The Economic Policy Council does not recommend more fiscal consolidation before 2017 - 2018

The Council does not recommend a further tightening of fiscal policy for 2015 and 2016. Significant adjustments of public finances are necessary, but they should be timed in such a way that business cycles are not aggravated as a result.

The current economic situation in Finland is weak with slow economic growth, growing unemployment and high public sector deficits. There is a strong tightening in fiscal policy for 2015. The effect of the changes in taxes and cuts in government spending on the budget balance is about 2.5 billion euros compared to 2014. Achieving fiscal policy goals would require even larger cuts and higher increases in taxes in 2015 and 2016. Without further adjustments the deficit will be larger than required by the fiscal policy laws.

However, a stronger fiscal tightening would lead to slower growth and to higher unemployment. Finland's economy has unutilized resources and the increase in unemployment has mainly been due to the business cycle situation. There has been almost no increase in structural unemployment. For example, long-term unemployment has not increased, and regional differences in unemployment have not grown. If policy decisions were not constrained by large deficits and debt, the normal policy recommendation would be to increase spending or cut taxes to increase domestic demand and employment.

The public sector finances are not in balance for the long term. The current deficit increases the need for adjustments. Creating a convincing plan on consolidating public finances is a key task for the next government. The Council suggests that a program with public sector expenditure cuts and tax increases are implemented in 2017 and 2018, when, according to most forecasts, the Finnish economy should be closer to its potential output level.

The surplus of the pension funds masks the weak state of central government and municipal finances

In Finland the pension funds are included in the public sector finances. A surplus in the pension funds masks the large deficits in other parts of the public sector. The municipality sector was in deficit even at the peak of the business cycle in 2008. Central government surplus was also small, for example, in 2008 given the phase of the cycle.

The Economic Policy Council recommends the adoption of separate goals for the structural deficits of the central government and municipalities. The deficit goals should be set so as to be in line with the long-term sustainability goals.

The Economic Policy Council recommends that the transparency of the fiscal framework should be improved by a similar treatment of taxation and expenditures. This implies that the use of the tax expenditures to avoid restrictions implied by the spending limits should be prevented by reforming the spending limit system.

According to the Council's calculations the structural deficit is about 3% of the GDP, when disregarding the budget effects of pension funds. Correcting the deficit requires substantial increases in taxes and/or spending cuts. Structural reforms, such as the reform of the pension system, improve the long-term sustainability of the public finances, affect the deficit only after 2020.

The pension reform diminishes the sustainability gap

The pension reform is a key measure in the structural programme. Lengthening the working career by 1,5 years and decreasing the sustainability gap by one percent were set as the goals for the pension reform. To accompany the Council's annual report the Council commissioned a report on the pension reform from the Research Institute of the Finnish Economy (ETLA). The ETLA report concludes that the pension reform reduces the sustainability gap, but the magnitude of the effects depends also on other factors that affect retirement behavior. ETLA estimates that the pension reform extends work careers by 3 - 6 months.

There is considerable uncertainty about the effects of those measures in the structural programme that relate to the control of municipal finances. The proposed new framework for macroeconomic steering of municipalities prevents circumventing central government spending limits through shifting expenditures to local governments. This may limit public sector expenditure growth, since increases in municipal tasks have been a key contributor to the increase in municipal expenditures. The new system however does not necessarily limit expenditure growth resulting from municipalities' own decisions.

Large reductions in company taxation

The most important tax policy decision during the current parliamentary term was the lowering of the company tax from 26 per cent to 20 per cent. The reduction in the tax was motivated by improvements in competitiveness. However, the reduction was relatively large. International tax competition creates pressures to reduce corporate taxes but Finland should not be proactive in this competition.

Lowering the income tax for low wage groups improves the incentives to work, and for the income distribution. However, the employment effects of this tax change will most probably be small. The changes in direct taxation and benefits during the parliamentary term have reduced income inequality.

There is scope for simplifying the Finnish tax system and making it more efficient. Raising the reduced rates of the value added tax would make the system more efficient and increase tax revenue, and abolishing tax expenditures would simplify the tax system.

The inheritance tax should be retained, as it is more neutral for economic activity than many other taxes.

An independent assessment on economic policy by five professors

The Economic Policy Council for Finland was established in 2014. The chairman of the council is Professor Roope Uusitalo. The other members are Professor Torben M. Andersen, Professor Kaisa Kotakorpi, Professor Liisa Laakso and Professor Mikko Puhakka.

The goal of the Council is to improve the quality of economic policy, its planning, and the decision making process. In addition, the Council will offer an independent perspective based on research findings to the public discussions on economic policy.

The first report of the Council assesses the fiscal policy decisions over the electoral period, the functioning of the fiscal policy rules, tax policy, and the effects of the pension reform, the new system of governance for municipal finances, and preparation and planning of economic policy.

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