reductions in grants to local government 2012 - 2018 (EUR billion)

	2012	2013	2014	2015	2016	2017	2018
Savings in central government appropriations without cuts in grants to municipalities	**-0.6**	**-0.4**	**-0.1**	**1.7**	**1.8**	**2.0**	**2.2**

Source: Calculations of the Council; MoF, Economic Survey, Autumn 2014

Box 2.3.1 The size of the fiscal policy multiplier

How much does aggregate output change when the government buys more goods and services? The answer to this question tells a lot about the effects of fiscal policy: can the different types of stimulation packages increase output, and consequently employment? The ratio of the output change to the change in government expenditure or taxes is the fiscal policy multiplier. The multiplier describes the quantitative impact of different policy measures, and thus provides decision-makers with crucial information.

We survey the research on the size of the multiplier from the recent economics literature (a more detailed survey is Ramey 2011, and in Finnish Kajanoja 2014). We mainly look at a case where increases in public expenditure are deficit-financed, i.e. the public debt increases. We review the results using calibrated theoretical models, aggregate time series macro models, and models where the size of the multiplier can differ depending

on whether the economy is in a recession or not.

In a simple undergraduate textbook model, "the Keynesian cross", the multiplier equals 1/(1-*mpc*). *mpc* is the marginal propensity to consume, and in simple models is often assumed to be around 0.8. In this context the multiplier can be as high as five, which would indicate a very strong expansionary effect from fiscal policy. This simple model does not, however, take into account the fact that public expenditure can crowd out private expenditure, and the fact that part of the higher consumption goes to imports. In the extreme case an increase in public expenditure totally crowds out private expenditure, leading to a multiplier effect of zero.

The calibrated models generate time series for the important aggregate economic variables in such a way that they correspond well to the observed time series. These models can be used to simulate how the economy reacts to policy changes. There are two main approaches in calibrated models: the new classical and new Keynesian models. Both models build on the optimizing (utility and profit-maximizing) behaviour of economic agents. The sizes of the multipliers tend to be larger in the new Keynesian models than in the new classical models. Part of the explanation for the difference is that the Keynesian models take into account many frictions such as price stickiness. The multipliers can even be negative in the new classical models (see e.g. Guajardo, Leigh and Pescatori 2014). Overall the size of the multiplier in the new classical calibrated models falls between -2.5 and 1.2. The size of the multiplier in Keynesian models can be higher than two. The size of the multiplier in both approaches seems to depend, to a large extent, on the way in which monetary policy is modelled, how persistent public expenditure is, and how it is financed.

There have been many time series studies on the effects of government expenditure on the level of aggregate output at least since Evans (1969). The recent upsurge in interest in the topic was spurred by the recent financial crisis and its aftermath with many stimulatory policy proposals. The effects of government spending have been estimated by employing vector autoregressions (VARs). VARs are not always able to capture the effects of stabilization policies, since the innovations generated in the analysis are not related to the state (business cycle phase) of the economy (see Andersen 2005, p.521-522). There are well known identification (w.r.t. shocks) problems in this approach, but many studies have used Choleski decompositions to identify the government spending shocks. Studies covering many periods and many countries reveal the government spending multiplier to lie between 0.6 and 1.8.

Auerbach and Gorodnichenko (2012) estimate a regime-switching model to find out whether, and by how much, the fiscal multipliers differ in recessionary and

expansionary times. The difference is quite striking when they do not allow the regime to switch endogenously. The multiplier in recessionary times can be as large as 2.2 and in expansionary periods the multiplier can drop below zero (-0.3). When the economy is allowed to move from one regime to another endogenously, they find the multipliers to be between zero and 0.5 during expansions, and between one and 1.5 during recessions.

To circumvent the impossibility of controlled experiments in macroeconomics, Jorda and Taylor (2011) apply propensity score methods to explore the size of the multipliers. The method can take into account the fact that the chosen fiscal policy depends on the state of the economy. The method allows a better assessment of the causality between fiscal policy and aggregate output; in particular what is the precise effect of a particular fiscal policy measure on output? They argue that the size of the multiplier can be even four, if the economy is in a depression, thus casting doubt on austerity measures (e.g. in Greece).

In addition to the phase of the business cycle, the size of the multiplier can depend on many other characteristics of the economy. Favero, Giavazzi and Perego (2011) formulate a multi-country (8 countries) "global VAR model" to study the size of the fiscal multipliers and pay special attention to the debt dynamics of each country. The size of the multiplier for a particular country depends on the debt dynamics, the degree of openness of the economy, and the different policy styles and timing between countries (e.g. do fiscal consolidations happen contemporaneously in the U.S. and Canada?). In one country (Japan), with the most unstable debt dynamics (and the highest initial level of debt) among the countries studied, contractionary policy leads to a significant expansion, i.e. the multiplier is negative. The same happens with the U.S. (a closed economy in this exercise) and Canada, but with a lag and to a lesser degree. In the countries with more stable dynamics, contractionary policy leads to contractionary results, i.e. the multiplier is positive. For many countries Favero, Giavazzi and Perego find that the multipliers are quite small.

The size of the multiplier apparently depends on the state (recession, expansion, near full employment) and characteristics of the economy in question (closed vs. open economy, exchange rate regime, size of public debt). Closed economies have much larger multipliers than open economies, as is the case for economies with predetermined exchange rate regimes. For countries with a high level of debt the output response is short-lived and much less persistent than in countries with a low debt to aggregate output ratio. (Mendoza, Vegh, Ilzetzki 2009). The difference in the size of the multiplier during recessions (when the multiplier is large) and expansions is quite large.

What is the size of the fiscal policy multiplier in Finland, when its economy is in a

prolonged recession, and the interest rate is close to zero? Finland is a small open economy that belongs to a monetary union, and thus does not have an independent monetary policy. Hence the interest rates in Finland do not depend on fiscal policy. The openness of Finland's economy, the well functioning financial system and almost negligible effect of fiscal policy on the interest rate have conflicting effects on the size of the multiplier. In his survey Kajanoja (2014) evaluates the multiplier effects of the recent fiscal policy measures in Finland to be between 0.5 and 1.0. There is uncertainty in this evaluation, since there are not many recent studies on the effects of fiscal policy in Finland.

2.4 Economic Policy Council's assessment of fiscal policy

The Council notes that Finland is deviating from its medium-term fiscal policy objective to which it has committed in the Stability and Growth Pact and in the Finnish fiscal policy law 869/2012. According to the autumn 2014 forecast of the Ministry of Finance, the structural deficit of general government is -1.2% of GDP in 2014. The structural deficit is projected to increase to -1.3% of GDP in 2015 and remain around -1% of GDP until 2018. All this means that the structural deficit is deviating substantially from its medium-term objective, which is -0.5% of GDP.

According to the Ministry of Finance forecast, Finland will also exceed the 60% public sector debt limit of the Stability and Growth Pact in 2015. After that public debt as a fraction of GDP will continue to grow, albeit slowly. Finland is unlikely to exceed the 3% deficit limit, although the projected deficit for 2014 is close to the limit (-2.7%). Negative shocks could increase the deficit enough to break the limit.

According to the fiscal policy law, the government is required to take corrective actions if its evaluation indicates that the structural deficit of the public sector deviates substantially from the medium-term objective. However, the law also states that the government may refrain from taking corrective actions if the deviation is due to exceptional circumstances, and if the deviation does not endanger the sustainability of the public sector in the medium term. This interpretation depends on the opinion of the EU Council.

Finland has experienced negative growth in two consecutive years: 2012 and 2013, and is expecting near-zero growth for 2014. Such a prolonged recession could be interpreted as an exceptional circumstance as defined in the Stability and Growth Pact, which would justify deviations from the medium-term fiscal objectives.

A goal of Prime Minister Jyrki Katainen's government was to reduce the central government debt-to-GDP ratio by the end of the parliamentary term. The government also committed to undertaking further adjustment measures if the ratio does not shrink, and if the central government deficit shows signs of exceeding the limit of 1% of GDP. Economic forecasts have been revised downwards on several occasions since 2011 and the government has implemented adjustment measures as promised in the government's programme. Despite these measures, the target of reducing the central government debt-to-GDP ratio has not been achieved, mainly due to the lower GDP growth. According to the latest forecasts (autumn 2014), the debt-to-GDP ratio will start to decline in 2017. The current government of Prime Minister Alexander Stubb follows the general fiscal policy targets of the previous government. Fiscal policy will be substantially tightened in 2015 also. Discretionary fiscal policy decisions will improve the central government budget balance by about EUR 2.5 billion from 2014 to 2015.

According to the autumn 2014 Economic Outlook of the Ministry of Finance, the output gap is -2.7% of GDP in 2014 and it is forecasted to be -1.9% in 2015. There are thus underutilised resources in the economy. The inflation rate is still low; in November 2014 the consumer price index increased by 1.0% compared to the previous year. The number of vacancies is low and the usual indicators show no sign of an increasing mismatch in the labour market. If the debt and deficit goals posed no constraints, a usual fiscal policy recipe at this stage of the business cycle would be to increase public spending or cut taxes in order to boost demand and increase employment.

Tightening fiscal policy in 2015 is clearly based on the objectives set in the government's programme, and it will clearly bring the structural deficit closer to its medium-term objective. The Council's view, however, is that the adjustments are relatively large given the state of the business cycle, and that they will have a negative effect on domestic demand and employment. According to current forecasts, the output gap will also remain negative in 2016. Therefore tightening of fiscal policy should be avoided in the budget for 2016 also. The timing of fiscal policy measures and balancing stabilisation policy with fiscal sustainability is a difficult task. Postponing tightening of fiscal policy to avoid fiscal contraction in a recession increases the risk of having to implement contractionary measures later despite low growth.

Instead of the drastic consolidation measures in 2015 and 2016, the Council recommends a credible commitment to spending cuts or tax increases to be implemented in 2017 and 2018 when economic growth is projected to have brought the economy closer to its potential output level. The needed magnitude of these adjustments is substantial. They should not only be large enough to reduce the structural deficit of the public sector to less than 0.5% of GDP, but also large enough to gradually reduce the structural deficits of the local and the central government sectors to sustainable levels. The Council estimates the structural deficit without pension funds to be around 3% of GDP.

The Council also notes that even though the government's structural policy plan is ambitious, it provides little support for sustainability in the medium term (2-5 years). For example, the pension reform implemented by the suggestions put forward by the unions and the employers' confederation would start to shrink pension expenditure in 2021. Hence, one of the most important tasks for the incoming government after the parliamentary elections in April 2015 is to formulate a concrete (with timetables) plan to stabilise public finances. The plans of the current government for reducing the tasks of the municipalities and imposing spending limits on social and health care expenditure could be an integral part of such a programme. However, stabilising the public finances will most likely require spending cuts or tax increases.

3 Fiscal framework and sustainability

3.1 Fiscal policy frameworks – an overview

The importance of fiscal policy planning and monitoring has been brought to the fore by the financial crisis. Underlying the so-called sovereign debt crisis are not only the effects of the crisis but, more importantly, failures to consolidate public finances in the past and to undertake reforms addressing future pressure on public finances arising from demographic changes and other forces. It is widely perceived that this situation has arisen due to political deficiencies, causing deficit biases and myopia in fiscal policy planning.

This has prompted a reinforced interest in fiscal frameworks, including rules and institutions for fiscal policy. With a lag, this discussion is similar to the earlier discussion in relation to monetary policy. For monetary policy there has been a significant shift towards independent and rule-based policy making[4]. Monetary policy targeting builds on an announced inflation target, implementation with the focus on inflation forecasts (stabilising expectations) and a high degree of accountability/transparency. The institutional framework is an independent central bank with a mandate for price stability, which can thus be held accountable for its policy decisions relative to the mandate.

Although there have been proposals to develop similar independent institutions for fiscal policy (see e.g. Wyplosz (2002) and Calmfors (2003)), the consensus is that this is not feasible without interfering too much in the policy decision process and the autonomy of democratically elected governments. Instead, the focus has been on the

[4] There is a vast theoretical and empirical literature on monetary policy rules and targeting (see e.g. Svensson (2011) for a recent overview).

development of fiscal policy procedures, targets and rules with the purpose of increasing the political costs of opportunism and myopia in economic policy making. These costs can be further increased by assigning independent institutions (watch dogs) a role in monitoring and commenting upon the extent to which actual policies have followed the fiscal targets and rules (see e.g. Calmfors and Wren-Lewis (2011)).

A fiscal framework (institutional/procedural rules, e.g. a budget law and numerical fiscal targets) thus serves two overarching purposes. First, it serves to increase transparency and accountability in economic policy making and thus provides a better basis for the planning and formulation of economic policies. Transparency is essential for accountability, and presupposes continuous access to information and monitoring as well as auditing of policy planning and outcomes. Second, it creates fiscal discipline by emphasising the importance of fiscal planning, which in turn minimises the risk of short-run bias and opportunistic behaviour. The fundamental requirement is that fiscal targets and plans should be mutually consistent and in accordance with broader policy objectives.

Fiscal frameworks do not necessarily have any implications for economic policy outcomes like the size or composition of the public sector as such, but serve to ensure that policies are planned taking into account all benefits and costs in the short and long run. Targets for fiscal policy can, however, be defined based on several different variables and different types of targets have different implications for the size of the public sector: for example, an expenditure target affects the size of the public sector directly, whereas a debt target can be achieved either through expenditure cuts or tax increases and therefore does not directly imply a smaller public sector.

As noted, there has in recent years been a trend towards fiscal frameworks. Sweden is a front-runner in defining intermediate targets for fiscal policy (fiscal rules) as well as in setting up an independent fiscal council to monitor and comment on developments. Swedish public finances are among the most sound in the OECD, with a low debt level (reflecting consolidation) and meeting the requirements for fiscal sustainability. Accordingly there has been an interest in understanding the Swedish case. The Swedish fiscal policy framework has developed in response to the economic crisis in the early 1990s. It builds on three pillars: a rolling expenditure target, a balanced budget requirement for municipalities and a surplus target (see e.g. Calmfors (2012), Floden (2012), Jonung (2014) and Andersen (2013a)). Numerical fiscal targets are also well known from the EU Growth and Stability Pact, and in the light of the financial crisis the fiscal policy governance structure within EU has been tightened, see below.

Intermediary targets for fiscal policy

An essential element of a fiscal framework is a set of numerical fiscal targets, or intermediary fiscal policy targets. These targets put down markers against which economic policy is planned and assessed. Such targets are thus instrumental in short-term policy planning and monitoring. Ideal intermediary targets are well defined and easy to measure and are closely related to factors under political control. Thereby they serve the purpose of helping in ensuring political accountability and increasing the political costs of opportunistic policies.

A key question is whether there should be only one or several intermediary targets. The underlying uncertainty and the problem of unravelling the underlying state of the economy are arguments for having a portfolio of intermediary measures. The primary advantage is that many targets imply some risk-pooling and allow some learning. A disadvantage is that it leaves open when to react (when just one or all of the measures are off target), but also that it creates lack of transparency since policy makers may shift between targets depending on performance. With many targets, there is a great likelihood that at least one is performing well and is thus highlighted. In short, it is more difficult to hold policy makers accountable with several targets. Overall this supports having just one or a few intermediary targets.

For all indicators or targets there is both a *filtering* problem and an *error-correction* problem. The filtering problem refers to the need to separate cyclical and temporary influence beyond political control from political decisions. The purpose of targets is to hold politicians accountable for their policies relative to their stated targets/objectives. The error-correction problem refers to how policies should be adjusted to the failures and shocks in the past so as to remain on track relative to the medium- to long-run objectives. An immediate response to bringing the variable to its target value will not in general be optimal since the underlying objective is to smoothen policy responses. Hence there is a *response problem*. This problem is larger the larger the filtering problem is since there is a risk of overreacting to temporary variations which have been incompletely separated from trends and structural changes[5]. Ideal targets minimise the filtering problem and specify a response mechanism as to how to adjust policies when targets are not reached.

[5] One of the intermediary targets used by the Swedish government is a running 7-year average of the budget (past three years, current year, and coming three-year budget period), and hence this measure both filters the past (minimising risk of reacting to temporary changes) and smoothes responses (not making all the adjustment immediately).

Targets can be specified for summary budget measures such as public revenues (T), expenditures (G), the primary budget balance (B) and the public debt level (D) (from these other intermediary targets may be derived e.g. for the employment level). Clearly, these are related via budget identities, which implies that they cannot all be set independently. In principle all of these variables could be made intermediary targets for fiscal policy to ensure that the path underlying fiscal sustainability is fulfilled and various policy objectives are reached.

An important question for fiscal policy is whether the conditions for fiscal sustainability are satisfied. A sustainability analysis implies paths for expenditures, revenues and the public sector budget position and debt level. Hence, in principle, a sustainability analysis implies targets for these key fiscal policy variables, cf. below. However, sustainability analyses are complicated and the sustainability metric is not itself a suitable intermediate target. But the intermediate targets in the framework should be derived from a policy plan satisfying requirements for fiscal sustainability.

A target for either expenditures or revenues relates to the overall size of the public sector, while a target for deficits/debt reflects the extent to which financing is smoothed or redistributed across time and thus generations. Since revenue is exposed to substantial variation, expenditures are a more useful target. Determination of an expenditure target enforces a top-down procedure on the budget process, which is conducive for prioritisation[6]. Since automatic budget reactions are also important on the expenditure side, the target has to allow for variations in such expenditure, e.g. by excluding them from the target.

The budget balance is an obvious choice as an intermediary. It is regularly accounted for and reasonably well understood. The problem is that the primary budget position is affected by short-run factors (business cycles), and hence the structural budget balance is more appropriate theoretically. But this is a calculated metric, which is more subtle to interpret and communicate. It is well known that estimates of the structural budget balance are subject to substantial uncertainty, cf. below.

The debt level may be an alternative candidate since it is regularly measured and well understood. It may be argued that the public debt level is the key variable affecting

[6] Holm-Hadulla et al. (2010) show that expenditure restraints and numerical expenditure rules are important for budgetary discipline. See also IMF(2014) and the references given therein. There is an issue of reverse causality if fiscal frameworks are adopted by policy makers already pursuing tight policies. It thus cannot necessarily be inferred that a country automatically attains credibility and discipline by introducing a fiscal policy framework.

future generations. Future generations may want to take different decisions than current generations, and it is not obvious that the former should constrain this possibility. A key element of the past of importance for future decision-making is the debt level, i.e. "leaving all future generations with the same options as current generations". This is also illustrated by the fact that any assessment of fiscal sustainability is based on the initial debt level in combination with projected paths for revenues and expenditures. On the other hand, many public services (such as good-quality education and daycare, health care and social services targeted at families) are to a significant extent investments in the welfare of future generations, and it appears natural that future working-age generations will participate in financing them. It is not obvious whether future generations would rather opt for a higher debt level or poorer services that may also be expensive to rebuild. Since future generations cannot participate in decision-making today, the current generation has the responsibility of making the best possible choices on their behalf.

To reach a given debt level, it may however be useful to target the structural budget balance since it is more closely related to policy decisions. One problem with the debt level as an intermediary target is that in the short run it is not that closely related to policy decisions since asset price variations can cause substantial variation in the debt level for unchanged policies. If these variations are perceived as temporary, they should not significantly affect assessments of fiscal sustainability. When the debt target is defined as a debt/GDP ratio, as in Finland, a further problem is that this target is very sensitive to movements in GDP, and hence the debt target may be violated solely because of adverse GDP developments, and vice versa. For example, after the economic crisis of the 1990s, strong GDP growth implied a large decline in the debt ratio.

3.2 Finnish fiscal policy framework

The Finnish fiscal policy framework should be seen in the perspective of the EU principles and rules for fiscal policy governance, cf. Box 3.2.1. The specific numerical fiscal targets are that the actual budget deficit cannot exceed 3% of GDP, the structural budget deficit cannot exceed 0.5 % of GDP, and the gross-debt level cannot exceed 60% of GDP.

Box 3.2.1 EU fiscal governance

Economic and fiscal governance in the EU and the euro area has been changed a number of times and is now based on the so-called "six-pack" and the "Fiscal

Compact".

The six-pack (so named since it is made up of five Regulations and one Directive) applies to all EU countries but with some specific rules for the euro area Member States, especially regarding financial sanctions. The six-pack concerns both fiscal and macroeconomic surveillance

For fiscal policy, the six-pack strengthens the Stability and Growth Pact (SGP). Under the so-called preventive arm, the budgetary balance shall converge towards the country-specific medium-term objective (MTO) for the structural budget balance. Moreover, the actual general government deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP (or at least diminish sufficiently towards the 60% threshold).

The Excessive Deficit Procedure (EDP) – the corrective arm - applies to Member States that have breached either the deficit or the debt criterion. The six-pack ensures stricter application of the fiscal rules by defining quantitatively what a "significant deviation" from the MTO or the adjustment path towards it means in the context of the preventive arm. Moreover, it operationalises the debt criterion, so that an EDP may also be launched on the basis of a debt ratio above 60% of GDP which is not set to diminish towards the treaty reference value at a satisfactory pace.

Financial sanctions for euro area Member States are imposed in a gradual way, from the preventive arm to the final stages of the EDP, and may eventually reach 0.5% of GDP. The six-pack introduces reverse qualified majority voting for most sanctions to increase the likelihood that they are imposed.

Treaty on Stability, Coordination and Governance (Fiscal Compact)

Signed by 25 EU Member States (all but the UK and the Czech Republic); it is binding for all euro area Member States, while other contracting parties will be bound once they adopt the euro or earlier if they wish.

The compact requires countries to respect/ensure convergence towards the country-specific medium-term objective (MTO), as defined in the SGP, with a lower limit of a structural deficit (cyclical effects and one-off measures are not taken into account) of 0.5% of GDP; (1.0% of GDP for Member States with a debt ratio significantly below 60% of GDP). Correction mechanisms are designed to ensure automatic action to be undertaken in case of deviation from the MTO or the adjustment path towards it, with escape clauses for exceptional circumstances. Compliance with the rule to be monitored by independent institutions.

These budget rules shall be implemented in national law through provisions of "binding force and permanent character, preferably constitutional". Compliance with the rule implementing the MTO in national law shall also be monitored at the national level by independent institutions. The compact also includes various provisions to ensure the implementation of the SGP. Finally, the pact sets criteria for surveillance and coordination of economic policies.

The two-pack aims at improving the coordination, monitoring and assessment of draft budgetary plans and ensuring the correction of excessive deficits in euro area Member States.

The current fiscal policy regime has the following numerical fiscal policy rules:

- **Budget target:** The medium-term objective (MTO) for the structural budget deficit is 0.5% of GDP. This is the maximum allowed within the EU Fiscal Compact for countries with a debt level close to or above 60% of GDP. in addition a policy objective has been formulated of bringing the actual deficit below 1% of GDP and achieving a substantial reduction in the central government debt ratio by the end of the electoral term. In addition the actual deficit cannot exceed the EU rules on deficit and debt levels.

- **Expenditure target:** Spending limit rules are set for the duration of the parliamentary term, i.e. four years, but adjusted annually. It applies for central government expenditures which are not cyclically dependent (about 80% of total expenditures). Debt servicing and similar also fall outside the rule. The rule allows for price/wage adjustments. The rule is not anchored in law but in practice (since 2003). Once the target has been set it can only be revised downwards (otherwise at the loss of political credibility). The system includes supplementary budgets to cope with unanticipated changes, the target being a maximum.

- **Municipalities:** No explicit target, but implicitly a balanced budget requirement over the medium term. New local government budget framework is being planned, but without strict control over local government finances, cf. sections 3.5 and 4.2.

There is a further target that the reforms should be implemented no later than 2018 to ensure fiscal sustainability (see below). There are also other targets, e.g. that the employment rate should be at least 72% and that the effective retirement age should be

62.4 years by 2025, which in part are motivated by the fiscal policy implications of ensuring an increased labour supply and employment.

Table 3.2.1 gives a snapshot of the recent and projected trend in three key numerical targets; structural deficit, actual deficit/net lending and debt.

Table 3.2.1. General government structural deficit, net lending and debt 2011-2016, ratio to GDP (%)

	2011	2012	2013	2014	2015	2016
Structural deficit		-1.2	-0.8	-1.2	-1.3	-1.2
Net lending	-1	-2.1	-2.3	-2.7	-2.4	-1.7
Debt	48.5	53	55.9	59.6	61.2	62.1

Note: 2014-2016 are forecasts. Source: Ministry of Finance

The Economic Policy Council finds that the fiscal framework has the proper overall structure and serves to strengthen transparency and consistency in economic policy planning. The fiscal framework matches what is seen in other countries. However, in retrospect the framework has not ensured sufficient consolidation in the years prior to the financial crisis, and this is constraining the degree of freedom at present. Moreover, the numerical rules could be more clearly defined, and in general the reporting could be improved to shed more light on whether policies are in accordance with the targets. There is no clear link between national determined numerical targets and those implied by the EU rules. The many targets and their unclear relationship are problematic in terms of transparency and accountability.

3.3 Budget targets

The structural budget position is of crucial importance because it is both a key indicator of public finances, and since the medium-term objective is defined in terms of the structural budget position, cf. above. The present practice raises issues in relation to the reporting but also the methods used to assess the structural budget position.

The actual budget position is very sensitive to the business cycle situation and accordingly there is a need for a measure that aims at correcting for cyclical and temporary effects to assess the underlying budget position. The measure of the structural budget balance aims to do this by assessing the underlying budget position in a normal business cycle situation. While this is an appealing theoretical concept for which it is straightforward to give a principle definition, it is very difficult to operationalise. The structural budget position cannot be directly observed or measured and it has to be assessed via the cyclically adjusted budget (CAB) position, i.e. by removing the cyclical component from the actual budget position.

There is no single correct method for assessing the CAB. A widely used method – also applied by the Ministry of Finance - is to correct the actual balance for business cycle influences and one-off items, i.e.

Structural balance = actual balance - cyclical component - one-off items,

where the cyclical component is determined as

Cyclical component = budget sensitivity x output gap.

The procedure used to measure the cyclical component is to combine an estimate of the sensitivity of the budget position to the cyclical situation with an assessment of the output gap (the difference between actual and potential output). Adjustment for one-off items[7] is usually done on a more discretionary basis.

The method used in assessing the structural budget balance may thus be characterised as a residual-based method since the structural balance is measured by the CAB found as the residual remaining in the actual budget after controlling for the cycle position and

[7] The code of conduct for the Stability and Growth Pact states "one-off measures having a transitory effect that does not lead to a sustained change in the intertemporal budget position", see "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and concept of stability and convergence programmes", endorsed by the ECONFIN Council on 11 October 2005.

the one-off items. While this makes sense conceptually since it aims to remove factors which are considered to be temporary, it suffers from the problem that all measurement problems, errors and noise end up in the measure of the CAB, which is then used as the measure of the structural budget position.

This is problematic due to the central role the structural budget plays in the fiscal framework. It is a target variable for fiscal policy, with changes in the structural budget balance being used as a measure of discretionary fiscal policy changes, and it is a critical input into assessments of the sustainability of public finances. These problems can be illustrated in various ways. It is to be expected that a structural measure displays less variability than the actual measure since the idea is to remove the cyclical component. However, actual measures of the cyclically adjusted budget balance tend to display at least the same degree of variability as the actual budget balance, see Andersen (2013b). This suggests that substantial noise remains in the cyclical measure precisely due to its residual character. It is also well known that estimates of the structural budget balance are subject to substantial revisions between ex ante and later ex post assessments and that they tend to display a pro-cyclical bias. Moreover, it is well established that measures of the CAB produced prior to the financial crisis overestimated the structural position by taking temporary revenue increases to be permanent, see e.g. Joumard and André (2008). The "biased" fiscal policy in the period cannot thus solely be attributed to political biases; the information and advice provided to policy makers on the structural budget position were also deficient. In short, the structural budget balance is assessed with substantial uncertainty, which undermines its adequacy as an intermediate fiscal policy target.

The current practice for assessing the structural budget balance raises several issues. First, given the importance of the structural budget balance, it is striking that it does not play a more dominant role in the reporting. The reporting in the Economic Survey Reports is very limited and is supplemented with a very brief discussion.

Second, there is also a need to document more clearly how the assessment of the structural budget balance is made. It depends critically on assessments of budget sensitivities as well as on the output gap and thus potential output. If the assessment of the output gap is incorrect, it will have significant effects on the structural budget balance and thus create noisy information for policy discussions.

Third, there is a need to reconsider the methods used to assess the structural budget balance. As explained above, the current method is very summary, implying that the structural budget balance is assessed with a high degree of uncertainty. There are various alternative methods to assess the cyclical component which differ in their

degree of sophistication in terms of methods and disaggregation (see e.g. Aasdalen et al. (2011), Larch and Turrini (2009) and Girouard and André (2005)). It is worh noting that the Norwegian Ministry of Finance applies a method which makes a direct estimation of the underlying levels of the major tax bases. One advantage of this is that it makes it more straightforward to incorporate the effects of changes in the tax system.

Pension funds

The private sector occupational pension system is included in the general government sector budget balance, although pension liabilities are not recorded. On average the pension scheme has generated a surplus of about 2% of GDP, and it is thus of significant importance for the overall budget position.

The current reporting is a source of confusion. Surpluses in the pension funds are part of the budget balance, but not of the public sector net-asset position (see e.g. table page 79 in Economic Survey Autumn 2014). The current system is thus not transparent, and may conceal the underlying budget position under political control.

Even though the system is mandatory, there is an issue with the extent to which the management of the pension funds is under (partial) political control. This is an issue for the State Pension Fundin particular. According to the Act on the State Pension Fund, there can be an annual transfer of up to 40% of the annual pension expenditure. When the fund has assets amounting to 25% of pension liabilities, it is determined in the state budget how much is to be transferred to the state. For next year a discretionary decision has been made to increase the transfer. It is not clear from the reporting whether the above-mentioned conditions have been met.

To increase transparency, the MTO has to be supplemented by clearly defined targets for the subsectors. The current practice implies that policy deviations are masked by transfers from the pension funds.

3.4 Spending limits

The system of spending limits has developed since 2003 and has gained quite some credibility and the political costs of deviating from the limits have thus increased. The system has been instrumental in ensuring better expenditure control and a top-down procedure for prioritisation of various public sector activities.

The current system does have some weaknesses, and it may be worth considering making a more formal expenditure law to clarify the principles and procedures.

Spending limits can be avoided via tax expenditures, as exemplified by the recent change of the child subsidy to a tax deduction for families with children, and the change from minimum pensions to pension income taxation. By converting expenditures into tax deductions, the spending limit is effectively avoided. In the spirit of the spending limit, the limit should be adjusted downwards when such tax expenditures are implied by policy changes.

Similar issues relate to asset sales. In 2015 sale of shares for about 105 million euro finances a "growth package" outside the spending limit. Such actions are against the spirit of the spending limits. The same applies to establishment of strategic units outside the spending limit.

There is a related issue in relation to state guarantees. By the end of the first quarter of 2014 the stock of state loan guarantees amounted to EUR 34.3 billion, about 12% higher than a year earlier. This includes guarantees to state-owned joint stock companies and special credit institutions backed by central government. Such guarantees may appear costless to issue, since the costs will only become visible when the guarantee is called upon. However, a lack of systematic accounting of such guarantees lowers transparency in accounting.

3.5 Local government

The target that budgets for local government should balance on average has not been met, cf. Figure 2.1.1. There have been systematic deficits and an upward trend in debt. At the same time local government expenditures have increased, but tax increases have been insufficient to avoid increasing deficits and debts.

The fiscal framework is thus deficient in relation to local government. Expenditures by local government amount to 22% of GDP, and thus a large part of the expenditures are not regulated in the same way as expenditures under the expenditure limit. Some changes are planned in the relation between central and local government. The changes mainly serve to reshuffle revenues and expenditures between local and central government, which in itself may be motivated and contribute to ensuring more efficiency in local services.

The current situation raises problems for public finance management and the coordination of fiscal policy between central and local government. If local government increases expenditures it is equivalent to a violation of the expenditure limit. Even if local taxes are raised to finance this, there is an issue of fiscal policy coordination in

relation to the overall size of the public sector, tax wedges etc. It is a serious weakness of the fiscal framework that local government finances are not under control, and in particular the systematic deficits and accumulation of debt. Local government is discussed in more detail in Chapter 4.2.

3.6 Sustainability of public finances

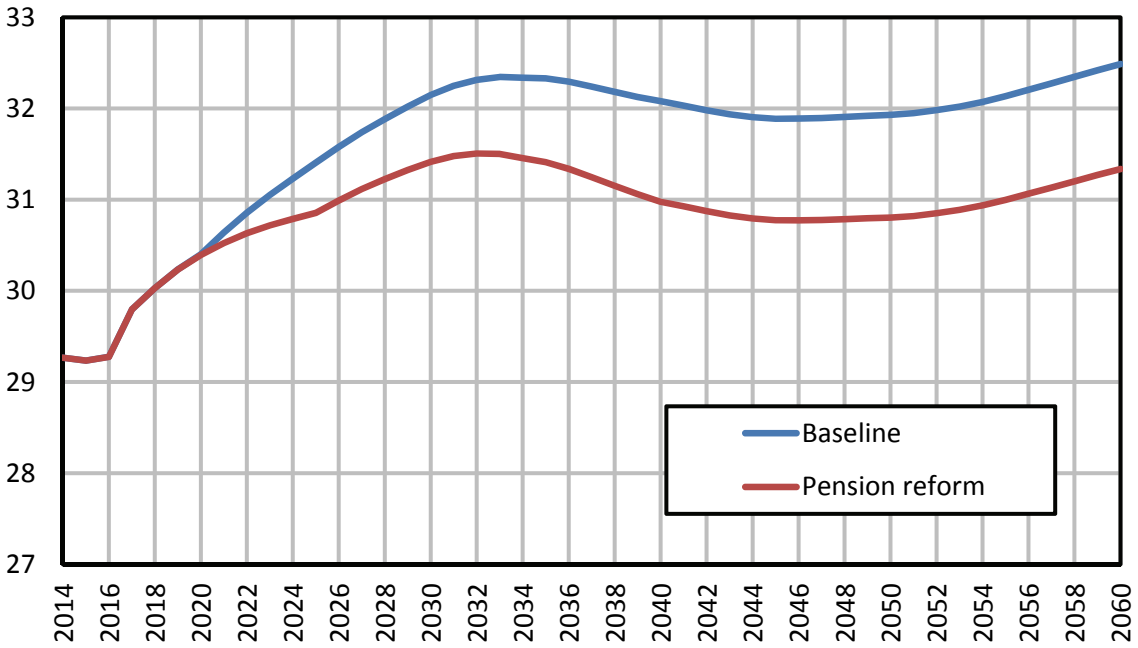
Fiscal sustainability can be seen as an additional fiscal policy target. The government has announced that it is aiming to ensure fiscal sustainability by 2018. Current estimates indicate that the primary deficit of the public sector would need to be reduced permanently by an amount equivalent to 4% of GDP in order to balance revenues and expenditures in the public sector over the long term.

An analysis of fiscal sustainability begs the question whether the expenditures implied by current policies (provision of welfare services on a per capita basis, design of the social safety net etc.) can be financed by revenues generated by an unchanged tax system. Fiscal sustainability does not require that the budget is in balance each year, but that there is balance in present value terms[8].

Fiscal sustainability is threatened by increasing ageing costs, i.e. an increase in expenditures on pensions, health care and old-age care due to an ageing population, cf. Figure 3.6.1. The increase will be gradual but implies a significantly higher expenditure level. With unchanged policies this implies systematic budget deficits and an increasing debt level, cf. Figure 3.6.2. This situation is evident and policy actions are required. In the baseline scenario (before the recent pension reform) assessments of fiscal sustainability suggest a gap of 4% of GDP as measured by the so-called S2 indicator, which indicates the permanent improvement in the primary budget balance (in % of GDP) needed to meet the government's intertemporal budget constraint. The recent pension reform will reduce the sustainability gap to 3% of GDP by reducing ageing expenditures and this will lead to smaller deficits and a less rapidly increasing debt level. While the pension reform reduces the sustainability problem, it does not fully solve the problem.

[8] To be precise, that the present value of expenditures plus initial public net debt does not exceed the present value of revenues.

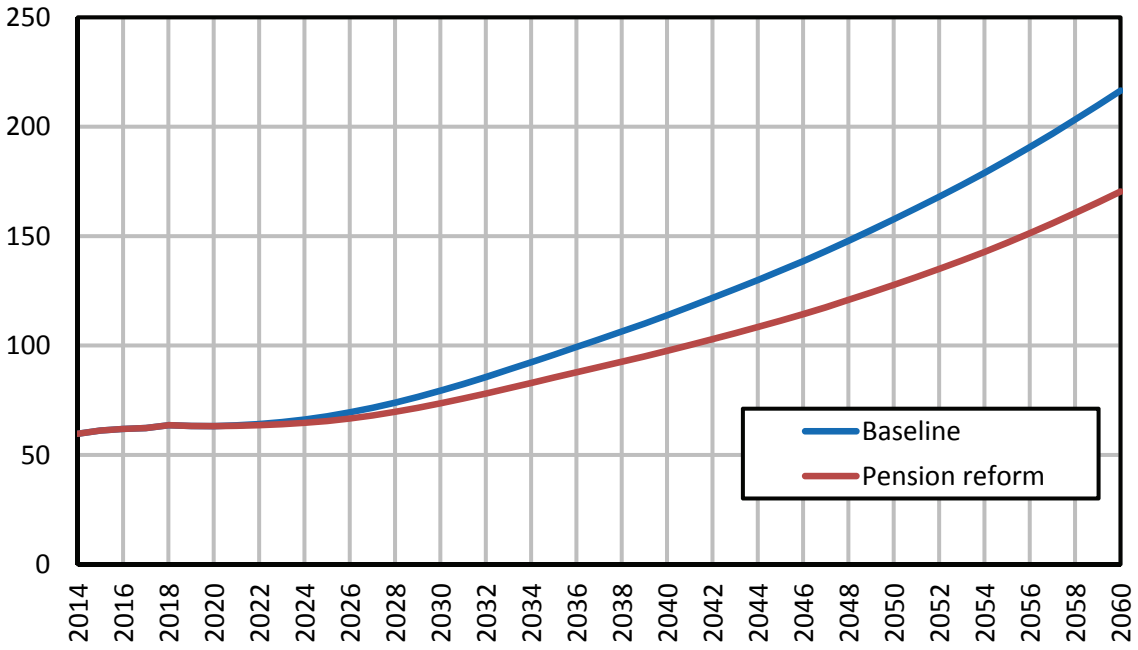
Figure 3.6.1. Predicted ageing-related public expenditure in 2014 – 2060, ratio to GDP (%)



Source: Calculations by the Council.

Note: Ageing costs are the sum of expenditures on pensions (net of pension taxes), health care, old-age care, education and unemployment benefits. The calculations are based on the MoF's calculations in the 2014 stability programme. The difference between "baseline" and "after pension reform" is an assessment of the effects of the recent pension reform.

Figure 3.6.2. Predicted trend in public debt 2014 – 2060, ratio to GDP (%)



Source: Calculations by the Council.

Note: The calculations are based on the MoF's calculations in the 2014 stability programme. The estimate of the structural balance was revised down by about 1% in the autumn economic forecast, and the revised estimate is used here. The difference between "baseline" and "after pension reform" is an estimate of the effects of the recent pension reform.

Fiscal sustainability analyses are a feasibility test and not an optimality test. They simply ask whether current policies can be maintained or have to be adjusted for financial reasons, but do not take a stand on whether the initial policy setting is in some sense optimal.

The issue of fiscal sustainability may appear very abstract and thus may be neglected in policy debates, and therefore clear communication (including a discussion of assumptions, sensitivity analysis etc) is very important as a means to create an understanding of the importance of the issues involved. The reporting of the Swedish government in its spring budgets (and convergence reports) may be seen as an example of how to do this, see e.g. Swedish Ministry of Finance (2014).

The spring forecast and the stability report include a very brief discussion of fiscal sustainability. It is surprising that this discussion is not more detailed. The sustainability

indicator went from 3% in the spring to 4% in the autumn without much explanation or discussion, except that it is attributed to a worsened structural budget position.

Assessments of fiscal sustainability are known to be very "assumption-heavy", so it is important to set out the assumptions clearly, and to make sensitivity analysis. From the reporting it is not possible to see the key assumptions regarding e.g. indexation of transfers, productivity in the private and public sector, discount rates etc.[9]

Numerous policy paths are consistent with fiscal sustainability, and it is thus not sufficient just to stipulate fiscal sustainability as an objective. This is a necessary but not a sufficient condition for a credible fiscal policy plan. Fiscal sustainability is basically a test of whether the intertemporal budget constraint is met and this can obviously be done in many ways with widely different budget profiles. It is thus important to show how different policy proposals may ensure fiscal sustainability to clarify the options and trade-offs involved in policy reforms to ensure sustainability. Moreover – and importantly – different proposals have different implications for intergenerational distribution, hence fiscal sustainability is not only a technical discussion/constraint but has crucial importance for the design of fiscal policy.

Fiscal sustainability also has to be seen against the numerical fiscal rules in the fiscal framework. Since different paths for the budget (and debt) are consistent with fiscal sustainability, some of the paths may be in conflict with the medium-term budget target (structural deficit not to exceed 0.5% of GDP). This underlines that fiscal sustainability issues cannot be assessed solely from the sustainability indicator (S2), and the implied time profile for the budget balance and debt has to be considered.

Fiscal sustainability is assessed on the basis of current standards in various publicly provided welfare services (education, health, day care etc.). There are reasons to believe that demand will increase due both to greater wealth (income effect) and technological progress (new and better treatments in health care). Likewise, demand for leisure (shorter working hours over the year/life-cycle) will reduce tax bases and thus the financial basis for public welfare arrangements. Some services may also become relatively more costly to provide, since productivity increases in them may be below average productivity increases in society. Fiscal sustainability analysis may thus give an overly optimistic view of the policy options. Likewise, since not all transfers are fully

[9] The report says that the model runs to 2060, but the S2 indicator assumes an infinite horizon. Is 2060 data projected for the infinite future?

indexed to wages, the implication is growing inequality – is this a time-consistent policy path?

3.7 Council views on fiscal framework

- The fiscal framework has the proper structure and serves to strengthen transparency and consistency in economic policy planning. There are numerous intermediate policy targets, and transparency can be improved by streamlining the targets. There is no clear link between nationally determined numerical targets and those implied by EU rules. Moreover, the reporting of developments relative to targets and assessments hereof can be improved.

- The target that the structural deficit may not exceed 0.5% of GDP is the centrepiece of the fiscal framework. Developments in public finances are heavily influenced by surpluses in the pension sector. To increase transparency, the MTO should be supplemented with targets for the structural budget balance for central and local government. The current practice implies that policy deviations are masked by a surplus in the pension funds.

- Expenditure targets work to ensure control over and prioritisation of public expenditures. The target can be circumvented by e.g. tax expenditures and this calls for a tighter definition of the expenditure targets.

- Despite a target that municipalities should have a balanced budget in the medium term, there is a systematic deficit bias and debt accumulation in municipalities. Moreover, municipalities account for substantial expenditures outside the expenditure target. Both factors imply that essential parts of fiscal policy are not sufficiently integrated in the overall fiscal framework.

- Fiscal sustainability is an important objective for fiscal policy. The reporting and discussion of fiscal sustainability measures need to be improved. There is a need for a more careful discussion of the policy choices underlying fiscal sustainability, the risks involved and policy strategies.

4 Structural policy programme

The government published its structural policy programme in August 2013. The goal of the programme was ambitious. The programme aimed to close the entire sustainability gap in public finances and still guarantee financing of public services and benefits. The elements in the programme included reforms that would raise the employment rate, increase the economic growth rate and improve productivity in public services. According to the government programme the reforms will be implemented starting in 2015 but their effect on public finances will be realised in the medium to long term.

The new government appointed in the summer of 2014 did not alter the goals related to reducing the sustainability gap. Implementing the reforms listed in the structural policy programme was a key task adopted by the new government.

The structural policy programme was a 52-item list of various policy proposals. However, some of these were ongoing projects that were implemented irrespective of whether they were part of the structural policy programme (e.g. combating the shadow economy and promoting healthy competition) or reforms that may enhance employment and productivity growth but have a rather minor impact on the sustainability of public finances (e.g. tightening the conditions for job alternation leave or dividing the home care allowance between both parents).

Even though in August 2013 the structural policy programme was mainly a rough draft where policy changes were not yet specified, its expected effects were already listed in the appendix of the programme. In the text these numbers were more appropriately called numeric sub-goals rather than estimates of the programme effects.

The structural policy programme contained three major policy initiatives designed to make up 4 percentage points of the 4.7 percentage point sustainability gap:

- reducing the tasks of local government and improving productivity in local service provision
- reforming the funding and organisation of the social and health care system
- increasing employment rates, in particular by postponing the effective retirement age

The latest update on the progress of the programme was made in August 2014. In its decision on implementation of the structural policy programme (28 August 2014), the government states that the decisions reducing the tasks of local government will reduce local government expenditures by EUR 350 million. The government did not present estimates of the impacts of social and health care reform. Other labour market reforms were estimated to increase employment by 6400 person years, substantially less than the goal of extending work careers by an average of half a year. The government decision did not contain details of the evaluation or any references to published impact estimates. Despite this, the government stated that if the policy initiatives listed in the decision are implemented, the sustainability gap can be closed.

In this report the Economic Policy Council evaluates in detail the effects of the pension reform proposal (Chapter 4.1). After this we evaluate the effects of a reform in the management of local government finances. On both topics a separate background report is published simultaneously with the Council's main report . At this stage we do not attempt to evaluate the effects of the social and health care reforms because many important details of the reform still remain to be decided upon and because detailed evaluation is performed by the National Institute of Health and Welfare.

4.1 Pension reform

4.1.1 Objectives

A key part of the government's structural policy programme is the pension reform. In the agreement published on 29 August 201, the government set the reform the goal of raising the retirement age to 62.4 by 2025. This target is defined in terms of the expected retirement age for a 25-year-old person as calculated by the Finnish Centre for Pensions. The government and the key labour market organisations agreed on this target already on 11.3. 2009.

According to the structural policy programme, the government aims to extend the length of work careers by two years. Of this, 1½ years would be due to extending the length of careers at the end, i.e. raising the effective retirement age. In the structural policy programme the government also states that a two-year extension in the length of average work careers would reduce the sustainability gap by 1.4 percentage points, i.e. it would account for roughly a third of the sustainability gap, estimated to be 4.7% of GDP at the time when the structural policy programme was published.

In the implementation decision of the structural policy programme (29.11.2013), the goals are more precise. The government states that "the social partners will prepare a pension reform in accordance with the objectives confirmed in the 2012 working careers agreement so that it is possible to estimate with sufficient certainty that the expected average retirement age will rise to at least 62.4 years by 2025" and that "the reform, which would represent a commitment by social partners, will extend working careers by at least 1½ years and reduce the sustainability gap by just over 1 percentage point."

4.1.2 Main elements of the reform proposal

The labour market organisations reached an agreement on a proposal for the pension reform on 25 September 2014. The agreement was signed by all the parties that took part in the negotiations except trade union confederation of affiliates for highly educated people, Akava, who rejected the agreement because it lowered pension accrual rates at the end of careers in a way that reduces the pensions of those who continue working until the old-age retirement age. (http://www.akava.fi/miksi_ei)

The key elements of the proposal include:

- Raising the lower age limit of old-age pensions gradually from 63 to 65 between 2017 and 2025. The upper age limit is raised simultaneously so that the difference between the lower and upper age limits remains at five years.

- An agreement on the principles of how the retirement age is linked to life expectancy after 2027. The goal is to keep the ratio of average years receiving pensions and average years in employment at the 2015 level. At the same time the automatic adjustment of pensions to changes in life expectancy will be modified to take into account the changes in the age limits.

- Removing the higher pension accrual rates for workers over 53. According to the proposal, the pension accrual rate will be 1.5% per year from age 17 to retirement age.

- Disability pensions are calculated as if the worker had contributed to the pension system until old-age retirement age. Increasing the old age retirement age will extend this "future time" and increase disability pensions both in absolute terms and in particular compared to old-age pensions.

- Removing the deduction of employee pension payments from the wage on which pension accruals are based. Effectively this will increase the accrual rate from 1.43% to 1.5% and increase pensions by about 5% in the long term.

- Replacing higher accrual rates (4.5%) in the retirement window by an adjustment for deferred retirement of 0.4% per month. The age range where this adjustment is made follows the retirement age.

- Introduction of a years-of-service pension that offers the option to retire at age 63 after a working career of 38 years in mentally or physically demanding jobs.

- Replacing part-time pensions with a partial old-age retirement option. In contrast to current part-time pensions, partial old-age retirement will reduce pensions by 0.4% per month in which retirement takes place before the old-age retirement age. This reduction is permanent and also affects pensions after retirement.

- An increase in the eligibility age for extended unemployment benefits from 61 to 62 years. This decision is conditional on the results of an evaluation of active labour market policies offered to unemployed persons who risk losing their right to earnings-related benefits.

4.1.3 Estimates of the effect of the reform on employment and the sustainability of public finances

The first estimates of the effect of the reform were produced while the negotiations between the labour market organisations on the reform proposal were still ongoing. The Finnish Centre for Pensions (ETK) evaluated the effect of the reform on age-specific employment and retirement rates and on pension expenditures. These calculations were published on the ETK website on 30 September 2014 right after the agreement was signed by the labour market organisations. The Ministry of Finance produced a brief report on the effect of the reform on the long-term sustainability of public finances. The evaluation by the Ministry of Finance was based on employment projections by the Finnish Centre for Pensions. The projections of future pension expenditures in the sustainability calculations are also directly based on ETK projections. The Council had access to the data used in these calculations.

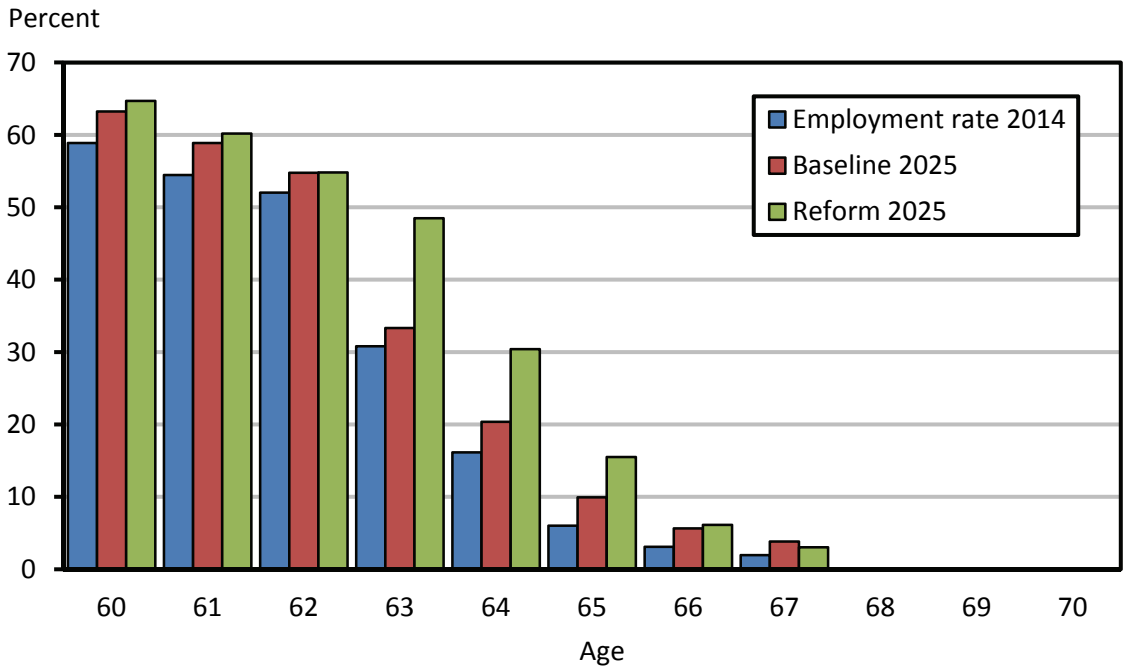
The ETK prediction of the reform's effects is based on various assumptions regarding changes in age-specific entry rates into the pension system. In its report, the ETK states that these assumptions are based on register data on population shares in employment and on pensions as well as on experiences from previous reforms. The ETK report assumes that an increase in the age limits of old-age pensions will increase the retirement age, but not in a one-to-one manner. As the age limit for old-age pensions increases, exits from employment into disability pensions and into unemployment are also projected to increase in the age groups that are no longer eligible for old-age pensions. In all the ETK's calculations, the reform is only expected to affect those age groups whose retirement options change. For example, it is assumed that no changes in employment rates or retirement behaviour will take place in age groups below 60.

Perhaps the largest uncertainly is related to the popularity of years-of-service pensions. This system will offer a financially attractive route into retirement as it involves no deduction in pensions for early retirement. According to ETK calculations, roughly half of non-retired employees have at least 38 years of service at age 62. Hence, the numbers of retirees taking up years-of-service pensions will crucially depend on how physically or mentally demanding work is defined.

Figure 4.1.1 displays the current age-specific employment rates and ETK predictions for employment rates in 2025 under a baseline scenario and under a scenario that includes the effects of the pension reform. In Figure 4.1.2 the same employment-to-population rates are plotted in 2050.

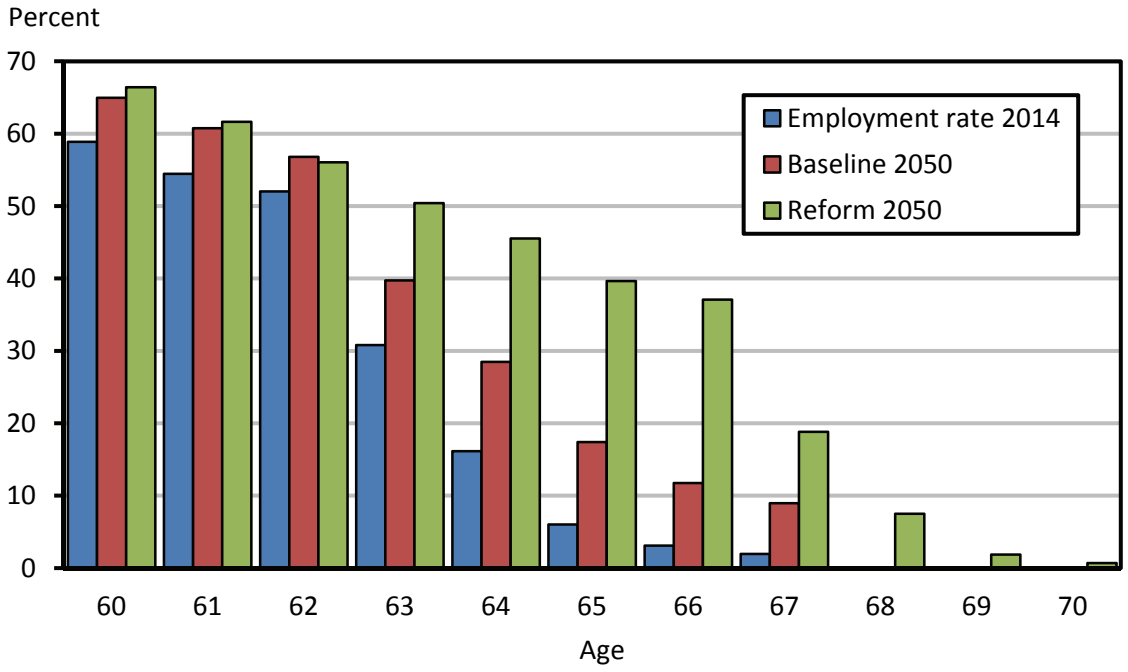
According to the ETK's predictions, the greatest changes are expected in age groups between 63 and 65. The employment rate of 63-year-olds is expected to increase by 18 percentage points compared to the current level and by 15 percentage points compared to the baseline. In 2050 the predicted increases are much larger still. The employment rate in the age group 64 – 66 is expected to increase by more than 30 percentage points compared to the current level and by more than 20 percentage points compared to the baseline. As a result, the reform is expected to increase total employment by 24,000 by 2025 and by 68,000 by 2050. Even the baseline scenario indicates a substantial increase in employment. According to the baseline protection, employment in these age groups will increase by 110,000 by 2025 and by 250,000 by 2050.

Figure 4.1.1. Estimates of employment rate by age group in 2025



Source: Calculations by the Council based on data provided by ETK.

Figure 4.1.2. Estimates of employment rate by age group in 2050



Source: Calculations by the Council based on data provided by ETK.

Incentives to retire

The effects of the pension reform on employment rates are due to both the direct effect of increasing the retirement age and to reactions to the incentives created by the system among cohorts approaching retirement age. The ETK predictions are based mainly on the direct effects. However, the reform will also change the incentives to retire. In the old-age pension system this is mainly due to various effects of higher accrual rates and the adjustment of pensions to later retirement. On average, the reform will have little effect on these incentives. However, the higher accrual rate creates relatively strong incentives to defer retirement for those who are earning relatively high wages compared to their accrued pension rights. The new system, with its adjustment for deferred retirement, increases incentives more if accumulated pension rights are high compared to earnings at retirement age.

The changes in incentives to retire before the old-age retirement age are substantially larger. The reform will increase the lowest possible old-age retirement age and move forward the date from which adjustment for later retirement starts affecting pensions. As a result, a person born in 1960, for example, who retires at age 64.5 after the reform will receive a pension 7% lower than a person who retires at the same age under the current rules. At the same time disability pensions will increase because they are calculated as if the person had worked until the old-age retirement age. Increasing the retirement age will extend this "future time" and increase disability pensions both in absolute terms and especially compared to old-age pensions. The new years-of-service pension will also affect incentives to retire. Those who are eligible for a years-of-service pension will have little incentive to continue to work after establishing eligibility.

Incentives to retire can be measured in several different ways. Simply comparing the size of pensions to wage levels does not measure incentives because the retirement decision mainly concerns the timing of retirement, not whether one eventually retires or not. Therefore the incentives to retire are usually measured by comparing available pension benefits at different possible retirement ages.

One relatively simple measure is the implicit tax rate of postponing retirement. This is estimated by first calculating expected pension contributions from a person's current age until retirement and the expected pension flow from retirement until death at each possible retirement age. These flows are discounted with a suitable discount rate (which takes into account the likelihood of remaining alive at each age) and summed up to yield the discounted present value of pensions. Postponing retirement increases monthly pensions but shortens the period in receipt of pensions. Their combined effect is the

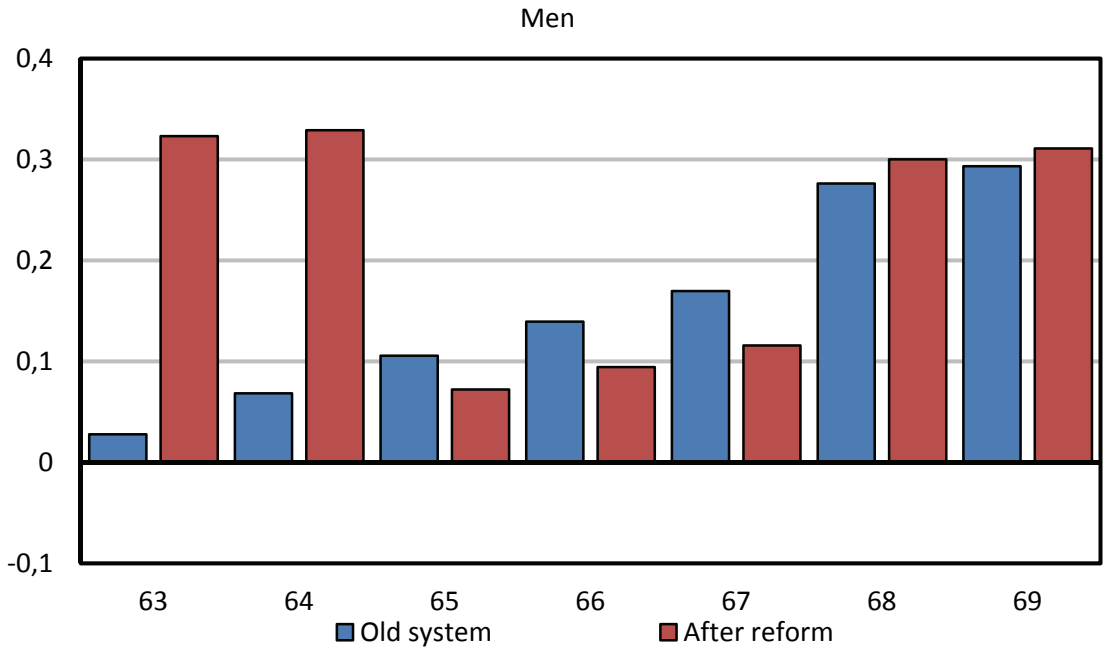
effect of postponing retirement on the discounted value of future pensions during the remaining lifetime, i.e. on the expected pension wealth. The implicit tax rate due to the pension system can then be calculated by comparing the change in pension wealth due to postponing retirement by one year and relating that change to current earnings.

Figures 4.1.3A and 4.1.3B below illustrate the results of such calculations. The implicit tax rates are calculated using a simulation model developed for evaluating the 2005 pension reform (Uusitalo & Nivalainen, 2013). The model computes pensions based on the current pension rules and under an alternative scenario based on the reform proposal. In the previous report these calculations were based on micro data from the ETK registers. These data were no longer available when writing this report, so the calculations are based on representative sample cases, simple assumptions on earnings growth and average accumulated pensions by age group picked from a social expenditure simulation model.

Measuring incentives in the old-age pension system is rather straightforward but it is not clear how the incentives in the early retirement options should be measured. In the new pension system freely available early retirement options no longer exist. Granting disability pensions is subject to a medical evaluation and years-of-service pensions require a work history in mentally or physically demanding jobs. In the calculation presented below, the incentives are measured only for years-of-service pensions and old-age pensions. The mplicit tax rates related to disability pensions would be substantially higher as delayed entry into a disability pension has no effect on the size of the pension and only reduces the time in receipt of a pension.

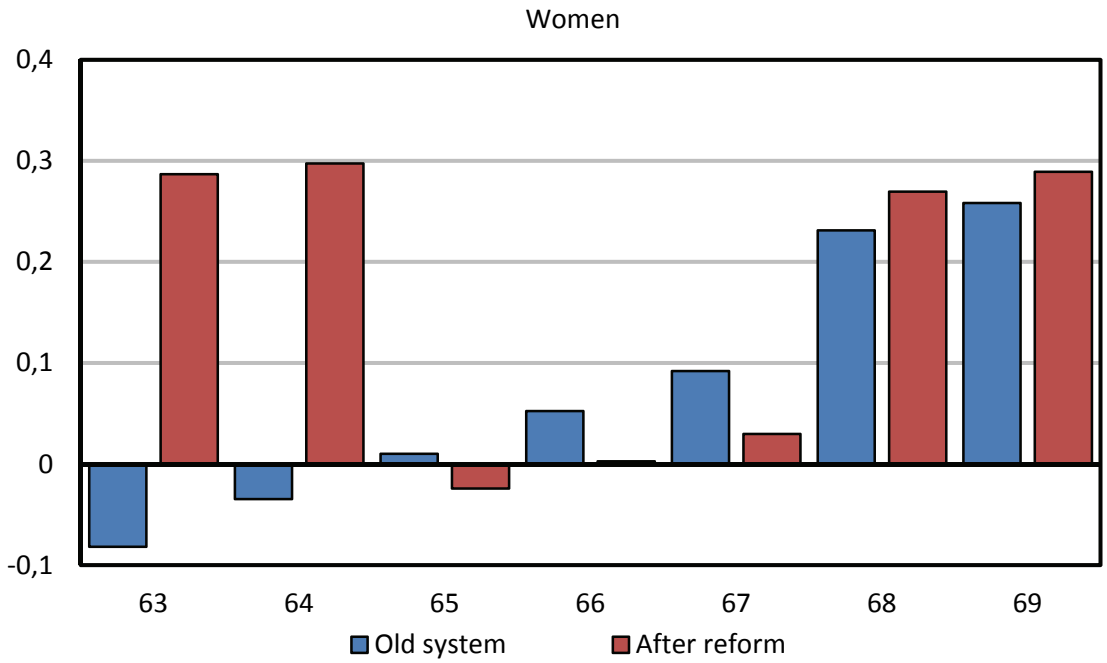
As demonstrated in Figures 4.1.3A and 4.1.3B, the implicit tax rates increase substantially after the reform at 63 and 64. After the reform, postponing retirement decreases the present discounted value of pension wealth by about 30% of gross earnings at those ages. This increases marginal taxes and creates a strong disincentive to continue in work for those who are eligible for the years-of-service pension. At the old-age retirement age the pension system is roughly actuarially fair. Postponinig retirement increases future pensions by an amount that is roughly equal to the forgone pensions. The difference between the current system based on elevated accrual rates and the new system based on pension adjustment is not very large. At the upper end of the age scale the differences are also relatively small. In terms of aggregate effects on the expected retirement age these are also less important since the fraction of cohorts still employed at those ages is relatively small.

Figure 4.1.3A. Implicit marginal tax rate due to pension rules by retirement age, men



Source: Calculations by the Council.

Figure 4.1.3B. Implicit marginal tax rate due to pension rules by retirement age, women



Source: Calculations by the Council.

Effect on retirement age

The changes in the pension system will affect retirement decisions because of the changes to the age limits and incentives to retire. Both of these effects need to be evaluated when predicting the effects on the average retirement age. This is commonly done using a dynamic simulation model.

A background paper published simultaneously with the Council report by Tarmo Valkonen, Niku Määttänen and Jukka Lassila from ETLA uses such a model to evaluate the effects of the reform. In their model agents at each age choose between continuing to work and retiring. The agents are assumed to be utility maximisers and make choices that are optimal given the available information. The model is stochastic and in each period the agents update their information on the expected future utility of each option and revise their decisions accordingly. The model copes with age limits easily, since the choice set only includes options that are available at each age.

A imilar model was used earlier to evaluate the 2005 pension reform. The model contains parameters from the current tax and pension system and parameters matching the reform proposal. The behavioural parameters are calibrated so that the model reproduces age-specific employment rates that match empirical estimates from the Labour Force Survey. These parameters are then adjusted so that the situation in 2025 matches the baseline scenario by ETK. The effects of the reform are evaluated by comparing the simulation results under the reformed pension rules to this base scenario. Calculations are performed separately by education and gender so that they take into account differences in wage levels, wage growth, disability risks and life expectancy across these groups. Disability pensions and unemployment are exogenous in the model and the effect of the reform on these risks is not modelled. A detailed description of the model can be found in the background report by Niku Määttänen, Tarmo Valkonen and Jukka Lassila published in the publication series of Prime Minister's Office.

The ETLA simulation compares post-reform predictions to a counterfactual situation with an unreformed pension system. The cleanest comparison to the ETK calculations is the effect on the cohort born in 1962, which is the first cohort whose old-age retirement age is 65 years.

The ETLA and ETK predictions of age-specific employment rates are fairly close to each other. The ETLA calculations ignore some groups that are outside the labour force. As a result the baseline employment rate is lower before the retirement age. However,

the predicted effects of the reform are quite similar. Both in the ETK and ETLA predictions, the employment rate increases substantially among 63 – 64 –year-olds. Most of the total employment effect of the reform is due to increases in employment rates in these age groups. ETLA predicts that employment rates will decrease before the old-age retirement age partially because an increase in the old-age retirement age makes unemployment a more attractive option. The ETK predictions have no such mechanisms. The predictions also differ in groups over 65. ETK predicts that entry rates into pensions are evenly postponed, while ETLA predicts a peak at a new lower old-age retirement age. The ETLA prediction is likely to be more realistic if retirement rates depend mainly on incentives that remain almost unchanged for persons over 65. A possible delay in retirement rates in these age groups would have to be explained by psychological factors, changes in employer attitudes or wealth effects.

It is worth noting that the ETLA evaluation ignores the effects of the years-of-service pension. Modelling its effects is difficult because comparable systems do not exist in the current pension system and because the eligibility conditions of the years-of-service pension are still unclear. The years-of-service pension is an economically attractive retirement option and uptake of it will crucially depend on the eligibility conditions and the definition adopted of "physically or mentally demanding work". The ETLA prediction of employment rates in the eligible age groups is therefore likely to be an overestimate. ETK assumes that every year about 5% of workers who fulfil the requirements related to length of career and age will take up a years-of-service pension.

Figure 4.1.4. Estimates by ETK and ETLA of the effect of the pension reform on employment rate by age group

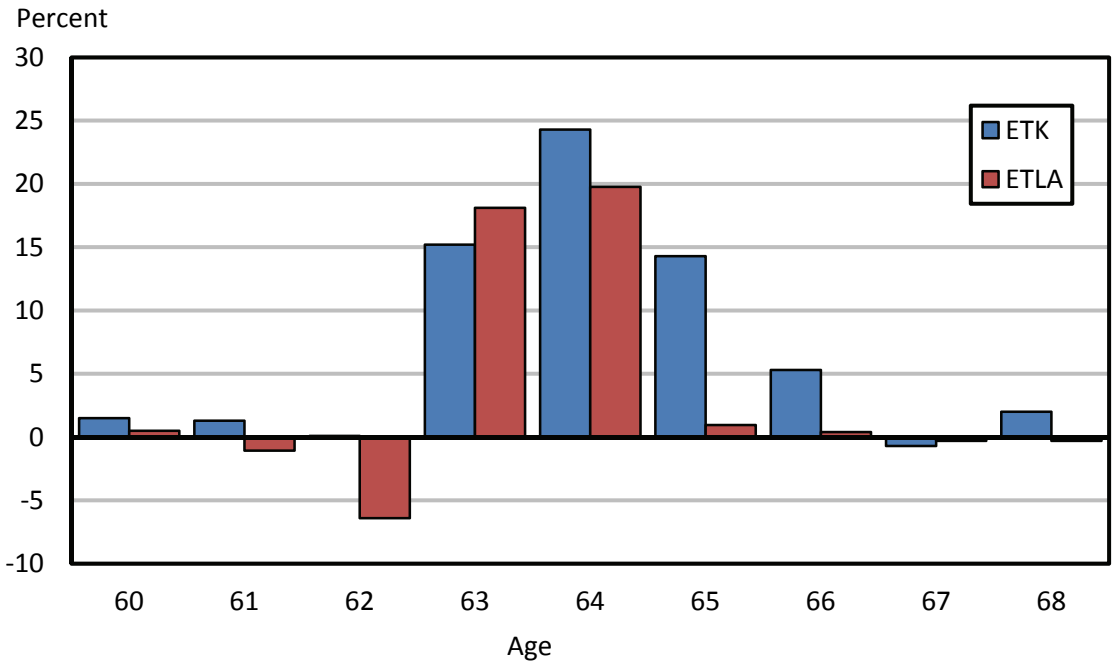


Table 4.1.1 details the ETLA estimates of the effect of the pension reform on work careers, retirement age, pension wealth, and net taxes, i.e. the difference between pension contributions paid and pension benefits received. According to the ETLA estimates, the pension reform will extend work careers by five months. The retirement age will increase by more than this, on average by slightly over one year. The difference is due to changes in unemployment as the retirement age increases. Pensions will decrease by 6% on average. The decline is largest among highly educated groups and larger for women than for men. The decrease in pensions is related to both a shorter time period in receipt of pensions and a decrease in monthly pensions after the higher accrual rate at ages 63 and 64 is removed. Net taxes increase, which also implies that the reform reduces public sector expenditures.

Table 4.1.1. ETLA's estimates of the effect of the pension reform on length of employment career, average retirement age, present value of pensions and net taxes

	Employment, months	Retirement age, months	Pensions, %	Net taxes, %
men, basic education	3.7	12.5	-3.0	1.9
men, secondary education	3.5	12.1	-3.5	2.2
men, tertiary education	6.4	11.2	-8.2	5.2
women, basic education	4.8	14.9	-4.1	2.9
women, secondary education	4.8	14.5	-4.7	3.6
women, tertiary education	4.8	11.1	-8.9	6.2
Average	**4.7**	**12.5**	**-5.7**	**3.9**

The ETLA report also gives alternative scenarios. The effect of the pension reform depends on how it affects unemployment rates. In particular, the part related to extended unemployment benefits in the pension proposal leaves room for different interpretations. Both ETK and ETLA assume that the lower age limit of extended unemployment benefits increases to 62 years. If this age limit is left unchanged, the effect of the reform on work careers would be only three months. ETLA also predicts that the effect of the reform will be smaller if the increase in the retirement age due to factors other than the reform turns out to be smaller than expected.

Effects of the reform on sustainability

The pension reform will affect the sustainability of public finances through three separate channels. First, an increase in the lower age limit of old-age pensions also reduces pension expenditure if it delays entry into the pension system. Second, the reduction in pension accrual rates and postponement of the age from which deferred retirement adjustment is calculated reduces pension expenditures. This effect is partly

undone by an increase in pension accruals due to removal of the deduction of pension payments from underlying wages. Third, if the reform increases employment and GDP it will reduce the deficit-to-GDP ratio.

In the evaluation, published after the pension agreement was reached, the pension expenditure and employment projections were based on ETK calculations. The Ministry of Finance used these projections to calculate the expected effect on the sustainability gap. These calculations were based on the social expenditures simulation model (SOME) developed at the Ministry of Social Affairs and Health and a common template for sustainability calculations agreed at the EU level. In this framework a decline in pension expenditure decreases age-related expenditures and an increase in employment increases GDP. The sustainability gap is measured using the S2 indicator, which indicates how much public sector deficit would need to change in order to balance public expenditures and revenues over the long term. In spring 2014 the Ministry of Finance estimated that the sustainability gap was around 3% of GDP. According to their estimates the pension reform would reduce the sustainability gap by 1 percentage point.

The ETLA estimates on the effect of the pension reform on the sustainability gap are based on an overlapping generations model. The model is a general equilibrium model where employment growth due to the pension reform affects all key macro variables. Production increases as in the Ministry of Finance predictions, but in addition the reform increases investments, lowers wages and affects the price level. The main outcome is still very close to the outcome in the calculations by the Ministry of Finance. In the baseline scenario the pension reform improves the sustainability of public finances by 1.1% of GDP. In a pessimistic scenario the effect is 0.6% of GDP.

One problem in predictions of the reform effect is that the models used in the calculations are representative consumer models. The ETLA overlapping generations model, the social expenditure simulation model and the ETK long-term forecasting model are all based on age-group averages. The calculations do not take into account selectivity. However, in addition to average age of retirement, selectivity also matters for sustainability. The effect is larger in the current system, where postponing retirement is encouraged using higher pension accrual rates. High accrual rates for high-income earners with long life expectancy will become expensive for the pension system. In the new system too, the costs will depend on whether those who postpone retirement are those whose life expectancy is longer or shorter than average. A model used in the ETLA evaluation is an improvement as the calculations are made separately in groups that differ with respect to disability and unemployment risks as well as with respect to life expectancy. ETK is developing a microsimulation model of pensions that would

enable individual-level predictions. Using such a model in evaluating the pension reform could have offered several benefits.

4.1.4 Council views

The Council agrees that tying the targets of the reform beforehand to a well- specified measure increases the credibility of the reform proposal and lessens the temptation of creative evaluation by choosing a measure afterwards that meets the target. Expected retirement age as defined by ETK is also a better measure than e.g. average age of retirement because it is independent of the changes in the cohort size and it reacts in the right direction to changes in retirement behaviour. However, the Council notes that expected retirement age does not measure all important dimensions of retirement behaviour. In particular, a discrete zero/one measure of retirement does not capture the changes in hours worked. Part-time retirement is still important. In the official measures part-time retirees are counted as employed even though their working hours have been reduced by 50% on average. It is also increasingly common to continue working part-time after retirement, an event that is completely ignored in official retirement age calculations. And, most importantly, expected retirement age only measures entry into the retirement system. An exit from the labour force into the extended unemployment benefit system is not counted as retirement according to this measure. Therefore, the 2005 reform that replaced unemployment pensions by extended unemployment benefits had a large effect on the official measures of retirement age even though it had only a marginal effect on the benefits received by the long-term unemployed and little effect on the sustainability of public finances.

The Council recommends that even if expected retirement age is used in evaluating the likely effects of the proposed reform, other measures should also be used to monitor retirement behaviour. A computationally simple measure would be the age-adjusted full-time equivalent employment rate in the 55-70 age group, as proposed by Uusitalo and Nivalainen (2013).

The Council notes that outsourcing preparation of legislation to labour market organisations is problematic. The negotiators are not politically accountable for their decisions. Even if the agreement is later approved by the parliament, the details of the reform hardly ever change at this stage. We will return to a discussion of the reform process in Chapter 6.

The Council notes that the government has explicitly made sustainability of public finances a key target of pension reform. This is clearly a more appropriate policy goal

than the effect of pension reform on the effective retirement age. Sustainability and retirement age targets may or may not be consistent, since retirement age can also be increased in ways that do not improve the sustainability of public finances. However, the Council notes that ultimately the policy goal should be to maximise the welfare of citizens. The public sector budget and the reactions of employees to incentives are only constraints in the policy design.

A background report by ETLA predicts that the pension reform will increase employment rates and the retirement age. The estimated effect is similar as in the preliminary evaluation by ETK though somewhat smaller in magnitude. ETLA predicts that work careers will be extended by 3 – 6 months. The effect on the retirement age is larger but less relevant and part of the effect is related to a predicted increase in unemployment. ETLA estimates that the reform will improve the sustainability of public finances and decrease the sustainability gap by 0.6–1.1% of GDP. The size of the effect of the reform also depends on how other factors affecting retirement change, i.e. on changes in the baseline scenario.

The reform will improve early retirement benefits. In the case of disability benefits the change may be well justified. Automatic adjustment of pensions for increases in life expectancy will also reduce disability pensions, and the disabled are often not able to respond by postponing retirement. However, this also creates incentives for early retirement and may make reaching the employment rate goals of the reform difficult. Therefore, the eligibility criteria for the years-of-service pension, for example, require careful consideration.

4.2 Regulation of local government finances

4.2.1 Background

Achieving the aims of the fiscal framework will require extending regulation beyond central government to municipal government finances. That would make it possible, for example, to avoid shifting expenditures between different sectors of government in order to ensure that the finances of the public sector as a whole are balanced. This

chapter draws heavily on the background report written by Antti Moisio (Moisio 2015).[10]

Municipal debt has increased since the beginning of the 2000s and in 2013 it stood at 7.4% of GDP (see Fig. 2.1.1. in this report). Most of the increase in municipal debt relates to financing municipal investments. Only a small fraction, about 6%, of the increase in municipal debt between 1997-2013 relates to financing operating expenditures. On the other hand, a significant part of the increase in municipal expenditures relates to an expansion in tasks allocated to municipalities and other factors beyond the control of municipal decision-makers (e.g. public sector pay increases that are negotiated centrally). On the other hand, decisions taken by the municipalities affect expenditures, in particular through the productivity of service provision. According to Statistics Finland, the productivity of municipal services declined in the period 2002-2011. Some commentators, however, have criticized the input-output indicators used by Statistics Finland (Pursiainen et al. 2011). According to the National Institute for Health and Welfare, the productivity of hospital services (without psychiatry), for example, remained constant on average between 2008-2013 (National Institute for Health and Welfare 2014).

In the structural programme, the key measures relating to municipal finances are new measures concerning the macroeconomic governance of municipalities, reductions in tasks allocated to municipalities, and measures aimed at improving the productivity of municipal service provision. Reductions in municipal tasks and productivity increases aim at expenditure savings amounting to EUR 2 billion by 2017. Financing the planned new social and health care service areas, and the expenditure framework related to regulating the finances of these new entities, are of vital importance for the development of the finances of the local government sector as a whole.

In what follows, we concentrate in particular on new measures related to the macroeconomic governance of municipalities, because the new financial framework for the local government sector is a major development compared to the earlier system, and it is closely related to the fiscal rules discussed in Chapter 3. The other parts of the structural programme related to local government finances are discussed only briefly.[11]

[10] The Economic Policy Council takes sole responsibility for the contents and interpretations in this Chapter.

[11] For example, many details of the social and health care reform are still open. An evaluation of the effects of the reform is being carried out at the National Institute for Health and Welfare.

4.2.2 Macroeconomic governance of municipalities

The current framework for the macroeconomic governance of municipal finances, as well as the proposed changes, are described in Table 3 of the background report corresponding to this chapter (Moisio 2015). The proposed changes are described in more detail in a report by the working group set up by the Ministry of Finance (Ministry of Finance 2014a). The purpose of the new regulation is to tie the planning of municipal finances more closely to central government budgeting and the preparation of a general government fiscal plan.

The new framework for macroeconomic governance of municipalities consists of four three elements. The first two elements make up the financial framework for the local government sector:

- Local government spending limit: the spending limit sets a euro limit for the change in expenditures accruing to municipalities from central government measures during the parliamentary term. The limit applies to both new and existing tasks carried out by municipalities, and it is set for each branch of government separately. The spending limit is meant to be equally binding as central government spending limits. The new regulation is coupled with a requirement that expenditure increases caused by new or more extensive tasks being imposed on municipalities will be completely financed by central government transfers.

- A balance target for local government finances: local government finances, as measured by net lending, should balance over a four-year term. This target applies to the local government sector as a whole (i.e. to all municipalities and joint municipal authorities taken together), not to individual municipalities. The key measures for achieving the balance target are the following: (i) an adjustment to the division of costs between central government and local government will be made annually; and (ii) central government transfers and the fraction of corporate income tax revenue received by municipalities will be adjusted to take into account the state of the business cycle.

- Individual municipalities or joint municipal authorities should cover any deficits within a four-year period. If not, they will be subject to crisis municipality negotiations with central government. The aim of the negotiation is to find a way of consolidating the finances of the municipality. The strongest possible sanction is a forced merger of municipalities. Deficit rules will be extended beyond the

budget and financial statements of the municipality itself, to cover public utilities and other companies owned by municipalities. The new rules also apply to joint municipal authorities.

Let us next turn to an evaluation of the proposed changes to the macroeconomic governance of local government finances. We will discuss each of the three main measures in turn.

First, it appears clear that the *spending limit on local government* is a necessary complement to central government spending limits. Given that local government makes up a large part of total public sector expenditures, leaving the local government sector outside the scope of financial regulation would endanger the aim of limiting expenditure growth in the public sector. In the absence of a spending limit on local government, central government could circumvent its spending limits by shifting new tasks and hence expenditures to municipalities. In past decades, there has been a large increase in the number of tasks allocated to municipalities (see Fig. 8 in Moisio 2015), and these have only partially been financed by transfers from central government. The new requirement, stating that new tasks allocated to municipalities should be financed through central government transfers, increases the credibility of the spending limits. It ensures that central government has full incentives to take into account any new expenditures that its decisions impose on municipalities. The new measures are therefore both necessary from the point of view of ensuring fiscal discipline in the public sector, and implemented in a way that is likely to make them effective.

Second, the *balance target for the local government sector* appears to be – at least in principle – a fairly strict measure, given recent developments in municipal finances. The implications of the balance target are not completely clear, however, as the working group report (Ministry of Finance 2014) does not discuss how it should be interpreted. A strict interpretation would imply that net lending in the local government sector should on average be zero over a four-year term, and we should see an end to debt accumulation by local government.

How effective the balance target will be in practice is an open question. Even if the target was in principle interpreted fairly strictly, its practical implications are not clear since it is defined at the level of the local government sector as a whole. If the target is not met, no sanctions will follow. It appears that the target does not directly constrain the actions of individual municipalities. Experiences with similar aggregate-level regulation in Denmark are not very encouraging – the financial situation of municipalities there did not improve until clear sanctions for not meeting the targets were added to the system.

Even though the balance target in principle applies to the local government sector, it appears to be intended more as a measure affecting the behaviour of central government, and the relationship between central and local government. The main reason for the increase in debt has been to finance investments and only a small fraction has been related to covering operating expenditures. If the balance target were to be strictly enforced, adequate investment financing would need to be ensured through other means, mainly through actions taken by central government. This line of reasoning indeed appears to be evident in the measures that are to be put in place to ensure meeting the balance target: the target is complemented with more frequent adjustments to the sharing of expenditures between municipalities and central government (to be carried out annually instead of every four years), possible adjustments to revenue sharing of corporate taxation between municipalities and the central government, and adjustments to central government transfers to provide a better buffer for business cycle fluctuations. It therefore appears that in the new system, ensuring a balance in the finances of the local government sector is mainly the responsibility of central government.

In addition to the observation that the balance target does not effectively constrain individual municipalities, the measures chosen for its implementation raise some additional questions. For example, changing the degree of revenue-sharing from corporate tax appears to be a fairly blunt instrument: it is hard to tailor these changes to the needs of individual municipalities, since the financial situation of municipalities is likely to be highly heterogeneous. There is also likely to be a lag associated with changing revenue-sharing rules or central government transfers. Second, it appears that the balance target for the local government sector may even harbour the risk that decision-makers in municipalities or joint municipal authorities will feel that their budget constraints have become softer than before. This would, contrary to the aims of the new regulation, imply lower incentives for municipalities to keep costs down. This worry is not very prominent in the case of small municipalities, as cost increases in a small municipality are very unlikely to lead to adjustments in expenditure-sharing rules that are after all conducted at the level of the entire local government sector. However, the problem may materialise when more of the responsibilities of the local government sector are concentrated into larger entities (e.g. five social and health care areas, as planned at the time of writing). It would then be important to ensure that increased funding from central government only applies to expenditure increases that are beyond the control of local decision-makers.

In sum, the balance target for the local government sector is in principle a strict measure. For the sustainability of local government finances, the mode of financing

expenditures and investments is not a crucial factor, and debt financing should not be completely prohibited. There are, however, a number of open questions associated with the implementation of the balance target. A worst case scenario is that the target may even have a detrimental effect on fiscal discipline in the local government sector, if decision makers in municipalities – or in particular in large joint municipal authorities – feel that it means a softening of their budget constraint (due to the more active involvement of local government in ensuring that the balance target is met).

The third feature of the new regulation is *the requirement that municipalities should cover their deficit within a four-year period*. Unlike the other two measures, this rule applies to single municipalities. It should be noted that the rule was first implemented already in 2006, and there is some indication that it has led to a reduction in municipal deficits (Moisio 2015, section 6.1). Nevertheless, it has not been sufficient to tackle debt accumulation in the local government sector. As noted above, much of the debt has been used to finance investments. On the other hand, much of the increase in municipal expenditures has been due to new tasks allocated by central government or to other external factors (like public sector pay increases, negotiated centrally).

The proposed modifications to the deficit rule appear to be fairly modest. The modifications are related to the coverage of the rule (extending coverage e.g. to joint municipal authorities) and the associated sanctions (more circumstances under which crisis municipality negotiations are initiated). However, it is not clear whether the most severe possible sanction, namely forced mergers of municipalities, can be implemented solely on the grounds of certain financial criteria being fulfilled.

Since the modifications to the rule are fairly modest and due to the uncertainty associated with the sanctions that would follow for breaking it, one might worry whether the new regulations are stringent enough to ensure fiscal discipline. However, it has to be borne in mind that more stringent regulation of individual municipalities would be problematic given the traditionally strong autonomy of municipalities in Finland. Furthermore, there are clear benefits in allowing municipalities the flexibility to adjust to changes in local conditions and to differences in preferences. For these reasons, we would not recommend more stringent regulation of individual municipalities at this time. Municipalities could be encouraged to set targets for themselves, e.g. regarding debt accumulation. It would also be advisable to first gather evidence on the performance of the new framework, and consider implementing further measures only if significant problems remain.

A final point to note is that the closer monitoring of municipal finances implied by the new framework poses increased demands on the information base and preparation of

statistics on municipal finances. There is a clear need for improvement in this respect. In addition to better statistics, there should be an increased emphasis on careful evaluation of the effectiveness of proposed new policies or programmes. Sufficient time and resources should be set aside for the preparation of new legislation, so that high-quality evaluation both ex ante and ex post is possible. Reliable quantitative evaluation can be carried out when both the new policy and its target group are clearly defined and there is extensive information available both about the new policy and the target group. Policy experiments and pilot studies give the best possibilities for informative evaluation, if evaluation can be based on randomised trials (Hämäläinen 2010), i.e. the policy is first implemented in randomly chosen municipalities or areas. It is naturally not always possible to evaluate policies using randomised trials or other quantitative research methods. In those cases ex ante evaluation has to be based on calculations or scenarios whose results are likely to be somewhat more unreliable.

4.2.3 Other measures related to municipal finances in the structural policy programme

One part of the structural programme is an implemention of reductions in municipal tasks, which would result in a decline in municipal expenditures. The aim is to reduce expenditures by EUR 1 billion, which is approximately half of the estimated structural deficit of the local government sector. A detailed list of the proposed measures associated with the reduction in municipal tasks and expenditures was published in autumn 2013. The ministries were supposed to prepare the necessary changes to legislation and guidelines by the end of February 2014. By the budget negotiations in August 2014, one third of the original goal had been achieved: measures amounting to an estimated reduction in municipal expenditures of about EUR 350 million have so far been specified.

However, the degree to which these measures will actually bring down expenditures remains uncertain. The possibilities for direct regulation of municipal expenditures are limited. For example, one could consider attempting to steer municipalities towards expenditure reductions by cutting central government transfers by an amount corresponding to the estimated cost savings associated with the proposed measures. However, it is not clear whether such anticipatory or proactive reductions in transfers are possible. It therefore appears clear that meeting the target for expenditure reductions remains highly uncertain. It is not clear which municipal tasks will be eliminated, nor whether that would directly lead to a corresponding decline in expenditures.

Reducing the responsibilities of municipalities naturally has some drawbacks. It is almost inevitable that reductions in responsibilities will lead to some decline in the level of service provision by municipalities. One therefore needs to consider whether the tasks no longer carried out by municipalities are such that they do not belong in the public sector. There is a clear justification for public provision of certain services such as health care, given considerations such as failures of private insurance markets. The aim of structural reforms, indeed the aim of all public sector activities, should be to maximise the welfare of citizens. The simple aim of reducing expenditures hardly represents a sufficient guideline for policy.

The structural programme also aims at expenditure reductions through increased productivity. The aim is to increase productivity in public service provision by 0.5% per year. This is a challenging goal, since a number of estimates indicate that in recent years productivity in public service provision has either declined or remained constant. The structural programme does not propose concrete measures as how this development would be reversed. The aim of reducing the increase in personnel from the current level of 3000 employees per year to 1000 employees per year, and modifying the qualification requirements for personnel, are of key importance in order to attain increased productivity. However, in order to achieve true increases in productivity, one needs to ensure that output or service quality do not decline as a result of the measures. What does a loosening of the qualification requirements for personnel in social work or schools entail in practice? It remains uncertain whether and to what extent productivity increases in the provision of public services will be achieved in practice.

A crucial question regarding the future development of the costs of public service provision relates to expenditures in the new social and health care areas. In the early stages of the reform in particular, there is a significant risk that costs will in fact increase, e.g. due to harmonisation of wages across the municipalities making up the new entities. In addition, large reforms such as the current one, where responsibility for service provision shifts from municipalities to completely new organisations, may be associated with various types of optimisational behaviour that may lead to an increase in expenditures even before the new organisations are formed (see Saarimaa and Tukiainen 2013, Moisio 2012).

We do not aim to evaluate the overall impact of the social and health care reform on expenditures in social and health care services. Below, we only make some remarks on the spending limit system for social and health care services, which is still under preparation. According to some preliminary information, the spending limit system would be a kind of a total budget for social and health care services, which would define the contributions of the central and local government sectors. The total budget would be

used to define the spending limits for the proposed five social and health care service areas. The municipalities would make their share of the payments to the social and health care areas, and the central government transfer would be paid to the social and health care areas either directly or through individual municipalities.

Based on the preliminary plans, the spending limits for the social and health care service areas appear to be more like guidelines rather than binding limits on the spending of health care service areas, joint municipal authorities (service providers), or individual municipalities. It appears that if the aim is to effectively limit spending growth, some further measures may be necessary. The plans are naturally going to become clearer in due course, and it is possible that new measures are already being drafted. One possibility that might be considered in the early phases of the new system is to make investments in the new social and health care areas subject to a licensing procedure. Such a system might, however, be unnecessarily bureaucratic and inflexible. Another possibility discussed in the background report is to remove the system of the adjustment of the division of costs between the central government and local government sectors. Adjustments to the division of costs makes the system less mechanical, which appears at least to some extent contrary to the aim of the spending limit system for social and health care areas.[12]

One important implication of social and health care reform will be that joint municipal authorities will play a much more important role than they have done in the past. There are interesting questions associated with the treatment of joint municipal authorities in the new regulation. Unlike decision-makers in municipalities, the decision-makers in joint municipal authorities are not elected; rather, they are representatives appointed by the individual municipalities. The lack of political accountability may have adverse effects on spending discipline.[13] Another question again relates to whether the requirement to cover deficits within a four-year period will be binding or not. In principle, it is an important development that this deficit rule has been extended to apply to joint municipal authorities in the new system. However, it is not clear what the sanctions associated with breaking this rule (ultimately, forced mergers of municipalities) imply in the case of joint municipal authorities. The rule may therefore be less effective in the case of joint municipal authorities than it is in the case of individual municipalities. The details of the spending limit system for the new social

[12] The new framework for macroeconomic governance of municipalities has, however, aimed at the opposite development, namely making adjustments to cost-sharing more frequent.

[13] On the other hand, one key rationale behind fiscal policy rules is that elected decision-makers may be susceptible to myopic policies. Such pressure may be mitigated in the case of appointed representatives.

and health care areas will therefore be of key importance for the development of the finances of the local government sector.

4.2.4 Council views

A large proportion of the increases in local government expenditure has been caused by an increase in the number of tasks allocated to the municipalities. Investments have been the main cause of the increase in municipal debt. The new local government spending limit is an important new measure for ensuring spending discipline in the public sector, because it prevents circumventing central government spending limits by shifting tasks and expenditures to the municipalities.

The balance target for the local government sector is in principle a strong requirement. For the sustainability of local public sector finances, it is not crucial how investments are financed, and therefore debt financing should not be completely prohibited.

The local government spending limit constrains the actions of central government and the balance target is set at the level of the entire local government sector. Therefore these measures are not effective constraints on individual municipalities. The deficit rule that concerns individual municipalities, on the other hand, will only be slightly modified and the sanctions associated with breaking the rule are not very strong. Even though there is some suggestive evidence that the current deficit rule has had some effect on limiting the growth in municipal deficits, the new system may not be sufficient to limit expenditure growth resulting from municipalities' own decisions.

The structural programme aims at reducing the tasks of municipalities and increasing productivity in public services. The details of the implementation of these measures are still unclear. It is uncertain whether they will be successful in curtailing expenditure growth, as the means for direct regulation of municipal expenditures are limited. If these measures succeed they will contribute to closing the sustainability gap, but reaching fiscal policy targets in the medium term is likely to require new measures.

The ultimate goal of structural programmes, as well as the public sector as a whole, should be to maximise utility of citizens. Reducing municipal tasks almost inevitably leads to a reduction in the level of services. There is a clear justification for the public provision of many services, such as health care, due to the incompleteness of private insurance markets. Measures aiming at productivity increases can be successful only if cost reductions do not lead to a corresponding decline in the level of services.

5 Structure of taxation

5.1 Tax changes over the parliamentary term 2011-2014

In the present chapter, we concentrate on the structure of the tax changes introduced during the parliamentary term 2011-2014. Their effects on the overall fiscal stance were discussed in Chapter 2. An overview of the key tax changes over the parliamentary term is presented in Table 5.1.

Table 5.1. Major tax changes over the parliamentary term 2011-2014, projected average static effects on annual central government tax revenue in 2015-2018 (EUR million)

	Change	Revenue 2011	% change
Corporate income tax	-1290	5130	-25
Personal income tax (earned income and capital income)	1020	7650	13
Value added tax	950	15 170	6
Environmental and health taxes			
Energy tax, car use tax and car tax	1030	5710	18
Health taxes (Alcohol, tobacco, sweets)	430	2150	20
Gift and inheritance tax	90	400	23

Source: Authors' calculations based on background information for the Economic Survey (Autumn 2014), provided by the Ministry of Finance.

In constructing the table, we have taken into account decisions made until the budget negotiations in autumn 2014, as well as the abolition of the planned increase in the sweets tax that took place shortly after the budget negotiations.[14] The figures in the table concern the projected *static effects* on tax revenue. That is, they only take into account the change in the tax rate, assuming that behaviour of firms and individuals was unchanged. This effect is given both in absolute terms and as a percentage of central government tax revenue[15] from the given tax item in calendar year 2011 i.e. at the start of the parliamentary term. Actual revenue effects that also take into account changes in behaviour differ from the figures reported in the table. (Alternatively, one could report changes in tax rates rather than revenue. This would be more complex, however, as there are many different tax policy changes associated with each figure. E.g. the personal income tax item covers about 50 individual measures taken over the parliamentary term.) Inflation adjustments to tax brackets are not taken into account in the table as reforms; rather, they are taken to be part of a neutral benchmark. However, abolitions of inflation adjustments decided upon during the parliamentary term should be considered as discretionary measures, and their revenue effect is included in the table. The effect of the introduction of the public broadcasting tax, on the other hand, is not taken into account in the table: the tax replaced the television licence fee, and should therefore not be thought of as a new tax.

According to Table 5.1, major tax changes during the parliamentary term include large reductions in corporate income tax on the one hand, and increases in taxation of earnings and capital income on the other hand. As part of fiscal consolidation, value added taxes and excise taxes have also been increased.

Low incomes have been treated relatively leniently in the income tax changes. Measures affecting low incomes in particular include a reversal of the abolition of inflation adjustments for the three lowest income tax brackets (in 2014, estimated effect on tax revenue EUR -100 million) and increases in the earned income tax credit (several smaller changes whose aggregate effect is approximately EUR -270 million). Smaller increases were implemented to the pension income deduction. A new temporary tax

[14] Changes to other tax items besides those listed in the table are not discussed in this report.

[15] The revenue change for other tax items is compared to central government tax revenue in 2011, except for corporate income tax, where the change is compared to total revenue from corporate income tax in 2011. The reason is that the revenue losses associated with the corporate income tax reductions were compensated to other tax recipients by central government, and therefore the entire revenue loss was borne by central government.

credit for families with children was introduced to compensate for a cut in child benefits.

Furthermore, it is important to note that the figures in Table 5.1 concern changes to central government tax revenue only. From the point of view of the entire public sector as well as the finances of individual citizens, changes in local taxes are also important. The policy changes implemented by central government are estimated to cause a reduction of EUR 130 million to municipal income tax revenue in 2015. This reduction is mainly due to increases in the various tax credits and deductions described in the previous paragraph, as well as to increases in the basic allowance in municipal taxation that have been implemented annually. Hence these reductions to municipal tax revenue have been mostly concentrated at low incomes. Furthermore, however, there have been increases in municipal taxes decided upon by individual municipalities, equivalent to an increase in tax revenue of about EUR 600 million annually in 2015-2018. Because central government income taxes have been reduced at the same time, the balance of personal income taxation has shifted towards municipal taxation. Finally, central government also sets the minimum and maximum levels of the property tax, and the actual rates are determined by individual municipalities within these limits. Both the minimum and the maximum rates will be increased in 2015, with an estimated effect of an increase of EUR 50 million in property tax revenue.

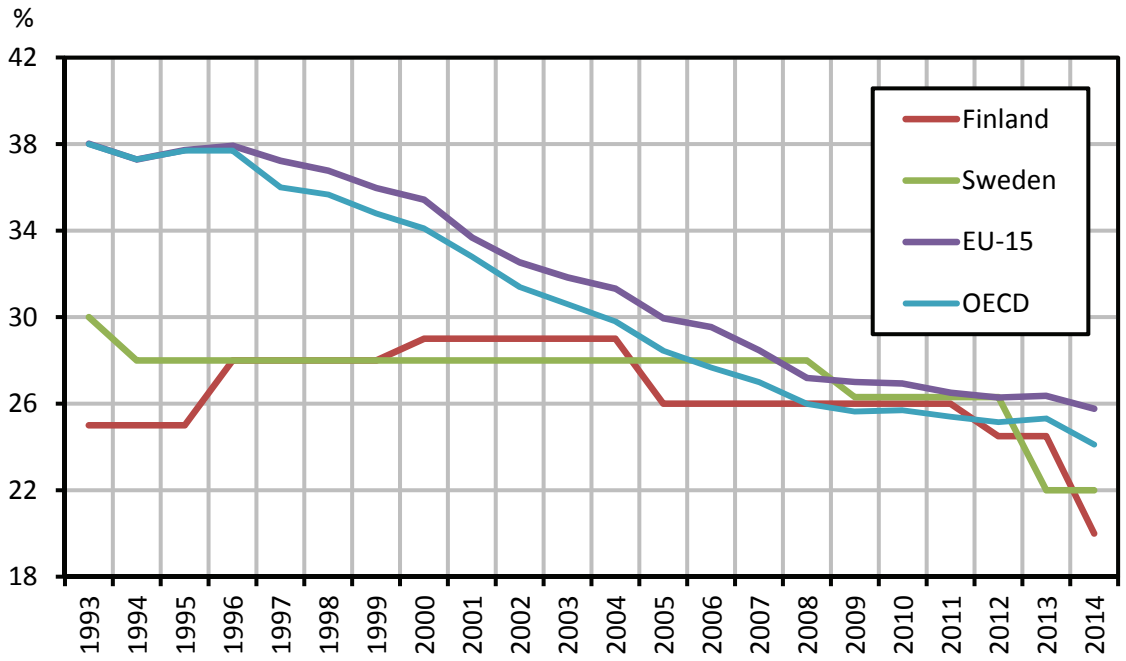
Evaluating each of the above tax changes in any detail is beyond the scope of this report. Below, we discuss some general principles regarding the optimal structure of taxation, and make some remarks on the reforms as well as some other aspects of the existing tax structure in the light of those principles.

5.2 Corporate income tax

The largest tax change during the parliamentary term was the large reduction in corporate income tax. The corporate income tax rate was reduced on three occasions during the parliamentary term, from 26% to 20 %. This change is large both compared to corporate tax rates in other countries, and compared to for example the recommendation of the report of the working group for the development of the Finnish tax system (Ministry of Finance, 2010), which recommended a reduction to 22%. The estimated revenue effect in Table 5.1 takes into account all changes to corporate income taxation during the parliamentary term: it includes the above changes to nominal tax rates, and also several smaller changes to deductions (such as a tightening of interest rate deduction rules) affecting revenue from corporate income tax.

The development of corporate tax rates in Finland, Sweden, the EU 15 and the OECD countries is depicted in Figure 5.1. A clear downward trend in average corporate income tax rates in OECD countries and the EU 15 is evident from the mid-1990s onwards. In the late 1990s corporate income tax in Finland was fairly low by international comparison, but since the mid-2000s it has been close to the the EU 15 average. After the latest adjustment, however, the Finnish corporate income tax rate is far below those of the comparison groups shown in Figure 5.1. The figure shows statutory or nominal tax rates. Effective tax rates in Finland are also relatively low compared to other OECD countries (Bilicka and Devereux 2012). A notable feature is the alternating corporate tax rate reductions in Finland and Sweden since the latter part of the 2000s.[16]

Figure 5.1. Corporate tax rates in Finland, Sweden, EU 15 and OECD 1993-2014



Source: KPMG and Taxpayers Association of Finland.

The clear downward trend in corporate tax rates internationally is commonly interpreted as a sign of tax competition between countries. Tax competition refers to countries lowering their tax rates in an attempt to attract businesses and investment that might

[16] In Sweden, a proposal was made in June 2014 to reduce the corporate income tax to 16.5%, see http://www.regeringen.se/content/1/c6/24/22/09/ac924e9c.pdf. It is uncertain whether the proposal will be implemented.

otherwise be located in other countries. Quite generally, tax competition should be seen as a negative development: whatever the government's objective, tax competition poses an additional constraint on policy that prevents countries from implementing those policies that would be optimal from the point of view of achieving their objectives. It erodes the possibilities for financing welfare services in the future. It is important to note that tax competition is a negative sum game: for example, both Finland and Sweden wish to increase their tax base by lowering corporate taxes (in an attempt to cause an inflow of investments, new firms), but when they both do so, the end result is that tax bases are unaffected but tax revenues are lower, due to the lower tax rates. It is therefore highly questionable whether Finland should be proactive in this development. The challenges associated with implementing the proposed financial activities tax in the EU is another example of unfavorable tax competition.

The above argument implies that any positive effects of tax reductions related to firms' location choices or to improved competitiveness vis-à-vis other countries do not necessarily materialize in the long run. On the other hand, reductions in corporate income taxes may have other positive effects. For example, according to some studies, corporate tax reductions may promote growth. (Arnold 2008 and Arnold et al. 2011.) In 2013, when the latest reduction in corporate taxation was proposed, the so-called dynamic effects of the reduction (i.e. the resulting increases in the corporate tax base) were assessed to compensate for approximately half of the estimated static revenue loss. For example, de Mooij and Ederveen (2008) have reviewed results from international empirical research on the effects of corporate tax rates on the corporate tax base. A corporate tax reduction may increase the corporate tax base through (i) changes in the legal form of operation, (ii) changes in the financial structure of firms, (iii) changes in the reporting of profits (so-called profit-shifting) and (iv) increases in investment. The assessment of dynamic effects in the 2013 proposal to reduce the corporate tax was also based on the existence of these channels. According to de Mooij and Ederveen (2008), mechanisms (iii) and (iv) are particularly important. In particular, evidence on profit shifting (whether profits are reported in the home country or abroad via transfer pricing) is fairly strong (e.g. Dharmapala & Riedel 2013). Research utilising most recent econometric methods (albeit on U.S. data), however, assess the effects on investment (channel (iv)) to be much lower than indicated in earlier research, or even non-existent (Yagan 2013). Furthermore, effects through channel (i) are easily misinterpreted: they increase the corporate tax base, but *reduce* overall tax revenue (as the effects accrue due to income being shifted from tax bases with a higher tax rate, to the more leniently taxed corporate tax base, de Mooij & Nicodeme 2008).

To summarise, assessing the magnitude of the so-called dynamic effects of taxation is difficult and empirical evidence is often contradictory. Therefore using dynamic effects as justifications for policy changes bears the risk that the assessment of the effects is subjective or goal-oriented. The dynamic effects of the latest corporate tax reduction played a significant role in the original policy proposal, but they were not included in the tax revenue assessment in the final government proposal (HE 185/2013). According to the Council's view, the practice of including only the direct budget effects of such policy changes in government proposals is well justified.

In theory, a good way of reducing unfavourable tax competition would be to coordinate taxes between countries (though minimum tax rates or harmonisation). To the extent that this is not feasible in practice, a good option is to accommodate tax competition via an automatic mechanism where reductions in corporate taxes are offset by increases in dividend taxes. Dividend taxes fall on domestic shareholders and are therefore less susceptible to tax competition. The working group for the development of the Finnish tax system (Ministry of Finance, 2010) also recommended a shift from company taxation towards the taxation of individual shareholders. Indeed, the corporate tax reductions undertaken during the parliamentary term were accompanied by an increase in dividend taxation, but the magnitude of the increase was much smaller than the reduction in the corporate income tax. Grönberg et al. (2013) have assessed the effects of the dividend tax reform on the taxation of entrepreneurs. The analysis also takes into account the effects of reduced corporate income tax. Their assessment is that the changes had a relatively small effect on entrepreneurs, and the tax rate for most entrepreneurs remained unchanged. Ropponen and Määttänen (2014) have examined the effects of the new dividend tax system on the investment incentives of unlisted corporations. After the reform, the system still remains complex, and certain simplifying measures would be likely to have beneficial effects on the allocation of investment.

5.3 Income taxation

The structure of taxation is usually evaluated using two main criteria, namely effects on efficiency and equity. Efficiency considerations refer to minimizing the distortions to the economy from collecting a given amount of tax revenue. Distortions occur, for example, when taxation reduces the incentives to work and invest. Equity considerations, on the other hand, refer to the effects of taxation on the income distribution. The conceptual framework behind the key insights from optimal income tax literature is outlined in Box 5.3.1.

Box 5.3.1 Conceptual framework behind optimal income tax analysis

The key results of the theory of optimal income taxation are reviewed for example in Piketty and Saez (2013a). The purpose of optimal tax theory is to derive expressions for tax rates that maximise the aggregate welfare of citizens: what should the tax system look like for aggregate welfare to be at the highest possible level? Usually aggregate welfare is defined as the (possibly weighted) sum of individual utilities, and optimal tax rates are those that maximise this sum. The individual weights in the summation reflect society's views on income distribution. If the same weight is given to each individual in the optimal tax calculation, this would imply that there is no concern for equality: an increase in welfare would be equally valuable regardless of whether it accrues to the richest or the poorest individual. On the other hand, if one is concerned about equality, one may want to put a higher weight on the welfare of the least-well off individuals in society.

Optimal taxes depend on how individuals react to taxes: if higher taxes have large effects on work effort, for example, this diminishes the pie to be shared between individuals, which reduces welfare, which in turn puts a limit on how high taxes should be. The efficiency effects - the so-called deadweight loss - of income taxes depend on how much taxable income responds to tax changes, i.e. on the *elasticity of taxable income* (ETI - see e.g. Feldstein 1995). Individuals may respond to taxes through changes in the labour supply (labour force participation or working hours), through work effort, tax avoidance and evasion, and so on. The combined effect of these responses on tax revenue constitutes the ETI.

Optimal taxes also depend on the income distribution before taxes: for example, if there are a lot of people at a given level of income, one should not put high marginal tax rates on that level of income because then the work incentives of a lot of people will be distorted. (On the other hand, if there are a lot of people *above* a given level of income, a higher marginal tax rate on that level of income will raise a lot of revenue.) Overall, higher income inequality implies that a more progressive income tax schedule with higher marginal tax rates would be optimal.

The optimal marginal tax rate at a given income level therefore depends on

- the welfare weight of individuals at that income level (reflecting society's preferences for redistribution);
- the elasticity of taxable income (reflecting e.g. the sensitivity of labour supply

and other responses to taxation) at that income level;

- the income distribution before taxes.

The stated objective behind the tax adjustments in the Fiscal Plan 2015-2018 was to target the required tax changes in such a way that they would have the smallest possible negative effect on employment and company activity, i.e. the emphasis was on efficiency considerations. Accordingly, we concentrate mainly on efficiency in the current section. The employment effects of taxation will also be further discussed in the Council's next report. The distributive effects of the tax changes are discussed in Section 5.7 below.

As outlined in Box 5.3.1, the disincentive effects of taxation, e.g. on labour supply, are a key determinant of the efficiency cost of taxation. In general, labour supply is most responsive to taxes at low incomes, where individuals (in particular secondary earners) consider whether or not to participate in the labour market at all. Hence, from the point of view of improving incentives to work, it is reasonable to pay specific attention to the taxation of low earnings.

However, the various measures targeted at low incomes can have very different effects on work effort, depending on how they treat income from work vs. other sources of income. The earned income tax credit increases work incentives, since it amounts to a more favourable tax treatment of income from work. On the other hand, increases in the basic allowance in municipal taxation may have detrimental effects on work effort, since this applies equally to all types of income (income from work but also benefits), and goes to zero already at relatively low levels of annual income (about EUR 25,000 in 2014). Hence it reduces incentives to work for individuals whose earnings if working would exceed this threshold. Kotamäki and Kärkkäinen (2014) have examined the overall effects of tax and benefit changes during the current parliamentary term on the incentives for labour market participation (measured by participation tax rates). According to their calculations, the policy changes have increased the average participation tax rate associated with transitions from unemployment to full-time work, and also the fraction of individuals in unemployment traps (with participation tax rates exceeding 80%) has increased. Furthermore, an important issue to note is that the overall employment effects of tax changes also depend on other factors besides the labour supply elasticity of a particular group of individuals, and the effects of tax changes on total employment may remain modest. A number of recent studies from the Nordic countries have found that tax reductions have not had significant positive effects

on employment (e.g. Huttunen et al. 2013, Korkeamäki and Uusitalo 2009, Skedinger 2014). We will return to the employment effects of tax policy in our next report.

Relatively lenient tax treatment of low incomes can also be justified for equity reasons, if one is concerned about increases in income inequality (points (i) and (iii) in Box 5.3.1). We turn to the equity effects of the tax reforms in Section 5.7.

Turning to the taxation of high incomes, high-income individuals are less likely to change their labour supply in response to tax changes: taxation affects in particular the decision of whether or not to work (i.e. the participation decision). This decision is more relevant at low incomes. High-income individuals may find it hard to change their hours of work when taxation changes. On the other hand, high-income individuals may react to income tax changes through other channels, such as shifting income between different tax bases, or even emigration. Income-shifting refers in particular to the possibility of converting some of one's earned income into more leniently taxed capital income.

These types of responses, which are not directly related to labour supply, should also be taken into account in designing tax policy. Regarding the effects of taxation on migration decisions, there is relatively little empirical evidence to date (Kleven et al. 2013). Piketty and Saez (2013a) conclude that the migration elasticity is likely to be fairly low in most countries. Furthermore, in Finland it is likely to be lower than in many other countries due to the relatively low fraction of foreigners (whose migration elasticity is higher than that of natives) in the population. The effect of migration on optimal top tax rates is therefore likely to be fairly limited in practice, even though its importance is likely to increase in the future due to increased integration of labour markets internationally.

Regarding income-shifting, on the other hand, there is evidence of this from Finland too (Pirttilä and Selin 2011, Harju and Matikka 2013). The differential taxation of capital and earned income and the implied income-shifting possibilities have at least two implications for an assessment of taxation of high incomes. First, when assessing the burden of taxation on high income earners, one has to take into account the share of capital income in high incomes. For example, the share of capital income in the income the highest 1% of income earners in Finland has increased in recent decades and was about 45% in 2012. This implies that the average tax rate of top earners has also decreased and was just over 30% in 2012. (Riihelä et al. 2014.) Second, it is often argued that one should remove income-shifting opportunities by moving the top tax rates on earned income and capital income closer together. Despite the increases in capital income tax and dividend taxation implemented over the parliamentary term, the

highest effective marginal tax rates on these forms of income are still far apart from the tax rates on earned income.

5.4 Commodity taxation

Value added tax

All VAT rates were increased by 1% point in 2013. The general VAT rate is now 24%, but there are also reduced rates at 14% (e.g. food and restaurant services) and 10% (e.g. books, medicine, sports services, admission to cultural and sports events). A 2% point increase in all rates was recommended by the working group on reform of the Finnish tax system (Ministry of Finance, 2010a). Given that VAT rates had been increased by 1% point in July 2010[17] (after the recommendation was originally given in the interim report of the working group), the implemented additional increase in VAT rates can be interpreted as being in broadly line with the recommendation of the working group. In addition, the working group concluded that moving towards a more uniform VAT structure would be desirable in the future. The removal of the zero VAT rating on newspaper and magazine subscriptions implemented in 2011 was a modest move in this direction. It is interesting to note that the reduced VAT rates constitute the second largest tax expenditure item (after provisions related to income taxation taken together) in the Finnish tax code, with an estimated revenue loss in the order of a couple of billion euros annually according to calculations by the Ministry of Finance[18] (using a similar static measure as in Table 5.1). In addition, the financial sector is exempt from VAT in the EU.

The modern analysis of optimal commodity taxation draws on the same conceptual framework as the analysis of income taxation, outlined in Box 5.3.1. When designing an optimal tax system, we should consider the tax system as a whole, i.e. taking into account both income and commodity taxes.[19] When thinking about the efficiency effects of commodity taxation, it is important to note that effects on incentives to work are again of key importance: commodity taxes also affect incentives to work in the same

[17] The VAT for restaurant services on the other hand was reduced from the general rate to the higher one of the reduced rates (then 13 %) in 2010.

[18] https://www.vm.fi/vm/fi/04_julkaisut_ja_asiakirjat/03_muut_asiakirjat/20140915Verotu/Verotuet_2013_-_2015e.pdf (in Finnish).

[19] E.g. the commonly known Ramsey rule (Ramsey 1927), which states that those goods whose demand reacts a lot to tax changes (i.e. goods with relatively elastic demand) should be taxed leniently, relates to a situation where commodity taxes are the only instrument. The result is of limited relevance when the income tax system is well developed.

way as income taxes, since higher commodity taxes imply that one's income has lower purchasing power.

Taking into account work incentives in the design of commodity taxation implies that we should tax leniently those commodities that encourage labour supply (and vice versa), i.e. commodity taxes should be lower on those commodities that are complementary with work. This means that there is a good case for subsidised or publicly provided daycare, for example. However, for the vast majority of other commodities, we lack good empirical evidence on how they are related to work incentives, or the evidence suggests that the differences between goods are small in this respect. [20] Therefore, a uniform VAT rate is recommended as a good general rule for tax policy (Crawford, Keen and Smith 2010).[21]

In line with this argument, there is indeed a good case in terms of better efficiency and also large revenue potential if the reduced VAT rates currently in place were to be reconsidered. On the other hand, no new reforms involving moving new categories of goods or services to the lower brackets should be implemented. There are even cases where the reduced rates in the current system are in direct contrast with efficiency considerations – for example the reduced rate on admission to cultural and sports events constitutes a subsidy on leisure, not on labour. Furthermore, there is Finnish empirical evidence that the stated objectives (increased employment, increased demand for labour-intensive services, combatting the grey economy) of lower VAT on labour-intensive services were not achieved, and the first-order effect was a loss in tax revenue (Kosonen 2013).

In a reform where reduced VAT rates are increased, it is advisable to pay attention to possibly adverse effects on income distribution (see e.g. Boadway 2011, 1154). However, the Council's view is that the equity objectives of the reduced VAT rates (e.g. related to food taxation) would also be better achieved in Finland through other measures, notably through a more progressive income tax system and measures specifically targeted at low-income individuals. The benefits of reduced VAT rates are very poorly targeted from the point of view of income inequality as those benefits accrue in all income groups, and in absolute terms high-income individuals benefit more than low-income individuals. In general, the objectives of policy are most effectively achieved using the most direct instrument: if one wants to support low-income

[20] Pirttilä and Suoniemi (2014) provide Finnish evidence on the degree of complementarity between different commodities and work.

[21] E.g. Boadway (2012) discusses a number of caveats to this result, pointed out in the theoretical literature, but nevertheless concludes that a uniform VAT rate is a good guideline for policy making in practice.

individuals, one should look for measures that are specifically targeted at them. Finally, the redistributive effects of increased VAT are also to some extent mitigated by the fact that most benefits are indexed to the consumer price index.

Environmental and health taxes

A key exception to the general rule of uniform commodity taxation is corrective taxation, i.e. for example environmental taxes and taxes on unhealthy goods. This type of taxation is very different from taxation in general. Most taxes cause distortions to choices by making individuals consume less and different goods to what they would in the absence of taxation. Environmental taxes and taxes on unhealthy consumption on the other hand have a corrective effect on consumption / production choices, as their main purpose is to lower the level of a harmful activity. Notable increases to these types of taxes have been implemented during the parliamentary term 2011–2014, as can be seen from Table 5.1.[22]

The case for taxes on unhealthy consumption ("health taxes") differs somewhat from the rationale behind environmental taxes, however. The case for environmental taxes is based on mitigating harm to others (externalities), whereas the case for health taxes is additionally based on mitigating the harm caused to the individual himself. This type of harm can provide a justification for higher taxation of these commodities, if it is the case that individuals do not take future harm fully into account in their decision-making, for example because of myopia or weak will. Due to their corrective nature, increases in environmental and health taxes look like good candidates for tax increases, though determining their optimal level is beyond the scope of this report.

Cross-border shopping is often seen as a reason to avoid increases in excise taxes in particular, in order not to lose tax revenue to neighbouring countries. It is also often mentioned that the public health benefits of a high alcohol tax, for example, can no longer be achieved, as consumers can obtain essentially unlimited amounts of cheaper alcohol from abroad. However, it should be noted that tax incrases do lead to a reduction in total consumption and hence to a reduction in harm: the reduction in domestic purchases caused by an increase in alcohol or tobacco taxes is larger than the corresponding increase in the amount purchased abroad (either legally or illegally).

[22] Regarding environmental taxes, the table includes the energy tax, car tax, and car use tax. In addition to these taxes, Statistics Finland includes a number of other much smaller items (not included in Table 5.1) in its definition of environmental taxes (http://tilastokeskus.fi/til/yev/2013/yev_2013_2014-11-06_tie_001_fi.html) (in Finnish). Different types of environmental taxes are likely to have different impacts on the environment. For example, putting the emphasis on car use (rather than car ownership) in the taxation of motoring would be justified for environmental reasons. The structure of environmental taxation is not discussed in more detail here.

Therefore total consumption and harm from consumption is reduced when taxes are increased.[23] In Finland also, alcohol consumption has declined at the same time as alcohol taxes have been increased.

Higher alcohol and tobacco taxes also lead to higher tax revenue. In Finnish research on alcohol demand, for example, the price elasticity of demand has remained stable (and below one) for several decades and does not seem to have increased markedly for example after Estonia joined the EU. (Vihmo 2006, Holm ja Suoniemi 1992, Ahtola, Ekholm ja Somervuori 1986.) On the other hand, increased cross-border shopping and easier access to illegal alcohol might lead to an increase in the price elasticity of domestic consumption and therefore the situation should be closely monitored. In addition, it is important to note that regardless of the effects on tax revenue, a decline in consumption reduces the social cost of alcohol use, which has to be taken into account when assessing the impact of tax changes.

High tobacco and alcohol taxes are often also opposed because expenditure on these goods makes up a larger proportion of the total expenditure of low-income individuals than of high-income individuals. However, measured in absolute terms, it is high-income individuals who benefit most from low taxes on these goods. In general, as was noted above, redistributive objectives are better dealt with through more direct measures than commodity taxation. Also, the positive health effects of high health taxes may be largest for low-income individuals (Härkänen et al. 2014).

5.5 Inheritance taxation

Finland has a progressive inheritance tax with separate schedules for close relatives (tax class I) and other heirs (tax class II). Slight increases in inheritance taxation have been introduced during the parliamentary term: the rates in all brackets were increased by 1% point, and the schedule was made more progressive by introducing two new top brackets for inheritances over EUR 200,000 (in tax class I) and another bracket for inheritances over EUR 1,000,000. (It is interesting to note that during the previous parliamentary term, on the other hand, inheritance taxation was reduced considerably on two separate occasions, in 2008 and 2009.) The working group on reform of the Finnish tax system (Ministry of Finance, 2010) recommended an increase in the progression of the inheritance tax, and the reforms implemented during the current parliamentary term are therefore in line with those recommendations.

[23] In general, it is hard to think of a model of demand where total demand for e.g. alcohol increases when the price for domestic consumption increases (see e.g. Kotakorpi 2009).

The total effect of these changes on central government tax revenue is estimated to be about EUR 85 million per year in 2015-8. The top tax rate for inheritances over EUR 1,000,000 is now 19% in class I and 35% in class II. On the other hand, inheritances below EUR 20,000 are untaxed, implying that about 42% of heirs paid inheritance tax in 2013. There is great variability in the tax treatment of inheritances internationally. Many countries tax very large inheritances at a much higher rate than Finland, whereas several countries (e.g. Sweden, Estonia, Norway, Russia) have abolished inheritance taxation altogether.

Inheritance taxation has been the subject of debate recently in Finland too, with some calls for its removal. The total tax revenue from inheritance and gift taxation was EUR 650 million in 2013, and its removal would lead to a large loss in revenue. Of course one may consider the possibility of filling this gap with revenue from other sources. However, inheritance tax is generally viewed as a relatively efficient tax, and therefore shifting the tax burden from inheritances to other tax instruments does not seem warranted. According to the Council's assessment, removing the inheritance tax would be an undesirable development. Some key lessons from the economics of inheritance taxation are reviewed in Box 5.5.1.

Box 5.5.1 Optimal inheritance taxation

Optimal inheritance taxation has been analysed for example in Piketty and Saez (2013b) and Cremer and Pestieau (2006). The overall conclusion is that inheritance tax can be regarded as a (relatively) efficient tax and the case for a zero tax on inheritances is very weak.

The efficiency effects of inheritance taxation depend on bequest motives. Bequest motives matter because they have different implications for how bequests will respond to taxation, and therefore on the efficiency effects of the tax. Bequest motives include for example (i) altruism (parents care for the welfare of their children); (ii) joy of giving; (iii) no motive (accidental bequests). The optimal inheritance tax may be zero only in some instances where pure altruism is the only reason for leaving bequests, i.e. if the only reason for bequests is that parents care about their children as much as they care about themselves (and therefore parents behave as if they lived forever). Even in that case, a zero tax is optimal only "in some instances", as there are also other very restrictive assumptions behind this result. The result was originally derived by Chamley (1986) and Judd (1986). On the other hand, if bequests are to a large extent accidental – if individuals cannot predict how long they will live and therefore keep more money

than they actually need to finance their own consumption – then the optimal inheritance tax can be very high. The intuition is that if bequests are accidental, they will not be affected by taxation, and the distortionary effects of taxation are therefore mitigated.

Inheritance taxes are also an effective way of achieving any redistributive goals that society may have. Bequests tend to be very concentrated, more so than other types of wealth. Bequest taxation may also be viewed as fair compared to other types of redistributive taxation, as bequest wealth (or the lack of it) is not a virtue (or the fault) of the individual himself. Bequest taxation also promotes equality of opportunity in society.

In sum, the optimal inheritance tax depends on similar factors as those listed in Box 5.3.1 related to income taxation (Piketty and Saez 2013b). The optimal inheritance tax depends on

- society's preferences for redistribution;
- the elasticity of bequests with respect to taxation (which is in turn determined by bequest motives);
- distribution of income and bequests.

Piketty and Saez (2013b) calibrate the optimal inheritance tax (in a simple system with one or two tax brackets) using estimates of the elasticity of bequests from earlier literature, and data on the distribution of income and bequests from France and the U.S. Their conclusion is that the optimal inheritance tax could be around 50-60 %, and the top rate even higher. It has to be kept in mind, however, that this result depends heavily on assumptions made about society's preferences for redistribution. The higher the weight given to high-income individuals, the lower the optimal inheritance tax is. Unfortunately, no suitable data is currently available for doing similar calculations for Finland.

One argument for the removal of inheritance taxation that has been particularly prominent in the Finnish discussion is that it presents a burden for family businesses, when ownership is transferred to a descendant. This argument, however, is misplaced for a number of reasons. First, such situations constituted only 2.5% of all cases of inheritance taxation in 2013, and it does not seem warranted to base overall judgments on inheritance taxation on special considerations related to these relatively few cases. Furthermore, there is already preferential treatment of inheritances related to transfer of ownership of a family business, implying that the tax liability in those cases is about

40% of what it would otherwise be. The special treatment of transfer of ownership amounted to an estimated reduction of about EUR 160 in tax revenue in 2013. Second, abolition of the inheritance tax would cause a new distortion, because the descendants of the current owner would be favoured relative to other potential buyers of the business.[24] Inheritance taxation has been discussed from a Finnish perspective for example in Pirttilä and Aura (2007).

5.6 Tax expenditures

When considering the effects of taxation, one should take into account not only actual tax rates, but also other aspects of the tax system. Over the current parliamentary term various changes have been made to so-called tax expenditures. Tax expenditures constitute exceptions to the regular tax code with the purpose of making taxation more lenient in some well defined instances. Various tax credits, deductions and tax allowances are examples of tax expenditures. Tax expenditures reduce the tax base and therefore have important effects on government finances and individual tax liabilities.

Altogether, there are currently over 180 different tax expenditure items in the Finnish tax code and their number has remained fairly constant over the parliamentary term 2011-2014. Over half of the value of tax expenditures comes from items related to income taxation. Examples include the earned income tax credit and the basic allowance in municipal taxation, which have been increased during the parliamentary term. On the other hand, various other tax expenditures have been tightened. In addition to changes in existing tax expenditures, some completely new tax expenditure items have been introduced, such as the temporary tax credit for families with children, which has received a lot of attention in the media, but whose revenue effect is estimated to be fairly small. Besides expenditures related to income taxation, provisions related to the reduced VAT rates constitute the second largest tax expenditure item as measured by lost tax revenue (12% of the estimated value of all tax expenditures in 2015). The total value of all tax expenditures – measured by the total effect on tax revenue for all sectors of government taken together – has increased by 10% over the parliamentary term (from

[24] On the other hand, to the extent that descendants have some private information about the value of the business, some form of preferential tax treatment of transfer of ownership, such as the current provisions, may be justified.

2011 to 2015) according to calculations provided by the VATT Institute for Economic Research and the Ministry of Finance.[25]

Some tax expenditures, like the earned income tax credit and the basic allowance in municipal taxation, are important instruments for designing an optimal income tax system. Some complexity in the tax system is warranted, in order to achieve the various goals of tax policy: for example, a simple linear tax system (a flat tax) would not be optimal (e.g. Tuomala 2009). In general, it would however be advisable to reduce the importance of tax expenditures for a number of reasons. First, there is evidence that many tax credits are not very salient to taxpayers, and hence efficiency gains from more lenient taxation may partly be lost (see e.g. Chetty 2011). Second, these measures are often not very well targeted. For example, the child tax credit was in part introduced to offset the effects of child benefit cuts. If one wants to help families with children (the likely objective of child benefits), this aim would be most effectively reached through using the most direct instrument. As we mentioned in connection with the redistributive goals of the reduced VAT rates, here too the general principle applies that it would be advisable to use the most direct instrument to achieve a given policy goal. For example, a tax credit will not benefit the poorest families with no taxable income. Third, the use of tax breaks to circumvent earlier decisions on spending limits should be prohibited. If tax expenditures are used in this way, it makes the system less transparent and the decision-making process less predictable and there is a risk that the objectives of spending limits will not be achieved – this issue was discussed also in Chapter 3. Fourth, the proliferation of tax credits makes the tax system unnecessarily complicated, thus increasing administrative costs.

5.7 Effects of the policy changes on the income distribution

Let us next turn to an assessment of how the policy changes implemented during the parliamentary term have affected the income distribution. The assessment is based on microsimulation analysis carried out at the research service of the Finnish parliament. Unlike other parts of this chapter, the analysis of the redistributive effects takes into account changes to both taxes and benefits. (A separate assessment of the redistributive

[25] Details of tax expenditures are provided in https://www.vm.fi/vm/fi/04_julkaisut_ja_asiakirjat/03_muut_asiakirjat/20140915Verotu/Verotuet_2013_-_2015e.pdf

effects of tax changes has not been carried out). Changes to municipal taxation and social insurance contributions are taken into account. On the other hand, the microsimulaiton model used in the analysis does not include indirect taxation, and therefore changes to VAT rates and other commodity taxes are not accounted for. It is important to bear this in mind when interpreting the results.

The microsimulation method allows one to separate the effects of changes in policy from other causes of changes in the income distribution (such as demographic changes). The method yields an estimate of the static effects of policy changes, i.e. it shows for example the direct effects of tax rate changes, but does not take into account any further indirect effects that arise due to changes in behaviour. For example, relative to the dividend tax reform, the method takes into account the fact that dividends are taxed more heavily, which reduces the income of shareholders, but it does not take into account any effects resulting from a possible increase in dividends due to the reform. The same method has been used and is described in more detail in Bargain and Callan (2010) and Honaken and Tervola (2014).

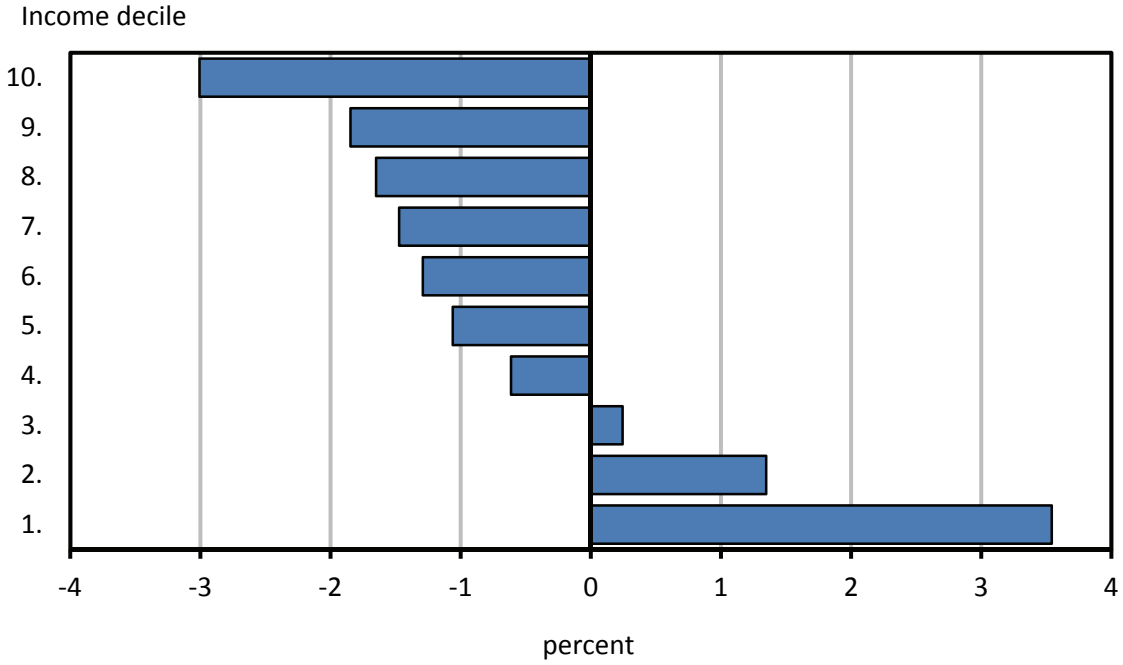
The direct policy effects are calculated by applying the tax and benefit rules in place at the end of the parliamentary term (2014) to income data from the beginning of the term (2011). Using the SISU microsimulation model developed by Statistics Finland for the Finnish economy, it is possible to assess how the income distribution of 2011 changes when the tax and benefit rules for 2014 are applied to it. Any tax and benefit parameters defined in euro terms are converted to base-year levels using the index of wage and salary earnings. Using the index of wage and salary earnings implies that the simulation also takes into account passive policy changes related to lower growth in benefits compared to earnings. Callan et al. (2006) have also argued that adjusting nominal tax-benefit parameters in line with earnings growth provides a distributionally neutral benchmark.

The analysis shows that the overall effect of the tax and benefit reforms implemented over the parliamentary term has been to reduce inequality in disposable income. The most commonly used measure of economic inequality, the Gini coefficient, declined by approximately 0.8 points (from 28.6 to 27.8) due to government policies. The poverty rate[26] declined by 1.2% points (from 15.7% to 14.5%), with a similar decline in child poverty. The effect on disposable income in various income groups is depicted in Figure 5.2. The figure shows that the effect of the government's tax and benefit policies was to

[26] The share of individuals living in households with equivalent disposable income below 60% of the median.

increase disposable income in the lowest three income deciles, whereas disposable income declined in the other deciles. The downside has been that while income inequality has declined, there have been some adverse effects on work incentives (Kotamäki and Kärkkäinen 2014). This is a good example of the central challenge in designing tax and benefit systems, namely the trade-off between equity and efficiency considerations.

Figure 5.2. The effect of tax policy changes (2011-2014) on the income distribution: effect on disposable income (%) by income decile



Source: Research Service, Parliament of Finland

5.8 Structure of taxation – Council views

- A reduction in corporate income tax was justified from the point of view of maintaining competitiveness. However, it appears fairly large in magnitude. It causes a large reduction in tax revenue, and there is considerable uncertainty related to the magnitude of the so-called dynamic effects of the tax reduction. International tax competition puts downward pressure on corporate taxes. Tax competition, however, should be seen as a negative tendency that makes it more difficult to achieve the goals of tax policy, and Finland should not be proactive

in this development. One way of accommodating tax competition is to increase dividend taxation to offset reductions in corporate taxes.

- Targeting tax reductions at the low end of the income distribution has contributed to a reduction in income inequality. The effects on work incentives are likely to be mixed, as only some of the tax reductions concern income from work and some also apply to income from other sources. The overall employment effects of these tax changes are likely to be rather small.

- A more uniform VAT would improve the efficiency of the tax system and would potentially lead to a large increase in tax revenue. Careful consideration should be given to the equity effects of the reform, but in general equity objectives are better achieved through income taxation and through measures targeted directly at low-income individuals.

- Increases in excise taxes lead to higher tax revenue and they can also have beneficial effects related to health promotion and/or environmental protection. These benefits can be achieved despite cross-border shopping.

- Reducing the number of tax expenditure items in the tax code would reduce the complexity of the tax system. In particular, using tax breaks to circumvent spending limits should be prohibited.

- The inheritance tax should not be abolished. Inheritance tax is an efficient way of raising revenue because it causes fewer distortions on economic activity than many other taxes. It also reduces income inequality.

6 Preparation of economic policy

The parliament holds the highest decision-making power in economic and financial policy. The Finance Committee and its subcommittees deal with financial legislation, budget proposals, taxation matters and government financial reports. Proposals are made by the government and they are influenced by the government's programme. Most of the responsibility lies in practice with the Minister of Finance and the civil servants under him/her. However, the political guidance of the preparation of decisions is not quite straightforward.

Preparation also happens outside of parliamentary and executive institutions. Labour market organisations and other interest groups are important players. The Nordic countries are often characterised as corporatist economic systems – or rather neocorporatist systems to differentiate them from their historical models where the representative institutions were organised according to trades or corporations. A central feature of this system is the so-called tripartite framework: employees' and employers' organisations and the government negotiate on national incomes policy and on related settlements concerning e.g. taxation, pensions and social policy. For example, a majority of the members of the Economic Council that meets regularly under the Prime Minister represent the social partners and other interest groups.

Another group exerting significant influence consists of experts, most of whom are outside of the parliament and civil service. Some of them are in research institutions, others work for interest groups or enterprises like banks and insurance companies. They produce commissioned analyses, they are consulted and they provide advice to decision-makers. Expert preparation also takes place within the civil service, for example in government research institutes. The influence of experts is based on their knowledge.

Knowledge, however, is tied to the context in which its producers and their contractors work. Examples of the use of experts range from reports and presentations commissioned from researchers by the Economic Council or statements by the expert

group on financial policy (Hetemäki et al. 2014) to high-profile events where civil society and media representatives or for instance bishops are invited to discuss the ethics of the economic system. These also include diverse memoranda by small groups of experts (see Holmström et al. 2014) or individual expert analyses like the services offered by the former Swedish Minister of Finance.

The connections of organisations and experts to economic policy decision-making are diverse and intertwined. It is not self-evident how these connections are established and how they can be influenced. It also depends on the issue at hand. The preparation of the taxation reform and the pensions reform can serve as examples of very different processes. The working group for the development of the Finnish tax system, the so-called Hetemäki group, was composed of experts. It aimed at maximum transparency in its work and in the end produced a 240-page report (VM 2010a), which was later tagged as one of the reports that "disappeared" (Helsingin Sanomat, editorial 8.11.2014). On the other hand, the Finnish earnings-related pensions system that provided the background to the work of the pensions reform preparation group has been criticised as being "undemocratic" (Korkman 2011, 208). No official information was given to the public on the negotiations between labour market organisations before the 14-page agreement was made. Several opinions and studies were produced in the course of both processes, thus complementing the body of empirical research in Finland on taxation and pension issues.

How were the taxation and pensions reform groups formed, how did they work and what was their impact? What interaction did they have with the executive (civil service) and decision-making authorities (politicians)? The reports published by the groups and the commentaries they elicited as well as testimonies of people involved in the groups' work can shed light on the way economic policy is formed.

The following description is based on semi-structured interviews made by Liisa Laakso in October-December 2014. It reflects the subjective views of the interviewees. A request for an interview was sent to 10 key informants: seven of them were men and three were women. They were selected to include civil servants, researchers, politicians and interest group representatives, as well as leaders, ordinary members and secretaries of the working groups and people that followed the groups' work closely. Eight interviews were eventually made. One agreed interview was cancelled due to the interviewee's busy schedule and one interview request was never answered. The names of the interviewees are listed at the end of this chapter, but the material is used in an anonymous way in order to ensure the interviewees could speak as freely as possible.

The Economic Policy Council's own assessment of the preparation processes and their impact is presented in chapter 6.4.

6.1 Working group for the development of the Finnish tax system

It has not been standard practice to involve experts in planning Finnish taxation policy. Expertise in economics and law studies has been used often, but with a rather limited mandate. For example, the significant changes in the 1990s were implemented mostly by applying reforms prepared in other countries like Sweden or Norway.

Taxation policy is prone to short-term decision-making, especially during economic downturns. In order to maximise their support, political parties respond to demands from various economic sectors and population groups by including individual proposals for taxes or tax deductions in their programmes, instead of dealing with taxation as a whole. A good example is the cut made in child benefit, followed by a tax deduction for persons with children. Individual decisions can affect the overall efficiency and predictability of the taxation system. Therefore the need for expert discussion on taxation policy is greatest when decision-makers have to make difficult choices. Discussion requires not only knowledge but also suitable fora. The working group for developing the tax system was supposed to provide such a forum. The novelty in it was both its transparency and its broad basis in economics research.

6.1.1 Establishment of the working group

The Minister of Finance established the working group for the development of the Finnish tax system in September 2008. It started its work with a "clean slate" in the sense that its mandate was unrelated to the implementation of the government's programme. The goal was not to prepare any legislation already agreed, but to look at taxation as a whole and to support the making of new policies. It had to "evaluate changes required to the tax system arising from the present tax system and changes in the economic environment, also taking the fairness of taxation into consideration" (VM 2010a, 6). The preparation was not based on political considerations, the views of political parties or finding a compromise between those views. The group's background was in research and an international model for it was provided by the Mirrlees Review, a taxation development project born on the initiative of researchers in the UK (IFS 2010).

The convener and Chair of the working group was Martti Hetemäki, Permanent Under-Secretary in the Ministry of Finance, who has a PhD in Economics. Other representatives of the Ministry were Lasse Arvela, Director General of the Tax Department, and Senior Adviser Terhi Järvikare. In addition, the group's secretariat included five civil servants from the Ministry, with some degree of mobility. The second secretary of the working group was first Senior Financial Officer Marja Paavonen and later Special Adviser Laura Vartia, both from the Economics Department of the MoF. The Prime Minister's Office was represented in the working group by Permanent State Under-Secretary, PhD Vesa Vihriälä. The Vice-Chair of the group was Heikki Niskakangas, Professor in Tax Law at Aalto University. He was the only member of the group with a university background. He also acted as adviser to the main ruling party, the Centre Party, and to Prime Minister Matti Vanhanen. The Government Institute for Economic Research (VATT) was represented by Director General Seija Ilmakunnas and, acting as Secretary General of the group, Research Director Seppo Kari, whose unit includes several tax economists. The secretariat supporting the group also included two researchers from VATT. Three members came from other economic research institutes: Managing Director Sixten Korkman from the Research Institute of the Finnish Economy (ETLA), Research Director Reija Lilja from the Labour Institute for Economic Research (PT), and Research Director Raija Volk from Pellervo Economic Research (PTT). They represented research in macroeconomics, economic structures and the labour market, but had also knowledge in applied and empirical tax research. One member, CEO of the Taxpayers Association of Finland Teemu Lehtinen, came from an interest group, but even he had a background in economics research in the form of a PhD thesis. He also represented, at least unofficially, the National Coalition Party.

The composition of the group was indeed criticised for political expediency and shallowness of tax research expertise (Haaparanta 2010). One contributing factor may have been the small amount of research done in the field of the economics of taxation in Finnish universities. Attention was drawn, however, to the fact that even that small amount of expertise was not summoned to join the group. The group did commission a prepared memorandum from 10 university professors. On the other hand, some strong expertise in tax law in various interest groups also remained outside the group. Yet it would be difficult to say that the group was political. It included a number – small enough to sit around a table – of civil servants and researchers from various quarters who had expertise in and were able to discuss economics and the administration of public finances. Its composition was not arbitrary, but it could have been different.

6.1.2 Work of the group

The goal of the group was not to produce new academic research but to utilise and apply existing research. According to the wishes of the MoF, the objective was a concrete reform package, including both a comprehensive reform and specific proposals that could have been written into legislative text. There were some commentaries, though, for example by the Confederation of Finnish Industries (EK), that said a presentation of policies at ageneral level would have been more reasonable. Reflecting the need for the MoF to ease its burden of routine work, the Minister added to the group's mandate some separate and relatively time-consuming tasks, concerning for instance statements on the artificial conversion of earned income into capital income, forestry taxation and R&D activities, which had either very little to do with evaluating changes required to the tax system as a whole, or represented advice of a more technical nature.

The practical working of the group was the responsibility of the secretariat composed of civil servants from the MoF and VATT. They included the Chair, the Secretary General and secretaries. VATT produced analyses and gathered existing scientific research. The participation of PhD-level researchers was facilitated by the fact that they, in accordance with good academic practice, published their research in their own name so that the group did not have to take a position on it. Following the expertise in VATT, the focus was in corporate taxation, which was dealt with in depth and was the subject of new research. The Secretary General of the group was an expert in the taxation of non-listed company dividends. But the capacity of the MoF to produce solid and research-based background texts and calculations on earned income taxation remained weaker than planned.

On the suggestion of the secretariat, the working group commissioned a variety of studies in various areas of taxation from several domestic and foreign researchers and invited them to present their findings. The background material on dividend taxation was, however, produced by the secretariat itself, and only one external opinion was requested on tax law, which was better represented in the group.

The working group followed closely the early stages of the Mirrlees Review, which later became an authority in the debate on the economics of taxation. Its material at the time still consisted mainly of literature reviews, but the group became familiar with the goals and approach of the Mirrlees Review. Its leader Richard Blundell was consulted already in 2008 when he visited Finland, and the Secretary General visited the home institution of the project, the Institute for Fiscal Studies in London.

Like the Mirrlees Review, the working group applied the principle of "open source tax policy": all expert studies and opinions were published on the website (see www.vm.fi/verotyoryhma). The nature of the work facilitated a transparency that was exceptional in the preparation of tax policy. Being research-based and dealing with comprehensive policies was not as sensitive as writing specific pieces of tax legislation. This openness reflected a new ethos in a wider perspective too. A close comparison can be made with the SATA Committee, which was mandated with preparing a comprehensive reform of social security and which reached a dead end in its work. Unlike in the SATA Committee, drafting a common proposal in the working group was not prevented by interest group conflicts, although tensions ran high at the end and the opposing sides can be seen to correspond to political dividing lines.

Political interest was nevertheless drawn to the work of the group, not least because it involved issues that were not included in the government's programme. The Chair of the group informed the Prime Minister and the Minister of Finance of its results before they were published. Background discussions also had an impact on the analysis. For instance, the proposal for a EUR 2 billion easing of earned income taxation was not the result of the working group's internal discussions but was brought in into the report by the MoF.

However, the government coalition parties had delegated the more detailed follow-up of the group's work to the ministers' political advisers. The coalition parties did have tax policy experts, but instead it was agreed by them to pass information on a level that left the impact rather limited. This contributed to letting the group work in peace, but it also prevented a thorough political scrutiny and consideration of the proposals. Contacts with the Parliament, for example with the tax subcommittee of the Finance Committee, were limited to a few hearings. As a consequence the working group's proposals did not trigger a deeper political discussion during the mandate of the group. Political parties did not have reasoned views on them. In this sense interaction with the parties remained superficial.

More important were contacts with interest groups and organisations i.a. through hearings organised by the working group itself. The influence of interest groups and other stakeholders was augmented by the openness of the working group's programme and the steady pace at which it progressed. The programme did change in the course of the process, though. The most substantial change was the decision to issue an interim report, which led to an accelerated timetable for the analyses and the formulation of recommendations. The MoF wanted to use the interim report to influence the following year's budget, although in practice the impact remained insignificant.

A consultation was launched in late June 2010 after the issuing of the interim report. The timing of the consultation in the summer probably contributed to the relatively poor response. Individual academic experts, e.g. Matti Tuomala, Professor at the University of Tampere, and institutions like the Finnish chambers of commerce and the Bank of Finland commented on the provisional conclusions of the working group. The general policy guideline of widening the tax base was universally accepted. No unexpected response was received on questions that had prompted a debate within the group, for instance dividend taxation. Most critical voices were heard from business and enterprise organisations.

Towards the end of the working group's mandate internal disagreements arose in the group on dividend taxation, but also on details of labour taxation, on inheritance and gift taxes and on value added tax. In some cases it was a conflict between a legal and an economic approach. Stronger evidence was produced on the latter. In spite of research-based evidence, there was an unwillingness to promote for example a universal VAT base as the number one proposal. One obstacle was that the government had lowered the VAT on foodstuffs in August 2009, as some were of the opinion that cancelling this decision could have caused market disturbances. Disagreements did not prevent the drafting of a research-based proposal. All the members of the working group agreed to present a common model.

The timing of the publication of the report was discussed in the working group in view of the upcoming parliamentary elections. In the end it was agreed with political advisers and the government to publish the report before Christmas 2010. Political parties and stakeholders knew very well what was coming, but the approaching election campaign probably accentuated their critical views on the report.

6.1.3 Results

The comprehensive nature of the reform proposals was emphasised in the final report and at the publication event. It was important that the proposed increases and decreases in taxes matched each other. It is doubtful that the working group could have agreed on changes in the overall level of taxation, which, indeed, is a political question. In practice all stakeholders found some negative things among the proposals.

Within the ruling coalition, the Centre Party and the National Coalition Party found the changes in corporate taxation and the criticism from business and enterprise organisations most crucial. These organisations had lobbied the government directly against tightening dividend taxes. Receiving the working group's report, Minister of

Finance Jyrki Katainen asked if "business incentives are represented in the best possible way in this report" (VM 2010b). The National Coalition Party did not, however, immediately reject the whole reform proposal. The Centre Party did reject it outright and all other parties presented more criticism than praise. The position of the Centre Party was presented by the chair of its tax and economic group, Mika Lintilä MP, instead of the Prime Minister. (YLE 21.12.2010) By the time Mr Hetemäki gave a presentation of the final report in the Parliament's Finance Committee, even the National Coalition Party had distanced itself from it. The public impression was that the government rejected the study it had commissioned. An editorial in the Helsingin Sanomat in November 2014 said the main ruling party had concluded that "the study cannot serve even as a basis for discussions" (HS 8.11.2014).

The vocal rejection of the working group's proposals can be at least partly explained by the difficulties expected by the coalition parties in the elections and the rising support for the Finns Party. In retrospect it can be said that the working group was independent and not dominated by any of the coalition parties. Paradoxically, the party that plucked the largest number of ideas from the reform proposals for its own programme was the opposition Social Democratic Party.

However, the working group's proposals have been followed up. In the government's programme in 2011 a step was taken towards lowering the income tax base for corporations, and during the government's term that tax base was further reduced, but instead of a comprehensive reform changes have been piecemeal. These include i.a. changes made in real estate tax, deductions for interest on home loans and income tax for corporations – in some occasions even earlier than proposed by the working group. Even VAT has been increased. The first increase from 22 to 23 percent occurred already in July 2010, before the final report of the group was published. The VAT increase to 24 percent was done during the term of the Katainen government. The least problematic in terms of the government's programmes have been the so-called environment taxes levied on fuels, sweets and soft drinks. They were, however, under discussion even before the group's proposal.

Have tax rises been made because of the working group's proposals or just because the state has needed to raise more funds? Instead of lowering the earned income tax, the government has had to raise it. Corporate taxation has also undergone reforms, but the reasons presented for them have been less than convincing in view of the overall picture.

In the spring of 2013, the MoF submitted to the government the dividend tax model suggested by the working group. However, on the basis of a proposal from business and

enterprise organisations, the government made a hasty decision that it was forced to amend immediately (see National Audit Office of Finland 2014). The model eventually adopted is far from the working group's proposal.

In many respects that working group's report remains useful and may have a delayed impact. The researchers of VATT have been promoting several issues. And, for example, economists from ETLA have defended the inheritance tax and said that favouring family businesses can have a negative impact on the restructuring of the business sector and on productivity (ETLA 2010, Maliranta – Valkonen 2013).

6.2 Pension reform

The majority of the pensions reform preparation work has taken place in negotiations between labour market organisations. The power of the labour market organisations stems from the origin of the Finnish earnings-related pensions system (see Hannikainen and Vauhkonen, 2012). From the organisations' point of view, pensions policy fulfils the goals of the earnings-related pensions system. The state's role has been reduced to converting the labour market organisations' proposals into legislation. The legitimacy of decision-making based on the tripartite framework has been the subject of at times heated debate (see e.g. Korkman 2011 and Rantala 2011).

The importance of pensions policy in financing the public sector in general has drawn less attention. In this respect the negotiations conducted in 2014 represented a change. The labour market organisations recognised that the pensions system is part of public finances. At the same time, the political steering of the negotiations was raised to a new level.

6.2.1 Background

A major pensions system reform took place in Finland in 2005. It was largely the result of the government's insistence, although it was negotiated in a working group consisting of the central labour market organisations, the so-called Puro group (later known as the Rantala group, see box 6.2.1). From the government's point of view, the reform remained incomplete and pension issues – as regards pensions paid by KELA (the Social Insurance Institution) – came back on the agenda in the SATA Committee. In February 2009 the labour market organisations agreed a reform of pensions and unemployment benefits. This so-called "sosiaalitupo" (national incomes settlement in social matters) included the abolition of employers' national pension contributions. Just a few weeks after the "sosiaalitupo" was agreed, the government proposed to raise the

retirement age for old-age pensions to 65 years for the sake of public finance sustainability. The Prime Minister said this idea took shape while "skiing at mount Ruka". It had been agreed neither with employers' nor with employees' organisations, and eventually the government had to abandon its proposal because of strong opposition from the Central Organisation of Finnish Trade Unions (SAK).

Negotiations on raising the old-age retirement age were entrusted to the Rantala group. Disagreement arose in the group about the so-called "unemployment path to retirement", i.e. the continued right of elderly persons who become unemployed to claim unemployment allowance until their retirement. The expected retirement age is influenced by factors like changes in exit from the labour force to disability pension and demand for labour, and therefore it proved too inaccurate to be used as a tool in the negotiations (Ilmakunnas 2009, 53-54). The negotiations ended without a result. However, some progress in developing the field of labour had been made in a working group led by Director Jukka Ahtela from the Confederation of Finnish Industries (EK).

Box 6.2.1 Central labour market organisations' working group on pensions

A working group composed of representatives of labour market organisations, also including managing directors of earnings-related pension companies. The group agrees i.a. on the amount of earnings-related pension contributions.

It was originally known as the "Puro group", as it was led by Managing Director Kari Puro of Ilmarinen, who had earlier served as Permanent Secretary in the Ministry of Social Affairs and Health. In a press interview in 2005, Puro explains: "In the early 1990s, the central labour market organisations asked me to convene the group. As these agreements require a lot of work and preparation, someone has to steer and lead this preparation." (Seies 2006.)

After Puro retired, Managing Director Jukka Rantala of ETK became the new leader of the group. He has also served in managing positions in the MSAH during his career, as head of the insurance department. The employers' representative in the group has been Lasse Laatunen, Legal Affairs Director and later Labour Market Director of EK. There have been various successive employees' representatives from SAK, Akava and STTK. The expert members include Director General Outi Antila of the MSAH and Director General Jukka Pekkarinen of the MoF and the managing directors of Varma, Ilmarinen and Pension Fennia. (See Nieminen – Sorjanen 2014.)

As part of its programme of sustainable economic growth and employment, the government set up the group on working careers in spring 2010 to set out options for developing the earnings-related pension system. In the autumn of 2011, the Minister of Social Affairs and Health (MSAH) Paula Risikko asked the Rantala group to draw up concrete proposals to lengthen working careers. The group issued recommendations on part-time pensions and age limits for the unemployment path to retirement, and on that basis the labour market organisations held negotiations on lengthening working careers in March 2012. Raising the retirement age was not under discussion, since Minister of Finance Jutta Urpilainen had promised before the parliamentary elections that the Social Democratic Party would not accept it during the coming parliamentary term. Instead it was agreed to implement a pensions reform in 2017. This was the first step the labour market organisations took towards raising the retirement age for old-age pensions.

The preparation process for the working careers agreement was also significant for the future. An embarrassing disagreement surfaced on the calculation method of the agreement's impact. The government referred to an assessment made by the labour market organisations that the agreement would lengthen working careers by one year.

The MoF calculated the impact to be only five months. In order to avoid such confusion in the future, if was agreed to involve the MoF more in the preparation process.

6.2.2 Work of the group

An expert Pension Panel was established to make progress in pensions reform, and the labour market organisations decided to ask Jukka Pekkarinen of the MoF to chair the panel. This so-called Pension Panel was supposed to report to the Rantala group. Pekkarinen invited Director General Outi Antila of the MSAH, Director Seija Ilmakunnas of the Labour Institute for Economic Research (PT), Head of Department Olli Kangas of KELA, Managing Director Jukka Rantala and Director Hannu Uusitalo of the Finnish Centre for Pensions (ETK), Justice Timo Viherkenttä of the Supreme Administrative Court and Managing Director Vesa Vihriälä of the Research Institute of the Finnish Economy (ETLA) as members of the panel. Head of Research Department Mikko Kautto of ETK and Director, PhD Tuulia Hakola-Uusitalo of the MoF acted as the panel's expert secretaries. Two senior financial officers from the MoF also participated i.a. in preparing the sustainability calculations.

In the summer of 2012, the labour market organisations and employment pension institutions established a steering group to monitor the work of the Pension Panel. Its members were Director Minna Helle of the Finnish Pension Alliance (TELA), Head of Pensions and Careers Department Kaija Kallinen of SAK, Director Mikko Karpoja of Pension Fennia, Director Jaakko Kiander of Ilmarinen, Chief Economist Eugen Koev of Akava, Chief Investment Officer Risto Murto of Varma, lawyer Heli Puura of the Finnish Confederation of Salaried Employees (STTK), and expert Antti Tanskanen of EK. Contacts with the panel remained so limited, however, that the steering group had practically no influence on the content of the work.

The use of high-quality background studies had much more impact, although the panel itself did not commission any research. One crucial study concerned the impact of the 2005 pensions reform, which was published by the Prime Minister's Office (Uusitalo – Nivalainen 2013). The ETK also organised an international evaluation of the reform (Barr 2013, Ambachtsheer 2013). On the basis of Barr's evaluation, researchers from ETLA – with the support of the MSAH and ETK – produced a study that analysed linking the retirement age to increasing life expectancy and how that would affect the sustainability of public finances (Lassila et al. 2013). The expert secretaries of the panel, Tuulia Hakola-Uusitalo and Mikko Kautto, were members of the steering group of this study. Links between ongoing research projects and the Pension Panel's own activities were discussed within the panel, as it proved to be a problematic situation. The panel's

role was limited to hearing presentations on the study, and its members were not equally placed when it came to influencing the research questions and settings. Some panel members interacted directly with the authors of the study through their own organisations (ETLA, MSAH, ETK) or through the steering group.

The available background studies did not initially cover all issues that were of interest to the panel's members. One example was taking into account socio-economic differences, which was later included in the final report of the above-mentioned ETLA study (Määttänen 2013). There are significant variations in increases in life expectancy in various income brackets. During the panel's mandate, Ms Ilmakunnas and Research Director Reija Lilja of PT published an article in the journal Talous & Yhteiskunta in which they criticised raising the retirement age as an unjust measure: "especially workers on a low income, with a high unemployment or disability risk and lower than average life expectancy, will have to pay for this kind of reform" (Ilmakunnas – Lilja 2013, 38). Similar criticism against the Pension Panel was heard directly from employees' organisations: "is it socially sustainable to use the life expectancy coefficient to cut the pensions of people on low incomes just because people on high incomes live longer?" (Trade Union for the Public and Welfare Sectors JHL et al. 2013).

The report of the expert pension panel "Adjusting the Finnish pension system to increased life expectancy" was published in the autumn (ETK 2013). The report places much emphasis in on the sustainability gap in public finances, and the complexity of this concept increases the expertise power of the MoF. The report presented alternative ways to adjust to extended life spans. Little attention was paid to well-being at work or the employment rate of the elderly, for instance. As expressed by Jaakko Kiander, member of the panel's steering group: "… the report concludes that raising the retirement age is a better alternative with regard to employment, income distribution and public finances than relying on a broader model which would be based on the current system of individual choice, flexibility and financial incentives" (Kiander 2014, 88, 89).

The government decided in its structural policy programme in autumn 2013 that the pensions reform will come into effect by 2017. The objectives set in the programme were to reduce the sustainability gap in public finances by an amount corresponding to just over one percentage point of GDP, extending working careers by 1.5 years and raising the average retirement age to at least 62.4 years by 2025.

6.2.3 Political guidance

The negotiations on the pensions reform itself were conducted between the central employees' organisations SAK, STTK and Akava on the one hand, and the employers' organisations EK and Local Government Employers (KT) on the other. This was the first time local government employers participated alongside EK in pension negotiations.

In March 2014, before the annual government decision on spending limits, Prime Minister Katainen and Minister of Finance Urpilainen invited representatives of the central labour market organisations, Labour Market Director Lasse Laatunen of EK, Director General Markku Jalonen of KT, President Lauri Lyly of SAK, President Antti Palola of STTK and President Sture Fjäder of Akava to the Government Palace. The ministers were accompanied by State Secretary Olli-Pekka Heinonen. The government representatives seemed "rather serious" and spoke about the bad economic situation and the Ukraine crisis. They asked the labour market organisations if they were prepared to reach a settlement in line with the structural policy programme that would reduce the sustainability gap in public finances by a quarter. The organisations said they were ready to do this. Katainen requested the promise in writing. This was not easy, because the actual negotiations had not yet even started. The paper was eventually drafted with some "imaginative wording". The promise meant that the organisations committed themselves to negotiate a result in keeping with that objective.

The negotiations got off to a promising start, because the unemployment pathway's upper limit had already been raised in the "sosiaalitupo" and the unemployment pension had been abolished earlier. In the beginning the negotiations were led by Chief Policy Adviser Vesa Rantahalvari of EK. In August he was replaced by Laatunen and the presidents represented the central employees' organisations. In his public statements Laatunen said: "EK will only agree on a settlement that fulfils the commonly agreed conditions based on Ministry of Finance calculations" (Mikkonen 2014).

Throughout the negotiations, Jukka Pekkarinen of the MoF and Jukka Rantala of ETK played a crucial role. Director General Outi Antila of the MSAH was also kept informed, but she kept a lower profile. Pekkarinen's participation was seen as appropriate not only because he had supervised the preparatory study for the negotiations but also because through him the government could be kept informed about the progress of the negotiations. The labour market organisations also wanted to avoid any conflicts with the MoF. The negotiations were concluded only after MoF had calculated the impact of the agreed model on the sustainability gap.

From the government's perspective, the impact on the sustainability gap was the main precondition for an earnings-based pension system with a solid basis. Pekkarinen, "as a responsible civil servant", deemed an age limit of 65 years to be insufficient, and said it would be necessary to link the age limit to life expectancy. The most difficult part of the negotiations concerned these issues. It was a new approach in many ways. There were few examples in the world of an existing system that applied both a life expectancy coefficient and an old-age pension tied to the increase in life expectancy. Even in Finland reaching this kind of agreement would probably not have been possible earlier. What was significant was the linkage between life expectancy and the old-age pension age limit in the form of an administrative decision. The rest of the preparation was essentially finding a compromise between the respective interests of the labour market organisations. A conceptual breakthrough happened 2-3 weeks before the final settlement. The conclusion was delayed by efforts – that proved to be in vain – to get Akava to join the settlement.

The role of Jukka Rantala was crucial in producing the ETK calculations and in finalising certain details. ETK assessed the impact of the settlement on e.g. earnings-related pension contributions. In the final stages, it was practically on continuous stand-by. No part of the settlement was decided without an impact assessment. After the settlement was concluded, ETK immediately published an assessment.

From the government side, Ministers Stubb and Rinne followed the negotiations most closely and they were in direct contact with the negotiators. Ministers did not intervene in the content of the talks, but emphasised how important it was to reach an agreement. The delay in the conclusion of the process created some concern in the government.

The parliament, on the other hand, was sidelined from the negotiations. Certain details concerning for example the technical timetable of the reform were checked with the legislator, and the organisations' representatives visited parliamentary committees to explain their views. Information was passed through personal contacts and political parties had trusted individuals who were well aware of how the talks were progressing.

It is interesting that one or more negotiators leaked information to the media, even though it is an agreed principle that no information should be given on unfinished issues to ensure a calm negotiating atmosphere and to avoid misunderstandings. Helsingin Sanomat published detailed reports on the talks, but this did not seem to hold up progress. The public attention did, however, have the effect that EK cancelled its press conference at the signing ceremony. The signing of the settlement on 26 September was no longer a news item.

After the agreement was concluded it was revealed that Akava, which was not part of the settlement, had also lobbied the government directly. Minister of Defence Carl Haglund made surprise comments on the result of the negotiations, saying it was problematic from an equality point of view (YLE 27.9.2014). Critical comments received relatively little support however, and even the opposition parties have been more supportive of than against the proposal. No major problems are expected during the legislative drafting phase, which will be led by the MSAH.

6.3 Comparison of tax and pensions reforms

The working group for the development of the Finnish tax system submitted its report towards the end of 2010. It aimed at an ambitious and comprehensive tax reform, but its proposals did not get the support of political parties and only part of them have been implemented. Agreeing on a pensions reform, on the other hand, has progressed on the basis of a study made in 2013 by an expert pension panel. Both reforms concern issues that are prone to short-sighted decision-making: populism, vote catching and pressure from interest groups. Decision-makers will easily pay more attention to specific taxes and acquired pension benefits than to social and societal sustainability and fairness. The context is difficult not only for representative democracy but also for the utilisation of evidence-based research. But why does the preparation of the pensions reform seem to have succeeded, whereas that of the tax reform seems to have failed?

The mandate of the working group for the development of the tax system was to entirely rethink tax policy. The goal was not to save a certain amount of money. Nevertheless, the MoF aimed at concrete results to the extent that even the wording of the proposals was supposed to help in drafting legislation. The interim report was in essence an attempt to influence the next year's budget. The requirement of concrete results put an extra burden on the group and its secretariat. But it has also been beneficial in that the specificity of the proposals made them useful to the MoF and it has been possible to proceed with some reforms – albeit that the motivation behind this has more probably been the worsened economic situation and a need to increase the government's tax revenue rather than the fiscally neutral overall reform promoted by the working group. The objective of the pensions reform, on the other hand, was both specific and very broad at the same time. The sustainability gap is a complex concept in itself, but it is possible to measure reduction of the gap in concrete terms and it is also linked to the state of public finances in general and by nature reaches far into the future.

The objective also included a time horizon. In both preparation processes the working groups' timetables as such were realistic, although the working group for the

development of the tax system was burdened by additional tasks given by the MoF. The only additional task of the expert pensions panel was to produce a separate study on the funding of municipal pensions. As for the tax working group, its impact was diminished by the one-off character of the experts' contribution. The economic situation changed during and immediately after its mandate. The fiscally neutral reform proposal by the working group could no longer have been implemented as such even if the political will had been there. The pensions reform can be implemented on the basis of the settlement reached in the autumn of 2014. But it has been pointed out that had the government attained better cooperation with the labour market organisations, it could have made the reform happen even earlier.

It is useful to briefly come back to the question asked in the beginning about the interaction between experts and interest organisations on the one hand and civil servants and politicians on the other, this time from the perspectives of the Ministry of Finance, political parties, the tripartite framework and research activities. What kind of strengths and weaknesses emerged regarding the participation of the various actors in the preparatory processes?

6.3.1 Ministry of Finance

An obvious factor contributing to the success of the preparation is the existence and use of the ministry's own expertise, or alternatively lack thereof and how this gap is filled.

Much of the work done in the MoF focuses on drafting legislation. Especially in the field of taxation, thorough legal expertise is needed, e.g. in international taxation and its sub-categories. The tax department of the MoF is strong in tax categories, but its expertise is quite technical. Economists have less influence on tax policies within the MoF. In Sweden and Norway, for example, the finance ministries have many times more civil servants concentrating on tax policy, including both legal and economistic expertise. The MoF has no resources of its own to reflect on tax policy as a whole.

This is why tax policy preparation in the MoF is particularly vulnerable to short-term political interests. Tax issues are easily seen from the outset as a question of interest groups and objects of interest organisations' lobbying. Legal expertise has to take a defensive position against pressure from the outside: "people are looking for loopholes and incentives". This is also probably what prompted a requirement for the working group for the development of the tax system to produce as concrete proposals as possible.

In the pension negotiations and the preceding study process, the MoF also had an active role in producing strategic information. The guidance role of the MoF was built on the expertise of its economics department: it knew all there was to know about the concept of the sustainability gap. Although pension issues belonged under the MSAH, the MoF was seen as the "super ministry". The weak link between the earnings-related pension system with a decentralised governance structure and public finances meant that "the MoF dominated the playing field".

However, the MoF does not have its own research capacity and the number of civil servants with research experience in the ministry is small. Therefore its ability to generate research questions and commission studies is limited, which necessarily weakens its strategic planning of economic policy as a whole.

6.3.2 Political parties

In both the tax and pensions reforms, the ability and motivation of political parties to follow and participate in economic policy preparation seem reactive rather than proactive. This reactivity makes the parties vulnerable to direct lobbying. In the case of the tax reform, the poor knowledge about these issues within political parties made it possible for e.g. business and enterprise organisations to work against the reform through the government coalition parties. Akava, which remained outside the pensions settlement, managed to get – at least for a while – one government party minister to voice its views. More significant as far as the fate of the pensions reform is concerned is the political influence of the organisations that support it.

Of course the short-term perspective brought about by electoral cycles is an integral part of politics, but economic policy as such is a permanent item on the agenda of political parties. They have their economic policy programmes and groups that include interest groups' representatives and researchers. The parties are able, if they so choose, to conduct even detailed discussions in the parliament, for example in the tax subcommittee of the Finance Committee. Active and competent MPs are able introduce changes in legislative proposals. However, often there is not enough time to get to know the issues and the parliament is prone to populism; its role can be reduced to being a "rubber stamp". Contrary to e.g. Sweden, the cooperation between the government and the parliament in economic policy preparation has not been facilitated through ad hoc parliamentary committees where both government coalition parties and opposition parties are represented. There are no regular government reports submitted to the parliament on the ways in which economic policy needs to develop, similar to e.g. government reports on security policy.

It is true that information and expertise relayed by the MoF is available to government coalition parties, for example in connection with the preparation of the structural policy package. Opposition parties also consult MoF experts, although they need to create their own resources for preparing their economic policy positions. All political parties also use expertise and research from outside the ministries, especially from people and institutions that are close to their support base. For example, the National Coalition Party and the Swedish People's Party utilise expertise from EK. Parties have "trusted researchers", but they also consult e.g. ETK when drafting their own pension policy programmes. In the end, political parties probably pay attention to research results that they like the most.

According to some commentaries, relying exclusively on expertise watered down the political credibility of the proposals of the working group for the development of the tax system. Professor of Tax Law Seppo Penttilä, in his opinion on the interim report, referred to earlier failed attempts to implement reforms and said that transparency and consultation of stakeholders are not enough. He said both interest organisations and political parties should have participated in making the proposals, even if the results had been compromises that would have appeared less robust in the light of research (Penttilä 2010, 3). On the other hand, working groups established by the Economic Council, for example, have been criticised for producing "irrelevant compromises" based not on research but on consensus.

6.3.3 The tripartite framework

Interest organisations had a role to play in both the tax and pensions reform preparation processes. They did not participate in the working group for the development of the tax system, but they did contribute to burying the results through the government coalition parties. Earnings-related pension organisations were actively involved in the pensions package. If the settlement they negotiated is eventually converted into legislative proposals and approved by the parliament, the neocorporatist system will have proved its potential. But at the same time the pension talks showed that the interest organisations' role has diminished. The MoF exerted significant power over the labour market organisations. Of course, it depends on the beholder if the glass is half full or half empty.

The effectiveness of the tripartite framework can be attributed partly to crisis awareness. Even if hard times make decision-making difficult, a sufficient amount of hardship also makes it acceptable to make difficult decisions. It is also possible that the neocorporatist

system as such is changing and that the pensions settlement of autumn 2014 reflects future trends.

From the labour market organisations' point of view, the pensions settlement was about relatively clearly definable goals and about negotiations for which both empirical and theoretical research data was available. For political decision-makers, i.e. the parliament, making the decisions directly would have been more complicated, because voters would probably not have rewarded any party for cutting pension benefits. In practice, there may be more economic realism in labour market organisations than in political parties. Besides, the labour market organisations had to promote not only their own interests, e.g. those of EK or SAK, but the interest of the earnings-related pension system as a whole. It was crucial that labour market organisations recognised the pensions system as part of public finances. Earlier they had tried to maintain distance vis-à-vis the rest of the public sector: "There was a fear that the public sector would just swallow the pension system in its enormous mouth."

In 2014 the starting point was that the pensions settlement would affect the whole of public finances, employment, benefits and contributions. In this sense the "cultural wall fell down". Labour market organisations had been initially prepared to just accept the "proposal from Ruka", raising the retirement age to a little over 62 years by 2025. Background studies, however, showed that in terms of economic sustainability, the retirement age had to be re-evaluated according to life expectancy. The government used the structural policy programme to justify the link between retirement age and life expectancy and the time horizon until 2060 and 2080.

The meeting in March 2014 with the Prime Minister and Minister of Finance and the government's demand for a specific written commitment were important. It is crucial for the legitimacy of the tripartite framework and the preservation of the interest organisations' power that the organisations were able to keep their promise. And it is also crucial that the government can "do its part" in implementing the reforms in social welfare and health care and local government structures.

A model where the government defines certain limits within which the interest organisation can negotiate could be used again for finding solutions to certain social policy or labour questions that are important for the interest organisations. It is easier for the government to propose and for the parliament to decide on measures that contribute to undoing the welfare state if the preparation work is delegated to the interest organisations or if these are at least consulted. The organisations, on the other hand, have a strong incentive to find solutions to those important issues if the alternative

is that they are decided directly by political parties with low levels of expertise in the relevant matters.

6.3.4 Research

The available research data and research capacity naturally affect the quality of preparation. As mentioned before, the MoF is dependent on external research. The work of the group for the development of the tax system highlighted the difference between the MoF's preparation capacity and the longer-term preparatory work done in research institutions like VATT. To some extent, VATT acts as an addition to or substitution for the ministry's civil servant expertise in economics. This leads to some tension between serving the ministry and applied research on the one hand and producing basic research and academic publications on the other.

Research on tax and pension policies is produced in several Finnish research institutions, but these fields are not very wide. It seems that there remains a gap in tax law expertise left by the late academic experts Edward Andersson and Kari S. Tikka. This shallowness in academic research is reflected in the linkages between university research and economic policy decision-making.

The preparation processes highlighted interesting issues on the political or non-political nature of knowledge. The expert material or assessments used in the preparation and negotiations are usually not questioned. For example, the labour market organisations did not try to influence the data produced by ETK and the MoF, which was also requested in a centralised manner. In general it is important for the negotiations that the parties have the same assessment of the situation.

ETK is in an interesting position. It is owned by earnings-related pension institutions, but it has a statutory role and also serves the needs of the government and the parliament. It is financed through a dedicated part of the earnings-related pension contribution. This means the financing of its research activities, be they routine calculations or larger research programmes, has a very solid basis. In the case of the expert pension panel, a question arose about the ways in which the members of the group could influence research, especially regarding research questions. The roles of various research institutions are somewhat out of balance. ETLA has been supported by ETK, and made a significant contribution to the pension panel's work. PT does not have a corresponding research infrastructure at its disposal.

VATT has continued its tax research in several projects without linking them to the working group for the development of the tax system. The reference point has rather

been the Mirrlees Review project. The calls for research financing proposals to be offered by the Prime Minister's Office may make it possible in the future to study in more detail the impact of the reforms implemented in Finland.

6.4 The Council's opinion of the impact of the preparation

Both the working group for the development of the Finnish tax system and the expert Pension Panel utilised research results in an exemplary way. Empirical research in tax law, the economics of taxation and pension systems is done in Finland, but these fields are not very strong in Finnish universities. In practice most of the data is produced in research institutions, whose sources of funding and various consultancy tasks impose limitations on critical and long-term scientific work. The tax reform highlighted the expertise in VATT and reflected the international example of the Mirrlees Review. The role of ETK and ETLA was highlighted in the preparatory work for the pension reform.

The working group for the development of the Finnish tax system submitted its report towards the end of 2010. It aimed at a comprehensive reform, but only part of its proposals have been implemented. The impact was hampered by the fact that decision-makers were neither given nor did they take ownership in following and participating in the group's work. Instead of their top tax experts, the government coalition parties dispatched an advisory-level delegation. This ensured a calm working atmosphere in the group, but at the same time interest groups lobbied against the reforms directly with decision-makers, both government and opposition politicians.

The concentration of the MoF's expertise in tax law and its weakness in the economics of taxation was highlighted in the tax preparation process, which is why the working group and its secretariat had to do more work than was initially planned. However, supporting the practical work also meant greater practical impact. Thanks to a level of transparency that was exceptional, it was possible to comment on the work in all its phases. This created a basis for broader discussion and still supports the next stages of the work.

Negotiations between the labour market organisations on the pension reform in 2014 took place behind closed doors. In the pensions case, the government gave precise guidelines to the preparation led by interest organisations. The government's guidance role was based on an agreement with the labour market organisations and on the active part played by the MoF in the analytical work preceding the negotiations. The settlement was tied to the sustainability of public finances in line with the structural

policy programme. Through this model, the tripartite framework proved its potential, which may also reflect future trends in decision-making. The Economic Policy Council draws attention to the transparency in decision-making based on the tripartite framework and in the expert knowledge supporting it. The decision by ETK to publish impact assessments immediately after the settlement was concluded was useful, because it provided important information for broader discussion. Long-term and careful planning of economic policy requires a continuous and open dialogue between decision-makers and experts.

Interviews

Martti Hetemäki, Permanent Secretary in the Ministry of Finance, Helsinki, 12.11.2014.

Seija Ilmakunnas, Director of Labour Institute for Economic Research (PT), Helsinki, 8.12.2014

Seppo Kari, Research Director of Government Institute for Economic Research (VATT), Helsinki 3.12.2014

Sixten Korkman, Professor of Practice, Aalto University, Helsinki, 27.10. 2014.

Lasse Laatunen, Labour Market Director of the Confederation of Finnish Industries (EK), Helsinki, 19.11.2014.

Jukka Pekkarinen, Economic Policy Coordinator in the Ministry of Finance, Helsinki, 12.11.2014.

Jukka Rantala, Managing Director of the Finnish Centre for Pensions (ETK), Helsinki, 12.11.2014.

Kimmo Sasi, Chair of the Parliament's Finance Committee, Helsinki, 19.11.2014.

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